

# REPORT ON INFLATION

14 December 2016

## Both headline and core inflation slowed in November

- Consumer prices fell by 0.7% YoY in November, diving deeper in negative territory, after the annual inflation rate stood at -0.4% in October (see Chart 1). In month-over-month comparison, consumer prices barely increased, adding 0.1%. The newly released figures undershot expectations, with the market consensus projecting -0.45% YoY headline inflation for the penultimate month of the year (Reuters survey), while our forecast was -0.50% YoY. It may be worth mentioning that excluding the first-round impact of January's VAT reduction, consumer prices would have increased by 0.7% YoY, according to our estimation (Chart 3). Beyond the negative reading of the headline data, our in-house underlying CPI measure, *filtered inflation*<sup>1</sup> also surprised us on the downside, slowing from 1.4% YoY, to near 1.2% YoY (in fact, the monthly drop is closer to 0.1 percentage point; the numbers do not add up due to rounding).
- The gap between the headline CPI and our forecast came primarily from the larger-than-assumed decline in administered prices and to a lesser extent it was the result of swiftly easing market services inflation, after insurance fees fell sharply in November. The latter group of items left its mark on our underlying measure as well, explaining the largest part of our forecast error on the line of filtered inflation.
- Administered prices decreased in November, first of all driven by the evolution of heating price. This item picked up a month earlier, but the movement proved to be short-lived, driving the index back to its previous level in November (Chart 6). This rarely seen pattern causes modest downside risk to our year-end inflation forecast of -0.3% YoY. Other non-core items were broadly in line with our expectations. Unprocessed foods accelerated a bit (Chart 7) in contrast with the inflation of tobacco and alcohol products as well as fuels. The former group lost steam primarily on fading base effects, while fuels were pulled back also by the lower average level of crude oil futures last month.
- Going back to market services (Chart 10), we note that November's sharp fall mainly came from the line of other services, covering first of all insurances. Most likely, the movement reflects the response of financial companies to the intensified tensions around the mandatory car insurance premiums (RCA) as well as the actions of the Financial Supervisory Authority to limit maximum tariffs. Nonetheless, even excluding the quite volatile group of other services, inflation eased in the segment, after some signs of stabilization in the previous month. We think that even though the downward trend continues in the short term, the rapidly surging wages in the sector could make entrepreneurs start to raise prices in order to preserve profit margins. Therefore, a turnaround might be round the corner in the case of core market services. The other two components of filtered inflation – processed foods' (Chart 8) as well as goods' (Chart 9) – caused little excitement in November, in line with our expectations.
- To sum it up, we believe that the big picture remained broadly the same, despite the larger-than-thought drop in inflation in November. As we noted in our previous [report](#) too, the precursors of demand-pulled inflation arrived, reflected by robust consumption, while unit labour costs are rising rapidly (Chart 11). In addition, with the stabilization seen on global financial markets in the latest period, the pull-back effect of commodity prices should fade gradually, and the impact of VAT changes will also vanishes. These factors are set to put headline inflation on a gradually increasing trend in the quarters ahead.
- Regarding our 2016 year-end forecast, we see some downside risks on the back of November's weak data, but these are partially offset by the perspective of higher crude oil prices in December. Therefore we maintain our projection at -0.3% YoY. We also continue to mention that the latest news on next year's tax changes may significantly alter our forecasts. Mr Dragnea, the leader of leftist Social Democrat Party (PSD) said recently that the one-percentage-point VAT cut planned for 2017 could be postponed, while the reduction of the excise duty on fuels may be withdrawn. Nonetheless, the PSD aims to lower standard VAT by 2 pps in 2018. Our initial estimation suggests that if the measures will be implemented, inflation may rise to around 3% in 2017 (instead of 2.6%), while it could be only 2.5% in 2018 (down from 2.9%). We will update our forecast more precisely, after the situation around the proposals becomes clearer.

