otp Research

REPORT ON INFLATION

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Headline inflation down on base effects

- In October, Romania's headline inflation dropped to 4.3% YoY, down from 5.0% YoY a month earlier (see Chart 1). The sharp deceleration was mainly due to base effects in the case of administered as well as fuel prices. In addition, a slowdown in the rise of volatile food prices also helped. October's outturn was in line with our expectation but exceeded the market consensus (Reuters' poll: 4.1%). In month/month comparison, the CPI index rose by 0.5%, mainly on the back of seasonal impacts and the spill-over effect of higher crude oil prices. Core3 inflation, the NBR's preferred underlying measure was practically unchanged, at 2.8% YoY, while our in-house *filtered inflation*[1] indicator was also stable (at 2.7% YoY; Chart 3).

- Regarding the broader picture, we recall that headline inflation marked a particularly steep revival in H2 2017, propelled primarily by administered price hikes, soaring Brent price and the weaker leu. Meanwhile, underlying CPI indicators also rose. Amid these developments and escalating overheating fears, Romania's central bank launched the normalisation cycle earlier than most of its peers. However, as consumer price inflation reached a turning point in the middle of this year, the NBR kept interest rates on hold in H2.

- Administered prices played the key role in October's deceleration of the headline data, as the steep increase of electric energy, natural gas, and central heating CPI in the same month of the previous year dropped out (Chart 10). Another base effect caused by last year's hike of the special excise duty on fuels also helped headline inflation to ease. In addition, a setback in fruits' inflation contributed to a softening of seasonal unprocessed food price growth. This came after seasonal food inflation posted a sharp pick-up a month earlier owing to soaring potato prices (Chart 11). We note that this year, potato production fell in Romania and also in the whole EU, owing to unfavourable weather conditions. Core unprocessed food inflation (raw meat, flour, and milk) continued to decrease in October, because of low pressure from agro-commodity prices (Chart 12). The supply-side shock coming from the African swine fever (up to the beginning of November, more than 360,000 pigs - around 8% of the total stock - have been slaughtered due to the disease) has not appeared yet in prices, probably owing to higher imports. Nonetheless, the potential spill-over effect of the disease remains a risk worth monitoring in the months ahead.

- Similarly to core unprocessed foods, processed food inflation decreased further in October (Chart 13). In our August report, we wrote about the risks stemming from the rallying wheat futures on European commodity exchanges. Since then, wheat prices have shown a correction, but remained at relatively high levels. The pass-through into domestic prices is still uncertain, but based on early data on agro-commodities (Chart 14) and the latest statistics on domestic wheat harvest (fresh figures pointed to higher-than-expected output), we think that agro-commodity inflation will show a rather mild acceleration in the following period. Given this context and also owing to another minimum wage hike (salaries in the food industry are around 30% below average wages in Romania, therefore minimum wage hikes have a more significant and rapid impact on production costs), we expect the downward trajectory of processed food inflation to stop at the beginning of next year, and later a slight re-acceleration cannot be excluded either.

- Last month, goods' inflation picked up, owing to higher prices in the case of non-durable goods. The upswing came chiefly on the back of rising clothing and footwear CPI. It is worth noting that, all in all, goods inflation has been on an increasing trend since the beginning of 2017 (Chart 15). This suggests that underlying cost-push and demand-pull pressures are slowly building up in the background. Turning to market services, October's data pointed to an increase, but this came from the leu's depreciation. Excluding exchange rate effects, market services inflation showed further signs of stabilisation, albeit at an elevated level (Charts 17 and 18). The flattening of the indicators is good news, but there is a risk that further wage hikes and a potential strengthening of domestic demand will re-ignite services inflation.

