Macroeconomic and
Strategic Analysis

Quarterly Report

UniCredit Bank

07 July 2016

“External turmoil but no political noise before elections”

Outlook – The technocrat government will remain in power until parliamentary elections (expected in November), when the Social Democrats are favourites to win. Any government may have to tighten fiscal policy to keep the budget deficit below 3% of GDP in 2017. The economy is past its cyclical peak and the Brexit aftershock will accelerate the slowdown in 2017. Consumption is boosting imports and the widening of the C/A deficit. This, in turn, is slowing reflation. The NBR may have to delay any tightening if inflation remains close to target and carry trades emerge.

The information contained in this report represents UniCredit Group’s view upon Romania, as it was included in the CEE Quarterly report, distributed on 06 July 2016.

External turmoil but no political noise before elections

PSD will be favoured to win parliamentary elections in November…

…but needs a strong victory to govern

The Social Democrat Party (PSD) will be the favourite in November's parliamentary general elections after winning local elections held on 5 June. Its vote tally for county councils – probably the best proxy for general elections – was 37.6% vs. 31.9% for the National Liberal Party (PNL). The result may be repeated if PNL does not run on a clear pro-reform campaign to attract more of the voters who backed President Klaus Iohannis in December 2014. PSD would need a wide victory this autumn to form a coalition government with its populist ally ALDE. Too narrow a victory may see PNL form a coalition with the Hungarian minority party and PMP, the party of former President Traian Băsescu.

The technocrat government will remain in place until elections

While parliamentary parties vowed to keep the technocrat government of Dacian Cioloș in place until general elections, they also decided to limit its mandate over the summer. Hence, no important changes may be implemented via emergency ordinances, meaning that economic policy is unlikely to change significantly before autumn. However, the government faces the risk that parliament will resort again to populist, pre-election spending.

Consumption will be the main growth driver in 2016 and 2017…

… amid tighter labour market conditions

Economic growth will be driven mainly by private consumption in 2016 and 2017. While the technocrat government prevented a deluge of public spending that is typical before elections, past fiscal easing is fuelling private consumption via tax cuts and wage increases. As a result, real wage growth accelerated to above 16% yoy in April after a seventh (and hopefully last) minimum wage increase in less than four years. This led to a slower drop in unemployment and to poor performance in manufacturing branches with low-value added, such as footwear and clothing, where wages are a big cost component. In addition, Romanian exports and industrial production may underperform those of other CEE countries in 2016 due to: localized labour shortages in large cities and Transylvania, a lack of significant investment (leading to stalling productivity), and an overvalued RON compared to regional peers.

Growth acceleration in 2016 is due to the harvest…

… with a slowdown following in 2017

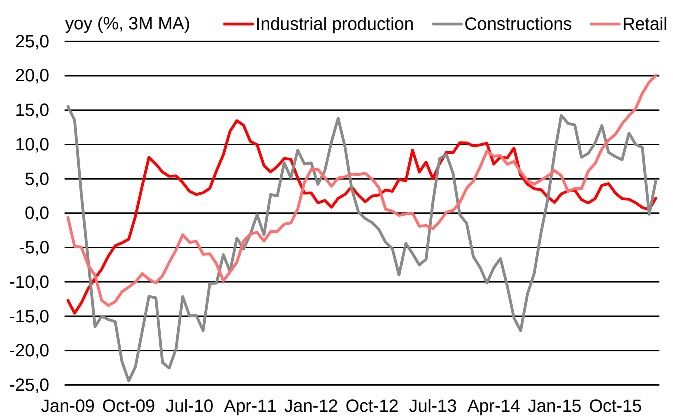
We expect growth to accelerate temporarily to 4.1% in 2016, only to slow again to 3.1% next year. Adjusting for the impact of agriculture, growth is expected to decline to 3.6% this year and 3.1% in 2017 after peaking at 4.2% in 2015. The reason for this slowdown are: 1) the reliance on imports to cover most additional consumer demand, 2) the slowdown in exports following Brexit, 3) a likely negative fiscal impulse and 4) the uneven performance of different sectors.

