Romania –Strong real GDP growth momentum set to slow in 2020, as economic imbalances start to bite

CHRIS FINDLAY
ECONOMIC RESEARCH OFFICE | LONDON
T: +44-(0)20-7577-1712
E: christopher.findlay@uk.mufg.jp

MUFG Bank, Ltd.
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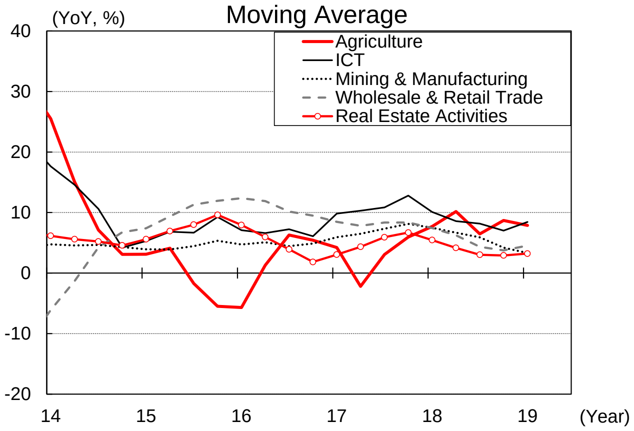
1. Introduction

Romania's 5-year real GDP growth rate has averaged 4.5% YoY from 2013 to 2018, the *third highest level in the Emerging Europe region*. On a nominal USD GDP basis, the economy is the *12th largest in Europe* and, in terms of GDP per capita, Romania averaged USD 10,913 in 2018, based on a population figure of 19.6 million people. The main driver of real GDP growth has been private consumption, which has been underpinned by a strong labour market and further stimulated by expansionary government fiscal policy. This being said, Romania's economic and fiscal imbalances have increased. The current account deficit is currently the widest it has been since 2013 due to strong consumption trends. Added to this, the fiscal deficit has also widened to 2.9% of GDP in 2018 from 1.4% of GDP in 2015.

2. Real GDP Growth Contributions

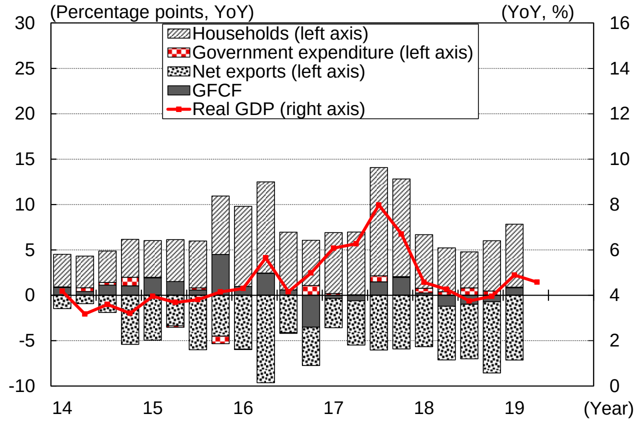
On a gross value added basis in 2018, the industrial sector expanded by 4.2% YoY in 2018, with retail trade up by 3.8% YoY and ICT up by an impressive 7.2% YoY (Chart 1). This growth momentum has continued over the first half of 2019 (Chart 2) and is expected to remain solid with the latest consensus forecasts estimate of real GDP growth of 3.7% YoY in 2019 and 2.8% YoY in 2020, from 4.1% YoY in 2018.

Chart 1: Real GDP Growth by Production, 12-Month Moving Average



Source: Romanian National Institute of Statistics, MUFG Bank Economic Research Office

Chart 2: Contributions to Real GDP Growth



Source: Romanian National Institute of Statistics, MUFG Bank Economic Research Office

(1) Strong private consumption
Private consumption has been the main contributor to real GDP growth in the last 5 years. This has been driven by a tight labour market, as unemployment has declined and real wages have risen. In fact, unemployment now stands at close to historical lows at 4.0% as of June 2019 (seasonally adjusted) after strong net wage growth in the first half of 2019 and double-digit growth of 12.5% YoY in 2018. This has been helped by 'tax cuts, hikes in minimum and public sector wages, and increases in pensions', all of which have boosted disposable income according to the World Bank.

