Romania: weaker growth without reforms

After the peak in job creation in mid-2016, the Romanian economy expanded robustly on fiscal stimulus. Though some inertia remains, growth could be strangled by a lack of structural reforms

Chief Economist
Ciprian Dascalu
ciprian.dascalu@bcr.ro

Senior Analyst
Dorina Ilasco
dorina.ilasco@bcr.ro

Senior Analyst
Eugen Sinca
eugen.sinca@bcr.ro

2020: glass half full or half empty?

The economy is still running on borrowed time, supported by generous fiscal and wage policies. Fiscal consolidation is unavoidable after the elections, regardless of their outcome, and implies short-term cost in terms of GDP growth, although structural reforms (i.e. public sector digitalization, education, labor market, healthcare) could mitigate it in the medium term.

After a tumultuous 2019, the political scene is warming up for another two rounds of elections in 2020: local in mid-2020 and general in late-2020. We expect the latter to break the political deadlock and bring more policy consistency, with four years then ahead without any elections in sight.

Last year, the economy shrugged off the political noise and managed to expand at a robust pace of 4.1%, a mild slowdown from the year before. We expect the growth deceleration to continue into 2020 to 3.5%, as external demand is unlikely to quickly recover, while domestic labor resources are stretched. Consumers are in pretty good shape. Unless shaken by an external shock, confidence should remain high, as the tight labor market and social policies are likely to lead to a nearly double-digit rise in wages this year. For 2021, we forecast 2.0% growth, assuming fiscal adjustment of 1pp of GDP. Depending on the size and timing of the fiscal consolidation, we stand ready to revise it.

For 2020, strong consumption remains the full half of the glass. The economy running out of resources – labor and capital – is the empty half. Labor is scarce due to migration, low labor force participation, and outdated education curricula. Public capital expenditure has been trimmed down in recent years, while private investments posted sluggish growth rates. The central bank is constrained by the divergent twin deficit story and subsequent RON weakening pressures. Higher RON interest rates vs. peers to fend off RON softening, given the relatively high FX pass-through, lead to higher cost of capital. We forecast a CPI of 3.4% by end-2020 and 3.1% by end-2021, assuming a relatively stable real exchange rate.

Regardless of the election outcome, we expect meaningful fiscal consolidation in 2021 due to three main constraints: (i) excessive deficit procedure (EDP); (ii) possible action from the rating agencies (S&P has a negative outlook since late-2019 and the government has 24 months to take action before the subsequent rating action); (iii) and relatively high government borrowing costs vs. countries with similar nominal GDP growth rates. Hence, the overdue fiscal correction (post-election) is likely to be gradual, assuming a benign global backdrop. Some frontloading could be optimal from the budget deficit/GDP growth trade-off perspective. Romanian politics is known for its unpredictability. A hung parliament is the main risk to our forecast scenario. Stay tuned for updates!

CEE Macro & FI Research
Juraj Kotian (Head)

Zoltan Arokszallasi, CFA
(CEE FX and FI Strategist)
Katarzyna Rzentarzewska
(Chief CEE Macro Analyst)
Malgorzata Krzywicka
(Junior Analyst PL)

Macro monitor

We keep our 2020 GDP growth unchanged at 3.5%

Real GDP expanded by +1.5% q/q and +4.3% y/y in 4Q19, above our forecast (+0.4% q/q and +2.9% y/y) and the Bloomberg median of +3.2% y/y. Economic growth accelerated from +0.6% q/q and +3% y/y in the third quarter. Full-year growth stood at +4.1% in 2019.

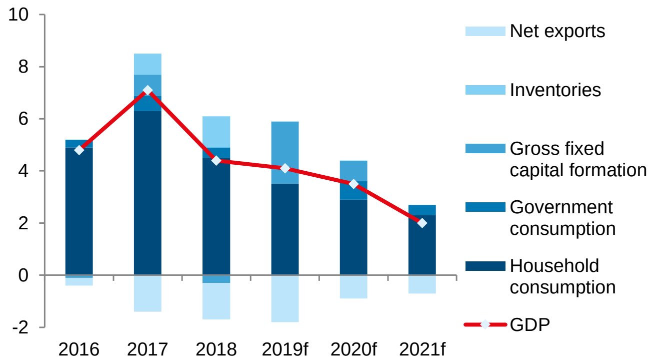
The GDP breakdown is due on March 10. We believe that heavy government spending at the end of 2019 was behind the upside surprise reading. In spite of the higher-than-expected carryover effect of the 4Q19 figure into 2020, we keep our GDP growth forecast unchanged at +3.5% for 2020, as the current trajectory of the economy is weaker than previously estimated. In 2021, Romania's growth could decelerate further, to +2.0%, due to the likely adoption of corrective fiscal measures after elections.

