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Weekly Briefing

Hungary Economy briefing:

Hungarian Economy trends

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Availability and abundance of financial resources is crucial in every economy, in particular in the Hungarian economy, which can be characterized by an overall lack of savings, thus capital necessary to modernize the economy. Trends in saving and borrowing stand in focus now, when **the financing environment in the world economy seems to be in a profound change, not only the last and this week's crash in the stock markets but improving economic indicators (in particular the unemployment rate) might push the FED to raise interest rates earlier than anticipated. From a Hungarian point of view, it is crucial to ensure capital to development goals, so growing interest rates in the US will make the access to alternative capital sources (Chinese and Russian capital) more important in Hungary in the medium and long term.** Therefore this briefing focuses on the recent development of inflation, interest rates, liquidity and the Hungarian external trade.

The Hungarian economy's fast growth slowly increased the average inflation rate in 2017, which – as we hinted in our previous analyses – might force the Central Bank of Hungary to raise interest rates in the long term. However, this week in an interview, the Vice-President of the Central Bank, Márton Nagy reinforced **the Central Bank's willingness to keep low interest rates and not raise them until the end of 2020. In December 2017,** (the latest available data) annual inflation rate (consumer price index) was 2.1 percent in Hungary. The difference between industrial price index and consumer price basket vividly shows the robust demand in the Hungarian industry. In December 2017, industrial prices were by 3.9 percent higher than in the previous December. Manufacturing prices which make up two third of the changes in the industrial price index in these statistics, grew rapidly, by 5.2 percent over 2017, while the remaining component (energy prices) basically did not change between December 2016 and December 2017.

According to the MNB's forecasts, target inflation rate (3 percent) will only be reached in mid-2019. It is hard to forecast the inflation trajectory, but it is clear upward pressures are strong in the Hungarian economy, f. ex. the volume of total retail turnover significantly rose in December 2017; this time, the rise was 5.9 percent compared to December 2016.

The surge in retail sales clearly shows improving and increasing purchasing power of the Hungarian consumers. **Over the last 54 months, the retails sales have been growing in Hungary!** As we pointed out earlier, labor market shortages force firms in the entire economy to increase wages, however, the same increase can lead to falling profitability on firm-level. Profitability problems drive firms rethink their business models and find innovative solutions. That is the very case in the retail store segment, where the German firms (Lidl, Aldi) have a competitive edge over Hungarian and other foreign firms. While Aldi and Lidl have been able to raise wages and hire skilled workers over the last months, the Hungarian COOP has struggled with labor shortages, and many of its stores cannot open or they are only partly open. In other words, **the example of retail store segment demonstrates a novel situation to the Hungarian firms, as they are compelled to find new advantages over the competitors and relying on cheap labor is not a sufficient model any more**.

Along with the labor shortages, a new trend has been unfolding in the Hungarian economy over recent months; **there are more and more already retired persons being employed by private firms**. If looking at the data, it is obvious, **pensioners are to be considered as reserve labor force of the Hungarian economy.** Male employment rate for the age group 55-64 years is 53.6 percent in Hungary and 62 percent in the EU, the same rate for females is 41.5 percent in Hungary, and 48.9 percent in the EU. Adequate employment policies could help to alleviate these shortages of the Hungarian economy.

As we could see there are upward pressures on the domestic inflation, however until now, **global trends seem to help the implementation of these Hungarian inflation target goal** because after the sudden increase of global inflation in early 2017, the inflation growth rates declined in the second half of 2017 and low inflation characterized the world economy in November and

December 2017. However, this state of the word economy will change in short term, since bond markets and stock markets peaked in December showing a strong global optimism, which was underpinned by relatively robust growth data in the euro area. **The main question which remains in this context, is how to interpret the crash on the American and later other significant international markets over the last week, especially the 5th of January 2018,**

- **whether it will have further consequences since investors fearing interest rates hikes in the future expect worsening profits of debt-ridden firms (long-term effects);**
- **or investors wanted to cash in former increases in the stock market (short-term effects).**

The former case with long-term effects is clearly a threat to the Hungarian economic development goals, in particular, to keeping low interest rates until end-2020. **And that is the point when availability of Chinese capital could make China's role in the world economy, in particular in Hungary more significant.**

However, if short-term effects prevail – which is more likely in our interpretation **– it is only a test to the new Hungarian economy policy, what will happen, when the world economy returns to normalcy, i.e. there are positive interest rates on bonds, and the Hungarian state has to pay higher interest rates for borrowed money**. Until now the effectiveness of the new Hungarian economic policy was probed. Stability of the financial environment is strengthened by positive current account balance, in the three first quarters of 2017, current and capital balance reached 5.3 billion euro, around 7-8 percent of the GDP. The balance of export and import was 7.7 billion euro in the first eleven months, which was lower than a year before demonstrating a slightly worsening trade balance.

In this context, we again must refer to the interview given by Mr. Nagy, who emphasized that the **main goal of the Central Bank of Hungary is to reduce the real interest rates margin between regional, ECB and**

Hungarian interest rates, in other words to reduce real interest rates margin. That shows a more flexible and liberal approach, which might lead to a weaker currency. He underlined Central Bank targets the level of state bond rates and credit rates. Another formulated goal of the Central Bank of Hungary is to replace adjustable, free interest rates (usually linked to BUBOR) by fixed interest rates in the housing market. The implementation of this policy goal would reinforce stability and predictability of the credit market to consumers. According to the announcement of the Central Bank of Hungary (01-02-2018), average cost indicator of loans, private credits, mortgage loans that were borrowed in December 2017, declined compared to previous months. The same trend can be demonstrated at loans to non-financial firms, except for loans over 1 million euro.

Along with liquidity enhancing measures, the other strategic goal is to improve the competitiveness of the Hungarian small and medium enterprises. This strategy is in line with strengthening domestic economy, owned by Hungarians. **The Minister for Economic Affairs, Mr. Varga told about the SME-strategy of the Hungarian government in a press conference the 5th of February 2018. The strategy was prepared and concluded by the involvement of the Organization for Economic Co-operation and Development (OECD).** The strategy sets the emphasis on productivity improvement of Hungarian SMEs while considering the country's characteristics in regulations, and corporate environment.

SMEs are crucial elements of the Hungarian economy policy, since the domestically owned part of the Hungarian economy is still small, if compared to other European countries. **Central European countries are basically foreign-owned and run economies, the famous French economist, Thomas Piketty concluded in a blog post the 16th of January 2018, while comparing EU-transfers to the Central European countries with the capital transfers from these countries.** This blog post triggered a heated debate in Hungary, the left-leaning economist surely cannot be accused of being nationalist or having protectionist views on the economy thus his post provided the Hungarian government with good arguments in the coming debate on the EU-budget and the Hungarian economy model.

To sum it up, improving American economic indicators, changing international financing environment and slowly increasing inflation in Hungary are threats to the Hungarian economy, which together might raise difficulties in keeping low interest rates and improving liquidity in the Hungarian economy, however, trade surpluses still ensure a much larger maneuverings room for the Hungarian monetary and economic policy than before the Great Recession (2009-2010). It must be stressed that positive conditions might easily change in the financing environment forcing Hungary to find new alternative sources of capital. As pointed out earlier, not only Chinese but Russian capital might be considered. This change would have the long-term consequence to increase further the significance of the Hungarian state in the economy, pushing Hungary – in our understanding – to the implementation of a new version of developmental state.