

REPORT ON INFLATION

9 October 2019

Inflation fell below the target; the current level of the EUR/HUF will not result in above-the-target inflation

- According to the KSH statistical office, inflation in Hungary slowed to 2.8% YoY in September, down from 3.1% in the previous month, and below the MNB's target. We forecasted 2.7% inflation for September, while the market consensus was 3.0%. So the incoming data was roughly in line with our expectations, but was below the market consensus.
- Underlying indicators remained roughly unchanged:
 1. The closely watched constant tax core inflation increased to 3.4% from 3.2%. Our filtered inflation figure (inflation without volatile items and all government measures) also accelerated, to 3.1% YoY from 2.9% in the previous month. Our trend inflation indicator, which is similar to the MNB's demand-sensitive and sticky price inflation, also rose by 0.2ppts to 3.2% YoY, while its 3M/3M annualized change fell further to 2.4%, from 2.6% in the previous month (it oscillated in the 3.3%-3.5% range between October 2018 and March 2019). We can identify two reasons for the higher-than-expected underlying indicators. First, telecommunication prices grew by 3.2% MoM, which means very strong re-pricing (but it can easily mean that there will be no further re-pricing for a while). Second, the rising precious metal prices have started to pass through into jewellery prices. Despite the upside surprise in the underlying inflation data, the current 3M/3M changes are still below our medium-term forecast.
 2. Core services' (the most demand and labour cost sensitive items) inflation decelerated to 5.3% YoY in September (from 5.4% in August). As a result, the annualized 3M/3M change has been declining since May/June (the annualized 3M/3M change has peaked between March and June at 5.8-5.9%).
 3. To sum it up: underlying indicators are still on a declining trend. Currently it is mostly the consequence of the deteriorating external environment (lower imported inflation). But, looking ahead, the business cycle in Hungary may have passed its peak and the expected slowdown in GDP growth as well as domestic demand (in particular household consumption expenditure) can also contribute to the stabilization of the underlying inflationary processes.
- Turning to the non-core segments: the price of the non-seasonal part of unprocessed foods and processed foods grew somewhat faster than we had expected. This was a result of raw meat and milk (unprocessed foods) as well as processed meat and dairy product (processed foods). Higher meat prices could be the result of the prolonged effect of the African Swine Fever (ASF): pork prices increased by roughly 2.5% MoM, while other raw meat (poultry, beef) prices grew by only 0.5%. It seems that the ASF's effect will last longer than we previously thought, but it will have temporary effect on the price level. So, when the ASF's effect starts to fade, the inflation of raw meats may decline significantly. We should also note that agricultural producer prices of wheat fell significantly in July, which has not yet appeared in flour prices (but we expect it to happen sooner or later). On the other hand, seasonal food prices fell sharply; with vegetables prices sliding the most (-9% MoM, SA). We have expected this process a long time ago (roughly since May), and it seems to have finally started.
- Our short-term projection factors in the effect of the weaker HUF (we assumed 334 EUR/HUF rate, while in previous reports, our short-term projection had calculated with 327-328 EUR/HUF levels). As a result, our trend inflation and filtered inflation projections have grown considerably in comparison with our previous short-term projections, but it is still below our medium-term forecasts' path. So, despite the weaker HUF, we still think that our below- consensus CPI forecast for 2020 is on track. Inflation may peak at 3.7% around December-January (due to base effect from the fuel prices), but it can decline rapidly after that.

