Monthly Focus

No more kind of magic

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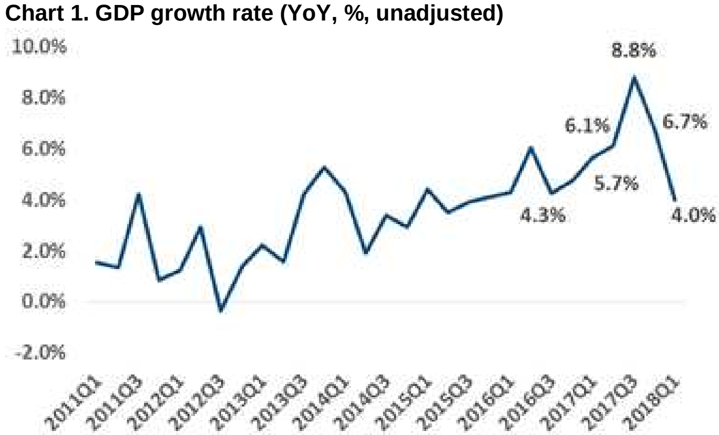
Since I joined BCR as chief economist at the beginning of 2017, the story that I had to tell investors, clients and other foreign institutions interested in Romania's fate was that our country is a front runner in the economic recovery chase. Even if I knew and shared the obvious concern about the sustainability and the health of that fiscal stimulus based consumption led growth, I must admit I was secretly proud to picture Romania as the "tiger" of CEE and of the EU at large. Well, it looks like at the beginning of 2018 this tiger's got seriously injured and with it my national pride's bubble has if not burst, then at least fizzled.

Of course, the surprise was actually not that large as the signs have been kind of written on the wall for some months: consumer confidence has been worsening for 6 months in a row, wage growth was bound to slow significantly after the social contributions "revolution" and Romania's export markets were also beginning to show signs of "growth fatigue". Not to mention that GDP growth itself had been relatively meagre already in the fourth quarter of last year, much below the average growth of 2017[1]. Even if to some extent expected, the first quarter's GDP figures of 0.0% QoQ/ 4.0% YoY, together with the NSI's downward revisions of quarterly growth rates in the last 3 quarters of 2017 are no longer compatible with a 4.7% GDP growth rate for this year. We are therefore revising our 2018 forecast downwards to 4.1%. That number is in line with GDP dynamics expected in other countries in the CEE region, so we have nothing special to really brag about.

Chart 1. GDP growth rate (YoY, %, unadjusted)



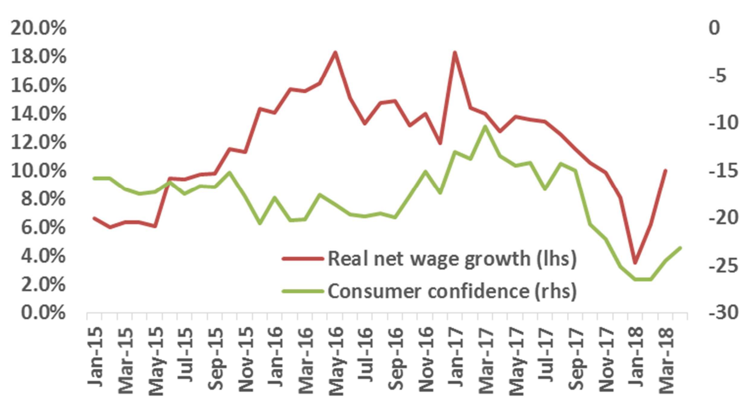
Source: National Statistics Institute

Should these figures make us depressed? Our implicit message from the new forecast we have put forward is "No, it's too soon for that". There are of course reasons to be concerned, given that Economic Sentiment indicators have been slowing also in April and recently

[1] This was even before NSI's quarterly growth rates revision which was published together with the Q1 flash GDP estimate, indicating 17Q4 growth rate at 0.3%, down from 0.5%.

