otp Research

MONETARY POLICY COMMENT

7 April 2017

First rate hike could be delayed for 2018; the interest rate corridor is set to be reduced to +/-1% around the policy rate

- In line with the unanimous consensus of the market, the central bank left the policy rate at 1.75% for its 15th consecutive meeting. Last time the policy rate was modified in May 2015, when the members of the Board decided to cut it by 25 basis points, from 2.00%. As we expected, the other key instruments were also left unchanged, maintaining the standing facilities at 0.25% and 3.25%. Meanwhile, the minimum reserve requirement ratios were untouched as well (8% for RON and 10% for hard currency liabilities). Following the policy meeting, the leu gained around 0.3% compared to the euro. Indeed, NBR chief Mr Isarescu made soothing comments regarding the exchange rate on his press conference, but we suspect that this was rather the triggering event behind the leu's movement, and not necessarily the key reason. It is important to mention that the leu underperformed its CEE region's peers in the past few months and a correction was widely anticipated.
- The most important explanation behind the central bank's wait-and-see attitude was the still subdued consumer price evolution. As Mr Isarescu highlighted, headline inflation (at 0.2% YoY in February) is far from the 2.5% target, and it is unlikely to exceed the lower bound of the target (1.5%) before Q4 2017. We recall that the NBR projects 1.7% CPI growth for the end of the year, practically in line with our forecast (1.8%).
- Headline inflation left negative territory in recent months, as the base effect of last year's significant VAT reduction faded out, but another bunch of tax changes (an additional standard VAT rate cut, the elimination of the special excise duty on fuels as well as the radio&TV fee) still weighs on the indicator. After excluding these negative impacts, consumer prices would have increased by almost 1.2% YoY in February, according to our in-house estimation.
- Meanwhile, a change regarding the big picture started to take shape, after cost-push inflation pressures showed signs of a return, highlighted by reviving producer prices (see Chart 2). Swiftly rising unit labour costs, coupled with currently stabilized commodity futures, helped the PPI to inch higher at the beginning of this year. The precursors of demand-pull inflation were present earlier too, reflected by rising consumption. Indeed, the growth pace of households' expenditures softened more in H2 2016 than we have expected, but overall it remained healthy. These developments reinforce our view that headline inflation may continue to go up in the following period.
- It may also be worth noting that the IMF staff, which visited Bucharest on 8-17 March, recommended to the NBR to remain vigilant amid rising inflation pressures and to consider tightening measures. The IMF added that the government budget suffers from structural weaknesses too, as it is designed to fuel further consumption among others via wage and pension hikes. These could put further pressure on underlying consumer price dynamics in the quarters ahead.
- Nonetheless, the messages of the press conference were a bit more dovish than we had expected, with Mr Isarescu stating that the NBR cannot balance the weaknesses in other areas, alluding to the very stimulative stance of the government budget, as it would be a suboptimal policy mix. At the same time, the governor also suggested that the NBR cautiously follows the movements of other central banks in the CEE region, in order to avoid significant capital inflows.
- Regarding the minimum reserve ratio for hard currency, the CB chief said that it would be lowered every time when there is the possibility to do so. We recall that the harmonization of MRRs with the levels seen in other EU countries is an old-established aim of the central bank. However, the question of reserve ratios for leu is a more complex one, Mr Isarescu said too. At this point, it is important to mention that excess liquidity characterizes the money market. In our opinion, this is due to two main drivers: first of all, the government made large expenses at the end of December, and its spillover effects still persist. Secondly, the private sector looked to be relatively cautious in the last few quarters, with stronger propensity to save, especially in the case of households (for further details on this issue please see our Q4 GDP report). In addition, with the outlook of monetary policy normalisation, which was confirmed by Mr Isarescu, such reductions would be not a wise choice.

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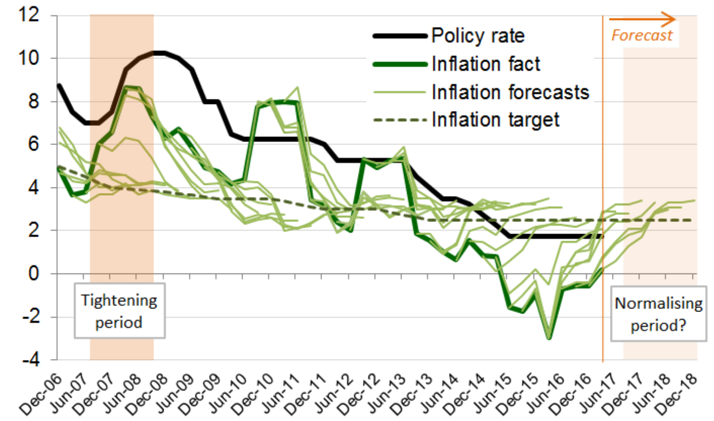
- In all, we think that the first rate hike will be delayed, probably for the beginning of 2018 (previously we have expected it for December 2017), given a bit more lenient approach of the NBR. Nevertheless, the general outlook remains the same. With February's guidance of the central bank on the perspective of rising interest rates, and with the most recent statements of Mr Isarescu about the aim of reducing the interest rate corridor to +/-1% around the policy rate, it seems that the NBR slowly, but steadily paves the way for policy normalisation. We suspect that before the first rate hike, the central bank may narrow the corridor in two equal steps in H2 2017.
- We recall that the cautious approach of the NBR in respect of starting normalisation steps is not an exception in the CEE region. With relatively similar backgrounds, the other central banks are also vigilant and keep track of the movements made by their peers, in order to mitigate potential appreciation pressures. As economic growth got traction and simultaneously headline inflation started to rise, also helped by the fact that several negative base effects dropped out, there are more signs suggesting that the end of the extra loose monetary policy is round the corner. The first important step was made by Czech National Bank just in recent days, by removing the cap on the EUR/CZK.

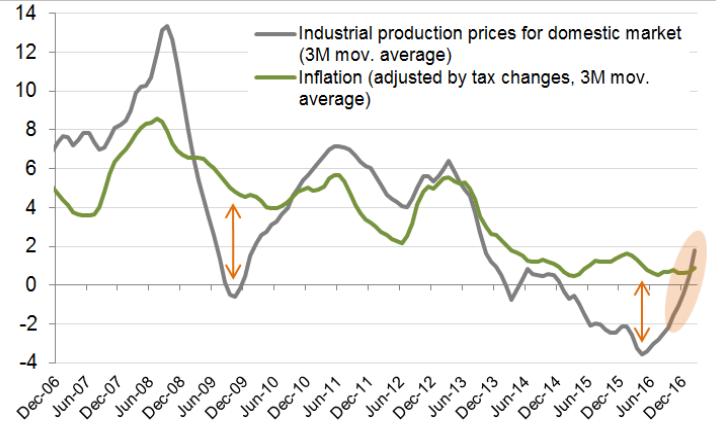
Chart set:

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



Sources: NBR, NIS, OTP Research

Chart 2: Industrial production prices vs. inflation (YoY %)



Sources: NBR, OTP Research

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