Romania: inflation forecast update

We revise down year-end inflation forecast amid declining soft commodity futures prices and lower energy prices. Inflationary pressures should ease after the first quarter, due to favourable energy-related statistical base effect. We see NBR holding key rate steady at 7.00% throughout 2023. Persistent and broad-based features of the current high inflation suggests that it should not decline quickly and hence upside risks to inflation trajectory remain.

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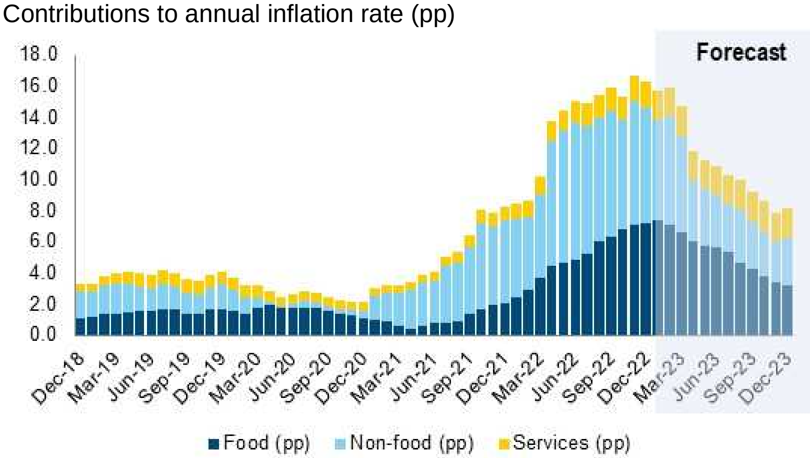
Above target inflation over the policy horizon

Inflation has been the main macro topic for the past year around the world and it is likely to remain in 2023. Therefore, we decided to release an updated view on Romania consumer prices, due to some changes in forecast assumptions. We see inflation at 8.0% by year-end vs. the 8.7% previously, after peaking at 16.8% in November 2022, the fastest pace in almost 20 years. We expect core inflation to peak-out in February 2023 at 15.4% and remain above headline inflation over the entire projection horizon. Headline inflation is projected to decline to around 5.0% by end- 2024, still above the upper bound of the NBR's target range of 2.5%±1pp over the medium term. Uncertainties around our inflation outlook remain elevated over the short term and depend on domestic and EU growth profiles, while the war in Ukraine and re-opening of China could potentially have meaningful impact on world commodity prices.

The downward revision of the 2023 inflation outlook is particularly related to lower energy prices, given the price caps on electricity and natural gas prices over the next couple of years and the assumed decline in soft commodity prices, in line with their futures prices.

Fig. 1: Food and non-food prices behind disinflation process in 2023
Contributions to annual inflation rate (pp)



Source: NIS, BCR Research

With potentially slowing inflation, we believe that the central bank will keep the key rate on hold at 7.00% throughout 2023. Meanwhile, liquidity management, the NBR's favourite policy tool, is likely to be actively used in the following quarters, depending on the EUR/RON and upcoming inflation readings.

Romania Macro & FI Research

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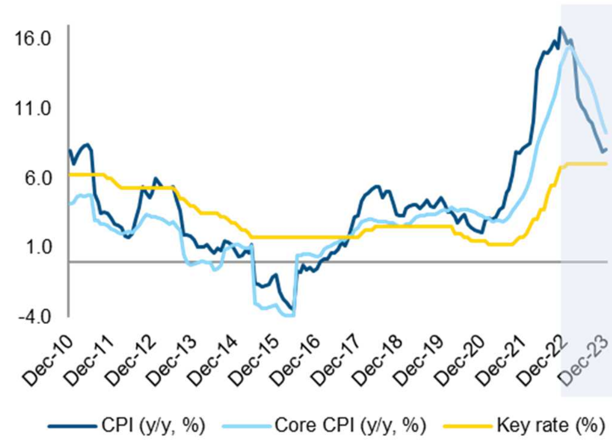
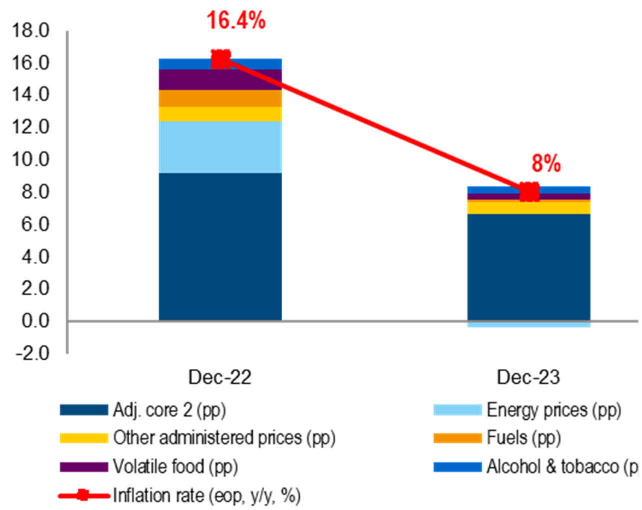
Note: Past performance is not necessarily indicative of future results.

