Macroeconomic and financial market developments

April 2014

Background material
to the abridged minutes of the
Monetary Council meeting
29 April 2014

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

The abridged minutes and the background materials to the minutes are available on the MNB's website at:

http://english.mnb.hu/Monetaris_politika/decision-making/mnben_mt_jegyzokonyv

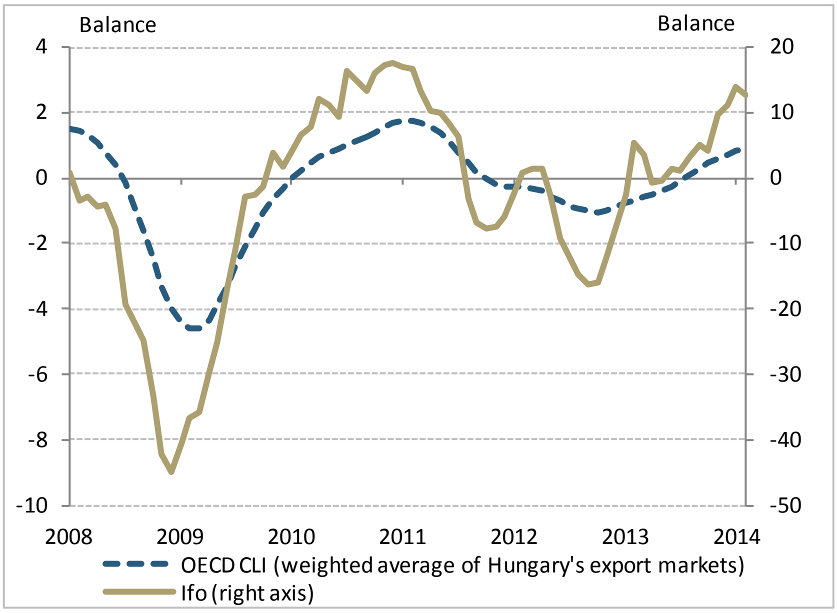
Macroeconomic developments

1.1 The global economy

Growth in Hungary's export markets continues to pick up gradually. The recovery of the euro area from recession has continued in recent months. At the same time, economic growth in emerging markets has slowed down. The outlook for growth deteriorated, mainly in countries affected by the turbulence in financial markets and political tensions. Inflationary pressures from the world market have remained weak in recent months.

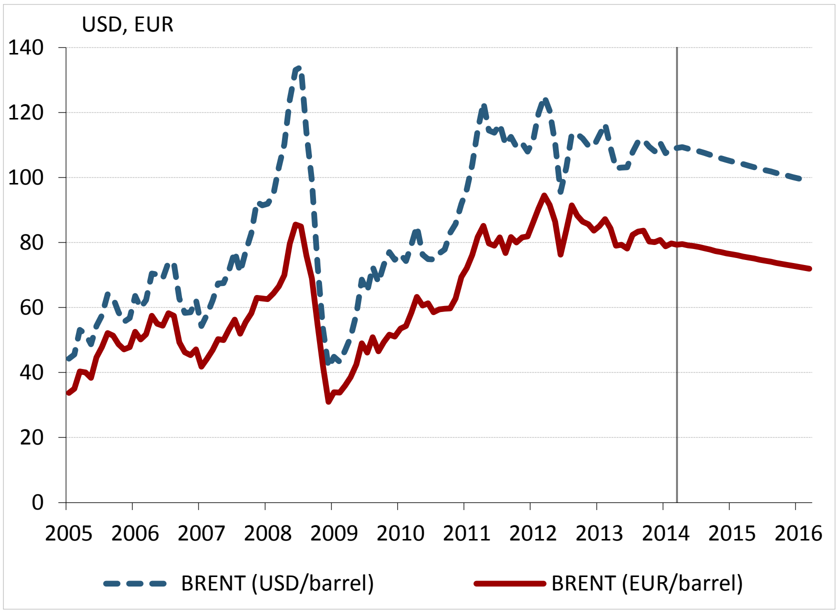
The recovery in the global economy continued in 2013 Q4. The growth environment moved on diverging paths for the developed and emerging economies. Activity in emerging market economies, which had previously shown rapid growth, slowed down in the final months of 2013, in contrast with the advanced economies where signs of an upturn in economic activity became increasingly evident. Based on the latest indicators of activity, these divergent trends continued in the early months of 2014.

