otp Research

REPORT ON INFLATION

15 February 2018

Headline inflation surprised on the upside and is expected to accelerate until the end of Q2; further rate hikes are in the pipeline; Underlying CPI data point to early signs of moderation

- In January, Romania's annual inflation jumped to 4.3%, up from 3.3% in December, chiefly owing to vanishing base effects, significant regulated prices hikes and accelerating fuel inflation (see Chart 1). In MoM terms, consumer prices grew by 0.8%. The figures exceeded the market's and our expectations (Reuters: 4.1% / Bloomberg: 3.9% / OTP: 4.1%), but slightly undershot the NBR's projection (4.4%). Simultaneously, underlying price indicators also continued to inch higher, with our *filtered inflation*[1] reaching 2.4% YoY, up from 2.2% a month earlier (Chart 3). The CORE3 inflation, the NBR's preferred underlying measure, rose by 0.4 pps to 2.8%.
- We recall that after hitting record low levels in 2015-2016, consumer price growth skyrocketed in the past few quarters, frequently surprising on the upside. The rebound was supported by one-off factors as well as strong fundamentals (Charts 5-8). Owing to the changing outlook, overheating worries and also in order to contain inflation expectations, Romania's central bank launched the policy normalization cycle in H2 2017, earlier than most of its peers.
- Our forecast error mainly came from non-core items. First of all, administered prices grew somewhat faster than we had penciled in, after electric energy and central heating prices registered a stronger-than-expected pick-up. It should be noted that the increase in natural gas' CPI was lower than the communication of authorities and energy companies had suggested (3.8% MoM vs. 5.6% MoM). This was in line with our expectation, as the hike was implemented on 10 January (instead of the first day of the month), implying a potential late pass-through in February. The CPI of fuels rose a bit faster than the evolution of crude oil prices would have indicated (Chart 10). Nonetheless, we think that some of January's surprises could be reversed. Fuels' CPI frequently shows short-term deviations from its theoretical level and, most recently, crude futures also pointed to a significant drop, triggered by nervousness on global financial markets. Earlier, we had expected important administered CPI hikes for the second quarter of the year, but on the back of January's sharp increases, this seems to be less likely. Therefore, we do not alter our year-end forecast (3.2% YoY).
- Food inflation eased slightly in January, dragged down primarily by volatile unprocessed foods (Chart 9). The largest deceleration was posted by vegetables (first of all, due to potato prices) and eggs. However, it is also important to note that the more smoothly changing components lost impetus too, with both the core unprocessed (raw meat, dairy and milling products) and core processed food prices pointing to weakening momentum. This outturn was in line with the signals provided by our agro-commodity trackers. It should be added that foods' inflation reached relatively high levels and it also seems to be more persistent than at the previous two peaks of the tracker indicators (Chart 11 & 12). Our models suggest that this could be the result of significantly stronger cost pressures from wages. However, as the external shocks triggered by the fipronil scandal in the case of eggs started to fade, the rally of several dairy products likely will run out of steam and also due to last year's excellent harvest, we continue to expect for moderating food inflation.
- Usually the first month of the year is a key period for economic agents to reset their offer prices, therefore, we paid special attention to January data. The signs were rather mixed. Goods inflation slightly eased in the first month of the year, as the CPI of non-durable goods weighed on the indicator (Chart 13). At the same time, durable goods maintained their general upward trajectory, but lost some impetus on monthly basis (Chart 14). Similarly to durables' inflation, the annual growth rate of market services CPI continued to climb higher (Chart 15), but high-frequency indicators pointed to weakening momentum (Chart 16). A deeper look on the individual components paints a quite mixed picture too. Given the strong fundamentals, it is quite likely that January was a month for taking a breath before advancing even higher.

[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

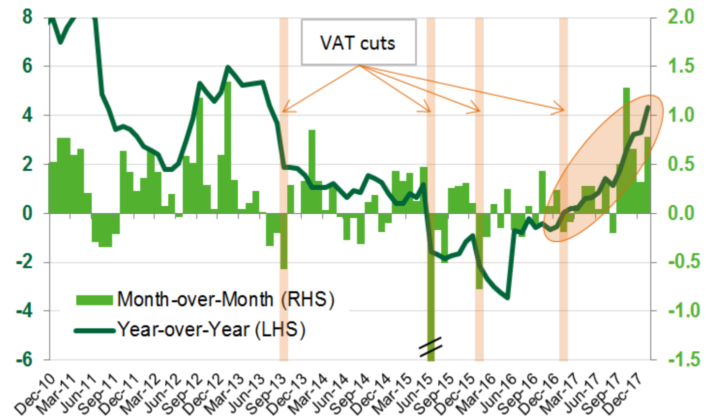
Analyst
Csaba Bálint
+4021 307 58 96
csaba.balint@otpbank.ro

Nevertheless, the softer outturn may have been the first response of prices to the sharp fall in confidence (Chart 17) and tightening monetary conditions. In any case, it is too early to answer this question at this moment.

