

REPORT ON INFLATION

11 September 2018

Inflation may have topped out in August but underlying inflation is on the rise. We raised our CPI forecast

- Hungary's inflation was 3.4% YoY in August, the same as in the previous month, the KSH said. We forecasted 3.3% inflation for August, and the market consensus was the same. So the incoming data was slightly higher than our forecast and the consensus. Filtered inflation (inflation without volatile items and all government measures) stagnated at 2.5% YoY. Its annualized 3M/3M change (rolling QoQ) was 2.7% and this was the third month in a row when it increased. Core inflation and trend inflation categories were in line with our expectation.
- The higher-than-expected inflation was due to seasonal foods, as potato and vegetables prices rose significantly. Taking into account the bad weather conditions during the summer, we think this price level shift may remain long-lasting, until next summer. On the other hand, the much less volatile core unprocessed and core processed foods items' inflation was less than we expected. This suggests that the acceleration in seasonal food inflation will not result in general food price shock.
- Trend inflation, which contains the most demand-and-labour-cost-sensitive items, was 2.5% YoY, while its annualized 3M/3M change (rolling QoQ) was 2.9%. It is definitely higher than the figures seen at the end of 2017 and the beginning of 2018 (around 2%). Our medium-term forecast suggests that the annualized QoQ change in trend inflation may reach the 3.5-4% range in the second half of 2019. This is mainly because of the currently high ULC growth and expected rise in imported inflation, but the even wider (positive) consumption gap also enhances the re-pricing power of businesses. In all, we think the general 'price pressure' that comes from the cyclical position, which has already been seen in many sectors, is gradually appearing in consumer prices. The YoY inflation of 'core services' accelerated again from 3.9% to 4.1% after three consecutive months of deceleration. Furthermore, in some non-core service items (catering and transportation), inflation hit its highest in a decade.
- Our medium-term forecast takes account of the latest news (excise duty hikes on tobacco products and an increase in highway toll fees). As a consequence, we raised our inflation forecast to 2.7% and 2.5% for 2018 and 2019 (previous: 2.6% and 2.2%), respectively (our medium-term forecast was revised before the August inflation data were published). The incoming data and the reasons for the negative surprise (higher inflation) make us think that inflation in 2018 is more likely to be 2.8%. The abovementioned new measures have changed not only the annual average inflation but its pattern, too. Inflation could reach its peak in July/August and we still expect a gradual decline until December, but to a lesser extent than previously thought. At the beginning of 2019 inflation can climb above 3% again. As a result, the 12-month annual average inflation between April 2018 and May 2019 can be 3%. After that, negative base effects come from gasoline prices, and seasonal foods (see later) force down inflation in the second half of 2019. If we concentrate on the filtered inflation category, which does not contain the above inflation items, we expect 2.5%, 2.6% and 3% inflation rates for 2018, 2018 and 2020 respectively. So inflation may reach the MNB's target in a sustainable manner over the policy horizon¹.
- In its latest Inflation Report, the MNB forecasted 3.4% inflation for July and 3.3% for August. As we wrote earlier, the upside surprise (in comparison with our 3.3% expectation for August) came from seasonal food prices, which the MNB will probably identify as a temporary effect. In our view, the MNB's communication may put the emphasis on core inflation, which currently remained muted. As we pointed out, filtered inflation may reach 3% in 2020. That is in line with the MNB's communication, which stated that the inflation target can be reached over the policy horizon under current monetary conditions. As the financial turmoil became muted in recent weeks, the EUR/HUF stabilized in the 320-330 range, and long yields also declined, we do not think the MNB will change its policy stance.

