REPORT ON INFLATION

13 April 2016

Romania's annual inflation hit a new historical low at -3.0% in March, but underlying price dynamics remained broadly unchanged.

- **Following February's 2.7% YoY decline, consumer prices fell by 3.0% YoY in March, diving even deeper into negative territory** (see Chart 2). This was the third consecutive month when the annual inflation inched lower and **as a result, it reached a fresh historical low**. Meanwhile, the CPI increased slightly compared to February, by 0.1% MoM (see Chart 1), first of all helped by rising fuel prices at the petrol pumps (+1.3% MoM), after getting a boost from the rebound of crude oil futures. The recent data, released on Monday by the National Institute of Statistics matched our forecast and mostly was in line with the market consensus (Reuters: -3.0%, Bloomberg: -2.8%).
- In retrospect, we see that **the annual inflation marked a sharp downturn at the beginning of 2016**, after it ended last year at -0.9%**. The primary reason behind this rapidly falling shape was the implementation of the reduced value added tax**. The standard VAT rate, which is applied to the majority of services, non-food products, as well as alcoholic beverages, covering around two-thirds of the CPI basket, was diminished starting from 1 January by four percentage points, to 20%. In addition, the earlier food VAT reduction from 24% to 9% still weighs on the headline figure. **Under such conditions, the focus should be on the tax adjusted price developments. Our in-house estimation indicates that the headline inflation, filtered from VAT changes diverged from the NBR's target (2.5% +/- 1%) in March, slipping slightly below the 1.5% lower limit of the variation band**, **after staying relatively close to 2% at the end of last year. Nevertheless, the underlying price dynamics showed a roughly flat evolution in the same period**, with our *filtered indicator*[1], pointing to a 1.3% YoY increase last month (Chart 3). In addition, we deem that the NBR's preferred adjusted CORE2 inflation would have been also relatively little-changed since the end of last year, after eliminating the negative impact of tax modifications. Of course, this view is subject to some modelling uncertainty.
- **The bulk of the divergence between the evolution of the headline and the core inflation measures came from the prices of seasonal unprocessed foods**, which cover mostly vegetables and fruits, and also from the negative dynamics in the case of eggs (Chart 5). To a lesser extent, the slowing administrated prices also left their mark on the headline figure.
- Turning back to the underlying processes, **we saw that the filtered inflation was stable, but still at a quite low level**, with its main components moving in different directions, as the increase in the case of processed foods (Chart 6) was offset by the weakening growth at goods (Chart 7) and market services, excluding telephone charges (Chart 8). Nonetheless, it is worth mentioning that **while commodity, energy as well as import prices remained sluggish, domestic factors continued to signal the building up of inflationary pressures**. We recall that the output gap is expected to turn positive in the middle of the year (Chart 9), while the growth pace of real wages reached levels similar to 2008 (Chart 10), with newer hikes in the pipeline. The rapidly advancing domestic demand coupled with the pressures coming from the latest wage-setting patterns, which ignores the limited gains in productivity, should put the underlying price dynamics on an upward trend in the second half of the year. Meanwhile, most recent data reveal that price expectations seemingly started to bottom out (Chart 11). Accordingly, we foresee that **the headline inflation could rise to 1.3% YoY at the end of 2016**, also helped by the fading base effect of foods' VAT reduction, **with the perspective of further acceleration next year.**
- In our opinion, **despite the record low level of inflation, March statistics do not change significantly the big picture. As a result, we continue to expect several rate hikes in 2017**, as we noted in our previous monetary policy comment.
- As a final thought, it also may be worth noting that reviving consumption is not only a Romanian feature; the other countries of the CEE region also give signs of a healthy recovery. Meanwhile, wages mark a more general accelerating trend, when unemployment rates are already at relatively low levels. These factors coupled with a potential turnaround in commodity prices, if they appear simultaneously, could trigger a higher than currently anticipated inflation path across the whole CEE region. Nonetheless, these risks may come into focus later, sometime in 2017.

