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REPORT ON INFLATION

11 June 2019

Still waiting for a downturn in inflation

- According to the KSH statistical office, Hungary's inflation was 3.9% YoY in May, the same as in the previous month. We forecasted 3.8% inflation for May, while the market consensus was 0.1ppts higher than our expectation. So the incoming data was slightly exceeded our forecast.
- Underlying indicators seem to have gained momentum in May:
  1. The closely watched constant tax core inflation accelerated to 3.7%, from 3.4% in April. We had expected just 0.1ppts uptick, based on our constant tax core inflation proxy, which rose by 0.2ppts. The MNB calculated with 3.4% constant tax core inflation for Q2, and it was 3.6% in the average of April-May. So, we need 3.2% rate to achieve the 3.4% figure, which seems challenging.
  2. Our filtered inflation indicator (inflation without volatile items and government measures) was 3.2% YoY, up from 2.9%, but its annualized 3M/3M change accelerated to 3.9% (up from 3.6% in April), the highest figure since June 2012.
  3. Our trend inflation indicator, which is similar to the MNB's demand-sensitive and sticky price inflation, accelerated to 3.4% YoY from 3.2% in the previous three months. Its annualized 3M/3M change was 3.2%. Core services' inflation (the most demand and labour cost sensitive items) accelerated to 5.2% YoY in May (up from 5.1%), and its annualized 3M/3M change jumped to 5.9% from 5.7%. Services' re-pricing had already been very strong before May, but it gained new momentum in May (see Chart 6). As the pricing behaviour is very auto-regressive in this segment, it may become a major issue in the coming year(s). The inflation of core durable goods (the most demand and exchange rate sensitive items) was 2.5% YoY (down from 2.6%, and it was the fourth consecutive month for the YoY change to decline), 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).
  4. In all: the acceleration of the underlying indicators is in line with the current state of the business cycle, but as long as trend inflation is around 3.2% on annualized QoQ basis, the underlying processes are in line with our expectation. The 0.3 ppts acceleration in constant tax core inflation is significant, partly because of the African swine fever (see later). We emphasize that we had expected in our medium-term forecast some deceleration in trend inflation in 2020, due to cost and demand side factors. But there is a clear risk that this deceleration will not happen, particularly in the light of the development of demand-sensitive and sticky price inflation.
- The difference between our forecast and the published data mainly stemmed from food prices. Seasonal foods' price level is finally starting to decline, which we had expected to happen in earlier months. If this process continues, it will generate significant (negative) basis effect in the last third of 2019 and the first third of 2020. The upside surprise came from the core processed and core unprocessed foods, mainly due to one reason: the African swine fever. Raw pork prices jumped by 6.5% MoM, lifting both raw meat prices (part of core unprocessed foods) and processed meat prices. The disease's effect added around 0.1ppts to CPI in May. In our view, its effect on inflation will be temporary, but this period may take months. We assume that the African swine fever will raise whole-year CPI by 0.1ppts, through direct and spillover effects. Therefore, we raise our CPI forecast from 3.1% to 3.2%.
- In our calculations, the announced excise duty hikes on tobacco products will raise inflation by 0.22% in 2020, and by 0.17% in 2021. Accordingly, inflation may be close to 4% at the beginning of 2020 again. Cutting VAT from 27% to 5% on accommodation services may lower inflation by 0.06-0.08% in 2020. The resultants of indirect tax changes on inflation are +0.15% and 0.17% for 2020 and 2021, respectively.

