

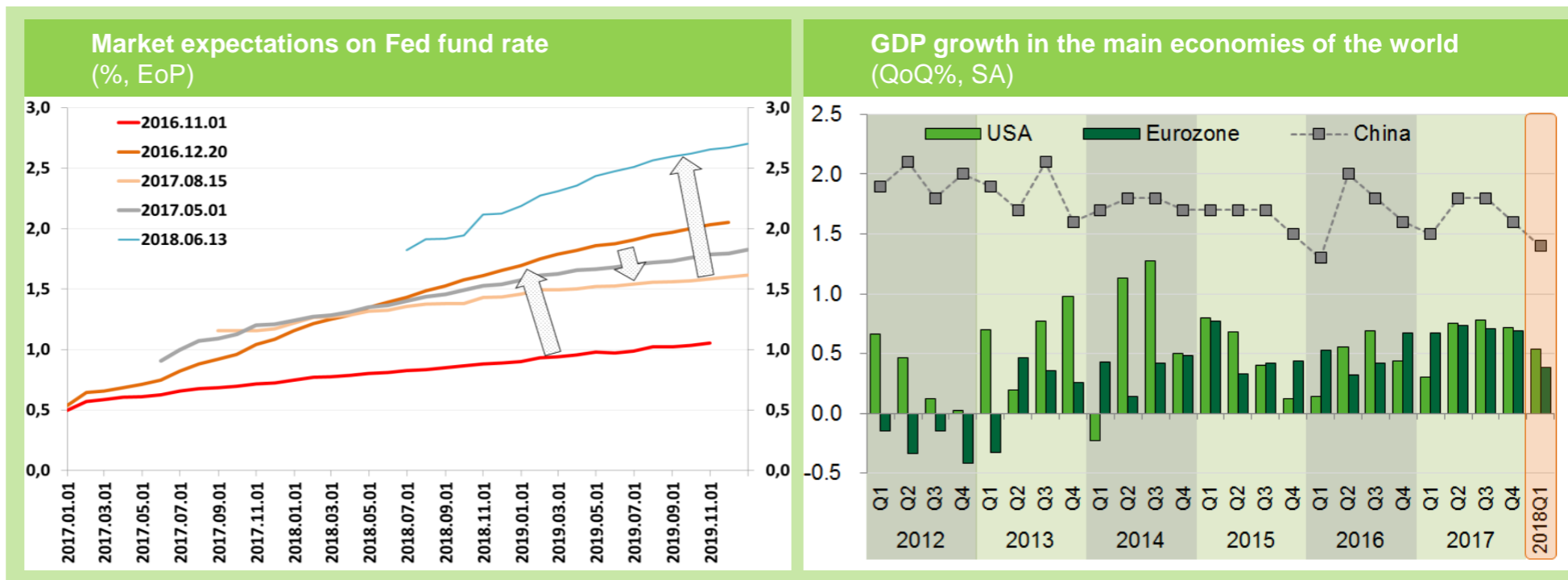
Macroeconomic perspectives

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SUMMARY:

- In the beginning of 2018, the international environment changed significantly;
- Ultra-loose monetary policy seemingly came to an end;
- Near-term growth outlook is still rather favourable, but further protectionist measures and more aggressive than previously thought monetary tightening poses downside risks; growth is expected to soften over the medium term;
- Precaution is warranted, particularly in the case of countries with macroeconomic imbalances and/or less sound economic policies;



Since 2010 the US enjoyed a long period of high economic growth and the recovery also started in the Eurozone. But due to the low capacity utilization, the anchored inflation expectations and later the declining commodity prices, inflation was well below the inflation target in the US and other major economies as well for an extended period of time. In this environment the monetary policy was extremely accommodative; liquidity was ample, short term interest rates declined toward or below 0%, which increased risk appetite in the world.

However in the past few quarters, the sentiment on international financial markets changed materially. First, the US 10 year bond started to increase rapidly in Q4 2017 (toward 3%) and the US stock indices downturned from their historical height in the beginning of 2018. Second, due to the rising oil prices and increasing capacity constraints in the advanced economies, the inflation outlook changed in the advanced and EM economies as well. (US inflation increased from 2.5% to 2.8% yoy in May, Eurozone inflation increased from 1.3% to 1.9% yoy,) Due to the above major stock indices dropped and international capital outflow started from the EM countries. These effects weighted more severely on those countries which have macroeconomic imbalances and/or inflation came well above expectation and/or the central bank was perceived as not credible – Argentina, Turkey. Additionally the ECB announced recently it will phase out its QE program and could start to increase interest rates in the second half of 2019.

GDP growth in the main economies of the world remained robust but failed to replicate the particularly impressive figures seen in most of 2017. On quarter-over-quarter basis, US economic expansion slowed to 0.5% in Q1, down from Q4's 0.7% gain. Simultaneously, Eurozone's GDP posted 0.4% advance (vs. 0.7%) and the Chinese economy also lost some impetus (1.4% vs. 1.6%). Q1's slowdown can be explained by a series of individual factors, including a moderation in confidence, higher energy prices, as well as several temporary effects, like unfavourable weather conditions in several advanced economies. In addition, the slower pace may also reflect a pull-back from the definitely strong growth observed in the previous few quarters.

In 2018, the **US economy** is expected to register another impressive advance, as sharp tax cuts (mainly personal income tax and statutory business tax) and higher government spending provides an additional impulse for the already healthy domestic demand. Nonetheless, starting from 2019, the country's growth is set to lose steam as the stimulus fades and monetary policy tightens.

Regarding the broader picture it is important to note that a series of indicators signal that the USA is in the late stage of the business cycle. Given this context, an unusually pro-cyclical fiscal policy (similarly large-scale easing has not been seen since the 1960's) may translate into risks over the medium term.

First of all, the sudden jump of the federal deficit is set to derail the trajectory of the public debt ratio in an unsustainable manner. Therefore, the consolidation of the budget will be inevitable. This means that several stimulus measures will be reversed when the economy is expected to be in a more fragile stage. Simultaneously, the easing actions, which propel the economy even further when it is already operating at full employment, may lead to more rapid wage dynamics and additional excess demand. These accompanied with higher import prices (fuelled also by new tariffs) translate into stronger underlying price pressures and increase the risk of higher-than-expected inflation outturns down the road. As a response, the Federal Reserve may be urged to speed-up the tightening cycle, raising interest rates temporarily above neutral level.

It is also worth mentioning that excess demand is set to support import growth, contributing to a wider trade deficit, a sensible issue for the Trump administration. The levies implemented so far by the US administration most likely have modest effects on real economy, but they are already weighing on sentiment and the escalation of the trade tensions is also on the cards. Further protectionist measures coupled with tightening monetary policy may outweigh the positive effect of the fiscal boost.

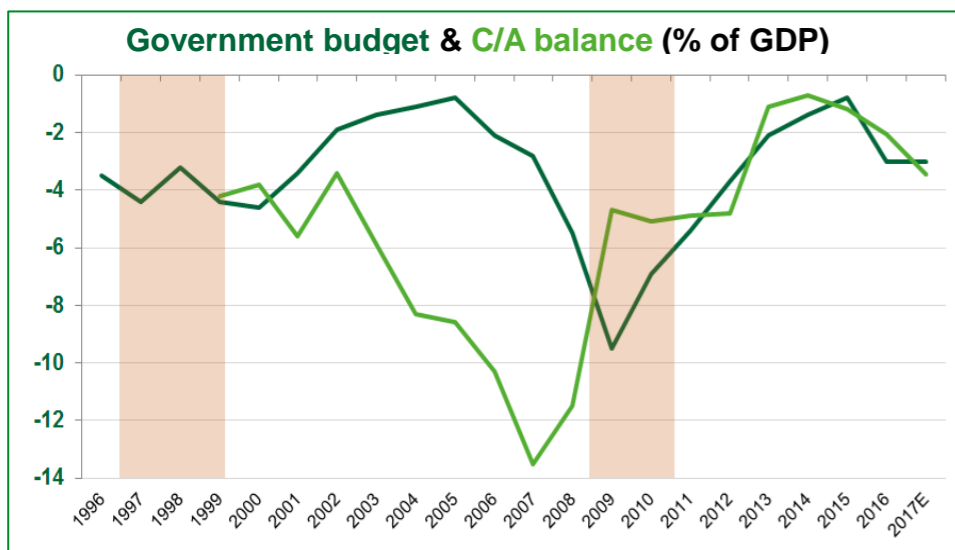
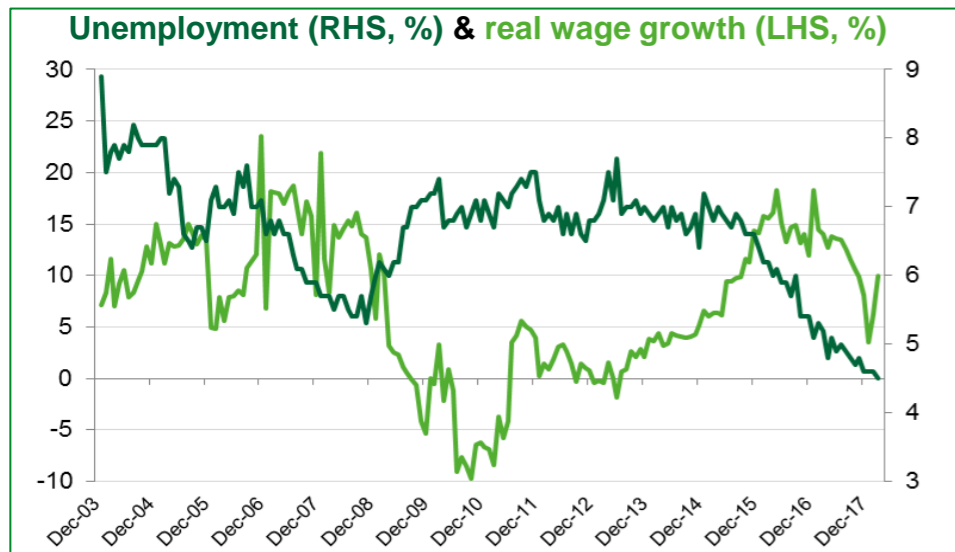
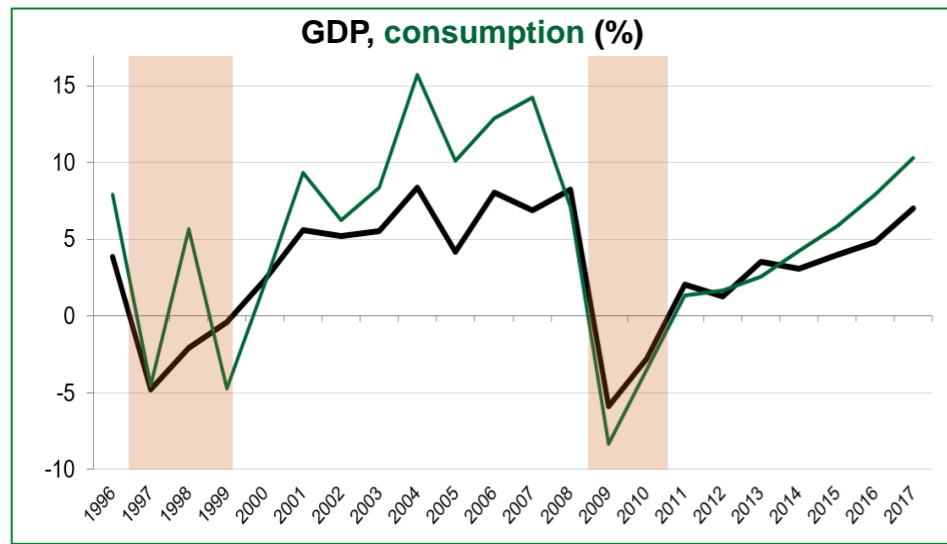
In the past few years, markets were rather lenient, but the early symptoms of higher interest rates, trade war fears and the de-compression of risk premiums have started to show up, particularly in some emerging market countries with US dollar denominated debt overhang and weaker fundamentals.

The **eurozone economy** still seems to be in good shape, as the improving labour market is expected to provide support for domestic demand. The still loose monetary policy and healthy momentum paves the way for another favourable GDP outturn in 2018. Nonetheless, growth is expected to moderate later as negative output gaps close and monetary policy normalisation unfolds. It is important to underscore too that the perspective of increasing interest rates doesn't bode well, particularly, for countries like Italy, where debt sustainability challenges prevail and political uncertainties are also high.

Despite the headwinds coming from the unfolding structural shift from investment and credit-led growth to a consumption and services oriented economy, **China's GDP growth** remained robust in the beginning of this year. Simultaneously, Chinese authorities continued to implement various actions in order to manage the private debt overhang but a long road is still ahead. With less credit and fiscal stimulus, growth may moderate somewhat in 2018, after advancing by 6.6% last year.

Summing it up, the general growth outlook still seems to be favourable for this year. However, it is important to note that the downside risks rose significantly too owing to escalating trade tensions as well as the higher likelihood of more rapid than previously expected monetary tightening. Therefore, precaution is warranted in the period ahead.

Big picture: (2017) the economy was propelled by loose fiscal and monetary policies, the revival of the EZ economy and excellent agriculture harvest; (2018) normalisation is underway



Big picture

- **Business cycle is in the mature phase, getting an extra boost from loose fiscal policy, growth normalizes as stimulus fades**
 - GDP growth practically reached pre-crises level fuelled by consumption
 - Already healthy underlying growth was propelled further by aggressive fiscal loosening, supportive monetary policy, healthy external demand and excellent agriculture harvest
 - Growth pace decelerates as the impact of stimulus measures fades
 - Overheating risk escalated due to miscalibrated government policy, widening current account gap and rapidly rising inflation
 - External debt and public debt is low
 - Loans and real estate prices are growing but much slower than in the previous boom

Monetary Policy

- The NBR had started the normalisation cycle
- Eurozone entry was postponed several times, but there is still willingness to adopt the euro (target date: 2024)

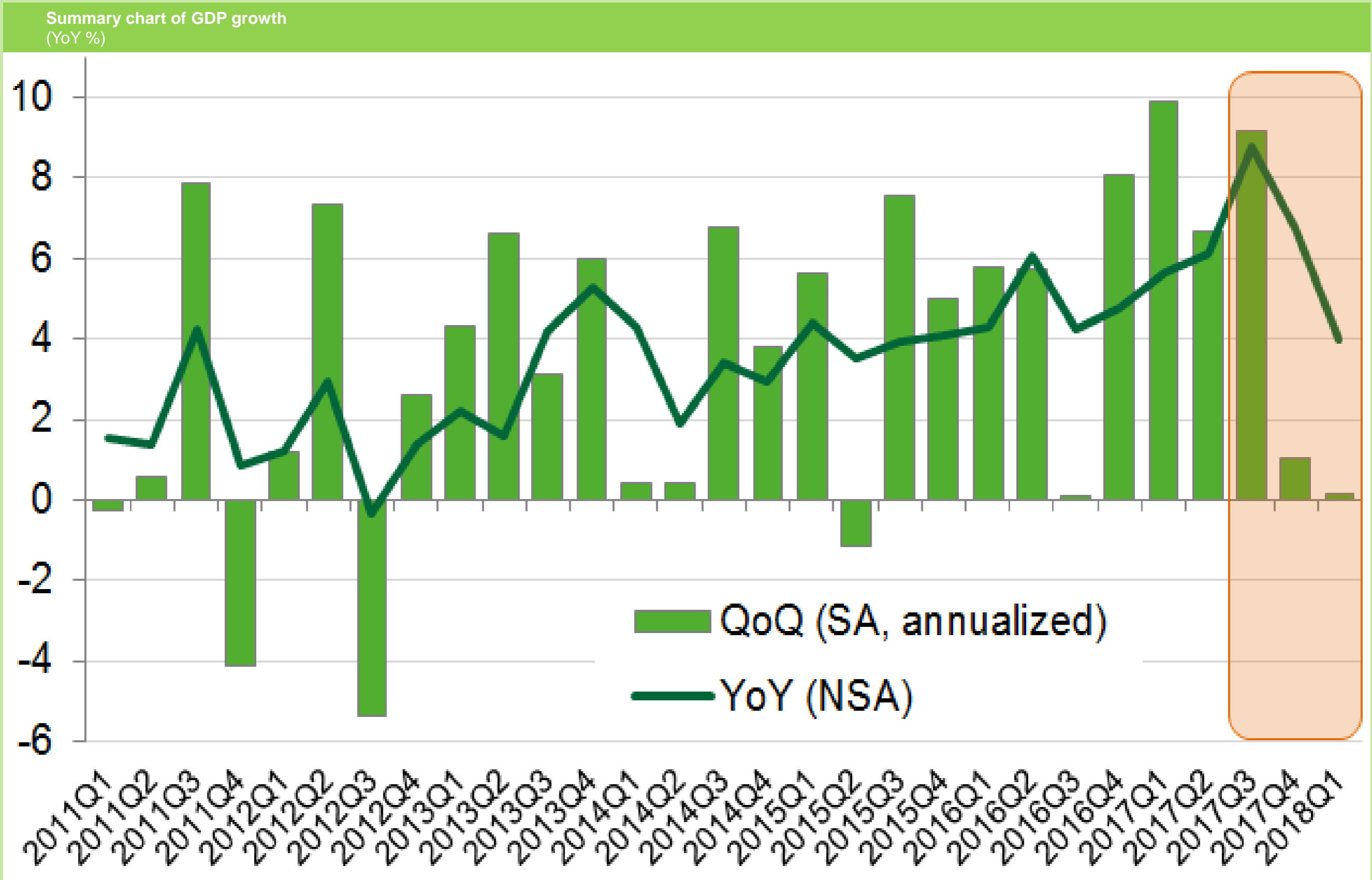
Fiscal policy

- The highly pro-cyclical budget is the key risk of the economy
- There is no room for further loosening
- Fiscal policy will continue to struggle with the 3% deficit limit

Labour market

- Unemployment hovers at record low
- In Q1 2018, real net wage growth lost momentum as inflation picked up and tax changes weighed, but rebounded owing to the tight labour market and further public wage hikes.