- Regarding the short-term outlook, we think that headline inflation may peak near 5% in the middle of the year, underpinned by significant statistical base effects, but may end the year at 3.2% (Chart 18) and could remain close to 3% in 2019 (unchanged compared to our previous projection). In February, the impact coming from the elimination of TV&radio fee will drop out from the statistical base, resulting in a significant boost for the headline data, while the effect of regulated price hikes as well as higher fuel excise duty will linger further (the excise duty on fuels was lowered at the beginning of last year, but re-introduced in H2 2017). We reiterate that the risks are skewed to the upside, among others owing to the pro-cyclical fiscal policy and the stronger-than-expected revival of the global and EU economy.
- As the January data was close to the NBR's projection, our earlier outlook for the policy rate remains valid. We think that Romania's central bank will raise the benchmark rate by 25 bps to 2.50% in Q2, most likely already on its 6 April meeting. The key rate may end this year at 2.75% and reach 3.25% before taking a longer break in H2 2019. This pattern would be in line with the latest hints of the NBR. The minutes about the February rate-setting meeting revealed recently that the central bank's Board had expected monetary conditions *'to become quasi-neutral in 2019'*. In our understanding, this does not mean the return of the policy rate to pre-crisis levels, but rather positive, albeit still close to zero real interest rates, as the global monetary context has changed dramatically since the financial collapse in 2008. The NBR's officials reiterated several times that the central bank had to take into account what other policy-makers do, also noting that the real-appreciation of the leu should be avoided owing to competitiveness issues.

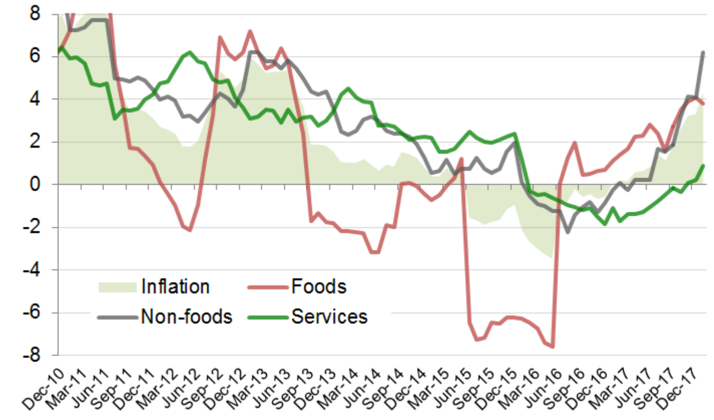
Chart set:

Chart 1: Headline inflation
(%, NSA data)



