Macroeconomic and financial market developments

December 2014

Background material
to the abridged minutes of the
Monetary Council meeting
16 December 2014

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The background material 'Macroeconomic and financial market developments' is based on information available until 12 December 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

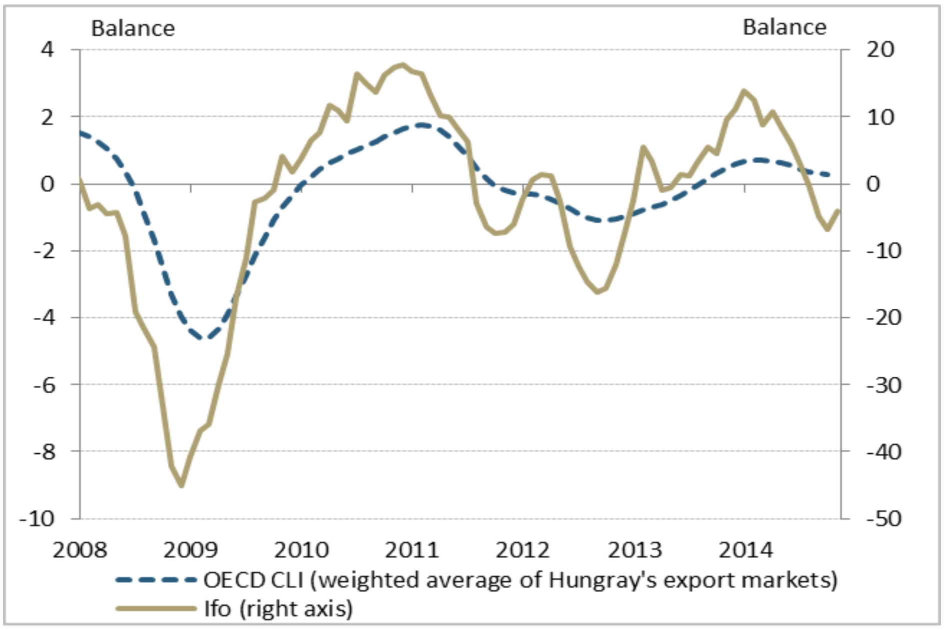
1.1. The global economy

Based on data for recent months, economic growth in Hungary's export markets has slowed. The outlook for growth this year deteriorated and, looking ahead, the dynamics of growth are likely to be more moderate than previously expected. The outlook for growth in the world's emerging regions also continues to be fragile. Geopolitical tensions may also adversely affect the performance of developed countries through the effects of declining demand and economic sanctions. The inflationary pressure from foreign markets has remained muted in recent months. The pronounced decline in the global oil prices in recent weeks has significantly reduced the inflation expectations for the coming year.

Growth in the world economy continued in the third quarter of 2014, but at a slower-than-expected rate. Based on available data, growth was consistent with the deterioration in the outlook in previous months. In some euro-area economies, growth turned out to be slightly better. The slowdown in economic activity partly reflected the adverse effects of the conflict between Ukraine and Russia and the related economic sanctions, which may intensify looking ahead. Emerging market economies, where growth had been rapid in previous years, have slowed significantly this year and, looking ahead, growth prospects are modest, which can be mitigated by the decline in world commodity prices.

The euro-area economy registered a quarter-on-quarter growth rate of 0.2 per cent in the third quarter of 2014. The monthly production data received show a slowdown in the economic activity of the region. Simultaneously, the forward-looking indicators of economic activity also imply a negative performance (Chart 1). However, the deterioration of expectations for German economic growth came to a halt in November. The slowdown in economic activity is partly the result of the tense geopolitical situation: the growing insecurity and the expanding bilateral economic sanctions could cause a slowdown in economic activity. In line with expectations, third-quarter growth slowed as foreshadowed by the deterioration in indicators of economic activity and production data.

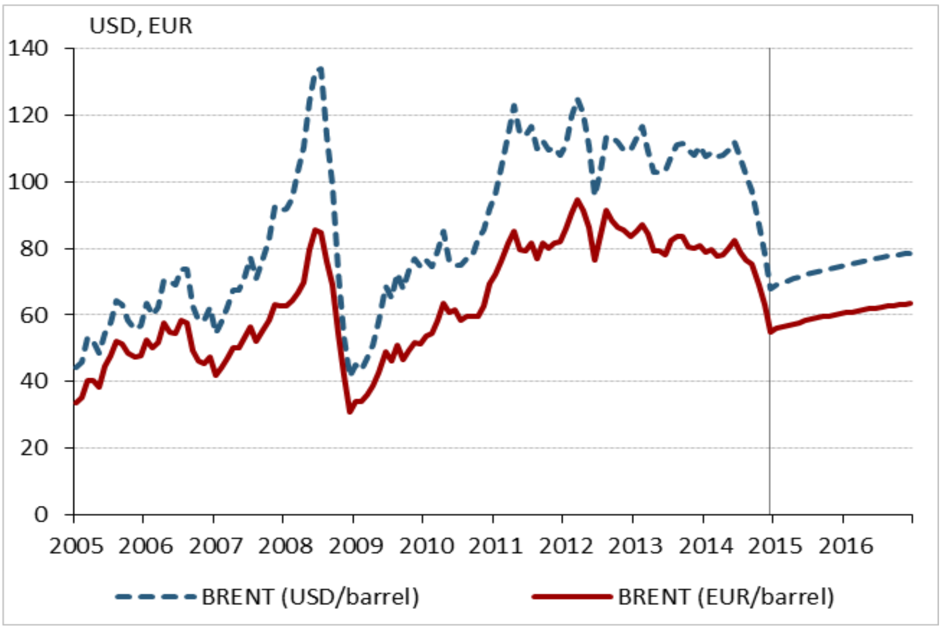
Chart 1: Indicators of activity in Hungary's export markets



The performance of Central and Eastern Europe was favourable in the third quarter, but industrial output slowed in the region in recent months according to monthly indicators.The escalation of the conflict between Ukraine and Russia and the slowdown in Europe have had only a limited impact on growth in the CEE region so far, but looking ahead, the slowdown in the euro area may lead to a weakening in growth in the region as well. The industrial output of Germany, Hungary's main trade partner, corrected only partially in September and October after a significant decline in the August.

