ISSN: 2241-4843

Eurobank Research
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NEW EUROPE
ECONOMICS & STRATEGY

September 29, 2014

FOCUS NOTES: ROMANIA

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Disappointing Second Quarter Output Performance

- **Romania slipped again into technical recession on disappointing second quarter GDP growth reading**
- **GDP growth decelerated sharply to 1.2% on a yearly basis in Q2-2014 down from 3.9% in Q1-2014, driven by the weak performance of investments**
- **The subdued inflation outlook, the persistent negative output gap and the restrictive credit conditions may trigger further 50 bps NBR interest rate cuts by year-end**

The second quarter output reading disappointed expectations of a robust FY-2014 GDP growth rate performance

Romania slipped again into technical recession in the second quarter. GDP contracted for a second consecutive quarter posting a -1% qoq in Q2-2014 vs. -0.2% qoq in Q1-2014. On an annual basis, real GDP growth retreated from 3.9% yoy to only 1.2% yoy accordingly. The dynamics of high frequency indicators predisposed for a slowdown in economic activity in Q2-2014, yet the outcome far outpaced the predictions of the consensus (+3.3% yoy).

On the demand side, growth was mainly driven by net exports again. Domestic demand failed to live up to expectations as the negative contribution of investments offset that of final consumption. With the aid of inventories restocking (+0.3pps in Q2-2014), domestic demand contribution remained barely positive.

On the positive side, final consumption increased by 3.7% yoy in Q2-2014 down from 5.3% yoy in Q1-2014. Private consumption expanded by 3.9% yoy in Q2-2014 down from 5.8% in Q1-2014, up from -0.1% yoy in Q2-2013. The positive contribution of private consumption increased from 0.1pps in Q2-2013 to 2.9pps in Q2-2014. The rise in the minimum wage which came into effect since the beginning of 2014, the subdued inflationary pressures which have maintained real net wages at positive territory (annual dynamics have improved to 5.1% yoy in Q2) have boosted both the purchasing power and sentiment of consumers. At the same time, government consumption rose by 1.1% yoy which translated into a minimal 0.1pps contribution in Q2.

Investments were the negative surprise in the GDP numbers, weighing negatively on output performance. Gross fixed capital formation plummeted by 12.8% yoy in Q2-2014 subtracting 3pps from output performance. Investments lost ground for a seventh consecutive quarter. To make things worse, the contraction accelerated from -8.4% yoy in Q1-2014 versus -2.2% yoy in Q2-2013. Investments suffered from a very poor record of EU absorption in Q2, the halting of public infrastructure projects plus the introduction of a pillar tax on construction investments other than buildings.

Net exports were yet for another quarter a positive contributor to growth. However, the contribution of net exports declined from 1.2 pps in Q1-2014 to 0.9pps in Q2-2014. Exports expanded by 10.7% yoy in Q2-2014 down from 15.0% yoy in Q1-2014 up from 8.2% in Q2-2013. Imports decelerated to 8.7% yoy in Q2-2014 against 13% yoy in Q1-2014 vs. -3.6% yoy in Q2-2013.

On the supply side, Industry and Information and Technology Communication (ICT) had the largest positive contributions. In contrast, the performance of agriculture and construction deteriorated markedly. Industry remained a key growth generator (+2.1% yoy in Q2-2014 down from 8.0% yoy in Q1-2014 vs. +4.9% in Q2-2013). However, the contribution declined to +0.7pps in Q2-2014 vs. +1.4pps in Q2-2013. ICT expanded by an astonishing +2.3% qoq/+9.8% yoy in Q2-2014, making a 0.3pps contribution in the growth rate. Agriculture (+2.6% qoq/-7.6% yoy) and Construction (-1.5% qoq/-5.2% yoy) had a negative contribution of -0.3 pps respectively. However, the sector of retail trade (-2.6% qoq/-4.3% yoy) had the largest negative contribution (-0.5 pps) which contradicts the strong numbers in retail sales. The introduction of a fuels tax complicated the picture even further.

Overall, the second quarter reading was very poor so that our revised full year forecast -2.8%-is no longer feasible. In our report back in April 2014, we upgraded our forecast from 2.5% to 2.8% based on the flurry of macroeconomic data that came out in the first months of the year. In any case, we highlighted that it would be hard to repeat the robust performance of 2013 again, given the downside risks from base effects in agriculture and industry. Yet the performance of both of them so far has not undershot expectations. In addition, investments were expected to receive support from improved EU funds absorption and public investments while private consumption was expected to from higher real incomes. Nevertheless, domestic demand has failed to make a meaningful contribution as the first assumption didn't materialize. The most important determinant of GDP performance in the second quarter was the negative performance of investments. Although more supportive data are expected to come out in the 2H-2014, the second quarter output performance disappointed expectations of a swift rebalancing from net exports to domestic demand driven growth. The key take away from the second quarter performance is that the structural drivers of a sustainable growth rebound are missing. In that direction, a revival of investments is essential to achieve sustainable growth in the medium term. Government policies ought to become more supportive of investments. On top, more downside risks have accumulated from the indirect impact of the Ukraine-Russian conflict and the weaker than expected Euroarea growth outlook in 2014-2015.

