

Monthly Focus

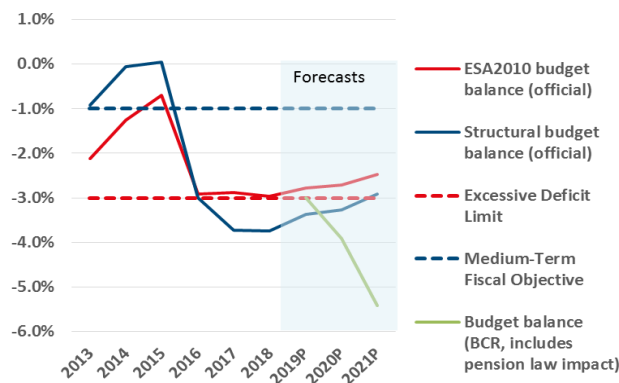
Let's call the duck, a duck

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It's actually a sitting duck and it refers to **Romania's fiscal stance**, which is at risk of being significantly derailed from its short-term targets, after having breached its medium-term objective since 2016. Ourselves as well as the larger local macro analyst community, along with the European Commission, the Fiscal Council and Romania's central bank have repeatedly warned about Romania's fiscal policy being pro-cyclical and hence prone to risks of falling in the Excessive Deficit pit (i.e. breaching the 3% budget deficit ceiling) should the economic cycle turn, but the recent events and current circumstances are such that an EDP accident has for us become part of the baseline scenario for the next 2 years. There are several factors at play in this scenario, most of which we would have played down as general risks were not for the heavy electoral calendar that lies ahead of us, which makes it considerably less likely that fiscal adjustment measures will be taken.

That is a problem, especially in the context of the recently adopted public pensions law, which envisages a heavy social spending bill already in the next 2 years.

Chart 1: General consolidated budget deficit estimates vs. target in absence of compensatory measures (ESA2010 terms, % GDP)



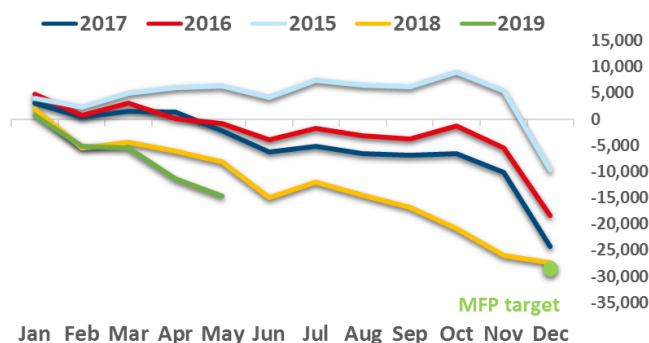
Source: Ministry of Finance, Govt. Fiscal-Budgetary strategy, BCR Research

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As seen in Chart 1, we envisage that, without any financing measures being taken by the government, only the pension point increases enshrined by the pension law should lead to a budget deficit of 4.0% of GDP in 2020 and 5.4% of GDP in 2021. This is even before accounting for likely increases in the number of pensioners and before taking account of the changing methodology for calculating public pensions, which according to authorities' claims, should lead to more generous retirement benefits.

While the pension law seems like the big fiscal elephant in the room, it is not the only worry in our cards. The current budget execution is already challenging, even before getting into the pensions issue.

Chart 2: General consolidated budget execution in the current and previous 4 years (cash terms, mn RON)



Source: Ministry of Finance

As seen in Chart 2, the January-to-May budget execution numbers look worse those in the last year in cash terms, despite the target deficit being broadly similar to that in 2018. One might argue that, in accrual terms, the deficit may look better, but the accrual numbers recently published by Eurostat for the first quarter indicate that on a rolling four-quarter basis, Romania's budget deficit has already exceeded 3% of GDP by 0.3%, for the first time since 2013Q2. Despite the core problem being the high current expenditures, in more recent quarters, the deterioration of the rolling deficit has come on the back of increasing gross investments from 2% to 3% of GDP and despite an increase of current revenues as % of GDP. While this may sound like good news, we actually think that it highlights some further risks.

