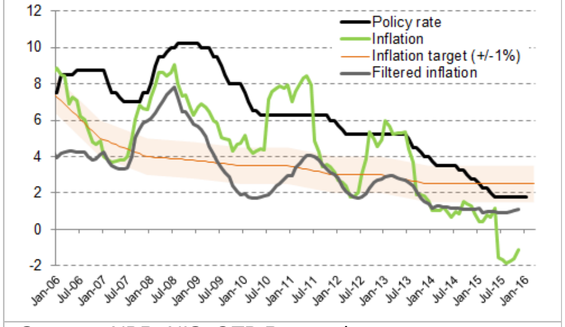
MONETARY POLICY COMMENT

8 January 2016

The NBR kept its benchmark interest rate at 1.75%, but reduced the minimum reserve ratio for FX liabilities by 2 pps to 12%.

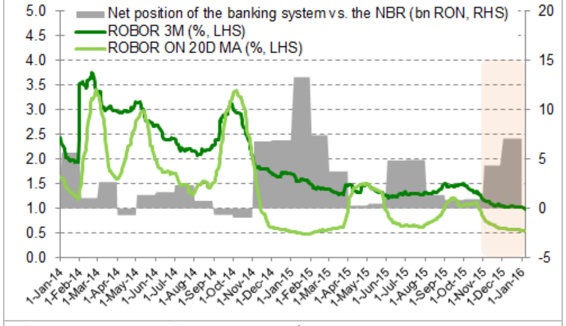
- In its first policy meeting of the year, **the National Bank of Romania left the key interest rate unchanged at a historical low of 1.75%** yesterday. Simultaneously, **the central bank's Board opted for reducing the minimum reserve requirement ratio (MRR) for foreign currency liabilities to 12%, from 14%** earlier, while it maintained the level of MRR for RON at 8%. Regarding the liquidity management in the banking system, policymakers' communication was not altered compared to the previous meeting: the NBR will continue to apply an "adequate" approach.
- The central bank decision to hold the benchmark rate at a record low, reached first time in the beginning of May 2015, had little impact on financial markets yesterday, as it was foreseen by analysts almost unanimously. Nevertheless, the reduction of the MRR for FX liabilities was somewhat unexpected. As we noted in our previous monetary policy comment, the central bank probably kept the plan of reserve ratio reductions on its agenda, but yesterday's movement came slightly earlier than we assumed. **This two-percentage-point cut**, to be implemented starting from 24 January, **may imply around EUR 0.5 bn**, which amount should not raise any notable concern from the point of view of official foreign currency reserves of the NBR. All the more so, they started to grow again in the last few months of 2015, ending the year at EUR 32.2 bn, helped by payments from the EU and higher government borrowing.
- We suspect that **the bulk of these fresh funds to the banking sector will be used for lowering the external debt of local subsidiaries and for the refinancing of public EUR denominated debt** rather than lending purposes. This view may be supported also by the trends on domestic credit market, which is characterized by sharply falling volumes in the case of FX loans and strongly advancing leu-denominated lending. At the same time, the money market is already characterized by abundant RON liquidity and very low interest rates (see Chart 2), hence transforming FX funds to leu, with the aim of boosting further lending activity does not seem too likely at this moment.
- **Romania's central bank**, as it was also highlighted by Governor Isarescu, **faces an unusual dilemma**, as the **headline inflation rate is still well below zero** (-1.1% as of November 2015; see Chart 1) and it would slump deeper into the negative territory on the back of a newer round of VAT reductions from the beginning of this year. **On the other hand, domestic demand seems to be definitely strong**, with households' consumption advancing by 6.6% YoY in Q3 2015, which is the highest gain since 2008. It may be worth noting that the main reasons behind the record low inflation rate are mostly driven by transitory external factors (such as already mentioned tax changes or plunging commodity prices). We recall that **excluding the first-round impact of VAT reductions, the annual inflation rate would have recently re-entered the NBR's +/-1 pp. variation band of the 2.5% target**. This was confirmed by the central bank's communique as well.
- Among others, CB chief Isarescu also noted that the favourable macroeconomic conditions on the domestic front contributed positively to the stability of the RON's exchange rate, underscoring the importance of a balanced policy mix. As we noted earlier, the NBR gradually may put more attention on interest rate stability on the medium and long term (presumably with some detriment on FX stability), as RON-based lending is strengthening. Thus the country's macrostability should play an even more important role.
- In the light of rapidly growing average wages and with a newer notable minimum wage hike in the pipeline, as well as aggressive fiscal loosening to be implemented during this year, **risks may build up**. **Therefore, we think that the NBR could keep the policy rate at 1.75% during 2016, but it may start to raise interest rates to 2.75% next year.** Nevertheless, cautious MRR reductions could also come in line with the NBR's plan to harmonize the level of reserve ratios with that of other EU countries.
- The next policy meeting will be held on 7 February, when the new inflation report will be discussed too.

Chart 1: Policy rate and inflation indicators (YoY%)



Sources: NBR, NIS, OTP Research

Chart 2: Money market rates and liquidity conditions



Sources: NBR, OTP Research

Note: 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 or car prices, as these are strongly connected to the EUR/RON exchange rate.

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