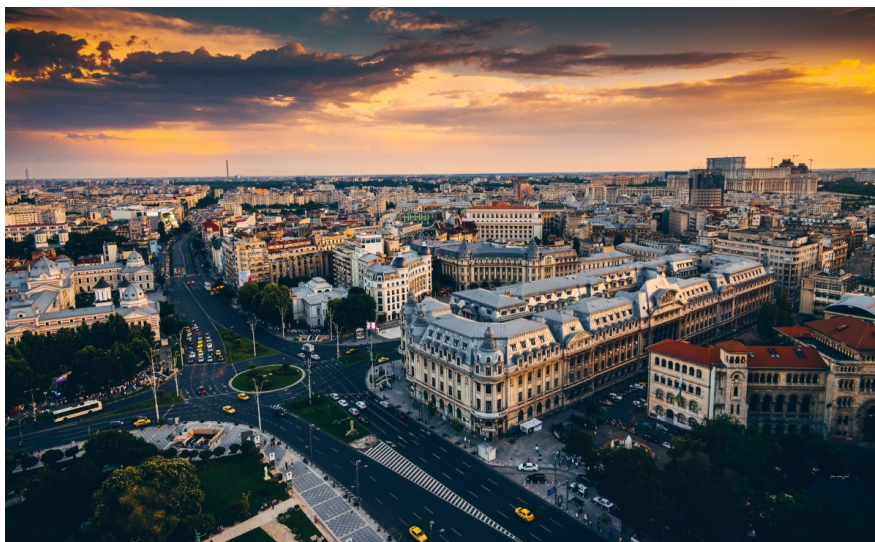


Monitoring Romania: Robust internal demand clouded by weaker-than-expected growth

Our latest Romania update highlights the impact of recent activity data on the economic growth outlook. We also outline our latest views on the fiscal situation, and what it means for inflation and rates



Bucharest, Romania

Main views and forecasts

- The unexpected weakness in growth has prompted us to revise down our 2024 GDP forecast from 2.8% to a still optimistic 2.0%, with risks at play.
- Industrial production growth should continue to muddle through given the rather weak fundamentals of the German industry and local demand.
- The retail sector will likely remain in good shape for the rest of this year and next, although risks to its outlook remain foggy due to a combination of sharp growth in credit-based consumption and weak economic growth.
- Services for companies should continue to diverge between robust demand for engineering services and uncertainty in other sectors, like IT and road transportation.
- Services for the population have underperformed recently and the prospects for improvements are limited in the near term.

- The construction sector is set to continue to benefit from large-scale civil engineering projects, with persistently subdued activity in residential and commercial – which will get tailwinds from lower rates but also headwinds from weaker-than-expected GDP growth.
- A worsening trade balance and a lower surplus in services are set to weigh on the current account and reverse some of last year's gains.
- Fiscal policy is set to remain loose. We estimate the cash deficits this year and next at 7.0% and 6.5% of GDP.
- Monetary policy is set to remain fairly restrictive through the forecast horizon, although downside risks for rates have increased due to the weak GDP data and fairly well-behaved headline inflation.
- We continue to see inflation ending the year at 4.2% and 4.1% at the end of 2025.

Quarterly forecasts

Quarterly Forecasts	Q2 24	Q3 24	Q4 24	Q1 25	Q2 25	Q3 25	Q4 25
Economic Growth (GDP, ann. var. %)	0.8	2.8	3.3	2.1	2.9	2.5	3.0
Inflation (CPI, ann. var. %, eop)	4.9	4.4	4.2	3.4	4.1	3.8	4.1
NBR Reference Rate (% eop)	7.0	6.5	6.5	6.5	6.3	6.0	5.8
3-Month ROBOR (% eop)	6.0	5.7	5.6	5.6	5.3	5.1	4.8
10-Year Bond Yield (% eop)	6.7	6.6	6.6	6.6	6.5	6.4	6.2
Exchange Rate (RON per EUR, eop)	5.0	5.0	5.0	5.0	5.0	5.1	5.1

