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Romania: signs of a slowdown

After a record GDP growth of 8.3% in 2004, economic growth has slowed down in Romania in 2005. In the first quarter of the year the economy still grew by an impressive 5.9%, marginally less than the 6.2% recorded in the same period of the previous year. Private consumption expanded rapidly but government consumption contracted and net exports declined further. Investments increased close to the rate recorded a year earlier. A less abundant harvest will result in lower agricultural output while manufacturing industry grows at a rate of 5%. Construction and retail trade are the most dynamic sectors of the economy.

With the tax cuts introduced at the beginning of 2005 – a flat tax rate (16%) for corporate and personal incomes – there had been widespread fears that the budget deficit would widen. Although a deficit in the range of 1.5% of GDP would not have been detrimental, the government felt obliged to discuss with the IMF some countervailing measures. But revenues in the first four months of the year showed a substantial increase: The rise in revenues from indirect taxes and social security contributions was much stronger than the decline in revenues from taxes on profits and personal income. The government has therefore postponed the introduction of a capital gains tax to next year, and the 10% tax on interests – originally envisaged for April, then for June – is still not in place. The budget rectification that would accommodate all the expected results of the changes introduced since the beginning of the year has not been passed yet, and as of mid-June the country has no valid budget for the current year. After the talks with the IMF in mid-June a budgetary deficit of 0.7% of GDP was agreed for the current year. A similar deficit is now envisaged for 2006 when the rate of VAT should increase to 22% while social security contributions should diminish.

The tax cuts and public-sector wage increases are reflected in the growth of net wages and retail sales. Real net wages increased by 13% in the first quarter while retail trade turnover boomed by 19%, cars and fuel sales by 23%; only the increase of services was modest. Savings of the population grew by 30% in real terms compared to the first quarter of the previous year, probably as a reaction to the threat of the new tax on interest on new deposits. Employment profited from the economic boom: the number of wage-earners increased and the unemployment rate fell to 6%, the lowest rate in ten years.

Increased demand has not generated inflation as measured by the official consumer basket. In May 2005 consumer prices were 10% higher than a year earlier, but it was mainly government-administered prices that accounted for that rise. Further increases will come in July and October when gas and communal heating prices will be increased. At the

same time, currency appreciation has been a factor working towards price stability. The National Bank envisages 7% inflation in December 2005, year-on-year: in view of the latest developments this target may be exceeded by about one percentage point.

The nominal appreciation of the Romanian leu (ROL) has continued in 2005. At the end of April, the local currency was 8.7% stronger in relation to the euro than at the end of December 2004. Improved credit ratings and high interest rates have attracted foreign portfolio investors, increasing the demand for the local currency. The liberalization of sight deposits for foreigners in April has prompted a further albeit modest inflow of foreign currency. To forestall inflows, the National Bank reduced the policy interest rate by 2 percentage points, to 12.5%. The National Bank has also lowered the interest rate on its lending and deposit facilities and the rates on compulsory reserves. The reference interest rate of central bank operations came down from 18% in December 2004 to 8% in June 2005, which demonstrates high liquidity of the banking system. Still the interest applied by commercial banks to non-government non-bank clients fell from 25% in December 2004 to only 22% in April 2005 while deposit rates dropped from 14% to 8%. Following the liberalization of the capital account, the National Bank again intervened on the foreign exchange market to curtail appreciation – successfully. Interventions and privatization-related capital inflows resulted in a jump of National Bank reserves to the amount of EUR 13.2 billion (gold excluded) by the end of May, 80% more than a year before and equal to 5.6 months of imports. The cost of keeping such high reserves tends to be higher than the advantage of stability it may provide.

Exports expanded by 18% in current euro terms in the first four months of 2005. The highest increases were registered for metallurgical and mineral products, reflecting to a large extent the price development of these commodities on international markets. Machinery and transport equipment exports increased by 32% and their share reached 23.5% of total exports. Exports of textile and clothing products increased by just 2% and their share declined to less than 20%. This upgrading of the export structure is a favourable response to the declining competitiveness in labour-intensive low-tech industries. Imports rose by some 23% in the first four months of 2005, faster than exports. Also in imports, the highest growth rates in current euro terms were achieved by mineral and metallurgical products as well as vehicles. The foreign trade deficit of goods and services nearly doubled in the first quarter of 2005 as compared to the same period a year earlier and also the current account deficit increased from 4.8% of GDP to 6.7%; the year-end result may be as much as 8.3%. In this respect, the government's policy target was missed by a wide margin, and the authorities seem to lack the tools to forestall a further current account deterioration.

In 2005 and 2006 the Romanian economy will grow less rapidly (5.5%) than in the previous year, partly due to lower agricultural production, partly to less vigorous foreign demand. In

the second half of 2005, wage expansion will slow down and the nominal appreciation of the leu will probably come to an end. The correction of the expansionist policy will proceed moderately but inflation will remain somewhat above the target.

The European Commission is expected to provide the next screening of Romania in November 2005. There are several chapters, including competition, where the Romanian government may get a bad mark. If this is the case, the safeguard clause by which accession would be postponed to 2008 will probably come into effect. Following the negative referenda on the European Constitution, the Commission will be more strict when judging the conditions in the country. A postponement of accession by one year will not do much harm to Romania and could be used for further institutional preparation and increasing competitiveness.

