

REPORT ON INFLATION

11 June 2018

CPI accelerated to 2.8% YoY and is likely to temporarily exceed the MNB's 3% target in summer 2018

- Inflation in Hungary was 2.8% YoY in May, up from 2.3% in the previous month, the KSH statistical office has said. We forecasted 2.7% inflation for May, while the market was a bit divided as the polls of portfolio.hu, Reuters, and Bloomberg were 2.8%, 2.7%, and 2.6% respectively. In all, the incoming figure means slight upward surprise.
- Although it was the higher fuel prices that drove the CPI to the second highest level since February 2013, services CPI also accelerated to 2.1% YoY (unadjusted data). If we filter out the effect of the 2018 January VAT cuts on catering services, our core services inflation indicator (i.e. services that are the mostly labour-intensive and demand-sensitive) shows 4.5% YoY price index in SA terms, accelerating from 4.3% YoY a month earlier. The intra-year price setting indicator shows clearly the strongest re-pricing intentions in the current decade. On the other hand, filtered inflation (inflation without volatile items and all government measures) declined to 2.4% YoY, owing to the declining goods inflation.
- We would like to emphasize that we made methodological changes to our analyses' framework. We created a new core services indicator, filtering out financial services from our previous one, because financial services tend to follow, rather than set, inflation trends. For similar reasons, we create a filtered durable goods price index that does not include the effects of the recent price decline in used cars (supposedly related to the diesel scandal) as well as of the durable cultural goods (whose prices have been steadily declining for many years, thus they follow the technological trends rather than demand evolution). Furthermore, we changed our view on the suitable correction of the effects of indirect tax changes. Because it is very hard to estimate the pass-through of a tax cut, from now on we incorporate 100% pass through, i.e. the entire theoretical effect. Please note that tax changes' effects are asymmetric as hikes appear more distinctly in consumer prices than cuts.
- The big picture is that upon the strong domestic demand, the capacity constraints, and the tight labour market we see accelerating inflation in many areas such as intermediate goods prices, real estate prices, and wages. However, the domestic demand's effect on consumer prices is mitigated as more than 50% of the consumer basket is more dependent on external or administrative factors than demand-sensitive. If we focus on the most demand-sensitive services and durable goods, we see 4.5% core services and 2.1% goods inflation, mirroring a growing pressure.
- Foods inflation exceeded our forecast, generally because of unprocessed foods. Seasonal food prices jumped in May due to the record high potato prices, whose contribution to unprocessed foods' YoY inflation grew by 1.3 pp compared to April. (However, an upward jump in May is not unprecedented and is usually followed by price declines.)
- Our baseline is that the CPI will temporarily exceed the MNB's 3% target in summer 2018 but then will go down because of base effects and the slowing inflation of foods and goods. Taking into consideration the recent fuel prices, our current average forecast for year 2018 is 2.6%. The consumer price index may reach 3% YoY in a sustainable manner around the middle of 2019. However, one of our key assumptions is that this year is likely to bring more favourable harvest season than the previous two ones, which will result in declining foods inflation. The data available to date are not completely supporting this scenario. In all, risks are tilted towards higher inflation. We do not foresee any tightening measure from the central bank until the end of 2019 but if CPI gets further impetus next year, the MNB may be forced to act. The predictions of the updated Report on Inflation, set to be published on 21 June 2018, will be interesting from this point of view.

