Macroeconomic and financial market developments

March 2015

Background material
to the abridged minutes of the
Monetary Council meeting
24 March 2015

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The background material 'Macroeconomic and financial market developments' is based on information available until 20 March 2015.

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://www.mnb.hu/Monetaris_politika/donteshozatal/mnbhu_mt_jegyzokonyv

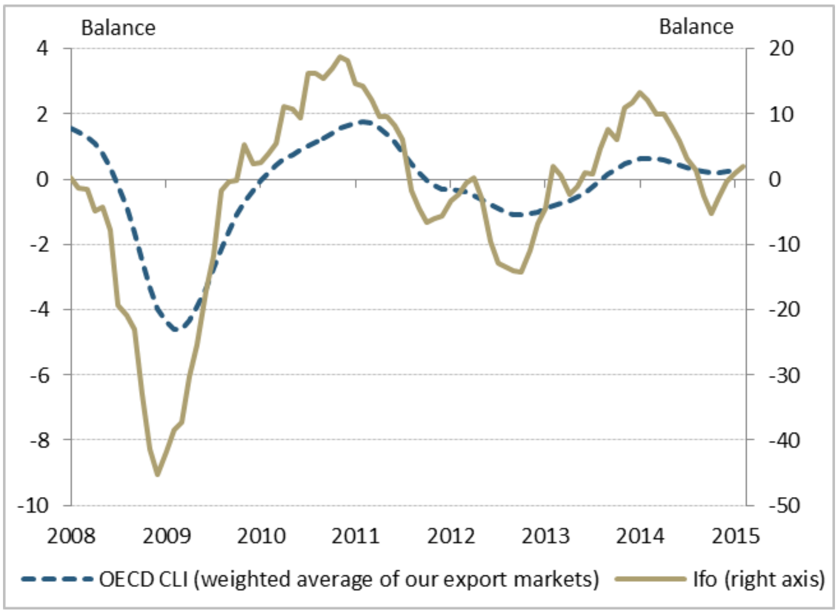
1. MACROECONOMIC DEVELOPMENTS

1.1. Global macroeconomic environment

GDP data for the fourth quarter of last year were in line with expectations in Hungary's export markets; thus the outlook for growth this year may evolve in accordance with the previously expected dynamics. Growth remains fragile surrounded by both upside and downside risks. The outlook for growth in the world's emerging regions also continues to be subdued compared to pre-crisis levels. Persisting geopolitical tensions slow growth in developed countries through weaker demand and economic sanctions. The steep decline in oil prices may boost growth in oil-importing economies and curb inflation. Owing to the decline in oil prices, inflationary pressures from the world market have remained muted in recent months.

Growth in the world economy continued in the fourth quarter of 2014. Based on available data, this growth was consistent with expectations. In some euro area economies, growth data proved even better slightly. The adverse effect of the Russia-Ukraine conflict may have continued to impede economic growth in the fourth quarter through weaker demand and economic sanctions.

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

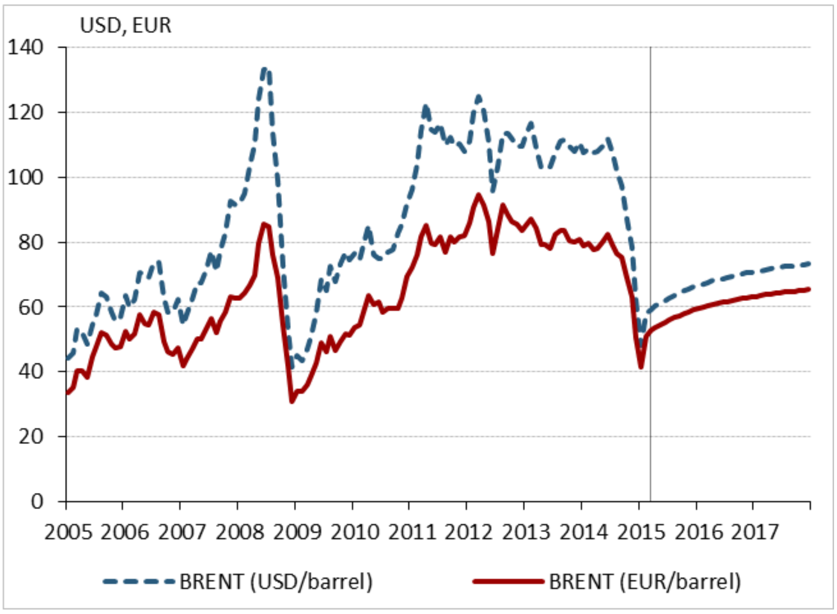


The euro-area economy registered a quarter-on-quarter growth rate of 0.3 per cent in the fourth quarter of 2014. The monthly production data received show a moderate upturn in the

economic activity of the region. The forward-looking indicators of economic activity imply moderately improving performance. Economic activity was still affected adversely by the tense geopolitical situation; activity was restrained by growing insecurity and the expanding bilateral economic sanctions. Meanwhile, after the slowdown seen in recent quarters, the moderate pick-up in economic expansion continued in the fourth quarter. The quarterly performance of Hungary's most important export partner, Germany, proved to be better than expected, which stimulated all euro area economies. Expectations for German economic growth (Ifo) improved slightly further in early 2015 (Chart 1) and the stock of industrial orders has increased moderately in recent months; thus, looking ahead, the slow improvement in economic activity may continue.

