ROMANIA: How much fiscal consolidation?

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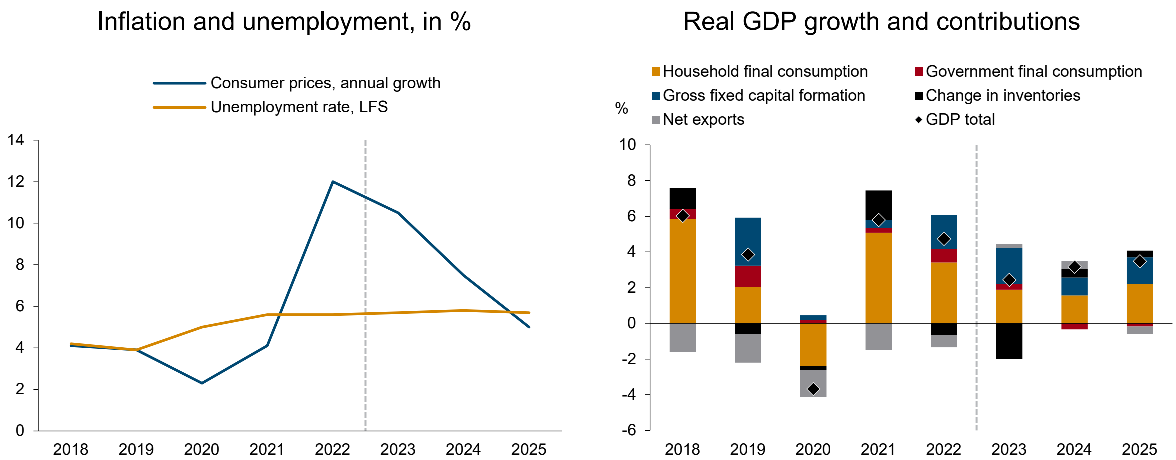
Romania will suffer a significant economic growth slowdown to 2.5% in 2023, but – helped along by EU funds and a good harvest – its growth will still be above that of most of its peers. Inflation fell to single digits in August, but real incomes are proving slow to recover. The current account deficit has shrunk due to lower imports of goods and higher exports of services. High fiscal deficits jeopardise the country's access to EU funds, but no harsh stabilisation measures will be necessary to keep most of the funds flowing. The rising political risks moderate our growth expectations for the election year of 2024.

Figure 6.17 / Romania: Main macroeconomic indicators



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

The Romanian economy suffered a severe slowdown in Q2 2023. GDP increased by only 1.1%, compared to the same period of last year – considerably less than the 2.4% of Q1. Household consumption weakened significantly, as inflation gobbled up much of the wage rise that came into effect at the beginning of the year. Government consumption increased, reflecting a widening fiscal gap. Gross fixed capital formation surged, mainly in infrastructure projects and machinery, while residential construction fell. The rapid depletion of stocks led to negative gross capital formation, which was the primary cause of economic deceleration. Net exports contributed positively to growth, as exports of goods and services fell less than the corresponding imports.

Industrial production decreased by 4.8% in the first 6 months, compared to the same period last year. With a similar fall for the year as a whole, Romanian industry will be back where it was in 2017 – worse off than in most other EU-CEE countries. Prohibitive energy costs meant that companies engaged in energy-intensive industries (which have a major presence in Romania) had to stand idle for months, at the same time as international demand for their products was shrinking. Food producers were also running at reduced capacity after last year's poor harvest. There were just a few industrial activities that enjoyed increased production, albeit these were the more sophisticated ones: pharmaceuticals, computers and electronics, machinery and transport equipment. A similar structural shift could be observed in the country's exports, 45% of which were accounted for by machinery and transport equipment – more than before.

Marginally declining employment and a stable rate of unemployment characterised the labour market in H1. The contracting economic activity in some parts of the economy had no major negative effects on unemployment, as it was mainly the capital-intensive sectors that were affected, while labour-intensive activities did relatively well. Employment may decline and unemployment may increase if the government's fiscal adjustment plans come to fruition.

Inflation fell to 9.4% in July 2023 from a peak of 16.8% in November 2022. Services were the main driver of inflation. Food prices also rose faster than average in the first half of the year, but began to decline in June. The government took active steps to rein in inflation, prescribing tight trade margins on food products. But it also changed regulation of the pharmaceutical trade, which triggered a jump in prices. The national bank (BNR) has not been very active in adjusting the policy rate: it reached a high point of 7% in January 2023 and remained stable through August. A small cut may follow later in the year, depending on how sticky inflation remains. The BNR has been active on the currency market, achieving remarkable exchange-rate stability. While this was a useful measure to combat inflation, exporters have suffered.

The current account gap narrowed to EUR 9.8bn in H1 2023, from EUR 12bn the year before. Imports of goods contracted on account of lower fuel prices and subdued economic activity, while export growth was sluggish due to weak external demand and the strong domestic currency. More than half of the deficit in the trade in goods was balanced by the surplus in the trade in services. Romanian hauliers benefited from the increased need to transport goods across the country to and from Ukraine and Moldova. Exports of telecom and computer services also boomed.

