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# Romania:
## Election cycle ahead

The 2009-2010 contraction of the Romanian economy was one of the deepest and longest lasting in Europe. The austerity measures introduced in mid-2010 additionally suppressed domestic demand and caused an at least 1% decline of GDP for the year as a whole. Wage cuts in the public sector and a 5 percentage points VAT increase resulted in a 4% decline of net real wages. The reasoning behind these measures was in line with the IMF programme put in place in 2009. It aimed at curtailing the budget deficit to GDP ratio by improving the fiscal balance and taking GDP contraction as a side effect.

Private and public investment activity remained very much suppressed in 2010; gross fixed capital formation fell by about 15% after a similar contraction rate in the previous year. But stock building increased considerably, compensating the effect on gross capital formation, thus the latter had a largely neutral effect on GDP growth. Investments in buildings remained at a very low level, residential construction and the issuance of building permits continued to decline, while machinery investments recovered close to the previous year's level. Net exports made a positive contribution to the change of GDP due to strong export demand.

Industry and exports were growing quite rapidly in 2010 while agriculture and services suffered declining outputs. The production of motor vehicles, electrical machinery and metallurgy increased by about 30% and surpassed the pre-crisis level. The shift of production and related exports to higher value-added products continued. Machinery and transport equipment comprised about 42% of exports, up from 38% just two years before, while total goods exports in euro terms rose by 11% to a new peak. The Renault subsidiary Dacia was one of the most successful car producers in Europe and has good further growth prospects; in 2011, the production of Ford will start and add to the success of this industrial sector in Romania. The other side of the coin is that industries serving mainly the domestic market such as construction materials production continued to shrink. The whole corporate sector is split between the successful exporters and related suppliers and those trying to sell to the local customer. Payment arrears have disrupted the functioning of SMEs and the number of bankruptcies increased three-fold, mostly affecting trade and construction.

The unemployment rate has risen to about 7.4% (LFS end of 2010) – back to where it was four years ago, but still low in international comparison. A main reason for the low unemployment is the high employment level in public services and the generous labour protection legislation causing labour market rigidity. In order to economize on public funds, labour market and social benefit reforms are being introduced in the framework of the IMF agreement. Public employment started to be reduced already in 2010. Measures effective in 2011 include labour market flexibilization and streamlining unemployment benefits by changing the related laws. These extend the employers' right to establish differentiated working hours and to force employees to work extra hours with no extra payment. Employers can more easily send people on leave when there is not enough work and obtain more freedom with labour contracts. Another stipulation is eliminating the nine-month interdiction to hire new employees in the place of employees that were collectively fired. Such labour market flexibilization measures are bound to increase unemployment.

The tax surge drove end-2010 inflation up to 8% (the highest rate among the NMS); still inflation has so far not been considered a problem by the National Bank. The policy rate was reduced in May to 6.25% and has been left unchanged ever since. Major fluctuations of the exchange rate were avoided in 2010 by market interventions which kept the annual average close to the previous year's level. The effects of the VAT hike will continue in the first half of 2011, and also higher international commodity prices will exert additional inflation pressure. As a result, the average CPI may not come down below 4% even in 2012.

The general government budget deficit improved from 7.4% of GDP in 2009 to 6.6% in 2010 on a cash basis, somewhat below the government's target. (The deficit according to EU definition was substantially higher, 8.6% of GDP in 2009; the corresponding figure for 2010 is not yet available.) Budget revenues increased mainly due to VAT and excises hikes while income and profit tax related revenues declined. Expenditures rose mainly to co-finance EU projects. The budget plan for 2011 envisages a cash deficit of 4.4% of GDP based on conservative 1.5% economic growth forecast. Public sector wages were raised in February by 15% partially compensating for the cuts of last year. A good deal of improved efficiency of the public sector and an increasing inflow of EU structural funds are taken for granted, but bear downside risks. The government has a number of investment plans, especially in infrastructure, most of them to be financed from EU structural funds. Up to the end of 2010, Romania received only 10% of the EUR 20 billion European funds it is eligible for in 2007-2013. Measures have been taken to speed up disbursement but their effectiveness has yet to be seen.

The current account balance worsened slightly in nominal EUR terms in 2010 and stayed at a financeable level. The goods trade balance improved but all other items worsened. The deficit of the incomes account increased both due to higher interest payments and profits of foreign investors. The surplus of the current transfers, 4.3% of GDP in 2009, declined to 2.8% of GDP in 2010, meaning that Romanians working abroad earn and transfer home less during the crisis (there is little evidence of return migration). On the financial account FDI declined but portfolio investments and short-term capital inflows recovered. The main source of foreign inflow were funds from the IMF and a major part of it did not leave the reserves of the National Bank.

