Macroeconomic and
Strategic Analysis

Quarterly Report

UniCredit Bank

04 October 2016

“The first signs the economy is cooling off”

Outlook – The Social Democratic Party is expected to win parliamentary elections held on 11 December and head the next coalition government. Regardless of the next government’s composition, fiscal policy may have to be tightened in 2H17 to keep the budget deficit below 3% of GDP. We expect investment to be crowded out again. As a result, the main risk of past fiscal easing is weaker economic growth over the next few years. Inflation may stay close to target in 2017 and the NBR could remain on hold to prevent currency appreciation.

The information contained in this report represents UniCredit Group’s view upon Romania, as it was included in the CEE Quarterly report, distributed on 29 September 2016.

The first signs the economy is cooling off

The Social Democrats are favoured to lead the next government

The Social Democrat Party (PSD) is expected to win the parliamentary elections scheduled for 11 December, with the National Liberal Party (PNL) coming in second. Several smaller parties are polling close to the 5% threshold, with the Hungarian minority party, UDMR, the populist ALDE and maybe the Popular Movement (PMP) of former president Traian Băsescu having the best chances of entering parliament. The likeliest outcome is a PSD-ALDE government that may include PMP and/or UDMR. A grand coalition between PSD and PNL has a lower probability and would require the two parties to get a similar vote tally and several smaller parties to enter parliament. The least likely outcome at the moment is a government led by PNL, which currently trails PSD in opinion polls by 5-10pp.

Fiscal policy will have to be tightened in 2H17

Regardless of which coalition will lead Romania from December onwards, large fiscal commitments made in previous years will constrain policies. With economic growth slowing and discretionary public expenditure reduced by significant tax cuts and wage increases, the new government will have to tighten fiscal policy before the end of 2017 to keep the budget deficit below 3% of GDP. This threshold should not be breached: most of the budget deficit is incurred in the last quarter of every year, so the government will know exactly how much it can spend. That said, some of the past promises could be postponed (such as increasing a wide range of wages and cutting the VAT rate by 1pp to 19% in January 2017).

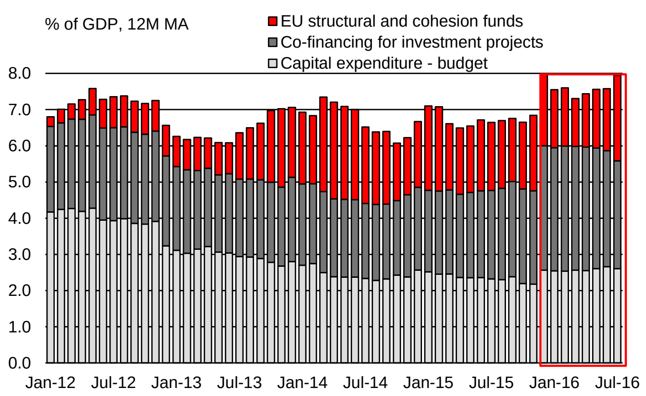
The likely victim of the inevitable fiscal tightening will be public investment. The current government finalised the absorption framework for EU funds until 2020, but this is no guarantee for future performance. State co-financing for EU funds and infrastructure spending could be crowded out by other types of public spending, as it was in 2012-15. Thus, the big fiscal risk is not a rapidly-widening budget deficit, but slower economic growth.

Economic growth will peak this year

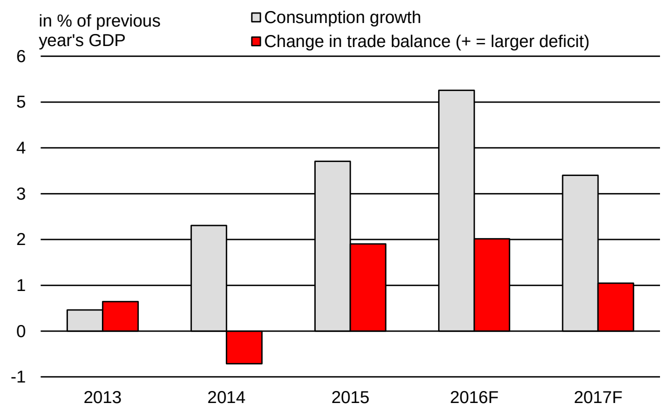
GDP growth could reach a post-financial crisis high of 4.4% this year. However, excluding agriculture, growth already peaked last year (4.2% vs. 4.1% in 2016). Strong private consumption growth could translate into higher imports than anywhere else in central Europe (CE), as local producers fail to benefit from the retail spending boom. Moreover, exports will also grow slower than in the rest of CE due to a lack of large investment projects in past years. On a positive note, fixed investment is rising much faster than in CE for three main reasons: 1. Late EU fund disbursements from the 2007-13 EU budget reached EUR 2.9bn in 8M16; 2. The government is spending more on public investment and, especially, on EU fund co-financing than last year; and 3. Residential construction is rebounding.

