REPORT ON INFLATION

13 November 2023

The way to the 5-6% inflation range is paved, but there are still question marks what will happen thereafter

- Hungary's headline inflation decelerated to 9.9% YoY in October, from 12.2% in September, and returned to single-digit territory after almost one and a half years. The data was below our forecast (10.2%) and market expectations (10.3-10.4%, depending on the poll). In its latest Inflation Report (published in late September), the MNB had forecast 10.5% inflation for October, so the incoming data was below the national bank's trajectory as well. The fall in the YoY figure was caused by the moderate recent repricing and base effects, while the surprise compared to our forecast was rather broad-based.

- The improvement of underlying indicators continued in October. The closely watched constant tax core inflation decreased from 13.1% to 10.9% YoY. The MNB's sticky price inflation gauge sank to 10.9%, from 12.2% YoY. Our trend inflation indicators also slowed from 13.5% to 12.5% YoY, but here we can find some "on the other hand" factors. Our trend inflation indicator's annualized 3M/3M change nearly stagnated (September: 7.2%, October: 7.0%), while its annualized MoM change has started to rise. While this measure was 8.5% in the average of May and June, and it had declined to 6.3% in the average of July and August, it has accelerated to 7.3% in the average of September and October. In general, we could observe dualities in the latest data. While the inflation of market services and non-durable goods was lower than we had expected, this was basically a consequence of a single product group (non-durable goods: coffee & tea; services: catering)

- The disinflation drivers were very strong in the first three quarters of the year. As a consequence, the annualized MoM change of our filtered inflation indicator (inflation without fuel and seasonal foods and filtered from government measures) decelerated significantly from 25.5% (average of October and November 2022), and it was 3.3% in the average of the past six months. Before this period, declining energy prices, the re-appreciation of the HUF, the sharp weakening of domestic demand due to falling real wages, fiscal and monetary tightening all suppressed inflationary pressures. We must emphasize that falling food prices contributed greatly to this sharp inflation deceleration as the price level of the non-seasonal foods has been declining since April.

- Nevertheless, the abovementioned disinflationary factors may weaken in the future. This became at first visible in the case of the most exchange-rate-sensitive durable goods, as the EUR/HUF has been on upward trend (marking HUF depreciation) since early June. And as we mentioned in the second paragraph, for now it seems that the deceleration of the MoM trend inflation has also halted (at least temporarily). Real wage growth has turned positive (on MoM basis), retail trade has also stabilized since May, and we expect consumption growth to restart in the last quarter of the year. These developments can make the further decline of the MoM rates more difficult, especially from the current moderate level. Since the government's most important economic policy goal for next year is to restart growth, this may further complicate the continuation of disinflation. We also think that the rumoured 15% minimum wage hike may pose upside risk to wage growth, and thereby to inflation.

- The published data showed that in most cases the food prices that were under price caps still have not converged with their "shadow" prices. Our shadow price calculation is based on the

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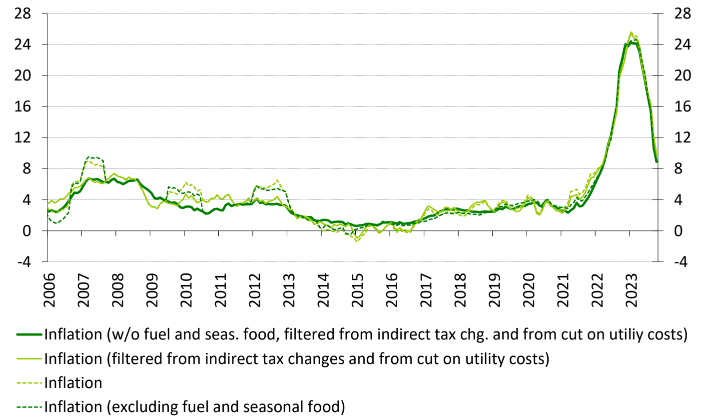
price development of close substitute products (e.g. ESL and UHT milk). We think prices will gradually meet on the forecast horizon, but it may take longer than we had previously thought.