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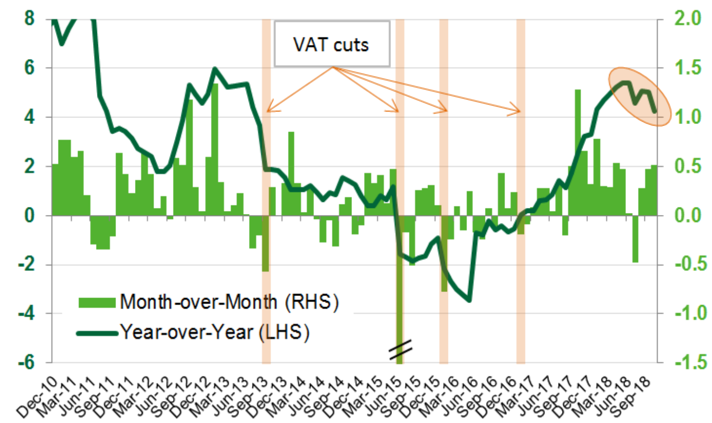
[1] *Filtered inflation is an in-house measure of underlying inflation dynamics. It excludes unprocessed food, fuels, administered as well as beverage and tobacco prices, filtering out the first-round impact of indirect tax changes. Moreover, it eliminates certain other items too, such as telephone charges and car prices, as these are strongly connected to the EUR/RON exchange rate.*

- Looking ahead, we expect headline inflation to end this year at 3.7%, 0.2 percentage points lower than earlier (due to the downturn of crude oil prices in the past few weeks), but still slightly above the NBR's tolerance band (2.5% +/- 1%; Chart 19). At the end of 2019, consumer price inflation could decrease near 3%. We forecast the headline data to hover near the upper bound of the central banks' target in Q1 2019, and enter it in Q2. With broadly stable core inflation and the outlook of further easing headline inflation, the NBR was not in hurry to tighten in the second half of this year. However as next year business-cycle-related core indicators will become the primary driver of consumer prices and as upside significant risks surround the outlook (owing to the tight labour market, loose fiscal policy, as well as the perspective of higher import prices, and tightening steps of other central banks), we think that the NBR will resume the normalisation cycle. We expect the policy rate to end next year at 3.25%.

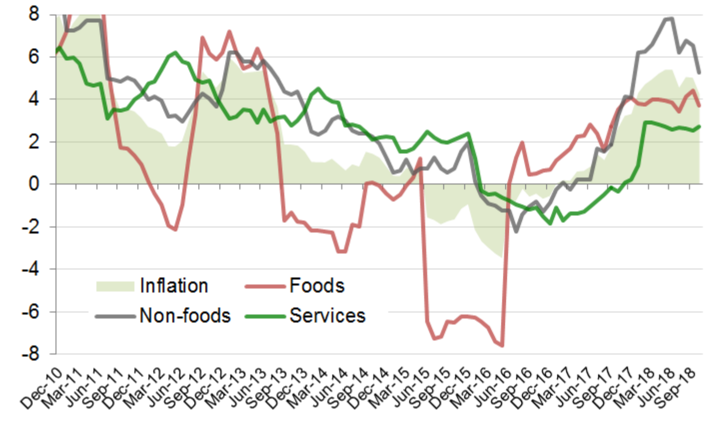
Chart set:

Chart 1: Headline inflation
(%, NSA data)



