Romania: slower cruising speed

Policymakers in denial

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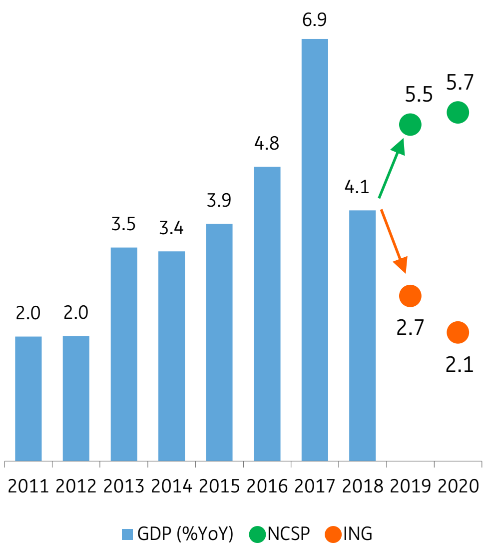
www.ing.com/THINK

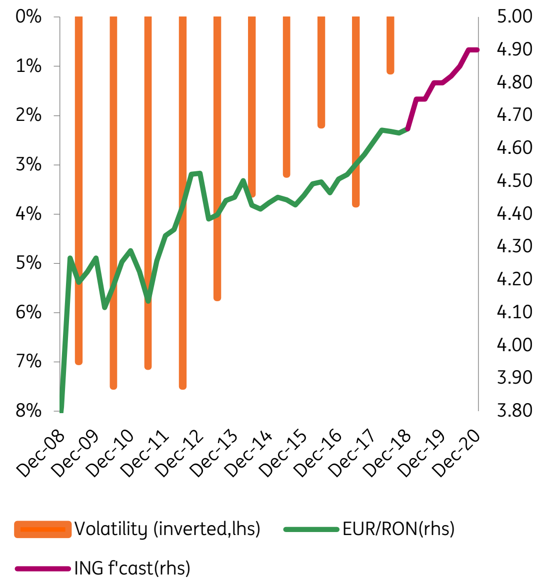
Main ING forecasts

Economic growth



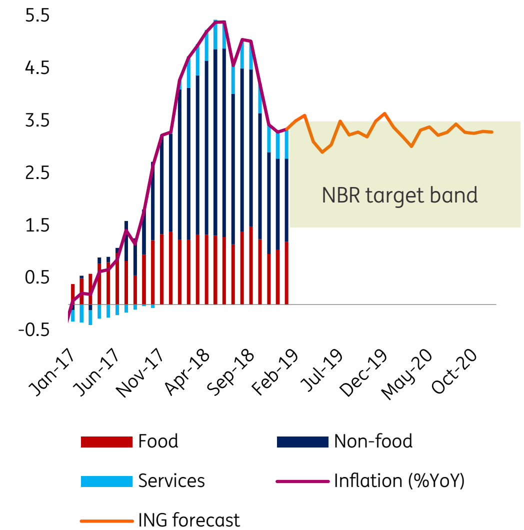
We believe economic growth will slowdown towards 2.7% in 2019 and 2.1% in 2020

EUR/RON



We see the EUR/RON at 4.80 in Dec-2019 and 4.90 in Dec-2020

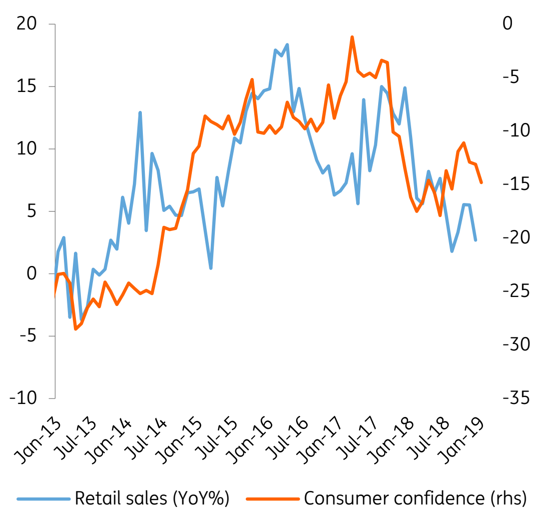
Inflation



Inflation looks broadly contained. Our forecast: 3.6% in Dec-2019 and 3.3% in Dec-2020

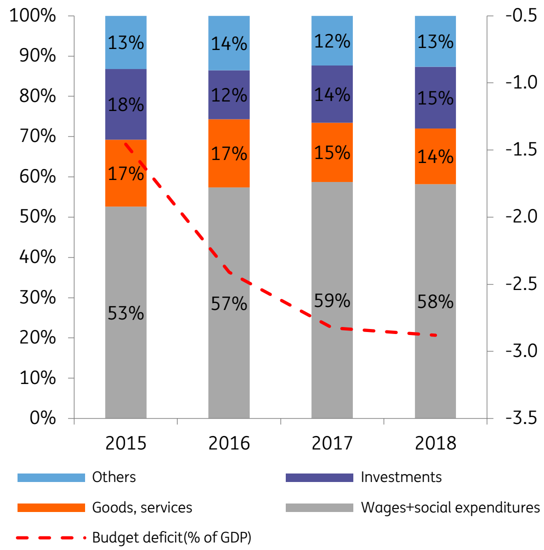
GDP lower. Why?

Consumer confidence shifting gradually lower



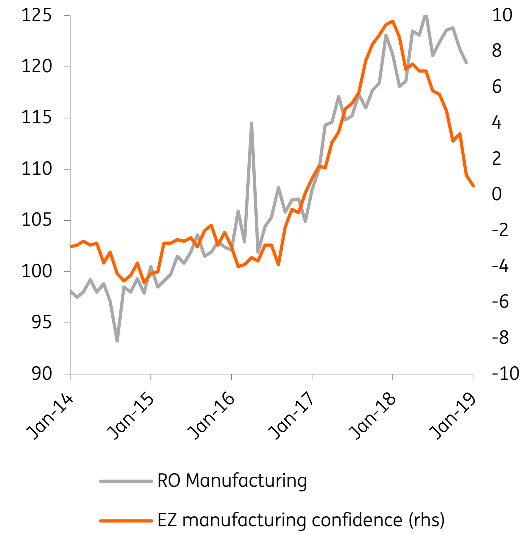
Consumers are unlikely to increase their spending further. Retail sales look on a downward trend

Limited room for fiscal impulse



The composition of budget expenditures is pro-cyclical and leaves limited fiscal space to prop-up the economy when a downturn occurs

External backdrop is deteriorating



The soft patch in the Eurozone doesn't look transitory. Germany narrowly avoided technical recession in the fourth quarter of 2019

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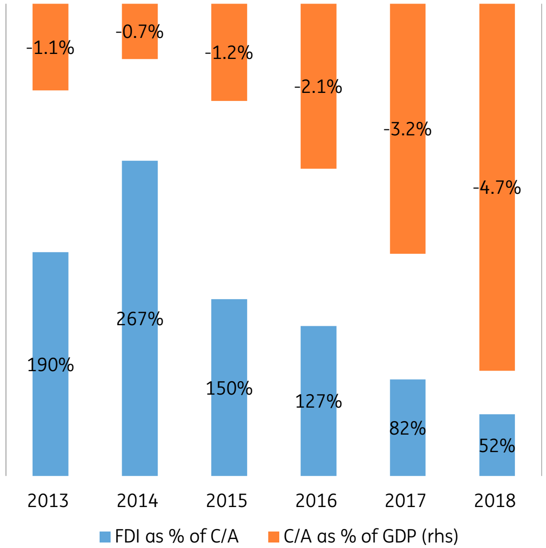
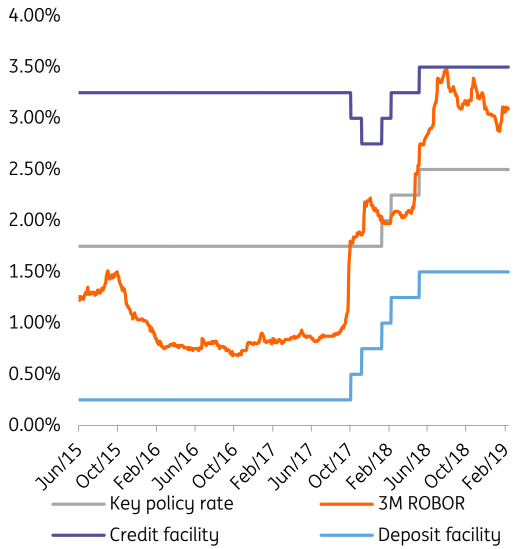
EUR/RON gradually higher. Why?

Current account deficit becoming problematic



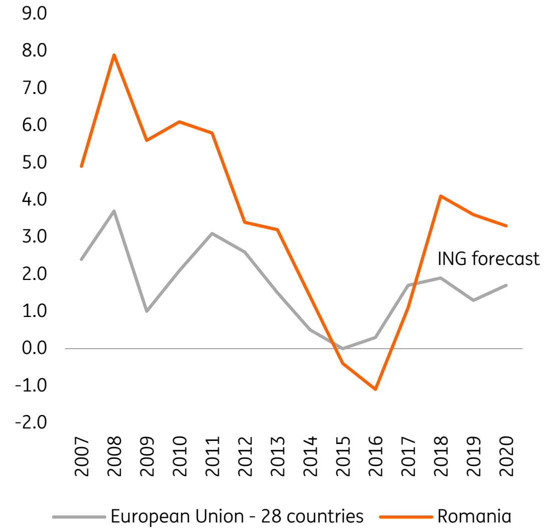
Foreign direct investments covered only 52% of the C/A gap in 2018 and EU funds absorption remained sluggish

Interest rates have already increased significantly



Protecting the FX via higher interest rates has been a tool of choice for NBR but the room for maneuver is diminishing due to lending transmission and bank tax

Inflation differential between Romania and EU



We forecast a 2.3% inflation differential in 2019 and 1.6% in 2020

Summary

1. External backdrop: all good things come to an end

2. Domestic context

2.1. Economic growth outlook: slower for longer

2.2. Fiscal outlook: extend and pretend

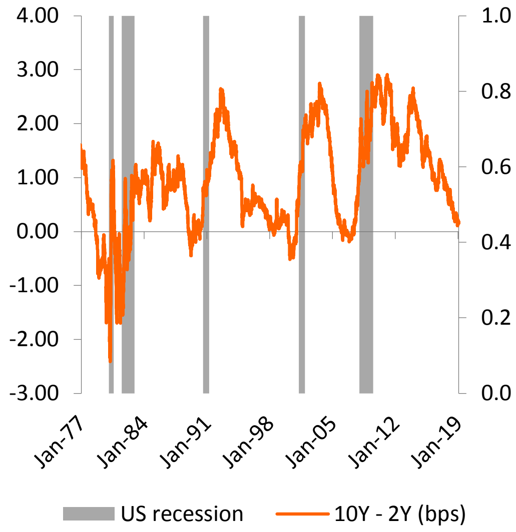
2.3. Monetary policy: there is no free lunch

3. Forecasts*

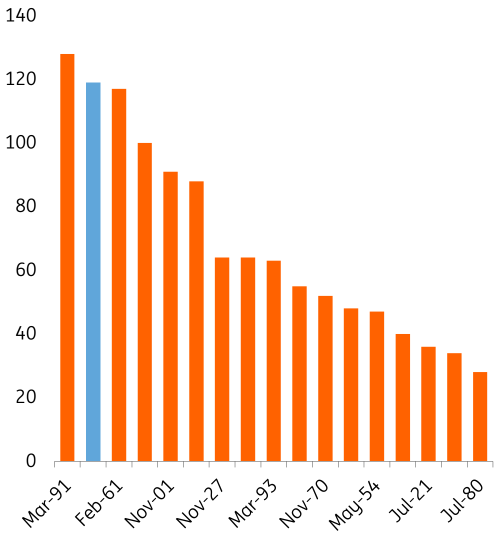
*the only function of economic forecasting is to make astrology look respectable (John Kenneth Galbraith)

