MACROECONOMIC AND FINANCIAL MARKET DEVELOPMENTS

BACKGROUND MATERIAL

TO THE ABRIDGED MINUTES OF THE

MONETARY COUNCIL MEETING

OF 19 NOVEMBER 2019

November

2019

Time of publication: 2 p.m. on 4 December 2019

The background material 'Macroeconomic and financial market developments' is based on information available until 14 November 2019.

Article 3 (1) of the MNB Act (Act CXXXIX of 2013 on the Magyar Nemzeti Bank) defines achieving and maintaining price stability as the primary objective of the Magyar Nemzeti Bank. The MNB's supreme decision-making body is the Monetary Council. The Council convenes as required by circumstances, but at least twice a month, according to a pre-announced schedule. At the second scheduled meeting each month, members consider issues relevant to decisions on interest rates. Abridged minutes of the Council's rate-setting meetings are released regularly, before the next policy meeting takes place. As a summary of the analyses prepared by staff for the Monetary Council, the background material presents economic and financial market developments, as well as new information which has become available since the previous meeting.

The abridged minutes and the background materials to the minutes are available on the MNB's website at:
http://www.mnb.hu/en/monetary-policy/the-monetary-council/minutes

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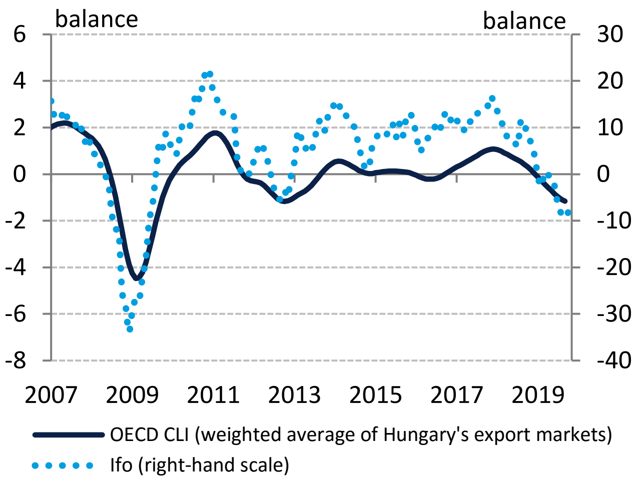
1. Macroeconomic developments

1.1. Global macroeconomic environment

In the third quarter of 2019, GDP growth in the United Stated decelerated compared to the previous quarter, but at the same time, it exceeded economists' expectations. Based on the preliminary data, growth in the euro area slightly slowed down in the third quarter, and growth prospects are still dominated by downside risks. Growth of the CEE region may still substantially exceed the growth rate of the euro area.

Chart 1: Business climate indices in Hungary's export markets



Source: OECD, Ifo

In the third quarter of 2019, the US economy rose – at a rate exceeding the expectations – **by 1.9 percent on an annual basis.** Growth was also supported by household investments, in addition to household and government consumption. Net exports and inventories made negative contribution to economic performance, and machinery and building-type investments also curbed economic growth. Growth of the US economy may gradually decelerate in the coming period in parallel with the run-out of the growth supporting measures (tax cuts and infrastructural investment programme).

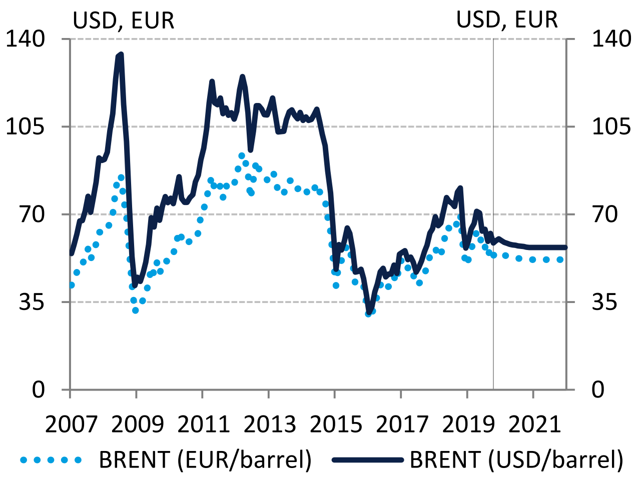
In line with the weakening and increasingly uncertain external activity, in the third quarter of 2019 economic growth was moderate across Europe. Economic growth of **the euro area calculated, on year-on-year and quarter-on-quarter basis, rose by 1.1 and 0.2 percent, respectively. The economic performance of Germany**, Hungary's key trading partner, **rose by 0.1 percent on a quarterly basis, and thus the German economy avoided technical recession.** The extremely moderate growth was supported primarily by household and government consumption. The forward looking purchasing manager indices for the manufacturing industry still suggest continued unfavourable prospects, but at the same time showed moderate improvement during last month. The Ifo index, capturing the outlooks of the German economy, remained in the negative range (Chart 1). German new industrial orders declined further in September on an annual basis, but rose compared to the previous month. **The short-term impact of the German industrial trends on Hungary's prospects is qualified by the fact that in the past months Hungarian vehicle manufacture has continued to outperform that of Germany.**

The performance of the **French** economy rose by 1.3 percent year on year. Growth was primarily supported by households' consumption, while decline in net exports curbed growth. The economic growth of **Austria** – based on a wide range of sectors – continued, and at 1.5 percent it outstripped the GDP growth of the euro area. Based on the preliminary data, the **Italian** economy grew by 0.3 percent year on year. In the years ahead, the concerns related to the high government debt, the budget and Italy's major government securities market exposure will weigh on Italian growth. Based on preliminary data, in the third quarter of 2019, economic performance of the **United Kingdom rose by 0.3 percent** quarter on quarter, which is primarily attributable to growth in services and construction. **The exit of the United Kingdom from the EU – and the uncertainty stemming from the Brexit talks**, already make their effect felt in the British economy. As a result of the risk of trade difficulties, major labour shedding commenced in the British manufacturing industry and the decline in corporate investments also curbed growth.

