GDP REPORT

11 June 2018

Romania's economy is expected to bounce back later this year, but the stellar gains characterizing 2017 are likely over;
Downside risks around the medium-term outlook may rise as potential output growth moderates, and the fiscal room for addressing shocks is limited

- Romania's Q1 2018 GDP growth rate was confirmed at 4.0% YoY (gross data, see Chart 1) and 0.0% QoQ (seasonally and working day adjusted data). These statistics correspond to a sharp deceleration compared to Q4's 6.7% YoY and 0.3% QoQ advances, driven mainly by a setback in household consumption. We recall that the flash Q1 GDP estimation of the NIS, released a few weeks earlier, caused a significant surprise undershooting the market's (Reuters: 5.4% YoY; Bloomberg: 5.5%) as well as our (5.3% YoY) expectation. Non-farm private sector GDP, an indicator tracking underlying developments more accurately, also pointed to a sizeable slowdown (Chart 2).
- Regarding the broader picture it is important to note that one-off factors, such as the concerns triggered by tax changes (first of all, the reallocation of social contributions) played an important role in Q1's disappointing evolution of household consumption. However, the unusually tight labour market is expected to support wage dynamics, re-igniting consumption growth in the quarters ahead. Nonetheless, the weak data also underscores that the stellar GDP advances, which characterized 2017, may be over, as external economic conditions became less supportive, the impact of fiscal stimulus measures started to fade, and monetary policy is turning less accommodative. In addition, last year's excellent agriculture harvest is unlikely to re-occur. Given this context, economic growth is expected to align gradually with its potential expansion rate. It is worth mentioning that the risks coming from pro-cyclical government policy led to higher downside risks over the medium and long term as well.
- On the expenditure side, household consumption shaved off the most from Q1's GDP growth rate, but investments into gross fixed assets also softened (Chart 3 & 5). The weakness of household expenditures can be explained mainly by a setback of net nominal wage growth (particularly in January: see Chart 6). This came on the back of important tax changes (transferring the burden of social contributions from employers to employees) as well as significant base effects. Slower wage dynamics, coupled with the rebound of inflation, had a negative impact on real disposable incomes. Furthermore, sharply rising borrowing costs, the weakening pressure on the leu, as well as noise coming from the political scene all weighed on consumer sentiment too. Nonetheless, we expect that consumption may bounce back later this year, as households' propensity to consume will rise, supported by re-accelerating wage growth and stabilizing confidence. We note that net wages in March posted an impressive advance again (15.5% YoY, up from January's 8.0% and February's 11.2%), while households' consumer sentiment index consolidated at levels seen in mid-2014 (Chart 7). Furthermore, early data for April also signals a modest upswing in consumption, after the steep drop in the previous few months (Chart 8).
- Gross capital formation was a bit weaker than we had expected as it pointed to a throw-back in Q1, despite the signs of revival in 2017 (Charts 3 & 5). More detailed data reveal that investments into new constructions could have played the key role in this outturn (Chart 9). High-frequency statistics showed that construction output fared relatively well in January-February, helped by favourable weather conditions and recovering civil engineering works. Nevertheless, it seems that the return of winter in March more than offset the gains recorded in the previous two months. At the same time, the growth rate in the segment of the residential segment also dipped in negative territory, after marking stellar advances in 2017. Most likely, the surge of borrowing costs and uncertainties around several tax changes might have had some negative spill-over effects too. However, as the first quarter is generally characterized by muted investment activity, because of seasonal impacts, far-reaching conclusions should be pondered cautiously about the outlook for investments in 2018.