- We reduced both our 2023 forecast from 17.9% to 17.7%, and our 2024 inflation forecast from 4.6% to 4.5%. We expect the rate of inflation to decline to around 6.5% by the end of this year. By December 2024, inflation can be around 4%.

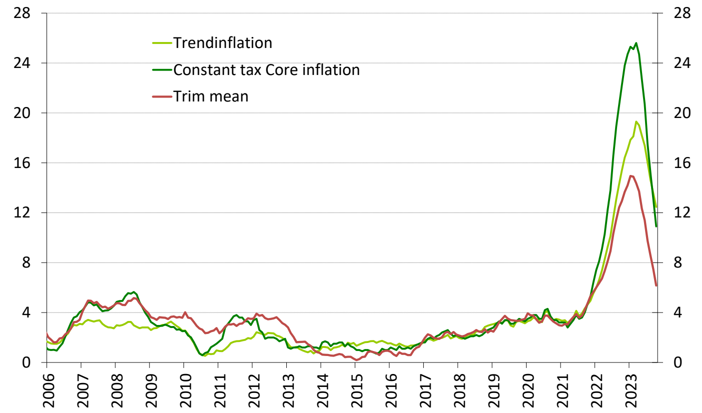
- We think the MNB will continue the easing cycle with 75bps steps. As a consequence, the base rate may decline to 10.75% by the end of this year, and to 8.5% by the end of Q1 2024. Although the current inflation data and the appreciating HUF can support bigger steps, we think the MNB wants to stay on the safe side.

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



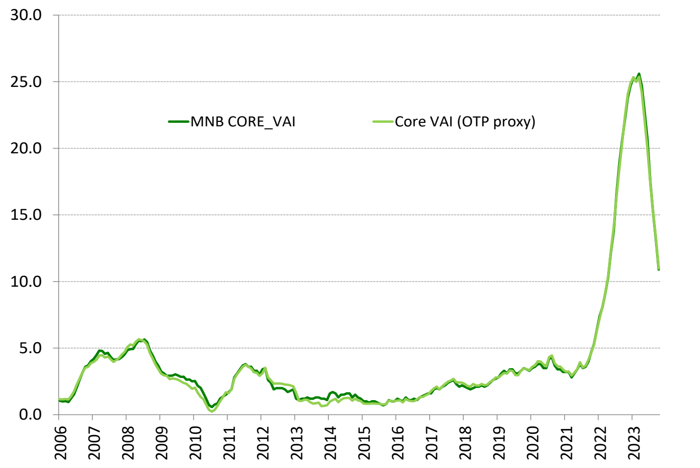
Sources: KSH, OTP Research
**: our filtered inflation indicator corrected with the price-cap effects on certain food items*

Chart 2: Core, trend* and trimmed mean 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, %)

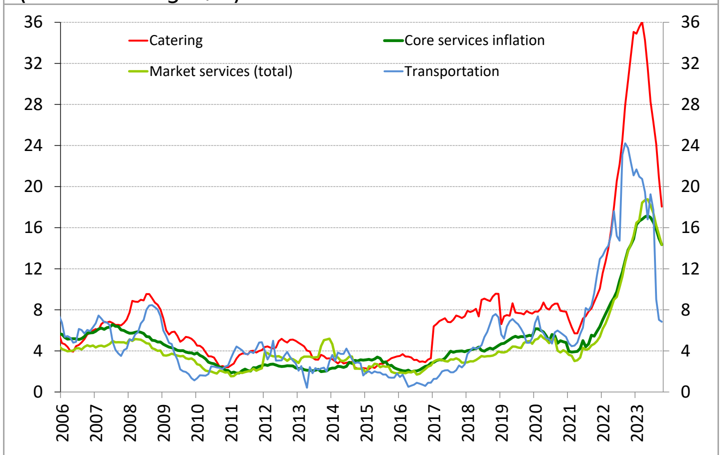


Sources: KSH, OTP Research
** We cannot reproduce exactly the tax-filtered core inflation because (1) the MNB has its own methodology for the calculation of tax changes, which is not known to us. (2) In addition, core inflation cannot be calculated exactly from the KSH's 160 CPI items. So, our calculation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

