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Romania: Economy has made a solid start in 2014

- **The strong data releases on retail sales and industrial production in the first two months point to a strong jump in output growth in the first quarter of 2014**
- **The precautionary IMF-EU agreement is back on track after the successful completion of the first and the second programme review**
- **NBR left interest rates and the minimum reserve requirements unchanged on March 28th**

The completion of the combined first and second review by the IMF-EU puts the program back on track despite the animosities between President Basescu and Prime Minister Ponta

On March 26th, the IMF executive board approved both the first and the second review of the precautionary agreement with Romania. The conflict between the President Basescu and the Prime Minister Ponta- over the implementation of a fuel tax hike as an integral part of the review-had initially put the agreement at risk. The implementation of the fuel excise tax of €0.07 per lt. was not approved by the President so that the budget law of 2014 was endorsed upon the condition that hike 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, so that the first review was postponed and put on hold together with the second review.

On March 5th, President Basescu ratified the letter of intent which contained no explicit reference to the implementation of the fuel excise tax. However, the President argued in a press conference that the government fiscal policies are inappropriate and need to be adjusted immediately, adding that he had addressed a letter to the Parliament whereby he called on MPs to reject the law which envisages the fuel tax hike.

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 2013 performance criteria and structural benchmarks were met. With the exception of the target for the general government overall balance that was missed by a small margin, the rest of the quantitative performance criteria were met. In addition, with the exception of the target for the central government an owned enterprises arrears that was missed by a wide margin, the other four indicative targets were met.

On the structural reforms agenda, the government made progress in a number of areas including privatizations, the roadmap of the energy prices liberalization, the modernization of the health care system, the improvement in EU funds absorption and management. 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.

All in, the IMF board approval puts the program back on track despite the animosities

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between the President and the Prime Minister. Effectively, Romania doesn't need the financing, though the agreement helps as a discipline device for growth enhancing structural reforms and anchoring investors' expectations. The next – extraordinary-review has been scheduled for next June.

The GDP growth rate of the last quarter of 2013 has been revised upwards while the change in decomposition revealed stronger domestic demand dynamics.

The GDP growth rate of Q4-2013 was revised upwards to +1.6% qoq/+5.4% yoy in up from +1.7% qoq /+5.2% yoy. In any case, the extraordinary performance of the last quarter pushed the full year output performance to 3.5%, much stronger than expected, compared to only 0.7% in 2012. The large revisions of aggregate demand components revealed much stronger domestic demand dynamics in Q4 and subsequently to full year 2013. Real GDP (excluding agriculture) expanded by 2.4 % yoy in 2013.

Growth was entirely net exports driven from the demand side and agriculture and industry on the supply side. Industry (+8.1% yoy) and agriculture (+23.4% yoy) had the highest positive contribution to GDP dynamics (+2.3pps and +1.1pps respectively). From the demand side point of view, growth was entirely net exports driven (+4.4pps against +4.1pps in the initial announcement). External demand was the main driver of growth offsetting the decline in gross fixed capital formation (-0.9pps against -1.5pps in the original announcement) and the weak performance of total consumption (+0.6pps against +0.3pps in the initial announcement).

The surge in exports (+12.8% yoy in real terms) translated into a visible boost in industrial activity, although total consumption remained depressed and gross fixed capital formation 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.

Leading and high frequency indicators point to a strong start in the first quarter of 2014. We have upgraded our baseline scenario forecast for 2014

The economy started the year on good foot. The latest leading and high frequency data support our view of an ongoing recovery in economic activity, excluding agriculture in the first quarter of 2014.

- Industrial production advanced by +9.4% yoy (+10% yoy on seasonally adjusted terms) in Jan-Feb 2014. Manufacturing is still the key driver of industrial production dynamics advancing by 10.7% yoy (+11.1% yoy in seasonally adjusted terms).
- Export oriented industries were among the best performers in manufacturing. Electrical equipment (+16.0 yoy), paper products (+35.6% yoy), computers and electronic products (+20.2% yoy) and other transport equipment (+29% yoy) were among the best performers. The strong annual dynamics were driven by capital and durable goods (+13.1% yoy) and consumer durables (+15% yoy).
- Industrial production would have been even higher if it had not been for the poor performance of the energy (+3.8% yoy in both nominal and seasonally adjusted terms) and mining sectors (-3.5% yoy and -2.6% yoy in seasonally adjusted terms)
- Driven by thriving non-food items (+11.4% yoy), retail sales in volume terms (excluding motor vehicles) were also strong, expanding by 7.0% yoy in Jan-Feb 2014.
- The Retail Trade Confidence Indicator got even stronger in March which predisposes for an equally strong retail sales performance (climbing to 8.1 in March 2014 vs. -0.1 in December 2013).
- The rise in real wages (+3.7% yoy in 2M-2014) bodes well with the improvement in consumption dynamics. The economic sentiment is also on an improving trend.
- The Economic Sentiment Indicator (ESI) stood at 97.6 in March, close to a 2 year high 98.7 recorded in May 2012
- Even though the result may have been overstated by bad weather conditions in January, exports advanced by 12% yoy in February up from 6.3% yoy in January
- Data from new orders and capacity utilization support the view of an accelerating growth rate in 1H-2014. Industrial sales and new orders showed a healthy progress in 2M-2014, posting a rise of 11.5% yoy and 20.4% yoy respectively

