Monthly Focus

¡Atención a la Revolución!

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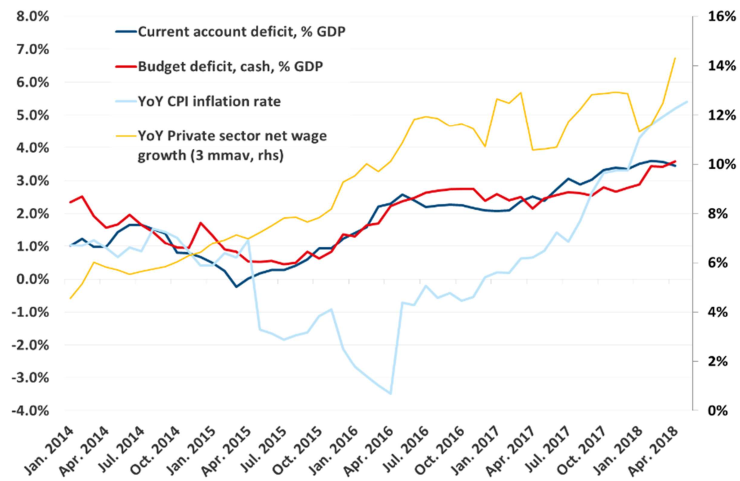
Financial markets are about two things: Return and Risk. Until recently, in a world where the low interest rate environment was the overarching theme, it was the Return, the so called “search for yield” which seemed to dominate the psyche of investors, not least because central banks gave the impression that they were willing to handle the downside market risks in order to fuel an economic recovery which has proved quite fragile in the aftermath of the Global Financial Crisis and of the Eurozone Sovereign Debt Crisis. Things may be changing, however, as a Revolution seems to unravel before our eyes: it’s the Revolution of Risk over Return.

As with most Revolutions, it’s almost impossible to perfectly identify where the first spark came from, especially that we have many candidates aligned. Looking at the US alone, we have President Donald Trump stepping up protectionist trade policies, the Federal Reserve stepping up the retrenchment from its extraordinary monetary stimulus through a combination of balance sheet reduction and accelerating interest rate hikes, a policy that comes in stark contrast to the Republican administration’s fiscal policy loosening implemented at the beginning of this year. In Europe, too, we have a potential reincarnation of the Core-Periphery dichotomy, sparked by Italy’s choice of a populist government, having fiscal expansion and Euro bashing at the core of its new economic program. Geopolitical ping-pong (the US-North Korean stand-off turned soap opera vs the Iran nuclear deal turned into a hand slap game) and rising political/policy uncertainty in some important Emerging Markets (Turkey, Argentina, Brasil) are also good candidates, at least for a supporting role in the unfolding drama.

But if we don’t know exactly where and when the spark was ignited, we know that the appreciation of the US dollar was clearly involved in the making of the fire which burned through most of the investor goodwill towards Emerging Markets since April. We also know that capital outflows from Emerging Markets, like wildfires, can take a life of their own even when the US dollar will stop depreciating. Finally, we Romanians should know that even if it remains behind the Great Money Wall erected by the ECB and the Great Ignorance Wall which we have ourselves built with our domestic policies in order to keep investors out, this fire has enough heat to make us sweat. It will perhaps not burn the house down, but it can definitely melt the icing on our consumption cake, if not fully transform it into a cake soup.

