Global economic trends and their impacts especially on the German economy, and consequences for Hungary's economy and public finances

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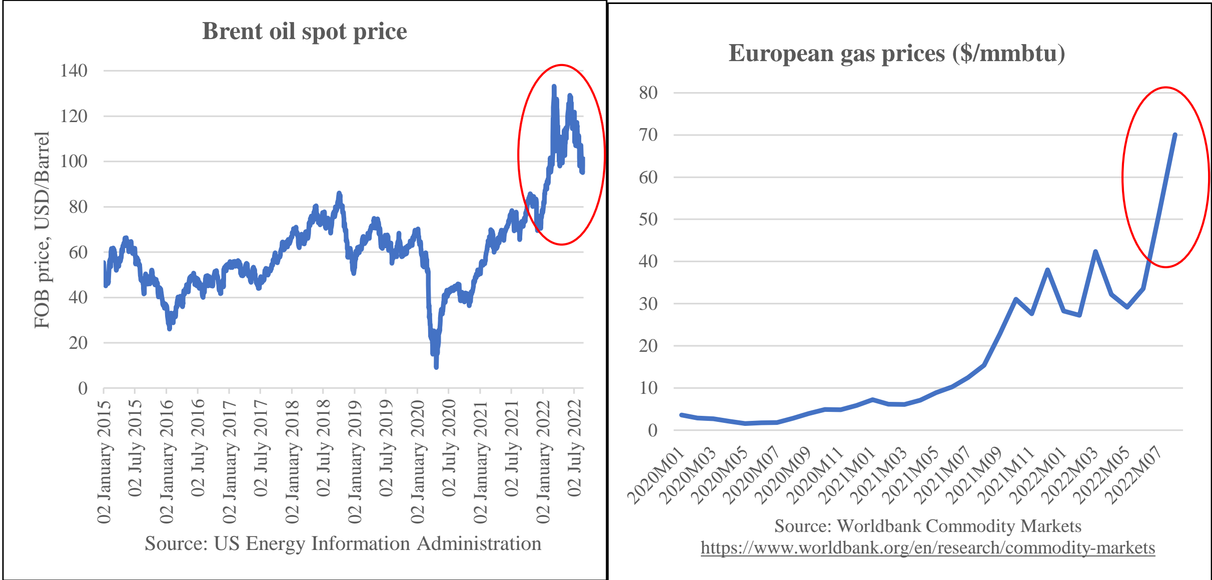
Executive Summary

Following the recovery in 2021, the outlook for economic activity around the world is increasingly bleak. The ***global outlook*** for the second quarter of 2022 is marked by the slowdown in China, the escalation of the Russia-Ukraine conflict, the energy crisis and rising inflation. Most central banks are responding to the latter with various instruments of monetary tightening. The increasingly tightening monetary environment, however, is holding back growth, without having a real impact on inflation developments in the short run. For economies with high indebtedness, monetary tightening and rising government bond yields are making financing more difficult, and this is narrowing the room for manoeuvre for fiscal policy. Hence, in the current period, neither monetary nor fiscal policy will be as supportive as it was during the pandemic. The IMF and OECD forecast a global growth of around 3% this year, but the mounting downside risks suggest that we can expect worse than this. For now, all trends signal that in 2022 European policymakers could face with unprecedented challenges, and that conflicts of interest between EU countries could plunge the whole European Union into crisis. The biggest problem is uncertainty: there is no way of knowing how Europe's gas supply will evolve in 2022-23. Everywhere, the switch from Russian gas will take time and could entail heavy sacrifices, such as the application of measures to restrict its use. Accepting these with the public and business will be a conflictual process and is sure to lead to strikes and political unrest on more than one occasion. All in all, we are facing a difficult few months ahead: a slowdown in growth will characterise both this year and next. To a greater extent in Europe and to a lesser extent in the US. The global consequences of China's zero tolerance for disease control and the slowdown in production and logistics caused by natural disasters will be felt everywhere. However, the dynamic growth in the production of green energy and e-mobility-related products, as well as the increased importance of Chinese deliveries for Russia as a consequence of the Ukrainian conflict, will reinforce China's global economic dominance. As it will become an increasingly important partner for Russia, both in terms of trade in goods and services and in the flow of working capital. In addition to the deterioration of the global environment, developing countries are also affected by the Russian-Ukrainian conflict and the difficulties in grain supply, with rising food prices as a consequence, causing famine in more than one country. China is increasingly active in helping countries in distress. The possibility of stagflation and a debt crisis cannot be excluded. Inflation is not yet at its peak, energy tensions and high prices persist, interest rate hikes are ongoing, and the consequences of the Russia-Ukraine conflict are becoming more serious.