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- Net exports was again a negative contributor to Romania's GDP growth (Chart 3), but its effect was milder than in the previous quarters, as the backsliding consumption growth led to softer demand for imported goods. Meanwhile, exports remained quite healthy despite the moderation of the eurozone's economic growth (for further details on this subject please visit our Balance of Payments Report).
- On the production side, in line with our expectations, the deceleration was broad-based in Q1 (Chart 4), with all of the main economic sectors posting slower annual gains. Value added in industry rose by 4.4% YoY, down from Q4's 9.0%, market services grew 3.8% YoY vs. 7.4% YoY a quarter earlier and construction output even fell (-2.2% vs. +0.1%). Numerous branches of the economy registered drops in QoQ terms, including ITC, Romania's most dynamic sector. Most likely, the sudden softening of domestic demand was an important factor behind the less impressive growth figures, but several production side constraints probably also showed up. Among the latter group, we underscore the role of the tightening labour market. The number of employees in the economy exceeded the peak seen before the outburst of the financial crisis, while unemployment hovered near an all-time low as well (Chart 11). Survey-based statistics also confirm that the shortage of labour force is an increasing drag on production (Chart 12). Nonetheless, early soft data for Q2 also provide some reasons for optimism, as after easing in the past few quarters, economic sentiment appears to have bottomed out (Chart 13).
- Summing it up, we think that the re-accelerating wage growth will boost consumption in the following quarters, but due to Q1's downside surprise, data revisions, as well as the slim chance of the repetition of last year's excellent agriculture harvest, we slightly reduced our GDP growth forecast for 2018 to 4.0% from 4.2% earlier. Regarding the longer-term perspective, we think that Romania may post still robust but milder advances, as the economy is set to return to its potential growth pace. Nonetheless, downside risks surrounding the outlook are rising as potential output growth moderates and the fiscal room for addressing potential shocks is limited. Admittedly, at this moment Romania seems to be much more resilient than before the financial crisis, but the relatively high twin-deficit puts the country into an unfavourable position compared to its peers in the EU (Chart 14). This picture may spook some investors when global financial conditions become adverse.

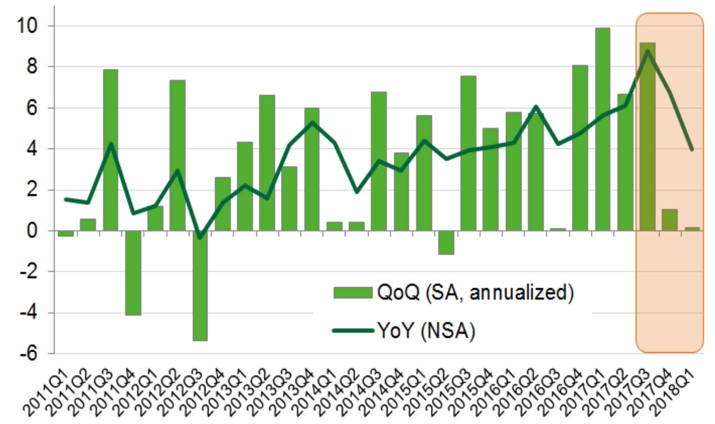
Main macro forecasts

Key economic indicators		2011	2012	2013	2014	2015	2016	2017	2018F	2019F
Real GDP	%	**2.0**	**1.2**	**3.5**	**3.1**	**4.0**	**4.8**	**6.9**	**4.0**	**3.8**
Final consumption of households	%	1.3	2.4	-2.4	4.4	5.7	7.4	9.0	4.5	3.7
Cons. expenditure of housh.	%	1.4	1.7	2.6	4.2	5.8	7.9	10.2	5.3	4.2
Public consumption	%	0.2	0.3	-4.6	0.8	0.2	3.1	0.7	1.3	1.4
Investment	%	6.2	3.6	-5.4	3.2	7.4	-2.0	4.7	4.6	4.7
Exports	%	11.9	1.0	19.7	8.0	4.6	8.7	9.7	8.6	7.8
Imports	%	10.1	-1.8	8.8	8.7	8.0	9.8	11.3	9.3	7.9
Consumer prices	% annual avg	5.8	3.3	4.0	1.1	-0.6	-1.5	1.3	4.7	3.1
Government sector balance	in % of GDP	-5.4	-3.7	-2.1	-1.4	-0.8	-3.0	-2.9	-3.0	-2.9
Public debt	in % of GDP	34.0	36.9	37.5	39.1	37.7	37.4	35.0	35.1	35.6
Current account	in % of GDP	-5.0	-4.8	-1.1	-0.7	-1.2	-2.1	-3.3	-4.0	-4.1
Key interest rate	% annual avg	6.2	5.3	4.8	3.3	1.9	1.8	1.8	2.5	3.2
Key interest rate	% end of period	6.00	5.25	4.00	2.75	1.75	1.75	1.75	2.75	3.25
EUR/RON	annual avg	4.24	4.46	4.42	4.44	4.44	4.49	4.57	4.65	4.64
EUR/RON	end of period	4.32	4.43	4.48	4.48	4.52	4.54	4.66	4.65	4.63
Nominal GDP	RON bn.	562.1	595.4	637.5	668.1	712.7	762.3	858.3	935	1,005
Unemployment	%	7.2	6.8	7.1	6.8	6.8	5.9	4.9	4.5	4.4
Nominal wage growth	%	4.1	4.2	4.8	7.6	9.8	9.9	14.8	11.4	9.3
Real wage growth	%	-1.6	0.8	0.8	6.5	10.4	11.7	13.3	6.4	6.0
Nominal GDP	EUR bn.	132.6	133.6	144.3	150.3	160.3	169.8	187.9	201	217

