MINISTRY
FOR NATIONAL ECONOMY

Positive inflation trends persist in the Hungarian economy

The National Bank of Hungary (MNB) published its latest inflation report on 22 June 2017, in which the bank predict that inflation – underpinned by favourable domestic and international effects – is set to rise slightly and hit the rate considered to be sustainable and in line with the MNB's target in the first half of 2019.

Hungary's inflation had traditionally been high up to the beginning of the 2010s, when the effects of Government measures implemented at that time and a couple of positive global economic trends (such as declining raw materials prices) had kicked in and fundamentally changed the situation. In recent years, low inflation rates have come to pose new challenges. According to the latest report of the MNB published on 22 June 2017, inflation has begun to rise slowly again. However, contrary to prior forecasts, the inflation rate is projected to reach the 3 percent level considered by the MNB to be adequate and sustainable only in the first half of 2019.

Inflation in itself causes no troubles for any economy, provided it is predictable, not too high and it impacts the entire economy in a proportionate manner. Current data show that inflation in Hungary is nearing the 2-3 percent band, which experts usually regard as the hallmark of soundly growing economies.

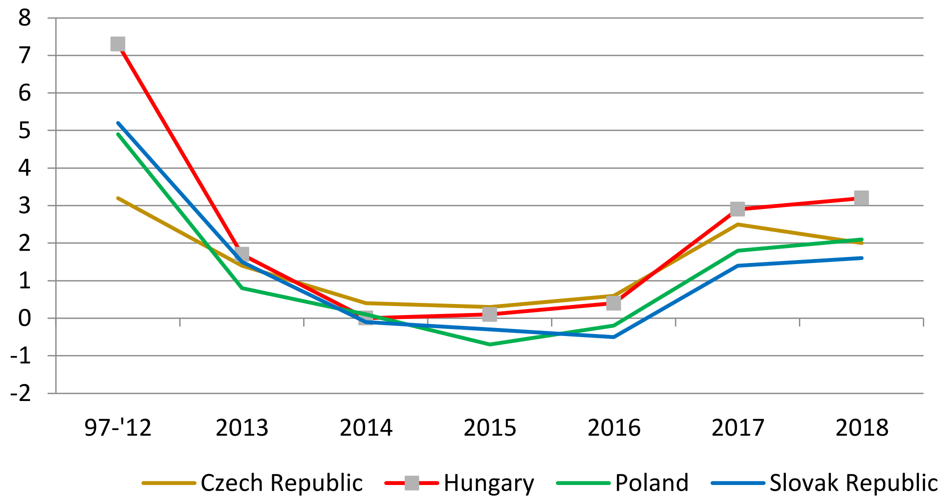
In case of a country like Hungary with a small and open economy, international trends typically influence changes in inflation. In this regard, we could witness favourable developments in recent years and in the initial months of 2017. Within the European Union, Hungary's number one trade partner, the rate of inflation has been low: it fell from a peak of around 3 percent in 2011 to 0 percent by 2015, only to edge up again to 0.3 percent last year. In coming years, inflation is predicted to pick up within the EU, but it is not expected to exceed 1.6 percent, and it is seen to decline again next year to around 1.3 percent. Compared to the December prognosis the European Commission revised downward its inflation estimate in the European Economic Forecast Spring 2017, published on 11 May 2017, to below 2 percent for the region, the long-term target set by the European Central Bank.

One of the main determinants of inflation rates is the price of raw materials, including that of crude oil, regarding which no substantial price hike is expected in the near future. The fact that core inflation, the indicator adjusted for calendar effects which even more aptly shows real economic processes, is currently around 0.8 percent also signals that inflation is unlikely to soar within the EU in the foreseeable future.

Taking a look at countries around Hungary, the Visegrad Four, reveals similar processes. The gaps in the inflation rates of the region's countries have narrowed in recent years, a trend best demonstrated by core inflation data. On the other hand, the same phenomenon can also be observed with regard to consumer price indices published by the EU; however, the prognoses for 2017-2018 already show growing divergence again. The comparison of Hungary with other Visegrad Four members reveals that while Hungary's inflation had exceeded the region's average up to 2011, it was in line with the average in the period 2014-2016.

Fig. 1 below shows the harmonized index of consumer prices in the V4.