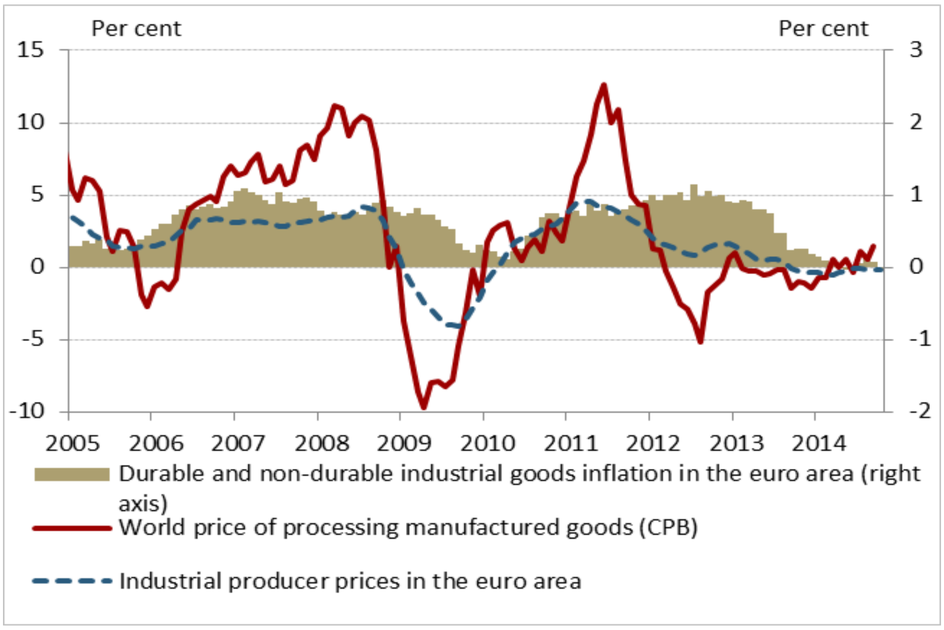
Inflationary pressures from the export markets continued to weaken. Declining commodity prices, combined with slow global growth, have reduced inflation. As a result, inflation rates remain below target in the world's major economies and the consumer price index continues to be low in the euro area. The global oil price continued to decrease in December and dropped to nearly 65 Dollars during the month. Movements in the price of oil reflect weak demand mainly on account of slow growth in the larger oil importing economies, in addition to growing supply boosted by an increase in oil production by Saudi Arabia and the pick-up in shale oil extraction in the US (Chart 2). The OPEC meeting in Vienna in late November exercised further downward pressure on oil prices. Led by Saudi Arabia, the OPEC countries pooling oil exporting countries giving about 40 per cent of the global oil production, decided not to reduce their production quota.

Chart 2: World market price of Brent crude oil



The dynamics of the world market prices of industrial commodities and unprocessed food remained moderate. The world market prices of manufactured goods continued to be low (Chart 3).

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



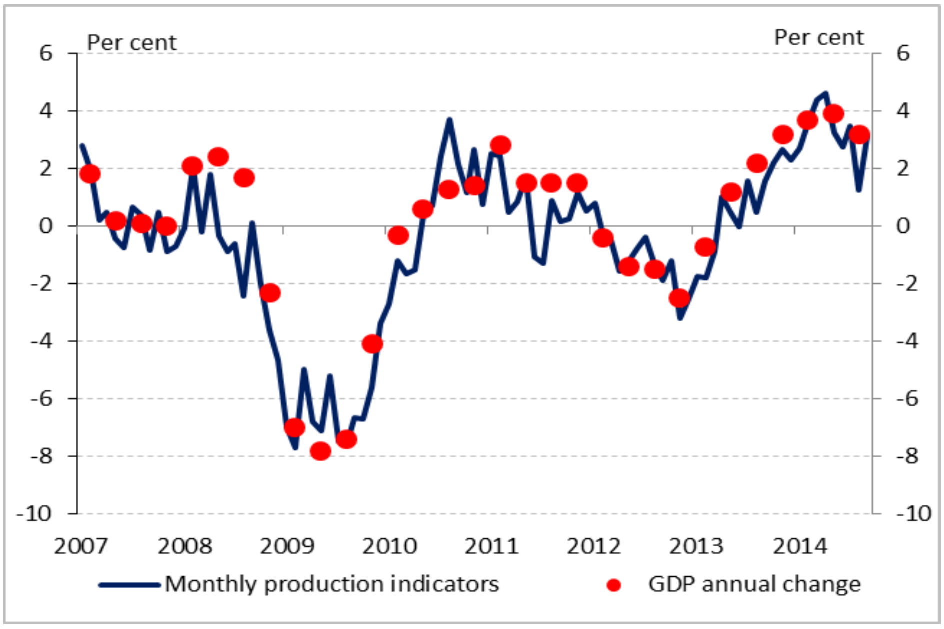
1.2. Domestic real economic developments

1.2.1. Economic growth

The economy continued to grow in the third quarter of 2014. Hungary's GDP expanded by 3.2 per cent relative to the same period a year earlier (0.5 per cent growth relative to the previous quarter).

