

Romania

Mixed bag

Counter powers and institutional watchdogs have proved to be quite effective in stemming the government's business-unfriendly measures and attempts to undermine the Rule of Law. This may pave the way for a more pragmatic and predictable policy stance. Meanwhile, owing to weaker external conditions, a soft landing of the economy is expected in the coming quarters whereas domestic demand should remain dynamic. Despite the lower risk of overheating, macro imbalances must be monitored: inflationary pressure is lingering and the twin deficits may widen even further. The banking system has recovered from times of trouble, and the softening of the bank tax (and other "emergency taxes") provided significant relief for the business community.

■ Testing the system of checks and balances

Counter powers and institutional watchdogs (i.e. Parliament, the President, the Constitutional Court, the Central Bank, the European Union, the civil society and the business community) have been put to the test by the administration, which came to power in 2017. So far, they have proved to be quite effective in confining the government's attempts to implement controversial reforms and undermine the Rule of Law, which has improved since Romania's accession to the EU in 2007.

For two years, the government has called into question the independence of the Judiciary and its effectiveness, notably with regard to its pet peeve: the National Anti-Corruption Directorate. This has resulted in bouts of political and social tensions and damaged the relationship between Brussels and Bucharest. The European Commission (EC) has threatened to trigger Article 7 of the EU Treaty as it previously did vis-à-vis Hungary and Poland. In December 2018, the government enforced a number of unexpected measures that were amended by Parliament in March-May 2019. This "emergency package" was adopted by ordinance without consultation with parliament, the Central Bank (NBR) or interest groups. It included changes in the mandatory pensions system, a cap on energy prices and a tax on energy/telecom companies and banks (see below). The announcement of the reform package triggered a 3% depreciation of the leu (RON) against the euro and a 15%-20% drop in the main stock market index.

The PSD-ALDE ruling coalition secured only 22% of the votes in the late May European parliamentary elections (vs. 46% in the 2016 national parliamentary elections). President Klaus Iohannis's right-wing PNL took the lead with 27% of the votes. Ahead of the next presidential election (November 2019) and parliamentary elections (end of 2020 or early 2021), the government may adopt a less controversial, more pragmatic/predictable policy stance, especially since PSD leader Liviu Dragnea was sentenced to prison for abuse of power.

■ Soft landing and lingering inflationary pressure

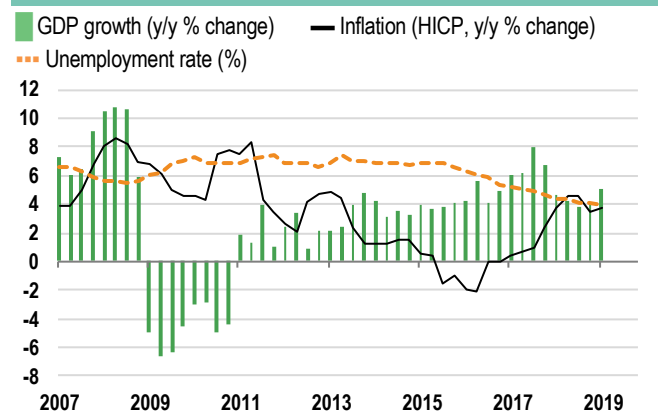
The gradual deceleration in GDP growth since its cyclical peak of 6.8% in 2017 has reduced the risk of overheating. Economic growth surprised on the upside in Q1 2019, reaching 5% y/y vs. 4.2% on average in 2018. But in the coming quarters, it is likely to converge with GDP potential estimated to be around 3%. Apart from a high base effect and the fading effect of pro-cyclical fiscal policy, the main driver of the slowdown is a less-benign global environment,

1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	6.8	4.2	4.2	2.5
Inflation (CPI, year end, %)	1.3	4.6	4.1	3.7
Gen. Gov. balance / GDP (%)	-2.7	-3.1	-3.3	-3.3
Gen. Gov. debt / GDP (%)	35.2	35.0	35.1	35.9
Current account balance / GDP (%)	-3.3	-4.4	-4.7	-5.4
External debt / GDP (%)	51.9	49.3	48.6	47.7
Forex reserves (USD bn)	37.1	36.8	36.3	35.8
Forex reserves, in months of imports	5.4	4.9	4.4	4.1
Exchange rate EURRON (year end)	4.7	4.7	4.8	4.8

e: BNP Paribas Group Economic Research estimates and forecasts

2- Growth, inflation and unemployment



Source: National Institute of Statistics, Eurostat

notably the EU slowdown and uncertainty about global trade due to protectionism. Private consumption is expected to remain robust thanks to real income growth despite persistent inflationary pressure. Investment is likely to recover from the 2018 contraction thanks to a rebound in private sector investment and EU-funded projects. Still-dynamic domestic demand should go hand-in-hand with a negative contribution to the growth of net exports.

Annual inflation spiked to 4.1% y/y for HICP and 4.6% y/y for CPI on average in 2018. Against a backdrop of strong domestic demand and the still-positive output gap, CPI reached 4.1% y/y in May 2019



and core inflation accelerated to 3.2% y/y. Headline inflation is well above the upper bound of the NBR target of 2.5% +/- 1 percentage point. The NBR initiated a tightening cycle in early 2018 following the narrowing of the interest rate corridor around the policy rate in late 2017. It was raised on three occasions from 1.75% to 2.5% (last increase in May 2018), the first rate hikes since 2008.

