Romania: Contained pension hike meets reality check

A 14% pension hike during a severe economic contraction, a no-confidence motion and approaching elections are all laying the ground for some complicated short-term developments. We see the budget deficit slightly above 9.0% of GDP this year and increased pressure on the already tense ratings as the debt-to-GDP ratio will border 50% in 2021

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Politics and budget

The local elections are scheduled for 27 September 2020, while the general elections have no fixed date yet, but cannot be held later than March-2021. We expected the political noise to become the norm, though the no-confidence motion filed by PSD takes political uncertainty to a different level. Voting on the no-confidence motion could take place in early September. For now, we tend to read this procedure more in the electoral key imposed by the upcoming local elections (but to some extent also by the internal PSD elections). However, given the Parliamentary arithmetic, the chances for the motion to pass are considerable (say 40-50%).

If the current PNL government is toppled, it will probably remain in place in the interim until the local elections. After that, we believe that the Parliamentary dynamics will adapt to the local election results.

The most important difference is that as an interim government, it will not be able to issue emergency ordinances. These ordinances – among others – have been used until now to postpone or modify legislative initiatives aimed at increasing spending, such as doubling the child allowances or the recently adopted 14% pension hike instead of the scheduled 40%. Hence, without this instrument, the possibility to bar similar legislative initiatives will be reduced. On the other hand, an interim government means we could see some choppier budget execution on the expenses side. Overall, we don't expect a meaningful budgetary slippage to occur should the no-confidence motion pass.

The adopted 14% pension hike came slightly above our expectations for a 10% increase, but admittedly it doesn't change the budgetary picture that much. It will have an impact of around 0.3 percentage points in this year's budget deficit and around 1.2ppt in 2021. The PSD announced that it will modify in Parliament the government's decision on the 14% pension increase in order to take it back to the initial 40% that was scheduled. Nevertheless, we expect this procedure to take some time, at least through the local elections, after which -as mentioned before- the Parliamentary dynamics will probably adapt to the election results.

The government recently adjusted its budget deficit forecast for this year to 8.6% of GDP, in line with our already long-standing forecast. However, given the slightly higher-than-expected pensions increase, the 20% child allowance increase (which we haven't factored in previously and is still uncertain given the advanced parliamentary procedures to double these allowances) and our expectations for the economy to recover at a somewhat slower speed in the second half of the year (thus lower VAT revenues, profit tax etc.), we see the 8.6% deficit target as still reachable, but only under the optimistic scenario. We adjust our central scenario to a 9.3% deficit forecast which includes the 14% pension hike and only 20% increase in child allowances. We revise our forecast for the 2021 budget deficit as well, from 5.2% to 6.3%. A 3ppt budget deficit reduction pace (from 9.3% in 2020 to 6.3% in 2021) is -in our view- striking a reasonable balance between the need for fiscal consolidation and not damaging economic growth. Attempting to reduce the deficit by more than that next year could have contractionary effects for the economy which any government will likely try to avoid.

Under the above assumptions, the financing needs for the August-December period (deficit financing and repayments) should come close to RON10bn/month, which is a respectable amount by any means. For comparison, in January-July period, the issuance (excluding the almost EUR10bn in Eurobonds) was somewhere below RON7.0bn/month. Given the lower-than-expected issuance in August to date, it seems that the small amount of breathing room that the Ministry of Finance had at mid-year is pretty much gone and issuing pressures are slowly resurfacing. To counter that however, the almost EUR10bn issued this year on the external markets have apparently taken the MinFin's cash buffer to record levels (no up-to-date numbers available though, just official statements). This buffer can be tapped and will likely contain the debt issuing pressures. And above all, the National Bank of Romania is there to help as well.

Ratings

The deterioration in the fiscal balance sheet over the last few years has pushed Romania (Baa3 neg/BBB- neg/BBB- neg) close to the edge of losing its investment grade ratings. Amid the ongoing pandemic, concerns are that the looming pension hike would put a nail in the coffin, thus the reduction from the initial 40% to 14% is supposed to appease rating agencies and investors alike.

Indeed, our view that rating agencies are willing to look through the current electoral context and wait for a new government to take over and embark on a more serious fiscal consolidation path is contingent on such a reduction (albeit we had expected a cut to 10% instead of 14%). For now, we maintain this view, also supported by some optimism coming from last month's agreement on the EU recovery fund.

However, we will closely monitor political developments. Ahead of the upcoming rating reviews (Moody's and Fitch in October, S&P in December), near-term risks will come from the upcoming no-confidence, potential opposition-led efforts to reverse the pension hike reduction and the 27 September local elections. Medium-term, the deteriorating debt metrics will pose additional challenges. In any case, we believe that the risk of downgrades will remain a constant threat at least through 2021.

> We expect some complicated weeks ahead and a lot of noise on the political scene. The government's position doesn't look secure for the no-confidence vote, but we think that political waters will calm down for a while after the 27 September local elections. The eventual populist measures aimed at increasing spending during this period might hit the budget more than we estimate now, but – except for pensions – they could be reversed or smoothed out by a future government.

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