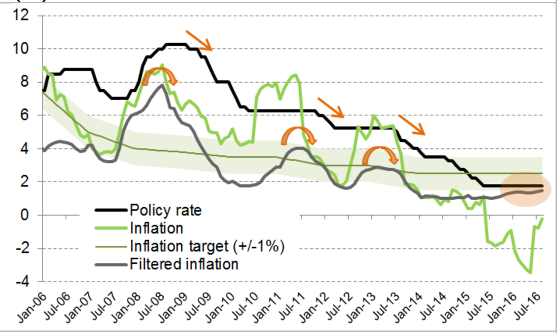
MONETARY POLICY COMMENT

3 October 2016

Key rate unchanged at 1.75%; no tightening before H2 2017

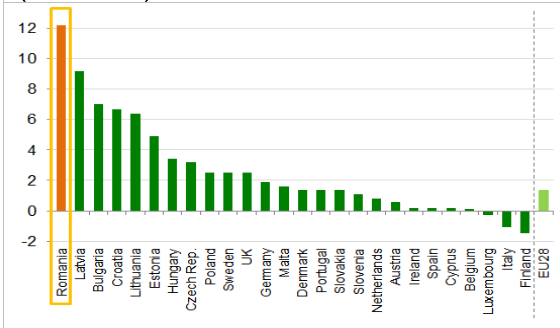
- As it was widely expected, the Board of **Romania's central bank left the benchmark interest rate untouched** on its penultimate policy meeting of the year. As a result, the level of the key rate had been remaining at the historical low of 1.75% since May 2015. Not surprisingly, there was no any significant market reaction after the decision, as the outcome of the meeting was foreseen by analysts, at least in regards the policy rate.
- **The National Bank of Romania also decided to lower the minimum reserve requirement ratio (MRR) for foreign currency-denominated liabilities to 10%, down from 12%,** while the MRR for RON deposits was unchanged at 8%. In our estimation, the reduction of the reserve requirements on FX liabilities would release additional funds for banks, amounting to around half a billion euro. Indeed, the timing of the action was unexpected to some extent, but on the whole such a movement appears to be in line with the central bank's plan to harmonize the MRR ratios with the general standards in Europe. According to the argumentation of the central bank, the declining trend of foreign currency loans, the adequate level of FX reserves as well as the improving structure of these reserves were the main factors behind the decision to cut the MRR.
- We suspect that **the bulk of the fresh funds will be not utilized for lending purposes, as leu-denominated credits rules the market**, while there is already excess liquidity in RON. Therefore, banks might rather use the released amounts for lowering the debts toward their parent institutions.
- The NBR's press release following the policy action brought little new element compared to the previous communications. It was started with a short description about the developments of the key macroeconomic variables. The press release noted that the headline inflation was on the rise in August, climbing to -0.2% YoY, from -0.8% YoY a month before, but as we highlighted in our latest report on consumer prices, this movement was primarily due to non-core items. Meanwhile, underlying CPI dynamics indicated that price pressures remained weak.
- Nevertheless, the NBR also drew attention to the better than expected performance of the economy in Q2, which continued to be fuelled by households' consumption, underscoring the rapidly growing unit labour costs as well. It may worth mentioning that Romania recorded the fastest increase of ULC among the members of the EU in the second quarter of 2016 (see Chart 2). This together with the definitely strong demand may boost inflation on the medium term. Central bank's chief **Mr Isarescu indicated that although the NBR does not yet consider countercyclical measures, the moment probably is nearing.**
- **We deem that this moment, in the form of the first rate hike may come in the second half of 2017, preceded by the narrowing of the interest rate corridor.** In the middle of 2017, inflation dynamics may start to show clear evidence of acceleration, giving enough reason to the central bank to launch tightening actions. Nonetheless, the uncertainties regarding the timing remain very high, as external shocks could weigh further on import prices, while on the domestic front general elections make the future less predictable. We also think that the NBR would prefer a smoothed path of policy normalisation, in order to avoid a sudden jump in lending rates, even more in the presence of extra loose monetary conditions in the region and rapidly expanding RON credit. Therefore **we expect for two 25 bps rate hikes in 2017**, instead of three, while the interest rate corridor may be narrowed gradually to +/-1%, from +/-1.5%.

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: Unit labour costs in Q2 2016
(YoY %, SA)



Sources: Eurostat, OTP Research

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