

# REPORT ON INFLATION

13 June 2016

## *Another record low, but probably the last for a long time.*

- Consumer prices climbed almost 0.3% MoM higher in May, but this was not enough to change the direction of the recent trend in the annual inflation rate (see Chart 1). Accordingly, consumer prices continued to slide downward in year-on-year comparison and hit a new historical low for the fifth time in a row, reaching to -3.5% YoY in May. A month earlier CPI's annual growth rate stood 0.2 percentage point higher, at -3.3% YoY. However, this new record low didn't come as a surprise, as it was in line with both our and the consensus forecast of the market (June's Reuters survey).
- As we noted in our previous [report](#), these extremely low inflation figures in the first half of the year primarily were the result of the value added tax reductions in June 2015 and January 2016. Similarly to the NBR's latest calculations, our estimation also confirms that the cumulative impact of the tax changes exceeded 4 percentage points by rather a wide margin. Therefore, in order to get to a less biased picture, VAT adjusted inflation figures should be followed as well. Our in-house data suggest that the growth rate of consumer prices also continued to lose steam in May, and it slipped well below 1% (Chart 3). On the other hand, the *filtered inflation*<sup>1</sup>, our preferred underlying price measure was practically unchanged, staying at 1.3% YoY.
- The widening gap between the underlying indicator and the VAT adjusted headline inflation was due to a bunch of non-core items (Chart 5). Unprocessed food prices eased quite rapidly in year-on-year terms in the first half of 2016 (Chart 6), but indeed we expected for an even larger drop in May. This evolution most probably was helped also by the favourable weather conditions in the latest period. Beyond unprocessed food prices, the effect coming from the plunge of crude oil futures still weighed on the headline indicator (the CPI of fuels dropped by around 5% YoY, excluding the VAT impact), but this may fade out gradually, as Brent prices showed a strong reversal from their lows in the beginning of the year (Chart 7). Moreover, administered as well as tobacco and alcohol prices pulled back May's inflation too. The former was influenced by the 1.1% MoM decrease of gas bills last month.
- Turning back to the main components of our filtered inflation measure, we see that processed food prices slightly accelerated in May (Chart 8), to some extent surprising us on the upside. Among others, the movement was sustained by sugar prices, while the CPI of cheese products also increased a bit more rapidly than we presumed. As wheat, corn and rape futures climbed somewhat higher on international commodity markets, we deem that these rises may indicate a mild increase in processed food prices in the following period.
- The evolution of goods' inflation was mostly in line with our anticipation. The growth rate of non-durables' CPI remained above 1.5% YoY and durables' CPI continued to ease (Chart 9). On this front, we are still waiting for more clear signs from the impact of the very strong domestic demand. Nevertheless, the largest surprise among the groups of core items was brought by market services, after they slowed by 0.2% percentage points in annual terms (Chart 10). We recall that the main driver of Romania's economic growth was the sector of market services in Q1 too (for further details please see our latest [report](#) on Q1 2016 GDP), boosted by domestic demand, while further increases are foreseen as well. In such conditions, we reckon that May's drawback was rather a transitory event, and the inflation of market services may accelerate later during the year, even more due to the fact that services cannot be imported like several durable and non-durable goods, and therefore their prices are more exposed to the costs of rapidly rising nominal wages.
- Regarding the inflation outlook, we think that the series of record lows came to an end in May, as the base effect of last year's VAT cut on food products runs out in June, with an estimated impact of around 2.8 pps, lifting the annual inflation significantly higher. In the absence of other large one-off items and taking into account that almost all the important factors on the domestic front (wages are surging, the labour market is tightening, the output gap is being closed) are pointing to rising domestic driven inflationary pressures, CPI indicators may gradually accelerate in the coming quarters. Nonetheless, it is also important to note that we revised our short-term inflation forecast significantly (to 0.4% YoY for the end of 2016, versus 1.3% YoY earlier), after May's downside surprise, incorporating among others the impact of the much lower path of unprocessed food prices and subdued perspectives of administered prices ahead of elections. At the same time, we left 2017's projection unchanged at 2.8% YoY. As underlying price dynamics may remain sluggish on the short-term and the external environment is supportive for loose monetary conditions, we expect that [policy rate](#) increases could come only in 2017.