Further ahead, in 2020, slower net wage growth and weaker global real GDP growth momentum could dent consumption. First, net wage growth is likely to slow as nominal unit labour costs rise faster than labour productivity gains. Nominal unit labour costs increased strongly in 2018 and Q1 2019, however over the same period, labour productivity growth has been weaker and more recently it has started to stabilise at a lower level of growth. This suggests that, further ahead, companies might be unwilling to offer greater wage rises as this could affect cost competiveness. In addition, pay rises in the public sector are expected to slow, albeit from double digits in both 2017 and 2018, which could have an influence on pay rises in the private sector. Second, there is also the prospect that the weaker global economic environment could affect consumer sentiment, although currently global services PMI's have been more resilient, so this risk is harder to judge at present.

(2) Drag of net exports
On the downside in 2019, as a result of strong domestic demand, robust import growth has outweighed the rise of exports and led to a large negative contribution from net exports. Romania's exports could be affected in the medium-term by the recent deceleration of global real GDP growth (discussed below). In the event of weaker exports, this would exacerbate the drag of net exports on Romanian real GDP growth. Added to this, public investment has also lagged due to weakness in EU-funded and domestic capital spending (partly explaining small contributions from both government expenditures and gross fixed capital formation).

3. Economic Imbalances

(1) External imbalances
The board of the National Bank of Romania (NBR) has deemed, in its July 2019 MPC statement, that 'in view of its size and evolution, as well as given its financing structure, the economy's external imbalance was increasingly worrisome'. For instance, the latest 12 month moving average current account deficit (CAD) has increased to 5.1% of GDP in Q2 2019 from 4.5% of GDP in Q1 2019, after widening since 2015 (Chart 3). Looking ahead, the CAD is forecast to remain higher than its 5-year average in both 2019 and 2020 with an IMF forecast of 5.2% of GDP in 2019 and 4.8% of GDP in 2020. Risks are expected to the upside (i.e. a larger CAD).

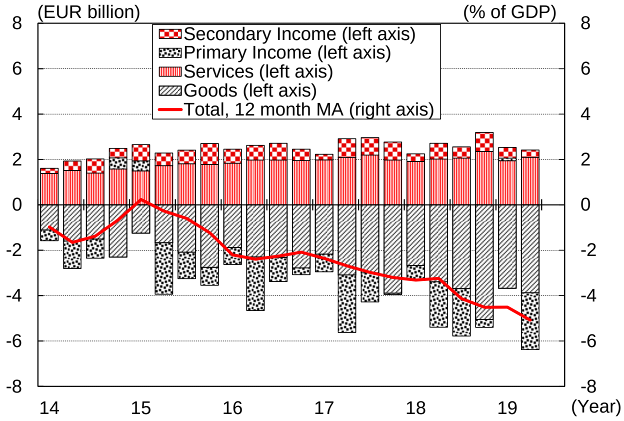
The main driver of the CAD has been strong private consumption trends which have led to the continued and growing deficit of the goods account through greater imports, in particular, those of chemicals, fuel, food and manufactured products.

Further ahead, import trends should start to slow from 2020 as private consumption decelerates while gross exports could be affected from the increased global economic headwinds and the global manufacturing decline. The net effect is expected to be a slight lessening of the CAD as per the IMF's forecasts, but with risks firmly to the upside. These risks include, for instance, the cases where the government's fiscal deficit is larger than expected or the pass-through from higher wages to consumption is stronger than expected.

Given that the household sector demand is relatively solid compared to the business sector demand across the globe, Romania's exports could be more resilient as some exports are for final consumption rather than capital goods or materials. That being said, auto-exports, which have provided a small net positive contribution to the trade account, could still be affected, as highlighted by the recent decline. Romania is most exposed to a slow-down in real GDP growth from Germany (22.9% of total exports), Italy (11.2% of total exports) and France (6.8% of total exports).

