Macroeconomic and financial market developments

May 2014

Background material
to the abridged minutes of the
Monetary Council meeting
27 May 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

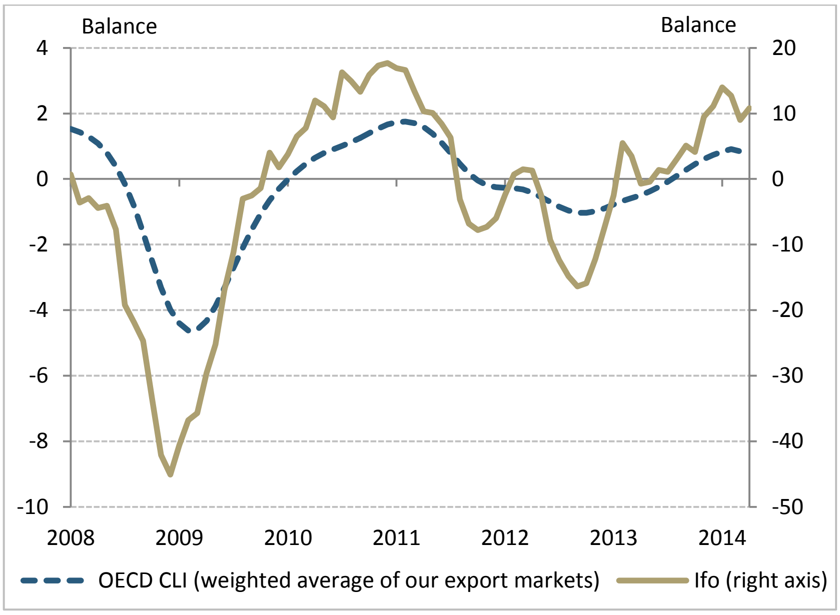
1. Macroeconomic developments

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. 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 advanced economies where signs of an upturn in economic activity became increasingly evident. Based on the latest activity indicators, these divergent trends may continue for the rest of 2014 (Chart 1).

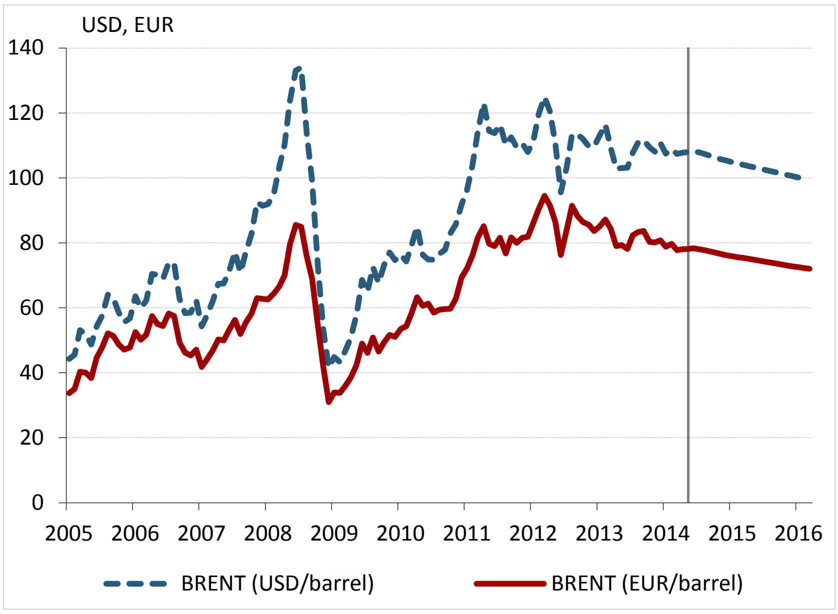
Chart 1: Indicators of activity in Hungary's export markets



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 April show a further expansion of growth, but the rise in forward-looking indicators halted due to mounting risks. The output of Germany, Hungary's most important trading partner, and the volume of orders from German industry fell slightly in March.

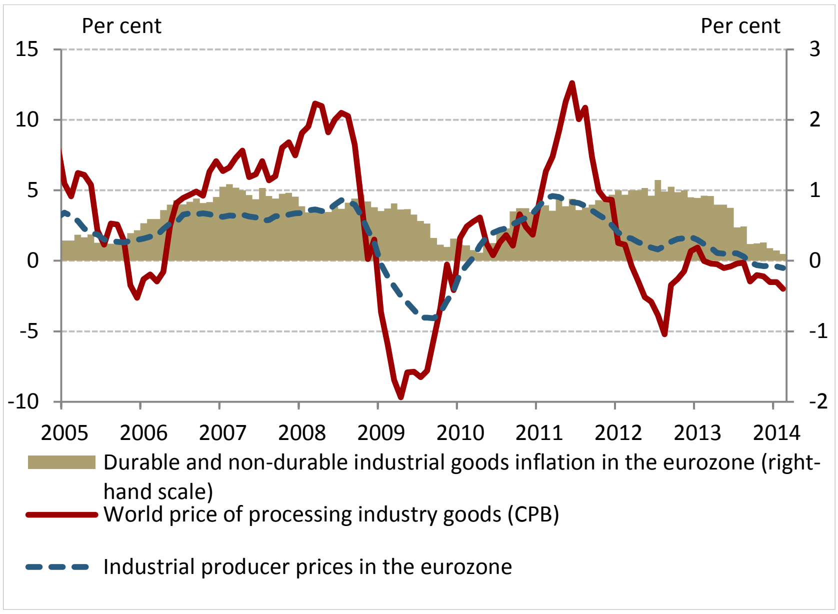
The Ifo Business Climate Index, a measure of the expectations of German industrial firms, has declined slightly in recent months, which might be partially attributable to the increasing uncertainty due to the conflict between Ukraine and Russia.

Chart 2: World market price of Brent oil



Inflationary pressures from the world market have remained subdued in recent months. Declining commodity prices (Chart 2), 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. In line with this, the increase in the consumer price index was low in the euro area as well. 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 (Chart 3).

