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MONETARY POLICY COMMENTARY

7 August 2017

NBR chief puts expectations of quick rate hikes to rest

- The Board of Romania's central bank kept the key monetary instruments unchanged on its 4 August policy meeting. Accordingly, the base rate remained at the historical low of 1.75%, for more than two years, while the interest rate on the deposit as well as on the lending facility stayed flat, at 0.25% and at 3.25% respectively. The reserve requirement ratio for both leu and foreign-currency denominated liabilities remained at 8% too. The outcome of the Board meeting matched the market's (Reuters poll in July) as well as our expectations. In the absence of any surprise, the policy meeting did not cause too much excitement on the leu's market on Friday. The EUR/RON climbed a touch higher after the NBR decisions were revealed, but this marginal upside movement was reversed quickly in the second half of the trading session. Overall, the day of the meeting was a quite motionless session for the leu.
- As we noted earlier, given the rather subdued inflation outlook on the short term, and with accommodative monetary policies in the eurozone and in the CEE region, there is no particular pressure on the NBR to launch the policy normalisation process. In addition, the uncertainties around the government budget (how stimulating will it be and what correction measures may come) are also set to keep central bankers on the sidelines, at least for now. However, the big picture is that inflation showed clear signs of a broad-based recovery, rapidly gathering momentum in the latest period, while further acceleration is also widely expected. This calls for putting an end to the ultra-loose monetary conditions soon.
- Amid the growing number of evidences on the reflation process, the wording of the NBR's press release turned a bit more hawkish, adding an adjective to the description about the monetary conditions. In the context of unchanged interest rates and rising consumer price inflation, *"real monetary conditions have a **pronounced** stimulative nature"*, the communique released after the policy meeting noted. Simultaneously, the report also said that the central bank revised upward its inflation projection *"over the entire forecast period"*, with larger changes in the short term. However, it also mentioned that the annual inflation was likely to remain within the variation band of the target (2.5% +/- 1%). In the light of higher-than-expected consumer price data in June, the upward revision of the CPI trajectory came as no surprise. We also see upside risks to our 1.6% year-end projection (our forecast is in line with May's expectation of the NBR), but we will update our estimation after July's statistics will see the light of day.
- Nevertheless, governor Mr Isarescu put the expectations of quick rate hikes firmly to rest, stating that the NBR, indeed, must take action in the future but a decision cannot be made without looking at regional peers. Accordingly, the NBR will put bigger emphasis on actions of other CEE central banks as well as the ECB. Regarding the Czech National Bank's move to raise the benchmark rate, Mr Isarescu said that the CNB is not a proper peer for the NBR, as the Czech key rate was near 0% (vs. Romania's 1.75%), while inflation exceeded 2% in the most developed CEE country (vs. 0.9% in Romania). Poland's central bank is a much more appropriate peer for the NBR, Mr Isarescu added.
- Admittedly, there are several important differences between Romania and the Czech Republic, particularly in an ex-post comparison. However, analysing the key indicators from a slightly different view, based also on ex-ante evaluation, the gaps seem to shrink. On the one hand, in Romania, interbank interest rates point to a much more stimulative stance of monetary conditions, than the NBR's key rate would suggest (see Chart 1). On the other hand, the impact of tax changes still drags down the consumer price index. Without these one-offs, annual inflation would have been around one percentage-point higher in June, at 1.9% (vs. 0.9%), with the perspective of a significant jump in July (likely to 2.4%), fuelled by a large electricity price hike as well. We also deem that headline inflation may slightly exceed the midpoint of the NBR's target (2.5%) in the beginning of next year. Practically, this means that at the end of Q1 2018, the NBR may face a situation rather similar to that of the CNB: inflation slightly above the target and real interbank rates in negative territory.

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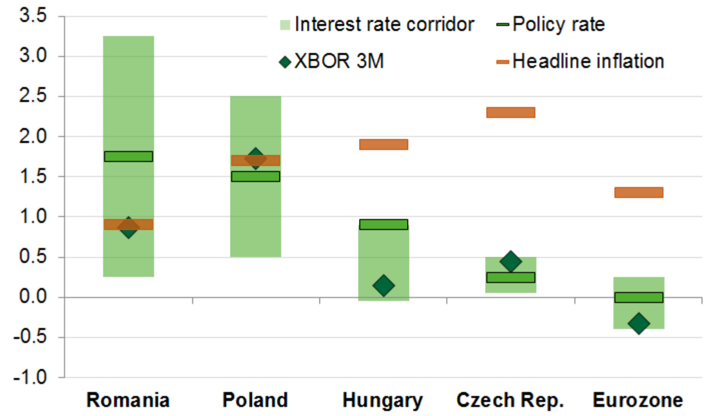
- Taking into account Romania's features, but also the anchor provided by Mr Isarescu regarding the NBR's special focus on the other central banks of the EU (primarily the NBP and the ECB), we think that the first rate hike could be delivered at the end of Q2 2018 rather than in Q1 2018. However, we continue to expect 2.50% policy rate for the end of next year, even though this call seems to be less certain than earlier. In line with our previous view, we still believe that before lifting the benchmark rate, the NBR will narrow the interest rate corridor.
- It is important to mention that despite a potential delay in the starting date of policy rate hikes, we are quite confident that the NBR will keep its rather conservative profile. Therefore, we do not exclude that instead of lifting the key interest rate, the central bank may impose prudential measures, if needed, in order to avoid a too rapid credit expansion in the medium term (the risk of swift advances seems to be more likely in the case of households). We recall that lending activity started to get steam in the first half of 2017, with non-government loans advancing by 4.0% YoY in June (FX-adjusted data), up from May's 2.6%, as both household and corporate credit growth accelerated. Meanwhile, RON-denominated loans rose by 14.7% YoY (out of which households' loans went up by 21.0% YoY).

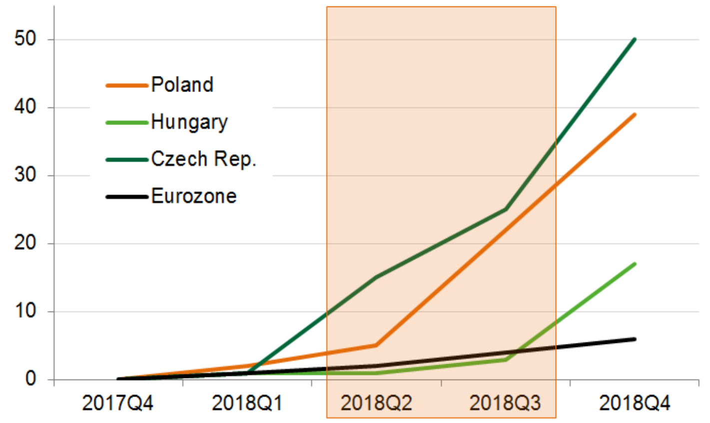
Chart set:

Chart 1: Key monetary indicators
(%)



Sources: Central banks, Reuters, OTP Research
Note: XBOR 3M as of 7 August; headline inflation - latest available

Chart 2: Expected change in the benchmark rates
(end of quarter; in basis points)



Sources: Focus Economics, OTP Research

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