More progress on Romanian services inflation needed for NBR to cut confidently

A stronger-than-expected deceleration in price pressures bodes well for purchasing power but the policy implications are not clear-cut. We think that the National Bank of Romania (NBR) needs more progress on the all-important services inflation front to start cutting rates. We revise our 2024 year-end inflation forecast from 4.8% to 4.2%

Romanian inflation decelerated significantly to 5.1% in May from 5.9% in the previous month. Significant positive contributions came from food inflation – which increased by only 1.2% annually, the lowest reading since April '21 and significant progress since May 2023's whopping 18.8%. Flour, vegetables, fresh fruits, eggs and sugar recorded monthly declines, supporting the reading. While price growth of non-food items remains at levels inconsistent with the inflation target (6.4% in May), it nevertheless made a step in the right direction in monthly terms.

The biggest contribution to the positive inflation surprise came again from energy prices, particularly natural gas, which decreased by 7.0% in monthly terms, subtracting 0.3ppt from the

5.1% headline inflation. This came after another 11.0% monthly drop in April, on the back of the government's decision to cap intermediary prices.

Turning to the all-important services inflation, the stickiest component of the basket and the one which arguably matters the most to the NBR right now, further progress is needed given the still high 9.3% annual price increase in May (0.4% month-on-month). Price pressures there have barely entered single digits after 16 months in double digits. Moreover, upward monthly increases are still quite spread out across the basket, feeding into the NBR's discomfort, especially when wage growth is still in double digits. Core services inflation made some progress but it's yet to prove that it escaped the stickiness pressures.

On the outlook, we are now revising down our 2024 year-end forecast from 4.8% to 4.2% as the downside impact from the energy prices can't be ignored. That said, what brought down inflation meaningfully in the past two releases were rather one-off elements, likely not the ones NBR wants to see. As the structural pressures remain, stemming from services and non-food items (other than fuel), we don't think that there is room for inflation to decelerate much more next year, especially given the largely anticipated tax hikes upcoming in 2025. Other factors such as wages, the budget deficit and lending activity continue to point towards limited room for NBR policy easing in 2024 and 2025.

Concerning the upcoming monetary policy decisions, the NBR will likely acknowledge the current progress but still keep an eye on more structural domestic and external developments. The room for rate cuts has increased with this release, though, and we are now more confident in our August and November rate cut call. We are not excluding the first one to come in July, but we place a significantly smaller probability on it. Today's conclusion might be that while upside risks for rates have diminished, we continue to think that policymakers can deliver only a very cautious easing cycle ahead.

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