Romania: Investment slump and consumption boom

GÁBOR HUNYA

Expanding private consumption and a good harvest softened the economic slowdown generated by an investment slump. Further slowdown is expected in 2015, should there be no major turnaround in terms of investments. Increased political and economic stability will benefit longer-term economic growth, yielding an increase of some 3%.

GDP growth fell back in 2014 as compared to a very strong previous year but the country was still among the good performers in the EU. Private consumption boomed due to expanding real wages supported by both nominal wage expansion and subdued inflation. Investments, both public and private, declined as part of fiscal austerity on the one hand and due to further credit squeeze on the other. Exports continued their upward trend ahead of imports but the contribution of net exports to economic growth shrank compared to previous years. The forecast for annual GDP growth in 2015-2017 ranges between 2.5% and 3.0% depending on the robustness of the likely turn-around in investments and on harvest results. We take a conservative stance for 2015 in both respects.

Fiscal policy can at least in part be blamed for the investment slump. The deficit reduction was especially harsh in 2014 (amounting to 1.4% of GDP, cash-based) which is to be eased to 0.13% of GDP in 2015. The budget for 2015 aims at achieving a deficit of 1.45% of GDP (ESA 2010 based) following about 2% in 2014. The 2015 budget law stipulates significantly higher spending on investments than the previous year while total expenditures should be lower by economising on staff. Also revenues should contract as a result of a 5 percentage points cut in the social security contribution introduced last November. The aim of the measure is to lower wage costs and thereby increase the competitiveness of enterprises. Personal income tax revenues should increase, nevertheless, due to higher minimum wages and wage adjustments in the public sector.

The 2015 deficit target is based on Romania's Medium-Term Objective (MTO), an obligation under the preventive arm of the EU Stability and Growth Pact and the IMF precautionary stand-by agreement to reach a 1% structural deficit this year. In this context, Romania has one of the most disciplined fiscal policies in the EU especially in view of the country's modest public debt of less than 40% of GDP. One can hardly find proper arguments to defend intense austerity when economic growth is below 3% mainly as a result of contracting public investment. During the negotiations with the IMF in early February, Finance Minister Valcov tried in vain to postpone the MTO in order to gain more room for increasing public investment without cutting the public sector wage bill. The IMF mission ended without an agreement only because of differing opinions on gas price liberalisation for households and the streamlining of a metallurgy plant. The agreement stays valid, nevertheless, and the next mission is due in April this year.

Cumbersome public procurement has been one of the main causes of Romania's inability to benefit from EU structural funds. At the end of 2014 the rate of utilisation of the structural and cohesion funds reached only 52% and Prime Minister Ponta announced the government's goal to achieve 75-80% in 2015. This means that about one quarter of the amount allocated for the 2007-2013 financing period will be lost for the country. Institutional capacity is still inadequate to manage large infrastructure projects. In addition, procedures are often blocked as civil servants avoid passing decisions in fear of ex-post investigations for breaching public interest which is a side-effect of the current anti-corruption campaign.

Success in fighting corruption has been verified by the European Commission. The anti-corruption agency (DNA) investigates against scores of former and current high public officials and business persons inter alia for influence peddling, bribe taking/giving and using bribe money for party financing. If the political and economic life gets finally cleansed, conditions for doing business would improve. Some of the allegations of prosecutors might be exaggerated, however. In a most controversial case the court sentenced two ex-ministers and several foreign consultants for espionage and treason related to planned privatisations which never took place. There may also be a touch of political bias: last year investigations targeted mainly politicians in or around former socialist-led governments, while the supporters of former President Basescu are the more recent targets.

Monetary policy has been easing for more than a year now. In view of falling inflation the National Bank of Romania (BNR) cut the monetary policy rate in several steps, from 4% in December 2013 to 2.25% in February 2015. In addition, minimum reserve requirements have been lowered and the spread for the permanent deposit facility reduced. Money market rates have been even lower than the BNR policy rate. Although commercial interest rates subsided both in nominal and in real terms, lending has not increased. Commercial banks used the new liquidity to return credits to parent banks while some of the funds returned as equity (FDI) to increase the capital adequacy ratio. Banks have also taken steps to work out non-performing loans by writing them off or selling them at a discount, and have converted some foreign currency loans into domestic RON. As a result, the banking sector's exposure to non-performing loans declined. While the banks suffered losses (EUR 800 million in January-November 2014) the soundness of the banking system increased, at least until the Swiss franc crisis starting in January 2015.

