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ROMANIA : MACRO OUTLOOK

Macro imbalances call for political stability

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December 12, 2024

Spot Rates as of: December 12, 2024
Note: Information on past performance is not a reliable indicator for future performance.
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Macro imbalances call for political stability

“Prediction is very difficult, especially if it’s about the future!” Niels Bohr, the Nobel laureate in Physics, once said. This sentiment rings true in the wake of the first round of Romania’s presidential elections, where the consensus was upended. The Constitutional Court annulled the elections, citing interference by a foreign state - an unprecedented decision. The elections are now likely to be rerun in March–April 2025. The unexpected success of far-right political forces has prompted pro-European parties to solidify their stance. PSD, PNL, USR, UDMR and MPs representing ethnic minorities (controlling 65% of parliament) have committed to forming a government and are discussing backing a common presidential candidate. For the incoming government, entering a clear fiscal consolidation path and implementing Recovery and Resilience Plan (RRP) reforms are expected to be top priorities.

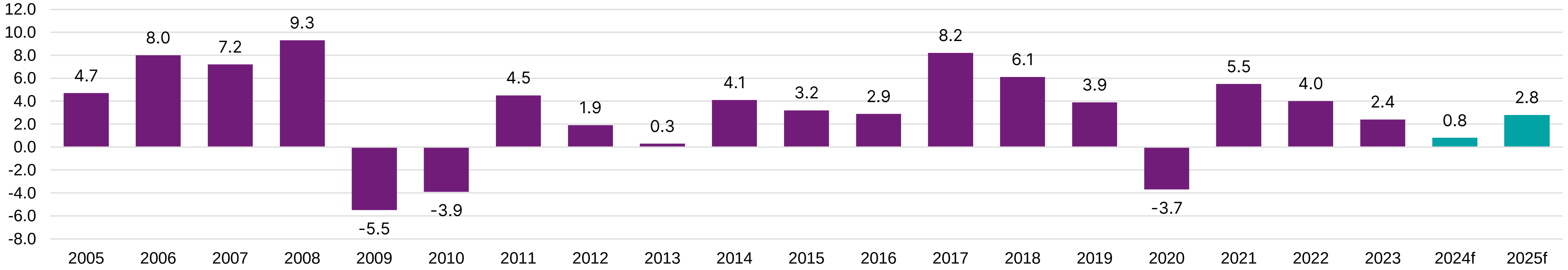
While macroeconomists are often thought to have a “crystal ball,” we must admit that ours is cracked. Despite holding a positive long-term outlook anchored in EU values, with potential GDP growth estimated at 3% and inflation eventually converging toward the NBR’s target range of 1.5-3.5%, the outlook for 2025 remains blurred. GDP growth is projected to recover to 2.8% y/y in 2025 under a no-policy-change scenario, aided by statistical base and carry-over effects. However, the risks are clearly skewed to the downside. The extent of this downside will depend on the structure, size, and timing of fiscal consolidation, as policymakers now face a critical reckoning. On inflation, we are slightly more confident, forecasting 3.7% y/y by the end of 2025. Still, fiscal policy remains the primary source of idiosyncratic uncertainty. Post-elections, the NBR is expected to resume cutting rates mid-year. We project the NBR key rate to decrease by 75bp to 5.75% by the end of 2025. Amid persistent uncertainty, FX stability is likely to remain a cornerstone of the NBR’s policy response. We expect the EUR/RON exchange rate to remain stable until after the presidential elections, with some flexibility for mild RON depreciation thereafter, as the central bank has acknowledged competitiveness concerns. As the situation evolves, we are working to piece together a new “crystal ball.” We hope that by the start of the new year - with a new government in place and a reasonably credible 2025 budget bill - some of the current fog will begin to dissipate.

Source: Eurostat, Refinitiv, Erste Group Research

GDP growth

In 2024, consumption accelerated significantly, driven by robust nominal wage growth and easing inflation. By the end of the third quarter, household consumption made the largest contribution to GDP growth and is expected to remain the primary growth driver, as it has been historically. However, structural issues in the Romanian economy mean that increased consumption leads to higher imports. Amid weak external demand, exports could not keep pace with the surge in imports, resulting in net exports offsetting most of the positive impact of consumption. Consequently, the economy grew by 0.8% y/y after three quarters. Due to an unfavorable base effect, even a relatively strong performance in the final quarter is unlikely to raise full-year 2024 growth beyond 0.8%. The outlook for 2025 is uncertain, as the government is expected to implement fiscal measures to address the large budget deficit. Our baseline projection anticipates GDP growth of 2.8% for 2025, but depending on the timing and structure of these fiscal adjustments, growth could be up to one percentage point lower. On a positive note, a mild recovery in external demand is expected next year, which should provide some support to Romania's GDP growth.

