Monitoring Romania: Navigating weak growth amidst political uncertainties

Our latest update examines the impact of recent activity data and the latest administrative challenges on the economic growth outlook. We also present our updated forecasts and perspectives on the fiscal situation, highlighting the associated risks for inflation and interest rates

Bucharest, Romania

Main views and forecasts:

- We recently revised our 2024 GDP growth forecast from 1.3% to 1.0%. Despite the uncertainty brought by the ongoing electoral context, we still anticipate GDP growth to accelerate to 2.6% next year
- We continue to see the fiscal deficit at 8.0% in 2024 and 7.0% in 2025, both with upside risks at play
- We argue that it may not be long before the benefits of the Schengen ascension in 2025 and infrastructure upgrades will start translating into productivity improvements
- The much-needed fiscal correction could weigh on competitiveness, private sector investment decisions and stoke inflation as well
- Shifting consumer and business sentiment in the scenario of large-scale uncertainties in the political space are adding to the foggy picture ahead

- Should the outcome suggest a coalition focused on policy continuity, reforms and fiscal measures which are also required by the European Commission (EC) through the Recovery and Resilience Plan (RRP) milestones could remain the viable common ground for compromise, limiting the potential for EU funds delays/losses
- On the inflation front, risks remain tilted to the upside. Our latest forecasts see inflation ending 2024 at 5.0% and 2025 at 4.4%
- The National Bank of Romania (NBR) is likely to remain cautious with its easing cycle, with the high-for-longer story back in play. We don't foresee any new cuts until the second quarter of next year at the earliest. We have pencilled in a total of 75bp of cuts in 2025, taking the key rate to 5.75%, with risks tilted visibly towards higher rates and more policy space preservation in the face of both internal and external risks

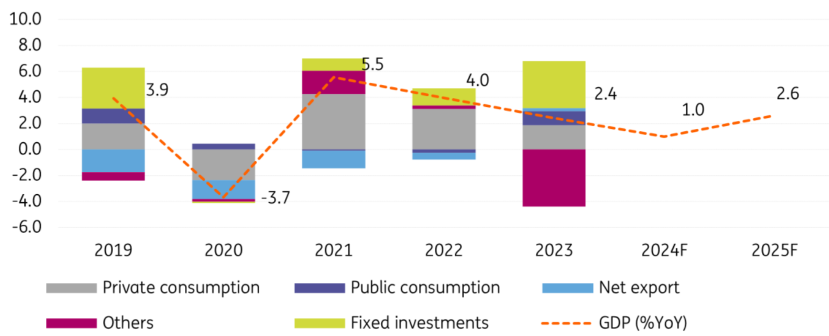
GDP – growing well below Romania's potential

The latest data shows that the economy performed visibly worse than expected over the first nine months of the year, growing only 0.9% year-to-date (YTD). Annual growth printed again below consensus at 1.1% in the third quarter. While data due on 6 December will reveal the full picture, high-frequency data and anecdotal evidence point to a continuation of the strong private consumption trends and a marginal investment spending increase, both weighed on by net exports. Given the electoral context, government spending likely remained generous into the year-end. Current spending (as a % of GDP) was roughly 2.0pp higher this year compared to 2023, growing in magnitude in the third quarter, according to the budgetary execution data up to October.

On the supply side, civil engineering-related activities continued to outshine pretty much every other sector as manufacturing and most services activities remained a drag or at best a neutral factor for output. Key worrying trends come from the IT sector, which has been flashing red for four months now and from this year's drought, which is set to weigh on the agricultural output, as well as on the food inflation.

Overall, we have recently revised down our growth forecast for 2024 from 1.3% to 1.0% on the back of persistently weak growth prints and limited potential of improvements this year. In essence, while internal demand is strong, the economy continues to perform poorly at preventing the benefits of sturdy activity from dissipating externally through imports, which weighs on growth.

