

REPORT ON INFLATION

13 April 2017

Headline figure was flat at 0.2% YoY, as expected; underlying inflation measures signal an inflection point

- In March, headline inflation was flat at 0.2% YoY (see Chart 1), matching our call and slightly undershooting the market consensus of 0.3% YoY (Reuters survey). It is important to add that the fresh data was in line with the latest forecast of the NBR too. In month-over-month comparison, consumer prices increased by 0.1%, after registering a 0.1% drop in February. Meanwhile, *filtered inflation*¹, our in-house underlying CPI measure, was basically unchanged at 1.1% YoY (see Chart 3), as we have expected.
- We recall that annual inflation returned into positive territory at the beginning of this year, for the first time since the middle of 2015, supported by the fading base effect of last year's four-percentage-point VAT reduction. However, a new series of tax reliefs (another one-pp standard VAT rate cut, the elimination of the special excise duty on fuels, as well as scrapping the radio&TV fee) continues to weigh on the headline figure. Without these on-off items, consumer prices would have increased by around 1.3% YoY, in our estimation.
- In March, the relatively subdued dynamic of the annual inflation was first of all due to fuel prices, after they slipped by 1.0% MoM, as crude oil futures also decreased. In addition, negative base effects pulled back the annual growth rate of fuels' CPI as well, after prices at the petrol pumps showed a strong rebound in the same period of the previous year (Chart 6). On the other hand, this unfavourable impact was offset by the spill-over effects coming from the depreciation of the leu, while unprocessed foods' inflation also accelerated (Chart 7).
- Regarding underlying CPI dynamics, it is important to mention that a change in the big picture started to take shape in the latest period, as we noted in our last week's momentary policy [comment](#) too. Fuelled by the rapidly rising unit labour costs (Chart 8) and stabilized commodity futures, producer prices in industry picked up in Q1 2017. This suggests that cost-push inflation pressures could be on their way back up, while the signs of demand-pull inflation were present earlier too, reflected by healthy increases in consumption. Indeed, compared to our expectations, households' expenditures slowed a bit more in the second half of last year, but with strong consumer confidence, record low unemployment rate (Chart 10) and further significant public wage hikes in the pipeline, this softening most likely was rather transitory.
- Our filtered inflation indicator was little changed in March, and its largest component, the CPI of processed food did not bring too much excitement (Chart 11) either. Nevertheless, the other core elements revealed important details. Durable goods inflation (excluding highly exchange-rate-sensitive items, like car accessories etc.) apparently bottomed out, helping the growth rate of goods' CPI to inch modestly higher (Chart 12&13). In addition, following a long downward trend, core market services' inflation (which among others excludes telephone charges and volatile insurance premiums) also started to change direction recently (Chart 14&15). These long-awaited signs reinforce our view that a turning point in filtered inflation is round the corner.
- Taking into account all of the market services components, the consumer prices index of the group rebounded in March, getting a boost from the weakening leu. The EUR/RON hit multi-year record highs last month, even visiting levels above 4.56 for a short period. The weakness of the domestic currency was transmitted into consumer prices primarily via rising telephone charges. However, it is worth noting that at the beginning of April, the leu reversed some of its earlier losses. After excluding this strongly exchange-rate-sensitive item, market services inflation decelerated slightly in recent months, as insurance fees continued to weigh on the indicator. We recall that mandatory car insurance premiums (RCA) were capped in November, leaving their mark on the overall index. Nevertheless, it should be added that the Financial Supervisory Authority plans to eliminate the maximum tariffs starting from the second half of May.

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.

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- To sum it up, we think that both headline and core inflation measures will gain steam in the following quarters, given the gradual change in the big picture. Nonetheless, we modified marginally downward our year-end inflation forecast, to 1.6% YoY (vs. 1.8%), as the acceleration of underlying price dynamics seems to be a bit late compared to our previous medium-term assumptions, while the regulatory authority announced 2% increase of natural gas prices for April, below the earlier plans. At the same time, we continue to expect 2.9% average inflation for 2018 with some upside risks, coming from increasing wage pressures, after the government announced further significant hikes in the public sector. As we noted in our latest [MPC report](#) too, we suspect that monetary policy normalization could start in H2 2017, by narrowing the interest rate corridor.