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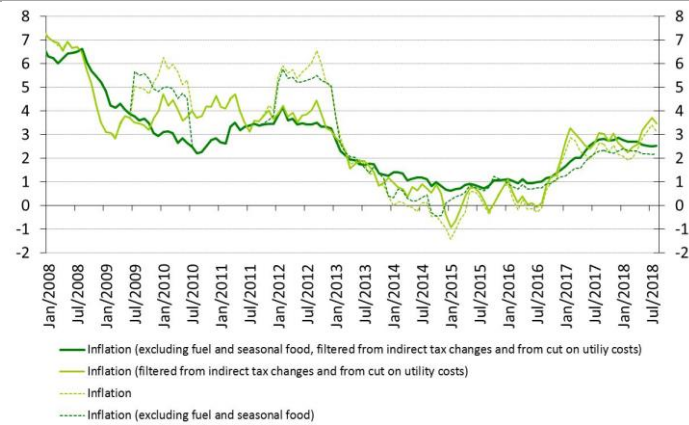
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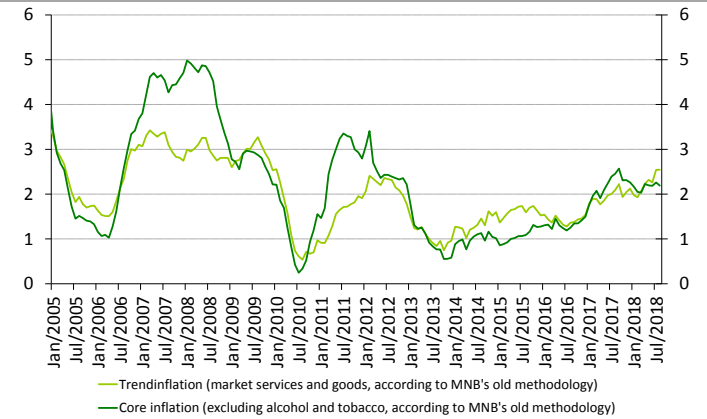
¹:naturally, our forecast is based on our assumption for monetary conditions. We assumed very slight HUF depreciation over the forecast horizon

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



Sources: KSH, OTP Research

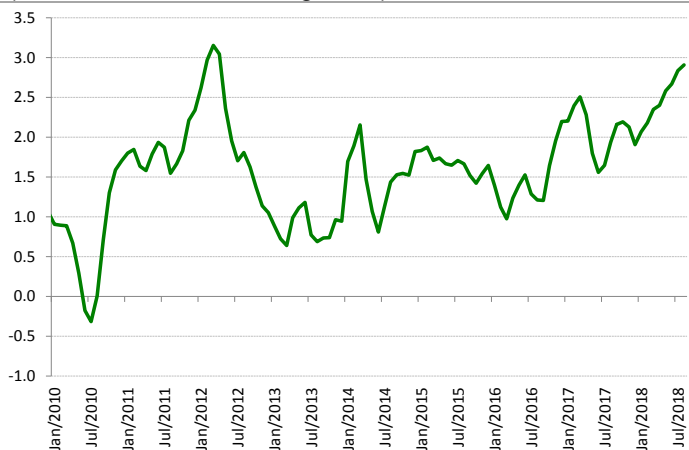
Chart 2: Core* and trend inflation**
(annual changes, %)



Sources: KSH, OTP Research

*: Filtered from indirect tax and visit fee changes, and one-off items
*: w/o second-hand car prices

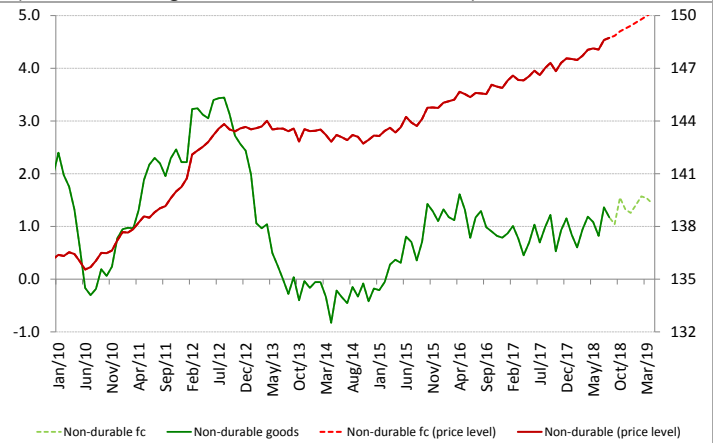
Chart 3: Trend inflation*
(annualized 3M/3M changes, %)



Sources: KSH, OTP Research

*: Filtered from indirect tax and visit fee changes, and one-off items, w/o second-hand car prices

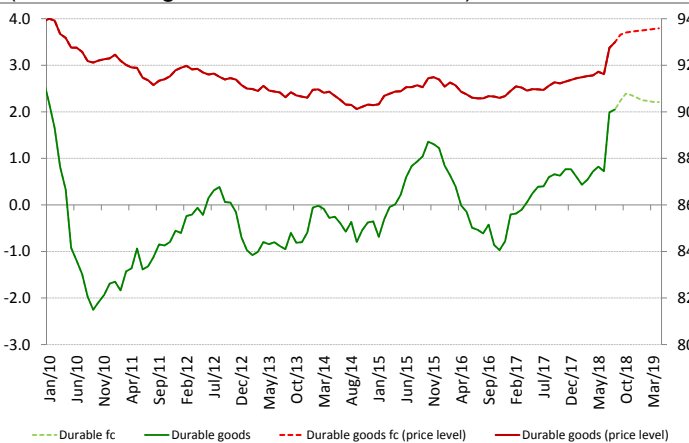
Chart 4: Non-durable goods inflation*
(annual changes % and 2000 Jan=100)



