MACROECONOMIC AND FINANCIAL MARKET DEVELOPMENTS

BACKGROUND MATERIAL

TO THE ABRIDGED MINUTES

OF THE MONETARY COUNCIL MEETING

OF 21 JULY 2020

JULY

2020

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The background material 'Macroeconomic and financial market developments' is based on information available until 16 July 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 website at:
http://www.mnb.hu/en/monetary-policy/the-monetary-council/minutes

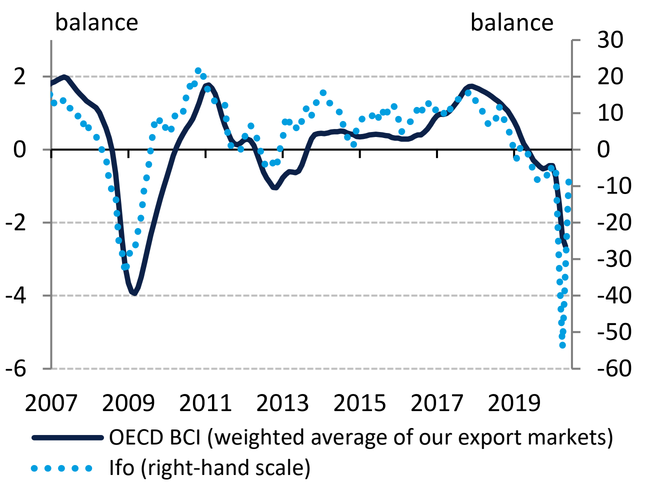
Table of contents

1. Macroeconomic developments

1.1. Global macroeconomic environment

Recently, the trends in economic performance have primarily been determined by the COVID-19 virus and the measures taken to control it. In the first quarter of 2020, the performance of the large economies typically declined, which may be followed by an even more severe downturn in Europe based on the activity data of April and May. The pandemic curve started to rise once again in several countries.

Chart 1 Business climate indices in Hungary's export markets



Source: OECD, Ifo

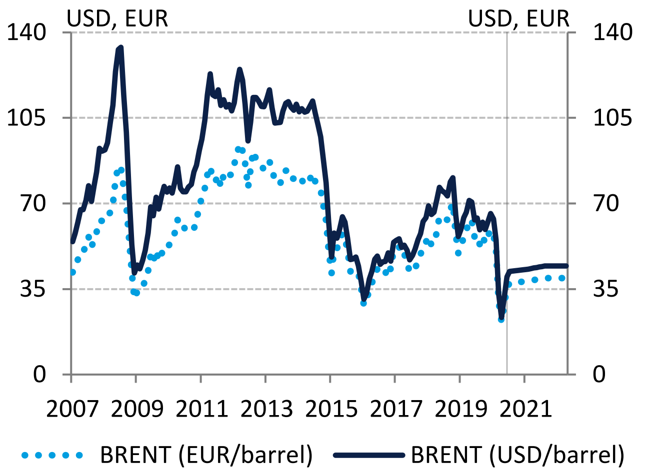
Recently, trends in economic performance have primarily been determined by the COVID-19 virus and the measures taken to control it. The pandemic hit the global economy in a weakened state, and the negative economic impacts rapidly appeared in several countries). **Global tourism practically was brought to a standstill in mid-March,** also evidenced by the plunge in the number of passenger flights. **The past weeks have been characterised by gradual adjustment in air traffic,** which reflects **the ongoing restart of the economies**.

As a result of the restart of the Chinese economy, in the past weeks **capacity utilisation has increased and business sentiment improved in China. In May, industrial production grew by 4.4 percent in annual terms**. The volume of retail sales and the number of motor vehicle registrations also improved in May after the historic low in January and February, but still fell short of the value a year earlier.

In the United States, the lack of measures, and later **the measures, taken rather late**, resulted in the fast spread of the virus throughout the country. Recently, **the epidemic curve in the USA has been starting to rise once again**. **In May,** US industrial output **declined by 15.3 percent,** year-on-year**.** In May 2020, **retail and catering sales volume declined by 6.1 percent,** year-on-year. **By the end of June,** following a continuous decline, **the number of new applications for unemployment benefit fell below 1.5 million.** In line with this, **the unemployment rate** of those over 16 years **peaked at 14.7 percent in April**, and **in June it stood at 11.1 percent.**

By March, the continuous deterioration of the economic situation, caused by **the coronavirus, reached Europe, as well. In April, economic performance of the United Kingdom fell by 24.5 percent**, year-on-year. The volume of retail sales fell by 13.1 percent in May. The **number of motor vehicle registrations plunged to close to zero in April, and in May, they registered a decline of almost 90 percent, year-on-year.** According to the **ECB's June projection, economic performance in the euro area may reach its low in the second quarter of 2020**, and thus euro area GDP **may fall short of the year-on-year figure by 13 percent**. Industrial production of Germany – Hungary's main **trading partner** – fell considerably (by 23.8 percent) in May as well on an annual basis. The changeover to alternative drive-train and tighter EU regulations have forced the German car industry to renew itself already in previous years. **The coronavirus further exacerbated the challenges of the automotive industry, which may slow down the recovery of the sector.** German retail sales volume grew by 3.8 percent in May year-on-year. By contrast, car registrations declined by almost 50 percent. **German business sentiment** considerably improved in June.

