otp Research

REPORT ON INFLATION

13 July 2018

In June, a turning point started to take shape, providing some relief for inflation fears

- After registering sharp jumps earlier this year, Romania's consumer price inflation remained unchanged at 5.4% YoY in June (see Chart 1), as the rise in fuel prices was broadly offset by slower tobacco and unprocessed food inflation. The data matched our expectation and it was 0.1 percentage point below the market consensus (5.5% according to a Reuters survey). In month-over-month comparison, the CPI index was practically flat. Another good news is that last month our in-house *filtered inflation*[1] indicator remained at 2.8% YoY, while on MoM basis it provided further evidence of stabilisation (Charts 3 & 4). Moreover, Core3 inflation, the NBR's key underlying measure (which excludes vegetables, fruits, eggs, fuels, regulated as well as beverages and tobacco prices) fell to 2.9% YoY, from 3.0% YoY a month earlier (Chart 3).
- Regarding the broader context, we note that headline inflation climbed to multi-year record highs in the past few months, propelled mainly by regulated price hikes, rallying crude oil, the weaker leu and other one-off effects (Chart 9). On top of these, underlying demand-pull and cost-push inflation factors appeared as well (Charts 5 to 8). In response to the changing domestic and also to the external environment, Romania's central bank launched the policy normalisation cycle in the second half of 2017, which led to a sharp increase in borrowing costs. Nonetheless, we see good chance that the worst is over as headline inflation is expected to mark an inflection point in summer months, while underlying CPI indicators also flattened, helped by the central bank's efforts too. These developments are set to alleviate inflation fears. On the other hand, we underscore that underlying price pressures are expected to remain sizeable owing to the tight labour market and the changing context on the external front. Therefore, further cautious normalisation steps should come in the quarters ahead.
- In June, fuel inflation registered around 1.1 percentage point contribution to the annual CPI growth (when including last autumn's excise duty hikes, the impact is even higher, at 1.4 pps), as Brent oil prices rallied (Chart 10). Our key assumption is that crude prices will approach 70 USD/barrel soon and will stick to that level, which would translate into a significant deceleration of fuel inflation starting from August 2018. Last month's increase in fuel inflation was partially offset by a statistical base effect in the case of tobacco and cigarettes (Chart 11). At the same time, administered prices were little changed. It is worth mentioning that excluding administered and fuel prices, annual inflation would have stood at 3.5%.
- Unprocessed food inflation eased as the effect of more expensive vegetables was outweighed by slower growth in egg and core unprocessed food (raw meat, flour, and milk) prices. In the case of eggs, the fresh statistics confirmed that the shock caused by the fipronil scandal continued to fade, while core unprocessed foods softened broadly in line with their agro-commodity tracker (Chart 12). Simultaneously, processed food inflation was broadly flat as producer cost pressures moderated somewhat (Chart 13). We think that processed food price growth may remain relatively stable in the following few months, but it is important to add that crop yield estimations for this year are well below the records seen in 2017. Therefore, agro-commodity prices may rise on the domestic market soon, with potential spill-over effects later on food inflation.
- In annual comparison, goods' CPI growth pace inched higher, continuing the upward trajectory observed in the past few quarters (Chart 14). Simultaneously, durable goods inflation accelerated as well. On the other hand, high-frequency indicators provided signs of flattening slightly above the 2% threshold (Chart 15).
- After rallying for several quarters, core market services inflation stopped rising in June (Chart 16), while high-frequency data also pointed to stabilisation, but indeed, at an elevated level (near 3.5%, see Chart 17). This break surprised us and it may give ground for modest optimism, but any far-reaching conclusion should be pondered cautiously because of the strong job market.