This is because we’re already quite hot. Even after being revised down and with a dismal first quarter, Romania’s GDP probably still remains in excess demand territory, as confirmed by the ongoing wage growth pressure and the continuously expanding current account deficit (see Chart 1). Then more recently we also have the hot weather, which can spell trouble for the agricultural sector. Already in May we have an upside surprise in case of food prices, which comes at a time when annual CPI inflation should have reached its peak (now at 5.4%, versus 5.2% expected). A hot and dry summer can add insult to injury: it can cause an output shock for agricultural products which will not only lift food prices and push inflation well beyond 6%, but it can also place an extra burden on GDP growth at a time when it is already down and flat (0.04% in 18Q1 over 17Q4). This is not yet our base scenario, but risks are mounting in that direction, such that inflation can end the year above and growth below our current projections of 3.7% and 4.1%, respectively. And beware, in a case of an agricultural output shock which is essentially a supply shock, a slowing GDP growth will not mean that excess demand is over and out. On the contrary, negative effects similar to the impact of excess demand will be present in the form of higher prices and increased pressure on the external deficit, as supply shortfall could be covered by rising food imports.

Chart 1. Growing imbalances supported by domestic demand expansion

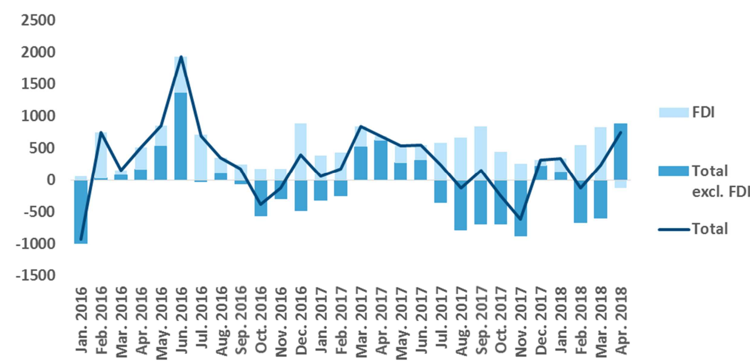


Source: National Statistics Institute

But let us come back to our Revolution of Risk Awareness. If this paradigm were to persist, foreign investors will definitely pay more and more attention to Romania’s toxic mix of double digit wage growth, high and rising inflation, relatively high and upwards pressured budget and current account deficits. It will not really matter that some of these indicators’ rise can prove temporary, as in the case of inflation, driven mostly by exogenous (energy + food price) shocks or the budget deficit, which through the magic of the Finance Minister can return within the target of 3% of GDP. Investors know the fire drill, when the fire bursts they rush for the exit door. They will only take time to go into the details afterwards, when things have cooled down.

I said “If the paradigm persists”, which doesn’t really square with the idea that we are already “living the Revolution”. So where are we exactly? According to the International Institute of Finance which tracks Emerging Market flows, when compared with recent past episodes of EM outflows following the Bernanke Taper Tantrum or the election of Donald Trump, outflows should probably have peaked by now and mid-May flows data actually showed their sharp reversal. However, the hawkish aftertaste of the Fed's recent hike and the escalation of the Trump-China import tariffs bidding war has soured the mood once more, while simultaneously reigniting the dollar's strengthening momentum. Meanwhile, the same IIF estimates that despite portfolio flows turning negative, other capital inflows have remained strong up until April and it continues to forecast overall capital flows into Emerging Markets will stay positive in the current and the next year. So it seems that investors and forecasters are struggling whether and to what extent to factor in the deteriorating global trade picture into their assessment of the economy which so far had been quite rosy. My take is that there is probably still ample room for pessimism to grow and for markets to spiral downwards.

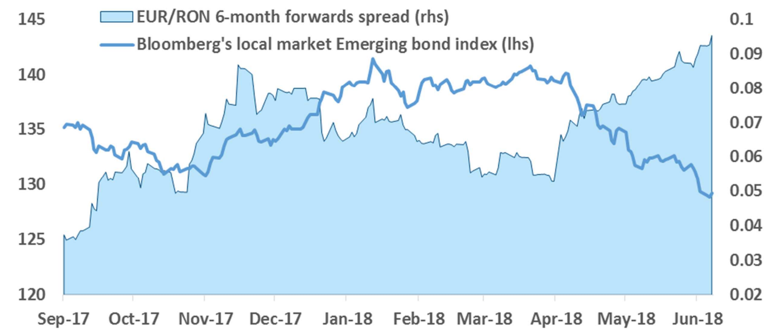
Chart 2. Adjusted financial account net inflows (mln EUR)*