As in the previous quarters, the Central and Eastern European region proved to be the growth centre of the European Union also in the third quarter of 2019. According to the seasonally adjusted data, Poland, Romania, Slovakia and the Czech Republic recorded GDP growth rates of 4.0 percent, 3.2 percent, 1.8 percent and 2.5 percent, respectively.

Growth prospects of the euro area continue to be dominated by downside risks. Economic growth may be curbed by the increase in trade tensions, the deteriorating industrial production observed in the past period, the challenges surrounding the automotive industry, the vulnerability of Italy stemming from the high government debt, the indirect effects of the deceleration of the Chinese economy and the uncertainty resulting from the fragile financial environment on the emerging markets. In addition, the **uncertainty surrounding the exit of the United Kingdom from the EU** continues to represent material risk and the "fallout" of the United Kingdom from the EU (hard Brexit) remains a realistic scenario. **Based on preliminary data, in October inflation in the euro area** stood at 0.7 percent and core inflation at 1.1 percent.

Chart 2: World market prices of Brent crude oil



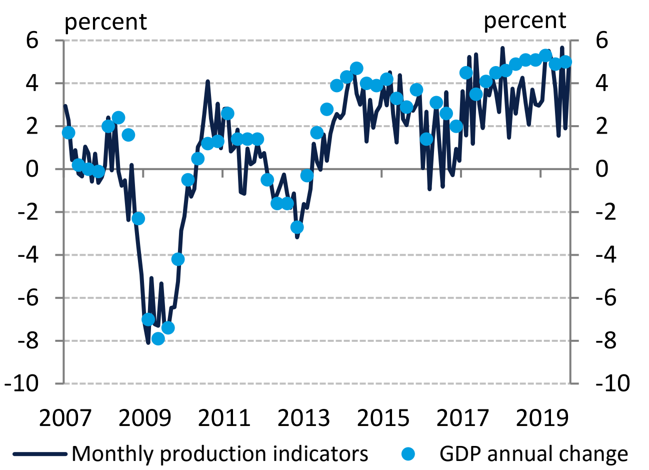
Source: Bloomberg

In the past period, the world market price of crude oil gradually rose close to USD 63 from USD 58, recorded in mid-October (Chart 2). The developments in prices were dominated by global demand, and the prospect of settling the trade tensions between the USA and China. It pointed to a decline in expectations related to global demand that the current forecast of IMF anticipated lower global growth both this year and next year. In addition, the worse than expected Chinese data (PMI) also strengthened demand concerns. At the same time, the world market oil price reducing effect of the foregoing was offset by several positive market events. On the one hand, the talks between the USA and China – pointing to a potential agreement – supported the rise in oil prices. On the other hand, it also contributed to the gradual rise in prices that Saudi Arabia agreed to the admission of part of Saudi Aramco for listing on the stock exchange, which has been on the agenda for years. The price of industrial commodities decreased, while the world market price of unprocessed food rose in October.

1.2. Domestic real economy developments

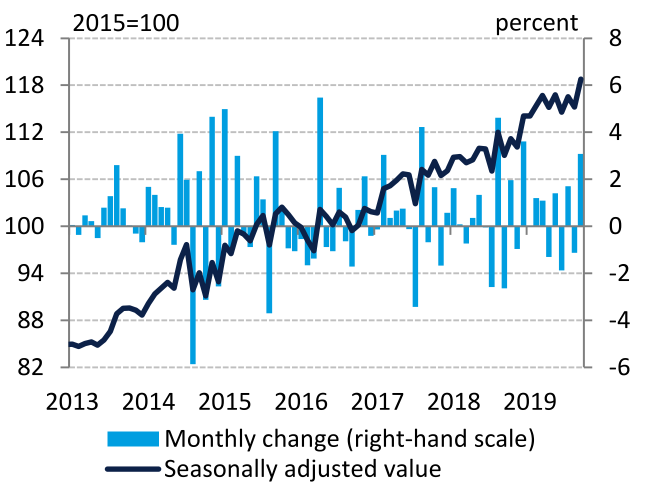
According to the HCSO's data, in the third quarter of 2019, Hungary's gross domestic product rose by 5.0 percent year on year. Based on the information provided by HCSO, growth was supported to the largest degree by industry, construction and market services. In the third quarter of 2019, seasonally adjusted unemployment rate remained at 3.4 percent. In the second quarter of 2019, based on the number of vacancies, corporate labour demand continued to decline in a wide range of the sectors.