[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.*

Treasury Sales Team
+40 372 31 85 88
sales.treasury@otpbank.ro

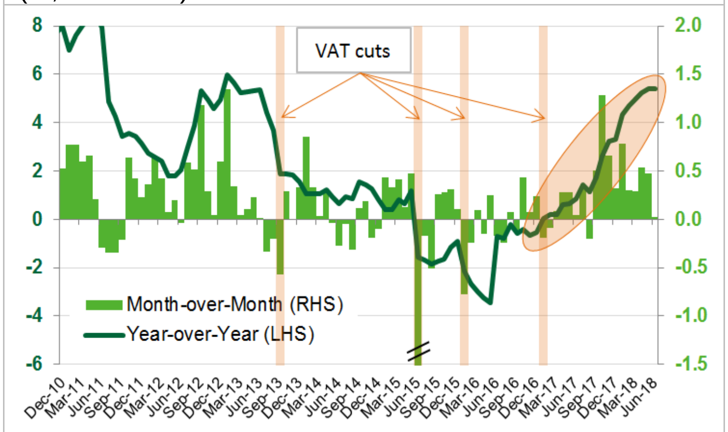
Chief Economist
Gergely Tardos
+36 1 374 7273
tardosg@otpbank.hu

Analyst
Csaba Bálint
+4021 307 58 96
csaba.balint@otpbank.ro

- In all, we reiterate that most likely headline inflation will mark an inflection point in the following months, while June's stabilisation signs in the case of core CPI measures are also encouraging for the outlook. Given this context, we maintain our year-end inflation forecast of 3.6% and we also expect that CPI growth may moderate near 3% in 2019. Nevertheless, it is important to add that the risks are tilted to the upside, as labour shortage will continue to drive wages (Charts 18 & 19), while recovering consumer prices on the external front could have spill-over effects as well. Therefore, the normalisation cycle may continue in the quarters ahead, with the NBR implementing cautious tightening steps. We see the policy rate to end this year at 2.75% and increase to 3.25% in 2019.

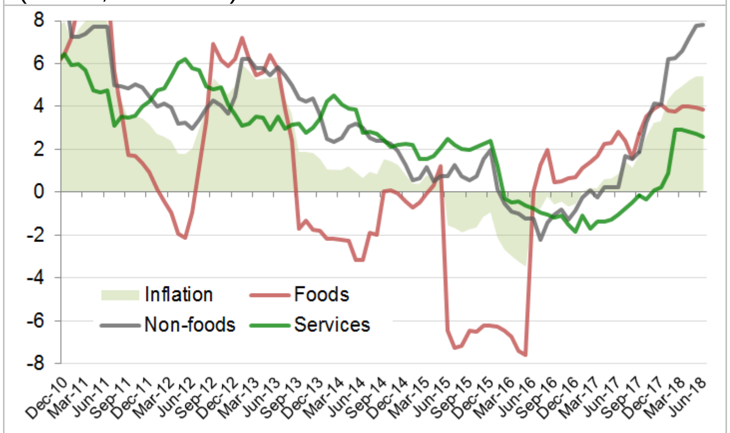
Chart set:

Chart 1: Headline inflation
(%, NSA data)



