# Macroeconomic and financial market developments

July 2014

Background material
to the abridged minutes of the
Monetary Council meeting
22 July 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

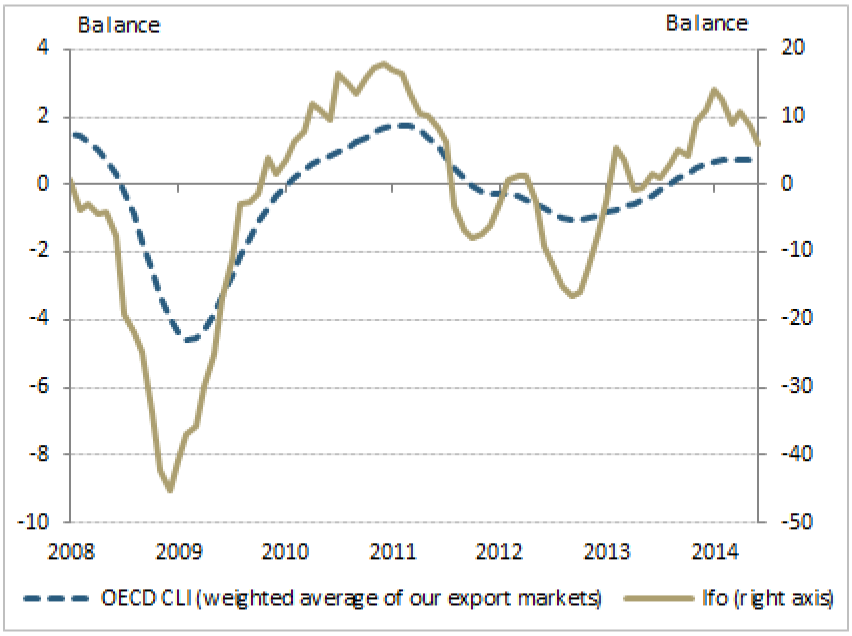
# 1 Macroeconomic developments

## 1.1 The global economy

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

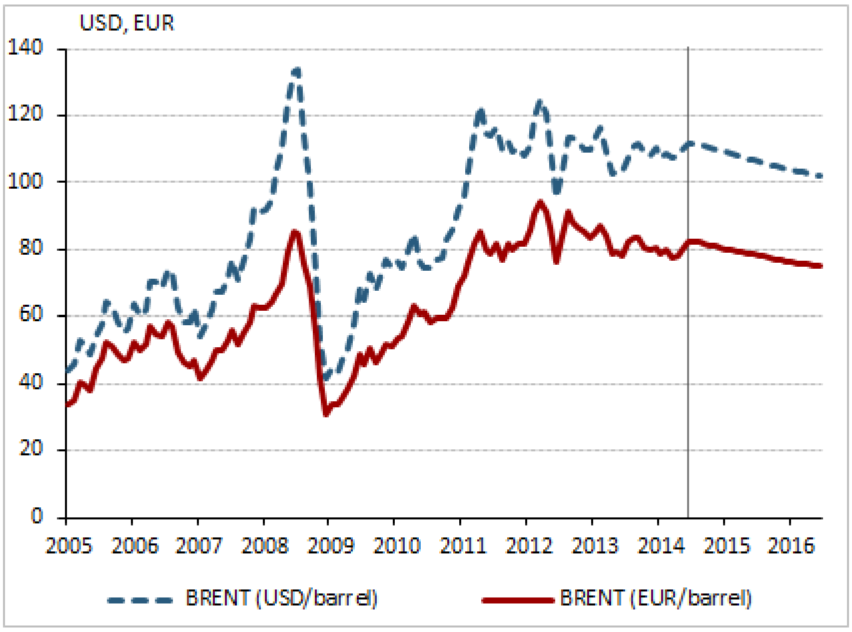
**In the first quarter of 2014, global economic activity slowly continued to improve.** The growth environment moved on different paths for the developed and emerging economies. Activity in emerging market economies which had previously shown rapid growth slowed down in the early months of 2014, in contrast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

