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REPORT ON INFLATION

13 June 2018

Inflation might flatten in the months ahead and soften at the end of this year owing to base effects; Given the tight labour market and the global reflationary process, inflation risks are expected to prevail in 2019 too

- Consumer price inflation in Romania hit another multi-year high, reaching 5.4% YoY in May, up from 5.2% a month earlier (Chart 1), after the impact of firmer leu and a favourable base effect in the case of administered prices were more than offset by rallying crude oil and higher tobacco prices. In MoM comparison, the CPI index rose by 0.5%, propelled also by seasonal effects in the case of volatile food prices. May's outturn exceeded the market consensus (5.2%, according to a Reuters survey) and was a bit higher than our call (5.3%). Core3 inflation, the central bank's key underlying CPI indicator, stood at 3.0% YoY, down from 3.1% YoY in the previous month, helped by the appreciation of the leu (Chart 3). Our *filtered inflation*[1] measure, which is less sensitive to the exchange rate, climbed a touch higher, to 2.8%.
- Regarding the big picture, we recall that inflation in Romania showed a particularly strong and broad-based revival, frequently surprising on the upside, after the base effect of tax cuts started to fade, administered and fuel prices rebounded, underlying cost-push and demand-pull inflation factors appeared. Meanwhile, overheating fears also rose, among others owing to pro-cyclical fiscal policy. Beside the domestic developments, the risk of higher-than-expected inflation outturns at global level could also fuel Romanian core measures to rise steadily in the quarters ahead. Given this context, the National Bank of Romania launched the monetary policy normalization process earlier than most of its peers.
- Our 0.1 pp forecast error came from two sources. Tobacco and cigarette prices increased by 1.3% MoM, slightly stronger than we had expected, on the back of a quite strong second-round effect of April's excise duty hike. We note that May's 1.3% growth came on the top of the 2.4% MoM advance a month earlier. In annual terms, the CPI of tobacco and cigarette surged 9.1%, but it is expected to soften a bit as some base effects drop out later this year (Chart 10). We had also pencilled in a sharper fall in telephone charges, as authorities set lower tariffs on interconnection services. However, the effect of this modification was subdued.
- As expected, the fuel price index was the key driver of May's acceleration (Charts 9 & 11). It is important to point out the strong rally of crude futures on international markets in the past few quarters, supported by both production constraints (such as the extension of the OPEC agreement to limit output, unplanned outages in Venezuela and the USA) as well as increased demand owing to the global economic recovery. Most recently, the tensions between Iran and the USA also contributed to the higher crude prices. On the other hand, vanishing base effects in administered prices (in May 2017, electric energy tariffs were raised by 1.1%) alleviated the pressures.
- Seasonal unprocessed food prices picked up, getting a boost from particularly volatile vegetable and potatoes CPI. Nevertheless, this upswing was more than offset by non-seasonal foods, after eggs inflation moderated further as the negative spill-over effect of the fipronil scandal continued to vane and core unprocessed food inflation (an aggregate indicator tracking raw meat, milk, and flour) eased too as agro-commodity-related costs were milder (Chart 12).
- Simultaneously, processed foods CPI, which has the heaviest weight in our filtered inflation indicator, was a bit higher than we had expected but still provided evidence of stabilisation. We note that domestic agro-commodity and producer prices signal softening cost pressures (Chart 13), which bodes well for the short-term outlook. Nonetheless, wheat futures on global markets picked up most recently and the prognosis for this year's crop yields in Romania is less favourable than in 2017. This, coupled with swiftly rising labour costs, suggests that a sizeable fall in processed food inflation is unlikely.

