Macroeconomic and financial market developments

September 2014

Background material
to the abridged minutes of the
Monetary Council meeting
23 September 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

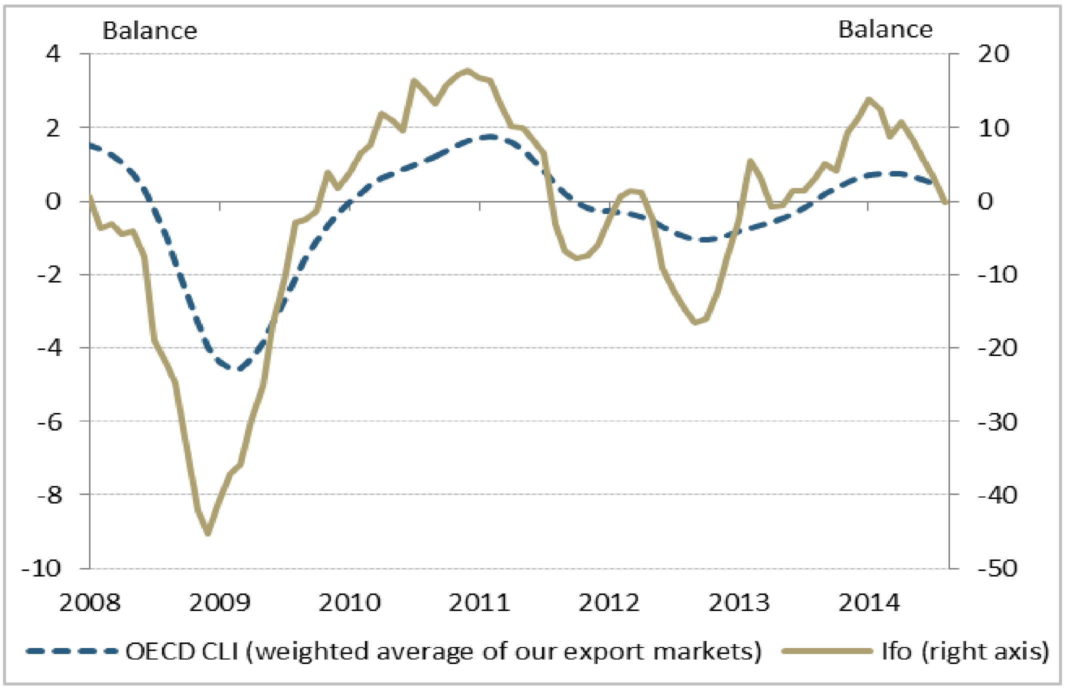
1.1 The global economy

Economic growth in Hungary’s export markets is gradually picking up. In recent months, euro area recovery has continued, although at a slow pace. However, second-quarter data turned out to be weaker than expected and expectations for growth in 2014 were revised down. The outlook for growth in emerging regions continues to be fragile. Heightened geopolitical tensions may also adversely affect the performance of developed countries through the effects of declining demand and economic sanctions. Inflationary pressures from the world market have remained muted in recent months.

Slow growth in the world economy continued in the second quarter of 2014. Growth continued to move on different paths for developed and emerging economies. Activity in emerging market economies which had previously shown rapid growth slowed down in the first half of 2014, in contrast with advanced economies where growth continued, but at a slower pace than previousely expected in the second quarter. This partly reflected weakening activity in major economies of Europe (including Germany, France and Italy) and the overall economic slowdown due to heightened geopolitical risks related to the conflict between Ukraine and Russia. Growth might even get slower in the second half of the year as economic sanctions are imposed.

In the second quarter of 2014, growth in the euro-area economy was flat relative to the previous quarter. Forward-looking indicators suggested a gradual slowdown in activity in recent months. This may primarily reflect the deterioration in the geopolitical situation. In addition, the increase in uncertainty and the gradually widening scope of mutual economic sanctions may lead to a slowdown in economic activity. In line with this, second-quarter data showed that growth was slightly weaker than expected. The industrial output of Germany, Hungary's most important trading partner, rose in July after stagnating in previous months, and the volume of new German industrial orders also rose (Chart 1).

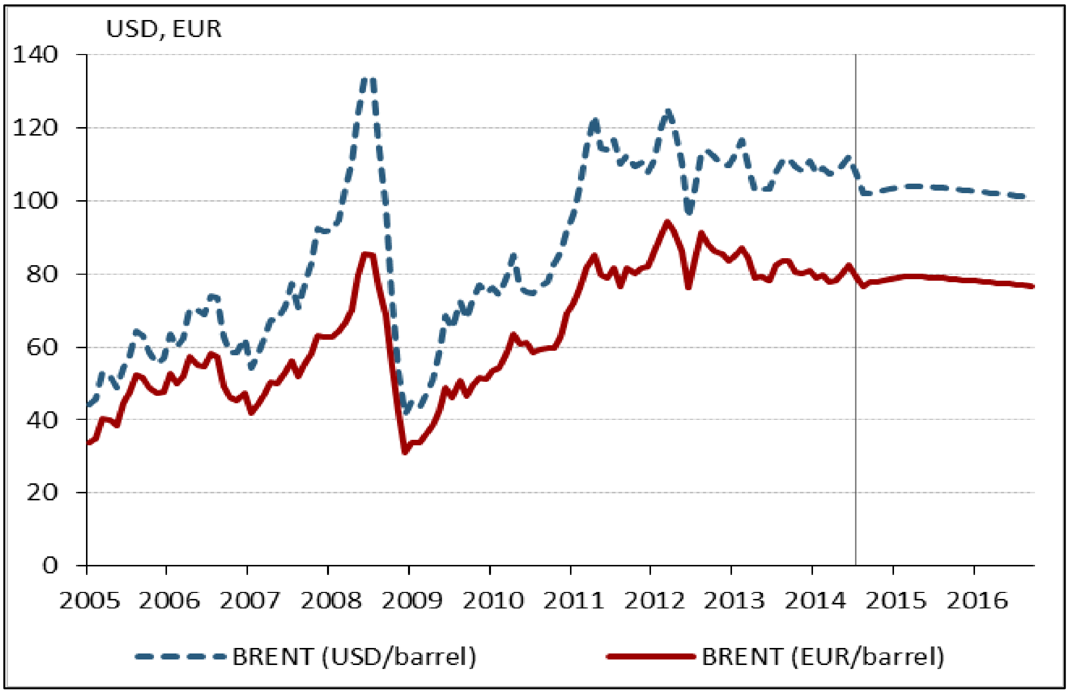
Chart 1 Indicators of activity in Hungary's export markets



Weaker-than-expected economic data were released in France and Italy, in addition to data showing a slowdown in Germany. However, the performance of Central and Eastern Europe was positive in the second quarter; the escalation of the conflict between Ukraine and Russia and the slowdown in Europe had only limited impact on growth in the CEE region so far.