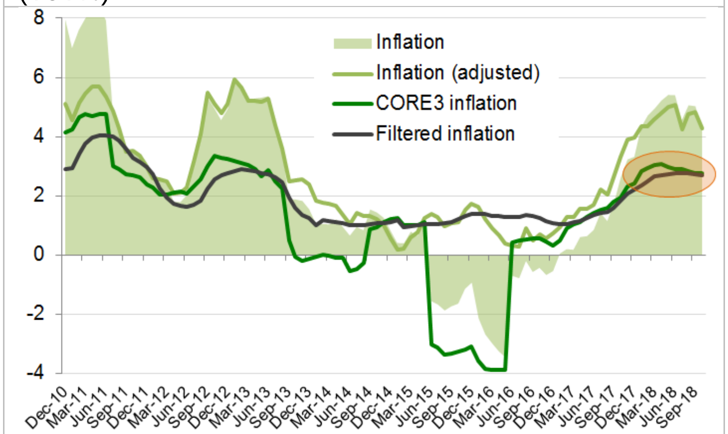
Sources: NIS, OTP Research

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



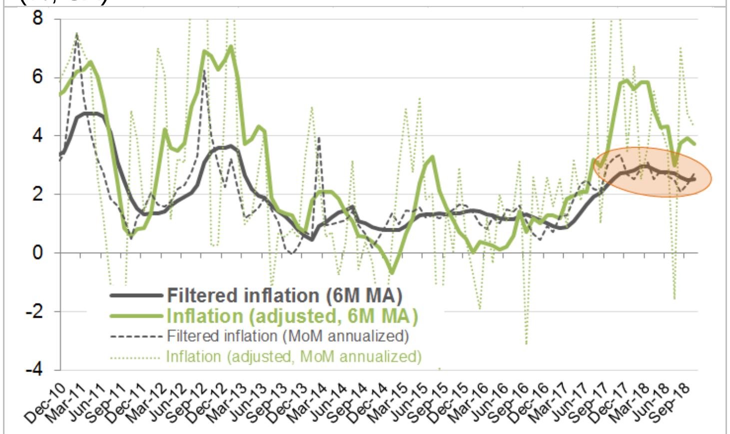
Sources: NIS, OTP Research
Note: in line with the National Institute of Statistics' (NIS) general segmentation.

Chart 3: Inflation and underlying processes
(YoY%)



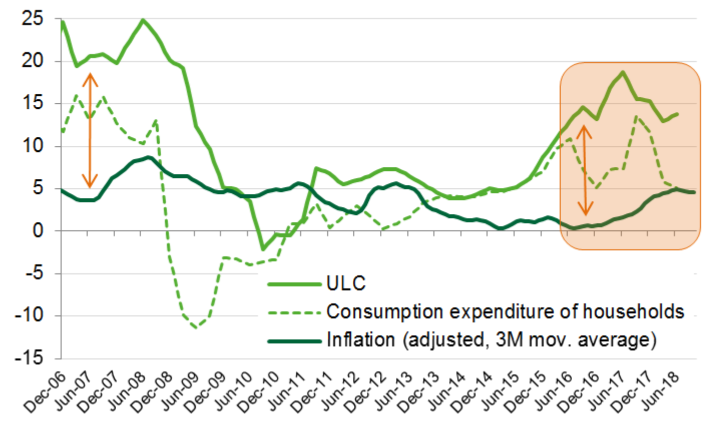
Sources: NIS, OTP Research
*Note: **CORE3** = inflation excluding VFE (vegetables, fruits, eggs), fuels, regulated as well as beverages and tobacco prices; **Filtered inflation** = in-house underlying inflationary measure (SA).*

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



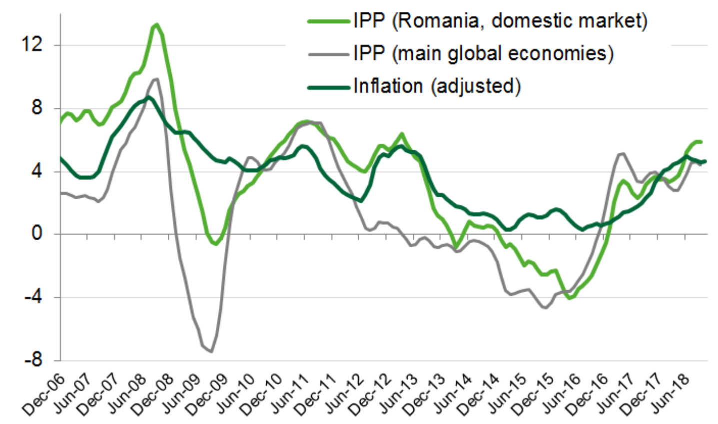
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes; 6M MA = six-month moving average.