<sup>1</sup> *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

#### 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

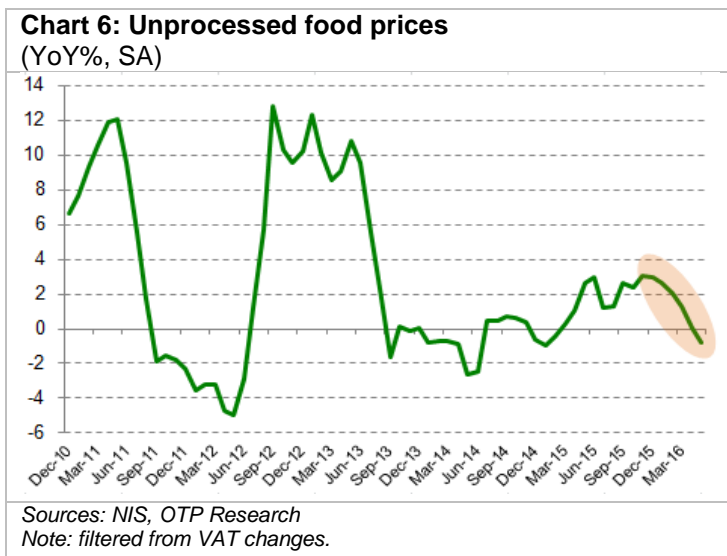
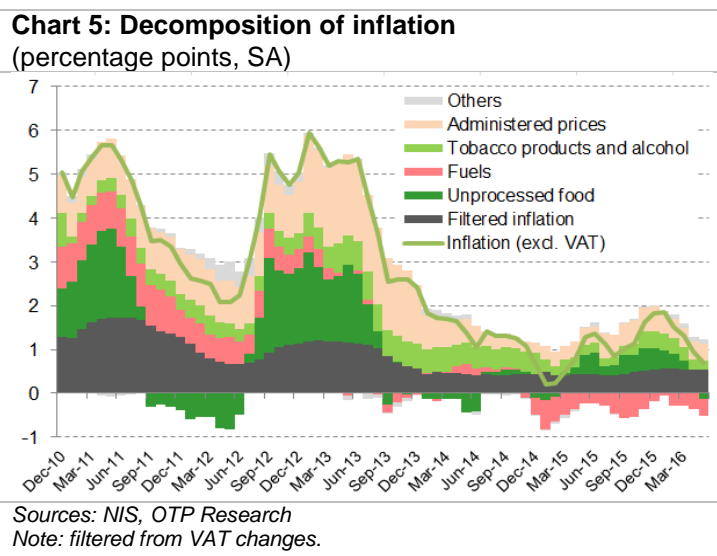
