

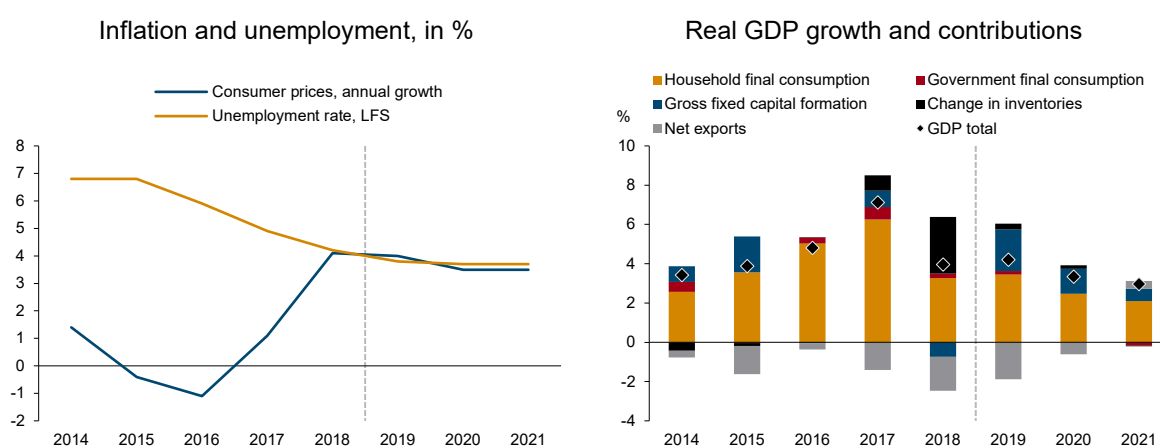


## ROMANIA: New government to initiate fiscal consolidation

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Economic growth is even stronger than last year, and could reach 4.2% in 2019, driven by household consumption and investment. Monetary and fiscal policy remains loose. Expanding deficits can be easily financed due to abundant international liquidity, albeit at a relatively high cost, constituting a burden for the future. Weaker external demand is already feeding through to industrial production, and will act as a barrier to growth in the future. We expect the interim government to take steps to curtail the fiscal deficit in 2020.

Figure 5.17 / Romania: Main macroeconomic indicators



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

**Real GDP growth reached a surprisingly strong 4.7% in the first half of 2019, prompting an upward revision of our full-year growth forecast to above 4%.** Rapidly rising wages fuelled household consumption, which increased by 6.2% in the first semester. Gross fixed capital formation recovered from a depressed level (+11.6%). Many of the unfinished projects, which fed into inventories in the previous year, were finished. The construction sector emerged from its three years of decline with very strong growth (+23.1%). Residential building was especially strong.

**However, industrial production and foreign trade data point towards a marked slowdown of the economy in the rest of the year.** Manufacturing production fell by 1.2% in the first eight months of the year and so did labour productivity. The production of textiles, leather and furniture declined as these labour intensive industries were strongly hit by soaring wages and labour shortages. Some foreign investors in these sectors left the country to cheaper destinations, such as Vietnam. The production of cars and other transport equipment remained buoyant, supported by rapidly rising investments and

labour productivity. The value of new orders in manufacturing was higher in August 2019 than a year earlier in nominal terms, but lower if corrected by the producer price index. The manager index expects stagnation of output in the manufacturing industry for the rest of the year.

**Manufacturing output reflects demand constraints appearing on foreign markets as seen in sluggish export growth**, (+1.7% in the first eight months y-o-y). Almost half of the exports were constituted by machinery and transport equipment. They are destined mainly to various European markets with no special concentration on recession-threatened Germany. Imports of goods expanded by 4.8% in the same period thus the trade deficit constituted the main component of the current account deficit. The services balance and the secondary income balance were on the positive side. The current account deficit is expected to widen to about 5.2% of GDP this year and be financed from bond issues as well as increasing capital transfers of the EU, as well as FDI.

**Fiscal and monetary policies have supported overheating, leading to higher deficits in the budget and the current account than last year.** The majority of the fiscal deficit remains externally financed at a high yield on 10-year sovereign bonds of about 4.2% which points at the rather high risk of unsustainability. (EU-CEE peers such as Hungary or Poland are being charged less than 2% as of August 2019.) But general government debt is still below 40% of GDP and may expand with no immediate punishment by the financial markets. The budget deficit is expected to widen to more than 3% of GDP in 2019. This may trigger a consolidation course in 2020 to avoid an excessive deficit procedure by the EU.