Fiscal tightening may be needed in 2017

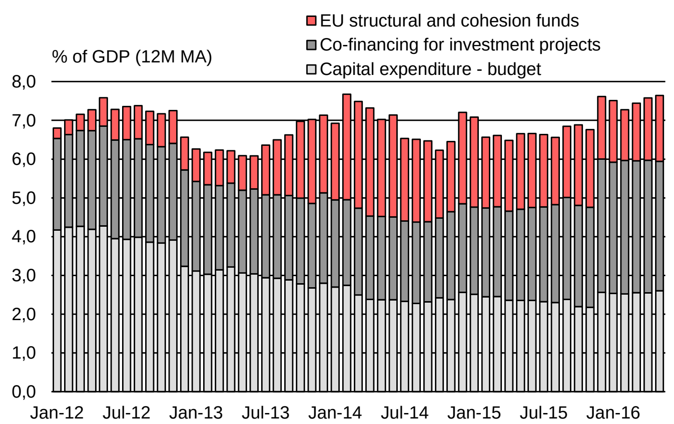
While the budget deficit will be below 3% of GDP in 2016, it may exceed that threshold in 2017. Thus, public investment and EU fund co-financing may be crowded out in 2017

GROWTH SLOWED BY POOR PERFORMANCE IN INDUSTRY AND A LIKELY NEGATIVE FISCAL IMPULSE IN 2017

Disproportionate contribution of retail to 2016 growth



The increase in public investment may be reversed next year



Source: NIS, NBR, UniCredit Research

after rising this year. The risk of tax increases will be significant next year as revenues could fall short of the very optimistic forecast if the economy slows due to external risks.

Retail sector will outperform industry and construction

Double-digit retail sales growth will contrast this year with poor industrial production and weak construction. Public investment growth in 1H16 is explained only by the comparison with poor infrastructure spending in 1H15. Small EU fund inflows at the start of the new disbursement period will affect public investment in 2H16, with fiscal policy probably being a drag in 2017. At the same time, Romania is one of the few central European countries where house prices are not rising, weighing on the recovery in housing projects.

The C/A deficit is widening faster than expected…

Sharp consumption growth contrasting sluggish exports may lead to a widening of the C/A deficit in 2016 and 2017. The goods trade deficit is increasing rapidly in 2016 and the pace could accelerate following the Brexit vote. Meanwhile, the trade surplus for services, which rose in the past in line with the deficit for goods, is hit by smaller revenues for transporters due to border bottlenecks in the EU. On top of a larger trade deficit, companies could decide to repatriate more profits if they fear the risk of higher taxes and/or currency depreciation.

…reducing stable capital flows' support for the RON

The larger C/A deficit will be barely covered by FDI and EU funds in 2016. Foreign investment continues to suffer from poor infrastructure and policy unpredictability. At the same time, EU fund inflows may recover more slowly than in Hungary and Poland. This is due to the framework devised by the former governments, which was rejected several times by the European Commission for lack of substance. The ensuing delays in the start of new projects will postpone the first significant inflows to 2H17 or later.