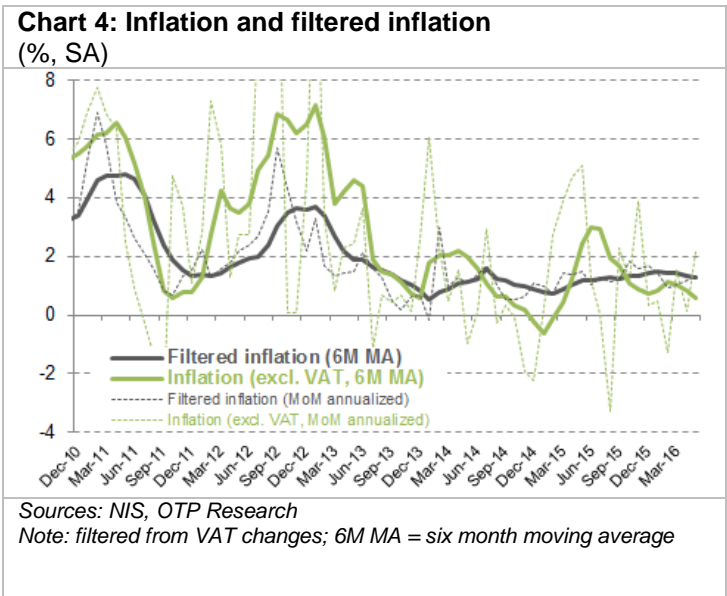
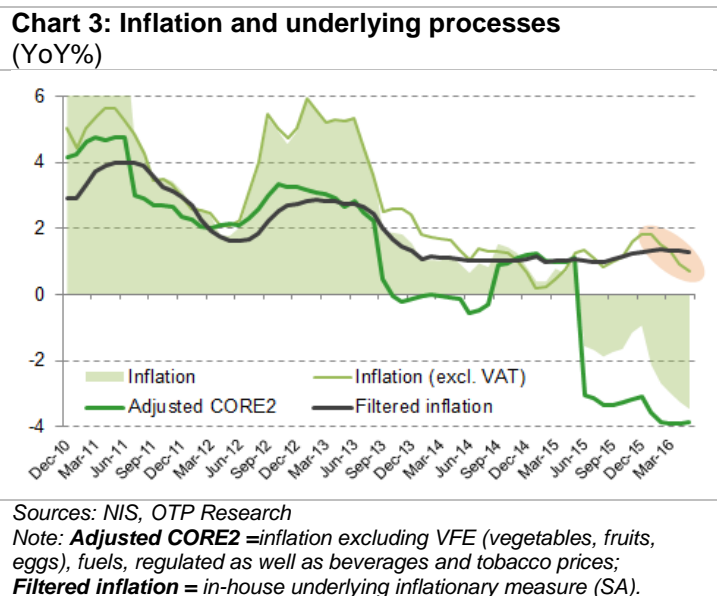
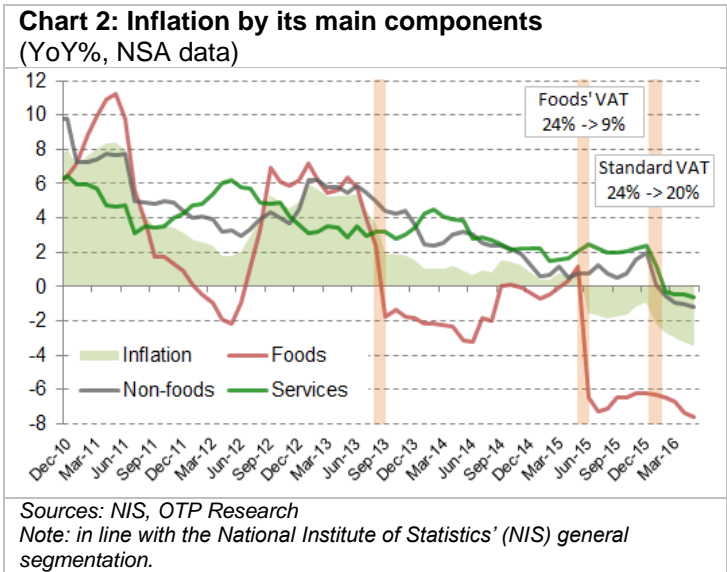
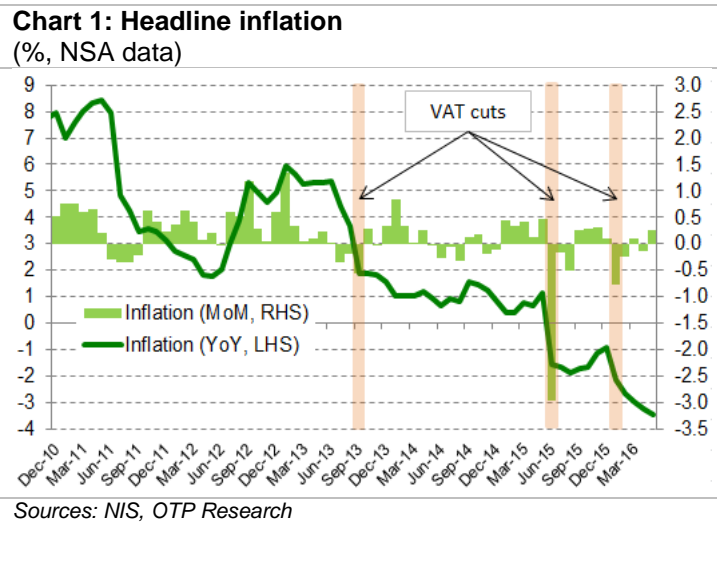
+36 1 374 7273  
tardosg@otpbank.hu