Loans denominated in Swiss francs amounted to RON 9.8 billion (EUR 2.2 billion) at the end of November, 4.3% of total lending affecting about 75,000 borrowers. A few thousand of them marched to the government building demanding an overall relief of the increased instalments. The National Bank's perception is that a conversion at an exchange rate other than the market rate is unconstitutional because it affects commercial banks' capital, and that of the shareholders. BNR and the Romanian Banking Association (ARB) agreed that there were a multitude of specific individual situations thus there was no generally applicable solution. They want to avoid moral hazard but encourage banks to find case-by-case reliefs. The six banks most affected have lowered interest rates and offered credit restructuring schemes to the customers involved.[1] The government plans to provide tax credits for borrowers who agree with banks to extend the term of their loans by two years.

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1 Of the total 75,000 persons that have CHF-denominated loans, 32% are Bancpost (subsidiary of Eurobank, Greece) clients, 24% are clients of Volksbank, 20% of Piraeus Bank, 11% of Raiffeisen, 7% of Banca Romaneasca (subsidiary of the National Bank of Greece) and 2% of OTP Bank. A conversion of the CHF credits into RON at the historical rate would generate RON 5.7 billion in losses (0.8% of GDP), and the conversion of all credits in foreign currency at the historical rate of the moment they were granted would generate RON 9.8 billion in losses (1.4% of GDP).

Further external shocks have had very limited effect on Romania. Trade dependence on Russia and on energy imports is small, thus neither the sanctions nor the oil price slump have changed the economic growth path. Export performance has been shaped by the booming automotive sector and also underpinned by exceptionally high grain and electricity sales. Mild weather played a positive role, hydropower stations could work at full capacity.[2] In addition, energy-intensive industries have suffered downsizing in the past few years. A decisive part of Romanian manufacturing is now anchored in European value chains and can grow ahead of its main trading partners. But the inflow of FDI is weak and despite some minor new manufacturing projects, export capacities do not increase as rapidly as earlier.

Low inflation rates have not led to deflation but moderated expectations. Nominal wages were raised at the beginning of 2014 and further increases followed in the public sector during the year. The resulting rapid real wage growth supported the acceleration of private demand. The pace of consumption growth will most probably decelerate in 2015 as wages will be less dynamic except in the case of minimal wage earners while on-farm consumption will decline. Inflation may pick up somewhat unless a bumper harvest is achieved. The labour market usually reacts only moderately to the business cycle; some modest decrease of unemployment (from the current 7% to 6.5%) is expected under the present economic growth scenario in the coming years.

Political uncertainty has decreased following the presidential elections in November 2014. The new president Klaus Iohannis comes from the opposition of the present government, but he does his work in a more conciliatory manner than his predecessor. His constitutional power is important in appointing the leaders of higher courts and secret services, especially at a time of heated anti-corruption allegations that have discredited a major part of the political and business leaders. Thus moral integrity and mediating power of the president is all the more in demand. He can also be the driving force of constitutional amendments aiming, among other things, at streamlining elected bodies and decentralising administration which may increase the efficiency of public institutions.

The governing socialists have been weakened by internal fights since they lost the presidential elections while the opposition liberals see a chance to join forces and demand early elections. This seems rather unlikely to succeed for the time being. The longer-term economic agenda of the socialist-led government includes further fostering of private consumption including a reduction of the VAT rate from 24% to 20% in 2016. For that to happen, they will need more room for fiscal manoeuvre which can only be granted if Romania graduates from IMF tutorship. Assuming full government responsibility for economic policy may be beneficial for the country, provided they do not slip back to excessive spending as before. EU regulations may now provide the necessary and adequate safeguard. Based on increased economic and political stability and improved governance, Romania would be able to grow ahead of its NMS peers and even faster than indicated in the present forecast of 2.5% to 3%, even more than 3% in terms of real GDP.

[2] In 2014, in the structure of electricity production the share of hydropower was 29%; coal accounted for 28%, nuclear power plants for 18%, hydrocarbons for 12%, wind for 9%, and solar power and biomass for 4%. There has been an important shift to renewable energy in recent years.