**Inflation accelerated to 4% on annual terms, which is well above the BNR target of 2.5%.**

However, the policy rate is kept firm also at 2.5% with a +/- 1pp band and is not expected to move up as core inflation is moderate and the exchange rate stable. Lending rates of commercial banks are positive in real terms keeping credit expansion under control.

**Real wages have grown stronger than last year despite a higher inflation rate.** Increase in the minimum wages by 15% is one explanation. The other is that the labour shortages have increased the bargaining power of workers. But the labour market tightness started to ease as indicated by the reduced job vacancy rates in recent months. Meanwhile the unemployment rate declined to 3.8% in the second quarter of 2019, 0.4 pp lower than a year before. The quota for non-EU foreign workers for 2019 was increased from twenty to thirty thousand in July. Most of the new temporary immigrants will come from Vietnam based on a recent agreement between the two governments. With the expected economic slowdown, the strain on the labour market may ease in the future and we do not expect a further increase in temporary immigration or a decline in the unemployment rate. Meanwhile emigration keeps increasing, albeit moderately, despite higher incomes and better job opportunities in Romania. The wage gap in comparison with the advanced EU countries is still wide enough.

**The government was ousted in a non-confidence vote on October 30.** The Social Democratic Party (PSD) lost its coalition partner ALDE and thus the governing majority. PSD was shaken by bad results in the European Parliament elections on 26 May but it was able to get rid of its controversial leader, Liviu Dragnea, who was put in jail for corruption just a day later. Within a week, the party and the government had been reshuffled and they gave up controversial initiatives to reform the legal system. Thus it could improve cooperation with EU institutions. But party leader and Prime Minister, Viorica Dancila, could not

resist running for the presidency by which she broke the agreement with ALDE which ended the coalition.

**The leading party of the opposition, the National Liberal Party (PNL), will form a minority interim government.** Early parliamentary elections are not possible before the presidential elections due in November. They are anyway unusual in Romania as MPs prefer sticking to their seats in Parliament although not necessarily to their party affiliation. Regular elections are scheduled for November 2020 until which time the PNL will have to govern with an unstable majority. But incumbent president, Klaus Iohannis from the same party, is expected to get a mandate for another five years and may press for early elections to consolidate his party's power. The need for fiscal consolidation is another argument to press for new elections as early as possible, because financing popular policies for another year may face financial limits. Social peace is unlikely to set in even after elections, as the PSD is expected to mobilise the people against austerity and take them on to the street against the PNL government.

**The new government is expected to pass an austerity budget for 2020.** This will mean consolidation with a soft landing and putting the brakes on economic growth. The government will likely curtail wage growth in the public sector and abstain from hiking minimum wages. The second step of the pension reform, which started in September 2019 and would add 2% of GDP to the budgetary expenditures in 2020, may be postponed. But public investments may not be cut and the drawing of EU funds will be stepped up. BNR may increase the policy rate by 25 basis points to tighten monetary policy in view of the above target inflation. External demand is also likely to curtail economic growth in 2020 which is expected to slow down to 3.3%.