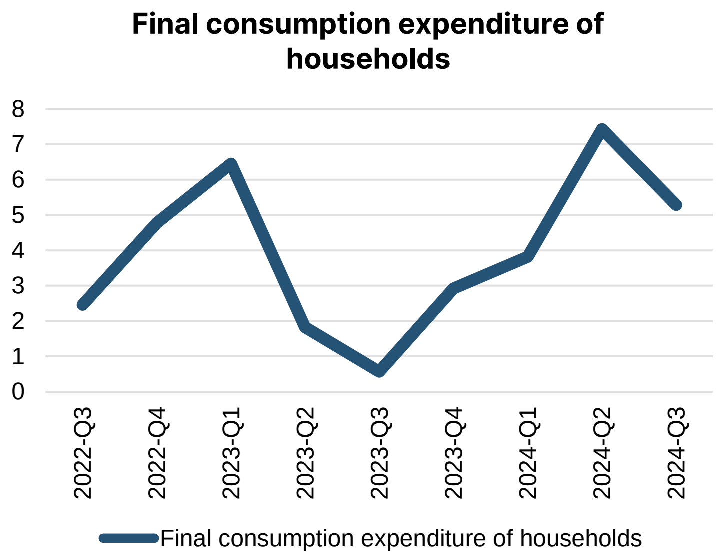
GDP growht, percent

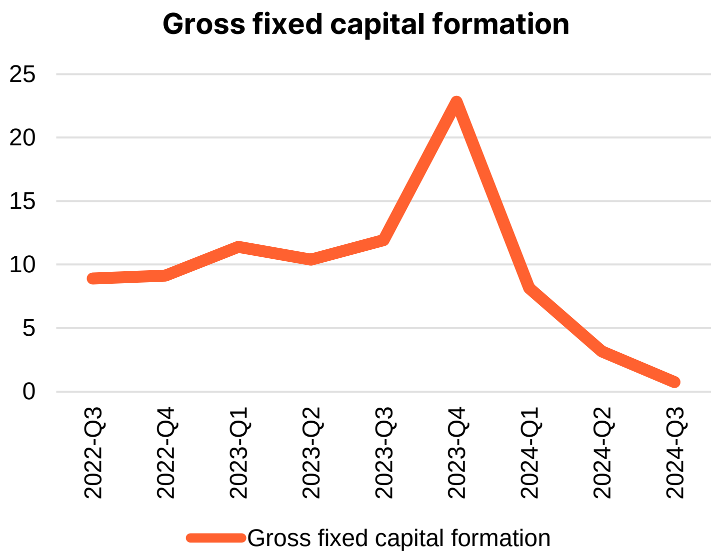


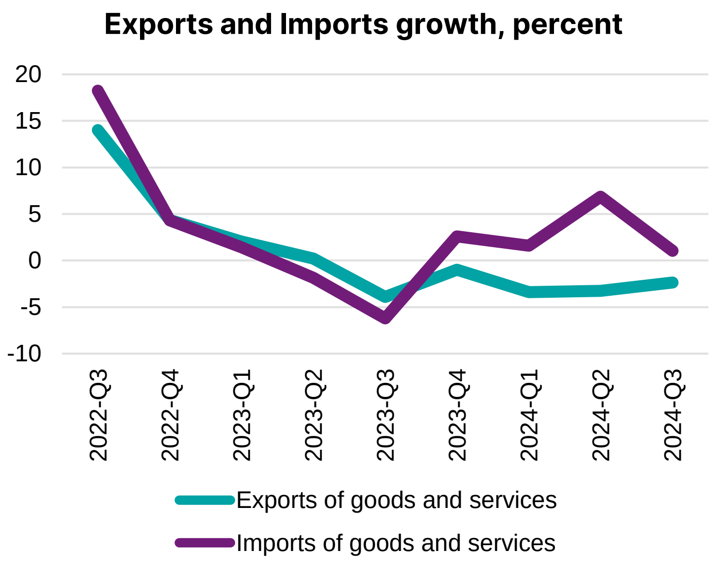
Source: Eurostat, Refinitiv, Erste Group Research

December 12, 2024

GDP structure



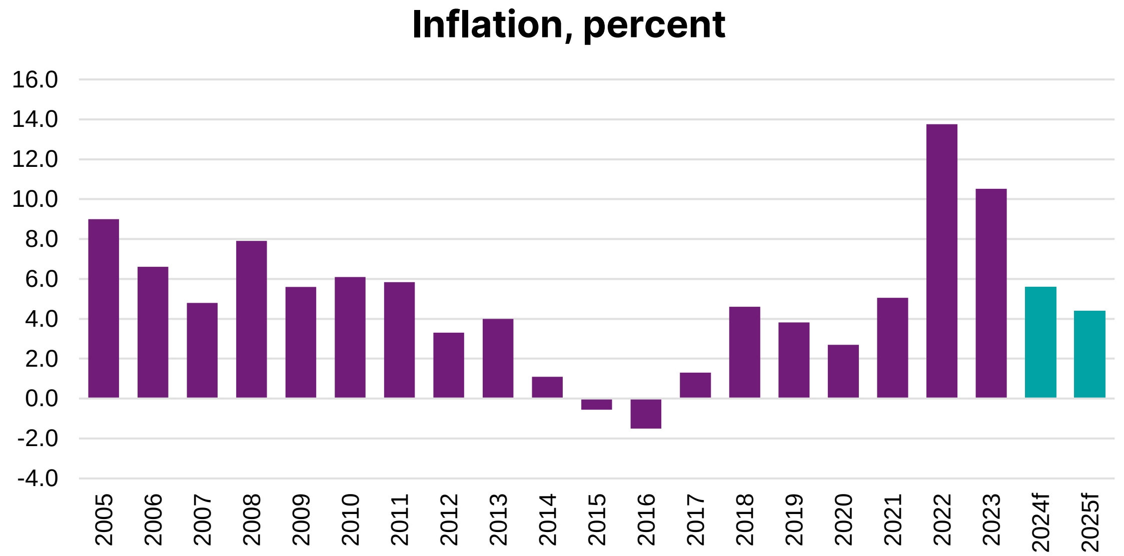


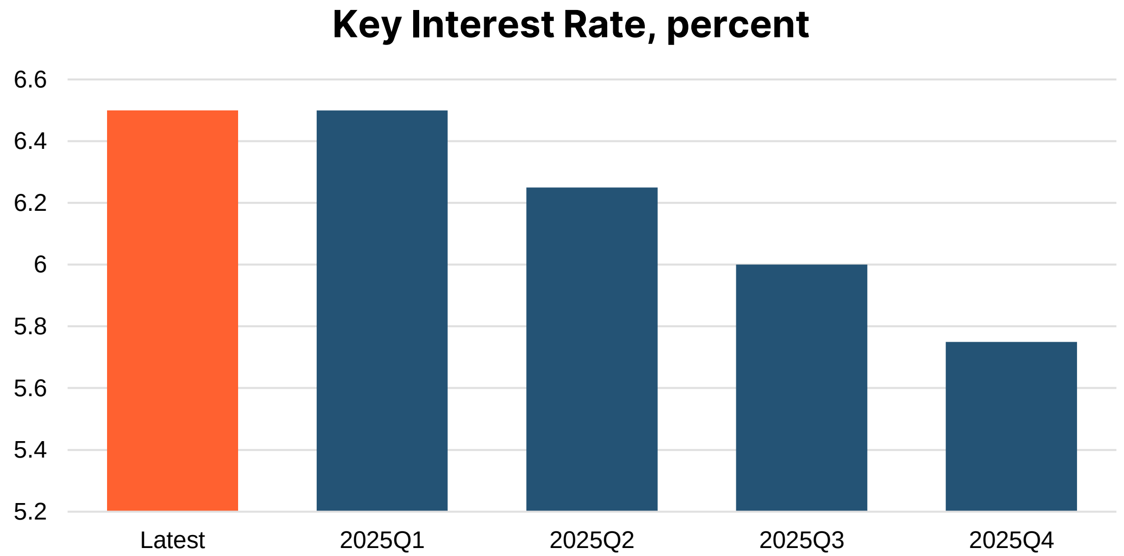


So far in 2024, the consumption boom has primarily fueled imports, as revealed by GDP structure data from the first three quarters. Private consumption contributed +3.2pp to the overall +0.8% y/y GDP growth during this period. This surge was largely driven by robust real wage growth and a consumer loan boom that triggered a spending spree, which fueled higher imports. With a negative contribution from exports as well, net exports subtracted -2.8pp from GDP growth. Investments have provided some support to growth, contributing +0.8pp, though their pace has slowed considerably compared to last year. The revival of EU funds and increased state investments are expected to sustain a positive impact from investments in the coming quarters. Agriculture has performed poorly in 2024, subtracting 1.9pp from the +1.1% y/y GDP growth in the third quarter alone and -0.6pp for the January–September period. While the services sector has been weak overall, it showed signs of recovery in the third quarter. Meanwhile, industry and construction have remained largely neutral contributors after three quarters.

