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Romania: No more technical recession

- ✓ **Political noise could re-emerge in the near future after the surprise outcome of the second round of the Presidential elections**
- ✓ **After significant past quarterly output data revisions and shift in methodology, it became evident that Romania never entered a technical recession in Q2**
- ✓ **GDP growth accelerated to 3.2% yoy in Q3 vs. 1.4% yoy in Q2 driven by resilient private consumption dynamics from the demand side and industry on the supply side**
- ✓ **The declining investment rate is a threat to the sustainability of growth in the medium-term**
- ✓ **We see limited room for further easing through rate cuts in the foreseeable future after the 50 bps cumulative cuts in September and October to 2.75%**

Presidential elections are over in Romania but political noise may not be

The second round of presidential elections, held on November 16th, delivered a surprise outcome. Mr. Klaus Ioannis received 54.4% of the vote in the run-off and was elected President. His contestant, Prime Minister Victor Ponta, leader of the ruling Social Democratic Party (PSD) received only 45.6% of the vote. The opposition candidate from the Christian Liberal Alliance (ACL) covered a handicap of ten percentage points from the first round, receiving a lot of support from the diaspora and urban areas.

The reversal of the first round lead was facilitated by the increase in the increased voters turn-out. The turnout of the voters reached 64.1% in the second round, the highest since 2000, compared to only 53.2% in the first. Mr. Klaus Ioannis is the third in a row second placed candidate in the first round to win the Presidential elections. His predecessor outgoing President Basescu had accomplished that twice. At the same time, it is the first ethnic minority –German- representative to ever assume such an important post.

In our view, the election of Mr. Ioannis will have multiple consequences. Even though, the President has limited executive powers from a constitutional point of view, it is more likely that the political heat will go up in the near future. Firstly, the new President will most probably not necessarily be friendly to a Ponta-led government. Secondly, the election of Mr Ioannis may help changing the public agenda. The newly elected President may put more emphasis on business environment and government policies issues given that his pre-election campaign was centered on the issues of corruption and government officials' efficiency.

Even if the political landscape may not change radically, animosities between the President and the Prime Minister may result in increased political noise in the coming months. Prime Minister Ponta has already declared his determination to remain in the post. That could be considered more or less given since PSD still holds the majority of seats in the parliament (USL controls 67% of the seats). However, frictions may turn into conflicts between the two personalities in the future. The animosities between the outgoing President Basescu and the incumbent Prime

Minister is an illustration of the past experience in Romanian politics. Last but not least, the defeat of Prime Minister Ponta could be a blow to his party leadership because it may stir up defections in the ruling camp and thus trim the constitutional parliamentary majority. The next parliamentary elections are scheduled for December 2016.

For the time being, the focus has now shifted to the adoption of the budget of 2015 and the expiration of the IMF agreement. The current precautionary IMF-EU balance of payments assistance is set to expire in September 2015. In order to achieve the ambitious fiscal targets of the medium-term program, the new budget ought to adopt new measures in order to address the underperformance of revenues. The fiscal deficit target of next year is set at 1.5% of GDP in 2015 vs. 2.1% expected in 2014. From that point of view, the budget of 2015 to be voted in next January will be the first actual test of coherence for the Ponta-led cabinet. While the chances of the budget not being voted are slim, if that happens, it will provide the opportunity to the President to nominate another Prime Minister.

The rating agencies picked up the subject, stating that the sovereign ratings are not at risk for the time being. S&P noted that the elections have no immediate impact on Romania's ratings yet they warned that in case of fiscal relaxation or deviation from fiscal stability amid political instability, the ratings would be revisited.

The response of the financial markets was muted in the aftermath of the second round presidential race results. The local currency traded at 4.4240/€ on Monday 17th November, almost unchanged compared to the closing of Friday before the elections. Bond yields have remained broadly unchanged. The financial markets are anticipating the signs in the post-election era to formulate expectations.

