UniCredit Bank

Macroeconomic and
Strategic Analysis

Quarterly Report

UniCredit Bank

10 April 2017

"Losing direction"

Outlook – The fiscal splurge at the beginning of 2017 is likely to support consumption while affecting investment in 2H17 and beyond. We expect economic growth to slow in 2017 and 2018, rather than budget deficits to widen sharply. The RON could weaken gradually as the C/A deficit increases. The NBR has turned more hawkish, although its actions are unlikely to influence liquidity conditions significantly. Inflation could remain inside the target range until the end of 2018 due to a stronger impact of imported inflation. Risks are to the upside.

The information contained in this report represents UniCredit Group's view upon Romania, as it was included in the CEE Quarterly report, distributed in March 2017.

Losing direction

While economic growth will remain robust, its overreliance on consumption (both private and public) could lead to widening macroeconomic imbalances. Meanwhile, higher social security spending will reduce potential growth.

Expected economic slowdown…

...linked to forced fiscal tightening in 2H17

We expect economic growth to slow below 4% this year, unless the budget deficit widens well above 3% of GDP. The government is expected to increase spending on wages, pensions and social security, while providing local authorities with more money than in previous years. Laxer rules will allow local administrations to spend in excess of the budget plan, thus returning to the fiscal indiscipline that led to huge structural deficits at the time of the global financial crisis. Given an overly optimistic macro and revenue forecast, fiscal risks are on the rise. The European Commission already warned the government that the budget deficit could widen to 3.6% of GDP this year. The EC asked for corrective measures before mid-April to avoid a return to the excessive deficit procedure (EDP).

The budget deficit could remain below 3% of GDP…

We believe that a return to the EDP is premature. First, the government may keep the budget deficit below 3% of GDP this year by cutting public investment. Combined with poor EU fund absorption, fixed investment is likely to fall, weighing on GDP growth in 2H17 and beyond. Thus, we still believe that the main risk of fiscal profligacy is slower economic growth, rather than sharply-higher budget deficits. Second, Romania's public debt is still below 40% of GDP (in ESA terms) and a rapid rise is unlikely.

… but risks have increased

That said, fiscal troubles will increase next year, when nondiscretionary public spending will rise further. If economic growth slows in 2018, the government may consider a widening of the budget deficit. On the revenue side, improvement in tax collection is unlikely before the central registry for retail sales is implemented. The deadline was pushed to 2018, but could be moved again. In case budget revenues fail to match expectations, ad-hoc taxes and even the replacement of the flat tax with a progressive scale with higher tax levels are possible.

Wage increases reduce competitiveness

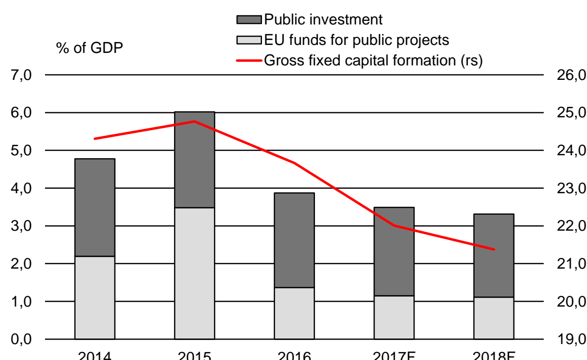
Wages will continue to grow at the fastest pace in central Europe, driven by repeated hikes in the minimum wage. Since productivity cannot keep pace, higher unit labour costs are already claiming the first victims among textile producers with low-value added. An uncertain tax environment will add to the lower competitiveness in weakening private investment, despite a robust rise in domestic demand. A new unified wage law for public employees promises wage increases well above any economic justification and is expected to push the public wage bill to levels not seen since the financial crisis.

A widening C/A deficit…

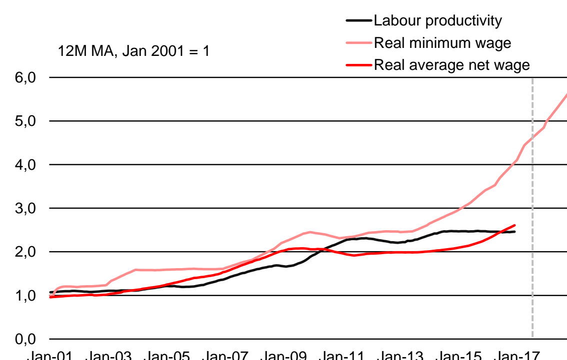
Local companies are failing to benefit fully from the increase in domestic demand. Instead, imports will further outpace exports, leading to a larger trade deficit for goods that cannot be covered by rising service exports. The latter could be capped by the lack of skilled labor in IT, where wages are reaching western European levels. Significant profit repatriation from multinational companies could accelerate the widening of the C/A

UNBALANCED GROWTH MODEL

Public investment could be crowded out by other types of expenditure



The planned increases in the minimum wage are unsustainable



Source: NIS, Labour Ministry, Ministry of Finance, UniCredit Research

deficit. The latter was safely covered by EU funds and FDI until now, but a smaller surplus of the extended basic balance could leave the RON more vulnerable to volatile capital flows.

