INFLATION REPORT

JUNE
2014

'...we shall make no attempt at anything that is contrary to the benefit and interest of the public.'

Mátyás Hunyadi

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Pursuant to Act CCVIII of 2013 on the Magyar Nemzeti Bank, the primary objective of Hungary's central bank is to achieve and maintain price stability. Low inflation ensures higher long-term economic growth and a more predictable economic environment, and moderates the cyclical fluctuations that impact both households and companies.

In the inflation targeting system in use since August 2005, the Bank has sought to attain price stability by ensuring an inflation rate near the 3 per cent medium-term target. The Monetary Council, the supreme decision-making body of the Magyar Nemzeti Bank, performs a comprehensive review of expected developments in inflation every three months, in order to establish the monetary conditions consistent with achieving the inflation target. The Council's decision is the result of careful consideration of a wide range of factors, including an assessment of prospective economic developments, the inflation outlook, financial and capital market trends and risks to stability.

In order to provide the public with a clear insight into how monetary policy works and to enhance transparency, the Bank publishes the information available at the time of making its monetary policy decisions. The Report presents the inflation forecasts prepared by the Directorate Economic Forecast and Analysis, the Directorate Monetary Policy and Financial Market Analysis, the Directorate Fiscal Analysis and the Directorate Financial System Analysis, as well as the macroeconomic developments underlying these forecasts. The forecast is based on the assumption of endogenous monetary policy. In respect of economic variables exogenous to monetary policy, the forecasting rules used in previous issues of the Report are applied.

The analyses in this Report were prepared under the direction of Dániel Palotai, Executive Director of the Directorate Monetary Policy. The analyses in this Report were prepared by staff at the MNB's Directorate Economic Forecast and Analysis, Directorate Monetary Policy and Financial Market Analysis, Directorate Fiscal Analysis and Directorate Financial System Analysis. The Report was approved for publication by Dr. Ádám Balog, Deputy Governor.

The Report incorporates valuable input from other areas of the MNB and the Monetary Council's comments.

The projections are based on information available for the period ending 18 June 2014.

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THE MONETARY COUNCIL'S STATEMENT ON MACROECONOMIC DEVELOPMENTS AND ITS MONETARY POLICY ASSESSMENT

Since August 2012, the Monetary Council has reduced the central bank base rate significantly.

The reductions in the base rate during the period were justified by the low inflation environment, subdued medium-term inflationary pressures and a degree of spare capacity in the economy. Risk perceptions associated with the economy were also generally supportive. In the Council's judgement, the significant easing of monetary policy implemented so far has helped the Bank achieve the inflation target in the medium term and has contributed to the strengthening of domestic economic growth. The Council's aim is still to maintain a balanced and conservative approach to policy. In addition to the primary goal of meeting the inflation target, the Council also takes into account the condition of the real economy and incorporates financial stability considerations into its decisions.

Inflation is likely to remain low for an extended period and to reach levels around 3 per cent consistent with price stability only at the forecast horizon.

In the Council's judgement, inflation is likely to remain well below the 3 per cent target in 2014, before moving into line with the medium-term inflation target from the second half of 2015. The dynamics of consumer price inflation have been historically low in recent months. Subdued inflation in external markets, the degree of unused capacity in the economy, moderate wage growth, the fall in inflation expectations and the reductions in regulated prices, implemented in a series of steps, have all contributed to the development of a low inflation environment. At the forecast horizon, the domestic real economic environment is expected to continue to have a disinflationary impact, although to a declining extent. Persistently low inflation alongside rising domestic demand reflects mainly the positive impact of moderate wage growth due to continued slack in the labour market and other supply-side cost shocks. The persistently low inflation environment is expected to help anchor inflation expectations playing a key role in determining the nominal path of the economy more firmly around the Bank's inflation target.

In the Council's judgement, the Hungarian economy returned to a growth path in 2013. Looking ahead, economic growth is likely to continue.

Economic activity has picked up gradually in the past quarters, with output rising across a wide range of sectors. Looking ahead, Hungarian economic growth may continue in a more balanced pattern than previously. Rising exports are likely to play an important role as a source of growth in the coming years as well. In addition, domestic demand is also expected to strengthen further. Investment is likely to continue accelerating, reflecting the improvement in the outlook for activity, the easing in credit constraints also due to the Bank's Funding for Growth Scheme and the increasing use of EU funding. Household consumption is also likely to grow gradually, resulting from the expected increase in the real value of disposable income and the reduced need for deleveraging. Meanwhile, the behaviour of a large number of households continues to be influenced by the ongoing reduction in debts accumulated in the years prior to the crisis and the gradual easing in credit conditions. As a result, propensity to save is likely to remain persistently above levels seen in the period prior to the crisis. Despite the pick-up in domestic demand, capacity utilisation is expected to improve only gradually due to the protracted recovery in Hungary's export markets.

Financing capacity stabilising at high levels; falling external debt.

The external position of the economy continued to improve towards the end of 2013, as reflected in the significant decline in external debt ratios. The trade surplus, while remaining substantial in the coming years even as import picks up due to increasing consumption and investment, is likely to keep the current account surplus high over the entire forecast period. The slight decline in the income balance deficit is expected to contribute to Hungary's external position remaining strong. On balance, the external financing capacity of the economy is likely to remain high despite the slight fall in EU transfers due the new budget cycle. In line with this, the country's debt ratios, key indicators in terms of the country's vulnerability, are likely to continue to improve. At the same time, the Bank's self-financing programme is expected to help reduce the country's gross external debt.

The Hungarian risk premium has declined significantly in the past quarter. Volatility fell in financial markets.

International investor sentiment was volatile in the past quarter, mainly reflecting the reduction in the pace of the Fed's asset purchases, the ECB's interest rate cut and announced new package of policy measures and the continuation of the conflict between Ukraine and Russia. Domestic risk premia have fallen significantly since publication of the March *Report*. The CDS spread, foreign currency bond spreads and long-term yields declined. The exchange rate appreciated. The volatility of the major risk indicators fell relative to the previous quarter. The announcement of the Bank's self-financing concept also contributed to the improvement in risk perceptions associated with the economy. Compared with other emerging market economies, Hungary's persistently high external financing capacity and the resulting decline in external debt have contributed significantly to the reduction in its vulnerability. The Monetary Council will continue to closely monitor developments in the global financial environment.

The macroeconomic outlook is surrounded by both upside and downside risks.

In connection with the baseline projection in the June *Report*, the Monetary Council identified three alternative scenarios which might significantly influence the future conduct of monetary policy. In the alternative scenario assuming a persistently low external inflation environment and a slower-than-expected recovery in external demand, the inflation target may be achieved with looser monetary conditions than assumed in the baseline scenario. In the risk scenario assuming an unfavourable external environment and higher investor risk aversion, inflation moves in line with price stability in the medium term under considerably tighter monetary conditions than implied by the baseline projection. A third scenario, assuming a pick-up in domestic employment and consumption, resulting in stronger growth in domestic economic activity, also implies a tighter monetary policy stance.

After reviewing the projection in the June *Report*, the Council judges that there remains a degree of unused capacity in the economy and inflationary pressures in the economy are likely to remain moderate for an extended period. The negative output gap is expected to close gradually at the monetary policy horizon; however, achieving price stability in the medium term points in the direction of monetary easing and the macroeconomic outlook points in the direction of persistently loose monetary conditions. Considering the outlook for inflation and taking into account perceptions of the risks associated with the economy and the pick-up in economic growth, further cautious easing of monetary policy may follow; however, based on available information the central bank base rate has significantly approached a level which ensures the medium-term achievement of price stability and a corresponding degree of support for the economy. Over the coming period, changes in the domestic and international environment might influence this picture.

SUMMARY TABLE OF THE BASELINE SCENARIO
(FORECAST BASED ON ENDOGENOUS MONETARY POLICY)

	2013	2014	2015
	Actual	Projection	
Inflation (annual average)			
Core inflation	3,3	2,4	3,0
Core inflation without indirect tax effects	1,5	1,6	2,8
Inflation	1,7	0,0	2,5
Economic growth			
External demand (GDP based)	1,0	1,9	2,1
Household consumption expenditure	0,2	2,0	1,9
Government final consumption expenditure	1,4	1,4	-0,3
Gross fixed capital formation	5,8	8,4	3,9
Domestic absorption	0,8	3,1	1,9
Export	5,3	6,2	6,6
Import	5,3	6,7	6,5
GDP	1,1	2,9	2,5
External balance[1]			
Current account balance	3,0	3,1	3,3
External financing capacity	6,5	6,4	6,4
Government balance[1,5]			
ESA balance (2013 data is preliminary)	-2,4	-2,7	-2,6
Labour market			
Whole-economy gross average earnings	3,0	2,8	3,7
Whole-economy employment	1,6	3,5	0,8
Private sector gross average earnings[2]	3,6	4,2	4,0
Private sector employment	0,8	2,8	1,0
Unemployment rate	10,2	8,7	7,9
Unit labour cost in the private sector[3]	2,1	3,5	2,0
Household real income[4]	1,5	3,2	1,5

[1] As a percentage of GDP.
[2] According to the original CSO data for full-time employees.
[3] Private sector unit labour cost calculated with full time equivalent domestic employment.
[4] MNB estimate.
[5] With complete cancellation of free reserves.

1. INFLATION AND REAL ECONOMY OUTLOOK

Accelerating growth and further declines in inflation rates were the main characteristics of the Hungarian economy in recent months. In parallel with this upturn in economic activity, employment in the private sector also continued to increase. During the first part of the year, private sector wage dynamics remained below pre-crisis levels. The lower-than-expected inflation rate in the past period was essentially the result of favourable cost-side developments.

According to our forecast, inflation this year is likely to remain substantially lower than the MNB's medium-term target and may approximate the target by the end of the forecast horizon. Spare capacity in the economy, moderate wage dynamics due to the labour market slack, subdued imported inflation and this year's latest round of regulated price cuts all suggest that inflation may remain low in the coming quarters. Inflation remaining persistently below target may help to reduce expectations, which may contribute to sustaining price stability over the medium term.

We anticipate economic growth to continue over our forecast horizon. A gradual recovery is expected to continue in Hungary's export markets, facilitating further growth in exports. Domestic demand is becoming an increasingly important component of growth, with investments and consumption both having expanded at a higher-than-expected rate. Steady growth in domestic demand may result in higher imports, which could in turn moderate the growth contribution of net exports. Public investments implemented from EU funds play a crucial role in fostering investment growth in the national economy. Corporate investment is supported by the pick-up in economic activity and the declining cost of financing. Companies' access to financing is being facilitated by policy rate cuts and the Funding for Growth Scheme, as well as the use of EU funds. Household consumption is expected to continue its modest upward trend over our forecast horizon, due to the rise in real household income induced by improving labour market conditions and low inflation. By contrast, the saving rate is set to remain at a high level, given the ongoing reduction in household debt and the slow easing of households' precautionary saving motives.

We expect the external financing capacity of the economy to remain significant over our forecast horizon. The fiscal deficit may remain below the government's target. Consequently, economic growth can continue while external and fiscal balance can be preserved.

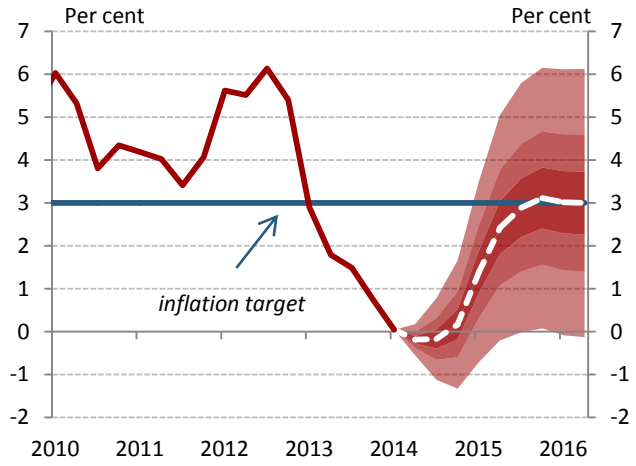
Thanks to growing economic activity, we project a rise in private sector employment. The expansion of the public work programmes also contributes to rising employment in the economy. Persistent slack in the labour market and the adjustment of inflation expectations help in sustaining moderate growth in wages.

The cyclical position of the real economy (the output gap) may remain negative across the entire forecast horizon, as a result of two opposing factors. Global underlying inflation trends are subdued, indicating weak inflationary pressure from the world economy. The output gap is persistently negative in Hungary's export markets, which also hinders the closing of the Hungarian output gap through lower capacity utilisation in the export industry. By contrast, the acceleration in domestic demand will result in the gradual weakening of domestic disinflationary forces. All things considered, the real economic environment will remain disinflationary over the entire forecast horizon. The output gap may close at the end of 2016.

1.1. Inflation forecast

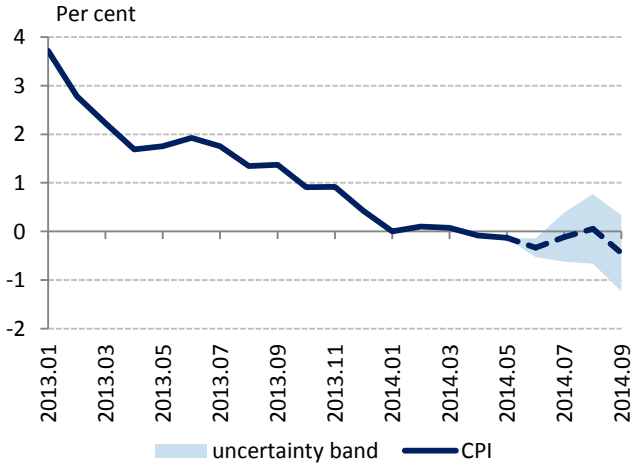
Compared to our March projection, we have lowered our forecast for inflation. Inflation is likely to remain below target both this year and in 2015, and only reach the medium-term target of 3 per cent by the end of our forecast horizon. Factors contributing to low inflation include weak price pressure from foreign trade partners, moderate wage dynamics, the negative output gap and the gradual decline of inflation expectations.

Chart 1-1: Fan chart of the inflation forecast



Source: MNB

Chart 1-2: Monthly evolution of near-term inflation forecast



Note: Annual change. The uncertainty band shows the root mean squared error of previous years' near-term forecasts.
Source: MNB

The consumer price index is likely to remain substantially below target this year, slightly below target in 2015 and to reach the 3 per cent price stability target only by the end of the forecast horizon (Chart 1-1). Over the entire forecast horizon, the inflation path is expected to be lower than projected in March.

According to our near-term forecast, the growth rate of prices may remain slightly negative in the months ahead (Chart 1-2). Over the near term, favourable developments in commodity prices and imported inflation, as well as a moderate demand environment and cuts in regulated energy prices may all promote a restrained inflation environment. Along with these factors, base effects may also have a significant impact on inflation (see Box 1-1). Given these base effects, inflation may temporarily fall significantly below zero in September. As the effects of last November's reduction in regulated energy prices begin to fade, we project inflation to rise starting from the end of the year.

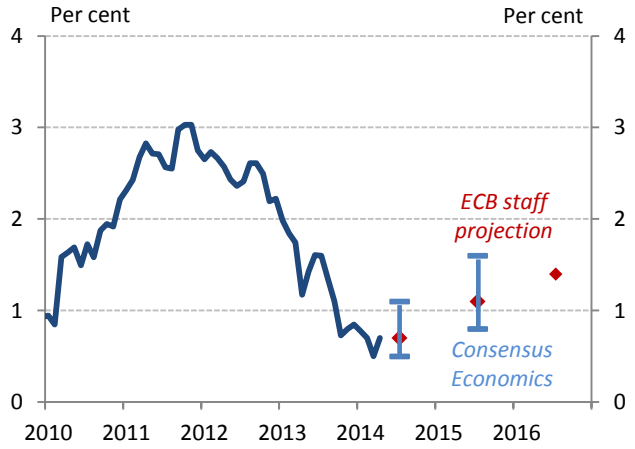
The factors determining medium-term inflation trends point to a low inflation environment. The output gap may remain negative over the entire forecast horizon, causing the real economic environment to exert disinflationary effects. While the narrowing of the output gap is being increasingly driven by domestic demand, the inflationary pressure from the Hungarian real economy may remain subdued.

The inflationary pressure from import prices is weak. Inflation in the eurozone, Hungary's main trade partner may remain well below the target of the ECB over our forecast horizon (Chart 1-3; reasons behind low external inflation are analyzed in special topic 6.1).

Unit labour cost in the private sector may rise at a moderate pace. Faster economic growth helps to improve productivity, while the labour market slack and inflation expectations dropping to near-target levels both promote restrained wage dynamics over our forecast horizon. Persistently low inflation may also reduce inflation expectations, thereby helping to sustain wage and price dynamics which are consistent with the inflation target over the medium term.

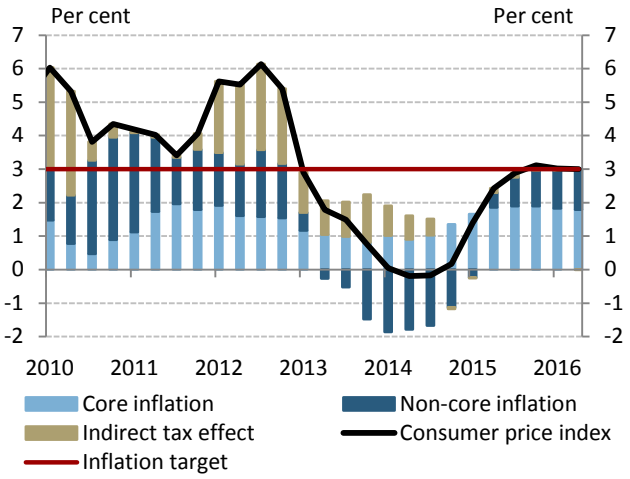
Core inflation excluding indirect tax effects may remain

Chart 1-3: HICP inflation in the eurozone



Note: Annual change. The chart shows the maximum and minimum of the individual forecasts in the Consensus poll.
Source: Eurostat, ECB, Consensus Economics

Chart 1-4: Decomposition of the inflation forecast



Source: MNB

Table 1-1: Details of the inflation forecast

		2013	2014	2015
Core inflation		3,3	2,4	3,0
Contribution to inflation		*2,2*	*1,6*	*1,9*
Non-core inflation	Unprocessed food	6,1	-4,9	3,8
	Gasoline and market energy	-0,9	-1,5	1,3
	Regulated prices	-3,7	-6,3	1,0
	Total	-1,2	-4,7	1,5
Contribution to inflation		*-0,5*	*-1,6*	*0,5*
Inflation		1,7	0,0	2,5

Source: MNB

moderate (Chart 1-4), primarily due to low imported price pressure and falling inflation expectations. In parallel with the revival in domestic demand, the rate of core inflation may gradually rise over the forecast horizon.

Price developments for non-core items may remain subdued over the entire forecast horizon. Crude oil prices in HUF have fallen since March[1], and unprocessed food prices also declined. Futures contracts for both crude oil and food products point to restrained dynamics.

The direct impact of government measures on inflation may remain low over our entire forecast horizon, thanks in part to the latest round of regulated price cuts that were passed at the beginning of 2014. Following this, our forecast assumes that regulated energy prices will remain unchanged until the end of the forecast horizon. Furthermore, we also expect a restrained rise in the regulated prices of non-energy items.

[1] In the second half of June, after the cut-off day of the Report, the spot price of Brent crude oil increased near USD 115 due to the escalation of the conflict in Iraq. Our projections do not take into account these recent developments.

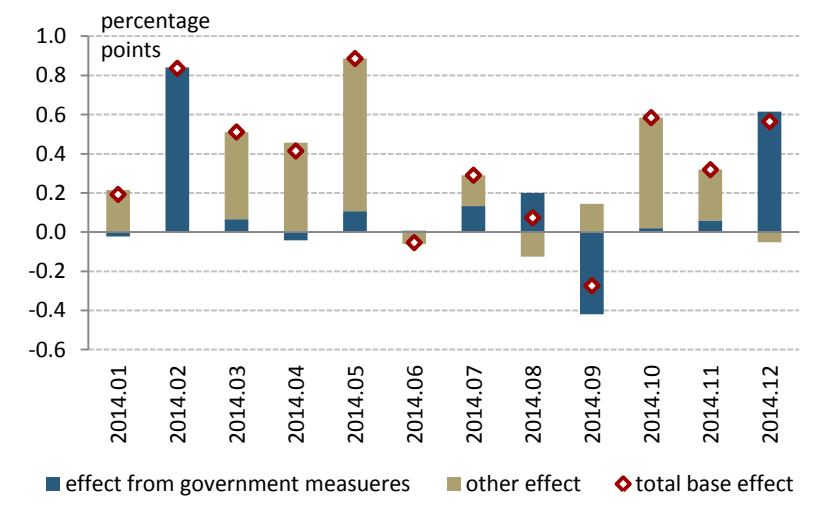
Box 1-1: Base effects impacting short-term inflation developments

The change in consumer prices compared to the corresponding month of the previous year is the principal measure of inflation. Changes in the inflation rate from one month to the next can be explained by two factors: short-term shifts taking place between the two most recent months, and price changes in the same month of the previous year. The latter is referred to the **base effect**, which can have a tangible impact on inflation. In an economic context, the base effect is defined as **the contribution of unusual changes in the CPI during the base period to changes in the annual rate of inflation**. In order to calculate the base effect, monthly changes in CPI during the base period must be compared to historic monthly changes.[2]

Our current short-term forecast is fundamentally shaped by base effects originating from extraordinary changes in prices that took place in 2013 (Chart 1-5), some of them related to **volatile developments in food and fuel prices**. Significant fuel-specific base effects are observed mostly in the October (positive) and December (negative) price indices. An additional upward base effect appears in October, due to the last year's unusual price decrease in airfares.

The impact of some **government measures** is also visible. From July onwards, the reduction in certain regulated prices (refuse disposal, water and sewage utility fees) will gradually disappear from the price index, with LP gas soon following suit given the mid-2013 price cut. This will have an upward effect on the inflation rates of this year's summer months, particularly in August. However, the gradual increases in tobacco prices that took place last year due to the retail margin hike will have an opposite effect from August. The resulting negative base effect will be most prevalent in September. As the financial transaction levy was raised last autumn, its base effect will no longer shape the inflation rate from September, thus suggesting a decline in the latter. By contrast, the base effect of last November's reduction in regulated energy prices will be registered as a notable inflation increasing effect in the December price index.

Chart 1-5: Impact of base effects on CPI this year



Note: The effect from government measures contains the effect of regulated prices, financial transaction levy, excise duty and increase of retail margin on cigarettes. Positve (negative) columns indicate that the base effects lead to an increase (decrease) of the price index.
Source: MNB calculation

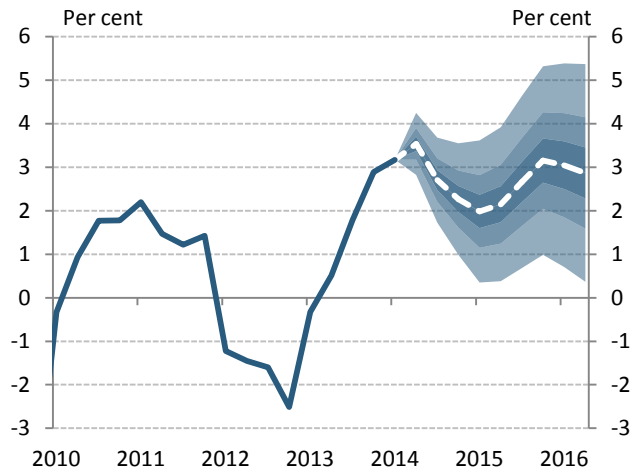
On the whole, changes in inflation this year will be substantially affected by the base effects originating from price changes implemented during 2013. In the first four months of 2014, these effects drove the inflation rate upwards, whereas the summer months, they have a near-zero impact. **While negative base effects are anticipated for September, the last four months of the year will be mostly subject to positive base effects.** Some of these can be attributed to volatile price changes in certain product categories, while others result from distinct government measures. These should be taken into account when projecting inflation and assessing incoming data.

[2] For a more detailed methodology, refer to the ECB's Monthly Bulletins for January 2005 and January 2007.

1.2. Real economy forecast

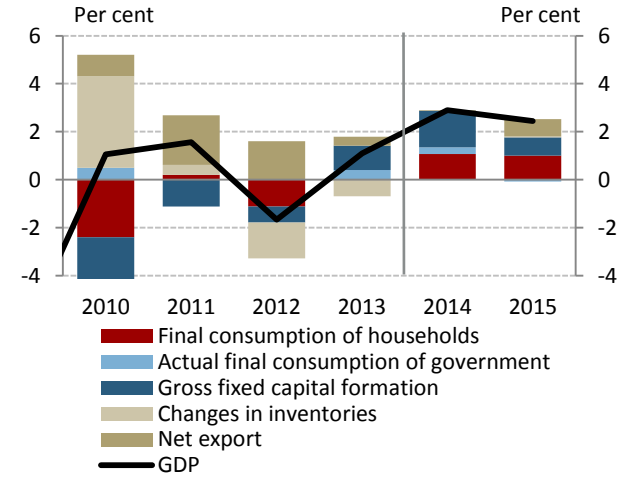
We expect steady economic growth over the forecast horizon. Along with export growth, domestic demand (both household consumption and investment) may also gradually accelerate. Investments in the national economy this year are primarily driven by public investments implemented from EU funds. The upturn in economic activity and lower financing costs both support private sector investments. The latter is helped by central bank interest rate cuts and the Funding for Growth Scheme. Household consumption may grow at a more moderate pace, facilitated by the rise in real household income induced by employment growth and low inflation. However, the saving rate is set to remain at a high level given the reduction of debt accumulated prior to the crisis.

Chart 1-6: Fan chart of the GDP forecast (based on seasonally adjusted and reconciled data)



Source: MNB

Chart 1-7: Evolution of GDP growth



Source: CSO, MNB

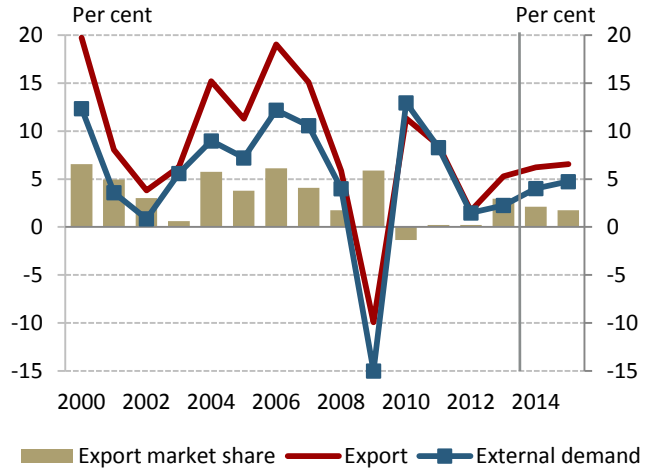
In the first quarter, economic growth picked up. The increase in added value was primarily attributable to the manufacturing and construction industries. Based on the available monthly indicators, growth may have been robust in the second quarter as well. On the expenditure side the pick-up in investment activity played a dominant role; consumption and exports also continued to grow.

Over the forecast horizon, economic growth may continue in a balanced structure (Charts 1-6, 1-7), with domestic demand becoming an increasingly important contributor to GDP growth. The improvement in global business activity, strong utilisation of EU funds, accommodative monetary conditions and the Funding for Growth Scheme all support economic growth. The Hungarian economy is expected to grow by close to 3 per cent this year, and by 2.5 per cent in 2015. Sustained growth is projected on a quarterly basis, the slowdown in the annual growth rate in the second half of 2014 is caused by a base effect.

Favourable external demand and the deployment of new automotive capacities can both facilitate exports (Chart 1-8). The euro area, Hungary's primary partner in foreign trade, is expected to see its economy recover gradually. By contrast, growth prospects have dimmed somewhat for emerging countries (in particular for Russia). Our expectations concerning developments in external demand have remained essentially unchanged. Exports may continue to be driven by automotive manufacturing. With the gradual deployment of additional production capacities, the number of vehicles manufactured in Hungary could increase by one-third in 2014, which may in turn contribute to a significant rise in export market share. Beside that, the spillover effects of the automotive industry's investment may improve the performance of suppliers, which could moderate the import content of vehicle exports. At the same time, the upswing in domestic demand could boost imports, which might reduce the growth contribution of net exports in the coming quarters.

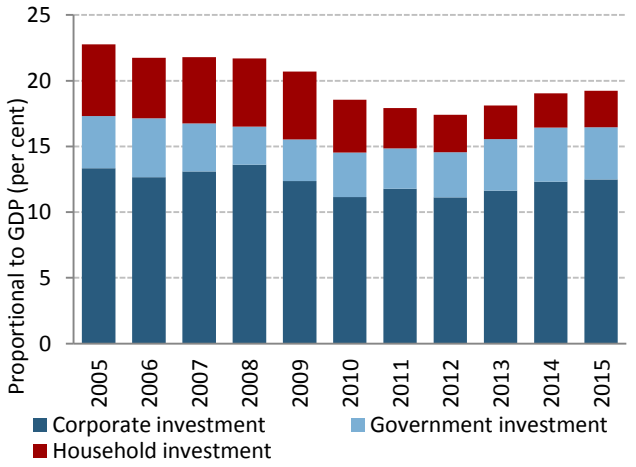
Public investments implemented from EU funds represent the primary driving force behind the significant

Chart 1-8: Changes in export market share



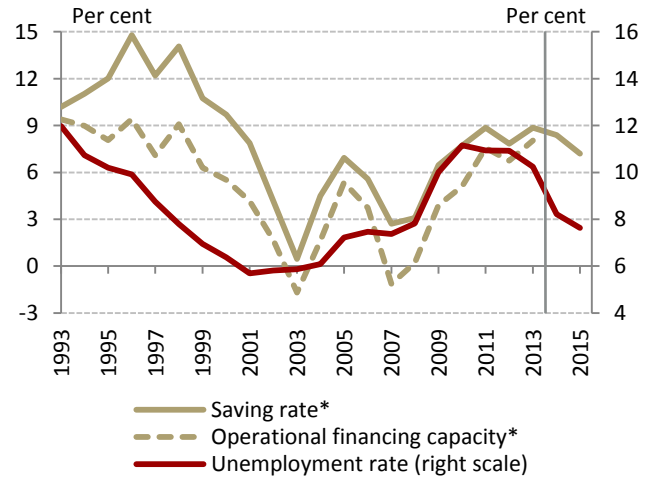
Note: Annual change.
Source: MNB

Chart 1-9: Development of sectoral investment



Source: CSO, MNB

Chart 1-10: Changes in the households' saving rate and the unemployment rate



Note: * As a proportion of disposable income.
Source: CSO, MNB

investment growth in the national economy (Chart 1-9). As the funds allotted to Hungary in the EU's 2007-2013 budgetary cycle are being drawn down at an increasing pace, the volume of co-financed investment projects has risen sharply in 2013-2014. Thereafter, in 2015, the volume of public investments may remain high (the timing of the utilization of EU funds is discussed in Box 5-1).

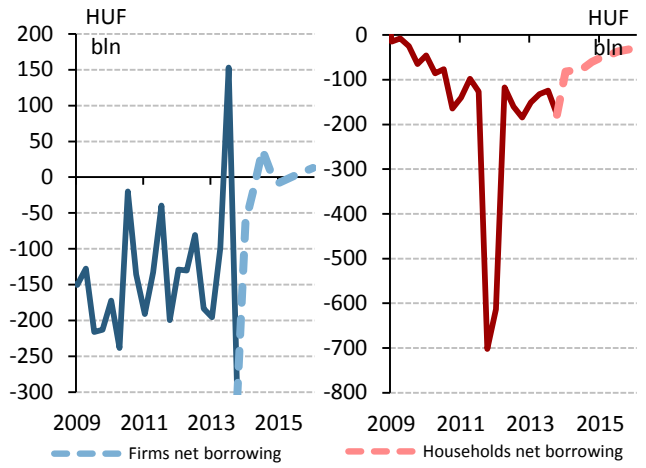
Corporate investment may also expand, in line with the improving real economic outlook and better financing conditions. Accommodative monetary conditions promote the reduction of financing costs. For small and medium-sized enterprises, the Funding for Growth Scheme contributes significantly to easing financing constraints, facilitating the implementation of investment projects preserving and expanding the capital stock. Corporate investment may also be stimulated by EU funds earmarked for economic development in the EU's upcoming budgetary cycle.

Households' consumption decisions continue to be primarily determined by the dual trends of an improving income position and a precautionary stance. Combined with a low inflation rate, improvements in labour market conditions are bringing a significant rise in the purchasing power of household income. On the other hand, a large share of the population remains focused on reducing debts which were accumulated before the crisis. Tight lending conditions and households' slowly easing precautionary stance can both contribute to keeping the household saving rate high. The sustained improvement in the employment outlook may help to ease precautionary considerations, leading to a mild decline in the savings rate (Chart 1-10). Additionally, the household investment rate may increase slightly from the current historically low level (Chart 1-12; for medium-term prospects of the real estate sector, see Box 1-2).

Corporate loans may remain stable in the years ahead, while household debt could continue to decline (Chart 1-11). Within the corporate loan portfolio, the Funding for Growth Scheme results in the continuous expansion of bank lending to SMEs.

