MACROECONOMIC

Slowing growth and deteriorating inflation outlook, the twin deficit problem persists

Quarterly report,
June 2022

PRESS HIGHLIGHTS

FUNDAMENTALS POINT TO SLOWING GROWTH, BUT Q1 GDP FORMS A BETTER-THAN-FORESEEN BASE FOR THIS YEAR'S PERFORMANCE

	OTP forecast					*Market consensus**		
	2019	*2020*	*2021*	*2022*	*2023*	*2021*	*2022*	*2023*
Real economy (YoY, %)								
Real GDP	4.2	-3.7	5.9	4.3	2.4	5.9	3.5	3.7
Cons. expenditure of housh.	3.8	-4.8	7.6	4.5	1.7	7.7	3.9	3.6
Public consumption	8.0	1.5	5.3	9.3	3.0	5.3	3.9	1.1
Investment	12.7	4.4	2.5	4.0	7.2	2.5	3.3	6.3
Exports	4.6	-9.3	12.8	5.1	2.7	12.8	5.3	5.3
Imports	8.8	-5.9	15.0	7.4	2.8	15.0	4.8	5.0
Prices and labour market (YoY, %)								
Consumer prices	3.8	2.6	5.0	12.2	8.8	5.0	10.5	6.2
Nominal wage growth	14.9	6.7	7.1	12.0	10.0	7.1	9.8	8.6
Unemployment	4.9	6.1	5.6	5.4	5.0	5.6	5.6	5.3
Government and BOP (% of GDP)								
Government sector balance	-4.3	-9.3	-7.1	-7.0	-6.0	-7.1	-6.7	-5.5
Public debt	35.3	47.2	48.8	48.8	52.2	48.8	50.9	51.8
Current account	-4.9	-5.1	-7.0	-7.7	-7.2	-7.0	-6.9	-6.3
Interest rate and exchange rate								
Key interest rate (%, eop)	2.50	1.50	1.75	7.00	6.50	1.75	5.18	4.89
EURRON (eop)	4.79	4.87	4.95	4.97	5.07	4.95	5.02	5.06

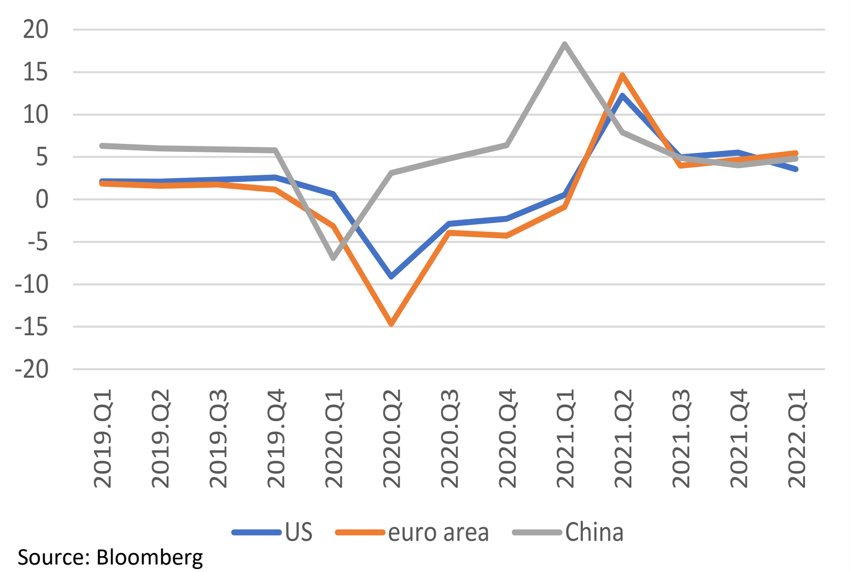
**Source: OTP bank, Focus Economics*

- GDP growth slows as inflation erodes real incomes, policies tighten, trade is affected negatively be the Russia-Ukraine conflict, and global growth slows. However, the sharp rise in Q1 GDP forms good basis for this year's performance.
- A double-digit inflation rate is foreseen until next spring, but the peak could be close.
- The central bank stepped up base rate hikes but still lags behind inflation developments. The base rate could reach 7.0% by the end of 2022.
- Fiscal consolidation stopped this year, the twin deficit problem deteriorates.
- Loan origination slowed but mostly remained strong in April, slowing activity and high interest rates will contribute to further gradual weakening

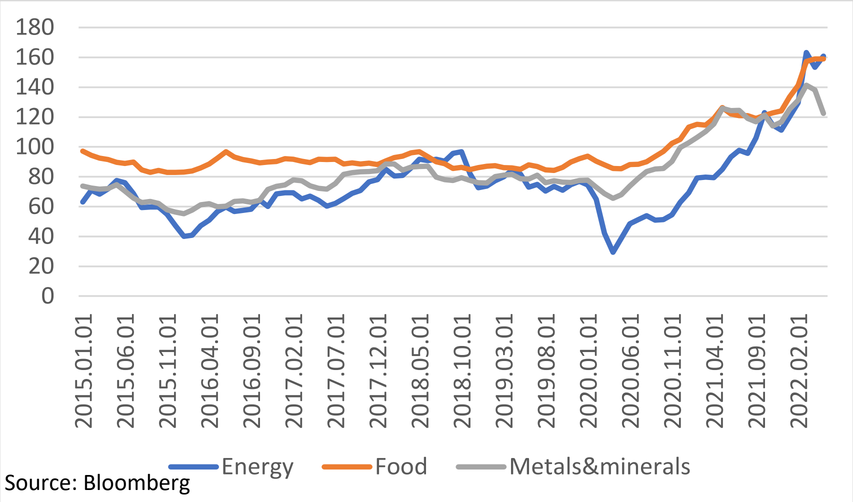
GLOBAL ECONOMY

Q1 GDP FIGURES IN MAJOR ECONOMIES WERE MIXED; ENERGY AND FOOD PRICES REMAINED SKY-HIGH

Quarterly GDP growth rates (YoY, %)



