Hungarian inflation drops on large base effects

The overwhelming majority of the deceleration in the headline figure comes from base effects, while the monthly repricing remains quite strong. Thus, we stick to our call for only a 25bp cut at the October rate-setting meeting

West End City Center shopping centre in Budapest, Hungary

12.2%

Headline inflation (YoY)

ING estimate 12.4% / Previous 16.4%

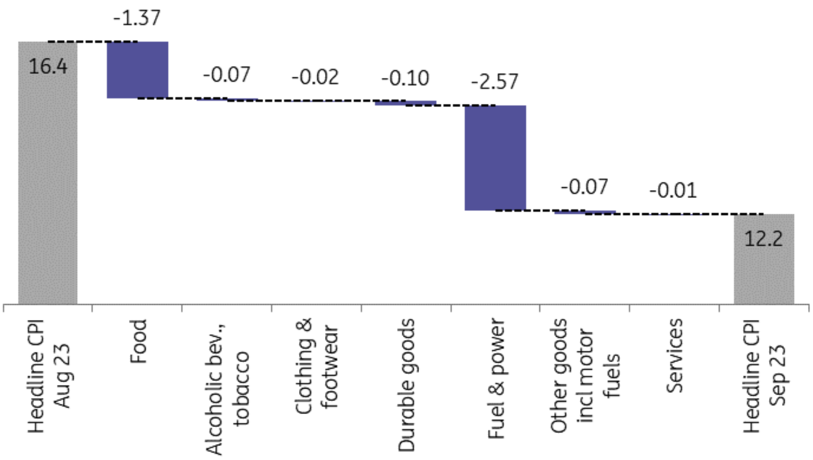
Better than expected

More than 85% of the deceleration is due to base effects

As expected, the disinflationary process shifted into a higher gear in September, as headline inflation rose 12.2% year-on-year (YoY). The large 4.2ppt drop compared to the previous month was mainly driven by base effects, out of which the contribution of the household energy component stands out the most. The government's changes to the Utility Cost Protection Scheme last August, which affected prices in September 2022, have now shaved 2.6ppt off this year's headline figure due to the negative base effect.

Although the deceleration in the yearly-based figure looks like good news, the 0.4% month-on-month (MoM) rate of increase remains above historical levels. In addition, it is important to note that in order to achieve price stability in a sustainable manner, the rate of monthly price increases should be at 0.25%. This means that September's monthly dynamics are still above the rate that would ensure price stability over the long run.

Main drivers of the change in headline CPI (%)

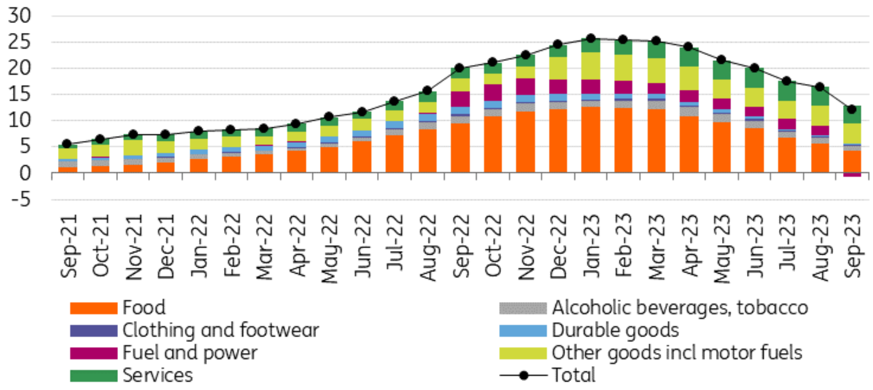


Source: HCSO, ING

The details

- We can identify two major factors behind the deceleration in the headline reading. First of all, there is the household energy component, where despite the 1% monthly inflation, last year's base was enormous (59.2% MoM in September 2022) due to the administrative price change.
- The second factor was food inflation, which has continued to decelerate for nine months now, although prices remain 15.2% higher than in September last year. On a monthly basis, prices fell by 0.2%. This was the second largest contributor to disinflation after the large base effects.
- We also need to mention an item, which is a key factor behind the strong monthly repricing. This is fuel. The strengthening of the dollar resulted in a much higher USD/HUF level, while oil prices rallied $10 during the same period. As a result, fuel prices jumped by 3.3% MoM, accounting for more than half of the monthly price pressure.
- Despite the ongoing global disinflationary trend, prices of durable goods increased in September, and prices of clothing and footwear components also rose. In general, on a monthly basis, price pressures increased everywhere, except for food.
- Services inflation is now up to 13.6% YoY, as a result of a 0.2% monthly repricing. Seasonal factors in holiday packages helped inflation to retreat, while these were counterbalanced by strong increases in household, healthcare and public transport services, as well as rising gambling prices.

