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ROMANIA

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Romania: Trip Notes

NBR is set to cut more aggressively

These notes draw upon meetings that took place in Bucharest on 6-7 May with senior officials from the Ministry of Finance, the Central Bank, international financial institutions, as well as market participants and independent analysts.

- **Romania's near-term economic prospects have improved considerably, thanks to the EUR 20 billion IMF-EU led financial package. Despite significant implementation risks—particularly on the fiscal front—we believe that the programme also improves the medium-term economic outlook.**
- **We argue that there is more at stake than just weathering the crisis. A credible implementation of the programme should put Romania in a stronger position for ERM 2 entry in 2012.**
- **We think that the strong external adjustment, the rising output gap and the alleviation of the near-term risks should lead the NBR to cut more aggressively than before. In our view, the Bank is likely to bring its policy rate to 7.25% by the end of this year.**
- **Despite risks, the current backdrop paints a more favourable picture for the leu. We expect EUR/RON to be around 3.95 by year-end, which amounts to a real depreciation of about 6.0%.**

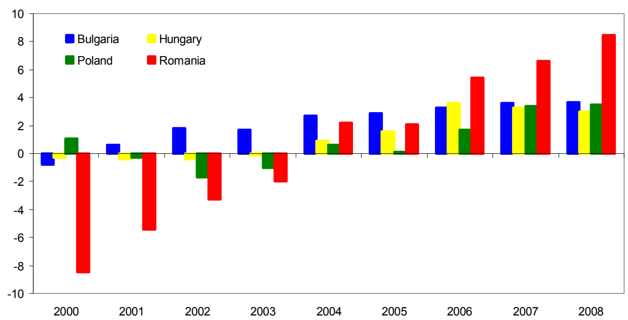
NBR is set to cut more aggressively

Overview

Romania is heading for a marked external adjustment …

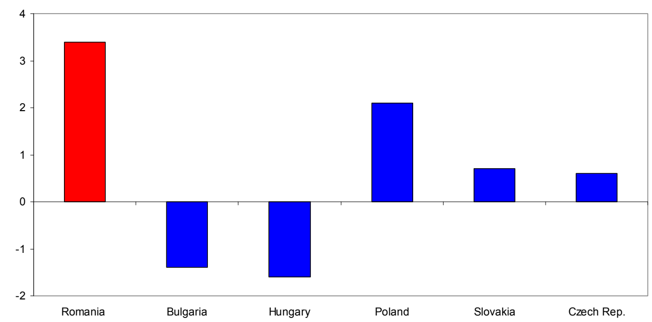
Romania's economic boom over the past five years, which led to overheating and unsustainable imbalances, has come to an end with the global economic downturn. The economy has entered a challenging process of correcting large economic imbalances. Given the degree of overheating and the vulnerabilities built up during the boom period—along with the marked fiscal relaxation in recent years, 2008 in particular—we expect the adjustment process to be an arduous one, as the global downturn increasingly spills over into the country (Figures 1 and 2).

Figure 1. Gap between Actual and Potential GDP



Source: AMECO Note: At 2000 market prices.

Figure 2. Fiscal Impetus (2008)

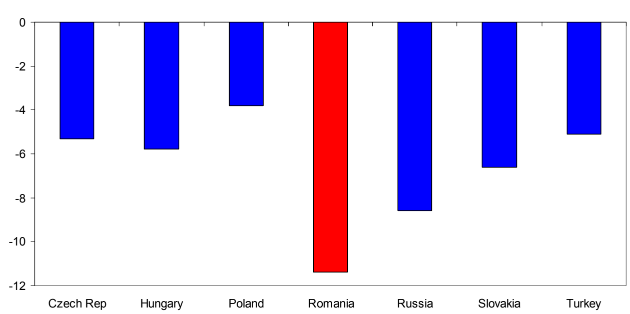


Source: EC Note: Change in the cyclically adjusted budget deficit.

… led by a sharp growth reversal.

