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REPORT ON INFLATION

14 February 2020

Strong re-pricing in January and further agricultural price shocks pushed Hungary's CPI to 4.7% in January. The pressure on the MNB to deliver is on the rise

- Hungary's inflation rate was 4.7% YoY in January, up from 4% in the previous month, the KSH statistical office said. We forecasted 4.5% inflation for January, while the market consensus was 0.1 ppts lower than that. So, the incoming data was higher than our forecast and the market consensus, and it is also well above the MNB's 4.3% expectation. Nevertheless, Hungary is not the only country to face significant inflation acceleration. CPI in the Czech Republic jumped to 3.6% from 3.2% (consensus: 3.2%), while inflation in Poland surged 4.4% from 3.4% (consensus: 4.2%) – still, Hungary's inflation was the highest in Europe.
- Regarding the big picture about Hungary's inflation, we emphasized several times that underlying indicators had already reached or somewhat exceeded the MNB's 3% target as a consequence of strong domestic demand, wage growth, and loose policies. In such case, any unexpected shock could easily push inflation to, or above, the upper edge of the MNB's target band. In the past few years, headline CPI drew near 4% on two occasions (in 2018 and in 2019), and the indirect tax-filtered inflation rate climbed above 3% three times (early 2017, mid-2018, and mid-2019; see chart 1), but in each case, inflation returned below 3% after the shocks generated by the volatile items and indirect tax changes had reversed. Nevertheless, the previously very low inflationary environment in Hungary seems to be changing:
    1. First of all, the stagnation phase, or rather declining trend, in food prices/agricultural materials seems to have ended by 2018. The question is whether agricultural product prices will follow a similar pattern to the one seen in the previous decade (and the rise of the food prices in the past two years was just the beginning of the trend), or the food price shocks seen since the beginning of 2018 will reverse after the new harvest season. In the first case, the current 3-3.5% level of underlying indicators is not consistent with the MNB's 3% target (and probably neither is with the upper edge of the band).
    2. Despite the low and declining inflation at our main trading partners, the exchange rate movement strongly surpassed this effect.
    3. And last but not least, it seems that the pass-through of the abovementioned shocks to consumer prices has become stronger and faster (and VAT cuts did not appear in the CPI, neither in the case of catering services in 2018, nor in accommodation services right now). It happened because other cost-side items (e.g. wages) grew rapidly and the domestic demand is strong. So these developments suggest that the price-setting behaviour is changing, and it carries the risk that inflation expectations may become unanchored.
- All underlying indicators are above the MNB's 3% target and they exceeded our forecast by 0.2 ppts in January. However, we should note that there is some methodological uncertainty about our underlying indicators. In the catering sector, VAT was cut from 18% to 5% but almost nothing appeared in the CPI. So we added the whole technical effect to our underlying indicators. We think it is the appropriate solution because in the case of VAT cuts the immediate and short-term effects are very limited but re-pricing in the following months is usually lower than it would be without the VAT cut. So, in the short run, our underlying indicators may over-estimate somewhat the 'actual' underlying trend, but in the second half of the year our figure will converge with the 'actual' figure.
    1. The closely watched constant tax core inflation accelerated to 3.7%, from 3.5%. Our filtered inflation figure (inflation without volatile items and all government measures) increased from 3.1% YoY to 3.4%. Our trend inflation indicator, which is similar to the MNB's demand-sensitive and sticky price inflation, accelerated to 3.3% YoY from 3.1%, and its 3M/3M annualized change stagnated at 3.6%. The MNB's sticky price inflation stagnated at 3.4% in the seventh month in a row.