Table 1 / Romania: Selected Economic Indicators

	2010	2011	2012	2013	2014 1)	2015	2016 Forecast	2017
Population, th pers., average 2)	20,247	20,148	20,058	19,981	19,930	19,880	19,830	19,780
Gross domestic product, RON bn, nom. 3)	533.9	565.1	596.7	637.6	662.0	700	740	780
annual change in % (real) 3)	-0.8	1.1	0.6	3.4	2.9	2.5	3.0	3.0
GDP/capita (EUR at exchange rate)	6,300	6,600	6,700	7,200	7,500	.	.	.
GDP/capita (EUR at PPP)	12,600	13,100	13,800	14,100	14,700	.	.	.
Consumption of households, RON bn, nom. 3)	331.5	347.7	366.6	384.1	403.0	.	.	.
annual change in % (real) 3)	1.0	1.0	0.8	1.1	4.0	2.0	3.0	3.0
Gross fixed capital formation, RON bn, nom. 3)	138.5	153.0	164.1	151.6	150.0	.	.	.
annual change in % (real) 3)	-2.4	2.9	0.1	-7.9	-3.0	4.0	4.0	4.0
Gross industrial production 4)								
annual change in % (real)	5.5	7.4	2.4	7.8	6.1	4.0	5.0	5.0
Gross agricultural production								
annual change in % (real)	1.0	8.9	-21.9	24.5	1.4	.	.	.
Construction industry 4)								
annual change in % (real)	-13.2	2.8	1.2	-0.4	-6.7	.	.	.
Employed persons, LFS, th, average 5)	9,239	9,138	9,263	9,247	8,600	8,620	8,640	8,670
annual change in %	0.0	-1.1	1.4	-0.2	0.6	0.2	0.2	0.3
Unemployed persons, LFS, th, average 5)	725	730	701	730	650	.	.	.
Unemployment rate, LFS, in %, average 5)	7.3	7.4	7.0	7.3	7.0	6.8	6.7	6.5
Reg. unemployment rate, in %, end of period	7.0	5.2	5.5	5.7	5.2	.	.	.
Average monthly gross wages, RON	1,902	1,980	2,063	2,163	2,278	.	.	.
annual change in % (real, gross)	-2.8	-1.6	0.8	0.8	4.2	.	.	.
Average monthly net wages, RON	1,391	1,444	1,507	1,579	1,661	.	.	.
annual change in % (real, net)	-3.7	-1.9	1.0	0.8	4.1	.	.	.
Consumer prices (HICP), % p.a.	6.1	5.8	3.4	3.2	1.4	2.0	3.0	3.0
Producer prices in industry, % p.a.	4.4	7.1	5.3	2.0	-0.2	.	.	.
General governm.budget, EU-def., % of GDP								
Revenues	33.0	33.7	33.4	32.9	32.7	.	.	.
Expenditures	39.6	39.2	36.4	35.2	34.7	.	.	.
Net lending (+) / net borrowing (-)	-6.6	-5.5	-3.0	-2.2	-2.0	-2.0	-2.0	-2.0
Public debt, EU-def., % of GDP	29.9	34.2	37.3	38.0	39.0	39.0	39.0	38.0
Central bank policy rate, % p.a., end of period 6)	6.25	6.00	5.25	4.00	2.75	.	.	.
Current account, EUR mn 7)	-5,788	-6,186	-6,060	-1,170	-696	-1,000	-1,400	-1,700
Current account, % of GDP	-4.6	-4.6	-4.5	-0.8	-0.5	-0.6	-0.8	-1.0
Exports of goods, BOP, EUR mn 7)	32,714	40,102	39,855	43,905	46,637	49,100	52,300	54,800
annual change in %	35.8	22.6	-0.6	10.2	6.2	5.3	6.5	4.8
Imports of goods, BOP, EUR mn 7)	41,683	49,063	48,779	49,339	52,154	55,000	58,600	61,600
annual change in %	27.4	17.7	-0.6	1.1	5.7	5.5	6.5	5.1
Exports of services, BOP, EUR mn 7)	7,828	8,685	9,866	13,431	15,050	16,300	17,400	18,600
annual change in %	-7.6	10.9	13.6	36.1	12.1	8.0	7.0	7.0
Imports of services, BOP, EUR mn 7)	6,335	7,031	7,392	8,733	9,181	9,700	10,300	10,900
annual change in %	-15.7	11.0	5.1	18.1	5.1	6.0	6.0	6.0
FDI inflow (liabilities), EUR mn 7)	2,441	1,745	2,181	2,891	2,737	2,500	3,000	3,000
FDI outflow (assets), EUR mn 7)	184	19	-175	-24	280	.	.	.
Gross reserves of NB excl. gold, EUR mn	32,606	33,166	31,206	32,525	32,216	.	.	.
Gross external debt, EUR mn 7)	93,624	99,926	100,857	98,069	94,259	.	.	.
Gross external debt, % of GDP	73.9	75.0	75.4	68.0	63.3	.	.	.
Average exchange rate RON/EUR	4.2122	4.2391	4.4593	4.4190	4.4437	4.46	4.46	4.50
Purchasing power parity RON/EUR	2.0873	2.1469	2.1575	2.2590	2.2666	.	.	.

1) Preliminary and wiiw estimates. - 2) According to census October 2011. - 3) According to ESA 2010. - 4) Enterprises with 4 and more employees. - 5) From 2014 according to census October 2011. - 6) One-week repo rate. - 7) BOP 6th edition.
Source: wiiw Databases incorporating Eurostat and national statistics.