Sources: NIS, NBR, Eurostat, OTP Research

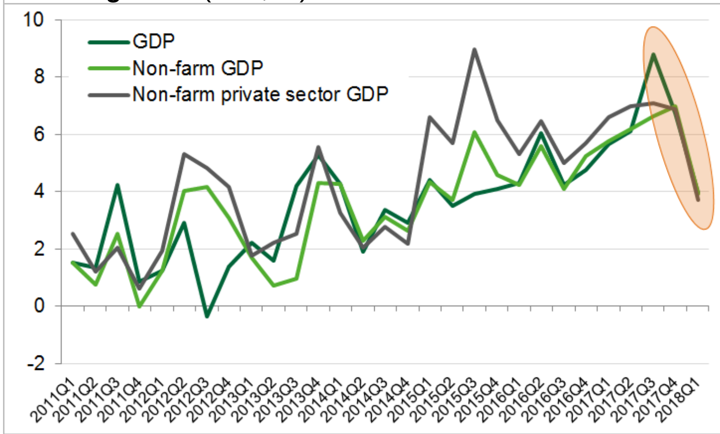
Chart set:

Chart 1: Summary chart of GDP growth (%)



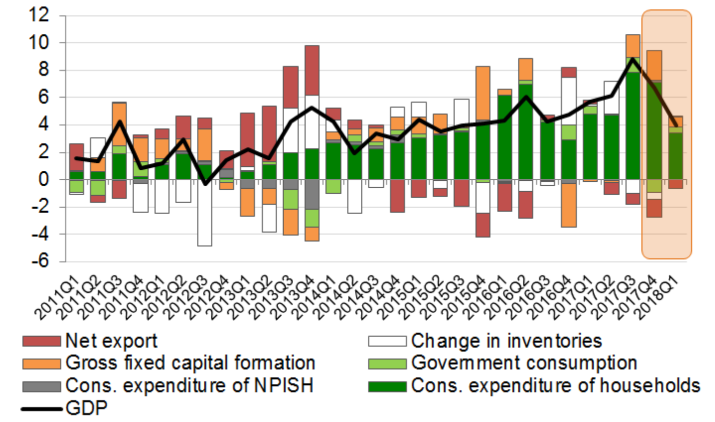
Sources: NIS, OTP Research

Chart 2: GDP vs. non-farm and non-farm private sector growth (YoY, %)



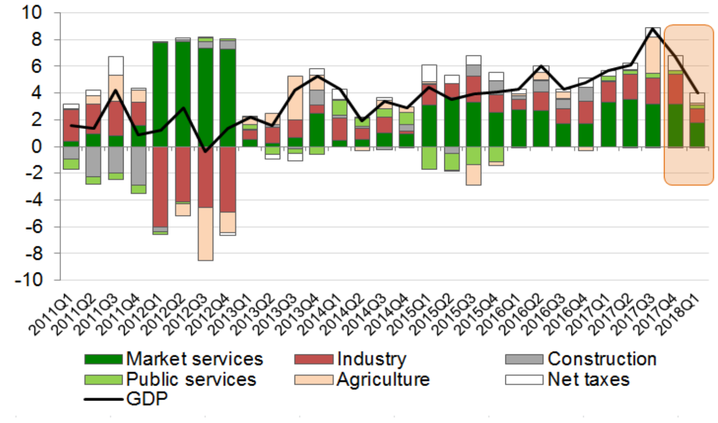
Sources: NIS, OTP Research

Chart 3: Decomposition of GDP growth by expenditure-side items (%)



