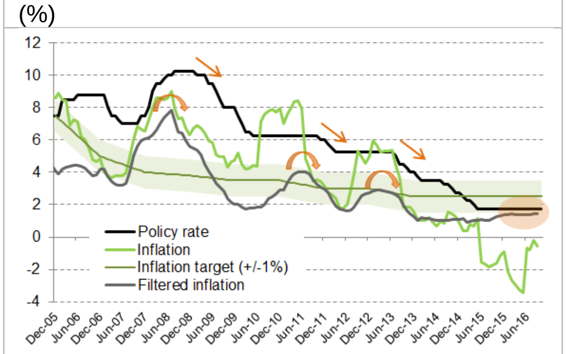
MONETARY POLICY COMMENT

7 November 2016

Policy rate finishes 2016 at the historical low of 1.75%

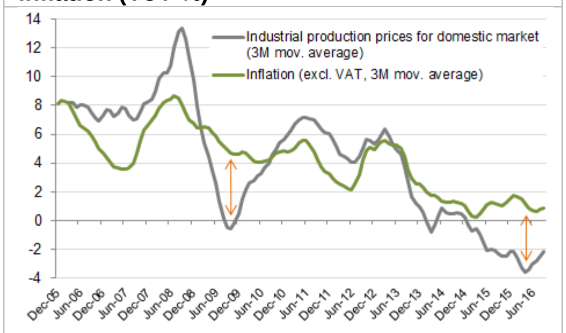
- **The Board of the central bank did not cause any surprise on the last policy meeting of the year, keeping the benchmark interest rates untouched** again. Regarding the minimum reserve requirements ratios, policy makers decided to keep them flat (8% on RON funds and 10% in the case FX-denominated liabilities), after the MRR for foreign currencies was lowered by two percentage points at the previous meeting in September, releasing roughly half a billion euro for commercial banks. As a consequence of Friday's decisions, the policy rate has at a record low of 1.75% for around 1.5 years. Domestic financial markets did not show any notable movement in response to the outcome of the meeting.
- **Neither the central bank's communication nor** the otherwise quite terse **press conference of Governor Isarescu provided hints regarding the policy outlook**, more specifically how long the loose monetary conditions may stay. However, such kind of guidance was not even expected ahead of the important events on the domestic and the external fronts, like the general elections in Romania and the long-awaited December monetary policy meetings of the Fed and the ECB.
- It may be worth mentioning that there are numerous unanswered questions around the next year's government budget, with a long series of legislative motions on the table, which are set to push the 2017 deficit well above the 3% threshold in the absence of any correction measures. At the same time, the monetary authorities of the Eurozone and the USA may take important steps too. It seems that the Federal Reserve could raise its benchmark interest rates in December, while there are indications that the European Central Bank may rethink its actual stimulus scheme, in order to provide further support for the eurozone's economy. Beyond these uncertainty factors in the cards, which prompt decision makers to maintain their wait-and-see approach, consumer price pressures also appear to remain subdued in the near term. Therefore, **the NBR has no reason to precipitate policy normalization,** at least not now.
- Similarly to our previous report, **we continue to think that the central bank would like to see more evidence of a sustainable CPI revival**. Admittedly, the precursors of demand-pulled inflation have arrived, represented among others by definitely strong gains in households' consumption and in an output gap, which probably turned into positive territory in recent quarters. Nevertheless, the extra low level of commodity as well as import prices still weighs on the cost side, dragging down underlying inflation. In addition, the perspective of the unusually loose monetary conditions in Europe and in the narrower CEE region may cause the NBR to be even more cautious before starting normalization steps.
- Given the confirmation of the upward trend in core price dynamics and with a clearer picture about the direction of the factors outside the central bank's control, we think that the subject of potential rate hikes could be back on the NBR's agenda in H2 2017. In the first step, this should be preceded by the narrowing of the interest rate corridor, as we suggested in our previous report too. Nonetheless it is also important to note that **the way of the normalisation process,** if it will be really initiated next year (our base scenario)**, most likely will be a smoothed one**, taking into account the outlook of monetary conditions in the region and the rising share of RON credit on the domestic front.
- Beside the policy vote, the Board of the NBR analysed and approved the new Inflation Report, which includes an updated CPI projection. The fresh forecast most likely is quite similar to the previous one, while the details will be presented to the public via a press conference on 10 November.

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: Industrial production prices vs. inflation (YoY %)



Sources: NIS, 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

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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