Chart 2 World market prices of Brent crude oil



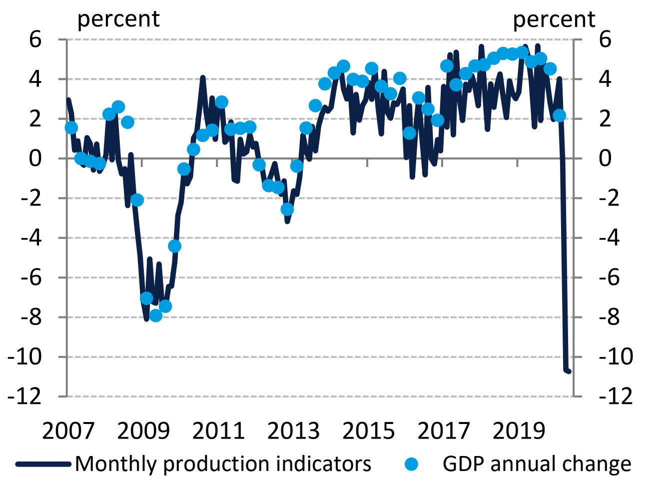
Source: Bloomberg

In June, euro area inflation rose to 0.3 percent, and consequently it slightly exceeded analysts' expectations, while **core inflation declined to 0.8 percent**. **The world market price of Brent crude oil has continued to rise recently** (Chart 2). Demand for oil rose, with earlier, coronavirus-related restrictive measures being lifted gradually, and some economies being restarted. Moreover, the greater-than-expected decline in the USA's oil reserves, and the record high production cut by the OPEC+ countries also pointed to a price rise. However, looking ahead, a fall in demand as a result of a potential second wave of the coronavirus pandemic may be identified as a serious risk. The price of industrial commodities increased, while the world market price of unprocessed food declined in May.

1.2. Domestic real economy developments

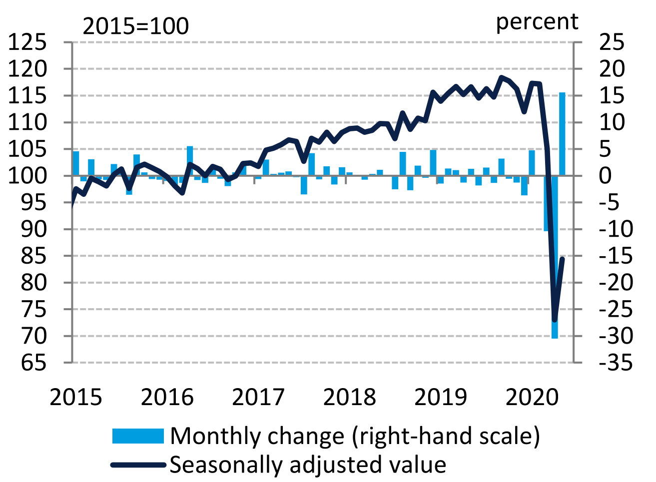
The negative impacts of the coronavirus are reflected in the production indicators of the second quarter. In May 2020, on the whole, total employment fell by 134,300 year-on-year to 4,399,000 persons. The number of the unemployed was 215,000, which exceeds the number registered in May 2019 by 54,800 persons, and thus the seasonally adjusted unemployment rate rose to 4.8 percent.

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

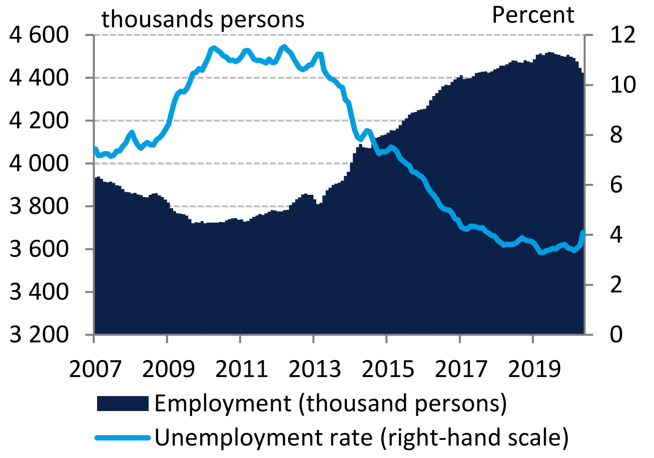
According to the HCSO's detailed data release – in accordance with the preliminary data release – **gross domestic product grew by 2.2 percent year-on-year in the first quarter of 2020** (Chart 3), which puts Hungary in the fifth position in the growth ranking of the European Union. The carry-over effect resulting from last year's sound economic performance also contributed to this economic performance, favourable even in an international comparison. **Hungary's GDP fell by 0.4 percent quarter-on-quarter. The impacts of the coronavirus were only partly reflected in first quarter data.** On an annual basis, almost all sectors contributed to economic growth.

