Macroeconomic and financial market developments

August 2016

Background material
to the abridged minutes of the
Monetary Council meeting
of 23 August 2016

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The background material 'Macroeconomic and financial market developments' is based on information available until 19 August 2016.

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 usually 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 background materials to the minutes are available on the MNB's

website at:

http://www.mnb.hu/en/monetary-policy/the-monetary-council/minutes

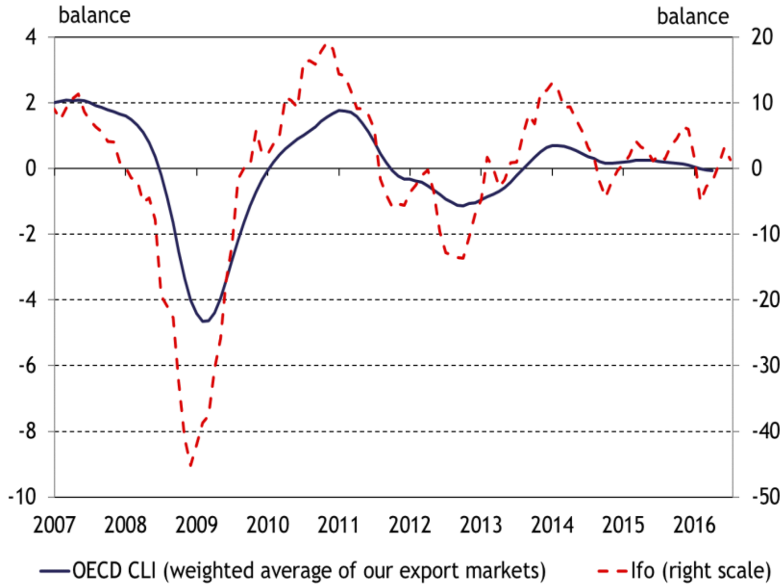
1. MACROECONOMIC DEVELOPMENTS

1.1. Global macroeconomic environment

The preliminary GDP figures for the second quarter showed a mixed picture on the whole. Growth in Germany, Hungary's most important trading partner, was more favourable than expected while that of the USA fell short of economists' projections. Looking ahead, global growth is expected to decelerate further in the coming quarters. In its July report, the IMF reduced its growth expectations of the developed economies compared to the April report and left that of the emerging economies unchanged. In its assessment, **growth remains fragile, surrounded by several downside risks**. Low commodity prices continue to drag on commodity exporters' activity growth, while persisting geopolitical tension still slows growth in developed countries as well through weaker demand and economic sanctions. The consequences of the UK referendum appeared in the money market over the short term, and, based on the confidence indicators, the economic impacts may be concentrated on the United Kingdom for the time being. However, over the medium and long term, depending on the outcome of the exit negotiations, it may also have a negative impact on the performance of the Hungarian economy, although the United Kingdom has relatively minor role in Hungarian exports.

The euro area economy registered a quarter-on-quarter growth rate of 0.4 per cent in the second quarter of 2016. The exit of the United Kingdom from the EU carries significant medium- and long-term risks. Dynamic economic growth in Germany, Hungary's most important export partner, continued in the second quarter, supported by increasing domestic demand, as well as by rising exports. Industrial performance increased slightly in June compared to the previous month. Rising expectations concerning the German economy since the beginning of this year (Ifo) halted in July (Chart 1). The economies of the region maintained their good performance in the second quarter of 2016 as well.

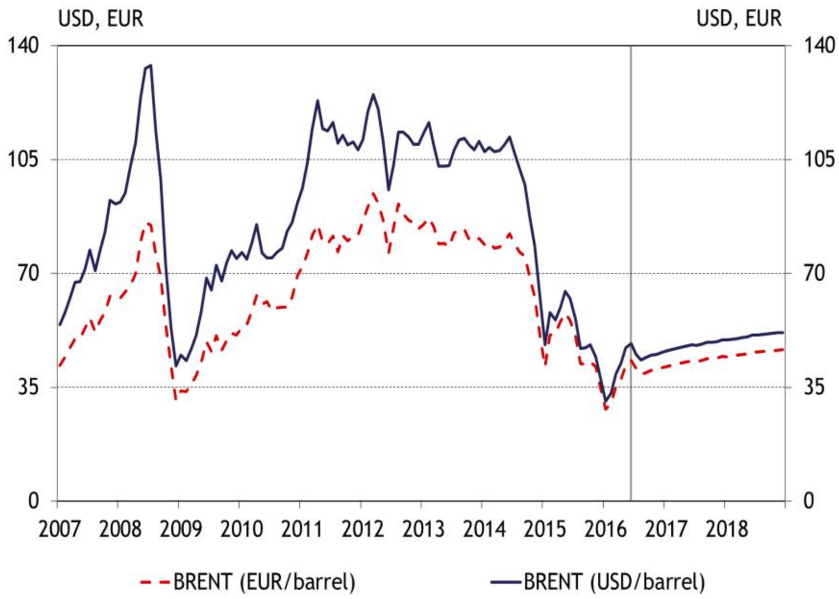
Chart 1: Business climate indices in Hungary's export markets



Source: OECD, Ifo.

Inflationary pressure from the world market continues to be weak, due partly to continued very low commodity prices and partly to subdued demand. As a result, inflation rates remain below target in the world's major economies. In recent months, oil prices have climbed close to USD 50, followed by a decline at the end of the period (Chart 2; for more details see subsection 1.3).

