ADA
ANALYSE. DEBATE. ACT.

# Romania Macro Monitoring

## Some imbalances, but not very severe (yet)

**After many years of seemingly unabated real GDP growth and virtually no political or currency concerns, the situation has started to become seemingly more frail since last year, and there is no sign of a turnaround. In our view, Romania is taking steps backwards, after the many improvements achieved after the balance of payment and fiscal crisis of 2008. However, the extent of the imbalances remains contained; thus, we see these changes as noteworthy, but not a cause of immediate alarm.**

**In 2016, the ruling PSD won the general election with 3.2m votes, in a country with a total population of 19m. This was possible thanks to the probably low enthusiasm of the Romanians (the turnout was only 39%), and an active and solid voter base for PSD. Since then, three Prime Ministers have led the country and several hundreds of people have protested in the streets against the judicial reforms put forward by PSD. It is difficult to assess the full impact of the latest changes, should they be confirmed by the President in September. However, it is most likely, in our view, that Romania will undo the improvements in terms of the fight against corruption achieved in the past five years, and it may be that the overall ranking of the country in terms of judicial performance - which is currently relatively good in the region - could fall in the coming years. The political landscape, on the other hand, could stay remarkably stable going forward, as PSD's voter base is widening, while there is no strong candidate in the opposition so far.**

**In recent years, Romania has followed a strategy of cutting income tax rates for households and companies, as well as the VAT rate, but raising social security contributions. Both total revenues and total spending have shrunk relative to GDP, from an already narrow base by European standards. The government's aim appears to be to support the business sector by cutting income taxes, while letting the tax base linked to the wage convergence process pay for everyday spending. This strategy has worked so far, as nominal GDP growth has been very high, and because, in the final budget implementation, there were more tax hikes than it appeared initially.**

**The European fiscal framework prevents Romania from targeting a budget deficit above 3% of GDP. Therefore, if the government goes ahead with further tax cuts and wage boosts, it is likely to have to find offsetting revenue measures (including, but not limited to, a potential suspension of the transfers to the private pension funds). Thus, we expect no positive impact on real GDP growth going forward from "fiscal stimulus" promises.**

**In terms of economic potential, Romania remains well-placed among the CEE, benefiting from: lower indebtedness relative to GDP compared to 10 years ago; better affordability of the housing market (at least for now); and a current account deficit that is half what it was when the previous crisis erupted. In our view, the modest leverage and improved profitability and productivity, cushion some of the steps backwards that are taking place at the moment, and should limit the magnitude of the economic downswing in the next two years, and continue to make the economy attractive to foreign investment.**

**We have updated our models for the RON and the local sovereign bond yields (10-year), and both signal that current valuations are reasonably in line with fundamentals. However, we note two risks that cannot be picked up in the econometrics. The first is that, given the repeated speculation in the press and the occasional obscure bill presented to parliament, the fate of the private pension funds - which have helped to keep local borrowing costs low in the past 10 years - appears rather grim. This may lead to higher local yields than forecast, although the holdings of non-residents in the local bond market are minor and, thus, should shield Romania from a volatile external environment. Second, our model signals a mild depreciation bias for the RON, consistent with our projections of the RON rising to 4.8 to the EUR next year. However, the funding gap may deteriorate even more, especially if growth proves stronger than we expect.**

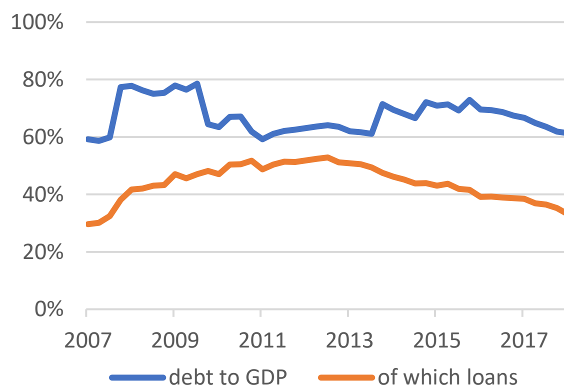
# Perhaps thanks to past efforts, but overall growth potential is up

As the recent news flow has been dominated by protests against the government and controversial judicial measures, it is easy to lose track of the genuine state of the economy from a long-term perspective. Overall, we believe that Romania's growth potential has improved over the course of the years: to a minor extent, due to infrastructure improvements related to the EU funds; to a larger extent, due to the balance sheet improvements of the past few years. Overall, in our view, Romania's potential growth has moved up from 2-2.5% around the 2008 crisis to 3%, and could rise further to 3.5% depending on what happens with the policy framework in the coming years.

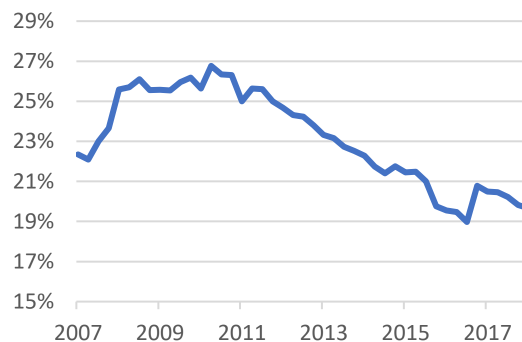
Romania's striking achievement since 2008 has been to reduce the indebtedness of businesses and households, while the profitability and productivity of the corporate sector has improved.

On the basis of the financial accounts computed by the NBR, on a consolidated basis, the aggregate debt of non-financial corporations (total financial liabilities excluding equities) stood at 61% of GDP in 1Q18, vs. an average of 74.4% in 2008. Total financial assets in the first quarter stood at 28% of GDP, and have remained at broadly the same level, ranging from 32% to 23%, in the past 10 years, of which deposits (transferable and others) are worth 12.75% of GDP. Overall, the asset base remains relatively small, but this is consistent with Romania being a relatively poor member state in the EU and the wave of foreign direct investment still being fairly recent.