[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.*

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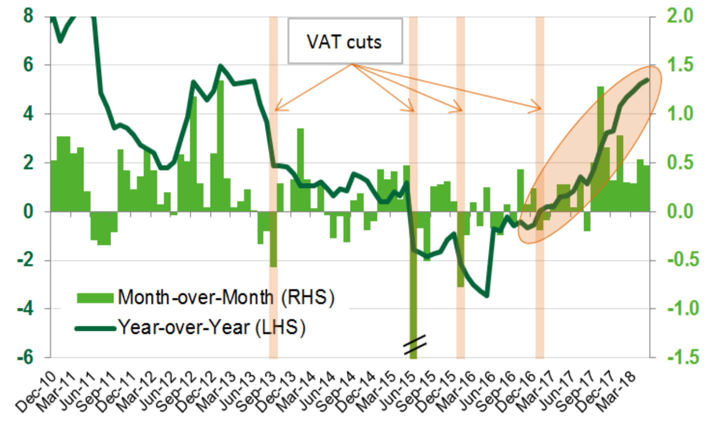
- Goods' inflation slipped a bit (less than 0.1 pp) in May, as the appreciation of the leu provided a relief (Chart 14). However, excluding exchange-rate-sensitive items (primarily the CPI of passenger cars, which could have been influenced also by the diesel scandal) the pace of the annual price growth was practically unchanged. Meanwhile, high-frequency indicators also showed that the stabilisation process continued (Chart 15).
- CPI growth in the case of market services decreased modestly but, similarly to goods, this was again the result of the stronger leu (Chart 16). Excluding telephone bills, market services' inflation marched even higher. In our previous report, we noted that high-frequency indicators for services took a break, stabilizing above 3%. Nevertheless, May's picture is more ambiguous, with the indicator registering an uptick. It cannot be excluded that a re-acceleration process has started to take shape (Chart 17). It is important to mention that services is the most labour-intensive and demand-sensitive group in the consumer basket, therefore, it reflects more accurately the underlying pressures coming from the particularly tight labour market.
- Summing it up, we think that headline inflation will stay near the current level in the following few months and it could ease to 3.6% YoY at the end of this year, as important base effects will drop out. Regarding outlook for 2019, we expect that Romania's annual inflation may stabilize near 3%, but despite this moderation of the headline data, underlying price pressures are expected to remain strong. We continue to expect that the policy rate will be raised to 2.75% this year and 3.25% next. Nonetheless, it is important to add that given the tight labour market (Chart 18 & 19) as well as the signs of the reflationary process at global level, the risks are tilted to the upside.

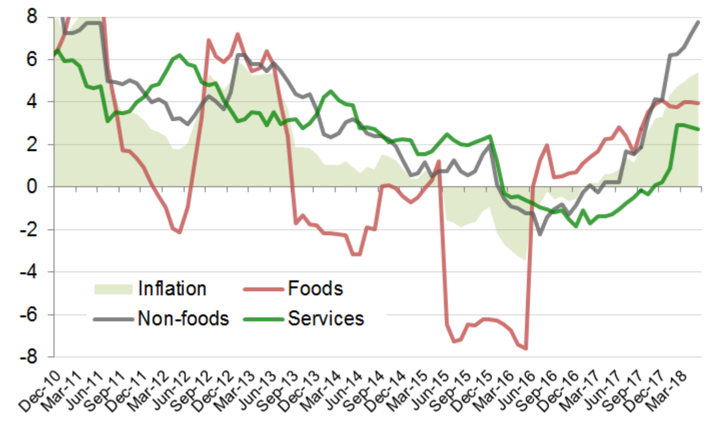
Chart set:

Chart 1: Headline inflation
(%, NSA data)



