

MONETARY POLICY COMMENT

8 February 2017

Rates on hold again; 2017 inflation forecast revised down, but longer-term outlook still signals that policy normalisation could come later this year

- On its February meeting, the NBR kept the benchmark interest rate unchanged again, at 1.75%. As a result of the yesterday's decision, the policy rate remained at a record low for 21 months, a fairly long period with stable rates in Romania's post-communist history. Nonetheless, the Board of the central bank also maintained the previous levels of minimum reserve requirement ratios (8% for RON and 10% in the case of FX liabilities) and decreed to continue the "adequate liquidity management" in the banking sector. The upshot of the rate-setting meeting met our and the market's call, and there was no significant market response to the decisions yesterday. The relatively large movements of the EUR/RON and government securities' yields seen in the most recent period came on the back of political developments.
- As we noted in our [previous reports](#), despite the build-up of medium-term risks, the NBR has no pressing motivation to hurry with policy normalization. Indeed, the headline [inflation](#) is set to leave negative territory at the beginning of the year, helped by fading base effects; but most likely it will remain below the midpoint of the target band (2.5% +/-1%) even at the end of 2017. It is also important to note that the short-term outlook of the CPI came lower, as core inflation measures slowed in the past few months, and administered prices are expected to decrease further in January. We think policy-makers would like to see much more evidence of a sustained rise in inflation before launching normalization steps. In our opinion, this confirmation may come some time in the middle of the year. Beyond these fundamental reasons, the recently increased social unrest, as well as the uncertainties around the political scene and the government budget could have added further grounds to the NBR to stay on hold.
- On the policy meeting, the Board of the central bank also analysed and approved the new Inflation Report. The details of the material have not been revealed yet, as it is planned to be presented by Governor Isarescu on his 9 February conference. Nevertheless, the press release provided some hints about the new forecast, confirming that the 2017 year-end inflation was revised downward, while the increasing trajectory was retained too, with a faster profile starting from the beginning of 2018. In November's projection, the NBR's staff anticipated 2.1% inflation for Q4 2017, and a 3.1% growth pace for the end of the forecast horizon (Q3 2018).
- As usually, the press release reminded of the domestic and the external risks, highlighting among others the fiscal and income policies. Regarding the 2017 government budget, the NBR's chief made a short assessment on the press conference, stating that the revenue side of the plan is "ambitious", and expenses are "optimistic". We recall that the budget draft was based on disputable assumptions, like 5.2% GDP growth and 4.3% gain in the number of employees, resulting in significant risk of a slippage from the 3% target deficit. Another important issue on the draft is that it strongly supports wage and consumption growth, when domestic demand is already well-set.
- Neither the press release nor the minutes of the January meeting provided clues on the tightening plan of the NBR, presumably given the sluggish inflation perspective for 2017 and prevailing uncertainties. Nevertheless, we think that such hints may sooner or later appear in the central bank's communication. Closely before and during the last tightening period, beside CPI developments, there were also several other factors, which played an important role. Such indicators, frequently mentioned by the NBR included rising unit labour costs, surging government expenses, the deterioration of the current account (for a more comprehensive list see Charts 3-10). We think these indicators could also help find out the timing of the expected policy normalization.
- Summing it up, we maintain our previous view that some tightening measures could come starting from the second half of this year. In the first step, most likely by narrowing the interest rate corridor, which could be followed by a 25 bps rate hike at the end of 2017.

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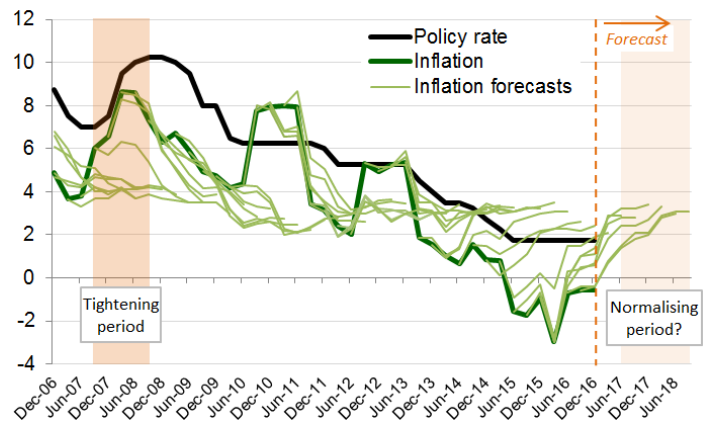
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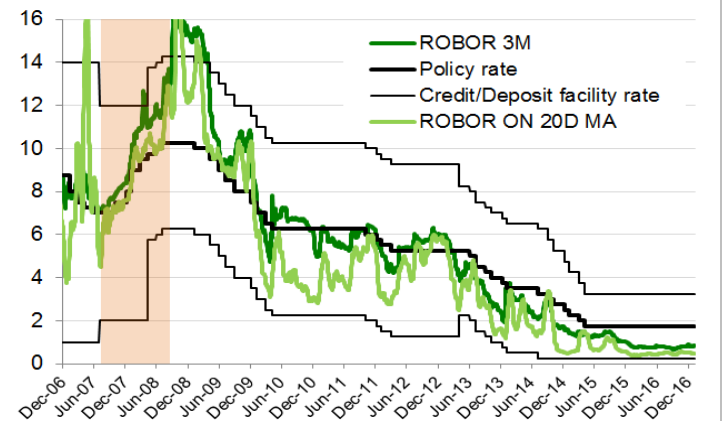
Chart set:

