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## **Romania: can new government continue expansionist policy?**

Economic growth reached a new record in 2004, close to 8%. It was supported by the expansion of household demand and of fixed investments, while public demand shrank and the foreign balance deteriorated. An exceptionally good harvest explains about 1.5 percentage points of the growth. The economy shows signs of overheating due to pre-election wage rises and credit expansion to the population. While growth may continue at a rate of about 5% in 2005, risks are present both in the fiscal and monetary spheres. Managing these risks is a primary challenge for the new government.

The social-liberal government, in office since December last year, enjoys a comfortable majority in both houses of parliament, but the four-party coalition may prove fragile, and President Basescu may also cause tensions with his frequent interference in daily politics. While the former government was associated with the old nomenklatura and trade union interests, the new government is mainly supported by the business class and urban people. No wonder that the first reform package provided tax relief to businesses and to high-income people.

Personal incomes and corporate profits are taxed with a flat rate of 16% in 2005. Low-income people receive a compensation for their higher tax rate, while high-income persons will definitely pay less than previously. Tax revenue losses for the budget are estimated at 1% of GDP. This will be partly compensated by increasing the turnover-based tax on micro-enterprises and postponing the planned reduction of social security contributions. An increase in excise taxes and of the VAT rate is suggested by the IMF but opposed by the government. While the government wants to keep the budget deficit at the 2004 level of 1.2% of GDP, the IMF insists on cutting it to half in order to correct the overheating. After meeting the IMF delegation in early February, the government agreed to raise taxes on interests, stock exchange gains and real estate transactions as well as to increase excise duties, but it defended the VAT rate. A rectified budget will be finalized by April.

The debate over the budget deficit boils down to the expected rate of disinflation. With the end-year CPI having declined to 9.3% (from 14.1% in December 2003), the central bank (BNR) was able to meet its 2004 target. This result was helped by three earlier unexpected developments: booming domestic food production kept prices down; the Romanian leu (ROL) started to appreciate and caused a decline in prices of some imported goods, and of euro-priced services; and the government postponed gas and electricity tariff rises to after the elections. When increasing the end-2005 inflation target from 6% to 7% in October last

year, the BNR included already the postponed tariff hikes. However, also this target is in danger due to the demand effects of tax cuts.

The nominal appreciation of the leu since the last quarter of 2004 has been a novelty for Romania. Improving credit ratings and high interest rates have attracted foreign portfolio investors, and also significantly more foreign exchange came into the country through FDI and remittances, all increasing the demand for the local currency. The BNR declared to stop intervening on the currency market last year but interfered several times in January 2005 to stop appreciation. It also intends to introduce direct inflation targeting in June 2005 and to further liberalize capital account transactions, allowing short-term ROL deposits for foreigners. To discourage short-term capital inflows and a further strengthening of the leu, the BNR has repeatedly cut the prime-rate (most recently to 15.75% on 14 February). Still it is likely that speculative capital will flow in at an accelerating pace after the liberalization in April. A nominally stable exchange rate through 2005 would help disinflation without hurting exports but as of February, all signs point to further appreciation. One can expect that direct inflation targeting will not be applied in the strict sense and the BNR will keep an eye on the exchange rate.

Exports expanded significantly in 2004, by about 21% in current euro terms. Despite some upgrading of the export structure, Romania is still highly specialized in labour-intensive low-tech products whose competitiveness is very sensitive to exchange rate developments. Wages have grown ahead of GDP for the second consecutive year and euro wages increased even more rapidly, draining the profits of manufacturing sector exporters and curtailing future export expansion. Imports rose by some 23% in 2004. The widening trade deficit was partially mitigated by remittances of Romanians working abroad. Still the current account deficit deteriorated to about 7.7% of GDP.<sup>1</sup> In this respect, the policy target was missed by a wide margin, and the authorities seem to lack the tools to forestall a further current account deterioration.

In 2005 and 2006 the Romanian economy will grow less rapidly than last year (at an annual rate of 5-5.5%), partly due to lower agricultural production, partly to less vigorous foreign demand. Wage expansion will be more moderate than last year and the nominal appreciation of the leu will come to an end. The correction of the expansionist policy will proceed moderately and inflation will remain somewhat above the level targeted by the government and the BNR.

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<sup>1</sup> The National Bank of Romania started to include re-invested earnings of foreigners into the current account and increased FDI in the capital account by the same amount. The new methodology applies for the balance of payments of 2003 and 2004.

The two years preceding Romania's accession to the EU in 2007 will require costly structural reforms. The privatization of utility companies and banks will be carried on. Confidence has increased that the new government will fight corruption more efficiently than the previous one. The country will enjoy upgraded assistance from the European Commission to meet the accession criteria but in case of non-alignment, the date of accession may be postponed. A delay by one year may not be a tragedy and allow for adjustments in the unprepared part of the Romanian economy.

