MACROECONOMIC AND FINANCIAL MARKET DEVELOPMENTS

BACKGROUND MATERIAL

TO THE ABRIDGED MINUTES

OF THE MONETARY COUNCIL MEETING

OF 28 JANUARY 2020

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The background material 'Macroeconomic and financial market developments' is based on information available until 23 January 2020.

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 web-site at:
http://www.mnb.hu/en/monetary-policy/the-monetary-council/minutes

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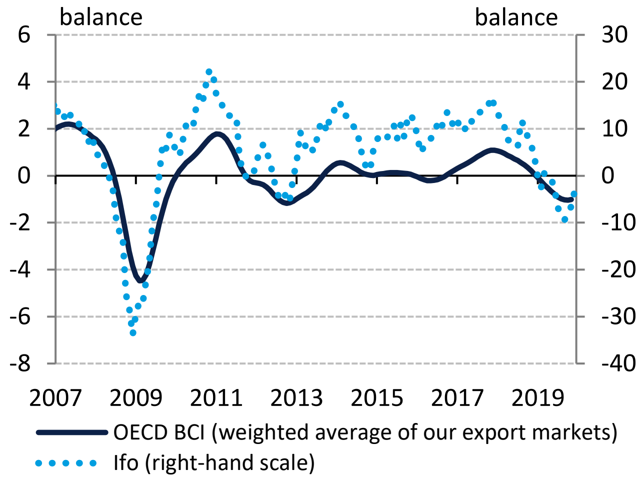
1. Macroeconomic developments

1.1 Global macroeconomic environment

In the third quarter of 2019, the economy of the United States and of the euro area grew at a moderate rate, slightly exceeding expectations. In the euro area, former fears of recession eased. Nevertheless, growth prospects remained persistently restrained. Growth of the CEE region still exceeded the growth rate of the euro area substantially.

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 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 the 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).

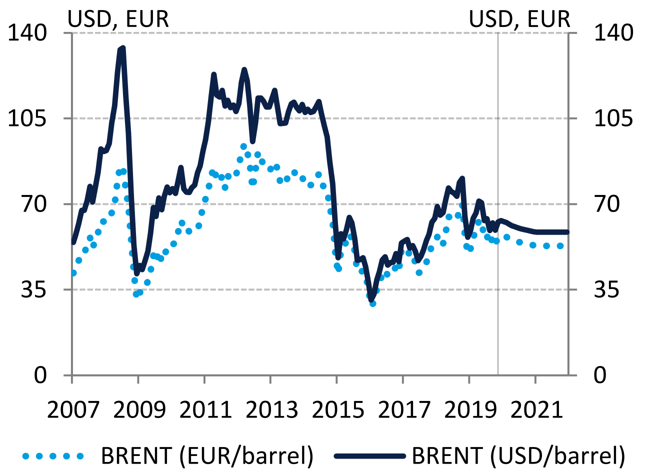
The large economies of the euro area avoided recession; however, in the third quarter of 2019, economic growth was moderate across Europe. Economic growth in the euro area increased by 1.1 percent year-on-year and by 0.2 percent quarter-on-quarter. T**he annual growth of** our key trading partner **Germany**, which was released by the German Statistical Office, **rose 0.6 percent compared to 2018. The German economy avoided technical recession,** the extremely moderate growth was supported primarily by household and government consumption. In addition, 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 outlook for the German economy, has been adjusting for several months, but it is still in the negative range.** New orders in the German industry declined further in November on an annual basis. **The fact, that in the past months Hungarian vehicle manufacturing has continued to outperform that of Germany, brings an additional perspective to the short-term impact of the German industrial trends on Hungary's prospects.**

As in the previous quarters, the Central and Eastern European region proved to be the growth centre of the European Union in the third quarter of 2019. According to 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. Overall, the region exceeded the growth of the euro area by almost 2.7 percentage points. Examining the region as a whole, growth is mainly driven by domestic demand, but despite the moderate external activity net exports made positive contribution to growth in several countries.

The deterioration of the business survey indicators in the euro area halted, which, looking forward, may signal a decline in recession risks. However, risks jeopardising economic growth include the increase in trade tensions causing persistent uncertainty, deteriorating industrial production observed in the past period, the challenges surrounding the automotive industry, the vulnerability of Italy stemming from high government debt, the indirect effects of the deceleration of the Chinese economy and the uncertainty resulting from the fragile financial environment of the emerging markets. In addition, the **uncertainty surrounding the exit of the United Kingdom from the EU** continues to represent substantial uncertainty as the “fallout” of the United Kingdom from the EU (hard Brexit) remains a realistic scenario.