Looking ahead, we anticipate growth to decelerate in 2014. In our view, growth was disproportionally influenced by agriculture and industry in 2013. In turn, the bumpy performance of agriculture would be very hard to repeat in 2014. Industrial activity is expected to have a smaller but nevertheless positive contribution in the output performance of this year as the main trade partner of Romania-Euroarea-recovers from recession. As a result, net exports will still be an important source of growth in 2014 as well.

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 support to gross fixed capital formation.

In the previous month analysis, we penciled in a 2.5% GDP forecast in 2014. Our forecast stands above those of AMECO (2.3% -winter 2014) and the recent IMF assessment report (2.2%-March 2014), while the consensus is gradually becoming more optimistic for the prospects in 2014-2015.

While the data of the first couple of months is certainly not illustrative or enough to make a sound judgment for the full year picture, the dynamics are still enough to put our full year forecast under review in order to upgrade it to 2.8%. If there are not any unpleasant surprises stemming from the external environment or negative news in the 2H from agriculture, the evolution of key economic metrics may prove our forecast to be conservative.

Romania: Eurobank Research Forecasts

	2011	2012	2013	2014f
Real GDP (yoy%)	2.2	0.7	3.5	2.8
Consumption	0.9	1.2	0.3	2.1
Investment	7.3	4.9	-5.7	4.0
Exports	10.3	-3.0	12.8	5.8
Imports	10.0	-0.9	2.3	4.0
Inflation (yoy%)				
CPI (annual average)	5.8	3.4	4.0	2.5
CPI (end of period)	3.1	5.0	1.6	3.5
Fiscal Accounts (%GDP, Cash Basis)				
General Government Balance	-4.3	-2.5	-2.5	-2.2
Gross Public Debt (including guarantees)	34.3	38.2	39.3	39.7
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	7.4	7.0	7.3	7.2
Wage Growth (total economy)	4.9	5.0	5.0	4.5
External Accounts				
Current Account (%GDP)	-4.5	-4.4	-1.1	-1.5
Net FDI (EUR bn)	1.8	2.2	2.6	3.0
FDI / Current Account (%)	31.0	38.1	173.6	150.0
FX Reserves (EUR bn)	37.3	35.4	35.4	31.6
Domestic Credit (*end of period*)	**2010**	**2011**	**2012**	**2013**
Total Credit (%GDP)	51.8	50.8	51.9	47.3
Credit to Enterprises (%GDP)	20.0	19.9	20.2	17.8
Credit to Households (%GDP)	19.5	18.0	17.8	16.4
FX Credit/Total Credit (%, private)	63.0	63.4	62.5	60.9
Private Sector Credit (yoy)	4.7	6.6	1.3	-3.3
Loans to Deposits (%)	137.7	142.5	133.9	118.4
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	3.50	3.50	3.50	3.50
EUR/RON	4.47	4.50	4.55	4.60

Source: National Sources, Eurostat, IMF, Eurobank Research & Forecasting

The political crisis is over for the time being but political noise could reemerge later in the year

The political crisis ended with the departure of PNL from the cabinet and the collapse of the USL coalition government. In our previous New Europe Economics Strategy Focus Note we made an extensive analysis on the political situation in Romania. The political crisis had emerged when the two major party leaders failed to reach an agreement over the reshuffling of the cabinet after the resignation of PNL nominated ministers. As a result, PNL withdrew from the USL coalition.

During the previous period, the PSD accomplished to weaken PNL within the parliament majority. PSD formed 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 received the support of at least one more minor opposition party (UDMR) thus enabling them to receive a vote of confidence and maintain the absolute majority in the parliament.