Trends in international oil and gas markets have been dominated by the consequences of the coronavirus epidemic in 2020 and, from February 2022, by the Western response to Russian aggression against Ukraine. The most significant of these are Western efforts to become

independent of Russian energy resources, embodied in measures to reduce imports, which are linked to Western sanctions against Russia. The main means of reducing Russian imports are reducing energy demand and the rise of the share of renewable energy. Eliminating dependence and reducing Russian imports can be achieved at relatively little cost in the case of oil and oil products, but at considerable economic and social costs in the case of natural gas. A complete cut-off of Russian gas supplies in response to the Western embargo would cause varying degrees of supply difficulties and a possible recession in the EU.

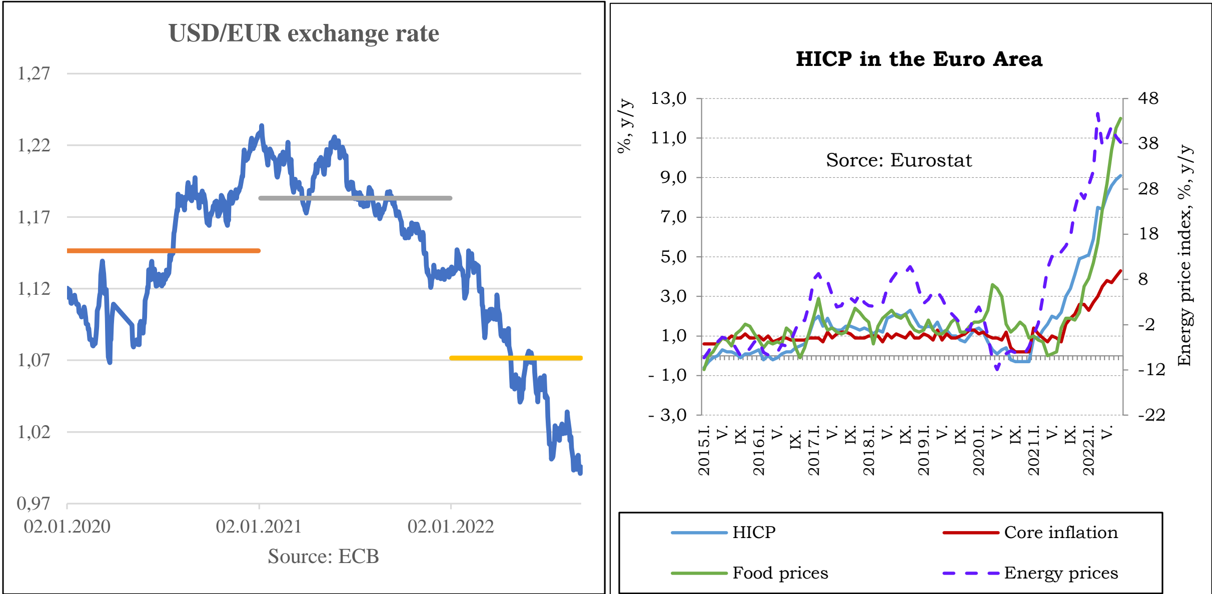


Despite their relatively modest weight in the world economy (Russia is ranked 11th in the world in terms of GDP volume and Ukraine 57th), the two countries play a dominant role in the world markets for some agricultural products, metals, energy carriers and mineral-based fertilisers. The consequences of the Russian invasion of Ukraine (reduction in the supply of Ukrainian cereals due to the war, closure of supply routes, etc.) have been overreacted to by international markets in the light of ex post analysis, as indicated by the fall in average prices in July. It remains to be seen how long the price fall will last, as the average price of several commodities rose in August compared with the previous month, whilst a new wave of decline took place in September.

In advanced countries, ***inflation*** started to accelerate dramatically in 2022. The large price increases can only partly be explained by the impact of the Russian-Ukrainian conflict, with energy and agricultural prices rising more sharply after the conflict broke out, and supply disruptions (e.g. Ukrainian industrial goods, spare parts) due to the conflict also pushing up the prices of some industrial goods. At the same time, some of the price increases were already prevalent before the outbreak of the conflict. This suggests that the various fiscal stimulus programmes implemented during the pandemic, coupled with loose monetary policy, have allowed for a demand expansion that the supply side was not prepared for. Thus, both in the US and the UK, as well as in Europe, core inflation started to rise sharply. The inflation outlook has worsened everywhere, with fears that inflation expectations will remain anchored at high levels. Producer prices are on an upward trend and are becoming increasingly embedded in consumer prices, and this trend is unlikely to reverse in the near future. In these circumstances, it is not surprising that the pace of ***monetary tightening*** is everywhere taking a more

pronounced form than previously expected. The *FED* started a wave of interest rate hikes in March this year, and so far, this year there has been a total of 225 basis point rate hikes, with further hikes expected. The maintenance of tight monetary policy will be needed for a longer period to restore price stability, despite fears that this could push the American economy into recession.

