**CEE FX: Short PLN/HUF**

**Background**

Recently, some CEE central banks have pivoted in the face of a looming recession, despite continued high inflation with the hopes that it has peaked. The CNB seems done with its hiking cycle, and the NBP has greatly decelerated its pace of hikes, on route to stop soon. Others have continued to increase rates: MNB continues to raise rates, while BNR is hiking cautiously. These developments reflect economic divergences between CEE countries that will affect their currencies' strengths moving forward.

**Thesis**

Poland's Monetary Policy Council has greatly reduced the pace of hikes and struck a dovish tone but, given both imported and domestic inflation pressures, a substantive drop in CPI during the remainder of this year seems unlikely. On the other hand, the MNB has remained particularly hawkish given broad-based inflation and spiralling wages in particular. Recent disputes with the EU over rule-of-law issues are likely to improve and restore foreign investors' confidence in the country.

**Polish economy faces slowdown, but persistent inflation**

In its recent meeting, Poland's Monetary Policy Council (MPC) hiked only 25bp and struck a dovish tone for future meetings. In a press conference, the National Bank of Poland (NBP)'s President Adam Glapinski placed strong emphasis on the disinflationary effect of the coming economic slowdown, saying that he believed that this summer was a turning point for inflation rises. The central bank's view is of an economic slowdown (but not recession) with unemployment kept low and inflation declining as a result, aided by base effect, government anti-inflation measures, and energy price caps.

However, I don't see a 'soft landing' scenario as warranted here. Already, we have seen inflationary anomalies in the recent CPI, with food prices failing to exhibit their seasonal decline in August and heating fuel rising prices rising rapidly much earlier than usual. Inflation has pushed up goods and services, aided by wage pressures supported by government policies. Poland's policy mix is already not very tight because of fiscal expansion this year and next and the anti-inflation measures on energy do not seem likely to be effective in preventing cost pass-throughs. This is especially the case because of quite high domestic inflation expectations on the part of both households and companies which will likely trigger secondary effects in the coming months. The external energy shock, the brunt of which has yet to be absorbed this winter, will be further warped by a weak zloty due to the NBP's dovishness, leading to more imported inflation and exacerbating domestic pressures. The NBP, though, seems overly-sensitive to recession prospects and now much more likely to surprise on the dovish side with no further rate rises than to return to a more hawkish tone. And fiscal policies are likely to become more accommodative rather than more restrictive as the ruling populist PiS party has lost some political support amid the cost-of-living crisis. This scenario somewhat mirrors what Hungary experienced earlier this year.

**Hungarian inflation will support further hikes, EC rule-of-law issues likely to improve**

Hungarian inflation has been particularly persistent (rose to 15.6% in Aug vs. 13.7% in Jul), in part due to the accommodative policies of the government earlier this year and late last year, which was driven by political reasons. As a result, Hungary is struggling with a wage-price spiral, with most companies likely to announce extra compensation for employees soon. The labour market remains tight; though it is likely that anticipated extra labour costs will mean an uptick in the unemployment rate, I don't see it resulting in significant lay-offs in the near-term even as the economy slows. Inflation expectations follow this pattern, and remain stubbornly elevated. With the backdrop of heating costs rising during the winter, the MNB has continued to be hawkish and support the forint, hiking 100bps last meeting and introducing measures to rein in excess liquidity. While future hikes could be less than 100bps, I expect that the MNB will still place a strong emphasis on inflation when compared to other CEE banks, especially the NBP.

The EC began the process of penalising Hungary for rule-of-law violations and is set to formalise that through a vote this Sunday, but they are increasingly expected to hold off on withdrawing funding in favour of a 'wait-and-see' approach on whether Hungary passes reforms. I am confident that, faced with a strong fiscal incentive, Hungary will make progress on these reforms and restore confidence, especially to foreign investors. This confidence is well-placed, given not just tangible commitments on policy coming from Orban's ministers but also the importance of access to EU funds as a whole for Hungary, so that they can be drawn on in the attempt to contain domestic energy costs. As such, I expect more positive news moving forward which should continue to support the forint's recovery.

**Romanian leu as an alternative to forint**

An alternative expression of this view, which I also think could be strong, is short PLN/RON. Romania's economy has so-far been much more resilient than its regional peers, with GDP rising 5.3% higher in Q2 vs a year ago and strong FDI figures throughout the year. The economy is slowing down due to drops in retail sales and industrial output, but not sharply, and remains attractive regionally. Inflation plateaued last month, only to rise again in latest data due to food prices rather than energy; the situation with energy has been strictly managed under new government policies attempting to cap prices, but utilities companies have complained that the policy is too strict - the potential economic fallout from this policy remains a risk, even though most gas is domestically produced. BNR (Romanian central bank) is relatively behind-the-curve and has indicated it would like to narrow the gap in its monetary policy vs regional peers. Despite a 6-3 vote for a lower-than-expected 75bps hike (vs 100bps expected and previous, with 3 favouring another 100bps), a backdrop of strong recovery vs pre-pandemic and only a moderate slowdown should continue to support its hiking cycle as other CEE CBs unwind. Though rate surprises are marginally tilted to the downside and the hikes are unlikely to be as aggressive as those in Hungary, the leu remains quite attractive regionally.