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 developments

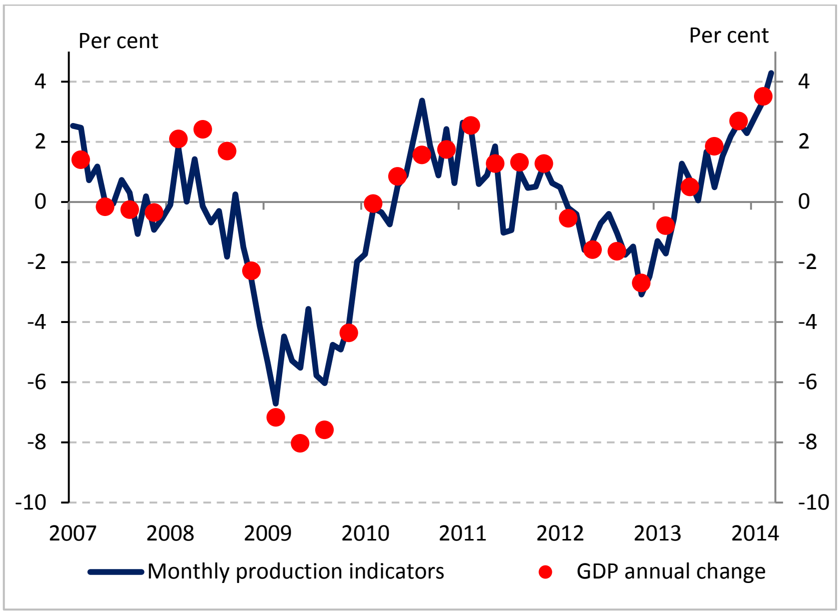
In early 2014, Hungarian economic growth picked up significantly. In the first quarter, output grew across a wide range of economic sectors; along with exports, domestic demand components may have also contributed to GDP growth. Furthermore, the whole-economy employment rate continued to rise, and unemployment fell below 8 per cent, which was attributable both to increasing labour demand of the private sector and the public labour programmes. In the early months of 2014, the labour market became tighter and the number of jobs per jobseeker increased.

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.** The GDP figures exceeded analysts' expectations and the projection in the MNB's March *Inflation Report*.

Based on the production indicators for February and March, the economy continued to accelerate at the beginning of this year, which was primarily attributable to robust growth in government investment activity, an upturn in vehicle industry output and the gradual expansion in household consumption (Chart 4).

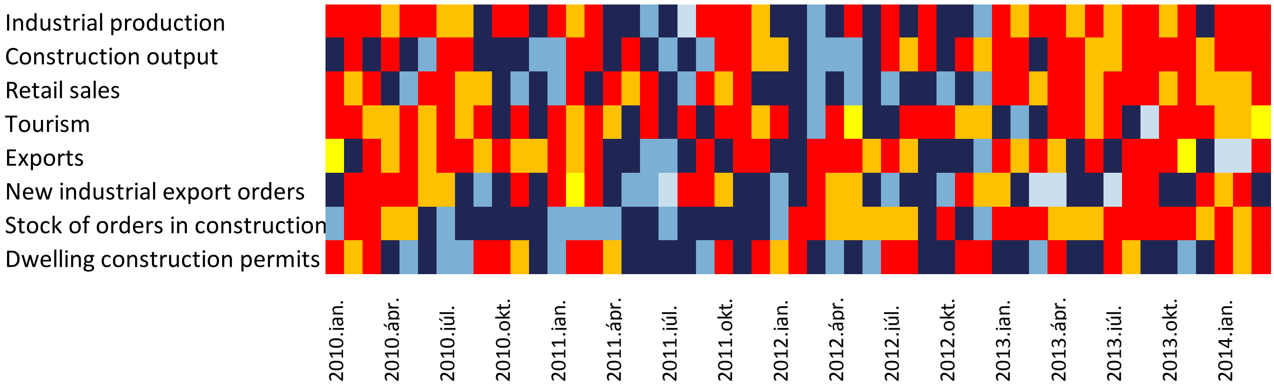
Chart 4: Monthly production indicators and annual change in GDP*



* 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.

In the quarters ahead, further gradual economic expansion is expected in a more balanced structure than before, with greater emphasis on the strengthening of domestic demand. In March, the output of both the export sector and sectors producing for the domestic market developed favourably. The growth heat map (Chart 5) summarises the development of certain domestic sectors' performance.

*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 posted a year-on-year increase of 10.6 per cent and rose by 0.5 per cent relative to the previous month. Production increased across a wide range of manufacturing sectors in February this year. Similarly to last year, the performance of the vehicle industry accounted for most of the expansion early in the year. The favourable demand environment points to similar performance for the coming months as well, which is also reflected in the stock of industrial orders. In March, there was a significant decrease in the output of the energy sector, similarly to the previous month, 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**, driven mainly by vehicle industry exports.

Construction output continued to rise in March (by 34.2 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. Although the mild weather in March may have also have contributed to the favourable production data, the sharp increase in industrial orders suggests vigorous growth in production in the coming months as well. Based on the favourable data from the construction sector, **building construction may have risen significantly in early 2014 as well.**

The gradual increase in consumption demand may have continued in the beginning of this year. In March, the volume of retail sales rose considerably, increasing by 5.8 per cent year on year. The expansion compared to the previous month was 0.8 per cent.[1] The significant rise in household real income, attributable to the historically low inflation, underpins 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. Nevertheless, based on the retail trade figures, consumption this year may grow faster than projected in the March projection.

Employment

According to labour force survey data, **the number of employees in the national economy did not change in March relative to the previous month. The unemployment rate stood at 8.4 per cent (7.8 per cent when seasonally adjusted).** The increase in employment in the first quarter may have primarily reflected the effect of public labour programmes during the winter. On the other hand, based on the preliminary figures, employment in the private sector also increased in the first quarter of 2014, with contributions from the manufacturing sector and market services as well (Chart 6).