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



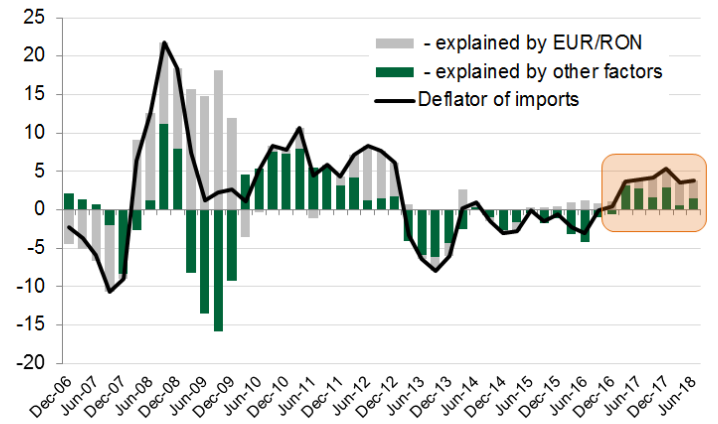
Sources: Eurostat, NIS, OTP Research
Note: inflation data adjusted by the impact of main tax changes.

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



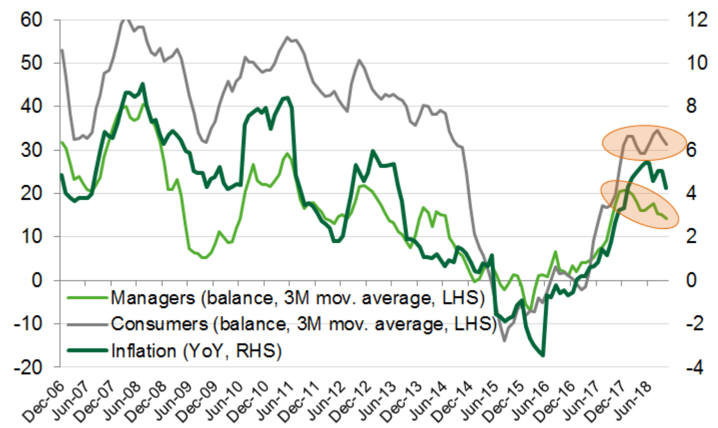
Sources: NIS, OECD, NBSC, OTP Research
Note: inflation data adjusted by the impact of main tax changes; the IPP (main global economies) includes data from EU28, USA and China

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



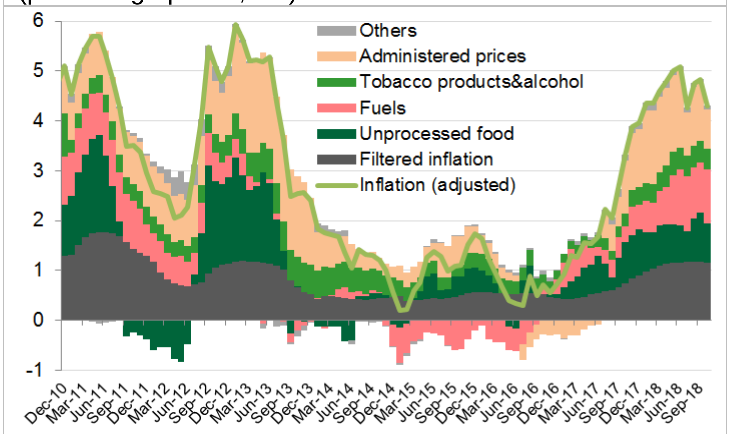
Sources: NBR, NIS, OTP Research

Chart 8: Price expectations vs. inflation (%)