Source: National sources, ING estimates

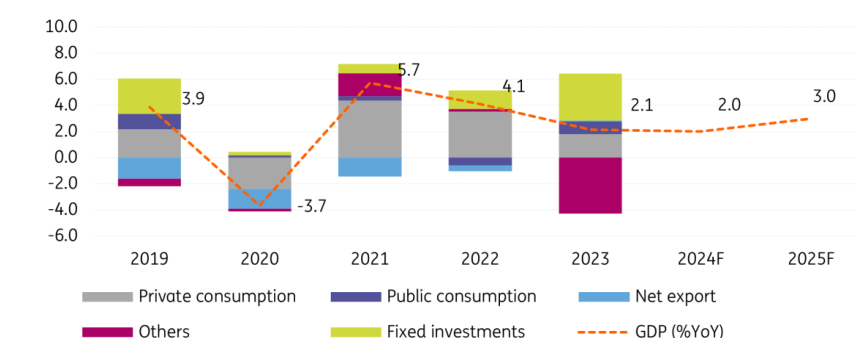
GDP – unexpected weakness set to bring a second consecutive growth slowdown

The latest data show that the economy performed visibly worse than expected over the first half of the year. Annual growth stood at 0.8% in the second quarter and at a downwardly revised 0.1% in the first quarter. While data due on 6 September will reveal the full picture, intermediate data points to strong private consumption and still robust but likely decelerating investments.

That said, net exports and inventories were probably a drag on growth, due to the combination of strong internal demand and a weak external sector. Given the electoral context, government spending looks set to remain generous, although its contribution to GDP growth might be limited given that 2023 closed with an already high 6.7% of GDP budget deficit. On this, current spending (as a percentage of GDP) was indeed roughly 1 percentage point higher this year compared to 2023, according to the budgetary execution data at mid-year.

We have recently revised down our growth forecast from 2.8% to a still optimistic 2.0% on the back of the weaker-than-expected performance in the first half of the year. Our forecast remains under review until the detailed release of the second-quarter GDP data on 6 September.

An acceleration in growth is no longer the base case



Source: NSI, ING

On the supply side of the economy, civil engineering-related activities continued to drive growth positively, while most manufacturing and some services activities were a drag on activity. Agricultural output was also reportedly visibly damaged by the sustained drought. Admittedly, the first half of the year brought some improvements in the services for the companies' sector, but services for the population remained lacklustre.

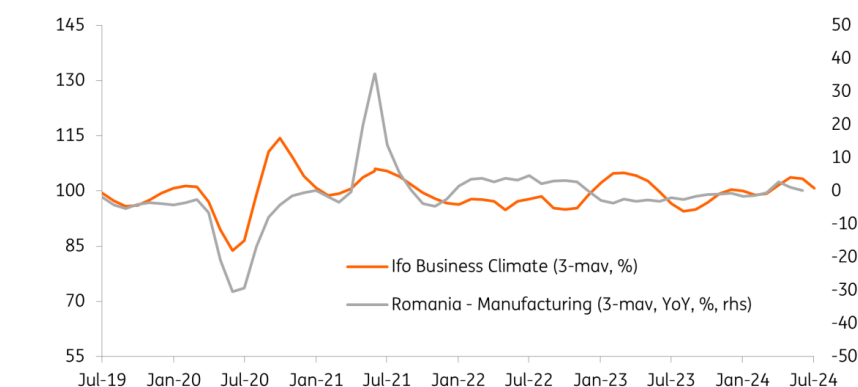
In the third quarter of 2024, early signs paint a mixed picture. The Economic Sentiment Indicator (ESI) dipped in July, although it remains at levels consistent with a fairly decent performance of activity. Sentiment indicators in the construction and consumer sectors continue to remain above their long-term averages, in line with the strong public investments and visible wage rises. On the more negative side, some of the real income gains were lost as a result of the acceleration of inflation towards 5.4% in July due to the higher fuel excise and higher gas prices. We expect this to be temporary, with disinflation set to resume as early as August, without a significant impact on the third quarter's private consumption. A positive impulse to consumption might come from the decline in interest rates, given the National Bank of Romania's cumulative 50bp cut in July-August. Usually, monetary policy operates with a lag, but in an instance where credit activity was still growing visibly at the peak of the hiking cycle, looser financial conditions should feed in much more quickly.

For the whole of 2024, the growth situation is rather uncertain. Our previous scenario was a GDP growth acceleration from 2.1% in 2023 to 2.8% in 2024. Given the negative surprises through the first half, a slower growth compared to 2023 looks like the base case now.

Industrial production – improving mildly or bottoming out?