Chart set:

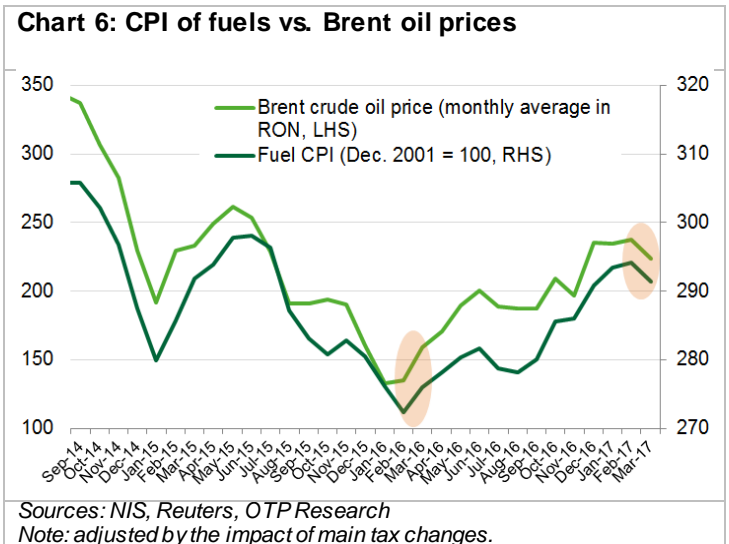
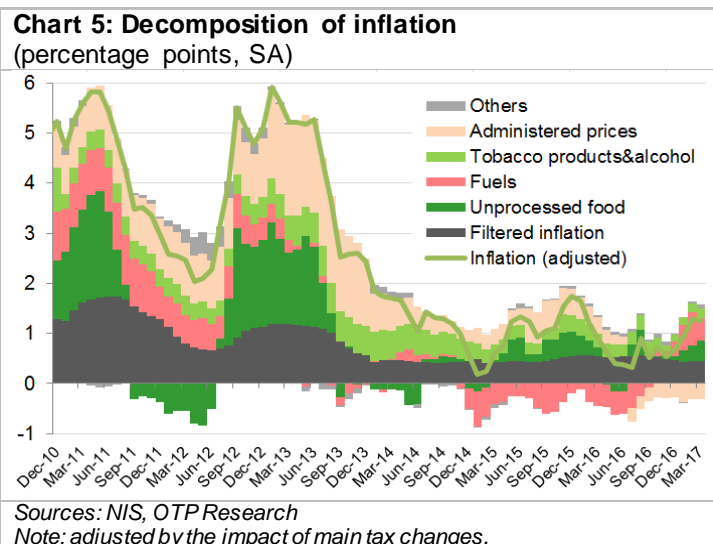
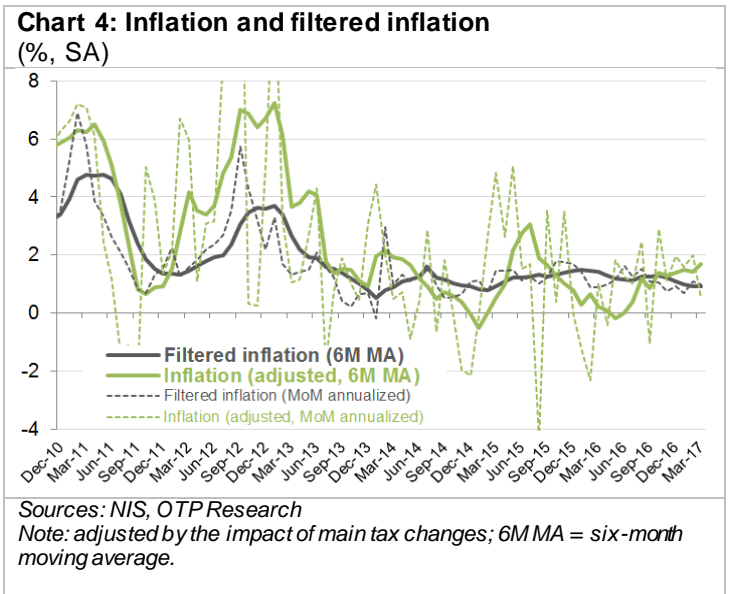
