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Romania: A new precautionary IMF agreement on the cards

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- The government will seek a new precautionary IMF agreement upon the successful completion of the last two reviews of the expired agreement
- Monetary easing resumed after 16 months: NBR cut interest rates by 25bps to 5% for the first time since March 2012
- GDP expanded by 0.5% qoq/+2.1% yoy in the first quarter, beating market expectations

IMF concluded the last two reviews of the precautionary agreement. The government has announced that it will seek a new one in July

On June 26th, IMF completed the last two reviews of the precautionary agreement with Romania. The IMF board deemed that Romania had successfully completed the second SBA. Based on the corrective action taken by the government, the board approved three waivers for the nonobservance of the performance criteria on net foreign assets of the NBR, the general government balance, and the central government arrears.

The initial expiration deadline of the precautionary agreement was in late March. The Romanian government had asked for an extension of three months until late June to complete the required structural reforms in the energy sector and take corrective action in a number of missed quantitative targets. Indeed, progress was made in the area of arrears. Although not entirely eliminated, the amount of central government and local government arrears declined to RON 19mn against a target of RON 20mn and to RON 150 mn against a target of RON 300mn respectively.

In addition, the privatization program of the government made some progress. The completion of critical privatization projects in the energy and transportation sectors were among the prior actions for the IMF approval. The government sold a 15% stake in the Transgaz through a secondary offering in mid April. In June, the candidate for the sale of a 51% stake in the rail freight carrier, CFR Marfa, was also selected. The privatization program for the rest of 2013 includes the sale of stakes in other companies such as the nuclear power company, Nuclearelectrica, the hydro power company, Hidroelectrica, the energy company CE Oltenia and the postal services Posta Romana.

The government has expressed its intention to negotiate a new agreement in July. Preliminary discussions have already started on July 17th immediately after the visit of the managing IMF Director Mrs. Lagarde in Bucharest. The Prime Minister, Mr. Victor Ponta has mentioned in a Bloomberg interview that the new precautionary agreement may be reached in autumn and that it may not be as detailed as the previous one.

In retrospect, the precautionary SBA has served Romania very well. From a structural standpoint, the Romanian economy is in a stronger position now than in the pre-crisis period to withstand external shocks. Over the past two years, the domestic economic environment has stabilized even though growth has been modest (Figure 1); core inflation has moderated while the internal and external imbalances have been greatly reduced (Figure 3, 6). As a result, direct financial support from IMF is no longer needed. However, progress in structural reforms is incomplete. The new agreement could serve as an anchor of investors' expectations and as a cushion for future external financing needs in case of a downturn. 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.

Monetary easing resumed for the first time since late March 2012. Focus turns towards the amplitude and duration of the easing cycle

On July 1st, the NBR cut interest rates by 25bps across the board. Thus, the main policy rate came down to 5%, the lending facility rate (Lombard) reached 8% and the deposit facility rate 2%. At the same time, the minimum reserves requirements were kept unchanged (at 15% on RON liabilities and 20% on FX liabilities for maturities below 2 years).

Although, it was the first rate cut since 29 March 2012, the move was broadly expected by the market. The decision matched the predictions of 11 out of 16 economists in a Bloomberg survey. The communication in the previous meeting on May 2nd had already predisposed for a rate cut in the next meeting. However, ever since there were voices of concern raised because of the recent bout of uncertainty in the financial markets. The domestic currency was also a victim of this uncertainty as the RON appreciation trajectory was interrupted. The negative sentiment in the market originated from expectations about FED may be tapering the stimulus program. If that happened, it would have profound negative implications on portfolio inflows in the emerging markets.

According to the Central Bank briefing rationale, the primary reason for lowering rates was the improvement of inflation outlook in the 2H. The Central Bank is convinced that inflation will now fall back inside the target band in Q3 (1.5%-3.5%). Inflation came at 5.3% in May unchanged compared to April little down from 5.6% in Q1 (Figure 3). However, despite upside risks stemming from energy prices adjustment, inflation is expected to decelerate in the 2H on favorable base effects from last year's food prices rally and the prospect of a good harvest in the forthcoming period.

Moreover, growth remained below potential while domestic demand remained extremely weak in Q1. To make things worse, credit conditions remained extremely tight. An illustration of the low demand pressures was the decline of the core inflation. The annual adjusted CORE2 inflation rate stayed on a downward path, falling to 2.7% in May compared to 3.2% percent in December 2012.

