

## Romania

# Monetary Policy Insights

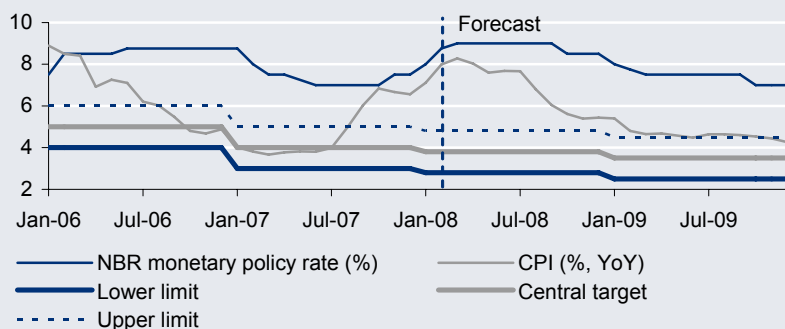
## No such thing as a free lunch

**We expect the NBR to hike by 75bp to 8.75% on 4 February. Still, even a hike of 100bp is highly possible because of the brisk exchange rate depreciation and the outlook downgrade by Fitch to negative from stable.**

The monetary policy stance loosened even after the 50bp hike on 7 January, so the NBR Board will be re-assessing the necessary measures to restore some monetary policy restrictiveness. The message policymakers send to the public will be very important after inflation missed the 2007 target and already looks unlikely to reach this year's target. Other topics could include:

- How to deal with eventual second-round effects stemming from the impact of supply-side shocks on inflation expectations.
- How high might the EUR/RON exchange rate go and is the NBR capable of stopping it through eventual FX interventions and without significant rate hikes.
- The increasing inflationary pressures at the global level, against a background of loose fiscal and wage policies in an election year.

**Fig 1 Inflation, inflation target and key rate**



Source: NBR, NIS and ING estimates

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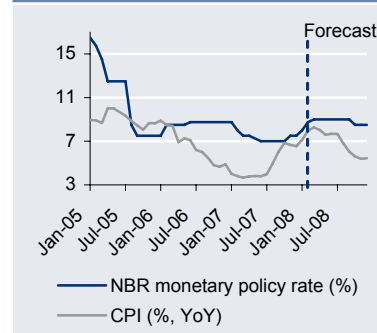
1 February 2008

### Headline inflation versus CORE

	1Q07	2Q07	3Q07	4Q07
CPI inflation	3.66	3.80	6.03	6.56
CORE1	2.48	2.32	5.51	7.01
CORE2	4.37	3.46	4.60	5.81
CORE3	2.82	2.65	4.17	5.45

Source: NIS, ING estimates

### Inflation and key policy rate



Source: NBR and ING estimates

### NBR policy instruments (%)

	End-2007	Now
NBR key policy rate	7.50	8.00
Avg 3-mth int rate	7.90	8.40
Deposit facility rate	2	2
Credit facility rate	12	12
MRR RON	20	20
MRR FX	40	40

Source: NBR

## No such thing as a free lunch

***The NBR missed 2007 inflation target and, most likely, will also miss the 2008 target***

Headline inflation came in at 6.6% YoY, significantly overshooting even the upper limit of the tolerance band (3-5%) around the NBR's central target. The central bank has missed the inflation target for the second time in three years and its credibility would be strongly affected by another failure to meet the target at the end of 2008, even though the NBR's eventual appeal to escape clauses would be justified for the 2007 inflation target. The justification for missing the inflation target could come from the fact that a considerable part of the increase was caused by supply-side factors (higher food and oil prices). Nevertheless, the exchange rate depreciation and persistent excess demand also drove up prices. The central bank should remain worried as the CORE3 measure of inflation climbed further reaching 5.5% YoY at year-end. Moreover, recent data support our view that inflationary pressures coming from excess demand should not be ignored, alongside supply-side shocks.

***Hikes above 9% would be required to stop RON depreciation and to bring inflation inside the target band***

Considerable hikes in the key policy rate (significantly above 9%) would be required to stop RON depreciation and to bring inflation inside the tolerance band before end-2008. That would imply accepting a fast and strong appreciation of the domestic currency (as the exchange rate channel is the most effective channel of the monetary policy transmission mechanism). However, the NBR expressed concerns about the unsustainable levels the exchange rate reached during the summer and we think it is very unlikely it will force the currency to appreciate since the external imbalances have not been tackled. Consequently, we do not see the NBR embarking on a strong exchange rate policy. As such, there is a high probability that the year-end inflation target will be missed once again.

***The new Inflation Report will probably show a higher deviation from the target***

Actually, we expect that the new Inflation Report, which should be published after the rate-setting meeting, will show inflation outside the target band. We base this conclusion on our inflation forecast which is above the upper limit of the target band and on a recent statement from Governor Isarescu saying that the NBR "hopes to bring inflation inside the tolerance band at the end of 2008 or at the beginning of 2009".

***At the moment it is preferable to have EUR/RON above the equilibrium level***

We think that it is preferable at this moment for the Romanian economy to have a EUR/RON exchange rate above the equilibrium level as it is required to correct the external imbalance. However, the same depreciated exchange rate puts upward pressure on inflation and also makes the current monetary policy stance loose.

***The dilemma faced by the NBR is quite complex***

The dilemma that the NBR faces is quite complex, as a decision to hike rates to a level consistent with bringing inflation in line with the target could have some undesired effects. One of them is a re-orientation of economic agents towards foreign-currency denominated loans, as the exchange rate would re-embark on an appreciation trend (because only an appreciating RON could help contain inflation). Another is related to the implications of nominal exchange rate appreciation at a speed exceeding that consistent with fundamentals. This would reignite the NBR's worries about a possible future reversal of the exchange rate's trend and the impact on future inflation. Recent experience proves that such a reversal would strongly impact inflation. Moreover, an appreciating exchange rate would lead to a pronounced widening of the C/A deficit (above our current forecast of 15.1% of GDP for 2008).

