23 February 2018
Emerging Markets

MonitorING Romania

2018: the year of inflation

The return of inflation forced NBR into aggressive tightening towards the end of 2017 and the cycle continued in the first two Board meetings in 2018. Given that 2019 and 2020 are electoral years, fiscal policy will probably not help much. On the bright side, there isn't much room for fiscal policy to expand further.

- We have revised our end-2018 CPI forecast up by 0.3ppt to 3.4%

January inflation surprised to the upside at 4.3% YoY, well above Bloomberg consensus at 3.9%. Though an important role in January inflation came from the base effect as the cuts in VAT and excise duty for fuel from January 2017 dropped out of the statistical base, inflationary pressures are broad-based and, even in the NBR's projections, it looks like inflation will stabilize at the very high end of the target band. In its attempt to contain inflation expectation, the NBR hiked rates and stressed the temporary nature of the "significant overshooting of the upper bound". The over-reliance on monetary policy to cool inflation was also mentioned. From the fiscal side, the only positive might be that the government is committed to a -3% of GDP budget deficit. Nevertheless, given that 2019 and 2020 are electoral years, corrective fiscal measures are unlikely. Hence, the adjustment will likely be suboptimal, with inflation, higher interest rates and weaker currency. As a result, the NBR has to balance: (1) a hawkish message and rate hikes to tame inflation expectations; (2) softer transmission into cost of credit (ROBOR rates) to favour investments while tacking consumer credit via prudential measures; (3) discouraging RON appreciation as the trade balance is already widening at a worrisome pace; (4) controlling RON depreciation due to the high FX pass-through; and (5) limiting the increase in government borrowing costs. Last but not least, the NBR needs to improve its credibility as its track record in inflation targeting is not impressive (it has missed the target band in 9 out of 13 years).

FX: We see NBR managing EUR/RON with an upside bias in the 4.60-4.70 range but allowing mild REER appreciation which implies a nominal depreciation of up to c.2.5ppt.

Domestic Debt: After the recent correction, back-end ROMGBs are at attractive levels.

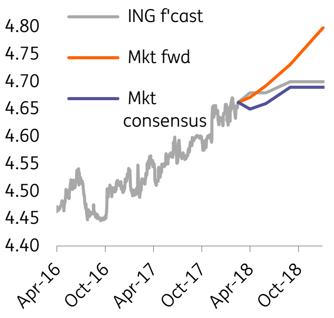
External Debt: The government tapped the external markets, issuing EUR750m in 12Y bonds and EUR1.25bn in 20Y papers at MS+133bp and MS+190bp respectively. Demand was heavy with total books for both papers over at EUR5.3bn which led to a significant tightening versus initial IPT at MS+150bp for 12Y and MS+210bp for 20Y. According to MinFin debt strategy for 2018, it plans to raise EUR4.5-5.0bn from international markets. The government has EUR1.5bn in Eurobonds redemption and EUR1.3bn in a tranche coming due, related to the EU/IMF bailout.

Quarterly forecasts

	4Q17	1Q18F	2Q18F	3Q18F	4Q18F	1Q19F	2Q19F	3Q19F
Real GDP (%YoY)	6.9	6.6	5.1	3.8	4.1	4.3	3.7	4.0
CPI (eop, %YoY)	3.3	4.7	4.6	4.5	3.4	3.4	4.0	3.7
Central bank key rate (eop, %)	1.75	2.25	2.50	2.75	2.75	3.00	3.25	3.50
3m interest rate (eop, %)	2.05	2.10	2.25	2.50	3.00	3.25	3.50	3.65
10yr yield (eop, %)	4.35	4.50	4.30	4.40	4.45	4.50	4.60	4.70
EUR/RON exchange rate (eop)	4.65	4.68	4.70	4.70	4.68	4.67	4.65	4.62
USD/RON exchange rate (eop)	3.88	3.77	3.73	3.67	3.60	3.59	3.52	3.47