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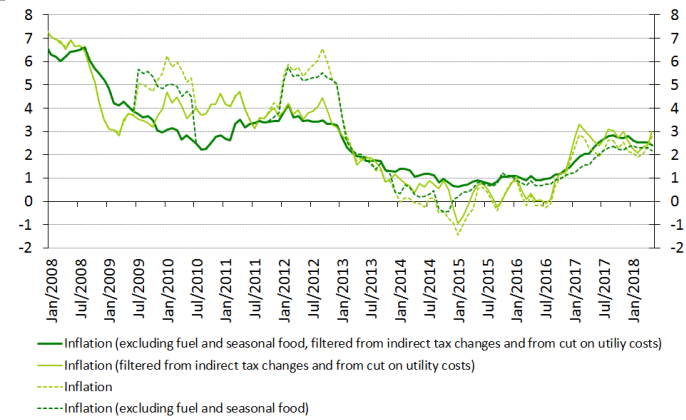
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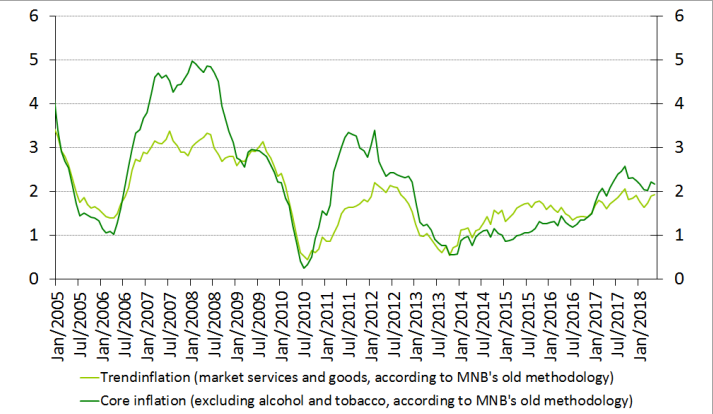
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Chart 1: Summary chart of inflationary processes
(annual changes, %)



Sources: KSH, OTP Research

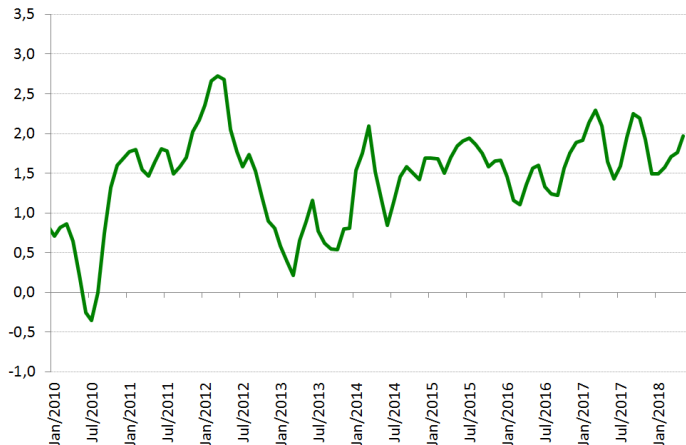
Chart 2: Core* and trend inflation*
(annual changes, %)



Sources: KSH, OTP Research

*: Filtered from indirect tax and visit fee changes, and one-off items

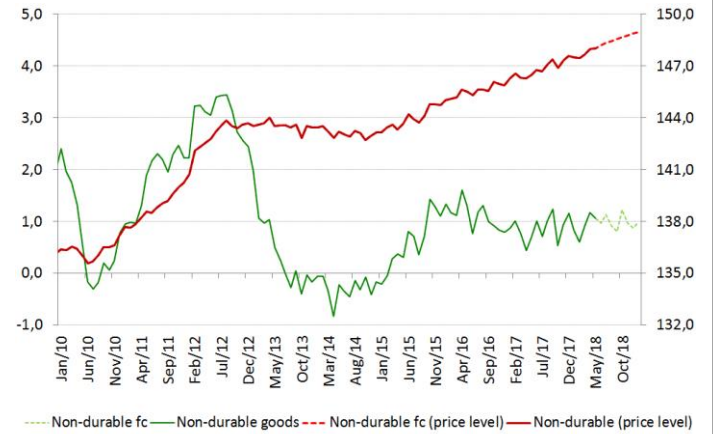
Chart 3: Trend inflation*
(annualized 3M/3M changes, %)



