Macroeconomic and financial market developments

June 2014

Background material

to the abridged minutes of the

Monetary Council meeting

24 June 2014

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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

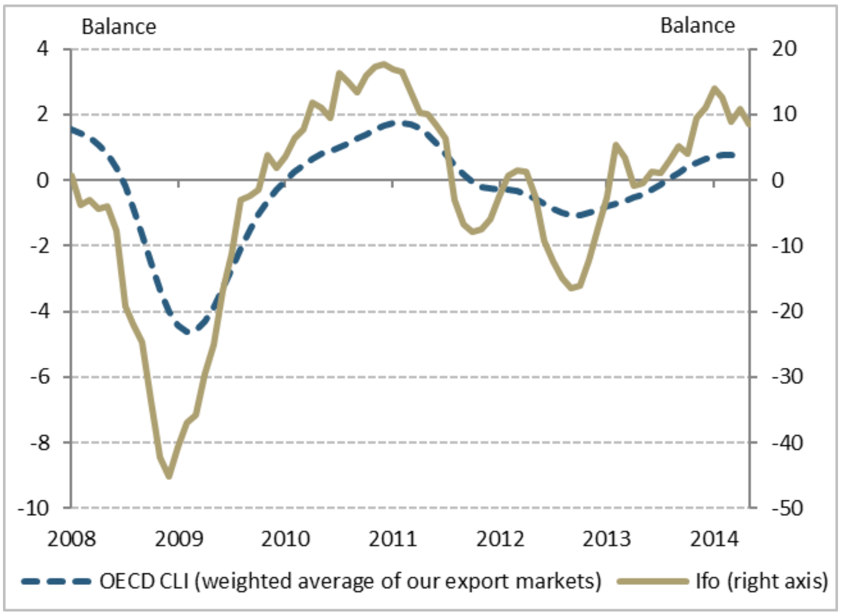
1. Macroeconomic developments

1.1. The global economy

Economic growth in Hungary's export markets is gradually picking up. In recent months the recovery of the euro area from recession has continued even if at a slow rate. Meanwhile, growth in emerging regions has slowed, and in particular the growth outlook of countries which were impacted by turbulence in the financial markets and political tensions has deteriorated. Inflationary pressures from the world market have remained weak in recent months.

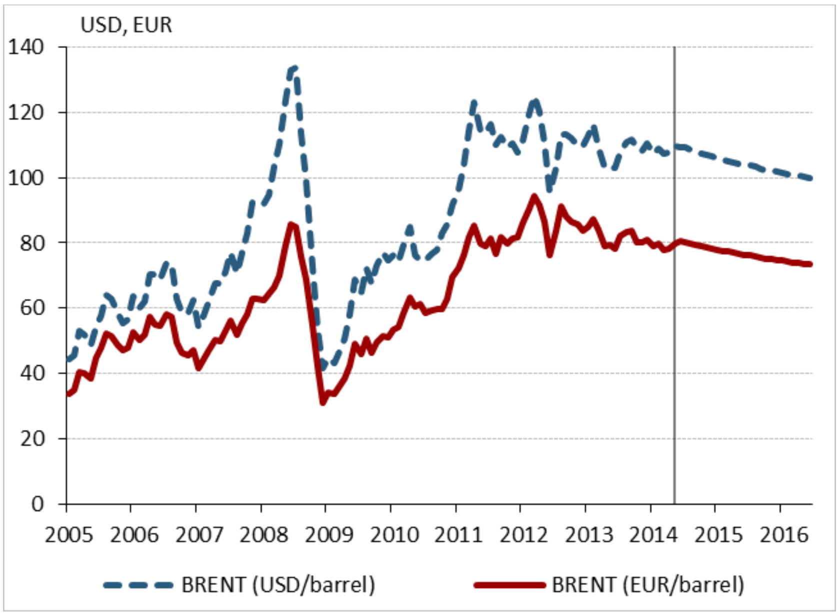
In the first quarter of 2014, global economic activity slowly continued to improve. The growth environment moved on different paths for the developed and emerging economies. Activity in emerging market economies which had previously shown rapid growth slowed down in the early months of 2014, in contrast to a broader group of advanced economies where signs of an upturn in economic activity became increasingly evident. The weak performance of the United States of America in the first quarter may have been connected to the extremely cold weather conditions (Chart 1).

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



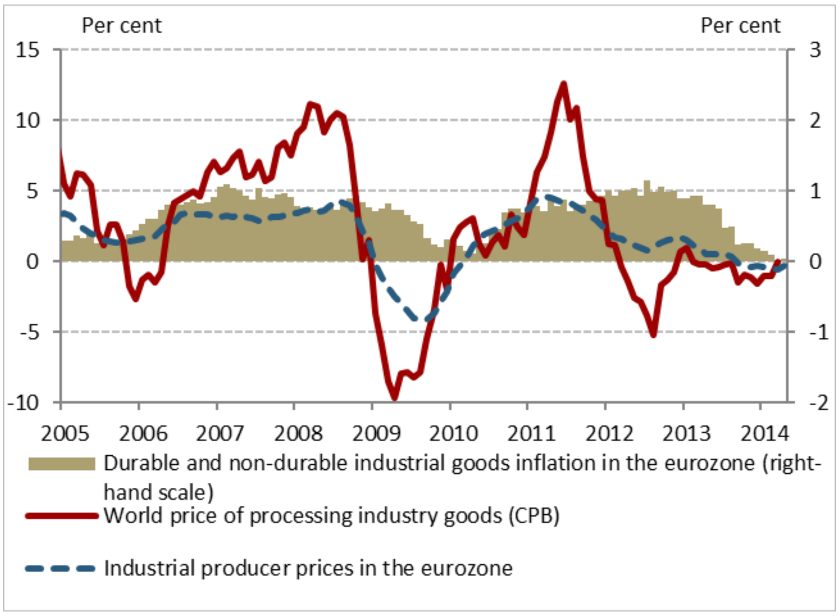
In the first quarter of 2014, the euro-area economy continued to expand at a moderate pace, with gross domestic product growing by 0.2 per cent relative to the previous quarter. Indicators of activity for May show a further expansion of growth, but the rise in forward-looking indicators halted. The industrial output of Germany, Hungary's most important trading partner, has stagnated in the aggregate in recent months, but the volume of new German industrial orders increased. The Ifo indicator, a measure of the output expectations of German industrial firms, has declined slightly in recent months, which might be partially attributable to the increasing uncertainty due to the conflict between Ukraine and Russia.

