Monthly Focus

Is ignorance bliss at the EU's periphery?

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I am a periphery guy myself, having been born in Oradea, a city close to the border with Hungary (which by the way I will unabashedly advertise as one of the most charming in Romania). Still, geographical periphery is not a curse for being marginalized or an insurmountable obstacle. On the contrary, it also implies being at the crossing of multiple cultures, which actually blesses you with more perspectives and with an open mind. Economic, financial and political periphery is however something completely different. It is indeed the opposite of having an open mind and a perspective; it is the concentration of all the community's efforts on "right here, right now" and "for us only". At least this is how it reveals itself today, in Romania.

Let's take the example of the pension law. As perfect as it may be in its content (I am not in a position to judge), the impact analysis provided by the Government is clearly lacking important elements: there is no impact analysis on the labor supply (whose shortage is a big pain for most businesses nowadays), while in the case of the financial impact, we have some numbers provided which, first of all, don't add up (for example a close to 14 bln RON or 23% increase in social contributions for 2019). Assuming these would eventually add up (via an increased taxation, re-routing of Pillar II contributions or some magical growth of the tax base?), they would still leave an unfunded budget expenditure of 42 bln RON (yes, forty two) cumulated over the next 4 years. That is a cumulated 3.5% of GDP (based on our GDP numbers), which comes at a time when Romania is struggling to maintain its deficit within 3% of GDP and it is already under a significant deviation procedure from the Medium-Term Budget Objective, based on the assessment of the European Commission.

Moving to the political governance and the strength of Romanian democratic institutions, we have food for thought insofar as the state of the rule of law in Romania will be a subject of a European Parliament debate in October and as the Constitutional Court is very busy nowadays ruling over what is called "Constitutional conflict between powers of the state". I leave the rest for political experts or political commentators and concentrate on our peripheral status on the financial markets. Considering the state of play described above, combined with the growing macro imbalances (think the rising inflation and external imbalance), as well as the recent escalation of the US – China import tariffs spat, one may think that Romanian assets should be somewhat

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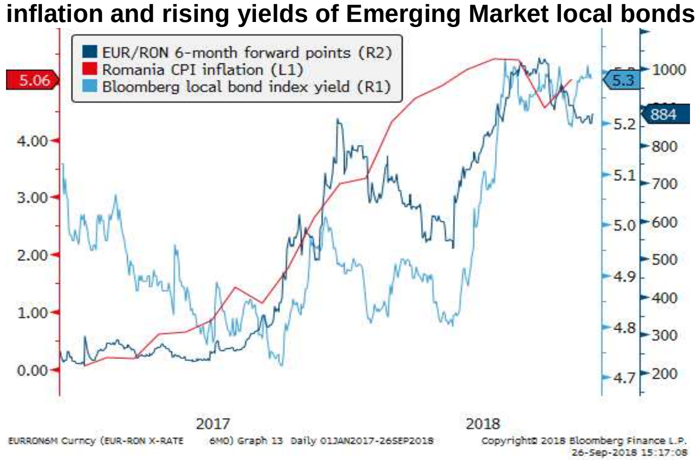
embarrassed.

Alas Romanian asset prices have remained quite stable and have even performed at least in relative terms: on a YTD basis, the Romanian sovereign bond index has widely over performed its Emerging Markets benchmark (while being among the few bond markets with positive absolute performance), our national currency, RON, has over performed most CEE FX peers, while also displaying the lowest volatility in the region and finally, our Cinderella Bucharest stock exchange has been among the top performers globally. How so? The official explanation of Romanian authorities and of their “enrolled” pundits is that, despite all the negative media and direful analysis of economists, Romania is generally in good economic shape, displaying resilient growth (a record last year followed by GDP dynamics close to potential growth this year) and imbalances that are broadly manageable (think for instance of the current account deficit that on a 12-month rolling basis stands entirely financed by FDIs and net capital transfers). While it is true that, on a relative basis, i.e. compared to the likes of Turkey or even Hungary, Romania’s macro story may stand positive scrutiny, my preferred explanation is nevertheless less flattering. It involves investors’ attention span being rather limited short-term trends such as that of inflation and perhaps less to longer term structural issues.

