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CENTRAL BANK WATCH: Romania & Serbia at different monetary policy paths

- Vindicating our and the market's expectations, the **National Bank of Serbia** (NBS) stayed put on its monetary policy at its scheduled meeting on March 17th, maintaining the key benchmark rate at the current record low level of 4.25%. Yesterday's decision follows a largely unexpected 25bps cut delivered in February, the first since October 2015, which came in the wake of 750bps of monetary easing since May 2013.

- In 2015 alone, the Central Bank had delivered 350bps of rate cuts. Despite persistently below target inflation and a negative output gap, we – in line with the market's median forecast – anticipated the Central Bank to hold its horses yesterday ahead of the upcoming general elections on April 24th. Looming fiscal slippage risks and potential delays in the implementation of IMF-backed reforms may exert depreciation pressures on the dinar. The RSD embarked on a weakening trend in October last year, having hit a record trough near 123.70 against the euro in late February. The Central Bank has repeatedly intervened in the FX markets over the last few weeks, selling euros to support the domestic currency. So far this year it has sold approximately €490mn.

- Following yesterday's decision, the NBS noted that it anticipates inflation to gradually rise from mid-year and return within the 4% +/-1.5% target tolerance band late this or early next year thanks to the current expansive monetary policy. It also acknowledged potential risks in the face of global growth prospects, volatility in commodity prices, geopolitical jitters and the expected further normalization of the Fed's monetary policy.

- Looking ahead we anticipate the NBS to retain its cautiously accommodative monetary policy stance. That said, the Central Bank will likely stay put on its monetary policy and maintain the benchmark policy rate at the current 4.25% level at least until the looming elections. Some modest rate easing thereafter cannot be ruled out entirely as inflation pressures remain subdued (February CPI at 1.5%) and private consumption continues to be weak in view of the government's ongoing fiscal consolidation efforts. Any such decisions will likely be dependent on the aforementioned risks and their potential implication on inflation dynamics as well as on the dinar's upcoming performance.

- Serbia's accommodative monetary policy stance is in line with that adopted over recent months by the majority of Central Banks in the CESEE region. In contrast, the **National Bank of Romania** (NBR) appears to be on a divergent path. The benign inflation environment allowed the Central Bank to deliver 175bps of cumulative rate cuts between August 2014 and May 2015 under the latest monetary easing cycle. It has stayed put on rates ever since. In the last monetary policy meeting on February 5th, the NBR left the key policy rate unchanged at 1.75%, in line with market expectations, while mandatory reserve ratios for both RON and FX liabilities were also kept unchanged at 8% and 12% respectively.

- However, the Central Bank's rhetoric turned more hawkish during the presentation of the Inflation Report a few days later on February 9th. The NBR Governor, Mugur Isarescu, pointed out that given the two years' time lag of the monetary policy transmission mechanism, the time of taking some action may be approaching. However, he added that narrowing the interest rate corridor - the first tightening step before rate hikes - might be delayed in order to deter short-term speculative capital inflows. The NBR upgraded its year-end inflation forecast in 2016 to +1.4% YoY vs. +1.0% YoY in November and presented for the first time its year-end forecast in 2017 at +3.4% YoY compared to +2.8% YoY in Q3-2017 in the previous report. Higher contribution from the volatile food component (+0.1ppts) as well as a rise in the Core2 inflation forecast (+0.4ppts) as a result of the wages rally throughout the past year were the main reasons behind the upgrade. In contrast, lower oil prices subtracted an additional 0.2ppts versus the previous forecast. The NBR Governor sounded even more hawkish in an interview to international media on February 24th, stating that the NBR may tighten monetary policy sooner than expected, even before the publication of the autumn Inflation Report, due to strong underlying inflationary pressures building amid solid consumption.

- Having surprised market expectations to the upside in January, inflation surprised to the downside in February. It dipped to -0.2% MoM/-2.7% YoY in February - a historic low for the standards of Romanian - down from -0.8% MoM/-2.1% YoY in January and compared down from +0.1% MoM/-0.9% YoY in December. The print was below market expectations of +0.2% MoM/-2.3% YoY. The implementation of a 4ppts headline VAT rate cut-from 24% to 20%-effective from January 1st, compounded by the food staff VAT rate cut-from 24% to 9% effective from last June-pushed has headline inflation further into negative territory. At the same time, the unwarranted pro-cyclical fiscal stimulus ahead of the parliamentary elections this year, induced by the amended Fiscal Code tax-cuts and the wide-spread public sector wage rises has pushed real wages in double digit territory-13.9% YoY in last January-fueling a consumption boom.

- Looking ahead, inflation is most likely to stay below the NBR target range (2.5%±1%) until the 1H-2016. However, notwithstanding the impact of taxes, inflation has already entered the target band that may justify the hawkish rhetoric. Despite the continuous energy prices slump and the negative base effects from fiscal easing, inflationary pressures are rising in Romania faster than its peers. HICP at constant taxes climbed to +2.9% YoY in January 2016 compared to +2.3% YoY in December2015 vs. only +0.3%YoY in December 2014, at a comparably significantly higher than its regional peers (Poland: +0.2% YoY, Hungary: +0.8% YoY, Bulgaria:-0.7% YoY).

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