**NFC debt and loans to GDP**



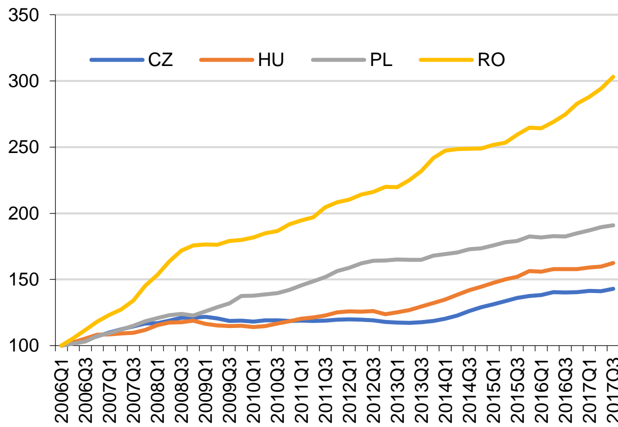

**Households' financial debt to GDP**

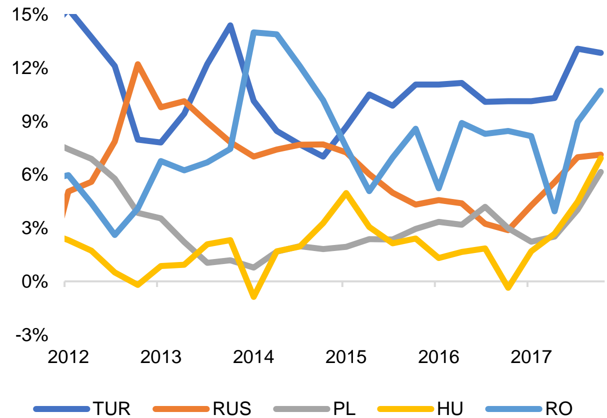



*Source: Macrobond, ADA Economics*

In terms of profits and productivity, the charts below show that aggregate profits have risen by around 3x since 2006, a gain only comparable with Turkey, and twice the next best performer in the region, Poland. In terms of labour productivity (a measure that, admittedly, is fraught with limitations, but remains the best available for cross-country comparison), Romania has also seen improvements that have exceeded those in the rest of the CEE.

**Aggregate profits** **Productivity**



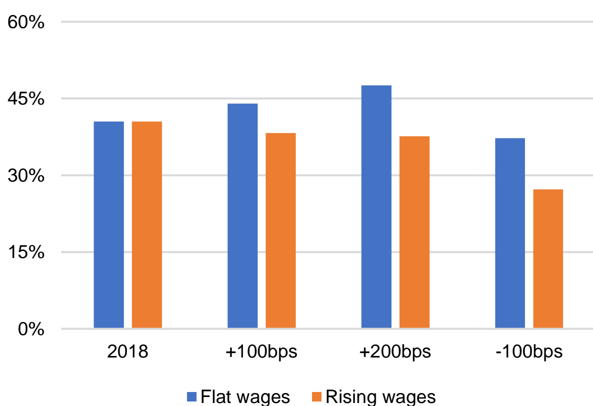



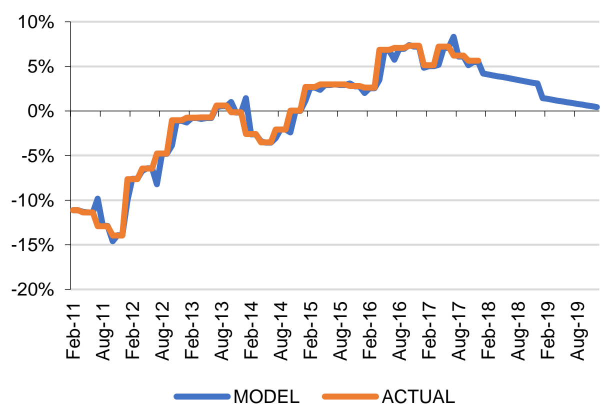

*Source: Macrobond, ADA Economics*

On the households front, debt to GDP stood at 19.7% of GDP in 1Q18, down from 26% of GDP in 2008. Importantly, the share of FX loans of households has dropped to 4.5% in 1Q18. Total assets were worth 19% in 1Q18, still modest on an international comparison, but up from 2008. The share of FX loans disbursed by the banks to households and non-financial companies has shrunk to around 4% of GDP, currently, from 12% of GDP in 2010-11.

House prices have recovered for the past three years, but remain 12% below the previous peak, on average. This is visible when looking at quotes from real estate agents for Bucharest, for example (although other cities, such as Cluj and Constanta, are faring structurally better than 10 years ago), or when looking at monthly surveys on the sentiment and pricing expectations of the construction sector.

