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NEW EUROPE
ECONOMICS & STRATEGY
October 12, 2012
FOCUS NOTES: ROMANIA

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Inflation stages a dynamic come-back

- GDP growth accelerated by 0.5% qoq/1.1% yoy in Q2 bringing the economy out of the technical recession path
- Inflation stages a dynamic come-back on food and energy prices: consumer prices leaped to 5.33% in September up from 3.9% yoy in August, above the 3% NBR year end target, against only 1.8% in last May
- Short-term political risk declined after the presidential impeachment referendum but progress in structural reforms lags behind

Inflation stages a dynamic comeback, climbing further during the summer months. Central Bank kept interest rates unchanged at 5.25% in September

Consumer prices leaped to 1.18%/5.33% mom/yoy in September compared to 0.5%/3.9% mom/yoy in August, from 0.6%/3.0% mom/yoy in July. The reading stood significantly above the consensus poll (0.6% mom). Inflation dynamics are driven by higher food and energy prices. The summer drought had a negative impact on domestic agricultural output. The negative base effects from last year's very good performance augmented the impact on food prices. As a result, food prices, which carry a significant weight (37.5%) in the consumption basket, more than doubled to 6.91% yoy in September up from 3.3% yoy in August against 1.2% yoy in July (Figure 1).

Non food items were also a positive contributor to inflation. Non food prices came at 4.3% yoy in September up from 3.9% yoy in August vs. 3.4% yoy in July. The main driver behind that development was the rise in gas prices (2.8% mom) and the pass through impact from higher market prices internationally in fuels in the past months. Effective Sep1st, gas prices were hiked 5% for consumers and 10% for industries. Lastly, services came down to 4.79% yoy in September compared to 4.9% yoy in August against 5.7% yoy in July. The appreciation in the domestic currency largely offset the rise in the utilities services (water and sewage +2.24% mom/+5.76% yoy) in September.

The latest inflation developments confirmed that the official year-end target CPI (3+/-1%) is out of reach, compared to 3.2% year-end Central Bank forecast in the latest inflation report. In our view, the domestic inflation outlook remains subject to significant risks, stemming mainly from supply side factors. Food prices are set to rise further in line with the global trend while the weaker agricultural output this year will not help either. To make things worse, further increases in the administered gas and energy prices have already been agreed upon with the IMF. In contrast, the adjusted CORE2 inflation came at 2.5% yoy in September, unchanged from August against 2.3% in July. This is evidence of negative output gap mitigating the impact from rising supply side pressures.

Output growth accelerated in the second quarter on improved domestic demand dynamics; Downside risks stemming from volatile weather conditions and the Euroarea recession may prevail in the 2H

Output growth accelerated in the second quarter, bringing the economy out of the technical recession path. Real GDP expanded by 1.1% yoy in Q2-2012, up from 0.3% yoy in Q1-2012 and 1.9% yoy in Q4-2011. On a seasonally adjusted basis, the GDP accelerated to 0.5% qoq in Q2, up from 0.1% qoq in Q1 and -0.1% qoq in Q4 2011. From a demand side point of view, consumption and investments outperformed. Private consumption expanded by +0.9% qoq/+1.4% yoy in Q2 vs. 0% qoq/+0.3% yoy in Q1, helped by historically low inflation which pushed real wages higher and prospective public wages hikes during H2-2012.

In addition, investments advanced by +4.4% qoq/+15.2% yoy in Q2 up from +1.9% qoq/+12.2% yoy in Q1 underpinned by public investments in the construction sector. In contrast net exports were visibly weaker in the second quarter. Imports edged up by +1.2% qoq/+0.2% yoy compared to -0.2% qoq/-0.3% yoy. Exports were lower by -1.2% qoq/+0.7% yoy in Q2 against +0.3% qoq/-2.2% yoy.

Overall, growth performance came at 0.8% in the 1H. Looking ahead, we anticipate a much weaker Q3 as downside risks to growth outlook prevail. A series of unfavorable international and domestic factors will kick in. Firstly, the Euroarea sovereign debt crisis weighs negatively on net exports and industrial production dynamics. Moreover, negative base effects from last year's outstanding agriculture performance will put a drag on growth in Q3. From the available data so far, this year's harvest will not repeat last year's output record.

We had warned in our previous issues of New Europe Economics & Strategy that agriculture would have a negative contribution in the 2H-2012. The summer drought already exacerbated the impact on this year's harvest. Last but not least, the underperformance in EU funds absorption (only 8% vs. an ambitious government target of 19%) has resulted in those funds earmarked for investments in the budget were cut in order to finance the public wages hikes as part of the budget revision in 2012. All in all, we have downgraded our long held growth forecast of 2012 from 1% to 0.7%. The government has cut their forecast from 1.5% to 1.2%. Accordingly, the IMF mission has revised their growth forecasts at 0.9% down from 1.5% previously.