Output will remain below its potential level over the entire forecast horizon. Household consumption, which is the most relevant component in terms of domestic inflationary pressure, will remain significantly below its pre-crisis level, despite its steady increase. Consequently, **the real economy will have a disinflationary effect over the entire forecast horizon. The output gap may close at the end of 2016.**

Chart 1-11: Quarterly forecast for household and corporate lending



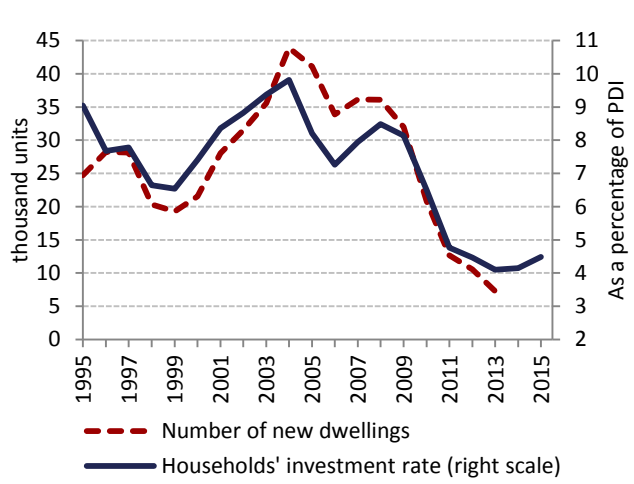
Note: Includes the fall in stocks of loans due to write-offs and sales, which means that regarding from transaction side in 2013 Q4 there is a 210 HUF billion fall.
Source: MNB

Box 1-2: Medium-term prospects for residential construction

The number of new homes built in Hungary has steadily declined since the onset of the crisis. This negative trend, however, seems to have reversed during the first few months of 2014. The number of new housing units built in 2014 Q1 was 51 per cent higher than during the corresponding period of the previous year. A 20 per cent increase was also observed in the number of building permits issued for housing purposes. However, the number of housing completions remains extremely low, barely reaching 25-30 per cent of the output of pre-crisis years (Chart 1-12).

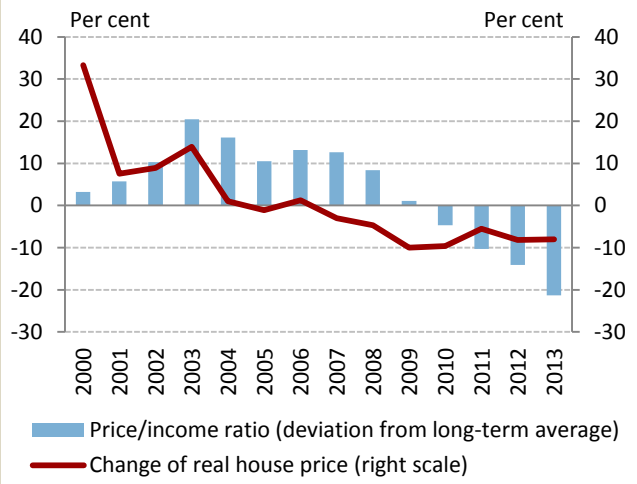
Housing prices have not yet shown signs of turning around: according to the FHB Housing Price Index, housing prices fell by 8 per cent in real terms in 2013 (Chart 1-13). The housing price statistics of the CSO indicate a stabilisation for newly built units, but the prices of pre-owned homes continue to fall. The housing market is still characterised by low turnover and the number of foreclosed properties in banks' portfolios remains high; both of these factors have the potential to reduce housing prices further.

Chart 1-12: Number of new dwellings and the houshold's investment rate



Source: CSO, MNB

Chart 1-13: The evolution of house prices



Source: FHB, CSO

This box explores the possible growth potential for the market of new homes in the coming years.

Over the long run, demand for housing is primarily shaped by certain social and economic variables such as underlying demographic trends, the income situation of the population and the relative return on property investments. Each of these has a different effect on the construction outlook:

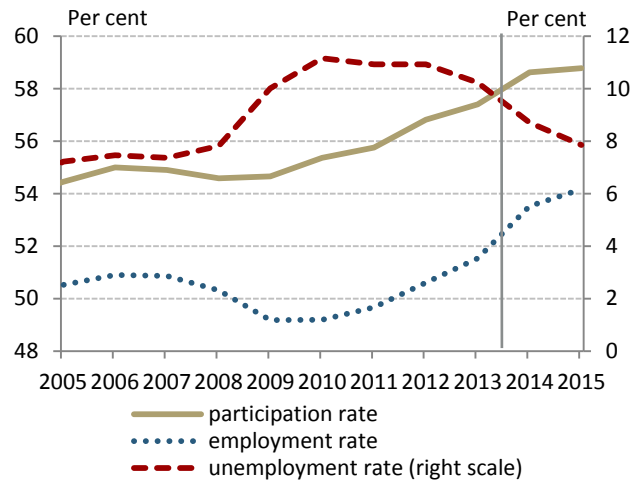
- **At the national level, demographic trends act as a constraint on the housing market recovery.** Hungary's population has declined by 216,000 over the past decade, whereas its housing stock has risen by 350,000. According to 2011 census data, 10.9 per cent of the country's 4.39 million dwellings are vacant, with this ratio increasing by 1.7 percentage points since 2001. The overall picture is nuanced by the fact that some regions, particularly Budapest, register positive migration rates. Furthermore, social processes have the power to change housing preferences. For instance, in view of the growing share of the elderly and single young adults within the population, demand for smaller homes may be triggered even with a declining population. Thus, in certain regions and for certain types of real estate, demographic trends can still be regarded as advantageous.
- **The income of the population may increasingly support a recovery in the housing market.** As household income continues to grow, demand for better quality real estate may also become stronger. Although there has been continuous progress in the average quality of Hungary's housing stock over the past decade, 7.6 per cent of homes were still rated as low-comfort units in 2011. The country's housing stock also falls significantly short of Western European standards in terms of energy efficiency. Therefore, rising income levels can provide an opportunity for meaningful improvements in housing conditions. At the same time, improvements in quality need not come in the form of newly built units, as progress can also be made through renovations.
- **Finally, the rate of return on housing as an asset type can rise.** Markets are currently characterised by low property prices and affordable financing options. In addition, along with the lower cost of financing, deposit rates and government bond yields have declined, making property investments a more attractive option and thereby improving the growth potential of the housing market. This picture is somewhat clouded by the fact that in the post-crisis era households have become more wary of the implications of long-term debt. Furthermore, pre-owned homes can be purchased just as well for investment purposes. Finally, given the ongoing decline in home prices, the entry point for new investors is difficult to identify.

On the whole, macroeconomic processes may pave the way for a recovery of the housing market. Over the medium term, demographic trends represent the most important restraint to growth. There is growth potential in improving the quality of the housing stock, which need not take the form of new constructions, as it is also possible through renovations. Therefore, instead of quantitative progress, the Hungarian housing market is more likely to undergo qualitative improvements over the medium term. That said, while we do expect to see a moderate rise in household investment volume over the next years, the household investment rate will persistently fall short of its pre-crisis level.

1.3. Labour market forecast

In parallel with the real economic upturn, employment in the national economy is expected to expand, with private sector job creation and public labour programmes both contributing. The unemployment rate may remain around 8 per cent over our forecast horizon. Part-time employment forms may continue to gain ground, and as a result employment could expand at a faster pace than the number of hours worked. In line with the slack labour market conditions and gradually declining inflation expectations, we expect wage dynamics to be subdued.

Chart 1-14: Employment, particiaption rate and unemployment in total economy



Source: MNB calculations based on CSO data

Chart 1-15: Evolution of productivity* and real wage costs in private sector

Note: * Calculated with full-time equivalent employment. Real compensation is deflated with the price index of private sector value added.

Source: MNB calculations based on CSO data.

In early 2014, employment continued to rise in the economy. This was made possible both by hiring in the private sector and by the expansion of public employment programmes. In addition, the activity rate also continued on its upward trend, while the unemployment rate dropped to its lowest level since the onset of the crisis.

Over the forecast horizon, we expect further increases in the participation rate (Chart 1-14), primarily on account of policy measures of previous years which aimed at increasing labour market participation. In addition, growing labour demand may enable unemployed persons who turned inactive to gradually return to the labour market.

In line with the upturn in economic activity, private sector labour demand may continue to increase. In the coming years, part-time employment may continue to gain ground. As a result, employment may expand at a faster pace than the number of hours worked in the years ahead. Furthermore, public employment programmes may continue to play a key role in shaping employment trends in the economy as a whole. In line with the government declarations, we expect the level of public employment to remain around 200 000 in the coming years.

The labour market remains slack, albeit to a lesser extent than in previous years. Unemployment is expected to gradually decline, thanks to the public employment programmes and rising private sector labour demand. Nevertheless, the unemployment rate may still remain higher than its pre-crisis level.

Wage dynamics in the corporate sector may remain subdued (Chart 1-15). Labour market slack continues to restrict wage growth. Moreover, the gradual adjustment in inflation expectations also contributes to keeping private sector wage dynamics significantly lower than pre-crisis levels. Meanwhile, productivity growth will gradually accelerate, ensuring moderate dynamics in unit labour cost in the private sector. Overall, inflationary pressure from the labour market may remain moderate.

The public employment programme and public-sector wages both exert a substantial influence on the average wage index for the national economy. Since the earnings

of public labour programme employees are well below the average of the national economy, the expansion of the public employment programme significantly reduces the national average wage index via composition effect. As for the public sector, no significant pay hikes are expected other than those scheduled as part of the teachers' career programme.

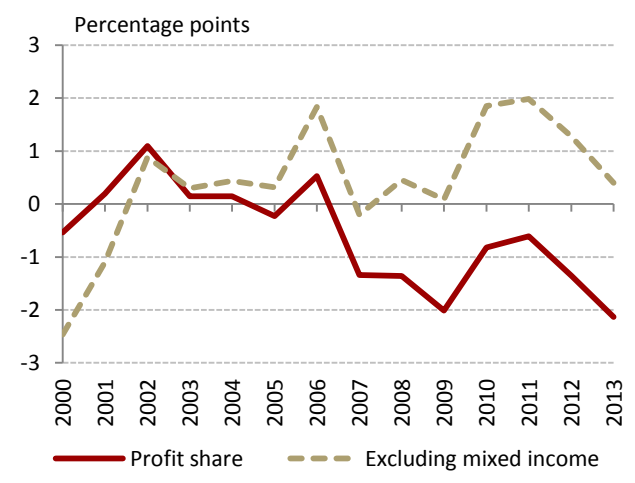
Box 1-3: Issues in measuring corporate profitability and their impact on our labour market forecast

In assessing labour market prospects, the gross operating surplus of the corporate sector receives special attention. **Gross operating surplus represents the portion of income earned by capital** and can be determined as the difference between value added and the compensation of employees. According to empirical observations and standard economic theory, the ratio of gross operating surplus to value added (the **profit share**) remains stable over the longer run. The profit share therefore conveys useful information about the behaviour of firms: if it decreases, companies can react by cutting back on unit labour costs. This may result in a decline in labour demand and a reduction in real wages.

In recent years, profit share calculated from national accounts has indicated weak profitability in the Hungarian corporate sector. In 2009, in parallel with a notable economic downturn, the profit share fell and only approached its pre-crisis level in 2011, thanks to a decline in employment, a slowdown in wage dynamics and the recovery of output. The recession in 2012 caused yet another drop in profit share, which has yet to show any signs of improvement despite the fact that economic growth returned in 2013.

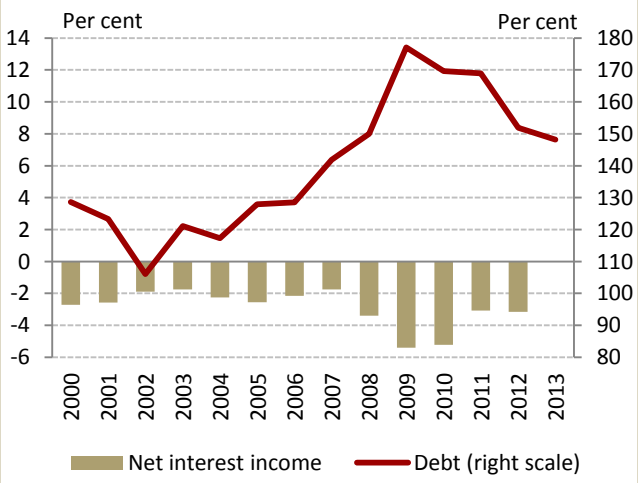
Labour market developments in recent years appeared to contradict the poor corporate profitability suggested by the profit share. Employment has grown steadily in the private sector in recent year, while wage dynamics have been relatively high even in higher income brackets, which were not directly affected by the minimum wage hike of 2012. In early 2014, both employment and wages grew substantially more than predicted in our March forecast.

Chart 1-16: Profit share in the private sector (deviation from 2000-2007 average)



Note: Estimate for 2013.

Chart 1-17: Debt and net interest income of non-financial corporations



Note: As a percentage of gross value added. Debt includes securities other than shares, loans and commercial loans.
Source: CSO, MNB

This contradiction can be explained at least in part by measurement issues. Gross operating surplus comprises the mixed income of unincorporated businesses (e.g. sole proprietorships). Since the owners of these enterprises are typically actively involved in company operations, no clear distinction can be made between the compensation they receive as employees and the entrepreneurial profit they realise as owners. On a macroeconomic scale, mixed income has been steadily losing weight over recent decades: in 1995 it accounted for 22 per cent of value added by the private sector, but

in 2012 it represented only 11 per cent. If we were to consider mixed income at least in part as labour compensation, recent years would show a higher profit share (Chart 1-16).

Furthermore, the profit share does not take into account every adjustment margin available to firms. From an accounting standpoint, gross operating surplus is related to the operating profit of corporations (with depreciation being the main difference between the two at the macro level). However, corporate profitability is also impacted, among others, by financial results and income taxes paid. Favourable trends in these factors might have given businesses substantial leeway in their payroll decisions in recent years:

- According to national accounts data, companies' debt burden increased significantly during the crisis, due in part to rising interest rates and revaluation of their foreign currency debt. **But in the period since 2010, the outstanding debt of non-financial corporations has decreased substantially. Lower interest payments were also supported by the significant reduction in lending rates.** As a result of these developments, the net interest income of non-financial corporations improved by 2.3 per cent of value added between 2009 and 2012 (Chart 1-16).
- **The changes in corporate taxation introduced in 2010 resulted in a tangible decrease in burdens on companies.** Altogether, abolishing the four per cent extra tax, raising the corporate tax rate from 16 to 19 per cent, and introducing the 10-per cent reduced tax rate and tighter rules on the bringing forward of losses resulted a tax cut amounting to 0.8 per cent of corporate value added.[3]

Finally, the equilibrium level of profit share may have also changed in the years following the crisis. Government measures implemented since the crisis aimed to stimulate labour supply, which has a downward effect on real wages. By contrast, the financial crisis resulted in increases in financing costs and a reinforcement of borrowing constraints, particularly for smaller enterprises. The shift in the relative price of production factors may have encouraged firms to increase the labour intensity of production, which may have led to a temporary decline in the capital/labour ratio.[4]

Due to the methodological distortions and omitted adjustment channels described above, the profit share calculated from national accounts data may have underestimated corporate profitability substantially in recent quarters. Therefore, firms may have more room to increase employment and wages than assumed by our earlier projections.

[3] The recently introduced taxes levied on corporations (e.g. sectoral extra taxes, financial transaction levy, insurance tax, telecommunications tax, e-toll and the increased business tax) are registered in the national accounts as current taxes on production, thereby increasing the difference between GDP at market prices and the value added at basic prices that is realised by companies. Therefore, gross operating surplus derived from value added at basic prices already takes into account the profitability reducing effect of taxes on production.

[4] See for instance Pessoa, J. P. – Van Reenen, J. (2014): The UK Productivity and Jobs Puzzle: Does the Answer Lie in Wage Flexibility? Economic Journal, vol. 124, pp. 433-452

Table 1-2: Changes in our projections compared to the previous Inflation report

	2013	2014		2015	
	Actual	Projection			
		March	Current	March	Current
Inflation (annual average)					
Core inflation	3,3	3,0	2,4	3,5	3,0
Core inflation without indirect tax effects	1,5	2,1	1,6	3,3	2,8
Inflation	1,7	0,7	0,0	3,0	2,5
Economic growth					
External demand (GDP-based)	1,0	1,7	1,9	2,2	2,1
Household consumer expenditure	0,2	1,3	2,0	1,7	1,9
Government final consumption expenditure	1,4	0,7	1,4	1,6	-0,3
Fixed capital formation	5,8	7,3	8,4	3,6	3,9
Domestic absorption	0,8	2,3	3,1	2,1	1,9
Export	5,3	5,8	6,2	6,5	6,6
Import	5,3	6,2	6,7	6,4	6,5
GDP	1,1	2,1	2,9	2,5	2,5
External balance[1]					
Current account balance	3,0	3,0	3,1	3,4	3,3
External financing capacity	6,5	6,3	6,4	6,5	6,4
Government balance[1,5]					
ESA balance (2013 data is preliminary)	-2,4	-2,9	-2,7	-3,0	-2,6
Labour market					
Whole-economy gross average earnings	3,0	3,8	2,8	6,1	3,7
Whole-economy employment	1,6	1,9	3,5	0,1	0,8
Private sector gross average earnings[2]	3,6	2,4	4,2	3,7	4,0
Private sector employment	0,8	1,2	2,8	1,0	1,0
Unemployment	10,2	9,1	8,7	8,9	7,9
Private sector unit labour cost[3]	2,1	1,9	3,5	1,4	2,0
Household real income[4]	1,5	2,0	3,2	1,3	1,5

[1] As a percentage of GDP.
[2] According to the CSO data for full-time employees.
[3] Private sector unit labour costs calculated with full time equivalent domestic employees. Due to different calculation method March 2014 data can only be compared to a limitid degree with the current data.
[4] MNB estimate.
[5] With complete cancellation of free reserves.

Table 1-3: MNB baseline forecast compared to other forecasts

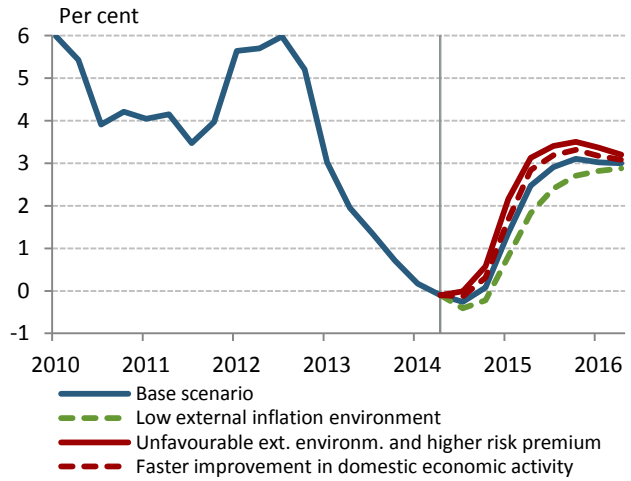
	2013	2014	2015
Consumer Price Index (annual average, %)			
MNB (June 2014)	1,7	0,0	2,5
Consensus Economics (June 2014)[1]	1,7	0,1 – 0,5 – 1,0	1,9 – 2,6 – 3,2
European Commission (May 2014)	1,7	1,0	2,8
IMF (April 2014)	1,7	0,9	3,0
OECD (May 2014)	1,7	0,5	2,8
Reuters survey (April 2014)[1]	1,7	0,2 – 0,7 – 1,8	2,5 – 2,8 – 3,5
GDP (annual growth rate, %)			
MNB (June 2014)	1,1	2,9	2,5
Consensus Economics (June 2014)[1]	1,1	2,0 - 2,7 - 3,6	1,7 - 2,3 - 3,9
European Commission (May 2014)	1,1	2,3	2,1
IMF (April 2014)	1,1	2,0	1,7
OECD (May 2014)	1,2	2,0	1,6
Reuters survey (April 2014)[1]	1,1	1,5 - 2,0 - 2,8	1,3 - 2,0 - 2,5
Current account balance[3]			
MNB (June 2014)	3,0	3,1	3,3
European Commission (May 2014)	3,1	3,0	2,7
IMF (April 2014)	3,1	2,7	2,2
OECD (May 2014)	3,0	3,6	3,9
Budget deficit (ESA-95 method)[3,4]			
MNB (June 2014)	2,4	2,7	2,6
Consensus Economics (June 2014)[1]	2,2	2,2 - 2,9 - 3,0	2,3 - 2,7 - 3,1
European Commission (May 2014)	2,2	2,9	2,8
IMF (April 2014)	2,4	2,9	2,9
OECD (May 2014)	2,3	2,9	2,9
Reuters survey (April 2014)[1]	2,6	2,7 – 2,9 – 3,0	2,3 – 2,9 – 3,0
Forecasts on the size of Hungary's export markets (annual growth rate, %)			
MNB (June 2014)	2,3	4,0	4,7
European Commission (May 2014)[2]	0,9	4,1	5,6
IMF (April 2014)[2]	1,1	3,1	4,2
OECD (May 2014)[2]	0,7	3,9	5,2
Forecasts on the GDP growth rate of Hungary's trade partners (annual growth rate, %)			
MNB (June 2014)	1,0	1,9	2,1
European Commission (May 2014)[2]	0,7	1,9	2,2
IMF (April 2014)[2]	0,7	1,8	1,9
OECD (May 2014)[2]	0,5	1,8	2,2

[1] For Reuters and Consensus Economics surveys, in addition to the average value of the analysed replies (i.e. the median value), we also indicate the lowest and the highest values to illustrate the distribution of the data.
[2] Values calculated by the MNB; the projections of the named institutions for the relevant countries are adjusted with the weighting system of the MNB, which is also used for the calculation of the bank's own external demand indices. Certain institutions do not prepare forecast for all partner countries.
[3] As a percentage of GDP.
[4] With complete cancellation of free reserves.
Sources: Eastern Europe Consensus Forecasts (Consensus Economics Inc. (London), June 2014); European Commission Economic Forecasts (May 2014); IMF World Economic Outlook Database (April 2014); Reuters survey (April 2014); OECD Economic Outlook No. 93 (May 2014).

2. EFFECTS OF ALTERNATIVE SCENARIOS ON OUR FORECAST

With regard to the baseline projection of the June Report on Inflation, the Monetary Council has identified three alternative scenarios which could significantly influence the future conduct of monetary policy. In the alternative scenario assuming a persistently low external inflation environment and a slower-than-expected recovery in external demand, the inflation target may be achieved with looser monetary conditions than in the baseline scenario. In the risk scenario assuming a deteriorating external environment and higher investor risk aversion, inflation moves in line with price stability in the medium term under tighter monetary conditions than implied by the baseline projection. The third scenario, assuming a tighter labour market and a dynamic acceleration of domestic consumption and hence, a faster recovery of domestic economic activity, also points to a tighter monetary policy stance than the baseline.

Chart 2-1: The impact of the risk scenarios on our annual inflation forecast



Source: MNB

Persistently low external inflation

Incoming data in recent months indicate that global inflation has continued to decline, contributing significantly to the sharp fall in inflation in Hungary as well. Euro area inflation has been below expectations in recent months and is expected to remain subdued going forward. According to the baseline projection, global inflation may remain moderate, but may begin to climb gradually near the targets of central banks.

Low global inflation, which is steadily below expectations and the related deflation fears may raise the possibility of a slower-than-expected recovery, resulting in a more negative output gap of Hungary's external markets than presently assumed. This may lead to persistently low inflation. In addition, risks related to growth deceleration in emerging economies, especially China, may also contribute to the weakening of global activity and a further fall in commodity prices.

In view of the above, **the alternative scenario assumes that weak international demand will have a stronger disinflationary impact, resulting in a persistently lower external inflation path and more subdued growth than expected in the baseline projection.** The persistently low external inflation resulting from the sluggish recovery in external demand and lower commodity prices generates more moderate imported inflation. In this scenario, as a result of stronger disinflation, the inflation target can be achieved in the medium term with looser interest rate conditions than those assumed in the baseline scenario, while the loose monetary policy can only partially offset the negative growth effects of weaker demand.

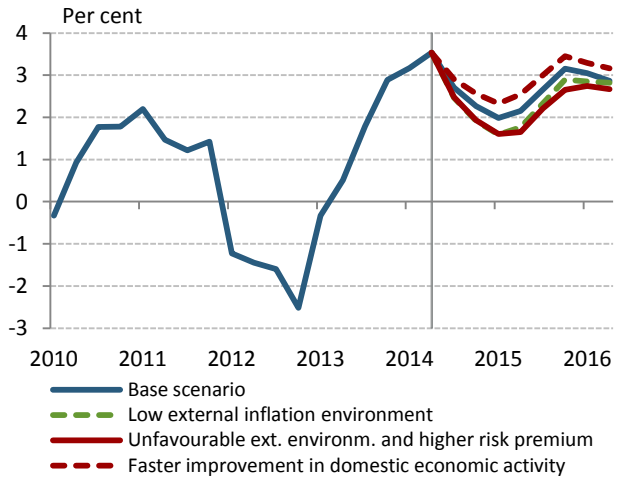
Deteriorating external environment and higher risk premium

International investor sentiment was volatile in the past quarter, but Hungarian risk premia decreased noticeably and the forint exchange rate strengthened. Our view on external demand has not changed much compared to the March forecast, with the baseline projection still assuming

a slow recovery in Hungary's export markets. In addition, the divergence in the growth prospects of developed and emerging economies which was observed in recent quarters persists.

At the same time, regarding Hungary's external demand and risk premium, there are numerous risk factors which may lead to a less favourable scenario than in the baseline projection. Such risk factors include, for instance, a possible deterioration in global risk appetite, the vulnerability of certain emerging economies, and concerns about the exacerbation of the Ukraine-Russia conflict, the increasing likelihood of default by Argentina and tensions in Iraq. A possible escalation of geopolitical conflicts could undermine money market sentiment and lead to depreciation of exchange rates in regional countries, and a downturn in import demand, or impair the banking systems of the countries concerned. The future growth prospects of developing countries are also vulnerable, as some of them face severe structural problems and are also exposed to falling commodity prices. Deterioration in the growth prospects of emerging countries would have a negative effect on global risk appetite and would harm the domestic and euro-area export outlook.

Chart 2-2: The impact of the risk scenarios on our GDP forecast



Source: MNB

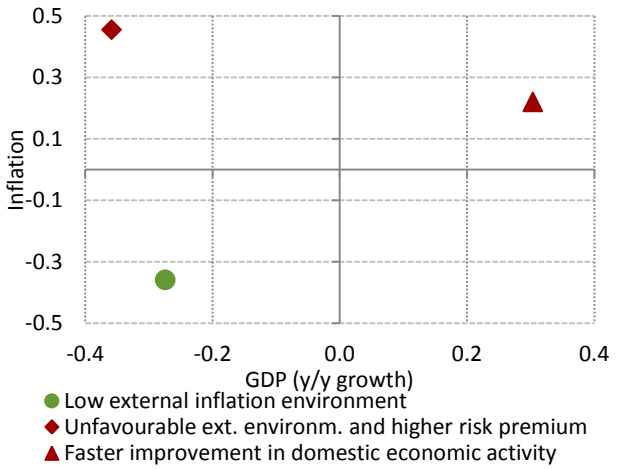
These risks could exacerbate real economic issues and spark financial market tensions, which may have a detrimental impact both on Hungary's risk premium and external demand. In light of the above, this scenario assumes lower external demand and, due to external factors, a rising risk premium path. Deteriorating global investor sentiment would take a toll on Hungarian risk spreads. In this alternative scenario, deteriorating risk perception and rising inflation warrant a tighter monetary stance than foreseen in the baseline scenario.

Faster improvement in domestic economic activity

According to data received during the past quarter, stronger-than-expected growth in retail sales volumes may signal an upturn in households' consumption demand; moreover, developments in income – one of the factors that determine consumption over the long term – appear to show a more positive picture. At the same time, many of households which became indebted before the crisis may still face the pressure in terms of balance sheet adjustment, while precautionary motives may also persist in many household segments. All of this may substantially increase households' net savings.

Looking forward, it is conceivable that the propensity to save will decline considerably, in line with improving consumer confidence and the reduction of debt. A

Chart 2-3: Risk map: The effect of alternative scenarios on baseline forecast



Note: The risk map presents the average diffenece between the inflation and growth path of the alternative scenarios and the baseline forecast on the forecast horizon. The red markers mean tighter and the blue markers mean looser monetary policy than the baseline forecast.

Source: MNB

sooner-than-expected easing of precautionary considerations and pressures for balance sheet adjustment may increase the propensity to consume and lead to a steeper rise in the consumption path.

In line with the gradual upswing in economic activity and employment, the labour market may also become tighter. Boosted by the effect of public labour programmes and more favourable developments in private sector employment, employment increased significantly in the previous period. This may be an indication of the private sector's rising demand for labour in recent quarters and hence, increased competition among employers, which may point to an acceleration of wage dynamics. This implies inflationary pressures on the forecast horizon. Through an increase in households' disposable income, higher-than-assumed wage dynamics may raise the consumption level which, in turn, may trigger a faster closing of the output gap than expected in the baseline scenario. Thus, rising domestic demand entails a narrower output gap and a more moderate disinflationary impact. These factors point to tighter monetary conditions than envisaged in the baseline projection.

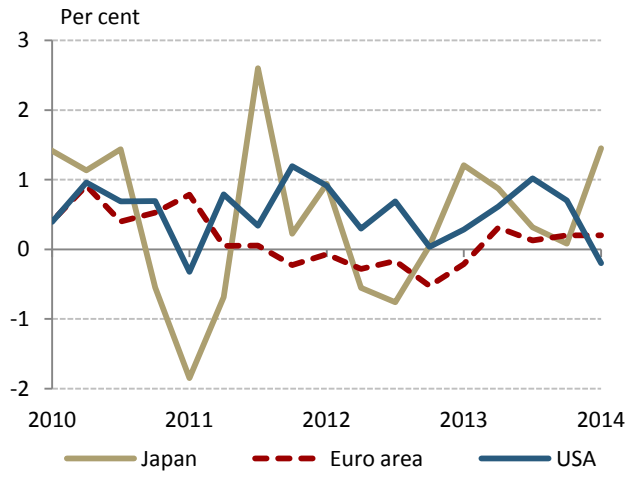
3.1. International environment

The recovery of global economy slowed somewhat during the past quarter, which affected both developed and emerging economies, albeit to different degrees. The deceleration can be primarily attributed to transitory factors. In the coming quarters, growth may accelerate in developed countries again, which could influence the economic performance of emerging countries positively through increased demand for exports. Declining commodity prices and the moderate growth in the global economy continue to have a disinflationary effect and consequently, inflation rates remained below the inflation targets of the major central banks. Developed-country central banks maintained loose monetary conditions, contributing to a supportive global money market sentiment.

3.1.1. Developments in global economic activity

During the first quarter of 2014, the global economy lost momentum, but performance is still favourable on the whole. The differential between growth in developed economies and emerging economies persists. In addition to transitory factors (such as adverse weather conditions in the USA), the decelerating growth dynamics may reflect the uncertainties surrounding emerging countries and the conflict between Russia and Ukraine. Looking forward, fiscal consolidation and the balance sheet adjustment of the private sector are coming to an end in the developed countries. Moreover, concerns about the debt crisis are easing and monetary conditions are persistently loose, which may boost growth. The pick-up in developed countries may support growth in emerging countries through foreign trade relations. However, the gradual normalisation of monetary conditions in the United States may have an adverse effect on emerging economies. On the whole, global economic activity may continue to gradually recover, although growth in specific regions may demonstrate marked differences (Chart 3-1).

Chart 3-1: GDP growth in the advanced economies (seasonally adjusted quarterly change)

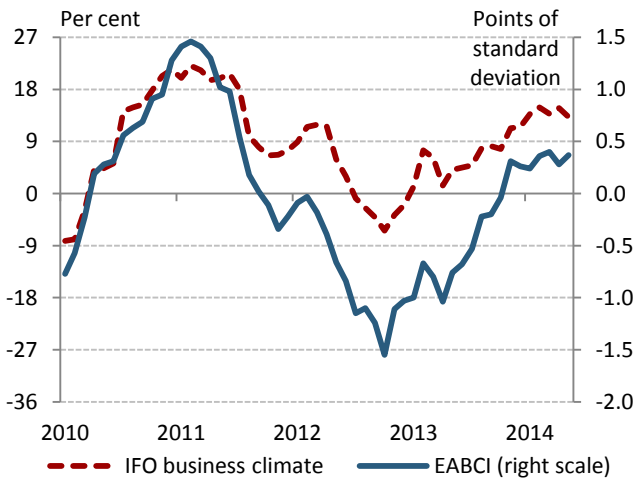


Source: OECD

Growth in the US economy in Q1 fell short of that seen at the end of 2013, mainly due to adverse weather conditions, more restrained business investment and declining public sector spending. Nevertheless, the volume of retail sales and manufacturing indicators suggest that economic performance may have picked up again at the beginning of Q2. The decline in unemployment observed at the end of last year came to a halt: after a small increase (to 6.7 per cent) in Q1, the unemployment rate fell to 6.3 per cent in April. The overall picture, however, is obscured by the decline in the activity rate, which may be an indication of discouraged job-seekers gradually exiting the labour market. Meanwhile, the number of part-time employees among those employed is steadily high, suggesting substantial unused capacities in the economy.

