

Hungary Watch: Positive inflation surprise

December's inflation reading was substantially below expectations (24.5% vs. 25.8% consensus). This is largely explained by deceleration of food price inflation and a methodology-induced decline of household energy prices. Market reaction was positive, but we remain concerned about existing high level underlying inflationary pressures. We kept our 2023 average inflation forecast unchanged at 17.9%.

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December's inflation reading was 24.5% yoy – significantly below expectations (market consensus was 25.8% yoy). Overall, average inflation came at 14.5% in 2022. On the monthly level, inflation increased by 1.9% in December. Core inflation was 24.8% yoy and 1.6% mom. While the December data displays certainly another large jump (inflation was 22.5% in November) and inflation development is a major concern in the Hungarian economy, eventually, the much lower than expected December inflation reading is positive news. It is important to find out what factors might explain such a surprise.

By looking at the details, we find that there are **two items** where the official data came significantly below our own inflation expectations and **responsible for the deviation between data and forecast: food prices and household energy prices**. In case of food prices, the **monthly increase was 2.1%** compared to 3% we expected. The data is **the lowest since March**, and the average monthly increase was 3.6% in the April-November period. The government extended the food price stop in the autumn to two additional staples (egg, potato). This measure has an extremely minor impact on the December food price inflation (-0.15% impact), so this factor alone does not explain the slow down of food price inflation. A more probable explanation for the slow-down might be the pre-holiday price campaign of major food-store chains, or, alternatively, the slow down might signal that food price inflation peak is already behind us and going forward a food price inflation may decelerate – but this hypothesis needs to be supported by next months' data. **Processed food price increase remained at 3% mom – this does not signal any positive turnaround yet.**

As for the **household energy prices, the 6% decrease over November is a major surprise** as headline prices remained unchanged – still the decline is explained by the statistical measurement practice. The statistical office measures the actual energy bills of households. The official explanation is that as households are using less energy (according to latest data natural gas consumption of Hungary decreased by 24%, electricity consumption decreased by 7% in the beginning of the heating season) there are several households whose energy consumption decreased and by now they fall into the below average consumption category (where there is still a hefty state subsidy). The problem with this explanation is that **the calculation is not fully transparent** (and it raises additional methodological questions), while at the same time it has a major impact on the inflation data (without this impact, headline inflation would have been around 25%

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yoy). **This brings additional noise in the future inflation data and makes inflation forecast less reliable.**

The other big ticket in the December inflation data was the major fuel price increase (due to the abolishment of the fuel price cap a 24% mom increase was registered) which itself explains the actual jump of the headline figure over November.

With no deceleration yet in market service prices and processed food prices, **underlying inflationary pressures are largely unchanged.**

We have revised slightly our 2023 inflation forecast: we are calculating with a more protracted deceleration due to elevated underlying price pressures, but at the same time we have brought down the expected inflation peak for January (from 26% to 24.9%) due to significantly lower December inflation reading versus our expectation. Overall, we **expect unchanged average inflation for 2023 (17.9%)** but somewhat higher year-end inflation reading than previously (8.5% versus 7.4% previously). We emphasize that besides the usual uncertainties surrounding our inflation forecast, there is a new one constituted by statistical methodology issues described above.

The HUF strengthened against the EUR by 0.5% and trades close to 395 now, upon the positive inflation surprise. Eventually, theoretically this is helpful for an early exit from the extra-high interest rate environment (i.e. we expect the first cut of the 18% reference rate for Q1).

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