Source: NBR, BCR Research calculations
Note: data is provisional and subject to revisions, especially in the case of the more recent months
** Memo: includes Errors & omissions, excludes NBR international reserves flows, flows to official creditors & primary market activity of the State Treasury)*

What should we then expect of Romanian authorities and how do the rising global risks change the picture for our economy? The immediate threat is that we get captured into the capital outflows tide, as mentioned above. Luckily enough, capital inflows into Romania's economy have not been stellar in the recent period, despite some pickup in the last 2 months, which means there isn't many of those investors to rush out the door. That being said, even meager outflows can cause an upset for a market without too much depth. In that sense, May's official reserves, combined with idiosyncratic EURRON downward movement amid falling Emerging Market indices and rising FX forward spreads suggests that the NBR may have already started the fight against such capital outflows via direct FX interventions, which according to our preliminary estimates could have been as high as 1 bln EUR. I will not discuss here whether such interventions were effective or what the motivation may have been (hopefully not fiscal dominance in the sense of NBR wanting to avoid producing too high a loss on its deposit sterilization operations), but rather on their effect, which was to provide further impetus to the excess liquidity drainage that the end-April tax payments probably induced. With the dissipating liquidity surplus and under the influence of the rising Fx swap implied interest rates, money market interest rates loosened from the anchor of the policy interest rate.

Chart 3. Emerging Market Bond index and FX Forward spread to EUR/RON spot exchange rate



Source: Bloomberg

If this is the tango pattern that foreign capital and the central bank are going to dance amid Emerging Market stress, then we will need to revise our somewhat benign interest rate outlook. For the time being, we are factoring out any impact of excess liquidity on market interest rates. This means we expect them to trade, on average, at the level of the NBR's policy interest rate. In the latter's case, we continue to expect only one more rate hike in August (with risks of a front load for the July's meeting), as Emerging Market stress must be factored against the slowing economic activity and the anticipated decline of the annual inflation rate starting with September (barring of course any new surprises in food or energy prices). Under these circumstances, the floating rate loans benchmark of 3M ROBOR will probably trade marginally higher than 3% by the year-end. With respect to the exchange rate, we maintain our call that EUR/RON continues to moderately weaken, reaching 4.70 by end-Q3 and 4.73 by year-end.

What about fiscal policy? If as we currently expect GDP growth rebounds to a full year 4.1%, driven by the high wage growth, then despite the undershoot of the 5.5% real GDP target the nominal budget coordinates may not cause a problem because the GDP deflator is likely to be much higher than projected by the Government. Furthermore, the strong wage growth can make up for the lost revenue from indirect taxes. Then with some tweaks and tricks here and there, the Ministry of Finance could perhaps make the 3% deficit happen. That is, however, priced in, especially with a yield curve as flat as it has last been 3 years ago. Risks of a deficit overshoot amid budget spending pressure, of political instability amid Justice laws' controversy, of deficit financing disruptions amid a pre-announced (but unknown) pension reform are not priced in. These risks are nevertheless very much real and getting them caught up in the Risk Awareness Revolution can cost us dearly. And if we get in the eye of the storm, the fine jokes or the proud speeches will not get us out. If anything, only credibility in the eye of the investors will, but that credibility is gained over time through active communication, transparency and policy consistency.

