Monitoring Romania

In the first quarter of 2022, Romania posted its second-highest quarterly GDP advance ever. Because of this, it would now take some terrible developments to take the growth story below 5.0% this year. Inflation remains by far the main enemy, with the National Bank of Romania (NBR) having little choice but to continue its hiking cycle

GDP growth in Romania is surprisingly strong

A snapshot of Romania's economy:

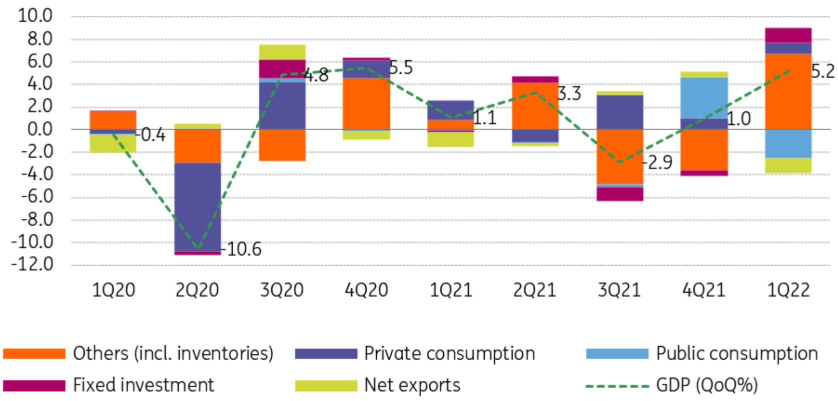
- GDP: after the +5.2% quarterly growth in 1Q22, we find little-to-no economic arguments for projecting a GDP growth below 5.0% this year. However, historical data revisions and/or abnormal statistical assumptions cannot be forecasted.
- Inflation: the endless upward revisions of the inflation forecasts have been a standard for the past year or so. But as energy prices have stabilised somewhat – albeit at higher levels – and second-round effects are becoming more measurable, the forecasts have somewhat stabilised as well. We see inflation at 13.0% in 2022 and 8.9% in 2023.
- EUR/RON: breaking above 4.95 is a matter for next year, as it's currently very stable.
- Budget deficit: it remains Romania's Achilles' heel, but so far the -5.8% of GDP target for this year still looks reasonable.
- Bond yields: with the entire curve trading in some 50 basis points around 9.0% and more hikes to come both locally and internationally, it is difficult to be constructive on it. However,

we believe that current levels do price in most of the known risks, and spreads versus the region are attractive again, hence the upside looks rather limited as well.

GDP growth: puzzlingly strong

The +5.2% GDP advance from the first quarter was the second-highest quarterly advance in history and markedly improved the 2022 outlook. Assuming no significant data revisions, even a quasi-stagnant economy for the rest of the year would still bring the annual GDP advance in 2022 to at least 5.0%. Add on top average inflation of around 13.0%, and the nominal GDP advance will flirt with 20% in 2022.

GDP growth (versus the previous quarter, %)



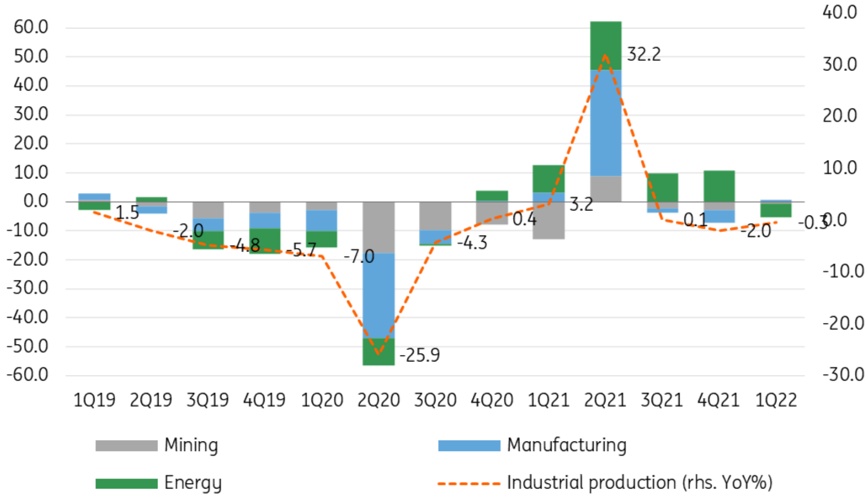
Source: NIS, ING

Looking at the detailed growth breakdown there are some details that cannot go unnoticed, for instance the almost 10% price drop estimated for the IT sector or the meagre 3.2% increase for the retail trade. Some of these estimates could be reversed in the upcoming quarters. Nevertheless, forecasting data revisions are out of our scope here, which is why by looking at the actual numbers we find little-to-no economic arguments for projecting GDP growth below 5.0% this year.