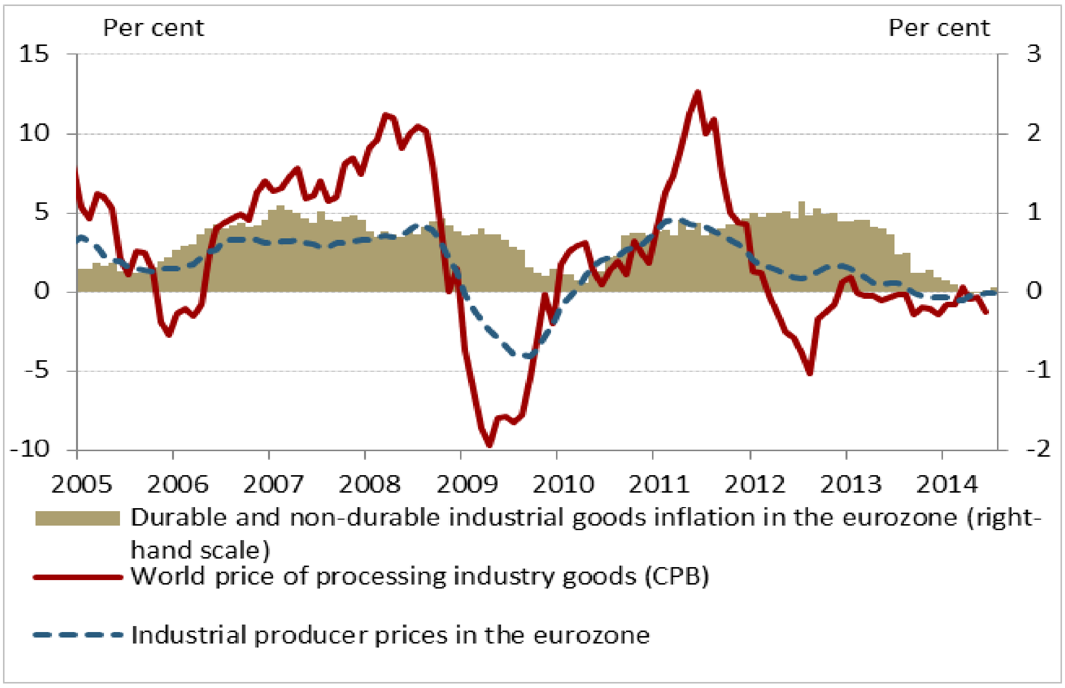
Inflationary pressures from the world market remained subdued. Declining commodity prices, combined with slow growth in the global economy, are exerting downward pressure on inflation. As a result, inflation rates remain below target in the world's major economies (the consumer price index continues to be unusually low in the euro area). The world market price of crude oil fell below USD 100 in early September. This may have reflected growing supply (an increase in oil production by Saudi Arabia and the pick-up in shale oil extraction in the US) and weak demand mainly on account of the slack growth in the larger oil-importing economies (Chart 2).

Chart 2 World market price of Brent crude oil



World market prices of industrial commodities, unprocessed food and manufactured goods remained moderate. (Chart 3).

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



1.2 Domestic real economic developments

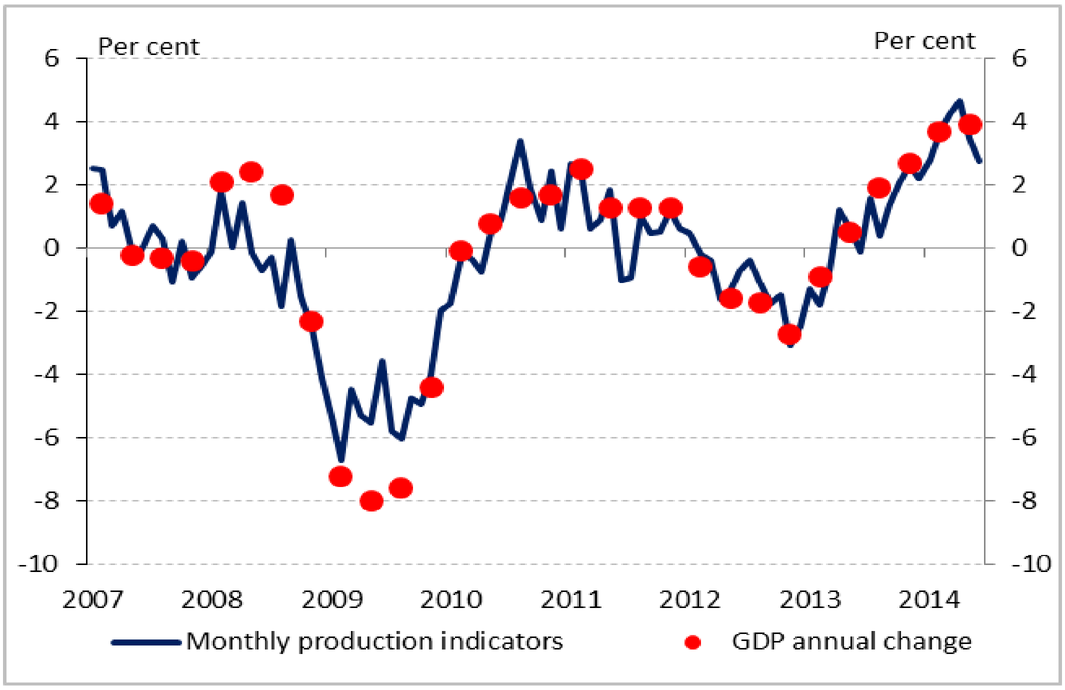
Economic growth continued in Hungary in the second quarter of 2014. Monthly indicators available for the third quarter suggest that output may have grown across a wide range of economic sectors, and domestic demand may have continued to pick up. Employment was flat for the whole economy in the second quarter, but private sector employment continued to rise.

1.2.1 Economic growth

In the second quarter of 2014, the economy continued to grow. Hungary's gross domestic product rose by 3.9 per cent relative to the same period a year earlier and by 0.8 per cent relative to the previous quarter.

Based on indicators available for recent months, growth continued to be robust in the third quarter (Chart 4).

Chart 4 Monthly production indicators and GDP growth*

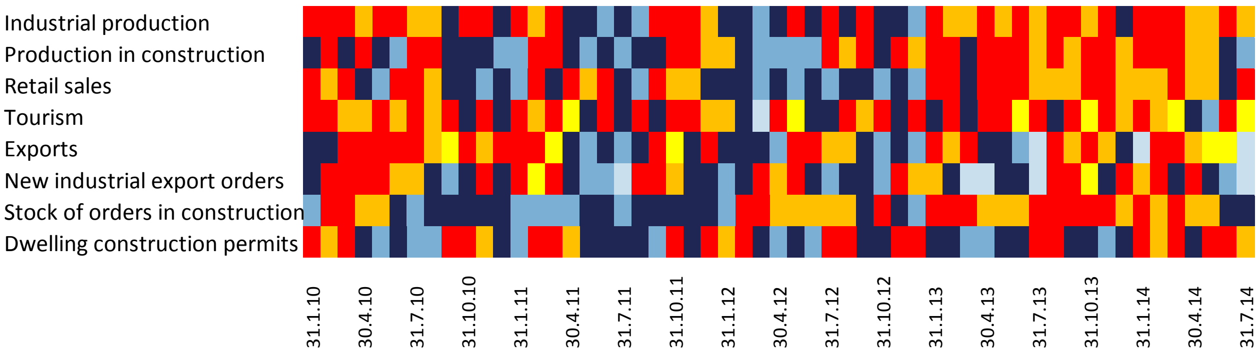


* Weighted average of monthly production indicators (industrial output, construction output and retail sales). The weights are derived from regression explaining GDP growth.

