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FOCUS NOTES: ROMANIA

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Improving macro fundamentals offer support against EM turmoil & domestic political scene upheaval

- Elevated political stress and growing political uncertainty could undermine government efficiency and push back crucial structural reforms
- The future of the precautionary agreement with IMF is uncertain as the disagreement between the President Basescu and the Prime Minister Ponta intensifies
- Output is expected to decelerate to 2.5% in 2014 on negative base effects from agriculture and car manufacturing
- In a widely anticipated move, NBR cut interest rates by 25bps to 3.5% signaling the end of the easing cycle on February 4th
- Fiscal and external accounts consolidation continued in 2013

Deadlock in the negotiations over cabinet reshuffle threatens the unity of the ruling government coalition. The resurgence of political stress could hurt government efficiency and push back crucial structural reforms

Politics have taken the stage once again in Romania. Tensions between the two biggest parties in the USL-the PSD and the PNL have escalated into a political crisis. The political crisis erupted after the junior coalition party National Liberal Party (PNL) decided to reshuffle the four PNL nominated ministers in an attempt to re-establish itself in the government coalition and put itself in the forefront of publicity ahead of the heavy election calendar. Following the conclusion of the visit of IMF mission, the Finance Minister and Deputy Prime Minister Mr. Daniel Chitoiu (from PNL), resigned on February 6th in order to support the party's campaign. The PNL national bureau decided on February 7th to endorse four new nominees for ministerial positions – Mr. Klaus Iohannis as Interior minister and deputy Prime Minister, Mr. Eugen Nicolaescu as Finance minister, Mr. Teodor Atanasiu as Economy minister and Mr. Cristian Busoi as Health minister (the latter replacing Mr. Nicolaescu).

Political noise grew even louder as the Prime Minister Mr. Ponta from the Social Democratic Party (PSD), the senior partner of the ruling coalition, refused to endorse the request for the appointment of Mr. Klaus Iohannis as an interior minister and vice-PM. According to the PSD leader, the change of government structure requires approval by a motion of confidence in the parliament that would trigger a new round of political instability. The counter-proposal on behalf of PSD for a mass-scale government restructuring to include more ministries was rejected by PNL leader Mr. Antonescu. According to the pre-election agreement, Mr. Antonescu was expected to be the Presidential candidate of USL, the multi-party coalition which collected 67% of the vote in the last parliamentary election in late 2012.

If the two major party leaders fail to reach an agreement over the structure of the new cabinet, then PNL will withdraw from the USL. The PSD has accomplished to form a new multi-party coalition–the Social Democratic Union (USD) within the USL, which comprises of PSD, PC and UNPR. At this point, USD controls 47% of the seats in the current parliament. However, PSD and its allies will need to have the support of at least one more minor opposition party (UDMR or PP-DD) in order not to lose the majority in the parliament.

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The cabinet reshuffle was not expected to have a major impact on key economic policies. However, if PNL leaves the government and early parliamentary elections are not called right away it will result in a new weaker government cabinet that will enjoy much less support in the parliament. In any case, elevated political stress and growing political uncertainty could undermine government efficiency particularly in the lower levels of administration and push back crucial structural reforms.

To make things worse, there is high risk that the agenda will shift to more populist policies that will be market negative and subsequently hurt RON and Romanian assets further. Flows will not be RON supportive in 2014 on parent groups deleveraging and Fed's tapering. The political stage upheaval and the heavy elections calendar (Presidential elections in November, Euro-parliament elections in May) may weigh further negatively. In contrast, improving fundamentals and shrinking imbalances and the probability of direct interventions of NBR on the FX is expected to keep a lid on depreciation pressures. FX is anticipated to reach or even exceed the level of 4.55 RON/€ by the end of 2014 (so that the average FX rate will stand around 4.50 RON/€) as international markets remain apprehensive about emerging market currencies. On February 21st, RON/€ stood at 4.5173 on a slightly depreciating trend (by almost 1% year to date).

The probability of a break up in the precautionary agreement with IMF has risen

The relations with IMF have also had a setback since last December. The conflict between the President Basescu and the Prime Minister Ponta has cast doubts on the sustainability of the agreement. The conflict has its roots in the implementation of a fuel tax hike in the budget law of 2014. The fuel tax hike was designed to raise revenues to finance the buildup of motorways infrastructure and increase capital spending. The fuel excise tax of €0.07 per lt. was not approved by the President and the budget law of 2014 was endorsed upon the condition that the implementation would be delayed until March.

The side-effect of this conflict was that the President refused to sign the letter of intent on behalf of the Romanian side for the smooth continuation of the process. The disagreement between the President Basescu and the Prime Minister led to a postponement of the first review. As a result, the first review of the new precautionary agreement was put on hold together with the second review. The combined first and the second review of the new precautionary IMF-EU agreement were completed on a staff level on February 4th. The mission assessed that most end-December performance criteria were met and structural benchmarks have either been met or are nearing completion.

