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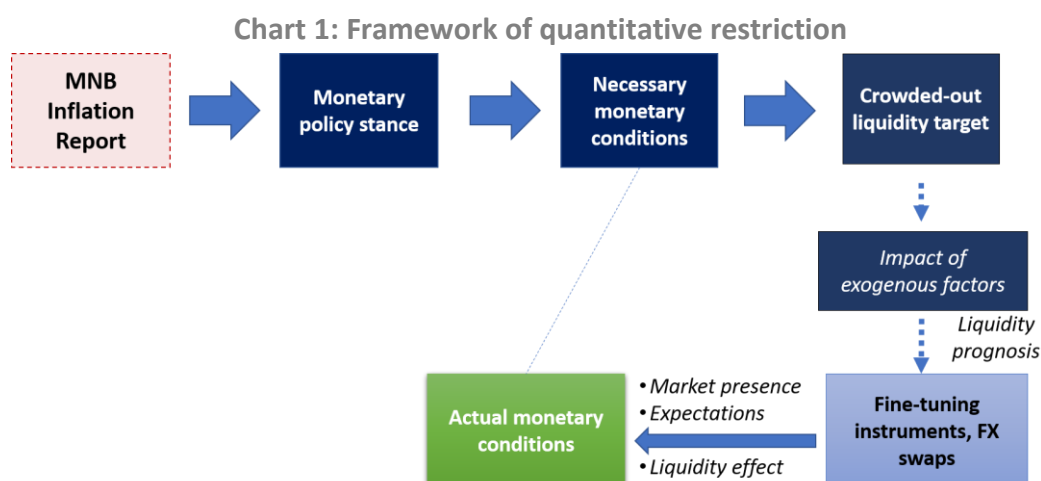
Current abundance of liquidity might melt away rapidly

Due to changes in the funding structure and an increase in budgetary expenditure at the end of 2019, the stock of overnight central bank deposits rose to over HUF 1,000 billion in January 2020. This entailed a more significant increase in liquidity than in recent months, materially exceeding the Monetary Council's quarterly target set at a minimum of HUF 300-500 billion. The MNB responded to this development by carefully reducing the stock of swaps. However, the current abundance of liquidity is projecting a false impression; looking ahead, significant changes might occur in banks' liquidity environment even over the short term. Maturities and repurchases of the Government's foreign currency bonds amounted to over HUF 850 billion in January and February and refinancing these, using the HUF, indirectly though, drains banking sector liquidity persistently. Meanwhile other items could have an expansionary effect on liquidity, in particular budgetary expenditure and the inflow of EU funds, but overall, all this means that the banking sector's current abundant liquidity might decline substantially even if the MNB's swap stock does not decrease. That should be taken into account in forecasting expected liquidity conditions.

The Magyar Nemzeti Bank (MNB) has introduced a monetary policy framework since 2016, in which developments in excess liquidity of the banking sector plays a key role, in addition to interest rate levels. The MNB's most crucial instrument in shaping liquidity developments is the stock of central bank swap, which attracts particular attention in the market. In recent weeks, the stock of overnight central bank deposits has increased substantially, with the Bank making extensive use of its swap instrument. Several analytic assessments have been published examining this phenomena. In reaction to this, in this note we aim to shed light again on the underlying features of the MNB's monetary policy framework, based on quantitative restriction, for the sake of clarity. We will also review currently expected developments in banking sector liquidity resulting from autonomous factors, which may help better understand central bank decisions and expected developments in the coming months.

The system of the quantitative limit

Under the current monetary policy framework in effect since the autumn of 2016, the Monetary Council makes decisions about the amount of liquidity to be crowded out of the main policy instrument on a quarterly basis. The MNB shapes monetary conditions to be achieved under the framework of the quantitative restriction (for a detailed description, see [this essay](#)). In short, the quantitative restriction means that the Bank diverts surplus liquidity in the banking sector towards the overnight deposit facility ('crowding-out effect') while also restricting the availability of instruments bearing interest at the base rate. As a result, short-term money market yields fluctuate within the interest rate corridor in line with the liquidity crowded-out. The amount of liquidity to be crowded out is set by the Monetary Council in line with the monetary policy stance on a quarterly basis, while taking into account the price stability objective to be achieved in accordance with the inflation projection (Chart 1).



