

REPORT ON INFLATION

14 February 2019

Inflation starts 2019 from a slightly higher-than-expected level but may stay in the upper half of the tolerance band; risks tilted to the upside

- In the first month of 2019, the growth rate of consumer prices stood at 3.3% YoY, unchanged compared to December 2018, the NIS' latest report on inflation showed (see Chart 1). January's outturn exceeded the market (Reuters: 3.2%) as well as our expectation (3.1%). It is worth mentioning that excluding the impact of the latest excise duty hikes and other tax changes, headline inflation would have been about 0.3 percentage points lower in January, our in-house estimation showed¹. In month-over-month comparison, the consumer price index climbed 0.8% higher, fuelled also by seasonal effects. Similarly to December, the NBR's preferred Core3 inflation measure (inflation that excludes vegetables, fruit, eggs, fuels and products whose prices are regulated, as well as beverages and tobacco) stood at 2.5% YoY. Simultaneously, our *filtered inflation*² indicator increased marginally, to 2.7% (Chart 3).
- With regard to the broader context, we [recall](#) that headline inflation had broken above the central bank's target (2.5% +/-1%) in 2018, reaching as high as 5.4%, but it re-entered the tolerance band at year-end, helped by fading base effects and lower oil prices. Due to the softening price pressure, the National Bank of Romania adopted a wait-and-see [approach](#), after implementing a series of tightening measures in the period of H2 2017 – H1 2018.
- January's flat headline data mask divergent dynamics among the components of the consumer basket. Unprocessed food prices picked up sharply last month (Chart 5), driven mainly by vegetables and fruits, while tobacco and alcohol product also became more expensive. The significant acceleration in the case of the latter group was fuelled, primarily, by excise duty hikes. Nevertheless, slowing administered price and fuel inflation offset the increases seen elsewhere. Administered inflation eased because of important base effects, while the annual inflation of fuels was helped by lower Brent futures. Our forecast error came from two sources: first, we had expected regulated prices to decelerate more significantly and, second, we underestimated the CPI of unprocessed food. The latter error could be reversed soon, as unprocessed food prices frequently post large swings, while the gap in the case of administered CPI, likely, is permanent. However, this deviation does not change the general outlook.
- In the case of core food inflation indicators, we saw signs pointing to the end of the downward trajectory, which have characterized these groups in the past few quarters. The moderation of core unprocessed food inflation (raw meat, flour, and milk) was hardly felt (Chart 6), while processed food inflation already bottomed out in January (Chart 7). These developments were in line with our expectations. As we had noted several times [earlier](#), the effect of higher wheat prices, coupled with another minimum wage hike in January, are set to increase the production cost of companies in the food industry, implying higher pressure for consumer prices too.
- Non-durable goods' inflation continued to climb higher last month but still remained at a rather modest level, slightly below the 2.5% threshold (Chart 8). High-frequency indicators revealed that January's uptick was chiefly the result of a base effect rather than a very significant acceleration at the end of the analysed period (Chart 9). In January, durables' inflation also rose modestly on the back of more expensive household appliances and furniture (Charts 8 & 10). We think that this pick-up was the result of higher-than-usual re-pricing of goods at the beginning of the year and, to a lesser extent, the weaker leu. Similarly to goods, the inflation of market services rose as well. Nonetheless, when we exclude EUR/RON-sensitive telephone charges, market services' inflation was broadly unchanged (but, undoubtedly, at a quite elevated level; Charts 11 & 12).

¹ We usually filter out extraordinary tax changes, but as excise duty hike at the year-beginning is quite a recurrent event, our charts present January data without filtering out the impact of the tax change