USA: Growth cycle peaking, headwinds ahead

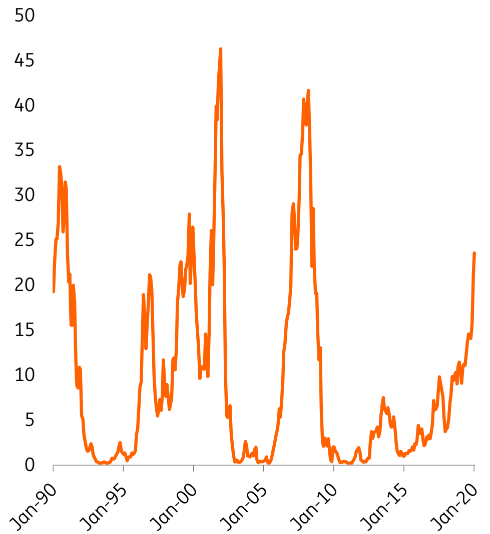
Best recession forecaster: the shape of US yield curve



The second-longest US expansion on record



UST Spread recession probability 12M ahead



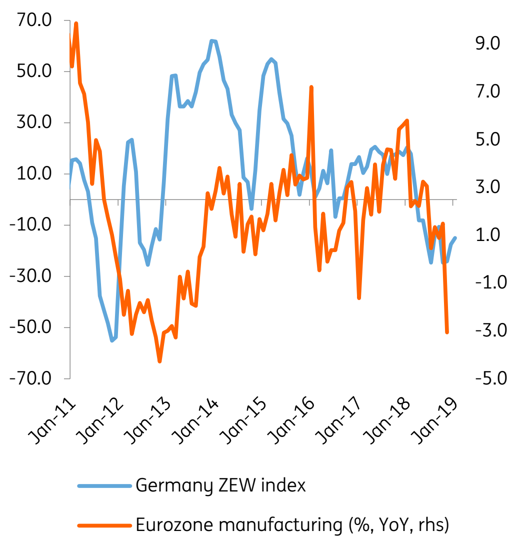
Self-fulfilling prophecy
Fed Powell downplayed the importance of the yield curve. We look for another rate hike in 2019.

Firing on all cylinders
Unemployment is near record lows, GDP growth on track and inflation is above target. Fed is unlikely to change course.

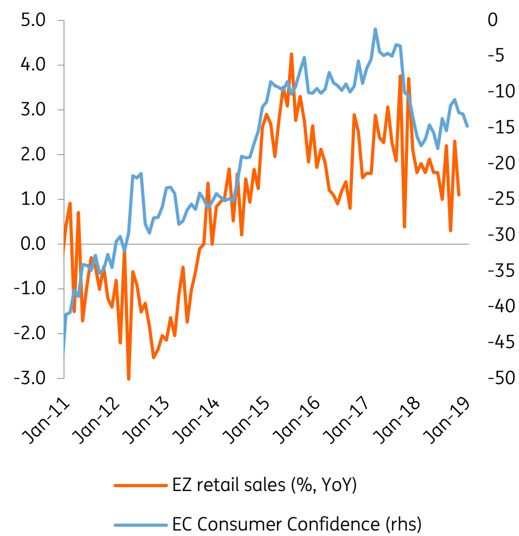
The 'R' word
Yield curve inversion preceded all nine recessions since 1955. Budget deficit at $1 trillion USD in 2019 (5%/GDP) can help prolong the economic cycle.

Eurozone 2018-2019: a start to forget, switching into a lower gear

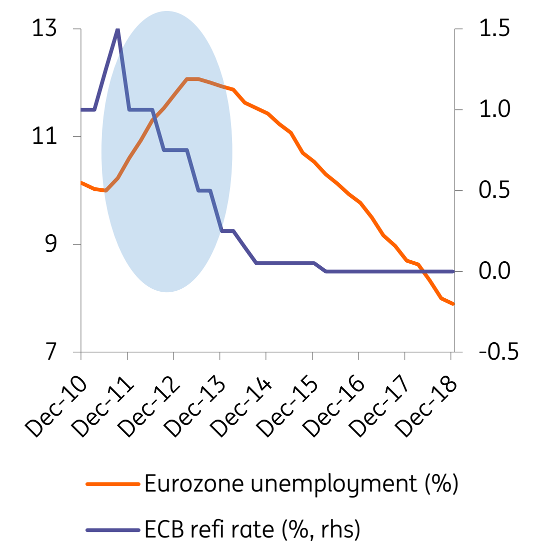
Sky fall? Not yet



A soft patch, not a downturn



ECB: haunted by past mistakes



Lower cruising speed

Worries: trade tensions, market volatility, ECB's monetary normalization. Looks like a transition period towards growth normalization.

Trade, geopolitical tensions

Oil biting into real wages – fading confidence, despite positive employment outlook due to increasing labour shortages in Eurozone countries

Core inflation near 1%

ECB needs more evidence on higher inflation outlook. A first rate hike in 4Q19. Mario Draghi's mandate ends in Oct-19.

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External backdrop – summing up

USA

- Late cycle, fiscal stimulus fading
- Still low but increasing recession probability
- One more Fed hike this year

Eurozone

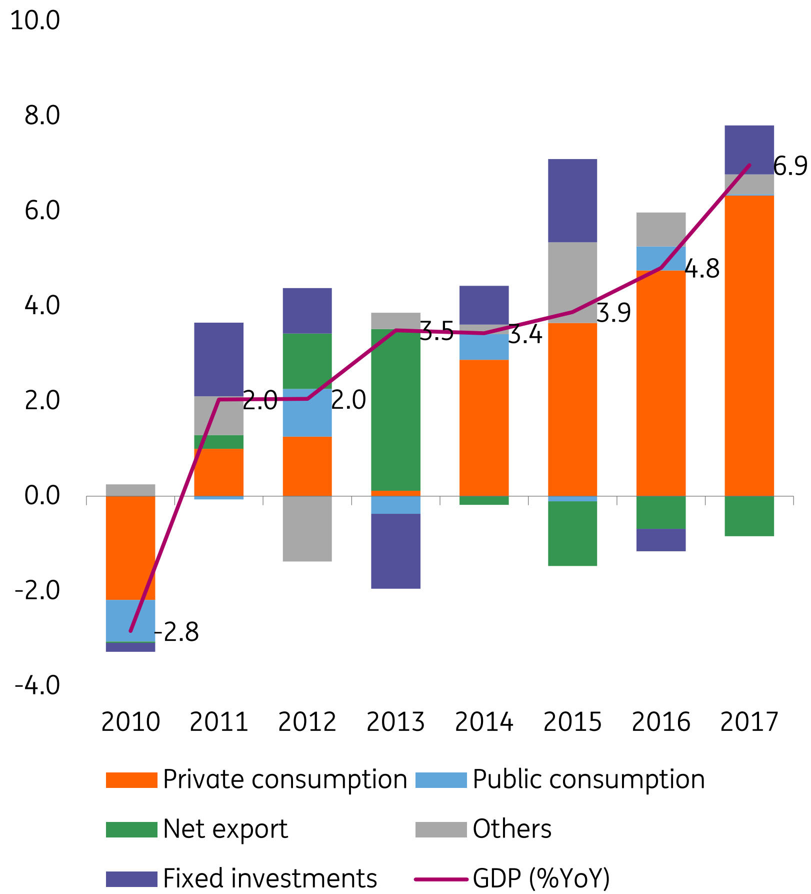
- At best, lower cruising speed lies ahead
- Structural reforms (labour market) and fiscal stimulus needed to boost growth
- ECB to move ahead with tightening in late 2019

EUR/USD: 1.20 in 12 months from now

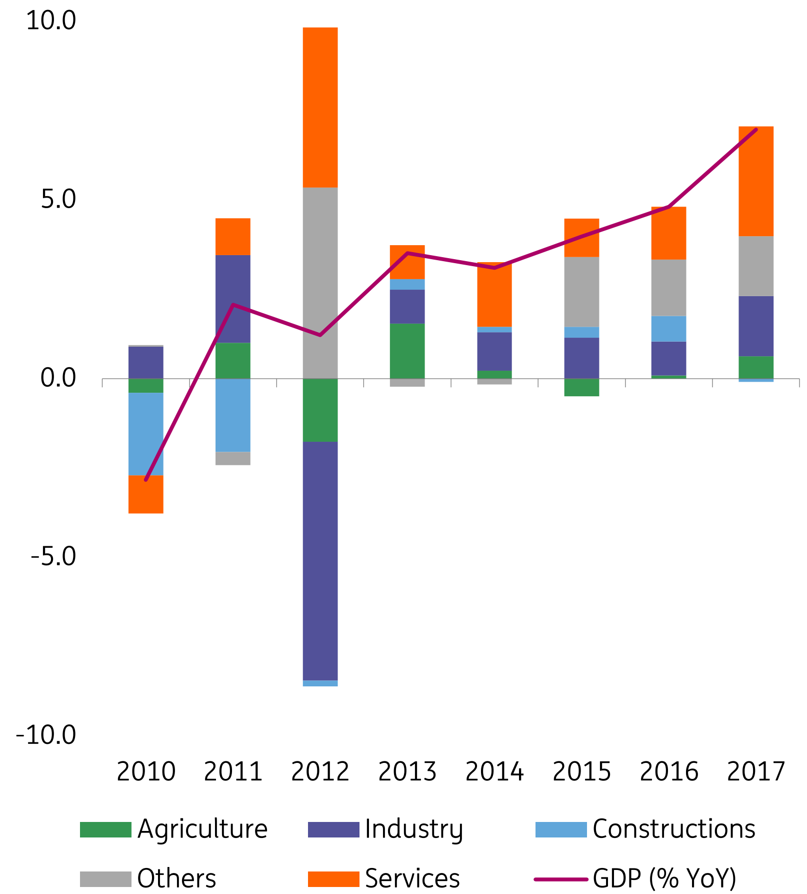
- We view the dollar bubble having been inflated in 2018
- The key question being when does this deflate/burst?
- Twin deficits should be bearish for the dollar at some stage
- Late 2019/early 2020 the market to start pricing of Fed easing cycle

Romania: 2017 growth - impossible to replicate, 2018 at potential, 2019 somewhat below

