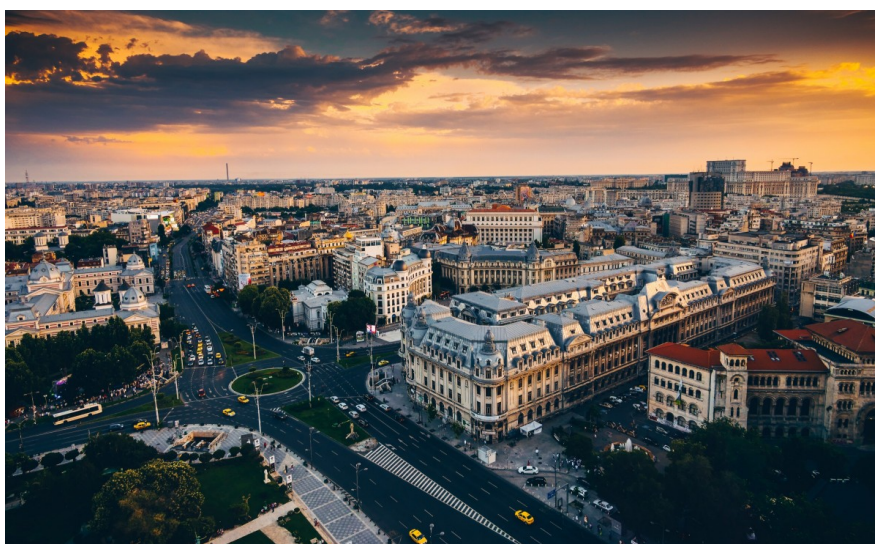


Monitoring Romania

Our latest update does not bring material changes to our main views. Yet we highlight the overdue fiscal correction and persistent inflation as reasons for the National Bank of Romania to take its rate-cutting cycle slowly. Growth-wise, EU funds should continue to boost public investments, while private consumption will turn more supportive



Bucharest, Romania

Main views and forecasts:

- Growth remains decent given the context but below potential. In 2023, GDP grew by 2.1% and we maintain our estimate for 2.8% GDP expansion in 2024.
- Private consumption is on the rise as wage growth remains in double digits, with public wages clearly decoupling from private.
- After the 2023 correction in the current account deficit, any further improvements are likely to be minor, if at all.
- Inflation is projected to decrease but remains sticky. We don't expect it within the central bank's 1.5%-3.5% target range over the next two years.
- The budget deficit was at 1.7% of GDP in February 2024, an all-time high compared to any other similar period in the past. While it's too early to revise higher our -5.5% of GDP full-year estimate, risks are clearly to the upside.
- The NBR is likely to find solid reasons to take it easy with policy easing. We still expect a 25 basis point cut to the key rate at the May meeting, to 6.75%. We maintain our 6.00% year-

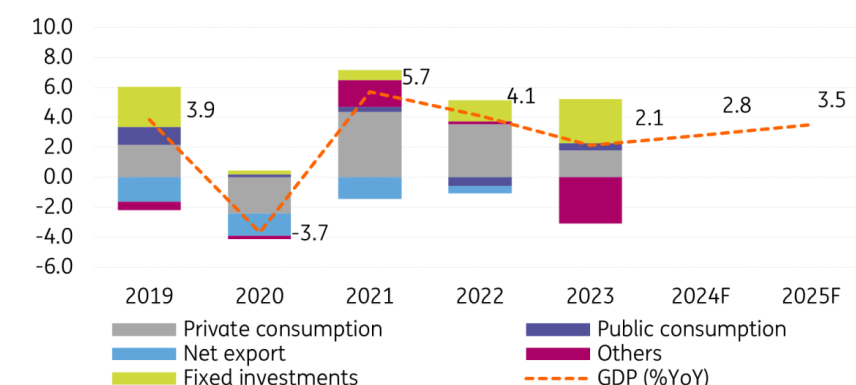
end estimate for the key rate, but here as well, the risks are to the upside.

- We keep our 5.04 forecast for the year-end EUR/RON, which however becomes a lower and lower conviction call with each month the inflation disappoints.