[1]Filtered inflation is an in-house measure of underlying inflation dynamics. It excludes unprocessed food, fuels, administered as well as beverage and tobacco prices, filtering out the first-round impact of indirect tax changes. Moreover, it eliminates certain other items too, such as telephone charges and car prices, as these are strongly connected to the EUR/RON exchange rate.

Headquarter Treasury Sales

Alexandru Tibuleac
+40372 31 85 85
alexandru.tibuleac@otpbank.ro

Cristian Ilie
+40372 31 85 86
ilie.cristian@otpbank.ro

Corina Bejan
+40372 31 85 84
corina.bejan@otpbank.ro

Alina Gheorghita
+40372 31 85 83
alina.gheorghita@otpbank.ro

Andreea Nica
+40755 000 106
andreea.nica@otpbank.ro

Regional Treasury Sales

Szilamer Kozma - Cluj
+40755 000 400
szilamer.kozma@otpbank.ro

Tudor Zaman - Bucuresti
+40755 000 199
tudor.zaman@otpbank.ro

Laura Sirbu - Bucuresti
+40729 963 540
laura.sirbu@otpbank.ro

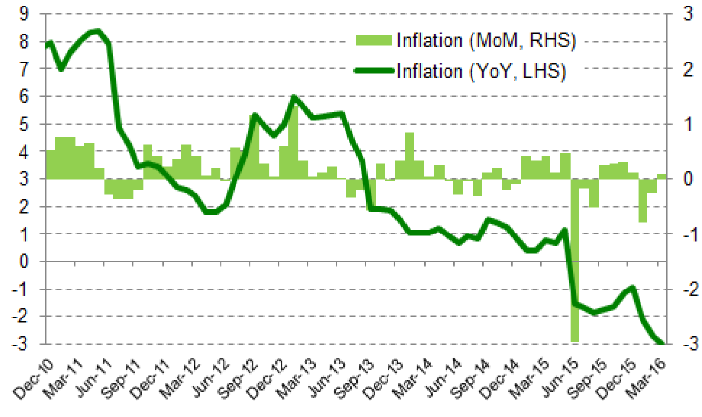
Alexandru Sabin - Arad
+40730 577 959
alexandru.sabin@otpbank.ro

Chief Economist
Gergely Tardos
+36 1 374 7273
tardosg@otpbank.hu

Analyst
Csaba Bálint
+4021 307 58 96
csaba.balint@otpbank.ro

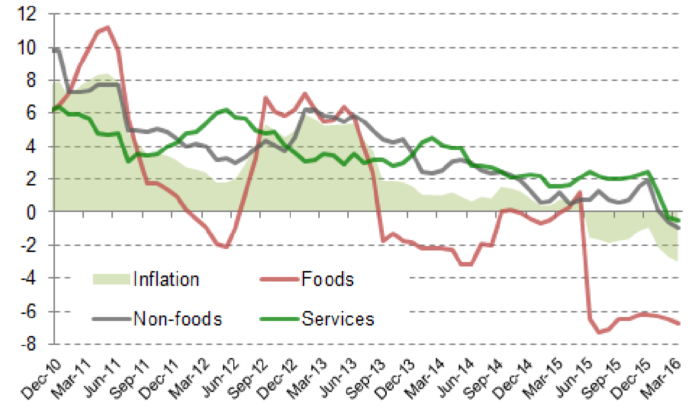
Chart set:

Chart 1: Headline inflation
(%, NSA data)