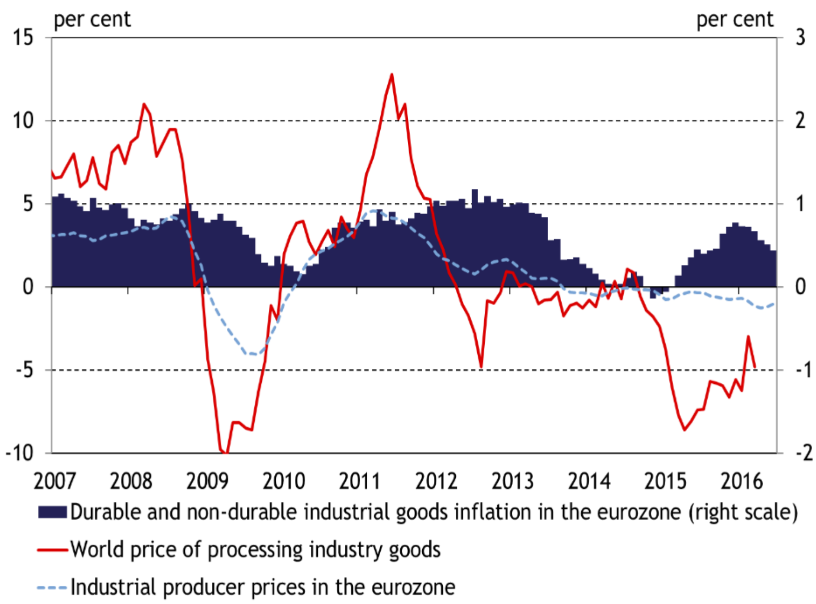
Chart 2: *World market price of the Brent crude oil*



Source: Bloomberg.

World market prices of industrial commodities and unprocessed food were low, while the prices of manufactured goods adjusted after a considerable fall in the first quarter of 2015 (Chart 3).

Chart 3: *Industrial producer prices and tradables inflation in the euro area and world market prices of manufactured goods (y/y)*



Source: Centraal Planbureau (www.cpb.nl), Eurostat, ECB.

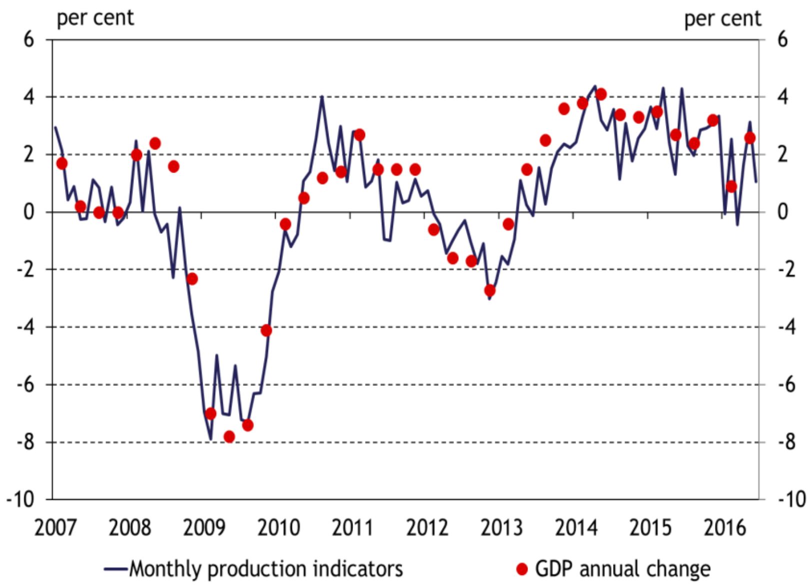
1.2. Domestic real economy developments

1.2.1. Economic growth

In the second quarter of 2016, Hungary's GDP grew at a rate of 2.6 per cent year on year and by 1.1 per cent compared to the previous quarter. Following the temporary loss of dynamics in the first quarter, the performance of the domestic economy adjusted in the second quarter.

On the output side, market services, industry and agriculture made a positive contribution to the growth. Construction output continued to contract year on year, primarily due to the lower volume of projects financed from EU funds compared to 2015. Accordingly, this sector continued to restrain the improvement in economic performance on an annual basis. In the second quarter, industrial output somewhat adjusted after the decline in the first quarter. In line with our expectations, the volume of retail sales continued to increase.

Chart 4: Monthly production indicators and GDP growth*



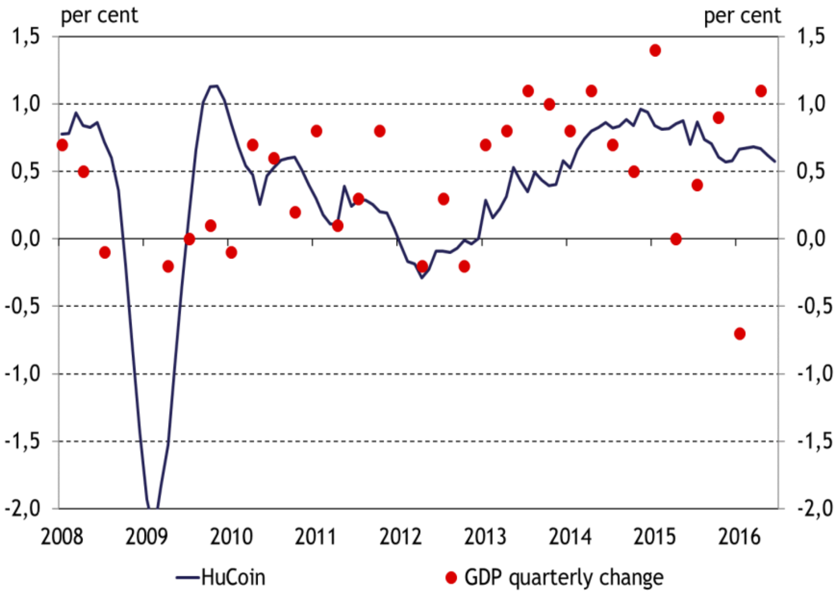
* Weighted average of monthly production indicators (industrial output, construction output and retail sales). The weights are derived from regression explaining GDP growth. Source: MNB calculation based on HCSO data.

Although the detailed structure of second-quarter GDP is not yet known, conclusions may be drawn with regard to its pattern based on the monthly indicators (Chart 4). On the expenditure side, household consumption may have increased significantly in the second quarter as well, which is also supported by the incoming figures on retail turnover volumes. Investment, on the whole, may have been weak, in line with the lower volume of public investment financed from

EU funds compared to the previous year and the subdued investment activity of the manufacturing companies. In parallel with the adjustment in industrial output in the second quarter and the better-than-expected performance of the German economy, domestic export dynamics may have recovered in the second quarter.