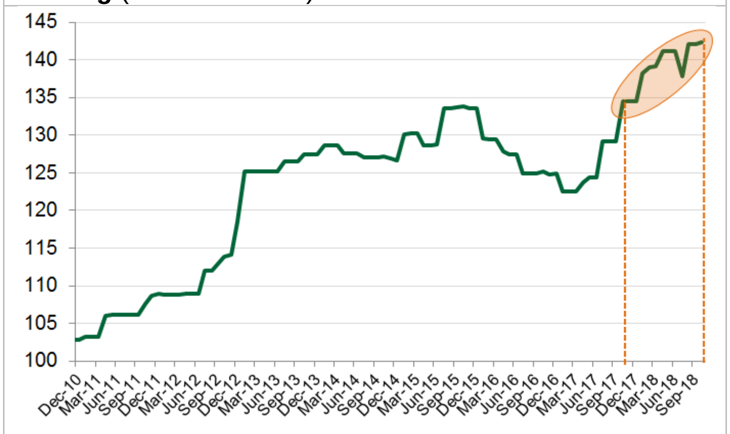
Sources: EC, NIS, OTP Research

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



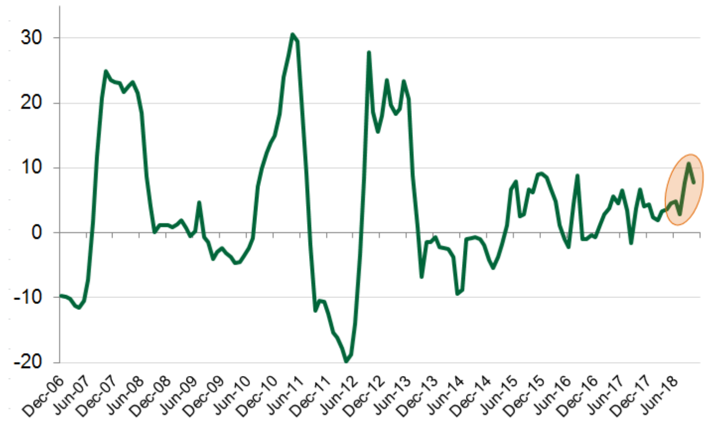
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 10: CPI of electric energy, gas and central heating (2010 av. = 100)



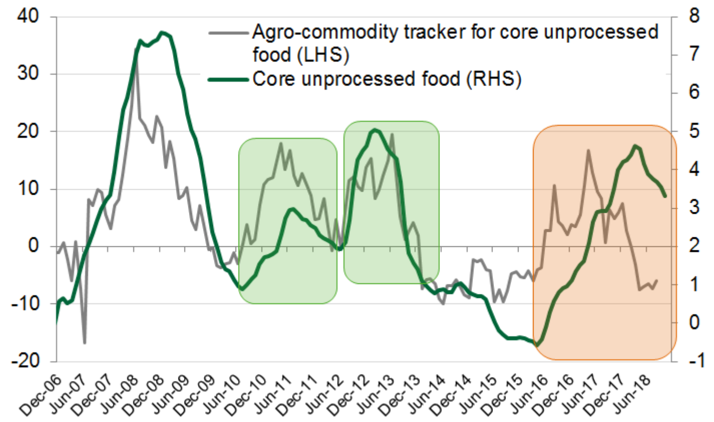
Sources: NIS, OTP Research

Chart 11: Seasonal unprocessed food prices
(YoY%, SA)