After disappointing in Q1, Romania's economy is expected to bounce back later this year, but the stellar gains characterizing 2017 are likely over; Downside risks around the medium-term outlook may rise as potential output growth moderates, and the fiscal room for addressing shocks is limited

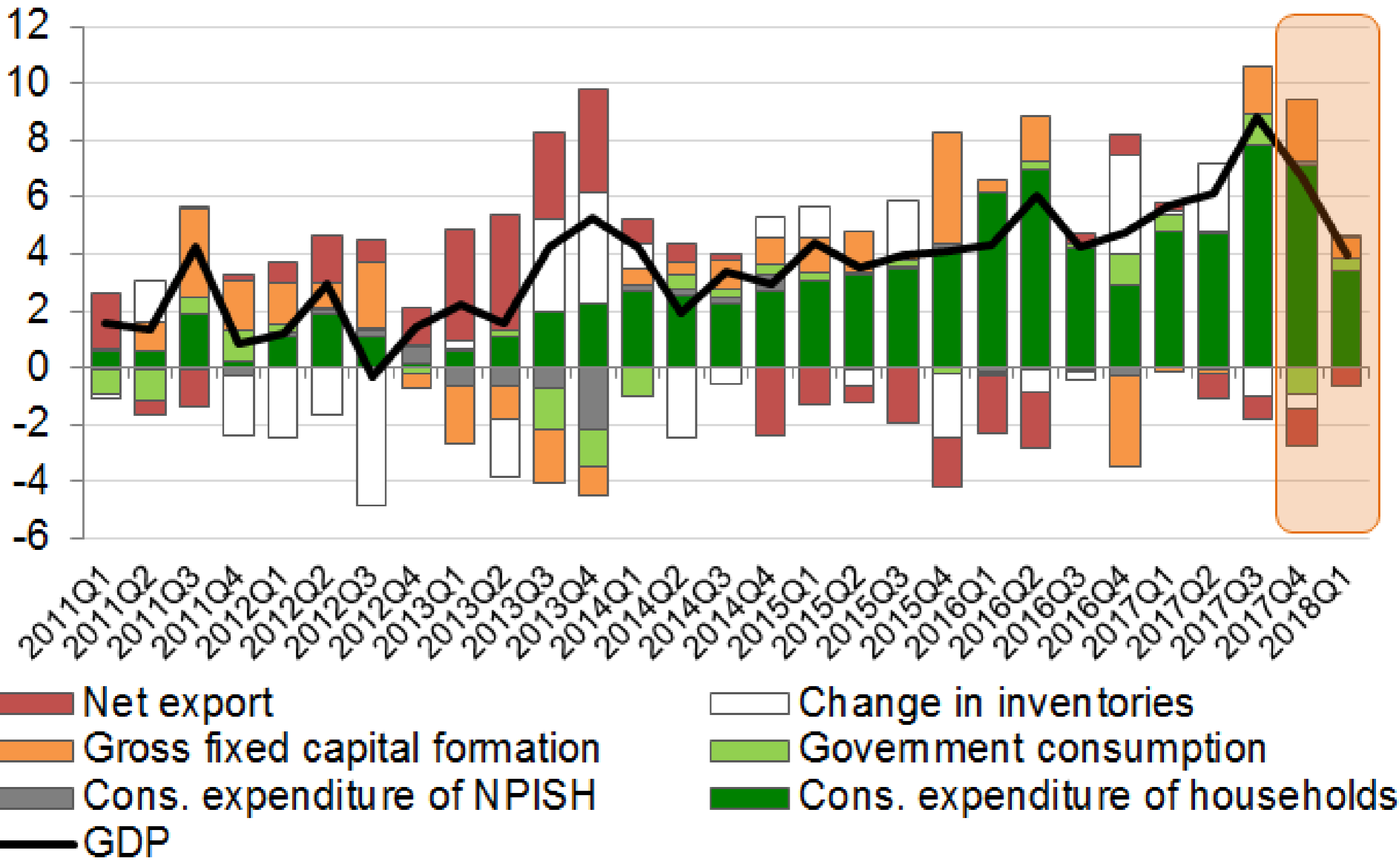


Sources: NIS, OTP Research

Romania's Q1 2018 GDP growth rate was confirmed at 4.0% YoY and 0.1% QoQ. The sharp deceleration compared to Q4's 6.7% YoY and 0.3% QoQ advances, was mainly driven by a setback in household consumption...



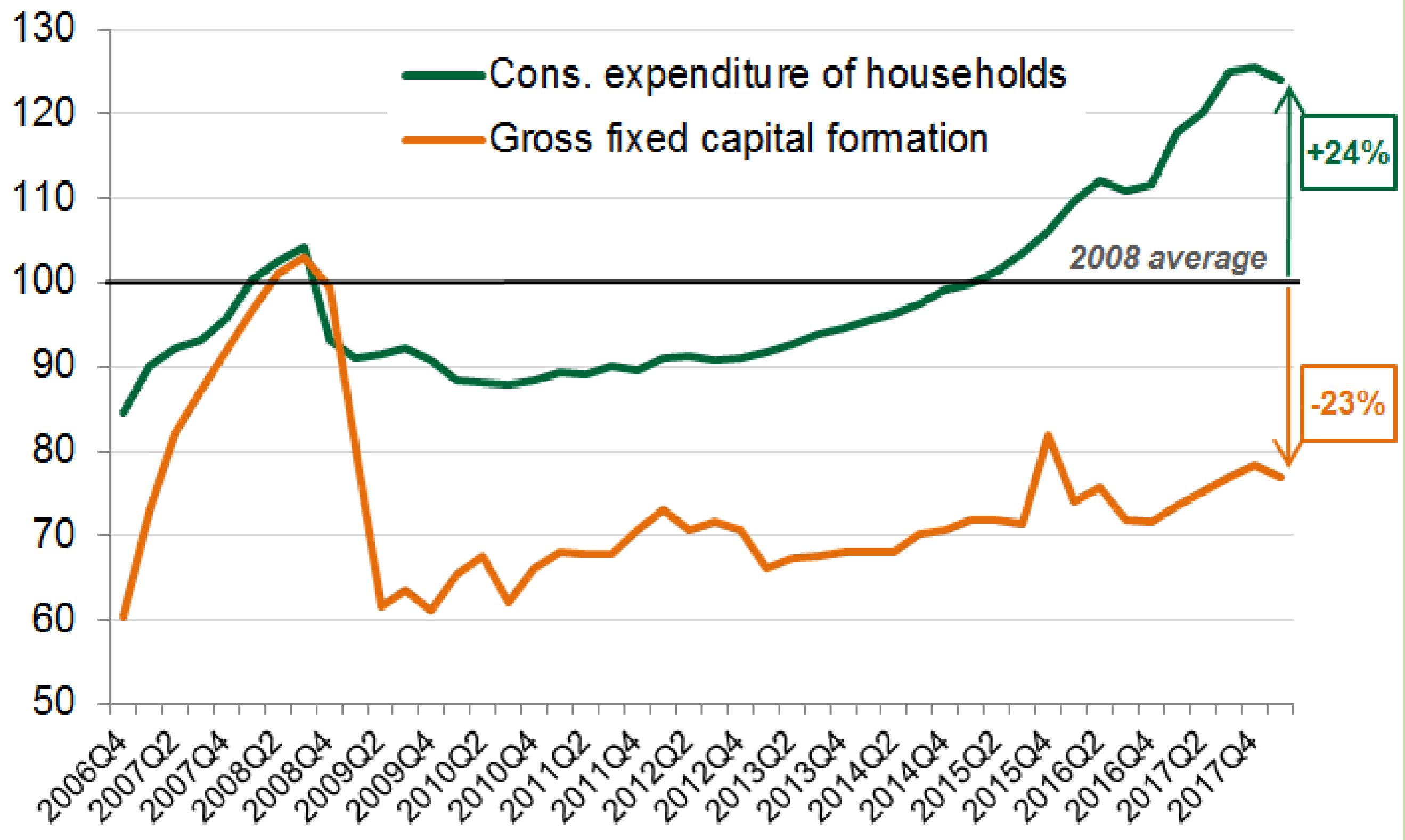
Decomposition of GDP growth by expenditure-side items (%)



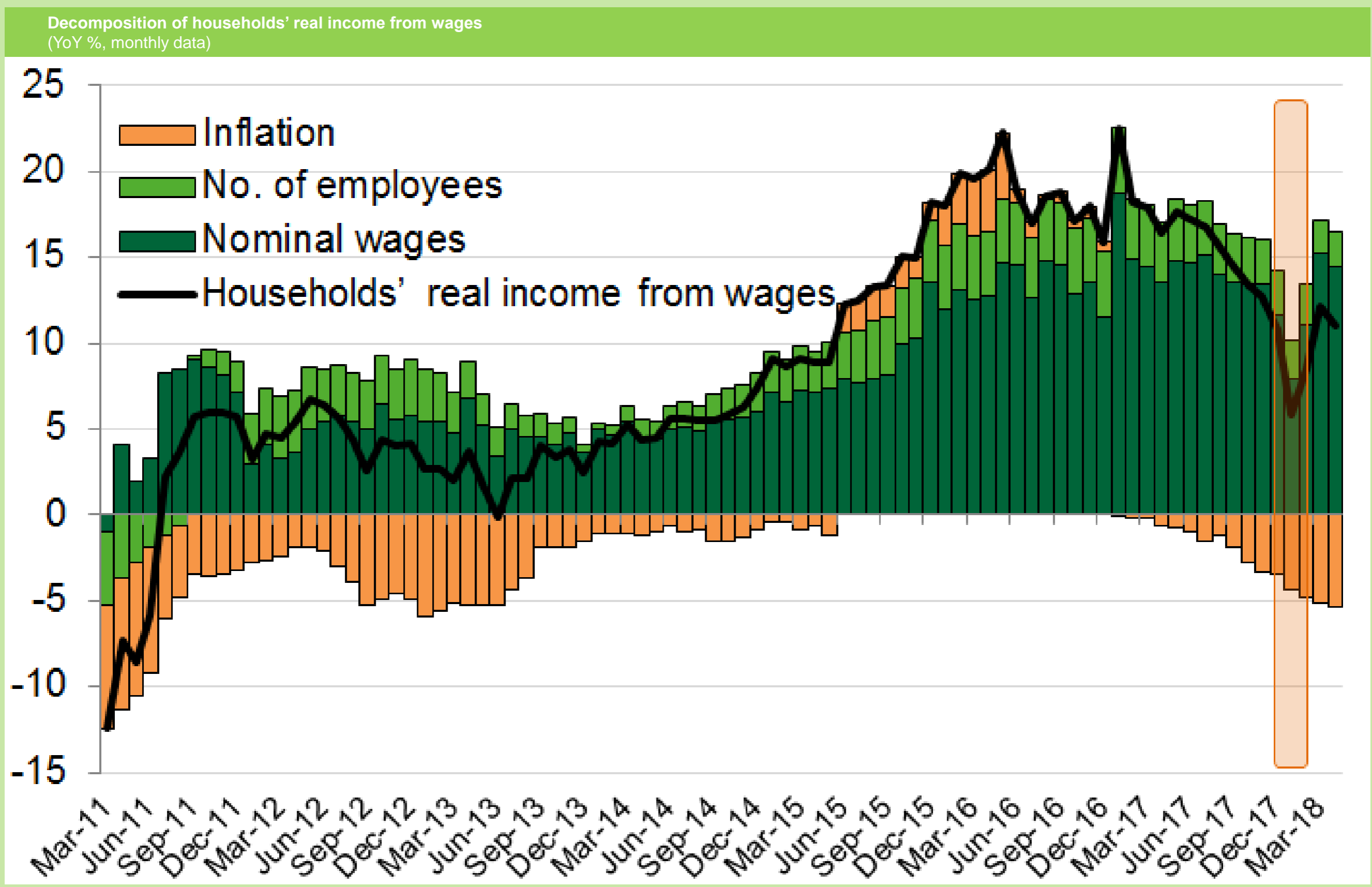
Sources: NIS, OTP Research

...but investments into gross fixed assets also softened.

Evolution of households' consumption vs. capital investment
(2008 av. = 100, SA)

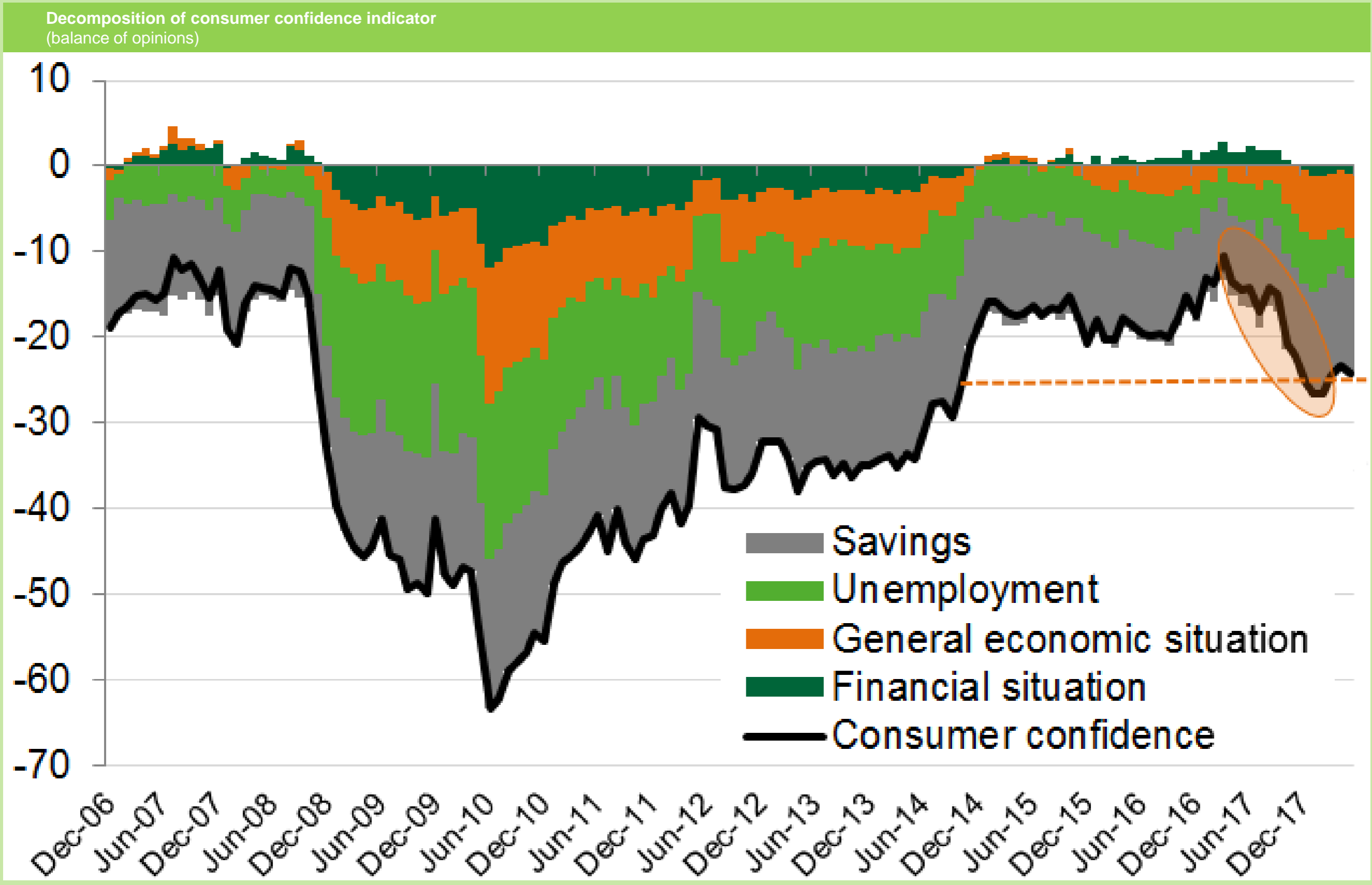


The weakness of household expenditures can be explained mainly by a setback of net nominal wage growth. This came on the back of important tax changes as well as significant base effects. Slower wage dynamics, coupled with the rebound of inflation had a negative impact on real disposable incomes



