China-CEE Institute
中国—中东欧研究院

ISSN 2939-5933

Vol. 68, No. 1 (HU)

December 2023

Weekly Briefing

Hungary political briefing:
EU and Hungarian economy in 2023

Csaba Moldicz

China-CEE Institute

Kiadó: Kína-KKE Intézet Nonprofit Kft.
Szerkesztésért felelős személy: Ju Weiwei
Kiadásért felelős személy: Feng Zhongping

1052 Budapest Petőfi Sándor utca 11.
+36 1 5858 690
office@china-cee.eu
china-cee.eu

EU and Hungarian economy in 2023

Global growth has been negatively affected by several factors this year. Geopolitical uncertainty has not decreased but increased with the eruption of the Gaza conflict, and there is no end to the war in Ukraine either. In addition to these relatively short and medium-term changes, we can see that countries in the West have put strong emphasis on the relocation of global supply chains. Words like reshoring, homeshoring, friend-shoring, and slowbalization are buzzwords in world politics nowadays. According to certain analyses, the ongoing changes in supply chains do not create more security in the world, but they merely extend the existing supply chains by channeling the flow of goods through countries such as Vietnam, Mexico, India, Bangladesh, etc. The extension of supply chains means more costs for end users and producers. Therefore, we expect slower growth and higher inflation in the years to come. This is the environment in which Hungary has to develop its economy. This briefing looks at macroeconomic trends in the European Union, especially in Hungary in 2023.

Economic Growth in 2023 and 2024

While 2022 saw relatively high economic growth in the EU (3.4 percent) and the Eurozone (3.3 percent), the economy in the region as a whole slowed down this year, as previously expected (Eurostat database). The slowdown is mainly due to two factors: tight macroeconomic policies associated with a high-interest rate environment and a high energy policy. At the same time, the labor market remained strong, and we can observe a demand market in the EU where a shortage of skilled labor is the main feature of the market. Both the European Commission and the International Monetary Fund expect very low GDP figures for next year (European Commission, 2023; IMF 2023). Estimates for both the EU and the Eurozone are between 0.7 and 1.50 percent for the year as a whole. [1]

As far as next year is concerned, analysts emphasize that while the overall inflation rate has fallen rapidly, core inflation in the European Union appears to remain at a high level. For this reason, the forecasts for development in 2024 are vague. On a positive note, consumers in Europe are gradually regaining purchasing power as prices fall and wages rise, which should

[1] https://economy-finance.ec.europa.eu/economic-forecast-and-surveys/economic-forecasts/autumn-2023-economic-forecast-modest-recovery-ahead-after-challenging-year_en

boost domestic demand. The extent of this economic upturn is likely to vary from country to country. Economies dominated by energy-intensive industries and manufacturing will most likely recover more slowly than other countries, as the price level of energy as an input is still extremely volatile on the markets. The same applies to inflation expectations. The IMF forecasts an average inflation of 5.8% for most advanced countries, while European emerging markets should expect inflation of 11.9%.[2]

The Hungarian Economy in 2023

The Hungarian economy, after contracting for four consecutive quarters, will experience a moderate fall in 2023 year on year. The European Commission predicted a 0.7 percent GDP fall, while Standard and Poor's forecast a fall of 2.5 percent. S&P did not change Hungary's sovereign debt rating and reaffirmed the country's BBB- rating. One of the main reasons S&P did not downgrade the economy was the significant improvement of balance indicators (trade balance, balance of payments).

The analysis highlighted three factors taken into account in the assessment:

Inflation has decreased significantly, dropping below 10 percent on a year-on-year basis after reaching a peak of 26.2 percent in January 2023.

The exchange rate of the domestic currency has stabilized in recent months.

Due to lower energy prices, the balance of payments has significantly improved in recent months. [3]

Fitch also affirmed Hungary at 'BBB' with a negative outlook. The negative elements Fitch emphasized in its assessment were high public debt relative to the country's peers, certain unorthodox fiscal and monetary policy steps, along with a worsening governance indicator in recent years. Fitch also underscored the positive effect of the structural indicator, investment-fueled economic growth, and solid net FDI inflows.