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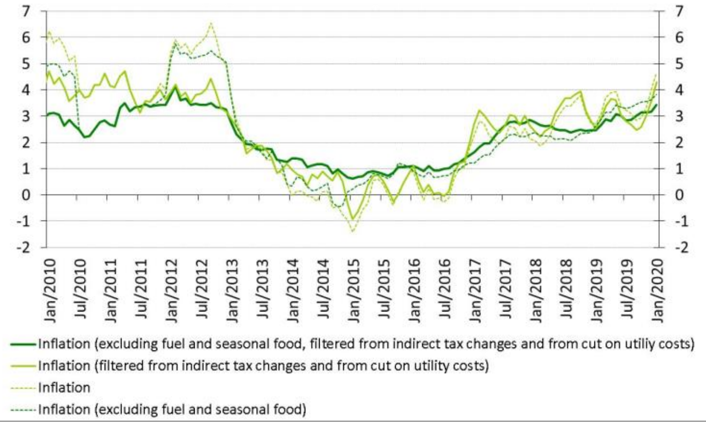
2. The inflation of core services (the most demand and labour cost sensitive items) jumped to 6.3% YoY in January, as its annualized 3M/3M change also reached 6.5%. Nevertheless, we should note that this inflation group was the most affected by the abovementioned methodological issue (the VAT effect estimation). We expect the 3M/3M change to return to the 5-5.5% range in a few months' time.

- In January the following items delivered negative surprise for us: seasonal foods, processed foods, goods (both non-durable and durable), and alcohol.

1. Seasonal food prices gained new momentum in January. Vegetable and fruit prices grew particularly rapidly.
2. In the case of goods, the exchange rate pass-through to consumer prices was stronger than expected.
3. In the case of alcoholic beverages, the re-pricing at the beginning of the year was stronger than we had expected. We think this will have permanent effect of this year's inflation.
4. Processed foods: it was mainly processed meat, dairy products, and cereals that contributed to the higher-than-expected inflation. We should highlight that, the 'non-processed pair' of these inflation items (raw meat, milk, flour) also gained momentum in January. It seems the African Swine Fever has much stronger and more lasting effect on Hungarian meat prices than we had thought in autumn 2019, as we could see still high MoM growth figure in the pork prices in January.

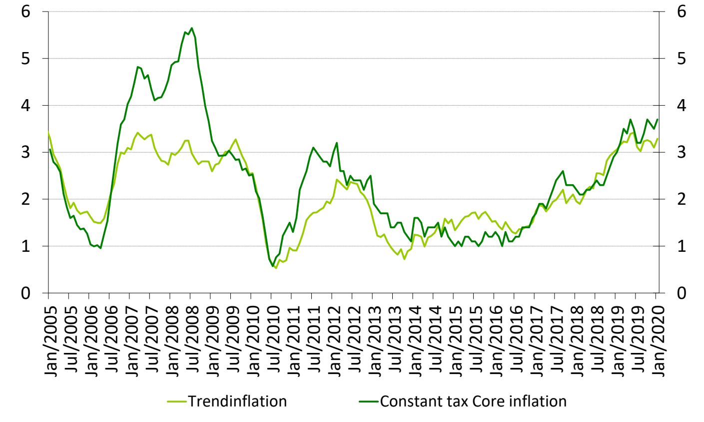
- Looking ahead, base effects will drive down inflation, which can return to the MNB 3%+/-1% band by March. Barring new inflationary shocks in the coming months, inflation may draw near 3%.
- As a consequence of the stronger-than-expected pass-through of the exchange rate, we raised somewhat our trend inflation expectation. Furthermore, we revised our view on the African Swine Fever's effect (both its size and the trajectory) and seasonal food prices. These revisions led us to raise our inflation forecast from 2.8% to 3.4% for 2020. We expect that inflation may hit the peak in January, and then it can decline below the upper edge of the MNB's target band by March.
- The current coronavirus epidemic has inflation risks to both sides. On the one hand, it can reduce airfare and gasoline prices and, to a lesser extent, accommodation prices as well. Furthermore, this shock raises further the recession risks in Europe, which can bring down further the inflation in the eurozone. On the other hand, if disruptions in the production chains become long-lasting, it can result in supply shortages which can raise consumer prices. This supply-side shock may challenge central banks because these types of shocks raise inflation and recession risks at the same time.
- From monetary policy point of view, the pressure is on the rise: the weak currency and high inflation are getting more public and policy attention. The MNB has already started the adjustment, as the central bank is narrowing liquidity through the FX swaps, which is pushing the BUBOR higher: it has risen from 16 bps to 42 bps over the past few weeks. As currently the BUBOR is the actual base rate, the MNB can change monetary conditions by affecting the banking sector's liquidity. After the January inflation data were published, Deputy Governor Márton Nagy also emphasized in an interview: the MNB will use all of its available policy tools to bring back inflation into its target range.

