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Romania: end of the upswing

Economic growth decelerated in the second half of 2005 and GDP grew by only 3.6% in the first nine months of the year. Assuming some recovery in the last quarter, the result for the year as a whole will be around 4%. Explanations and expectations differ according to the interpretation of the 2005 decline. The government stresses the one-time impact of natural calamities and the statistical effect of the extraordinarily high rate of growth in the base year. These arguments are certainly correct, they suggest that the deceleration of growth is only temporary. But there are additional factors as well: first of all the low competitiveness of Romanian products, as shown by the near stagnation of the manufacturing sector and by the widening foreign trade deficit. Based on the presence of severe structural problems, our economic growth forecast for the coming two years cannot be more than 4.5%, about one percentage point lower than what the Romanian government expects.

Consumption and investment both grew by about 9% in 2005, suggesting overheating rather than a slowdown of the economy. As for investment, there was a shift from equipment to construction. Private housing and public infrastructure investment expanded rapidly while the modernization of production capacities slowed down. Government consumption grew less than in the previous year and the deficit of the general budget is expected to be only 0.8% of GDP. Thus consumption expanded mainly in the household sector.

What are the reasons behind private consumption growing two to three times more rapidly than GDP? Wage policy was lax and the 16% flat tax represented a massive relief for the higher-income segments of the population. Real net wages were about 13.5% higher than in the previous year and retail sales expanded by some 18%. Wage expansion, tax reduction and appreciation had a cumulative effect on euro wages. In gross terms these were EUR 268 on a monthly average, in net terms EUR 204. This means that the average tax burden was EUR 64, i.e. 24% of the gross salary. One year earlier gross wages were only EUR 204 and EUR 147 in net terms, meaning that the tax burden was only EUR 57 but 28% of the gross salary. The 31% increase in gross wages curtailed the competitiveness of labour-intensive industries, the net wage increase by 39% stimulated private consumption and imports. Higher wages also increased the creditworthiness of the population, which became increasingly indebted in order to purchase durable consumer goods and construct new dwellings. Foreign currency loans were based on the assumption of both banks and customers that salaries and the exchange rate will develop with the same trend in the future. This however may not be the case, as towards the end of the year appreciation came to a halt and the National Bank introduced credit ceilings for each commercial bank to limit the credit expansion in foreign currency.

The buoyant domestic demand did not stimulate industrial output but mainly imports, which may be interpreted as a sign of structural weakness of the economy. The Romanian industry is mainly specialized on consumer goods of lower quality and prestige, not very much in demand by the better-off segment of the population which benefited most from the income surge. In the first three quarters of the year the exports of goods and services rose only by 6.8% while imports by 17.2%, resulting in a deficit one third higher than in the previous year. The decline in agricultural production generated imports and reduced exports, yet on the whole not very significantly. There has been a more significant change regarding the decline in textile, clothing and shoe production and exports. Romania was the 'tailor of Europe' in the past several years and suffers heavily under increased Chinese competition. This competition appeared both on the Romanian and on the export markets. The production of clothing articles declined by 16%, their exports by 2% in 2005. In numerous cases Italian companies, the owners or main customers of clothing and shoe producers in Romania, have shifted production to China. Along with the effect of appreciation and wage-drift, profits must have eroded, and a further shrinking of these industries seems unavoidable. Fortunately there are also booming parts of Romanian manufacturing, first of all the production of cars and household appliances where large foreign multinationals have invested. These sectors will support export growth but with a high import content in 2006 and 2007.

The current account deficit reached about EUR 7 billion or 9.1% of GDP in 2005. Capital inflow is abundant due to capital account liberalization and the improved risk ratings. While public debt declined, private medium- and long-term foreign debt soared; public and private debt combined reached EUR 23.6 billion by November – a 33% increase within one year. But the reserves of the National Bank expanded even faster, to EUR 16.8 billion. Even if the current account deficit were to expand further in 2006, financing problems would not appear. The sale of the Romanian Commercial Bank (BCR), acquired late last year by Erste Bank, will generate about EUR 2.3 billion net FDI inflow in 2006. Further large privatization deals are in the pipeline in 2006 and may bring an additional EUR 1.7 billion. Thus the high current account deficit represents no problem in the short run; in one or two years however, privatization revenues will dry up, the exposure to speculative capital movements will increase and the exchange rate may become more volatile.

