

REPORT ON INFLATION

14 November 2016

Fuel prices and the weaker RON pushed October's headline inflation higher

- In October, Romania's headline inflation stood at -0.4% on annual basis (+0.4% MoM), the fresh report of the National Institute of Statistics showed (see Chart 1). This level was 0.2 percentage points higher than a month earlier, exceeding the market expectation, which foresaw flat figure for October (Reuters survey: -0.6% YoY), and at the same time, it was also slightly above our call of -0.5% YoY. The difference between our forecast and the fact data comes from the somewhat stronger than anticipated increase in fuel prices and a bit higher unprocessed food CPI, which probably will have only temporary impacts on the evolution of the headline figure. It may be worth mentioning that excluding the negative impact coming from January's VAT reduction consumer prices would have increased by around 0.9% YoY (Chart 3), according to our estimation. Meanwhile, underlying CPI dynamics continued to outline sluggish price pressures, with our in-house *filtered inflation*¹ marginally slowing to 1.4% YoY, from September's 1.5% YoY, in line with our expectation.
- The rise in the headline figure was the result of several consumer items. First of all, fuel prices at the petrol pumps reflected the beneficial effects of rallying crude oil futures at the beginning of October (Chart 6). In addition, vanishing base effects also boosted fuel inflation last month. Beside these, the depreciation of the leu against the common European currency contributed to the CPI's pick-up via exchange rate sensitive items as well, in line with our anticipation. The otherwise quite tepid EUR/RON was shaken last month among others by the news on the CHF loans bill, approved unanimously in Romania's parliament.
- Regarding the deceleration showed by our filtered inflation measure from 1.5% YoY to 1.4% YoY, first of all, the evolution of processed foods is worth highlighting as one of the main reasons. The price indicator of this group lost some steam, slowing to a 1.2% annual growth pace last month, from the 1.3% advance in September. The fading momentum should not be a surprise in the light of weak pressures from agro commodities as well as the producer prices of foods (Chart 8). Nevertheless, we think that the setback will be rather temporary, as certain cereal futures, like wheat seem to have bottomed out in the most recent period, which may help processed foods' inflation to regain its mildly upward sloping trend.
- The other group of the consumer basket, which pulled back filtered inflation in October, covers the CPI of market services, excluding telephone charges, with a 1.7% YoY advance, down from September's 1.8% YoY. This came after only a few highly demand-sensitive items, like hygiene and cosmetics as well as restaurants indicated acceleration, proving to be too little to stop the downward shape drawn this year (Chart 10). We continue to believe that the direction of services' inflation should reverse sooner or later, fuelled by strong domestic demand and the eye-watering double-digit wage growth. Including telephone charges, which are highly exposed to the EUR/RON exchange rate, the CPI of market services picked-up in fact, to record 2.1% YoY growth. Meanwhile, relative stability was seen in the case of goods' inflation. At this point, the favourable news is that durable goods did not lose further steam in October (Chart 9).
- The main drivers behind the underlying evolution of the CPI remained practically the same. Indeed, the precursors of demand-pulled inflation arrived, such as the skyrocketing households' consumption (Chart 11), but with the prices of raw materials still staying at very low levels, cost-pushed inflation did not appear so far. In these conditions, the growth rate of producer prices remained below the zero bound, leaving their mark on the headline inflation too (Chart 12).
- In relation to the outlook, it may be important to add that the latest surveys of the European Commission provide evidence of stabilization in the price expectation of consumers and managers, with these coming out from negative territory (Chart 13). For the end of 2016, we continue to foresee -0.3% YoY inflation, with some downside risks coming from the most recent downturn of crude oil futures, while unprocessed foods also cause uncertainties. At the same time, we also suspect that the headline inflation will turn positive next year, with a tendency of modest acceleration, rising as high as 2.6% YoY at the end of 2017, among others led by fading VAT base effects, upside pressure on the back of higher positive output gap and assuming more stable commodity prices.

