

REPORT ON INFLATION

17 January 2019

***Inflation ends 2018 within the tolerance band;
2019's base scenario for inflation is favourable but uncertainties
surround the outlook, while monetary policy transmission mechanism
is set to weaken***

- In December, Romania's headline inflation dropped to 3.3% YoY, down from November's 3.4% (see Chart 1), mainly because of lower oil prices. The data was in line with [our](#) as well as the market's expectation (Reuters poll). December's outturn also means that consumer prices' growth ended last year slightly below the upper bound of the NBR's tolerance band (2.5% +/- 1%), an undoubtedly favourable development for central bankers, particularly as headline inflation hit 5.4% in mid-2018. In month-over-month comparison, the consumer price index rose by 0.2%, the NIS's report showed. Another good news is that underlying inflation measures fared well in December, with the NBR's preferred CORE3 indicator (inflation that excludes vegetables, fruit, eggs, fuels and products whose prices are regulated, as well as beverages and tobacco) easing to 2.5% YoY, down from 2.6% YoY a month earlier. Simultaneously, our in-house *filtered inflation*¹ indicator was also stable (Chart 3 & Chart 4).
- Regarding the broader picture, we [recall](#) that Romania's headline inflation broke above the central bank's target in January 2018, fuelled mainly by administered price hikes, soaring Brent, and the weaker leu. Nevertheless, as the impact of these price shocks started to fade, CPI growth marked a turning point in the middle of last year. In addition, underlying inflation indicators also showed signs of stabilisation in the second half of 2018. With softer inflation pressure, the central bank adopted a wait-and-see approach, after implementing a series of tightening measures in the period of H2 2017 – H1 2018.
- December's fall in the headline data came chiefly from lower prices at petrol pump stations, as crude oil futures marked a sharp drop at the end of last year (Chart 5). On the other hand, seasonal unprocessed food (mainly vegetables and fruits) and tobacco inflation accelerated in December, partially offsetting the effect of lower fuel prices.
- The components of our filtered inflation indicator were broadly stable in the last month of 2018. Processed food price growth was flat (Chart 7), similarly to non-durables (Chart 8 & 9), while durable goods' inflation even eased a bit (Chart 8 & 10). Market services inflation also showed little variation (Charts 11 & 12).
- Looking ahead, we think that Romania's headline inflation will stay mostly in the upper half of the tolerance band in 2019, ending the year close to 3%. Simultaneously, our filtered inflation measure may rise slightly, driven by processed foods. Despite the latest government measures, this outlook is similar to our [earlier expectations](#).
- We note that policy-makers recently decided to cap energy prices and lower the VAT rate on several services. It is quite difficult to assess the overall effect of capping natural gas prices charged by local producers and of freezing electric energy prices at this point, as several details about the implementation have not been revealed yet, while the cap is also expected to spur natural gas imports (the costs coming from imported natural gas can be passed on to industrial users). The additional costs of the new 2% tax on energy companies' turnover and still open questions about the implementation of the new duty make the equation even more complex.
- Based on past experience in the case of VAT changes at utilities, we think that the tax cut on water supply services will almost entirely pass through into consumer prices, but the measure's impact on overall inflation is set to be low (around 0.1 percentage point). Other recently approved VAT rate cuts in tourism will probably have even lower effect on headline inflation, owing to a very weak pass-through.

