

REPORT ON INFLATION

13 November 2017

Another sharp and broad-based acceleration; both headline and core inflation measures are at four-year peak

- Last month, consumer prices skyrocketed (+1.3% MoM), lifting Romania's annual inflation from 1.8% to 2.6%, the highest level since August 2013 (see Chart 1). Due to a hike in regulated energy prices and another increase in the fuel excise duty, a sharp pick-up was expected for October, still the fact data surprised on the upside, exceeding the market consensus (2.25%, according to a Reuters survey) as well as our projection (2.3%) by around 0.3 percentage points. Beside the one-off items mentioned above, the rise in unprocessed food prices, more expensive tobacco products, and accelerating core inflation also contributed to the significant upswing of the headline data. Filtering out the impact of the main tax changes (one-percentage-point standard VAT rate cut, modifications of the special excise duty on fuels, as well as scrapping radio&TV fees), Romania's annual inflation would have been at 3.2% YoY, up from September's 2.6%, our in-house estimation showed (Chart 3; for a detailed decomposition of the tax-adjusted data please see Chart 9).
- The CORE3 inflation, the NBR's preferred underlying indicator, continued to march higher in October (1.9% YoY vs. 1.8% YoY a month earlier) and our *filtered inflation*¹ measure also rose to 1.8% YoY, up from 1.6% (Chart 3). At the same time, high-frequency indicators also confirm that the reflationary process is on course, with both the headline and the filtered measures gathering momentum (Chart 4).
- We [recall](#) that consumer price growth marked historical lows in the past few years, after subdued external inflation dynamics, coupled with several tax cuts on the domestic front, had dragged down the headline CPI. However, as the base effect of tax reductions started to fade out and fundamental factors also fed CPI growth (see Charts 5 to 8), Romania's annual inflation followed a steep upward trajectory. In addition, regulated price hikes and reversing some earlier tax cuts resulted in an extra boost.
- Our forecast error mainly came from a stronger-than-expected pick-up of volatile food prices, covering vegetables, fruits and eggs (around 0.2 percentage-points out of the 0.3 pps discrepancy). The remaining part of the gap came from core inflation indicators, with processed food prices explaining the largest part. Volatile foods may reverse some of the discrepancy in the following months, as they frequently record sizeable changes, but we think that the error in the case of underlying indicators is permanent.
- In the light of decelerating agro-commodity and peaking producer price growth (Charts 10&11), the sharp upswing of processed (2.2% YoY, up from 1.9% YoY a month earlier) and core unprocessed food inflation (3.5% YoY vs. 3.1% YoY) was a bit surprising. We had expected less rapid acceleration for October. The higher fact data, probably, is also a sign of strong wage pressure. Nevertheless, we think that given the good harvest at both global and domestic level, food inflation may lose impetus, most likely starting from Q1 2018. The other key core CPI indicators got further steam last month. Overall, goods' inflation remained low, but continued to strengthen (Chart 12), while services' CPI growth marched higher again (Charts 13&14). On the back of the fundamental factors, the recent depreciation of the leu and the slowly but steadily rising underlying inflation in the eurozone (the share of imported goods is relatively high and even increased in the past few years), we think that goods' inflation may rise further. Meanwhile, the leu's weakness as well as the robust domestic demand and wage pressure will propel further the growth rate of market services' inflation in the following months. Given this context, together with a sharp revival of crude oil futures, we revised upward our year-end inflation projection, to 2.8% YoY, versus 2.4% YoY earlier. It is important to add that headline inflation could temporarily exceed 4% next year, probably ending 2018 at 3%. A potential hike of regulated natural gas prices acts as an important upside risk to our forecasts.
- The NBR also modified significantly upwards its year-end forecast (2.7% vs. 1.9% earlier), but left the outlook for Q4 2018 unchanged at 3.2% and even lowered its expectation for the end of the projection horizon to 3.1% (Q3 2019; see Chart 15). In his press conference, Governor Mr Isarescu warned about the risks of pro-cyclical fiscal policies, but he also reiterated that monetary policy cannot entirely offset the negative effects coming from other sides, as it would lead to an unhealthy policy mix. At the same time, the central bank chief has also pointed out that negative real interest rates are quite common these days, and the NBR has to take into account this external environment. Summing it up, the press conference sounded rather dovish, suggesting that central bankers may overlook a temporary breach of the target. Accordingly, we had pencilled in only one 25 bps rate hike for 2018 in our latest [MPC report](#).

