

REPORT ON INFLATION

15 January 2018

December inflation indicators still point to acceleration, albeit less sharply than in recent months; more tightening should come in the quarters ahead

- Romania's headline inflation ended last year at 3.3% YoY, mildly increasing from November's 3.2% YoY figure, and exceeding by a wide margin the level recorded in December 2016 (-0.5% YoY). In month-over-month comparison, the consumer price index increased by 0.3% (see Chart 1). After a series of significant positive surprises, December's data matched market expectations and our call (both at 3.3% YoY). Excluding the effect of last year's VAT reduction, the changes in the fuel excise duty, and the scrapping of radio&TV fees, consumer prices would have risen by 3.9% YoY, according to our in-house estimation (Chart 3). That is, it would have stood outside the variation band of the NBR's target (2.5% +/- 1%). The underlying CPI indicators continued to climb higher in December, with *filtered inflation*¹, our preferred measure, reaching 2.2% YoY, up from 2.1% YoY a month earlier.
- We [reiterate](#) that the headline inflation stood at extra-low level for a quite long period, after being dragged down by weak import prices and a series of tax reductions. But the CPI sharply rebounded last year, and may continue to increase for months, fuelled by fundamental (see Charts 5 to 8) and one-off factors. Given this context and also due to overheating worries, Romania's central bank launched the monetary policy normalisation cycle earlier than most of its key peers.
- The acceleration of the headline inflation was quite broad-based in the past few months and the main components of the consumer basket remained in positive territory in December too (Chart 9). Fuel prices rose slightly faster than we had expected (Chart 10), but this modest deviation has no noticeable impact on the outlook. Fuel data are often characterized by smaller or larger swings. In addition, the latest hikes of the fuel excise duty also caused uncertainties. We usually filter out the first-round impact of one-off items, but it cannot be excluded that, in certain cases, some upside pressure still lingers in the figures. These late pass-through effects are difficult to identify precisely.
- Last month's 0.1 pp pick-up in the headline figure was supported primarily by food prices, even though they surprised us slightly on the downside. Processed food inflation grew to 2.7% YoY, up from 2.6% YoY a month earlier and 2.2% in October (Chart 11). Meanwhile, the annual growth rate of core unprocessed CPI, which cover meat, dairy, and milling products, increased to 4.2% last month, after 4.0% in November and 3.5% in October (Chart 12). At the same time, eggs inflation was practically unchanged compared to the level seen a month earlier (43% YoY), when the effect of the fipronil scandal had spilled over into Romania. Overall, we interpret December's softer increase in food inflation as a sign of losing momentum. We [recall](#) that the price pressure coming from agro-commodities is rather soft (see our tracker indicators in Charts 11&12) and owing to last year's abundant harvest, it could remain low as well. Therefore we continue to believe that food inflation is set to stabilise and may even ease in the following period.
- Admittedly, goods inflation was still low in December, but it continued to march higher quite rapidly (Charts 13&14). Moreover, the advance was definitely broad-based, with almost all components gathering momentum. On top of this, the depreciation of the leu also added reasons to raise prices, as a large share of durable and non-durable goods is imported, translating into higher costs to merchants. The general picture was very similar in the case of market services inflation (Charts 15&16). On the back of the strong domestic demand, rallying price expectations and swiftly rising unit labour costs, services became more expensive again. These developments are set to urge the NBR to continue its tightening cycle.

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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- Regarding the short-term outlook, we think that the headline inflation will break above 4% in the months ahead, propelled by important base effects (at the beginning of 2017, the government reduced the standard VAT rate by one percentage point and eliminated radio&TV fees; the impact of these one-off measures will drop out from the base) as well as by a significant increase in natural gas prices. We also expect consumer price inflation to peak a touch under 5% in mid-2018 and could finish the year at 3.2%, slightly below the upper bound of the NBR's target (2.5% +/- 1%).
- In line with our [earlier](#) expectations, we see the NBR's policy rate to end this year at 2.75%, but with a higher chance of frontloading the rate hikes, among others owing to the particular shape of the headline inflation and strengthening underlying pressures. Now we think that the next increase could come a bit earlier, on 7 February. This would allow the NBR to send a firm message before January's skyrocketing inflation figures see the light of day, with the risk of negative spill-over effects on the already soaring price expectations of economic agents (Chart 8). We think that a long-lasting and major slippage from the inflation target can be avoided (as reflected by our 3.2% year-end projection), but it requires the central bank to effectively manage the normalisation process, balancing between the combination of price expectations together with overheating worries, and the rising burden of borrowing costs on households and companies.