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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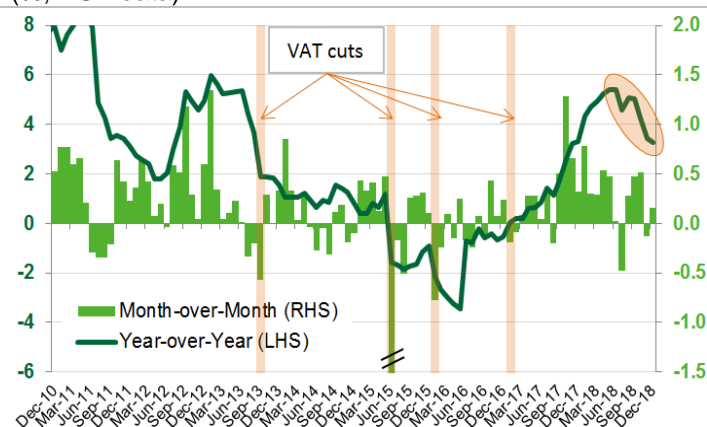
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- We think that the effect of capped energy prices, lower VAT, and probably softer economic growth will be, at least in part, offset by other factors. Higher excise duties on tobacco, fuel, and alcohol may add 0.3 pps to headline inflation and some secondary impacts from extra taxes in the telecom sector can be expected as well. Meanwhile, further minimum and public wage hikes as well as another pension increase will support consumption and maintain cost pressures from wages. We also expect a somewhat weaker than previously thought leu in 2019.
- Regarding our still benign, near 3% inflation projection for this year, it is important to note that uncertainties are particularly high due to the complex side effects, and still pending questions about the government's latest measures and the fiscal frame (the 2019 draft budget has not been approved yet).
- In recent weeks, the uncertainties around the monetary policy outlook rose too. In our baseline scenario for inflation, we do not see pressure to rapidly hike rates, but over the medium term a modest increase of interest rates still may be needed to keep inflation well anchored to the target. It is important to note as well that Romania's consumption-led growth model, looming risks on the external front, coupled with the country's relatively high twin deficit, may make the economy vulnerable. However, the latest news about the special bank tax (the ROBOR-linked levy on assets may be four times higher than previously thought) makes the NBR's duty very difficult, as interest rate hikes would trigger important financial stability questions, particularly if external or unexpected inflationary shocks appear.

Chart set:

Chart 1: Headline inflation

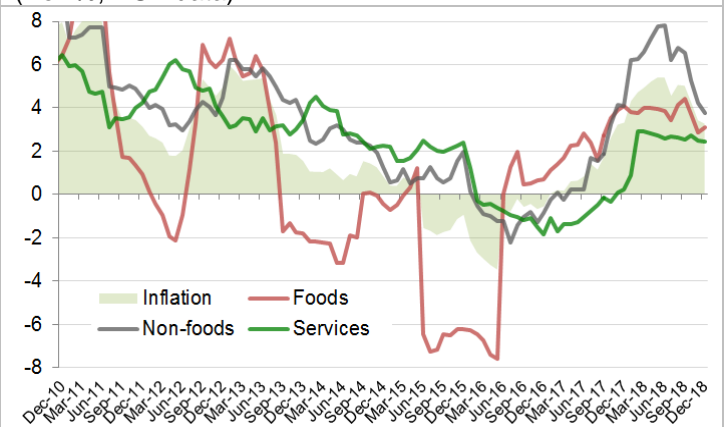
(%, NSA data)



Sources: NIS, OTP Research

Chart 2: Inflation by its main components

(YoY%, NSA data)

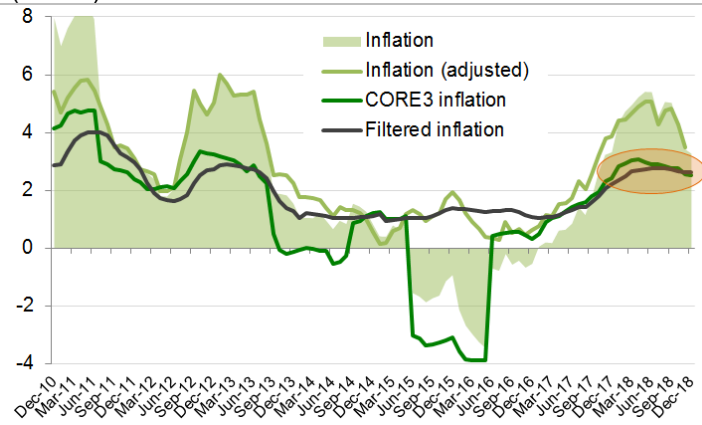


Sources: NIS, OTP Research

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

Chart 3: Inflation and underlying processes

(YoY%)