DOMESTIC DEMAND GROWTH COULD SLOW IN 2017

Public investment recovered in 2016, but could fall again in 2017



Consumption growth spills over to higher imports



Source: Markit, CZSO, UniCredit Research

The omens of slower growth are already present

We expect growth to fall to 3.4% next year, the first signs of a slowdown being visible in this year's data. First, agriculture will contribute less (if at all) to growth after this year's bumper harvest. Second, new RON lending has peaked this summer and is likely to slow down further in 2017. In 2016, the government allocated RON 2.7bn (0.4% of GDP) in guarantees for the First Home program (the main driver of mortgage loans). Going forward, authorities could reduce both the amount of pledged guarantees and the access of better-off borrowers. Third, real wage growth may slow next year due to smaller revenue increases and higher inflation. Pre-election promises for wage rises will be difficult to fulfill in 2017 as long as the budget deficit remains below 3% of GDP.

Inflation could stay close to target…

Annual inflation is expected to rise above 1% in 1Q17 from close to zero at the end of 2016, touching 2% in 2Q17. However, we do not expect inflation to exceed the 2.5% target even when factoring in a rise in the Brent oil price to USD 65/bbl by the end of next year. The main reasons are: low food prices, cheap imports from the eurozone and a small contribution of administered prices to inflation.

… keeping the NBR on hold

If our benign inflation scenario is confirmed, the NBR is likely to remain on hold throughout 2017. Moreover, the central bank may postpone narrowing the interest corridor as well for two main reasons: 1. A higher deposit rate would increase the carry for eurozone investors and 2. A narrower interest corridor could result in higher EUR-RON volatility, something the NBR is trying to avoid.

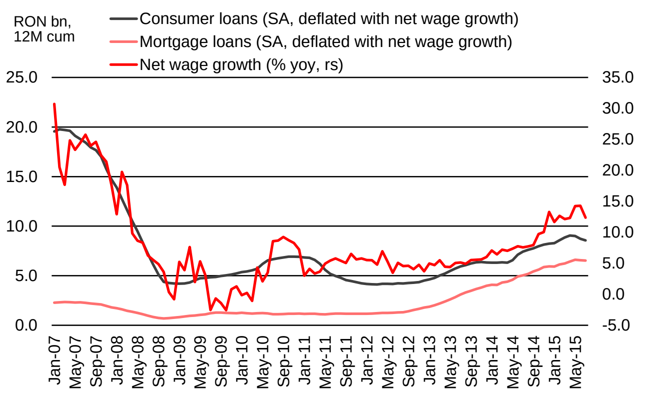
EUR-RON remains stronger in real effective terms than its regional peers. With the stock of FX loans still at 45% of the total, strong depreciation remains off the table. Thus, EUR-RON is expected to trade closer to the top of the 4.40-4.50 range for most of 2017. Any monetary tightening could push the pair lower. If the refinancing of FX loans into RON continues, the EUR-RON range may be gradually widened on the upside. A wider C/A deficit and ongoing bank deleveraging are still covered by FDI and EU fund inflows, but the cushion is smaller than in other CE countries, leaving EUR-RON more sensitive to volatile capital flows.

The economy is not overheating

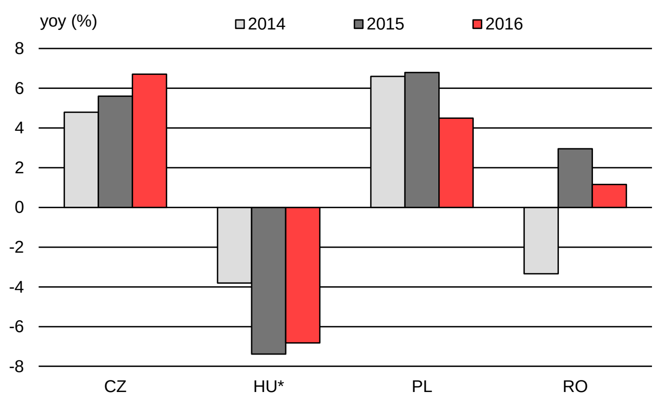
Fears of a credit-driven overheating of the economy are overblown for at least three reasons. First, the fast rise in RON lending is linked to a gradual refinancing of FX loans into RON. Second, housing loans remain dependent on the First Home program.

FEARS OF A CREDIT-INDUCED OVERHEATING ARE OVERBLOWN

New RON lending is slowing, as is wage growth



In FX-adjusted terms, outstanding loans are growing slower



Source: UniCredit Research

The government supplemented it recently for a second time this year, but the amount of available guarantees is much smaller than in 1H16. Moreover, the First Home program caps the value of purchased homes at EUR 70,000, preventing a recovery in house prices. Third, monthly new RON consumer lending slowed over the summer. The strong correlation with wage growth means that the slowdown could continue.