First of all, there is one metric where Romania has been under-performing and that is on short-term interest rates, which since a year ago have increased most in the EU (by more than 200 bps). Of course, we had 75 bps worth of rate hikes (even 125 bps if we look only at the deposit facility rate), but the move upwards, as we know, was driven starting with August last year by a strong pressure on the FX spot and FX swaps markets. Since the NBR did its utmost to protect EUR/RON spot, it was rather the FX swaps and FX forward market where the pressure was felt. It’s also apparent from Graph 1 that the heat was highest at times when Emerging Markets funding costs were also being pressured upwards. It may be also worth observing that throughout the period, Romanian CPI inflation index rose fast, in stark contrast to price gauges from other European countries. Once, however, it became apparent around July that inflation was probably going to peak, the upward trend in forward premium and short-term interest rates seems to have eased, despite Emerging Markets pressure resurfacing at the beginning of August. If inflation is indeed a major driver of financial asset prices in Romania, then we could relax somewhat, as the inflation outlook in the next 12 months looks more benign, at least based on NBR’s and our own current forecasts. There is a caveat though. Many in the investor community were believing that inflation was a symptom of the excess demand in the economy, however both we and the NBR repeatedly noted the prevalence of supply side push factors. If investors are right, then with the easing of GDP growth (3.8% according to our forecast for 2018), we should have nothing to worry about. However if supply side factors are the main drivers, one can never exclude further shocks. The fast rise of the oil price in the recent month and the given the evolution of energy prices and the African swine fever crisis are just a couple of risks worth watching in terms of their impact on overall energy and food prices.

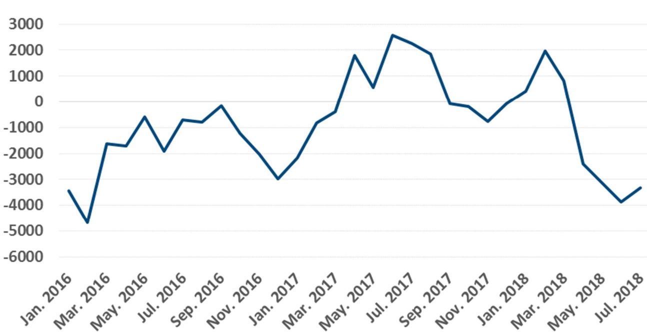
Graph 1: Evolution of FX forward spreads (difference between FX forward and spot quotes) in the context of rising CPI (annual) inflation and rising yields of Emerging Market local bonds



Source: Bloomberg

The other part of the explanation, which concerns the stability and even over-performance of other Romanian assets is I believe related to our peripheral status. Romania is a frontier market: officially so in terms of equities, but also borderline that status in the FX and bonds space, at least if we consider the low level of liquidity in those markets. As such, portfolio investors are also not flocking to our doors unless there is a particularly strong price appreciation story. Last year, for instance, despite Romania's super growth performance, the country received net portfolio inflows of 2.8 bln EUR, which was however entirely due to external issuances of Eurobonds in a EUR market flooded with liquidity where Investment-Grade bonds with above 2% yield are in very short supply. The same is true this year until July, as net portfolio inflows are virtually flat when corrected for primary market activity.

Graph 2: Net inflows financial account, including Errors & omissions and excluding FDIs and international reserves (mln EUR, 12-month cumulated)



Source: NBR

Furthermore, if we check YTD correlations for daily changes in local asset prices respective Emerging Market benchmarks[2], the coefficients

[2] Correlation coefficients in the case of EURRON (vs JPM EM currency index), 10Y government bond yields (vs JPM local bond index GBI-EM Global Diversified), 10Y Romanian Eurobond yields (vs JPM EMBIG index) and BET-XT local equity index (vs EM Global Equity Index) were respectively: 13.2%, 22.7%, 19.7% and 38.4%.

turn out insignificant, with the exception of the equity market index. Such lack of (significant) correlation has nevertheless worked in our favor, since most Emerging Market indices have been performing negatively this year. Thus it seems that investor ignorance has been our bliss.