Based on preliminary data, inflation trends measured in euro area, in line with economists' expectations, **rose in December**, which was also attributable to the base effect of the decrease in fuel prices at the end of last year. **Accordingly, both inflation and core inflation could be 1.3 percent. In the past period, the world market price of crude oil, showing significant volatility, fluctuated in the USD 65-70 band** (Chart 2). The world market price of Brent oil rose to over USD 69 in the beginning of January by reason of the United States air strikes in Iraq on targets in Iran. However, within days of the attack, corrections in oil price took place as US-Iranian tensions seemed to be easing (the closure of the Strait of Hormuz was becoming less likely), furthermore the latest EIA analysis showed a surge in oil supply beyond expectations. As a result, **the world market price of crude oil is currently around USD 65 / barrel**. The world market price of both industrial commodities and unprocessed food increased in December.

Chart 2 World market prices of Brent crude oil

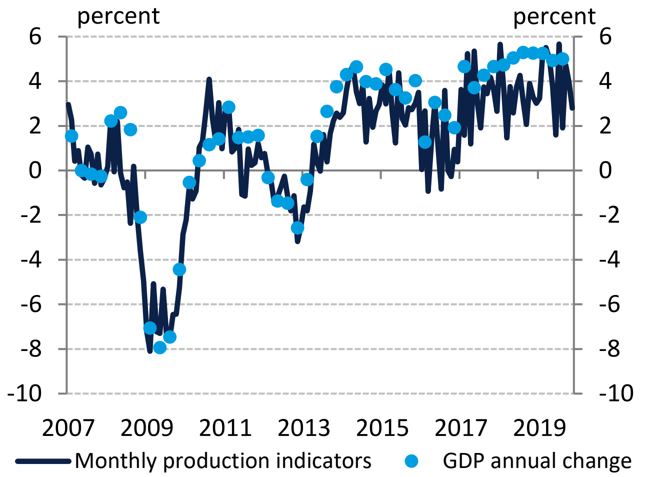


Source: Bloomberg

1.2 Domestic real economy developments

Industrial and construction production as well as retail sales also showed dynamic growth in the autumn months. The seasonally adjusted unemployment rate remained 3.5 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



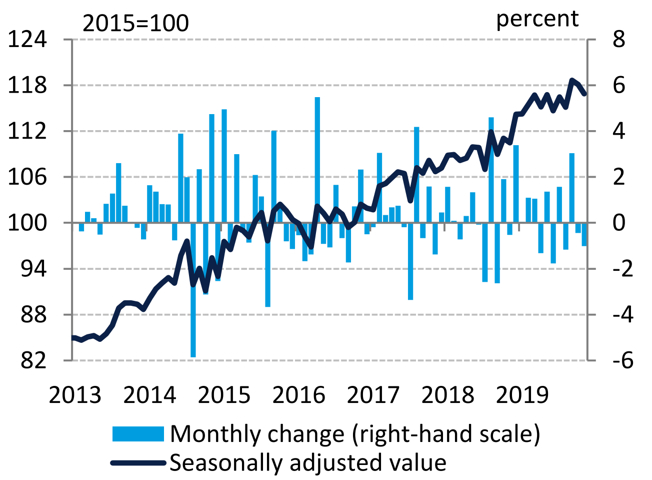
Note: Weighted average of monthly production indicators (industrial output, construction output and retail sales). The weights are derived from regression explaining GDP growth.
Source: MNB calculation based on HCSO data

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. A wide range of the sectors contributed to the growth.** Hungary ranked first in the European Union member states' growth ranking in annual terms. **From the output side, market services together with industry and construction** supported GDP growth **to the largest degree** (Chart 3). Despite a weaker German industrial production, Hungarian automotive industry substantially increased in the third quarter of the year, and as a result, industry made a positive contribution to growth. **On the expenditure side, domestic demand factors** – consumption and investment – continued to expand significantly and support the economic growth, **and exports also made a positive contribution to GDP growth**.

In November 2019, **industrial output was up by 3.6 percent** year-on-year, while production decreased by 1.0 percent compared to the previous month (Chart 4). **The seasonally and working-day adjusted index exceeded last year's value by 5.7 percent,** reflecting one less working day than last year. The output of automotive industry, representing a significant share, increased by 4.0 percent in annual terms. As regards other sectors, the **manufacture of electric machinery** (17.6 percent) registered significant growth. In addition, **the growth in the domestic manufacture of computer, electronics and optical products, pharmaceutical manufacturing and food production** also exceeded the industrial average. In November, the performance of the **metal industry** (-1.9 percent) and the output of the **textile industry** (-14.8 percent) **declined** year-on-year.