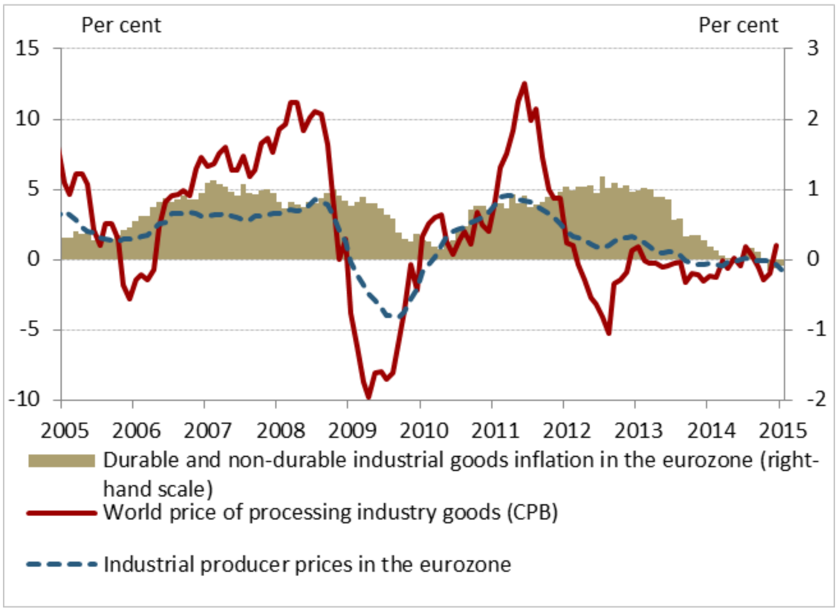
The performance of Central and Eastern Europe was favourable in the fourth quarter but, according to monthly indicators, industrial output has slowed in the region in recent months. The repercussions of the Russia–Ukraine conflict have had only a limited impact on growth in the CEE region so far, but looking ahead, the expected significant contraction in the Ukrainian and Russian economy will exert, both directly and indirectly, a negative impact on economic growth in the region.

Chart 2: World market price of Brent crude oil



Inflationary pressures from the world market remain weak. Moderating commodity prices combined with slow global growth have reduced inflation. As a result, inflation rates remain below target in the world's major economies (euro area inflation stood at –0.3 per cent in February). Standing at around USD 60 (Chart 2), global oil prices remained largely unchanged in February; in early March, however, they started to decline. On the whole, the price of oil remains subdued amid continued high supply and the weak demand associated primarily with sluggish growth in the larger oil importing economies. The world market prices of industrial commodities, unprocessed food and manufactured goods continued to be restrained (Chart 3).

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



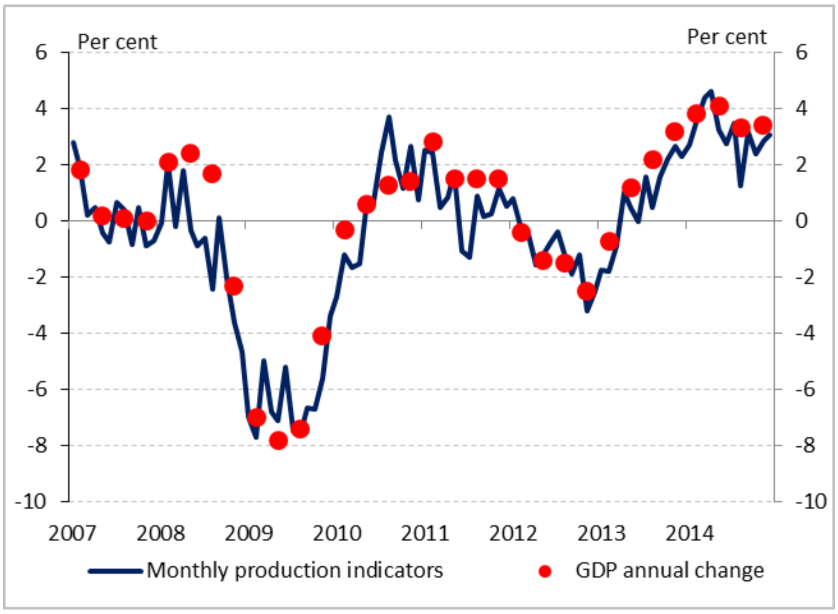
1.2. Domestic real economic developments

1.2.1. Economic growth

The Hungarian economy continued to grow in the fourth quarter of 2014. Hungary's GDP was up 3.4 per cent year-on-year, with a 0.8 per cent growth recorded relative to the previous quarter.

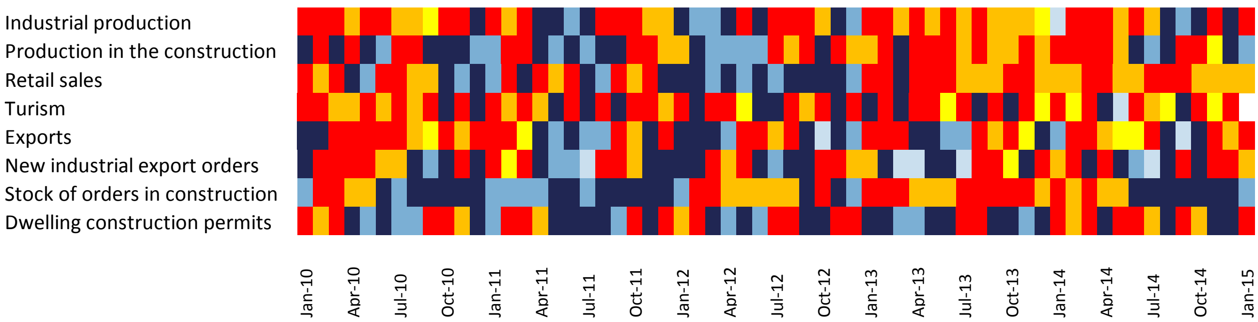
Growth accelerated in the last quarter of 2014 (Chart 4).The manufacturing sector and services were the most important contributors to growth. The increase in value added was still linked primarily to the increasing production of vehicle manufacturing and the related subsectors, while the expansion observed in a wide range of market services was boosted by recovering domestic demand. Parallel to outstanding crop yields, agriculture contributed to GDP growth significantly throughout 2014.

