

National Bank of Hungary preview: The era of positive real rates is here

Given the recent improvement in inflation dynamics and market sentiment, we expect a 50bp cut in the policy rate in October. However, if the opportunity arises, the National Bank of Hungary could do even more



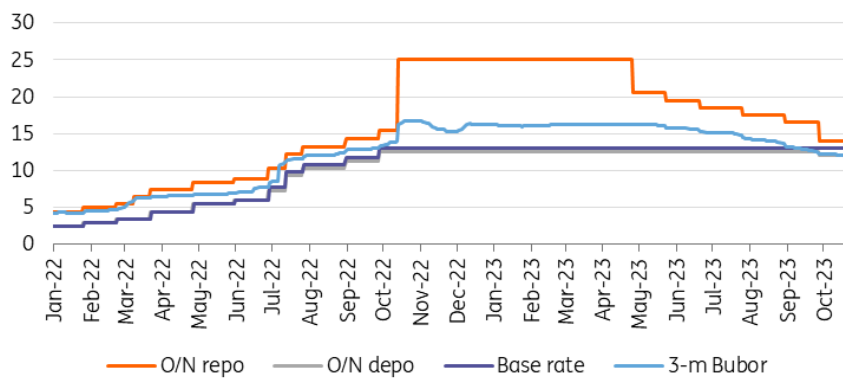
The National Bank of Hungary in Budapest

The monetary policy setup was simplified in September

At its September meeting, the National Bank of Hungary (NBH) carried out the final stage of monetary policy normalisation by cutting the effective interest rate by 100bp to 13%. In fact, after a five-day transition period, the quick deposit tender was phased out on 1 October, which left the base rate as the effective rate, standing at 13%.

This means that the monetary policy setup has been simplified, as the reserve account became the main monetary policy instrument. The reserve account is available to banks without an upper limit remunerated at the base rate. On top of these changes, the Monetary Council re-symmetrised the interest rate corridor with a range of +/- 100bp.

The main interest rates (%)



Source: NBH, ING

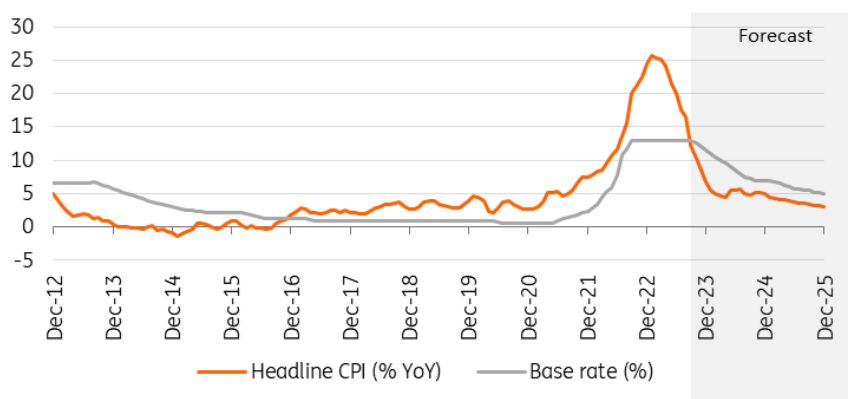
As for other instruments, the NBH will continue to offer the one-day FX swap tender, the long-term deposit facility, and the central bank discount bill to market participants. The rate of the FX swap tender is guided by the depo rate, while the rates of the latter two are tied to the base rate.

Inflation dynamics in the spotlight

The central bank made clear that it is not on autopilot, and will continue to take a step-by-step, agile and cautious approach. The forward guidance indicates three factors which shape the NBH's reaction function: the assessment of incoming macroeconomic data, the outlook for inflation, and the developments in the risk environment.

In this regard, we believe that inflation dynamics have come to the fore and will continue to have the greatest influence on the central bank's decisions. The NBH has continuously pressed the importance of a positive real interest rate environment to achieve price stability in a sustainable manner. In our view, positive real rates will be a key metric to monitor, because this will shape the monetary policy outlook for the coming months.

