

REPORT ON INFLATION

13 August 2018

Headline inflation fell more than expected in July; Damaged crops across Europe present a new risk

- In July, Romania's consumer price inflation slowed to 4.6% YoY, after remaining at a multi-year record high of 5.4% YoY in June and May (see Chart 1). July's gauge surprised on the downside, as the market had expected 4.85/5.15 (Reuter/Bloomberg) price growth. The data also undershot our below-consensus estimate (4.8%). The sharp deceleration came mainly from administered prices, owing to an electricity price cut on top of fading base effects. To a lesser extent, the slowdown in unprocessed food inflation also helped the headline rate drop. In month-over-month comparison, the CPI index decreased by almost 0.5%. The fresh statistics also revealed that underlying price dynamics were stable in July, with Core3 inflation, the NBR's preferred measure, remaining at 2.9% YoY (Chart 3), while our *filtered inflation*¹ indicator was unchanged too (2.8% YoY).
- We [reiterate](#) that consumer prices marked a particularly sharp rebound in the past few quarters (Chart 1), supported mainly by regulated price hikes, rallying crude oil prices, the weaker leu and other one-off effects (Chart 9). In addition, underlying demand-pull and cost-push inflation factors appeared as well (Charts 5 to 8). On the back of the changing environment, the NBR launched the policy normalisation cycle earlier than most of its peers, which led to swiftly rising borrowing costs. Nonetheless, as headline inflation reached a turning point recently, the central bank also took a break. However, as underlying inflation pressures are expected to remain sizeable over the medium term, we think that data-dependent normalisation steps could come in the quarters ahead.
- In July, regulated prices shaved off around 0.6 percentage points from the headline rate (Chart 9), as an important base effect in the case of electricity dropped out (in July 2017, the average electricity bill rose by 6.9% MoM; Chart 10). In addition, electricity prices fell by around 4% MoM in July 2018, after the implementation of an ANRE's (Romanian Energy Regulatory Authority) decision. Unprocessed foods had also a non-negligible contribution to July's deceleration (about 0.1 pp).
- Our forecast error came chiefly from seasonal unprocessed foods (mostly vegetable and fresh fruits) and to a lesser extent from administered inflation, as electricity bills fell slightly more than the ANRE had indicated (4% MoM vs. 3.5% MoM). Vegetables and foods frequently point to sharp swings (Chart 11), therefore the gap between our forecast and the fact data could be reversed later this year. Nonetheless, the fall in the case of regulated prices is expected to have a permanent effect.
- Beside volatile vegetable and fruit prices, the inflation of egg prices also softened somewhat as the shock caused by the fipronil scandal continued to dim in July. At the same time, core unprocessed foods (raw meat, flour, and milk) pointed to a marginally slower rate of growth as well (Chart 12).
- The inflation of processed foods, which have the largest weight in our filtered inflation indicator, decreased marginally as cost pressures coming from agro-commodities remained modest (Chart 13). Nevertheless, it is important to note that risks have started to build up, as this year's harvest seems to be less favourable than previously thought, not only in Romania but across Europe too. Owing to the damage in crops, wheat futures on European commodity exchanges rallied sharply in July, and marched even higher at the beginning of August. Statistics for the domestic market are published with a few months' lag, therefore the spill-over effects have not appeared yet, but historical evidence suggests that Romanian agro-commodity prices may follow the trends seen elsewhere in Europe (Chart 14). Accordingly, cost pressures from agro-commodities could revive, providing a boost for processed food inflation starting from the last few months of this year.
- In July, non-durable goods inflation kept rising (Chart 15), while on a short-term basis, it also picked up (Chart 16). Durable consumer price growth accelerated as well. At the same time, market services inflation was broadly stable (Chart 17) and high-frequency statistics provided further signs of stabilisation, albeit remaining at a rather elevated level (Chart 18). The gradual recovery of goods inflation and stable but relatively high market services inflation suggests that underlying dynamics are solid, in line with the economy's fundamentals.