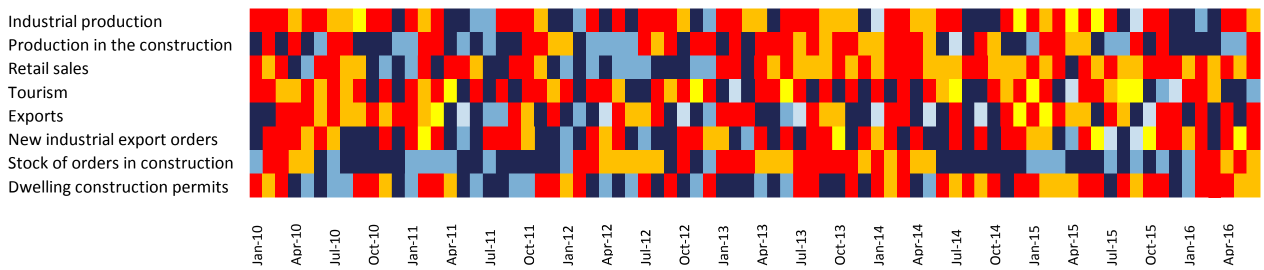
Capturing domestic economic performance outlook over the medium term, the HuCoin was generally stable considering the average of the past period (Chart 5).

Chart 5: Evolution of HuCoin indicator



Note: Due to the revisions to GDP data, the historic values of the HuCoin indicator may have also changed.

*Chart 6: 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. Source: MNB calculations based on HCSO data.

In June 2016, industrial output was down 0.3 per cent year on year and 2.4 per cent compared to the previous month on a seasonally adjusted basis. Production in the manufacturing subsectors showed a mixed picture. Output in the engineering industry, which represents the most important role, increased slightly compared to the previous month, accompanied by modest growth in the performance of light industry. Industrial production slowed in the rest of the subsectors, with a major decline in the metal industry. **On the whole, forward-looking indicators reflect a mixed picture with regard to the short-term outlook of the domestic industry.** The EuroCoin indicator, which marks the underlying trends of the euro area's economic activity, rose moderately, while there was a major increase in the ESI index, which captures the prospects of domestic industry, accompanied by a slight decrease in Hungarian export orders. The Ifo indicator reflecting the prospects of German industry, decreased in July.

Based on preliminary data, expressed in euro terms, in June 2016 the value of exports and imports increased by 5.0 per cent and 1.3 per cent, respectively, year on year. The trade surplus was up EUR 302 million from last June. In May 2016 the terms of trade continued to improve, with low energy prices remaining the largest contributor.

In June 2016, **the volume of construction output was down 16.2 per cent year on year**, while output increased by 7.5 per cent compared to the previous month. Production of the two main construction groups developed differently: construction of buildings increased by 7.4 per cent, while as a result of slow growth of EU-funded projects, the volume of other construction fell by 36.8 per cent. In the second quarter, construction output contracted by 23.7 per cent in total relative to the same period of the previous year. The volume of new contracts increased further due to the rise in the number of contracts for the construction of buildings and the civil engineering works. The rise in the number of new contracts was also supported by the contracts concluded for residential buildings.

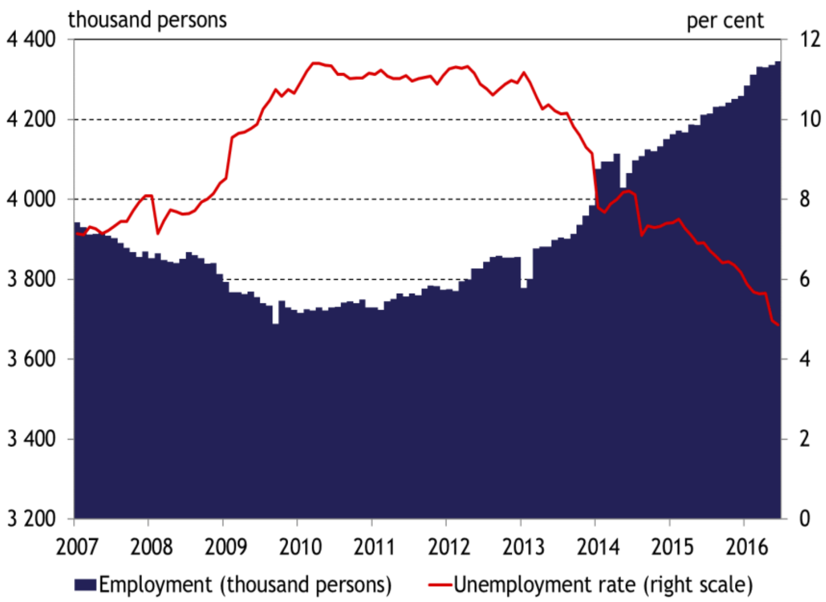
Consumption demand may have continued to recover in the second quarter, in line with the sustained increase in retail sales volume. Based on preliminary data, in June the volume of retail sales was up 5.7 per cent year on year and 0.6 per cent compared to the previous month. As regards the structure of sales, an increase in the volume of sales was registered for a wide range of products. The sales of non-food consumer durables contributed to the increase in the volume of retail sales to a greater extent than previously. This was accompanied by a continued growth in food and fuel sales.

1.2.2. Employment

According to Labour Force Survey data, **in the second quarter of 2016 the number of employees in the national economy increased by 3.4 per cent year on year**. Unemployment fell, while the labour force participation rate, similarly to the previous quarters, continued to increase. As a combined result of these effects, the unemployment rate dropped to 5.1 per cent in the second quarter (Chart 7).

Relative to the previous quarter, the number of employees in general government increased slightly, which was attributable to the rise in the number of public workers to the level seen at the end of the previous year. Within the private sector, the dynamic increase in the workforce continued, primarily in the market services sector.

