MONETARY POLICY COMMENT

9 January 2017

The rates are on hold, as expected; but fiscal easing may push the NBR to tighten in H2 2017

- **On the first rate-setting meeting of the year, the Board of the central bank left the benchmark interest rate unchanged at 1.75%**. The deposit and the lending facility rates as well as the mandatory reserve ratios were also untouched by policy makers. The "no change" outcome of the January's meeting was fully in line with the market's and our anticipations. Under these conditions, the decisions had limited impact on the EUR/RON on Friday.
- In our previous report, we noted that there had been several factors, which probably made it quite difficult for the NBR to design a suitable strategy for the following period. Since then, some of the uncertainties dropped out, as the ECB revealed its new bond purchasing plan and the Fed also did an important step, by raising the benchmark rates in December. However, **vagueness lingered further on the domestic front, with numerous questions about the fiscal outlook**. These uncertainties probably also inclined the central bank to continue its wait-and-see approach, without providing any clue about further policy actions.
- **In relation to the broader picture, we deem that the situation is basically unchanged**. Underlying price dynamics are still weak, as external factors continue to weigh on the CPI, while there are some precursors of demand-pulled inflation. Short-term outlook also seems to be relatively subdued, despite the fading effect of VAT cuts (for further details please visit our latest inflation report). Therefore, the NBR has no strong reason to swiftly launch the policy normalization process. Nonetheless, further signs of a turning point showed up. Commodity prices appeared to stabilize, crude oil futures even pointed to a strong rebound, and the eurozone's HICP inflation climbed higher again, reaching a 3.5-year peak in December. Simultaneously, on the domestic front the parties winning the general elections are planning to introduce a new bunch of fiscal stimulus measures, aiming to boost the already robust domestic demand. These support the idea that tightening should to come later this year.
- Regarding the perspective of the fiscal stance, it would be too early to form a final judgement, as many important details are yet to be revealed. Nevertheless, the latest actions and the campaign promises, coupled with the increasing risk of a slippage indicate that **the new government budget could be a game-changer, with the potential to trigger a monetary tightening cycle**. Hence, developments on this side require particular attention.
- The NBR communique and Mr Isarescu's press conference provided no guidance about future policy actions. The CB's governor also avoided commenting on the recent government measures, recalling that the final form of the new budget is still unknown. The minutes of the meeting may provide some additional information in this respect.
- Since the NBR shifted to direct inflation targeting in August 2005, there were only two tightening periods. The latest, and also the more severe one, took place between October 2007 and July 2008. Even though the overall situation was quite different at that time, as huge macroeconomic imbalances and clear signs of overheating characterized the country, it may be worth drawing parallels between them. Inflation perspectives deteriorated rapidly in this period (see Chart 1), among others due to the *"persistence of negative supply-side effects, high household income dynamics, the projected rise in public spending towards year-end, as well as uncertainties over leu exchange rate movements"*. It should be noted that some of these triggering factors, like swiftly surging wages and growing budget expenses are already manifest at present too.
- **In conclusion, we maintain our earlier expectation that the central bank may start to normalise its monetary policy in H2 2017**, pushing money market rates gradually higher. In the first step, this may happen though narrowing the interest rate corridor, and later by raising the key rate too. We also suspect that the benchmark rate could reach gradually as high as 3% on a two-year horizon. Meanwhile, fiscal development should also be closely monitored.

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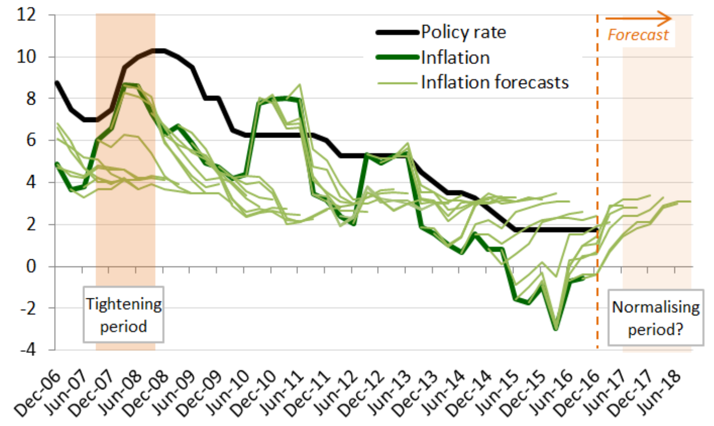
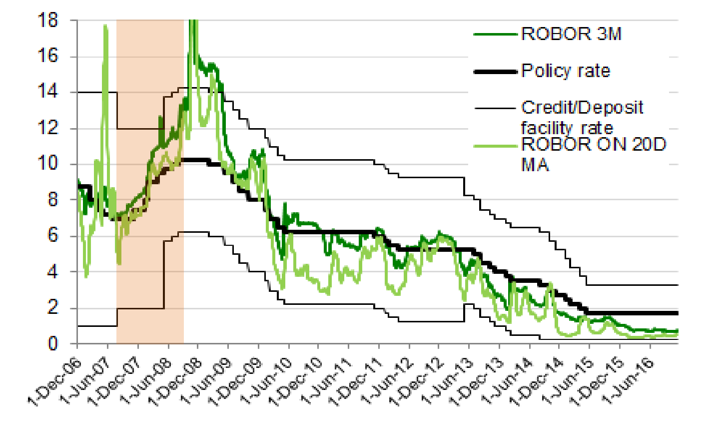
Chart set:

Chart 1: Policy rate, inflation, and the inflation forecasts of the NBR (%)



Sources: NBR, NIS, OTP Research

Chart 2: Policy rates and interbank MM rates (%, daily data)



Sources: NBR, OTP Research

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