The second quarter's production indicators received to date already reflect the temporarily decreasing economic performance resulting from the coronavirus. According to the HCSO's preliminary data release, **industrial output** was down by **30.7 percent** year-on-year in May 2020. Following its low registered in April, production (based on seasonally and working-day adjusted data) **rose by 5.6 percent on a monthly basis** (Chart 4). Production volume declined in all of the manufacturing subsectors. **Representing the largest share, the decline in the automotive industry was particularly large. Hungarian manufacturing PMI rose from 40.3 points in May to 47 points in June.**

Based on preliminary data, **exports and imports fell by 28.9 percent and 25.5 percent, respectively, in euro terms, year-on-year in May 2020** according to the HCSO's data release. Hungary's external trade turnover considerably grew compared to the previous month; the level of exports and imports exceeded that of the previous month by 19.4 and 8.7 percent, respectively. Merchandise trade surplus amounted to EUR 155 million, representing a year-on-year decrease of EUR 491 million. **The balance adjusted for VAT residents** fell by EUR 321 million on an annual basis, and as a result, **it showed a deficit of EUR 162 million** in May**.**

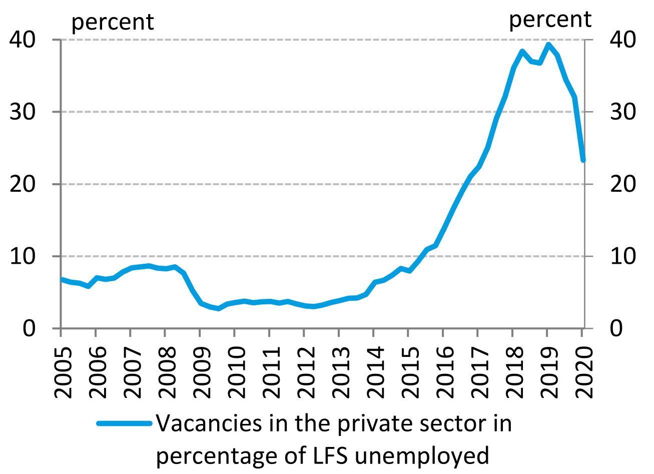
Construction output was down by 20.1 percent year-on-year and by 20.3 percent relative to the previous month In May 2020, based on the seasonally and working-day adjusted data. Output of both main construction groups decreased: construction of buildings by 24 percent and other construction by 15.6 percent, in annual terms. The volume of new contracts decreased by 7.4 percent year-on-

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

year. The month-end volume of construction companies' contract portfolio fell short of the value at end of May 2019 by 14.5 percent.

In May, **the volume of retail sales** (including sales of vehicles and components) **was down by 3.2 percent year-on-year, based on the seasonally and calendar adjusted data. The easing of the restrictions implemented during the pandemic emergency situation had the greatest impact on the turnover of non-food shops.** Turnover substantially grew at the mail order shops and web retail sales and general stores selling industrial goods, while retail sales of grocery products, furniture and appliances increased moderately; sales in all other product groups saw a more moderate decline than in April. Demand for durable goods continues to fall short of the level a year earlier. Despite the lifting of the curfew measures, fuel consumption continued to decline considerably compared to the level last year. In addition, vehicles and components sales and the number of new vehicle registrations declined in May on an annual basis.

In line with the curfew measures and the border shut-down, tourism fell sharply in May. **Compared to last year, nights spent at tourist accommodations in Hungary fell by 93 percent.**

1.2.2. Employment

Based on the data of the Labour Force Survey (LFS), **in May 2020 total employment fell by 134,300 to 4,399,000 persons year-on-year** (Chart 5). The number of the unemployed was 215,000, exceeding the number of unemployed persons registered in May 2019 by 54,800 persons. As a result, **the seasonally adjusted unemployment rate rose to 4.8 percent.** According to the LFS methodology, **in May the number of the economically inactive decreased by 59,000 compared to April; 31,000 of them were classified as employees and 28,000 as unemployed**. After the lifting of the curfew measures, the 28,000 unemployed persons were unable to find a job despite the fact that they actively sought employment and would have been able to start work within two weeks. Accordingly, based on the international standard methodology they were registered as unemployed persons. Based on the data published by the National Employment Service (Nemzeti Foglalkoztatási Szolgálat - NFSZ), in May 2020, the number of registered jobseekers in Hungary was 363,300, exceeding the year-on-year figure by 110,000 persons.

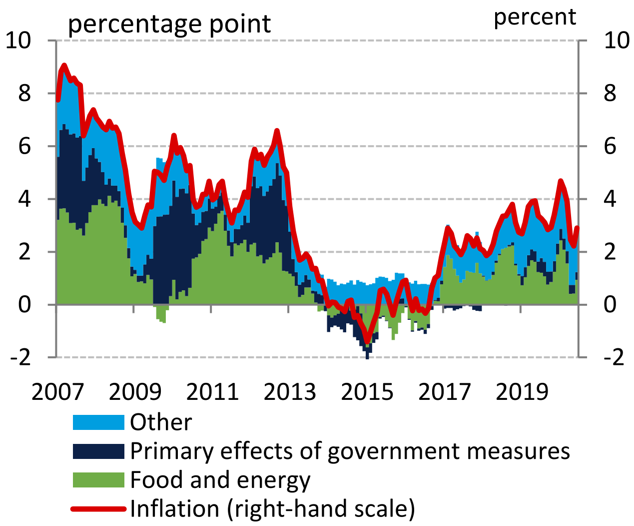
In the first quarter of 2020, based on the number of vacancies, **corporate labour demand continued to decline**

in a wide range of sectors. In addition to manufacturing, the decline is primarily linked to the trade, real estate transactions, professional sectors, and to the sectors supporting administrative and services activity. The labour market **tightness indicator** calculated from the ratio of job vacancies and unemployed persons, slackened further – similarly to the previous quarters – and in the first quarter fell to the level registered at the beginning of 2017 (Chart 6).