Chart 1: Indicators of activity in Hungary's export markets



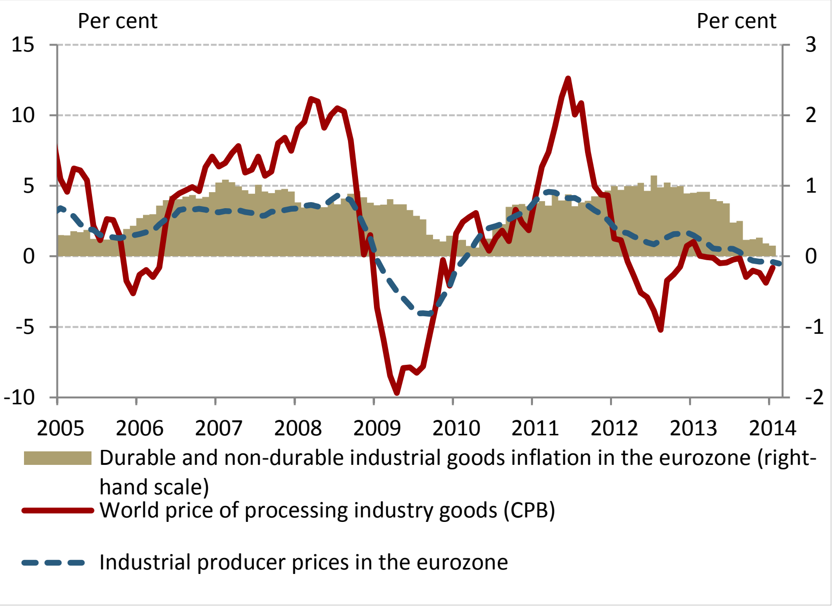
The euro-area economy recovered from recession in the second half of 2013. Indicators of activity for February signal further acceleration in growth, but the recovery in forward-looking indicators seems to have faltered due to higher risks. Output in Germany, Hungary's most important trading partner, continued to grow slightly in February, but German industrial orders were flat. The Ifo Business Climate Index, a measure of the expectations of German industrial firms, slowed down somewhat, mainly reflecting the intensification of political tensions.

Chart 2: World market price of Brent crude oil



Inflationary pressures from the world market have remained weak in recent months. Declining commodity prices, coupled with modest growth in the global economy, are pushing inflation down, and as a result, inflation rates in the world's major economies remain below target (harmonised consumer prices in the euro area continue to be low). Movements in the prices of industrial commodities and unprocessed foods continue to be moderate. Growth in the world price of manufactured goods remains subdued.

Chart 3: Industrial producer prices and tradables inflation in the euro area and world market prices of processed industrial goods



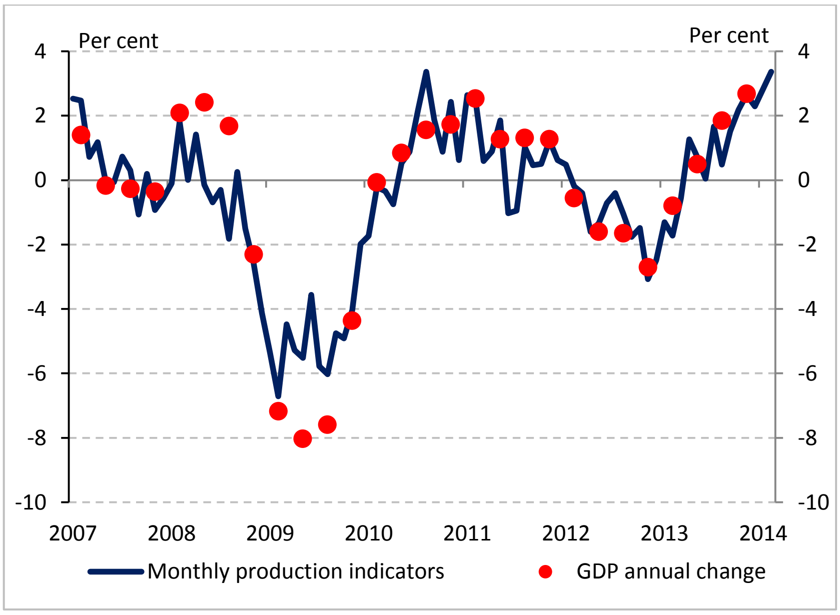
1.2 Domestic real economic and labour market developments

Domestic economic growth continued in early 2014. Output grew across a wide range of economic sectors in February, with domestic demand likely to have contributed to GDP growth in Q1, in addition to exports. In addition, total employment continued to grow and unemployment fell below 8 per cent, with rising private sector demand for labour and public labour programmes as contributing factors. The labour market tightened in the first few months of 2014 and the number of vacancies per person continued to rise.

1.2.1 Economic growth

Domestic economic growth continued in 2014 Q1. The Hungarian economy picked up gradually during 2013, with gross domestic product growing by 2.7 per cent in Q4 compared to the same period a year earlier. Based on the production measures for January–February, economic growth continued to accelerate in early 2014, mainly reflecting rising output growth in the vehicle industry, the gradual recovery in household consumption and the sharp increase in government investment activity.

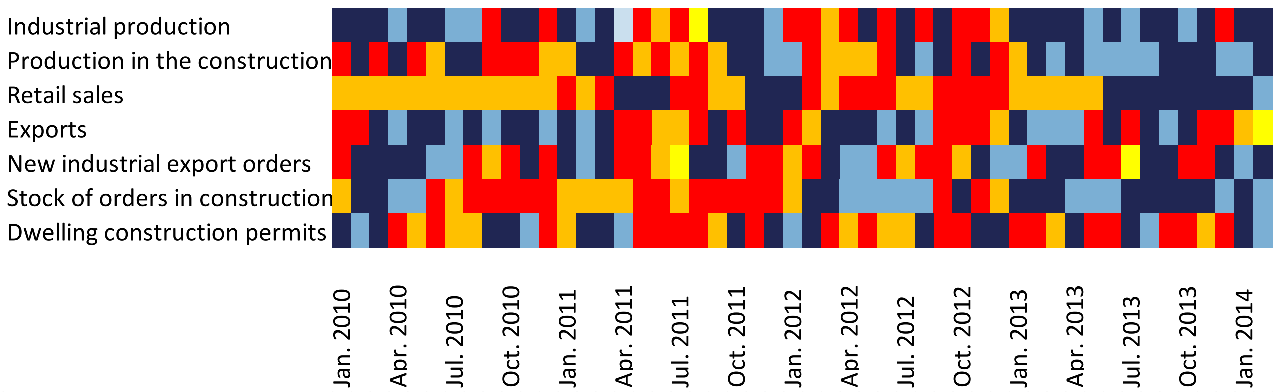
Chart 4: Monthly production indicators and annual change in GDP*



* The monthly production indicator is the weighted average of industrial output, construction output and retail sales. The weights are derived from regression where GDP is determined by these three indicators.