Chart 2: World market price of Brent oil



Inflationary pressures from the world market have remained subdued in recent months. Declining commodity prices, combined with a slowly growing global economy, exerted downward pressure on inflation, as a result of which inflation rates remained below the inflation targets in the world's major economies (the consumer price index continues to be low in the euro area). Favourable trends continued in the world market prices of the industrial commodities and unprocessed food. Changes in the world market prices of manufactured goods remained moderate. At the same time, as a result of the tensions in Iraq in the middle of June, the world market price of oil rose above USD 110.

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



1.2. Domestic real economic developments

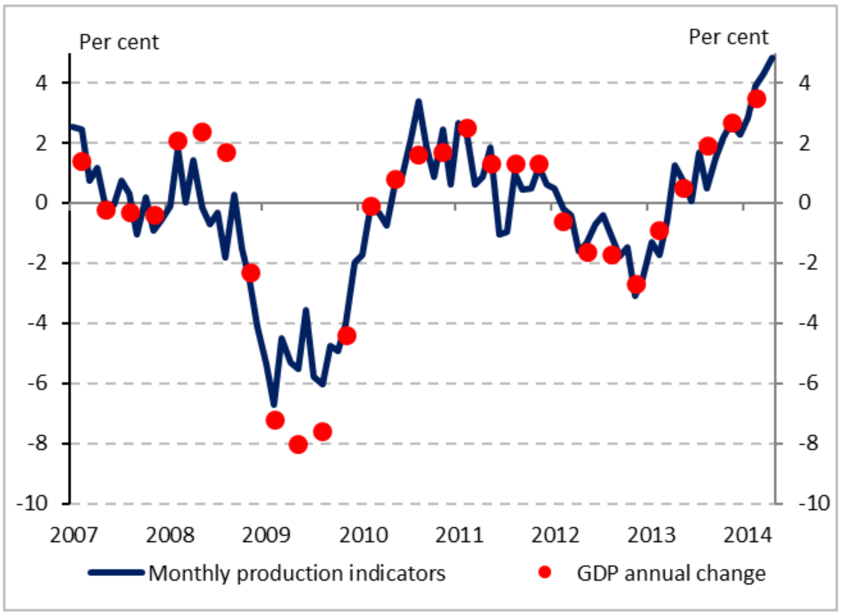
In early 2014, Hungarian economic growth picked up significantly. In the first quarter, output grew across a wide range of economic sectors; along with exports, domestic demand components also contributed to GDP growth. Based on the indices for April, vigorous growth may very well have been sustained during the second quarter. Furthermore, the whole-economy employment rate continued to rise, and unemployment fell below 8 per cent, which was attributable both to increasing labour demand of the private sector and the public labour programmes.

Economic growth

In the first quarter of 2014, the economy continued to grow. Based on the preliminary figures published by the CSO, **gross domestic product increased by 3.5 per cent year on year and by 1.1 per cent relative to the previous quarter.**

Based on the production indicators for April, vigorous growth may very well have been sustained during the second quarter. The performance of industry, construction and retail sales all expanded significantly year on year. Industrial production increased significantly compared to the previous month which may indicate improving underlying developments apart from the upturn in vehicle industry capacities. On the other hand, construction output decreased relative to the previous month.

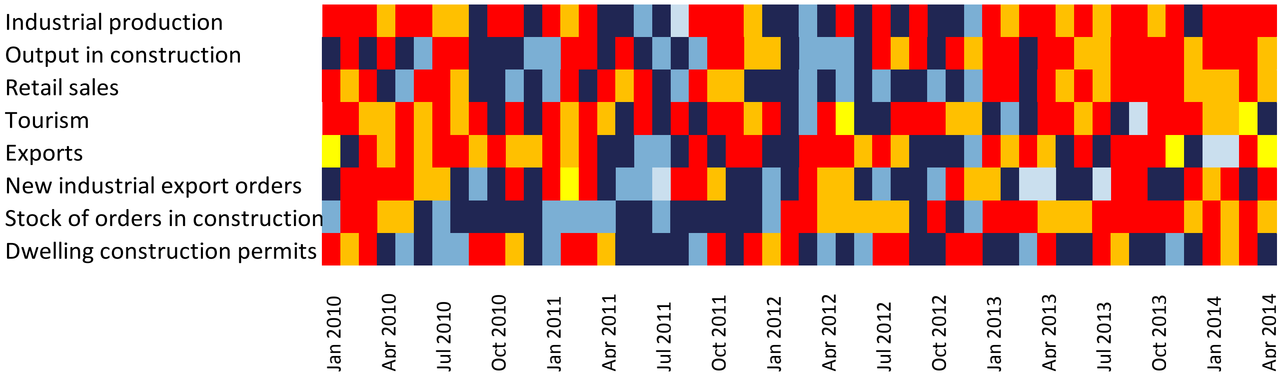
Chart 4: Monthly production indicators and development in GDP*



* Weighted average of monthly production indicators (industrial output, construction output and retail sales). The weights are derived from regression explaining GDP growth.

In line with our expectations, the growth of the economy was balanced, both exports and domestic demand have seen an upturn. The main driving force behind the increase of GDP in the first quarter was the investment activity but consumption and exports also continued to expand.

*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: red = grows above the five-year average, at an accelerating rate; orange = grows above the average, at a slowing rate; yellow = grows below the average, at an accelerating rate; light blue = grows below the average, at a slowing rate; blue = falls at a slowing rate; dark blue = falls at an accelerating rate.