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.

In January 2015, industrial output rose by 5.3 per cent year-on-year, and by 7.7 per cent excluding the working-day effect. **Seasonally adjusted production level excluding the working day effect was up 4.3 per cent compared to December 2014.** Output expanded in a broad range of manufacturing subsectors in the first month of 2015. Sluggish European economic activity and the Russia-Ukraine conflict may have adversely influenced the industrial production of the region, with a general slowdown in the dynamics of industrial output in the second half of 2014. Forward-looking indicators point to improving prospects overall.

Denominated in euro, **in January the value of exports and imports increased by 3.7 per cent and by 1.0 per cent, respectively, year-on-year;** thus the surplus of the trade balance increased. The sharp fall in oil prices in the second half of 2014 may improve the terms of trade of goods in the first half of 2015.

In January 2015, **the volume of construction output rose by 8.0 per cent year on year.** Adjusted for seasonality and the working-day effect, **production was up 6.5 per cent compared to the previous month;** accordingly, the downturn observed in December 2014 corrected in January. The significant expansion observed in construction output in 2014 was typically linked to infrastructural investment financed from EU sources, typically affecting projects completed and delivered in the first half of 2014. Approaching the end of the 2007–2013 EU programming period, however, construction output is expected to be moderate in the course of 2015. The downturn in the performance of the sector may reflect the continuous contraction of orders and 2014's high base.

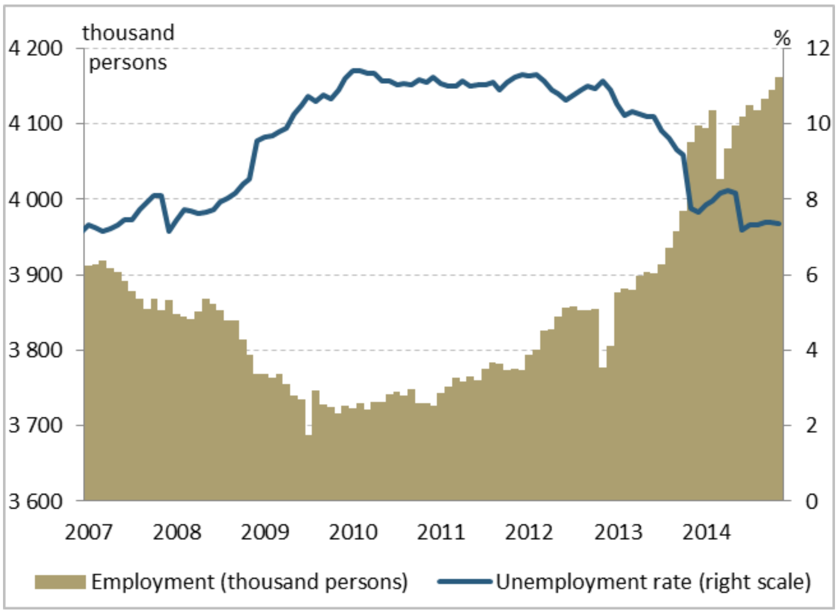
Consumption expanded further in the fourth quarter, possibly bolstered by the improved labour market situation, rising real wages in the low inflation environment and the upswing in retail sales volumes. According to preliminary data, retail sales continued to rise in January, its growth rate exceeding the level observed in the same period of 2014 by 8.2 per cent. According to the structure of sales, turnover may have increased in a wide range of products in January. The sharp decline in oil prices and hence, fuel prices, may boost the retail sales of non-fuel products looking ahead.

The baseline projection of the March Inflation Report foresees continued growth with a balanced structure. The economy grew by 3.6 per cent in 2014 as a whole, which may be followed by an expansion of over 3 per cent this year. Economic growth is supported by the recovery in domestic demand, the absorption of EU funds, loose monetary conditions and the improvement in labour market conditions. Although moderate oil prices may boost growth in EU Member States, the protracted Russia–Ukraine crisis and the deteriorating growth outlook in Russia and Ukraine may point to a deceleration.