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



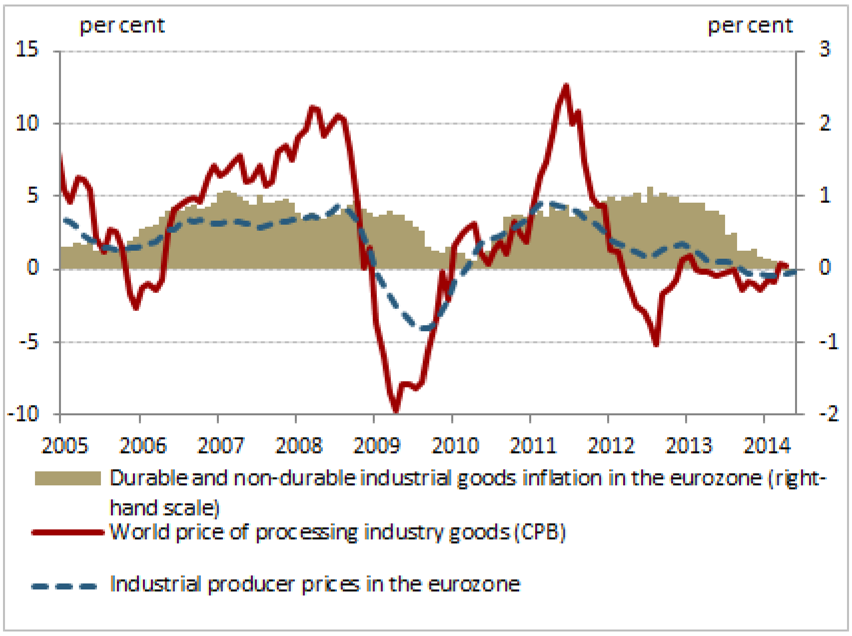

**In the first quarter of 2014, the euro-area economy continued to expand at a moderate pace, with gross domestic product growing by 0.2 per cent relative to the previous quarter. Forward-looking indicators of activity stopped rising after April and reversed in May–June, although they remained at high levels.** This may reflect the deterioration in the geopolitical situation, as the increase in uncertainty may also affect negatively output dynamics. Consequently, economic performance in the second quarter may turn out to be weaker based on economic data becoming available in recent months. The industrial output of Germany, Hungary's most important trading partner, fell in the past two months and the volume of new German industrial orders dropped slightly. The Ifo indicator, a measure of the output expectations of German industrial firms, continued to fall in June, which might partly reflect the increase in uncertainty due to the conflict between Ukraine and Russia. Looking ahead, other emerging geopolitical tensions may also pose downside risks to the economic environment (Chart 1).

*Chart 2 World market price of Brent oil*




**Inflationary pressures from the world market remain subdued.** Declining commodity prices, combined with a slowly growing global economy, are exerting downward pressure on inflation. As a result, inflation rates remained below inflation targets in the world's major economies (the consumer price index continues to be low in the euro area). The world market price of crude oil fell to around USD 107 by mid-July. This may have reflected the opening of new Libyan oil ports and the easing in concerns related to the decline in oil production in Iraq (Chart 2). Favourable trends continued in the world market prices of industrial commodities and unprocessed food. Movements 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 manufacturing goods*




## 1.2 Domestic real economic developments

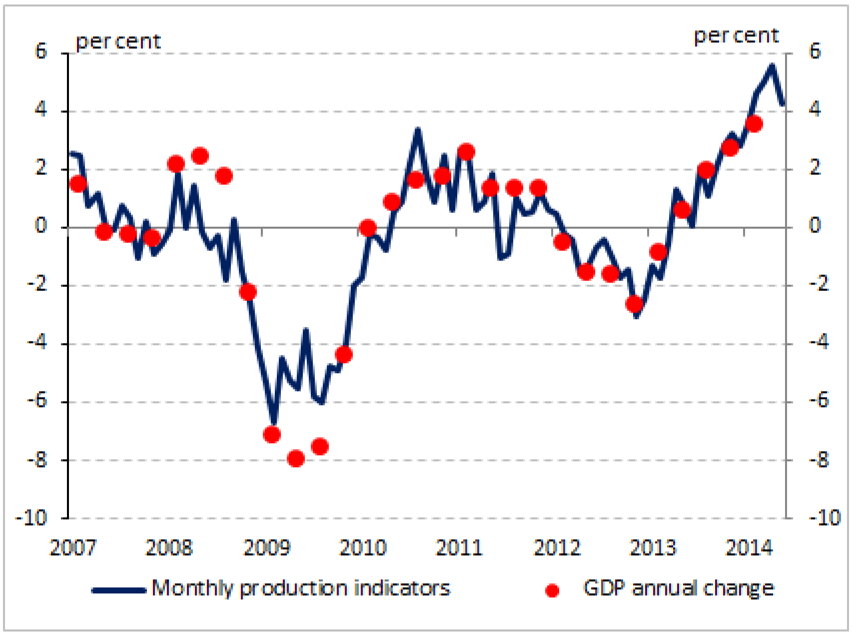
*In early 2014, Hungarian economic growth picked up significantly. Output grew across a wide range of economic sectors in the first quarter; along with exports, domestic demand components also contributed to GDP growth. Based on the indices for May, growth may have continued during the second quarter.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

### 1.2.1 Economic growth

**In the first quarter of 2014, the economy continued to grow.** Based on the preliminary figures published by the CSO, Hungary's **gross domestic product rose 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 and May, vigorous growth may well have continued during the second quarter (Charts 4 and 5). The performance of industry, construction and retail sales expanded significantly year on year. In May, industrial production fell relative to the previous month, but continued to grow strongly relative to the same period a year earlier. Favourable underlying developments in industry reflect the expansion in vehicle industry capacity. In addition to this, the rate of output growth increased across a range of sectors. Construction output picked up slightly relative to the previous month.

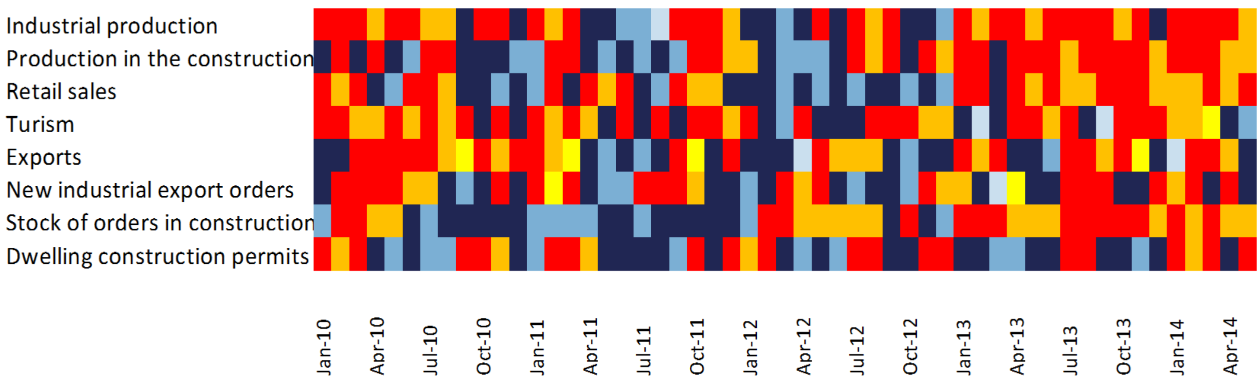
*Chart 4 Monthly production indicators* and development of GDP*