1.3. Inflation and wages

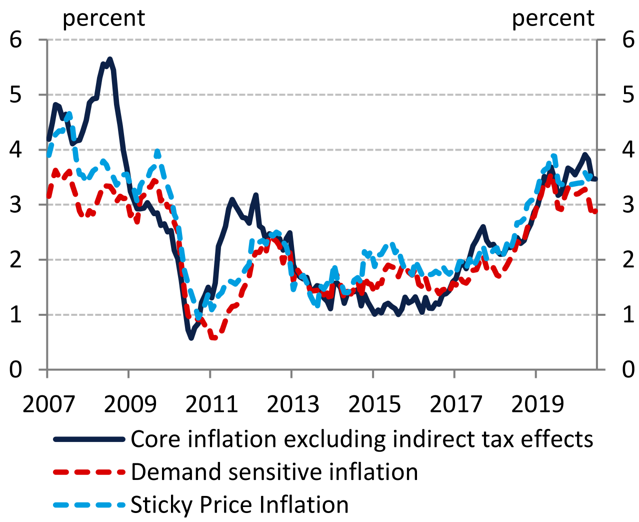
In June 2020, inflation calculated on a year-on-year basis was 2.9 percent, while core inflation and core inflation excluding indirect taxes stood at 4.0 and 3.5 percent, respectively. Of the underlying inflation indicators capturing persistent trends, the price index of demand sensitive and sticky price products and services essentially remained unchanged compared to the previous month. In April 2020, gross average wages in the private sector rose by 7.7 percent year-on-year. The monthly increase in regular average wages exceeded the rate registered in previous years, while bonus payments were similar as last year.

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 April 2020, gross average wages in the private sector rose by 7.7 percent year-on-year. The monthly increase in regular average wages exceeded the rate in previous years, and bonus payments were similar as last year. **Wage growth within the private sector showed high volatility. In the manufacturing sector there was practically no wage increase,** while in the market services sector HCSO registered a growth over 10 percent. The economic consequences of the coronavirus pandemic had shown their effects as early as April. Average wages declined in one of the most affected sectors, i.e. accommodation and catering (by 2.2 percent), and in the smaller industrial sectors (mining, electricity). HCSO registered the highest wage growth in healthcare (15.5 percent), construction (12.2 percent) and trade (11.1 percent).

1.3.2. Inflation developments

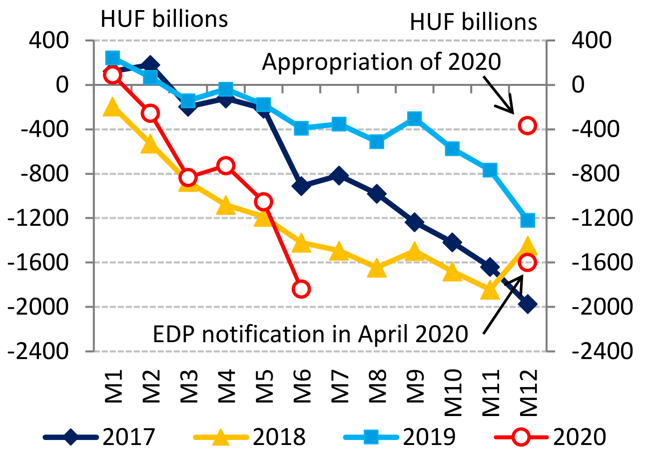
In June 2020, inflation calculated on a year-on-year basis was 2.9 percent, while core inflation and core inflation excluding indirect taxes stood at 4.0 and 3.5 percent, respectively (Chart 7). Relative to the previous month, inflation increased by 0.7 percentage points, while core inflation remained unchanged. The increase in inflation is primarily attributable to the growth in the fuel price index, partly due to the base effect. Within core inflation excluding indirect taxes, inflation of market services declined from 4.8 percent to 4.7 percent, while the price index for industrial goods remained low, below 1 percent. Inflation of processed food in June fell further from the value in May and stood at 6.1 percent.

Of the underlying inflation indicators capturing persistent trends, the price index of demand sensitive products and sticky price products and services remained broadly unchanged compared to the previous month (Chart 8). In May 2020, agricultural producer prices increased by 7.1 percent in annual terms, while domestic sales prices in sectors of consumer goods increased by 5.5 percent.

1.4. Fiscal developments

The central sub-sector of the general government closed with a deficit of HUF 785 billion in June 2020, and thus the deficit accumulated since the start of the year rose to HUF 1,837 billion by the end of June 2020. The higher cash deficit, relative to the previous year, is primarily attributable to the economy protection measures, the one-off income supplement paid to health workers and health sector employees, the pre-financing of EU transfers and to the decline in tax revenues.