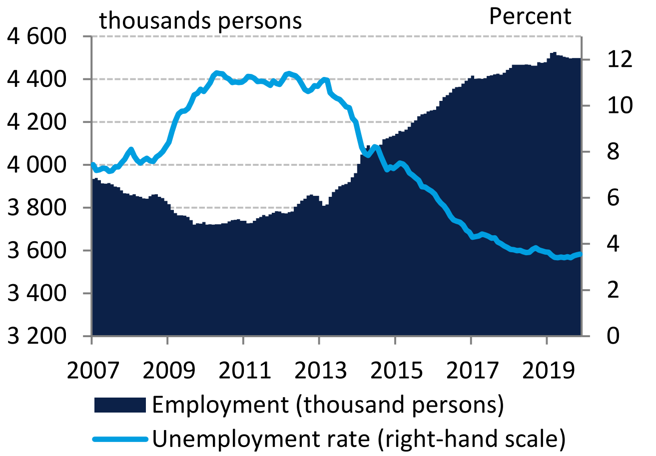
Chart 4 Development in industrial production



Source: MNB calculation based on HCSO data

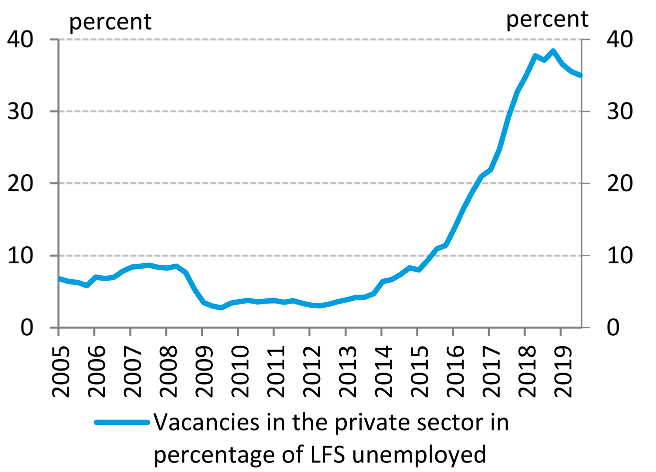
Based on preliminary data, **expressed in euro terms**, **the value of exports and imports was decreased by 0.1 percent and 0.8 percent,** respectively, in an annual comparison in November 2019, and as a result, trade surplus rose by EUR 59 million. In October 2019, terms of trade improved further in an annual comparison, which may be attributable to the relative change in the price of mineral fuels, machinery and transport equipment.

Chart 5 Number of persons employed and the unemployment rate



Source: HCSO

Chart 6 Development of labour market tightness indicator



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

In November 2019, the volume of construction output was up by 6.8 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 regarding other structures to road and railway development works. **The volume of new contracts increased by 24.7 percent year-on-year,** the number of contracts for buildings increased by 9.0 percent, while it was up by 36.5 percent for other structures.

In November, **retail sales volume, based on the data adjusted for the calendar effect, was up by 7.2 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 (furniture, technical and industrial goods, mail order shops). **At the same time, vehicle sales growth has moderated compared to recent months.** Sales of business groups selling non-durable goods continued to increase and contributed significantly to the growth in retail sales.

1.2.2. Employment

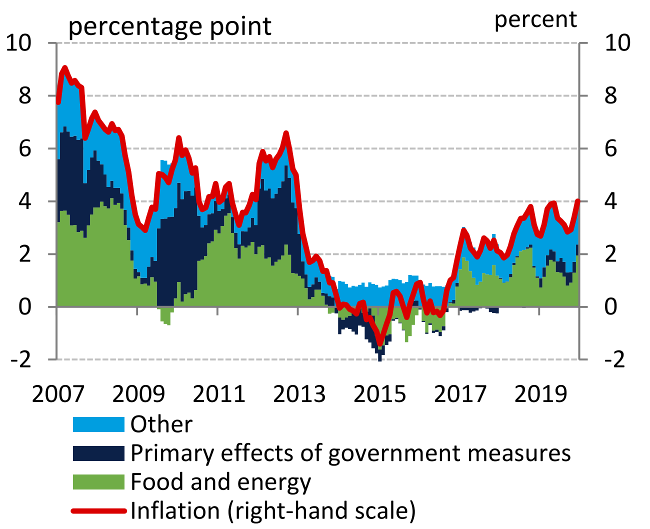
According to the (seasonally adjusted) data of the Labour Force Survey, in the period of September-November 2019, both the labour force participation rate and the number of people in employment essentially remained unchanged. The number of people in public employment stagnated, while the number of people employed abroad increased to 120 thousand. **The seasonally adjusted unemployment rate remained 3.5 percent.** (Chart 5).