2018: weaker consumer confidence, small public investments with low multiplier

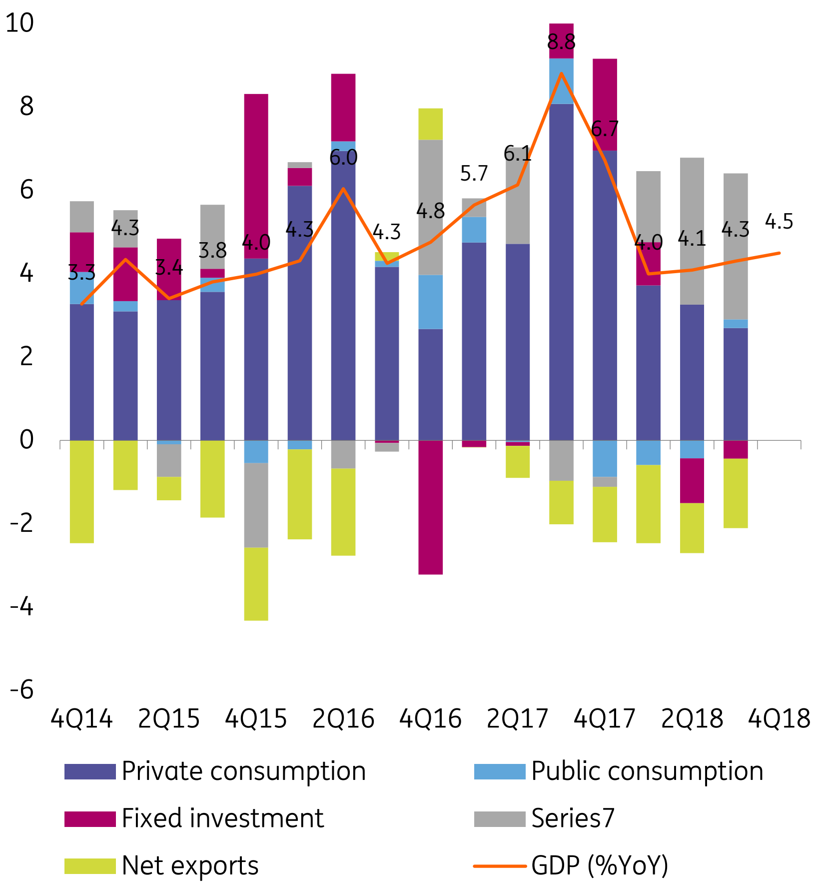


2018: industry affected by softer external demand

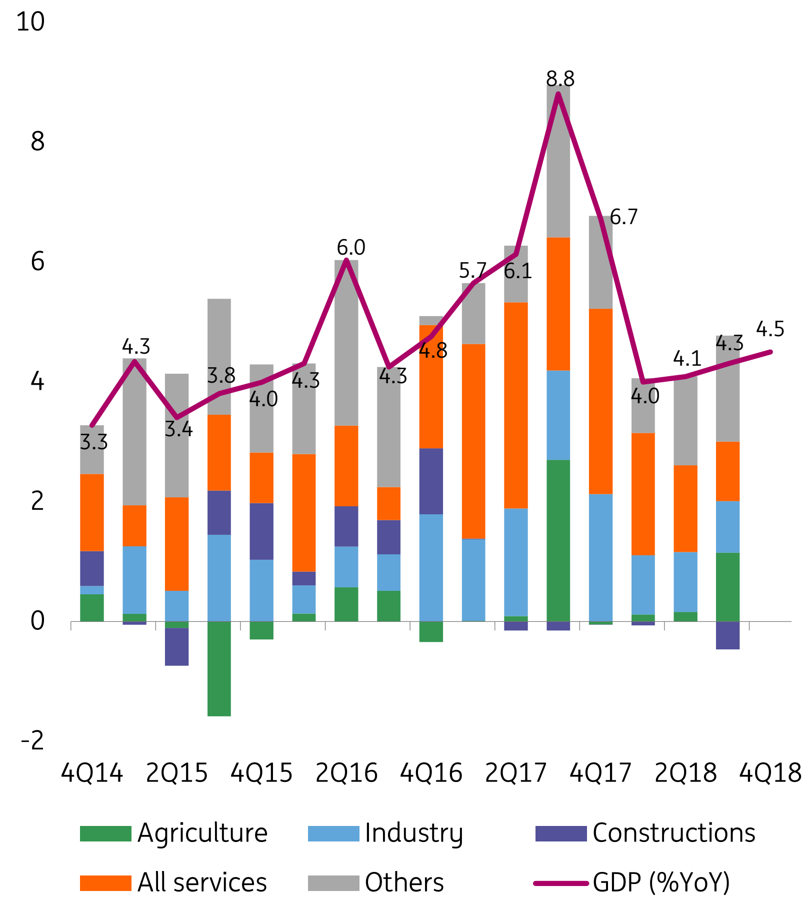


Scarce labour supply, costlier capital, tighter policies. ING forecast: 3.0% growth in 2019

Consumption to slowdown on: trimmed expectations, wealth effect, higher rates.



Lower cruising speed on external demand. Weakness across the board.



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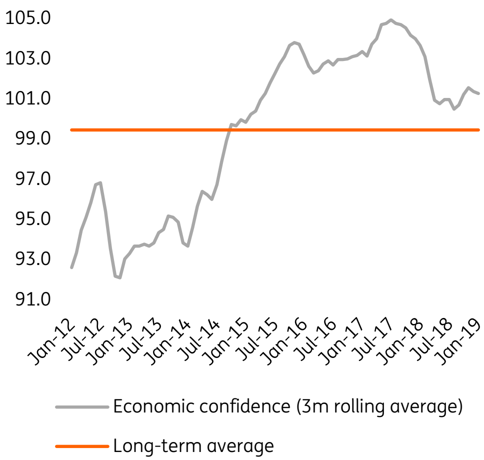
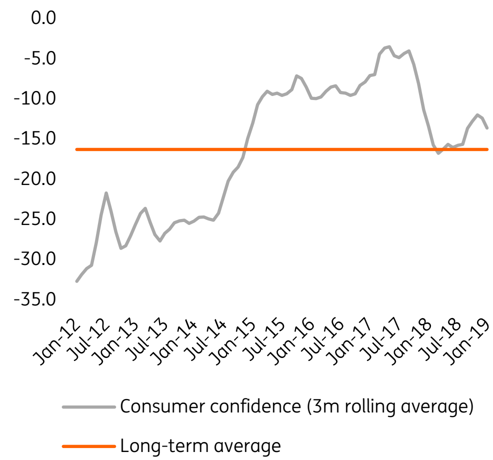
Converging to historical average; construction sector still roaring

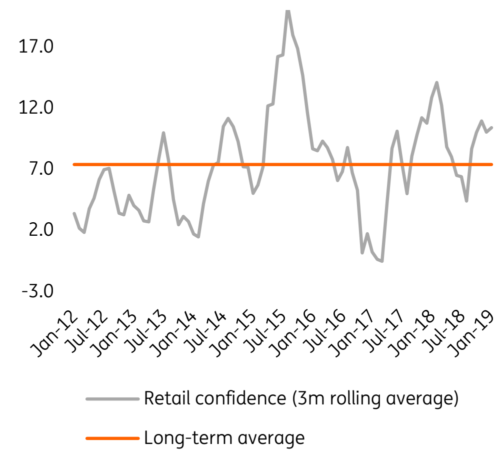
Economic sentiment index



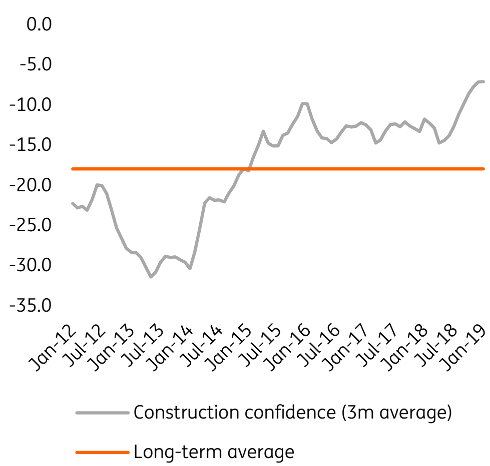
Consumer confidence



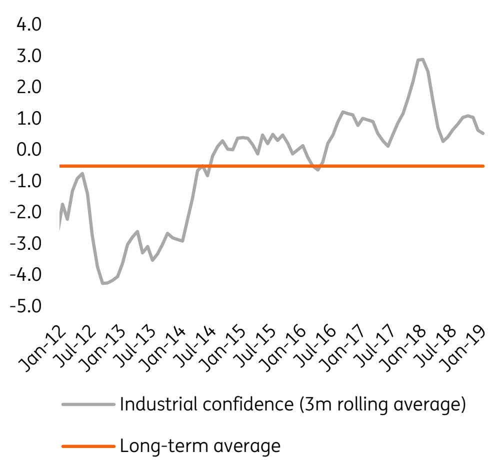
Retail sentiment



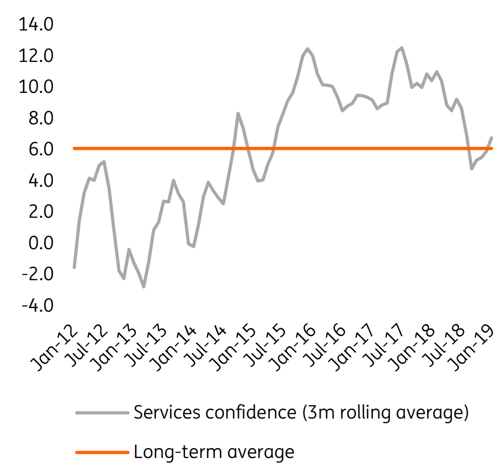
Construction sentiment



Industry sentiment

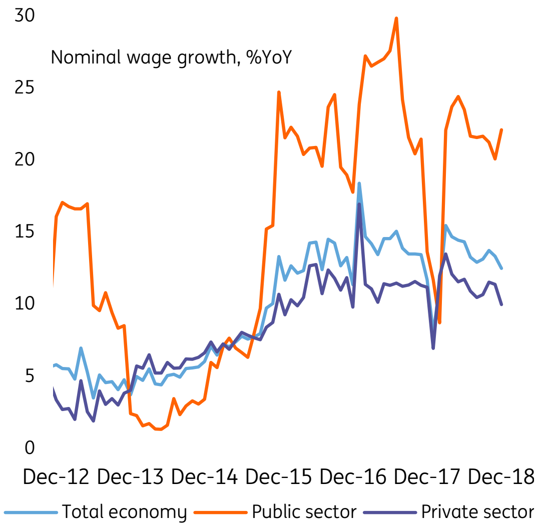


Services sentiment

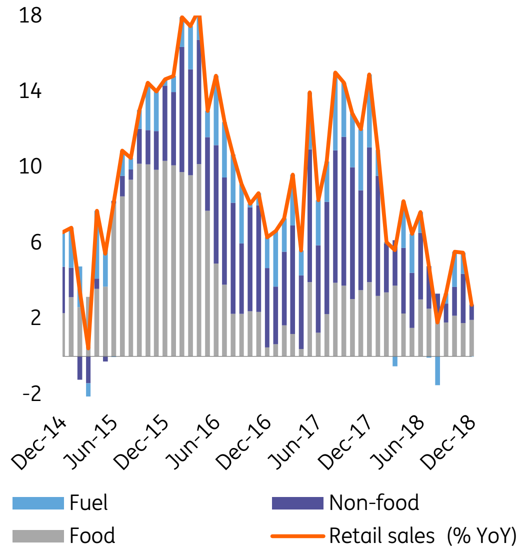


Solid wages to still keep things moving

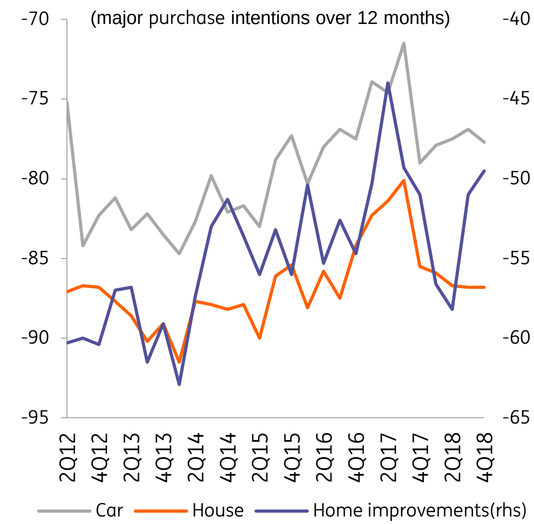
Salaries pushed higher by generous state wage policy



Retail sales softer but not in free fall



Consumers turning cautious on investment decisions



2-digit wage growth…

Due to minimum pay hikes, pay increases for state employees. Concerns about competitiveness in labour intensive sectors.