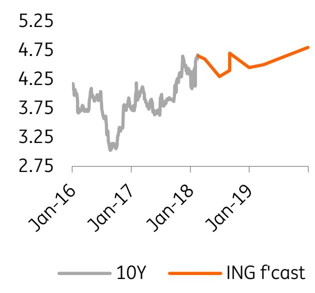
Source: ING estimates

EUR/RON



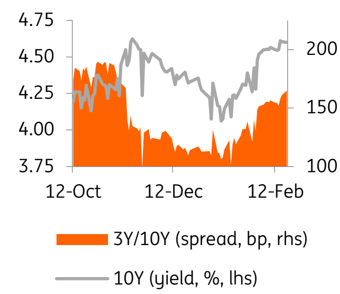
Source: Bloomberg, ING estimates

Local 10yr yields



Source: Bloomberg, ING estimates

ROMGBs



Source: Reuters

Latest indicator surprises

Output	Negative
Consumption	Neutral
Inflation	Higher
External	Neutral
Budget	Neutral

Source: Bloomberg

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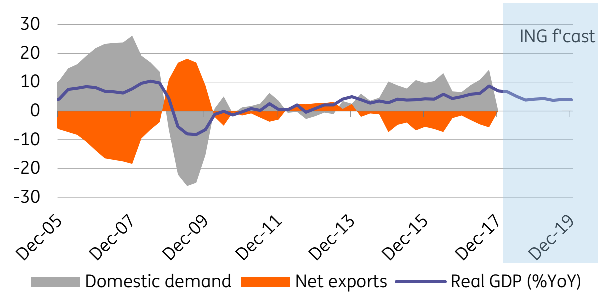
Fig 1 Real GDP (%YoY) and contributions (ppt)

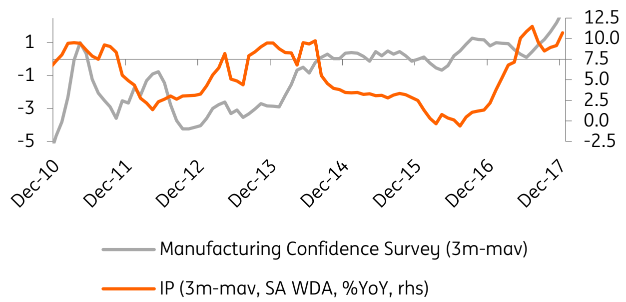


Source: Macrobond, ING

GDP growth slows in 4Q17

- 4Q17 marked a significant sequential slowdown to 0.6% QoQ vs an average quarterly growth rate of 2.0% for the first three quarters of 2017. Sequential growth was below our call and the Bloomberg median, but hefty historical data revisions led to full-year growth of 7.0%. While we expected a slowdown as suggested by soft data like the Economic Sentiment Index (ESI) and weaker QoQ retail sales, the flash GDP estimate is certainly disappointing even for conservative estimates.
- For 2018 we forecast 4.7% YoY GDP growth vs 4.1% Bloomberg median.

Fig 2 IP vs Manufacturing Confidence

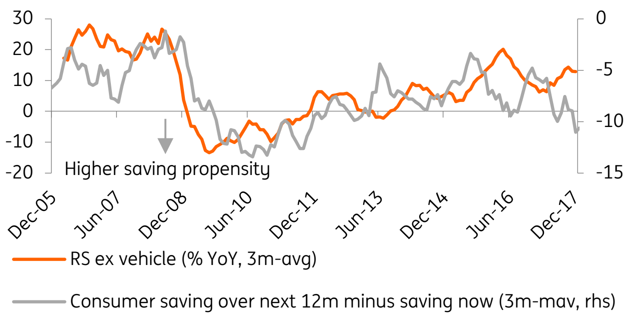


Source: Macrobond, ING

Industrial production jumps

- Industrial production accelerated in December to 12.2% YoY from 9.9% in November in line with confidence reaching a post-GFC high. The non-seasonal adjusted data showed industrial production increasing by 8.2% YoY in 2017 versus 1.7% in 2016. In seasonally-adjusted terms, IP jumped 9.2% YoY in 2017 (vs a 0.7% YoY advance in 2016) thanks to export orders and expected production.
- The strong performance was due to the manufacturing segment, which posted a 16.5% advance in December 2017, and 9.9% for the whole year. Mining and utilities expanded in 2017 by 5.5% and 1.5% respectively, versus the previous year.

