

GDP REPORT

9 December 2016

With fading fiscal stimulus domestic demand slowed down in Q3

- In the third quarter of 2016, Romania's economic growth pace lost steam, pointing to a 4.4% annual rise after the sharp, 6.0% pick-up in Q2 (gross data, see Chart 1), also undershooting the expectations (5.0%, according to a Reuters survey) by a fairly wide margin. QoQ growth slowed down to 0.6% from the 1.5% gain in the period of April-June (SWDA data). The deceleration was caused by lower growth in domestic demand, while on the production side, agricultural output and construction works slowed most sharply. Despite the slowdown, the 4.4% growth is the highest number in the European Union (but there is a small group of countries who have not revealed Q3 figures yet). In addition, the growth rate of our preferred indicator, the non-farm private sector GDP remained above the 5% threshold (Chart 2), overall reflecting strong underlying performance.
- Regarding the broader picture, as in our previous [report](#) we note that Romania appears to be in the mature stage of the economic cycle, led primarily by domestic demand, which got an additional boost from large-scale fiscal easing measures.
- Admittedly, Q3's domestic demand was weaker than analysts had expected, but the more general fact – that the annual gains in consumption and investments diminished somewhat in the last quarter – was not a surprise. On the one hand, we suspect that the economy's stellar performance in Q2 could have been a positive outlier to some extent, characterizing not only Romania but the broader CEE region as well. Meanwhile, the base effect of last year's aggressive VAT cut on foods (from 24% to only 9%) has faded out. Retail trade, a fairly good proxy for tracking consumption, provides additional insight into the boosting effect of the VAT changes, highlighting also the normalization process that started to take shape in the latest period (Chart 6). At the same time, gross fixed capital formation was pulled back by struggling public investments (Chart 7), while presumably companies were also more cautious about launching new projects in Q3. Nevertheless, as domestic demand weakened, imports lost more steam, helping to reduce net exports' negative impact on GDP expansion (Chart 3).
- On the production side (Chart 4), the slowdown in the annual growth rates was quite broad-based in Q3, with agriculture, constructions and public services showing the largest drops. In agriculture, the initial perspective was fairly encouraging with a relatively soft output a year earlier and promising yield forecasts for 2016. But this bright outlook deteriorated swiftly, just before the harvest of maize began (Chart 8), as inadequate water supply left its mark on crops in southern and eastern Romania. At the same time, sluggish public investments and the temporary drop in EU funds for new projects most likely weighed on the construction sector, reflected by the downturn of civil engineering works (Chart 9).
- In the last quarter of the year, we suspect that a modest acceleration could come, suggested also by strengthening economic sentiment in the period of October-November (Chart 10), after it was sustained primarily by a pick-up in consumer confidence ahead of the December general elections. This also supports the idea that some of the Q3 fall in households' expenditures may reverse, helping domestic demand in Q4. Despite the expected mild acceleration at the end of 2016, our [previous](#) growth forecast for this year now seems to be rather optimistic, therefore we revised it downward by 0.2 percentage points, to 4.8%.
- In relation to the longer-term outlook, we did not alter our view. As the fiscal boost is set to run out of steam gradually and monetary policy may also turn less supportive in the forthcoming years, we suspect that the country's GDP growth pace will return to lower levels. Gains in real disposable income could normalize as wage growth momentum moderates (among others, this year's spectacular advances were helped by significant public wage hikes) and after consumer prices start to climb again. But, with the swiftly tightening labour market, the increase in real incomes may remain steady enough to sustain robust expansion of households' consumption in the quarters ahead. All in all, we foresee 3.8% GDP increase in 2017, which could ease to 3.5% in 2018.
- Admittedly, the tightening labour market should fuel wages and accordingly consumption as well, but with the unemployment rate drawing closer to 2008's record lows (Chart 11) amid strong job creation trends (Chart 12), companies may face more difficulties in hiring skilled employees. We recall that beyond the cyclical shortage, Romania also struggles with some geographical disparity in free workforce (Chart 15) similarly to its peers in the CEE region. Not surprisingly, in Romania's leading economic hubs with high per capita output, unemployment rate is staying well below the broader average (Chart 13). However, it may take time to redirect larger masses from agriculture to other sectors (Chart 14), while the persistent educational mismatches hinder the pace of potential output growth.