**Romania: debt servicing costs** **House price model**

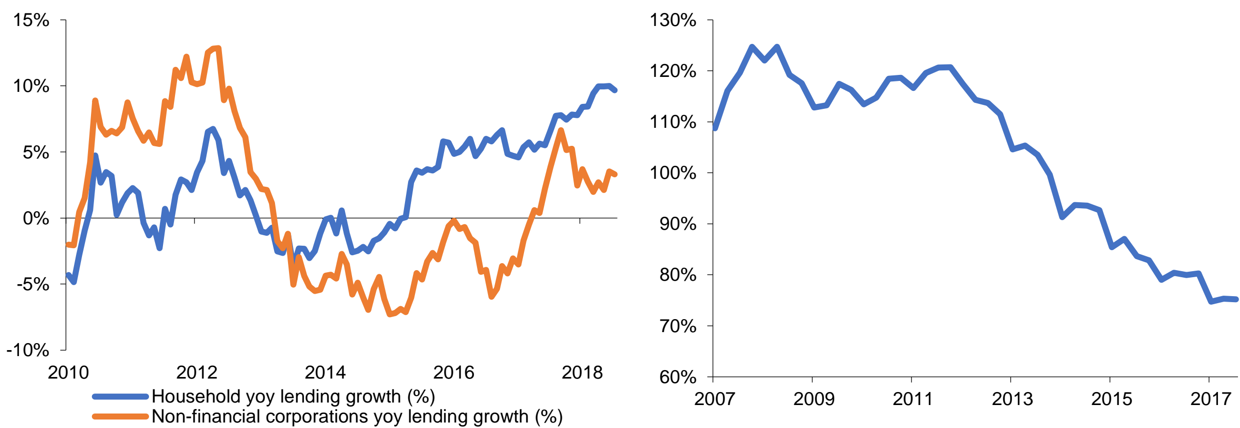



*Source: Macrobond, ADA Economics*

We have also attempted to estimate debt servicing costs for households, given the pick-up in house prices. The message of our estimates is that continuing fast wage growth of at least 8% should keep the affordability of the housing market unchanged, even in the event of a further 300bp increase in the policy rate and in retail borrowing costs, with current RON mortgages at around 4%. However, should wages stop growing or drop, in the event of a recession, affordability will begin to look stretched, with an additional 200bp of tightening. In both cases, this is well above what the NBR appears willing to do.

**Year-on-year lending growth** **Banking sector loan to deposit ratio**




*Source: Macrobond, ADA Economics*

# Politics: forwards and backwards, and a lot of confusion

The last two big elections took place in 2014 and 2016, resulting in the appointment of President Iohannis and delivering a mandate to PSD. The turnout at the presidential elections was 62.04% of total citizens with the right to vote, while the parliamentary elections were less popular, having a turnout of only 39.4%. Klaus Iohannis won with 54.5% of the votes, while his opponent, Victor Ponta, gained 45.56% of the votes. However, the PSD effortlessly won the majority in both the Chamber of Deputies and the Senate, with 45.31% of the votes, followed by PNL at 19.95%.

**Presidential elections 2014: 62.04% turnout (11,553,152 citizens)**

| | | |
|---|---|---|
| Klaus Iohannis (PNL) | 54.50% | 6,242,825 |
| Victor Ponta (PSD) | 45.49% | 5,211,097 |

*Source: BEC2014.ro, ADA Economics*

**Presidential elections 2016: 39.49% turnout (7,212,022 citizens)**

| Political Parties | Chamber of Deputies seats | Senate seats |
|---|---|---|
| PSD | 150 | 70 |
| PNL | 67 | 25 |
| USR | 28 | 13 |
| UDMR | 21 | 9 |
| ALDE | 19 | 12 |
| PMP | 13 | n/a |
| National Minorities Group | 17 | n/a |
| Other deputies not affiliated | 14 | 7 |

*Source: Senat.ro, CDEP.ro, ADA Economics*

Since then, the approval rating of PSD has dropped by as much as 10 points, to around 37% currently, while PNL is currently around 24%: roughly constant but with the caveat that different surveys seem to give significantly different estimates over time. In our view, PSD's voter base is widening, thanks to the extra passports extended to 1m Moldovans by the end of 2018E, which, in our view, should lead them to vote in support of PSD, as well as the increasing social spending and planned retirement changes.

The prospects of more of the same are somewhat puzzling, given the continuing public protests against the government's judicial reforms. Thousands of people have protested during the past two years, but the latest massive protest, organised from 10-12 August, attracted more than 150,000 people in Bucharest, and ended with riot police using tear gas and violence, and 450 people left injured. The European leaders are emphasising the urgency of remediation, especially as no one appears willing to take responsibility. The scepticism and distrust of Romanian citizens in their political representatives has expanded, with 80% declaring their unhappiness in relation to the current situation, as stated by Klaus Iohannis in an interview broadcast by Digi24 on 23 June 2018.

The controversial judicial changes, which PSD is trying to get fully approved, include the limitation of the President's right to name the Minister of Justice, the Higher Court of Cassation or the Head of National Anticorruption Directorate, and reducing the penalties related to corruption. The famous, and powerful, leader of the National Anticorruption Directorate, Laura Kovesi, was forced to resign. The government is now aiming to influence other important institutions through the Emergency Ordinance that reforms the Penal Code entirely. Amnesty for penalty charges of up to three years; reducing sentences (by three years) of up to seven years for bribery, abuse of office and abuse

influence; announcing someone is under investigation even before starting any inquiry; and not acknowledging digital proofs from third parties as evidence, are only some of the amendments being considered. However, the proposed Penal Code has been returned to parliament by the President for reconsideration, and is going be challenged in the Constitutional Court on 25 September. The government may still be able to approve these amendments, as the President has the right to refer the laws to the Constitutional court only once.

In order to put the changes to the judicial reforms into an international context, it is useful to look at Romania's performance in global rankings on corruption and the effectiveness of the judicial system. The World Justice Project Rule of Law index includes factors such as government power, corruption, transparency, justice and security, where 1 signifies the highest score and the absence of corruption, and 0 represents the lowest score and high levels of corruption. Romania's overall index is 0.65, weaker than the Western European countries, but not the worst, while the factors with the lowest values remain regulatory enforcement and criminal justice. Index conditions have improved, increasing from 0.59 in 2011, to 0.66 in 2016, followed by a slight decline to the present. The perceived independence of the justice system has also declined gradually since 2016 and, in our view, is expected to continue falling if the proposed Reform of the Penal Code is promulgated.