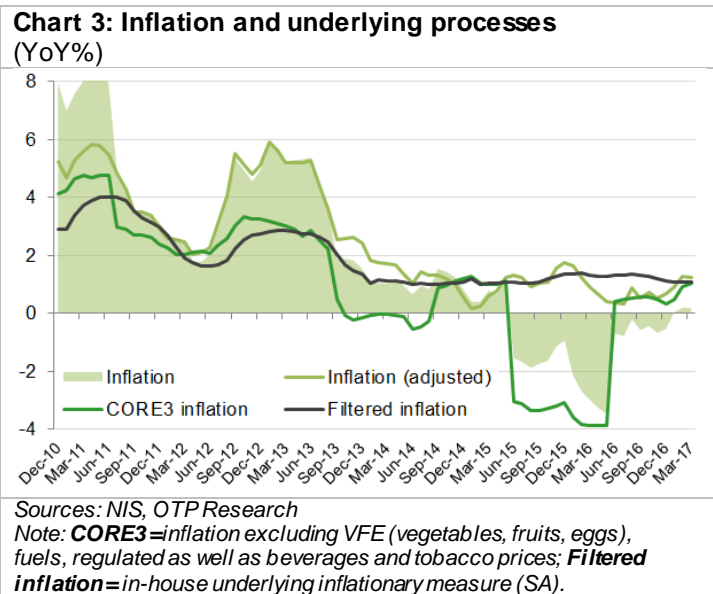
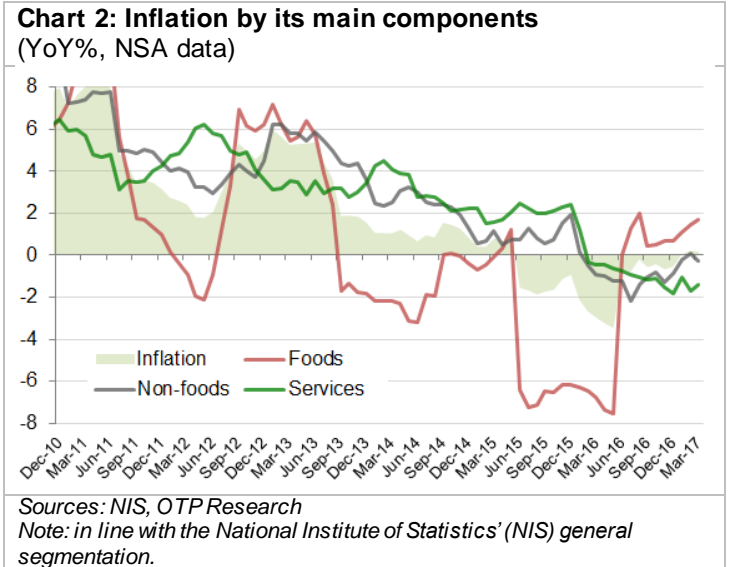
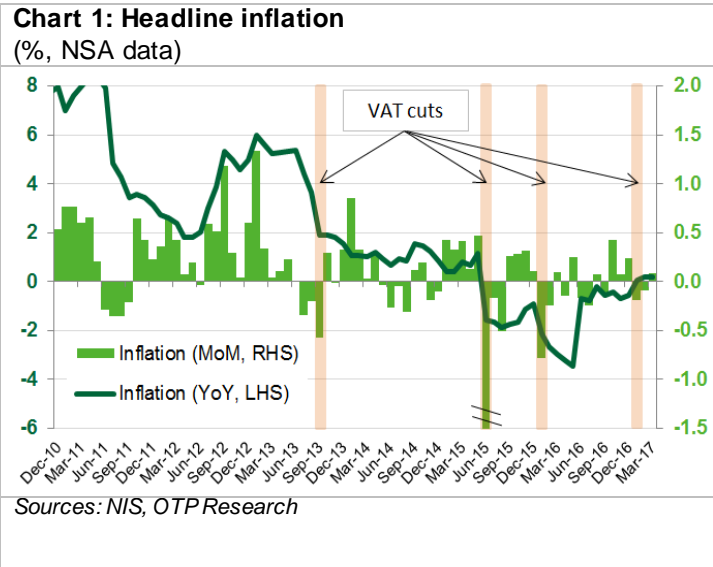
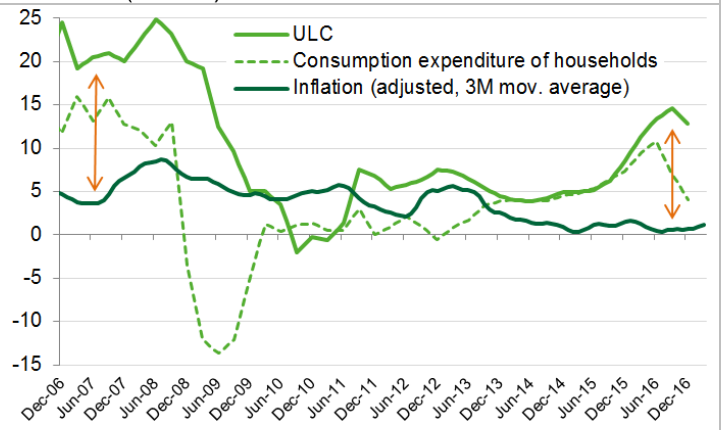