Industrial production remained weak through the first half of the year, continuing its multi-year downward trend, as lower external demand and competitiveness issues continued to bite. The signs of life shown by the German industry in spring failed to translate into a more visible recovery, [in line with our expectations](#). By extension, this translated only into some mild improvements for the Romanian manufacturing sector through the first half of the year. On the other hand, energy production continues to remain deep in negative territory.

German activity continues to provide headwinds



Source: NSI, Ifo Institute, ING

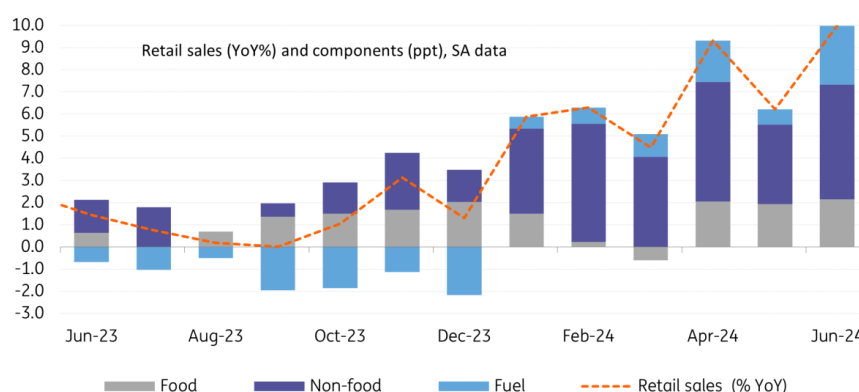
Looking ahead, we don't see realistic prospects of a sustained recovery of industrial production. Demand from European peers does not have the fundamentals to revive suddenly over the forecasting horizon. Moreover, a still-overvalued RON and higher advances in labour costs compared to other markets are set to continue to weigh on local manufacturing, at least in the near-to-medium term.

What's more, while not a threat in itself, producer prices are no longer falling as PPI inflation returned to positive territory for the first time since the summer of 2023. In the medium-to-long term, industry should benefit from the ongoing large energy projects – Neptun Deep by 2027 and an increased capacity of the Cernavoda nuclear powerplant, potentially by 2030, while the manufacturing side seems bound for a long muddle-through.

The consumer sector – where the sun shines and wages rise

Retail sales grew by 7.0% year-on-year in the first six months of 2024, setting the stage for a much better performance in 2024 compared to the rather meagre 1.8% growth in 2023. Non-food sales accounted for the largest proportion of growth, followed by fuel and food. The significant increase, higher than what we had expected for this year, came as a result of a strong response from consumers to the real wage gains they acquired.

Consumers – living in the moment(um)



Source: NSI, ING

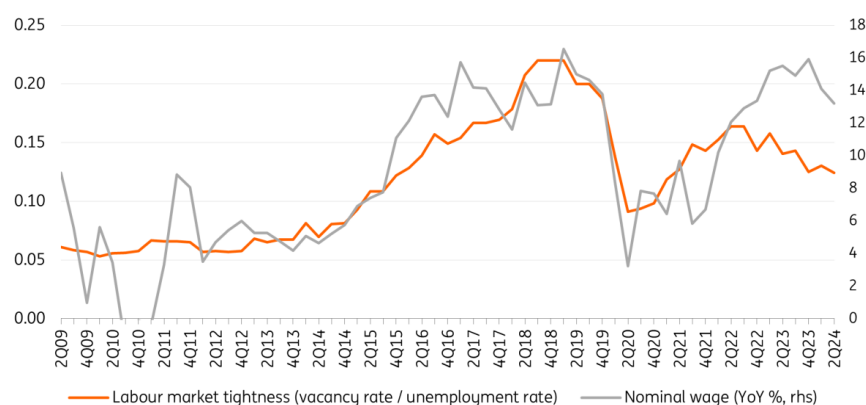
Looking ahead for the rest of this year, we continue to see retail sales remaining at robust annual growth rates, supported by still-strong income growth (both wages and pensions) and lower interest rates. For 2024 as a whole, we have pencilled in 8.0% real growth.

Next year, the retail sector's growth is set to slow, in line with real wages. Rises in public sector wages are unlikely to continue to dominate as they did this year and the overall wage dynamics should start to align more with private sector wage growth, which has started to moderate already. That said, pension increases as of this autumn will add support, especially in the first half of 2025. Overall, after this year's strong performance, we expect the retail sector to post a still-decent 3.5% growth in 2025.