All in, the status of the precautionary agreement remains unclear. The probability of a collapse in the agreement has gone up. The future of the agreement and its implementation is at stake. Romania doesn't need the financing, though the agreement helps as a discipline device for growth enhancing structural reforms and anchoring investors' expectations.

In the past year, the precautionary agreement has helped the current government coalition push for the structural reforms agenda in a number of areas. Privatizations received a boost with the initial public offering (IPO) of 15% stake in "Romgaz", the state-owned gas supplier, on the Bucharest Stock Exchange and the London Stock Exchange, the IPO of a 10% stake in Nuclearelectrica and a secondary public offering (SPO) of a 15% stake in Trangaz. Last but not least, Romania made significant improvement in the EU funds absorption during 2013. The EU funds absorption rate increased significantly to 33.47% in 2013 vs. 14.92% in 2012.

Last quarter extraordinary output performance pushed full year growth up to 3.5% in 2013. The stellar output performance of last year would be hard to repeat in 2014.

Real GDP registered an extraordinary performance in the last quarter of 2013. According to the flash estimate, real GDP growth came at +1.7% qoq /+5.2% yoy in Q4-2013 up from +1.1% qoq /+1.1% yoy in Q4-2012 and +1.6% qoq/+4.1% yoy in Q3-2013. The reading surpassed consensus expectations significantly (+0.4% qoq/+1% yoy) and was the highest in EU-28 (it remained above that of Euroarea for a tenth quarter in a row). Since detailed data are still not available, the massive acceleration above consensus expectations has given rise to speculation that other sectors than agriculture and industry may have been driving growth in the last quarter.

The extraordinary performance of the last quarter pushed the full year output performance to 3.5% compared to 0.7% in 2012. Economic activity came out much stronger than expected. Provided that there are no significant changes in the structure of GDP growth in the last quarter of 2013, growth was entirely net exports driven from the demand side and agriculture and industry on the supply side. Industry (+5.1% yoy in 9M-2013) and agriculture (+17.9% yoy in 9M-2013) had the highest positive contribution to GDP dynamics (1.4pps and 1.0pps respectively in 9M-2013). Real GDP excluding agriculture is expected to have expanded by approximately 2% yoy in 2013.

From the demand side point of view, growth was entirely net exports driven (+5.1pps in 9M-2013). External demand was the main driver of growth offsetting the decline in total consumption (-0.2pps in 9M-2013) and gross fixed capital formation (-1.1pps in 9M-2013). The surge in exports (+21.7% yoy in 9M-2013 in real terms) translated into a visible boost in industrial activity, although retail sales (+0.4% yoy in volume terms in 2013) and construction (-0.3% yoy in volume terms in Jan-Nov 2013 or -1.7% yoy in seasonally and working days adjusted terms in the same period) remain depressed and in recessionary territory

respectively. The improvement in industrial activity (up by 7.8% yoy in 2013 after increasing by 10.6% yoy and 10.2% yoy respectively in October 2013 and December 2013 only) was underpinned by the car manufacturing industry.

Looking ahead, we anticipate growth to decelerate to 2.5% in 2014. In our view, growth was disproportionally influenced by agriculture and industry in 2013. The latter is reflected in the non-agricultural performance which is expected to pick up in 2014. In turn, the bumpy performance of agriculture would be hard to repeat in 2014. More importantly, domestic demand is expected to pick up in order to support growth in a more meaningful way. Higher real incomes stemming from historically low inflation rates and the increase in the minimum wage will provide more support to private consumption at least in the 1H. In addition, improved EU funds absorption and public investments could provide some support to gross fixed capital formation. On the other hand, industrial activity is expected to have a smaller but still positive contribution in next year's output performance.

From that point of view, monetary policy is expected to be supportive. The NBR delivered a cumulative 125bps cut in the main policy rate (from 5.25% to 4.00% in the 2H-2013) and further by 50bps to 3.5% in the first two months of 2014. In a widely anticipated move, NBR cut interest rates by 25bps to 3.5% signaling the end of the easing cycle on February 4th. The reference rate is expected to remain unchanged at 3.5% by the end of 2014. The room for rate cuts is limited but the need to support economic activity and stimulate lending will shift NBR focus to MMR. The MMR differential remains well above that of EU. The MMR on RON denominated liabilities have already been reduced to 12% from 15% and the FX denominated liabilities to 18% from 21% previously. The amount released in the market stood at RON 4bn and €0.5bn, helping boost the liquidity. We anticipate MMR on RON liabilities to decline by at least another 2pps by the end of 2014.

