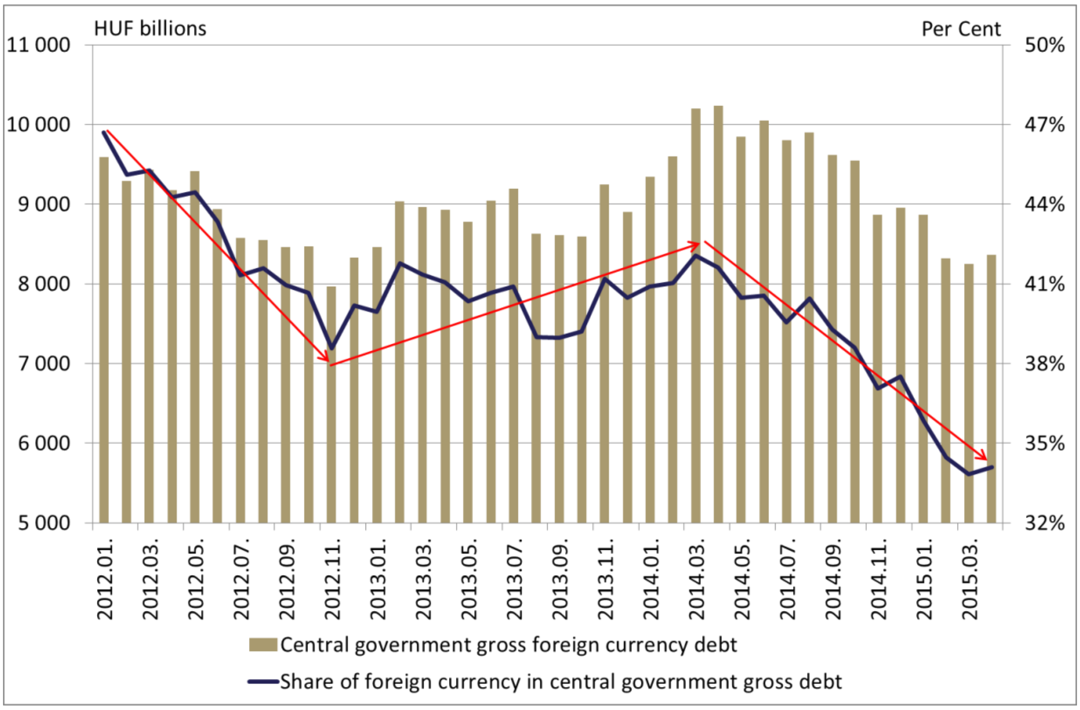
<u>Márton Nagy – Dániel Palotai:</u>

<u>The MNB further reduces Hungary's vulnerability by reforming its policy instruments</u>

The Magyar Nemzeti Bank (MNB) has restructured its policy instruments in order to support the refinancing of government debt from domestic forint funding. As a cornerstone of this reform, the main policy instrument of the MNB will be the three-month central bank deposit from the end of September 2015, while the two-week deposit will be auctioned with quantity restrictions. Holdings of the two-week deposit will be reduced in a staggered manner, and will reach the cap set at HUF 1,000 billion at the end of 2015. The restructuring of the policy instruments helps achieve the goal of self-financing, since government securities receive a more favourable treatment from a liquidity perspective than the new three-month central bank deposit. This will encourage banks bound by regulatory requirements to increasingly finance the government instead of the central bank. Due to the adjustment involving stepped-up purchases of government securities, the credit supply to the real economy will not be disrupted.

In addition to its primary task of achieving and maintaining price stability, the Magyar Nemzeti Bank views the reduction of Hungary's external vulnerability and improving the currency composition of government debt as a key priority. One of the tools for this has been the self-financing concept and programme announced in 2014 that, through the cooperation between the MNB, the Government Debt Management Agency (ÁKK) and the banks, has paved the way for renewing the maturing FX debt from forint and for achieving the above mentioned goals. Since Spring-2014, the Bank has been fostering this process by reforming its monetary policy instruments (conversion into deposits) and expanding it (introduction of interest rate swap tenders). This has enabled banks to hold a portion of their funds in long-term government securities instead of central bank deposits. In 2014 and the first quarter of 2015, as a result of the programme, banks' forint government securities holdings increased by more than HUF 900 billion, and the government repaid EUR 3.5 billion of external FX debt from forint funding, while increased demand from banks reduced government securities' market yields, especially at the longer-end of the yield curve, which reduced the financing cost of government debtas well as its FX share.