Risks to the outlook are visible and balanced in both directions, in our view. On the one hand, this year's momentum could continue to surprise upward and take retail growth to around 10.0%, on the back of further increases in consumer credit. On the other hand, data on consumer deposits and retail bond buying show that, at least for some parts of the population, the savings appetite is also strong. What's more, the negative surprise in GDP growth shows that some sectors of the economy are not performing that well. In this environment, the risks of consumers losing their appetite more quickly than usual are larger, especially as momentum seems to have a meaningful credit-based component.

Further nuances regarding consumption patterns ahead can be inferred from labour market developments.

Nominal wage growth set to resync with the labour market tightness



Source: NSI, ING

In short, higher values of the labour market tightness indicator are essentially pushing up wages. The reverse applies as well. The disconnect of the last two to three years has come on the back of a rather strong inflationary spike, a lot of which has cooled in the meantime – inflation reached 5.4% in July. As such, we expect the relationship to restrengthen in the coming quarters, with the labour market tightness continuing to exhibit a good predictive power for nominal wage evolution.

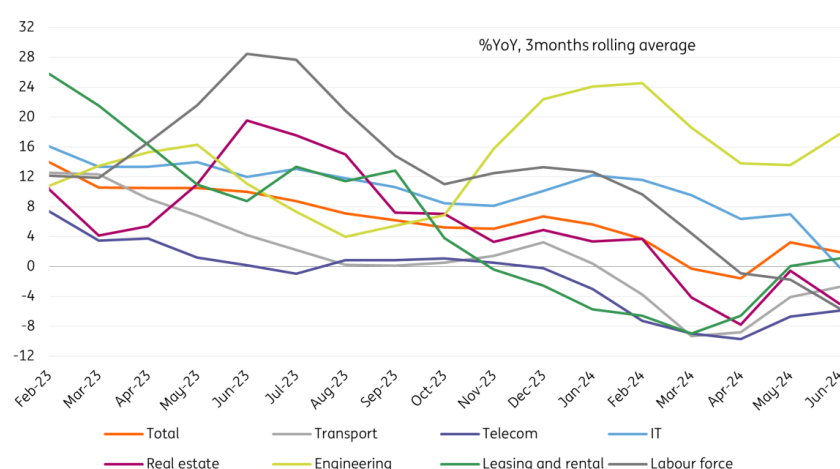
The current downward trend in labour market tightness could reach theoretical levels consistent with 6-7% nominal wage growth in the coming quarters, and actual wages should follow suit as the relationship normalises. A scenario in which growth continues to disappoint in the coming

quarters could align the two even earlier, to the detriment of private consumption.

Services for companies – asymmetric developments carry on

The evolution in this sector resembles the dynamics seen in other sectors. In the first half of this year, engineering services remained comfortably in double-digit growth, another element that points to the ongoing public investments boom. This remains the only category that shines here. On the other hand, the IT sector suddenly plunged into a steep contraction at the end of the second quarter; a worrisome signal for the sector. Real estate and transport performed poorly as well, while the leasing and rental sector has started to recover some of its losses from the last year.

Services for companies



Source: NSI, ING

Looking ahead, we expect broadly the same picture to remain in place over the coming quarters. Namely, engineering should continue to perform well as long as the push towards large investment programmes remains. So far, based on the recent reported discussions between the government and the European Commission, this continues to be the case.

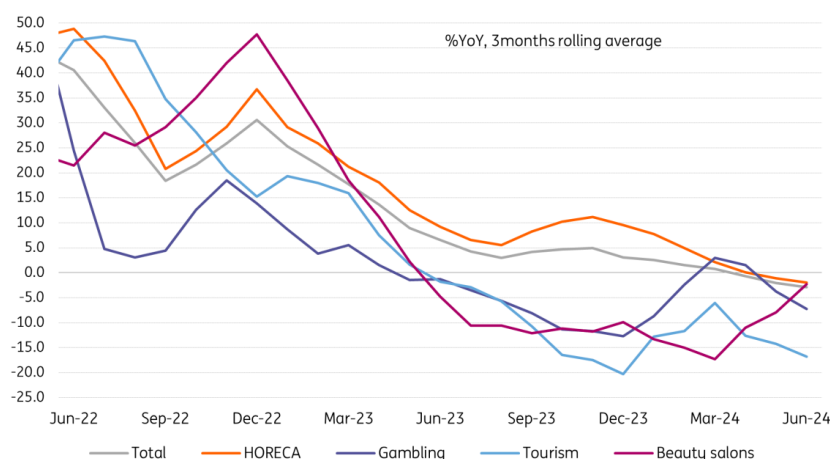
On the other hand, the increased likelihood of deceleration of the economy in 2024 will cap the improvements of most other categories, at least in the short run. At the same time, barring an unexpected recession, the situation is unlikely to worsen either. A key factor to watch is the extent to which the recent losses of the IT sector will remain temporary or become more structural. For Romania, as a key outsourcing destination, the impact on activity could turn out to be sizeable.