* 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 the Bank's expectations, economic growth was balanced, and both exports and domestic demand picked up.** The main driving force behind the increase in GDP in the first quarter was 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 9.6 per cent and declinedby 1.2 per cent in May relative to the previous month. Production increased across a wide range of manufacturing sectors.** The output of the electronic and optical industry, having fallen sharply during the crisis but retaining a significant weight, grew for the third consecutive month in May. The negative influences of the conflict between Ukraine and Russia have been felt primarily in the pharmaceutical industry in recent months. Developments in the stock of industrial orders point to continued growth in the coming months. By contrast, the main European forward-looking indicators (ESI, Ifo) may signal a slight slowdown in growth. **Goods exports continued to rise, in line with developments in industry.**

**Construction output continued to rise in May (by 28.7 per cent year on year).** Industrial investment by the corporate sector continued to be the main factor accounting for the expansion in building-type investment, 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 rose significantly in the first half of 2014, and data on the stock of orders point to favourable performance of construction in the second half.**

**The gradual increase in consumption demand has continued in recent months.** According to preliminary data, retail sales rose by 2.6 per cent in the first quarter year on year.[1] Sales volumes picked up across a wide range of products. The improvement in the labour market and the significant rise in household real income, attributable to historically low inflation, are underpinning 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 June baseline projection pointed to continued economic growth with a balanced structure. The economy is expected to expand by 2.9 per cent in 2014.** Growth is likely to continue on a quarterly basis, with the slowdown in the annual dynamics appearing as the result of base effects. The monthly indicators were in line with the Bank's expectations in June. The recovery in

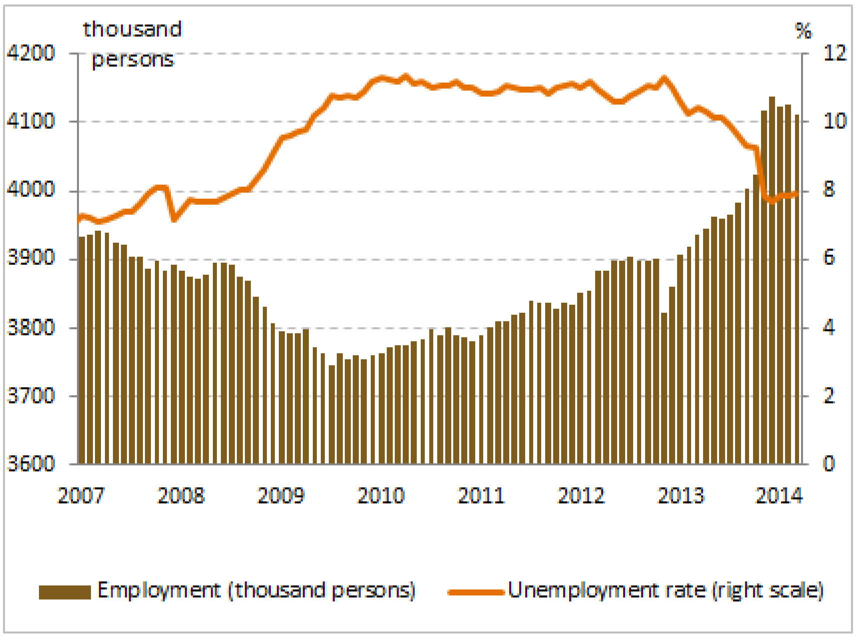
[1] In January 2014, the Central Statistical Office changed the method of monitoring the turnover of tobacco products. Instead of the representative sample-based assessment, it switched to the full data supplied by Nemzeti Dohánykereskedelmi Nonprofit Zrt. The figure published by CSO contains the tobacco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

external demand, the intensive use of EU funds, loose monetary conditions, the improvement in the labour market and the strengthening in business and consumer confidence are all supporting growth.

### 1.2.2 Employment

According to Labour Force Survey data, **the number of employees in the national economy fell slightly in May.** This mainly reflected a drop in the number of persons employed in public employment programmes; excluding public employment, the number of employees has been flat in recent months. **The unemployment rate has stagnated since the beginning of the year and fell to 7.6 per cent in May (seasonally adjusted, it stood at 7.9 per cent)** (Chart 6).

*Chart 6 Numbers employed and the unemployment rate*




**The number of newly announced, non-subsidised jobs was unchanged in May**, according to data released by the National Employment Service. The number of non-subsidised vacancies has been falling since the beginning of the year, following the sharp increase last year. This indicates that positions in the private sector have been filled continuously since the beginning of the year, as reflected in the increase in the number of employees in the first quarter. **The labour market is less loose** than early last year (Chart 7).