IMF board approved the sixth review of the precautionary agreement. Short-term political risk declined after the presidential impeachment referendum but progress in structural reforms is lagging behind

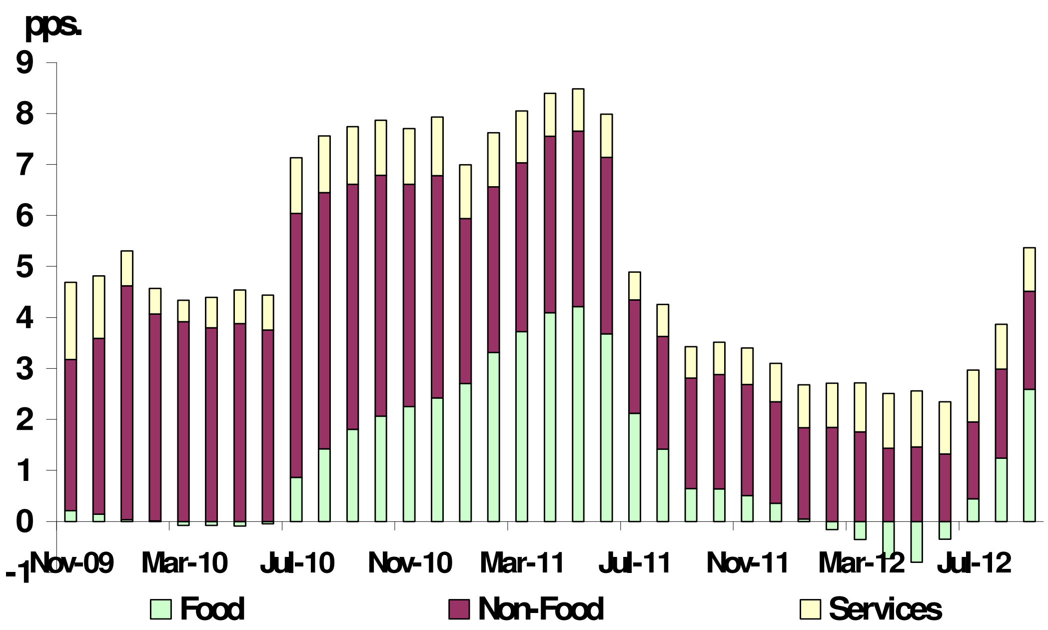
The short term political risk declined after the referendum in late July. President Basescu returned to his post after the result of the impeachment referendum was deemed to be unsuccessful by the Constitutional court. The Constitutional Court ruled that the participation of the electorate was below the constitutional threshold allowed to impeach President Trian Basescu. As a result, President Basescu returned to his post. Nevertheless, this by no means the end of the political rift between the Prime Minister Victor Ponta and President Trian Basescu. Unless survey polls are not confirmed, the ruling coalition will win the elections which means that the rift will continue more intense after the parliamentary elections. All in all, the domestic political landscape is set to remain challenging in the coming months.

Meanwhile, the sixth review of the precautionary agreement was approved by the IMF board on September 28th. The approval enabled the Romanian authorities to have access to a €512.9 mn tranche, or €3.2bn cumulatively since the beginning of the new arrangement. However, the government has indicated that it does not plan to utilize the funds unless needed.

The review assessed that all quantitative criteria were met with the exception of the central and local government arrears for which the government was granted a waiver. More importantly, the appraisal contained a positive assessment of the policies implemented. According to the press release, the government is on track to meet the 3 % of GDP fiscal target in 2012. The review praised the government for its progress in the energy prices liberalization, its fiscal efforts, and the solid condition of the banking system.

On the negative side, the review underlined the lack of progress in structural reforms. The government reform agenda is lagging behind. It is important to speed up the process of privatizations of state-owned enterprises. The privatization of Oltchim (state-owned chemical company), which together with the sale of a 15% stake in Transgaz is a prior action for the approval of the review, has turned out to be a highly political and controversial issue which may push back the program. The privatization program also includes selling of stakes in Romgaz, Tarom, and the railway company CFR Marfa). Additional effort is needed to improve areas such as tax administration, the health care system, and the energy and transportation sectors.

Figure 1: Inflation climbed higher during the summer months on food and energy prices



Source: National Statistics, Eurobank Research

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