<sup>1</sup> *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.*

### 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

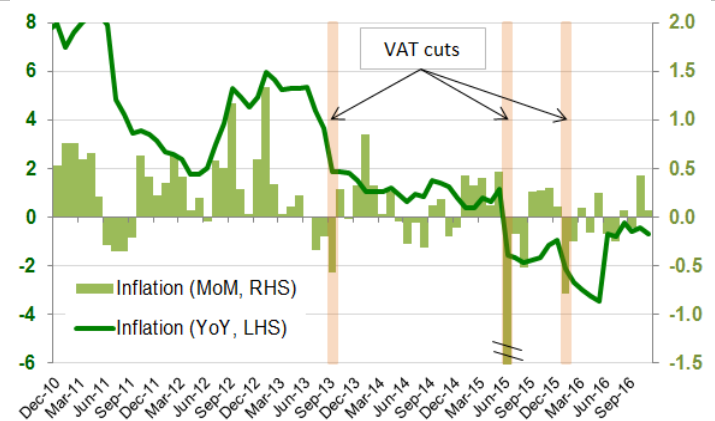
**Gergely Tardos**  
+36 1 374 7273  
tardosg@otpbank.hu

### Analyst

**Csaba Bálint**  
+4021 307 58 96  
csaba.balint@otpbank.ro

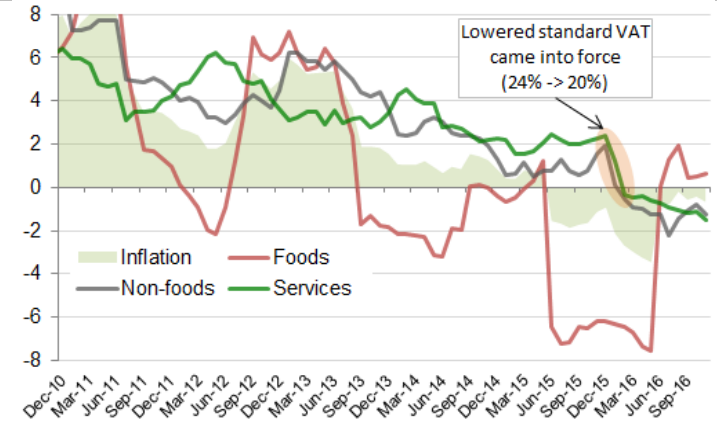
**Chart set:**

**Chart 1: Headline inflation**  
(%, NSA data)



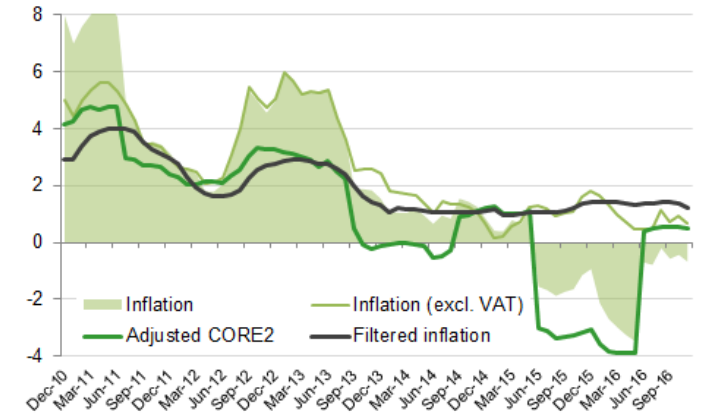
Sources: NIS, OTP Research

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



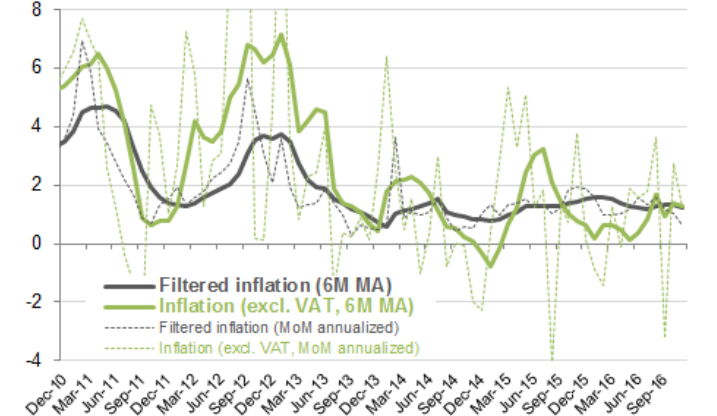
Sources: NIS, OTP Research  
Note: in line with the National Institute of Statistics' (NIS) general segmentation.