We expect the economy to grow steadily in the period ahead, with exports and domestic demand both likely to expand. The output of both the export sector and sectors producing for the domestic market grew in February.

*Chart 5: Growth heat map**



* The growth heat map shows the three-month moving averages of the seasonally adjusted monthly growth rates of the most important monthly indicators of activity, using the following colour code: dark blue = grows above the five-year average, at an accelerating rate; blue = grows above the average, at a slowing rate; light blue = grows below the average, at an accelerating rate; yellow = grows below the average, at a slowing rate; orange = falls at a slowing rate; red = falls at an accelerating rate.

Industrial production rose by 8.1 per cent relative to a year earlier and by 1.4 per cent relative to the previous month. Output increased across a wide range manufacturing industries in February. As seen last year, the performance of the vehicle industry accounted for the greater part of the expansion at the beginning of the year. The favourable demand environment points to similar performance in the coming months, as reflected in the stock of industrial orders. In February, the output of the energy sector fell due to the mild weather, temporarily restraining growth in industrial production. Goods exports continued to rise, in line with developments in industry, driven mainly by vehicle industry exports.

Construction output continued to grow in February (by 28.3 per cent year on year). Industrial investment by the corporate sector continued to be main contributing factor to growth in building investment; private sector investment remained subdued. Government investment activity mainly in infrastructure, financed from EU funding, continued to be robust. Although the mild weather may also have been reflected in the favourable production data, the sharp increase in industrial orders points to vigorous growth in production in the coming months. Based on the favourable data for construction activity, building construction may have expanded significantly in early 2014.

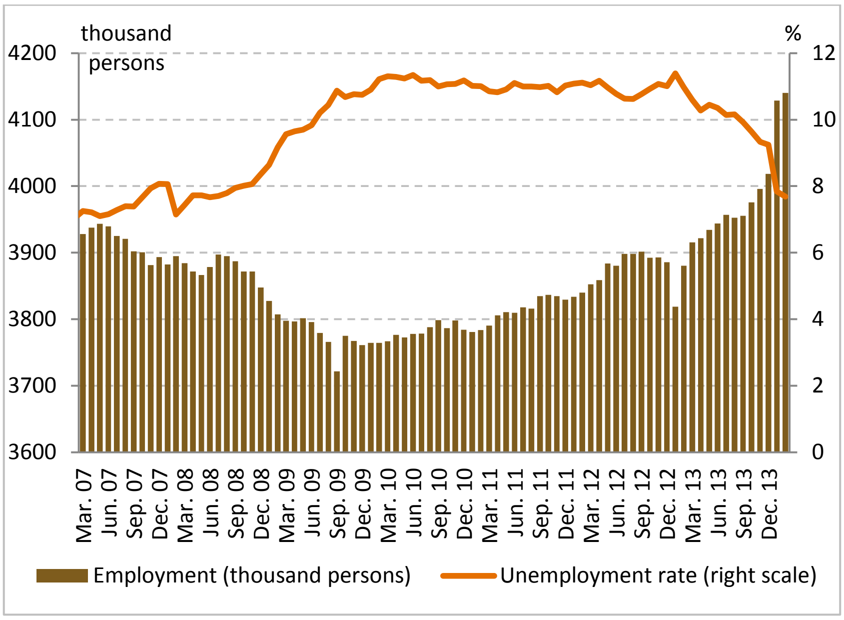
The gradual increase in consumption demand may have continued in early 2014. The volume of retail sales rose significantly, by 4 per cent in February year on year and by 0.3 per cent relative to the previous month.[1] Household real income rose significantly due to historically low inflation, underpinning a further increase in household consumption. However, the recovery is only expected to be modest, reflecting the strong presence of precautionary savings and households' balance sheet adjustment. However, available data for retail sales suggest that consumption will increase at a slightly stronger pace than in the March projection.

[1] In January 2014, the Central Statistical Office changed the method of recording turnover in tobacco products. Instead of the previous sampling method, the CSO switched to the data supply by Nemzeti Dohánykereskedelmi Nonprofit Zrt. providing full coverage of tobacco sales. Data released by the CSO cover tobacco sales recorded under the old method until June 2013 and those recorded under the new method from July. This caused a structural break in the time series. Therefore, the analysis presents the index calculated using the old methodology. According to data calculated by the CSO using the new method, retail sales rose by 6.7 per cent relative to the same period of the previous year.

1.2.2 Employment

According to Labour Force Survey data, the number of employees in the total economy stagnated in February. The unemployment rate stood at 8.4 per cent (at 7.8 per cent in seasonally adjusted terms). The increase in employment in Q1 may have mainly reflected the effect of public labour programmes during the winter. According to preliminary data, private sector employment also grew in 2014 Q1, with employment in manufacturing and market services also contributing.

Chart 6: Employment and the unemployment rate



According to data released by the National Employment Service, the number of new, non-subsidised jobs continued to rise in Q1, confirming a continuous improvement in corporate demand for labour. The number of vacancies per person continued to rise, suggesting less loose conditions in the labour market relative to the previous period.

