Romania | Macro Outlook

Weak structure of economic growth in 2Q18
Inflation to decline in coming months
Lower bond yields in August
Leu fluctuates within narrow interval

Economy (%)	2018e	2019e	2020e
GDP (real, y/y)	3.8	3.4	3.9
Unempl. Rate	4.6	4.8	5.0
CPI (y/y)	4.6	3.3	2.9
Retail Sales (y/y)	6.0	4.0	4.8
Ind. Prod. (y/y)	4.5	3.5	4.5
Public Debt/GDP	35.2	35.8	35.8

Source: Erste Group Research

Market	Spot	18Q4	19Q1	19Q2
EUR/RON	4.64	4.73	4.74	4.75
USD/RON	3.99	4.19	4.12	4.09
Target Rate (%)	2.50	2.50	2.75	3.00
3M Rate (%)	3.24	3.00	3.10	3.40
2Y Bond (%)*	1.61	3.90	3.90	4.10
5Y Bond (%)*	2.44	4.80	4.80	5.10
10Y Bond (%)*	3.81	5.40	5.40	5.80

Source: FactSet, Erste Group Research

Rating	Current	Outlook
Moodys	Baa3	stable
S&P	BBB-	stable
Fitch	BBB-	stable

Source: Erste Group Research

General	2018
Population mn	19.5
GDP/Capita EUR	10,272

Source: Erste Group Research

Spot Rates as of:
06th Sep. 2018

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Note:
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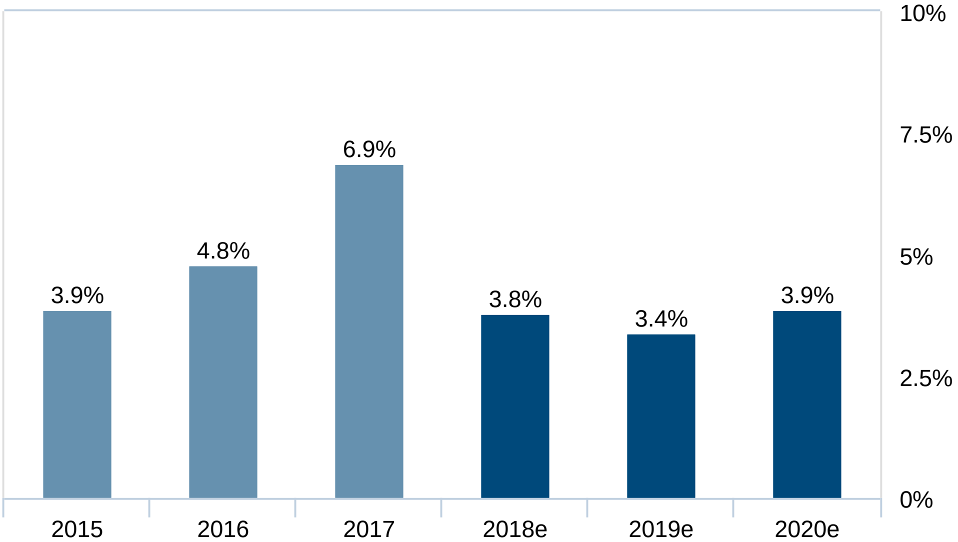
We revised our economic growth forecast for 2018 to 3.8%, from 4.1%, after the release of the GDP breakdown for 2Q18. The growth structure was weak, with an unusual high contribution of inventories of 3pp to the growth rate of 4.1% and a decline of gross fixed capital formation, which subtracted 0.7pp from overall GDP in 2Q18. Data about investments disappointed, as it stopped a short and hesitant recovery of gross fixed capital formation that started in 2H17, not to mention here the high need of the Romanian economy for fresh investments. Risks related to the quality of the agricultural year, weaker consumer and business sentiment and monthly figures about industry and services changing frequently from strong to weak were other reasons for our decision to cut the 2018 growth forecast. Fiscal stimulus is fading gradually and economic growth rates are normalizing, while external risks related to the global trade war can only complicate the entire picture.

We foresee the inflation rate at 3.5% in December 2018, the upper limit of the NBR's target. Following the NBR's decision to keep the policy rate unchanged in August and taking into consideration the inflation outlook and external developments, we have revised our forecast for the policy rate in 2018. We now see the policy rate flat at 2.50% in the remainder of 2018 (the previous forecast was 2.75% in December 2018). The long end of the yield curve is vulnerable to external shocks and we think that the ongoing steepening process, with a rising spread between 5Y and 10Y yields throughout August, will continue. On the FX market, we favor the scenario of a slight depreciation of the leu.

