

Romania: Inflation strikes back

February CPI came in at 3.8% year-on-year, significantly above the Bloomberg consensus of 3.45%, but in line with our call. Core inflation inched up 0.2 percentage points to 2.7% YoY, similar to our forecast



People on Calea Victoriei, Bucharest

An average monthly depreciation of 0.9% in the Romanian leu passed through to consumer prices in February, directly impacting gasoline prices and phone bills. The former was also impacted by higher oil prices while the latter was affected by rising taxes as well. Prices for cigarettes continued to inch up, with companies gradually passing on a 1 January hike in excise duty. Food inflation accelerated significantly above the historical pattern, spiking to 4.5% year-on-year in February from 3.8% in January. Non-food inflation jumped from 3.3% to 3.7% YoY, while prices for services increased by 3.1% YoY versus 2.7% in the previous month.

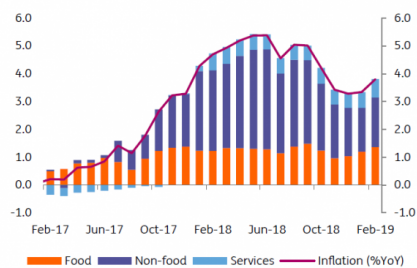
3.8%

Higher than expected

February CPI

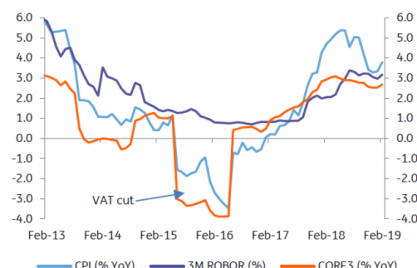
(YoY) in line with ING call

Fig 1 Broad based inflationary pressures



Source: NIS, ING

Fig 2 Core inflation to drive headline higher



Source: NIS, NBR, ING

The latest projections from the National Bank of Romania saw inflation at 3.0% at the end of March and year-end. We expect the central bank to revise its year-end forecast towards our estimate of 3.8%. The NBR's trade-off between reaching its CPI target without affecting external competitiveness didn't go particularly well in 2018. Inflation moved into the target band helped by oil prices but the current account hit 4.7% of GDP, overshooting the medium-term equilibrium level, which is seen at 4%.

With inflationary pressures persisting, economic growth slowing, and NBR policy flexibility on rates still limited by the bank levy level linked to ROBOR (which is yet to be amended), the central bank dilemma is only getting worse. The NBR is likely to accept a weaker leu and short-term inflation overshooting its target, perhaps even at the cost of its credibility, as currency vulnerabilities are on the rise. We see asymmetric risks for the leu's outlook and the chances for a sharper adjustment are on the rise.

We expect the NBR to stay on hold at 2.50% for this year, provided some reasonable amendments to the bank levy are adopted. Market rates are likely to remain significantly higher to discourage positioning against the leu. The current NBR Board is likely to avoid taking unpopular decisions for the rest of its mandate and the new Board, which will take over in October, is unlikely to change anything at the last meeting of this year on 6 November. If anything, the new Board is likely to be even more dovish and open to exploring unconventional policy measures to support growth in targeted economic segments, with Hungary cited as a case study. Due to a totally different current account profile, a dovish stance is likely to burn into FX reserves.