

# REPORT ON INFLATION

12 July 2017

## *Reflation process seems to be on course; both headline and core inflation measures inched up in June*

- In June, consumer price inflation continued to climb higher, reaching 0.85%, up from 0.64% in the previous month (see Chart 1). This level was the highest since May 2015, the month before the government implemented the lowered VAT rate on food products. The fresh data practically matched the market consensus, but exceeded our call by 0.2 percentage points mainly due to one-off items. Compared to May, the consumer price index was broadly flat (+0.04% MoM), but it is important to add that this sluggish growth rate came on the back of seasonal effects too as well as easing fuel prices.
- Romania's headline inflation had stood at unusually low levels for an extended period, primarily as it was dragged down by important tax changes, but it started to gather steam most recently (Chart 1). As we highlighted in our [previous reports](#) too, both cost-push and demand-pull inflation factors appeared to be ready for supporting a broad-based recovery in consumer prices. Moreover, fading base effects are set to provide an additional boost for the headline figure.
- In relation to the underlying dynamics, June's data provided further evidence of an increasing trajectory, just as we expected. Our in-house filtered inflation indicator pointed to another advance (1.3% YoY vs. 1.2% YoY a month earlier – see Chart 3), while short-term measures also signalled that momentum was kept up (Chart 4). Without the tax changes put into force at the beginning of this year, headline inflation would have been significantly higher, slightly exceeding 1.7%, our estimation showed (Chart 3).
- Our forecast error came from a few one-off impacts. Above all, tobacco prices rose more rapidly than we had expected, suggesting that not only the increased excise duty made cigarettes more expensive in June, but the additional costs coming from the implementation of the EU's Tobacco Products Directive also could have continued to propel prices. This translates into a modest upside risk to our 1.6% year-end inflation forecast. Meanwhile, the CPI of fuels dropped less than we had penciled in, probably reflecting a correction following the slightly smaller-than-expected pick-up in May. And finally, highly volatile unprocessed foods, covering vegetables, fruits, and eggs, also surprised us on the upside, but as this item group frequently shows large swings, a reversal cannot be excluded in the following months.
- The CPI of core unprocessed foods, which includes more smoothly changing raw meat, milling products, and milk prices, continued to grow in June (Chart 6), matching our anticipations. The acceleration seen in the past few months was chiefly owing to a revival of pork meat inflation, after the price of pigs for slaughter picked up swiftly. The latter was a key factor in the sharp upswing of our agro-commodity tracker for core unprocessed foods (Chart 7). The bulk in the acceleration is likely over, and raw meat prices may enter into a more stable period soon, but we also suppose that the general upward trend of core unprocessed CPI could be kept up, at least in the short run.
- The components of our underlying price measure, filtered inflation came in line with our expectations. Processed foods' CPI gathered further momentum in June, as the related agro-commodity and producer price trackers had also suggested, lifting the annual growth rate to 1.5%, up from 1.4% in May (Chart 8). We think that May and June may have brought the strongest advances in processed food prices (in both months the index rose by around 0.3% MoM based on seasonally adjusted figures), but increases may remain quite healthy in the subsequent months too. The upward trajectory in goods (Charts 9&10) and market services' inflation (Charts 11&12), highlighted in our previous reports, slowly but steadily continued in June, providing further evidence that the reflationary process seems to have begun. We expect the upward trend to hold in the coming period as well.
- Summing it up, we think that given the reviving core inflation coupled with fading base effects (natural gas, electric energy prices as well as insurance fees sharply dropped in H2 2016) and expected administered prices increases, the headline figure is set to advance further in the forthcoming months. Regarding the longer-term perspective, we also expect for the continuation of the upward trajectory, as fundamental forces signal a build-up in price pressures. Domestic demand is definitely strong, unit labour costs are increasing rapidly (Chart 13) and inflation expectations are on the rise too (Chart 15), while a dramatic change in this background seems unlikely. Indeed, industrial producer inflation lost a bit of steam most recently (Chart 14), but this level still could be well enough to prompt companies to raise the prices on their products. In addition, this year's tax changes will drop out, therefore the annual inflation may reach the NBR's target (2.5%) at the beginning of 2018, and it could slightly exceed 3% at the end of next year. It is important to mention that the main domestic risks came from the uncertainties around government policies.

