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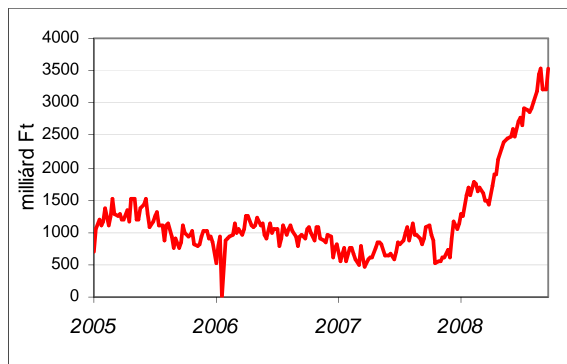
Should we be channelling funds out of NBH two-week bonds?

"The National Bank of Hungary (NBH) has a massive portfolio of two-week bonds. The funds need to be channelled out of these at long last", goes the policy proposal I have been hearing from a number of experienced, old hands. By who? Where to? Why?

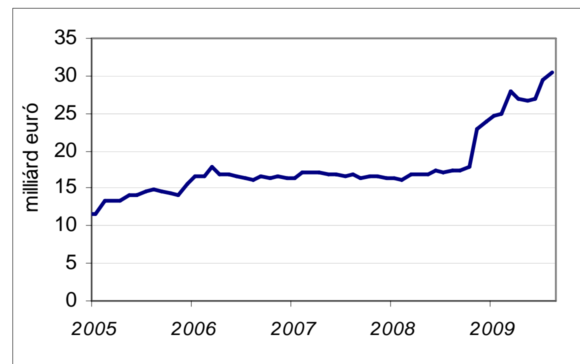
It is true that the volume of NBH two-week bonds, which serves as a sort of forint-based "sterilised intervention" portfolio in the Hungarian money market, has grown explosively over the recent period. The reason for this is similar to the justification for crawling-peg devaluation way back when: we are witnessing a net influx of capital as the IMF loans are being drawn down at a rate that far exceeds the extent by which other sources of FDI have slowed, essentially as a pre-emptive response to the fact that private capital influx will remain sporadic for a while. The NBH, just as it did 10 years ago, is engaging in a form of sterilised intervention by converting the IMF assistance (foreign currency) into forint, in other words using it to increase reserves, and the forints thus "created" are unavoidably leading to growth in the central bank's liabilities.

The NBH's two-week bond portfolio



Source: National Bank of Hungary

International reserves



Source: National Bank of Hungary

The path taken by the forints generated at the NBH (on this occasion not into euro, but into two-week bonds) is as follows. As a result of the temporary sharp decline in government securities issues, and the repurchase of bonds already in circulation, a vast amount of cash has accumulated in the banking system. Some of the government securities were bought back from banks, of course. However, even the cash hoarded together by institutional investors has ended up at the banks. The migration of household savings from investment funds to bank deposits is also less of a cause than a side-effect of the general decline in the overall volume of forint securities accompanied by growth in forint liquidity. The banking system is a willing

accomplice in all this, and has even given the process an extra boost in the form of promotional interest rates on deposits, since it fits in with the banks' current "strategy", which places achieving a reduction in the loan-to-deposits ratio above all else. Although this train of thought began with the drawdown of IMF assistance, in reality it was a diverse combination of requirements – the need to offload forint government securities (directly or through the investment funds), to reduce the loan-to-deposit ratio, to increase reserves and close certain forint positions – that made the IMF loan necessary in the first place. In other words, these factors cannot be regarded as additional reasons for the generation of the extra liquidity.

Of the measures implemented recently, only the reduction in the mandatory reserve rate generated any extra forint funds for the banking system; and these also ended up in the two-week bond portfolio.

So, goes the argument, all this forint liquidity has been accumulated and it's expensive for it to just be sitting there, as it means we're paying high interest on a large portfolio. And it's not even as if the money was being put to work – there are no forint loans, no demand in the economy. "Let's channel it out of there."

The situation is that if any of it could be channelled out, it would, but there isn't anywhere for it to go. Every since the latest spate of interest-cutting began, the banking system has been seeking sanctuary in longer-term instruments. Just take a look at how popular the 3-year fixed-rate bonds issued by the Student Loans Centre have become, and they didn't even have to be advertised. It would only exacerbate the situation if the NBH were to limit the volume of two-week bonds available for issue, or reduce the interest (widening the overnight corridor, etc.), as some are recommending. Any "channelling" operation would be successful, but pointless: it would be possible to channel the surplus liquidity from the two-week bonds right into overnight deposits, in the process of which the "channelled" volume of forints, looking for somewhere to go, would push down money-market interest rates and weaken the forint's exchange rate. It's possible that forint lending would pick up on the back of the lower money-market interest, although this is at least as dependent on the banks' conduct and willingness to assume risks as on anything else. One thing is certain, the volume of two-week bonds is neither a cause nor an effect in this process. The portfolio wouldn't shrink as the result of growth in forint lending, since the loan taken out by a company or household becomes the borrower's own deposit at the moment of disbursement, and once it has been spent it becomes someone else's deposit; but it never disappears from the system. The one exception to this is if the NBH responded to the weakening exchange rate by introducing foreign currency to the market, thereby siphoning off and eliminating the "channelled-out" forints. All of this, however, could also be performed without the imposition of quantitative measures and restrictions. Indeed, at the moment this appears to be the most likely scenario – the NBH cuts the base interest rate and reinforces expectations of additional reductions; and in the event of a more dramatic weakening the most it would do is to intervene, and buy forint in the open market.

The other realistic scenario for a reduction in the two-week portfolio would be if the state treasury were to issue several government securities to market players seeking refuge from the declining interest rates. At present, however, such securities are already available. In

principle, the volume of relatively short-term forint government bonds (one-year discount treasury bond, three-year bond) could be raised, with the result that the liquidity that currently swells the two-week bond portfolio would be passed on to the state. However, the state doesn't need it either, since although it makes little to the system as a whole, for the treasury it is by no means irrelevant whether it keeps the forint funds at the NBH, or the banking system keeps it invested in two-week bonds. Firstly, the interest expenditure arising from the "sterilisation" portfolio is recorded among fiscal expenses at a later juncture than the interest paid on bonds and discount T-bills. Secondly, the issued bonds increase the state's gross debt, even if the counter-value of the government bonds is not actually spent. Thus, the treasury has no reason to increase the volume of short-term bond issues either.

Having said that, the NBH could do something to satisfy the strong demand for short-term instruments, by putting the 2-3-year bonds that it purchased six months ago back on the market. The volume of government securities held by the NBH is by no means insignificant, at more than HUF 300 billion. In the interests of market neutrality the sale of HUF 200 billion in 2-3-year notes could be counterbalanced by the risk-weighted purchase of longer-term securities, thus reducing the two-week bond portfolio by HUF 100 billion. Another reason it would be necessary to purchase long-term securities is to ensure that by selling the shorter-term bonds NBH doesn't (even unintentionally) send out a message to the market that the interest cycle is coming to an end. Indeed, if possible it should support long-term sustainability without raising its interest exposure.

However, we should not lose sight of the fact that although, in my opinion, such a move would be beneficial in terms of alleviating the surplus liquidity and the resulting money-market pressure; the loosening of monetary conditions could also continue without it, simply through a reduction in the base rate in the usual manner, pretty much regardless of the size of the two-week bond portfolio.

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