The Transparency International Perceived Corruption index (where 100 represents the highest value and the most transparently-perceived country, while 0 is the lowest value and the most corrupt) has increased from 44 in 2012 to 48 in 2017, improving slowly compared to other Eastern European countries, but remains below the average of Western Europe, at 66. However, this perception is likely to drop drastically during 2018E, as a consequence of the ongoing political disputes.

**World Justice Project Rule of Law Index**

| Countries | 2017 Global Ranking (out of 180) | 2017/18 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Romania | 59 | 0.65 | 0.66 | 0.62 | 0.59 |
| Hungary | 66 | 0.55 | 0.57 | 0.58 | 0.61 |
| Poland | 36 | 0.67 | 0.71 | 0.71 | 0.67 |
| Czech Republic | 42 | 0.74 | 0.75 | 0.72 | 0.67 |
| Italy | 54 | 0.65 | 0.64 | 0.64 | 0.63 |
| Germany | 12 | 0.83 | 0.83 | 0.81 | 0.80 |
| France | 23 | 0.74 | 0.72 | 0.74 | 0.74 |

*Source: data.worldjusticeproject.org*

**Transparency International Corruption Perception index**

| Countries | 2017 Regional Ranking (out of 24) | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Romania | 19 | 48 | 48 | 46 | 43 |
| Hungary | 23 | 45 | 48 | 51 | 54 |
| Poland | 17 | 60 | 62 | 63 | 61 |
| Czech Republic | 12 | 57 | 55 | 56 | 51 |
| Italy | 20 | 50 | 47 | 44 | 43 |
| Germany | 6 | 81 | 81 | 81 | 79 |
| France | 13 | 70 | 69 | 70 | 69 |

*Source: Transparency.org*

# Bold budget changes and more to take place in 2019E

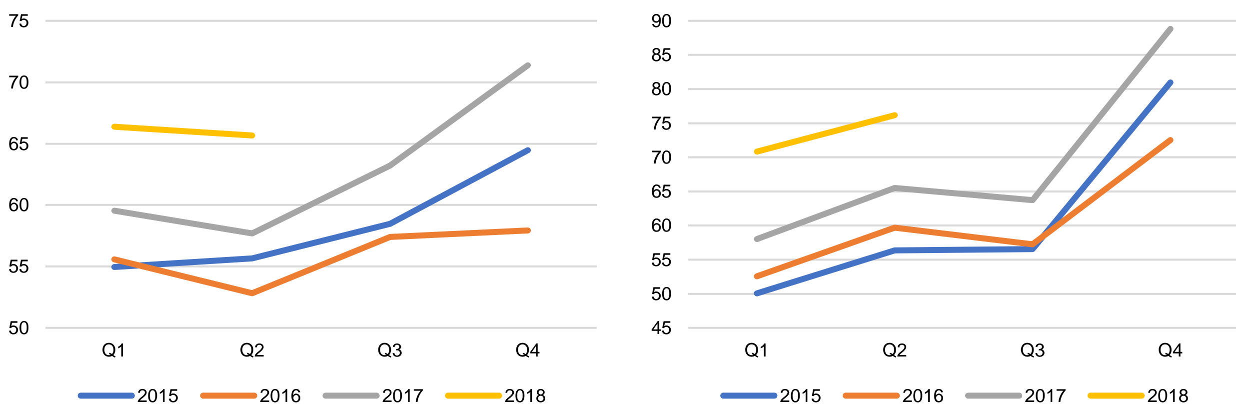
- ✓ The 2019 final draft Budget is being prepared currently and will be presented in Parliament in
early-October.
- ✓ Romania has witnessed an expansionary fiscal stance since the beginning of 2017, due in large part to a double-digit increase in social assistance and capital expenditures.
- ✓ General government revenue trends are showing structural changes, with direct tax collection having dropped and growth in indirect tax collection yoy (particularly VAT).
- ✓ Various proposals have been discussed in the press on future VAT rate cuts, including a 9ppt drop for utilities and a 1ppt cut for the overall index in 2019E. A 1ppt cut in the VAT rate, in our view, would cost 0.3% of GDP and dampen the inflation reading for 2019E by around 0.5ppt.
- ✓ The gross minimum wage has increased to RON 1,900, while social contributions for part-time employees are now equal to the full-time minimum wage amount.
- ✓ Pillar 2 pension funds may be affected, but no clear proposal is on the table officially yet.
- ✓ Gradually increasing the pensions programme by 2021E may have a negative impact on the government's budget and lead to an inability to cover social spending.
- ✓ The budget deficit stood at 1.3% of GDP in the first half of the year, as most of the spending is concentrated in December. The government has the ability, if it wishes, to keep the shortfall below the 3% of GDP deficit ceiling.
- ✓ The government is following a strategy of boosting wages and pensions, something that is feasible thanks to high nominal GDP growth at the moment. However, if economic activity and inflation slow further, it will become increasingly difficult to do so. As a rough guide, nominal growth of 5% (which could materialise if inflation is at target and growth slips below potential) could easily see the budget deficit widening to 6% of GDP, assuming unchanged policies.

The budget process is an iterative one that lasts for a full year, coinciding with the calendar year, i.e., 1 January to 31 December. Based on the National Prognosis Commission (NPC) projection of macroeconomic indicators for the budget year, the Ministry of Public Finance (MPF) submits proposed ministerial expenditure ceilings to the government for consideration, which the government is obliged to approve by 15 May. Once the ceilings are approved, each minister submits their respective departmental budget proposals by 15 July. The next three months are then used to iron out disparities in objectives and proposals. Then, finally, the MPF prepares the draft budget law and draft state budget. The final draft budget is submitted to Parliament in early-October, which has until 28 December to approve the budget for the next fiscal year. Concurrently, the Fiscal Council (FC) supports the government and Parliament in designing and implementing fiscal policy in order to promote transparency and the sustainability of public finances. It issues an Annual Report that analyses the conduct of the fiscal policy during the previous year against the framework set out in the Fiscal Strategy and the Annual Budget, to assess macroeconomic and fiscal developments, as

well as the objectives, targets and indicators included in the budget documents. Its five members are appointed by Parliament for a period of nine years, from various economic bodies and associations.

