Gábor Hunya

Romania: investment-led recovery

Romania has recovered from last year's growth deceleration. In the first quarter of 2006, GDP expanded by 6.9% over the same period of the previous year. Growth was driven primarily by private consumption (+10.9%), which recovered from the slowdown in the second half of last year despite a more moderate increase in real wages. Another factor of growth was fixed capital formation, up 11.4% over the first quarter of the previous year. Construction sector value added expanded by as much as 20%, mainly due to road construction and real estate development. Government consumption made a positive contribution to GDP as the general government budget was in surplus because expenditures are delayed to the end of the year. Domestic consumption grew to the detriment of the foreign trade balance. Net exports amounted to -9.8% of GDP, implying a one percentage point deterioration of the trade deficit as compared to a year earlier. The Romanian government does not consider the external imbalance to be alarming and accepts the increasing inflationary pressure caused by the overheating in order to keep the dynamism of economic growth.

Besides construction, there was also a rapid expansion of services in the first quarter of 2006 (6.8%). Services contribute already to more than half of the GDP, but we lack more detailed information about the development of value added in this sector. Looking at the turnover of trade and transport, no significant expansion can be observed. Success reports have be issued, on the other hand, concerning the expansion of the telecoms market. Manufacturing production, which contributes only 24% to the GDP, expanded by 4.8% in the first quarter of 2006 – an acceleration as compared to the previous year. The structural change towards machinery and away from light industries continues. It has been partly enforced by Chinese competition and the appreciation of the Romanian leu (RON), which led to declines in the textile and clothing industries, and partly generated by new capacities in the automotive and electrical machinery industries. As manufacturing sector employment continued to decline, labour productivity increased by 7.7%.

Foreign trade results based on customs statistics for the first four months of 2006 reveal an export growth of 17.2% and an imports growth of 24.6%. Exports and imports of machinery and equipment have outpaced all other commodities: together with vehicles they made up close to 30% of exports and 34% of imports. The share of the once leading export commodity group, textiles, clothing and footwear, declined to 22%. Due to high international oil prices, export and import growth of mineral products was fast, effecting some decline in the share of the EU among the trading partners. The current account deficit increased to above 9% of GDP in the first quarter of 2006 and is expected to rise further. However, FDI inflows were even higher than the current account deficit. Further high FDI is expected when the full price of EUR 3.7 billion will be paid according to the privatization contract of the largest commercial bank signed last year with Erste Bank. While privatization revenues are the main part of the extraordinarily high FDI in 2006, also green-field and modernization investments increase in the chemicals and automotive sectors.

It is still uncertain how the one-time privatization revenues will be booked in the budget. They may be used for current expenditures as public debt is only 15% of GDP. But the budgetary plans do not calculate with this possibility yet. The rectification of the government budget in April increased the 2006 deficit target from 0.5% to 0.9% of GDP. Further increases of deficits cannot be ruled out, which means that the government diverts from the stability path encouraged by the IMF. But there are also attempts at increasing revenues. On 1 July 2006, excises will be raised for electricity, petrol, natural gas, cigarettes and alcohol. Energy excises will continue to rise until 2009 to reach the EU level by then, while in the case of alcohol and cigarettes Romania will comply with EU standards by the beginning of 2007. The government envisages to modify the tax code as of 1 January 2007 but to keep the flat tax rate on corporate and private incomes at 16% and to maintain the VAT at the current level of 19%. The 16% rate will be expanded to all types of incomes and profits, and to all activities. This will mean an increase in taxes on dividends and interest earnings and of the tax burden on the so far exempted micro-enterprises. A major uncertainty in terms of budgetary policy is that it is not in conformity with Eurostat rules. According to EU forecasts, the general government deficit will be 2.3% of GDP in 2006, rising to 5.4% in 2007.

