REPORT ON INFLATION

14 December 2017

Consumer price measures continued to accelerate swiftly; cautious policy rate hikes may come in order to keep inflation expectations well anchored

- In November, Romania's consumer price inflation registered another sharp advance, reaching 3.2% YoY, up from 2.6% YoY a month earlier. In MoM terms, the CPI grew by 0.7% (see Chart 1). This outturn exceeded our and the market's expectations (both at 3% YoY). Excluding the impact of various tax changes (one-percentage-point standard VAT rate cut, modifications of the special excise duty on fuels and scrapping radio&TV fees), headline inflation would have broken above the upper bound of the NBR's target (2.5% +/-1%; Chart 3). Simultaneously, our preferred *filtered inflation*[1] measure increased by 0.3 percentage points, to 2.1% YoY.
- As we noted in our previous reports too, headline inflation stood at record low level for a prolonged period, owing to sluggish import prices and several tax cuts. Nevertheless, cost-push and demand-pull factors (see Charts 5 to 8) together with fading base effects and several one-off actions resulted in a sharp revival of CPI dynamics in the past few quarters.
- In November, the continuation of the steep upward trajectory of the annual inflation was supported by a wide range of items from the consumer basket (Chart 9). Fuel prices increased again rapidly on the back of rallying crude oil prices (Chart 10). Tobacco products became much more expansive as vendors lifted prices, while the depreciation of the leu also had an important contribution to the jump in the headline data. These three items together explain around 0.4 percentage points out of last month's 0.6 pps rise of the annual inflation. We see only slim chance for a reversion of the increases in the short term.
- We also note that besides these non-core components of the basket, the inflation of foods also pointed to a non-negligible rise in November (Chart 11). The annual growth rate of vegetable and fruit prices lost momentum but this was more than offset by skyrocketing egg prices. Therefore, overall, unprocessed food inflation continued to accelerate last month, albeit at a slower pace. The CPI of eggs registered a sudden jump (43.4% YoY vs. 18.4% YoY a month earlier) in the wake of the fipronil scandal in the Netherlands, one of the largest egg exporters of the European Unions. The effect of the shock may persist in the following few months. That said, we do not expect a very quick correction of egg prices.
- Processed food inflation pointed to another significant and broad-based increase last month (2.6% YoY, up from 2.2% YoY). Some one-offs, including the significant increase in demand for certain dairy products in the EU, but also the strengthening underlying inflation dynamics could have played a role in the growth. Nonetheless, the overall cost-push pressure coming from agro-commodities appears to be rather modest and this year's excellent harvest is set to keep cost pressures at low levels in the months ahead (Chart 12). Therefore, we continue to expect that food inflation may enter a stabilization period soon and may even ease, starting from Q1 2018. It is important to note that last month's rise in our filtered inflation measure was mainly due to the acceleration of processed food prices, as this group makes up the largest (more than 40%) portion of our underlying indicator.
- Other components of filtered inflation also inched up. The growth rate of goods' prices accelerated, supported by the increasing trajectory of durable goods (Charts 13&14). The depreciations of the leu also had a positive contribution to the rise. In the case of non-durables, the CPI's annual growth pace was little changed. Simultaneously, market services' inflation indicators accelerated further (Charts 15&16), fuelled by fundamental factors, a positive base effect (at the end of 2016, mandatory car insurance premiums were scaled back due to regulatory interventions), and again, owing to the weaker leu.
- November's inflation outturn and the perspective of potential energy price hikes at the beginning of 2018 made us revise upwards our CPI forecasts for the following period. Most likely, headline inflation will stay at 3.3% YoY in December (up from 2.8% YoY), it could finish 2018 at 3.2% (vs. 3.0%) and may be near 2.9% (no change) in 2019. However, on average, the annual inflation is set to exceed 4% in 2018, quite far from the NBR's target of 2.5% (+/-1%). We noted in our previous reports that if inflation continues to surprise to the upside, the central bank would need to launch the policy rate hike cycle earlier than its key peers, in order to keep inflation expectations anchored.