Chart set:

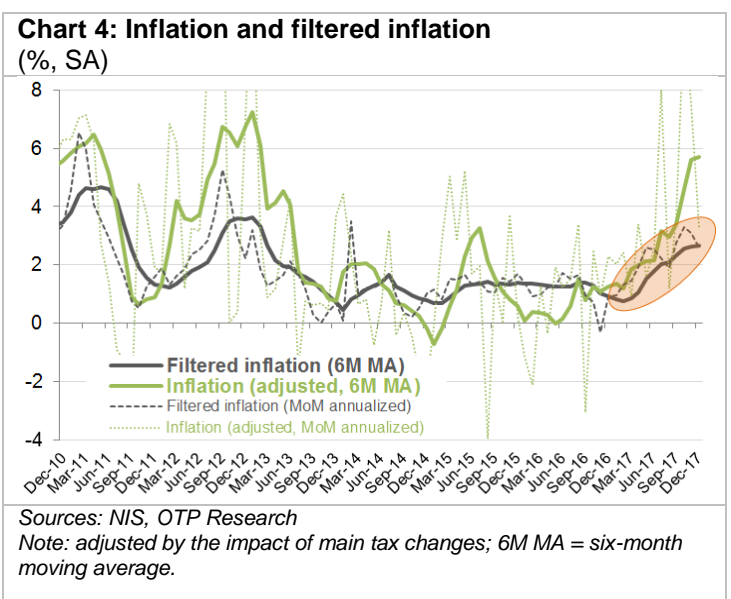
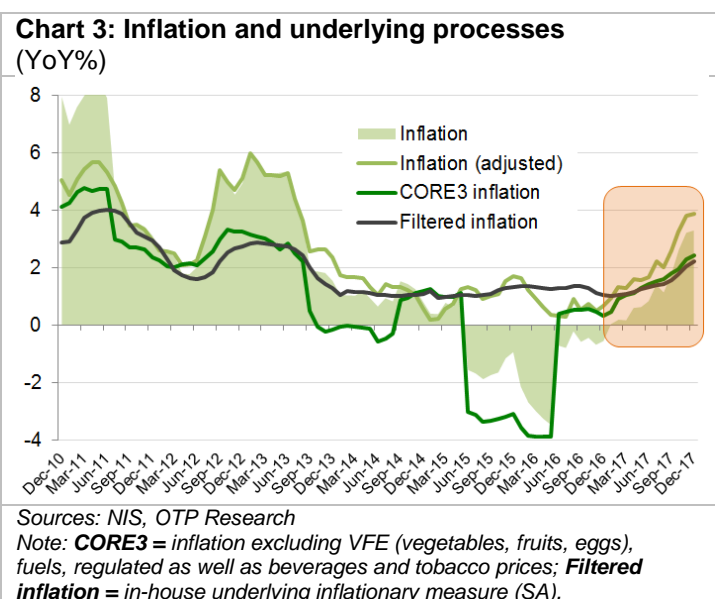
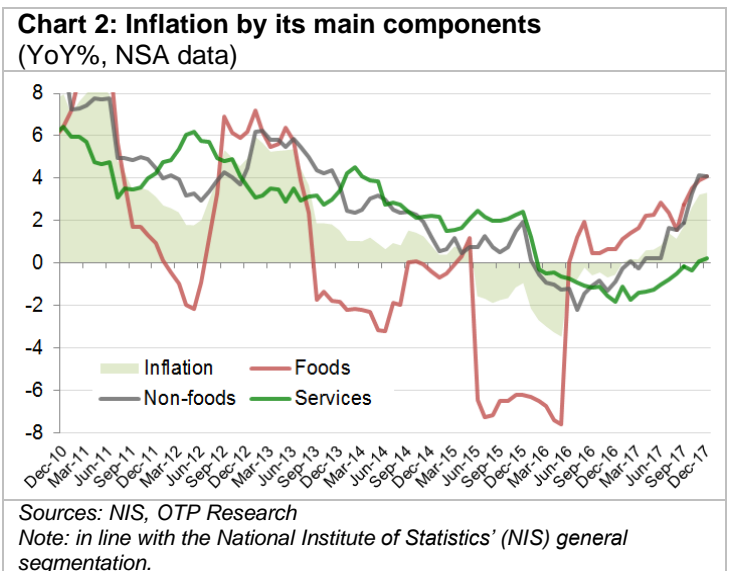