The Romanian National Bank's (BNR) policy remains moderately restrictive, by maintaining an 8.5% interest rate and the high (40%) level of the rate of the compulsory minimum reserves on foreign currency deposits. But credit expansion continues disregarding the restrictive measures. Non-governmental credit increased by 41.7% in real terms in April 2006 as compared to April 2005. RON crediting, primarily to households, was the main factor of growth, with a 95.7% annual increase. Foreign currency loans calculated in RON have risen by 22.3% since late April 2005, in accordance with the BNR's policy to shift credits to local currency.

Disinflation is slower than envisaged by the BNR. The inflation target for the end of 2006 is 5% plus/minus 1% – but based on the current and expected developments the BNR expects 6.8% according to its May Inflation Report. Average annual inflation may not come down under 8%, which is the highest rate in Europe. Centrally administered prices continue to rise due to adjustment to EU rules.

The aim of joining the EU is the major political objective which keeps the governing coalition together and guides most of its action. In its May 2006 assessment, the European

Commission failed to give a go-ahead to Romania's EU accession. This was confirmed at the EU Summit on 13-14 June by stating that 'it is the common objective of the European Union to welcome Romania and Bulgaria in January 2007, if the countries are ready'. The document states that the Commission will write a new monitoring report on the two countries in early October at the latest. Until then, peer reviews and assessment missions will be taking place to support reform measures in Romania. Some of these measures are in the area of justice and the fight against corruption. In the economic sphere, the ministry of finance will have to review the VAT collection system, and improvement is needed concerning the administrative capacity in taxation. The country will also have to make advance in institution building in order to be able to benefit from EU funds: new personnel is to be employed and trained at the Agriculture Paying Agency and the Paying Agency for Rural Development and Fisheries. If the EU finds deficits in the preparations of Romania (and Bulgaria) in October, accession in 2007 is still possible but with restrictions. In the framework of the monitoring process agreed in the accession treaty, access to EU financing and participation in the single market can be limited even during a pro-forma membership. This solution would save face regarding the accession date and thus the political image of the Romanian government, but delay the application of some of the most important benefits of membership (and thus backfire on the popularity of EU membership in Romania).

The 2007 outlook for the Romanian economy is moderately positive, with expected economic growth close to 5%. We recon with EU membership but with limited access to new funds. Inflation will not come down to the BNR envisaged rate and will hover around 8%. Fiscal adjustments will become necessary to comply with EU standards, which will increase deficits. Romania has no target for the introduction of the euro but will have to oblige to the rules of the Stability and Growth Pact. Fiscal and monetary policies will be moderately restrictive as none of the existing tensions will prompt decisive action.