Source: Bloomberg



Source: Bloomberg

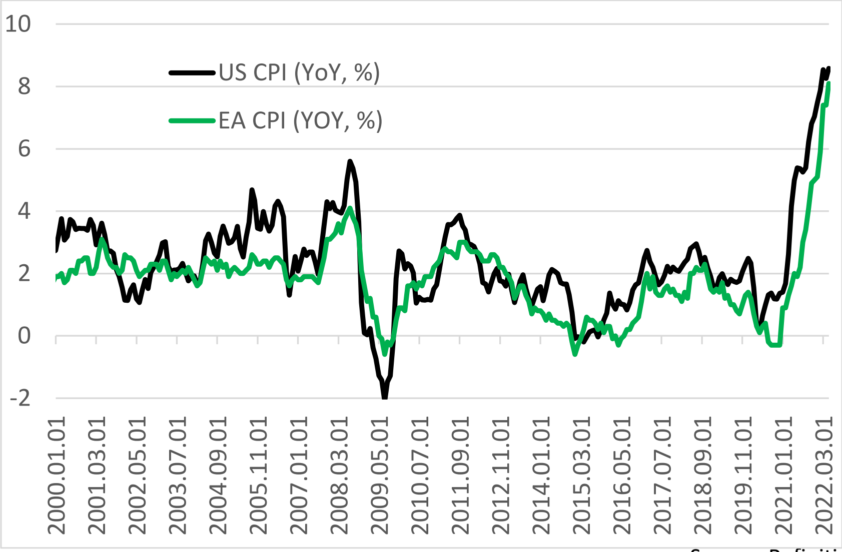
Commodity prices (2010=100)

- With ample policy support, all major economies have exceeded their pre-pandemic level.
- The recent, 2022Q1 GDP figures were mixed (US below, EA in line, China above consensus). However, these did not suggest substantial slowdown yet, but high frequency indicators for Q2 already depict a worsening real economy picture.
- Energy and food prices remained sky-high

GLOBAL ECONOMY

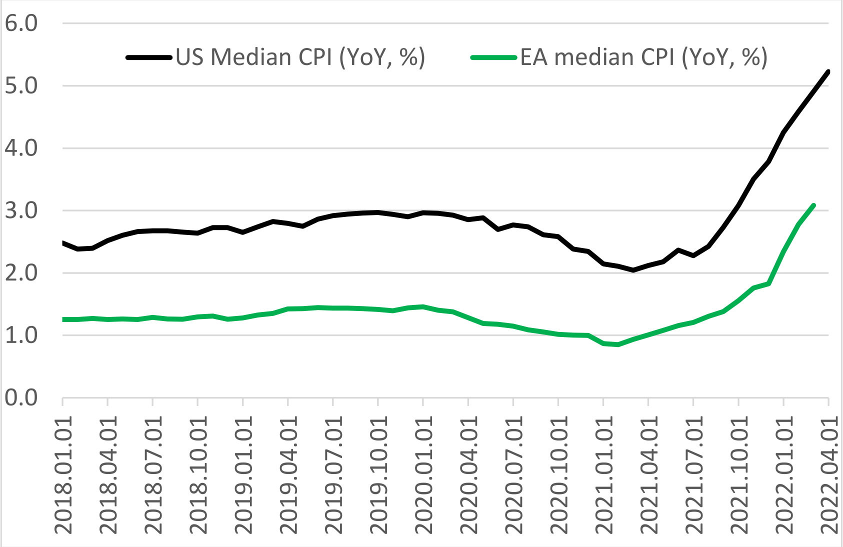
INFLATION RATES COULD NOT HAVE PEAKED, UNDERLYING FIGURES DETERIORATED

Inflation rates (YoY, %)



Source: Refinitive

Underlying inflation indicators (YoY, %)



Source: Refinitive

- The direct energy+food inflation contribution is 3.5 ppts in the US, 5 ppts. in the euro area.
- Both recent US and euro area data caused upside surprises and showed that the CPI peak is not yet in sight
- What is more worrying in recent data that underlying price pressures are still moving upwards (lower chart), while wage growth is not consistent with inflation targets