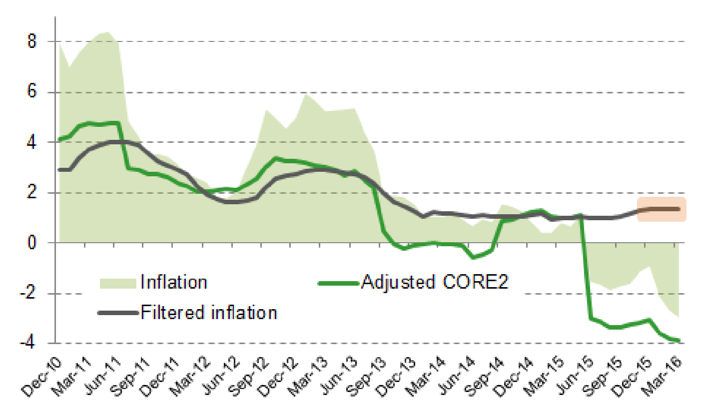
Sources: NIS, OTP Research

Chart 2: Inflation by its main components
(YoY%, NSA data)



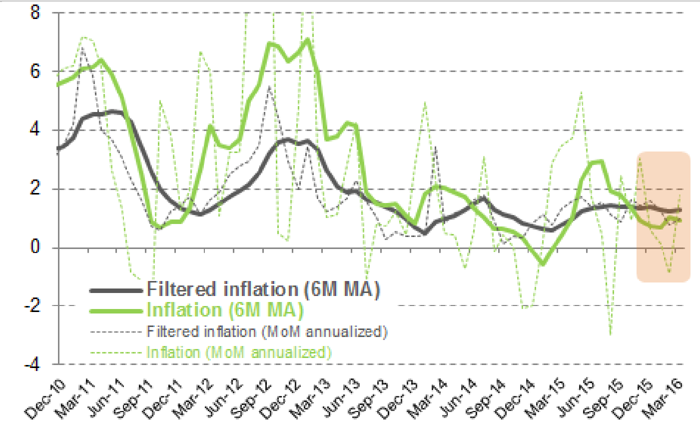
Sources: NIS, OTP Research
Note: in line with the National Institute of Statistics' (NIS) general segmentation.

Chart 3: Headline inflation and underlying processes (YoY%)



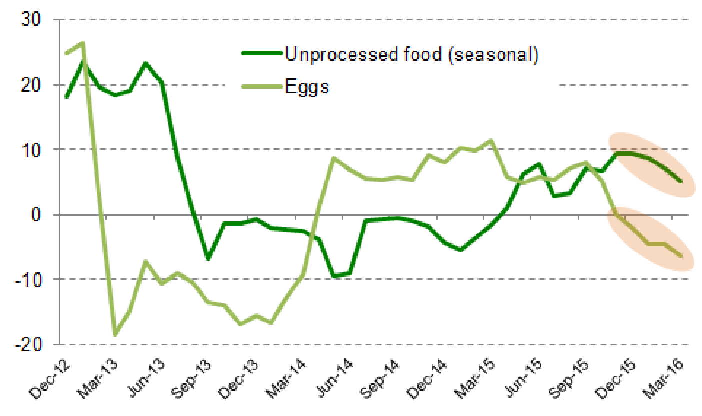
Sources: NIS, OTP Research
Note: ***Adjusted CORE2 =****inflation excluding VFE (vegetables, fruits, eggs), fuels, regulated as well as beverages and tobacco prices;*
Filtered inflation = *in-house underlying inflationary measure (SA).*

Chart 4: Headline inflation and filtered inflation
(%, SA)



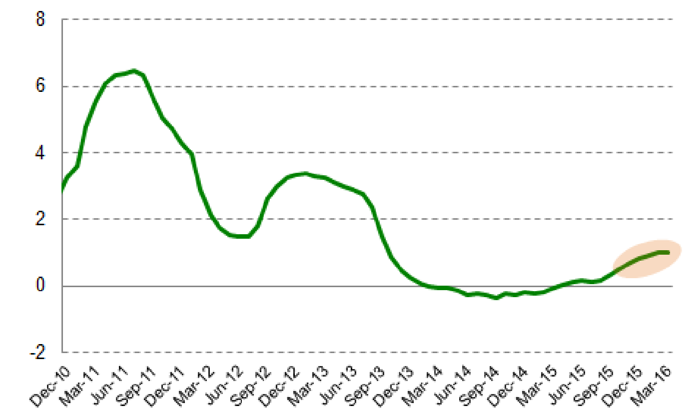
Sources: NIS, OTP Research
Note: the headline inflation is also filtered from indirect tax changes.

