Márton Nagy – Barnabás Virág

The Bank's unconventional easing is a success

In July, the MNB indicated that it would limit banks' access to the three-month deposit facility, i.e. it intended to ease monetary conditions by using an unconventional instrument while maintaining the stability of the base rate. Although various doubting opinions were heard in connection with the efficiency of the measures, by now it has become obvious that the MNB's restructured monetary policy instruments have passed the exam, being able to achieve further substantial easing: since the announcement of the limitation in the summer, the three-month BUBOR has declined by 45 basis points to 0.57 per cent, the three-month discount Treasury bill yield by 47 basis points to close to 0.3 per cent and swap rates by 57 basis points to 0.55 per cent. At annual level, the fall in the BUBOR resulted in interest savings of around HUF 27 billion for domestic household and corporate borrowers. The limitation of banks' access has become part of the monetary policy instruments; the Monetary Council will decide on the limit to be applied at the end of Q1 2017 next in December.

The stability of the base rate supports long-term economic decisions by ensuring predictability and planning certainty, thereby anchoring expectations. As a result of the Bank's cautious and gradual easing cycles, the Hungarian policy rate declined by 610 basis points and reached a historical low of 0.9 per cent. By reducing the base rate further, the MNB would proceed increasingly towards an environment where the fundamental laws of economics and monetary policy may behave differently, i.e. unintended side effects may arise. The current level of the base rate lies on a more charted area for the Bank. Moreover, the stability of the base rate in itself is an important value, as a persistently unchanged interest rate level means greater predictability and better security of planning for market participants, thereby facilitating long-term economic decision-making. Bearing all this in mind, the Monetary Council does not endeavour to reach the lowest possible base rate attainable in the short run, but aims at a sufficiently low base rate level, whose continued maintenance, which may even last for years, facilitates the medium-term achievement of the inflation target. Therefore, the MNB may continue to maintain loose monetary policy conditions at least until the end of 2017, or even until 2018-2019. According to the latest surveys, market analysts expect continued maintenance of the current base rate and loose monetary conditions over the forecast horizon.

