## Trading Desks
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## Fixed Income Desk

**András Sovány**
+36 1 288 7561
SovanyA@otpbank.hu

**Benedek Károly Szűts**
+36 1 288 7560
SzutsB@otpbank.hu

## FX Desk

**András Marton**
+36 1 288 7523
MartonA@otpbank.hu

**József Horváth**
+36 1 288 7514
Horvath.Jozsef@otpbank.hu

## Money Market Desk

**Gábor Fazekas**
+36 1 288 7536
FazekasGa@otpbank.hu

**Gábor Heidrich**
+36 1 288 7534
HeidrichG@otpbank.hu

**Judit Szombath**
+36 1 288 7533
SzombathJ@otpbank.hu

## FX Option Desk

**Gábor Réthy**
+36 1 288 7524
RethyG@otpbank.hu

**Máté Kelemen**
+36 1 288 7525
KelemenMat@otpbank.hu


# MONETARY POLICY COMMENTARY

# HUNGARY

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otp Research

# The MNB signalled it could start to tighten the monetary policy conditions sooner than expected

In the beginning of 2018, the international environment changed significantly, however until then the international environment was very supportive for the MNB. Since 2010 the US enjoyed a long period of high economic growth and the recovery also started in the Eurozone. But due to the low capacity utilization, the anchored inflation expectations and later the declining commodity prices, inflation was well below the inflation target in the US and other major economies as well for an extended period of time. In this environment the monetary policy was extremely accommodative; liquidity was ample, short term interest rates decline toward or below 0%, which increased risk appetite in the world.

In the past years the main issue for the MNB was the below target inflation and the appreciating pressure on the HUF. (The appreciating HUF could have lowered the inflation which is the opposite which was needed to reach the inflation target.) So the MNB in this environment was allowed to pursue a very expansive monetary policy. Therefore it gradually reduced the base rate below 1%, started to introduce non-conventional monetary policy measures (like FGS, Self-financing programs) in order to control the short end (FX-swaps) and the long end (unconditional IRS) of the yield curve. As a result, short term yield lowered toward 0% and despite the appreciation pressure on the HUF, the exchange rate remained stable. Additionally the MNB stated that based on the current inflation forecast, rate hike may only come in 2020.

However at the end of 2017 and the beginning of 2018, the sentiment on international financial markets changed materially. First, the US 10 year bond started to increase rapidly in 2017Q4 (toward 3%) and the US stock indices downturned from their historical height in the beginning of 2018. Second, due to the rising oil prices and increasing capacity constraints in the advanced economies, the inflation outlook changed in the advanced and EM economies as well. (US inflation increased from 2.5% to 2.8% yoy in May, Eurozone inflation increased from 1.3% to 1.9% yoy,) Due to the above major stock indices dropped and international capital outflow started from the EM countries. These effects weighted more severely on those countries which have macroeconomic imbalances and/or inflation came well above expectation and/or the central bank was perceived as not credible – Argentina, Turkey. Additionally last week the ECB announced it will phase out its QE program and could start to increase interest rates in the second half of 2019.

In this changed environment the market expects the MNB to adjust its monetary policy. This is due to the fact that besides the current risks-premium shock, inflation risks rose so fighting the appreciation pressure on the HUF is not a concern anymore. The big picture concerning inflation is that upon the strong domestic demand, the capacity constraints, and the tight labour market inflation accelerating in many areas such as intermediate goods prices, real estate prices, and certain market services. In the next couple of month inflation could reach 3% due to the increase in oil prices. Due to the above, in recent weeks the market may have tested the central bank's commitment toward its inflation target as the market may perceive the MNB's current monetary policy setup as incompatible with the changing macroeconomic outlook. This case is strengthened by the fact that other countries in the CEE region already hiking interest rates (Czech Republic and Romania) or already have a relatively high base rate (Poland).

In today's Monetary Policy meeting, the MNB did not disappoint. Although it left the monetary policy conditions (in terms of interest rates) unchanged, but the Press Release changed. The central bank still states that loose monetary policy needed to reach the inflation target next year. But it also acknowledged that the current monetary conditions are not sustainable in a 5 to 8 quarter horizon. This is mainly due to the changing international environment as the period of ample liquidity and low-interest rates nearing to its end, as it was reflected in the ECB's decision last week.