GDP (real,y/y)



Source: Erste Group Research

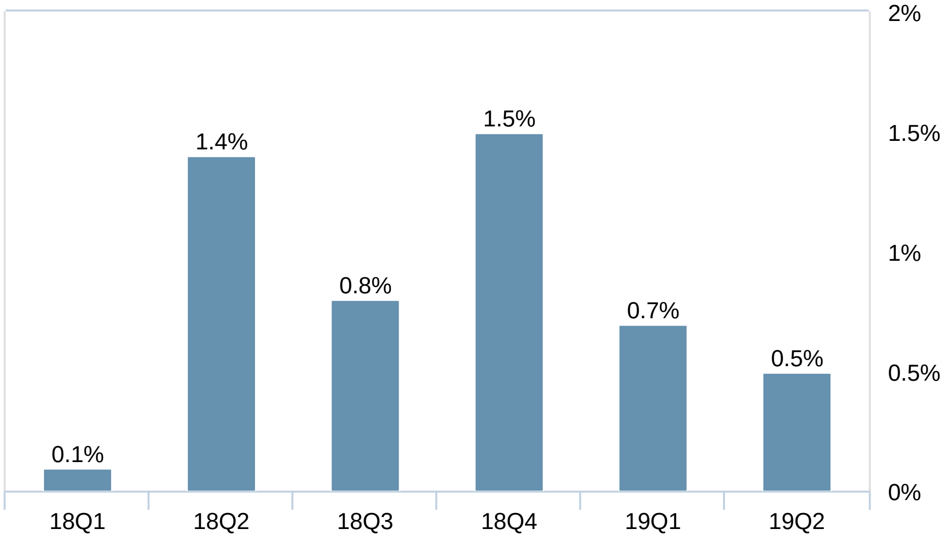
GDP

Weak structure of economic growth in 2Q18

Real GDP grew by 1.4% q/q and 4.1% y/y in 2Q18. On the supply side, industrial production and services were top contributors, bringing together 2.9pp from the total growth of 4.1%. A look at the demand side of the economy shows that gross fixed capital formation fell by 3% y/y and subtracted 0.7pp from the y/y real GDP. A fragile recovery of investments that started in the second half of 2017 makes the data even more disappointing, besides the high need of the Romanian economy for fresh investments. An unusually strong contribution of change in inventories to real GDP of 3pp raises doubts about the growth structure. Household consumption remained the key growth driver, expanding by 5.1% y/y and adding 3.3pp to the overall growth. However, household consumption grew more slowly than in previous quarters, pointing to the fading effects of the fiscal stimulus. Net exports were a negative contributor to growth, lowering real GDP by 1.4pp.

We revised our full-year economic growth to 3.8% in 2018 (-0.3pp), having in view the fragile composition of real GDP in 2Q18 and rather weak monthly indicators released so far for 3Q18. Retail sales lost speed in July and the Economic Sentiment Indicator weakened on average in July-August. A big question mark comes from the future evolution of agriculture, which increased by a staggering 33.2% y/y in 3Q17, thus creating a negative base effect for 3Q18, on top of preliminary signals received from the market, showing only an average agricultural crop this summer.

GDP (real, s.a., q/q)



Source: Erste Group Research

Annual	2016	2017	2018e	2019e	2020e
GDP real	4.8%	6.9%	3.8%	3.4%	3.9%
CPI (y/y)	-1.5%	1.3%	4.6%	3.3%	2.9%
Private Consumption	7.7%	10.1%	4.6%	4.0%	3.9%