Chart 7 Indicators of labour market tightness

Sources: CSO (Labour Force Survey) and National Employment Service.

1.3 Inflation and wages

Inflation was at historically low levels in the early months of 2014. Favourable developments on the cost and demand sides, weak imported inflation and the adjustment of expectations were factors which contributed to low inflation. The private sector wage index picked up in early 2014, but the March data will contain useful information on underlying developments in wage growth.

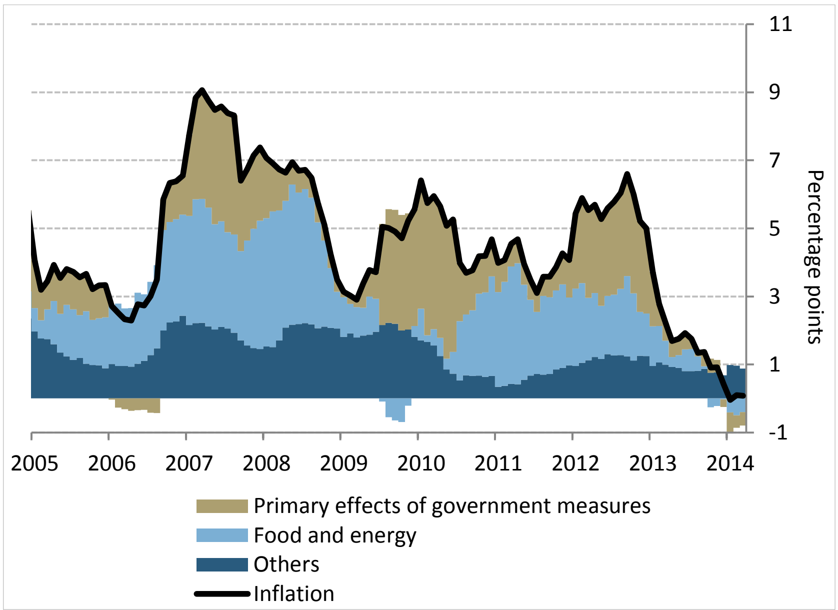
1.3.1 Wages

Private sector earnings growth was moderate in 2013 as a whole, with gross average earnings rising by 3.6 per cent. In January–February 2014, however, earnings growth in the private sector accelerated relative to December 2013. In February, gross average earnings of full-time employees increased by 5.2 per cent relative to a year earlier. As most companies disburse usual pay increases due early in the year only in March, wage data for March will contain more meaningful information on this year's underlying wage developments.

1.3.2 Inflation developments

Hungarian inflation slowed further in early 2014 and remained at a historically low level, well below the 3 per cent inflation target. In March 2014, the consumer price index stood at 0.1 per cent, core inflation at 2.7 per cent and core inflation excluding the effect of indirect taxes at 1.5 per cent. Headline inflation was unchanged, and core inflation fell by 0.1 percentage point relative to the previous month. Annual inflation of individual items changed only slightly. Including the March data, inflation was 0.1 per cent and core inflation 3.0 per cent in Q1. Inflation excluding indirect taxes, calculated by the Bank, stood at -0.9 per cent and core inflation adjusted for tax effects at 1.5 per cent in 2014 Q1. Underlying inflation inidcators were broadly unchanged relative to the previous month.

Chart 8: Decomposition of the consumer price index

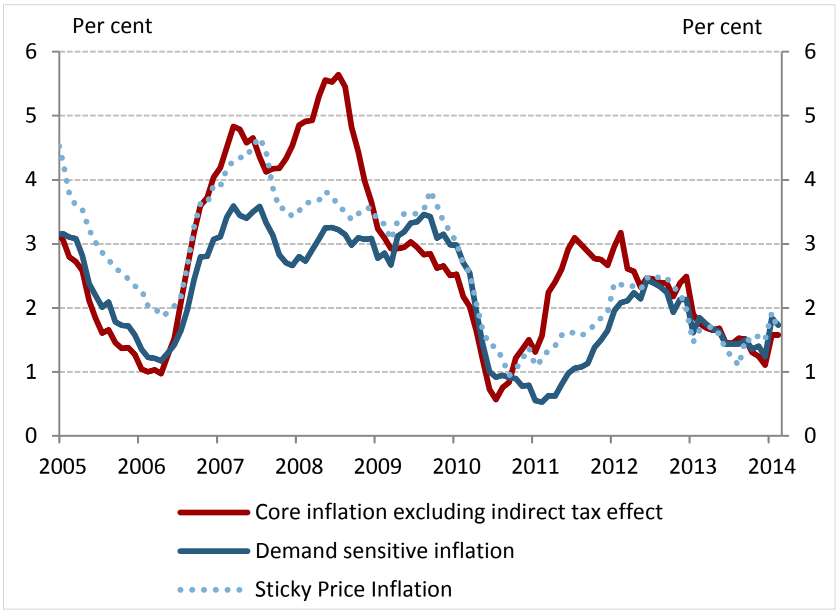


The low level of underlying inflation measures continues to point to a moderate inflation environment. Core inflation adjusted for tax effects is likely to begin rising from its current low level in 2014 Q2 as domestic demand picks up and as the weaker exchange rate since the beginning of the year gradually passes through.

