Macroeconomic and Strategic Analysis

Quarterly Report

UniCredit Bank

8 February 2024

“Policy inaction in election year”

Outlook – We expect the economy to grow by 3% in 2024 and by 1.6% in 2025, with the government tightening fiscal policy only after the elections scheduled for 2024. Domestic demand will drive growth this year, with exports likely to play a more important role in 2025. We expect inflation to miss the target in 2024-25, with the NBR cutting rates to 6% in 2024 and 4% in 2025. We see EUR-RON moving to a 5.00-5.10 range in 1Q24. The wide C/A deficit will remain fully funded by FDI, EU transfers and sovereign debt issuance abroad. We expect the current governing coalition to remain in power after this year’s elections.

The information contained in this report represents UniCredit Group’s view upon Romania, as it was included in the CEE Quarterly report, distributed in January 2024. The report includes updates as of the date of the publication.

Policy inaction in election year

Busy election schedule in 2024

2024 will be a busy political year, with elections for the EP (9 June), local administrations (no later than 22 September), president (probably before the end of November, maybe with local elections) and parliament (after 6 December). The timing of elections will be extremely important. The Liberals (PNL) wish to hold local elections with those for parliament or president to leverage on their popular mayors. Their senior coalition partner, the Social Democrats (PSD), seem to be heading for a clear win in parliamentary elections, according to opinion polls.

Loose fiscal policy in 2024, budget deficit close to 6% of GDP

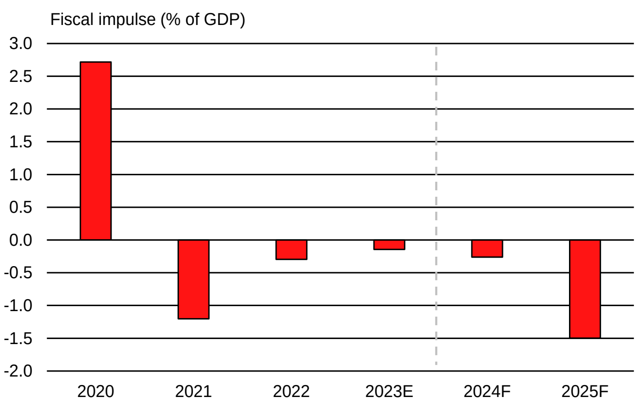
The government offered its supporters two increases in pensions (by more than 40% cumulatively in January and September), two in wages for teachers (in January and June, for a total of 20%) one for other public-sector employees (by more than 10%), and one in the minimum wage (by around 12%). While Prime Minister Marcel Ciolacu hopes to keep the budget deficit below 5% of GDP in 2024, we think this goal is unattainable, given insufficient offsetting measures. As always, the government committed to improve tax collection, although this never happened in an election year. It also aims to reduce public spending by streamlining employment in administration. We see at least three more risks that could keep this year's budget deficit close to 6% of GDP:

1. Higher spending for goods and services due to the cost of organizing up to five election rounds and to covering the funding gap of local administrations.
2. Lower indirect-tax revenues (in percent of GDP) due to poor tax compliance in rural retail stores and for custom duties, which tend to worsen in election years.
3. Arrears accumulated in 2023 and paid this year. While some of them will be assigned to the 2023 budget (wages and compensations of public employees), some could be carried over to 2024 (e.g., in the health sector, public procurement and investment).

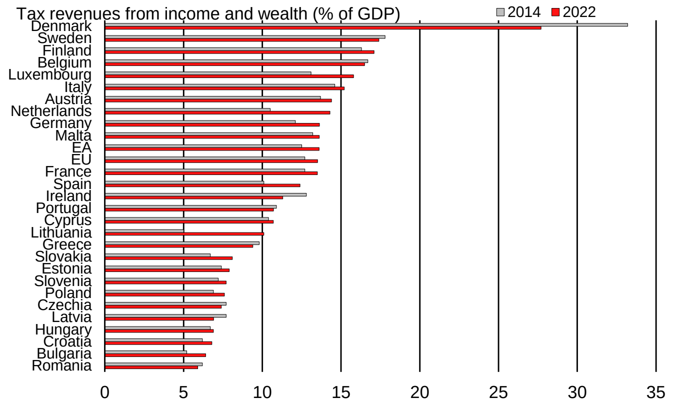
The budget deficit to fall to 4.6% of GDP in 2025 and below 3% of GDP in 2027

Mr. Ciolacu ruled out any tax increase in 2024, but presented two options for raising tax receipts from 2025 onwards. The first assumes that the flat personal income tax of 10% will be replaced with a progressive tax system. The second assumes that all taxes will be unified at 16%. This would imply higher taxes on incomes, microenterprises and authorized individuals, thus closing tax loopholes that past PSD administrations opened in 2016-19. We see a combination of both plans as more likely to reduce the budget deficit below 3% of GDP. Thus, we expect progressive tax levels for income and profits, the further closing of tax loopholes for microenterprises and authorized individuals, as well as higher taxes on property and commodity extraction. Excise duties on fuels, tobacco and alcohol are likely to be raised every year, while the price cap on electricity and natural gas might be removed in 2025. These measures would allow to reduce the budget deficit towards 3% of GDP by 2027 and stabilize public debt by 2026.

