22. ROMANIA

Growth contracts sharply

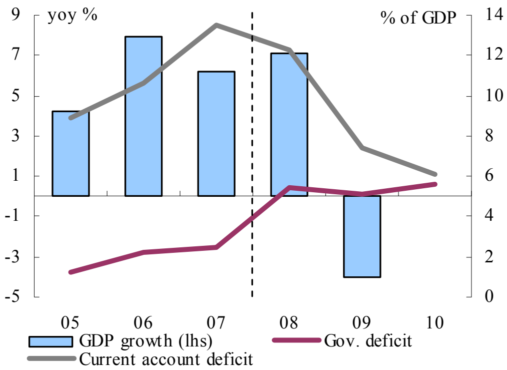
The domestic demand boom ended abruptly in the fourth quarter of 2008

Despite a sharp drop in the last quarter of the year, GDP growth accelerated to 7.1% in 2008, from 6.2% in 2007. In the first three quarters, domestic demand for both consumption and investment boomed at double digit rates, fuelled by strong wage increases and a rapid expansion of credit. Net exports continued to record a negative contribution to GDP growth. The largely foreign-financed domestic demand boom and overheating pressures came to a sudden end at the beginning of the fourth quarter, following the significant tightening of international capital inflows, increased investor risk aversion to home-grown vulnerabilities and decelerating disposable income. Hence, domestic demand contracted by almost 2% y-o-y in the fourth quarter, compared with an average increase of 14½% y-o-y in the first three quarters. The contribution from net exports turned positive in the fourth quarter, notwithstanding a concurrent severe drop in external demand.

Overall, net borrowing from the rest of the world slightly eased but remained at a high level of 11.8% of GDP in 2008, down from 12.8% of GDP in the previous year. FDI inflows increased in 2008, covering 56% of net external borrowing compared with 47% in 2007.

In view of the large domestic and external imbalances and the adverse effect of the global financial turmoil on the economic and financial situation in Romania, the authorities made a request to the European Commission for balance of payments support in March 2009. The financial assistance that the EU intends to provide will be conditional on the implementation of a comprehensive economic policy programme, encompassing fiscal, financial sector and structural reform measures.

Graph 2.22.1: **Romania - GDP, goverment deficit and current account**



Significant adjustment expected in 2009 and 2010

GDP growth is projected to turn negative in 2009 to around -4%. The slackening rate of household disposable income growth and tighter credit conditions will depress household consumption, while government spending is anticipated to contract following a significant fiscal adjustment. The anticipated strong contraction of gross fixed capital formation will be cushioned by an increase in public investment, as EU funded investment is safeguarded in the current budget. GDP growth is expected to remain around zero in 2010.

Net exports are set to keep their positive contribution to growth, notwithstanding weak demand from the euro area. Hence, net external borrowing is anticipated to ease significantly from 11.8% of GDP in 2008 to roughly 6½% in 2009 and just above 5% in 2010.

This macroeconomic scenario constitutes the basis for the EU medium-term financial assistance programme to Romania.

Easing pressures on labour market, costs and prices

Following the decline in economic activity, unemployment is expected to rise from a record low of 5% in 2008 to about 8% in both 2009 and 2010. While inflationary pressures had eased in the second half of 2009 on the back of falling international commodity prices, inflation picked up again early 2009 caused primarily by a sharp RON depreciation. In the course of 2009 and 2010 inflation is projected to decrease following lower wage growth and still low international commodity prices. By the end of 2009, inflation is expected to enter the national bank target band of 3.5 +/- 1%. The exchange rate depreciation recorded in the first months of the year, together with the lower pressures on wage growth will contribute to improving Romania's international competitiveness.

High government deficits despite envisaged measures

The budget deficit was 5.4% of GDP in 2008 (up from 2.5% of GDP in 2008). This was mainly due to substantially higher-than-planned current spending, notably in public wages and social transfers. In addition, overly optimistic revenue projections did not materialise and a sudden drop in revenue collection in the last two months of the year owing to the economic slowdown added to the worse-than-expected outcome.

