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Romania:
New government relaxing the budget

In Romania the new, centre-left government concentrates power and dilutes fiscal austerity. Controversy between government and president increases political uncertainty. The economy may come out of technical recession based on household demand and exports in the second half of the year.

A change in political leadership a few months ahead of the general elections has caused a politico- economic upheaval in Romania. In a vote of no confidence, parliament tossed out the centre-right coalition government led by the Democratic Liberal Party (PDL) after several MPs had switched allegiance to the centre-left opposition, the Social Liberal Union (USL). After being sworn in on 7 May, the new government got off to a dynamic start. It amended the election law that will enter into effect in time for the November elections and within a matter of weeks it replaced all the senior officials in various public bodies. For good measure, it also initiated wage-hikes in the public sector. The new government's popularity was resoundingly confirmed in the local elections held on 10 June and they are currently clear favourites in the upcoming general elections in November. As they can apparently draw on some fiscal reserves and count on the goodwill of both the IMF and the EU, they will apparently be in a position to fund popular expenditures.

The economy grew by a modest 0.5% in the first quarter of 2012 year-on-year, whereas for the second time in a row negative rates were recorded in comparison to the previous quarter. Modest private consumption, deteriorating export performance and fiscal austerity were the main causes of the current economic stagnation. On the positive side, investments picked up and the inflow of EU funds improved.

Data for the first four months show that industrial production flattened in comparison to the previous year. Shrinking internal and external demand for durable consumer goods and the closure of the Nokia production facility in Cluj have had a lasting effect. Driven by sales of food and fuel, retail trade turnover rose by 3.4% in the first four months of 2012, whereas sales of other industrial goods stagnated at the same level as the previous year. Inflation dropped to its lowest level for decades: to 1.8% in May 2012 as against the same month in the previous year. Administered prices recorded almost no increases and food prices stabilised in the wake of the previous year's bumper harvest. Unemployment stood at 7.7% in the first quarter of 2012, practically at the level of the previous year. In May business sentiment improved across all sectors of the economy with the (widely anticipated) change in government bumping up optimism in general.

The banking sector continued to be soundly capitalized; deleverage does not seem to have posed any problems in Romania. The National Bank reported robust credit expansion. At the end of April 2012, non-government loans edged up year-on-year by 9.8% (7.9% in real terms), including a 3.3% increase in RON-denominated loans (1.4% in real terms) and 13.9% in foreign currency-denominated loans expressed in RON (5.5% in nominal EUR terms). At the same time, the share of non-performing loans rose and companies complained of the increase in credit costs. Insolvency is expected to rise among larger companies which, until recently, benefited from rescheduling facilities that helped them survive and funded their current operations in the first few years of the crisis. At present, companies are increasingly unable to abide by the terms set for credit rescheduling; their cash reserves are dwindling and banks are no longer willing to reschedule bad loans.

The current account deficit shrank compared to the first quarter of 2011. The trade balance, however, deteriorated with exports contracting marginally and imports rising in a like manner. In that context, due account should be taken of the extraordinarily high import and export growth in the first quarter of 2011 that subsequently dropped. Consequently, the base-effect may well diminish during the year and both exports and imports may well grow again; it all depends on external demand. Following a significant boost, the current transfers surplus offset the trade deficit. In that context, remittances increased a jot or two, while general government transfers recorded a threefold increase. The latter item and the tenfold increase in capital transfers received by the general government indicate that access to EU financing has improved.

While policies determining economic growth will need more time to take shape, the left-leaning government is in a position to introduce some immediate changes on the fiscal front. It has agreed with the IMF and the European Commission to keep the general government deficit (as per ESA95) below 3% of GDP, while permitting the cash deficit to increase from 1.9% to 2.2% of GDP. Public-sector wages will rise by 8% as of 1 June 2012; pensions will go up as well. This will be followed by another wage-hike prior to the elections, thereby providing compensation for the reductions introduced in the context of the austerity package launched mid-2010.

There is every expectation that public finances will be less austere than in previous years. Budget implementation in 2011 was better than planned. The cash deficit declined to 4.2% of GDP, while the ESA95 deficit fell from 6.8% in the previous year to 5.2% on account of a series of one-off expenditures (such as social security contributions that had been drawn down pensions in breach of the national constitution). Despite relatively agreeable economic growth of 2.5% in 2011, fiscal revenues diminished moderately by 0.9 percentage points to 32.5% of GDP - mainly on account of privatization plans that failed. Expenditures fell by 2.5 percentage points to 37.7% of GDP. For two years, expenditures on both wages and subsidies had been curtailed, whereas those on interest payments and investments, including the co-financing of EU projects, increased.