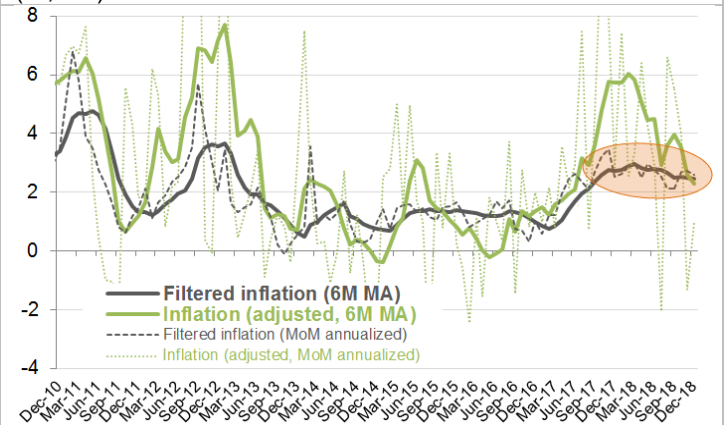


Sources: NIS, OTP Research

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

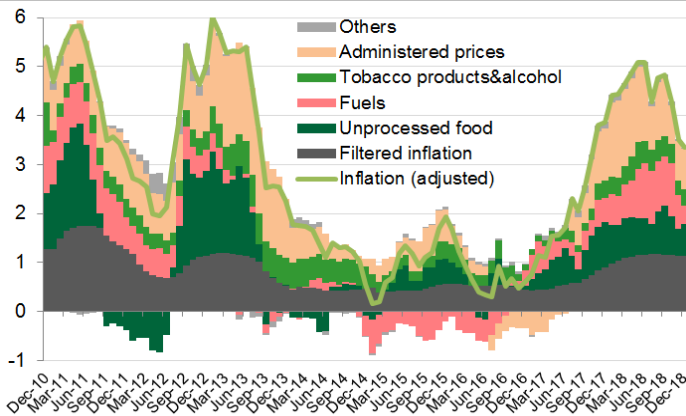
(%, SA)



Sources: NIS, OTP Research

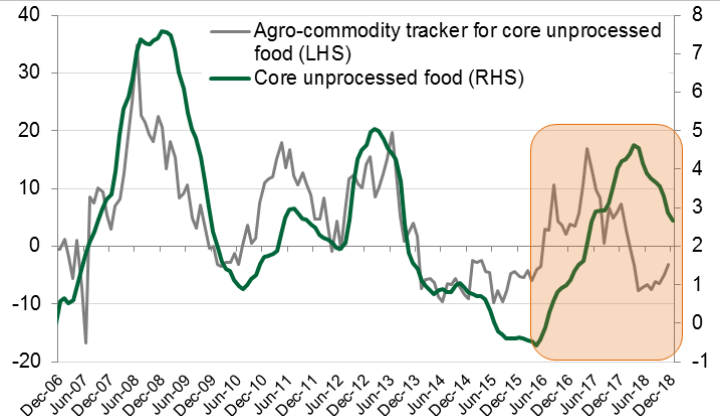
Note: adjusted by the impact of main tax changes; 6M MA = six-month moving average.

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



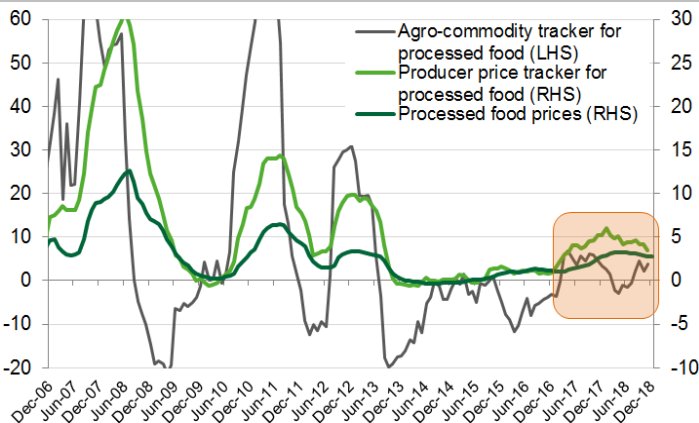
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

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



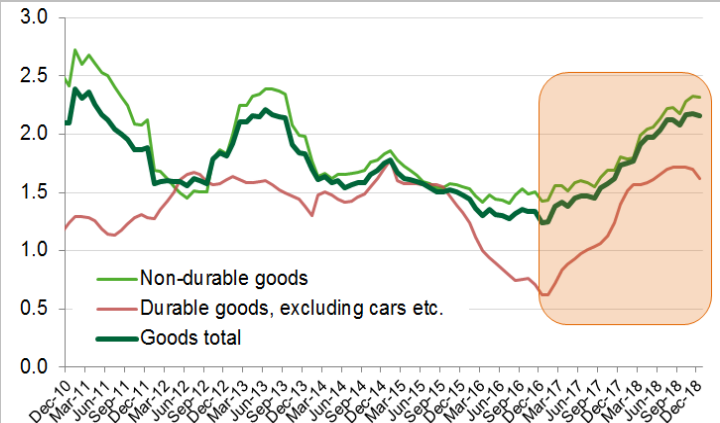
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

