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An Insight into the Nature of Inflation

Welcome by the Editor-in-Chief

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Inflation is the rise in the price level of goods and services on the internal market, where the purchasing power parity of a unit of money decreases, meaning that we get less for our money. For a more sophisticated economic definition, we could say that inflation is caused by the imbalance between supply and demand, with demand constantly exceeding supply. It propels spending, and dealers in return raise the price of their merchandise. In an inflation-ridden economy, the incentive to cumulate savings decreases and indebtedness is bound to prevail. Indebtedness seems more fruitful when the real value of the capital keeps dropping, especially when repayments are due.

By default, central banks react to inflation by subduing or reducing solvent demand. Free, liquid funds in commercial banks get diverted to the central bank, along with substantial financial incentives. In many cases, the incentives come in the form of high interest rates for commercial banks covered by the central bank at a loss to itself, very much in line with the practice prevalent in continental Europe. Accordingly, their main task is to curb inflation to reduce the financial pressure on the economy, i.e., the cause of inflation. They also 'target' higher interest rates on the credit markets by raising the policy interest rate, which increases the interest costs of the loans that commercial banks disburse, and thus, ideally, discouraging the appetite to borrow, namely the motor of the quasi-substitute solvent demand. Ideally, it is one way to curb down price increases.

Inflation has caused so many problems throughout history; states and powers lose dominance, businesses fail, families become impoverished. Theories before J.M. Keynes described the essence of inflation as excessive or even increasing (an increasing amount of money is put into circulation) level of solvent demand for a given level of output. Now, in the 21st century, the situation seems much more elaborate. We have to take into account the investment intentions of businesses and households, the business interests of international commercial banks, and the unionized wage demands of workers. In particular, the effects of the more moderate volumes introduced in the '00s, designed to combat the 2007-2008 crisis, which have carried over to the present period, such as the increase in instrumental government incentives that strongly favour social interests, and the persistence of subsidy demand. Nor should we forget about the additional government spending to offset the negative economic effects of the COVID-19 pandemic in the early 2020s, as well as the dramatic impact of the ongoing

Russo-Ukrainian war on the energy market and the exchange rates of smaller countries, which have already led to soaring prices of hydrocarbon derivatives and food, in part due to the difficulties of the acquisition of oil, natural gas and commodities, which have triggered a rise in prices. The same is true for food imports. Consequently, prices have risen globally, exacerbated by the deterioration of the exchange rate of the Hungarian forint, with a direct impact on the value of imports. And, as demonstrated, rising inflation is holding back economic growth and worsening foreign trade and balance of payments positions. Moreover, it appears to result in an increasing lack of planning, a decline in the purchasing power and investment value of households and businesses.

In recent years, we Hungarians, have been particularly hard hit by inflation, which in January 2023 was 25.7% higher than a year earlier.[1] This is the highest the EU has seen. Additionally, the highest value of inflation rate for food reached 48.2%, while the average in the EU was 18.4%. In fact, the phenomenon of 'profit markup inflation' has emerged, with shops setting their prices far above that which their increased costs would justify.[2] In simple terms, government measures were abused to increase social spending and wages. Households had built up savings[3] and, encouraged by all this, shops and sellers went on a 'price increase spree'. The greed of the traders is being curbed increasingly effectively by the Hungarian Competition Authority, which has reduced the profit-taking of retailers by putting into place targeted inspections along with a price monitoring system, while the Hungarian Government has broken the cycle of sharp increases in price by imposing compulsory action. A specific situation has also developed in the hydrocarbon derivatives market. The EU has imposed sanctions on Russian raw materials, even though its industrial systems were powered by these sources[4]. However, US shale oil, shale gas and Brent crude oil products, which had partly replaced Russian oil and had become orders of magnitude more expensive, were built into production and then market prices, and ultimately caused inflation, which spilled over into the Hungarian market. To add even more fuel to fire, the EU is putting in place a series of discriminatory measures not only against Russia but also against Hungary. The (structural) Cohesion and Resilience Fund, which is a fund granted conditionally, does not provide resources for development, amounting to some HUF 13,000 Bn, or falters in doing so the very least. Seeing Hungary's vulnerable position, foreign exchange dealers joined in, putting speculative pressure on the Hungarian currency. The forint seems to have experienced the strongest attacks in the region.[5]

In the light of all this, it is of huge significance that the Hungarian inflation rate, which reached 26% in 18 months, was reduced to 3.8% in 12 months and then to 3.7% by February 2024. Inflation in food prices, which was approaching 45 percent a year or so ago, has now fallen to just 2.2%. The 2.2% monthly inflation in food prices in February 2024, calculated on an annual basis, has been the lowest in nearly seven years.[6]

In addition to government and central bank measures, the Hungarian Competition Authority has also contributed to the positive developments in terms of real earnings growth and economic recovery. Combatting inflation in Hungary is unique in that Hungarians have had to face a number of external effects propelling inflation, mainly coming from the EU's administration in Brussels, while a number of measures have had to be put in place for the protection Hungarian companies and households.

As we take stock of these impressive achievements, we must not forget the challenges ahead of us. While maintaining price stability, we need to be ready to embrace the latest technological solutions, ensure a successful energy transition and invest orders of magnitude more in developing our knowledge capital. We must return to the recipe for success of the previous decade. Sustainable economic growth will only be achieved through fiscal balance and low inflation rate. This calls for the reinforcement of the competitiveness of the Hungarian economy, developing creative industries, digitalization systems and the green economy. The new economic model, which is able to upkeep the middle-class, Christian values and the continuity of the policy of the state in line with these principles, can only be imagined through investments guaranteeing added value. After all, higher productivity contributes to price stability and to balancing external and fiscal accounts. This requires further cooperation between government and central bank monetary aggregates.

Issues 4–6 of Polgári Szemle Volume XIX showcase papers and analyses that can be used to construct this future.

It is worth checking back with *Polgári Szemle* in the future too!

Budapest, on the Ides of March 2024

Prof. Dr. Csaba Lentner university professor
Editor-in-chief of *Polgári Szemle*

Notes

1 to EUROSTAT, which uses a different methodology, inflation reached 26.2% in January 2023.

2 Nominal corporate gross operating surplus and mixed income growth between Q4 2019 and Q4 2022 in the European Union was 19%, while in Hungary it was 60%.

3 This is mainly due to wage subsidies in the sector, to compensate families and workers who have been hit by the covid crisis.

4 The supply of Russian oil to Western Europe is almost unchanged, except now occurring indirectly. In the former Soviet republics, in the Middle and Far East, the bulk of the shipments are essentially repackaged and relabelled.

5 Developments at the end of February 2024 suggest that, after the speculative wave of 2022/2023, we are facing another one. The forint/euro exchange rate is approaching 400 forints again.

6 The last time food inflation was lower than this was in April 2017, with 1.9%.

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