MINIMAL FISCAL ADJUSTMENT IN 2022-24



ROMANIA HAS THE LOWEST LABOR TAX BURDEN IN THE EU



Source: Ministry of Finance, NIS, UniCredit Research

PSD and PNL likely to remain in power after the 2024 elections

We see risks of the PSD-PNL coalition breaking before elections because the government will have to commit to some tax increases before 2025 (opposed by PNL) and because the PNL might try to reassume its anti-PSD stance from the previous elections. However, the two parties are likely to end up in another coalition after this year's elections, probably with renewed support from the Hungarian minority party, UDMR. We expect the nationalist, populist Alliance for the Unity of Romanians (AUR) to do better in EP elections (which are usually protest elections) than in parliamentary elections. Its president, George Simion, could make it to the second round of presidential elections. We believe that the latter have little importance for economic policies in Romania because the Constitutional Court reduced presidential powers over the last decade.

We forecast GDP growth at 3% in 2024 and 1.6% in 2025

We expect the economy to grow by 3% this year, boosted by fast real-income growth and public spending. Building projects could gradually add to infrastructure works in boosting value added, as financial conditions are likely to ease further, especially in 2H24. We see industry and exports lagging in 2024 due to weak foreign demand, scarring in energy-intensive sectors and poor price competitiveness in low value-added sectors. In 2025, we forecast domestic demand to grow at a much slower pace due to tax increases, with GDP advancing by just 1.6%. Better foreign demand could limit the damage, without offsetting the loss of purchasing power we expect from higher taxes on the middle class.

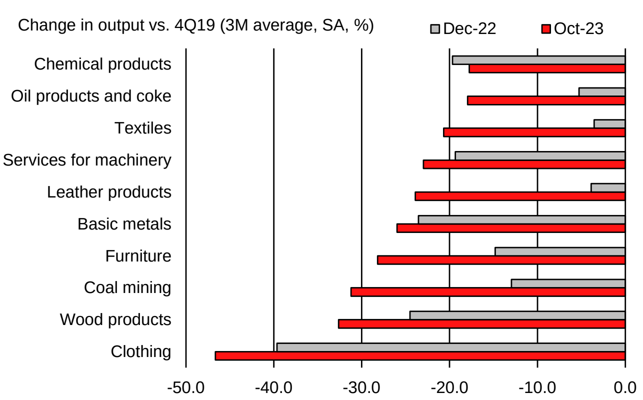
We expect inflation at 6.0% in 2024 and 3.9% in 2025

We do not see inflation returning inside the target range in 2024 (6.0%) because of strong consumer demand and higher taxes, nor in 2025 (3.9%) because of higher indirect taxes. The NBR could start rate cuts in 2H24 only if the budget deficit can be financed without pressure on yields and the RON. We still expect 1pp in cuts to 6% this year, but the scope is narrowing. Even if the NBR starts cutting later than its regional peers, financial conditions will not be tighter because the Romanian central bank allowed interbank rates to fall close to the overnight deposit rate of 6% by leaving excess liquidity in the interbank market. We expect rate cuts to 4% in 2025, when the budget deficit will tighten faster.

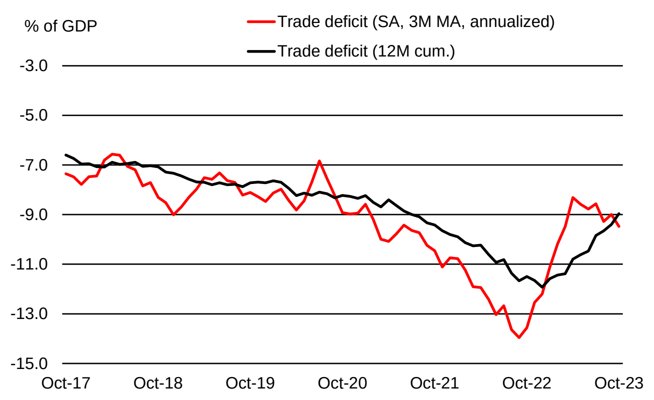
The RON could lose around 1.5% in 1Q24

In 2024, the NBR could allow EUR-RON to move into a 5.00-5.10 range, returning to 0.1 RON depreciation per year. This will only slow the RON's real appreciation. Romania's structural C/A deficit has widened to more than 5% of GDP, but a strong currency is not the most important culprit: a volatile tax and regulatory system, and poor infrastructure have undermined foreign and domestic investment into productive capacities, with aggregate supply lagging aggregate demand. The NBR can do little to offset this imbalance, but the economy would benefit from a gradual move to a more loosely managed exchange rate.

SCARRING AND LOW COMPETITIVENESS AFFECT INDUSTRY



WIDENING TRADE DEFICIT AFTER CORRECTION IN ENERGY



Source: NBR, Eurostat, Ministry of Finance, UniCredit Research

The C/A deficit will remain wide but fully funded

In 2024-25, the C/A deficit will remain fully funded by EU transfers, FDI and sovereign external borrowing. We expect FX reserves to grow further, even if the NBR might have to defend the RON through spot interventions in risk-off episodes. A slow rise in public and external debt should prevent downgrades to the sovereign rating, in our view.