Romania adopted an expansionary fiscal stance at the beginning of 2017, which is still continuing. From the general government expenditure data from 1Q and 2Q, the figures have seen 17% and 18% increases yoy, respectively. The rise in expenditure was caused, in large part, by an increase in social assistance and capital expenditure, which witnessed double-digit growth (14-15% and 22-25% yoy, respectively, in the first two quarters of 2018), while there was a reduction in the expenditure on subsidies (12% and 16% yoy in the first two quarters of 2018), although this is only c. 2.5% of the annual expenditure.

**Strong seasonality in revenues (LHS) and spending (RHS)**




*Source: Ministry of Public Finance (Govt. of Romania), data in RONbn, showing general government revenues and spending*

General government revenue trends are showing signs of structural changes. Direct tax collection has started to drop yoy, while indirect tax collection (particularly VAT) has been growing, starting in 1Q18. Insurance contributions have been rising steadily since 3Q16 and look buoyant. The proposed reduction in VAT from 19% to 10% in January 2019E is something to watch closely, in our view, as VAT has historically accounted for roughly 20% of annual revenues. Previously, along with reductions in the VAT rate in both 2016 (24% to 20%) and 2017 (20% to 19%), there were losses of revenue of RON 3.67bn in 2016 (or 9% yoy) and RON 128m in 2017 (or 0.33% yoy). A 9ppt decline in VAT would lead to a drop of roughly RON 23bn in VAT revenue in 2019E, if we assume that the current macroeconomic conditions prevail in 2019E.

### Key fiscal indicators

| Romania general government | Source | | | | Percent of GDP | | | |
|---|---|---|---|---|---|---|---|---|
| **(proportion of GDP)** | | **2013** | **2014** | **2015** | **2016** | **2017E** | **2018E** | **2019E** |
| Revenue & expenditure | | | | | | | | |
| Total revenue | IMF | 31.4% | 32.0% | 32.8% | 29.0% | 28.0% | 28.4% | 29.0% |
| Total expenditure | IMF | 33.9% | 33.9% | 34.2% | 31.4% | 30.8% | 32.0% | 32.5% |
| **Deficit** | | | | | | | | |
| Budget balance | IMF | -2.5% | -1.9% | -1.5% | -2.4% | -2.8% | -3.6% | -3.5% |
| Primary balance | IMF | -0.8% | -0.4% | -0.2% | -1.1% | -1.7% | -2.4% | -2.2% |
| Current budget balance | MPF | -1.3% | -1.6% | -1.6% | -1.0% | -2.8% | NA | NA |
| **Debt** | | | | | | | | |
| GG public debt | MPF | 37.6% | 39.1% | 37.7% | 37.1% | 35.0% | NA | NA |
| **Romania general government** | **Source** | | | | **RONbn** | | | |
| Revenue & expenditure | | | | | | | | |
| Total revenue | IMF | 200.0 | 213.8 | 233.6 | 220.8 | 240.4 | 263.0 | 290.1 |
| Total expenditure | IMF | 215.8 | 226.3 | 244.0 | 239.1 | 264.7 | 296.6 | 325.0 |
| **Deficit** | | | | | | | | |
| Budget balance | IMF | -15.7 | -12.5 | -10.3 | -18.3 | -24.3 | -33.6 | -34.9 |
| Primary balance | IMF | -5.2 | -2.5 | -1.6 | -8.6 | -14.5 | -21.9 | -21.5 |
| Current budget balance | MPF | -8.3 | -10.4 | -11.3 | -7.3 | -23.9 | NA | NA |
| **Debt** | | | | | | | | |
| Public debt | MPF | 239.6 | 261.2 | 268.6 | 283.1 | 300.7 | NA | NA |

*Source: IMF, Ministry of Public Finance (Govt. of Romania)*

The position on the current budget is deteriorating, resulting in the government borrowing to finance its current spending. Within a year, the current budget deficit has increased from 1% to 2.8% of the GDP, amounting to an increase of RON 16.5bn. This is an imprudent path, as future generations are essentially paying for services consumed by the current generation. Most importantly, Romania is very close to the 3% deficit ceiling required by the European Union.

### Romanian government public debt service projections

| | | Percent of GDP | |
|---|---|---|---|
| | **2017** | **2018** | **2019** |
| (a+b) Government public debt service | 5.8% | 5.8% | 5.4% |
| (a) Principal | 4.7% | 4.6% | 4.4% |
| (b) Interest & Commission | 1.1% | 1.2% | 1.0% |
| | | **RONbn** | |
| (a+b) Government public debt service | 50 | 53.9 | 54.1 |
| (a) Principal | 40.3 | 42.4 | 43.8 |
| (b) Interest & Commission | 9.7 | 11.5 | 10.3 |

*Source: Ministry of Public Finance (Government of Romania)*

### Sensitivity analysis to growth for the budget (ADA Projections)

| Assumed nominal GDP growth | | Budget deficit (percent of GDP) | |
|---|---|---|---|
| | **2018E** | **2019E** | **2020E** |
| 5% | 3.9% | 5.1% | 6.4% |
| 8% | 3.2% | 3.7% | 4.1% |
| 10% | 2.8% | 2.8% | 2.8% |
| | | **Budget deficit (RONbn)** | |
| 5% | 35.5 | 48.5 | 63.4 |
| 8% | 30.1 | 36.9 | 44.6 |
| 10% | 26.5 | 29.0 | 31.7 |