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



Source: Budget Act of 2020, Hungarian State Treasury, National Reform Programme 2020

The central sub-sector of the general government closed with a deficit of HUF 785 billion in June 2020, and thus the deficit accumulated since the start of the year rose to HUF 1,837 billion by the end of June 2020 (Chart 9).

In June 2020, budget revenues fell short of those a year ago by HUF 83 billion. Tax revenues declined by 5 percent year-on-year, which is partly attributable to the economy protection measures and partly to the deceleration of the economy caused by the virus. Gross VAT revenues declined by 10 percent, excise tax revenues by 4 percent, social contribution tax and contribution revenues by 10 percent and personal income tax by 7 percent compared to last June.

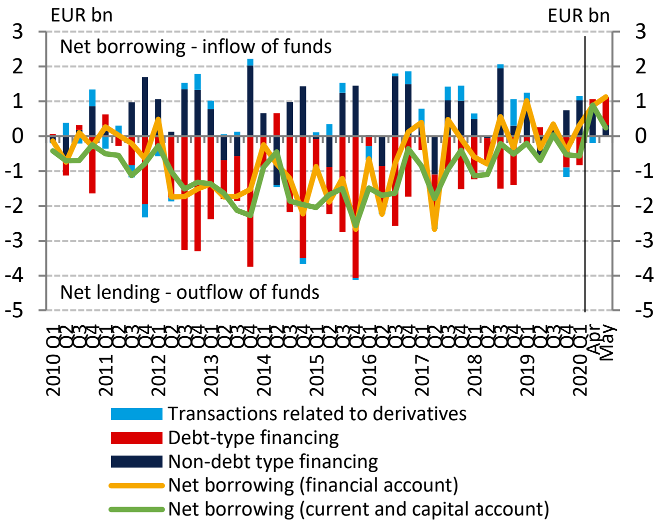
Expenditures of the central sub-sector were up by HUF 489 billion year-on-year. The growth in expenditures resulted from the implementation of the economy protection measures, and the one-off extraordinary income supplement paid to health workers and health sector employees in recognition of their extra work during the emergency.

According to the HCSO data release related to the balance of the general government in the first quarter, **the accrual-based government budgetary position** was -1.5 percent of GDP, while gross government debt amounted to 66.6 percent of GDP based on the MNB's financial accounts data.

1.5. External balance developments

In May, net borrowing was EUR 237 million, while current account deficit amounted to EUR 412 million. External balance indicators improved in a monthly comparison, which is due to the growth in export in excess of imports. As regards the financing side, capital inflows were mostly linked to the rise in net external debt and net foreign direct investments also grew substantially.

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 May, net borrowing of the economy was EUR 237 million, while current account deficit amounted to EUR 412 million. The major fall in the goods deficit was attributable to the growth in exports in excess of imports, which was due to the substantial improvement in industrial production compared to previous month. Imports were increased by the costs of the prevention of the pandemic. The services surplus stood at a similar low value as in the previous month. Meanwhile, the absorption of EU transfers also made a positive contribution to the country's net lending in May (Chart 10). Based on preliminary data, the income deficit considerably decreased year-on-year.

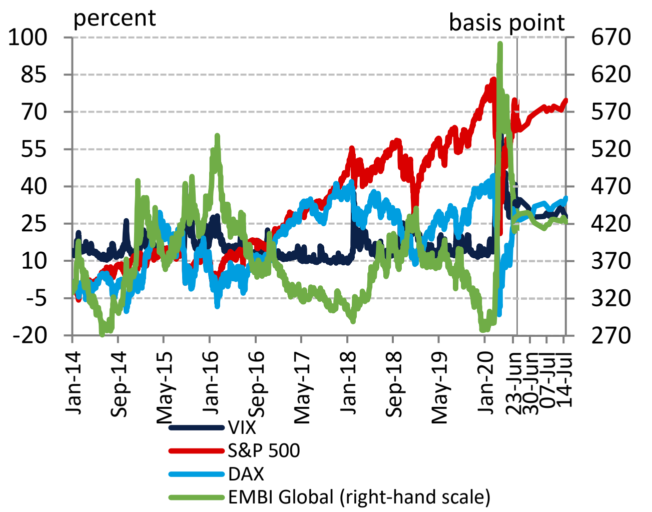
According to financial account data, foreign direct investments and debt liabilities of the economy increased in May. According to the financial account data, the net borrowing amounting to more than EUR 1.1 billion was partly attributable to the inflow of foreign direct investments in the amount of almost EUR 500 million, despite the usual dividend payments of foreign-owned companies in this period. Net external debt of the economy rose mostly due to the banking sector, while the general government’s indicator decreased as a result of the growth in foreign exchange reserves and the decline in liabilities.