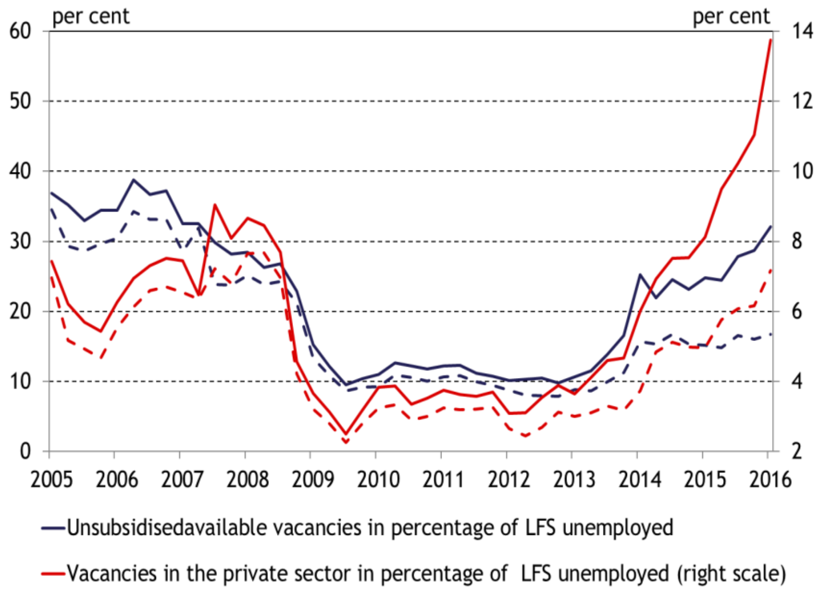
Chart 7: *Number of persons employed and the unemployment rate*



Source: HCSO.

In July 2016, according to the data provided by the National Employment Service (NES), **there was no substantial change in the number of newly announced non-subsidised jobs**, while the end-of-month number of vacant non-subsidised jobs fell slightly, but it is still at a historic high in respect of the post-crisis period. The number of vacant jobs in the private sector, published by the HCSO, was at a historic high in the first quarter. The gradual tightening of the labour market, observed since 2013, has continued according to the tightness indicators calculated from the various statistics (Chart 8).

Chart 8: *Indicators of labour market tightness*



Note: The dotted line marks labour market tightness indicators adjusted for public workers. Source: National Employment Service, HCSO

1.3. Inflation and wages

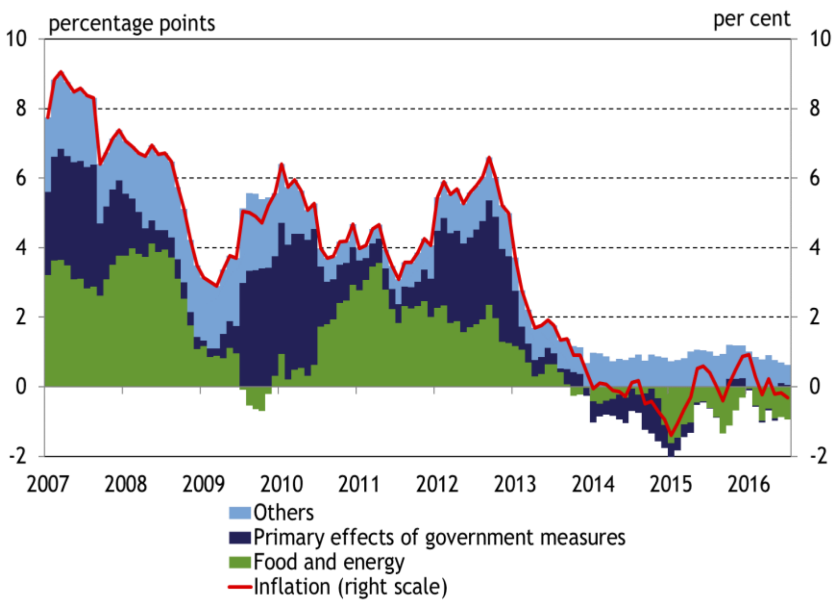
1.3.1. Wages

In the second quarter of 2016, there was no substantial change in annual wage growth in the private sector compared to the previous quarter, thus the wage dynamics is still stronger than that observed last year. According to seasonally adjusted data, gross average wages in the private sector increased by around 5 per cent year on year. June bonus payments were mostly the same as in the previous year. In the private sector, the annual dynamics of gross average wages in manufacturing outstripped that of the market service sector in June.

1.3.2. Inflation developments

In July 2016, inflation was -0.3 per cent, while core inflation was 1.3 per cent and core inflation excluding indirect taxes stood at 1.2 per cent (Chart 9). Inflation dropped primarily as a result of the fall in fuel prices.

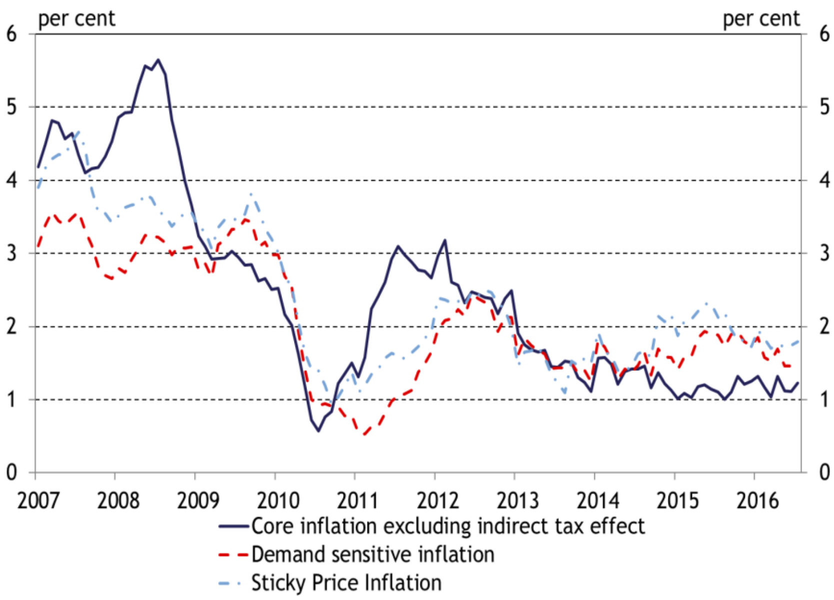
Chart 9: *Decomposition of inflation*



Source: MNB calculation based on HCSO data.

