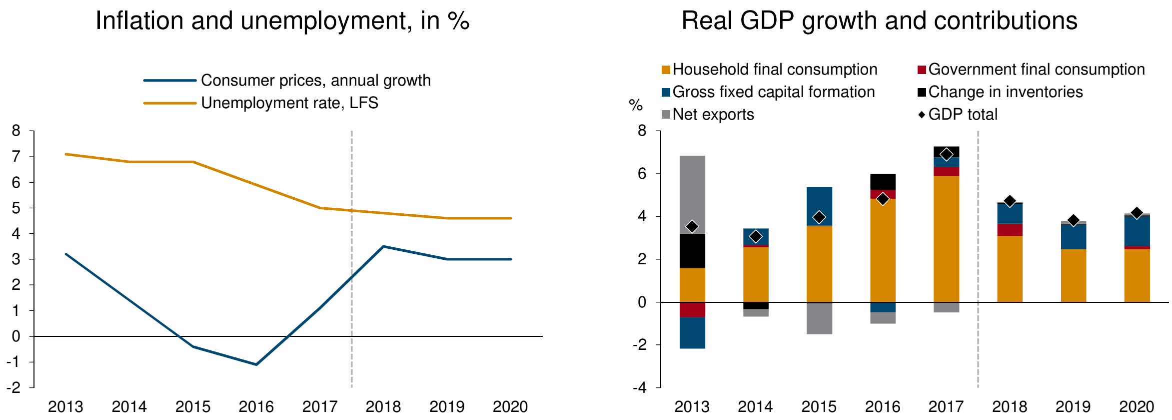
ROMANIA: Down from the peak

GÁBOR HUNYA

Economic growth in Romania is expected to decline from close to 7% last year to 4.7% in 2018, and even lower in the following two years. Fiscal imbalances will trigger restrictive policies. Household consumption will remain the main growth driver, while investments are expected to recover slowly and the current account deficits to shrink modestly. Political instability and unpredictable structural reforms will continue to put a drag on the economy, elevating investment risk.

Figure 55 / Romania: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

The Romanian economy will descend from the peak and grow much more slowly in 2018 than the year before. The extraordinary growth rate of 6.9% in 2017 increased the base level for subsequent years, but external demand has improved and the expectations of business are positive; thus the 2018 wiiw forecast has been adjusted slightly upwards, to 4.7%. Last year, pro-cyclical fiscal measures stimulated a boom in household consumption, while gross fixed capital formation almost stagnated. Demand on the main foreign markets expanded, pulling up production in manufacturing. A deterioration in the external balance occurred in the wake of surging imports of consumer goods and despite rapidly rising exports; thus net exports made a negative contribution to GDP growth. In the real sector, industry attained a high rate of output growth (8.2%), while construction contracted (-5.4%). A bumper harvest (agricultural production +10.3%) added to the amount of available goods and stimulated on-farm consumption.

Investments, which grew very modestly in 2017, need to be revamped. Public investments declined, as did private investments in buildings. There were delays to infrastructure investment, including motorway construction which is badly needed to clear major bottlenecks. At the same time, bullish investments in machinery and equipment supported an increase in labour productivity. A change in the public procurement law and a new organisation of EU project implementation are expected to bring better access to EU funds in the future. But budgetary resources may still fall short of requirements, if investment expenditures again fall victim to deficit balancing.

With economic growth probably slower than expected by the government, the fiscal deficit will widen to beyond 3% of GDP and austerity measures will be demanded by the EU Commission. The 2018 budget law is based on an over-ambitious assumption of 5.5% GDP growth and 3% of GDP budget deficit (the spring 2018 forecast of the National Commission of Forecasting for GDP growth in 2018 is even higher, at 6.1%). In 2017, the consolidated budget deficit reached 2.9% of GDP – marginally less than expected, but well above the level of 2016. Revenues went up by 12.5% and expenses by 14% in current RON terms. Public investments were sacrificed (10.5% less than in 2016 and 33% less than provided for under the 2017 budget law) to keep expenditure under control and to finance public sector wage rises. On the revenue side, the state failed to draw the estimated amount of EU funds, but compensated for this by extracting dividends from state-owned companies, thus blocking their investment plans. Personal income taxation was reformed as of 1 January 2018, shifting the total social security contribution to gross wages and simultaneously reducing the flat tax from 16% to 10%. At the same time, the minimum gross wage increased from RON 1,450 to RON 1,900 (EUR 408). Income from dividends will continue to be taxed at 5%, but will also be subject to a 10% health insurance contribution.