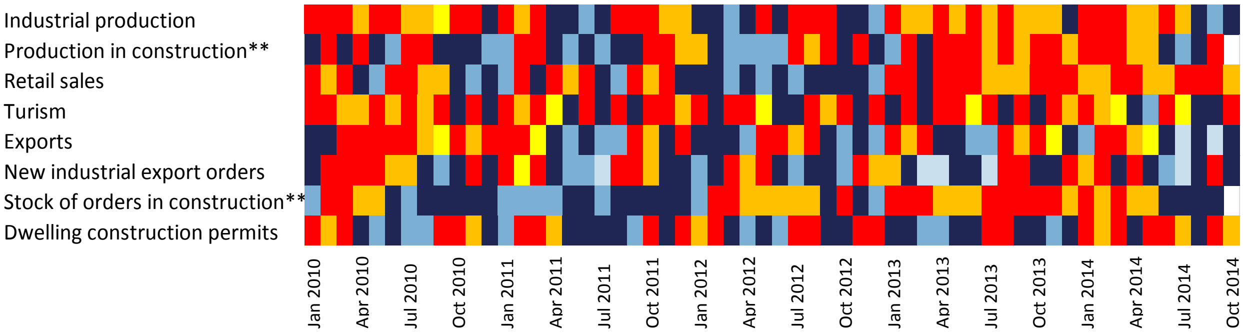
Growth slightly slowed in the third quarter (Chart 4). The industry and the construction industry contributed to GDP growth positively, although to a lesser extent than in the first half of the year, while the contribution of agriculture increased. In parallel with the recovery of internal demand, the added value also expanded in a wide range of market services. Based on the monthly production indicators, growth is expected to slow further in the fourth quarter, which is supported by the data available on the industrial production in October as well.

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.

*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.

** There are no data available for October.

The industrial production was weaker in recent months than previously. The output increased in the third quarter by 6.6 per cent on an annual basis, however, it fell by 0.7 per cent on a quarterly basis. **Based on the October data and on a yearly basis, the dynamics continued to slow** (the growth was 1.7 per cent) and production **decreased by 2.6 per cent compared to the previous month**. The output in seven of the thirteen manufacturing subsectors decreased compared to September. Of the subsectors of engineering industry, representing a significant weight, electronics and optics, as well as vehicle production witnesses a decline in production. The subdued than expected European economic growth and Russian-Ukrainian conflict, and the economic sanctions imposed as a result, can negatively affect the year-end industrial output. Forward-looking indicators provide mixed signals for the short-term outlook. The expectations for the German economy are at a moderate level, while the confidence indicator for the Hungarian economy continued to improve.

In parallel with the decline in industrial value added, exports grew in the third quarter at a slower pace than in the first half of the year. Import growth was faster quarter-on-quarter than export growth due to the pick-up in domestic demand and one-off factors (filling the gas storage facilities). As a result, the contribution of net exports to growth was negative in the third quarter.

Construction output rose at 7.3 per cent (year-on-year) in September, but fell by 1.5 relative to the previous month. Investments focused mainly on infrastructure financed from EU sources continued to be a major factor contributing to the performance of the sector, while private sector investment activity remained subdued. **The sharp decline in the number of new contracts for construction observed in recent months and the gradual decline in orders for construction point to a slowdown in this sector's output growth in the fourth quarter.**

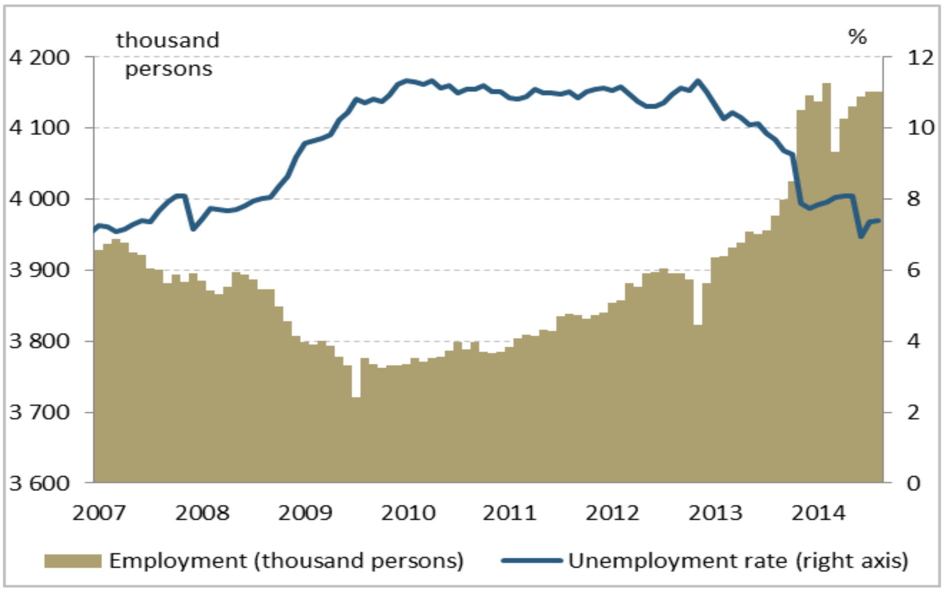
Household consumption expanded further in Q3, bolstered by rising real wages reflecting the improved labour market and low inflation as well as the upswing in retail sales. The expansion of household consumption expenditure remained below the dynamics of retail trade turnover, noting that the latter could be increased by the whitening effect resulting from the activation of the National Tax and Customs Administration cash registers and spending by non-residents during the summer tourist season. According to preliminary data, retail sales continued to rise in October and the gowth rate reached 5.2 per cent (year-on-year).