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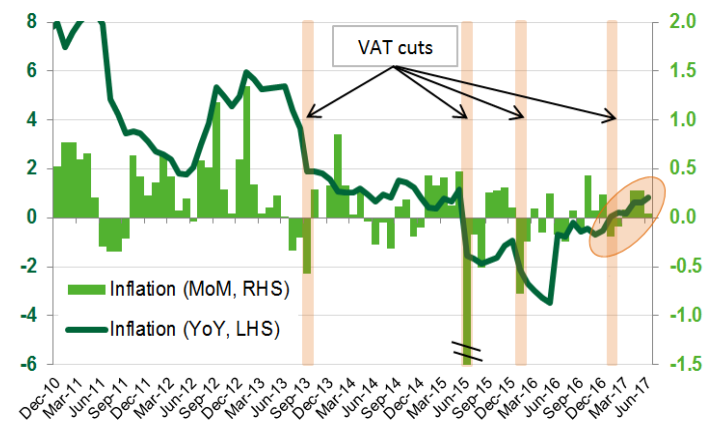
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- With the perspective of gradually accelerating CPI and also due to the rising number of question marks about the planned government measures, we maintain our call for starting the monetary policy accommodation process this year, by narrowing the interest rate corridor. For 2018, we continue to foresee three rate hikes, by 25 bps each.

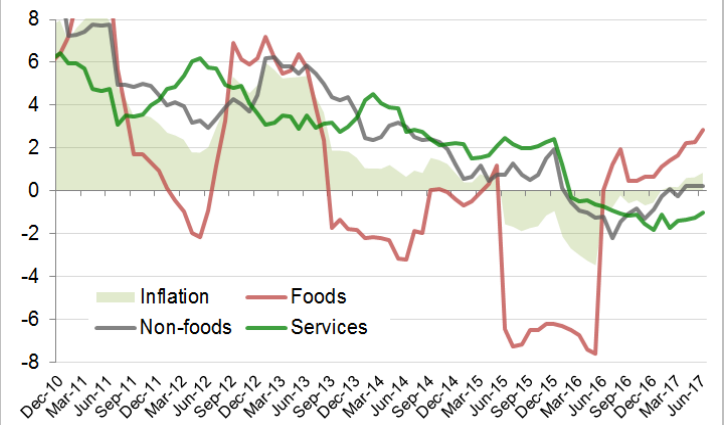
## Chart set:

**Chart 1: Headline inflation**  
(%, NSA data)



Sources: NIS, OTP Research

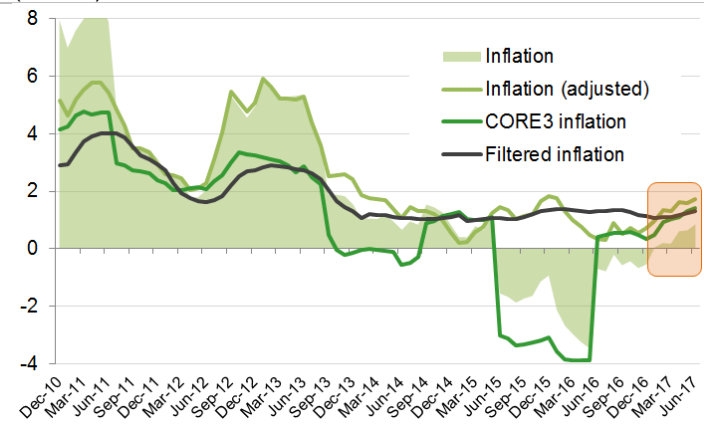
**Chart 2: Inflation by its main components**  
(YoY%, NSA data)