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

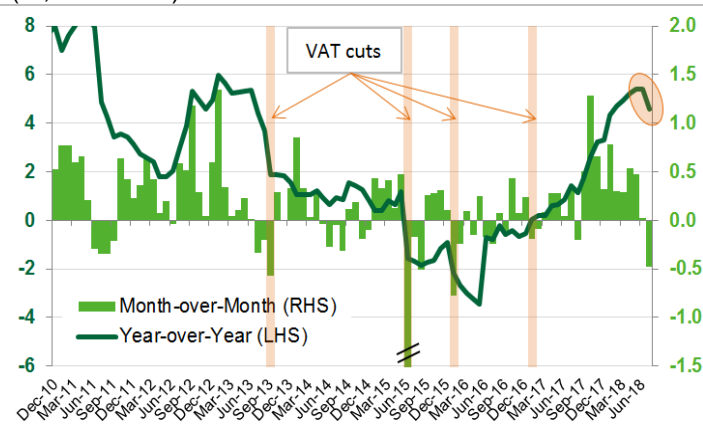
+4021 307 58 96

csaba.balint@otpbank.ro

- We recall that, at beginning of this month, Romania's central bank revised its CPI projection downwards. According to the new forecast, headline inflation will slow to 3.5% YoY at the end of this year, reaching the upper bound of the NBR's tolerance band (2.5% +/- 1%), while it is expected to ease further to 2.7% in 2019. The previous report had projected 3.6% inflation at the end of 2018 and 3.0% in 2019. The downward revision was mainly due to lower Core3 inflation (2.7% vs. 3.2% at the end of this year and 3.2% vs. 3.4% in 2019). However, it is worth noting that the new projection did not incorporate the most recent spike in agro-commodity prices (this appeared in the report as an upside risk), therefore we suspect that the forecast could be modified in the following projection. If wheat prices remain at the level seen at the beginning of August, on average, headline inflation could be 0.2 percentage point higher in 2019, while in the case of underlying indicators the impact would be as high as 0.4 pps, in our estimation.
- To summarize, we [maintain](#) our year-end inflation forecast of 3.6%, as further base effects are set to drop out. Consumer price growth may stabilise close to 3% in 2019, owing to significantly decelerating fuel inflation, as well as assuming that there will be no large regulated price hikes. However, it is important to underscore that even though the headline rate is expected to be significantly lower than in 2018, its structure will be quite unfavourable as business-cycle-related core indicators will become the primary driver. This shift warrants prudence from the central bank. It is also worth mentioning that the balance of risks is skewed to the upside because of the tight labour market, the increasing import prices and a potential escalation of global trade war. Most recently, the spill-over effects of higher agro-commodity futures became another important risk. We recall that, surprising the market, the central bank left the [key rate](#) unchanged for the second consecutive time in August. However, given the perspective of inflation dynamics and its sizeable uncertainties as well as due to the policy normalisation cycle in the USA and in Europe, we believe that the NBR will resume the hikes of its policy rate. We project the policy rate to end this year at 2.75% and reach 3.25% in 2019.

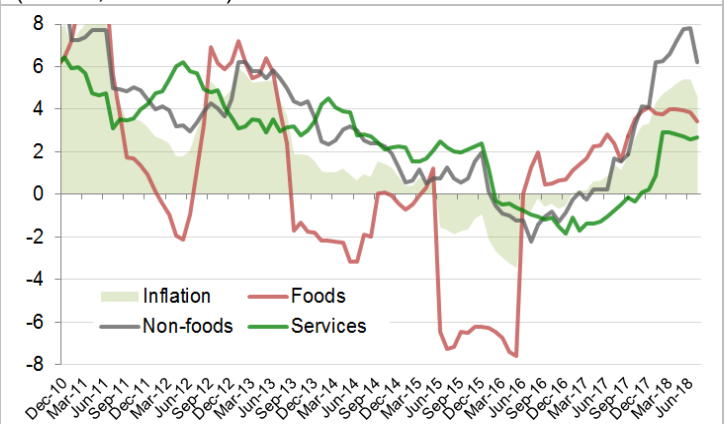
Chart set:

Chart 1: Headline inflation
(%, NSA data)



Sources: NIS, OTP Research

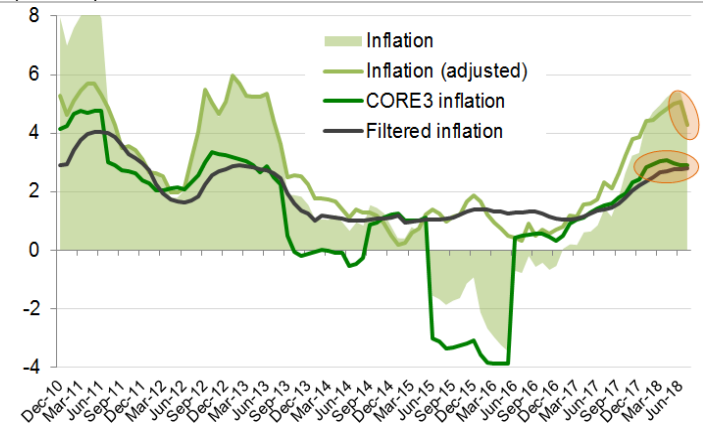
Chart 2: Inflation by its main components
(YoY%, NSA data)



Sources: NIS, OTP Research

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

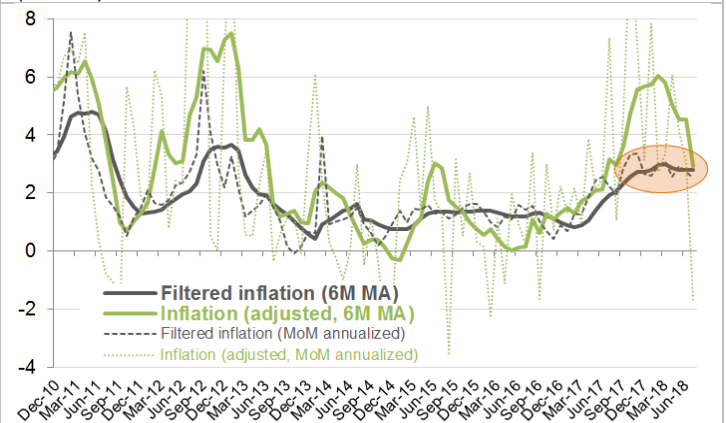
Chart 3: Inflation and underlying processes
(YoY%)



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).

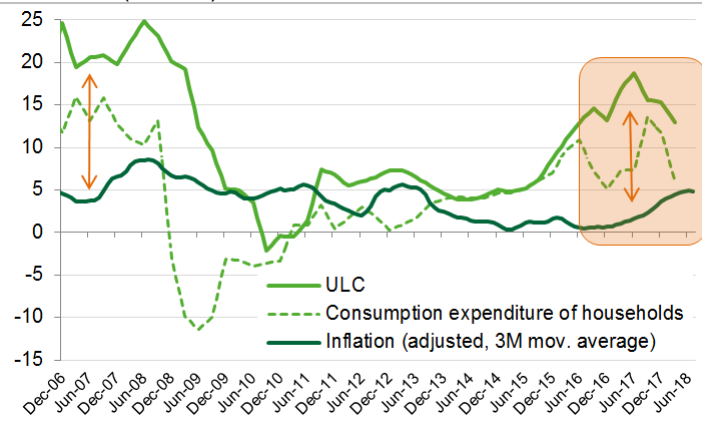
Chart 4: Inflation and filtered inflation
(%, SA)



