23. ROMANIA

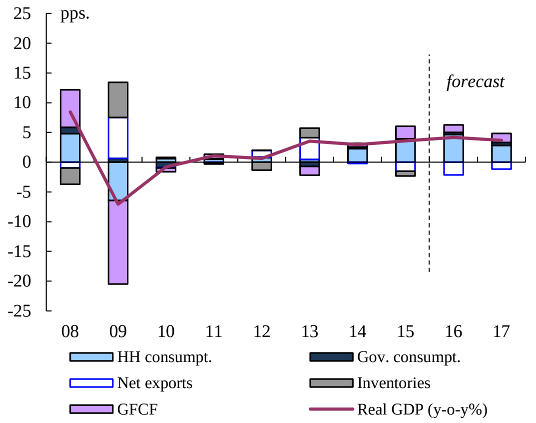
Fiscal expansion fuels domestic demand as financial risks increase

Real GDP growth is set to remain above potential over the forecast horizon, driven by robust domestic demand. Inflation is expected to return to positive territory from mid-2016 while the labour market stays overall stable. The general government deficit is projected to substantially increase in 2016 and 2017 on the back of tax cuts and expenditure increases.

Strong growth ahead

The Romanian economy grew by 3.8% in 2015. Surging domestic demand drove the expansion, while strong imports led to a significantly negative growth contribution of net exports (-1.5 pps.). A fiscal stimulus amounting to almost 2% of GDP is expected to further boost domestic demand in 2016. Accordingly, GDP growth is forecast to accelerate to 4.2%. Economic growth is then projected to ease somewhat to 3.7% in 2017, supported by an additional fiscal stimulus, albeit of a lower magnitude than the one in 2016.

Graph II.23.1: **Romania- Real GDP growth and contributions**



The 4 pps. cut of the standard VAT rate from January 2016 along with accelerating wage growth and a 19% increase of the minimum wage from May 2016 are expected to raise household disposable income and push private consumption to a post-crisis peak in 2016. The recent rebound of credit to households on the back of record low real interest rates has been supportive of this trend, but future credit developments are surrounded by increasing uncertainty. Investment picked up in 2015 (8.8% y-o-y) and is likely to continue growing, but at a slower pace in 2016 with the end of the 2007-2013 financing period for EU funding. Stronger implementation under the 2014-20 EU financing period and the abolition of the construction tax from January 2017 are set to support investment growth in 2017.

The current-account deficit widened in 2015 due to (i) lower export growth on account of a slowdown in external demand and (ii) an increase in imports as the growth rate of domestic demand almost doubled compared with 2014. The trend is expected to be sustained over the forecast horizon, as domestic demand continues to grow.

Inflation to turn positive from mid-2016

Inflation reached a historical low in March (-2.4% y-o-y) after the reduction of the standard VAT rate. Inflation is expected to stay negative until mid-2016, when the base effect of the food VAT cut from June 2015 will wear out and the output gap is projected to close. The surge in domestic demand combined with accelerating wage growth and the increase of the minimum wage from May 2016 is likely to add to the upward pressures on prices, but the impact of the VAT cut is expected to curb inflation to -0.6% on annual average. The annual average inflation rate is forecast to increase to 2.5% in 2017 despite the additional 1 pp. cut of the standard VAT rate envisaged for January 2017.

Wage dynamics may erode competitiveness

Overall employment growth is set to remain broadly flat with modest improvements in labour force participation and job creation in the context of continued rigidities in the labour market. The unemployment rate is expected to decline very slightly from 6.8% in 2015 to 6.7% in 2017. Enacted increases of both public sector wages and of the minimum wage are likely to weigh on competitiveness and temper job creation and, with the closing of the output gap, unit labour costs are expected to trend upward over the forecast horizon.

Risks are tilted to the downside

On the domestic side, downside risks to the macroeconomic outlook have increased significantly due to the uncertainty caused by the adoption of a debt discharge law by Parliament on

13 April. This law could have a substantial negative impact on investor confidence and credit outlook over the forecast horizon and beyond. The external environment is surrounded by uncertainty.

General government deficit set to increase

In 2015, the general government deficit improved to 0.7% of GDP, from 0.9% of GDP in 2014, thanks to a robust growth of tax revenues. Strong economic growth and enhanced tax compliance more than offset enacted tax cuts, such as the cut in the VAT rate for food products as of June 2015 and in the special constructions tax.

Despite robust economic growth, the headline deficit is set to rise significantly within the forecast horizon on the back of further tax cuts and expenditure increases.