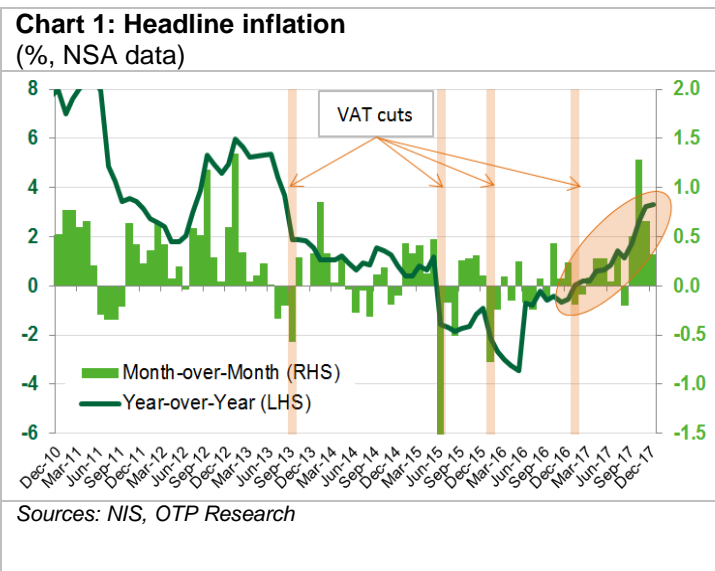
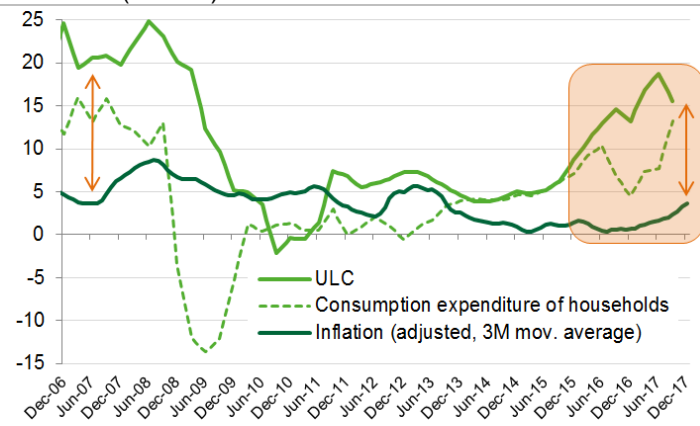
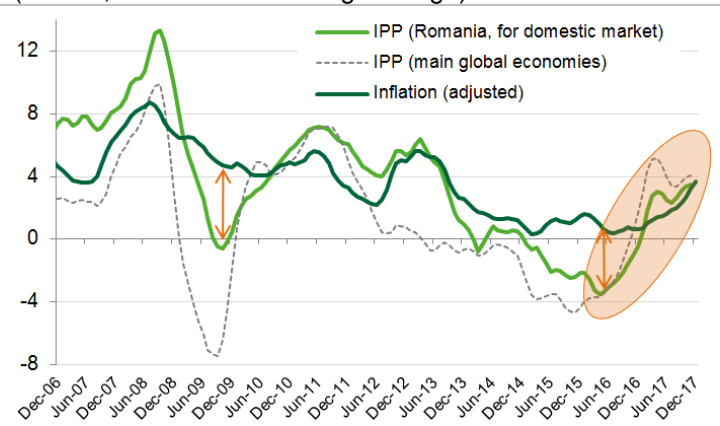