*Source: *calculations based on yoy Gg Expenditure and CPI growth at 10% and 3%, respectively*

**Sensitivity analysis to growth for debt (ADA Projections)**

| Assumed nominal GDP growth | Debt to GDP | | |
|---|---|---|---|
| | 2018E | 2019E | 2020E |
| 5% | 37.3% | 40.6% | 45.1% |
| 8% | 35.7% | 36.7% | 38.1% |
| 10% | 34.6% | 34.3% | 33.9% |
| | Government public debt (RONbn) | | |
| 5% | 336.2 | 384.7 | 448.1 |
| 8% | 330.8 | 367.7 | 412.3 |
| 10% | 327.2 | 356.2 | 387.9 |

*Source: Calculations based on ADA Economics budget deficit projections and official Romanian government public debt statistics*

## Fiscal and pension reforms adopted and proposed

The first quarter of 2018 saw a large number of fiscal amendments adopted, 45% of which affect the business sector directly, creating complexity and confusion. The social contributions were transferred entirely from employers to employees, but with the payment entitlement remaining with employers. However, the challenge lies with part-time employees, who are forced to pay contributions equal to full-time minimum wage employees, and the minimum wage has also been increased to RON 1,900, causing greater pressure on micro and small companies.

The Minister of Finance estimates that the reconsideration of the SMEs classification, increasing the ceiling of the micro-enterprises' income tax (1% with more than one employee and 3% with no employees), from EUR 500,000 to EUR 1,000,000 turnover, could have a negative impact on the government's budget, declining by RON 140.4m by the end of 2018E. The companies with turnover above this ceiling are still paying 16% income tax. However, the proposal to reduce the VAT from 19% to 10%, likely to be effective from January 2019E, could have a positive impact on the business sector.

**Pension assets**

| | Per cent of GDP | | | | |
|---|---|---|---|---|---|
| | 2015 | 2016 | 2017 | 2018E | 2019E |
| (a+b) Total pension assets | 7.0% | 6.8% | 6.7% | 6.4% | 6.47% |
| (a) Pillar 1 - Government contribution | 3.5% | 2.7% | 2.1% | 1.6% | 1.66% |
| (b) Pillar 2 - Private contribution | 3.5% | 4.1% | 4.6% | 4.7% | 4.80% |
| | RONbn | | | | |
| (a+b) Total pension assets | 49.8 | 52.2 | 57.6 | 58.9 | 64.82 |
| (a) Pillar 1 - Government contribution | 25.1 | 20.8 | 17.8 | 15.2 | 16.72 |
| (b) Pillar 2 - Private contribution | 24.7 | 31.5 | 39.6 | 43.7 | 48.10 |

*Source: ASF.ro, CNPP.ro*

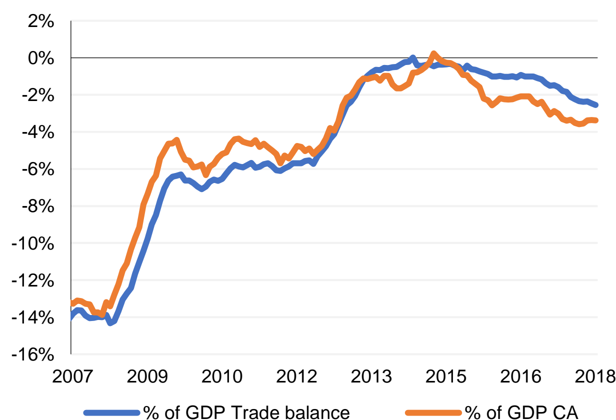
The pension system is also suffering significant adjustments. From 2021E, the point of reference for all pensions will be calculated taking into consideration the years worked and the level of danger imposed by the workplace, and multiplied by the number of points accumulated during a minimum of 25 years, reduced from 35 years as of now. Also, from 1 July 2018, the state pension was raised from RON 520 to RON 640, and the minimum pension was raised by 10%, to RON 1,100. According to the government's planning, the reference base will increase gradually, reaching RON 1,775 by 2020E. However, Laurentiu Dodan, an expert in fiscal policies, is arguing that allowing pensions to be calculated based on a reduced point of reference, rather than relative to the current gross medium wage, will eventually cause a decline in a significant number of pensions.

# Currency and borrowing costs up, but not dramatically so

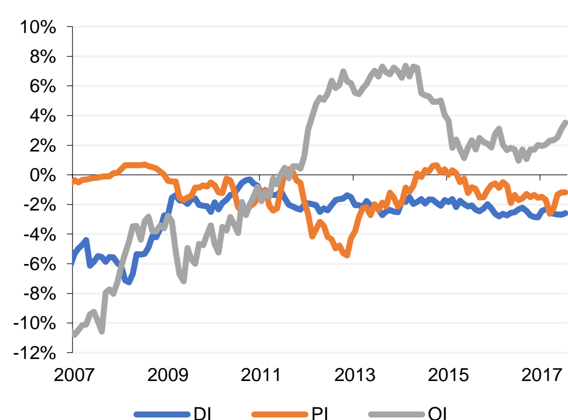
Romania's current account balance has been on a deteriorating path since 2015, but only in the last year and a half have the magnitude and the speed of deterioration been noteworthy enough to signal some depreciation pressures ahead. On a 12-month rolling sum basis, the current account deficit stood at 3.4% of GDP in the first half of the year. Of this, 2.6% of the GDP deficit was for goods and services (compared with 14% of GDP back in 2008), with an 0.8% of GDP income deficit (vs. a 2.3% of GDP surplus in 2008). On the funding side, net FDI has remained steady since mid-2012, at around 2% of GDP, while net portfolio investment inflows reached a peak of 2.3% in 1Q18, accelerating from the post-crisis low of 0% of GDP in 2015. The "other investment" component, which reflects all types of funding other than bonds, equities or actual purchases of plant, is widening again, after the gradual shrinking experienced in the past few years to a bottom of 1%, showing an outflow equal of 3.5% of GDP in the first half of 2018.

