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MONETARY POLICY COMMENTARY

HUNGARY

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The MNB delivered on its promise: IRS and mortgage-bond buying programme starts in 2018

At its previous two meetings the MNB underlined that:

- since the last Inflation Report in September, the MNB sees even stronger downside risks to inflation and its view was supported by the lower-than-expected inflation data in October. This is in line with our long-held forecast that inflation next year could easily surprise to the downside.
- the appreciating HUF is considered by the MNB as undesirable tightening of monetary conditions via lower imported inflation, which should be counterbalanced by lower rates
- therefore short-term rates could be around zero or even in the negative territory for at least two years, which is already priced in
- to reach this the outstanding amount of FX swaps will be increasing (it grew from HUF 900 billion to HUF 1,400 billion in the past two months)
- **most importantly: the MNB would prefer to see an increase in the share of loans with long periods of interest rate fixation, which could be aided by lower longer-term yields.**

Before the meeting, the market expected the MNB to do something extraordinary – this was reflected by the fact that short-term yields stayed around zero, the two-year forward for the short-term yield fell 40 bps and the 10-year bond yield dropped 50 bps in the past two months.

The MNB did not fail to deliver, it even surpassed these expectations. **The MNB's Monetary Council introduced a new, unconditional interest rate swap (IRS) and a mortgage-bond buying programme, to control the long end of the yield curve. The short end is already controlled by the O/N interest rate and the FX swaps.**

Unconditional IRS:

- Amount: HUF 300 billion in 2018Q1, but every three months, the Monetary Council will review this amount for the next three months, much in the same way as it does in the case of the 3M central bank deposit.
- The overall amount for 2018 could be HUF 1,000-1,500 bn, the Deputy Governor said.
- Maturity will be five and ten years and could be used for hedging the interest rate risk of government bonds or of corporate and household loans as well.
- The programme will run for one year but it could be extended further if the Monetary Council deems it desirable.

Mortgage-bond-buying programme:

- Amount: on average, 50% of the mortgage-bond market, around HUF 500 bn
- Maturity: three years or longer
- Will run for one year and due to its huge size relative to the market, we assume that it will not be extended further

Finally, the last sentence of the press release changed, to indicate that no new monetary policy tool is in the pipeline at this point.

The above mentioned tools are aiming to lower the longer-term yields, which will help facilitate the spreading of fixed-interest-rate loans, which the MNB sees desirable, Deputy Governor Marton Nagy added. In 2018 HUF 1,180 bn worth of government bonds will mature and the banking sector is holding around HUF 7,000 bn worth of government bonds, so the IRS programme seems powerful in its amount to reduce longer-term yields.

In the case of the mortgage-bond market the current outstanding amount is HUF 951 bn, but next year it could reach or even surpass HUF 1,000 bn because under the current MNB decree every HUF 100 worth of mortgage loans must be financed with HUF 15 worth of mortgage bond. This rate will increase to 20% from 2018 October, effectively increasing the size of the market.

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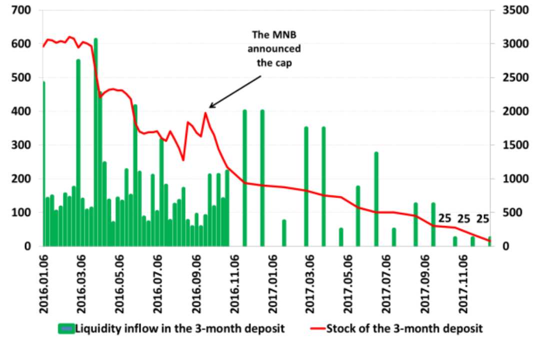
The transmission mechanism of the new tools:

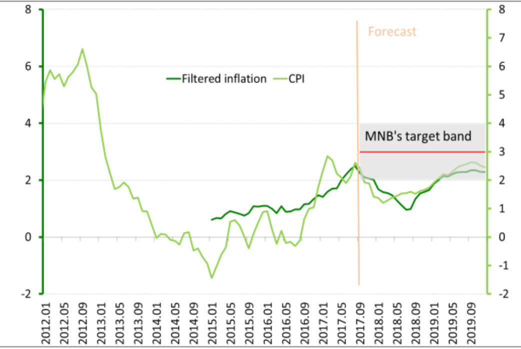
1. The MNB wants to see an increase in the share of the loans with long period of interest rate fixation. For this to happen, longer-term yields must be lowered.
2. With the new IRS programme, the longer-term swap yields are lowered, which will also have an effect on government bond yields
3. Because the IRS is unconditional, the spread between the swap and bond yield could increase.
4. These will reduce the yields on government and mortgage bonds, which will facilitate the increase of the loans with longer period interest rate fixation.

