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# MONETARY POLICY COMMENTARY

*5 April 2018*

## *Unexpectedly, the NBR remained on hold*

- After two consecutive 25 bps hikes at the beginning of 2018, Romania's central bank took a break, keeping the policy rate unchanged at 2.25% on its April meeting. In line with the policy rate, the deposit as well as the credit facility rate remained flat at 1.25% and 3.25% respectively. The minimum reserve requirement ratio was also unchanged at 8%. The outcome of the NBR's Board meeting came as a significant surprise, as the market (including us) had expected another rate hike. Nonetheless, the leu's response to the news was rather soft, with the EUR/RON inching marginally higher.
- We recall that the National Bank of Romania launched the monetary policy normalization cycle in H2 2017, earlier than most of its peers, after consumer prices pointed to a strong rebound (see Chart 1) surprising frequently on the upside and as overheating concerns increased on the back of the pro-cyclical fiscal policy.
- We noted in our February MPC report that the NBR probably will moderate the speed of rate hikes, in order to find a healthy balance between the combination of containing price expectations, overheating fears and the rising burden of borrowers. Nevertheless, with the headline inflation jumping to 4.7% YoY in February, well above the upper bound of the target (2.5% +/- 1%), we found continued rate hikes likely in April.
- The press release pointed out that the latest inflation figures came in marginally lower than the NBR had expected. This, coupled with the rising confidence of policy makers that consumer price growth will return to the tolerance band, played an important role in the decision to remain on hold. Nonetheless, Governor Mugur Isarescu provided a series of additional explanations to support the decision of the rate-setting meeting. However, earlier speeches of the NBR chief included most of these arguments.
- First of all, Mr Isarescu reiterated that the NBR had to pay special attention on what other central banks do, also adding that nominal interest rates in Romania are already high, while a meaningful appreciation of the leu is undesirable, as it would lead to a wider current account deficit. In the past few months the EUR/RON hit a record high on overheating fears, but the pressure on the FX rate faded after the central bank started to increase the key rate. The NBR's cautiousness regarding the C/A balance comes from the experience of 2003-2007, when Romania stood in the doorstep of EU accession. In that period, the economy was booming, while large capital inflows led to significant appreciation of the real effective exchange rate, and to a skyrocketing current account gap (Chart 2).
- Another reason for keeping the policy rate unchanged was that the impact of earlier tightening measures was not fully transmitted, Mr Isarescu said, referring to interbank lending rates. ROBOR rates up to the 3M maturity stay well below the NBR's policy rate owing to abundant liquidity conditions. Nonetheless, as the excess liquidity will be absorbed gradually, short-term ROBOR rates are expected to rise even in the absence of a further rate hike. Moreover, there is still room for commercial banks to increase the interest rates on deposits to clients, Mr. Isarescu added.
- The NBR's governor also remarked that wage dynamics softened at the beginning of this year. We noted in our latest inflation report that slowing real wage growth could help the central bank's effort to curb consumer price pressures. In addition, other early indicators for Q1 also suggested that GDP growth may decelerate. At the press conference, Mr Isarescu reiterated that monetary policy could not fully offset weaknesses in other areas, as it would lead to a suboptimal policy mix. At the same time, the CB chief also underscored that the NBR makes decisions according to its mandate based on facts and data. Politics can influence the climate but it does not determine the NBR's decisions, he said in answer to journalists' questions regarding the central bank's independence.
- Despite the dovish twist of the NBR, we think that the normalisation cycle will continue with cautious and gradual rate hikes, following a data dependent approach. We maintain our projection that the policy rate could reach 2.75% at the end of 2018 and may be raised to 3.25% before taking a longer break in H2 2019.


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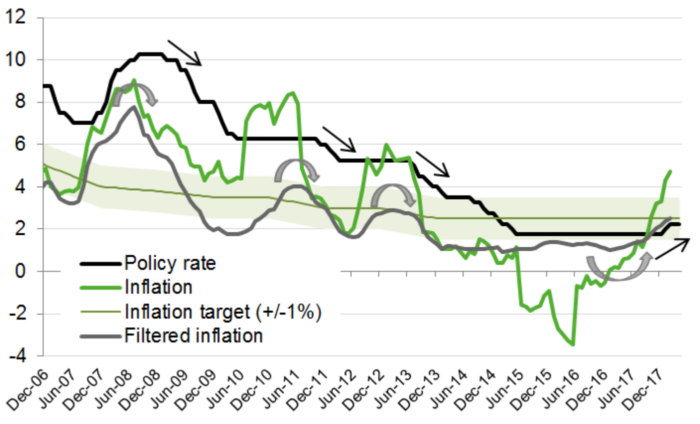
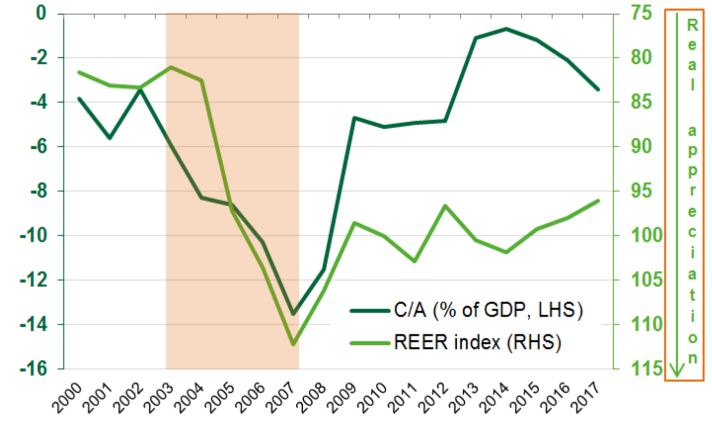
## Chart set:

**Chart 1: Policy rate and inflation indicators**
(%)




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

**Chart 2: Current account balance vs. the real effective exchange rate of the RON**




*Sources: Eurostat, NBR, OTP Research*
*Note: REER (deflator: consumer price indices - 42 trading partners)*

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