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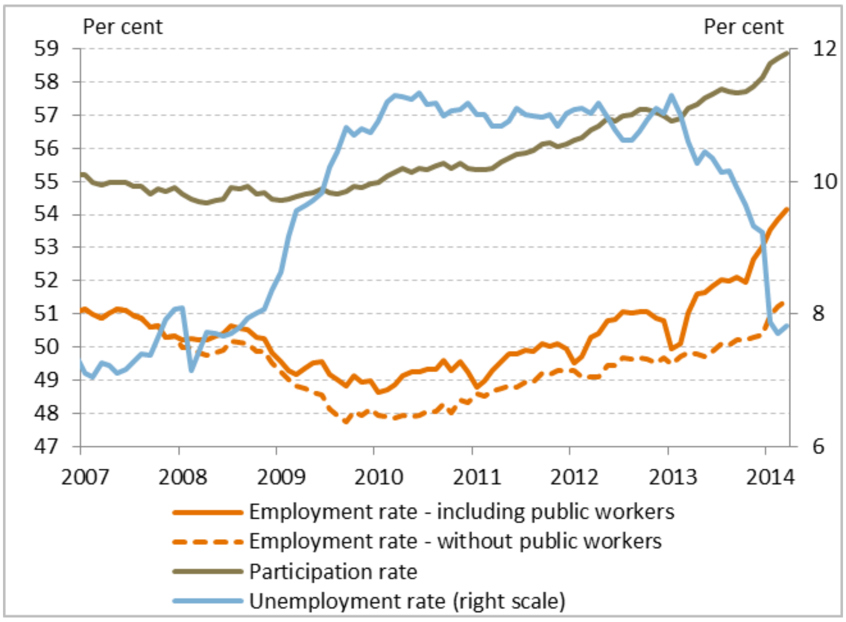
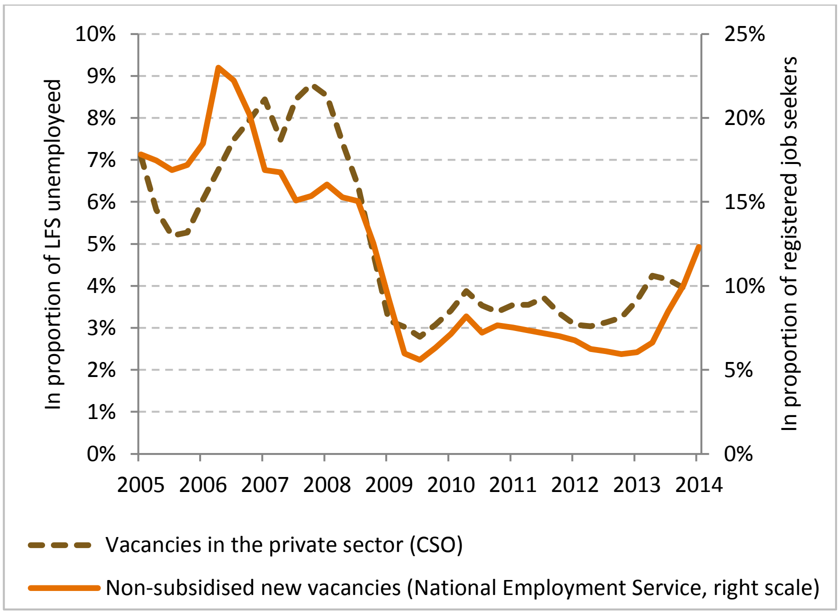
[1] In January 2014 the Central Statistical Office changed the method of monitoring the turnover of tobacco products. Instead of the representative sample-based assessment, it switched to the full data supplied by Nemzeti Dohánykereskedelmi Nonprofit Zrt. The figure published by CSO contains the tobacco 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. CSO published year-on-year growth of 8.3 per cent, calculated under the new methodology.

Chart 6: Activity, employment and the unemployment rate



According to data released by the National Employment Service, the number of newly announced, non-subsidised jobs continued to increase in the first quarter, reflecting a **gradual improvement in corporate demand for labour.** In parallel with this, the number of new jobs per jobseeker continued to increase further (Chart 7), i.e. **the labour market may be less loose than before.**

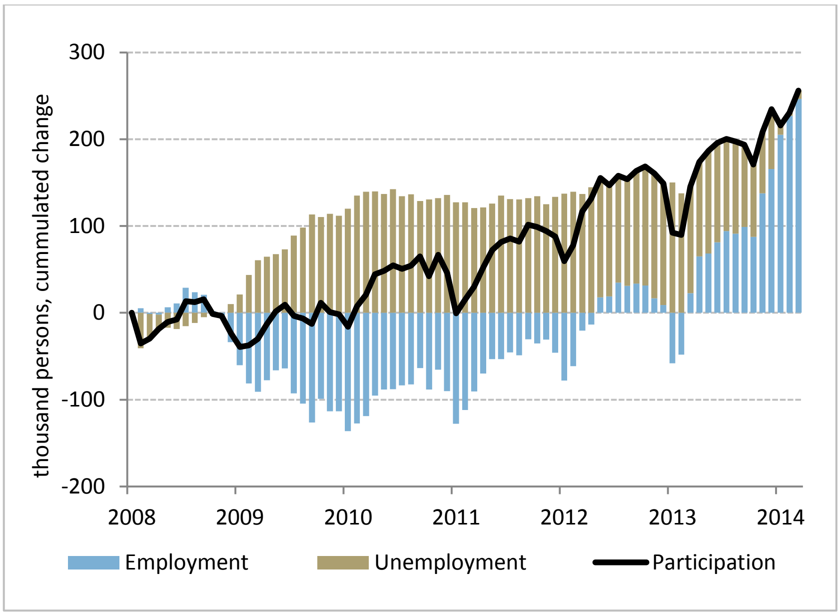
Chart 7: Indicators of labour market tightness



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 employees into the labour market. According to labour force survey data, in March 2014 the activity rate stood at 58.9 per cent (Chart 8).