The performance of industry, construction and retail sales continued to expand year on year. In July, industrial production rose by around 2 per cent relative to the previous month and continued to grow strongly relative to the same period a year earlier. The favourable underlying developments in industry continue to be driven by the capacity expansion in vehicle industry. Output increased across a range of sectors. In July, construction output grew by 4 per cent relative to the previous month.

Economic growth was balanced, both exports and domestic demand accelerated in the second quarter. Investment activity remained the main driving force behind GDP growth, but consumption and exports also continued to expand. The contribution of net exports to growth fell, due to the rising import demand of the economy.

*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 12.3 per cent and a month-on-month rise of 2.0 per cent in July. Production increased across a wide range of manufacturing sectors. The output of motor vehicle sector, which still accounts for a significant weight, and the related industries grew the most strongly. The output of electronic and optical industry also grew significantly. Both industrial exports and domestic sales by industry rose markedly in July. **Goods exports continued to rise, in line with developments in industry.**

Construction output continued to rise in July, expanding at a year-on-year rate of 17.5 per cent. Government investment activity focused mainly on infrastructure financed from EU funding which contributed strongly to the performance of construction. Private sector investment remained subdued. In line with the favourable construction industry data, **building-type investment grew significantly in the first half of 2014, and data on the stock of orders also point to good performance by construction in the second half.**

The gradual increase in consumption demand may have continued in recent months. According to preliminary data, retail sales rose by 2.9 per cent in July year on year.[1] The improvement in the labour market and the significant rise in household real income, reflecting the historically low inflation environment, are underpinning the upturn in household consumption. However, the recovery is likely to be gradual, reflecting the continued dominance of precautionary savings and balance sheet adjustment by the households.

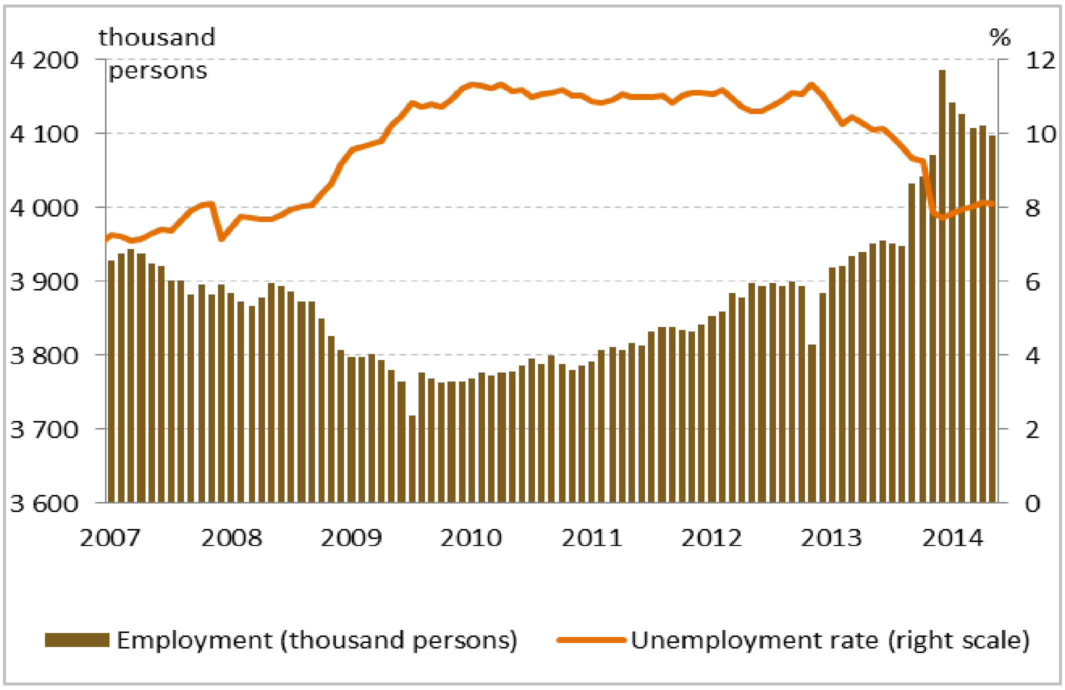
The September baseline projection points to continued economic growth with a balanced structure. The economy is expected to grow by 3.3 per cent in 2014. Growth is likely to continue on a quarterly basis, with the slowdown in the annual dynamics appearing as the result of base effects. The recovery in domestic demand, the intensive use of EU funds, loose monetary conditions, the improvement in the labour market and the strengthening of business and consumer confidence all support growth.

1.2.2 Employment

According to Labour Force Survey data, **the number of employees in the national economy rose by 3.8 per cent in July relative to a year earlier**. **However, employment was flat relative to the previous month, according to seasonally adjusted data.** Private sector employment rose slightly in the second quarter, but the number of public sector employees fell, which was mainly attributable to a reduction in public employment programmes. **Unemployment has been rising slowly since the beginning of the year, with the unemployment rate at 8.0 per cent in July** (Chart 6). The slight drop in employment since the start of the year mainly reflected the decline in the number of people participating in public employment programmes (Chart 6).

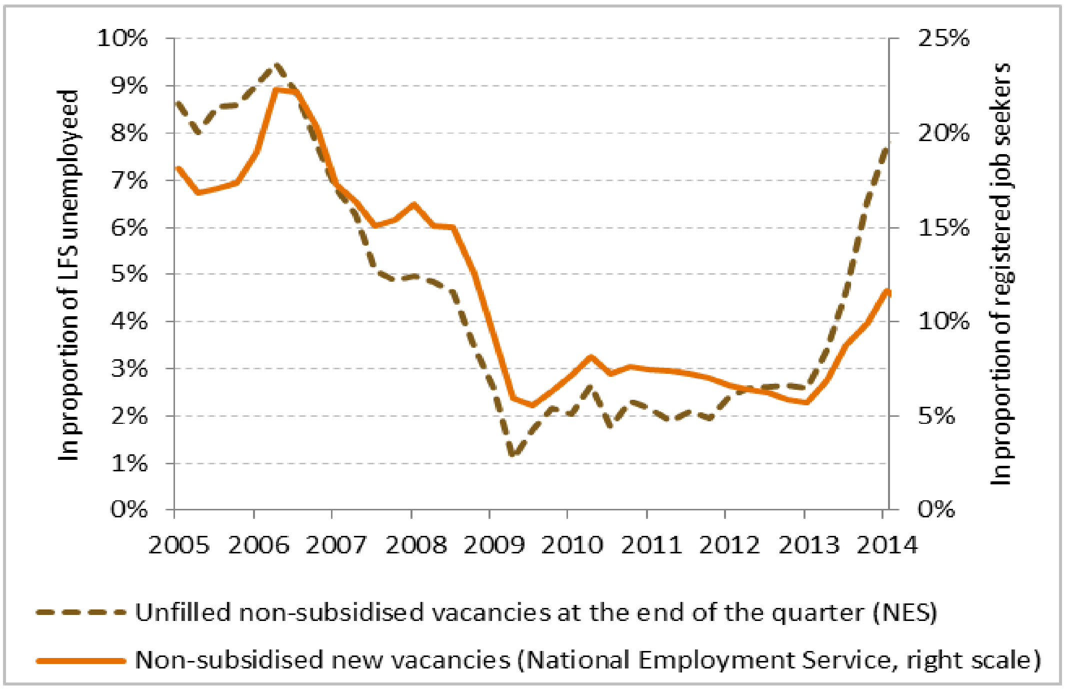
[1] In January 2014, the Central Statistical Office changed the method of monitoring the turnover of tobacco products. Instead of the representative sample-based assessment, it switched to the full data supplied by Nemzeti Dohánykereskedelmi Nonprofit Zrt. The figure published by CSO contains the tobacco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

Chart 6 Numbers employed and the unemployment rate



The number of newly announced, non-subsidised jobs fell in the second quarter relative to the previous period, according to data released by the National Employment Service. However, the number of vacancies has risen in recent months, which may suggest that mismatches in the labour market may be growing (Chart 7).