Sources: NIS, OTP Research

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

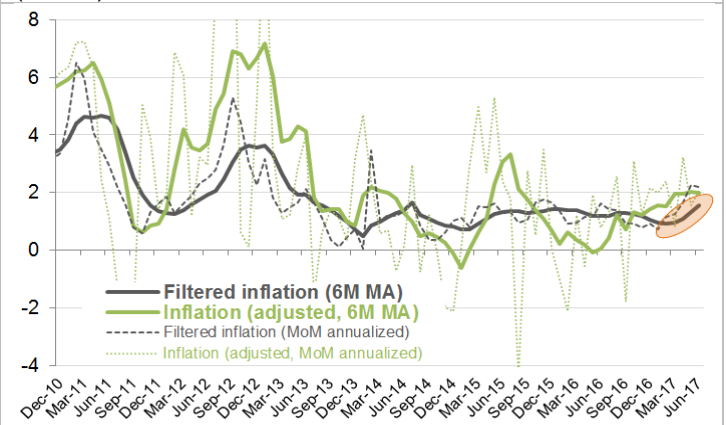
**Chart 3: Inflation and underlying processes**  
(YoY%)



Sources: NIS, OTP Research

Note: **CORE3** = inflation excluding VFE (vegetables, fruits, eggs), fuels, regulated as well as beverages and tobacco prices; **Filtered inflation** = in-house underlying inflationary measure (SA).

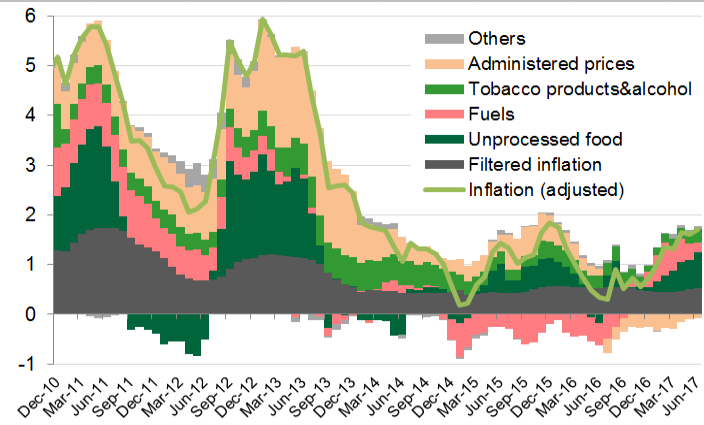
**Chart 4: Inflation and filtered inflation**  
(%, SA)



Sources: NIS, OTP Research

Note: adjusted by the impact of main tax changes; 6M MA = six-month moving average.

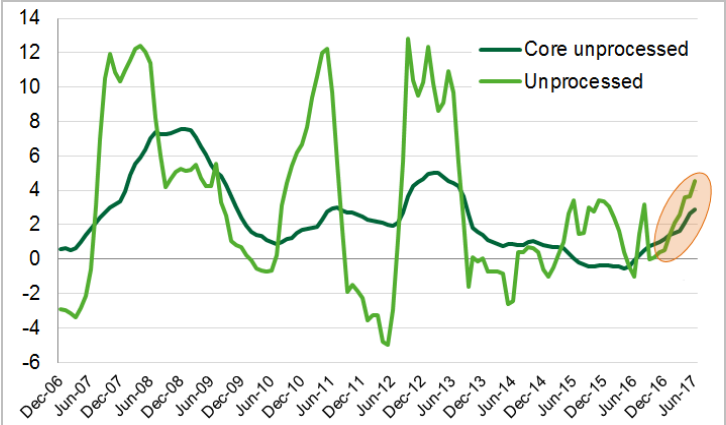
**Chart 5: Decomposition of inflation**  
(percentage points, SA)



Sources: NIS, OTP Research

Note: adjusted by the impact of main tax changes.