The overall effect of the 2018 changes to the personal income tax system is expected to be net-wage neutral. The government does not plan major wage increases in the public sector of the sort seen in previous years. But there will be carryover effects from the hikes last year. Wages in the private sector may rise due to labour shortages, as reflected in trade union demands. In view of inflation climbing above 3%, the net wage increase may turn out to be meagre and may put the brakes on household consumption. This is a major change compared with the growth scenario in the two previous years.

Consumer price inflation is expected to peak in the middle of 2018 at well over 4%, then moderate to 3%, provided commodity prices do not surge. The cyclical element of inflation is the result of excess demand, and also of rising import prices leading to year-on-year consumer price inflation of 4.3% in January 2018. Government-managed energy prices have increased, as these are tied to the import price of gas and oil (with some delay). In response, the National Bank of Romania (BNR) has hiked the monetary policy rate twice already in 2018 – by 0.25 percentage points each time – to 2.25%, leaving it negative in real terms. The BNR has stated that it will not push for a tightening in the monetary conditions, but has called for fiscal action to cool the economy.

The economic upturn has had positive labour market effects, which could stabilise over the next few years. The number of employed persons grew and the activity rate increased to above 66% of the working-age population – a trend that may remain. The unemployment rate is set to fall to just below 5% in 2018. Labour shortages are widely present, demand being especially buoyant for a skilled workforce. Combined with higher wages, this may reduce the push to emigrate. The government will allow 7,000 new non-EU foreigners into the Romanian labour market in 2018, a 40% increase over the previous year.

Exports and imports are expected to grow more slowly in 2018 than in the previous year, while the contribution of net exports to GDP will turn slightly positive. Exports will expand on account of rising demand on the main markets, while slower expansion in household demand will put the brakes on imports. In 2017, high demand in Europe stimulated goods exports, which grew by 9.5% in current euro terms, while the domestic demand surge triggered an import increase of 12.6%. Even the imports of services grew more rapidly than exports for the first time in many years, especially on the transport and travel accounts. The current account deficit of 3.5% of GDP in 2017 will come down to 3% over the forecast period. About two-thirds of it can comfortably be financed by the inflow of FDI.

Government instability will continue, despite the reshuffle in January 2018. The coalition led by the Social Democratic Party (PSD) enjoys a majority in both houses of parliament after the election of December 2016. The recurring government crisis (three prime ministers in one year) is the result of infighting within the PSD. Party boss Liviu Dragnea wants to rule over the government, which leads to tensions with the prime minister. Also the conflict between the National Anti-corruption Directorate (DNA) and the government is set to continue, as the DNA will continue prosecuting PSD politicians and has Mr Dragnea as its ultimate target. At the same time, DNA chief prosecutor Laura Codruța Kövesi is being investigated by the Judicial Inspection for possible misconduct, despite the support of President Iohannis and Western embassies.

Investors and business perceive an elevated political risk, as government instability may lead to economic destabilisation. Ten-year government bond yields rose from an average of 3.8% in the first half of 2017 to 4.4% in the last quarter and through January 2018. (In comparison, Hungarian bonds were traded at 3.5% in the first quarter of 2017, falling to 2% in January 2018.) Direct investors have not become hesitant yet, as the conditions for doing business are relatively good. Romania ranks 45th on the World Bank's Ease of Doing Business index, just ahead of Italy and Hungary. In addition, the European growth cycle is generating demand for Romanian exports, although this is expected to subside in 2019. Machinery investments are expected to remain strong and FDI inflow may stay in the range of EUR 4.5 billion.

Economic growth will hover at around 4% over the coming two years. The precondition for this is that the country manages to shift the growth driver from consumption to investments. Export expansion will slow when EU growth subsides, but imports may grow even less, and net exports could make a marginally positive contribution. External and fiscal imbalances will persist, but will not present a danger of serious instability. Some fiscal austerity will become necessary, which will curtail GDP growth to 3.9% in 2019. Government plans for further cuts in the VAT rate will most probably be abandoned. Access to EU funds may accelerate in the later years when funds under the current financing period can be drawn (2020-2022), which may boost GDP growth above 4% again.

