otp Research

REPORT ON INFLATION

10 April 2019

Inflation rose close to its peak in March, nonetheless medium-term upside risks have increased

- Hungary inflation hit 3.7% YoY in March, up from 3.1% in the previous month, the KSH statistical office said on Tuesday. This growth was driven by the rise in fuel prices, airfare, and the higher inflation of alcohol and tobacco. The latter caused the surprise compared to our forecast of 3.6% (the market consensus was 3.5%) So, the incoming figure was slightly higher than our forecast and the market consensus, as well.
- Underlying indicators of inflation also rose:
  1. The closely watched constant tax core inflation accelerated from 3.2% to 3.5%. We expected only 0.1ppts acceleration, and as we calculated from the latest Inflation Report, the MNB also may have expected 0.1ppts acceleration. So the data is a huge negative surprise. Nevertheless, we should note that the very volatile air fare prices grew by 9.3% MoM, with an effect of 0.1ppts. It is difficult to say whether the high MoM growth rate of air fares was just a consequence of some seasonality effect (significant re-pricing is quite usual in April, so changing seasonality is possible), or we could see a strong re-pricing behaviour.
  2. Our filtered inflation indicator (inflation without volatile items and all government measures) was 2.9% YoY, up from 2.7%. It was the third time in the past four months for filtered inflation to rise (in the remaining one month, inflation was unchanged compared to the previous month). Its annualized 3M/3M change (rolling QoQ) was 3.3% and this was the tenth month in a row when it increased. Beside airfares, we saw upside surprise in housing rent fees[1] too. The cumulative price level growth of this item since previous December was 4.1% vis-à-vis 1.7% in the previous year. But this acceleration is definitely in line with the recent developments on the real property market.
  3. Our trend inflation indicator, which is similar to the MNB's demand sensitive and sticky price inflation, was 3.2%, up from 3.1% in February. Core services' inflation (the most demand and labour cost sensitive items) was 4.9% YoY in March (up from 4.7%), and its annualized 3M/3M change hit 5.5% (up from 5.2%). Core durable goods' (most demand and exchange rate sensitive items) inflation was 2.7% YoY (down from 2.9%), but this YoY change is still very high in historical comparison (the only time when this item's inflation was higher than now was after the significant HUF depreciation in 2009). So both our and the MNB's underlying indicators show clearly rising inflationary pressure, in line with the business cycle.
- However, it is not a surprise that underlying indicators have been on the rise. Our previous medium-term forecast (made in last September) projected that our trend inflation indicator may reach 3.6% YOY in last third of 2019, driven by the weaker HUF, strong demand, and high wage growth.
- However, we expect underlying inflation indicators to reach their peak soon. Since September **trend inflation** has remained below our previous medium-term forecast's path, and the annualized 3M/3M change has already decelerated from 3.4% in last October to 3% by March. **Looking ahead, we expect trend inflation to remain around 3% YoY for an extended period,** based on the following arguments: imported inflation can be much lower than we had previously thought (the EUR/HUF has fallen from the 328 levels in September), ULC growth may decelerate (see here), and consumption growth may also have passed its cyclical peak. So, in our updated medium-term forecast (made in February) we revised down our trend inflation forecast and the March data confirms this view.
- Regarding headline inflation, the continuous upside inflation surprises of the last couple of months was not driven by **underlying inflationary processes**, **but the seasonal foods and the processed foods** (the latter is also included by the constant tax core inflation indicator of the MNB). And the **food shocks could easily be reversed**, particularly in the

[1] In Hungary the 'market-based' housing rent is a niche market. Therefore the housing rent fee can be considered as administered price, so core inflation does not contain this item. But we should emphasize that housing rent fee definitely has a 'market-based' part, and in our view this part explains most of the time series' variance.

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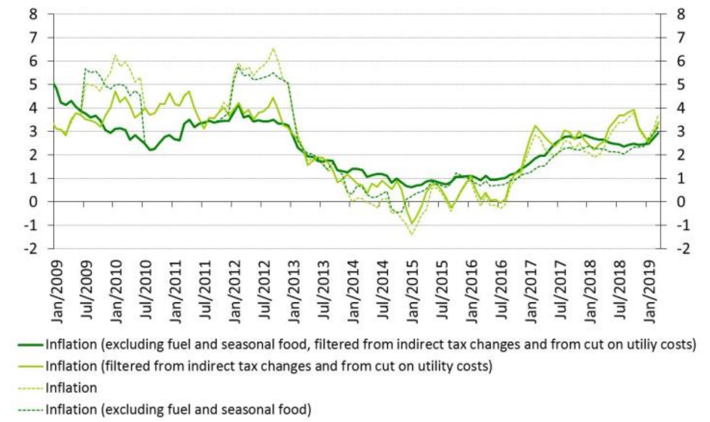
case of the seasonal foods, which can result a significant negative basis effect in the next year. So, the current higher inflation does not mean automatically higher inflation also in 2020, but adds to the risks of a stronger decline in 2020. This explains why we forecast lower average inflation for 2020 (2.4%) than for 2019 (3.0%, up from the previous forecast of 2.8% due to the recent negative surprises).