In the third 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 still **remained at a high level** (Chart 6).

1.3 Inflation and wages

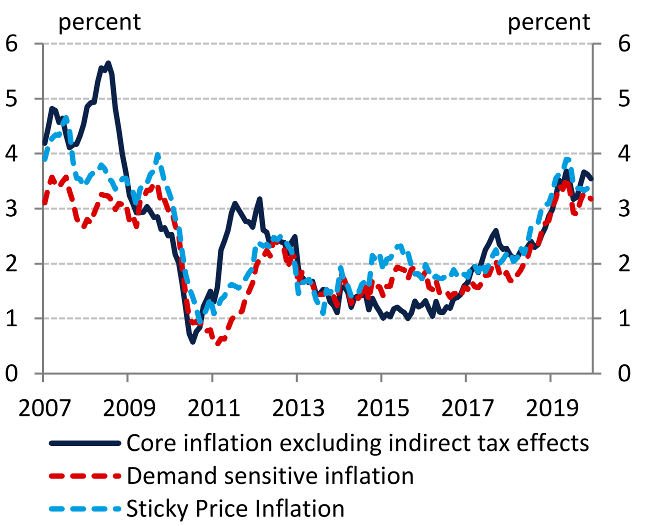
In December 2019, inflation calculated on year-on-year basis was 4.0 percent. Core inflation stood at 3.9 percent and core inflation excluding indirect taxes at 3.5 percent. The underlying inflation indicators capturing more permanent trends (inflation of demand sensitive and sticky price products and services) remained unchanged compared to the previous month. In October 2019, gross average wage in the private sector rose by 11.5 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 October 2019, gross average wage in the private sector rose by 11.5 percent year-on-year. The monthly raise in regular average wage was close to the historical average, i.e. in line with normal seasonality. The bonuses paid by companies in October were higher than in recent years. The regular raise in wages and the bonus trends may have been partly shaped by the reduction of the social contribution tax rate by 2 percentage points as of 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

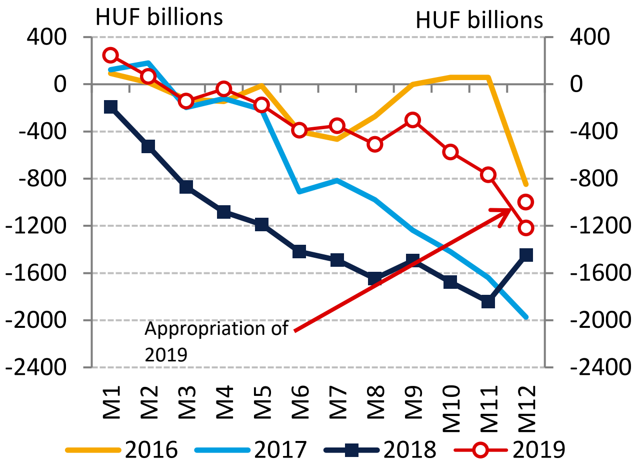
In December 2019, inflation calculated on year-on-year basis was 4.0 percent. Core inflation stood at 3.9 percent and core inflation excluding indirect taxes at 3.5 percent (Chart 7). Compared to the previous month, inflation increased by 0.6 percentage point, while core inflation decreased by 0.1 percentage point. The increase in inflation is mainly attributable by the base effect of last year's fall in fuel prices. The slight decrease in core inflation was caused by a decline in the market services price index. As of December, the consumer price index for the whole of last year stood at 3.4 percent, core inflation at 3.8 percent, and core inflation excluding indirect taxes at 3.4 percent.

The underlying inflation indicators capturing more permanent trends (inflation of demand sensitive and sticky price products and services) remained unchanged compared to the previous month (Chart 8). In November 2019, agricultural producer prices increased by 5.2 percent in annual terms, while the domestic sales prices in sectors of consumer goods increased by 6.2 percent.

1.4 Fiscal developments

In December 2019, the central sub-sector of the general government closed with a deficit of HUF 453 billion, which resulted in a deficit of HUF 1,219 billion in 2019. The annual cash flow deficit is below the 2018 deficit, but it is about HUF 200 billion higher than the budgetary appropriation.

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



Source: Budget Act of 2019, Hungarian State Treasury

In December 2019, the central sub-sector of the general government closed with a deficit of HUF 453 billion, which resulted in a deficit of HUF 1,219 billion in 2019. The annual cash flow deficit is below the 2018 deficit, but it is about HUF 200 billion higher than the budgetary appropriation (Chart 9).