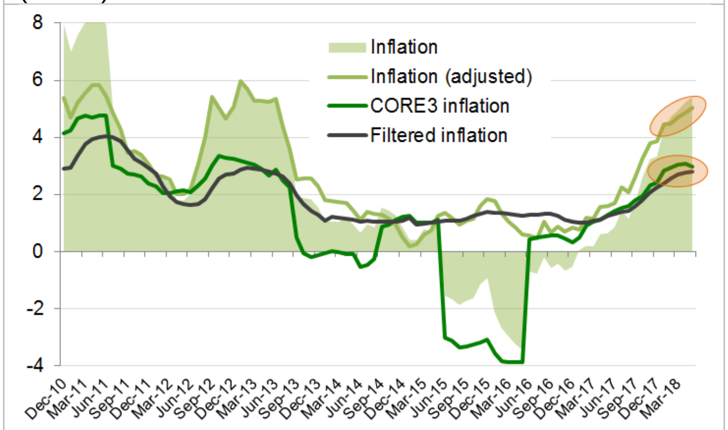
Sources: NIS, OTP Research

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



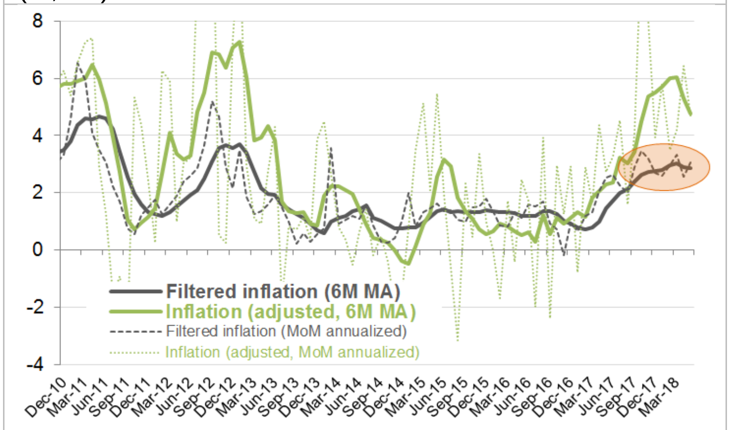
Sources: NIS, OTP Research
Note: in line with the National Institute of Statistics' (NIS) general segmentation.

Chart 3: Inflation and underlying processes
(YoY%)



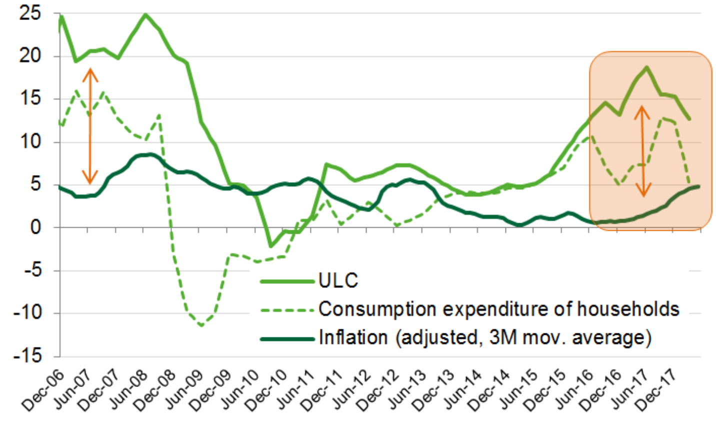
Sources: NIS, OTP Research
*Note: **CORE3** = inflation excluding VFE (vegetables, fruits, eggs), fuels, regulated as well as beverages and tobacco prices; **Filtered inflation** = in-house underlying inflationary measure (SA).*

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



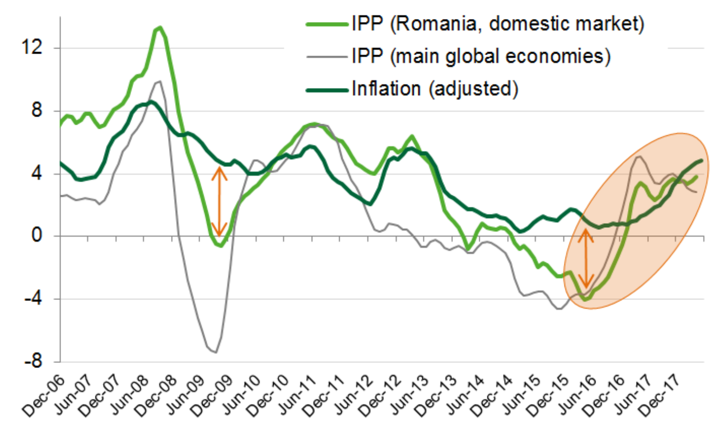
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes; 6M MA = six-month moving average.