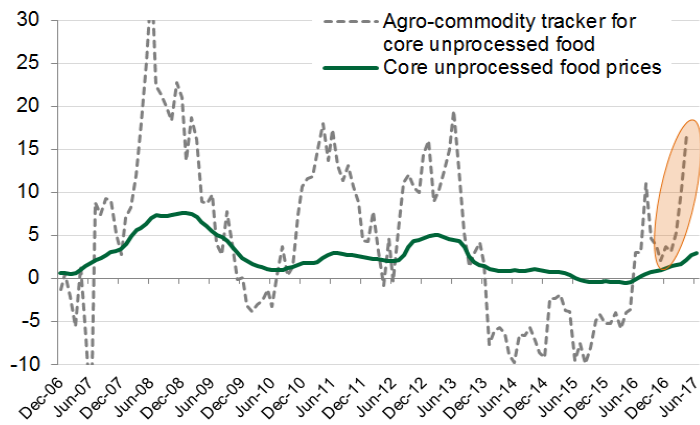
**Chart 6: Unprocessed food prices**  
(YoY%, SA)



Sources: NIS, OTP Research

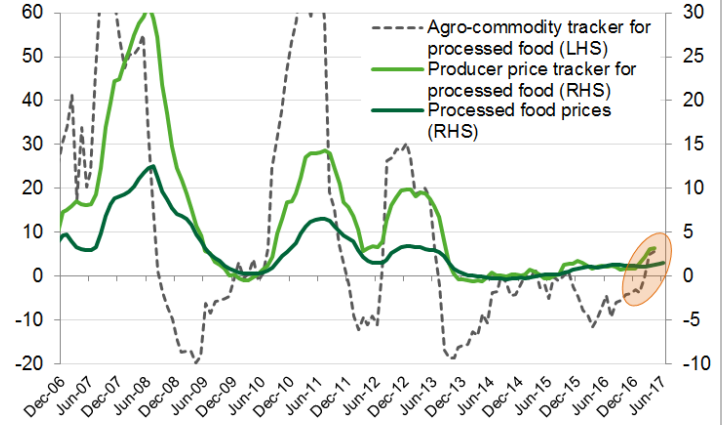
Note: adjusted by the impact of main tax changes.

**Chart 7: CPI of core unprocessed foods vs. agro-commodity prices (YoY%, SA)**



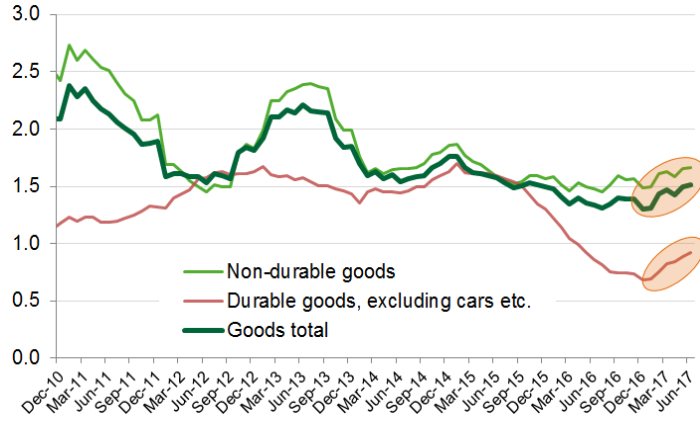
Sources: NIS, OTP Research  
Note: adjusted by the impact of main tax changes.

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



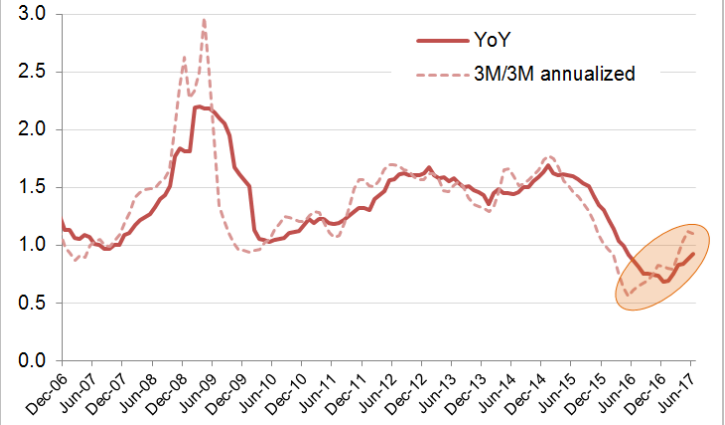
Sources: NIS, OTP Research  
Note: adjusted by the impact of main tax changes.