Chart 7 Indicators of labour market tightness



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

The labour market is less loose than at the end of last year, but during the second quarter the indicator of labour market tightness fell back from its elevated first-quarter level.

1.3 Inflation and wages

Inflation has been at historically low levels recently. Numerous factors contributed to the low inflation environment, such as low inflation in external markets, favourable developments in commodity prices and imported inflation, the subdued demand environment, the adjustment of expectations and the decline in administered prices. At the beginning of 2014, the private sector wage index accelerated, before stabilising in recent months.

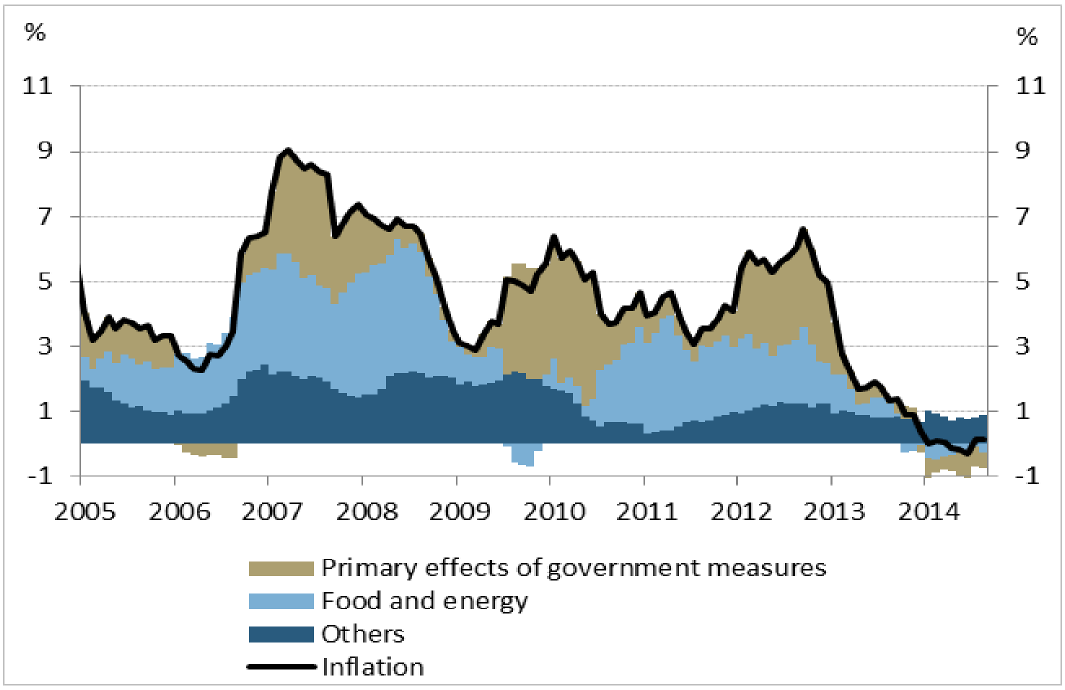
1.3.1 Wages

In the first half of the year, private sector wages rose by 4.8 per cent. However, in recent months, wage growth has been weaker relative to the beginning of the year. Wage growth in manufacturing was higher that in market services. At the beginning of 2014, the ratio of bonuses paid was higher than in previous years, but in recent months the bonus ratio has been broadly flat at the level of previous years. **Overall, wage dynamics remained subdued.The growth rate of unit labour costs in the private sector fell in the second quarter.**

1.3.2 Inflation developments

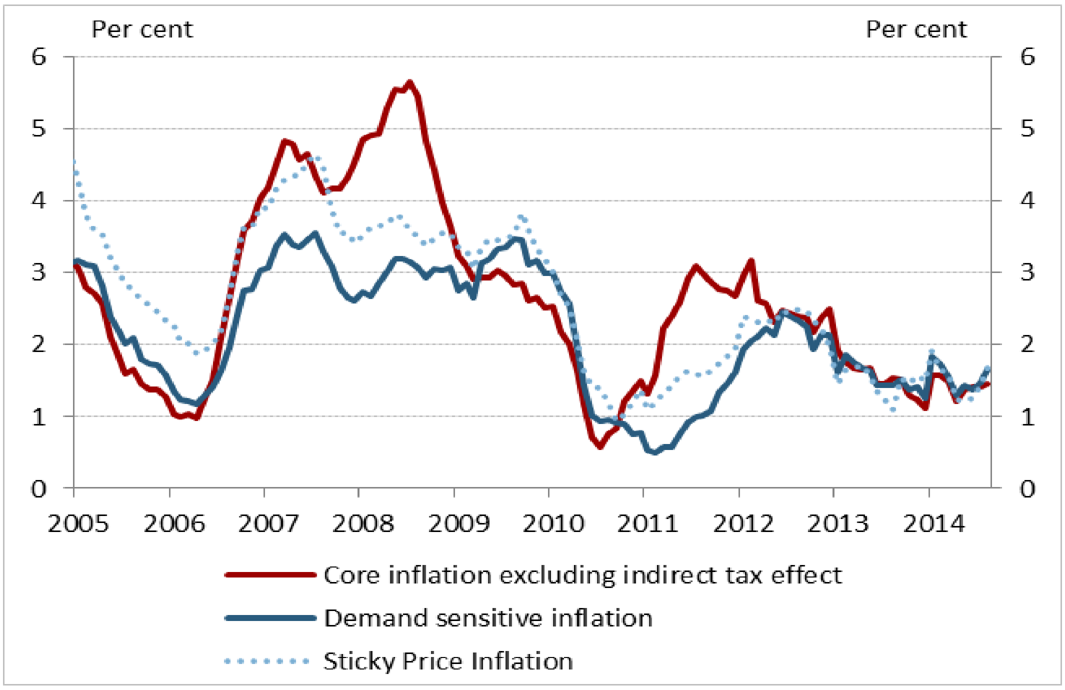
In August, consumer price inflation stood at 0.2 per cent and core inflation at 2.4 per cent.Core inflation excluding the effect of indirect taxes was 1.5 per cent (Chart 8). Inflation rose by 0.1 percentage point and core inflation fell by 0.1 percentage point relative to the previous month. The rise in inflation mainly reflected the dropping-out of the reductions in administered prices implemented in the middle of 2013.

