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Romania:
on the verge of recession

Earlier wiiw forecasts warned that the overheating of the Romanian economy based on abundant external financing ultimately emerging in the form of extremely high current account deficits and currency appreciation would sooner or later require correction. That time has come: since September 2008 Romania has been sliding into an economic crisis. Currency depreciation and the decline in output have served as buffers to date, thus helping to avert a hard landing.

The EU-wide recession hit Romania at a most unfavourable point in time. Robust economic growth over several years up until the third quarter of 2008 (8.9% growth in the first three quarters of last year) generated formidable structural changes in output which led to improving competitiveness. The country established itself as a favoured FDI target and exports started to grow faster than imports. Although private consumption was by far the most decisive growth factor, fixed capital formation was also buoyant (up by 28% in the first three quarters of last year). Much of the recent boom was based on easy external borrowing by the private sector and the channelling of foreign funds into the country by foreign-owned banks. In October 2008 financial deadlock almost brought the economy to a sudden stop. Although it proved possible to overcome the short-term crisis, currency depreciation and interest rate hikes failed to provide a lasting solution. Growth is slowing down severely and an ultimate slide into recession cannot be ruled out.

The scale of the crisis is evidenced by the drop in industrial production, contraction of exports and currency depreciation over the past few months. Companies, especially large export-oriented foreign subsidiaries in the automotive, steel and machinery sectors, shifted to shorter working hours and some fifty thousand workers reportedly lost their jobs in December. Small and medium enterprises stopped payments and are soon expected to go out of business on a massive scale. Imports declined even more than exports; the current account deficit thus shrank in 2008. Retail and corporate bank loans still increased by 1.5% in December compared to November, but the annual growth rate of credits slowed down massively for the third consecutive month to 33.7% compared to 38.2% in November.

The outgoing government entered into unfounded social commitments and promised higher wages and pensions. The proliferation of budgetary spending in the last month of the previous year resulted in an unsustainable fiscal deficit (more than 5% of GDP in 2008). The new coalition government (social democrats and democratic-liberals) that was formed in December disposes of an overwhelming majority in parliament and enjoys the support of the President; it thus has all the prerequisites for assuming an active role in mitigating the economic crisis. Its capacity and means, however, are limited. As a first step, the new government discarded the budget previously set for

2009. The new targets include a consolidated budget deficit of 2% of GDP, 2.5% GDP growth and 5.3% inflation. It is also envisaged that wages and pensions will only rise apace with the rate of inflation. However, when employees pressed for wage increases and employers lobbied for financial support, they managed to delay the passage of the budget law until late February.

While the declared intention for to cut the deficit can only be welcomed, the scale of cuts seems unrealistic – all the more so as the budget is based on over-optimistic economic growth assumptions. We expect that expenditures cannot be cut all that much since unemployment benefits and other social outlays will have to increase. There is also pressure to soften the impact of the crisis on companies. The only real anti-crisis measure to date has been the decision to capitalize the state-owned savings banks CEC and the Eximbank. Extra financing may come from the EU, as much as 2% of GDP, part of which could be used to bolster public investment projects. For the latter projects, the government hopes to re-employ at least part of those construction workers who have been laid off.

We expect a stagnation of the economy in 2009, yet no outright recession. Investments will decline and consumption will hardly grow above the level of the previous year. On the positive side, with imports contracting more than exports, foreign trade will contribute positively to GDP. The current account will adjust sharply. Financing the gap will still prove highly problematic since FDI is bound to decline and external loans (if available at all) will be expensive. Romania is already in the high-risk category and investors, in yet another wave of negative sentiment, may lose confidence. Therefore, we do not exclude a further tightening of foreign financing. At this point of time, we can only stress that Romania remains highly exposed to external shocks and a hard landing leading ultimately to recession cannot be ruled out. Financial support from the EU and a stand-by agreement with the IMF would help to keep the economy going.

In the wake of the current crisis, social hardship will become even more acute. Unemployment is bound to increase sharply and wage expectations will not be fulfilled. Past experience suggests that social unrest will quite likely come to the fore. While import prices in EUR will fall, inflation will not drop very much owing to the currency losing strength. The employment situation may well become even more dire, if migrant workers start returning home. This may occur given the deteriorating employment situation in Spain and Italy. A significant part of the returnees may not immediately show up in the figures for the unemployed, but they will undoubtedly swell the ranks of the already overcrowded rural population. By another interpretation, migrants may not return as it is the experience up to now, since their relative situation abroad does not deteriorate compared to the home country due to exchange rate adjustments.

As things stand in mid-February 2009, recovery will not be robust – even in 2010 and 2011. We cannot expect external financing to rebound to its previous level; the country will have to switch to domestic savings. Consumption, therefore, will hardly recover next year and the current account deficit will have to be reduced still further. Recovery, however, can be expected in terms of both investments and FDI, should the core EU economies manage to expand. As a result of new investments, accelerated structural change and infrastructure modernization, the country may achieve medium-term economic growth of the order of 4-5%, two percentage points lower than before the crisis.

