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Hungary Economy briefing:

The Beginning of a New Era in the World Economy and the Hungarian Economy?

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The Beginning of a New Era in the World Economy and the Hungarian Economy?

In recent months, rapidly growing prices, and wages combined with labor shortage have indicated the possible end of an economic development stage in the Hungarian economy. The previous period could be characterized by the fast rise in employment, a more flexible labor market, substantial tax cuts, and easier access to cheap credits. The next stage of economic development builds on a different global economic environment in which

— trade disputes between the regional blocs (trade wars) are more likely to occur,

— higher interest rates will lead to more expensive money- and credit facilities

— and labor shortages (mainly in Europe and the advanced and middle income countries) will force the countries to focus more on new technologies (development of intelligent technologies, and solutions of the 4.0 industrial revolution etc.)

In this new era, the goals that the Hungarian economy policy should pursue, must be adjusted to the new environment. This briefing analyzes two elements that are decisive in shaping the future of the Hungarian economy,

1. **recent changes in the foreign credits markets with the potential to affect public debt, public budget, inflation and exchange rate and**
2. **policy responses, necessary to tackle with the new challenges.**

Before getting to these points, let's take a brief look at recent developments of the Hungarian economy (growth, inflation and interest rates, indicators that show new trends emerging in the economy).

The Hungarian economy grew by 4.4 percent in the first quarter of 2018. The rapid growth was bolstered by a substantial increase in market services, and construction. The construction sector was able to grow by 22.5 percent in Q1

2018 compared to Q1 2017, at the same time agriculture was the only sector where the output decreased by 0.6 percent compared to the Q1 of the previous year. The entire economy can be characterized by rapid growth in 2018, which on the other hand generated increasing inflationary pressures in the economy. The inflation rate in the Hungarian economy grew by 3.1 percent in June 2018 compared over the last 12 months.

1. Recent changes in the foreign credits markets with the potential to affect public debt, public budget, inflation and exchange rate

The rise in inflation has been a global trend in recent years. The inflation rate in the euro zone was 2.0 percent, and 2.9 percent in the US in June 2018. These data are very much in line with market expectations, the rise in inflation was mainly boosted by higher prices of energy and food.

Therefore, it should not come as a surprise that not only the rapid growth of the Hungarian economy but external conditions (the rise in oil prices and the uncertainty in the international financial markets) contributed to the relatively rapid rise of the Hungarian inflation rate. In recent weeks, turbulences of the foreign exchange markets also hit the Hungarian currency leading to a volatile exchange rate. The HUF weakened to 330 (HUF/EURO) end of June, while the average exchange rate was around 310 in the last 6 months. Weakening exchange rates of the Hungarian currency also add to the already existing inflationary pressures.

The volatility of the international markets can be easily explained when thinking of the interest rate raise of the FED and the intention of the EBC to slow down and then stop the money-creation process in the euro zone. When the Americans will raise the interest rate by 2.5-3.0 percent, the dollar will be strengthened and all the investments now flowing into the emerging markets, will change its direction and flow in American state bonds which are the still the most secure investments in the market. In the new era of global economic development, besides security, investment in dollar bonds can also ensure relatively high returns.

When it comes to the Hungarian economy, there are two additional elements predicting the new era: the slow-down of the European markets, and the rise of oil prices can adversely affect the Hungarian growth rate. In both cases, the vulnerability of the Hungarian economy is traditionally high. Consequently, times when cheap money was easily available to Hungary, seem to end, which directly affects the exchange rate of the Hungarian currency, and the inflation rate as it could be witnessed in the last months.

As a result of these processes, the pressure on the Central Bank of Hungary to raise interest rate grew very intensive in recent weeks. However, if one looks at the fact that the weakening only reached 12 percent between the first of January and end of June, it is clear that not the extent of the weakening but its intensity and its causes are alarming. But at the same time, it must be added that the Central Bank of Hungary thoroughly follows its mandate when keeping an eye on the price stability (inflation rate) not the exchange rate. The Central Bank often argues, it doesn't have any exchange rate targets, only inflation rate target which is 3 percent, where the interval of "tolerance" is +/- 1 percent, In other words, based on the target, the Bank is not forced to intervene, and raise the interest rate. (The last change took place in 2016, when the Central Bank cut the interest rate to 0.90 percent.)

If the Central Bank of Hungary would be forced to raise the interest rates, the rise not only would affect the expansion and investment of the domestic firms, but the mortgage loans whose interest rates would increase. That is the reason why the Central Bank has tried to put pressure on the market players in recent months to prefer loans applying fixed interest rates constructions. However, the new loans (borrowed after the raise) would be lent out at higher costs adversely influencing the construction sector, and other linked sectors. If interest states raised, state bonds could be sold easier to buyers, however, it would lead to higher cost in financing public debt. In other words, a change of the interest rate policy would have adverse and far-reaching consequences on the Hungarian economy,

2. Policy responses, necessary to tackle with the new challenges

Between 2010 and 2013, the main challenge of the Hungarian government was to decrease public budget deficit, and public debt. Between 2013 and 2017 – since interest rates could be lowered due to decreasing debt, – new and cheaper credit facilities were opened and offered to private firms and households. These steps helped decrease the vulnerability of the Hungarian economy. Between 2013 and 2017, the economy underwent an extensive growth phase when the economic growth was built on the rise of employment. The inclusion of more people, the growing flexibility of labor market and the declining taxation burden also contributed to a relatively rapid growth of the Hungarian economy.

In recent months, the government and the Central Bank of Hungary started to shift the focus on new elements of the economic policy. The new, so-called intensive growth path doesn't build economic growth on higher employment levels exclusively, but rising productivity, improvements of competitiveness, support of research and development, development of capital- and human resources and creative industries are emphasized in the new strategies. Being aware of the necessary changes, the National Competitiveness Council discussed three economy policy strategies in recent weeks,

- first the strategy of the Hungarian Chamber of Commerce and Industry,
- then the working paper of the Ministry of Innovation and Technology and
- thirdly the proposal of the Hungarian Bank of Hungary.

After the comparison of the three strategies, the Council will advise the Hungarian government to take the necessary steps and measures.

In this briefing, we only would like to highlight the ideas and suggestions of the Central Bank of Hungary regarding the export strategy, formulated in the document that contains 180 concrete proposals. The part on export strategy starts with a very strong emphasis on the small and medium enterprises. The document makes the following proposals in this field:

— measures to utilize geostrategic advantages of Hungary in the implementation of the Belt and Road Initiative (logistical developments, and the attraction of Chinese capital investments),

— measures to enter emerging markets with stabile political and economic institutions (South-East Asia ASEAN, South-Africa, Brazil, and Mexico),

— the formulation of a new trading house concept,

— strengthening of services export (environment protection, green energy, waste water treatment etc.) and other measures as for branding and promotion etc.

As we can see, the new approach doesn’t mean relevant changes in the export strategy, only it tries to make former strategic directions more explicit and concrete and if it needed it makes small adjustments to them.

To sum it up, it can be seen, that the Hungarian economic policy decision makers are aware of the need to speed up the modernization of the Hungarian economy. In this process, research and development, intelligent technologies must play a more important role than in the previous period of economic development. At the same time, financing opportunities might be more restrained than before based on recent development in the world economy, unless the internationalization of the Chinese RMB will speed up in the near future and offer new alternative financing opportunities to Hungary and other countries in need of more capital.