ROMANIA: Getting away with large fiscal imbalances

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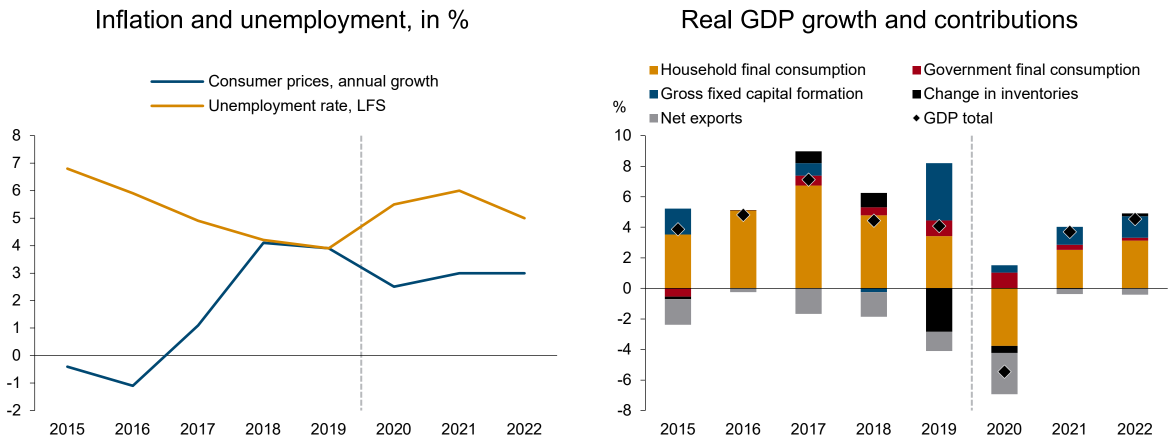
Despite the high epidemiological risk, the government plans only local lockdowns in future. GDP is projected to decline by 5.5% in 2020 and to hit its 2019 level only in 2022. A budget deficit of close to 10% of GDP has caused a rise in bond yields and currency depreciation, but presents no immediate risk to external financing. The December election should produce a centre-right coalition government; it is expected to improve public governance – an important precondition for spending EU funds.

Figure 4.17 / Romania: Main macroeconomic indicators



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

Romania has suffered severe losses in terms of human life and economic performance due to the COVID-19 pandemic. The number of infections first peaked in April 2020, but subsided in May after a general shutdown. Numbers rose again in July, when the lockdown was lifted, peaking for a second time in early October, when the daily number of infections and deaths was more than three times greater than in April. With 3.7 fatalities per hundred thousand inhabitants, Romania had the second highest death rate in the EU in the first half of October (after the Czech Republic and just ahead of Spain). Despite the high medical risk, the government has ruled out a return to lockdown, but has been forced recently to impose it partially and locally. Following the Coronavirus cycle, economic performance improved in the third quarter over the second; if this trend continues, the annual GDP decline in 2020 will be 5.5%, rather better than the wiiw Spring forecast. The recession may be deeper, however, if lockdowns affect major cities and industrial centres in the fourth quarter.

GDP fell by 10.3% in the second quarter of 2020, year on year, after a 2.5% growth in the first three months. Household consumption and net exports made a negative contribution to growth in the first half of 2020, while government consumption and investments mitigated the decline. Retail sales, personal services and the hospitality sector all suffered large setbacks during the lockdown, although Romania is not a frequent tourism destination and has a negative account on travel services. The most remarkable GDP position was the positive development in gross fixed capital formation: it saw no decline, even in the second quarter of the year.

Construction was a sector that witnessed positive growth in the first six months. Both EU-financed infrastructure projects and private housebuilding managed to avoid recession. Gross fixed capital formation is expected to grow throughout the year, but stocks are depleted; thus, capital formation will remain at the level of 2019. Information and communication technology has been another expanding economic sector, reflecting the intensive use of telephones and the internet.

Industrial production is expected to fall by 13% in 2020. It had started to decline in the first quarter, responding to sluggish external demand even before the pandemic, and was 16% lower in the first six months than the year before. Export-oriented industries – and primarily the automotive sector – suffered the largest setback, whereas food and beverages production and the electronics industry kept on growing. Industry, exports and the retail sector recovered in July, the latter almost reaching the level of the previous year. International production chains have revived production at least partially, and the Renault subsidiary Dacia has presented the revamped versions of its models. Agricultural production dropped as a result of adverse weather conditions. This has also curtailed farmers' consumption and has generated food price inflation.

The Romanian labour market usually witnesses a relatively minor response to economic shocks. The unemployment rate is expected to reach 5.5% in 2020 – up from 4% in the previous year. The most visible effect of the pandemic has been an increase in the number of employed persons absent from work: they made up 10% of the employed population in the second quarter – a rate seven times higher than a year earlier. Some of these people returned to normal working hours in the third quarter. The number of the unemployed is expected to grow during the winter, as companies (some of which may go bankrupt) shed excess employees. Government support for employment and EU programmes to benefit SMEs may mitigate the process. Romanians working abroad are reported to have returned to Western Europe after the Easter lockdown. Still, remittances in the first half of 2020 (some 2.6% of GDP) were about 16% down on the year before; depending on the job situation, this figure may not decline any further in the second half of the year.