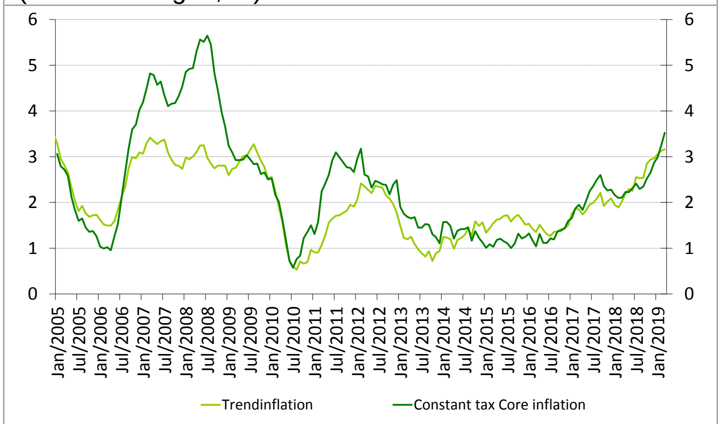
- Looking ahead, we see two main risks:
    1. The very tight labour market and strong domestic demand could loose the anchor of inflation expectations and result in stronger re-pricing activity.
    2. The tight labour market conditions may result in higher wage inflation. In this case, we consider the public sector as a source of risk, as administered prices make up roughly one-sixth of the CPI basket. So, if wage growth in publicly owned companies accelerates further, the currently muted inflation in administered prices could not be sustained any more.
- Regarding monetary policy consequences, we think that the MNB caught between a rock (strong domestic price pressures) and a hard place (gloomy external environment). Due to the fact that for now, the former seems to be the stronger. Constant-tax core inflation rose faster than the forecast of the previous Inflation Report. Furthermore the data led to forint depreciation and higher yields at the longer end of the curve. Consequently, while the baseline picture suggests that headline inflation will revert to the target by the last quarter of 2019, medium-term upside risks have increased. If strong domestic demand and above target inflation levels remain for a prolonged period, the MNB could risk inflation expectations becoming less anchored. Therefore we think that, in the current critical period, the stability of the exchange rate is important to keep inflation expectations anchored. Based on these arguments, the MNB, which has adopted a "data-driven" approach, may deliver another small tightening in June, when the next Inflation Report is published by hiking the O/N depo rate by another 10 bps, and decreasing further the volume of liquidity crowded. This step would be in line with our year-end forecast on the 3M BUBOR of 40 bps.