Summing up, the political crisis may have ended for the time being but political risks are still relatively high. The election calendar is heavy and full of opportunities for political noise in 2014. Euro-parliament elections are scheduled in late May and Presidential elections in late November. To make things worse, the working relationship between the outgoing President Basescu and Prime Minister Ponta gives rise to speculation that the end of the term of far from good. The increasing political risks in Romania have also been highlighted in the latest review of the IMF-EU program published in last March. The review highlights the risks stemming from the electoral process this year could lead to decisions to reduce taxes, increase expenditures, and loosen the fiscal targets.

In line with consensus expectations, NBR left monetary policy unchanged on March 28th

On March 28th, NBR left all monetary policy instruments unchanged. The key policy rate unchanged at 3.5% and the minimum reserves requirements (MMR) were kept unchanged (at 12% on RON liabilities and 15% on FX liabilities for maturities below 2 years). The decision was in line with market consensus. The decision matched the forecasts of 16 economists in a Bloomberg survey.

NBR had already spelled out the end of the monetary easing cycle in the previous meeting in February with a 25bps rate cut to 3.5%. At that time, the NBR governor Mr. Isarescu had stated in the briefing that the level of the policy rate was “well positioned”. 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.

The deterioration in the inflation outlook in the 2H-2014, the risk of depreciation pressures on the local currency from the emerging markets turmoil weighed negatively on Central Bank’s decision making for further rate cuts. Inflation has retreated to historic lows in the 1H-2014. Inflation came at 1.1% yoy in

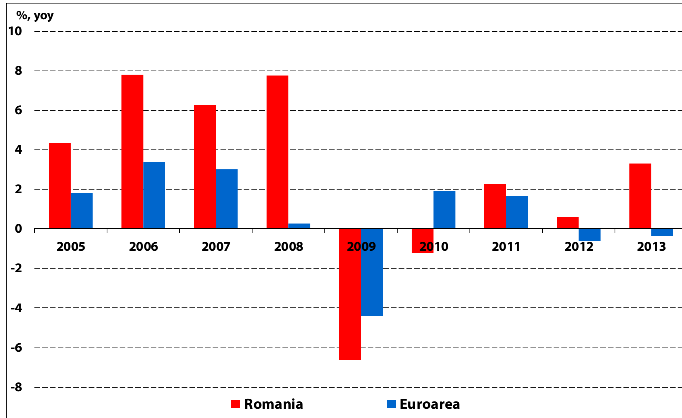
February 2014 vs. 5.6% yoy in February 2013 (significantly below the 2.5% +/-1% year-end target. This may have been the lowest reading in 2014.

The implementation of a tax excise hike in oil since April, the rise in gas prices and the phasing out of favorable base effects from last's year food prices decline is going to push inflation higher. Inflation is now expected to end at 3.5% yoy in 2014 so that the average inflation will most probably amount to 2.5% yoy down from 4% yoy in 2013. As a result, the NBR is anticipated to refrain from further action until at least the end of 2014, leaving the reference rate unchanged at 3.5%

The room for rate cuts is limited but the need to support economic activity and stimulate lending has shifted NBR focus to MMR. Lending dynamics have been persistently weak in the aftermath of the international crisis in 2009-2010. The cross-border deleveraging and the withdrawal of funds from Romania have led total credit expansion in deep red. The accommodating monetary policy plus the government sponsored loan programs has accomplished partially to shift lending away from FX to lending in domestic currency. However, the MMR differential remains well above that of EU, which leaves enough room for further cuts. The MMR on RON denominated liabilities have been reduced to 12% from 15% and the FX denominated liabilities to 18% from 21% previously.

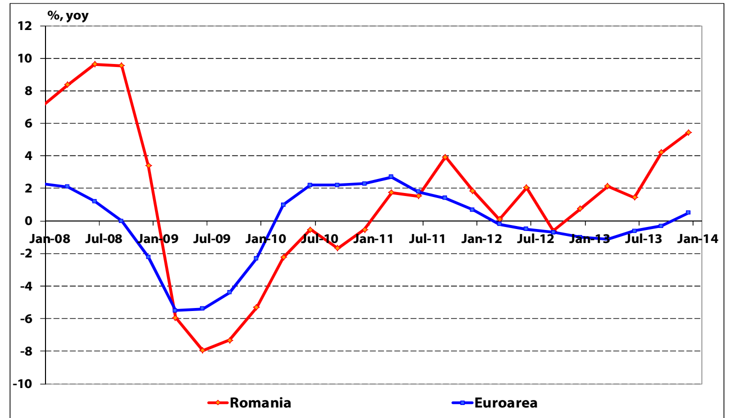
The improvement in the liquidity surplus of the banking system has resulted in money market rates (across all tenures) slipping below the reference rate in March. The 1M-3M money market rate stood at 2.5%-3% respectively on April 2nd. Allowing a larger band of fluctuation of money market rates with the reference rate hampers the monetary policy transmission policy mechanism. The latest IMF review made a specific recommendation to increase the effectiveness monetary policy framework. From that point of view, the decision not to change the MMRs could most probably be only a postponement until the liquidity surplus declines or the Central Bank starts to sterilize it. Yet, the NBR has reiterated once more its intention to reduce MMR differential with EU. Thus, we anticipate MMR on RON liabilities to decline by at least another 2pps by the end of 2014.