The improved inflation outlook motivated NBR to resume rate cuts in August

On August 4th, the NBR cut interest rates by 25bps across the board to 3.25%. At the same time, the minimum reserves requirements were kept unchanged (at 12% on RON liabilities and 16% on FX liabilities). The decision met the expectations of half of the analysts in Bloomberg and the poll conducted by the local Association of Financial and Banking Analysts (AAFBR). Although the 25bps rate cut in last February was broadly deemed to be the end of the easing cycle, the improvement in the inflation outlook created room for further easing. Expectations for such a move had already started building after the previous NBR policy meeting in early July, fuelled by the dovish comments of the Central Bank governor Mr. Isarescu. But ever since, the communication of the Central Bank predisposed for further action if inflation remained subdued, yet the market consensus was divided over the timing of such action.

Inflation readings have surprised to the downside throughout 1H-2014. Inflation fell to a historic low of 0.7% yoy in last June only to rise modestly to 1% yoy in July, compared to 5.7% yoy a year ago and 1.6% yoy in December 2013. The downward trend over the last months has been reinforced by a number of supply side effects. A better than expected so far agricultural harvest plus good weather conditions has pushed food prices much lower. The most volatile component of the consumer basket, VFE (Vegetables-Fruits-Eggs) price dynamics fell more steeply in Q2, a decline which is not justified by the standards of a good agricultural harvest. The Russian embargo on EU-28 food products has already added further downward pressure on the prices of vegetables and meat. Moreover, the disinflation process has been supported by the past appreciation trend of RON in 1H-2014. In addition, the VAT rate cut in bread and bread-related products since last October, the low imported price dynamics from Euroarea which have a favorable impact on services and a 2.6% cut in electricity prices effective July 1st weighed positively on headline inflation. In contrast, fuels, tobacco and alcohol products were the only components with positive contribution in inflation, which reflect past hikes in administered prices. For instance, the fuel tax hike in last April was the only source of inflation pressure in Q2.

The downward trend is also reinforced by muted demand side pressures. The adjusted Cored 2 inflation (adjusting for food, energy and administered prices) has been negative since last October. Last but not least, inflation expectations remain anchored within the target band of BNR (2.5+/-1%). Looking ahead, inflation is widely expected to pick-up until the end of the year. Negative base effects from the phasing out of the VAT cut for bread and products will kick in Q4. Nevertheless, NBR forecasts have been adjusted lower to reflect the impact of lower food prices throughout 2014-15. In the inflation report of August, the Central Bank downgraded its year-end inflation forecast in 2014 down to 2.2% and to 3% in 2015 against 3.3% previously for both years.

Similarly to the previous assessments, the NBR considers the external risks the main source of uncertainty in the inflation outlook. The RON performance in the next months could provide more incentives to the Central Bank to resist further easing. The local currency is highly sensitive to capital outflows stemming from geopolitical tensions in Ukraine-Russia dispute. For the time being, increased portfolio inflows have fuelled appetite for RON and RON-denominated assets. In addition, Fed's tapering could put RON under more depreciation pressure in Q4. From a domestic side point of view, the uncertainty from the evolution of food prices in the future is still high while the uncertainty from the implementation of structural reforms within the context of the precautionary Stand-by arrangement in an election year generates additional upside inflation risks.

On the other hand, the GDP growth deceleration (+1.1% yoy in Q2 vs. +3.8% yoy in Q1) and the persistent negative output gap favor further policy action-advocate in favor further monetary policy easing. All in, the revision of the inflation outlook provides scope for further monetary policy easing. Unless there is no unforeseen external shock from the geopolitical tensions in Ukraine t wouldn't come as a surprise if the Central Bank resorts to further easing. Under the current circumstances, we see room for further 50 bps rate cuts from the current levels until year end. The money market and the government bond yields are already consistent with those levels. Meanwhile, the Central Bank has one more tool in its arsenal to stimulate economic activity. NBR has already reduced the minimum reserve requirements twice in 2014, but there is more room to do so in order to reduce the MMR differential close to the EU levels. The reduction of MMRs has provided ample liquidity in the market and pushed lending rates down. However, total credit is still in negative territory, as new lending in local currency has not been growing fast enough to offset the contraction in FX lending.