…will push EUR-RON gradually higher

The NBR finally admitted that the RON is too strong, a case we have been making for more than a year. As a result, EUR-RON moved up to the lower half of the 4.50-4.60 range. We expect the exchange rate to inch gradually higher, since the RON remains the strongest currency in central Europe in real effective terms. With unit labour costs rising fast, this overvaluation could increase even if the RON weakens compared to last year's levels.

NBR hawkishness is probably unwarranted

The NBR turned more hawkish with the release of the February inflation report, after the inflation forecast for 2018 was pushed close to the upper limit of the 1.5-3.5% target range. The NBR expects a positive output gap in excess of 3% at the end of 2018, double our own estimate. This hawkish assessment of inflationary pressures paves the way for two increases in the marginal deposit rate, currently at 0.25%. Outright rate increases may be postponed to 2018. We believe that an increase in interest rates is unwarranted for three main reasons.

Liquidity conditions are expected to tighten slightly at the short end

First, interbank and cross currency swap interest rates are already moving higher due to a smaller liquidity surplus in the interbank market. The surplus shrunk less than expected in February, probably because of poor tax compliance. If tax collection improves, 1M ROBOR should climb towards 0.75% without the need for the NBR to increase the deposit rate.

Inflation expected inside the target range in 2017-18

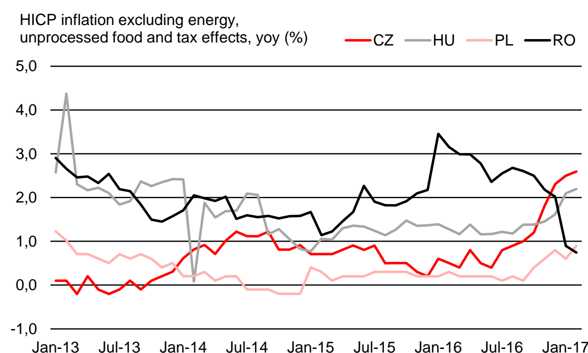
Second, underlying inflationary pressure remains subdued. While volatile prices are driving inflation higher, inflation excluding energy, unprocessed food and tax effects has been falling for more than a year and is now below 1%, according to Eurostat. This does not rule out a sharp rebound in core inflation in 2018, but we believe that a wider C/A deficit may keep inflation low due to subdued price pressure in the eurozone. Risks for higher inflation are linked to a poor harvest, higher commodity prices and/or a weaker RON.

The gradual FX loan conversion needs to continue

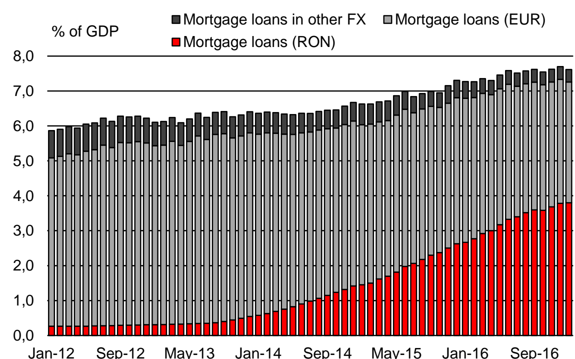
Third, the natural conversion of FX loans into RON needs to continue after the Constitutional Court ruled that forced conversions at historical exchange rates are unconstitutional. If the stock of FX loans remains high, especially for households, RON depreciation would actually lead to a negative wealth effect that could dampen consumption by the middle class.

HIGHER INTEREST RATES ARE UNWARRANTED AT THE MOMENT

The RON has appreciated in real terms vs. peers since 2012



Mortgages in FX are still half of the mortgage loan stock



Source: Eurostat, NBR, UniCredit Research

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MACROECONOMIC DATA AND FORECASTS

