

## 22. ROMANIA

### Gradual recovery and correction of imbalances under way

#### High external and fiscal imbalances increased Romania's exposure to the global economic downturn

The economic boom between 2004 and 2008 has led to overheating pressures and unsustainable fiscal and external imbalances: real GDP growth in this period averaged 6.6%; inflation peaked at 8.4% in Q2-2008; the current account deficit reached 12.3% of GDP in 2009; banks and other businesses were increasingly reliant on short-term external funding; and half of domestic private credit was in foreign currency. Moreover, years of procyclical budgetary policy had led to a sizeable deterioration in the underlying fiscal position, with the structural deficit rising from 2.4% of GDP in 2005 to 8.5% of GDP in 2008. Market participants and economic agents became increasingly concerned by these developments. This resulted in a significant tightening of capital flows to Romania and stress in the banking system. Pressures on the exchange rate increased, resulting in a more than 30% cumulative depreciation between August 2007 and January 2009. Balance-sheet effects and a sharp decline of export demand plunged the economy in a severe recession in late 2008.

In these conditions, the authorities decided to seek external financial support. The EU, the IMF, the World Bank, the EIB and the EBRD responded by making available to Romania medium-term financial assistance of up to EUR 20bn. This assistance is conditional upon the implementation of a comprehensive economic policy programme, comprising fiscal consolidation and reform measures in the area of fiscal governance, structural reform and financial sector supervision. The adoption of the policy programme has contributed to an improvement in market sentiment and had a positive impact on the Romanian economy. Financial stress eased, pressures on the exchange rate declined and strains on the government securities market diminished with average yields on government bonds declining from 14% end-2008 to just above 10% in August 2009.

#### Deeper-than-expected recession in 2009, shallow recovery starting in 2010

The tightening of access to credit and the decline in export demand resulting from the worldwide crisis caused the Romanian economy to plunge into a severe recession, which has been deeper than previously expected. For 2009, growth is expected to decline by about 8%, followed by a shallow recovery by 2010.

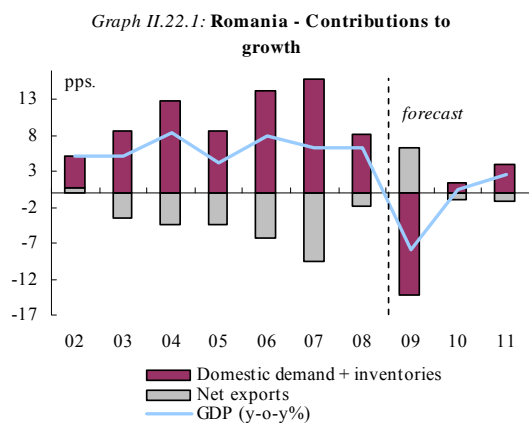
In the first half of 2009, real GDP contracted by 7.5% y-o-y. As in many other countries in the region, the recession was led by a large drop of export volumes, followed by a very sharp contraction of domestic demand. The unemployment rate has jumped to 6.6% of the labour force in August, up from 5.4% one year earlier. Although wage and price pressures are easing, headline CPI inflation has remained relatively high: it stood at 5.0% in September reflecting, inter alia, hikes in excise duties and increases in the public wage bill.

A large balance of payments adjustment is under way. The current account deficit fell by about  $\frac{3}{4}$  in the first half of 2009 compared to the same period of 2008. This reflects the sharp contraction of import volumes associated with the drop in domestic demand, which more than offset the decline of exports. Developments in the capital and financial account have been more favourable than projected, with higher rollover by corporates and stronger FDI inflows more than offsetting a slightly lower rollover rate for foreign banks. Against this background, pressures on the exchange rate have eased.

In the second half of 2009, first signs of economic recovery started to appear, initially driven by export demand. The decline in industrial production and exports has been moderating and m-o-m private credit developments turned positive in August after 5 months of negative growth. The forecast assumes these trends will consolidate over the coming quarters. The recovery of domestic demand is expected to follow with some delay given still rising unemployment and decelerating wage growth. Real GDP growth is expected to turn positive by the first quarter of 2010 leading to a moderate  $\frac{1}{2}$ % real GDP growth rate in 2010, gradually accelerating to  $2\frac{1}{2}$ % in 2011. The

recovery, however, will remain shallow because of a continued need for fiscal adjustment, diminished capital inflows, at least in comparison with the pre-crisis period, and the continued high rate of unemployment.

