Romania: NBR cites again the need for adequate dosage of its policy

The National Bank of Romania (NBR) Board members unanimously voted to keep the key rate unchanged at 2.50% in the last meeting of 2018

The National Bank of Romania building in Bucharest

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The board members started by noting that despite being on a downward trajectory, headline inflation declined less than expected as the strong disinflationary base effects have been offset to some extent by the rising fuel and vegetable prices. The NBR maintains its year-end inflation forecast at 3.5% for 2018 and revised upward its 2019 forecast from 2.7% to 2.9%.

Regarding the economic activity, the NBR sees “a larger-than-anticipated re-widening of the positive output gap” in the second quarter and a shift in the composition of economic growth drivers as inventories took the lead ahead of household consumption which is “probably relevant from the perspective of inflationary pressures”. For the third quarter, however “a significant deceleration in economic expansion” is expected followed by a mild recovery in the fourth quarter. This should make an already above expectations output gap rise further in the second half.

On the monetary policy front, the minutes noted a “considerable interest rate differential versus the prevailing levels in the EU and across the region” as a reason for the exchange rate stability over the last period. However, the current account widening and “the decrease in its coverage by foreign direct investment and capital transfers” is cited as a concern.

Base effects aside, the NBR expects that “the major contribution” to annual inflation decline to come from supply-side factors. Board members remarked, “the heightened uncertainties” of these price developments, namely oil, administered prices, tobacco and some agri-food commodities which could have been influenced by the African swine fever outbreak.

On the fiscal policy, the central bank’s projections assume “an abatement of the expansionary nature of fiscal policy in 2018” which is expected to remain unchanged in 2019 and only turn “quasi-neutral” in 2020. The fiscal and income policy stance is seen as a source of risks “in the near future at least” together with labour market tightness. The risks are “seen stemming especially from the budget execution features in the first three quarters of 2018”. Other key assumptions under the current forecast refer to a “less accommodative monetary conditions over the projection horizon”, improved EU funds absorption, robust growth in the euro area and globally.

More concerns were raised regarding the negative contribution of the gross fixed capital formation to this year’s GDP, a large contraction in construction works, low EU funds absorption and budget spending composition, falling foreign direct investments and “worsening contribution from net exports to this year’s economic growth”.

Finally, the minutes underline, once more, “the importance of the dosage and pace of adjustment of the monetary policy stance”.

All in all, the dovish and optimistic twist delivered by governor Mugur Isarescu in his latest speech appears tempered by the less optimistic minutes. With the inflation outlook expected to remain in the upper half of the band until the end of the forecast horizon, the risk balance has clearly tilted to the upside and with the need for “anchoring inflation expectations”, we doubt that this is the end of the tightening cycle driven by idiosyncratic factors, though the NBR is likely to delay it for as long as the FX is manageable.

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