The high primary income deficit is the blot on the current account. It amounted to more than 90% of the current account deficit in H1 2023. Investors' income was mostly booked in Q2, thus the primary deficit will have a lower share of the current account deficit in the remainder of the year. Reinvested foreign direct investment (FDI) earnings compensated for half of the primary income deficit. Portfolio investments, especially in government securities, not only financed a major part of the current account deficit, but also increased the level of foreign exchange reserves. These covered 5 months of imports in July 2023, as against 4 months the year before.

In view of the increasing fiscal strains, the government issued bonds in excess of its financing plans, which boosted reserves. This increased the external debt of the general government by 23% in H1 2023. Total external debt has also grown, but will still be among the lowest in the EU, at about 53% of GDP by the end of the year. The interest rate on 10-year government bonds was 6.2% in July – the second highest in EU-CEE, after Hungary. Debt service obligations, still relatively low, will be a growing item of fiscal expenditure and will increase the country's vulnerability to external shocks in the future.

In June, the European Commission sent Romania notification for the country to curb its budget deficit, otherwise part of the cohesion funds would be suspended. Romania was under the Excessive Deficit Procedure prior to the Covid-19 crisis (when the regulation was temporarily suspended) and that has now been reactivated. In view of the mid-year results, the country is unlikely to meet the deficit target of 4.4% of GDP this year. The fiscal deficit has expanded, following generous pay rises in the public sector and lower-than-planned revenue due to sluggish consumption. As of mid-September, the government agreed on a fiscal consolidation package to be introduced as of 1 October and put it up for discussion. The government would like to cut only 1 percentage point from the projected deficit of 6.5% of GDP for this year. The main part of the higher revenues is expected to come from a 1% extra tax on the turnover of companies and banks. Tax allowances and extra benefits for various groups of the population will be abolished. An extra tax on valuable real estate and cars would also be imposed. More radical measures – such as switching the flat 10% rate of personal income tax to a progressive system – were abandoned as they divided the two coalition partners. The planned consolidation measures will reduce the fiscal deficit by about 0.6 percentage points per annum for five years. This is less than the cut expected by the Commission, thus further measures cannot be excluded. Somewhat more inflation, higher unemployment and less economic growth seem to be the likely macroeconomic effects of the fiscal tightening, and these have been factored into our forecast.

In view of the results for the first 6 months and the upcoming fiscal consolidation, it is justified to revise our GDP forecast downward – to 2.5% for 2023 and 3.2% for 2024. However, in H2 2023 growth looks better than in H1. Household consumption has picked up recently on the back of a better harvest than last year and an exceptional rise in the minimum wage. Net exports may grow more rapidly if external conditions improve. Inflows from the Multiannual Financial Framework and Next Generation EU may amount to 4.0% of GDP in 2023 and 2024, which would maintain the growth of gross fixed capital formation. The prerequisite is that Romania meets its milestone conditions; thus delays are likely, as the government is hesitant about the size of the fiscal adjustment.

Fiscal restrictions in exchange for EU funds will be a fundamental economic policy issue over the coming years. Moderate fiscal consolidation is the most likely trajectory to be agreed with the Commission, meaning that the deficit will not dip below 3% of GDP before 2026. In its negotiations with the EU, Romania will be able to rely on its improved international standing as a supporter of Western political and military efforts in Ukraine. Government stability is a precondition for both the success of the negotiations and the smooth implementation of any fiscal reform. There is some risk that the governing coalition may split over the reform agenda if further tightening becomes necessary. Slippages in the country's fiscal stance could delay or even lead to some loss of EU funds and put the brakes on economic growth. The assumption underlying our forecast is that EU funding will continue to flow, even if there are delays and cuts.

In 2024, Romania will have four rounds of elections. First, the EU elections in June, followed by the local elections. Towards the end of the year, presidential and parliamentary elections will be held. The ruling coalition of the two largest moderate parties (PSD and PNL) could lose votes to the right-wing populist party (AUR), which currently heads the polls. The latter opposes fiscal reform and the fulfilment of EU conditionalities, and is active in stirring up an ideological dispute between sovereignty and globalism. The risk of political instability acts as a drag on the economic growth forecast even for 2025, when the international environment may allow some acceleration.