Industry

January-April 2022 industrial production contracted by 3.1% versus the same period in 2021, gradually resuming its pre-pandemic downward trend. In fact, the seasonally-adjusted numbers show that compared with the similar period of 2019 industrial production is down by 4.9%.

Industrial production and its main groups (YoY%)

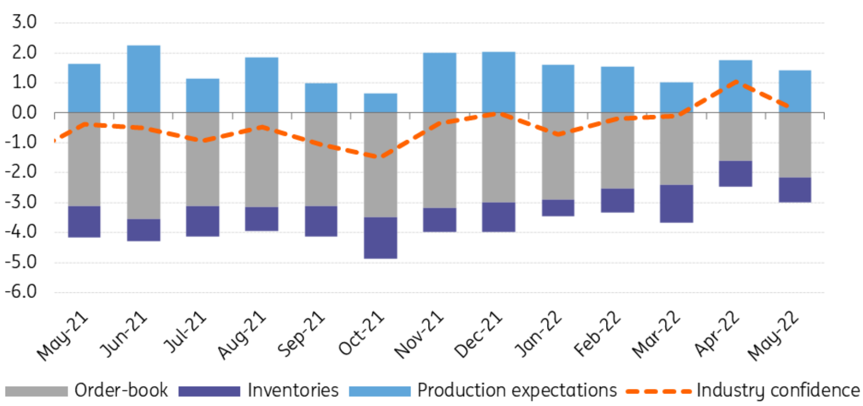


Source: NIS, ING

Issues lie within the manufacturing sector, which has an 80% share of total industrial production and is looking to be muddling through with some difficulties. Its main subcomponent – automotive manufacturing – has been constantly contracting over the past three quarters and closed the month of April 2022 almost 18% below the same month in 2021. We note that the main problem here was not the demand, but rather supply chain issues which have been strangling production for some time now. However this explanation probably brings no comfort as the outlook for supply chains remains foggy at best, while the abnormally high producer price inflation (almost 27% in April 2022 for the manufacturing sector) will in the end hurt the demand side as well.

The latest confidence data is pointing towards a quasi-flat outlook for the industrial sector on the back of a marginal decrease in order books, stable inventories and stable production expectations.

Economic Sentiment Index - Industry



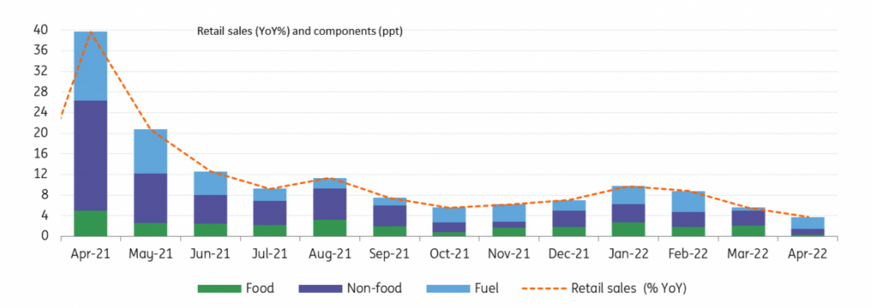
Source: EC, NSI, ING

Retail sales

Now that the post-pandemic consumption boom has calmed down on pent-up demand exhaustion, consumers seem to have entered some sort of comfort zone. This translates into relatively steady increases in sales with numbers not large enough to call it a consumer frenzy but sufficiently robust to alleviate any short-term worries for a hard landing in private consumption. The +6.9% annual advance of sales over the January-April 2022 period fits well with the above description.

Something worth mentioning is that all subcomponents of retail sales witnessed robust advances during the first four months of 2022, with fuel sales expanding by 10.1% versus the first four months of 2021 (the number is already adjusted for the fuel price spikes from the last couple of months), followed by non-food items (+6.7%) and the less cycle-sensitive food items (+4.6%).