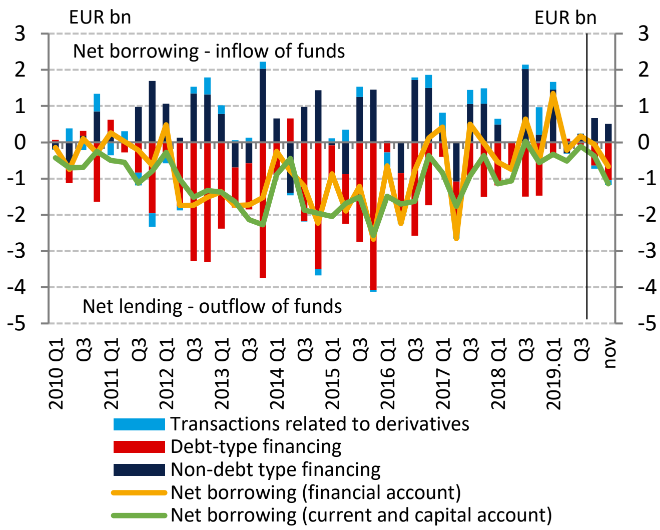
Fiscal revenues in December were HUF 472 billion lower compared to the same period in 2018. The two main reasons for this were that the absorption of EU subsidies was not concentrated in December and due to the abolition of the year-end corporate tax advance supplement, corporate tax revenues were significantly reduced.

In December the expenditures of the central sub-sector exceeded the value registered in 2018 by HUF 378 billion, which was mostly produced by the higher level of the central organisations' expenditure. Central organisations' net expenditures in December 2019 were about HUF 400 billion (nearly 50 percent) higher than a year earlier.

1.5 External balance developments

In November, net lending of the economy increased to EUR 1,143 million, while the current account surplus to EUR 271 million. The current account surplus was mainly driven by the increasing use of EU transfers, while data on trade balance showed a slight moderation compared to October.

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 November, net lending of the economy increased to EUR 1,143 million, while the current account surplus to EUR 271 million. The current account surplus was mainly driven by the increasing use of EU transfers, while data on trade balance showed a slight moderation compared to October (Chart 10).

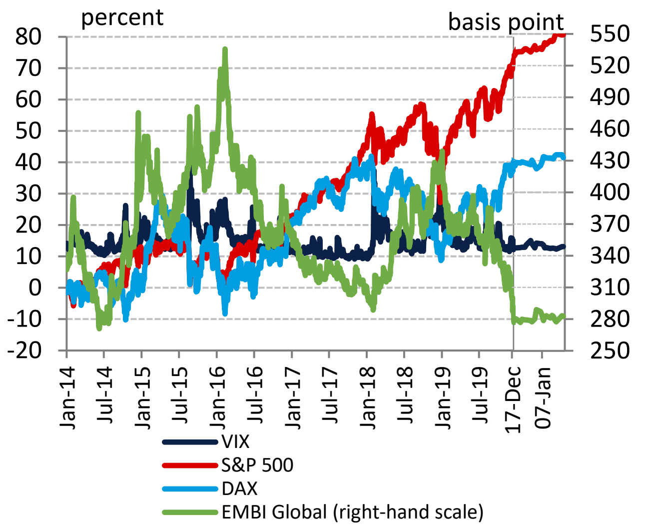
According to the financial account data, direct investments increased by around EUR 500 million in November, while the net external debt of the economy declined by EUR 1 billion. On the financing side, the net lending amounted to about EUR 670 million – the outflow of resources is attributable to the continued decline in net external debt, resulting from rising foreign exchange reserves in line with the high utilization of EU transfers and to the declining government debt securities holdings held by non-residents. In parallel, net foreign direct investment by non-residents increased, mainly related to reinvested earnings.

2. Financial market

2.1 International financial markets

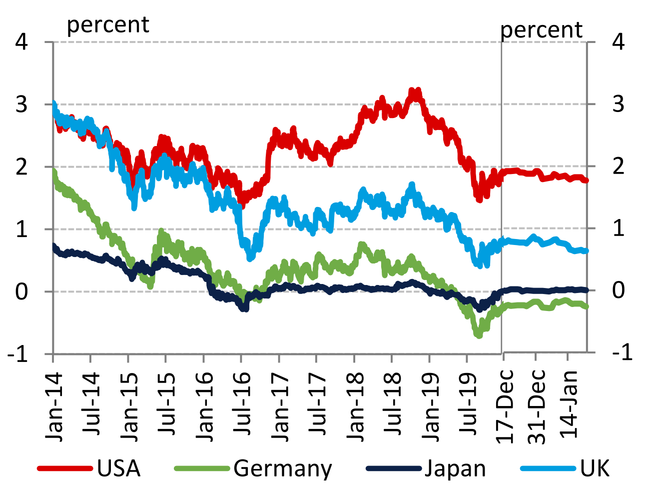
Since the last interest rate decision financial market sentiment did not change significantly. Market sentiment was largely determined by developments in the trade war and tensions in the Middle East. Developed and emerging equity markets have risen, while bond markets have been characterized by divergent yield developments. Oil prices have fallen in recent years following a temporary rise at the beginning of the year.