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

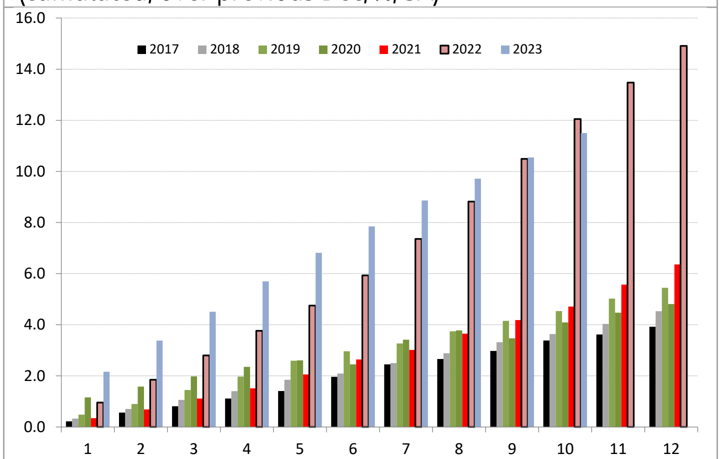
Sources: KSH, OTP Research
** Filtered from indirect tax (including the financial transaction tax) and visit fee changes*

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



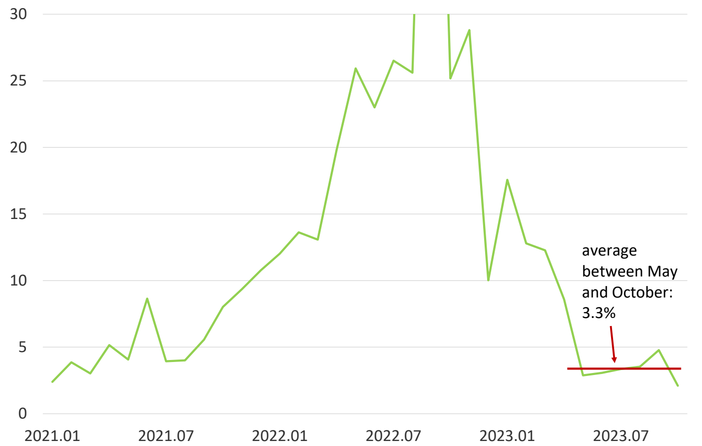
Sources: KSH, OTP Research
** Filtered from indirect tax (including the financial transaction tax) and visit fee changes*

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



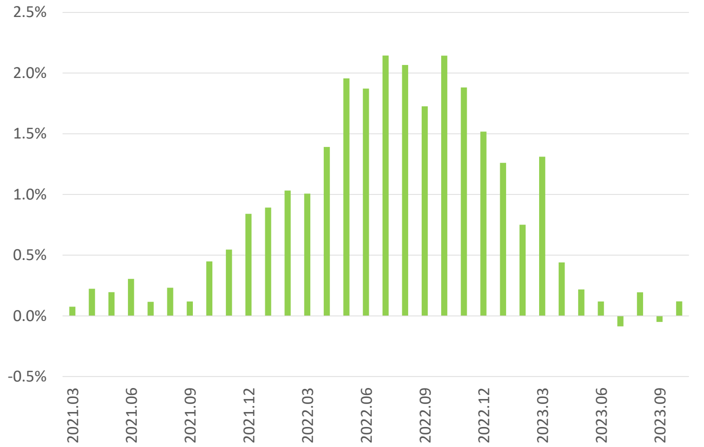
Sources: KSH, OTP Research
** Aggregation of the most demand-sensitive and labour-intensive services, filtered from indirect tax and visit fee changes*

Chart 7: Filtered inflation
(annualized MoM change, %)



