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Romania:
Desperate austerity

The contraction of the economy is deeper and lasting longer than earlier expected, mainly due to suppressed private demand and investment. GDP fell by 2.6% in the first quarter of 2010 compared to the same quarter of the previous year; private consumption fell by 4.8%, public consumption by 3.2% and gross fixed capital formation collapsed by 29%. But inventories were stocked up to such an extent that capital formation became positive. Exports of goods and services increased faster than imports thus net exports also contributed positively to GDP. On the production side, particularly construction but also the services sectors reduced their activities while industry recovered. Domestic demand may contract further in the wake of the new fiscal austerity measures introduced in June which will further depress the economy during the year.

Manufacturing sector output came out of recession in the first quarter, 4% higher year on year. At the same time, employment continued to decline thus labour productivity soared by 22%. The output recovery was especially robust in the industries producing basic metals, electrical machinery and motor vehicles while the production of consumer goods declined. The recovery was export driven whereas the domestic market for most goods contracted. Domestic car sales went down further and retail sales plummeted at two-digit rates while the value of motor vehicles exports soared. Goods exports increased by 19% in the first quarter, as much as they had declined in the same period of the previous year. Imports rose only by 11% comprising mostly inputs for the export sector.

The government had to give up the implementation of the budget law for the current year which had been passed in January and had planned a deficit of 5.8% of GDP[1]. Revenues in the first four months were 1.2% lower and expenditures were 3.4% higher in nominal terms as compared to the same period of last year. According to the calculations of the

[1] The reported and targeted general government budget deficits are on a cash basis according to IMF methodology. The deficit by EU definition (quoted in Table RO) includes fiscal commitments. In 2009, the deficit by EU definition was 1.1 percentage points higher than by IMF definition. Fiscal commitments are to a large extent payment arrears the government accumulated to meet the deficit target agreed with the IMF. The government promised the Fund to reduce these arrears but has been unable to meet that target.

IMF, the fiscal deficit would have soared to above 9% of GDP had no action been taken. Such a gap could not have been financed under the current programme. An amendment of the fiscal target was agreed with the IMF in May 2010 to keep the deficit below 6.8% of GDP. This is still higher by almost one percentage point than stipulated in the budget law but demanding austerity in the current circumstances.

A debate unfolded whether the fiscal deficit should be curtailed by cutting expenditures or by increasing revenues. The government, in agreement with the business sector, declared that they were against revenue-side measures and advocated general expenditure cuts in the public sector. Wages in the public sector were cut by 25%, and as of 1 July 2010 pensions and unemployment benefits had to be cut by 15%. The lowest wage in the economy of RON 600 (EUR 144) per month and the minimum guaranteed pension of RON 350 were kept intact. (Just eight months before, word was still about increasing the minimum pension to RON 500.) The measures do not apply to the state-owned companies. Their employees' wages have only been frozen. The state will also eliminate subsidies to district heating and tax allowances on companies' food stamps. Unions announced a general strike on indefinite term beginning on 31 May and affecting all main public sectors – education, healthcare and public administration – but they were not sufficiently organized to really challenge the government. Also the non-confidence vote in Parliament failed, thus the measures could have been implemented had the constitution court not voted against the reduction of pensions on 25 June. As these measures could not be implemented, the government decided to increase value-added tax from 19% to 24%.

Owing to the new measures at least the cost of borrowing can be earned for the current year. In 2010, Romania is due to pay interests and commissions on its public foreign debts amounting to approximately EUR 2 billion. Estimates indicate that thanks to the austerity measures the government will reduce expenses on public sector employees by EUR 1.3 billion in the second half of the year and earn by the increasing VAT revenues another EUR 1-1.3 billion. On the whole, the government opted for a simple solutions and not for sophisticated and more cumbersome reforms of the inefficient public administration. Cutting employment and salaries across the board without introducing structural reforms may increase bottlenecks in public services and related costs for the business sector. The austerity impact will affect the whole economy as lower government expenditures will lead to a further fall of domestic demand. The VAT surge will add to inflation and further curtail demand.

