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MONETARY POLICY COMMENTARY

8 February 2019

The policy rate may remain flat in 2019; but risks are likely to keep NBR vigilant throughout the year

- On the second rate-setting meeting of the year, the National Bank of Romania kept the key rate at 2.50%. The decision was in line with the market's as well as our expectation. The central bank's Board also approved the February 2019 Inflation Report. The new projection reconfirmed that consumer price inflation is set to stay inside the NBR's tolerance band, the post-meeting press release revealed. The details of the new report will be presented in a press conference next week.
- With regard to the broader picture, we recall that Romania's headline inflation had broken above the NBR's target (2.5% +/- 1%) in 2018, reaching as high as 5.4%, but it re-entered the tolerance band at year-end, owing to fading base effects and lower oil prices. With softening inflation pressure, the NBR adopted a wait-and-see approach, after implementing a series of tightening measures in the period of H2 2017 – H1 2018.
- Answering the questions of journalists, Mr Isarescu rejected suggestions that ROBOR rates should be recalculated or scrapped. This came after government officials expressed hopes to reach a radical change in how ROBOR is calculated. Regarding the leu's depreciation in January, Mr Isarescu said the move was rather small, and broadly in line with the country's fundamentals, but he did not deny FX interventions. The NBR's governor remained critical of the government's latest measures, including the new tax on bank assets.
- We recall that the government linked the new bank levy to the evolution of 3M and 6M ROBOR on a progressive basis. The tax rate starts from 0%, if ROBOR rates stay below the 2% threshold, but may reach as high as 0.5%, if ROBOR exceeds 4%. Moreover, the levy would be paid fully on quarterly basis. This means that, under current ROBOR levels, the tax rate may reach 1.2% in 2019. This is well above the long-term average of banks' ROA (Chart 1). Among others, the levy came as Romanian banks apply wide interest rate margins, government officials had suggested. Compared to the EU average, indeed, interest margins tended to be high in Romania, but were broadly in line with that of other countries with lower development and bank penetration ratios (Chart 2; it is far beyond the scope of our monetary policy commentary to judge how well these margins cover the country-specific risks associated with Romania).
- As regards the monetary policy outlook, we think that the National Bank of Romania has several reasons to keep the benchmark rates unchanged in the following period. First, the external environment has changed. With slowing growth in several key economies of the world, unfavourable financial developments, modest inflation pressure and the risk of another federal government shutdown, the Fed signalled that the tightening cycle could end sooner than expected. In addition, the January meeting of the ECB adopted a more cautious tone, pointing to downside risks to eurozone growth outlook. Simultaneously, in the CEE region, Poland's central bank suggested that it may keep the policy rate unchanged in 2019 and possibly even in 2020. In the Czech Republic, core inflation pressures warrant hikes, but uncertainties around the eurozone economy may make the CNB more cautious than previously thought. In Hungary, the MNB is expected to launch data-driven interest rate normalisation due to picking up core inflation. Nevertheless, the normalisation would start from a very loose policy stance and it may be postponed or stopped at any time, depending on external conditions.

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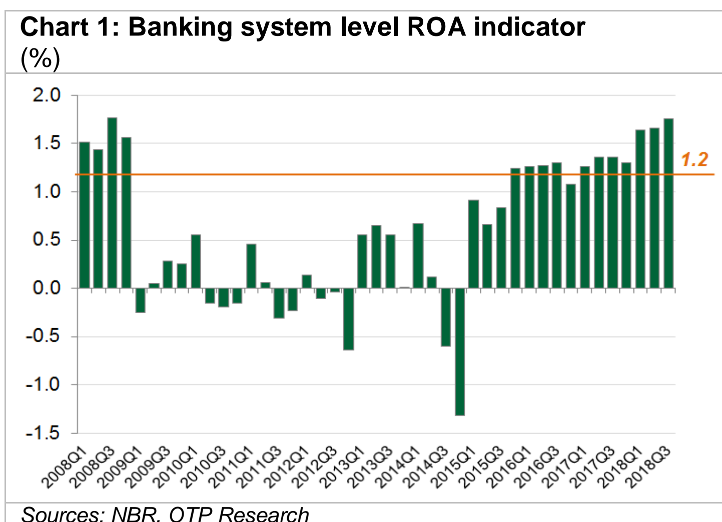
- We recall that Romania's central bank reiterated frequently that it pays special attention to what other central banks do, and that it cannot be pulled out from the regional context.
- On the domestic front, it is important to note that consumer price inflation is expected to stay inside the NBR's tolerance band in 2019 (we project headline inflation to end this year near 3%; for further details please see our latest Inflation Report). Meanwhile, interbank interest rates are staying above the 3% threshold, translating into slightly positive real rates. In addition, the stricter lending conditions introduced from 1 January, and more importantly, the worries about the new tax on banks' assets is expected to limit lending growth and may raise interest rates applied on household and company credit. The actual formula used for the calculation of the bank sector tax may also trigger some issues with regard to financial stability, if ROBOR sharply rose. These factors support the NBR's wait-and-see stance.
- To summarise, we think that the domestic and global contexts do not urge the central bank to raise the policy rate rapidly. The current level of the benchmark rates, together with prudent liquidity management, could be enough to make the job in 2019. Nonetheless, over the medium term a modest increase of the policy rate still may be needed to keep inflation well anchored to the target. There are also a plenty of risks surrounding the outlook. Rapid wage growth (for 2019, we expect around 10% increase in average net wages) will continue to fuel unit labour costs and household consumption. Pro-cyclical and unorthodox fiscal policies as well as the relatively high and widening current account deficit signal a build-up of vulnerabilities. Therefore, the NBR has to be particularly vigilant.

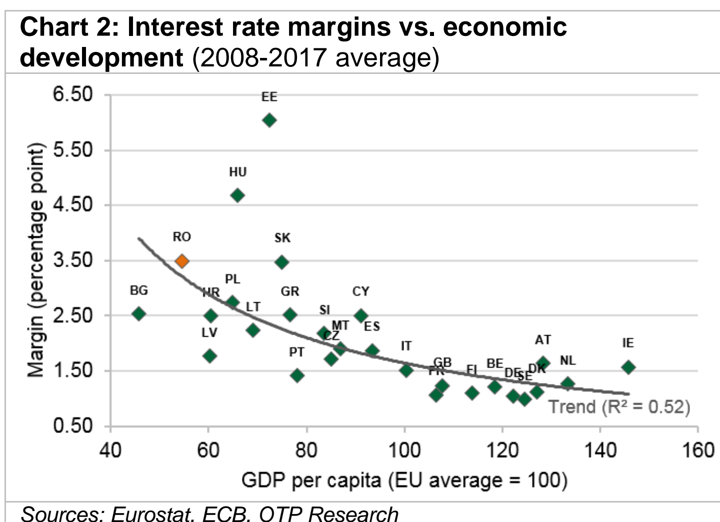
Chart set:

Chart 1: Banking system level ROA indicator (%)



Sources: NBR, OTP Research

Chart 2: Interest rate margins vs. economic development (2008-2017 average)



Sources: Eurostat, ECB, OTP Research

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