Developments in banking sector liquidity are greatly affected by autonomous factors, independent of the MNB, in addition to central bank instruments, in particular money movements made by general government and changes in cash holdings. There are items in government expenditure and revenue with relatively well-predictable and quantifiable liquidity effects, e.g. VAT payments of significant liquidity effect, whose date and amount are known (VAT payments are a significant drain on liquidity in the second half of each month). By contrast, there might be government deficit and financing items which are much less predictable; however, they may cause considerable shifts in the liquidity path on a quarterly basis (e.g. unforeseen government expenditure items or government security issuance not planned ahead). In addition to the financial affairs of general government, changes in cash holdings, as an autonomous factor independent of the MNB's transactions, and the MNB's schemes and programmes affecting liquidity, e.g. the FGS *fix* or the Bond Funding for Growth Scheme, also influence banking sector liquidity developments. Basically, the drain and build-up of banking system liquidity is ceteris paribus accompanied by a fall or rise in liquidity crowded-out with the exception of targeted central bank schemes and programmes (FGS *fix* and BFG), as the MNB neutralises liquidity surplus resulting from them with a preferential deposit linked to the central bank base rate.

If the autonomous factors alter liquidity processes in a manner jeopardising the targeted amount of crowding-out set by the Council, the MNB offsets these effects by actively changing the stock of central bank swaps. The MNB introduced foreign exchange swaps providing forint liquidity in the autumn of 2016 to provide the minimum level of crowding-out and thereby to ensure the targeted monetary conditions, in the event of unexpected changes in the banking system liquidity, which are inconsistent with the monetary policy stance. In its press release, the Monetary Council states that (1) it takes into account the targeted amount of crowding-out in setting the stock of central bank swap instruments, and that (2) it is prepared to change the stock of the FX swap instruments in a flexible manner to ensure that the interest rate transmission changes in line with the decisions by the Monetary Council and the volatility of interbank rates remains at low levels. Therefore, under the current framework, changes in outstanding swaps cannot be interpreted in itself, from a monetary policy perspective. Changes in the stock of outstanding swaps can only be

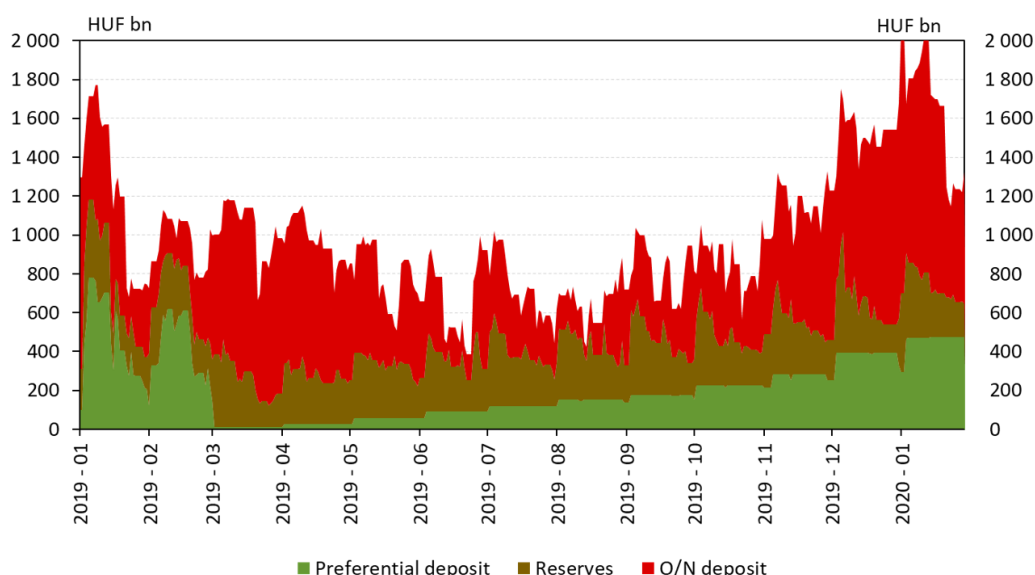
assessed based on the targeted amount of crowding-out and along with other liquidity developments.