Shifting into lower gear…

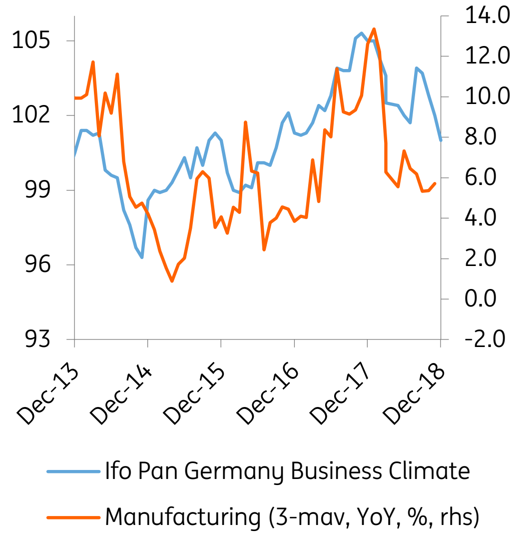
… on higher interest rates, weaker RON, uncertain outlook for taxes. All affected consumers' morale despite good job prospects.

Big ticket items…

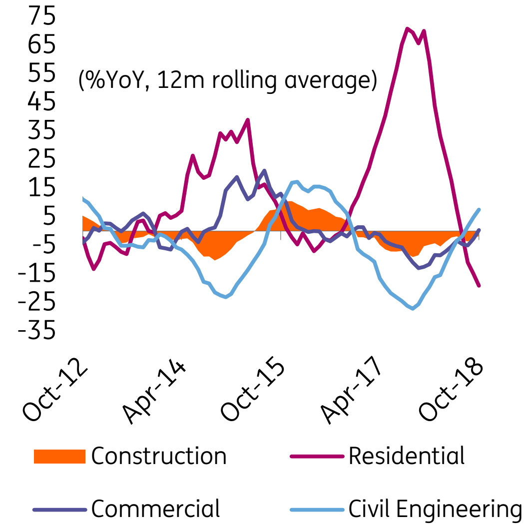
… just took a turn south in 4Q17 as the monetary policy transmission improved and could be underestimated (65% of lending in RON)

Supply side: industry driven by exports, residential take a nose dive on higher rates

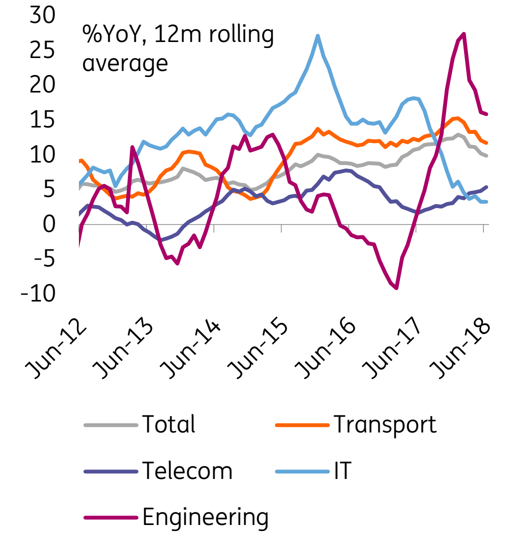
Ifo edging lower, Romania manufacturing follows



Public investments near all time low, at 2.5% of GDP



Cyclical or structural slowdown?



Ifo not doing well recently...
German economy starting to lose momentum on trade war, Brexit and emission norms. It could take until 2Q19 before a rebound takes place.

Cooling residential market...
... on higher interest rates. Public investments picking up a bit but with a low multiplier effect.

IT has reached its limits...
... as qualified labour force is limited. Transportation hinting at cyclical slowdown. Engineering pointing to investment pullback.

Domestic macro backdrop: summing up

- GDP: slower cruising speed. 2017 great, 2018 at potential, 2019 below
- Long term potential growth suffering from lack of structural reforms
- Consumer confidence softening despite (still) strong wage growth
- Retails sales growth switching into a lower gear
- Manufacturing outlook lower as well on weaker external demand
- Residential market in correction mode
- EU funds needed to boost investment
- Services are seeing less demand, though cyclical ones still in good shape
- 2.0-3.0% GDP growth for the next couple of years

Fiscal outlook

Kicking the can down the road

Ways to spend money according to M. Friedman

High concern for price

2. Spend your own money on somebody else (various gifts)

1. Spend your own money on yourself (family car)

Low concern for quality

High concern for quality

4. Spend somebody else's money on somebody else (government?)

3. Spend somebody else's money on yourself (expense account)

Low concern for price

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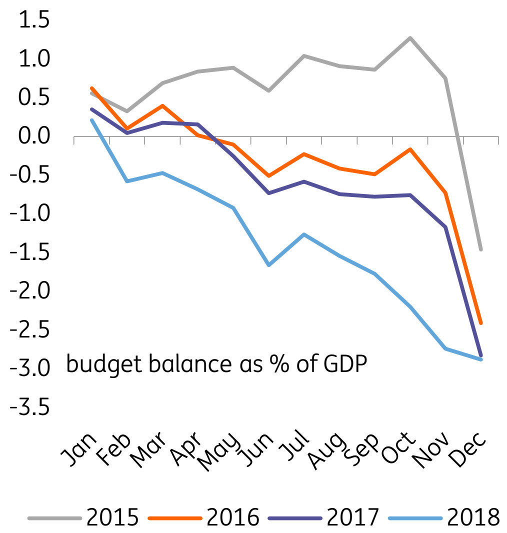
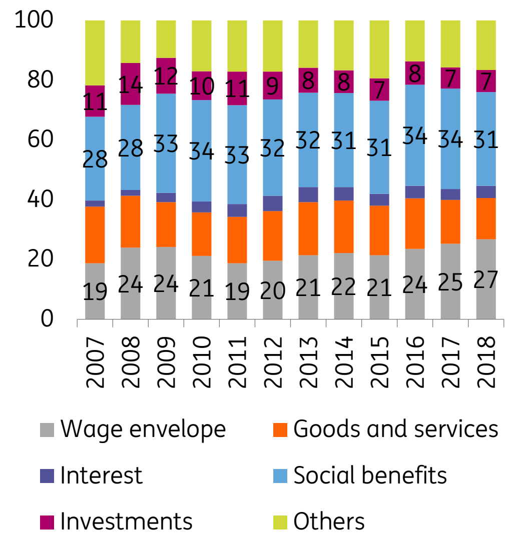
2018 budget execution: revenues in line, expenditures out of control

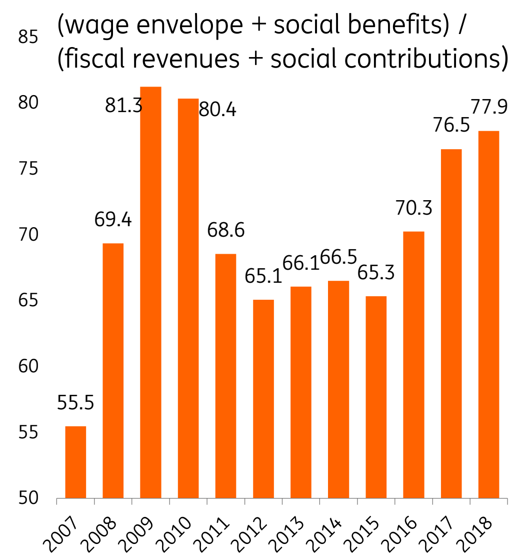
Budget execution pattern slightly different in 2018



Rigid budget spending at 58% of total spending



Wage envelope nears 80% of fiscal revenues



Fiscal gimmicks worked, so far…

Shift from public investments to wage envelope, excise duties, special dividends.

Investments cut

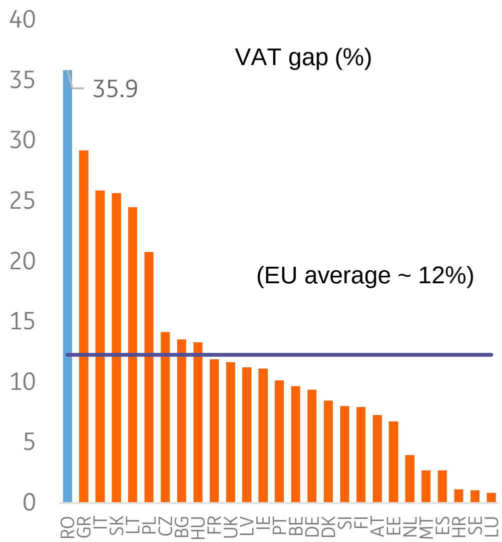
The composition of budget expenditures is pro-cyclical, unsustainable and represent a vulnerability in case of an economic downturn.

Higher taxes?

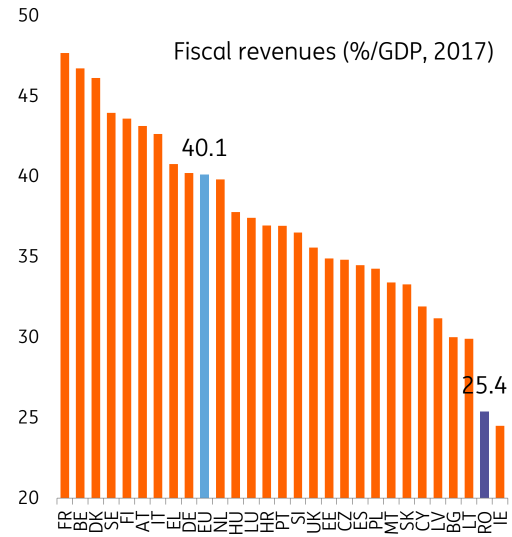
Hard to imagine another government cutting down wages in public sector and social benefits.

Medium-term fiscal outlook: a ticking bomb

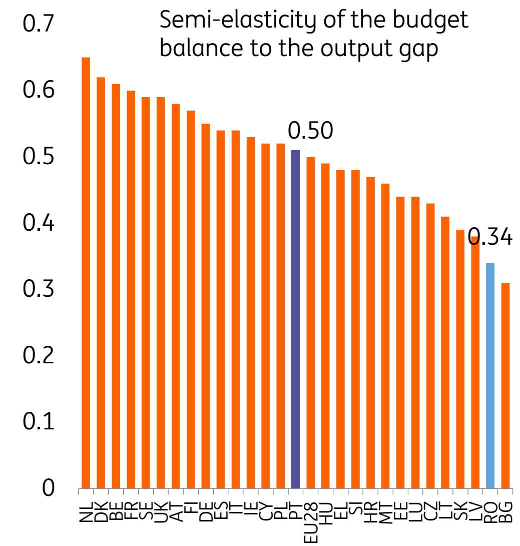
Largest VAT gap in Europe



Second lowest fiscal revenues as share of GDP



Lack of automatic stabilizers leads to discretionary policy



Untacked tax evasion

Low compliance rate, arrears from SOEs, WB program for ANAF declared off-track, large share of self-consumption in GDP.

Improving tax collection…

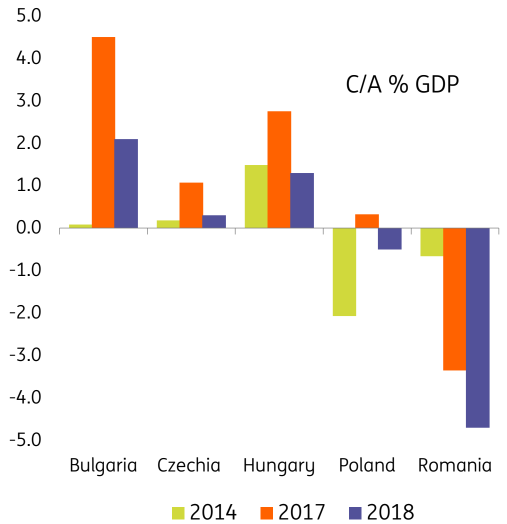
…remains illusive without structural reforms and upgrade of the IT system.