Chart 8: Cumulated change in activity, employment and unemployment since 2008



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

1.3. Inflation and wages

In early 2014, inflation was at a historic low. Favourable expenditure 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; however, only wage data from March may provide reliable information on the underlying developments in wages.

Wages

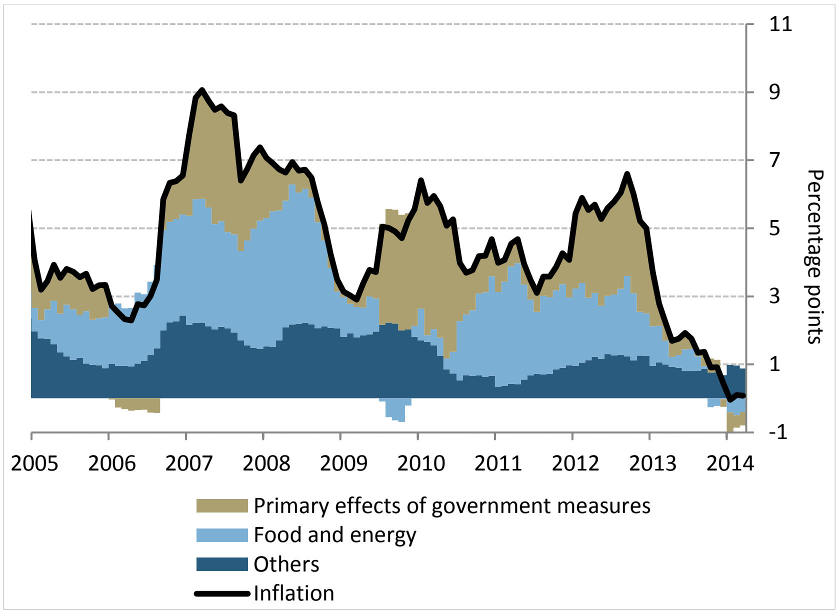
Private sector wage growth was moderate in 2013 as a whole, with gross average earnings rising by 3.6 per cent. In January-February 2014, in the private sector there was a higher wage growth relative to December 2013, on aggregate. In February 2014, the gross average wage of full-time employees increased by 5.2 per cent year on year. 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.

In March 2014, whole-economy gross average earnings grew by 2.8 per cent, by 5.3 per cent in the private sector and by 0.1 per cent year on year in general government (including the public labour programme). **The wage figures reported for March are higher than the projection in the *Inflation Report* published in March. The accelerating wage index was a general phenomenon in certain sectors.** Compared to previous months, wage growth accelerated in market services, both in terms of regular and gross average wages. In this sector, higher bonus payments were made in March relative to previous years. In the manufacturing sector, wages increased at the same rate as in the previous month. All of this reinforces the view related to the **tightening labour market.**

Inflation developments

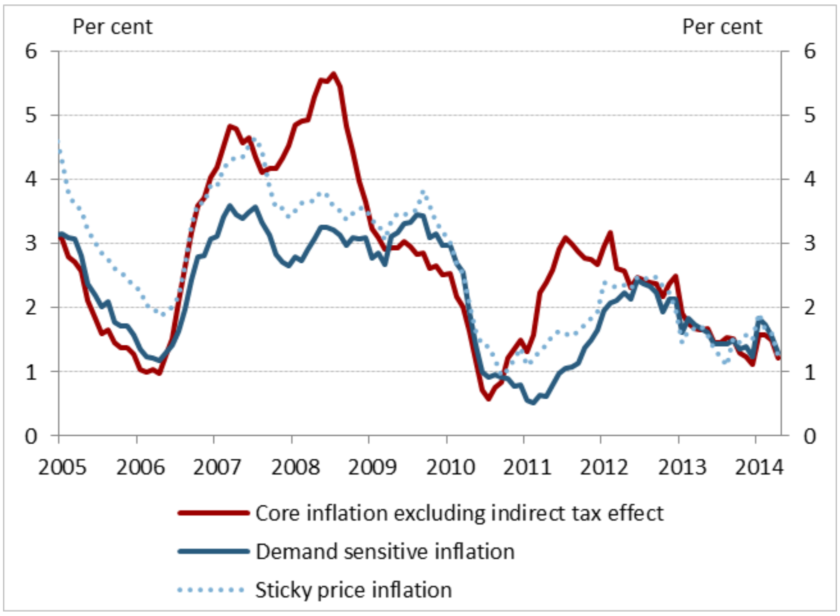
Inflation continued to decelerate at the beginning of the year and is still at its historic low, well below the 3 per cent target. The consumer price index in April 2014 was -0.1 per cent, core inflation was 2.3 per cent and core inflation excluding the effect of indirect taxes was 1.2 per cent. Compared to the previous month, inflation and core inflation decreased by 0.2 percentage points and 0.4 percentage points, respectively. The decrease in the inflation rate relative to March was mainly attributable to the fall in the annual index of tradable goods and market services included in the core inflation measure (Chart 9). Underlying inflation measures decreased relative to the previous month. The low level of the underlying measures still implies a moderate inflation environment (Chart 10). Despite its negative sign, the inflation figure for April does not imply deflation, while the low level of the underlying indices continues to indicate a moderate inflationary environment.

