

REPORT ON INFLATION

13 June 2019

Headline inflation may hover near 4% this year and we expect it to re-enter the tolerance band in 2020; Upward risks are really high

Treasury Sales Team

+40 372 31 85 88

sales.treasury@otpbank.ro

- In June, consumer price inflation stood at 4.1% YoY, unchanged compared to the level seen a month earlier (Chart 1). On month-over-month basis, the price index rose by 0.5%, the latest NIS report also showed. The headline data was in line with our estimation (4.1% YoY), but exceeded the market consensus by 0.2 percentage points (Reuters poll: 3.9% YoY). Our *filtered inflation*¹ indicator rose marginally (less than 0.1 pp), to 2.8% YoY, with high-frequency statistics also pointing to a slight acceleration last month (Chart 3 & 4). Nonetheless, the NBR's Core3 indicator increased more significantly, from 3.0% YoY to 3.2% YoY. The widening gap between the central bank's Core3² and our filtered inflation measure came from telephone charges. It is worth noting that telephone charges marked a sharp increase after the introduction of a new sector level duty on telecom companies at the beginning of the year.
- Regarding the big picture, we note that although headline inflation re-entered the central bank's tolerance band (2.5% +/- 1%) [at year-end](#), the relief was short-lived, as YoY inflation rose again above the target in February. It is also important to add that consumer prices has surprised on the upside several times in 2019, raising the pressure on the central bank.
- Among the key drivers of June's CPI data (Chart 5), we underscore the pick-up of telephone charges, while core unprocessed food prices (Chart 6) also pointed to acceleration mainly due to the spillover effect of China's African swine fever. Nonetheless, higher telephone and meat prices were offset by lower inflation in the case of fuels and tobacco.
- The components of our filtered inflation indicator showed rather small changes in May. Processed food inflation climbed a touch higher owing to an earlier agro-price shock as well as robust wage pressure (Chart 7). At the same time, non-durable goods inflation was practically flat and the growth rate of durable goods rose a bit (Chart 8). On the other hand, market services inflation soared, but this was again the result of more expansive telephone bills. Excluding telephone charges, market services inflation indicators were more or less stable last month.
- Looking forward, we expect headline inflation to end this year at 4%, YoY. (Chart 14). This forecast exceeds the upper edge of the target range (2.5% +/- 1%) and is significantly higher than our previous projections (a few months earlier, similarly to the market expectation, we had expected annual inflation to remain in the upper half of the tolerance band), nonetheless, this forecast is still a bit lower than the NBR's latest year-end estimation (4.2%). We also think that our filtered inflation indicator may end 2019 a touch above 3%, as underlying inflation factors will continue to fuel consumer price pressures.
- In the years ahead, in our base scenario, we expect consumer price dynamics to moderate gradually, with 3.3% and 3.1% average inflation rates in 2020 and 2021 respectively. This scenario is supported by the [perspective](#) of less cheering wage growth, slower but healthier GDP dynamics (less impressive consumption figures as well as rebounding investment helped by higher EU fund absorption), muted inflation pressure at global level and our assumption of a less consumption oriented fiscal policy. In this scenario, the central bank could keep inflation expectations well anchored much more easily, first of all, via fine-tuning of its current policy.

¹Filtered 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.

²Core3 inflation excludes vegetables, fruit, eggs, fuels and products whose prices are regulated, as well as beverages and tobacco