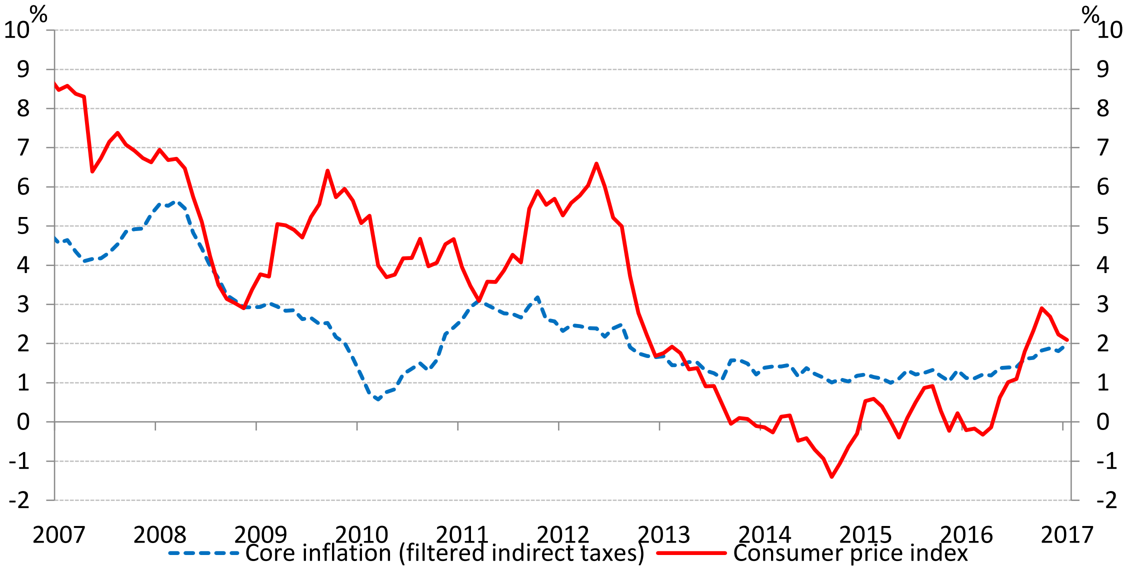
Fig. 1: Harmonised index of consumer prices in the V4 countries



Source: EC European Economic Forecast Spring, 2017

In the analysis of the domestic components of Hungary's inflation several factors must be highlighted. In the first four months of the year, inflation rose less than it had been formerly predicted by the MNB, due partly to the fact that the price rises of seasonal products, which tend to change with high amplitude, were smaller than anticipated. Besides agricultural products, the subdued price dynamics of tobacco products also contributed to a smaller-than-expected inflation rate. On the other hand, core inflation – despite low overall inflation – was around 2 percent in May, and it is forecast to continue to rise moderately in the remainder of the year. (Fig. 2 shows Hungary's core inflation and consumer price index)

Fig. 2: Inflation trends in Hungary



Source: www.mnb.hu

Positive domestic employment trends observed recently together with wage hikes introduced at the beginning of the year -- due to growing labour demand and subsequent wage competition –, along with the rise of the minimum wage have led to substantial wage increases in the private sector, and these have become a major driver of accelerating economic growth. Besides favourable wage trends, Hungary's economic growth this year, which is predicted to exceed the EU average, is also fuelled by a pick-up in investment activity.

Wage growth typically translates into consumption growth, which in turn lifts inflation. This trend is being moderated by the relatively high savings rate of households as well as payroll tax and corporate income tax reductions at enterprises.

The number of jobs is not expected to keep rising at the former pace, but domestic consumption is predicted to continue to grow, and households also expect inflation to remain benign. As a whole, household consumption is seen to rise in the (near) future, which trend is to slightly lift inflation. (See MNB Inflation Report, June 2017, p.7.)

With regard to factors outside core inflation, such as oil prices, neither the MNB nor independent analysts expect substantial price rises; there may only be a temporary (and short-term) boost to inflation due to the basis effect which is seen to peter out at the end of the year. The potential rise of raw foods – depending on the performance of the agricultural sector – may, however, add to inflation growth. (Table 1 shows the decomposition of inflation forecast). Yet another favourable factor determining Hungary's inflation is low international inflation rates analysed formerly. Thanks to these, imported inflation is set to remain subdued in coming months, and thus it is unlikely to prompt a major change in domestic inflation estimates.

Table 1: Decomposition of inflation forecast

Components	**2017**	**2018**	**2019**
Core inflation	2.3	2.8	2.9
Additional inflation items			
Raw agricultural products	0.7	5.4	7.8
Vehicle fuels & market energy prices	6.9	3,1	3.3
Regulated energy prices	0.5	1.6	1.5
Inflation forecast	**2.4**	**2.8**	**3.0**

Source: MNB Inflation Report, June 2017, p. 12.

As the combined result of both external and internal factors, Hungary's inflation is prognosticated to rise moderately, in a predictable manner in the near future, to 2.0-2.5 percent, and hit 3 percent in 2019. The inflation forecasts of international bodies and organizations (EU, IMF, OECD) are higher than that of the MNB, predicting 2.5-3.0 percent for 2017 and 3+ percent for 2018-2019 (MNB Inflation Report June 2017, p.20; IMF World Economic Outlook, April 2017, EU European Economic Forecast, Spring 2017). These studies point out the upward price pressure generated by rapidly growing domestic demand. Independent Hungarian analysts also expect inflation to rise moderately, reaching 2.4-2.5 percent for 2017.

Benign inflation contributes to stable, predictable economic growth, which can also be sustained through the maintenance of the MNB's loose monetary policy.