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



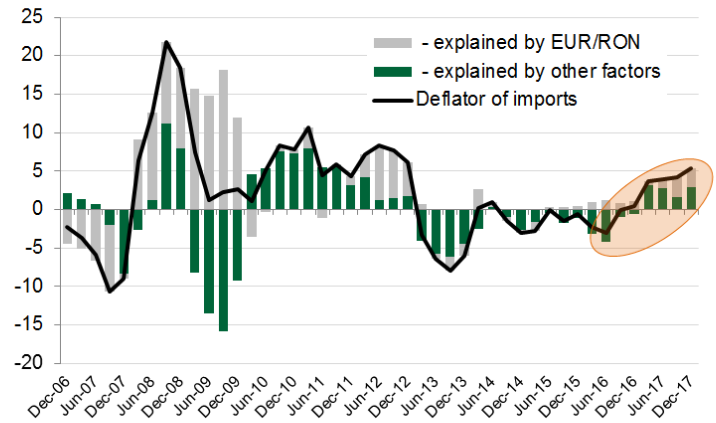
Sources: Eurostat, NIS, OTP Research
Note: adjusted by the impact of main tax changes.

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



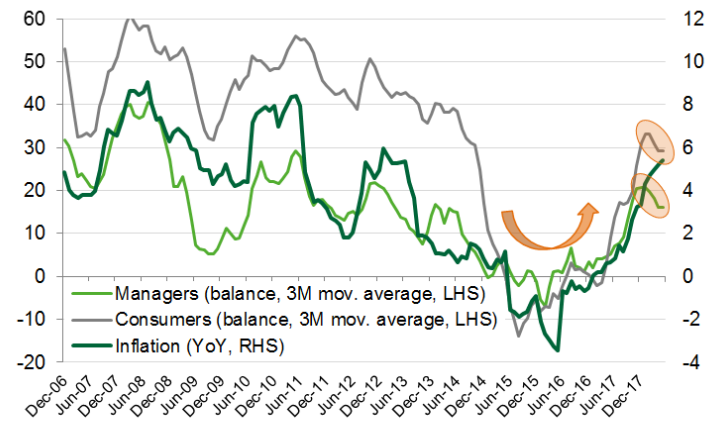
Sources: NIS, OECD, NBSC, OTP Research
Note: adjusted by the impact of main tax changes; the IPP (main global economies) includes data from EU28, USA and China

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



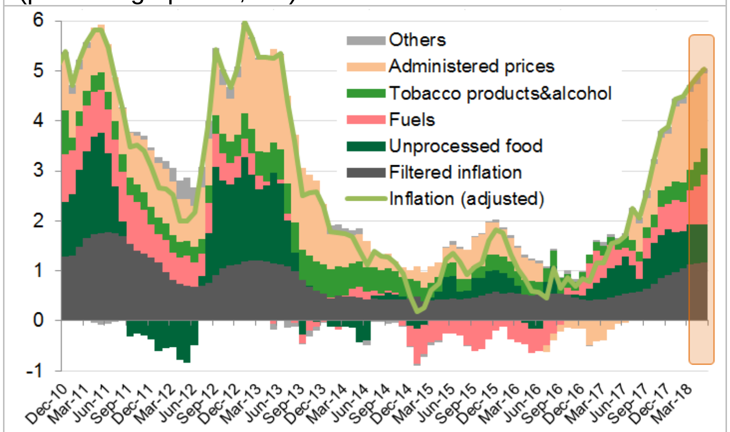
Sources: NBR, NIS, OTP Research

Chart 8: Price expectations vs. inflation
(%)