Favourable developments on the cost and demand sides, the gradual adjustment of expectations and subdued imported inflation may have all contributed to the development of a low inflation environment in recent months. Relative to a year earlier, agricultural producer prices fell by 10.9 per cent and domestic sales prices of sectors producing consumer goods rose by 1.7 per cent in

February 2014. Fuel prices continued to fall in March on a year earlier, but rose relative to February, reflecting the increase in crude oil prices expressed in forint terms. Based on the latest retail sales data, consumption demand probably increased in recent months as real earnings rose in annual terms. Nevertheless, the volume of retail sales remains significantly below levels seen during the years prior to the crisis. Consequently, the domestic demand environment probably still has a disinflationary impact, although to a lesser degree.

Chart 9: Measures of underlying inflation



The March inflation data were slightly lower than projected in the *Quarterly Report on Inflation*. This difference is mostly explained by the lower-than-expected price indices for tradables and unprocessed food. In addition, low price pressures from imported prices may have also made a strong contribution. Inflation is likely to remain moderate in the short term, as suggested, among other factors, by the further deceleration of euro-area inflation in March. The March price index of 0.5 per cent was lower than analysts' expectations, and the ECB's press release indicated that the inflation environment could remain low for an extended period.[2] In addition, the latest information from markets suggest that fuel price inflation in the coming months may be lower compared to our March forecast.

Taking account of these factors, domestic inflation may remain below the path projected in the March issue of the *Report*. In part, this may be offset by easing disinflationary pressures, as

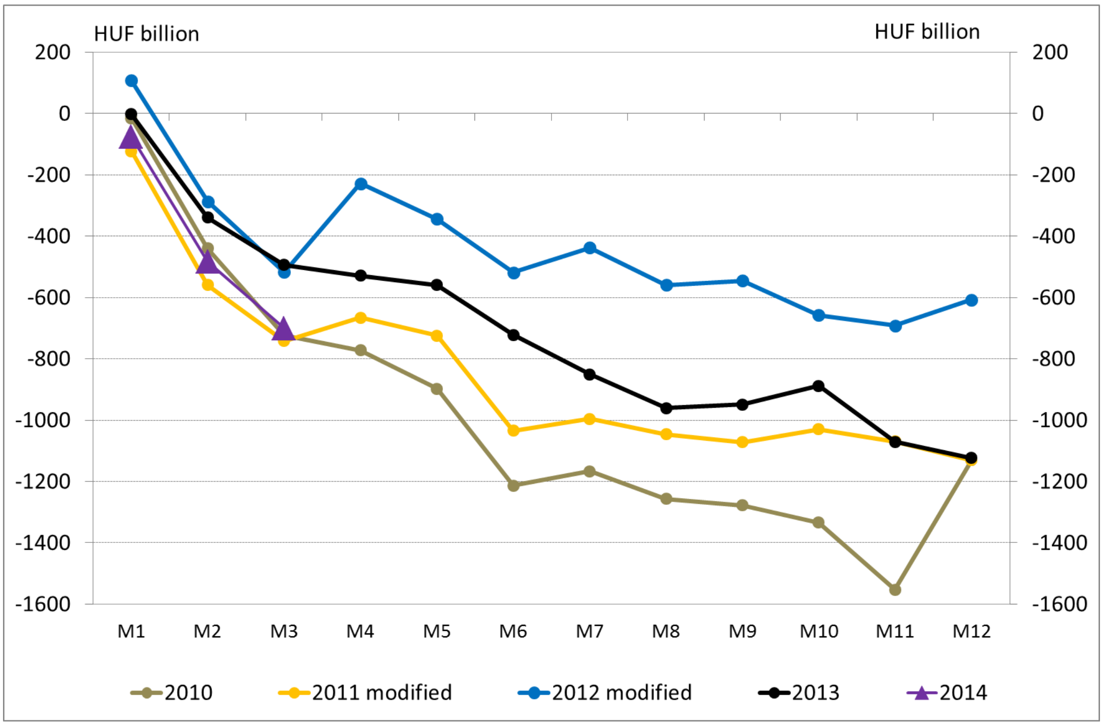
[2] The price index was negative in five member countries (Greece, Cyprus, Portugal, Spain and Slovakia).

suggested by the latest retail sales and labour market data. Based on available data, the Bank judges that there may now be a higher probability that two of the three alternative scenarios which the Council voted to include in the March *Report* will materialise, namely, the scenario of a persistently low external inflation environment and the scenario of weakening domestic disinflation.

1.4 Fiscal developments

The general government deficit amounted to HUF 218 billion in March, up HUF 64 billion on a year earlier. The deficit grew by HUF 205 billion in Q1 relative to the same period of 2013. This was accounted for entirely by increases in net expenditure at the government units and chapters. Government revenue was higher in Q1 than a year earlier, with certain government measures (for example, the increase in the rate of the transaction fee and the introduction of the e-road toll in the second half of the previous year) playing a role.

Chart 10: Intra-year cumulative government deficit



Note: The adjusted profile of deficit for 2011 does not include the effects of one-off items (contributions by the Pension Reform and Debt reduction Fund, the purchase of MOL shares, the one-off tax refund due to the European Court decision, the capital injection to MFB, the assumption of local authority and MÁV debt). The actual profile of deficit for 2012 was adjusted by eliminating the estimated effect of the introduction of new rules for VAT refunds introduced in 2012, in order to ensure better comparability of the deficit profile with those of earlier years.