The baseline projection of the December Inflation Report foresees continued growth with a balanced structure. The economy is expected to grow by 3.3 per cent in 2014. Hungarian economic growth may slow down on a quarterly basis, in part reflecting one-off effects. The dynamics of export will be restrained in 2015 by the subdued global economic cycle and the slowdown of the euro area, but the contribution of net exports to growth may increase during the second half of the forecast horizon. The expanded and extended Funding for Growth Scheme may boost corporate investment activities next year, but the weak international economic activity and the decrease in the inflow of EU funds have an opposite effect. The investment activity of households may gradually rise from historically low levels. As seen in previous quarters, real income rising due to low inflation is playing a key role in the recovery in household consumption. As a result of the legislative process affecting households loans, households net financial wealth is expected to increase, accelerating the deleveraging process. The conversion of foreign currency loans for forint-nominated loans can reduce the uncertainty about future income and financial situation, thus strengthening consumer confidence and supporting the growth of consumption and domestic demand.

1.2.2. Employment

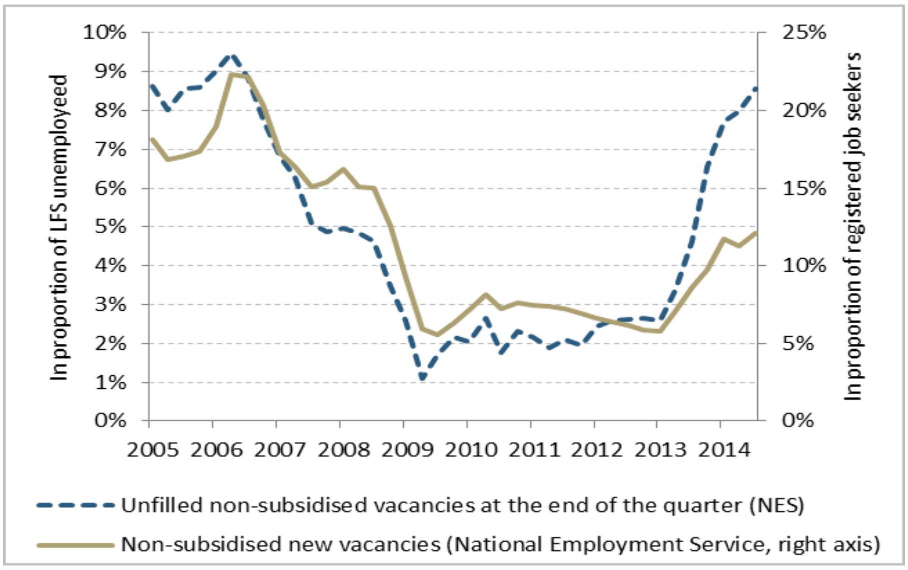
According to Labour Force Survey data, the number of employees in the national economy rose by 4.8 per cent in the third quarter relative to a year earlier. Employment in the competitive sector continued to expand over the previous quarter. Public sector employment rose. Unemployment decreased in the third quarter after rising in the previous period (Chart 6).

Chart 6: Numbers of employed and the unemployment rate



In October, the number of newly announced non-subsidised jobs decreased compared to the previous month. The number of month-end vacancies did not change essentially during the past months, but the number of unfilled vacancies returned to pre-crisis levels in the past 18 months, which may suggest that mismatches in the labour market are growing. **The labour market is tighter than at the beginning of last year** (Chart 7). In October, the number of reported layoffs declined compared to the previous month, but it is still above the annual average. The number of employees did not rise much in recent months, while unemployment is still considered low in spite of a slight increase.

Chart 7: Indicators of labour market tightness



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

1.3. Inflation and wages

Inflation evolved at a historically low level in the recent period. The low inflation was a result of the significant decline in oil prices, sluggish demand, subdued imported inflation and the adaptation of inflation expectations. In September 2014, the annual wage dynamics in the private sector increased slightly compared to the previous month.

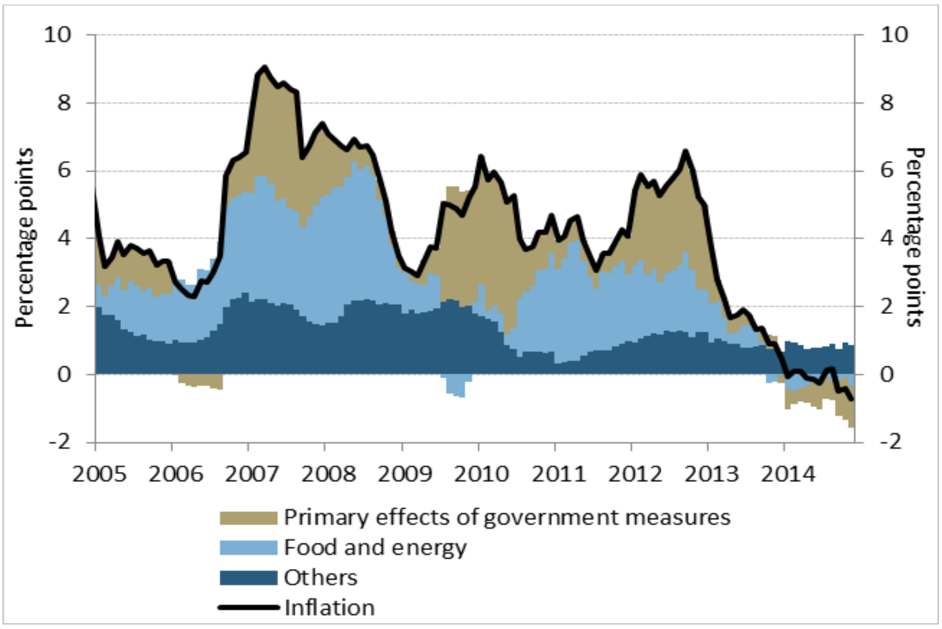
1.3.1. Wages

The private sector wage index rose by 4.6 per cent in September. The annual dynamics of gross wages rose slightly relative to the previous months. There was little difference between manufacturing and market services in terms of wage growth in this month. **The rate of the specific wage cost of the private sector, calculated by using the full-time equivalent staff, increased in the third quarter.**

1.3.2. Inflation developments

In November 2014, the inflation was -0.7%, while both core inflation and the core inflation filtered from indirect taxes was 1.2 per cent (Chart 8). Both indexes decreased by 0.3 percentage points relative to the previous month. In the case of inflation, the decrease was primarily due to the decrease in the fuel prices.