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MACROECONOMIC DATA AND FORECASTS

	2013	2014	2015	2016F	2017F
GDP (EUR bn)	144.3	150.2	160.4	168.7	179.8
Population (mn)	20.0	19.9	19.9	19.8	19.8
GDP per capita (EUR)	7,205	7,530	8,071	8,514	9,103
Real economy, change (%)					
GDP	3.5	3.0	3.8	4.4	3.4
Private Consumption	0.7	3.8	6.1	8.6	5.4
Fixed Investment	-5.4	2.5	8.8	5.9	2.7
Public Consumption	-4.6	0.3	1.6	2.1	0.6
Exports	19.7	8.6	5.5	3.9	2.9
Imports	8.8	8.9	9.1	8.7	5.3
Monthly wage, nominal (EUR)	507	531	576	640	689
Real wage, change (%)	1.0	4.2	9.1	13.7	5.6
Unemployment rate (%)	7.1	6.8	6.8	6.2	6.0
Fiscal accounts (% of GDP)					
Budget balance	-2.2	-1.4	-1.1	-3.0	-3.0
Primary balance	-0.5	0.1	0.3	-1.6	-1.5
Public debt	38.0	39.8	38.4	38.9	39.5
External accounts					
Current account balance (EUR bn)	-1.5	-1.0	-1.8	-4.1	-4.3
Current account balance/GDP (%)	-1.1	-0.7	-1.1	-2.5	-2.4
Extended basic balance/GDP (%)	3.0	3.7	2.9	1.9	2.0
Net FDI (% of GDP)	2.0	1.8	1.7	2.1	2.0
Gross foreign debt (% of GDP)	67.8	63.1	56.1	52.9	49.6
FX reserves (EUR bn)	32.5	32.2	32.2	32.6	33.5
Months of imports, goods & services	6.7	6.2	5.8	5.6	5.5
Inflation/Monetary/FX					
CPI (pavg)	4.0	1.1	-0.6	-1.4	1.9
CPI (eop)	1.6	0.8	-0.9	-0.2	2.0
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	0.75
USDRON (eop)	3.26	3.69	4.15	4.02	3.91
EURRON (eop)	4.48	4.48	4.52	4.50	4.50
USDRON (pavg)	3.33	3.35	4.01	4.03	3.96
EURRON (pavg)	4.42	4.44	4.44	4.49	4.49
Real effective exchange rate, 2000=100	105.8	106.9	105.0	102.2	99.4
Change (%)	4.7	1.0	-1.8	-2.7	-2.7

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2015	2016F	2017F
Gross financing requirement	**13.2**	**14.7**	**12.5**
Budget deficit	2.3	4.5	5.3
Amortization of public debt	10.9	10.2	7.2
Domestic	6.9	8.6	6.0
Bonds	4.2	6.3	3.6
Bills	2.4	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	**13.2**	**14.7**	**12.5**
Domestic borrowing	7.8	11.1	9.8
Bonds	5.5	8.9	7.9
Bills	2.0	2.1	1.8
Loans	0.3	0.1	0.1
External borrowing	2.8	4.0	2.7
Bonds	2.0	3.2	2.0
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)	2.6	-0.4	0.0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2015	2016F	2017F
Gross financing requirement	**32.5**	**30.8**	**29.3**
C/A deficit	1.8	4.1	4.3
Amortization of medium and long term debt	19.7	14.5	12.9
Government/central bank	6.2	3.5	3.0
Banks	6.4	5.0	4.0
Corporates/Other	7.1	6.0	5.9
Amortization of short-term debt	11.0	12.2	12.1
Government/central bank	0.4	0.1	0.2
Banks	3.5	4.9	4.5
Corporates/Other	7.1	7.2	7.4
Financing	**32.5**	**30.8**	**29.3**
FDI (net)	2.8	3.6	3.6
Portfolio equity, net	0.1	0.1	0.1
Medium and long-term borrowing	14.8	12.1	10.7
Government/central bank	3.8	5.1	3.8
Banks	4.5	2.0	2.0
Corporates/Other	6.5	5.0	4.9
Short-term borrowing	11.8	11.7	11.4
EU structural and cohesion funds	3.7	3.8	4.3
Other	0.0	0.0	0.0
Change in FX reserves (- = increase)	-0.7	-0.4	-0.8
Memoranda:			
Nonresident purchases of LC govt bonds	-2.2	1.3	1.2
International bond issuance, net	1.0	1.7	2.0

Data Source: NIS, NBR, MinFin, UniCredit Research

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