ROMANIA: Pro-cyclical fiscal loosening

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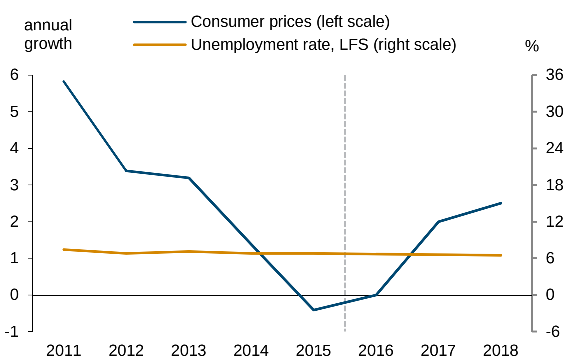
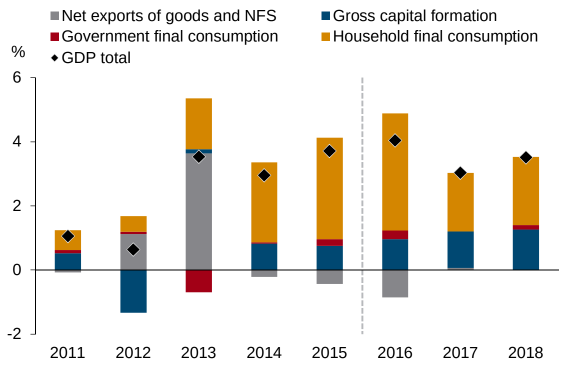
In 2015 economic growth accelerated. In 2016 GDP will expand further by some 4%. Private consumption will enjoy a pro-cyclical boost thanks to tax cuts and wage increases in the public sector, while fixed investments will also recover. For the most part, the impact of the fiscal stimulus will be short-lived; economic growth may well slow down in 2017.

Figure 51 / Romania: main macroeconomic indicators





Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Economic growth was ahead of expectation in 2015 (3.7%) and it is assumed to accelerate further, to about 4% this year. Household demand has been the main driver of growth; VAT cuts for food products, wage rises and negative inflation in 2015 have stimulated consumption. As to 2016, a general VAT cut from 24% to 20% is effective as of 1 January and a minimum wage hike is planned for May. The pro-cyclical boost was given to the economy by the previous Socialist government and the current care-taker government was obliged to implement it in the 2016 budget, increasing the general government deficit target to 2.95% of GDP. As public debt is below 40% of GDP, the current account nearly balanced and inflation negative, no immediate risk of overheating emerges although the country's vulnerability to external shocks may increase.

Good news is that gross fixed capital formation also recovered in 2015. The construction of new buildings and housing units took off and the increase in the number of construction permits suggests that the trend continues. But large infrastructure projects such as motorways, although swallowing funds, are in delay. The highway connection of Bucharest with the Western border will be completed only in 2023.

Delays are mainly due to the inability to draw EU funds, which is the result of institutional inefficiency and increased risk of punishment for corrupt practices. It is estimated that the absorption rate was 70% at the end of 2015, thus about EUR 5-6 billion of the financial allocation earmarked for 2007-2013 will be lost. The spending under the new financing period has hardly started and it is up to new EBRD, EIB and WB programmes to provide expertise and local co-financing.

The GDP growth in 2015 was achieved despite a dismal autumn harvest. Value added in agriculture was 10.5% lower than in the previous year and its contribution to GDP fell below 5%. But the population dependent on income from agriculture has declined in recent years. Thus the impact of harvest results on consumption has become smaller than a decade ago when weather conditions had a strong bearing on economic cycles.

Booming economic sectors in 2015 were first of all construction, hotels and restaurants and info-communication. Surprisingly slow growth was registered in industrial production (2.7%), but there should be no concern seeing how individual branches developed. It was mainly the low-skill industries that suffered setbacks of about 10% each: mining, textile, apparel, leather, chemicals, and other manufacturing. At the same time, production increased in industries benefiting from the construction boom such as the production of non-metallic minerals, fabricated metals and furniture, as well as in the export-oriented medium-high- and high-skill industries including the manufacturing of motor vehicles and of electrical equipment. The commodity structure of goods exports shifted towards transport equipment, which contributed more than 44% to total exports; additional one third is provided by electrical equipment and other manufactured goods. These products are increasingly exported within corporate networks to the EU, a destination which takes already three quarters of the total exports.

