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## **Romania: growth slowdown, expanding external imbalance**

Economic growth, while decelerating in the first quarter of 2007, was still fairly strong at 6% against the same period of 2006. Increasing overheating and external instability constitute a serious macroeconomic challenge: domestic demand expanded by close to 15% whereas the worsening of the external balance diminished the GDP by almost 9%. Despite the external imbalance the currency keeps appreciating and inflation falling. Fixed capital formation rose by 30.6% and construction output by 17.2% in the first quarter of the year, to a large extent due mild weather. Investments were made primarily in new constructions such as roads and urban real estate development while investments in equipment hardly increased. At the same time, the growth of the services sector – which contributes 60% to the GDP – decelerated as a sign of consolidation following years of rapid expansion in the wake of the privatization of this sector.

Manufacturing growth benefits from the investments made in the past two years and is undergoing rapid structural change. In the first four months of the year, output increased by 8.1% and labour productivity was 12% higher than one year earlier. The once very strong clothing industry is one of the main losers, together with petroleum refining and machine building. Expanding branches include, next to construction materials, the production of household electronics and cars. These changes are also reflected in the export structure. The currently sluggish investments in machinery and equipment and modest manufacturing sector FDI suggest that restructuring in manufacturing will continue without generating accelerated growth in the coming year.

The fiscal policy was relaxed in mid-2006 and the 2007 government target foresees a 2.8% deficit to GDP ratio according to the Romanian methodology and 3.2% according to EU methodology. In Romania the fiscal deficit is usually registered in December while during the year the budget is in surplus. 2007 deviates from this rule: in the first quarter the general government budget recorded a deficit of 0.7% of GDP (national methodology). The relaxation was explained by the financial needs of infrastructure development and the co-financing of EU projects, but also wages in the public sector expanded more strongly than envisaged by the government.

The deterioration of the foreign trade balance in the first quarter of 2007 was worse than expected: the deficit amounted to more than 14% of GDP. As known from the experience of other NMS in 2004, EU accession triggers a sudden increase in imports part of which is due to methodological changes. Also in the case of Romania it was imports from the EU that soared, by 41%, in the first quarter of the year while exports to this area rose by a modest 13%.

Further to commodity trade, a deficit on the current account is produced by increasing profits of the foreign sector as well as by interest payments. The increase in these items could only partially be compensated by remittances. In lack of large privatization revenues, FDI will be lower in 2007 than a year earlier. Portfolio and other capital inflows are of increasing significance in financing the current account deficit, or at least National Bank reserves will grow at a much slower pace than previously. The National Bank has given up its endeavour to curtail the credit expansion: the reference interest rate has been decreased by one percentage point during 2007, to 7.5% in May, back to the level of early 2006, and administrative restrictions have been abolished. This resulted in no surge of credits but in lower interest margins.

There has been a prolonged constitutional and governmental crisis in Romania that has set back the reform process. Measures to fight corruption and to operate the agricultural payment system have been delayed. On 27 June the European Commission presented its report on the progress of Romanian (and Bulgarian) reforms after EU accession. It did not suggest the application of safeguard clauses on the country, but left it dependent on the results of another assessment in October. This year much of the EU funds coming to Romania are still those related to pre-accession programmes. The exception is agriculture, which may lose – according to the safeguard clause – 25% of the envisaged EUR 742 million for 2007, and even the payment of the reduced fund may be postponed to next year.

The 2007 wiiw forecast for economic growth has been corrected half a percentage point downward in light of the first quarter data: 6% growth in 2007 and 5.5% in 2008. Both figures are lower than the prognosis of the Romanian government which has also been adjusted downwards (to 6.5% and 6.3% respectively) and also below those of the European Commission and the IMF. More modest optimism can be justified by the performance of agriculture and the external deficits. Agriculture has always been the dark horse of growth forecasts for Romania. The 2007 harvest looks worse than last year due to continuing drought and the bad shape of the irrigation system. This may cause lower GDP growth this year than our current forecast which may in turn be compensated next year.

The wiiw forecast concerning the current account deficit has usually been more pessimistic than the government's prognosis. That attitude has been justified by facts in the past few years including the current one. For 2007 we again forecast much stronger growth of imports than of exports. The deficit is the result of high capital inflows which trigger currency appreciation. As a positive side-effect, inflation declines. The question is how long the widening external imbalance will be sustainable, particularly in case of turbulence on international markets. The wiiw forecast indicates some likelihood of an adverse development. For 2008 we expect increasing inflation and some currency depreciation together with a further slowdown of economic growth. Economic policy will remain lax, with

reforms being delayed and fiscal control weakening as the absence of a government with strong parliamentary majority and presidential support seems to be lasting.

With adequate policies the country could soon fulfil the Maastricht criteria of which it misses only the inflation target. However, setbacks may occur if the current fiscal relaxation goes on and the government-controlled gas prices rise in 2008. The National Bank's caution concerning the introduction of the euro is justified; it envisages to join the ERM II not before 2012 and to adopt the euro two years later. In the short term priority will be given to real convergence and to achieving a sustainable exchange rate at a much lower current account deficit (and, eventually, a balanced current account).