published industrial confidence has continued to disappoint in the Eurozone. Our view nevertheless is that for the second quarter of 2018 we should expect a rebound in quarterly growth, at least as far as domestic consumption is concerned. Consumers seem to have left behind them the taxation change related turmoil and consumer confidence has stabilized and even slightly improved in April. This has come simultaneously with an improvement in wage dynamics, which may have been down to the temporary effect of bonus payments, but it nevertheless means more money in the pockets of consumers. Inflation too is no longer deteriorating as fast as it did in the past few months and very likely to peak soon in annual terms, then to decline abruptly in the last quarter of this year. This means that the purchasing power of the population has been on the rise and could continue to advance in the rest of the year. It's true, no more kind of magic in those growth rates. That however is good from a long-term economic perspective, because productivity growth in Romania is not running at the double digit rates that wages grew in 2016-2017, but a 4%-5% productivity advance has been a sustainable one for several years now, so a similar real wage growth rate can be accommodated without severely impairing on the competitiveness of Romanian employers.

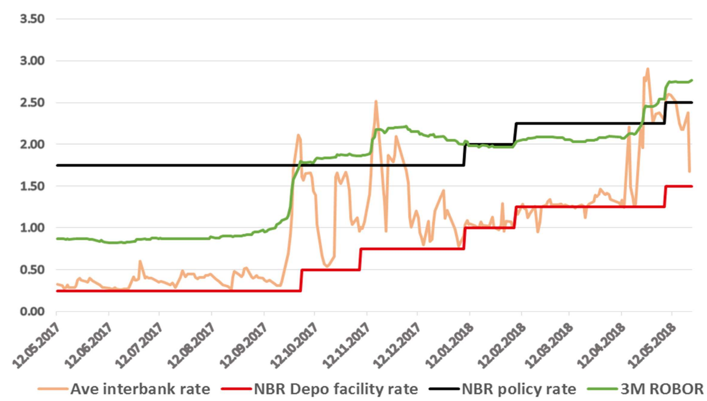
Chart 2. Real wage growth (YoY) and consumer confidence (index level)



Source: National Statistics Institute, European Commission

So our message here is one of normalization of economic dynamics. That is positive news for some policymakers and negative news for others. In terms of monetary policy, it means that the heavy lifting of interest rates (2 hikes in the deposit facility alone, then 3 hikes in the policy rate) that we witnessed in the last 6 months has no strong reason to continue. That is unless: (1) external market conditions were to severely worsen; (2) European central banks were to hasten their own tightening; (3) a new supply shock were to lift inflation rate even higher in the next 3-6 months or (4) fresh consumption stimulus is introduced by the Government, as promised actually in the Governing Program. Since we don't see a high likelihood of any of those alternative scenarios, we remain of the view that the NBR will slow its tightening pace. We therefore expect no more than 1 hike per semester in the next 12 months. One such preventive hike could come in the summer, if Emerging Market sentiment were to continue its current bad patch and eventually engulf the EURRON exchange rate, which is so far enjoying a fine strengthening ride supported by a positive carry-to-volatility spread versus peers. A second hike could only come well into 2019 and it should be very much conditional on significant progress in any of the 4 factors mentioned above, among which the ECB's end of QE looks like the most likely trigger.

Chart 3. Money market and policy interest rates, %



Source: National Bank of Romania

The slowdown in growth is not good news for fiscal policymakers, especially in the context of the strained relationship with the European Commission, which has recently sent another warning to the Romanian authorities with respect to their lack of convincing efforts to reverse the deterioration of the structural budget deficit. The ambitious tax collection plan for this year, especially in the case of VAT revenues, can be jeopardized by a slowing economy. Combined that with the EC's pressure and with the increasing pressure for the government to perform on the investments and the EU funds absorption side which imply extra spending compared to 2017, we see the odds as increasing for further fiscal adjustment measures. In that sense, the continuing request for special dividends collection from State-owned companies or a potential re-routing of social contributions funding the Pillar II private pensions system to the social security budget are just a way of buying time. They could carry the budget deficit home for perhaps one more year, but they are not solving the budget's structural problems.