Industrial production posted a year-on-year increase of 10.1 per cent and rose by 2.6 per cent in April compared to the previous month. Production increased across a wide range of manufacturing sectors. The changes in the stock of industrial orders point to a continued growth for the coming months. In March, there was a significant decrease in the output of the energy sector, due to the mild weather, which temporarily curbed the increase in industrial production. **Goods exports continued to rise, in line with developments in the industry.**

Construction output continued to rise in April (by 27.2 per cent year on year). The expansion of building-type investment is still primarily attributable to industrial investment by the corporate sector, while private sector investment remained subdued. Government investment activity mainly in infrastructure, financed from EU funding, continued to be robust. Based on the favourable data from the construction sector, **building construction may have risen significantly in the first half of 2014.**

The gradual increase in consumption demand continued in the beginning of this year. In the first quarter, the consumption expenditure of households rose by 1.5 per cent year on year. **In April, the volume of retail sales rose by 6.8 per cent year on year (or by 4.2 per cent net of the calendar effect).**[1] The significant rise in household real income, attributable to the historically

[1] In January 2014 the Central Statistical Office changed the method of monitoring the turnover of tobacco products. Instead of the representative sample-based assessment, it switched to the full data supplied by Nemzeti Dohánykereskedelmi Nonprofit Zrt. The figure published by CSO

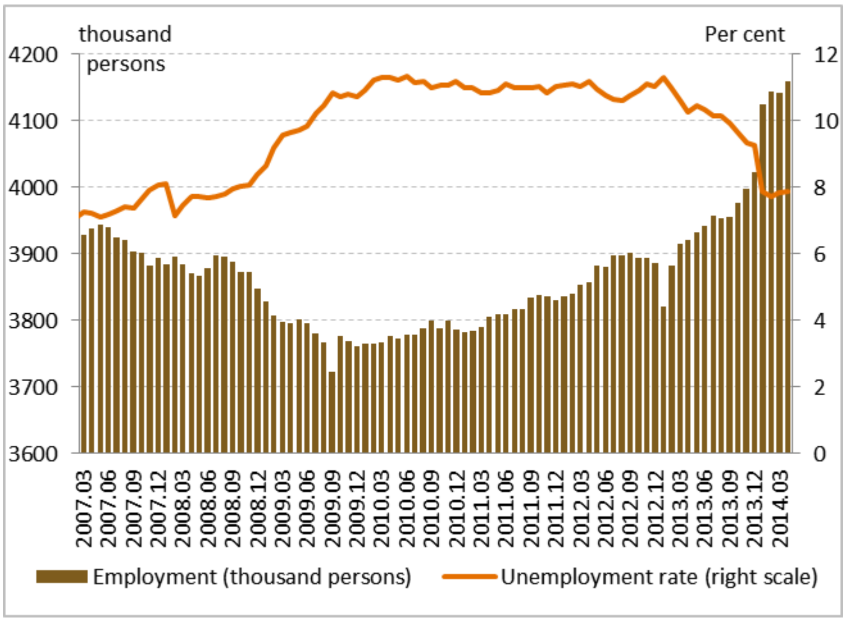
low inflation, and the improving situation on the labour market underpin the upturn in household consumption. However, the recovery is likely to be gradual, reflecting the still strong presence of precautionary savings and households' balance sheet adjustment.

The central projection of the June forecast projects continued economic growth with a balanced structure. The economy may expand by 2.9 per cent in 2014 and 2.5 per cent in 2015. We expect continuous growth on a quarterly basis, the slowdown of the annual dynamics is the result of the base effects. Upswing in external demand, intensive use of EU funds, loose monetary conditions, the improving situation on the labour market and the strengthening business and consumer confidence all underpin growth.

Employment

According to labour force survey data, **the number of employees in the national economy slightly rose in April relative to the previous month. The unemployment rate stood at 8 per cent.** The increase in employment in the first quarter may have primarily reflected the effect of public labour programmes during the winter, while employment in the private sector also rose significantly in the first quarter of 2014.

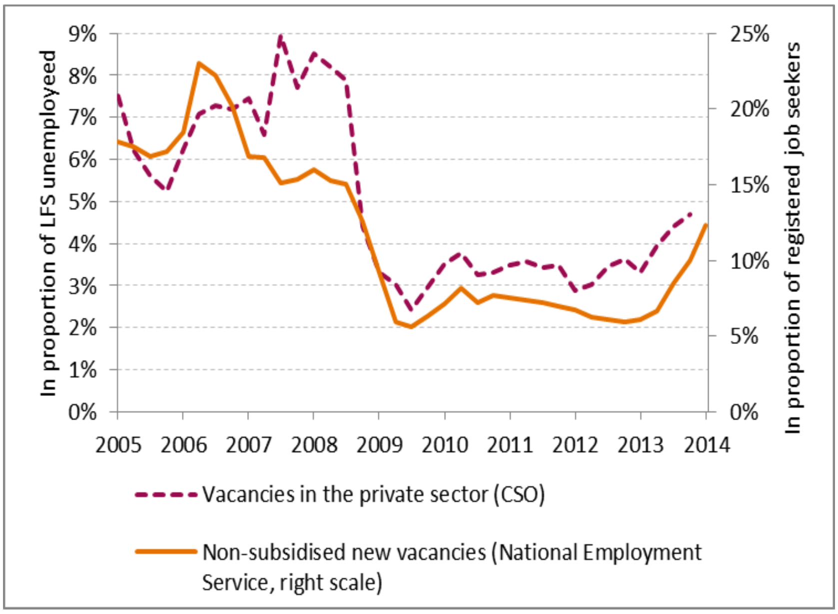
Chart 6: Numbers employed and the unemployment rate



contains the tobacco turnover under the old methodology until June 2013 and under the new methodology thereafter, which results in a structural break in the time series. For this reason, in our analysis we present the index by carrying on the old methodology.