Source: Erste Group Research

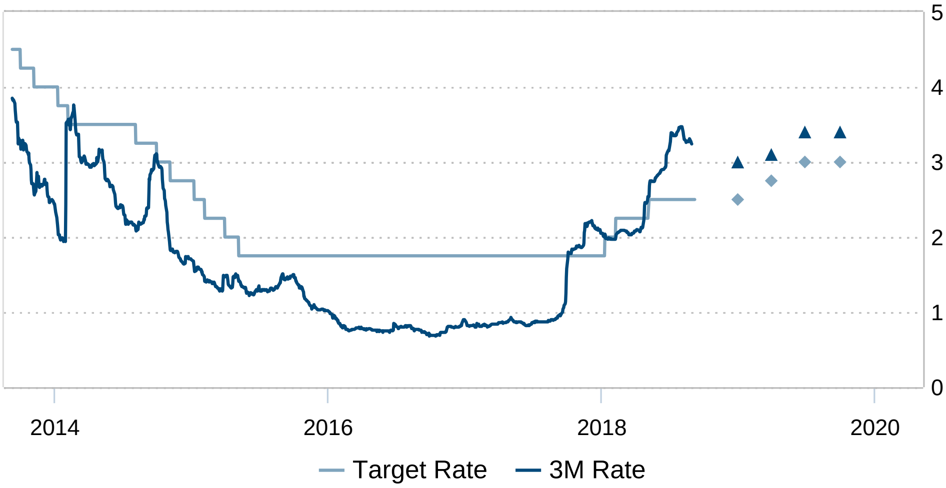
Monetary Policy

Inflation to decline in coming months

Inflation surprised to the downside in July at 4.6% y/y (June: 5.4% y/y) and we see a good chance of it entering the NBR's target at the end of 2018 at 3.5%. However, this downward trend in inflation anticipated by us for the following months does not necessarily have to be linear. Adjusted core 2 inflation, which is closely followed by the NBR when taking its monetary policy decisions, was unchanged at 2.9% y/y in July, suggesting that demand-side inflationary pressures have eased somewhat in recent months. The press conference of Governor Isarescu, after the decision to keep the policy rate unchanged at 2.50% in August, was dovish, with references to frontloading rate hikes in early-2018 for avoiding subsequent hikes later this year.

Under these circumstances, and with no surprises from the external environment, the NBR has little reason to hike the policy rate in the remainder of 2018; as a result, we foresee the policy rate at 2.50% in December this year. The trajectory of the policy rate in 2019 will mainly depend on the future stance of the ECB's monetary policy and the decisions of other central banks in the CEE. The NBR governor repeatedly said that the central bank wants to avoid a high interest rate differential between Romania and peer countries in the region that would fuel speculative capital flows into the local market.

Short Term Yields



Source: FactSet, Erste Group Research

Market (%)	Spot	18Q4	19Q1	19Q2	19Q3
Target Rate	2.50	2.50	2.75	3.00	3.00
3M Rate	3.24	3.00	3.10	3.40	3.40

Source: FactSet, Erste Group Research

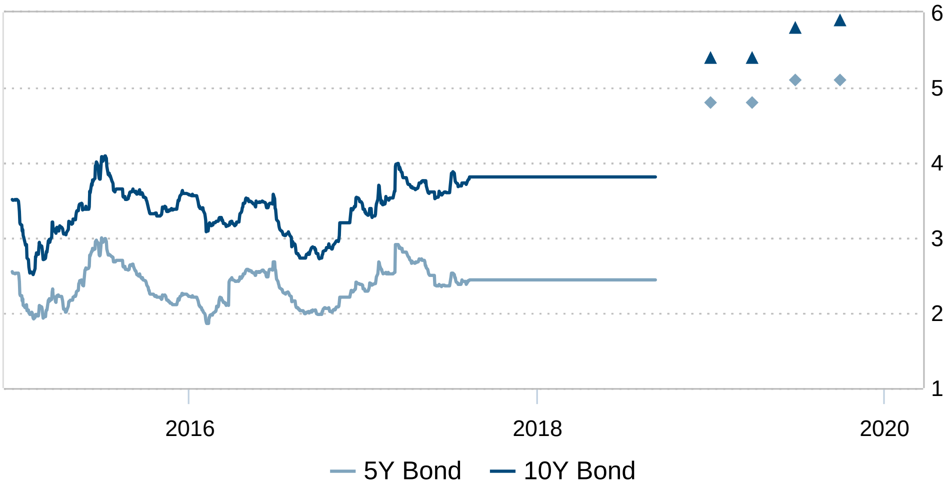
Bond Yields

Lower bond yields in August

RON bond yields fell by 10-30bp m/m in August, with the strongest move being seen at the middle of the yield curve. Better liquidity conditions in the market and the decline of the inflation rate in July explained the domestic component of this evolution. As a result, the extreme flatness of the long end of the curve started to correct itself and the spread between 10y bonds and 5y bonds rose to above 40bp at the beginning of September, from just 20bp in early-August. Events in Turkey had a minor impact on long-term RON bonds, which are held mainly by non-residents, and the increase in yields at the long end of the curve was short-lived.

Additional steepening of the yield curve through an increase in 10y yields is possible in the coming months. The inflation rate has already peaked and it will descend in the following months, while monetary tightening took a pause in the short term. Thus, key drivers that stood behind the increase in short-term yields in 1H18 will be less active in future, while the long end of the curve remains exposed to changes in foreign investor sentiment. The Ministry of Finance is behind schedule with bond issuance in the first eight months of 2018 (effective issuance on local and external market was 56% of planned borrowings).