The Government's bet is that investment spending can do that magic, especially if those much awaited infrastructure projects with large multiplier effects can finally hit the road. They could potentially boost GDP growth and "create" the basis for revenues to come back to the budget through extra taxes. Of course, who wouldn't support an investment led growth model? The business community certainly does, as reflected by the AmCham's recently published investment report[2], which also includes a few ideas on what/how/where to boost investments. The only problem is that ideas are many, but what is needed is hard, detailed work. In that respect, we are perhaps too much used to expecting the magic fairy perform instead of us. Having the public sector wages rise every year by 25% with no guarantee of a

[2] You can consult the report in Romanian language at the following link: https://www.amcham.ro/UserFiles/articleFiles/Investitiile%20Coloana%20Vertebrala%20pentru%20o%20dezvoltare%20economica%20sustenabila%20a%20Romaniei_05220848.pdf

corresponding productivity boost is not the way to go anymore. We need a different strategy or else we will all pay the costs in terms of higher taxes, lower social benefits and poorer and poorer public services.

Macro Monitor

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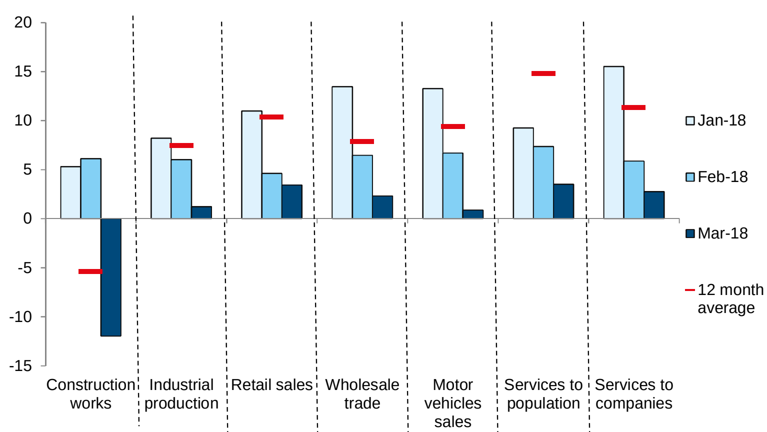
Romanian economy slowed down in first quarter of 2018

Real GDP growth arrived at 0% q/q (s.a. data) and 4% y/y in 1Q18, according to the flash estimate published by the National Institute of Statistics. The Romanian economy thus continued to lose momentum compared to 4Q17, when the economic growth was already pointing towards a slowdown at 0.3% q/q and 6.7% y/y. Economic growth deceleration in 1Q18 was not a surprise for us, as earlier signals from weaker confidence indicators and hard data reinforced our belief that the activity in industry, retailing and services was slowing. The Economic Sentiment Indicator averaged 102.3 points in 1Q18, the lowest quarterly reading in three years.

While no breakdown has been provided by the National Statistics Institute on what caused the slowdown, we think that both domestic and external factors stood behind the expected deceleration of the Romanian economy. The Eurozone, our leading trading partner, grew only 0.4% q/q in 1Q18, the weakest quarterly expansion over the last five quarters. Unfavorable weather conditions, strikes in some countries, and growing fears about a trade conflict between the US and its trading partners have often been cited as key reasons for the poorer growth performance of the Eurozone in the first quarter of this year.

Chart 4. Economic developments by sector in March, % y/y



Source: National Statistics Institute

At the same time, Romania experienced unusually cold weather in March, which most likely dampened the activity in some sectors. Industrial production, wholesale and retail trade, services for the population and companies only showed a marginal advance in March (2-3% y/y), after posting solid growth rates in the previous two months (10-15% y/y and 6-7% y/y in January and February). The surprise pullback in construction added to the slowing signs in 1Q18. The activity of this sector was particularly weak in March, when it fell almost 12% y/y, after three months of decent performance. March marked the third consecutive double-digit drop in the residential segment. Engineering works also shrank, while the non-residential segment barely rose. We currently think that it is too early to say whether the weakness in construction works will persist in the following months, as these disappointing numbers can be attributed to the unusually cold weather in the first month of the spring and not necessarily to structural weakness.

