

22. ROMANIA

Recovery to continue despite worsening external environment

Modest recovery after a long recession

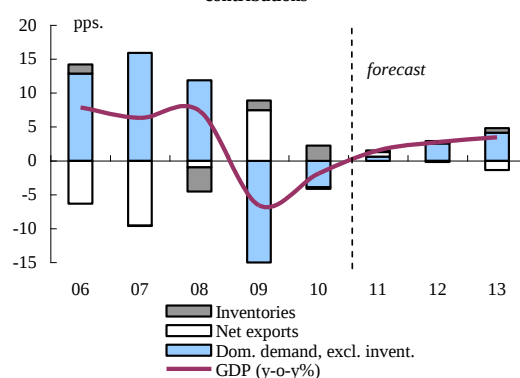
Economic growth was robust in the first quarter of 2011 (when GDP grew by 0.5% q-o-q), but tailed off in the second quarter to a mere 0.2% increase. Real GDP is currently projected to grow by around 1.7% in 2011 as a whole. On the demand side, net exports were the key driver for growth in the first half of 2011, but these are likely to contribute less to growth in the second half of the year due to the expected slowdown in external demand. Private consumption did not pick up significantly as it was held back by still weak household balance sheets. However, both retail trade developments and the retail sentiment indicator point to slight improvements lately. Public investment is assumed to increase towards the end of the year as the authorities are moving ahead with various road construction projects. The still very low EU funds absorption rate of 3.7% (as of end-September 2011) indicates that there is great potential for higher public investment.

Progress in implementing the measures required under the multilateral financial assistance programmes of the EU, the IMF and the World Bank⁽⁷⁰⁾ has reduced previously built-up imbalances and has helped restore confidence among investors in the country. Following the successful completion of the 2009-11 balance of payments assistance programme, Romania has returned to the financial markets and is now financing itself both on the domestic and the external market.

The labour market shows signs of improvement. The second quarter of 2011 saw significant improvement, probably also driven by important reforms implemented in April 2011 in the areas of labour market legislation (Labour Code) and social dialogue (Social Dialogue Code). While registered unemployment is coming down, indications from the labour force survey (LFS) point to a broadly

stable unemployment rate of around 7% as job losses level off and wages begin to rise. However, young people (aged 15-24) remain a particularly vulnerable group as their employment dropped in the second quarter of 2011 by 9% (y-o-y).

Graph II.22.1: Romania - GDP growth and contributions



Growth becomes more broad-based in 2012, but is affected by international turbulence

Growth is expected to moderately accelerate in 2012 to 2.1%. After export-led growth in 2011 activity is expected to become more broad-based in 2012 as the increase in exports spills over into domestic demand. External demand is expected to remain supportive but to be less robust in 2012 due to the worsening economic outlook in Europe and other parts of the world. Although households and corporates are expected to continue to adjust their balance sheets during the first half of 2012, the projected increase in employment, coupled with lower inflation, should support real disposable income. This contributes to a revival of private consumption during the second half of 2012.

Government consumption is not expected to contribute much to growth in 2012 as it is constrained by the need for further fiscal consolidation and the continued reduction of public sector employment. Investment is expected to be an important growth driver next year given the country's high needs to modernise its public infrastructure, partly with the help of co-financing from EU structural funds. Private investment is, however, likely to be weaker on account of increased uncertainty linked to the 2012 elections and due to the lagged effects of the turbulences in international financial markets during 2011. Credit

⁽⁷⁰⁾ Following the successful completion of the 2009-11 balance-of-payments (BoP) assistance programme and at the request of the Romanian authorities, a follow-up precautionary BoP programme for Romania was approved by the Council in May 2011 which entered into force in June. The new programme is again a joint programme with the IMF and the WB and it focuses on structural reforms to support the re-launch of economic growth, but the continuation of fiscal consolidation and the preservation of financial stability remain important conditions.

activity is expected to show a modest recovery in 2012, as financial institutions continue to repair their balance sheets after a long period of deterioration in asset quality.

Economic growth is expected to increase to 3.4% in 2013 about 1 pp. above current estimates of potential growth. Wages are expected to continue to readjust upwards from still very low levels (compared with the main trading partners), thus improving household balance sheets and leading to higher growth in private consumption than in 2012. Both private and public investment are expected to accelerate; on the public side, the Government is planning to increase its capital spending in 2013 while on the private side some of the investments planned for 2011 and 2012 will be delayed and will shift into 2013. Moreover, the infrastructure projects started in 2011-12, mostly financed by EU funds, are assumed to be executed at full speed. Although economic growth will be mainly driven by domestic demand in 2013, exports are expected to continue to increase on account of wage competitiveness and the sustained expansion in Romanian export capacity.⁽⁷¹⁾