The number of newly announced, non-subsidised jobs slightly fell in April, according to data released by the National Employment Service. On the other hand, the number of new jobs rose significantly in the past quarters, even compared to the number of jobseekers. Consequently, **the labour market may be less loose than before.**

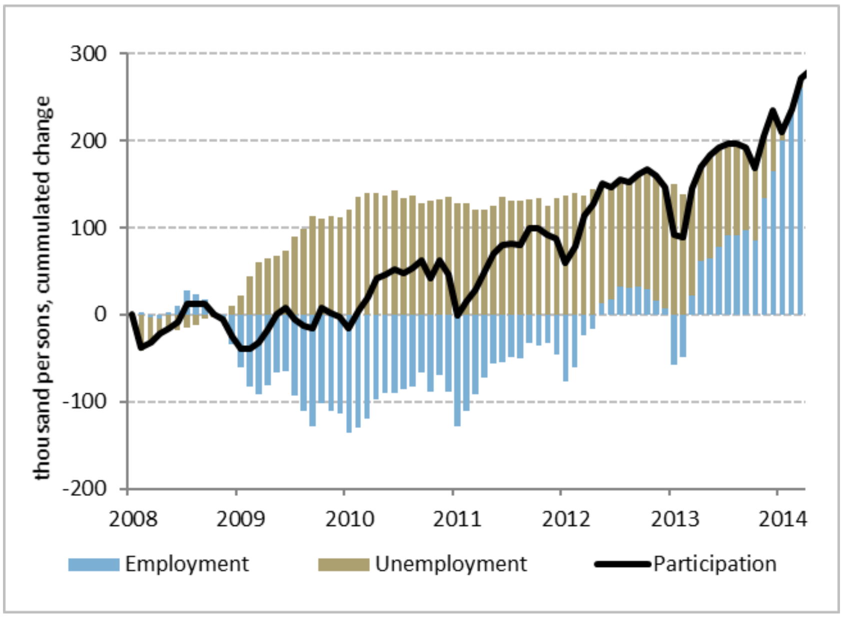
Chart 7: Indicators of labour market tightness



Source: CSO (Labour force survey) National Employment Service.

In the first quarter of 2014, the activity rate continued to rise. Activity increased in an environment of declining unemployment and rising employment, which reflects the inflow of inactive people into the labour market. According to labour force survey data, in March 2014 the activity rate stood at 58.9 per cent. Chart 8 shows that the number of those who have found jobs since 2008 on the labour market is roughly the same as of those who became active in that period, thus the rise in the activity rate was not felt in the growth of the unemployment rate.

Chart 8: Activity, employment and unemployment



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

1.3. Inflation and wages

In the first months of 2014, inflation was at a historic low. Favourable cost pressure and demand developments, moderate imported inflation and the adjustment of expectations all contributed to low inflation. At the beginning of 2014, the wage index of the private sector accelerated, then stabilised in April.

Wages

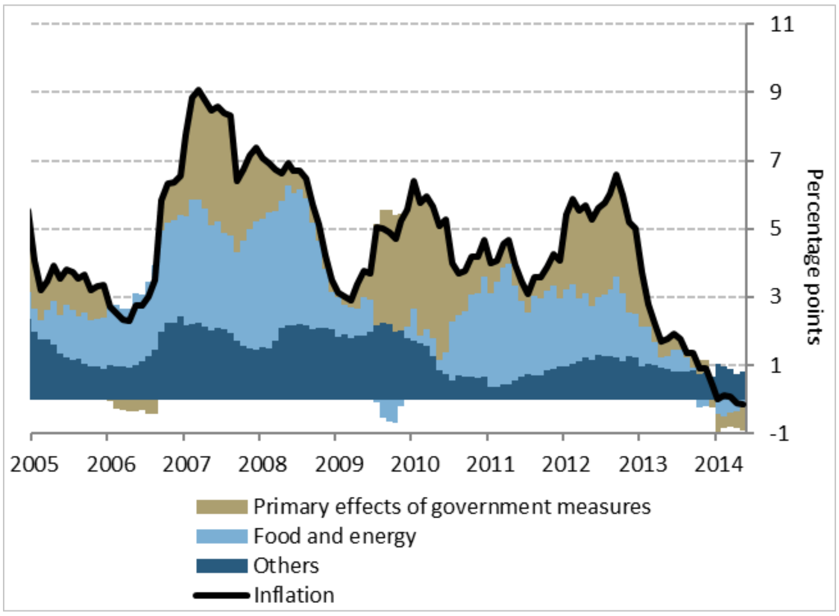
In the first quarter, in the private sector there was a higher wage growth relative to December 2013, on aggregate. In March, gross average earnings grew by 5.3 per cent in the private sector year on year. The payment of bonuses, which were due in December last year, was deferred to the beginning of 2014 in market services which may have contributed to the acceleration of wage growth. Regular wages rose by 3.9 per cent year on year. The growth rate of wages stabilised in April. **Compared to the years preceding the crisis, wage growth was subdued, while the unit labour costs of the private sector showed a moderate increase in the first quarter.**

Inflation developments

Inflation continued to decelerate at the beginning of the year and is still at its historic low. The consumer price index in May 2014 was -0.1 per cent, core inflation was 2.5 per cent and core

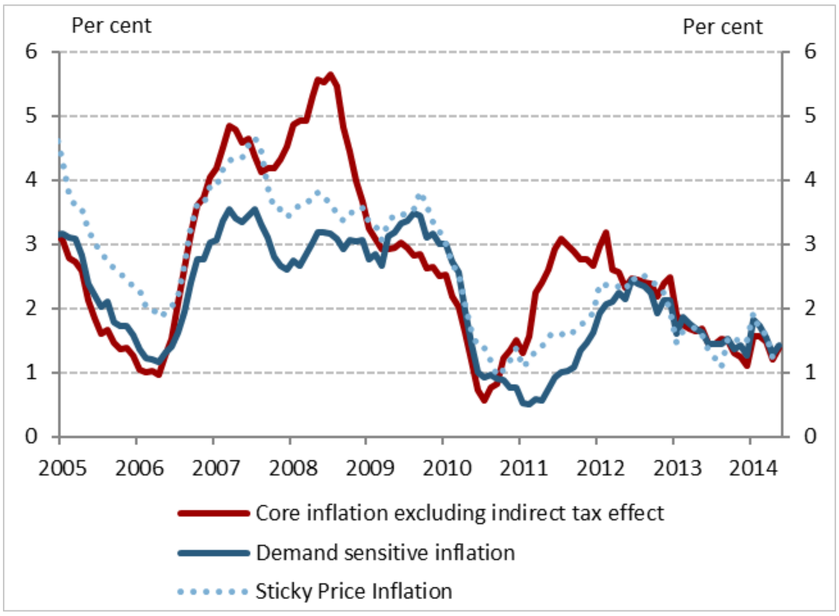
inflation excluding the effect of indirect taxes was 1.4 per cent. Inflation remained unchanged and core inflation increased by 0.2 percentage points compared to the previous month. The slight increase in core inflation was caused by the marginally rising inflation of several product groups. However, at the level of overall inflation, the rise in core inflation and the price index of fuels was offset by the decrease in household gas prices in April which was reflected in consumer prices.