Fig. 2: Double-digit core inflation for most of 2023
CPI inflation (core and headline) vs. NBR key rate



Source: NIS, NBR, BCR Research

Fig. 3: Large contribution from core inflation
Contribution to year-end inflation rate (pp)



Source: NIS, NBR, BCR Research

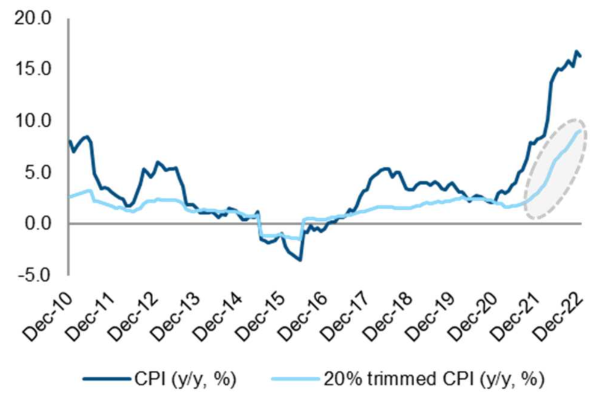
Headline inflation is likely to remain elevated in the short term (near or above the 15.0% y/y), before falling sharply (-3pp) at the beginning of the second quarter, due to a strong energy-related statistical base effect, and ending the year at 8.0% y/y, 0.7pp lower than to our previous forecast update released in August 2022.

Core inflation (CPI less administered, volatile food and fuels, tobacco, and alcohol), the central bank's preferred gauge for tracking underlying inflation pressures, is projected to peak just above the 15.0% in February this year, remain in double-digit territory until the last quarter of this year and stay above headline inflation at least over the following couple of years. We think that potentially cooling core inflation should give the central bank some breathing room on rates, especially as other CEE central banks already signalled the end of their hiking cycles.

Before offering more details on the current assumptions behind the forecasted path for headline inflation, we took a different look at the historical CPI data to see how broad-based the recent high inflation is. For this, we calculate a 20% trimmed-mean inflation, which is basically an alternative approach of measuring inflation by eliminating 10% of the most volatile m/m consumer price changes from both ends of the distribution. After removing the outliers, the trimmed inflation reveals that the current high inflation is not only a result of a sharp increase in the prices of a few items, and it is broad-based (see fig. 4). The broad-based nature indicates that the current high inflation should not go away so quickly, thus potentially making it harder for the central bank to bring inflation under control over the medium term.

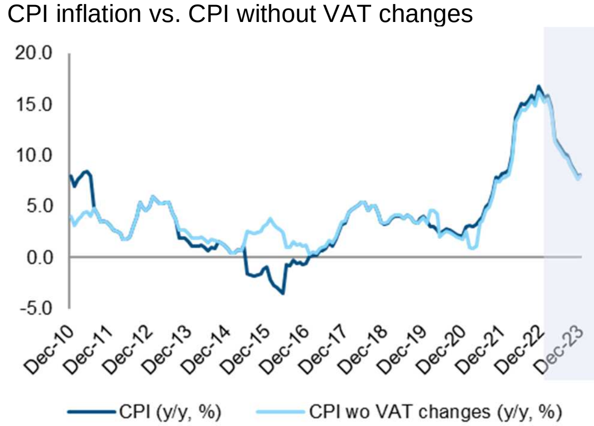
In our view, the uncertainties surrounding our inflation projection remain elevated over the short term and depend on domestic and EU economic growth profiles. The war in Ukraine is still playing a major role and the re-opening of China's economy should certainly influence the global economy, with both factors potentially having a meaningful impact on world commodity prices.