Monetary policy has to cope with increasing challenges while having limited means available in the framework of the inflation targeting policy. The 2005 year-end inflation, initially targeted at 7%, was 1.6% percentage points above that mark. During the year the target had been raised to 7.5% plus-minus 1 percentage point, thus the inflation targeting policy introduced in July missed its goal only by a small margin. But in fact this policy can neither tackle the impact of administrative price changes nor the excessive appreciation of the domestic currency. The National Bank and the government have set the 2006 year-end inflation target at 5% plus/minus one percentage point. This may prove over-optimistic

since tariff rises for utilities continue and the demand-pull factor remains strong. Annual average inflation may thus decline only marginally, to 8% in 2006 and 7% in 2007.

EU accession is on the agenda for 2007 or 2008. The Comprehensive Monitoring Report on Romania's progress towards accession, published on 25 October 2005, has raised hopes that the earlier date may be realized, but the final decision is due only in April 2006. Improvement was praised in the field of competition. As a result of privatization and more prudent government policies, subsidization has been curtailed; the Romanian authorities argue that the same processes have also made the economy more transparent and less prone to corruption. World Bank and EBRD surveys agree that the business environment has improved. EU experts still find a lot to do in the field of the judiciary and fighting large-scale corruption. In early 2006 the authorities started investigations against some leading politicians indicating their readiness to sacrifice some big fish, thus giving a demonstrative signal. The EU Commission also lists as problematic those areas which would allow Romania to get access to EU funds. The country's capacity of funds absorption will be limited initially and transfers will not boost economic growth in the first few years of membership.