Limited room..

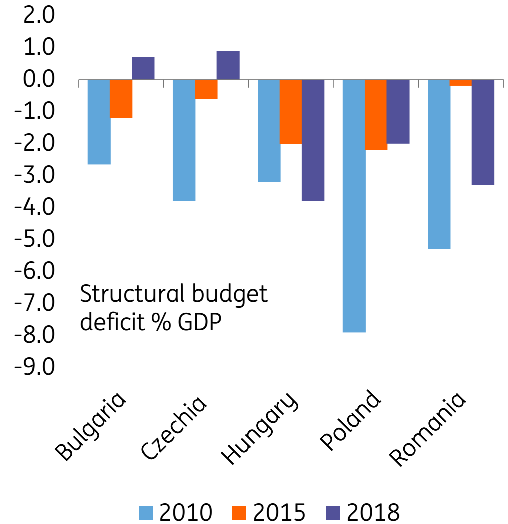
The budgetary semi-elasticity indicates by how much the budget balance changes as a ratio to GDP when the output gap increases by 1ppt.

Romania: much more exposed to headwinds. Twin deficits: under pressure.

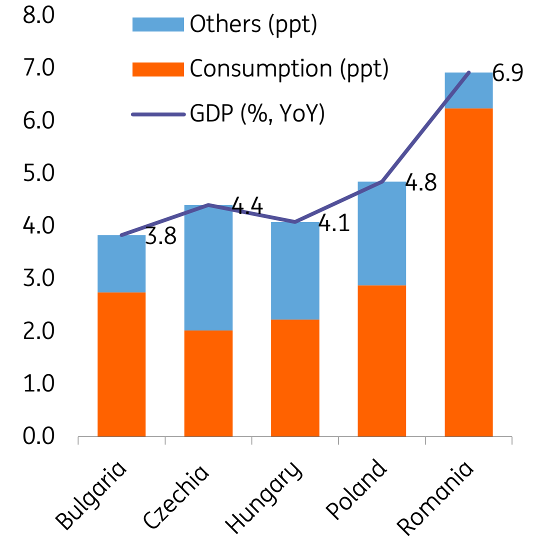
Only CEE country posting a widening C/A deficit.



Burning fiscal buffers during very good times



Unbalanced GDP growth. No improvement in potential.



Trade balance widening…

…resulted from ultra accommodative policy mix and unaddressed structural issues hampering competitiveness.

Fiscal consolidation reversed

Three consecutive years targeting 3.0% of GDP budget deficit. Most exposed in CEE to a rating downgrade when a downturn arrives.

Growth exposed to sentiment

Consumers more prudent despite better job prospects and higher savings. Political/geopolitical noise could affect the morale and derail the growth story.

Main fiscal measures adopted late 2018 and 2019 budget assumptions. Inflationist in short-run, contractionary over medium-term

Increase revenues

- Tax on bank financial assets linked to ROBOR. 1.2% at current ROBOR levels. Estimated revenue: RON4.5bn (0.45ppt of GDP)
- Lower fees and much higher capital requirements for private pension funds (pillar II). Revenues for a full year are around RON8bn (0.8ppt of GDP)
- 3% turnover tax for telecom sector and 2% turnover tax for utilities (gas, electricity, heating). Revenues expected RON1.5-2.0bn (0.15-0.2ppt of GDP)
- 5.5% real GDP growth assumption for 2019 and 3.8% rise in employment

Higher expenditure

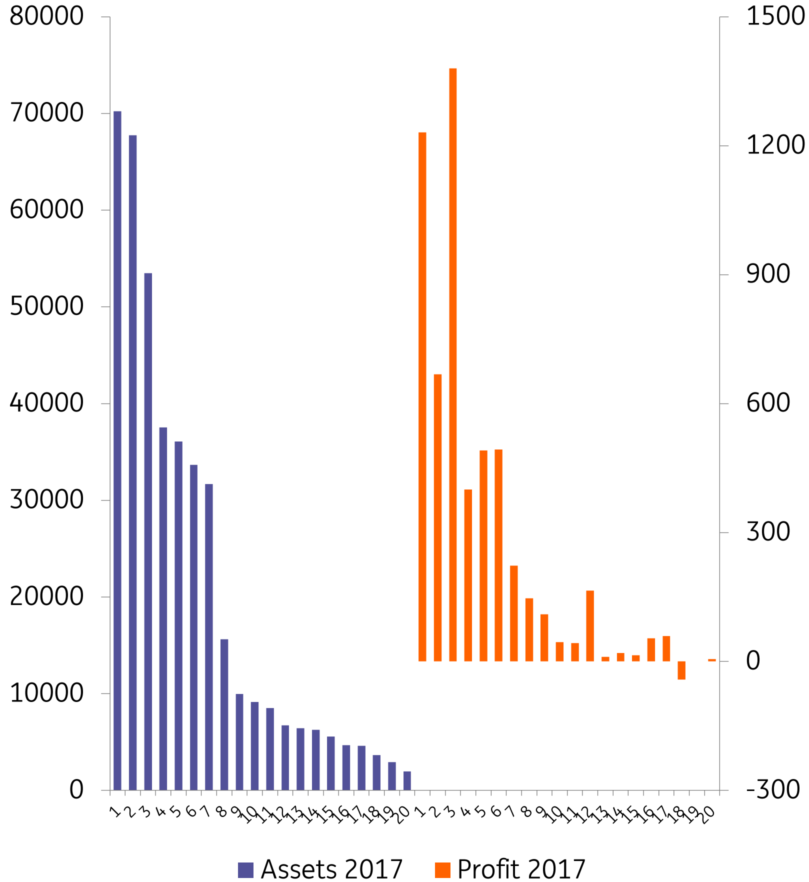
- Increase in pensions and public sector wages based on electoral promises. Estimated impact: RON17bn (1.7% of GDP)
- Set up a sovereign development and investment fund up to EUR10bn over 20 years. Estimated impact: n/a

Budget deficit target

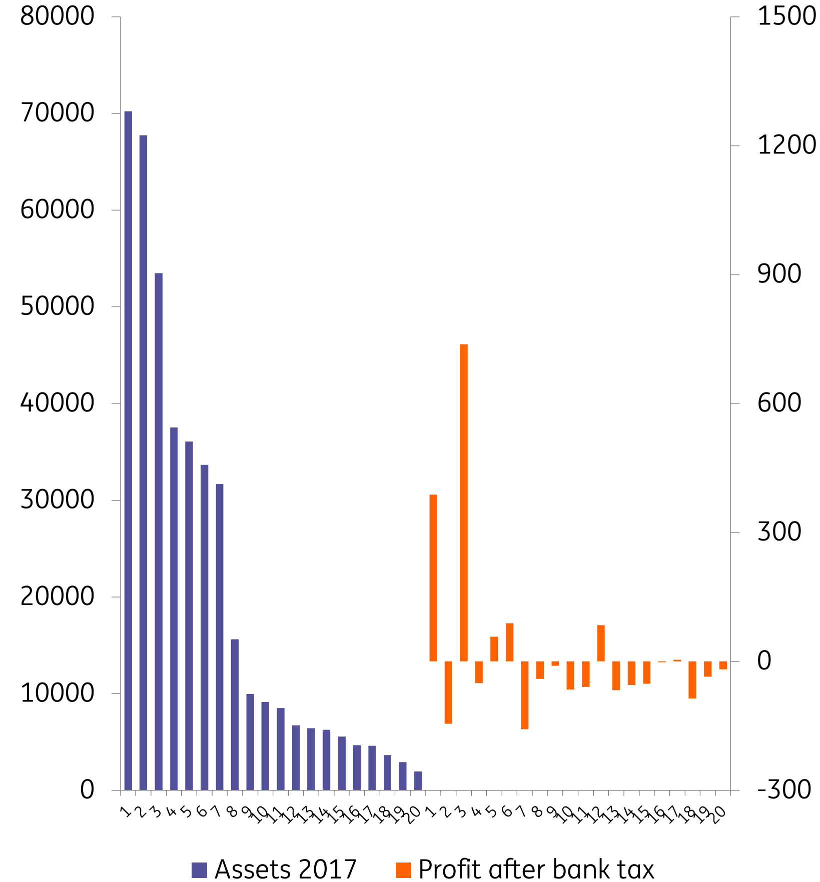
- **Below 3.0% of GDP (ambition for 2.76%)**

Tax on bank assets: a closer look

Banks: mostly profitable on lower credit risk. ROA: 1.74% in 2018, 0.44% 10 year average



Post bank tax: net loss for banking system. NBR: “look for bail-out public money”



Rating Outlook: pick your scenario

Agency	Upgrade Drivers	Downgrade Drivers
Moody's (12 Jul)	• Sustained improvement in the **fiscal and external metrics** • Higher **policy predictability and credibility** • Institutional effectiveness • **Structural reforms** (improving business environment and infrastructure gap)	• Persisting negative **institutional and fiscal** trends (rising susceptibility to event risk) • Rising **macroeconomic** balances • Further material deterioration in **balance of payments** and **international investment position**
S&P (1 Mar)	• Stabilisation of **institutional environment** • Sustained headway with budgetary consolidation (firmly downward trajectory of net government debt) • Strengthened **governance framework** (predictable and stable macroeconomic growth and government finances)	• Eroding **independence of key institutions** • **Policy reversals** (significant increase in general government deficits, debt and borrowing costs) • Re-emergence of **external imbalances** (widening current account deficit increasingly financed with debt)
Fitch (10 May)	• Reduced risks of macroeconomic instability and improved **macroeconomic policy** credibility • Implementation of **fiscal** consolidation (improving long-term public debt/GDP) • Sustained improvement in **external finances**	• Persistent high **fiscal** deficits (rapid increase in government debt/GDP) • Overheating **economy** or hard landing that undermines macroeconomic stability

Source: Moody's, S&P, Fitch, ING

Fiscal backdrop & outlook: summing up

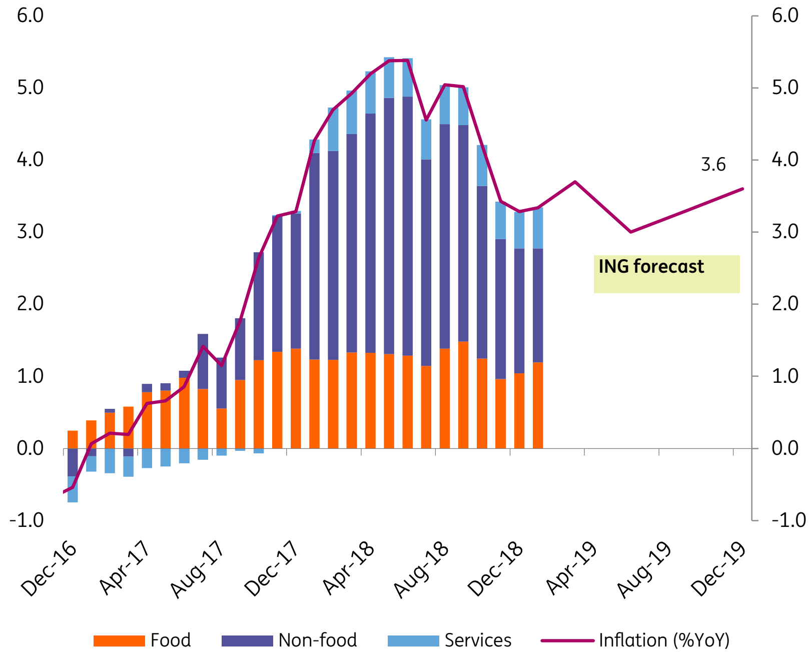
- Revenues in line with expectations, spending out of control
- Low fiscal revenues and tax base, poor tax collection, no reforms
- Ballooning rigid spending exposing debt metrics over medium term
- Lack of automatic stabilisers
- Fiscal policies to favour income redistribution from capital to labour
- Burning fiscal buffers. Debt to GDP was 12% ahead of the Great Recession