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



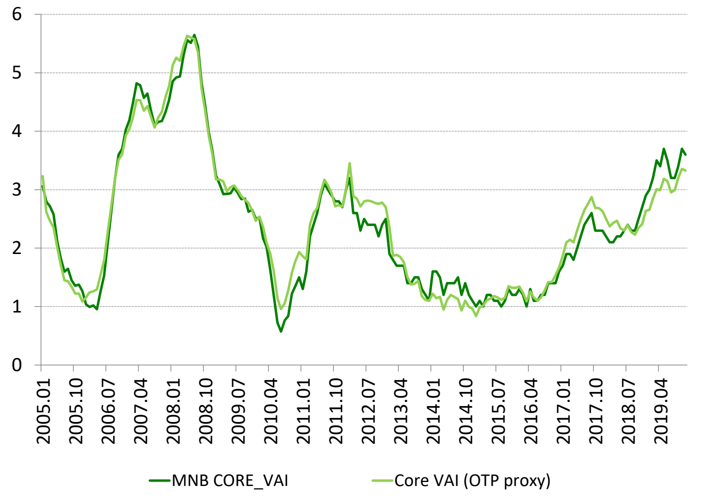
Sources: KSH, OTP Research

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



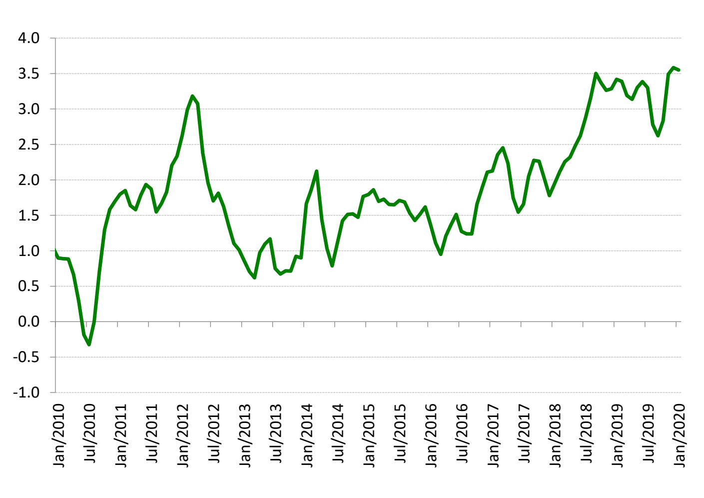
Sources: KSH, OTP Research
**: Filtered from indirect tax and visit fee changes, and one-off items and w/o second-hand car prices*

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



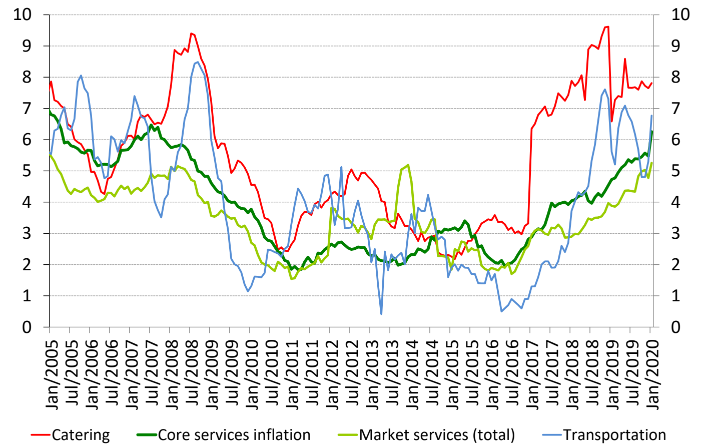
Sources: KSH, OTP Research
**: we cannot reproduce exactly the tax-filtered core inflation because (1) the MNB has its own methodology for the calculation of tax changes, which is not known to us. (2) In addition, core inflation cannot be calculated exactly from the KSH's 160 CPI items. So, our calculation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

