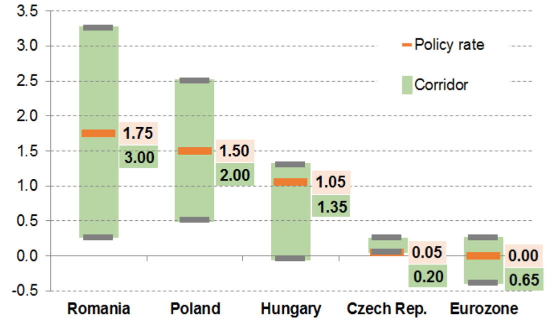
MONETARY POLICY COMMENT

6 May 2016

No surprise, the policy rate was left unchanged, but the NBR hit a milder tone.

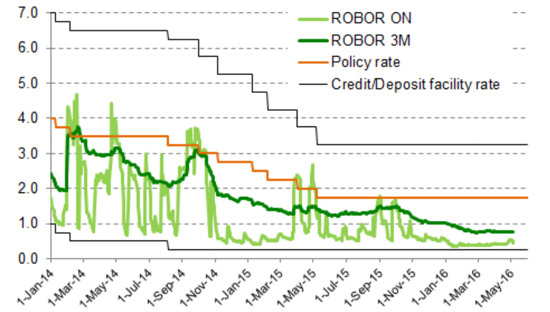
- **On its 5 May rate-setting meeting, the National Bank of Romania did not modify the level of the benchmark interest rates** or that of the minimum reserve requirement ratios, currently at 8% for RON and 12% for FX liabilities. The decisions of the NBR's Board were entirely in line with our and market anticipations. Accordingly, the recent policy update had little impact on the evolution of the leu's exchange rate and the interbank money market rates on Thursday. Beyond the regular policy issues, **the members of the Board also analysed and approved the new Inflation Report**, which should be presented to the public on 10 May in a press conference.
- The NBR's commentary, published after the policy meeting, gave some hints about the new inflation forecast of the central bank's staff, stating that the growth rate of consumer prices will remain in negative territory until July 2016 and it would gradually return *"inside the variation band of the target and standing in the upper half of the band at the end of the forecast horizon"*. These comments suggest that **the expected path of the headline inflation was revised slightly downward**. The first quarter of 2018, in other words the "new end" of the forecast horizon, should not be influenced by the expected tax changes, as by then the base effect of the 2017 VAT cut will fully fade out. In its previous projection, the NBR foresaw a 3.7% annual increase in the CPI index for Q4 2017 (excluding the first-round effect of the planned VAT reduction), which is somewhat higher than the upper limit of the target (2.5% +/- 1%). We expect 1.3% year-end inflation for 2016 with some downside risks, which may rise on average to 2.8% in 2017 and 3.0% in 2018.
- As we noted earlier, the NBR faces a complex situation, as divergent trends characterize the global and the domestic environment. This situation has not changed since our previous report, as policy loosening biases became even more evident in the region, while wage dynamics could accelerate further in the near term because of May's 19% minimum wage hike, building up risks of stronger inflationary pressures. Nevertheless, it is worth noting too that the recently approved debt discharge law with **the walk away option to borrowers is set to weaken the mortgage-based lending activity, which to some extent reduces the stimulating effect of the record-low interest rates**.
- **The new inflation projection together with the recent developments indicate that the central bank could have a slightly more permissive stance in its policy normalisation process, but we still maintain our previous call for flat key rate in 2016 and several rate hikes (up to 2.75%) until the end of next year, as the risks regarding the rebirth of wage inflation persist.**
- About the timing of the *"recalibration of monetary policy"*, which was mentioned by Mr Isarescu in his previous press conference in March, no details were revealed yesterday, after the debt discharge law came into the primary focus of journalists' questions. Nonetheless**, we continue to suspect that the first action could take place in the second half of 2016, by narrowing the interest rate corridor. But how far will the NBR go?**
- Compared to the region, Romania has the widest corridor (namely 3.00%, see Chart 1), even if it was reduced on the back of the 2014-2015 easing cycle (see Chart 2). This suggests that there is still a large room, but the **eurozone's 0.65% or Czech Republic's 0.20% corridor could be an adequate benchmark? We do not think so**, at least not on the NBR's forecast horizon. The weight of FX-denominated loans in total private credit has been reduced markedly from its around 65% peak in 2012 to nearly 47% in March 2016. Nevertheless, this level still may lead to serious difficulties in case of a significant unexpected shock in the EUR/RON, and the process to reduce the FX-denominated loans stock to easily manageable levels should last several years. Moreover, getting used to the so called "fully-fledged inflation targeting" regime also takes time for market participants and households. Under these circumstances, **Poland's 2.00% wide interest rate corridor seems to be a more plausible option**, offering somewhat higher flexibility for policy makers. It may noteworthy that a wider range is an important component of subserving FX stability. Therefore **we think that the corridor could be narrowed in two equal steps: first in H2 2016, while an additional action may follow in the beginning of 2017.**

Chart 1: Policy rates and interest rates corridors in the region (%)



Sources: central banks, Reuters, OTP Research

Chart 2: Money market rates and liquidity conditions (%)



Sources: NBR, OTP Research

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

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

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