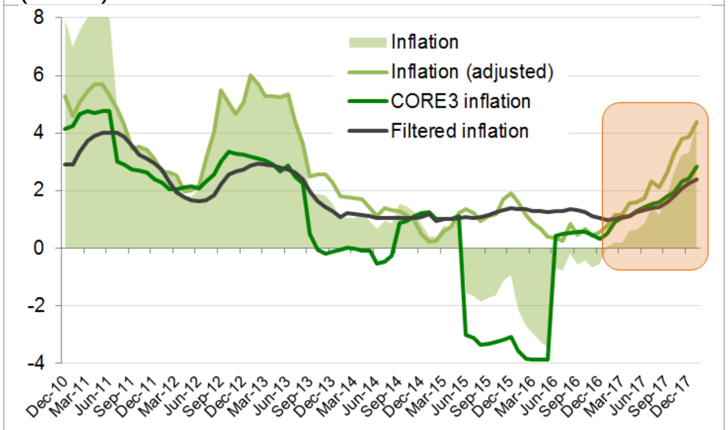
Sources: NIS, OTP Research

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



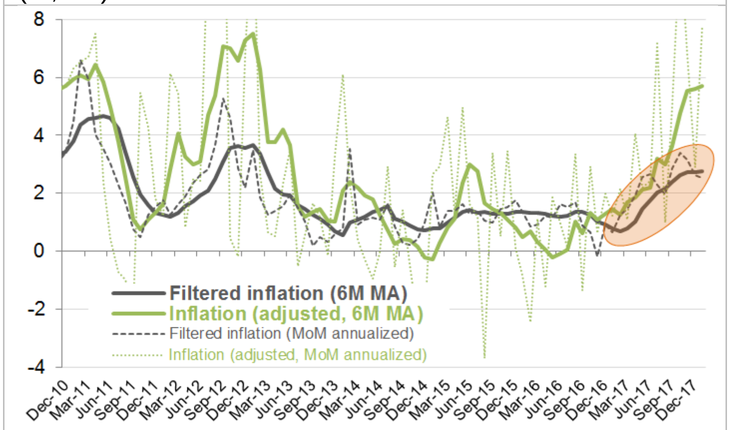
Sources: NIS, OTP Research
Note: in line with the National Institute of Statistics' (NIS) general segmentation.

Chart 3: Inflation and underlying processes
(YoY%)



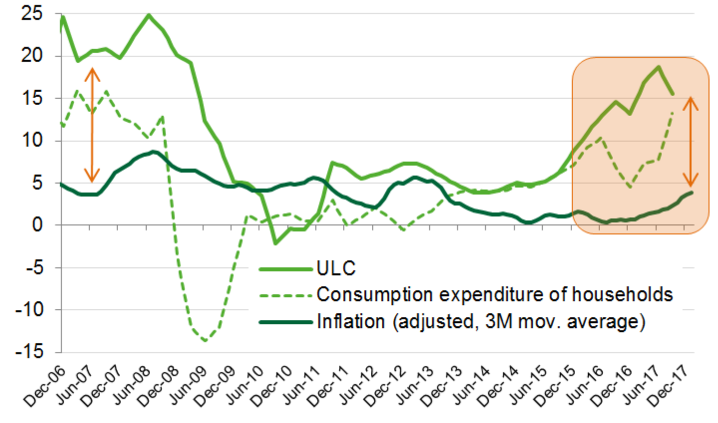
Sources: NIS, OTP Research
*Note: **CORE3** = inflation excluding VFE (vegetables, fruits, eggs), fuels, regulated as well as beverages and tobacco prices; **Filtered inflation** = in-house underlying inflationary measure (SA).*

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



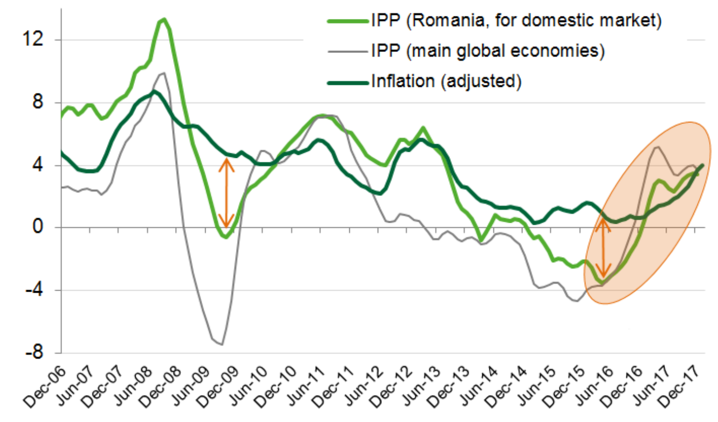
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes; 6M MA = six-month moving average.

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



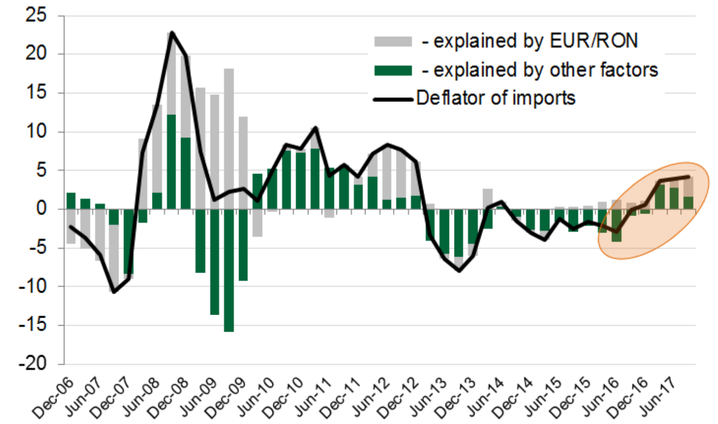
Sources: Eurostat, NIS, OTP Research
Note: adjusted by the impact of main tax changes.