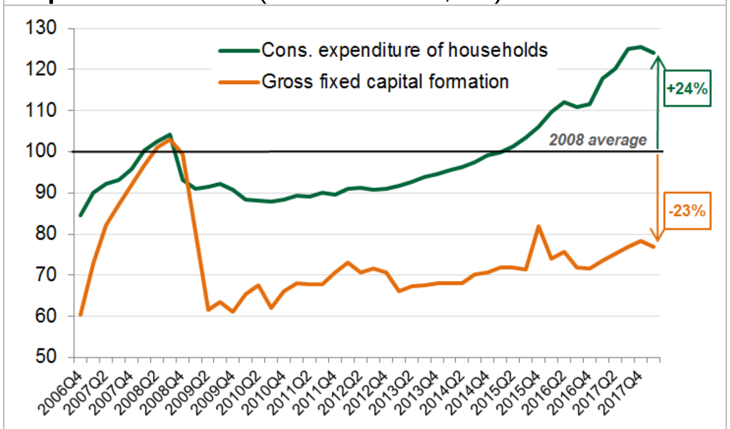
Sources: NIS, OTP Research

Chart 4: Decomposition of GDP growth by production-side items (%)



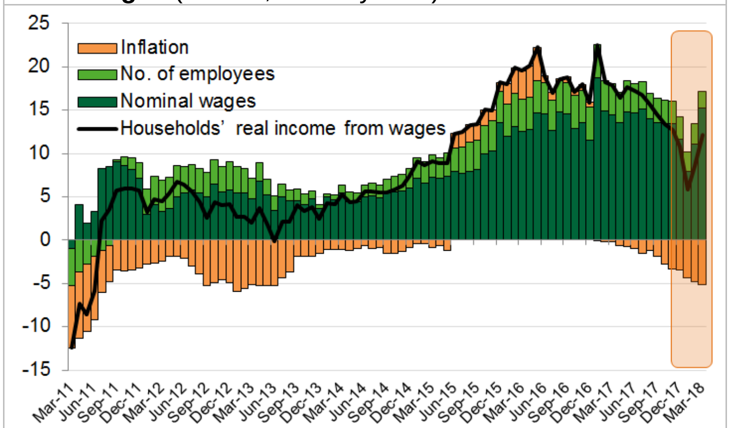
Sources: NIS, OTP Research

Chart 5: Evolution of households' consumption vs. capital investment (2008 av. = 100, SA)



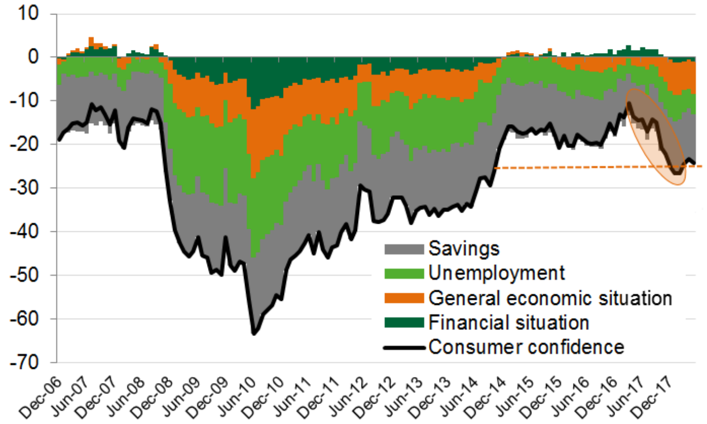
Sources: NIS, OTP Research

Chart 6: Decomposition of households' real income from wages (YoY %, monthly data)