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



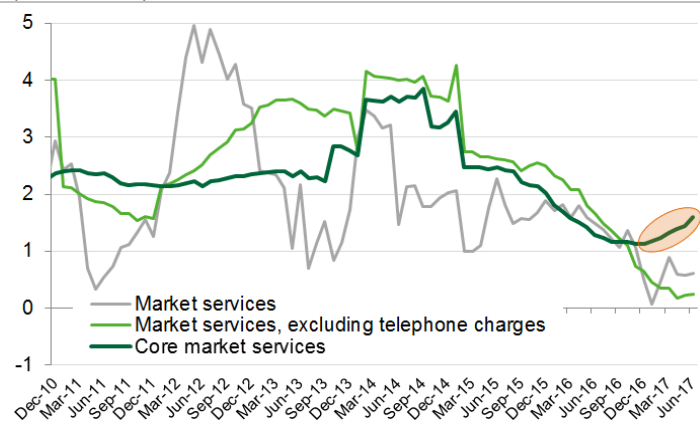
Sources: NIS, OTP Research  
Note: adjusted by the impact of main tax changes.

**Chart 10: Durable goods, excluding cars etc. (% SA)**



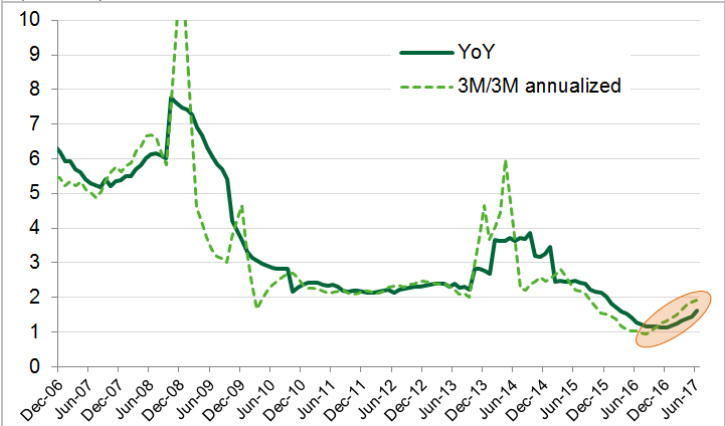
Sources: NIS, OTP Research  
Note: adjusted by the impact of main tax changes.

**Chart 11: Market services (YoY%, SA)**



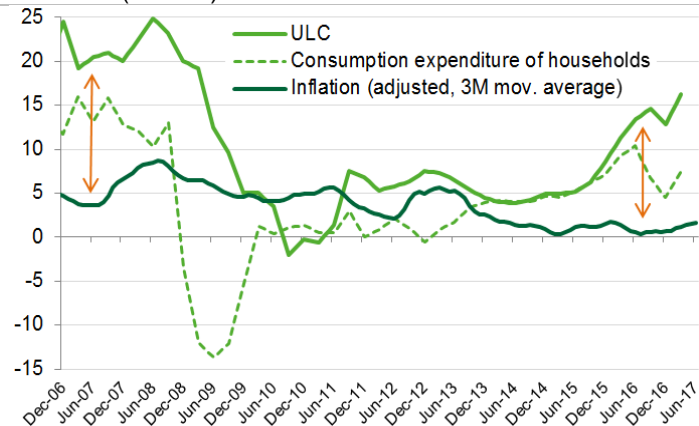
Sources: NIS, OTP Research  
Note: adjusted by the impact of main tax changes; **Core market services**, beyond the EUR/RON-related telephone charges, excluding the line of other services too, which covers mainly insurances.