In the long run, Romania should benefit from a new revenue stream due to the gas fields under exploration currently. However, in the next few years, the critical elements driving the current account will be the strength of domestic demand and how much multinationals decide to keep profits in Romania or repatriate them (there is an increasingly evident trend of earnings repatriation outflows in CEE). Over the next five years, a significant increase in gas exports is expected to narrow the trade deficit. Currently, Romania has the third-largest reserves of natural gas within the European Union, and new fields are still undergoing exploration. At current prices, the pipeline planned to be completed by 2020E is projected to increase Romanian exports of gas by USD 250m, with a further increase of USD 1.5bn in 2023E following the planned completion of a new offshore platform in the Black Sea. Cumulatively, these projects would be equal to 0.8% of GDP.

**Current account and trade balance**




**Financial account components**




*Source: Macrobond, ADA Economics*

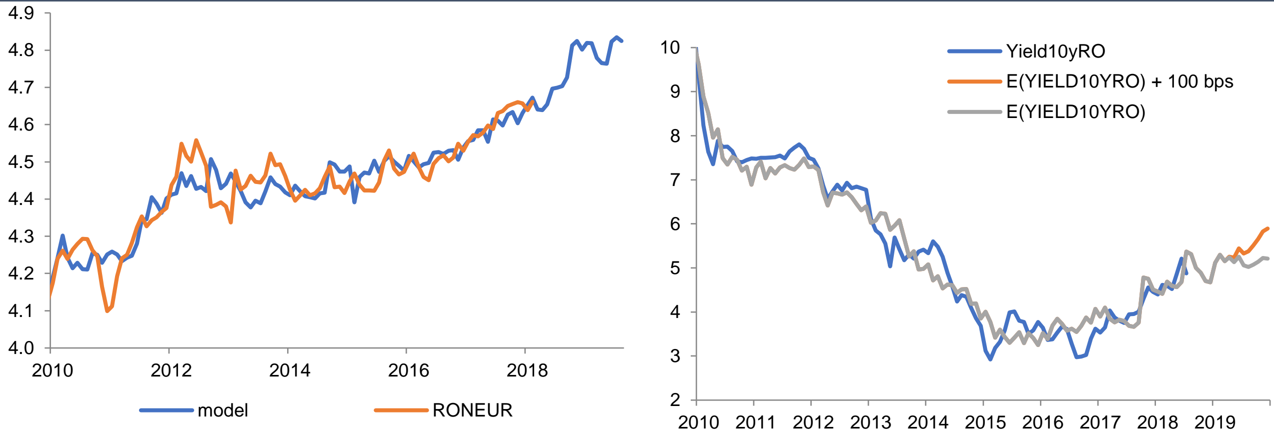
We present here our new model for the "fair" value of the RON. The model projects an average rate of 4.6 RON to the EUR for this year and 4.8 RON to the EUR in 2019E, very much in line with the forecasts we have had in the past year. The model is based on the Latife paper (2014, Modelling and forecasting the euro dollar exchange rate, published by the Canadian Centre for Science and Education), which we have modified and adapted to our use. In a nutshell, it is based on both the interest rate parity theory, which is the relationship that links interest rates to exchange rates; and

the purchasing power parity theory, which (in the neoclassical school) claims that the exchange rate between two countries should be linked between their respective purchasing powers, enriched by additional variables that account for the business cycle and monetary aggregates (such as M1, OECD real share value, ESI, and CB assets). The model assumes an average CPI for Romania of 4.3% in 2018E and 3.3% in 2019E, while it is projected to remain at 1.6% in the Eurozone for both years. For interest rates, we have applied our overall view, with the ECB projected to hike to 0.3% in autumn 2019E and Romania raising the policy rate to 3% by the end of 2018E, with no additional changes in 2018E. For the central banks' balance sheet projections, we have applied the MPC's released plan for the ECB, which is projected to stop purchases in 2018E, and used an historical weighted average for overall assets growth for Romania. Additionally, we assume the M1 for both the euro area and Romania grows following the historical weighted average of the past three years. For the business cycles indicator, we have added assumptions consistent with our overall view that we are past the peak of the business cycle, including a gradual decline in the ESI and the share price proxy by the end of 2019E.

In terms of the long-term borrowing costs of the Romanian State, we have updated our model for the 10-year local bond. The model projects an average rate of 4.8% for this year and 5.2% in 2019E, which highlight a potential divergence with the current YTM. The model reflects our assumptions for the debt/GDP rate, the total assets of Romania's central bank, consumer confidence, the policy rate and the inflation rate. The prediction for 2018-19E assumes: stability in the debt/GDP ratio; average yearly inflation of 4.4% and 2.8% for 2018E and 2019E, respectively; and integrates a policy rate increase to 2.75% in 2018E and 3% in 2019E (eop), and consumer confidence growth in line with the current pace of expansion range (3-6%).

The three main ratings agencies have kept the long-term rating of Romania's debt relatively stable during the past year, standing currently at BBB- for S&P and Fitch, and Baa3 for Moody's. The high growth since 2014 has helped to keep the lower medium investment grade, even though the looser fiscal policy highlighted possible weaknesses. In fact, while, on one hand, domestic demand was affected positively by the loose fiscal policy, it also contributed to increasing the current account deficit. Furthermore, over the next few years, the budget deficit is expected to widen to 4.2% of GDP in 2018E and 4.5% in 2019E, which compares with a median of around 2.1% of GDP in the 'BBB' sovereign debts. A higher deficit, lower-than-expected GDP growth, and the uncertainty surrounding judicial reform (which will affect governance indicators) are all potential risks for Romania's debt outlook. Nonetheless, we do not currently see ratings being cut in 2018E, even though a much more intense monitoring of the Romanian government's moves is likely.