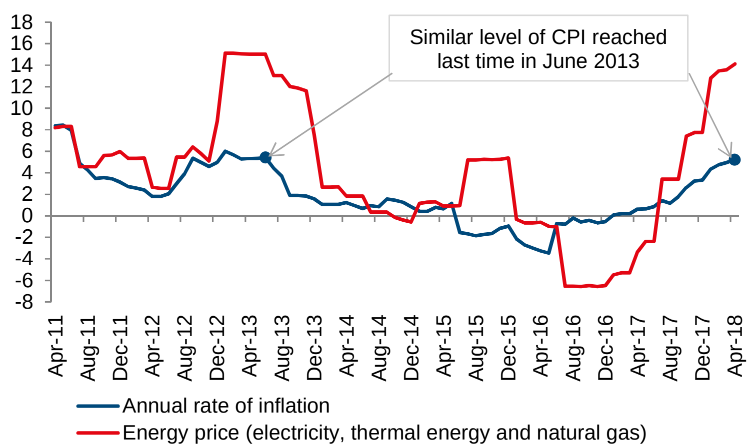
GDP growth is seen to rebound in the second quarter of this year, as we believe that part of the current slowdown is only temporary. March, however, brought some good economic news too. Annual growth in exports was faster than that of imports (+6.6% versus +5.8%), indicating a possible recovery in industry after a period of modest readings. What is more, new orders' solid development, including the domestic new orders, amid slightly perkier consumer confidence in April, adds to the evidence for stronger industry reading in the second quarter.

Consumer prices at 5-year high in April, to slow around year-end

Annual inflation headed higher to 5.2% in April from 5% in the previous month, as it was mostly influenced by some temporary factors such as the natural gas price hikes or higher excise duties for tobacco. The mark-up in fuel prices was also substantial and was driven by a run-up in Brent oil price.

Barring the hikes in natural gas and tobacco prices and rise in fuel prices, inflation would have slowed slightly to 4.8% in April. Core 2 adjusted inflation (CPI less administered, volatile food and fuels, tobacco and alcohol), central bank's preferred gauge for tracking underlying inflation pressures, barely moved in April. However, because of rounding, core 2 adjusted inflation ticked up to 3.1% (from 3% in March).