Chart 3: Monthly production indicators and GDP growth



Note: Weighted average of monthly production indicators (industrial output, construction output and retail sales). The weights are derived from regression explaining GDP growth.
Source: MNB calculation based on HCSO data

Chart 4: Development in industrial production



Source: MNB calculation based on HCSO data

1.2.1 Economic growth

According to HCSO's data release, in the third quarter of 2019, Hungary's gross domestic product rose by 5.0 percent year on year. Based on the seasonally and working-day adjusted data, Hungary's GDP rose by **1.1 percent quarter on quarter**. Hungary is ranked first in the EU member states' growth ranking in year-on-year terms. Based on the information provided by the HCSO, from the output side, most of the national economy branches contributed to the growth, and market services, together with industry and construction, supported GDP growth to the largest degree (Chart 3). Despite the ailment of German industrial production, the Hungarian automotive industry materially rose in the third quarter of the year, and thus industry made positive contribution to growth.

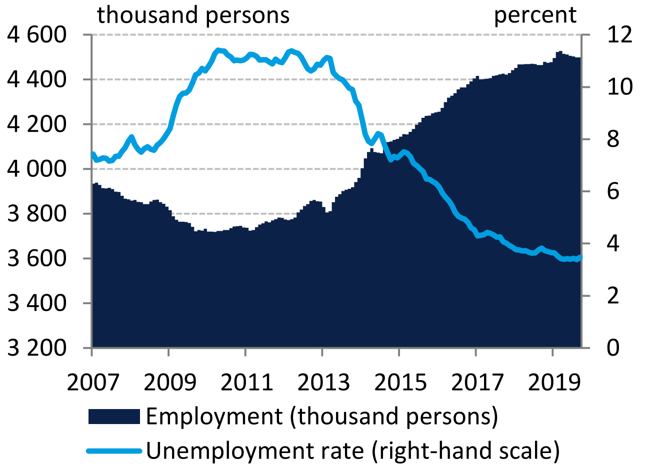
In September 2019, **industrial output was up by 11.1 percent** year on year, while production rose by 3.1 percent compared to the previous month (Chart 4). **The index adjusted for working days exceeded that of last year by 8.9 percent**; the difference is attributable to the one more working day compared to last year. The output of automotive industry, representing a large weight, rose by 22.0 percent year on year. In addition, the rise in the **domestic manufacture of computer, electronics and optical products** (26.1 percent) and **electric machinery** (17.6 percent) exceeded the industrial average. In September, the performance of the **metal industry** (- 1.4 percent) and the output of the textile industry declined (- 4.2 percent) year on year.

Based on preliminary data, **expressed in euro terms, the value of exports and imports was up by 10.8 percent and 6.6 percent**, respectively, in an annual comparison in September 2019, and thus trade surplus rose by EUR 385 million. In August 2019, terms of trade improved further in an annual comparison, which may be attributable to the relative change in the price of mineral fuels, machinery and transport equipment.

In September 2019, the volume of construction output was up by 17.8 percent year on year. Output increased both in the number of buildings and other structures. The growth in the construction of buildings was attributable to the construction of residential, cultural and industrial buildings, while of other structures to road and railway development works. **The volume of new contracts rose by 60 percent year on year**; the number of contracts for buildings increased by 16.6 percent, while it was up by 98.8 percent for other structures. In September, high-value contracts were concluded for the construction of roads and flood prevention facilities. The month-end volume of the construction companies' contract portfolio fell short of the value registered a year ago by 7.6 percent.

In September, retail sales volume, based on the data adjusted for the calendar effect, was up by 5.7 percent year on year. The rise in the total retail sales volume was primarily attributable to the continued growth in the turnover of non-food products (motor vehicles and vehicles parts, industrial goods, mail order shops), and to the somewhat accelerating increase in fuel sales compared to the previous month. In addition, the turnover of food stores and groceries, representing a considerable weight, continued to rise year on year, albeit to a lesser degree than in August.

Chart 5: Number of persons employed and the unemployment rate



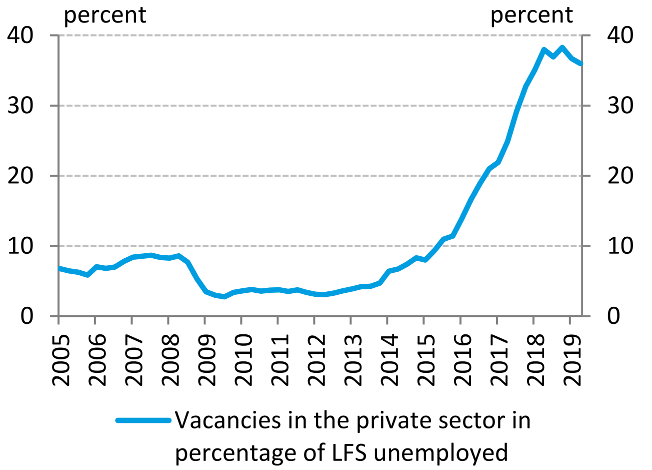
Source: HCSO

1.2.2. Employment

According to the (seasonally adjusted) data of the Labour Force Survey, in the third quarter of 2019, both the labour force participation rate and the number of people in employment essentially remained unchanged compared to the previous quarter. In an annual comparison, the rise in total employment is attributable to the private sector, while employment in the government sector moderately decreased. The number of people in public employment decreased to 108,000, while the number of people employed abroad rose to 118,000. **Seasonally adjusted unemployment rate remained at 3.4 percent** (Chart 5)**.**

In the second quarter of 2019, based on the number of vacancies, **corporate labour demand continued to decline in a wide range of the sectors**. The labour market **tightness indicator** calculated from the ratio of job vacancies and unemployed persons, slackened – similarly to the previous quarter – but **remains at a high level** (Chart 6).