That turns our attention towards the amplitude and duration of the easing cycle. Looking ahead, the Governor Mr. Mugur Isarescu, has hinted that further monetary easing is to come. According to him, the outlook for consumer prices allows for "gradual" monetary policy easing. The latter may translate into further easing of 50-75bps from this point on until the end of the year. As a result, rates are expected to reach 4.25%-4.5% by the end of December provided there are no unexpected negative shocks from changes both in the domestic environment (from the agricultural sector) and or external (market volatility from Fed tapering) We anticipate NBR to be cautious in further rate cuts in a global environment where the easing cycle of most central banks has already reached an end. From that point of view, NBR has been lagging behind in monetary easing compared to its peers. The NBR has made extensive use of liquidity management tools instead of using rates in the past period.

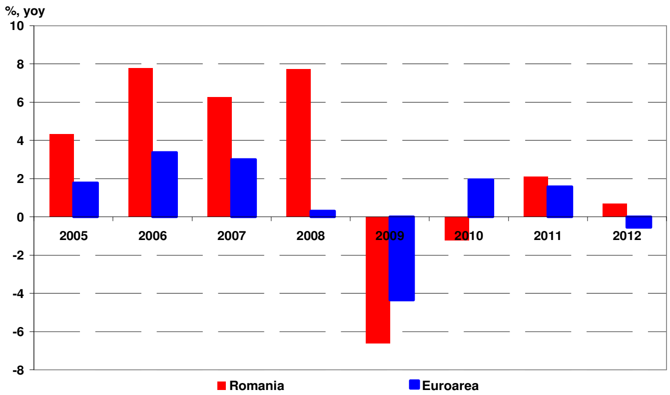
First quarter GDP reading started on good foot. Growth was supported entirely by net exports while domestic demand dynamics remain recessionary.

GDP growth in the first quarter came out stronger than expected. Real GDP growth came at +0.7% qoq /+2.2% yoy in Q1-2013 up from +0.4% qoq /+1.1% yoy in Q4-2012 and -0.1% qoq/+0.4% yoy in Q1-2012. The reading surpassed consensus expectations (+0.4% qoq/+1% yoy) and was above that of Euroarea for a seventh quarter in a row (Figure 2).

From a demand side point of view, growth was entirely backed by net exports. Exports expanded by an astonishing 9.1% yoy in Q1 while imports declined by -0.1% yoy. Thus, net exports contributed 4.4pps in Q1 growth, revised from 3pps in the flash estimate. The impressive performance is to a large extent explained by the rise in automobiles exports. From a geographical point of view, the growth of exports to non-EU countries outpaced that of EU countries (+10.9% yoy vs. +2.2% yoy).On the negative side, domestic demand is still in recession. Total final consumption was disappointing for another quarter. Total final consumption contracted by -0.6% qoq/-0.3% yoy, having a minor negative contribution of -0.2pps in Q1. The contraction in private consumption broadly reflects the dip of consumer sentiment, which is rooted in the rise of energy prices and the stagnant real wage growth which undermined purchasing consumer power in Q1 (Figure 5). In addition, relatively high unemployment (7.1% according to Eurostat in Q1) and continued bank deleveraging weighed negatively on consumption. Gross fixed capital formation remained in red, an illustration of lower capital investments outlays from the national and EU co-financing budgets as a result of the low EU funds absorption rate. Gross fixed capital formation contracted by -0.2% qoq/-0.7% yoy in Q1, thus subtracting 1pps from growth.

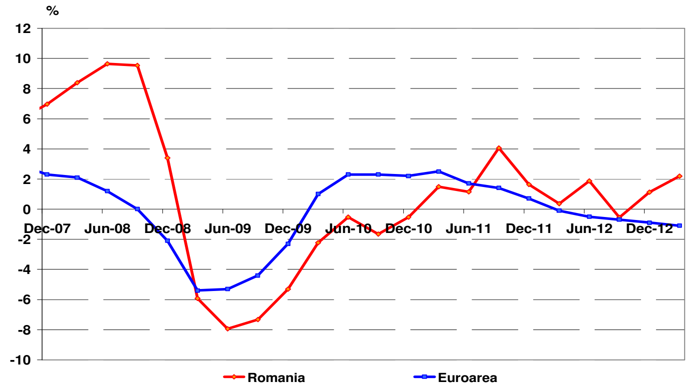
Overall, growth started on a good in the first quarter. The reading is supportive of our full year forecast in 2013. GDP growth is expected to average 2% in 2013 on a bumpier agricultural season and support from exports particularly in the automotives industry. On the negative side, the domestic demand performance is disappointing. Yet, the divergence between net exports and domestic demand performance ought to diminish. It is questionable whether net exports can sustain their dynamism given the negative influence from the Euroarea recession and the source of expansion. On the other hand, domestic demand is expected to have a more positive contribution in the 2H as inflation recedes, the impact of the new agricultural season kicks in and the EU funds absorption rate gradually goes up.

