REPORT ON INFLATION

16 January 2017

December's inflation remained in negative territory, presumably for the last time for a while; underlying price pressures are still subdued

- Romania's annual inflation ended last year at -0.5%, inching somewhat higher from November when the indicator stood at -0.7% YoY (see Chart 1). At the same time, consumer prices advanced 0.2% on monthly basis in December, the NIS report also said. The recently published statistics matched the market consensus (Reuter's survey: -0.5% YoY) and undershot our expectation of -0.4% YoY by a narrow margin. Our forecast error was mainly the result of weaker-than-assumed increase in vegetable prices and a softer transmission of rallying crude oil futures into the CPI of fuels. These small differences have no impact on the longer-term outlook, as they could swiftly reverse. The group of vegetables is traditionally the most volatile item of the consumer basket and the transmission channel of fuels also frequently shows slight discrepancies. Meanwhile, *filtered inflation*[1] moved in line with our expectations in December, finishing last year at 1.2% YoY (Chart 3).
- As 2016 just ended, it may be worth taking a brief look back. Last year was the second in a row for the annual inflation to stand in negative territory. What is more, the headline figure dipped even lower in 2016, with a -1.5% YoY average level, down from 2015's -0.6%. Nevertheless, these developments mainly reflected the impact of consecutive VAT reductions (15-percentage-point VAT cut on foods as of June 2015, and another 4 pps decline in the standard VAT rate in January 2016). Without these measures, the average inflation would have been practically the same in both years, at 1%, our in-house estimation showed. Indeed, this level still points to considerable slackness in price dynamics, and is well below the NBR's target of 2.5% (+/-1%). However, the big picture should be completed with the fact that external factors also put significant downside pressure on CPI evolution, and simultaneously domestic-demand-lead inflation risks started to build up.
- In recent years, the relatively sluggish economic recovery, substantial overcapacity in several industrial sectors and softening commodity prices led to a very low inflationary environment at global level. The spill-over effects were felt in Romania too, among other channels via import prices. The GDP deflator, which captures the price evolution of all goods and services produced in the country, persistently pointed to increases in this period. Even though the gains were not spectacular (wobbling in the 0-5% range), they showed a strong contrast compared to the deflator of imports (Chart 5). Since the beginning of 2013, the latter has pointed to declines with only a few exceptions. Not surprisingly, the EUR/RON exchange rate played an important role in the determination of import prices, as the eurozone is Romania's largest trading partner. In some periods, like just after the outburst of the financial crisis, the weakness of the leu more than offset the negative spill-over effects coming from abroad. On the other hand, similar absorbing impacts were absent in the past few years, as the EUR/RON showed resilience to shocks, leaving its mark not only on the imports' deflator but on CPI dynamics as well.
- Turning back more specifically to the December's data, it is worth mentioning that the main driver of the acceleration was the increase in fuel prices (1.6% MoM). This surge was due to a strong rebound in crude futures (Chart 6), after an important deal among the largest oil producer countries to scale back their oil output. The other non-core items, like unprocessed foods, administered prices, as well as tobacco products and alcohol had only marginal influence on December's movement of the headline figure (Chart 7).
- Meanwhile, the main components of our filtered inflation measure showed a mild but broad-based deceleration, with processed food prices increasing 1.1% YoY in December, down from 1.2% YoY a month earlier (Chart 8). Nevertheless, we think this group of items may bottom out in the coming months, as agro commodities started to stabilize. Simultaneously, goods' as well as services' CPI also lost some steam in December (Chart 9&10), in line with our short-term forecast.

