IB Economics – Commentary 2

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Hungarian PM says stimulus needed to achieve 4% growth target

Hungarian PM holds rare international press conference

By bne IntelliNews **January 12, 2019**

Prime Minister Viktor Orban has suggested economic stimulus will be necessary to keep Hungary's GDP growth above 4%, and said the government has no target date for adopting the common European currency, at a rare press appearance on January 10. Hungary's illiberal strongman also made it clear for the first time that he wants an anti-immigration majority in all EU institutions.

Nevertheless, the prime minister received some tough questions during the two-hour session about the wealth of his friends and family members, the crackdown on the Central European University (CEU), academic freedom, and the tilted media powers.

Orban focused on economic issues initially and later went on to lay out his visions for Europe.

Stimulus needed to meet growth targets

Orban summed up the economic achievements of the past year: rising economic output and household spending, record employment and falling state debt, but said that economic stimulus in the first quarter is needed to keep to this year's 4.1% growth target.

Analysts expect Orban to expand on the stimulus plans and announce further support to families to address Hungary's demographic crisis during his annual state of the nation speech scheduled for February 10.

Without any boost to the economy, GDP growth could be 3.9% in 2019, Orban said, citing his finance minister. Higher tax revenues due to stronger growth and the whitening of the economy could provide cover for financing any stimulus, local media reported.

He praised his Czech counterpart, Andrej Babis, for his record in creaating employment and he vowed to do even better. The number of employed people could stabilise at 4.5mn-5mn in the long term, which is near full employment, he said. In his view, the labour shortage is rather positive than negative as it allows workers to demand higher pay and better training. The Hungarian economy needs to grow at a pace that can be supported by a workforce of this size, he said, suggesting that Hungary needs to take more steps to improve competitiveness by increasing efficiency.

He defended the government's amendments to the Labour Code on overtime rules, which has sparked widespread anti-government protests and united opposition parties. He attributed these protests to the European Parliament election campaign. Labour unions are making preparations for nationwide demonstrations and road blockades on January 19.

In the last few days, multinational retailers Tesco and Spar have announced they are not going to apply the new overtime rules, which would allow an annual 400 hours of overtime work.

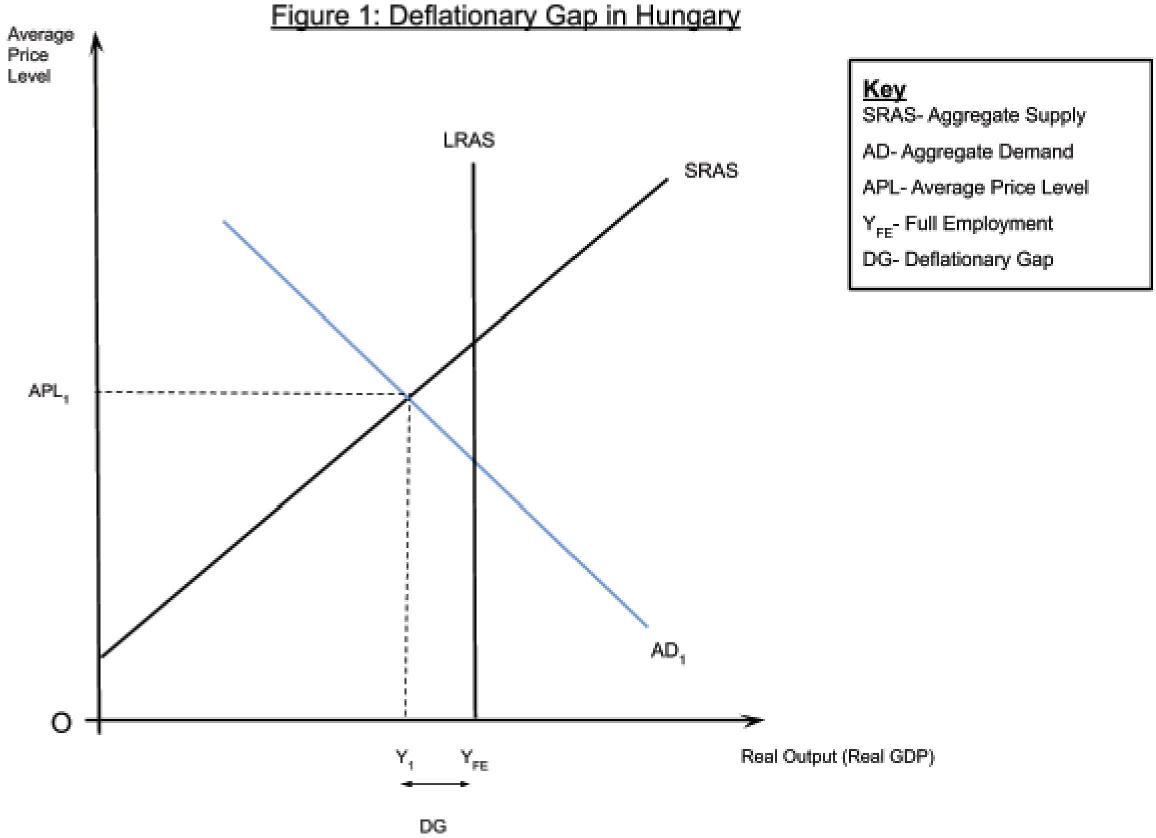
Orban confirmed that Hungary has no target date for adopting the common European currency. Nobody knows in what direction the eurozone will develop in the future, which requires a "cautious, wait-and-see" policy, he added.