GLOBAL ECONOMY

MARKET PRICING OF RATE HIKES INCREASED SHARPLY AND LONG-TERM YIELDS ALSO MOVED-UP

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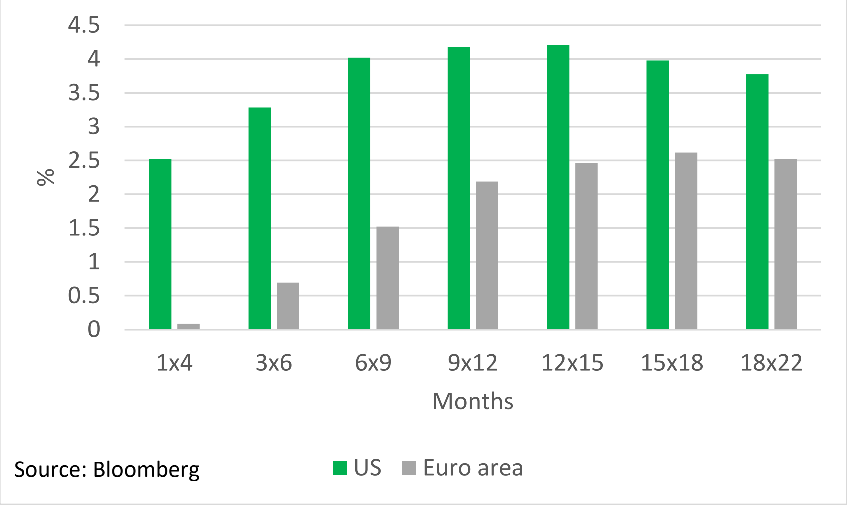
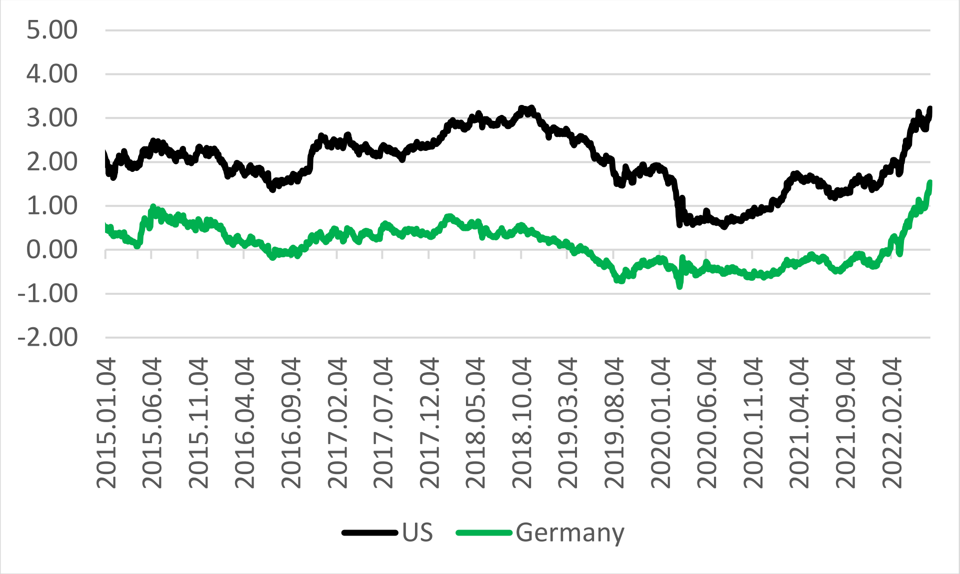
Market expectation of central bank rates, %



Source: Bloomberg



Long-term interest rates, %

Source: Refinitive

- Driven by the high inflation, the peak of expected policy rates increased by 1 ppts since a few weeks ago.
- The FED might end-up at 4% already early next year, while the ECB could start rate hikes in July by 50 bps and the end year base rate could reach 1%.
- However, the real economy outlook has started to complicate the picture. Markets increasingly price a recession for both the US and euro area (~30%), while in the euro area, the widening of intra euro government bond spreads also complicate the situation..