Table RO

Romania: Selected economic indicators

	2001	2002	2003	2004	2005 [1]	2005	2006	2006	2007
						1st quarter		forecast	
Population, th pers., mid-year [2]	22408.4	21794.8	21733.6	21673.3	21623.8	.	.	.	.
Gross domestic product, RON mn, nom.	116768.7	151475.1	197564.8	246371.7	287186.3	50984.7	61034.7	331700	378900
annual change in % (real)	5.7	5.1	5.2	8.4	4.1	6.0	6.9	5.0	4.8
GDP/capita (EUR at exchange rate)	2002	2224	2420	2805	3665	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	5460	6060	6520	7290	8140	.	.	.	.
Gross industrial production									
annual change in % (real)	8.3	4.3	3.1	5.3	2.0	5.7	4.5	4	4
Gross agricultural production									
annual change in % (real)	22.7	-3.5	7.5	24.1	.	.	.	.	.
Construction output total									
annual change in % (real)	9.0	10.0	9.8	9.2	8.2	3.2	20.7	.	.
Actual final consump.of househ., RON mn, nom.	91718.6	116940.4	149259.0	189538.4	223331.3	42970.4	52173.4	.	.
annual change in % (real)	6.8	4.8	8.2	12.9	9.1	12.5	10.9	.	.
Gross fixed capital formation, RON mn, nom.	24115.4	32283.6	42293.0	53291.8	66356.8	7903.3	9547.8	.	.
annual change in % (real)	10.2	8.2	8.5	10.8	13.1	5.2	11.4	10	8
LFS - employed persons, th, avg. [2)3)]	10696.9	9234.3	9222.5	9157.6	9146.6	8948.1	.	.	.
annual change in %	-0.6	.	-0.1	-0.7	-0.1	1.5	.	.	.
Reg. employees in industry, th pers., avg.	1901.0	1891.0	1848.0	1741.0	1704.0	.	.	.	.
annual change in %	1.5	-0.5	-2.3	-5.8	-2.1	-0.2	-4.0	.	.
LFS - unemployed, th pers., average [2)3)]	750.0	845.3	691.8	799.5	704.5	831.6	.	.	.
LFS - unemployment rate in %, average [2)3)]	6.6	8.4	7.0	8.0	7.2	8.5	.	7	7
Reg. unemployment rate in %, end of period	8.8	8.4	7.4	6.3	5.9	6.0	6.2	5.8	5.7
Average gross monthly wages, RON	422.0	532.1	663.8	818.3	957.5	915.6	1072.7	.	.
annual change in % (real, net)	5.1	2.4	10.8	10.6	13.5	13.1	5.9	.	.
Consumer prices, % p.a.	34.5	22.5	15.3	11.9	9.0	8.8	8.6	8.5	8.0
Producer prices in industry, % p.a.	38.1	23.0	19.5	19.1	10.5	13.3	10.9	.	.
General governm.budget, nat.def., % GDP									
Revenues	30.1	29.6	28.7	28.7	29.1	.	.	.	.
Expenditures	33.3	32.2	30.9	29.9	29.9	.	.	.	.
Deficit (-) / surplus (+)	-3.2	-2.6	-2.2	-1.2	-0.8	.	.	-1	-3
Public debt, EU-def., % of GDP [4)]	23.2	23.8	20.7	18.0	15.2	.	.	.	.
Discount rate, % p.a., end of period [5)]	35.0	20.4	20.4	18.0	7.5	10.8	8.5	.	.
Current account, EUR mn	-2488	-1623	-3060	-5099	-6891	-980	-1564	-9000	-10000
Current account in % of GDP	-5.5	-3.3	-5.8	-8.4	-8.7	-7.1	-9.1	-9.5	-9.5
Gross reserves of NB excl. gold, EUR mn	4445.3	5876.8	6373.6	10848.2	16795.6	12561.5	18146.1	.	.
Gross external debt, EUR mn [6)]	14685.5	16199.8	17835.3	21894.8	30653.9	.	32360.6	.	.
FDI inflow, EUR mn	1294	1212	1946	5183	5197	754	1720	8000	5000
FDI outflow, EUR mn	-18	18	36	56	-11	8	29	.	.
Exports of goods, BOP, EUR mn	12722	14675	15614	18935	22255	5095	6213	26700	29300
annual growth rate in %	12.9	15.4	6.4	21.3	17.5	17.4	21.9	20	10
Imports of goods, BOP, EUR mn	16045	17427	19569	24258	30061	6156	7907	37600	42100
annual growth rate in %	22.1	8.6	12.3	24.0	23.9	21.1	28.4	25	12
Exports of services, BOP, EUR mn	2273	2468	2671	2903	3931	790	1141	5500	7150
annual growth rate in %	19.0	8.6	8.2	8.7	35.4	25.9	44.4	40	30
Imports of services, BOP, EUR mn	2402	2463	2609	3116	4365	909	1130	5670	7300
annual growth rate in %	10.7	2.5	5.9	19.4	40.1	48.5	24.3	30	29
Average exchange rate RON/USD	2.9061	3.3055	3.3200	3.2637	2.9137	2.8297	2.9624	.	.
Average exchange rate RON/EUR (ECU)	2.6027	3.1255	3.7556	4.0532	3.6234	3.7094	3.5641	3.5	3.6
Purchasing power parity RON/USD	0.8324	0.9893	1.1894	1.3312	1.3563	.	.	.	.
Purchasing power parity RON/EUR	0.9547	1.1475	1.3946	1.5586	1.6311	.	.	.	.

*) 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; European Commission (Spring 2006); wiiw forecasts.