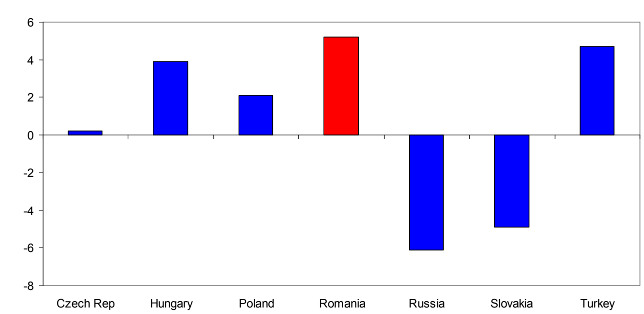
In view of the country's underlying economic problems, we had earlier argued that Romania's external adjustment is likely to rely more on a slowdown of economic growth (see for instance *En route to a soft landing amidst challenges*, 29 February 2008 for more on this). Our current forecasts seem to corroborate this view, as Romania seems to be heading for the largest growth reversal and external adjustment in the region (Figures 3 and 4). The large magnitude of the required adjustment, in turn, reiterates the importance of the IMF-EU-led package in facilitating a less painful correction process.

Figure 3. Expected Growth Reversal in 2009



Source: Citi.

Figure 4. Expected Magnitude of the External Adjustment in 2009



Source: Citi Note: Percentage of GDP.

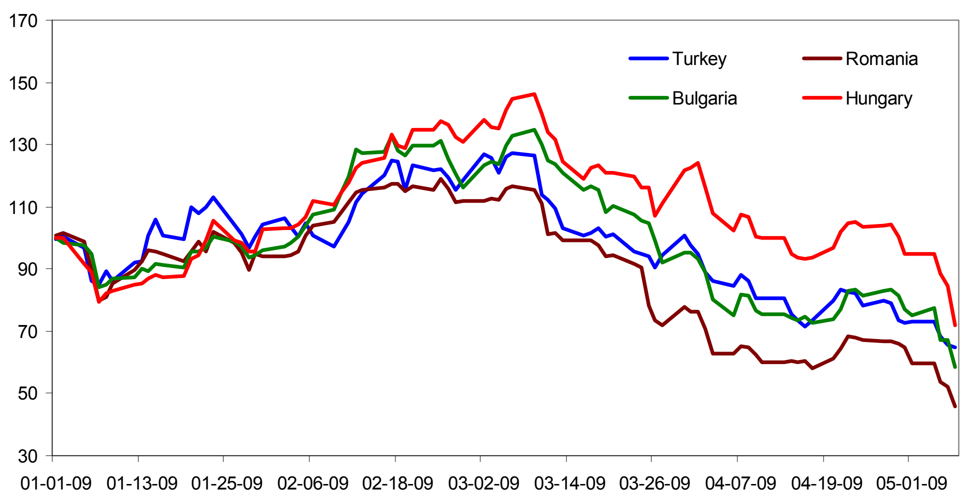
The IMF-EU led programme eases the burden of adjustment ...

The IMF-EU supported economic programme—a €20 billion financial package for two years—was indeed a turning point in arresting the deterioration in investor sentiment (Figure 5).[1] The new economic programme aims at bolstering fiscal discipline and financial stability to alleviate short-term funding pressures and enhance medium-term economic prospects.

...in a front loaded manner.

With the approval of the programme by the IMF's Executive Board on 4 May, €5.0 billion has become immediately available and the remainder will be disbursed in instalments subject to quarterly reviews (the first one is likely to take place in September). In parallel, the first tranche of the EU assistance (€2.5 billion) is expected to be disbursed in July.

Figure 5. Evolution of 5-Year CDS Spreads (December 2008=100)



Source: Bloomberg.

There are, however, significant implementation risks ...

We recognise that the IMF-EU supported new economic programme has played an important role in reducing near-term risks, while improving the prospects for addressing vulnerabilities accumulated during the boom period—a conjecture, which is also confirmed by the initial favourable market response (Figure 5). However, the remainder of this year and 2010 will be challenging not only because of the difficult global backdrop, but also due to the presence of implementation risks associated with the economic programme—especially on the fiscal front—which will also test the resolve of the government. In fact, the upcoming elections (for the European Parliament in June and Presidential in November) may prove to be an important source of distraction for economic policy making, thereby adversely affecting investor sentiment.

... as there is more at stake than just riding out the financial storm.

In our view, successful implementation of the IMF-EU-supported programme has important implications beyond weathering the crisis. A credible implementation of the programme should put Romania in a stronger position for ERM 2 entry in 2012. As a result, we believe that there is more at stake than just riding out the financial storm.