Romania was to become subject to the EU excessive deficit procedure, on account of the budget deficit posted in 2019 (4.3% of GDP), following the socialist government's pro-cyclical fiscal policy. The recent relaxation of EU fiscal rules has rendered the procedure redundant and has allowed Romania to spend about 4% of GDP in connection with the epidemic, while at the same time enduring revenue loss on account of the recession and tax reliefs. Public spending was set to surge from September, as the socialist parliamentary majority insisted on implementing the 40% rise in pensions that was agreed earlier and included in the so-called budget rectification law, which is actually intended to restructure resources in the fight against COVID-19. In response, the government and the president have decided to use all available means to postpone implementation and apply only a 14% increase.

The fiscal deficit may rise to 9.5% of GDP (or more) in 2020, and is likely to fall only slowly in the coming two years. At the same time, household consumption may receive a fillip, although part of the population may prefer to save rather than spend, in anticipation of difficult times ahead. External financing of the deficit by the markets seems likely, but that could be jeopardised in the event of a financial shock. In the short term, the possibility of a budget deficit of close to 10% of GDP has triggered a rise in bond yields and a depreciation of the Romanian currency. A weaker RON could actually help improve the trade balance: annual depreciation is expected to be 2.3%, close to the consumer price index but considerably more than the stagnating industrial producer prices.

The National Bank has taken steps to increase liquidity in the economy, by reducing the policy rate three times, by altogether 1 percentage point (to 1.5%), and has narrowed the interest rates corridor to ±0.5 percentage points (from ±1.0 percentage points), which has further reduced the lending facility rate. However, further rate cuts are unlikely, due to rising external financing needs, a current account deficit of about 4.5% of GDP and the recent depreciation.

Local and regional elections on 27 September brought success for the National Liberal Party of the interim prime minister, Ludovic Orban. He thus stands a good chance of heading a centre-right coalition government after the parliamentary elections on 6 December. The likely new government is expected to oversee a stabilisation of the rule of law and to exercise better public governance than was the case under the former socialist government.

An improvement in public governance is of the utmost necessity, as the country will be in a position to spend a huge amount of EU money over the next few years – mostly grants, but also credits. Under the EU's Economic and Social Recovery Plan (Next Generation EU – NGEU), Romania will be entitled to receive EUR 33 billion (of which EUR 19.6 billion will be non-reimbursable) – money that it will have to absorb by 2023. This comes in addition to the EUR 30 billion European Structural and Investment Funds (ESIF) for 2014-2020, of which only 40% had been spent by the end of September 2020, one of the lowest rates in the EU. The deadline for spending the rest is also 2023, which will be a huge challenge for the country's public administration. Further EU support of EUR 4 billion in preferential loans may also become available in 2020 to target the fight against unemployment – especially the short-time work scheme. The disbursement of this loan may be hampered by the recent increase in spending on pensions, which could be seen as misuse of fiscal resources for purposes unrelated to the fight against COVID-19. The new resources from the 2021-2027 EU MFF will be in the range of EUR 40 billion, but this will barely be accessed during the forecasting period. Nevertheless, the preparation of strategies and projects will be on the agenda.

Although we expect a recovery in 2021, this will fall short of a V shape; the GDP level of 2019 will only be attained in 2022. GDP will shrink by about 5.5% in 2020 and will grow by less than 4% in 2021, and then more robustly the following year. A downside risk to the growth forecast in the second half of 2020 and 2021 is provided by the spread of the COVID-19 virus and the severity of restrictions in Romania and its main markets. At the same time, an extremely loose fiscal policy, coupled with EU transfers, will mitigate the negative effects of the pandemic. Financing the fiscal deficits will not be a problem, even if private investors are displaying growing concern: EU funds will balance much of the current account deficit and will partly replace FDI.