An acceleration in growth in 2025 remains our base case



Source: NSI, ING

In the fourth quarter of 2024, early signs paint a mixed picture. The Economic Sentiment Indicator (ESI) picked up in October-November. Above-average consumer confidence, fuelled by still-high wage growth, is likely to help the persistent momentum of private consumption in the near term. On the more negative side, some of the real income gains will be lost as a result of the likely acceleration of inflation towards the year-end. What's more, the likely desire of policymakers to preserve a relative FX stability through a volatile year-end might have led to tighter financial conditions more recently, as visible in the diminishing interbank liquidity surplus. In turn, this could result in the peak of an already vigorous consumer credit growth by the end of the year. All in all, while private consumption is likely to remain strong in the fourth quarter, some early signs of fatigue are not excluded.

After this year's 1.0% projected outturn, for 2025, we have pencilled in an acceleration towards 2.6%. At a technical level, base effects stemming from this year's low outturn will contribute positively. Concerning economic drivers, real wage gains (albeit smaller than in 2024) and new minimum wage increases will continue to drive private consumption, while EU-funded large-scale investments are set to carry on. An automatic indexation of pensions is also scheduled for January 2025, which will give an extra boost to consumption. Lower interest rates in the eurozone should limit the downfall of the external sector somewhat, although at this stage our house view is that structural factors will continue to keep European activity in a weak state, at least in the near term. Upside potential could come from a more expansionary fiscal stance in Germany next year, depending on the early election outcome.

> *Fiscal reform next year could be in the making, potentially posing downside risks for growth and upside risks for inflation*

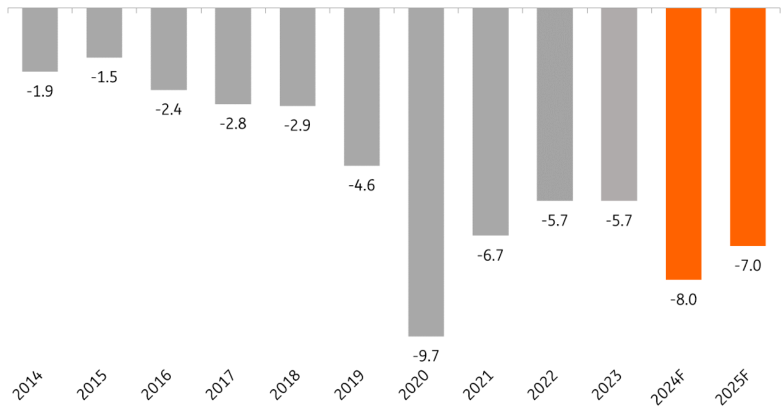
Returning to local factors, a fiscal reform to kick in next year could be in the making, potentially posing downside risks for growth and possible upside inflationary pressures. Key factors to watch are the structure, magnitude, and timing of these fiscal changes. In our view, the lengthier the political negotiations for a new government will be, the higher the risks for sub-optimal fiscal measures. Overall, risks to growth steming from the current electoral context are now higher and asymmetrically tilted to the downside.

On the other hand, potential early boosts to activity, productivity, and future business expectations could stem from the progress that will have been achieved on large-scale investments (especially roads) by then and immediately ahead. Ultimately, many of the simultaneous ongoing projects are 'once-in-a-generation' public works, delayed for many years. It should not be long before they start to impact business efficiency and optimism more visibly. Last but not least, a boost to activity will also come from the Schengen ascension scheduled for January 2025.

Bottom line, at face value, the fiscal correction will likely weigh to an extent on growth in the short run. If delayed, it will force sub-optimal measures (i.e. a larger-than-planned increase in one or more of the main taxes). However, (re)gaining the credibility on the fiscal front is a must in our view, especially after a year when the budget deficit could exceed 8.0% of GDP. Maintaining market access and smooth financing is particularly important at a time when infrastructure-driven productivity improvements will be in full swing, in an international context where friendshoring and nearshoring will likely remain key policy priorities.

