MONETARY POLICY COMMENTARY HUNGARY

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The weak HUF led to the 15-bps silent rate hike at yesterday's 1-week depo tender, which opened the door for further hikes

Two day after the MNB's rate setting meeting, the central bank yesterday surprised the market - and also us - by announcing that it will increase the interest rate from 0.6% to 0.75% on the 1-week deposit tender (and accepted all bids of HUF 1,925 bn on the higher interest rate). **The initial market reaction is positive as after the move, the yield curve has flattened, while the HUF appreciated against the EUR from around 366.6 to just below 362.**

It is important to emphasise that this step should be interpreted as a rate hike, despite having the "base rate" unchanged at 0.6%. Due to the current practice, when the central bank accepts all bids at the 1 week deposit tenders this instrument is a de facto standing facility. It is used to sterilize all liquidity at an interest rate fixed by the MNB, therefore it's determines the marginal yield on banking assets and money-market yields as well. This is clearly indicated by the fact that FX swap implied yields and the FRAs (forward rate agreement) reacted instantly and increased by roughly 15 basis points since the announcement (the interbank BUBOR yields also rose, albeit less, but their adjustment usually last longer).

Why did the central bank hike rates just two day after the rate setting decision and after the two cuts in the summer months? The answer is the exchange rate in our view. Yesterday's seemingly surprise move came amid further depreciation move raising worries that the HUF could reach new highs against the EUR, which could also have negative effects on inflation and inflation expectations. With the recent high inflation numbers, it also became clear that the central bank has become more sensitive to a weaker HUF and high exchange rate volatility. As a first step the MNB increased FX liquidity by introducing the reversed FX swap facility (injecting short term FX liquidity into the banking system and withdrawing HUF) and cancelling the usual FX swap auctions this week and next in order to prevent the usual, country specific weakening of the HUF, which took place at the end each recent quarter. Both at the end of March and June FX liquidity dried up, FX swap implied yields fell sharply, and the HUF depreciated, likely because of balance sheet window dressing of local and non-resident players. These measures are increasing FX liquidity of the banking system by EUR 1.3 bn for the end of this quarter and the anomaly in FX swap implied yields has not taken place so far. Therefore the current depreciation my be related more to the risk of driven by the increasing worries of fast spread of the pandemic globally and especially in CEE. We also wrote in our previous MPCs, the MNB will be less tolerant for further depreciation, but we thought that they will use the FX swap facilities to avoid it.

The hike in the one-week deposit rates also gives an answer to how the central bank would like to balance between the gloomy cyclical position and significant inflation pressure. The quantitative easing measures – the asset purchase program and the collateralised loan facility will go on in maintain support for the bond and credit markets. However, the MNB showed stronger-than-expected commitment to avoid further depreciation and keeping inflation expectations more firmly anchored but considered higher short-term rates as a less painful sacrifice for the latter objective.

All in all, this also means that the uncertainty on the short end of the yield curve rose. Should the exchange rate reappreciate after the end of the quarter, the MNB may return to tendering the one- week deposits at the base rate, but this is unlikely taking into account the reversal in interest rate policy after the two recent cuts. Should the pressure on the exchange rate remain, even further hike(s) could come. Money market yields, both FRAs and FX swap implied yields are consistent with at least two more 15 basis point hikes on the one-year horizon. We think that this is more likely on the short run than next year, when the deterioration income position of the households may result in weaker inflation pressures, bringing some relief.

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