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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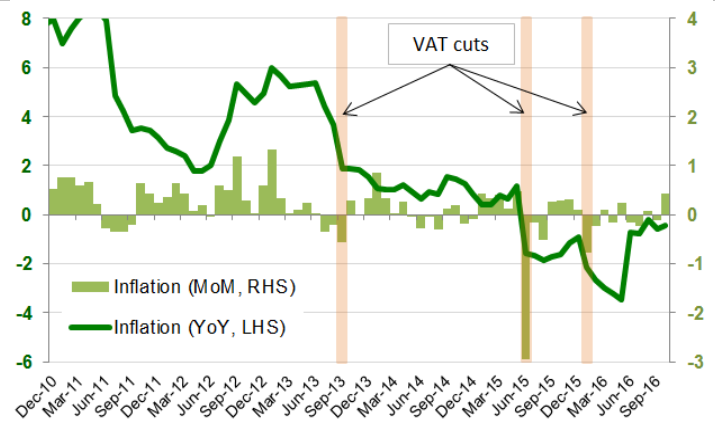
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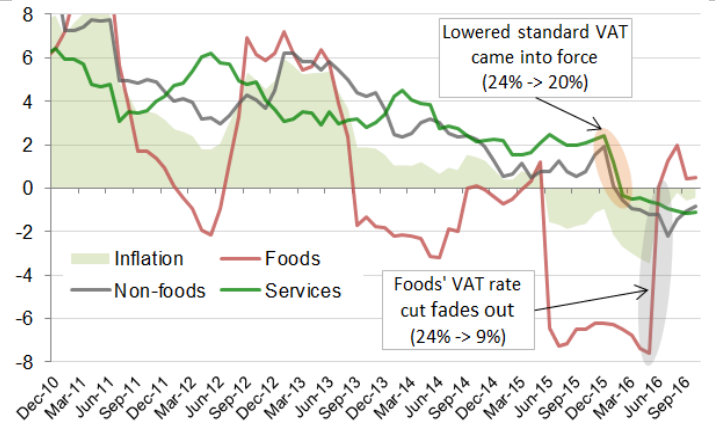
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Chart 1: Headline inflation
(%, NSA data)



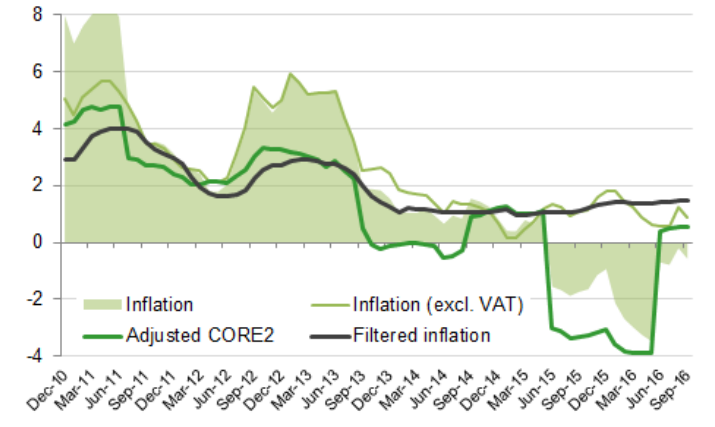
Sources: NIS, OTP Research

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



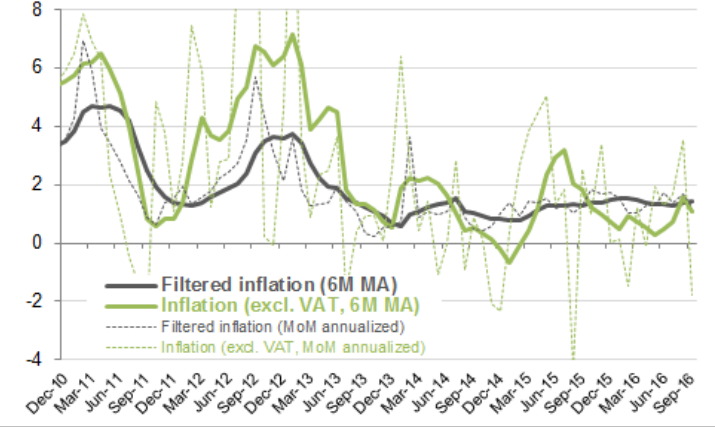
Sources: NIS, OTP Research
Note: in line with the National Institute of Statistics' (NIS) general segmentation.

