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Romania: inflation target failed, more uncertainty ahead

The Romanian economy continued its fast expansion in 2007 despite the setback in agriculture caused by severe drought. Growth was pulled by private consumption and investment while curtailed by external deficits. In the second half of 2007, the country's exposure to world-wide price increases and capital squeeze accelerated inflation and fuelled currency depreciation. Higher inflation and interest rates together with exchange rate uncertainties will cool down the economy in 2008. But the government faces elections and may further relax wage and fiscal policies thus stimulating private demand. The combined result of external factors and government action may be a slowdown of growth. However, assuming average weather conditions, agriculture will recover thus adding to growth almost as much as other factors contribute to slowdown. Longer-term prospects are favourable as structural change is fast. But fiscal stabilization may come onto the agenda in 2009 causing some further slowdown.

Structural upgrading and labour shortages

Manufacturing industry output increased by about 6% in 2007, carried by strong expansion in the car industry, rubber and plastics and communication equipment manufacturing. By contrast, production of the clothing industry fell by 21% due to soaring wage costs and Chinese competition. These trends point to a technological upgrading of the production structure. Output growth was achieved at declining employment thus labour productivity increased by 10.5%. Labour costs expanded twice as fast as productivity which made structural change all the more necessary. The export structure dynamics reflect the output structure: exports of transport equipment and processed goods grew strongly while those of fuel and light industry consumer goods declined. Manufacturing output and exports can expand in the future due to two large FDI projects in the course of realization, Ford Motors in car manufacturing and Nokia in mobile phone production. The construction boom went on with 30% growth in 2007. Investor surveys show lasting optimism despite rapidly rising land prices and construction worker shortages.

Unemployment declined and labour shortages appeared in several sectors. The number of vacancies in the third quarter of 2007 was two times larger than of the registered unemployed. Shortages have emerged across all skill and occupation groups, with the exception of trade. Most in demand are highly skilled technical experts. The labour market is rigid as, despite strong demand, inactivity does not decline because of the basic lack of skills and educational deficiencies in the rural areas. Emigrants (estimated at about one tenth of the population) do not return home as foreign wages are still substantially higher than the rapidly rising domestic wages.

Expanding deficits, rising inflation

The budget deficit remained below 3% of GDP in 2007, one percentage point higher than in the previous year. A further expansion of the deficit can be assumed for 2008 due to the expected slower increase in revenues and soaring expenditures in the social security budget and for public sector wages. The budget law, based on meanwhile outdated growth and inflation assumptions, expresses the government's intention to share the benefits of economic growth with the less well-to-do segments of the population – minimum-wage earners, pensioners and public services employees. Still it claims that the 2008 budget is tight and reckons with a deficit below 3%, a figure doubted by most analysts. One can only hope that a more stable government coming to power after the elections towards the end of 2008 will show more restraint in the coming years. Until then, lax fiscal and wage policies may add to inflation.

Consumer price inflation accelerated in the second half of 2007 because of higher food prices and currency devaluation. The pass-over of high import prices was modest and one can expect more to happen during 2008. Energy prices for households are linked to the exchange rate and thus due to rise. More than half of the agricultural products used in the food industry is imported, which will also trigger inflation. Most of the downward trend in inflation up to mid-2007 was in fact based on currency appreciation, which has reversed. In addition, Romania has the obligation, under its EU accession treaty, to raise the prices of domestically produced gas (covering 60% of consumption) to the level of prices of imported gas. The government is eager to postpone this step until after the elections, but then the price rise will finally have to be introduced. Higher gas prices will severely hit the chemical industry but also other large energy users such as the cement and brick industries and slow down construction works. Thus the price hikes currently underway will not die off very soon, and inflation will slow down only gradually.