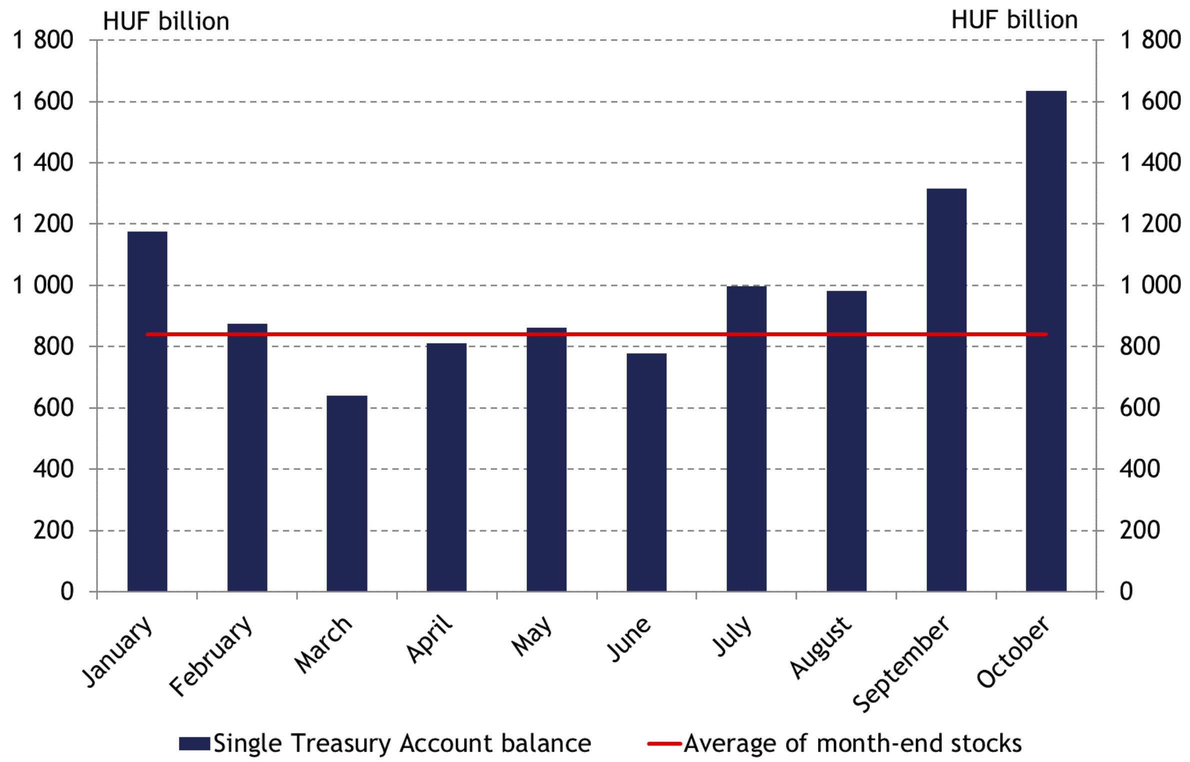
In the current situation, by stimulating liquidity flows in the banking sector, unconventional instruments are able to contribute more efficiently to the achievement of the MNB's objectives than a reduction in the base rate. In applying unconventional instruments, the MNB introduces incentives in the system, as a result of which the banking sector's excess liquidity flows – temporarily or permanently – into assets that are in line with the Bank's objectives and preferences. More efficiently than cutting the base rate, all this can contribute directly as well to the reduction in the vulnerability of the country by the moderation of risk premia, or to the expansion in lending and through that to the pick-up in economic growth. In this framework, an important incentive was increasing the asymmetry of the interest rate corridor, which was started in September 2015 and had an impact on banks' liquidity management practices: as a result of this step, financial institutions placed some of their excess liquidity in liquid securities with relatively high interest rate, eligible as collateral, and treated temporary liquidity shocks by making use of short-term central bank credit facilities. In line with the Bank's efforts, all this reduced the yields in the markets relevant in terms of monetary transmission, particularly in the government securities market. Assuming an unchanged level of the O/N deposit rate, a base rate cut would have reduced the asymmetry of the interest rate corridor, and thus this targeted easing impact as well. Together with that, a reduction in the base rate would also have moderated the attractiveness of the preferential deposits introduced within the framework of the Market-Based Lending Scheme in order to encourage lending, as the overnight deposit facility created for banks which are active lenders also pays the base rate.

With the base rate remaining unchanged, the MNB decided to limit the access to the three-month deposit facility in order to ease monetary conditions in a targeted way. Upon selecting the MNB's unconventional instruments applied to date, a key consideration was which (group of) instrument(s) is able to give the most efficient, targeted answer in order to solve the problem intended to be treated under the given conditions. Most recently the Monetary Council decided to introduce further unconventional instruments in order to achieve its current objective - the targeted easing of monetary conditions, with the base rate left unchanged. Namely, the MNB decided to limit the access to the three-month deposit facility. As a result of the crowded-out liquidity and the banking sector adjustment, a significant decline in yields may be achieved in the relevant financial markets, even with a stable base rate. Central bank steps will result in a decline in interbank rates, which may lead to a repricing of loans and an increase in credit demand, and thus the limitation may amplify the effect of the central bank instruments used to date to encourage lending. If banks re-channel crowded-out liquidity to the government securities market, the external vulnerability of the country decreases in accordance with the spirit of the Self-financing Programme, which also means a major improvement and progress for the whole economy. In addition, the ensuing decline in yields results in interest savings for the government budget.

The essence of the mode of action of the quantitative restriction on yields is that the liquidity that is crowded out of the three-month deposit 'is looking for its place' in the interbank market, and is placed in lower-interest central bank deposit, thereby having a downward pressure on yields. As a result of a quantitative restriction on the three-month deposit, liquidity crowded out flows into other assets. As a first step, liquidity appears in the interbank market, as due to the banking sector's system-wide excess liquidity, participants attempt to get rid of their excess liquidity, which has a reducing effect on interbank yields. Excess liquidity is spread unevenly within the banking sector; some banks, for example, have a shortage of liquidity, and thus the restructuring also facilitates the redistribution of liquidity across banks. Eventually, liquidity crowded out may flow through the interbank market into low-interest, overnight central bank deposits and to the government securities market, reducing yields in these market segments (interbank yields in the former case and government securities yields in the latter case).

