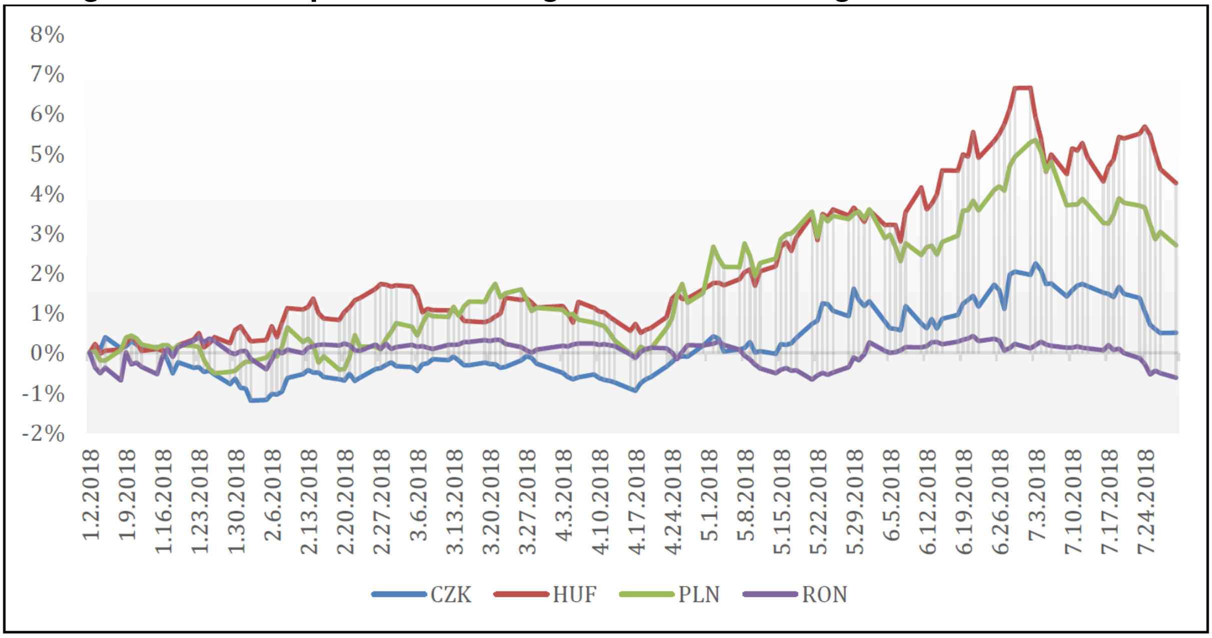
WHO BENEFITS FROM A WEAK FORINT?

Following the Fed's raise in interest rates and the normalisation of American monetary policy, the European Central Bank has also embarked on a path of contractionary policy (a strategy that the National Bank of Hungary is yet to pursue). The change in international financial conditions, the possibility of a global trade war, the shock experienced by the Turkish financial system, as well as the uncertainty in the Italian political scene have all led to an outflow of capital from developing countries, including Hungary. After a few years of constant but modest decline in value, **the forint depreciated significantly**: from April to early July, the EUR/HUF exchange rate decreased by 6 percent, and the USD/HUF exchange rate fell by 10 percent, followed by a slight appreciation of the currency.