Despite the dramatic rise in inflation, the *ECB* held interest rates steady for a long time, but in July it raised all three benchmark rates by 50 basis points. For the time being, the ECB has reactivated its asset purchase programme and has developed a new instrument to help indebted countries in the South of Europe, making it easier for them to finance their debt and curbing turbulence in bond markets. In September, everyone expected the ECB to raise interest rates by up to 75 basis points, as it actually happened and to start quantitative tightening. However, there are also arguments for the ECB to raise interest rates along a slower, steadier path, so that it has room for manoeuvre to correct course if necessary. As a result of all these developments, the euro has reached unprecedented lows against the dollar, with minor fluctuations. In general, monetary tightening has also started *in other developed countries*, except in Japan, where inflation is not yet so dramatic that the central bank needs to act. Even in Switzerland, interest rates moved upwards, but still remained in negative territory. In the Central-Eastern European region, more drastic interest rate adjustments have taken place as inflation has also been higher. The base rate is the highest in Hungary. Although the pace of inflation is expected to moderate somewhat next year, the period of low inflation during the pandemic will not return. Central banks will maintain a tighter monetary policy over the forecast horizon, even if inflationary pressures ease, to avoid a possible renewed inflation run-off.



For the ***EU-27*** as a whole, GDP growth is expected to be slow down this year as compared to last year. An average growth of 2.6-2.7% is forecast, and could slow to 1.5% next year, depending on global economic trends. This year's growth is being pulled by a stronger-than-expected first quarter performance of 5.6% (y/y), with the expected slowdown starting in the second quarter, when GDP expanded by 4% y/y. Resources of the Recovery and Resilience Fund also underpin growth in most countries. At the same time, developments in the Russia-

Ukraine conflict pose a significant risk. The downside risks are significant, with the escalation of the war and its external and domestic economic consequences.

The economy of the ***euro area*** expanded by 5.5% year-on-year in the first quarter of 2022. The pace of growth has also been affected by the base effect, as the *EA economy* was still in contraction in the first quarter of 2021. In the second quarter of 2022, the slowdown is already showing signs of abating, with GDP expanding by 3.9% on a year-on-year basis. In 2020 and 2021, average GDP per capita in PPS for the EU-19 was below the 2019 level in all but a few countries, indicating that more than half of the euro area countries had not yet recovered from the losses caused by the pandemic by the end of 2021. European sentiment indicators have been trending downwards since the spring, with June-July data in most countries showing that the consequences of the escalation of the Russia-Ukraine conflict, growing supply and demand problems in many areas, the energy crisis and soaring inflation are making the situation for businesses increasingly desperate. Manufacturing output has been falling since March and this trend is expected to continue in the coming months as well. As a result, we have revised downwards our previous forecasts concerning the short-run trends of the main GDP aggregates.

The *inflation rate* in the euro area was 8.1% in May and picked up to 9.1% by August compared with the same period a year earlier. However, actual inflationary developments are masked by the fact that price shocks are being dampened by various regulatory measures in several countries, so that actual inflationary pressures are significantly higher than the data suggest. A growing number of countries are forcing the impact of price increases on private households through various fiscal instruments.

The economies of the ***13 new Member States of the European Union*** have been badly hit by the coronavirus crisis. However, fiscal stimulus programmes and loose monetary policy have helped these economies to return to growth in 2021, although some countries are only growing at a lower level. The economic impact of the Russia-Ukraine war is most felt in the CEE region, almost exclusively due to unilateral energy dependence. The effects of the war are mainly reflected in inflation imported through energy imports. These prices are then reflected in consumer prices of other products through the various price transmission channels within a few months. The room for manoeuvre of central banks in terms of monetary policy stance is rather limited and inflationary pressures are unlikely to ease, with somewhat lower price indices due to base effects at most.

In the first half of 2022, changes in global economic conditions affected the ***Hungarian budget*** through several channels. In the short term, the most important of these is the global inflation environment. A higher and rising price index reduces the fiscal deficit and the public debt-to-GDP ratio, as inflation increases the level of revenues much more than expenditure directly and to a much larger extent, especially in the area of consumption taxes.

At the same time, the weakness of the world economy and world trade, the deterioration of the global environment, is already worsening the budget position in the short to medium term. While inflation will continue to boost fiscal revenues next year and possibly even in 2024, the growth in household consumption will slow down significantly and is expected to decline in 2023. Indeed, inflation will only increase consumption at current prices as long as it does not reduce the household's purchasing power. Other revenue items are also expected to decline, e.g.

taxes on household income and on corporate profits. Therefore, the inflation improves the fiscal position only temporarily and in the short term.