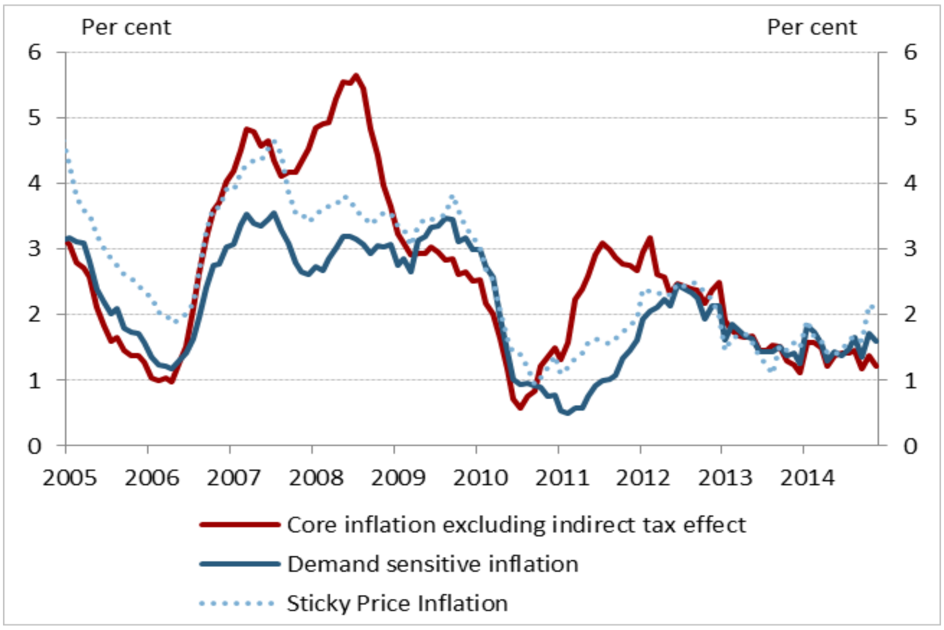
Chart 8: Decomposition of the consumer price index



The substantial drop in oil prices, low demand, the adjustment of inflation expectations and low imported inflation may have contributed to the moderate underlying inflation recorded in

recent months (Chart 9). In October 2014, agricultural producer prices fell by 5.7 per cent in annual terms, while domestic sales prices of the consumer goods sectors rose by 0.6 per cent relative to a year earlier. Fuel prices fell in November compared to the previous month as a result of the decline in oil prices. Based on retail sales data, consumption demand may have increased gradually in recent months, in line with the year-on-year rise in real incomes. Despite this, 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.

Chart 9: Measures of underlying inflation



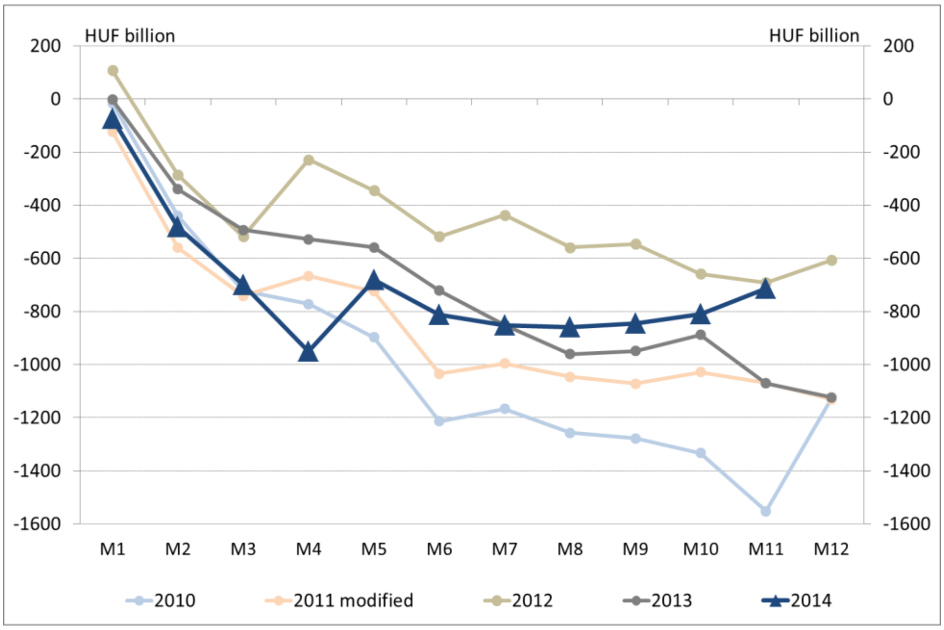
Inflation in Hungary is expected to remain around 0 per cent in the short term. Inflation in November was below the expectations of the September Inflation Report, which is basically explained by the essentially lower than expected food prices and falling oil prices. Inflation is likely to produce negative figures in the coming months, reflecting the decline in oil prices expressed in forint in recent weeks.

1.4. Fiscal developments

The surplus of the Government budget of public finances in November was HUF 96 billion, therefore the cumulative deficit dropped to HUF 714 billion. The positive balance in November compared to previous years was primarily a result of the revenue from the sale of communication frequencies, and the revenue from VAT and personal income tax also grew as compared to previous years. The overall expenditures fell short of their level last year.

The cumulated deficit of the Government budget in 2014 was HUF 714 billion in November, equivalent to 73 per cent of the cash flow target deficit envisaged in the Budget Act. The deficit continues to be lower than the values recorded in previous years (Chart 10).