Table RO

Romania: Selected Economic Indicators

	2000	2001	2002	2003	2004 ¹⁾	2004 1st quarter	2005	2005 forecast	2006
Population, th pers., mid-year	22435.2	22408.4	21794.8	21733.6	21673.3	.	.	.	.
Gross domestic product, ROL bn, nom.	803773	1167687	1514751	1903354	2387914	408957	497251	2746000	3100000
annual change in % (real)	2.1	5.7	5.1	5.2	8.3	6.2	5.9	5.5	5.5
GDP/capita (EUR at exchange rate)	1795	2002	2224	2332	2718	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	4990	5440	6040	6330	7070	.	.	.	.
Gross industrial production									
annual change in % (real)	7.1	8.3	4.3	3.1	5.3	5.9	5.3	5	5
Construction output total									
annual change in % (real)	2.8	9.0	10.0	9.8	9.2	8.8	3.1	.	.
Actual final consump. of househ., ROL bn, nom.	634590	917186	1169404	1483481	1896937	344886	428598	.	.
annual change in % (real)	0.2	6.8	4.8	7.2	10.8	9.5	12.5	.	.
Gross fixed capital formation, ROL bn, nom.	151947	241154	322836	422535	532549	67778	79407	.	.
annual change in % (real)	5.5	10.2	8.2	9.1	10.1	7.3	5.2	7	8
LFS - employed persons, th, avg. ²⁾	10763.8	10696.9	9234.3	9222.5	9157.8	8816.9	.	.	.
annual change in %	-0.1	-0.6	.	-0.1	-0.7	0.1	.	.	.
Reg. employees in industry, th pers., avg.	1873.0	1901.0	1891.0	1848.0	1818.0	.	.	.	.
annual change in %	-5.9	1.5	-0.5	-2.3	-1.6	-2.4	-0.2	.	.
LFS - unemployed, th pers., average ²⁾	821.2	750.0	845.3	691.8	799.5	850.2	.	.	.
LFS - unemployment rate in %, average ²⁾	7.1	6.6	8.4	7.0	8.0	8.8	.	7	7
Reg. unemployment rate in %, end of period	10.5	8.8	8.4	7.4	6.2	7.8	6.0	.	.
Average gross monthly wages, ROL	2876645	4282622	5452097	6741152	8261492	7852024	9155605	.	.
annual change in % (real, net)	4.6	4.9	2.1	10.7	9.5	9.0	13.1	.	.
Consumer prices, % p.a.	45.7	34.5	22.5	15.3	11.9	13.6	8.8	9	7
Producer prices in industry, % p.a.	53.4	38.1	23.0	19.5	18.6	17.9	13.3	.	.
General governm. budget, nat. def., % GDP									
Revenues	31.2	30.1	29.5	29.8	29.6	.	.	.	.
Expenditures	35.2	33.3	32.1	32.1	30.7	.	.	.	.
Deficit (-) / surplus (+)	-4.0	-3.2	-2.5	-2.3	-1.1	.	.	-1.0	-1.0
Public debt, EU-def., % of GDP ³⁾	23.9	23.2	23.3	21.3	18.5	.	.	.	.
Discount rate, % p.a., end of period ⁴⁾	35.0	35.0	20.4	20.4	18.0	21.3	10.8	.	.
Current account, EUR mn	-1494	-2488	-1623	-3060	-4402	-484	-899	-6000	-6000
Current account in % of GDP	-3.7	-5.5	-3.3	-6.0	-7.5	-4.8	-6.7	-8.3	-7.4
Gross reserves of NB excl. gold, EUR mn	2654.8	4445.3	5876.8	6373.6	10838.5	6725.1	12561.5	.	.
Gross external debt, EUR mn ⁵⁾	11162.6	13575.0	14969.4	15853.8	18099.5	15993.0	20455.4	.	.
FDI inflow, EUR mn	1147	1294	1212	1946	4098	498	365	.	.
FDI outflow, EUR mn	-14	-18	18	36	56	7	-8	.	.
Exports of goods, BOP, EUR mn	11273	12722	14675	15614	18935	4336	5091	22000	24200
annual growth rate in %	41.3	12.9	15.4	6.4	21.3	14.8	17.4	16	10
Imports of goods, BOP, EUR mn	13140	16045	17427	19569	24258	5061	6131	29100	32000
annual growth rate in %	43.4	22.1	8.6	12.3	24.0	20.8	21.1	20	10
Exports of services, BOP, EUR mn	1910	2273	2468	2671	2903	617	777	3100	3300
annual growth rate in %	48.4	19.0	8.6	8.2	8.7	4.6	25.9	7	6
Imports of services, BOP, EUR mn	2170	2402	2463	2609	3116	612	909	3400	3600
annual growth rate in %	31.0	10.7	2.5	5.9	19.4	5.0	48.5	9	6
Average exchange rate ROL/USD	21692.7	29060.9	33055.5	33200.1	32636.6	32430.0	28296.9	.	.
Average exchange rate ROL/EUR (ECU)	19955.8	26026.9	31255.3	37555.9	40532.1	40573.7	37093.6	38000	38000
Purchasing power parity ROL/USD	6316.4	8383.3	10141.4	11992.4	13511.4	.	.	.	.
Purchasing power parity ROL/EUR	7183.6	9579.8	11504.9	13830.0	15581.9	.	.	.	.

Notes: 1) Preliminary. - 2) From 2002 break in methodology and according to census March 2002. - 3) According to ESA 95, excessive deficit procedure. - 4) From February 2002 reference rate of NB. - 5) Medium- and long-term.

Source: wiiw Database incorporating national statistics; Eurostat; EU Economic Forecasts, Spring 2005; wiiw forecasts.