Chart 6: Development of labour market tightness indicator

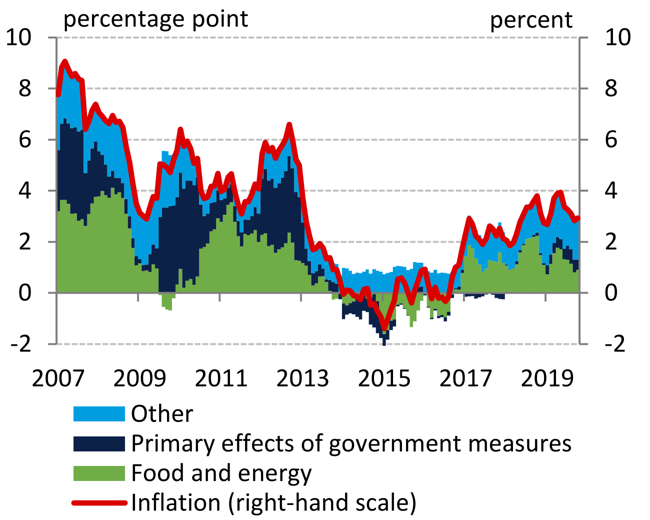


Note: Quarterly data.
Source: National Employment Service, HCSO

1.3. Inflation and wages

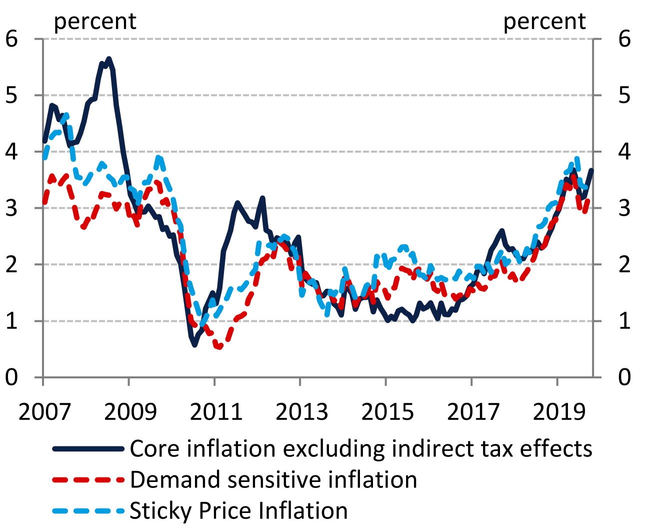
In October 2019, inflation stood at 2.9 percent, core inflation at 4.0 percent and core inflation excluding indirect taxes at 3.7 percent. Of the underlying inflation indicators capturing the more permanent trends, the inflation of demand sensitive products rose, while that of sticky price products and services declined compared to the previous month. In August 2019, gross average wage in the private sector rose by 11.4 percent year on year. The wage dynamics, still exceeding the 8 percent rise in the minimum wage and the guaranteed wage minimum, may primarily be attributable to the tight labour market conditions determining the underlying wage setting trend.

Chart 7: Decomposition of inflation



Source: MNB calculation based on HCSO data

Chart 8: Measures of underlying inflation indicators



Source: MNB calculation based on HCSO data

1.3.1. Wage setting

In August 2019, gross average wage in the private sector rose by 11.4 percent year on year. The increase in the regular average wage on a monthly basis materially exceeded the usual August seasonality, while the bonuses paid by the corporations in August were similar to those registered in the previous years. The raising of regular wages and the bonus trends may have been partly shaped by the reduction of the social contribution tax rate by 2 percentage points on 1 July. Within the private sector, similarly to the previous months, wage dynamics in manufacturing substantially exceeded the wage growth of the market services sector. The wage dynamics, exceeding the 8 percent rise in the minimum wage and the guaranteed wage minimum, may still primarily be attributable to the tight labour market conditions determining the underlying wage setting trend.

1.3.2. Inflation developments

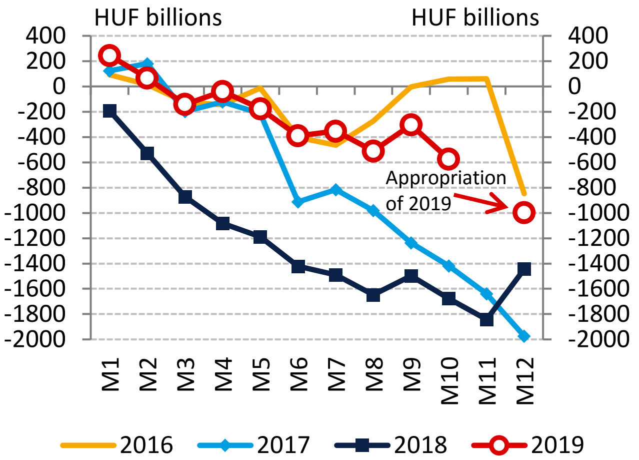
In October 2019, year-on-year inflation was 2.9 percent, while core inflation and core inflation excluding indirect taxes stood at 4.0 and 3.7 percent, respectively (Chart 7). Inflation and core inflation both rose by 0.1 percentage point compared to the previous month, which is attributable to the price index of processed food.

