

## CE4 FX: How tolerant are central banks to FX weakness?

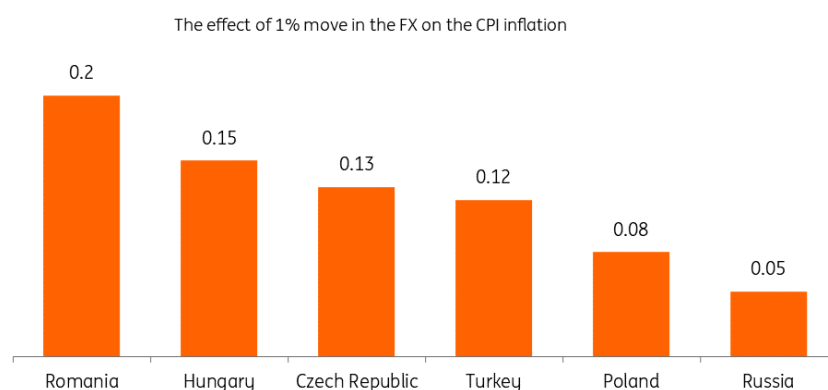
Being in the immediate geographical vicinity of what seems to be the largest military conflict since World War II, the CE4 countries are naturally prone to contagion risks. So far, the high FX-passthrough into inflation (among others) makes the National Bank of Romania stand out in terms of the firmness of its FX stance, but who else could follow Romania?



The National Bank of Romania stands out in terms of the firmness of its FX stance

Being in the immediate geographical vicinity of what already seems to be the largest military conflict since World War II, the CE4 countries (the Czech Republic, Hungary, Poland, and Romania) are naturally prone to contagion risks. The initial market reaction was a predictable flight to safety, but its extent seems to not have been that impactful for the CE4 currencies. Yet all CE4 central banks are currently in a tightening mood and will have more incentive than usual to prevent weaker currencies from triggering an unwelcome easing of monetary conditions. So far, the high FX-passthrough into inflation (among others) makes the National Bank of Romania stand out in terms of the firmness of its FX stance but who else could follow Romania?

## FX pass-throughs show an eclectic picture in CEE



Source: ING, central banks estimates

### Forint: FX interventions seem a remote option

After getting close to the all-time high 372 level, tension on EUR/HUF eased somewhat and it is now hovering around 368 levels. The National Bank of Hungary did not make any comment regarding how it will handle market developments regarding the Ukrainian situation. But based on moves in EUR/HUF and PLN/HUF we doubt that the Hungarian central bank made any interventions to prevent HUF from further weakening.

What makes it less likely that an intervention has happened and will happen in the future is the presence of the one-week deposit facility. The National Bank of Hungary (NBH) has separated the rates of the base rate and the one-week deposit facility since November with the base rate now sitting at 3.40% and the one-week deposit rate at 4.60%. The central bank's intention with the separation was to be able to respond quickly and flexibly by changing the one-week deposit rate if warranted by an increase in short-term risks in financial and commodity markets.

Against this backdrop, we think that the main tool for the National Bank of Hungary to react to a new round of (abrupt) sell-off of HUF and HUF assets in money markets is reverting to a weekly based decision-making process on the one-week deposit facility, hiking it to stabilise forint or at least mute the depreciation.

What makes the FX intervention less likely as well – besides the fact that the central bank has already got a proper tool in place – is the stance of FX reserves. Hungary's international reserves sit at €35.5bn as of the end of January, out of which €4.9bn is in gold while FX reserves sum up to €27.9bn (around 18% of GDP). This is roughly in line with a merchandise import coverage ratio of three months, matching international standards. However, in the recent volatile environment, where commodity prices have moved up significantly and with chances of this continuing remaining high, any major FX intervention using FX reserves would jeopardise this ratio and thus increase Hungary's external vulnerability in an already uncertain global environment. In this regard, we doubt that the NBH has any line in the sand at which it will want to intervene to buy HUF using its FX reserves.

When it comes to a pro-inflationary impact, Hungary is having one of the strongest FX pass-through (second to Romania), but with cost pressures on all sides (wages, transportation, energy and other commodities), we don't think that FX pass-through is something which poses the single major risk amidst these all-around pressures. So while we admit that weakening HUF is adding to

inflationary pressures, in this situation we don't believe that the possible anti-inflationary benefit of keeping EUR/HUF below its record high 372 level will outweigh the costs carried by the risk of the depleting FX reserves.

## CZK: Weakness will have CNB leaning more hawkish

EUR/CZK turned lower from above 25.00 after the Czech National Bank (CNB) said it was ready to react at any time to 'excessive exchange rate fluctuations'. There is no indication that the CNB did intervene yesterday, and the comments look completely consistent with a central bank's role to preserve financial market stability.

