ROMANIA: Moderate growth despite loose fiscal policy

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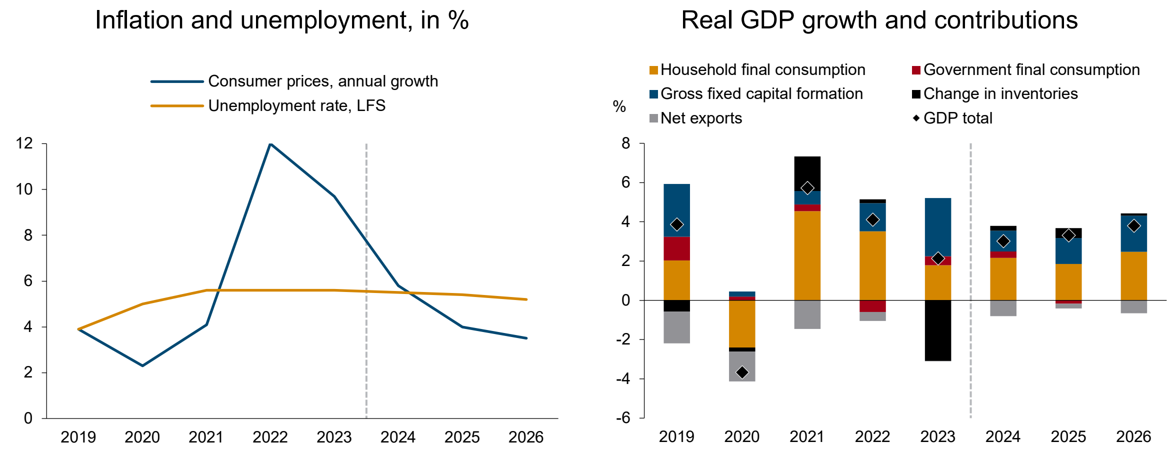
While high fiscal and current account deficits are lasting features of the Romanian economy, they do not pose any imminent danger. Fiscal austerity will not be implemented in the current election year. Economic growth will be about 3% in 2024, fuelled by bullish household demand but hampered by sluggish foreign demand and the slow arrival of EU funds. Fiscal consolidation will dampen growth in 2025, while external demand and private investment will boost it to 3.3% in 2025 and further to 3.8% in 2026.

Figure 6.17 / Romania: Main macroeconomic indicators



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

Growth in the Romanian economy slowed to 2.1% in 2023, about half the rate achieved the previous year. Household consumption was up 2.9%, contributing 2 percentage points (pp) to growth. Gross fixed capital formation was buoyant, increasing by 12% and contributing 2.9 pp. Public consumption also had a positive effect, while that of the foreign trade balance was neutral. Thus, the decline in inventories was the only component on the negative side: this reflected the completion of infrastructure projects and the lack of confidence in future demand. Economic activities with rising value added included agriculture, construction, and information and communication technology. Industrial value added contracted by 2.3% and manufacturing production fell by 4.6%, most prominently in the export-oriented branches, reflecting sluggish demand on Romania's main export markets.

After a bullish start to the first half of 2023, growth decelerated well into 2024. Growth was especially modest in Q4 2023 at only 1% year on year, while GDP was 0.5% lower than in the previous quarter. But the March 2024 business surveys indicate an improvement in the expectations of managers across all major economic activities. Domestic demand will boost the economy, as indicated by rising retail sales backed by growing real incomes.

Real wages increased in 2023, especially in the final quarter of the year. Recent nominal wage claims have sought to recoup the losses caused by the elevated inflation of the previous year. These claims have not been fully met, but the awards have been generous enough to encourage consumption to lift off. A major reform of the pension system will provide a further boost to consumption from September 2024, with the effects being felt well into 2025.

Inflation subsided slowly in 2023, from 15% in January to 7% in December. It remained almost constant in the first two months of 2024, due mainly to indirect tax hikes. Price increases were reported for non-food items and services, but the cost of several foodstuffs fell. Disinflation will resume for the rest of the year, but will be mitigated by growing household demand, resulting in annual average inflation of 5.8%.

The National Bank of Romania (NBR) will be cautious about relaxing the policy rate in 2024, in view of the stubborn inflation and loose fiscal policy. It did not rely much on the policy rate to counter inflationary pressure in 2023, when it correctly assessed that the major part of the inflation was imported and could not be suppressed by that particular monetary instrument. After a series of small hikes, the policy rate ended up at 7% in December, when the domestic component of inflation became dominant. Rate cuts will also follow in small steps during 2024 and 2025 until inflation drops below 3.5%, which is on the upper side of the inflation target band. Over the past two years, the main anti-inflationary tool of the NBR has been to keep the exchange rate for the local currency against the euro almost stable. The NBR may reduce its activity on the currency market in the future and allow for some modest nominal depreciation.

