

REPORT ON INFLATION

13 July 2016

In June, headline inflation climbed significantly higher on fading VAT cut effect; nonetheless, it remained well below zero, missing expectations

- In June, Romania's annual inflation rate climbed to -0.7% (see Chart 1), after May's historical low of -3.5%, as the base effect of last year's VAT cut on foods dropped out. In June 2015, the value added tax applicable for food products was reduced from the standard rate of 24% to only 9%, with a large impact on the evolution of consumer prices (Chart 2). Indeed, the headline figure got significantly closer to zero on the back of the fading base effect, but it remained in negative territory and missed both the market (Reuters consensus: -0.5% YoY) and our expectation (-0.6% YoY). After adding 0.3% in May, the consumer price index dropped by 0.2% in month-over-month comparison, mostly on sinking seasonal foods' inflation. The difference between our projection (-0.6% YoY) and the fact data (-0.7% YoY) for June can be explained mainly by lower unprocessed food prices and slower growth in fuels' CPI.
- Beyond last year's foods VAT cut, another indirect tax change, the four percentage-point reduction of the standard value added tax also left its mark on CPI's dynamics. As the lower standard rate was introduced starting from January 2016, its impact on inflation figures still persists and therefore we continue to rely on our in-house VAT adjusted data in order to assess the latest price patterns as correctly as possible. Accordingly, the annual inflation adjusted by the indirect tax changes eased marginally, to around 0.7% (nonetheless it is important to note that this figure may be subject to some estimation uncertainty). Simultaneously, our preferred underlying price measure, *filtered inflation*¹ accelerated a bit to 1.4% YoY (Chart 3).
- The divergent trend of the headline and the filtered inflation came primarily from unprocessed food prices (Chart 5), which slid deeper in negative territory, after excluding the effect of VAT modifications (Chart 6). As we noted in our previous [report](#) too, this downward trend could be related to the milder weather conditions, with a positive impact on agriculture output. To a much lesser extent, administered as well as tobacco and alcohol prices also weighed on the headline indicator, while the annual fall of fuels' CPI softened (but not as much as we had expected), after crude oil futures marched higher, based on RON-denominated terms (Chart 7). Regarding administered prices it is worth mentioning that they could stay on a downward sloping shape, as the Regulatory Authority for Energy announced recently that the prices of natural gas supplied to household consumers should decrease by 3% on average as of 1 July. At the same time, we also suspect that administered CPI may remain sluggish in the second half of this year too, as general elections take place at the end of 2016.
- June's slight increase in the filtered inflation was due to processed food prices' advance by 1.1% YoY last month, up from May's 1.0% YoY gain. Nevertheless, we do not foresee any significant acceleration in this, as the pressure from producer prices seems to be quite low (Chart 8), while the evolutions of agro commodities, which play an important role in the price-setting pattern of food producers, give also little sign of gaining steam. Meanwhile, the CPI of non-durable goods was broadly unchanged and in the case of durable goods' inflation the prior trend continued (Chart 9). The other main component of our filtered inflation, namely prices of market services, excluding telephone charges posted a 2.2% YoY rise, similarly to May (Chart 10). To sum it up, it appears that the impact of the definitely strong demand coming from households is still offset by the external factors, such as extra low commodity and import prices.
- On the other hand, the potential effects of an overheated economy should not be neglected. We recall that real wages are increasing at an elevated pace (Chart 11) and households' consumption surged by 10% YoY in [Q1 2016](#), similarly to the golden years of 2007-2008. Therefore, we reckon that the NBR will remain vigilant in the following period, even though the inflation outlook seems to be more subdued than previously thought in the short term. Keeping in mind the planned cut in administered prices, the relatively sluggish CPI evolution in June, and the perspectives of price dynamics in the external environment, we revise our year-end inflation forecast from 0.4% YoY to 0.0% YoY. Given the new projection, we feel more confident to change our view about the timing of the narrowing interest rate corridor. Previously we expected that the NBR could tighten the corridor in 2016 (for further details please see our latest monetary policy [comment](#)), but now we deem that it could be delayed until the beginning of 2017. Moreover, a further reduction of the mandatory reserve ratio should not be ruled out in the following period, especially if the uncertainties coming from the impact of the UK's referendum intensify.