The government also decided to enforce new measures aimed at curbing tax evasion. On 1 August, the authorities will suspend the licences of customs warehouse operators and will issue new ones to those that have no debts towards the state budget and pay a guarantee. Credit institutions will have to provide the National Agency for Fiscal Administration with data about the cash flows and/or balances of the accounts they manage, and to inform it whether they leased safe-boxes to creditors. Financial Guard commissaries and Customs Authority employees will see their powers extended to fight tax evasion.

Revenue shortfalls to the budget were first of all due to the mounting financial problems of companies. Also banks have made increasing provisioning for the rapidly increasing bad debts as the insolvency of companies soared. But interest rates on new loans declined in the first half of the year while the credit volume contracted in real terms. The National Bank reported that in April 2010, 4.7% of the debts was past-due against 2.4% a year earlier. The number of debtors shrank by 3.8%, but those in default increased by 16% year on year. The share of non-performing loans (overdue by 90 days or more) in total loans increased from 18.5% in April 2009 to over 25% in January 2010 and has stayed on that very high level through April (the highest among the CESEEs). Meanwhile the banks have increased their prudential indicator (solvency ratio) to 15% against the minimum requirement of 8%. While the banking sector seems to be able to cope with the impacts of the crisis, the domestic market oriented non-financial private sectors face more hardship to come.

Romania’s external financing underwent radical changes in 2009 and further in the first quarter of 2010. The adjustment of the current account took place by a sharp improvement of the trade balance, last year by import adjustments, in 2010 by an export boom. Despite lower deficits on goods and services in the first quarter of 2010 than one year before, the current account deficit increased due to subsiding current transfers in which remittances of Romanians working abroad declined by 35%. While in 2008 remittances amounted to 3.6% of GDP, they fell to 2.9% in 2009 and may further go down to 1.6% in 2010. Remittances are missing not only in the current account but also in households’ income available for private consumption. On the financial account Romania was in a dire position in 2009 when FDI and the IMF-led loan package provided by and large the only positive inflow positions. In the first quarter of 2010 portfolio investments and foreign deposits returned while direct investments declined. These items were more than enough to finance the current account deficit. The disbursed tranche of the IMF loan added, the National Bank’s reserves were stocked up by EUR 3 billion. Some of these reserves were depleted in the second quarter in the absence of a new IMF tranche.

2010 growth expectations for the Romanian economy have been adjusted downwards. In April, the IMF, unisono with the Romanian government and the EU Commission, revised its forecast to +0.8% compared to the earlier estimate of 1.3%. A month later, IMF representatives predicted a slump of the economy by 0.5% compared to 2009. This is now the official government forecast as well, which underlies the budget rectification including the austerity measures. The wiiw forecast of February 2010 predicted a stagnation of GDP which is now revised to -1%. Also the growth in the coming two years has been revised downwards. The main reason for the downward adjustment is fiscal austerity not only in Romania with its negative effects on consumption in the country, but also across the EU which will curtail demand there and thus export possibilities for Romania. Unemployment is modestly rising but its rate will remain below 9% in 2010. Inflation is at about 4% annually and cannot subside mostly due to government-initiated price rises (subsidies for district heating and energy are to be phased out) and rising import prices. The current account deficit will increase to about 6% of GDP which is within the foreseeable financial limits of the country. As for 2011, most outside observers including the IMF expect a strong rebound of the Romanian economy based on optimistic international expectations. In our view, the recovery will turn out less robust. The domestic demand factors may recover only hesitantly while even a minor recovery will provoke a negative contribution of net exports.