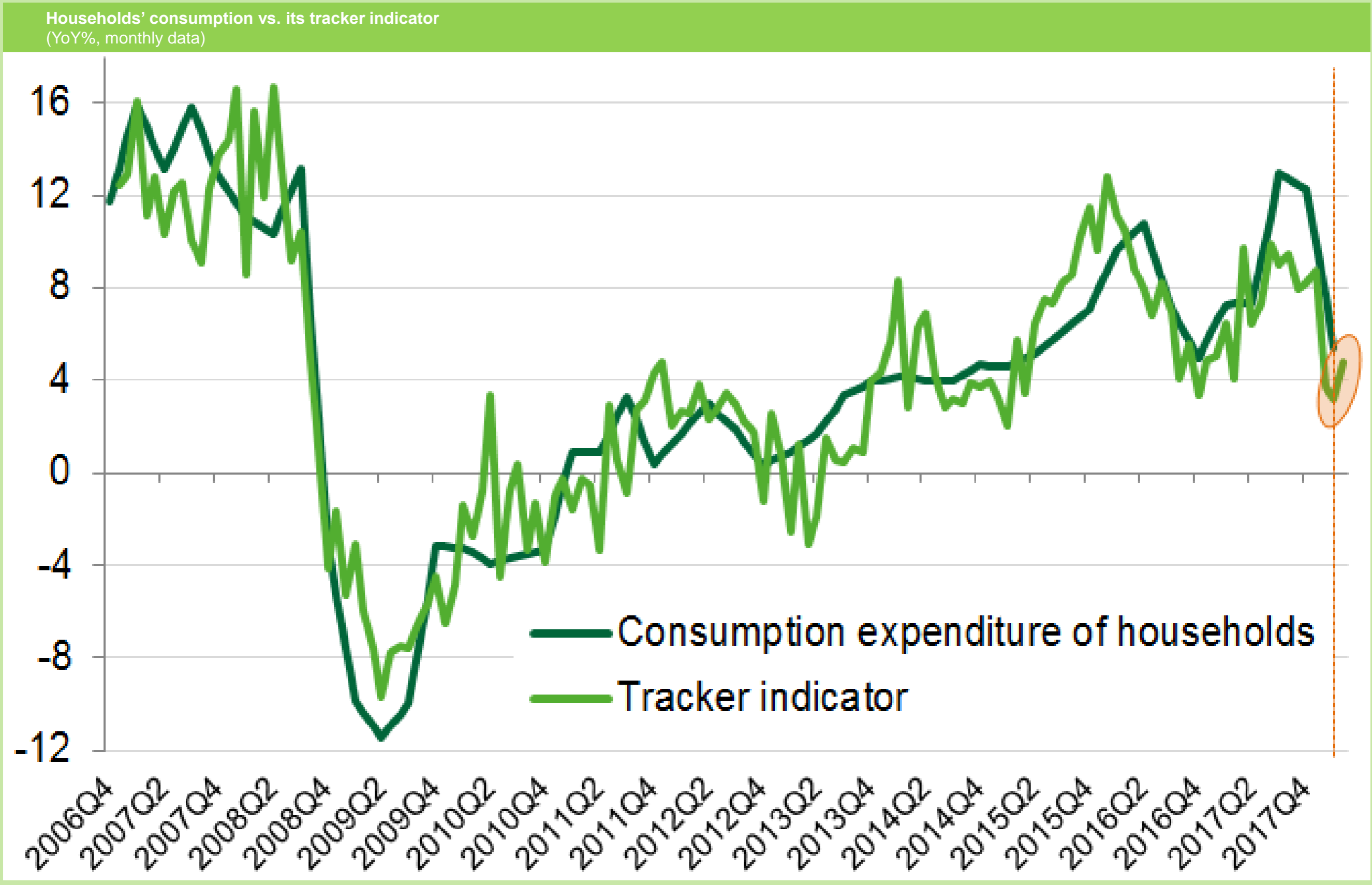
Sources: NIS, OTP Research

Sharply rising borrowing costs, the weakening pressure on the leu, as well as noise coming from the political scene all weighed on consumer sentiment too. Consumption may bounce back, as households' propensity to consume will rise, supported by re-accelerating wage growth and stabilizing confidence



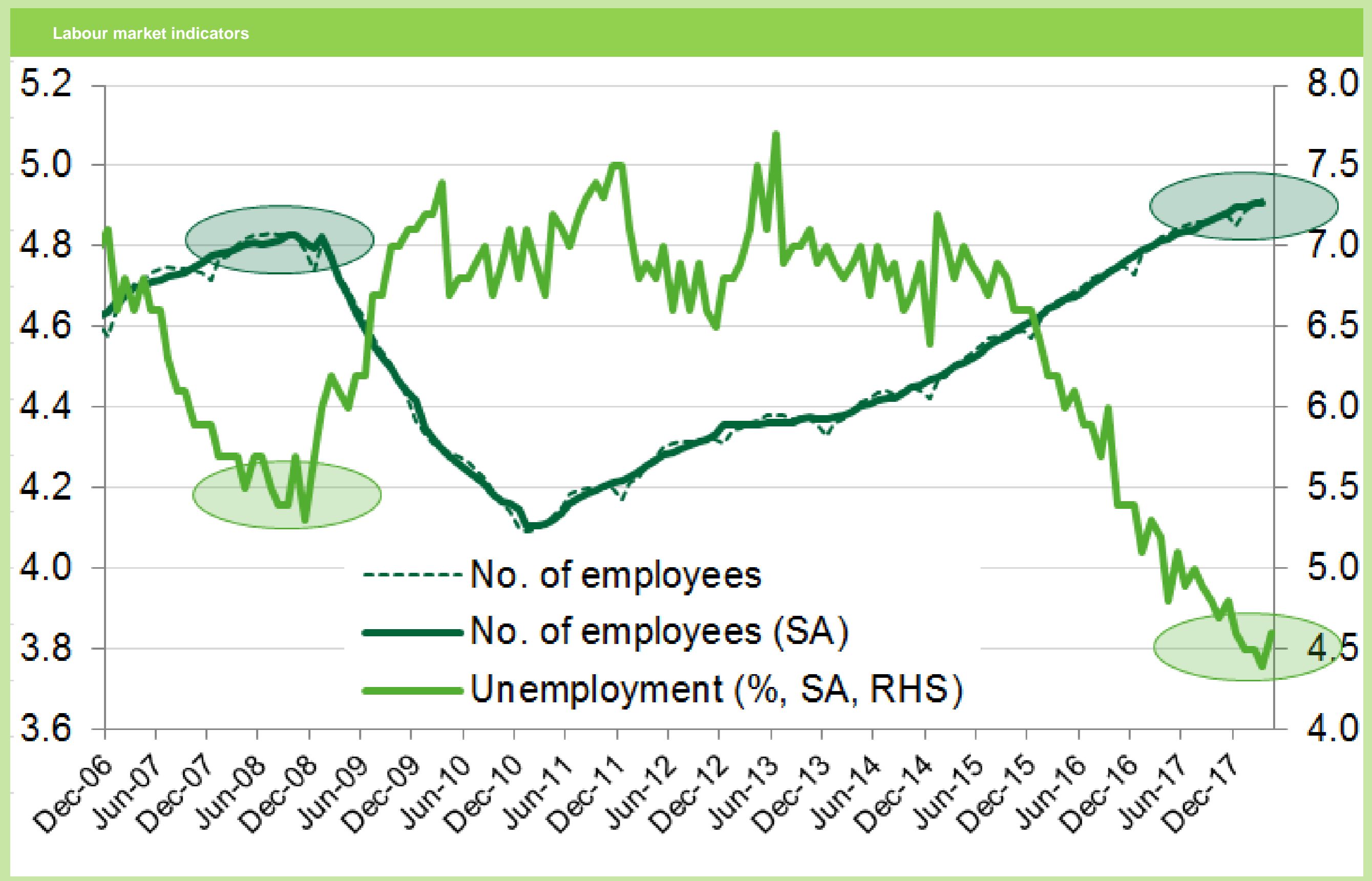
Sources: EC, OTP Research

Early data for April also signals a modest upswing in consumption, after the steep drop in the previous few months



Sources: NIS, OTP Research

The number of employees in the economy exceeded the peak seen before the outburst of the financial crisis, while unemployment hovered near an all-time low as well

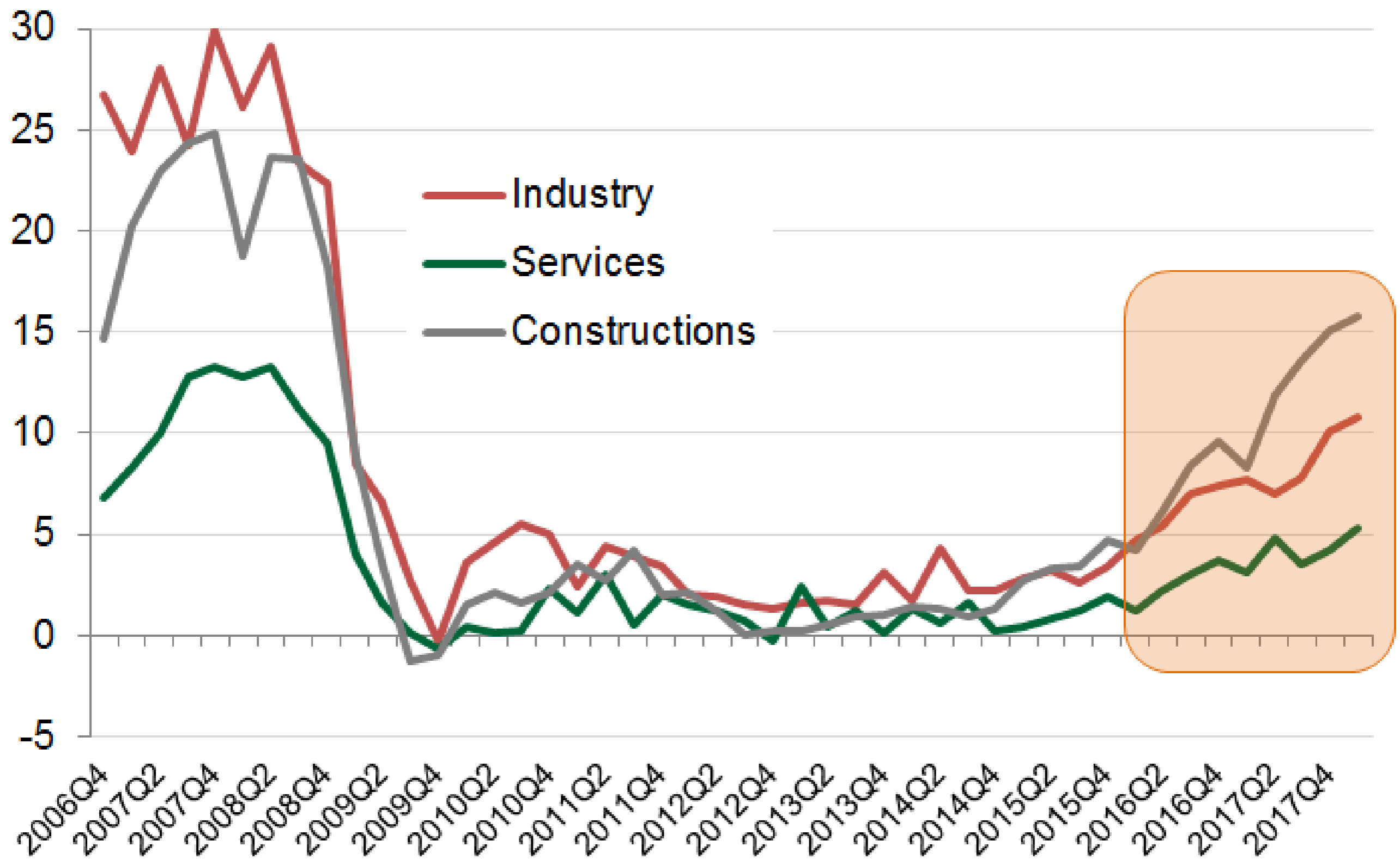


Sources: NIS, OTP Research

Survey-based statistics also confirm that the shortage of labour force is an increasing drag on production

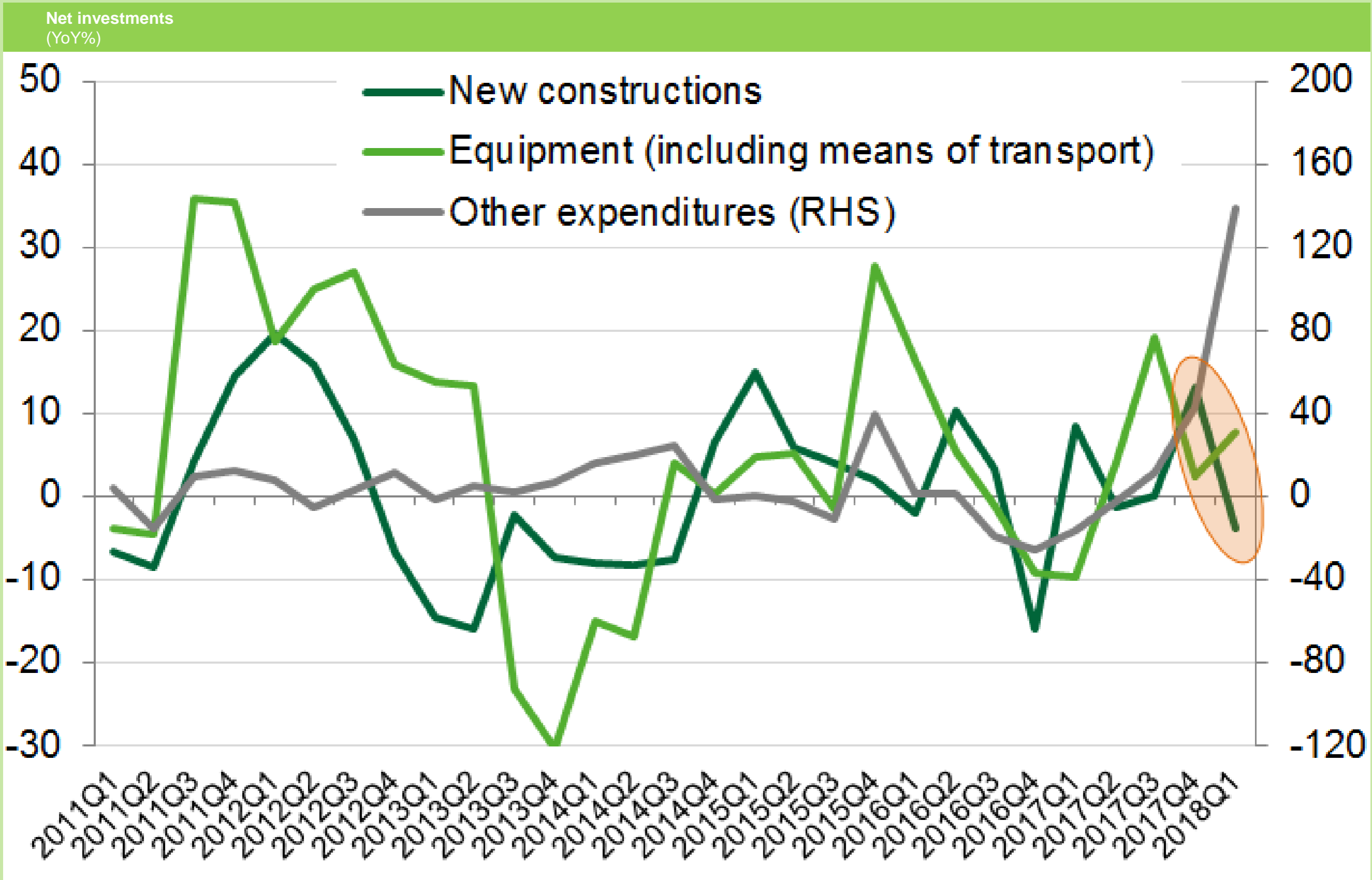


Shortage of labour force as a limiting factor of production (by sectors, balance of opinions)



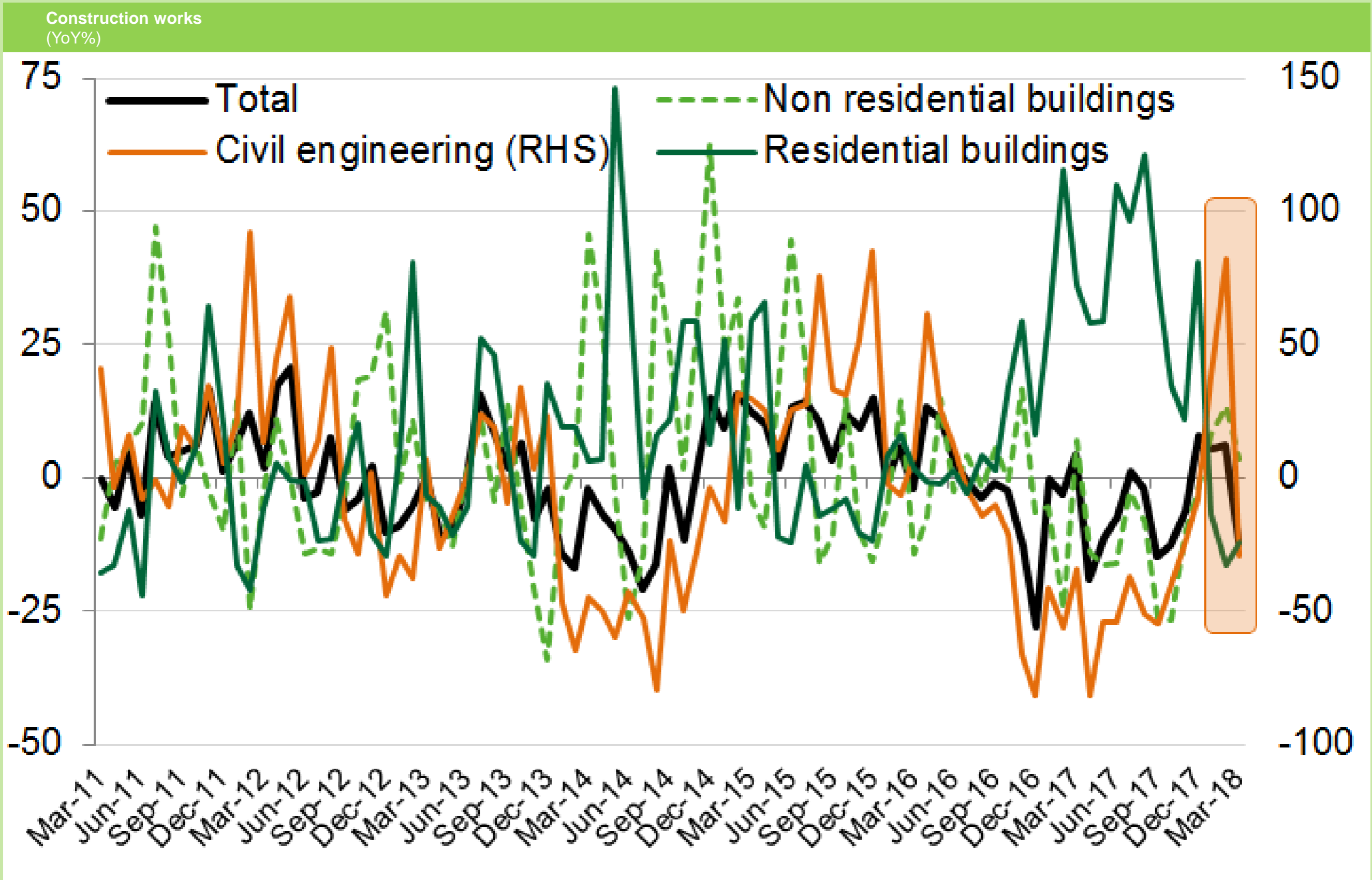
Sources: EC, OTP Research

Gross capital formation was a bit weaker-than-expected as it pointed to a throw-back in Q1, despite the signs of revival in 2017. More detailed data reveal that investments into new constructions could have played the key role in this outturn.