There is limited room for further easing through rate cuts. The benign inflation outlook leaves scope for further monetary policy easing

NBR turned more dovish in the previous two meetings in line with expectations. The NBR delivered two 25 bps cuts in October and November so that the policy rate now stands at 2.75% vs. 3.25% in the beginning of the summer. At the same time, NBR resorted to using the tool of Minimum Reserve Requirements (MMRs) reducing both the RON-denominated MMRs by 2% from (12% to 10%) in September vs. 15% in the beginning of the year. Accordingly, the FX-denominated MMRs were cut by 2% (from 16% to 14%) in November vs. 20% in the beginning of the year. The market was not surprised and has started building expectations for further cuts.

Inflation readings have surprised to the downside throughout 2014. Inflation fell to a historic low of 0.7% yoy in last June only to rise modestly to 1.4% yoy in October (below the inflation target band 1.5 +/-1%), compared to 1.9% 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. On top, lower world oil prices have eased price pressures further. Inflation expectations remain well anchored and stabilized. Inflationary pressures will most probably remain contained until year end, as a number of factors are still playing in: a very good agricultural harvest in 2014, the freezing of the natural gas price liberalization, favorable exchange rate developments, well anchored inflation expectations at lower levels and a persistent negative output gap.

On the other hand, demand side pressures remain muted. The adjusted Cored 2 inflation (adjusting for food, energy and administered prices) was negative for the past eleven months (since October 2013) and turned positive in September 2014 after the phasing out of the VAT cut in bread (+0.98% yoy in September vs. -0.29% yoy in August 2013). As a result, NBR has downgraded the inflation forecast to 1.5% in 2014 vs. 2.2% in the previous inflation report. The inflation forecast in 2015 has been downgraded from 3% in the previous inflation report to 2.2% in November.

In our view, the bulk of easing through rate cuts has been completed. In our previous report issued in late September, we noted that 50bps more rate cuts were anticipated by year end. NBR would still be reluctant to go ahead with deeper cuts even though seems comfortable with a lower level of real interest rate compared to the past (1% vs. 2.5% on an ex-post basis). For that reason, we believe there is room for one more 25bps cut given that inflation will most probably follow an upward trend from now on until Q1-2015. If there is no other negative shock, that rate cut will most probably take in the next meeting scheduled in January 2015.

Meanwhile, we anticipate the focus of the Central Bank to shift to the use of the minimum reserve requirements. NBR has already reduced the minimum reserve requirements three times 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 private sector credit is still in negative territory (+0.3% mom/-3.3% yoy in Oct14) as new lending in local currency (+1.7% mom/+6.5% yoy in Oct14) has not been growing fast enough to offset the contraction in FX lending (-0.2% mom/-10.6% yoy in Oct14).

The strong performance of the third quarter brought the cumulative GDP growth performance at 2.8% in the first nine months of 2014

The hefty revisions on quarterly data as a result of the change in methodology (from ESA1995 to ESA2010) brought Romanian economy out of technical recession. According to the new ESA2010 methodology, GDP grew by an extraordinary +1.8% on a quarter on quarter basis in Q3. In addition, there was a significant upward revision in the data of the previous two quarters (**Q2**: -0.4% qoq (ESA 2010) vs. -1.0% qoq (ESA 1995) & **Q1**: +0.7% qoq (ESA 2010) vs. 0.1% qoq (ESA 1995). Annual dynamics remained almost unchanged in the first two quarters. On an adjusted basis, real GDP came at 4.0% yoy in Q1 followed by a very weak 1.4% yoy in Q2. The third quarter's strong performance (+3.2% yoy) brought the cumulative GDP growth performance at 2.8% in the first nine months of 2014.

On the demand side, growth was mainly driven by resilient private consumption dynamics and to a less extent by net exports. Private consumption expanded by 4.1% yoy in Q3-2014 down from 3.9% yoy in Q2-2014, up from 1.6% yoy in Q3-2013. The positive contribution of private consumption increased from 0.2pps in Q3-2013 to 2.3pps in Q3-2014. At the same time, government consumption rose by 0.7% yoy which translated into a minimal 0.1pps contribution in Q3. Gross fixed capital formation, the negative surprise in the GDP numbers, plummeted by 3.5% yoy in Q3-2014 subtracting 1.1pps from growth. Investments lost ground for an eighth consecutive quarter. To make things worse, the contraction accelerated from -12.8% yoy in Q2-2014 versus -4.1% yoy in Q3-2013. Net exports were yet for another quarter a positive contributor to growth (0.9pps in Q2-2014 to 0.8pps in Q3-2014). Exports slowed down to 2.5% yoy in Q3-2014 down from 10.5% yoy in Q2-2014 vs. 21.7% in Q3-2013. Imports decelerated to 0.4% yoy in Q3-2014 against 8.4% yoy in Q2-2014 vs. 8% yoy in Q3-2013.