*Chart 7 Indicators of labour market tightness*


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

## 1.3 Inflation and wages

*In the second quarter 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, before stabilising in April.*

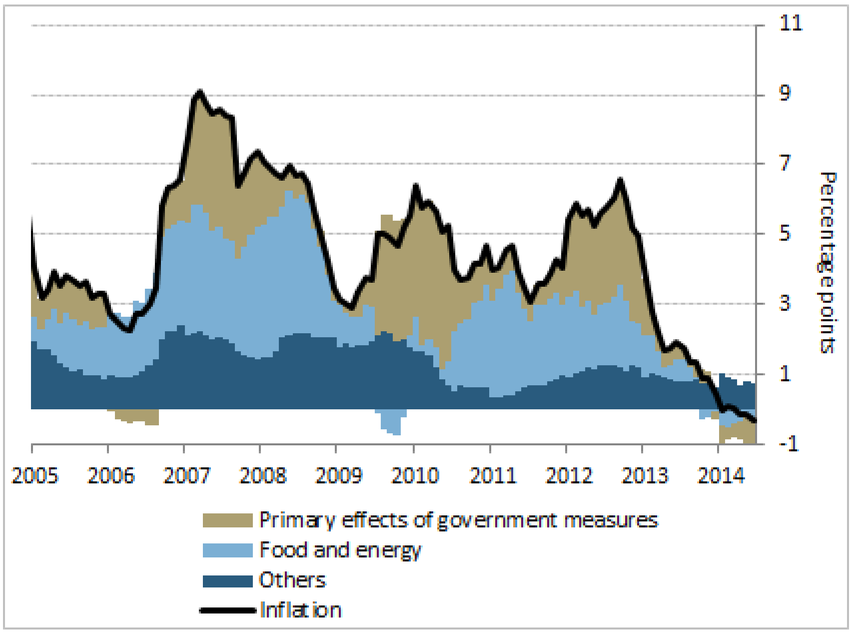
### 1.3.1 Wages

**In the first quarter, growth in the private sector wage index accelerated.** The payment of bonuses, which were due in December last year, was deferred to the beginning of 2014 and the modest pick-up in regular pay growth may have contributed to the acceleration of the wage dynamics. The growth rate of wages stabilised in April–May. **Overall, wage dynamics remained subdued, and unit labour cost in the private sector increased moderately in the first quarter.**

### 1.3.2 Inflation developments

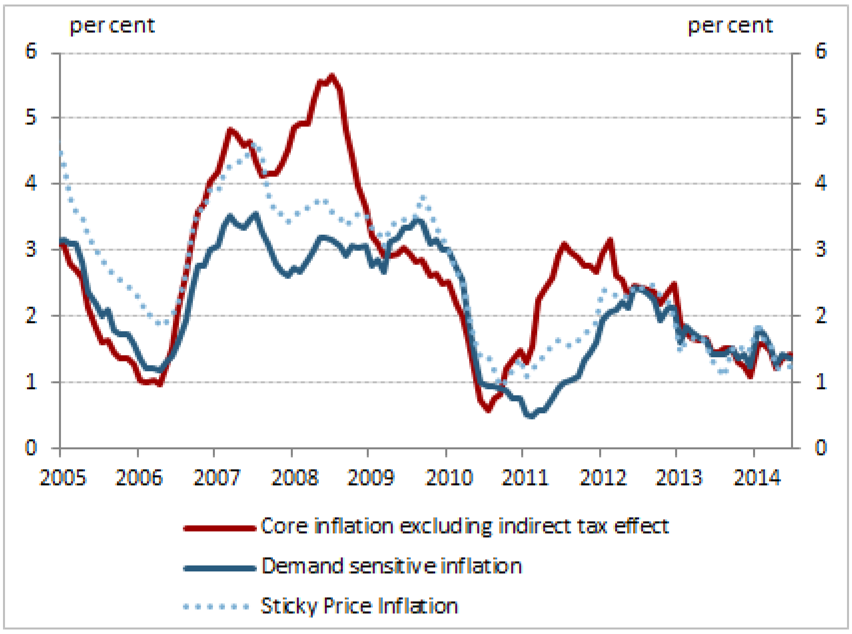
**Inflation remained at historic lows in the first half of the year. In June, consumer price inflation stood at -0.3 per cent and core inflation at 2.5 per cent, while core inflation excluding the effect of indirect taxes was 1.4 per cent** (Chart 8). Inflation fell by 0.2 percentage points and core inflation was unchanged relative to the previous month. The drop in inflation mainly reflected the moderation in price indices for unprocessed food and tradables.

*Chart 8 Decomposition of the consumer price index*




**Favourable cost pressures and demand developments, the gradual adjustment of expectations and low imported inflation may have contributed to the moderate underlying inflation recorded in recent months** (Chart 9). In May 2014, agricultural producer prices fell by 9.2 per cent in annual terms and domestic sales prices of the sectors producing consumer goods rose by 0.5 per cent. Fuel prices rose slightly in June year on year. The domestic demand environment continued to have a disinflationary impact, though to a declining extent.