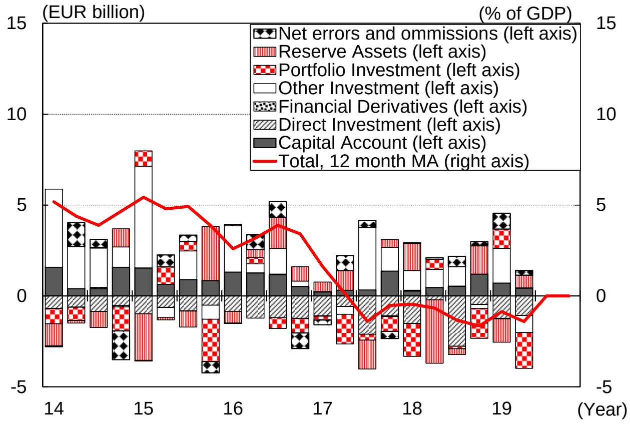
In terms of the funding of the CAD, financial and capital account inflows have been in decline since mid-2016. This being said, however, prior to mid-2017, the financial and capital account was in a strong surplus predominantly driven by non-debt creating inflows (Chart 4). The deterioration since mid-2016 has been largely due the deterioration of the 'Direct investment', 'Reserve asset' and 'Portfolio investment' balances. More recently, in Q2 2019, 'Portfolio investment' and 'Other investment', which include currency, deposits, and loans, have led to deterioration.

Chart 3: Current Account Deficit



Source: National Bank of Romania (NBR), MUFG Bank Economic Research Office

Chart 4: Financial and Capital Account, Net



Source: National Bank of Romania (NBR), MUFG Bank Economic Research Office

With this in mind, how much of a risk is the wider CAD? First, there has been a positive trend in the decline of net external debt in Romania which fell to 15.6% of GDP in 2018, from 40% of GDP in 2012, due to the strong surplus of non-debt creating inflows witnessed in the financial and capital account. This has also been combined with a longer-term decline in external debt servicing costs (including principal and interest), which fell to 21.9% of current external revenues (CXR) in 2018 from 32.0% in 2014. On top of this, gross external financing needs are also set to decline up to 2021. Second, the monetary policy backdrop of the major global central banks has also been more dovish, highlighted by the recent 25bps cut to the main US Fed rate. On balance, further ahead, this should provide a more favourable backdrop for inflows into Romania.

All these factors above taken into account, external risks are low at present. However, on the downside, the absolute level of net external debt is projected to increase as the CAD is increasingly funded by debt creating inflows. In addition, there have also been negative developments with regards to a decline in official reserves. Therefore, with the CAD likely to remain under pressure, this situation will have to remain monitored. Looking ahead, risks will depend on global developments, especially how global recession risks pan out, and the background of a larger fiscal deficit in Romania in 2019 and 2020, both of which are affected by a lot of uncertainty at present.

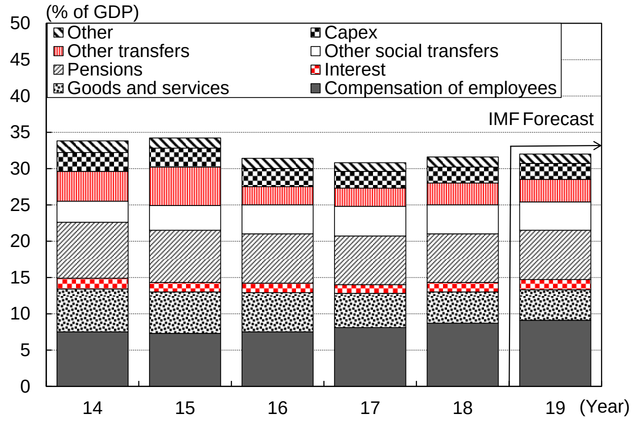
(2) Wider fiscal deficit

Fiscal risks are low at present. First, interest payments are manageable as a percent of total revenues at 3.7% in 2018. Second, the government 10-year bond yield has been in decline and stands at 4.1% at present. Third, there are no concerns regarding gross general government debt levels and government debt dynamics benefits from the strong downward forces of strong real GDP growth. When compared to other EU states, gross general government debt is still fairly low and is forecast to increase only slightly to 39.7% of GDP at end-2020 from 36.6% in 2018.