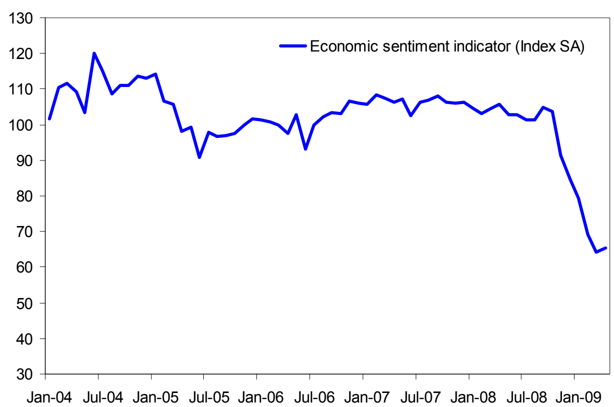
[1] The total international support is around €19.9 billion, with the EU providing €5.0 billion, the World Bank €1.0 billion, and the EBRD, EIB, and the IFC a combined €1.0 billion. The IMF component of the package will be used to bolster international reserves, the portion provided by the EU will be channelled to the Treasury to cover the budget deficit.

A marked reversal of economic growth is underway

Growth is set to contract sharply ....

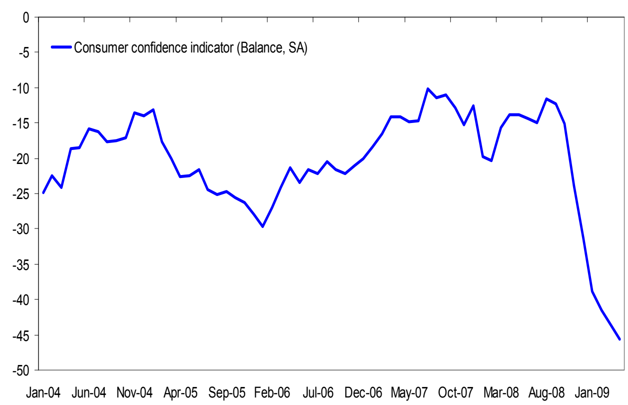
The marked deterioration in consumer confidence and economic sentiment indicators—along with the marked rise in the unemployment rate to 5.7% in April from 4.4% in December 2008—underline the severity of economic downturn (Figures 6 and 7). The tightening global financial conditions, reversal of capital inflows and shrinking export markets have precipitated a major growth reversal that will lead to an estimated decline in the real 2009 GDP growth rate to -4.3% from 7.0%.

Figure 6. Economic Sentiment (Balance, SA)



Source: Ecowin.

Figure 7. Consumer Confidence (Balance, SA)



Source: Ecowin.

... led by domestic demand.

We see the current growth reversal as being led by a plunge in domestic demand, with private consumption and investment both posting significant negative contributions to overall growth (Figure 8). In parallel, we expect the net foreign demand to have a positive contribution, as the impact from shrinking export markets is more than outweighed by the collapsing imports. We expect gradual normalisation of the growth dynamics in 2010, with domestic demand going back into positive territory.

Figure 8. Contribution to GDP growth

	2004	2005	2006	2007	2008	2009F	2010F
Gross Domestic Product	8.5	4.1	7.9	6.2	7.1	-4.3	1.3
Domestic Demand	12.7	11.7	14.9	17.9	14.9	-6.3	1.4
Consumption	10.4	8.4	10.2	10.2	8.7	-2.3	1.0
Gross Fixed Investment	2.3	3.3	4.7	7.6	6.2	-4.0	0.4
Change in stocks	1.5	-2.2	0.4	0.0	-2.9	0.0	0.0
Net Exports	-5.4	-6.1	-10.2	-16.6	-6.3	2.0	-0.1

Source: Ecowin and Citi Note: Contributions may not add up due to the statistical error.

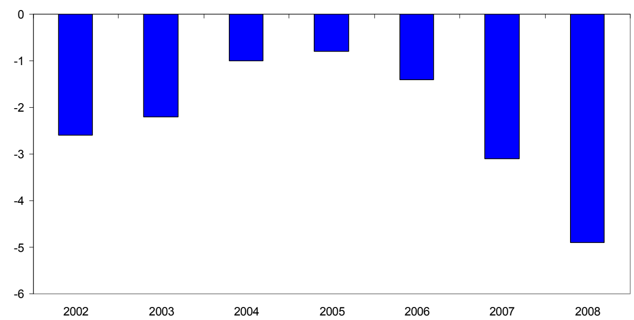
All eyes will be on fiscal performance

Fiscal policy has deteriorated rapidly.