Liquidity processes in the second half of 2019

In Spring-Summer 2019, there were material changes in the autonomous factors affecting liquidity flows, with an accompanying sharp increase in the Treasury Account balance. There were significant fluctuations in the autonomous factors influencing changes in banking sector liquidity, presented above, during the course of the year. Currency in circulation grew less strongly than in previous years, but nevertheless had a liquidity-draining effect. The Hungarian Government Security Plus (MÁP+) was launched successfully on 1 June, which led to a significant increase in the Single Treasury Account (KESZ) balance. Even in the first two weeks, sales amounted to nearly HUF 700 billion, and by January 2020 the value of securities holdings exceeded HUF 3,400 billion. The Government Debt Management Agency (GDMA) responded to the increase in the balance by repurchasing household holdings of securities accumulated at banks, curbing institutional issues, repurchasing foreign currency bonds before maturity and conducting repo transactions.

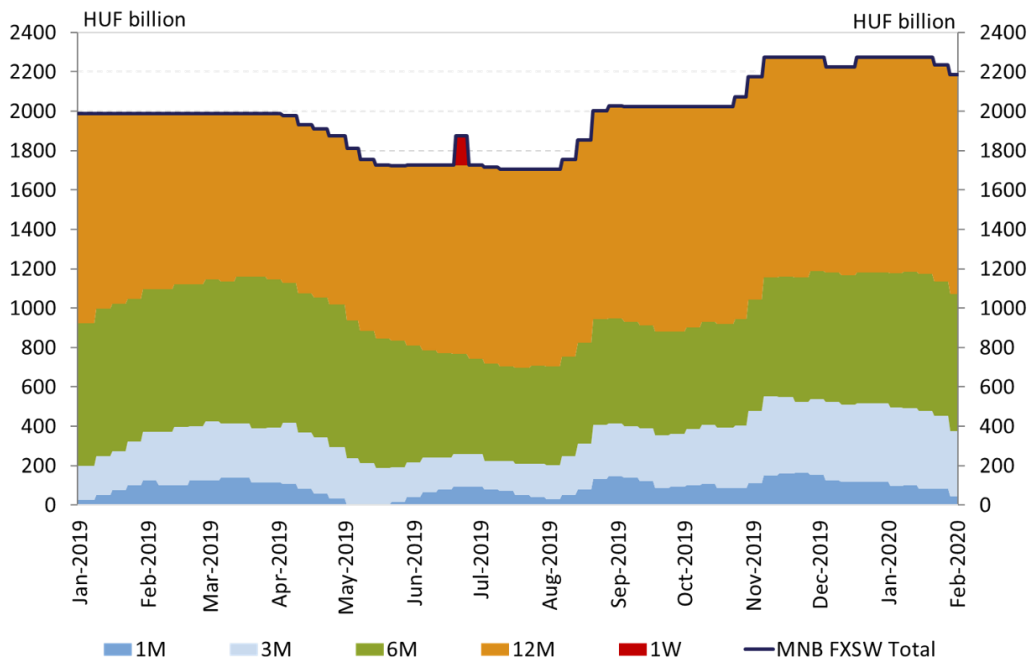
Towards the end of the year there was a reversal, with liquidity flowing back from the Treasury Account into the banking sector in the fourth quarter of last year, due to the Treasury adjustment and budgetary items. The KESZ fell sharply at the end of the year as a result of concentrated budgetary expenses and negative net issuances. In parallel with this, banking sector liquidity also rose markedly to exceed HUF 1,000 billion (Chart Chart 2). Although liquidity fell in the last third of January, this mainly reflected VAT and contribution payments in the month, and therefore it can be considered temporary.

Chart 2: Central bank instruments (2019-2020)



In line with past practice, the Bank influences its swap stock in order to achieve its quarterly target level by taking into account autonomous processes. Thus, the Bank responded to the abundance of liquidity by reducing the stock of outstanding swaps, in accordance with the rules of the operating framework in effect (Chart Chart 3).