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Chart set:

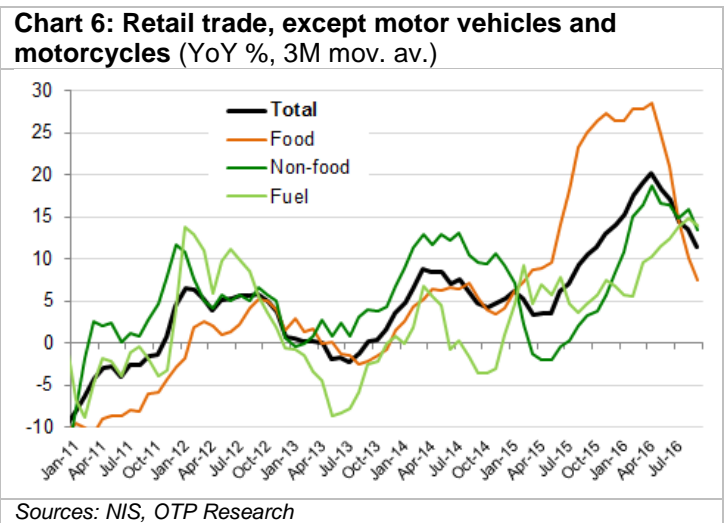
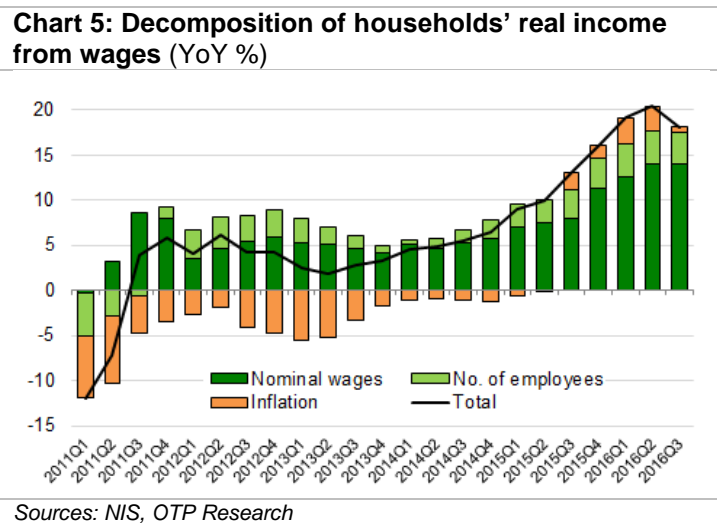
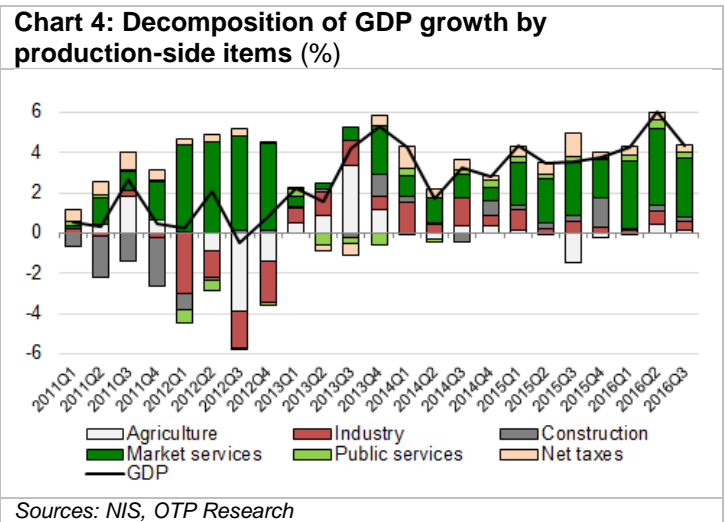