Consumer price inflation was negative (-0.4%), but leaving aside the impact of the VAT rate cut, it would have run close to 2% according to the calculation of the National Bank. The annual inflation rate is expected to move again into negative territory following the lowering of the standard VAT rate. But the effects of the rate cut for foodstuffs will fade out in the second half of the year and vigorous household demand may push inflation into the positive again. The effects of this year’s VAT cuts will expire in 2017 and inflation may return to the normal level of 2-3%.

The dynamics of credit to the private sector advanced into positive territory in 2015, solely on account of the faster growth of RON-denominated loans and declining lending in foreign currency. New credits to businesses and households as well as loan conversion both contributed. Loans in domestic currency surpassed 50% of the loan stock, up from 36% three years before. The share of non-performing loans declined; they were partly sold by commercial banks to other institutions. Foreign financing of domestic banks dropped and was compensated by domestic deposits. It seems that the banking sector is well on its way to neutralise the effects of the financial crisis.

There has been no positive labour market effect of the current economic recovery yet. Contrary to expectation, employment declined and unemployment stagnated at the level of the previous year. An explanation could be that wage increases put limits to the appetite to hire. Labour shortages in construction and some other activities may increase both hiring and wages in 2016. One of the large supermarket chains has recently implemented extraordinary wage rises.

The current account deficit widened in 2015 but still remained within a range of 1% of GDP. Imports grew ahead of exports on account of booming consumption and despite falling fuel prices. The deficit on goods trade was almost offset by the surpluses generated in services. There were two important items in services trade producing the surplus: transport services, which boomed, and 'manufacturing services performed on physical inputs owned by others' (processing trade), which was stagnating. The main novelty against previous years was that the primary income deficit (mainly the income of foreign investors) grew faster (by 66%) than the surplus in secondary income (50% growth) in which remittances remained flat. The widening gap between the two income categories constituted the overwhelming part of the current account deficit. FDI inflow in Romania (calculated according to the directional principle) increased by about 25%, to EUR 3 billion, over the previous year. The inflow was in the form of equity investment, implying that the country is considered an attractive destination for business investors.

The short-term forecast for Romania is dominated by the growth-stimulating effects of the fiscal relaxation. In 2017, when the one-time effects of tax cuts and wage corrections expire, a slowdown in economic growth will set in. Household demand will cool down, while net exports may recover. Due to the ongoing structural change in the Romanian economy, future growth will depend less on agriculture and more on the euro-area GDP. If the latter keeps growing at the current rate, Romania may attain some 3.5-4% GDP growth in the medium term.

Installing a non-partisan transitory government has proved a good idea up until now, calming public frustration over the political class. But controversies will surface again when the local elections scheduled for May 2016 will draw near and especially in the autumn, ahead of the parliamentary elections scheduled for November. The current transitory solution benefits the president first of all and probably also the National Liberal Party close to him. It is still too early to speculate on the outcome of these elections, in particular as several new parties have appeared across the whole political spectrum. Quite certainly, economic policy alternatives will not provide a topic for the election campaign and also the forthcoming government will lack longer-term visions and reform programmes.