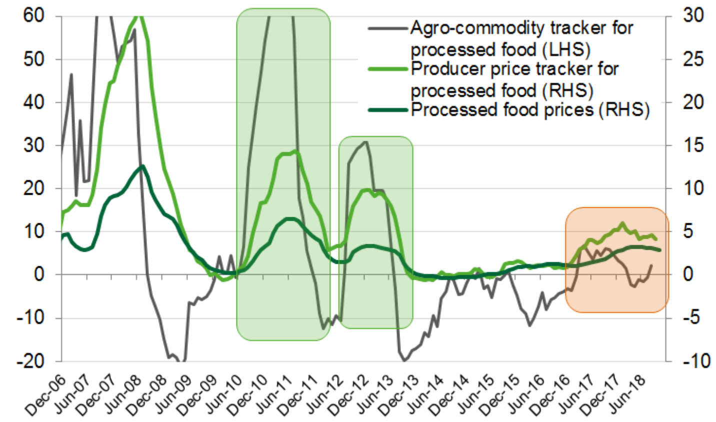
Sources: NIS, OTP Research
Note: seasonal unprocessed foods cover mostly vegetables and fruits; adjusted by the impact of main tax changes

Chart 12: CPI of core unprocessed foods vs. agro-commodity prices (YoY%, SA)



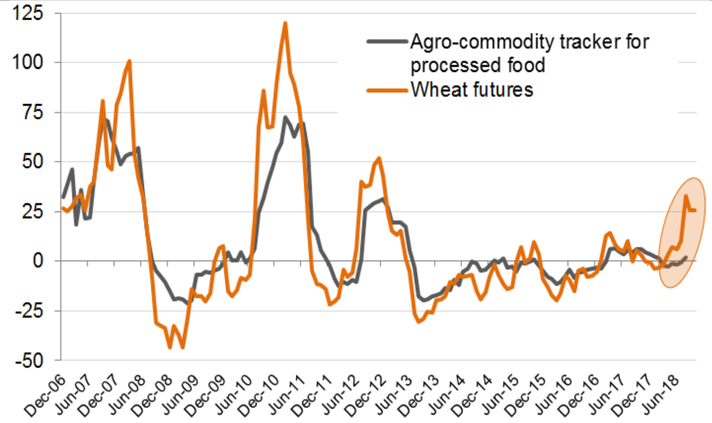
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 13: CPI and PPI of processed foods vs. agro-commodity prices (YoY%, SA)



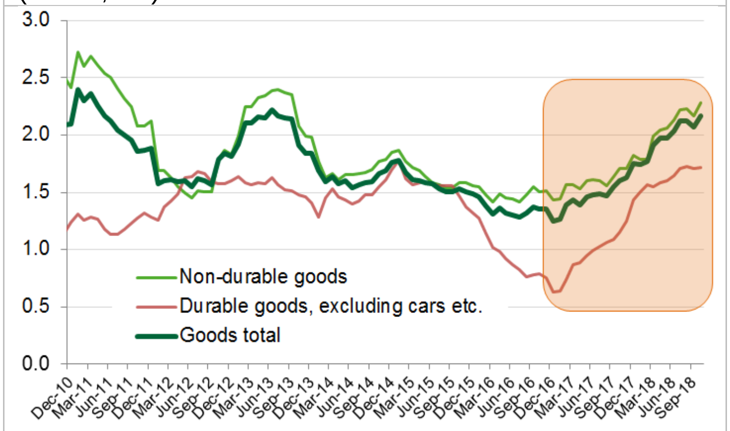
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 14: Agro-commodity prices vs. wheat futures
(YoY%, SA)



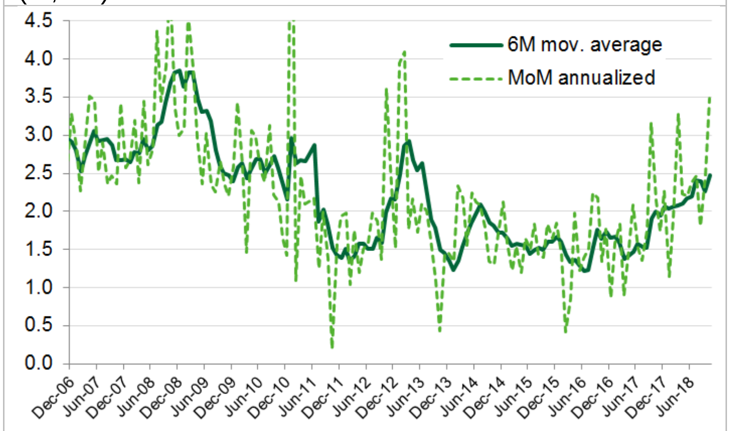
Sources: NIS, Reuters, OTP Research
Note: October data for wheat futures is the average of 1-12 October