**Currency model 10 year bond yield model**




*Source: Macrobond, ADA Economics*

**The ADA Team** **3rd of September 2018**

ADA
ANALYSE. DEBATE. ACT.

## Disclaimer

TERMS AND CONDITIONS OF USE

YOU AGREE THAT YOU ARE USING THIS REPORT AND THE ADA Economics Ltd ("ADA") SERVICES AT YOUR OWN RISK AND LIABILITY. NEITHER ADA NOR ANY DIRECTOR, OFFICER, EMPLOYEE OR AGENT OF ADA ACCEPTS ANY LIABILITY WHATSOEVER FOR ANY DIRECT, INDIRECT, CONSEQUENTIAL, MORAL, INCIDENTAL, COLLATERAL OR SPECIAL DAMAGES, OR LOSSES OF ANY KIND, INCLUDING, WITHOUT LIMITATION, THOSE DAMAGES ARISING FROM ANY DECISION MADE OR ACTION TAKEN BY YOU IN RELIANCE ON THE CONTENT OF THIS REPORT, OR THOSE DAMAGES RESULTING FROM LOSS OF USE, DATA OR PROFITS, WHETHER FROM THE USE OF OR INABILITY TO USE ANY CONTENT OR SOFTWARE OBTAINED FROM THIRD PARTIES REQUIRED TO OBTAIN ACCESS TO THE CONTENT, OR ANY OTHER CAUSE, EVEN IF ADA IS ADVISED OF THE POSSIBILITY OF SUCH DAMAGES OR LOSSES, AND EVEN IF CAUSED BY ANY ACT, OMISSION OR NEGLIGENCE OF ADA OR ITS DIRECTORS, OFFICERS, EMPLOYEES OR AGENTS, AND EVEN IF ANY OF THEM HAS BEEN APPRISED OF THE LIKELIHOOD OF SUCH DAMAGES OCCURRING.

I/ Copyright 2018 ADA. All rights reserved.

This report may provide information, commentary on and the discussion of issues relating to the state of the economy and the capital markets. All opinions, projections and estimates constitute the judgment of the author as of the date of the report and are subject to change without notice. ADA is under no obligation to update this report and readers should therefore assume that ADA will not update any fact, circumstance or opinion contained in this report.

The content of this report is provided for discussion purposes only. Any forward-looking statements or forecasts included in the content are based on assumptions derived from historical results and trends. Actual results may vary from any such statements or forecasts. No reliance should be placed on any such statements or forecasts when making any investment decision, and no investment decisions should be made based on the content of this report.

This report is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and particular needs of any specific person. Under no circumstances does any information represent a recommendation to buy or sell securities or any other asset, or otherwise constitute investment advice. Investors should seek financial advice regarding the appropriateness of investing in specific securities or financial instruments and implementing the investment strategies discussed or recommended in this report.

This report should not be regarded by recipients as a substitute for the exercise of their own judgment and readers are encouraged to seek independent, third-party research on any companies discussed or affected by this report.

Securities and other financial instruments discussed in this report are not insured and are not deposits or other obligations of any insured depository institution. Investments in general and, derivatives, in particular, involve numerous risks, including, among others, market risk, counter-party default risk and liquidity risk. No security, financial instrument or derivative is suitable for all investors. In some cases, securities and other financial instruments may be difficult to value or sell, and reliable information about the value or risks related to the security or financial instrument may be difficult to obtain. Investors should note that income from such securities and other financial instruments, if any, may fluctuate and that the price or value of such securities and instruments may rise or fall and, in some cases, investors may lose their entire principal investment. Past performance is not necessarily a guide to future performance.

Foreign currency rates of exchange may adversely affect the value, price or income of any security or financial instrument mentioned in this report. Investors in such securities and instruments effectively assume currency risk.

Any information relating to the tax status of financial instruments discussed herein is not intended to provide tax advice or to be used by anyone to provide tax advice. Investors are urged to seek tax advice based on their particular circumstances from an independent tax professional.

Individuals identified as economists in this report do not function as research analysts. Under U.S. law, reports prepared by them are not research reports under applicable U.S. rules and regulations.

In accordance with rules established by the U.K. Financial Services Authority, macroeconomic analysis is NOT considered investment research.

Materials prepared by ADA research personnel are based on public information. Facts and views presented in this material have not been reviewed by, and may not reflect information known to, professionals in other business areas of ADA.

To the extent that this report discusses any legal proceeding or issues, it has not been prepared as nor is it intended to express any legal conclusion, opinion or advice. Investors should consult their own legal advisers as to issues of law relating to the subject matter of this report. ADA research personnel's knowledge of legal proceedings in which any ADA entity and/or its directors, officers and employees may be plaintiffs, defendants, co-defendants or co-plaintiffs with or involving companies mentioned in this report is based on public information. Facts and views presented in this material that relate to any such proceedings have not been reviewed by, nor discussed with, and may not reflect information known to, professionals in other business areas of ADA in connection with the legal proceedings or matters relevant to such proceedings.

The information herein (other than the disclosure information relating to ADA and its affiliates) was obtained from various sources and, while all efforts have been made to provide accurate information, ADA does not guarantee its accuracy. This report may contain links to third-party websites. ADA is not responsible for the content of any third-party website or any linked content contained in a third-party website. Content contained on such third-party websites is not part of this report and is not incorporated by reference into this report. The inclusion of a link in this report does not imply any endorsement by or any affiliation with ADA.

Any unauthorised use or disclosure is prohibited.