Table 5.17 / Romania: Selected economic indicators

	2015	2016	2017	2018 <sup>1)</sup>	2018 January-June	2019	2019 Forecast	2020 Forecast	2021
Population, th pers., average	19,816	19,702	19,587	19,466	.	.	19,400	19,300	19,200
Gross domestic product, RON bn, nom.	712.6	765.1	857.9	944.2	395.9	441.0	1,040	1,130	1,210
annual change in % (real)	3.9	4.8	7.1	4.0	4.0	4.7	4.2	3.3	3.0
GDP/capita (EUR at PPP)	16,300	17,400	18,800	20,000	.	.	.	.	.
Consumption of households, RON bn, nom.	432.6	471.9	533.7	582.5	254.1	284.2	.	.	.
annual change in % (real)	5.9	8.3	10.1	5.2	5.5	6.2	5.6	4.0	3.4
Gross fixed capital form., RON bn, nom.	176.5	175.0	192.2	200.4	74.0	88.3	.	.	.
annual change in % (real)	7.5	-0.2	3.6	-3.3	-2.2	11.6	10.0	6.0	3.0
Gross industrial production <sup>2)</sup>									
annual change in % (real)	2.8	3.1	7.9	3.5	4.2	-0.5	0.0	2.0	3.0
Gross agricultural production									
annual change in % (real)	-6.8	2.5	12.5	11.9	.	.	.	.	.
Construction industry <sup>2)</sup>									
annual change in % (real)	10.5	-4.4	-5.5	-4.1	-0.7	23.1	.	.	.
Employed persons, LFS, th, average	8,535	8,449	8,671	8,689	8,655	8,651	8,690	8,690	8,690
annual change in %	-0.9	-1.0	2.6	0.2	0.1	0.0	0.0	0.0	0.0
Unemployed persons, LFS, th, average	624	530	449	380	397	354	340	330	330
Unemployment rate, LFS, in %, average	6.8	5.9	4.9	4.2	4.4	4.0	3.8	3.7	3.7
Reg. unemployment rate, in %, eop	5.0	4.8	4.0	3.3	3.5	3.0	.	.	.
Average monthly gross wages, RON <sup>3/4)</sup>	2,555	2,809	3,223	4,357	4,382	5,003	4,900	5,300	5,700
annual change in % (real, gross)	10.4	11.7	13.2	8.0	7.7	9.9	9.0	5.0	3.0
Average monthly net wages, RON <sup>4)</sup>	1,859	2,046	2,338	2,642	2,636	3,050	3,000	3,300	3,500
annual change in % (real, net)	10.1	11.8	12.8	8.0	7.7	11.4	9.0	5.0	3.0
Consumer prices (HICP), % p.a.	-0.4	-1.1	1.1	4.1	4.1	4.0	4.0	3.5	3.5
Producer prices in industry, % p.a.	-2.3	-1.8	3.5	5.1	4.6	4.5	4.5	3.0	4.0
General governm.budget, EU-def., % of GDP									
Revenues	35.4	31.8	30.9	32.0	.	.	33.0	33.0	33.0
Expenditures	36.1	34.5	33.6	35.0	.	.	36.5	36.0	36.0
Net lending (+) / net borrowing (-)	-0.7	-2.7	-2.7	-3.0	.	.	-3.5	-3.0	-3.0
General gov.gross debt, EU def., % of GDP	37.8	37.3	35.1	35.0	.	.	35.0	35.5	36.0
Stock of loans of non-fin.private sector, % p.a.	2.5	0.9	5.3	7.9	7.0	6.7	.	.	.
Non-performing loans (NPL), in %, eop	13.5	9.6	6.4	5.0	5.7	4.7	.	.	.
Central bank policy rate, % p.a., eop <sup>5)</sup>	1.75	1.75	1.75	2.50	2.50	2.50	2.50	2.75	2.75
Current account, EUR mn	-1,977	-3,548	-5,991	-9,335	-3,632	-4,565	-11,400	-11,800	-12,000
Current account, % of GDP	-1.2	-2.1	-3.2	-4.6	-4.3	-4.9	-5.2	-5.0	-4.9
Exports of goods, BOP, EUR mn	49,111	52,167	57,160	61,836	31,050	31,882	63,100	65,000	67,600
annual change in %	4.8	6.2	9.6	8.2	10.2	2.7	2.0	3.0	4.0
Imports of goods, BOP, EUR mn	56,896	61,467	69,339	76,677	37,133	39,553	81,300	85,400	89,100
annual change in %	6.6	8.0	12.8	10.6	11.0	6.5	6.0	5.0	4.3
Exports of services, BOP, EUR mn	16,640	18,006	20,692	23,265	10,930	12,453	26,300	28,900	31,200
annual change in %	10.2	8.2	14.9	12.4	10.7	13.9	13.0	10.0	8.0
Imports of services, BOP, EUR mn	9,849	10,284	12,482	14,564	6,827	8,097	17,200	18,700	20,000
annual change in %	6.6	4.4	21.4	16.7	17.4	18.6	18.0	9.0	7.0
FDI liabilities, EUR mn	3,885	5,656	5,225	6,205	2,432	2,977	6,800	.	.
FDI assets, EUR mn	930	1,143	348	1,259	839	282	500	.	.
Gross reserves of NB excl. gold, EUR mn	32,238	34,242	33,494	33,065	31,766	32,569	.	.	.
Gross external debt, EUR mn	92,069	92,910	97,361	99,841	97,125	105,363	110,000	115,000	120,000
Gross external debt, % of GDP	57.4	54.5	51.9	49.2	47.9	48.1	50.2	49.1	48.6
Average exchange rate RON/EUR	4.4454	4.4904	4.5688	4.6540	4.6545	4.7420	4.75	4.82	4.90

1) Preliminary. - 2) Enterprises with 4 and more employees. - 3) In 2018 the social security contribution paid by employers was added to gross wages; real growth 2018 refers to net wages. - 4) Half-year data refer to enterprises with 4 and more employees. - 5) One-week repo rate.

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