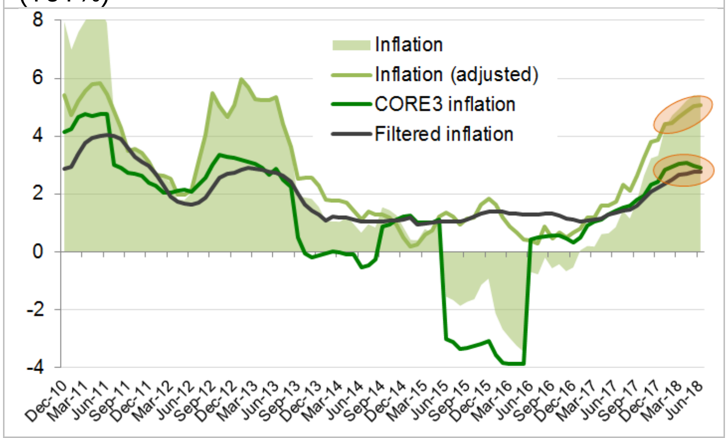
Sources: NIS, OTP Research

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



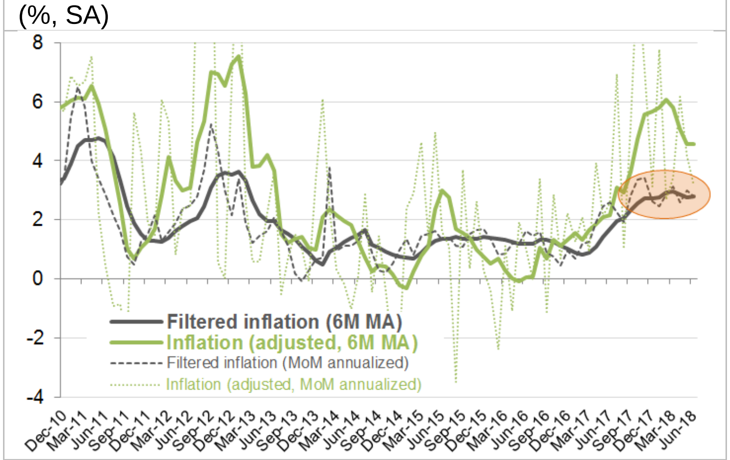
Sources: NIS, OTP Research
Note: in line with the National Institute of Statistics' (NIS) general segmentation.

Chart 3: Inflation and underlying processes
(YoY%)



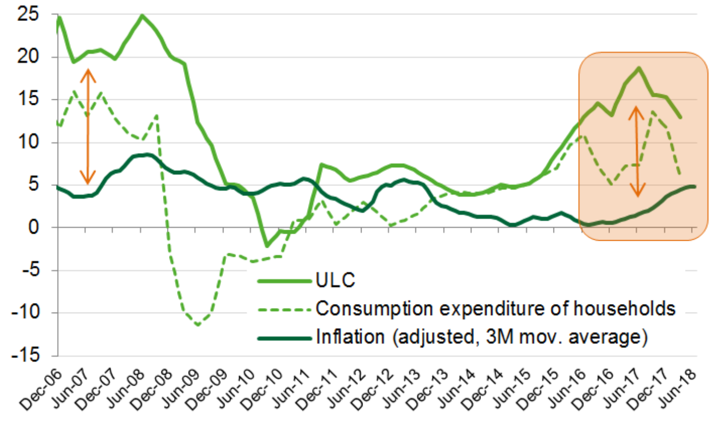
Sources: NIS, OTP Research
*Note: **CORE3** = inflation excluding VFE (vegetables, fruits, eggs), fuels, regulated as well as beverages and tobacco prices; **Filtered inflation** = in-house underlying inflationary measure (SA).*

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



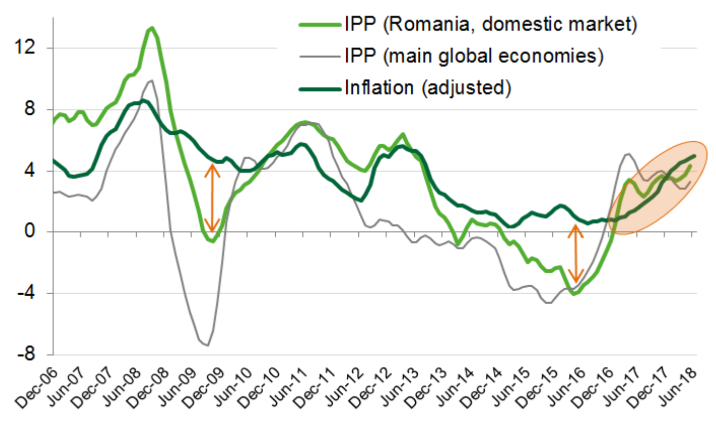
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes; 6M MA = six-month moving average.