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



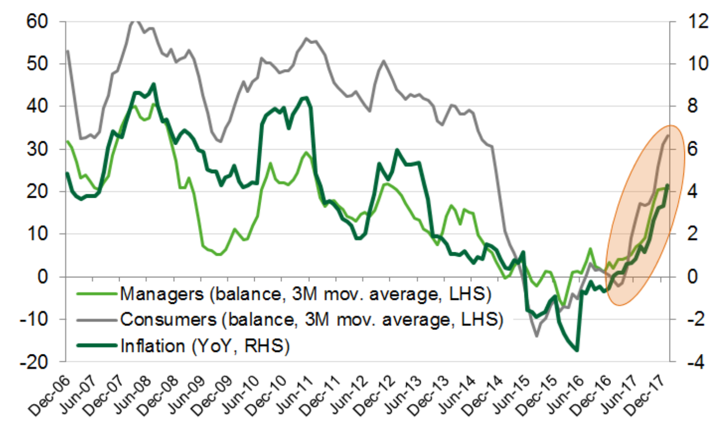
Sources: NIS, OECD, NBSC, OTP Research
Note: adjusted by the impact of main tax changes; the IPP (main global economies) includes data from EU28, USA and China

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



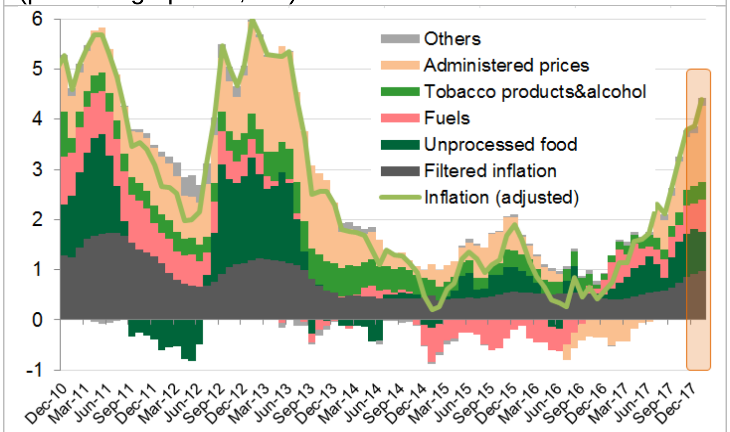
Sources: NBR, NIS, OTP Research

Chart 8: Price expectations vs. inflation
(%)



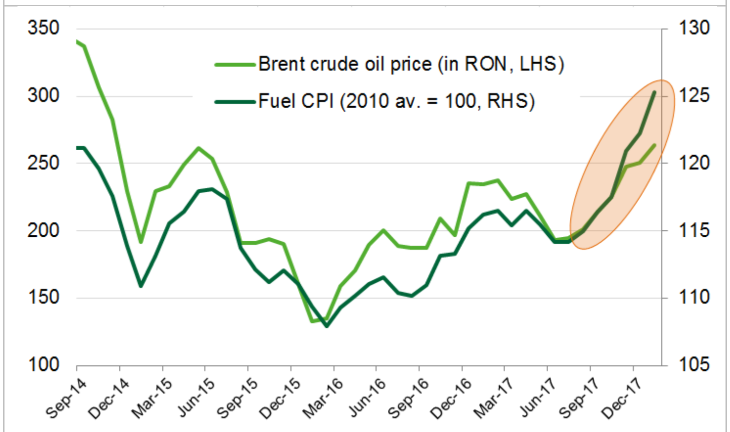
Sources: EC, NIS, OTP Research

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



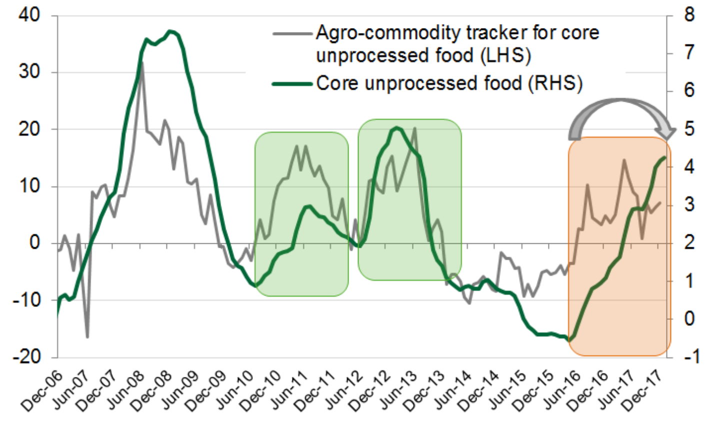
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 10: CPI of fuels vs. Brent oil prices