1.2.2. Employment

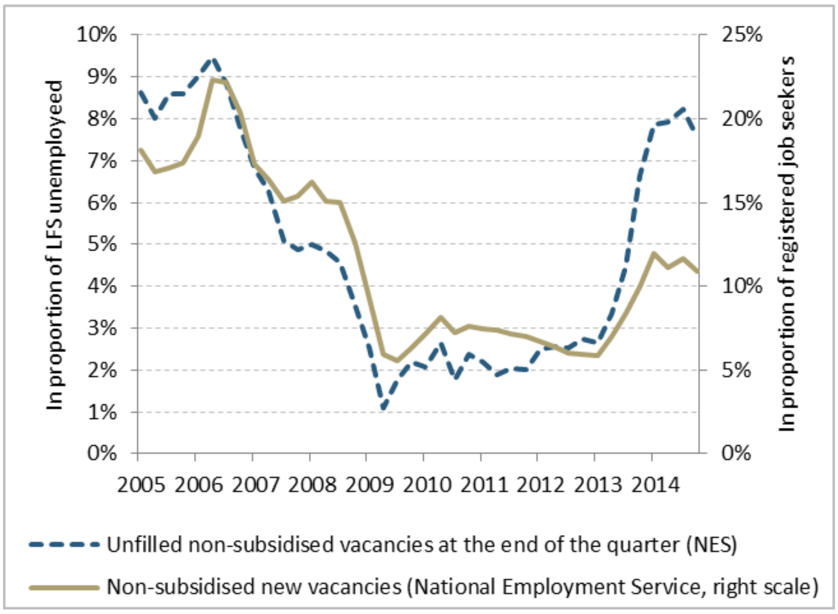
According to Labour Force Survey data, **the number of employees in the national economy remained essentially unchanged in January 2015 relative to previous months.** In the fourth quarter of 2014, private sector employment was down compared to the previous quarter, which may have been linked to the downturn in market services. Public sector employment rose. **In the first month of the year, unemployment did not change compared to the previous months; in January, seasonally adjusted unemployment rate stood at 7.4 per cent** (Chart 6).

Chart 6: Number of persons employed and the unemployment rate



In January, the number of announced, non-subsidised new jobs stagnated compared to the previous month. After the increase observed in the previous month, the number of non-subsidised unfilled vacancies at the end of the month decreased. Although the labour market can still be considered tighter than at the beginning of 2013, the process of tightening came to a halt in the course of 2014 (Chart 7).

*Chart 7: Indicators of labour market tightness**



* NES: National Employment Service

1.3. Inflation and wages

1.3.1. Wages

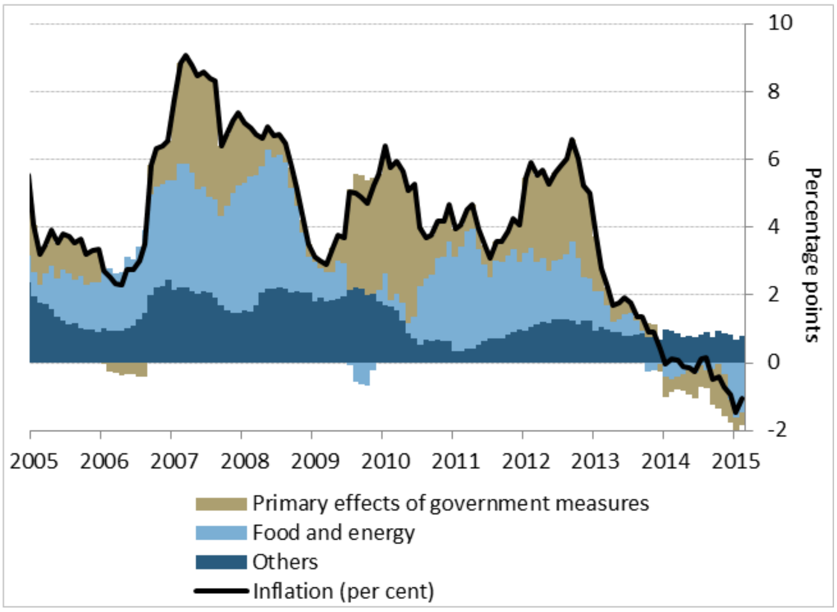
Gross private sector wages rose by 3.5 per cent in January compared to the same period of the previous year. The mild deceleration of wage dynamics is consistent with the wage forecast of the Inflation Report. Wage growth slowed compared to the previous months both in the manufacturing sector and in the market services sector. In January the decline in regular wages was stronger than usual month-on-month, while bonus payments remained largely the same as in the previous years. In the last quarter of 2014, the dynamics of unit labour costs[1] decelerated in the private sector.

1.3.2. Inflation developments

In February 2015, inflation was –1.0 per cent, core inflation and core inflation excluding indirect taxes stood at 1.0 and 1.1 per cent, respectively (Chart 8). In the case of inflation, the increase was primarily due to the rise in unprocessed food prices, while the higher price index of market services elevated core inflation. The latter can be explained by the fact that the free cash withdrawal option introduced last February dropped out of the base.

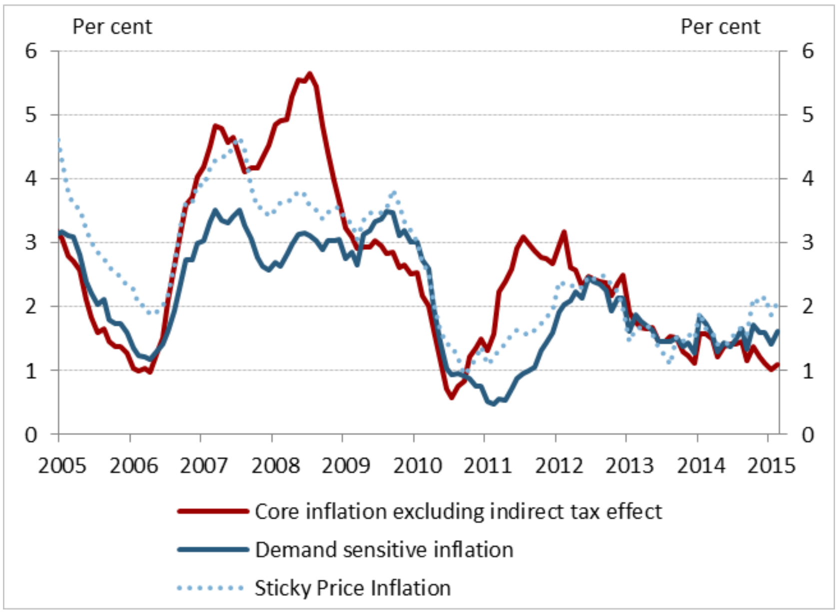
[1]Full-time equivalent.