Trading Desks

Dealing code: OTPH

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Fixed Income Desk

András Sovány

+36 1 288 7561

SoványA@otpbank.hu

Benedek Károly Szűts

+36 1 288 7560

SzutsB@otpbank.hu

FX Desk

András Marton

+36 1 288 7523

MartonA@otpbank.hu

József Horváth

+36 1 288 7514

Horvath.Jozsef@otpbank.hu

Money Market Desk

Gábor Fazekas

+36 1 288 7536

FazekasGa@otpbank.hu

Gábor Heidrich

+36 1 288 7534

HeidrichG@otpbank.hu

Judit Szombath

+36 1 288 7533

SzombathJ@otpbank.hu

FX Option Desk

Gábor Réthy

+36 1 288 7524

RethyG@otpbank.hu

Máté Kelemen

+36 1 288 7525

KelemenMat@otpbank.hu

Analyst

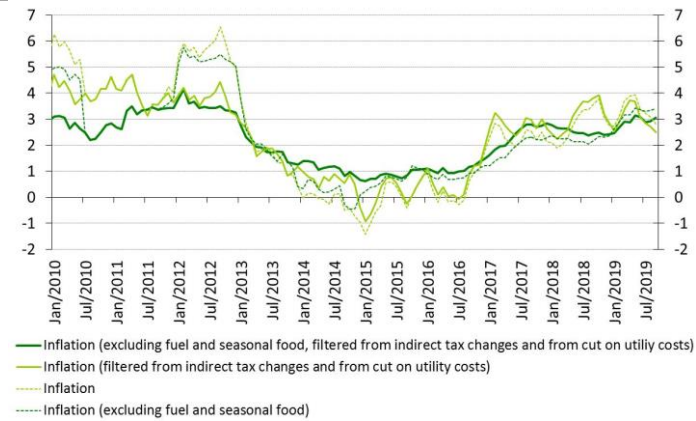
Mihály Kovács

+36 1 374 7274

Mihaly.Andras.Kovacs@otpbank.hu

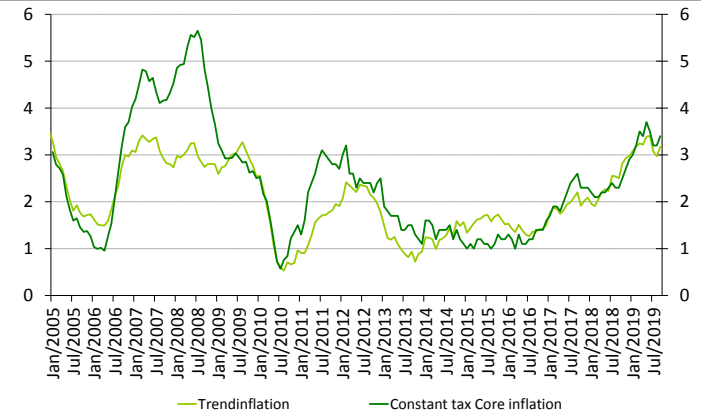
- Regarding the monetary policy consequences: the MNB had calculated with 3.0% CPI for September in its latest Inflation Report, so the incoming data is below the MNB's expectation. Furthermore, the MNB emphasized in its new inflation projection that its staff had factored in the currently weaker HUF. Consequently, the current level of the EUR/HUF will not change the MNB's view on inflation. Furthermore, if the external environment sharply deteriorates, the MNB has enough room for manoeuvre to ease monetary conditions (e.g. via FX swaps, QE).

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



Sources: KSH, OTP Research

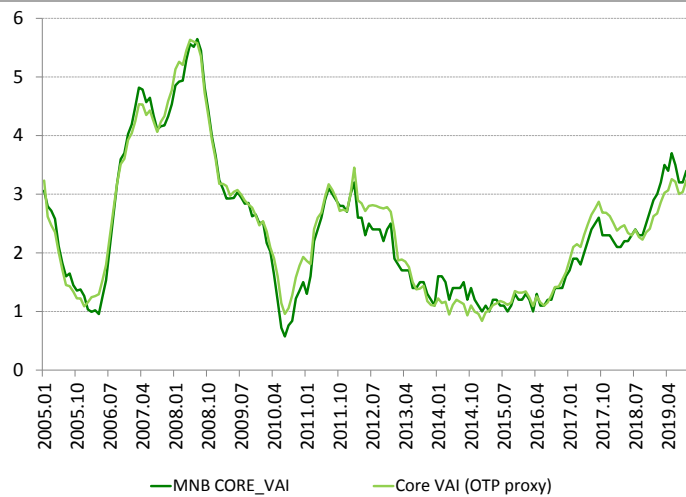
Chart 2: Core and trend inflation*
(annual changes, %)