On the supply side, industry remained a key growth generator (+ 4.6% yoy in Q3-2014 up from +2.1% yoy in Q2-2014 vs. 7% yoy in Q3-2013). Yet, the contribution of industry declined to +1.4pps in Q3-2014 vs. +1.9pps in Q3-2013. Information and Technology Communication (ICT) expanded by an astonishing +8.8% qoq/+20.8% yoy in Q3-2014, making a 0.8 pps contribution in the growth rate. The picture is completed by agriculture (+2% qoq/1.8% yoy-0.2pps), construction (-0.6% qoq/-1.8% yoy-0.1pps) and retail trade (1.8% qoq/3.5% yoy-0.3pps) which had a minimal contribution.

Most high frequency indicators showed a decelerating trend during Q3 compared to 1H-2014. Indicators such as retail sales (volume terms: 5.5% yoy in Q3 vs. 8.0% yoy in Q2) and industrial production (working day adjusted terms: 3.7% yoy in Q3 vs. 9.0% yoy in Q2) showed some weakness, implying that the economy was losing momentum. In fact, the negative performance of industrial production on a quarter on quarter basis (-1.2% qoq on seasonally and working day adjusted basis) was the first one since Q2-2011. Construction activity edged higher (+2% qoq in Q3 vs. -1.4% qoq in Q2) on the quarter but is still far from making a positive contribution to GDP numbers, as annual dynamics remain in red (-11.2% yoy in Q3 vs. -10.6% yoy in Q2). Construction activity was supported by the solid expansion of the non-residential segment but was undermined by the lack of public spending on civil engineer projects (-0.1% qoq/-26.5% yoy in Q3). Export activity remained strong in Q3 (+6.1% yoy in Q3 vs. +5.2% yoy in Q2 vs. 10.1% yoy in Q1) as exports recorded a new record high in September (up by +10.2% yoy to €4.9bn in September only).

Overall, private consumption and net exports have supported growth in the first nine months of 2014. A number of factors are behind the resilience of private consumption:

- **Robust real wage growth**: + 5% yoy in Jan-Sep2014 as a result of subdued inflation and dynamic nominal wage growth. The minimum wage went up twice in 2014 (from 800 Leu to 900 Leu in 2014)
- **Improved consumer confidence**: the consumer confidence indicator, a survey conducted by the European Commission) showed visible improvement in the 2H-2014 that far (June 2014: -30.6-October 2014: -26.0).
- **Credit dynamics**: A slowdown in the deleveraging process of households amid a low interest rates environment.
- **Public spending** should give private consumption an additional boost in Q4. Ahead of the Presidential elections, a number of public servants (teachers, military, and judges) have received compensations out of final court rulings.
- **Non-wage labor cost**: The decline of social contributions by 5pps for employers

In addition, exports have remained strong despite growing headwinds in Euroarea- the main export market- and indirect negative spillovers from the geopolitical tensions in Ukraine. So far, net exports have still made a positive-yet much lower compared to last year-contribution to GDP numbers (1.0 pps in the 9M-2014 vs. 4.4pps in FY2013). In contrast, weak investments have weighted negatively on the growth performance of 2014. Weaker EU funds absorption leveraged by even weaker capital expenditure spending had a negative impact on public investment (-21% yoy in Jan-Sep). More importantly, tight fiscal policies through the introduction of a so called pillar tax on buildings other than buildings had a further negative impact on construction.

Overall, the extraordinary performance in the third quarter has changed again the arithmetic of the GDP data. The change in methodology (shift from ESA1995 to ESA2010), the change of seasonal adjustment method plus the inclusion of a new observation in the data from the Statistical Service of Romania has changed the picture of national accounts. Although we remain very cautious in the analysis of the reading and the interpretation of the drivers behind growth in Q3 from a qualitative point of view, we see full year GDP growth ending up at 2.8% in 2014-unless a new statistical surprise comes out. In any case, our assessment has remained the same as before the announcement of the poor reading in Q2 and the change of the methodology.