Chart 5: ULC and households' consumption vs. inflation (YoY %)



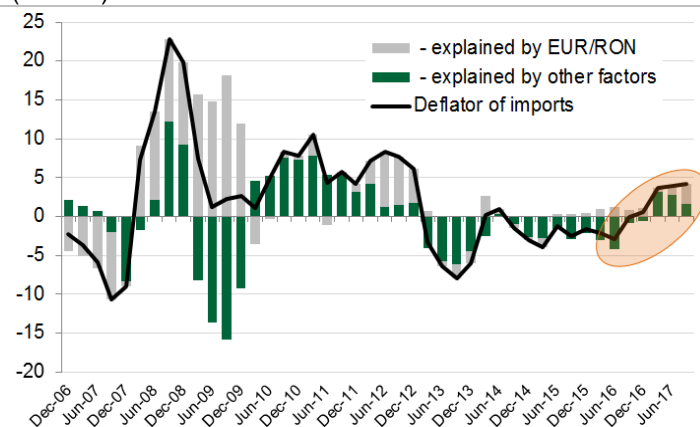
Sources: Eurostat, NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 6: Industrial production prices vs. inflation (YoY %, three-month moving average)



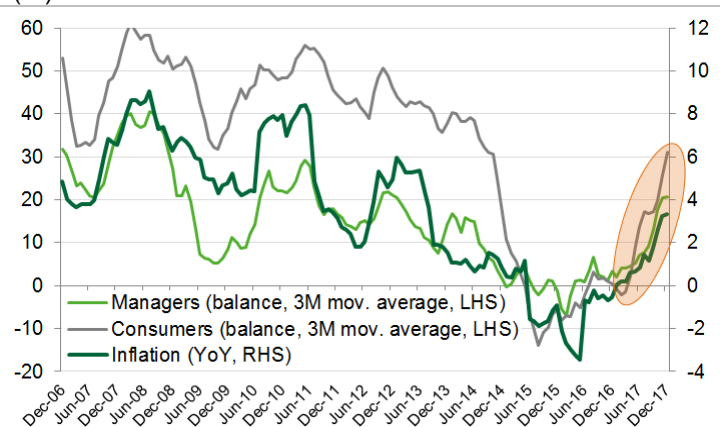
Sources: NIS, OECD, NBSC, OTP Research
Note: adjusted by the impact of main tax changes; the IPP (main global economies) includes data from EU28, USA and China

Chart 7: Decomposition of imports' deflator (YoY %)



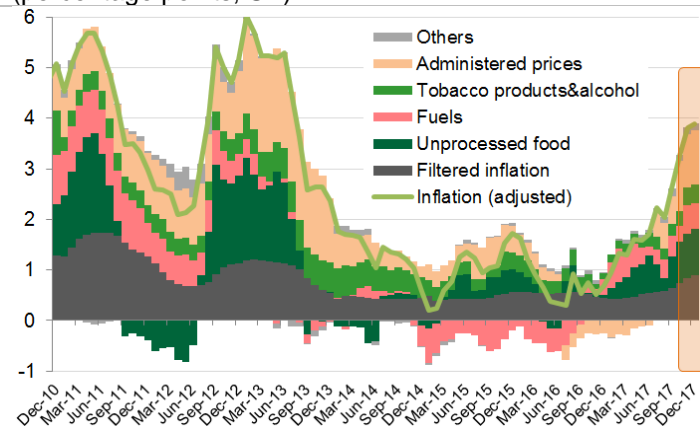
Sources: NBR, NIS, OTP Research

Chart 8: Price expectations vs. inflation (%)



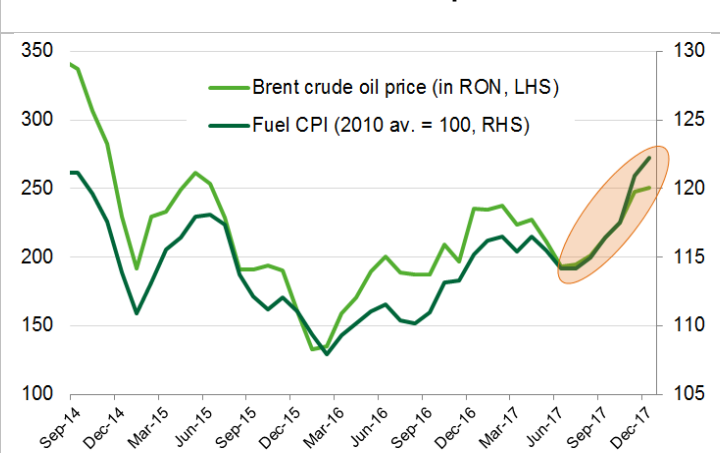
Sources: EC, NIS, OTP Research

Chart 9: Decomposition of inflation (percentage points, SA)



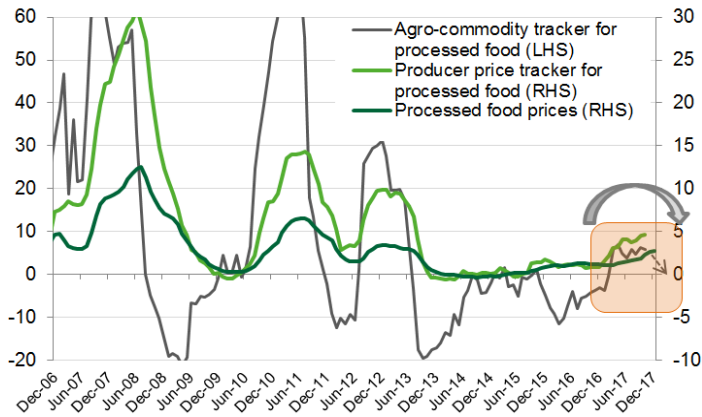
Sources: NIS, OTP Research
Note: adjusted by the impact of main tax changes.