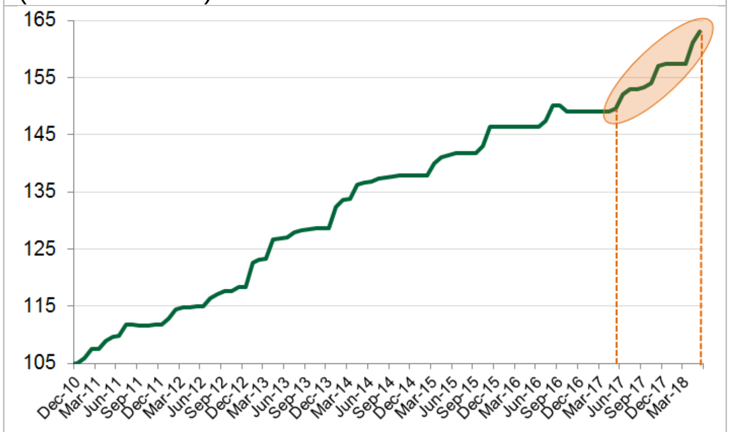
Sources: EC, NIS, OTP Research

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



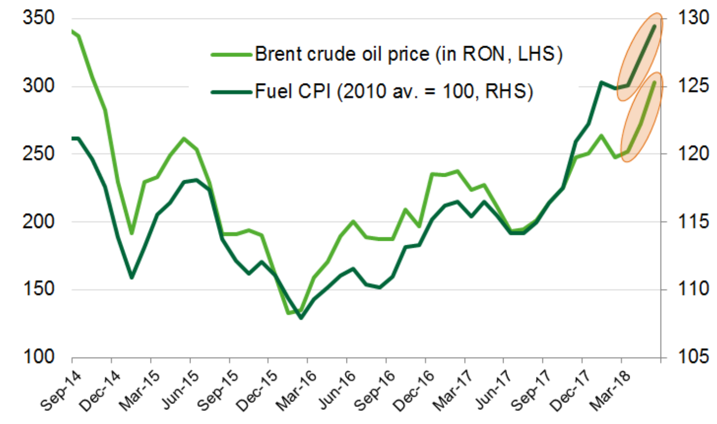
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 10: CPI of tobacco and cigarettes
(2010 av. = 100)



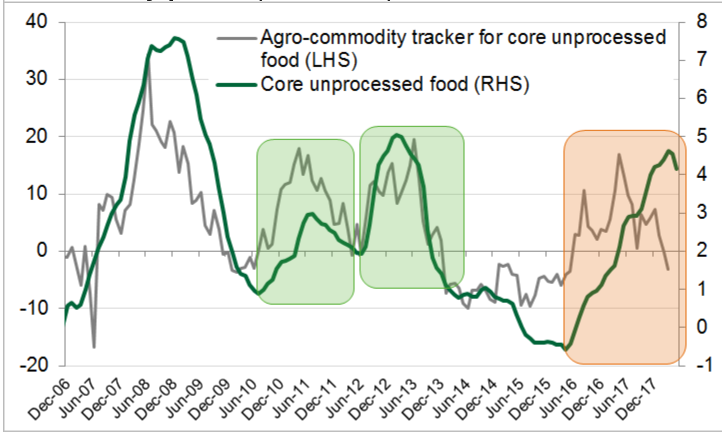
Sources: NIS, OTP Research

Chart 11: CPI of fuels vs. Brent oil prices



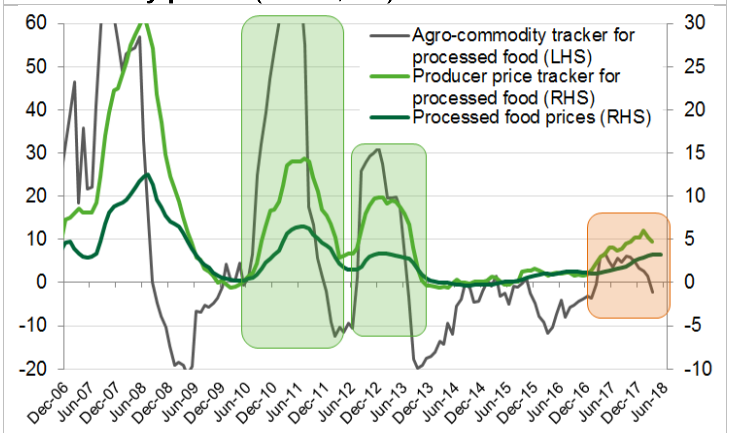
Sources: NIS, Reuters, OTP Research
Note: Fuel CPI is adjusted by the impact of main tax changes.