Sources: NIS, OTP Research

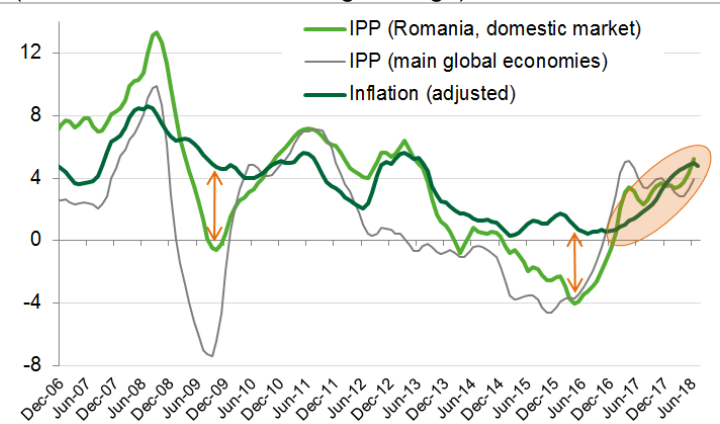
Note: adjusted by the impact of main tax changes; 6M MA = six-month moving average.

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



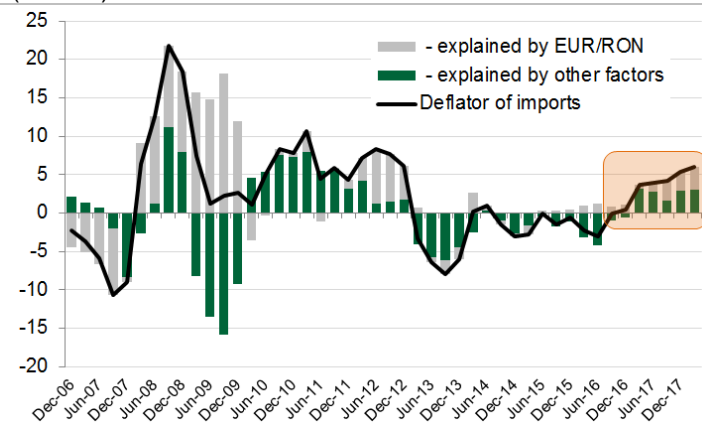
Sources: Eurostat, NIS, OTP Research
Note: adjusted by the impact of main tax changes.

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



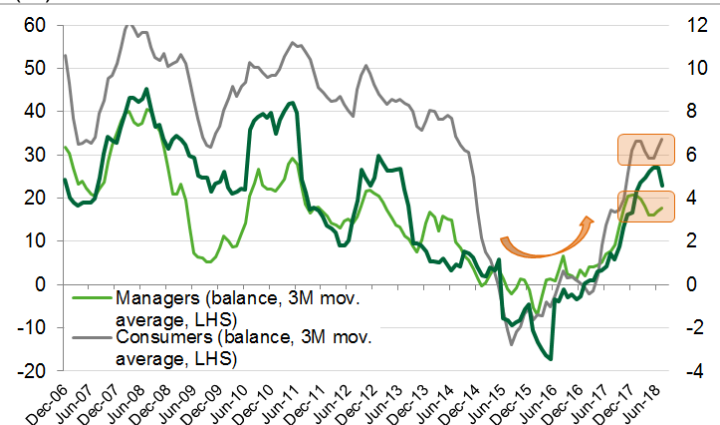
Sources: NIS, OECD, NBSC, OTP Research
Note: adjusted by the impact of main tax changes; the IPP (main global economies) includes data from EU28, USA and China

