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# Economic News

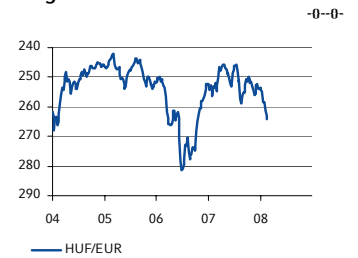
## ELIMINATION OF EXCHANGE RATE BAND FOR HUNGARIAN FORINT

### Hungarian forint floating freely

The Hungarian central bank unexpectedly abandoned the forint's exchange rate band yesterday. The currency is floating freely as a result and any firming from now on could be stronger than in the past. This makes it easier for the central bank to focus on its goal of price stability. At the same time, the prospect of joining the European Monetary Union is becoming more distant.

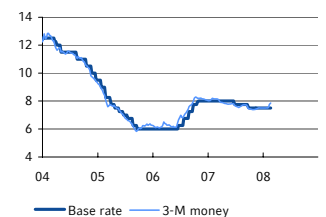
- The Hungarian forint has been fluctuating in a range of  $\pm 15\%$  around a central parity rate of HUF 282.36 against the euro since 2001. While the **elimination of the exchange rate band** has long been the subject of debate, the timing of the move came as a surprise. However, it is a good time to do so as the forint is trending slightly weaker at present, i.e. trading comfortably within the range. Speculation of the band's removal previously always arose whenever the forint was trading close to its lower range. If the central bank had given in to pressure from the market in such a situation, it would certainly have lost credibility.
- The exchange rate band placed restrictions on the forint's price movements, particularly at the lower end. The central bank was forced to intervene massively in January 2003 and only prevented an excessive firming of the forint by drastically cutting rates and limiting quantities. The forint will now be able to appreciate more strongly in future. In explaining its decision to abandon the exchange rate band, the central bank claimed that it can now concentrate solely on achieving its goal of price stability. Inflation and exchange rate targets have not always been compatible. A **firming of the currency, which could prove stronger in future than in the past**, will indeed curb domestic inflation via lower import prices.
- There may yet be other reasons for eliminating the exchange rate band at this time. The forint is currently in a weak phase. The risk appetite of international investors has declined on the back of the financial market turmoil, and a higher risk premium is being demanded for investments in Hungarian forints. The Hungarian economy is on the verge of sliding into stagflation. Inflation has soared and growth has slumped as a result of the consolidation programme in 2006/07. Due to unfavourable external circumstances (high crude oil and food prices driving up inflation, as well as a slowdown in global economic growth), Hungary will not be able to recover as rapidly as planned.
- Moreover, high deficits in the federal budget and current account, as well as high levels of foreign debt, render the Hungarian currency vulnerable to swings in confidence. With regard to the price stability target and the fact that high inflation expectations could gain a foothold if inflation does not fall quickly, the central bank will probably be concerned about trying to prevent **a further depreciation of the forint**. During the forint's previous weak periods, the NBH (sharply) raised policy rates to make Hungarian forint-denominated investments more attractive via higher interest rates. In the current situation, rate hikes could help the currency to firm but would be a further drag on an economy that is already weak as it is. For this reason, the central bank is evidently making an effort to **initially desist with rate hikes** and to strengthen its credibility through other measures.

Hungarian forint



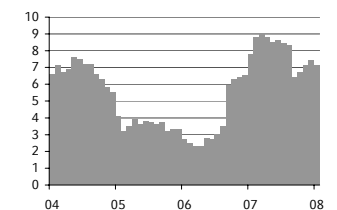
Interest rates

in %



Inflation

% y/y



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- The elimination of the forint's exchange rate band met with a positive reception in the markets, triggering a significant firming. However, we doubt whether the forint will be able to sustain this.
- We expect that the forint will continue to fluctuate around HUF 265/EUR in the short run, **only firming significantly again towards the end of the year** when the turmoil on the international financial markets is over and the outlook for the US economy has brightened again. We do not, therefore, expect the Hungarian central bank will need to support the currency with interest-rate hikes.
- However, the inflation trend and the risk of entrenched inflation expectations are a cause of grave concern for the central bank. Faced with an annual average inflation rate of almost 6% this year, the central bank is a long way off its inflation target of 3% and the inflation rate is not likely to come back down near this target until 2009. It is, therefore, comprehensible that the central bank's latest statement hinted at its clear '**tightening bias.**' But given that the inflation rate is likely to fall significantly in H2 and as rate-tightening measures could hurt an already sluggish economy, we assume that the central bank will leave its **key rate unchanged** over the next six months. We believe the fact that it abandoned the exchange rate band yesterday instead of raising interest rates supports this view.
- The abandonment of the exchange rate peg, the structure of which was highly reminiscent of the Exchange Rate Mechanism II, the prelude to membership of **Monetary Union**, also suggests that the introduction of the euro has receded even further into the future. Since Hungary has problems meeting the Maastricht convergence criteria, **we do not expect accession before 2014.**

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