**Chart 3: Inflation and underlying processes**  
(YoY%)



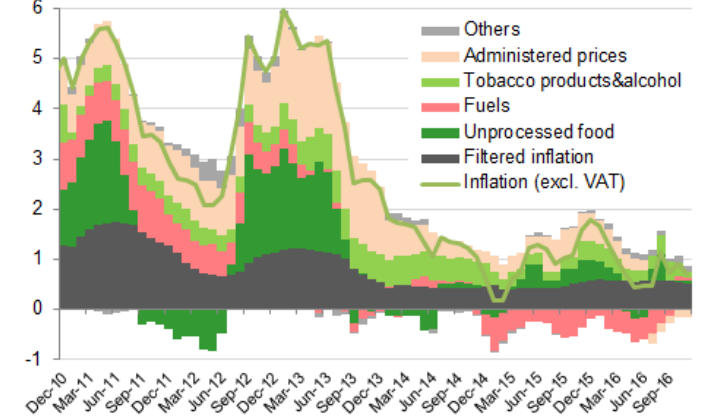
Sources: NIS, OTP Research  
Note: **Adjusted CORE2** =inflation excluding VFE (vegetables, fruits, eggs), fuels, regulated as well as beverages and tobacco prices;  
**Filtered inflation** = in-house underlying inflationary measure (SA).

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



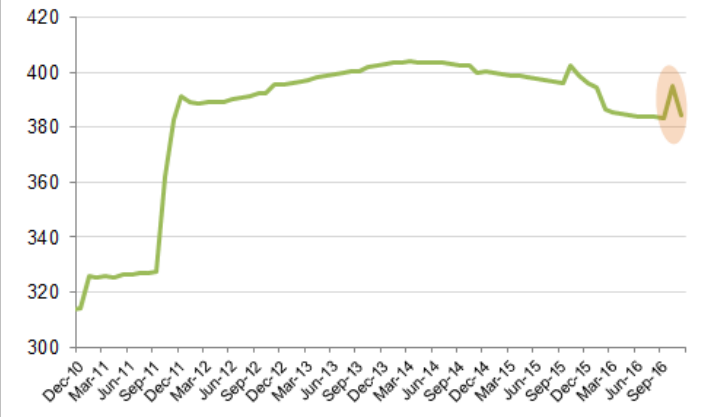
Sources: NIS, OTP Research  
Note: filtered from VAT changes; 6M MA = six-month moving average

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



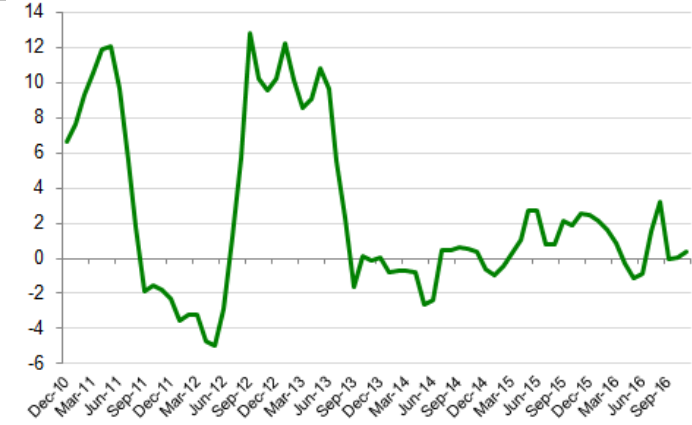
Sources: NIS, OTP Research  
Note: filtered from VAT changes.

