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MONETARY POLICY COMMENTARY HUNGARY

26 July 2023



No surprise: the MNB delivered another 100 bps cut. Given the rapid disinflation, we foresee the same pace until March 2024, then the pace of cuts could slow down.

The decision: The MNB delivered the third 100 bps cut in the overnight deposit tender, to 15%. The interest rates on the optional part of mandatory reserves (to 15%), the overnight collateralised lending rate (to 17.5%), and the implied yield of FX swap tenders will also be reduced by 100 bps.

The MNB's key messages:

- Hungary's improved risk perception let the MNB cut the key rate by another 100 bps.
- Disinflation gained more traction. In June the share of falling prices in the CPI basket increased, service sector inflation slowed in YoY terms, for the first time since June 2021. Food prices could fall significantly further in July. End-year inflation could be around 7%.
- From a monetary policy point of view, it is very important that disinflation should continue in 2024 and this requires clearly positive real interest rate.
- The real economy will remain in recession in Q2, a gradual rebound starting from Q3 is already visible.
- In May, the current account position of the economy improved more than expected and it could cause a positive surprise in 2023 (in the Inflation Report the MNB forecast a C/A balance of -2% /-3% of GDP, the market consensus is -3.7%, our call is -1%).
- If risk perception improves further, 100 bps cuts could continue until the one-day deposit rate and the base rate meet. However, even in case of faster-than-expected disinflation, a larger pace of cuts is not on the table.
- The base rate was held at 13%, changing it was not in the cards.
- The exchange rate passthrough has strengthened recently, the positive effects of a weaker HUF on growth have moderated, the economy needs a more stable exchange rate.
- Regarding the reimbursement of the central bank's loss, the MNB and the MinFin work on a regulation that is in line with the best international practice. However, credibility depends on firm disinflationary commitment, not on the central bank's capital position.

Market reactions:

- In the absence of a major surprise, market reaction was very modest. Around the decision there was some volatility in the EUR/HUF, and the forint weakened by 0.3% to around 379 in the early afternoon. The FRA curve, which contained a bit smaller cut, shifted modestly down at the within-year part. Neither the IRS (interest rate swap), nor the bond market reaction are worth mentioning.

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Before the decision: we expected another 100 bips cut, just like a market.

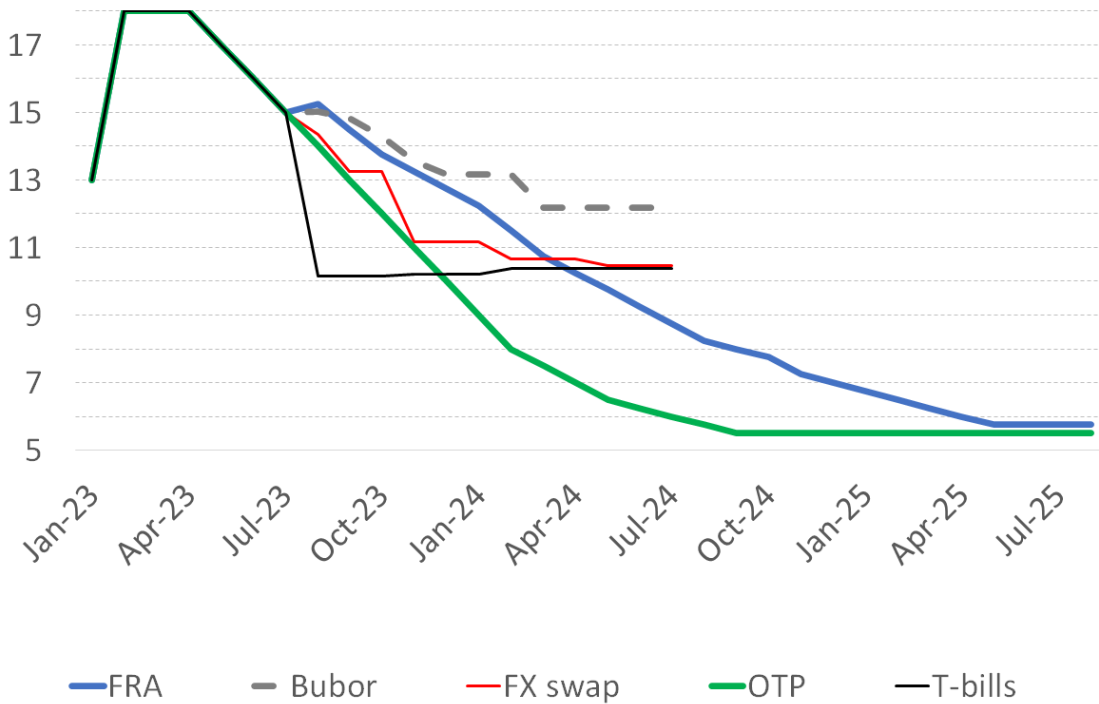
The MNB has kept the benchmark interest rate at 18% for more than half a year, then promised a cautious, predictable easing cycle after disinflation had clearly started, gas prices began to decline, Hungary's current account balance had improved notably, and the forint had recovered. In May and June, the MNB reduced the key interest rate by 100 basis points, to 17% and then to 16%, resisting the temptation of a stronger interest rate cut. Since the latest rate-setting meeting, inflation has slowed further, suggesting that CPI may drop below 10% before the end of 2023. However, the path of the HUF's exchange rate has become less certain: the forint, which had previously stuck near 370 versus the euro, weakened twice in the past three weeks: once to around 390 and then to near 380. On the other hand, the balance of payments data for the first quarter reflected a significant improvement (from -8% of GDP to -3.5%); moreover, the preliminary, seasonally adjusted monthly data have been indicating surplus since March.