Chart 9: Decomposition of the consumer price index



Favourable cost pressure and demand developments, the gradual adjustment of expectations and low imported inflation have likely all contributed to the moderate underlying inflation recorded in recent months. Agricultural producer prices fell by 8.9 per cent in annual terms in April 2014, and the domestic sales prices of the sectors producing consumer goods rose by 1 per cent year on year in April 2014. Fuel prices slightly rose in May in annual terms, but in monthly terms they moderately fell. In addition to the current market developments, the base effect also contributed to the rise in the annual inflation of fuels. According to retail sales data, consumption demand may have picked up gradually in recent months, in parallel with the increase in real wages calculated on an annual basis. Despite this, the level of the retail sales volume is still significantly lower than that observed in the years preceding the crisis, thus altogether the domestic demand environment is likely to have a continued disinflationary impact, though to a gradually decreasing extent.

Chart 10: Measures of underlying inflation (per cent)



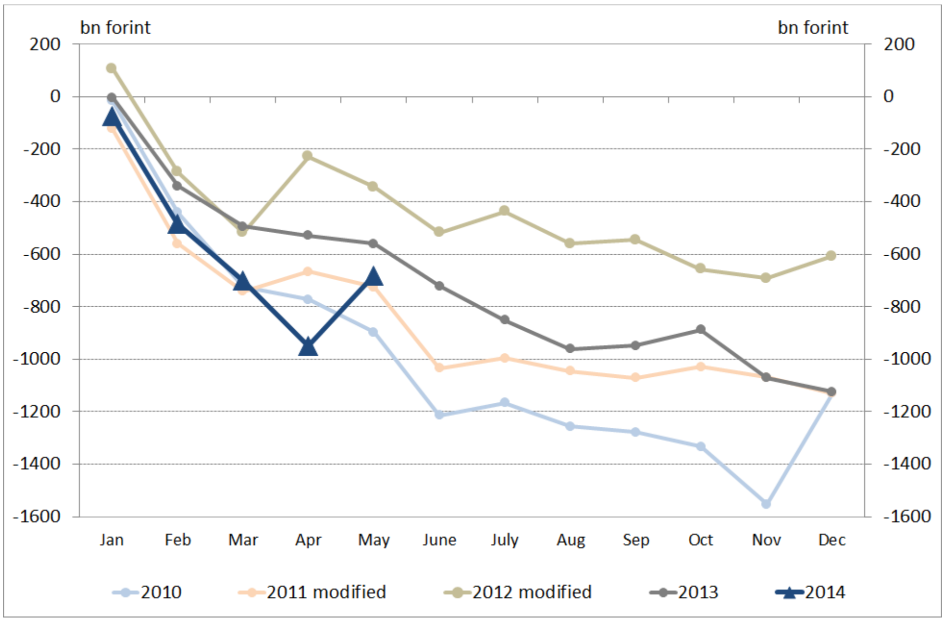
Based on the baseline scenario of the June projection, **inflation may remain below the path of the March *Inflation Report*. In the short term, inflation may remain around 0 per cent**, then from the end of the year, the inflation rate may increase as the effect of the regulated energy price cuts performed last autumn will phase out. Subsequently, inflation may be around the 3 per cent target in the second half of the forecast horizon. **The underlying inflation may increase on the forecast horizon parallel to a gradual recovery in demand.**

1.4. Fiscal developments

In May, the general government budget had a surplus of HUF 269 billion, which is by HUF 300 billion higher than a year ago. In revenues, the discrepancy is explained by the effects of the interim measures of last year (introduction of the electronic toll, increase of the financial transaction tax) that were felt this year already as well as the receipt of some of the formerly missed EU revenues, while in expenditures, by the payments brought forward to April due to the 4-day weekend around May 1. In addition, in terms of revenues, tax revenues related to consumption (VAT, excise duty) and wages (PIT, social contribution tax and contributions) changed favourably.

The balance cumulated since the beginning of the year improved significantly as a result of the above compared to April, thus the government budget deficit fell to HUF 682 for January-May, which is slightly higher than the figure for last year but overall it can be considered as average compared to the relevant periodical values of former years (Chart 11).