Of the **other underlying inflation indicators capturing the more permanent trends**, the inflation of demand sensitive products rose, while that of sticky price products and services declined compared to the previous month (Chart 8).

1.4. Fiscal developments

In October 2019, the central sub-sector of the general government closed with a deficit of HUF 272 billion, and thus the deficit accumulated in the first ten months rose to HUF 575 billion, which still substantially falls short of the cash-based deficit registered in the first ten months of the previous two years.

Chart 9: Intra-year cumulative cash balance of the central government budget



Source: Budget Act of 2019, Hungarian State Treasury

In October 2019, the **central sub-sector of the general government** closed with a deficit of HUF 272 billion, and thus the deficit accumulated in the first ten months rose to HUF 575 billion, which still substantially falls short of the cash-based deficit registered in the first ten months of the previous two years (Chart 9).

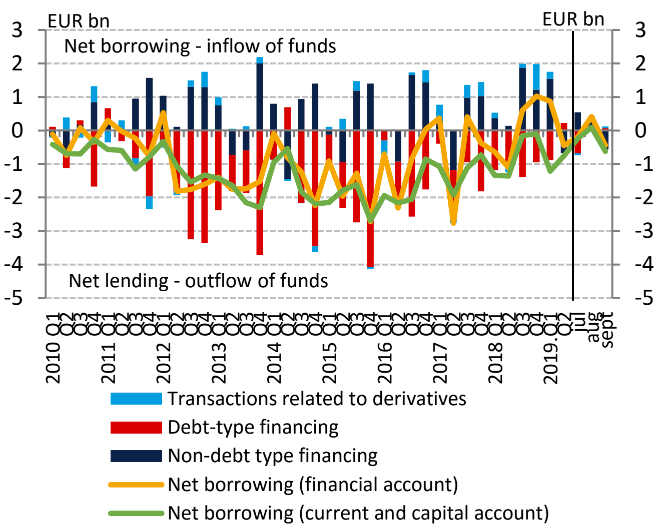
Fiscal revenues were up by HUF 53 billion year on year. The difference is primarily attributable to the higher realisation of tax revenues. Within revenues, tax and contribution revenues rose by roughly HUF 140 billion, which was primarily caused by the increase in VAT revenues, while revenues from EU grants declined by HUF 130 billion compared to last October.

The **expenditures of the central sub-sector** exceeded those registered in October 2018 by roughly HUF 140 billion, which was mostly caused by the higher level of expenditures related to state property and EU transfers.

1.5. External balance developments

In September, net lending of the economy amounted to EUR 623 billion, while the current account surplus was EUR 256 billion. According to the financial account data, foreign direct investments declined, while net external debt of the economy did not change materially.

Chart 10: Structure of net lending (unadjusted transactions)



Note: Positive values indicate net borrowing (inflow of funds), while negative values indicate net lending (outflow of funds).
Source: MNB

In September, net lending of the economy amounted to EUR 623 billion, while the current account surplus was EUR 256 billion. The turning of the current account into a surplus is attributable to the rise in trade surplus, while the transfer balance also increased (Chart 10).

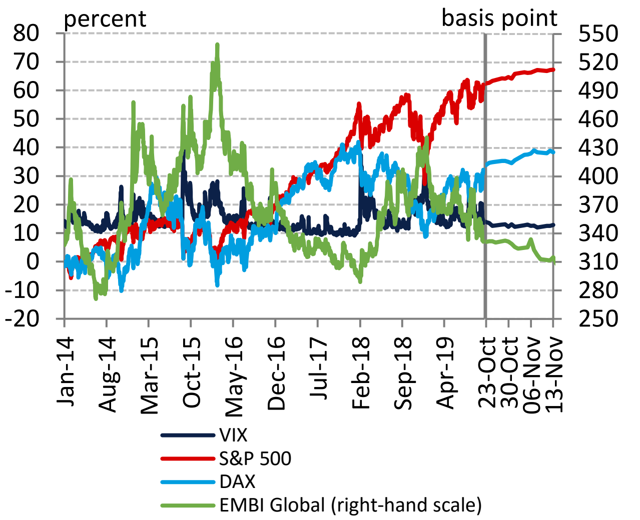
According to the financial account data, foreign direct investments declined, while net external debt of the economy did not change materially. According to the financial account data, net lending amounted to roughly EUR 440 million; the outflow of funds can be primarily connected to direct investments, mostly attributable to the domestic agents' outward equity investments. In parallel with this, the stock of debt type funds did not change materially due to transactions: the decline in the net external debt of the general government was more or less offset by the rising net external debt of corporations