Table RO

Romania: Selected Economic Indicators

	2006	2007	2008	2009 [1]	2009	2010	2010	2011	2012
					1st quarter			Forecast	
Population, th pers., average	21588	21547	21514	21482	.	.	21460	21440	21410
Gross domestic product, RON mn, nom.	344651	416007	514654	491274	96617	96707	510700	539100	583000
annual change in % (real)	7.9	6.3	7.3	-7.1	-6.2	-2.6	-1	1.5	3
GDP/capita (EUR at exchange rate)	4500	5800	6500	5400	.	.	.	.	.
GDP/capita (EUR at PPP)	9100	10400	12000	10600	.	.	.	.	.
Consumption of households, RON mn, nom.	233135	273418	327882	301416	65913	65017	.	.	.
annual change in % (real)	12.9	12.0	9.5	-10.9	-12.3	-4.8	-2	1	2
Gross fixed capital formation, RON mn, nom.	88272	125645	164264	125826	22995	16613	.	.	.
annual change in % (real)	19.9	30.3	16.2	-25.3	2.7	-28.9	-10	5	10
Gross industrial production [2]									
annual change in % (real)	9.3	10.3	2.6	-5.5	-13.0	4.1	4	5	7
Gross agricultural production									
annual change in % (real)	2.4	-17.7	21.2	-1.1	.	.	.	.	.
Construction industry [2]									
annual change in % (real)	15.4	33.2	26.7	-15.0	2.7	-20.9	.	.	.
Employed persons - LFS, th, average	9291.2	9353.3	9369.1	9243.5	9038.6	.	9150	9150	9200
annual change in %	1.9	0.7	0.2	-1.3	-0.9	.	-1	0	1
Unemployed persons - LFS, th, average	728.4	640.9	575.5	680.7	666.1	.	.	.	
Unemployment rate - LFS, in %, average	7.3	6.4	5.8	6.9	6.9	.	8.5	8	6
Reg. unemployment rate, in %, end of period	5.2	4.0	4.4	7.8	5.6	8.4	.	.	.
Average gross monthly wages, RON	1146.0	1396.0	1761.0	1887.1	1865.7	1993.7	.	.	.
annual change in % (real, net)	9.0	14.7	16.5	2.0	9.3	0.9	.	.	.
Consumer prices (HICP), % p.a.	6.6	4.9	7.9	5.6	6.8	4.6	4	3	4
Producer prices in industry, % p.a.	9.5	7.5	15.3	1.8	5.7	3.5	.	.	.
General governm.budget, EU-def., % GDP									
Revenues	33.1	33.5	32.1	32.1	.	.	.	.	.
Expenditures	35.3	36.0	37.6	40.4	.	.	.	.	.
Net lending (+) / net borrowing (-)	-2.2	-2.5	-5.4	-8.3	.	.	-8	-7	-6
Public debt, EU-def., in % of GDP	12.4	12.6	13.3	23.7	.	.	27	31	33
Discount rate of NB, % p.a., end of period [3]	8.75	7.50	10.25	8.00	10.1	7.3	.	.	.
Current account, EUR mn	-10220	-16758	-16178	-5167	-910	-1504	-7000	-9000	-11000
Current account in % of GDP	-10.5	-13.4	-11.6	-4.5	-4.0	-6.4	-5.8	-6.8	-7.5
Exports of goods, BOP, EUR mn	25953	29542	33656	29124	6601	7879	33200	36500	40900
annual growth rate in %	16.6	13.8	13.9	-13.5	-19.0	19.4	14	10	12
Imports of goods, BOP, EUR mn	37765	47365	52729	35907	8148	9048	39500	43500	49600
annual growth rate in %	25.6	25.4	11.3	-31.9	-33.9	11.0	10	10	14
Exports of services, BOP, EUR mn	5585	6885	8751	7012	1678	1341	6300	6300	6900
annual growth rate in %	36.2	23.3	27.1	-19.9	-12.6	-20.1	-10	0	10
Imports of services, BOP, EUR mn	5581	6475	8091	7367	1743	1613	6600	6600	7300
annual growth rate in %	25.4	16.0	25.0	-8.9	-2.0	-7.5	-10	0	10
FDI inflow, EUR mn	9060	7280	9501	4528	1475	754	3500	.	.
FDI outflow, EUR mn	338	206	186	158	4	38	.	.	.
Gross reserves of NB excl. gold, EUR mn	21299	25325	25977	28303	25121	32037	.	.	.
Gross external debt, EUR mn	41196	58628	72354	80200	71500	86034	.	.	.
Gross external debt in % of GDP	40.4	50.8	56.6	69.2	61.7	70.8	.	.	.
Average exchange rate RON/EUR	3.5258	3.3353	3.6826	4.2399	4.2682	4.1148	4.2	4.1	4.0
Purchasing power parity RON/EUR	1.7600	1.8621	1.9869	2.0739	.	.	.	.	.

Note: Gross industrial production, construction output and producer price index refer to NACE Rev. 2.

1) Preliminary. - 2) Enterprises with 4 and more employees. - 3) Reference rate of NB.

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