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.*

Headquarter Treasury Sales

Ionut Constandache

+40372 31 85 86

ionut.constandache@otpbank.ro

Corina Bejan

+40372 31 85 84

corina.bejan@otpbank.ro

Anamaria Toma

+40372 31 85 85

anamaria.toma@otpbank.ro

Cristian Bodirca

+40372 31 85 88

cristian.bodirca@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

Andrei Sala – Brasov

+40755 000 015

andrei.sala@otpbank.ro

Chief Economist

Gergely Tardos

+36 1 374 7273

tardosg@otpbank.hu

Analyst

Csaba Bálint

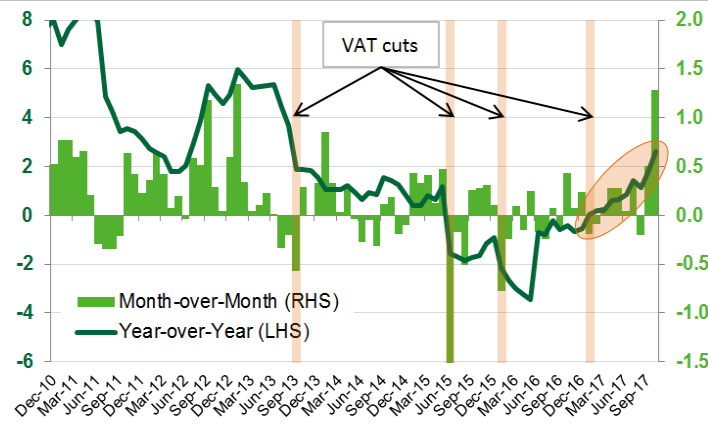
+4021 307 58 96

csaba.balint@otpbank.ro

- However, October's fresh data and the potential continuation of upside surprises make the excuses difficult to sell. Admittedly, underlying inflation is still below the target, and food prices may provide some relief in the following period, given cheap agro-commodities prices. Nevertheless, with the headline data breaking well above the upper bound of the target, even if temporarily, price expectations may shift higher too. In order to keep inflation anticipations well anchored, in our view the NBR will consider frontloading rate hikes. Therefore, the risks to our baseline scenario are tilted, definitely, to the upside. If inflation continues to surprise, a clear and proportional response will be needed, with at least three rate hikes next year.

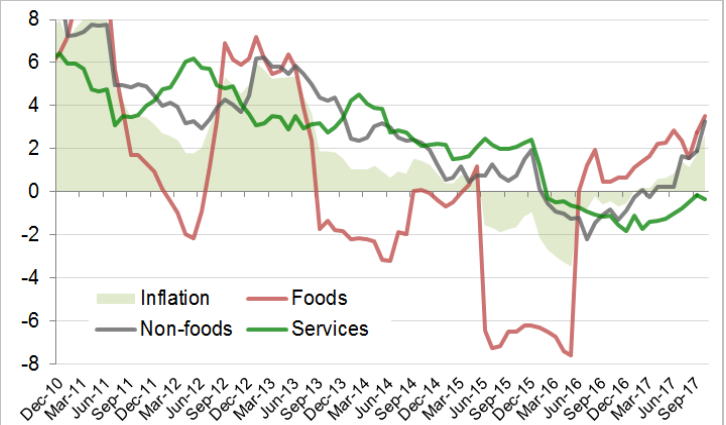
Chart set:

Chart 1: Headline inflation
(%, NSA data)