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



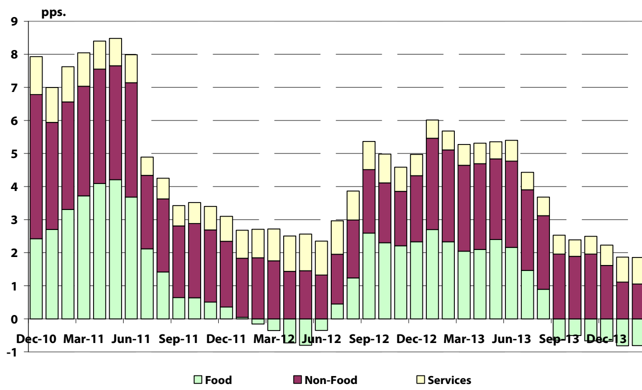
Source: National Statistics, Eurostat

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



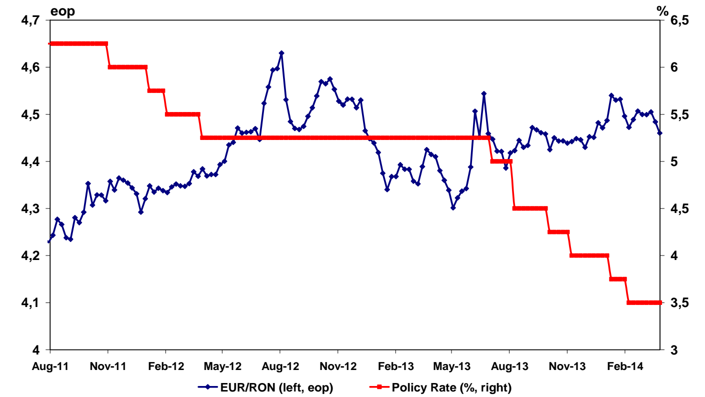
Source: National Statistics, Eurostat

Figure 3: Inflation components



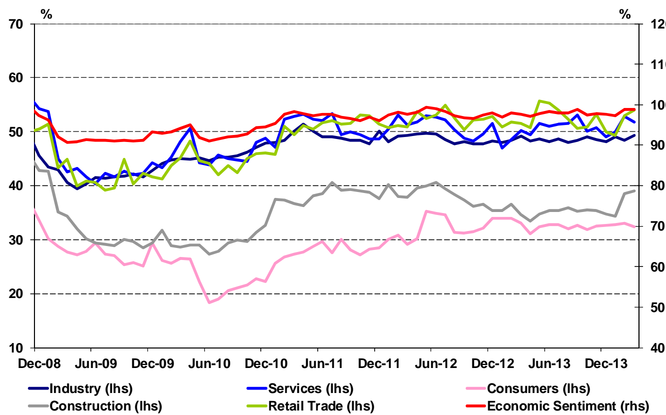
Source: Eurostat, Eurobank Research

Figure 4: FX & Policy rate



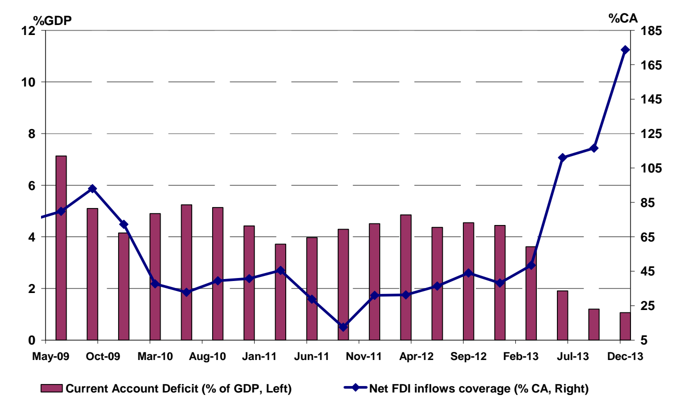
Source: Central Bank, Bloomberg, Eurobank Research

Figure 5: DG Ecofin Survey Indicators



Source: Eurostat, Eurobank Research

Figure 6: Current Account Deficit



Source: Central Bank, Eurobank Research

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