Source: Eurostat, Refinitiv, Erste Group Research

Inflation and monetary policy





The slow disinflation process continued through most of 2024, driven by lower food price inflation, predominantly its core components, and lower energy prices. A bad agricultural year pushed food prices higher and triggered a trend reversal toward the end of the year. Strong wage growth also translated into sticky services and non-food components.

We forecast headline inflation at 5.2% y/y by the end of 2024, declining to 3.7% y/y by the end of 2025. Core inflation is projected to remain above headline inflation, at 5.6% and 4.0% for end-2024 and end-2025, respectively. Fiscal policy remains the primary idiosyncratic source of uncertainty for the inflation outlook.

After delivering two 25bp cuts in 3Q24, reducing the key rate to 6.50%, the central bank shifted to a “wait-and-see” stance, awaiting fiscal clarity. The NBR governor emphasized that monetary policy remains counter-cyclical, with the current stance still restrictive. As inflation continues to decelerate, this restrictive stance effectively tightens further.

The timing of the next rate cut will depend on the implementation of a coherent and credible fiscal consolidation program. We currently anticipate the next cut in 2Q25, though there is a risk of delay into 3Q25. By the end of 2025, we expect the key rate to stand at 5.75%.

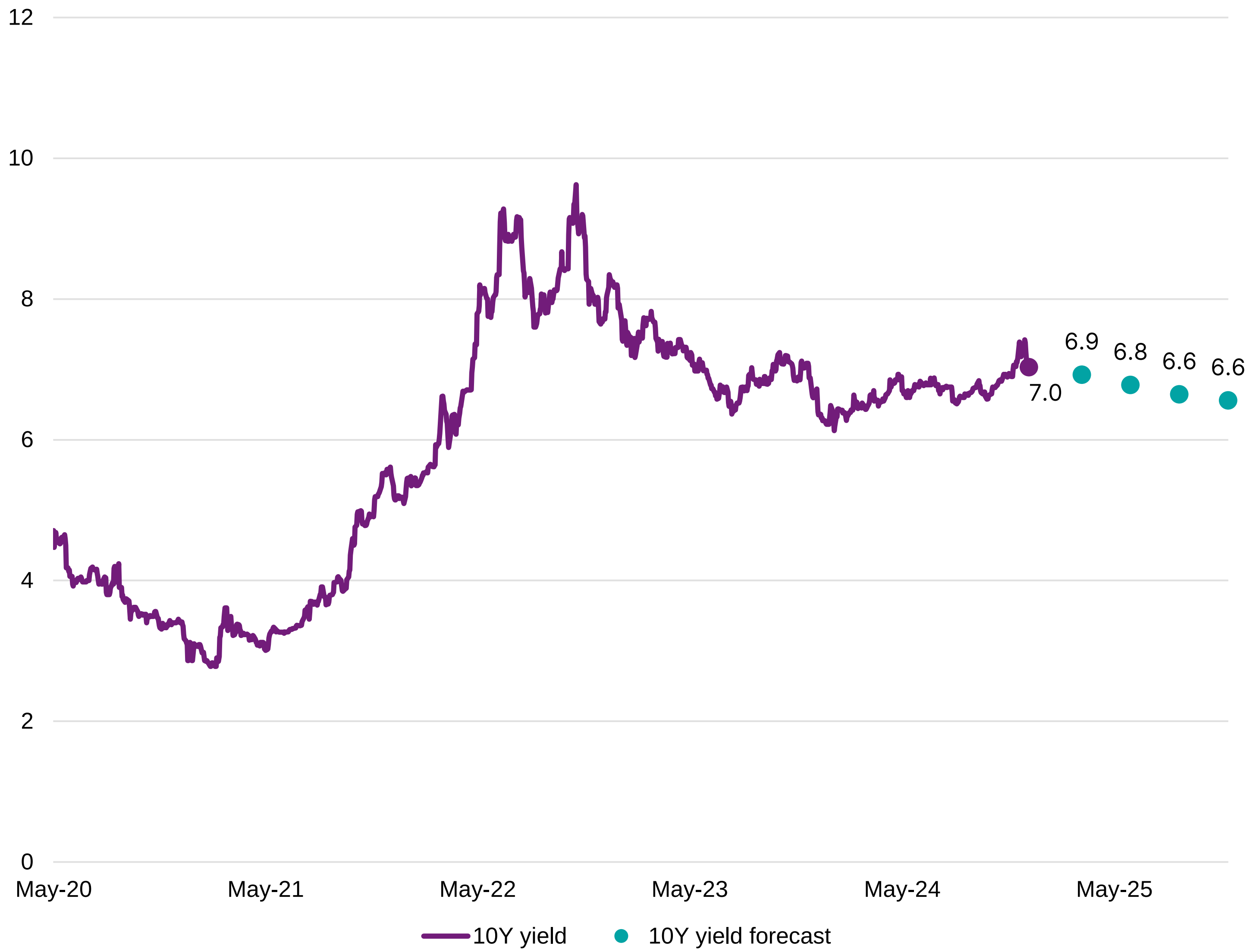
Source: Eurostat, Refinitiv, Erste Group Research

Yields and spreads

Following market panic over the strong performance of far-right candidates in the presidential elections, yields edged lower but stabilized above pre-crisis levels. Offshore investors have remained overweight in ROMGBs. The patience of both rating agencies and sovereign debt investors has been tested over the past few years, as budget deficits have consistently exceeded initial targets. Without a meaningful, coherent, and credible fiscal correction plan, both groups are likely to lose patience, leading to a market-driven adjustment.