Sources: KSH, OTP Research

*: Filtered from indirect tax changes

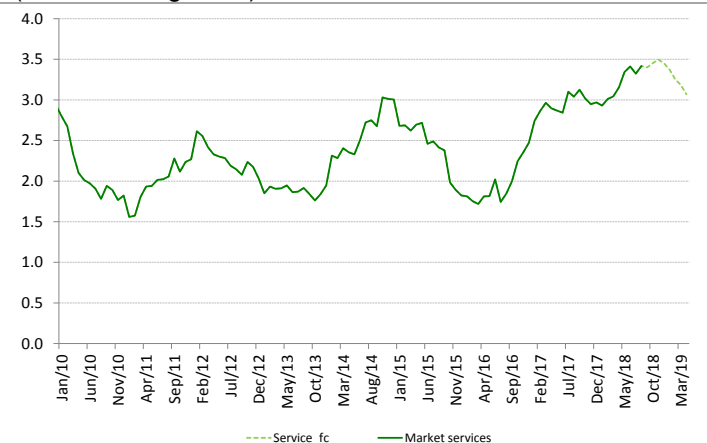
Chart 5: Core-Durable goods inflation*
(annual changes % and 2000 Jan=100)



Sources: KSH, OTP Research

*: Filtered from indirect tax changes and second hand passenger vehicle prices

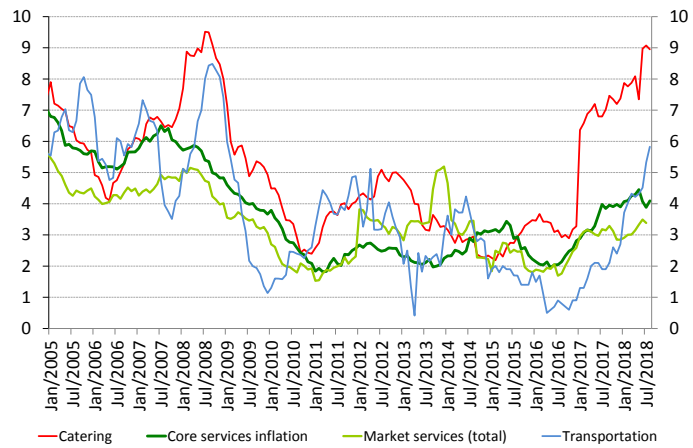
Chart 6: Market services inflation*
(annual changes, %)



Sources: KSH, OTP Research

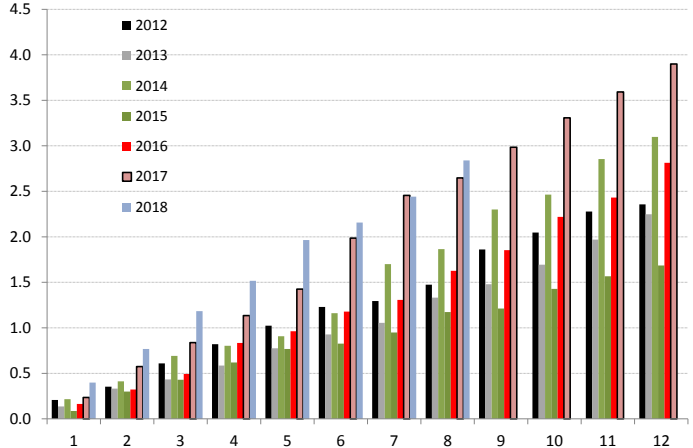
*: Filtered from indirect tax (including the financial transaction tax) and visit fee changes