The composition of headline inflation (ppt)



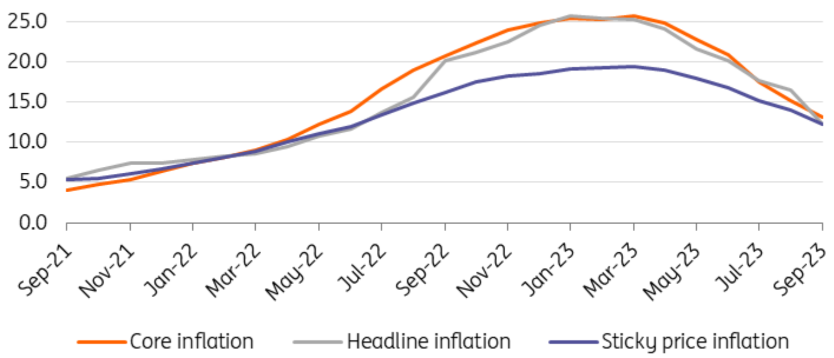
Source: HCSO, ING

Monthly core inflation turns negative, a reason for optimism

As the downward pressure on inflation in September came mainly from energy and partially from unprocessed food items, disinflation came in weaker in the core basket. The core reading fell 2.1ppt to 13.1% YoY. This is not just a base effect phenomenon, as the month-on-month print was showing 0.2% deflation. This is the first time since December 2020 that monthly core inflation moved into negative territory.

Moreover, over the last three months, core inflation has averaged 0.1% MoM, which is lower than would be needed to reach price stability over the monetary policy horizon. Thus while headline inflation looks like a red flag, core inflation provides some hope. We are not saying the job is done, but the underlying inflation performance is encouraging, while non-core items are responsible for the recent generally strong repricing.

Headline and underlying inflation measures (% YoY)



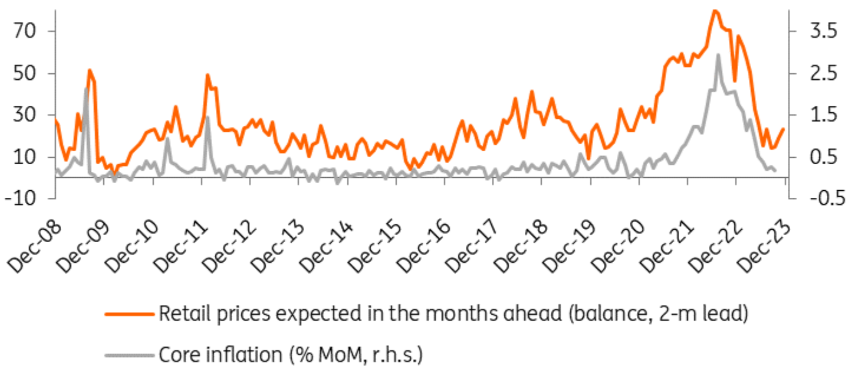
Source: HCSO, NBH, ING

The risks of reflation, and a warning against complacency

In the short term, therefore, inflationary pressures remain in some segments of the economy. At the same time, the continued weak repricing of services (and in general in core items) in September, is certainly a cause for some optimism. Although there are significant upside risks, in particular from fuel, we don't see a threat which would jeopardise the continuation of disinflation in the short term. The December and January year-on-year inflation prints will be greatly helped by the base effect, but thereafter, given the recent monthly headline repricing and the risks, it will be quite difficult to bring inflation down from 7% to 3%. So, from a monetary policy perspective, the hard part is just about to start, as the central bank's task is to achieve the 3% inflation target, not just single-digit inflation.

As for the average inflation rate in 2023, we continue to expect an annual rate of close to 18%. Next year, however, we expect average inflation to be slightly above 5%, with upside risks. Fuel price increases could continue, and the second-round effects of tax changes already enacted and yet to come, as well as the expected dynamic real wage growth, all pose inflationary risks. In addition, the Israeli-Palestinian war carries the risk of increased risk aversion, affecting not only energy prices but also the forint, thus adding further pro-inflationary risks. Another factor that suggests we can't relax is that retail price expectations have been somewhat stronger recently, a warning sign of a possible reacceleration in core inflation.

The correlation between retail price expectations and core inflation



Source: Eurostat, HCSO, ING

Risk sentiment is a key driver for monetary policy

In our view, monetary policy is likely to be significantly influenced by inflation developments in September. This statement shouldn't surprise anyone who follows the central bank's communication. The National Bank of Hungary is now in an agile, data-driven phase of easing, taking into account incoming inflation data and risks to the outlook.

However, the pace of 100bp rate cuts cannot be continued as this would push the ex-post real interest rate back into negative territory after the rate cut. Such an outcome would run counter to the NBH's commitment that, as disinflation accelerates, the domestic real interest rate will turn positive in September and continue to rise gradually thereafter.

We continue to expect a 25bp cut in October, as incoming inflation data supports a more aggressive move, financial market volatility has increased, and caution is particularly warranted given rising risk aversion. If there is a de-escalation in the Israeli-Palestinian war in the coming weeks and market sentiment and energy prices improve significantly, there could be room for up to 50bp of easing.

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