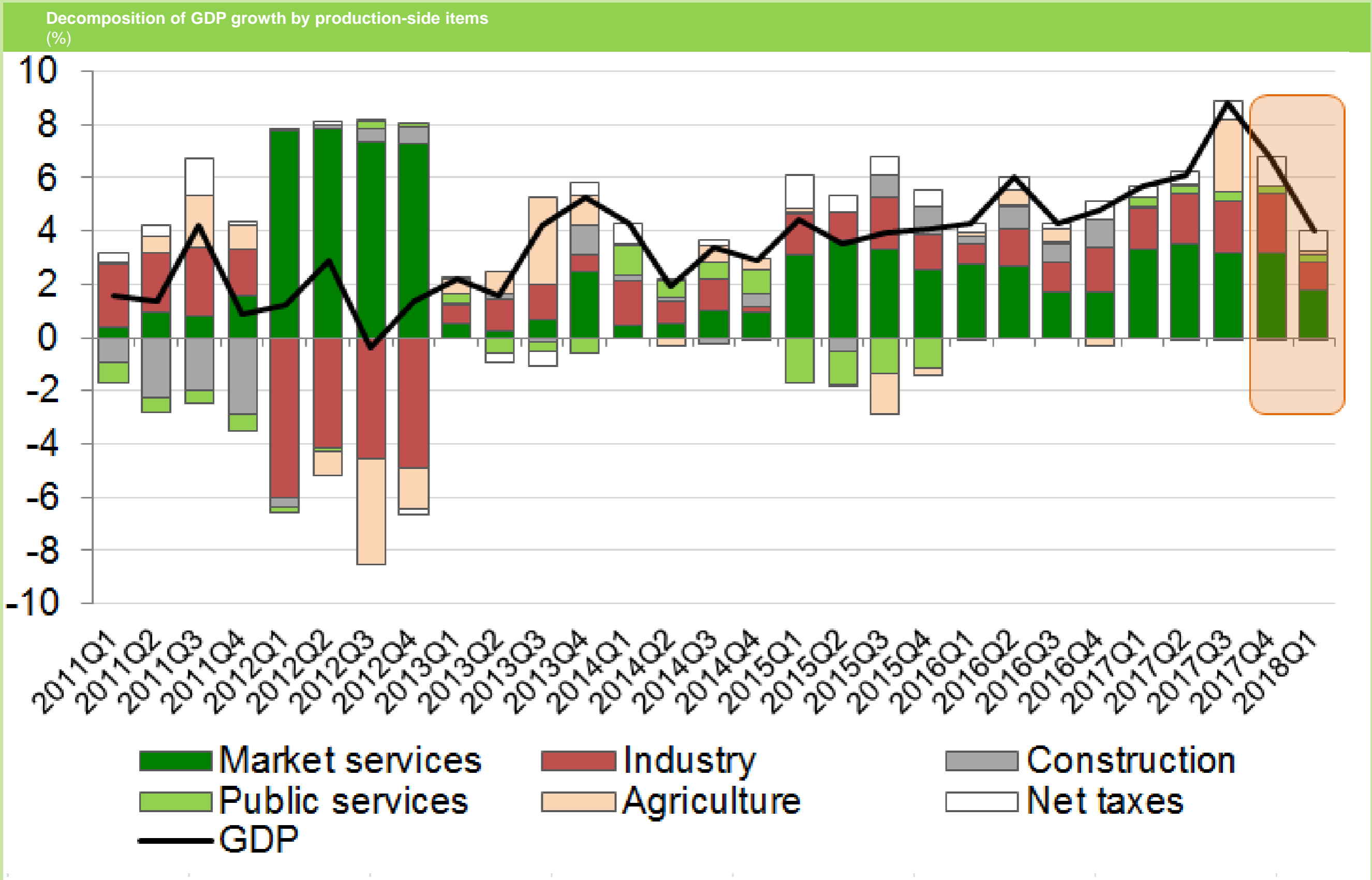
Sources: NIS, OTP Research

High-frequency statistics showed that construction output fared relatively well in January-February, helped by favourable weather conditions and recovering civil engineering works. Nevertheless, it seems that the return of winter in March more than offset the gains recorded in the previous two months.



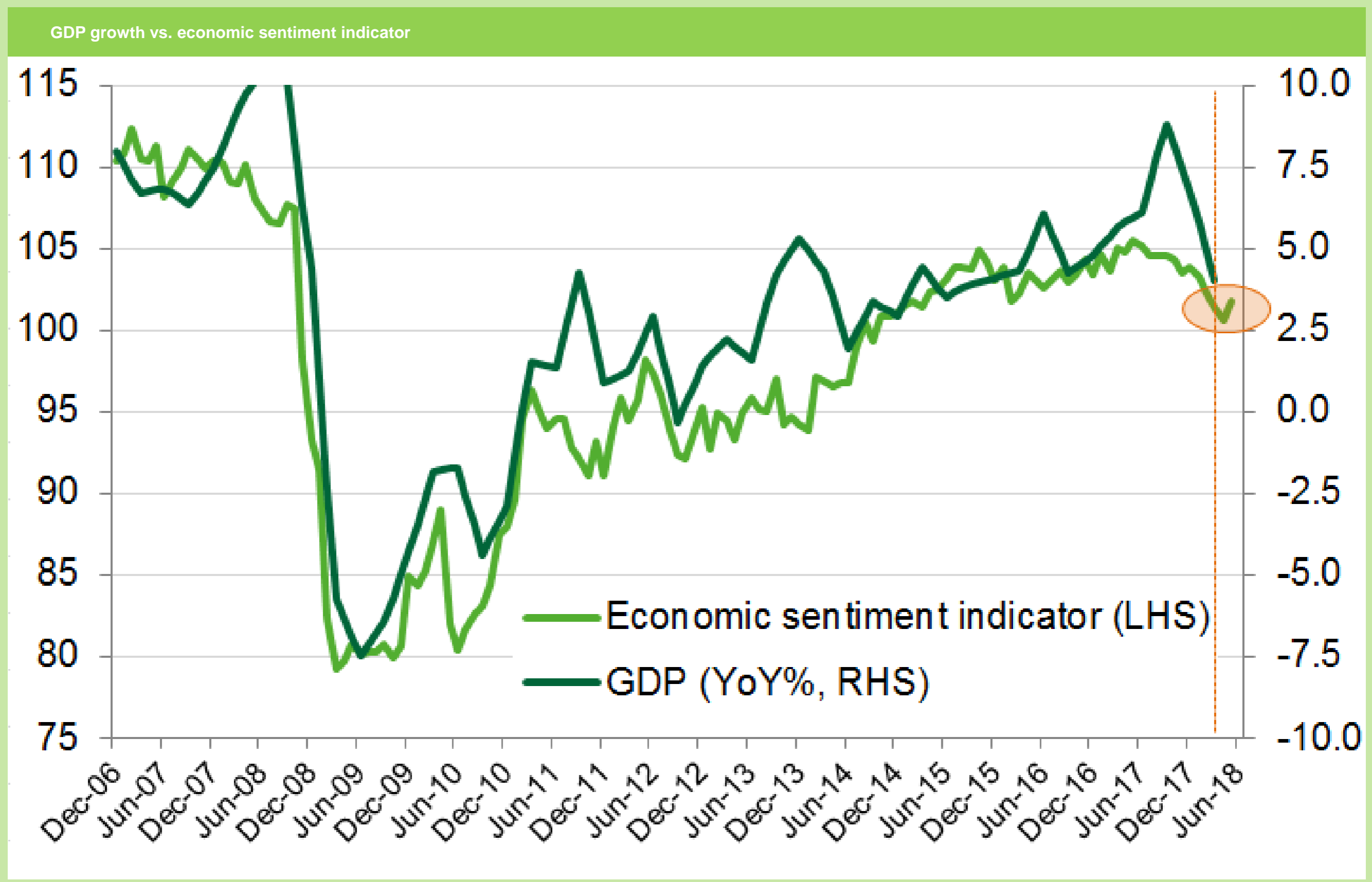
Sources: NIS, OTP Research

On the production side, the deceleration was broad-based in Q1, with all of the main economic sectors posting slower annual gains. Most likely, the sudden softening of domestic demand was an important factor behind the less impressive growth figures, but several production side constraints probably also showed up

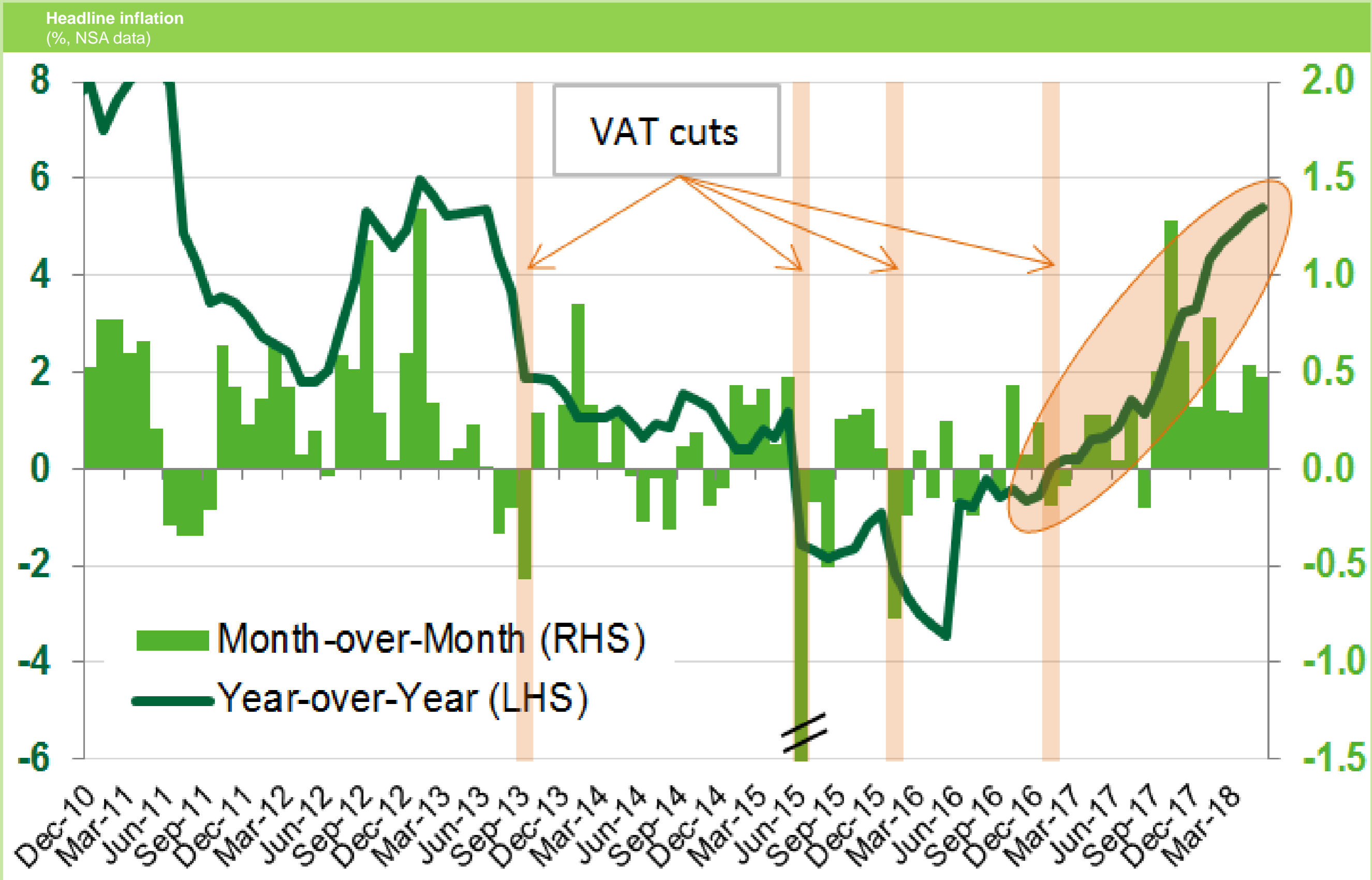


Sources: NIS, OTP Research

Nonetheless, early soft data for Q2 provide some reasons for optimism, as after easing in the past few quarters, economic sentiment appears to have bottomed out.

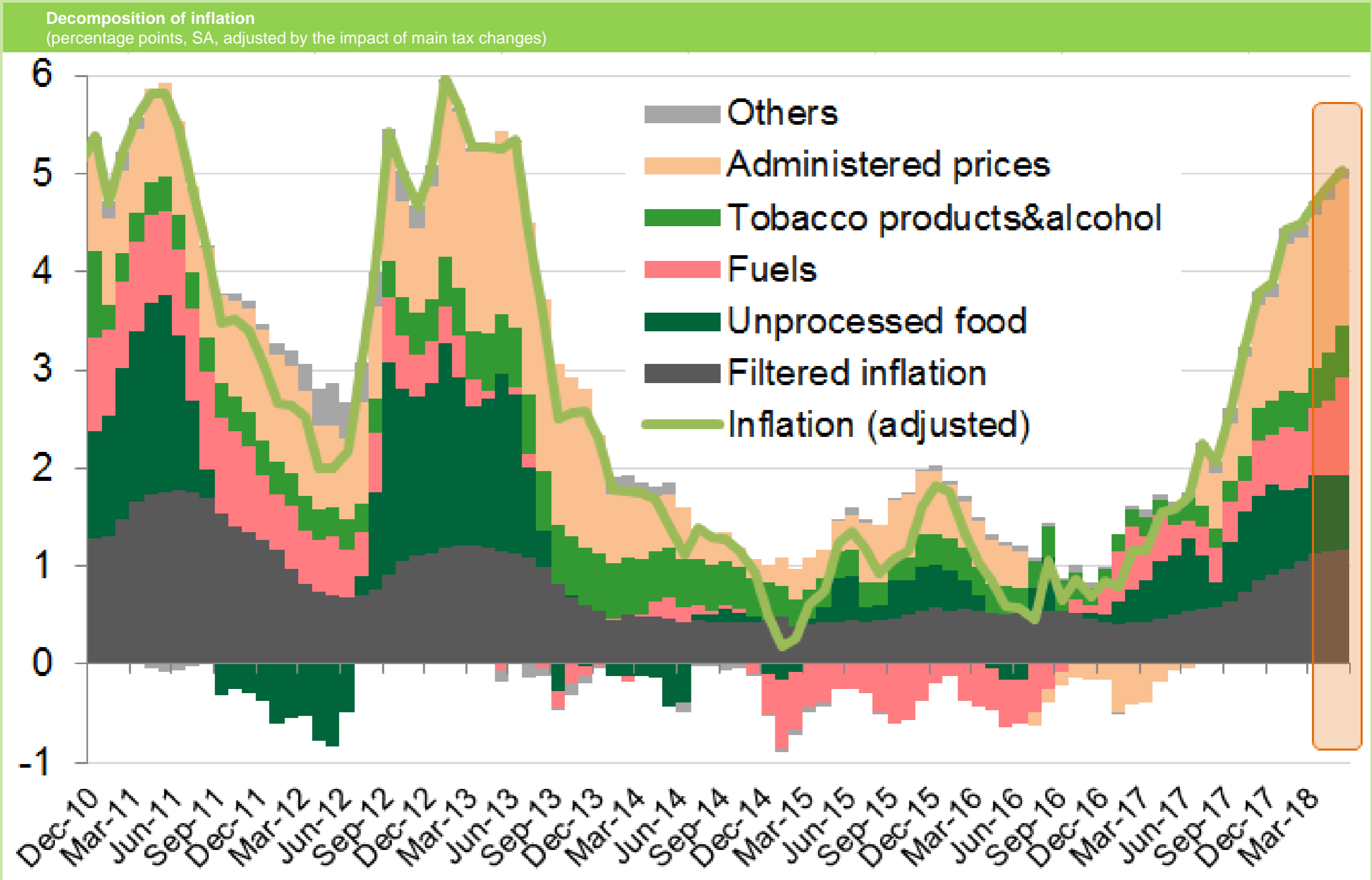


Consumer price inflation hit another multi-year high, reaching 5.4% YoY in May, up from 5.2% a month earlier...