Foreign currency share of the central government debt (from 2012 to April 2015)



Therefore, the aims of the self-financing programme of 2014 have been fulfilled; however, the programme in its current form has reached its limits, because the banks' adjustment linked to the changes to the policy instruments has been completed. Continuing and strengthening the self-financing programme is still desirable, and this can be achieved through further changes to the monetary policy instruments. In the next, second phase of the self-financing programme, central bank measures will lead to another round of banks' adjustment.

The new central bank measures comprise the following:

1. From end-September 2015, the two-week central bank deposit will be replaced by a fixed-rate three-month deposit as the main policy instrument, and the latter will be available to banks without quantitative restrictions;
2. The MNB will restrict the availability of the two-week central bank deposit, and from the end-2015, banks may only hold a maximum of HUF 1,000 billion in this facility;
3. The MNB will continue with the central bank interest rate swap tenders, supporting banks in managing their interest rate risks and directing demand away from short-term government securities to longer-term ones.

As regards the impact of these measures, it is of particular importance that the MNB's Financial Stability Board will make a decision in the period ahead to increase banks' Liquidity Coverage Ratio (LCR) to 100 percent in 2016, as enabled by the international regulatory framework. Liquidity coverage requirements help ensure that in the short term (30 days), liquid assets of sufficient quantity and quality are available to banks in the case of a potential liquidity shock. According to international standards, the LCR which quantifies this, shall be raised to 100 per cent from 2018; however, the MNB would exercise Hungary's national discretion and do this two years earlier.

As a joint result of the above factors, banks will replace part of their central bank deposits with government securities. Since the maturity of the new policy instrument is longer than the 30 days taken into account by the LCR, extending the maturity of the key policy instrument is unfavourable for banks' compliance with the LCR requirement. Compliance with the LCR requirement, however, is compulsory; therefore banks will have to adjust, with effects on the purchase of government securities. Tightening of the regulation, besides the liquidity objectives, will have the effect of an even more intensified and robust adjustment, while the interest rate swap (IRS), suitable for managing interest rate risks, will facilitate banks' purchasing of longer-term government securities, more beneficial in terms of stability, instead of shorter term ones.

The three-month deposit facility shall become MNB's key policy instrument

Following the end-September 2015 scheduled rate-setting meeting, the base rate determined by MNB's Monetary Council shall mean the interest paid on the three-month instrument. The instrument shall be available to banks without quantitative restrictions, enabling it to function as a key policy instrument.

By extending the maturity of the key policy instrument, the liquidity profile of the sterilisation instruments relevant from a regulatory perspective can be significantly influenced, and thereby the desired bank adjustment can be achieved. In addition, extending the maturity of the sterilisation instrument can have several benefits for the economy:

- The extension of the maturity of the key policy instrument represents lower interest rate risk at the consolidated level (general government plus central bank)
- Due to the longer maturity of the sterilisation instrument, the risk of possible currency crises is reduced, since the banking system may be less able or willing to transmit speculation. This follows from the fact that domestic banks would require O/N credit in order to participate in speculation, which would represent additional costs, but speculation shall also be limited by the eligible collateral of banks.
- Due to banks' intention to achieve a maturity match, the maturity of liabilities of the banking system may be extended, which is beneficial from the perspective of financial stability.

