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MONETARY POLICY COMMENTARY

8 February 2018

The normalisation process continues

- The Board of the NBR raised the policy rate by 25 bps to 2.25% for the second time this year. Simultaneously, the interest rate corridor also shifted a quarter percentage-point higher, to 1.25%-3.25% (Chart 1). The outcome of the meeting was in line with our, as well as the market's expectation. Regarding the NBR's liquidity management, governor Isarescu said that the central bank did not intend to implement a firmer approach now, even if there had been discussions on this subject, as the narrower corridor already resulted in more efficient monetary transmission and some room for manoeuver was also preserved for unexpected situations. Referring to the FX market, NBR chief also said that the EUR/RON was traded where 'it should be'. The news had little impact on the leu, while ROBOR rates climbed 4-17 basis points higher, with the largest movement at the short end.
- The latest decision of the Board was in line with the broader picture. Romania's central bank started the normalisation cycle earlier than most of its key peers, as consumer prices pointed to a sharp revival, while the annual inflation is also set to break above the tolerance band of the NBR (2.5% +/- 1%) at the beginning of this year, fuelled by both one-off and fundamental factors. The overheating fears amid pro-cyclical fiscal policies added to the pressure, too. It is also worth mentioning that the normalisation process was speeded up compared to the earlier expectations, as both inflation and economic data frequently surprised on the upside in the past few quarters.
- The tone and the key messages of the governor's post-meeting speech broadly matched our anticipations with Mr Isarescu seeking to curb inflation expectations. NBR chief Mr Isarescu said that the central bank was 'fighting inflation'. In our opinion, this reflects the NBR's commitment to curb consumer prices, and it also sends a firm message to the public. Nonetheless, he also added that the CB 'does not expect a long battle', as headline inflation should 'return within the target by year-end', that is to say CPI's rush is transitory, providing anchor to economic agents. We noted earlier that managing inflation expectations will be a key issue (Chart 3), particularly at the beginning of this year. February's policy meeting provided an excellent opportunity to do the job both via the rate hike and the main messages, before January's skyrocketing consumer price data see the light of day. At the same time, given the large excess liquidity on the money market (Chart 4), the pass-through of the 25 bps hike could be smoother than amid tight conditions, buying time to borrowers to adapt to higher financing costs.
- Regarding the outlook of the policy rate, Mr Isarescu did not reveal anything specific, reiterating that the NBR, unlike its peers, does not provide forward guidance. Given the current context with several important questions, we think that the central bank will follow a data dependent approach in the quarters ahead. At least one rate hike seems to be likely in Q2, probably delivered in April rather than in May. However, then the NBR may switch to a slower pace, as the annual inflation peaks and as an assessment about the impact of tightening actions becomes necessary too. We recall that the ROBOR 3M, the main benchmark for credits with variable interest rates, has rallied around 120 bps since the middle of last year, translating into 5%-15% higher monthly instalments in the case loans for house purchases. However, at this moment, only a handful of economic figures are available about the end of 2017, and even less information about the beginning of this year, to evaluate the effects of increased financing cost.
- In addition, the burden coming from the transfer of social contributions from companies to employees starting from January 2018 causes uncertainties too, as it is set to result in lower net wages, unless employers raise gross salaries properly. Therefore, Q1 wage dynamics will be worth watching. The rising concerns among households were reflected in early soft indicators. Consumer confidence fell sharply recently, after hitting a record high in early 2017 (Chart 5), with the negative trend continuing in January. On the other hand, hard data suggest that household's demand remained rather healthy, with retail trade (a proxy for household's consumption) rebounding in December. Meanwhile, other hard indicators pointed to a modest deceleration of the economy in Q4. The stock of private loans dipped by RON 3.6 bn (FX adjusted data) in December. Nevertheless, it seems that this came mainly on the back of write-offs and NPL sales on company side. Admittedly, consumer credit also lost momentum in the last month of 2017, but at this moment, it is difficult to determine how much of the fall is due to portfolio cleaning. Meanwhile, housing loans continued to increase steadily.