The deficit is projected to decline to 5.1% of GDP in 2009. The 2009 budget adopted in February 2009, contains several measures to lower the deficit, including a recruitment freeze and the reduction of various bonuses in the public sector, cuts in expenditure for goods and services and subsidies, limiting pension increases to inflation, a 3.3pps rise in the pension contribution rate and a bringing forward of the schedule to increase excise taxes. Under the economic programme to be undertaken in the framework of the balance of payment support, the government has pledged to undertake additional expenditure-driven fiscal adjustment measures, e.g. further cuts in the public sector wage bill, expenditure on goods and services, certain capital spending items and subsidies. On the revenue side, measures aim at eliminating certain tax deductions and allowances (in particular on company cars and depreciation of revalued assets). On the other hand, the government plans a substantial increase in public investment in 2009 compared with 2008. These measures are reflected in a budget rectification approved by the government in April 2009.

Under the assumption of unchanged policies, the budget deficit is anticipated to increase to some 5½% of GDP in 2010. However, in the financial assistance programme, the authorities committed to continue the fiscal adjustment throughout 2010, aiming at a deficit of below 3% of GDP in 2011.

The high primary deficits and a significant increase in interest payments on government debt will result in the debt-to-GDP ratio rising from 15¼% to 22¾ % between 2008 and 2010.

Table 2.22.1:

Main features of country forecast - ROMANIA

	2007		Annual percentage change						
bn RON	Curr. prices	% GDP	92-04	2005	2006	2007	2008	2009	2010
GDP at previous year prices	412.8	100.0	1.6	4.2	7.9	6.2	7.1	-4.0	0.0
Private consumption	277.8	67.3	3.7	10.1	12.7	11.6	9.1	-3.7	-0.3
Public consumption	64.3	15.6	0.7	3.8	-4.1	1.6	3.2	-11.0	0.1
Gross fixed capital formation	125.6	30.4	6.5	15.3	19.9	29.0	19.3	-6.5	-0.5
of which : equipment	60.8	14.7	8.7	18.9	23.5	27.1	19.0	-7.0	-1.0
Exports (goods and services)	121.9	29.5	11.2	7.6	10.4	7.9	19.4	-16.9	0.6
Imports (goods and services)	179.7	43.5	11.6	16.0	22.6	27.2	17.5	-17.3	-0.5
GNI at previous year prices (GDP deflator)	398.9	96.6	1.3	5.5	7.4	6.2	6.3	-3.8	0.4
Contribution to GDP growth : Domestic demand			4.7	10.9	12.9	15.7	12.5	-6.3	-0.3
Stockbuilding			-1.8	-2.3	1.4	0.1	-3.5	0.0	0.0
Foreign balance			-1.1	-4.5	-6.3	-9.5	-1.9	2.3	0.3
Employment			-2.1	-1.5	0.7	0.4	0.3	-2.2	0.6
Unemployment rate (a)			6.5	7.2	7.3	6.4	5.8	8.0	7.7
Compensation of employees/head			73.1	28.6	12.4	22.4	22.0	8.5	7.5
Unit labour costs whole economy			66.8	21.6	4.9	15.7	14.3	10.5	8.1
Real unit labour costs			-1.3	8.4	-5.1	2.6	0.2	0.7	1.4
Savings rate of households (b)			-	-	-	-	-	-	-
GDP deflator			69.0	12.2	10.6	12.7	14.0	9.7	6.6
Harmonised index of consumer prices			-	9.1	6.6	4.9	7.9	5.8	3.5
Terms of trade of goods			0.7	3.5	7.2	10.3	2.9	7.9	2.1
Trade balance (c)			-7.0	-9.8	-12.0	-14.4	-13.3	-9.1	-8.0
Current account balance (c)			-	-8.9	-10.6	-13.5	-12.3	-7.4	-6.1
Net lending(+) or borrowing(-) vis-à-vis ROW (c)			-4.1	-7.9	-10.4	-12.8	-11.8	-6.4	-5.1
General government balance (c)			-	-1.2	-2.2	-2.5	-5.4	-5.1	-5.6
Cyclically-adjusted budget balance (c)			-	-1.8	-3.8	-4.5	-7.9	-5.2	-4.7
Structural budget balance (c)			-	-1.8	-3.1	-4.4	-7.9	-5.2	-4.7
General government gross debt (c)			-	15.8	12.4	12.7	13.6	18.2	22.7

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