[2] https://www.imf.org/en/News/Articles/2023/10/13/tr-101323-european-department-press-briefing-economic-outlook-in-europe
[3] https://index.hu/gazdasag/2023/12/08/hitelminosito-standard-and-poors-kormany-makrogazdasag-besorolas-inflacio-gdp-novekedes/

Inflation Fears and Interest Rates in Hungary and the Eurozone

In November 2023, prices in Hungary grew by 7.9 percent compared to the same month in 2022. When comparing price levels to October, prices did not change; however, fuel prices declined by 3.9 percent. The question remains about how long the advantageous international environment will stay with us regarding oil prices. This uncertainty has two causes: the war in Ukraine has a huge effect on the development of crude oil prices in the global market, and the Red Sea attacks have recently impacted global prices. [4] Although Goldman Sachs and Citigroup predict lower oil prices for 2024, [5] we cannot exclude sudden jumps in oil prices.

At the same time, the Hungarian government expects lower inflation for 2024. The Ministry of Finances anticipates inflation to be below 7 percent in December and below 5 and 6 percent for 2024. [6] Despite significant progress in curbing inflation, Hungarian data are higher than the EU average, and as a result, key interest rates are also higher than in the Eurozone. While the key interest rate was 4.5 percent in the Eurozone, the key interest rate was 11.5 in Hungary after a cut of 0.75 percentage points this month.

FED decisions have a significant impact on interest rates in the Eurozone and Hungary. Therefore, it is worth noting that in its last meeting on December 13, 2023, the FED decided to leave its benchmark interest rate unchanged at a 22-year high. In the FED release, it was announced that the FED expects three rate cuts next year.[7] FED Chairman Jerome Powell underlined that interest rates are most likely at or near their peak during this cycle of tight monetary policy. Based on these conditions, we can predict that the Hungarian central banks will be able to make significant interest rate adjustments next year, potentially resolving the dispute around the proper key interest rate. Some analysts still believe that the interest rate could be cut further.

The chief analyst of Markoökonom put it this way in November 2023: "Although the 75-basis-point interest rate cut signifies a strong easing, the 11.5% base interest rate is still high, especially considering that inflation has dynamically slowed down, entering the single-digit

[4] https://www.reuters.com/markets/commodities/oil-prices-extend-gains-red-sea-attacks-disrupt-supply-chains-2023-12-19/
[5] https://oilprice.com/Energy/Oil-Prices/Oil-Prices-Poised-to-Bounce-Back-in-2024.html
[6] https://www.portfolio.hu/gazdasag/20231216/megvan-mennyi-lesz-az-ev-vegi-inflacio-magyarorszagon-658137
[7] https://www.investopedia.com/fed-meeting-live-blog-fed-holds-key-rate-steady-signals-rate-cuts-ahead-8415317

range in October. The elevated base interest rate is reflected in corporate interest rates as well, currently restraining lending and investments."[8]

Medium term challenges

In the medium term, we face major challenges, as the European economic model was built on the simple formula that the combination of cheap Russian energy and European technology and know-how makes European economies competitive. Low productivity and an aging population are undermining European competitiveness. The EU economy is now 65% of the US economy in dollar terms, up from 90% ten years ago (Economist, 2023). When examining productivity levels (GDP per hour worked), only the small Western and Scandinavian countries (Denmark, Belgium, Austria, Sweden) can outperform the American economy, while the large EU countries (Germany, France, Italy, the Netherlands, and Spain) lag behind, and the Central European countries are at the bottom of the list.

Table 1. Competitiveness in 2022 (USD per hour)

Country	US	Germany	France	Italy	Slovenia	Czechia	Poland	Slovakia	Hungary
GDP per hour in USD	90	87	84	71	60	55	53	52	50

Source: Economist, https://www.economist.com/graphic-detail/2023/10/04/productivity-has-grown-faster-in-western-europe-than-in-america

The IMF advised EU members to implement a strict monetary policy to curb inflation, rebuild fiscal buffers, and reduce the cost-of-living packages that were necessary during the energy crisis. Additionally, the recommendation is to focus on addressing obstacles to economic cooperation and avoid diluting the rules on state aid.[9] The IMF's advice is a classic example of neoliberal thinking and is unlikely to lead these countries anywhere, but it is probable that they will follow this recipe.