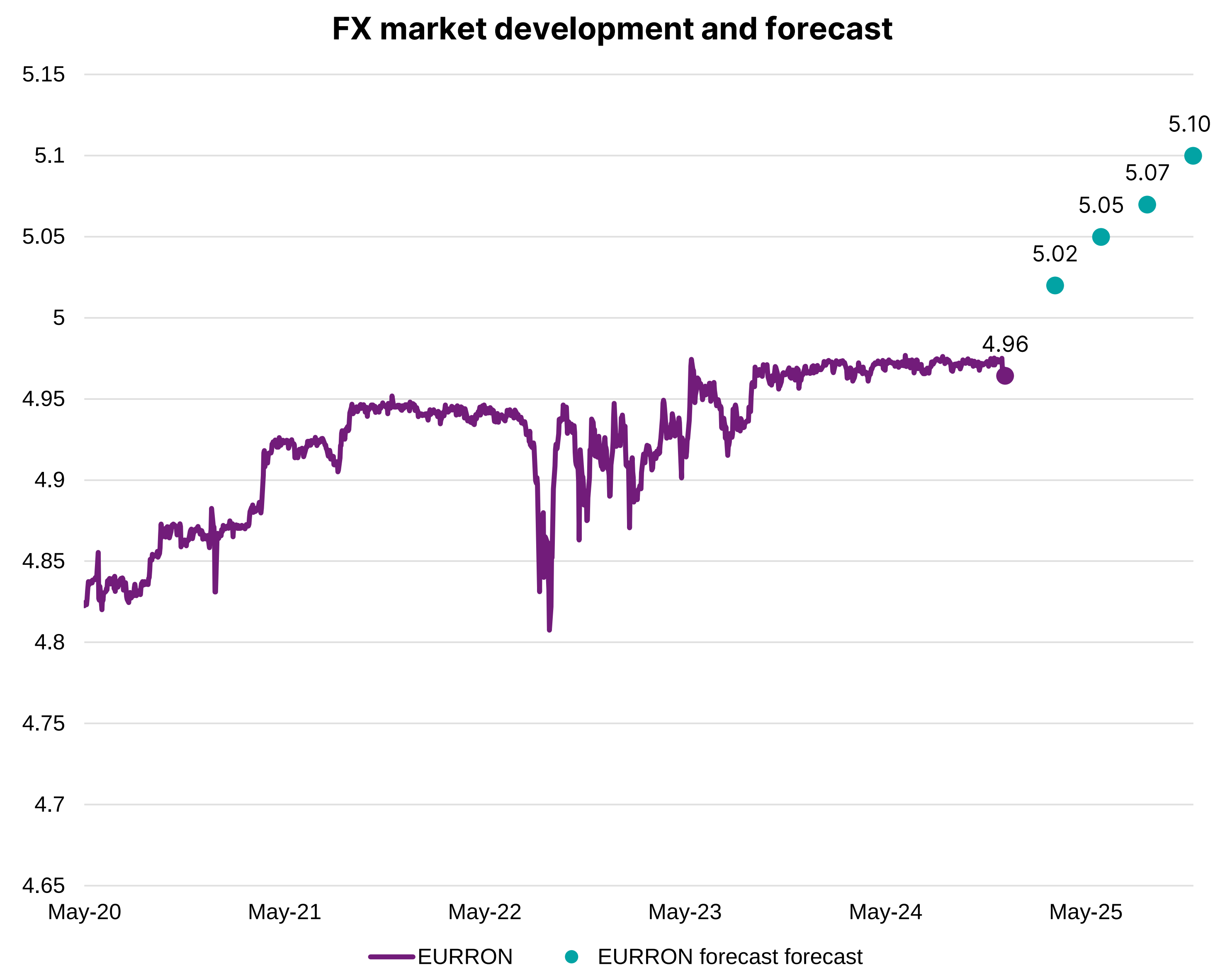
The 10Y ROMGB yield is currently trading near fair value, according to our models. We see potential for ROMGBs yield curve steepening, with the fair value for the 10Yv2Y spread estimated at above 100bp. Assuming a cash budget deficit of 7.0% of GDP in 2025, gross funding needs are estimated at RON 230bn.

