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MONETARY POLICY COMMENTARY

8 May 2018

The NBR raised the policy rate for the third time this year

- In its May policy meeting, the National Bank of Romania raised the key interest rate by 25 basis points, to 2.50%. Simultaneously, the symmetric interest rate corridor around the policy rate shifted higher as well, with the interest rate on the standing deposit and credit facilities climbing to 1.50% and 3.50% respectively. Nonetheless, the mandatory reserve ratios were left unchanged at 8% for both leu and foreign currency-denominated liabilities. The outturn of the Board meeting was in line with our expectations and also matched the majority of analysts' calls (according to a Reuters survey).
- The Board of the NBR analysed and approved the new Inflation Report as well. According to the post-meeting press release, the expected trajectory of consumer prices was little changed, with headline inflation returning 'to the vicinity of the upper bound' of the target (2.5% +/- 1%) in Q4 2018. In our opinion, this phrasing may imply a marginal upward revision of the year-end forecast (in its February's report the NBR had projected 3.5%). In April, we also increased slightly our prediction. The details of the central bank's new Inflation Report will be presented on Wednesday (9 May).
- Supported by the rate hike, Romania's leu held ground against the euro, while other currencies in Central and Eastern Europe weakened by 0.2-0.3%. Meanwhile, ROBOR interest rates grew 12-17 bps and government securities' yields increased 2-6 bps, with higher movements at the short end.
- Regarding the big picture, we reiterate that Romania's CB started the normalisation process already in the second half of 2017 (see Chart 1), after consumer prices marked an unexpectedly sharp revival, fuelled by several on-off (e.g. regulated price hikes, fuel excise duty increase) and fundamental factors. Moreover, escalating overheating concerns also urged the NBR to tighten. On the back of the normalisation measures (including the narrowing of the interest rate corridor, base rate hikes and liquidity sterilisation actions), interbank lending rates have risen by almost 200 basis points on average since August 2017.
- In answer to journalists' questions whether interbank rates could reach 4% until the end of this year, Mr Isarescu said firmly that the NBR did not want such an outcome. In contrast, the CB prefers a not-too-sharply-ascending trajectory for interest rates. The governor also reiterated that, after enduring around ten years, the era of ultra-low interest rates undoubtedly came to an end. However, there is no clarity when (if it all) monetary policy will return to interest rate levels and tools viewed as normal in the decades before the crisis. Mr Isarescu also mentioned that Board members debated this subject thoroughly, but their views differed.
- In the governor's opinion, positive real rates should return some day. However, this does not mean that it would happen certainly as well, he added. In the case of Romania, he would like to see interest rates and consumer price inflation to meet down the road, as CPI growth softens and interest rates climb higher but the country cannot be isolated from the world. As real rates in Europe are still in negative territory by around two percentage points, the domestic interest rate is also below the annual inflation. A gap is expected to be maintained in Romania, but its width can differ from that seen elsewhere in Europe, depending also on the market reactions.
- Touching the subject of attacks coming from the political scene, Mr Isarescu underlined that the latest press release did not include any reference on the effect of fiscal policy on inflation. This came after rallying consumer prices had triggered waves in the political discussions. Most recently, the negative echoes against the NBR were appeased owing to dialogue between the CB and the leaders of the ruling coalition.
- Interestingly, at the end of the post-meeting press conference, Mr Isarescu also noted that he would not seek another term as governor of the central bank, owing to his age (close to 70). It is worth mentioning that his mandate will expire in 2019. The retirement of Mr Isarescu would end an almost three-decade-long period in service.

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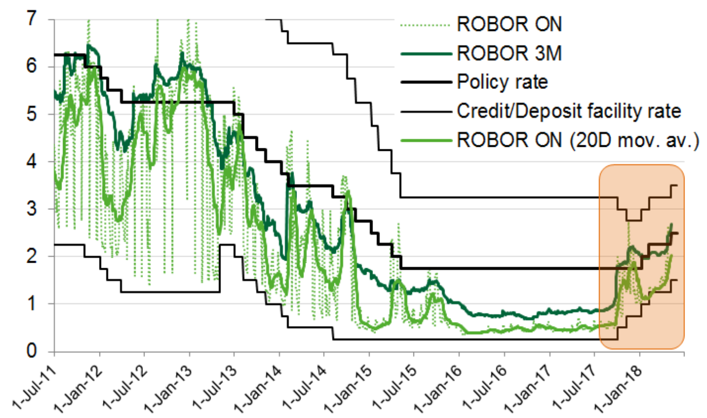
- Summing it up, we maintain our previous view that the policy rate could reach 2.75% at the end of 2018 and may be raised to 3.25% in H1 2019. The NBR likely will follow a data-dependent approach and it will also carefully balance between the combination of containing price expectations, overheating fears, and the rising burden of borrowers. We think that the next 25-bps hike could come in August, when the new inflation report will be released. Stronger-than-expected inflation outturns, more-aggressive-than-previously-thought tightening measures in Europe and the USA, as well as pressures on the EUR/RON may urge the NBR to speed up its policy normalisation cycle.

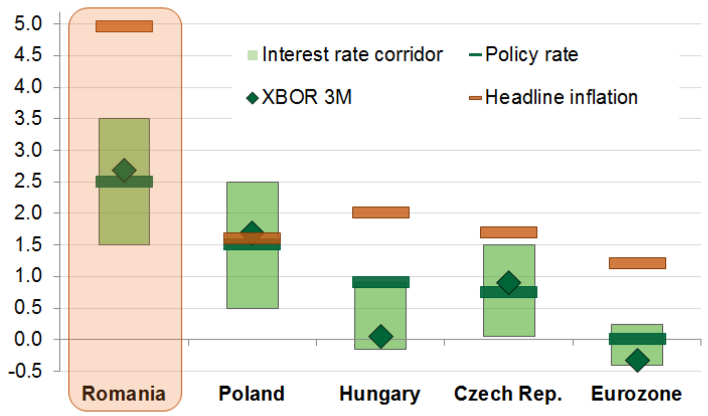
Chart set:

Chart 1: Policy rates and interbank MM rates
(%, daily data)



Sources: NBR, OTP Research

Chart 2: Key monetary indicators
(%)



Sources: Central banks, Reuters, OTP Research
Note: XBOR and headline inflation data - latest available

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