Chart 3: Central bank FX swap outstanding (2019-2020)



Banking sector liquidity is likely to decline markedly in the coming weeks

In January-February 2020, maturities and repurchases of government securities are expected to amount to more than HUF 850 billion, the refinancing of which from HUFs will reduce banking sector liquidity. One US dollar-denominated bond issued by the GDMA matured at the end of January 2020, the HUF equivalent of which was nearly HUF 300 billion. In addition, the GDMA repurchased foreign currency bonds before maturity to the tune of another USD 1 billion at the end of January 2020, which amounted to another HUF 300 billion. Subsequently, at the end of February 2020 one eurodenominated bond will mature. As a result, the total value of bond maturities in the first two months of the year is likely to be more than HUF 850 billion. The Government will refinance maturities from HUF rather than foreign currency issuances, which is clearly a constructive and positive development, as the decrease in foreign debt further reduces external vulnerability. As HUF financing by the Government exceeds HUF maturities, repayments of foreign currency debt, on balance, contribute to a reduction in banking sector liquidity.

Table 1: Foreign currency bond maturities and repurchases by the GDMA

Day of redemption/buyback	Amount in FX originated	Amount in HUF
2020.01.29	964 million USD	295 billion forint
2020.01.31	1 000 million USD	306 billion forint
2020.02.24	798 million EUR	269 billion forint

Source: GDMA, expressed at 28 January 2020 official exchange rates. The GDMA conducts swaps to hedge cross exchange rates of US dollar bonds; the HUF amount necessary for redemption may differ from that calculated at current exchange rates.

Other autonomous processes, in particular budgetary expenses and receipts of EU transfers, may partly offset the effects of foreign currency bond items, but the reduction in banking sector liquidity may pick up further in the coming weeks and months. The GDMA issued HUF-denominated government securities exceeding the amounts matured in January 2020 by several hundreds of billions of HUF. Issues of the MÁP+, continuing at rates similar to last year's, and the successful auction of the first 20-year government bond had an important role in this. Therefore, the reduction in liquidity has already started, but it did not reach a level in January which would result from the repayment of HUF 600 billion of US dollar-denominated bonds. Based on the GDMA's financing plan, published in mid-January for February-March 2020, issues of HUF-denominated government securities to institutional investors in the next three months may amount to HUF 400 billion net, which looking forward will reduce liquidity by the same amount. Add to this above-plan issues to institutional investors and households. However, the Government may finance foreign currency bond maturities not only from HUF sources but, to a lesser degree, by reducing the Treasury Account balance or downsizing the state's foreign currency deposits, with the result that the direct liquidity impact might be smaller than the total amount of foreign currency bond maturities. In this case, it must be taken into account that a lower level of the KESZ may be associated with a more subdued repo activity by the GDMA, which, although indirectly, may also lead to a reduction in banking sector liquidity. Of course, there are items of the state or Treasury which by themselves contribute to an expansion in liquidity (government deficit, spending of EU funds, etc.), but these may play a smaller role compared with liquidity-draining processes. There is a significant forecasting uncertainty with regard the stock of currency in circulation which rose markedly last year; however, on the whole this item also can easily lead to a further reduction in liquidity in the coming months.

Summary

In view of the above, the current liquidity environment is misleading, as interbank liquidity may fall markedly even in the short term due mainly to HUF financing of foreign currency bond maturities and repurchases. The level of KESZ has stabilised above HUF 1,000 billion, and the banking sector has ample liquidity despite VAT payments: banks make almost full use of the preferential deposit facility, continue to comply with reserve requirements, while they hold a high amount of surplus liquidity in the O/N deposit facility. Nevertheless, taking into account items potentially having an expansionary effect, banking sector liquidity may still decline and remain at a persistently low level in the coming months, due to maturing foreign currency bonds and the foreign currency bond repurchases announced by the Ministry of Finance in mid-January.

The contraction in liquidity resulting from autonomous factors, i.e. non-central banking activities, should also be taken into account in forecasting liquidity conditions. In its previous communication, the MNB made it clear that in the operative framework applied, a change in the swap stock may not in itself considered as a guide from the perspective of the monetary policy stance, and that it can only be evaluated fully in conjunction with the crowding-out target and other liquidity effects. Separate assessment of changes in the swap stock can be especially misleading in periods when autonomous factors have a marked impact on banking sector liquidity.

As we are facing such a period due to the significant liquidity-draining effect of foreign currency items, the results of swap tenders and developments in the swap portfolio should only be evaluated in the light of these effects.