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Monetary Policy Commentary Hungary

27 September 2023

No surprise: the one-day deposit rate was brought in line with the base rate. From October, the base rate will be the effective rate again as the monetary toolkit is reshuffled. As before, we foresee the base rate to decline to 8-9% by next spring.

The decision: *The MNB delivered its fifth 100-basis-point cut in the current rate-cut cycle, and brought the one-day deposit rate in line with the base rate. With the latter step, the Bank also phases out the one-day deposit tender from its toolkit, and sets the base rate again as the effective rate from October. The interest rate corridor is now set up by +/- 100 bps around the base rate. The effective instrument will be the reserve account at the central bank, where banks' all funds –above the 2.5% non-interest-bearing part– will receive payments at the base rate. The central bank discount bill, long-term deposit, and the swap instruments will remain in the toolkit; however, while the former two will pay the base rate, the swap tool will pay the lower end of the interest rate corridor.*

The MNB's key messages:

- Disinflation is on track, but the expected 7-8% inflation at the of this year is still very high and should be further decreased in 2024. As there are significant risks ahead, a very cautious monetary policy - which takes into account financial market stability - should be followed in the future.
- Monetary policy communication is key in this process, and the MNB will launch a briefing series on inflation, GDP, and current account data releases.
- As disinflation continues, the ex-post real interest rate moves into the positive territory from September.
- High-frequency data suggest positive YoY GDP growth from Q3.
- In the central bank's new projection, annual inflation could be between 17.6% and 18.1% this year (previous forecast: 16.5%-18.5%) and 4%-6% in 2024 (previously: 3.5%-5.5%), raised primarily due to the effect of higher fuel prices, and the MNB left its 2025 forecast unchanged at 2.5-3.5%.
- This year's GDP projection was cut to between -0.5% and +0.5% (from 0.0%-1.5%), next year's growth forecast was lowered to 3%-4% (from 3.5-4.5%), and the 2025 projection was left unchanged at 3.0-4.0%.
- After its sharp improvement this year, the current account could end up in a mild deficit, amounting to less than 1% of GDP.
- The Monetary Council sees upside risks to inflation and downside risks to growth around the baseline projection.

Market reactions:

- As the decisions of the National Bank did not cause any major surprise, market reaction was modest and it is hard to separate from the moves caused by core markets, where the long-term yield climbed to 10-15 year highs and the USD appreciated fast. Nevertheless, there was some temporary HUF appreciation around the press-conference, and FRAs also rose by 10-15 bps; both might have been related to the interest rate decision.

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Before the decision: we expected another 100 bps cut, just like a market, the question was more about the new projection and communication of future intentions

In light of the MNB's previous communication, it would have been an unexpected turn if the central bank had not cut the interest rate of its key instrument, the one-day deposit tender, by 100 basis points again, to 13%, thus closing the gap with the base rate. It was already known that starting from October, the MNB would decide on interest rates step by step, depending on the incoming data (primarily inflation, and money market stability, i.e. the HUF's exchange rate). Gyula Pleschinger had also revealed that the benchmark interest rate might decline to 10–11% by the end of this year.

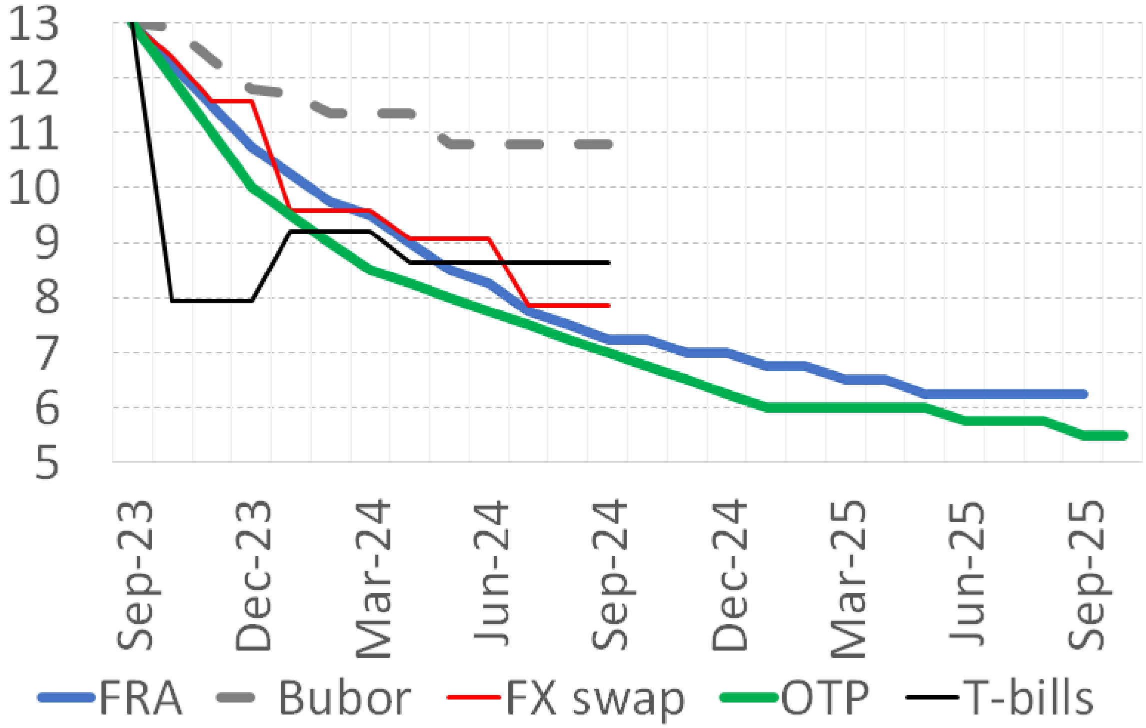
Owing to weak domestic demand, disinflation remained strong and broad-based; the rate of repricing slowed to 3-4% in recent months, which is very close to the level consistent with the inflation target, and it is among the lowest ones in the CEE region. The seasonally adjusted current account balance also showed a surplus in July, so it is likely to be in surplus in full year 2023 too. Based on these factors, even a stronger interest rate cut could have happened. However, developed markets' rising yield expectations, bond yields' hitting new highs, as well as their adverse effects on global growth and on demand for risky assets, coupled with the rapid rise in oil prices by themselves must have warned the MNB to be cautious. In addition, the domestic environment also gave plenty of reason for caution: the forint had weakened further, the future of Hungary's access to EU funds seemed to turn into a never-ending story, and how the government's plans to handle Hungary's huge budget deficit were yet to be seen.

