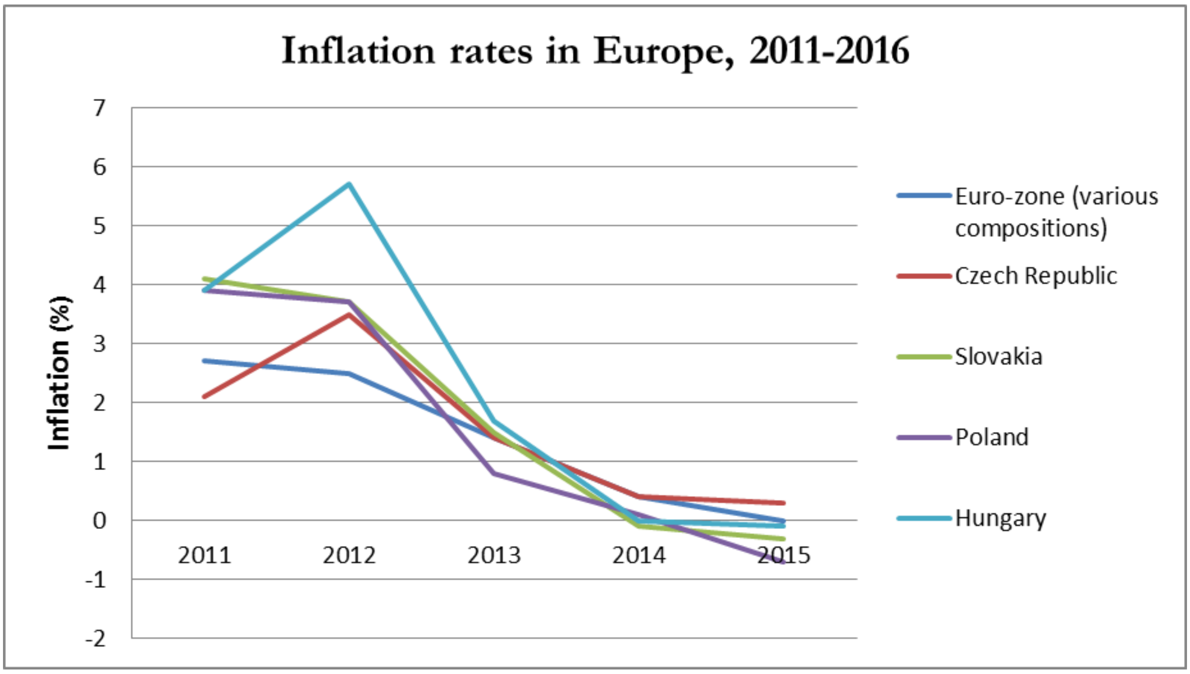
Stable forint exchange rate persists

According to data published by the Hungarian Central Statistical Office (KSH), in December 2015 consumer prices rose on average by 0.9 percent year-on-year. In the observed period, the prices of alcoholic beverages and tobacco products saw the biggest increase, while those of automotive fuels decreased to the largest extent. As a whole, in 2015 consumer prices were down by 0.1 percent in comparison to the previous year.