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



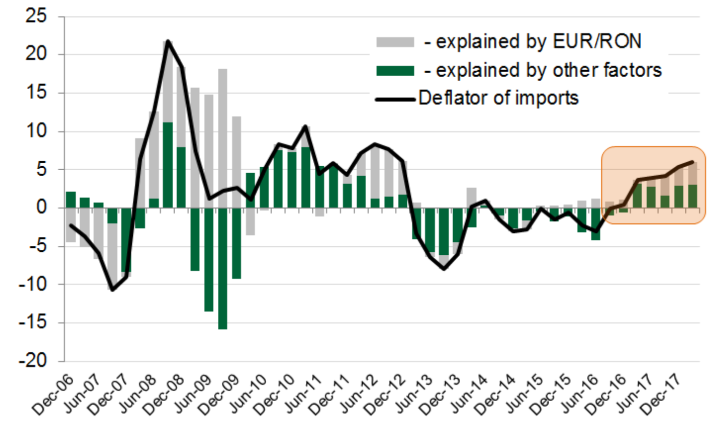
Sources: Eurostat, NIS, OTP Research
Note: adjusted by the impact of main tax changes.

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



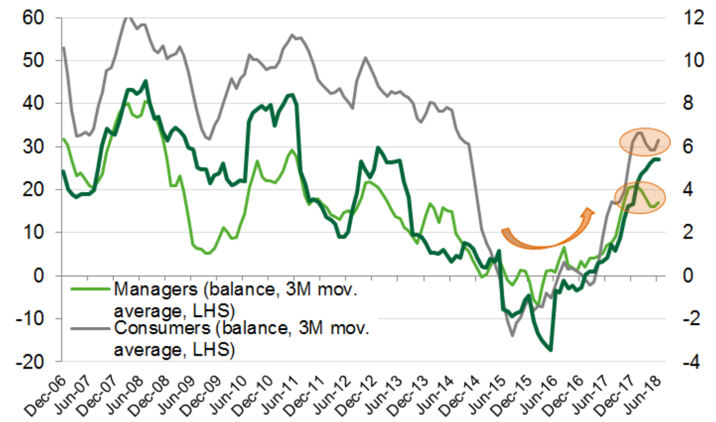
Sources: NIS, OECD, NBSC, OTP Research
Note: adjusted by the impact of main tax changes; the IPP (main global economies) includes data from EU28, USA and China

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



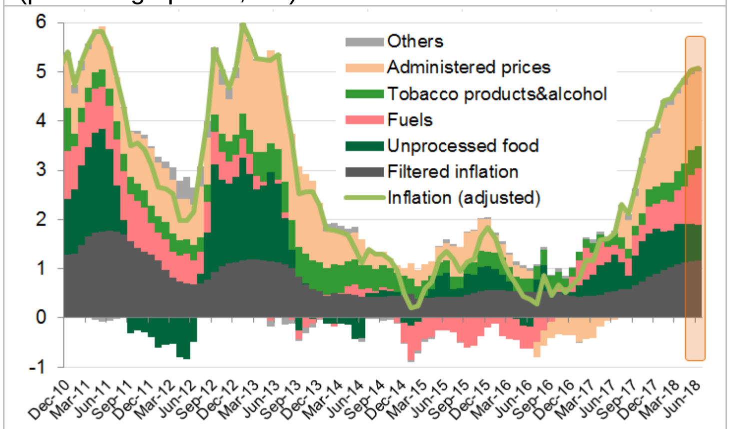
Sources: NBR, NIS, OTP Research

Chart 8: Price expectations vs. inflation (%)