² 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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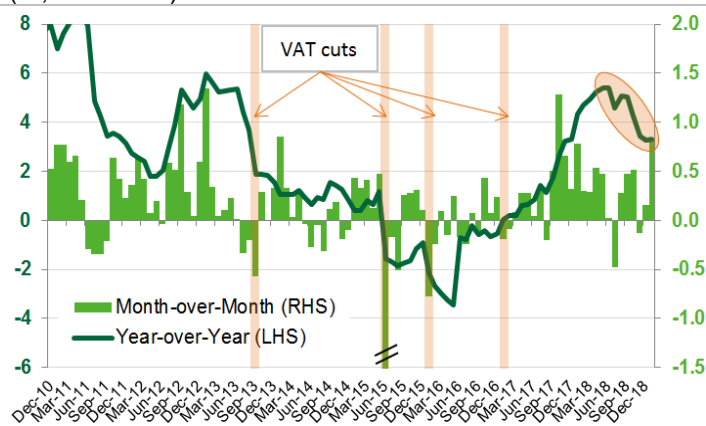
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- All things considered, we think that there is no fundamental change in the outlook. Headline inflation is expected to stay mostly in the upper half of the tolerance band in 2019, ending the year near 3%. Nonetheless, the risks remain high, among others owing to the uncertainties and complex side-effects coming from the government's latest measures (e.g. energy prices are set to be capped starting from this spring, but the technical details are not revealed yet; for further details please see our previous [report](#)). It is also worth mentioning that filtered inflation may rise modestly later this year due to fundamental factors, such as rapidly rising wages and potential secondary effects coming from the weaker leu. With higher underlying inflation, an important domestic or external shock could push headline inflation above the NBR's target range (2.5% +/-1%). Therefore, as we also noted in our Monetary Policy [Commentary](#) last week, the NBR likely will keep the policy rate flat in 2019, but the risks warrant vigilance throughout the year.

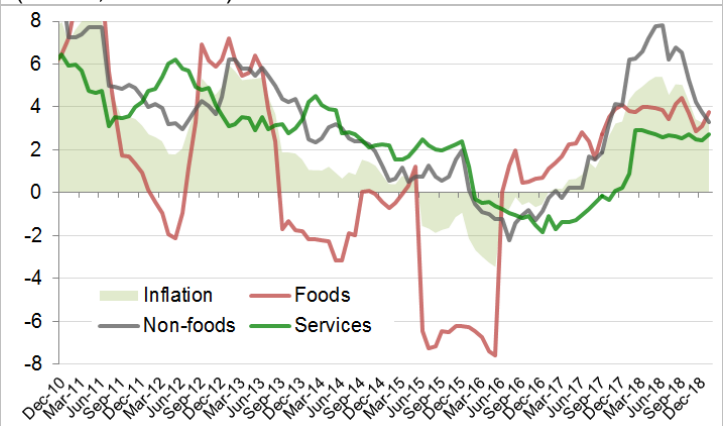
Chart set:

Chart 1: Headline inflation
(%, NSA data)



Sources: NIS, OTP Research

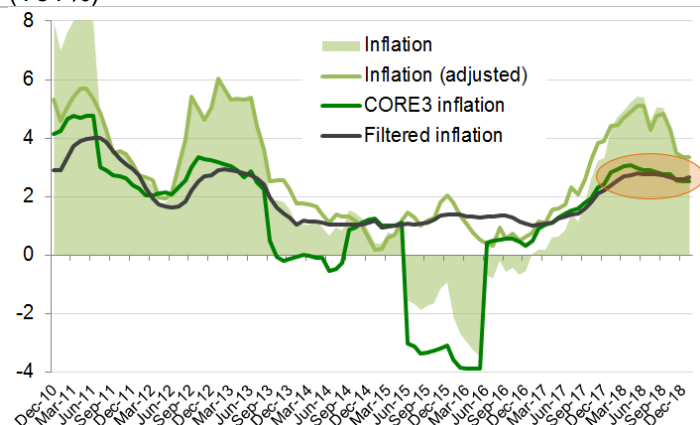
Chart 2: Inflation by its main components
(YoY%, NSA data)



Sources: NIS, OTP Research

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

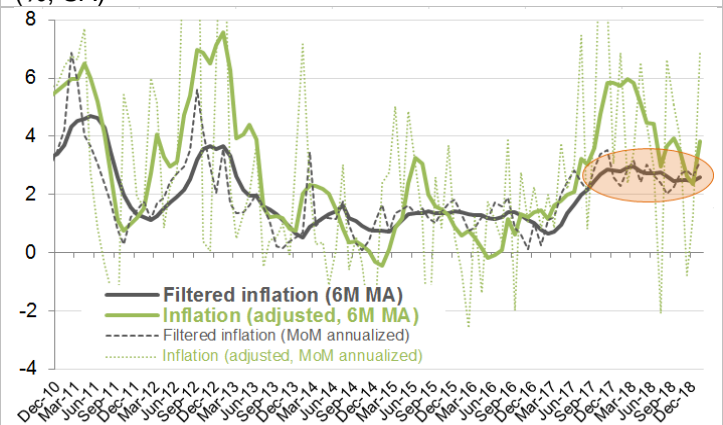
Chart 3: Inflation and underlying processes
(YoY%)



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).