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



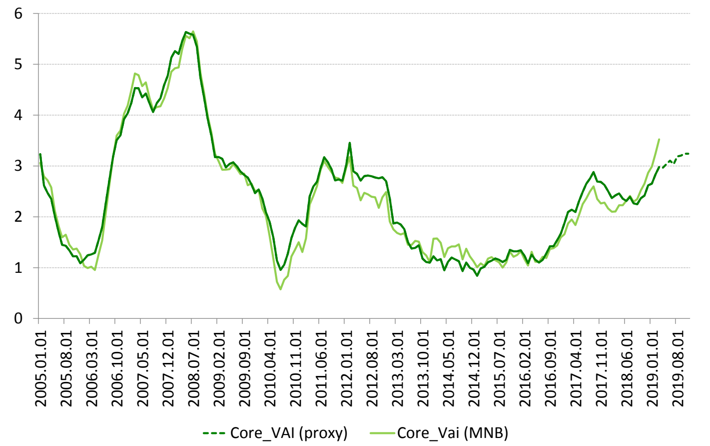
Sources: KSH, OTP Research

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



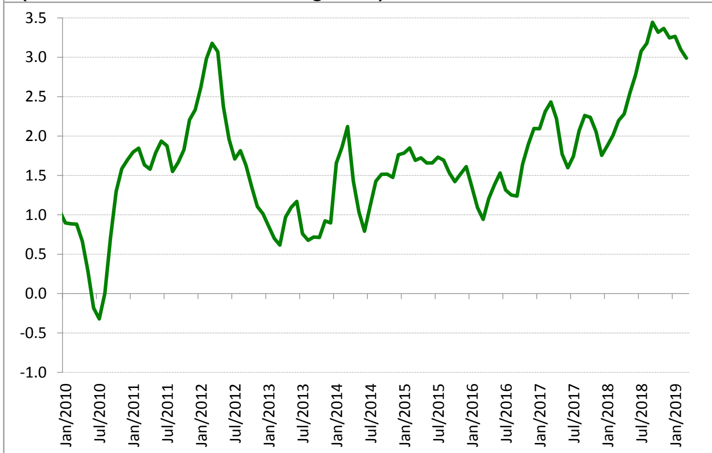
Sources: KSH, OTP Research
**: Filtered from indirect tax and visit fee changes, and one-off items and w/o second-hand car prices*

Chart 3: Constant tax core inflation and our proxy*
(annual changes, %)



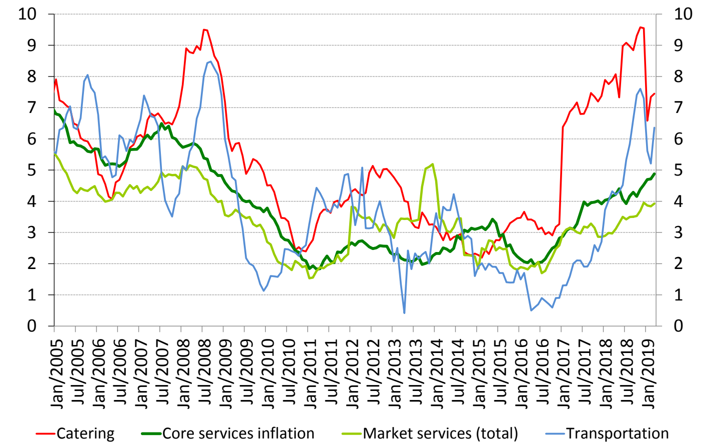
Sources: KSH, OTP Research
**: we cannot reproduce exactly the tax-filtered core inflation because (1) the MNB has its own methodology for the calculation of tax changes, which is not known to us. (2) In addition, core inflation cannot be calculated exactly from the KSH's 160 CPI items. So, our calculation tries to proxy the MNB's core vai indicator.*

Chart 4: Trend inflation*
(3M/3M annualized change, %)



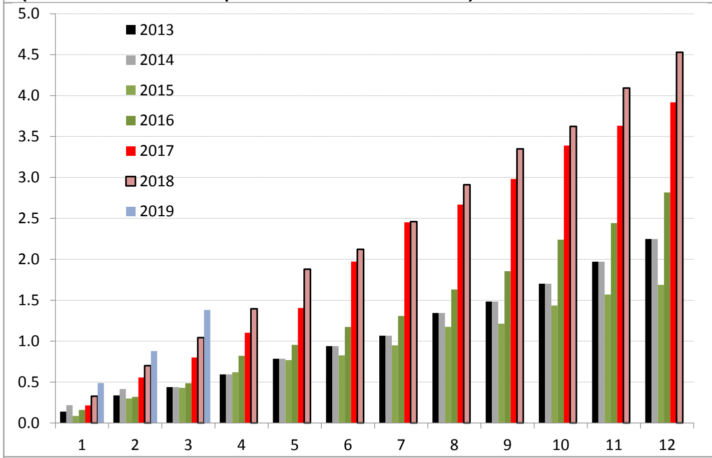
Sources: KSH, OTP Research
**: Filtered from indirect tax (including the financial transaction tax) and visit fee changes*

Chart 4: Services inflation*
(annual changes, %)



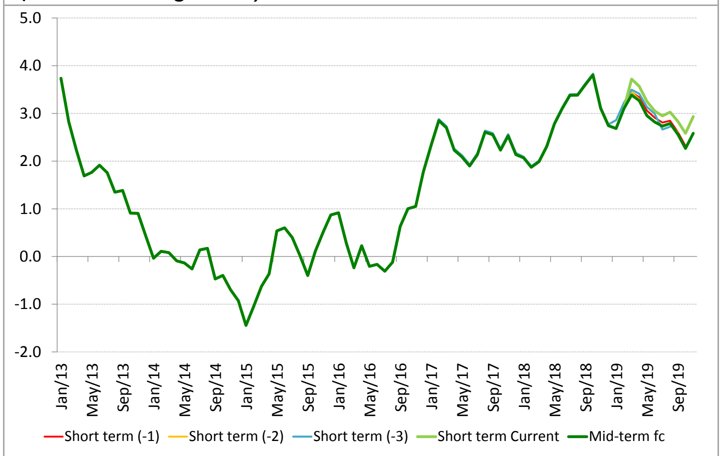
Sources: KSH, OTP Research
**: Filtered from indirect tax (including the financial transaction tax) and visit fee changes*

