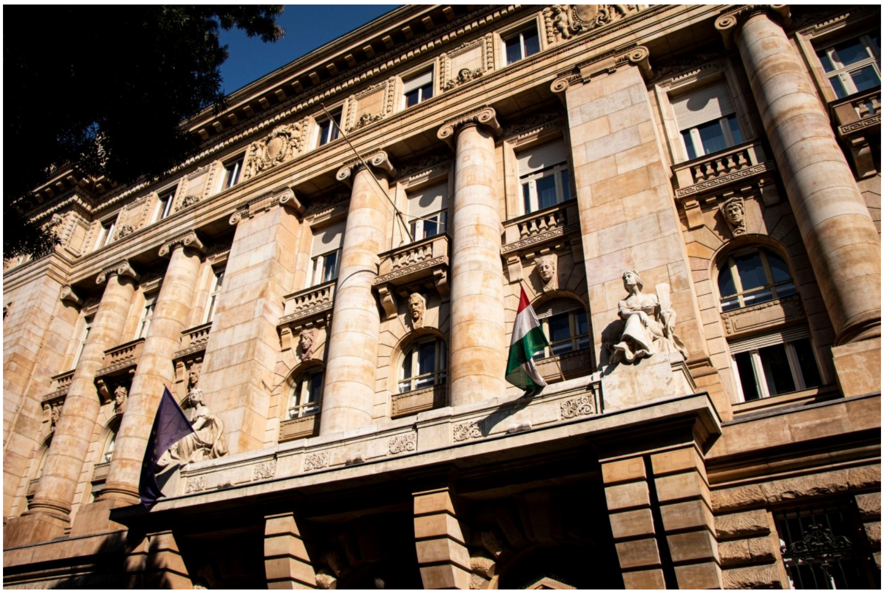
National Bank of Hungary review: Monetary policy to come off autopilot soon

The National Bank of Hungary continued its normalisation in August with another 100bp cut in the effective interest rate. However, monetary policy is likely come off autopilot from September. The central bank believes that market expectations of rate cuts in the fourth quarter are exaggerated



The National Bank of Hungary in Budapest

The National Bank of Hungary decided not to change the pace of normalisation in August. It cut the overnight collateralised lending rate (upper end of the rate corridor) by 100bp to 16.5%. More importantly, the central bank announced that from 30 August the interest rate on overnight quick deposit tender will be cut to 14%. This is an effective rate cut of 100bp. There will be a similar change in the overnight FX swap tender rate. In general, these changes did not come as a surprise.

The highlight of the policy event wasn't the decision itself, but the updated forward guidance and the corresponding communication. As we wrote in our preview note, the August rate-setting meeting provided a perfect opportunity for the central bank to manage market expectations for monetary policy in the fourth quarter. The Monetary Council took advantage of this opportunity.

In this respect, the press conference contained the golden nuggets, with Deputy Governor Virág reiterating that monetary policy is entering a new phase of normalisation after the merger of the effective and base rates.

This convergence is taking place in September and after which the second phase will involve a simplified monetary policy toolkit. In practice, this could mean, that the Monetary Council will get rid of the overnight quick deposit tender and rely on its traditional overnight deposit facility to mop up excess liquidity from the market. However, we can expect that the overnight FX swap tender and the central bank discount bill to remain part of the toolkit in the new phase.

On the rate path, the Deputy Governor was quite vocal about the rate cut expectations priced in by investors. While the central bank agrees with the view that the convergence will take place in September (so we can expect a final 100bp cut to end phase one), it disagrees with what has been priced in afterwards. The central bank sees market expectations as exaggerated and emphasises that monetary policy will come off autopilot in the second phase of normalisation. Decisions will be data-driven and made on a step-by-step basis, considering market stability and inflation risks.

In our view – based on market expectations ahead of the meeting – this means in practice that the NBH is either suggesting smaller steps in future cuts and/or adding the pause to the mix of decisions. Nonetheless, the pushback against “excessive expectations” is a clear hawkish message.

The September rate-setting meeting will be important because of the new Inflation Report, which contains the central bank’s updated macro outlook. Regarding the GDP outlook, the NBH sees downside risks materialising. However, inflation has been identified as the main culprit behind the collapse in domestic demand and weak economic activity. Against this backdrop, the main weapon to steer the economy onto a favourable growth path is through tight monetary conditions, positive real interest rates and thus faster consolidation of inflation. Another hawkish message.

Strategy in a nutshell

Today's meeting has a lot to calm the nerves of HUF bulls. All hawkish messages from the central bank point to a higher interest rate path than the market's latest expectations. This means that the relative carry opportunity is improving, supporting the forint. The central bank's commitment to continue fighting inflation and maintaining a positive real interest rate environment is also helpful not only from a tactical but also from a strategic perspective. All in all, we remain positive on the HUF.

The initial market reaction was clear and if the directional move remains intact, it may be satisfactory for monetary policymakers. The 6x9 month FRA rose 6bp on the comments, although we admit that this is still relatively modest, so we see some room for further correction. However, with the NBH willing to be data dependent, the rate market may be even more data sensitive than just reacting to central bank comments. The next test will be the incoming August inflation print on 8 September. If we see a higher-than-consensus inflation print – and we see a chance for an upside risk here mainly in services and fuel – then it can really shake the market's pricing of an aggressive easing cycle.

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