RON: interest rates & FX

NBR walking a fine line balancing FX and interest rates

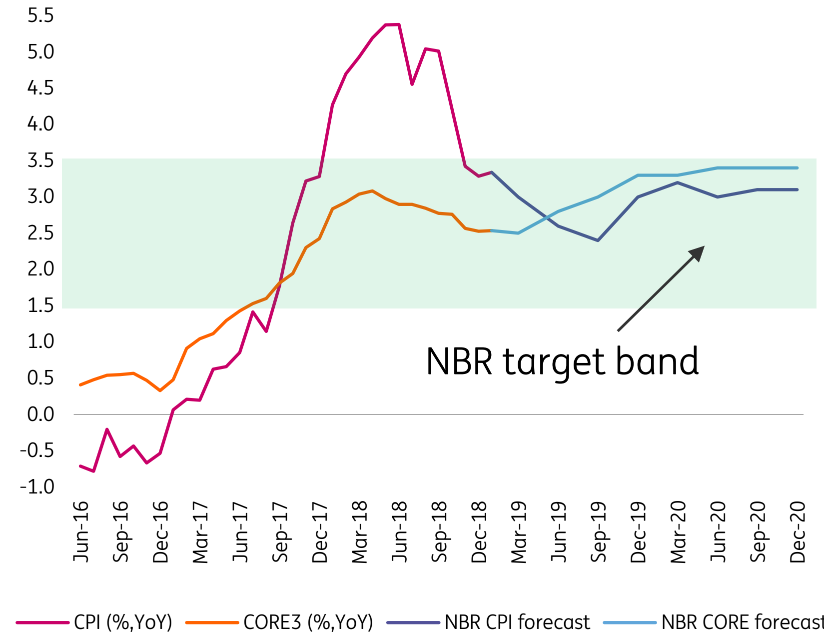
The era of very low inflation is over, but reflation is slow. Romania CPI is a special case…

Inflation profile looks more benign but mind the electoral years and NBR Board elections



Greatly helped by the drop in oil price towards the end of 2018, the central bank managed to bring inflation back within its 2.5%±1ppt target band.

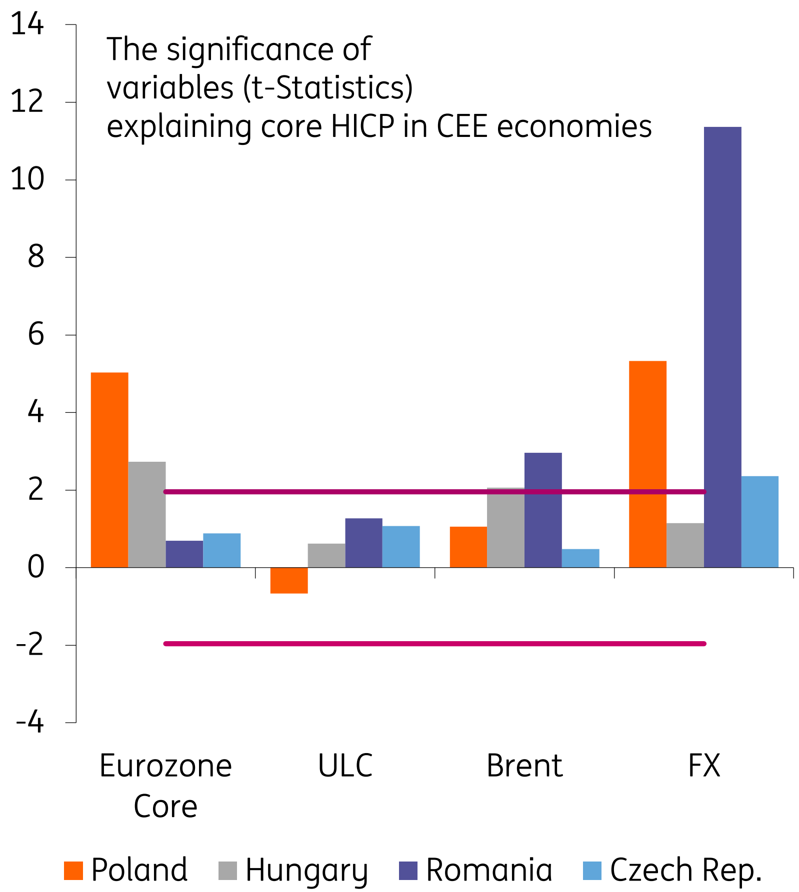
CORE3 inflation: inching higher, signaling possible currency weakness



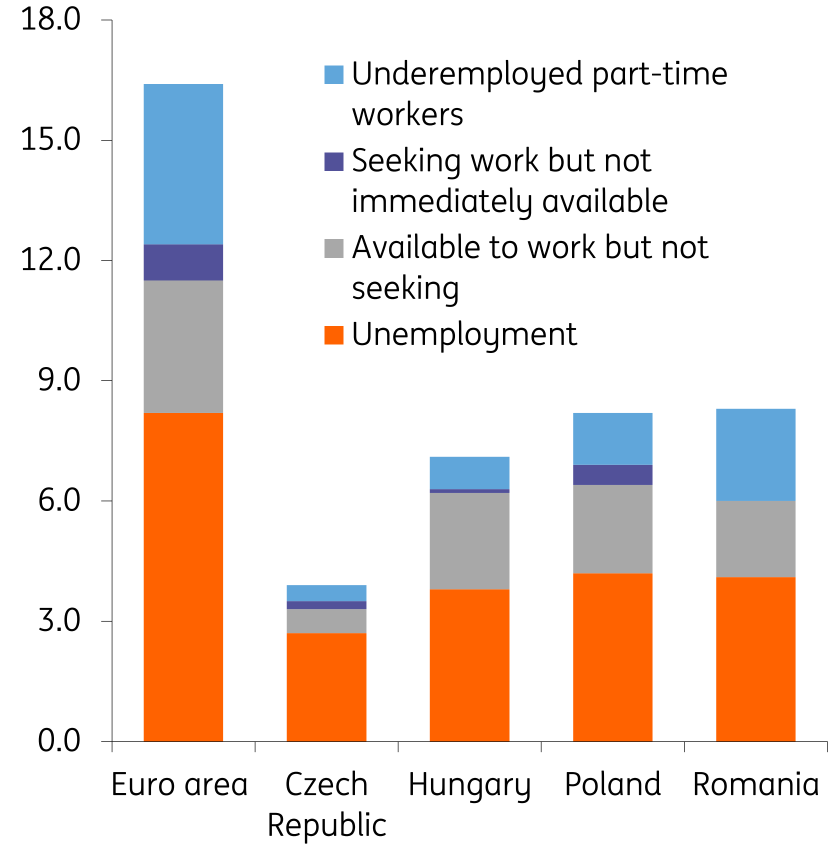
The NBR's forecasts see CORE inflation above the headline for the next two years. This could indicate more currency weakness embedded in NBR's scenario.

CE4: Hiding behind flat Phillips curves

Phillips curve broken across CEE; the strongest FX pass-through in Romania

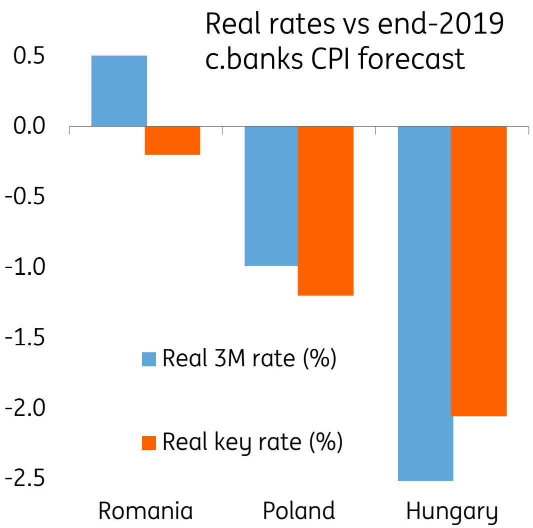


Significant untapped labour supply in Romania, but structural policies missing

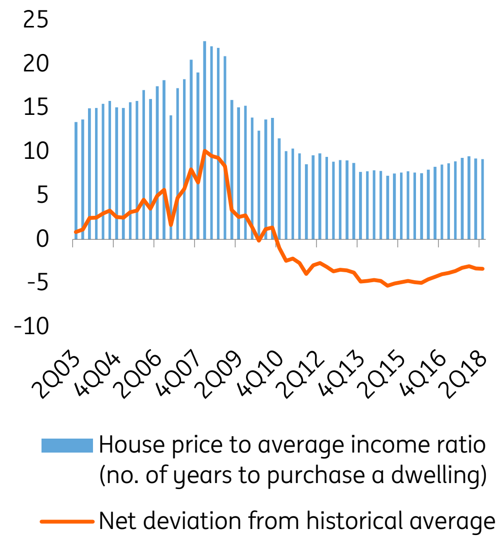


Massive tightening, assessment needed as transmission mechanism improved

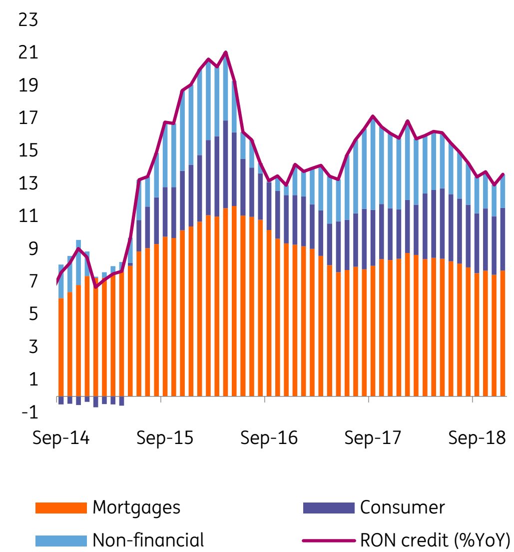
NBR acted swiftly to regain lost credibility



No compelling signs of an asset bubble



Lending still holding up



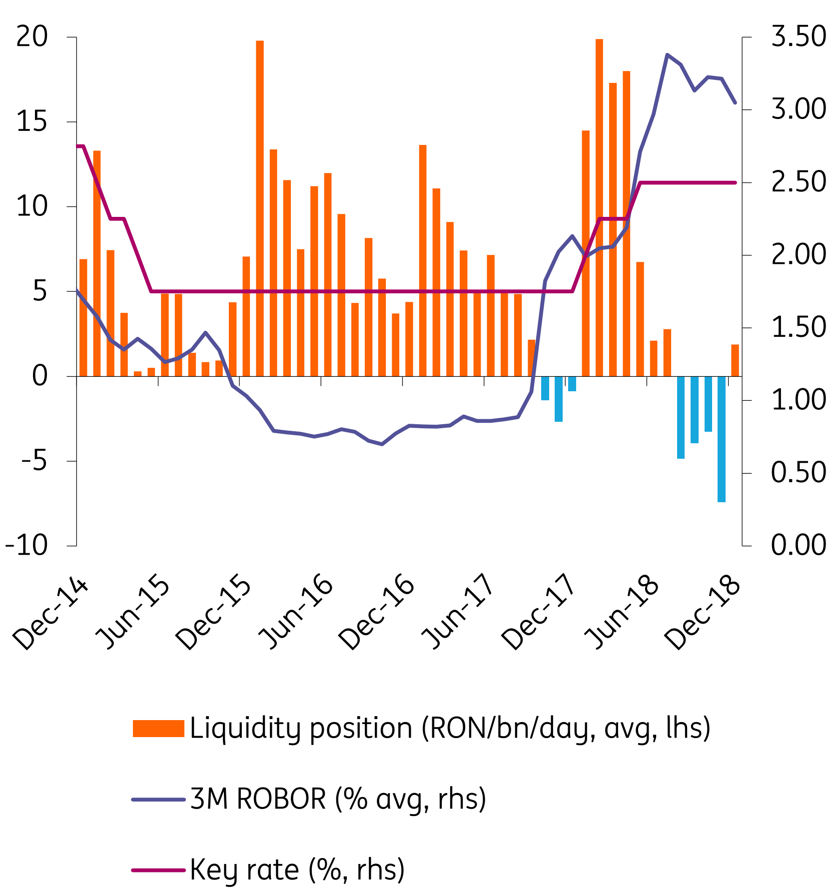
Over 200bps tightening…
…in less than one year – the cost to regain credibility. NBR policy was inconsistent and while verbally following NBP, it acted like NBH.

