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Hungary economy briefing:

The specter of inflation? Trends in Hungary

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The specter of inflation? Trends in Hungary

The threat of inflation seems to be the most discussed topic in debates concerning the global economy now. Some analysts argue that supply-side bottlenecks, massive fiscal spending and easy money policies around the world will inevitably lead to persistent and high inflation and undo savings, along with the results of many years of responsible fiscal policy. The argument partly relies on the Phillips curve, which postulates an inverse relationship between inflation and unemployment. Hungarian economic trends do not point to this risk of sustained high inflation. The reaction of the Hungarian Central Bank (MNB) to this fear has been moderate, with the "bidding out your time' approach working so far.

Introduction

The economic briefing starts with the short analysis of the international environment, which leads us to conclude that the recent sudden surge in inflation is rather temporary, although upside inflation risks continue to lurk in the global economy. The next section gives us an overview of inflation trends in Hungary, while the analysis also focuses on the MNB's moves on interest rates, and the exchange rate. It also discusses the significance of the build up of gold reserve at the MNB.

International environment

World trade contracted 5.0 percent last year and is expected to rebound this year, so the trade recovery will fuel prices around the world. Although the expansion of world trade will be uneven due to the different pandemic situations in countries, it will have an impact on inflation. According to the WTO, trade volumes are more likely to increase in North America and Asia than in Europe.

The last time rising inflation challenged global growth was the first oil crisis, when the combination of inflation and stagnation made the search for new policy solutions increasingly important. We may not face the same dilemma now, as markets in major economies appear to be thriving, but persistent bottlenecks along with global supply chains will still fuel inflation expectations around the world. (Even the blockage of the Suez Canal caused problems in global supply chains).

The monthly U.S. consumer price index jumped to 1.7 percent in March 2021, and economists expect it to rise above 2 percent and stay there as more U.S. states reopen.[1] The reopening of the US and China's rapid growth are key factors, however disinflationary forces are also at play (the proliferation of e-commerce and digital services). Jerome Power, the chairman of FED claims that the surge in inflation will be temporary instead of permanent.[2] In the eurozone inflation averaged 0.3 percent in 2020, with a more significant increase of 0.9 percent in December 2020. According to ECB, the increase in the consumer price index will continue in 2021, peaking in the last quarter of 2021 (2.0 percent). Similar to the US, inflationary trends are expected to be temporary.[3]

Inflation and interest rates in Hungary

Against this background, it is understandable that the changes in the international environment have also triggered fears of a higher inflation rate in Hungary. According to the latest available statistics, consumer prices have risen by 3.7 percent until March 2021 compared to the corresponding period of the last year. Core inflation was 3.1 percent in March 2021. Looking at product groups, we find that prices of petrol (17.7 percent) and tobacco, spirits (10.3 percent) rose faster on average. The growth dynamics of price changes show that annual inflation will continue to accelerate. At the same time, in its latest communication on inflation trends in Hungary,[4] the MNB pointed out that in March 2021 the indicators capturing more persistent inflation trends - such as the price index of demand-sensitive products or services and the inflation of products and services whose inflation rarely changes - declined compared to the previous months.

For this reason, it can be argued that the MNB is most unlikely to change its interest rates soon. The key interest rate was cut from 0.75 percent to 0.60 percent last summer to give the

[1] Irwin, Neil (2021): How 10 Prominent Economists Think About Overheating New York Times, https://www.nytimes.com/2021/03/24/upshot/economy-inflation.html

[2]Lameez Omarjee (2021): Brace for higher, but temporary inflation, US Fed chair Jerome Powell warns at IMF debate on global economy, Fin 24, https://www.news24.com/fin24/economy/brace-for-higher-but-temporary-inflation-us-fed-chair-jerome-powell-warns-at-imf-debate-on-global-economy-20210409

[3] Philip R. Lane (2021): Inflation dynamics during a pandemic Europea Central Bank, Blog. https://www.ecb.europa.eu/press/blog/date/2021/html/ecb.blog210401~6407b23d87.en.html

[4] Magyar Nemzeti Bank (2021): Havi elemzés az infláció alakulásáról https://www.mnb.hu/letoltes/inflacios-alapmutato-aktualis-havi-ertekeles.pdf

Hungarian economy a boost. Despite slowly rising inflation, we do not expect a tight money policy to be implemented in Hungary any time soon.