**Chart 6: CPI of heating**  
(Dec. 2001 = 100, SA)



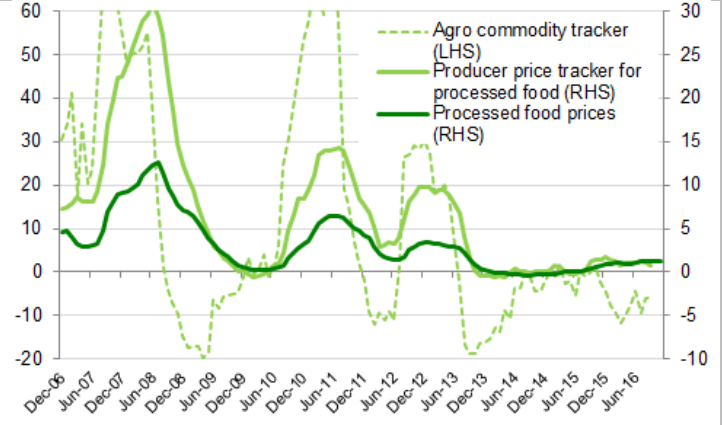
Sources: NIS, Reuters, OTP Research  
Note: filtered from VAT changes.

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



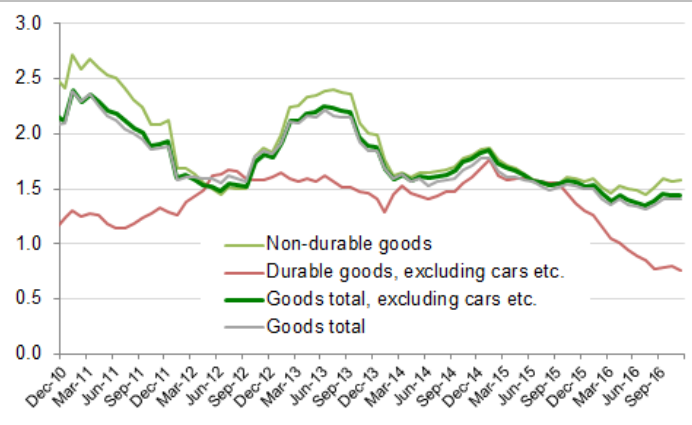
Sources: NIS, OTP Research  
Note: filtered from VAT changes.

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



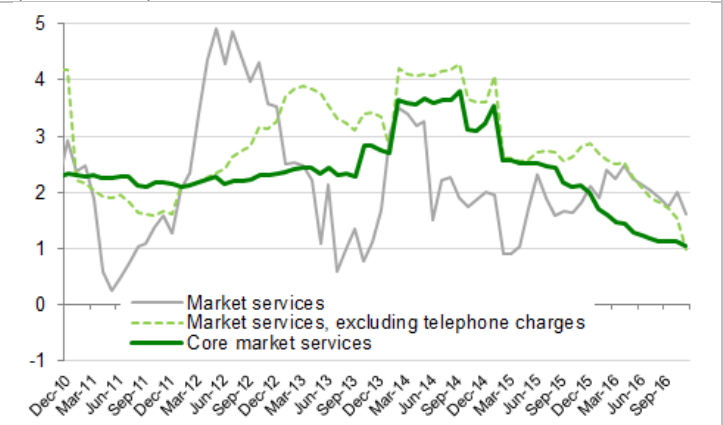
Sources: NIS, OTP Research  
Note: filtered from VAT changes.

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



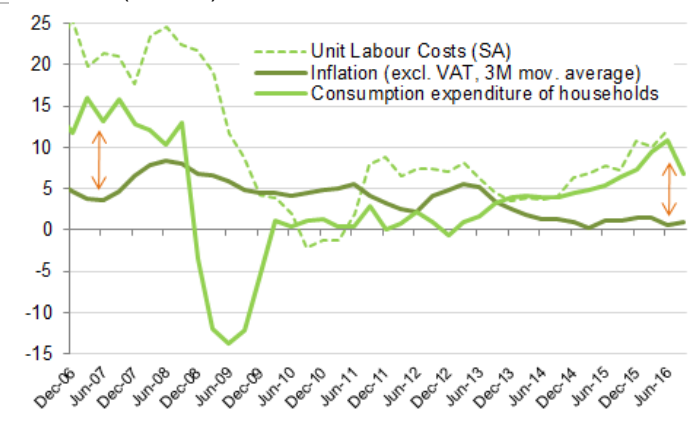
Sources: NIS, OTP Research  
Note: filtered from VAT changes.

