

REPORT ON INFLATION

12 October 2017

Headline inflation may break temporarily above the upper bound of the NBR's target range in H1 2018

- In September, Romania's headline inflation jumped to 1.8% YoY / 0.5% MoM, continuing its steep upward trajectory (see Chart 1), after a transitory setback in August (1.2% YoY / -0.2% MoM), the latest NIS report revealed. Given the substantial hike of the excise duty on fuels, the surging crude oil quotations, the leu's weakness compared to the euro and a positive statistical base effect in the case of unprocessed foods, a sharp acceleration was expected for September, but the fact data exceeded the market's as well as our expectations (both at 1.6% YoY), causing a positive surprise. Excluding the impact of main tax changes, the headline inflation would have easily reached the NBR's objective of 2.5% YoY in September, corresponding to a four-year peak, our tax-adjusted data showed (Chart 3; for a detailed decomposition of inflation please see Chart 9).
- Meanwhile, core inflation measures also got steam, signalling a broad-based acceleration last month (Chart 3). The NBR's favourite underlying indicator, the CORE3 inflation, climbed 0.2 percentage points to 1.8% YoY, and our more smoothly moving *filtered inflation*¹ measure registered a similar advance, reaching 1.6% YoY, the highest level since October 2013. High-frequency indicators also showed evidence of increasing price pressures, with filtered inflation registering 2.6% annualized MoM surge in September (Chart 4).
- Last month's sharp advance was in line with the big picture. As we noted in our [previous report](#) too: after Romania's CPI growth had been dragged down by large tax cuts, low import prices, and the plunge in commodity prices, most recently it started to rebound, helped by fading base effects as well as strong fundamentals. Unit labour costs marked another post-crisis high, households' consumption signalled definitely strong domestic demand (Chart 5), the growth rate of industrial producer as well as import prices stood in positive territory (Charts 6&7), while the price expectation of consumers and managers revived (Chart 8), keeping Romania's annual inflation on a sustained upwards trajectory.
- The higher-than-expected upswing in underlying dynamics and a bit faster fuel inflation explains the larger part of our forecast error. The former is even more surprising, given the fact that core inflation items usually move much more slowly than their non-core peers. The upward shift of the CPI seems to be largely permanent.
- Both core unprocessed and processed inflation accelerated last month, even though their tracker indicators apparently marked a turnaround earlier (Chart 10 & 11). The latter signalled that cost-push pressures, at least those coming from raw materials, may ease in the following months. Owing to the good agricultural harvest at global level, we see slim chance for sharp increases in foods' consumer price inflation. In September, goods' (Chart 12) and market services' inflation (Charts 13 & 14) rose, even faster than we had pencilled in. We think that demand-sensitive as well as labour-intensive consumer goods and services may continue to point to higher price increases in the months ahead.
- In the light of stronger underlying inflation dynamics in September, another fuel excise duty hike (RON 0.16 per litre), and the decision to increase electricity tariffs by 6% (both starting from 1 October), and also due to likely higher natural gas prices (the decision to lift natural gas prices is still pending, but a 6%-7% rise is quite probable), the annual inflation may grow rapidly in the following months. At this moment, we expect 2.4% year-end inflation (Chart 16), up from our earlier 2.0% forecast. Moreover, propelled further by the positive statistical base effect coming from the tax changes at the beginning of 2017, the headline inflation is set to register another jump in Q1 2018.
- Most likely September's sharp acceleration surprised the NBR too and accordingly central bankers will revise upwards their CPI prognosis for December 2017 (1.9% YoY) significantly. The new inflation report of the NBR will be discussed at the next monetary policy meeting, planned for 7 November. With underlying CPI indicators getting close to the policy rate (Chart 15) and the perspective of the headline figure to break temporarily above the upper bound of the inflation target in H1 2018 (Chart 16), now we see stronger possibility of narrowing further the interest rate corridor already in November (instead of the beginning of 2018). The potential continuation of September's rapid upswing of the core inflation over the coming few months and the risk of elevating inflation expectations of economic agents, given the higher than targeted headline in H1 2018, could prompt the NBR to raise the policy rate before other central banks in the CEE region do so, and much