Chart 9: Decomposition of the consumer price index



Favourable expenditure 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. While agricultural producer prices fell by 10.2 per cent in annual terms in March 2014, domestic sales prices of firms producing for the domestic market rose by 1.4 per cent year on year in February. Fuel prices continued to fall in April in annual terms, but in monthly terms they remained unchanged as a result of the rise in oil prices in US dollar terms and the strengthening of the forint exchange rate. 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. 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)



The inflation figure for April was lower than forecast in the March *Inflation Report*. The difference is mostly attributable to the more moderate-than-expected price index of fuel prices, tradable goods and unprocessed food, supplemented mainly by the low pressure from import prices. Moderate imported inflation is likely to remain in the short term: amongst other things, this is suggested by the fact that inflation in the euro area was at a low level in April and may remain well below the ECB's price stability target of close to, but below 2 per cent. The harmonised consumer price index of the euro area increased by 0.7 per cent in April, which was slightly lower than the ECB's own projection and market expectations. According to the statement of ECB, the low inflation environment may stay for a longer period.[2]

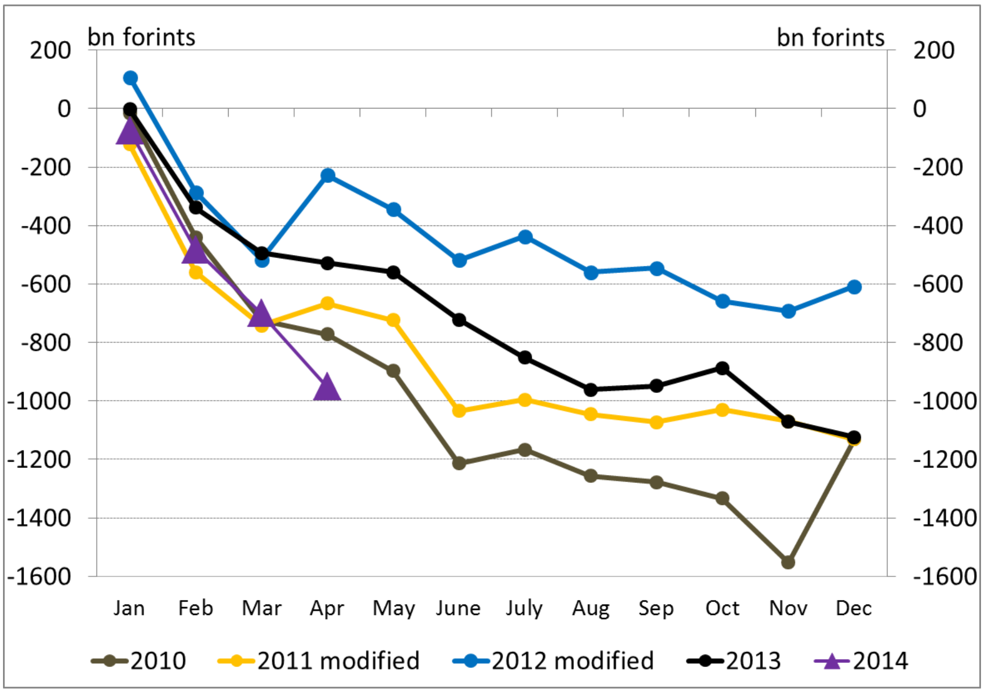
Looking ahead, in view of all these factors**, inflation may remain below the path of the March *Inflation Report*. This may be partially offset by the slackening of disinflationary pressure from domestic demand, as be suggested by the latest retail and labour market figures.** In our view, based on the received data, the probability of two of the three alternative scenarios identified by the Monetary Council in the March *Inflation Report* – i.e. the long-term lower external inflationary environment and the slackening of domestic disinflation – may have increased recently.

[2] Meanwhile, the price index was negative in four member states (Greece, Cyprus, Portugal and Slovakia).

1.4. Fiscal developments

In April, the general government deficit was HUF 250 billion, which is HUF 215 billion higher than a year earlier. On aggregate, the deficit in the first four months was HUF 951 billion, which is HUF 420 billion higher than a year before (Chart 11). In the first four months, over 90 per cent of the deficit projected by the Bank, assuming the full cancellation of the National Protection Fund, and 97 per cent of the estimate was realised. However, the high deficit in the beginning of the year does not jeopardise the meeting of the annual deficit target, as the development of the deficit is attributable to temporary and deceptive reasons. The prefinancing of EU subsidies and the payment of the early May subsidies and wages at the end of April have a temporary effect, while the impact of the debt assumed from the municipalities, which does not increase the consolidated deficit, is deceptive.

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



The MNB published preliminary financial accounts data in respect of general government on 19 May, according to which gross government debt amounted to 84.6 per cent of GDP at the end of the first quarter. This was higher than the figure of 79.2 per cent recorded at the end of 2013 and was mainly attributable to three factors.

1.) *In the first quarter, the debt manager increased its financial reserves that had decreased at the end of 2013*, i.e. debt issuance exceeded the budget deficit. As a result of this, government deposits increased by about HUF 1,100 billion (by 3.5 per cent of GDP) in the first three months, which also increased the debt ratio by a similar rate. A major part of the deposit accumulation comes from the successful issue of foreign currency bonds in the amount of USD 3 billion in March.

2.) *By the end of March, the cash deficit of the budget had reached 70 per cent of the annual estimate.* Due to the timing of the tax revenues, it is a common phenomenon in Hungary that the major part of the deficit accumulates in the beginning of the year; however, in 2014 this was slightly higher than expected.

3.) *The forint exchange rate* versus the euro depreciated from 297 at year-end to 307, which – via the revaluation of foreign currency debt – resulted in a debt ratio (expressed in forint) higher by 1 per cent of the GDP.

Net government debt increased to a lesser extent than the gross level, as a major part of the gross debt increase was attributable to the accumulation of deposits, which does not increase net debt.