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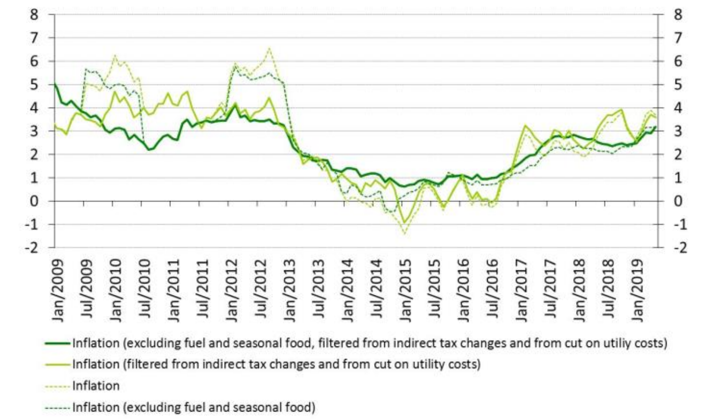
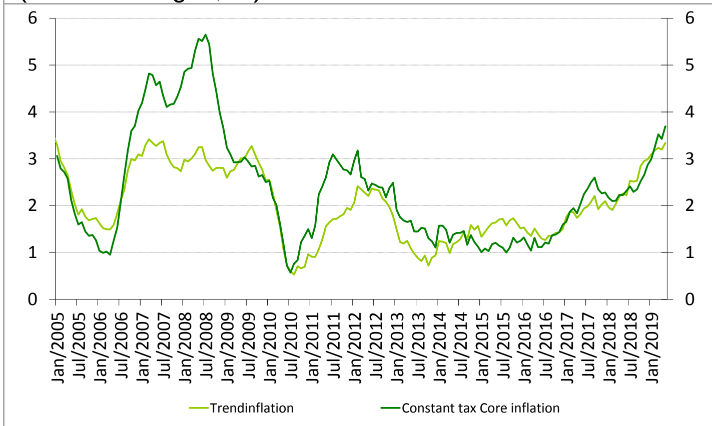
- The situation about our inflation expectation for 2020 is rather complicated.
    1. On the one hand, we see that seasonal food and oil prices have sky-rocketed since last autumn. Furthermore corn and wheat prices increased to a somewhat stronger extent than we had earlier expected, and currently we face the African swine fever. But the price development of these raw materials can easily reverse (as it happened with oil prices, and it has already started in the case of seasonal foods), which can generate a very significant negative basis effect. This is why we currently expected 2.5% inflation (without the abovementioned indirect tax changes) for 2020.
    2. On the other hand, the development of underlying indicators is concerning. Even though the rolling QoQ change in the trend inflation is currently in line with our medium-term forecast, we cannot be sure that the expected (slight) slowdown will actually happen in 2020. Therefore headline inflation might return to 3% or below that in 2020, but the structure of this inflation will be very unfavourable, as only the negative base effect of the volatile items would drag inflation back to the target.
- Regarding monetary policy consequences, we think the published data further raised the possibility of a rate hike in June. This step would be in line with our year-end forecast on the 3M BUBOR of 40 bps. The main question is how the MNB will interpret the announced draft budget law, in which the government lowered the deficit target. The MNB might think that if the government is so disciplined, then the central bank needs to counterbalance the fiscal policy's effect on growth with looser monetary conditions. The other factor that may make the MNB precautious is the worsening global growth outlook, best proxied by the US 10Y bond yield, which fell further in the past few weeks as rate cuts have been priced in. If the MNB needs arguments to communicate further delays in tightening monetary conditions, these factors could be cited.