Underlying inflation indicators continue to point to a moderate inflation environment, which is attributable to the low level of imported inflation and low commodity prices (Chart 10). In June 2016, agricultural producer prices rose by 1.5 per cent in annual terms, while domestic sales prices of consumer goods sectors remained essentially unchanged.

Chart 10: *Measures of underlying inflation*



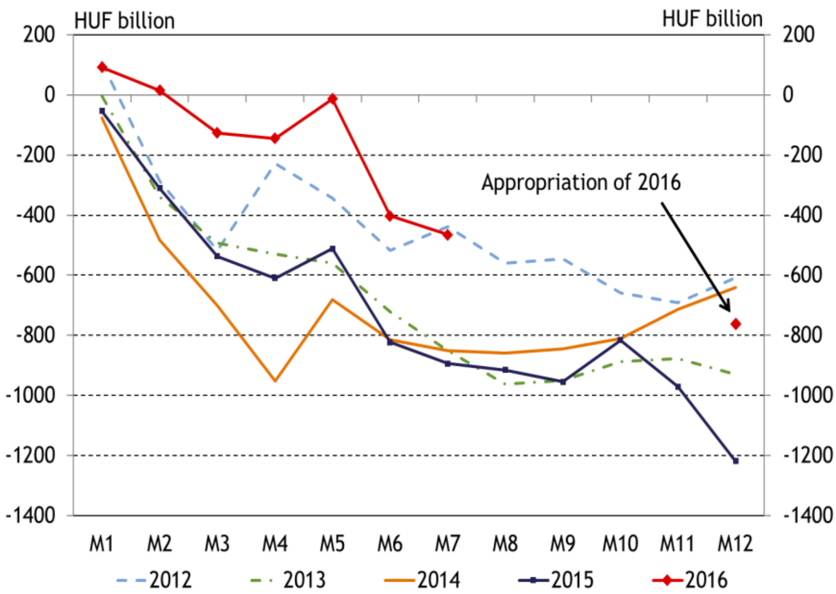
Source: MNB calculation based on HCSO data.

The data received for July were lower than the forecast published in the June Inflation Report, reflecting the unexpected decline in vehicle fuel prices. Looking ahead, inflation may fall significantly short of the 3 per cent target and may approximate it only by the end of the forecast horizon. During the autumn, inflation may rise to the positive territory again.

1.4. Fiscal developments

The deficit of the central subsystem of general government stood at HUF 63 billion in July 2016, representing a similar balance as in the same period of the previous years. Slightly lower revenue than last July reflected the fact that in July 2015 the corporate income tax payment was outstandingly high. Expenditures also became lower on year-on-year basis, which is partly related to interest expenses and partly to EU grants. **In the first seven months of the year the cumulated cash deficit of the central budget was HUF 465 billion, one of the lowest figures in recent years** (Chart 11).

Chart 11: Intra-year cumulative cash balance of the state budget



Source: Budget Act of 2016, Hungarian State Treasury.

In July 2016, **tax and contribution revenues of the central sub-sector** fell short of the July 2015 revenues by HUF 36 billion, which is related to the corporate income tax and the value added tax. **Corporate income tax** is expected to be high at an annual level, partly due to surplus revenue from the tax credit for growth. The lower revenue compared to last July was attributable to an outstandingly high corporate income tax payment in July 2015 due to one-off factors. Compared to last July, the budget realised low revenues from **value added tax**, which is partly also due to one-off factors. With the phase-out of the impact of whitening measures, the dynamics of VAT revenues declines year on year, but it is still well above the consumer price index. Wage-related revenues continue to develop favourably, in line with our projection.

In July 2016, the **expenditures of the central sub-sector** fell short of those in July 2015 by HUF 44 billion. The lower level is due to expenditures related to EU transfers and interest expenses, which are lower than last year. The payment of grants in larger volumes to the applicants within the framework of the 2014-2020 programming period has already started, but the transfers fall short of the extremely high base of last year. This year the volume of grants paid within the framework of the new programming period exceeded HUF 300 billion. In 2016 **net cash interest expenditure** may continue to decline as a result of the persistently low yield environment. Based on the incoming data of the last seven months, this year's interest expenditures develop in line with our forecast, which represents a more favourable expenditure level than specified in the statutory appropriation by roughly 0.1 percentage point relative to GDP.

1.5. External balance developments

According to the data, in June the seasonally unadjusted external financing capacity amounted to EUR 780 million, which was almost fully attributable to the current account surplus of EUR 730 million, while the capital account surplus was EUR 50 million. The increase in net lending was mostly due to the balance of goods, which was mostly attributed to the rise in engineering industry output and improved terms of trade. The surplus on services was once again high and slightly exceeded the year-on-year figure.

Based on the financing side processes, net lending – slightly falling short of the real economy data – was around EUR 660 million, achieved in combination with a larger fall in external debt and a more moderate outflow of non-debt funds. The outflow of non-debt funds was attributable to lower direct investment as a result of dividend payments. On the other hand, the degree of dividend payments is still significantly behind the figure relative to a year earlier. The decrease in net external debt – in excess of EUR 400 million – continued. The decline primarily related to corporations; the increase in the net external debt of government sector by EUR 1 billion was offset by a decline of similar degree in the banking system. The change in the banks' and the government's net external debt in the opposite direction was attributable to the expiry of the swaps related to the conversion of foreign currency loans into forint: banks' foreign currency assets increased, while the government's foreign exchange reserves decreased.