Chart 11: Within-year cumulated balance of the government budget

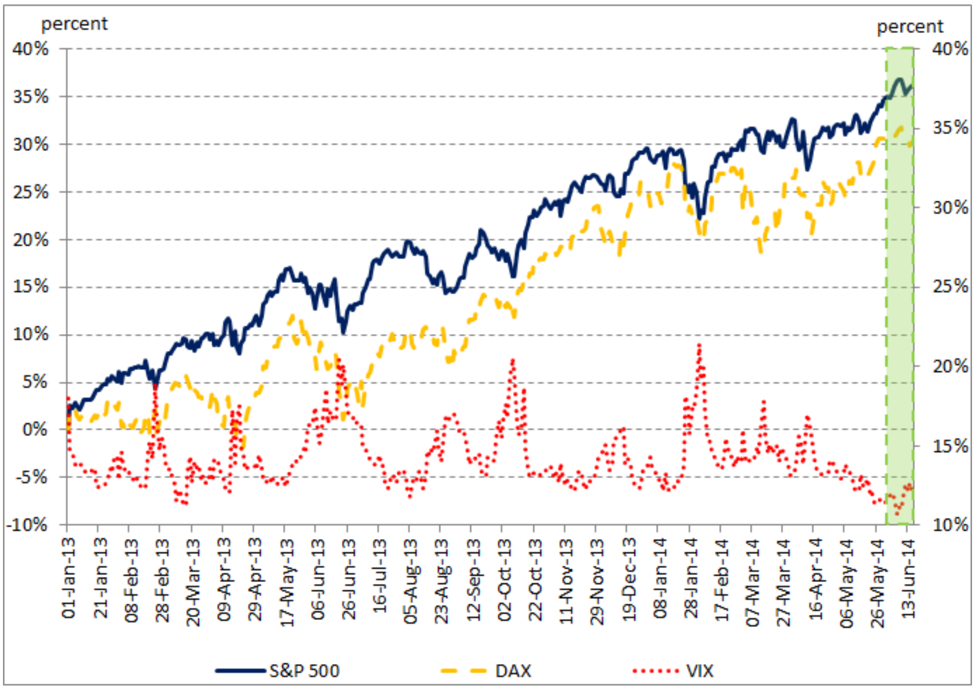


2. Financial market developments

2.1. International money markets

As a whole, global market sentiment developed favourably in the last month. Stock market indices in the main developed countries continued to rise in the first half of the month, taking many of them to new historic highs once again. The reversal that started in the second half of the period proved to be temporary and after the decision of the Federal Reserve made in June, positive sentiments inspired the market movements again. Risk indicators decreased to a several-year low, when the VIX index that measures stock exchange volatility and the emerging market bond index (EMBI) fell below the levels observed upon the previous interest rate decision, which implied the further strengthening of market risk appetite. The American 10-year benchmark yield rose by 10 basis points, while German long-term yields are again around the levels seen at the end of May after the decrease that can be connected to the announcement of the ECB package of policy measures. The euro depreciated against most currencies during the month, its exchange rate against the US dollar fluctuated below 1.36 in the first half of the period, and the ECB's decision on the easing of the monetary stance may have played a significant role in it.

Chart 12: Developed market equity indices and the VIX index



The central banks of the developed countries maintained their accommodative monetary policy stance throughout the month. Markets still expect the Fed to continue the gradual tapering of the quantitative easing program at a monthly level, while the market consensus is that these can be closed in 2014 Q4. As expected, at its meeting held in June, the Fed decreased its quantitative easing program by USD 10 billion to USD 35 billion per month and indicated that nothing justifies not to phase out the program as planned which means that the quantitative easing may end in October 2014. They also changed the macroeconomic path according to the expectations: although as a result of the weak first quarter, they deteriorated the GDP prediction for 2014, the situation on the labour market may become more favourable than expected. The Chair of the Fed indicated that the supportive monetary policy has to be maintained in order to achieve the goals of the central bank. The market reaction after the meeting of the Federal Reserve in June was positive, thus market sentiment was characterised again by a stronger risk appetite. During the period, the Fed disclosed its Beige Book which revealed that gradual economic growth continues. The report points out that the situation on the labour market improved significantly in the United States, the pressure from wages is still moderate, household consumption continued to expand, while tourism and manufacturing both show the signs of recovery. However, the trends on the housing market, where home sales were characterised by muted dynamics, are less favourable.

The Japanese and the British central banks did not change their monetary conditions at their rate-setting meetings in June, but economists' expectations regarding an interest rate increase are all the more rising in the United Kingdom and the market considers it ever more likely that out of the large central banks, the British may be the first that will start the normalisation of the accommodative monetary stance by increasing the policy rate. Based on the latest analyst survey prepared by Bloomberg, the analyst median expectations regarding the interest rate increase by the British central bank shifted from 2015 Q2 to 2015 Q1.

The market developments for this month were greatly influenced by the strengthening market expectations related to the easing of the monetary stance by ECB, while later, at its rate-setting meeting held in June, the ECB made decisions on the introduction of a series of measures aiming at the easing of the monetary conditions. It was announced that the policy rate will be decreased to 0.15 per cent, while the deposit rate will be mitigated from zero per cent to -0.1 per cent and a comprehensive package of liquidity measures was also described. In addition, the president of the ECB indicated that, if necessary, the monetary stance may be eased further in the future. The decision on the monetary stimulus and its tools basically fulfilled preliminary market expectations, thus they did not cause any surprises on the markets. Accordingly, market reactions following the decision remained moderate which may be due to the fact that the impacts of the potential easing of the monetary stance were already priced on the market. On the other hand, the ECB's decision on the periphery of the euro area, where the CDS spreads of the peripheral countries and their long-term yields on the market of government papers fell by 20-30 basis points compared to the value prior to the decision, triggered significant reactions, while in the case of Greece, an even stronger impact was felt.

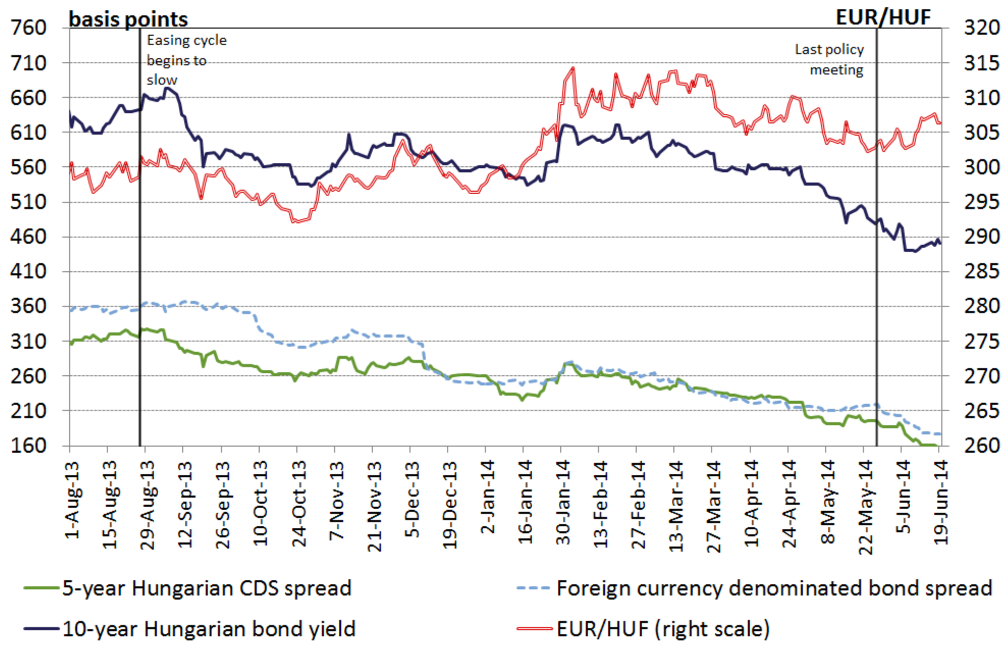
The globally favourable sentiment was strengthened by the monetary policy of the central banks of the developed countries throughout the month but the strengthening of global risk factors and the appearance of new ones worsened this mood in the second half of the period. While in the first half of the period, despite the continued armed conflict, the negative impact that the Russian-Ukrainian situation made on the market was slightly smaller than before, the developments in the middle of June regarding the Ukrainian gas supply and the further deterioration of the conflict were more strongly felt and worsened European investor sentiments. The conflict in Iraq arose as another risk factor and the World Bank's growth prediction that was more pessimistic than the one in January also contributed to the worsening of sentiments, but after the meeting of the Federal Reserve in June, the global risk appetite strengthened again.