Chief Economist

Gergely Tardos

+36 1 374 7273

tardosg@otpbank.hu

Analyst

Csaba Bálint

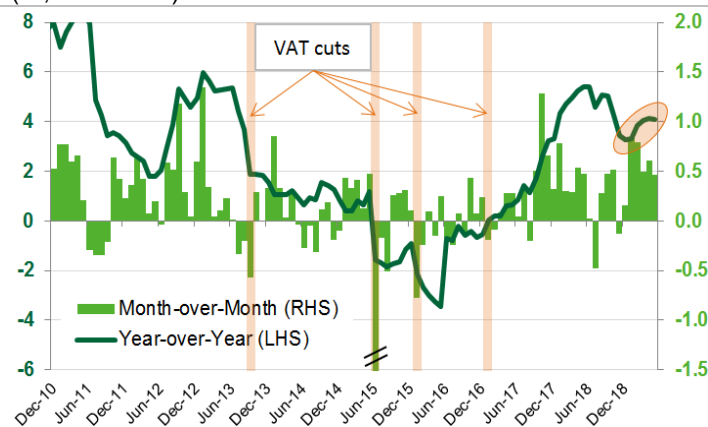
+4021 307 58 96

csaba.balint@otpbank.ro

- It is worth mentioning that NBR hinted already that it plans to introduce new tools in order to further tighten liquidity control (without the details of these new tools, we keep our policy rate forecasts at 2.50% and 3.00% for the end of this year and next. We may change our 2020 forecast when new information becomes available). Relying on tighter liquidity control rather than raising the policy rate is also supported by the changing external environment. In the past few quarters, market expectations moved from further tightening to monetary loosening in the case of the key central banks of the world.
- Nevertheless, several things could turn out less benign, compared to the assumptions in the base (or soft lending) scenario. Wages may stick to double digit growth pace, owing to the record low unemployment and backward looking wage-setting habits. With further elections on the agenda, the long-awaited reorientation and consolidation process of the government budget could be also delayed. These would translate into higher than expected underlying price pressures in the years ahead. Owing to the relatively high twin-deficit, a potential global downturn would also catch the economy on the wrong foot. This may result in higher pressure on the leu's exchange rate and an unfavourable effect on inflation expectations. Therefore, both alternative scenarios call for vigilance.
- To conclude, we reiterate that, most likely, headline inflation will end this year above the tolerance band (2.5% +/- 1%), near 4%, however, it is expected to return inside the target band in 2020. We expect 3.3% average inflation for next year. Nonetheless, it is also important to add that uncertainties around the outlook are quite high, keeping the NBR vigilant in the following period too.

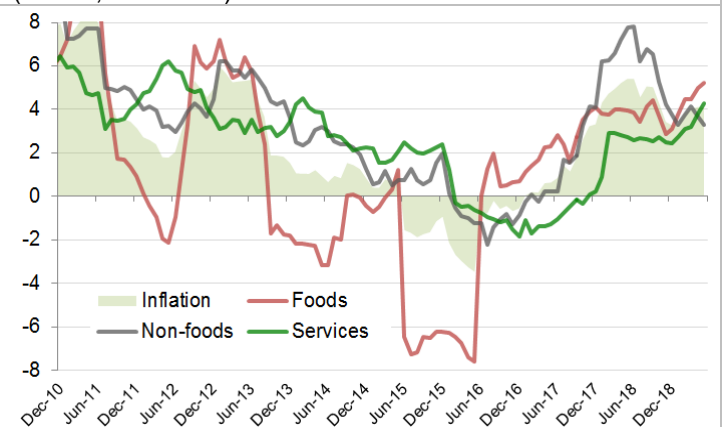
Chart set:

Chart 1: Headline inflation
(%, NSA data)



Sources: NIS, OTP Research

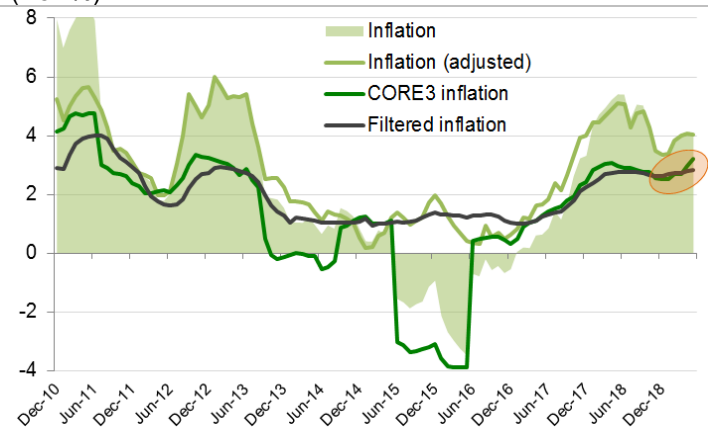
Chart 2: Inflation by its main components
(YoY%, NSA data)