In our opinion, two things were worth watching. First, the forecasts in the new Inflation Report, as the inflation forecast may have been driven by the rising oil price, and the growth picture has deteriorated significantly; in light of the second-quarter data, a recession in 2023 might be hardly avoided. The second interesting topic was how the MNB would change its instruments after closing the gap between the base rate and the key rate.

We keep our assessment: while domestic factors could allow the MNB to continue with 100 bps cuts for a longer period, in our view, the MNB prefers a more cautious and flexible approach to address potential risk premium shocks

- Just like in our August Report, we still believe that the trajectory of domestic inflation and growth would support the interest rate path we indicated in July, but keep a more cautious approach, given that all risks are tilted to the upside, and the MNB also signalled a cautious approach.
- We think that at first, the MNB might continue by further 75-100 bips this year. This would bring the base rate to 10-11% (in line what was communicated by Council Member Gyula Pleschinger), and well above the expected inflation (around 7-8%), and rates in the CEE region (CZ: 6.9%, PL: 5.25%).
- However, further on, instead of a stable monthly pace of rate cuts, the total amount of rate cuts that could be implemented by next spring and December will be based on the evolution of domestic inflation and priced-in interest rate path of other central banks in the CEE region, reflecting that the MNB is targeting the largest positive real interest rate in the region in 2024. In Hungary, inflation could fall to around 5-5.5% YoY by next spring. By March, Czechia's key rate is expected to be cut to 6.4%, Poland's to 4.75%, and both to 4%-4.25% by next December. Following this approach, we think that the MNB's key rate and the base rate could fall to 8-9% by next spring, and to 6.0%-6.5% by end-2024.

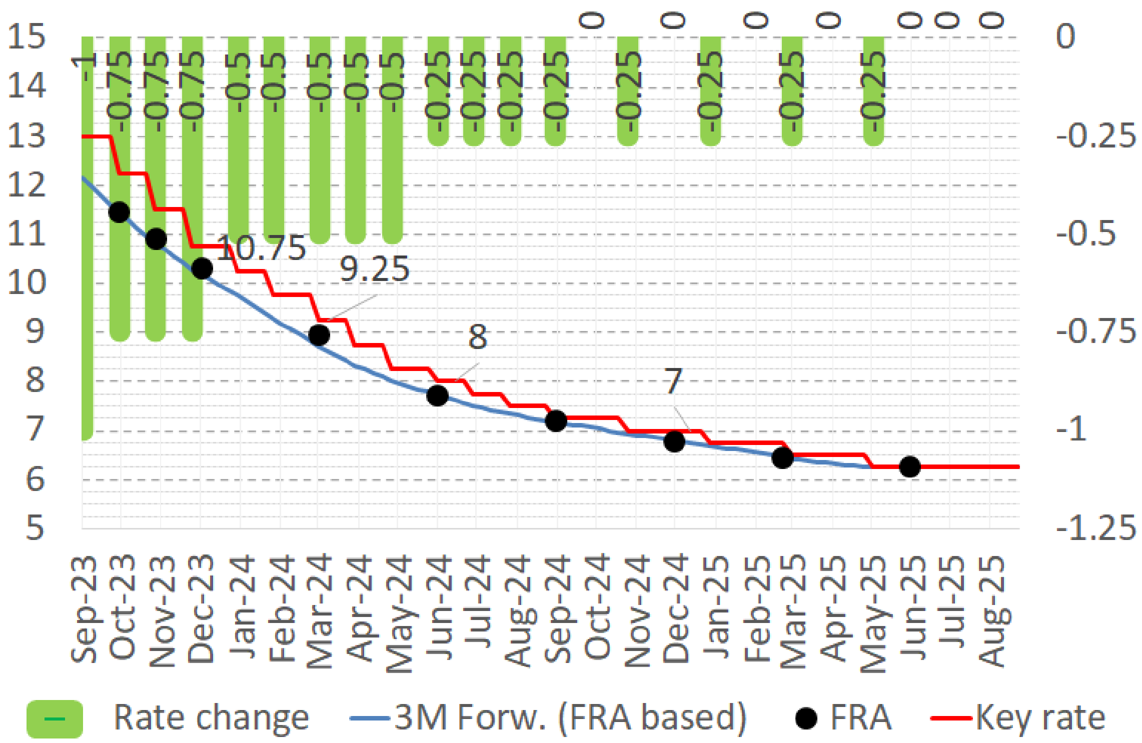
- **Expectations on the key rate* (%)**



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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