Macroeconomic and financial market developments

October 2014

Background material
to the abridged minutes of the
Monetary Council meeting
28 October 2014

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The background material 'Macroeconomic and financial market developments' is based on information available until 22 October 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:

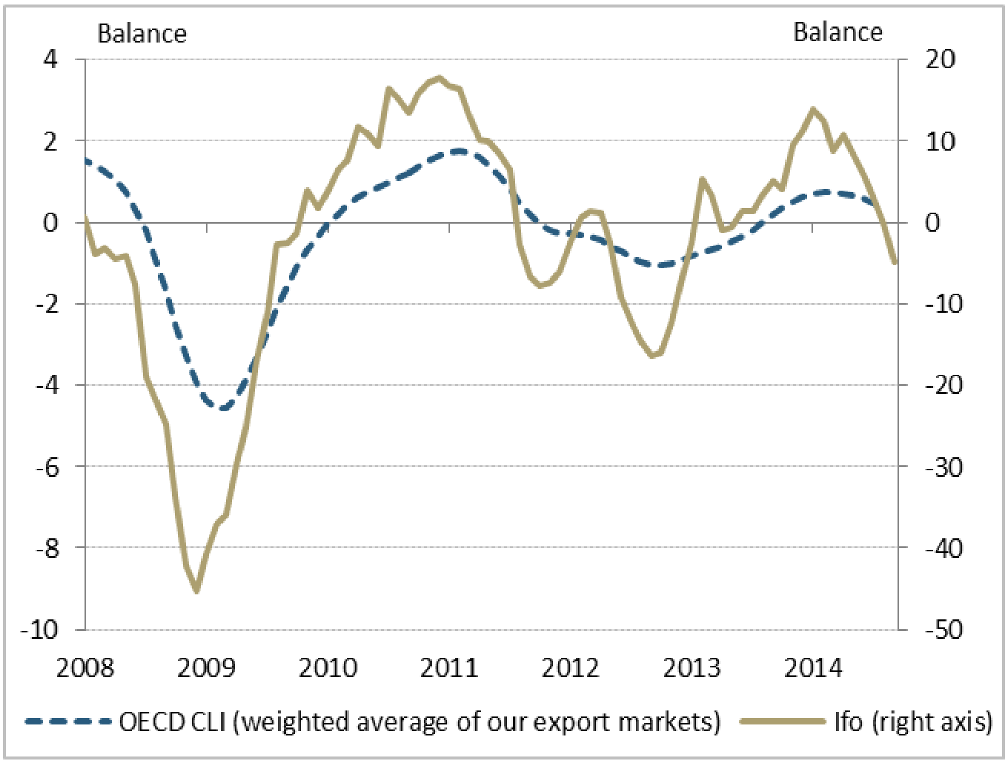
http://english.mnb.hu/Monetaris_politika/decision-making/mnben_mt_jegyzokonyv

1 MACROECONOMIC DEVELOPMENTS

1.1 The global economy

Based on data for recent months, economic growth in Hungary's export markets has became more unfavourable. The outlook for growth this year deteriorated and, looking ahead, the dynamics of growth is likely to be more moderate than previously expected (Chart 1). The outlook for growth in the world's 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.

Chart 1 Indicators of activity in Hungary's export markets

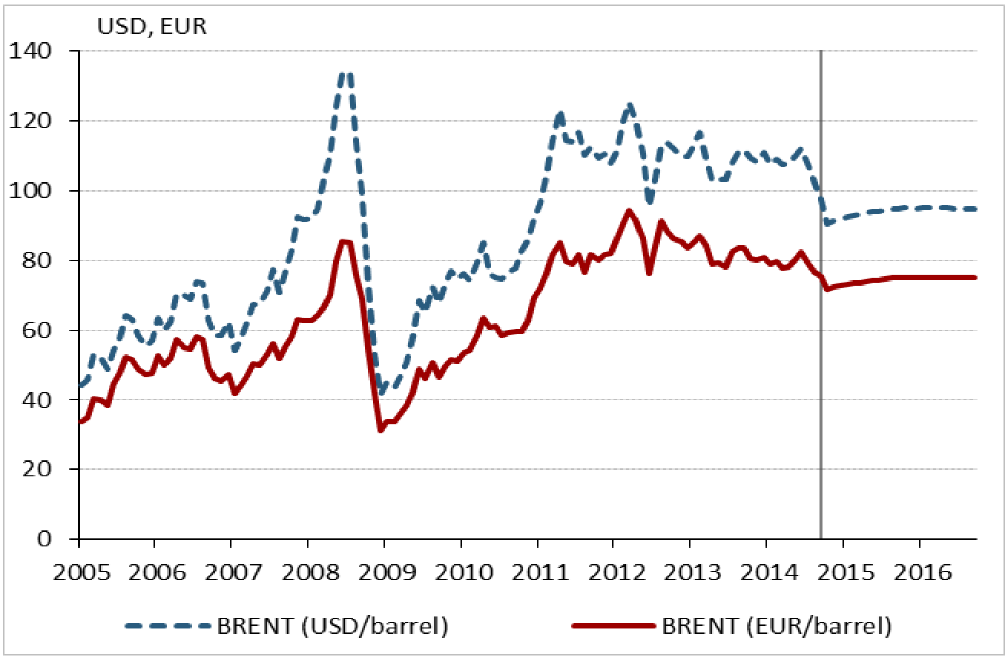


Growth in the world economy slowed after the second quarter of 2014. Weak output data were released in developed economies which had previously shown robust growth, with a resulting moderation in the outlook for growth this year. This partly reflected the negative effects of the conflict between Ukraine and Russia and the related economic sanctions, which may intensify looking ahead. Emerging market economies, where growth had been rapid in previous years, slowed significantly this year and, looking ahead, growth prospects are modest, which may be more moderate by the decline in world commodity prices.