Table RO

## Romania: Selected Economic Indicators

	1998	1999	2000	2001	2002	2003	2004 <sup>1)</sup>	2005 forecast	2006 forecast
Population, th pers., mid-year	22502.8	22458.0	22435.2	22408.4	21794.8	21733.6	21700	.	.
Gross domestic product, ROL bn, nom.	371194	545730	803773	1167687	1512617	1890778	2316000	2700000	3100000
annual change in % (real)	-4.8	-1.2	2.1	5.7	5.0	4.9	7.8	5	5.5
GDP/capita (EUR at exchange rate)	1651	1491	1795	2002	2221	2316	2630	.	.
GDP/capita (EUR at PPP - wiiw)	4670	4760	5010	5460	6060	6320	6980	.	.
Gross industrial production									
annual change in % (real)	-13.8	-2.4	7.1	8.3	4.3	3.1	5.3	5	5
Gross agricultural production									
annual change in % (real)	-7.5	4.0	-14.8	22.7	-3.5	3.6	.	.	.
Construction output total									
annual change in % (real)	-0.5	-0.2	2.8	9.0	10.0	6.5	8.5 <sup>HX</sup>	.	.
Actual final consump. of househ., ROL bn, nom.	.	453308	634590	917186	1151356	1451166	.	.	.
annual change in % (real)	.	-1.1	0.2	6.8	3.1	7.1	9	.	.
Gross fixed capital formation, ROL bn, nom.	68112	96630	151947	241154	322383	425917	.	.	.
annual change in % (real)	-5.7	-4.8	5.5	10.2	8.2	9.2	13	10	8
LFS - employed persons, th, avg. <sup>2)</sup>	10844.9	10775.6	10763.8	10696.9	9234.3	9222.5	9077.0 <sup>HVI</sup>	.	.
annual change in %	-1.9	-0.6	-0.1	-0.6	-13.7	-0.1	-0.5 <sup>HVI</sup>	.	.
Reg. employees in industry, th pers., avg.	2272.0	1991.0	1873.0	1901.0	1891.0	1855.0	.	.	.
annual change in %	-7.0	-12.4	-5.9	1.5	-0.5	-1.9	-1.8 <sup>HVI</sup>	.	.
LFS - unemployed, th pers., average <sup>2)</sup>	732.4	789.9	821.2	750.0	845.3	692.0	800	.	.
LFS - unemployment rate in %, average <sup>2)</sup>	6.3	6.8	7.1	6.6	8.4	7.0	7.5	8	8
Reg. unemployment rate in %, end of period	10.4	11.8	10.5	8.8	8.4	7.4	6.2	.	.
Average gross monthly wages, ROL	1357132	1957731	2876645	4282622	5452097	6741152	8261492	.	.
annual change in % (real, net)	3.4	-3.8	4.6	4.9	2.2	8.8	9.5	.	.
Consumer prices, % p.a.	59.1	45.8	45.7	34.5	22.5	15.3	11.9	9	7
Producer prices in industry, % p.a.	33.2	44.5	53.4	38.1	23.0	19.5	18.6	.	.
General governm. budget, nat. def., % GDP									
Revenues	31.7	32.8	31.2	30.1	29.6	29.8	.	.	.
Expenditures	35.3	34.7	35.2	33.3	32.1	31.9	.	.	.
Deficit (-) / surplus (+)	-3.6	-1.9	-4.0	-3.2	-2.5	-2.0	-1.0	-1.5	-1.5
Public debt, EU-def., % of GDP <sup>3)</sup>	18.0	24.0	23.9	23.2	23.3	21.8	21.8	.	.
Discount rate, % p.a., end of period <sup>4)</sup>	35.0	35.0	35.0	35.0	20.4	20.4	18.0	.	.
Current account, EUR mn	-2575	-1355	-1494	-2488	-1623	-3060	-4402	-5500	-6000
Current account in % of GDP	-6.9	-4.0	-3.7	-5.5	-3.4	-6.1	-7.7	-7.7	-7.4
Gross reserves of NB excl. gold, EUR mn	1177.3	1520.0	2654.8	4445.3	5876.8	6373.6	10711.5	.	.
Gross external debt, EUR mn <sup>5)</sup>	8054.3	8756.4	11113.4	13507.1	14691.0	15683.0	17547.0	.	.
FDI inflow, EUR mn	1763	964	1147	1294	1212	1946	4098	.	.
FDI outflow, EUR mn	-8	15	-14	-18	18	36	56	.	.
Exports of goods, BOP, EUR mn	7400	7977	11273	12722	14675	15614	18935	20800	22900
annual growth rate in %	-0.9	7.8	41.3	12.9	15.4	6.4	21.3	10	10
Imports of goods, BOP, EUR mn	9718	9164	13140	16045	17427	19569	24258	27200	30000
annual growth rate in %	5.4	-5.7	43.4	22.1	8.6	12.3	24.0	12	10
Exports of services, BOP, EUR mn	1089	1287	1910	2273	2468	2671	2903	3100	3300
annual growth rate in %	-19.3	18.2	48.4	19.0	8.6	8.2	8.7	7	6
Imports of services, BOP, EUR mn	1619	1657	2170	2402	2463	2609	3116	3400	3600
annual growth rate in %	-4.0	2.3	31.0	10.7	2.5	5.9	19.4	9	6
Average exchange rate ROL/USD	8875.6	15332.9	21692.7	29060.9	33055.5	33200.1	32636.6	.	.
Average exchange rate ROL/EUR (ECU)	9989.3	16295.6	19955.8	26026.9	31255.3	37555.9	40532.1	38000	38000
Purchasing power parity ROL/USD, wiiw	3067.8	4465.4	6316.4	8383.3	10141.4	11992.4	13586.8	.	.
Purchasing power parity ROL/EUR, wiiw	3534.8	5107.9	7156.5	9539.7	11455.9	13775.4	15297.8	.	.

Notes: 1) Preliminary. - 2) From 2002 break in methodology and according to census March 2002. - 3) According to ESA 95, excessive deficit procedure. - 4) From February 2002 reference rate of NB. - 5) Medium- and long-term.

Source: wiiw Database incorporating national statistics; wiiw forecasts.