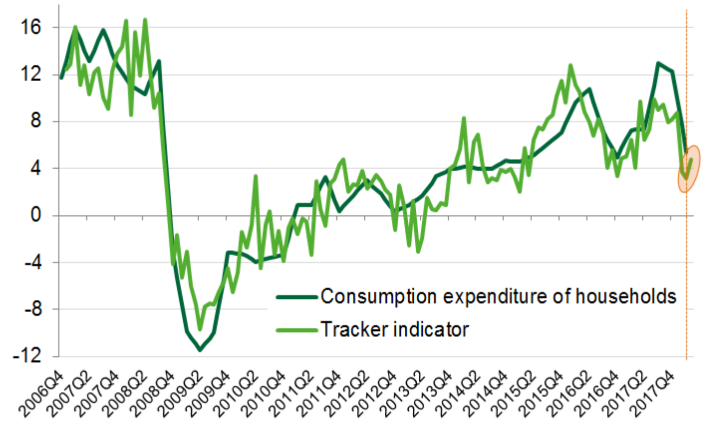
Sources: NIS, OTP Research

Chart 7: Decomposition of consumer confidence indicator (balance of opinions)



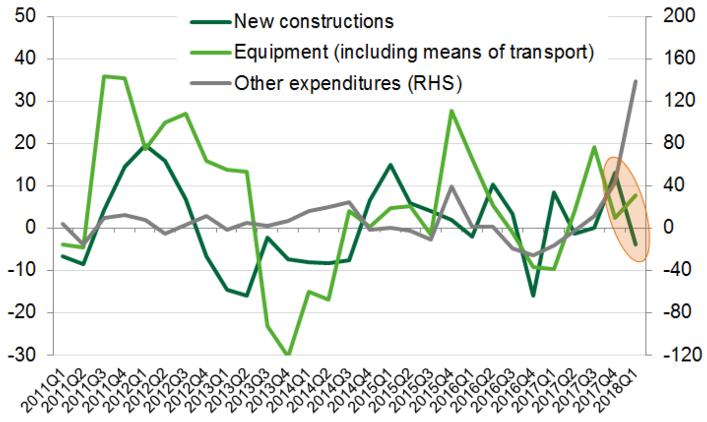
Sources: EC, OTP Research
Note: the components of the consumer confidence indicator reflect the expectation of households over the next 12 months

Chart 8: Households' consumption vs. its tracker indicator (YoY%, monthly data)



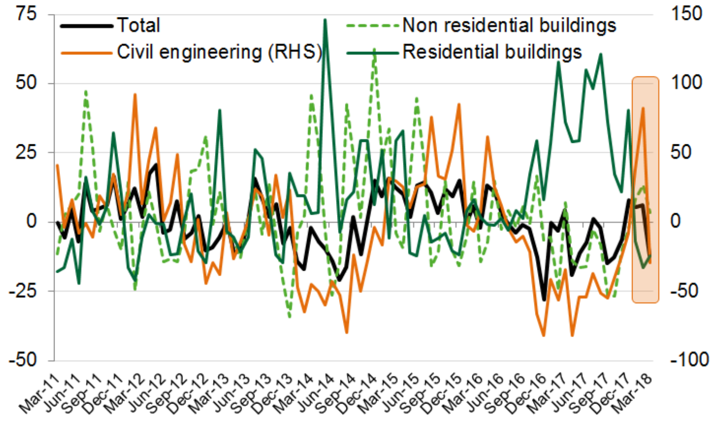
Sources: NIS, OTP Research
Note: the consumption tracker is an in-house composite indicator based on various high-frequency indicators, including among others retail sales and passenger car registration data

Chart 9: Net investments
(YoY %)



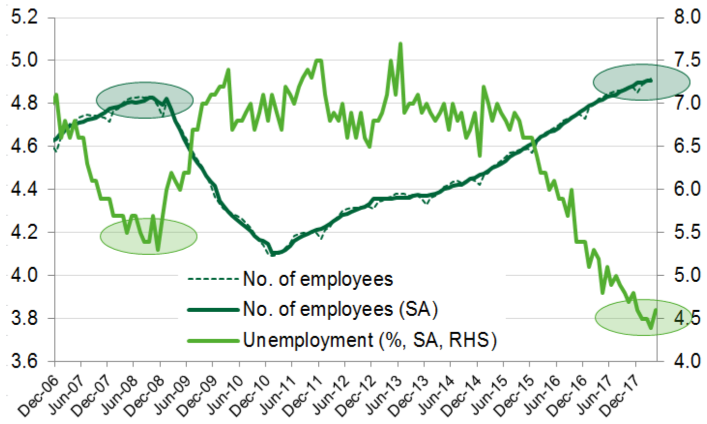
Sources: NIS, OTP Research

Chart 10: Construction works
(YoY, %)