¹ *Filtered inflation is an in-house measure of underlying inflation dynamics. It excludes unprocessed food, fuels, administered as well as beverage and tobacco prices, filtering out the first-round impact of indirect tax changes. Moreover, it eliminates certain other items too, such as telephone charges and car prices, as these are strongly connected to the EUR/RON exchange rate.*

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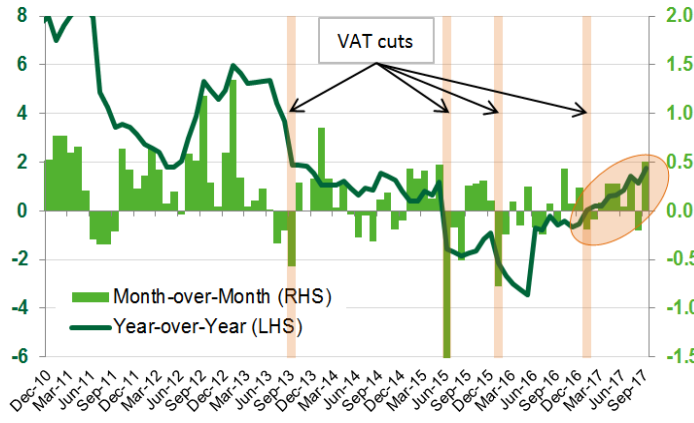
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earlier than the ECB. This would be in contrast with the NBR's hints indicated at the August's [Board meeting](#). Nonetheless, the signals provided by other central banks will remain important factors (both the ECB and the Fed will keep closely-watched rate-setting meetings before 7 November). In addition, the government's plans about next year's budget will be also crucial.

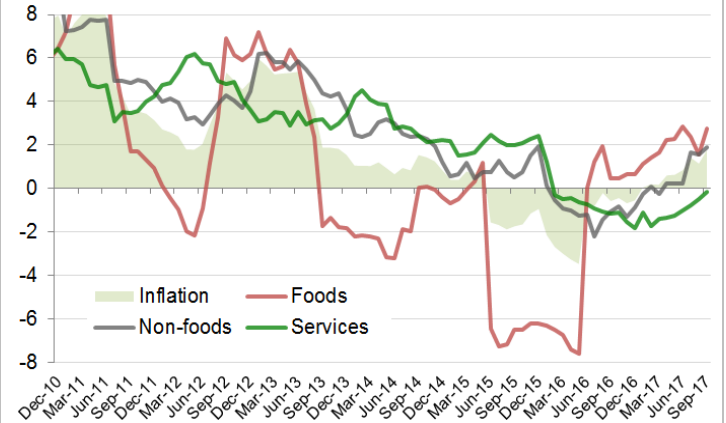
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Chart 1: Headline inflation
(%, NSA data)



Sources: NIS, OTP Research

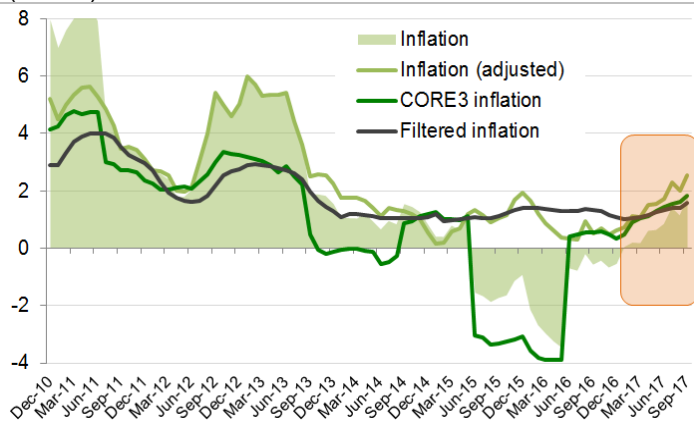
Chart 2: Inflation by its main components
(YoY%, NSA data)