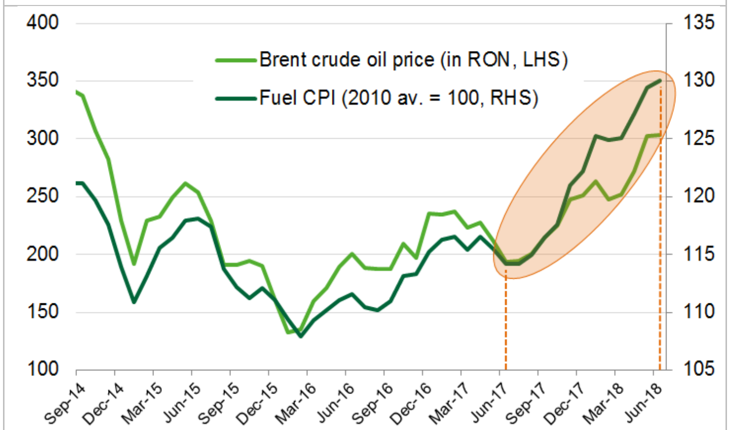
Sources: EC, NIS, OTP Research

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



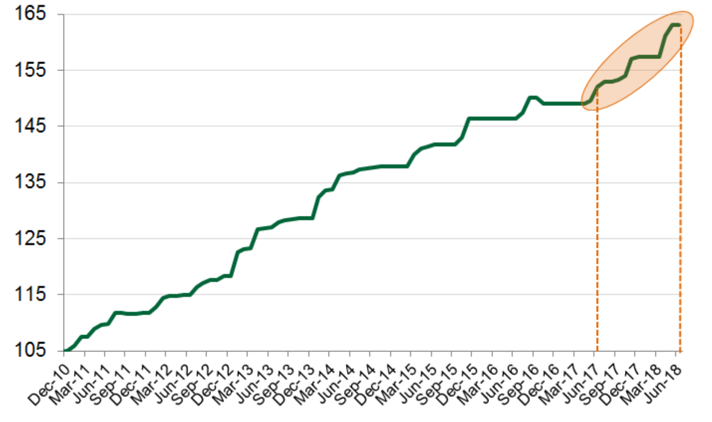
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 10: CPI of fuels vs. Brent oil prices



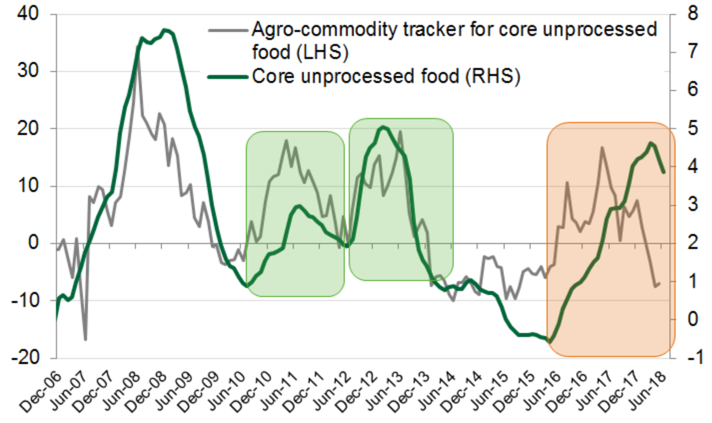
Sources: NIS, Reuters, OTP Research
Note: Fuel CPI is adjusted by the impact of main tax changes.

Chart 11: CPI of tobacco and cigarettes
(2010 av. = 100)