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

Since the last interest rate decision financial market sentiment did not change significantly. Over the past month, market participants have focused on the outcome of the initial trade deal between the US and China and on the tensions in the Middle East. Increased tensions between the US and Iran in early January worsened market sentiment, but expectations of a positive outcome of the US-China trade agreement followed by an initial trade deal in mid-January, improved sentiment again.

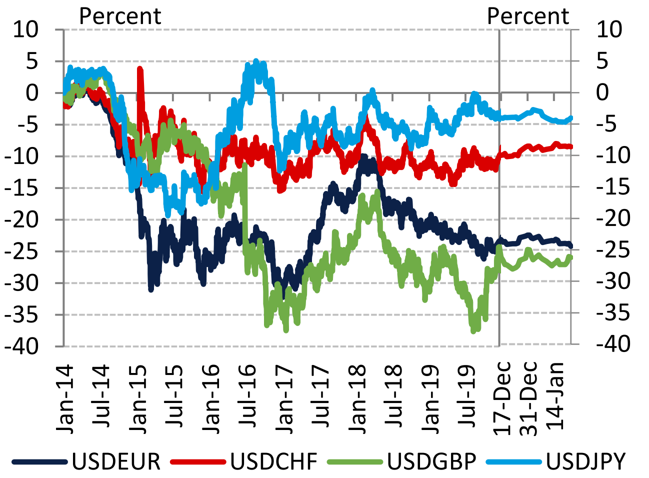
The VIX index, the key measure of equity market volatility, increased by 0.6 percentage point to 12.9 percent, while the emerging bond market EMBI Global spread rose slightly, by only 2 basis points to 283 basis points (Chart 11). In the past month, the developed stock exchange indices rose by 1.5-2 percentage points, and thus still standing close to their historic high, while the composite MSCI, measuring the performance of the emerging market, was up by 2 percent. Gold price rose during the period and was 5.5 percent higher than a month earlier.

Developed market bond yields have evolved differently since the last interest rate decision (Chart 12). The US and the UK long-term yield fell by 11-12 basis points to 1.77 and 0.64 percent, respectively, while the German 10-year yield rose by 4 basis points, to -0.26 percent. Emerging market yields also varied differently: South African and Turkish ten-year yield fell by 20-25 basis points and Brazilian by 45 basis points, while the Central and Eastern European region was characterised by a yield increase.

The United States and China signed an initial trade deal on January 15 to settle a trade war that lasted nearly two years. However, the additional duties on Chinese goods shall remain in force until the parties have clarified the details of the final agreement.

Oil prices have fallen in recent years following a temporary rise at the beginning of the year. In the first half of the period, oil prices rose as a result of rising geopolitical tensions in the Middle East, then corrected downward as tensions eased. The drop in oil prices was also supported by continued growth in US shale oil supply, large oil consumers

Chart 13 Developed market FX exchange rates



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

Source: Reuters

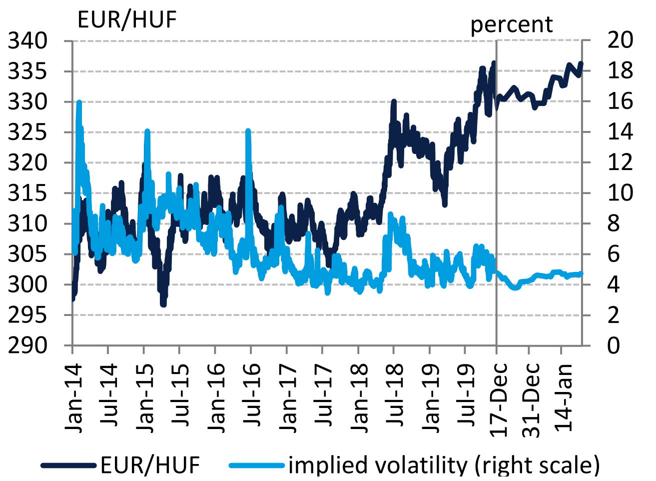
with significant reserves and OPEC's large free oil production capacity. Thus, overall, air strikes in the Middle East have only temporarily caused supply-side concerns. Demand for oil is not expected to grow significantly, despite the consolidation of the US-China trade relationship supporting the demand side.