Romania's budget deficit, which was below 1.0% of GDP in 2005, has expanded considerably over time, reaching 5.0% in 2008. The higher-than-planned current expenditures—especially in public wages and social transfers—ahead of the November election, and the sharp drop in revenues in the last two months of 2008 because of the slowdown, were the key factors behind the marked rise in the budget deficit last year (Box 1).[2]

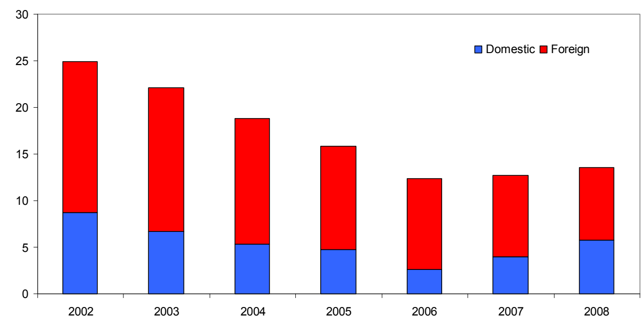
Box 1: Selected Fiscal Indicators

Figure 9. Budget Balance (Percent of GDP)



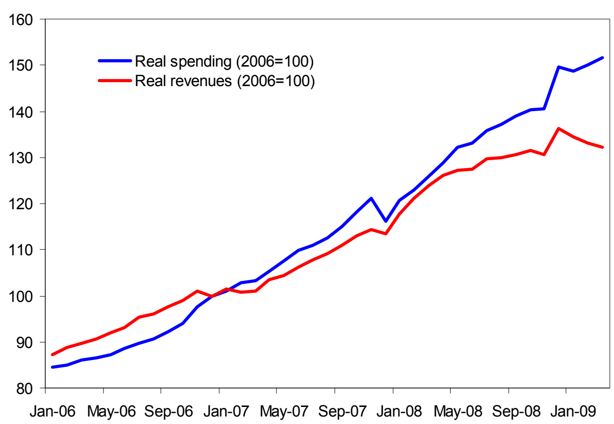
Source: Ecowin .

Figure 10. Public Debt (Percent of GDP)



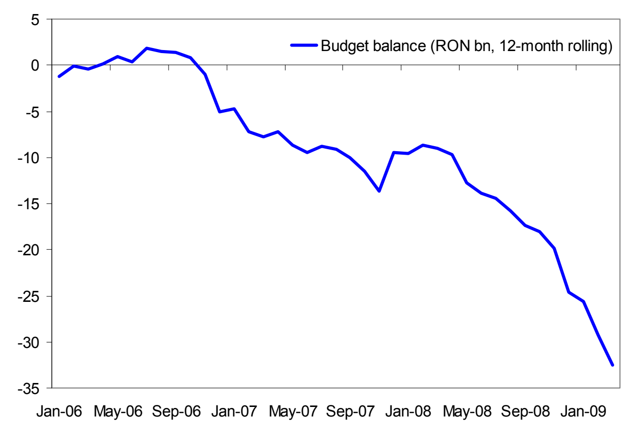
Source: Ministry of Public Finance.

Figure 11. Fiscal Indicators (2006=100, 12-Month Moving Average)



Source: Ecowin and Citi.

Figure 12. Budget Balance (RON Billion)



Source: Ecowin .

The IMF-EU-led programme aims at arresting the marked deterioration in fiscal performance …

The IMF-EU-supported programme aims at containing the rapid deterioration in fiscal performance in the near term. Specifically, the programme includes consolidation measures that amount to 1.1% of GDP both on the revenue (0.25%) and expenditure (0.85%) sides in order to meet the revised budget deficit target of 4.6% of GDP this year.

[2] We also note that fiscal policy was pro-cyclical during the boom period (including 2008), which, in turn, aggravated the cycle (Figure 2).