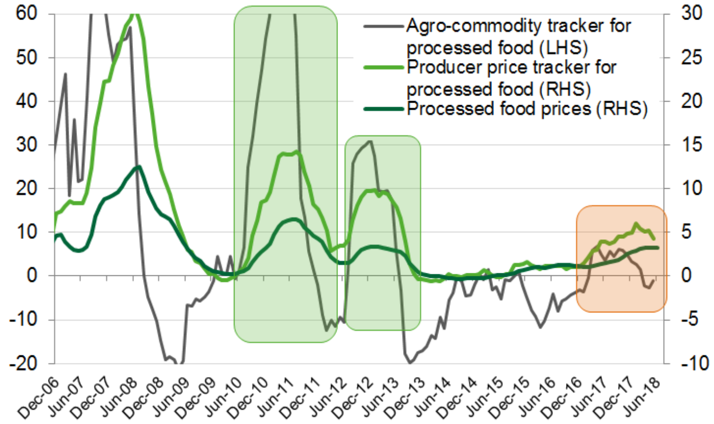
Sources: NIS, OTP Research

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



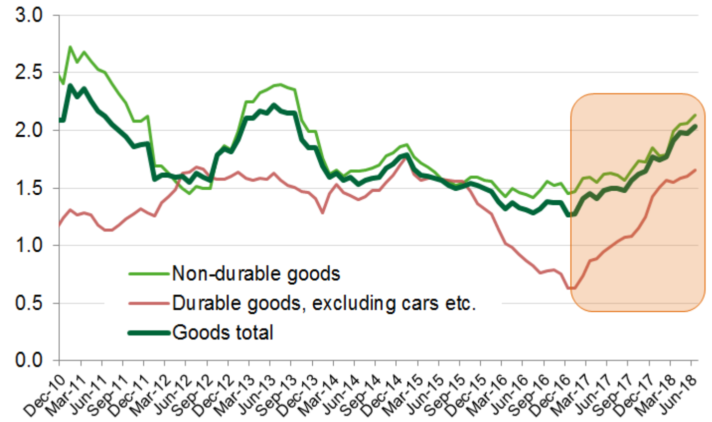
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

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



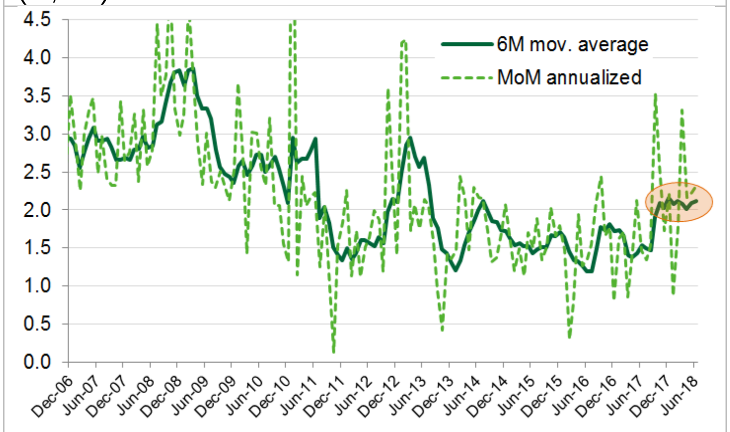
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

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



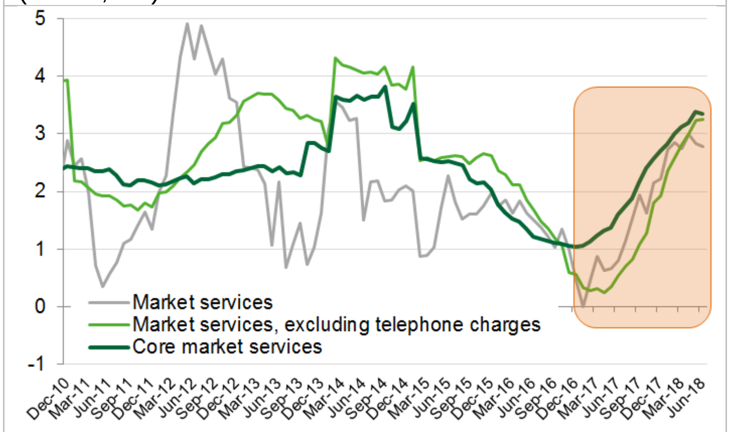
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

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



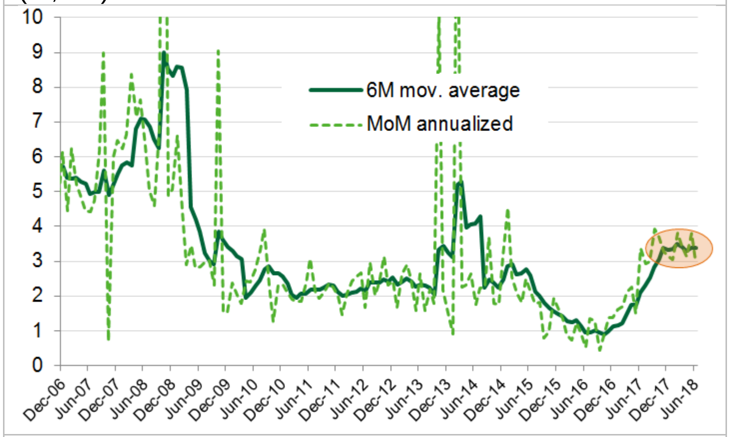
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 16: Market services
(YoY%, SA)