Chart 5: Prices of seasonal unprocessed foods and eggs (SA, YoY %)



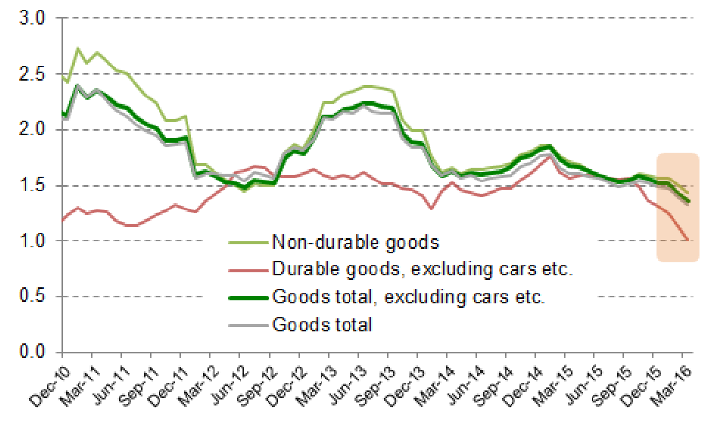
Sources: NIS, OTP Research
Note: filtered from VAT changes.

Chart 6: Processed food prices
(YoY%, SA)



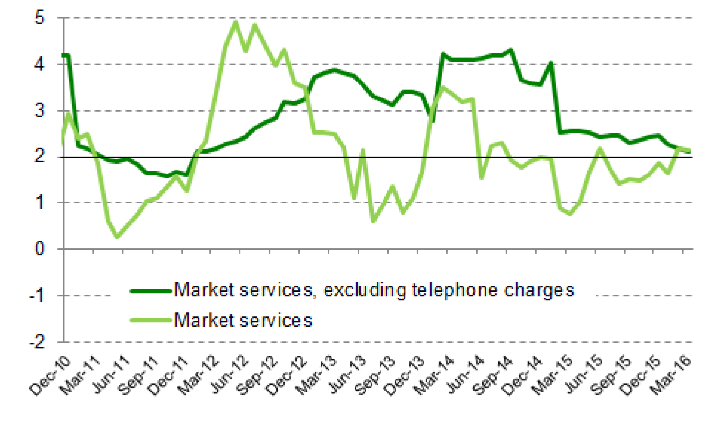
Sources: NIS, OTP Research
Note: filtered from VAT changes.

Chart 7: Goods' inflation
(SA, YoY%)



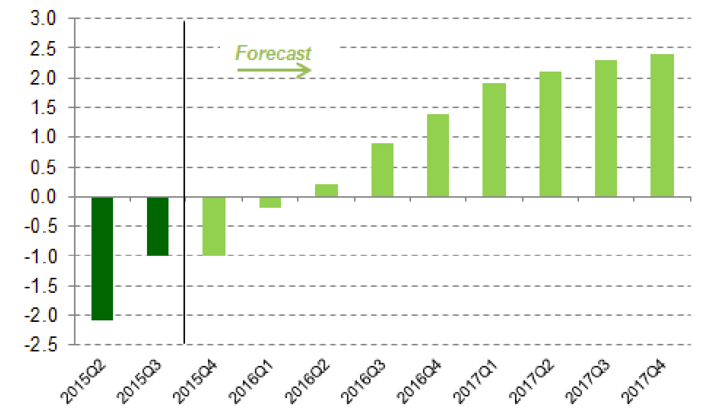
Sources: NIS, OTP Research
Note: filtered from VAT changes.