There are upside risks to this macroeconomic outlook. Assuming that global financial markets do not go through another round of stress, the economy may recover slightly faster than projected in this baseline. On the negative side, the current political uncertainty could delay the implementation of measures aimed at stabilising the economy and weaken the recovery in a still fragile external environment.



The unemployment rate is expected to rise from 5.8% in 2008 to about 9% in 2009, followed by a gradual easing to about 8 ½ % in 2011. Wage pressures have diminished considerably in the course of 2009 but are likely to re-emerge, although to a lesser extent, once the economy rebounds. The widening output gap, the declining domestic demand and the recent stabilisation of the RON exchange rate have significantly eased inflationary pressures over recent months. Yet, core inflation remains relatively high, following the increase in excise duties and structural rigidities in the labour market, driven among others by still significant increases in the public wage bill observed in the first 8 months of the year. HICP inflation is expected to edge down from 7.9% in 2008 to 5.7% in 2009 and entering into the Central Bank end-2009 target band of 3.5 +/-1%. For 2010 and 2011, a further easing to 3.5% and 3.4%, respectively, is anticipated.

As the economy returns to a more sustainable growth path for a transition country, external balances are expected to remain in negative territory. As the projected rates of increase in

imports exceed those in exports, both the trade and current account deficits are forecasted to go up by one quarter of a percentage point between 2009 and 2011.

#### Improving competitiveness would help achieve sustainable growth

The external competitiveness of the Romanian economy has been eroded by years of high wage increases, driven by loose income policy in the public sector – wage agreements in the public sector play an important signalling role for private sector wages. In addition, growing skill shortages have put upward pressure on compensation levels in the private sector. In 2005, 2007 and 2008 real compensation per head rose at double-digit rates. In parallel the export sector had to cope with a 22% nominal appreciation of the RON between 2004 and 2007. Even though annual productivity growth rates in this period exceeded 5%, significant losses in competitiveness were unavoidable. The real effective exchange rate of the RON (based on unit labour costs in the total economy) rose by no less than 72% between 2004 and 2008. The measures taken in the framework of the balance of payments assistance programme to support wage moderation in the public sector will therefore help not only to reduce budgetary deficits but also act, in the medium-term, as a stimulus to competitiveness. Over the past decade Romania has recorded significant productivity gains. Following the set-back of 2009 it faces the challenge to bring back labour productivity growth rates to pre-recession levels.

#### Deterioration in public finances

The sharper than anticipated growth contraction in the first half of the year has resulted in a significant decline in government revenue. The general government deficit is forecast to deteriorate from 5.5% of GDP in 2008 to 7.8% of GDP in 2009. Yet, achieving this target assumes that the government will implement the announced measures to freeze the wage bill. Furthermore, the target assumes full implementation of the announced spending cuts in goods and services and in subsidies. Considerable risks remain. In particular, the current political turmoil could delay the implementation of the announced expenditure cuts and could weaken the willingness and capacity of the authorities to control the traditional end-year surge in public spending.

The general government deficit is expected to decline only marginally to respectively 6.8% and 5.9% of GDP in 2010 and 2011. As the 2010 budget has not yet been adopted, this forecast only partially includes the effect of the announced additional cuts in goods and services expenditure and a freeze in pensions (excluding social pensions). Risks to the 2010 budget are mixed: on the one hand, the adoption and full implementation of the Unified Wage law would contribute to reducing the size of the public wage bill (this law was designed to gradually reduce the size of the public wage bill to 7% of GDP by 2015, but it is currently under review by the Constitutional Court). Similarly, progress on key structural fiscal reforms (pension law and fiscal responsibility law), as required in the balance of payments programme, would contribute to the fiscal consolidation process. On the other hand, the current political gridlock may weaken or delay the fiscal consolidation and structural reform efforts.

The large budget deficits will result in a more than doubling of public debt from 13.6% of GDP in 2008 to 31½ % of GDP in 2011, which however remains one of the lowest in the EU.