GDP growth – accelerating on the back of stronger private consumption

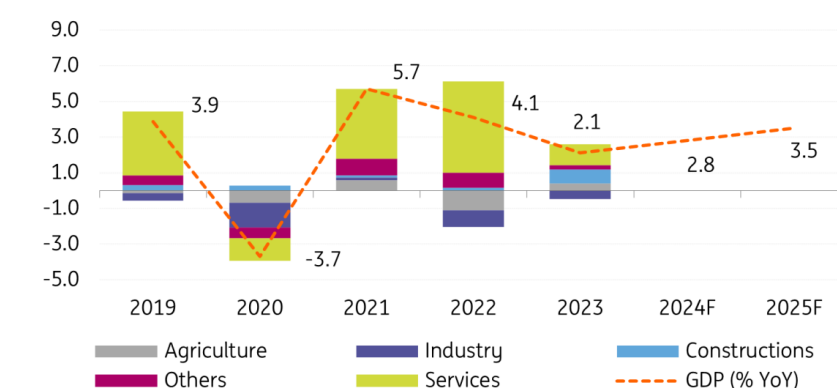
Annual GDP growth in Romania slowed to 2.1% in 2023 from 4.1% in 2022. On the demand side, weaker private consumption and net exports took their toll on output due to high inflation, more restrictive monetary conditions and a lacklustre performance of key trading partners in Europe. On the other hand, a sharp acceleration in fixed investments stemming from EU-funded projects kept the economy afloat. Moreover, government spending rebounded, with visible improvements in the spending associated with EU projects.

GDP growth (YoY%) and main components (ppt) - demand side



On the supply side, with the notable exception of civil engineering-related activities, most manufacturing and services activities were a drag on output growth.

GDP growth (YoY%) and main components (ppt) - supply side



In the first quarter of 2024, early signs point to much stronger than expected private demand.

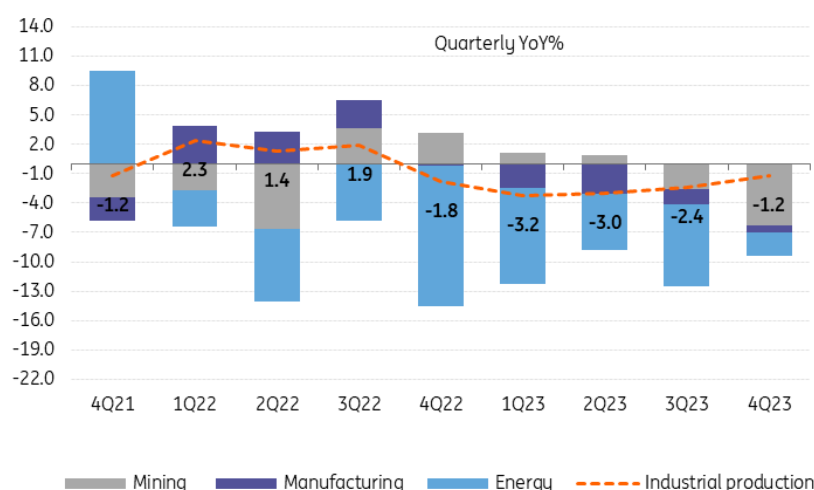
Data for January showed that retail sales already picked up by a whopping 3.8% on the month (2023 YoY average: 2.2%). We argued [here](#) why we are rather cautious about the data and that some downward adjustments might occur. If the strong data is reconfirmed in February, the case for an upward revision of the overall GDP growth would look much stronger. At this stage, however, we think that more evidence is needed before revising our growth forecast higher.

For the whole of 2024, our view is that growth will accelerate to 2.8%. On the one hand, we expect real wages and incomes to continue to grow strongly for a second consecutive year and we think that this will continue to fuel the momentum in private consumption which began in the fourth quarter of 2023. Furthermore, the super-electoral year might bring even stronger momentum in government spending. On the other hand, fixed investments are unlikely to continue to accelerate at a stronger pace but we think they will still remain robust and push the productive potential higher. On the external sector, a rather weak performance of the eurozone, weighing on Romanian goods demand, coupled with stronger internal demand, will likely reverse most of last year's trade deficit gains and contribute negatively to GDP growth.

Industrial production – some mild improvements likely ahead

Industrial production remained weak last year, continuing its multi-year downward trend, due to lower external demand and competitiveness issues. Over 2023 as a whole, industrial output fell 2.4% on average, after 2022's 1.0% growth. This decline is smaller than what data had shown for a while, before the National Statistics Institute changed the base year from 2015 to 2021. Zooming in, the largest falls were experienced by the wood processing, metallurgy, textiles and coal mining sectors. Overall, both durable and consumer goods recorded close to double-digit production declines. Non-durables also fell on the year but at a much lower pace. On the other hand, what stood out positively was the significant acceleration in car production, coupled with pick-ups in the food and beverages production sectors.