2. FINANCIAL MARKETS

2.1. International financial markets

Market sentiment has been generally favourable since the Council's latest policy decision. The UK referendum and the attempted coup in Turkey do not appear to have lasting impact on the financial markets. The US macro figures showed a mixed picture, while the European ones were more favourable in the period. Investors positively viewed the larger-than-expected easing of monetary policy by the Bank of England, as well as the results of the EBA's stress test, as they showed an improvement compared to 2011.

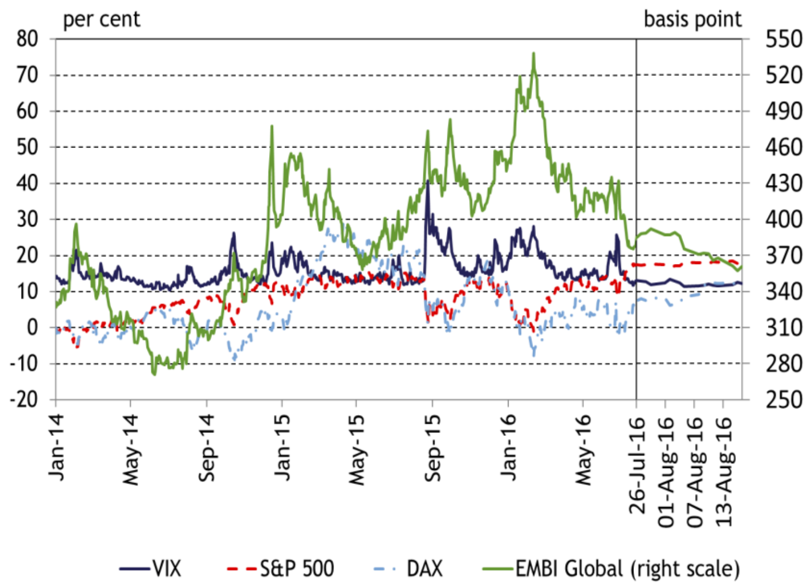
The European and Asian stock market indices rose to a greater degree compared to the previous period, while US indices increased moderately. European indices were up by 1-4 per cent, which was mostly attributable to the favourable macro figures (slightly better-than-expected inflation, GDP, and confidence index data) and the post-Brexit adjustment. The 0.5 per cent, moderate, rise in US indices can be explained by the mixed macro figures: data published on the labour market were favourable, while those on growth were considered unfavourable. In the emerging equity markets, the MSCI composite stock price index showed slow and persistent growth of more than 4 per cent.

Risk indices declined slightly, reflecting the calming of global investor sentiment after the events in the UK and Turkey. The VIX index fell from the initial 13 per cent to 12.2 per cent, while the emerging bond market EMBI Global premium was down by 24 basis points during the month. There was no lasting increase in the indices reflecting the risk of developed and emerging countries even after the attempted coup in Turkey; its impact concentrated primarily on the local financial markets. The MOVE index, measuring the volatility of the US bond market, also posted a minor decrease. **Oil prices have increased by around 9-11 per cent since the last policy decision**, with prices per barrel approaching USD 50.

In calm investor sentiment, yields on developed market long-term bonds continued to fall. US and German yields fell by 2 and 5 basis points, respectively, while the 10-year GBP yield fell remarkably by 17 basis points, after the major post-Brexit yield decline. Ten-year Spanish yields fell below 1 per cent for the first time, and in Italy yields also came close to the 1 per cent psychological threshold.

Of the major currencies, the dollar depreciated during the period, similarly to the pound, the depreciation of which was the result of the interest rate cut by the Bank of England. At the beginning of the period, the dollar depreciated after the Fed's interest rate decision and weak second quarter GDP data, followed by a minor adjustment, mostly attributable to robust employment data. However, by the end of the period it started to depreciate once again. Thus on the whole the dollar depreciated against the euro by 3 per cent. The pound depreciated against the euro by 3 per cent, after the Bank of England cut its policy rate by 25 basis points and introduced the Term Funding Scheme (TFS), in addition to which it will purchase corporate bonds for GBP 10 billion and increase the financial allocation for the purchase of government securities by GBP 60 billion. The Japanese yen appreciated against the dollar by almost 5 per cent, as the minor easing applied by the Japanese central bank (doubling the global amount of the ETF purchase programme) fell short of investors' expectations.

Chart 12: Developed market equity indices, the VIX index (left scale) and the EMBI Global Index (right scale)



Source: Bloomberg.

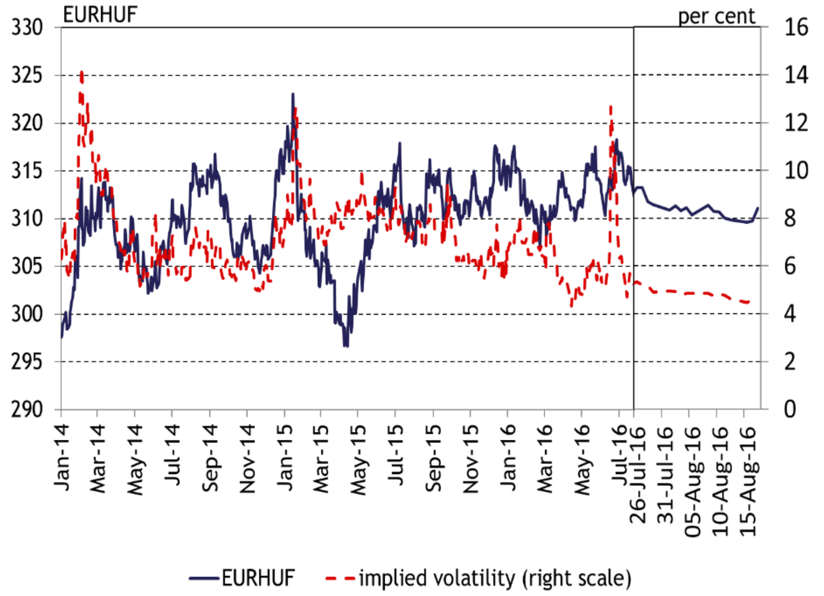
Overall, throughout the period the yields on long-term bonds of developed markets, regarded as safe-haven assets, declined significantly, particularly during the post-Brexit period. Ten-year EUR, USD and GDP yields were down by 5, 11 and 45 basis points, respectively, marking a low in decades in UK yields, and reaching a level below zero in the case of EUR yields.