In the second quarter of 2014, growth in the euro-area economy was flat relative to the previous quarter. Monthly production indicators suggest a slowdown in activity in the region, which is consistent with the continuous deterioration in forward-looking indicators in recent months. This slowdown may primarily reflect geopolitical tensions: 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 and available monthly data for the third quarter signal a further slowdown in activity. The industrial output of Germany, Hungary's most important trading partner, slowed significantly in August after stagnating in previous months, and the volume of new German industrial orders also fell sharply. By contrast, the performance of Central and Eastern Europe was favourable in the second quarter; however, industrial output slowed in the region according to monthly indicators for recent months. So far, the escalation of the conflict between Ukraine and Russia and the slowdown in Europe have had only a limited impact on growth in CEE, but looking ahead the slowdown in the euro area may lead to a weakening in growth in the region as well.

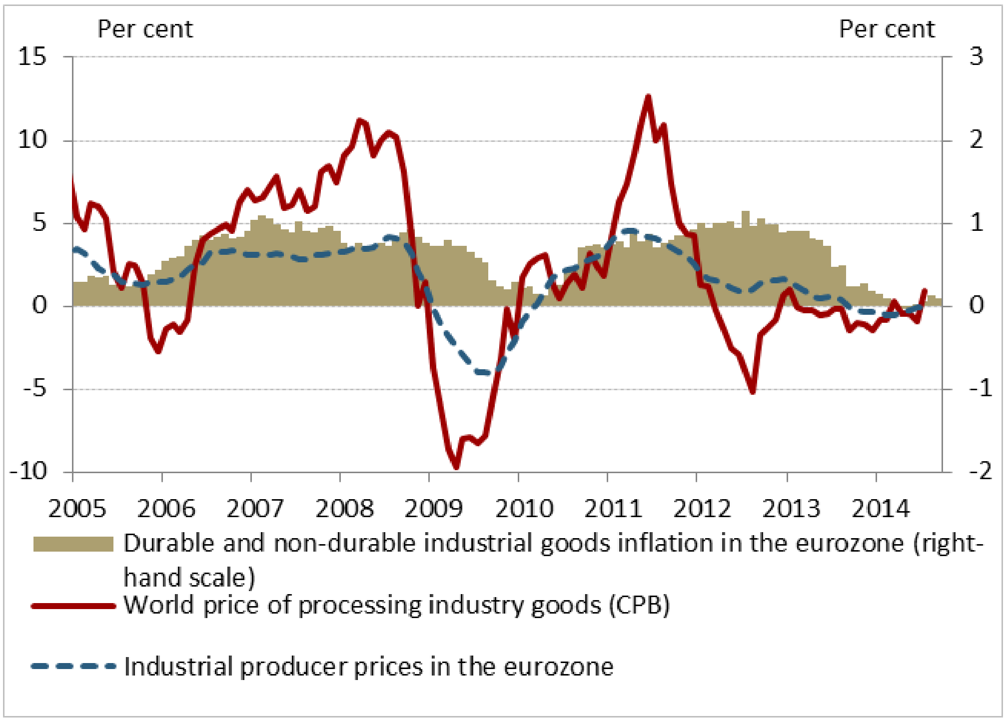
Inflationary pressures from the world market continued to weaken. Declining global commodity prices, combined with slow growth in the global economy, are decreasing the inflation. As a result, inflation rates remain below target in the world's major economies (the consumer price index continues to be low in the euro area). The world market price of crude oil fell in October, with the Brent and WTI both falling as low as below USD 85. This is reflected in growing supply (an increase in oil production by the OPEC and the pick-up in shale oil extraction in the US) and weak demand mainly on account of slack growth in the larger oil-importing economies (Chart 2).

Chart 2 World market price of Brent crude oil



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

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



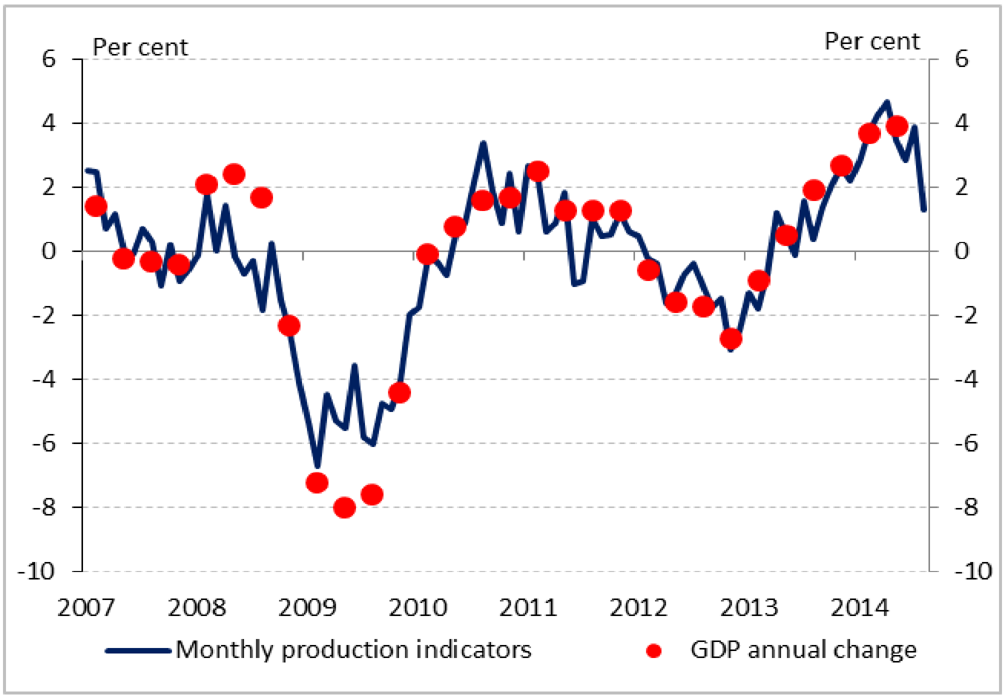
1.2 Domestic real economic developments

1.2.1 Economic growth

The economy continued to grow in the second quarter of 2014. 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, Hungarian economic growth may slow in the third quarter (Chart 4). Production indicators for August also depict an unfavourable picture (Chart 5).