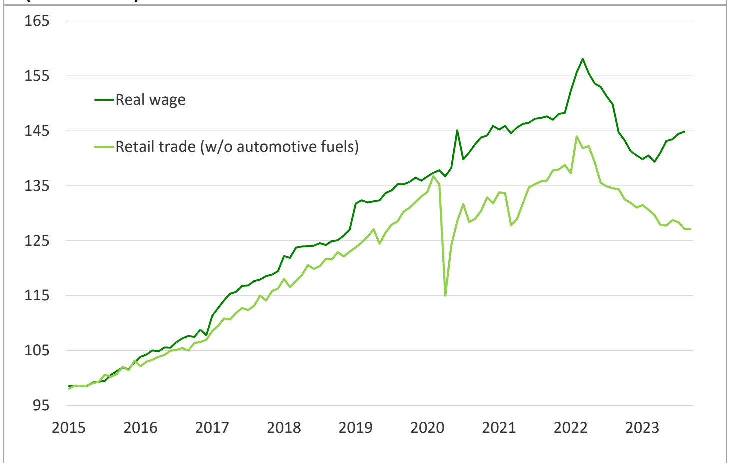
Sources: KSH, OTP Research

Chart 8: Extra re-pricing* in the constant tax core inflation
(%point)



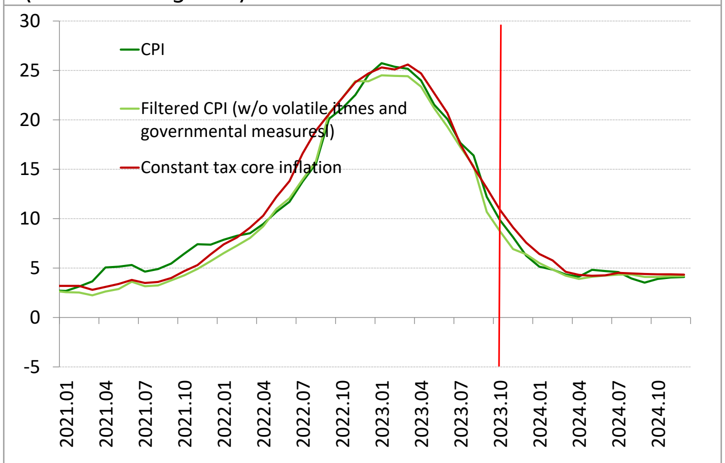
Sources: KSH, OTP Research
: %point difference of MoM changes compared to the average MoM rate of given month in the 2017-2019 period; from February 2022, data are adjusted by the effect of the price caps on vegetable oils, sugar, and milk

Chart 9: Retail trade and real wage growth*
(2015=100)



Sources: KSH, OTP Research
: full and part-time workers, but w/o public workers

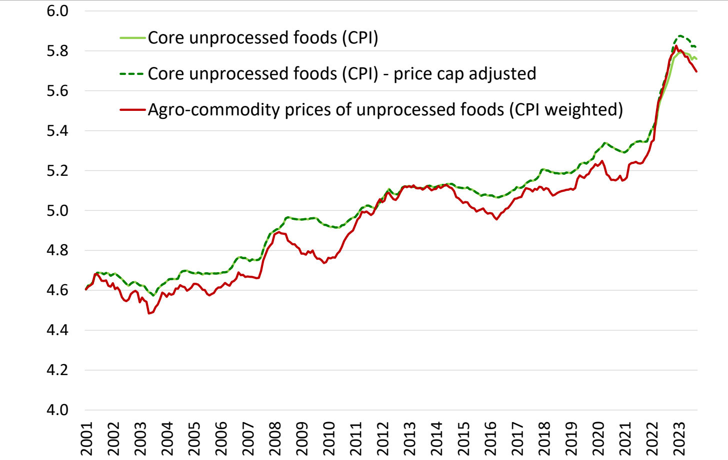
Chart 10: Forecasts of main inflation indicators
(annual changes, %)