The two-week deposit will become an instrument facilitating the banks's liquidity management

In addition to introducing the three-month key policy instrument, the two-week deposit shall remain part of MNB's instruments; however, substantial modifications are introduced as compared to the current situation:

- The MNB will apply a cap on the availability of this instrument,

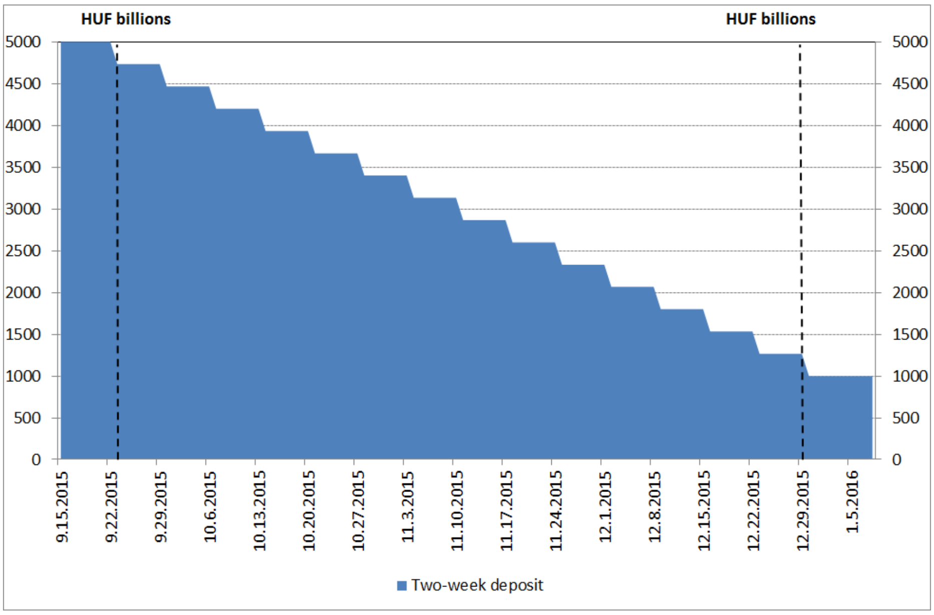
- The amount to be deposited by individual banks from the available total amount will be allocated on the basis of competitive auctions,

- The interest rate on this instrument is not fixed; the base rate shall only determine the interest rate ceiling, while the actual interest paid will be determined at the auctions, based on banks' demand, thus reflect market conditions.

The cap on the two-week MNB deposit is a strategically important parameter of the new measures. This target value (of HUF 1000 billion) was determined on the basis of the general government's financing plan and FX profile, sectoral developments in demand for government securities, as well as the specific features of banks' liquidity management. We have determined the target value of the two-week stock which shall, together with the regulatory liquidity requirements, support banks' demand for government securities, as well as ensure the seamless provisioning of banks' liquidity management.

Based on the financing scenarios examined and the extent of non-bank purchases of government securities, there is a need that banks purchase government securities at around HUF 1,000-1,500 billion in the course of 2015-2016 so that maturing FX loans can be renewedfrom forint fundinf both in 2015 and in 2016. Such a level of adjustment in banks' demand is expected to take place at two-week deposit holdings of around HUF 1,000 billion. This is also consistent with the fact that, based on last years' experience, at banking system level the two-week deposit holdings above HUF 1,000 billion were not active part of banks' liquidity management. In view of these factors the MNB decided to put a cap in place on the holdings of the two-week instrument at HUF 1,000 billion by the end of 2015, while the remaining liquidity shall be absorbed in other central bank instruments, primarily in the three-month deposit facility. Holdings of the two-week facility shall gradually reach in the course of three months the target value of HUF 1,000 billion by the end of 2015.