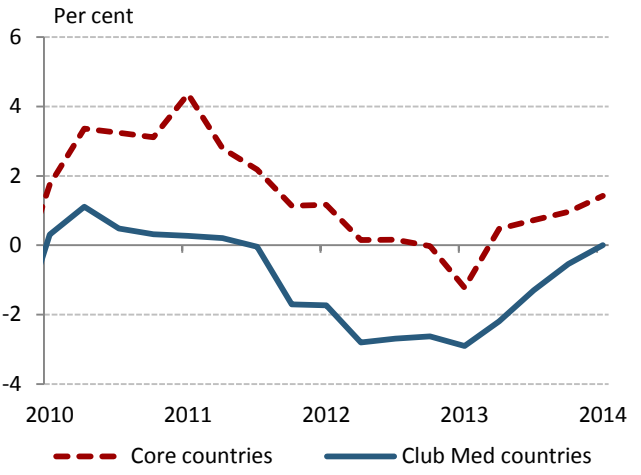
In Japan, loose monetary policy and the transitory effects of fiscal policy support the upswing in domestic demand

Chart 3-2: Business climate indices for Germany and the euro area



Source: European Commission, IFO

Chart 3-3: GDP growth in the euro area



Note: Annual change.
Source: Eurostat

and hence, economic expansion. Economic growth accelerated remarkably in 2014 Q1, which resulted in part from the expansion of exports and consumption brought forward due to the consumption tax increase in April. Data for April indicate deterioration in the business environment and a steep decline in consumer confidence in wake of the tax increase. In order to offset the adverse effects of the April tax increase on growth, the government is planning to launch a fiscal stimulus programme amounting to 1.1 per cent of GDP for people with low income. Improving labour market conditions are also expected to support the further expansion of consumption: in April, the unemployment rate dropped to a 7-year low at 3.6 per cent.

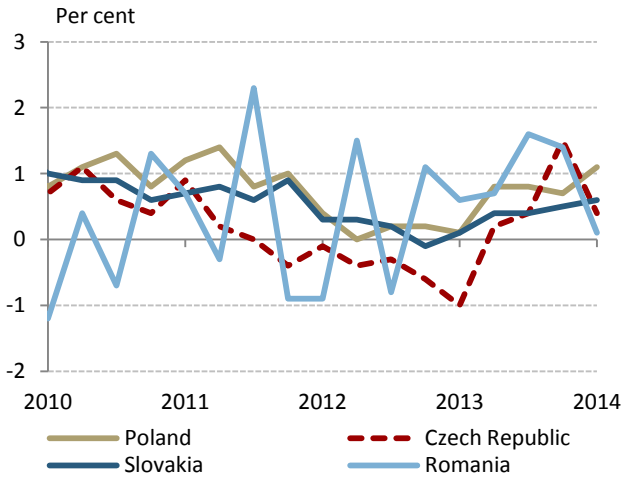
In the euro area, slow recovery continued in 2014 Q1. The significant increase in retail sales went hand in hand with improving consumer confidence. While business confidence indicators are at good levels, there has been no further improvement since early 2014 (Chart 3-2). Corporate lending remains restrained. The positive effects of euro-area economic recovery may reach the labour market with some delay. At 12 per cent, the unemployment rate is still high. Growth in Germany was higher than expected in Q1, possibly as a result of stronger construction industry activity during the mild winter. Although corporate investment also improved, it remains at historically low levels. The upswing in industrial production was also buoyed by strong demand for capital goods in economies outside of the euro area. In France, the economy stagnated compared to the previous quarter. The construction industry remains weak, while manufacturing output and machinery investment increased. The slow recovery in household consumption came to an abrupt halt in Q1. This was the combined result of subdued energy consumption during the mild winter and the fact that, owing to the January increase in tobacco prices and the expected strengthening of taxes on car purchases at the beginning of the year, households brought forward their consumption expenditures to 2013 Q4.

Like the core countries of the euro area, the economies of periphery countries also showed signs of recovery in early 2014 (Chart 3-3). Growth accelerated in Spain, as consumption and business confidence improved and employment started to grow, contributing to a gradual recovery in domestic demand. In Italy, output declined slightly in Q1. Employment decreased, while unemployment was on the rise once again.

Among European countries outside of the euro area, growth accelerated in the United Kingdom helped by burgeoning consumption. Besides the accommodating

monetary policy, the improvement observed in the labour market also contributed to the increase in consumption. Nevertheless, investment and exports remained subdued. Buoyant lending activity boosted demand in the real estate market, which was reflected primarily in rising real estate prices.

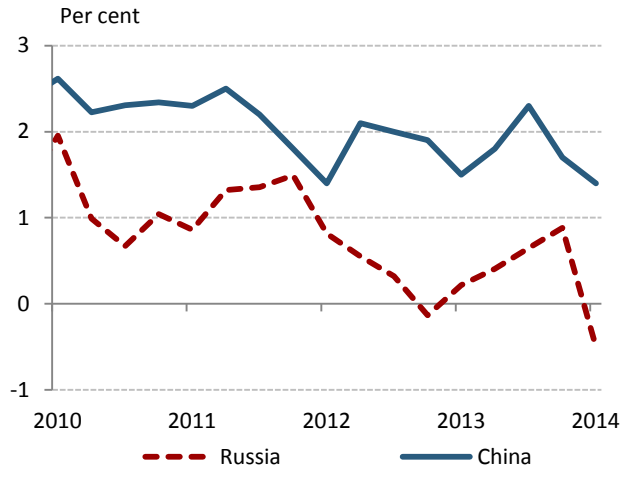
Chart 3-4: Quarterly economic growth of the CEE countries



Source: Eurostat

The CEE region continued to grow, but the economic performance of the various countries showed a mixed picture (Chart 3-4). The economic recovery seen in the main foreign trade partners, primarily Germany, continued to play a decisive role in the region's growth. Compared to the previous quarter, in the CEE region, the Czech Republic and Romania lost momentum, while economic growth in Slovakia remained largely the same and Poland experienced faster growth. In the Czech Republic, along with improving external demand, the easing of domestic monetary conditions and the accommodating fiscal policy both spurred growth. In Poland, growth was driven primarily by exports, but increasing domestic demand and investment also made positive contributions to economic performance. The pick-up in Romania's economic activity is supported by the increase in exports and the gradual strengthening of consumption. The outstanding performance of Slovakia in Q1 can be primarily attributed to exports, as well as to developments in investment and public consumption.

Chart 3-5: GDP growth in China and Russia (seasonally adjusted quarterly change)



Source: OECD

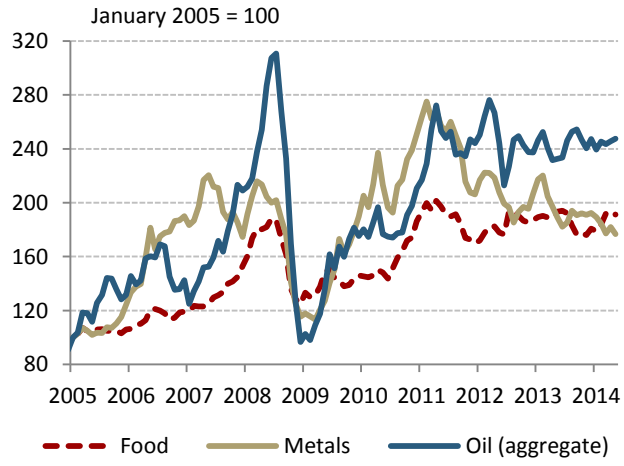
Regarding the major emerging economies, GDP growth in China dropped to 7.4 per cent in Q1, mainly as a result of muted industrial performance and a downturn in exports (Chart 3-5). Although household consumption can still be considered strong, growth in disposable income shows signs of deceleration. The expansion in investment has slowed down, in the context of efforts to curb lending activity and tighter regulations on real estate investment.

The performance of the Russian economy slumped in early 2014 (Chart 3-5). Before the outbreak of the Ukrainian crisis, economic growth in Russia was subdued. Quarter-on-quarter growth accelerated slightly throughout 2013, primarily as a result of a surge in gas exports. At the beginning of 2014, however, the economy slowed down sharply according to short-term indicators, with a 0.5 per cent decline in GDP compared to the previous quarter. Deteriorating business confidence since the outbreak of the crisis in Ukraine and large-scale capital outflows were the main contributors to this deceleration. Looking forward, sanctions against Russia could hinder investments.

3.1.2. Global inflation trends

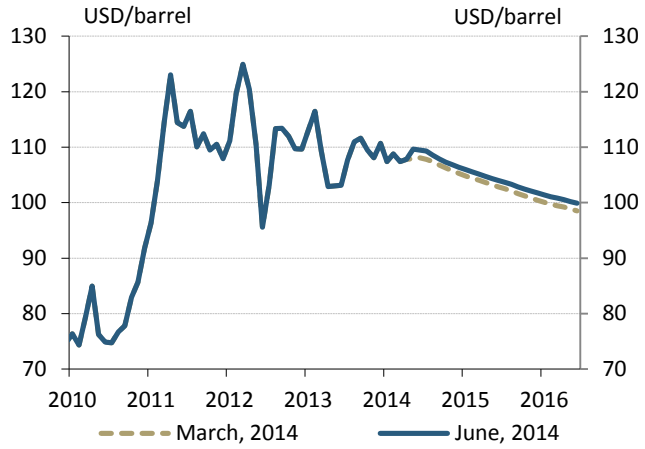
Commodity prices were subdued in recent months (Chart 3-6). Still fluctuating around USD 110 per barrel, the Brent

Chart 3-6: Changes in major commodity prices (USD)



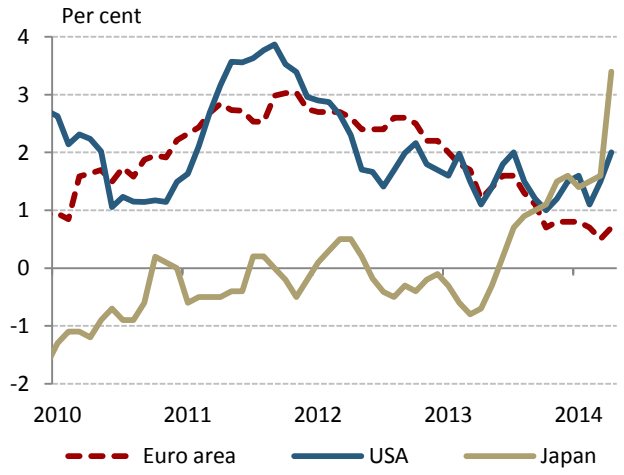
Source: IMF-IFS

Chart 3-7: Change in oil price assumptions



Source: Bloomberg

Chart 3-8: Inflation in advanced economies



Note: Annual change.
Source: OECD

crude oil price has not changed much in recent months. In the second half of June, the deterioration of the situation in Iraq drove global prices near USD 115 per barrel.

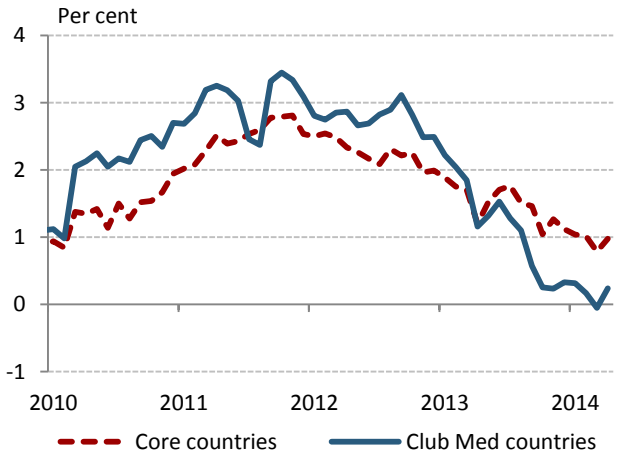
Future contracts signal a gradual decline in USD oil prices (Chart 3-7). In recent years, the increasing extraction of shale oil has been able to offset the effects of declining oil production due to political conflicts (especially in the Middle East and Africa). Improving energy efficiency and increased reliance on renewable energy may result in slower increase in the demand of oil relative to the supply capacities. Despite the recovery of the world economy, the world market price of oil may remain moderated. Geopolitical instabilities, however, point to continued high voltatility in the near future.

Mainly reflecting the downturn in China's demand for steel, **the prices of industrial commodities** (iron ore and coal) **decreased sharply**. By May, the price of iron ore had fallen by more than 20 per cent compared to the beginning of the year. Following an increase at the beginning of the year due to adverse weather conditions, **the world price of unprocessed food stabilised**.

Inflation rates were close to or below target in most developed countries (Chart 3-8). The output gap remained negative in developed countries and demand-pull inflation was moderate. The combination of declining commodity prices and slow economic growth restrained inflation. In April, inflation amounted to 2 per cent in the USA and 0.7 per cent in the euro area. Euro-area inflation dropped to 0.5 per cent in May. Inflation decelerated in core countries as well (Chart 3-9); according to data for May, the growth rate of prices dropped to 0.9 per cent in Germany. The high level of unused capacities, appreciation of the euro (Chart 3-10), declining fuel prices and low growth in food prices all contributed to moderate euro-area inflation. In Japan, the consumer price index (3.4 per cent) exceeded the central bank's 2 per cent target in April, primarily due to the increase in turnover tax from 5 per cent to 8 per cent. Although inflation trends are promising, analysts warn that similar growth in wages would be necessary to achieve a sustainable growth path. In the United Kingdom, the inflation rate fell to 1.8 per cent in April.

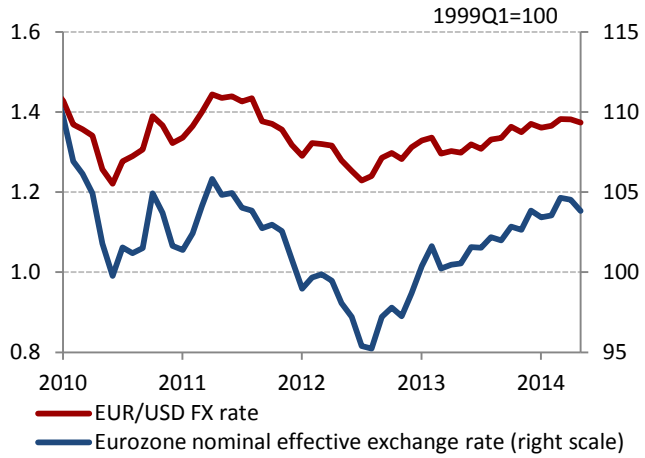
As regards major emerging economies, inflation remained relatively moderate in China, where annual inflation had fallen to 1.8 per cent by April, following an increase at the end of last year. In Russia, upward risks to price stability were fuelled by increasing energy and food prices and the depreciating exchange rate, driving the consumer price index to 7.3 per cent by April (Chart 3-11).

Chart 3-9: Inflation in the euro area



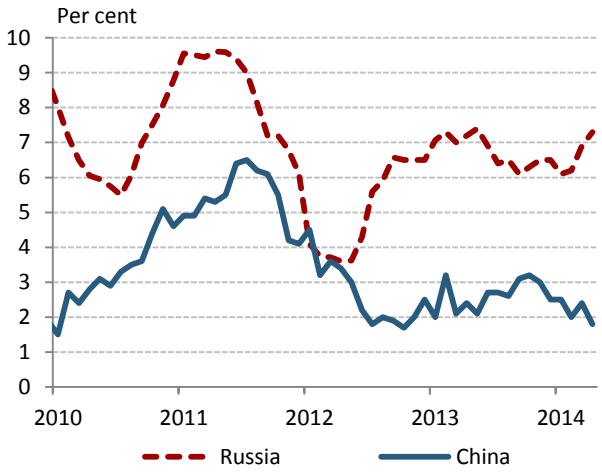
Note: Annual change.
Source: Eurostat

Chart 3-10: Eurozone NEER and EUR/USD exchange rate



Note: Higher values mean euro appreciation.
Source: ECB, Eurostat

Chart 3-11: Inflation in China and Russia



Note: Annual change.
Source: OECD

Inflation remained below target levels in the Central and Eastern European region. The output gap is still negative in CEE countries. In the Czech Republic, the consumer price index and inflation excluding the primary effect of indirect tax changes (relevant variables for monetary policy) have stayed around zero since the beginning of the year. This reflected the disinflationary effect of unused capacities in the economy as well as weaker inflation in administered prices. Eventually, the pass-through of the weakening exchange rate resulting from central bank intervention (to weaken the currency) and the fading of administrative price reductions are expected to put upward pressure on inflation.

Inflation in Poland was 0.3 per cent in April and thus remained well below the 2.5 per cent target. Although core inflation has climbed gradually in recent months, it is still at a low level (1.1 per cent). Inflation was stuck at low levels in Romania, amounting to 1.2 per cent in April. Apart from temporary effects, the disinflation observed since 2013 can be attributed to the negative output gap and moderating inflation expectations.

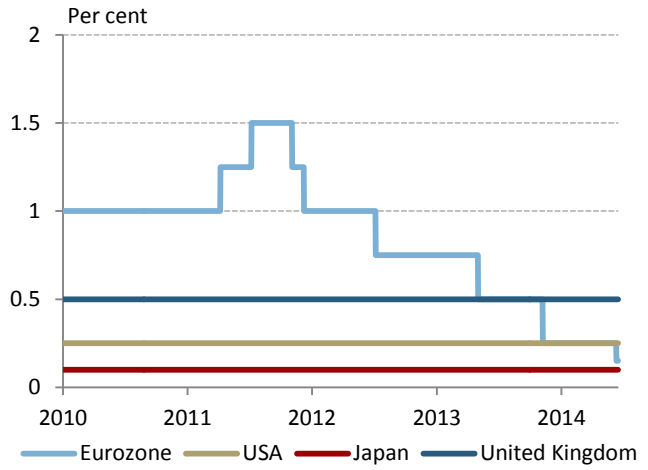
3.1.3. Monetary policy and financial market developments

The **central banks of global importance** continue to feel that medium-term inflation risks are moderate in the current economic environment, and thus **maintained their relaxed monetary conditions** (Chart 3-12).

In line with the trend commenced in December 2013, the Federal Reserve continued to taper its monthly asset purchases; thus, starting from May, monthly asset purchases are limited to USD 45 billion. According to its forward guidance, an increase in the near-zero policy rate is not expected until well after the termination of asset purchases, especially if inflation remains below the 2 per cent long-term target. The Fed's decision-makers expect the first interest rate increase in 2015.

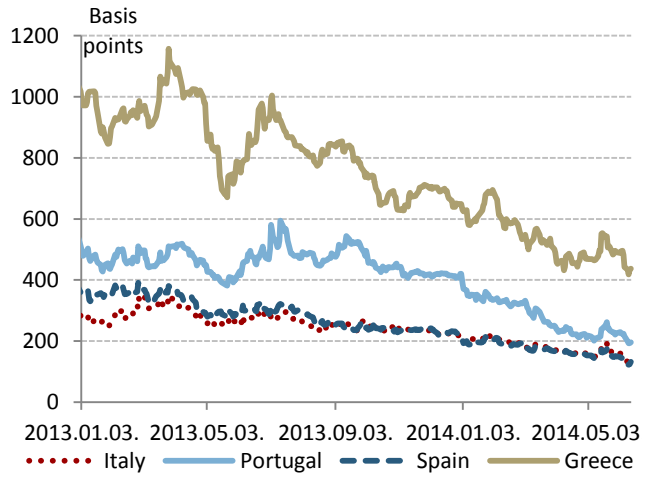
In June, the European Central Bank reduced its key policy rate by 10 basis points to 0.15 per cent. In parallel with that, the width of the interest rate corridor was reduced asymmetrically by 35 and 10 basis points; thus the interest rate on marginal lending facility and deposit facility were reduced to 40 basis points and minus 10 basis points, respectively. The ECB announced a further package of measures composed of four non-conventional elements which, combined, are considered to be quantitative easing aimed at boosting real economy lending and restoring the transmission mechanism. With some modifications, President Draghi reiterated the ECB's forward guidance to the effect that, based on the current inflation outlook, the

Chart 3-12: Central bank rates in advanced economies



Source: Databases of central banks

Chart 3-13: 10Y periphery bond spreads over the 10Y German bond yields



Source: Bloomberg

ECB's interest rates will remain at the existing levels for an extended period of time. The financial market stabilisation seen since the summer of 2012 continues. Yields on government bonds and interbank interest rates remain low in core euro-area countries, while deposits that had been moved to core countries continued to flow back to periphery countries (Chart 3-13).

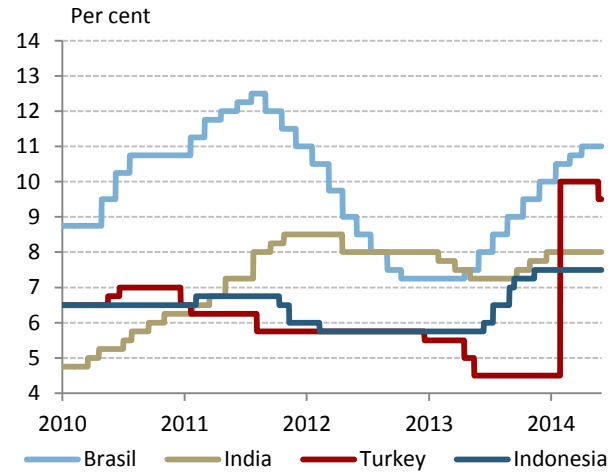
Having reached the unemployment threshold set in its previous guidance, the central bank of the United Kingdom adjusted its forward guidance. In this spirit, the central bank stressed that the interest rate is expected to be raised only gradually, with the timing, extent and progress of the increase depending on economic conditions and various indicators linked, primarily, to capacity utilisation. It also indicated that it would maintain the prevailing value of asset purchases at least until the next increase in the policy rate from its current level of 0.5 per cent.

The central bank of Japan left the quantitative and qualitative easing announced last April unchanged, with a view to achieving the 2 per cent inflation target. Financial market conditions remain favourable. In order to encourage bank lending, the Japanese central bank extended its lending incentive programmes (Stimulating Bank Lending Facility, Growth Support Facility) as early as February. The total amount available under both programmes has been doubled and the maturity of the latter instrument was extended to 4 years from 1-3 years.

On the whole, global financial market sentiment was supportive during the period. Risky assets performed well; the main stock exchange indices hit historically high levels several times, while most emerging market stock exchanges also demonstrated an upward trend. Bond yields in emerging countries declined, while several Asian and emerging market currencies strengthened against the dollar. While the monetary policy of the central banks of major developed countries was marked by tightening on the whole last year, key interest rates remained broadly unchanged in recent months (Chart 3-14). On several occasions in March and April, escalation of the conflict between Russia and Ukraine – one of the main market-moving events of the period – resulted in significant deterioration in global risk appetite, but this had a less pronounced effect on international markets in May.

Central banks in the Central and Eastern European region maintained loose monetary conditions. In line with expectations, the central bank of Romania did not adjust its 3.5 per cent key policy rate at its latest rate-setting

Chart 3-14: Central bank rates in major emerging economies



Source: Databases of central banks

meeting in May. In recent months, the Czech central bank also kept its 0.05-per cent key policy rate by unanimous decision. With a view to easing monetary conditions, decision-makers expect the central bank to remain committed to maintaining the level of the exchange rate at least until the beginning of 2015. In line with their reconfirmed guidance of maintaining the key policy rate until at least September 2014, at their rate-setting meetings in April and May the decision-makers of the Polish central bank left the level of the key policy rate unchanged.

Box 3-1: Deflationary risks in the euro area? – What the Japanese experiences show

Inflation has fallen to below 1 per cent across the euro area in recent months, intensifying worries about deflation. For two decades, the Japanese economy struggled to overcome the problems of deflation and sluggish economic growth, and therefore, it may serve as a useful point of reference for recent developments in Europe.

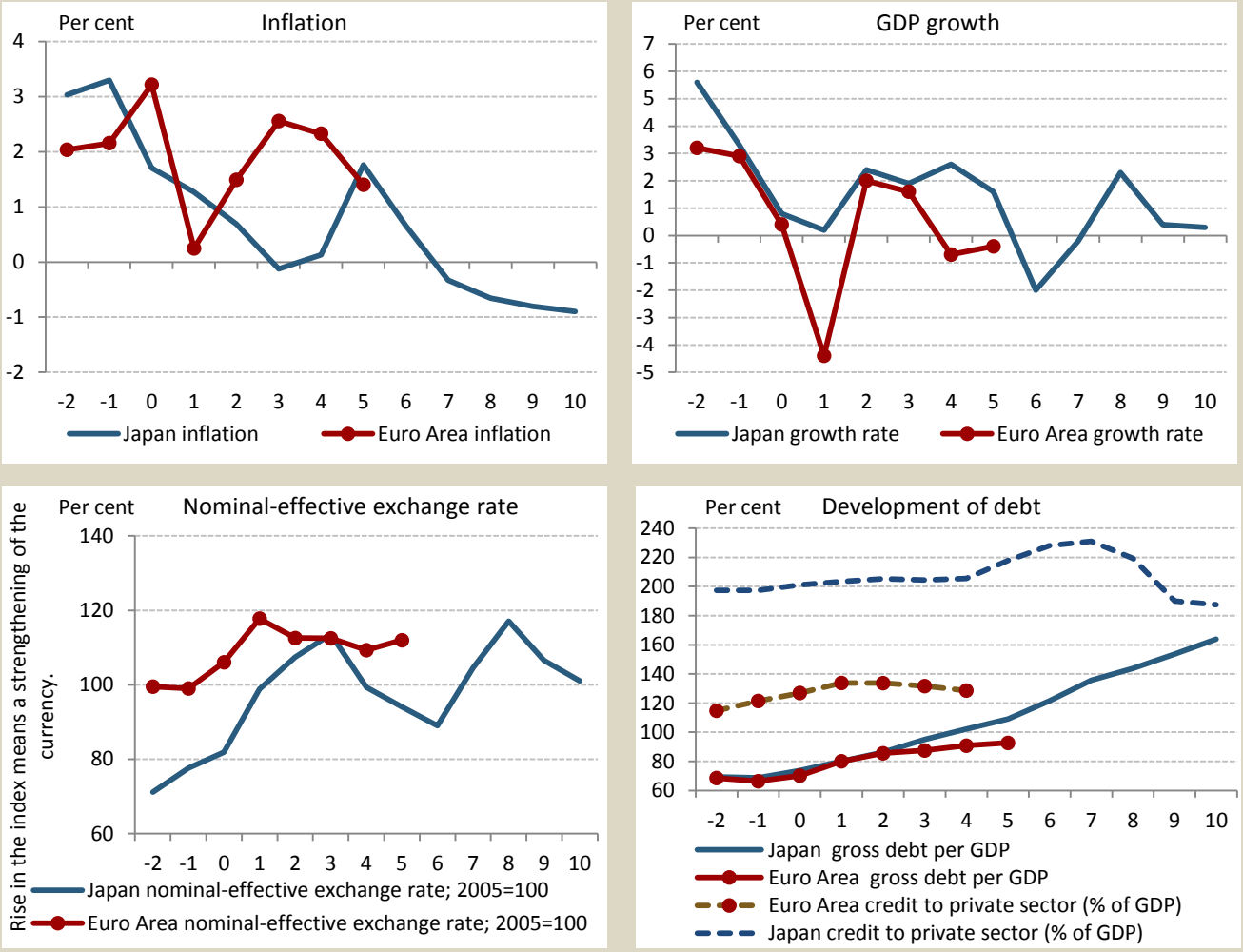
Japan has faced the problem of downward movement in prices since the 1990s. The inflation rate slipped into negative territory in 1995 for the first time and remained below zero from 1998 up until last year. It is impossible to pinpoint a single reason for the **emergence of deflation in Japan**; more likely, it **resulted from a combination of several factors**.

- **A real estate bubble emerged before the 1990s.** Strengthened by export revenues, Japanese firms invested their funds in the real estate market, which contributed to the bubble. Furthermore, loose monetary policy tried to offset the negative effect of a strengthening yen (after the Plaza Agreement in 1985[5]), which also fuelled the assets bubble. **After the bubble burst in 1992, there was a steep rise in unemployment and a sharp fall in real estate and land prices.** Amid falling asset prices, both the general government and the banking sector suffered severe losses, which **triggered a credit crunch, and demand slumped**. Permanently loose fiscal policy was also unable to boost aggregate demand, while fiscal expansion caused a steady rise in public debt.
- Along with permanently subdued demand, Japan's economy also suffered from the **weakening potential output**. The aging society and declining productivity growth may have been contributing factors in this regard. Declining productivity growth may have been related to the permanently subdued investments, which was caused by firms' and banks' balance sheet adjustment.
- **Appreciation of the yen** despite the Japanese central bank's continuous efforts to weaken the exchange rate contributed, to a large degree, to the emergence of a negative price index.
- Negative price dynamics were also followed by a **decrease in nominal wages**. While electronics manufacturing has large share in the Japanese economy, the substantial decline of this sector's prices significantly affected the country's price-index development. On one hand, cheap labour in developing Asian countries played a role in the decline. On other hand, the Plaza Accord in 1985 had also a significant effect in the period before deflation: depreciation of the US dollar resulted in a substantial appreciation of the yen.

[5] This agreement aimed at weakening the highly overvalued dollar at the first half of the 80's through common interventions of developed countries' central banks. As a result the yen appreciated by around 50 per cent against the dollar in the period between 1985 and 1987.

- Changes in **inflation expectations** also played a role in the process. In the case of Japan, many analysts argue that the downward spiral in prices was a self-fulfilling process. The central bank failed to anchor the population's expectations and although 10-year expectations were still in a reassuringly positive range, one-year projections had already fallen steeply on the brink of the deflationary period.

Chart 3-15: The comparison of Japan and the euro area



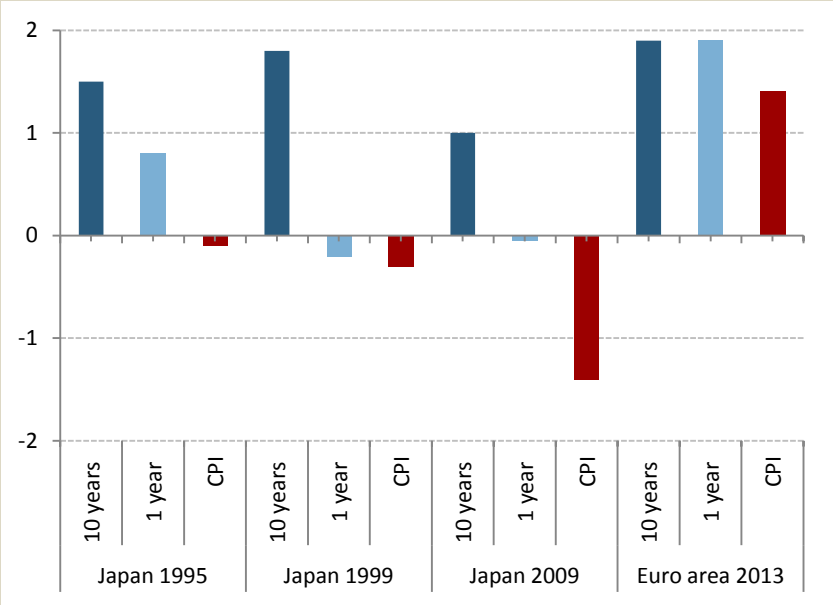
Note: On the horizontal axis 0 means the year of the crisis (in case of Japan: 1992, in case of Euroarea: 2008).
Source: Eurostat, WDI, OECD

Analysing the most important macro data **in the euro area, several similarities can be identified, but for the time being the degree of the movements involved is substantially smaller than was the case in Japan**. Before the outbreak of the economic crisis, many European countries experienced a real estate bubble as well (mainly in the periphery countries: Spain and Italy) and once it burst, real estate prices plummeted. The slump in real estate and financial asset prices also took a toll on the financial system of the currency union. Recapitalisation and strengthening of the financial system and cleaning the bad assets from banks' balance sheets has been a slow process and consequently credit supply is currently weak. The fiscal austerity measures adopted with a view to reducing public debt also narrowed demand further. However, there is a significant difference: while even the private sector struggled with enormous debts in Japan, apart from a couple of periphery countries, this is not true for the euro area as a whole. At the same time, there are similarities such as worsening demography trends, weakening investment activity and declining productivity growth. The euro has also appreciated, but not nearly to the extent of the Japanese yen in the 1990s.

There is also a significant difference. In Europe, a negative price-wage spiral has not developed, although wages in some periphery countries have substantially decreased since the financial crises occurred. In addition, euro-area inflation expectations, for both the short term (1 year) and long term (10 years), are stuck near the 2-per cent target even after the

price index fell significantly. Many analysts also emphasise that the European Central Bank has acted faster and more decisively against the risk of deflation, as compared to the Bank of Japan in the 1990s.

Chart 3-16: Inflation expectations of the households



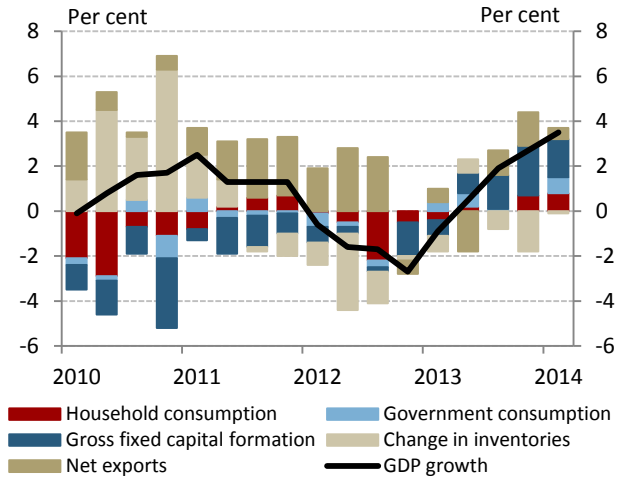
Source: Consensus Economics

As shown by the Japanese example, there is no single factor that can be blamed for the emergence of deflation. The banking system's prolonged weakness, insufficient aggregate demand, worsening growth potential, exchange rate appreciation and the negative price-wage spiral which developed from the expectations also played a significant role. In several respects, the current European situation shows similarities with the Japanese events. However the magnitude of these, for the time being seems more moderate and manageable in the euro area.

