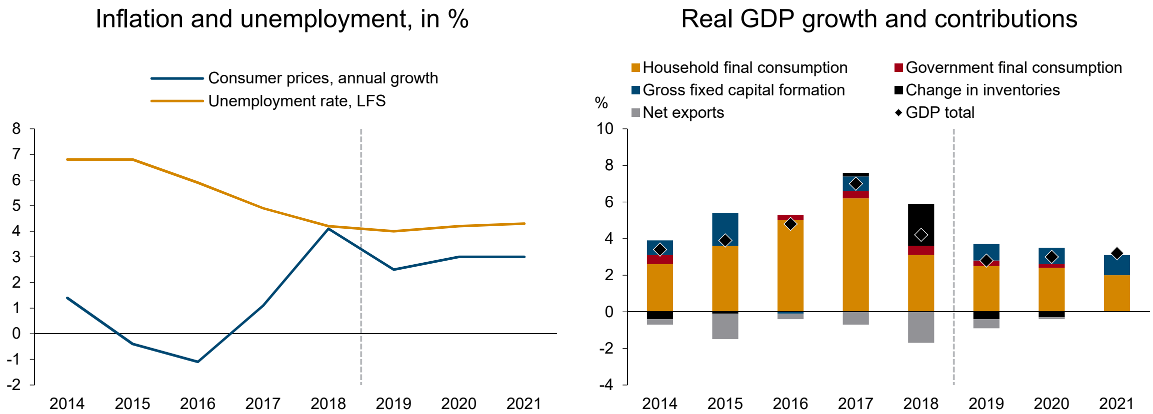
ROMANIA: Who pays the bill for fiscal loosening?

GÁBOR HUNYA

Economic growth turned out at 4.2% in 2018, above wiiw expectation, and the decline to or below 3% p.a. in 2019-2021 will be below earlier forecasts. Beyond deteriorating external conditions and weak investments, new unorthodox fiscal policy measures will drag on the economy. Raising fiscal revenues by taxing turnover in the banking, telecom and energy sectors will suppress economic activity.

Figure 6.17 / Romania: Main macroeconomic indicators



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

Economic growth of 4.2% in 2018 was based on growing household consumption and the expansion of inventories. Fixed investments stagnated and the balance of goods and services trade deteriorated steeply. Industrial production increased by a moderate 3.5%. Mainly the automotive industry expanded its production, by 20% despite labour shortages, largely on account of a new model launched by the Ford plant in Craiova. Agriculture had another excellent year boosting the production and exports of foodstuff and also on-the-farm consumption. The construction industry reported declining production for the third year in a row.

Investments are the sore point of the Romania economy. In 2017 public investments were subdued as budgetary revenues faltered in the wake of tax cuts and expenditures were shifted to public sector wages. The resulting soaring household income gave a 70% boost to private house construction. Thus, not surprisingly, in 2018 residential building fell by 24% and non-residential construction by 5.5%. On the other hand, 8% growth was attained in civil engineering works in 2018 after a 22% decline in the previous year. The latter signalises that public investments in infrastructure started to recover in the second half of 2018 which was also visible on the expenditure side of the state budget. But investment projects remained unfinished by the end of the year, increasing inventories instead of gross fixed capital formation. All in all, investment outlays were about the level of the previous year in 2018; construction investments fell in real terms (note the 15% increase in construction costs) but investments in machinery and transport equipment increased due to companies' efforts to replace workers by technology.

Labour shortages have shown up in increasing employment and vacancy rates while the unemployment rate came below 4% by the end of 2018. This has a two-way impact on investments: (i) it hinders labour-intensive construction works and pushes up wages and prices in this sector, and (ii) it triggers labour-substituting investments in companies that can afford it. Some companies in the labour-intensive clothing and shoe-making sectors have not been able to keep up with surging wage demands and closed down factories. (One of them moved production to Vietnam.)

The government has tried to make employment in the construction sector more attractive by raising the minimum wage in this sector to RON 3000 as of January 2019 (EUR 638, the same also in net terms, as the payment of income tax and social contributions has been suspended in this sector). The general minimum wage in other sectors rose only to RON 2080 (RON 1263, or EUR 265 in net terms). Public sector wage hikes are moderating in 2019, but pension hikes will come in September 2019 just ahead of the presidential elections. Public pensions are planned to be hiked by 70% during 2019-2021, but pillar II private pension funds will be squeezed.