[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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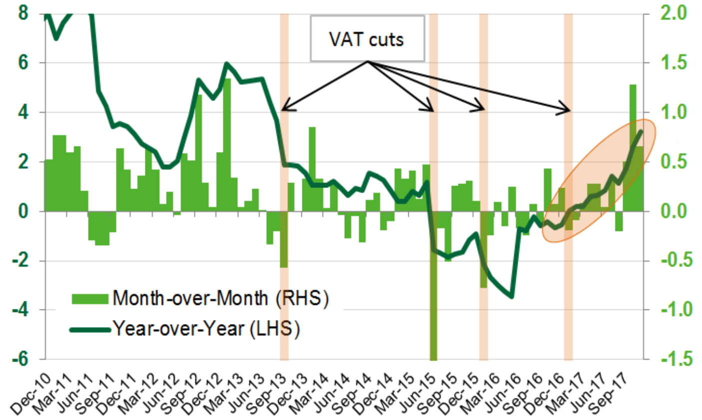
- Now we expect the NBR to start to raise the policy rate by 25 bps in each quarter, with the first hike made probably at the turn of Q1-Q2 (2018's full meeting calendar has not been revealed yet). Thus the policy rate could reach 2.50% at the end of next year, instead of 2.00% in our more optimistic earlier projection. This pace of increases still may appear to be rather slow, given the perspective that headline inflation could peak only a touch below 5%. However, core indicators are likely to stay inside the variation band of the NBR's target (2.5% +/- 1%) next year, while economic growth and wage dynamics are set to lose some impetus too (for further details see our latest GDP report).
- In addition, the ROBOR 3M, the key benchmark for clients with variable interest rate, has already risen by 120-130 basis points since August. In practice, this corresponds to five policy rate hikes (25 bps each) in only four months. In the case of housing loans, the higher ROBOR will translate into 6%-16% increase in monthly instalments (depending on the maturity of loans; see Chart 18), our simulation shows. Admittedly, this is still far from the shock caused by the depreciation of the leu in the period of the August 2008 – February 2009 (then the leu lost almost 22% against the euro owing to the outburst of the financial crisis), but it is not negligible. The NBR estimated that a 200 bps hike in interest rates would lift the non-performing loan ratio of the mortgage portfolio of banks from 5.8% to 7.3% on a one-year horizon, with the largest burden on socially vulnerable borrowers.

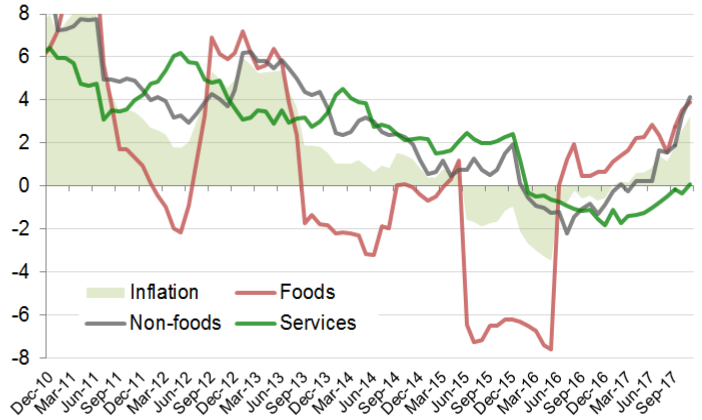
Chart set:

Chart 1: Headline inflation
(%, NSA data)