Retail sales (YoY%) and main components (ppt)



Source: NIS, ING

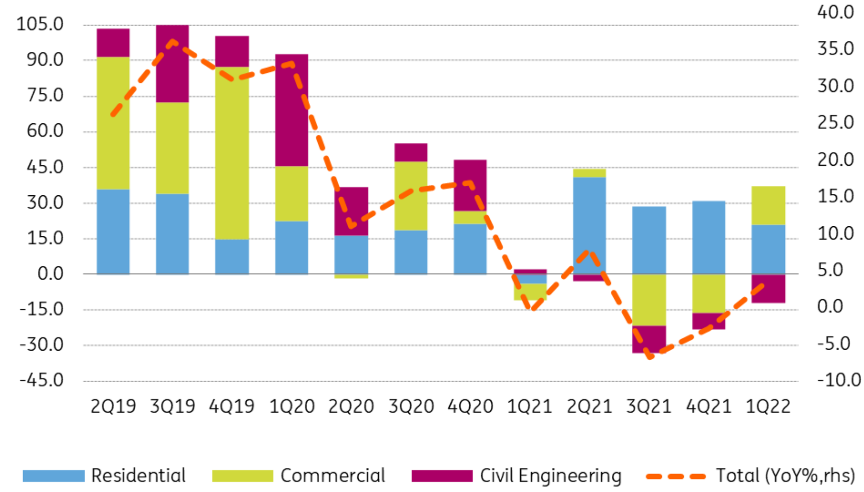
Looking forward, the negative impact of high inflation – which has already been eating up most of the wage advances over the past quarters – will only grow. We estimate that wage advances will fail to keep up with inflation this year, while in 2023 they might just break even. This should not necessarily mean a grim outlook for consumption, but it definitely puts a lid on the upside potential. Hence, low single-digit growth (and even periods of mild contraction) might be the new normal for some time.

Construction

What seemed like a normalisation of the growth pace seems to have slowly turned into a lingering stagnation trend in the construction sector. After four months of 2022, the construction index is almost flat, following a year (2021) when it decreased by just 0.6%.

In structure, it is still the residential sector that bears the growth burden as it advanced by 11.1%. After a year to forget, commercial real estate is making a comeback advancing by 10.9%. The disappointment comes from the civil engineering side where the high hopes around the public infrastructure works have not been matched by comparable actions.

Construction by main groups (YoY%)



Source: NIS, ING

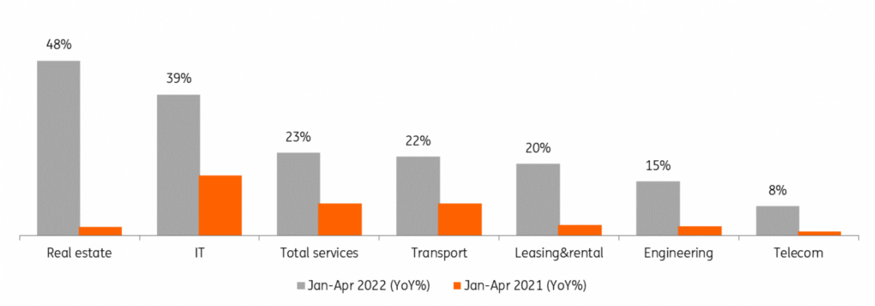
Looking forward, the outlook for the sector remains somewhat blurred. On the one hand, the skyrocketing costs of construction materials are pressuring companies, on the other hand the interest rates environment remains stimulative, with credit rates below inflation for some time already. This is keeping the demand side afloat, although early signs of a slowdown are starting to appear. And then we have the public infrastructure works which have the potential to lift the entire sector but remain somewhat difficult to predict. Overall, for the rest of the year in inflation-adjusted terms we tend to expect a mild contraction of the construction sector, while in nominal terms the numbers will undoubtedly look very good.

Services

The service sector as a whole managed to deliver quite an amazing year-to-date performance, growing 23% in the first four months of this year. All the main sub-sectors are in positive territory this year. Zooming in to April's data (which is more relevant in the context of the war in Ukraine) we do see some deceleration (-0.7% versus March), but so far that's comparable to a normal correction after 12 months of sustained growth.

In structure, the real estate services have advanced by a staggering 48%, but that's also on account of a low comparable base from early 2021. Moreover, in April the real estate contracted by 2.7% versus March, hence the boom does not look long-lived. We remain impressed by the IT sector's continuous (over)performance. The size of the sector has basically doubled over the last three years and there is little sign of it slowing down.

