



## KBC Flash

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### Hungary moves to free-floating FX to fight inflation

- The National Bank of Hungary (NBH) and the government decided to scrap the forint's trading band and adopt a free-float exchange rate regime in order to focus solely on meeting the medium-term inflation target of 3%
- The inflation outlook contains significant upside risks to the 2009 inflation target and the central bank may have to hike rates to counterbalance these risks, but the forint and bonds may perform well if this strategy becomes credible

The Hungarian government agreed with the central bank to abandon the fluctuation band of the forint on 26 February 2008. The timing of the decision was a surprise for markets as the government didn't support the idea before. The decisive factor could have been the risk/need of rate hike(s) as inflation has become a major concern for economic policy and as the credibility of the 3% inflation target was at stake.

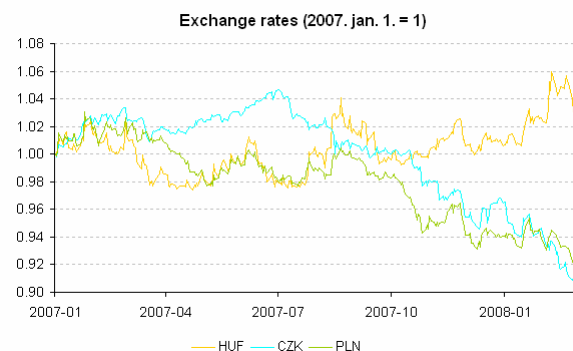
The conflicting dual inflation and exchange rate targets have been mentioned by many observers as a possible source of instability. The IMF, economic think tanks and many economists argued in recent years that Hungary would be able to achieve low inflation easier without the band.

The band was introduced as part of the Bokros Austerity package in 1995 and was widened to +/-15% in 2001, when the central bank adopted the inflation targeting framework.

#### Low credibility of the inflation target

Inflation has accelerated to above 7% since last autumn, in line with the trend of other CE4 countries. However, there have been signs that inflation has not just risen on one-off shocks, like food, fuel or regulated prices, but that also services and tradable goods showed some acceleration in recent months.

The underperformance of the forint and of the long end of the local government bond curve were a signal that markets feared the inflation shock was not just temporary, but that part of that could become a permanent development.



#### Floating FX first, rate hike later

The Hungarian central bank revised its inflation projection higher. The Monetary Council's statement emphasised that it will not tolerate a deterioration of inflation expectations (i.e. high yields at the long-end of the curve) and that rate hikes may come if needed. Governor Mr Simor said that the rate decision was a close call as a 25bp hike was also discussed. The band abolishment was decided before the rate decision, which means that all members took that factor into account. The message that the "Council's aim is to cut inflation to target in 2009" seems ambitious. This requires significant disinflation as both core and headline CPI are projected at 3.6% for average-2009, well above the 3% target, although the projection is close to 3% at end-2009. The medium-term target thus is not yet achieved and consequently, rate hikes are not off the agenda.

The central bank will monitor markets and macro developments closely and if they see some additional risk to the target, a rate hike could come. The recent vote suggests that a rate hike could mean a 25bp in-



crease to 7.75% first, followed by similar moves later, if the inflation outlook will not develop in a satisfying way. The market is currently looking for an 8% base rate over the next 3 months.

### **Inflation is the key for bonds and HUF**

The band abolishment has helped the HUF so far as the market probably sees the inflation target more credible without the band. In this respect, the recent move from the central bank can also be interpreted as a reinforcement of the NBH's committed to achieve the inflation target.

The medium-term consequences will depend on the inflation outcome. If the central bank is successful in reducing inflation (and markets' inflation expectations) long-dated bonds could advance. In this scenario of a positive appeal from bonds, the currency might be supported by capital inflow and eventually could strengthen. This could move the EUR/HUF pair back to the 250-255/€ range, which would also help inflation to decline through cheaper imported goods. The current yield levels offer plenty of room for spreads to shrink as they are at historic highs against the euro.

The HUF's fair value is estimated around 250-255/€ as the country's real convergence is roughly equal to

the nominal convergence at this exchange rate level. Real convergence refers to the per capita GDP on PPP basis relative to the EU27 average. Hungary is estimated at 60% in 2008. Using the above mentioned exchange rate, the price level is also estimated at 60% of the EU27 average.

### **Fundamental background**

The inflation debate is centred on possible second-round effects of recent inflation shocks. The NBH assumes that the steep rise of food, fuel and regulated prices are causing a large, but temporary rise in inflation as shrinking consumption and zero real wage growth are limiting companies' ability to pass through the higher production cost to the consumers.

The budget deficit is expected to decrease to 4% of GDP or lower this year, down from the record 9.2% level in 2006. Albeit fiscal consolidation may slow down as the government is facing a referendum about co-payments on March 9, a budget deficit of 3.2% is feasible next year.

A turnaround in the inflation outlook together with a close to 3% of GDP budget deficit may open the way for long-term investors to position for yield convergence in Hungary. The 10-year yield is now trading at 7.6%, some 350bp above the Bund equivalent.



Brussels Research (KBC)		Global Sales Force	
Piet Lammens	+32 2 417 59 41		
Peter Wuyts	+32 2 417 32 35	Brussels	
Didier Hanesse	+32 2 417 59 43	Corporate Desk	+32 2 417 45 82
Peter Fontaine	+32 2 417 56 11	Commercial Desk	+32 2 417 53 23
Bob Maes	+32 2 417 51 94	Institutional Desk	+32 2 417 46 25
Dublin Research (IIB)			
Austin Hughes	+353 1 6646892	London	+44 207 256 4848
Prague Research (CSOB)		Frankfurt	+49 69 756 19372
Jan Cermak	+420 2 6135 3578	Paris	+33 153 89 83 15
Zdenek Safka	+420 2 6135 3570	New York	+1 212 541 06 97
Jan Bures	+420 2 6135 3574	Singapore	+65 533 34 10
Bratislava Research (CSOB)			
Marek Gabris	+421 2 5966 8400	Prague	+420 2 6135 3535
Silvia Cechovicova	+421 2 5966 8405	Bratislava	+421 2 5966 8436
Warsaw Research (Kredybank)		Budapest	+36 1 328 99 63
Piotr Radzewicz	+48 22 6345 946	Warsaw	+48 22 634 5210
Budapest Research (K&H)			
Gyorgy Barcza	+36 1 328 99 89		

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