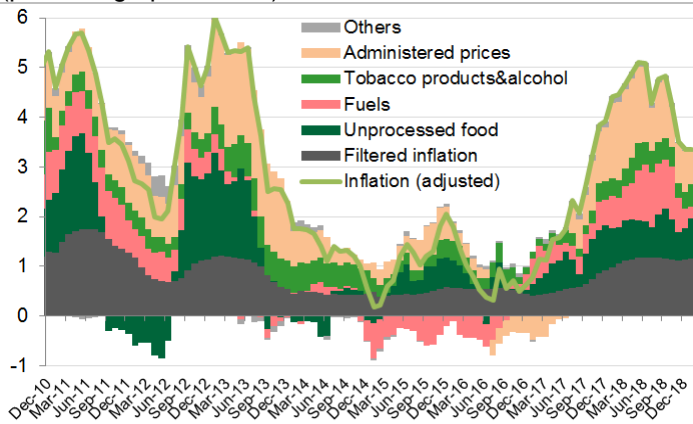
Chart 4: Inflation and filtered inflation
(%, SA)



Sources: NIS, OTP Research

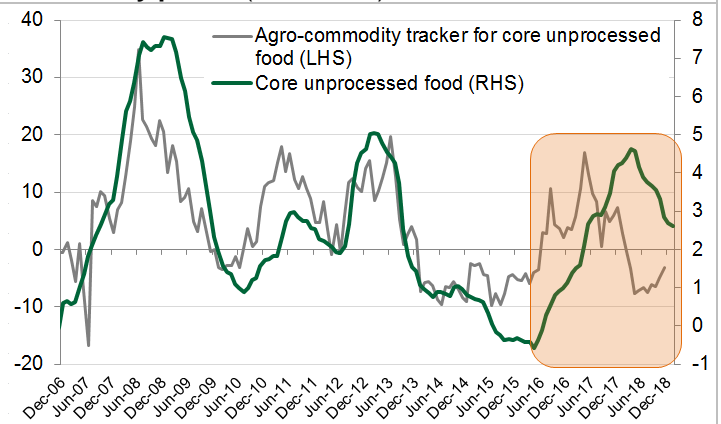
Note: adjusted by the impact of main tax changes; 6M MA = six-month moving average.

Chart 5: Decomposition of inflation
(percentage points, SA)



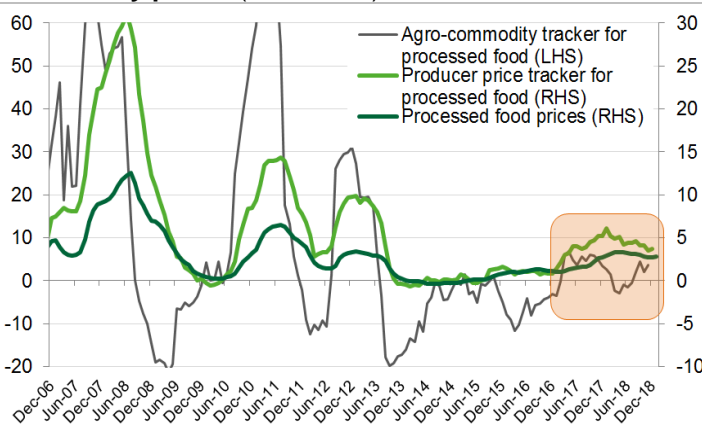
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 6: CPI of core unprocessed foods vs. agro-commodity prices (YoY%, SA)



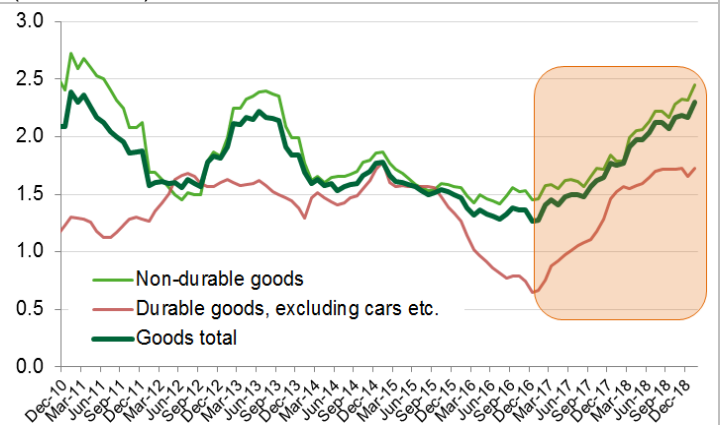
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 7: CPI and PPI of processed foods vs. agro-commodity prices (YoY%, SA)