[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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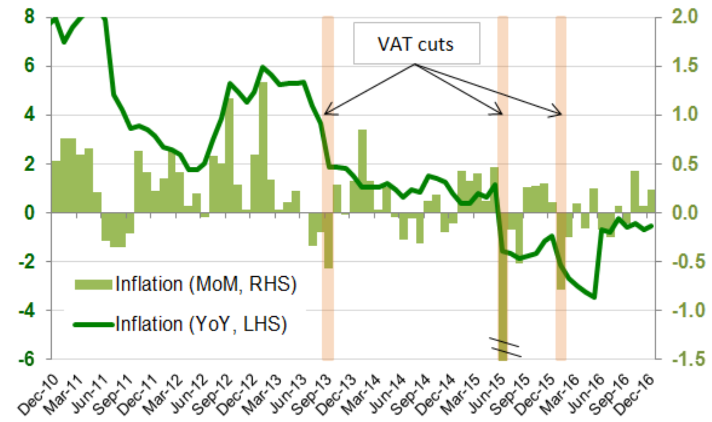
- Finally, it is important to note that the period of negative inflation in Romania most likely came to an end in 2016. Admittedly, there is some uncertainty about the pass-through of January's tax changes, especially at the new, 1 percentage point cut of VAT, but these should not offset the fading base effect of the earlier VAT reduction. Therefore, annual inflation is set to return into positive territory at the beginning of 2017. In addition, we also suspect that the domestic factors, like skyrocketing unit labour costs (Chart 11) and normalizing inflation dynamics on the external front may start to be reflected gradually in the CPI, while a potential reversal in raw material prices could result in additional pressures, especially via foods' CPI.
- In the light of the recent evolution of oil prices, and to a lesser extent due to the still weak filtered inflation, we revised our year-end CPI forecast down, from 2.6% YoY to 2.2% YoY. After the sharp increase in crude futures, we see limited upside potential, which could have a negative base effect on fuel prices, pulling back the headline data as well at the end of 2017. Based on our updated forecast, we think that one 25 bps policy rate hike may come this year, instead of two. Nevertheless, the broader picture remains the same, namely the policy normalizing could start in H2 2017. At the same time, developments on the fiscal front cause high uncertainties.

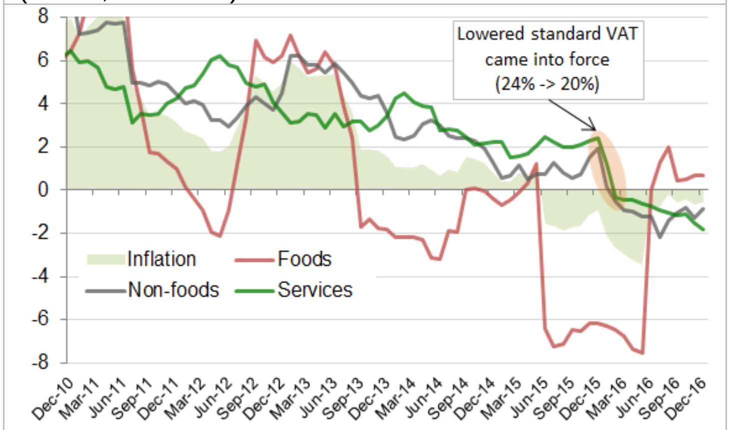
Chart set:

Chart 1: Headline inflation
(%, NSA data)