But should that keep our sleep worry free? Thomas Gray, whose line we borrowed, seems to have the answer, ‘cause: "Where ignorance is bliss, 'tis folly to be wise". When trying to put this into economic perspective, just think that markets are often a judge of the quality of economic policies in a country. In Turkey, for instance, markets have penalized a toxic combination of a drift away from democracy and political freedom, a drift away from central bank independence, which were coming on top of swelling macroeconomic imbalances. Faced with market pressure, Turkish authorities had to respond, by adjusting policy in the proper direction. Also in the case of our own central bank, market pressure amidst the rising inflation trend meant it had to tighten policy. However, for a government living the bliss of investor ignorance, such pressure does not exist, so an internal drive for reform will have to prevail. In the Romanian case, such drive clearly does not exist at the moment and it probably never did. On the contrary, the leeway offered by investors' ignorance seems to be used to move forward with expansionary income policies that are not backed by measures to increase productivity. This is going to erode Romania's competitiveness further, to a point where we won't be able to attract even the attention that we want, which is that of long-term capital investors. If that happens, we will get however the unwanted attention, because our current account deficit will remain unfunded, opening up a financing gap that is often a harbinger of crisis.

Macro Monitor

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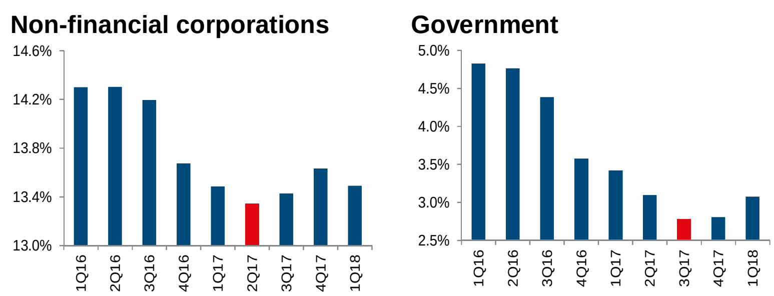
Is anybody investing here?

The release of the structure of real GDP for 2Q18 at the beginning of September prompted us to revise our full-year economic growth forecast for 2018 to 3.8%, from 4.1%. While headline GDP numbers for 2Q18 remained unchanged compared with the flash estimate released earlier by the National Institute of Statistics, the structure was weak. The biggest disappointment came from a reversal of positive trends seen in the previous three quarters for gross fixed capital formation, which fell by 3% y/y in 2Q18. Our scenario regarding a greater role played by investments in this year's economic growth is clouded by the recent evolution of gross fixed capital formation, with the entire landscape being complicated by an unusually high contribution of inventories to real GDP in 2Q18 (no less than 3pp from a total 4.1%). While we recognize that there might be statistical noise around the numbers for real GDP on the demand side, the overall structure of the economic growth remains weak.

With no breakdown of gross fixed capital formation on institutional sectors available so far for 2Q18, a key question remains regarding who cut investments recently. Was it the government, non-financial corporations or households?

The modest recovery of investments between the third quarter of 2017 and the first quarter of 2018 was driven by both non-financial corporations and the government, although in the case of the latter, a large part could be explained by heavy investments in new military equipment in February this year. We suspect that the soft patch from 2Q18 was determined by both the limited growth of public investments once the one-off element related to military spending was removed as well as the hesitant approach of private companies regarding new investments. The series for gross fixed capital formation for non-financial corporations and the government seem to be positively correlated, with appetite for investment activity increasing or decreasing almost simultaneously.

Graph 3: Share of gross fixed capital formation to GDP by institutional sectors



Source: NIS, BCR Research

Going forward, we are not very optimistic on the contribution of gross fixed capital formation to this year's economic growth, due to limited public resources available for large investments and a cautious stance among private companies when it comes to developing new projects. The shortage of skilled labor force, infrastructure bottlenecks and above all clouds gathering over global free trade would make investors think twice in the next years, too, before putting their money in a foreign country.