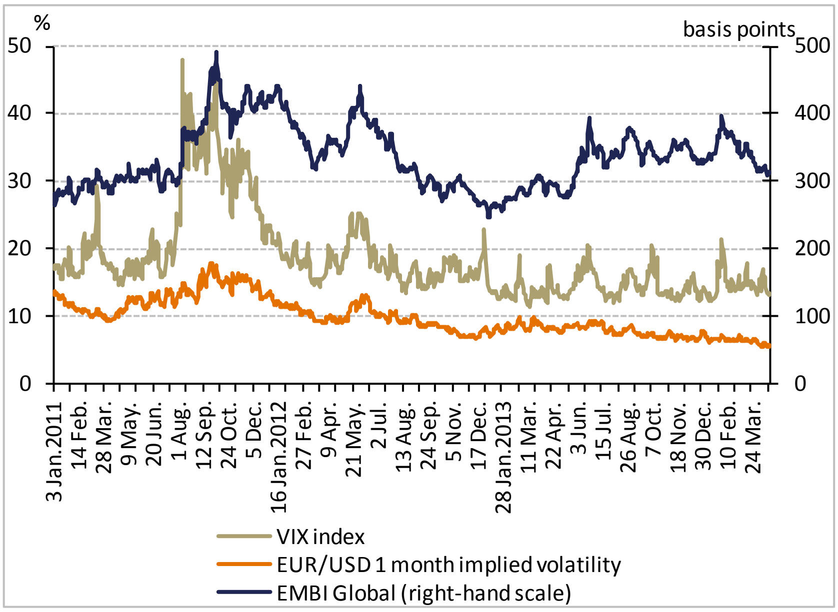
The Central Statistical Office sent preliminary data for the general government balance and debt for 2013 to the European Union at the end of March. According to the data report, the EDP government deficit amounted to 2.2 per cent of Hungary's GDP and the deficit on an ESA-95 basis amounted to 2.3 per cent of GDP in 2013. The accrual-based government deficit for 2013 fell significantly relative to the deficit figures for the years prior to 2011; last year the government deficit was broadly unchanged relative to 2012. The deficit fell markedly, by 0.4 percentage points, relative to the 2.7 per cent deficit target projected in the 2013 Budget Act.

The general government debt for 2013 was 79.2 per cent of GDP, with the debt ratio falling by 0.6 percentage points relative to its level at the end of 2012. The decline in the debt ratio was mainly accounted for by the low government deficit; however, debt management measures and the use of the Pension Reform and Debt Reduction Fund also contributed to the decline in debt. By contrast, the depreciation of the forint exchange rate relative to its level at the end of 2012 would have by itself resulted in a higher debt ratio by 0.6 per cent of the GDP. Although the assumption of local government debt increased the central government debt in the course of the year, this did not cause an increase in the consolidated debt.

Financial markets

In the period since the Council's March interest rate decision, conditions in financial markets have been volatile. Sentiment was influenced mainly by signals from leading central banks, releases of macroeconomic data, the US quarterly reporting season and escalation of the conflict between Ukraine and Russia. Developed-country equity markets rose by 2–5 per cent in the first half of the period, reflecting increasing risk appetite in response to positive news from emerging markets (e.g. the IMF financial package for Ukraine). But equity indices fell sharply in the middle of the period as the conflict in Ukraine escalated and news from the US corporate sector became more mixed. This was followed by a marked reversal of earlier losses towards the end of the period. Movements in risk indicators continued to diverge: while the VIX index, a measure of the implied volatility of the US equity market, rose in the first part of the period, the EMBI Global, an indicator of emerging countries' bond market developments, fell to a local low. Simultaneously with this, large amounts of capital flowed into emerging-country equity and bond markets, reaching levels not seen since the beginning of last year.

Chart 11: Main international risk indicators



The Fed continued to taper its asset purchases, in line with expectations, and the Fed Chair stressed that the US economy would need a supportive environment for quite a period to come, given the slow improvement in labour market conditions, despite the rapid decline in the unemployment rate.

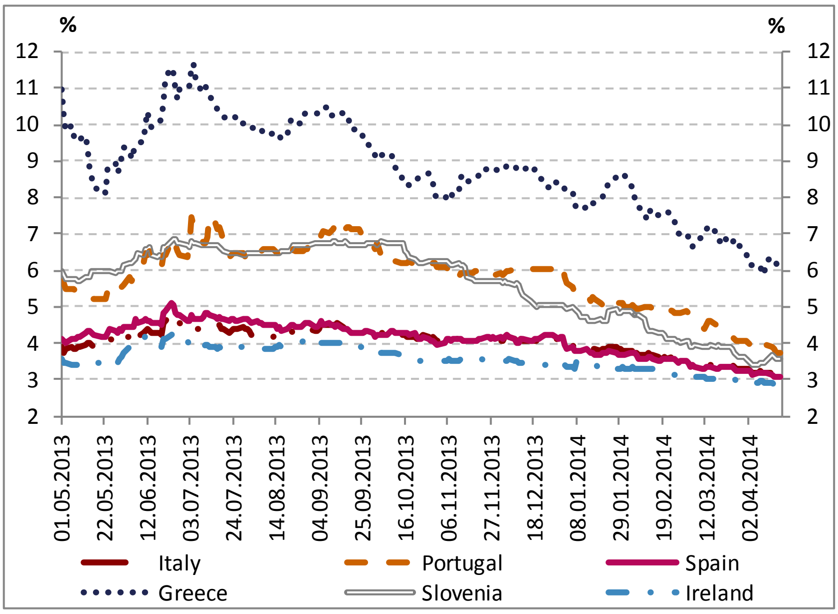
Analysts did not expect a change in interest rates at the ECB's policy meeting in March, but deflation concerns resurfaced, following another surprise fall in euro-area inflation in March relative to January–February levels. President Mario Draghi, however, noted once again that the ECB considered the continuation of the desinflation process as a temporary phenomenon and expected inflation to increase in April. At the same time, he admitted that the Governing Council had discussed the possibility of using unconventional instruments and that the ECB was ready to use such if warranted by inflation developments. The euro fluctuated between EUR/USD 1.37–1.39 against the US dollar during the month, but stagnated over the month as a whole. The strong euro may give rise to concerns due to the export performance of the periphery countries and, through this, their economic growth.