Chart 15: Goods' inflation
(YoY%, SA)



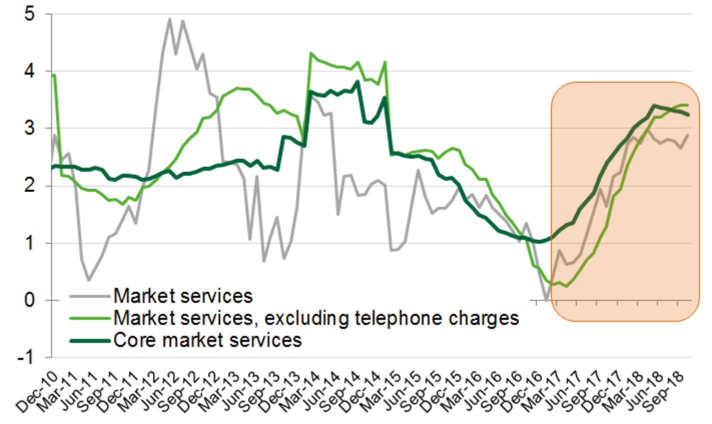
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 16: Non-durable goods
(%, SA)



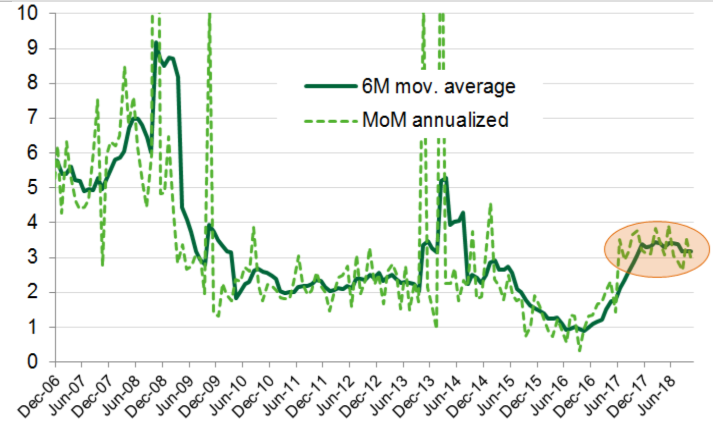
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 17: Market services
(YoY%, SA)



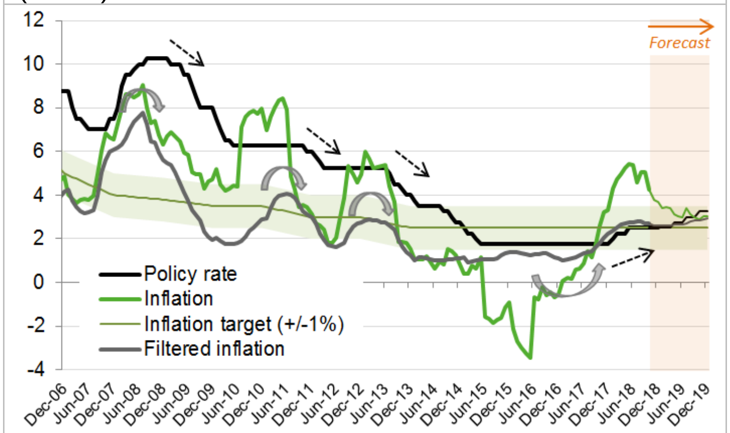
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes; ***Core market services*** *excludes the EUR/RON-related telephone charges as well as insurances*

Chart 18: 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 19: Inflation vs. NBR's inflation target
(YoY%)



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

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