Persistent weakness in manufacturing

Industrial production decreased by -3.6% in 2019, after +5.0% expansion in 2018. Its main component, the manufacturing sector, contracted by -2.5% in 2019 after posting a +5.5% increase the previous year. The level of manufacturing sector integration in European value chains suggests that weak external demand is the main driver of the slump in Romanian industry.

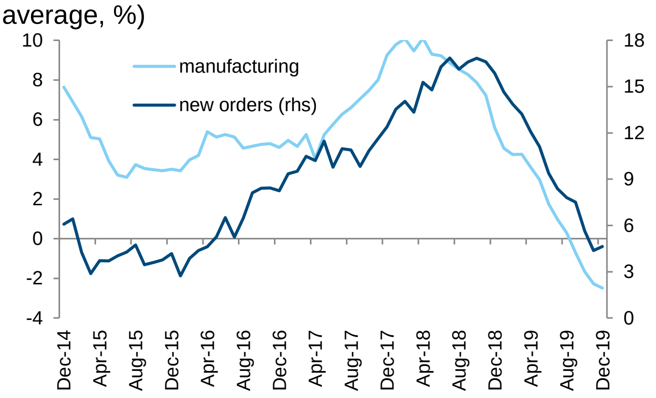
In December, industrial production dropped by -0.1% m/m and -6.9% y/y, with manufacturing down by -4.7% y/y vs. -4.6% in November. On a quarterly basis, industrial production posted a -1.5% q/q drop, with manufacturing declining -1.1% q/q in the fourth quarter, from -3.2% and -3.1%, respectively, in the previous quarter. This is too little evidence to call the bottom for the industry, as the overall trend remained weak.

Deceleration in GDP growth set to continue
(contributions to real GDP growth, ppt)



Source: NIS, BCR Research

Negative contribution of industry to growth
(manufacturing and new orders, 12-month moving average, %)



Source: NIS, BCR Research

The short-term outlook for local manufacturing remains negative, as new orders trended lower and manufacturing confidence softened in January after bouncing back in December. Romanian manufacturers cited lower order books and weaker production expectations in the next three months as reasons for the negative sentiment, which outweighed the reported drop in inventories.

Solid retail sales

Retail sales ended 2019 on a strong note, in line with earlier signs from brighter consumer confidence. The growth rate reached a nine-month high of 8.3% y/y in December (November: 6.4% y/y), boosted by sales of non-food items and in particular electronics and furniture.

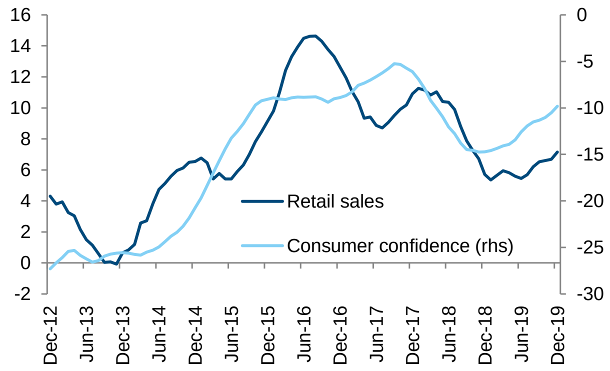
Full-year growth for retail sales accelerated to +7.1% in 2019 from +5.6% in 2018. In sequential terms, retail sales expanded by +2.6% q/q in the fourth quarter vs. 1.9% in 3Q19, likely supported by the 15% increase in pensions in September and in line with improving consumer confidence. We see retail sales as the top contributor to the current year's economic growth, despite mild deceleration.

Inflation to enter NBR's target band in February

The inflation rate fell to 3.6% y/y in January, from 4% y/y in December. Cheaper car fuel prices following the elimination of the additional excise duty and a statistical base effect stood behind this development. Adjusted CORE2 inflation (headline inflation minus administered prices, volatile prices, tobacco and alcohol), which is closely followed by the NBR, was marginally higher in January, at 3.8% y/y, from 3.7% y/y in December.