Services for the population – unlikely to outperform in the near term

When it comes to the services for the population, asymmetries are less stark compared to services for companies, and all the categories we follow are now in contraction. From a private consumption perspective, this represents a visible contrast to the retail sales activity. Potential reasons for this discrepancy could be related to the still high and stubborn services inflation, as well as less generous holiday vouchers lately, contrasted by smaller price pressures across most

goods and a likely constant stream of promotions that have continued to stimulate retail consumers. Also, ultimately, the stronger credit activity for consumption purposes is much more likely to go towards goods, like new home appliances, rather than services, like HORECA, where cash at hand is a stronger deciding factor.

Services for the population



Source: NSI, ING

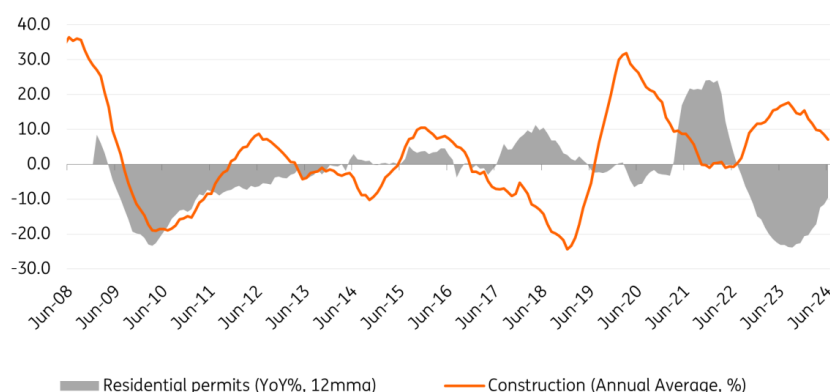
Looking ahead, we expect this sector to remain in stagnation mode in the near term and even in the medium term, given the prospects of a slowing down economy and potentially higher taxes in 2025.

Construction – civil engineering continues to run the show

After a solid 15.4% expansion in 2023, the construction sector fell 2.3% year-on-year in the first half of the year. The worsening can be traced to a very weak performance in January after a relatively strong December outturn, likely related to the increased tax burden on property transactions which came into play this year.

For reference, over the first half of the year, the residential sector fell by 21.8%, commercial projects stagnated, while civil engineering output is up 9.4%. So far, these dynamics set the stage for a visibly worse performance of the sector compared to last year, when residential stagnated, commercial picked up 4.0%, while civil engineering projects picked up by an impressive 31.6%.

Improvements in residential permits set to keep constructions afloat



Source: NSI, ING

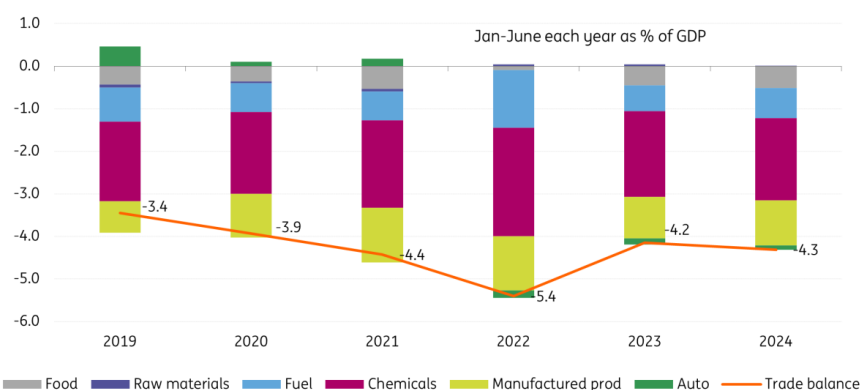
Overall, we expect the construction sector to broadly stagnate in 2024. For civil engineering, robust growth rates in the coming quarters are likely on the back of a political consensus and National Recovery and Resilience Plan (NRPP) deadlines that are set to stimulate investments further.