Sources: NIS, OTP Research

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

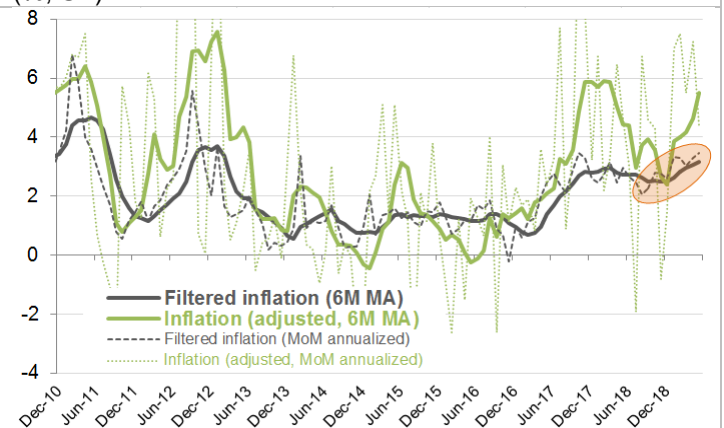
Chart 3: Inflation and underlying processes
(YoY%)



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).

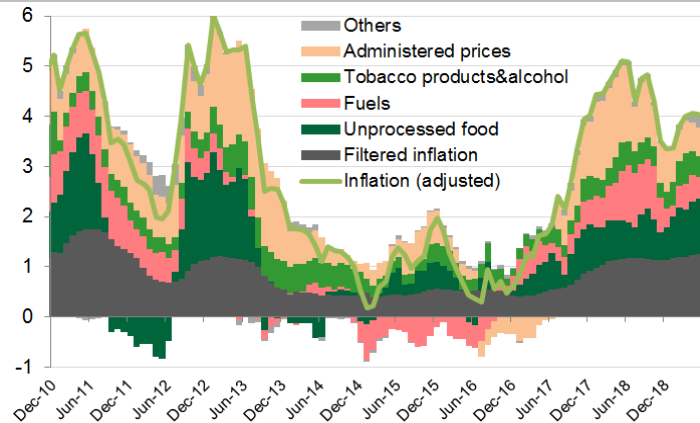
Chart 4: Inflation and filtered inflation
(%, SA)



Sources: NIS, OTP Research

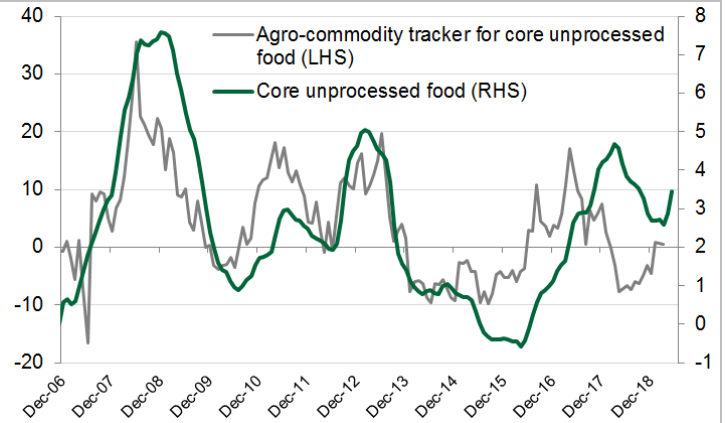
Note: adjusted by the impact of main tax changes; 6M MA = six-month moving average.

Chart 5: Decomposition of inflation
(percentage points, SA)



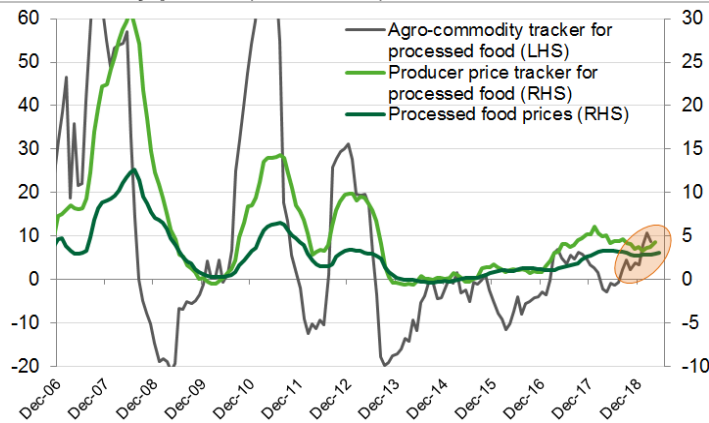
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 6: CPI of core unprocessed foods vs. agro-commodity prices (YoY%, SA)