The NBR may postpone tightening the rate corridor to 2017…

…if inflation remains close to target next year…

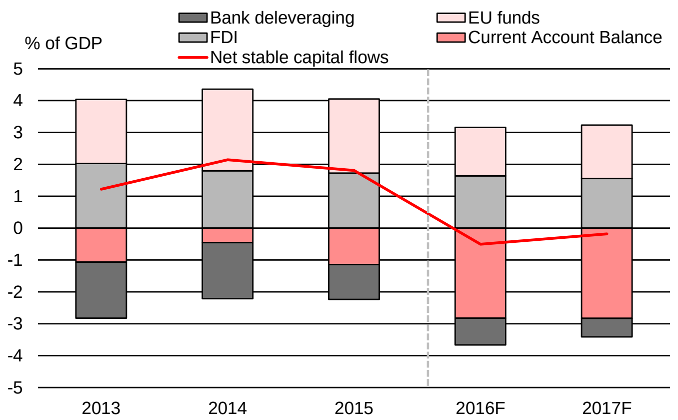
The NBR has turned more dovish since the May inflation report. Thus, a tightening in the interest rate corridor may be postponed to 2017 or later due to the debt discharge law and lower imported inflation. The wider C/A deficit increases the impact of low import prices on non-food and food prices. The latter may decline further if the 2016 harvest is a good one. We expect annual inflation close to zero by end-2016 and close to, but below the 2.5% target throughout 2017 even as past VAT cuts leave the base. The forecast assumes little oil price volatility and low imported inflation until the end of 2017.

…and may delay rate hikes beyond 2017…

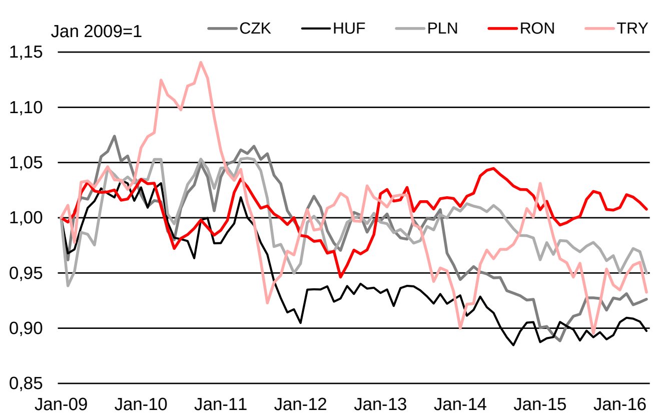
The central bank may have to delay increases in the policy rate if carry trades emerge after the UK referendum. The preference for a stable currency and the positive interest rate differential vs. the eurozone could postpone rate hikes beyond what fundamentals would require. While reflation would imply at least 75bp in rate increases to bring the real

A DETERIORATION IN STABLE CAPITAL FLOWS AND A LOSS OF COMPETITIVENESS WOULD REQUIRE CURRENCY DEPRECIATION

Stable capital inflows may not cover bank deleveraging in 2016



The RON has appreciated vs peers in real effective terms



Source: NBR, NIS, JP Morgan, UniCredit Research

…if carry trades emerge

interest rate close to zero by the end of 2017, the NBR may have to follow its regional peers and increase interest rates only if inflation threatens to exit the 1.5-3.5% target range. Otherwise, the RON may appreciate at a time when it is already stronger than its regional peers.

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MACROECONOMIC DATA AND FORECASTS