GLOBAL ECONOMY

GROWTH TO SLOW, INFLATION DECLINES BUT STAGFLATION RISKS ARE HIGH

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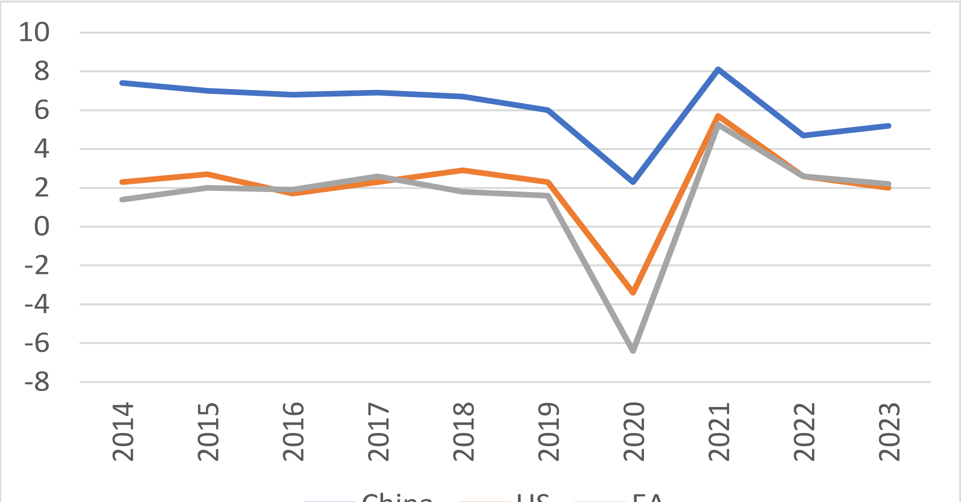
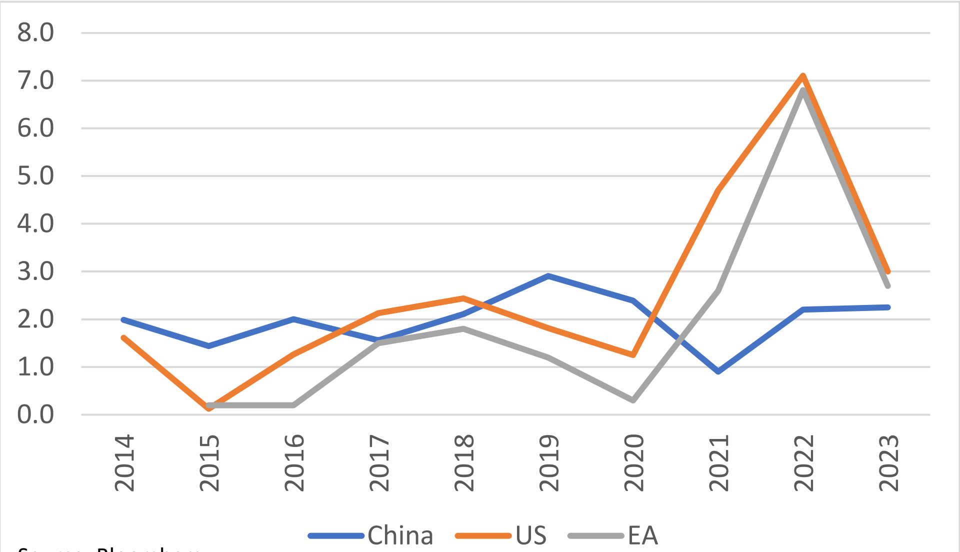
GDP growth outlook (YoY, %)



Source: Bloomberg

Inflation outlook

(YoY, %)



Source: Bloomberg

The economies are expected to slow on the forecast horizon (i) given the foreseen monetary tightening (ii) high inflation, which erodes real income (iii) trade effect of the Russia-Ukraine conflict. Covid situation and the real estate market problems complicate China's outlook

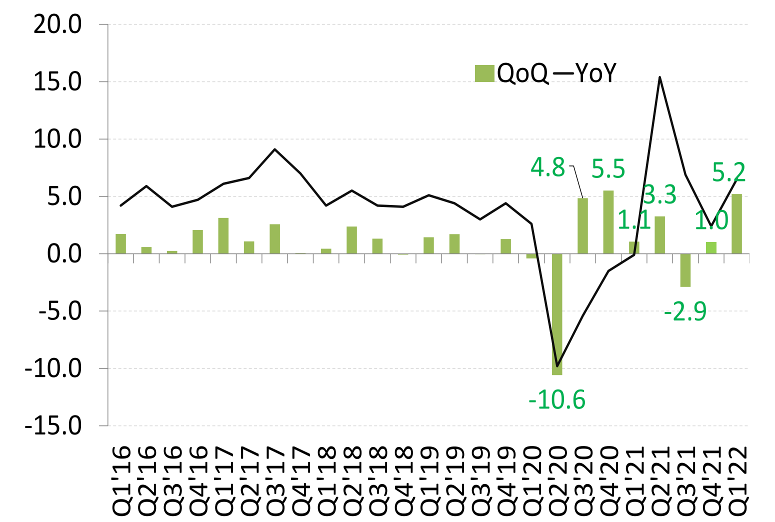
The market currently foresees a sharp slowdown in inflation by 2023, as the direct effect of energy and food prices shocks fade away.

Risks point toward higher inflation and slower growth. The recession probability of major western economies are increasing (currently ~30%).

2022Q1 GDP WAS A HUGE UPSIDE SURPRISE

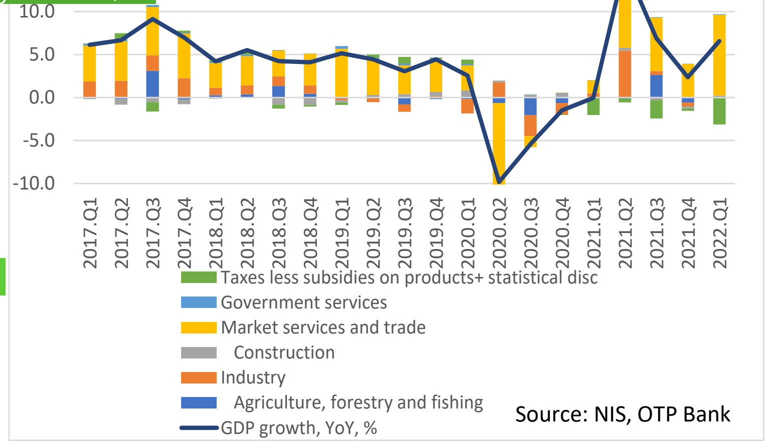
- We, as well as the consensus expected a correction in Q1 GDP growth compared to the stagnation in 2021H2. However, the Q1 data was an extremely huge upside surprise.
- The published details suggests two sectors in market services and trade: (i) wholesale+retail trade +hospitality, (ii) IT services, responsible for the surprise
  - The strengthening in the first sector could have been related to increased service consumption, once the pandemic has practically passed. Additionally Ukrainian refugees might have had and effect.
  - In the ICT sector, the effect is more complex, hard to find a clear explanation.