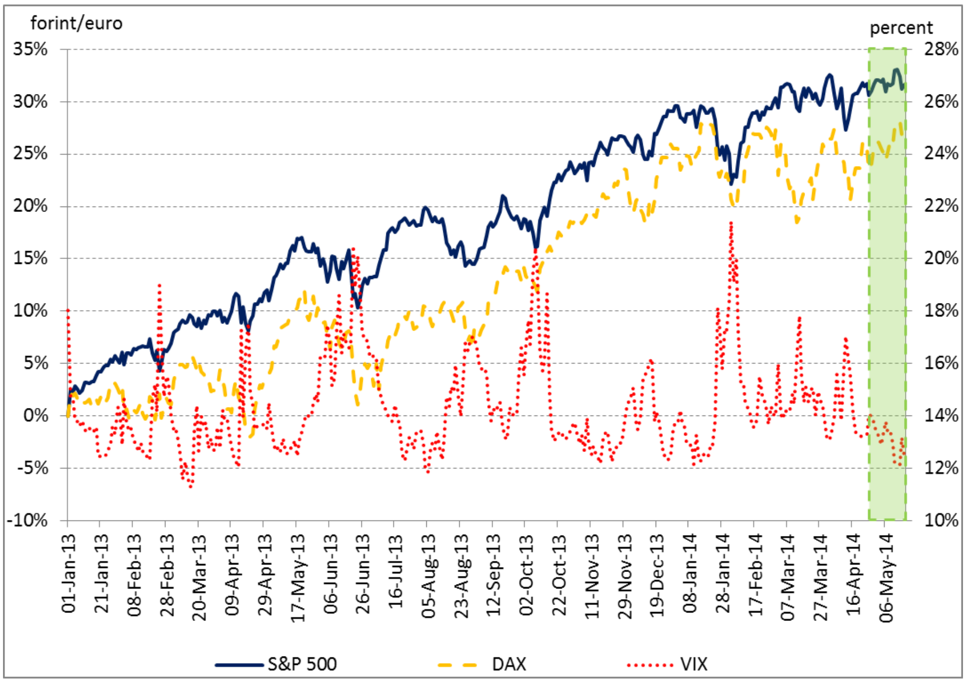
The seemingly high figures **reflect temporary effects, and thus we still expect an annual deficit of slightly below 3 per cent and a year-end government debt ratio lower than the current one.**

2. Financial market developments

2.1. International money markets

As a whole, global market sentiment developed favourably in the last month. Equity markets in the main developed countries continued to rise, taking them close to historic highs once again during the month. Market indicators of risk perceptions declined, and most risk indices fell below the level of one year ago, i.e. before the communication on the tapering of Fed's quantitative easing programme. In addition to this, there was a general decline in yields and risk spreads in the global government bond markets. US and German long-term yields fell by about 10 basis points. The emerging markets bond index (EMBI) also decreased to a one-year low (Chart 12). In the first half of the period euro appreciated against US dollar as the exchange rate came close to the level of 1.4, but following the expansive tone of the ECB's communication the exchange rate corrected to the level of 1.37.

Chart 12: Developed market equity indices and VIX index trends



At its April meeting, the Fed continued to taper its quantitative easing programme as expected, while ECB noted that it might take further measures in the coming period due to the low inflationary environment. According to the Fed, considerable monetary policy adjustments would be required in the future as well. Although there were some signs implying an improvement in the labour market, conditions were still far from desirable. The Fed's decision did not surprise investors and consequently did not result in any substantial movements in the market. In the coming months, the market expects further tapering of the quantitative easing programme at the current pace.

In response to the low inflation environment in recent months, ECB decision-makers commented on the central bank's potential measures several times, but no specific steps have been taken so far. However, since the inflation developments experienced in the euro area continue to signal an extremely slow price increase and – according to the latest survey of ECB – the anchoring of expectations may have also weakened, at the press conference held after the May meeting the President of the ECB noted that the central bank was less and less willing to tolerate the current situation. **Most market participants interpreted the message from the press conference as a clear sign of further easing.** The market considers a 10–15 basis point reduction in the key policy rate, and in parallel with that a reduction of the central bank deposit rate to the negative domain, as the most likely measures. In addition to this, the strengthening of its forward guidance, the announcement of a new LTRO programme or other liquidity boosting measures may also be possible. The market believes that the announcement of a major asset purchase programme is unlikely in the short term, and therefore such a measure would have a more significant impact.

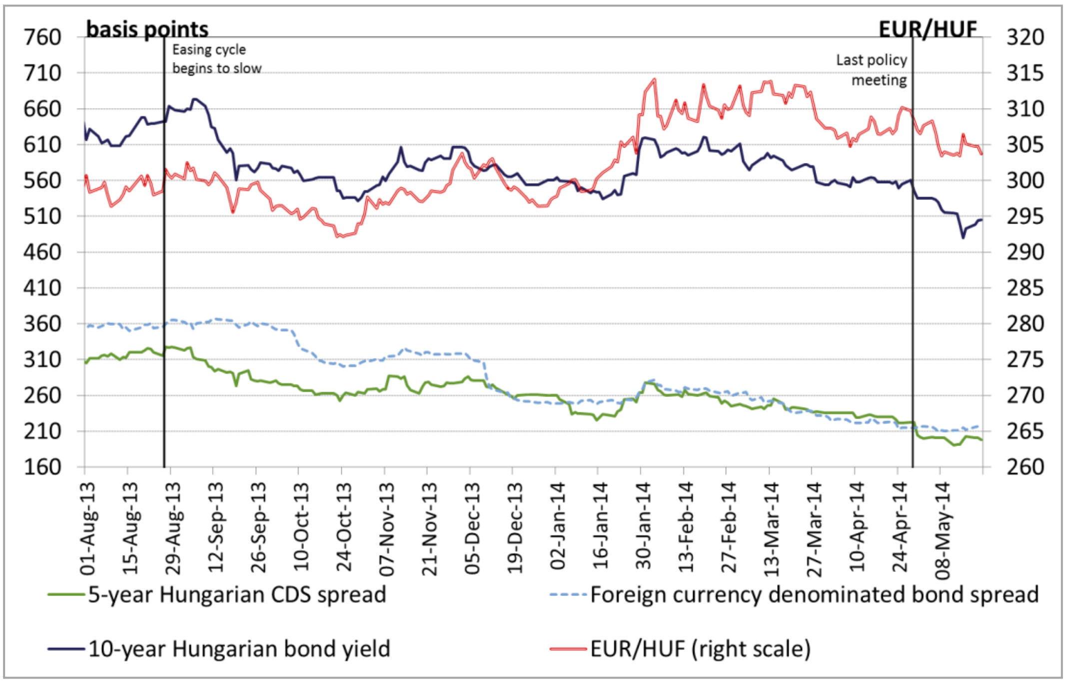
Apart from the ECB's communication and its expected steps, the favourable sentiment was also attributable to the fact that developments in the Russian-Ukrainian conflict impacted international risk appetite to a lesser extent than before. On the one hand, this may be attributable to the fact that the earlier rapid escalation was followed by a somewhat more stable situation in Ukraine, and, on the other hand, Russia also took a more restrained position. As a result of this, the market could have enough time to assess and price in the related risks. Improved risk perception of the market is also reflected in the fact that favourable developments commenced during the month in Ukrainian and Russian asset prices. The fact that IMF paid the first tranche of the USD 17 billion package, in the amount of USD 3.2 billion, contributed to the decrease in Ukrainian yields. Nevertheless, the future outcome of the Ukrainian-Russian conflict and its effects on the financial market are still uncertain.