There are two ways through which rising imbalances could be corrected. The first and the hardest for the Romanian economy could be brought by market forces. A painful adjustment of the C/A deficit would lead to a significant depreciation of the exchange rate and a hard landing for the economy. The other way is by an appropriate mix of

economic policies: monetary, fiscal and wage policies. However, the second solution is hard to imagine in an election year. The most likely scenario is, consequently, the adoption of certain measures by the NBR that will not solve the fundamental issues, but will, likely, allow a soft landing. This is partly understandable as, usually, every central bank tries to avoid inducing shocks into the economy, but it comes at the high cost of increased uncertainty regarding future the development of the Romanian economy. This uncertainty mainly translates into a volatile exchange rate and volatile inflation.

### **‘Hawks’ – reasons for a rate hike**

- All core measures of inflation (including CORE3) jumped above the upper limit of the 2007 inflation target in December and, more worrying, the outlook is gloomy. We see CORE2 at 5.2% in December 2008. Moreover, we expect the NBR to significantly revise its end-2008 inflation forecast upwards, currently at 4.3% (above the 3.8% target), as our forecast (5.4%) is above the upper limit of the tolerance band.
- Higher inflation throughout the world and especially in the Eurozone (where it once again exceeded expectations), along with the weak domestic currency, increase the risk of not meeting the 2008 inflation target.
- As the NBR missed the inflation target for the second time in three years, its credibility would be strongly affected by another failure to meet the target at the end of 2008, even though the NBR’s eventual appeal to escape clauses would be justified for the 2007 inflation target (because of food and oil prices).
- The state budget for 2008 focuses mainly on increased social spending and targets a budget deficit of 2.7% of GDP. However, we expect considerable fiscal slippage with the budget deficit reaching 4.2% of GDP for 2008 because of already engaged expenses and other likely expenses typical for an election year. Consequently, increased pressure on the expenditure side will make it almost impossible for the NBR to achieve its 2008 inflation target.
- Although the minority government said it will not allow wage increases above 10% on average in the public sector, there is a high probability they will allow more in union negotiations. The labour market remains tight and we do not see any improvement in the near term; so, the NBR should increase monetary policy’s restrictiveness to compensate for loose wage policy.
- Uncertainties at the global level, coupled with the weak fundamentals of the Romanian economy, have increased the risk premium on the RON and significantly eroded the yield advantage. The C/A deficit will probably end the year at 14% of GDP and its sustainability raises additional worries, as FDI coverage is below 45%. More worrying is the fact that prospects for 2008 C/A deficit financing are not favourable. As a result, we would expect more pressure on the RON exchange rate in the short term.
- Real monetary policy interest rates are very low and substantially below the natural real interest rate. Since the exchange rate has depreciated significantly recently, above its equilibrium level, this implies that monetary conditions have become loose.
- Since the inflation targeting regime is new, expectations are poorly anchored. Expected inflation has increased considerably recently and, as oil prices touched

new highs and the prolonged drought boosted food prices, the materialisation of persistent inflation is not far off.

- Strong credit growth (60.4% YoY in December), along with increasing external debt, represents a significant threat to the inflation outlook over the policy horizon. More concerns are raised by the continuation of households borrowing in FX even as the exchange rate depreciates.
- Economic growth in the fourth quarter and the growth outlook for 2008 are likely to show persistent excess demand longer than estimated by the NBR.

### **‘Doves’ – reasons against a rate hike**

- 125bp in cuts by Fed in just two weeks brought some positive feeling to the markets. However, US recession risks are present and market sentiment should experience increased volatility.
- High credit growth continues to be driven by FX borrowing; this might raise concerns for some MPC members about the side-effects from raising interest rates.
- The interest rate channel influences prices mainly through the exchange rate, and not through excess demand. An appreciating exchange rate affects competitiveness in the tradables sector and further stimulates imports, thus leading to C/A deficit widening.
- It is very hard to empirically show the consequences of high credit and wage growth on inflation.
- There is risk of a moderation in growth (due to, among others, a significant slowdown in the euro area and global economy). As a result, the output gap could close sooner than expected, thus diminishing demand-side inflationary pressures.
- The effect of interest rates on prices through excess demand is limited in Romania’s case and lags are very long. Thus, the aggregate demand channel of the monetary policy transmission mechanism is weak and a hike in interest rates would not show up immediately in higher lending rates, but in an appreciating exchange rate, which would stimulate consumer demand.

### **Bottom line**

***We expect a hike of 75bp, although we admit that 100bp is also very likely***

After testing the waters at the previous rate-setting meeting, the NBR has to take a really tough decision on 4 February as they have to send a clear signal to the markets. Consequently, we expect to a bold move in the monetary policy rate, especially as various NBR officials have expressed the need for monetary policy tightening. Nevertheless, taking into account the NBR’s history we see a hike of 75bp, although we admit that 100bp is also very likely. An increase below 75bp would certainly disappoint market players and we do not think that now is the appropriate moment for such an action.

As for the administrative measures, we do not expect an increase in the MRR since this instrument has proved not too efficient in controlling lending. However, with credit growth at a strong pace, lowering the reserve requirements would send a dangerous signal and would encourage lending, generating extra inflationary pressures.

***We expect the NBR to further increase rates***

Going forward, further rate hikes and risks remain on the upside for the interest rate profile. Hikes would be justified by an attempt to restore the restrictiveness of monetary policy, as the inflation outlook has considerably deteriorated. However, hikes are also highly dependent on exchange rate developments.

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