Fig 3 Retail sales vs Saving intentions

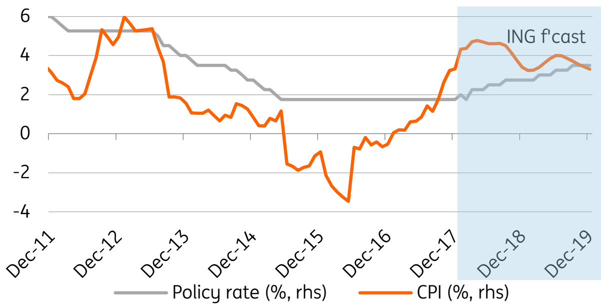


Source: Macrobond, ING

Consumers shrug off pessimism

- Retail sales accelerated in December to 13.3% year-on-year from 11.8% previously amid a Christmas spending spree. The acceleration was across the board, with non-food jumping by 4.2% MoM in seasonal and working days adjusted terms, leading to a 15.8% YoY rate versus 11.7% in the previous month. This came after an unexpectedly weak November for this category, especially as Black Friday has gained popularity recently.
- Nevertheless, for the whole quarter, growth decelerated in sequential terms from 4.8% to 2.5% QoQ suggesting slowdown in private demand.

Fig 4 CPI vs policy rate

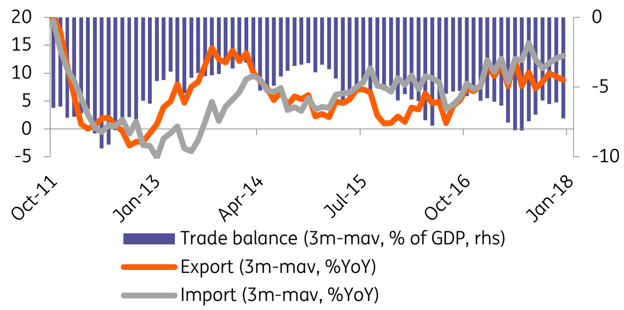


Source: Macrobond, ING

Above consensus January CPI

- Inflation came out at 4.3% YoY versus our call of 4.2% and NBR forecast of 4.4%. Core inflation came in at 2.8%, in line with our expectations, inching up from 2.4% previously.
- Food inflation slowed down to 3.7% in January from 4.1% YoY in December. Prices for non-food items accelerated from 4.1% to 6.2% due to hikes in regulated prices for gas and energy, responsible for 0.56ppt out of 1.08% MoM advance. Prices for services spiked from 0.2% to 0.9% YoY with weaker RON and base effects factored in. CPI for services is expected to accelerate in February due to base effect as indirect tax cuts from February-2017 are going out of the statistical base. Hence, we could see February headline inflation jumping further to 4.7% YoY.

Fig 5 Trade balance (3m, % of GDP)

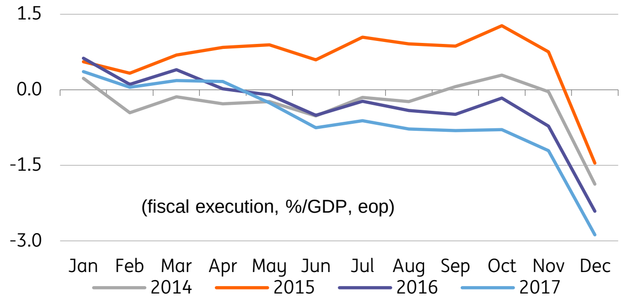


Source: Macrobond, ING

C/A at -3.5% of GDP in 2017

- The deterioration of the C/A balance was mostly expected due to the fast widening of the trade deficit by c.30% YoY in 2017. Behind the trade balance shortfall are: uncompetitive food industry, higher oil prices and a lower surplus in the auto sector due to the elimination of a car emission tax at the start of the year. Second-hand car registration jumped by 75.2% YoY in 2017.
- The services surplus increased by a meagre 3.1% YoY in 2017. Primary income widened by 12.7% to EUR-5bn likely due to higher dividend outflows. FDIs ticked up only by 1.4% YoY and are covering only c.71% of the C/A shortfall vs 129% in 2016. The capital account (C/A) inflows dropped sharply by c.48% to EUR2.2bn. The overall external position (C/A+KA+FDI) barely remained in positive territory at EUR0.3bn.