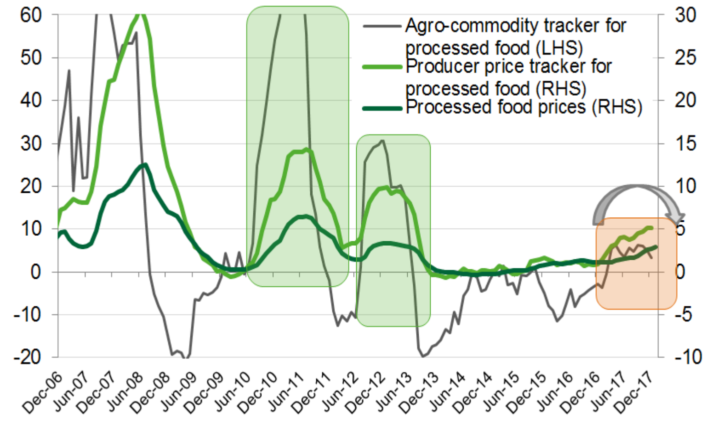
Sources: NIS, Reuters, OTP Research
Note: Fuel CPI is adjusted by the impact of main tax changes.

Chart 11: CPI of core unprocessed foods vs. agro-commodity prices (YoY%, SA)



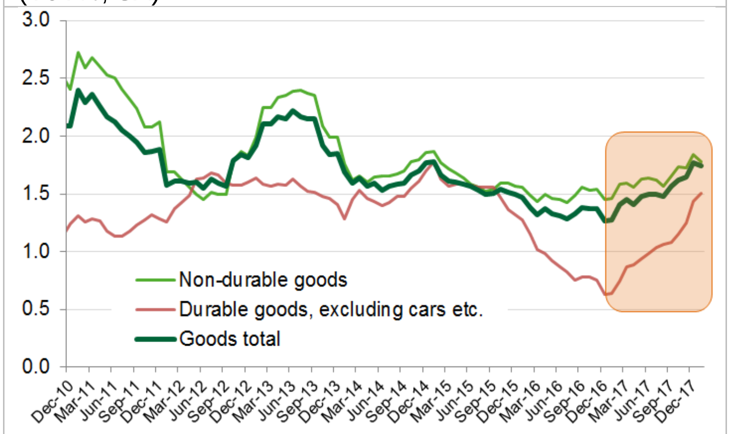
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

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



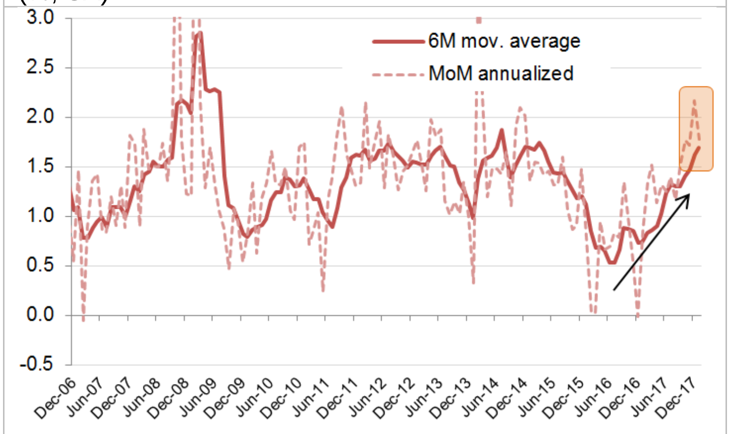
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