Not to avoid the elephant in the room, strictly on the economic front, even in a scenario where the political landscape shifts towards being less policy continuity-oriented, the negative impact on growth and additional fiscal slippage could still be limited by the relatively tight RRP milestones that condition still generous EU funds disbursements.

Fiscal – skating on thin ice



Source: Ministry of Finance, ING

The market's patience on the fiscal developments has been constantly tested throughout 2024. This was due to both subsequent upward revisions of the budget deficit target and financing needs in the short run, as well as through a reasonable questioning of the credible path towards a 3.0% deficit in the long run. The uncertainty surrounding the elections outcome insert more uncertainty into the picture, adding to the upside risks for the 2025 deficit.

- We think it is more likely than not that the 12.1% automatic pension indexation will kick in starting January 2025. This pension increase will come on top of the last increase in September 2024
- A political uncertainty risk could remain priced across the yield curve, pressuring the already rising interest expenditures
- Key compromise areas might revolve less around this year's typical political economy debates like flat versus progressive taxation. Instead, issues like military pensions, corporate governance, and the dimension of the state apparatus will likely dominate the debate. Next in line would probably sit the taxation of SMEs, property, dividends, and luxury
- Despite a mixed progress so far, the government managed, to an extent, to deliver minimum reform requirements while still keeping the local political arena aligned – this has largely limited the EU money losses so far but accumulating more delays is not an option if the country still wants to fully tap its EU funds allocation
- The relationship with the EC and EU has also remained in good standing, an element which ranks high on both investors and rating agencies' heatmaps, despite the large fiscal deficit and the EDP procedure
- The structure of a new fiscal package remains uncertain: a hypothetical scenario could involve a significantly reduced SMEs ceiling, coupled with a higher tax burden on property, luxury and dividends, as well as a full removal of fiscal facilities for certain industries. VAT

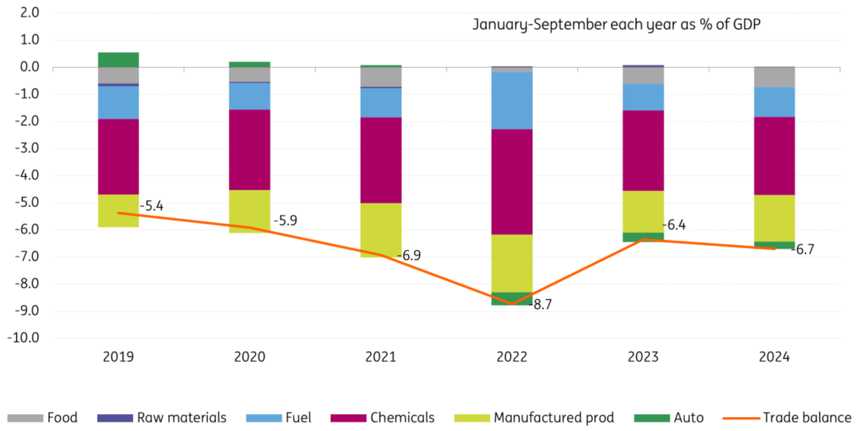
and or PIT increases are not to be excluded either, but the upwardly revised inflation prospects through the medium term complicate this matter greatly

- On the expenditures front, while the post-elections environment theoretically favours such corrections, it still remains one of the most exposed matters to the new coalition consensus
- On the outlook, we continue to envision an 8% of GDP budget deficit for 2025, and 7.0% in 2025. This year's vigorous spending could still bring upside surprises, given an emergency decree draft published on the Ministry of Finance website on 2 December, stating that the ceiling of the 2024 budget deficit sits at 8.58% of GDP. All in all, concerning financing costs, a still-high issuance, a revised inflation path and rising risk premiums will likely keep the pressure on country's yield levels. Forming a government coalition quickly will be very beneficial, but markets may still wait for concrete measures before regaining a more positive sentiment towards Romanian debt.