The current account deficit remained elevated, although its ratio to GDP eased from 9.2% in 2022 to 7% in 2023. This change was mainly brought about by a contraction in the import of goods – mainly fuels and raw materials (reflecting the lower prices for oil and gas). The deficit will stay relatively high in the coming years, partly on account of the import needs generated by rising consumption. Another important component of the current account deficit has been the income of foreign investors: the deficit on primary income almost matched the deficit on goods and services in 2023. Companies achieved large windfall profits, but only part of those was tapped by fiscal measures. Foreign banks and energy companies have also recently reported high earnings on their activities, which means that foreign direct investment (FDI) income may not subside before 2025. Unfortunately, only 45% of FDI earnings were reinvested in Romania in 2023, although one cannot exclude the possibility that some of the profits returned via the portfolio channel. Relatively high yields and an almost stable exchange rate have attracted large volumes of portfolio investments. Such inflows amounted to 5.7% of GDP, compared to the FDI and capital account balances, which were both in the order of 2% of GDP.

The excessive fiscal deficit (about 6% of GDP over the past two years) has been the weak point of Romania's economic policy. In 2023, it was obvious from the outset that the country would not meet its deficit target of 4.4% of GDP. Following a warning from the European Commission, a fiscal consolidation package was introduced from 1 October. Revenue started to be generated by an extra tax on the turnover of large companies and banks, while some tax allowances and extra benefits for certain groups of the population were abolished. These measures can reduce the fiscal deficit by only 0.6 pp per annum. However, in Q4 2023, the main short-term policy tool was a curb on current expenditure, mainly by the military. As for 2024, the government has again stipulated low deficits – unrealistic in an election year, especially as the governing parties are losing popularity. When it became aware of this problem in March, the European Commission again sent Romania notification, urging the country to rein in its budget deficit, otherwise a portion of the funds it is due will be suspended. But the deadline for action has been set as the end of the current year, and so it will be the task of the government following the general election in December to implement the necessary austerity measures – and that will be no easy matter.

A pension reform to take effect in September 2024 will cost the budget some 1.3% of GDP; as yet there is no counterpart to this on the revenue side. Both pension reform and a reform of the system of public-sector wages were among the targets of the National Recovery and Resilience Plan (NRRP), and both imply higher fiscal expenditure in the years to come. Thus, the EU programmes will place Romania under fiscal pressure on both the expenditure and the deficit side simultaneously. An overhaul of the revenue side of the budget – which currently operates with low flat tax rates – will have to be put on the agenda.

Accessing EU funds is a fundamental target of the government. Nevertheless, Romania found the disbursement of funds delayed in 2023 – partly on account of poor institutional capacity and partly through having to renegotiate some of the NRRP targets. There was only one disbursement of EUR 2.76bn from the Recovery and Resilience Facility (RRF) in 2023; meanwhile EUR 4.5bn came as the final instalment under the Multiannual Financial Framework (MFF) 2014-2020 (altogether 2.2% of GDP). This year, EU funds will be thin on the ground, as most of the projects that are to be financed from the MFF 2021-2027 have not started yet and no more than one instalment of funds will be disbursed under the RRF. Consequently, the expansion of investment will slow temporarily.

Relatively large future current account and fiscal deficits may constrain the country's capacity to withstand adverse shocks. Of all the EU-CEE countries, Romania has attracted the worst foreign currency credit rating from all the major rating agencies; it also has the highest government bond yields. Given both the relatively high perceived risk and the high cost of financing, the country really needs to follow a more prudent policy in the future. Fortunately, the risk premiums on German federal government bonds have fallen internationally in the past 12 months – for Romania, from 3.3 to 2.1 basis points between January 2023 and January 2024 – thus financing costs have eased somewhat. The large international reserves of the NBR – 35% of the relatively low external debt (52% of GDP) – provide an ample buffer.

Medium-term economic growth will depend on success in securing the disbursement of EU funds, while implementing fiscal consolidation. For the baseline scenario, we expect a compromise with the European Commission and no shocks on the financial markets. Major fiscal stress could be avoided by increasing certain tax rates in 2025 without excessively damaging domestic demand. Also in 2025, there could be a recovery in demand on the main export markets, so that net exports would neutralise the effects of fiscal austerity. The result should be solid GDP growth of 3% in 2024, 3.3% in 2025 and 3.8% in 2026.

However, it is also worth considering a negative scenario. The general election scheduled for December 2024 may yield inconclusive results. A fragile government coalition may prove incapable of managing the fiscal deficit and related social issues. This could result in more limited access to EU funds and lower FDI inflows, to be followed by more severe austerity later. In this case, the economic growth rate could be 1 pp lower than the baseline forecast.