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



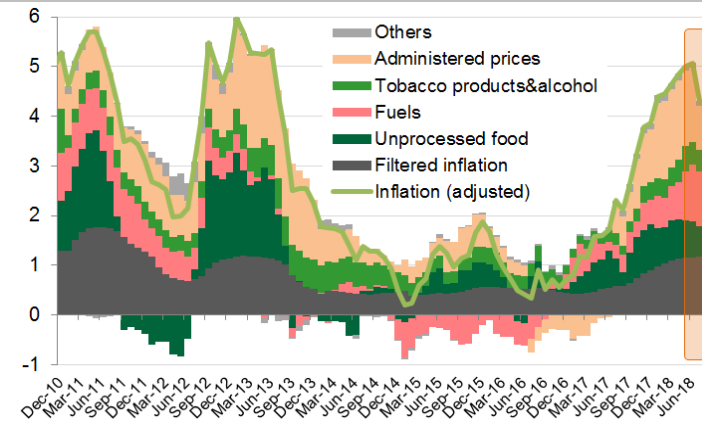
Sources: NBR, NIS, OTP Research

Chart 8: Price expectations vs. inflation (%)



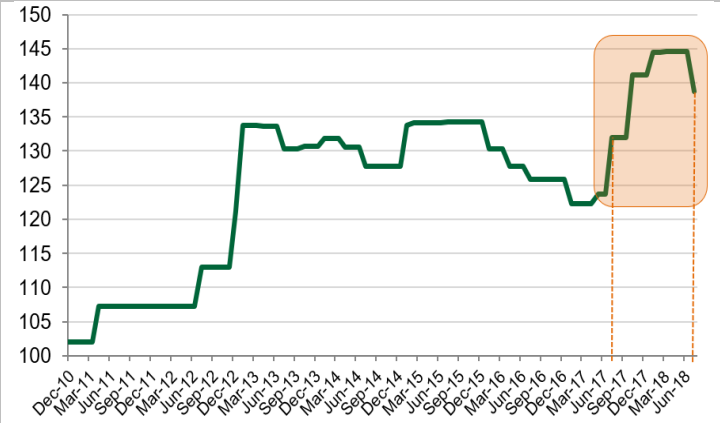
Sources: EC, NIS, OTP Research

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



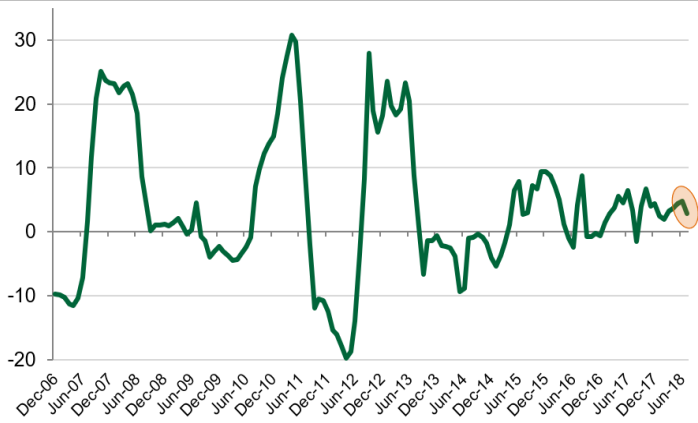
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 10: CPI of electric energy (2010 av. = 100)



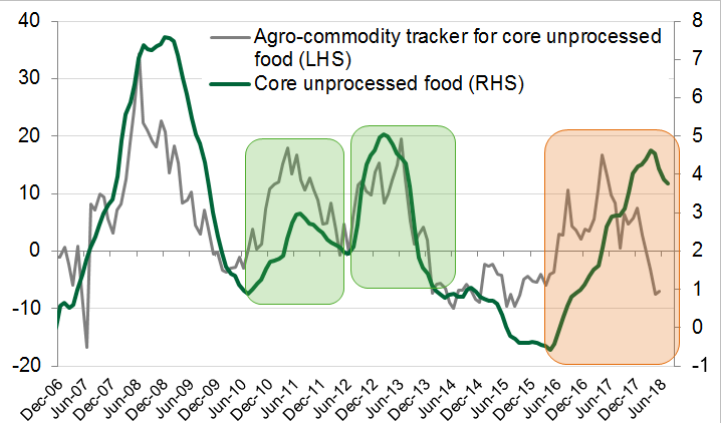
Sources: NIS, OTP Research

Chart 11: Seasonal unprocessed food prices (vegetables and fruits; YoY%, SA)