The balance of risks is skewed to the downside. Notwithstanding the domestic political noise, the external environment is not supportive. The FED's tapering program has made financing conditions in emerging markets more difficult while the ongoing deleveraging of the banking sector doesn't allow for a recovery in credit activity. On the downside, credit activity keeps shrinking (-3.3% yoy in nominal terms in 2013) putting a break on consumer spending. On the positive side, asset quality deteriorated at a slower pace. Non-performing loans (NPLs) rose to 21.6% in Q3-2013 vs. 20.3% of total loans in Q2-2013 compared to 14.3% at end-2011, reflecting slow credit growth, the deteriorating quality of loans and the challenging domestic demand conditions.

Fiscal and external accounts consolidation continued in 2013

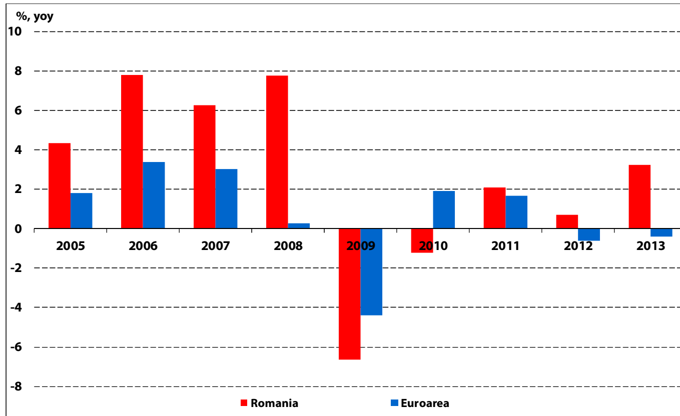
The improving macro fundamentals suggest that Romania to be one of the Emerging Europe economies very well positioned to withstand the ongoing global financial markets turbulence following the beginning of the tapering of quantitative easing measures by FED. Since the 2008 global financial crisis, Romania has made significant progress in reducing macroeconomic imbalances and rebuilding fiscal and financial buffers. Over the past three years, the domestic economic environment has stabilized even though growth has been fairly modest; core inflation has moderated while the internal and external imbalances have been greatly reduced. However, progress in structural reforms is incomplete. The implementation of structural reforms in the broad government sector could work as a catalyst for releasing the growth potential in the medium-term. According to IMF, the medium term growth (next 3-5 years) could reach 3.5-5% if the government accelerates the structural reforms implementation.

Still, Romania remains relatively vulnerable to external shocks from uncertainties in the euro area as well as global volatility in capital flows to emerging markets. Romania is currently rated at Baa3/BB+/BBB- by Moody's/S&P/Fitch. S&P improved the rating outlook from stable to positive in late November 2013, estimating there was at least a one-in-three chance to upgrade the country's sovereign rating in the second half of 2014 if there was progress in public finances and public companies restructuring.

Romania has made an extensive and impressive fiscal adjustment effort in the past three years that have put public finances on a sustainable path under the steering of IMF-EU. The fiscal and external accounts consolidation continued in 2013. The consolidated government deficit in cash terms ended at 2.5% of GDP in 2013, unchanged compared to 2012 and in line with the revised target agreed with international lenders. The target for 2014 has been set at 2.2% of GDP. The fiscal deficit in accrual terms-ESA 95 terms- has further declined to 2.6% in 2013 down from 3.0% of GDP in 2012 vs. 5.6% in 2011. As a result, Romania exited the Excessive Deficit Procedure in 2013. The public debt (in ESA95 terms) stood at 38.7% of GDP in 2013 vs. 37.9% in 2012 and 34.7% in 2011.

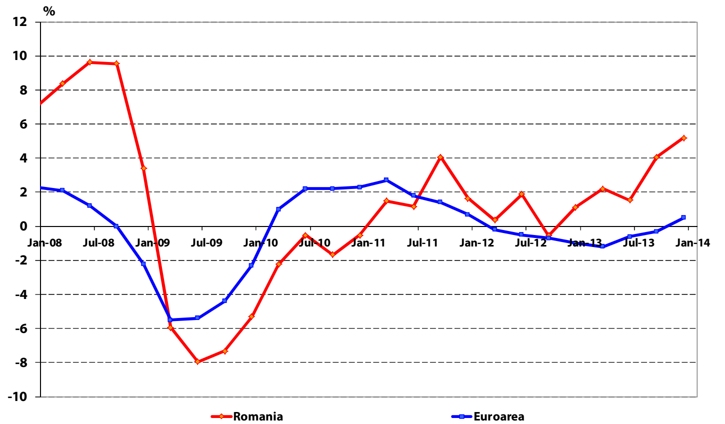
On the external side, the current account posted a significantly lower deficit in 2013 (€1.05bn-1.05% of projected GDP) down from €5.8 bn-4.4% of GDP deficit a year ago. More importantly, the FDI inflows have recovered in 2013 vs. the level recorded in 2010. The FDI inflows climbed to €2.7bn in 2013 up by 26.8% against €2.1bn in 2012. As a result, the FDI coverage of the current account deficit increased to 180% in 2013 vs. only 37% in 2012.