According to market expectations, the probability of an interest rate increase by the Fed this year has not changed. The probability of this year's rate hike (December) is still 49 per cent, while the probability of a rate increase in September fell from 28 per cent to 22 per cent. However, in the communication of its interest rate decision in July the Fed emphasised that short-term risks declined and developments in both employment and household consumption were favourable. According to the minutes of the decision, the next monetary policy measure will require further data. **In the euro area inflation expectations did not change; the 5-year ahead 5-year forward inflation expectations still stagnate at around 1.33 per cent.**

2.2. Developments in domestic money market indicators

In the past month domestic asset prices were driven by both domestic and international factors. During the period the EUR/HUF rate fluctuated within a band of 309-314, appreciating by around 1 per cent overall (Chart 13). Positive international sentiment and regional news – in Hungary the second quarter GDP figure, while in Poland the information related to the foreign currency loan package – both pointed to the appreciation of the currencies in the region. Compared to the Polish zloty the forint appreciated to a lesser, while compared to the Romanian leu and the Czech koruna to a greater degree during the period. Of the domestic data releases particularly the GDP and the retail sales volume figures had a strengthening effect on the exchange rate. According to the economists' opinion, the policymakers' announcements related to the government's economic stimulus measures also pointed to this direction. The forint appreciated 4 per cent, the Romanian leu and Czech koruna by roughly 3 per cent, and the Polish zloty by almost 5 per cent against the dollar. The stability of the forint is reflected by the fact that exchange rate volatility was continuously around its historic low during the month.

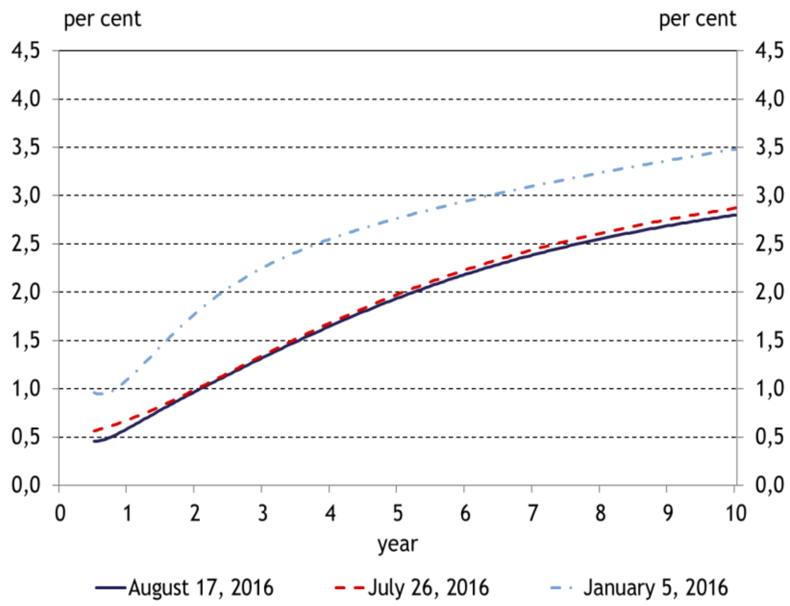
Chart 13: EUR/HUF exchange rate and the implied volatility of exchange rate expectations



Source: Bloomberg.

The yield curve of the government securities market declined during the period, with the yields falling more markedly in the short and long-term section, and to lesser degree at medium-term maturities. Short-term benchmark yields in the government securities market dropped by 8 to 10 basis points. The medium, 3 to 5-year section of the yield curve decreased by a few basis points, while longer-term yields also dropped by around 10 basis points (Chart 14).

Chart 14: Shifts in the spot government bond yield curve



Source: MNB, Reuters.

Demand at the bond auctions of the period was mostly strong, but in some cases the Government Debt Management Agency issued less government bonds than the announced quantity. At the beginning of the period, demand was outstanding for 1 and 3-year bonds, while in the second half of the period demand was more moderate at the auctions. On the whole, auction yields dropped; the largest fall was seen at the 3-year maturity, where average yields at auction fell by 30 basis points compared to the last auction of the previous period.

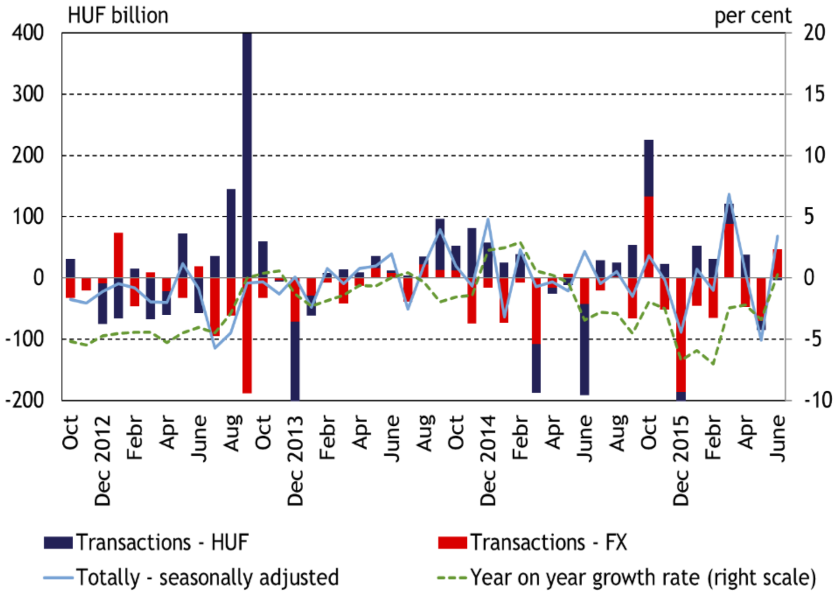
Non-residents' holdings of government securities have increased slightly since the last policy decision, with their portfolio rising to HUF 3,587 billion during the period. In the first half of the period non-residents' holdings of government securities decreased by HUF 10 billion, while as a result of the increase during the rest of the period, their portfolio rose by 40 billion in total. The share of foreign holdings within the portfolio of HUF government securities remained close to 25.5 per cent. In positive international sentiment, the Hungarian 5-year CDS spread fell steadily, and then stabilised at around 136 basis points.