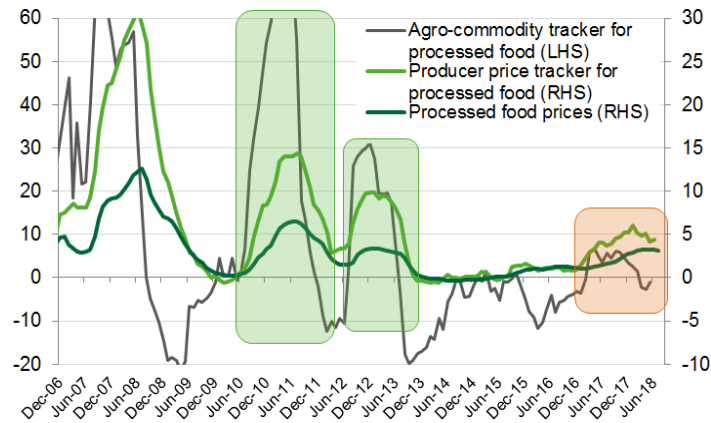
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

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



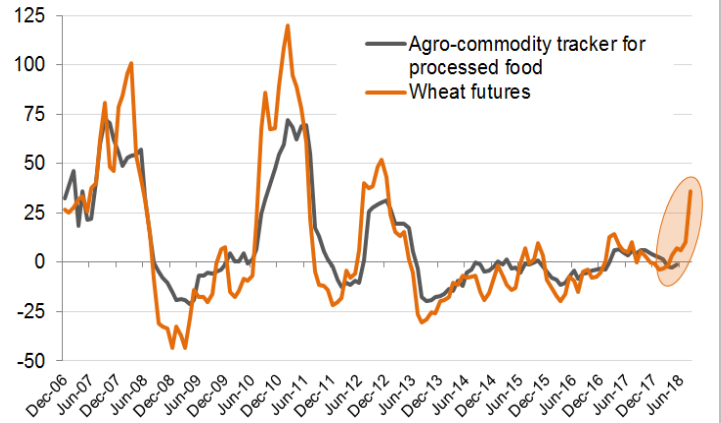
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

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



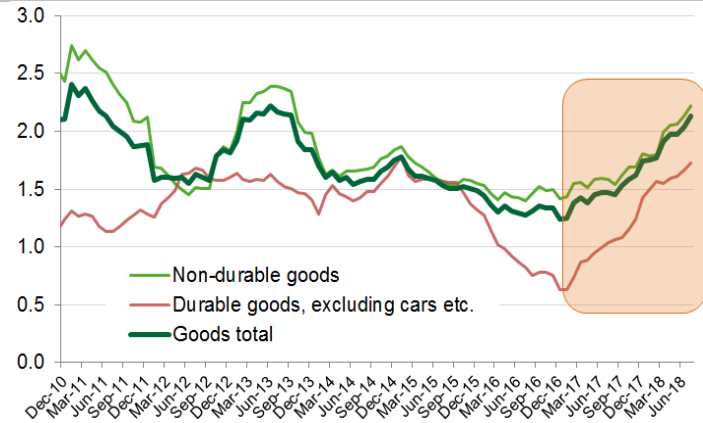
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 14: Agro-commodity prices vs. wheat futures (YoY%, SA)



