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MONETARY POLICY COMMENT

8 May 2017

Benchmark rates on hold, as expected; the 2pps cut of the MRR translates into EUR 0.5 bn extra fund to the banking system

- As it had been widely expected, the Board of the central bank decided to maintain the benchmark rates at their previous levels. Accordingly, the policy rate remained at 1.75% and the interest rates on the central bank's key instruments (deposit and lending facilities) were left unchanged at 0.25% and 3.25% respectively. Simultaneously, the NBR reduced the minimum reserve requirement ratio (MRR) by two percentage points to 8% for FX liabilities, while in the case of leu-denominated funds the MRR was untouched (8%). The outcome of the rate-setting meeting had limited impact on Friday's trading, as the decisions did not bring any major surprise. The press conference of NBR chief Mr Isarescu was relatively short too, as the new inflation report will be presented to the public on a separate event soon.
- The move of the central bank to cut the reserve ratio by 2 pps was in line with the old-established intention of policymakers to harmonize the MRRs with the levels practiced in other EU member state. At the previous meeting, Mr Isarescu underlined that the reserve ratio would be lowered every time when there is a possibility to do so. The reduction will make around EUR 0.5 bn extra liquidity available for the banking sector. However, we think that the additional funds will have negligible impact on monetary conditions in general. As lending activity is mainly financed from leu sources, and the interbank market is already ruled by significant RON surplus, there is no special need for hard currency. In these conditions, we assume that an important part of this amount may pass the borders, probably in the form of redemptions to mother banks. In the press release following the monetary policy meeting, the NBR also cited raising FX reserves to above adequate levels as a motivation for the MRR cut. We recall that the central bank's FX reserves recently reached new highs, easily covering short-term external debt and imports (for further details see our Balance of Payments report).
- The decision of the Board to maintain the loose monetary conditions was supported by the sluggish outlook of annual inflation in the short term. Consumer prices increased by only 0.2% YoY in March, and their growth rate most likely will remain well below the NBR's 2.5% target even at the end of this year (we expect 1.6% annual inflation for December). Nevertheless, it is important to mention that underlying price measures signal an inflection point, as both cost-push (via rising producer prices) and demand-pull (on the back of strong domestic demand) inflation factors point to a gradual pick-up. Moreover, the government's plan to swiftly raise wages in the public sector puts additional pressure on the medium-term inflation perspective. Admittedly, a reconsideration of the remuneration system would be necessary in the sector to reduce the significant disproportionalities, but the proposed unitary wage bill goes far beyond this objective. In our opinion, the implementation of the new law could result in spillover effects in the private sector too, as entrepreneurs may be also compelled to rapidly raise salaries in order to retain well-prepared workforce on a tight labour market. Beyond rising inflation pressures, a growth pace that exceeds productivity gains by a wide margin is set to lead to higher current account deficit too, while a deterioration of the government balance is also expected.
- Not surprisingly, the Board of the central bank seemed to be concerned by recent fiscal and income policies. Nevertheless, the minutes of the previous meeting reaffirmed members' view that *"monetary policy could not offset or counter weaknesses in other areas"*, as it would led to a *"suboptimal policy mix"*. At the same time, the report mentioned staff analyses, which had suggested that core inflation sensitivity to the output gap declined in the latest period. Board members also discussed credit developments, proposing macroprudential measures (without reference to higher interest rates) to counteract a potential overheating on the lending side. Finally and most importantly, the NBR's communique, including Mr Isarescu's latest press conference, indicated that policy makers cautiously monitor other central banks' actions too. These support our earlier expectation that the NBR will probably be relatively permissive, and will not raise the policy rate before Q1 2018. However, it is important to note that normalization steps still could come this year, by narrowing the interest rate corridor. We recall that interbank rates are staying well below the policy rate (see Chart 2), given the sizable liquidity surplus on the market.

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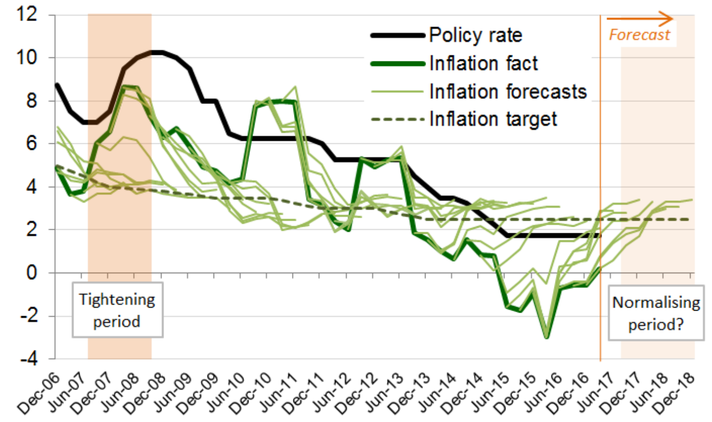
- Regarding the new inflation forecast, the NBR's press release pointed out that the CPI trajectory was revised slightly down (they projected 1.7% year-end inflation for 2017), but reiterated that the growth rate of consumer prices is set to gain momentum. We also lowered marginally our December 2017 inflation forecast to 1.6%, down from 1.8% earlier. The details of the NBR's new report will be revealed on 15 May, together with the minutes of the monetary policy meeting.

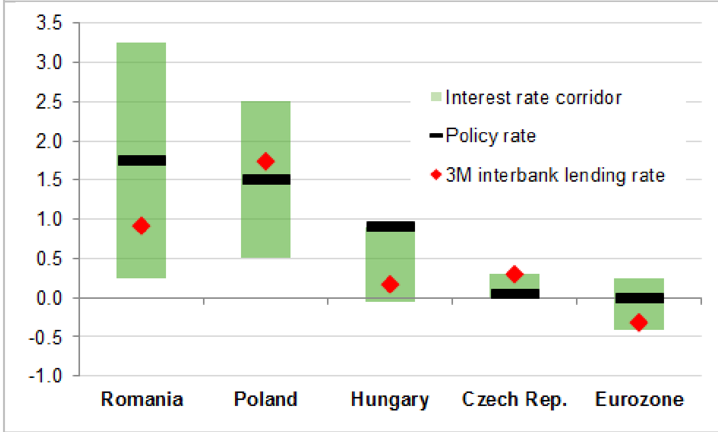
Chart set:

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



Sources: NBR, NIS, OTP Research

Chart 2: Benchmark rates (%)



Sources: central banks, Reuters, OTP Research
Note: 3M interbank lending rates as of 5 May 2017

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