… while tackling structural problems on the fiscal sphere…

The programme also comprises structural reform measures directed at improving the budgeting process, improving fiscal discipline, and tackling the key structural problems on the fiscal sphere. In this respect, the programme envisions the following policy actions:

- New legislation to streamline public wages through establishing a unified pay scale and limiting bonuses, while also prohibiting the creation of non-monetary bonuses.
- Pension reform, which entails measures such as changing indexation structure (from wages to inflation) and raising the contribution rate, among other things, to ensure the financial viability of the system.
- Adoption of a new fiscal responsibility law, with a view to improving multi-annual budgeting and containing discretion in the conduct of fiscal policy.

…which are politically sensitive but entail long-term benefits.

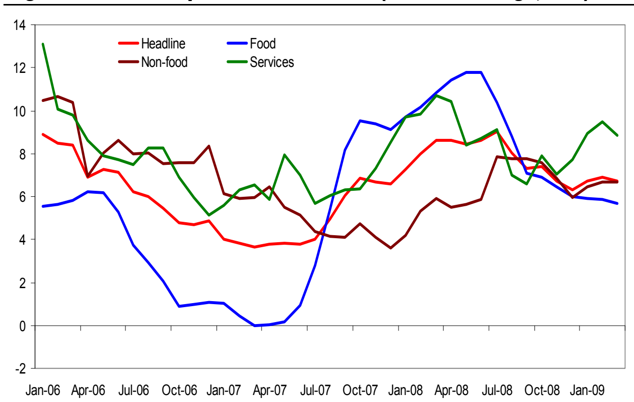
All in all, the fiscal component of the IMF-EU-supported programme contains the most contentious/politically sensitive measures.[3] In this regard, successful implementation of the structural reform measures mentioned above is a prerequisite for expediting the convergence of the Romanian economy.

Conditions appear ripe for more aggressive easing

Inflation has surprised on the upside in 1Q 09.

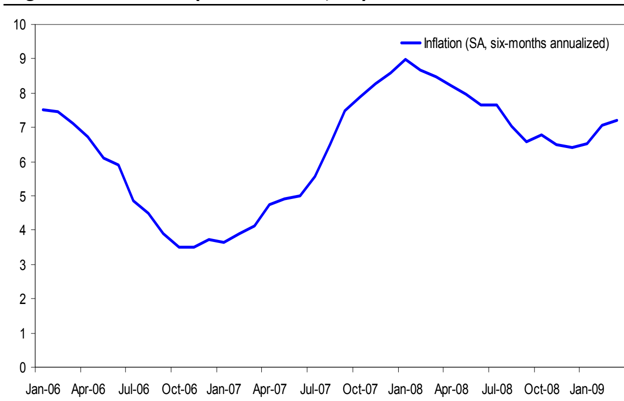
The higher-than-expected inflation readings in the first quarter were largely driven by leu weakness and certain food items, whose prices grew at a considerably quicker pace. In parallel, core inflation measures have not displayed a noticeable improvement, suggesting that inflationary pressures failed to ease during this period.

Figure 13. CPI Components of Inflation (Percent Change, YoY)



Source: Ecowin.

Figure 14. Inflation (Percent MoM, SA)



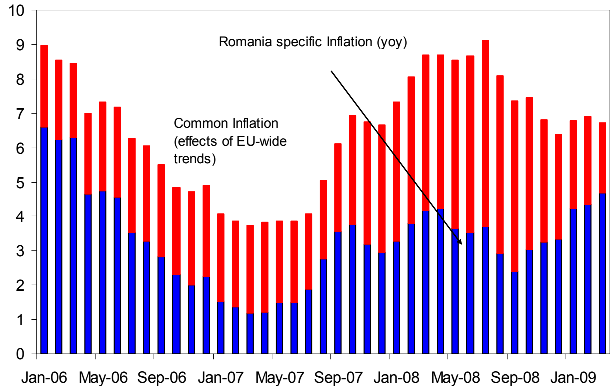
Source: Ecowin and Citi.

… which is largely due to domestic factors such as the leu depreciation.

Furthermore, a simple exercise demonstrates that the Romania-specific component of overall inflation has been increasing progressively since last September, which currently stands at its highest since June 2006 (Figure 15). The role of common EU-wide inflation trends (adjusted for Romanian inflation weights), in contrast, have been shrinking. Leu weakness, which puts upwards pressure on tradable prices and relatively sticky services prices, appear to be the main reasons for this pattern. In parallel, inflation expectations remain don't display a marked improvement, failing to yet reflect the potential disinflationary effect of the growth collapse (Figure 16).