2. Financial markets

2.1. International financial markets

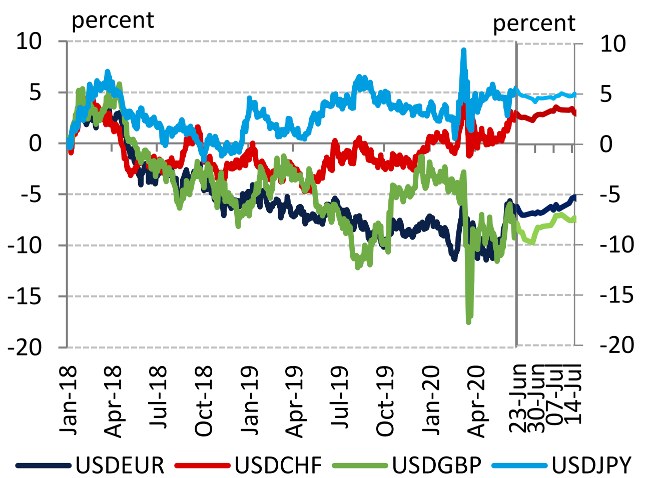
In the period since the last interest rate decision global investor sentiment varied, while global risk indicators still stand at a high level. The VIX index, the key measure of equity market volatility and the developed bond market MOVE index declined. Developed foreign exchange markets were characterised by the depreciation of the dollar. Oil prices rose further. In the emerging markets, China was in the investors' focus after the repeated deepening of the conflict between the USA and China.

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



Source: Bloomberg

Chart 12 Developed market FX exchange rates



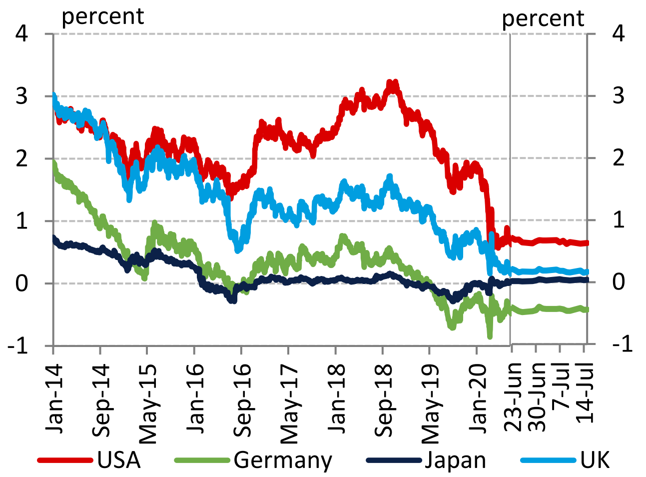
Note: Positive values indicate the strengthening of the variable (second) currency.
Source: Reuters

In the period since the last interest rate decision investor sentiment varied, while global risk indicators still stand at a high level. The improving sentiment was supported by the fall in investors' concerns related to the coronavirus pandemic and the positive news about the development of the vaccine. The macroeconomic indicators published last month also came as a positive surprise compared to the investors' expectations, although their absolute value is typically still unfavourable. Under favourable sentiments stock exchange indices recovered further from the fall suffered in the coronavirus crisis, while yields on the developed long-term government securities slightly declined. In parallel with the pick-up in global demand, oil prices rose by 1-2 percent, despite the fact that OPEC+ commenced negotiations on the reduction of production cuts and at the end of the period approved it.

The VIX index, the key measure of equity market volatility, decreased by 3 percentage points to 29 percent, while the developed bond market MOVE index declined by 7 basis points to 47 basis points. The rise observed in the previous months in developed stock market indices continued, registering a growth of 2-3 percent, and the MSCI composite index, which measures emerging market performance, also increased at a higher rate (by 5 percent). The latter was mostly attributable to the major, more than 8 percent, soar observed at the Chinese stock exchange, for the dampening of which later government measures were taken to prevent overheating. Developed foreign exchange markets were characterised by the decreasing volatility and the depreciation of the dollar, which also reflects a rise in risk appetite. The dollar depreciated by roughly 0.9 percent against the euro, and by 0.3 percent against the pound sterling (Chart 12). The price of gold still implies cautious investor behaviour, since it rose further, by 2 percent, during the period under review, and thus it stands at USD 1,807/oz.

Developed bond yields have declined slightly since the last interest rate decision (Chart 12). The US and German

Chart 13 Yields on developed market long-term bonds



Source: Bloomberg

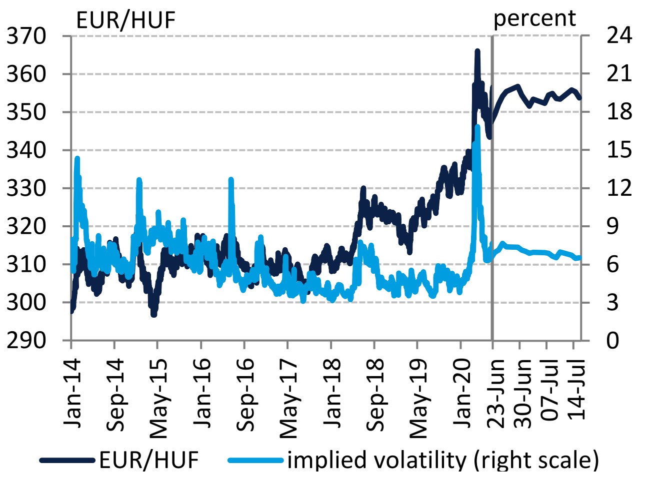
10-year yields fell by 9 and 4 basis points, to 0.62 and -0.45 percent, respectively (Chart 13). **Emerging countries' bond yields showed a mixed picture.** In the CEE region, Hungarian, Romanian and Czech 10-year yield rose by 32, 15 and 10 basis points, respectively, while the Polish one fell by 2 basis points. Greater fall was observed in the Philippine (-65 basis points) an the Brazilian (-56 basis point) yields.