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



1.5. External balance[1]

In October, Hungary's seasonally adjusted external financing capacity was in excess of EUR 1.1 billion. The increase in the country's financing capacity mainly reflected the correction in the balance of trade in goods, related to the output of the automobile industry. The transfer surplus continued to be significant, mainly reflecting EU transfers, while the deficit on the income balance remained low.

Based on financial account data, debt liabilities continued to fall, while direct investments by non-residents in Hungary increased slightly. In September, the country's financing capacity, calculated on the basis of the financial account, amounted to EUR 240 million. This resulted from an outflow of EUR 400 million in debt liabilities and a slight inflow of FDI liabilities. General

[1] Based on incoming data until 19 November. Balance of payments data are published on the 16th of every month, so the October data were not available until the preparation of the background material. Therefore, the material contains the section that described the external balance processes presented in relation to the previous decision.

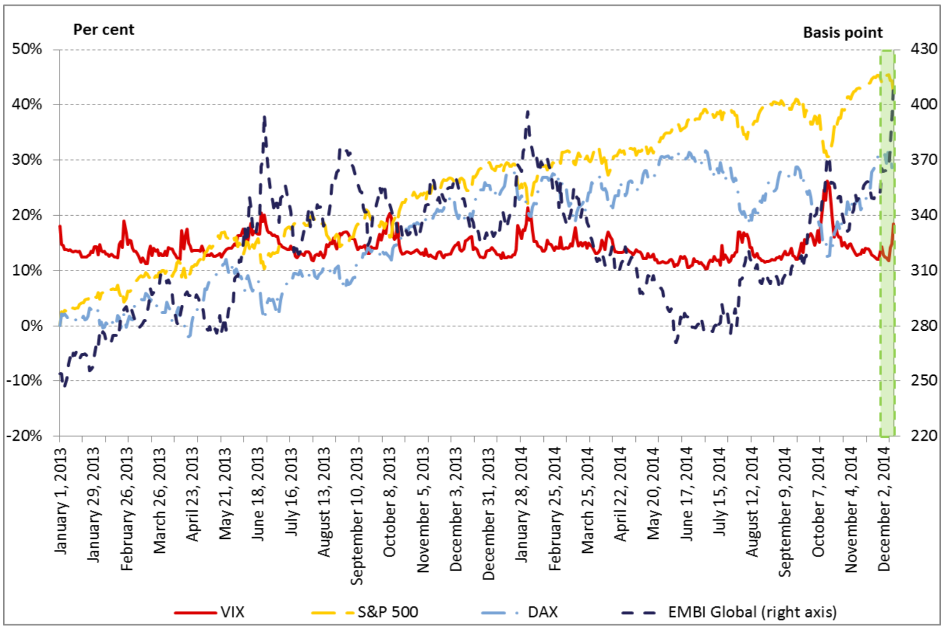
government net external debt consolidated with the MNB rose, reflecting an increase in government securities holdings by non-residents and the fall in reserves due to the MNB's swap facility. However, inflows of liabilities at consolidated government level were more than offset by the fall in external debts of banks and companies. Net inflows of FDI reflected the increase in non-resident holdings of shares and a comparable decline in inter-company loans.

2. FINANCIAL MARKET DEVELOPMENTS

2.1. International financial markets

Over the past month, risk appetite deteriorated slightly in the international money and capital markets, what can be linked especially to the macroeconomic data, which shows a mixed picture globally, and the unchanged monetary policy of the ECB. Stock indices slightly decreased, while risk indexes slightly increased during the period. Although the US stock market indices still remain near their historic highs, they weakened 1.5 per cent during the period. The developed European stock markets also fell, only the DAX rose half a per cent. Nikkei could not maintain its rise seen at the beginning of the period, and dropped in the order of 1 per cent due to the deterioration in the global atmosphere observed at the end of the period. The VIX index increased considerably to 18 per cent from 12 per cent, seen at the time of the previous interest rate decision, and the growth of the developed market bond volatility MOVE index and the emerging market EMBI Global index also indicates declining risk appetite. Brent oil price continued its downward trend, and the price fell to levels close USD 65. The price of WTI similarly moved down. US and German ten-year yields fell slightly. Similarly to the previous period, the European periphery countries observed a reduction in the yield of long-term maturities, which reflects a relief compared to the high levels seen in early November. The only exception is Greece, where the mood worsened due the early presidential election. In parallel with the slight deterioration in the global investor mood, the price of gold and silver price also rose slightly during the period.

Chart 11: Developed market equity indices, the VIX index (left axis) and the EMBI Global index (right axis)



The macroeconomic data coming from the US was mixed. At the start of the period, the final 3rd quarterly GDP growth rate was published, the 3.9 per cent value of which not only exceeded the expectations, but also significantly outperformed the preliminary data of 3.5 per cent. The purchasing managers index also showed a value better than expected by the analysts and, as a result, the dollar strengthened against the euro to a level of 1.23. The Beige Book published by the Fed also drew a positive picture of the economy and the flash report season also showed good corporate performance. The consumer confidence index, however, developed unfavourably, since its score of 88.7 was significantly lower than the score of 94.1 seen in the previous month. In November, 321,000 new jobs, that is more than expected, were created, while the unemployment rate stagnated at 5.8 per cent.

The ECB has not changed the monetary conditions and announced that more unconventional steps can be taken in early 2015, if necessary, but only subject to the then current macro data and the impact of previous moves. Before the press conference, the investors raised that the ECB may report already this month about the extension of the asset purchase programme to sovereign bonds as well, but this has not yet happened. Therefore, the euro strengthened half per cent after the press conference.