GDP growth: YoY and QoQ, %



Source: NIS, OTP Bank

Production components of GDP growth, %



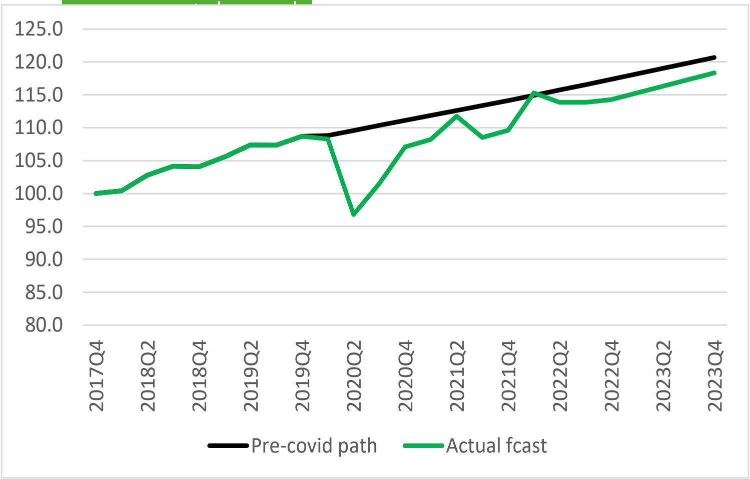
Source: NIS, OTP Bank

REAL ECONOMY

SHORT-TERM GROWTH OUTLOOK IMPROVED, BUT THE SLOWDOWN SEEMS INEVTABLE

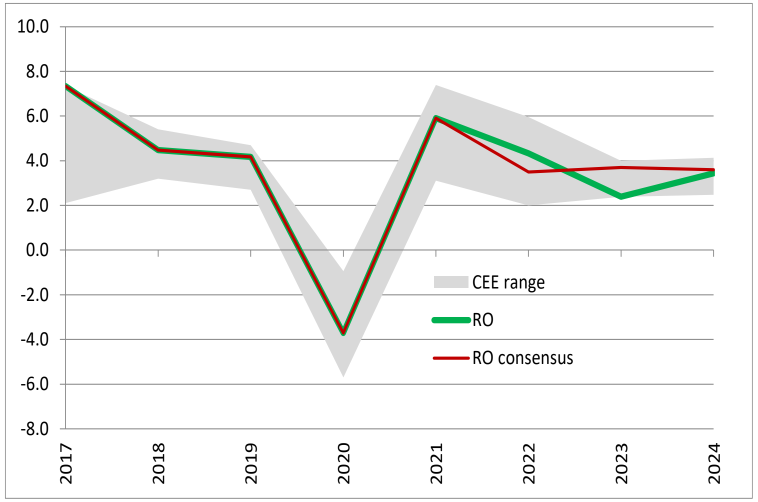
- High inflation, stagnating real wages, slowing global growth and the trade effect of the Russia-Ukraine conflict will slow Romania’s GDP growth this year visibly. However, the strong Q1 data will be enough to reach an annual growth above 4%, even if later quarters will weaken.
- Later on, fiscal consolidation, just as the increasing interest rate environment will start to bind, and growth could be below 3% in 2023. On the positive side Romania is expected to receive funds from the EU ~3.5% of GDP annually on the forecast horizon.
- Regional comparison suggests close to average growth this year, below next. This year we are more optimistic, next year more pessimistic than the consensus.

