Romania: Previous central bank prudence paying off

By not pushing its key rate close to zero, the National Bank of Romania (NBR) has now just a bit more time to act than its regional peers. While risks for rate hikes in 2021 have increased, we still believe the NBR will try to delay such measures until 2022. Inflation will be a headache, but tighter liquidity management should be the initial tool of choice

The National Bank of Romania building in Bucharest

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With its latest revised inflation forecasts visibly outside its target range, it looks like the National Bank of Romania might be the last to join the regional chorus calling for a tighter policy stance. That said, there are other factors to consider.

All CE4 central banks except the NBR have noted with various degrees of conviction that they are considering tightening in 2021 (Czech and Hungary) or mid-2022 at the latest (Poland). But the NBR is not there yet and it might choose to stay behind the curve for longer. Why?

We believe that although the NBR will not remain complacent on rising inflation, the particularities of Romanian inflation will call for a different approach than its regional peers - where “standard” rate hikes are chiefly considered.

1 Core vs headline

Headline inflation is indeed seen by the NBR at 4.1% in Dec-2021, way above the initial 3.4% estimation and the 3.5% upper bound of the 2.5%±1ppt inflation target range. However, core inflation was only modestly revised upwards, by 0.1-0.3ppt for the entire forecast horizon and is generally seen as stable just below 3.0% until the end of 2022

2 Not in my back yard

The spike in headline inflation is repeatedly attributed mainly to “factors outside monetary policy control”, especially energy.

3 More time to buy

We now consider the NBR’s behavior and statements during the pandemic. The Bank has emphasised the need for it to preserve its policy space, and did this. While all the other relevant central banks in the region have slashed their interest rates close to zero, the NBR has kept a relatively generous interest rate differential, stopping the rate cuts at 1.25% despite most market forecasts calling for sub 1% rates. This provides the space for a “wait-and-see” approach now, with inflation at the door. It also reinforces NBR's increasing tendency to "look-through" inflation cycles.

4 What would a rate hike achieve, given the nature of the current inflation spike?

On our view, the main points to consider are:

- Is the economy overheating? Until today, the answer was a simple `no`. The economy should have reached pre-crisis levels some time in late 2Q21/early 3Q21. With today’s GDP numbers, we know that we are already above pre-crisis levels. However, despite posting good numbers, the economic recovery is still fragile as growth sustainability and the outlook remain very much dependent on Covid-19 developments. More significant overheating signals should not be apparent before mid-2022 in our view.
- Is the recovery credit-driven? Here a simple `no` will do. Despite an above-expectations dynamic during 2020, lending growth remains mostly stuck in lower single digits.The traditionally low financial intermediation ratio (24.6% in 2019) improved in 2020 (to 26%) but not entirely for the right reasons. GDP contraction has also played a role.
- The exchange rate effect: the exchange rate pass-through to inflation is notoriously high in Romania (at around 0.2ppt for every 1% depreciation of the leu, though this estimate can vary significantly on numerous factors and assumptions). A rate hike would certainly help to cool depreciation pressures. However, we believe that the NBR is able and ready to maintain the stability of the FX rate without reverting to policy rate hikes (more on our FX views here).

As a result, an eventual rate hike would probably work mainly through the expectations channel, which again - given the nature of the current inflation spike - is probably sub-optimal as a policy choice.

Despite all the above and while not being our base case, a rate hike scenario in 2H21 is definitely not easily dismissible. It will depend of course on inflation itself, but also on the strength of the economic recovery and - not least - the other regional central banks. However, we believe that the NBR has more time to wait than do the other central banks. Its previous policy choices have also shown that the Bank does not hesitate to employ non-transparent tightening as well, usually through its liquidity management strategy. We expect the banking system liquidity to gradually shift towards a neutral or even slightly short liquidity position by the beginning of 3Q21 and repo operations (possibly on a bilateral basis again) to be employed. The relative stability of the EUR/RON rate should also be part of NBR's strategy in its battle against the current inflation bout.

Should the current scenario presented in the latest Inflation Report prove correct - a scenario which we consider realistic - we think that the NBR will not resort to policy rate hikes in 2021. We therefore maintain our view for a relatively modest 50bp rate hike in mid-2022 and a gradual switch to firmer liquidity management until then.

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