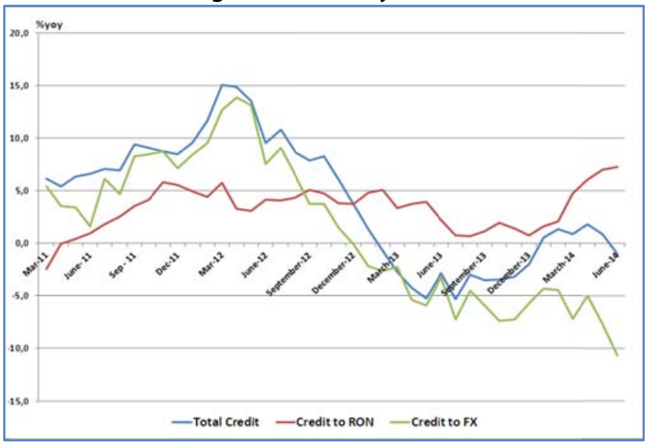
Romania: Eurobank Research Forecasts				
	2011	2012	2013	2014f
Real GDP (yoy%)	2.2	0.7	3.5	2.3
Consumption	0.9	1.2	0.3	3.0
Investment	7.3	4.9	-5.7	-5.0
Exports	10.3	-3.0	12.8	9.5
Imports	10.0	-0.9	2.3	8.5
Inflation (yoy%)				
CPI (annual average)	5.8	3.4	4.0	1.5
CPI (end of period)	3.1	5.0	1.6	2.3
Fiscal 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	2.3
FDI / Current Account (%)	31.0	38.1	173.6	100.0
FX Reserves (EUR bn)	37.3	35.4	35.4	34.0
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	3.25	3.00	3.00	2.75
EUR/RON	4.41	4.50	4.55	4.55

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

Credit dynamics in the domestic banking system remain relatively unchanged in July

Credit dynamics in the domestic banking system remain relatively unchanged in July. Total credit growth run at -1.0% mom/-0.4% yoy in July 2014, improving compared to the reading of 0.06% mom/-1%yoy in June 2014. The dynamics of lending were influenced by the rise in local currency lending vs. the decline in FX lending. Credit in RON rose by 0.7% mom/8.6%yoy in July up from 0.65%mom/7.3%yoy in June. In contrast, FX credit contracted by -1.7% mom/ -10.8%yoy in July against -1.69% mom /-10.7%yoy in June. The government subsidized mortgage loan scheme for small homes purchases by youths has been the strongest driver behind the switch to credit in RON vs. FX. In addition, the new Central Bank restrictions against borrowing in FX if there is no natural hedge have deterred new lending in FX as well. On the other hand, the deposit base of the banking system is growing steadily. Total deposits expanded by 0.1%mom/6.9%yoy in July vs. 5.9%yoy/-0.5mom in June. The main driver, deposits in RON increased by -0.4% mom /+9% yoy, vs. 0.13%mom /8.43%yoy in June. FX deposits expanded by 1.1%mom/3.3%yoy in July compared to /-1.62%mom /+1.5%yoy in June.

Figure 7: Credit Dynamics



Source: NBR, Eurobank Research

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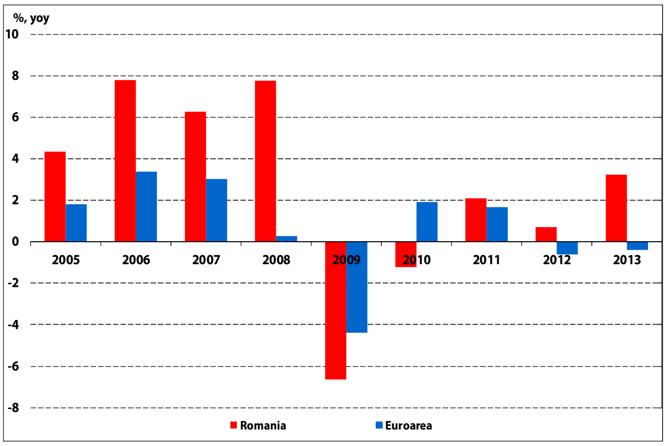
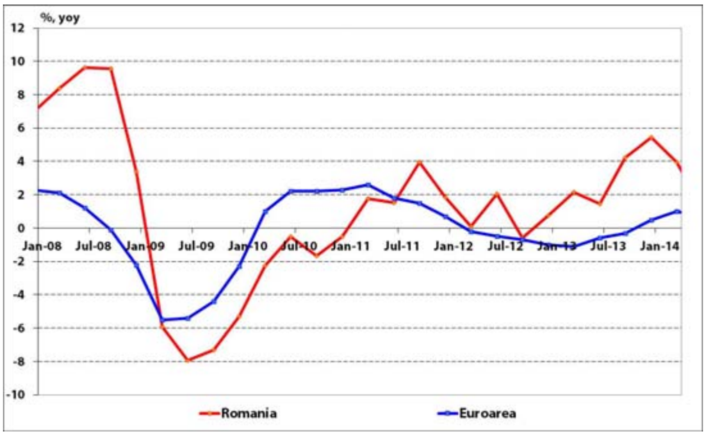
Figure 1: Annual GDP growth rates: Romania & Euro area