The budgetary programme for 2012 maintains the austerity policy in line with the agreements reached with the IMF and the EU Commission; a deficit of 2.8% of GDP has been set as the target on the assumption that real GDP growth will reach either 1.7% as envisaged by the government or 1.4% as predicted by the EU Commission. The general taxation framework, including flat tax, has been maintained and a number of minor taxes and fees are to be consolidated. Revenues are to be restored to 33.4% of GDP, their level in 2010, without increasing taxes by relying on improved tax collection. Expenditures should decline by 1.5 percentage points to 36.2% of GDP. Whereas the EC and the government do not contest the above figures, the two institutions appear to have quite different views on the structure of expenditures. The Commission’s recommendations would shift the structure of expenditures away from wages and social security payments to higher fixed capital formation. The former government’s priority laid down in the Convergence Programme of April 2012 was quite the opposite. The new government’s public wage policy may give rise to even more shifts away from investments. The government is also harbouring exaggerated hopes of increasing public-sector efficiency and absorbing more EU funds that would then enhance investments. Unrealistic expectations for the revenue side and new commitments for expenditures mean fiscal relaxation even if not openly admitted.

The new government has not yet adopted a clear stance on the structural reform chapter of the IMF treaty that lists a series of measures to be taken in order to: (i) reduce losses and arrears in the public sector; and (ii) increase the transparency and efficiency of funding in the energy, health and transport sectors. In general, the new government is in favour of transparency and efficiency, but progress in that respect has always been sluggish. In the context of energy sector reform, the previous government agreed with the IMF to eliminate regulated electricity prices and social tariffs in a series of stages over the period 2013-1015. Special prices granted to major clients will be re-negotiated as their introduction in the past was often based on favouritism. The elimination of gas price subsidies has been postponed yet again; a new deadline for stepwise implementation has been set for the period 2015-2017. However, regulated tariffs for industrial consumers are to be phased out by the end of 2013. It should be noted that for energy-intensive industries, low electricity and gas prices are critical competitive factors. Among the EU-27, Romania applies the lowest gas prices and the second lowest electricity prices (after Bulgaria) for both household and industrial consumers.

A long-standing political controversy is raging in Romania over the privatisation of state-owned enterprises. The USL has declared that the privatisation steps included in the current IMF agreement 'are detrimental to the Romanian interests'. In fact, the outgoing coalition was equally unenthusiastic and the delay in taking steps towards privatisation proved to be a main stumbling block on the path to fulfilling the terms of the IMF agreement. It is unlikely that the interim government will contradict the IMF, but further delays or slow responses will become the norm. As happened several times before in the case of restructuring the energy sector, the IMF may relax the deadlines.

Developments in early 2012 are in line with the wiiw annual GDP growth forecast of 1%. Pessimism on our part is supported by the emergence of: (i) growing difficulties where exports to stagnating West European markets are concerned; (ii) continuing sluggish domestic demand; (iii) a probable drop in agricultural production; (iv) a slowdown of credit expansion owing to Greek and Austrian banks restructuring their balance sheets and aligning them with new provisioning requirements. The wiiw forecast has already taken account of some fiscal relaxation in the election year. The public-sector wage increases may not have a major positive effect on growth; they will stimulate demand, but they may also lead to a further deterioration of net exports.

The medium-term wiiw forecast for Romania is based on a standard external environment and no shocks. It is assumed that external demand and capital inflows will consolidate and fiscal austerity will not drag down domestic demand. In the medium-term, all these conditions will be less favourable than before the crisis. We thus forecast an average GDP growth of 3% instead of 5%, the pre-crisis rate. A severe downside risk to this forecast is the probability of a protracted European crisis.