Table RO

## Romania: Selected Economic Indicators

	2002	2003	2004	2005	2006 <sup>1)</sup>	2006 1st quarter	2007	2007 forecast	2008 forecast
Population, th pers., mid-year	21794.8	21733.6	21673.3	21623.8	21584.4	.	.	.	.
Gross domestic product, RON mn, nom. <sup>2)</sup>	151475.1	197564.8	246468.8	288047.8	342418.0	60985.7	68498.6	388000	438000
annual change in % (real) <sup>2)</sup>	5.1	5.2	8.5	4.1	7.7	6.9	6.0	6.0	5.5
GDP/capita (EUR at exchange rate) <sup>2)</sup>	2224	2420	2806	3676	4501	.	.	.	.
GDP/capita (EUR at PPP - wiiw) <sup>2)</sup>	6060	6510	7400	8030	9000	.	.	.	.
Gross industrial production									
annual change in % (real)	4.3	3.1	5.3	2.0	7.1	4.7	7.6	6	6
Gross agricultural production									
annual change in % (real)	-3.5	7.5	18.0	-13.1	0.7	.	.	.	.
Construction output total									
annual change in % (real)	10.0	9.8	9.2	9.5	19.3	20.9	30.6	.	.
Consumption of households, RON mn, nom. <sup>2)</sup>	102671.0	128150.4	167244.7	196354.2	235136.7	46739.0	54086.9	.	.
annual change in % (real) <sup>2)</sup>	5.3	8.5	14.5	9.7	14.1	12.0	12.1	10	8
Gross fixed capital formation, RON mn, nom. <sup>2)</sup>	32283.6	42293.0	53850.3	66503.8	84260.3	9972.6	12787.2	.	.
annual change in % (real) <sup>2)</sup>	8.2	8.5	11.1	12.6	16.1	11.3	17.2	14	10
LFS - employed persons, th, avg. <sup>3)</sup>	9234.3	9222.5	9157.6	9146.6	9313.3	9028.6	.	.	.
annual change in %	.	-0.1	-0.7	-0.1	1.8	0.9	.	.	.
Reg. employees in industry, th pers., avg.	1891.0	1848.0	1741.0	1672.0	1610.0	.	.	.	.
annual change in %	-0.5	-2.3	-5.8	-4.0	-3.7	-4.0	-4.4	.	.
LFS - unemployed, th pers., average <sup>3)</sup>	845.3	691.8	799.5	704.5	728.4	762.5	.	.	.
LFS - unemployment rate in %, average <sup>3)</sup>	8.4	7.0	8.0	7.1	7.2	7.8	.	7	7
Reg. unemployment rate in %, end of period	8.4	7.4	6.3	5.9	5.2	6.2	4.9	5	5
Average gross monthly wages, RON	532.1	663.8	818.3	968.0	1150.0	1072.7	1286.7	.	.
annual change in % (real, net)	2.4	10.8	10.6	14.3	9.6	5.9	14.3	.	.
Consumer prices, % p.a.	22.5	15.3	11.9	9.0	6.6	8.6	3.8	4.0	4.5
Producer prices in industry, % p.a.	23.0	19.5	19.1	10.5	11.6	10.9	9.4	8	8
General governm.budget, EU-def., % GDP <sup>4)</sup>									
Revenues	37.6	32.1	31.1	32.4	30.1	.	.	.	.
Expenditures	39.6	33.6	32.6	33.7	32.0	.	.	.	.
Deficit (-) / surplus (+)	-2.0	-1.5	-1.5	-1.4	-1.9	.	.	-3.5	-4.0
Public debt, EU-def., % of GDP <sup>4)</sup>	23.8	21.5	18.8	15.8	12.4	.	.	.	.
Discount rate, % p.a., end of period	20.4	20.4	18.0	7.5	8.8	8.5	8.1	.	.
Current account, EUR mn	-1623	-3060	-5099	-6888	-9973	-1358	-3055	-15000	-15000
Current account in % of GDP	-3.3	-5.8	-8.4	-8.7	-10.3	-7.9	-15.1	-13.0	-11.6
Gross reserves of NB excl. gold, EUR mn	5877	6374	10848	16799	21310	18146	21530	.	.
Gross external debt, EUR mn	16200	17835	21504	31093	41422	.	43634	.	.
Gross external debt in % of GDP	33.4	33.9	35.4	39.1	42.6	.	.	.	.
FDI inflow, EUR mn	1212	1946	5183	5213	9082	1965	1312	7000	7000
FDI outflow, EUR mn	18	36	56	-24	31	33	-3	.	.
Exports of goods, BOP, EUR mn	14675	15614	18935	22255	25850	6218	7102	29700	34200
annual growth rate in %	15.4	6.4	21.3	17.5	16.2	22.0	14.2	15	15
Imports of goods, BOP, EUR mn	17427	19569	24258	30061	37609	7910	10290	47000	54100
annual growth rate in %	8.6	12.3	24.0	23.9	25.1	28.5	30.1	25	15
Exports of services, BOP, EUR mn	2468	2671	2903	4102	5513	1264	1772	7440	9300
annual growth rate in %	8.6	8.2	8.7	41.3	34.4	60.0	40.2	35	25
Imports of services, BOP, EUR mn	2463	2609	3116	4451	5507	1177	1599	7160	8590
annual growth rate in %	2.5	5.9	19.4	42.8	23.7	29.5	35.9	30	20
Average exchange rate RON/USD	3.3055	3.3200	3.2637	2.9137	2.8090	2.9624	2.5820	.	.
Average exchange rate RON/EUR (ECU)	3.1255	3.7556	4.0532	3.6234	3.5245	3.5641	3.3818	3.36	3.40
Purchasing power parity RON/USD	0.9893	1.1811	1.2962	1.3917	1.4816	.	.	.	.
Purchasing power parity RONEUR	1.1473	1.3955	1.5371	1.6590	1.7627	.	.	.	.

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

1) Preliminary. - 2) According to ESA'95 (from 2003 FISIM adjusted and real change based on previous year prices). - 3) From 2002 break in methodology. - 4) According to ESA'95, excessive deficit procedure.

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