Sources: NIS, OTP Research

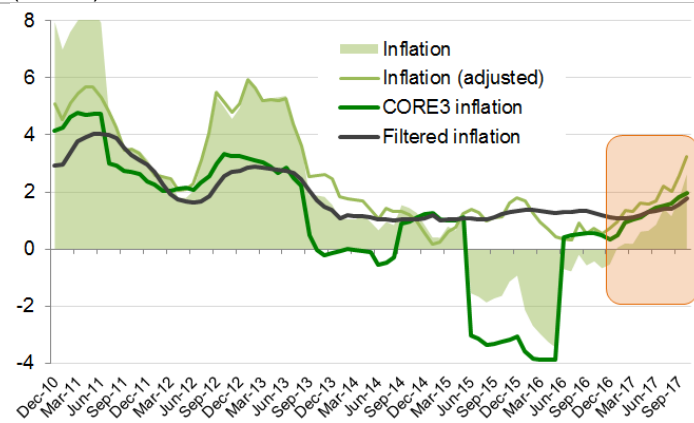
Chart 2: Inflation by its main components
(YoY%, NSA data)



Sources: NIS, OTP Research

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

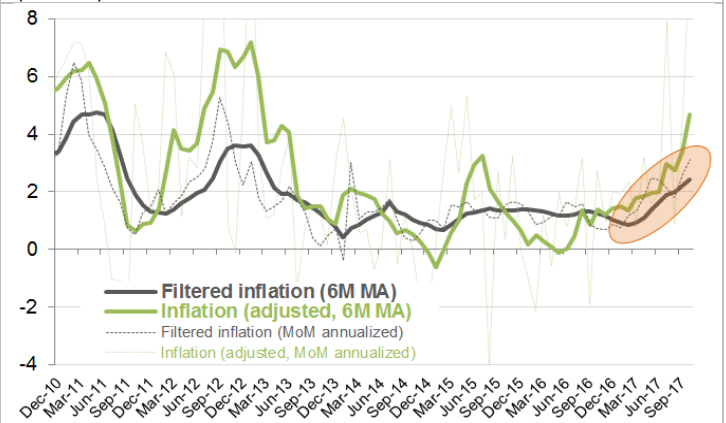
Chart 3: Inflation and underlying processes
(YoY%)



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).

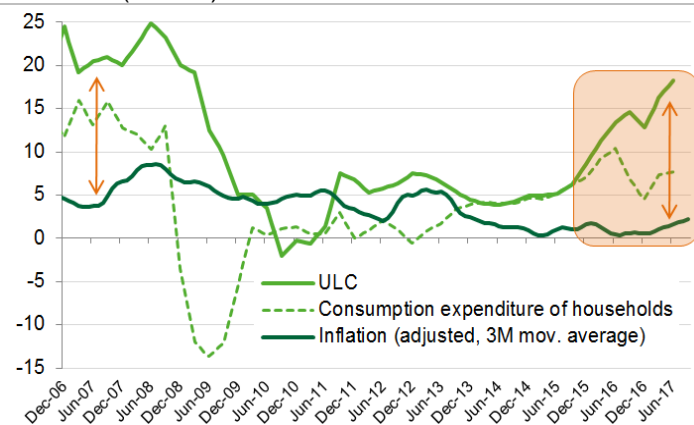
Chart 4: Inflation and filtered inflation
(%, SA)



Sources: NIS, OTP Research

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

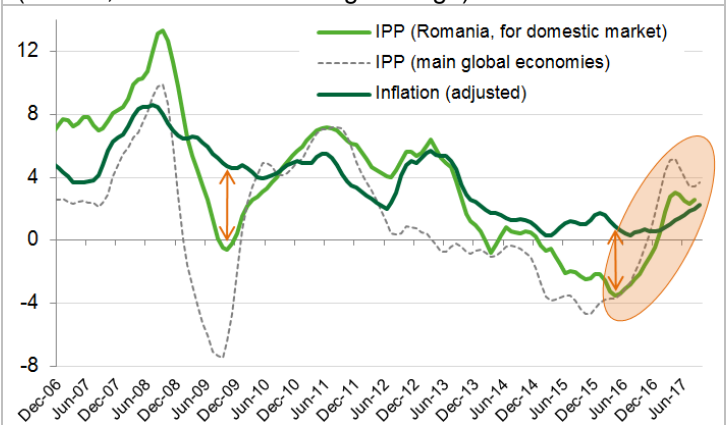
Chart 5: ULC & households' consumption vs. inflation (YoY %)



Sources: Eurostat, NIS, OTP Research

Note: adjusted by the impact of main tax changes.