The MNB's two interest rate cuts so far can be seen as forward guidance; therefore it is not surprising that OTP Research and analysts' consensus both expected another 100-basis-point rate cut at July's monetary policy meeting. The market pricing was more ambiguous: FX swaps were pricing in a 100-basis-point cut, but forward rate agreements (FRAs) were consistent with a slightly smaller one, by 75 basis points. All-in-all, it seemed almost certain that the overnight deposit rate (currently the key rate) would drop to 15%, while the base rate would remain at 13%.

Our assessment: we think the MNB will continue with 100 bps cuts until March 2024, when the pace of rate cuts will be slowed. The end-2024 rate could be around 5.5%.

- In the MC's press release and at the press conference, it was clearly stated that if risk perception continues to improve, further rate cuts could come in at a 100 bips pace until the one-day deposit rate and the base rate meet (most probably in September).
- The interesting part of the press conference was that Deputy Governor Barnabás Virág, in our view sounded relatively hawkish, when he was asked what could come after September. It was stressed that it is important that disinflation should continue in 2024 and the real interest rate, which could move into positive territory already in the autumn, should also be kept in the positive territory later on. Still, in our view, the current quick pace of disinflation, along with a mix of tight fiscal and monetary policy, make it very likely that the MNB could keep the 100 bips pace of cuts until next March; then, with a new Inflation Report, the pace could be slowed, to bring the base rate around 5.5% by end-2024. However, we still think that the MNB will try to avoid substantial HUF weakening until inflation is seen to safely return toward targets, so interest rate risks point to the upside compared to our baseline path.

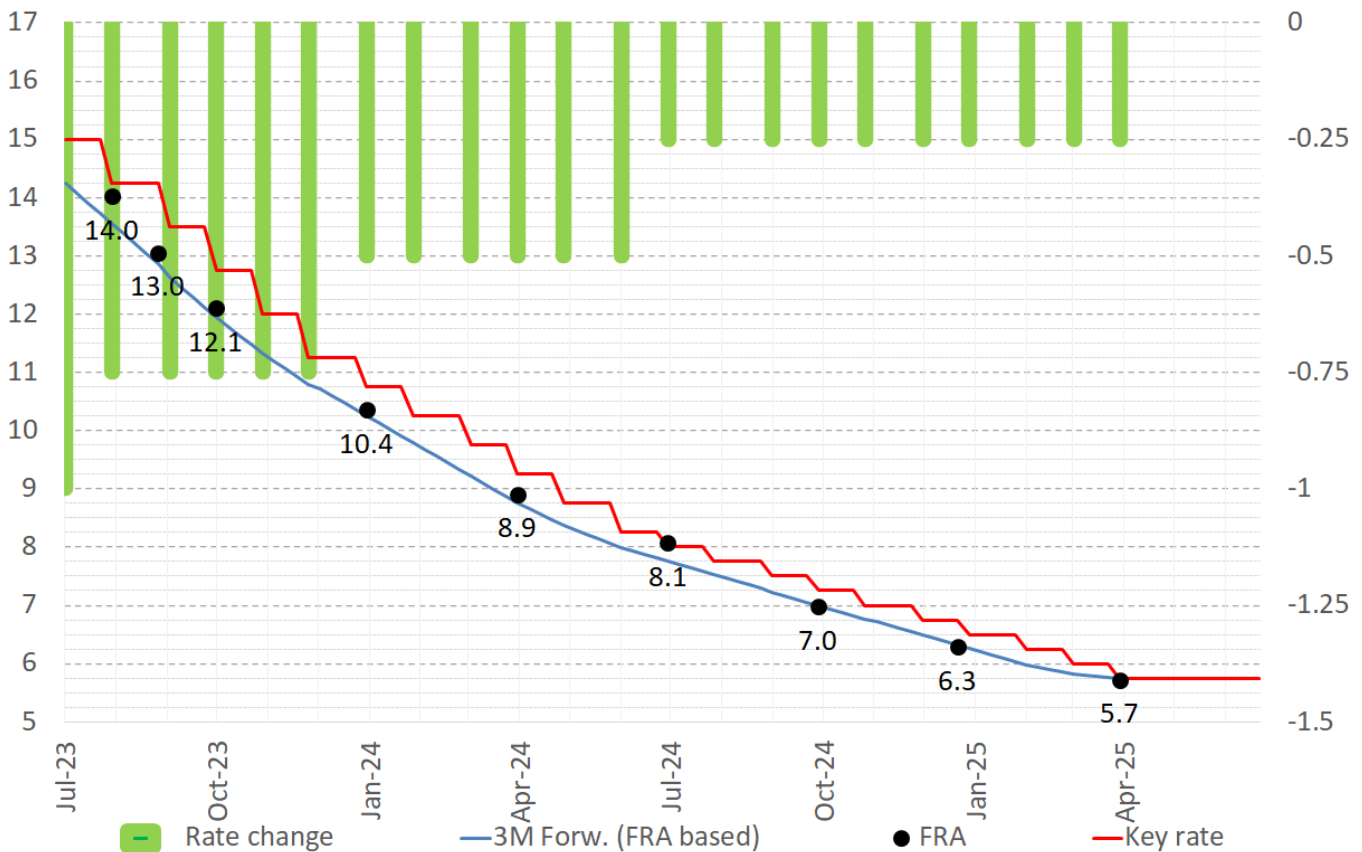
Expectations on the key rate* (%)



Sources: Bloomberg, OTP Research, MNB

*currently the interest rate of the O/N deposit tender

Key rate trajectory based on FRA pricing (%)



Sources: Bloomberg, OTP Research

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