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



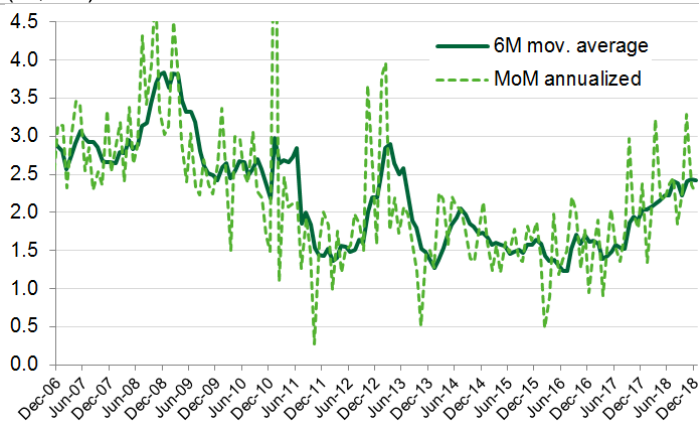
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

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



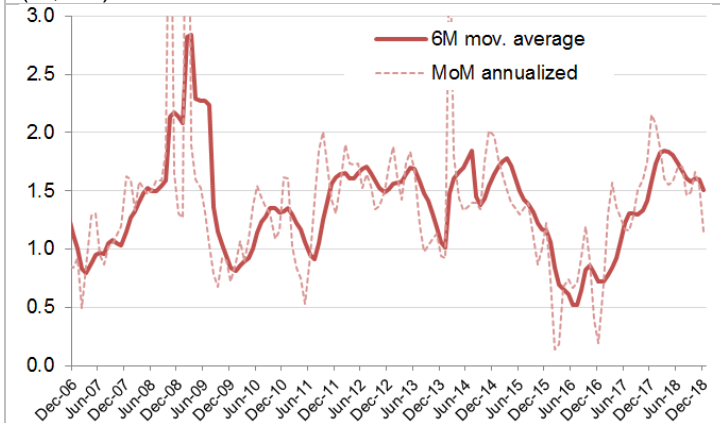
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 9: Non-durable goods (% SA)



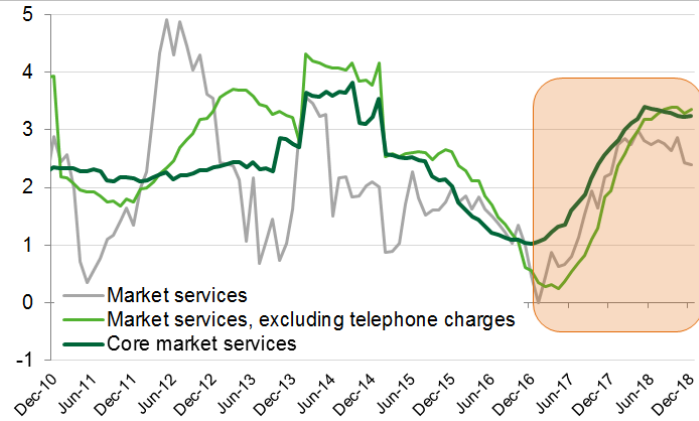
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 10: Durable goods (% SA)



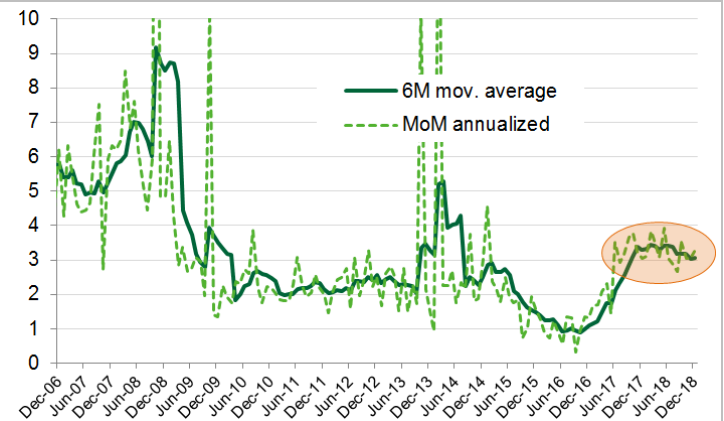
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

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.

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