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



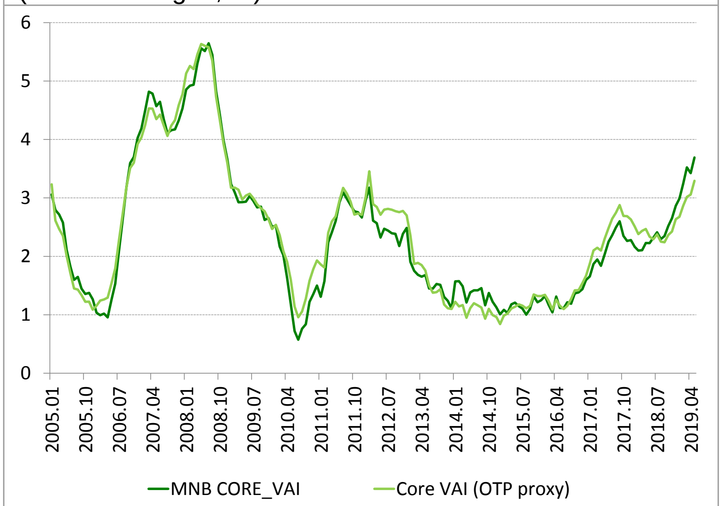
Sources: KSH, OTP Research

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



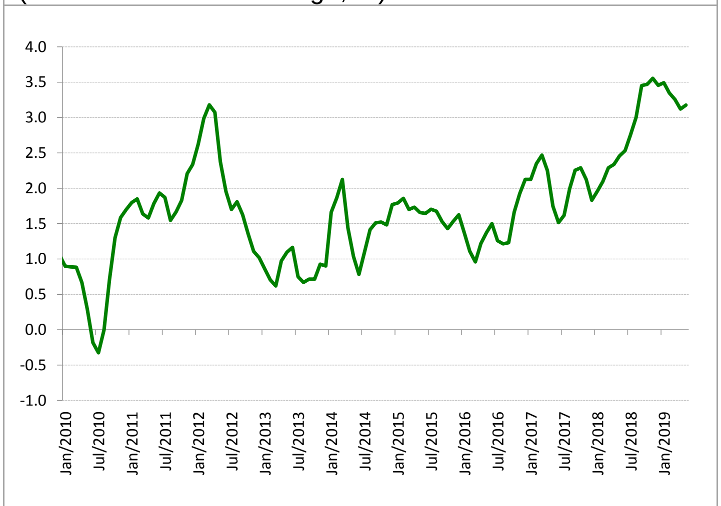
Sources: KSH, OTP Research
**: Filtered from indirect tax and visit fee changes, and one-off items and w/o second-hand car prices*

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*

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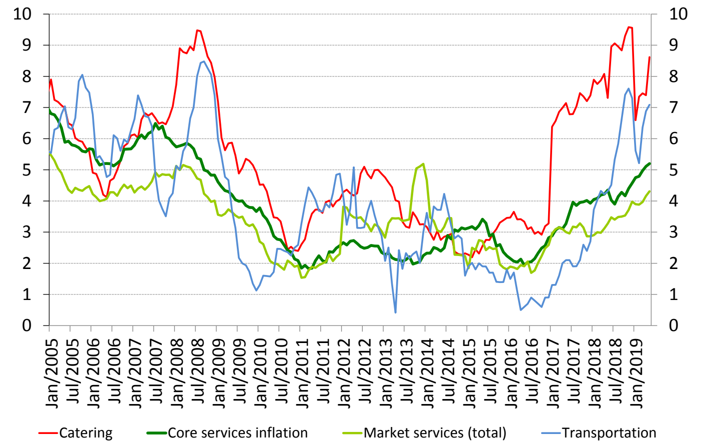
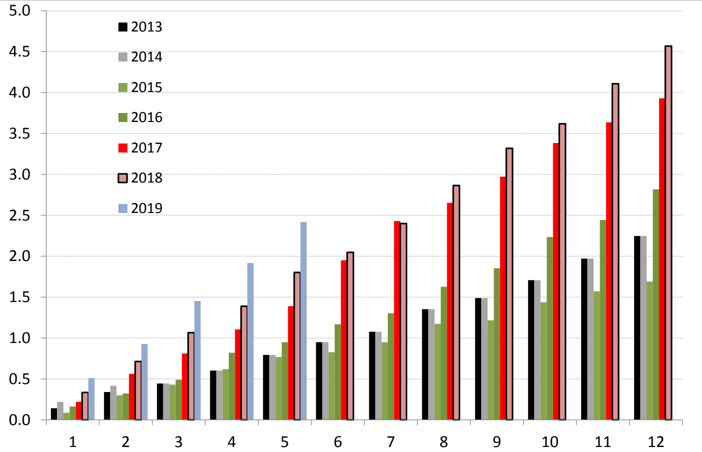
Chart 5: Services inflation*
(annual changes, %)



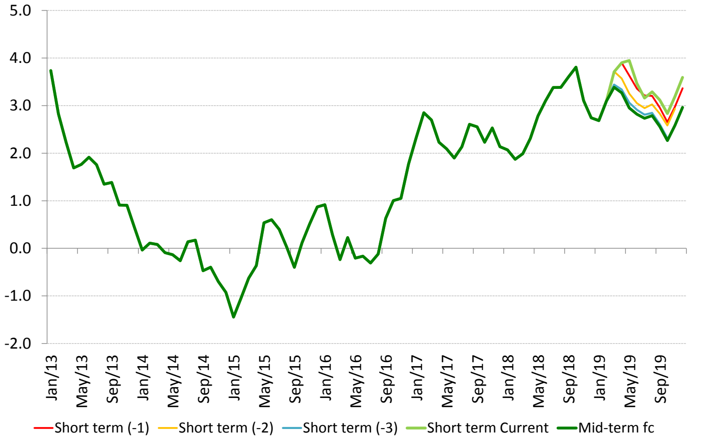
Sources: KSH, OTP Research
**: Filtered from indirect tax (including the financial transaction tax) and visit fee changes*