For residential and commercial, the situation is rather mixed. On the one hand, improvements in residential permits (a proxy for future projects) and the beginning of the easing cycle from the National Bank of Romania (NBR) are both factors that will add support to supply and demand. That said, the economy is not performing at its best and has the potential to slow this year. As such, risks are for headwinds to be stronger than tailwinds.

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

In the first half of the year, the trade balance (the most important driver of the BoP) visibly worsened – the deficit increased by 13.2% YoY in the first six months, almost fully reversing last year's progress over the same period. Between January and June, goods exports amounted to €46.3bn, while imports were €61.3bn, leading to a deficit of €15.0bn. 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.

Strong internal demand pushing the trade imbalance higher



Source: NSI, ING

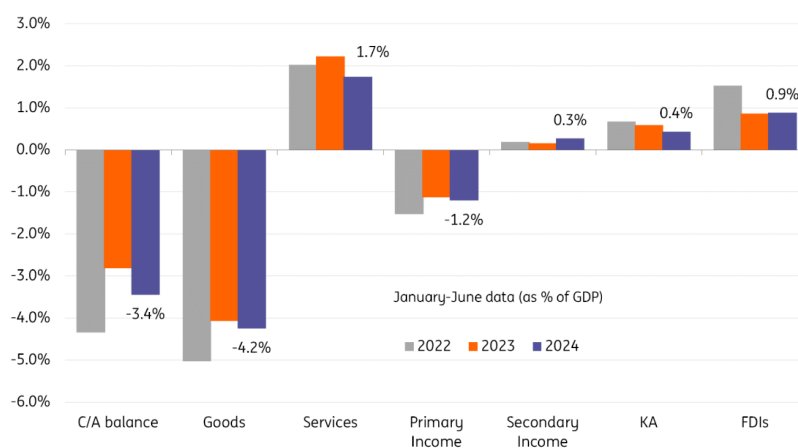
Overall, the trade balance reading reflects a strengthening internal demand generated by a sharp response of consumers to real wage gains, a loose fiscal policy and large-scale investments which likely need lots of imported items and machines in the process. All of this has happened simultaneously with a structural worsening in activity and the prospects of the German industry, Romania's key trading partner. For the rest of 2024, we expect the same situation to prevail. Only a significant and sudden cooling of the economy, which we do not expect, could act as a mitigating factor. Meanwhile, we expect the eurozone economy to continue to grow relatively modestly in the coming quarters, which will still act as a headwind for exports.

Turning to the surplus in services, declines in 2024 compared to 2023's €13.5bn surplus are now likely as the surplus over the first half of the year is now almost 15.0% smaller. Transport, telecommunications and IT activities will likely continue to bring most of the surpluses. Through the medium term, the strong interest in AI at a global level makes for a challenging outlook for Romania's IT exports, unless the local industry is adaptive enough.

On other items of the BoP, we don't see much potential for an improvement in the primary income balance given the unfavourable dynamics of portfolio investments. On the other hand, 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 pick up 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 this year as well. We have pencilled in a marginal deterioration from -7.1% of GDP to -7.3% of GDP.

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



Source: NBR, ING

Fiscal – persistent slippage as the new normal but investments are finally here

The fiscal deficit stood at 4.0% of GDP after the first seven months of the year, paving the way for our 7.0% year-end estimate to remain the base case. This has been our view for a while now and, more recently, we have started to see indications that such a scenario is officially on the cards. As

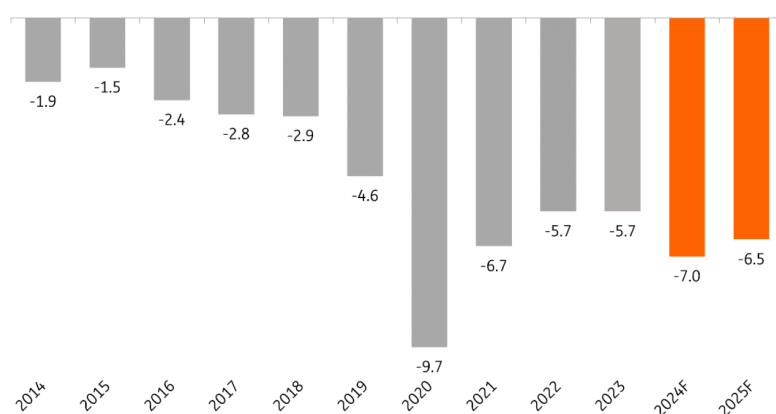
of July, revenues amount to roughly 19% of GDP, while spending is 23%, amounting to a deficit of 4%.