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



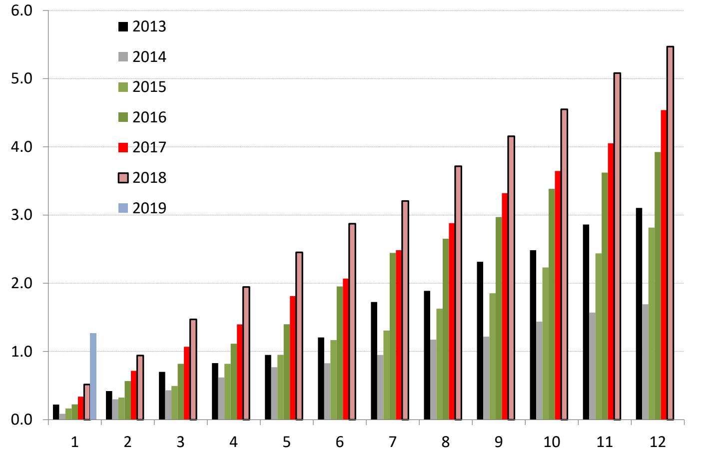
Sources: KSH, OTP Research
**: Filtered from indirect tax (including the financial transaction tax) and visit fee changes*

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



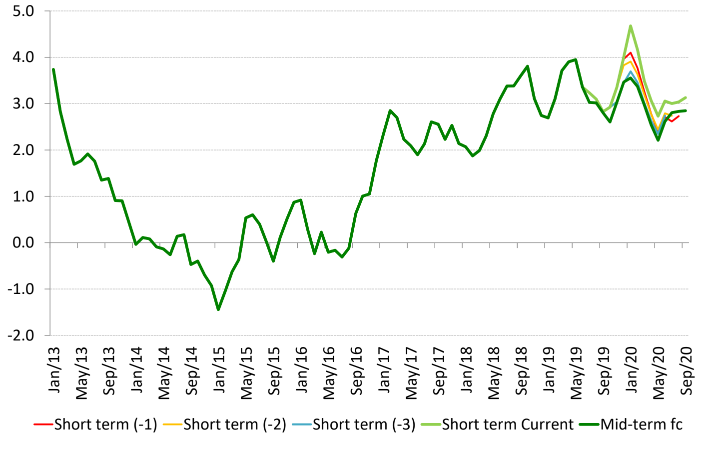
Sources: KSH, OTP Research
**: Filtered from indirect tax (including the financial transaction tax) and visit fee changes*

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



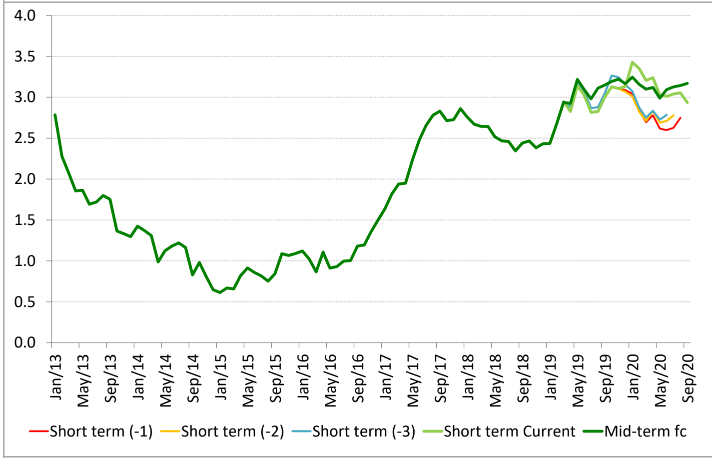
Sources: KSH, OTP Research
**: Aggregation of the most demand-sensitive and labour-intensive services, filtered from indirect tax and visit fee changes*