Chart 1: Policy rate, inflation, and the inflation forecasts of the NBR (%)



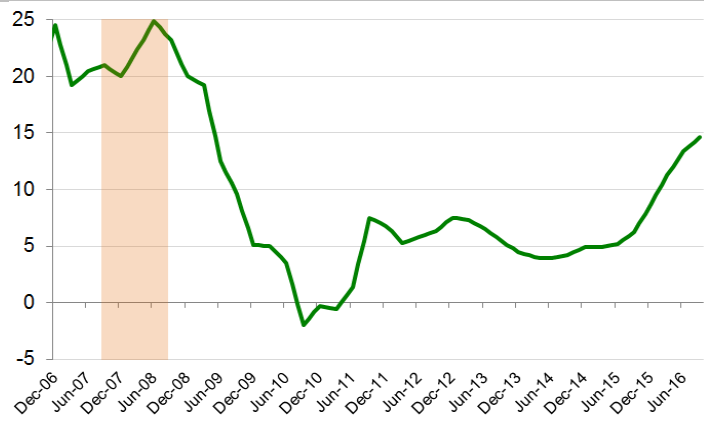
Sources: NBR, NIS, OTP Research

Chart 2: Policy rates and interbank MM rates (% , daily data)



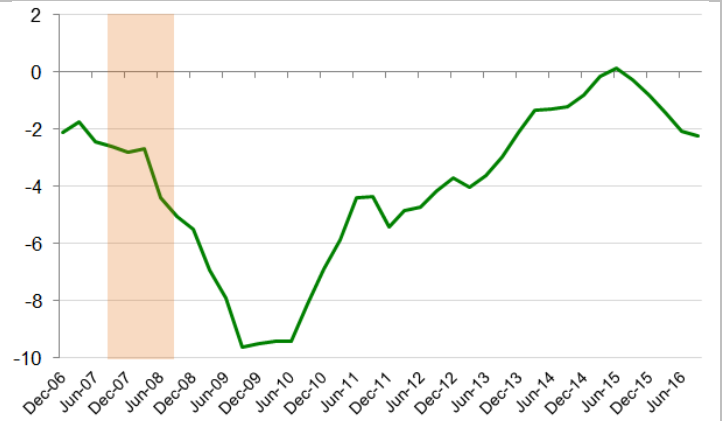
Sources: NBR, OTP Research

Chart 3: Unit labour costs (YoY %)



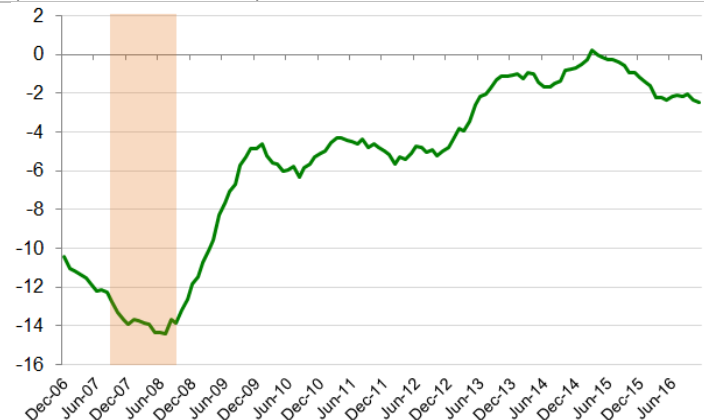
Sources: Eurostat, NIS, OTP Research

Chart 4: Budget balance (% of GDP, 4Q roll.)



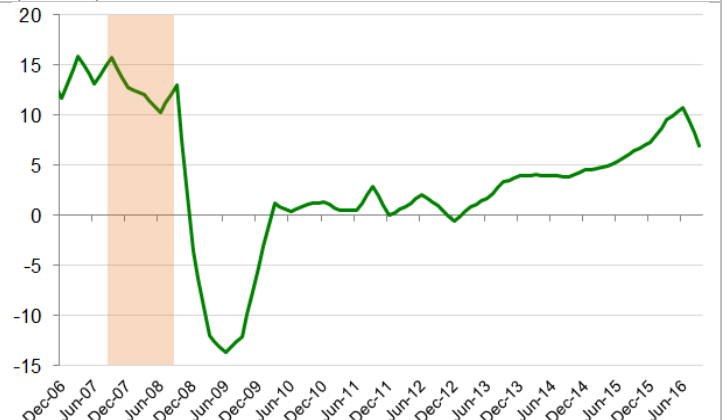
Sources: Eurostat, OTP Research

Chart 5: Current account balance (% of GDP, 12M roll.)