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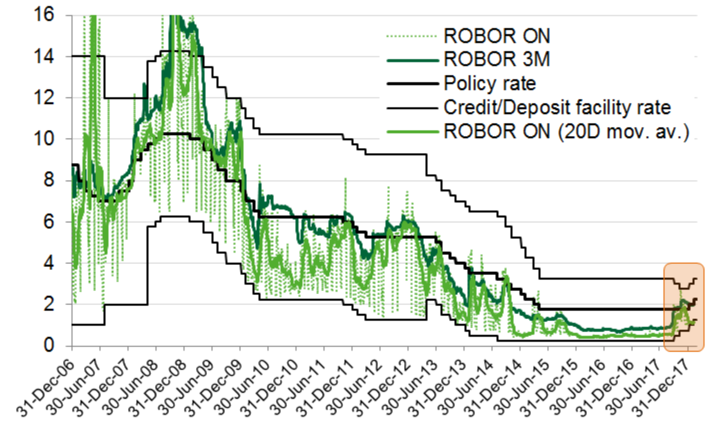
- Summing it up, we maintain our opinion that the normalisation cycle has further to run, but probably at a slower pace of rate hikes, as in the following quarters the NBR has to carefully seek balance between the combination of containing price expectations, overheating fears and the rising burden of borrowers. Accordingly, we think that the policy rate could reach 2.75% at the end of this year and may be raised to 3.25% before taking a longer break in H2 2019. Nonetheless, it is important to mention that risks are skewed to the upside. At the beginning of this year, stronger-than-expected economic and CPI outturns could force the NBR to frontload the hikes again. We also note that, currently, monetary conditions are still very loose at global level, but as the world economy booms and inflation gradually returns, monetary policy should become tighter too in the years ahead. A more-aggressive-than-previously-thought tightening may urge the NBR to prolong the current normalisation cycle, which would result in higher policy rate in 2019.

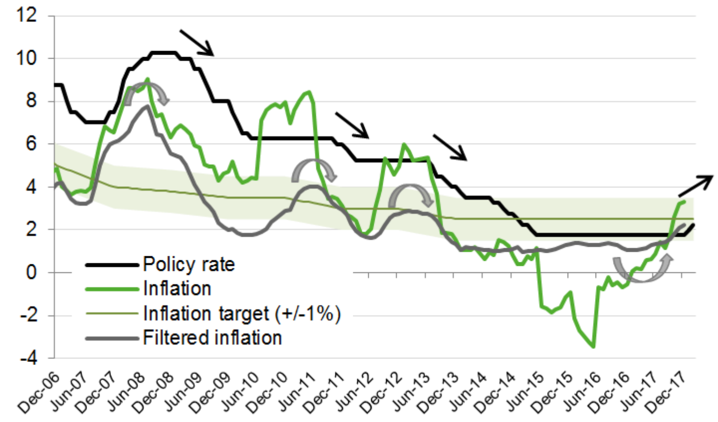
Chart set:

Chart 1: Policy rates and interbank MM rates
(%, daily data)



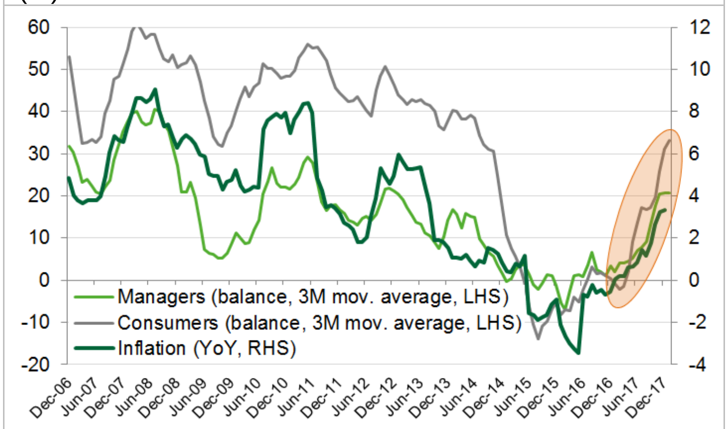
Sources: NBR, OTP Research

Chart 2: Policy rate and inflation indicators
(%)



