Monetary Policy Commentary

Hungary

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NBH cuts base rate to 6.50% probably with 4-3 vote: Inflation is not an anchor any longer

Yesterday the National Bank of Hungary cut the base rate by 25 basis points to 6.50%. Analysts were divided whether the Council would cut the rates by 25 bps or would leave it unchanged – we anticipated a close call, but with the base rate kept unchanged. As it was expected, the Monetary Council discussed two proposals: to hold the rate or to cut it by 25 basis points. It decided to reduce the benchmark rate with 'tight majority', which probably means 4-3 votes. In view of the MC members' earlier interviews and comments, and taking into account the members' monetary policy attitudes and voting records, it is almost certain that the four external members voted for rate cut and outvoted the three internal members' opinion again. The market reactions were muted in the first few hours.

With this decision the Monetary Council 'de facto' left the inflation targeting regime. The staff's assessment on the inflation is conflicting with the ultimate rate decision even more than last month. According to the baseline scenario in the new Report on Inflation, the consumer price index will be 5.0% in 2013, while the inflation target is 3.0%. The June forecast was 3.5% – this high increase in the forecast is unprecedented and surprising, considering that the Reuters poll consensus is only 4.2%. The 5.0% forecast was made by assuming unchanged base rate from last month's 6.75% level, thus with this rate cut it could be even higher. Core inflation is expected to be 4.9% in 2013 – or at least it was, with the base rate permanently at 6.75%.

The Council discussed two alternative scenarios as well. The first one calculated with higher potential GDP growth, thus higher disinflation effect from the higher output gap. But even with this scenario, the base rate should have been left unchanged at 6.75% for at least six months in order to meet the inflation target in the second half of 2014. However, as we emphasized in our former reports, due to structural reasons the output gap's disinflation effect is not as strong as it was expected earlier, thus this scenario does not seem too realistic. The other alternative scenario was calculated with less anchored expectations, which resulted in higher secondary effects and hence in the need for tighter monetary policy (i.e. rate hike).

Thus it seems that the external members are willing to accept higher inflation and weaker HUF – despite the official IT regime – in order to boost economic growth. That means that the inflation parameter has changed in the MC's reaction function, making this policy change permanent, a regime shift. The problem with this (apart from that the Council's objective is to ensure price stability) is that with the structural problems causing lower potential GDP growth, the rate cut is much less effective than it would be in a healthy economy. First, without the interest rate transmission, the rate cut is simply ineffective (for several reasons), and second, potential significant HUF weakening could actually contribute to the GDP with a minus sign because of the high FX debt.

From the aspect of real interest – which just declined by 175 bps automatically (150 bps higher inflation expectation, and 25 bps rate cut) –, Hungarian assets will become much less attractive. The growing uncertainty of the future CPI path increases both the expected inflation and its deviation. As last month's decision was the beginning of a cycle, it is predictable that real interest rates will decline further.

We warned about the dangers of this path in our commentary last month. Let us recap: *speculators could easily think that the NBH is willing to cut the rates without supporting macroeconomic fundamentals* – from now on, they could be almost sure about it. *From market logic, it could induce more significant rate cutting bet on the future base rate through money market instruments. If the MC justifies this kind of market pricing again –*

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which it just did – *then it may reach the 'point of no return': when the market will think that Hungary's monetary policy could not control the inflation expectations any more.*

After yesterday's decision, we have to say that the NBH's credibility has eroded to a high extent. This rate cut – as it confirms that last month's decision was the beginning of a rate cut cycle – has undesirable consequences in the middle run. The first and most obvious is the growing uncertainty of the future CPI path. This could lead to growing long yields and country risk premium. So, while there is a lot of liquidity on the market due to major central banks' actions and there is strong emerging market bond inflow, these should not be great problems. However, when the global market sentiment turns bad again, these could induce huge and quick sell-off amongst Hungarian assets.

The future path of the base rate has become uncertain as well in the middle run. In the short run, we expect more rate cuts – the easing bias at the end of the MC's monetary policy assessment (the Council will consider a further reduction in interest rates if the improvement in financial market sentiment persists and medium-term upside risks to inflation remain moderate) and the interview of one of the external members stating that there is room for 100 bps rate cut before the EU/IMF agreement and for another 100 bps after the agreement both suggest that.

We revised our forecast for this year and expect two more rate cuts – with the base rate at 6.00% at the end of this year. After that, it is highly dependent on the EU/IMF negotiations.

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