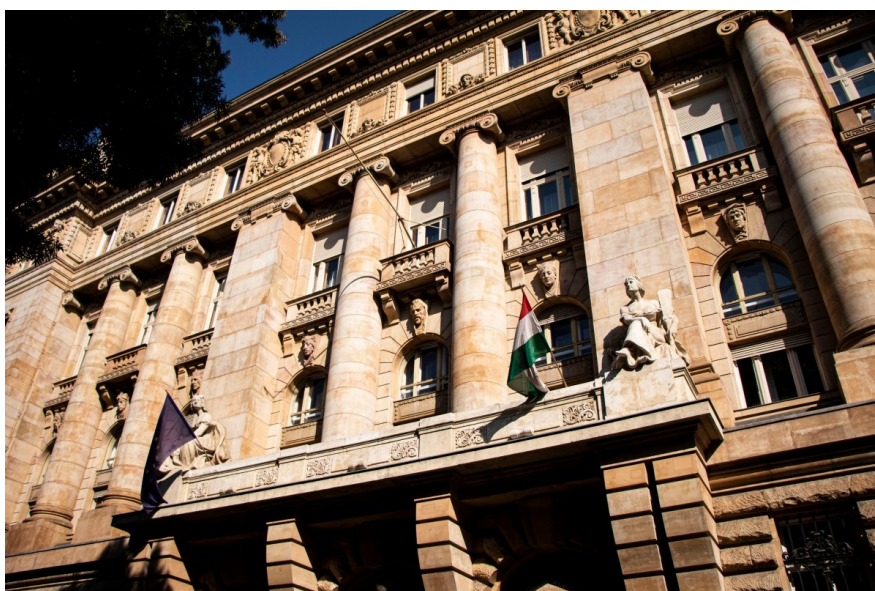


National Bank of Hungary Preview: It's time to think big

We expect the Hungarian central bank to continue its decisive tightening with another 100bp hike next week. Our updated inflation outlook leads us to expect additional measures to hike rates sooner rather than later, which could reduce the excess liquidity, thus improving the monetary transmission and supporting the forint



The Hungarian National Bank in Budapest

+100bp

ING's call

Change in the base rate

The rationale behind our call

The better-than-expected second-quarter GDP growth cemented our view that this year's performance will be sound. Our upgraded outlook sees a 5.2% GDP growth in 2022, which takes into account strong first and second quarters but weak third and fourth quarters. We see a technical recession coming, caused by an unfolding cost-of-living crisis. Therefore, we have

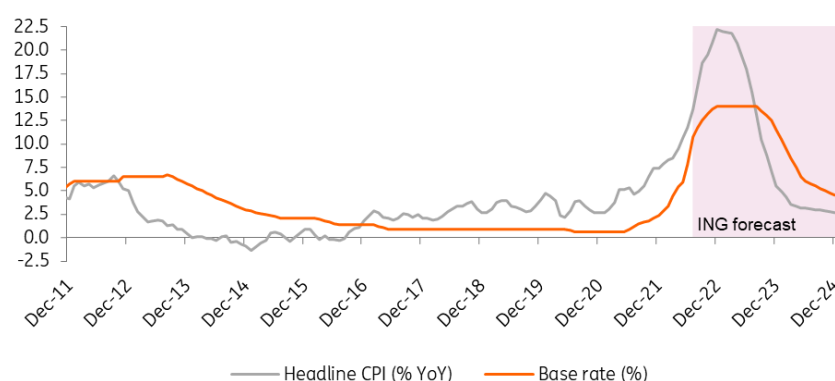
downgraded our 2023 outlook to 1.0-1.5% with further downside risks.

Our view about the cost-of-living crisis is based on our updated inflation forecast. The changes in the fuel price cap regulation will add roughly 1ppt to the August inflation, while the modified utility bill support scheme and significantly hiked public parking prices could boost the CPI by another 1-1.5ppt from September. Whether the peak comes in October or later depends on the fuel price cap, as it expires on 1 October if the government doesn't change the decree.

We expect a gradual phase-out of the fuel price cap, so the peak could come in December at 22% year-on-year. In all, the regulatory changes, the upside surprise in July inflation and the rising commodity prices lead us to call a 14% headline inflation in 2022, followed by a 15.3% average CPI in 2023. As for now, we expect price changes to drop to the range of 3-4% only in the first half of 2024.

At first sight, this screams for more tightening. But in our view, the terminal rate could be more of a function of the behaviour of the forint rather than the CPI peak. Moreover, despite the already double-digit interest rate environment, the National Bank of Hungary (NBH) couldn't shield the forint from the shocks of a confidence crisis. A crisis that lies in the Rule-of-Law debate and the negative impact of the energy crisis on the economic outlook and the external balance.