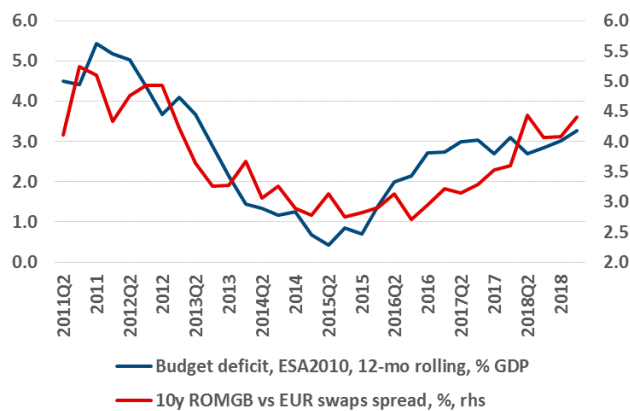
On the one hand, the improvement in current revenues is almost entirely due to increases in social contributions, which are further linked to rising wages. The latter are the reflection of, on the one hand, minimum wage and public sector wage increases and, on the other hand, of the tight labor market conditions putting pressure on competitive private sector wages. The former are unlikely to rise looking forward as fast as they did in the last 5 years (when they virtually doubled in nominal terms), especially as the bulk of the increases due to the public sector wage law are behind us. The latter will continue to be prominent, given the shortage in the labor force, but they can only be sustained for as long as economic growth has a strong momentum. For the manufacturing industry, this is already starting to become a challenge, especially as

Romania starts feeling the chilly wind coming from Western Europe (see below, in the Macro Monitor section). Further weakness in our trading partners' economic momentum is likely to challenge a fast rising local wage growth model, especially given Romania's fast-rising external trade deficit. Our forecast indeed indicates both slower economic growth and slower wage growth in 2020-2021, coming from both slower Eurozone growth (especially given the below consensus Erste Group Research expectations of 1.0% in 2020) and slower consumption dynamics, which could already become apparent as of Q3 of this year. All this means that fiscal revenue growth coming solely on the back of fiscal base expansion will be hard to come by if no reforms are undertaken.

The other seemingly positive development is related to public investment growth, which especially accelerated in 2018Q4 and more recently in 2019Q2. While rising public investments are desirable in principle, if we look at least at the 2019 vs. 2018 figures, we see that the biggest rise comes from the investments financed from local administration budgets (which grew by 50% in the first 5 months of 2019 vs. the similar period of 2018, compared with investments from the central administration, which were down by 15%). That detail may mean nothing, if it were not for Romania's poor track record at keeping local administrations' spending at bay and especially if it were not for the approaching local elections in spring of 2020, which will only increase spending pressure from local politicians. Combine that with the more fragmented political landscape after the first round of elections we had in May 2019 and I hope you agree with me that enacting a tough control on local administrations' spending will be quite a challenge for the current central administration.

As I mentioned before, Romania's fiscal woes are not necessarily new and it would seem that so far investors did not really pay attention, or at least they did not pay attention with their pockets, as the cost of local debt has not risen and is in fact lower than 1 year ago (by approximately 50 bps for the 10-year tenor). Remember, however, the "mirage of the fortress": Romanian bonds are lower in yield today, but to a much lesser extent than Eurozone bonds. In fact, the spread to EUR swaps of local currency paper, which is often assimilated with the local risk premium requested by investors, has been rising almost steadily since 2016, as seen in Chart 3. By coincidence or not, Romania's fiscal balance has been deteriorating over the same period. This suggests that there is a price being paid for the fiscal risks we have taken, but also that the return aspect seems to prevail in investors' minds over the fear from risk. God forbid were this trade-off to be reconsidered, as that would indeed put local assets in the line of fire. While this is not our baseline scenario, due to the easy global monetary policy environment, it is important to highlight once more, at the twelfth hour, that there is no substitute for fiscal responsibility to earn the respect of the markets for a country. The financial game is a game of trust: it takes one bad policy measure to squander it, but it may take many painful years of fiscal adjustments to earn it back.