There was no significant shift in global foreign exchange markets during the period (Chart 13).

2.2 Developments in domestic money market indicators

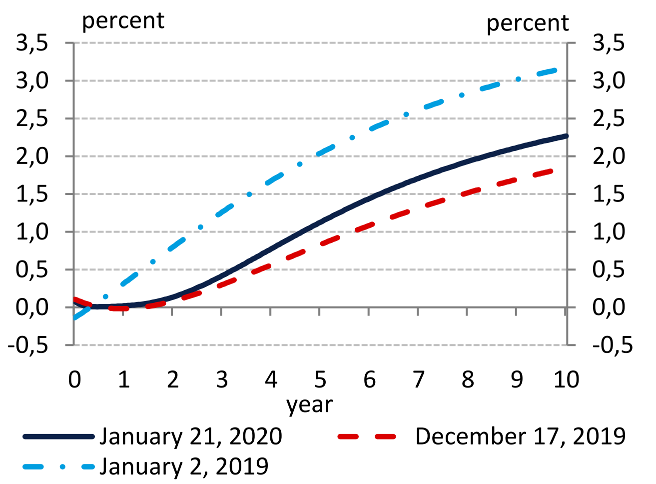
During the period, the forint weakened against the euro, breaking away from the movement of regional currencies. The 3-month BUBOR rose slightly (to 0.19 percent).

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 December, the forint exchange rate weakened against the euro by 2 percent from 330 to 337 (Chart 14). Within the CEE region, the Czech koruna appreciated by 1.4 percent and the Polish zloty by 0.7 percent, while the exchange rate of the Romanian leu did not change substantially. Thus, the forint weakened against the regional currencies.

The 3-month BUBOR, relevant for the monetary policy transmission, rose by 3 basis points since the last interest rate decision, and thus it stood at 19 basis points at the end of the period. **The middle and long section of the government securities yield curve shifted significantly upwards** (Chart 15). An increase of 1-4 basis points was observed in the short section of the yield curve and 10-40 basis points in the middle and long section. The steepness of the government securities yield curve rose during the period under review.

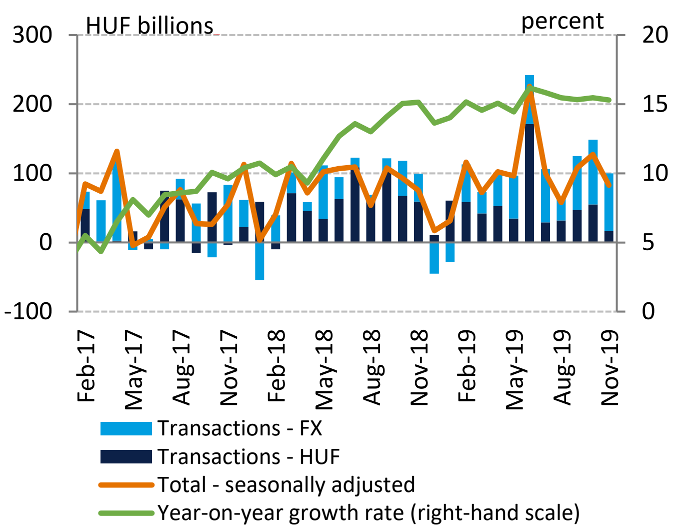
During last month, the discount Treasury bill and government bond auctions were mostly characterised by strong demand, however, the average auction yields - in line with secondary market developments - increased at all maturities by the end of the period. The demand for 3-month and 12-month Treasury bills was strong, especially at the auctions held in the beginning of the year, thus at these auctions the GDMA accepted a larger amount than announced. The average yield on 3-month auctions rose from -0.06 percent to 0.02 percent, and the average yield on 12-month Treasury bill auctions also rose to 0.01 percent. Demand was also strong at the long-term government securities auctions: at the 3-, 5-, 7-, 10- and 20-year maturities the Government Debt Management Agency accepted higher volumes than previously announced. The demand for 7-year floating rate government securities was more than 10 times higher. The average auction yield of the 10-year government securities rose by 19 basis points to 2.06 percent and of the 5-year government securities by 8 basis points to 1.22 percent. The Hungarian 5-year CDS spread fell by 12 basis point during the period under review, thus at present it stands at 59 basis points.