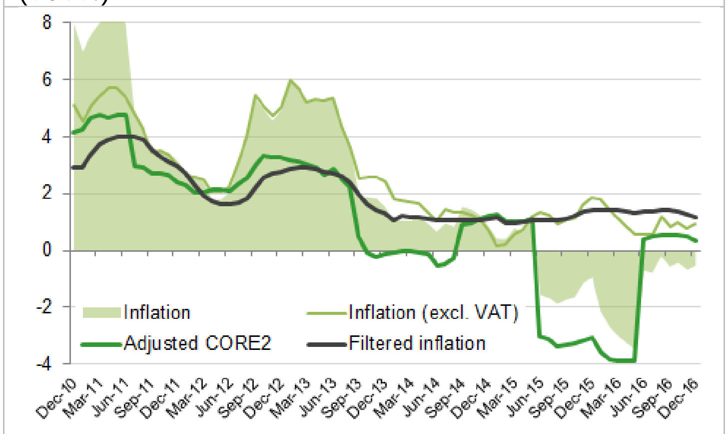
Sources: NIS, OTP Research

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



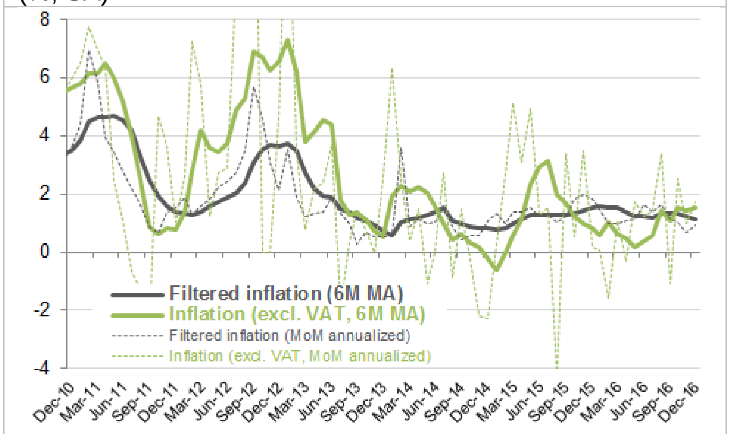
Sources: NIS, OTP Research
Note: in line with the National Institute of Statistics' (NIS) general segmentation.

Chart 3: Inflation and underlying processes
(YoY%)



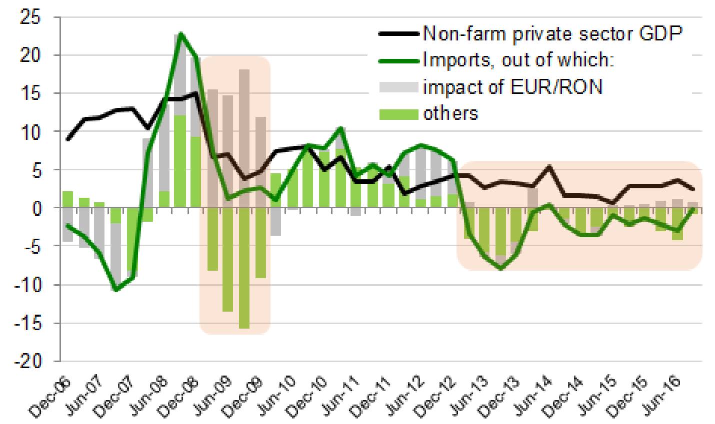
Sources: NIS, OTP Research
Note: ***Adjusted CORE2*** *=inflation excluding VFE (vegetables, fruits, eggs), fuels, regulated as well as beverages and tobacco prices;*
Filtered inflation *= in-house underlying inflationary measure (SA).*

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



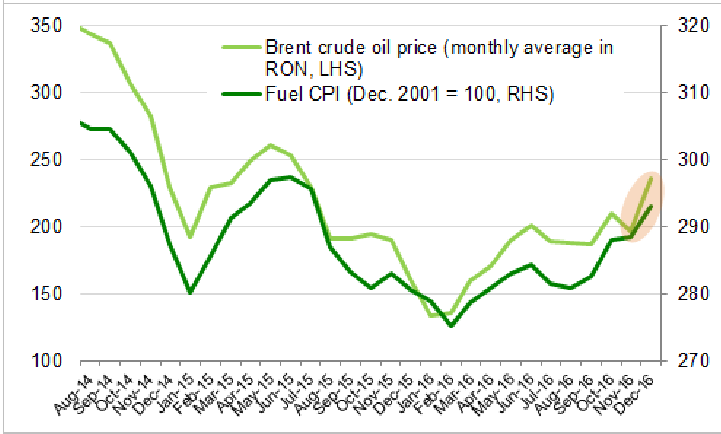
Sources: NIS, OTP Research
Note: filtered from VAT changes; 6M MA = six-month moving average

Chart 5: Deflator of imports and GDP
(YoY%)