Chart 1: Liquidity inflow and volume of the 3M deposit (HUF bn)



Sources: MNB, OTP Research

Chart 2: Inflation forecast, (YoY, %, NSA)



*Sources: KSH, OTP Research *: Filtered inflation reflects to inflation any volatile items as well as all governmental measures*

In the coming quarters, the MNB will use the available and the newly introduced tools to manage the shape of the yield curve and the HUF exchange rate. These monetary policy tools help longer-term yields drop further, and we think that the share of loans with long periods of interest rate fixation will increase.

It is worth noting that the ECB started to taper off its QE programme this year and it could completely phase it out in the end of 2018. Besides, other CEE countries (the Czech Republic and Romania) also started to gradually normalize their monetary conditions. In Romania, the tightening is due to the high real-wage dynamic and the high business-cycle-adjusted fiscal balance, while the Czech Republic wants to prevent the overheating of its economy.

Even though Hungary is in the same stage of the business cycle as the other CEE countries, and there are sectors in the economy that are close to full capacity, the MNB deemed it desirable to loosen the monetary conditions further and pledged that interest rates could be staying at the current low levels for the next two years (until 2019). It is a risky strategy, but if inflation remains below expectations after 2019 as well, it could pay off.

Dates of the meetings	Dates of the minutes	Inflation report	Base rate decision	3M BUBOR*
21 January 2014	5 February 2014, 14:00 CET		2.85	
18 February 2014	5 March 2014, 14:00 CET		2.70	
25 March 2014	9 April 2014, 14:00 CET	x	2.60	
29 April 2014	14 May 2014, 14:00 CET		2.50	
27 May 2014	11 June 2014, 14:00 CET		2.40	
24 June 2014	9 July 2014, 14:00 CET	x	2.30	
22 July 2014	6 August 2014, 14:00 CET		2.10	
26 August 2014	10 September 2014, 14:00 CET		2.10	
23 September 2014	8 October 2014, 14:00 CET	x	2.10	
28 October 2014	12 November 2014, 14:00 CET		2.10	
25 November 2014	10 December 2014, 14:00 CET		2.10	
16 December 2014	23 December 2014, 14:00 CET	x	2.10	
27 January 2015	11 February 2015, 14:00 CET		2.10	
24 February 2015	11 March 2015, 14:00 CET		2.10	
24 March 2015	8 April 2015, 14:00 CET	x	1.95	
21 April 2015	6 May 2015, 14:00 CET		1.80	
26 May 2015	10 June 2015, 14:00 CET		1.65	
23 June 2015	8 July 2015, 14:00 CET	x	1.50	
21 July 2015	5 August 2015, 14:00 CET		1.35	
25 August 2015	9 September 2015, 14:00 CET		1.35	
22 September 2015	7 October 2015, 14:00 CET	x	1.35	
20 October 2015	4 November 2015, 14:00 CET		1.35	
17 November 2015	2 December 2015, 14:00 CET		1.35	
15 December 2015	23 December 2015, 14:00 CET	x	1.35	
26 January 2016	10 February 2016, 14:00 CET		1.35	
23 February 2016	9 March 2016, 14:00 CET		1.35	
22 March 2016	13 April 2016, 14:00 CET	x	1,20	
26 April 2016	11 May 2016, 14:00 CET		1,05	
24 May 2016	8 June 2016, 14:00 CET		0,90	
21 June 2016	13 July 2016, 14:00 CET	x	0,90	1,00
26 July 2016	10 August 2016, 14:00 CET		0,90	0,94
23 August 2016	7 September 2016, 14:00 CET		0,90	0,86
20 September 2016	12 October 2016, 14:00 CET	x	0,90	0,88
25 October 2016	9 November 2016, 14:00 CET		0,90	0,85
22 November 2016	7 December 2016, 14:00 CET		0,90	0,66
20 December 2016	11 January 2017, 14:00 CET	x	0,90	0,60
24 January 2017	8 February 2017, 14:00 CET		0,90	0,30
28 Febraury 2017	15 March 2017, 14:00 CET		0,90	0,23
28 March 2017	12 April 2017, 14:00 CET	x	0,90	0,21
25 April 2017	10 May 2017, 14:00 CET		0,90	0,16
23 May 2017	7 June 2017, 14:00 CET		0,90	0,15
20 June 2017	5 July 2017, 14:00 CET	x	0,90	0.15
18 July 2017	2 August 2017, 14:00 CET		0,90	0,15
22 August 2017	6 September 2017, 14:00 CET		0,90	0,15
19 September 2017	4 October 2017, 14:00 CET	x	0,90	0,12
24 October 2017	8 November 2017, 14:00 CET		0,90	0,03
21 November 2017	6 December 2017, 14:00 CET		0,90	0,03
19 December 2017	to be published later	x		

*: forecast - our expectation on 3M BUBOR rate

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