3.2. Aggregate demand

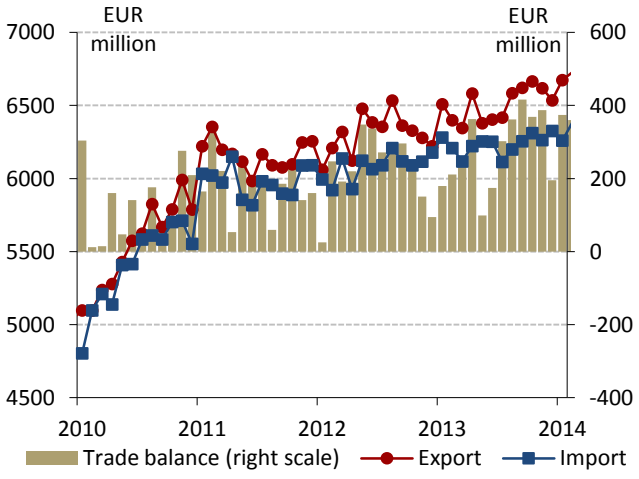
GDP growth continued in a balanced structure in the first three months of 2014. From the expenditure side, this can be attributed mainly to the accelerating growth in investment and household consumption. The growing domestic components increased import demand, reducing the positive contribution of net exports.

Chart 3-17: Structure of annual GDP growth



Source: CSO

Chart 3-18: Foreign trade and foreign trade balance



Source: CSO

In 2014 Q1, Hungary's GDP expanded at a rate of 3.5 per cent in year-on-year terms. Output increased by 1.1 per cent compared to 2013 Q4 and thus exceeded the 0.7 per cent growth rate observed in the last three months of 2013.

Economic growth is proceeding with a balanced structure. Household consumption, private and public-sector investment and exports all increased (Chart 3-17).

3.2.1. Foreign trade

The trade surplus continued to grow in the first quarter (Chart 3-18). As was the case in previous quarters, vehicle manufacturing was the driving force of exports. At the same time, sales increased in a broader range of other production sectors. Based on data for April, exports may continue to expand in the second quarter. Imports accelerated in response to the slowly recovery in domestic demand, but this growth was tempered by reduced energy imports amidst mild winter weather conditions. The growth contribution of net exports amounted to 0.5 per cent of GDP in Q1, which is below the values recorded in previous quarters. For the most part, the slower development of the trade surplus can be attributed to higher import demand.

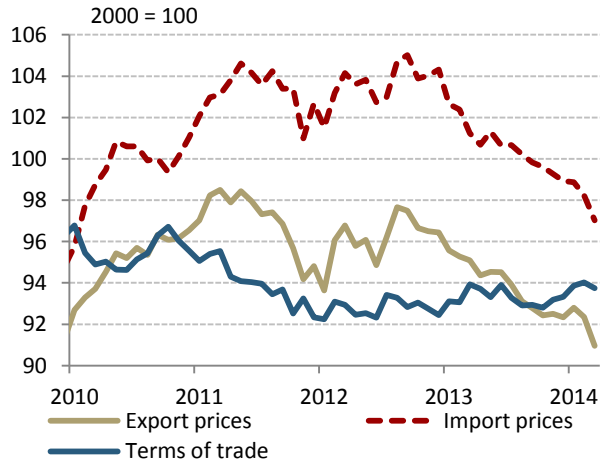
Foreign trade in services increased further in Q1. Growth in exports and imports in the key sectors of tourism and transportation exceeded ten per cent, while the likewise significant sector of business services grew by almost five per cent. Overall, the balance of services improved slightly in the first few months of 2014 (for more details on foreign trade in services, see Box 3-2).

In the context of mildly decreasing export prices and further significant declines in import prices (in euro terms), **the terms of trade improved moderately in the first months of the year**. The terms of trade were influenced positively by subdued external inflation, moderate commodity prices and the shift to higher-value products in the composition of exports (Chart 3-19).

3.2.2. Household consumption

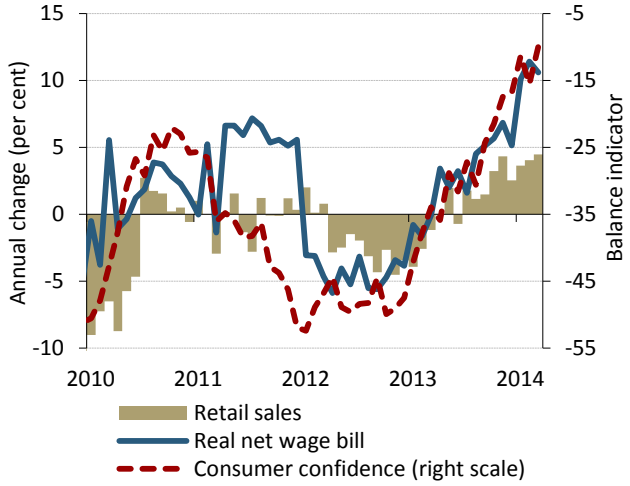
The second half of 2013 saw a turnaround in households' consumption expenditures. Improving labour market conditions coupled with rising real incomes in the low inflation environment and positive consumer confidence both raised the volume of household consumption (Chart 3-20). In Q1, household consumption expenditures

Chart 3-19: Change in terms of trade



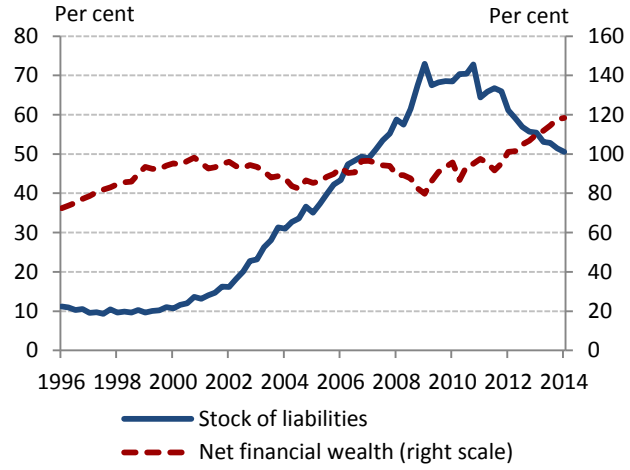
Source: CSO

Chart 3-20: Developments in retail sales, income and the consumer confidence index



Source: GKI, CSO

Chart 3-21: Households' net financial wealth



Note: As a percentage of personal disposable income. Net financial wealth is corrected with the transfer of private pensions to the state pension system in 2011Q1.

Source: MNB

increased by 1.5 per cent compared to the same period of the previous year. Based on the retail turnover data for April, the slow recovery may continue in Q2. At the same time, the precautionary motives observed in recent years remain strong and households still exhibited a considerable propensity to save at the beginning of the year. In Q1, the pick-up in consumption may have been tempered by the depreciation of the exchange rate as a result of the increasing instalment amounts of foreign currency debts, and this may have also strengthened precautionary savings.

Similarly to previous quarters, households' net financial wealth rose further in the first few months of 2014. Owing to a high propensity to save, in the context of the gradual downsizing of outstanding debt the portfolio of financial instruments also increased further. The financial wealth-to-income ratio rose to a historical peak in the first quarter (Chart 3-21).

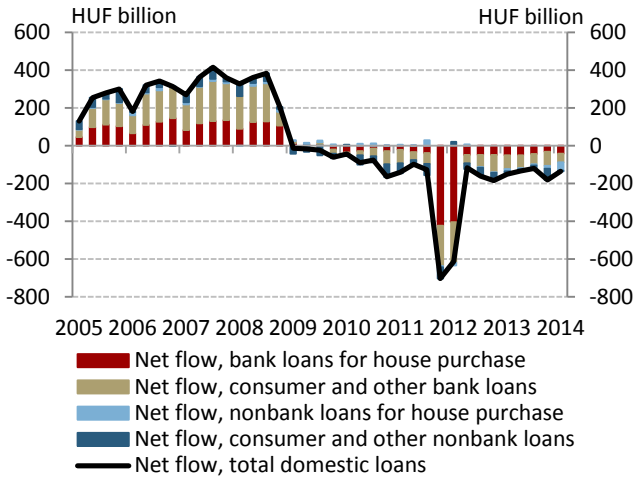
Loans to households from the financial intermediary system continued to decline in Q1, falling by around HUF 135 billion in total (Chart 3-22). On the supply side, banks' conditions eased slightly in the case of consumption product types, and were maintained overall for housing loans. At the same time, parallel to the reductions of the key policy rate, interest rates on new housing loans declined, which on the whole may generate an increase in loan demand in the household segment. Although the first quarter was characterised by restrained borrowing due to seasonal effects, households' precautionary motives and continued balance sheet adjustment may remain dominant factors in borrowing decisions.

3.2.3. Private investment

After the restrained activity observed in previous years, investment performance has been rising significantly since mid-2013, and this positive trend in investment continued in 2014 Q1 (Chart 3-23). Hungarian investment activity is being boosted by the combination of gradually recovering demand, faster absorption of EU funds and declining lending rates.

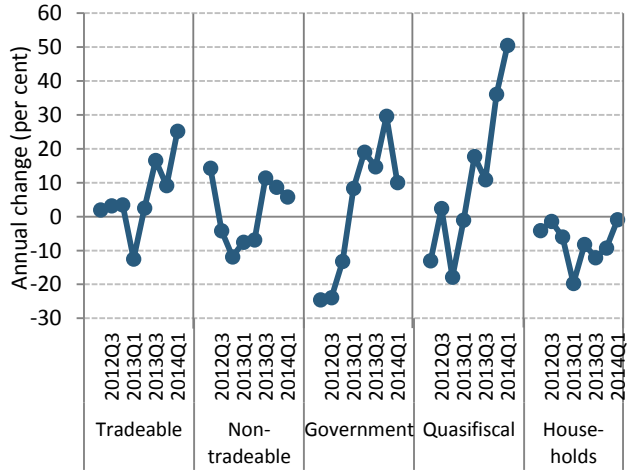
Gross fixed capital formation rose 13.3 per cent in 2014 Q1, and the investment ratio reached 19 per cent. Underlying investment trends have become more favourable in recent quarters. Based on the spring investment survey of the European Commission, demand and financial conditions increasingly support the upswing in investment. At the same time, the high growth rate may also reflect the low basis from last year and the mild weather conditions at the beginning of the year, which benefited the construction industry. Machinery purchases under the Funding for

Chart 3-22: Quarterly net increase in loans to households from domestic financial intermediaries



Note: Loans granted by banks (without specialized institutions), foreign branches, cooperative credit institutions and other financial intermediaries. Seasonally unadjusted change in outstanding amounts, with rolling exchange rate adjustment.
Source: MNB

Chart 3-23: Development of sectoral investments



Source: CSO

Growth Scheme (FGS) launched in 2013 were already implemented in the first phase at the end of the year, and the loan scheme may also have boosted investment activity this year.

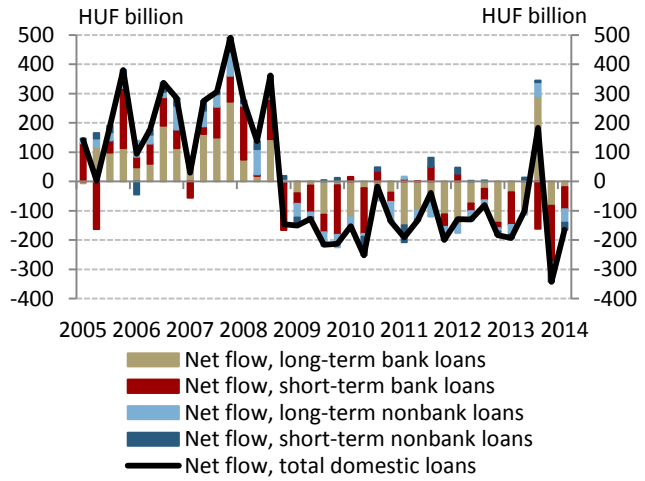
As was the case in previous quarters, investment activity in the manufacturing sector was significant. Numerous related suppliers increased capacities for the previously implemented, substantial vehicle manufacturing capacities. The HUF 500 billion amount available under the second phase of the FGS is being gradually utilised. This can be explained by the longer time frame available on the one hand, and modified terms and conditions on the other hand. The new terms give preference to borrowing for investment purposes, which requires a longer period of preparation.

Household investment activity may pass its trough in 2014. The combination of households' considerable balance sheet adjustment, high propensity to save and tight credit conditions has impeded housing market activities since the outbreak of the crisis. While the consumption expenditures of households have grown steadily in recent quarters, the housing market may have started to rise from the bottom only at the beginning of 2014. However, Q1 construction data and the stock of orders indicate that the level of housing construction has remained low (housing market trends and medium-term prospects are presented in more detail in Box 1-2).

In 2014 Q1, the corporate loan portfolio in the overall financial intermediary system contracted by a total of HUF 165 billion, with most of this decline seen in short-term loans (Chart 3-24). Total loans outstanding in the corporate segment were down 1.6 per cent on a year-on-year basis, but in terms of the composition of the portfolio, SME loans grew by 0.5 per cent year-on-year. The underlying trends in corporate lending were still characterised by tight credit conditions in the review period as, according to the lending survey, the majority of banks did significantly not change their price and non-price conditions. On the demand side, in addition to the FGS, the moderate interest rate environment and the improving outlook for economic activity may have encouraged borrowing by non-financial corporations.

Although the corporate loan portfolio contracted on aggregate, technical effects may also have contributed to this decline. Furthermore, lending to SMEs increased, thanks to the FGS. Some of the contraction of outstanding borrowing may be explained by the indirect effects of the FGS. On the one hand, similar to previous quarters, the

Chart 3-24: Quarterly net increase in loans to non-financial corporations from domestic financial intermediaries



Note: Loans granted by banks (without specialized institutions), foreign branches, cooperative credit institutions and other financial intermediaries. Seasonally unadjusted change in outstanding amounts, with rolling exchange rate adjustment.
Source: MNB

transaction volume linked to unrenewed loans owing to new borrowing under the first phase of the FGS (borrowing brought forward) may have remained significant during the quarter. On the other hand, such a technical effect may also arise looking forward: owing to loan applications planned for the second phase of the FGS, companies may defer their borrowing (loan applications postponed).

3.2.4. Government demand

Similar to the previous period, developments in government demand were shaped by a fiscal policy focusing on the reduction of government debt and accelerating the pace of absorption of EU funds. Investment demand from sectors tied to the state continued to increase significantly in Q1; due to the accelerating pace of the utilisation of EU funds, the state's infrastructure investment grew further which, in turn, was buoyed by mild weather conditions at the beginning of the year, benefiting construction works. In addition, equipment purchases linked to public transport increased substantially.

3.2.5. Changes in inventories

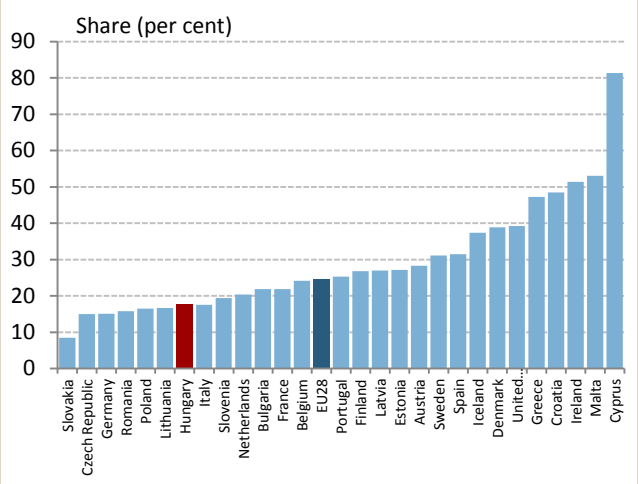
In the first three months of 2014, inventories of the national economy made a slightly positive contribution to GDP. In line with improving economic activity and easing lending conditions, the self-produced inventories of the economy expanded further.

Box 3-2: Foreign trade in services

In the assessment of foreign trade developments, trade in goods is usually discussed at length, while little mention is made of services, even though they account for one fifth of foreign trade as a whole. Moreover, in the past decades the **trade of services has gained a more important role in the world economy**. Services trade rebounded during the crisis not only in Hungary, but also in other parts of the world in the past few years (Chart 3-26). This is partly due to the fact that demand for services depends less on economic cycles and external financing. Furthermore, during the crisis the process of relocation probably intensified and depreciating currencies in some economies may have also been a supportive factor.

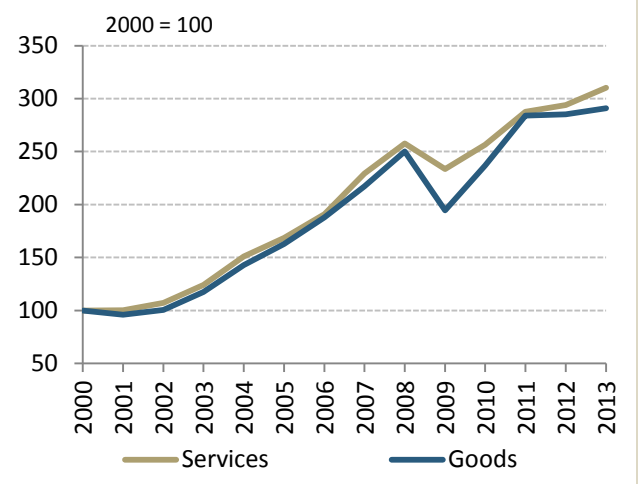
In Hungary, the share of services in total exports is low, similar to all other countries of the region (Chart 3-25). As regards the foreign trade balance, however, the role of services has increased significantly in recent years. **The trade balance of services has been continuously positive since the 1990s**, with the volume rising steadily even during the crisis (Chart 3-27). **The surplus of the services balance accounted for half of the trade surplus last year.** Therefore the factors behind the favourable trade performance of services are worth analyzing in detail.

Chart 3-25: Share of services in exports (2012)



Source: Eurostat

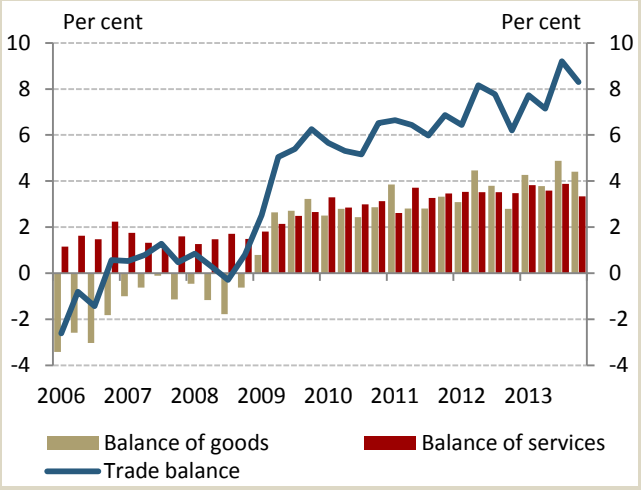
Chart 3-26: The evolution of world trade



Source: World Bank

Both cyclical (change is demand) and structural (establishment of new capacities) factors can explain the significant surplus in the balance of services. Of the key export-oriented service sectors, **tourism, transportation and business services grew significantly during the previous period** (Chart 3-28). For domestic tourism, the period was dedicated to the renewal of existing capacities and the build-up of new capacities, drawing to a great degree on financing from EU funds. The sector also benefited from the depreciation of the exchange rate. Due to this and also due to the increasing share of domestic tourism, the balance of tourism services showed signs of continuous improvement. The export of transportation has been rising steadily since 2009. This supported by numerous new investments in logistics and the imnrease in transportation equipment in the period after crisis, when the foreign demand became favourable. Besides the traditional services, new modern business services also can support the growing exports. A large number of foreign corporations moved their service centres to Hungary mainly with headquarters in Budapest, thanks to the highly skilled labour and moderate wage costs compared to the European average (e.g. EPAM Systems, GE and Vodafone).

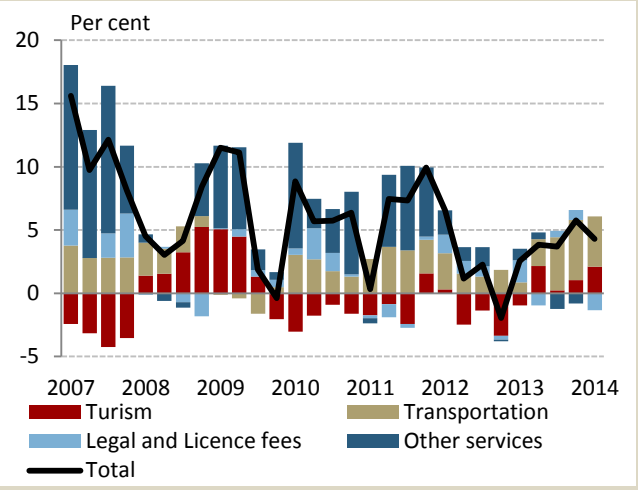
Chart 3-27: Changes in balance of goods and services



Note: As percentage of GDP.

Source: CSO

Chart 3-28: Sectorial contributions to service exports



Note: Annual change at current prices.

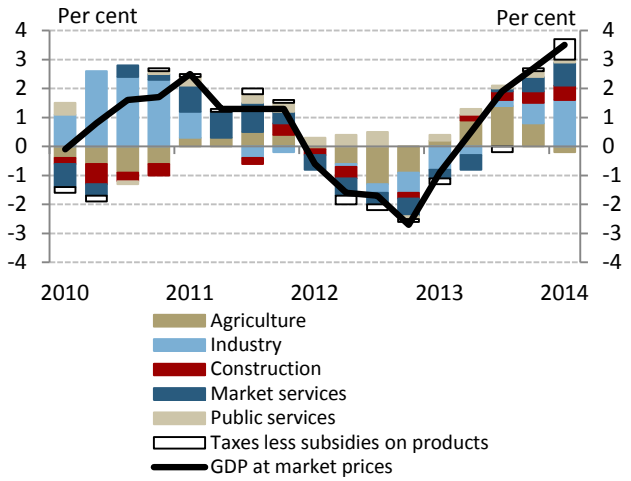
Source: CSO

The exports of services was uninterrupted since the breakout of the crisis, thus the service sector is becoming a larger influence on overall export performance. As services typically have relatively low import content, the increasing share of the **service exports can raise the domestic value added content of exports.** Finally, trade in services is **less affected by the business cycle**, thus a more diversified export structure can dampen the volatility in the economy.

3.3. Production and potential output

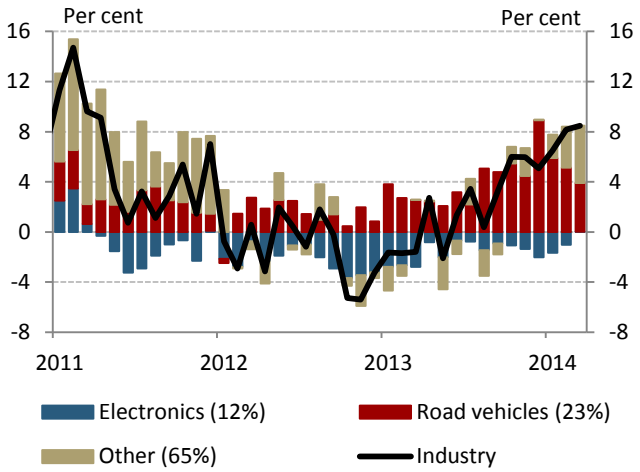
In 2014 Q1, economic activity picked up in a wide range of sectors. Output expanded not only in sectors producing for export, but also in those producing for domestic demand. The rebound in investment activity and improving labour market conditions point to a gradual recovery of potential growth.

Chart 3-29: Contribution of the output of the main sectors of the national economy to GDP growth



Source: CSO

Chart 3-30: Contribution of subsectors to the annual change of industrial production



Note: Seasonally adjusted data. The legend shows the weight of each sector in total industrial production.
Source: CSO

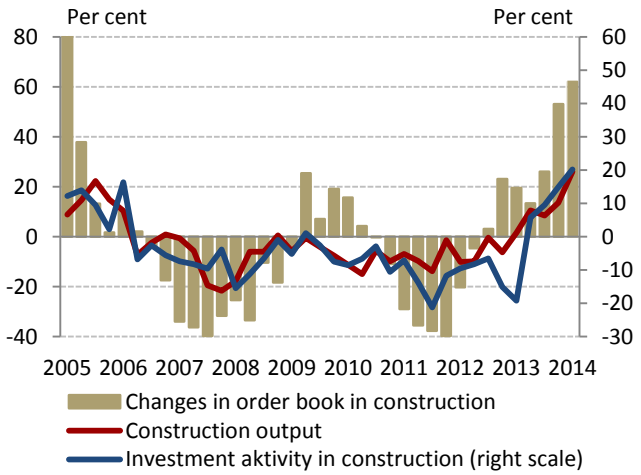
In the first three months of 2014, the performance of the Hungarian economy improved. Output rose 1.1 per cent compared to 2013 Q4. Construction and industrial production demonstrated the most remarkable performance and stronger activity was also seen in market services. Agriculture contracted slightly at the beginning of the year (Chart 3-29). As data for April signals that industrial production accelerated further, performance for Q2 is also expected to be significant.

Following the revival in the second half of 2013, industrial output continued to expand in the early months of 2014. Value added of the sector increased by 6.7 per cent compared to the first quarter of 2013. In line with the favourable external environment and improving economic outlook, industrial production increased in a wide range of sectors. By contrast, owing to mild weather conditions at the beginning of the year, energy production declined considerably. The utilisation of new capacities implemented in recent years in the automotive industry has been steadily rising. Based on the business plans of the main exporters, the increase in the output of the automotive industry is expected to continue this year. Moreover, the performance of the sector's suppliers is picking up gradually. The production of the electronics and optical sectors has contracted steadily in recent years and may have reached its trough at the end of last year before edging slightly higher again in Q1 (Chart 3-30).

Construction output rose steeply in Q1, with this low-weighted sector contributing 0.5 per cent to GDP growth. The 25-per cent annual growth can be primarily attributed to infrastructure investments implemented from EU funds, but construction of buildings connected to the industrial sector also picked up. By contrast, after having hit bottom, the housing market is still in a trough, and only a slow recovery can be expected looking forward. To a large degree, the outstanding performance of the construction sector observed in the first quarter was also facilitated by milder-than-average winter weather. Based on increasing orders and the confidence indicators of the sector, construction output is expected to grow further in the coming quarters (Chart 3-31).

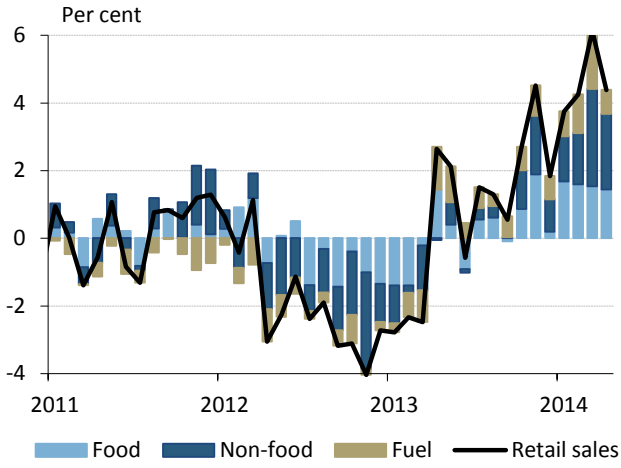
Value added generated by the agricultural sector decreased slightly in Q1. Agricultural output has been extremely volatile in recent years, with the unpredictable

Chart 3-31: Annual changes in construction output, orders and investment



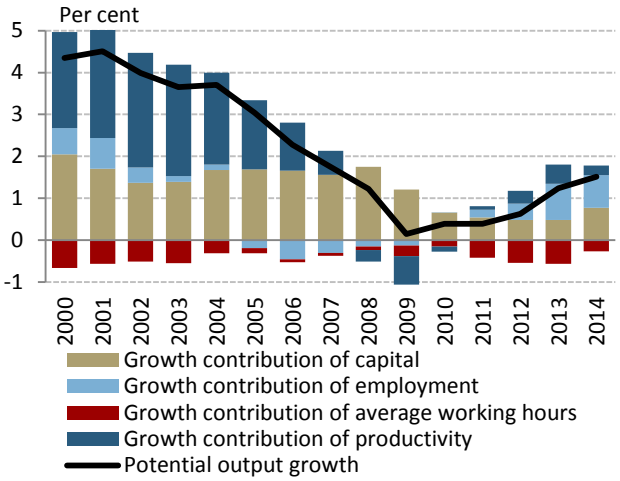
Source: CSO

Chart 3-32: Annual changes of retail sales



Source: CSO

Chart 3-33: Potential ouput growth and growth contributions



Source: MNB calculations

weather conditions as a major factor in this regard, due to the significant weight of crop farming. Last year saw average crop yields on the whole. Initial expectations for this year point to largely similar crop prospects.

Services continued to grow in the first three months of 2014. The value added of market services increased by 1.3 per cent compared to the same period of the previous year. The performance of the sub-sectors finance and real estate transactions declined again in Q1 however. This may be due to weak lending activity and the slack conditions on the real estate market.

Retail sales accelerated significantly from the beginning of 2014. The volumes growth 6.5 per cent in the first quarter (car sales included. Sales increased in all product categories (Chart 3-32). Against the backdrop of moderate inflation and increasing real incomes, household consumption continued to grow, while the upturn in retail sales may be explained in part by the whitening effect resulting from the installation of tax authority cash registers.

The performance of the hospitality and tourism sectors also improved in the first half of the year with an increase registered both in the number of overnight stays and in catering turnover in the first four months. The upswing in tourism demand reflects the improving income position of households and the increased utilisation of benefits in kind which stimulates domestic tourism. In addition to the capacity expansion of recent years, the weaker forint exchange rate may also have contributed to the continuing rise in overnight stays by foreign guests.

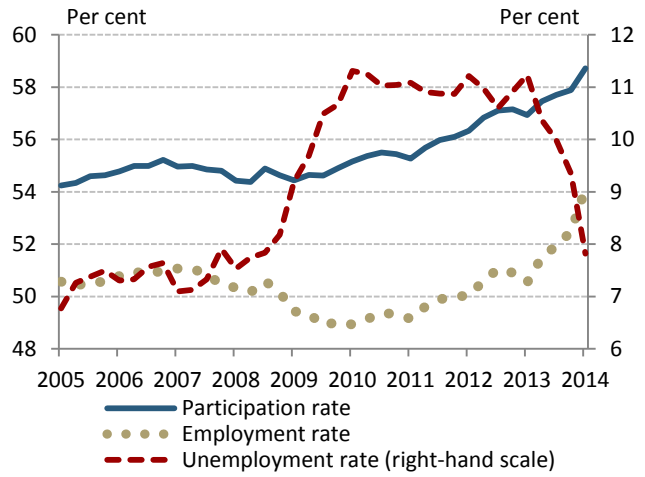
Value added in the sub-sectors of finance and real estate transactions declined further in Q1. Lending activity remained subdued and accordingly, the activity of financial intermediaries was restrained. The market of new homes is at a historical low, while an upward drift is perceivable in the market of used homes.

Potential growth is expected to accelerate gradually. New capacities in the automotive industry may contribute significantly to this acceleration which – combined with the group of domestic suppliers – may raise the production capacities of the economy by as much as 0.5 per cent annually. Labour market participation and employment in the private sector also increased in the first quarter. From the production side, potential growth will be also driven by the improving performance of corporate investment and intensifying labour market activity (Chart 3-33).

3.4. Employment and unemployment

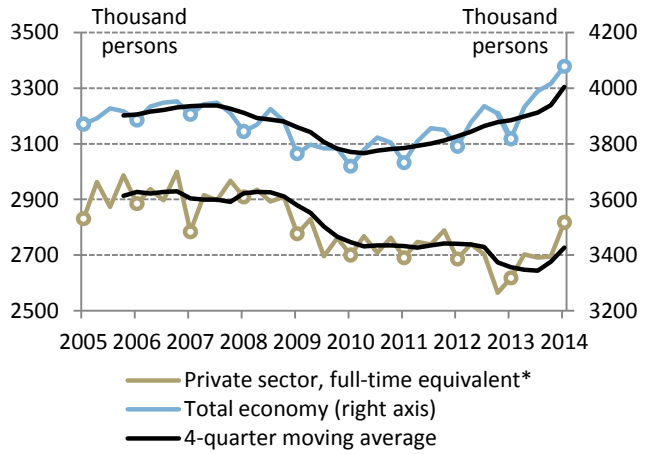
In Q1, the number of employees increased further, partly owing to public work programmes and rising employment in the private sector. The unemployment rate declined further before stabilising in April. Growing labour demand in the private sector and the low level of unemployment suggest that the labour market is less slack than it was in previous years.

Chart 3-34: Participation, employment and unemployment, total economy



Source: CSO

Chart 3-35: Evolution of employment



Note: * Without workers employed abroad and without fostered workers. Markers indicate Q1 data.

Source: CSO

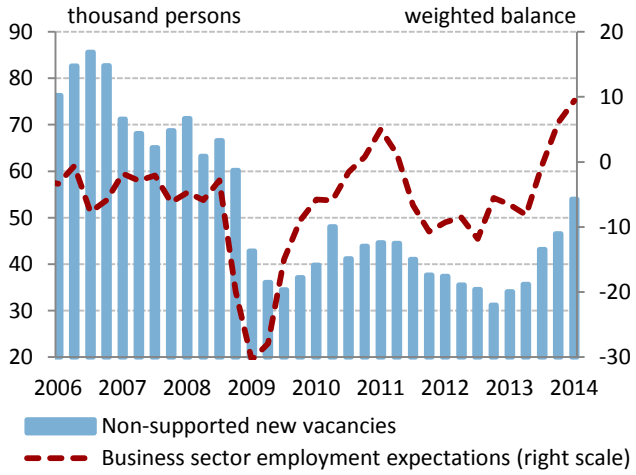
Participation continued to increase at the beginning of the year, mainly due to the inflow of inactive persons to the labour market, as the rise in employment was more pronounced than the decline in unemployment. In Q1, the participation rate was 58.7 per cent for the 15–74 age group (Chart 3-34).

