Santa arrives early at Romania’s central bank

Inflation slowed down to 3.4% year-on-year, entering the National bank of Romania's target band earlier than expected. Assuming stable oil prices, we expect headline CPI to continue to drop in the coming months ahead reaching a low of around 2.6% YoY in May

The National Bank of Romania building in Bucharest

Source: Shutterstock

CPI surprise: volatile food prices

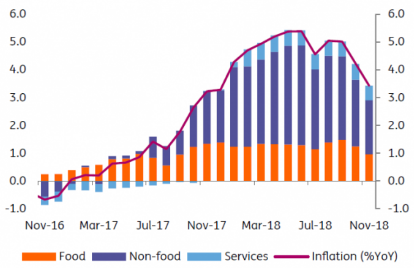
Inflation slowed down to 3.4% year on year entering central bank's target band earlier than expected, after a -0.1% month-on-month drop in November. This is considerably lower than the Bloomberg consensus and ING estimate of 3.7% and 3.6% respectively.

CPI coming back into National Bank of Romania's target band was pre-announced yesterday by the deputy governor Liviu Voinea. The forecast error from our side came almost exclusively from volatile fresh fruit and vegetable prices. Food inflation decelerated from 3.7% YoY in October to 2.9% on the back of large statistical base effects and after a 0.3% month-on-month decline in November.

Inflation for non-food items also dropped sharply from 5.3% in the previous month to 4.2% YoY in

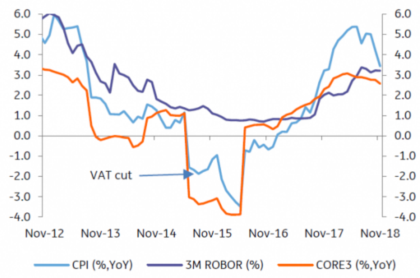
November, with oil prices an important factor. CPI for services declined by 0.2ppt to 2.5% YoY. Core inflation also declined by 0.2ppt to 2.6% YoY, which looks in line with the central bank's projection, but slightly lower than our estimates.

Fig 1 Broad based disinflation



Source: NIS, ING

Fig 2 Core inflation below the market interest rates



Source: NIS, NBR, ING

We expect headline CPI to continue to drop in the coming months, reaching a low of around 2.6% YoY in May, assuming stable oil prices.

We see core inflation near its bottom, and after a c.0.1ppt decline in December, we expect it to reverse its declining trend. We forecast headline inflation at 3.4% YoY for 2019, with core inflation slightly overshooting the central bank's target band of 1.5-3.5%.

On the other hand, the structure of GDP growth for the first three quarters of 2018 looks weak and suggests downside price pressure ahead if inventories come into the market. Inventories contributed 3.0ppt to the 4.2% YoY GDP growth for January-September and 3.3ppt to the 4.3% YoY growth in 3Q18.

Implications for policy: Hikes unlikely in 1H19, unless RON comes under pressure

The central bank's focus on the target band rather than the mid-point could lead to anchoring inflation expectations near the upper end of the range as the central bank suggested it is willing to accept slightly higher CPI as the convergence process comes with the Balassa-Samuelson effect.

The NBR seems comfortable with what it has done so far, and it is likely to link any further rate hikes to policy changes by the ECB and in the CEE region - think Poland. Given our outlook for the ECB, we see two rate hikes by Romania's central bank in 2H19, as markets are unlikely to see a linear adjustment as enough given the country risk profile.

The FX outlook remains the biggest uncertainty, and its pass-through to CPI is the highest in the CEE space.

Romania stands out in the region due to its divergent twin deficits accompanied by counterintuitive relative currency outperformance

For now, the NBR has struck some balance between carry and fundamentals, but the relations between the two variables is time-varying.

The central bank anticipates real broad monetary conditions “to diminish their stimulative influence over the projection interval” with this path “mainly shaped by the real effective exchange rate developments”. Hence, it does not see nominal depreciation beyond the inflation differential. Our view on the currency outlook versus fundamentals is a bit different. But, as always, a trigger is needed. With an election calendar ahead, the market will keep a close eye on fiscal and political developments.

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