Table 6.17 / Romania: Selected economic indicators

	2020	2021	2022	2023 1)	2024	2025 Forecast	2026
Population, th pers., average	19,265	19,122	19,049	18,900	18,800	18,700	18,500
Gross domestic product, RON bn, nom.	1,066.8	1,189.1	1,401.3	1,598.6	1,750	1,890	2,030
annual change in % (real)	-3.7	5.7	4.1	2.1	3.0	3.3	3.8
GDP/capita (EUR at PPP)	21,870	23,940	26,670	29,220	.	.	.
Consumption of households, RON bn, nom.	642.1	722.6	875.6	987.8	.	.	.
annual change in % (real)	-3.9	7.5	5.8	2.9	3.5	3.0	4.0
Gross fixed capital form., RON bn, nom.	251.0	288.4	346.5	421.9	.	.	.
annual change in % (real)	1.1	2.9	5.9	12.0	4.0	5.0	7.0
Gross industrial production 2)							
annual change in % (real)	-9.2	7.1	0.5	-3.0	2.0	4.0	4.0
Gross agricultural production							
annual change in % (real)	-15.4	14.3	-15.9	6.1	.	.	.
Construction industry 2)							
annual change in % (real)	15.9	-0.6	12.3	16.1	.	.	.
Employed persons, LFS, th, average 3)	8,521	7,756	7,807	7,696	7,710	7,750	7,790
annual change in %	-1.8	0.7	0.7	-1.4	0.2	0.5	0.5
Unemployed persons, LFS, th, average 3)	452	459	464	456	450	440	430
Unemployment rate, LFS, in %, average 3)	5.0	5.6	5.6	5.6	5.5	5.4	5.2
Reg. unemployment rate, in %, eop	3.4	3.0	3.0	2.9	.	.	.
Average monthly gross wages, RON 4)	5,213	5,535	6,126	7,016	7,700	8,300	8,900
annual change in % (real, gross)	4.7	1.1	-2.7	3.7	4.0	3.5	3.5
Average monthly net wages, RON	3,217	3,416	3,801	4,384	4,800	5,200	5,600
annual change in % (real, net)	4.9	1.1	-2.2	4.5	4.2	3.7	3.7
Consumer prices (HICP), % p.a.	2.3	4.1	12.0	9.7	5.8	4.0	3.5
Producer prices in industry, % p.a.	0.0	14.4	43.8	4.6	1.0	2.0	2.0
General governm. budget, EU def., % of GDP							
Revenues	32.5	32.9	33.9	34.0	34.8	36.0	35.5
Expenditures	41.8	40.0	40.2	40.2	40.5	40.3	39.0
Net lending (+) / net borrowing (-)	-9.3	-7.2	-6.3	-6.2	-5.7	-4.3	-3.5
General gov. gross debt, EU def., % of GDP	46.8	48.5	47.5	50.0	51.0	52.0	52.0
Stock of loans of non-fin. private sector, % p.a.	5.0	14.3	11.2	5.9	.	.	.
Non-performing loans (NPL), in %, eop	3.8	3.4	2.7	2.3	.	.	.
Central bank policy rate, % p.a., eop 5)	1.50	1.75	6.25	7.00	6.00	4.00	3.00
Current account, EUR m	-10,893	-17,471	-26,052	-22,634	-22,600	-22,300	-23,700
Current account, % of GDP	-4.9	-7.2	-9.2	-7.0	-6.5	-6.0	-6.0
Exports of goods, BOP, EUR m	57,532	70,170	86,046	86,537	89,100	94,400	101,000
annual change in %	-8.8	22.0	22.6	0.6	3.0	6.0	7.0
Imports of goods, BOP, EUR m	76,476	93,286	118,110	115,540	119,000	125,500	135,500
annual change in %	-5.5	22.0	26.6	-2.2	3.0	5.5	8.0
Exports of services, BOP, EUR m	23,764	27,881	36,938	40,455	43,300	47,600	53,300
annual change in %	-12.2	17.3	32.5	9.5	7.0	10.0	12.0
Imports of services, BOP, EUR m	14,321	18,462	23,865	26,961	28,800	31,400	35,200
annual change in %	-22.2	28.9	29.3	13.0	7.0	9.0	12.0
FDI liabilities, EUR m	3,056	9,933	10,902	7,796	.	.	.
FDI assets, EUR m	112	1,117	2,095	1,240	.	.	.
Gross reserves of CB excl. gold, EUR m	37,379	40,475	46,636	59,770	.	.	.
Gross external debt, EUR m	126,750	136,585	143,887	168,812	190,000	206,000	220,000
Gross external debt, % of GDP	57.5	56.5	50.6	52.2	54.3	55.0	55.5
Average exchange rate RON/EUR	4.8383	4.9215	4.9313	4.9467	5.00	5.05	5.12

Note: Introduction of new index 2021=100 (new weights) for gross industrial production, construction and producer prices in industry.

1) Preliminary and wiiw estimates. - 2) Enterprises with 4 and more employees. - 3) From 2021 new LFS methodology 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.