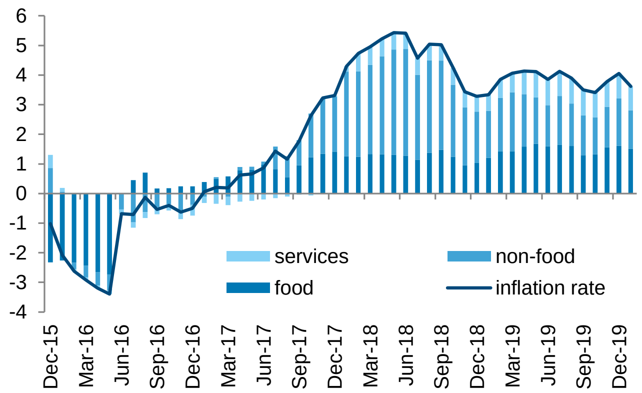
We expect inflationary pressures to ease in 1H20 and inflation to remain within the NBR's target band for most of the two-year policy horizon. Our year-end CPI forecast stands at 3.4% for 2020. This offers comfort to the NBR to keep the policy rate unchanged at 2.50% throughout 2020, given the relatively high interest rate differential vs. peers and ECB.

Strong consumer morale propping up retail sales
(retail sales and consumer confidence, 12-month moving average, %)



Source: NIS, EC, BCR Research

High inflationary pressures from food products
(contributions to y/y inflation rate, ppt)



Source: NIS, BCR Research

2020: NBR key rate on hold, one more cut in FX RRR

The NBR cut the FX reserve requirement ratio (RRR) to 6% (-2ppt) and kept the policy rate unchanged at 2.50%. The reduction of FX RRR releases around EUR 600mn into the market, creating better conditions for the Ministry of Finance to issue EUR-denominated bonds in the local market.

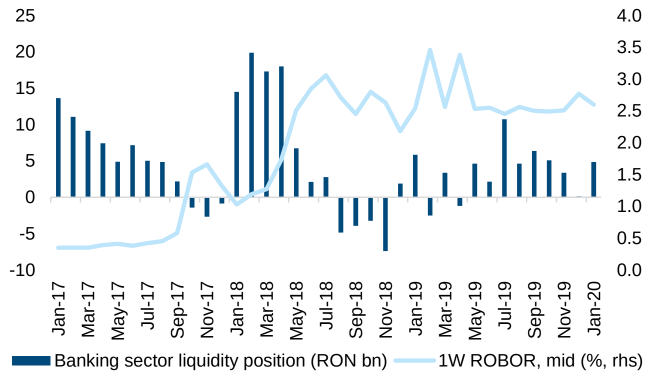
We do not expect any change in the RON RRR until there is evidence of meaningful fiscal consolidation that can allow the central bank to accommodate it by easing its policy stance. We see the monetary policy rate as unchanged at 2.50% and one more cut of 2ppt in FX RRR by the end of 2020.

Current account deficit to narrow post-2020

The current account deficit reached EUR -10.5bn in 2019 (-4.7% of estimated GDP), from EUR -9bn in 2018 (-4.4% of GDP). Romania's external balance deteriorated at a slower pace in 2019 compared with the fast degradation over the previous three years.

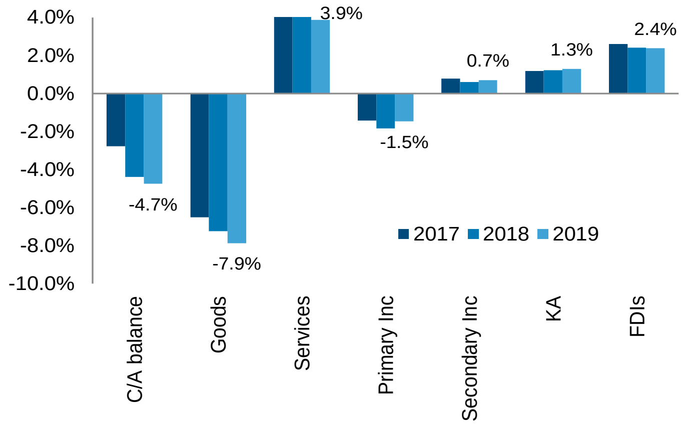
2021 should bring a gradual adjustment of the external imbalance, as we expect fiscal consolidation after the parliamentary elections, which are likely to weigh on household consumption. Weakening pressures on the leu should ease once the twin deficit problem is addressed, allowing the central bank to consider policy accommodation in 2021.