GDP quarterly level and the



Source: NIS, OTP Bank

Growth outlook, %



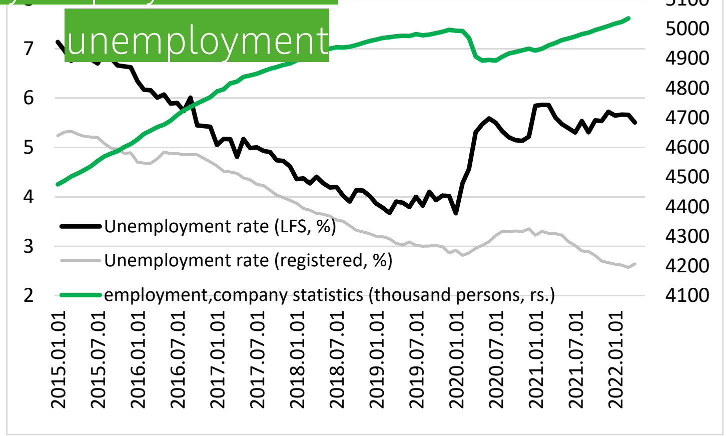
Source: NIS, Bloomberg, OTP Bank

LABOUR MARKET

WAGES MOVED UP WITH HIGH INFLATION, BUT STRUGGLE TO KEEP THE PACE

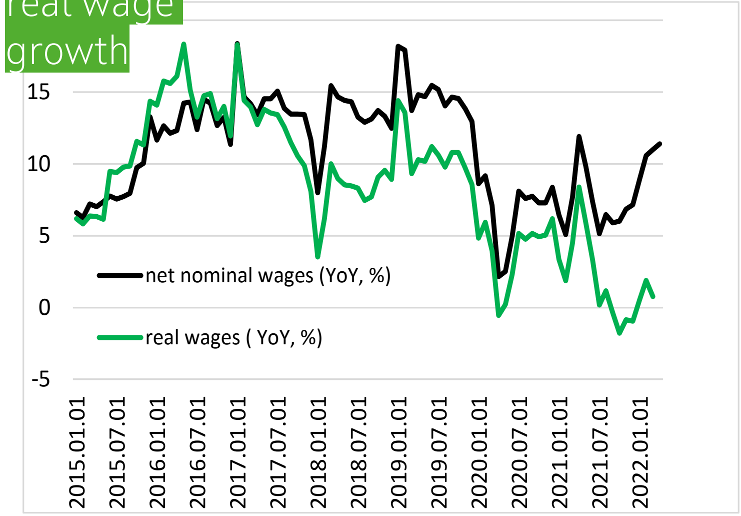
- Company employment kept increasing, although unemployment shows mixed trends, and the survey figure is still above precovid levels.
- Nominal wages grew around 11% in March-April, which is a significant pick-up from last year and suggests that (i) inflation expectations are not well anchored and (ii) on a relatively tight labor market employees have some bargaining power. Nevertheless, real wages barely grew even with the last few months pick-up in nominal wages.

Monthly employment and unemployment



Source: Refinitive, OTP Bank

Nominal and real wage growth

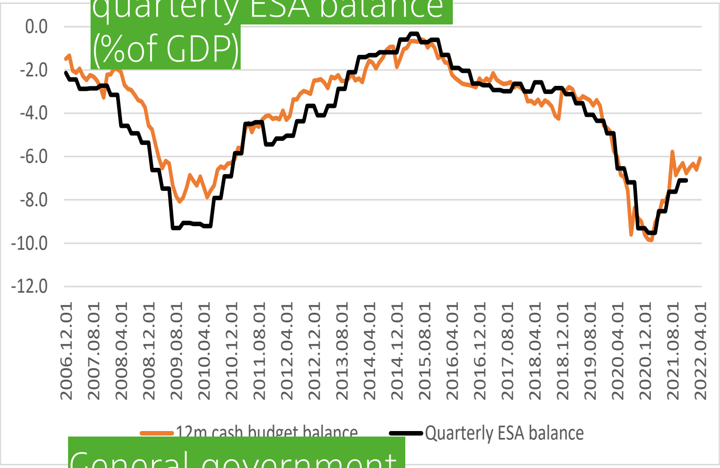


Source: Refinitive, OTP Bank

FISCAL CONSOLIDATION HAS COMPLETELY STOPPED

- Fiscal consolidation is a must amidst rising interest rates, and due to the fact that Romania is under an Excessive Deficit Procedure (EDP).
- Cash data until April suggests no improvement in the deficit instead of consolidation. The figures do not yet contain the effect of the social package. Although the government plans to reduce budget spending by 10%, except investment, wage and social expenditures as of Jul 1, it is not clear how those objectives would be accomplished.
- Overall, we think fiscal consolidation will visibly resume only by 2023, when energy prices could probably moderate and Romania will likely need to adapt to EU rules under EDP.

Monthly budget balance data and the quarterly ESA balance (%of GDP)



Source: Refinitive, OTP Bank

General government balance and public debt outlook

Source: Refinitive, OTP Bank

EXTERNAL POSITION

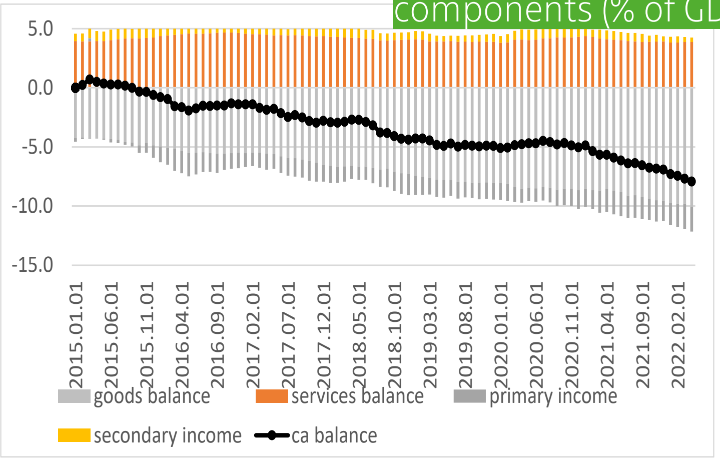
THE TWIN DEFICIT PROBLEM PERSISTED, HIGH ENERGY PRICES KEEP THE CURRENT ACCOUNT DEFICIT ELEVATED

- Despite the collapse in domestic demand in 2020, the twin deficit problem persisted as the goods balance continued to deteriorate practically uninterruptedly.

- The current account has been also affected negatively by the rise in energy prices, as Romania is a net energy importer, although in net terms to a much smaller extent than neighboring countries.