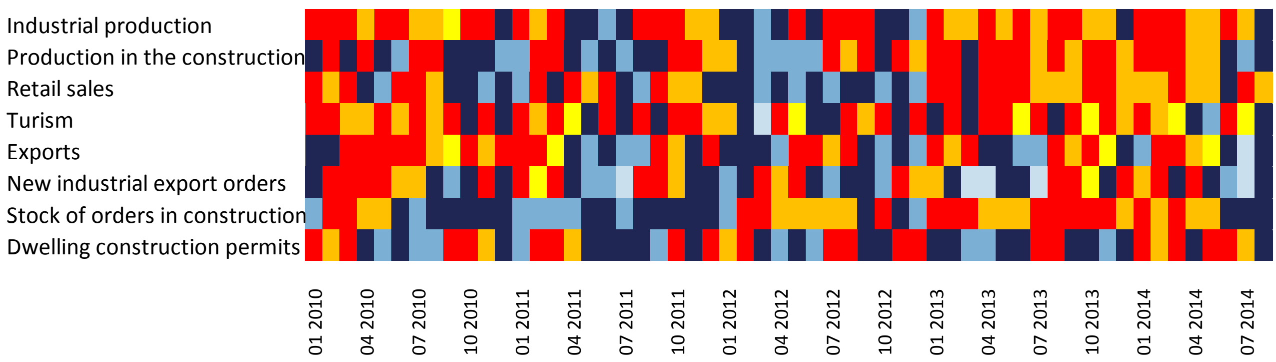
Chart 4 Monthly production indicators and GDP growth*



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

In August, industrial production posted a year-on-year increase of 0.5 per cent, significantly less than in previous months. Relative to the previous month, production fell by 5.7 per cent in August. In part, the sharp decline reflected one-off effects; for example, several automobile manufacturers closed production temporarily in August. The CSO reported weaker performance in the case of other sectors, in addition to vehicle production, explained in part by the bilateral sanctions imposed due to the conflict between Ukraine and Russia. The decline in manufacturing orders foreshadows a slight fall in industrial production. **Exports and imports of goods fell in August, in line with developments in industry, and the trade surplus was lower. Imports fell by less due to the recovery in domestic demand, and therefore the contribution of net exports to growth diminished in the third quarter.**

*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.

Construction output rose at a year-on-year rate of 13.1 per cent in August and fell by 0.2 relative to the previous month. Government investment activity focused mainly on infrastructure financed from EU funding continued to be a major factor contributing to the performance of construction. By contrast, private sector investment remained subdued. **The sharp decline in the number of new contracts for construction foreshadows a slowdown in the sector's output growth, but the stock of orders also point to good performance by construction in the second half of year.**

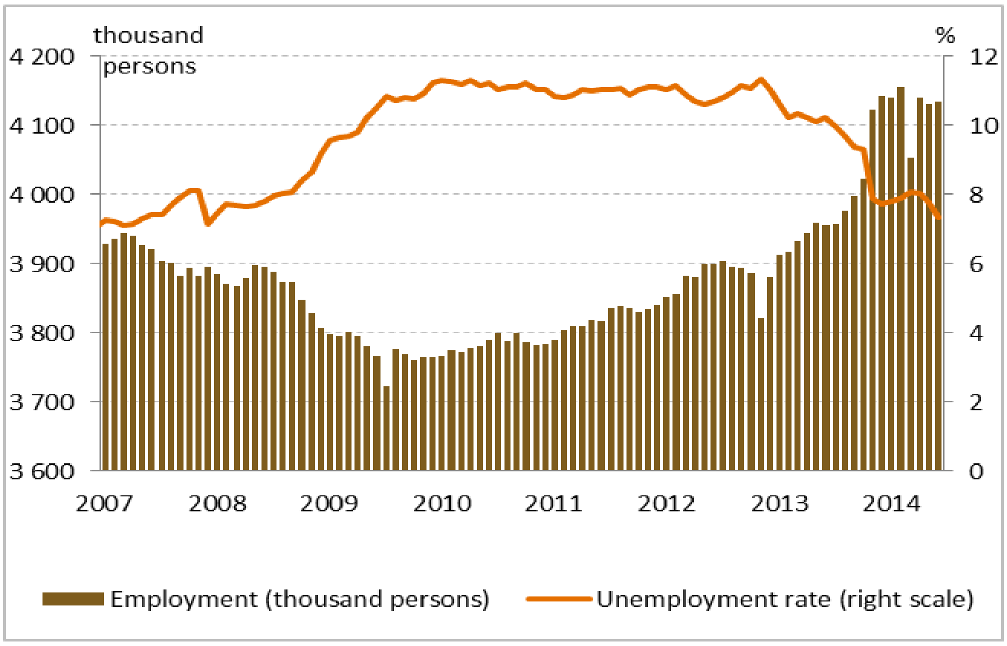
The gradual increase in consumption demand may have continued in recent months. According to preliminary data, retail sales rose by 2.5 per cent in August year on year. The improvement in the labour market and the significant rise in household real income, reflecting the historically low inflation, are underpinning the upturn in household consumption. However, the recovery is likely to be gradual, in line with the continued dominance of precautionary savings and balance sheet adjustment by 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 may slow down on a quarterly basis, in part reflecting one-off effects. The recovery in domestic demand, the intensive use of EU funds, loose monetary conditions and the improvement in the labour market all support growth. However, the weakening in activity abroad and the slowdown in growth in Hungary's major export markets represent a downside risk looking ahead.