Sources: KSH, OTP Research

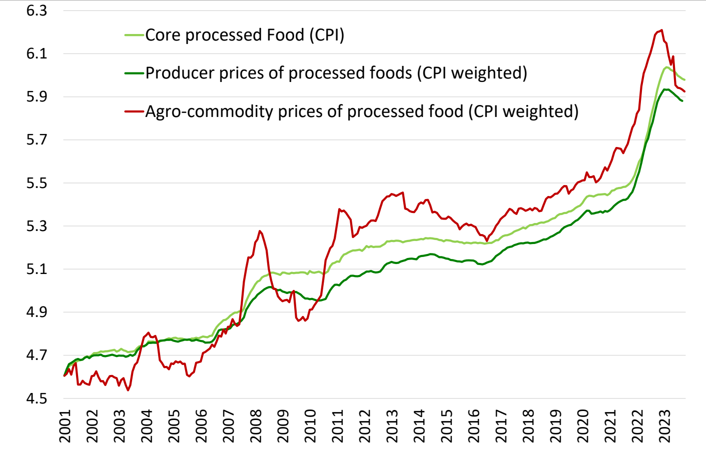
Inflation Pressure Monitor

Unprocessed Food supply chain monitor
(2001.01=100 on logarithmic scale)



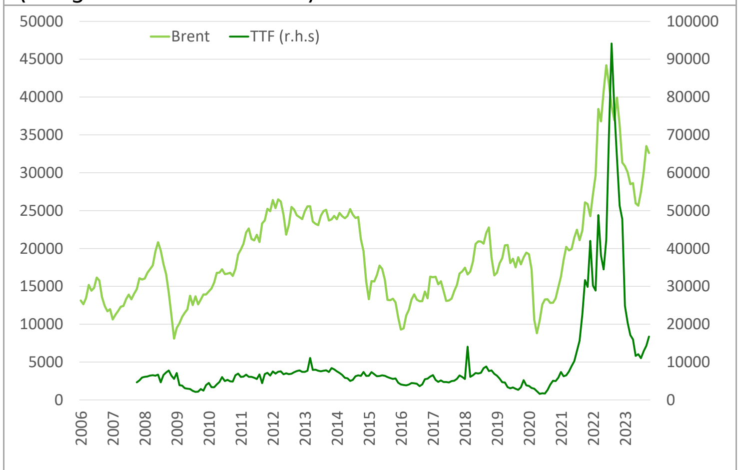
Sources: KSH, OTP Research

Processed Food supply chain monitor
(2001.01=100 on logarithmic scale)



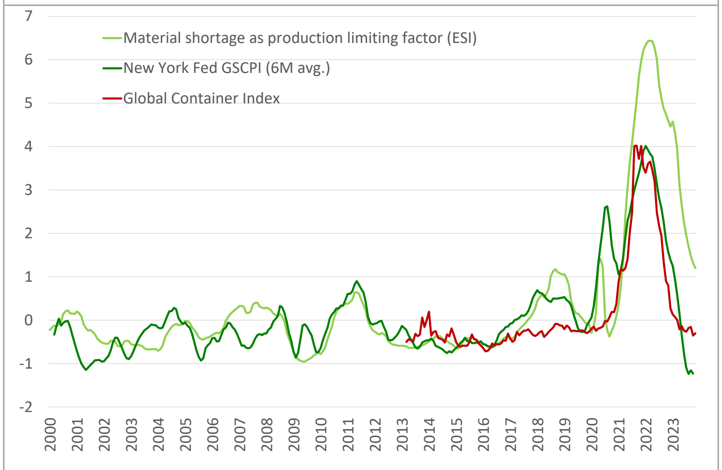
Sources: KSH, OTP Research

Energy prices
(TTF gas and Brent in HUF)



Sources: Datastream, MNB, OTP Research

Supply chain problems*



Sources: New York Fed, European Commission, Bloomberg, OTP Research
**: normalized values (adjusted by the mean and divided by the standard deviation)*

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