But the speculation over the CNB selling EUR/CZK comes amidst the backdrop of some calls for the CNB to use sales from its large FX reserves – now €157bn – to support its tightening cycle. So far the CNB has said it would sell the returns from its FX reserves – perhaps €3-5bn – but has avoided going any further than that.

We doubt the CNB has any line in the sand at which it will want to intervene to sell EUR/CZK, but yesterday it notably mentioned that the net effect of the Ukraine crisis is inflationary. Trade links with Russia were low (at just 1-2% of exports and imports) and the bigger impact would come through higher energy prices (CNB had assumed Brent in the mid-70s this year) and a weaker than expected CZK (CNB projections had EUR/CZK trading around 24.50 now).

This raises speculation that the CNB will again have to lift its inflation forecast at its next meeting on 31 March. Currently, it sees CPI peaking at just under 10% over the next few months. A higher inflation profile is building expectations that the CNB tightening cycle does not stop at 4.75%. Indeed, the forward rate agreement (FRA) markets are now toying with a policy rate closer to 5.00%.

Expect the CZK to remain volatile and dependent on events to the East. But any signs of calm coming back could quickly see EUR/CZK returning to the 24.20/30 area ahead of a fresh round of CNB hawkishness.

## Romania: Leu holding the fort

The Romanian leu (RON) has remained flat against the euro in the wake of the crisis. The increased turnover around 4.95 suggests official offers have been protecting the leu. This is consistent with our view for a stable FX rate throughout most of 2022.

Should the pressure ramp-up locally and the other less managed floating regional currencies (the zloty and the forint in particular) take a more severe hit (say over 6.0-7.0% depreciation) we believe that the RON could be left sliding higher, but only to a very limited extent (i.e. closely around the 5.00 level). However, we stress that this is a rather extreme scenario and that in the base case the NBR will most likely try to keep the FX rate stable through a combination of FX interventions and spiking carry rates if needed.

The liquidity picture at the end of January 2022 showed that the system was less than RON2bn on surplus, which could have easily vanished throughout February. Once the liquidity position changes from surplus to shortage, the Lombard rate (3.50% at the moment) will become the relevant one. The FX swap implied yields will most likely trade very much decoupled from the deposit market during times of stress as is currently the case. For instance, the one-month FX

swap implied yield spiked yesterday through the 6.00% level while the longer-term – say one-year tenor – settled above 5.00%.

Even more than the FX flows going through the market these days, the central bank will likely be very vigilant to notice any retail behaviour changes (i.e. a rush to exchange lei into euros). This could be the strongest incentive to either tolerate a small depreciation or hold the fort and keep the FX stable at any cost.

## Poland: NBP to stay tolerant as weakness might be temporary

The conflict between Russia and Ukraine is likely to remain a significant drag on the Polish zloty (PLN) in the weeks to come, despite limited trade links (Russia and Ukraine account for ~5% of Polish exports). Poland is now next to a full combat zone with fights very close to its borders. As such we expect the EUR/PLN to hover around or above 4.60 for a few weeks.

Current EUR/PLN levels are inconvenient for NBP (National Bank of Poland), which aimed to use PLN gains as a quick tool to combat inflation. We don't expect substantial FX interventions from the central bank though. Based on past Monetary Policy Council (MPC) comments, the central bank should be unwilling to directly counter Central and Eastern Europe sentiment-based market moves. This is especially the case since the zloty remains relatively stable against, for example, the forint since the beginning of the war, suggesting no risk premium specifically for the PLN. We have already seen a significant NBP tolerance for PLN volatility in late 2021. 4.8/€ is the level where interventions likelihood would rise more significantly.

That said, the NBP / MoF have another tool at their disposal. The central bank was converting EU proceeds into the zloty outside the FX market via printing PLN equivalent to the EU funds bought. Even prior to the Russia attack on Ukraine, NBP chairman Adam Glapiński considered limiting the scale of such operations to shore up the zloty. Based on our rough estimates, these operations weakened the zloty by some 3% and it is now even more likely that EU funds will be converted on the market (Poland received €12bn funds net in 2021).

Also, we expect the central bank to continue its rate hikes (we no longer see upside risk to our 4.5% forecast and we see a risk that terminal rate would be reached later). We roughly estimate that the fallout of the conflict can lower Poland's GDP by over 1pp, mainly via loss in trade and lower confidence affecting consumption and investments. This should not be enough to deter the central bank from continuing its tightening cycle which we expect to conclude at 4.5%. Those factors alone should contribute to a substantial PLN recovery as soon as market tensions fade. Also, the geopolitical risk makes a compromise on rule of law and unfreezing Recovery funds more likely. That should also support PLN.

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