Generic Bond Yields (%)



Source: FactSet, Erste Group Research

Market	Spot	18Q4	19Q1	19Q2	19Q3
2Y Bond*	1.61	3.90	3.90	4.10	4.10
5Y Bond*	2.44	4.80	4.80	5.10	5.10
10Y Bond*	3.81	5.40	5.40	5.80	5.90

Source: FactSet, Erste Group Research

Note:
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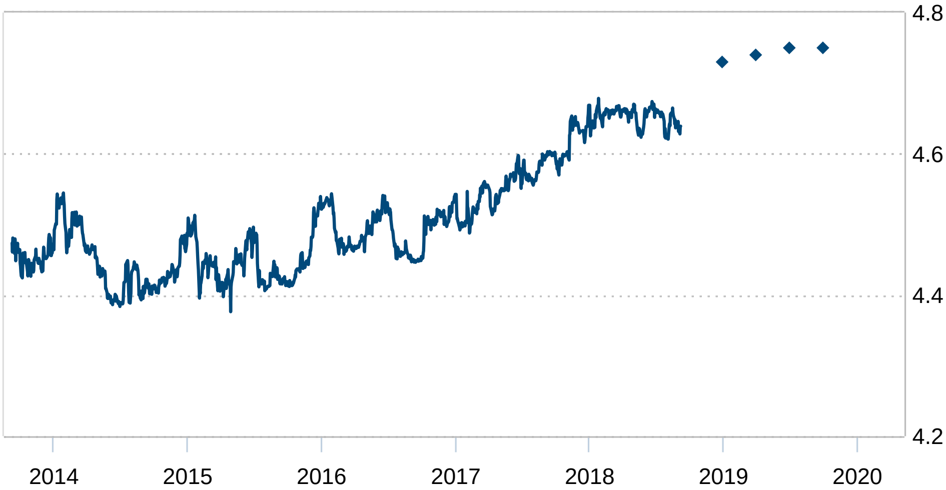
Romanian Leu

Leu fluctuates within narrow interval

The Romanian leu was traded at 4.63-4.66 most of the time in August, with no clear tendency. It seems that the NBR withdrew its strong support for the leu through FX interventions in August, most likely because it was no longer necessary. In May, unexplained outflows from FX reserves amounted to around EUR 900mn. The central bank might also have been active in the market in June, but to a lesser extent and we identified unexplained FX outflows of around half the May amount. The local FX market was immune to the street protests in Bucharest and to the FX turbulences in Turkey in August.

We favor the scenario of a gradual and modest depreciation of the leu in the coming quarters due to risks related to twin deficits. At the same time, we acknowledge that pressure from the C/A deficit has eased in recent months and the widening of the external imbalance will be smaller this year (an increase in the C/A deficit to the tune of 0.5pp of GDP in 2018 vs. 1.2pp of GDP in 2017). Taking into account the fact that macroeconomic fundamentals are better at present than in 2008 and the recent events in Turkey showed that the leu is resilient to some extent to turbulence from abroad, we think that only a severe external shock could trigger strong movement of the EURRON FX rate.

EUR/RON



Source: FactSet, Erste Group Research

	Spot	18Q4	19Q1	19Q2	19Q3
EUR/RON	4.64	4.73	4.74	4.75	4.75
vs. Spot		*1.9%*	*2.2%*	*2.4%*	*2.4%*
USD/RON	3.99	4.19	4.12	4.09	4.09
vs. Spot		*5%*	*3.3%*	*2.5%*	*2.5%*