Balance of Payments (BoP) – last year's gains had a short life

In the first nine months of the year, the trade balance (most important driver of the BoP) worsened visibly as the deficit increased 15.1% year-on-year. This is already reversing last year's gains. The negative drivers, compared to the same period of 2023, were higher deficits in foods, fuels, chemicals and manufactured products, coupled with a much smaller surplus in raw materials. A smaller deficit was recorded in the auto sector.

Strong internal demand pushing the trade imbalance higher



Source: NSI, ING

Overall, the trade balance reading continues to reflect a strong internal demand generated by a sharp response of consumers to real wage gains, a significant fiscal slippage and large-scale investments. All of these elements have boosted imports significantly, while the state of the German industry and European activity as a whole remained weak, weighing on exports.

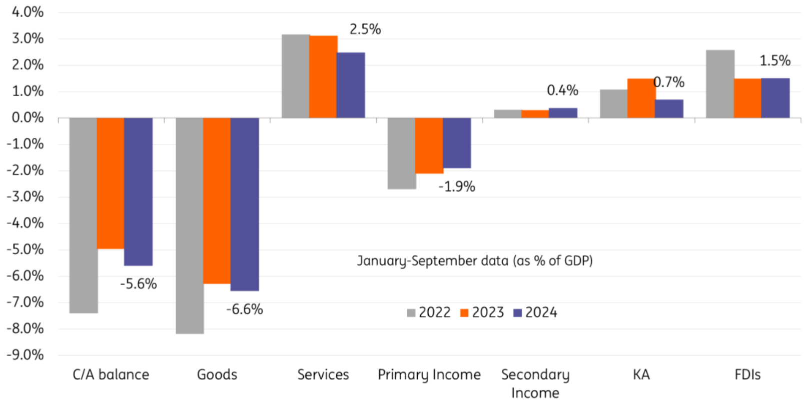
For 2025, we don't expect meaningful changes in the trade balance dynamics, since we do not anticipate a significant or sudden cooling of the economy. Meanwhile, our view is that the outlook for the eurozone economy remains relatively gloomy, which will still act as a headwind for exports in the near term. Here, upside risks stem from potential industry stimulus programmes in Germany, while downside risks stem from US tariffs entering the scene.

Turning to the surplus in services, declines in 2024 compared to 2023's EUR13.5bn surplus are now likely as the surplus over the first half of the year is now almost 15.0% smaller. Transport and IT activities will likely continue to bring most of the surpluses. Meanwhile, tourism abroad will likely continue to weigh negatively on the services trade balance for the foreseeable future.

On other items, we expect EU-funds inflows directed towards infrastructure projects to continue to stimulate the capital account, while on foreign direct investments, we could see some marginal pickup as the new infrastructure projects gradually start to shape up new business opportunities which were previously not viable.

All in all, we expect the current account deficit to remain elevated in 2025 as well. Nevertheless, we have pencilled in a small improvement from this year's projected -7.9% of GDP to -7.4% of GDP.

The current account deficit worsened compared to the same period of 2023



Source: NSI, ING

Ratings – No downgrade expected, but risks have nevertheless increased

The persistent fiscal slippage, with a slow-paced projected adjustment, will continue to remain the main cause of concern for rating agencies, weighing on Romania's prospects. While the bar for a downgrade remains high, we think, risks for an eventual negative outlook cannot be ignored and have likely increased.

Overall, we expect the rating reports to display a harsher tone on fiscal developments. That said, we see rating downgrades as a possibility in the case of an imminent and significant EU funds absorption issue, which is not the case right now, or a general deterioration in the relations with the EC – also not the base case. A prolonged political instability period (also not anticipated) could weigh in on the negative side as well since this would delay the needed fiscal reform. However, the fact that the deficit remains high but there is a plan agreed with the EC that backs EU funds inflows and the financial markets' confidence should, in principle, keep rating agencies from downgrading Romania over the forecasting horizon.