The Romanian currency suffered the biggest slide among the NMS currencies during the recent world-wide turbulence. We expect the RON/EUR rate to fluctuate between 3.5 and 3.8 for the rest of the year. In fact we consider the expected average rate at around 3.6 RON/EUR much more in line with economic fundamentals than the 3.3 rate in 2007. As a result, we expect an improvement in the foreign trade balance, since depreciation will put a brake on imports. Unfortunately, exports may not be much affected, as most of them come from large companies unable to react fast and much of the exports depend on imported components. Apart from importers, clients having contracted forex credits (half of the non-government credit) will be negatively affected by the weaker RON.

In 2007 the current account deficit jumped to about 15% of GDP; only 44% of it was covered by FDI. Despite high external deficits, official reserves increased. Excessive current account deficits had been easily financed in times of global liquidity. But, since liquidity has been squeezed lately both investors and banks have become more cautious

and nervous. Their temporarily withdrawal from countries with vulnerable foreign positions such as Romania caused depreciation.

Growth slowdown in election years

Government policies are to a large extent paralysed until after the elections, the date for which is not set yet. If sticking to the rule, local elections should be held in June and parliamentary elections in November, while the president is to serve one more year. All polls point to a fall of the present coalition which has a minority in parliament and depends on the mercy of the Social Democratic Party. Polls also suggest that the oppositional Democratic and Democratic-Liberal parties, if winning, will need more than one coalition partner to form a new government. The major question is in fact not whether the current coalition will remain in power (they are doomed to fail for certain), but which of the opposition formations, a Socialist-led coalition or one led by the Democrats, will be able to form the new government. The president will certainly use his power to support the latter. Anyway, as for economic policy, not much difference is to be expected.

External uncertainties, inflation and devaluation pressures point to lower growth of private demand in 2008. This may slow down economic growth by one or two percentage points. But government consumption and net exports are about to increase and there is also no sign of a setback in investment yet. In addition, the recovery of agriculture will add one or two percentage points to GDP following the year of poor harvests in 2007. Thus, while the structure of growth will be different in 2008 from what it was in the previous year, its speed may not decelerate all that much. For 2009 we expect fiscal stabilization, more modest wage growth and an average harvest, all cutting back the GDP growth rate to 5%. The results of the ongoing investment boom and a stable currency will improve international competitiveness in the long run, thus stronger growth may be resumed in 2010.

