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MONETARY POLICY COMMENTARY

4 July 2017

Benchmark rates on hold again; more hawkish tone, but no new hints at the policy normalisation process

- On its 3 July meeting, the National Bank of Romania left its key interest rate unchanged at 1.75%. The interest rate corridor (+/-1.5% around the policy rate) remained untouched too, similarly to the reserve requirement ratios: 8% both for leu and foreign-currency denominated liabilities. We recall that the reserve ratio for FX-denominated liabilities was lowered by 2 percentage points in May, releasing around EUR 0.5 bn extra fund for commercial banks. The outcome of July's monetary policy meeting came as no surprise, after the latest economic polls, in line with our expectations, had showed that the policy rate was set to stay at 1.75%, at least until the end of this year.
- Regarding the market reaction, after motionless morning hours, the EUR/RON went north after the policy decision, finishing the session around 0.3% higher. Apparently, the modest depreciation of the leu was triggered by the concerns expressed in the NBR's press release regarding the fiscal and income policies of the government.
- The decision to keep the benchmark rates flat can be justified by the still subdued short-term inflation perspective. Romania's headline inflation stood at only 0.6% in May, and most likely it will stay well below the central bank's target of 2.5% until the beginning of next year. The political turmoil around the coalition parties as well as the heightened uncertainties over the updated government programme provided further reasons to keep rates on hold.
- Nevertheless, it is important to underscore that the headline inflation is expected to continue its upward trend in the following period, bolstered by vanishing base effects and also fuelled by the recovery of core price dynamics. As we noted earlier, the main fundamental forces, among others with definitely strong domestic demand and wage growth outpacing productivity gains, indicate that prices may gradually accelerate. And indeed, an increasing number of evidences suggests that underlying reflation process started to take shape most recently (for further details on this subject please read our latest inflation report).
- The press release published after the policy meeting emphasized the recovery process of CPI indicators, pointing out that inflation trajectory could be slightly above the one projected in May's medium-term forecast. Simultaneously, the report underlined the stronger-than-expected performance of the economy in Q1 too, adding that the outlook for Q2 is also quite bright. In addition, central bankers warned about the risks coming from fiscal policies as well. Admittedly, neither the press release nor Mr Isarescu speech provided any cue about the launching date of the normalisation process, but apparently the tone became more hawkish compared to the previous meeting.
- In relation to the developments on the political scene, we think that the government crisis, which led to the dismissal of the Grindeanu cabinet had limited impact on real economy, as a new government was set up relatively quickly. However, the recently revised government programme, with a long series of promises, including further aggressive wage hikes and major tax changes, induce large uncertainties as to the outlook. In our opinion, the promises, as presented in the programme, have gone too far and can be implemented only with the risk of a significant deviation from the 3% deficit target. This could lead to different sanctions, including the undesired suspension of EU funds. Therefore, we suppose that the initial plans of the government may undergo several changes in the following months, but it is extremely difficult to foresee the final form of the package and what kind of (if any) correction measures may follow it.
- Undoubtedly, Romania has one of the lowest labour costs in the EU, but this competitive advantage is partially offset among others by lower productivity, underdeveloped infrastructure, inefficient public administration, and weak achievements in innovation. Meanwhile, wage increases exceeding productivity gains are set to result in higher inflation pressure.
- In this context, we continue to expect that the normalisation process could be started later this year by narrowing the interest rate corridor, and the first policy rate hike is unlikely to come before Q1 2018. The proposed fiscal measures may propel inflation higher in 2018, but it is too early to see the impacts, therefore we still expect three rate hikes next year.

Headquarter Treasury Sales

Alexandru Tibuleac
+40372 31 85 85
alexandru.tibuleac@otpbank.ro

Ionut Constandache
+40372 31 85 86
ionut.constandache@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

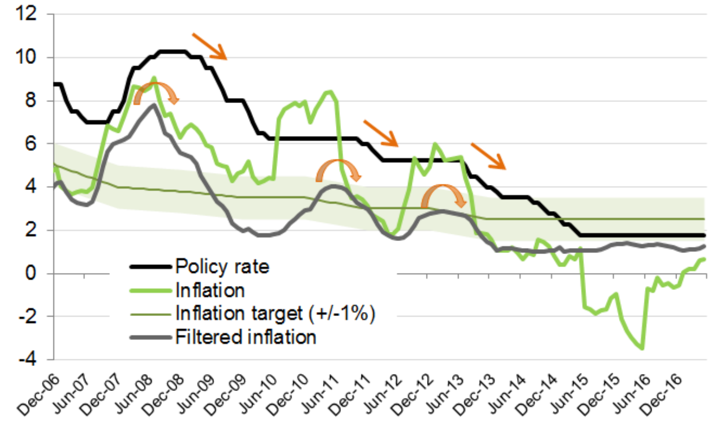
Gergely Tardos
+36 1 374 7273
tardosg@otpbank.hu

Analyst

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

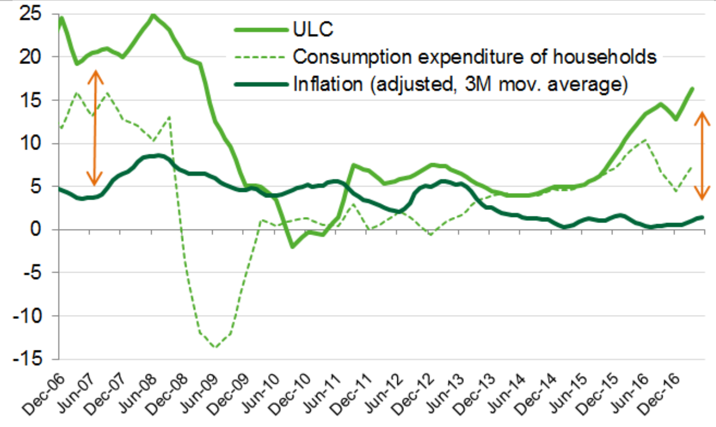
Chart set:

Chart 1: Policy rate and inflation indicators (%)



Sources: NBR, NIS, OTP Research
Note: Filtered inflation is an in-house underlying inflationary measure.

Chart 2: ULC & households' consumption vs. inflation (YoY %)



Sources: Eurostat, NIS, OTP Research
Note: inflation adjusted by the impact of main tax changes.

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