Macro Monitor

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Stronger economic activity in April

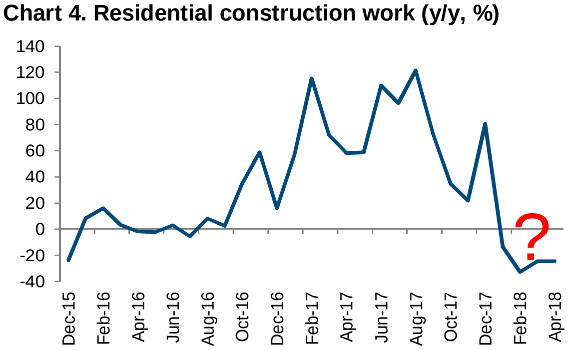
While economic activity gained speed in April compared with March, good monthly indicators alternated with disappointing ones, which makes us moderately optimistic for the next period. We see good chances that real GDP growth from 2Q18 will be above that of 1Q18, but at the same time we think that the full-year economic growth from 2018 will be below that seen in 2017.

Monthly indicators pertaining to household consumption like retail sales, motor vehicles sales and services for the population showed a stronger propensity of consumers to spend money and greater optimism. The growth composition for retail sales was different from the previous months and non-food items along with car fuels saw the strongest growth rates in y/y terms in April, close to 10% each. Sales of food products, beverages and tobacco were slower at around 3% y/y. Motor vehicles trade and services for the population also performed better in April, but we think that a series of one-offs stood behind this development – the launch of the annual governmental program for the renewal of the vehicle fleet and mild weather in April after freezes in March, which boosted the activity of hotels and restaurants.

Industrial production grew slowly in April (+3.6% y/y, unadjusted series), in line with its Eurozone counterpart. However, it seems that local industrial production has already reached a trough in March and the April data came in slightly better.

The evolution of the residential construction sector since the beginning of 2018 drew a lot of attention because the National Institute of Statistics has reported a string of weak monthly data, which sparked debates about market saturation, an incipient crisis or the potential existence of a stock of unsold new houses in the market.

Chart 4. Residential construction work (y/y, %)



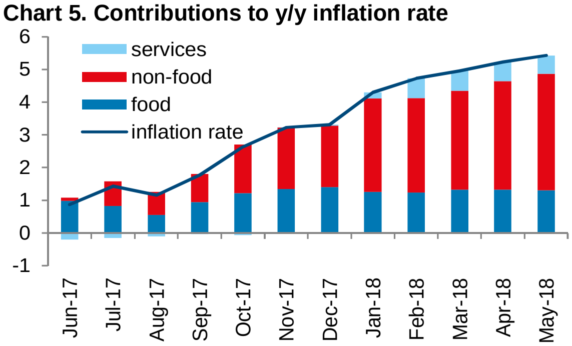
Source: National Statistics Institute

After explosive growth in 2017 (residential construction work was up 70% last year), the first four months of 2018 brought unexpectedly weak data. The residential construction sector fell by 24% y/y in April, while the cumulative decline from January – April was 25%. It seems that there is big gap between the officially reported data from the National Institute of Statistics (which is weak) and anecdotal evidence showing residential construction sites in almost every neighborhood in big cities, residential projects that are sold before the start of the construction work (or at least these are the plans of the developers) and transactions with land plots in full swing. We think that one explanation comes from the methodology employed by the National Institute of Statistics when computing monthly data about the volume of the construction work. These indicators refer to finished construction work by physical stage whose payment has been accepted by the beneficiary. As a result, there might be some periods with weak reported data, especially if one takes into consideration a long construction cycle for residential buildings. Secondly, we think that a correction was likely after unsustainably high growth rates in 2017, even though almost nobody, including us, was thinking about deep falls. Going forward, we think that the residential sector will recover to some extent and a crisis is not a plausible scenario in the absence of some unforeseeable events.

Inflation – at opposite ends of spectrum over past two years

Prices continued to rise in May, as annual inflation pushed through 5.4%, a level that was difficult to predict two years ago when Romania was coping with deflation (declines in consumer goods prices). Over the past four months, Romania featured the sharpest increases in consumer goods' prices in the European Union, only two years after it boasted the lowest inflation on the continent, which turned out to be short-lived. Whatever perspective one chooses to take – a local historical one or an EU country-based comparative one – inflation in Romania did a U-turn over the last two years, and this is not good.