Muddling through in negative territory



NSI, ING

Our outlook remains for a moderately improving picture this year. The deflationary environment of producer prices since July last year should add some support to the input cost burden of firms.

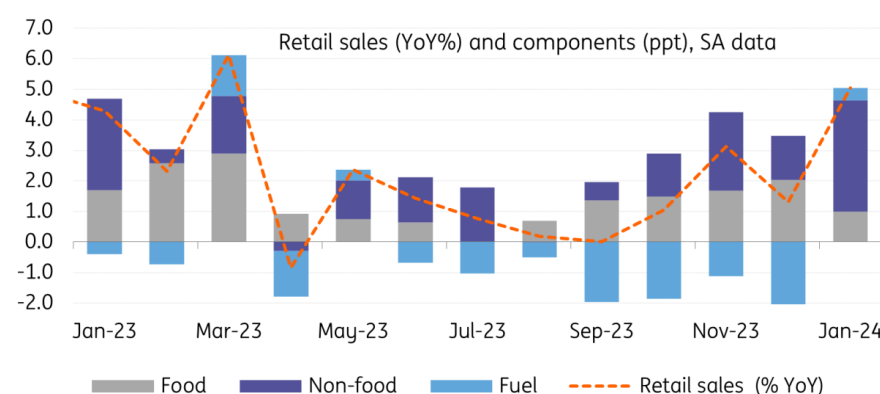
Moreover, stronger internal demand from consumers and still strong EU-funded investment project activity are also set to add a marginal boost in turnover. On the other hand, lacklustre European growth is set to keep external demand weak. Moreover, upside surprises and the stickiness of inflation earlier this year give little reason to expect a helping hand from the FX rate to boost export competitiveness.

In the medium-to-long run, we are slightly more optimistic. Firstly, a gradual recovery in European economic growth should feed into external demand from 2025 onwards. In this direction, initiatives of European policymakers to reinstate the competitiveness of European manufacturing would also add a boost. Secondly, industry should receive a big boost from stronger energy output through the Neptun Deep project (from 2027 onwards) – which is set to make Romania the largest natural gas producer in Europe – and through the doubling of capacity of the Cernavoda nuclear powerplant by 2030. Although still distant prospects, if implemented according to the plan, these developments will also add a much-needed boost to government revenues and to some extent help with the competitiveness issues faced by manufacturers on the energy costs front.

Retail sales – consumer fatigue seems to be behind us

Retail sales grew only 1.8% in 2023, significantly slower than the 4.8% growth recorded in 2022. While food sales picked up over the year, non-food sales growth slowed and fuel sales contracted. Overall, there were significant improvements in 4Q23, after the semi-stagnation of 3Q23, which can be traced to last year's significant real wage growth advance, which averaged almost 5.0%. It took Romanian consumers around six months since the first real wage gains arrived until their purchasing decisions started to reflect the improvement in incomes.

Broad based acceleration at the beginning of 2024



NSI, ING

In early 2024, retail sales grew by a whopping 3.8% month-on-month in January only. This increase sets the stage for a strong first quarter of 2024. Currently, we are still waiting for further evidence before revising our private consumption and growth projections upwards. Indeed, consumer credit has made quite a decent comeback recently. But for a month when a stronger tax burden was implemented and prices grew faster than expected, we think that these numbers overall looked too strong, too soon.

On the outlook for 2024 overall, we expect retail sales growth to continue to accelerate on the back of a second consecutive year of significant real wage growth – which we think will show an

average increase of around 5.0% in 2024. Since consumers had already started to act on their wage gains as of 4Q23, we think it's likely they will continue to keep up the private spending momentum for at least a couple of quarters, provided there is no newer external event which puts them in risk-averse mode. Overall, we think this will push retail growth to around 4.0% this year, which will be a visible improvement but still far from the long-term trend growth rate of around 7%. Downside risks stem from the sticky behaviour of inflation, which could moderate the real wage gain advances and lead to higher-than-expected rates from the NBR.