Chart 8 Decomposition of the consumer price index



Favourable cost 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).

Chart 9 Measures of underlying inflation



In June 2014, agricultural producer prices fell by 5.1 per cent in annual terms, while domestic sales prices of the sectors producing consumer goods rose by 1.2 per cent relative to a year earlier. Fuel prices fell in August year on year. Based on retail sales data, consumption demand may have increased gradually in recent months, in line with year-on-year rises in real incomes. Despite this, however, the volume of retail sales remained significantly below levels seen in the years prior to the crisis. Consequently, domestic demand is likely to continue to exert a disinflationary impact, though this effect is gradually fading.

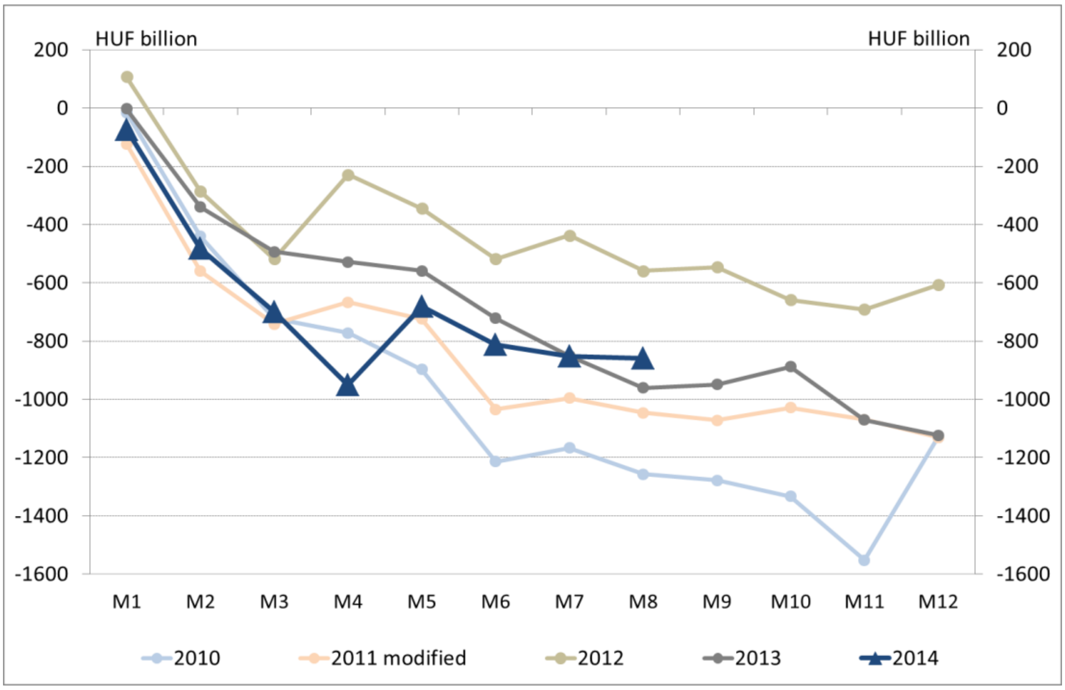
Inflation in Hungary is expected to remain around 0 per cent in the short term. The July–August inflation data were slightly higher than the projection in the June *Inflation Report*. Inflation is expected to sink slightly into the negative domain in September and then rise from the end of the year as the effects of the reductions in administered energy price of last autumn wear off.

1.4 Fiscal developments

In August, the government budget registered a deficit of HUF 7 billion, which was HUF 103 billion lower than a year earlier. On the revenue side, the difference is explained by the effects of favourable macroeconomic developments on consumption and wages. On the expenditure side, there were contrasting developments: net expenditures by the budgetary units and chapters and other expenditures by central government exceeded levels seen last August, but this effect was more than offset by lower net interest expenses and other expenditures.

The government deficit amounted to HUF 859 billion in the first eight months of the year, accounting for 87 per cent of the annual target. The cumulative deficit was lower than values recorded in previous years (Chart 10).

Chart 10 Intra-year cumulated balance of the government budget



1.5 External balance

According to the monthly data release for July, the external surplus of the economy has increased. Hungary's external financing capacity, calculated as the combined surplus on the current and capital accounts, amounted to around EUR 735 million. The higher external financing capacity reflected an increase in the transfer surplus which also includes EU funding. In addition to the transfer balance, the seasonally adjusted trade surplus also increased slightly as a result of exports rising more strongly than import growth. The use of EU transfers amounted to around EUR 500 million, the majority of which, at EUR 360 million, was dedicated to supporting investment. The economic sectors spent nearly EUR 2.8 billion in the first seven months of the year.

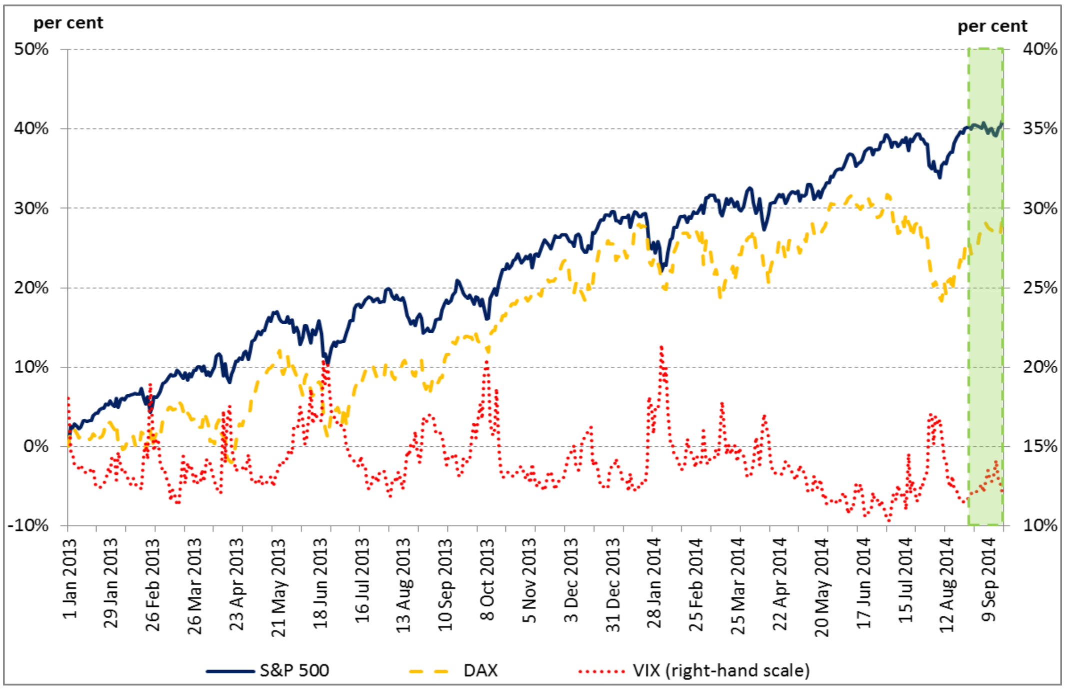
At nearly EUR 1 billion, financial accounts data indicated a higher financing capacity than that calculated as the combined current and capital account surplus. Declines in debt liabilities (EUR 620 million) and non-debt liabilities (EUR 330 million) contributed to the outflow of funds. Transactions by the banking sector and consolidated general government accounted for most of the decline in net external debt, while the external debt of the corporate sector was broadly unchanged. The decline in the banking sector's net external debt, however, reflected an increase in the sector's external assets rather than a decrease in external liabilities. The decline in nonresident holdings of discount Treasury bills and MNB bills accounted for most of the reduction in net external debt of the consolidated general government. The foreign currency bond maturity in July did not have a significant impact on the sector’s net external debt, as the repayment was also reflected in the level of foreign exchange reserves. The decline in non-debt liabilities was closely related to the fall in net portfolio equity investments, which mainly reflected equity purchases abroad by Hungarian residents. Consequently, net foreign direct investment fell only marginally in July, following sharp outflows in the second quarter.