Emerging markets showed a mixed picture during the month but overall we cannot talk about a general deterioration. Equity indices rose, yields fell in the majority of the countries, but exchange rates changed differently. The currencies of the "fragile five" group, considered more risky, depreciated by 2-3 per cent during the month, except for the Brazilian real, while the exchange rate of the Russian ruble and the Ukrainian hryvnia did not show any substantial changes by the end of the period.

2.2. Developments in domestic financial market indices

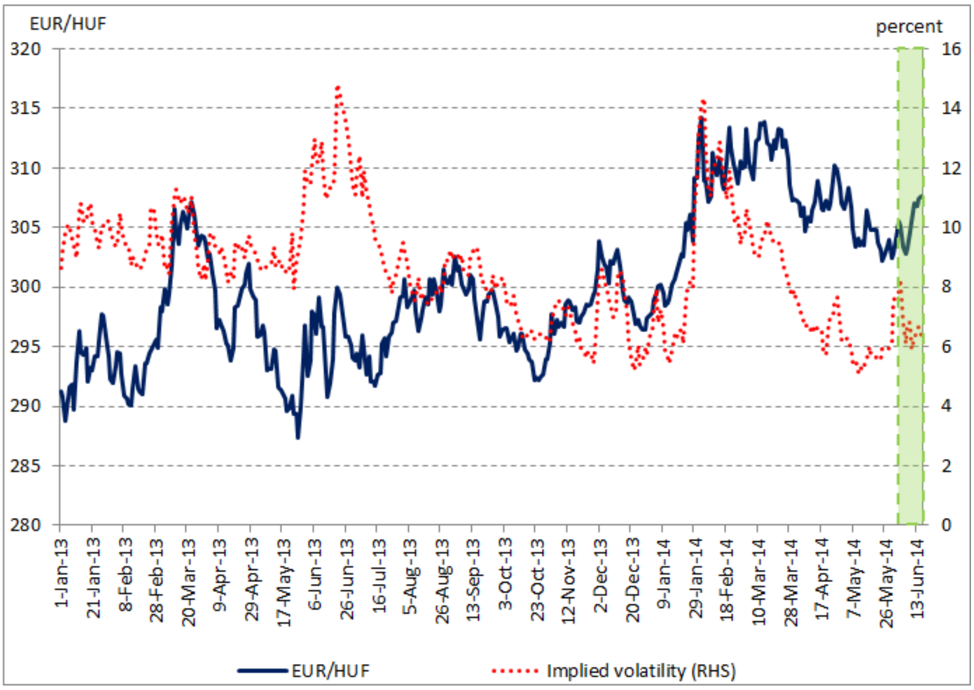
Domestic financial market developments were strongly influenced by the international events, thus the indices of the Hungarian financial market have developed in line with the improving global risk appetite. The trading band of the HUF/EUR exchange rate fluctuated between 302.2 and 307.8 during the month. The forint exchange rate fluctuated around the stronger levels in the first half of the month, but it started to weaken in the second half (Chart 13).

Chart 13: Domestic risk indicators



With its 0.5 per cent depreciation against the euro, the forint underperformed among the exchange rates of the narrower region, while in the broader context of emerging markets, it was in the middle. In parallel with the depreciation, the implied volatility of the forint exchange rate rose significantly from its low in the previous month, but later, following some corrections, it stabilised, while in the period under review, the skewness measure remained below the level observed in May. In addition to the worsening international sentiment, the low value of the inflation figure for May, the decision of the Supreme Court (Curia) on individual foreign currency loan contracts and the government's declaration regarding the saving of those with foreign currency loans may have had a weakening impact on the Hungarian currency, while the ECB's interest rate decision and strong measures might have temporarily strengthened the forint.

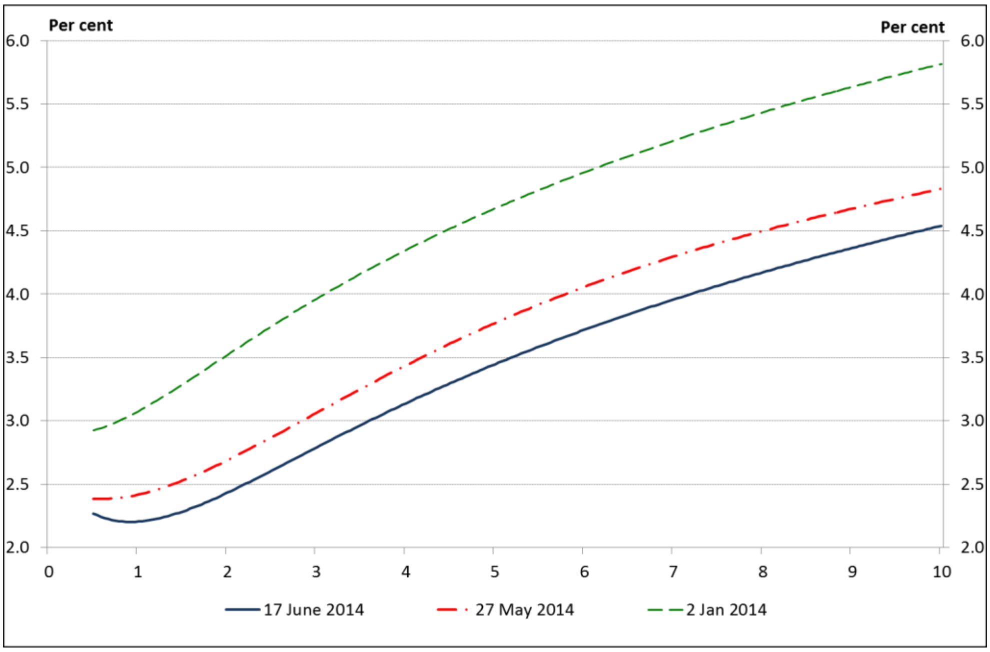
Chart 14: EUR/HUF exchange rate and its implied volatility