Employment in the whole economy grew further in 2014 Q1 (Chart 3-35). According to the seasonally unadjusted data, employment in Q1 grew by 60,000 employees instead of the usual decline in Q1. This growth was seen in both the public and the private sector as well. The increase in the number of employed in the public sector was driven by the extension of winter public work programmes. Growth in the private sector, in turn, was boosted by rising employment in the manufacturing sector and market services. Despite the significant growth in employees, the labour demand of the private sector is still lower than before the crisis.

Growing labour demand in the private sector was demonstrated by the increase in the number of non-subsidised vacancies registered with the National Employment Service in Q1 and the employment expectations in the business confidence indicators (Chart 3-36). In April-May, the number of new non-subsidised vacancies decreased slightly, and accordingly the labour demand of the private sector may have slowed down in Q2.

The number of unemployed continued to decrease in the first quarter of the year (Chart 3-34). The sharp decline may have been driven by the commencement of winter public work programmes. At the same time, monthly data both from the Labour Force Survey and the National Employment Service indicate that the decline in the number of unemployed came to a halt. The unemployment rate was near 8 percent in April. With the rise in the number of non-subsidised vacancies, the labour market has become less slack than it was in previous quarters (the calculation of spare labour capacity is discussed in special topic 6.2.).

Chart 3-36: Indicators of labour demand



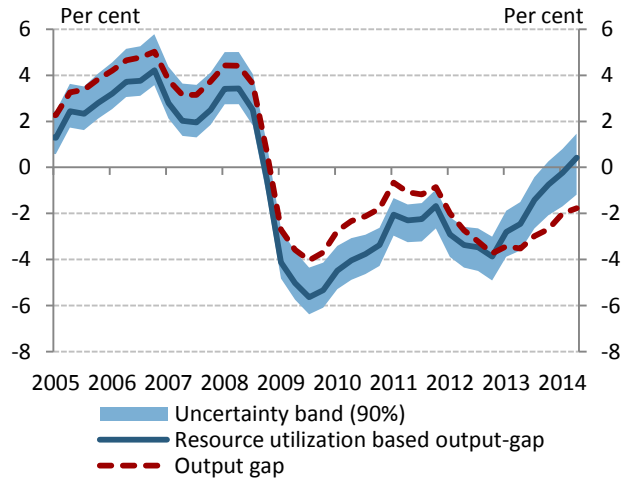
Note: The series of business sector employment expectations is the weighted average of the series for industry, construction, trade and services in the ESI survey.

Source: National Employment Service MNB calculation based on European Commission data

3.5. The cyclical position of the economy

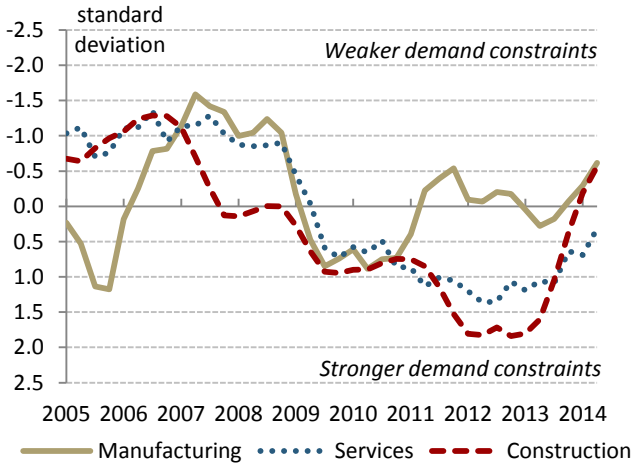
The economy is still likely to be characterised by spare capacities, and thus inflationary pressure from the real economy remains moderate. Owing to strong demand-side disinflationary pressures prevailing in the world economy, the domestic output gap may be more open than previously estimated. At the same time, as demand picks up, the output gap is closing gradually, which is also confirmed by the indicators measuring resource utilisation.

Chart 3-37: Output gap measures



Note: The RU gap consolidates the information content of various corporate capacity utilisation indicators into a single indicator. The uncertainty band reflects the uncertainty of that estimate. For a detailed description of the methodology, see: Rácz O. M. (2012): Using confidence indicators for the assessment of the cyclical position of the economy, MNB Bulletin, June 2012.
Source: MNB

Chart 3-38: Demand as primary limiting factor of production in the ESI survey



Note: Standardized data, reversed scale. 3-quarter moving averages.
Source: European Commission

The real economy continues to exert disinflationary effects. In line with subdued underlying inflation trends, our estimate for the output gap – which captures domestic inflationary pressure – remains negative. The presence of spare capacities is also indicated by the fact that unemployment is still higher than its pre-crisis levels.

Incoming data since the March forecast suggests that growth and inflation in Hungary are being shaped by better-than-expected supply-side developments. Economic growth accelerated faster than expected in the recent period, while inflation proved to be lower than our March forecast. For the most part, the low inflation reflects cost-side factors (commodity prices, import prices). The productive capacity of Hungary expanded faster than anticipated, also buoyed by the surge in the output of new capacities in the automotive industry.

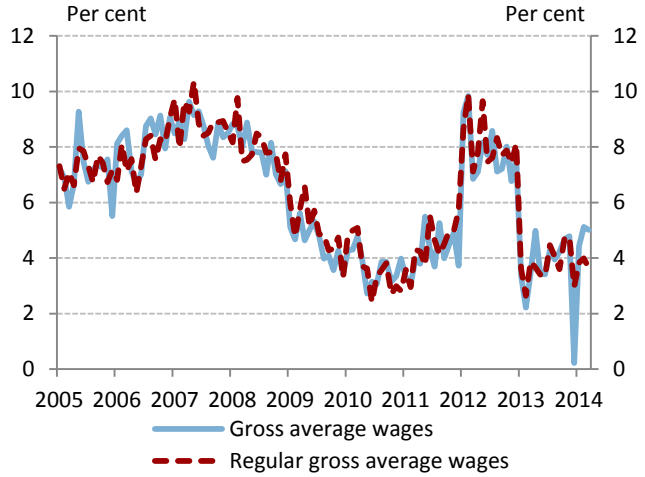
Compared to the March Inflation Report, the output gap is now deemed to be more open. European inflation trends are more moderate than analysts' expectations suggested, and may reflect the stronger disinflationary impact of the international demand environment. The negative output gap of Hungary's export markets dampens the capacity utilisation of the Hungarian export sector, thereby opening the domestic output gap. At the same time, through import prices, low international inflation also affects the domestic economy directly. Strong disinflationary effects from the global economy are partly offset by the fact that domestic household consumption is recovering faster than was projected in the March forecast. The upturn in consumer demand points to gradual weakening of the disinflationary force of domestic demand.

Based on corporate surveys, confidence indicators have improved steadily in recent months, which is a potential indication that capacity utilisation may increase as demand picks up. According to the surveys, the expansion of production is less and less restricted by the lack of demand. At the same time, this primarily affected those economic sectors which do not play a key role from the aspect of domestic inflationary pressure (industry, construction).

3.6. Cost and inflation

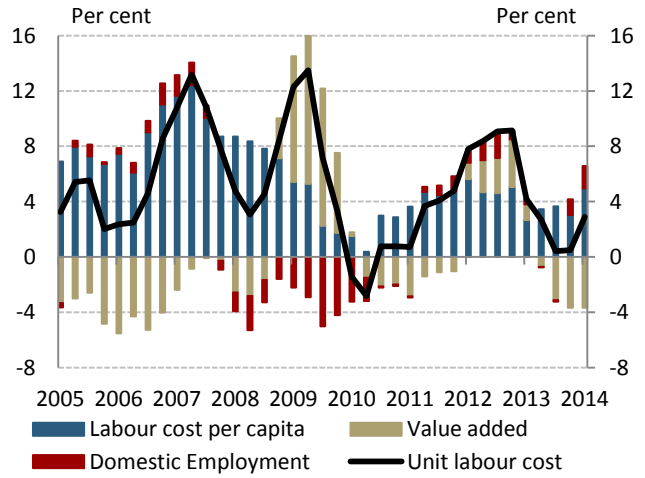
Inflation has continued to decelerate in recent months and resides at historically low levels well below the 3 per cent inflation target. The moderate inflation rate is likely to be the combined result of favourable cost pressure, restrained demand, gradual adjustment of expectations and cuts in regulated energy prices. The wage index of the private sector accelerated in Q1, mainly due to bonus payments carried over from the previous year and the increasing dynamics of regular wages.

Chart 3-39: Annual changes in gross average wages and regular wages (excluding premiums and one-month bonuses)



Source: CSO

Chart 3-40: Annual changes and components of unit labour cost in private sector



Source: MNB calculation based on KSH data CSO

3.6.1. Wages

The wage index of the private sector accelerated in Q1, due to bonus payments carried over from the previous year and mild acceleration in regular wage growth as well. At the beginning of the year, private sector wages accelerated both in respect of regular wages and gross average wages. At the end of last year, the amount of bonuses paid in the market services was less than in previous years, and the difference was made up at the beginning of this year. This rescheduling contributed to this year's higher wage index. Wage dynamics in the manufacturing sector are similar to those seen last year. The dynamics of regular wages are slightly stronger than indicated in the March forecast, but are still lower than before the crisis (Chart 3-39).

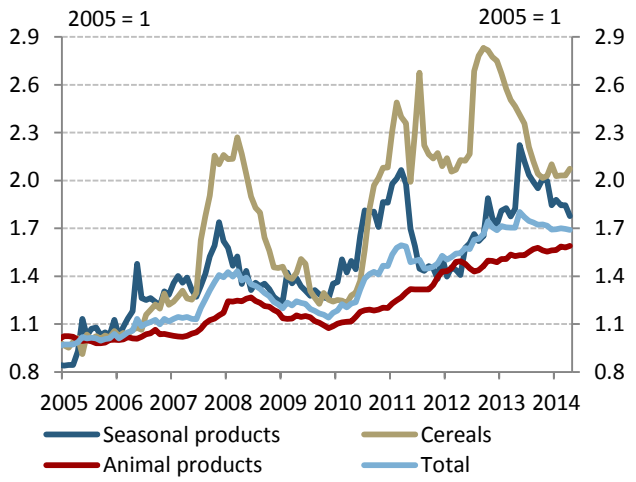
Growth in unit labour costs is modest, with a rise of around 3 per cent in the private sector. However, the fast increase in the number of employees in Q1 slowed down the productivity. At the same time, wage growth increased and accordingly, the growth rate of ULC slightly accelerated compared to the levels seen last year. However, the dynamics of ULC are still considered to be moderate in a long-term comparison (Chart 3-40).

3.6.2. Producer prices

Inflationary pressures from commodity prices have been generally restrained in recent months. The evolution of agricultural producer prices was stable overall (Chart 3-41). The price level of grains and corn edged up slightly, while the prices of seasonal products declined further. Prices of meat and dairy products rose slightly, mostly due to price increases for milk. In the coming quarters, falling fodder costs may reduce the prices of meat and dairy products.

Industrial producer prices have been characterised by restrained dynamics in recent months (Chart 3-42). The favourable dynamics of producer prices have also been observed at the global level. Prices of consumer goods producer branches and of those producing intermediate goods remained practically the same. The effect of the weaker exchange rate recorded for the recent period may have been dampened by subdued demand and low

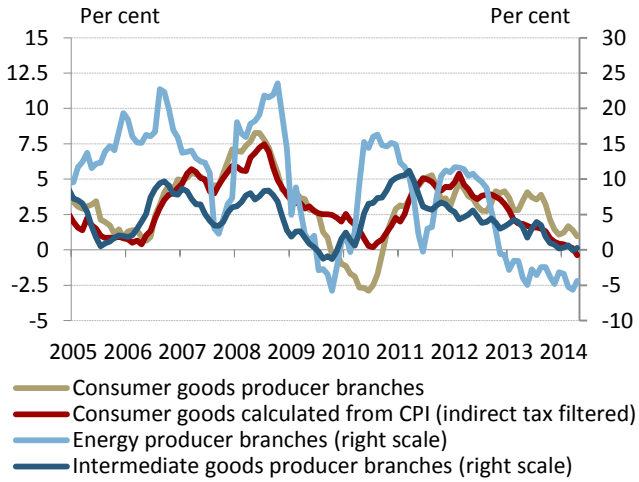
Chart 3-41: Agricultural producer prices



Note: Seasonal products: fruit, vegetables, potato, cereals: wheat, oil seeds; products of animal origin: pork, poultry meat, egg, milk; weighting was based on the estimated size of the effects on the consumer price index.

Source: MNB calculation based on CSO data

Chart 3-42: Annual change of industrial producer prices



Source: MNB calculation based on CSO data

imported inflationary pressure. The prices of energy producer branches dropped in an annual comparison. The changes in the producer prices of the branch were due in part to the impact of declining household energy prices. In EU Member States, the prices paid by industrial users for electricity and gas consumption fell slightly last year.

Trends in Hungarian producer prices were broadly consistent with developments in the euro area. Changes in producer prices may be explained by a combination of weak demand, restrained commodity prices and the gradual adjustment of inflation expectations. Consequently, **inflationary pressure remains low in the category of processed goods**.

3.6.3. Consumer prices

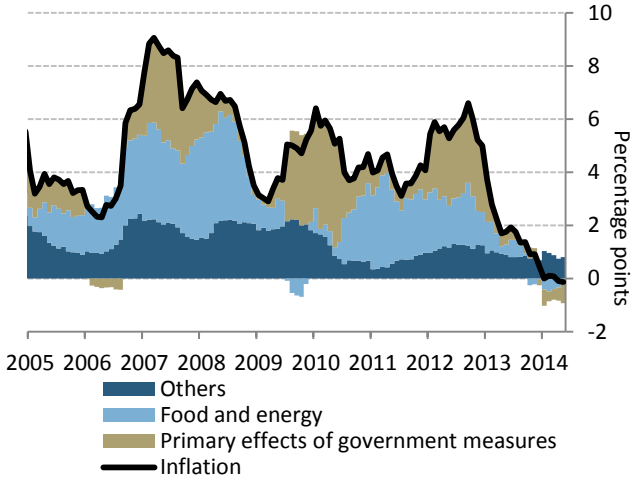
Inflation has continued to decelerate in recent months and remains at near-zero levels. Favourable cost-side pressure, restrained demand, the gradual adjustment of expectations and the cuts in regulated energy prices may all have contributed to the moderation of inflation (Chart 3-43).

Underlying inflation indicators decreased in the recent period (Chart 3-44). **The low level of the underlying measures continues to point to moderate inflation.** The indicators remain consistently in the positive range; therefore, despite the near-zero level of the consumer price index, deflationary risks should be considered extremely moderate.

Prices of tradable goods have changed moderately during recent months, due to the favourable changes in import prices and slack demand. On the whole, tradable goods were characterised by moderate price dynamics in the previous period. Even combined with the rebound in household consumption, the weaker exchange rate was unable to offset the external price pressures. Within tradable goods, following a three-month period of increase, the inflation of durable products has declined in recent months. Meanwhile, the prices of non-durable goods have shown restrained dynamics.

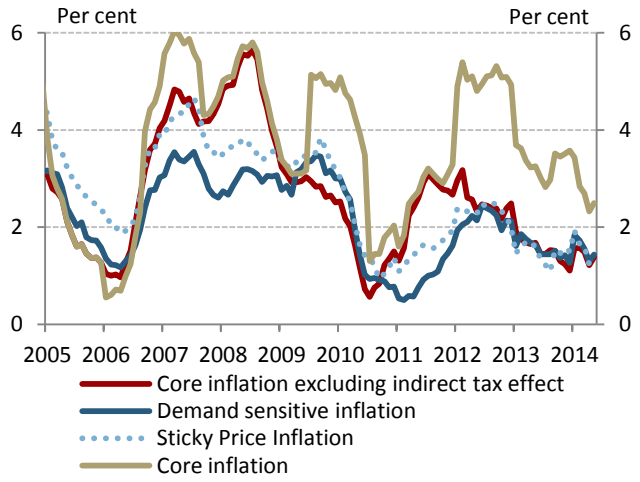
In the period under review, the monthly price change of market services remained moderate overall. In April, the inflation of the product category was influenced by a one-off factor, the retraction of banking fee increases (the price change affects a limited range of products and it only has a temporary effect on inflation; therefore, its effect has been recognised under indirect taxes). Disregarding these effects, the prices of a wide range of other services increased at a moderate rate. As a result, the inflation of

Chart 3-43: Decomposition of inflation



Source: MNB calculation based on CSO data

Chart 3-44: Developments of underlying inflation indicators



Source: CSO and MNB calculation based on CSO data

this product category – excluding indirect taxes – is moderate.

In line with the changes in agricultural producer prices, changes in food prices were moderate. Processed products have generally been characterised by subdued price dynamics in recent months. The decline observed in the seasonally adjusted price level of unprocessed foods in May could have been driven by favourable weather conditions in the spring. **Fuel prices basically remained unchanged in the period.** The slight increase in international oil prices was offset by strengthening of the HUF/USD exchange rate. Earlier during the quarter, European refineries were going through maintenance, putting upward pressure on price margins. Since the beginning of May, full capacities have been put back into operation, leading to a decline in margins and a moderation of fuel prices.

The inflation rate of administered prices has remained low in recent months. The inflation rate of this category was significantly affected by the reduction of regulated energy prices at the end of last year and further energy price cuts later during the year. On the whole, price changes among other administered items have been also moderate. Since the price cuts are reflected in the CPI and HICP indices with different timing, the two inflation indicators show a temporary gap.

Incoming inflation data has been lower than the expectations of the central bank. Much of the difference can be attributed to cost-side factors, in particular the favourable change in raw material and crude oil prices. The moderate inflation of tradable goods also contributed to the difference, which may have resulted primarily from the low price pressure from import prices.

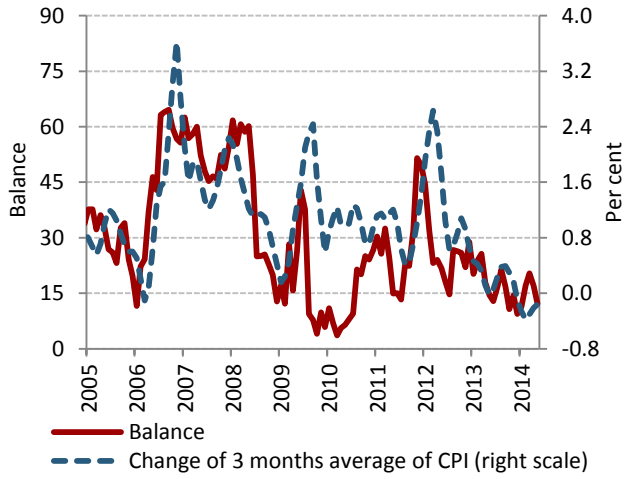
On the whole, moderate inflation has been observed in recent months. Raw material prices and import prices may exert moderate inflationary pressure over the short term, while the gradual pick-up in domestic demand is expected to have an opposite effect.

3.6.4. Inflation expectations

The expectations of the retail sector in respect of sales prices, which play a crucial role in the short-term developments in consumer prices, **remained low in the previous period.** This is an indication that cost and demand factors do not warrant a price increase in the coming months (Chart 3-45).

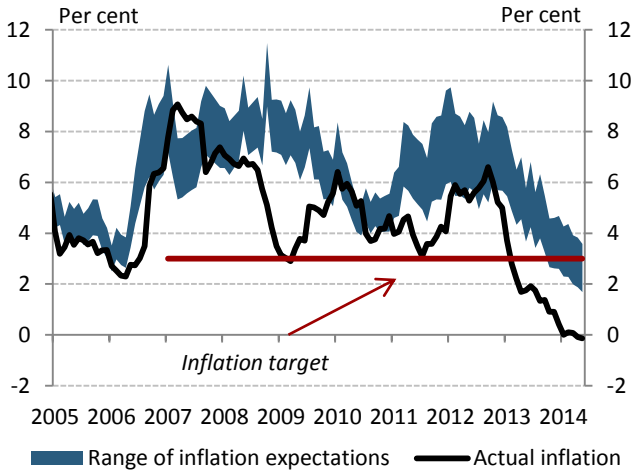
Household inflation expectations decreased steadily last year, in line with the decline in actual inflation. A further

Chart 3-45: Expected changes in retail sales prices in the next 3 months* and actual inflation



Note: * Balance is the difference between the proportion of corporations expecting price increase and price decrease.
Source: GKI and MNB calculation based on CSO data

Chart 3-46: Households' inflation expectations



Source: MNB calculations based on data from the EU Commission

decline has materialised since the beginning of the year (Chart 3-46). Restrained inflation expectations may help ensure that the pricing and wage-setting decisions of economic agents remain consistent with the inflation target in the medium term.

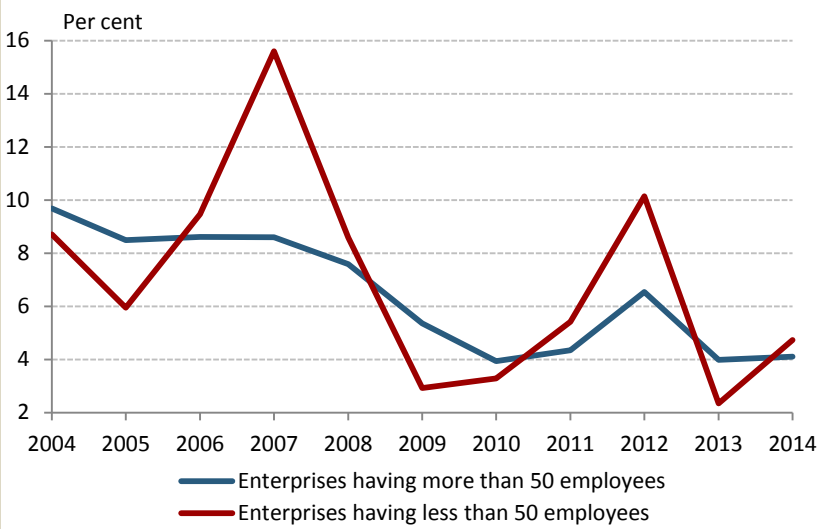
Box 3-3: Factors shaping the assessment of wage-setting in the private sector

The March Report on Inflation envisaged low (2.4%) wage dynamics for 2014 in the private sector. This projection was based on the weak profitability of companies, slack labour market conditions and the gradual decline in inflation expectations. A slack labour market allows companies to improve their profitability by restraining pay rises if there is limited room for doing so through consumer price increases. Declining inflation expectations, in turn, may contribute to the medium-term stabilisation of low wage dynamics. Consequently, we had assumed that a disciplined restraint on wage costs may remain in place even in a recovering demand environment. Accordingly, we had concluded that inflationary pressure from the labour market would remain weak.

By contrast, **wage data for March 2014** – which, based on previous experience, play a decisive role in wage developments for the entire year – **indicate that wage dynamics have exceeded our expectations**: gross average wages increased by 5.3 per cent and regular gross average wages increased by 3.9 per cent compared to the same period of the previous year. **The higher-than-forecasted actual data may reflect several factors.**

- On the one hand, **economic activity proved to be more favourable** than foreseen in the March forecast, with GDP volume up 3.5 per cent and value added on current prices up 7 per cent in Q1 compared to the same period of the previous year, which may have left more room for wage increases. Sectoral confidence indicators have been pointing to the improving prospects of companies since the end of 2012. If companies raised wages in line with the increase in productivity, the higher wage index would not generate inflationary pressure.
- On the other hand, **the profitability of companies may have been better than previously assumed**, which may have left more room for wage increases in the previous years than we assumed (see Box 1-3).
- Moreover, **there is a possibility that companies planned pay rises for this year on the basis of earlier, higher inflation expectations**. This assumption is supported by the fact that at the beginning of the year the agreed pay increase recommendation of the employers' association and trade unions for 2014 uses a consumer price index of 2.5 per cent, while our current forecast projects 0 per cent inflation for 2014. The alignment of wages to higher-than-warranted inflation expectations may prompt an adjustment on the part of companies. In the case of weak demand, future pay rises may be more restrained, while improving demand may well lead to price increases.
- **The higher-than-expected wage dynamics may also suggest that the labour market environment has become tighter than assumed** (problems arise from measurement of the tightness of the labour market are discussed in special topic 6.2). Given the decreasing number of jobseekers per job vacancy, firms are forced to offer higher wages in order to recruit or retain sufficient labour force, so the tighter labour market environment demands higher wage dynamics. This fuels inflationary pressure from the cost side of the labour market.
- In addition, **measurement issues may also play a role in higher wage dynamics.** The institutional wage statistics of the CSO observes companies with more than 50 employees comprehensively, and smaller firms by way of representative sampling. The sample of companies with less than 50 employees is replaced annually, which may distort the wage index through composition effects. Changes in the wage indices of the two staff number categories suggest that the sample change may have distorted the 2013 wage index downward. According to data regarding bigger companies and based on comprehensive observation wage dynamics of regular gross average earnings did not accelerate in this year (Chart 3-47). If statistical effects account for the higher wage index, that does not imply inflationary pressure from the cost side of the labour market.
- On the other hand, the reform of the personal income tax regime and Government measures aimed at increasing the efficiency of tax collection may have led to the whitening of wages (indeed, in 2006-2007 this phenomenon drove the marked increase in the wage indices of companies with less than 50 employees). If that is the case, the higher wage index will not generate inflationary pressure.

Chart 3-47: Annual changes in regular gross wages in private sector (annual average)



Note: Q1 data for 2014.
Source: CSO

Altogether, several factors may have contributed to the higher-than-expected wage dynamics. To a large degree, **the assessment of the inflationary effects** associated with the higher wage index **depends on the perception of the profitability position of firms, changes in unused capacities and the tightness of the labour market.** Wage data for the next month may help decide this more accurately. In our baseline projection, slack labour market conditions and decreasing inflation expectations may ensure the persistence of a more moderate wage index than seen in previous years.

Table 3-1: The possible effects of factors influencing waging

Factors explaining the increase of wage index	Expected changes in wage index	Risk to inflation
more favourable economic conditions	no changes	low
more favourable corporate profitability	no changes	low
higher inflation expectations	decrease	medium
tighter labour market	no changes/increase	high
measurement error	no changes	none
whitening	no changes	none

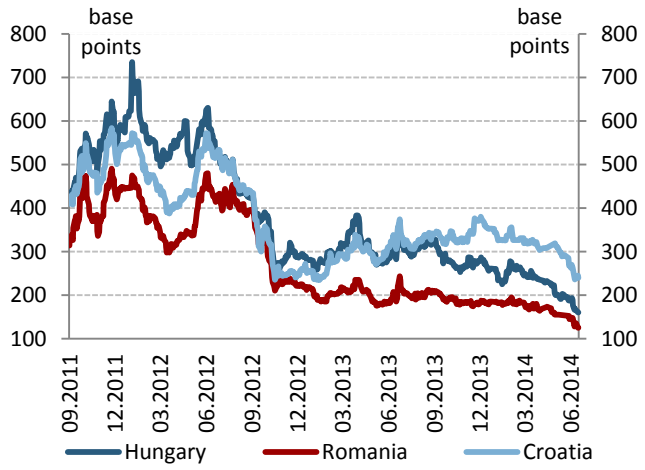
4.1. Domestic financial market developments

Over the past three months, the risk assessment of Hungary improved. Among the international market-moving events, the Russia–Ukraine conflict was of primary significance. Apart from a temporary period of easing, there were no clear signs of improvement in this regard during the period, but troublesome news from the region was less reflected in the Hungarian money markets than before. Toward the end of the period, issues surrounding the gas supply of Ukraine and a further escalation of the conflict put the Ukrainian situation back in focus for the markets once again. In addition, markets scrambled to make adjustments in response to the intensification of the conflict in Iraq and the World Bank's more pessimistic growth forecast. The monetary policy of major central banks was thrust into the limelight in connection with market expectations regarding the ECB's steps – and later the adoption of specific measures – of monetary easing, while the Fed's tapering of its asset purchases in line with the expectations of the market consensus did not cause any market upheaval. At the beginning of the period, central bank communication in respect of the expected timing of the Fed's first interest rate increase spurred temporary market turmoil, but US central bankers managed to calm the markets shortly by issuing a number of further statements. On the whole, the monetary policy of major central banks was characterised by an accommodating stance in the past three months, which benefited both global and domestic market developments.

The risk assessment of Hungary was shaped mainly by global trends, while among the country-specific factors, lower-than-expected inflation figures weakened the forint exchange rate somewhat, while the publication of the GDP figure – which surpassed expectations – exerted an opposite effect on the forint. The risk perception of Hungary may have been improved by S&P's decision to improve the country's outlook; however, several issues remained open in respect of the Government's solution following the Supreme Court's legal uniformity resolution. At the beginning of the period, apart from a surge in the forint exchange rate at the end of March, in parallel with slight easing of tensions related to the Ukrainian crisis and the political conflict between Russia and the Western powers, Hungarian risk indicators began to decline and improved further during the rest of the period. The Hungarian CDS spread gradually declined below 170 basis points compared to a level around 240 basis points in mid-March. The forint exchange rate appreciated by almost 1 per cent overall during the period.

As a result of a considerable fall in market yields on government paper, Hungarian benchmark yields plummeted to a historical low. The short end of the government securities market yield curve fell by 50–55 basis points compared to the levels recorded in March, while the long end was down 130 basis points. Government security auctions sparked heightened demand for both short-term and long-term bonds. In the case of most bonds, the issuer borrowed funds in excess of the announced amount amidst declining average yields. The government security holdings of non-residents rose by nearly HUF 300 billion and exceeded HUF 4,900 billion.

Chart 4-1: 5 year sovereign CDS spreads in the region

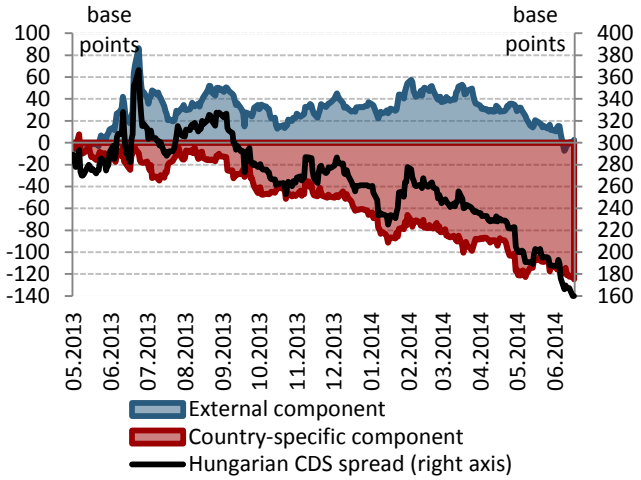


Source: Bloomberg

4.1.1. Risk assessment of Hungary

Hungary's risk premia have improved considerably since the March Inflation Report. The Hungarian five-year CDS spread declined significantly, yields on government bonds fell sharply and, amid mild fluctuations, the exchange rate of the forint strengthened overall. Global market sentiment basically benefited Hungarian risk indicators, prompting positive changes in most asset categories, including emerging market asset prices. Global investment appetite was undermined by events related to the crisis in Ukraine which resulted in deterioration of the risk assessment of the region; subsequently, however, no notable negative effects were registered in CEE markets despite the persistence of tensions surrounding the internal affairs of Ukraine. At the same time, the repeated escalation of the Ukrainian conflict toward the end of the

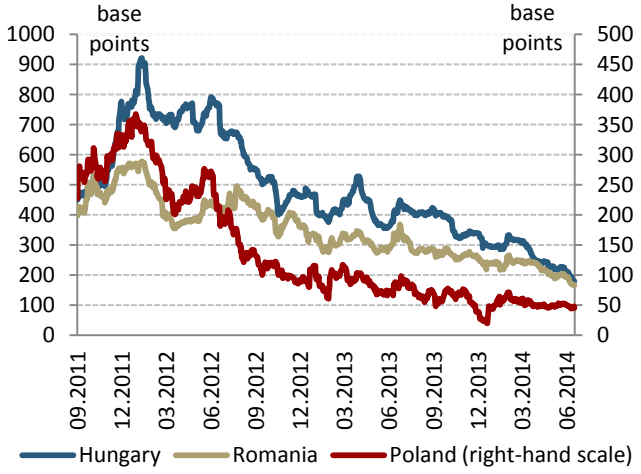
Chart 4-2: Components of 5-year Hungarian CDS spreads



Note: The used decomposition method can be found in MNB Bulletin: Variance decomposition of sovereign CDS spreads, Kocsis–Nagy (2011).

Source: Bloomberg

Chart 4-3: Spreads of CEE sovereign euro bonds maturing in 2018



Source: Thomson Reuters

period warns of a highly precarious situation.

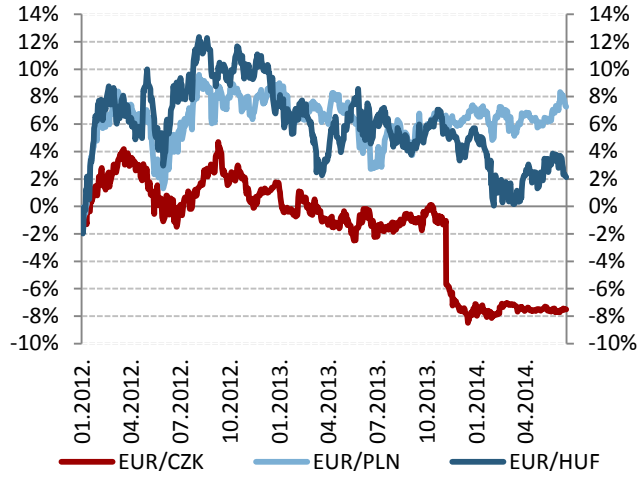
The Hungarian five-year CDS spread gradually dropped below 170 basis points compared to its level in mid-March, which translates into a decline of around 70 basis points. Regional CDS spreads also contracted considerably, indicating that the Hungarian risk premium moved in line with other CEE countries with a similar risk assessment (Chart 4-1). The risk assessment of Hungary may have been positively influenced by Standard and Poor's decision to adjust the outlook on Hungary's debt rating from negative to stable, citing faster economic growth and the reduction in Hungary's external vulnerability. At the same time, Fitch Ratings did not adjust Hungary's previous rating and left its stable outlook in place. The central bank's self-financing programme announced during the period was received warmly and, through the expected moderation of Hungary's external vulnerability, it may have contributed to the improvement in the risk indicators of the country. No significant market reactions were triggered by the outcome of the parliamentary elections, or by the interest rate decisions, which were consistent with the market consensus.