Services for companies – asymmetries behind, asymmetries ahead, but with a smaller gap

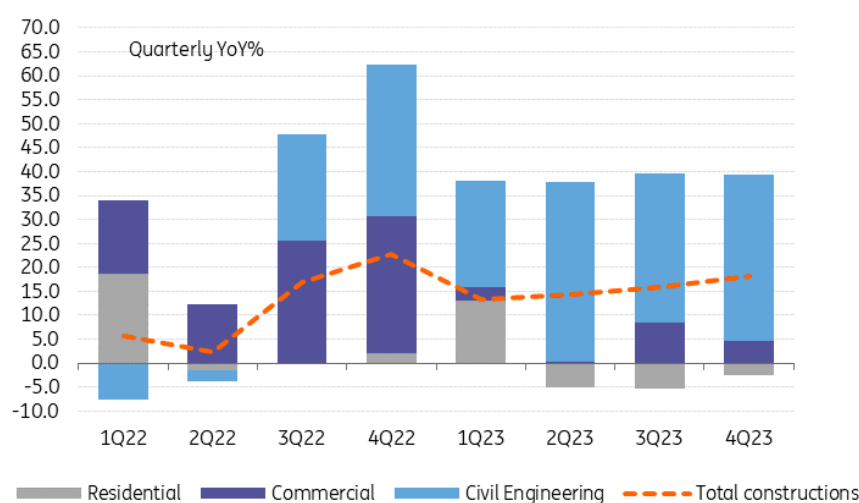
After slowing visibly last year, the annual growth of services for companies started reversing its downward trend in 4Q23. Developments were quite asymmetric though. On the one hand, engineering services performed well – in line with the ongoing developments in fixed infrastructure investments. They were also the only category to pick up sharply in 4Q23. Some improvements were also experienced by the transport sector. On the other hand, the cycle-sensitive leasing and rental sector continued to weaken visibly while the IT sector continued to trend down gradually.

Overall, these datasets tell a broadly similar story to the GDP data – namely that it's the fixed investment activity and the additional demand revolving around it that kept growth afloat last year. Looking ahead, while we expect the recent momentum to carry on, we don't think it will turn into eye-catching growth. The corporate sector faces cost pressures from multiple fronts ahead. One of them is the recently increased tax burden and the prospect of further increases next year. The other relates to the growing wage pressures in a labour market where public wages are decoupling again from private ones. Overall, we anticipate growth to accelerate but it doesn't look like a banner year is shaping up.

Construction – civil engineering, the only game in town in 2023, to still dominate in 2024

The construction sector grew at a very swift pace of 15.4% in 2023, picking up from the 11.6% growth recorded in 2022. That said, the factor to analyse is the sectoral distribution of this strong growth rate. The positive impact of civil engineering projects (accelerating to 31.6% growth in 2023 from 9.8% in 2022) continued to dominate heavily and contributed almost entirely to last year's growth. Meanwhile, commercial project growth slowed and the residential sector stagnated over the year.

Construction by main groups (YoY%)