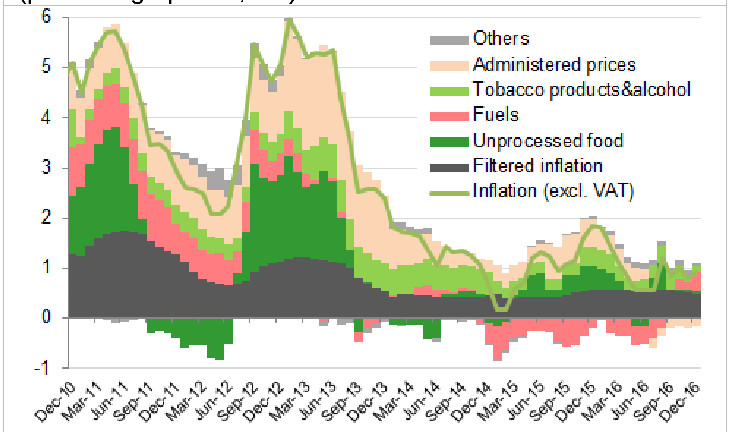
Sources: NIS, OTP Research

Chart 6: CPI of fuels vs. Brent oil prices



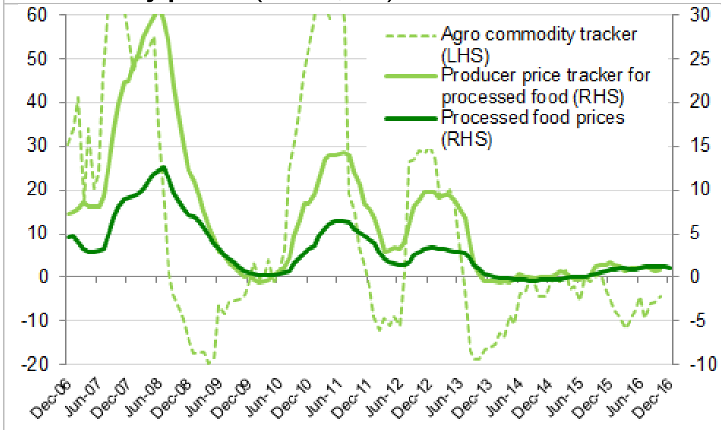
Sources: NIS, Reuters, OTP Research
Note: filtered from VAT changes.

Chart 7: Decomposition of inflation
(percentage points, SA)



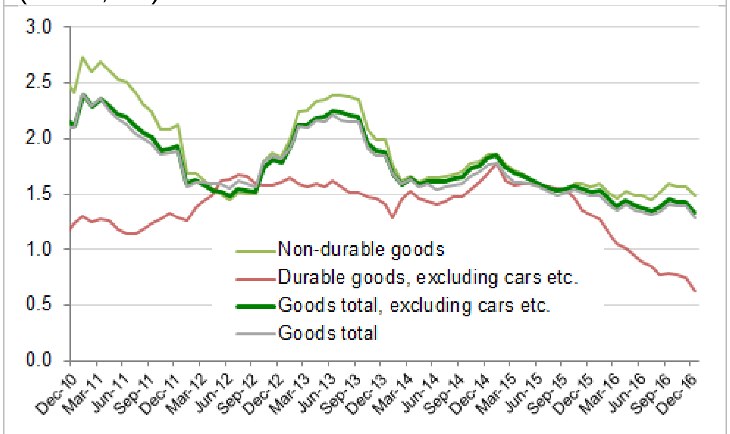
Sources: NIS, Reuters, OTP Research
Note: filtered from VAT changes.

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



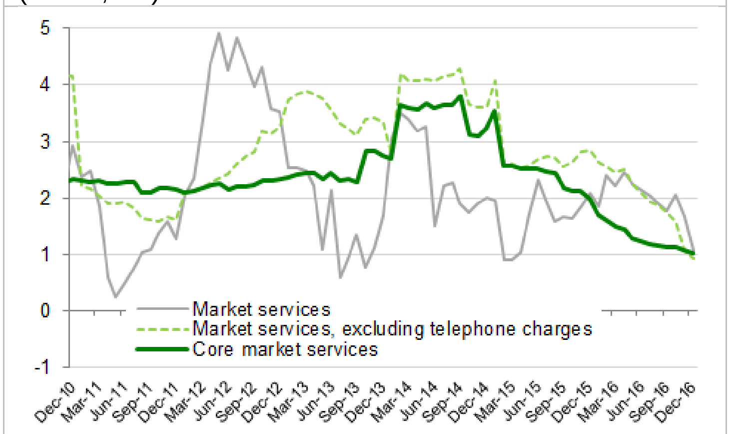
Sources: NIS, OTP Research
Note: filtered from VAT changes.