Sources: KSH, OTP Research

*: Filtered from indirect tax and visit fee changes, and one-off items

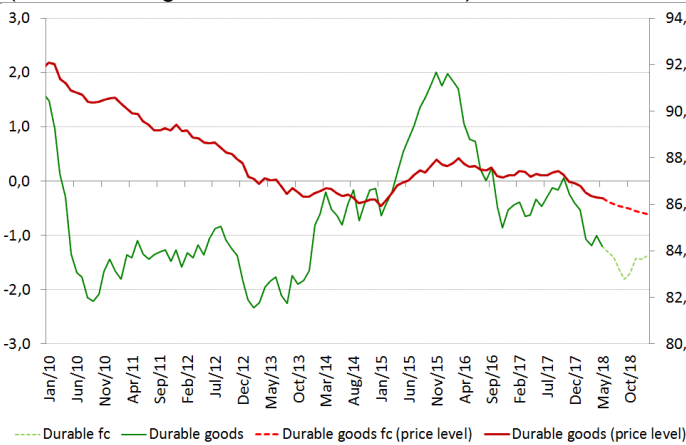
Chart 4: Non-durable goods inflation*
(annual changes % and 2000 Jan=100)



Sources: KSH, OTP Research

*: Filtered from indirect tax changes

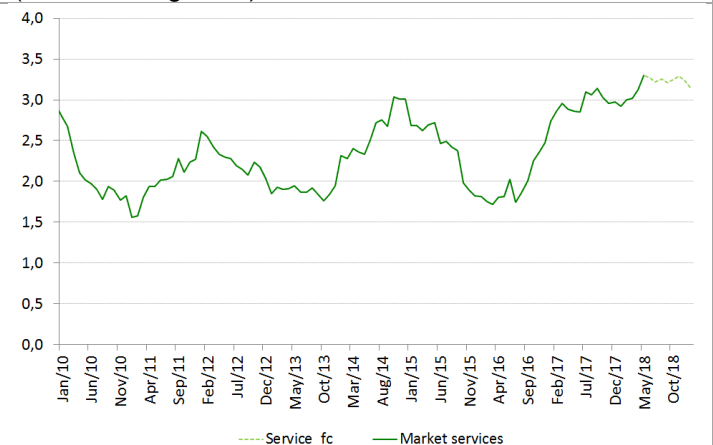
Chart 5: Durable goods inflation*
(annual changes % and 2000 Jan=100)



Sources: KSH, OTP Research

*: Filtered from indirect tax changes

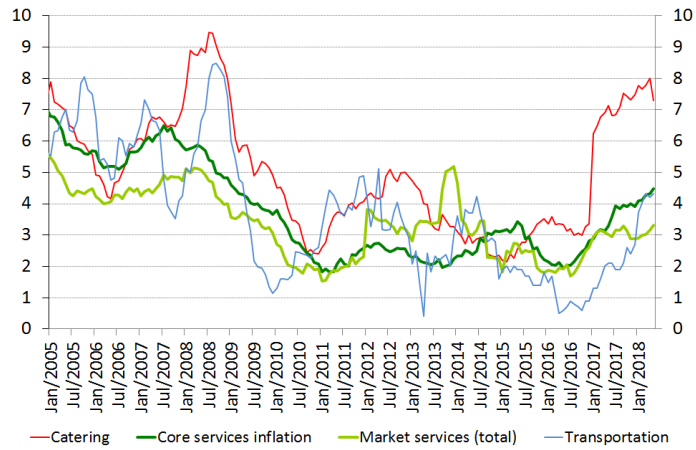
Chart 6: Market services inflation*
(annual changes, %)



Sources: KSH, OTP Research

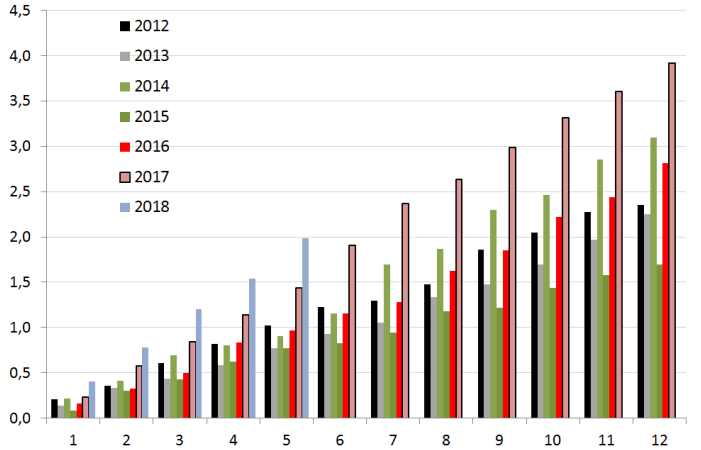
*: Filtered from indirect tax (including financial transaction tax) and visit fee changes