ING's inflation and base rate forecasts for Hungary



Source: HCSO, NBH, ING

Fifty shades of agility

As the central bank's reaction function looks relatively complex based on its forward guidance, this keeps practically every option open from a pause to a continued 100bp rate cut. At least in theory. This is what we can call agility, a sexier word for data-driven. However, looking at the latest inflation reading from September, headline inflation sank to 12.2% year-on-year (YoY) against the backdrop of large base effects. This means that we can take a pause off the table at the October meeting because this would be an overly cautious move after such a significant drop in the reading.

Even though we argued for a 25bp cut in [our latest inflation note](#), based on recent market developments (strengthening of the forint) and incoming data (e.g. lowering fuel prices in Hungary) we have changed our call. We highlighted a 50bp cut as an upside risk to our previous call, but now we see this as the most likely option.

We think that the central bank will opt for a 50bp cut

Our assessment of inflation dynamics has improved in the short run, showing a lower year-end inflation rate than previously. This comes from the 0.2% monthly deflation in the core reading, which caught us off-guard. On top of this, the latest balance of payment report (published on 16 October) can be seen as a welcome sign, as the current account balance ended August in a surplus of EUR 205mn. The outlook for the current account is therefore promising, as we expect it to end the year in a roughly balanced state.

As far as market stability is concerned, we would like to highlight the resilience of the forint despite the continued strengthening of the dollar. In addition, the Hungarian currency is behaving surprisingly well in the wake of the uptrend in global rates at the long end. As far as the CEE region is concerned, the Polish election results will improve market sentiment regionally (or at least won't add a new set of concerns), lending another helping hand to the National Bank of Hungary.

For the time being, the strong rally in oil prices seems to have come to a halt (though at a relatively high level), which would otherwise have increased the risks of a slowdown in disinflation. Nevertheless, we acknowledge that geopolitical risks in the Middle East are likely to remain with us, which could keep oil prices elevated as long as there is no clear de-escalation.

Taking into account the latest developments (lowered inflation profile, encouraging current account data and Polish election results), we are updating our call and now see the NBH cutting the base rate by 50bp at the October meeting. Regarding the remainder of the year, we see the central bank sticking to this size, reflecting its cautiousness and graduality. As a result, we expect the base rate to end the year at 11.50%, 50bp lower than our previous call.

When opportunity meets agility: our alternative scenario

Given the agility of monetary policy, we now present our alternative scenario for the October meeting. Government officials held several online meetings with the European Commission and finally travelled to Brussels on 19 October. In parallel, Hungary sent its official answers to the nine questions posed by the European Commission. Now that the response is officially in (at least according to Stefan de Keersmaecker, the EC's coordinating spokesman), the clock has started ticking again, with only three weeks left for the European Commission to decide. Our latest understanding is that there are a growing number of

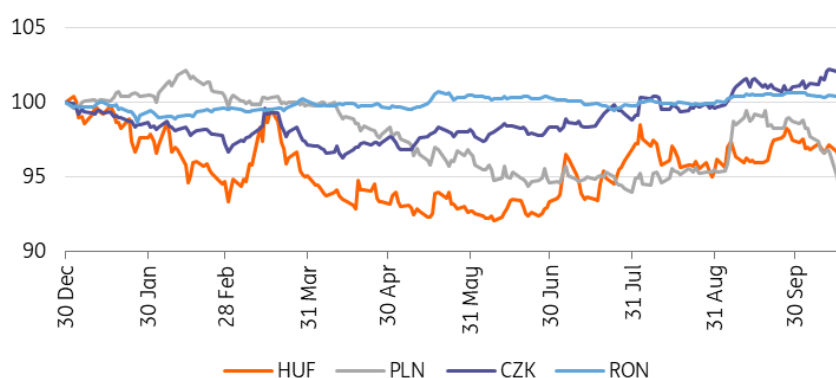
stakeholders in this debate on the EC side who would like to see this debate concluded as soon as possible. Should Hungary get the green light in the coming days and have access to a large part of the Cohesion Fund, this could boost market sentiment towards Hungary. As a result, the National Bank of Hungary will have the opportunity to lower the key interest rate at a faster pace. This pace would depend entirely on the HUF reaction, and while we wouldn't rule out a further 100bp cut in the event of an extreme HUF reaction, we see a 75bp cut as more likely, especially with the pledge regarding the ex-post positive real interest rate. In short, if opportunity meets agility, we see the policy rate at 12.25% after the October decision in our alternative scenario and a continued 75bp pace of easing thereafter.