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



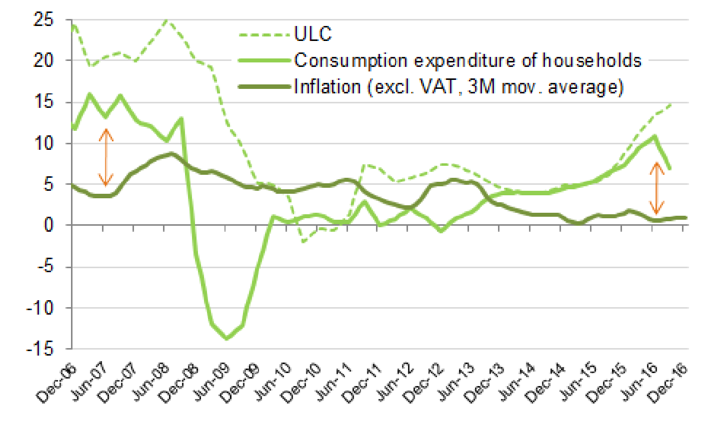
Sources: NIS, OTP Research
Note: filtered from VAT changes.

Chart 10: Market services
(YoY%, SA)



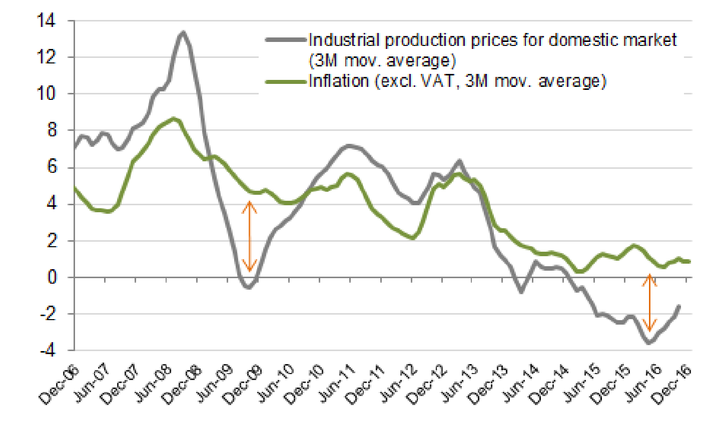
Sources: NIS, OTP Research
*Note: filtered from VAT changes; **Core market services**, beyond the EUR/RON-related telephone charges, excludes the line of other services too, which covers mainly insurances.*

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



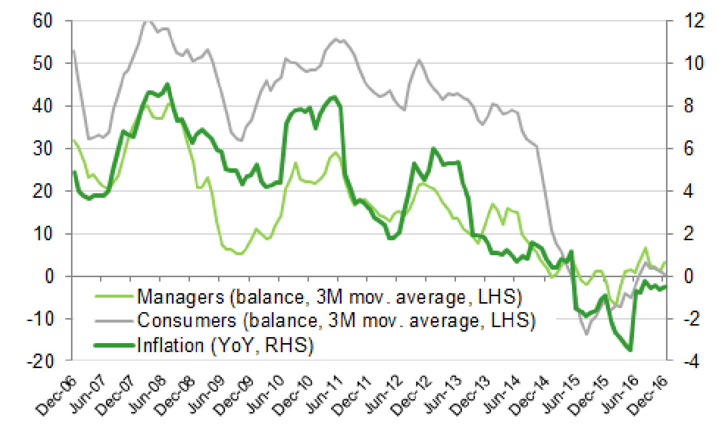
Sources: Eurostat, NIS, OTP Research

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



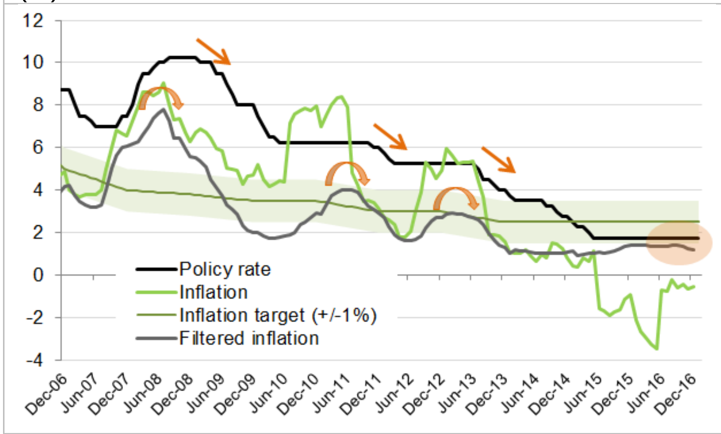
Sources: NIS, OTP Research

Chart 13: Price expectations vs. inflation
(%)



Sources: EC, NIS, OTP Research

Chart 14: Policy rate and inflation
(%)



Sources: NBR, NIS, OTP Research

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