Chart 8: Decomposition of the consumer price index



The substantial drop in oil prices, low inflation expectations and moderate imported inflation may all have contributed to the trend of restrained underlying inflation in recent months (Chart 9). In January 2015, agricultural producer prices fell by 7.2 per cent in annual terms, while the domestic sales prices of the consumer goods sectors did not change relative to the same period of the previous year. In February, fuel prices increased as a result of an increase in USD-denominated 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. This notwithstanding, the volume of retail sales remained well below pre-crisis levels. Consequently, domestic demand is likely to continue to exert a disinflationary impact overall, although this effect is gradually fading.

Chart 9: Measures of underlying inflation

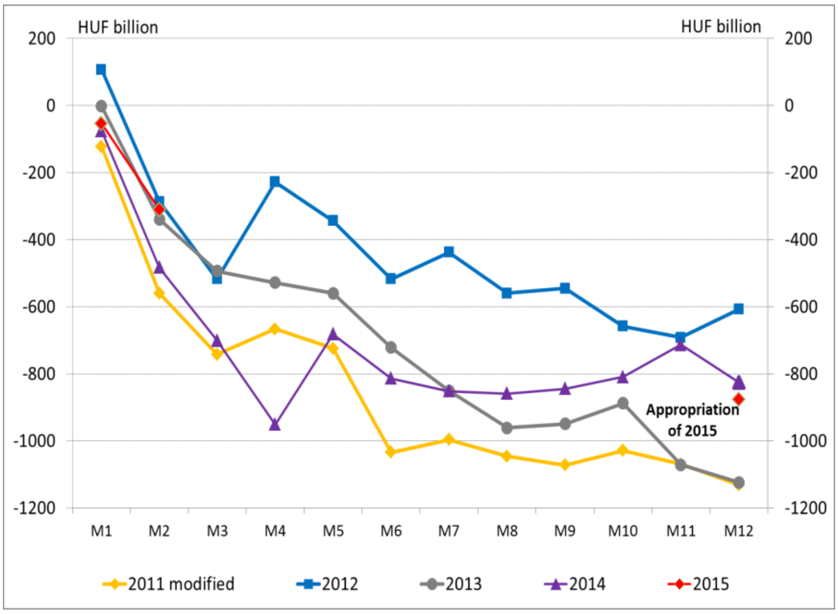


Inflation in Hungary is expected to remain below 0 per cent in the short term. Inflation data in February fell short of the expectations of the December Inflation Report, which can be primarily attributed to lower-than-expected food and fuel prices. Inflation is likely to produce negative figures even in the coming months, reflecting the decline in oil prices in the past period.

1.4. Fiscal developments

The deficit of the state budget stood at HUF 257 billion in February 2015, which is a considerable improvement compared to the deficit levels recorded in February in recent years (Chart 10). Current deficit is HUF 150 billion lower than the value recorded last February which reflects, for the most part, lower expenditures and, to a lesser degree, an increase in government revenues (especially VAT and contribution revenues). Owing to a change in the short-term distribution of interest expenses and the lower yield environment, substantial savings emerged on the expenditure side in net interest expenses compared to February 2014.

Chart 10: Intra-year cumulated balance of the central subsystem of the general government



Note: the adjusted profile for 2011 excludes the effect of one-off items (payments to the Pension Reform and Debt Reduction Fund, the acquisition of a stake in MOL, a one-off VAT refund in compliance with the decision of the European Court of Justice, a capital injection to the Hungarian Development Bank and the assumption of MÁV's debts).

1.5. External balance

Hungary's seasonally unadjusted external balance surplus was around EUR 800 billion in January. The decline in external surplus mainly reflected the decrease in the transfer balance, which reflected the lower absorption of EU transfers compared to December. The surplus of goods and services edged up slightly, in line with the expansion observed in the manufacturing sector (especially in vehicle production) and chemical production (manufacture of coke and refined petroleum).

Based on financial account data, debt liabilities declined, while net foreign direct investment increased slightly. In January, Hungary's net lending, calculated on the basis of the financial account, amounted to EUR 400 million. This resulted from an outflow of debt liabilities, in particular, a decline in the external debt of the consolidated general government. The net decline in public debt emerged in the context of a substantial rise in reserves. Some of this decline may have resulted from maturing overnight FX swap contracts concluded with the banking sector at the end of the year. The banking sector's external debt rose slightly as a correction of the sharp fall at the end of the year. FDI increased mainly as a result of the reinvestment of earnings.