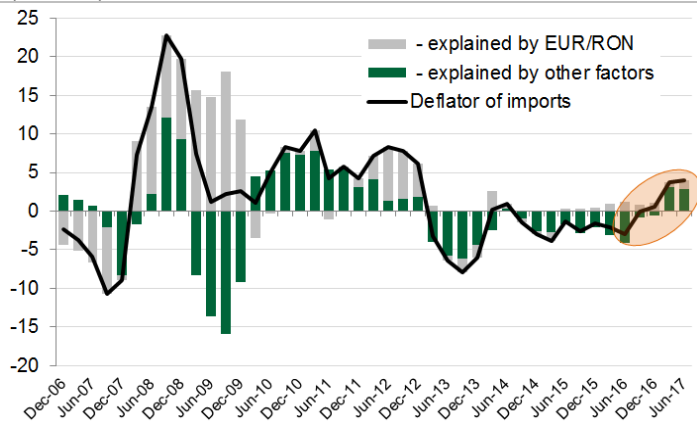
Chart 6: Industrial production prices vs. inflation
(YoY %, three-month moving average)



Sources: NIS, OECD, NBSC, OTP Research

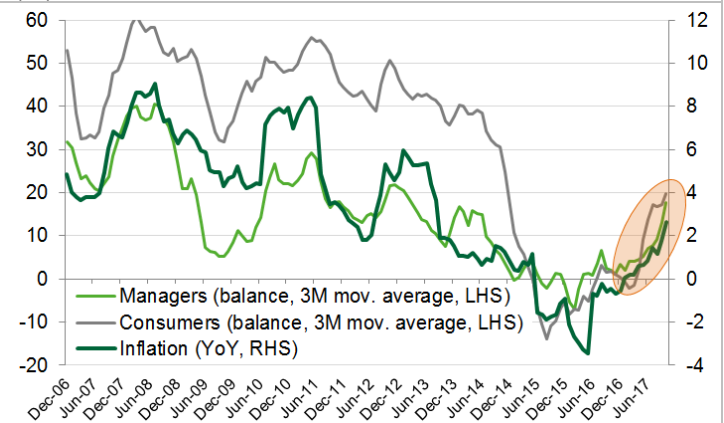
Note: adjusted by the impact of main tax changes; the IPP (main global economies) includes data from EU28, USA and China

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



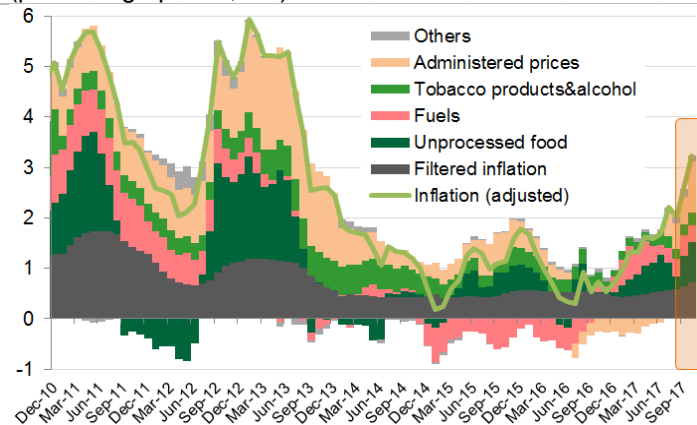
Sources: NBR, NIS, OTP Research

Chart 8: Price expectations vs. inflation (%)



Sources: EC, NIS, OTP Research

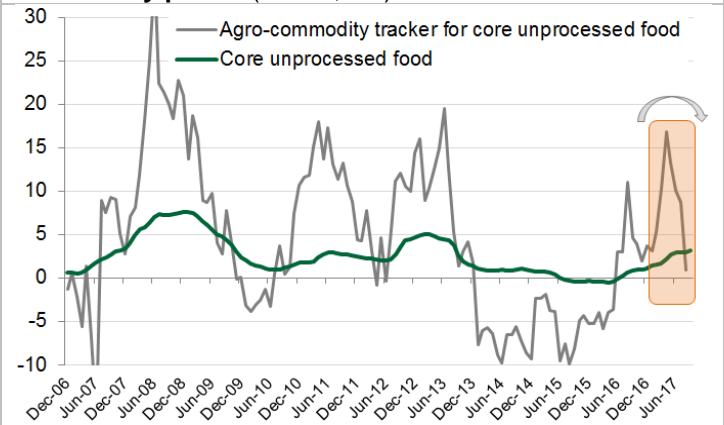
Chart 9: Decomposition of inflation (percentage points, SA)