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



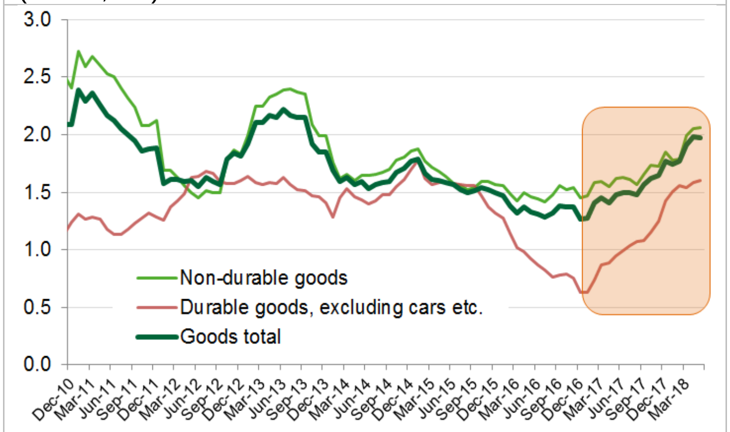
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

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



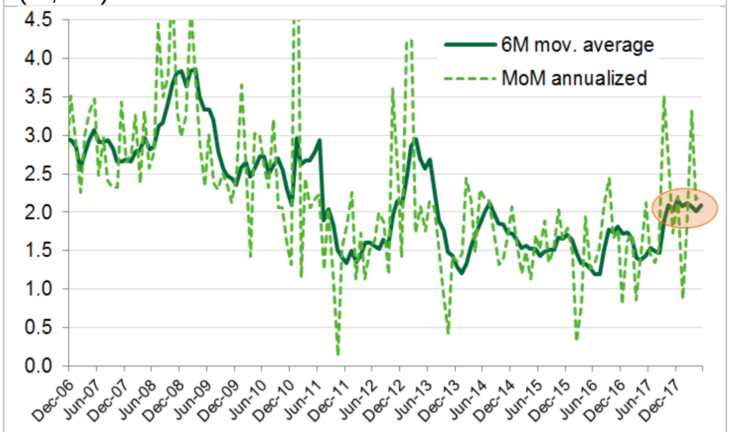
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 14: Goods' inflation
(YoY%, SA)



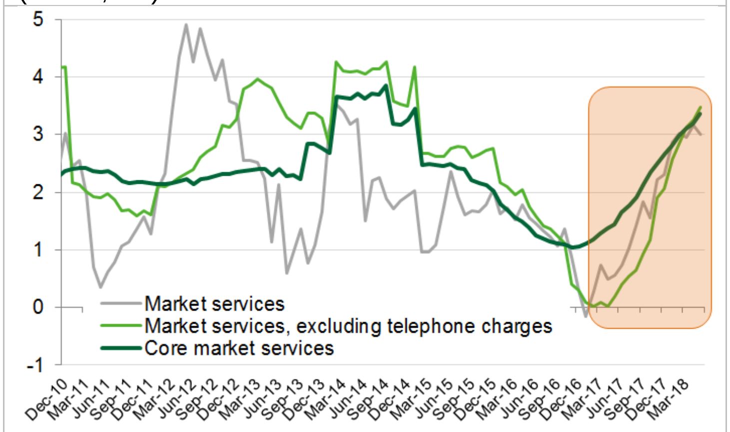
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 15: Non-durable goods
(%, SA)



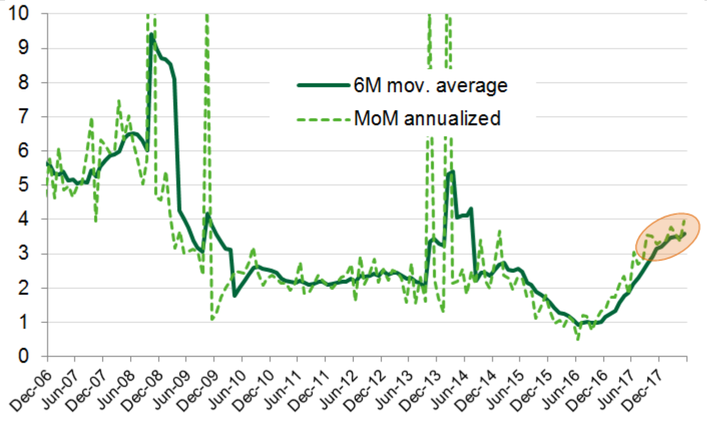
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 16: Market services
(YoY%, SA)