In our previous issues of New Europe Economics & Strategy (back in April and September 2014) we highlighted for one more time that it would be hard to repeat the robust output performance of 2013, given the downside risks from negative base effects in agriculture and industry. Indeed, the contribution of agriculture (0.0 pps vs. 1.1 pps) and industry (1.3pps vs. 2.3pps) to growth has declined in the first nine months versus last year. On the demand side, the nine month revised output performance has confirmed that a swift rebalancing from net exports to private consumption driven growth, is taking place.

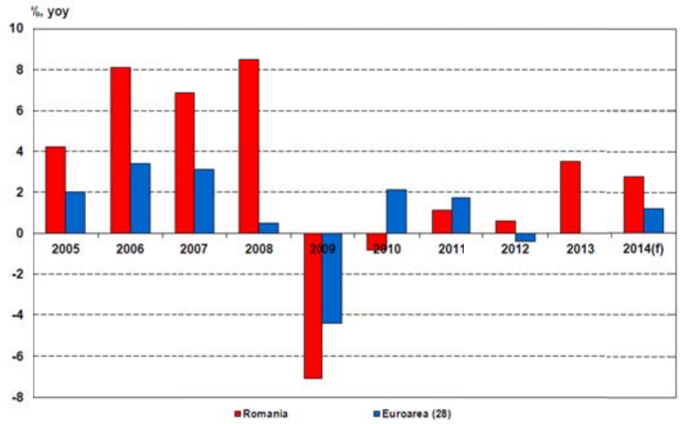
However, the most important determinant of GDP performance in the first nine months was still the negative performance and contribution to growth from the investments side. One of the most important structural drivers of a sustainable growth rebound is missing. Although the economy appears to be in better shape than other regional peers, the decline in investments is a threat to the sustainability of growth in the medium-term. The decline in investments affects not only one of the production resources but also indirectly total factor productivity. The decline in investments has been more pronounced in the investment rate. As a result, investments as a percentage of GDP stood at only 22.5% in the 9M-2014 down from 24.1% in 2013 and a multi-year high at 33.4% in 2008. From that point of view, government policies ought to become more supportive of investments. Last but not least, 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.

Romania: Eurobank Research Forecasts

	2011	2012	2013	2014f
Real GDP (yoy%)	1.1	0.6	3.5	2.8
Consumption	0.8	1.0	0.4	3.0
Investment	2.9	1.9	-4.9	-2.0
Exports	11.9	1.0	21.5	3.5
Imports	10.2	-1.5	8.2	2.5
Inflation (yoy%)				
CPI (annual average)	5.8	3.4	4.0	1.5
CPI (end of period)	3.1	5.0	1.6	1.8
Fiscal Accounts (%GDP, Cash Basis)				
General Government Balance	-5.5	-3.0	-2.2	-2.0
Gross Public Debt (including guarantees)	34.2	37.3	37.9	39.5
Labor Statistics (annual avg, %)				
Unemployment Rate (% of labor force)	7.4	7.0	7.3	7.5
Wage Growth (total economy)	4.1	4.2	4.8	4.0
External Accounts				
Current Account (%GDP, BPM5)	-4.4	-4.4	-1.1	-1.2
Net FDI (EUR bn)	1.8	2.2	2.6	2.0
FDI / Current Account (%)	31.0	38.1	173.6	100.0
FX Reserves (EUR bn)	37.3	35.4	35.4	35.0
Domestic Credit *(end of period)*	**2011**	**2012**	**2013**	**Q3-2014**
Total Credit (%GDP)	52.7	52.0	47.0	44.9
Credit to Enterprises (%GDP)	20.7	20.3	18.0	16.5
Credit to Households (%GDP)	18.7	17.8	16.5	15.4
FX Credit/Total Credit (%, private)	63.4	62.5	60.9	56.7
Private Sector Credit (yoy)	6.6	1.3	-3.3	-4.5
Loans to Deposits (%)	142.5	133.9	118.4	108.5
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	2.75	2.50	2.50	3.00
EUR/RON	4.42	4.50	4.55	4.55