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.*

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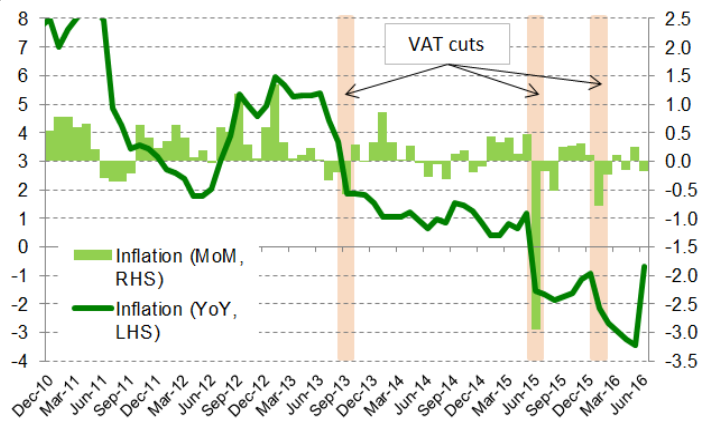
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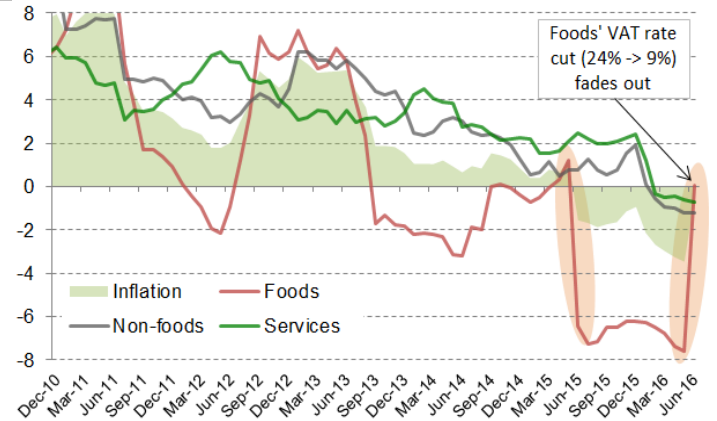
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Chart 1: Headline inflation
(%, NSA data)



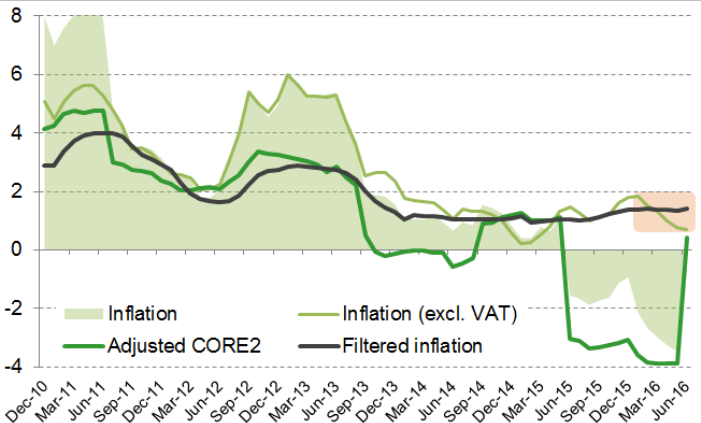
Sources: NIS, OTP Research

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



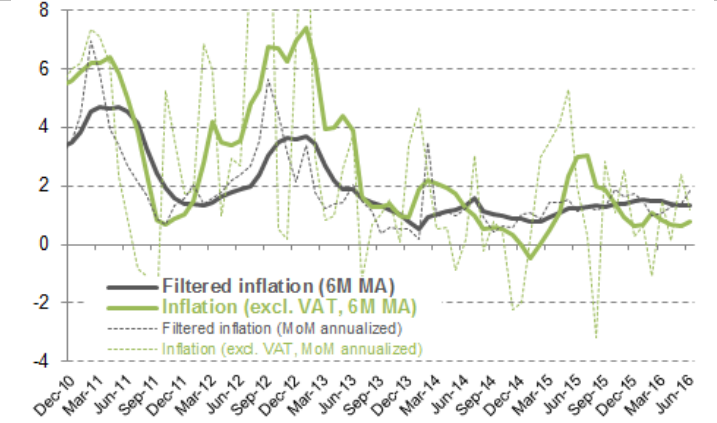
Sources: NIS, OTP Research
Note: in line with the National Institute of Statistics' (NIS) general segmentation.