Fig. 4: Trimmed inflation signals persistent and broad-based price growth
CPI inflation vs. trimmed inflation rate



Source: NIS, BCR Research

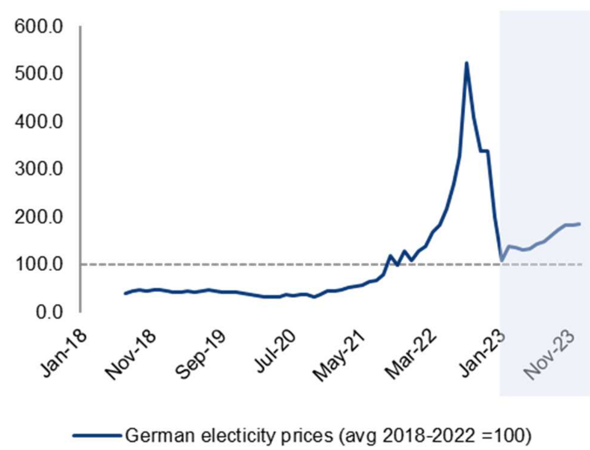
Fig. 5: Recent VAT hikes add just 0.1pp to year-end inflation
CPI inflation vs. CPI without VAT changes



Source: NIS, BCR Research

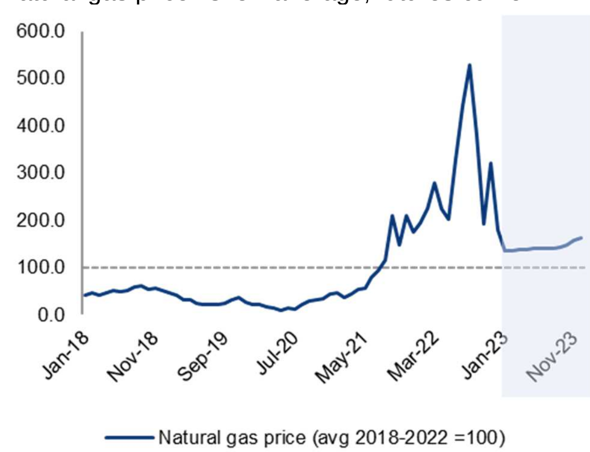
After hitting all-time highs in 2022, the global energy market is likely to be more stable this year, with a mild winter and calmer energy prices. Futures prices indicate that electricity and natural gas prices should moderate in 2023, though stay significantly above the five-year average for some time (see fig. 6 and 7).

Fig. 6: Electricity futures prices 50% higher vs. 5Y average
Electricity price vs. 5Y average, futures curve



Source: Bloomberg, BCR Research

Fig. 7: Natural gas futures prices 40% higher vs. 5Y average
Natural gas price vs. 5Y average, futures curve



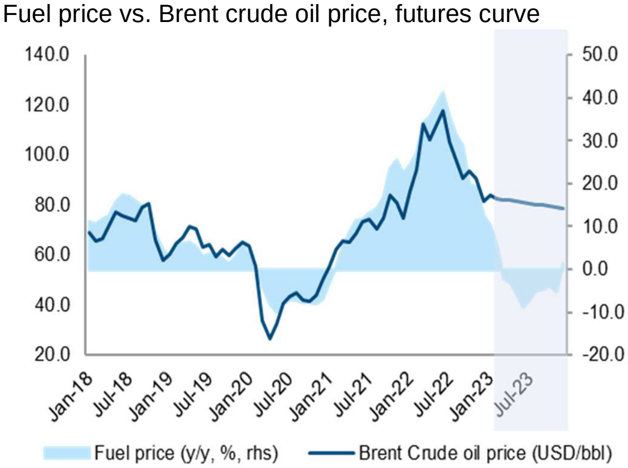
Source: Bloomberg, BCR Research

Turning back to our newest projection, we reiterate that the downward revision for 2023 is particularly related to exogenous factors such as volatile commodity prices and government measures to tackle them.

The new fiscal measures, those designed to keep price caps on electricity and natural gas prices until March 2025 and establishing electricity tariffs based on actual consumption, not on the average consumption of 2021, explain nearly half of our forecast revision. On the other hand, the short-term inflation outlook is likely to be only slightly affected by the recently introduced VAT rate hike from 9% to 19% for non-alcoholic drinks that contain added sugar and from 5% to 9% for hotel accommodation, restaurant and catering services starting January 1. Assuming a full and immediate pass-through into final prices, these could have an impact of 0.1pp on the annual figure, all other things equal (see fig. 5). Prices for mandatory car insurance is also expected to go higher following the rise in the contribution to the Insurance Guarantee Fund (from 2.5% to 4%). According to our estimates, the measure may have an upward impact of less than 0.1pp in 2023, assuming low double-digit price growth for mandatory car insurance. In the case of a much sharper surge (closer to a mid-double-digit advance), it would have a sizable impact on the CPI rate. Supply-side pressures related to the new hike in excise duties for tobacco as of April are already visible, as the most important producers partially increased in advance cigarette prices starting with late December or mid-January.