Of the emerging market countries, last month the focus was on China, since the US - China conflict was again intensified. The USA revoked the special status of Hong Kong and threatened high-ranking Chinese officials with sanctions after China has tightened national security regulations in Hong Kong. These measures may have negative impact on the Hong Kong economy, which has already underperformed before as well due to the quarantines related to the coronavirus and to the previous demonstrations. China promised to take countermeasures in response to the US actions, which may further exacerbate the diplomatic conflict between the two countries. In parallel with this, the Chinese stock market strongly grew and the 16-percent rise in the stock exchange index just in a few days started to show signs of overheating, for the dampening of which the Chinese government ordered the public funds to reduce their equity portfolio and cool the stock market growth. On the whole, the Shanghai and Shenzhen stock exchange indices rose by 8 and 10 percent, respectively.

2.2. Developments in domestic money market indicators

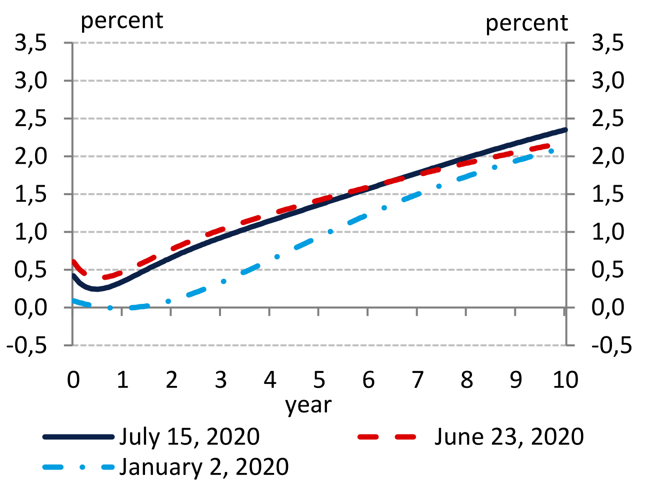
In the period since the last interest rate decision, the forint, similarly to the emerging market currencies, depreciated against the euro. Government securities market yields declined on maturities up to 5 years, while they rose on the longer maturities, particularly over the 10-year, maturities. Demand at the government securities auctions was strong; at the auctions of the longer-term securities the Government Debt Management Agency accepted higher volumes than previously announced.

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 June interest rate decision, forint exchange rate against the euro depreciated by 1.3 percent, from 349.2 to 353.6 in the deteriorating global environment at the beginning of the period, which in the period of the interest rate cut and the quarter-end deleveraging exceeded the depreciation of the currencies of the region (Chart 14). Of the currencies of the CEE region, the Czech koruna and the Polish zloty depreciated against the euro by 0.2 percent and 0.6 percent, respectively, while the Romanian leu essentially remained unchanged.

The government yield curve became steeper (Chart 15). The 1-3 year section of the yield curve registered a decrease of 10-13 basis points and 1-10 basis points on the middle section, while an increase of 1-15 basis points was observed at the longer end in the past period. As a result of the fall in short-term government securities yields and the rise in long-term yields, the steepness of the yield curve increased.

In the past month, both the discount Treasury bill and government bond auctions were characterised by strong demand. At the 3 and 12-month Treasury bill auctions, the Government Debt Management Agency did not accept higher volume than announced despite considerable demand. The average yield at the 3-month auctions declined from 0.49 percent to 0.25 percent, and the average auction yield at the 12-month Treasury bill auctions dropped from 0.42 percent to 0.36 percent. Demand was also strong for the 3- and 5-year government securities; at the 5-year auctions, the Government Debt Management Agency accepted bids in higher volume than announced on several occasions. The average yield on the 10-year government security auction was 2.42 percent, representing a rise of 11 basis points compared to the last average auction yield of the previous period. The latest average yield on 5-year government security auction rose by 15 basis points to 1.43 percent, while at 3-year securities it rose by 9 basis points to 1.03 percent. The Hungarian 5-year CDS spread fell by 1 basis point during the period under review, thus at present it stands at 73 basis points.

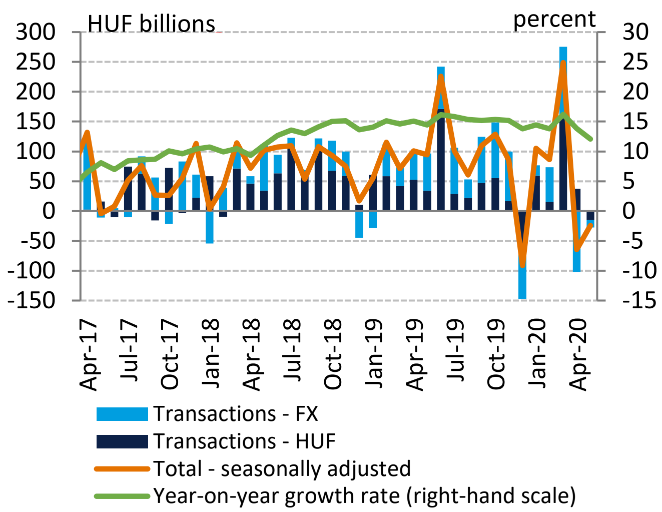
Non-residents' holdings of forint government securities

decreased. Non-residents' forint government securities holdings fell by HUF 30 billion to HUF 4,349 billion, in spite of this, at the end of the period the market share of forint government securities held by non-residents increased from 23.12 percent to 23.25 percent.