Chart 7: Unprocessed food prices (YoY%, SA)



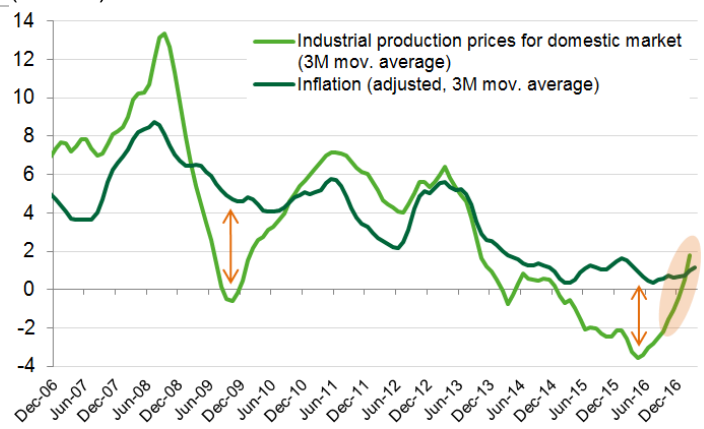
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 8: ULC & households' consumption vs. inflation (YoY %)



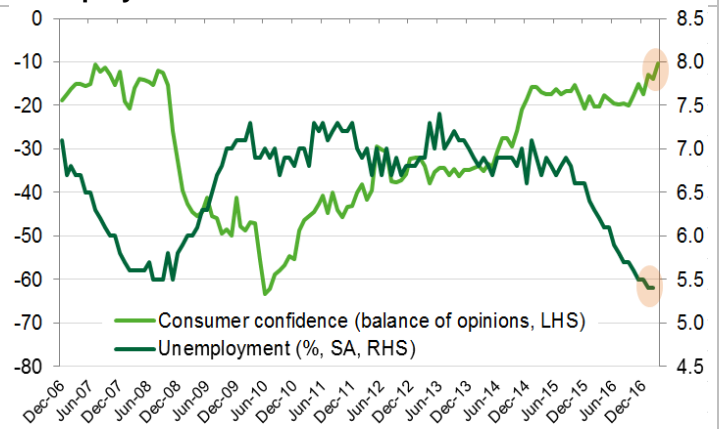
Sources: Eurostat, NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 9: Industrial production prices vs. inflation (YoY %)



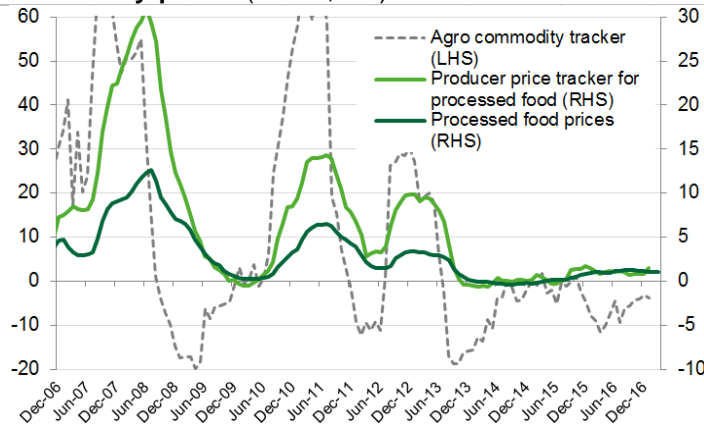
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 10: Consumer confidence indicator and unemployment rate



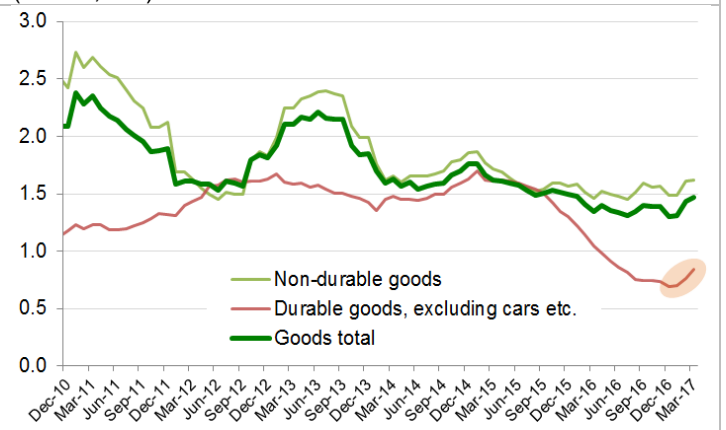
Sources: Eurostat, NIS, OTP Research

Chart 11: CPI and PPI of processed foods vs. agro-commodity prices (YoY%, SA)