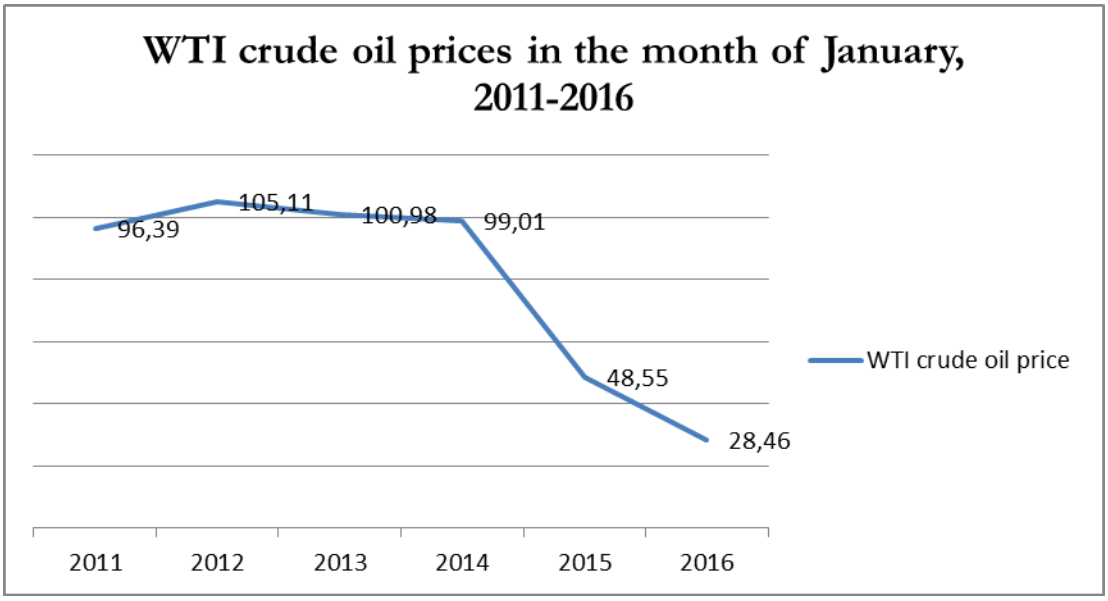
Low inflation has helped maintain low interest rates, a key factor for Hungary's economic growth. The inflation report of the National Bank of Hungary (MNB) for the month of December shows that the bank's medium-term target of 3 percent may only be attainable at the end of 2017. Data from the last quarter of 2015 already shows that inflation has been edging closer to the target level. The economic outlook of the European Commission published in November 2015 also predicts that a narrowing output gap will in the near future increase inflationary pressure. The Commission also envisages that inflation is to reach 3 percent by the end of 2017, but the annualized average is expected to be only 2.5 percent. The MNB inflation report points out that imported inflation will remain low, but consumption growth will offset this factor. Rising consumption will be underpinned by a lower personal income tax rate and the phasing-out of forex loans. The MNB study notes that the direct impact of Government measures on inflation will not be substantial.

The below chart clearly signals that inflation has recently fallen in other European countries, too. Low inflation, on the other hand, may also pose risks, but the European Commission forecast predicts that inflation is set to be nearing the target in coming months. The MNB is also of the opinion that the asset purchasing programme of the European Central Bank and the stabilization of raw materials prices will lift inflation at our main trade partner, the Euro-zone.



Source: Eurostat, Hungarian Central Statistical Office (KSH)

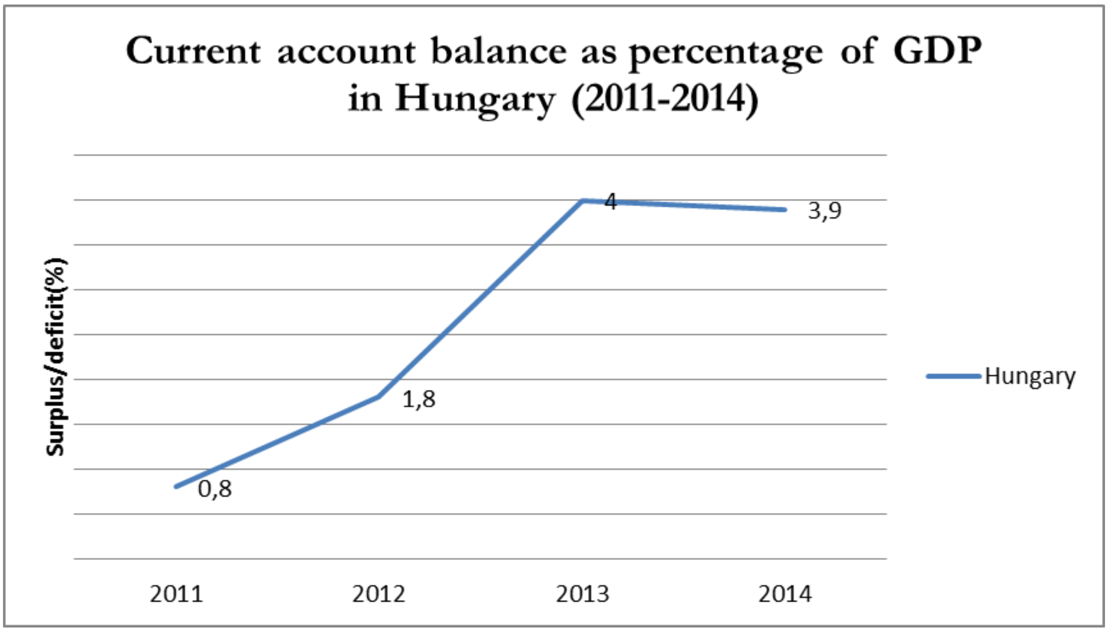
International trends, such as permanently low oil prices, have also been instrumental in curbing inflation. As the diagram shows, the price of crude oil has fallen by more than 70 percent since 2014. Low prices are the result of oversupply and jitters over China's economic growth outlook. Oversupply may even rise as sanctions against Iran have been lifted, and the country is increasing output which in turn is depressing the market. The drastic price slump is having a favourable effect on developed, oil-importing economies and that may also boost the Hungarian economy in coming months.



