MONETARY POLICY COMMENT

5 August 2016

The policy rate remained unchanged, as expected; however the NBR's inflation projection was scaled back significantly

- On Thursday 4 August, **the National Bank of Romania kept the policy rate at a record low of 1.75%**; the other main monetary tools of the central bank were left unchanged as well. With yesterday's decision of policy makers, the benchmark rate remained untouched on the 11th consecutive meeting. The base rate was last modified in May 2015, when Board members voted for a 25 bps cut. The current decision to remain on hold was in line with market expectations.
- At the same time, the Board of the NBR analyzed and approved the new Inflation Report, prepared by the central bank's staff. The details of the updated projections have not been revealed yet (the full report will be presented on Monday 8 August), but the policy statement published after the meeting as well as Mr. Isarescu's press conference provided clear guidance. According to the CB's experts, **consumer prices may follow a path that is significantly below the earlier expectations**. More explicitly, the press release notes that the annual inflation rate most likely *"will remain in negative territory until the end of 2016"*, in contrast to the previous projection, which foresaw 0.6% YoY growth in CPI. We recall that our forecast currently is staying at 0.0% for December, but in the light of the recent developments on external markets, such as the latest downturn in crude oil prices, we aim to cut it back by a few tenths of percent when July's data comes out. Regarding the medium-term perspectives, the NBR remarks that the inflation rate could return *"inside the variation band of the target"* (2.5% +/- 1%) next year, staying below the mid-point as of December 2017, while it may climb higher, inside the 2.5%-3.5% range until Q2 2018, retaining its upward sloping profile.
- **The CPI outlook continues to be ambiguous**, the central bank's press release suggested, similarly to our earlier inflation updates. On the one hand, domestic factors point to rising inflationary pressures, coming from excess aggregate demand and rapidly increasing unit labour costs, until then *"the persistence of low inflation at global and regional levels"* leads to spillover effects.
- In our previous report, we noted that the shock caused by the Brexit vote had limited impact in Romania, at least until now. This view is confirmed by our in-house ***financial conditions index***[1] too, which aggregates a series of financial variables into one single indicator, proving to be a useful short-term precursor for real economic activity (see Chart 2). Nevertheless, the UK's exit from the European Union, together with the clouded growth perspectives at global level, among others may cause more sluggish inflation dynamics in the euro area, acting as a drag on domestic price evolutions. **In this complex and uncertain situation, the NBR could follow a more *"pragmatic"* approach in its decisions, as Governor Isarescu also underscored**, adapting to new data and fresh developments.
- Beyond regular monetary policy issues, Mr Isarescu announced that after analysing the latest procedures of several central banks, **the NBR will also make public the minutes of its rate-setting meetings** (as well as the remuneration of Board members) in order to provide better transparency. About the exact form of the minutes and other related questions, the Board will decide this month. These moves may support the NBR's generally excellent reputation, which was challenged to some extent in the latest period.
- **In all, we continue to foresee a flat policy rate for 2016 and we also deem that the narrowing of the interest rate corridor could be started at the beginning of next year. Nevertheless, the key rate may be raised to 2.50% until the end of 2017, instead of 2.75% as we believed earlier, after the perspective of inflation dynamics appear to be more sluggish, while monetary conditions could be looser than previously thought, especially in Europe.**

[1] *Financial conditions index (FCI) is an in-house composite indicator, which is built from a bunch of financial variables, such as interbank interest rates, different spread measures, loan flows, M1 money aggregate, the real exchange rate of RON, etc. The individual components of the FCI are aggregated using specific weights (the index may be revised as new information becomes available).*

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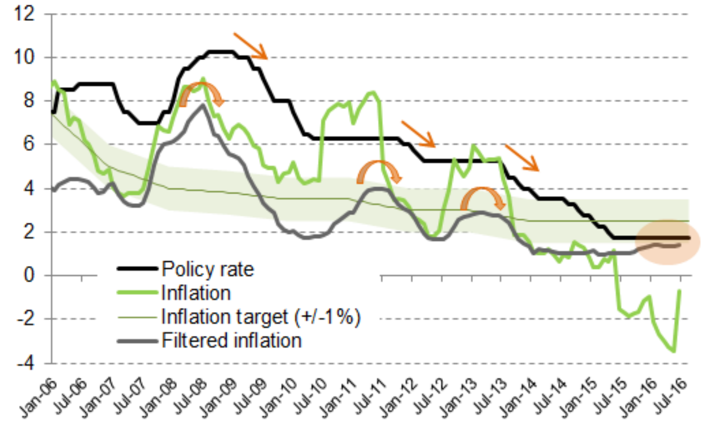
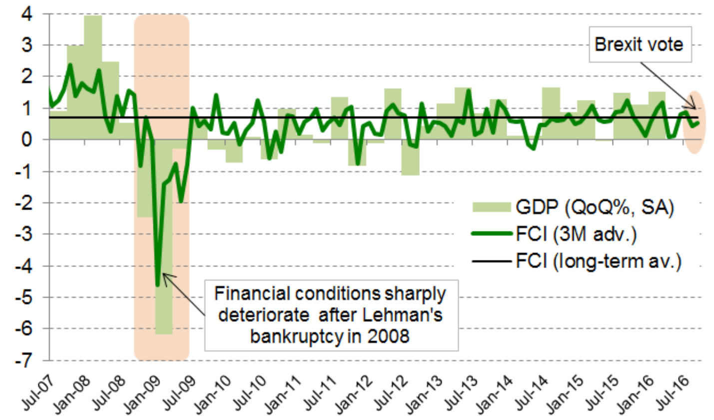
Chart set:

Chart 1: Policy rate and inflation dynamics (%)



Sources: NBR, NIS, OTP Research
Note: filtered inflation is an in-house measure of underlying inflation dynamics, which among others excludes the impact of VAT changes.

Chart 2: Financial conditions index vs. economic growth in Romania



Sources: NIS, OTP Research

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