*Chart 9 Measures of underlying inflation (per cent)*



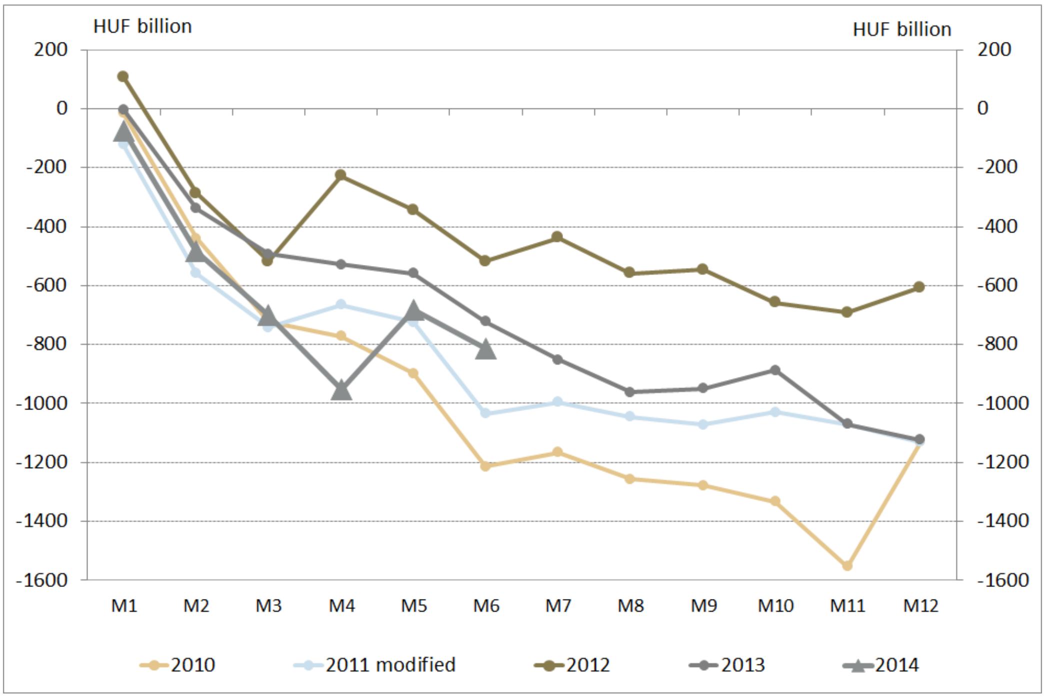
**Based on the baseline scenario in the June projection, inflation is likely to remain around 0 per cent in the short term. The June inflation data was in line with the Bank's expectation.** The inflation rate is expected to rise from the end of the year as the effects of the regulated energy price decreases of last autumn wane.

### 1.4 Fiscal developments

**In June, the government budget registered a deficit of HUF 132 billion, which was HUF 30 billion better than a year earlier.** On the revenue side, the difference is explained by the effects of favourable developments in macroeconomic (employment and wage statistics) and the measures taken during the course of last year (introduction of the electronic toll, increase in the financial transaction tax) that were felt this year already. This was slightly offset, on the expenditure side, by the increase in normative and other subsidies as well as interest expenses relative to June 2013.

The cumulative government deficit amounted to HUF 814 billion in the first half of year, accounting for 83 per cent of the annual target. This was slightly higher than a year earlier, but remained close to the average for the first halves of previous years (Chart 10).

*Chart 10 Intra-year cumulated balance of the government budget*

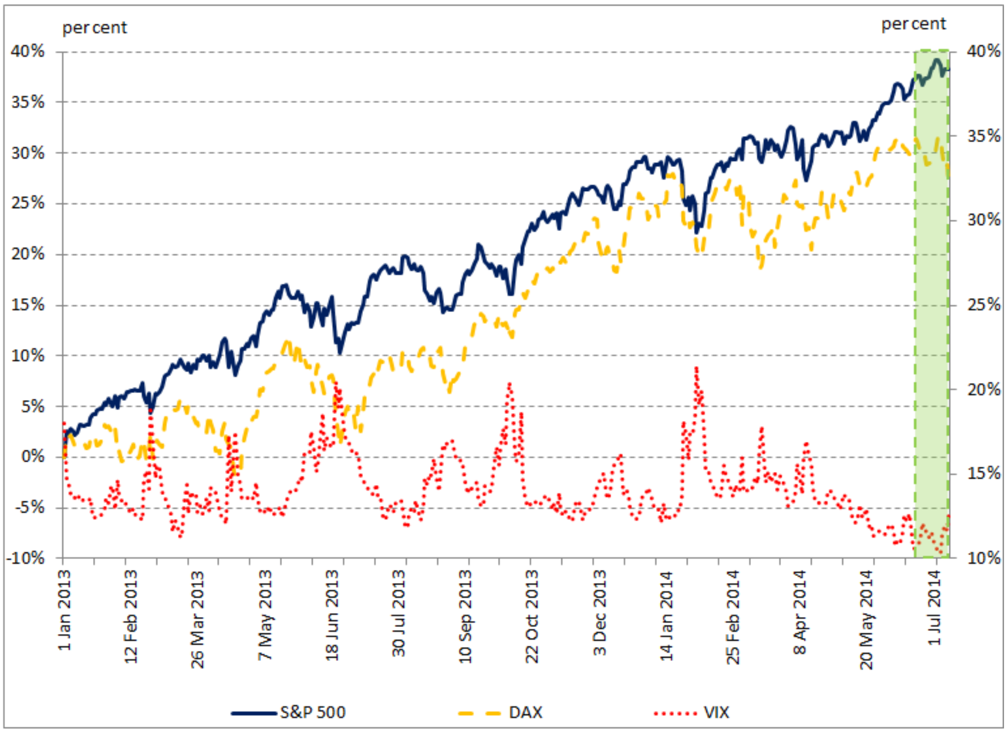


# 2 Financial market developments

## 2.1 International money markets

**Appetite for risk deteriorated slightly in international financial markets in early June, but improved in the second half of the month, despite rising geopolitical risks.** Movements in the main risk indicators and asset prices reflected the continued increase in risk appetite seen in previous months. The major equity indices rose to levels close to their historical high, despite profit-taking at the end of the month. The low level of global risk indicators suggests that investor risk appetite remains strong. The VIX index, measuring volatility in equity markets, continued to rise, but remained close to its historical low, indicating that investor risk appetite remains intact (Chart 11). The US ten-year benchmark yield fell by 10 basis points, after rising by the same amount in early July. German long-term yields fell steadily, by more than 10 basis points. As an effect of the favourable PMI and employment data released in the US, the dollar returned to levels around 1.36, after performing weakly against the euro in the first half of the month.