Table 4.17 / Romania: Selected economic indicators

	2017	2018	2019 1)	2020 1Q	2020 2Q	2020 1-2Q	2020 Forecast	2021 Forecast	2022 Forecast
Population, th pers., average	19,587	19,473	19,366	.	.	.	19,300	19,200	19,000
Gross domestic product, RON bn, nom.	857.9	951.7	1,059.8	216.0	223.1	439.1	1,030	1,100	1,200
annual change in % (real)	7.3	4.5	4.2	2.4	-10.3	-4.5	-5.5	3.7	4.5
GDP/capita (EUR at PPP)	18,650	19,910	21,620	.	.	.	.	.	.
Consumption of households, RON bn, nom.	536.7	599.4	665.1	143.7	138.6	282.3	.	.	.
annual change in % (real)	10.9	7.6	5.4	3.8	-13.3	-4.9	-6.0	4.0	5.0
Gross fixed capital form., RON bn, nom.	192.2	200.4	250.5	36.8	59.7	96.5	.	.	.
annual change in % (real)	3.5	-1.1	17.8	13.1	2.2	6.7	2.0	5.0	6.0
Gross industrial production 2)									
annual change in % (real)	7.9	3.5	-2.3	-6.0	-26.7	-16.3	-13.0	6.0	7.0
Gross agricultural production									
annual change in % (real)	12.5	7.2	-3.0	.	.	.	.	.	.
Construction industry 2)									
annual change in % (real)	-5.5	-4.1	27.6	34.2	10.8	19.4	.	.	.
Employed persons, LFS, th, average	8,671	8,689	8,680	8,519.5	8,505	8,512	8,510	8,420	8,420
annual change in %	2.6	0.2	-0.1	0.4	-3.5	-1.6	-2.0	-1.0	0.0
Unemployed persons, LFS, th, average	449	380	353	382.4	482	432	500	540	440
Unemployment rate, LFS, in %, average	4.9	4.2	3.9	4.3	5.4	4.9	5.5	6.0	5.0
Reg. unemployment rate, in %, eop	4.0	3.3	3.0	2.9	3.0	3.0	.	.	.
Average monthly gross wages, RON 3)	3,223	4,357	4,853	5,285	5,253	5,269	5,100	5,400	5,800
annual change in % (real, gross)	13.2	8.0	7.3	4.4	0.4	2.4	2.5	3.0	5.0
Average monthly net wages, RON	2,338	2,642	2,986	3,228	3,220	3,224	3,100	3,300	3,600
annual change in % (real, net)	12.8	8.0	8.9	4.9	0.7	2.7	2.5	3.0	5.0
Consumer prices (HICP), % p.a.	1.1	4.1	3.9	3.1	2.1	2.6	2.5	3.0	3.0
Producer prices in industry, % p.a.	3.5	5.1	3.8	2.6	-1.4	0.6	0.5	2.0	2.0
General governm.budget, EU-def., % of GDP									
Revenues	30.8	31.9	31.7	.	.	.	30.0	30.0	30.0
Expenditures	33.5	34.9	36.0	.	.	.	39.5	37.0	34.0
Net lending (+) / net borrowing (-)	-2.6	-2.9	-4.3	.	.	.	-9.5	-7.0	-4.0
General gov.gross debt, EU def., % of GDP	35.1	34.7	35.2	.	.	.	45.0	48.0	50.0
Stock of loans of non-fin.private sector, % p.a.	5.3	7.9	7.0	6.2	4.1	4.1	.	.	.
Non-performing loans (NPL), in %, eop	6.4	5.0	4.1	3.9	4.4	4.4	.	.	.
Central bank policy rate, % p.a., eop 4)	1.75	2.50	2.50	2.00	1.75	1.75	1.50	1.50	1.75
Current account, EUR mn	-5,239	-8,961	-10,480	-933	-2,975	-3,908	-10,000	-10,200	-11,200
Current account, % of GDP	-2.8	-4.4	-4.7	-2.1	-6.5	-4.3	-4.7	-4.6	-4.7
Exports of goods, BOP, EUR mn	57,162	61,814	63,075	15,785	10,672	26,456	52,400	56,900	62,600
annual change in %	9.6	8.1	2.0	-1.4	-32.7	-17.0	-17.0	8.5	10.0
Imports of goods, BOP, EUR mn	69,365	76,617	80,492	20,167	14,995	35,162	71,600	77,300	85,000
annual change in %	12.8	10.5	5.1	2.2	-24.5	-11.2	-11.0	8.0	10.0
Exports of services, BOP, EUR mn	21,730	23,791	27,058	6,234	5,196	11,431	23,300	25,400	29,200
annual change in %	15.1	9.5	13.7	3.5	-22.1	-9.9	-14.0	9.0	15.0
Imports of services, BOP, EUR mn	13,544	15,431	18,408	4,019	2,924	6,943	15,100	16,200	18,000
annual change in %	23.1	13.9	19.3	-4.8	-33.6	-19.5	-18.0	7.0	11.0
FDI liabilities, EUR mn	5,225	6,205	6,574	-646	647	0	500	.	.
FDI assets, EUR mn	348	1,259	1,721	-242	-879	-1,121	500	.	.
Gross reserves of NB excl. gold, EUR mn	33,494	33,065	32,927	34,123	35,002	35,002	.	.	.
Gross external debt, EUR mn	97,446	99,841	105,873	107,919	111,452	111,452	117,000	120,000	122,000
Gross external debt, % of GDP	51.9	48.8	47.4	50.8	52.5	52.5	55.1	54.0	51.3
Average exchange rate RON/EUR	4.5688	4.6540	4.7453	4.7969	4.8378	4.8174	4.85	4.95	5.05

1) Preliminary. - 2) Enterprises with 4 and more employees. - 3) From 2018 the employers' social security contribution was transferred to the employees; real growth 2018 refers to net wages. - 4) One-week repo rate.

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