1.2.2 Employment

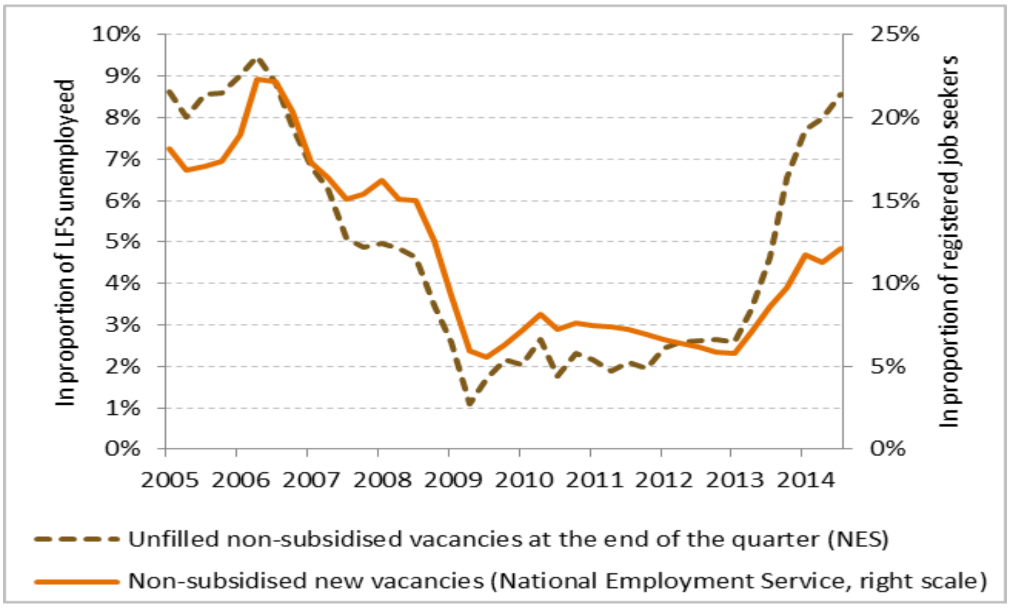
According to Labour Force Survey data, **the number of employees in the national economy rose by 5.4 per cent in August relative to a year earlier.** Employment, including people employed under public employment programmes, was flat relative to the previous month, according to seasonally adjusted data. However, excluding public employment programmes, employment fell slightly in August. The detailed data reveal that private sector employment rose slightly on a quarterly basis in the second quarter, but the number of public sector employees fell, which was mainly attributable to a reduction in public employment programmes. Unemployment fell sharply, continuing the drop in the previous month, with a part of the unemployed becoming inactive in the month. **The unemployment rate stood at 7.3 per cent in August** (Chart 6).

Chart 6 Numbers employed and the unemployment rate



The number of newly announced, non-subsidised jobs was broadly unchanged in the second quarter relative to the previous quarter. The number of vacancies fell slightly, but returned to pre-crisis levels during the past 18 months, which may suggest that mismatches in the labour market may be growing. **The labour market is tighter than at the beginning of last year** (Chart 7). The number of reported lay-offs increased significantly in September, mainly as a result of the closure of the Nokia factory at Komárom.

Chart 7 Indicators of labour market tightness



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

1.3 Inflation and wages

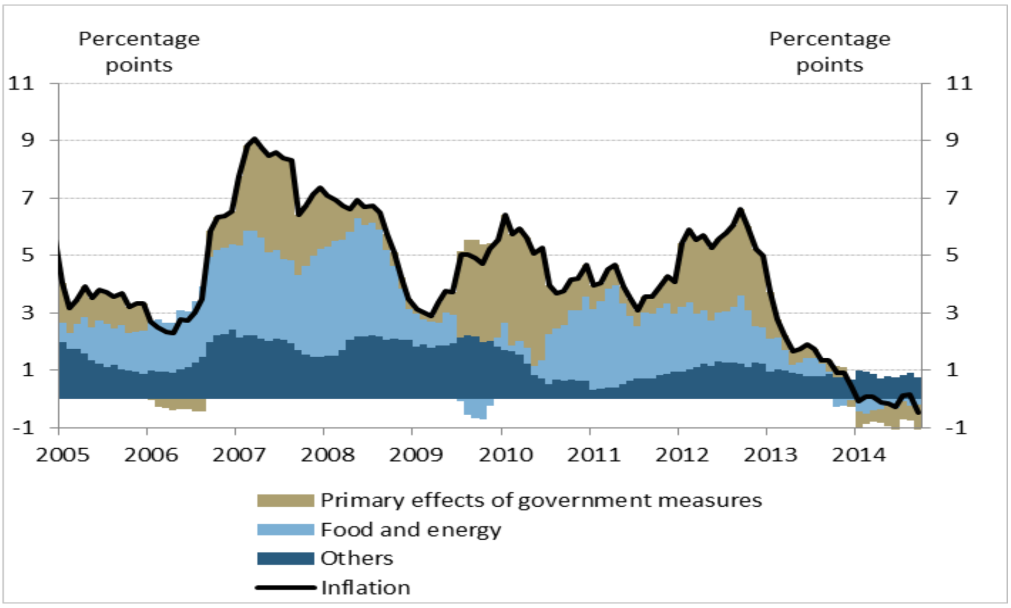
1.3.1 Wages

The private sector wage index rose by 4.2 per cent in August. The rate of wage growth reflected a base effect in the month; while the regular incomes fell in last August relative to the previous month, it was broadly unchanged this year. In August, the rate of wage growth was stronger in market services than in manufacturing. **Wage growth in the private sector continues to be moderate.**