Chart 7: Services inflation*
(annual changes, %)



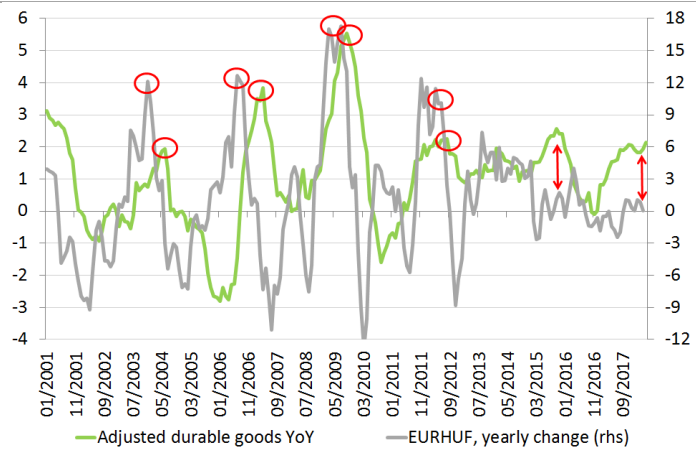
Sources: KSH, OTP Research
*: Filtered from indirect tax (including financial transaction tax) and visit fee changes

Chart 8: Intra-year price setting in core services*
(cumulated, over previous Dec, %, SA)



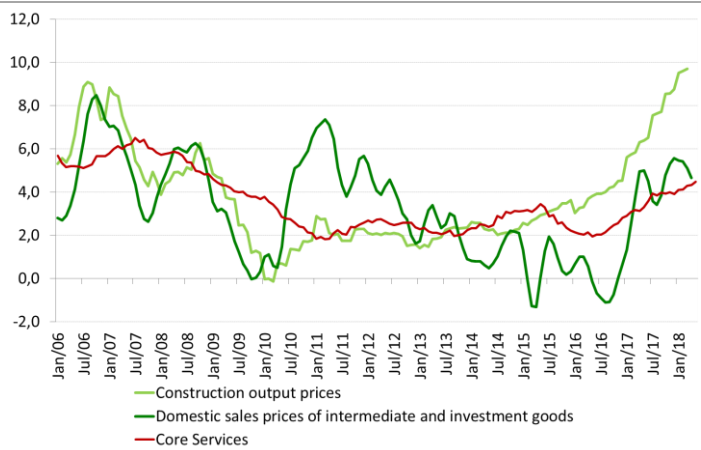
Sources: KSH, OTP Research
*: Aggregation of the most demand-sensitive and labour-intensive services, filtered from indirect tax (including financial transaction tax) and visit fee changes

Chart 9: Durable goods w/o used passenger vehicles and cultural goods vs the change of EUR/HUF
(annual changes, %)



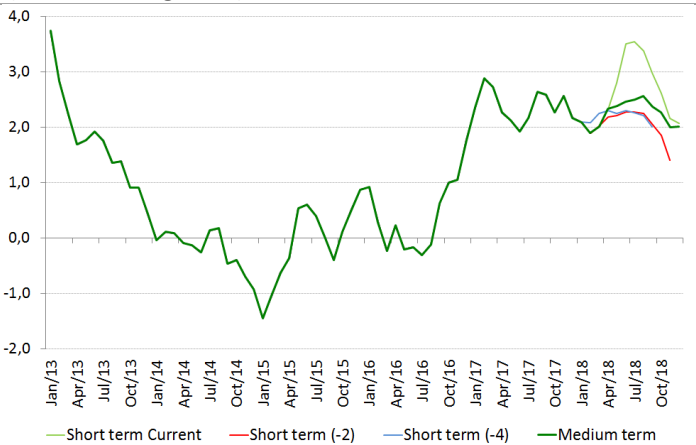
Sources: KSH, OTP Research

Chart 10: Inflation in different segments of the economy (annual changes, %)