Chart 3: Inflation and underlying processes
(YoY %)



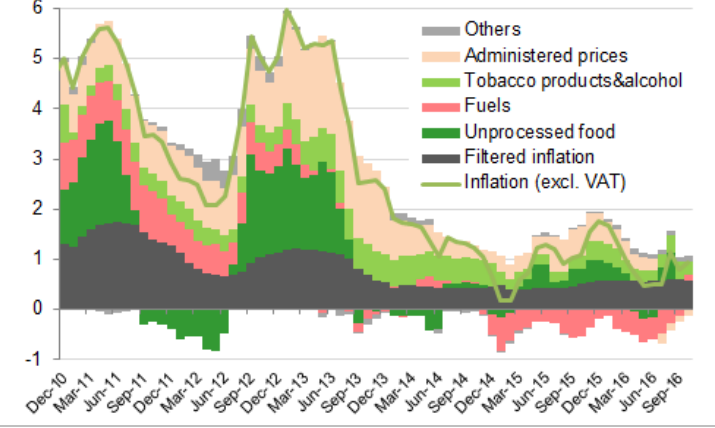
Sources: NIS, OTP Research
Note: **Adjusted CORE2** =inflation excluding VFE (vegetables, fruits, eggs), fuels, regulated as well as beverages and tobacco prices;
Filtered inflation = in-house underlying inflationary measure (SA).

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



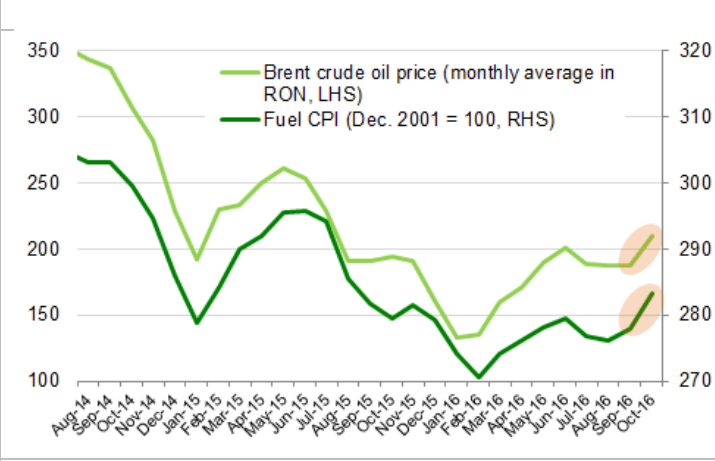
Sources: NIS, OTP Research
Note: filtered from VAT changes; 6M MA = six-month moving average

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



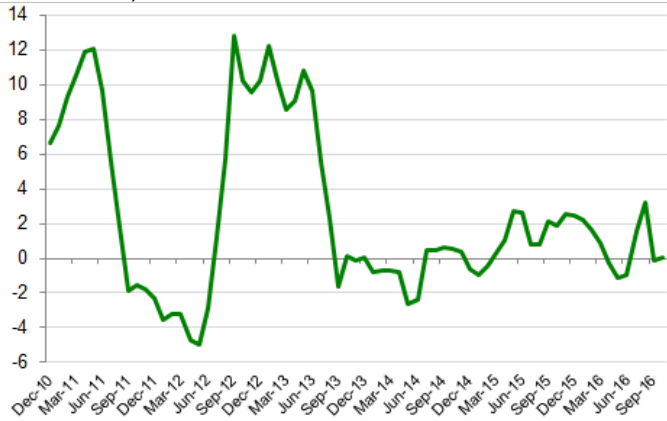
Sources: NIS, OTP Research
Note: filtered from VAT changes.