Monetary policy and inflation – high(er)-for-longer back in play

The NBR began the easing cycle in July-August on the back of a fairly good inflation progress through the first half of the year. The 50bp of cuts in the summer brought the policy rate to 6.50%, where it has remained since. This has been in line with our view that only a gradual and slow easing cycle is currently viable, given the upside risks for inflation through the medium term. Some of them, mainly food inflation, have indeed materialised. Also, services inflation continued to remain stubbornly high. This led to a higher projected inflation path through the medium term, which involves an acceleration over the next few months.

This factor, coupled with higher uncertainty stemming from local elections, geopolitics and the policy of central banks in core markets, could lead the NBR to embark on a policy strategy that involves less excess liquidity in the interbank market. Remember, over the last two years, EU funds inflows and the government's FX debt sales have indirectly boosted the interbank excess liquidity, which reached a peak of RON60.7bn in January this year. In practice, this led to looser financial conditions for both the government and the private sector, compared to the outcome where the NBR had intervened to sterilise this excess liquidity at the policy rate. As such, market rates have revolved around the deposit facility of the Bank, and not the key rate.

As of recent, interbank rates started to shift visibly higher from the previous alignment with the 5.50% deposit facility, and at the time of writing, they sit close to the midground between it and the 6.50% key rate. This could be an indication that the NBR wishes to bring the liquidity surplus closer to levels that could be kept in-check, if needed, without large-scale and sudden market interventions. As such, it should not be excluded that, going forward, we might see excess liquidity levels sitting between RON10bn and RON20bn, as a middle ground between tackling higher uncertainties and preserving not-too-tight financial conditions.

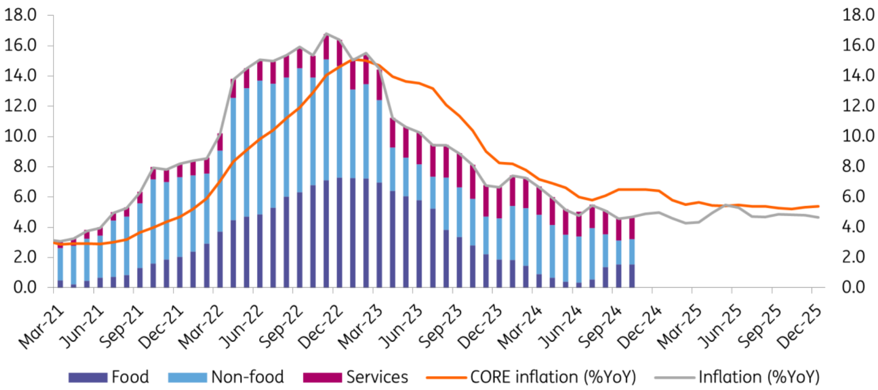
We believe that NBR's policy restrictiveness had a limited impact on the domestic demand and credit activity. On top, upside risks for inflation are now magnified by the possibility of both food and energy price pressures hitting the economy simultaneously or at close intervals, at a time when the minimum wage and pensions continue to grow. This raises the stakes for the need to preserve the policy space in the near term. This is also in tune with Governor Isarescu's recent hint that rates might stay in place until there is more clarity on the fiscal outlook and the subsequent inflationary pressures attached to it.

Concerning the FX markets, we continue to think that there is little room for EUR/RON to move from the current levels in the short run. The NBR will likely aim for the disinflationary trend to resume as soon as possible, after the projected near-term term hiccup, and we think that FX stability will continue to play a key role here.

> *We now expect the National Bank of Romania to cut rates by 75bp in total for 2025, with the cuts to be backloaded*

All in all, we continue to see policymakers remaining cautious with policy easing ahead. We have recently revised our total rate cuts forecasted for 2025 from a total of 100bp to 75bp. Moreover, we expect the Bank to hold fire through the first half of the year, with cuts backloaded into the second part of 2025. As such, we foresee a key rate of 5.75% at the end of 2025, with upside risks at play. Key factors to watch are the extent of wage growth moderation, the fiscal reform and energy markets developments.

Core inflation set to remain above headline through the forecast horizon



Source: NSI, ING

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