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



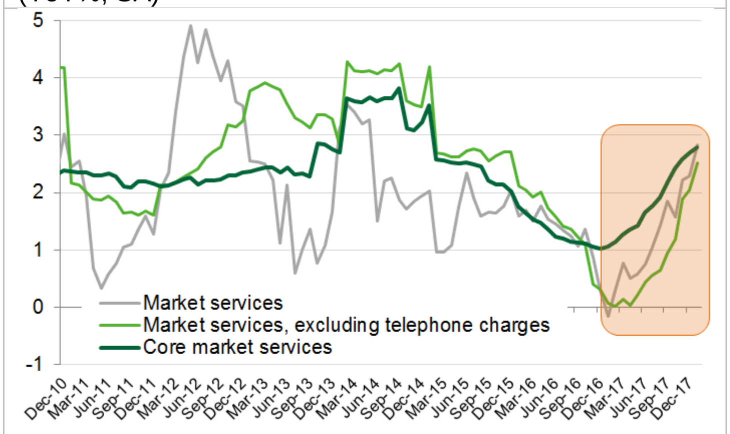
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

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



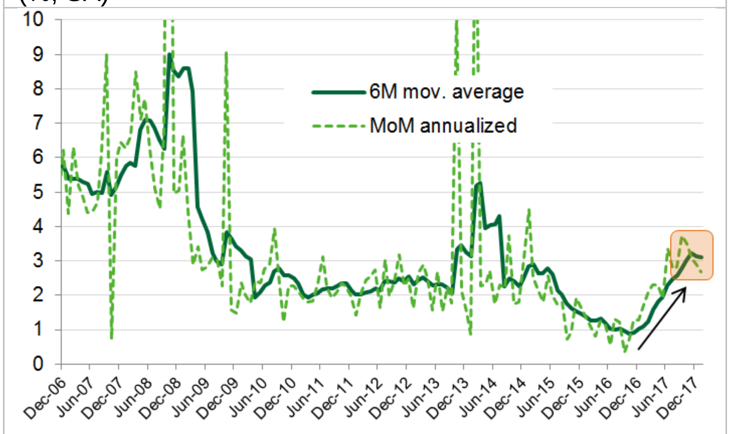
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 15: Market services
(YoY%, SA)



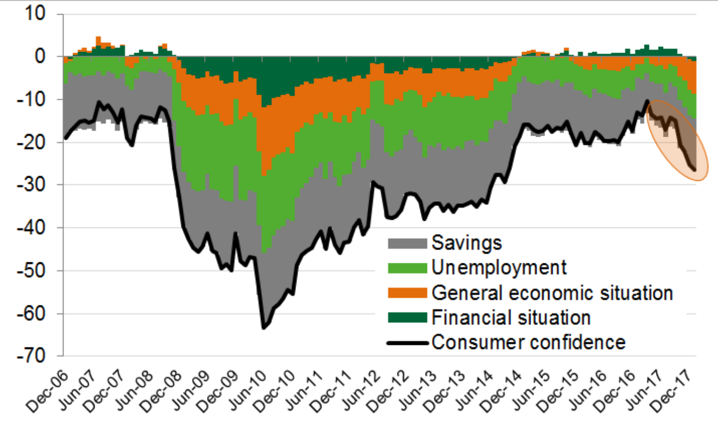
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes; ***Core market services****, excludes the EUR/RON-related telephone charges as well as insurances*

Chart 16: Core market services
(%, SA)



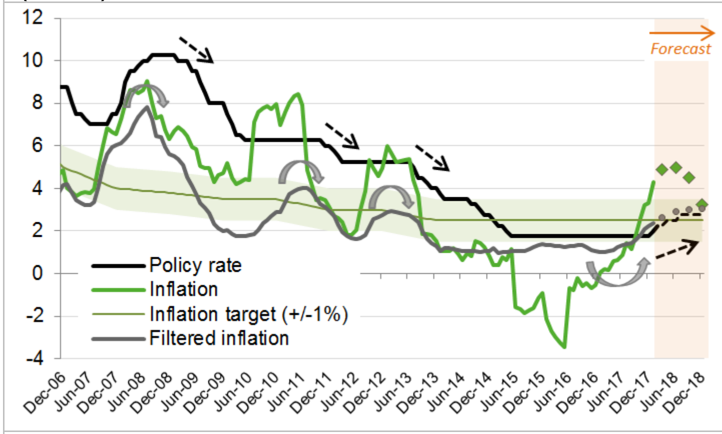
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes; ***Core market services*** *excludes the EUR/RON-related telephone charges as well as insurances.*

Chart 17: Decomposition of consumer confidence indicator (balance of opinions)



Sources: EC, OTP Research
Note: the components of the consumer confidence indicator reflects the expectation of households over the next 12 months

Chart 18: Inflation vs. NBR's inflation target (YoY%)



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

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