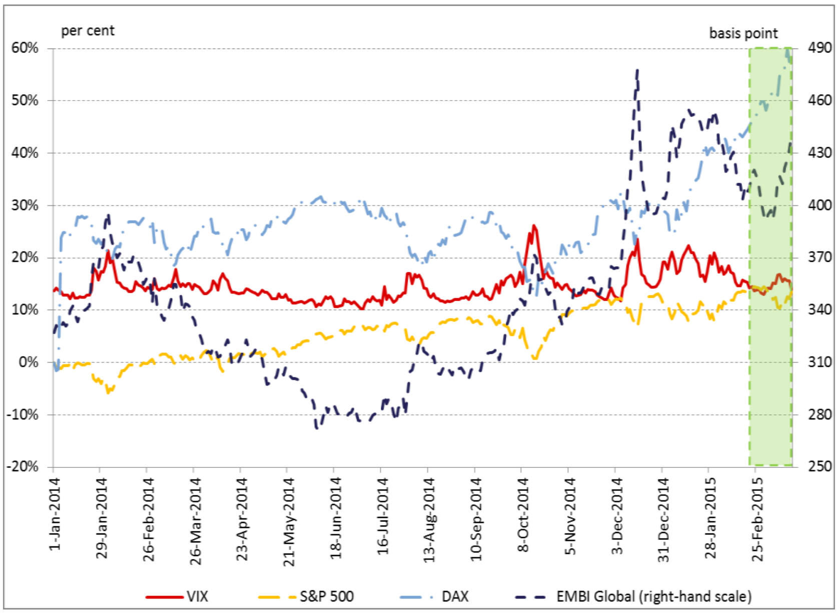
2. FINANCIAL MARKET DEVELOPMENTS

2.1. International financial markets

In the period since the last interest rate decision, several factors have had a profound effect on global risk appetite in money and capital markets: while the extension of the Greek bailout programme by four months assuaged market concerns temporarily, the vulnerability of the Russia–Ukraine situation, the extraordinary interest rate increase in Ukraine and the recessionary Russian economic outlook had a negative impact on emerging markets. In addition, the opposing monetary policy stances of the Fed and the ECB prompted significant shifts in certain sub-markets (Chart 11). As a result, the movement of developed stock exchanges have diverged in recent weeks: while German and Japanese stock markets surged in response to central bank decisions and expectations regarding central bank steps, revived expectations of an interest rate increase weakened US stock markets. The sentiment overseas was also deteriorated by an abrupt decline in oil prices in March after a period of apparent stabilisation in February. The spread between ten-year US and German yields widened further in response to indications by the Fed and the ECB and heightening expectations of the Fed's interest rate increase based on the disclosure of favourable US macro data. At the same time, owing to communications following the Fed's rate-setting meeting in March, the US stock exchanges recovered from most of the 2–3 per cent fall sustained previously, reducing the overall decline to less than 1 per cent.

The VIX index – the indicator measuring developed equity market volatility – exhibited similar movements: parallel to the stock market weakening it rose by 2.5 per cent before returning close to the level observed at the beginning of the period following the Fed meeting. On the other hand, after a temporary decline, the EMBI Global index, which reflects the risks associated with emerging bond markets, rose to 440 basis points – the level observed at the end of January – in the second half of the period, which suggests that investor sentiment in bond markets continues to be negatively affected by tensions surrounding the emerging region (Russia–Ukraine crisis) and expectations regarding the Fed's interest rate increase. Meanwhile, the German stock market index and the Japanese Nikkei rose by more than 7.5 per cent and 5.5 per cent, respectively, in response to the ECB's decision and the expected loosening indications of the Bank of Japan. With an optimistic attitude about the economic and inflation outlook, at its meeting in mid-March the Bank of Japan was trying to dampen heightened market expectations about another monetary stimulus, but even this failed to hold back the rising of the Tokyo stock exchange.

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



As a result of the diverging monetary policies of developed regions, the exchange rate of the dollar appreciated sharply both against emerging currencies and the euro, pushing down the EUR/USD cross rate to its 13-year trough. Ten-year US yields increased for a significant part of the period but dropped in the days preceding the Fed's meeting, and continued to decline for the rest of the period; thus the yield rose only slightly overall in the review period – by 5 basis points –, while the ten-year German yield sank to a historic low – below 0.2 per cent – after the launch of the ECB's asset purchase programme in March. Ten-year periphery yields decreased by 15–45 basis points in the review period, while the Greek long-term yield increased by 280 basis points overall, which indicates that markets were not appeased for long by the temporary extension of the Greek bailout programme. This is reconfirmed by a survey conducted in February among market participants: based on their responses, the number of those expecting Greece's exit from the euro area within the next 12 months increased compared to January.

Macroeconomic data received from the US were mixed overall. The decline in US inflation was steeper than expected in January, showing negative values not only compared to the previous month, but also on an annual basis. The downturn in retail sales, falling consumer confidence indicators, stagnating wages and weaker than expected, 2.2 per cent 2014 Q4 GDP data point to a possible delay in the Fed's interest rate increase until economic data suggest a more straightforward picture. At the same time, several signs indicate that disinflation fuelled mainly by the fall in energy prices will be temporary only. Moreover, markets tend to attach a key significance to monthly employment and unemployment data, which have been improving for months (according to the latest data release, US unemployment sank to 5.5 per cent), and accordingly, the heightening expectations of an interest rate increase have been primarily driven by these figures in recent months. Indeed, the expectations of market participants before the FOMC meeting point to an earlier start date for rate increases, possibly as early as June instead of September. At the March rate-setting meeting of the FOMC the Fed clearly indicated that the chances of raising the interest rate in April were rather slim; however, it offered no guidance in respect of the timeline of the interest rate increase, and the wording of the communication continues to be extremely cautious. However, it was not this but the release of the quarterly macroeconomic projection that improved market sentiment. The FOMC report included members' projection about the expected interest rate path, which reveals that members envisage a significantly lower interest rate path for the next two years than they had expected in December. Decision-maker median interest rate forecast is 0.625 per cent by the end of this year and 1.875 per cent by the end of 2016, compared to the expectation of 1.125 per cent and 2.5 per cent, respectively, in December.