1.3.2 Inflation developments

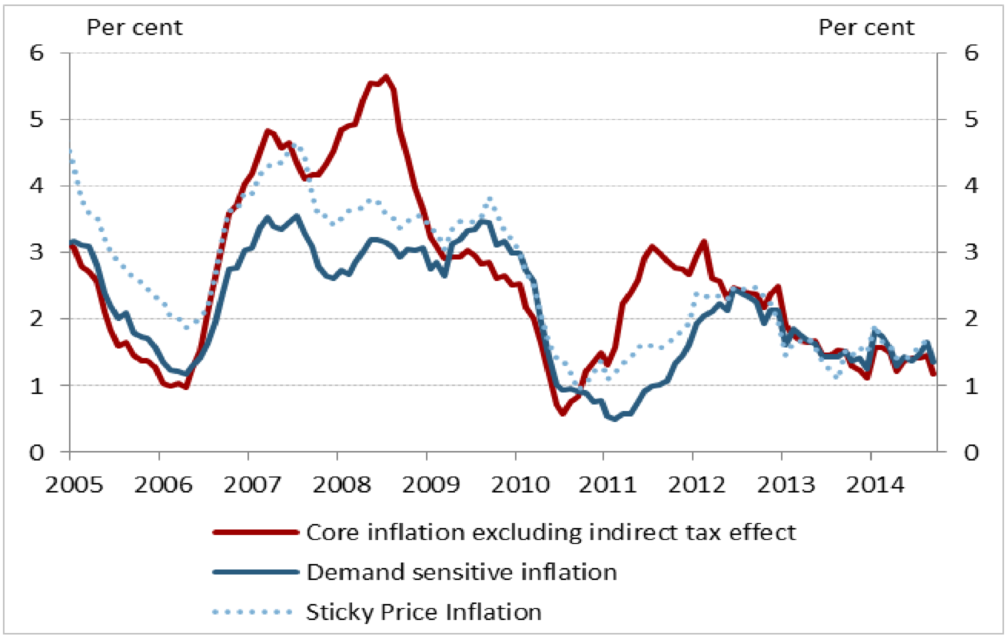
In September 2014, consumer price inflation stood at -0.5 per cent, core inflation at 1.4 per cent and core inflation excluding the effect of indirect taxes at 1.2 per cent (Chart 8). Inflation fell by 0.7 percentage points and core inflation by 1.0 percentage point relative to the previous month. The drop in inflation also reflected developments in tradables prices (and particularly in highly volatile air fares) and, to a lesser extent, factors falling outside the scope of monetary policy (administered prices). The drop in headline and core inflation reflected the dropping out of the increase in the financial transaction tax and the retail margin on tobacco products in the autumn 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). In August 2014, agricultural producer prices fell by 3.3 per cent in annual terms, while domestic sales prices of the sectors producing consumer goods rose by 0.7 per cent relative to a year earlier. Annual fuel price inflation fell due to the base effect of the increase in prices last September. 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.

Chart 9 Measures of underlying inflation



Inflation in Hungary is expected to remain around 0 per cent in the short term. The September inflation data were slightly lower than the projection in the September issue of the *Inflation Report*, partly reflecting one-off effects (e.g. developments in air fares). **The Bank's view of future inflation developments has been broadly maintained.**

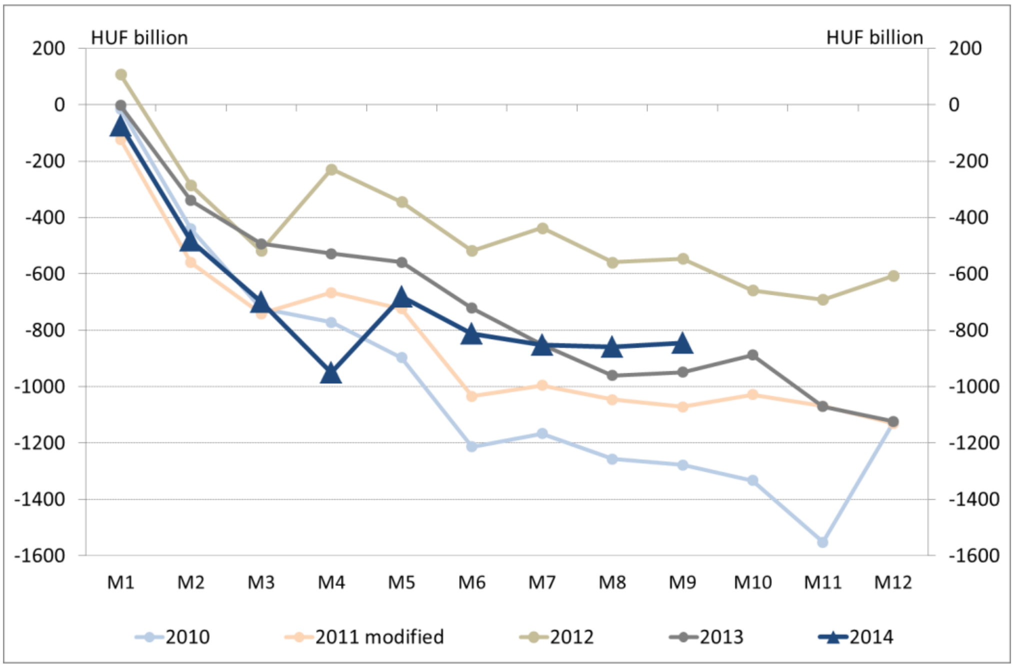
As a result of the decline in the forint price of oil prices in recent weeks, inflation is likely to remain in negative domain in the coming months. The inflation rate is expected to rise gradually from the end of the year as the effects of the reductions in administered energy price of last autumn wear off, and move into the positive domain, but is likely to remain below the projection in September *Report*.

1.4 Fiscal developments

In September, the central government budget (excluding the local government sub-sector) registered a surplus of HUF 14 billion, which was largely the same as a year earlier. Revenues of taxes on wages (personal income tax and contributions) increased, while expenditures on various subsidies and those related to EU funding increased relative to a year earlier.

The central government sub-sector registered a HUF 845 billion deficit in the first nine months of the year, which was 94 per cent of the forecast of deficit excluding the assumption of the cancellation of the Country Protection Fund and 86 per cent of the cash-based deficit target envisaged in the Budget Act. In nominal terms, the cumulative deficit continued to be 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 preliminary balance of payments data for August, the external surplus of the economy, calculated as the combined current account and capital account balance, fell, but continued to be high. Hungary's external financing capacity declined to EUR 650 million, but the country's financing capacity, calculated from monthly data, continued to be around EUR 8 billion. The lower external financing capacity mainly reflected a decline in the surplus on goods. Here, the presumably temporary reduction in automobile industry output and the slower drop in imports due to the recovery in domestic demand played an important role. The transfer surplus continued to be significant, mainly reflecting EU transfers, while the deficit on the income balance was reversed from the large deficit registered in the previous month. The use of EU transfers continued to be significant, rising slightly relative to a year earlier, and amounted to EUR 5.5 billion year on year.

