



Policy and politics: Post-Covid world tests central bank credibility

Author

Malin Rosengren

BlueBay Asset Management

Portfolio Manager



As we emerge from the grips of Covid-19, we've seen the two dovish strongholds of Central Eastern Europe – Hungary and Poland – exit the crisis with a material divergence in central bank reaction functions. This has manifested into a departure in approach to monetary policy, with huge implications on central bank credibility as a result.

At a time when tensions with the EU are culminating in a material risk to the flow of EU funds for both countries, central bank credibility could be a game-changer for the trajectory of their respective currencies.

The traditionally pro-growth biased central banks are now at odds on the nature of inflation. The National Bank of Hungary (NBH) confirmed its view on the permanency of inflation quite early on and has been leading the region in a front-loaded hiking cycle. Conversely, the National Bank of Poland (NBP) assessed inflation as 'transitory' and committed to leaving rates unchanged... that is until it shocked the market in October with a 40 basis point hike.

Given that both economies are experiencing record-high inflation and are structurally quite similar, the disparity between the central banks raises questions for investors and potential opportunities for alpha generation.

Hungary walks its talk

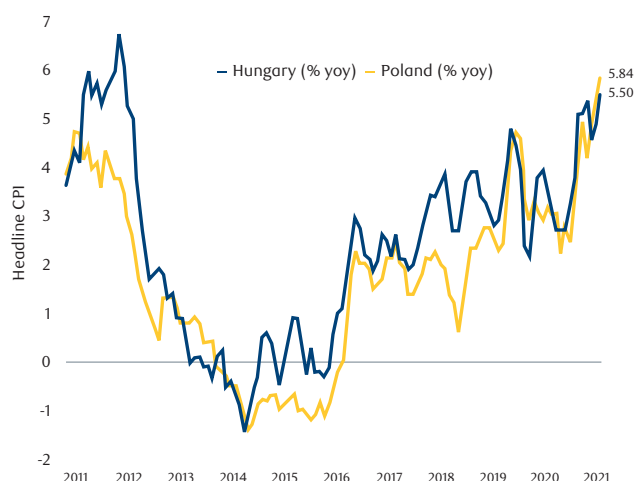
In May, the NBH was already signalling the imminent start of a tightening cycle. Equipped with a fine-tuned

PowerPoint, NBH Deputy Governor Virág said it straight: *"We have an inflation issue [and] these are the reasons why we believe inflation is permanent and not transitory"*.

This was jaw-dropping for market participants – many of whom have been taught a lesson or two over the years on the trickery within the NBH's reactive approach to monetary policy.

But true to its word, the first hike came in June 2021 and has been followed every month since. This proactive approach to policy setting is beginning to turn the market's perception on its head. As the front-runner in the hiking cycle both regionally and globally, the Hungarian central bank is carving a new, more credible name for itself.

Central bank credibility is more important than ever as we transition to a post-Covid world marked by shockingly high energy prices, supply shortages and uncertainty



Source: Macrobond, 26 October 2021

Central bank surprises in Poland

Over in Poland, Governor Glapinski was unwavering on high inflation being transitory and a product of factors outside the scope of monetary policy. His guidance remained unchanged from the pre-Covid era: rates will not be hiked during this Monetary Policy Council's (MPC) term (ending 2022). Glapinski made his hardline stance clear back in March when he said flat out that *"the market is wrong"* to expect rate hikes and the probability of tightening *"during this MPC's term is near zero"*.

This line of communication was held strong through the summer months until September, when the central bank surprised the markets with a 40 basis point hike to the policy rate. Glapinski informed the press that it was the MPC's intention to surprise the market – completely unabashed to the magnitude of contradiction to all prior central bank guidance.

The consensus view of the NBP had already fallen from grace over the course of Glapinski's leadership. However, the deterioration in governance was tolerated by markets because it brought with it predictability: no rate hikes. The September policy decision called the market to seriously question the bank's credibility.

Putting two and two together

Both Hungary and Poland provided similar levels of extraordinary fiscal support measures through the pandemic and implemented QE programmes of similar magnitude. So how did the two central banks exit the crisis with such a divergence in behaviour?