Services and selected sub-sectors (YoY%)



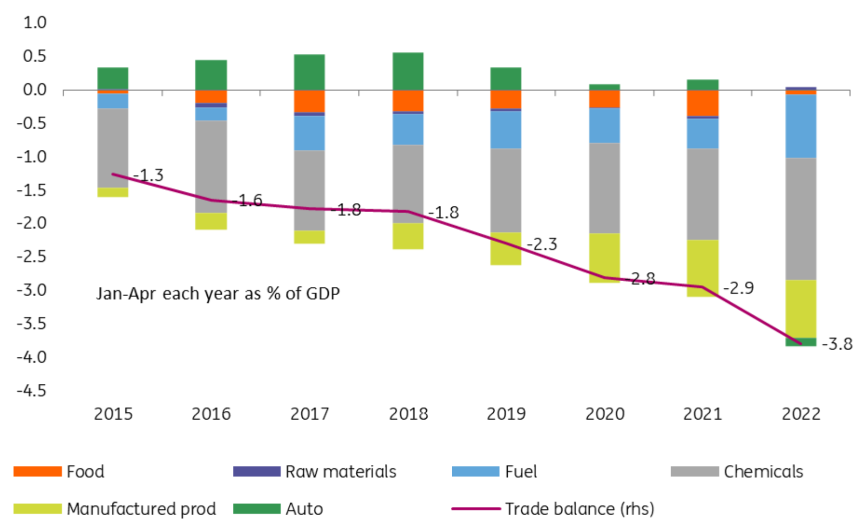
Source: NIS, ING

Looking forward, April has brought some signs of a tentative slowdown, although it is not a clear trend yet. Nevertheless, the usually leading transport sector did contract by 2.3% over March, with skyrocketing fuel prices likely to jeopardise a potential recovery. We estimate that the road will become bumpier as we head into the second half of 2022, on account of higher inflation, higher interest rates, and an almost certain growth slowdown compared to the first quarter.

Trade balance and current account

Coming in at just over €10bn (3.8% of GDP) after four months of 2022, Romania's trade balance deficit widened by a staggering 41% compared to the same period of 2021. To put things into perspective, the January-April 2022 deficit is equal to the full-year deficit from 2016. While this can be regarded as a measure of how much larger the economy is nowadays, it also gives a measure of its structural problems that have failed to be corrected throughout the years. That's especially true when we look at numbers in relative terms and can see that the last time Romania recorded such a deficit was in 2008, just before the economic downturn that followed in 2009-10.

Trade balance

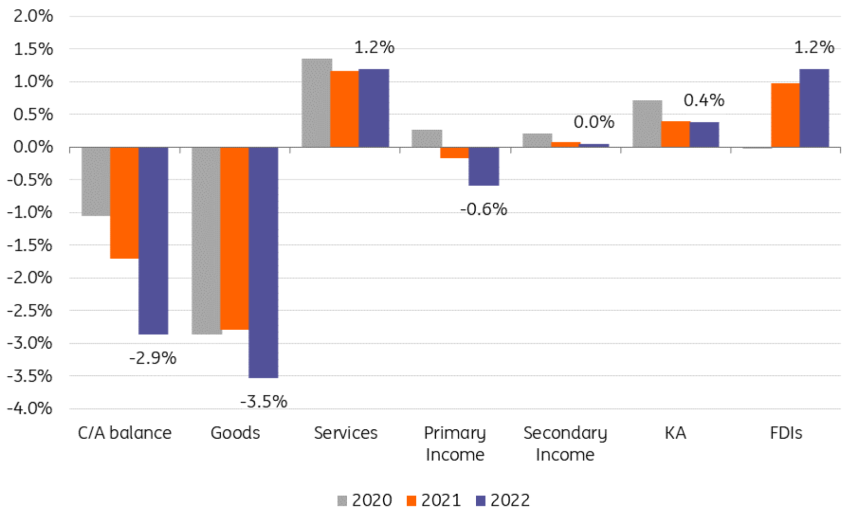


Source: NIS, ING

Particularly worrying in our view is that there are very little prospects for the situation to improve in the near future. Even a full and efficient absorption of the EU funds (already a bit of a fanciful assumption) which have the potential to improve the competitiveness of the economy would – at least initially – most likely result in higher imports. We therefore anticipate the trade deficit to come in well over €30bn this year and land somewhere between -12% and -13% of GDP.

The abovementioned trade deficit remains the root cause of the current account deficit, though a deterioration in both primary and secondary incomes can also be noted. Overall, we project this year's current account to widen closer to -8.0% of GDP, from -7.0% in 2021.

