NBR preview: An incoming pivot to a cautious easing cycle

While the latest disinflation developments bring some justification for the National Bank of Romania to cut rates at its meeting on Friday, we narrowly expect policymakers to proceed with caution once again. Robust consumption, wage growth and services inflation remain problematic. Two 25bp cuts in August and November are our base scenario

The Romanian National Bank in Bucharest

At face value, the National Bank of Romania would have the policy space to cut as early as this Friday. Headline inflation decelerated to 5.1% in May and could dip below 5.0% in June, while the de facto policy rate (the deposit rate) sits at 6.00%. Cutting down on restrictiveness is certainly on the table. However, as we have emphasised here, the asymmetric positive developments across the inflation basket are likely to remain a discomfort for policymakers.

Indeed, food inflation is now quite well-behaved and back within target. But services and non-food inflation are far from there, and they arguably matter more for the NBR right now. While the central bank clearly welcomes the positive developments on the food inflation front, they are nevertheless more of an outcome stemming from international markets. As such, the NBR is unlikely to celebrate too much given that non-food and services inflation – which are much more closely intertwined with local demand dynamics – remain at levels inconsistent with the target.

All of this also happens at a stage when credit activity is blossoming, real wages continue to grow strongly and the fiscal slippage persists. On top of this, external developments also predominantly go against a rate cut, with the Federal Reserve pushing its easing more and more towards year-end, the European Central Bank not offering much guidance after its June cut and regionally, Poland and Hungary's central banks signalling no more cuts this year.

We think that August is a better option for the NBR to start cutting. Sure, one month will not substantially change the non-food and services inflation picture. But with one more confirmation that they're at least headed in the right direction, coupled with an opportunity to communicate this key policy decision in tandem with fresh forecasts in a new Inflation Report, there looks to be a stronger case for August than July. However, we still think that the probability of a cut on 5 July is relevant at around 30%.

> Ultimately, the most important element here in our view is less about the first cut itself and more about type of easing cycle we have ahead of us. The NBR can't deliver more than a cautious easing cycle as long as structural factors related to internal demand keep inflationary pressures sticky across most of the consumer basket. So while policymakers deciding to become a bit less restrictive in July or in August remains relevant, we think it's of secondary importance. The longer term fine-tuning of the easing cycle is the real challenge, especially as our view is that inflation will remain above the upper range of the inflation target in the vicinity of 4.0% throughout the forecast horizon.

Romanian government bonds (ROMGBs) remain a complicated story despite NBR rate cuts looming. On the supply side, we estimate that the Ministry of Finance has covered about 51% of the issuance, assuming a public deficit of 6.5% of GDP. This alone seems like sufficient progress. On the other hand, demand has gradually declined since the beginning of the year and bid-to-cover is around 1.3, the lowest among CEE peers after POLGBs. Moreover, fiscal risk remains here, which could further increase ROMGBs issuance by the end of the year.

On the demand side, we see ROMGBs breaking away from the region and trading separately with a much lower beta to core markets. 10-year yields have gradually moved up from January lows of 6.20% to the current 6.85-6.90%, usually underperforming against its CEE peers. At the same time, the region has also lost some gains in recent weeks and valuations are not as attractive for ROMGBs. Especially with the HGBs yield at the same level, we believe market demand will head there.

The only attraction for ROMGBs these days is the upcoming start of the NBR's rate cutting cycle. Looking at FX implieds, the market seems to have shifted in recent weeks and some rate cuts are priced in, limiting gains for ROMGBs. It's still possible that we could see some inflow on the back of the NBR story, but it's likely to be a short-term tactical move. Overall, we can see why a more negative view on ROMGBs could be taken when compared against other CEE peers.

Author

Stefan Posea
Economist, Romania
tiberiu-stefan.posea@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com