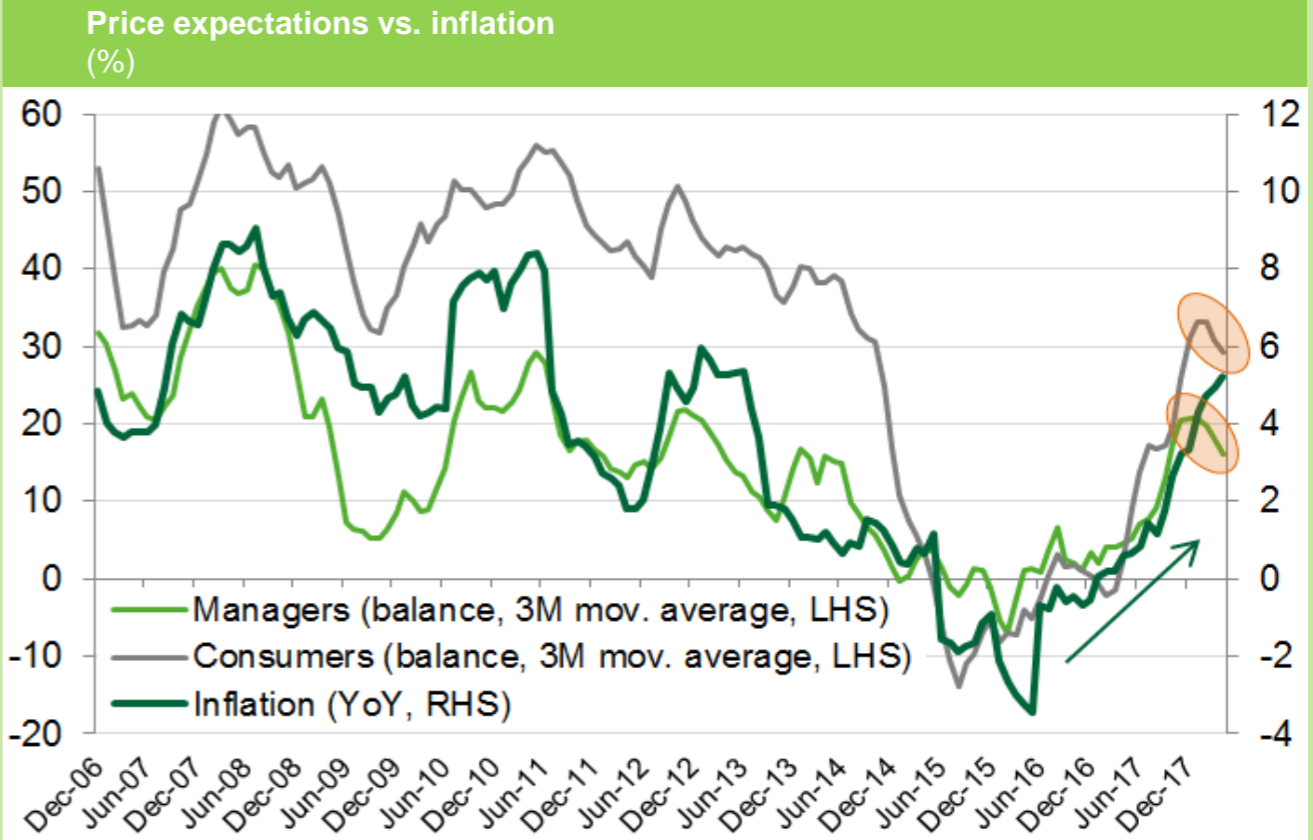
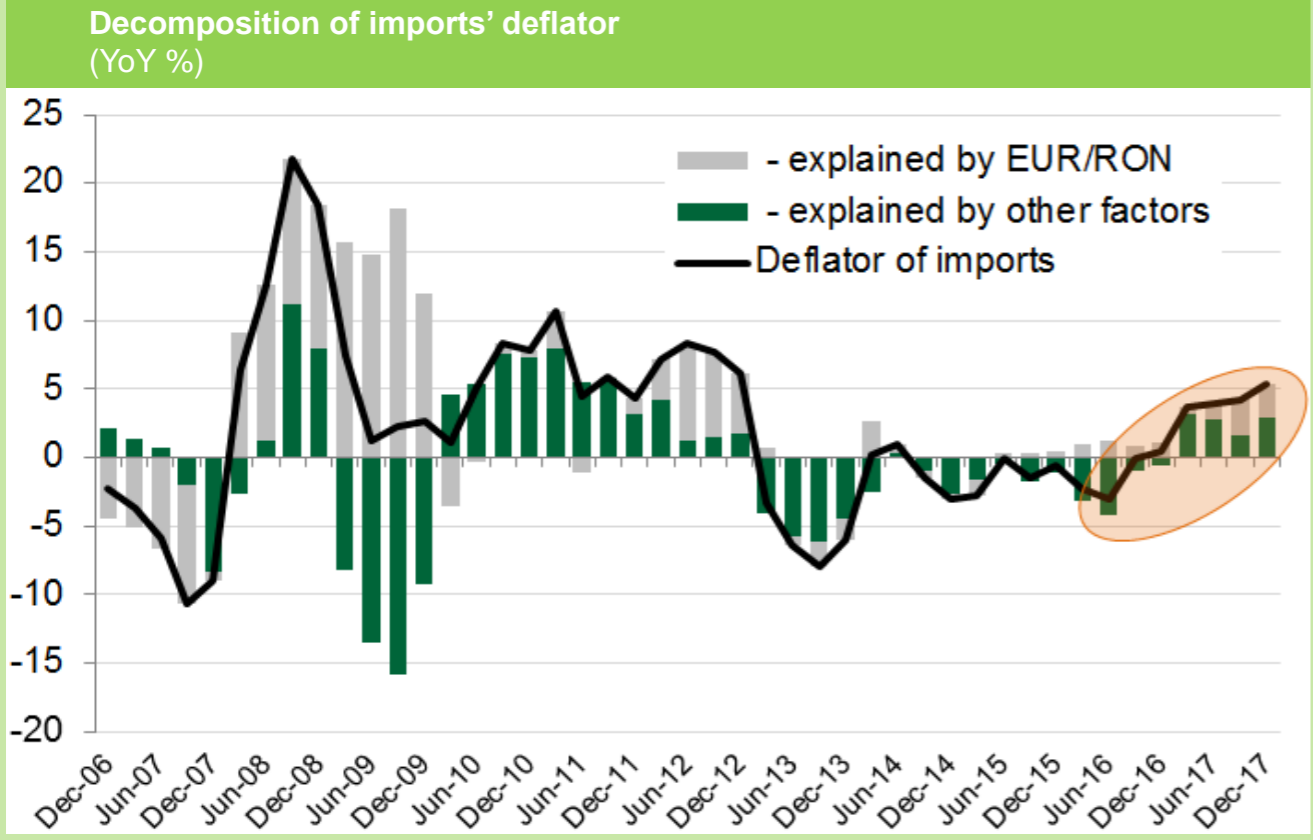
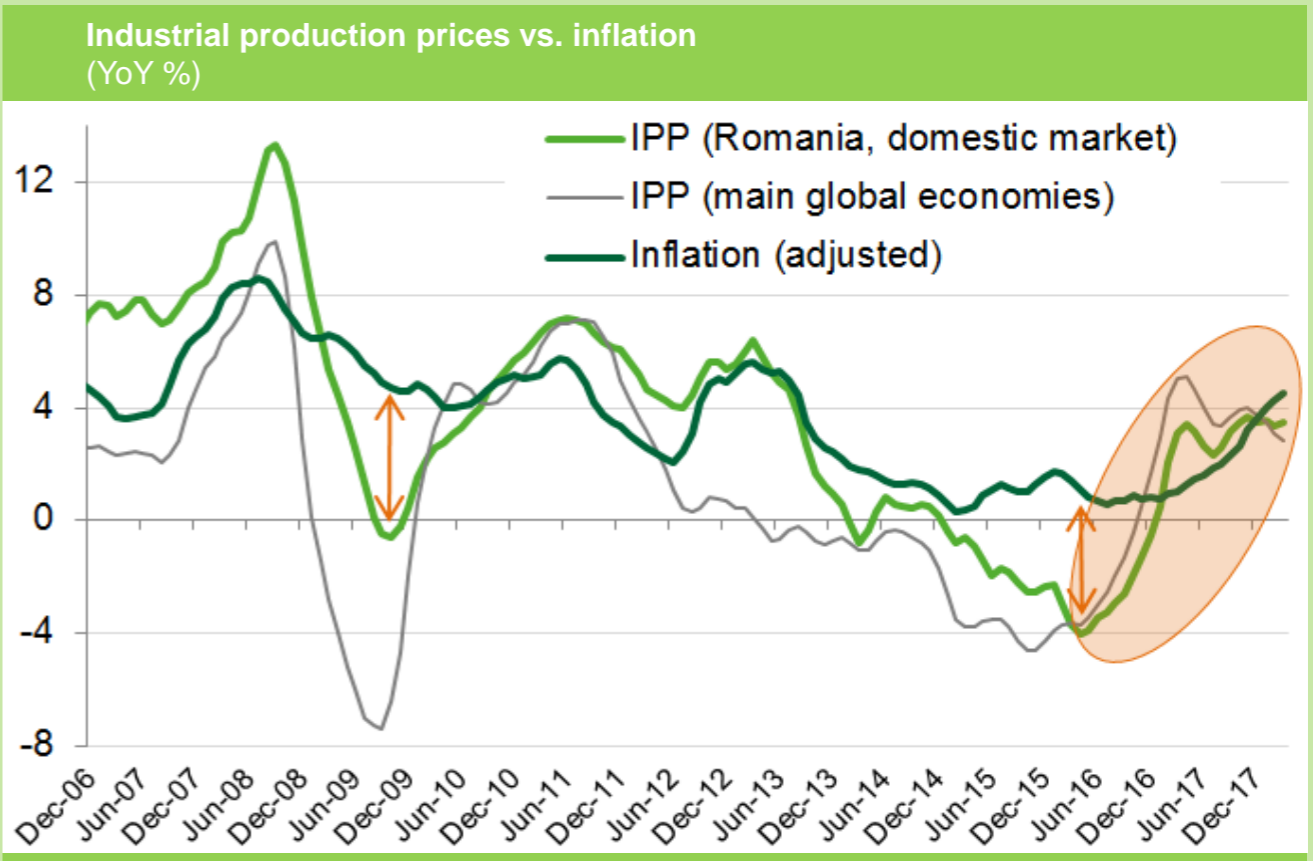
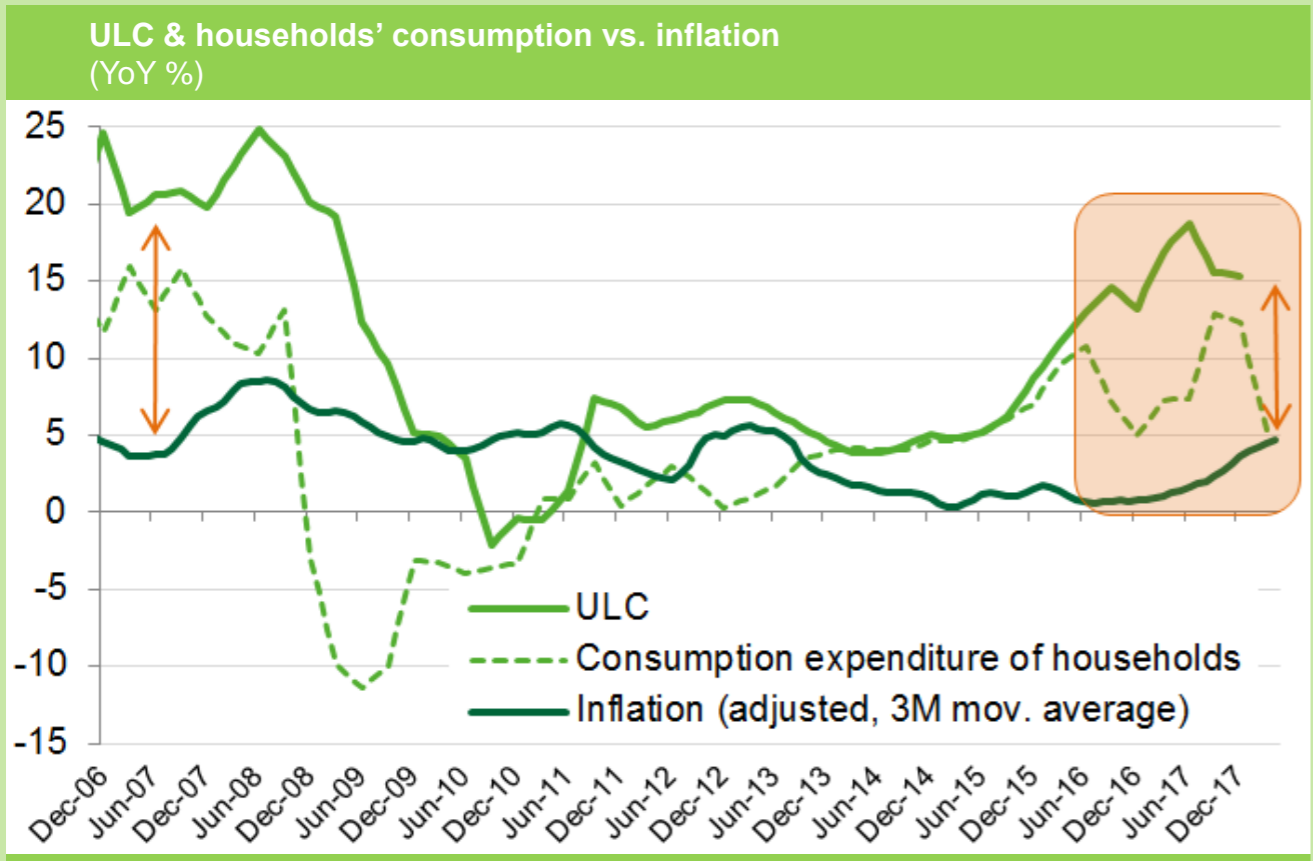


Sources: NIS, OTP Research

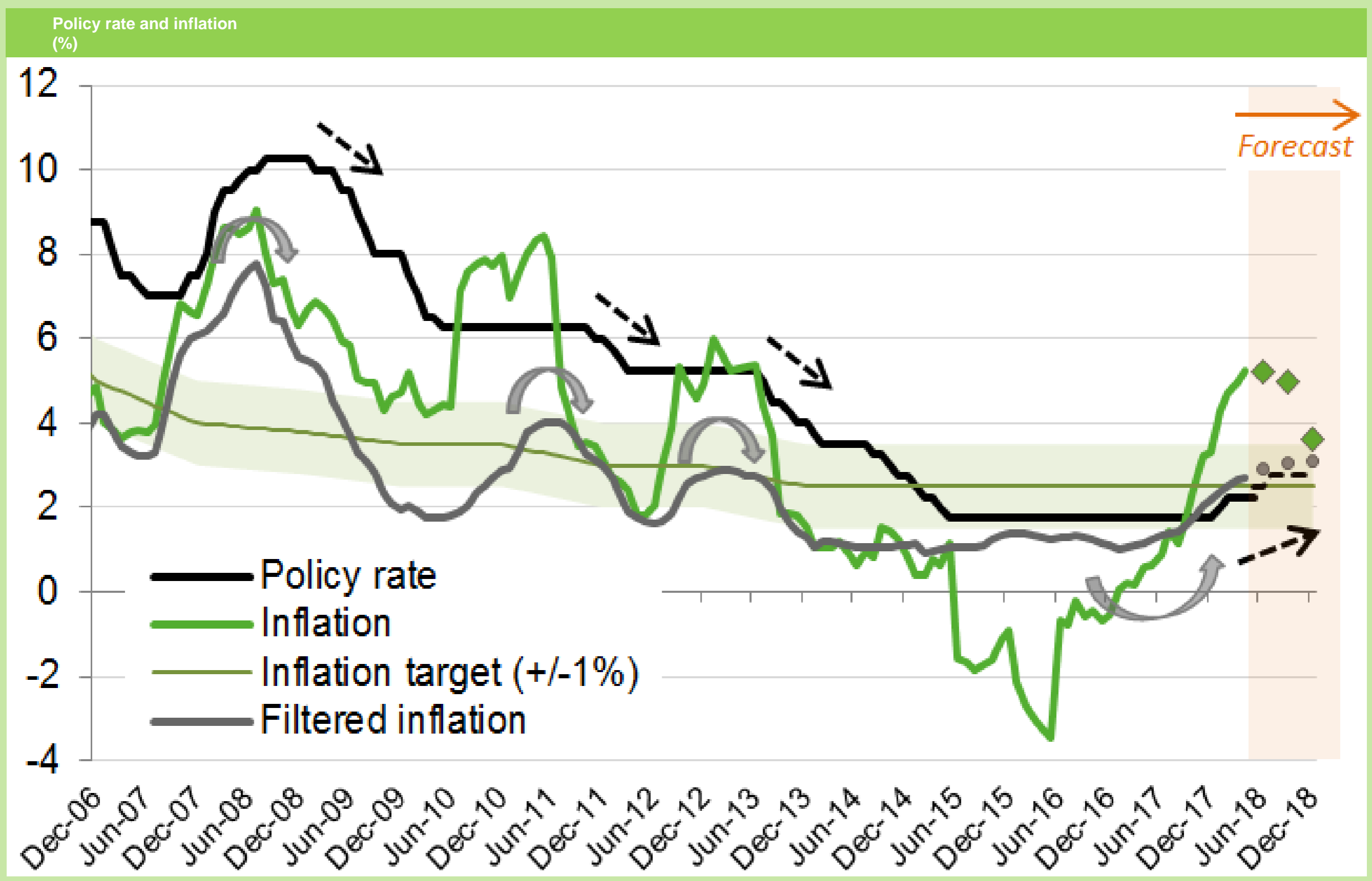
Headline inflation marked a particularly sharp and broad-based revival in the past few quarters, as the positive base effect of tax cuts dropped out, regulated and fuel prices rose sharply...



