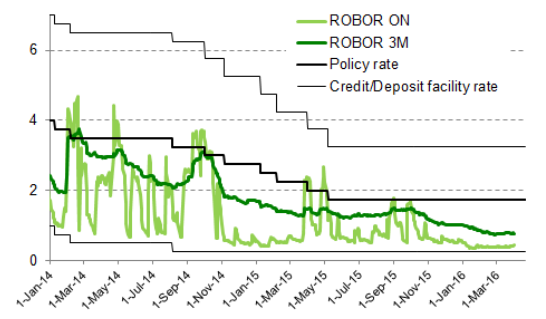
MONETARY POLICY COMMENT

1 April 2016

On hold, as expected, interest rate corridor could be narrowed in H2. On the middle run rate hikes, appreciating and more volatile RON could be in the pipeline.

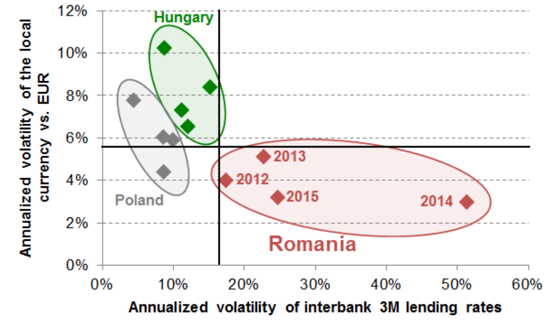
- **The National Bank of Romania remained on hold, keeping the main monetary policy instruments unchanged** on its Thursday's Board meeting. Accordingly, the key rate was left at 1.75%, as it was anticipated unanimously by analysts. The decision had no significant impact on financial markets yesterday.
- **Romania's central bank faces a more complex situation, stemming from divergent trends in the domestic and the global environment:**
  - **Overall monetary conditions are looser than previously predicted on the external front**, as significant uncertainties about the outlook of global economic growth persist and inflation seems to be quite sluggish. Accordingly, the ECB announced further easing actions in the beginning of March and the US Federal Reserve is also more cautious about raising interest rates. Meanwhile, newer loosening measures were implemented in the CEE region too.
  - **Nevertheless, domestic factors and perspectives indicate that policy normalisation measures should come** sooner or later, as the fiscal policy turned strongly expansionary in recent quarters, after a long period of budgetary adjustments and consolidation, with the risk of further populist measures in the light of this year's elections. In addition, real wages started to show growth rates as high as in 2008 on the back of minimum wage hikes and the tightening labour market, while these gains in wages were not offset by significant improvements in productivity. As a result of rapidly increasing real disposable incomes, coupled with strengthening lending activity, households' consumption accelerated further, pointing to a 7.6% YoY advance in Q4 2015. Indeed, the annual inflation rate hit a new historical low in February, surprising analysts (-2.7% YoY vs. market consensus of -2.3% YoY), but the movement was due to several one-off effects, with little impact on the underlying processes. It may worth to note too, that excluding tax changes, Romania would have shown the highest increase of consumer prices in the CEE region.
- As we suggested already, **the NBR may favour an interest rate environment that gradually becomes more stable and predictable**, after the volume of RON denominated loans started to outweigh that of FX credits'. On his yesterday's press conference, **this process was named by NBR Chief as a "*recalibration of monetary policy*" toward a "*fully fledged inflation targeting*"**. We recall that Romania's CB is following at the moment a managed float policy which puts somewhat more weigh on FX stability and lets MM rates to show higher volatility (see Chart 2). In this way, external and internal shocks can be managed with more flexibility. **Taking into account the expected change of the policy regime, we presume that the gap between the interbank MM rates and the policy rate should gradually decrease in the next quarters**. **According to Mr Isarescu's guidance, the corridor (see Chart 1) could be narrowed by 0.5% in the first step, which translates to a 25 bps rise of the deposit facility rate**, and a 25 bps decrease in the case of the interest rate on the credit facility. About the timing of these actions no details were revealed yesterday, but hints may come at the next Board meeting, scheduled for 5 May, when the new Inflation Report will be discussed as well.
- **We deem that the narrowing of the corridor may take place in the second half of 2016 or even in the middle of the year**, and similarly to our previous report, we expect that these measures will be followed by key rate hikes next year due to higher inflation outlook.
- Considering the extra loose monetary conditions in Europe, a tightening policy may trigger some currency appreciation, which would be undesired, given the already widening trend of the current account deficit. Moreover, too rapidly increasing money market rates would also undermine to some extent the long-awaited switching process between FX and RON-denominated loans. Hence, **we suspect that the central bank will be cautious in altering of its policy in the near future, but on the middle run modest appreciation of the RON, coupled with larger volatility still could come.**

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



Sources: NBR, OTP Research

Chart 2: Volatility of FX and money market rates in the CEE region (2012-2015)



Sources: NBR, Reuters, OTP Research

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