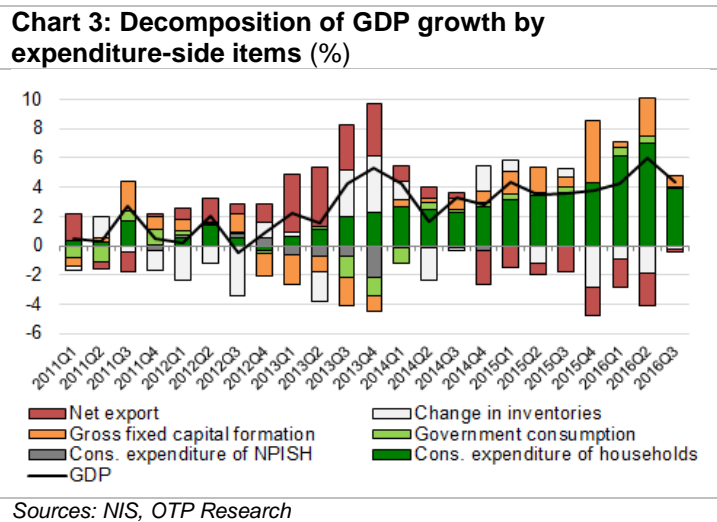
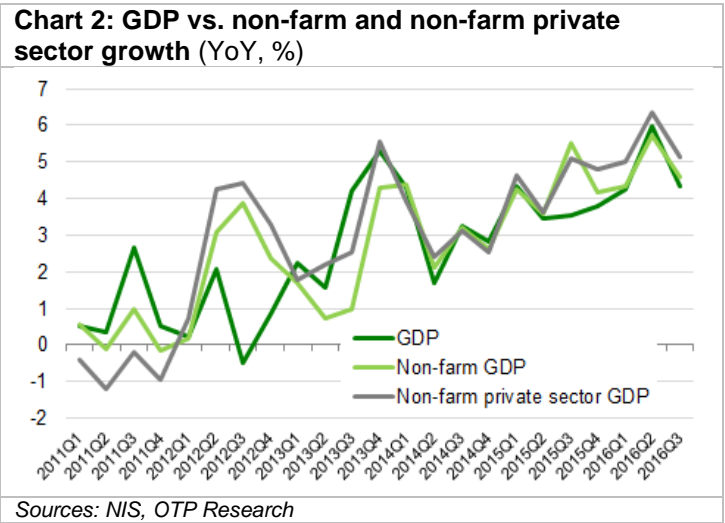
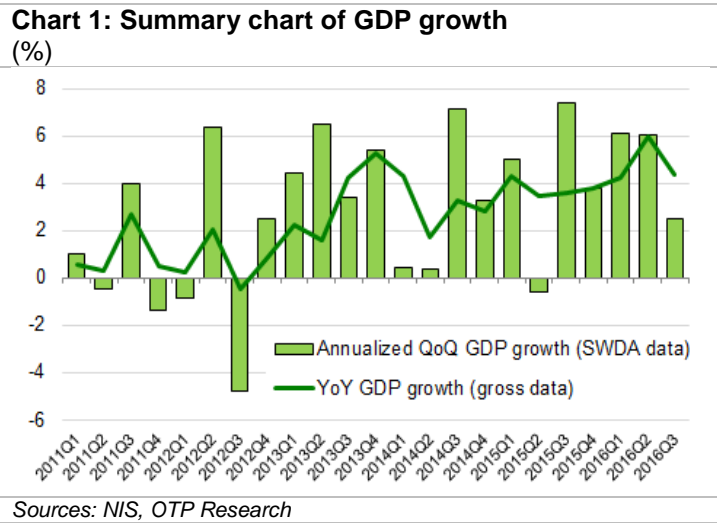
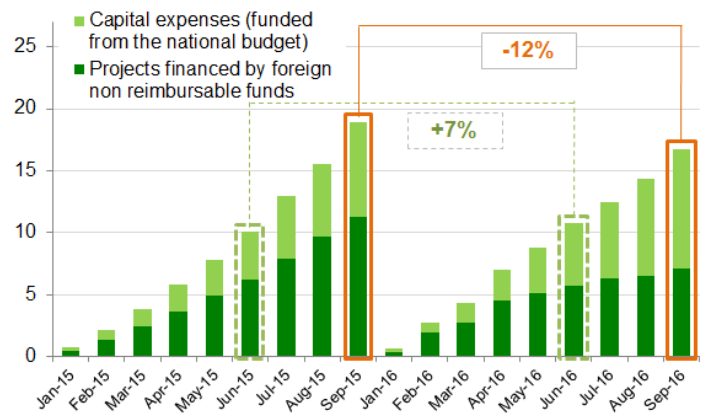
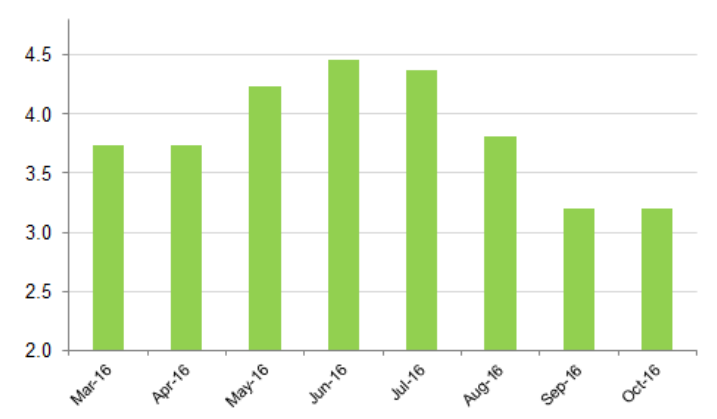