3. Trends in lending

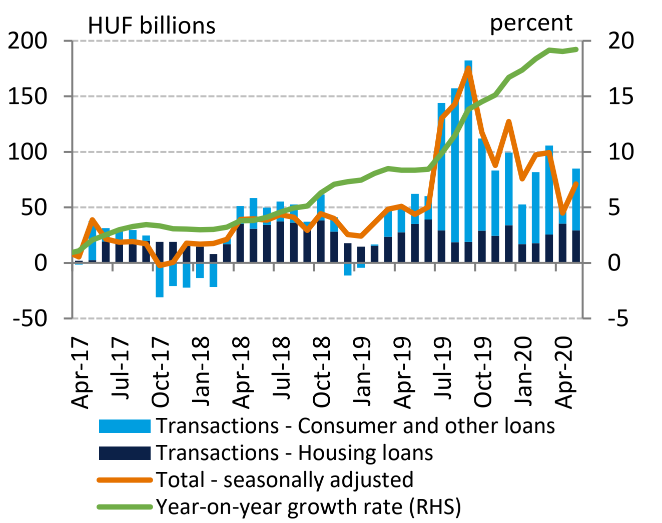
In May 2020, outstanding borrowing of non-financial corporations declined by HUF 28 billion, as a result of the fall in outstanding forint borrowing by HUF 15 billion and in foreign currency loans by HUF 13 billion. Outstanding borrowing of households grew by more than19 percent until the end of May in annual terms, partly due to the technical effect of the missing instalment payments resulting from the moratorium on loan repayments, and partly due to the lifting of the restrictive measures aiming at isolation.

Chart 16 Net borrowing by non-financial corporations



Source: MNB

Chart 17 Net borrowing by households

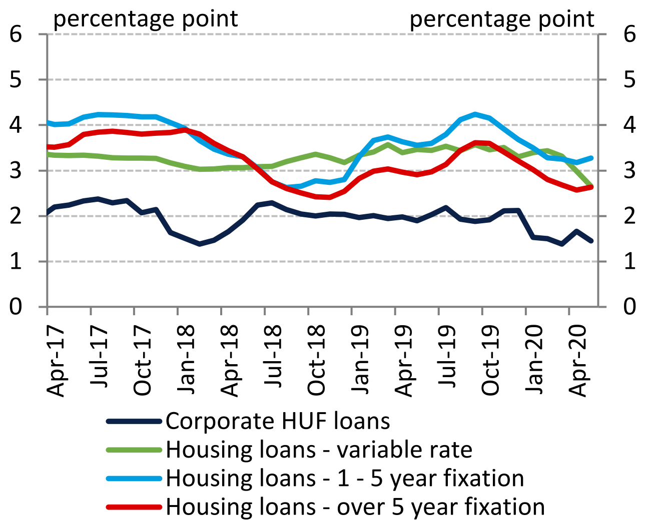


Source: MNB

In May 2020, outstanding borrowing of non-financial corporations declined by HUF 28 billion, as a result of the fall in outstanding forint borrowing by HUF 15 billion and in foreign currency loans by HUF 13 billion. As a result, the annual growth rate declined close to 12 percent (Chart 16). At the same time, there was a pick-up in the number of new disbursements in May, when credit institutions disbursed new loans in the amount of HUF 207 billion, which represents a year-on-year growth of 40 percent (and it is one and a half times higher than the value registered in April). Credit institutions concluded forint contracts under the FGS scheme in the amount of HUF 38 billion with corporations, which accounted for almost 60 percent of the entire corporate sector's forint investment loans and practically the total monthly volume of the SME sector's forint investment loans.

Outstanding borrowing of households grew by more than 19 percent until the end of May in annual terms (Chart 17)**, partly due to the technical effect of the missing instalments resulting from the moratorium on loan repayments, and partly due to the lifting of the isolation measures.** However, due to the moderate economic activity and the banks' more prudent risk appetite, new disbursements of housing loans and personal loans both decreased during the month in an annual comparison. Despite the deteriorating economic environment, there is still strong demand for state-subsidised loan schemes, which may support lending to households.

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 1.45 percent in May 2020, representing a decrease of 0.17 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) declined further during the month** and amounted to 2.65 percentage points. **The spread on products with interest rate fixation periods longer than one year, up to 5 years and more than 5 years also rose slightly compared to April. The average spread on housing loans with interest rate fixation periods longer than one year and up to 5 years reached 3.28 percentage points in May, while the spread on products with interest rate fixation periods of more than 5 years was 2.63 percentage points.**