Chart 3: Budget deficit and Romanian government bond spread



Source: Bloomberg, Eurostat

Macro Monitor

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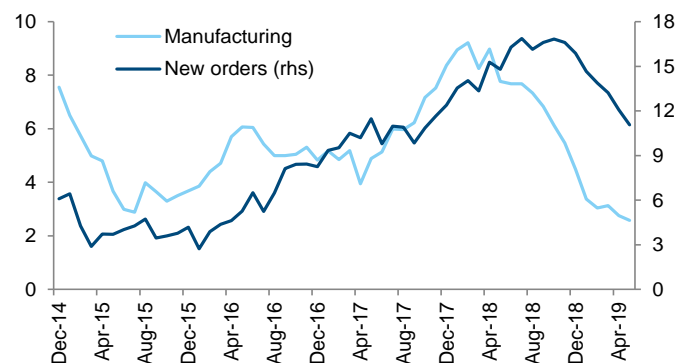
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Weak industrial production

Industrial production continued its seesaw movement in May and came very close to zero (+0.2% y/y according to unadjusted data). Manufacturing, which accounts for 80% of industrial production, and is strongly linked to external demand from the Eurozone was negative, at -0.3% y/y.

Chart 4: Manufacturing and new orders in manufacturing (12-month moving average, %)



Source: NIS, BCR Research

Most sectors continued to suffer in May, like industries exposed to a rising minimum wage per economy, which saw their price competitiveness further eroded (manufacturers of clothing, textiles, leather). Further negative impact came from weak external demand, with industries like machinery and equipment in negative territory. Among the few bright spots, manufacturers of motor vehicles and manufacturers of other transport means increased in May, external demand being a positive driving factor here, besides an increase in local

production capacities in some cases.

Present trends for local manufacturing are among the weakest in CEE, pointing towards local competitiveness issues besides weak foreign demand explained by the European business cycle. A widening of the C/A deficit, which goes hand in hand with a suboptimal structure of real GDP growth, is a direct consequence of poor industrial production.

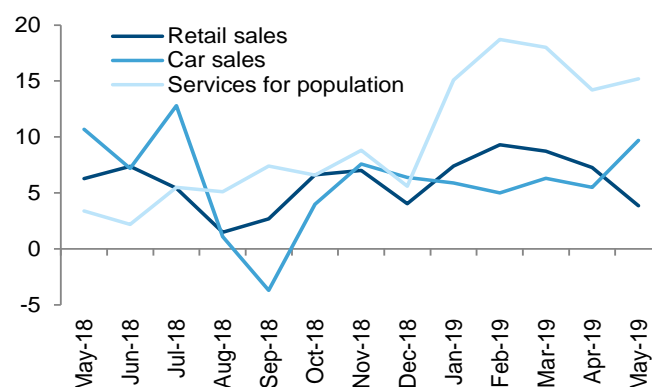
Private consumption at crossroads

Signals received from indicators in the sphere of household consumption are mixed, with a deceleration of retail sales in April and May, but strong services to the population, car sales and consumer confidence.

Besides hard and soft monthly data related to consumption, the announcement of a series of soft fiscal consolidation measures on the occasion of the budget rectification could affect consumer optimism. Details are vague at the time of writing (taxation of pensions / special pensions above a certain threshold, possibly RON 10,000 per month, and a reduction of some social benefits received by students). With the budget deficit under intense pressure from personnel and social expenditures, it is possible that future increases in pensions would be partially funded through a relocation of some categories of budgetary items, implying winners and losers from this strategy.

Coming back to May data, retail sales increased by 3.9% y/y, half the growth rate from previous months, due to falling sales of car fuels. Turnover of companies in hotels and restaurants was very strong in May at 22.2% y/y, similar to previous months, but we suspect that part of the growth was induced by a reduction of the grey market for tourism after a government decision to give holiday vouchers to public employees, a decision which was also followed by a number of private companies.

Chart 5: Retail sales, car sales and services for population (y/y, %)



Source: NIS, BCR Research

Going further, we think that consumption will fare pretty well in 2019, largely helped by good results from 1Q19, but a gradual slowdown could set in at the end of 2019 / beginning of 2020, affecting full-year growth of household consumption next year.

Divergent trends between headline and core inflation

The inflation rate decreased to 3.8% y/y in June from 4.1% y/y in May. In m/m terms, consumer prices fell by 0.2% after positive trends seen for a series of volatile prices.