Source: www.macrotrends.net

The Commission report reveals that along with oil prices the prices of foodstuff have recently also decreased on international markets and that may put downward pressure on Hungary's inflation, too. Falling oil prices have also been having a positive impact on the country's current account balance. Over the past years, as the below chart demonstrates, the current account balance in Hungary has invariably posted massive surpluses. Changes in the price of oil have naturally influenced the prices of other goods -- especially those of imported products, which include higher transport costs. Accordingly, imported products can significantly curb inflation.

For how long low oil prices will remain is still a question. The adjustment of oil producing countries to demand and the decimating impact of low prices on new technology-based output is expected to reverse the current trend. Consequently, another oil price U-turn is inevitable, only the exact timing is uncertain.



Source: World Bank

China's economic growth has been gradually decelerating in recent years, falling from over 10 percent to below 7 percent percent last year. Chinese economic expansion has been a main factor behind oil prices, as the most populous country of the world is also one of the largest oil importers. The weakening growth of the Chinese economy stems partly from deep-rooted structural problems and partly from the fact that the country is facing a structural paradigm-change. China's leadership is aiming to place domestic consumption as the main economic growth engine in the foreground and abandon the old, export-oriented growth model. This attitude change has been a logical consequence of the fact that increasing Chinese wages have been gradually eroding the country's cost-competitiveness. These processes are in line with the economic thesis stating that the growth potential of an economy diminishes parallel to the increase in the level of development, as marginal product of capital is also edging lower. Worsening growth prospects in case of China and other emerging countries are also having a negative impact on import-inflation through other products.

As far as Hungary is concerned, household utility price cuts in recent years have also contributed to lower inflation. In addition, it has to be noted that the country has been characterized by a stable fiscal policy: the budget deficit remained below 3 percent of GDP in each of the past three years. Prudent fiscal policy has also prevented a rise in inflation. Therefore, Hungary now meets Maastricht criteria in terms of fiscal deficit and inflation, while the level of general government debt has also been on a descending path.

The MNB's benchmark rate is at a historic low with 1.35 percent. In light of the latest inflation data low interest rates are set to remain in coming months. This would certainly be favourable for lending in Hungary, as the post-crisis negative lending trend only began to turn around in 2014, thanks primarily to the MNB's Funding for Growth Scheme which is scheduled to be gradually phased out as of 2016. However, as the MNB's December inflation report concludes, low interest rates facilitate the growth of market-based lending. The study predicts that the volume of household debt will continue to diminish and that will also boost lending. On the other hand, the inflation report finds that demand for consumer loans will stay modest for years. Thanks to pro-housing Government measures, the residential property market is set to expand further and the lending volumes of new home loans will accordingly also rise. In coming months, the MNB forecasts that higher demand for loans will also fuel the volume of corporate lending. The reduction of bank tax is another instrument for igniting lending: the bank tax rate will fall from 0.53 percent to 0.24 percent of balance sheet total; up to a total HUF 50bn the lower tax rate remains 0.15 percent.

SME lending volumes are still inadequate, but low interest rates for loans help remedy this problem. Permanently low interest rates may boost confidence which in turn may drive demand for capital investment loans higher. Along with the current level of interest rates, financial instruments provided by EU funding schemes are also expected to assist the expansion of the lending market and supply enterprises which would be unable to raise funds under market conditions with resources. Lending growth will then boost competitiveness as enterprises complete planned development projects.

As another positive result, low interest rates are expected to fuel consumption and enable alternative investment schemes such as commercial and residential properties, which would lead once again to higher demand for real estate loans. The exchange rate of the forint vis-á-vis the euro has managed to remain relatively stable and unscathed last year. Currency depreciation may have increased inflation through the rising prices of imported goods.