Sources: NIS, OTP Research

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

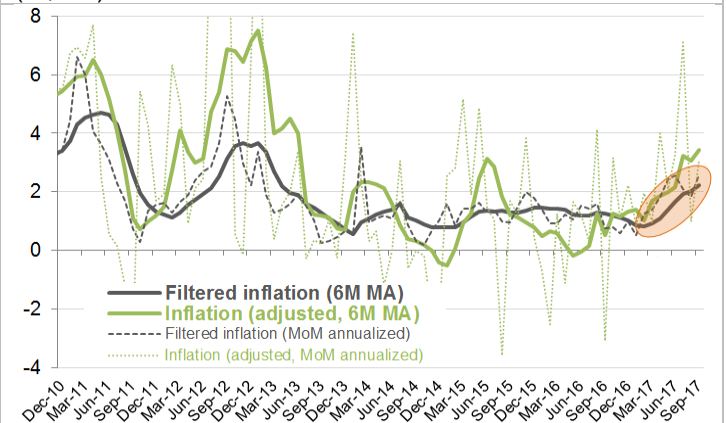
Chart 3: Inflation and underlying processes
(YoY%)



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).

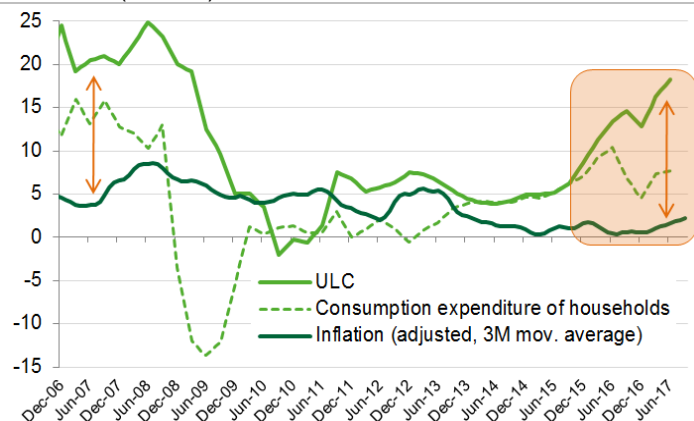
Chart 4: Inflation and filtered inflation
(%, SA)



Sources: NIS, OTP Research

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

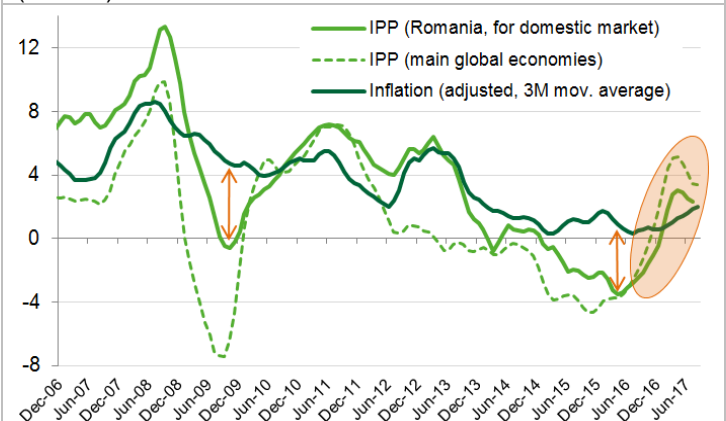
Chart 5: ULC & households' consumption vs. inflation
(YoY %)



Sources: Eurostat, NIS, OTP Research

Note: adjusted by the impact of main tax changes.