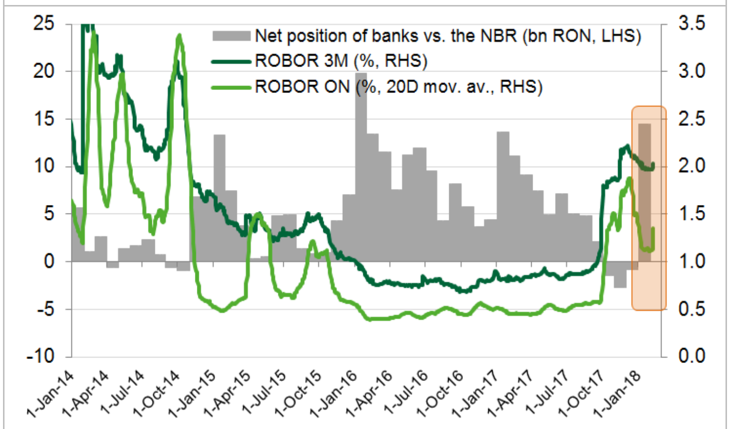
Sources: NBR, OTP Research
Note: Filtered inflation = in-house underlying inflationary measure (SA).

Chart 3: Price expectations vs. inflation
(%)



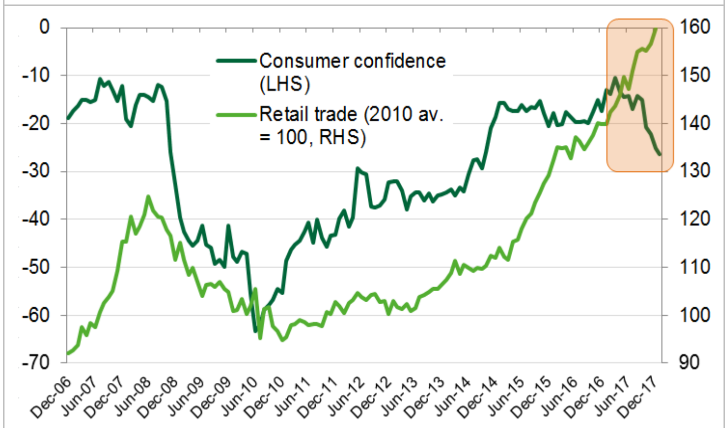
Sources: EC, NIS, OTP Research

Chart 4: Money market rates and liquidity conditions



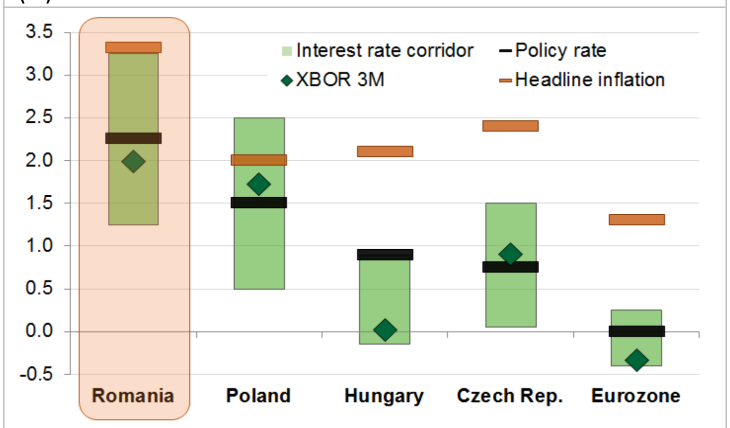
Sources: NBR, OTP Research

Chart 5: Consumer confidence vs. retail trade



Sources: EC, NIS, OTP Research

Chart 6: Key monetary indicators
(%)



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

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