Sources: NIS, OTP Research

Note: adjusted by the impact of main tax changes.

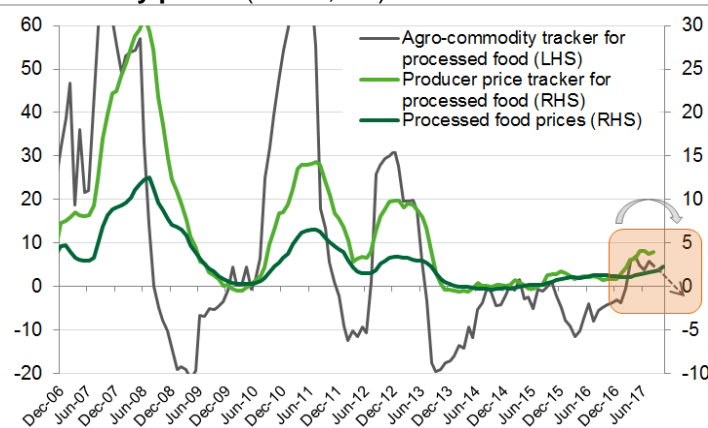
Chart 10: CPI of core unprocessed foods vs. agro-commodity prices (YoY%, SA)



Sources: NIS, OTP Research

Note: adjusted by the impact of main tax changes.

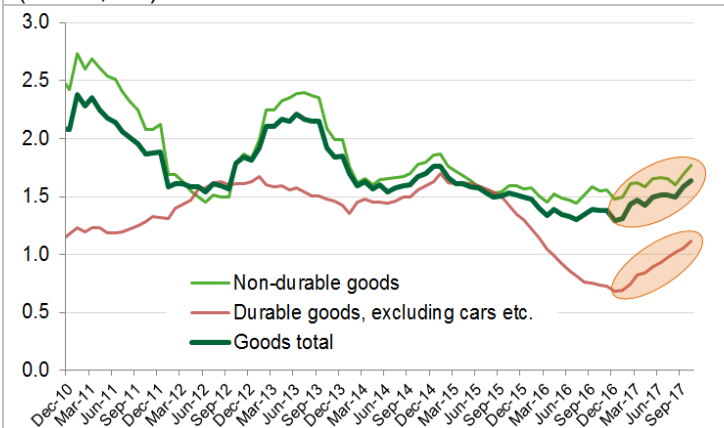
Chart 11: CPI and PPI of processed foods vs. agro-commodity prices (YoY%, SA)



Sources: NIS, OTP Research

Note: adjusted by the impact of main tax changes.

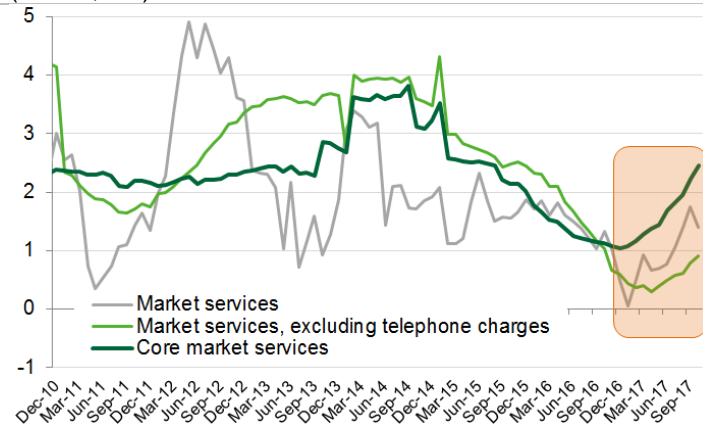
Chart 12: Goods' inflation (YoY%, SA)



Sources: NIS, OTP Research

Note: adjusted by the impact of main tax changes.