Mortgage lending evolution…
…supported the housing market, prices increased, but home affordability remains within historical average limits

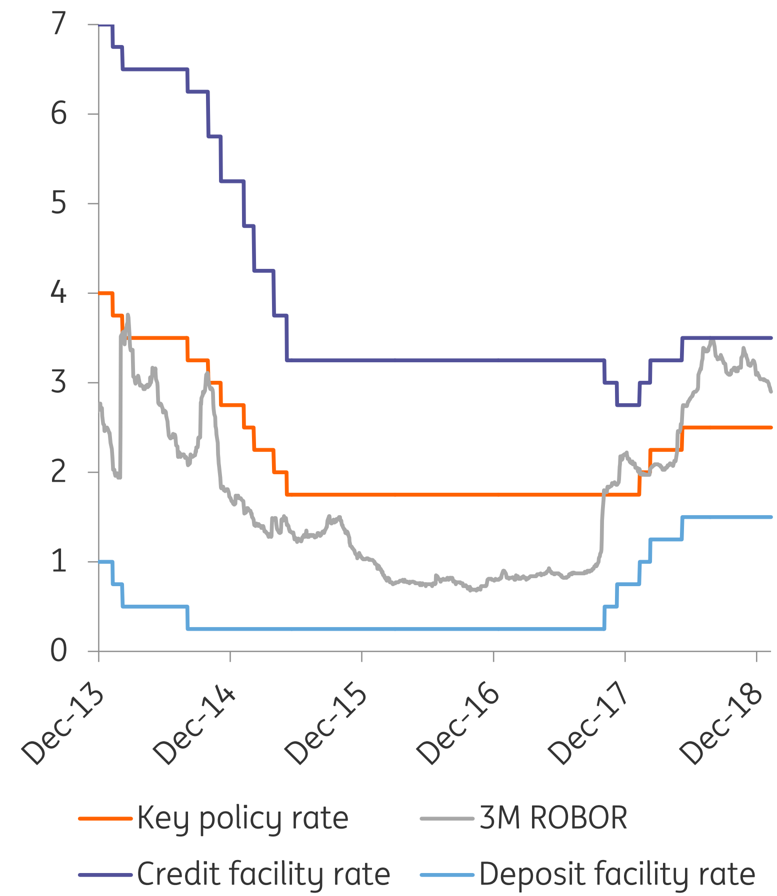
Credit-less recovery
Financial intermediation at 26.4% of GDP in 2017 from close to 40% in 2007. Macro-prudential measures aimed mainly at retail borrowers.

Liquidity management as the main policy tool

Liquidity squeeze: FX interventions, public debt pre-financing, state dividends

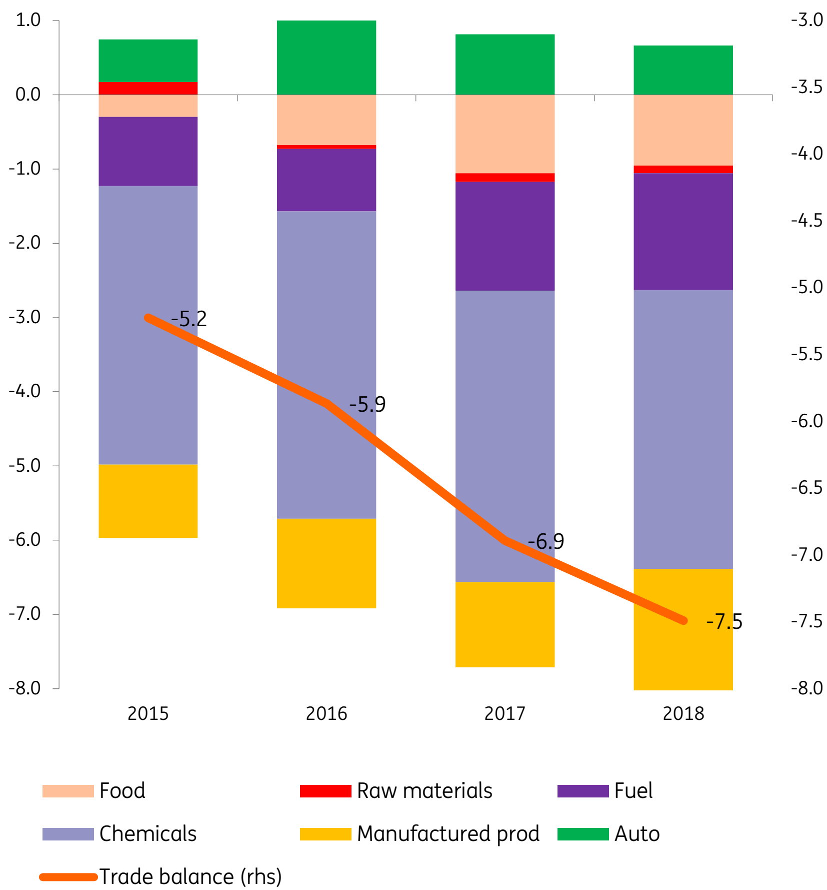


Front-loaded hikes with improved transmission ensures lower terminal rate

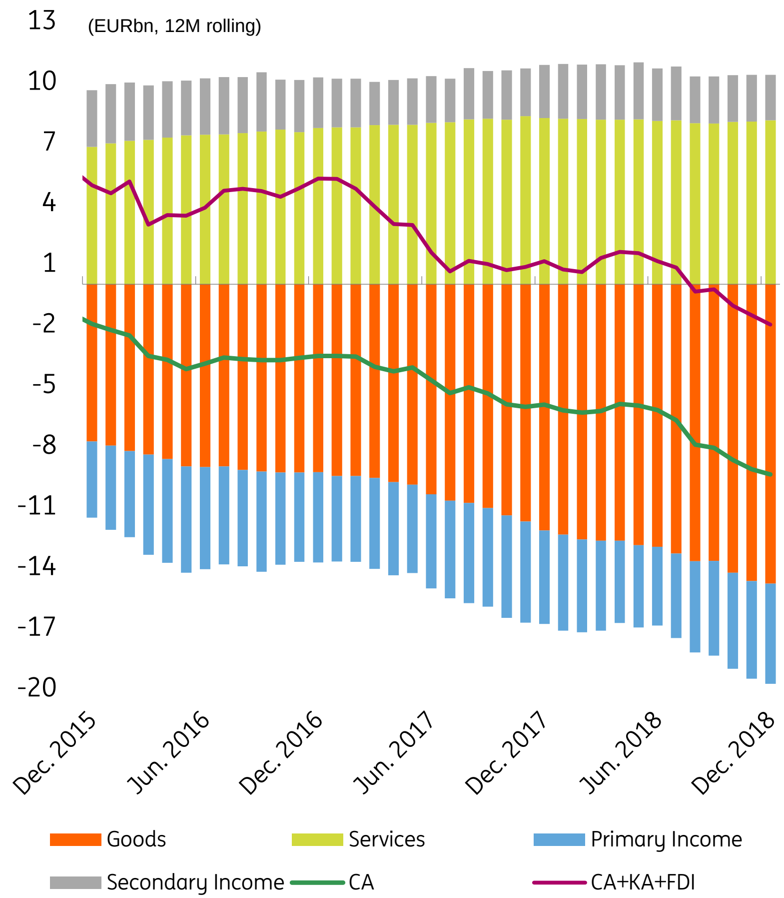


Deteriorating external picture

Trade gap widening driven by faster import growth. Auto sector cannot compensate

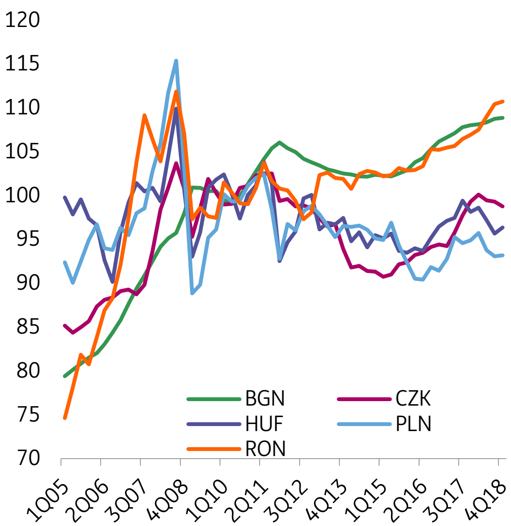


Services surplus not enough to cover the trade gap for goods

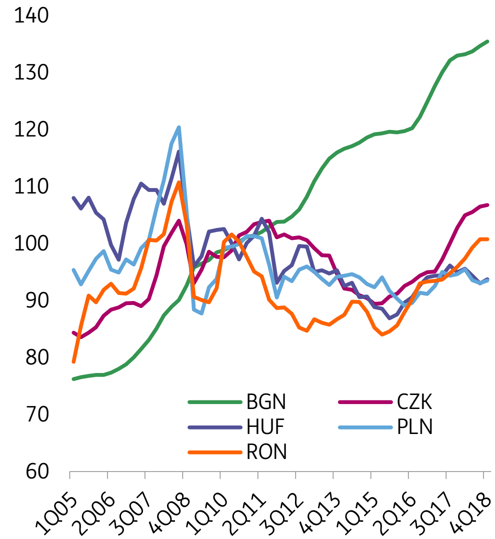


RON: expensive or cheap?

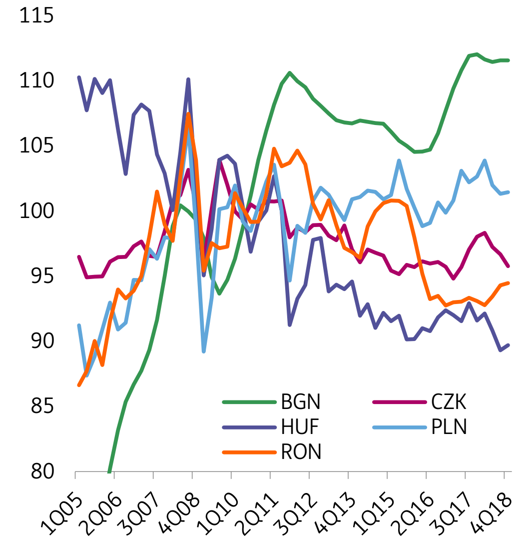
Real effective exchange rate (REER), GDP deflator



REER deflated by unit labour cost (ULC) for the economy



Real effective exchange rate, export prices deflated



High inflation differential
...leading to worries about RON overvaluation.