Based on balance of payments data, debt liabilities fell sharply, while direct investments by non-residents in Hungary increased. In August, the country's financing capacity, calculated on the basis of the financial account, was in excess of EUR 1.1 billion. This resulted from an outflow of EUR 1.2 billion in debt liabilities and a slight inflow of FDI liabilities. General government net external debt consolidated with the MNB fell by more than EU 1.7 billion. The transformation of the MNB's instruments related to its self-financing concept, the decline in non-resident holdings of government securities and the increase in foreign exchange reserves played a major role in this, among other factors. However, part of liquidity released from MNB deposits may have increased the external debt of the banking sector, as non-resident investors may have placed it in bank deposits.

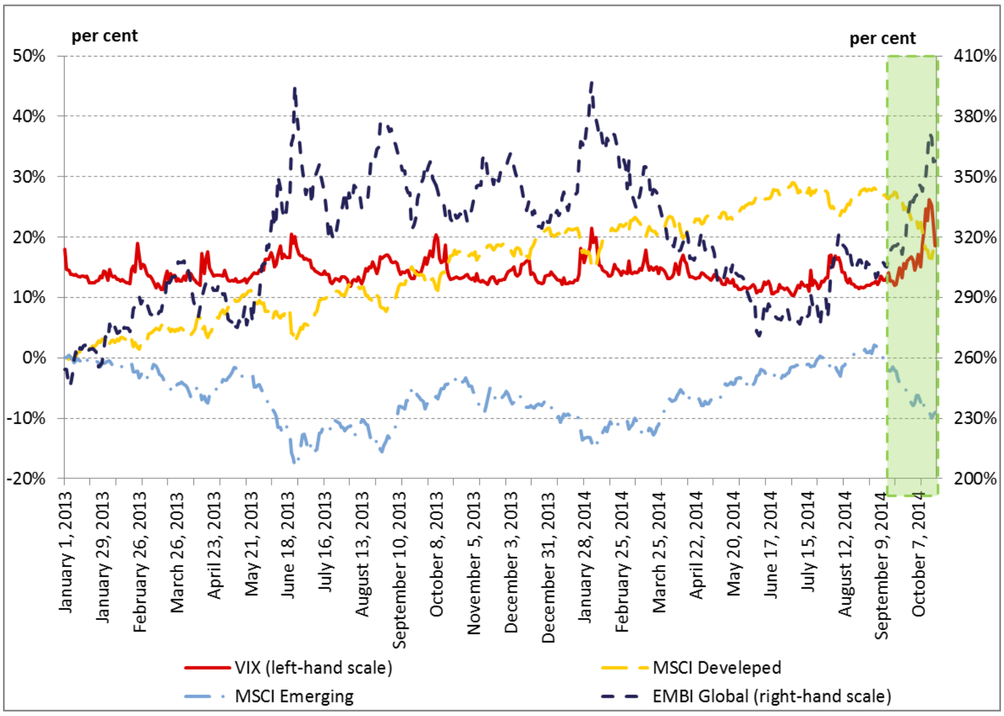
2 FINANCIAL MARKET DEVELOPMENTS

2.1 International financial markets

Risk appetite has deteriorated in international financial and capital markets in the period since the Monetary Council's previous interest rate decision, mainly in response to geopolitical conflicts and the deterioration in the outlook for activity. The deterioration in sentiment was mainly reflected in the sharp decline in equity indices and the steep rise in risk indices. Demand for bonds increased. Emerging market assets came under less severe selling pressure than developed country assets; however, emerging regions also became segmented. Data on capital flows confirm the outflow of funds from equity markets and the improved performance of bond markets. In summary, the previous 'risk on/risk off'[1] behaviour of investors appears to have changed in recent months, and this has been observed since the September interest rate decision. Developed equity markets fell by 5–10 per cent and the VIX index, measuring volatility in equity markets, almost rose to a three-year high. The Move index, a measure of options-implied interest rate volatility in developed markets, and the EMBI index, a gauge of emerging market bond performance, both rose (Chart 11). There has been a slight reversal of the increase in recent days.

[1] Kedvezőtlen piaci hangulatban a kockázatos eszközök együtt, egységesen estek, míg a menedékeszközök emelkedtek, míg kedvező hangulatban épp ellenkező irányú folyamatok játszódtak le. Az egyes részpiacok közötti szegmentáció csak limitáltan volt jellemző.

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



Long-term yields generally showed a decreasing tendency, with ten-year US bond yields declining particularly strongly (by 30–40 basis points). However emerging market bonds appreciated, while yields in the periphery countries of Europe rose, reflecting in part the repayment of an IMF loan by Greece and publication of its market refinancing plan.

The increase in negative sentiment had an only limited impact on emerging market currencies, as they depreciated by 1–2 per cent against the US dollar. Central and Eastern Europe outperformed other regions in this respect, and bond market yields declined sharply, by 30–50 basis points within the region.

In relation to the conflict between Ukraine and Russia, the crisis management by Russia occupied the centre of attention, in addition to the actual events and disturbances. The Central Bank of Russia sold USD 13 billion in October to defend the exchange rate of the rouble, but was not able to arrest the depreciation. As the rouble depreciated, the widening of the floating range, exchange rate liberalisation and the foreign currency liquidity demand of state enterprises and the banking sector, as well as the negative impact of declining oil prices of the federal budget were in the centre of attention.