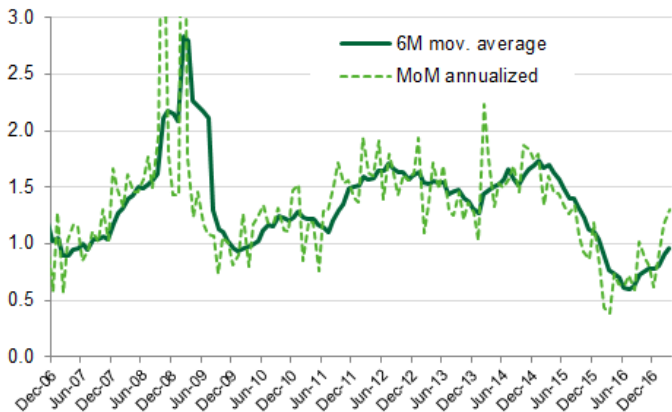
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 12: Goods' inflation (YoY%, SA)



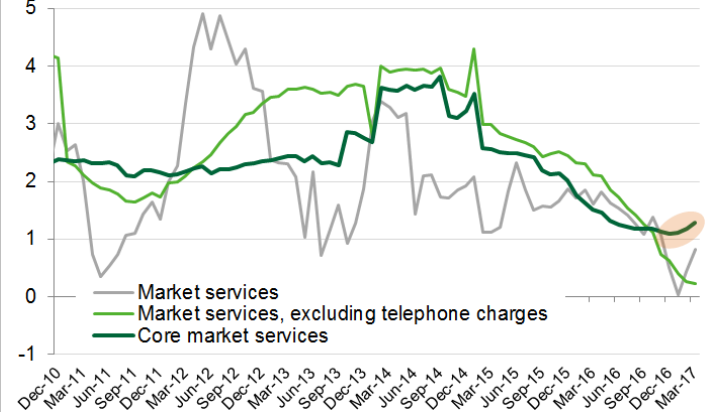
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 13: Durable goods, excluding cars etc.
(%, SA)



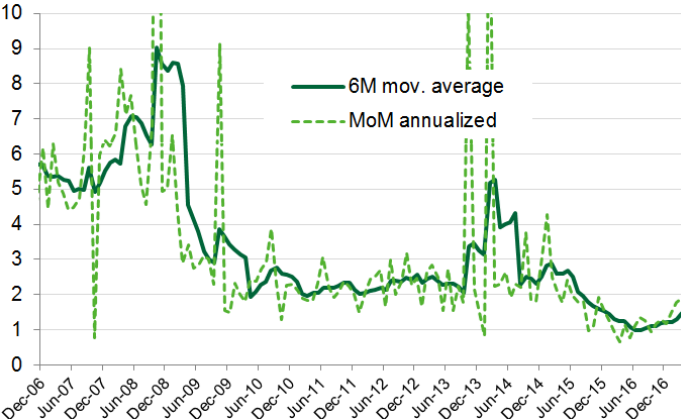
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 14: Market services
(YoY%, SA)



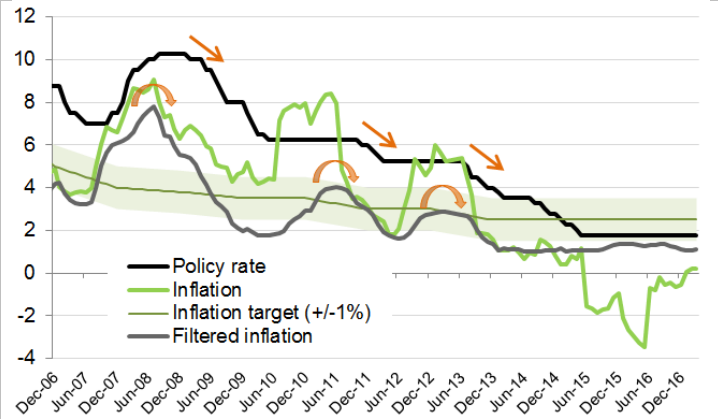
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes; **Core market services**, beyond the EUR/RON-related telephone charges, excluding the line of other services too, which covers mainly insurances.

Chart 15: Core market services
(%, SA)



Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes; **Core market services**, beyond the EUR/RON-related telephone charges, excluding the line of other services too, which covers mainly insurances.

Chart 16: Policy rate and inflation
(%)



Sources: EC, NIS, OTP Research

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