10Y yield development and forecast



Source: Eurostat, Refinitiv, Erste Group Research
December 12, 2024

FX Market

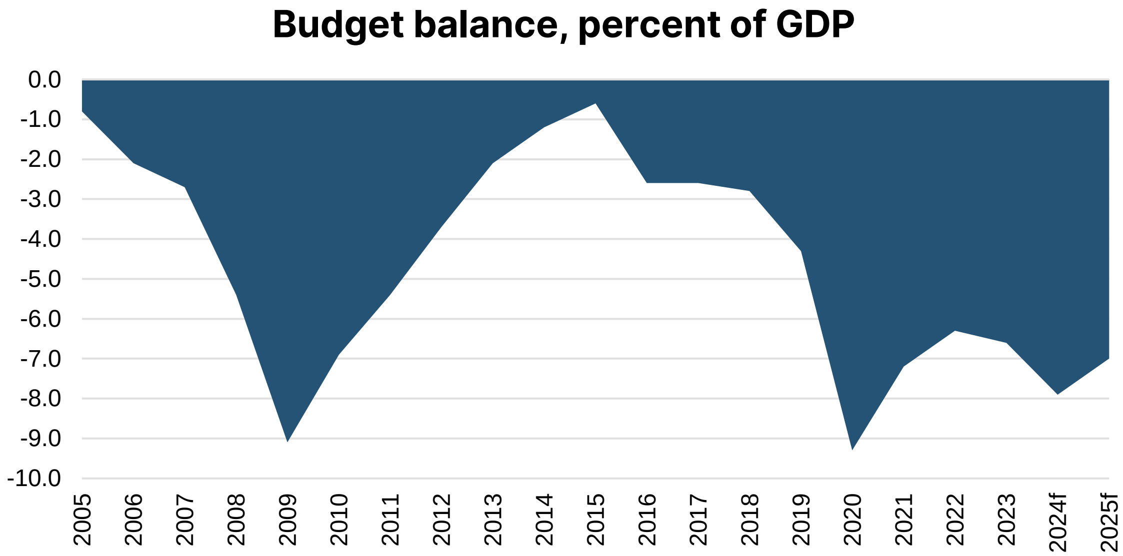


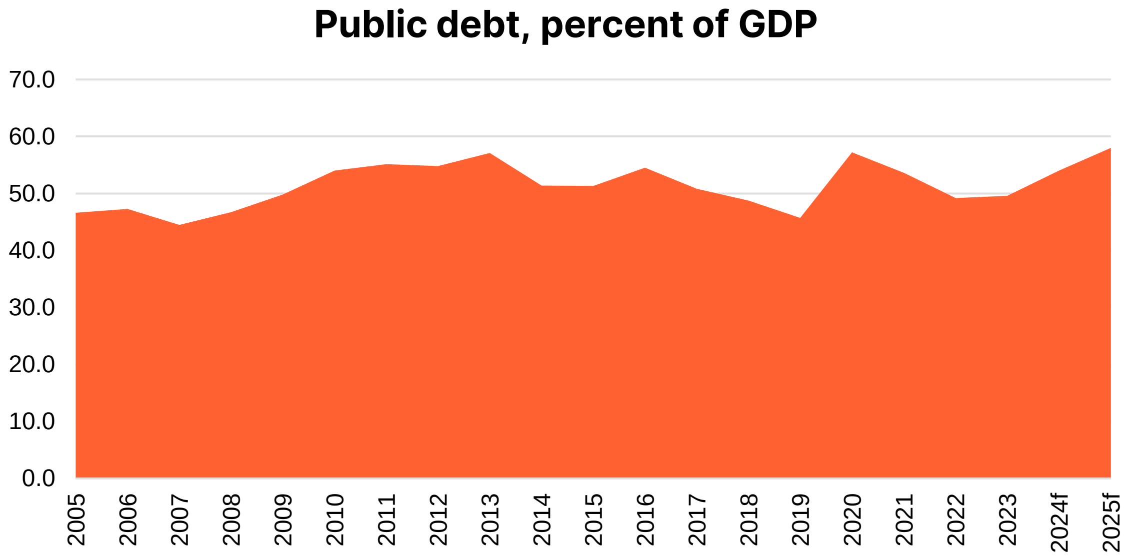
The NBR is likely to defend FX stability until after the rescheduled presidential elections, with some flexibility for mild RON depreciation expected afterward. Recently, the NBR governor stated that, based on the central bank's real effective exchange rate measures, the RON is up to 5% overvalued, which does not explain the large external deficit. We project the current account deficit at 8.1% of GDP in 2024, narrowing slightly to 7.8% in 2025. Romania remains an outlier among its peers in terms of external imbalances, as a significant portion of its trade gap is structural.

Currency overvaluation particularly affects sectors with tight profit margins, reliant on low-skilled labor. Our models indicate that the RON is overvalued in real terms by 6–7% against the EUR. We anticipate a gradual nominal RON depreciation over time, with improving fundamentals guiding the currency toward its fair value.

Source: Eurostat, Refinitiv, Erste Group Research

Fiscal situation





There appears to be broad political consensus that initiating a fiscal consolidation process is essential starting next year. Financial markets, rating agencies and the EU Commission view it as a necessity, leaving politicians little room to delay without risking a market-driven correction. We project a budget deficit for 2024 of 7.9% of GDP on ESA terms and 8.6% in cash terms. The government has already outlined a medium-term fiscal plan targeting a reduction in the budget deficit to 2.5% of GDP by 2031. The fiscal consolidation plan begins with an ESA budget deficit of 7.9% in 2024.

A credible fiscal consolidation path should involve meaningful frontloading, and we anticipate the budget deficit narrowing to 7.0% of GDP by the end of 2025. However, the rescheduled presidential elections, likely in March-April 2025, could weaken the appetite for reform, delaying significant measures until mid-year. The structure of fiscal corrective measures is expected to focus on the revenue side, given the rigid nature of government spending. Historically, revenue-based fiscal adjustments have been less detrimental to growth compared to expenditure cuts, though they tend to be inflationary in the short term. Eliminating fiscal loopholes is likely a priority on the adjustment agenda, as this approach is broadly neutral for both economic growth and inflation while potentially generating additional budget revenues equivalent to around 1pp of GDP.

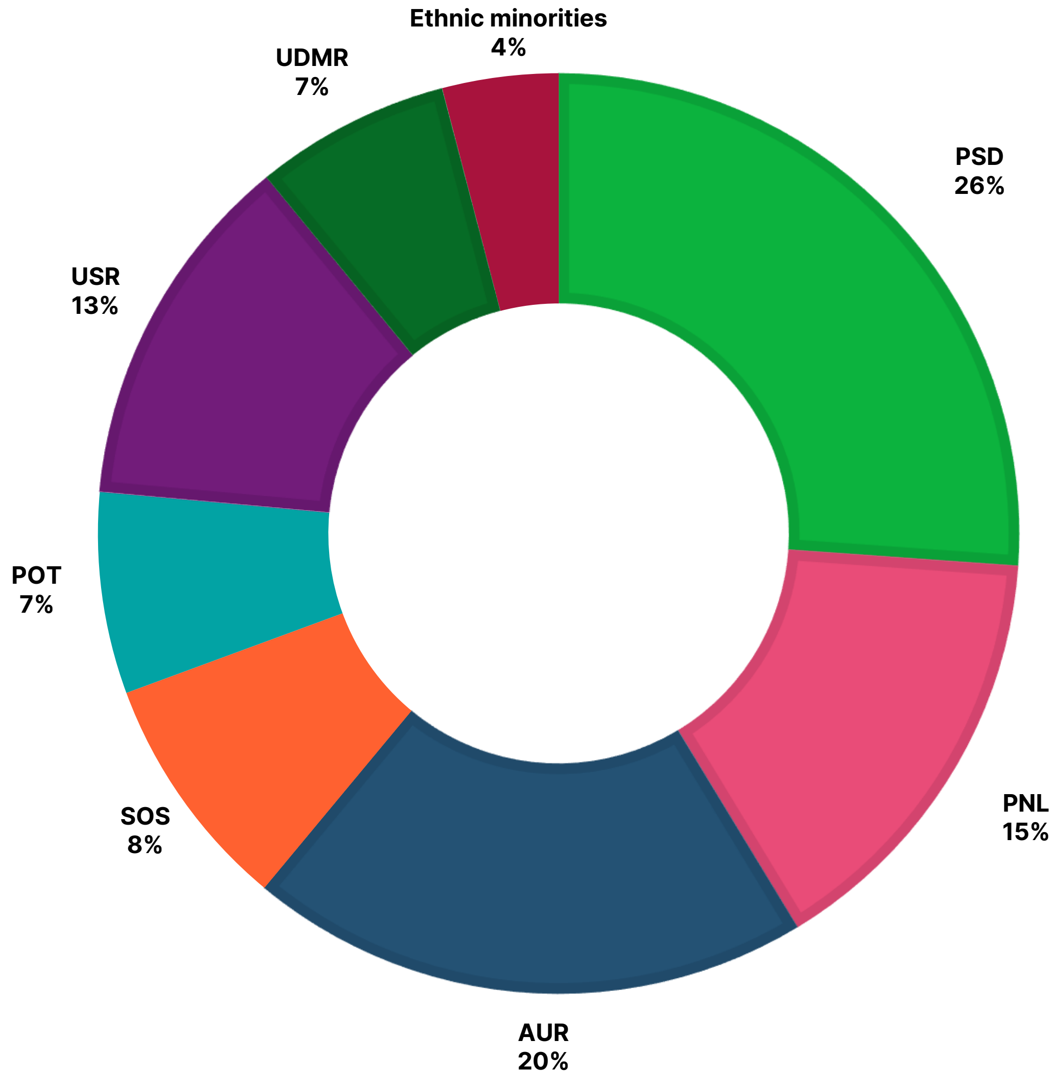
Source: Eurostat, Refinitiv, Erste Group Research