Sources: NIS, OTP Research

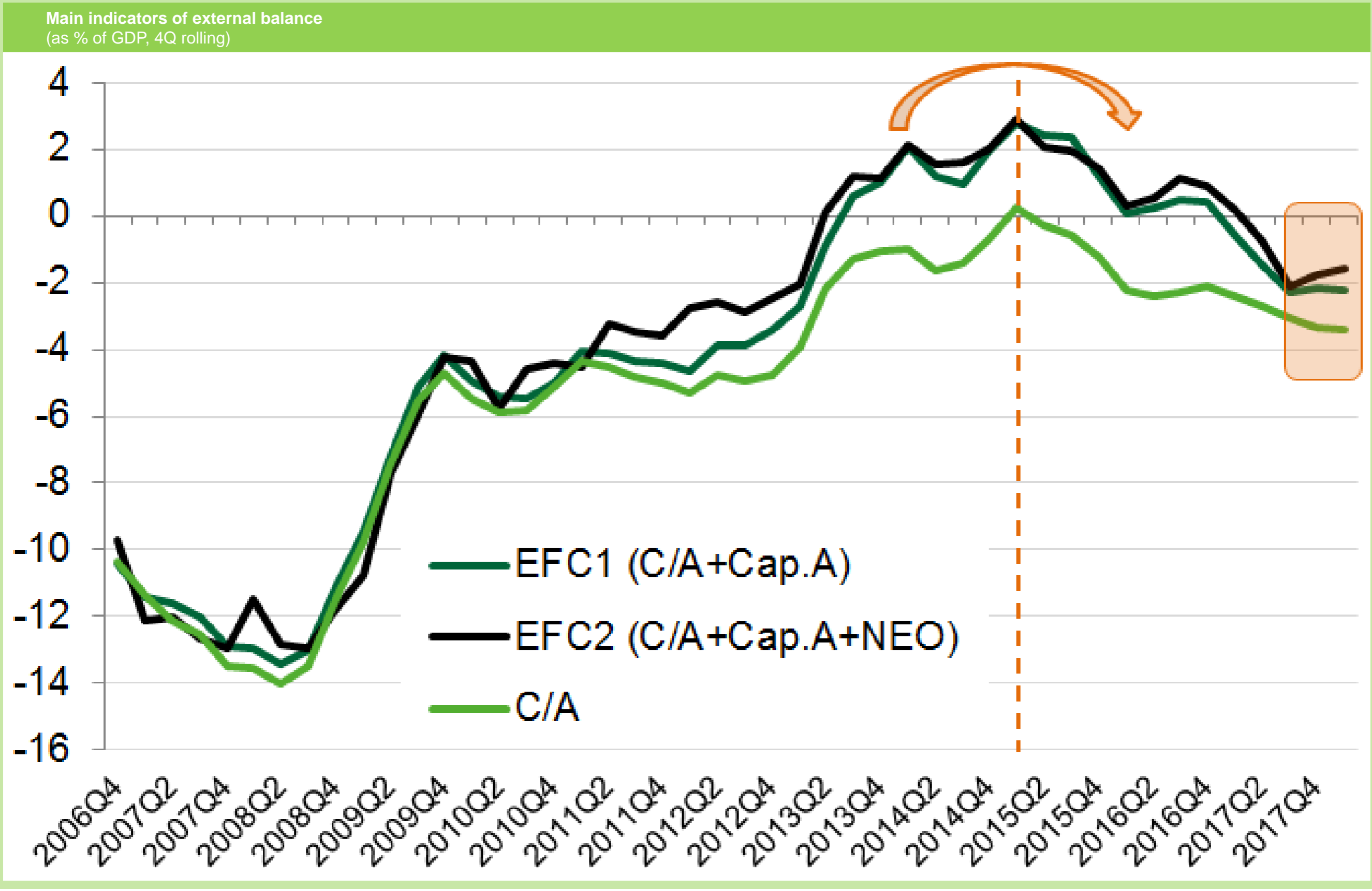


CPI inflation might flatten in the months ahead and soften at the end of this year owing to base effects; however, underlying prices pressures could remain high



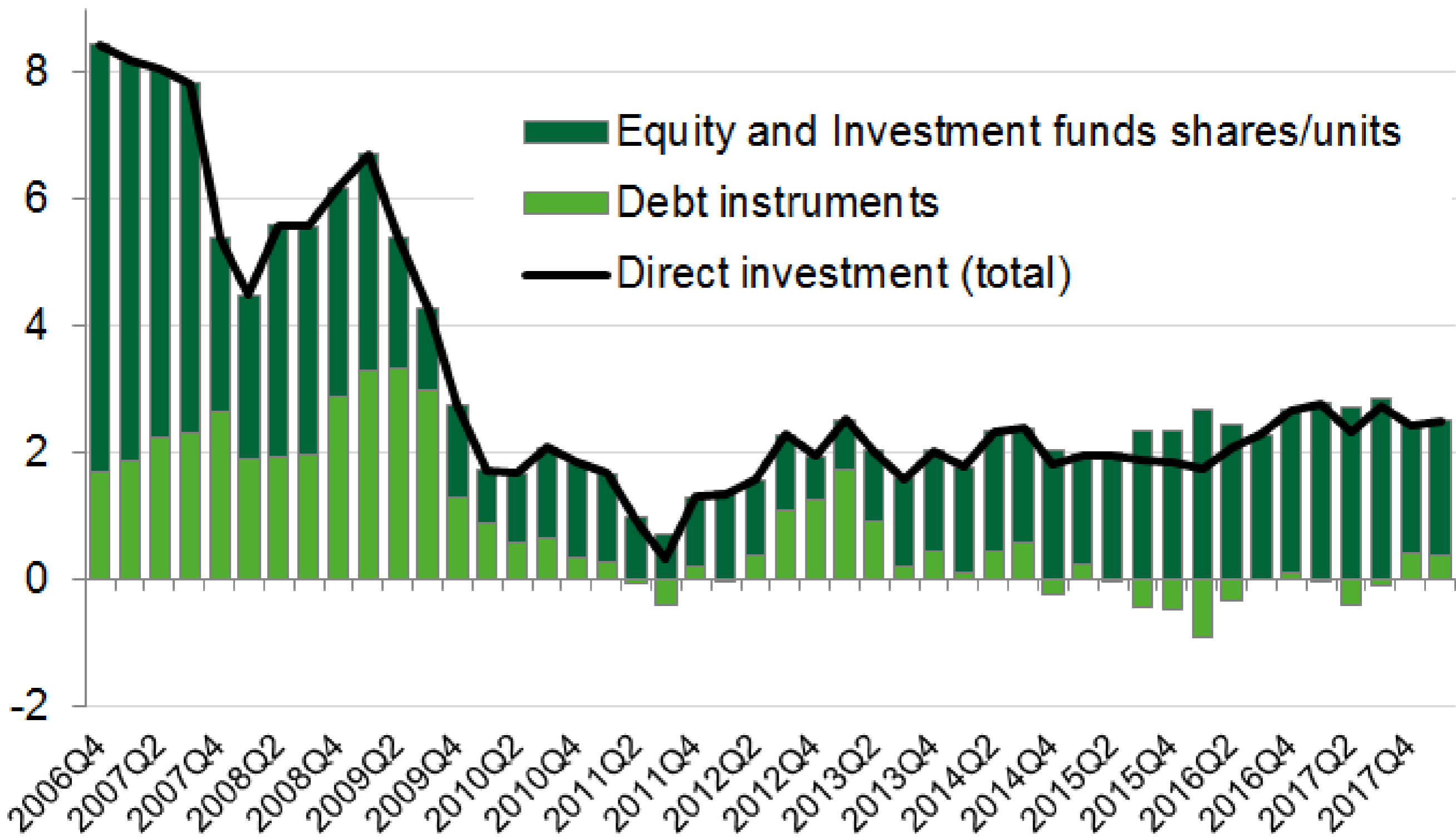
Source: NIS, NBR, OTP Research / Note: Filtered inflation = in-house underlying inflationary measure (SA).

Softer consumption provided relief for the C/A balance in Q1; the deficit may widen moderately later this year. The country's external balance indicators registered a turning point in 2014-2015, as the rebounding domestic demand, stimulated by loose fiscal policies too, boosted imports. Nonetheless, the C/A gap is still financed by EU funds...



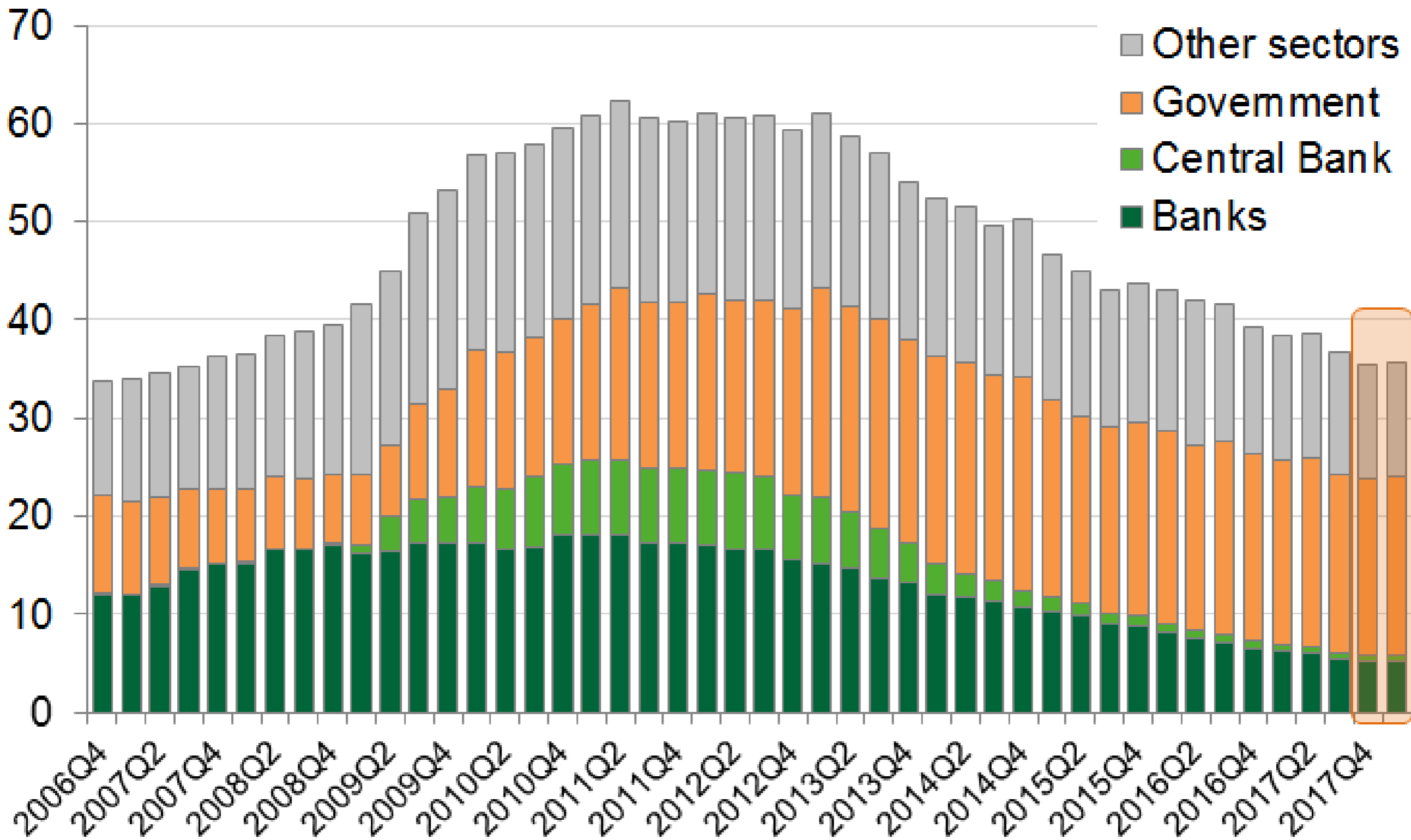
Sources: NBR, NIS, OTP Research

Net direct investment
(as % of GDP, 4Q rolling)



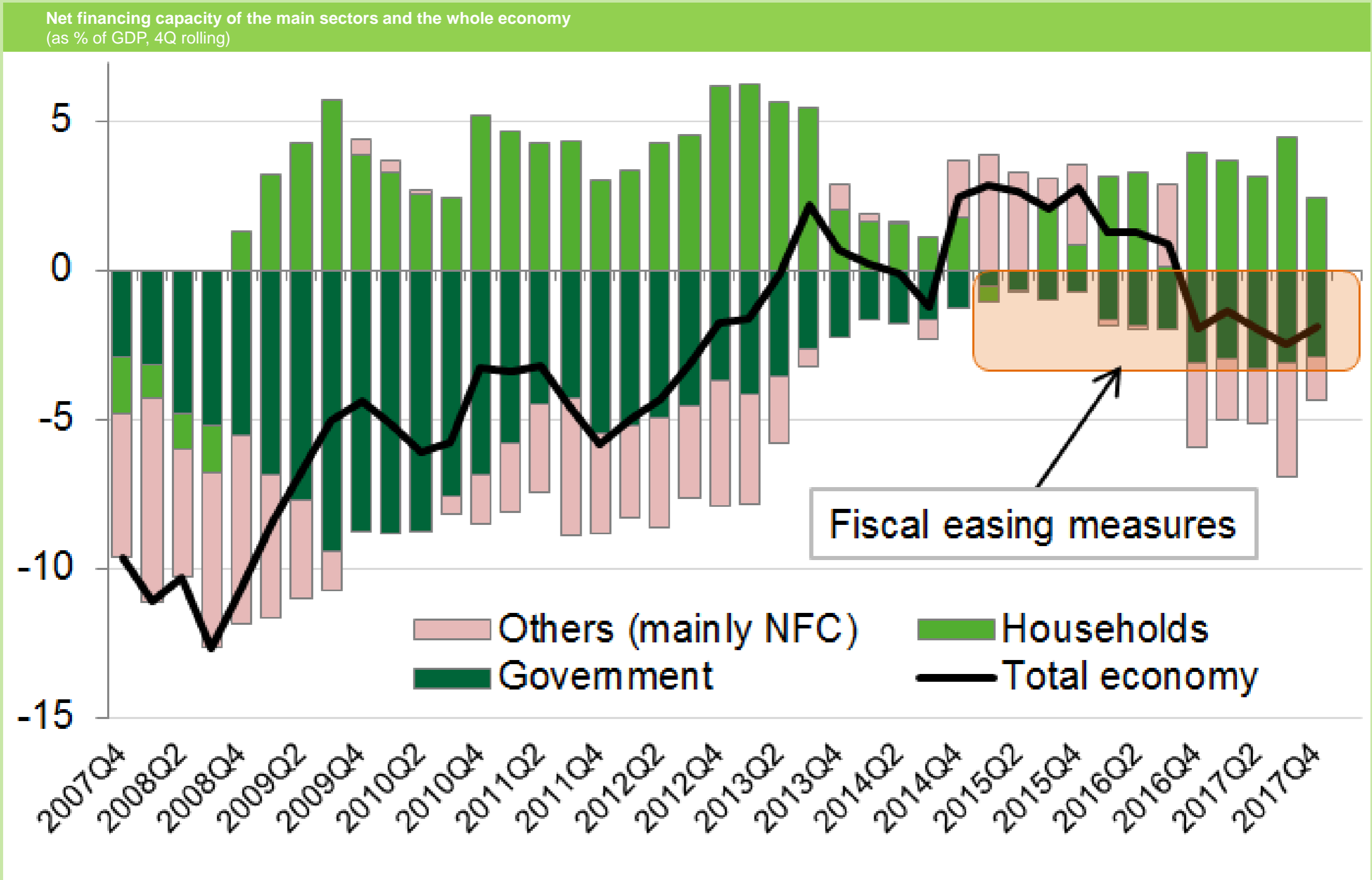
Sources: NBR, NIS, OTP Research

Gross external debt by sectors
(as % of GDP)



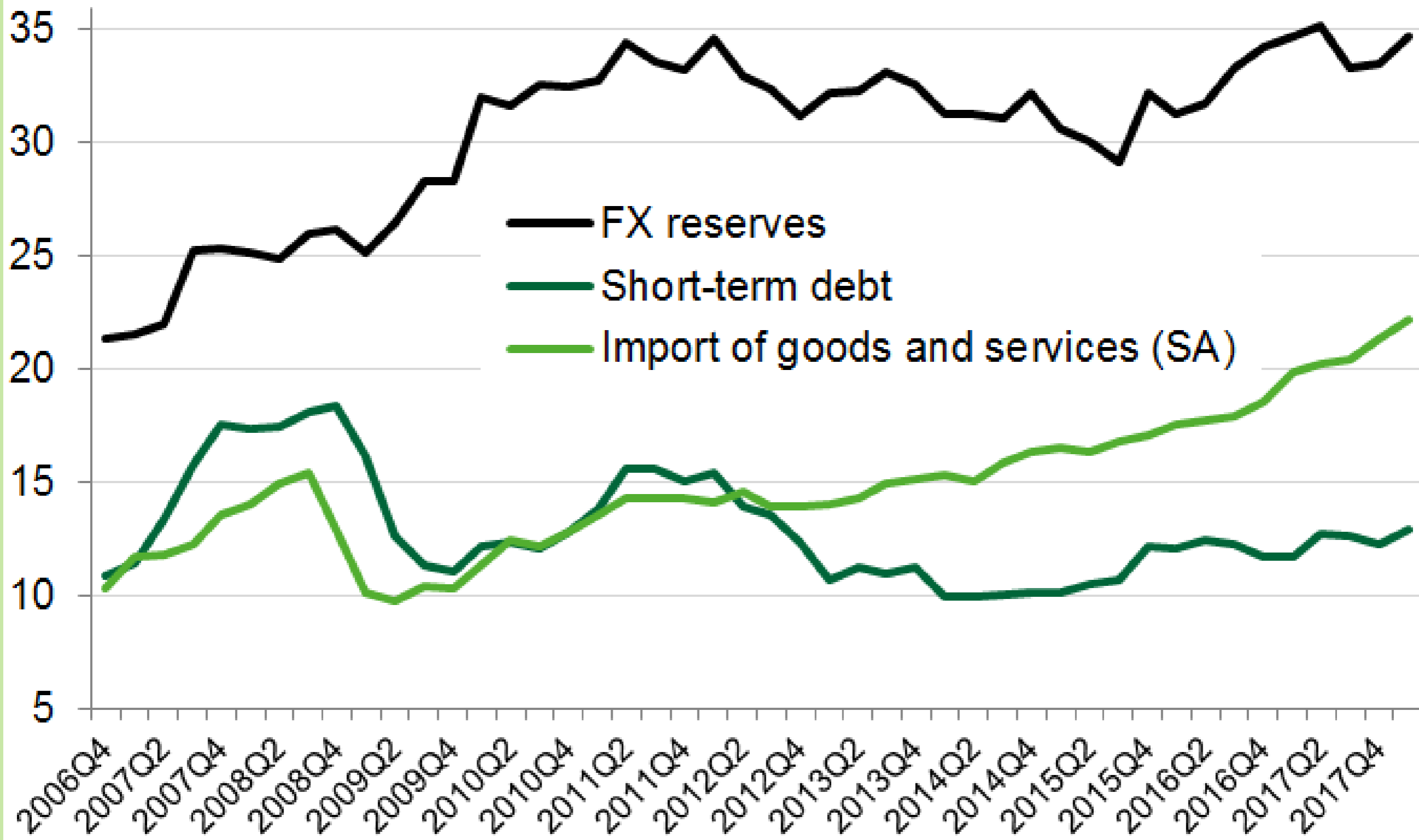
Sources: NBR, NIS, OTP Research

It is worth mentioning that the financing need of the government increased owing to the fiscal easing, but the private sector seems to be more prudent than before the financial crisis, which is mitigating the risks.