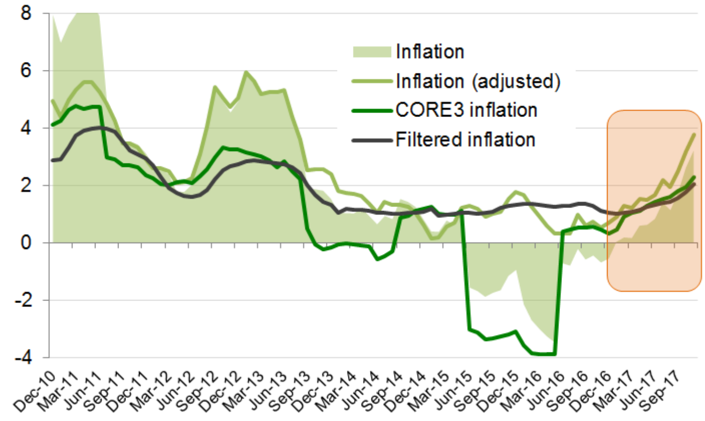
Sources: NIS, OTP Research

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



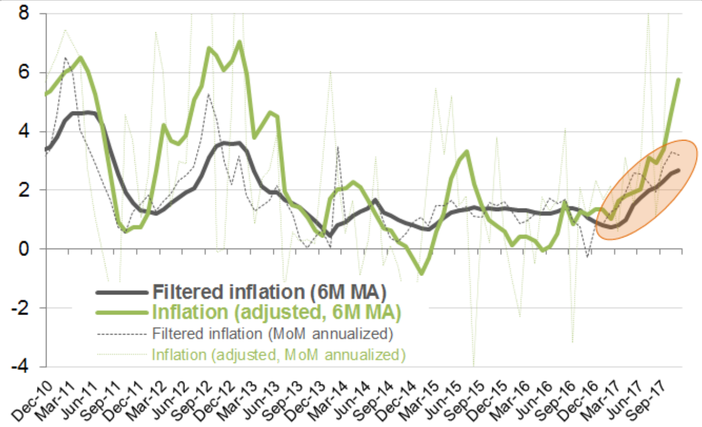
Sources: NIS, OTP Research
Note: in line with the National Institute of Statistics' (NIS) general segmentation.

Chart 3: Inflation and underlying processes
(YoY%)



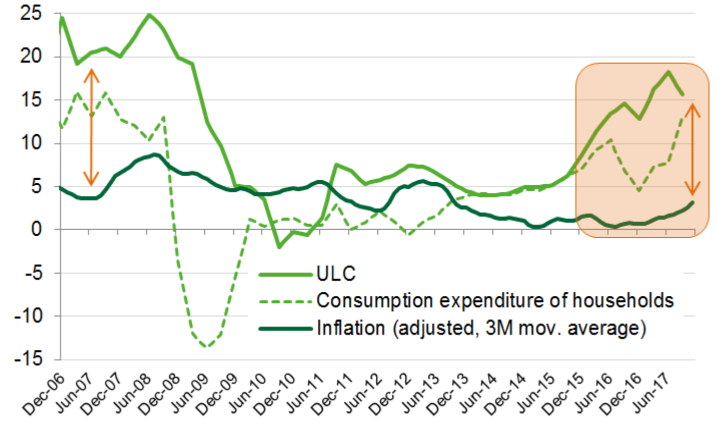
Sources: NIS, OTP Research
*Note: **CORE3 =** inflation excluding VFE (vegetables, fruits, eggs), fuels, regulated as well as beverages and tobacco prices; **Filtered inflation =** in-house underlying inflationary measure (SA).*

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



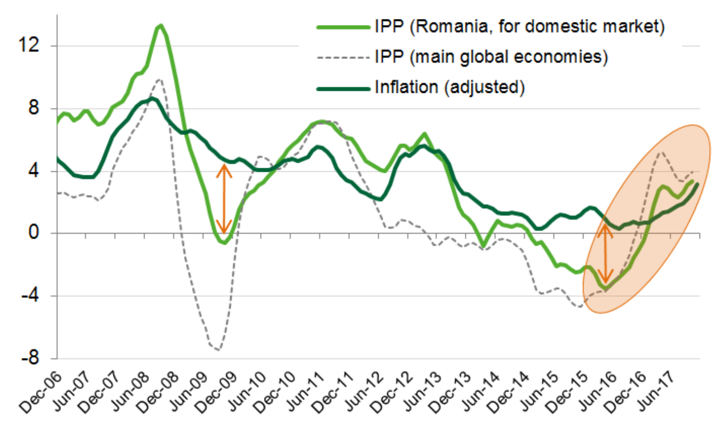
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes; 6M MA = six-month moving average.

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



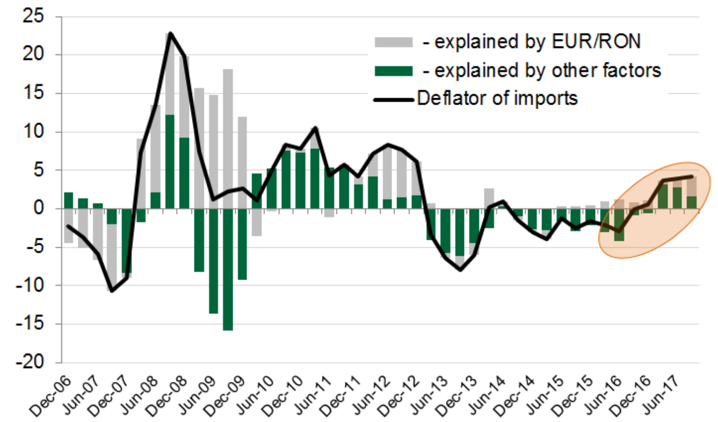
Sources: Eurostat, NIS, OTP Research
Note: adjusted by the impact of main tax changes.