The amount of liquidity actually crowded out is determined by the quantitative limit on the three-month deposit as well as by developments in the banking sector's overall liquidity in the given period. In September 2016, the MNB set a limit of HUF 900 billion on three-month deposit holdings at the end of December 2016, which, based on the information available at that time, meant that liquidity amounting to at least HUF 200-400 billion would be crowded out of the three-month central bank facility. However, liquidity actually crowded out greatly depends on developments in general government financing, the liquidity management operations of the Government Debt Management Agency (ÁKK), currency in circulation or banks' borrowing from the Bank. In the event that actual developments in liquidity deviate from the forecast used upon determining the quantitative limit, further measures may be needed in order to achieve the targeted amount of crowding out. In the case of persistent and major liquidity shocks, i.e. if – due to the developments in liquidity – the crowding out entailed by the quantitative limit set for the end of the quarter is different from the original plan, the Bank applies fine-tuning, liquidity absorbing deposit facilities and forint liquidity providing swap instruments, whose maturity is not more than three months.

Chart 1: End-of-month STA holdings

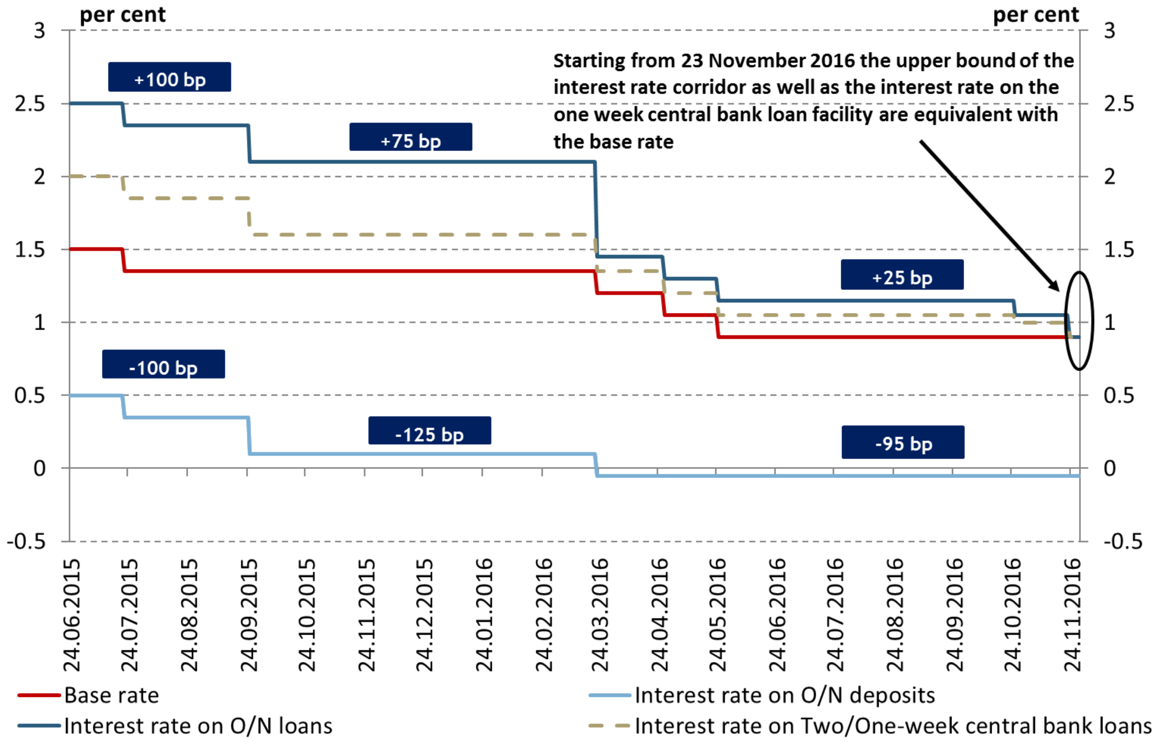


Source: MNB

Compared to earlier projections, the banking sector's liquidity declined significantly in October 2016, mainly as a result of favourable developments in the financing of general government, which necessitated the application of liquidity-providing swap instruments. Developments in general government financing were more favourable than expected before; demand at the government securities auctions was significant in the past period. It was also reflected in the fact that the balance on the Single Treasury Account (STA) held with the Bank increased by a further HUF 300 billion in October from the already high end-September level of around HUF 1,300 billion (Chart 1). Looking ahead, the lower-than-expected fiscal deficit and financing requirement of the government budget also point to a higher STA, further narrowing the banking sector's liquidity. As a result of the impact mechanism described above, lower-than-expected banking sector liquidity made it necessary to hold forint liquidity-providing swap tenders. The tenders held in October and November were successful; banks showed a two-threefold excess demand for the facility in four tenders. As a result of the tenders, the banking sector's liquidity expanded by HUF 350 billion, ensuring that the HUF 900 billion quantitative limit has the planned crowding-out effect in the last quarter as a whole, easing monetary conditions accordingly.

The crowding-out effect of the quantitative restriction may increase in the remaining part of the year; in addition to relevant markets, liquidity crowded out may appear in short-term central bank deposits. As the MNB sets a quarterly limit regarding the three-month deposit, both the developments in liquidity and the achievements should be evaluated over a quarterly time horizon. Nevertheless, the MNB's actions have already resulted in a major decline in yields in the interbank market and the government securities market. Three-month BUBOR and discount Treasury bill yields had started to fall already after the announcement in July, while the quantitative restriction started only at the end of October. The MNB held its first limited, three-month deposit tender on 26 October; HUF 100 billion was accepted of banks' offers amounting to HUF 314 billion. As expected, most of the liquidity crowded out in the first tender was spent by banks on the repayment of their central banks loans borrowed earlier, and therefore it appeared in the central bank deposits only partly. However, in the tender on 23 November the Bank accepted only HUF 400 billion of the offers amounting to nearly HUF 700 billion, which already means significant crowding out, in line with our preliminary expectations. Accordingly, the liquidity held in three-month central bank deposits declined to HUF 937 billion. All this also means that the Bank will accept an amount of HUF 400 billion at the December tender as well. Looking ahead, on the whole it is expected that, following the limited tender in December, the crowding out effect may be significant again, mainly as a result of high deposit maturities and developments in financing. This trend is also corroborated by the fact that, starting from the beginning of December, the MNB will reduce the required reserve ratio from 2 per cent to 1 per cent, as a result of which the banking sector's liquidity will expand by a further HUF 170 billion. Consequently, in addition to the interbank market, even more liquidity may appear in overnight central bank deposits, which may strengthen the yield reducing effect.