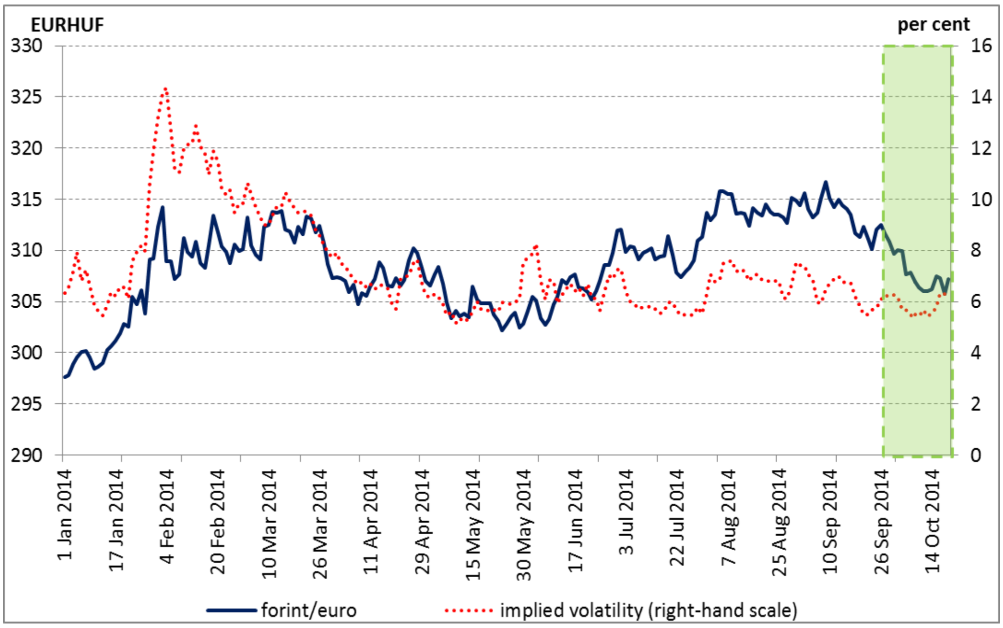
The divergent interest rate policies pursued by developed country central banks remained the focus of investors' attention. The ECB published the details of its liquidity-providing measures. The euro appreciated temporarily after the decision, as concrete details proved to be short of market expectations. Among analysts questioned about the ECB's policy, the share of those expecting the European Central Bank to purchase government securities rose from one-third in September to 50 per cent, with most of them expecting it to happen in the course of 2015. In addition, on 20 October the ECB began outright purchases of eligible covered French and Spanish bonds. The published minutes of the Fed's September policy meeting indicated a slightly looser monetary conditions; however, statements by FOMC members on interest rate policy were divergent in many instances. Overall, the shift toward an easier monetary policy stance and less favourable macroeconomic data both contributed to the flattening of the yield curve.

2.2 Developments in domestic financial market indices

Domestic financial market developments have been influenced by both international and country-specific factors since the Monetary Council's last interest rate decision. The former mostly have a negative and the latter a mostly positive influence on developments in Hungary's market indicators. The two new FX swap instruments related to the phasing-out of household foreign currency loans, announced by the MNB, was received positively by the market, as the instruments may relieve pressure on the forint exchange rate arising from currency conversions. In the case of the Bank's conditional instrument, the market also received positively the expected reduction in the banking system's short-term external liabilities. Statements by government officials during the month had market-moving effects: the Minister for National Economy announced that the Government plans to reduce expenditures and implement structural changes next year, and redistribution as a percentage of GDP may be reduced over the longer term. In connection with the deficit target for the end of the year, the Minister said that movements in the forint exchange rate will have a significant role, which in turn may have led to an appreciation of the forint. However, news about the draft law concerning fair banks as well as a publication by the European Commission about the Hungarian government budget, according to which currently there is no risk that an EDP would be launched against Hungary, did not move the market. The interest rate reduction by the Polish central bank had an upward effect on the forint exchange rate; however, the deterioration in sentiment in global markets had a negative impact on part of domestic developments.

Investor sentiment in Hungarian financial markets has been calm in recent weeks. However, the exchange rate depreciation towards the end of the period due to international factors provided a somewhat more mixed picture. The exchange rate fluctuated in a range between EUR/HUF 310 and 313, before gradually appreciating to levels below EUR/HUF 305.2. The positive performance of the forint was outstanding in the emerging region and compared with exchange rates of other countries in the CEE region (CEE currencies fluctuated around levels seen at the beginning of the month or depreciated slightly). This suggests that movements in the forint were influenced by country-specific factors. The deterioration in sentiment towards the end of the period led to a significant correction in the exchange rates of emerging market currencies and the forint. Consequently the gain of the forint against the euro since the previous interest rate decision narrowed to 1.1 per cent. It is important to note that the forint decoupled from currencies of the wider and also the narrower region in the period, then depreciated together with them near the end of the period. As a result of the shift in the EUR/USD exchange rate, the forint depreciated against the dollar throughput most of the month, but appreciated by 1 per cent near the very end of the period. The skewness measure the EUR/HUF exchange rate fell in most of the period, consistent with movements in the exchange rate, which was not fully corrected by the appreciation towards the end of the month (Chart 12).

Chart 12 EUR/HUF exchange rate and its implied volatility



The steepness of the interbank forward curve fell overall during the month. The short end of the forward curve implied from interbank rates was broadly unchanged, with the curve continuing to price a 2.1 per cent interest rate level. However, rates at the longer end of the forward curve shifted down by 10–15 basis points, with the interbank forward curve flattening out for the year as a whole.

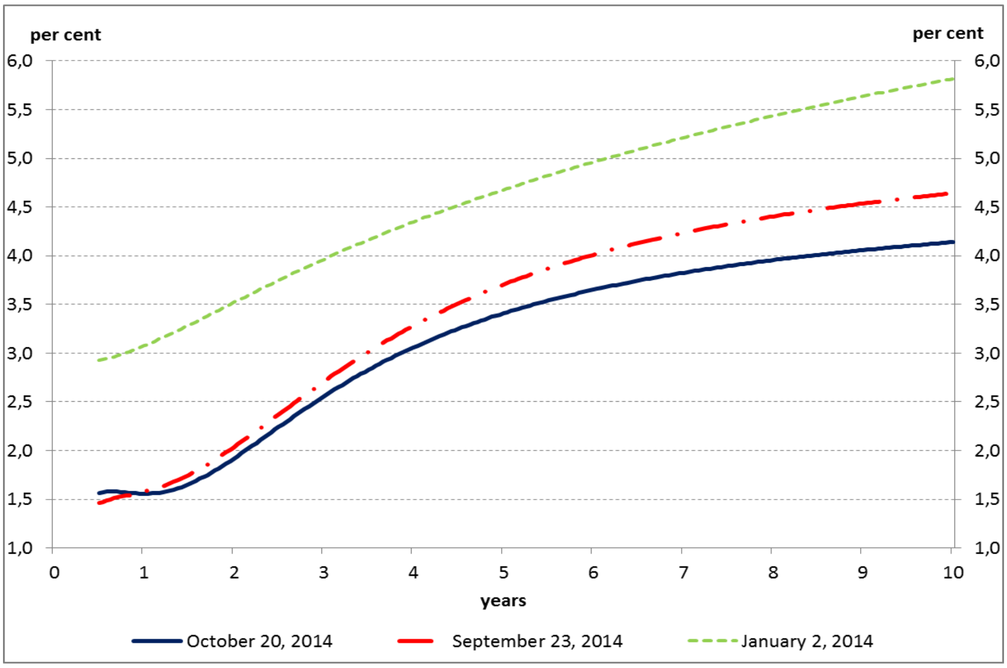
FX swap market spreads fell at every maturity in the monthly, indicating a reduction in tensions seen in recent months. Overnight FX swap market spreads fell to levels around 35 basis points, and one-week and one-month spreads declined by 60–70 basis points. While spreads at the shortest maturities approached their average seen in the first half of the year, spreads at three and six months continue to be high.