For the most part, data received from the euro area were upbeat; based on the latest figures, the protracted descent in the rate of inflation has apparently come to a halt. According to the preliminary release for February, euro area prices decreased by 0.3 per cent compared to –0.6 per cent in January. In line with expectations, the GDP figure for Q4 was 0.9 per cent. The performance of industrial production in January and the substantially higher than expected euro area retail sales volume, however, caused a positive surprise. In addition, the consistently rising value of the Sentix investor sentiment index in recent months also points to significantly improved expectations about the business environment. At its meeting in early March, the ECB disclosed the detailed conditions of its asset purchase programme, and on 9 March it commenced bond purchases. It was also revealed that the ECB (and NCBs) were willing to purchase bonds with negative yields as well, as long as they are not below the deposit facility rate.

Following a stabilisation and a slight increase in February, oil prices were on the decline in March again, losing value by 5–10 per cent amid the continuous strengthening of the dollar. In part, the decline may reflect the news about substantially higher-than-expected US oil stocks and the information released about the decision of OPEC countries to maintain their production quota for the time being. The price of Brent crude oil dropped to USD 55 from USD 58.6, while the WTI crude oil price fell below its January trough, to USD 43.4 from USD 49.3.

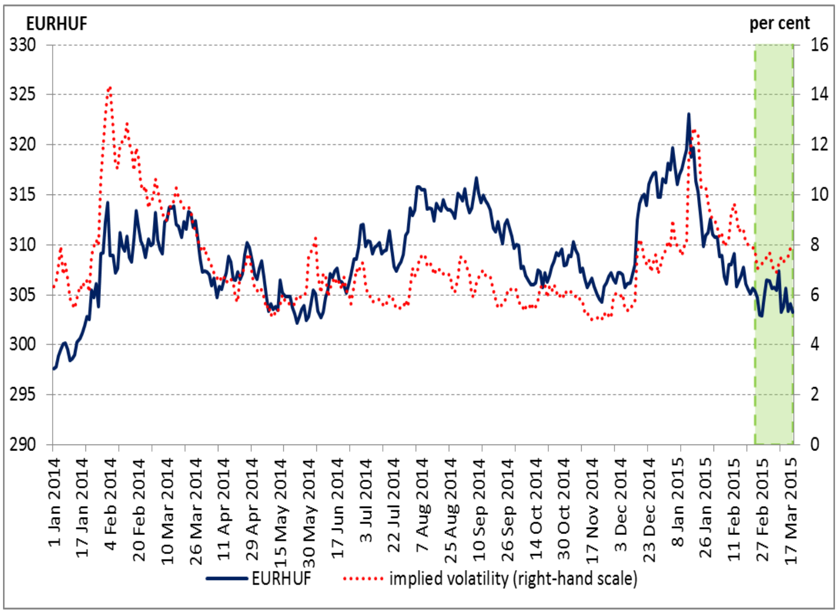
The vulnerability of the armistice between Russia and Ukraine and unfavourable news from the region weigh down on the perception of the region. In view of the continued nose-dive of the hryvnia, the National Bank of Ukraine raised its key policy rate to 30 per cent from 19.5 per cent. It underpins the severity of the Ukrainian situation that the IMF announced in March the immediate disbursement of USD 5 billion for Ukraine from the previously negotiated, four-year credit facility of USD 17.5 billion. Shortly after the announcement Ukraine was reported to have commenced negotiations with its creditors about the rescheduling of its debt. According to the staff projections of the IMF, the Ukrainian economy may contract by 5.5 per cent this year, although a slight growth is already expected for next year. Meanwhile, Moody’s downgraded Russia’s credit rating to category Ba1 from Baa3. As a result, Russia has lost its investment grade status at two major credit rating agencies (S&P, Moody’s).

2.2. Developments in domestic money market indicators

Domestic financial market developments have been mainly shaped by international factors since the previous interest rate decision; however, country-specific factors have been also in play.

For the most part during the past four weeks, the HUF/EUR exchange rate fluctuated within a ±1 per cent range around its level of 305. By the end of the period the forint appreciated by 1.2 per cent. The Polish zloty followed a similar trajectory. The one-week implied volatility of the EUR/HUF exchange rate increased slightly. Amid the general strengthening of the dollar the forint depreciated by nearly 5.3 per cent against the US currency, which was consistent with regional trends. The forint weakened by 0.6 per cent against the Swiss franc.

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

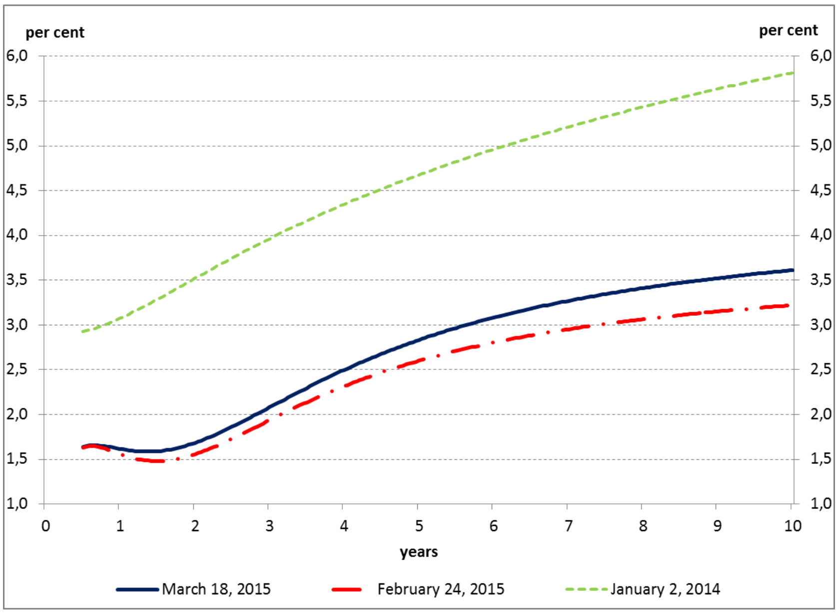


The Hungarian five-year CDS spread rose to 137 basis points from 126 basis points recorded at the beginning of the period. According to the decomposition, this increase was driven mainly by country-specific factors, and international factors played only a minor role.