Table RO

Romania: Selected Economic Indicators

	1999	2000	2001	2002	2003	2004	2005 ¹⁾	2006	2007
	forecast								
Population, th pers., mid-year ²⁾	22458.0	22435.2	22408.4	21794.8	21733.6	21673.3	21623.8	.	.
Gross domestic product, RON mn, nom.	54573.0	80377.3	116768.7	151475.1	190335.4	238791.4	277500	313100	350000
annual change in % (real)	-1.2	2.1	5.7	5.1	5.2	8.3	4	4.5	4.5
GDP/capita (EUR at exchange rate)	1491	1795	2002	2224	2332	2718	3500	.	.
GDP/capita (EUR at PPP - wiiw)	4770	5010	5460	6060	6280	7070	7440	.	.
Gross industrial production									
annual change in % (real)	-2.4	7.1	8.3	4.3	3.1	5.3	1.5	3	3
Gross agricultural production									
annual change in % (real)	4.0	-14.8	22.7	-3.5	7.5	24.1	.	.	.
Construction output total									
annual change in % (real)	-0.2	2.8	9.0	10.0	9.8	8.9	7.5	.	.
Actual final consump.of househ., RON mn, nom.	45330.8	63459.0	91718.6	116940.4	148348.1	189693.7	.	.	.
annual change in % (real)	-1.1	0.2	6.8	4.8	7.2	10.8	9	.	.
Gross fixed capital formation, RON mn, nom.	9663.0	15194.7	24115.4	32283.6	42253.5	53254.9	.	.	.
annual change in % (real)	-4.8	5.5	10.2	8.2	9.1	10.1	9	8	10
LFS - employed persons, th, avg. ²³⁾	10775.6	10763.8	10696.9	9234.3	9222.5	9157.6	9160	.	.
annual change in %	-0.6	-0.1	-0.6	.	-0.1	-0.7	0.0	.	.
Reg. employees in industry, th pers., avg.	1991.0	1873.0	1901.0	1891.0	1848.0	1818.0	1790	.	.
annual change in %	-12.4	-5.9	1.5	-0.5	-2.3	-1.6	-1.6	.	.
LFS - unemployed, th pers., average ²³⁾	789.9	821.2	750.0	845.3	691.8	799.5	695	.	.
LFS - unemployment rate in %, average ²³⁾	6.8	7.1	6.6	8.4	7.0	8.0	7.0	7	7
Reg. unemployment rate in %, end of period	11.8	10.5	8.8	8.4	7.4	6.2	5.8	5.8	5.7
Average gross monthly wages, RON	192.2	284.0	422.0	532.1	663.8	826.1	970	.	.
annual change in % (real, net)	-3.8	4.6	4.9	2.1	10.7	9.5	13.5	.	.
Consumer prices, % p.a.	45.8	45.7	34.5	22.5	15.3	11.9	9.0	8	7
Producer prices in industry, % p.a.	44.5	53.4	38.1	23.0	19.5	19.1	11	.	.
General governm.budget, nat.def., % GDP									
Revenues	32.8	31.2	30.1	29.5	29.8	29.6	.	.	.
Expenditures	34.7	35.2	33.3	32.1	32.1	30.7	.	.	.
Deficit (-) / surplus (+)	-1.9	-4.0	-3.2	-2.5	-2.3	-1.1	-0.8	-1	-2
Public debt, EU-def., % of GDP ⁴⁾	24.0	23.9	23.2	23.3	21.3	18.5	16.2	.	.
Discount rate, % p.a., end of period ⁵⁾	35.0	35.0	35.0	20.4	20.4	18.0	7.5	.	.
Current account, EUR mn	-1355	-1494	-2488	-1623	-3060	-5099	-7000	-7600	-8300
Current account in % of GDP	-4.0	-3.7	-5.5	-3.3	-6.0	-8.7	-9.1	-8.5	-8.5
Gross reserves of NB excl. gold, EUR mn	1520.0	2654.8	4445.3	5876.8	6373.6	10848.2	16794.7	.	.
Gross external debt, EUR mn ⁶⁾	9140.4	11969.6	14685.5	16199.8	17835.3	23943.9	28218.5 ^x	.	.
FDI inflow, EUR mn	964	1147	1294	1212	1946	5183	4800	5000	4000
FDI outflow, EUR mn	15	-14	-18	18	36	56	30	.	.
Exports of goods, BOP, EUR mn	7977	11273	12722	14675	15614	18935	22500	25000	27500
annual growth rate in %	7.8	41.3	12.9	15.4	6.4	21.3	19	11	10
Imports of goods, BOP, EUR mn	9164	13140	16045	17427	19569	24258	30000	33000	36300
annual growth rate in %	-5.7	43.4	22.1	8.6	12.3	24.0	24	10	10
Exports of services, BOP, EUR mn	1287	1910	2273	2468	2671	2903	3800	4200	4500
annual growth rate in %	18.2	48.4	19.0	8.6	8.2	8.7	31	11	7
Imports of services, BOP, EUR mn	1657	2170	2402	2463	2609	3116	4400	5000	5600
annual growth rate in %	2.3	31.0	10.7	2.5	5.9	19.4	41	14	12
Average exchange rate RON/USD	1.5333	2.1693	2.9061	3.3055	3.3200	3.2637	2.9137	.	.
Average exchange rate RON/EUR (ECU)	1.6296	1.9956	2.6027	3.1255	3.7556	4.0532	3.6234	3.5	3.6
Purchasing power parity RON/USD	0.4459	0.6293	0.8324	0.9893	1.1894	1.3312	1.4580	.	.
Purchasing power parity RON/EUR	0.5097	0.7147	0.9547	1.1475	1.3946	1.5586	1.7239	.	.

*) On 1st July 2005 the new Romanian leu was introduced (1 RON = 10000 ROL). Data in this table are presented in new leu (RON).

Notes: 1) Preliminary. - 2) From 2002 according to census March 2002. - 3) From 2002 break in methodology. - 4) According to ESA 95, excessive deficit procedure. - 5) From February 2002 reference rate of NB. - 6) From 2004 including short-term deposits and foreign direct investment intercompany lending.

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