Looking ahead, as the US Fed and the ECB have turned more dovish owing to concerns about a sharp economic slowdown, the NBR may refrain from tightening monetary conditions. The economists' consensus forecasts call for 2.7% policy rate as of end-2019 and 3% as of end-2020. Thanks to the support of the ruling coalition and the main opposition party, NBR Governor Mugur Isarescu was just reappointed for another five years with the objective of joining the euro area. In the meantime, wide twin deficits and political noise may generate pressure on the RON. Given the still high vulnerability of the government and the banking sector to currency risk, the NBR will probably intervene to smooth FX volatility.

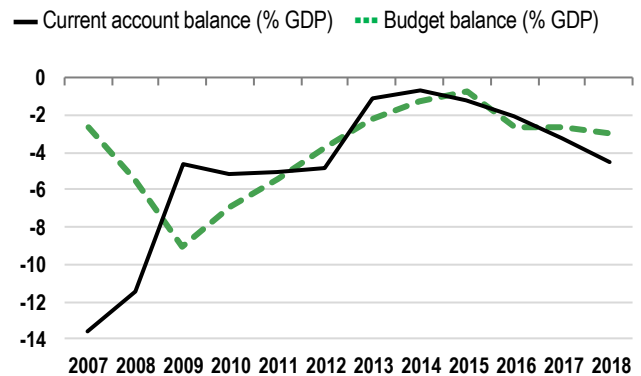
■ Twin deficits under scrutiny

Since 2016 the budget deficit has deviated from the medium-term structural target, triggering the EU commission's warning under the preventive arm of the Stability and Growth Pact. Fiscal policy has been loosened with tax cuts and public sector wage hikes. Meanwhile, dynamic domestic demand and rising commodity prices until end-2018 have contributed to a sharp widening in the trade balance deficit and the Current Account Deficit (CAD).

The external accounts deteriorated even further in the first four months of 2019 and are unlikely to improve in the short term. Strong wage growth has put pressure on unit labour costs and competitiveness as it has been well above productivity gains. Combined with EU funds, net foreign direct investments, which were dynamic in 2017-2018, may no longer offset the CAD. Romania's external liquidity position is not at risk in the short term as FX reserves provide a comfortable cushion and external financing requirements are manageable. The external debt-to-GDP ratio declined to below 50% thanks especially to the deleveraging of banks.

On the fiscal side, the 2019 budget targets a deficit equivalent to 2.8% of GDP owing to an unrealistic revenue growth forecast (+16% compared with circa 7% growth in nominal GDP). The sharp increase in spending on old-age pensions and the upcoming elections do not bode well for fiscal consolidation in the coming quarters. The deficit is likely to breach the threshold of 3% of GDP yet again, which might result in triggering the EU's excessive-deficit procedure. In this context, public debt is likely to increase gradually from a moderate level, while the low interest rate environment has allowed a reduction in debt servicing costs. The risks related to contingent liabilities in the banking sector have declined. Sovereign exposure to foreign investors is relatively high as non-residents hold almost half of government debt of which more than half is denominated in foreign currency (mostly euros).

3- Twin deficits



Source: Eurostat, NBR

■ Banks to go back to “business as usual”

The banking system has recovered from the times of trouble in 2013-2016. It is now well capitalised and profitable.

This reform would have been detrimental to the independence, flexibility and effectiveness of monetary policy, and it would have been a blow to the banking system's profitability, solvency and credit activity (see below). At the end of the day, the negative conclusions of a commission of experts from the NBR, the Ministry of Finance and the Banking Supervisory Authority led to the adoption of a watered-down bank tax (no link to ROBOR, the lower tax rate and narrower tax base).

The amendment to the bank tax provided strong relief: in view of the banking system's return on assets of 1.6% in 2018, the initial tax may have erased as much as two-thirds of annual profits.

Neither companies nor households are highly leveraged (the credit-to-the-private sector/GDP ratio is below 30%). Credit growth resumed in 2017-2018 thanks to low interest rates, the robust labour market and the government's policy of increasing home ownership. Credit is funded mainly by deposits. Despite higher inflation, the NBR has maintained the minimum reserve requirement ratios for banks' liabilities at 8%. Credit risk declined with total non-performing loans (NPLs) declining to 4.9% of total loans as of March 2019 from the peak of 22% in 2014. But the level of NPLs for companies remains high (above 10%), especially among SMEs. The surge in mortgage loans (mostly at variable rates) exposes banks to the real estate sector and a sharp increase in interest rates. Banks have repaid the bulk of their foreign debt, and the sector's net external position is now close to balance. Domestic “euroisation” remains a weakness with 35% of total loans and 30% of total deposits still denominated in foreign currency. Banks are (indirectly) exposed to currency risk via lending to domestic (unhedged) borrowers and to sovereign risk with government debt amounting to 20% of banks' total assets.

Sylvain Bellefontaine

sylvain.bellefontaine@bnpparibas.com