Table 20 / Romania: selected economic indicators

	2011	2012	2013	2014	2015 [1]	2016	2017 Forecast	2018
Population, th pers., average	20,148	20,058	19,984	19,904	19,880	19,830	19,780	19,700
Gross domestic product, RON bn, nom.	565.1	595.4	637.5	667.6	710.0	750	800	850
annual change in % (real)	1.1	0.6	3.5	3.0	3.7	4.0	3.0	3.5
GDP/capita (EUR at exchange rate)	6,600	6,700	7,200	7,500	8,000	8,200	8,400	9,000
GDP/capita (EUR at PPP)	13,300	14,300	14,400	15,200	16,200	.	.	.
Consumption of households, RON bn, nom.	347.7	366.2	385.5	406.2	440.0	.	.	.
annual change in % (real)	1.0	0.8	2.6	4.1	5.2	6.0	3.0	3.5
Gross fixed capital form., RON bn, nom.	153.0	162.8	157.5	161.4	175.0	.	.	.
annual change in % (real)	2.9	0.1	-5.4	2.5	6.0	3.0	4.5	5.0
Gross industrial production [2]								
annual change in % (real)	7.5	2.4	7.9	6.1	2.8	4.0	4.0	5.0
Gross agricultural production								
annual change in % (real)	8.9	-21.9	24.5	2.9	-10.5	.	.	.
Construction industry [2]								
annual change in % (real)	2.7	1.4	-0.6	-6.7	10.4	.	.	.
Employed persons, LFS, th, average [3]	9,138	8,605	8,549	8,614	8,560	8,600	8,600	8,600
annual change in %	-1.1	0.9	-0.7	0.8	-0.6	0.5	0.0	0.0
Unemployed persons, LFS, th, average [3]	730	627	653	629	626	620	610	600
Unemployment rate, LFS, in %, average [3]	7.4	6.8	7.1	6.8	6.8	6.7	6.6	6.5
Reg. unemployment rate, in %, end of period	5.2	5.5	5.7	5.4	5.0	.	.	.
Average monthly gross wages, RON	1,980	2,063	2,163	2,328	2,525	2,700	2,900	3,100
annual change in % (real, gross)	-1.6	0.8	0.8	6.5	9.1	7.0	4.0	5.0
Average monthly net wages, RON	1,444	1,507	1,579	1,697	1,838	2,000	2,100	2,300
annual change in % (real, net)	-1.9	1.0	0.8	6.4	9.0	6.8	3.8	4.8
Consumer prices (HICP), % p.a.	5.8	3.4	3.2	1.4	-0.4	0.0	2.0	2.5
Producer prices in industry, % p.a.	7.1	5.3	2.0	-0.2	-2.0	1.0	2.0	2.5
General governm.budget, EU-def., % of GDP								
Revenues	33.7	33.3	33.0	33.5	34.0	33.0	33.0	33.0
Expenditures	39.1	36.5	35.2	34.9	35.5	36.0	35.5	35.5
Net lending (+) / net borrowing (-)	-5.4	-3.2	-2.2	-1.4	-1.5	-3.0	-2.5	-2.5
Public debt, EU-def., % of GDP	34.2	37.4	38.0	39.8	38.7	38.0	38.0	38.5
Central bank policy rate, % p.a., end of period [4]	6.00	5.25	4.00	2.75	1.75	2.00	2.25	3.00
Current account, EUR mn	-6,594	-6,394	-1,542	-677	-1,757	-2,800	-3,200	-4,000
Current account, % of GDP	-4.9	-4.8	-1.1	-0.5	-1.1	-1.7	-1.9	-2.3
Exports of goods, BOP, EUR mn	40,102	39,855	43,893	46,832	49,103	51,600	54,200	56,900
annual change in %	22.6	-0.6	10.1	6.7	4.8	5.0	5.0	5.0
Imports of goods, BOP, EUR mn	49,474	49,114	49,709	53,167	56,868	61,400	64,500	68,400
annual change in %	16.9	-0.7	1.2	7.0	7.0	8.0	5.0	6.0
Exports of services, BOP, EUR mn	8,688	9,868	13,434	15,102	16,294	17,300	18,200	19,100
annual change in %	11.0	13.6	36.1	12.4	7.9	6.0	5.0	5.0
Imports of services, BOP, EUR mn	7,031	7,392	8,733	9,236	9,426	10,200	10,700	11,200
annual change in %	11.0	5.1	18.1	5.8	2.1	8.0	5.0	5.0
FDI liabilities (inflow), EUR mn	1,712	2,380	2,894	2,931	3,425	.	.	.
FDI assets (outflow), EUR mn	19	-175	-24	227	663	.	.	.
Gross reserves of NB excl. gold, EUR mn	33,193	31,206	32,525	32,216	32,238	.	.	.
Gross external debt, EUR mn	99,926	100,857	98,069	94,744	90,896	89,700	95,000	100,900
Gross external debt, % of GDP	75.0	75.5	68.0	63.1	56.9	55.0	57.0	57.0
Average exchange rate RON/EUR	4.2391	4.4593	4.4190	4.4437	4.4454	4.60	4.80	4.80
Purchasing power parity RON/EUR	2.1096	2.0753	2.2083	2.2120	2.2069	.	.	.

1) Preliminary and wiiw estimates. - 2) Enterprises with 4 and more employees. - 3) From 2012 according to census October 2011. - 4) One-week repo rate.

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.