3. BANKING SYSTEM

3.1. Trends in lending

In June, as a result of transactions, **outstanding loans of credit institutions to the corporate sector** rose by a total of HUF 43 billion, equivalent to an increase of HUF 68 billion on a seasonally adjusted basis (Chart 15). In terms of currency denomination, forint loans fell by HUF 4 billion, while foreign currency loans increased by HUF 47 billion during the month. The annual rate of the total volume of corporate lending turned positive by the end of June, thus the increase in outstanding lending reached 0.3 per cent in annual terms.

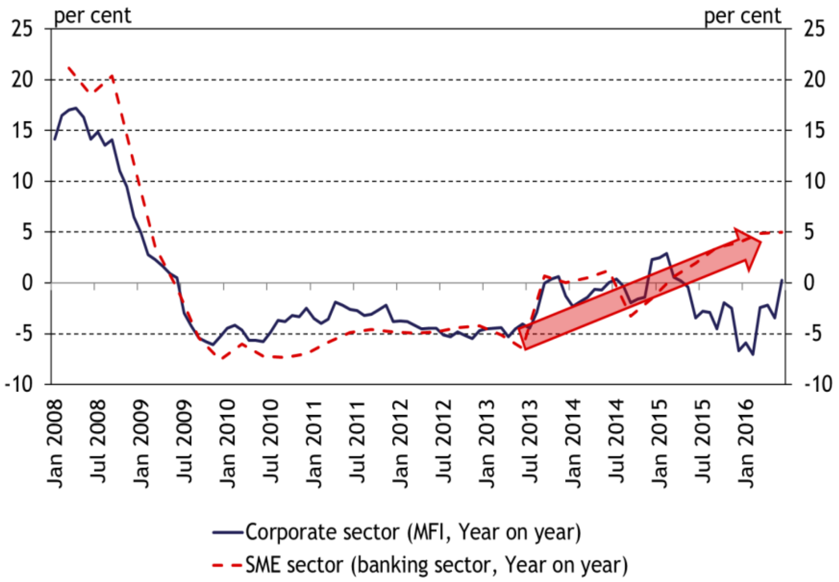
Chart 15: Net borrowing by non-financial corporations



Source: MNB.

Based on preliminary data, outstanding borrowing by the SME segment showed an annual increase of 5 per cent in the second quarter (Chart 16). Principal instalments of the loans disbursed in Pillar 1 and 2 of the Funding for Growth Scheme – also including the FGS+ programme – amounted to around HUF 22 billion in June. In June, loan agreements made under Pillar 3 of the Funding for Growth Scheme increased the outstanding forint and foreign currency loans by HUF 17 billion and HUF 5 billion, respectively.

Chart 16: Growth rate of loans outstanding of the whole corporate sector and the SME sector

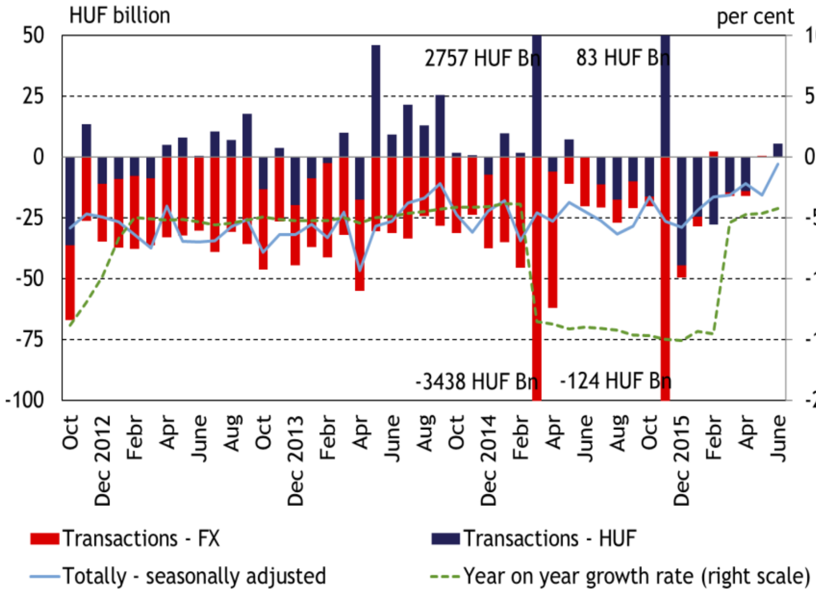


Source: MNB.

In June, interest rates on **newly granted corporate loans** were down to a historic low, with interest rates on both small and high-value loans being half of lowest pre-crisis interest rates. In the case of newly granted corporate loans, the average annualised interest rate on small-value forint loans decreased by 0.44 percentage points to 4.18 per cent from May, while the average – cleaned from money market transactions – interest rate on higher-value forint loans, , decreased by 0.87 percentage points to 3.54 per cent.

Based on transactions, the value of loans denominated in foreign currency remained unchanged in the **household segment** in June, while the value of forint loans outstanding rose by HUF 5 billion (Chart 17). During the month, the decrease in the outstanding loans was 4.2 per cent in annual terms. In the period under review, the total value of new contracts of household loans was HUF 101 billion, thus the average annual growth in new business is 38 per cent. The amount of contracted loans increased in all loan segments, with the volume of new housing loans and personal loans increasing the most significantly.

Chart 17: Net borrowing by households



Source: MNB.

In June, interest rates on **new household loans** were below the pre-crises interest rate level. The annual percentage rate of charge on housing HUF loans remained unchanged, thus it was 5.71 per cent in June, while that on home equity HUF loans fell by 0.40 percentage points to 7.11 per cent.