Table RO

Romania: Selected economic indicators

	2002	2003	2004	2005	2006	2007 ¹⁾	2008	2009 Forecast	2010
Population, th pers., mid-year	21,795	21,734	21,673	21,624	21,584	21,538	.	.	.
Gross domestic product, RON bn, nom. ²⁾	151.5	197.6	246.5	288.2	344.5	394	458	524	594
annual change in % (real) ²⁾	5.1	5.2	8.5	4.2	7.8	6.0	5.5	5	6
GDP/capita (EUR at exchange rate)	2,224	2,420	2,806	3,678	4,529	5,486	.	.	.
GDP/capita (EUR at PPP - wiiw)	6,000	6,490	7,360	7,930	9,140	10,140	.	.	.
Gross industrial production									
annual change in % (real)	4.3	3.1	5.3	2.0	7.2	5.4	6	6	7
Gross agricultural production									
annual change in % (real)	-3.5	7.5	18.1	-13.1	2.4
Construction output total									
annual change in % (real)	10.0	9.8	9.2	9.5	27.8	33.6	.	.	.
Consumption of households, RON bn, nom. ²⁾	102.7	128.2	167.2	197.0	233.2	271	.	.	.
annual change in % (real) ²⁾	5.3	8.5	14.5	9.9	12.6	11	10	6	8
Gross fixed capital formation, RON bn, nom. ²⁾	32.3	42.3	53.9	66.5	88.3	121	.	.	.
annual change in % (real) ²⁾	8.2	8.5	11.1	12.7	19.3	25	20	10	15
LFS - employed persons, th, avg.	9,234	9,223	9,158	9,147	9,313	9,560	.	.	.
annual change in %	.	-0.1	-0.7	-0.1	1.8	2.6	.	.	.
Reg. employees in industry, th pers., avg.	1,891	1,848	1,741	1,672	1,632	1,570	.	.	.
annual change in %	-0.5	-2.3	-5.8	-4.0	-2.4	-3.7	.	.	.
LFS - unemployed, th pers., average	845.3	691.8	799.5	704.5	728.4	670.0	.	.	.
LFS - unemployment rate in %, average	8.4	7.0	8.0	7.2	7.3	6.5	6.5	6.5	6
Reg. unemployment rate in %, end of period	8.4	7.4	6.3	5.9	5.2	4.1	.	.	.
Average gross monthly wages, RON	532.1	663.8	818.3	968.0	1,146	1,410	.	.	.
annual change in % (real, net)	2.4	10.8	10.6	14.3	8.9	15.4	.	.	.
Consumer prices, % p.a.	22.5	15.3	11.9	9.0	6.6	4.8	8	7	5
Producer prices in industry, % p.a.	23.0	19.5	19.1	10.5	11.6	8.1	.	.	.
General governm.budget, EU-def., % GDP ³⁾									
Revenues	37.6	32.1	31.2	32.2	32.9	33.9	.	.	.
Expenditures	39.6	33.6	32.7	33.6	34.8	36.8	.	.	.
Net lending (+) / net borrowing (-)	-2.0	-1.5	-1.5	-1.4	-1.9	-2.9	-4	-3	-3
Public debt, EU-def., % of GDP ³⁾	25.0	21.5	18.8	15.8	12.4
Discount rate, % p.a., end of period	20.4	20.4	18.0	7.5	8.8	7.5	.	.	.
Current account, EUR mn	-1,623	-3,060	-5,099	-6,888	-10,156	-16,872	-19,000	-21,000	-23,000
Current account in % of GDP	-3.3	-5.8	-8.4	-8.7	-10.4	-14.3	-14.9	-14.4	-13.6
Gross reserves of NB excl. gold, EUR mn	5,877	6,374	10,848	16,799	21,310	25,307	.	.	.
Gross external debt, EUR mn	16,200	17,835	21,505	30,914	41,152	57,000	.	.	.
Gross external debt in % of GDP	37.3	37.1	34.6	39.4	40.4	52.2	.	.	.
FDI inflow, EUR mn	1,212	1,946	5,183	5,213	9,060	7,069	8,000	.	.
FDI outflow, EUR mn	18	36	56	-24	337	100	100	.	.
Exports of goods, BOP, EUR mn	14,675	15,614	18,935	22,255	25,850	29,380	32,900	36,800	42,300
annual growth rate in %	15.4	6.4	21.3	17.5	16.2	13.7	12	12	15
Imports of goods, BOP, EUR mn	17,427	19,569	24,258	30,061	37,609	49,966	56,500	62,200	70,300
annual growth rate in %	8.6	12.3	24.0	23.9	25.1	32.9	13	10	13
Exports of services, BOP, EUR mn	2,468	2,671	2,903	4,102	5,587	7,533	9,790	11,750	14,100
annual growth rate in %	8.6	8.2	8.7	41.3	36.2	34.8	30	20	20
Imports of services, BOP, EUR mn	2,463	2,609	3,116	4,451	5,583	7,268	9,300	11,160	13,390
annual growth rate in %	2.5	5.9	19.4	42.8	25.4	30.2	28	20	20
Average exchange rate RON/USD	3.3055	3.3200	3.2637	2.9137	2.8090	2.4383	.	.	.
Average exchange rate RON/EUR (ECU)	3.1255	3.7556	4.0532	3.6234	3.5245	3.3373	3.6	3.6	3.5
Purchasing power parity RON/USD	0.9906	1.1822	1.2994	1.4210	1.4678	1.4761	.	.	.
Purchasing power parity RON/EUR	1.1592	1.3996	1.5445	1.6799	1.7459	1.8054	.	.	.

Note: The term "industry" refers to NACE classification C+D+E.

1) Preliminary and wiiw estimates. - 2) According to ESA'95 (from 2003 FISIM adjusted; real change based on previous year prices). - 3) According to ESA'95, excessive deficit procedure.

Source: wiiw Database incorporating national statistics; Eurostat; wiiw forecasts.