Chart 6: CPI of fuels vs. Brent oil prices



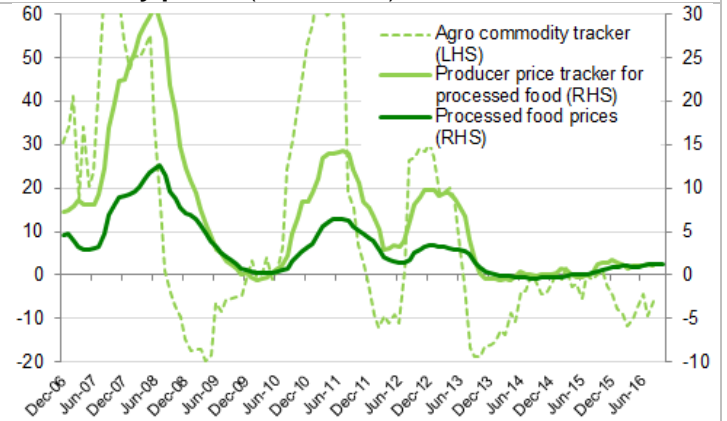
Sources: NIS, Reuters, OTP Research
Note: filtered from VAT changes.

Chart 7: Unprocessed food prices (YoY %, SA)



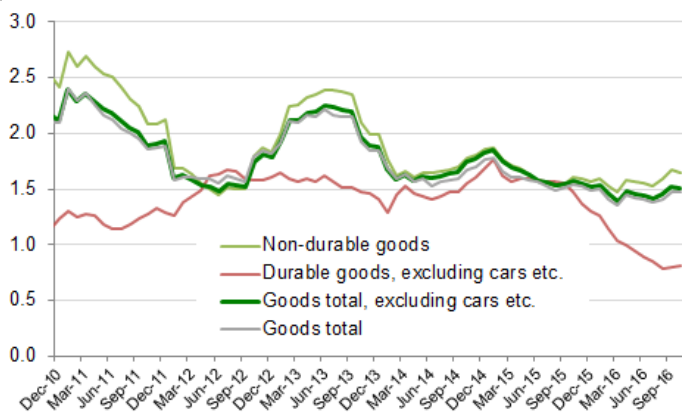
Sources: NIS, OTP Research
Note: filtered from VAT changes.

Chart 8: CPI and PPI of processed foods vs. agro-commodity prices (YoY %, SA)



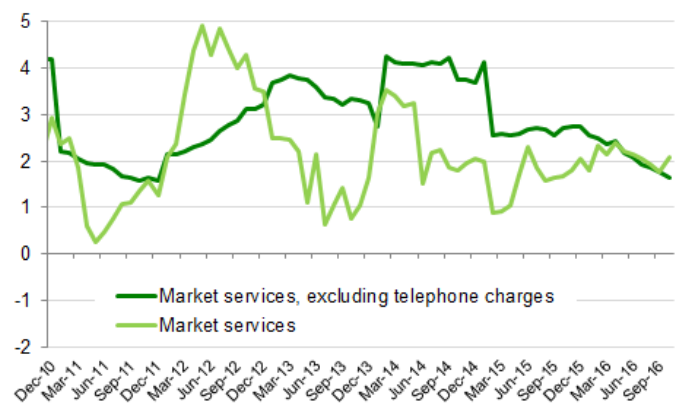
Sources: NIS, OTP Research
Note: filtered from VAT changes.

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



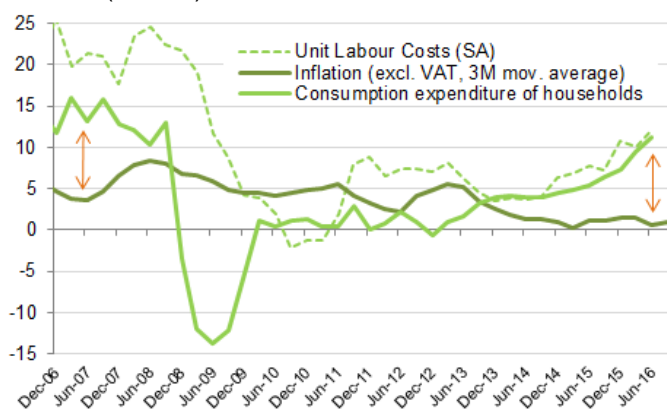
Sources: NIS, OTP Research
Note: filtered from VAT changes.