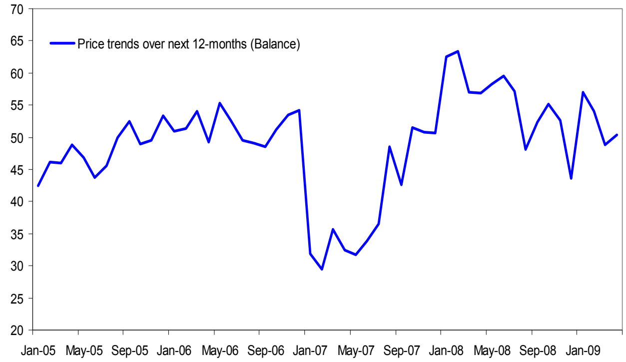
[3] Concurrently, we note that there is uncertainty as to whether the IMF will display any flexibility in the event of delays/slippages. This, in turn, also highlights that the IMF may face a trade between creating a moral hazard and being percieved as excessively harsh.

Figure 15. Inflation Decomposition (Percent Change YoY)



Source: Eurostat and Citi. Note: We calculate virtual inflation by using Romania's basket weights to average EU27 inflation rates for detailed HICP components. The virtual rate aims to demonstrate the effects of global price developments, which, in turn, allow us to extract external inflation and analyse country-specific inflation.

Figure 16. Inflation Expectations (Balance, SA)



Source: Ecowin.

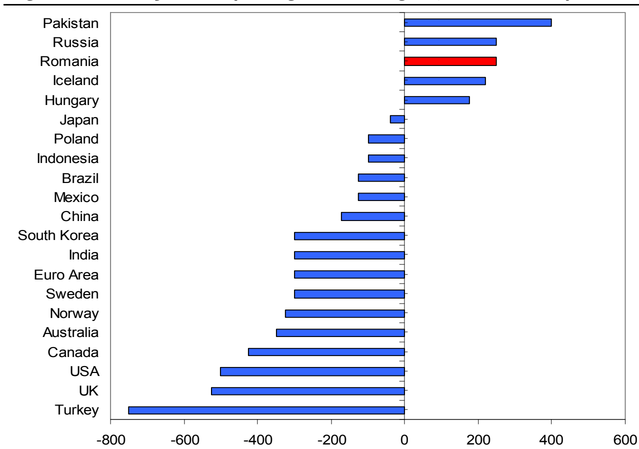
We expect inflation to ease during the remainder of the year.

Looking ahead, lower food and commodity prices—along with aggregate demand weakness and the recovery of the leu—should help lower inflation to around 5.0% in 2009, which is somewhat more pessimistic than the NBR's most recent forecast of 4.4%, from 6.3% in 2008. Despite the absence of a marked improvement in price dynamics during 1Q 09, we think our end-year inflation projection is feasible, barring exchange rate shocks.

While the NBR has been prudent so far …

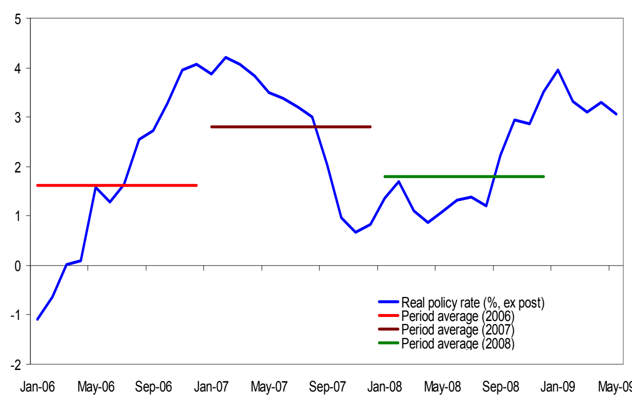
What are the implications of the above-described picture for the conduct of monetary policy? As can be seen from Figure 17, the NBR appears to have pursued a relatively prudent policy since the inception of the financial crisis. This is also confirmed by the evolution of the real policy rate (Figure 18). The NBR has in fact lowered its policy rate by only 75bp to 9.50% in the first five months of this year since December 2008.

Figure 17. Policy Rates (Change since Aug 07, Basis Points)



Source: Bloomberg.

Figure 18. NBR's Policy Rate (Percent, ex post)



Source: Ecowin and Citi.