Diagram 1: The depreciation of regional currencies against the euro in 2018

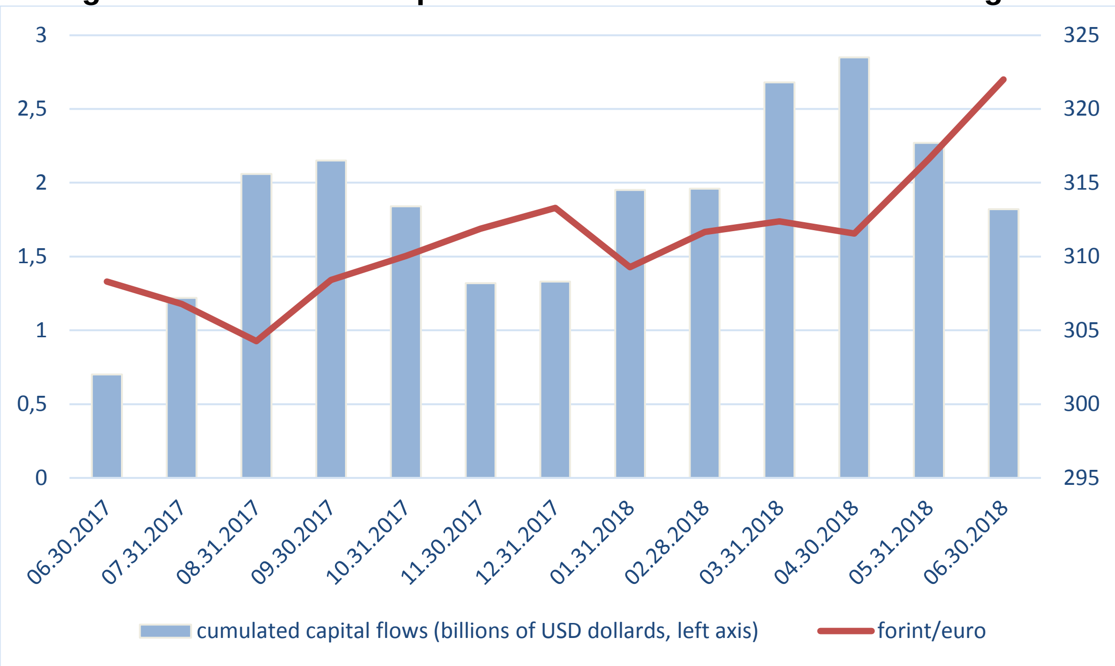


Source: Eurostat

In the Central-Eastern Europe region, the Polish zloty and the Czech crown have also depreciated against the euro: by the end of July, the former's value had decreased by 4 percent and the latter's by 2 percent since the start of the year. At the same time, the Romanian leu remained stable, while the forint depreciated by 5 percent in this period. **The National Bank of Hungary's (NBH) loose monetary policy, intended to maintain steady economic growth and provide cheap funding for government spending, is increasingly diverging from the strategy of monetary tightening adopted by leading central banks and national banks in the region.** With this approach, the NBH has become one of the most lax central banks in the world. Such a loose monetary policy is made possible by the significant decrease in the share of foreign currency loans: its size fell from 50 percent to less than 20 percent in government debt, while completely disappearing in household debt thanks to the influx of EU funding.

The depreciation of the forint was expected, however, the rate at which it did so in May was not. Treasury bills of risky, but low-yield countries such as Hungary have lost part of their appeal, which increased the yield of securities, while **a significant share of foreign investors decreased their holding of the Hungarian currency**, leading to greater volatility.