Chart 10: Market services (YoY %, SA)



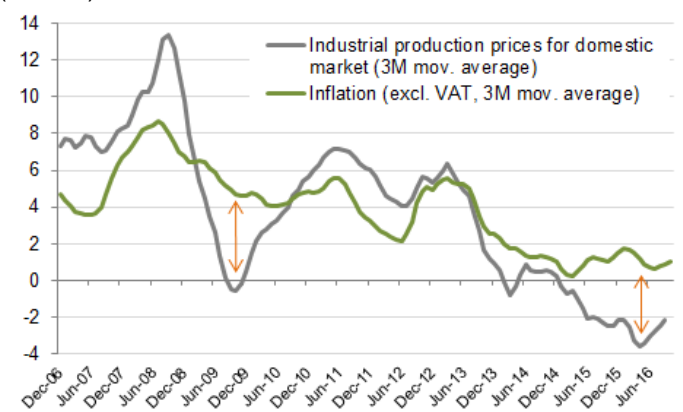
Sources: NIS, OTP Research
Note: filtered from VAT changes.

Chart 11: ULC & households' consumption vs. inflation (YoY %)

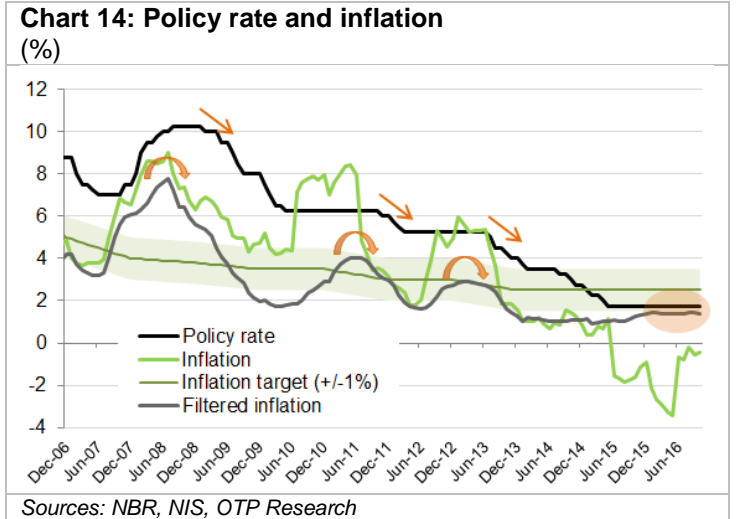
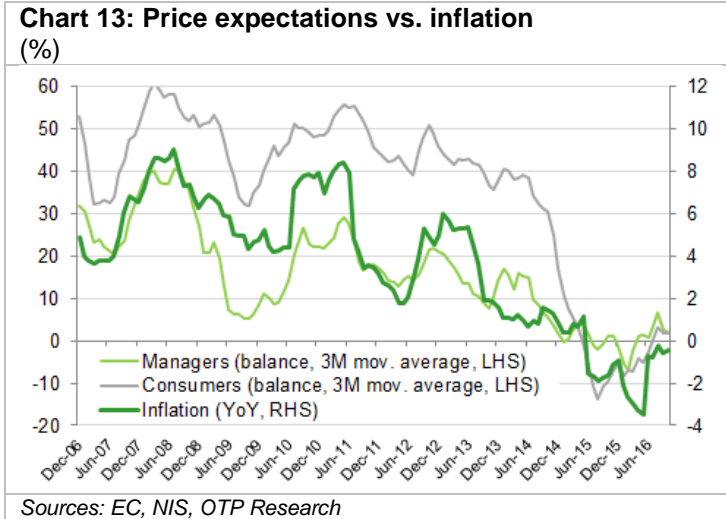


Sources: Eurostat, NIS, OTP Research

Chart 12: Industrial production prices vs. inflation (YoY %)



Sources: NIS, OTP Research



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