Risks to the current forecast are skewed to the downside for 2011 and balanced thereafter. There is a downside risk for 2011 due to the economic uncertainties surrounding the Eurozone, the sovereign-debt crisis and financial markets. However, going forward risks appear more balanced. Downside risks include: (i) the additional needs for repairing household balance sheets coupled with tighter credit standards for consumer lending may result in lower-than-expected private consumption; this in turn could harm the assumed transition to a more broad-based recovery driven by private household demand; (ii) continuing uncertainty in financial markets and sovereign debt developments in the euro-area periphery, as well as the global economic outlook in general may affect Romania's future prospects. However, there are upside risks: (i) the role of investment foreseen in the baseline may be more pronounced if the absorption of EU funds improves significantly in 2012 and 2013; (ii) moreover, since 2012 is an election year there is an upside risk of stronger domestic demand induced by fiscal slippages, possibly in the form of a combination of reductions in social security

contributions, increases in public sector wages, and investment spending. Although this will have a positive impact on short-term growth, it will negatively impact the fiscal deficit target for 2012.

Although the latest developments on the balance-of-payments front are positive, decreasing demand from European partners may have a negative impact in 2012. Exports – especially in the machinery sector – accounted for a decline of 22% in the first half of 2011 in the trade deficit (to 4.2% of GDP). The current-account deficit is expected to remain stable at around 4.3% of GDP in 2011 and to marginally widen in 2012 and 2013 due to a stronger pick-up in private consumption and a deterioration of the primary income and net transfers balances.

Inflation moderated significantly recently, but upside risks remain over medium-term

Significant upside risks to the medium-term inflation outlook remain in place, although price pressures eased in the course of the summer. In the second quarter of 2011, following a succession of upward price shocks, Romania was still the Member State with the highest inflation in the EU (at 8.4% in May 2011). Annual inflation dropped sharply in the third quarter of 2011 reaching its lowest level in 21 years (i.e. 3.5% in September 2011) due to a base effect resulting from the VAT hike a year ago and helped further by easing food prices. Therefore inflation has come into the NBR's target range of 3.0% $\pm$ 1 pp. set for end-2011.

Inflation is expected to remain within the target range in Q4-2011 and the first half of 2012. Nonetheless, looking further ahead, the temporary downward pressure on headline price indices stemming from volatile food prices may reverse in the second half of 2012, although inflation is currently assumed to stay within the target range. Moreover, the main upside risks to the inflation outlook still relate to prospects for sizeable upward adjustments in administered prices (in particular of electricity, gas and other utilities). Conversely, a deterioration in global economic conditions (including lower commodity prices) would have a disinflationary effect.

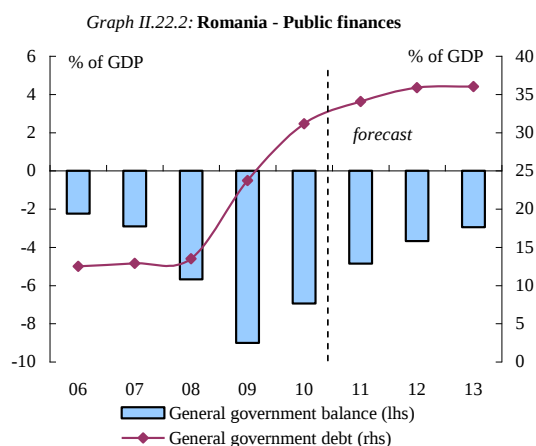
Fiscal consolidation will continue

The budget deficit is projected to decrease from 6.9% of GDP in 2010 to 4.9% of GDP this year.

⁽⁷¹⁾ Romania has seen an improvement in its price and cost competitiveness since the onset of the financial crisis; the ULC-deflated real effective exchange rate weakened both due to nominal effective depreciation of the leu and muted growth of unit labour costs.

The austerity measures taken by the authorities in July 2010 continued to have a decreasing effect on the deficit in the first half of 2011. Moreover, total revenue is expected to increase compared with 2010, although it has been showing signs of underperformance in the July and August budget execution. Income from both VAT and excises was better than expected in the first six months of the year as a result of improved tax collection. However, excises have been underperforming in the budget execution for end-August. Non-tax revenue has also been lower than projected, while other items are evolving broadly in line with expectations.

On the expenditure side, savings are higher than expected due to a better performance of personnel spending following a faster-than-anticipated reduction in public sector employment. Capital spending has also been under-executed in the first eight months of the year and is therefore projected to register a more modest growth rate for 2011 compared to original expectations.



Domestic payment arrears decreased at end-August relative to end-January 2011, but arrears in the health sector may re-accumulate by the end of the year if measures fall short of what is needed and funding is not increased. Moreover, while arrears continue to be on a decreasing trend, they have increased slightly at end-August compared to end-July. The fall in arrears between January and August was due to decreases at local government level and in social security, whereas arrears at central government level increased. Most of the arrears are at the level of local government (50% of the total stock of arrears), followed by the social security sector (39%).