Chart 5: Intra-year price setting in core services*
(cumulated, over previous Dec, %, SA)



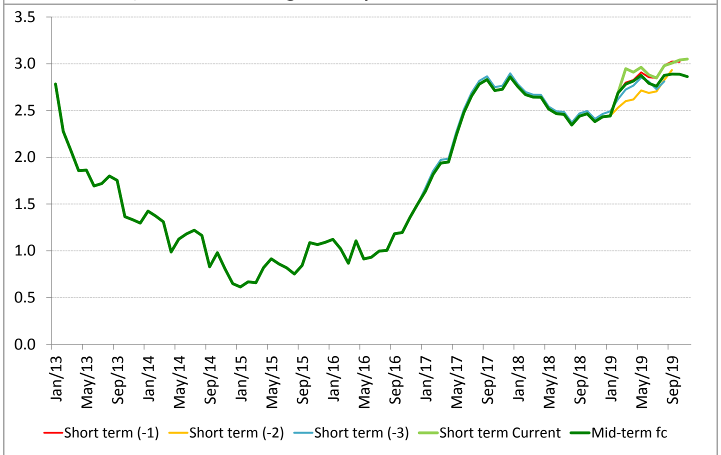
Sources: KSH, OTP Research
**: Aggregation of the most demand-sensitive and labour-intensive services, filtered from indirect tax and visit fee changes*

Chart 7: Incoming data's effect on our CPI forecast
(annual changes, %)



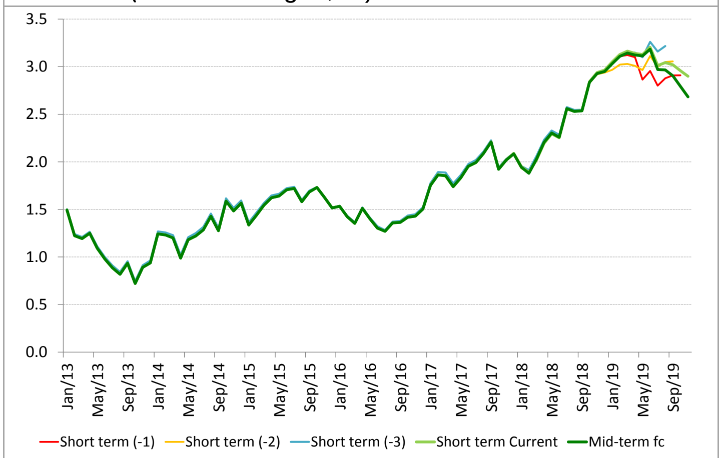
Sources: KSH, OTP Research

Chart 8: Incoming data's effect on our filtered CPI forecast (annual changes, %)



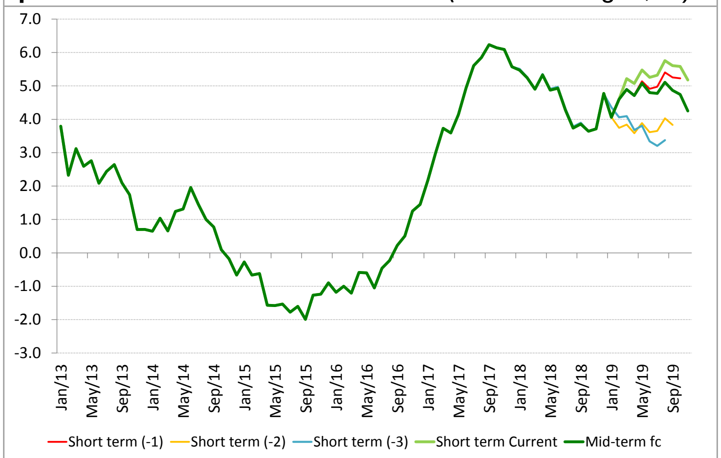
Sources: KSH, OTP Research

Chart 9: Incoming data's effect on our trend inflation forecast (annual changes, %)



Sources: KSH, OTP Research

Chart 10: Incoming data's effect on our core-processed food inflation forecast (annual changes, %)



Sources: KSH, OTP Research

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This document was prepared on 10 April 2019.