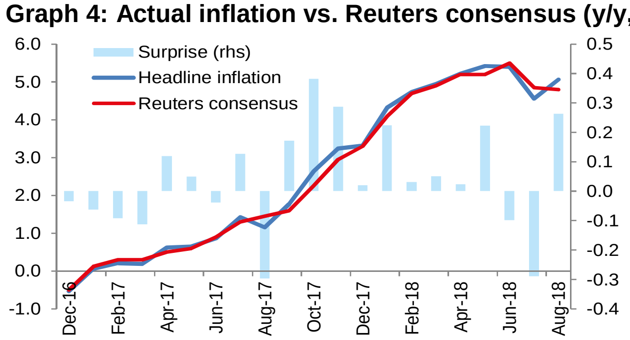
Inflation rate – we are not out of the woods yet

When economists say that predicting inflation is a tough job, they are probably looking at the actual inflation numbers vs. the market consensus for Romania in July and August. While in July inflation surprised to the downside (actual figure: 4.6%, Reuters consensus: 4.9%), in August it was the other way around and inflation exceeded expectations (actual figure: 5.1%, Reuters consensus: 4.8%).

Leaving the joke aside, the sizable surprises delivered by the inflation rate in summer (to the tune of 0.3pp in each month) show how fragile the current disinflation trend is. Last-minute announcements about increases in administered prices, such as we had at the end of July for renewable energy beginning with August and a truly volatile character of the price of fresh vegetables caught analysts on the wrong foot.

Core inflation was flat at 2.9% in recent months, but while its modest decline from May and June in m/m terms came as positive news after a steady increase of more than one year, subsequent stickiness at 2.9% brings under the spotlight the issue of deteriorating inflation expectations under the impact of energy shocks and the convergence of Eurozone inflation towards the 2% target.

Graph 4: Actual inflation vs. Reuters consensus (y/y, %)



Source: Reuters, BCR Research
Note: Inflation surprise is actual inflation minus inflation forecast in Reuters survey (median)

We maintain our year-end inflation forecast of 3.5% and acknowledge that risks of seeing a higher figure in December have intensified. Brent oil is poised for 9% growth in USD terms on average in September vs. August and the domestic crisis in the pork industry could boost meat prices just ahead of the Christmas season. The evolution of the leu and short-term trajectory of administered prices will thus play an even higher role in the NBR's task of reaching the inflation target in December 2018.

Somewhat stronger leu in December 2018, but underlying weakening trend to persist

We revised our year-end EURRON forecast to 4.68 in December 2018, from 4.73. Since old habits die hard, the leu was not allowed by the central bank to fluctuate more in the market and we again witnessed bouts of volatility for interest rates but a rather stable local currency throughout 2018, except for some periods like recent depreciation trend of the leu in September. At the same time, investors seemed to pay less attention to Romania's vulnerabilities than we thought.

Our scenario about a core weakening tendency of the leu is intact and we maintain our forecast of 4.77 in December 2019. A mix of sustained monetary tightening by the FED, possible minor steps by the ECB in this direction in 2H19 and risks of increased economic protectionism worldwide will add pressure on the leu from the external environment.

Bond monitor

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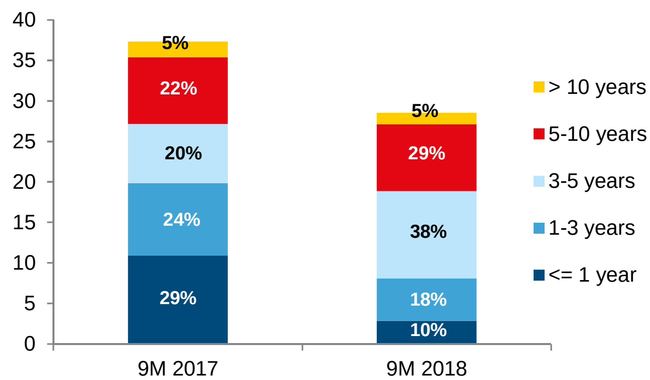
Investors favored short maturities for RON bonds in September and yields fell by 5-10bp vs. August once liquidity conditions improved in the local market. An NBR official played down the negative surprise delivered by the August inflation data and his statement was in a similar dovish note as the press conference held by Governor Isarescu in early August. Short-dated bonds were also favored by investors, due to risk-related reasons, and here we have plenty of events that might spoil the party for local bonds in the future, beginning with the reaction of emerging markets to monetary policy normalization in the US and Eurozone and arriving at local fiscal and external vulnerabilities.