Source: FactSet, Erste Group Research

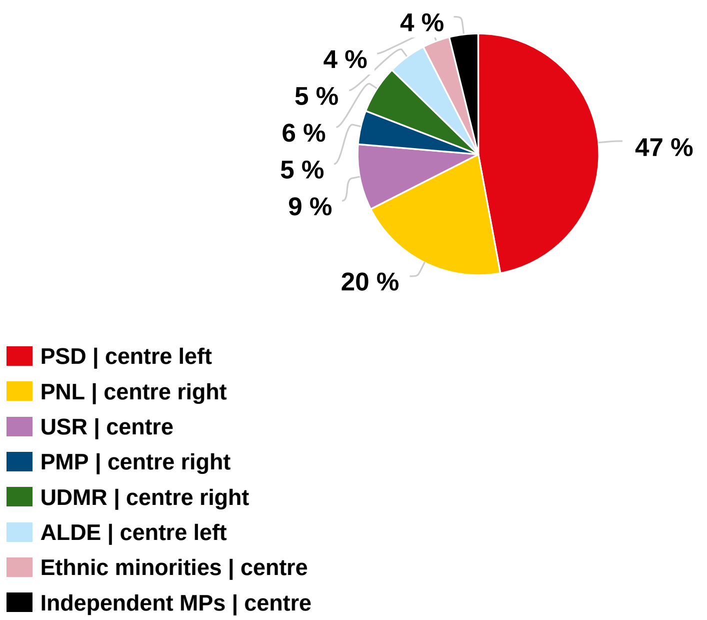
Politics

Ruling coalition caught between electoral promises and fiscal rules

Protests in the streets of Bucharest against the Social-Democrat government and the intervention of the riot police in August drew the attention of the international media, although there was almost no market reaction to those events. The issue again came under the spotlight at the beginning of September, when senior officials from the Social-Democrat Party expressed different opinions about the political responsibility associated with those events. So far, the decision-making process in the parliament has been swift because the ruling coalition formed by the Social-Democrat Party, the Alliance of Liberals and Democrats and ethnic minorities has the majority. Under these circumstances, opposition attempts to pass no-confidence motions failed and the government was able to follow its agenda of loose fiscal policy and generous wage and pension increases.

Keeping the headline budget deficit at 3% of GDP is paramount for Romania in 2018. Fiscal consolidation in structural terms is not a priority for the Romanian government this year and the structural deficit is officially estimated at 3.3% of GDP, with a decreasing trend starting only in 2019. In May 2018, the EC warned Romania of the existence of a significant deviation from the medium-term budgetary objective (MTO) and concluded that the response of the government has been insufficient. The government has to report to the EC on specific action taken to reduce the deficit by October 15, 2018. We think that the government will avoid any strong collision with the EC at the very last moment and will propose a number of measures in the future for keeping the budget afloat.

Parliament Seats



Source: Erste Group Research

Last Election:
2016

Forecasts

Next Election:
2020

Annual	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018e**	**2019e**	**2020e**
Real GDP growth	1.2	3.5	3.4	3.9	4.8	6.9	3.8	3.4	3.9
Inflation (CPI, avg)	3.3	4.0	1.1	-0.6	-1.5	1.3	4.6	3.3	2.9
Unemployment rate (avg)	6.8	7.1	6.8	6.8	5.9	4.9	4.6	4.8	5.0
Retail sales growth	4.1	0.5	6.4	8.9	13.5	10.7	6.0	4.0	4.8
Industrial output growth	2.4	7.8	6.1	2.7	1.7	8.2	4.5	3.5	4.5
Private consumption growth	2.1	0.7	4.7	6.0	7.7	10.1	4.6	4.0	3.9
Fixed capital formation growth	3.6	-5.4	3.3	7.5	-2.1	4.7	3.5	4.5	5.5
Percent of GDP									
Trade balance	-7.2	-4.0	-4.0	-5.2	-5.8	-6.9	-7.2	-7.2	-6.8
Current account balance	-4.8	-1.1	-0.7	-1.2	-2.1	-3.3	-3.8	-4.1	-4.0
Foreign direct investment	1.6	1.9	1.6	2.2	2.7	2.4	2.4	2.4	2.3
Budget balance	-3.7	-2.1	-1.4	-0.8	-3.0	-2.9	-3.4	-2.9	-2.5
Public debt	36.9	37.6	39.1	37.7	37.1	35.0	35.2	35.8	35.8
External debt, gross	74.4	68.0	63.0	57.4	54.7	49.7	46.0	42.8	39.5
FX, money market									
USDLCY average	3.47	3.33	3.35	4.00	4.06	4.05	4.02	4.09	4.13
EURLCY average	4.46	4.42	4.44	4.45	4.49	4.57	4.70	4.75	4.79
EURLCY eop	4.43	4.48	4.48	4.52	4.54	4.66	4.73	4.77	n.a.
(percent)									
CB policy rate (avg.)	5.34	4.84	3.34	1.75	1.75	1.75	2.38	2.90	3.38
3m interbank offer rate (avg.)	5.34	4.22	2.55	1.34	0.77	1.15	2.75	3.23	3.68
2Y Yield (average)*	n.a.	n.a.	2.92	1.64	1.34	1.57	3.50	3.85	4.20
5Y Yield (average)*	6.10	4.98	3.54	2.58	2.56	2.84	4.60	5.00	5.30
10Y Yield (average)*	n.a.	5.41	4.40	3.69	3.43	3.91	5.00	5.70	6.10

Source: Erste Group Research

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