2. Financial markets

2.1. International financial markets

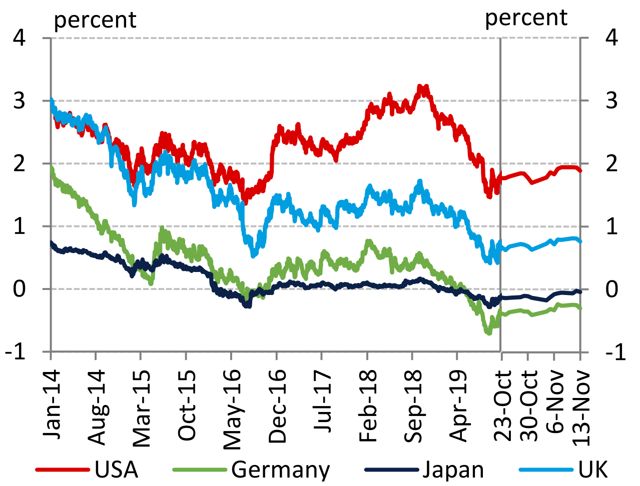
Since the last interest rate decision risk appetite increased, which was mostly attributable to the positive developments related to the trade war and to the continuation of the Brexit talks. The ECB did not change its monetary conditions, while the Fed reduced its benchmark interest rate band by 25 basis points. A rise was observed both on the developed and emerging equity markets, while bond markets were characterised by increasing yields in the past month, but emerging market bond spreads declined. Oil prices also rose as a result of the favourable sentiment.

Chart 11: Developed market equity indices, the VIX index (left-hand scale) and the EMBI Global Index (right-hand scale)



Source: Bloomberg

Chart 12: Yields on developed market long-term bonds



Source: Bloomberg

Financial market sentiment improved in the past period. Positive developments related to the trade war and the decline in the probability of a no-deal Brexit contributed to the increasing risk appetite. The Chinese diplomacy made concessions to the US in the trade war (e.g. by purchasing agricultural products), and the US communication also took a tone pointing to an agreement.

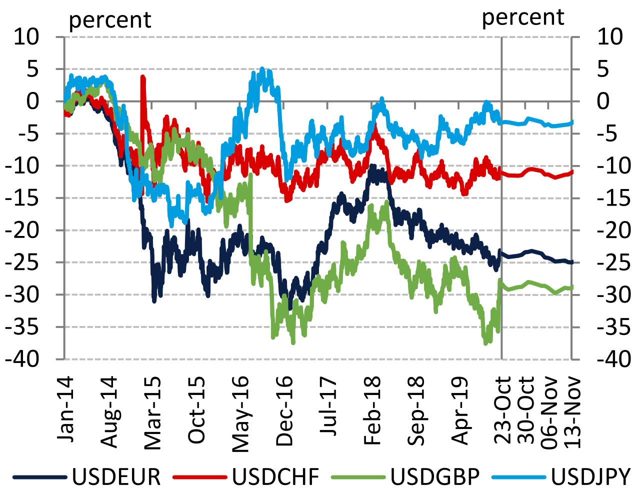
The VIX index, the key measure of equity market risks, dropped from 14 to 13 percent, while the emerging bond market EMBI Global spread fell by 16 basis points to 317 basis points (Chart 11). **In the past one month the developed stock exchange indices rose by 3-5 percent, while the composite MSCI, measuring the performance of the emerging market, was up by 0.9 percent.** In parallel with the strengthening of the risk appetite, gold price dropped by 1.5 percent.

Developed market bond yields rose since the last interest rate decision (Chart 12). The US long-term yield rose by 9 basis points to 1.85 percent, while the German 10-year yield was up by 5 basis points, reaching -0.32 percent. Emerging market yields also rose: the largest increase was registered by the South African ten-year yield, and the Central and East European region was also characterised by a yield increase. At the same time, Turkish long-term yields fell by more than 170 basis points, which is presumably attributable to major interest rate cut by the Turkish central bank.

The ECB did not modify its monetary conditions at its October rate setting meeting. Monetary policy remained unchanged and Christine Lagarde has officially taken over the position as President of the European Central Bank from Mario Draghi. Meanwhile, the expectations related to an interest rate cut disappeared from the market pricing, and thus at present the market anticipates a stable benchmark interest rate level.

In accordance with the expectations, the Fed reduced its benchmark interest rate band by 25 basis points. At the rate-setting meeting held on 30 October, the US central bank reduced its interest rate band already for the third time

Chart 13: Developed market FX exchange rates



Note: Positive values indicate the strengthening of the variable (second) currency.

Source: Reuters

this year. However, the forward rate quotes changed a lot on the US market as well. While earlier investors calculated with one more interest rate cut this year, by now these expectations disappeared from the pricing, and the market anticipates no interest rate cut before July 2020.

The European Union and Great Britain managed to agree on the prolongation of the Brexit process. Based on the agreement between the EU and Great Britain, the Brexit talks are prolonged until 31 January 2020 and after the decision the British Parliament voted for an early election, to be held on 12 December 2019. **Due to the declining chance of a no-deal Brexit the implied volatility of the British pound declined considerably.** The 1-month EUR/GBP implied volatility of over 10 percent, registered at the beginning of the period, dropped to 6.8 percent by the end of the period.

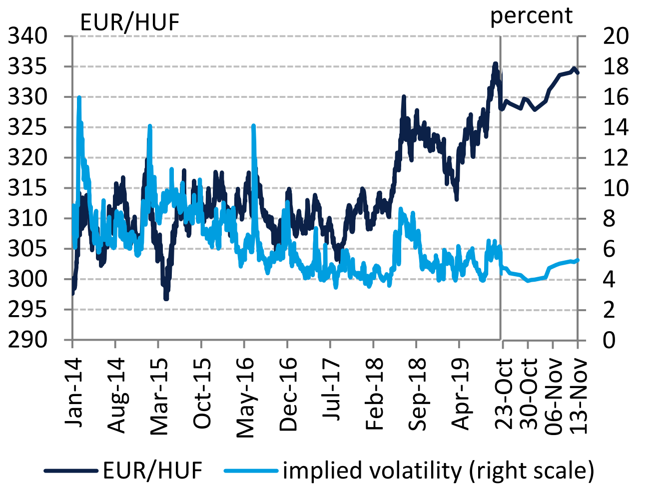
During the period under review, global foreign exchange markets were dominated by the appreciation of the dollar, which was 1 percent against the euro (Chart 13). On the emerging markets, the Chilean peso markedly depreciated due to the strengthening riots in the country, which thus depreciated against the dollar by 9 percent.