Chart 8: Market services
(SA, YoY%)



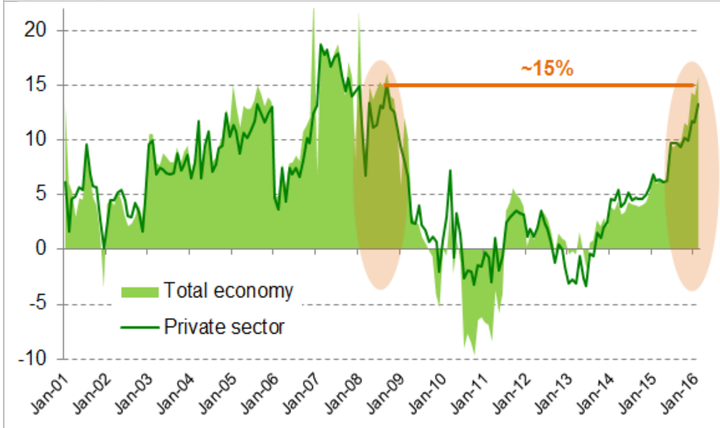
Sources: NIS, OTP Research
Note: filtered from VAT changes.

Chart 9: Output gap
(% against potential GDP)



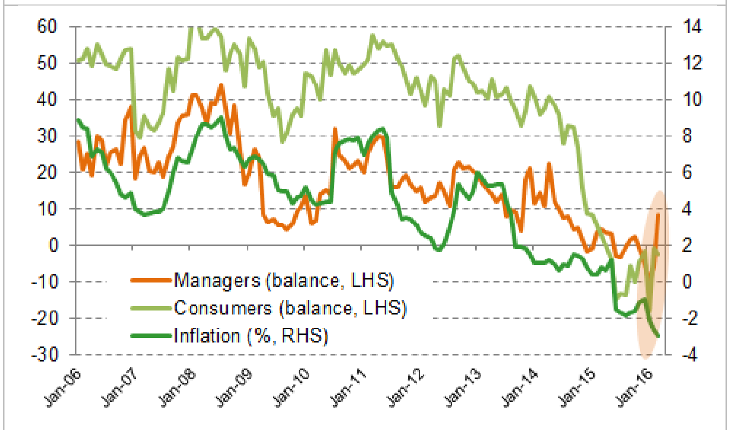
Sources: NBR (February 2016 – Inflation Report), OTP Research

Chart 10: Net real wages
(YoY%)



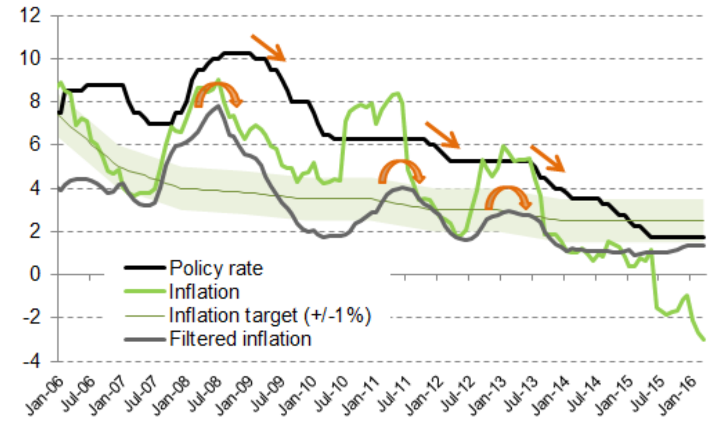
Sources: NIS, OTP Research

Chart 11: Price expectations



Sources: EC, NIS, OTP Research

Chart 12: Policy rate and inflation
(%)



Sources: NBR, NIS, OTP Research

Disclaimer

OTP Bank Romania S.A. does not intend to present this document as an objective or independent explanation of the matters contained therein. This document a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research, and b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This communication does not contain a comprehensive analysis of the described issues. This report is issued for information purposes only and should not be interpreted as a suggestion, an invitation or an offer to enter into any transaction, as an investment advice, and it does not constitute legal, tax or accounting advice. Also it is not and should not be considered a recommendation for investment in financial instruments according to NSC Regulations no. 32/2006 and 15/2006.