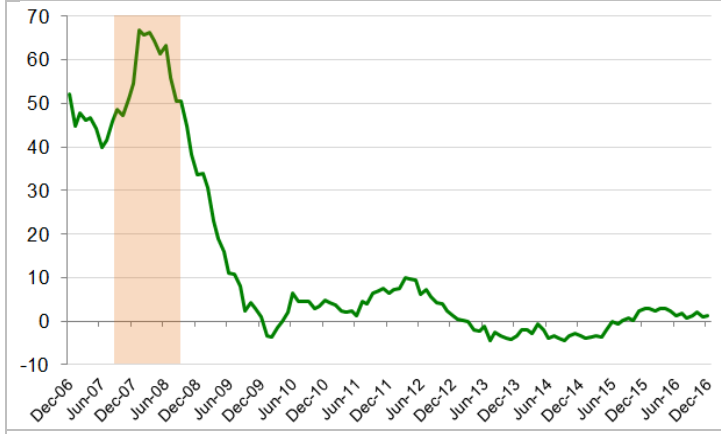
Sources: NBR, NIS, OTP Research

Chart 6: Consumption expenditure of households (YoY%)



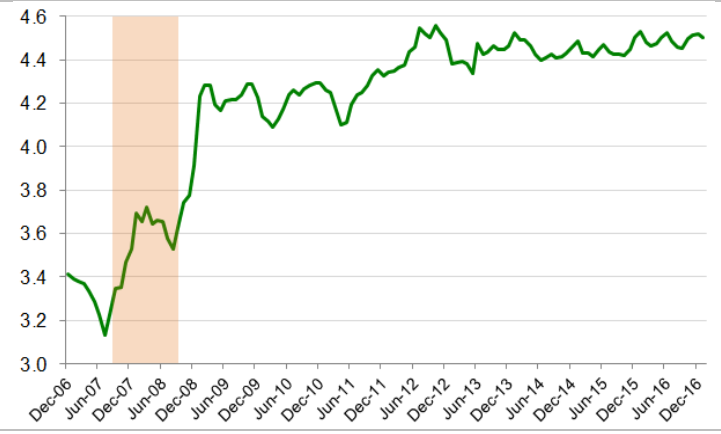
Sources: NBR, OTP Research

Chart 7: Growth of private credit (YoY%)



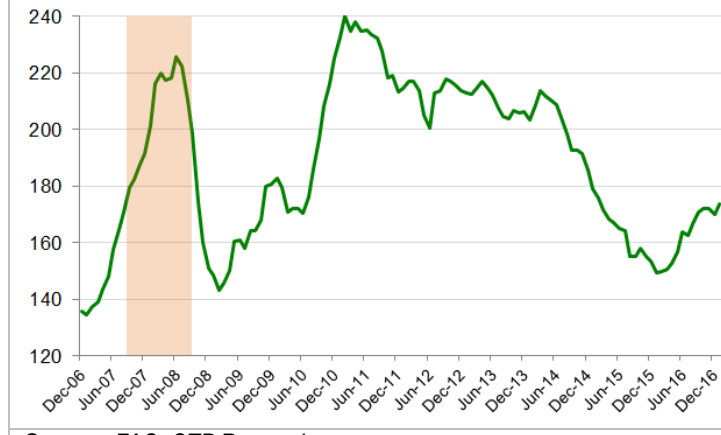
Sources: NBR, OTP Research

Chart 8: EUR/RON



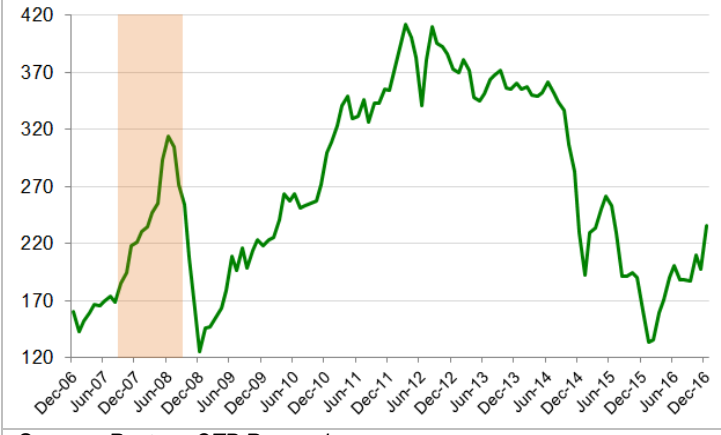
Sources: NBR, OTP Research

Chart 9: Global food prices (2002-2004 average = 100)



Sources: FAO, OTP Research

Chart 10: Brent crude oil price (monthly average in RON)



Sources: Reuters, OTP Research

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