According to our CDS decomposition methodology, at the beginning of the period the domestic components affecting the CDS spread put upside pressure on the spread, which, however, was offset by the spread-reducing effects linked to international factors. For the rest of the period, both international and country-specific factors pointed to a decline in the spread, but looking at the review period as a whole, the spread-reducing effect of international components was more dominant (Chart 4-2). **Yields on both USD- and EUR-denominated bonds decreased significantly during the past 3 months.** EUR-denominated bond spreads decreased by nearly 50 basis points on average, while bonds denominated in USD were down 60 basis points on average (Chart 4-3).

4.1.2. Developments in foreign exchange markets

With mild volatility compared to the previous quarter, the forint exchange rate fluctuated between 301.8 and 313.7 against the euro, appreciating by almost 1 per cent overall since the cut off date of the March Inflation Report. The EUR/HUF cross rate resided at weaker levels initially, which was followed by intense appreciation at the end of March and consequently, after a strengthening corresponding to that observed in the case of emerging exchange rates, it moderated to 305 before being hit by yet another weakening spell. During the second phase of the appreciation, the forint may have been strengthened by the better-than-expected GDP figure, heightened

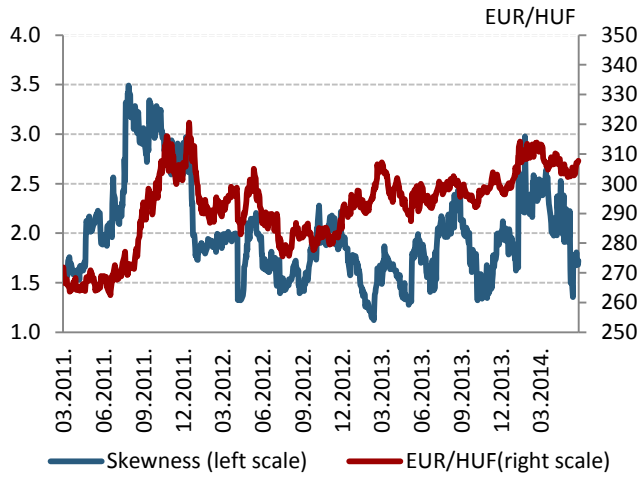
Chart 4-4: Exchange rates in the region



Note: Changes compared to begining of 2012. Positive values mean an appreciation of the currency.

Source: Thomson Reuters

Chart 4-5: EUR/HUF exchange rate and 1 month skewness



Note: Skewness = Risk reversal/Volatility *10

Source: Bloomberg

expectations about the ECB's monetary policy steps, as well as a fundamentally benevolent global sentiment. As a result of the correction at the end of the period, the EUR/HUF exchange rate rose above 307.

Regarding the period as a whole, compared to CEE exchange rates, the forint outperformed the stagnating Czech koruna, but underperformed both the Polish zloty – which appreciated by 1.5 per cent – and the Romanian leu (Chart 4-4).

The skewness of the EUR/HUF exchange rate exhibited opposing movements during the period; however, a considerable decline was registered for the period as a whole. EUR/HUF volatility moderated in line with the strengthening of the forint exchange rate, pointing to a shift in exchange rate expectations towards a stronger future exchange rate. According to Reuters' data on short-term analyst exchange rate expectations, amid lower dispersion, expectations shifted towards an exchange rate level stronger than that seen in March, while the median value of expectations increased somewhat over the one-year horizon despite a stronger spot exchange rate.

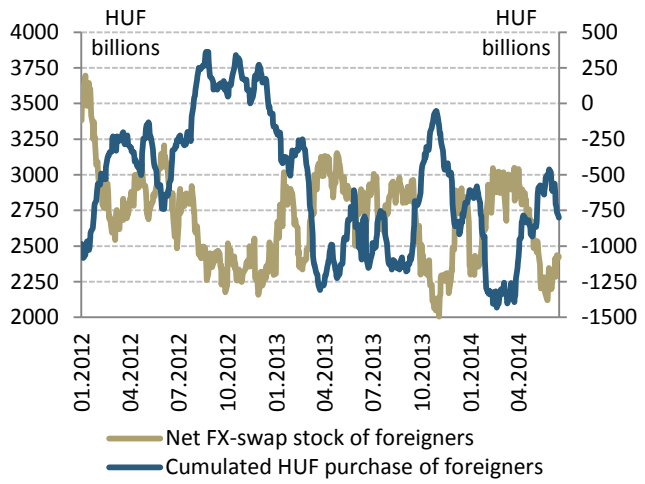
The domestic FX market was basically characterised by calm trading. Short-term FX-swap market spreads exhibited the volatile swings already observed in previous periods, but the spreads returned to the initial levels by the end of the review period. Spreads demonstrated more volatile swings at the end of March, but the surge associated with the end of the quarter proved to be temporary only. Longer-term spreads were not affected by end-of-quarter tensions and the swap spreads showed no noticeable shifts during the period.

The net FX-swap holdings of non-residents fell by HUF 470 billion by the end of the period, with a corresponding increase in non-residents' cumulated forint purchases (Chart 4-6). Following a substantial decline, the two-week MNB bill holdings of non-residents diminished by nearly one half. After a downsizing of the portfolio in the first quarter, the government security holdings of the sector of non-residents increased by around HUF 300 billion and approached the levels observed before the emerging market turbulence at the beginning of the year. Their share within the total portfolio rose above 42 per cent (Chart 4-7).

4.1.3. Government securities market and changes in yields

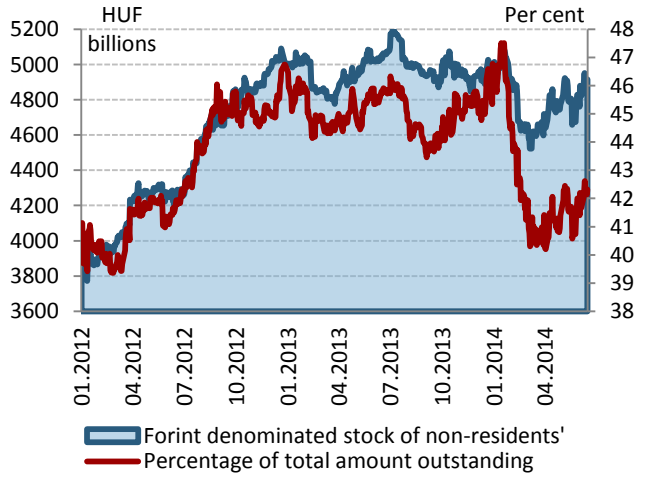
Short-term treasury bill auctions were characterised by 2.7 times coverage on average, and in most of the cases, the volume of government securities issued by the Government Debt Management Agency (ÁKK) exceeded

Chart 4-6: HUF FX Swap stock, and cumulated HUF purchase of non-residents



Note: Cumulated HUF purchase of foreigners: 4 January 2010 = 0.
Source: MNB

Chart 4-7: Hungarian forint-denominated government securities held by non-residents



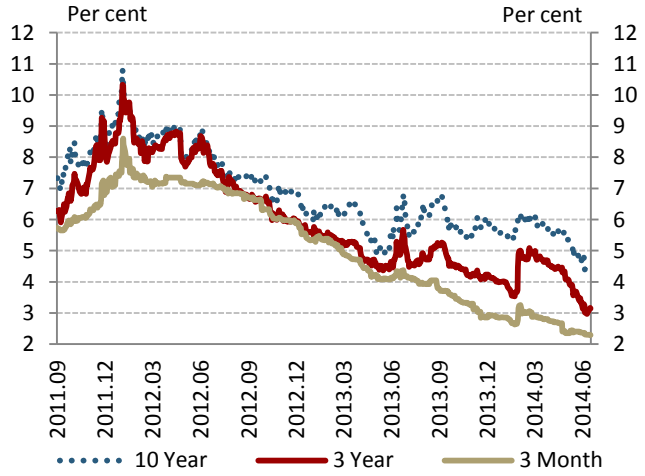
Note: The chart shows the stock of T-bills and T-bonds and the amount of government securities held by non-residents; but retail securities are not included.
Source: MNB

the announced quantity. In the case of 3-month Discount Treasury Bills, a total of HUF 250 billion was allocated at 13 auctions, while excess liquidity of HUF 120 billion was allocated on six occasions in the case of the 12-month DTB. The average auction yield declined in the period as a whole, consistent with the changes observed in interest rate cut expectations and the heightened demand for HUF-denominated government papers.

In the primary market of government securities, excess demand for 3, 5 and 10-year government bonds amounted to three times the supply on average. Apart from a few auctions, the issuer borrowed funds in excess of the announced amount even in the case of government bonds, and average auction yields fell by 100 basis points during the period.

The government securities market yield curve shifted downward compared to the beginning of the period. The short end of the curve fell by 50–55 basis points compared to the levels recorded in March, while the long end was down 130 basis points. The steepest fall took place in the middle of the curve, where 3- and 5-year benchmark yields dropped by 150 basis points (Chart 4-8). Parallel to the sharp decline in secondary market long-term yields, the slope of the yield curve also flattened. While declining yields were typical both across the broadly interpreted emerging universe and in CEE countries, the yield decline in Hungary outstripped that of the neighbouring countries, pushing the Hungarian 10-year benchmark yield below that of Romania at the end of May. The self-financing programme announced by the MNB at the end of April, the ECB's measures aimed at monetary easing, the accommodating international environment and the moderation in inflation expectations may all have contributed to the decline in Hungarian yields. The interbank spot yield curve also exhibited a significant shift, albeit to a lesser degree than the government security market curve. The significant decline in the forward interest rate path implied from interbank rates was due to the fact that the risk scenarios surrounding the interest curve may have been removed from the prices during the period. The 110 and 140 basis point respective decline in forward interest rates pertaining to the end of this year and next year took place amid the flattening of the curve.

Chart 4-8: Yields of benchmark government securities



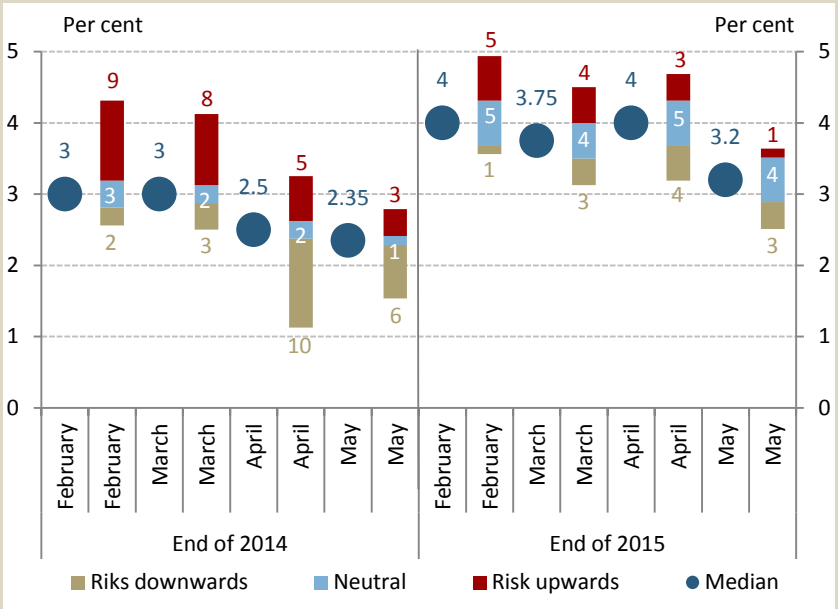
Source: ÁKK

Box 4-1: Analyst and market interest rate expectations point to the persistence of loose interest rate conditions

Short-term analyst and market interest rate expectations underwent a spectacular change this year. The change is perceivable both in the most probable scenario of the interest rate path captured by analyst surveys and in the risks surrounding the baseline scenario.

Analysts expect that the loose monetary conditions will be maintained for longer than was expected at the beginning of the year. Besides the surveys, similar conclusions can be drawn from market prices, given that the short-term slope of the interbank yield curve flattened considerably in the past period, returning to values close to the emerging market average.

Chart 4-9: Reuters Poll forecasts of the end-2014 and end-2015 NBH base rate and the dominant risk around the baseline scenario perceived by the forecasters



Note: The columns represent the dominant risk around the baseline scenario perceived by the forecasters.

Source: Thomson Reuters

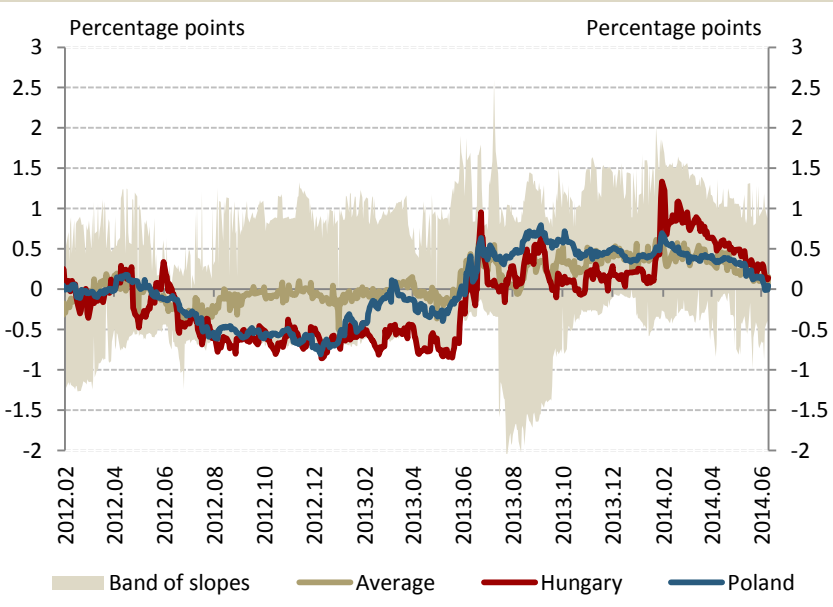
Until the May analyst survey, the consensus preceding the rate-setting decisions did not expect any further interest rate cuts beyond the current interest rate decision (Chart 4-9). The expectations reflected in the baseline scenario envisaged a

gradually rising interest rate curve over the time horizon until 2015, where the expected interest rate increase would have materialised as early as this year. By contrast, **the Reuters poll in May revealed that the experts interviewed projected further easing and expected the key policy rate to remain at a low level longer than before.** Moreover, the policy rate expected for the end of 2015 was believed to be lower than anticipated a month before.

The change in expectations is even more evident in the risks surrounding the interest rate path envisaged by the baseline scenario. In February and March, analysts typically perceived upward risk both in respect of the levels prevailing at the end of 2014 and at the end of 2015. **From April** however, even though the dispersion of individual responses pertaining to the end of the following year remained high, **downward risks gained ground relative to the baseline scenario**. The shift may be attributable, on the one hand, to the persistence of an unexpectedly low inflation environment and, on the other hand, to expectations about the European Central Bank's further easing steps, which have indeed come to pass since then.

The short-term slope of the interbank yield curve points to a similar process as the change suggested by analysts' expectations (Chart 4-10). Following the emerging market turbulence observed in January, deviating from the emerging region average, the differential between the two-year and three-month points of the HUF yield curve surged spectacularly and, after the adjustment in early February, it levelled off at significantly higher levels than before. As a result of the decrease started in the middle of March, the slope of the Hungarian curve returned to the emerging region average by the end of May. A surge similar to the one seen in January was observed previously on two occasions, both related to the Fed's tapering of its asset purchases, which reduced risk appetite noticeably: after Bernanke's statement in May 2013 and before the FOMC meeting in September. Accordingly, the current near-zero level of the slope may suggest that, as a result of the materialisation or persistence of downside risks, money market participants expect a persistently low interest rate environment for the next two years.

Chart 4-10: The development of the short slope based on the swap yield in the emerging market

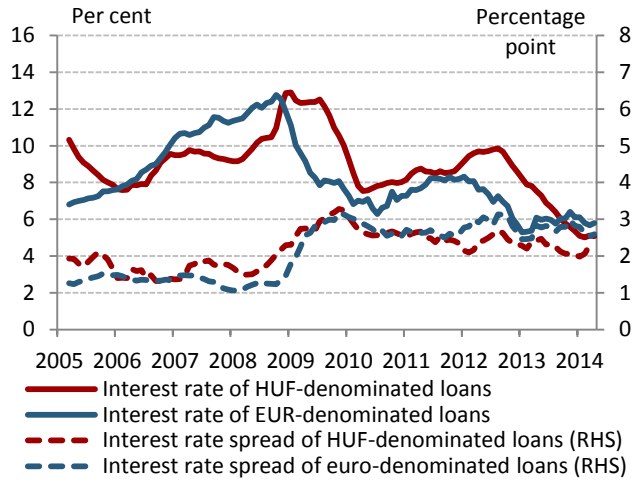


Note: The examined emerging markets are: Chile, South Africa, India, Poland, Hungary, Romania, Thailand, Turkey.
Source: Bloomberg

4.2. Credit conditions of the financial intermediary system

Based on actual transactions, the cost of financing decreased in the corporate segment in the first four months of 2014. The decline in interest rates in the first months of the year fell short of the downward trend of the reference rate, and thus the interest rate spread increased. According to respondents to the Lending Survey,[6] banks generally maintained their credit conditions. The economic outlook warrants the easing of conditions for nearly a third of banks in net terms, but certain sector-specific problems continue to point to tightening conditions. In the household segment, conditions for consumer credit continued to ease, while those of housing loans remained practically unchanged. The APR declined in all segments, and in the case of housing loans, interest rate spreads over the reference rate decreased as well. As a result of falling inflation expectations, the 1-year real interest rate has increased in recent months; however, in comparison with previous experiences, it is still considered historically low.

Chart 4-11: Smoothed interest rates and spreads on corporate loans by denomination



Note: Interest rates smoothed by the 3-month moving average. The spread on the moving average of the 3-month BUBOR and EURIBOR, respectively. Loans with floating interest rates or with up to 1 year initial rate fixation.
Source: MNB

4.2.1. Corporate credit conditions

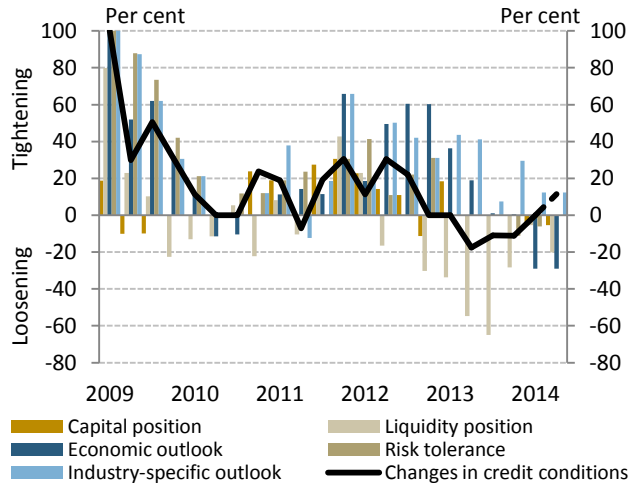
In 2014 Q1, corporate lending rates declined in parallel with the gradual base rate cuts. Based on new disbursements, corporate HUF lending rates, floating or up to 1 year initial rate fixation[7] smoothed by a three-month average, decreased to 5.1 per cent from 5.4 per cent during the first quarter, and remained essentially unchanged in April. Overall, the drop in the interest rates did not reach the level of the decline in the benchmark rate (3-month BUBOR) during the same period, thus as a result, the average spread rose to 2.4 percentage points by April. For creditworthy SMEs, the 2.5 per cent lending rates of the Funding for Growth Scheme continue to offer low-cost financing. As regards EUR-denominated loans, both the interest rates and the spreads over the benchmark rate (3-month EURIBOR) declined in Q1, before starting to rise slightly in April. As a result, in April the interest on EUR-denominated loans smoothed by a three-month average reached 2.9 per cent, while the spread amounted to 2.6 per cent (Chart 4-11).

Based on the Lending Survey, credit conditions did not change in general in 2014 Q1. On the upside, nearly one third of banks in net terms reported that the economic outlook began to ease their credit conditions. In addition, easing is also warranted by the more favourable liquidity and capital position – the determinants of lending capacity – and by the improved risk appetite. Nevertheless, owing to the persistent risk aversion of banks since the outbreak of the crisis, credit conditions are still considered tight, and certain industry-specific problems continue to impede the easing of credit conditions (Chart 4-12).

[6] For a detailed analysis of the findings of the Lending Survey, please refer to the MNB's latest *Trends in Lending* publication, available at: *http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Kiadvanyok/trends-in-lending/201406/Hitelezesi_folyamatok_201406_EN.pdf*

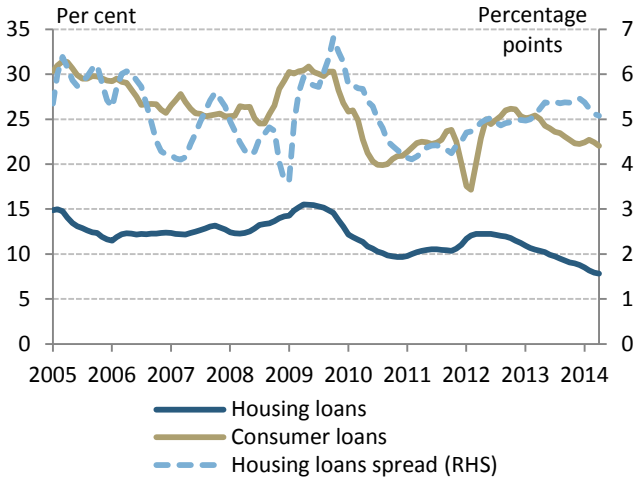
[7] Since the majority of loans granted within the Funding for Growth Scheme are long-term loans, the interest rates reviewed by the MNB mainly reflect market developments.

Chart 4-12: Changes in credit conditions and factors contributing to the changes in the corporate segment



Note: Net percentage balance of respondents tightening/easing credit conditions weighted by market share.
Source: MNB based on banks' responses

Chart 4-13: The smoothed annual percentage rate of charge (APRC) and spreads of housing and consumer loans



Note: Interest rates and spread smoothed by the 3-month moving average. Prior to 2009 HUF denominated mortgage lending was marginal.
Source: MNB

4.2.2. Household credit conditions

The APR on new housing loans disbursed has dropped by around 1 percentage point since the end of 2013 on a three-month average, and stood at 7.8 per cent in April. Since the decline in lending rates exceeded that of the 3-month BUBOR during the same period, the interest rate spread stood at 5.1 per cent in April, compared to 5.4 per cent in December (Chart 4-13). The state interest rate subsidy may further lower the cost of credit for clients, bringing down the interest rate payable to a level as low as 6 per cent. In 2014 Q1, nearly one third of all disbursements were subsidised by the state.

In Q1, the APR on consumer loans increased slightly overall on a three-month average before declining by around 0.4 percentage points in April. Lending rates have decreased both for home equity loans and for other consumer credit since December. The APR on the latter was reduced to 24.5 per cent from 25.2 per cent and, in case of home equity loans, the APR dropped to 10.3 per cent from 10.9 per cent.

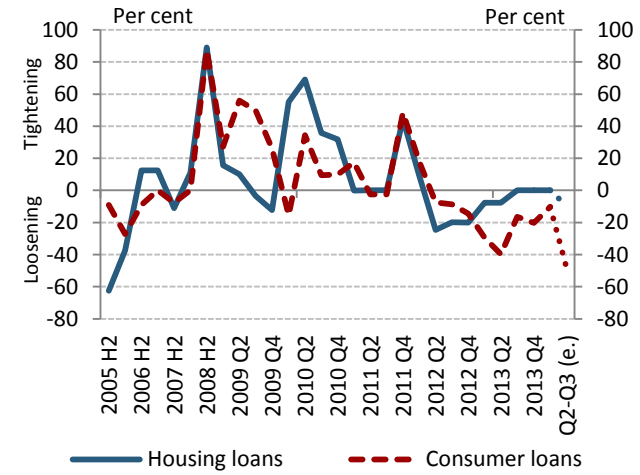
The findings of the Lending Survey revealed that, as in the previous quarter, banks left conditions on housing loans unchanged in Q4, while a net 10 per cent of banks[8] reported an easing of conditions on unsecured consumer loans. Credit standards for new loans disbursed are still tight in terms of rates: the average loan-to-value ratio (LTV) of newly disbursed housing loans was around 56 per cent in Q1, coupled with an interest rate spread of over 5 percentage points, which is also considered high by international standards. Looking ahead, banks expect an easing of credit conditions in both household segments (Chart 4-14).

4.2.3. Changes in real interest rates

In 2014 Q1, 1-year forward looking real interest rates increased slightly, based on both the 1-year government bond yield and short-term deposit rates (Chart 4-15). The upward trend observed in the first three months of the year turned around in April, and real interest rates began to decline. The moderation in inflation expectations has put upward pressure on real interest rates since December 2013, but this is tempered by the decline in zero-coupon yields. The real interest rate is still considered historically low, at 0.4 per cent based on 1-year government bond yields and at -0.4 per cent based on short-term deposit rates in April.

[8] Net percentage balance of respondents tightening and easing credit conditions, weighted by market share.

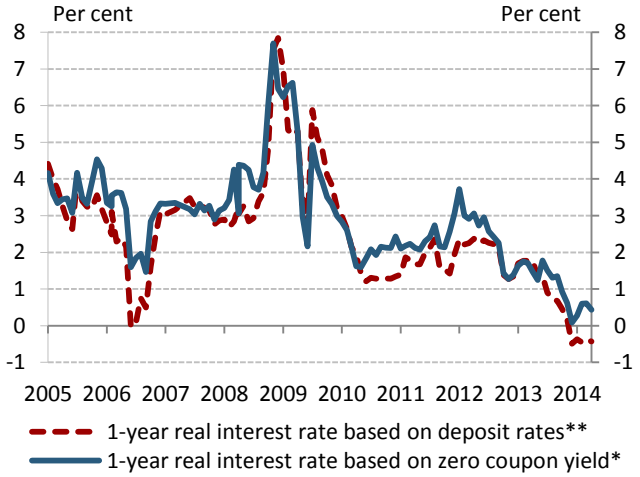
Chart 4-14: Changes in credit conditions to the household sector



Note: Net percentage balance of respondents tightening/easing credit conditions weighted by market share.

Source: MNB based on banks' responses

Chart 4-15: Forward-looking real interest rates



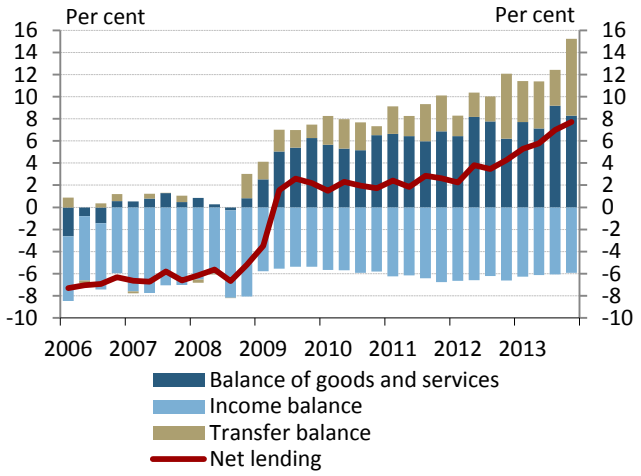
Note: * Based on the one-year forward-looking inflation expectations of analysts calculated by the MNB using the 1-year zero coupon yield and the Reuters poll. **Based on the one-year forward-looking inflation expectations of analysts calculated by the MNB using deposit rates with maturity up to 1 year and the Reuters poll.

Source: MNB, Reuters poll

5.1. External balance and financing

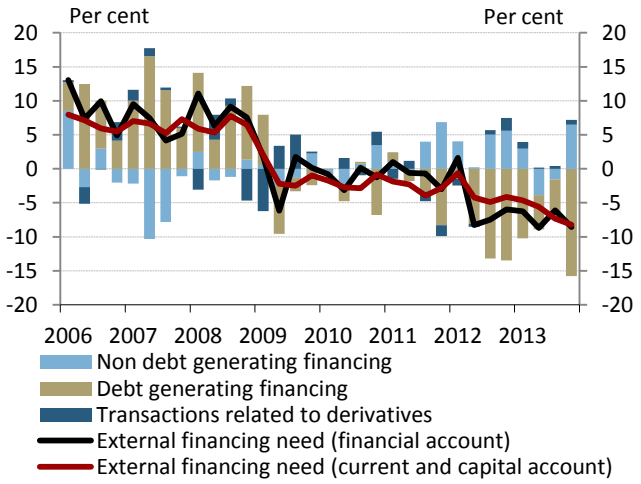
Hungary's net lending increased further, approaching 8 per cent of GDP in 2013 Q4. This growth was primarily connected to the rise in the foreign trade surplus, which was offset by a slight decline in the balance of goods and services. Financing data indicated a similar level of external financing capacity, which primarily reflected the outflow of debt-type funds. Accordingly, external debt ratios – indicators of key significance from the perspective of the country's vulnerability – declined further in the fourth quarter.

Chart 5-1: Changes in net lending (seasonally adjusted values; as a proportion of GDP)



Note: Time series are adjusted directly for seasonal effects, thus the sum total of external financing capacity does not necessarily correspond to the adjusted values of the external financing capacity.
Source: MNB

Chart 5-2: Structure of external financing (transactions as a proportion of GDP)



Note: The net borrowing calculated from financial account side corresponds to the total of the net lending and the net errors and omissions.
Source: MNB

5.1.1. Developments in Hungary's net lending position

Net lending calculated from the side of the real economy approached 8 per cent of GDP in 2013 Q4. Although **net exports** decreased slightly in Q4, the surplus accounting for nearly 8 per cent of GDP continues to contribute significantly to Hungary's net lending. The improvement in the net lending position may be linked to the sharp increase in the **transfer balance** (Chart 5-1). Net EU transfer absorption approached EUR 2.2 billion in Q4, significantly surpassing (by around EUR 550 million) the already high value observed in the same period in 2012. Similarly, throughout 2013 the utilisation of EU transfers significantly exceeded the values observed in previous years, amounting to EUR 5.4 billion in total. The high level of absorption is due to the fact that payments were largely concentrated towards the end of the 2007-2013 EU budget period. The slight improvement in the **income balance** deficit also contributed to the increase in net lending. The level of the deficit was lower than observed in previous quarters, reflecting in particular the reduced interest payments.

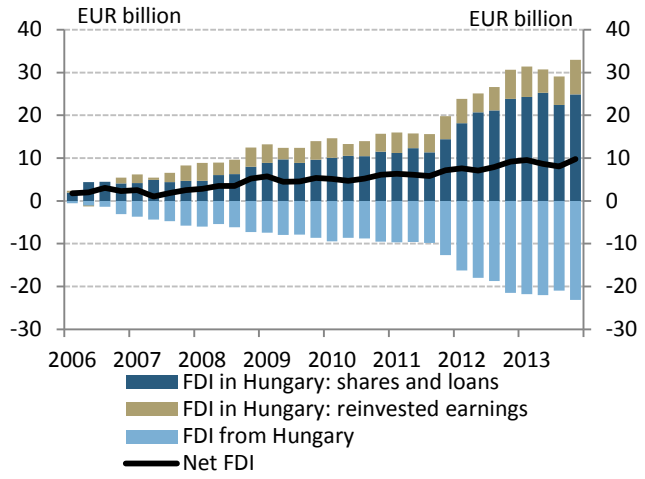
For 2013 as a whole, Hungary's net lending amounted to 6.5 per cent of GDP. The rising trade surplus resulting from the commissioning of new automotive industry capacities, the increased absorption of EU funds and the slight decline in the income balance deficit all contributed to the improvement in external balance. According to the preliminary data in the first quarter the surplus of the goods and services balance increased again.

5.1.2. Developments in financing

The indicator calculated from financing data also showed a robust net saving position in Q4, the level of which was comparable to the figure calculated from the real economy data. In line with the external financing capacity, net debt-type funds declined sharply, while substantial inflows were registered for non-debt type liabilities (Chart 5-2).

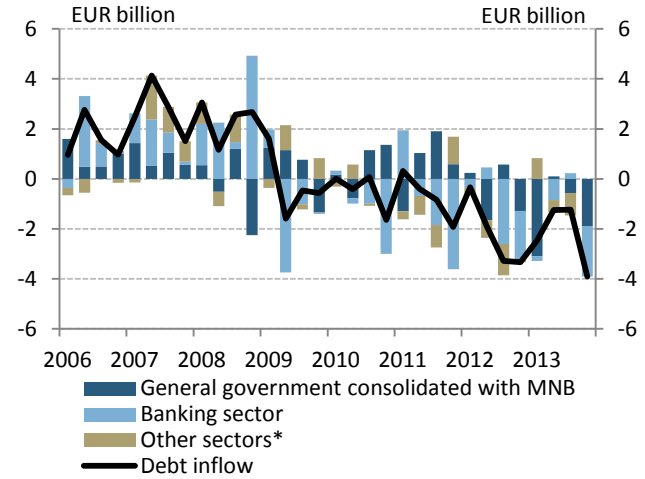
Following the decline recorded for previous quarters mainly in relation to seasonal or one-off items (E.ON

Chart 5-3: Changes in composition of foreign direct investment (cumulated transactions)



Source: MNB

Chart 5-4: Sectoral breakdown of debt inflow



Note: * Non-financial corporations, other financial corporations, households.