Table 25 / Romania: Selected economic indicators

	2013	2014	2015	2016	2017 1)	2018	2019 Forecast	2020
Population, th pers., average	19,984	19,909	19,815	19,699	19,650	19,600	19,500	19,400
Gross domestic product, RON bn, nom.	637.5	668.1	712.7	762.3	850.0	910	960	1,020
annual change in % (real)	3.5	3.1	4.0	4.8	6.9	4.7	3.8	4.2
GDP/capita (EUR at PPP)	14,600	15,200	16,300	17,000	18,200	.	.	.
Consumption of households, RON bn, nom.	385.5	406.4	433.1	471.6	540.0	.	.	.
annual change in % (real)	2.6	4.2	5.8	7.9	9.5	5.0	4.0	4.0
Gross fixed capital form., RON bn, nom.	157.5	162.4	176.3	175.1	185.0	.	.	.
annual change in % (real)	-5.4	3.2	7.4	-2.0	2.0	4.0	5.0	6.0
Gross industrial production 2)								
annual change in % (real)	7.8	6.1	2.8	1.7	8.2	6.0	5.0	4.0
Gross agricultural production								
annual change in % (real)	24.5	2.9	-6.8	2.5	10.3	.	.	.
Construction industry 2)								
annual change in % (real)	-0.6	-6.7	10.3	-4.8	-5.4	.	.	.
Employed persons, LFS, th, average	8,549	8,614	8,535	8,449	8,660	8,830	8,960	9,050
annual change in %	-0.7	0.8	-0.9	-1.0	2.5	2.0	1.5	1.0
Unemployed persons, LFS, th, average	653	629	624	530	460	450	430	440
Unemployment rate, LFS, in %, average	7.1	6.8	6.8	5.9	5.0	4.8	4.6	4.6
Reg. unemployment rate, in %, eop	5.7	5.4	5.0	4.8	4.0	.	.	.
Average monthly gross wages, RON 3)	2,163	2,328	2,555	2,809	3,225	4,400	4,700	5,000
annual change in % (real, gross)	0.8	6.5	10.4	11.7	13.3	.	4.0	4.0
Average monthly net wages, RON	1,579	1,697	1,859	2,046	2,337	2,500	2,700	2,900
annual change in % (real, net)	0.8	6.4	10.1	11.8	12.7	5.0	4.0	4.0
Consumer prices (HICP), % p.a.	3.2	1.4	-0.4	-1.1	1.1	3.5	3.0	3.0
Producer prices in industry, % p.a.	2.0	-0.2	-2.4	-1.9	3.7	2.0	2.0	2.0
General governm.budget, EU-def., % of GDP								
Revenues	33.3	33.5	34.9	31.0	33.0	30.0	31.0	31.0
Expenditures	35.4	34.9	35.7	34.0	36.0	33.5	34.0	33.5
Net lending (+) / net borrowing (-)	-2.1	-1.4	-0.8	-3.0	-3.0	-3.5	-3.0	-2.5
General gov.gross debt, EU def., % of GDP	37.8	39.4	37.9	37.6	36.7	37.7	38.7	38.9
Stock of loans of non-fin.private sector, % p.a.	-3.4	-3.7	2.5	0.9	5.1	.	.	.
Non-performing loans (NPL), in %, eop	21.9	13.9	13.5	9.6	7.4	.	.	.
Central bank policy rate, % p.a., eop 4)	4.00	2.75	1.75	1.75	1.75	2.75	3.00	3.00
Current account, EUR mn	-1,542	-1,004	-1,977	-3,496	-6,463	-6,600	-6,500	-6,400
Current account, % of GDP	-1.1	-0.7	-1.2	-2.1	-3.5	-3.4	-3.2	-3.0
Exports of goods, BOP, EUR mn	43,893	46,839	49,111	52,164	57,100	61,700	66,000	70,000
annual change in %	10.1	6.7	4.8	6.2	9.5	8.0	7.0	6.0
Imports of goods, BOP, EUR mn	49,709	53,375	56,896	61,412	69,128	74,700	80,300	85,500
annual change in %	1.2	7.4	6.6	7.9	12.6	8.0	7.5	6.5
Exports of services, BOP, EUR mn	13,434	15,104	16,640	18,006	20,576	22,800	25,300	27,800
annual change in %	36.1	12.4	10.2	8.2	14.3	11.0	11.0	10.0
Imports of services, BOP, EUR mn	8,733	9,236	9,849	10,284	12,613	13,900	15,000	16,200
annual change in %	18.1	5.8	6.6	4.4	22.6	10.0	8.0	8.0
FDI liabilities, EUR mn	2,894	2,931	3,885	5,656	4,380	.	.	.
FDI assets, EUR mn	-24	227	930	1,143	-197	.	.	.
Gross reserves of NB excl. gold, EUR mn	32,525	32,216	32,238	34,242	33,494	.	.	.
Gross external debt, EUR mn	98,069	94,744	92,069	92,910	93,954	98,000	100,000	103,000
Gross external debt, % of GDP	68.0	63.0	57.4	54.7	50.5	50.1	49.0	48.0
Average exchange rate RON/EUR	4.4190	4.4437	4.4454	4.4904	4.5688	4.65	4.70	4.75

1) Preliminary and wiiw estimates. - 2) Enterprises with 4 and more employees. - 3) In 2018 the social security contribution paid by employers was added to gross wages increasing the latter by 25%. - 4) One-week repo rate.

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