Chart 10: CPI of fuels vs. Brent oil prices



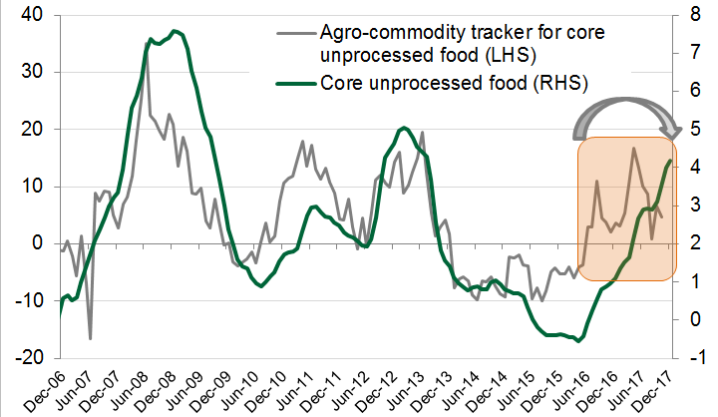
Sources: NIS, Reuters, OTP Research
Note: Fuel CPI is adjusted by the impact of main tax changes.

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



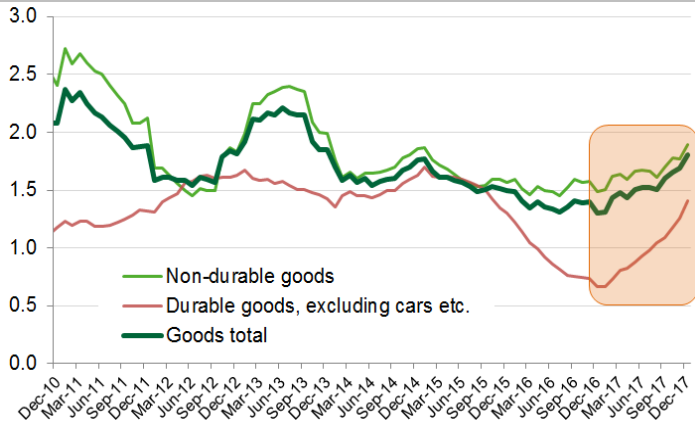
Sources: NIS, OTP Research
 Note: adjusted by the impact of main tax changes.

Chart 12: CPI of core unprocessed foods vs. agro-commodity prices (YoY%, SA)



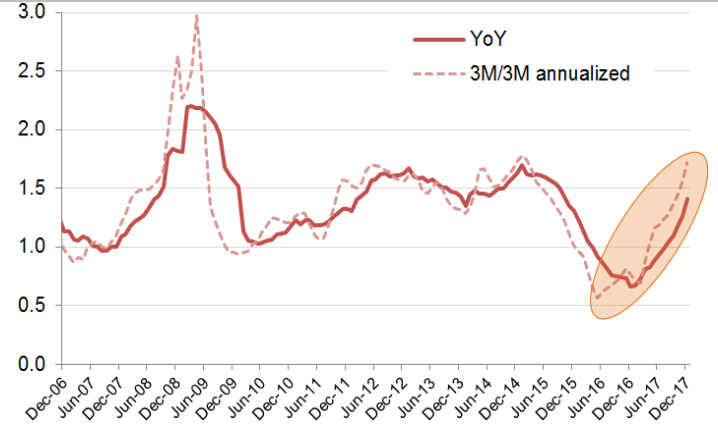
Sources: NIS, OTP Research
 Note: adjusted by the impact of main tax changes.

Chart 13: Goods' inflation (YoY%, SA)



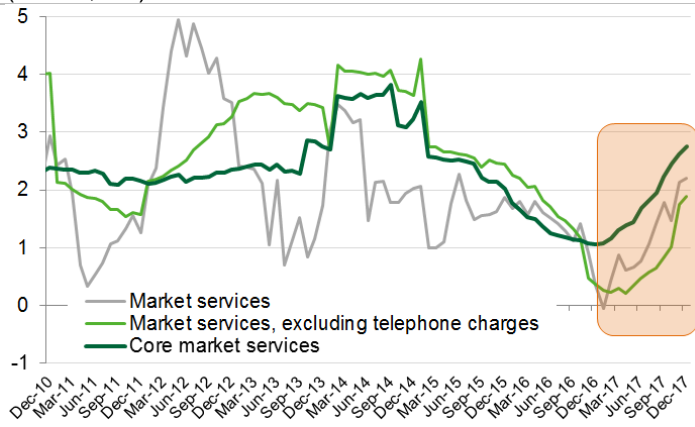
Sources: NIS, OTP Research
 Note: adjusted by the impact of main tax changes.