Asked to comment on whom he would propose to fill the position of governor of the central bank when Gyorgy Matolcsy's six-year mandate ends early this year, Orban said: "no surprise is expected".

Commentary

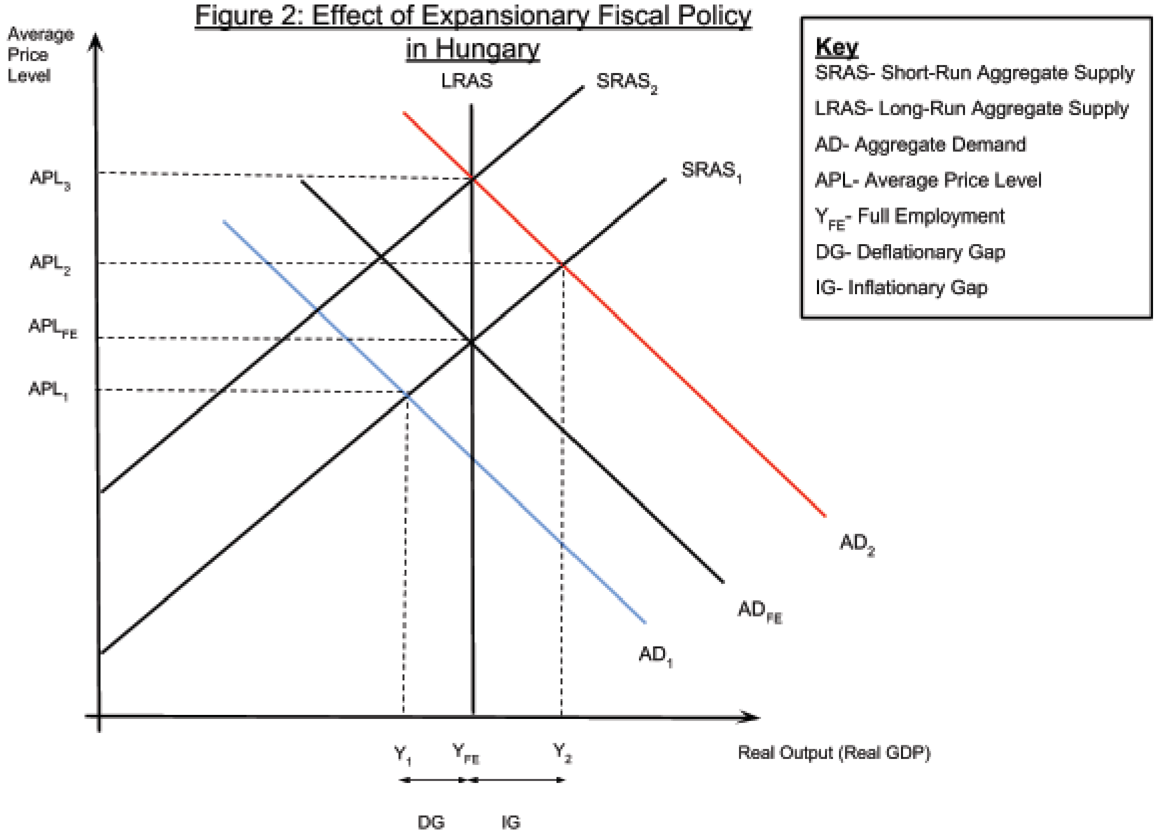
Orban proposed expansionary fiscal policy to achieve Hungary's "4.1% growth target" through a stimulus package. Expansionary fiscal policy is the manipulation of taxes and government spending to expand Hungary's economy. The stimulus package, essentially government spending, increases aggregate demand which promotes economic growth. Economic growth is the increase in an economy's real output over a period of time. Although the stimulus package should be beneficial, the potential inflationary effects of unsustainable growth resulting from an over-injection remain a risk.

Figure 1: Deflationary Gap in Hungary



The economy currently operates at (Y_1,APL_1), where the SRAS intersects AD. However, with LRAS positioned to the right of the current equilibrium, a deflationary gap of (Y_1-Y_{FE}) is present.

Figure 2: Effect of Expansionary Fiscal Policy in Hungary



To achieve the 4.1% GDP growth target, Orban intends to increase government spending, shifting the curve AD_1 to AD_{FE} to reach new-equilibrium (Y_{FE},APL_{FE}), where full-employment is attained. Good results on economic indicators like growth and employment strengthen the economy, which promotes consumer and business confidence as economic performance is expected to continue. Reaching the growth target may entice foreign investors, creating further injections into the circular-flow; long-run growth may improve through increases in the quantity of physical capital. Operating at full employment (Y_{FE}) means that Hungary produces at optimal productive capacity.

However, a significant danger of introducing such policy "near full employment" is an increased vulnerability to demand-pull inflation. Inflation is the sustained increase in the general level of prices in Hungary over a period of time. Government spending activities create jobs directly or through firms, causing an increase in the derived-demand for labour. Due to excess demand in the tighter labour market, wages increase as competition for labour rises. This causes "rising household spending" as workers have more purchasing power, promoting consumption. The rise in AD will likely increase prices, creating demand-pull inflation. If the inflation matches the rate of wage increase, households will suffer from money illusion as supposed gains in household utility are forfeit.