Higher liquidity in local banking sector in January
(banking sector liquidity position and 1W ROBOR, mid, %)



Source: NBR, BCR Research

Wider trade deficit for goods in 2019
(selected BoP items, % of GDP)



Source: NBR, NIS, BCR Research

Bond monitor

Strong demand for RON bonds

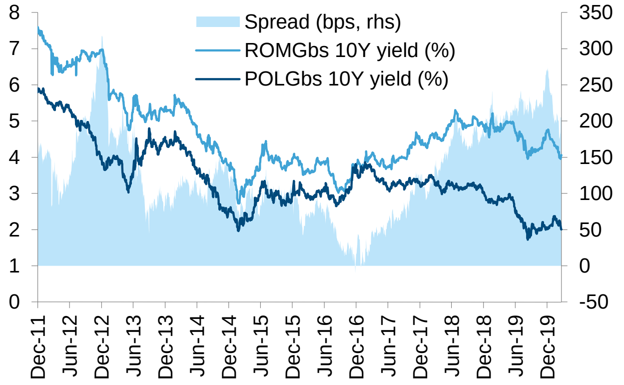
In February, the short end of the RON yield curve was supported by strong demand from domestic investors due to a large benchmark redemption of over RON 9bn at the end of the month. There were inflows into the long end from non-resident investors, as the market to some extent pricing in the snap-elections scenario pushed borrowing costs lower. As a result, yields dropped by 20-30bp on average across the curve. Primary market auctions were oversubscribed, enabling the MinFin to issue 40% more debt than initially planned.

Supportive global liquidity conditions and attractive local yields led to a tightening in the spread between RON bonds and German bunds, with 10y maturity which compressed to 420bp in late-February from 470bp at the beginning of January. This is likely due to investors assessing higher chances for early elections, which could lead to a frontloading of a gradual fiscal consolidation process and remove some short-term fiscal uncertainties.

Further supportive news was that local government bonds will be added to the Bloomberg Barclays Global Aggregate Index from September, which could bring USD 1.4bn in passive inflows as benchmark investors add exposure.

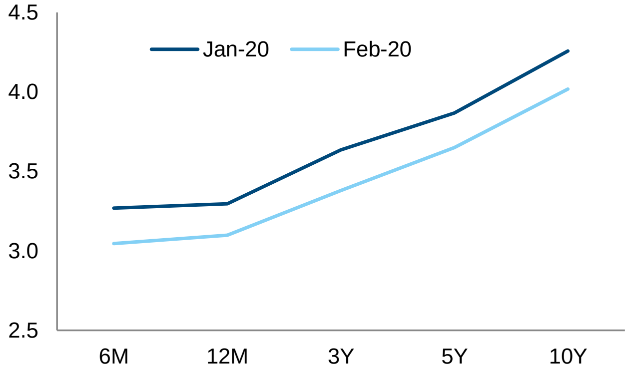
We see the risks related to early elections as asymmetric. In the event of early elections, RON yields could decrease marginally, as this scenario is largely priced in. In the event of no snap elections, the correction in yields could be more ample. ROMGBs spread over POLGBs tightened by 26bp during February until the Constitutional Court decision on the president’s nomination for PM, after which the spread widened by 20bp.

Bond yields gyrating on political news
(spread between 10y ROMGBs and POLGBs)



Source: Bloomberg, BCR Research

Lower bond yields across curve in February
(RON yield curve, mid, %)



Source: NBR, BCR Research

Appendix – macroeconomic forecasts

Real economy	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F
GDP (real change y/y, %)	2.0	2.1	3.5	3.4	3.9	4.8	7.1	4.4	4.1	3.5	2.0
GDP (RON bn)	559.2	593.7	635.5	668.6	712.6	765.1	857.9	952.4	1050.5	1138.2	1203.6
GDP per capita (EUR thou.)	6.5	6.6	7.2	7.5	8.1	8.6	9.6	10.5	11.4	12.2	12.8
Household consumption (real change y/y, %)	1.6	1.6	2.0	4.2	5.9	8.3	10.1	7.2	5.5	5.2	3.4
Gross fixed capital formation (real change y/y, %)	6.1	3.1	-5.6	3.3	7.5	-0.2	3.5	-1.2	18.0	3.6	0.0
Industrial production (real change y/y, %)	7.5	2.4	7.8	6.1	2.8	3.1	7.8	3.5	-2.3	-1.8	2.4