Source: MNB

acquisition), **the volume of foreign direct investment started to rise in Q4.** The growth in Q4 was also facilitated by increased shares in affiliated undertakings, reinvested earnings and a rise in inter-company loans (Chart 5-3). Taken together, despite the declines recorded for Q2 and Q3, net FDI inflows amounted to nearly EUR 0.6 billion in 2013, more or less corresponding to post-crisis levels.

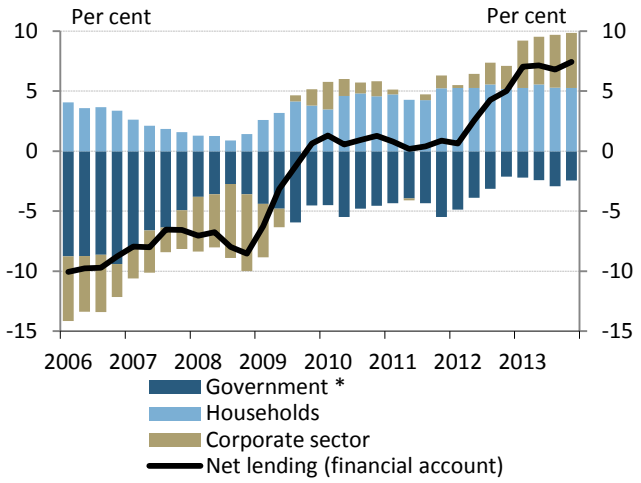
In Q4, the net outflow of debt-type liabilities approached EUR 4 billion. The decline can be primarily linked to two sectors: the general government consolidated with the MNB and the banking sector both reduced their net external liabilities by EUR 2 billion each. The reduction of net external government debt can be partly attributed to the shrinking government security holdings of non-residents and the rising level of foreign currency reserves in the context of EU transfers. Following the moderate overall outflows observed in previous quarters, the external debt of the banking sector decreased substantially in Q4, partly as a result of the contraction in the corporate loan portfolio: in all probability, banks used the funds thus released to reduce their external debt. At the same time, corporations' external debt remained largely unchanged (Chart 5-4).

Debt-type outflows in 2013 amounted to nearly EUR 9 billion, i.e. close to the level seen in the previous year. The outflow of debt-type financing affected all three sectors, but as opposed to previous years, the highest outflows were registered by the general government instead of the banking sector: besides the increase in foreign currency reserves in the wake of EU transfers, this outflow was also supported by domestic sectors' stronger involvement in the financing of the government sector.

The historically high level of net lending resulted from the consistently high level of households' net financial savings, the improving saving of corporations and the declining net borrowing of the general government (Chart 5-5). In line with the rise in real incomes, households' four-quarter net savings accounted for more than 5 per cent of GDP. The four-quarter accrual-based net borrowing of the consolidated general government also declined as a result of the changing seasonality of tax revenues compared to the previous year. The financial savings of the corporate sector rose further, partly buttressed by the significant absorption of EU transfers at the end of the year.

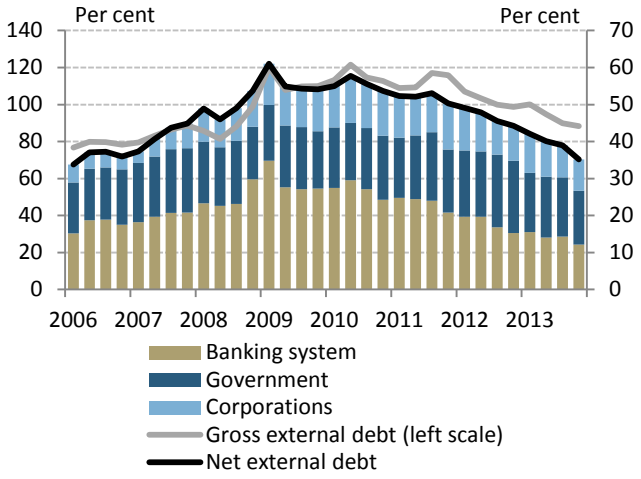
As a net result of these developments, Hungary's external debt indicators – which are important measures for the country's risk assessment – continued to improve in Q4: Hungary's GDP-proportionate net external debt sank to

Chart 5-5: The breakdown of net lending by sectors (four quarter cumulation as proportion of GDP)



Note: * As regards the general government, net borrowing based on the financial accounts is presented, adjusted for the transfer of private pension fund assets in 2011.
Source: MNB

Chart 5-6: Breakdown of external debt by sectors (values as a proportion of GDP)

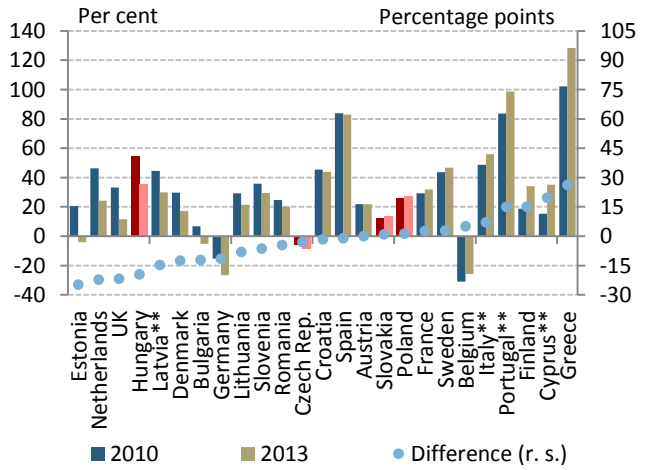


Note: Excluding intercompany loans.
Source: MNB

35 per cent, while gross external debt stood at around 88 per cent of GDP. Following a slight increase in the previous quarter, the net external debt of the banking sector declined again in Q4, dropping to a significantly lower level than seen at the outbreak of the crisis. The net external debt of the consolidated general government also decreased to levels not seen since 2006. Meanwhile, net external debt within the corporate sector did not change perceivably and remained at one of the lowest levels recorded in recent years. The decline in gross external debt was more moderate than that observed in net indicators, mainly due to the issuance of FX bonds in November, which generated a corresponding increase in foreign currency reserves (Chart 5-6).

As regards net external outstanding debt, Hungary's adjustment was substantial even in comparison to other EU Member States. While a number of countries in the region (e.g. Slovakia, Poland) have seen a slight increase in GDP-proportionate external debt, in Hungary the ratio decreased significantly, by around 20 percentage points since 2010 and amounted to 35 per cent of GDP at the end of 2013. Although Hungary's net external debt is still above the regional average, thanks to the massive adjustment in recent years, the difference is now less conspicuous (Chart 5-7).

Chart 5-7: Net external debt* in EU (values as a proportion of GDP)



Note: * Excluding intercompany loans. ** 2013 Q3 data.
Source: Eurostat

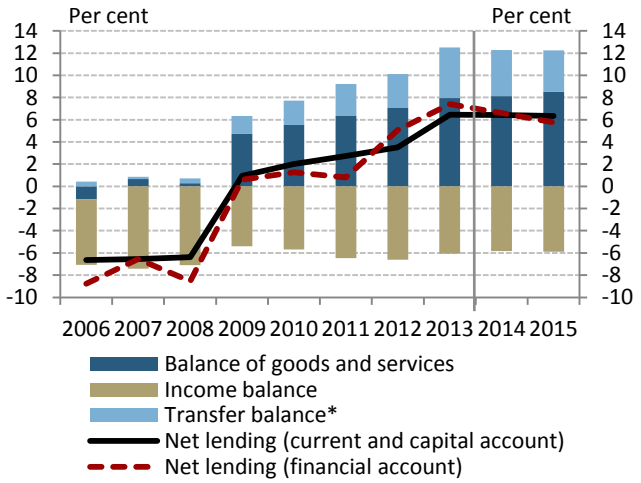
5.2. Forecast for Hungary's net lending position

In 2014–2015, Hungary's net lending is expected to stabilise at a high level. In 2014, the foreign trade balance may remain at a level similar to that seen last year and may improve further in 2015, in the context of reduced domestic absorption and the recovery of external demand. At the beginning of the new EU budget period, the transfer balance, which primarily includes EU funds, may decrease slightly, but it is still expected to contribute significantly to Hungary's net lending. In line with the decline in external debt, the deficit on the income balance is expected to shrink somewhat. Looking at the saving position of individual sectors, thanks to a sound fiscal policy, the general government's borrowing requirement is likely to remain restrained, while the projected net saving of the private sector may remain at a relatively high level. Nevertheless, corporate savings may contract in the coming years owing to increased investment activity, while the net financial savings of households may stabilise at high levels next year following the growth recorded this year.

Hungary's net lending position is expected to stabilise at high levels. Thanks to the improvement in terms of trade, net exports may remain strong in 2014 despite the increasing imports generated by consumption and investment, while next year reduced domestic absorption and a likely upswing in external demand will contribute to a substantial foreign trade surplus. In addition to the foreign trade balance, EU transfers may also contribute significantly to Hungary'snet lending in the next few years. While EU funds may still exceed the levels seen in previous years, transfers may decline slightly in 2014–2015 in the context of the new EU budget period. The moderate decline in the income balance deficit may also help to keep the country's net lendig position at high levels. Among other factors, a more favourable income balance may also be facilitated by the reduction of external debt in line with the net lending and hence, by lower future interest expenses transferred abroad (Chart 5-8).

Looking at net lending developments from a sectoral perspective, we can say that **the historically high net**

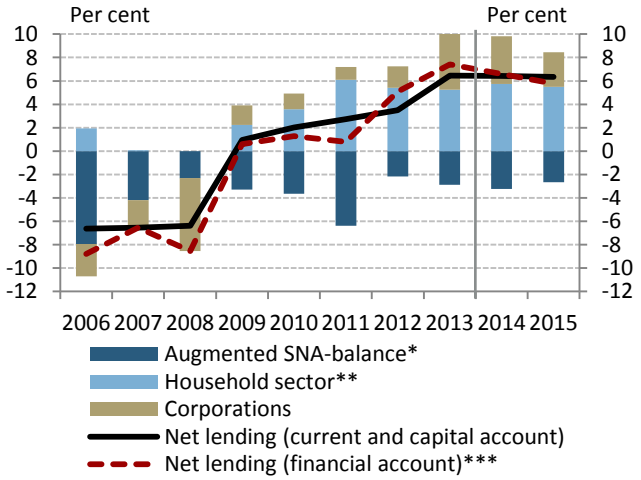
Chart 5-8: Evolution of net lending (as a proportion of GDP)



Note: * The sum of the balance of the current transfers and the capital account balance.

Source: MNB

Chart 5-9: Changes in savings of sectors (as a proportion of GDP)



Note: * In addition to the central government, the augmented general government includes local governments, MNV Inc., institutions discharging quasi-fiscal duties (MÁV, BKK), the MNB. The augmented SNA deficit takes into account private pension savings. ** Net financial saving of households consistent with the SNA deficit does not contain the pension savings of those who return to the public pension system. The official net saving (shown in the financial account) is different from the data in the chart. *** We expect that 'Net errors and omissions' (NEO) returns to historical average.

Source: MNB

lending may occur in conjunction with the high private sector position and restrained spending by the general government (Chart 5-9).

The net saving position of the corporate sector may embark on a path of slow decline in the coming years reflecting an upswing in investment activity for the most part. Besides the Funding for Growth Scheme, payments from the previous EU budget period may also facilitate the acceleration of corporate investment.

Households' net savings are expected to rise further this year and level off at high levels next year. As was the case in the previous period, developments in household savings will be shaped primarily by precautionary motives and balance sheet adjustment. Households will set aside a portion of their increased incomes and therefore the level of household savings may remain steadily high in the next few years, despite increased consumption.

The financing need of the general government may remain restrained in the coming years, but within this the augmented SNA-balance may increase somewhat in 2014. The factors behind the higher net borrowing include the introduction of teachers' career model, the extension of family allowance and stepped-up public work programmes, which will only be partly offset by the higher tax revenues collected from certain tax categories. However, the accrual-based deficit may moderate in 2015, owing to the impact of the economic upswing in general, as well as declining GDP-proportionate pension expenditures in the context of the low inflation environment, and more restrained wage increases in the public sector.

In parallel with the net lending, the outflow of foreign – mainly debt-type – funds may also continue. Accordingly, the high net lending may be also reflected in further reductions in net external debt. The decline in gross external debt may be facilitated by the MNB's self-financing programme. The shift in the financing of government debt from foreign exchange bond issuance to HUF funding may reduce gross external debt. In addition, the programme may yield benefits beyond the reduction of gross external debt: it may also have a positive effect on the foreign currency composition of debt, and the fluctuations of the forint exchange rate will be less reflected in debt indicators. At the same time, the programme will not affect the country's net external debt, given that maturing foreign currency debt depletes the level of foreign exchange reserves in the context of reduced FX bond issuance.

5.3. Fiscal developments

According to our forecast, the ESA deficit may remain below the government's target both in 2014 and 2015, at 2.7 per cent and 2.6 per cent of GDP in 2014 and 2015, respectively, in compliance with the Maastricht criteria. In line with our previous forecasts, but in deviation from the budget law, our projection assumes the full cancellation of the National Protection Fund, which would leave a margin of 0.2 per cent of GDP each year, compared to the deficit target. It was primarily due to macroeconomic developments and changes in budget revenues that we revised and reduced our deficit forecast for both years compared to our March projection. Another change is that, as per government decree, the number of public employees is expected to be around 200,000 in the forecast horizon, and – apart from the career model of teachers – we assumed very restrained wage increases in the public sector in 2015 based on the Convergence Programme. Following a deficit of 2.4 per cent in 2013, the demand-increasing effect of fiscal policy is expected to be around 0.7 per cent of GDP in 2014, which may be reflected primarily in the increase in households' disposable income. By contrast, in 2015 fiscal policy is expected to generate a slight decline in demand. While the gross government debt-to-GDP ratio calculated on the basis of the exchange rate as at end-2013 is expected to decrease over the entire forecast horizon, i.e. the government debt rule will be observed, the actual debt ratio will continue to be significantly exposed to changes in the forint exchange rate.

5.3.1. Main balance indicators and the fiscal demand effect

According to our forecast, the 2014 and 2015 ESA deficit of the general government may be around 2.7 per cent and 2.6 per cent of GDP, respectively, meaning that we have adjusted the estimated deficit figures downwards for both years compared to the March Report on Inflation, primarily in view of actual monthly budgetary figures and the improvement in the macroeconomic outlook (Table 5-1). In 2014, the cyclical position of the economy will contribute to the deficit by 0.5 per cent of GDP, but based on the macroeconomic forecast, the output gap will close significantly in 2015, and hence the cyclical component of the fiscal deficit will also decrease. Despite the rebound in economic performance, the ESA balance will change only marginally in 2015: as opposed to 2014, substantial revenues may no longer be collected from the one-off sales of public assets (concession fee revenues).

Table 5-1: General government balance indicators (as a percentage of GDP)

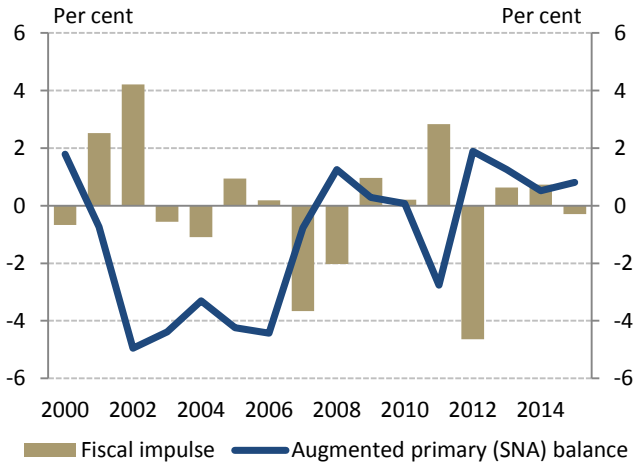
	2013**	2014	2015
ESA-deficit*	-2,4	-2,7	-2,6
Cyclical component (MNB)	-1,0	-0,5	-0,1
Cyclically-adjusted augmented (SNA) deficit*	-1,9	-2,8	-2,6
Fiscal impulse***	0,6	0,7	-0,3

Note: * Complete cancellation of the available free reserves (National Protection Fund) was assumed upon the calculation of the balance indicators. ** The 2013 ESA-deficit was slightly increased because of the latest EDP data and the revision of the GDP. *** Change in the augmented (SNA) primary balance.
Source: CSO, MNB

Following the increase in demand in 2013, fiscal policy will stimulate aggregate demand again in 2014.[9] According to our forecast, fiscal policy will increase households' disposable income through a noticeable increase in public wages, while tax burdens may even decline slightly in proportion to GDP, primarily owing to the job protection action plan. Subdued growth in social expenditures will have an opposite, albeit less dominant, impact. Regarding the direction of the business sector, the increase in investment and material costs causes a positive fiscal impulse. In 2015 the fiscal impact may turn slightly negative. The expected fiscal restraint, which may amount to 0.3 per cent of GDP, is related to the reduction of capital

[9] The fiscal impact is quantified by the change in the augmented (SNA) primary balance, which gauges the impact of fiscal measures, fiscal developments and the automatic stabilisers on the income position of other sectors.

Chart 5-10: Fiscal impulse (as a percentage of GDP)



Note: 1) The fiscal impulse corresponds to the change in the augmented (SNA) primary balance. 2) The positive prefix indicates demand expansion, while the negative prefix implies demand restraint. 3) Assuming the cancellation of the available free reserves in 2014–2015.
Source: MNB

Table 5-2: Decomposition of the change in the 2014 ESA balance forecast (compared to the March issue of the Quarterly Report on Inflation; as a percentage of GDP)

	Macro data	Measure	Other
I. Central government revenues	0,4	-	-0,1
Consumption-type tax revenues	0,1	-	-
Burden on labour income (tax, contribution)	0,3	-	-0,1
II. Central government expenditures	-	-0,1	-
Public work programme	-	-0,1	-
III. Other effects	-	-	0,1
Balance of local governments	-	-	0,1
Other items	-	-	-0,1
Total (I.+II.+III.)	0,4	-0,1	-0,1

Note: The positive and negative prefixes indicate deficit-reducing and deficit-increasing effects, respectively.
Source: MNB

expenditures in the context of a slight decline in EU transfers (Chart 5-10).

5.3.2. The 2014 balance

According to our forecast, the 2014 ESA deficit will amount to 2.7 per cent of GDP, which is 0.2 per cent lower than our projection in the March issue of the Quarterly Inflation Report (Table 5-2). The difference can be mainly attributed to the fact that we adjusted our projection on consumption tax revenues upwards, in view of the favourable tax and contribution revenue figure for Q2 on the one hand, and the expected more dynamic rise in the whole-economy wage bill on the other hand. Revenues from consumption taxes may exceed our previous expectations by 0.1 per cent of GDP, primarily owing to an upturn in retail sales. Our forecast already takes into account revenues from the advertising tax.

Annual interest revenues may surpass our March forecast by nearly 0.1 per cent of GDP, as the level of the premium realised at issuance is more favourable in the current low yield environment, and the annual average deposit holdings of the government may be more substantial than anticipated.

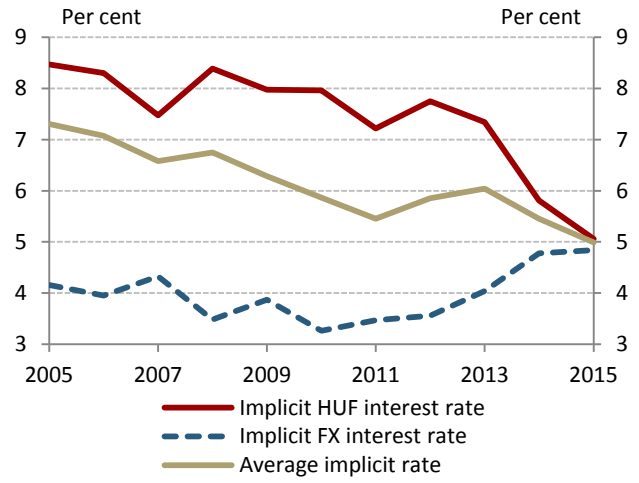
On the expenditure side, our expenditure forecast of the National Employment Fund were raised by 0.1 per cent of GDP in line with the increased number of public workers envisaged by the government, based on which the number of public workers may be around 200,000 over the long run. While the announced government acquisitions[10] raise the cash-flow deficit, they are not expected to have an impact on the ESA balance, in which they are recognised as financial transactions. As a net result of two opposing effects, we maintained our accrual-based interest expense projections. Declining yields significantly reduce the gross interest expenses of the general government, while increased issuance for pre-financing purposes in the first half of the year raised these expenses. The financing of forint-denominated debt has become far less expensive; therefore, with a decline in the average implicit rate, the implicit interest on public debt will be nearly identical for both currencies at the end of the forecast horizon (Chart 5-11).[11]

In our previous projections, we had already assumed that the balance of local governments would probably show a surplus in 2014 and, based on data pertaining to the first

[10] Acquisition of Főgáz Zrt. and Antenna Hungária Zrt.

[11] Due to changes in the ESA methodology, as of 2014, profit (or loss) on derivative transactions are excluded from the balance calculated on the basis of the EDP methodology.

Chart 5-11: Development of the implicit interest rates of general government



Source: MNB

Table 5-3: Differences between our forecast and the appropriations set out in the 2014 Budget Act (as a percentage of GDP)

	Difference from appropriation
I. Central government revenues	-0,1
Consumption-type tax revenues (VAT, excise duties)	-0,5
Business tax on small-sized companies	-0,1
Burden on labour income (tax, contribution)	0,7
Road charges, income tax on energy suppliers and other taxes	-0,2
II. Central government expenditures	-0,2
Budgetary organisations - KLIK funding needs	-0,1
Budgetary organisations - EU co-financing	0,3
Public work programme	-0,2
Net interest expenditures	-0,1
III. Other effects	0,5
Balance of local governments	0,3
Cancellation of the reserves	0,3
Other items	-0,1
Total (I.+II.+III.)	0,2

Note: The positive and negative prefixes indicate deficit-reducing and deficit-increasing effects, respectively, compared to appropriations.

Source: MNB

quarter, it appears that their balance may improve by a further 0.1 per cent of GDP.

The ESA deficit target set by the government in the 2014 Budget Act is 2.9 per cent of GDP. Our projection is 0.2 percentage point lower (Table 5-3). The difference stems in part from the fact that, as opposed to the Budget Act, we assumed that the total amount of the Country Protection Fund will be cancelled, which alone would improve the balance by 0.3 per cent. Consumption tax revenues will benefit from increased retail sales, but the low inflation level will reduce revenues. The government's VAT forecast may be based on the assumption of a significant improvement in the efficiency of VAT collection. This may largely account for the difference in our revenue forecast, which is lower than the appropriation by 0.5 per cent of GDP. As regards the tax and contribution burden on labour income, our revenue projection is higher by 0.7 per cent of GDP. This substantial difference is mainly attributable to favourable changes in the whole-economy wage bill and the different assumptions about the use of the small business tax category. Our revenue projection for this category is lower than the government's projection by 0.1 per cent of GDP, as we assume more limited use of both the small business tax (KIVA) and the itemised tax for enterprises with a small tax base (KATA).

Due to the public work programme, accrual-based net interest expenditures and the financing needs of the Klebelsberg Institution Maintenance Centre (KLIK),[12] expenditures may exceed the appropriations by 0.5 per cent of GDP. The difference in the expenditures of public work programme is warranted by the planned increase in the public employee workforce to 200,000, while the different interest expense figure can be attributed to the release of actual data pertaining to 2014 Q1. As a precaution we assume (similarly to our March projection) a lower utilisation of EU grants than expected by the government, which requires less state co-financing and thus improves the balance. In addition to all of the above, based on data released for this year, the balance of local governments may be better than the government estimate by 0.3 per cent of GDP.

[12] According to the report of the Commissioner performing the due diligence, KLIK is expected to incur non-wage expenditures in the range of 0.1 per cent of GDP.

Table 5-4: Decomposition of the change in the 2015 ESA balance forecast (compared to the March issue of the Quarterly Report on Inflation; as a percentage of GDP)

	Macro data	Measure	Other
I. Central government revenues	0,3	-	-0,1
Consumption-type tax revenues	0,1	-	-
Burden on labour income (tax, contribution)	0,2	-	-0,1
II. Central government expenditures	0,1	-	0,1
Public sector - wages	-	0,2	-
Pension expenditures	0,06	-	0,06
Public work programme	-	-0,1	-
Total (I.+II.)	0,4	0,0	0,0

Note: The positive and negative prefixes indicate deficit-reducing and deficit-increasing effects, respectively.
Source: MNB

5.3.3. The balance in 2015

At 2.6 per cent, our ESA deficit-to-GDP ratio forecast for 2015 has improved by 0.4 percentage points compared to our March forecast; however, it is 0.2 percentage point lower than the target set by the Convergence Programme (Table 5-4). The change in the balance was largely due to similar effects than those seen for 2014. On the revenue side, we raised our estimate regarding revenues from income taxes, social security contributions and consumption taxes. On the expenditure side, in line with the Convergence Programme, we lowered our projection for public sector wage expenditures. Previously, we had assumed a growth comparable to the private sector wage index, but the Convergence Programme does not envisage a general pay rise in the public sector for 2015. Based on this and in consideration of the average figure of recent years, in our current forecast we assume a moderate wage adjustment of under 1 per cent (besides the next step in the career model for teachers). Based on the government's staffing plan, the expenditures of the National Employment Fund in relation to the Public Work Programme have been adjusted upwards by 0.1 per cent of GDP compared to our previous projection. Based on actual data for 2014 and in line with lower inflation expectations, we reduced our 2015 projection for pension and pension-type benefits by 0.1 per cent of GDP.

5.3.4. Risks surrounding the baseline scenario

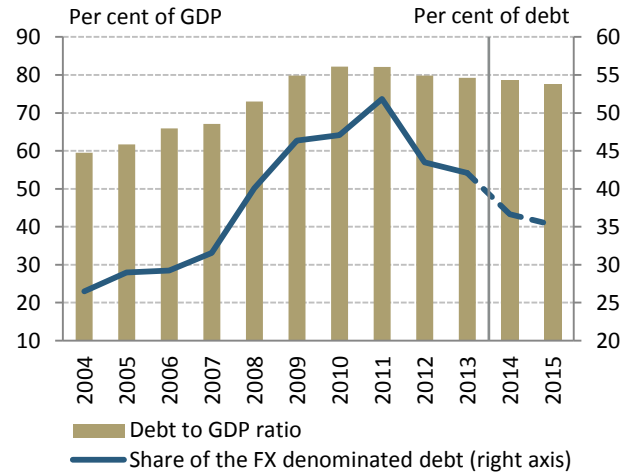
Our forecast is surrounded by risks on both sides. On the one hand, among other things, developments in social security contributions may lead to a more favourable balance, given that we were cautious in raising our wage-related revenue forecast: indeed, revenues from social security contributions increased faster in April and May alone than our forecast for the rest of the year. In addition, a deficit-decreasing risk of 0.2 per cent of GDP may appear in 2015 related to the intermediate consumption because, based on previous experiences and in line with the principle of prudence, we assumed a higher expenditure level than envisaged in the Convergence Programme.

A downside risk is related to the government's acquisitions, as some of these purchases may increase the ESA deficit. Moreover, the 2014 cash balance of EU grants and project-related government transfers – even calculating without co-financing – may be negative this year, which will be adjusted during the calculation of the accrual-based balance; however, the level of the positive balance adjustment is uncertain and might be lower than we assume. In addition, for lack of detailed information, over our forecast horizon we did not take into account the

drawdown of the loan related to the expansion of the Paks nuclear power plant and commencement of the project.

5.3.5. Expected developments in public debt

Chart 5-12: Gross public debt forecast - from 2013 at constant, end-2013 exchange rate



Source: MNB

Based on the MNB's preliminary financial accounts data, gross consolidated debt of the general government amounted to 84.6 per cent of GDP at the end of the first quarter of 2014. The increase compared to the end of 2013 mainly reflects transitory factors. On the one hand, around two-thirds of the expected annual cash-based deficit materialised as early as the first quarter. On the other hand, in the wake of successful HUF- and FX-denominated government bond auctions, the deposit holdings of the state increased substantially; however, in the second half of the year these are expected to decline close to the level seen last year, which will reduce the level of debt. Finally, as a result of the depreciation of the forint exchange rate, the government debt-to-GDP ratio rose by 1.1 percentage point compared to the previous quarter.

In respect of end-of year data, assuming an unchanged exchange rate compared to end-2013, the debt ratio is expected to decline over the entire forecast horizon, i.e. the government debt rule is likely to be met. By the end of 2014, the government debt-to-GDP ratio may reach 78.7 per cent which, despite the higher-than-expected GDP growth and the decline in deficit, is identical with our March projection owing to the financing requirement of state acquisitions. As a result of the favourable effects discussed above, the debt-to-GDP ratio may drop below 78 per cent next year (Chart 5-12).

The decline in the government debt-to-GDP ratio is expected to be supported by economic recovery and the low deficit of the government sector which, according to our forecast, may be in line with the Maastricht criteria. Upon preparing our forecast, we took into consideration the new financing plan of the Government Debt Management Agency, which relies on HUF-denominated issuances to a greater extent; consequently, the share of foreign currency debt within total outstanding debts may decrease faster than before. Our forecast was prepared based on the exchange rate as at end-2013; however, changes in the forint exchange rate may have a considerable impact on the debt ratio. For instance, a depreciation of the exchange rate by 10 HUF/EUR would increase the debt ratio by 1.1 percentage points through the revaluation of foreign currency debt expressed in forints.

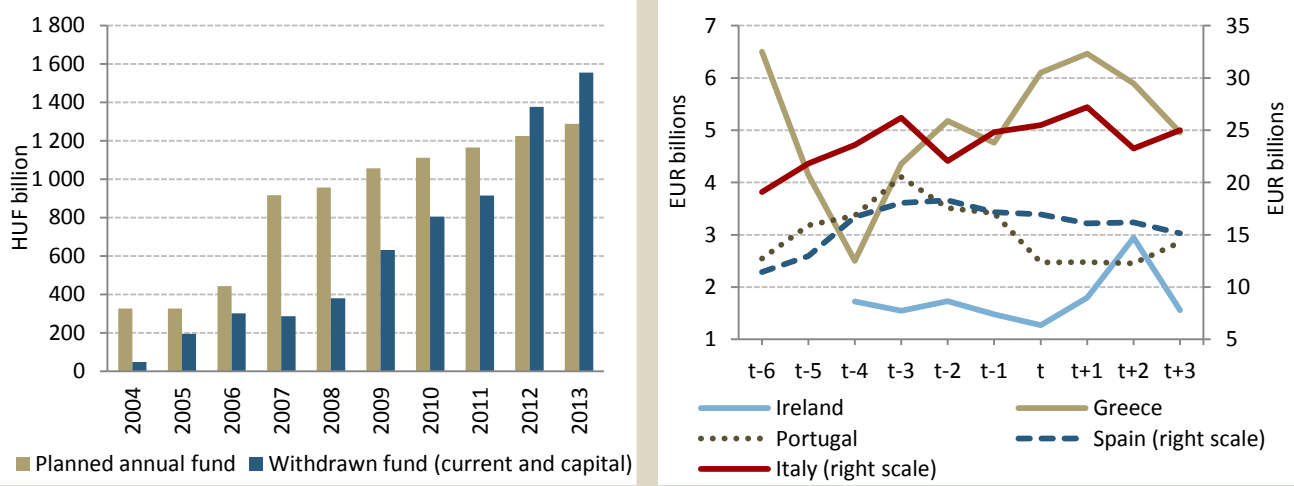
Box 5-1: The role of EU funds in investment activity

As EU funds are being drawn down at an increasing pace, investments have risen steadily from the second half of 2013 onwards. From an investment standpoint, the funds listed in the central budget are of key importance, such as the allocations from Structural Funds and the Cohesion Fund, as well as the amounts available for rural development. Following more moderate funding in the period 2004-2006, according to the 2014 Convergence Programme of the Government a total of HUF 8,200 billion was earmarked for Hungary in the 2007-2013 programming period, 70 per cent of which represented capital transfers. For the upcoming 2014-2020 programming period, Hungary has been allocated the equivalent of HUF 7,500 billion in EU funds to be drawn down.

A large share of these funds was absorbed towards the end of the programming period. Low amounts had been drawn down at the beginning of the 2007-2013 programming period, after which the use of the budgeted funds accelerated as the institutional system's absorption capacity improved and by the end of 2013 this rate almost reached 70 per cent. Under current EU legislation, budgeted funds which have not been used in the given year can be still drawn down within two years (the so-called n+2 rule), therefore we expect that by the end of 2015 more than 20 per cent of the allocated funds for the 2007-2013 period can be still used. Consequently, the use of the allocated funds may exceed 90 per cent. Additionally drawing down the funds from the previous period can offset the initially low level of used funds in the new budgetary cycle. In the case of the new funds, the slower pace of draw-down may be a result of the changing conditions of grants amongst other things, to which the participants have to adapt. Additionally, for large infrastructure investments, the preparations may take a longer time.

International experience on the timing of the usage of EU funds is mixed (Chart 5-13). In the 2000-2006 EU budgetary cycle in the peripheral countries, which received significant funds, two patterns are observable. In one group of the countries (Greece, Ireland, to a lesser extent Italy) the use of received investment grants was lower at the beginning of the cycle. Here towards the end of the period a significant acceleration and then a considerable fall can be seen. In other countries (Spain, Portugal) the funds were used in a more even pace, and no drop can be observed here. In Hungary, the use of funds in the period 2007-2013 is similar to the first group.