*Chart 11 Developed market equity indices and the VIX index*




**The technical details of the TLTRO were in the focus of the ECB's communications. There continued to be no clear indication about the timing of the expected tightening by the Fed.** In line with expectations, the ECB left interest rates unchanged. In his speech, President Mario

Draghi said that under the targeted LTRO, recourse to the facility could be as high as EUR 1,000 billion. Mr Draghi stressed that asset purchases would only be justified by a deterioration in the inflation environment. Meanwhile, no new material information became available from the Fed. Based on the minutes of the FOMC meeting in June, the Committee judged that asset purchases could end in October 2014, following a reduction of USD 15 billion. In her speech before Congress, Chair Janet Yellen said the FOMC had broadly maintained its assessment of the macroeconomic situation: if the improvement in the labour market proves faster than expected, then interest rates could be raised earlier than currently assumed. However, if there is a delay in recovery in growth, then the current accommodative policy stance would be maintained for an extended period. FOMC members assign an important supportive role to the interest rate remunerated on required reserves, in addition to the federal funds rate, during the return to conventional monetary policy. The Bank of Japan and the Bank of England did not change their monetary policies, in line with expectations, and therefore market reaction to the news was muted. Market participants expect the minutes of the Bank of England's Monetary Policy Committee, to be published at the end of the month, to provide guidance about whether expectations of an interest rate increase are reinforced by a potential division of views among members at its latest decision to leave interest rates unchanged.

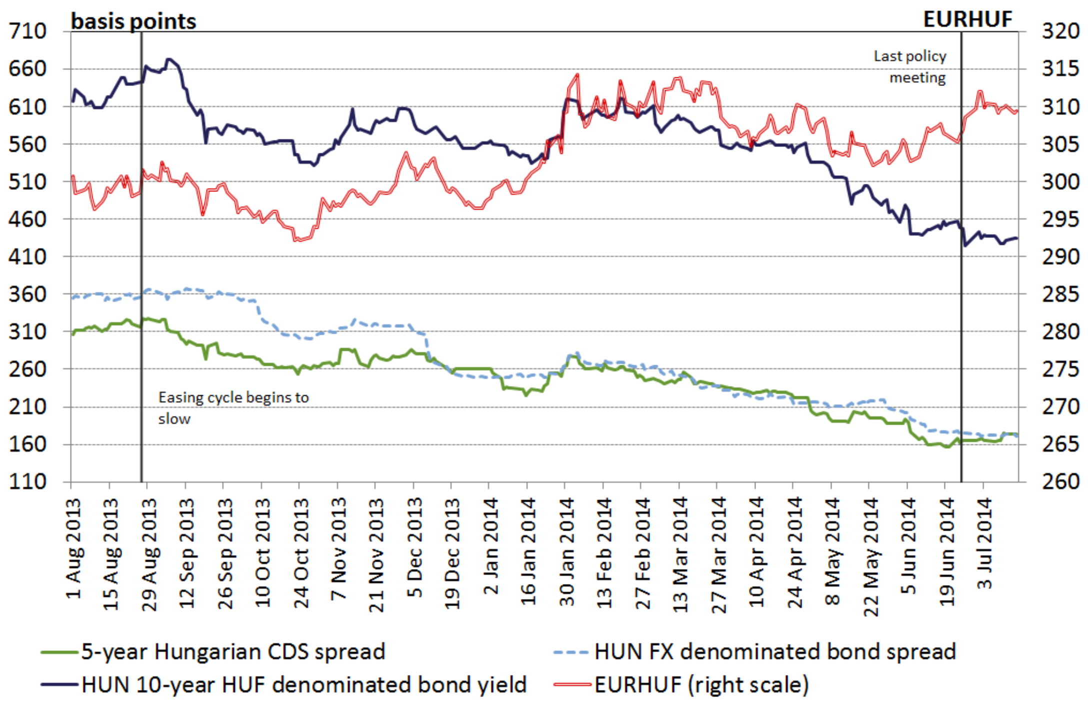
**Monetary policy pursued by developed country central banks strengthened positive global sentiment, but the emergence of new risks and continued negative geopolitical events acted as a drag on international markets.** In the euro-area periphery, the rescheduling of debt of an entity belonging to the second largest banking group of Portugal led to strong reactions. Yields in Spain, Greece and Italy rose after the immediate rise of 25 basis points in Portuguese ten-year yields. Negative news related to the Portuguese banking sector was also reflected in an increase in CDS spreads in the euro-area periphery. In addition to a more than 50 basis point rise in the Portuguese five-year CDS spread, spreads rose by 10 basis points in other euro-area periphery countries. Negative events in emerging markets, such as the re-emergence of the armed conflict between Ukraine and Russia, rating downgrades by credit rating agencies, stability risks related to the Bulgarian banking sector, the near-default situation in Argentina and unfavourable PMI data from the CEE region were all reflected in risk perceptions about the region, but did not lead to an across-the-board deterioration in sentiment.

Of the **central banks of the emerging region**, the central banks of the Czech Republic, Poland and Romania left their policy rates unchanged. Following the rate-setting meeting of the Polish central bank, the zloty appreciated slightly against the euro, which suggests that the market may have priced out expectations of an interest rate increase. As a result, the zloty outperformed other currencies of the narrower region by the end of the period.