Chart 5. Annual rate of inflation, %



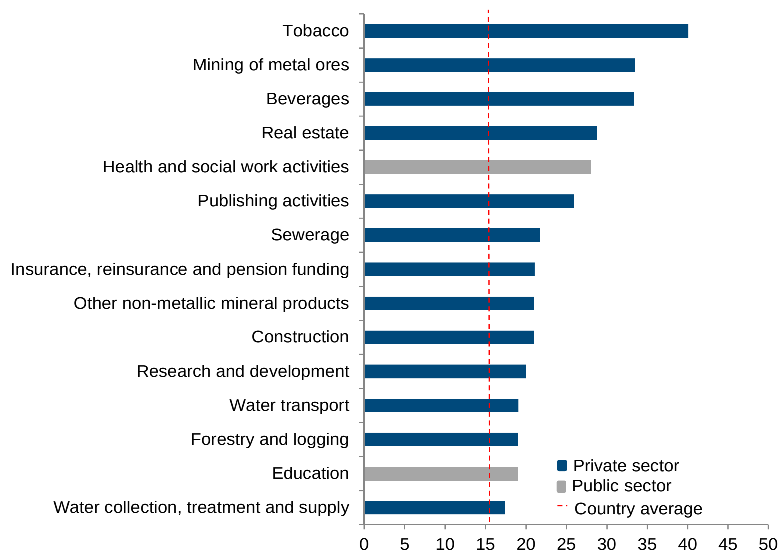
Source: National Statistics Institute

We think there is no reason to worry at least as yet, even though the CPI is more likely to hover around the 5% level throughout the autumn. We continue to expect the inflation to slacken off to 3.7% as of end-2018 helped by a favorable base effect. Risks to our baseline scenario are rather tilted to the upside, as the unremitting tensions in the Middle East that could drive the international price of oil even higher. Also, we do not rule out some negative surprises from local agriculture – derelict irrigation systems make it largely vulnerable to the elements.

Salary gains scaled dizzy heights in March, helped by private sector

Net salary gains picked up significant speed in March (+15.5% y/y), bolstered by notable pay rises in both the public and private sectors. The steepest growth rates were reported in 'health' and 'education', where net salary gains were up a whopping 28% y/y and 19% y/y, respectively. In the private sector, industries such as 'tobacco', 'mining of metal ores' and' beverages' were at the top end of net salary gains in March (33.4-40.1% y/y); this was mostly a seasonal impact of employers paying bonuses and other sums to their workers. The recent surge will gradually taper off in the coming months, once the recent bonuses extended drop out of the base effect.

Chart 6. Average net wages by sector in March, % y/y



Source: National Statistics Institute

Bond Monitor

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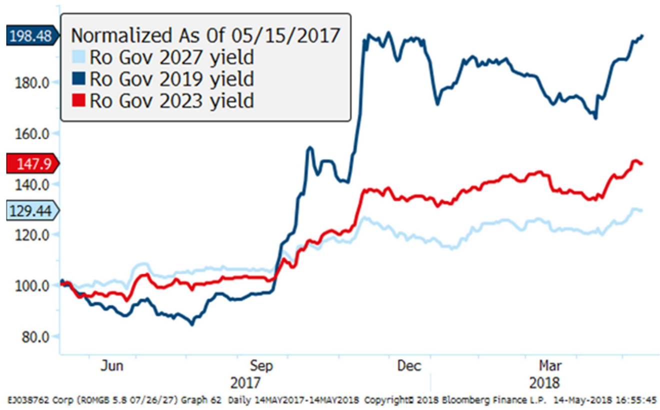
Compared to a month ago, Romanian government bond yields rose on average by approximately 60 bps, boosted by an adverse combination of both local and external factors. Local drivers included the NBR's liquidity tightening and its subsequent policy interest rate hike, but also the relatively high inflation print in April, which took the year-on-year CPI growth rate to a 4-year high of 5.2%. External factors were also unsupportive for bonds, with US Treasury yields moving past the 3% resistance level and Emerging Market bonds feeling the pinch of the rising USD FX and interest rates, on top of the country specific negative stories such as the bailout requested by Argentina and the virtual currency crisis in the close-by Turkey.

Chart 7. One year evolution of Romanian government bond yields maturing in 2019, 2023 and 2027 (base period = 100)



Source: Bloomberg

As was the case since the autumn of 2017, in the past month it was also short-term yields that rose faster that long-term ones. Over the last year, this has led to a significant flattening of the yield curve: the term spread between 10-year and 1-year government bonds has declined from a high of 300 bps in the summer of 2017 to less than 200 bps today. In a country where monetary policy is full swing in a tightening cycle, this may not be surprising and it mirrors a similar phenomenon from other markets (e.g. UST market or Polish government bond market). We nevertheless think that further flattening days may be over. As we mentioned before, monetary policy is likely to slow down its tightening pace as inflation tail risks are diminishing with the slowing economy and with the more stable RON. A more sluggish GDP growth may nevertheless shift investor focus towards fiscal policy risks, with long-term bond yields usually more sensitive to such investor concerns.