	2013	2014	2015	2016F	2017F
GDP (EUR bn)	144,3	150,2	160,4	168,5	179,2
Population (mn)	20,0	19,9	19,9	19,8	19,8
GDP per capita (EUR)	7.205	7.530	8.071	8.506	9.075
Real economy, change (%)					
GDP	3,5	3,0	3,8	4,1	3,1
Private Consumption	0,7	3,8	6,1	8,2	5,2
Fixed Investment	-5,4	2,5	8,8	4,2	1,6
Public Consumption	-4,6	0,3	1,6	2,1	0,4
Exports	19,7	8,6	5,5	1,5	1,8
Imports	8,8	8,9	9,1	6,7	4,1
Monthly wage, nominal (EUR)	507	531	576	627	678
Real wage, change (%)	1,0	4,2	9,1	11,6	5,7
Unemployment rate (%)	7,1	6,8	6,8	6,7	6,6
Fiscal accounts (% of GDP)					
Budget balance	-2,2	-1,4	-1,1	-2,9	-3,1
Primary balance	-0,5	0,1	0,3	-1,6	-1,9
Public debt	38,0	39,8	38,4	38,3	39,2
External accounts					
Current account balance (EUR bn)	-1,5	-0,7	-1,8	-4,8	-5,1
Current account balance/GDP (%)	-1,1	-0,5	-1,1	-2,8	-2,9
Extended basic balance/GDP (%)	3,0	3,9	2,9	0,3	0,3
Net FDI (% of GDP)	2,0	1,8	1,7	1,6	1,5
Gross foreign debt (% of GDP)	67,8	63,1	56,1	53,3	50,2
FX reserves (EUR bn)	32,5	32,2	32,2	30,4	28,6
Months of imports, goods & services	6,7	6,2	5,8	5,3	4,8
Inflation/Monetary/FX					
CPI (pavg)	4,0	1,1	-0,6	-1,3	2,0
CPI (eop)	1,6	0,8	-0,9	0,1	2,1
Central bank target	2,50	2,50	2,50	2,50	2,50
Central bank reference rate (eop)	4,00	2,75	1,75	1,75	1,75
3M money market rate (Dec avg)	2,58	1,69	1,03	0,75	1,07
USD/FX (eop)	3,26	3,69	4,15	4,02	3,91
EUR/FX (eop)	4,48	4,48	4,52	4,50	4,50
USD/FX (pavg)	3,33	3,35	4,01	4,04	3,96
EUR/FX (pavg)	4,42	4,44	4,44	4,49	4,49
Real effective exchange rate, 2000=100	105,8	106,9	105,0	101,4	98,2
Change (%)	4,7	1,0	-1,8	-3,4	-3,1

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2015	2016F	2017F
Gross financing requirement	**13,0**	**15,1**	**12,9**
Budget deficit	2,3	4,9	5,6
Amortization of public debt	10,7	10,2	7,3
Domestic	6,7	8,6	6,1
Bonds	4,7	6,3	3,7
Bills	1,7	2,0	2,1
Loans	0,3	0,3	0,3
External	4,0	1,6	1,2
Bonds and loans	1,0	1,5	0,0
IMF/EU/Other IFIs	3,0	0,1	1,2
Financing	**13,0**	**15,1**	**12,9**
Domestic borrowing	7,9	11,1	10,6
Bonds	5,5	8,9	8,7
Bills	2,1	2,1	1,8
Loans	0,3	0,1	0,1
External borrowing	2,8	3,0	2,2
Bonds	2,0	2,2	1,5
IMF/EU/Other IFIs	0,8	0,8	0,7
Privatization/Other	0,0	0,0	0,0
Fiscal reserve change (+ stock decline/- stock increase)	2,3	1,0	0,1

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2015	2016F	2017F
Gross financing requirement	**32,5**	**31,6**	**30,4**
C/A deficit	1,8	4,8	5,1
Amortization of medium and long term debt	19,7	14,6	12,9
Government/central bank	6,2	3,6	3,0
Banks	6,4	5,1	4,0
Corporates/Other	7,1	5,9	5,9
Amortization of short-term debt	11,0	12,2	12,4
Government/central bank	0,4	0,1	0,1
Banks	3,5	4,9	4,9
Corporates/Other	7,1	7,2	7,4
Financing	**32,5**	**31,6**	**30,4**
FDI (net)	2,8	2,7	2,7
Portfolio equity, net	0,1	0,1	0,1
Medium and long-term borrowing	14,1	12,4	11,3
Government/central bank	3,8	3,8	3,1
Banks	3,8	3,5	3,2
Corporates/Other	6,5	5,1	5,0
Short-term borrowing	11,8	12,0	11,4
EU structural and cohesion funds	3,7	2,6	3,0
Other	0,0	0,0	0,0
Change in FX reserves (- = increase)	0,0	1,8	1,9
Memoranda:			
Nonresident purchases of LC govt bonds	1,3	0,9	1,1
International bond issuance, net	1,0	0,7	1,5

Data Source: NIS, NBR, MinFin, UniCredit Research

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