External sector	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F
Exports of goods (FOB, EUR bn)	45.3	45.1	49.6	52.5	54.6	57.4	62.6	67.7	69.0	71.1	74.1
Imports of goods (CIF, EUR bn)	55.0	54.7	55.3	58.5	63.0	67.4	75.6	82.8	86.3	90.3	93.0
Trade balance goods, (FOB - CIF, % of GDP)	-7.3	-7.2	-4.0	-4.0	-5.2	-5.9	-6.9	-7.4	-7.8	-8.1	-7.7
C/A balance - % of GDP	-5.0	-4.8	-0.8	-0.2	-0.6	-1.4	-2.8	-4.4	-4.7	-4.9	-4.6

Prices	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020F	2021F
CPI (y/y, %)	3.1	5.0	1.6	0.8	-0.9	-0.5	3.3	3.3	4.0	3.4	3.1
CPI (average, %)	5.8	3.3	4.0	1.1	-0.6	-1.5	1.3	4.6	3.8	3.4	3.4

Labour market	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F
Unemployment rate (%)	7.2	6.8	7.1	6.8	6.8	5.9	4.9	4.2	3.9	4.0	4.2
Net nominal wages (monthly, RON)	1475	1547	1622	1706	1848	2088	2384	2696	3099	3393	3611
Net wages (nominal change y/y, %)	4.8	4.9	4.8	5.2	8.3	13.0	14.2	13.1	14.9	9.5	6.4

Public sector	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F
Budget deficit (Eurostat, % of GDP)	-5.4	-3.7	-2.1	-1.2	-0.6	-2.6	-2.6	-2.9	-4.6	-3.8	-3.0
Public debt (Eurostat, % of GDP)	34.2	37.0	37.6	39.2	37.8	37.3	35.1	34.7	36.1	37.1	38.0

Interest rates	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020F	2021F
Monetary policy rate (eop, %)	6.00	5.25	4.00	2.75	1.75	1.75	1.75	2.50	2.50	2.50	2.00
ROBOR 3M (avg, %)	5.8	5.3	4.2	2.5	1.3	0.8	1.2	2.8	3.1	3.0	2.7
10y bond yields (avg, %)	7.4	6.7	5.3	4.6	3.5	3.3	3.9	4.7	4.5	4.3	4.0

FX rates	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020F	2021F
EUR/RON (eop)	4.32	4.43	4.48	4.48	4.52	4.54	4.66	4.66	4.78	4.87	4.97
USD/RON (eop)	3.34	3.36	3.26	3.69	4.15	4.30	3.89	4.07	4.26	4.23	4.32