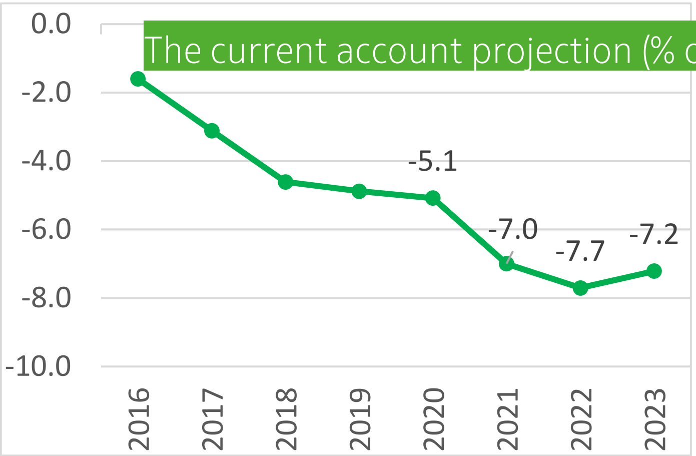
- Given the temporary stop in fiscal consolidation and high energy prices, the current account deficit could rise further this year, which could start moderating once fiscal consolidation proceeds and energy prices start to normalize.

12 months cumulative current account and its components (% of GDP)



Source: Refinitive, OTP Bank

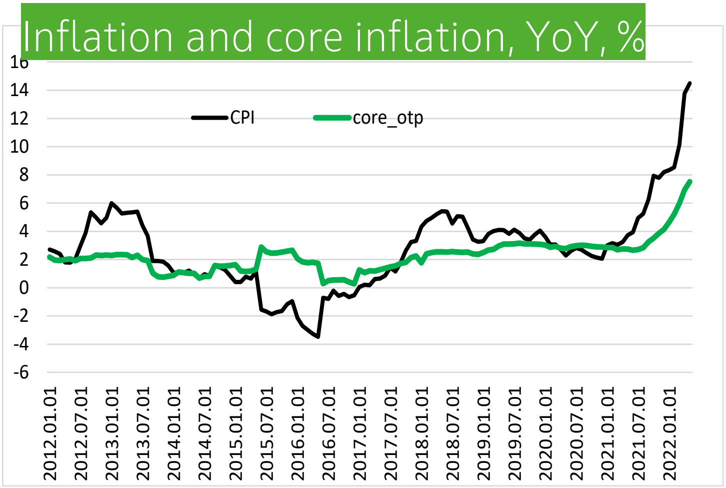
The current account projection (% of GDP)



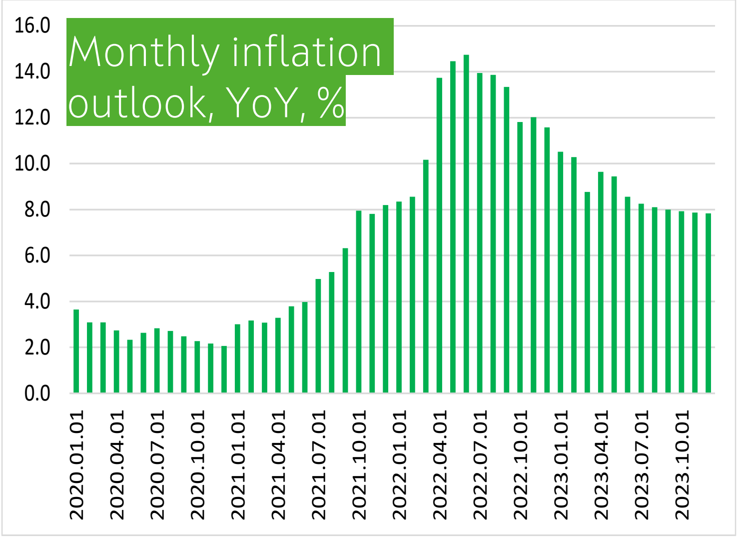
Source: Refinitive, OTP Bank

INFLATION SEEMS ALMOST AT PEAK BUT REMAINS STUBBORNLY HIGH

- Inflation has been on a sharp upward path reaching 13.8% by April and 14.5% in May. The April data was a huge upside surprise compared to the consensus of 11-11.5%. This was mostly due to the 26% MoM increase in household energy prices, which was caused by the narrower new energy prices cap (starting from April 2022 until next March).
- May inflation was broadly in line with the consensus, MoM dynamics have weakened slightly, suggesting that inflation could soon reach peak.
- In our baseline inflation could peak in June slightly below 15%, but the decline will be slow afterwards. Single digit rates are not expected before next March. The driving force from energy and food moves to core inflation, where high unit labor costs cause problems. Additionally, we assume another household energy price increase next April, when the current cap expires.