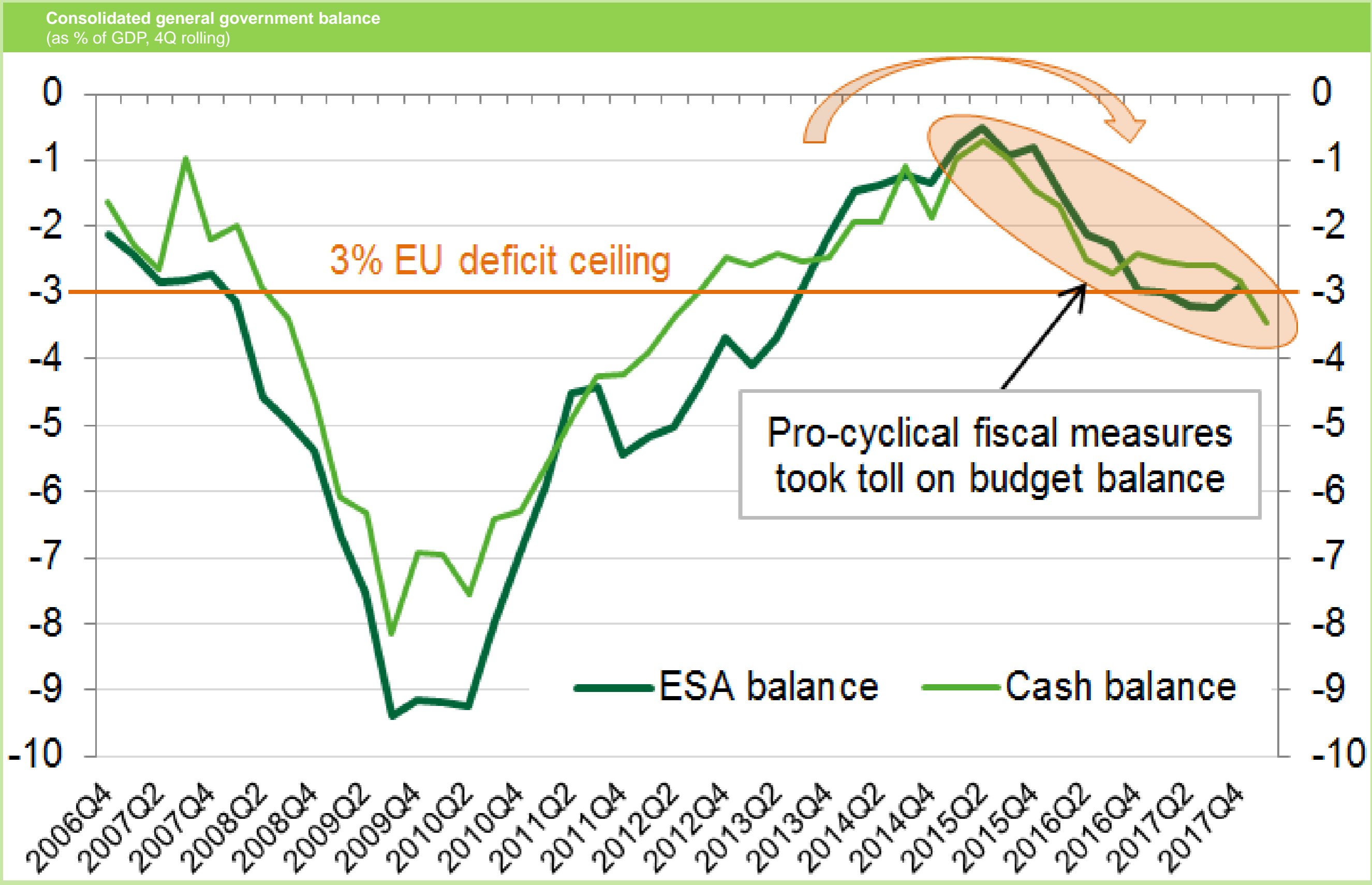


Sources: NBR, NIS, OTP Research

GDP growth vs. economic sentiment indicator

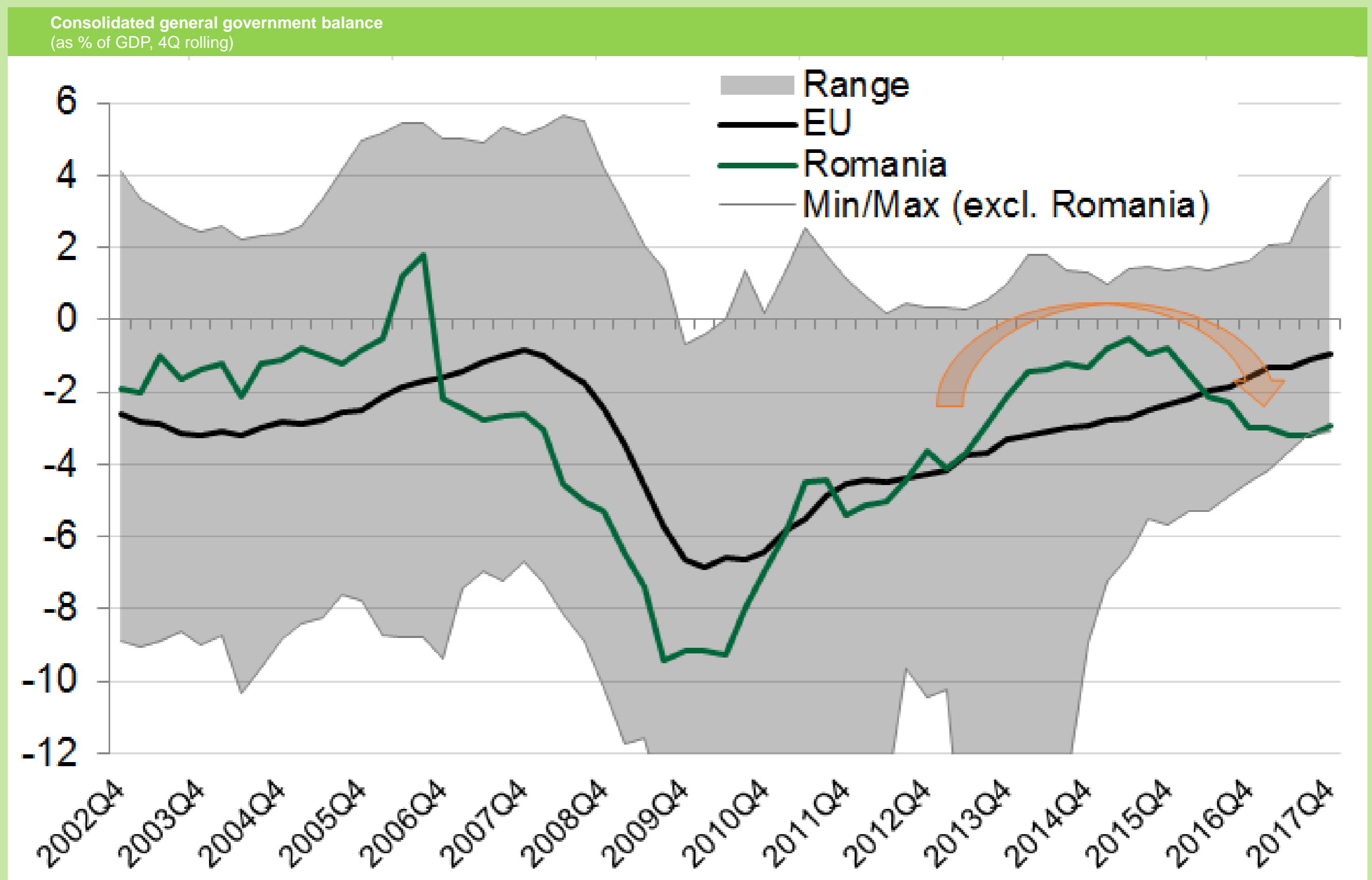


The budget started 2018 on a weak note; keeping the deficit at 3% will not be effortless; declining public debt ratio could come to an end. In the period of 2010-2015, the budget deficit shrank remarkably on the back of painful austerity measures and the reviving economy. However, the government balance marked a turning point in 2015, as policy-makers started to utilize the fiscal room



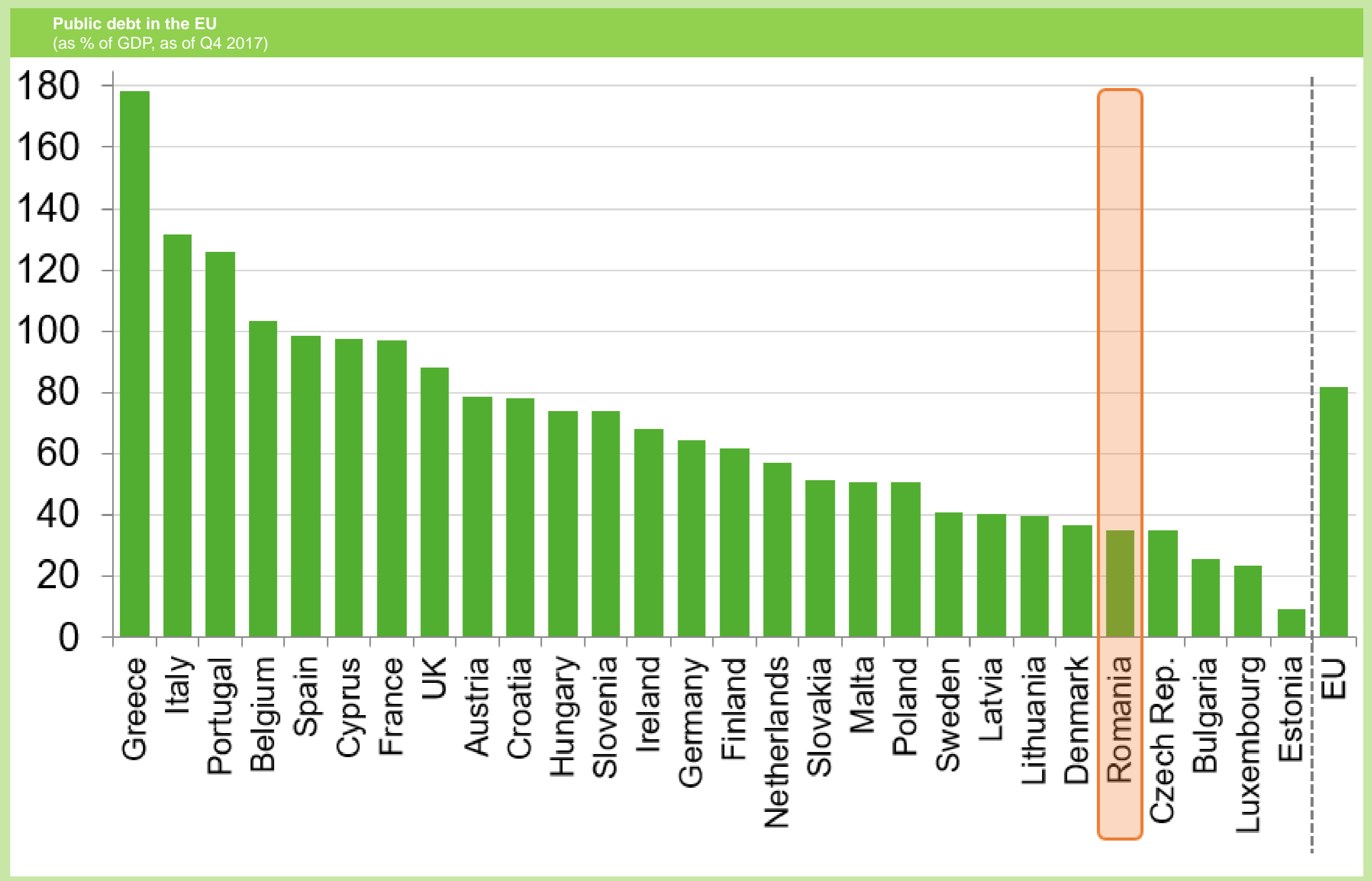
Sources: Eurostat, Ministry of Finance, OTP Research

Last year's outcome was in sharp contrast with the trends seen in the European Union, as only Spain (3.1%) and Portugal (3.0%) recorded higher deficits



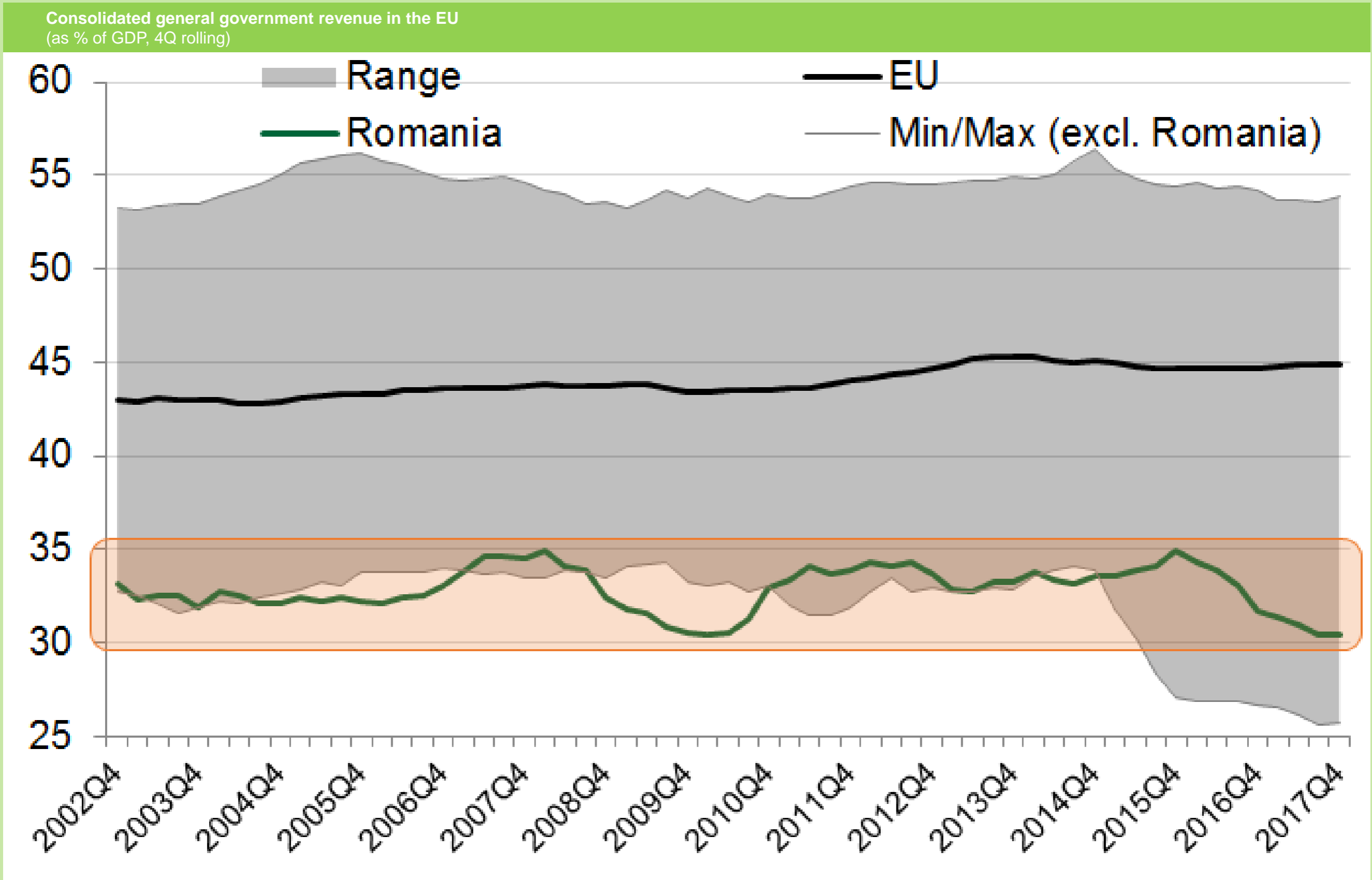
Sources: Eurostat, Ministry of Finance, OTP Research

The good news is that in 2017 Romania's public debt shrank by 2.4 percentage points, to 35.0% of GDP. This was one of the lowest levels in the EU