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



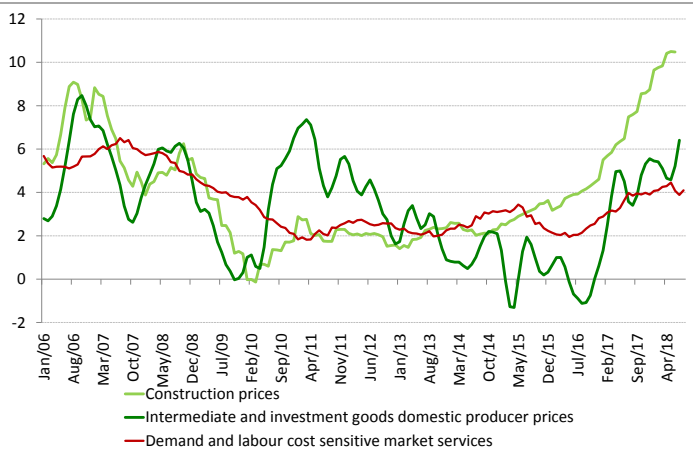
Sources: KSH, OTP Research
*: Filtered from indirect tax (including the financial transaction tax) and visit fee changes

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



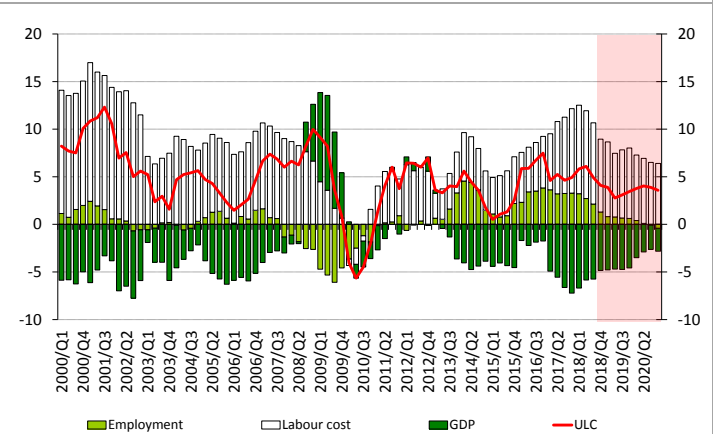
Sources: KSH, OTP Research
*: Aggregation of the most demand-sensitive and labour-intensive services, filtered from indirect tax and visit fee changes

Chart 11: Price evolution in some non-CPI items
(annual changes, %)



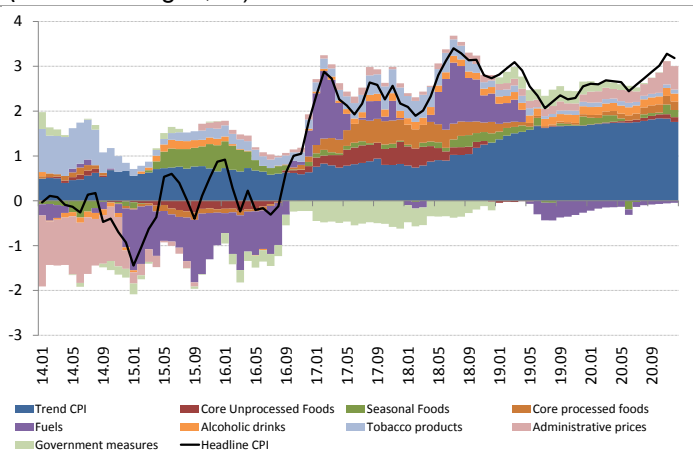
Sources: KSH, OTP Research

Chart 12: Evolution of Unit Labour Cost
(YoY and growth contributions, %)



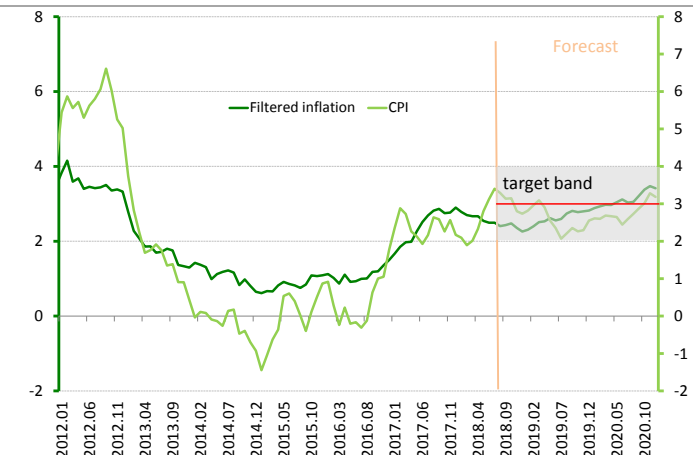
Sources: KSH, OTP Research

Chart 11: Decomposition of our inflation forecast
(annual changes, %)



Sources: KSH, OTP Research

Chart 12: Our medium-term forecast for CPI
(contribution to annual changes, pp, YoY, %)



Sources: KSH, OTP Research

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