The domestic CDS spread has further decreased since the previous interest rate decision, and after a more than 30-basis point monthly decline, it fell below 160 basis points. The decrease of regional CDS spreads implies the presence of international premium decreasing impacts; country-specific components contributed to the improvement of the risk assessment of Hungary to a smaller extent.

The government bond market yield curve shifted lower during the month. However, the various sections of the curve developed differently: the short-term yield level shifted downward by less than 10 basis points, while long-term yields fell by 30-35 basis points. As a result, **there was a substantial decrease in the steepness of the yield curve.** Five-year benchmark yields decreased below 3.5 per cent and ten-year benchmark yields fell close to 4.5 per cent, which is another historic low. The decrease in long-term yields was observed in the region also, but the domestic decrease stood out even within the region. The supportive external environment, then the ECB's easing of the monetary stance could contribute to the decrease in yields, while on the domestic side, increased demand for government papers and the low inflation environment may have also helped it.

Chart 15: Shift in the spot government bond yield curve



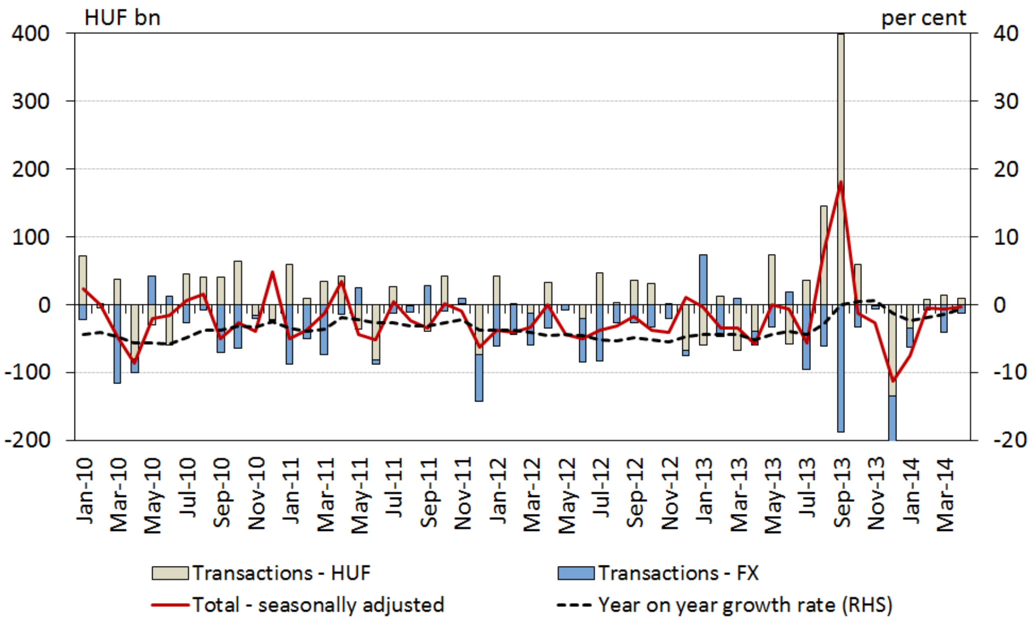
During the month, the government bond auctions took place besides high interest and with declining average yields. In most cases, ÁKK raised forint funds from the market substantially above the announced volume during the auctions held in June. The bond auction held in the middle of June represented an exception, where the issuer accepted less offers than planned besides a coverage ratio slightly exceeding one.

The consumer price index of -0.1 per cent, which was published for May during the period, met the market expectations. Several analyses emphasised that the subdued inflationary environment in both the euro area and Hungary and the measures of the ECB taken in June all support the continuation of the easing cycle pursued by the MNB. The analysts' reactions imply that they do not see any risk of deflation even despite the data.

3. Trends in Lending

In April, the volume of outstanding corporate borrowing within the total credit institution sector shrank slightly, by HUF 4 billion as the balance between disbursements and repayments. The downturn is the result of the rise of 9 billion in forint loans and the decrease of 13 billion in foreign currency loans, so the decline in the foreign currency loans of corporations seen since the crisis continued. The transaction-based annual rate of decline of outstanding corporate borrowings improved significantly, its value changed from 1.3 per cent in March to 0.5 per cent. In April, the average interest rate on small-value forint loans further decreased, while the average interest rate of high-value forint loans returned to the former declining trend after the temporary increase seen in March.

Chart 16: Net borrowings of non-financial corporations



In April, households were again net loan repayers against the total credit institution sector i.e. repayments exceeded disbursements. The value of the transaction-based decrease totalled HUF 55 billion which was the sum of the decline of 17 billion in forint loans and nearly 38 billion in foreign currency loans. The annual rate of decline fell from 5 per cent to 5.4 per cent. Compared to the previous months, a larger downturn was mainly realised on overdraft facilities whose value fell by nearly HUF 25 billion. The fact that salary payments, which were shifted to the end of April due to the long weekend, triggered automatic overdraft facility repayments also contributed to this. The average interest rate on newly disbursed household housing loans continued to fall in April, while it essentially remained the same in the case of home equity loans.

Chart 17: Net borrowings of households