There is a lot of uncertainty concerning the future economic policy. None of the three governments of the past two years has been able to come up with a credible fiscal programme that could be actually implemented. The authorities have essentially shifted economic policy making to the IMF. The two-year agreement is going to expire in early 2011 and the question is what to put in its place thereafter. The planned new precautionary accord with a fund of EUR 3.6 billion from the IMF, EUR 1.4 billion from the EU and EUR 0.4 billion World Bank projects will span for two years from May 2011. This new agreement may provide some safeguard but will put a much weaker constraint on fiscal policy than the outgoing regime. Meanwhile, in order to finance the maturing loans, the government has to be more active on international financial markets where the country has little exposure. There are also plans for selling minority shares of state-owned companies included in a property restitution fund recently listed on the stock exchange. Improving efficiency of the state-owned enterprises which currently carry losses and eliminating the payment arrears will be part of the conditions of the new IMF agreement and will be supported by new programmes of the World Bank.

Nevertheless, there has been growing confidence in Romania's fiscal stability in the past few months. The five-year CDS-spreads moved together with those of Hungary until the end of November 2010 when both were about 300 basis points. The two countries disconnected later on with Romania staying flat and Hungary's CDS increasing. The IMF programme has been valued as a success and the fiscal plan for 2011-2012 as sustainable while in the case of Hungary markets were waiting for new structural policy measures. In January/February 2011 the ratings of both countries were improving and Romania continued faring better. Still Romania has a one notch worse credit rating, the worst among the NMS together with Latvia, presumably due to negative GDP growth. Risks may increase as soon as the role of the IMF to monitor and direct economic policy will decline.

For the coming years we reckon with an election cycle. We expect that the government will not stick to fiscal and wage restraint when approaching parliamentary elections in late 2012. The result can be stepped-up GDP growth to 4% in the election year. This will necessarily be followed by corrections in 2013 which will result in a lower GDP growth rate. Compared with the autumn 2010 forecast of the Romanian government we expect a somewhat faster recovery in 2011 and a similar growth in 2012. The main discrepancy is in 2013 for which we expect a deceleration of economic growth and a tense external financial situation while the government predicts acceleration of GDP growth with a contracting current account deficit.

In support to our boom-bust growth scenario we can refer to earlier experience. In the previous two election years 2004 and 2008, consumption growth was much higher than in the preceding and subsequent year. This will likely happen again but this time conditions allow only a smaller amplitude. First of all, the country's external financing capacity is more restricted in the wake of the financial crisis. It has to rely on market financing in the case of public debt whereas private sector financing is more expensive and less readily available than before the financial crisis. At the same time, public debt is still relatively low, leaving room for fiscal expansion and the country has also good prospects for FDI recovery.