Among revenues, the biggest improvements (as a percentage of GDP) compared to the same period of last year came from social insurance contributions, as well as income and profit taxes – which likely resulted from a mix between lower fiscal facilities for certain industries, a higher minimum wage and potential improvements in collection. It is worth noting that this increase came in the context of a much slower-than-expected GDP growth over the first half of the year. Moreover, VAT revenues are also up in terms of GDP compared to the same period of last year, and so are some EU money inflows.

On the spending side, the core drivers pushing up the deficit are items related to investments, wages and social assistance. On current spending, public sector employee compensation is visibly up – 0.6pp higher in terms of GDP compared to the same period of last year. Also, spending on goods and services and social assistance have had a visible upward contribution.

As it stands, we maintain our deficit forecast of 7.0% of GDP this year and 6.5% in 2025. Assessing the latest developments, we believe the risks are now balanced, with several recent facts and news supporting this argument.

Fiscal slippage set to carry on



Source: MoF, ING

Firstly, Romania's negotiations with the European Commission (EC) are likely to result in a seven-year adjustment plan, leaving room for smaller adjustments in 2025-26 as long as the investment cycle carries on, which will be compensated by larger adjustments afterwards. In itself, this agreement should prevent rating agencies and financial markets from worrying too much about Romania's growing macro imbalances. That said, it is unlikely that the EC will remain lenient towards a deficit that's anything above 7.0% as a starting point for the adjustment.

Secondly, the government looks committed to keeping spending slightly more in check in the second half of 2024 and likely next. In short, schemes to lower its arrears and to freeze current spending on non-essential items are set to come into play. Also, public goods spending in the last four months of the year should not exceed the average of the January-August period, with certain exceptions, like medicines, for example. What's more, just as it did this year, the government can also defer some payments towards 2025, to the gain of the cash deficit.

For next year, it had long been our view that the tax burden will increase. While we continue to see the need for higher revenues, the latest developments make it more likely that the government will pursue minimal improvements, most of them via the spending channel, leaving the main taxes in place until 2026. In this scenario, only one quick tax adjustment could come from a higher tax burden on SMEs after the elections, which would unlock additional NRPP money next year. Instead, the first half of 2025 would be left for the new government to design a fiscal reform that would start more predictably in 2026. While the reform is unlikely to come without higher taxes, a potentially good development could emerge from a better alignment between the labour and capital tax burden.

We believe this scenario, while the most plausible right now, is highly contingent on the EC's protracted patience towards a minimal improvement in the budget deficit next year. It is not a given yet but recent declarations point in that direction. From an activity point of view, keeping taxes in place after a year of weaker-than-expected growth would avoid pro-cyclical-like measures. On the other hand, postponing adjustments increases the risks and the stakes of adverse global events catching Romania in a weak position, with potentially severe effects later on.

Ratings – No downgrade expected

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.

Overall, we expect the rating reports to display a harsher tone on fiscal developments. That said, we see rating downgrades as a possibility mainly in the case of an imminent and significant EU funds absorption issue, which is not the case right now, or a general deterioration in relations with the EC – also not the base case. Concerning the future, 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 – Weaker-than-expected growth complicates the higher-for-longer case

The National Bank of Romania began its easing cycle in July and continued in August on the back of fairly good progress on inflation in the May-June period. The 50bp of cuts so far brought the policy rate to 6.50%. As it had been the case for a while, the unsterilised excess liquidity in the interbank market pushed market rates lower and anchored them to the deposit facility, which is currently at 5.50%.

It had been our view for a long time that the Bank can only deliver a cautious easing cycle. We think that is still the case. Ultimately, progress on the inflation front was largely due to factors outside the NBR's control, like food prices – which have a strong influence from international markets, and gas prices – which are an outcome of local regulation.