The MNB has pursued a very active and creative monetary policy since 2010, with many "out of the box" solutions. It was able to facilitate funds for economic development, ensured price stability and prepared for bad times. For this reason, the MNB built up a substantial amount of gold reserves, a move that definitely deviates from the neoliberal monetary policy that reduced the role of gold among reserves in the 1970s and 1980s. In recent years, global demand for gold reserves grew and uncertainty in the wake of the Coronavirus pandemic fuelled fears of growing government debt and inflation. The MNB decided to increase its gold reserves in 2018 when the amount of gold reserves increased tenfold from 3.1 tons to 31.5 tons. This year, the amount of gold reserves was tripled to 94.5 tons. The size of Hungary's gold reserves is 36th in the international ranking, 3rd in the region Central European region. Looking at gold reserves per capita, Hungary ranks 1st in the Central European region. Given the growing uncertainties in the global economy and politics, it makes sense to expand the scope of monetary policy instruments on which the MNB can rely.

As mentioned above, the MNB changed the key interest rate last summer and no significant changes have been made since. The last communication on the Monetary Council's meeting was published on March 23, 2021 and the report of the meeting on April 7, 2021. The communication highlighted the following elements that resulted in not changing the key interest and other elements of the financing environment in Hungary:

- The fourth quarter of 2020 showed a surprisingly rapid recovery in the global economy, and although the third wave led to new lockdowns, the global economy will most likely recover after the third wave of the global pandemic.
- The U.S. responded with the adoption of a stimulus program and maintained its easy money policy.
- The European Central Bank did not change the key interest rate and continued its asset purchase program.

Based on these elements, the communication concluded that monetary and financial conditions will continue to prevail in the future, and they do not expect the FED, ECB and other regional central banks to change their policies significantly. They also added domestic factors that ensure the fast recovery potential of the Hungarian economy:

- The investment rate was high in 2010 (27.5 percent).
- The unemployment rate is low by international standards.

- The expansion of the credit market prevailed despite the global pandemic.
- The rise in the population's income, the increase in public investment and EU transfers also support the rapid recovery.

For several months, the MNB was criticized for the weak Hungarian currency. After the first wave of the global pandemic and lockdowns in 2020, the forint went through several waves of weakening, the first peak was in September-October, when the €/HUF rate was around 365, the next peak came in mid-March, when the rate reached almost 368 HUF. However, the domestic currency’s exchange rate has risen significantly since, almost returning to the pre-pandemic rate of 350 €/HUF. In our opinion, the combination of good news (robust growth in China, the US and several stimulus packages adopted in major economies), good economic fundamentals in Hungary and the successful launch of the vaccination program makes investors optimistic and this optimism is now reflected in the exchange rate. At the same time, we do not know now whether the strengthening will prevail, because

- The political debate between the Hungarian government and the European Union is far from over. Uncertainty around EU transfers can affect exchange rate movements.
- In recent weeks, US government bond yields have been rising. If this trend proves to be permanent, it will have a negative impact on emerging market currencies, including the Hungarian Forint.

Summary

From the international environment, it can be concluded that fears of high, permanent inflation are unfounded, but upside risks remain, which could have a negative impact on the exchange rate of the Hungarian currency. The real economic trends in Hungary do not justify the fears, and for this reason we do not expect the interest rate to be raised soon. It is certain that the end of economic lockdown and the subsequent pick-up in the economy will create upward pressure on inflation, but only temporarily. We could also see the MNB preparing for significant shifts in the international monetary regime as it is increasing the volume of gold reserves at the MNB.