In view of expanding fiscal deficits, the government decided to introduce extra taxes in various segments of the economy without touching on the basic tax rates. The budget for 2019 was passed with much delay on 15 February due to the new revenue-side measures published in a decree just before the end of 2018. The targets of turnover-based extra taxes are banking, energy and telecom companies. In the explanation, Finance Minister Teodorovici blamed multinational companies for reporting abnormally low profits (hence profit taxes paid) in energy and telecom, abnormally high profits in the banking sector and for the high energy prices paid by both residential and industrial users. The government has therefore capped energy prices for households. The banks will have to pay a tax on their financial assets when the average interbank offer rate (ROBOR) for the maturities of three and six months exceeds the 2% benchmark; it has recently been in the range of 3-3.5%. Further revenues will be generated by channelling a major part of the mandatory private pension fund contributions back to the public pension system. All these measures have a touch of unorthodox economic policy similar to Hungary applied during the post-crisis years. Preliminary calculations of the government suggest that the fiscal package could hinder about 1% of GDP fiscal shortfall. Thus, Romania could avoid a fiscal deficit slippage below 3% of GDP provided the assumptions of the budget, 5.5% economic growth in 2019, prove realistic – but they certainly won't and not just because of deteriorating external conditions.

The new fiscal measures will have negative effects on economic growth. The economic activity of the sectors hit by extra taxation will decline. The tax on financial assets will account for a major part of the banks' profits. This will not threaten the viability of the largest banks, but it may make the rest unprofitable. Banks have just come out of a prolonged loss-making period cleaning up non-performing loans and increasing credits to the economy. They made a net profit of EUR 1.5 billion, up by 30% in 2018, which in the government's opinion should be shared with the budget. Negative effects can be expected, however, as banks will reduce assets. In general, investor trust has been shaken.

As a first reaction, the local currency devalued, sovereign bond yields soared, and commercial banks got worse ratings. The impact on corporate investments may not be a disaster, as banks have a minor role compared with companies' own funds. But everyday life may become more difficult if revolving credit lines used to finance companies' daily activities become more expensive and available under stricter conditions. The impact on FDI could be negative as investors' confidence more generally may deteriorate due to the government's unpredictable economic policy. If foreign investors leave the affected sectors, a redistribution of assets to less transparent investors may follow – the state or oligarchs may buy cheap as has been the case in Hungary. Seeing the outrage of affected banks, the National Bank and also of the ECB, negotiations have started in Romania to scale down and better target the banking tax, yet with no results at the time of writing.

Financial inflows are highly necessary, as expanding domestic demand triggered a deterioration of the trade balance, which made 1.7 percentage point negative contribution to GDP growth in 2018. Exports of goods did not constitute a problem as more than 8% increase (in nominal euro terms) was recorded and the shift to higher value added products continued. The sore point was the 11% surge in goods imports. Part of the increase was triggered by international prices for fuels and chemicals but also by import volumes of these products. The impact of consumer demand was most visible in the imports of cars and various consumer goods. Lower international oil prices will help Romania to narrow the import bill gap in 2019. At the same time, we expect lower demand on the main foreign markets, especially in Italy and Germany, thus also exports will grow at a slower pace. As a result, the current account deficit will stay near 4.5% of GDP.

The government and other public institutions passed the 'National Plan for the Adoption of the Euro' on 15 February 2019, setting the target accession date for 2026. The plan lists some intended structural measures such as increasing fiscal revenues, increasing the fiscal space and sustainably strengthening public finances, developing infrastructure, and increasing the competitiveness of the economy through a better structure of production. One may be sceptical about these plans as they go against the fiscal policy of recent years.

Worsening external and internal conditions will squeeze economic growth below 3% this year and close to it in the rest of the forecasting period. Fixed capital formation is expected to pick up moderately on account of EU transfers, but household consumption will be less robust than before. Wages are expected to rise more moderately while pensions will grow but private consumption all-in-all will give a smaller boost to GDP. Whatever the EU funds allocation principle will look like during the next financing period, Romania will still be eligible for substantial transfers of structural and investment funds on account of its low level of economic development. If the compliance with democratic values plays a role in funds allocation, this would – based on the current situation in the country – reduce the access to funds. The disintegration of the political system will continue towards the presidential and parliamentary elections (late 2019 and late 2020, respectively) and represents a downside risk to the current forecast.