Information herein reflects current market practices. Additional information may be available on request. This document is intended only for the direct and sole use of the selected customers of OTP Bank Romania S.A. Any form of reproduction or redistribution to any other person that the intended recipients, including publication in whole or in part for any purpose, must not be made without the express written agreement of OTP Bank Romania S.A. Although the information in this document has been prepared in good faith from sources which OTP Bank Romania S.A. believes to be reliable, we do not represent or warrant its accuracy and such information may be incomplete or condensed. The issuer of this report does not claim that the information presented herein is perfectly accurate or complete. However it is based on sources available to the public and widely believed to be reliable. Also the opinions and estimates presented herein reflect a professional subjective judgment at the original date of publication and are therefore subject to change thereafter without notice. Furthermore there can be no guarantees that any market developments will unfold as forecasted. Opinions and estimates constitute our judgment and are subject to change without notice.

OTP Bank Romania S.A. may have issued reports that are different or inconsistent with the information expressed within this report and is under no obligation to update or keep current the information contained herein.

OTP Bank Romania S.A. may hold a position or act as market maker in the financial instrument of any issuer discussed herein or act as advisor or lender to such issuer. This document is not intended to provide the basis for any evaluation of the financial instruments discussed herein. In particular, information in this document regarding any issue of new financial instruments should be regarded as indicative, preliminary and for illustrative purposes only, and evaluation of any such financial instruments should be made solely on the basis of information contained in the relevant offering circular and pricing supplement when available. OTP Bank Romania S.A. does not act as a fiduciary for or an advisor to any prospective purchaser of the financial instruments discussed herein and is not responsible for determining the legality or suitability of an investment in the financial instruments by any prospective purchaser.

This report is not intended to influence in any way or to be considered a substitute to research and advice centred on the specific investment objectives and constraints of the recipient (including tax concerns) therefore investors should obtain individual financial advice. Before purchasing or selling financial instruments or engaging investment services, please examine the prospectuses, regulations, terms, agreements, notices, fee letters, and any other relevant documents regarding financial instruments or investment services described herein in order to be capable of making a well-advised investment decision. Please refer to your competent adviser for advice on the risks, fees, taxes, potential losses and any other relevant conditions before you make your investment decision regarding financial instruments or investment services described herein. OTP Bank Romania S.A. in compliance with the applicable law, assumes no responsibility, obligation, warranty or guarantee whatsoever for any direct or indirect damage (including losses arising from investments), or for the costs or expenses, detrimental legal consequences or other sanctions (including punitive and consequential damage) sustained by any natural or legal person as a result of the purchase or sale of financial instruments or engaging investment services described herein, even if OTP Bank Romania S.A. was warned of the possibility of such occurrences.

Figures described herein refer to the past and past performance is not a reliable indicator of future results. Investments in financial instruments carry a certain degree of risk (fluctuation of share prices, uncertainty of dividend, yields and / or profits, exchange rate fluctuations, etc.). The capital invested is not guaranteed, investment gains, usually assumed proportionate to risk, and past performance of financial instruments is not a guarantee for future performance.

Please note that the Internet is not a secure environment and OTP Bank Romania S.A. does not accept any liability for any loss caused by the result of using this report in a form altered or delayed by the wilful or accidental interception, corruption or virus infection.

This document has been provided to the recipients upon their prior request. Your abovementioned permission may be withdrawn by an e-mail addressed to csaba.balint@otpbank.ro or a written mail addressed to OTP Bank Romania S.A , Buzesti Street, no. 66-68, 1st district, Bucharest, Romania. Please refer to your name and e-mail address in both cases.