During the last one month oil prices rose, and thus the price of Brent and WTI rose by 5.1 percent close to USD 63 and by 6.2 percent over USD 57, respectively. The favourable sentiment that developed due to the easing of the trade war between the USA and China and the expectations that OPEC member states may moderately increase their production cuts at their December meeting, pointed to an increase.

2.2. Developments in domestic money market indicators

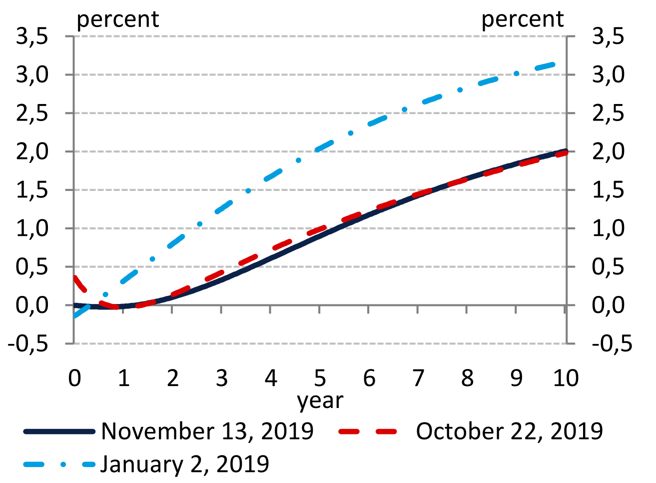
During the period under review, the forint depreciated against the euro. The 3-month BUBOR declined slightly, to 0.19 percent. The shortest and middle section of the government securities yield curve shifted downwards, but its steepness essentially remained unchanged. The government securities auctions of the past month mostly attracted strong demand.

Chart 14: EUR/HUF exchange rate and the implied volatility of exchange rate expectations



Source: Bloomberg

Chart 15: Shifts in the spot government yield curve



Source: MNB, Reuters

Since the interest rate decision in October, the forint exchange rate against the euro depreciated by 1.5 percent from 329 to 334 (Chart 14). The currencies of the region moderately depreciated: the Polish zloty by 0.5 percent, while the Czech koruna and the Romanian leu by 0.1 percent.

The 3-month BUBOR, relevant for the monetary policy transmission, decreased by 2 basis points since the last interest rate decision and thus it stood at 19 basis points at the end of the period under review. **The shortest and middle section of the government securities yield curve shifted downwards** (Chart 15). The up to six months section of the yield curve registered a decrease of 15-35 basis points, while the rest of the short section remained unchanged. The middle section was characterised by a decrease of 5-10 basis points, while the long section registered a rise of 1-2 basis points. The steepness of the government securities yield curve did not change materially during the period under review; it became flatter only on the shortest and medium-term maturities.

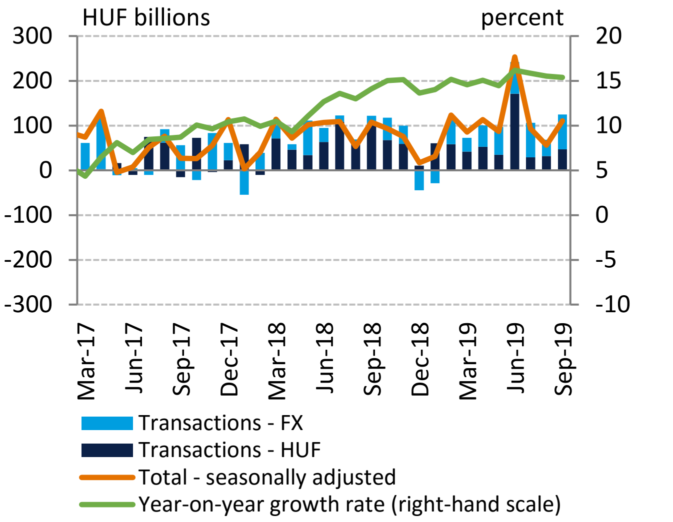
During the last month, the Treasury bill and government bond auctions were mostly characterised by strong demand, and thus the average auction yield declined on almost all maturities by the end of the period. The auctions of the 3- and 12-month Treasury bills were characterised by continuously rising demand during the month, but the Government Debt Management Agency issued the announced volume at each time. The average yield of the 3-month auctions was below 0 percent throughout the period, and on the last occasion it fell from the previous -4 and -5 basis points to -7 basis points. Average yield also declined at the 12-month Treasury bill auctions. Demand was also strong at the long-term government securities auctions: at the auction of the 3-, 5- and 10-year auctions the Government Debt Management Agency accepted higher volumes than previously announced. The average yields of the 3- and 10-year securities fell by 5 and 3 basis points, to 0.35 and 1.93 percent, respectively. At the same time, the average auction yield of the 5-year government securities rose, despite strong demand, by 18 basis points to 1.15 percent, since the debt management agency auctioned a new bond, with maturity longer by one year than the previous one. The Hungarian 5-year CDS spread fell by 4 basis points during the period under review, and at present it stands at 74 basis points.