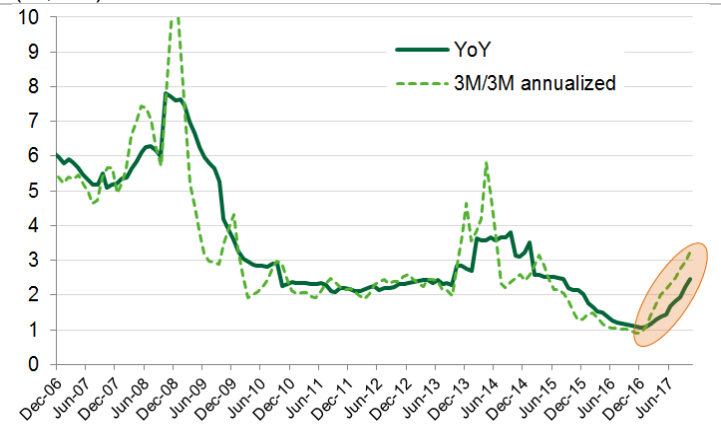
Chart 13: Market services
(YoY%, SA)



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.

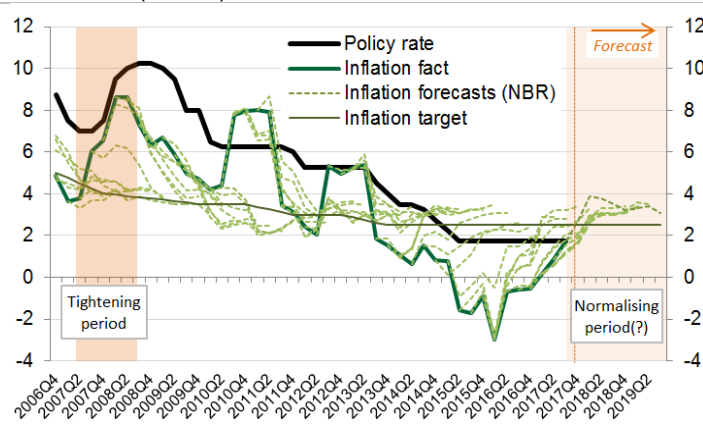
Chart 14: Core market services
(%, SA)



Sources: NIS, OTP Research

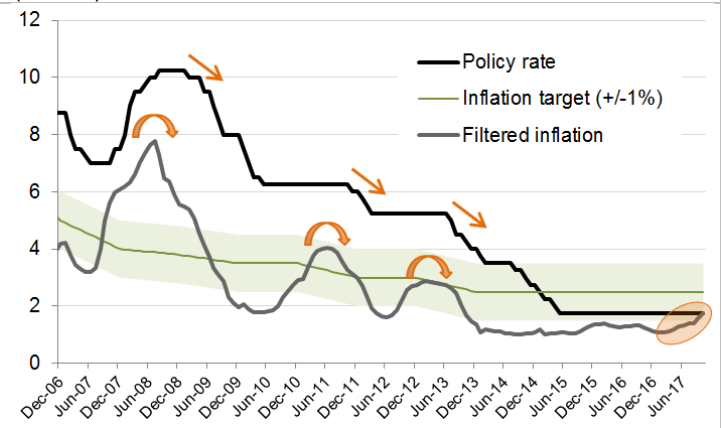
Note: adjusted by the impact of main tax changes; **Core market services** excludes the EUR/RON-related telephone charges as well as insurances.

Chart 15: Inflation vs. NBR's inflation target and forecasts (YoY%)



Sources: NBR, NIS, OTP Research

Chart 16: Inflation vs. NBR's inflation target (YoY%)



Sources: NIS, OTP Research

Note: **Filtered inflation** = in-house underlying inflationary measure (SA).