Chart 7: Government expenses for investments in 2015 and 2016 (cumulated, RON bn)



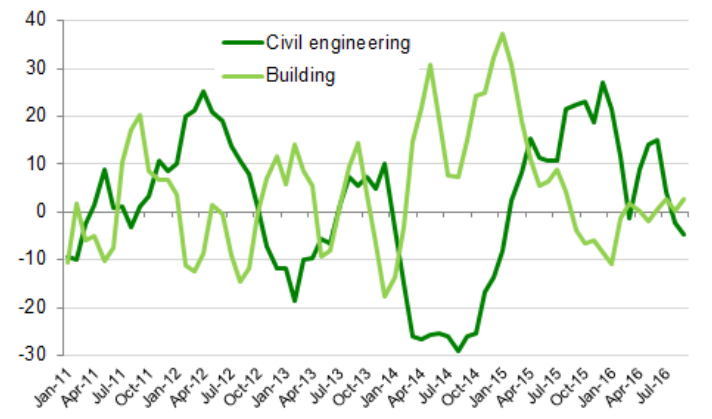
Sources: Ministry of Finance, OTP Research

Chart 8: Maize production, 2016's expectations by months (t/ha)



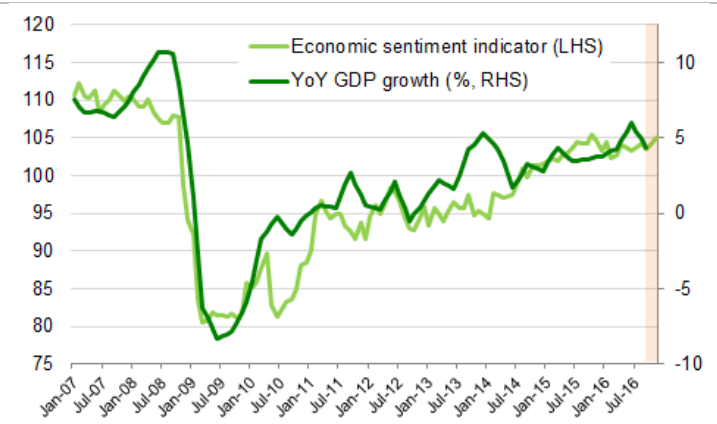
Sources: EC, OTP Research

Chart 9: Construction works (YoY %, 3M mov. av.)



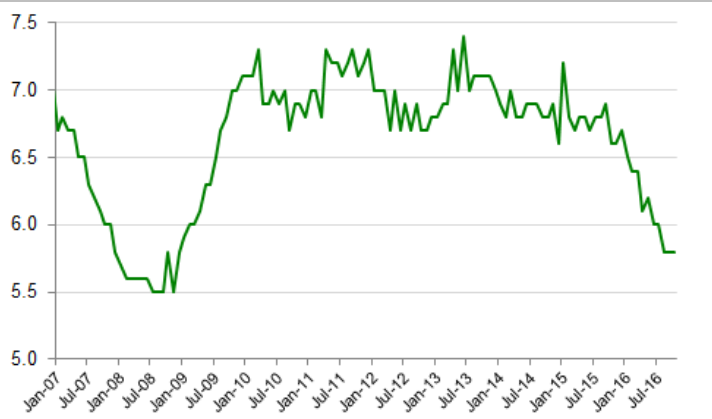
Sources: NIS, OTP Research

Chart 10: GDP growth vs. economic sentiment indicator



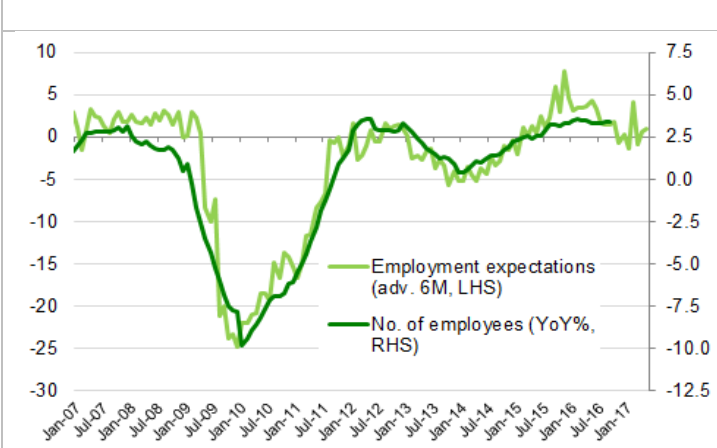
Sources: NIS, EC, OTP Research

Chart 11: Unemployment (% , SA)