Balance of payments by main categories (% of GDP)



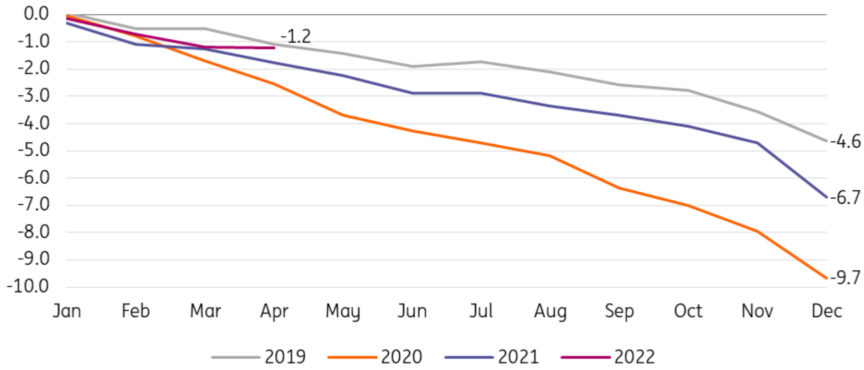
Source: NBR, ING

Given the international context and specific local weaknesses, it is difficult to envisage conditions for a correction of the current account anytime soon. The gradual budget deficit adjustment towards the 3.0% of GDP target will help to a good extent, but it will need to be seconded by other factors, such as a de-escalation of the military conflict, supply-chain amelioration, an efficient absorption of EU funds, and the eternally lagging structural reforms.

Budget and financing

Essentially, the budget deficit problems remain at the core of Romania's macroeconomic weaknesses. The rapid nominal GDP growth will make it a touch easier for the government to stick to its 5.8% budget deficit target in 2022. However, pressures on the 2023 budget are already shaping up to be substantial. Wages and pensions advance will most likely be sensibly below inflation this year and the pressure for a more rapid indexation will only grow. Add to this the obligation to further reduce the budget deficit from 5.8% in 2022 to 4.3% in 2023, the need to lower nominal and real growth, plus increased defence spending and we get a pretty difficult puzzle for 2023.

Budget deficit (% of GDP)



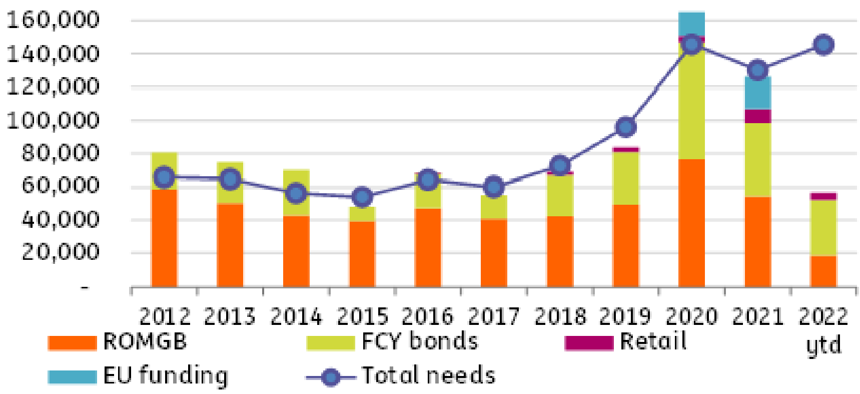
Source: MinFin, ING

On the financing side, things are not looking smooth either, but – somewhat counterintuitively – this might in fact be one of the motivations to stick to the deficit target. Financing for the 2022 deficit is already behind schedule, despite the Ministry of Finance accepting higher and higher yields at its auctions. As of the end of May 2022, approximately 39% of the financing needs had been covered via a mix of local currency and hard currency issuance, with more weight on the latter.

We estimate the funding needs for the June-December period at RON89bn. Subtracting what we approximate for another external issuance and RRF-related inflows (with both totalling some €8bn), we are still left with a hefty RON7bn monthly issuance on the local market. Retail bonds will likely help somewhat given the decent yields that the Ministry of Finance has decided to pay (7.2% for 1Y and 7.8% for 3Y bonds) but even so we will still be left with decent amounts to be issued for local investors (say RON5bn per month or so). All in all, while challenges remain, we believe that this year's financing needs will come to light as long as the Ministry of Finance will agree to pay close to the secondary market yields.

On the public debt side, the rapid GDP growth and exchange rate stability have been decisive in maintaining the debt-to-GDP below 50% so far (49.2% at the end of April). Under the current legislation, breaking above the 50% threshold would require the government to come up with a plan for public debt reduction.