Table RO

## Romania: Selected Economic Indicators

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 1) | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | Forecast | |
| Population, th pers., average | 21634 | 21588 | 21547 | 21514 | 21480 | 21460 | 21440 | 21410 | 21400 |
| Gross domestic product, RON mn, nom. | 288955 | 344651 | 416007 | 514700 | 498008 | 522500 | 558500 | 615100 | 667100 |
| annual change in % (real) | 4.2 | 7.9 | 6.3 | 7.3 | -7.1 | -1.2 | 2 | 4 | 3 |
| GDP/capita (EUR at exchange rate) | 3700 | 4500 | 5800 | 6500 | 5400 | 5800 | . | . | . |
| GDP/capita (EUR at PPP) | 7900 | 9100 | 10400 | 11700 | 10900 | 10900 | . | . | . |
| Consumption of households, RON mn, nom. | 197069 | 233135 | 273418 | 327928 | 304699 | 317700 | . | . | . |
| annual change in % (real) | 10.1 | 12.9 | 12.0 | 9.0 | -10.5 | -2 | 2 | 4 | 2.5 |
| Gross fixed capital formation, RON mn, nom. | 68527 | 88272 | 125645 | 164279 | 130603 | 116600 | . | . | . |
| annual change in % (real) | 15.3 | 19.9 | 30.3 | 15.6 | -25.3 | -15 | 4 | 7 | 6 |
| Gross industrial production 2) | | | | | | | | | |
| annual change in % (real) | -3.1 | 9.3 | 10.3 | 2.6 | -5.5 | 5.5 | 5 | 6 | 5 |
| Gross agricultural production | | | | | | | | | |
| annual change in % (real) | -13.1 | 2.4 | -17.7 | 21.2 | -2.2 | -2.2 | . | . | . |
| Construction industry 2) | | | | | | | | | |
| annual change in % (real) | 6.1 | 15.4 | 33.2 | 26.7 | -15.0 | -13.2 | . | . | . |
| Employed persons - LFS, th, average | 9114.6 | 9291.2 | 9353.3 | 9369.1 | 9243.5 | 9200 | 9150 | 9200 | 9200 |
| annual change in % | -0.5 | 1.9 | 0.7 | 0.2 | -1.3 | -0.5 | -0.5 | 0.5 | 0 |
| Unemployed persons - LFS, th, average | 704.5 | 728.4 | 640.9 | 575.5 | 680.7 | 735 | . | . | . |
| Unemployment rate - LFS, in %, average | 7.2 | 7.3 | 6.4 | 5.8 | 6.9 | 7.4 | 7.6 | 7 | 7 |
| Reg. unemployment rate, in %, end of period | 5.9 | 5.2 | 4.0 | 4.4 | 7.8 | 6.9 | . | . | . |
| Average gross monthly wages, RON | 968 | 1146 | 1396 | 1761 | 1845 | 1940 | . | . | . |
| annual change in % (real, net) | 14.3 | 9.0 | 14.7 | 16.5 | -1.5 | -4.0 | . | . | . |
| Consumer prices (HICP), % p.a. | 9.1 | 6.6 | 4.9 | 7.9 | 5.6 | 6.1 | 5.5 | 4 | 4 |
| Producer prices in industry, % p.a. | 8.1 | 9.5 | 7.5 | 15.3 | 1.8 | 6.3 | . | . | . |
| General governm.budget, EU-def., % GDP | | | | | | | | | |
| Revenues | 32.4 | 33.3 | 33.6 | 32.5 | 32.4 | 33.0 | . | . | . |
| Expenditures | 33.6 | 35.5 | 36.2 | 38.2 | 41.0 | 40.5 | . | . | . |
| Net lending (+) / net borrowing (-) | -1.2 | -2.2 | -2.6 | -5.7 | -8.6 | -7.5 | -6 | -5 | -4 |
| Public debt, EU-def., in % of GDP | 15.8 | 12.4 | 12.6 | 13.4 | 23.9 | 30.5 | 33 | 34 | 35 |
| Central bank policy rate, % p.a., end of period 3) | 7.50 | 8.75 | 7.50 | 10.25 | 8.00 | 6.25 | . | . | . |
| Current account, EUR mn | -6888 | -10220 | -16758 | -16178 | -4933 | -5158 | -6800 | -9000 | -9500 |
| Current account in % of GDP | -8.6 | -10.5 | -13.4 | -11.6 | -4.2 | -4.2 | -5.2 | -6.4 | -6.3 |
| Exports of goods, BOP, EUR mn | 22255 | 25953 | 29542 | 33656 | 29091 | 37251 | 41700 | 46700 | 52300 |
| annual growth rate in % | 17.5 | 16.6 | 13.8 | 13.9 | -13.6 | 28.0 | 12 | 12 | 12 |
| Imports of goods, BOP, EUR mn | 30061 | 37765 | 47365 | 52729 | 35959 | 43115 | 48300 | 55500 | 61100 |
| annual growth rate in % | 23.9 | 25.6 | 25.4 | 11.3 | -31.8 | 19.9 | 12 | 15 | 10 |
| Exports of services, BOP, EUR mn | 4102 | 5585 | 6885 | 8751 | 7061 | 6353 | 6700 | 7400 | 8100 |
| annual growth rate in % | 41.3 | 36.2 | 23.3 | 27.1 | -19.3 | -10.0 | 5 | 10 | 10 |
| Imports of services, BOP, EUR mn | 4451 | 5581 | 6475 | 8091 | 7352 | 7098 | 7500 | 8300 | 9100 |
| annual growth rate in % | 42.8 | 25.4 | 16.0 | 25.0 | -9.1 | -3.5 | 5 | 10 | 10 |
| FDI inflow, EUR mn | 5213 | 9060 | 7280 | 9501 | 3487 | 2598 | 3500 | . | . |
| FDI outflow, EUR mn | -24 | 338 | 206 | 186 | -60 | 158 | 200 | . | . |
| Gross reserves of NB excl. gold, EUR mn | 16785 | 21299 | 25325 | 25977 | 28249 | 32432 | . | . | . |
| Gross external debt, EUR mn | 30914 | 41196 | 58628 | 72354 | 81220 | 90766 | . | . | . |
| Gross external debt in % of GDP | 39.4 | 40.4 | 50.8 | 56.5 | 69.1 | 74 | . | . | . |
| Average exchange rate RON/EUR | 3.6209 | 3.5258 | 3.3353 | 3.6826 | 4.2399 | 4.2122 | 4.3 | 4.4 | 4.4 |
| Purchasing power parity RON/EUR | 1.6993 | 1.7599 | 1.8623 | 2.0481 | 2.1346 | 2.2438 | . | . | . |

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

1) Preliminary and wiiw estimates. - 2) Enterprises with 4 and more employees. - 3) One-week repo rate.

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