Non-residents' holdings in forint government securities did not change significantly. Non-residents’ holdings in forint government securities increased by a minimum of HUF 4 billion to HUF 4,165 billion. Thus, at the end of the period, it was still at 24 percent of the market.

3. Trends in lending

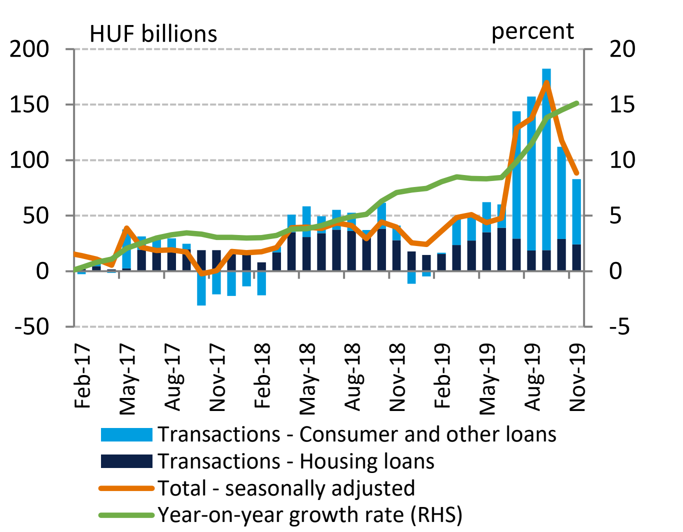
In November 2019, the outstanding borrowing of non-financial enterprises from the credit institution sector increased by HUF 100 billion due to transactions. Household loans increased at a somewhat more moderate rate relative to the previous month, but the annual growth still reached 15.1 percent.

Chart 16 Net borrowing by non-financial corporations



Source: MNB

Chart 17 Net borrowing by households

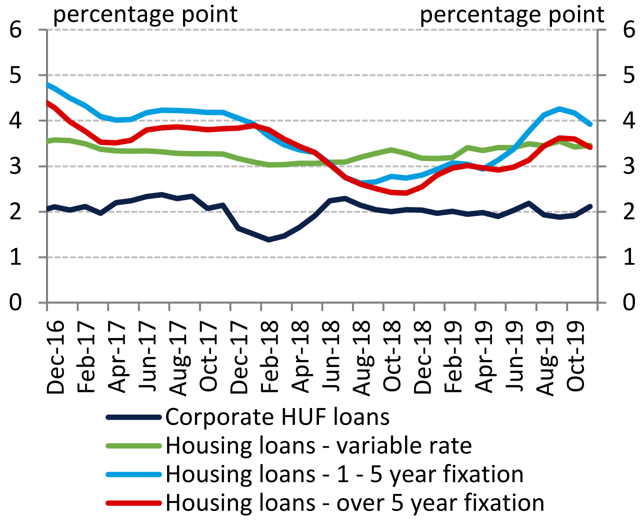


Source: MNB

In November 2019, the outstanding borrowing of non-financial enterprises from the credit institution sector increased by HUF 100 billion due to transactions (Chart 16). Last month, forint loans and foreign currency loans increased by HUF 17 billion and HUF 83 billion, respectively. As a result, the value of the corporate loan portfolio increased by almost HUF 1,200 billion, i.e. 15.3 percent, in terms of transactions, in the past 12 months. The annual growth in outstanding borrowing remained broad-based, regarding both banks and sectors.

In November, household loans increased at a somewhat more moderate rate relative to the previous month, but the annual growth still reached 15.1 percent (Chart 17). The value of new contracts increased by 43 percent in annual terms. In particular, interest in the prenatal baby support loans launched in July was significant in November, but lower than in previous months. Demand for personal and housing loans was also subdued, with output of the latter product rising by 5 percent on an annual basis. Lower November output is partly due to seasonal effects, while for prenatal baby support loans the additionality may still outweigh the crowding out effect of the product.

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 corporate loans in HUF was 2.11 percentage point in November 2019, representing an increase of 0.19 percentage point 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 slightly during the month** and amounted to 3.46 percentage points. It is noticeable that banks follow changes in funding costs only with some delay: longer-term funding costs (relevant IRSs) rose slightly in November compared to the previous month, while the APR level of fixed-rate housing loans declined. **The spread on products with an interest rate fixation longer than one year and up to 5 years declined by 0.24 percentage point, while that on products with interest rate fixation for more than 5 years dropped by 0.19 percentage point. The average spread on housing loans with an interest rate fixation longer than one year and up to 5 years reached 3.93 percentage points in November, while the spread on products with interest rate fixation for more than 5 years was 3.41 percentage points.**