Most of the arrears in the social security sector are in the health sector where the reforms implemented have not yielded the expected results. However, the authorities have committed to undertake an in-depth reform of the health sector by end-2011 to address persistent budgetary shortfalls. On the expenditure side, measures to restructure the system would include the implementation of a revised basic benefits package which would exclude non-essential health services from being insured by the government, a move to an increased use of generic drugs and a revision of the price and list of compensated drugs. On the revenue side, the reforms include a re-design of the clawback tax,⁽⁷²⁾ the introduction of a co-payment system for those using the healthcare system and the introduction of supplementary insurance to cover medical services which go beyond the basic benefits package.

⁽⁷²⁾ The tax is a mechanism to control spending overruns of the healthcare budget by requiring the pharmaceutical industry to pay back to the State the overrun in spending compared to the budget allocation for reimbursed drugs. The initial tax had not yielded the expected savings and is being redesigned

The budget deficit in 2012 is expected to decrease further to 3.7% of GDP under a no-policy-change assumption. The authorities have not yet finalised the 2012 budget, so therefore the current forecast does not include any additional policy measures that may be included in the 2012 budget. The current projections assume continued expenditure restraint, particularly regarding subsidies, as well as additional savings from the reforms that are currently being implemented such as the introduction of means tested social benefits, the reduction in the number of social assistance programmes and the continued implementation of the pension reform.

As part of the EU/IMF precautionary programme, the authorities are also working on shifting capital spending from domestic financing towards an increased use of EU structural funds, as well as prioritising the large number of existing investment projects and improving the capital budgeting process in order to achieve efficiency gains. No major discretionary measures have been taken into account in the revenue projections. In particular, no changes in the main tax rates are expected in 2012.

According to projections, the budget deficit is expected to decrease to 2.9% of GDP in 2013 as a result of a continued decrease in the share of total expenditure in GDP, as well as a slight increase in the share of total revenue in GDP.

Table II.22.1:

Main features of country forecast - ROMANIA

	2010			Annual percentage change						
	bn RON	Curr. prices	% GDP	92-07	2008	2009	2010	2011	2012	2013
GDP	513.6	100.0	2.7	7.3	-6.6	-1.9		1.7	2.1	3.4
Private consumption	321.3	62.5	5.4	9.0	-10.1	-1.6		0.7	1.9	3.4
Public consumption	84.1	16.4	0.5	7.2	3.1	-5.8		-1.5	1.5	3.5
Gross fixed capital formation	116.8	22.7	9.5	15.6	-28.1	-7.3		2.4	2.6	6.5
of which : equipment	50.4	9.8	10.4	10.9	-32.7	-2.0		4.5	2.3	7.5
Exports (goods and services)	183.8	35.8	11.1	8.3	-6.4	13.1		7.3	4.3	5.9
Imports (goods and services)	211.5	41.2	13.8	7.9	-20.5	11.6		4.7	4.5	8.5
GNI (GDP deflator)	507.3	98.8	2.5	8.1	-5.1	-1.8		1.1	1.8	3.2
Contribution to GDP growth :										
Domestic demand			6.5	11.9	-15.0	-3.9		0.7	2.0	4.1
Inventories			-1.5	-3.5	1.4	2.3		0.3	0.3	0.6
Net exports			-2.1	-1.0	7.0	-0.2		0.7	-0.3	-1.4
Employment			-2.4	0.0	-1.8	-1.8		0.1	0.6	0.6
Unemployment rate (a)			6.4	5.8	6.9	7.3		8.2	7.8	7.4
Compensation of employees/head			61.6	31.9	-6.8	1.6		4.7	6.4	8.5
Unit labour costs whole economy			53.5	22.9	-2.0	1.7		3.1	4.9	5.6
Real unit labour costs			-1.2	6.6	-6.0	-2.7		-1.8	1.2	0.7
Saving rate of households (b)			-	-1.1	0.0	-		-	-	-
GDP deflator			55.4	15.3	4.2	4.5		4.9	3.6	4.9
Harmonised index of consumer prices			-	7.9	5.6	6.1		5.9	3.4	3.4
Terms of trade of goods			1.5	3.2	0.1	2.4		0.7	-0.2	2.4
Merchandise trade balance (c)			-7.3	-13.6	-5.8	-4.8		-3.8	-3.9	-4.0
Current-account balance (c)			-	-11.4	-4.2	-4.2		-4.1	-5.0	-5.3
Net lending(+) or borrowing(-) vis-à-vis ROW (c)			-5.4	-11.0	-3.6	-4.0		-3.9	-4.8	-5.1
General government balance (c)			-	-5.7	-9.0	-6.9		-4.9	-3.7	-2.9
Cyclically-adjusted budget balance (c)			-	-8.7	-9.1	-5.9		-3.7	-2.6	-2.2
Structural budget balance (c)			-	-8.3	-9.6	-6.1		-3.7	-2.6	-2.2
General government gross debt (c)			-	13.4	23.6	31.0		34.0	35.8	35.9

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