Graph 5: Government RON bond issuance by residual maturity, 9M 2017 vs 9M 2018 (RON bn)



Source: NBR, BCR Research
Note: time intervals are closed on the right side

On the primary market, in September, the Ministry of Finance issued more than planned for the second month in a row, which led to an improvement of its liquidity buffer, considering also that bond maturities were zero in this month. A lot depends on budget execution in September, more specifically whether Romania made a significant payment for military equipment worth around RON 2.5bn, as previously disclosed by some government officials. Even under this scenario, the liquidity buffer probably came close to its level from December 2017 after being constantly below that level between April and August. This offers only partial relief to the Ministry of Finance because RON bond issuance will intensify in the coming months to meet the full-year target. This will weigh on short- and medium-term bonds, given that 2/3 of the RON bonds issued so far in 2018 had maturities below five years and the structure is unlikely to see deep changes in the remainder of 2018, simply because there is no strong demand at the long end of the curve.

Macro forecasts

	2011	2012	2013	2014	2015	2016	2017	2018f	2019f
Real economy									
GDP - %, y/y real change	2.0	1.2	3.5	3.4	3.9	4.8	6.9	3.8	3.4
GDP - RON bn	562	595	636	669	713	767	859	944	1007
GDP per capita - EUR thou.	6.6	6.6	7.2	7.5	8.1	8.6	9.6	10.4	11.0
Households consumption - %, y/y	1.1	2.1	0.7	4.7	6.0	7.7	10.1	4.9	4.0
Industrial production - % y/y	7.5	2.4	7.8	6.1	2.7	1.7	8.2	4.0	3.5
Retail sales - %, y/y	4.4	4.1	0.5	6.4	8.9	13.5	10.7	6.0	4.0
External sector									
Exports of goods, FOB - EUR bn.	45.3	45.1	49.6	52.5	54.6	57.4	62.6	68.3	72.7
Imports of goods, CIF - EUR bn.	55.0	54.7	55.3	58.5	63.0	67.4	75.6	82.8	87.9
Trade balance goods, FOB - CIF, % of GDP	-7.3	-7.2	-4.0	-4.0	-5.2	-5.8	-6.9	-7.2	-7.1
C/A balance - % of GDP	-5.0	-4.8	-1.1	-0.7	-1.2	-2.1	-3.3	-3.8	-4.1
Prices									
CPI - y/y (%)	3.1	5.0	1.6	0.8	-0.9	-0.5	3.3	3.5	2.8
CPI - average (%)	5.8	3.3	4.0	1.1	-0.6	-1.5	1.3	4.6	3.3
Labour market									
Unemployment rate - %	7.2	6.8	7.1	6.8	6.8	5.9	4.9	4.6	4.8
Net nominal wages - RON	1,475	1,547	1,622	1,706	1,848	2,088	2,384	2,703	2,920
Net wages - %, nominal	4.8	4.9	4.8	5.2	8.3	13.0	14.2	13.4	8.0
Public sector									
Fiscal deficit - % of GDP (Eurostat)	-5.4	-3.7	-2.2	-1.3	-0.8	-3.0	-2.9	-3.4	-2.9
Public debt - % of GDP (Eurostat)	34.0	36.9	37.6	39.1	37.7	37.1	35.0	35.2	35.8
Interest rates									
Policy rate, eop	6.00	5.25	4.00	2.75	1.75	1.75	1.75	2.50	3.00
ROBOR 3M - %, avg	5.8	5.3	4.2	2.5	1.3	0.8	1.2	2.7	3.2
10y bond yields, %, eop	7.3	6.4	5.3	3.6	3.7	3.5	4.3	5.2	5.4
FX rate									
EUR/RON eop	4.32	4.43	4.48	4.48	4.52	4.54	4.66	4.68	4.77
USD/RON eop	3.34	3.36	3.25	3.69	4.27	4.30	3.89	4.14	4.04

Source: NBR, Eurostat, INS, Ministry of Finance, Reuters, BCR Research

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Published by:

Erste Group Bank AG
Group Research
1100 Vienna, Austria, Am Belvedere 1
Head Office: Wien
Commercial Register No: FN 33209m
Commercial Court of Vienna

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