We think that officials have not yet been satisfied with the way that policy restrictiveness managed to impact internal demand and credit activity. Indeed, the deceleration of inflation allowed for the policy space to begin cutting rates. But more fundamental elements for demand such as double-digit wage growth, the "living-in-the-moment" retail sales consumers and a loose

fiscal stance mean that medium-term risks for inflation remain tilted to the upside. As such, the policy fine-tuning is unlikely to leave as much room for rate cuts as a typical easing cycle.

Against this background, the recent prospects of disappointing GDP growth rates this year turn the situation in favour of less policy restrictiveness. In a scenario in which the economy slows from an already sub-par growth rate recorded last year, the probability of another rate cut this autumn has increased materially.

On another note, EU fund inflows and new FX debt sales by the government are set to continue to stimulate interbank excess liquidity ahead – with no clear end in sight. This will continue to keep the deposit rate as the de facto policy rate through the forecasting horizon, unless a major global event prompts the NBR to tighten policy quickly by using the key rate. We don't expect any changes to the corridor, meaning that the deposit rate will likely remain 1.0pp below the key rate for the foreseeable future. For 2025 as a whole, we expect a total of 75bp in rate cuts with risks for more rather than less.

Inflation – probably not enough to reach the target by end-2025

Inflation reached 5.4% in July, picking up at the beginning of the third quarter from 4.8% in June, mostly due to the hike in fuel excises. Looking at the year-to-date developments, the disinflation process has shown visible progress, but we think that the NBR is a bit too optimistic about the outlook.

Food inflation – with a large influence from international markets – was a key contributor to the disinflation process, decelerating from 5.6% in January to 1.6% in July. On the other hand, non-food and services inflation – much more relevant for the internal demand that the NBR is supposed to influence with its policy – remained quite stubborn – decelerating from 7.4% to 7.0% and from 10.9% to 8.5%, respectively, over the same period. Both look still high and the underlying factors that support them, like a still-sharp wage growth and a loose fiscal policy, have limited room for cooling this year.

We think that policymakers are unlikely to treat these matters lightly in the upcoming decisions, especially since they've already used some of the policy space available with the 50bp of cuts so far, and uncertainty over the medium-term inflation prospects remain, namely risks that inflation might hover above the 3.5% upper target through the forecasting horizon.

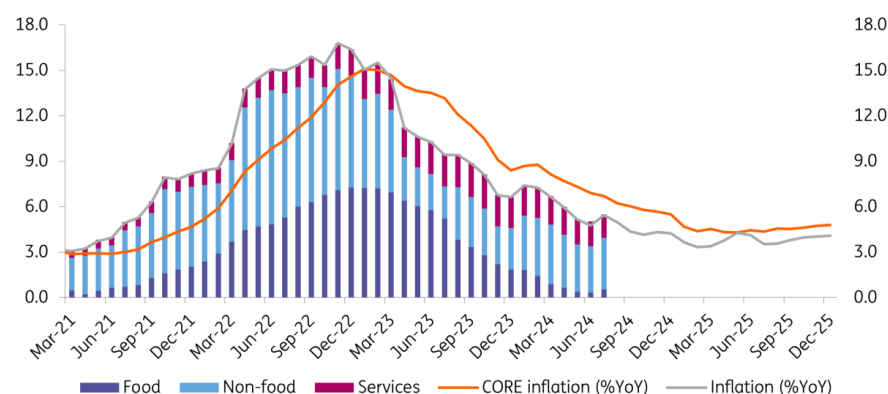
In our scenario, the key risk for inflation ahead is the fiscal policy and how the fiscal adjustment will be carried out. Should it put more emphasis on income taxes, then the prospects for inflation to cool are on the rise. However, raising taxes on labour is usually not the preferred way for officials, hence adopting measures that can then be more easily transferred into prices might offset some of the deflationary trend. However, the possibility of that diminishes considerably if the government manages to agree with the EC on the prospects of delivering an only slightly lower deficit in 2025-26 through collection improvements and a higher spending caution only.

Recent hints from officials pointed in this direction, with credibility added by the fact that the relationship between the EC and the government has proven to be consistent. Instead, these fiscal policy risks for inflation would move further down the forecasting horizon, in 2026 – when both the fiscal reform and the public sector wage reform (prepared more predictably next year) would enter

into force.

Overall, we are holding on to our inflation forecasts of 4.2% by year-end and 4.1% by the end of 2025, with balanced risks.

Price pressures set to remain slightly above target through the forecasting horizon



Source: NSI, ING

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