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



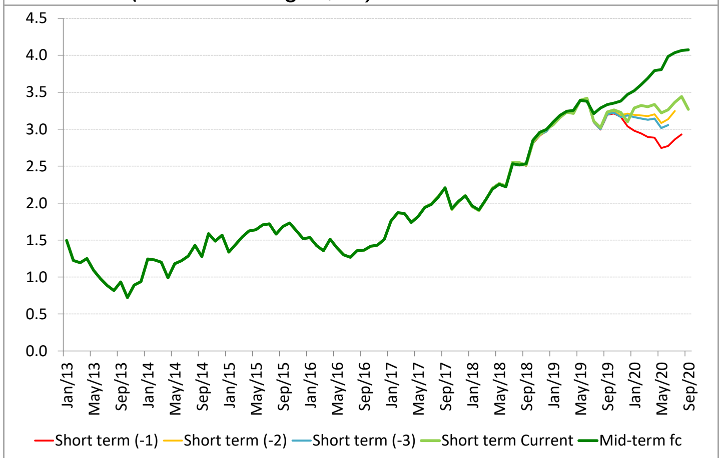
Sources: KSH, OTP Research

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



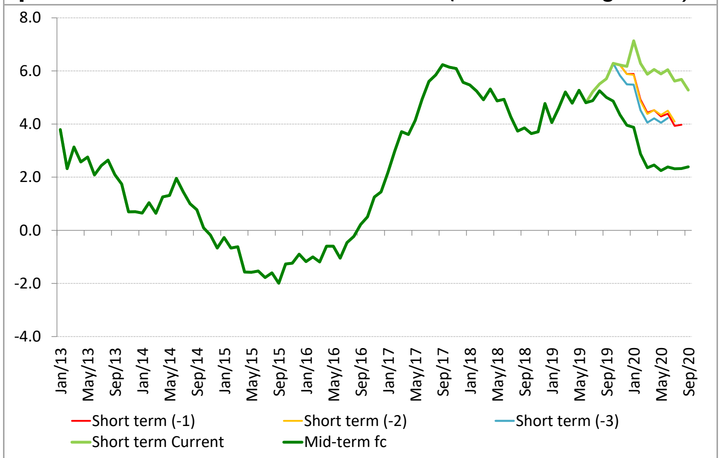
Sources: KSH, OTP Research

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



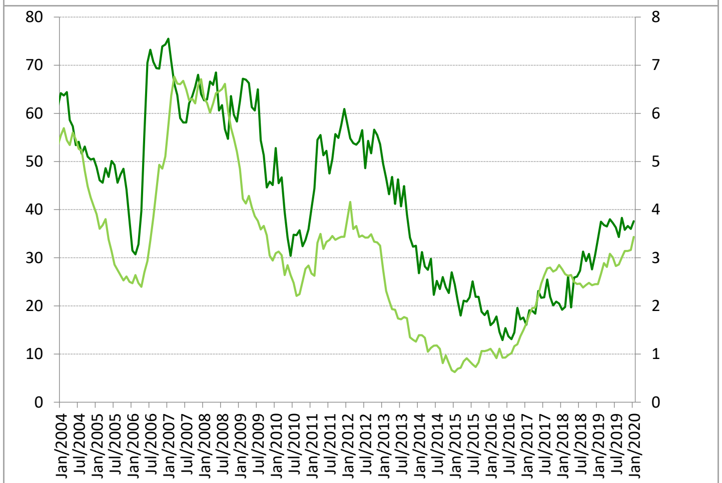
Sources: KSH, OTP Research

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



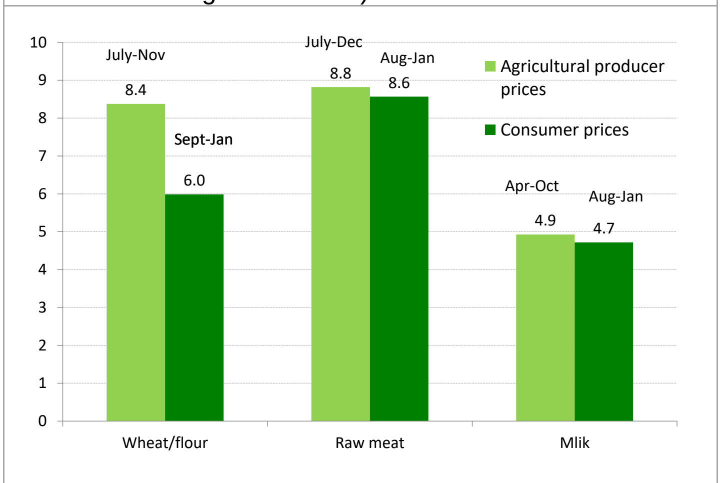
Sources: KSH, OTP Research

Chart 11: Consumer price expectations and filtered cpi (balance point and annual changes, %)



Sources: KSH, OTP Research

Chart 12: Pass-through of agricultural prices to consumer prices in some cases (price level increase in % between the given months)



Sources: KSH, OTP Research

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