Non-residents' forint government securities holdings rose. Non-residents’ forint government securities holdings rose by HUF 50 billion to HUF 4,342 billion. At the same time, their share within the total portfolio declined by 0.2 percentage points, and thus at the end of the period it was close to 24.9 percent of the market holding.

3. Trends in lending

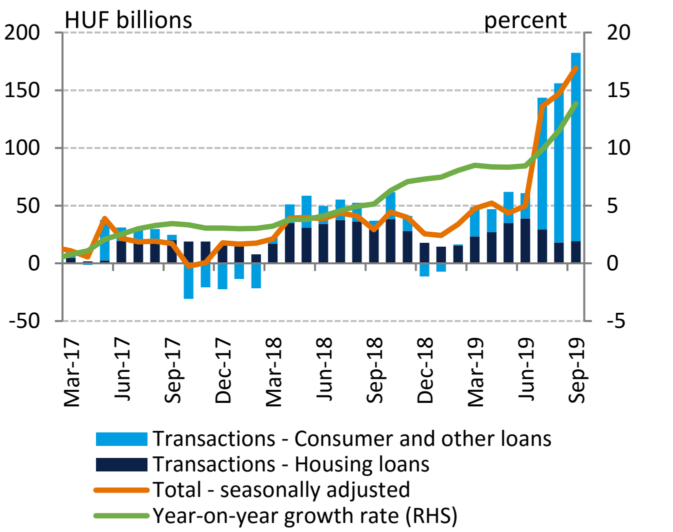
In September 2019, the outstanding borrowing of non-financial enterprises from the credit institution sector increased by HUF 125 billion due to transactions. Household loans rose materially and at an accelerating rate in September as well, and thus outstanding borrowing increased by almost 14 percent on an annual basis.

Chart 16: Net borrowing by non-financial corporations



Source: MNB

Chart 17: Net borrowing by households

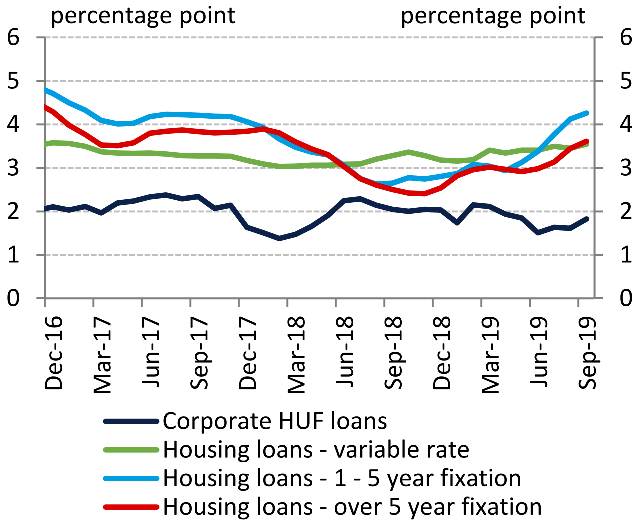


Source: MNB

In September 2019, the outstanding borrowing of non-financial enterprises from the credit institution sector increased by HUF 125 billion due to transactions. (Chart 16). Forint loans and foreign currency loans rose by HUF 47 billion and HUF 78 billion, respectively. The growth registered in the past 12 months due to transactions continues to exceed HUF 1,000 billion. Thus the annual growth rate of the outstanding corporate loans remained at a high level, above 15 percent. **The growth in outstanding borrowing still rests upon a broad base in a breakdown of banks and industries as well.**

Household loans rose materially and at an accelerating rate in September as well, and thus outstanding borrowing rose by almost 14 percent on an annual basis (Chart 17). The value of new contracts increased by 40 percent in annual terms. **The large volume of new loans disbursed in the third quarter, was caused by the buoyant demand for prenatal baby support loans, launched in July**, which – for the time being – is not accompanied by materially lower demand on the personal loan or housing loan market, and thus its additional impact may be deemed high.

Chart 18: Development of corporate and household credit spreads



Note: In the case of corporate forint loans, the spread over the 3-month BUBOR. In the case of housing loans with variable interest or interest fixed for 1 year at the most, the 3-month BUBOR, while in the case of housing loans fixed for over one year, the APR-based margin above the relevant IRS.
Source: MNB

The **smoothed interest rate spread of forint corporate loans** was 1.82 percent in September 2019, **representing a rise of 0.2 percentage points compared to the previous month** (Chart 18). The average smoothed interest rate spread on variable rate housing loans calculated on the basis of the annual percentage rate (APR) rose during the month and amounted to 3.55 percentage points in September. The decrease in the longer term funding costs (relevant IRS), observed in the third quarter, was not accompanied by a fall of a similar degree in the APR level of housing loans, and thus the **spread on housing loans with interest rate fixation longer than one year rose by 0.6-0.9 percentage point** compared to the end of the previous quarter. **The average spread on housing loans with an interest rate fixation longer than one year and up to 5 years reached 4.26 percentage points** in September, while **the spread on products with interest rate fixation for more than five years was 3.62 percentage points.**