### 2.2 Developments in domestic financial market indices

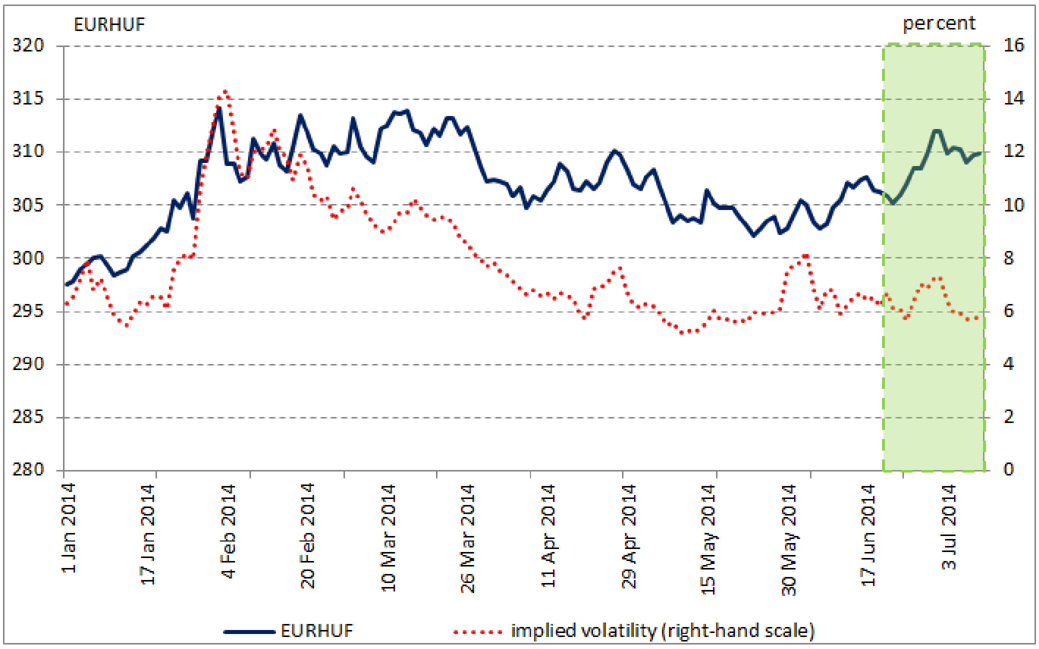
**Domestic financial market developments were influenced in part by international and domestic events, the latter mainly having a negative impact on risk perceptions.** The country report by the European Commission, which contained a warning that Hungary may be placed under the EDP again, and the adoption by Parliament of the law on the rescue package for foreign currency debtors had a negative impact on market sentiment. Following the vote, several Hungarian banks (Erste, KBC, OTP and Raiffeisen) published their calculations about the likely losses they may incur this year due to the compensation for their customers with foreign currency debt. In connection with this, the rating agencies Fitch and Moody's announced that they would revise their credit ratings for Hungarian banks. It was mainly the EUR/HUF exchange rate that reacted to the negative sentiment, while yields and risk spreads remained broadly unaffected (Chart 12).

*Chart 12 Domestic risk indicators*



From levels around EUR/HUF 305, the forint depreciated steadily to a trough of EUR/HUF 312 in the first part of the month, before appreciating slightly from early July and fluctuating around 310 until the end of the month, as the euro depreciated. The forint depreciated to USD/HUF 229 against the US dollar, due in part to dollar appreciation in response to favourable US macroeconomic data, after which the forint appreciated again slightly. With its more than 1.6 per cent depreciation against the euro, the forint showed the weakest performance relative to other currencies of the region. Despite the depreciation, however, by the end of the month the implied volatility of the forint exchange rate and the skewness measure both returned to levels seen in the previous month, following a slight, temporary increase (Chart 13).

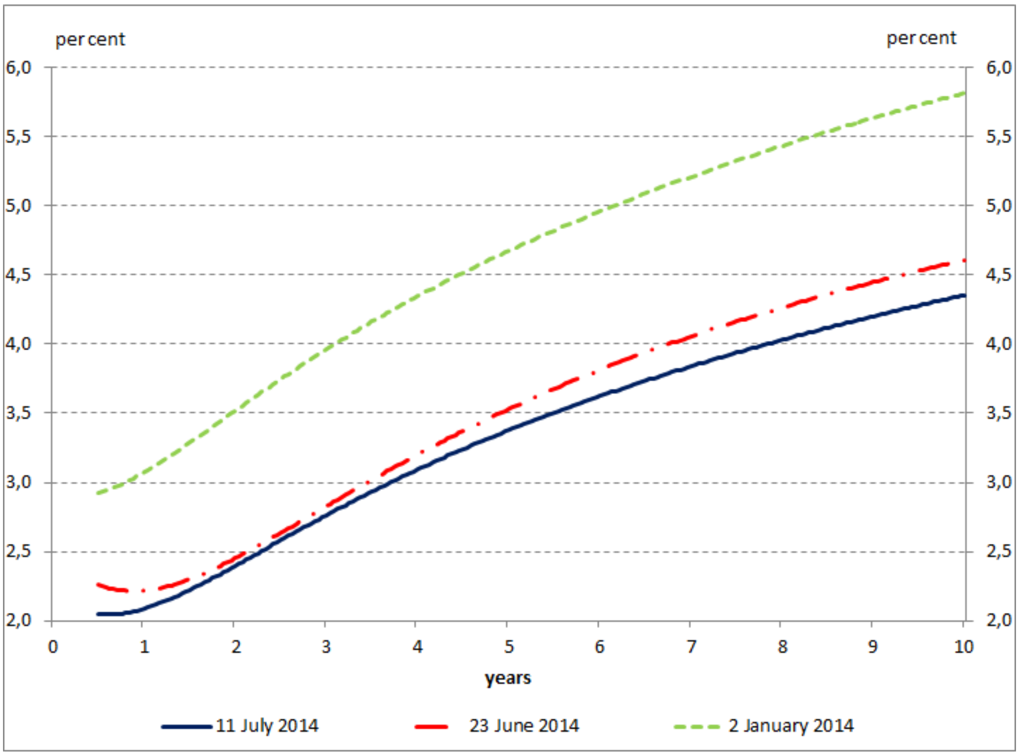
*Chart 13 EUR/HUF exchange rate and its implied volatility*