Table 6.17 / Romania: Selected economic indicators

	2020	2021	2022 1)	2022 January-June	2023 January-June	2023 Forecast	2024 Forecast	2025 Forecast
Population, th pers., average	19,265	19,122	19,047	.	.	18,900	18,800	18,700
Gross domestic product, RON bn, nom.	1,066.8	1,187.4	1,409.8	601.9	690.0	1,600	1,770	1,890
annual change in % (real)	-3.7	5.8	4.7	5.6	1.7	2.5	3.2	3.5
GDP/capita (EUR at PPP)	21,830	24,040	27,070	.	.	.	.	.
Consumption of households, RON bn, nom.	642.1	732.6	883.6	382.5	443.5	.	.	.
annual change in % (real)	-3.9	8.4	5.5	7.5	4.1	3.0	2.5	3.5
Gross fixed capital form., RON bn, nom.	251.0	281.9	351.6	134.5	161.7	.	.	.
annual change in % (real)	1.1	1.9	8.0	2.2	11.1	8.0	4.0	6.0
Gross industrial production 2)								
annual change in % (real)	-9.2	7.1	-1.8	-0.9	-4.8	-3.0	3.0	4.0
Gross agricultural production								
annual change in % (real)	-15.4	14.3	-15.8	.	.	.	.	.
Construction industry 2)								
annual change in % (real)	15.9	-0.6	12.9	4.4	11.8	.	.	.
Employed persons, LFS, th, average 3)	8,521	7,756	7,807	7,815	7,683	7,730	7,690	7,690
annual change in %	-1.8	0.7	0.7	1.0	-1.7	-1.0	-0.5	0.0
Unemployed persons, LFS, th, average 3)	452	459	464	467	455	470	470	460
Unemployment rate, LFS, in %, average 3)	5.0	5.6	5.6	5.7	5.6	5.7	5.8	5.7
Reg. unemployment rate, in %, eop	3.4	3.0	3.1	2.8	2.9	.	.	.
Average monthly gross wages, RON 4)	5,213	5,535	6,159	6,284	7,145	6,900	7,600	8,200
annual change in % (real, gross)	4.7	1.1	-2.2	-1.1	0.8	1.0	3.0	3.0
Average monthly net wages, RON	3,217	3,416	3,832	3,871	4,464	4,300	4,700	5,100
annual change in % (real, net)	4.9	1.1	-1.4	-0.5	2.2	2.0	2.5	3.5
Consumer prices (HICP), % p.a.	2.3	4.1	12.0	10.3	11.3	10.5	7.5	5.0
Producer prices in industry, % p.a.	0.0	14.9	44.7	46.7	13.2	8.0	4.0	4.0
General governm. budget, EU def., % of GDP								
Revenues	32.3	32.7	33.5	.	.	33.5	34.0	34.0
Expenditures	41.5	39.8	39.7	.	.	38.7	37.5	37.5
Net lending (+) / net borrowing (-)	-9.2	-7.1	-6.2	.	.	-5.7	-4.5	-4.0
General gov. gross debt, EU def., % of GDP	46.9	48.6	47.3	.	.	50.0	49.0	48.0
Stock of loans of non-fin. private sector, % p.a.	5.0	14.3	11.2	16.6	5.8	.	.	.
Non-performing loans (NPL), in %, eop	3.8	3.4	2.7	3.0	2.7	.	.	.
Central bank policy rate, % p.a., eop 5)	1.50	1.75	6.25	3.75	7.00	6.75	5.00	4.00
Current account, EUR m	-10,893	-17,471	-26,706	-11,996	-10,804	-22,800	-20,000	-19,600
Current account, % of GDP	-4.9	-7.2	-9.3	-9.9	-7.7	-7.0	-5.6	-5.2
Exports of goods, BOP, EUR m	57,532	70,170	85,862	41,670	44,185	89,300	94,700	102,300
annual change in %	-8.8	22.0	22.4	22.4	6.0	4.0	6.0	8.0
Imports of goods, BOP, EUR m	76,476	93,286	118,222	56,121	57,191	120,600	126,600	136,700
annual change in %	-5.5	22.0	26.7	26.7	1.9	2.0	5.0	8.0
Exports of services, BOP, EUR m	23,764	27,881	37,002	16,926	19,489	41,400	46,400	51,000
annual change in %	-12.2	17.3	32.7	35.4	15.1	12.0	12.0	10.0
Imports of services, BOP, EUR m	14,321	18,462	24,290	11,359	12,142	25,500	28,100	29,800
annual change in %	-22.2	28.9	31.6	36.8	6.9	5.0	10.0	6.0
FDI liabilities, EUR m	3,056	9,933	11,295	4,741	6,841	11,000	.	.
FDI assets, EUR m	112	1,117	1,663	331	2,598	4,000	.	.
Gross reserves of CB excl. gold, EUR m	37,379	40,475	46,636	42,033	53,418	.	.	.
Gross external debt, EUR m	126,750	136,585	144,561	136,512	159,233	170,000	190,000	205,000
Gross external debt, % of GDP	57.5	56.6	50.6	47.8	49.6	52.4	53.1	54.2
Average exchange rate RON/EUR	4.8383	4.9215	4.9313	4.9457	4.9339	4.93	4.95	5.00

1) Preliminary. - 2) Enterprises with 4 and more employees. - 3) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 4) Including the employers' social security contribution. - 5) One-week repo rate.

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