S&P upgraded the credit rating to BB+ with stable outlook on 20 March, thus Hungary's credit rating is identical by all three credit rating agencies. According to S&P, the external vulnerability of Hungary has decreased since the outbreak of the global financial crisis, the country has become more resilient to potential external shocks.

The steepness of the Hungarian government securities yield curve has increased since the previous interest rate decision (Chart 13). At 1.54 per cent, the three-month discount Treasury bill's yield is still below the key policy rate, which implies a 5 basis-point dip since the previous interest rate decision. As regards long-term maturities, yields exhibited a 15–50 basis-point temporary rise which, save for the ten-year yield, has corrected completely after the Fed's interest rate decision. Despite the end-of-period decline, the ten-year yield is still up 19 basis points compared to the value recorded at the previous interest rate decision. In the region, Poland and Romania saw a moderate, temporary rise in the ten-year benchmark yields (19–32 basis points), while the yields tended to decline steadily in Slovakia and the Czech Republic.

Chart 13: Shifts in the spot government bond yield curve

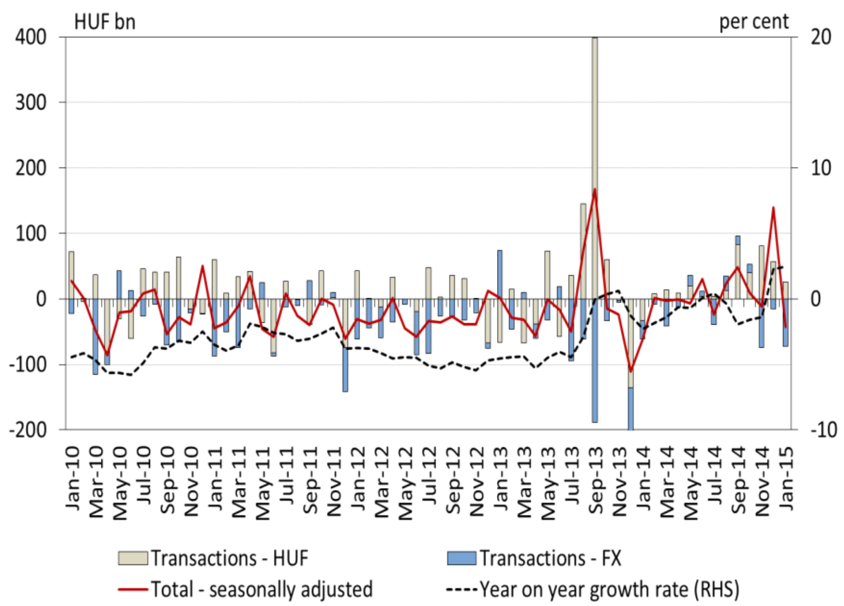


Average yields remained essentially unchanged at short-term government security auctions during the period. Average yields did not change considerably during the period at three-month and twelve-month Treasury bill auctions; except for one three-month auction, demand was generally one and a half times higher than the quantity offered. On one occasion, low demand forced the Debt Manager to cut back the scheduled quantity by HUF 10 billion. There was mixed demand at the auctions of fixed-rate bonds with longer-term maturities, and the Debt Manager reduced the announced quantity by HUF 5 billion overall. Yields remained unchanged in the three-year segment, declined for five-year securities and increased slightly in the case of ten-year papers. The Debt Manager stepped up the issuance of five-year floating rate notes by HUF 10 billion.

3. TRENDS IN LENDING

In January, outstanding lending by banks to the corporate sector rose by a total of HUF 47 billion based on transaction value (Chart 14). Looking at the currency breakdown, outstanding forint loans increased by HUF 26 billion, while foreign currency loans declined by HUF 73 billion. The gross amount of new corporate loans extended by the credit institution sector as a whole was HUF 152 billion in January, implying subdued new lending compared to both December and the same period of the previous year. In January, contracts for a mere HUF 17 billion were concluded under the FGS. The decline in new FGS lending is primarily associated with seasonality; however, the value of new contracts was up 50 per cent compared to January 2014.

Chart 14: Net borrowing by non-financial corporations



Households were net loan repayers to the entire credit institution sector in January: the decline in transactions amounted to around HUF 27 billion (Chart 15). The decline in the loan portfolio can still be attributed to the contraction in foreign currency loans. In the case of forint loans, disbursements exceeded repayments, and the transaction-based change in the portfolio was around HUF 10 billion in January. The annual rate of the portfolio decline slowed to 3.8 per cent from 4 per cent recorded in December. Gross lending to households by the credit institution sector as a whole amounted to HUF 39 billion in January, up 29 per cent compared to the same period of the previous year. The disbursement of new housing loans did not decrease despite the adoption of the MNB Decree on the regulation of the debt-to-income ratio and loan-to-value ratio.

Chart 15: Net borrowing by households