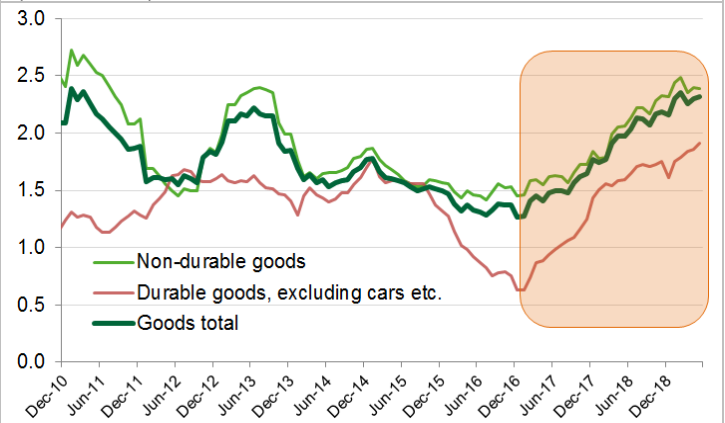
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 7: CPI and PPI of processed foods vs. agro-commodity prices (YoY%, SA)



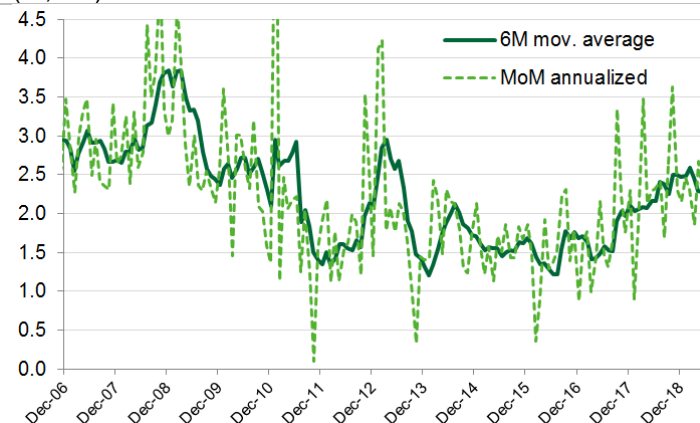
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 8: Goods' inflation (YoY%, SA)



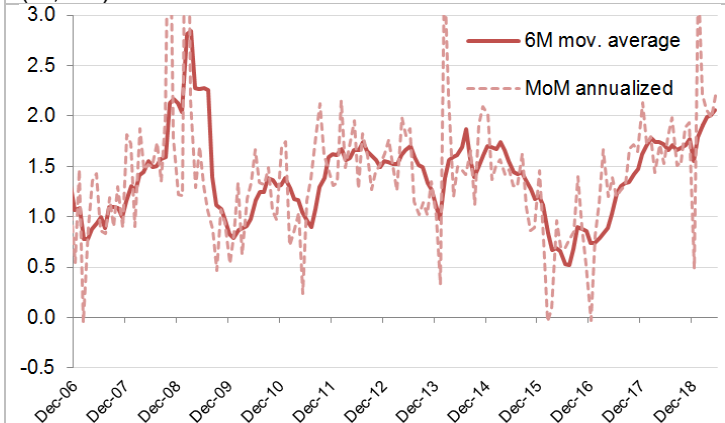
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 9: Non-durable goods (% SA)