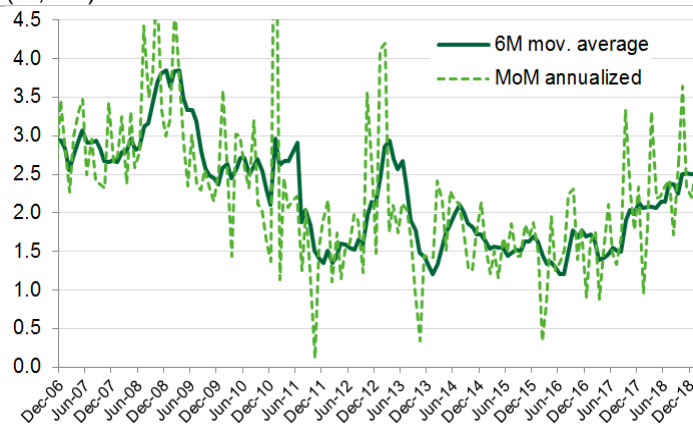
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 8: Goods' inflation (YoY%, SA)



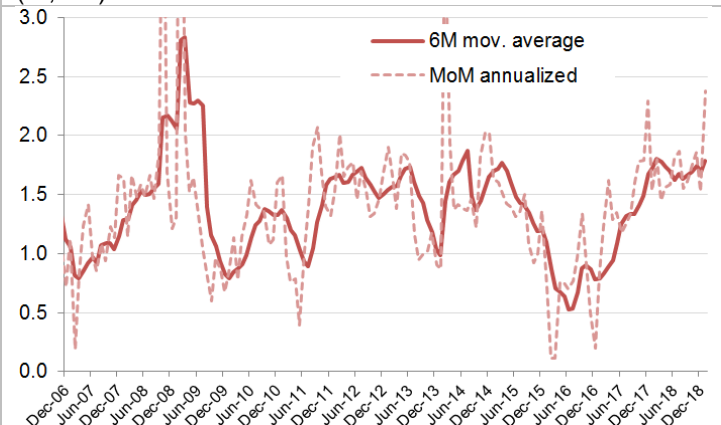
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 9: Non-durable goods (% SA)



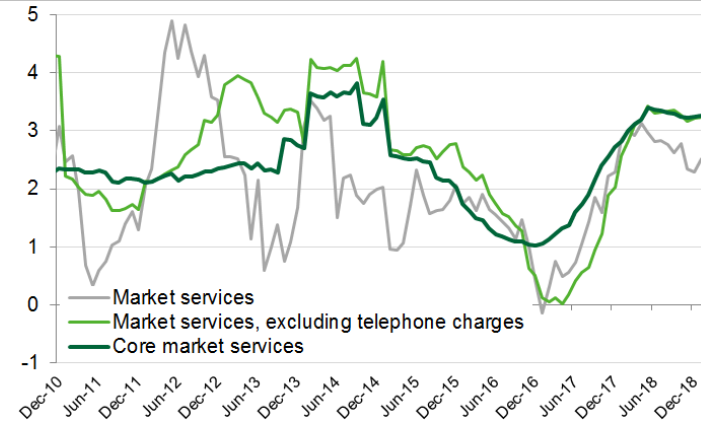
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 10: Durable goods (% SA)



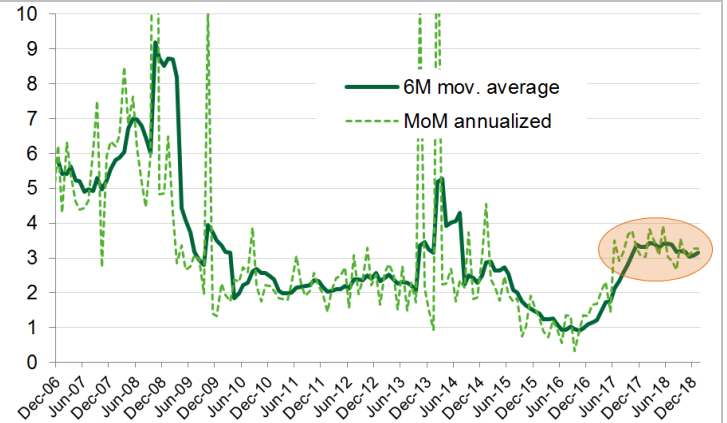
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 11: 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 12: 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.

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