Chart 5-13: Use of EU funds in Hungary and recieved investment grants in eurozone periphery countries



Note: The right panel shows the D.92 category of the national account (received investment grants) for the total economy, which contains EU funds. The end of the 2000-2006 budgetary period (2006) is period t on the graph.
Source: Ministry of National Economy, Eurostat

The spending structure in the new period will only become dominant once outstanding amounts from the previous budgetary period have been used. Roughly two thirds of all capital transfers during the 2007-2013 period are received by the government, which uses these funds mainly for infrastructure development. Most of the funds drawn down since 2013 at an increasing pace are also directed into such projects, a fact indicated by a marked expansion in quasi-fiscal investments starting in the second half of last year. We consider those sectors as quasi-fiscal, which contain both government initiated and clearly business-oriented investments. The transportation and storage sector has the largest weight within the group of quasi-fiscal sectors (road- and railway reconstruction, as well as vehicles acquired for public

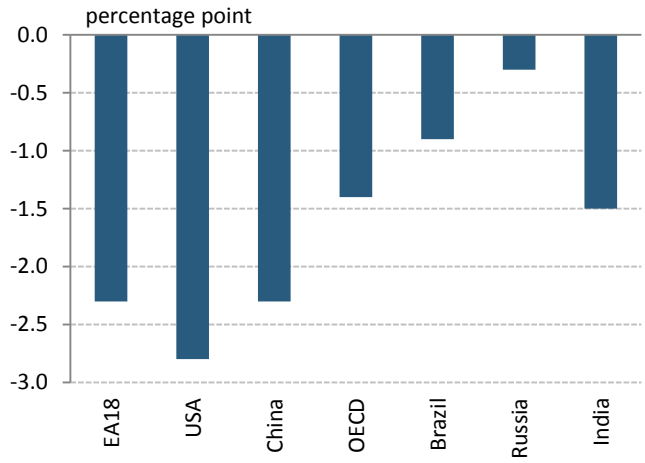
transportation are accounted for within this sector). **Under the new 2014-2020 programming period, focus is shifted onto business development, thus the private sector should see its share in capital transfers rise.** The type of the programmes to be announced will determine the exact share of private sector in the EU funds.

On the whole, government investment will continue to display a steady increase during 2014 and remain unchanged in 2015, in line with the expected pace of the utilisation of EU funds. Looking ahead, as the use of EU funds may decrease substantially **in 2016, we expect government investments to decrease significantly**. Following the decline in 2016, in line with the new EU priorities, **transfers received by businesses may increase to higher levels than before**, while funds used by the government may remain at a lower level for a longer period.

6.1. Reasons behind low external inflation

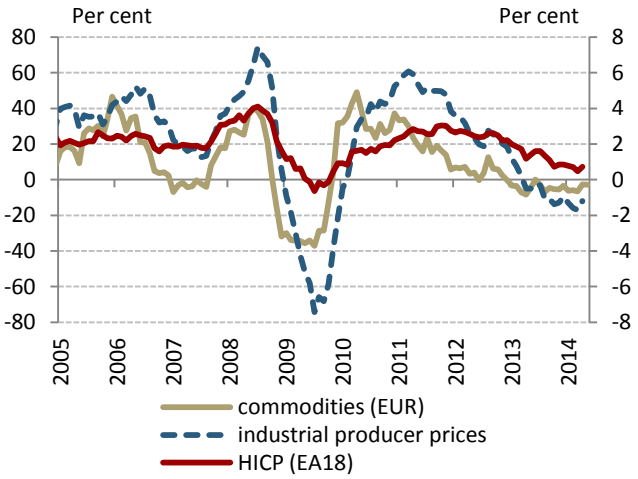
Since mid-2011, global inflation trends have been characterised by favourable developments. Inflation in the euro area declined considerably compared to the end of 2011, and several major economies reported improving inflation figures worldwide (Chart 6-1). Accordingly, the level of inflation has been below central bank targets in recent periods. However, excessively low levels of inflation may boost the risk of a persistently low inflation environment or that of declining prices (deflation), which would have an adverse impact on the real economy. For a better understanding of global trends, it is important to review the underlying factors behind the currently observed global disinflation.

Chart 6-1: Decrease in global inflation in Q1 2014 compared to Q4 2011



Source: OECD

Chart 6-2: Commodity, industrial producer and consumer prices in the eurozone



Source: IMF, Eurostat

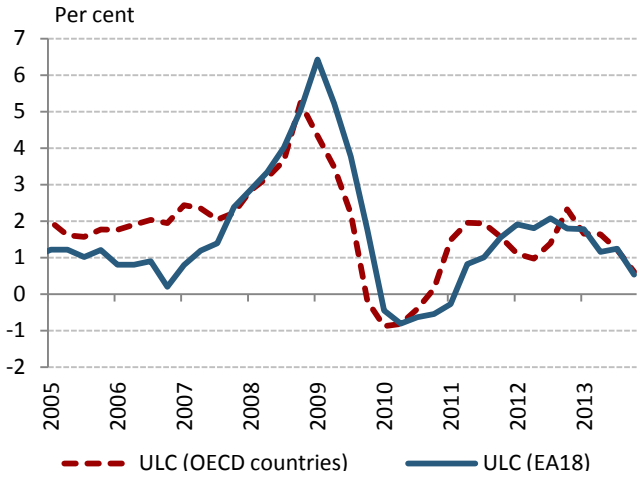
6.1.1. Direct causes of global disinflation

The disinflation observed is the net result of several effects: besides cost and demand factors, it may be also attributed to the adjustment of expectations. In certain countries, transient factors may also be involved. The effect of the indirect tax and regulated price increases carried out in the context of budgetary consolidation dropped out of the price index. In addition, the fading of previous cost shocks (food and oil prices) from the basis also pointed to lower inflation (Chart 6-2).

As regards cost side factors, **generally moderate price pressure has been perceived from commodity prices** since the beginning of 2012. The increase in energy and food prices was subdued, with a nearly zero contribution to euro-area consumer prices at the beginning of 2014. The moderate dynamics of commodity prices can be attributed to improving supply conditions and weak demand. On the supply side, new technologies which are being used (shale gas/shale oil) may increase the extent of exploitable reserves, and decrease the marginal cost of production. Furthermore, geopolitical risk eased in some regions as well, which also increased the supply. Among the weak demand conditions, the deceleration of Chinese growth deserves special attention. The structural change in China's growth (private consumption gains momentum, while the pace of infrastructure investment slows down) could reduce the commodity intensity of its economy. **In the euro area, the moderate pressure from commodities was boosted by the considerable (roughly 10 per cent) strengthening of the euro against the US dollar in comparison to mid-2012.**

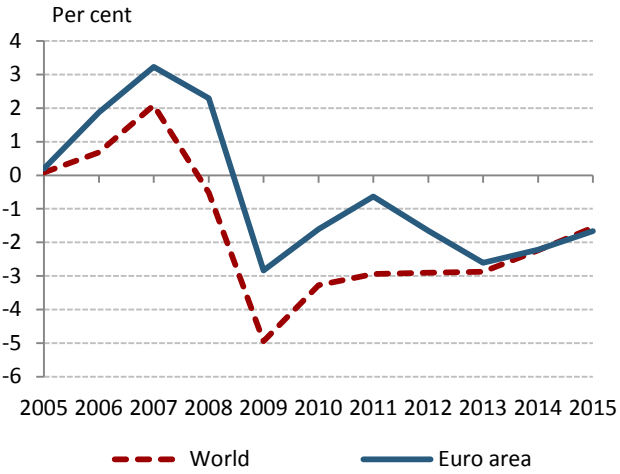
In developed economies, price pressure from the labour market is also mild, in addition to commodity prices. As a result of slack labour market conditions, wage setting is typically subdued, with unit labour costs only rising at a moderate pace (Chart 6-3).

Chart 6-3: Development of global ULC



Source: OECD, Eurostat

Chart 6-4: Output gap in the world economy and in the euro area



Note: The global output gap was calculated from output gap estimations for individual countries using shares in world GDP.
Source: MNB calculation based on IMF WEO (April 2014)

In developed economies, output continues to fall significantly short of its potential level. Some of the developed countries went through a synchronized debt crisis. Historical experience shows that the recovery of demand after debt crises is extremely slow. The main reasons for this are the adjustment of balance sheets, the considerable slowdown of the financial sector and the general strengthening of precautionary considerations. As a result, **demand exerts moderate inflationary pressure** on pricing decisions, which is also reflected in the gradual decline in core inflation. The output gap is estimated to remain negative in OECD countries, with only a gradual narrowing expected over the next few years (Chart 6-4).[13]

In recent periods, expectations have adjusted in line with the decline in inflation, contributing to the emergence of a low inflation environment. In recent quarters, households' inflation expectations have moderated in conjunction with the decline in actual inflation. Analysts (SPF) foresee the persistence of a low inflation environment in the coming years, with inflation below the ECB's target. Based on surveys pertaining to the second quarter, analysts' medium-term inflation expectations have declined further. At the same time, analysts continue to agree that the probability of a negative price index remains low. Additional downward risks are primarily attributed to internal factors – economic growth, labour market – with external trends (commodity prices, exchange rates) also playing an important role.

In addition to short-term cyclical factors, some analyses mentioned the effects of demography on inflation. An aging society and sustainability concerning the pension system change the consumers' consumption-saving behaviour. In the economies affected, the reduction in the propensity to consume permanently diminishes inflationary pressure.

[13] The question arises whether the inflationary effect of demand has changed. Several analyses have focused on this issue recently. Some argue that the effect of weak demand on consumer prices can be stronger in the case of persistently negative, large output gaps. A number of estimates are available for examining this question; however, for the time being, no clear conclusion has been drawn.

6.1.2. Trends expected looking forward

Given the spare capacities of the global economy, inflation is expected to remain subdued in the coming months. However, parallel to the loose monetary policy and the upswing in economic activity, inflation is likely to increase gradually over the medium term.

Altogether, external inflation has decreased substantially in recent periods in the context of weak demand combined with the considerable contribution of falling commodity prices and the gradual adjustment of inflation expectations. Over the next 2-3 years, economic analysts expect to see a slowly increasing price index below the ECB's inflation target. The June forecast of the ECB, as well as prognoses by other international institutions, suggest a similar outlook. In addition to a persistently low inflation, loose monetary conditions are also expected to remain, not only in the euro area but in other developed economies as well.

6.2. Measuring labour utilisation

Unemployment has fallen considerably recently: according to the Labour Force Survey, the number of unemployed was 28 per cent lower in 2014 Q1 than a year before, thus having returned to its pre-crisis level. The number of unemployed is important because **it reflects the degree of unutilised labour capacity**, which in turn affects inflationary pressure from the labour market. However, **unemployment is not the only indicator that can be used to gauge free labour capacities**. In the current state of affairs, there is more uncertainty about the degree of labour market slack than before. This uncertainty is present not only in Hungary: recently a number of major central banks have also discussed the issue.[14] In this analysis, we review the groups of society whose members can at least in part be considered as free labour capacity, and how they influence our understanding of labour market utilisation. The size of these groups is important for monetary policy decisions for two reasons: first, the amount of free labour capacity markedly influences wage pressure on the labour market. Given the rate of economic growth, wage pressure is smaller if there is more free labour capacity. Second, a larger ratio of those potentially employable on the short term may dynamise cyclical economic growth during the recovery.

According to the definition used by the ILO (International Labour Organisation), the unemployed comprise all persons who are without work, who are currently available for and seeking work. However, the free labour capacity includes people who could be potentially involved in production, irrespective of whether they qualify as unemployed by definition. In order to estimate the tightness of the labour market (an important measure for the central bank for gauging the inflationary pressure from the labour market), it is the number of those who could be considered potential applicants for a particular vacancy in the private sector that we look at.

In an extreme case, everyone who is not in employment during a reference period can be considered as free labour capacity, since they can become employable in some time period. This, however, is a highly heterogeneous group that also comprises people who could only be involved in production with great difficulty and at low rates of productivity. The unemployed are the easiest to become involved in production, for they are momentarily out of work, but are available and are able to start working. However, even the unemployed should be differentiated by the length of period spent in unemployment, because the longer a person is without work the higher the risk of seeing previously acquired skills erode, which can make finding a job even harder. Furthermore, certain groups of the employed and the active also represent un or underutilised labour capacity who could be involved in production over a relatively short term.

The following groups of society will be assessed according to the degree at which they can be involved in production:

1. of the *unemployed*, those who have been out of work for a longer term have less chance of finding a job, for they are less likely to be regarded as free labour capacity than those unemployed for a shorter period.
2. some of the *employed* could be seen as partially available labour capacity, or they might be competing for vacancies in the private sector. They include:
    a. underemployed part-time workers;
    b. fostered workers (or workers in public employment programmes) who are in such positions on a temporary basis and who, during or after their term in public employment programmes, are looking for work in the private sector;
    c. those temporarily working abroad but who will look for a job in the domestic labour market at the time of the recovery.
3. there are certain groups of *inactives* who meet some components of the ILO's definition and thus may be considered as free labour capacity. They are:
    a. discouraged workers: people who want a job but are no longer searching because they feel they cannot find one at the current position of the economic cycle;

[14] Bank of England (2014): Report on Inflation, May 2014
Bank of Canada (2014): Beyond the Unemployment Rate: Assessing Canadian and U.S. Labour Markets since the Great Recession, Bank of Canada review, Spring 2014
European Central Bank (2013): Monthly Bulletin, June 2013
Rosengren, Eric S. (2014): Underutilization in U.S. Labor Markets, Federal Reserve Bank of Boston, speech on 6 February 2014
Sveriges Riskbank (2013): Monetary Policy Report, October 2013

b. other potential labour force: people who are seeking work but cannot start working in two weeks, or who already hold a position in which they will only start working at a later date.

Table 6-1 below provides an overview of how easily different groups of the underemployed can be involved in production. The categories are based on the time and training requirements of involving them in production. (For the employed, at least the recruitment and notice periods must be taken into account when changing jobs, with only recruitment period applying to the unemployed. Nevertheless, the time needed for training and induction may also be considered in both cases.) This will be followed by a detailed analysis of the main characteristics and numbers of people in each category.

Table 6-1: Groups of unutilised labour capacity by their availability to be involved in production

Very easy to be involved in production (no recruitment or training cost incurred)	underemployed part-time workers	employed but would like to work more hours, typically in the current position
Easy to be involved in production (can start within a short time frame)	unemployed for less than 12 months	without a paid job but looking for and able to work, skills not yet eroded
Involvement in production is difficult (employed, or employment is likely subject to training)	long-term unemployed (for more than 12 months)	without a paid job but looking for and able to work, skills eroded
	fostered workers	with a paid job that is nevertheless temporary and intended to help private sector employment
	discouraged workers	without a paid job, able to work but no longer seeking
Involvement in production is extremely difficult	other potential labour force	they do not have paid work, are looking for a job but would not be able to start working, or they do not have paid work, would not be able to start working, but they are looking for a job passively, or they already have a job that they will start later
	emigrants due to cyclical reasons	employed abroad, due to the slack domestic labour market

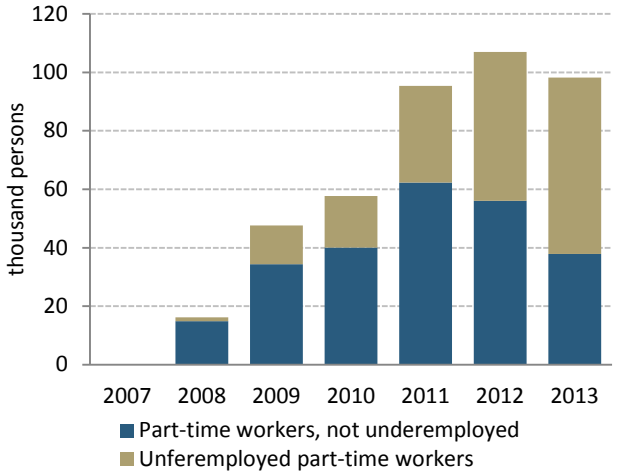
6.2.1. Underemployed part-time workers

Since the onset of the crisis, the number of people in part-time employment has risen to a large degree, even though it is still considered low on an international scale. There might have been several reasons behind this increase. According to our analysis,[15] one such reason was that companies adjusted to decreased aggregate demand by changing per-capita hours worked. This meant having people previously hired as full-time employees work part-time, and also lowering the hours worked by full-time employees (for instance through the reduction of overtime). When the economy starts to recover, the easiest way for companies to adjust is to raise the number of hours worked by their part-time employees, as this method incurs no recruitment or training costs, and has no time implications either.

More than a third of part-timers would like to be employed in more hours – they are referred to as underemployed part-time workers. What this means is that they ought to be regarded partially as free labour capacity. The number of part-time workers slightly declined in 2013, but that of the underemployed has grown (Chart 6-5). Underemployed part-time workers work an average of 22 hours per week; meanwhile full-time employees work an average of 38 hours per week. Therefore, underemployed part-time workers could nearly double their weekly work hours before reaching full-time status. In order to quantify underemployment, several studies focus on underemployed part-timer headcount – we also determined their numbers as a setback percentage of hours worked by full-timers.

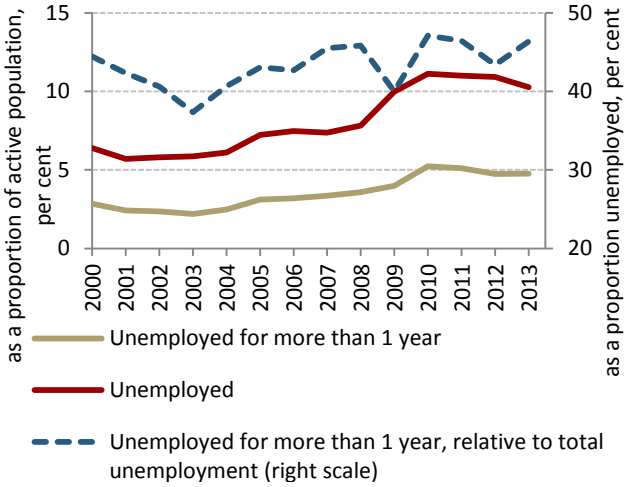
[15] Bodnár, K. (2014): Part-time employment during the crisis, MNB Bulletin, March 2014.

Chart 6-5: Change of part-time employees since 2007



Source: Labour Force Survey

Chart 6-6: Unemployment ratio and ratio of long-term unemployed



Source: Labour Force Survey

6.2.2. The unemployed according to the length of unemployment

During periods spent in unemployment, the skills once used for work become outdated and eroded. As a result, finding a job can be more difficult for those who have been without a job for a prolonged period, which in turn can result in even longer periods of unemployment. This might be one of the reasons behind **the increase of the equilibrium unemployment rate following a significant rise in the actual unemployment rate** (*hysteresis*). We therefore conclude that involving the long-time unemployed in production is difficult, as their hiring and re-qualification would likely incur considerable expenses and losses in time for the companies.

In the years since 2008, as a combined result of a decreased demand for labour and the rise in labour market activity, the number of unemployed has risen by about 50 per cent. Those having been without a job for at least 12 months are considered long-term unemployed (although a recent study claims that 8 months of unemployment are enough for the callback rate to decline sharply in the US job market[16]); their rate within the active population rose from close to 3 per cent to above 5 per cent, only declining in 2012-2013. Nearly half of those looking for a job have been doing so for more than a year (Chart 6-6). This rate has largely been driven by public employment programmes, as long-term unemployed have been able to find a job in these programmes rather than in unsubsidised positions. Through the subsidised hiring of the long-time unemployed, the Job Protection Action Plan may have had a positive impact as well (contribution allowances can be claimed after employees having been registered as job seekers for at least 183 of the 275 days prior to hiring, not including the duration of public employment).

6.2.3. Fostered workers

Under the International Labour Organisation's standards, fostered workers are to be considered employed (having spent at least one hour in paid employment during the reference week), whose hiring therefore statistically reduces the number of unemployed. However, **the public employment programme –** the goal of which is to make up for the decreased demand for labour in the private sector and prepare entrants to the job market for private sector employment after periods spent in inactivity **– aims at offering temporary forms of employment that are seen as a means of transition towards the private sector**. It is therefore **important to establish the extent to which fostered workers are considered**

[16] Kroft, Kory – Fabian Lange – Matthew J. Notowigido (2013): Duration Dependence and Labor Market Conditions: Evidence from a Field Experiment, The Quarterly Journal of Economics, 2013, pp. 1123-1167

free labour capacity; in other words, whether a public employment programme-induced decline in unemployment is indeed accompanied by a decrease in free labour capacity (Table 6-2).

Table 6-2: Groups of fostered workers and their effect on the amount of available labour capacity

Before public work program…	During public work program…	As a result of public work programs, free labour capacity…	The amount of free labour capacity is…
1. searched for work in the private sector and had qualifiations needed there	not seeking work	decreases	reflected fairly by unemployment
2. searched for work in the private sector and had qualifiations needed there	seeking work	does not change	underestimated by unemployment
3. did not search for work in the private sector or searched but did not have qualifiations needed there	not seeking work	does not change	reflected fairly by unemployment
4. did not search for work in the private sector or searched but did not have qualifiations needed there	seeking work	increases	underestimated by unemployment

If fostered workers fail to search for jobs throughout the duration of their programme, they need not be considered as free labour capacity (scenarios 1 and 3). This assumption is supported by the fact that, based on the Labour Force Survey, the majority of fostered workers do not search for jobs during their programme, and also by the low ratio of those leaving public employment programs finding a job. However, it does not prevent that, once out of the public employment programme, people may start applying for jobs in the private sector and therefore can still be considered as free labour capacity.

If, during their terms in public employment programmes, fostered workers search for jobs in the private sector – and therefore represent real competition to other applicants (scenarios 2 and 4) – **their numbers must be included in free labour capacity.** In our estimates, the amount of free labour capacity (with fostered workers included) has recently declined to a lesser extent than unemployment itself. It is likely that fostered workers are split among the above listed categories; we nevertheless are unaware of the proportion of those who, from a utilisation standpoint, are closer to being unemployed and those who must not be considered as free labour capacity.

6.2.4. Discouraged workers and other potential labour force

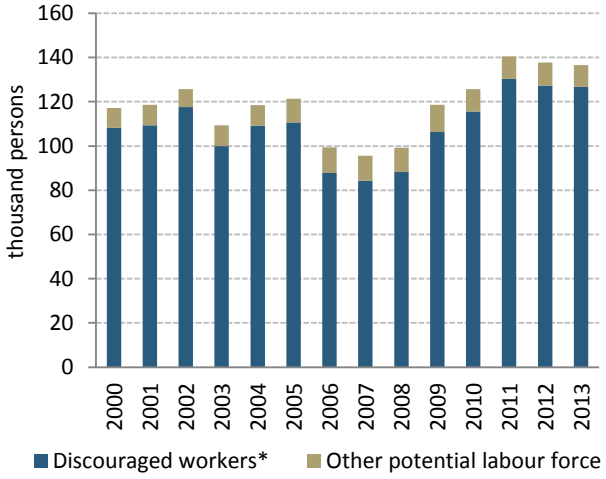
In an economic downturn, the number of people exiting from the labour market due to rising unemployment may increase. They quit searching for jobs due to a lack of confidence in being able to get hired in the given labour market situation. People in this group would like to work, but do not search during a given cyclical phase. Once there is less slack in the labour market, however, they can return to applying for jobs.

Finally, people who are seeking paid employment but unavailable to work, or already have a position in which they will only start at a later date, are categorised as **other potential labour force**. This group also includes those who would be able to start and are also searching, albeit only passively (e.g. browsing job postings or awaiting interview results). Only a small but constant number of people are included here, irrespective of the economic cycle.

6.2.5. People temporarily working abroad due to cyclical reasons

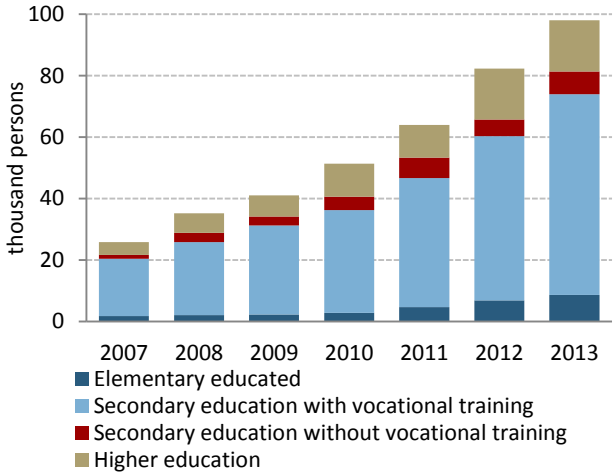
During the crisis, there was an increase in the portion of the population working abroad. Some people started to work abroad probably due to cyclical reasons; in other words, once domestic demand for labour begins to improve they are most likely to start looking for a job in Hungary again. While we cannot determine their exact share of the overall population working abroad, their ratio must be higher among Hungarian residents temporarily working abroad than among those having permanently emigrated. By late 2013, there were approximately 100,000 Hungarians working abroad on a temporarily basis. According to our analysis, the majority of the population temporarily working abroad and included in the Labour Force Survey possess secondary-level vocational qualifications, whose domestic employment have drastically declined. This could suggest that their employment abroad is due to cyclical reasons and once employment growth in Hungary is restored they will return home for work.

Chart 6-7: Discouraged workers and other potential labour force



Note: * Could start working, but does not seek a job, because he/she thinks none is available.
Source: Labour Force Survey

Chart 6-8: Number of employees temporarily abroad since 2007 by highest education

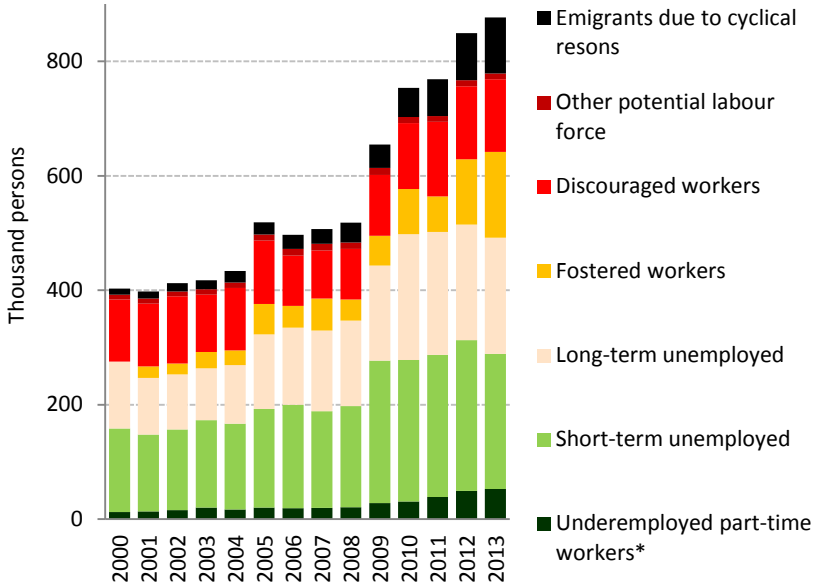


Source: Labour Force Survey

6.2.6. The extent of free labour capacity

We have examined the extent of free labour capacity, taking the above groups of the population into consideration. However, **it is not clear what proportion of fostered workers and those working abroad temporarily can be considered as free labour capacity from the point of view of domestic companies**. As an upper estimation, the whole group is considered as free capacity. The figure calculated this way is influenced most by how fostered workers are considered: **if all fostered workers are considered as free labour capacity, labour utilisation has not increased until end-2013. However, if they are not considered free labour capacity, then the amount of workforce available for production has declined significantly.** Based on data for 2014 Q1, the decrease of unemployment was not entirely due to the increase in public work programmes. **Free labour capacity, however, is still above its pre-crisis level**, and thus, a substantial increase in inflationary pressure from the labour market cannot be observed yet and we do not expect this on the forecast horizon either (Chart 6-9).

Chart 6-9: Unutilised labour force



Note: * As a proportion of hours missing for full-time employment

Source: Labour Force Survey

In summary, our analysis has pointed out uncertainties around the measurement of free labour capacity. As regards inflationary pressure from the labour market, over the short term it is the number of people who can be made involved rapidly in production that matters. **When assessing the non-accelerating inflation rate of unemployment (NAIRU), readily mobilisable groups need to be taken into account. The number of people belonging to these groups started to decrease with the recovery**, and thus, the slackness of the labour market has moderated. **Over the medium term, larger groups that are more difficult to be involved in production today can also be activated. The medium-term equilibrium rate of unemployment can depend on the employment probabilities of these people to a large degree.**

7. BREAKDOWN OF THE AVERAGE CONSUMER PRICE INDEX FOR 2014

Table 7-1: Decomposition of the inflation to carry over and incoming effect (2014)

	Effect on CPI in 2014		
	Carry over effect	Incoming effect	Yearly index
Administered prices	-1,0	-0,2	-1,2
Market prices	-0,2	0,9	0,7
Indirect taxes and government measures	0,7	-0,1	0,5
Inflation	-0,6	0,6	0,0

Note: The tables show the decomposition of the yearly average change of the consumer price index. The yearly change is the sum of the so called carry over and incoming effects. The carry over effect is the part of the yearly index, which can be explained by the preceding year's price changes, while the incoming effect reflects the changes in the recent year. We decomposed these indices to the sub-aggregates of the consumer price index; and we calculated inflationary effects of the changes in the indirect taxes, the administered prices, and market prices (not administered prices excluding indirect tax effects). The subgroups may not sum to the aggregate figure due to rounding.
Source: MNB

Table 7-2: Detailed decomposition of our inflation forecast to carry over and incoming effects (2014)

	2014				
	Average carry over effect	Carry over indirect tax effect	Average incoming effect	Incoming indirect tax effect	Yearly index
Food	-1,8	0,0	0,7	0,0	-1,1
non-processed	-6,0	0,0	-0,3	0,0	-6,3
processed	0,2	0,0	1,2	0,0	1,3
Traded goods	0,1	0,0	0,5	0,0	0,5
durables	-0,6	0,0	0,0	0,0	-0,6
non-durables	0,3	0,0	0,7	0,0	1,0
Market services	1,1	1,0	1,7	-0,8	3,1
Market energy	-0,6	0,0	-1,3	0,0	-1,9
Alcohol and Tobacco	0,0	4,9	1,4	0,3	6,7
Fuel	-1,8	0,0	1,5	0,0	-0,3
Administered prices	-5,4	0,0	-0,9	0,0	-6,3
Inflation	-1,2	0,7	0,7	-0,1	0,0
Core inflation	0,4	1,0	1,1	-0,2	2,4

Note: The tables show the decomposition of the yearly average change of the consumer price index. The yearly change is the sum of the so called carry over and incoming effects. The carry over effect is the part of the yearly index, which can be explained by the preceding year's price changes, while the incoming effect reflects the changes in the recent year. We decomposed these indices to the sub-aggregates of the consumer price index; and we calculated inflationary effects of the changes in the indirect taxes, the administered prices, and market prices (not administered prices excluding indirect tax effects). The subgroups may not sum to the aggregate figure due to rounding.
Source: MNB

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Mátyás Hunyadi

(23 February 1443 – 6 April 1490)

He ruled from 1458 to 1490 as King of Hungary, and had been Czech king from 1439 and Prince of Austria from 1486. Hungarian tradition regards him as one of the greatest Hungarian kings whose memory is preserved in many folk tales and legends. He is also known as Matthias Corvinus, King Matthias the Just or officially as Matthias I, but commonly he is simply denoted as King Matthias.

His father, János Hunyadi, the regent of Hungary, was one of the most outstanding military leaders and strategists in the country's medieval history who triumphed at the Battle of Nándorfehérvár in 1456. Matthias' mother was Erzsébet Szilágyi, and he had an elder brother, László Hunyadi. The future king was brought up by his mother and nurse until the age of six, and was subsequently placed under the supervision of his tutors. János Hunyadi did not have a chivalrous education in mind for his son: first, it was a Polish humanist, Gergely Szánoki who introduced him to the realm of knowledge, then this task was assigned to János Vitéz. Mátyás was brought up and educated in a humanistic spirit to become a versatile and curious-minded person who had been taught canon and constitutional law, arts and Latin. In addition to Hungarian, he also spoke German and Czech.

After the death of László V, his uncle, Mihály Szilágyi, and the armed forces supporting Hunyadi exercised pressure to have Matthias crowned as King of Hungary on 24 January 1458. Even in the early years of his reign Matthias had troubles both with the magnates of the country and Emperor Frederick III of the Holy Roman Empire. As the king was still a minor, parliament appointed Mihály Szilágyi to act as regent on his behalf. However, Matthias did not tolerate any guardianship and pushed his uncle to the background who devised a plot against the king in response. Returning from battle with the Turks, the king had the rebels captured and he imprisoned his uncle in the castle of Világos.

Upon his ascension to the throne the annual income of the treasury hardly exceeded 110 to 120 thousand forints. During his rule spanning thirty-two years the king managed to multiple revenues from taxes. Considering the average of the taxes levied, less the revenues from the Czech and Austrian provinces, this yearly amount approximated 628,000 forints and may as well reached 900,000 gold forints in the most prosperous years. This was still much less than the annual revenue of the western powers of the age. In order to raise the low income of the treasury, reform-like and comprehensive financial actions were needed. Matthias recognised that a centralised, nationwide financial system was the only solution to the problem, and that the royal revenues had to be directed to a single person, the treasurer. The reforms of Matthias were adopted by parliament and his decrees were promulgated on 25 March 1467.

We can get a glimpse of the cultural life in the royal court, which represented the elite of European civilisation at the time, at the partly reconstructed Royal Palace in Visegrád. The most distinguished pieces of the cultural legacy of Matthias are the Corvinian books, richly illustrated volumes of the former royal library.

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