ING's inflation and base rate forecasts for Hungary



Source: HCSO, NBH, ING

We see further rate hikes and more

In this regard, we maintain our 14% terminal rate call, reached by the end of this year. The next step in this route comes on 30 August with yet another 100bp move to 11.75%. But in our assessment, interest rate hikes alone won't do the trick to give the forint enough support. What could help is an active quantitative tightening to reduce the excess liquidity in the system. However, due to the structure of the central bank's balance sheet, we don't see this as a viable option.

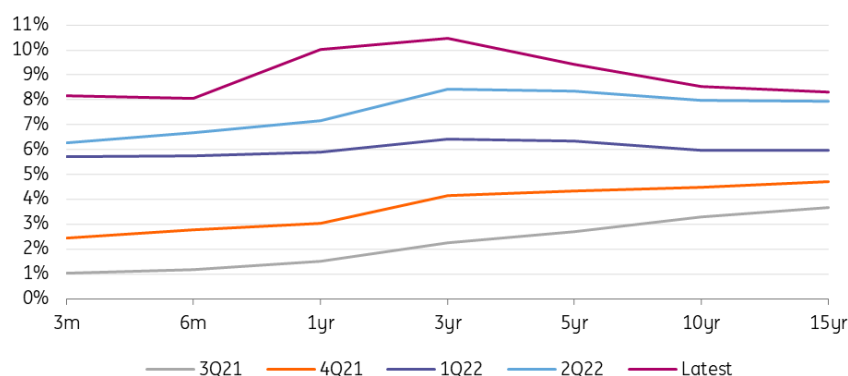
However, we could think about some options which could have the same impact, reducing the excess liquidity in a significant way. First, a stricter reserve requirement regulation could do the trick. The ratio is now only at 1%. Here the ECB's two-tier system, or more recently the Polish central bank, could provide an example, as the latter raised the RRR from 0.5% to 2.0% last October.

Or there is the reverse FX swaps example. First, it was an ad-hoc tool, then a quarter-end tool which finally became a regular one, improving the monetary transmission in short-dated rates. The same route is open in front of the central bank's short-term discount bill: making this instrument a permanent tool, tendering regularly and not just occasionally at the end of quarters. Of course, the NBH could come up with yet another creative, out-of-the-box solution to give an effective sidekick to its interest rate cycle. But one thing is for sure: the sooner the better.

What to expect in rates and FX markets

FX weakness in recent days has boosted market expectations and pushed the priced-in terminal rate just above 14%, in line with our forecast but taking a reasonable cutting trajectory for the end of next year. And given the current volatility and low liquidity, it is hard to look for opportunities in this environment. For this meeting, expect the markets to raise their short-term bets for the terminal rate even further under the prospect of headlines coming from the NBH, which is the only central bank open to rate hikes in the CEE region at the moment. This should lead to further flattening of the curve as seen in recent days. However, from a long-term perspective, the inversion of the HUF curve remains extreme, and we should see some normalisation later on, just as the fly trades in the last few days.

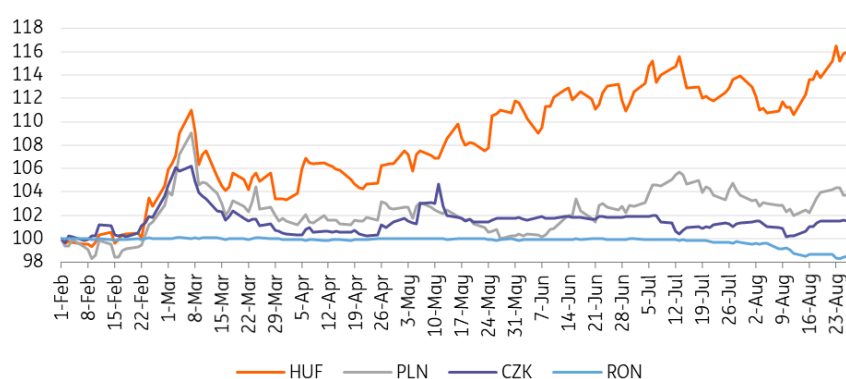
Hungarian yield curve



Source: Government Debt Management Agency, ING

On the bond side, we estimate AKK (the government debt management agency) has covered roughly 80% of the total financing needs, but supply should remain buoyant in the months ahead. On the other hand, given the recent sell-off across the CEE region, we see Hungarian government bonds (HGBs) as the most expensive within the region at the moment and are awaiting a correction in nominal and relative terms. So, we like HGB asset-swap (ASW) cheapeners.

CEE currencies vs EUR (1 Feb = 100%)



Source: NBH, ING

The forint has recently become heavily dependent on gas prices, adding to uncertainty about further moves. Moreover, markets are waiting for progress on the government's negotiations with the European Commission. We still believe that a positive scenario may offer the forint the biggest appreciation within the region, however a bumpy road is a more likely scenario at the moment. For the NBH meeting next week, we expect a short-term strengthening of the forint in response to the decision, however we believe this would only be a temporary boost and the real story of the forint is elsewhere, i.e. the gas and EU story.

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