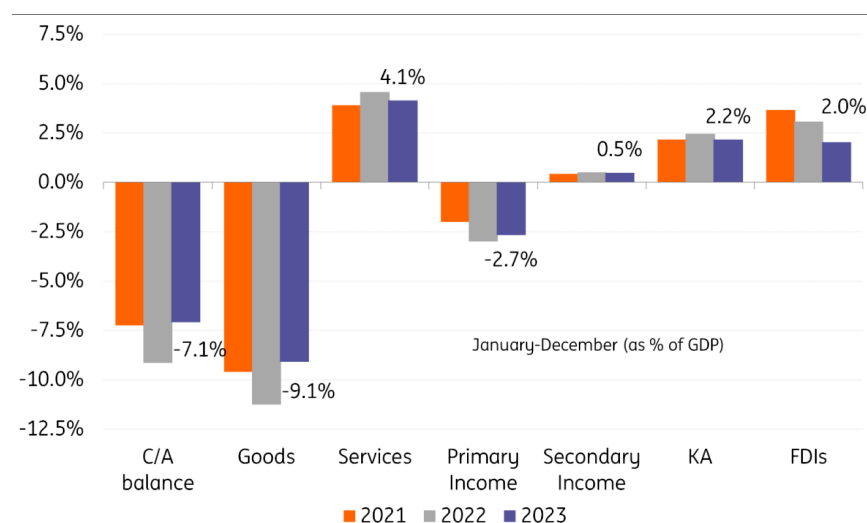
NSI, ING

Looking ahead (and temporarily ignoring the January data which we suspect had some data quality issues), we expect the construction sector to continue to bring healthy growth rates in 2024 as well, when the gap between residential and civil engineering is likely to diminish. Firstly, building permits (a proxy for future projects) for the residential sector have started to pick up again. Secondly, financial conditions should continue to loosen gradually. As a result, mortgages have started to pick up again and an environment of healthy wage rises and loosening financial conditions should benefit demand ahead. Altogether, we expect civil engineering projects to remain in double digits as EU-funded infrastructure projects are set to carry on, while commercial and residential projects should edge somewhat higher, as the appetite of developers is set to benefit from the higher growth, lower rates and rising wage momentum.

Balance of Payments (BoP) – looking better but with little prospect for further improvement

Last year, the trade balance (the most important driver of the BoP) improved visibly – the deficit fell from 11.9% to 9.0% (as a % of GDP). In terms of levels, in 2023, goods exports amounted to EUR 93.1bn, with imports at EUR 122bn, leading to a deficit of EUR 28.9bn. The positive drivers of the improvement compared to 2022 were lower deficits in fuel, chemicals and manufactured products, coupled with a stronger surplus in raw materials. Higher deficits in food and auto trade prevented an even stronger improvement in the trade balance.

Balance of payments by main items



NBR, ING

Looking at the relations between Romania and its trade partners, some interesting facts show up:

- Across Romania's top 10 export partners, exports to the Czech Republic and Turkey increased the most in 2023, by 12.8% and 8.6%, respectively. Meanwhile, exports to Hungary fell sharply by 22.3%, albeit after two years of strong growth.
- Exports to Ukraine continued to rise strongly (60.2% increase in 2023 vs 118.6% increase in 2022) while we saw a steep fall in the exports to China (20.9% decline vs 4.5% decline in 2022).
- Across Romania's top 10 import-origin countries, imports from the core eurozone members recorded single-digit increases, while imports from China fell 8.4%. Imports from Bulgaria recorded a sharp, double-digit decrease.
- Other interesting import developments are the 92.6% fall in imports from Russia, coupled with a 70% increase in imports from India. Moreover, and also energy-related, imports from Libya and Algeria picked up significantly, while imports from Azerbaijan and Iraq fell sharply.

Overall, the trade balance reading reflects both weakening demand and less expensive energy imports. For 2024, we expect strengthening internal demand to add new import pressures. Meanwhile, as we are a bit more pessimistic on the eurozone outlook compared to the consensus, we don't think that export growth will have room to keep up. A key upside risk for imports relates to the recent upside pressures in oil prices.

Turning to the surplus in services, we don't envision any large changes in last year's EUR 13bn surplus. Transport, telecommunications and IT activities will likely continue to bring most of the surpluses. Medium-term, the strong interest in AI and digitalisation at a global level make for a cloudy outlook for Romania's IT exports.

On other items of the BoP, we don't see much potential for an improvement of the primary income balance given the unfavourable dynamics of the reinvested profits, while for the secondary income, the remittance balance is likely to continue to deteriorate. Remittance outflows grew at a quicker pace than remittance inflows over the past three years, with a visibly widening gap in

2023. On the other hand, we expect EU-fund inflows directed towards infrastructure projects to continue to stimulate the capital account, while in foreign direct investment, we could see some marginal pick up as the new infrastructure projects implemented might create new business opportunities.

All in all, we expect the current account deficit to remain elevated this year as well. We have pencilled in a marginal improvement from -7.1% of GDP to -7.0% of GDP.

Fiscal – some slippage could be tolerated as long as investments remain strong

Last year's deficit remained very close to 2022's value, coming in at 5.7% of GDP. In the first two months of 2024, the slippage in the budget deficit is already visible. As of February, revenues amounted to 5.0% of GDP while expenses were 6.7% of GDP, leading to an early and strong deficit accumulation of 1.7% of GDP. Stronger capital expenditures were the main culprit. They are [reportedly](#) linked, at least partially, to postponed defence spending from late last year. Some pockets of weakness (when measured as a percentage of GDP) also came from fiscal revenues – however, February is generally a weak month for tax collection. A ray of sunshine comes from the reported above-plan tax collection in February by the National Fiscal Authority (ANAF).