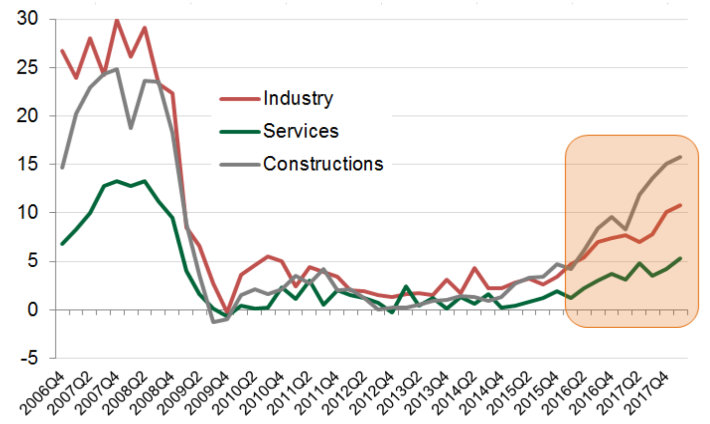
Sources: NIS, OTP Research

Chart 11: Labour market indicators



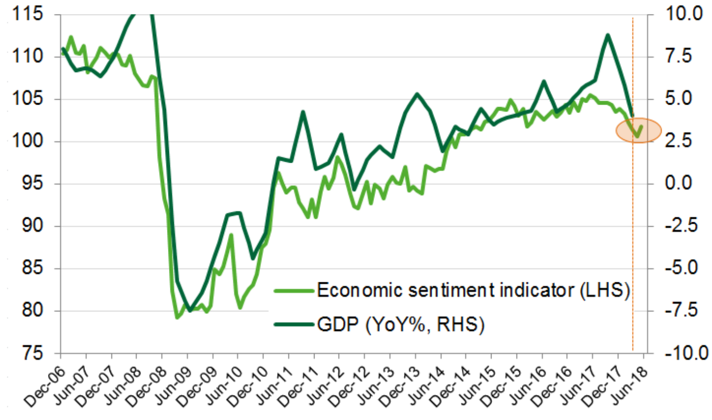
Sources: NIS, OTP Research
Note: no. of employees at entities with 4 employees and over

Chart 12: Shortage of labour force as a limiting factor of production (by sectors, balance of opinions)



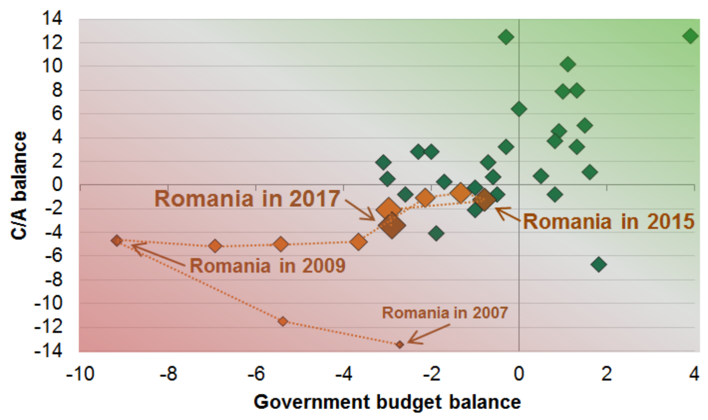
Sources: EC, OTP Research

Chart 13: GDP growth vs. economic sentiment indicator



Sources: NIS, EC, OTP Research

Chart 14: C/A and government budget balance in EU countries (% of GDP, 2017 or stated otherwise)



Sources: Eurostat, OTP Research

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