The European Commission is forecasting GDP growth of 1.4 percent for 2024, having revised down its expectations from 1.6 percent in October. The core of the problems is seen in Germany, where GDP is now expected to shrink by 0.4% in 2023. In the case of Germany, not

[8] https://makronom.eu/2023/11/21/csokkent-alapkamat/
[9] https://www.imf.org/en/News/Articles/2023/10/13/tr-101323-european-department-press-briefing-economic-outlook-in-europe

only has the unexpected rise in energy prices contributed to this slow growth, but political failures have also played a role. According to the IFO Institute, indicators for the business climate have deteriorated. While the European and German economies are grappling with an energy crisis, the German government continues its fight against climate change with small interventions in the decisions of companies and households. This political failure is leading to confusion and a deterioration of the business climate in the German economy, especially in the construction sector (European Commission, 2023).

Table 2. GDP forecasts for 2024 (%)						
	European Commission	IMF	OECD	United Nations	S&P	Goldman Sachs
European Union	1.4	0.8	-	1.2		-
Eurozone	1.3	0.7	1.5	-	1.0	1.25-1.50

It should be noted that the Gaza conflict is triggering demonstrations and growing political tensions in Europe, contributing to ongoing uncertainty in the economy. This is particularly true in France and Germany, where large groups of migrants from the Middle East are siding with the Palestinians, while European governments are showing solidarity with Israel.

To summarize, we can conclude that there is a good chance of economic recovery in European countries, but three factors must be taken into account:

1. The recovery is expected to be slower in countries that rely on energy-intensive production. This is true for Germany, where manufacturing accounts for 23.5% of GDP, and for Central European countries (Poland: 25.7%, Czech Republic: 27.0%, Slovakia: 25.5%, Slovenia: 25.7%, and Hungary 24.0%), while countries such as France (13.3%), Greece (17%), and the Netherlands (17%) have a low share of manufacturing in GDP. (UNECE, the data reflect the situation in 2022.)

2. The recovery also depends on the change in geopolitical conditions. At the same time, a rapid recovery in economic cooperation between Russia and the European Union is not expected. Europe must adapt to low-energy conditions, and its economic model must also change.

3. We also believe that a continued restrictive monetary policy would not contribute to a rapid recovery and appears to be a policy failure. The same applies to the advice to keep government subsidies at a low level. We agree with the advice to diversify supply chains.

Europe must improve its relations with China to receive growth impetus, as the Chinese economy, together with the Indian and Indonesian economies, is expected to grow rapidly in 2024.

Long-term Challenges

In recent years, due to the intensification of Chinese-American geopolitical competition, it has become increasingly clear to international companies that a review of supply chains is necessary to reduce corporate operational risks and prevent supply issues due to political risks. In addition to business considerations, the U.S. government has taken decisive steps to expedite this process. The two most obvious tools for this are the adoption and implementation of the "Inflation Reduction Act" and the "Chips Act." The global pandemic has accelerated the transformation process, and beyond its one-time impact, it continues to serve as a warning to companies and governments that such crisis situations may still occur.

The outbreak of the Ukrainian war, the unresolved issue of Taiwan, and the Gaza Strip conflict have reinforced the belief that we are living in an era of growing geopolitical risks, and we must be prepared for the emergence of similar situations. This part of the briefing examines what impact the transformation of supply chains has on the European Union.

The situation in the EU differs significantly from that in the USA in two main aspects:

1. In most EU countries, there is an intention to reduce China's role in trade, but the strength of this will is not equally strong across these countries. In terms of EU investments in China, Germany and France dominate, while other countries play a nominal role. Furthermore, German investments follow the "In China for China" model, implying that relocating capacities would mean losing the market. In contrast, American companies, following the "In China for the world" principle, have established themselves in the country to serve the global market, not necessarily just the Chinese market. In the latter case, losing the Chinese market is a loss, but it's not the only market for these companies.

2. The EU faces a more challenging situation in trade because, unlike the USA, it cannot rely on its technology and resources. In sectors such as pharmaceuticals, solar panels, rare earth

metals, and components for renewable energy production, the EU is exposed to Chinese companies. Therefore, EU officials express more cautious statements than their American counterparts, emphasizing derisking rather than decoupling.

Analyses examine the potential growth sacrifices associated with decoupling from China. In Felbermayr's study, the first scenario examines unilateral decoupling between the EU and the rest of the world to reduce imports and redirect production to EU countries. The second scenario explores mutual decoupling, limiting both EU imports and exports. Considering the increasing dependence on China, the third scenario simulates the effects of the EU's mutual decoupling from China only. Finally, the fourth scenario models mutual decoupling of the EU, the United States, and their allies from Russia.