Our market views

The Hungarian forint returned to stronger levels during October, which is clearly good news for NBH, but it is still very far from the strongest levels this year, below 370 EUR/HUF. Financial markets have adjusted bets slightly towards smaller cuts in the past two weeks, which has clearly supported FX. However, the geopolitical situation, the renewed risk of higher commodity prices, to which the HUF is traditionally strongly linked within the CEE region, and a stronger US dollar leave the HUF fragile in our view. Moreover, after the rally in recent days, positioning seems to be tilted to the long side, which would further amplify a possible sell-off in the event of a larger global shock.

However, putting risks aside, we see the HUF stronger and this is mainly due to the smaller size of the NBH rate cut compared to market expectations. We thus retain a slightly positive bias in the short term with risks in mind. Longer term, however, we expect the HUF to be stronger with 375 EUR/HUF at year-end and 365 EUR/HUF in the middle of next year, supported by the region's only positive real rate and carry, which is one of the highest in the EM space.

CEE currencies vs EUR (end 2022 = 100%)

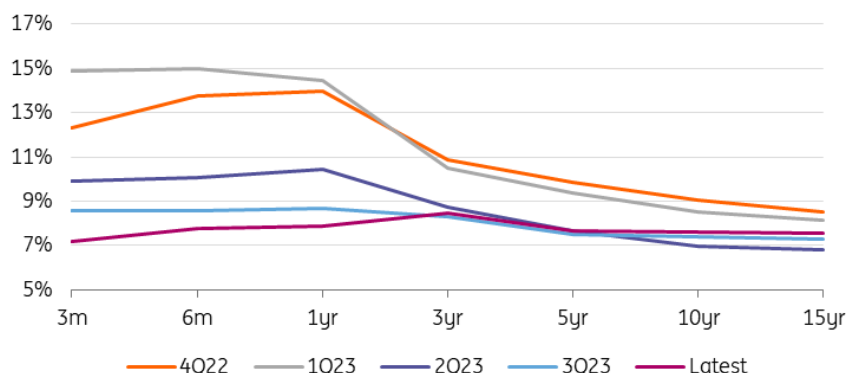


Source: NBH, ING

In the rates space, financial markets have slightly reduced their bets on dovish rate cuts and at the moment it appears that a 75bp rate cut for next week's meeting and 50bp moves for the next meetings are priced in. The market is still rather on the dovish side against our expectations.

Therefore, we expect next week's meeting to be another impetus for a repricing upwards, especially at the short end of the IRS curve. However, the space in this direction has narrowed significantly over the past two weeks. Ahead of the September meeting, we changed our short-term curve bias to flattening. The 2s10s flattened slightly only in the last few days and it seems that higher core rates will not allow for any more. On the other hand, it seems to us that it is early yet given market expectations for further steepening of the curve, so we are rather neutral here for now.

Hungarian yield curve



Source: GDMA, ING

In Hungarian government bonds (HGBs), on the supply side for this year, the situation seems to be fully under control with roughly 80% of this year's issue covered. However, the picture for next year is cloudy. Our first indications show roughly the same HGBs supply for next year, but here we can still see a lot of change in both directions. Within the CEE picture, HGB valuations seem fair to us at the moment. In the short term, however, the entire region is currently higher in yields due to record-high core rates at the long end of the curve. 10y HGB levels around 7.50% should therefore attract some demand and push the yield back down closer to 7%, especially if we see some progress on the EU money front, which should be the central theme.

Authors

Peter Virovacz

Senior Economist, Hungary

peter.virovacz@ing.com

Dávid Szónyi

Research Trainee

david.szonyi@ing.com

Frantisek Taborsky

EMEA FX & FI Strategist

frantisek.taborsky@ing.com

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