The European Commission announced a EUR 315 billion investment stimulation package. The package is designed primarily to support job creation and economic growth. It is planned to establish the European Strategic Investment Fund, which would receive only part of the overall package of EUR 21 billion from public funds with the assistance of the EU and the EIB. The remaining contribution is to arrive from private investors, and roughly 15-fold second-round effect of this leverage is expected to be available over three years in addition to the source from public funds. The programme may help create as many as 1.3 million new jobs in total.

The price of oil continued to significantly decrease over the period. At the meeting of OPEC, pooling the oil exporting countries, the members of the organisation decided not to reduce their production for the next year. The meeting received special attention, as there was a significant lobby effort before it in order to reduce the extraction, particularly on the part of Russia, among others, which was intended to prevent further oil price decline. However, following the decision, the Brent price weakened to levels below USD 70 per barrel level, and the WTI also reduced materially. The decrease of oil prices could have a dominant role in that the rouble weakened by 20 per cent against the dollar and the euro. Although the latest OPEC report released at the end of the period showed that the forecast for the 2015 oil extraction already decreased, the oil price does not show a significant reaction.

2.2. Developments in domestic money market indicators

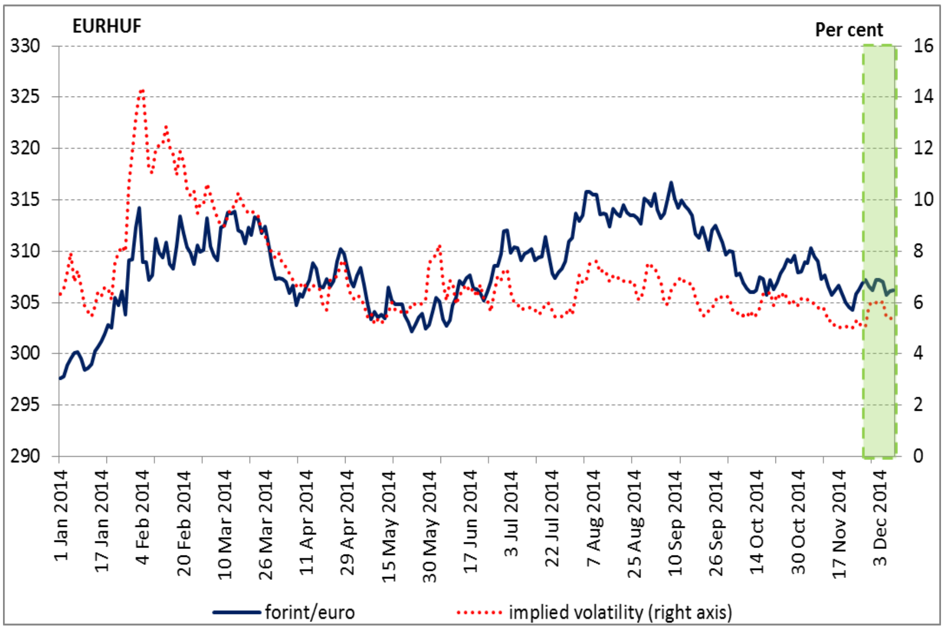
Neither international events, nor country-specific news had an outstanding impact on the Hungarian money market processes during the period since the previous interest rate decision. Of the domestic event, the most significant was the latest OECD forecast about Hungary.

Among the emerging markets, the currencies of the CEE region were average performers in the period. The Polish zloty was the only one that was able to gain ground against the euro, linked to the mitigation of the interest reduction expectations, as the Polish central bank did not change the prime rate. The Romanian leu and the Czech koruna did not change substantially over the period. The Polish zloty, again, was the only currency that showed some strength against the US Dollar, while the three other regional currencies did not change significantly.

The forint slightly weakened against the euro. Overall, the EUR/HUF exchange rate fluctuated in a range between 305.5 and 308 since the previous interest rate decision. The forint did not respond substantively to specific data disclosures in the period. In recent weeks, the forward holdings of residents continued to decline, and the position of non-residents against the forint did not change in substance. On the other hand, there was minor weakening in the market due to the -0.7% domestic inflation data, which is weaker than planned. In addition, the forward holdings of residents increased at a range of HUF 40 billion and the speculative holdings of non-residents against the forint increased by 30 billion HUF, while the exchange rate of the forint remained unchanged.

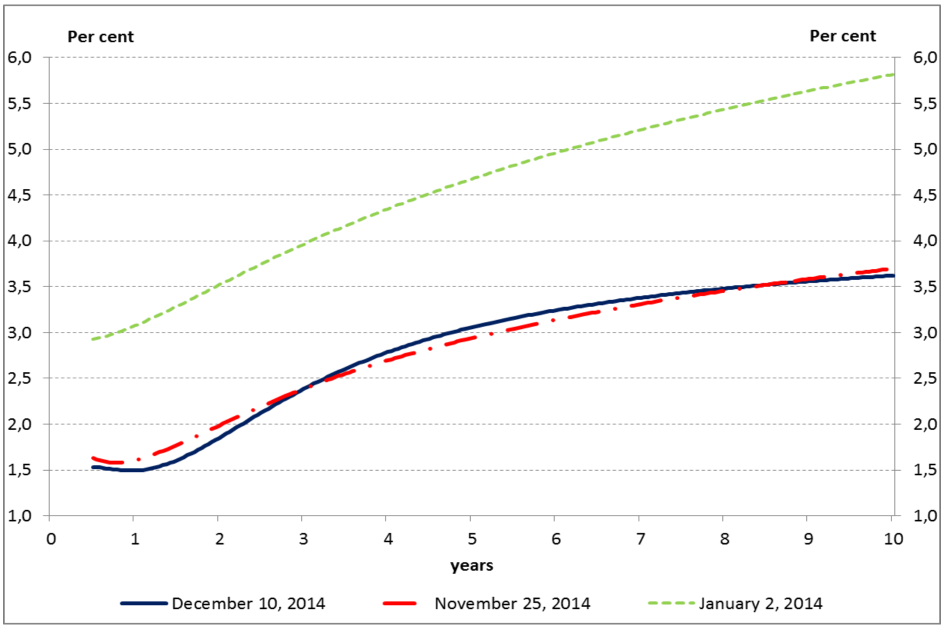
The OECD's latest report forecasts a better picture compared to the forecast in the spring. The organization changed its growth forecast regarding Hungary in the positive direction, so they calculate with 3.3 per cent growth for 2014. The favourable growth prospect is considered to be the upswing in domestic demand, which can offset the adverse external economic conditions. 2.1 per cent is growth is forecast for 2015 and 1.7 per cent growth is forecast for 2016, while the slowdown in the euro area and the excess reliance of the domestic economy on the automobile industry are highlighted as risk factors. The report expects 2.9 per cent budget deficit for 2014 and 2.6 per cent budget deficit for 2015.