Assessing the latest developments, we still choose to stick to our 5.5% deficit call for the end of 2024 and 5.0% for end-2025. That said, we acknowledge that the risks have increased and are heavily skewed to the upside. However, we think more data and more facts are needed before lifting the forecast.

Firstly, the tolerance of the European Commission towards Romania is not unlimited, and the latest slippage could make European policymakers less lenient towards Romania's fiscal problems. At the end of the day, the government could still cut this year's investment budget to keep spending slightly more in check, should the EC want immediate progress at all costs. Other spending improvements are unlikely in an electoral context and could be stories for 2025.

Secondly, revenues will indeed grow but will still likely remain far off from their ideal progress path. The latest fiscal package should, overall, strengthen revenues, but the delay to 1 June of the strict enforcement of the digitalised e-Factura reporting for businesses points to still-needed refinements in the tax collection process. Altogether, changes in expenditures are unlikely, unless some investments are again postponed, while revenues are still dependent on process refinements.

Thirdly, there are plenty of key factors to watch this year, which could bring changes to the deficit in either direction. At the local level, probably the most important is the reorganisation of the National Agency for Fiscal Administration (ANAF) towards stronger local units at the county level and the potential increase in SME taxation as part of Romania's commitments to the milestones of the third tranche of the Recovery and Resilience Facility. The former could boost revenues in the second half of this year, if it goes according to plan. The latter's outcome is contingent on negotiations with the EC and could either boost tax revenues later this year if implemented or lower RRF revenues if not implemented and counted as a missed milestone. At the European level, June's elections will result in a new composition of the EC and local policymakers will have to articulate the soundness of local public finances in front of a new EC leadership team, bringing another layer of uncertainty.

For 2025, we have pencilled in a reduction in the deficit towards 5.0% and we think that overall risks are balanced. Stronger revenues will likely come from a new fiscal package, which could be implemented early in 2025. Our central scenario assumes that the current coalition will remain in place. As potential upcoming measures, the improvements and experimentation with the newest digital upgrades of ANAF could, in principle, also prepare the technical infrastructure needed in the implementation of progressive taxation. Moreover, taxes on luxury and capital more broadly, as well as a more unified VAT system, are likely on the table. A key factor to watch is whether and how the government will reform public sector wages in order to reduce inequities in a similar manner to the recent pensions reform. This law could be adopted sometime this year and implemented in 2025.

Further down the line, the 3.0% of GDP deficit doesn't look achievable earlier than 2027-2028. By that time, revenues could also start getting a boost from the proceeds of the Neptun Deep project, if all goes according to plan. We believe that the EC is likely to remain tolerant towards delays in the deficit target objective as long as the government remains fully committed to public investments that boost the productive potential.

Ratings – no downgrade expected

The recent slippage of the budget early in the year is likely the main cause of concern for rating agencies right now, weighing on Romania's prospects. While the bar for a downgrade is quite high in our view, the risk of an eventual negative outlook cannot be ignored. For most of the additional spending in 2024, officials are wary about putting forward offsetting measures given the electoral context, thus strongly blurring the outlook for the fiscal position.

Overall, we expect the rating reports to display a much harsher tone on fiscal developments, with higher risks for a change in the outlook from Stable to Negative. We think that rating downgrades would be on the table, especially in the case of an imminent and significant EU funds absorption issue, which is not the case right now.

Monetary policy – an unhurried easing cycle to start in May

The NBR key rate, for more than a year now at 7.00%, continues to keep monetary conditions relatively restrictive. That said, as we have been mentioning repeatedly, the actual stance of monetary conditions is slightly looser than the key rate implies, as the unsterilised excess liquidity in the interbank market pushes market rates lower and anchors them to the deposit facility which is currently at 6.00%.

The stickier-than-expected inflation in the first two months of the year coupled with the early 2024 fiscal slippage and the likely persistence of the excessive liquidity environment are the key drivers which will require a higher-for-longer rates path from the NBR, in our view. For now, we still expect a first 25 basis point rate cut in May and we still keep our year-end forecast for the key rate at 6.00%. That said, we acknowledge that there are predominantly upside risks to our key rate forecast.