**Chart 10: Market services (YoY%, SA)**



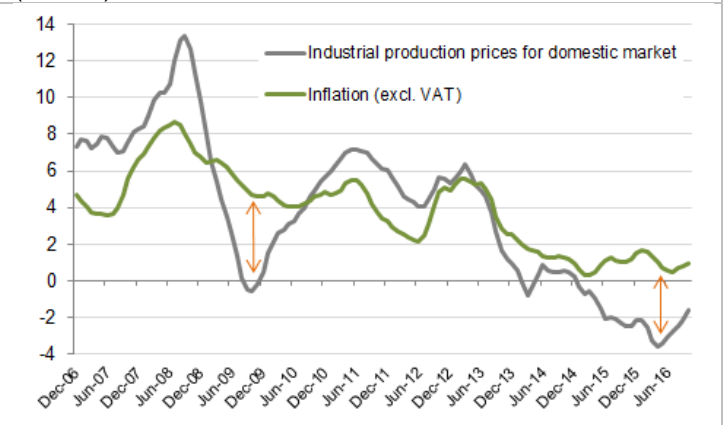
Sources: NIS, OTP Research  
Note: filtered from VAT changes; **Core market services**, beyond the EUR/RON-related telephone charges, excludes the line of other services too, which covers mainly insurances.

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

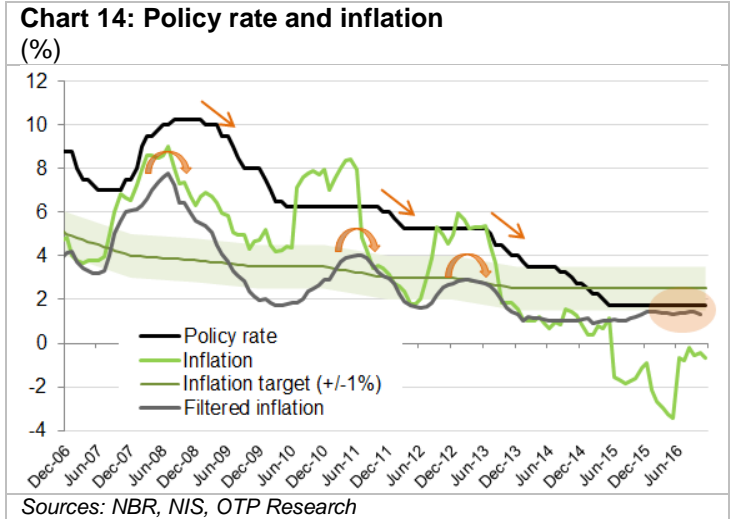
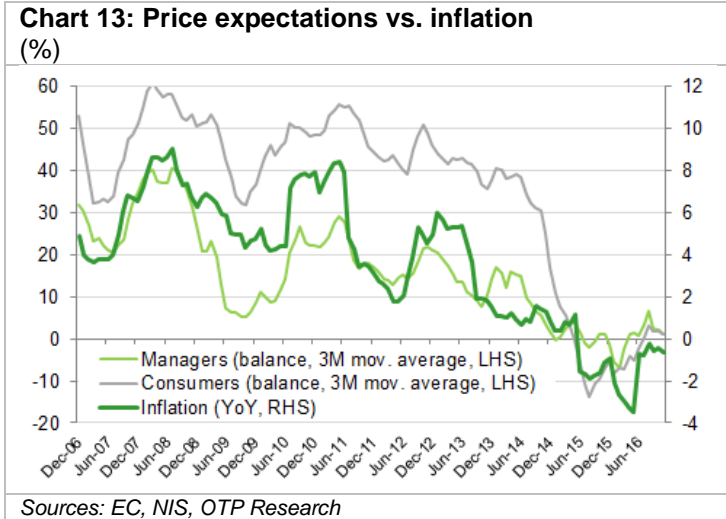


Sources: Eurostat, NIS, OTP Research

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



Sources: NIS, OTP Research



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