It's politics, baby.

As we've seen elsewhere around the world, the governing parties in Hungary and Poland have taken a popularity hit from increased public scrutiny over the management of



the Covid crisis. Government responses to voter dissent have varied between the two countries, reflecting their differing positions in the political cycle.

In Hungary, Prime Minister Viktor Orbán has been busy with his re-election campaign, with the spring election set to be highly contested. Orbán is using the full weight of his position of power to appeal to target voters: say hello to fiscal stimulus. We've seen cash handouts being pumped out of the treasury, keeping the budget deficit a puffy 7.5% of GDP – a substantial fiscal impulse for a rebounding economy expected to grow by roughly 7%.

“Inflation is a public enemy and the central bank should fight it.”

György Matolcsy,
Governor of the Hungarian National Bank

Conversely, the central bank has been astoundingly orthodox in response, voicing criticism against fiscal policy and reiterating the need for a tighter budget deficit. This was so out of character that the market assumed it was the result of some underlying tiff between Orbán and central bank governor György Matolcsy. But no. Instead, we've learned the trigger point for the NBH's policy stance: fiscal.

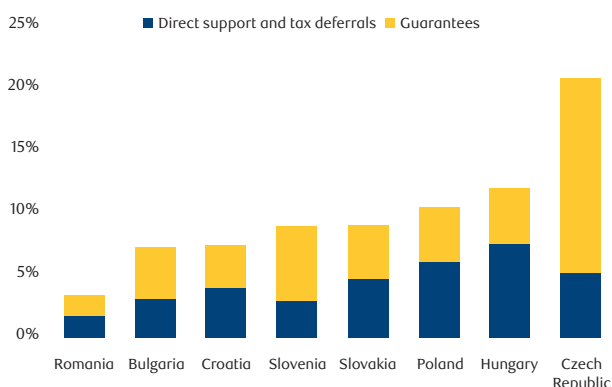
Hungarian central bank credibility = Improving

In Poland, the government coalition collapsed during the pandemic, leaving the ruling Law & Justice party (PiS) as a minority government in parliament and vulnerable to the risk of early elections being called.

Without a majority, the party is constrained in its ability to call upon fiscal stimulus to boost its re-election prospects. What it does have is a politically captured monetary policy committee at its disposal (all 10 members are affiliated with the PiS) to call upon to stimulate the economy.

Governments provided significant fiscal support in 2020

Extraordinary government support measures, % of 2019 GDP



Source: Moody's, 14 January 2021

This would explain the NBP's commitment to keeping rates unchanged, so why the surprise with the 40bps hike?

This is where it gets interesting...

The recent commodity crunch in Europe brought increased public attention to the issue of rising consumer prices. Inflation fears proliferated into one of the most popular headlines across Polish media and became a political point of contention.

The morning of the October monetary policy committee sitting, Prime Minister Morawiecki took matters into his own hands, stating the committee should action a 'proper' policy response to high inflation. The MPC followed with the first interest rate hike since 2012, shocking everyone.

Polish central bank credibility = Deteriorating

Credibility consequences

Central bank credibility is more important than ever as we transition to an uncertain post-Covid world. This is particularly true for Poland and Hungary, where inflationary pressures are hitting historic highs and persistently printing above the respective target bands. And when monetary policy is set by political order, central bank credibility is put at risk.

Market confidence in central banks to deliver the policy objective of price stability has huge implications for interest rate curves. The more this credibility comes into question, the more action will be needed on the part of the central bank to achieve this objective – and the more markets will test its resolve. As global government bond investors, this presents potential opportunities to generate alpha across our strategies.

Implications for FX investing

If the divergence in central bank behaviour continues, we expect the Hungarian forint (HUF) to be increasingly supported by inflows as investors buy into central bank credibility. On the flipside, we are anticipating increased hesitancy to bet on the Polish zloty, given the lack of confidence in the central bank and the high uncertainty that brings. We have a long bias on HUF, underpinned with the confidence that the central bank will do what it takes to achieve its objective.

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