Political landscape

Politics took center stage in 2024, with what was expected to be a predictable end to an election-filled year turning into a highly unexpected situation. The Constitutional Court canceled the presidential elections after the first round, citing interference by a foreign state. The elections are now likely to be rescheduled for March–April next year, with the current president, Klaus Iohannis, remaining in power. This delay is expected to dampen appetite for addressing the large fiscal deficit until after the new president is elected.

In parliament, the situation is somewhat more stable. Pro-EU, pro-NATO parties have secured a comfortable majority, holding approximately 65% of the seats, and have firmly committed to forming a government. PSD, PNL, USR, UDMR, and ethnic minority representatives are reportedly discussing backing a common presidential candidate. For the incoming government, entering a clear fiscal consolidation path and implementing RRP (Recovery and Resilience Plan) reforms are likely to be top priorities.

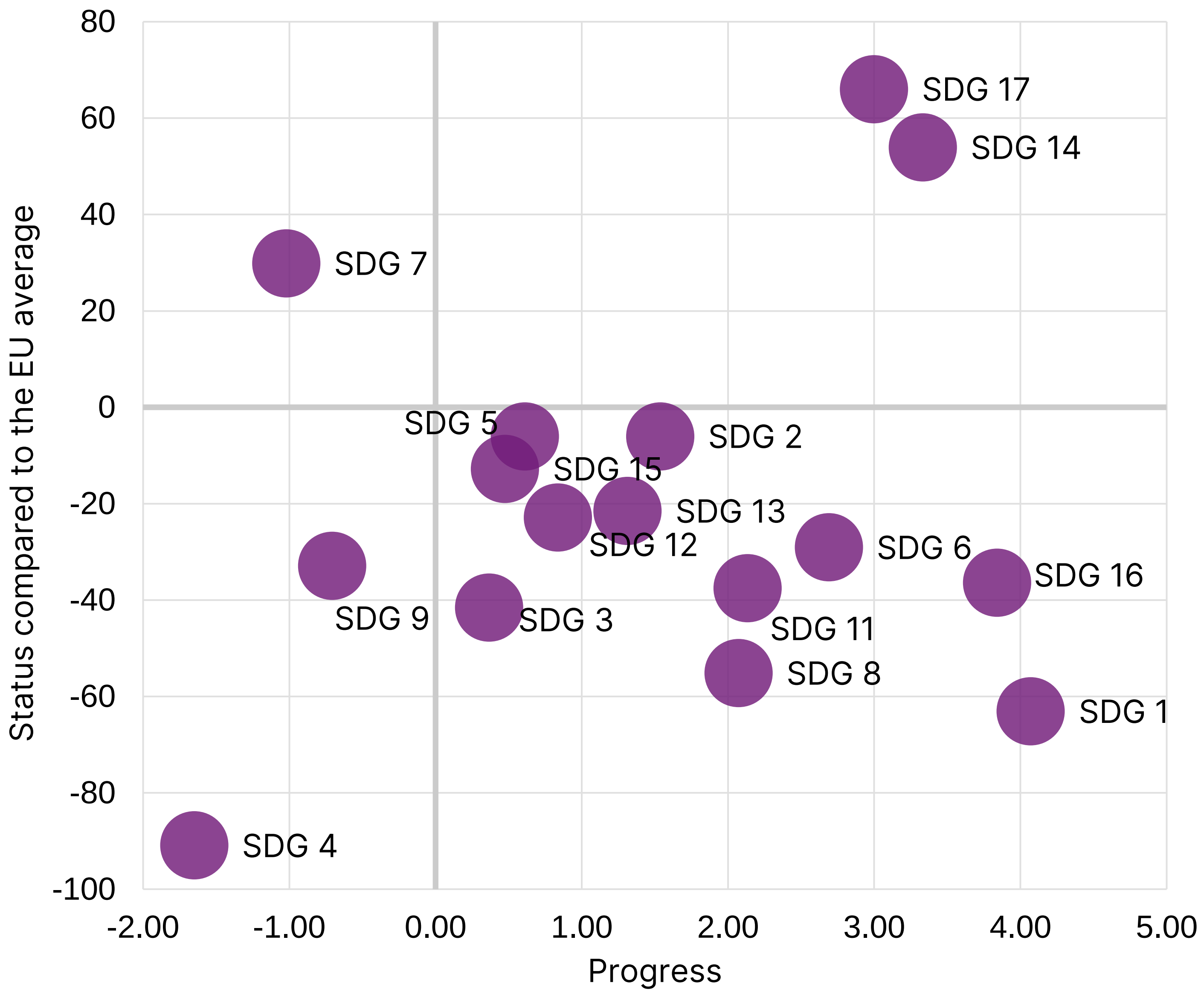
Parliamentary seats*



*) The figures are only preliminary estimates as the official numbers are not yet available.