Disclaimer

OTP Bank Romania S.A. does not intend to present this document as an objective or independent explanation of the matters contained therein. This document a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research, and b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This communication does not contain a comprehensive analysis of the described issues. This report is issued for information purposes only and should not be interpreted as a suggestion, an invitation or an offer to enter into any transaction, as an investment advice, and it does not constitute legal, tax or accounting advice. Also it is not and should not be considered a recommendation for investment in financial instruments according to NSC Regulations no. 32/2006 and 15/2006.

Information herein reflects current market practices. Additional information may be available on request. This document is intended only for the direct and sole use of the selected customers of OTP Bank Romania S.A. Any form of reproduction or redistribution to any other person than the intended recipients, including publication in whole or in part for any purpose, must not be made without the express written agreement of OTP Bank Romania S.A. Although the information in this document has been prepared in good faith from sources which OTP Bank Romania S.A. believes to be reliable, we do not represent or warrant its accuracy and such information may be incomplete or condensed. The issuer of this report does not claim that the information presented herein is perfectly accurate or complete. However it is based on sources available to the public and widely believed to be reliable. Also the opinions and estimates presented herein reflect a professional subjective judgment at the original date of publication and are therefore subject to change thereafter without notice. Furthermore there can be no guarantees that any market developments will unfold as forecasted. Opinions and estimates constitute our judgment and are subject to change without notice.

OTP Bank Romania S.A. may have issued reports that are different or inconsistent with the information expressed within this report and is under no obligation to update or keep current the information contained herein.

OTP Bank Romania S.A. may hold a position or act as market maker in the financial instrument of any issuer discussed herein or act as advisor or lender to such issuer. This document is not intended to provide the basis for any evaluation of the financial instruments discussed herein. In particular, information in this document regarding any issue of new financial instruments should be regarded as indicative, preliminary and for illustrative purposes only, and evaluation of any such financial instruments should be made solely on the basis of information contained in the relevant offering circular and pricing supplement when available. OTP Bank Romania S.A. does not act as a fiduciary for or an advisor to any prospective purchaser of the financial instruments discussed herein and is not responsible for determining the legality or suitability of an investment in the financial instruments by any prospective purchaser.

This report is not intended to influence in any way or to be considered a substitute to research and advice centred on the specific investment objectives and constraints of the recipient (including tax concerns) therefore investors should obtain individual financial advice. Before purchasing or selling financial instruments or engaging investment services, please examine the prospectuses, regulations, terms, agreements, notices, fee letters, and any other relevant documents regarding financial instruments or investment services described herein in order to be capable of making a well-advised investment decision. Please refer to your competent adviser for advice on the risks, fees, taxes, potential losses and any other relevant conditions before you make your investment decision regarding financial instruments or investment services described herein. OTP Bank Romania S.A. in compliance with the applicable law, assumes no responsibility, obligation, warranty or guarantee whatsoever for any direct or indirect damage (including losses arising from investments), or for the costs or expenses, detrimental legal consequences or other sanctions (including punitive and consequential damage) sustained by any natural or legal person as a result of the purchase or sale of financial instruments or engaging investment services described herein, even if OTP Bank Romania S.A. was warned of the possibility of such occurrences.

Figures described herein refer to the past and past performance is not a reliable indicator of future results. Investments in financial instruments carry a certain degree of risk (fluctuation of share prices, uncertainty of dividend, yields and / or profits, exchange rate fluctuations, etc.). The capital invested is not guaranteed, investment gains, usually assumed proportionate to risk, and past performance of financial instruments is not a guarantee for future performance.

Please note that the Internet is not a secure environment and OTP Bank Romania S.A. does not accept any liability for any loss caused by the result of using this report in a form altered or delayed by the wilful or accidental interception, corruption or virus infection.

All rights reserved – OTP Bank Romania S.A. (registered seat: Street Buzesti, no. 66-68, 1st district Bucharest, Romania; company registration number: 01-10-041585; NBR registration no RB-PJR-40-028/1999; for further information please refer to: <https://www.otpbank.ro/en>).

This document has been provided to the recipients upon their prior request. Your abovementioned permission may be withdrawn by an e-mail addressed to csaba.balint@otpbank.ro or a written mail addressed to OTP Bank Romania S.A , Buzesti Street, no. 66-68, 1st district, Bucharest, Romania. Please refer to your name and e-mail address in both cases.