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MONETARY POLICY COMMENTARY

5 July 2018

The NBR held the policy rate unchanged at 2.50%; inflation is under control, central bank governor said

- In July's monetary policy meeting, the NBR kept the key interest rate unchanged at 2.50%. Accordingly, the interest rate on the deposit as well as the lending facility rates remained at 1.50% and 3.50% too. At the same time, the minimum reserve requirement ratio was left at 8%. The outcome of the Board meeting caused a modest surprise as market expectations were split whether the central bank will raise the policy rate for the fourth time this year. The leu weakened slightly after the rate-setting meeting.
- We recall that the NBR has implemented a series of normalisation measures (including the narrowing of the interest rate corridor, base rate hikes and liquidity sterilisation actions) since the middle of last year in order to contain inflation and overheating risks. As a result, interbank lending rates have risen by 260 basis points on average since August 2017.
- In answer to reporters' questions, Mr Isarescu said that the key message of the NBR was that Romania's annual inflation rate would ease in the following period. Referring to last autumn's inflation shock, which was driven mainly by regulated price hikes, the governor added that the bulk of the increases was over and even negative monthly growth rates could come in the summer. It may be worth mentioning that, similarly to the NBR's projection, we expect headline inflation to hover near its latest level (5.4% YoY as of May) in the following few months and as the base effect of earlier hikes starts to fade, it might fall below the 4% threshold at the end of this year. In 2019, the annual CPI growth is expected to stabilize near 3%, inside the tolerance band (2.5% +/- 1%) of the central bank. The NBR's governor also added that the Core3 measure (inflation excluding vegetables, fruits, eggs, fuels, regulated prices, as well as beverages and tobacco prices), the central bank's key underlying CPI indicator softened to 2.95% YoY in May, down from 3.09% YoY a month earlier. This is the first sign that the normalisation actions of the NBR had results.
- Explaining the background of the policy decision, Mr Isarescu said that the NBR cannot be disconnected from what other central banks do, underscoring that the NBR's peers did not touch the policy rate despite the sizeable depreciation pressure on the CEE region's currencies. The central bank chief also reiterated that real interest rates in Europe are staying in negative territory. Meanwhile, monetary policy in Romania is tighter than the benchmark interest rate would suggest, as ROBOR rates stood in the upper half of the corridor. Given this context, the NBR's rate decision was correct and appropriate, Mr Isarescu said.
- Regarding the long-term outlook, the governor reminded of the end of the ultra-low interest rate era in the world. Referring to Mr Peter Praet, the chief economist of the ECB who recently visited in Bucharest, Isarescu said that it was too early to ponder when positive real interest rates would re-appear in Europe. In Romania, consumer price inflation and the policy rate should meet down the road and the NBR expects this to happen at a low level, the governor hinted (but without providing a timeline).
- The liquidity squeeze, which drove interbank lending rates close to the lending facility rate (see Chart 1), could be temporary, depending also on the seasonal variation of government budget spending, Mr Isarescu mentioned. Nonetheless, the governor refused to comment on questions about the impact of potential NBR interventions on the FX market. We think there are several convincing signs that the central bank stepped in the market in order to alleviate the depreciation pressure on the leu. Tighter liquidity conditions are a natural consequence of such operations.

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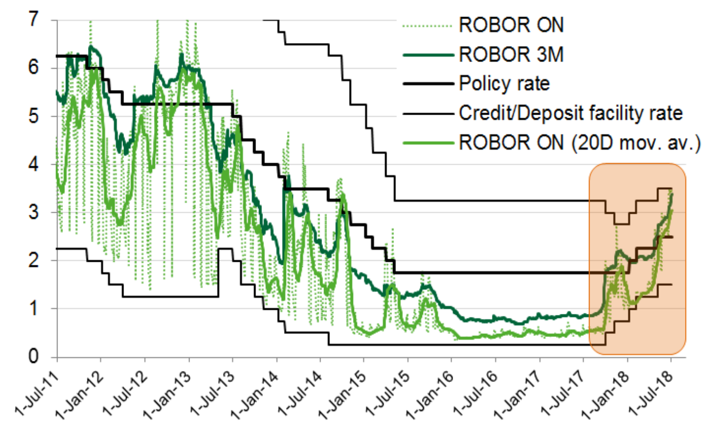
- Summing it up, we think that the NBR's decision to hold fire in July is like a stopover on the road. Indeed, headline inflation is expected to ease remarkably in the following quarters, but as underlying price pressures are set to remain strong owing to the tight labour market and higher import prices, as well as the era of ultra-low interest rates seemingly is over on the external front, Romania's central bank is likely to continue the normalisation cycle. Therefore, we maintain our previous view, expecting the policy rate to end this year at 2.75% and reach 3.25% in 2019. We reiterate too that stronger-than-expected inflation outturns, more-aggressive-than-previously-thought tightening measures elsewhere in Europe and the USA, may urge the NBR to speed up the normalisation cycle. Accordingly, interbank lending rates are set to increase over the medium term, but correction periods could appear too, when liquidity conditions improve (e.g. supported by year-end government spending) and the weakening pressure on the leu softens.

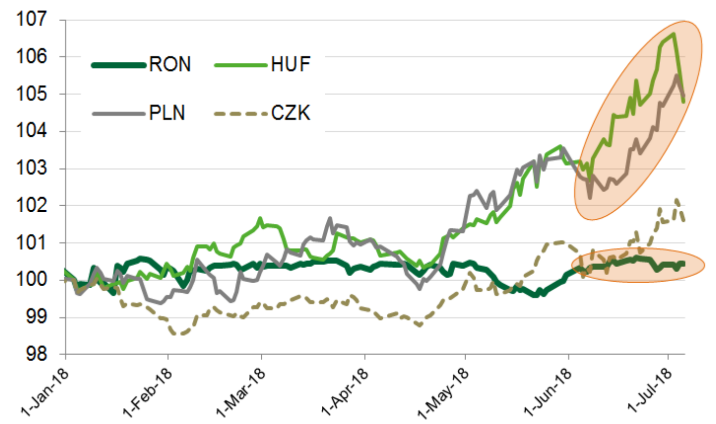
Chart set:

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



Sources: NBR, OTP Research

Chart 2: Performance of the CEE region's currencies vs. EUR (1 January 2018 = 100)



Sources: NBR, Reuters, OTP Research

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