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



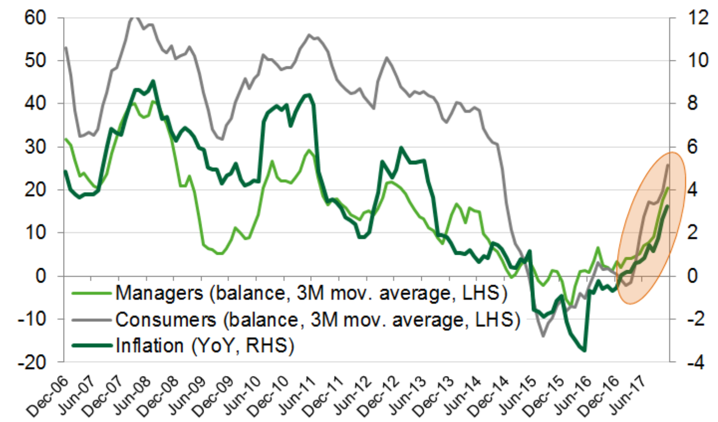
Sources: NIS, OECD, NBSC, OTP Research
Note: adjusted by the impact of main tax changes; the IPP (main global economies) includes data from EU28, USA and China

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



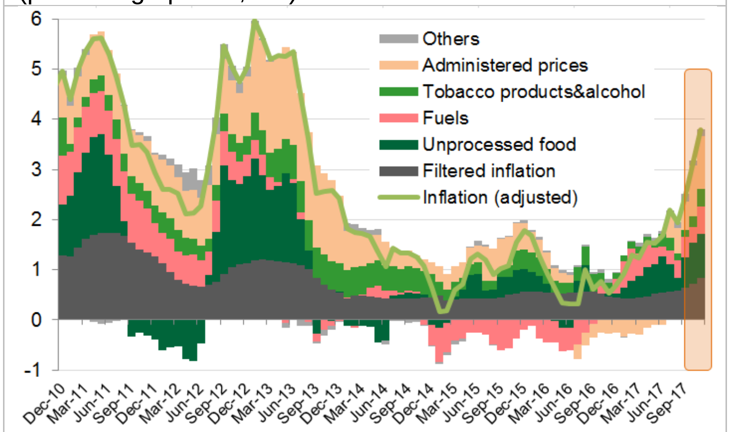
Sources: NBR, NIS, OTP Research

Chart 8: Price expectations vs. inflation
(%)



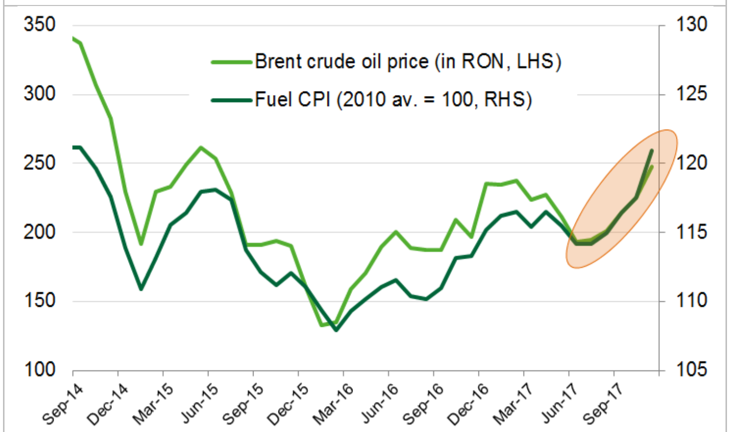
Sources: EC, NIS, OTP Research

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



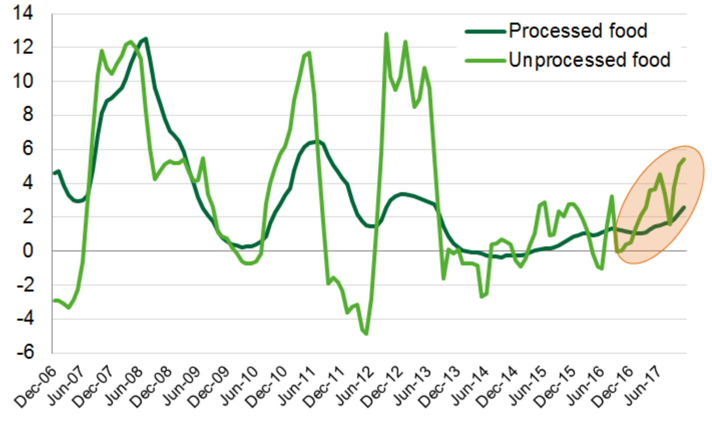
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 10: CPI of fuels vs. Brent oil prices