	2014	2015	2016	2017F	2018F
GDP (EUR bn)	150,3	160,0	169,1	179,3	190,2
Population (mn)	20,0	19,9	19,8	19,7	19,6
GDP per capita (EUR)	7.534	8.051	8.556	9.100	9.685
Real economy, change (%)					
GDP	3,1	3,9	4,8	3,9	3,3
Private Consumption	4,7	6,0	7,4	4,3	2,9
Fixed Investment	3,2	8,3	0,0	-3,3	0,3
Public Consumption	0,8	0,1	2,5	2,7	1,6
Exports	8,0	5,4	7,6	5,4	4,0
Imports	8,7	9,2	9,3	6,5	5,0
Monthly wage, nominal (EUR)	531	576	643	702	746
Real wage, change (%)	4,2	9,1	14,6	9,1	3,7
Unemployment rate (%)	6,8	6,8	5,9	5,3	5,1
Fiscal accounts (% of GDP)					
Budget balance	-0,8	-0,8	-2,4	-3,0	-3,5
Primary balance	0,7	0,5	-1,1	-1,7	-2,1
Public debt	39,4	38,0	37,6	39,2	39,8
External accounts					
Current account balance (EUR bn)	-1,0	-1,9	-4,1	-5,4	-6,0
Current account balance/GDP (%)	-0,7	-1,2	-2,4	-3,0	-3,2
Extended basic balance/GDP (%)	3,7	3,0	2,3	0,1	0,0
Net FDI (% of GDP)	1,8	1,8	2,3	2,2	2,2
Gross foreign debt (% of GDP)	63,0	56,5	54,7	50,7	47,0
FX reserves (EUR bn)	32,2	32,2	34,2	32,7	31,0
Months of imports, goods & services	6,2	5,8	5,7	5,1	4,6
Inflation/Monetary/FX					
CPI (pavg)	1,1	-0,6	-1,5	1,0	2,8
CPI (eop)	0,8	-0,9	-0,5	1,7	2,7
Central bank target	2,50	2,50	2,50	2,50	2,50
Central bank reference rate (eop)	2,75	1,75	1,75	1,75	2,50
3M money market rate (Dec avg)	1,69	1,03	0,83	1,23	2,10
USDRON (eop)	3,69	4,15	4,30	4,16	3,97
EURRON (eop)	4,48	4,52	4,54	4,58	4,60
USDRON (pavg)	3,35	4,01	4,06	4,21	4,01
EURRON (pavg)	4,44	4,44	4,49	4,53	4,55
Real effective exchange rate, 2000=100	126,1	124,2	121,7	118,1	115,3
Change (%)	0,9	-1,5	-2,1	-2,9	-2,4

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2016	2017F	2018F
Gross financing requirement	**14,3**	**13,2**	**16,3**
Budget deficit	4,1	5,4	6,8
Amortization of public debt	10,2	7,8	9,5
Domestic	8,6	6,6	6,6
Bonds	6,3	3,5	3,5
Bills	2,0	2,8	2,8
Loans	0,3	0,3	0,3
External	1,6	1,2	2,9
Bonds and loans	1,5	0,0	1,5
IMF/EU/Other IFIs	0,1	1,2	1,4
Financing	**14,3**	**13,2**	**16,3**
Domestic borrowing	10,7	10,8	10,9
Bonds	7,8	7,9	8,0
Bills	2,8	2,8	2,8
Loans	0,1	0,1	0,1
External borrowing	4,0	3,7	3,7
Bonds	3,2	3,0	3,0
IMF/EU/Other IFIs	0,8	0,7	0,7
Privatization/Other	0,0	0,0	0,0
Fiscal reserve change (- = stock increase)	-0,4	-1,3	1,7

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2016	2017F	2018F
Gross financing requirement	**43,6**	**41,0**	**39,2**
C/A deficit	4,1	5,4	6,0
Amortization of medium and long term debt	26,0	22,9	22,6
Government/central bank	3,6	2,8	4,5
Banks	8,0	7,2	6,5
Corporates/Other	14,4	12,9	11,6
Amortization of short-term debt	13,5	12,7	10,6
Government/central bank	0,0	0,3	0,2
Banks	4,9	3,2	2,8
Corporates/Other	8,6	9,2	7,6
Financing	**43,6**	**41,0**	**39,2**
FDI (net)	3,9	4,0	4,2
Portfolio equity, net	0,1	0,4	0,1
Medium and long-term borrowing	23,0	23,2	21,4
Government/central bank	4,5	4,7	4,7
Banks	5,6	5,7	5,2
Corporates/Other	12,9	12,8	11,5
Short-term borrowing	12,2	10,2	9,9
EU structural and cohesion funds	4,1	1,7	1,9
Other	0,0	0,0	0,0
Change in FX reserves (- = increase)	0,3	1,5	1,7
Memoranda:			
Nonresident purchases of LC govt bonds	1,4	1,2	1,2
International bond issuance, net	1,7	3,0	1,5

Data Source: NIS, NBR, MinFin, UniCredit Research t Research

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