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Romania: losing its shine

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On January 1st 2019, Romania will assume the Presidency of the Council of the European Union at a time when the country is slowly, but surely, turning from a growth champion to a reckless child within the EU.

On the political front, ongoing blows to judicial independence from the Social-Democrat government have reached fever pitch this summer, after continuous digs started in early 2017. The proposed changes were met with protests from the civil society, and drew criticism from EU institutions, including the Venice Commission (advisory body of the Council of Europe on constitutional law). As the fight against corruption is visibly weakening, it is not excluded that Romania will soon join Poland and Hungary on the list of EU countries facing Article 7 procedures. The political agenda will run hot next year, given that upcoming elections for European Parliament will be held in May 2019 and Presidential elections will be held in November-December 2019.

Slowing economy

Meanwhile, political noise clouds the recent unfavorable developments in the real economy. GDP grew by 6.9% in 2017 boosted by significant fiscal easing measures, but IMF projects that growth will decelerate to 4.0% in 2018 and 3.4% in 2019. After being uplifted by consecutive increases in minimum wage, public sector wages and public pensions, consumption slowed down markedly in H1'2018. In addition, financial conditions have tightened notably starting with September 2017, as the National Bank of Romania (NBR) adopted a more restrictive monetary policy to fight the expected increase in inflation. Despite three rate hikes in 2018 from 1.75% to 2.50% and likely interventions from the NBR in the forex market to slow RON depreciation, inflation remains stubbornly high above 5.0%. It is expected to decline below 4.0% in the coming months due to statistical base effects, but remains outside the Central Bank target interval.

Developing a twin deficits problem

In light of these developments, the government faces a difficult dilemma: it either reduces the ballooning social spending bill to cap the budget deficit at 3.0% in 2019 or it risks facing even higher rates. Given the government's populist agenda and 2019-2020 being election years, the latter option is the more probable one. Romania has been steadily developing a twin-deficit problem, which stands out among neighbor countries. Romania's macroeconomic vulnerabilities have been on the rise since 2016, as prudent fiscal policies were quickly reversed. Fiscal deficit was barely kept at 3.0% in 2017 despite the stellar growth performance and it is projected to surpass 3.5% in 2019. This gave rise to mounting fears that the government will decide to dismantle pillar two of the mandatory private pension system. Ceasing all payments into mandatory pensions would bring budget revenues of about 0.8% of GDP and could temporarily ease the fiscal burden. Changes to the mandatory private pension system could be proposed in 2019.

Romania: fiscal and current account balance

Source: Erste Asset Management GmbH

Forecasts are not a reliable indicator for future developments.

Rising wage growth and slow productivity advance have been eroding the country's cost competitiveness, as the current account deficit widened to 3.7% of GDP in August 2018. Together with an overvalued RON and slowing Eurozone growth, Romania's exports will likely suffer. Moreover, structural and investment fund inflows from the EU have yet to pick-up. A strong recovery is unlikely in the coming months as the government is cutting back public investments. As such, FDI and EU fund inflows are insufficient to cover the current account deficit, which leaves RON vulnerable to external shocks. The Central Bank has already spent significant FX reserves to prevent a sharper nominal depreciation.

Romania: Public and private sector wages

Source: Erste Asset Management GmbH

Forecasts are not a reliable indicator for future developments.

What's next?

Current political and fiscal developments leave Romania vulnerable to a potential rating downgrade, which would make it lose the investment grade status. Even without a deterioration in its credit ratings, Romanian bonds suffered a sharp correction since September 2017. As the effect of the Central Bank hikes and rising inflation was more significant, local currency bonds took the first blow. Meanwhile, hard currency bonds in EUR remain wider than their fair value, but performed relatively better than the local currency ones due to ECB's expansionary monetary policy.

Assuming the Presidency of the Council of the European Union at the same time as Brexit could be Romania's opportunity to regain its shine as a true growth champion and supporter of European values such as democracy, freedom and rule of law. It remains to be seen the extent to which it will capitalize on this opportunity.

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