Developments in the emerging markets as well were characterised by positive trends, possibly supported by favourable global sentiment and macroeconomic figures. Equity indices rose, yields fell and exchange rates generally strengthened in emerging countries. The currencies of the "fragile five" group, considered more risky, appreciated by 2-4 per cent during the month.

2.2. Developments in domestic financial market indices

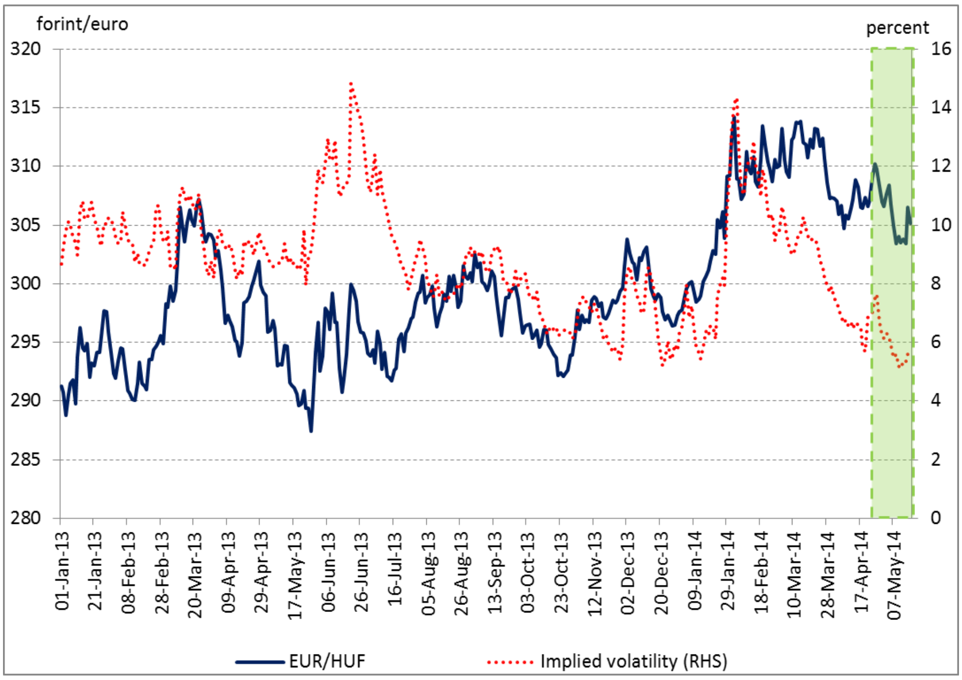
Recently, the indices of the Hungarian financial market have essentially developed in line with the improving global risk appetite. During the month, the EUR/HUF exchange rate appreciated from 309 to 303-304, which is a stronger-than-average appreciation in the narrower region, while in the broader context of emerging markets it corresponded to the appreciation of the more sensitive foreign exchange rates (Chart 13).

Chart 13: Domestic risk indicators



In parallel with the appreciation, the implied volatility of the forint exchange rate fell to a historic low, also reflecting favourable market perceptions (Chart 14). The domestic inflation figure had a weakening impact on the Hungarian currency, while the communication of ECB, the decision of the European Court of Justice of national relevance in respect of the foreign currency loans and domestic growth figures might have strengthened it.

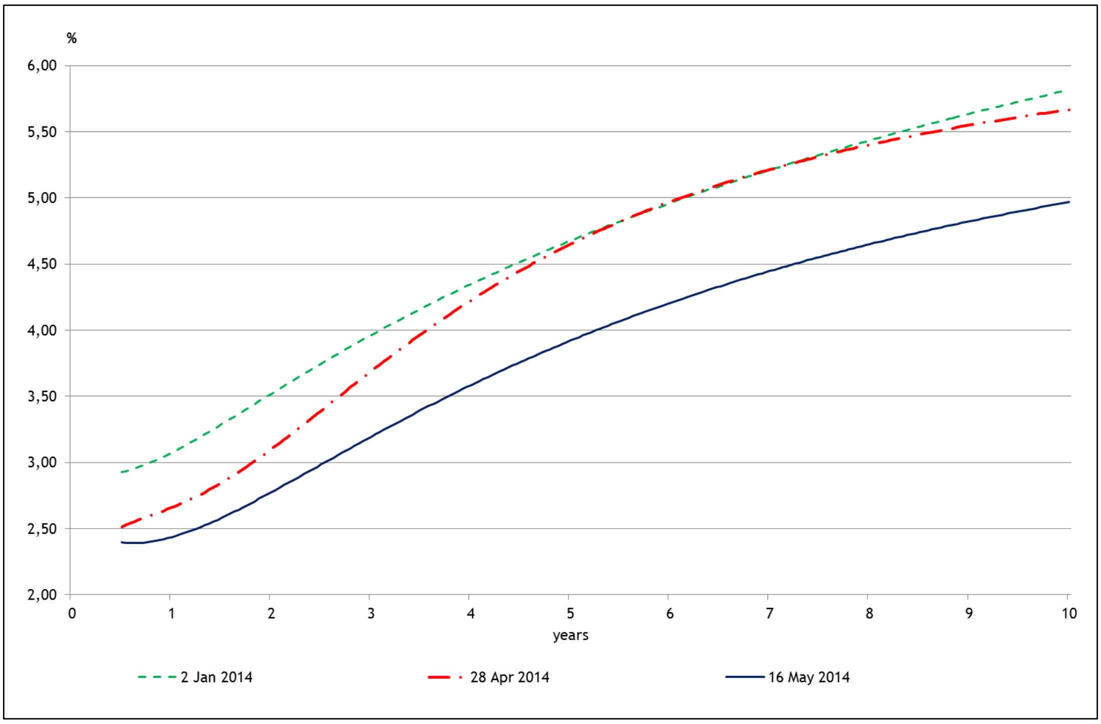
Chart 14: EUR/HUF exchange rate and its implied volatility



