National Bank of Romania Preview: Caution continues to be our base case

We expect the National Bank of Romania (NBR) to keep the policy rate at 6.75% at its 7 August meeting. However, the Bank's updated inflation forecasts are likely to edge lower, hence another 25bp rate cut will very likely be on the table as well. We believe that prudence will prevail and that the next cut will come together with the November Inflation Report

The Romanian National Bank in Bucharest

We find credible arguments for both keeping rates on hold and cutting for a second consecutive time. At the margin, we favour the former – that the NBR will hold rates where they are.

Reasons to hold:

- Inflation has come visibly lower, but services inflation is still high and wage growth does not show signs of slowing down.
- The recent signs of moderation in consumption are yet to prove themselves and lending activity continues to remain quite strong.
- July's projected pick-up in inflation is set to offset some of the recent disinflation gains.

- There is still uncertainty regarding the extent of policy easing in core markets, while in the region, the latest developments in Poland point to delays in policy easing towards next year. Right now, Romania's effective rate (the deposit facility) equals Poland's 5.75% key rate.
- Inflationary pressures and uncertainties remain, and the central bank wants to manage these without compromising the progress achieved so far. As per NBR Governor Mugur Isărescu's words, the worst-case scenario would be one in which the central bank begins cutting rates and is subsequently forced to raise them again.
- The more recent escalation in the Middle East and the potential impact on capital flight and oil prices are clearly also on the radar.
- The markets themselves did not seem to fully buy the previous rate cut. While the front end of the curve naturally followed the deposit facility, the longer end remained largely unchanged and only later started to edge lower, more in correlation with the core and regional markets.
- Fiscal slippage at mid-year was confirmed at 3.6% of GDP and the 5.0% official target is largely irrelevant now. We think that fiscal policy generally is an important constraint for lower interest rates over the short to medium term.

Reasons to cut:

- The policy space to cut would still be there – the depo rate is at 5.75%, while inflation is unlikely to go above 5.5% in July, with deceleration prospects from there onwards.
- Linking more cuts in a row as intermediary steps towards a defined policy stance might show an increased degree of confidence in the medium-term inflation prospects and a somewhat higher degree of policy consistency.
- Reaching a vantage point after two cuts from where the Bank could reassess the situation could still look manageable for policymakers, despite the risks.
- While domestic demand still has fairly strong prospects on the back of wage growth and public investment, the outlook for external demand is much less rosy, presenting downside risks to activity.
- Although not likely, should a policy firming be needed at a later stage, the NBR still has the liquidity management option, i.e. draining liquidity and raising market rates without changing the policy rate.

In conclusion, despite the door being open for an August rate cut, we maintain our view that the Bank will proceed with caution before easing policy again. This is not a usual easing cycle and we think that policymakers will still want to see more consistency between wage growth, internal demand, and the inflation target beforehand. More broadly, from a policymaking perspective, this type of economic cycle looks more consistent with acting on a window of opportunity in a data-dependent manner rather than engaging in a textbook easing cycle, which likely means more or longer interruptions in cutting rates along the way. More clarity on geopolitics and the easing cycle prospects of the Federal Reserve, the European Central Bank, and the National Bank of Poland would likely be welcomed by local policymakers as well.

We continue to see the end-year key rate at 6.50%, with the November meeting still the best candidate for another 25bp rate cut. Should a rate cut come next week, then our base case will likely be flat rates until 2025. In general, our view towards a more delayed ease in policy rests on our medium-term inflation projections which should continue to hover above target through the forecasting horizon.

What to expect in the fixed income space

Romanian government bonds (ROMGBs) are continuing to underperform Central and Eastern European peers in the second half of the year. The combination of an NBR rate cut and the global rally has helped somewhat and ROMGBs yields have fallen a bit. However, despite the start of the rate-cutting cycle, the focus is more on fiscal policy, which is not making life easy for ROMGBs. Assuming a 7% GDP fiscal deficit for this year, we estimate that MinFin has covered roughly 55% of ROMGB issuance. Although MinFin will try to tap other sources as much as possible (FX and retail issuance), we know that ROMGB issuance for the rest of the year will still be strong and MinFin will take advantage of any market demand. Market demand, on the other hand, is weaker compared to CEE peers and further negative fiscal headlines may be a problem for the market to absorb. At the same time, on the monetary policy side, we see the market pricing in roughly even odds for a rate cut in August and more rate cuts later, limiting a further ROMGB rally due to monetary easing. The main advantage of ROMGBs is thus attractive valuations with spreads widening against CEE peers. We remain rather negative here until we see more progress on the fiscal side on planned consolidation. At the same time, we expect some steepening of the curve again with an anchored front-end thanks to the NBR rate cut outlook and the high supply of ROMGBs.

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