The domestic five-year CDS spread rose from a low level of around 155 basis points at the time of the previous interest rate decision to 177 basis points. The negative relationship between movements in the forint exchange rate and the domestic CDS spread, observed in previous months, remained, but in a different direction: despite the appreciation of the exchange rate, the Hungarian CDS spread rose. However, the rise in the CDS spread in October may reflect a technical factor, namely, change to the CDS regulation.[2]

The steepness of the Hungarian government securities yield curve has fallen since the last interest rate decision. There were divergent movements at the short end of the curve, the three-month benchmark yield shifting down slightly, the six-month yield rising modestly and the 12-month yield stagnating. At maturities beyond one year, yields fell during the larger part of the month; however, the deterioration in global sentiment led to sharp, but temporary rises. At the five-year maturity, benchmark yields were around level seen at the time of the previous interest rate decision, the three-year benchmark yield fell by 20 basis points and the ten-year yield by 50 basis points (Chart 13).

[2] The ISDA (International Swaps and Derivatives Association) revised and expanded the definitions related to CDS transactions in 2014, which became effective from September.

Chart 13 Shifts in the spot government bond yield curve

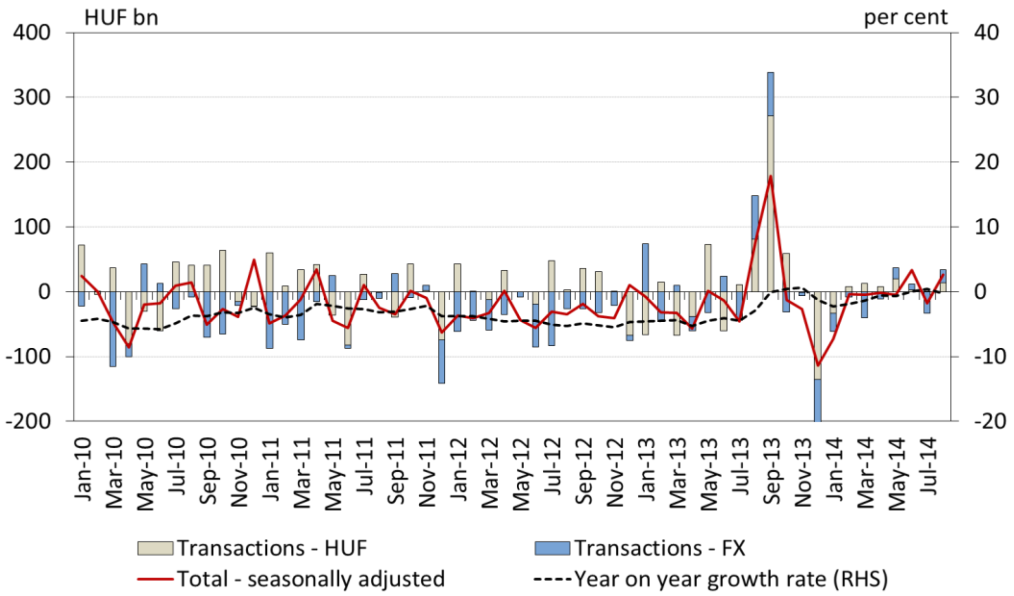


Demand at the discount Treasury bill auctions weakened relative to the previous months, while demand for bonds was strong. Yields continued to fall or stagnated as demand fell at the auctions of three-month papers held in the month. At the auctions for long-term government securities, the Government Debt Management Agency (GDMA) raised funding at levels above seen at the auctions held in October, owing to significant demand. By contrast, demand for 12-month discount Treasury bills held at the end of the month auctions was so weak that the GDMA did not raise new funding. Holdings of forint-denominated government papers by non-residents increased by HUF 115 billion relative to the level seen at the time of the previous interest rate decision, standing at HUF 4,845 billion in October.

3 TRENDS IN LENDING

In August, outstanding lending by banks to the corporate sector rose by a total of HUF 35 billion due to transactions. Here, the stocks of both forint and foreign currency loans increased. Seasonally adjusted, the value of transactions was HUF 26 billion. Loans disbursed under Pillar 1 of the Funding for Growth Scheme contributed HUF 33 billion to the increase in the stock of forint lending. The transactions-based annual rate of increase fell to -0.32 per cent, due to the dropping-out of the favourable data for last August (Chart 14).

Chart 14 Net borrowing by non-financial corporations



In August, households were net repayers of debt. Consequently, the stock of their debt fell by HUF 11.2 billion due to transactions. Seasonally adjusted, the same value was equal to a decline of HUF 19.6 billion. Forint loans have been rising for the fourth consecutive month. Household sector forint loans rose by HUF 13.0 billion due to transactions. The decline in the total outstanding stock of lending continues to reflect the fall in the stock of foreign currency loans. The annual rate of decline in foreign currency loans fell slightly relative to the previous month, from 4.6 per cent to 4.5 per cent (Chart 15).

Chart 16 Net borrowing by households