2 Financial market developments

2.1 International money markets

Risk appetite has been volatile in international financial markets in the period since the Monetary Council's previous interest rate decision. This reflected the Russian military intervention in Ukraine, followed by the violation of the ceasefire, the ECB's interest rate decision and uncertainty about the start of policy tightening by the Fed. On balance, US equity markets remained at levels close to their historical highs, and the escalation of military conflicts in Ukraine had a short-lived impact on European markets. The VIX index, measuring volatility in equity markets, rose slightly by 1.5 percentage points before falling back to its opening levels by the end of the period. The EMBI index, a gauge of emerging market bond performance, also remained in a relatively narrow range, fluctuating between 300 and 315 basis points in the period (Chart 11). The price of Brent crude oil fell below USD 100 after OPEC countries raised their oil production forecast. Long-term yields have risen slightly, after the slow, steady decline since the beginning of the year, with ten-year yields in developed countries up 10–20 basis points. Yields in the periphery countries were flat or rose slightly by 5–15 basis points, but remained close to their historical lows.

Chart 11 Developed market equity indices and the VIX index (right axis)



The conflict between Ukraine and Russia and its developments contributed to volatility in financial markets. Frictions escalated when Russian troops marched into Ukrainian territory, but the announcement of ceasefire brought some relief to international markets. In mid-September, however, the European Union decided to impose a new set of sanctions against Russia, limiting the access of the largest Russian energy industry companies and state-owned large banks to western funding and introducing a ban on the use of EU technology for oil drilling and production by Russia. In mid-September, Ukraine signed a free-trade agreement with the European Union.

The volatility of risk appetite was also reflected in movements in emerging market currencies. On balance, the majority of emerging country currencies depreciated against the US dollar during the period, with the Russian rouble suffering the greatest losses weakening by more than 4 per cent. The majority of emerging market currencies were flat or appreciated slightly against the euro, partially reflecting the depreciation of the single currency against the US dollar. Movements in yields in the Central and Eastern European region were divergent: Czech and Slovenian yields fell, while those in Poland, Romania and Hungary rose.

The divergent interest rate policies pursued by developed country central banks remained the focus of investors' attention. The ECB reduced further its policy rate and announced new liquidity-providing measures. As a result, by the end of the period the euro-dollar exchange rate had weakened by 2 per cent from 1.32 to 1.29, a level not seen for more than a year. Macroeconomic news from the US and EU economies reinforced the picture that while the US economy was growing steadily, the recovery in the euro area continued to be uncertain, as reflected in the sharp deterioration in forward-looking business expectations.

In early September, the ECB announced new quantitative easing measures, which surprised markets. Although analysts had expected the ECB to take such action in the autumn, the majority anticipated this step only after the launch of the TLTRO tender in September. Euro-area inflation fell to a new record low of 0.3 per cent in August, which may have played a role in triggering this decision. Macroeconomic data from Germany also raised the possibility of a slowdown in the economy. The decision may also have been prompted by the fact that euro-area medium and long-term inflation expectations, which appeared to be well-anchored in the first half of the year, have recently shifted downwards relative to the ECB's target of around 2 per cent. As an effect, the ECB announced that it would purchase asset-backed securities and covered bonds issued by euro-area financial institutions starting from October, in addition to its decision to reduce its key policy rate by 10 basis points. Markets expect the Fed to make important announcements in the autumn. Contrary to market expectations, the Fed did not significantly alter its previous communication or forward guidance with respect of the timing and pace of policy normalisation at its September meeting. As a result, US equity markets closed at new historical highs. The Bank of Japan did not change its monetary policy. However, markets expect the Bank to introduce new policy easing actions to ensure that the 2 per cent inflation target can be achieved within the intended time frame. Partly in response to this, the Japanese yen has weakened by 2.5 per cent against the dollar since the previous interest rate decision. The Bank of England also left its policy rate unchanged and did not alter its other monetary policy measures. In the emerging region, the Polish central bank left interest rates unchanged, but the possibility of monetary easing increased going forward, in light of the change in the Bank's forward-looking communication.

2.2 Developments in domestic financial market indices

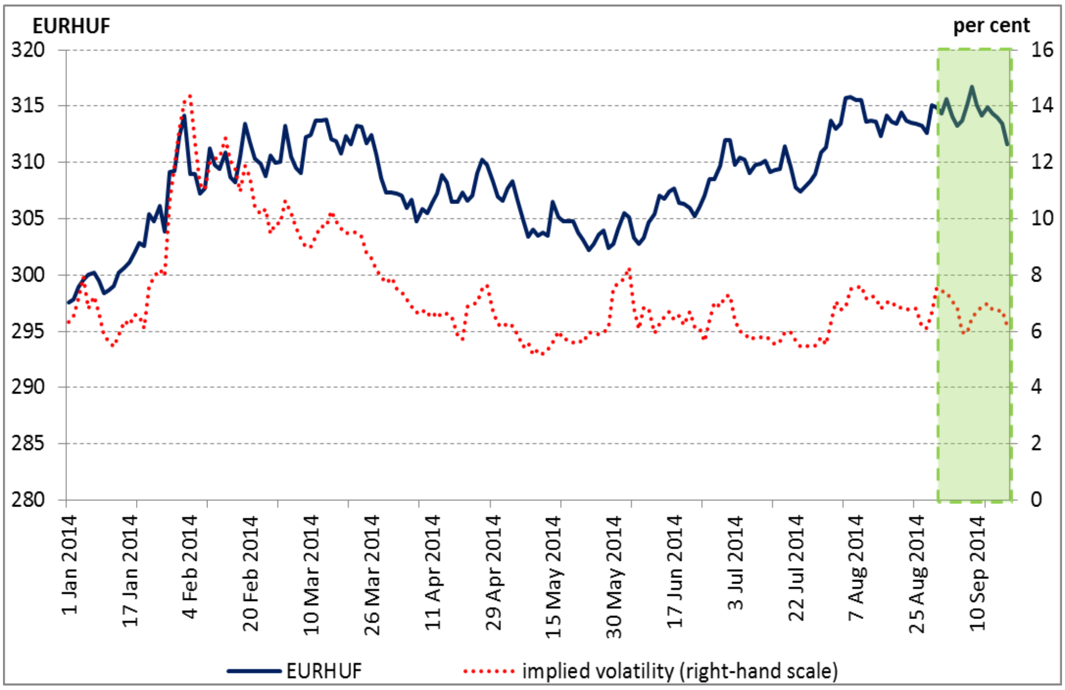
Domestic financial market developments have been influenced mainly by international trends since the Monetary Council's last interest rate decision. Developments related to foreign currency loans contained country-specific news, but this had little market-moving impact. In light of movements in emerging market currencies, CEE currencies were average performers, with their depreciation closely related to the Fed and the conflict between Ukraine and Russia.