EU-fund inflows, which policymakers have so far proved able to bring in, will continue to stimulate the interbank excess liquidity - which hardly has a clear end in sight at this stage. This will continue to keep the deposit rate as the de facto key rate for a while. We don't expect any changes to the corridor, meaning that the deposit rate will likely remain 1.0ppt below the key rate for the foreseeable future. For 2025 as a whole, we expect a total of 50bp in rate cuts, taking the key rate

to 5.50%. As a result, we expect ROBOR 3M to reach 5.30% by the end of 2024 and 4.75% by the end of 2025.

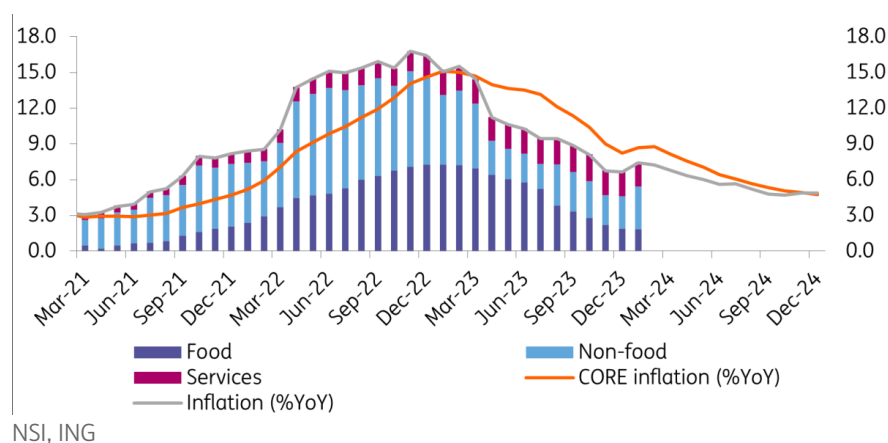
Inflation – probably not enough to reach the target by end-2025

Inflation ended last year at 6.7%, before picking up again in January, to 7.4% and moderating in February to 7.2%, due to the latest fiscal package implementation. Releases for both January and February came in above expectations and, unlike previous upside surprises where inflation was rather isolated in a few items, they brought in quite spread-out price pressures throughout the consumer basket. With still-persistent and elevated services inflation at a time of still-sharp wage growth, we expect the NBR policymakers to remain rather prudent with rate cuts and avoid sounding too dovish, too early.

In our scenario, the key drivers for this year's inflation trajectory are, on the downside, the fact that the overall monetary conditions will become more restrictive and the persistence of the essential products mark-ups cap across the food retail chain. Moreover, energy prices for consumers remain capped until 2025. On the upside, a whopping increase in retail demand early in the year could provide firms with the necessary confidence to bring more pricing power into the market. In addition, the recent increase in oil prices could keep fuel inflation elevated and filter through other items as well.

Altogether, despite the recent upside surprises, at this stage we continue to expect inflation to decline to 4.8% by year-end and foresee price pressures stabilising at around 4.0% in 2025.

Inflation(YoY%) and main components (ppt)



FX and Markets

In Romanian government bonds (ROMGBs), on the supply side, everything is going according to plan so far since the beginning of the year. MinFin covered about 32% of the planned issuance in the first quarter according to our calculations, so we do not see frontloading like last year, but at the same time, MinFin is meeting sufficient demand so far. Therefore, we can expect a similar monthly issuance pace in the second quarter or potentially higher if we see higher demand given MinFin's flexible approach. On the other hand, fiscal risks are to the upside, which would lead to higher borrowing needs.

On the demand side, we continue to see the ROMGBs position as neutral in the CEE space. Peer spread valuations in the region look neutral and given the risks mentioned, ROMGBs would be more attractive at higher yield levels in our view, which is what we saw when 10y ROMGBs jumped above 6.70% in the middle of March, triggering market demand and pushing yields back to 6.55%. On the other hand, the positive carry with FX implied yields compressed well below the NBR base rate still speaks in favour of ROMGBs.

FX-wise, the EUR/RON continues to be very stable within a tight range just below 4.98. With inflation still printing slightly above expectations and demand-side pressures building up in the economy, even a marginal shift higher doesn't look imminent. Moreover, the possible increase in the tax burden next year, at a time of projected growth acceleration, adds to the medium-term inflationary risks and, by extension, FX stability will be needed further down the line. All told, we maintain our 5.04 year-end estimate, but - as usual lately - we underline that the chances for an essentially flat nominal FX rate this year are considerable.

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