Increasing wages...
...erasing the competitiveness advantage, but not yet into overvaluation territory.

Export issues...
...RON a bit expensive relative to some peers, but export integrated global value chains is mitigating risks.

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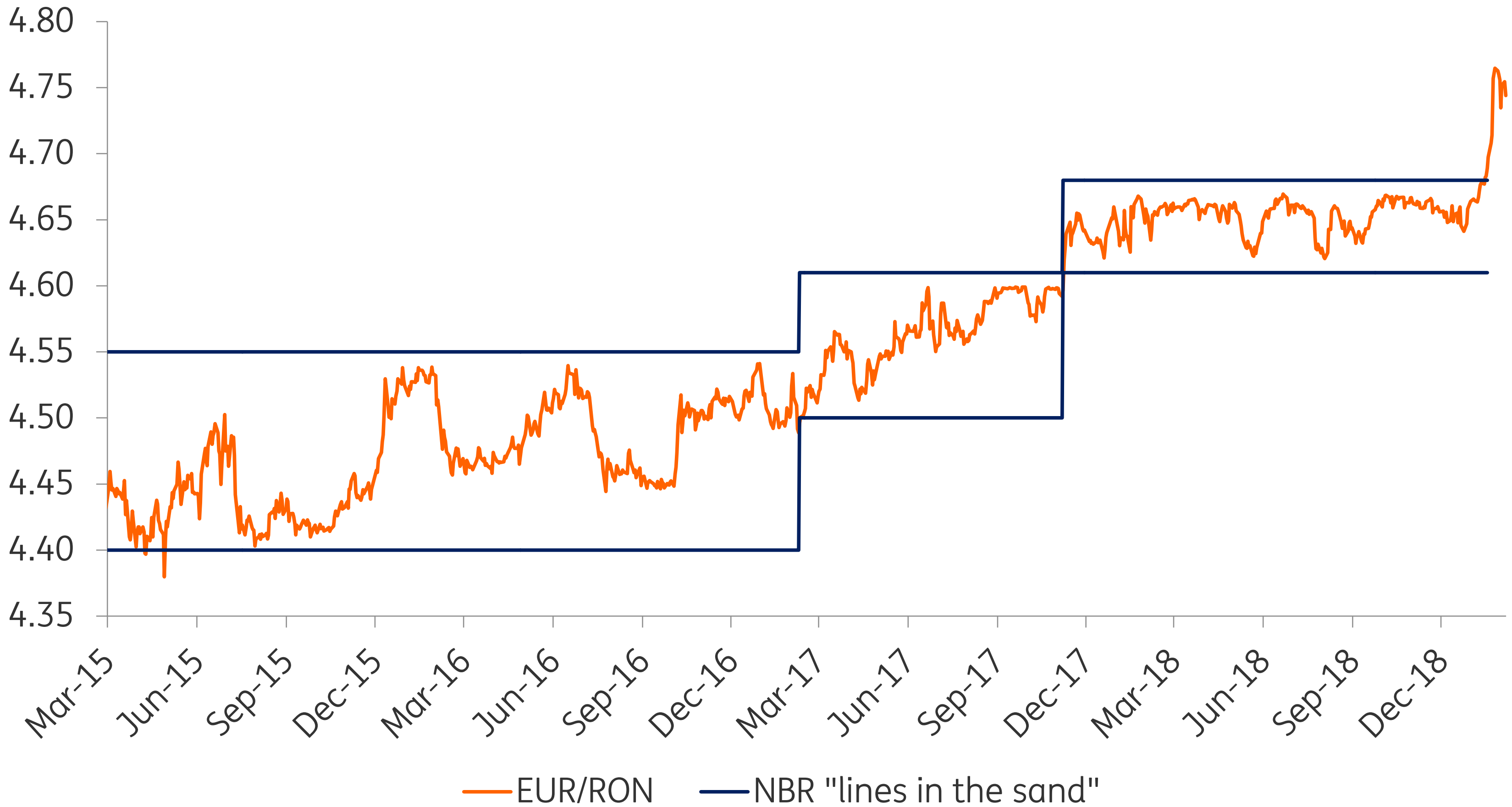
EUR/RON: The question is not if, but when the NBR comfort range will shift higher

EUR/RON heavily managed until now due to high FX pass-through (40%) to inflation, impact on inflation expectations and consumer confidence.



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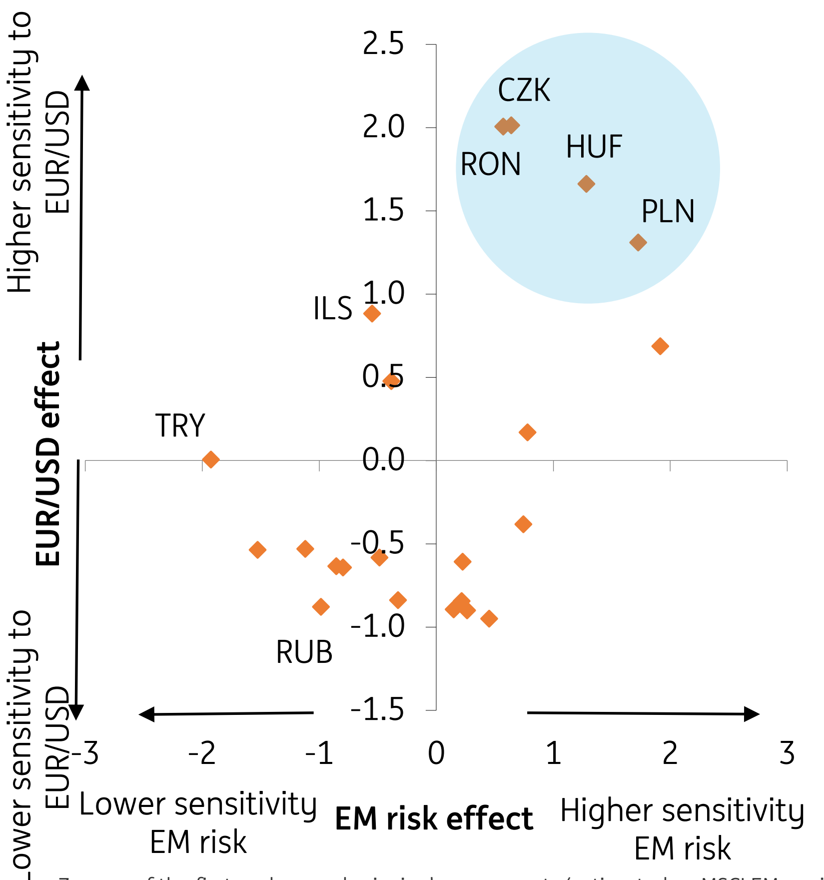
CE4 FX: in the 'wrong' quadrant in 1H19

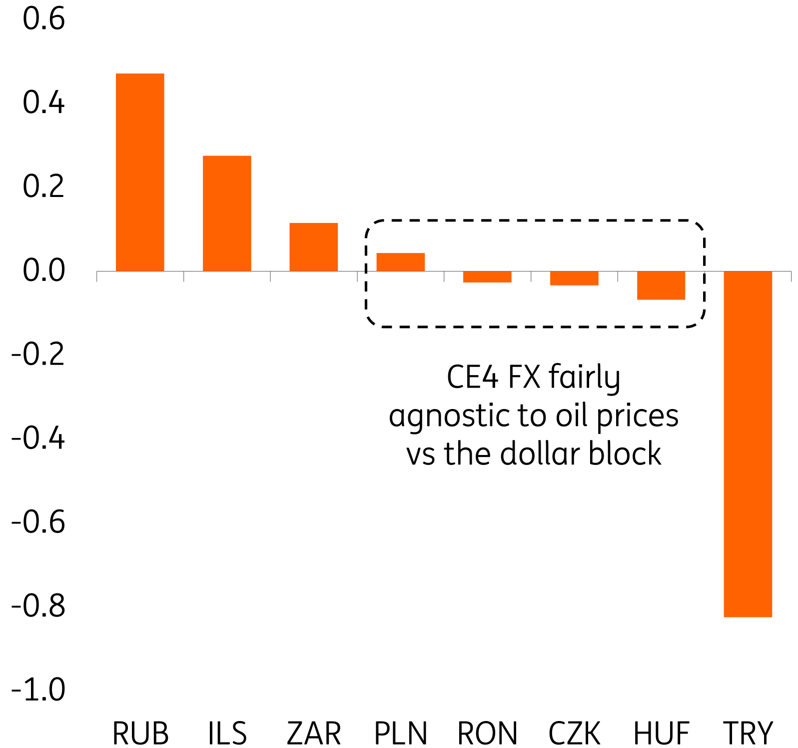
Levered to EUR/USD downside and precarious risk appetite



Z-score of the first and second principal components (estimated as MSCI EM equity index and EUR/USD, respectively) from our PCA analysis of drivers behind bilateral EM exchange rates vs USD

Oil matters only for the CEEMEA dollar block

PC3 (the third principal component) loadings to individual CEEMEA currencies vs USD. We identify PC3 as oil price.



Monetary backdrop & outlook: summing up

- **Rates outlook: Distorted by the fiscal dominance**

- NBR independence remains crucial for markets
- NBR walking a fine line balancing FX and interest rates
- Fiscally tightened credit conditions: NBR rate at 2.75% by year-end
- Weaker growth, flatter Phillips curve points to less tightening ahead

- **EUR/RON outlook: NBR to shift comfort range higher**

- Very high FX pass-through: 1ppt depreciation leads to 0.4ppt higher CPI
- Weaker fundamentals, relative overvaluation concerns
- Managed float, but political slippages might lead to RON weakness
- 3-4% RON depreciation is likely due to lower NBR flexibility on interventions

Main ING forecasts

	1Q17	2Q17	3Q17	4Q17E	2017	1Q18F	2Q18F	3Q18	4Q18F	2018	1Q19F	2Q19F	3Q19F	4Q19F	2019	2020
GDP (%YoY)	5.7	6.1	8.8	6.7	6.9	4.0	4.1	4.3	4.2	4.2	4.6	3.3	2.1	1.6	2.7	2.1
CPI (%YoY) *	0.2	0.9	1.8	3.3	1.3	5.0	5.4	5.0	3.2	4.6	3.7	3.0	3.3	3.6	3.6	3.3
Key rate (%)	1.75	1.75	1.75	1.75		2.25	2.50	2.50	2.50		2.50	2.50	2.50	2.50		
3M rate (%)	0.86	0.86	1.58	2.05		2.08	3.15	3.17	3.02		3.20	3.30	3.40	3.50		
10Y yield (%)	3.86	3.89	4.09	4.31		4.46	5.21	4.77	4.8		5.0	5.1	5.2	5.3		
EUR/RON	4.55	4.55	4.60	4.66		4.65	4.66	4.66	4.66		4.75	4.75	4.8	4.8	4.76	4.85
EUR/USD	1.07	1.14	1.18	1.20		1.23	1.17	1.16	1.14		1.12	1.12	1.13	1.15	1.13	1.18
USD/RON	4.27	3.98	3.89	3.88		3.78	3.99	4.02	4.07		4.24	4.24	4.25	4.17	4.23	4.10
Oil (US$/bbl)	53	48	58	67		70	79	83	54		65	68	69	72	69	74

Quarterly data – end of period, annual data - average

Thank you

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