Source: NIS, NBR, Reuters, Ministry of Finance, BCR Research

Contacts

Group Research

Head of Group Research	
Friedrich Mostböck, CEFA	+43 (0)5 0100 11902
CEE Macro/Fixed Income Research	
Head: Juraj Kotian (Macro/FI)	+43 (0)5 0100 17357
Zoltan Arokszallasi, CFA (Fixed income)	+361 373 2830
Katarzyna Rzentarzewska (Fixed income)	+43 (0)5 0100 17356
Malgorzata Krzywicka (Fixed income, Poland)	+43 (0)5 0100 17338
Croatia/Serbia	
Alen Kovac (Head)	+385 72 37 1383
Mate Jelić	+385 72 37 1443
Ivana Rogic	+385 72 37 2419
Czech Republic	
David Navratil (Head)	+420 956 765 439
Jiri Polansky	+420 956 765 192
Michal Skorepa	+420 956 765 172
Nicole Gawlasova	+420 956 765 456
Hungary	
Orsolya Nyeste	+361 268 4428
Romania	
Ciprian Dascalu (Head)	+40 3735 10108
Eugen Sinca	+40 3735 10435
Dorina Ilasco	+40 3735 10436
Slovakia	
Maria Valachyova (Head)	+421 2 4862 4185
Katarina Muchova	+421 2 4862 4762
Major Markets & Credit Research	
Head: Gudrun Egger, CEFA	+43 (0)5 0100 11909
Ralf Burchert, CEFA (Sub-Sovereigns & Agencies)	+43 (0)5 0100 16314
Hans Engel (Global Equities)	+43 (0)5 0100 19835
Margarita Grushanina (Austria, Quant Analyst)	+43 (0)5 0100 11957
Peter Kaufmann, CFA (Corporate Bonds)	+43 (0)5 0100 11183
Heiko Langer (Financials & Covered Bonds)	+43 (0)5 0100 85509
Stephan Lingnau (Global Equities)	+43 (0)5 0100 16574
Carmen Riefler-Kowarsch (Financials & Covered Bonds)	+43 (0)5 0100 19632
Rainer Singer (Euro, US)	+43 (0)5 0100 17331
Bernadett Povazsai-Römhild, CEFA (Corporate Bonds)	+43 (0)5 0100 17203
Elena Statelov, CIIA (Corporate Bonds)	+43 (0)5 0100 19641
Gerald Walek, CFA (Euro, CHF)	+43 (0)5 0100 16360
CEE Equity Research	
Head: Henning Eßkuchen	+43 (0)5 0100 19634
Daniel Lion, CIIA (Technology, Ind. Goods&Services)	+43 (0)5 0100 17420
Michael Marschallinger, CFA	+43 (0)5 0100 17906
Nora Nagy (Telecom)	+43 (0)5 0100 17416
Christoph Schultes, MBA, CIIA (Real Estate)	+43 (0)5 0100 11523
Thomas Unger, CFA (Banks, Insurance)	+43 (0)5 0100 17344
Vladimira Urbankova, MBA (Pharma)	+43 (0)5 0100 17343
Martina Valenta, MBA	+43 (0)5 0100 11913
Croatia/Serbia	
Mladen Dodig (Head)	+381 11 22 09178
Anto Augustinovic	+385 72 37 2833
Magdalena Dolenec	+385 72 37 1407
Davor Spoljar, CFA	+385 72 37 2825
Czech Republic	
Petr Bartek (Head)	+420 956 765 227
Marek Dongres	+420 956 765 218
Jan Safranek	+420 956 765 218
Hungary	
József Miró (Head)	+361 235 5131
András Nagy	+361 235 5132
Tamás Pletser, CFA	+361 235 5135
Poland	
Tomasz Duda (Head)	+48 22 330 6253
Cezary Bernatek	+48 22 538 6256
Konrad Grygo	+48 22 330 6254
Michal Pilch	+48 22 330 6255
Emil Poplawski	+48 22 330 6252
Marcin Gornik	+48 22 330 6251

Group Institutional & Retail Sales

Group Institutional Equity Sales	
Head: Brigitte Zeitlberger-Schmid	+43 (0)5 0100 83123
Cash Equity Sales	
Werner Fuerst	+43 (0)5 0100 83121
Josef Kerekes	+43 (0)5 0100 83125
Cormac Lyden	+43 (0)5 0100 83120
Institutional Equity Sales Croatia	
Damir Eror (Equity)	+385 72 37 28 36
Institutional Sales Czech Republic	
Head: Michal Rizek	+420 224 995 537
Pavel Krabicka (Equity)	+420 224 995 411
Martin Havlan (Equity)	+420 224 995 551
Jiri Feres (Equity)	+420 224 995 554
Institutional Sales Hungary	
Head: Peter Csizmadia	+36 1 237 8211
Levente Nándori (Equity)	+361 235 5141
Attila Preisz (Equity)	+361 235 5140
Balázs Zánkay (Equity)	+361 235 5156
Institutional Equity Sales Poland	
Jacek Jakub Langer (Head)	+4822 330 6265
Wojciech Wysocki (Equity)	+4822 538 6219
Przemyslaw Nowosad (Equity)	+4822 538 6266
Grzegorz Stepien (Equity)	+4822 330 6211
Institutional Equity Sales Romania	
Liviu George Avram	+40 3735 16569
Group Markets Retail and Agency Business	
Head: Christian Reiss	+43 (0)5 0100 84012
Markets Retail Sales AT	
Head: Markus Kaller	+43 (0)5 0100 84239
Group Markets Execution	
Head: Kurt Gerhold	+43 (0)5 0100 84232
Retail & Sparkassen Sales	
Head: Uwe Kolar	+43 (0)5 0100 83214
Corporate Treasury Prod. Distribution	
Head: Christian Skopek	+43 (0)5 0100 84146
Institutional Distribution CEE	
Jaromir Malak	+43 (0)5 0100 84254
Antun Buric	+43 (0)5 0100 11387
Ciprian Mitu	+43 (0)5 0100 85612
Institutional Distribution non CEE	
Margit Hraschek	+43 (0)5 0100 84117
Bernd Thaler	+43 (0)5 0100 84119
Thomas Rakosi	+43 (0)5 0100 84116

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