Sources: KSH, OTP Research

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

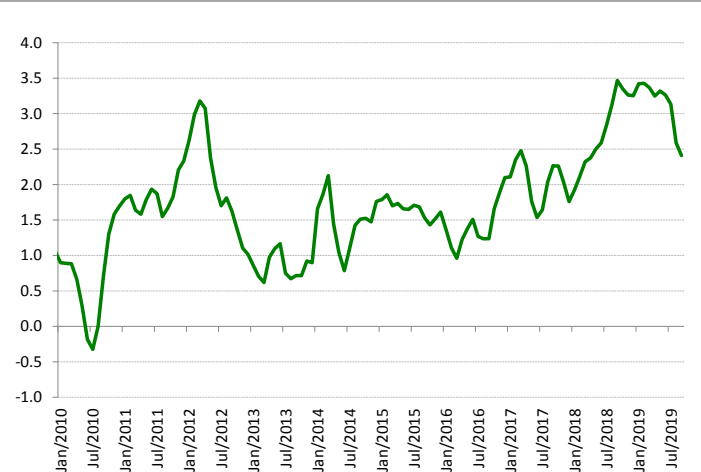
Chart 3: Constant tax core inflation and our proxy*
(annual changes, %)



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.

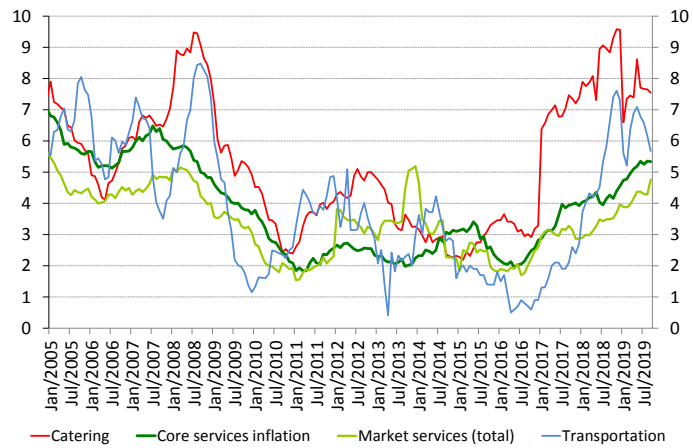
Chart 4: Trend inflation*
(3M/3M annualized change, %)



Sources: KSH, OTP Research

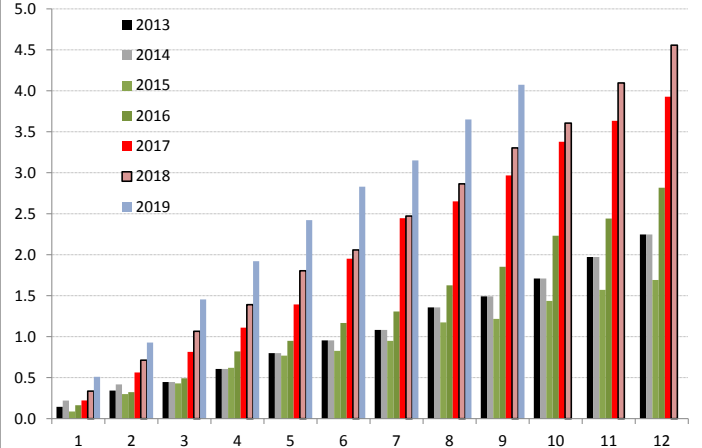
*: Filtered from indirect tax (including the financial transaction tax) and visit fee changes