In 2016, the headline deficit is expected to increase to 2.8% of GDP. The standard VAT rate has been decreased by 4 pps., the tax on dividends has been cut, and new exemptions in Personal Income Tax have been introduced. On the expenditure side, public wages were considerably increased. In contrast, public investment is projected to drop due to a slow take-up of big projects in the 2014-20 programming period of EU funding.

The headline deficit is projected to further deteriorate to 3.4% of GDP in 2017 on a no-policy-change assumption. An additional cut in the standard VAT rate by one percentage point, the abolition of the extra excise duty on fuel and of the special construction tax are expected to have a negative impact on revenues.

The structural deficit is forecast to increase strongly from just above ½% of GDP in 2015 to about 3½% in 2017 as a consequence of the fiscal easing. Despite strong GDP growth, Romania's debt-to-GDP ratio is thus projected to rise from 38.4% of GDP in 2015 to 40.1% of GDP in 2017.

The main downward risk to the fiscal outlook stems from additional expansionary legislative initiatives in the run-up to the local and parliamentary elections in 2016, including public sector wage policy.

Table II.23.1:

Main features of country forecast - ROMANIA

	2014		Annual percentage change						
bn RON	Curr. prices	% GDP	96-11	2012	2013	2014	2015	2016	2017
GDP	667.6	100.0	2.7	0.6	3.5	3.0	**3.8**	**4.2**	**3.7**
Private Consumption	408.2	61.2	4.9	1.2	0.7	3.8	**6.1**	**6.9**	**5.0**
Public Consumption	92.9	13.9	0.1	0.4	-4.6	0.3	**1.6**	**6.3**	**2.4**
Gross fixed capital formation	161.4	24.2	5.7	0.1	-5.4	2.5	**8.8**	**5.5**	**6.1**
of which: equipment	67.1	10.1	6.8	-2.7	4.8	-2.0	**9.0**	**7.4**	**6.2**
Exports (goods and services)	275.2	41.2	9.0	1.0	19.7	8.6	**5.5**	**4.5**	**4.8**
Imports (goods and services)	277.2	41.5	11.6	-1.8	8.8	8.9	**9.1**	**9.8**	**7.6**
GNI (GDP deflator)	662.1	99.2	2.7	0.2	3.0	4.1	**2.8**	**4.2**	**4.1**
Contribution to GDP growth: Domestic demand			5.0	0.9	-1.7	3.0	**6.1**	**6.4**	**5.0**
Inventories			-0.2	-1.4	1.6	0.2	**-0.8**	**0.0**	**0.0**
Net exports			-2.0	1.1	3.6	-0.2	**-1.5**	**-2.2**	**-1.3**
Employment			-1.5	-4.8	-0.9	0.8	**-0.9**	**0.0**	**-0.1**
Unemployment rate (a)			7.0	6.8	7.1	6.8	**6.8**	**6.8**	**6.7**
Compensation of employees / head			30.6	9.4	3.8	5.3	**3.2**	**6.9**	**6.2**
Unit labour costs whole economy			25.2	3.5	-0.6	3.1	**-1.4**	**2.5**	**2.3**
Real unit labour cost			-1.6	-1.2	-3.9	1.4	**-4.2**	**0.5**	**-0.1**
Saving rate of households (b)			-3.7	-14.6	13.3	-14.6	**-15.4**	**-12.8**	**-11.3**
GDP deflator			27.4	4.7	3.4	1.7	**2.9**	**2.0**	**2.4**
Harmonised index of consumer prices			25.9	3.4	3.2	1.4	**-0.4**	**-0.6**	**2.5**
Terms of trade goods			3.3	-3.4	0.4	0.9	**2.5**	**2.4**	**0.4**
Trade balance (goods) (c)			-8.0	-5.8	-5.5	-4.2	**-4.8**	**-5.9**	**-7.0**
Current-account balance (c)			-6.6	-4.3	-0.6	0.2	**-0.9**	**-2.1**	**-2.8**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-6.3	-2.9	1.5	2.8	**1.5**	**0.1**	**-0.7**
General government balance (c)			-3.8	-3.7	-2.1	-0.9	**-0.7**	**-2.8**	**-3.4**
Cyclically-adjusted budget balance (d)			-4.0	-2.0	-1.1	-0.2	**-0.4**	**-2.8**	**-3.4**
Structural budget balance (d)			-	-2.6	-1.1	-0.2	**-0.6**	**-2.8**	**-3.4**
General government gross debt (c)			19.9	37.4	38.0	39.8	**38.4**	**38.7**	**40.1**

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.