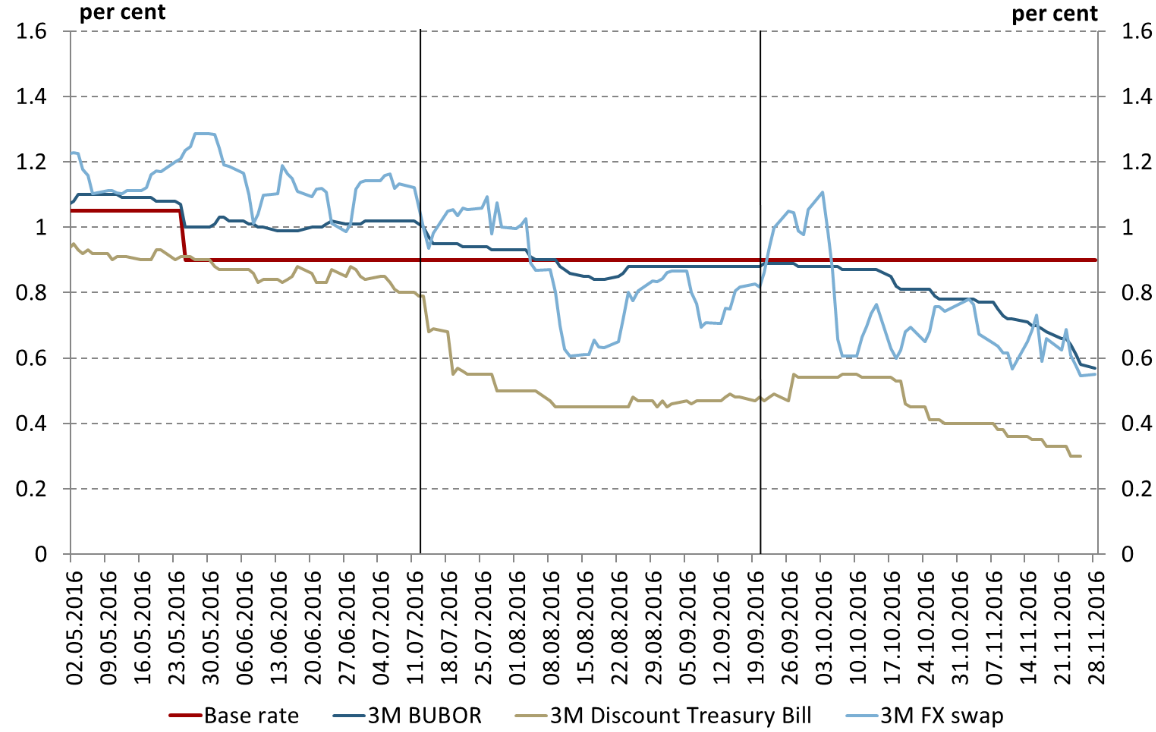
Chart 2: Changes in the central bank interest rate corridor



Source: MNB

In addition, the reduction in the upper bound of the interest rate corridor also contributed to the easing of monetary conditions. At its October and November meetings, the Monetary Council decided to narrow the interest rate corridor in order to achieve a further easing of monetary conditions. The overnight lending rate was reduced by 25 basis points to 0.90 per cent in two steps (Chart 2). In line with that, the interest rate on the one-week central bank loan facility declined by 20 basis points, also to 0.90 per cent. At the same time, the overnight deposit rate remained unchanged