Chart 14: Durable goods, excluding cars etc. (% SA)



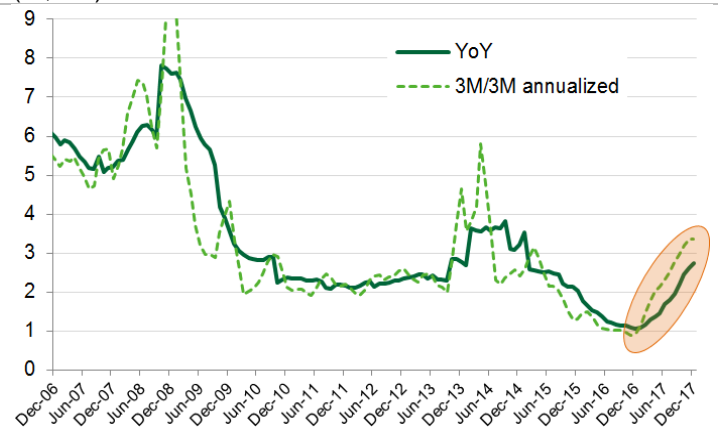
Sources: NIS, OTP Research
 Note: adjusted by the impact of main tax changes.

Chart 15: Market services (YoY%, SA)



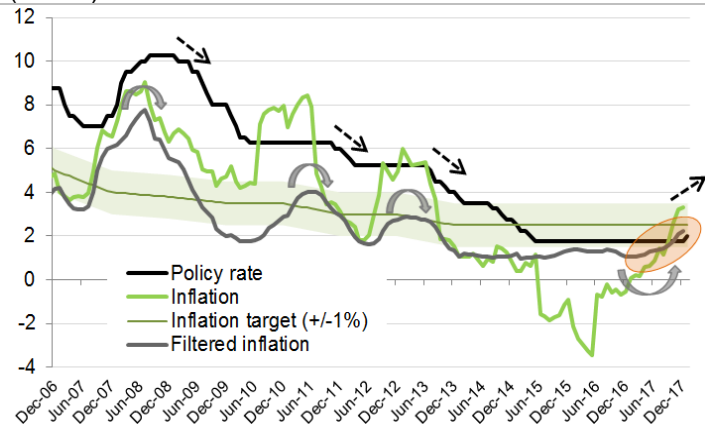
Sources: NIS, OTP Research
 Note: adjusted by the impact of main tax changes; **Core market services**, excludes the EUR/RON-related telephone charges as well as insurances

Chart 16: 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.

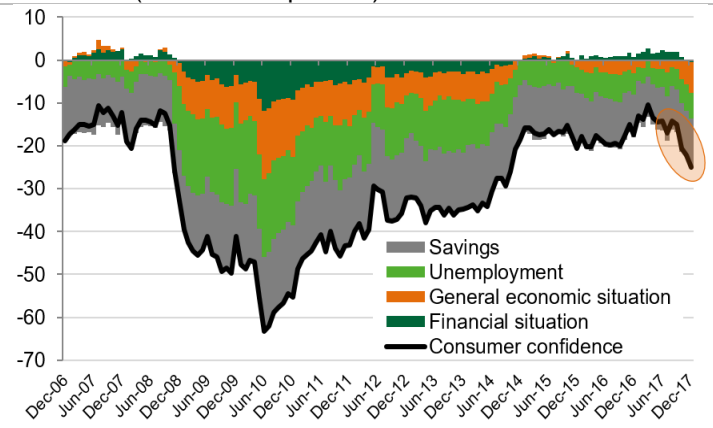
Chart 17: Inflation vs. NBR's inflation target (YoY%)



Sources: NIS, OTP Research

Note: **Filtered inflation** = in-house underlying inflationary measure (SA).

Chart 18: Decomposition of consumer confidence indicator (balance of opinions)



Sources: EC, OTP Research

Note: the components of the consumer confidence indicator reflects the expectation of households over the next 12 months

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