### Analyst

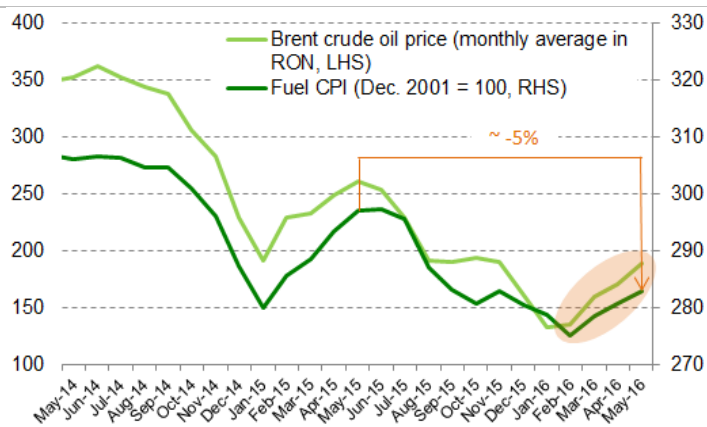
#### Csaba Bálint

+4021 307 58 96  
csaba.balint@otpbank.ro

**Chart set:**

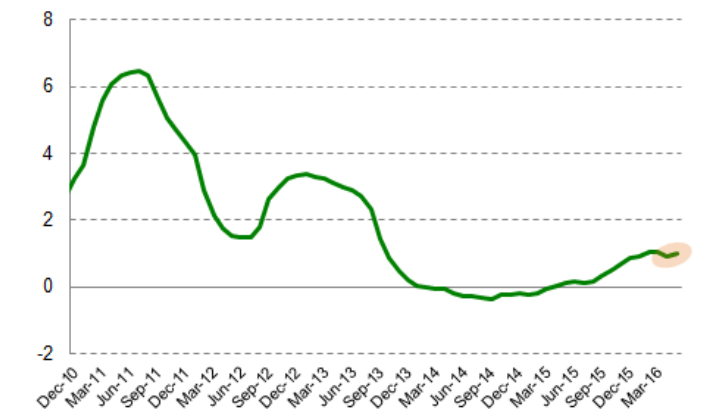


**Chart 7: CPI of fuels vs. Brent oil prices**



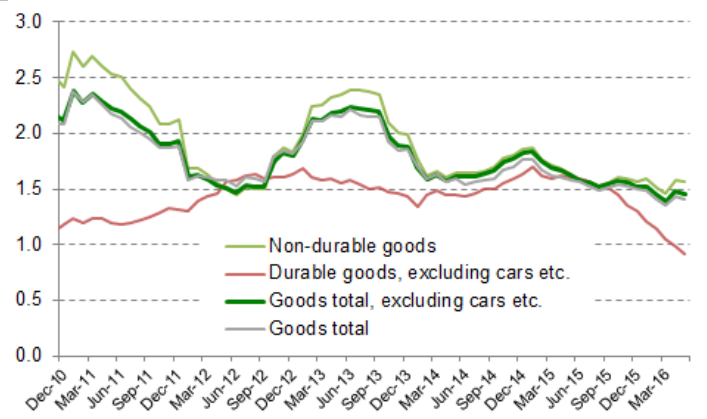
Sources: NIS, OTP Research  
Note: filtered from VAT changes.