The similar performance of the forint to other currencies in the region was associated with slightly greater volatility, as seen in the previous month. There was some forint-specific appreciation in the final days of the month. The exchange rate fluctuated in a range between EUR/HUF 310 and 317. The 0.5–0.6 per cent depreciation of the forint was about average among the currencies of the region (the forint weakened to a 2.5 year low against the US dollar, euro and Swiss franc[2]). Analysts believe that uncertainty about the rescue programme for foreign currency debtors may also have contributed to increased volatility, but they think that the fall in

[2] Against the dollar, the exchange rate was last weaker than the current levels in June 2012 and against the euro and Swiss franc in January 2012. The forint fell to a historic low against the pound sterling in August.

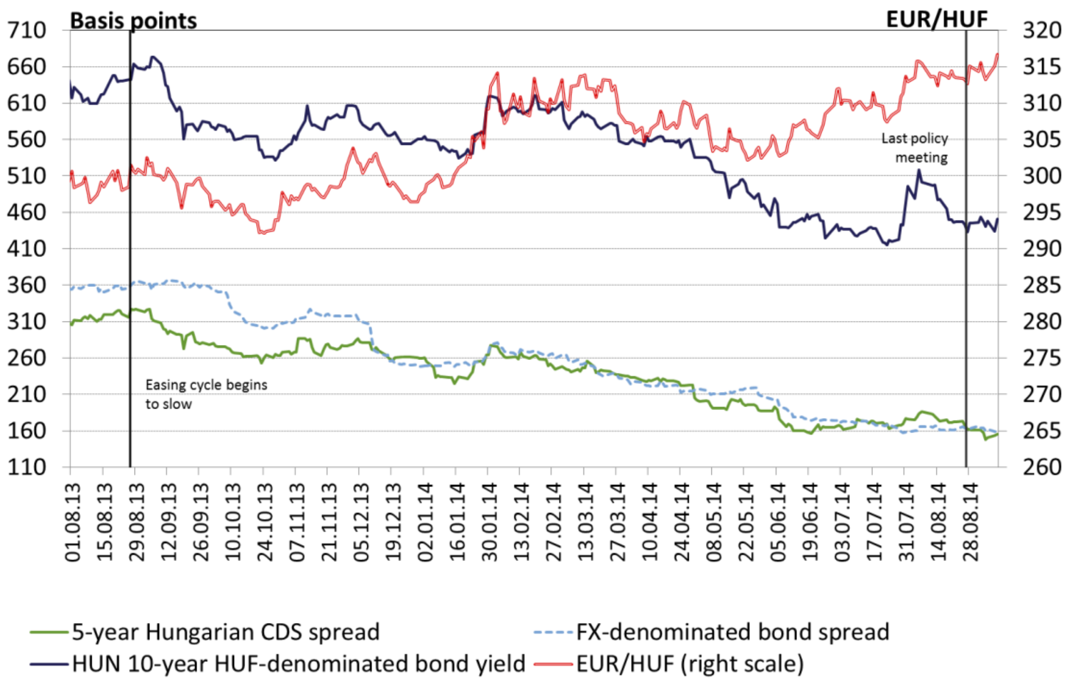
foreign currency exposure may have positive effects over the longer term. In addition, a misleading Bloomberg headline, corrected later, may also have played a role in the forint temporarily weakening more than other currencies of the region. In contrast to the statement by Deputy President Ádám Balog, the headline delivered the message that the policy easing actions of the ECB provided greater room for manoeuvre in Hungarian monetary policy. In recent days, there has been a correction in the forint exchange rate, accompanied by a slight appreciation. No significant shifts occurred in the measures of volatility and skewness (Chart 12). Interest rate expectations remained broadly unchanged and forward rate agreements were around the level of the base rate at maturities between six months to one year.

Chart 12 EUR/HUF exchange rate and its implied volatility



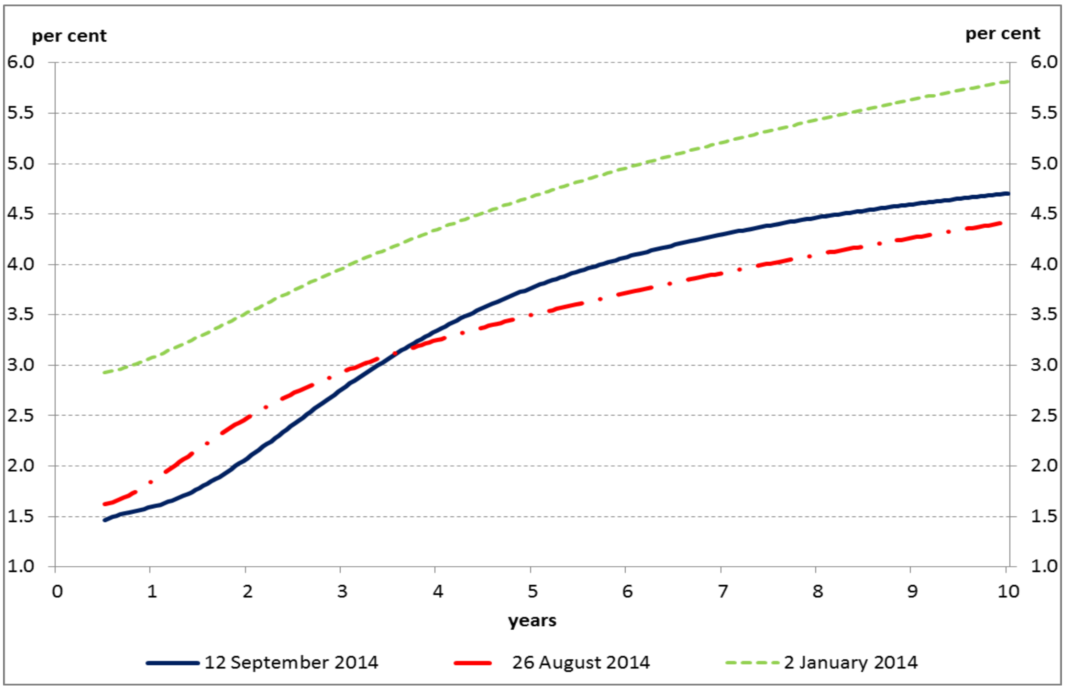
There was some tension in the swap market, with short-term implied forint yields falling to low levels, although the decline was partly reversed in the final days of the month. The increase in forint liquidity and low counterparty limits of certain market participants both contributed to the fall in yields and implied forint interest rates on FX swap transactions. Since the previous interest rate decision the domestic five-year CDS spread has changed only slightly in response to international events. Its current level of around 160 basis points is a historic low. Based on the recent period, **the CDS spread has fallen steadily as the forint exchange depreciated, in contrast to the previous trends** (Chart 13).

