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Romania:
boom resumed

Slight overheating, continuing structural change

Economic growth accelerated in the first quarter of 2008 contradicting widespread expectations and external uncertainties. The 8.2% growth was the fastest rate in history and second fastest in the EU after Slovakia. Although private consumption is by far the most decisive factor of growth, fixed capital formation is also increasingly important: the investment rate rose from 23% of GDP in 2005 to over 26% in 2007 and is expected to reach 30% this year. The current investment boom is broadly based and is not confined to speculative housing investments as a saturation of demand for city apartments is visible. The wiiw, the IMF, as well as the international rating agencies have repeatedly warned that Romania is in a danger zone due to overheating, but the confidence of creditors was shaken only briefly at the beginning of the year. As the central bank raised the policy interest rate and the local currency depreciated, income prospects for investors improved and the latter have resumed pumping money into the Romanian economy.

The sector with the most dynamic output growth is construction, followed by services (first of all trade and telecommunications) and manufacturing. The structural change in manufacturing continued, with shrinking output in the textile, clothing and leather industries, and expansion in the automotive sector. Also the production of communication equipments and of construction materials boomed, while that of instruments and electrical machinery fell due to still ongoing restructuring in domestically owned companies. Successful activities are all dominated by foreign subsidiaries. Due to strong FDI inflows in recent years, the share of foreign investment enterprises in manufacturing output reached 59% and in exports 75% in 2006 – as high as in Hungary, the country with the highest exposure to FDI in Central Europe, just four years earlier.

Further economic growth is hampered by labour shortages. Romania has below-replacement fertility, unemployment is low, and at least one million persons of the 12 million labour force work abroad. Their remittances increase the demand especially for housing construction and consumer durables including cars. Construction could reportedly employ an additional 300,000 people. The tight labour market is one of the driving forces of wages and the wage drift is driving inflation. In April the average net real wage was 14.9% higher than a year earlier (RON 1282 or EUR 350) but unequally distributed among industries. Wage hikes were meagre in the automotive industry and in metallurgy, thus export competitiveness could be maintained at least until recent strikes have enforced some adjustment. The highest wage growth was observed in the banking sector, in construction and trade, sectors that are booming based on domestic consumption.

Inflation a growing concern

Rising inflation is the result of excessive wage drift but also of imported energy and food prices as well as the weakening domestic currency. The industrial producer price increase accelerated as well, which foreshadows more consumer price rises in the rest of the year. A significant increase in the gas prices is expected in July, but the price of domestically produced gas will not be raised to the international level. The inflation target of the Romanian National Bank was missed last year, and this year's 3-5% target will most probably not be met either, despite monetary tightening. The central bank has raised its main interest rate five times since October 2007, to 9.75% in May, which is the highest rate in the EU. The RON/EUR rate depreciated by 9.1% compared to the first quarter of last year and stabilized in May-June at around 3.62, 3.5% above the previous year's level.

Low public debt and a well-managed public deficit remain strong features of the Romanian economy. Earlier fears of a budgetary loosening have so far not materialized, as economic growth resulted in soaring budget revenues. In addition, expenditures were curtailed by a budget rectification. If everything remains on track, the 2008 deficit can remain below 3% of GDP.

The speed of the expansion of crediting remains a concern of the central bank but its level is still not very high. At the end of April 2008, non-government credit was up by 51% in real terms year-on-year. Foreign-currency denominated loans soared twice as fast as domestic-currency denominated ones. While until October last year domestic currency loans had a higher share in new loans than forex loans, following the weakening of the Romanian leu more loans are taken in foreign currency. Loans to the private sector represent 37% of GDP (end-2007), more than twice the year 2000 level, but this share is still the lowest among the NMS. It is particularly low compared to Estonia and Latvia, which registered over 90% and proved vulnerable to a turnaround. Loans to households in per capita terms were EUR 920 as of end-2007 both in Romania and Bulgaria, only half of the level in Poland and one fifth of that in Estonia. This difference in the exposure to foreign financing may explain why a hard landing is not on the agenda in Romania, but the country is vulnerable to corrections.

The current account deficit, reaching 15% of the GDP, is another sore point. But, for the first time in the last five years, exports grew slightly faster than imports in the first quarter of 2008, year-on-year. (However, the base period marked the introduction of the EU trade regime, resulting in soaring imports.) Although FDI financed only 45% of the current account deficit – the rest relied increasingly on short-term capital –, in the longer run FDI can generate exports to improve the external balance.

No hard landing but corrections in sight

The Romanian economy continues to be in a somewhat overheated stage in 2008. The depreciation of the domestic currency and increased interest rates could not cool it down. Wage rises and inflation are too high. Also the credit boom fuels aggregate demand and increases inflation. A considerable risk of failure exists due to excessively high debt service, current account deficit and real estate prices. But, for the time being, there is no abrupt turn in sight. Investor surveys show lasting optimism despite rapidly rising land prices and construction worker shortages. The currency has been stable for quite some time and the budget deficit is not excessive. Still we think that the next government, coming to power after the elections later this year, will have to take stabilization measures and cut back the consumption race next year. This explains our forecast of only 5% growth in 2009. The Romanian authorities are committed to joining the eurozone in 2014; especially the inflation target will be hard to achieve.