Chart 5. Contributions to y/y inflation rate



Source: National Statistics Institute, BCR Research

What was the strongest driver that led inflation to top 5.4% in May? Non-food prices generated 2/3 of the headline inflation. More specifically, consumers had to reach deep into their pockets to pay for much costlier fuels, tobacco, electricity and natural gas. Higher food prices generated around 1/4 of the overall inflation growth of 5.4%, while the balance was covered by services (less than a tenth).

Was there a way to avoid some price increases? Yes, probably, but only predicated on a more suitable administered price liberalization calendar, especially for electricity and natural gas. The tables have turned and now natural gas and electricity prices are more or less at the same level as before the cuts carried out in 2016.

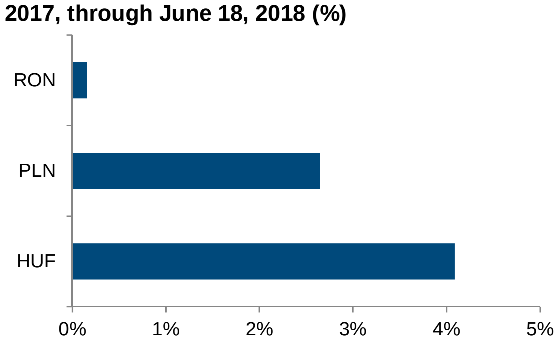
What's next? We think that inflation will hover between 3.5-5.5% until mid-2019, only to fall below 3% in the medium to long term. Inflation will thus re-enter the central bank target range, which in layman terms means more gradual price rises and less pressure on purchasing power.

RON – let's take a quick look around

Some say that one should not look too far to find one's own happiness. Since personal contentment stemming from the foreign exchange rate is rather complicated, it would not hurt to sometime take a look at the RON's regional peers.

As of the second week of June, the Hungarian forint has lost ground to the euro, amid a prevailing risk-off sentiment among investors. Between June 7 and 18, the forint shed 2%, the Polish zloty fell 1%, while the leu was down 0.3% against the European single currency. The external context played only a bit part in the grand scheme of things, with the main reason behind the forint's weakness being the highly accommodative monetary policy conducted by the Hungarian central bank (very low interest rates for an extended period of time), aimed at fostering economic growth. While this highly 'innovative' type of monetary policy has worked well in Hungary up until now, things seem to have changed, once the message sent by the forint was more than straightforward.

Chart 6. Leu, zloty and forint depreciation against euro, December 29, 2017, through June 18, 2018 (%)



Source: ECB, BCR Research

Coming back to Romania, repeated hikes in the key rate delivered in 2018, and the central bank's unflinching resolution to contain large swings of the FX rate, are now seen in a new light. Romania so far looks better positioned to face possible turmoil on the international markets generated by the still divergent monetary policies conducted by the Fed and ECB. Under these circumstances, the RON could follow a path spanning from stability to modest depreciation of 1-2% for the next 1-2 years.

Bond Monitor

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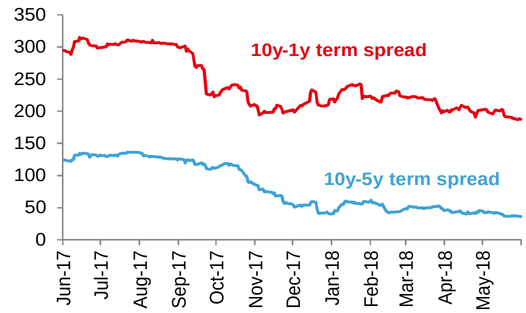
Local currency yields rose further over the past month, but the shape of the curve did not change too much, its extreme flatness at the long end still puzzling investors. While short-term yields were again impacted by tighter liquidity conditions in the market as a result of the NBR's deposit-taking operations and rose by 25-35bps in one month, long term yields were shaped by global developments and 10y yields rose by a minor 10bps. ECB's monetary policy decision was read by investors in a dovish note and long-term RON yields remained at low levels. The spread between the 10-year and 5-year bonds reached fresh multi-year lows at 37bps, while the spread between the 10-year and 1-year bonds fell to 190bps.