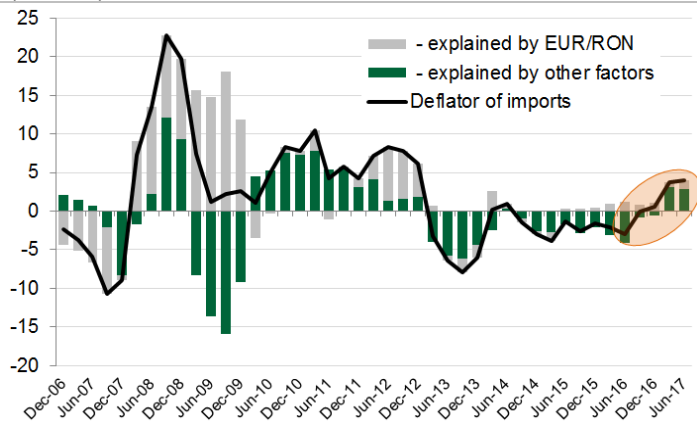
Chart 6: Industrial production prices vs. inflation
(YoY %)



Sources: NIS, OECD, NBSC, OTP Research

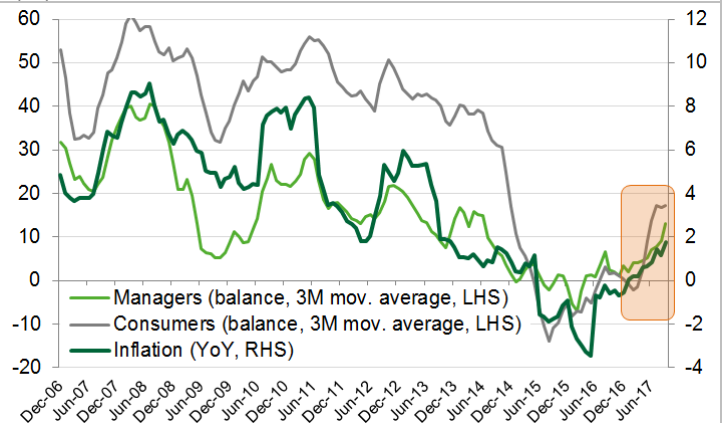
Note: adjusted by the impact of main tax changes; the IPP (main global economies) includes data from EU28, USA and China

Chart 7: Decomposition of imports' deflator (YoY %)



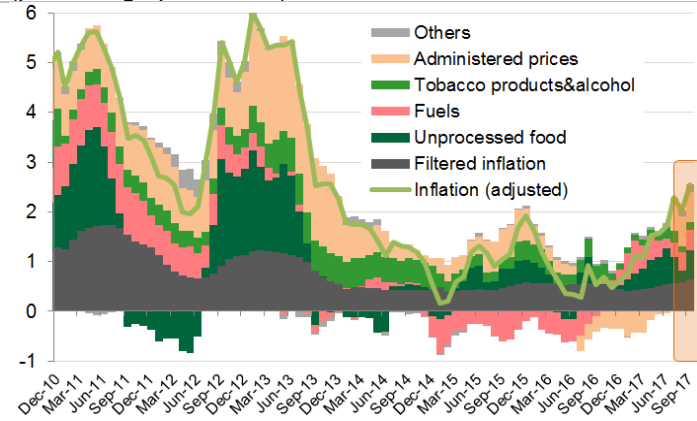
Sources: NBR, NIS, OTP Research

Chart 8: Price expectations vs. inflation (%)



Sources: EC, NIS, OTP Research

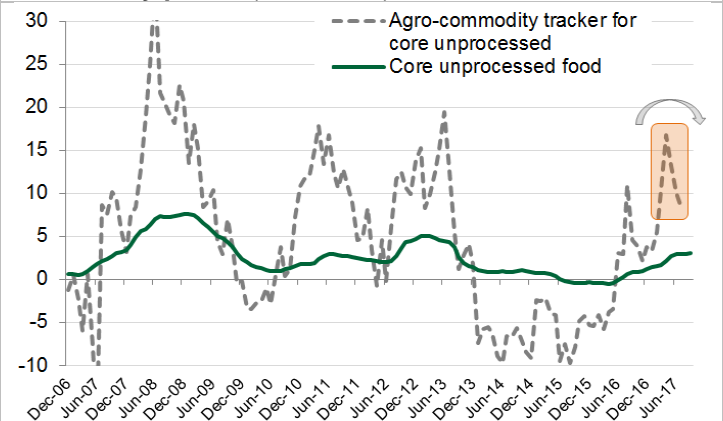
Chart 9: Decomposition of inflation (percentage points, SA)



Sources: NIS, OTP Research

Note: adjusted by the impact of main tax changes.