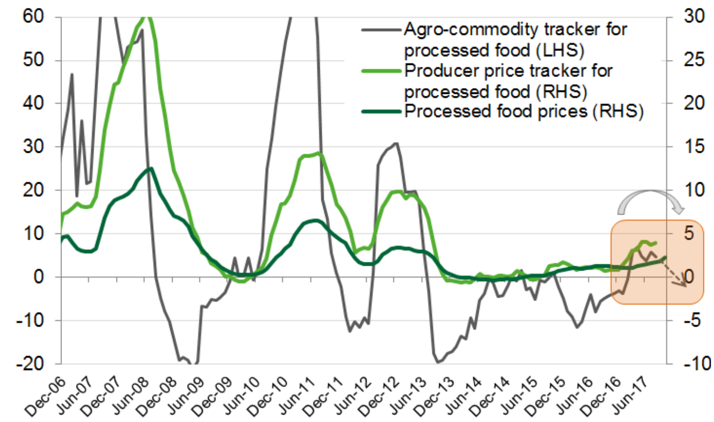
Sources: NIS, Reuters, OTP Research
Note: Fuel CPI is adjusted by the impact of main tax changes.

Chart 11: Foods' inflation
(YoY%, SA)



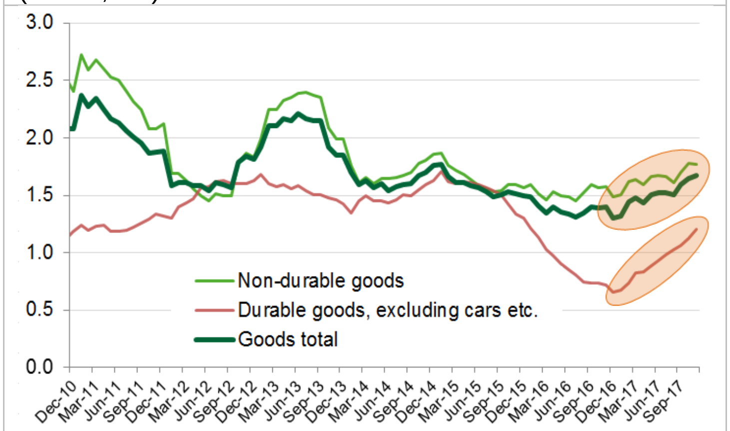
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 12: CPI and PPI of processed foods vs. agro-commodity prices (YoY%, SA)



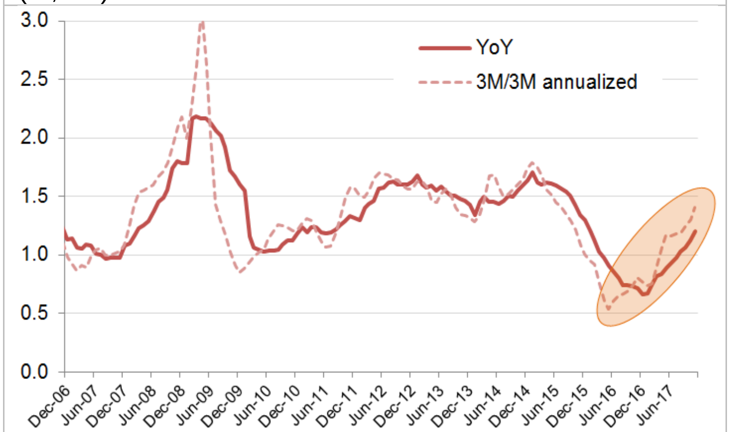
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 13: Goods' inflation
(YoY%, SA)



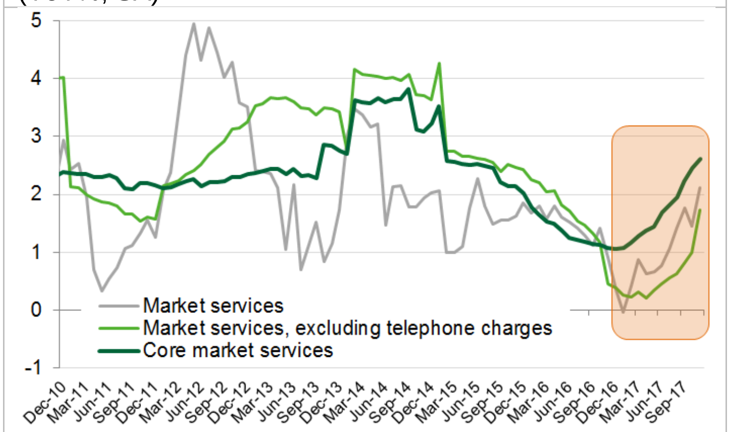
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 14: Durable goods, excluding cars etc.
(%, SA)



