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MONETARY POLICY COMMENTARY

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As inflation reached its peak, the NBR remained on hold, surprising the market

- The Board of Romania's central bank left the policy rate at 2.50% for the second time in a row. Simultaneously, the interest rate on the deposit (1.50%) and the credit facility (3.50%) was left unchanged too, while the minimum reserve requirement ratio remained at 8% for both leu- and foreign currency-denominated liabilities. The result of the policy meeting caused surprise, as the market consensus (Reuters' poll) had expected a quarter-percentage-point rate hike. The NBR's Board also analysed and approved the August 2018 Inflation Report. The updated forecast reaffirmed that the annual inflation rate would decrease meaningfully in the final months of 2018, towards the upper bound of the tolerance band (3.5%-1.5%). On a longer time horizon, the projection was slightly revised downwards, the central bank's press release also said. The details of the new report will be revealed via a press conference on Wednesday. We note that May's Inflation report expected headline inflation to finish 2018 at 3.6% and to slow to 3% by the end of next year.
- On the back of the policy decision as well as owing to a repo operation of the NBR, which provided RON 10.5 bn extra liquidity to the market, interbank rates started to ease. The ROBOR 3M, the key benchmark for loans with variable interest rates, fell to 3.36% this morning. On Friday, it stood at 3.47%. Meanwhile, Romania's leu softened around 0.5% in comparison to the euro, to 4.64.
- Regarding the big picture, we recall that in order to curb inflationary pressures and to avoid a further escalation of overheating fears, Romania's central bank had implemented a series of normalisation measures (including the narrowing of the interest rate corridor, base rate hikes and liquidity sterilisation actions). As a result, ROBOR rates have surged by around 260 basis points on average since August 2017, much more than the evolution of the policy rate would have suggested (in the analysed period, the NBR lifted the policy rate in three equal steps, from 1.75% to 2.50%; see Chart 1). However, the turning point in inflation dynamics, which started to take shape most recently, provided a relief for central bankers. We interpret yesterday's repo operation of the NBR as an additional sign of confidence regarding the inflation outlook.
- At the post-meeting press conference Mr Isarescu pointed out that on a month-over-month basis consumer prices might have fallen in July, contributing to softening of the annual inflation rate, which peaked at 5.4% YoY. The prospect of swiftly easing headline inflation was probably the key reason for the NBR's decision to keep rates on hold. The central bank's governor also hinted that the benchmark interest rate may not rise much higher. *'I cannot say at present that the board has mandated me to say that we have won the war, but a battle was won as it is clear inflation is starting to come down. There are indeed chances that the interest rate will not rise too much'*, Mr Isarescu said. Nevertheless, uncertainties are set to prevail, particularly in light of the normalisation process that can be observed at the global level: *'we are not in a position to say that we will not hike the rate anymore. We do not know what is happening in Europe and what the word normalisation means'*, Mr Isarescu added. The governor also reiterated that the NBR's peers in Poland and Hungary had not raised interest rates, and that the appreciation of the leu on a higher interest rate gap would be undesirable, as it might lead to a further widening of the current account deficit.
- In line with the NBR, we also believe that Romania's headline inflation is likely to ease, as several base effects drop out, while policy tightening is another important factor in containing inflation risks. It is important to add that the effect of earlier normalisation actions was has not yet fully transmitted into the interest rates of clients, as the re-pricing of outstanding loans and deposits takes place with a sizeable time lag (Chart 2). It is worth mentioning as well that even though ex-post real interest rates remain deep in negative territory (headline inflation reached 5.4% in June, exceeding by a wide margin ROBOR rates), on a forward-looking basis, real interest rates are broadly neutral (if headline inflation really stabilises near the 3% threshold in 2019, matching our base scenario).

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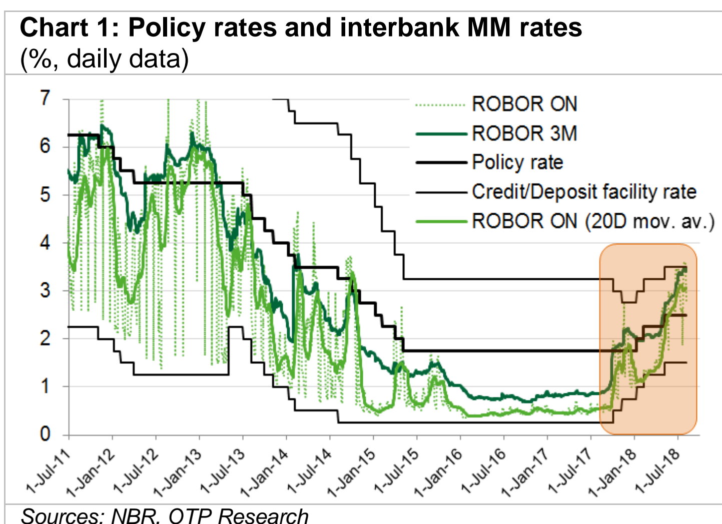
- Nevertheless, we think that underlying inflationary pressures will remain non-negligible. Owing to the unusually tight labour market, average wages are expected to soar in the following quarters too, fuelling both demand-pull and cost-push inflationary pressures. Imported price growth could be robust as well on the back of the spill-over effects coming from the global reflationary process. The policy normalisation cycle in the USA and in Europe is another motivation to raise interest rates. Significantly, with rising twin-deficits Romania seems to be more vulnerable to shocks than many of its peers in the CEE region (for further details on this subject please visit our Government Deficit and Balance of Payments reports). In addition, a new risk has also appeared on the horizon, as agro-commodity futures skyrocketed due to recent damage to grain crop across Europe. This could reignite food price growth in the coming quarters. As the sharp rebound of agro-commodity prices is quite a new development, we assume that the new forecast of the NBR's staff did not yet incorporate it.
- In all, we think that the sharpest ROBOR hikes could be over, and even corrections are starting to seem quite likely, as liquidity conditions have started to improve. Nonetheless, we think that, owing to the prospect of robust underlying price pressures, the war is not over yet. Therefore we maintain our expectation that the policy rate could end this year at 2.75% and reach 3.25% in 2019.

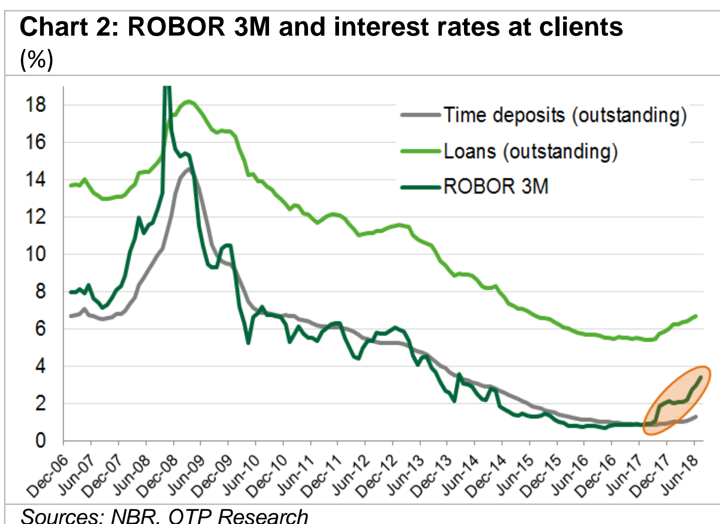
Chart set:

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



Sources: NBR, OTP Research

Chart 2: ROBOR 3M and interest rates at clients
(%)



Sources: NBR, OTP Research

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