Diagram 2: Cumulated capital flows and the forint/euro exchange rate



Source: Trounceflow, NBH

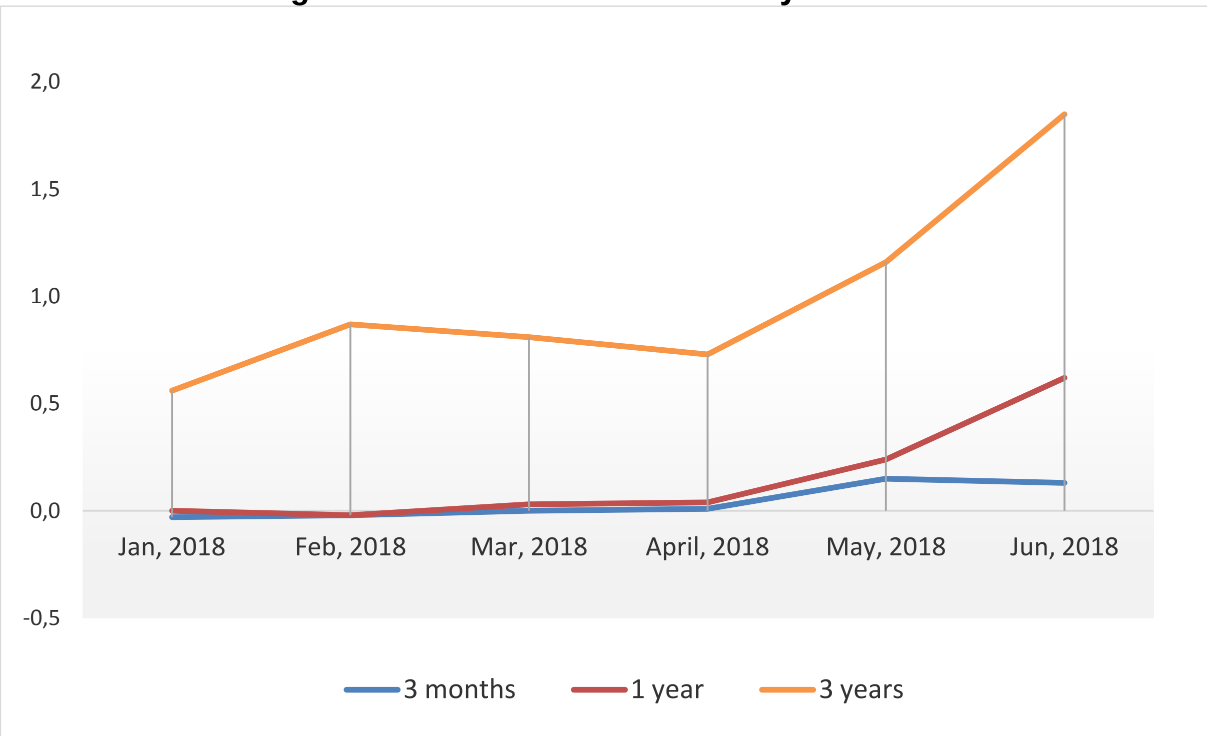
The depreciated domestic currency is supposed to affect the economy through multiple outlets. The rise in the price of imported goods increases the consumer price index. Rising import prices can even crowd out foreign goods, which allows domestic producers to raise prices more significantly. Moreover, the rise in prices does not yet reflect the past few years' surge in demand, which can influence prices to a greater degree given the fall in the competitiveness of imports.

The central bank, however, did not react to these dangers, feeling that the measures they are currently undertaking suffice to attain their main objective of a stable rate of inflation below 3%. However, inflation rates reached 3.1% by June (although the global hike in oil prices no doubt contributed to this significantly), and should this rate remain, the central bank would need to take action.

The depreciating domestic currency could improve the competitiveness of the economy, because in theory it boosts exports. However, this effect is hindered by the fact that most exports are handled by multinational corporations that usually operate with large import margins, so the exchange rate is a less significant factor in their calculations. **Individual open or hidden government subsidies or discounts are of greater significance.**

The depreciation of the forint, on the one hand, entails greater budget expenditures in terms of financing, and on the other hand it means that the EU funds not yet received will rise in value, and this increase in money will raise budget inflows. At an exchange rate of 320 Ft/euro, **a surplus of 300-350 billion forints can be gained through the change in the value of these EU funds**. Furthermore, the central bank can amass significant profits via its foreign currency reserves, with **a 1% depreciation giving 70-80 billion forints of profits to the central bank**, contributing to its endowments and budget.

Diagram 3: Government securities' yield in 2018



Source: NBH

In light of the above, **the following question arises: is the central bank's aim truly to control inflation, or do other factors contribute to shaping its monetary policy?** If inflation remains persistently above 3 percent, the central bank could be constrained both by its official objective, as specified by national law, and its less public objectives (its own profitability and the availability of cheap funding for government spending). In that case, one of the central bank's most important policy devices, credibility, which has already depreciated due to the controversial policy measures it implemented in the past years and the decrease in the transparency of its monetary policy, could lose its value even more.

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