Chart 7. Term spread for RON bond yields (basis points)



Source: NBR, BCR Research

Looking at external developments, Romania looked better than Hungary on bond markets in the past two weeks when the neighboring country felt the negative effects of its ultra-loose monetary policy in a period of volatile capital flows. This shows how sudden foreign investors' mood can change, even if they seemed to accept in the past the unusual orientation of the Hungarian monetary policy. Going further, we see the long end of the RON yield curve as the most sensitive to a sell-off by foreign investors triggered by an external shock and compounded by local fiscal vulnerabilities. The Hungarian experience shows that local economic fundamentals do not even have to change in order to see a sell-off in the market in a matter of days, but perception and credibility are the most important. Credible and timely plans for fiscal consolidation are important for Romania at present after repeated calls by the EC in this respect, although one can argue that the correlation between fiscal policy and bond yields has been weak so far. But until then, the next risk event for local bonds will be the unveiling of technical details of the deep reform of the private pension system in the summer having in view that 60% of the assets are invested in government bonds.

Macro forecasts

	2011	2012	2013	2014	2015	2016	2017	2018f
Real economy								
GDP - %, y/y real change	1.1	0.6	3.5	3.1	4.0	4.8	6.9	4.1
GDP - RON bn	562	595	637	668	713	762	858	935
GDP per capita - EUR tsd	6.6	6.6	7.2	7.5	8.1	8.6	9.6	10.2
Households consumption - %, y/y	1.1	1.7	-2.4	4.4	5.7	7.4	9.0	5.2
Industrial production - % y/y	7.5	2.4	7.8	6.1	2.7	1.7	8.2	5.1
Retail sales - %, y/y	4.4	4.1	0.5	6.4	8.9	13.5	10.7	6.0
External sector								
Exports of goods & services - EUR bn.	48.8	49.8	57.3	61.9	65.8	70.2	77.9	83.0
Imports of goods & services - EUR bn.	56.5	56.6	58.4	62.6	66.7	71.8	81.9	88.4
Balance of goods & services - % of GDP	-5.5	-4.8	-0.5	-0.3	-0.6	-0.9	-2.2	-2.7
C/A balance - % of GDP	-4.7	-4.5	-0.8	-0.5	-1.2	-2.1	-3.4	-4.0
Prices								
CPI - y/y (%)	3.1	5.0	1.6	0.8	-0.9	-0.5	3.3	3.7
CPI - average (%)	5.8	3.3	4.0	1.1	-0.6	-1.5	1.3	4.7
Labour market								
Unemployment rate - %	7.2	6.8	7.1	6.8	6.8	5.9	4.9	4.6
Net wages - RON	1,444	1,507	1,579	1,697	1,859	2,046	2,336	2,626
Net wages - %, real	-1.9	1.0	0.7	6.3	10.2	11.7	12.7	7.4
Public sector								
Fiscal deficit - % of GDP (Eurostat)	-5.4	-3.7	-2.1	-1.4	-0.8	-3.0	-2.9	-3.4
Public debt - % of GDP (Eurostat)	34.0	36.9	37.5	39.1	37.7	37.4	35.0	34.9
Interest rates								
Monetary policy rate, eop	6.00	5.25	4.00	2.75	1.75	1.75	1.75	2.75
ROBOR 3M - %, avg	6.1	5.3	4.2	2.5	1.3	0.8	1.2	2.4
10y yields, %, avg	7.4	6.7	5.3	4.6	3.5	3.3	3.9	4.8
FX rate								
EUR/RON eop	4.32	4.43	4.48	4.48	4.52	4.54	4.66	4.73

Source: Central bank, Eurostat, NIS, BCR Research

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