Chart 12: EUR/HUF exchange rate and its implied volatility



The steepness of the Hungarian government securities yield curve did not substantially change since the latest interest rate decision. The short end of the curve is generally 15–20 basis points lower. The secondary market yield on the three-month discount Treasury bill continues to stay below the prime rate, that is, at 1.47 per cent. As in respect of the long-term maturities, the yields decreased by 1–10 basis points, and the ten-year yield fluctuated around 3.5 per cent. In the region overall, there was a moderate rise in the long-term yields.

Chart 13: Shifts in the spot government bond yield curve

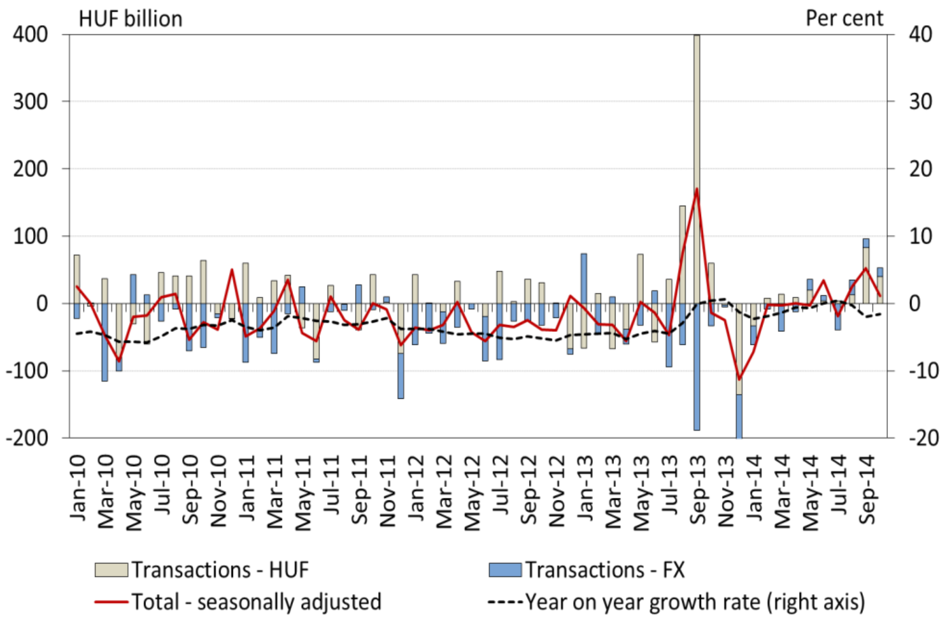


There was strong demand at the government securities auctions during the period. In the case of the short-term securities, demand was steadily decreasing, and the coverage was threefold even at the end of the period. Yields at the auctions fell by 15 basis points in the case of three-month discount Treasury bills, and there was a decline in the case of one-year discount Treasury bills as well. There was a 10–15 basis point decline at the auction of long-term securities as well since the previous interest rate decision, although demand was more than twofold here, too. Total government securities holdings of non-residents increased by HUF 10 billion, and amounted to HUF 4,977 billion by the end of the period.

3. TRENDS IN LENDING

In October, outstanding lending by banks to the corporate sector rose by a total of HUF 52.9 billion. Seasonally adjusted, the value of transactions was HUF 11.3 billion (Chart 14). Looking at the currency breakdown, outstanding forint and foreign currency loans both increased. Loans disbursed under Pillar 1 of the Funding for Growth Scheme contributed some HUF 34 billion to the increase in forint loans in October. The transaction-based annual rate of degradation moderated to 1.58 per cent from 1.95 per cent in September. The gross amount of the new corporate loans of the credit institution sector as a whole was HUF 248.8 billion. Of the new contracts, the volume of forint loans was HUF 143.8 billion, while that of the euro loans was HUF 105 billion. This month, contracts for HUF 57 billion were concluded in the framework of the FGS scheme, amounting to 23 per cent of all new loans.

Chart 14: Net borrowing by non-financial corporations



The households were net loan repayers to the entire credit institution sector where the value of the transactions was HUF -29.6 billion or, seasonally adjusted, HUF -16.5 billion (Chart 15). The decline of the loan holdings is still a result in the degradation of the foreign currency loans, which amounted to HUF -31.3 billion during the period. In the case of the forint loans, the range of the repayment equalled the disbursements, so transaction-based change in the holdings was about HUF 1.7 billion. The annual rate of decline in stocks fell slightly relative to the previous month, from 4.3 per cent to 4.1 per cent. The gross volume of new household loans of the entire credit institution sector amounted to HUF 49 billion in October. The recovery is striking in the case of housing and personal loans: in these segments, the number of new contracts exceeds the value of the same period of the previous year by 46 and 44 per cent, respectively.

Chart 15: Net borrowing by households