Fig 6 Budget performance YTD (% of GDP)

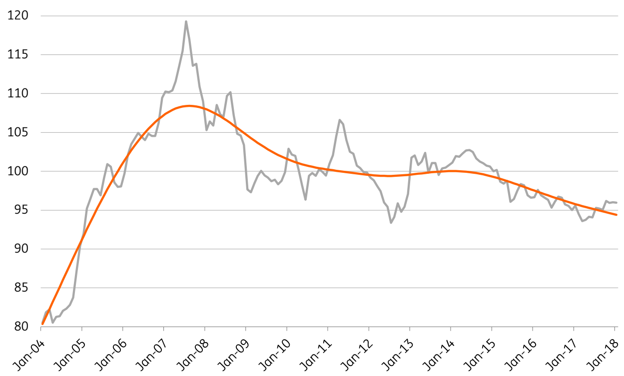


Source: MinFin, ING

Budget deficit within target in 2017

- The pattern of budget execution remained unchanged, with a cash-based deficit at -2.9% of GDP in December from -1.2% after eleven months, versus the -3.0% target.
- Budget revenues came in lower by 1.1%, despite better-than-expected economic growth. The government made some savings on budget expenditures which came 1.0% below the plan. Expenditures stood at 32.8% of GDP versus 32.9% planned. The wage envelope increased by 22.0% versus 2016 versus a plan of a 12.0% increase, or 9.0% higher than target. The largest savings came from capital expenditures -50.4% lower than planned, ending 2017 at 2.3% of GDP versus initial target of 4.8%. As a percentage of GDP this is the lowest allocation for public investments on record, with detailed data available since 2006.

Fig 7 FX: REER vs trend (index)



Source: BIS, ING

NBR sees REER appreciation in 2018

- The NBR governor reiterated that he sees no room for RON gains, but favours relatively low volatility due to its impact on inflation and inflation expectations. He also mentioned that the central bank discourages carry trade. The NBR follows the real effective exchange rate (REER). Minutes for the latest meeting highlight the importance of FX pass-through. Moreover, the NBR inflation outlook is dependent on “gradually less accommodative” and “quasi-neutral” monetary conditions in 2019.
- The Inflation Report notes that REER is expect to “diminish and even reverse” its “stimulative stance” for exports. Hence, the central bank sees a nominal RON weakness at most equal to the inflation differential of c2.5ppt. This broadly translates into an EUR/RON average for 2018 of around 4.68.

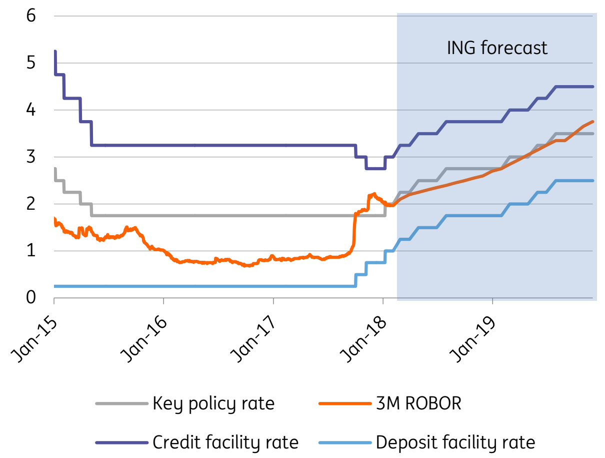
Fig 8 Main macroeconomic recent releases