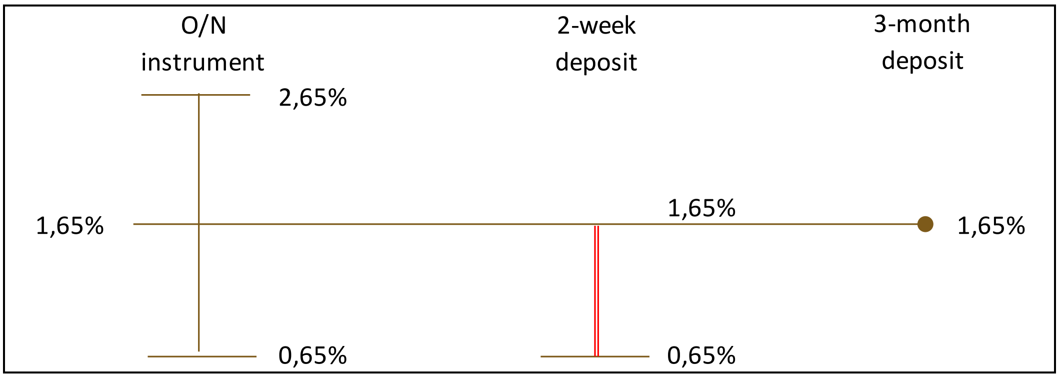
Decrease in the stock of two-week sterilisation instrument (illustration)



In the case of the two-week deposit facility, the MNB will apply an auction technique to ensure that banks exposed to higher volatility in liquidity will have access to the necessary instruments. The individual banks will receive an interest on their two-week deposit that corresponds to the interest rate in their bids submitted and accepted, i.e. the interest rate of the instrument will not be fixed: in the case of the two-week interest rate, the base rate is the upper limit, while the overnight (O/N) deposit rate, which is 100 basis points lower than that, is the lower limit.

Thus the yield of the two-week deposit can be lower than the policy rate, while the interest rate on the new policy instrument, i.e. the three-month deposit facility, will be exactly the base rate. In addition, the Bank can also use the available overnight interest corridor to influence market yields in an efficient manner in accordance with its monetary policy objectives.

Stylised illustration of the interest return on the MNB's monetary policy instruments (example at the current 1.65 per cent base rate)



Interest rate swaps remain the central bank instrument channelling the banks' funds

As a part of the self-financing programme, the MNB introduced the forint interest rate swap instrument (IRS) in June 2014, which allows easier management of banks' interest rate risks, i.e. it helps banks in exchanging shorter-term central bank deposits for longer (3-5-year) term government securities, while the increase in their interest rate risks remains at a moderate level. From June 2014 to May 2015, the MNB made IRS transactions with the banks of a total amount of HUF 456 billion to ensure that credit institutions increase their holdings of government securities at least by the same degree and in a sustained manner.

Similar to the first phase of the self-financing programme, the renewal of the sterilisation instrument encourages banks to purchase government securities, i.e. the MNB's IRS instrument will continue to play its "channeling role" in the reallocation of banks' funds.

Summary

The operational framework of the MNB established by these measures is novel, but its elements are not unprecedented in the world of central banks. For example, the Swiss National Bank or the People's Bank of China target an interest rate longer than the current Hungarian two-week policy interest rate, and the MNB has previously also applied 3-12 month instruments to absorb bank liquidity. There are also international examples for using more than one sterilisation instruments at the same time: absorbing the liquidity of the bank system by the central bank over several terms is common in emerging economies like Hungary, which are or used to be subject to high foreign capital inflows. The quantity restriction on the Bank's instruments is not exceptional, either: central banks, including the Danish and the Swiss central banks, impose quantity restrictions on their instruments absorbing banks' liquidity with more favourable conditions.

Due to the restructuring of the MNB's instruments and, as a result, the continuation of the self-financing programme, the size of banks' claims vis-a-vis the consolidated public sector does not change, only a portion of banks' funding will finance the general government rather than the central bank. As a result, the programme can be regarded as neutral for banks' lending activity.

Concluding the above, the conversion of the MNB's sterilisation instruments enables to continue the self-financing programme, to narrow the central bank's balance sheet and mitigate external vulnerability without negative effects. If the success of the self-financing programme continues, gross external debt can decrease significantly further, and foreign currency debt and the share of foreign investors in the financing of the public debt can continue to decline. The increased reliance on domestic funding and launching and implementing the second phase of the self-financing programme, is also supported by the favourable level of the MNB's foreign exchange reserve adequacy, which not only makes it desirable, but also feasible to reduce excess foreign exchange reserves, which represent a cost at whole-economy level.

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