Chart 3: Inflation and underlying processes
(YoY%)



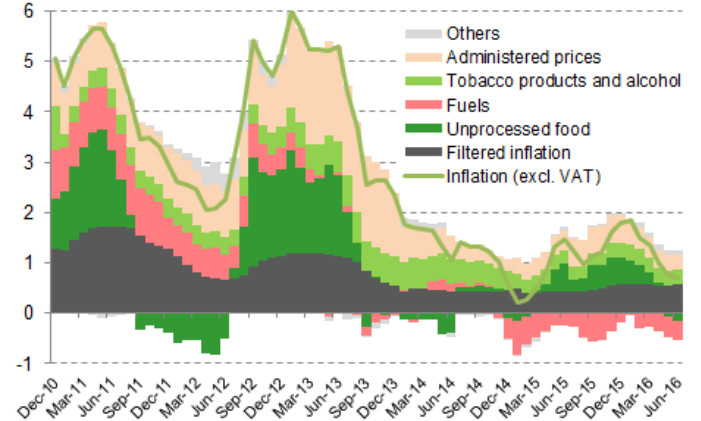
Sources: NIS, OTP Research
Note: **Adjusted CORE2** =inflation excluding VFE (vegetables, fruits, eggs), fuels, regulated as well as beverages and tobacco prices;
Filtered inflation = in-house underlying inflationary measure (SA).

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



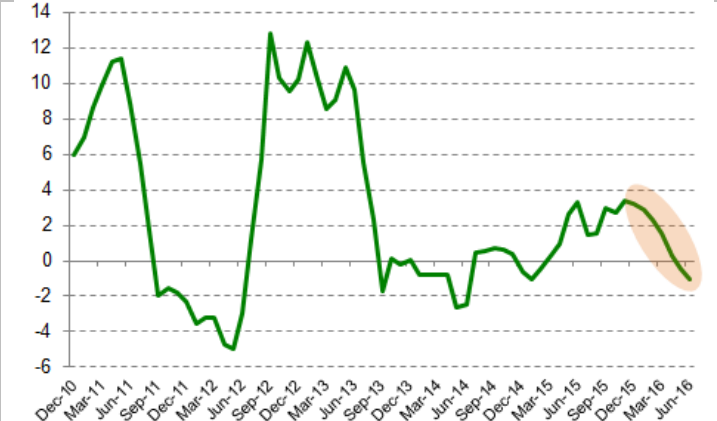
Sources: NIS, OTP Research
Note: filtered from VAT changes; 6M MA = six month moving average

Chart 5: Decomposition of inflation
(percentage points, SA)



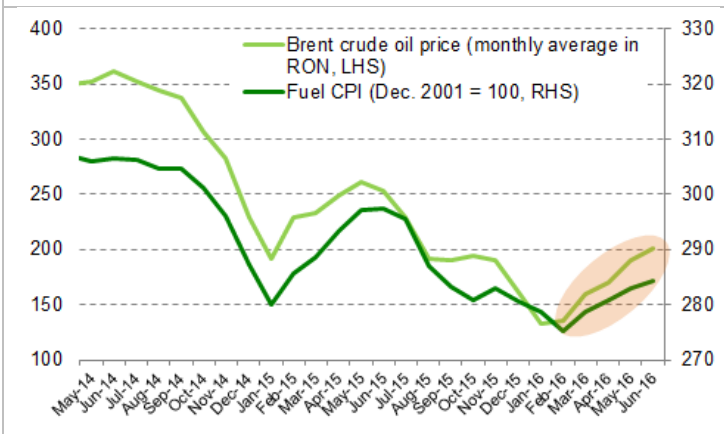
Sources: NIS, OTP Research
Note: filtered from VAT changes.

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



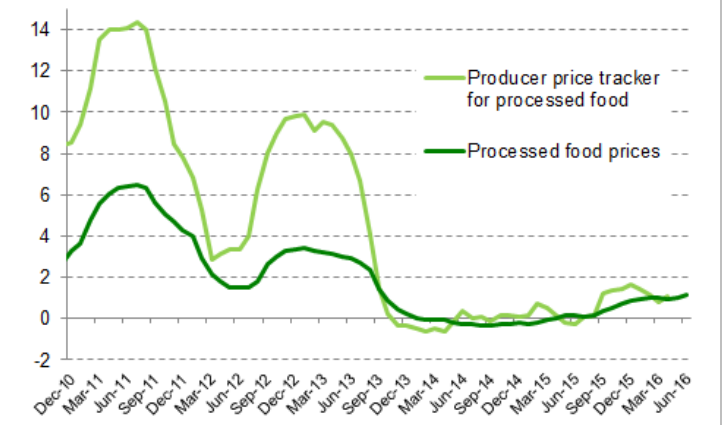
Sources: NIS, OTP Research
Note: filtered from VAT changes.