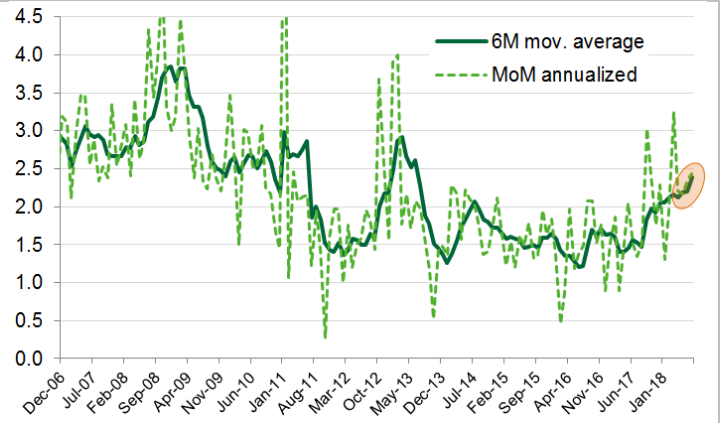
Sources: NIS, Reuters, OTP Research
Note: August data for wheat futures is the average of 1-10 August

Chart 15: Goods' inflation (YoY%, SA)



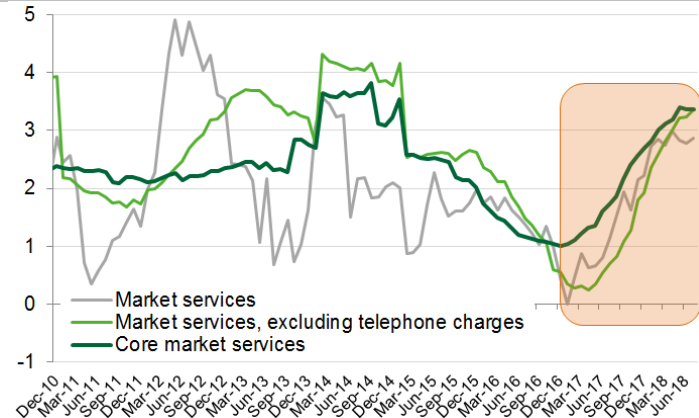
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 16: Non-durable goods (% SA)



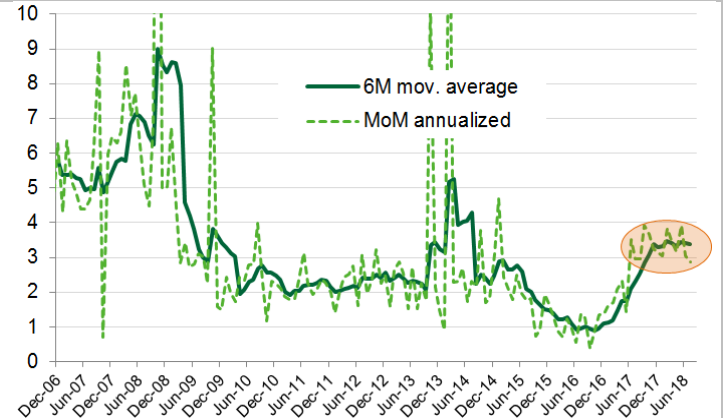
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 17: Market services
(YoY%, SA)



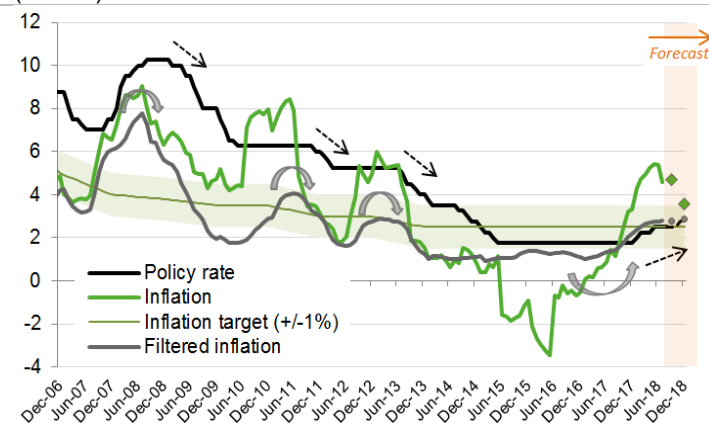
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes; **Core market services** excludes the EUR/RON-related telephone charges as well as insurances

Chart 18: 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 19: Inflation vs. NBR's inflation target
(YoY%)



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

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