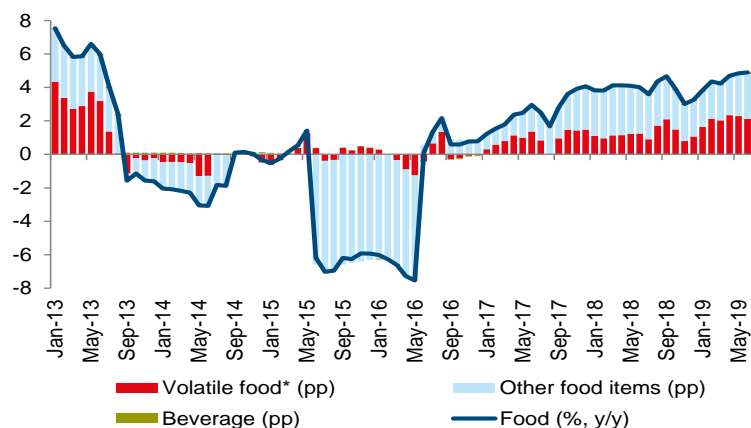
June brought a change in the evolution of actual inflation vs. market expectations, since after five months with actual prints above analysts' forecasts, in June inflation surprised to the downside. The market consensus (Reuters poll) was 3.9% y/y, while our forecast was also 3.9%.

The price of food products fell by 0.5% m/m in the first summer month due to cheaper vegetables and eggs. On the other hand, the price of meat continued to grow rapidly in June, a trend which was also seen in other European markets in recent months. Non-food items were cheaper in June (-0.2% m/m) helped by a decline in Brent oil on global markets which translated into lower car fuels price. Services increased by 0.2% m/m.

Core inflation went up to 3.3% y/y in June (May: 3.2% y/y) in a sign that basic inflationary pressures are still present in the economy and casting doubts on a clear disinflation process in the next months.

We foresee an inflation rate of 4% y/y in December 2019. In the short-term, inflationary pressures will ease to some extent for the volatile and administered component of the inflation rate (cheaper fruits and vegetables in summer months, a cut in the price of natural gas in July), but core inflation is likely to remain high (between 3.5% and 4% in 2H19), which calls for a prudent monetary policy.

Chart 6: Inflation for food products by categories (contributions to y/y rate, pp)



Source: NIS, BCR Research

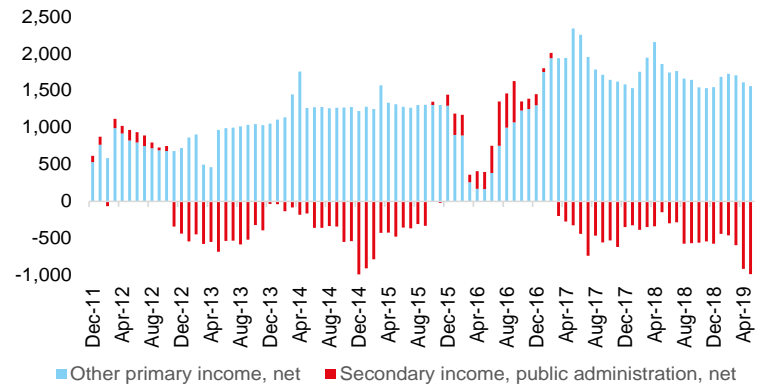
Note: *Volatile food denotes vegetables, fruits and eggs

C/A deficit under pressure from small inflows of EU funds

The C/A deficit widened further in May, but the pace of deterioration slowed down compared with April when some one-offs related to external payments made by public administration under secondary income account were in play. The C/A deficit reached EUR 10bn in May (12-month rolling sum) from EUR 9.7bn in April, with the bulk of the

deterioration coming from a higher trade deficit for goods and smaller European funds received by public administration.

Chart 7: Components of C/A balance related to EU funds absorption (EUR mn, 12-month rolling sum)



Source: NBR, BCR Research

The C/A deficit will continue to widen slowly in the absence of decisive fiscal consolidation steps taken by the government or an external financing shock, likely exceeding 5% of GDP in 2020.