Chart 7: CPI of fuels vs. Brent oil prices



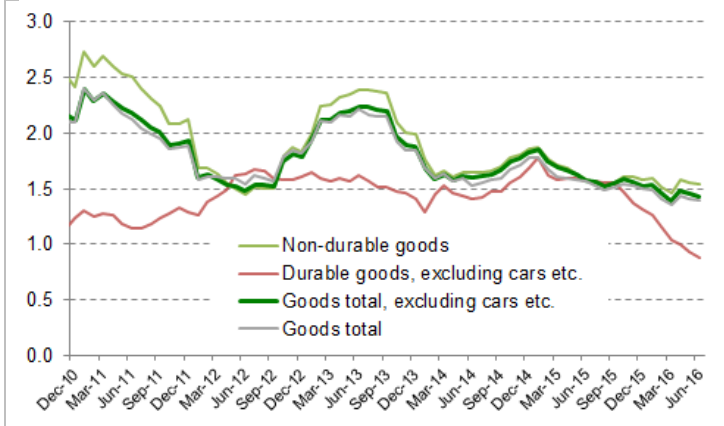
Sources: NIS, Reuters, OTP Research
Note: filtered from VAT changes.

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



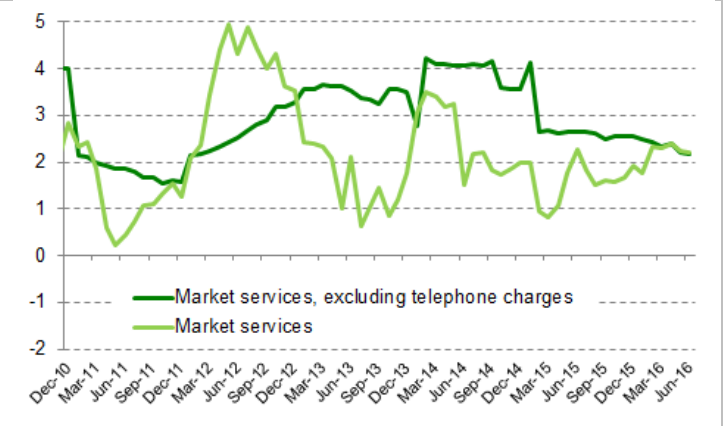
Sources: NIS, OTP Research
Note: filtered from VAT changes.

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



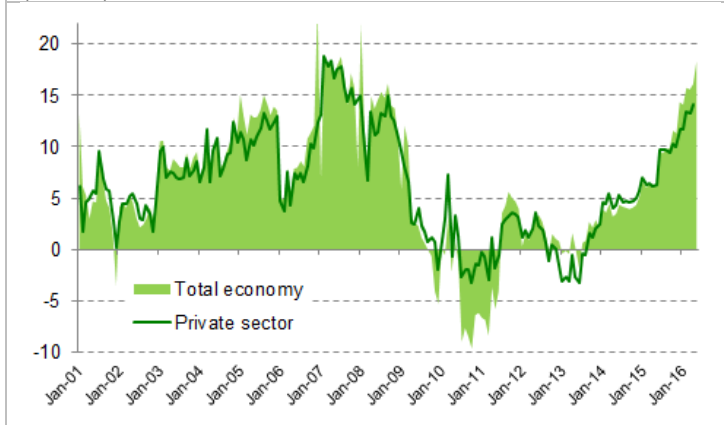
Sources: NIS, OTP Research
Note: filtered from VAT changes.

Chart 10: Market services (YoY%, SA)



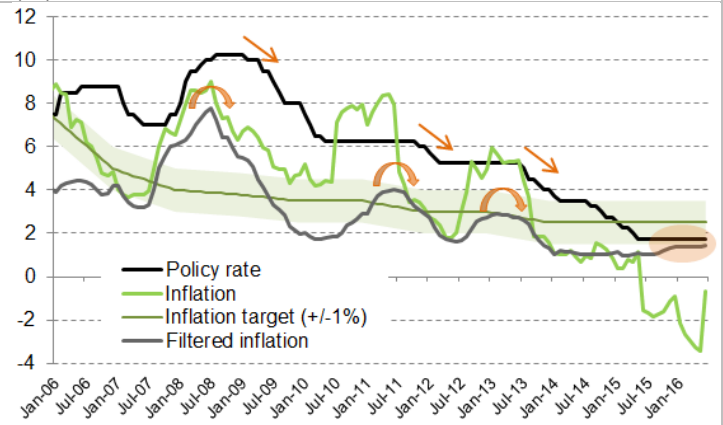
Sources: NIS, OTP Research
Note: filtered from VAT changes.

Chart 11: Net real wages (YoY%)



Sources: NIS, OTP Research

Chart 12: Policy rate and inflation (%)



Sources: NBR, NIS, OTP Research

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