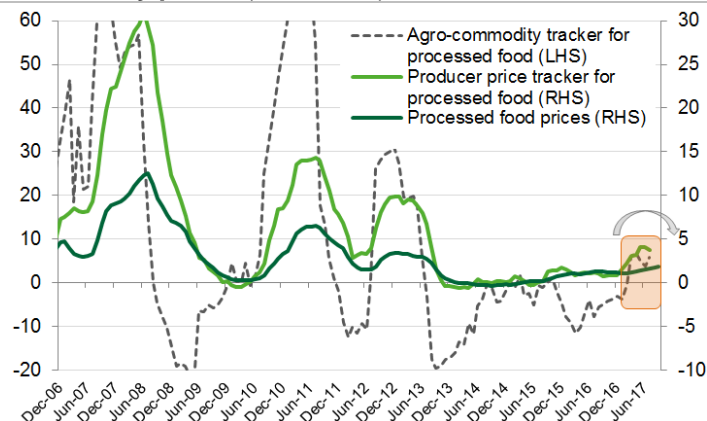
Chart 10: CPI of core unprocessed foods vs. agro-commodity prices (YoY%, SA)



Sources: NIS, OTP Research

Note: adjusted by the impact of main tax changes.

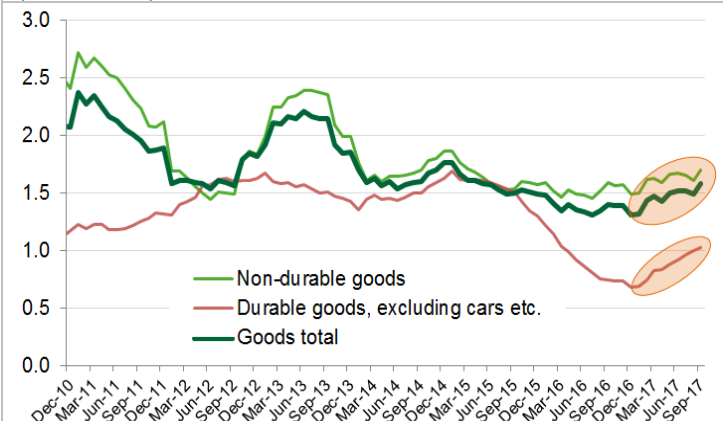
Chart 11: CPI and PPI of processed foods vs. agro-commodity prices (YoY%, SA)



Sources: NIS, OTP Research

Note: adjusted by the impact of main tax changes.

Chart 12: Goods' inflation (YoY%, SA)

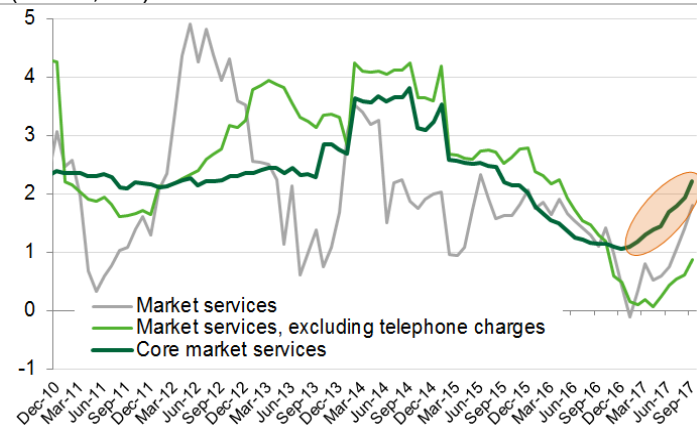


Sources: NIS, OTP Research

Note: adjusted by the impact of main tax changes.