at -0.05 per cent. Consequently, since 23 November the interest rate on central bank collateralised loan facilities is the same as the interest rate on the three-month deposit facility. As a result of the steps, the asymmetry of the interest rate corridor increased further. Looking ahead, the reduction in the upper bound of the interest rate corridor will lead to a further easing of monetary conditions, and will contribute to lower volatility of short-term interbank yields.

Chart 3: The effects of the limitation of the three-month facility on the money market



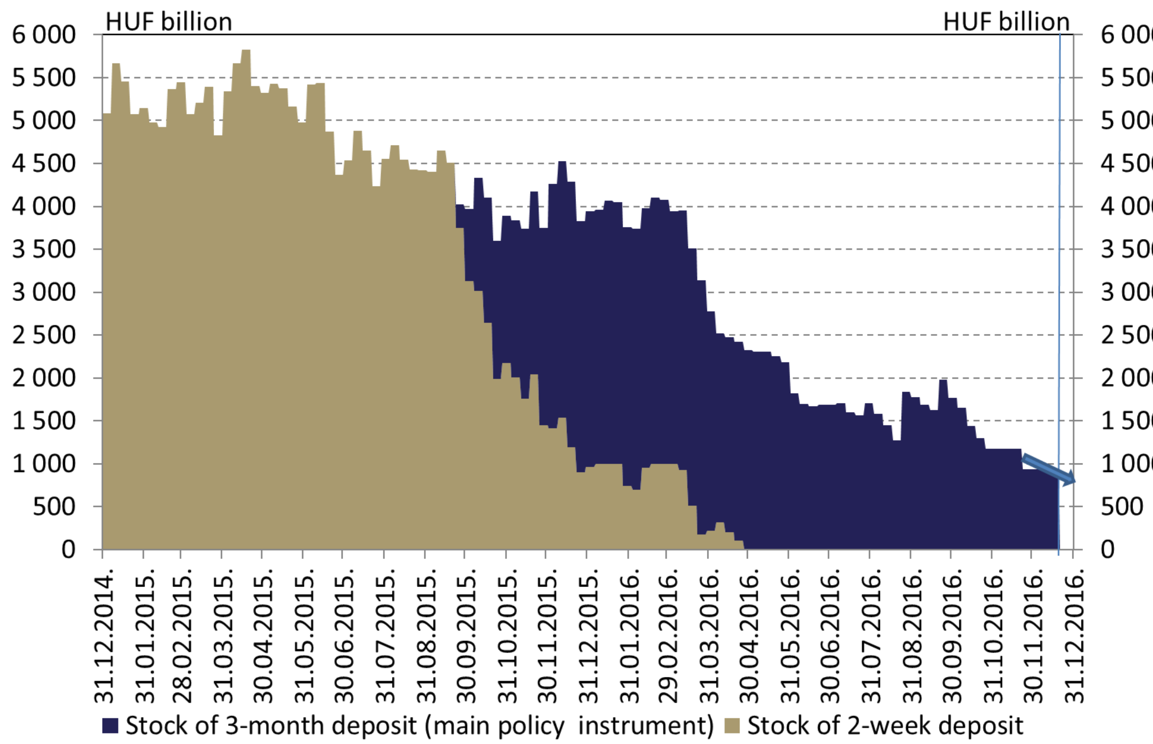
Note: the vertical lines indicate the dates of the announcements related to the limitation.