Table 6.17 / Romania: Selected economic indicators

	2014	2015	2016	2017	2018 [1)]	2019	2020 Forecast	2021
Population, th pers., average	19,909	19,815	19,702	19,584	19,500	19,400	19,300	19,200
Gross domestic product, RON bn, nom.	668.6	712.6	765.1	856.7	950.0	1,030	1,100	1,180
annual change in % (real)	3.4	3.9	4.8	7.0	4.2	2.8	3.0	3.2
GDP/capita (EUR at PPP)	15,200	16,300	17,400	18,800	19,900	.	.	.
Consumption of households, RON bn, nom.	405.7	432.6	471.9	533.5	590.0	.	.	.
annual change in % (real)	4.2	5.9	8.3	10.1	5.0	4.0	3.8	3.2
Gross fixed capital form., RON bn, nom.	162.4	176.5	175.0	192.0	210.0	.	.	.
annual change in % (real)	3.3	7.5	-0.2	3.5	0.0	4.0	4.0	5.0
Gross industrial production [2)]								
annual change in % (real)	6.0	2.8	3.1	7.9	3.5	3.0	2.0	3.0
Gross agricultural production								
annual change in % (real)	2.9	-6.8	2.5	12.5	8.4	.	.	.
Construction industry [2)]								
annual change in % (real)	-6.7	10.5	-4.4	-5.5	-4.1	.	.	.
Employed persons, LFS, th, average	8,614	8,535	8,449	8,671	8,690	8,710	8,710	8,710
annual change in %	0.8	-0.9	-1.0	2.6	0.2	0.2	0.0	0.0
Unemployed persons, LFS, th, average	629	624	530	449	380	360	380	390
Unemployment rate, LFS, in %, average	6.8	6.8	5.9	4.9	4.2	4.0	4.2	4.3
Reg. unemployment rate, in %, eop	5.4	5.0	4.8	4.0	3.3	.	.	.
Average monthly gross wages, RON [3)]	2,328	2,555	2,809	3,223	4,488	4,800	5,100	5,400
annual change in % (real, gross)	6.5	10.4	11.7	13.2	8.0	5.0	4.0	3.0
Average monthly net wages, RON	1,697	1,859	2,046	2,338	2,644	2,800	3,000	3,200
annual change in % (real, net)	6.4	10.1	11.8	12.8	8.1	5.0	4.0	3.0
Consumer prices (HICP), % p.a.	1.4	-0.4	-1.1	1.1	4.1	2.5	3.0	3.0
Producer prices in industry, % p.a.	-0.2	-2.3	-1.8	3.5	5.1	3.0	3.0	3.0
General governm.budget, EU-def., % of GDP								
Revenues	34.2	35.5	31.9	30.8	30.0	31.0	31.0	31.0
Expenditures	35.4	36.2	34.9	33.7	32.9	34.5	34.0	34.0
Net lending (+) / net borrowing (-)	-1.3	-0.7	-2.9	-2.9	-2.9	-3.5	-3.0	-3.0
General gov.gross debt, EU def., % of GDP	39.2	37.8	37.3	35.2	35.0	35.0	36.0	36.0
Stock of loans of non-fin.private sector, % p.a.	-3.7	2.5	0.9	5.3	7.8	.	.	.
Non-performing loans (NPL), in %, eop [4)]	13.9	13.5	9.6	6.4	5.0	.	.	.
Central bank policy rate, % p.a., eop [5)]	2.75	1.75	1.75	1.75	2.50	2.75	3.00	2.75
Current account, EUR mn	-1,004	-1,977	-3,496	-6,298	-9,416	-9,400	-9,500	-9,600
Current account, % of GDP	-0.7	-1.2	-2.1	-3.4	-4.6	-4.3	-4.2	-4.0
Exports of goods, BOP, EUR mn	46,839	49,111	52,164	57,159	61,880	65,000	68,300	72,400
annual change in %	6.7	4.8	6.2	9.6	8.3	5.0	5.0	6.0
Imports of goods, BOP, EUR mn	53,375	56,896	61,412	69,067	76,691	81,300	85,400	90,500
annual change in %	7.4	6.6	7.9	12.5	11.0	6.0	5.0	6.0
Exports of services, BOP, EUR mn	15,104	16,640	18,006	20,683	22,016	23,600	25,300	27,100
annual change in %	12.4	10.2	8.2	14.9	6.4	7.0	7.0	7.0
Imports of services, BOP, EUR mn	9,236	9,849	10,284	12,752	13,908	14,900	15,800	16,700
annual change in %	5.8	6.6	4.4	24.0	9.1	7.0	6.0	6.0
FDI liabilities, EUR mn	2,931	3,885	5,656	4,378	5,762	.	.	.
FDI assets, EUR mn	227	930	1,143	-196	824	.	.	.
Gross reserves of NB excl. gold, EUR mn	32,216	32,238	34,242	33,494	33,065	.	.	.
Gross external debt, EUR mn	94,744	92,069	92,910	97,361	98,476	102,000	105,000	110,000
Gross external debt, % of GDP	63.0	57.4	54.5	51.9	48.2	47.0	46.0	45.7
Average exchange rate RON/EUR	4.4437	4.4454	4.4904	4.5688	4.6540	4.75	4.82	4.90

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; real growth 2018 estimated. - 4) From 2015 broader definition of NPL (90 days criteria + loans where the creditor presumes that, without realising the collateral, the debtor will not be able to repay all of its debt). - 5) One-week repo rate.

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