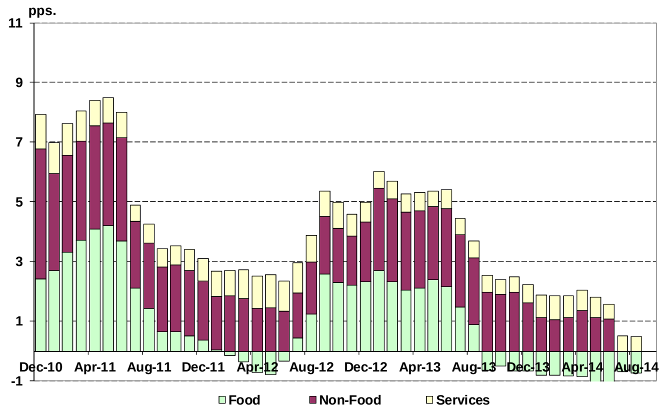
Source: National Statistics, Eurostat

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



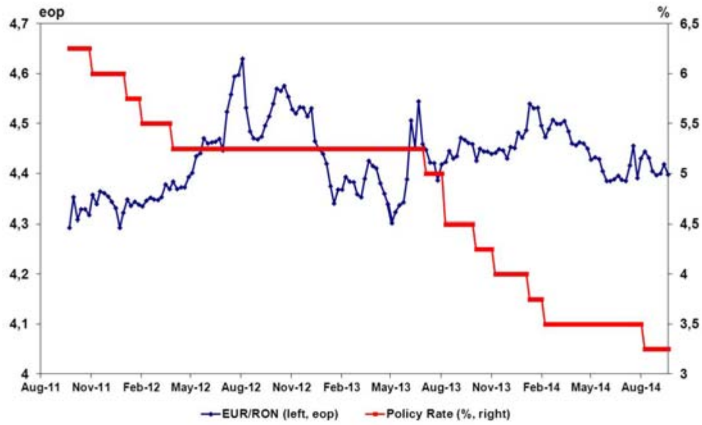
Source: National Statistics, Eurostat

Figure 3: Inflation components



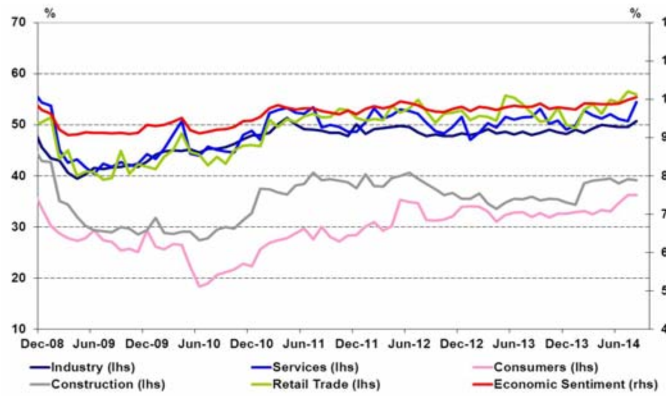
Source: Eurostat, Eurobank Research

Figure 4: FX & Policy rate



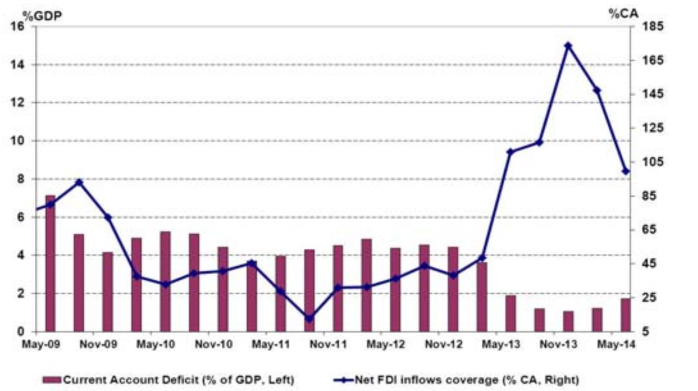
Source: Central Bank, Bloomberg, Eurobank Research

Figure 5: DG Ecofin Survey Indicators



Source: Eurostat, Eurobank Research

Figure 6: Current Account Deficit



Source: Central Bank, Eurobank Research

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ISSN: 2241-4843