Sources: Bloomberg, MNB

As a result of changing the central bank instruments, yields declined by 45–55 basis points in the main markets. Following the announcement on 12 July about the limitation of banks' access to the three-month deposit, the yield on three-month discount treasury bills declined by 30–35 basis points to 0.45 per cent, while the three-month BUBOR fell from around 1 per cent to a level persistently below the base rate (Chart 3). Following the first limited tender in October and the next one in November, a further decline is yields took place. As a result, discount Treasury bill yields fell further by 15 basis points to nearly 0.3 per cent, while the three-month BUBOR and FX swap yields fell well below the base rate, to 0.57 and 0.55 per cent, respectively. Overall, the three-month BUBOR declined by 45 basis points, while the three-month discount Treasury bill and swap yields decreased by some 47–57 basis points.

At an annual level, the fall in BUBOR yields resulted in interest savings of HUF 27 billion for domestic household and corporate borrowers. Outstanding loans and interest rate derivative transactions amounting to nearly HUF 30,000 billion, roughly corresponding to the value of Hungary's annual GDP, was priced on the basis of BUBOR in 2015. Of this, the pricing of loans amounting to more than HUF 6,100 billion depended on BUBOR, mainly due to the conversion of households' FX loans. About half of outstanding lending is tied to maximum one-month BUBOR, while the other half is tied to BUBOR with a maturity over one month. Accordingly, at annual level, the around 45 basis point decline in interbank rates that has taken place since the MNB's announcement on 12 July will result in a decrease in interest expenditures of some HUF 27 billion for domestic household and corporate borrowers. Approximately two-thirds of outstanding lending priced on the basis of BUBOR, i.e. HUF 3,800 billion, is related to households. In the case of the household sector, as a result of the decline in BUBOR rates, instalment may decrease by 2.3 per cent, while interest payment may fall by 8.4 per cent, equalling some HUF 1.4 billion lower interest payment on a monthly basis.

Chart 4: Changes in the central bank deposit facility



Source: MNB

The quantitative limit on the three-month deposit has become an integral part of the central bank instruments. Accordingly, the MNB may support the achievement of central bank objectives using unconventional measures in the future as well, while keeping the base rate at an unchanged level. The Monetary Council has announced that, if economic developments are in line with the forecast, '(...) maintaining the current level of the base rate for an extended period and the loosening of monetary conditions by the change in the monetary policy instruments are consistent with the medium-term achievement of the inflation target and a corresponding degree of support to the economy'. This also means that the Monetary Council considers the limit on the three-month deposit stock and its potential future change an integral part of monetary policy instruments. Forward guidance of the announcement following the interest rate decision indicated in September and also in October that, if economic developments justify it, the Monetary Council may increase the amount of liquidity crowded out by using unconventional instruments, including a stronger restriction on access to the three-month deposit, thereby easing monetary conditions further. The Monetary Council will decide on the limit to be applied at the end of Q1 2017 on 20 December.