Source: Local Media, Erste Group Research
December 12, 2024

Social development goals

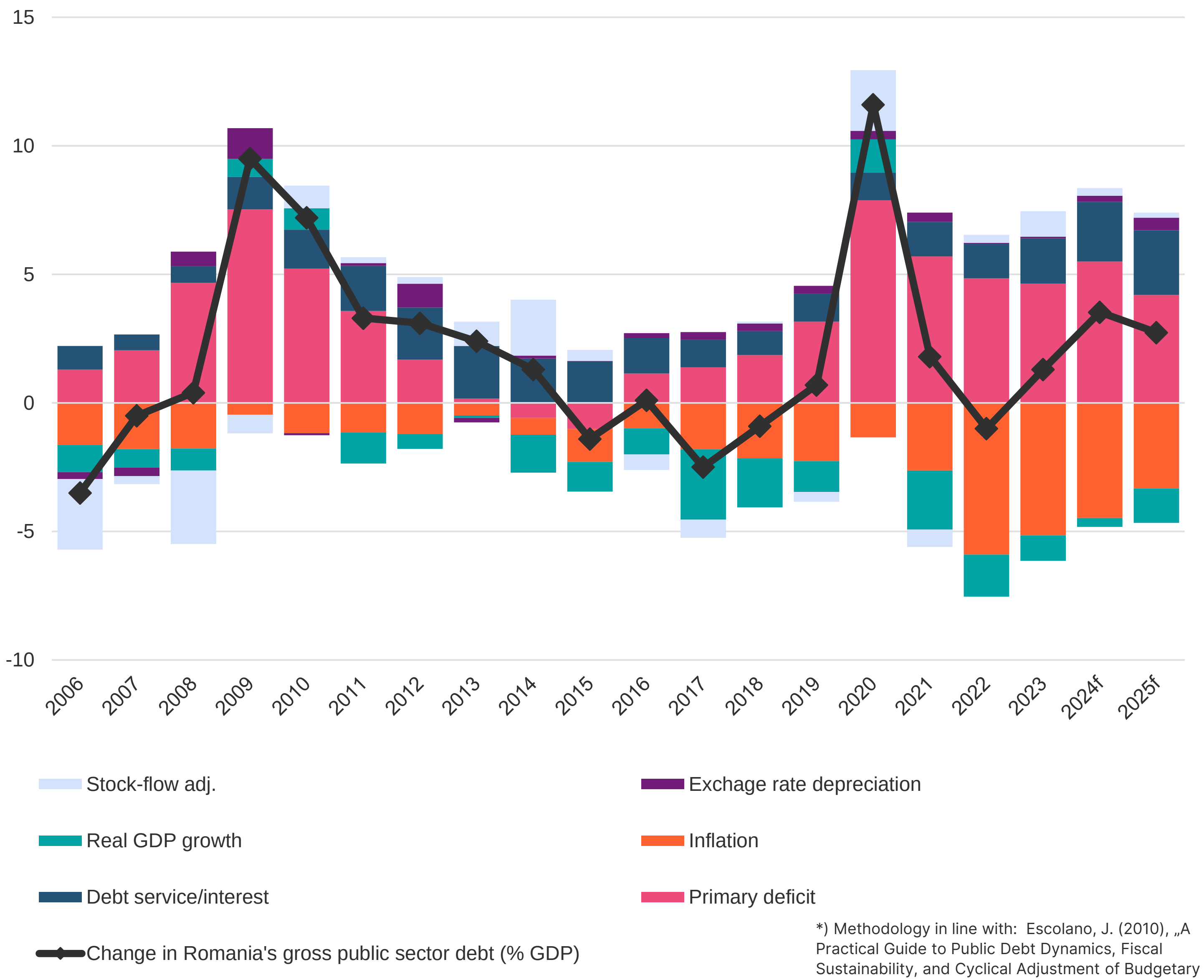


Romania performs better than the EU average and is making progress in two Sustainable Development Goal (SDG) areas: Partnerships for the Goals and Life Below Water. While Romania shows improvement in most other SDGs, it starts from a weaker position compared to the EU. Notable progress has been made in No Poverty and Peace, Justice, and Strong Institutions, where its performance stands out positively. However, Quality Education and Industry, Innovation, and Infrastructure remain key challenges. Romania not only lags behind the EU average in these areas, but is also moving further away from achieving the SDGs. To address these gaps, Romania needs to fully utilize EU funds and undertake significant reforms to its economy and society, particularly as part of its efforts toward OECD accession.

Public debt dynamic determinants

Public debt crossed the 50% of GDP threshold for the first time in 2024, rising to an estimated 52.4%, from 48.8% in 2023. The deterioration is driven by a large primary balance deficit, increasing interest payments, and slower real GDP growth. While public debt remains below the current ‘BBB’ median of 58% of GDP, the lack of significant fiscal consolidation could cause it to exceed this level by a considerable margin.

Rule of motion for public debt



*) Methodology in line with: Escolano, J. (2010), „A Practical Guide to Public Debt Dynamics, Fiscal Sustainability, and Cyclical Adjustment of Budgetary Aggregates", IMF Technical report

Romania's public debt as a percentage of GDP has been steadily rising, and we expect it to reach 52.4% by the end of 2024, up from 48.8% in 2023. In addition to the large primary deficits Romania has run in recent years, rising interest payments have exerted significant upward pressure on the debt-to-GDP ratio. While high inflation has provided some relief over the past 2-3 years by increasing the nominal GDP, this effect is expected to diminish considerably in the coming years. Slowing real GDP growth further compounds the challenge, limiting Romania's capacity to stabilize its debt trajectory. However, the relative stability of the EUR/RON exchange rate has been instrumental in mitigating the upward pressure, as approximately half of Romania's public debt is denominated in foreign currency.

Source: Eurostat, Erste Group Research

Romania: Forecasts

	2018	2019	2020	2021	2022	2023	2024f	2025f	2026f
Percent					**Annual average**				
Real GDP growth	6.1	3.9	-3.7	5.5	4.0	2.4	0.8	2.8	3.4
Private consumption growth	10.3	3.0	-3.8	7.3	5.2	2.8	5.5	2.4	2.2
Fixed capital formation growth	-1.8	14.9	-0.5	4.0	5.4	14.5	2.5	4.0	5.7
Inflation	4.6	3.8	2.7	5.1	13.7	10.5	5.6	4.4	3.2
Unemployment rate	5.3	4.9	6.1	5.6	5.6	5.6	5.3	5.3	5.2
Percent of GDP									
Budget balance	-2.8	-4.3	-9.3	-7.2	-6.3	-6.6	-7.9	-7.0	-5.5
Public debt	34.5	35.1	46.8	48.5	47.5	48.8	52.4	54.2	54.3
Current account balance	-4.6	-4.9	-4.9	-7.2	-9.2	-7.0	-8.1	-7.8	-6.8
					End of year				
EURLCY	4.66	4.78	4.87	4.95	4.95	4.97	5.00	5.10	5.20
Central bank policy rate	2.50	2.50	1.50	1.75	6.75	7.00	6.50	5.75	4.50
3M interbank offer rate	3.02	3.18	2.03	3.01	7.57	6.22	5.65	5.05	4.40
2Y Yield	3.70	3.55	2.46	4.17	6.99	6.09	6.50	5.57	5.25
5Y Yield	4.30	3.93	2.61	4.77	7.79	6.19	6.90	6.16	5.91
10Y Yield	4.80	4.40	2.97	5.14	8.19	6.23	7.20	6.56	6.41

Source: Eurostat, Refinitiv, Erste Group Research

December 12, 2024

Romania: Country overview

Official EU language: Romanian

Capital: Bucharest

Geographical size: 238 398 km2

Population: 19 064 409

GDP per capita (PPS): EUR 30 000, below the EU average

Currency: Romanian leu RON

Credit Ratings:

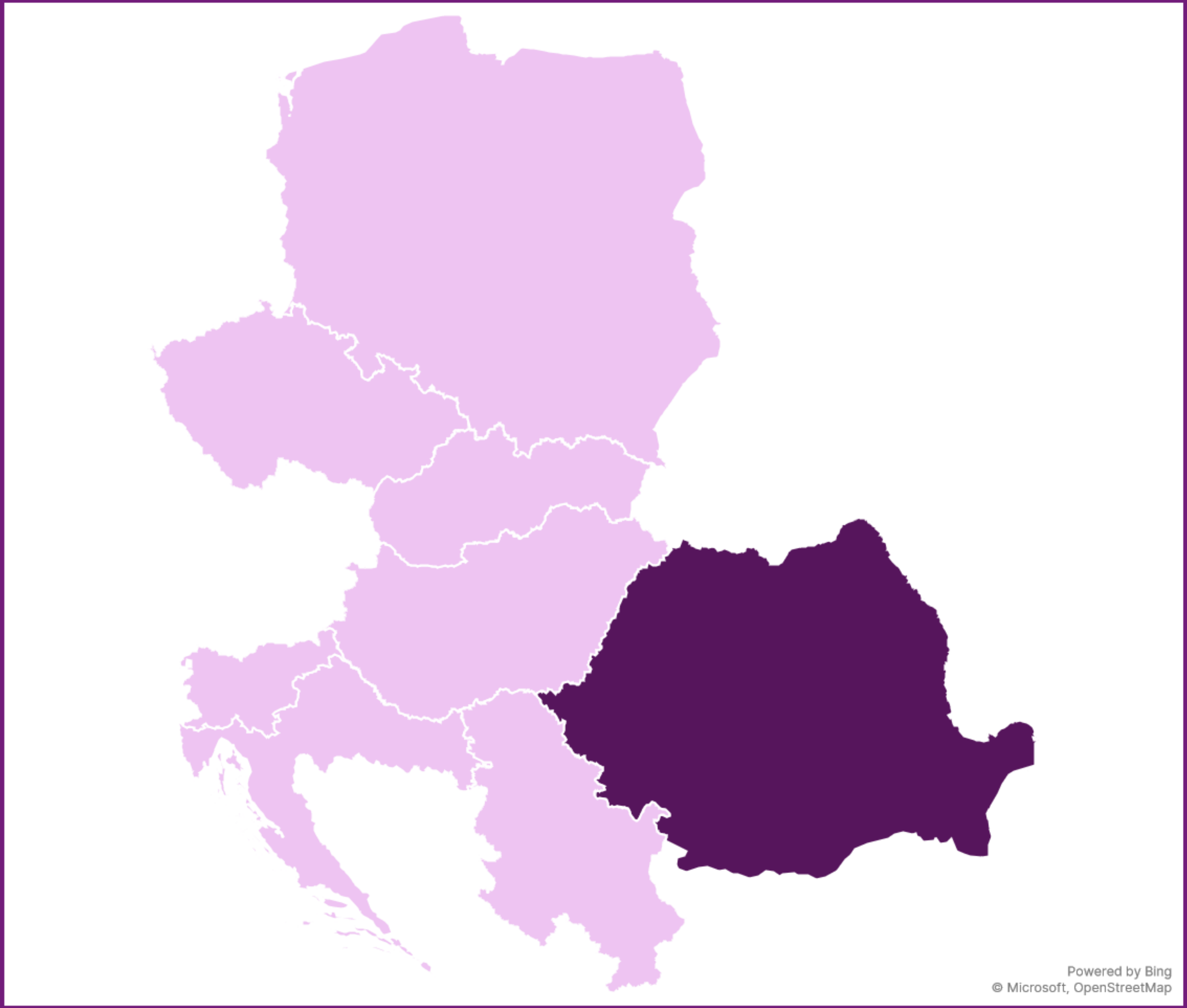
Moody's: Baa3, outlook stable

S&P: BBB-, outlook stable

Fitch: BBB-, outlook stable

EU member state: since January 1, 2007

Schengen: expected membership as of January 2025



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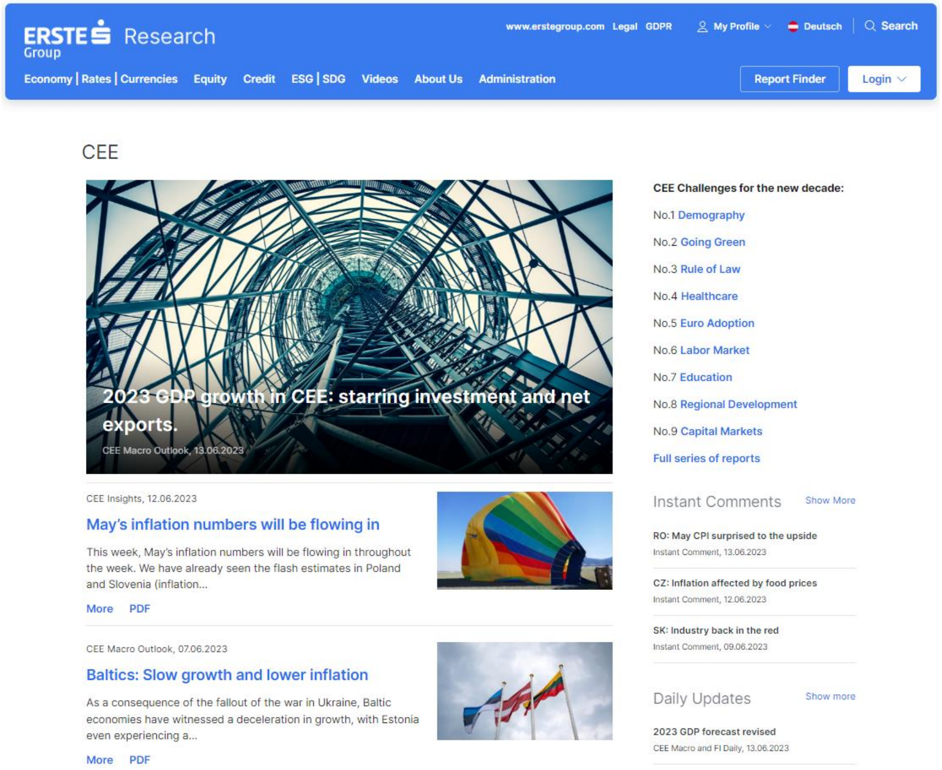

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