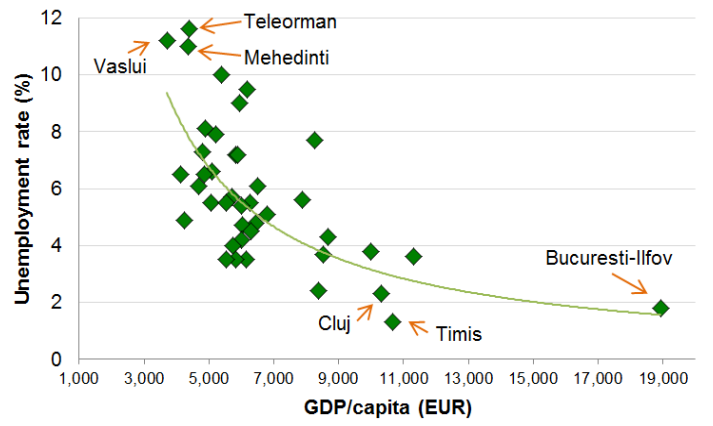
Sources: NIS, OTP Research

Chart 12: Employment expectations



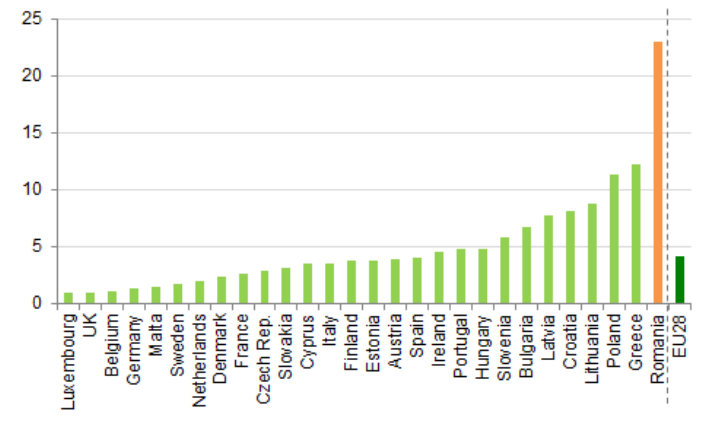
Sources: NIS, EC, OTP Research
 Note: employment expectations (measured as balance of opinions) are calculated as a weighted average of sectorial expectations

Chart 13: GDP per capita vs. unemployment rate by counties (2015)



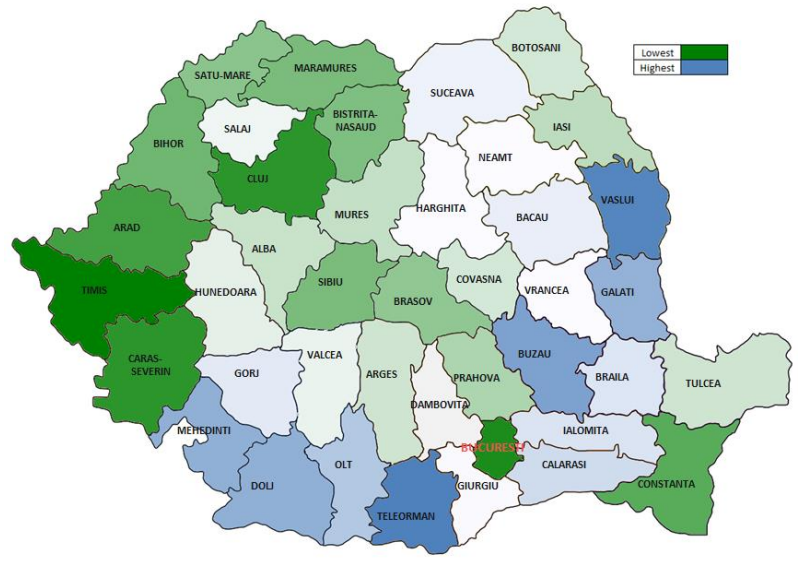
Sources: NIS, CNP, OTP Research
 Note: registered unemployment rate (Ministry of Labour definition)

Chart 14: Share of employees in agriculture (% of total)



Sources: Eurostat, OTP Research

Chart 15: Unemployment rate by counties (September 2016)



Sources: NIS, OTP Research
 Note: registered unemployment rate (Ministry of Labour definition)

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