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



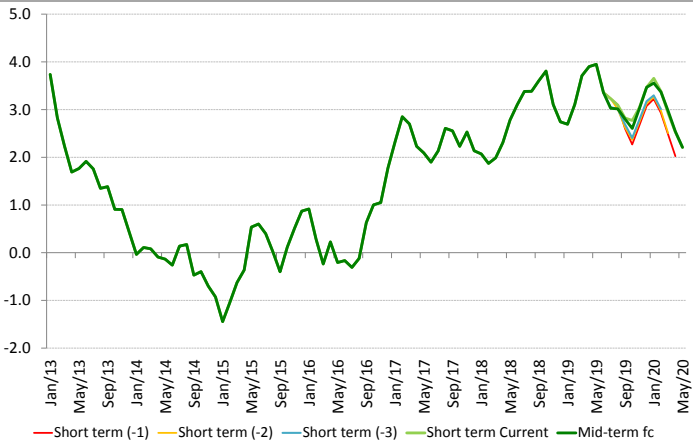
Sources: KSH, OTP Research
*: Filtered from indirect tax (including the financial transaction tax) and visit fee changes

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



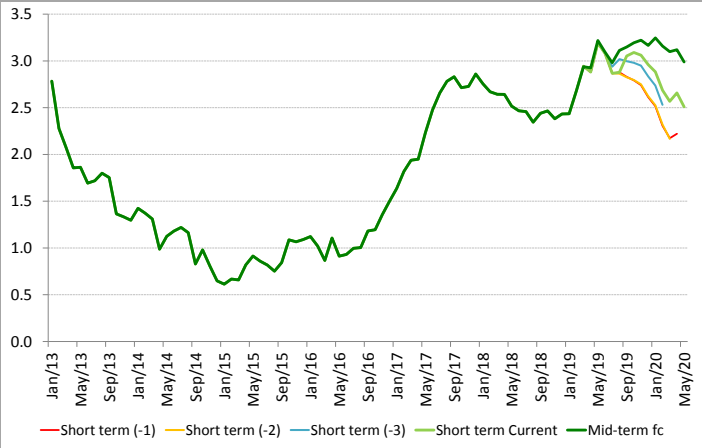
Sources: KSH, OTP Research
*: Aggregation of the most demand-sensitive and labour-intensive services, filtered from indirect tax and visit fee changes

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



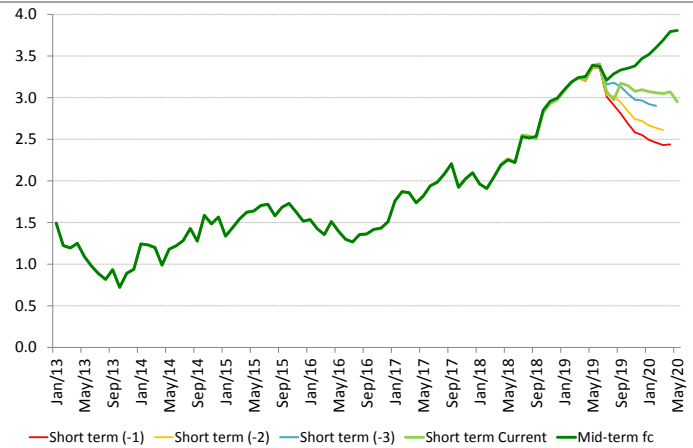
Sources: KSH, OTP Research

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



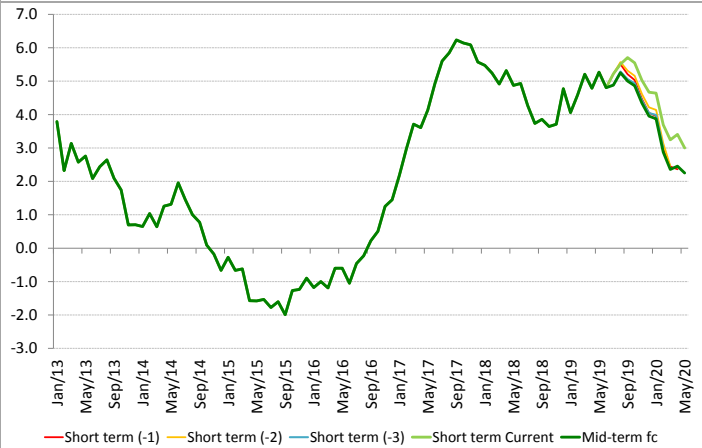
Sources: KSH, OTP Research

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-processed food inflation forecast
(annual changes, %)



Sources: KSH, OTP Research

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