It is worth focusing on the third scenario, relevant to our analysis. According to the model, doubling export and import barriers between China and the EU would almost entirely eliminate bilateral trade. EU exports would decrease by 97.7%, Chinese exports by 96.2%, resulting in approximately a 1% decrease in real income. While agreeing with the study's final conclusion, it's worth adding that the relocation of capacities to Europe would not only reduce real incomes but also lead to increased local shocks. The question remains whether geopolitical considerations will override economic logic. Recent political events suggest that partial decoupling from China will happen; the question for me is when the second wave, namely the Chinese decoupling, will begin after the shock of separating from the Russian economy.

Given the above, it is essential to highlight two key areas of the more general decoupling process: the issue of rare earth metals and, relatedly, the import of Chinese electric cars into the EU.

> Rare Earth Metals: Among the thirty raw materials classified as "critical" by the EU, Chinese imports account for 44%. According to the latest EU data, 98% of rare earth metals are imported from China. As part of the Belt and Road Initiative, Chinese state-owned companies are increasingly investing in global mining to satisfy their domestic demand. In addition, Beijing has entered into strategic agreements with other governments, allowing Chinese state-owned companies access to raw materials. However, raw material projects also receive specific support through loans from Chinese banks. The European Union aims to address the entire issue within the framework of green policies. According to the law on "critical rare materials," by 2030, at least 15% of these materials must be recycled, at least 10% must be extracted from

European mines, and at least 40% of the processing of these materials must be brought back to Europe. According to the plans, by 2023, no more than 65% of each material in each processing stage will come from a third country.

Import of Electric Cars: The import of Chinese electric cars into the EU is also considered a pressing issue. In 2022, the annual export of Chinese electric cars to the EU increased by 33%, reaching a total value of 2 billion dollars. However, this is evidently just the beginning. As mentioned earlier, the European Commission initiated an investigation at the request of France regarding Chinese government support. The result of the investigation is foreseeable, aiming to prevent Chinese imports from squeezing European companies out of the domestic market.

Summary

The economic landscape in 2023 presents a challenging scenario for Hungary and the European Union (EU) as a whole. Global growth is hampered by geopolitical uncertainties arising from conflicts such as the Gaza conflict and the ongoing war in Ukraine. Moreover, the relocation of global supply chains, marked by terms like reshoring and slowbalization, has been a focal point for Western countries, potentially leading to increased costs and slower growth.

In 2022, the EU and the eurozone experienced relatively high economic growth (3.4 percent and 3.3 percent, respectively). However, in 2023, a slowdown is observed due to tight macroeconomic policies, a high-interest rate environment, and energy policy challenges. The labor market remains robust, but GDP growth projections for 2024 are uncertain, with expectations ranging between 0.7 and 1.50 percent.

Hungary, after four consecutive quarters of contraction, is predicted to experience a moderate GDP fall in 2023. Forecasts vary, with the European Commission predicting a 0.7 percent GDP fall, while Standard and Poor's anticipates a GDP contraction of 2.5 percent. Despite this, Hungary's sovereign debt rating remains stable, with improvements in balance indicators contributing to this assessment.

Inflation and interest rates are key concerns for Hungary. In November 2023, Hungary experienced a 7.9 percent year-on-year increase in prices. The government expects lower inflation for 2024, but uncertainties in the international environment, influenced by events like the war in Ukraine, pose severe challenges.

Medium-term challenges for the EU include low productivity, an aging population, and strong competition with the U.S. The original European economic model, built on cheap Russian energy and European technology, faces hurdles as productivity levels lag behind the U.S. The EU is advised by the International Monetary Fund (IMF) to pursue strict monetary policies, rebuild fiscal buffers, and focus on economic cooperation obstacles.

Long-term challenges involve the transformation of supply chains, influenced by geopolitical competition, especially between China and the U.S. The EU faces challenges in reducing China's role in trade while maintaining caution due to dependencies on Chinese technology and resources. Decoupling scenarios are explored, with potential economic sacrifices in case of a drastic shift.

Two critical areas in the decoupling process are highlighted: rare earth metals and the import of Chinese electric cars into the EU. The EU aims to address rare earth metal dependency through recycling, domestic extraction, and processing within European borders. The import of Chinese electric cars is under investigation to prevent market domination and protect European companies.