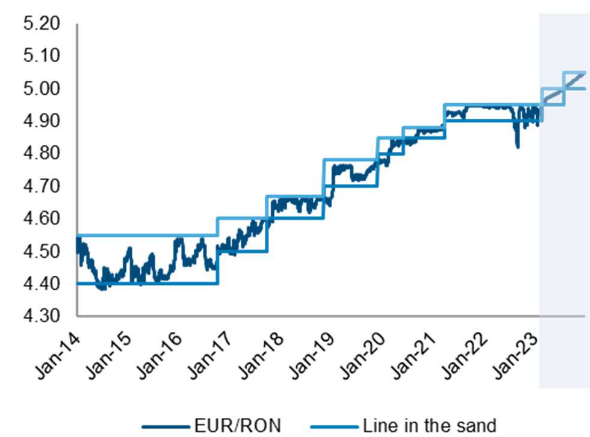
Fuel prices should decline marginally this year, due to the recent removal of the compensation for car fuel of 50 bani/litre as of January limited to some extent by the cuts in excise duties for gasoline and diesel, and firewood prices which are capped until the end of March. On top of these, Brent Crude oil futures prices are averaging 81 USD per barrel this year, down 18% relative to 2022 (see fig. 8). According to our estimates, a 10% drop in oil price should push overall inflation down by about 0.4pp within one-year time, due to both first- and second-round effects (ceteris paribus).

Fig. 8: Lower oil prices on weaker global demand
Fuel price vs. Brent crude oil price, futures curve



Source: NBR, Bloomberg, BCR Research

Fig. 9: Gradual depreciation of the local currency
EURRON rate and forecast

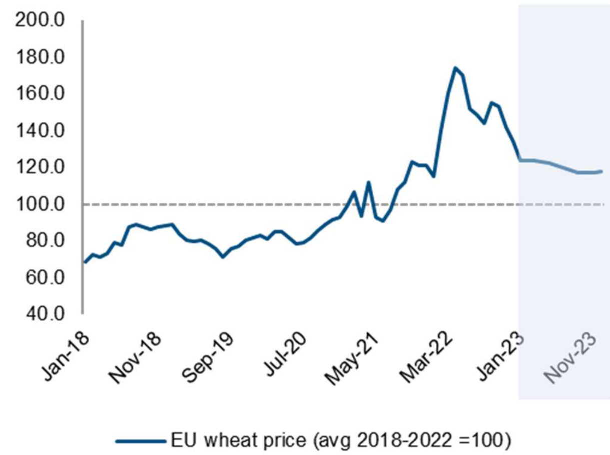


Source: NBR, BCR Research

Our year-end EURRON estimate stands at 5.05. Hence, we expect the depreciation to be gradual (about 2% on average), in line with past years, as fundamentals should ultimately prevail, and the RON should start to weaken once the offshore inflows into local currency sovereign debt fend-away. Furthermore, our estimates show that EURRON dynamics have an asymmetric effect on consumer prices and that a 1% depreciation of the leu against the euro should push consumer prices higher by about 0.25-0.3% over the following twelve months.

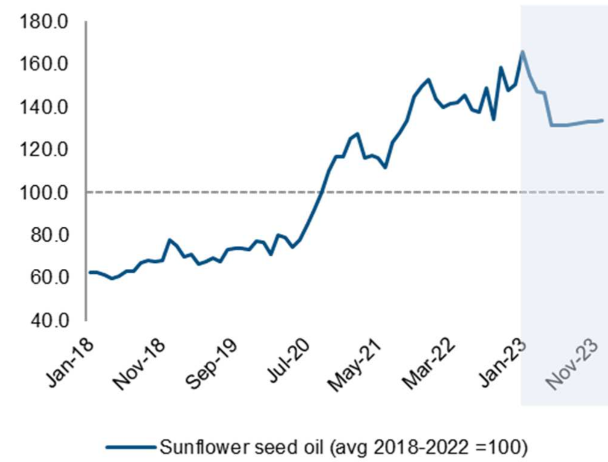
Inflationary pressures coming from food items are likely to ease. Food prices should increase slower in 2023 compared to the previous year, as prices of some global soft commodities like wheat, milk, pork meat, sunflower seed oil and sugar are seen to decline based on their future contracts (see fig. 10-15).