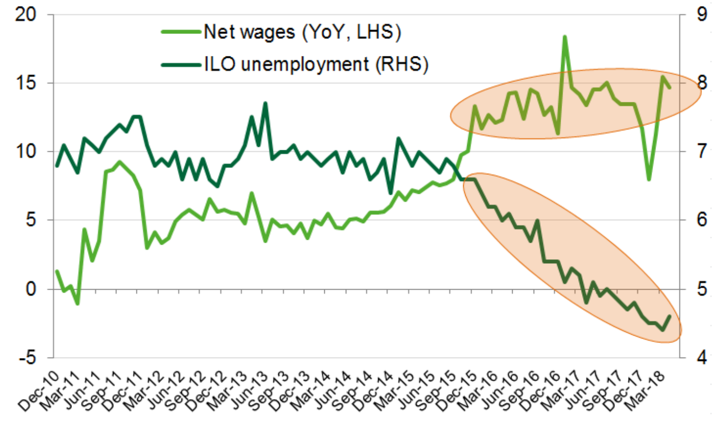
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes; ***Core market services****, excludes the EUR/RON-related telephone charges as well as insurances*

Chart 17: Core market services
(%, SA)



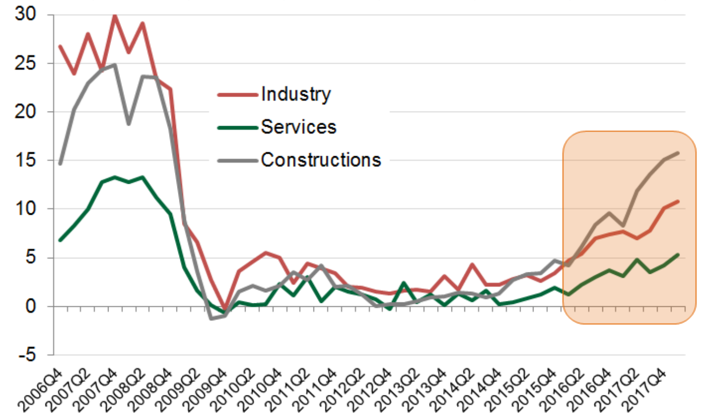
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes; ***Core market services*** *excludes the EUR/RON-related telephone charges as well as insurances.*

Chart 18: Labour market indicators
(%)



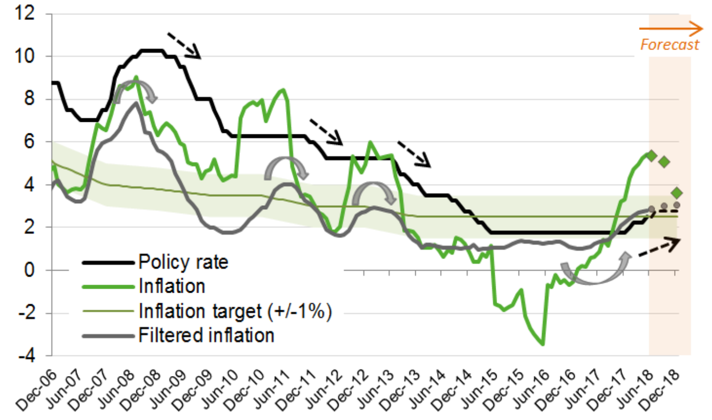
Sources: NIS, OTP Research

Chart 19: Shortage of labour force as a limiting factor of production (by sectors, balance of opinions)



Sources: EC, OTP Research

Chart 20: Inflation vs. NBR's inflation target
(YoY%)



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

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