Table RO

Romania: Selected Economic Indicators

	2004	2005	2006	2007 [1]	2007	2008	2008	2009	2010
					1st quarter			Forecast	
Population, th pers., mid-year	21673	21624	21584	21538	.	.	.	.	.
Gross domestic product, RON mn, nom. [2]	246469	288176	344536	404709	68842	86745	474100	542600	621200
annual change in % (real) [2]	8.5	4.2	7.9	6.0	6.1	8.2	6.5	5	6
GDP/capita (EUR at exchange rate)	2806	3678	4529	5631	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	7360	7930	9140	10000	.	.	.	.	.
Gross industrial production									
annual change in % (real)	5.3	2.0	7.2	5.4	7.6	5.4	6	6	7
Gross agricultural production									
annual change in % (real)	18.1	-13.1	2.4	-18.0	.	.	.	.	.
Construction output total									
annual change in % (real)	9.2	9.5	27.8	33.6	29.8	32.2	.	.	.
Consumption of households, RON mn, nom. [2]	167245	197024	233235	271398	54311	66887	.	.	.
annual change in % (real) [2]	14.5	9.9	12.6	11.2	12.4	15.6	11	6	8
Gross fixed capital formation, RON mn, nom. [2]	53850	66504	88272	123299	14323	21042	.	.	.
annual change in % (real) [2]	11.1	12.7	19.3	28.9	23.5	33.2	25	10	15
LFS - employed persons, th, avg.	9157.6	9146.6	9313.3	9353.3	9105.9	.	.	.	.
annual change in %	-0.7	-0.1	1.8	0.4	0.9	.	.	.	.
Reg. employees in industry, th pers., avg.	1741	1672	1632	1572	.	.	.	.	.
annual change in %	-5.8	-4.0	-2.4	-3.7	-4.4	-3.0	.	.	.
LFS - unemployed, th pers., average	799.5	704.5	728.4	640.8	690.4	.	.	.	.
LFS - unemployment rate in %, average	8.0	7.2	7.3	6.4	7.0	.	6.0	6	6
Reg. unemployment rate in %, end of period	6.3	5.9	5.2	4.1	4.9	4.2	.	.	.
Average gross monthly wages, RON	818.3	968.0	1146.0	1410.0	1286.7	1601.0	.	.	.
annual change in % (real, net)	10.6	14.3	8.9	15.4	14.3	13.7	.	.	.
Consumer prices, % p.a.	11.9	9.0	6.6	4.8	3.8	8.0	8	7	5
Producer prices in industry, % p.a.	19.1	10.5	11.6	8.1	9.4	14.4	.	.	.
General governm.budget, EU-def., % GDP [3]									
Revenues	32.4	32.3	33.1	34.4	.	.	.	.	.
Expenditures	33.6	33.5	35.3	36.9	.	.	.	.	.
Net lending (+) / net borrowing (-)	-1.2	-1.2	-2.2	-2.5	.	.	-2.5	-3.5	-3.0
Public debt, EU-def., % of GDP [3]	18.8	15.8	12.4	13.0	.	.	.	.	.
Discount rate, % p.a., end of period	18.0	7.5	8.8	7.5	8.1	9.0	.	.	.
Current account, EUR mn	-5099	-6888	-10156	-16950	-3173	-3519	-19000	-21500	-23000
Current account in % of GDP	-8.4	-8.7	-10.4	-14.0	-15.6	-15.0	-14.6	-14.3	-13.0
Gross reserves of NB excl. gold, EUR mn	10848	16799	21310	25307	21530	25158	.	.	.
Gross external debt, EUR mn	21505	30914	41234	58797	43633	61067	.	.	.
Gross external debt in % of GDP	34.6	39.4	40.5	52.4	.	.	.	.	.
FDI inflow, EUR mn	5183	5213	9060	7141	1890	1588	8000	.	.
FDI outflow, EUR mn	56	-24	337	-45	-15	-88	100	.	.
Exports of goods, BOP, EUR mn	18935	22255	25850	29402	7019	7965	33200	37200	42800
annual growth rate in %	21.3	17.5	16.2	13.7	12.9	13.5	13	12	15
Imports of goods, BOP, EUR mn	24258	30061	37609	47067	10534	11828	52700	58000	65000
annual growth rate in %	24.0	23.9	25.1	25.1	33.2	12.3	12	10	12
Exports of services, BOP, EUR mn	2903	4102	5587	7621	1892	2296	9500	11400	13700
annual growth rate in %	8.7	41.3	36.2	36.4	53.1	21.4	25	20	20
Imports of services, BOP, EUR mn	3116	4451	5583	7388	1607	2253	10300	13400	16100
annual growth rate in %	19.4	42.8	25.4	32.3	35.0	40.2	40	30	20
Average exchange rate RON/USD	3.2637	2.9137	2.8090	2.4383	2.5820	2.4617	.	.	.
Average exchange rate RON/EUR (ECU)	4.0532	3.6234	3.5245	3.3373	3.3818	3.6892	3.65	3.6	3.5
Purchasing power parity RON/USD	1.2994	1.4210	1.4678	1.5839	.	.	.	.	.
Purchasing power parity RON/EUR	1.5445	1.6799	1.7459	1.8796	.	.	.	.	.

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

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

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