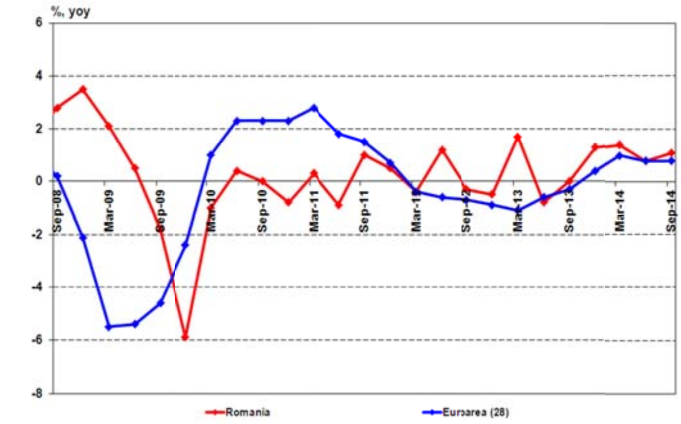
Source: National Sources, Eurostat, IMF, Eurobank Research & Forecasting

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



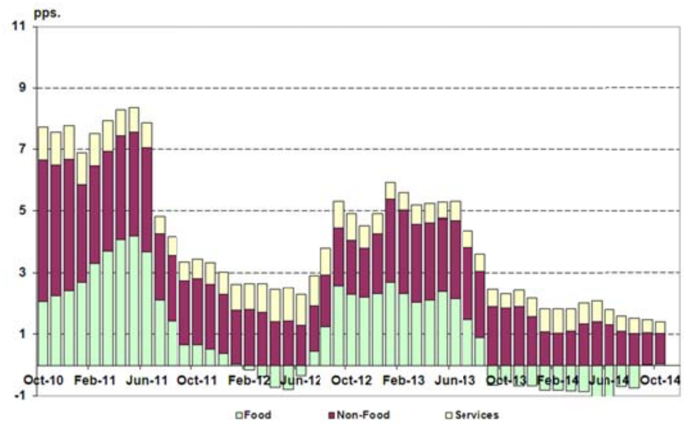
Source: National Statistics, Eurostat

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



Source: National Statistics, Eurostat

Figure 3: Inflation components

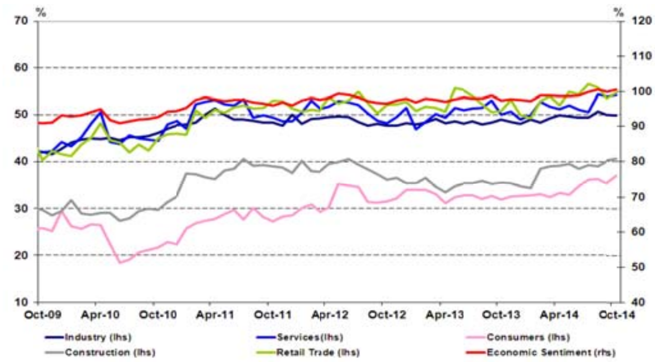


Source: Eurostat, Eurobank Research

Figure 4: FX & Policy rate

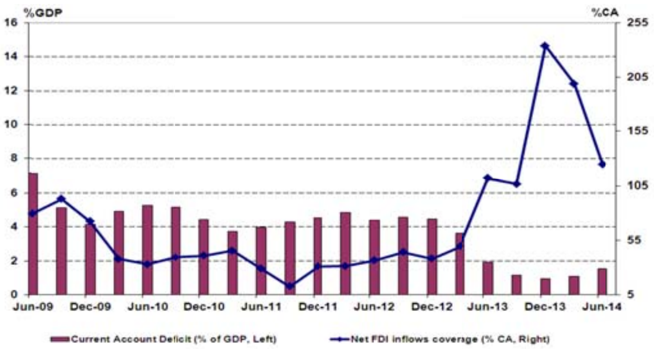
Source: Central Bank, Bloomberg, Eurobank Research

Figure 5: DG Ecofin Survey Indicators



Source: Eurostat, Eurobank Research

Figure 6: Current Account Deficit



Source: Central Bank, Eurobank Research

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