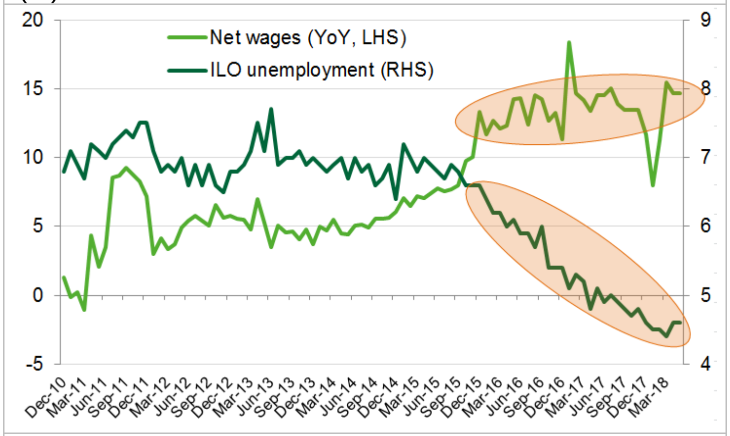
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes; ***Core market services****, excludes the EUR/RON-related telephone charges as well as insurances*

Chart 17: Core market services
(%, SA)



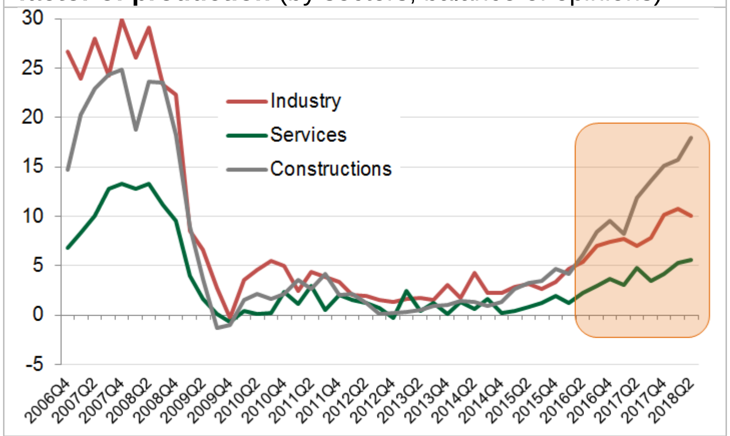
Sources: NIS, OTP Research
*Note: adjusted by the impact of main tax changes; **Core market services** excludes the EUR/RON-related telephone charges as well as insurances.*

Chart 18: Labour market indicators
(%)



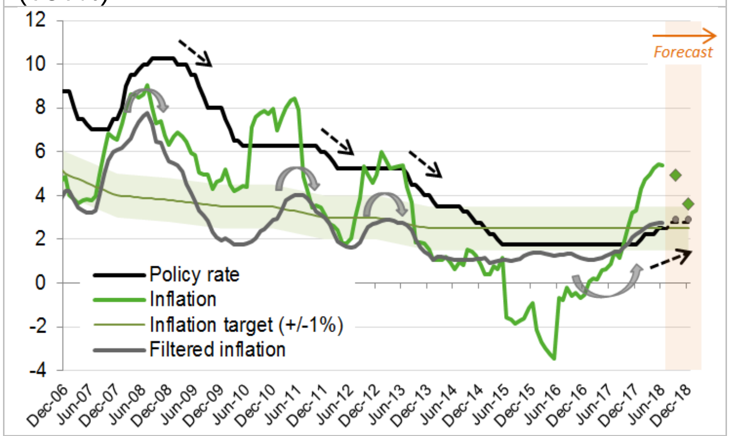
Sources: NIS, OTP Research

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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