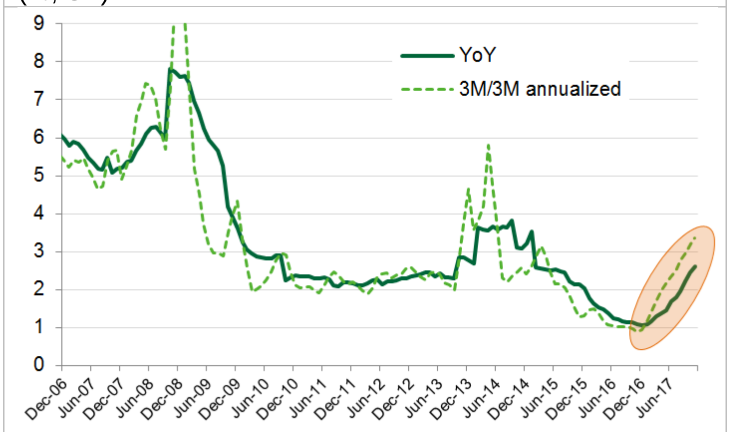
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 15: Market services
(YoY%, SA)



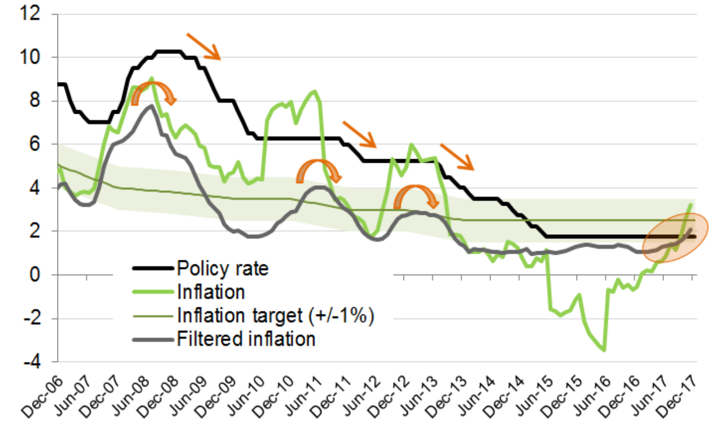
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes; ***Core market services****, excludes the EUR/RON-related telephone charges as well as insurances*

Chart 16: Core market services
(%, SA)



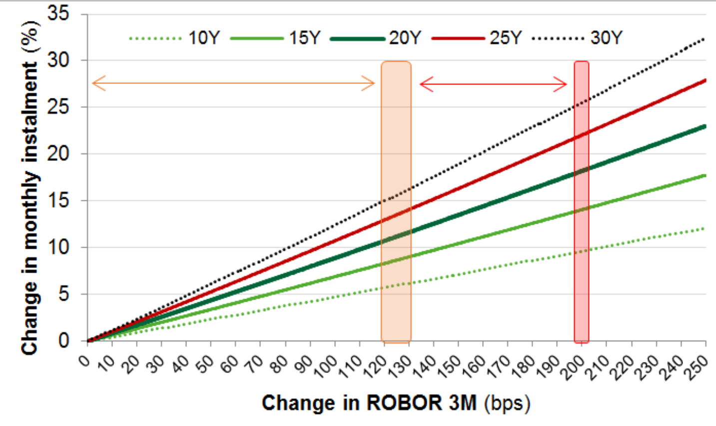
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes; ***Core market services*** *excludes the EUR/RON-related telephone charges as well as insurances.*

Chart 17: Inflation vs. NBR's inflation target (YoY%)



Sources: NIS, OTP Research
Note: ***Filtered inflation =*** *in-house underlying inflationary measure (SA).*

Chart 18: Simulated impact of ROBOR 3M hike on the monthly payment of borrowers (housing loans)



Sources: NBR, OTP Research
Note: the simulation was calibrated on a housing loan with 4.0% interest rate (initial ROBOR 3M = 0.89%, in line with August 2017 average)

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