Source: Refinitive, OTP Bank

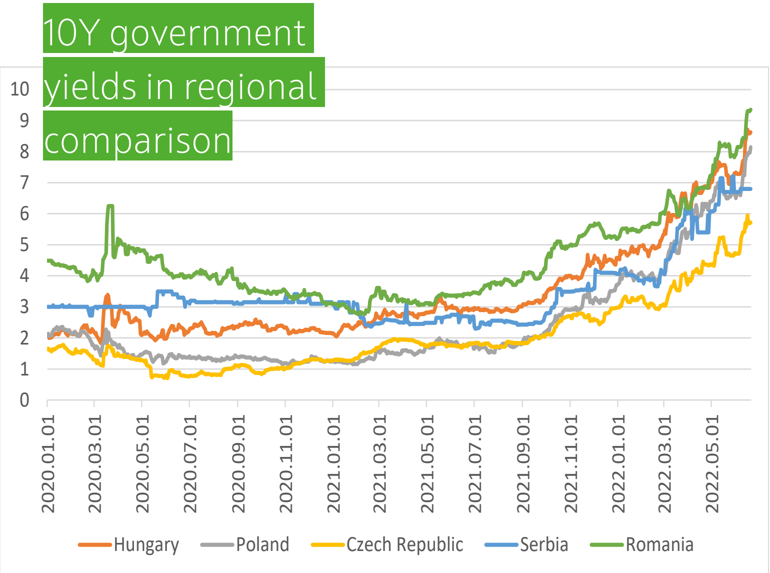


Source: Refinitive, OTP Bank

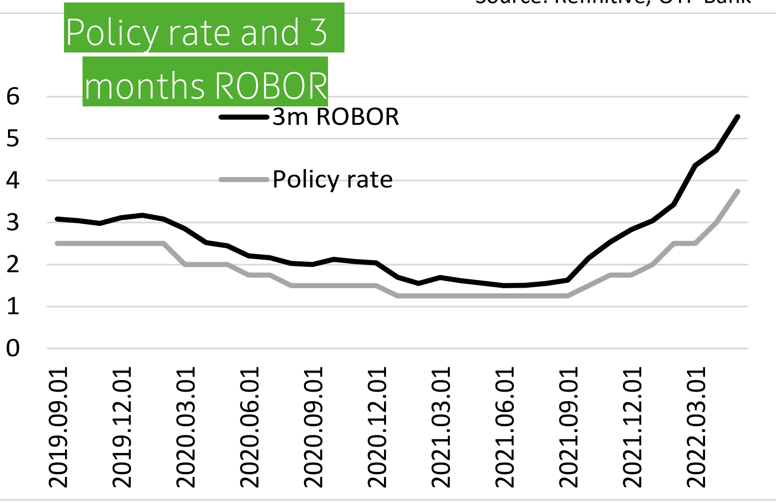
MONETARY POLICY

THE CENTRAL BANK WILL CONTINUE TIGHTENING, GIVEN THE INFLATION OUTLOOK, AND GLOBAL INTEREST RATE DEVELOPMENTS

- Long term yields are rising quickly, and the Romanian yield curve seems the steepest in the region with the 10Y bond yield at 9.3% and short yields around 6.0%.
- The increase in the yield curve was driven by the global increase in interest rates. substantial upward inflation surprises, but also concerns about the twin deficit problem.
- The BNR stepped up the base rate hike to 75 bips in May, however the level of the key rate (3.75%) is still very much lagging behind inflation developments and the risk premium on Romanian assets.
- We think the base rate could reach 7.0% by the end of the year, market pricing suggests - 8-9%, while the analyst consensus is 5.2%. Risks point to the upside.



Source: Refinitive, OTP Bank

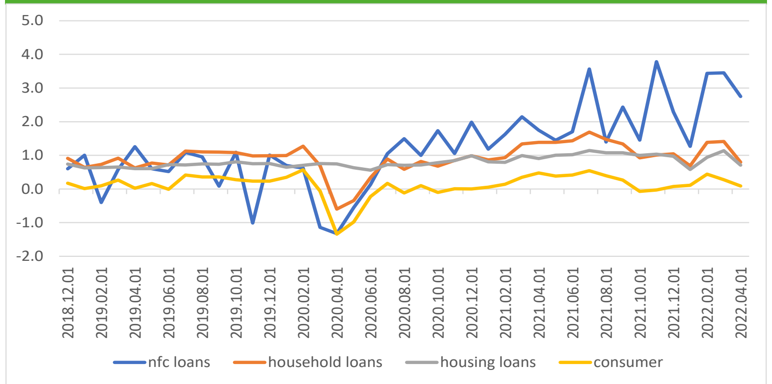


Source: Refinitive, OTP Bank

LOAN ORIGINATION SLOWED BUT MOSTLY REMAINED STRONG

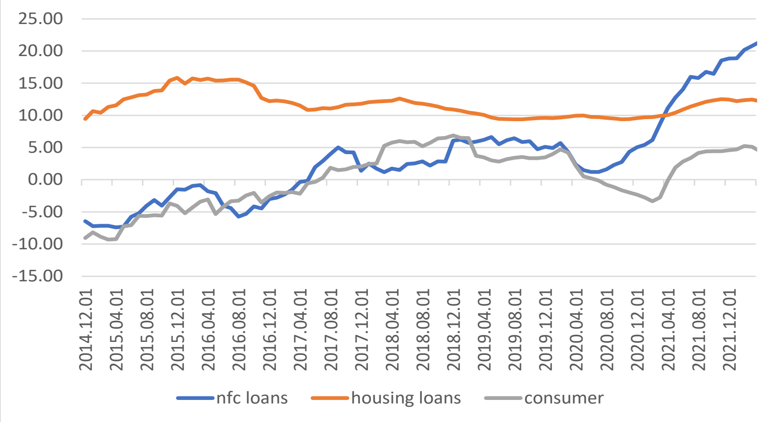
- Net loan origination in April slowed, but remained at high levels with NFC-s and mortgage loans in historical comparison. Annual growth of corporate loans increased to above 21%, housing loan growth stagnated around 12.5, consumer loan growth weakened below 5%.

Mortgage and consumer credit flows to GDP (monthly, SA, Annualised)



Source: Refinitive, OTP Bank

Corporate and retail credit growth (Y-o-Y; %, without revaluation)



Source: Refinitive, OTP Bank

- The outlook became gloomier, as weaker growth, the large energy price shock and higher RON rates will take their toll on loan demand.

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