Table RO

Romania: Selected Economic Indicators

	2003	2004	2005	2006	2007	2008 1)	2009	2010 Forecast	2011
Population, th pers., average	21742	21685	21634	21588	21547	21513	.	.	.
Gross domestic product, RON mn, nom. 2)	197428	247368	288955	344651	412762	512000	540000	580000	630000
annual change in % (real) 2)	5.2	8.5	4.2	7.9	6.2	7.8	0	1	3
GDP/capita (EUR at exchange rate)	2400	2800	3700	4500	5800	6500	.	.	.
GDP/capita (EUR at PPP)	6500	7400	7900	9100	10500	11400	.	.	.
Consumption of households, RON mn, nom. 2)	128438	167644	197069	233135	273063	.	.	.	.
annual change in % (real) 2)	8.4	15.8	10.1	12.9	11.7	9.5	0	1	3
Gross fixed capital formation, RON mn, nom. 2)	42497	53850	68527	88272	125645	.	.	.	
annual change in % (real) 2)	8.8	11.0	15.3	19.9	29.0	22	-7	3	10
Gross industrial production									
annual change in % (real) 3)	3.1	5.3	2.0	7.1	5.4	0.9	-8	3	5
Gross agricultural production									
annual change in % (real)	7.5	18.1	-13.1	2.4	-17.7	19.4	.	.	.
Construction industry (build.& civil engin.)									
annual change in % (real) 3)	6.9	8.9	8.6	20.5	34.0	26.0	.	.	.
Employed persons - LFS, th, avgerage	9222.5	9157.6	9114.6	9291.2	9353.3	9400	.	.	.
annual change in %	-0.1	-0.7	-0.5	1.9	0.7	0.5	.	.	.
Unemployed persons - LFS, th, average	691.8	799.5	704.5	728.4	640.9	600	.	.	.
Unemployment rate - LFS, in %, average	7.0	8.0	7.2	7.3	6.4	6.0	8	9	8
Reg. unemployment rate, in %, end of period	7.4	6.3	5.9	5.2	4.0	4.4	.	.	.
Average gross monthly wages, RON	663.8	818.3	968.0	1146.0	1410.0	1742.2	.	.	.
annual change in % (real, net)	10.8	10.6	14.3	8.8	14.8	14.0	.	.	.
Consumer prices (HICP), % p.a.	15.3	11.9	9.1	6.6	4.9	7.9	5	5	4
Producer prices in industry, % p.a.	19.5	19.1	10.5	11.6	8.1	15.8	.	.	.
General governm.budget, EU-def., % GDP 4)									
Revenues	32.1	32.4	32.3	33.1	34.7	33.5	.	.	.
Expenditures	33.6	33.6	33.5	35.3	37.3	38.7	.	.	.
Net lending (+) / net borrowing (-)	-1.5	-1.2	-1.2	-2.2	-2.6	-5.2	-4	-5	-4
Public debt, EU-def., % of GDP 4)	21.5	18.8	15.8	12.4	12.9	14	.	.	.
Discount rate of NB, % p.a., end of period 5)	20.41	17.96	7.50	8.75	7.50	10.25	.	.	.
Current account, EUR mn	-3060	-5099	-6888	-10220	-16715	-16877	-10000	-9000	-10000
Current account in % of GDP	-5.8	-8.4	-8.6	-10.5	-13.5	-12.1	-8.0	-6.5	-6.3
Exports of goods, BOP, EUR mn	15614	18935	22255	25953	29542	33614	30300	31200	33400
annual growth rate in %	6.4	21.3	17.5	16.6	13.8	13.8	-10	3	7
Imports of goods, BOP, EUR mn	19569	24258	30061	37765	47365	51813	41500	41900	44400
annual growth rate in %	12.3	24.0	23.9	25.6	25.4	9.4	-20	1	6
Exports of services, BOP, EUR mn	2671	2903	4102	5585	6931	8751	8300	9100	10000
annual growth rate in %	8.2	8.7	41.3	36.2	24.1	26.3	-5	10	10
Imports of services, BOP, EUR mn	2609	3116	4451	5581	6450	7915	7100	7800	8600
annual growth rate in %	5.9	19.4	42.8	25.4	15.6	22.7	-10	10	10
FDI inflow, EUR mn	1946	5183	5213	9060	7271	9000	4000	.	.
FDI outflow, EUR mn	36	56	-24	338	206	-300	0	.	.
Gross reserves of NB excl. gold, EUR mn	6367	10923	16785	21299	25325	26220	.	.	.
Gross external debt, EUR mn	17835	21505	30914	41234	58797	95000	.	.	.
Gross external debt in % of GDP	37.2	34.2	39.4	40.5	51.4	74.6	.	.	.
Average exchange rate RON/EUR	3.7551	4.0510	3.6209	3.5258	3.3328	3.6776	4.3	4.2	4.0
Purchasing power parity RON/EUR	1.3996	1.5442	1.6990	1.7618	1.8273	2.0832	.	.	.

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

1) Preliminary and wiiw estimates. - 2) According to ESA'95 (FISIM adjusted and real change based on previous year prices). - 3) Enterprises with more than 3 employees. - 4) According to ESA'95, excessive deficit procedure. - 5) Reference rate of NB.

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