Even if local fundamentals would support it, the trigger for a steepening of the local yield curve is still likely to come from abroad. This is because in all likelihood it is foreign investors that are currently most active on the longer part of the curve, given that local players (banks, pension funds, mutual funds) have few incentives to take on duration risk. In case of banks and mutual funds, their benchmarks are generally of shorter durations and in the case of pension funds, the uncertainty surrounding the future of the mandatory private system means they are more likely to steer their portfolios to safety in order to avoid recording negative absolute returns that would worsen their case in the heated public debate. Given the foreigners involvement, global market trends will set the mood for long-term Romanian bonds trading as well. Potential triggers for long-term yields going higher could come from a potential steepening of the ultra-flat US Treasuries yield curve or from the steepening of the Euro curve as the ECB announces further cutback or even the end of the QE program. The most nearby risk however comes from a continuing Emerging Markets turmoil, as a potential streak of outflows from dedicated bond funds can cause the pressure to build up also on Romanian bonds, even if their lack of liquidity and hefty yield spread to CEE peers have so far provided some protection.

Macro forecasts

	2010	2011	2012	2013	2014	2015	2016	2017	2018f
Real economy									
GDP - %, y/y real change	-1.1	2.3	0.6	3.5	3.1	4.0	4.8	6.9	4.1
GDP - RON bn	534	565	597	637	668	713	762	858	935
GDP per capita - EUR tsd	6.2	6.6	6.7	7.2	7.5	8.1	8.6	9.5	10.1
Households' consumption - %, y/y real ch.	0.2	1.4	1.5	-2.4	4.4	5.7	7.3	9.0	5.2
Industrial production - % y/y real ch.	5.6	5.6	0.0	7.8	6.1	2.7	1.7	8.2	4.9
Retail sales - %, y/y real ch.	-7.0	-1.2	4.1	0.5	7.0	8.9	13.5	10.7	6.0
External sector									
Exports of goods & services - EUR bn.	40.6	48.8	49.8	57.3	61.9	65.8	70.2	77.7	83.0
Imports of goods & services - EUR bn.	48.1	56.1	56.2	58.0	62.4	66.7	71.7	81.7	88.4
Balance of goods & services - % of GDP	-5.9	-5.5	-4.8	-0.5	-0.3	-0.6	-0.9	-2.2	-2.7
C/A balance - % of GDP	-4.6	-4.6	-4.5	-0.8	-0.5	-1.2	-2.1	-3.4	-4.0
Prices									
CPI - y/y (%)	8.0	3.1	5.0	1.6	0.8	-0.9	-0.5	3.3	3.7
CPI - average (%)	6.1	5.8	3.3	4.0	1.1	-0.6	-1.5	1.3	4.6
Labour market									
Unemployment rate - %	6.9	7.2	6.8	7.1	6.8	6.8	5.9	4.9	4.9
Net wages - RON	1,391	1,444	1,507	1,579	1,697	1,859	2,046	2,336	2,570
Net wages - %, real change	-3.7	-1.9	1.0	0.7	6.3	10.2	11.7	12.7	5.2
Public sector									
Fiscal deficit - % of GDP (ESA)	-6.9	-5.4	-3.7	-2.1	-1.4	-0.8	-3.0	-2.9	-3.3
Public debt - % of GDP (Eurostat)	29.9	34.2	37.3	38.0	39.8	37.9	37.6	35.1	34.9
Interest rates									
Monetary policy rate, eoy	6.25	6.00	5.25	4.00	2.75	1.75	1.75	1.75	2.75
ROBOR 3M - %, eoy	6.2	6.1	6.1	2.4	1.7	1.0	0.9	2.1	2.8
ROBOR 3M - %, average	6.7	5.8	5.3	4.2	2.5	1.3	0.8	1.2	2.4
10Y ROGB, %, eoy	7.2	7.2	6.4	5.3	3.6	3.7	3.6	4.3	5.4
FX rate									
EUR/RON eoy	4.28	4.32	4.43	4.48	4.48	4.52	4.54	4.66	4.73

Source: Central bank, Eurostat, NIS, BCR Research

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