Fig. 10: Wheat futures fall sharply into the summer
EU wheat price vs. 5Y average, future curve



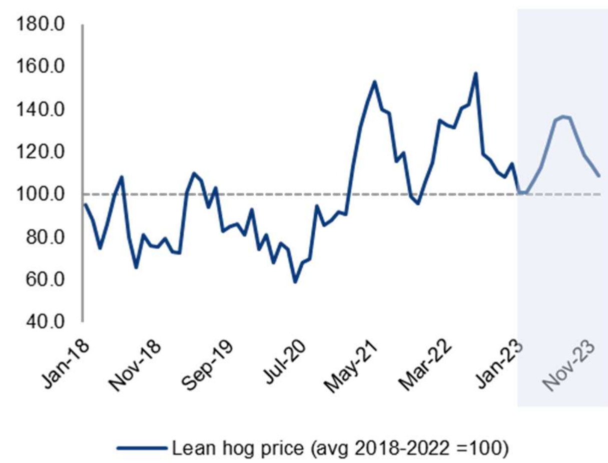
Source: Bloomberg, BCR Research

Fig. 11: Sunflower seed oil futures decline marginally
Sunflower seed oil price vs. 5Y average, future curve



Source: Bloomberg, BCR Research

Fig. 12: Cooling pork meat futures
Lean hog price vs. 5Y average, future curve

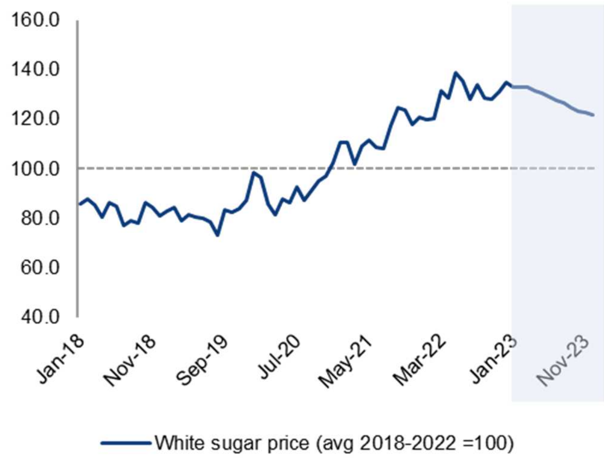


Source: Bloomberg, BCR Research

Fig. 13: Milk futures drop significantly
Milk price vs. 5Y average, future curve

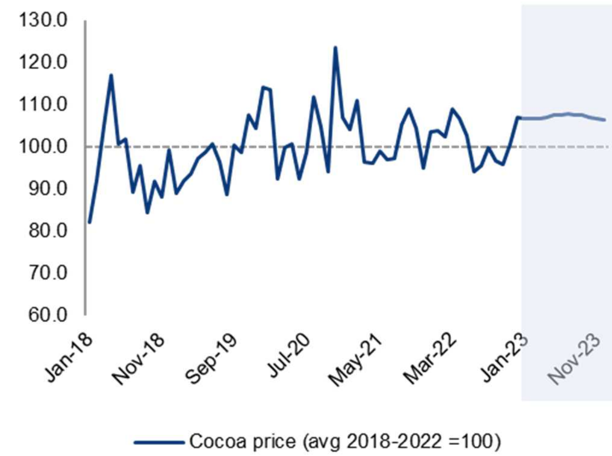
Source: Bloomberg, BCR Research

Fig. 14: White sugar futures decline gradually
White sugar price vs. 5Y average, future curve



Source: Bloomberg, BCR Research

Fig. 15: Cocoa futures inch higher
Cocoa price vs. 5Y average, future curve



Source: Bloomberg, BCR Research

Market impact

Next NBR rate setting meeting is scheduled for 9 February. We expect no change in monetary policy conditions after January dovish hike which combined with the drop in commitment to tight liquidity management from press release actually led to an easing in monetary conditions afterwards.

Updated inflation forecast is due for release after the meeting with the new *Inflation Report*. In the communique after the previous meeting, the NBR was expecting inflation 'to reach one-digit levels in 2023 Q3 already'. Furthermore, central bank's spokesman Dan Suciu said that price growth in Romania will probably ease to about 7% by the end of this year.

Lower inflation outlook is mostly priced into ROMGBs, in our view. At the same time, a significant deceleration in inflation should imply higher 'two-way flexibility' on FX. The NBR already signalled its discomfort with RON strengthening by loosening money market liquidity management.

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