Figure 1: Annual GDP growth rates: Romania & Euro area



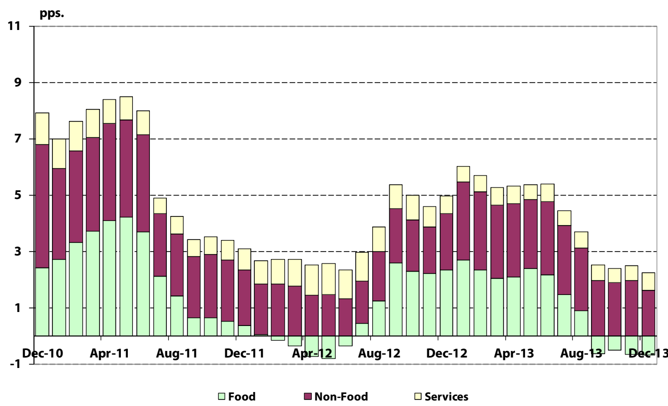
Source: National Statistics, Eurostat

Figure 2: Quarterly GDP growth rates: Romania & Euro area



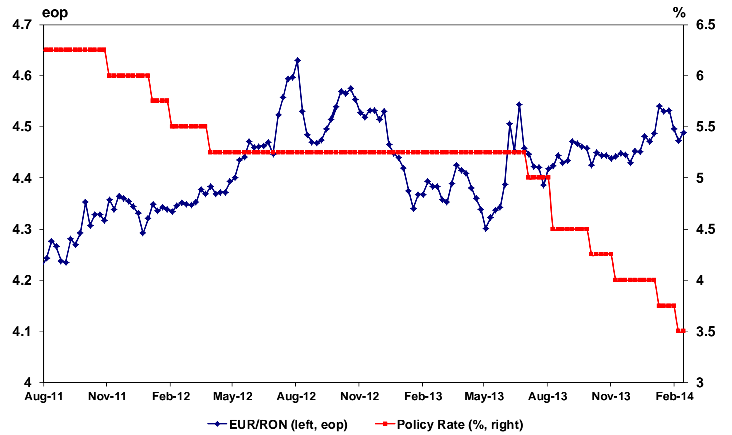
Source: National Statistics, Eurostat

Figure 3: Inflation components in Romania



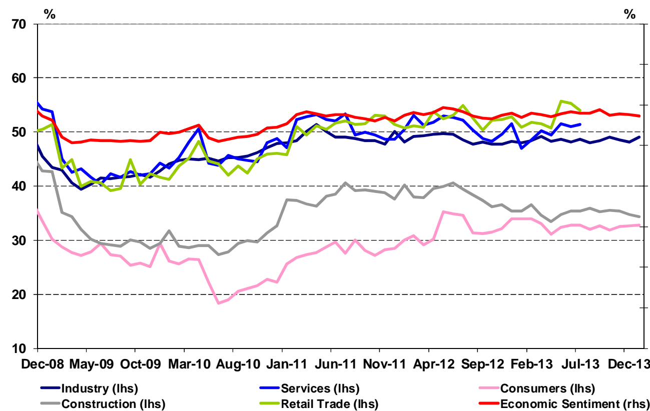
Source: Eurostat, Eurobank Research

Figure 4: FX & Policy rate



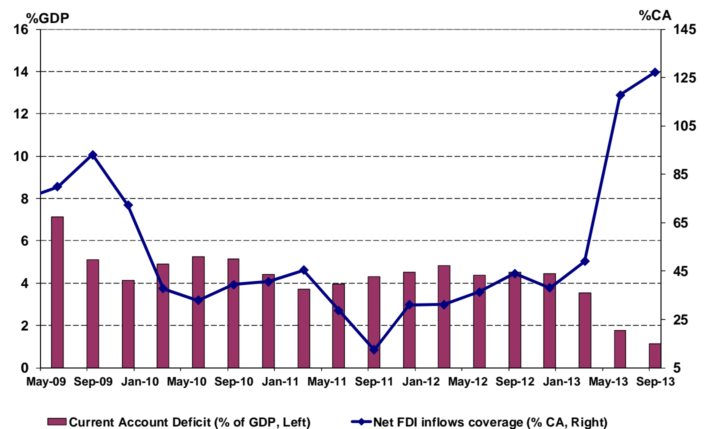
Source: Central Bank,Bloomberg, Eurobank Research

Figure 5: DG Ecofin Survey Indicators



Source: Eurostat, Eurobank Research

Figure 6: Current Account Deficit in Romania



Source: Central Bank, Eurobank Research

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