**Chart 8: Processed food prices (YoY%, SA)**



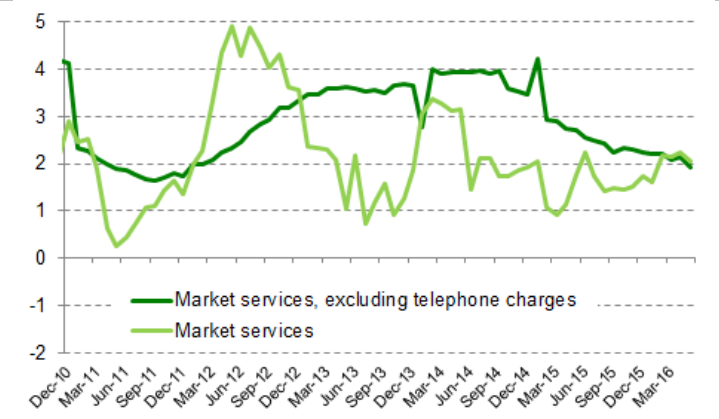
Sources: NIS, OTP Research  
Note: filtered from VAT changes.

**Chart 9: Goods' inflation (YoY%, SA)**



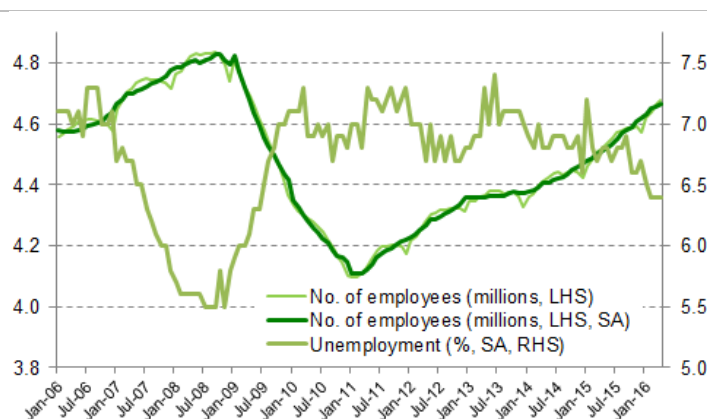
Sources: NBR (February 2016 – Inflation Report), OTP Research

**Chart 10: Market services (YoY%, SA)**



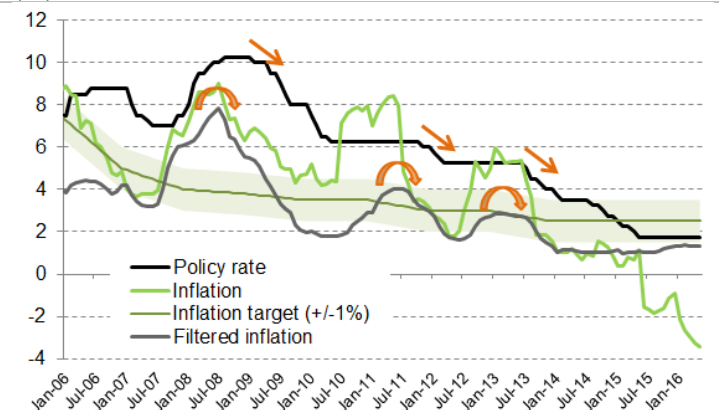
Sources: NIS, OTP Research

**Chart 11: Labour market indicators**



Sources: NIS, OTP Research

**Chart 12: Policy rate and inflation (%)**



Sources: NBR, NIS, OTP Research

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