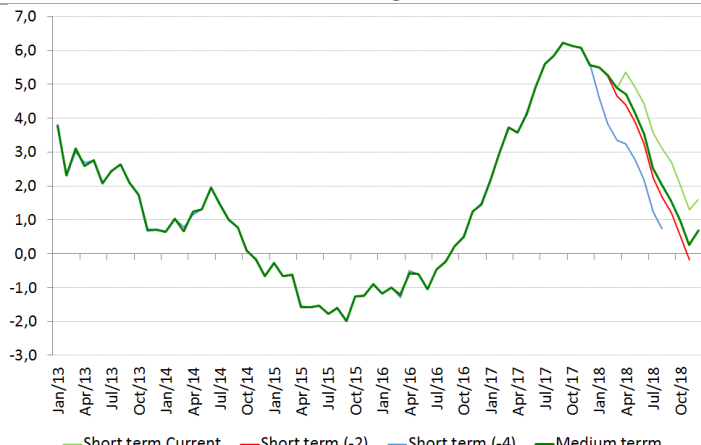
Sources: KSH, OTP Research

Chart 11: Evolution of our total CPI forecast
(annual changes, %)



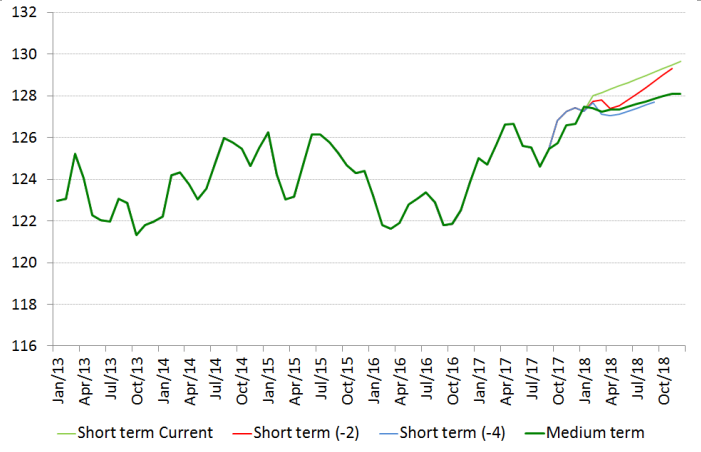
Sources: KSH, OTP Research
*: Filtered from indirect tax (including financial transaction tax) and visit fee changes

Chart 12: Evolution of our core-processed food inflation forecast (annual changes, %)



Sources: HCSO, EC, OTP Research
*: import price of non-food intermediate goods+passenger cars

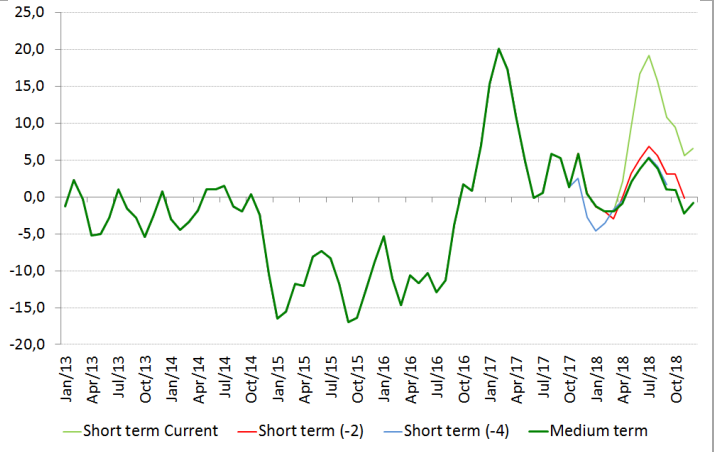
Chart 13: Forecast of imported inflation (2005=100)



Sources: KSH, OTP Research

*: import price of non-food intermediate goods+passenger cars

Chart 14: Evolution of our fuel price forecast (annual changes, %)



Sources: KSH, OTP Research

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