The Bank of England also left interest rates unchanged, but decision-makers might soon begin to discuss the starting date of a potential tightening cycle, due to the decline in the unemployment rate below 7 per cent stated in the Bank of England's forward guidance and rapid rises in property prices.

In April, the Ukrainian central bank made an unscheduled interest rate increase, raising its benchmark lending rate by 300 basis points, and explained the move by the strong increase in inflationary pressures and prevention of further depreciation of the hrivnya. The Ukrainian currency depreciated by more than 50 per cent against the dollar in the period January to the middle of April, and then reversed sharply following the interest rate increase. The agreement concluded between the IMF Ukraine provides for the free floating of the exchange rate and the introduction of the inflation targeting regime within one year.

Long-term yields in developed countries continued to fall. The euro-area ten-year bond yield declined to a nearly one-year low. Although the negative sentiment had little impact on long-term yields in periphery countries, yields fell by 30–60 basis points. In addition, Ireland, Slovenia and Greece conducted successful bond issues, and managed to raise a higher amount of market funding than announced, at lower-than-expected yields. Yields on government securities in emerging countries of the CEE region also fell. Bond yields in the Czech Republic, Romania, Poland and Hungary shifted downwards by 15–30 basis points by the end of the period.

Chart 12: Ten-year bond yields in periphery countries

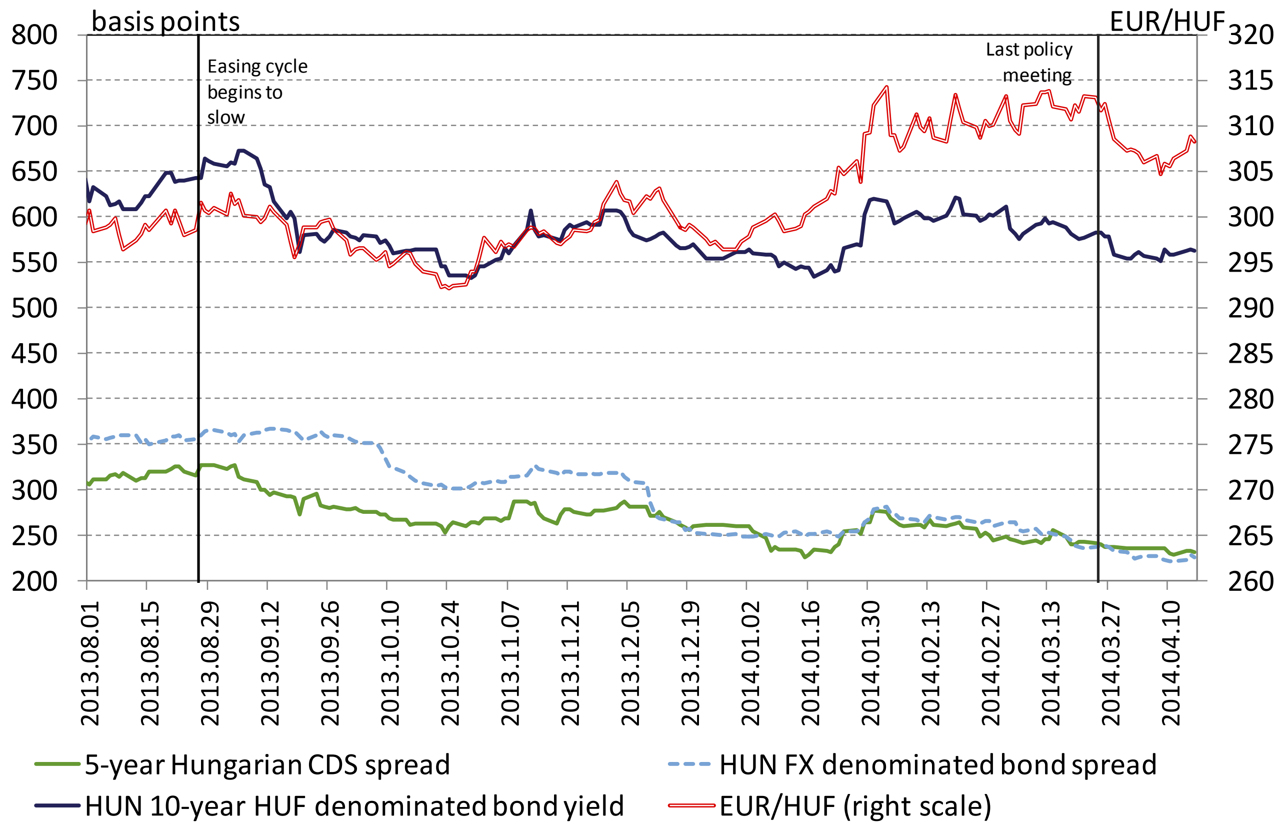


Developments in the domestic financial markets were mainly driven by international factors, but there have also been some important domestic events since the Monetary Council's interest rate decision in March. Looking forward, however, the basically favourable picture became somewhat more mixed due to the potential risks arising from the conflict between Ukraine and Russia, which might affect Hungarian asset prices more strongly than those of other countries of the region. Of the more important domestic events, the upward revision of the outlook for Hungary by S&P, some macroeconomic data releases and the parliamentary elections in April deserve special mention. Although the intensification of the conflict between Ukraine and Russia once again had a negative impact, the BUX index managed to rise by 5–6 per cent after declining by some 10 per cent in the period February–March.

