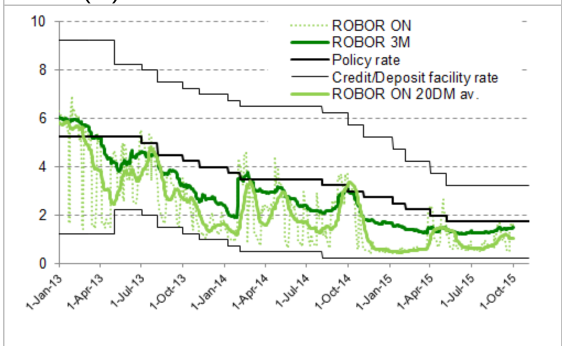
MONETARY POLICY COMMENT

1 October 2015

As expected, the NBR held rates at 1.75%, with a dovish tone

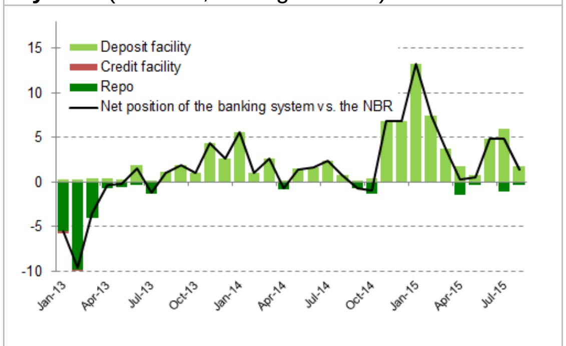
- **The Board of the National Bank of Romania kept the monetary policy rate at 1.75%** on Wednesday, and the **minimum reserve requirement (MRR) ratios were left unchanged** as well, at 8% for RON and 14% for FX liabilities. The decision to keep the benchmark interest rate at the previous level came as no surprise, after all of the analysts surveyed by Reuters expected the same and it was in line with our call too.
- Overall, **the messages of the NBR's press release and the governor's conference seemed to be more dovish**, compared to the comments of CB officials before the re-negotiation of new Fiscal Code. **Nevertheless, the NBR is still wary about fiscal issues**, underscoring the dependency of its policy on developments from the budgetary area: "*the macroeconomic policy mix is conditional on the manner in which the recently approved or announced fiscal and budgetary measures (the new Tax Code and pay rises) will be transposed into the 2016 budget configuration and execution*". Furthermore, CB chief Isarescu said at his yesterday's conference that a new agreement with the country's international partners would be welcome. At the same time, he also pointed out the importance of prudent public finances and the continuation of structural reforms.
- In our view, **if the budget-related developments and their impacts on the economy will be well managed, the NBR may aim to maintain the loose monetary conditions via several MRR reductions**, rather than through a new policy rate cutting cycle. The CB could choose the former option in order to avoid a too steep policy rate path in later periods. It may be worth noting that the main factors that led the inflation rate to fall deep into the negative territory, such as the VAT cuts and the plunge in oil prices, have transitory effects and should fade out over time. Nevertheless, domestic demand seems to be already quite healthy, hence it may put some upside pressure on consumer prices over the medium term. Our forecast shows that the headline inflation rate could reach the NBR's target of 2.5% (+/-1%) in January 2017.
- Nonetheless, **if both external and internal conditions will be especially permissive** (much looser than previously thought monetary conditions in the eurozone and in the CEE region, as well as there will be negligible consumption-driven inflationary pressures and build-up of macroeconomic imbalances), **an additional 25 bps policy rate cut in 2016 cannot be ruled out**. On the other hand, we see relatively slim chance for such a scenario at this moment.
- **The intended reductions of the MRR ratios may be implemented over a two-year horizon**, according to the governor's estimation, in order to reach reserve levels consistent with those in other European countries. In the light of the recent comments about the postponement of the eurozone accession's target (2019 is no longer feasible, as stated by NBR chief Isarescu yesterday, while NBR Board member Bogdan Olteanu also said earlier that 2022-2023 would be an appropriate objective), we suspect that this two-year period is open at the long end.
- At the same time, we revised our baseline expectation over the policy rate's path. Earlier we presumed that Romania's central bank could start to raise interest rates already in 2016. But taking into account the recent turmoil on global markets, triggered by growth fears and the expectations that accommodative monetary policies should stay longer in the eurozone, we think that **the first rate hike may take place later, namely in the beginning of 2017**. Summing it up, **this translates into the continuation of relaxed monetary conditions on the domestic front**.
- Interbank money market rates climbed somewhat higher in the latest period (see Chart 1), as the liquidity position of the banking system deteriorated (see Chart 2), but it may improve especially in the last two months of the year, because of larger government spending. **In 2016, we expect slightly higher MM rates on average**, as 2017's rate hikes are getting closer, while **the RON could firm to 4.35 compared to the EUR until the end of next year**, based on the country's bright economic outlook and attractive real interest rates.

Chart 1: Policy rates and interbank MM rates (%)



Sources: NBR, OTP Research

Chart 2: Liquidity position of the banking system (RON bn, average values)



Sources: NBR, OTP Research

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