Chart 13 Domestic risk indicators



The steepness of the yield curve has increased since the last interest rate decision. The short end shifted down by 15–20 basis points, and remained flat at three months. At maturities beyond one year, longer-term yields increased strongly by 15–20 basis points, with the three year yield rising only slightly. The three-month benchmark yield fluctuated around 1.35 per cent and the ten-year yield rose to around 4.6–4.7 per cent during the month. On balance, spreads between interbank rates and securities yields widened further. Securities yields are 60–80 basis points lower at the short end of the curve than interbank rates and 80–90 basis points higher at longer maturities (Chart 14).

Chart 14 Shifts in the spot government bond yield curve

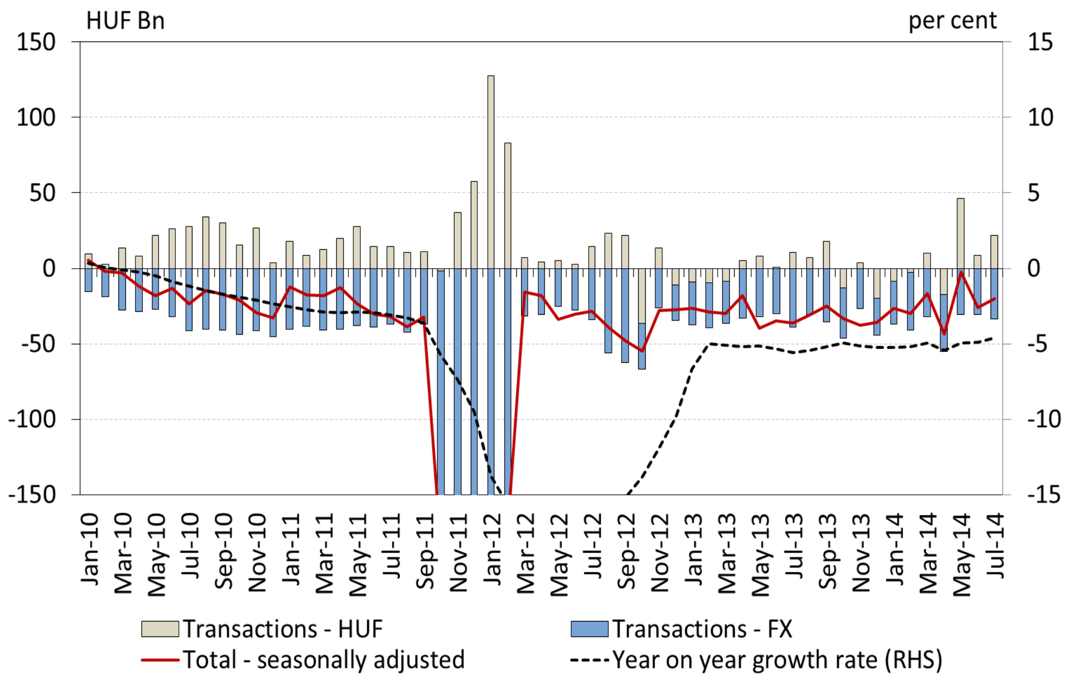


Demand at the government bond auctions weakened relative the previous months, mainly at shorter maturities. At the auctions of three-month paper held in the month, yields declined as demand fell. Investor demand was mixed at the auctions of long-term securities, but the Government Debt Management Agency was generally satisfied with demand. Demand was strongest for three year floating-rate interest-bearing securities, with coverage being 3.5 and 5.5 times the amount on offer at the two auctions held in the month. Holdings of government paper by non-residents were broadly unchanged, with the total fluctuating within a narrow range.

3 Trends in lending

In July, households were net repayers of debt, with the sector's transactions amounting to HUF -12 billion (HUF -20 billion seasonally adjusted). The reduction in foreign currency loans continued to account for the fall in the stock of lending, while new disbursements of forint loans exceeded repayments by some HUF 22 billion in the month. **The annual rate of increase changed from -4.9 per cent in the previous month to -4.6 per cent** (Chart 15).

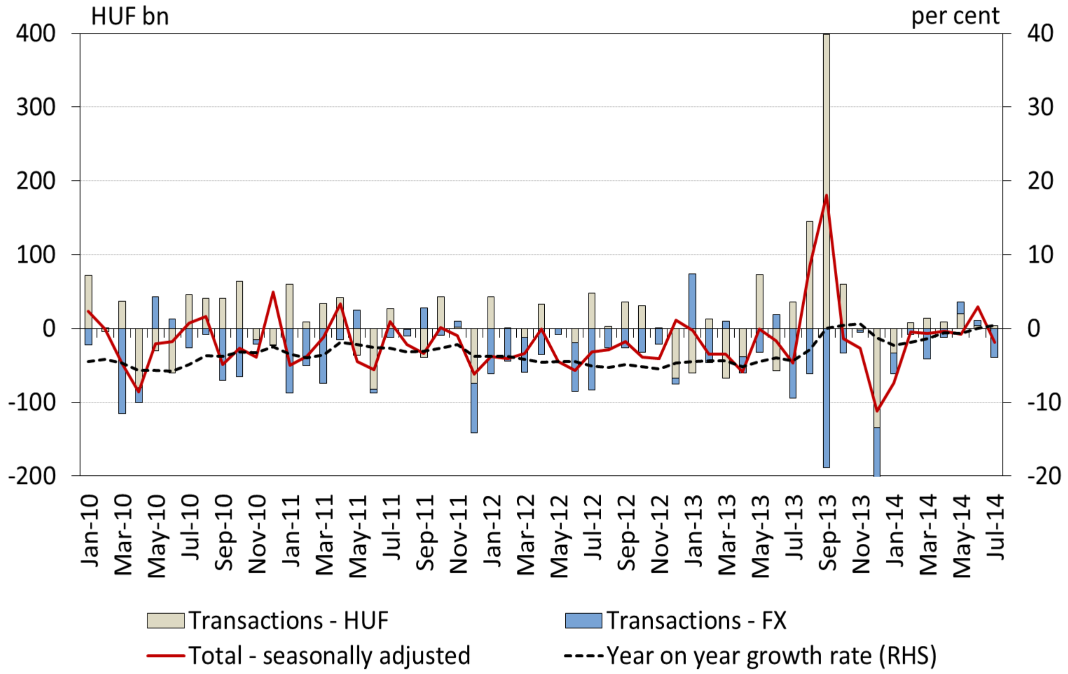
Chart 15 Net borrowing by households



Lending by credit institutions to the household sector amounted to HUF 54.0 billion, up nearly 30 per cent on the volume of new lending a year earlier. Lending for house purchases picked up particularly strongly: the volume of new business in this segment was some 70 per cent higher than in July 2013.

In July, outstanding bank lending to the corporate sector fell by a total HUF 35.0 billion (by HUF 19.0 billion seasonally adjusted) due to transactions (Chart 16).

Chart 16 Net borrowing by non-financial corporations



The corporate sector was a net borrower in the forint and net repayer in foreign currency. Loans disbursed under Pillar 1 of the Funding for Growth Scheme contributed some HUF 41 billion to the increase in the stock of forint lending in June. Although the seasonally adjusted amount of transactions was negative in the month, it exceeded the data for July 2013, with the annual rate of growth rising to 0.4 per cent.