The domestic CDS spread has been around or below 200 basis points since the beginning of May, which is a 20-basis point fall since the last interest rate decision.

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 40-50 basis points. As a result, **there was a substantial decrease in the steepness of the yield curve.** Five-year and ten-year benchmark yields fell close to 4 per cent and 5 per cent, respectively, which is a historic low (Chart 15). The decrease in long-term yields was observed in the entire emerging region, but the domestic decrease stood out even from this trend, suggesting that there may have been both international and country-specific reasons underlying the process. On the international side, the ECB communication could contribute to the decrease in yields, while on the domestic side it may be attributable to the announcement of MNB related to the concept of self-financing, the increased expectations related to the interest rate decrease as a result of low inflation and the better-than-expected GDP data.

Chart 15: Shift in the spot government bond yield curve



During the month, the government bond auctions took place with high coverage ratios and declining yields. On aggregate, ÁKK raised forint funds from the market substantially above the announced volume. During the month, there was a large-scale repurchase of government bonds expiring in August.

At the end of April, the European Court of Justice did not declare domestic foreign currency loan contacts invalid, but referred it to the competence of the Supreme Court (Curia) to judge whether it was unfair practice to apply buy and sell rates in the transactions related to such loans. Following the decision the forint appreciated, which was interpreted by the market that although the judgment was not unexpected, the likelihood of the scenarios burdening the banking system to a greater extent has decreased.

The inflation figure published in April, indicating an annual drop in prices of 0.1 per cent, was a downside surprise for the markets. Several analysts emphasised that the low figure relates to a wide range of product groups rather than to single segments, and that core inflation has also decreased. As a result of the surprise, several analysts revised their base rate projections downwards. **The domestic GDP figure related to the first quarter, projecting an annual growth of 3.5 per cent, was an upside surprise for markets,** as the consensus was 2.7 per cent.

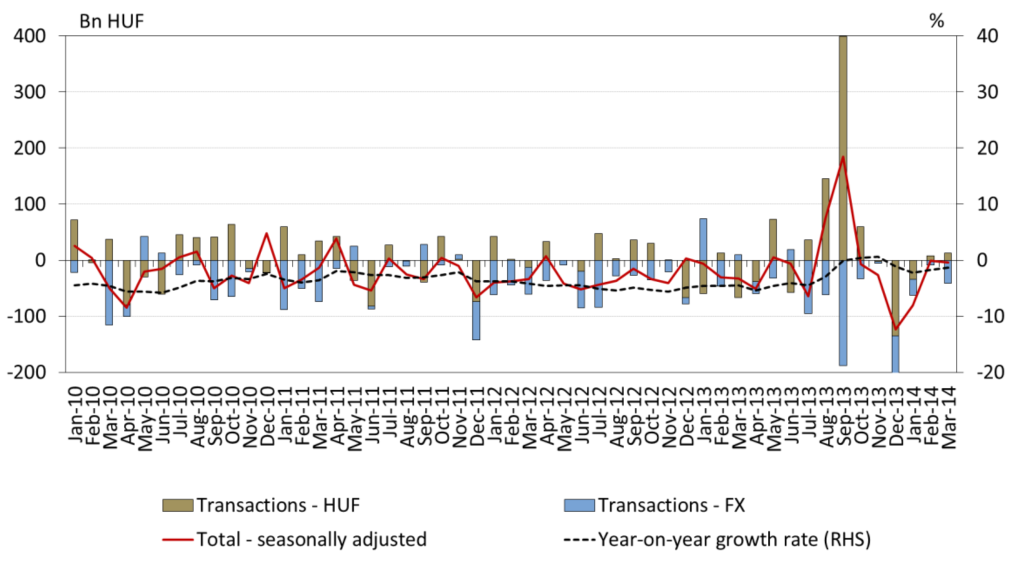
According to comments after the publication of the data, the view that the strengthening of the Hungarian economic activity continues has intensified. Several analysts made a substantial upward revision to their current year growth estimate.

3. Position of the banking sector

3.1. Lending conditions

Net borrowing of the non-financial corporations from the entire credit institution sector was negative, as repayments exceeded loan disbursements by about HUF 28 billion. After seasonal adjustment, the balance of transactions was HUF -4 billion. Compared to the previous month, the annual growth rate is less negative: its value in March was -1.3 per cent compared to the -1.8 per cent rate registered in February (Chart 16). The average interest rate on small-value forint loans decreased further, while the average interest rate of high-value forint loans started to rise again after the figure published in February.

Chart 16: Net borrowings of non-financial corporations



The decline in the household loan portfolio continued in March. The balance of transactions was minus HUF 22 billion, while the seasonally adjusted figure was minus HUF 17 billion. As a result of disbursements and repayments, the foreign currency loan portfolio decreased by HUF 32 billion, while forint loans increased by HUF 10 billion. The 5 per cent annual rate of decline of outstanding loans generated by transactions was a slight improvement compared to the previous month (Chart 17). The average interest rate on newly disbursed household housing loans continued to fall in March, while it essentially remained the same in the case of home equity loans.

Chart 17: Net borrowings of households