Indicator	Previous -2		Previous -1		Actual		Surprise	Consensus
Industrial Sales (YoY%)	Oct	17.5	Nov	13.0	Dec	11.4		-
Industrial Production (YoY%)	Oct	9.9	Nov	9.9	Dec	12.2		-
Retail Sales (YoY%)	Oct	12.4	Nov	11.8	Dec	13.4		-
Avg Net Wages (YoY%)	Oct	13.5	Nov	13.4	Dec	11.7		-
Unemployment rate	Oct	4.0	Nov	4.0	Dec	4.0		-
GDP (SA, QoQ%)	Q2	1.7	Q3	2.4	Q4	0.6	-	1.2
GDP (YoY%)	Q2	6.1	Q3	8.8	Q4	6.9	-	7.3
CPI (YoY%)	Nov	3.2	Dec	3.3	Jan	4.3	+	3.9
PPI (YoY%)	Oct	3.9	Nov	4.4	Dec	3.7		-
Key Policy Rate Announcement (%)	Nov	1.75	Jan	2.00	Feb	2.25		2.25
Trade Balance (€mn)	Oct	-1325	Nov	-1123	Dec	-1610		-
Current Account (YTD, €mn)	Sep	-4191	Oct	-5302	Nov	-5581		-

Source: Bloomberg

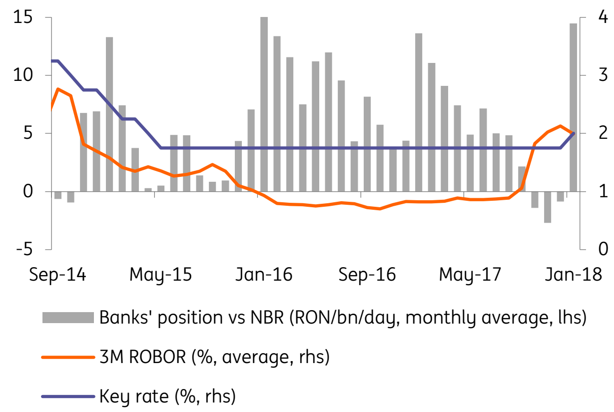
Higher interest rates as public policies inflated consumption

Fig 9 3M ROBOR to hover around the key rate...



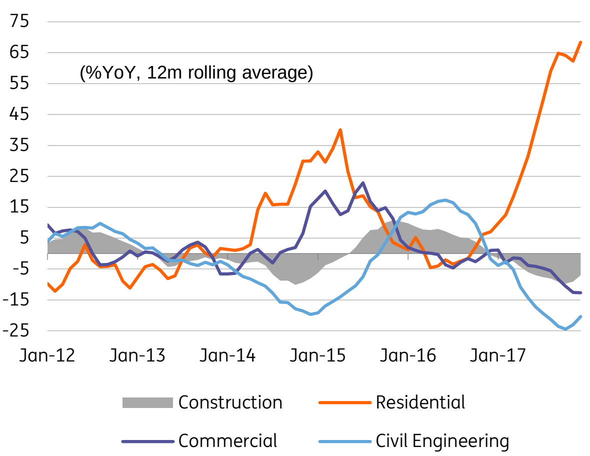
Source: NBR, ING estimates

Fig 10 ...as ample liquidity compresses term premia



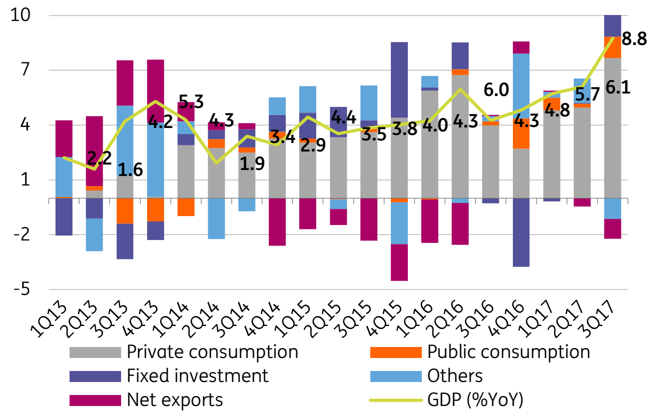
Source: NBR, ING

Fig 11 Public investments at all-time lows



Source: NIS, ING

Fig 12 Private consumption the main driver of growth



Source: NIS, ING

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