Funding needs and funding mix (RON mn equivalent)



Source: MinFin, ING

Ratings

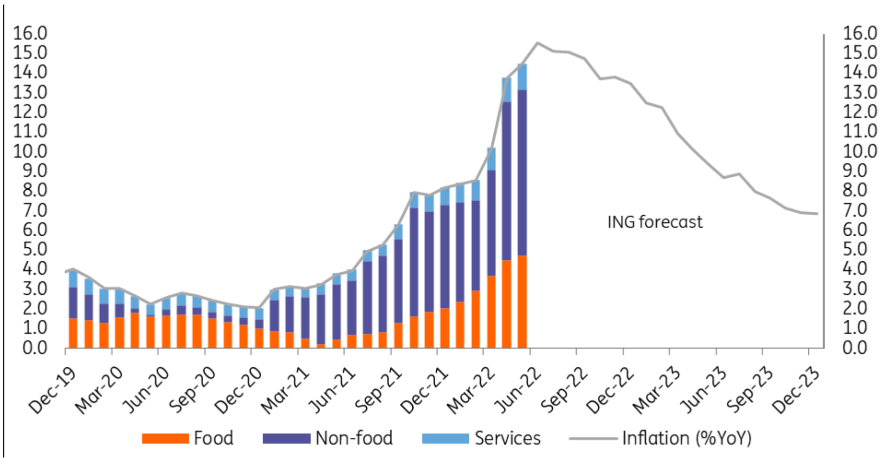
We remain of the opinion that Romania will maintain its investment grade for the foreseeable future. Admittedly, the long-awaited (and hardly begun) fiscal consolidation process will remain a sensitive topic given the still unclear path of fiscal reforms. However, being subject to the EU's Excessive Deficit Procedure and having already committed to fiscal reforms under the Recovery and Resilience Facility, Romania will have little choice but to apply the required measures in order to sustainably bring the deficit back to -3.0% of GDP.

Inflation and monetary policy

The above expectations for GDP numbers are likely to make it easier for the National Bank of Romania (NBR) to at least maintain its 75bp hiking pace at the July and August policy meetings. However, the attitude still seems to be one of doing the least possible as long as the main equilibriums (the FX rate in particular) are kept in check. We now estimate the key rate to reach 6.00% by the end of the year and stay flat in 2023.

Meanwhile, however, inflation continues to surprise to the upside and will likely exceed 15.0% in June. This could mark the peak of the current inflationary cycle but the road to lower levels will be long. We estimate this year's average inflation at 13.0% and 8.9% in 2023. A key factor for next year's inflation profile will be the decision on whether to extend the current price caps in place for natural gas and electricity provided to households. Given that 2023 is a pre-electoral year, we doubt that the caps will be fully removed.

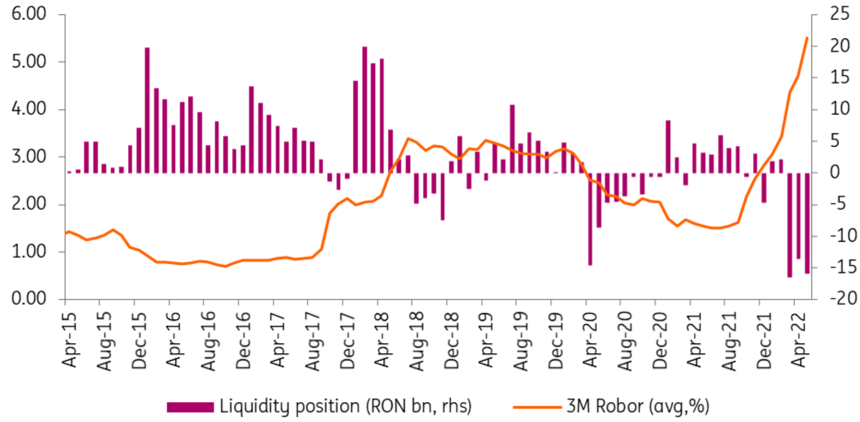
Inflation (YoY%) and components (ppt)



Source: NIS, ING

On the FX side, the 4.95 level for the EUR/RON remains untouchable for the moment with strong offers in the 4.9480-4.9500 range taming any upward pressure. In the context of a persistent liquidity shortage for the rest of the year, the relevant rate will in fact remain the credit facility (100bp higher than the key rate). The liquidity shortage will also continue to keep market rates much decoupled from the NBR's key rate and even from the credit facility.

Estimated liquidity position in the banking sector



Source: NBR, ING

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