Hungary: Central bank drops a bombshell with tightening talk

This week has barely started but the National Bank of Hungary has already provided the story of the week. Deputy Governor Virág talked about preparations for a benchmark rate hike, a move we haven't seen since late 2011

The National Bank of Hungary

In short, we expect the NBH to tighten this quarter (in June) but in contrast to our prior forecast, we don't look for frontloaded tightening but rather gradual hikes. We pencil in four 15bp hikes in 1-week depo this year, with the first hike coming at the June NBH meeting. The timing of the remaining three 15bp hikes (beyond June) is uncertain and data dependent. We expect the benchmark rate to increase by 75bp this year.

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The shift in NBH bias towards a proactive one points to near-term HUF gains and outperformance. We expect EUR/HUF to test 350 this quarter. But forint gains won't be permanent and we expect

EUR/HUF to end the year closer to 355-360 as a lot is already priced in. The current account should be in modest deficit and there is a big question mark as to whether the NBH is willing to tolerate an overly strong HUF. Nonetheless, the era of meaningful domestically driven HUF sell-offs (as seen last year and in 2019) seems to be over. This is good news for HUF.

What happened?

Deputy Governor Barnabás Virág provided the story of the week, talking about a data-driven tightening cycle. Such a move would have been hard to imagine over the past decade, but things are changing fast in the currently uncertain environment. The National Bank of Hungary has adopted hawkish rhetoric since inflation started to move upwards, but what we heard today is crystal clear. Virág said that the NBH must prepare for benchmark rate hikes to deal with sustained CPI risks. Since the March Inflation Report, upward inflation risks have risen, thus pushing the NBH into a policy turn. Virág was referring to a “cycle of hikes”, a “gradual phase out of the government bond purchasing programme”, “a policy turn in several steps”. It seems a permanent shift and a commitment to a sequence of changes.

Why now?

We see two main reasons and several other points which eventually triggered this clear signal of an upcoming shift.

1. **Inflation:** April headline inflation came in at 5.1% year-on-year, higher than markets expected. Although Virág said that April CPI was in line with central bank expectations, the underlying changes might influence the NBH thinking.
2. **Deficit:** The government presented the 2022 draft budget, which targets a 5.9% deficit-to-GDP ratio. The debt-to-GDP ratio is set to remain on a downward trajectory, although the steepness of this will be quite low. The Fiscal Council, which includes the head of the National Bank of Hungary, issued its report together with a note of caution, noting that the government, with such a high deficit figure, might push the Hungarian economy into overheating. It seems that the Ministry of Finance wasn’t overly concerned by this. On fiscal policy, the coronavirus crisis, has pushed the budget deficit beyond the 3%-of-GDP range, and out of a tightly managed budget situation. With huge transfer inflows expected from Brussels, the government is ready to provide all the needed local funds to support investment and economic activity before the April 2022 election.
3. Other points: Alongside spiking headline and core inflation, upside risks linked to fiscal policy have increased. But there are more. Agricultural and industrial producer prices are increasing at double-digit rates. Shipping rates have grown fast, and of building material prices have led to higher housing prices. Wage growth is much higher than expected at close to 10% YoY. All of these have contributed to increased inflation pressure since the March Inflation Report.

What is our view regarding monetary policy now?

Mr Virág made it clear that the NBH is preparing for a rate hike cycle. We believe that the NBH will eventually do this, and we expect a gradual cycle which will impact the whole interest rate corridor. As a starter for normalisation, we expect the NBH to raise the 1-week depo rate by at least 15bp and to move the base rate so as to match the newly set 1-week rate (the difference now is 15bp, with the depo rate higher). With a move affecting the whole corridor, the NBH would remove one of the most high-profile elements of an ultra-dovish monetary policy – negative interest rates – as the O/N depo rate would move back above the -0.05% level. In all, we look for a 60-75bp tightening in the 1-week depo rate, moving the 3-month Bubor to around 1.5%, a rate last seen in early 2015. We expect the NBH to make it clear, that the tightening cycle is data-dependent and that the pace and timing is not carved in stone. This, together with keeping the 1-week depo rate as a monetary policy tool, will give the NBH just enough flexibility in this currently volatile environment.

What could trigger a looser or a tighter monetary policy than now?

A more dominant and/or frontloaded tightening cycle than recent market expectations could be triggered via second round effects. If there is a stronger and more permanent price shock from the re-opening, or a sooner-than-expected labour shortage and wage push inflation, the NBH might be pushed into stepping up the pace of the cycle.

On the other hand, inflation is expected to be quite volatile in coming quarters, with this year's peak coming in 2Q. The third quarter will bring some relief – with inflation at close to 5% by year-end. With such volatility, the data-driven NBH might take its time between hikes in order to monitor the situation. The big unknown is the performance of the HUF. We expect the forint to act as a limit on the number/amplitude of hikes – the strengthening of the currency will help to reduce the upside risks in inflation. Hungary remains an extremely open economy and might want to preserve some edge in price competitiveness. Inflation higher than the Eurozone average and ongoing currency appreciation will hurt real Hungarian price competitiveness. Against this backdrop, we believe that the NBH will keep an eye on HUF appreciation and will see this as an important part of the decision-making process, using it as a trigger in a stop-and-go tightening cycle.

What does it mean for HUF? Near-term outperformance and the end to the era of selloffs

The clear shift in the NBH bias is bullish for HUF. The central bank is moving away from a reactive approach to being pro-active. This (a) largely reduces the probability of uncontrolled HUF sell-offs; (b) suggests near-term HUF strength and outperformance vs its CEE peers. The latter should be further facilitated by the positioning which we don't judge to be one way (as it is case for CZK, for example). We expect EUR/HUF to test and break the 350 level this quarter.

> *The clear shift in the NBH bias is bullish for HUF.*

While this is positive for EUR/HUF, we don't expect the cross to break below 350 on a persistent basis – it may do so, but only temporarily. First, a fair degree of tightening is already priced in (74bp of hikes for this year and 67bp for 2022) and, with the NBH likely to point to the data dependent tightening cycle, the four 15bp hikes in 1-week depo we now expect are not set in stone (particularly if we see an overly strong reaction in HUF). Second, we still expect Hungary to run a current account deficit (-0.6% of GDP) this year which should limit HUF upside potential. Third, there is a big question mark over whether the NBH is willing to tolerate an overly strong HUF (ie EUR/HUF at or below 340 this year). Although the importance of the export channel in the domestic economy may be a bit lower than in recent years given the expected rise in consumption and investment, we do not expect the NBH to preside over a strong forint. A high Hungarian CPI differential vs EZ this year (around 2.5%) means that HUF will strengthen in real terms and that some significant strength in nominal FX might not be welcomed.

Given the recent significant developments, we review our EUR/HUF forecast. We no longer expect frontloaded HUF weakness this quarter as the NBH moves from being reactive to cautiously proactive. We look for EUR/HUF to dip below 350 this quarter but still end the year modestly higher at or above 355 for the reasons stated above.

ING EUR/HUF forecasts

	1-month	3-month	6-month	12-month
New	350	352	357	362
Previous	370	363	368	373

Source: ING forecast

Importantly, the change in the NBH stance and the central bank being responsive to rising prices means that domestically-driven HUF sell offs (as seen last year and in 2019) are less likely. This also means lower scope for spikes in EUR/HUF volatility (as observed last year and in 2019).

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