Table RO

Romania: Selected Economic Indicators

	2008	2009	2010	2011 1)	2011	2012	2012	2013	2014
					1st quarter			Forecast	
Population, th pers., average 2)	21514	21480	21438	19043	.	.	19000	18950	18900
Gross domestic product, RON mn, nom.	514700	501139	522561	578552	105129	109722	619400	673100	728300
annual change in % (real)	7.3	-6.6	-1.6	2.5	1.7	0.5	1	2.5	3
GDP/capita (EUR at exchange rate)	6500	5500	5800	7200	.	.	.	.	.
GDP/capita (EUR at PPP)	11700	11000	11400	13300	.	.	.	.	.
Consumption of households, RON mn, nom.	327928	304667	327562	351206	71254	73688	.	.	.
annual change in % (real)	9.0	-10.4	-0.4	1.4	-1.2	0.6	1	2	3
Gross fixed capital formation, RON mn, nom.	164279	122442	125227	142094	17988	21008	.	.	.
annual change in % (real)	15.6	-28.1	-2.1	6.3	-2.1	11.8	3	5	6
Gross industrial production 3)									
annual change in % (real)	2.6	-5.5	5.5	5.6	11.4	-0.4	3	5	5
Gross agricultural production (EAA)									
annual change in % (real)	21.2	-2.2	1.0	11.4	.	.	.	.	.
Construction industry 3)									
annual change in % (real)	26.7	-15.0	-13.2	2.8	-4.5	-1.1	.	.	.
Employed persons - LFS, th, average	9369.1	9243.5	9239.4	9137.7	9068.7	.	9150	9150	9200
annual change in %	0.2	-1.3	0.0	-1.1	1.5	.	0.1	0	0.5
Unemployed persons - LFS, th, average	575.5	680.7	725.1	730.2	740.6	747	.	.	.
Unemployment rate - LFS, in %, average	5.8	6.9	7.3	7.4	7.6	7.7	7.5	7	7
Reg. unemployment rate, in %, end of period	4.4	7.8	7.0	5.1	6.0	5.1	.	.	.
Average gross monthly wages, RON 4)	1761	1845	1902	1995	1988	2059	.	.	.
annual change in % (real, net)	16.5	-1.5	-3.7	-0.9	-7.3	0.9	.	.	.
Consumer prices (HICP), % p.a.	7.9	5.6	6.1	5.8	7.5	2.7	3.5	4	4
Producer prices in industry, % p.a.	15.3	1.8	6.3	8.9	10.7	5.6	.	.	.
General governm.budget, EU-def., % GDP									
Revenues	33.6	32.1	33.4	32.5	.	.	.	.	.
Expenditures	39.3	41.1	40.2	37.7	.	.	.	.	.
Net lending (+) / net borrowing (-)	-5.7	-9.0	-6.8	-5.2	.	.	-3.5	-3	-3
Public debt, EU-def., in % of GDP	13.4	23.6	30.5	33.3	.	.	34	34	34
Central bank policy rate, % p.a., end of period 5)	10.25	8.00	6.25	6.00	6.25	5.25	.	.	.
Current account, EUR mn	-16178	-4938	-5499	-6007	-967	-543	-6500	-7000	-8500
Current account in % of GDP	-11.6	-4.2	-4.4	-4.4	-3.9	-2.2	-4.6	-4.5	-4.9
Exports of goods, BOP, EUR mn	33656	29091	37340	45031	11045	10998	46800	52400	58700
annual growth rate in %	13.9	-13.6	28.4	20.6	39.7	-0.4	4	12	12
Imports of goods, BOP, EUR mn	52729	35959	44931	52541	12035	12165	55700	61300	69300
annual growth rate in %	11.3	-31.8	25.0	16.9	25.8	1.1	6	10	13
Exports of services, BOP, EUR mn	8751	7061	6622	7352	1470	1652	7900	8700	9400
annual growth rate in %	27.1	-19.3	-6.2	11.0	4.3	12.4	7	10	8
Imports of services, BOP, EUR mn	8091	7352	6216	6979	1490	1624	7400	8100	8900
annual growth rate in %	25.0	-9.1	-15.5	12.3	2.9	9.0	6	10	10
FDI inflow, EUR mn	9501	3490	2227	1940	473	425	.	.	.
FDI outflow, EUR mn	186	-61	-12	22	-29	25	.	.	.
Gross reserves of NB excl. gold, EUR mn	25977	28249	32606	33166	32767	34605	.	.	.
Gross external debt, EUR mn	72354	81206	92458	98425	94803	98425	.	.	.
Gross external debt in % of GDP	51.8	68.7	74.5	72.1	69.5	69.9	.	.	.
Average exchange rate RON/EUR	3.6826	4.2399	4.2122	4.2391	4.2234	4.3533	4.4	4.3	4.2
Purchasing power parity RON/EUR	2.0425	2.1125	2.1445	2.2841	.	.	.	.	.

Note: Gross industrial production, construction output and producer prices refer to NACE Rev. 2. Gross agricultural production refers to Economic Accounts for Agriculture (EAA).

1) Preliminary. - 2) From 2011 according to census October 2011. - 3) Enterprises with 4 and more employees. - 4) Quarterly data refer to enterprises with 4 and more employes. - 5) One-week repo rate.

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