Table II.22.1:

**Main features of country forecast - ROMANIA**

|  | 2008            |              |       | Annual percentage change |       |       |       |       |      |      |
|--|-----------------|--------------|-------|--------------------------|-------|-------|-------|-------|------|------|
|  | bn RON          | Curr. prices | % GDP | 92-05                    | 2006  | 2007  | 2008  | 2009  | 2010 | 2011 |
| GDP  |                 | 504.0        | 100.0 | 1.8                      | 7.9   | 6.3   | 6.2   | -8.0  | 0.5  | 2.6  |
| Private consumption                              |                 | 330.4        | 65.6  | 4.3                      | 12.7  | 11.9  | 8.9   | -12.5 | 2.2  | 3.6  |
| Public consumption                               |                 | 78.8         | 15.6  | 0.0                      | -4.1  | -0.1  | -0.3  | -3.0  | -4.0 | -1.4 |
| Gross fixed capital formation                    |                 | 167.9        | 33.3  | 7.2                      | 19.9  | 30.3  | 19.3  | -12.3 | 1.1  | 5.8  |
| of which : equipment                             |                 | 78.9         | 15.7  | 9.6                      | 23.5  | 28.3  | 19.0  | -13.1 | 1.0  | 6.0  |
| Exports (goods and services)                     |                 | 155.8        | 30.9  | 11.0                     | 10.4  | 7.8   | 19.4  | -8.9  | 3.1  | 5.0  |
| Imports (goods and services)                     |                 | 219.3        | 43.5  | 12.0                     | 22.6  | 27.3  | 17.5  | -20.8 | 5.0  | 7.5  |
| GNI (GDP deflator)                               |                 | 483.6        | 96.0  | 1.6                      | 7.4   | 6.0   | 5.8   | -6.5  | 0.5  | 2.7  |
| Contribution to GDP growth :                     |                 |              |       |                          |       |       |       |       |      |      |
|  | Domestic demand |              |       | 5.1                      | 12.9  | 15.9  | 11.7  | -12.8 | 1.1  | 3.9  |
|  | Stockbuilding   |              |       | -1.8                     | 1.4   | 0.0   | -3.6  | -1.5  | 0.3  | 0.0  |
|  | Foreign balance |              |       | -1.3                     | -6.3  | -9.6  | -1.9  | 6.3   | -0.9 | -1.3 |
| Employment                                       |                 |              |       | -2.1                     | 0.7   | 0.4   | 0.3   | -3.3  | 0.8  | 0.9  |
| Unemployment rate (a)                            |                 |              |       | 6.6                      | 7.3   | 6.4   | 5.8   | 9.0   | 8.7  | 8.5  |
| Compensation of employees/head                   |                 |              |       | 69.5                     | 12.4  | 22.0  | 21.7  | 4.8   | 5.5  | 6.0  |
| Unit labour costs whole economy                  |                 |              |       | 63.1                     | 4.9   | 15.2  | 14.9  | 10.2  | 5.8  | 4.3  |
| Real unit labour costs                           |                 |              |       | -0.6                     | -5.1  | 1.5   | 0.7   | 2.8   | 0.5  | -0.7 |
| Savings rate of households (b)                   |                 |              |       | -                        | -     | -     | -     | -     | -    | -    |
| GDP deflator                                     |                 |              |       | 64.1                     | 10.6  | 13.5  | 14.0  | 7.2   | 5.3  | 5.0  |
| Harmonised index of consumer prices              |                 |              |       | -                        | 6.6   | 4.9   | 7.9   | 5.7   | 3.5  | 3.4  |
| Terms of trade of goods                          |                 |              |       | 0.9                      | 7.2   | 10.6  | 2.9   | 3.7   | 1.9  | 1.9  |
| Trade balance (c)                                |                 |              |       | -7.2                     | -12.0 | -14.3 | -13.3 | -6.2  | -6.2 | -6.5 |
| Current account balance (c)                      |                 |              |       | -                        | -10.6 | -13.6 | -12.3 | -5.5  | -5.5 | -5.7 |
| Net lending(+) or borrowing(-) vis-à-vis ROW (c) |                 |              |       | -4.5                     | -10.4 | -13.1 | -11.8 | -5.0  | -5.1 | -5.2 |
| General government balance (c)                   |                 |              |       | -                        | -2.2  | -2.5  | -5.5  | -7.8  | -6.8 | -5.9 |
| Cyclically-adjusted budget balance (c)           |                 |              |       | -                        | -4.4  | -5.1  | -8.5  | -7.1  | -5.5 | -4.6 |
| Structural budget balance (c)                    |                 |              |       | -                        | -3.8  | -5.1  | -8.5  | -7.1  | -5.5 | -4.6 |
| General government gross debt (c)                |                 |              |       | -                        | 12.4  | 12.6  | 13.6  | 21.8  | 27.4 | 31.3 |

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.