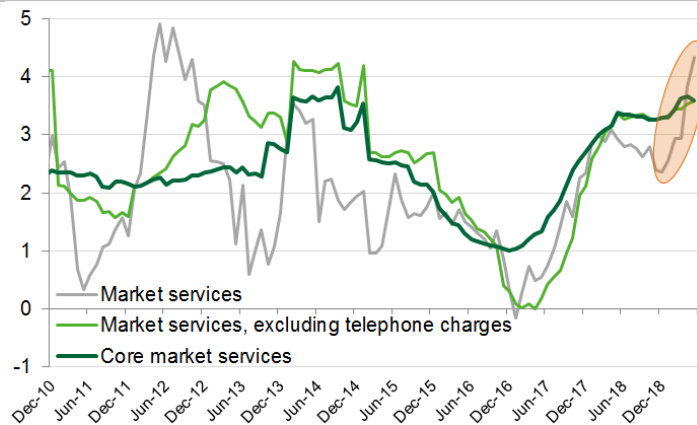
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 10: Durable goods, excluding cars etc. (% SA)



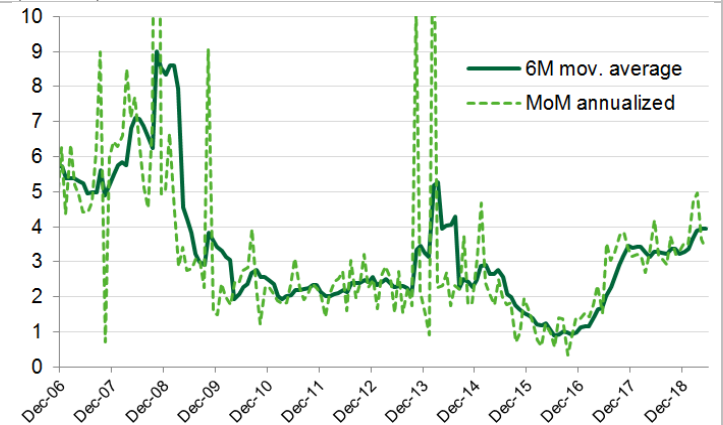
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 11: Market services
(YoY%, SA)



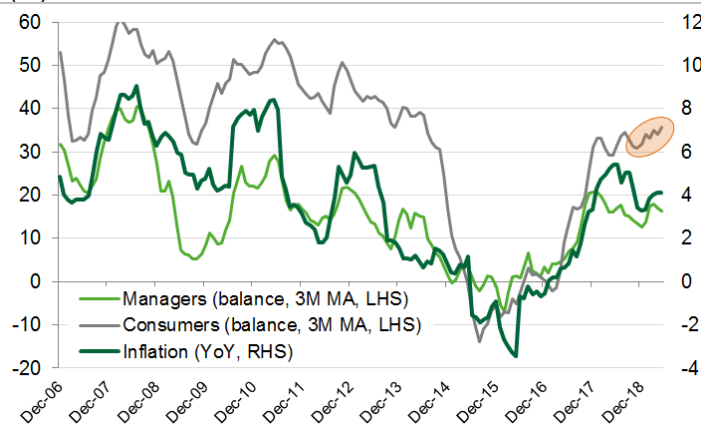
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes; **Core market services** excludes the EUR/RON-related telephone charges as well as insurances

Chart 12: Core market services
(%, SA)



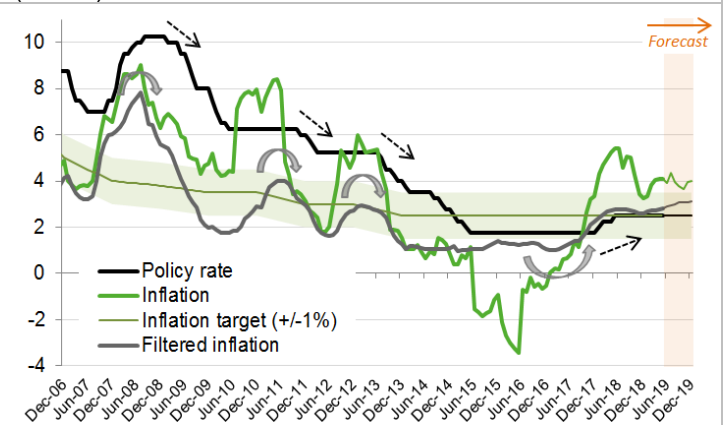
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes; **Core market services** excludes the EUR/RON-related telephone charges as well as insurances.

Chart 13: Price expectations vs. inflation
(%)



Sources: EC, NIS, OTP Research
Note: 3M MA = three-month moving average.

Chart 14: Inflation vs. NBR's inflation target
(YoY%)



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

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