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



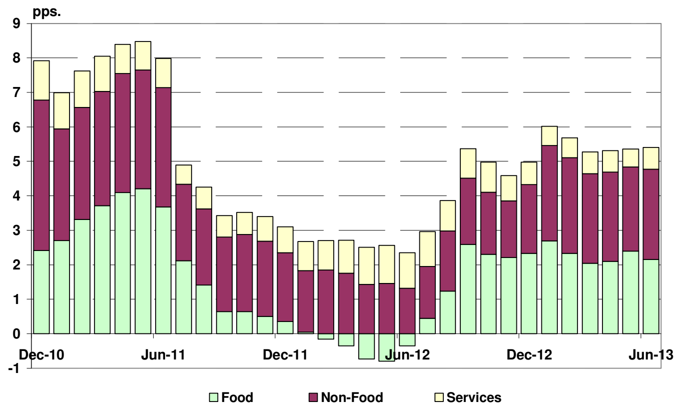
Source: National Statistics, Eurostat

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



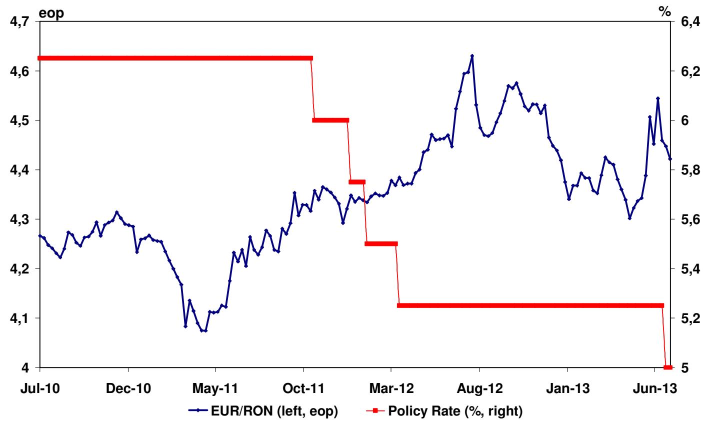
Source: National Statistics, Eurostat

Figure 3: Inflation components in Romania



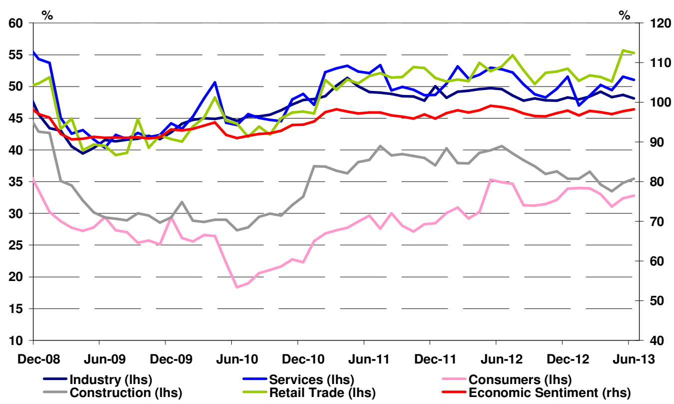
Source: Eurostat, Eurobank Research

Figure 4: FX & Policy rate



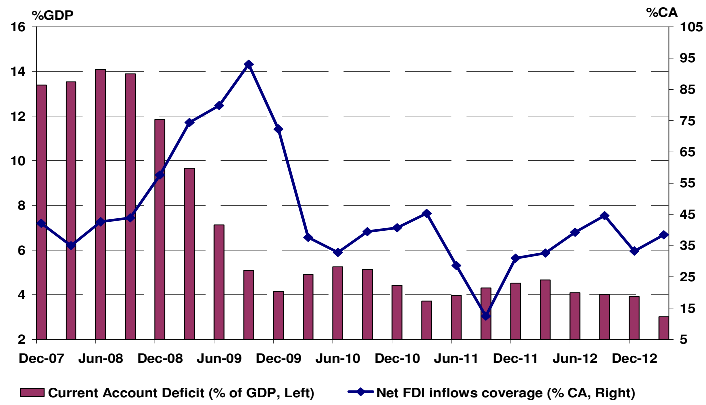
Source: Central Bank,Bloomberg, Eurobank Research

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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