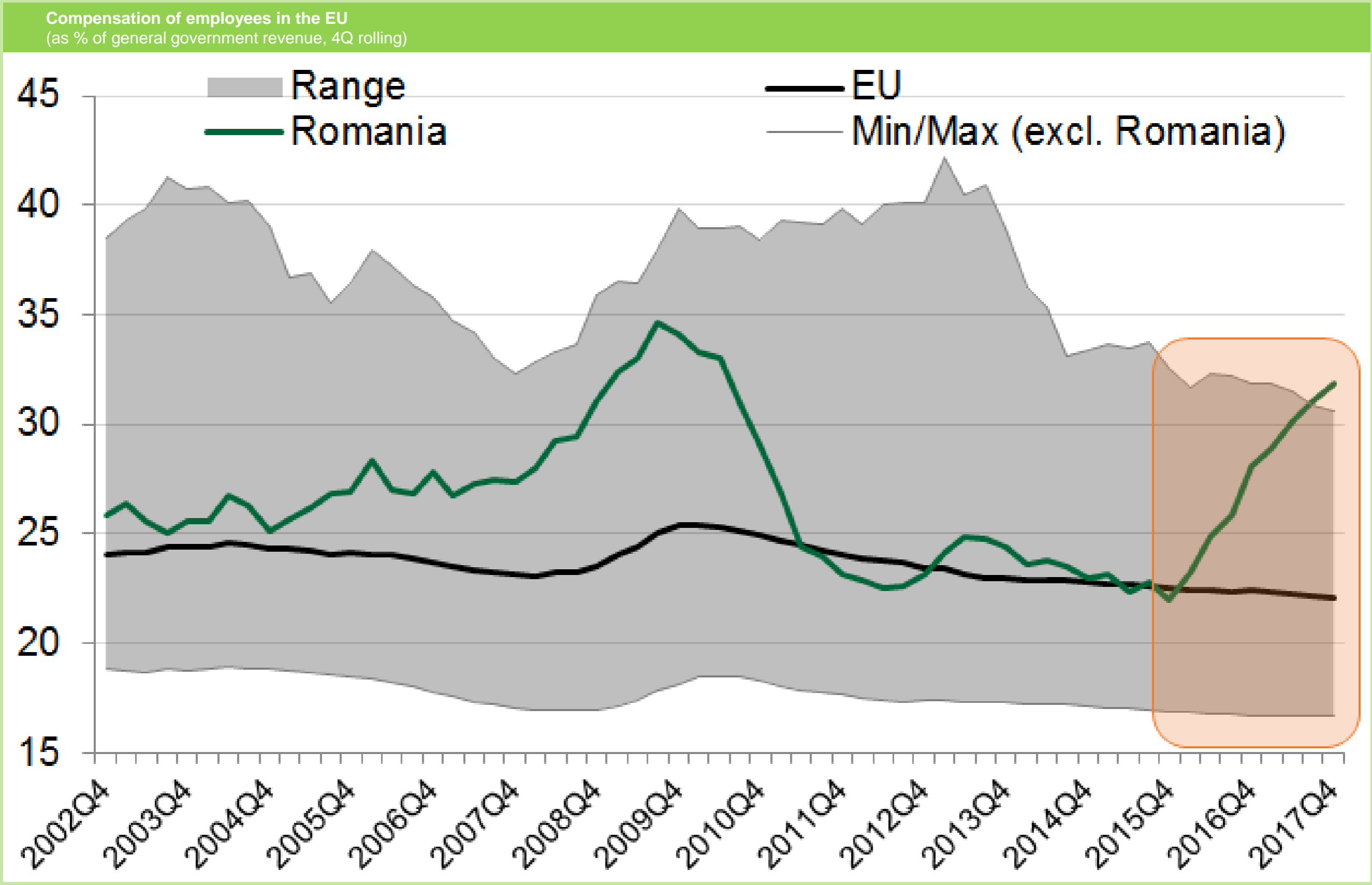


Sources: NIS, OTP Research

The collection ratio has been as low as that since the turn of 2009-2010, when the global financial crisis put an enormous load on the country's economy. This implies that the revenue side remained a particularly important soft spot of the government budget, pointing to a large gap relative to the EU average

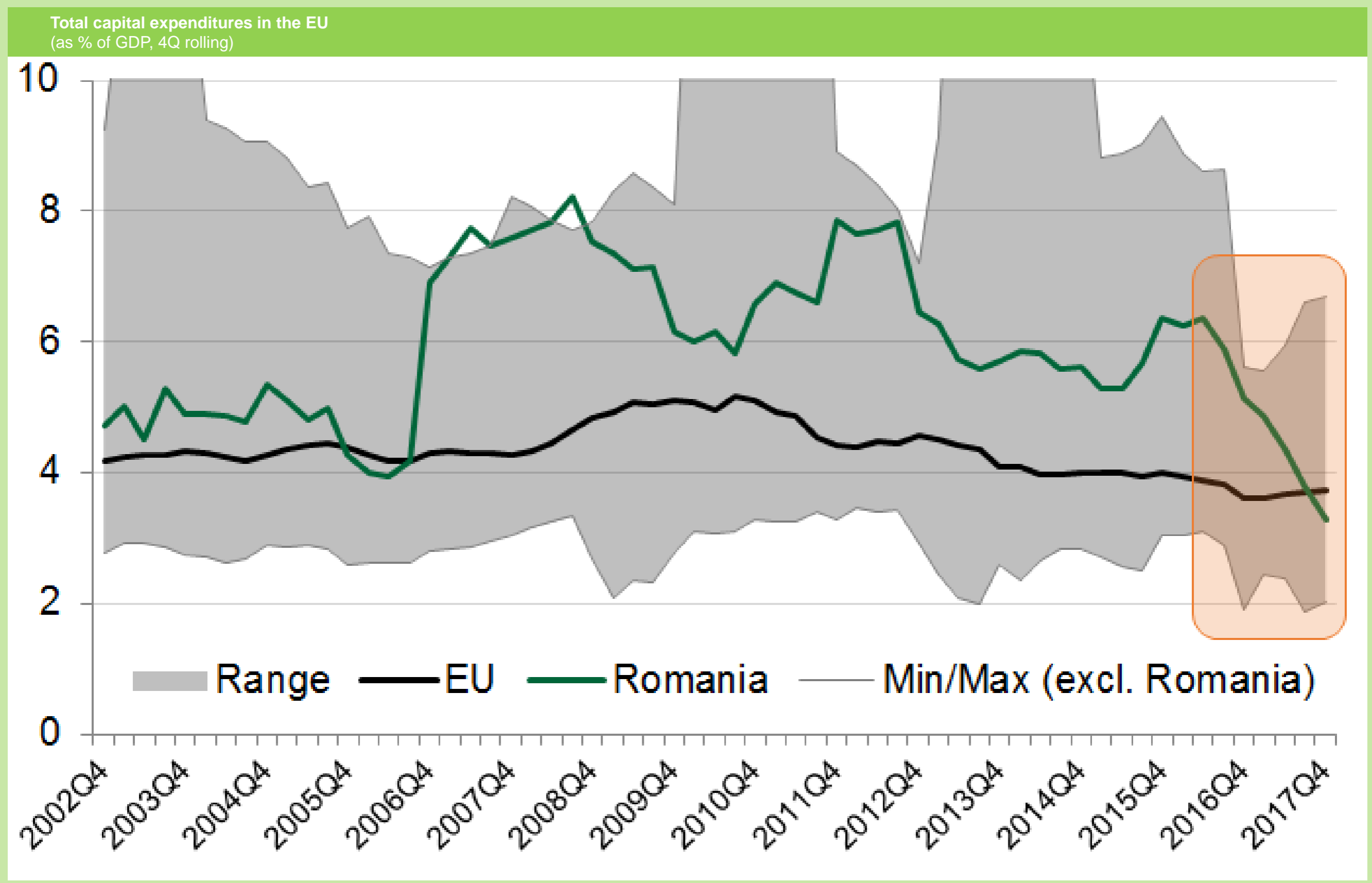


Compared to revenues, Romania's wage bill became the most expensive in the European community in Q4 2017

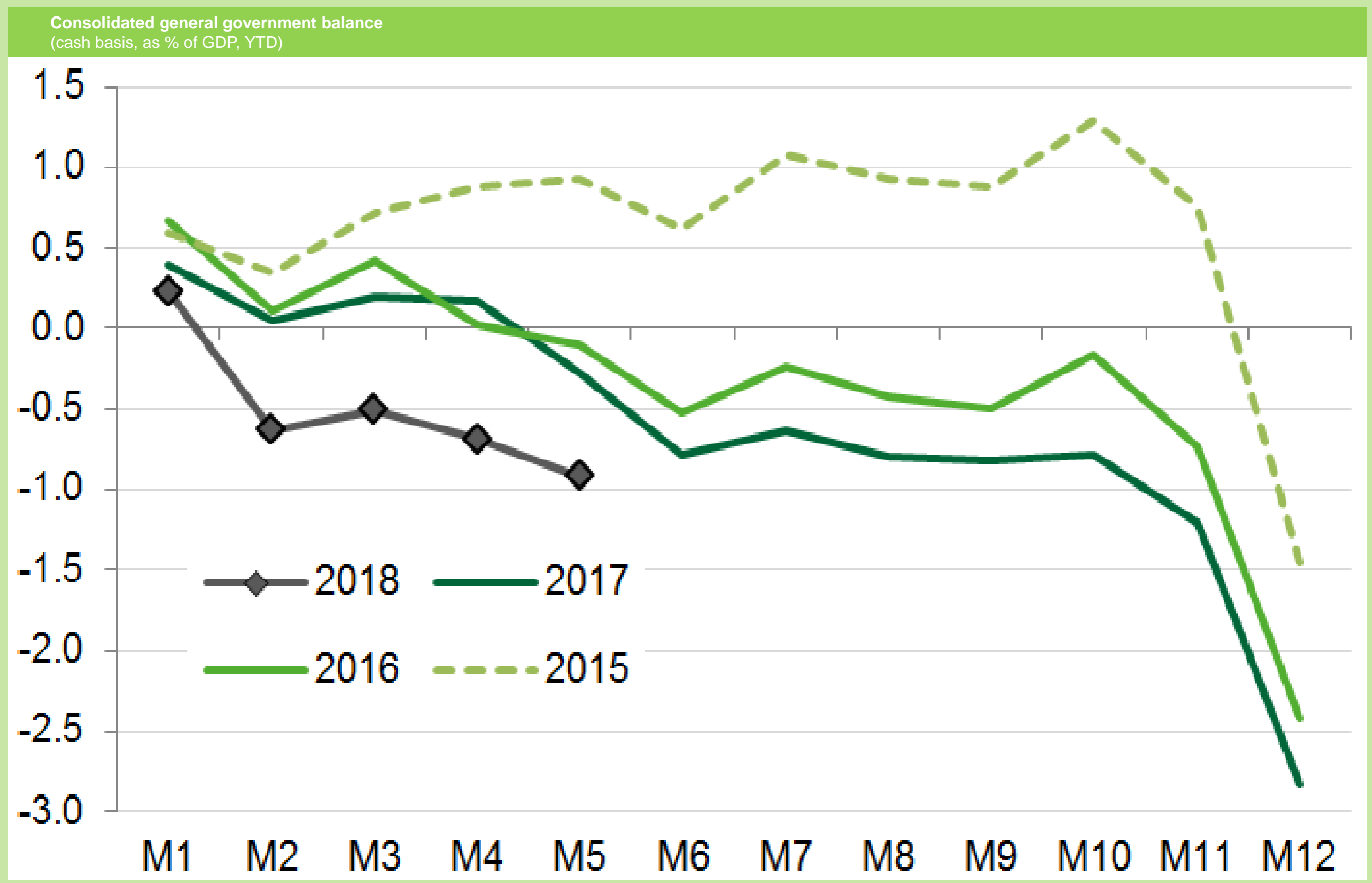


Sources: NIS, OTP Research

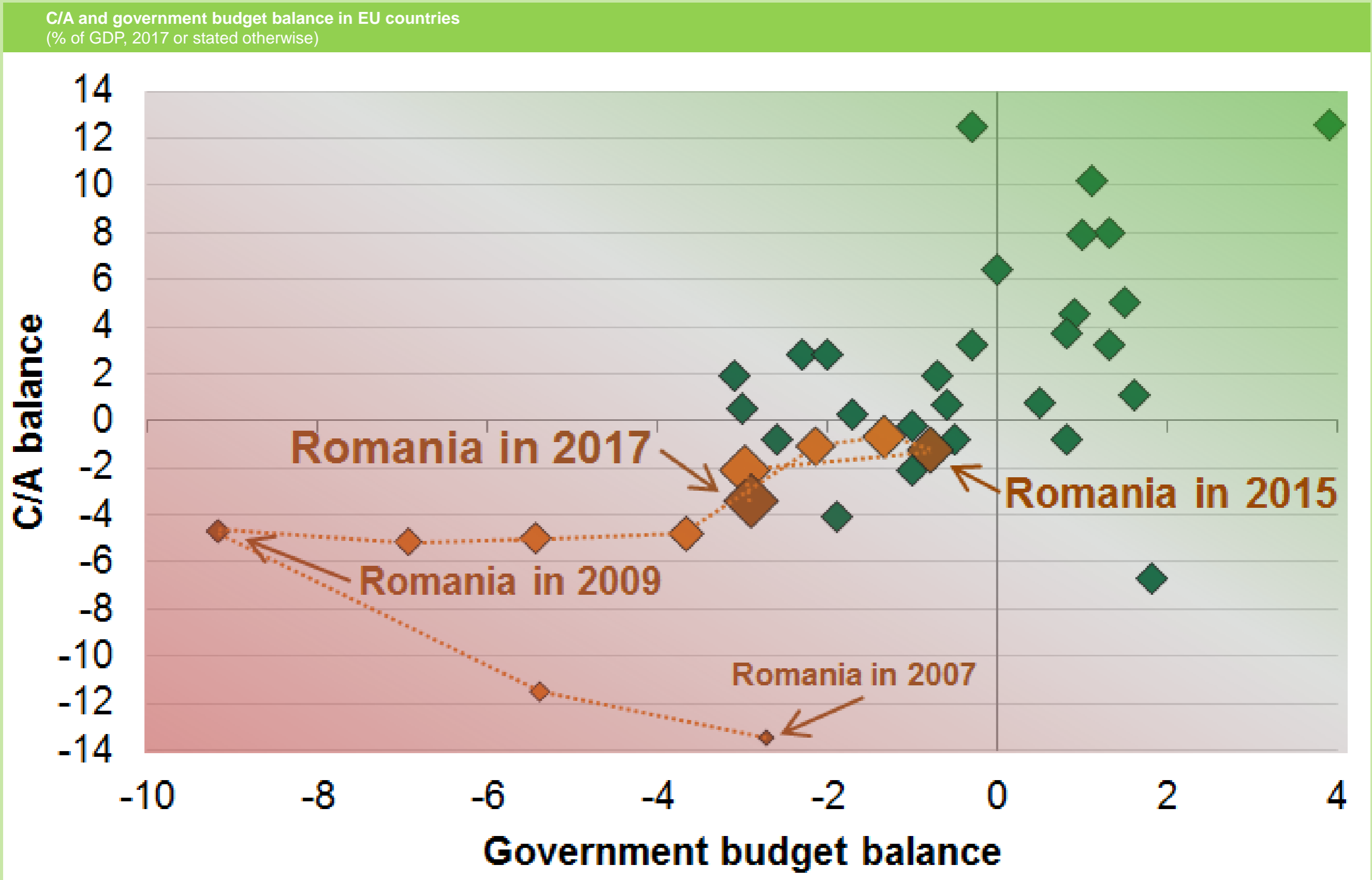
Simultaneously, total capital expenditures slipped below the EU average, a very unpleasant outcome for a country like Romania, with sizable need for infrastructure improvement.



This year's 3% deficit target seems to be challenging, particularly as cash-flow-based budget statistics were rather disappointing. Correction measures could come in order to keep the gap under control.



At this moment, Romania seems to be much more resilient than before the financial crisis, but the relatively high twin-deficit puts the country into an unfavourable position compared to its peers in the EU. This picture may spook some investors when global financial conditions become adverse



Thank You!

Key economic indicators		2011	2012	2013	2014	2015	2016	2017	2018F	2019F
Real GDP	%	2.0	1.2	3.5	3.1	4.0	4.8	6.9	4.0	3.8
Final consumption of households	%	1.3	2.4	-2.4	4.4	5.7	7.4	9.0	4.5	3.7
Cons. expenditure of housh.	%	1.4	1.7	2.6	4.2	5.8	7.9	10.2	5.3	4.2
Public consumption	%	0.2	0.3	-4.6	0.8	0.2	3.1	0.7	1.3	1.4
Investment	%	6.2	3.6	-5.4	3.2	7.4	-2.0	4.7	4.6	4.7
Exports	%	11.9	1.0	19.7	8.0	4.6	8.7	9.7	8.6	7.8
Imports	%	10.1	-1.8	8.8	8.7	8.0	9.8	11.3	9.3	7.9
Consumer prices	% annual avg	5.8	3.3	4.0	1.1	-0.6	-1.5	1.3	4.7	3.1
Government sector balance	in % of GDP	-5.4	-3.7	-2.1	-1.4	-0.8	-3.0	-2.9	-3.0	-2.9
Public debt	in % of GDP	34.0	36.9	37.5	39.1	37.7	37.4	35.0	35.1	35.6
Current account	in % of GDP	-5.0	-4.8	-1.1	-0.7	-1.2	-2.1	-3.3	-4.0	-4.1
Key interest rate	% annual avg	6.2	5.3	4.8	3.3	1.9	1.8	1.8	2.5	3.2
Key interest rate	% end of period	6.00	5.25	4.00	2.75	1.75	1.75	1.75	2.75	3.25
EUR/RON	annual avg	4.24	4.46	4.42	4.44	4.44	4.49	4.57	4.65	4.64
EUR/RON	end of period	4.32	4.43	4.48	4.48	4.52	4.54	4.66	4.65	4.63
Nominal GDP	RON bn.	562.1	595.4	637.5	668.1	712.7	762.3	858.3	935	1,005
Unemployment	%	7.2	6.8	7.1	6.8	6.8	5.9	4.9	4.5	4.4
Nominal wage growth	%	4.1	4.2	4.8	7.6	9.8	9.9	14.8	11.4	9.3
Real wage growth	%	-1.6	0.8	0.8	6.5	10.4	11.7	13.3	6.4	6.0
Nominal GDP	EUR bn.	132.6	133.6	144.3	150.3	160.3	169.8	187.9	201	217