Moreover the MNB emphasized its commitment toward its inflation goal, but also suggested it will look through temporary change in inflation (like an increase due to higher oil prices). It is worth noting, that besides the higher oil prices, the MNB does not see significant risks concerning second round effects. The MNB Press Release and the Q&A after convinced the

*Chief Economist*

**Gergely Tardos**
+36 1 374 7273
tardosg@otpbank.hu

*Analyst*

**Dániel Módos**
+36 1 301 2810
modosd@otpbank.hu

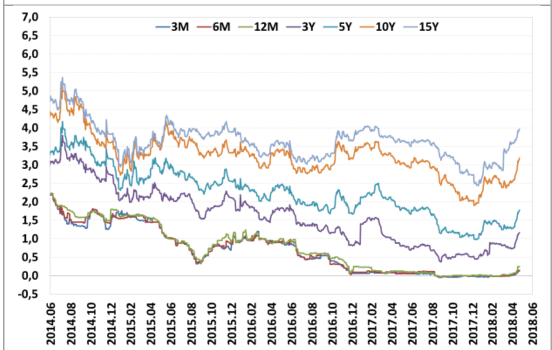
markets as the HUF appreciated below 322 against the EUR and the 10 year yield decreased as well. This could be a sign, that the MNB's message is perceived credible by the markets.

Looking ahead two questions will be important in the next few months: 1) when will the MNB starts to cautiously tighten the monetary conditions? 2) how much tightening is needed?

We think when the MNB starts to tighten the conditions; it will be through the reduction of the outstanding amount of the FX-swaps and/or with the increase in the O/N depo rate. This would gradually lift the short term rates closer to the base rate.

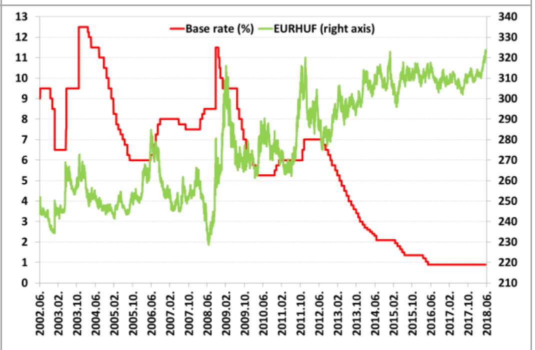
Concerning the second question, as we noted in our Report on Inflation upside risks to the inflation are increasing. If these risks materialize, it may warrant a more steeper base rate path later.

**Chart 1: Government bond yields (%)**



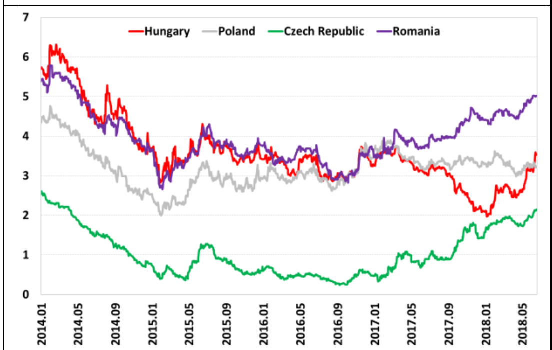

*Sources: ÁKK, OTP Research*

**Chart 2: Base rate (%) and the EUR/HUF rate**



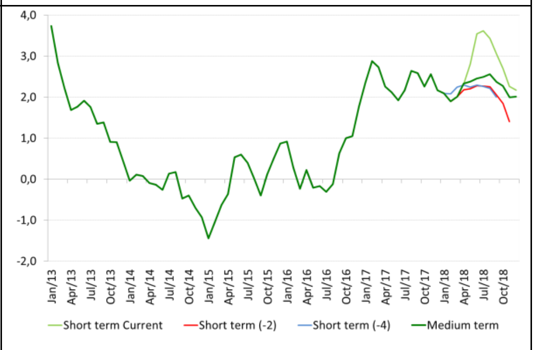

*Sources: MNB, OTP Research*

**Chart 3: 10-year government bond yields in the region (%)**




*Sources: Reuters, OTP Research*

**Chart 4: Evolution to our CPI forecast (annual changes, %)**




*Sources: KSH, OTP Research *: Filtered from indirect tax (including financial transaction tax) and visit fee changes*

| Dates of the meetings | Dates of the minutes | Inflation report | Base rate decision | 3M BUBOR |
|---|---|---|---|---|
| 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 | 10 January 2018, 14:00 CET | x | 0,90 | 0,03 |
| 30 January 2018 | 14 February 2018, 14:00 CET | | 0,90 | 0,02 |
| 27 February 2018 | 14 March 2018, 14:00 CET | | 0,90 | 0,02 |
| 27 March 2018 | 11 April 2018, 14:00 CET | x | 0,90 | 0,03 |
| 24 April 2018 | 9 May 2018, 14:00 CET | | 0,90 | 0,03 |
| 22 May 2018 | 6 June 2018, 14:00 CET | | 0,90 | 0,11 |
| 19 June 2018 | 4 July 2018, 14:00 CET | x | 0,90 | 0,18 |
| 24 July 2018 | 8 August 2018, 14:00 CET | | | |
| 21 August 2018 | 5 September 2018, 14:00 CET | | | |
| 18 September 2018 | 3 October 2018, 14:00 CET | x | | |
| 16 October 2018 | 7 November 2018, 14:00 CET | | | |
| 20 November 2018 | 5 December 2018, 14:00 CET | | | |
| 18 December 2018 | tba | x | | |

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