Movements in the Hungarian foreign exchange market and the country's risk indicators suggest an improvement in the perceptions of the risks associated with the economy. The domestic five-year CDS spread fell slightly in the period, in line with movements in other regional countries, and spreads on euro and dollar-denominated bonds edged down by 10–25 basis points. The yield on the ten-year forint-denominated government bond had dropped by 25 basis points by the end of the period. The exchange rate of the forint against the euro fluctuated within a band of EUR/HUF 304.5–312.5, appreciating in the first part of the period, followed by a slight reversal at the end of the period.

Overall, the forint appreciated by 1 per cent against the euro during the period, outperforming other currencies of the CEE region. The skewness measure, indicating short-term exchange rate expectations, continued to fall.

Chart 13: Domestic risk indicators



Primary issues in the forint government securities market were met with strong demand, as the issuer was able to raise the quantities of both short and long-term securities on offer, and average yields fell. Over the period as a whole, short-term yields in the secondary market of forint government securities fell by 10–15 basis points and long-term yields by 20–30 basis points.

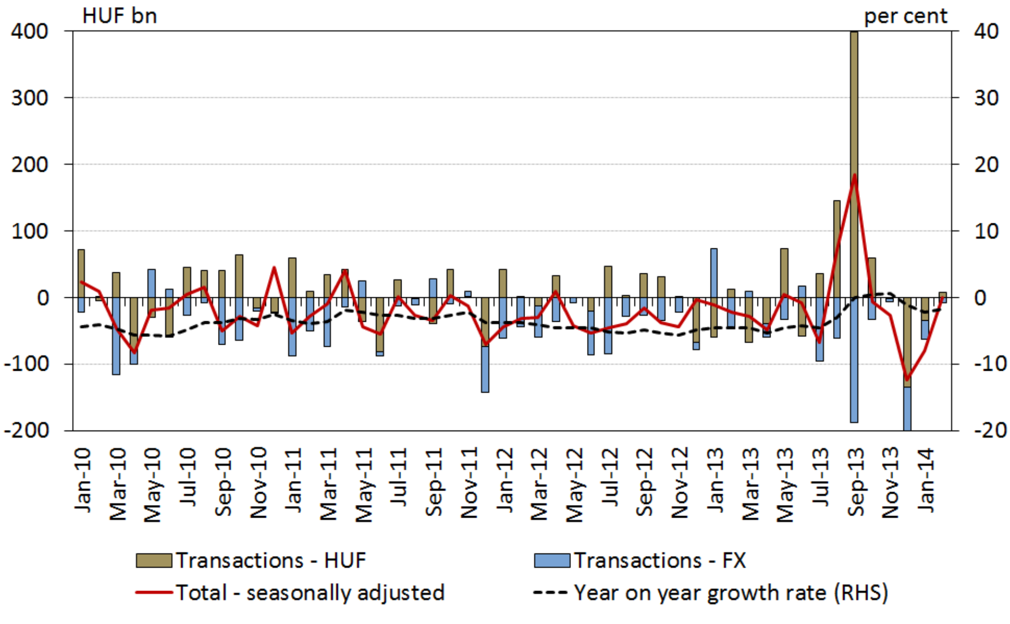
Position of the banking sector

In 2014 Q1, the profits of the domestic banking sector fell slightly relative to the same period a year earlier. The shock-absorbing capacity of the banking sector is adequate in terms of both liquidity and capital position. No disturbances were detected in the relevant financial markets.

Lending conditions

In February, the stock of net borrowing by the non-financial corporate sector was nearly equal to the amount of repayments, with the effect of transactions on the change in the stock of loans being nearly neutral. In seasonally adjusted terms, net borrowing amounted to HUF 7.4 billion. Consequently, the annual rate of growth increased relative to the previous month, from -2.2 per cent in January to -1.8 per cent in February. In February, the average interest rate on small-value loans was unchanged relative to January, while the average interest rate on large-value loans rose back to the levels last seen in November 2013.

Chart 14: Lending to the corporate sector



In February, net borrowing by the household sector from the banking sector continued to be negative. Transactions amounted to HUF -41.1 billion and to HUF -32.3 billion in seasonally adjusted terms. The fall in the stock of loans reflected a decline of HUF 38.6 billion in foreign currency loans and HUF 2.5 billion in forint loans. The annual rate of decline due to transactions was unchanged relative to the previous month, its value remaining 5.2 per cent. Average interest rates on new household mortgages and home-equity loans to the household sector continued to fall in February.

Chart 15: Lending to the household sector