… we expect the Bank to pursue a more aggressive easing, bringing the policy rate to 7.25% by the end of 2009.

Where do we go from here? In view of May's higher-than-expected rate cut (50bp versus 25bp) and the new inflation report, we believe that the NBR is likely to pay more attention to the rising output gap. This, coupled with the IMF-EU-led multilateral financial package and the stronger-than-expected external adjustment, is likely to encourage the NBR to ease more aggressively during the remainder of this year. As a result, provided that there is no abrupt halt in the external adjustment and absent significant pressure on the currency, we believe that the NBR will lower its policy rate to 7.25% by the end of this year.

Box 2: The IMF stand-by arrangement: monetary policy

As a prior action for the IMF programme, the NBR has undertaken a stress testing of all banks with more than 1.0% share by asset size in the Romanian market. As was decided in a recent meeting in Vienna, the parent institutions of the nine largest foreign-owned banks, with a market share of 70% of assets, have expressed their commitment to maintaining their exposure to Romania, while confirming that they stand ready to take appropriate measures in the light of the findings of the noted stress tests.

In the context of the programme, we believe that, as has been the case with other inflation targeting central banks, the NBR is likely to be required to have consultations with the IMF staff in the event of deviations of +/- 1.0 percentage point from the inflation target. Deviations above +/-2.0 will entail consultations with the IMF's Executive Board. In parallel, we expect quarterly targets for net international reserves (or NFA) under the umbrella of the IMF program.

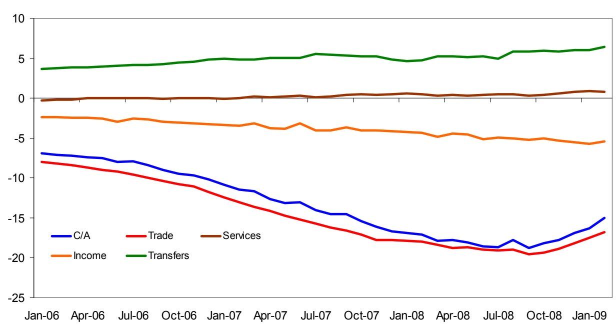
Source: Citi.

Current account gap is heading for a major contraction

We expect the current account gap to shrink to around 7½ % of GDP.

At below €0.1 billion, February's current account gap, which brings the 12-month rolling deficit to €15.0 billion from €16.3 billion in January, confirms the severity of the ongoing external adjustment (Figures 18 and 19). In our view, the combination of economic weakness and a more competitive exchange rate should help narrow the country's large current account deficit to around €9.0 billion (7.4% of GDP) this year, from almost €17 billion (12.3%) in 2008.

Figure 19. Current Account Developments (EUR Billion)



Source: Ecowin.

Figure 20. Current Account Balance (EUR Billion)

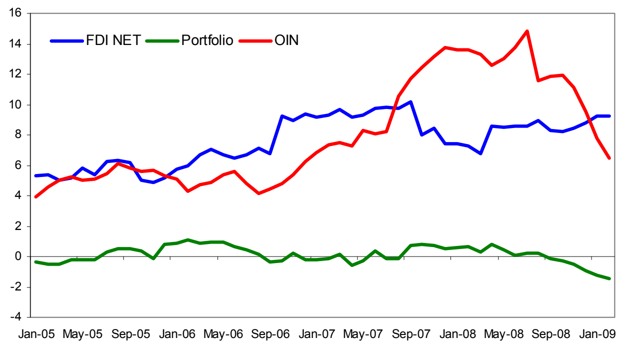
	Feb-08	Feb-09	Jan-Feb 08	Jan-Feb 09	% change
C/A balance	-1.35	-0.09	-2.50	-0.61	-75.47
Trade	-1.23	-0.58	-2.37	-0.96	-59.45
Services	0.05	-0.05	0.14	0.07	-50.37
Income	-0.40	-0.13	-0.81	-0.69	-14.14
Transfers	0.23	0.67	0.54	0.97	80.67

Source: Ecowin.

…which, coupled with the sizeable IMF-EU package, reduces external financing risks.