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MACROECONOMIC DATA AND FORECASTS

	2021	2022	2023F	2024F	2025F
GDP (EUR bn)	241.7	286.6	322.9	350.7	372.7
Population (mn)	19.2	19.1	19.1	19.1	19.0
GDP per capita (EUR)	12,596	14,979	16,902	18,386	19,566
Real economy, change (%)					
GDP	5.7	4.6	1.4	3.0	1.6
Private Consumption	7.2	6.9	2.6	2.6	0.3
Fixed Investment	2.9	5.6	9.7	4.8	2.1
Public Consumption	1.8	3.1	1.0	1.9	-0.2
Exports	12.6	9.6	-0.4	3.7	4.7
Imports	14.8	9.9	-2.2	3.8	2.4
Monthly wage, nominal (EUR)	1175	1303	1481	1670	1756
Real wage, change (%)	2.0	-2.2	3.1	7.6	1.9
Unemployment rate (%)	5.6	5.6	5.4	5.4	5.5
Fiscal accounts (% of GDP)					
Budget balance	-7.1	-6.2	-6.3	-6.0	-4.6
Primary balance	-5.6	-4.2	-4.2	-3.9	-2.4
Public debt	48.5	47.2	49.3	50.9	52.2
External accounts					
Current account balance (EUR bn)	-17.5	-26.6	-20.8	-18.2	-16.5
Current account balance/GDP (%)	-7.2	-9.3	-6.4	-5.2	-4.4
Extended basic balance/GDP (%)	-1.4	-3.6	-2.3	-1.3	-0.5
Net FDI (% of GDP)	3.7	3.7	2.3	2.0	2.0
Gross foreign debt (% of GDP)	56.5	50.4	52.1	49.6	49.9
FX reserves (EUR bn)	40.5	46.6	59.8	58.6	63.4
Months of imports, goods & services	4.3	4.0	5.0	4.7	4.8
Inflation/Monetary/FX					
CPI (pavg)	5.0	13.7	10.5	6.3	4.9
CPI (eop)	8.2	16.4	6.6	6.0	3.9
Central bank target	2.50	2.50	2.50	2.50	2.50
Central bank reference rate (eop)	1.75	6.75	7.00	6.00	4.00
3M money market rate (Dec avg)	3.01	7.57	6.22	5.32	3.93
USDRON (eop)	4.37	4.64	4.56	4.51	4.56
EURRON (eop)	4.95	4.95	4.97	5.05	5.15
USDRON (pavg)	4.16	4.68	4.57	4.45	4.40
EURRON (pavg)	4.92	4.93	4.95	5.02	5.10

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2023E	2024F	2025F
Gross financing requirement	**31.6**	**33.5**	**29.9**
Budget deficit	18.6	20.4	17.1
Amortization of public debt	13.0	13.0	12.8
Domestic	11.3	8.8	9.2
Bonds	10.5	7.5	7.9
Bills	0.5	1.0	1.0
Loans	0.3	0.3	0.3
External	1.7	4.2	3.5
Bonds and loans	1.7	3.6	3.2
IMF/EU/Other IFIs	0.0	0.6	0.3
Financing	**31.6**	**33.5**	**29.9**
Domestic borrowing	24.0	22.0	19.0
Bonds	19.0	17.0	16.0
Bills	1.0	1.0	1.0
Loans and retail bonds	4.0	4.0	2.0
External borrowing	12.6	10.0	9.0
Bonds	10.3	7.5	7.0
IMF/EU/Other IFIs	2.3	2.5	2.0
Fiscal reserve change (- = increase)	-5.0	1.5	1.9

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2023E	2024F	2025F
Gross financing requirement	**46.6**	**47.1**	**42.4**
C/A deficit	20.8	18.2	13.5
Amortization of medium and long term debt	12.9	14.3	13.9
Government/central bank	2.6	5.0	5.0
Banks	4.8	4.0	3.1
Corporates/Other	5.4	5.4	5.9
Amortization of short-term debt	12.5	14.2	14.6
Financing	**46.6**	**47.1**	**42.4**
FDI (net)	7.5	7.1	7.6
Portfolio equity, net	0.6	0.1	0.1
Medium and long-term borrowing	25.0	17.6	17.6
Government/central bank	14.6	9.6	10.2
Banks	4.3	3.2	2.2
Corporates/Other	6.0	4.8	5.3
Short-term borrowing	14.2	14.6	14.6
EU structural and cohesion funds	6.0	6.6	7.2
Change in FX reserves (- = increase)	-6.6	1.2	-4.7
Memoranda:			
Nonresident purchases of LC govt bonds	3.3	0.5	2.0
International bond issuance, net	8.6	3.9	3.8

Data Source: Eurostat, NBR, NSI, Ministry of Public Finance, UniCredit Research

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