Chart 13: Market services

(YoY%, SA)

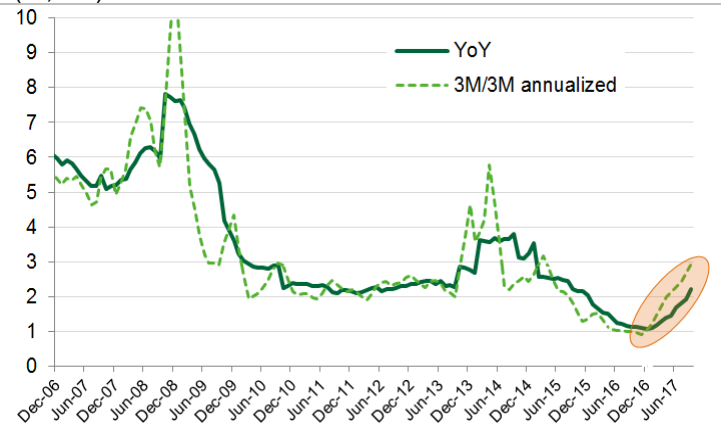


Sources: NIS, OTP Research

Note: adjusted by the impact of main tax changes; **Core market services**, excludes the EUR/RON-related telephone charges as well as insurances.

Chart 14: Core market services

(%, SA)

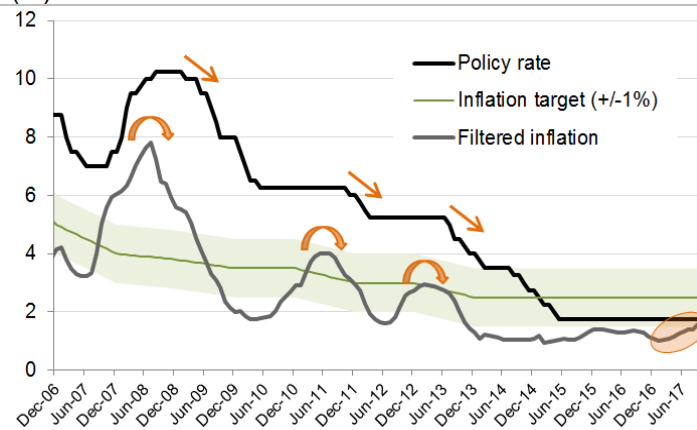


Sources: NIS, OTP Research

Note: adjusted by the impact of main tax changes; **Core market services** excludes the EUR/RON-related telephone charges as well as insurances.

Chart 15: Policy rate and underlying inflation

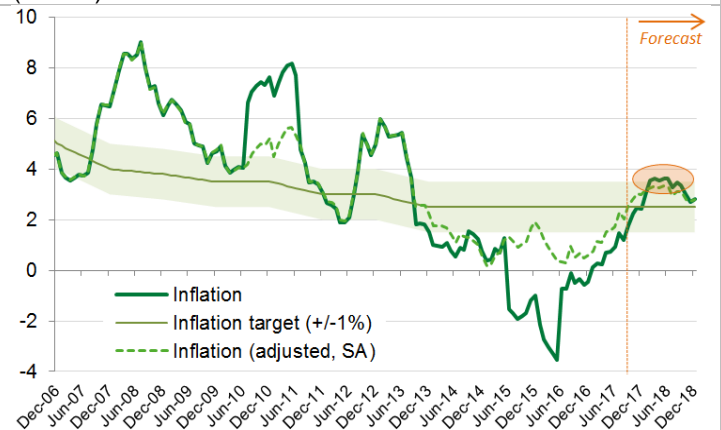
(%)



Sources: NBR, NIS, OTP Research

Chart 16: Inflation vs. NBR's inflation target

(YoY%)



Sources: NBR, NIS, OTP Research

Note: adjusted by the impact of main tax changes.

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