**Chart 12: Core market services (% SA)**



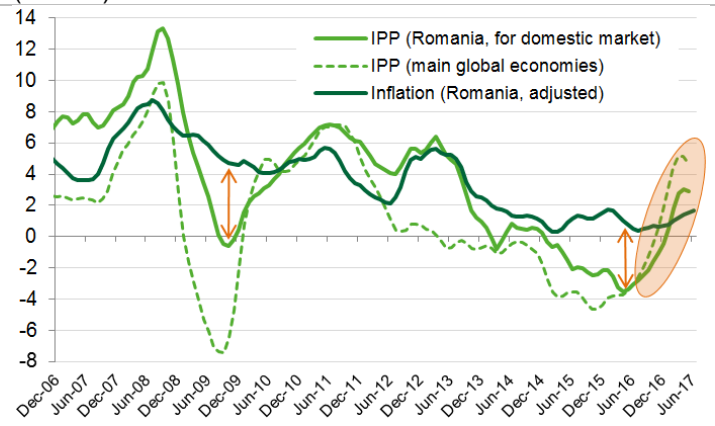
Sources: NIS, OTP Research  
Note: adjusted by the impact of main tax changes; **Core market services**, beyond the EUR/RON-related telephone charges, excluding the line of other services too, which covers mainly insurances.

**Chart 13: ULC & households' consumption vs. inflation (YoY %)**



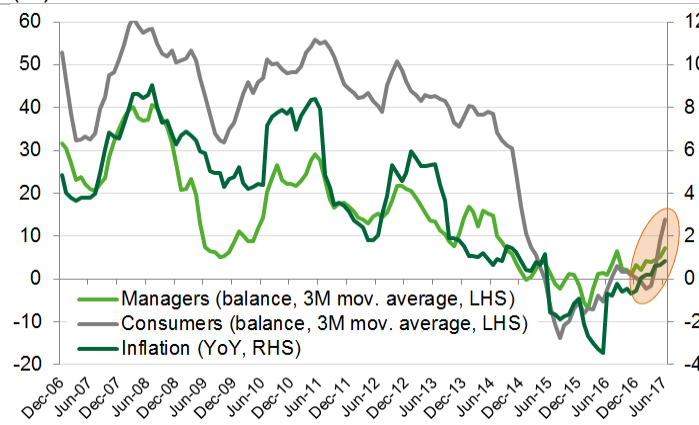
Sources: Eurostat, NIS, OTP Research  
 Note: adjusted by the impact of main tax changes.

**Chart 14: Industrial production prices vs. inflation (YoY %)**



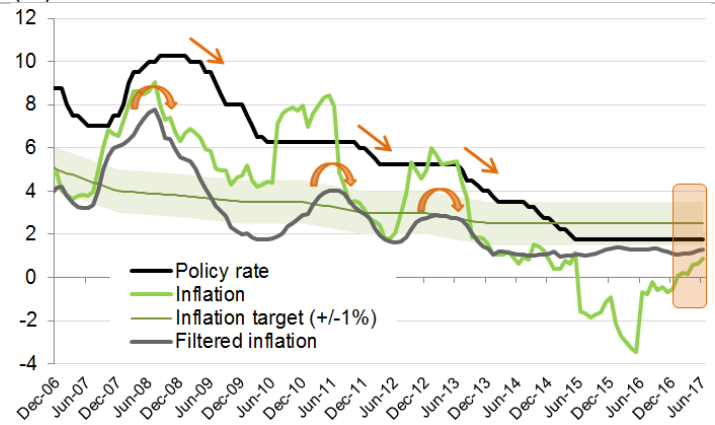
Sources: NIS, OECD, NBSC, OTP Research  
 Note: adjusted by the impact of main tax changes; the IPP (main global economies) includes data from EU28, USA and China

**Chart 15: Price expectations vs. inflation (%)**



Sources: EC, NIS, OTP Research

**Chart 16: Policy rate and inflation (%)**



Sources: NBR, NIS, OTP Research

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