Chart 6: Intra-year price setting in core services*
(cumulated, over previous Dec, %, SA)



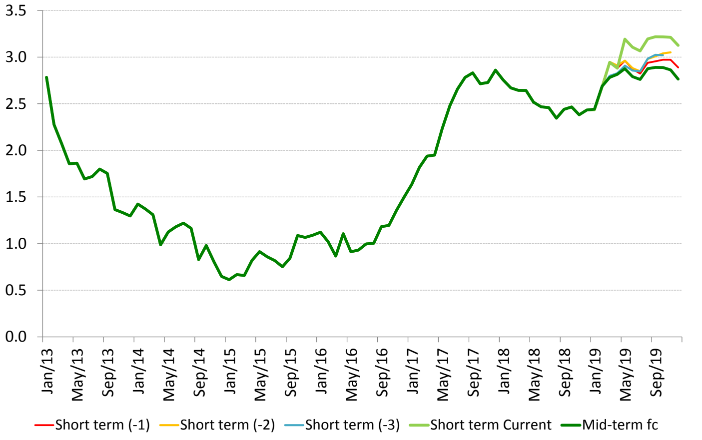
Sources: KSH, OTP Research
**: Aggregation of the most demand-sensitive and labour-intensive services, filtered from indirect tax and visit fee changes*

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



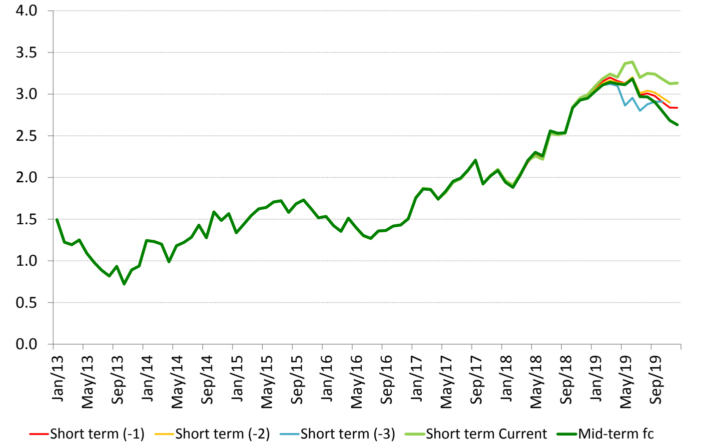
Sources: KSH, OTP Research

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



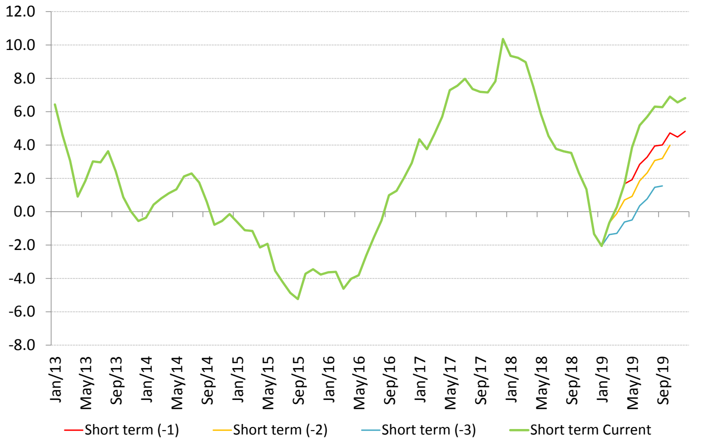
Sources: KSH, OTP Research

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-unprocessed food inflation* forecast (annual changes, %)



Sources: KSH, OTP Research
**: core unprocessed food category contains the raw meat prices*

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This document was prepared on 11 June 2019.