**The domestic five-year CDS spread has changed little since the latest interest rate decision, remaining around the low level of 170 basis points seen recently.** This represents a four-year low. Regional CDS spreads have also remained broadly unchanged over the past month. The small fluctuations in the domestic CDS spread may have been related to uncertainty about domestic foreign currency loan contracts.

**The government bond market yield curve continued to shift lower during the month.** The short-term yield level shifted downwards by 20 basis points, while long-term yields fell by 15 basis points. As a result, the three-month benchmark yield dropped to levels close to 2 per cent and the ten-year benchmark yield fell to 4.33 per cent, marking a historical low. The fall in yields in the region suggests that external factors may also have played a role in the downward shift, but low inflation data and the MNB's interest rate swap tenders may also have had a downward impact on yields in recent weeks (Chart 14).

*Chart 14 Shift in the spot government bond yield curve*

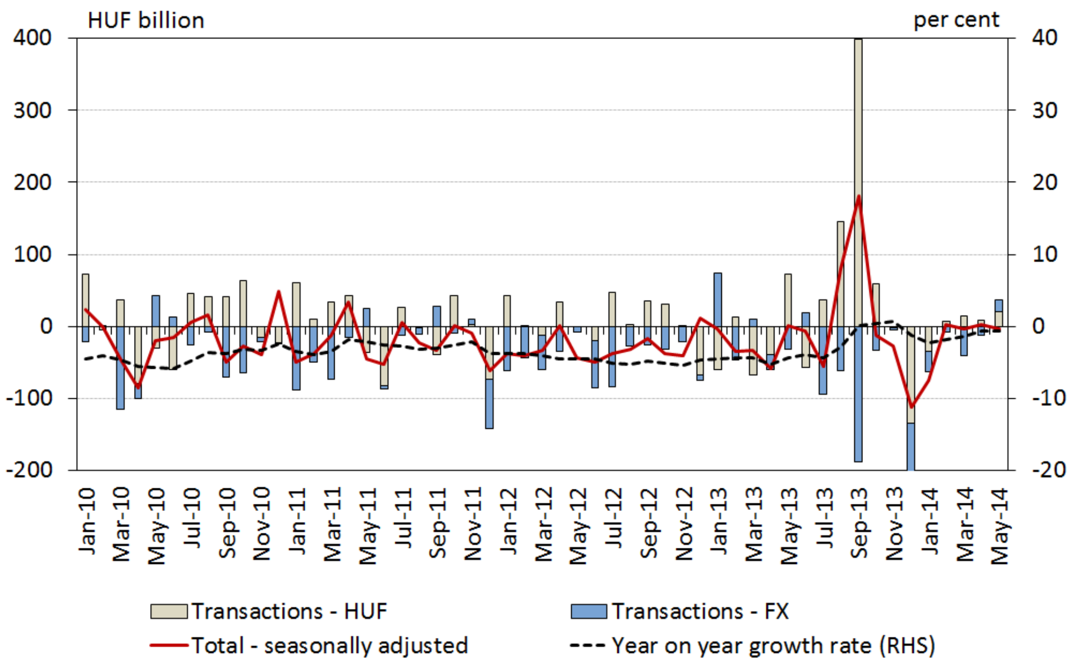



**During the month, the government bond auctions were accompanied by high demand and declining average yields.** In cases of long term bonds, ÁKK raised forint funds from the market substantially above the announced volume during the auctions. However, the amounts issued at the auctions of discount Treasury bills were smaller than previously and ÁKK did not raise amounts despite strong demand. **Holdings of government paper by non-residents changed little during the period,** amounting to HUF 4,900–5,000 billion. This is equal to a 43 per cent share of the Hungarian government securities market.

# 3 Trends in lending

**In May, the volume of outstanding bank lending to the corporate sector rose by around HUF 36 billion, resulting from broadly equal increases in forint and foreign currency loans** (Chart 15). As a result, the total stock of corporate loans fell by 0.7 per cent relative to a year earlier. This has been much more favourable for several months than the 4–5 per cent rate of decline during the period prior to Phase 1 of the Funding for Growth Scheme. On aggregate, movements in market interest rates broadly followed the Bank's easing cycle. In May, however, the average interest rate on small-value forint loans rose slightly, while that on larger-value forint loans fell relative to the previous month.

*Chart 15 Net borrowing by non-financial corporations*




**In May, households were net borrowers vis-à-vis the banking sector, with borrowing by households amounting to HUF 15.6 billion.** As a result, the annual rate of decline changed from 5.4 per cent in the previous month to 5.0 per cent. The increase reflected a HUF 46.1 billion rise in forint loans and a HUF 30.5 billion decline in foreign currency loans (Chart 16). The average interest rate on newly disbursed housing loans rose slightly in May, and that on home equity loans fell modestly.

*Chart 16 Net borrowing by households*