Bond monitor

Positive momentum for short-term bonds

Market liquidity improved in July and the NBR attracted one-week deposits from banks worth a record RON 17.1bn on July 15, after also carrying out similar operations in the previous two weeks, but with smaller volumes drained from the market at those moments. Short-term bond yields (maturities up to one year) fell by 5-10bp during the first three weeks of July. Yields for longer maturities traditionally connected to external markets were little changed, in line with the evolution of emerging markets bonds.

On the primary market, demand was very strong for short maturities (the bid to cover ratio was 3.4 at the auction for bonds maturing in October 2020, while in the past it stood between 1 and 2).

Financial markets are strongly convinced of a rate cut by the Fed at the end of July, with important bets even on a 50bp cut, which might look a little aggressive. On a similar note, economists polled by Reuters anticipate a 10bp cut in the deposit rate by the ECB in September and all of these should lend support to long-term RON bonds. However, there is a material risk of disappointment if large central banks prove less dovish, which would increase volatility for long-term bonds, which are taking their cue from global markets.

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	2011	2012	2013	2014	2015	2016	2017	2018	2019f	2020f
Real economy										
GDP - %, y/y real change	2.0	2.1	3.5	3.4	3.9	4.8	7.0	4.1	4.5	3.8
GDP - RON bn	559	594	636	669	713	765	857	944	1048	1131
GDP per capita - EUR thou.	6.5	6.6	7.2	7.5	8.1	8.6	9.6	10.4	11.4	12.2
Household consumption - %, y/y	1.6	1.6	2.0	4.2	5.9	8.3	10.1	5.2	6.2	4.7
Gross fixed capital formation - %, y/y	6.1	3.1	-5.6	3.3	7.5	-0.2	3.5	-3.2	5.5	4.8
Industrial production - % y/y	7.5	2.4	7.8	6.1	2.8	3.1	7.8	3.5	0.8	1.0
External sector										
Exports of goods, FOB - EUR bn.	45.3	45.1	49.6	52.5	54.6	57.4	62.6	67.7	71.5	75.5
Imports of goods, CIF - EUR bn.	55.0	54.7	55.3	58.5	63.0	67.4	75.6	82.9	88.3	93.9
Trade balance goods, FOB - CIF, % of GDP	-7.3	-7.2	-4.0	-4.0	-5.2	-5.9	-6.9	-7.5	-7.6	-7.9
C/A balance - % of GDP	-5.0	-4.8	-1.1	-0.7	-1.2	-2.1	-3.2	-4.5	-4.8	-5.2
Prices										
CPI - y/y (%)	3.1	5.0	1.6	0.8	-0.9	-0.5	3.3	3.3	4.0	3.0
CPI - average (%)	5.8	3.3	4.0	1.1	-0.6	-1.5	1.3	4.6	4.0	3.3
Labour market										
Unemployment rate - %	7.2	6.8	7.1	6.8	6.8	5.9	4.9	4.2	3.8	4.0
Net nominal wages - RON	1,475	1,547	1,622	1,706	1,848	2,088	2,384	2,696	3,065	3,348
Net wages - %, nominal	4.8	4.9	4.8	5.2	8.3	13.0	14.2	13.1	13.7	9.2
Public sector										
Fiscal deficit - % of GDP (Eurostat)	-5.4	-3.7	-2.2	-1.3	-0.7	-2.7	-2.7	-3.0	-3.0	-4.0
Public debt - % of GDP (Eurostat)	34.2	37.0	37.6	39.2	37.8	37.3	35.2	35.0	34.5	36.0
Interest rates										
Policy rate, eop	6.00	5.25	4.00	2.75	1.75	1.75	1.75	2.50	2.50	2.50
ROBOR 3M - %, avg	5.8	5.3	4.2	2.5	1.3	0.8	1.2	2.8	3.3	3.4
10y bond yields, %, avg	7.4	6.7	5.3	4.6	3.5	3.3	3.9	4.7	4.7	5.2
FX rate										
EUR/RON eop	4.32	4.43	4.48	4.48	4.52	4.54	4.66	4.66	4.77	4.87
USD/RON eop	3.34	3.36	3.26	3.69	4.15	4.30	3.89	4.07	4.22	4.13

Source: NBR, Eurostat, INS, Ministry of Finance, Reuters, BCR Research

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