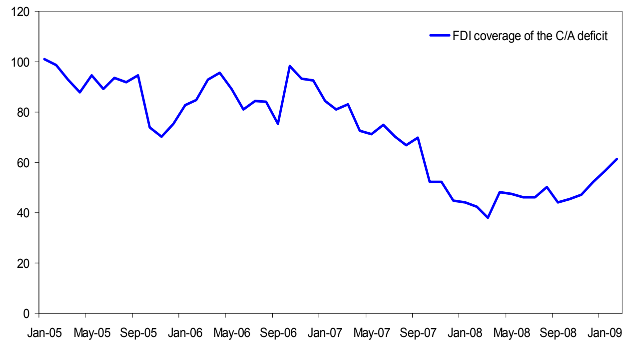
The envisaged narrowing of the current account deficit bodes well for efforts aimed at reducing the country's external financing requirement (Figures 21 and 22). In this regard, the Vienna agreement involving the parent institutions of the nine largest foreign-owned banks incorporated in Romania is also worth highlighting. The noted banks have confirmed that they remain committed to maintaining their exposure to Romania. In our view, this development, coupled with the IMF-EU-led package, constitutes an important step in alleviating concerns over the country's large external financing needs.

Figure 21. Capital Account Developments (EUR Billion)



Source: Citi.

Figure 22. FDI Coverage of the Current Account (Percent)



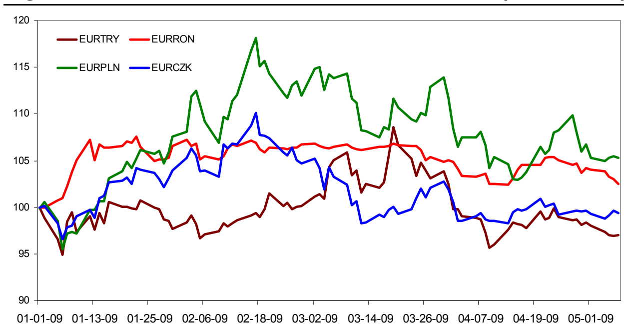
Source: Citi.

Prospects for leu recovery look good

The outlook for leu has improved in recent months…

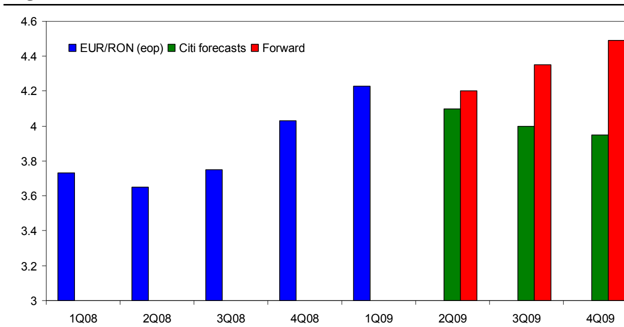
In our view, the IMF is comfortable with the NBR's active involvement in the FX market to contain excess volatility (Figure 23). This, coupled with the presence of a more credible macroeconomic framework supported by a sizeable IMF-EU-led financial package, should support the leu, barring a marked deterioration in global risk appetite. Moreover, the ongoing strong external adjustment is another important leu-supportive development.

Figure 23. Evolution of RON vs. Selected Currencies (Dec 08=100)



Source: Bloomberg.

Figure 24. EUR/RON forecasts



Source: Bloomberg and Citi.

… but there are potholes on the way to a stronger currency.

In our view, the above-noted factors paint a favourable picture for the leu in the near-term. Nonetheless, we acknowledge that there are risk factors which require close monitoring. For instance, in the event of a rapid leu appreciation, the NBR may opt for intervening through selling RON. Moreover, large deviations from the economic programme's fiscal targets, and political noise ahead of Presidential elections in November, may undermine investor sentiment, thereby adversely affecting the currency. Concerning the former risk factor, we think that the NBR is not likely to intervene unless the currency appreciation is accompanied with an abrupt halt in the external adjustment. In the case of the latter, the conclusion of the IMF's first review in September will be an important test case.

We expect the EUR/RON to be around 3.95 by year end, which corresponds to a real depreciation of around 6.0%.

Against this backdrop, we expect the EUR/RON at around **4.10** in 2Q, **4.00** in 3Q, and **3.95**, by year-end (Figure 24). The envisaged trajectory for the EUR/RON amounts to a real depreciation of about **6.0**%. We would like to underline that in addition to the risk factors above, the NBR's willingness to ease its policy stance more aggressively than before may have implications for the leu, which should also be monitored closely.

Disclosure Appendix A1

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