This being said, the government fiscal deficit is forecast to widen further and will remain subject to uncertainty. The government fiscal deficit has deteriorated from 1.5% of GDP in 2015 to 3.7% of GDP in 2018, following the introduction of fiscal measures in 2017 and 2018. The fiscal measures included increased expenditures on wages, from 7.5% of GDP in 2014 to 8.7% of GDP in 2018, together with increased spending on transfers, which includes pensions and social transfers (Chart 5). Over the same period, there has been a decline in total revenues predominantly due to the decline of VAT revenues from 2015, as well as receipts from personal income tax and excises (Chart 6). In 2018, the income tax rate was reduced from 16% to 10%. As a consequence of this, government fiscal revenues now rely significantly on Social Security Contributions (SSC), which are estimated at 35.6% of total revenues.

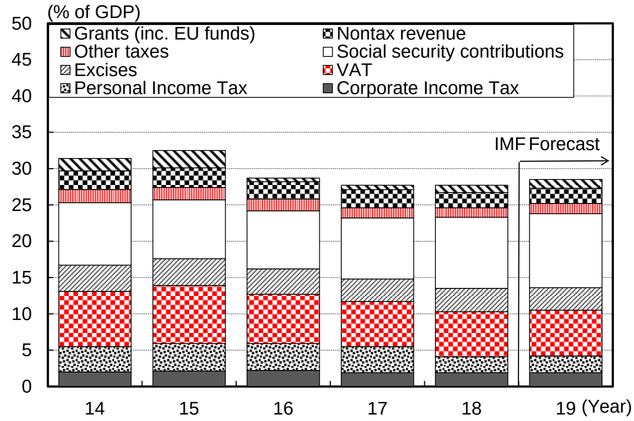
Further ahead, the fiscal deficit is set to widen and remain subject to a degree of uncertainty. In the past, the government has highlighted its willingness to use adjustment measures in order to keep the fiscal deficit below 3% of GDP, and in the last 5-years the average fiscal deficit has averaged 2.5% of GDP (2014-2018). However, this time around, the IMF forecasts a wider fiscal deficit of 3.8% of GDP in 2019 and a further increase to 4.1% of GDP in 2020.

Chart 5: Government Fiscal Expenditures



Source: IMF Article IV Consultation, MUFG Bank Economic Research Office

Chart 6: Government Fiscal Revenues



Source: IMF Article IV Consultation, MUFG Bank Economic Research Office

In terms of the fiscal uncertainty, the government have budgeted for a fiscal deficit of 2.8% of GDP in 2019 which is much lower than the IMF forecast of a 3.8% of GDP deficit. The main reason for the difference between the government and the IMF forecasts in 2019 is mainly down to different forecasted real GDP values. Whereas the government expects real GDP growth of 5.5% YoY in 2019, the IMF forecasts are predicated on real GDP growth of 3.1% YoY. There is also a degree of uncertainty with regard to the pension payments in 2020. If there was a significant increase in pension payments in 2020, fiscal risks would increase.

Consequently, Romania is under the European Commission's (EC) 'Significant Deviation Procedure'. The aim of this procedure is to give member states the chance to change the deviation of their fiscal policy in order to avoid the opening of an 'Excessive Deficit Procedure' (EDP). The EC recommends Romania to take appropriate measures in order to achieve an 'appropriate adjustment path' towards its medium-term budgetary objective (MTO). In order to achieve this, the nominal growth rate of net primary government expenditure must not exceed 3.3% in 2019 and 4.7% in 2020 (an annual structural adjustment of 1% of GDP in 2019 and 0.75% in 2020).

(3) Structural challenges/ elections

Key structural challenges remain, such as, the low labour participation rate and high youth unemployment. The quality of infrastructure in Romania is also poor when compared to Central Eastern and South-Eastern Europe (CESEE). This includes the quality of air transport, roads, ports and railroads. Moreover, in terms of government institutions, these also score poorly across the board when compared to the CESEE EU average. Altogether, these are important contributing factors to Romania's low level of GDP per capita, at USD 10,913 in 2018.

On infrastructure, the recent growth of government spending on current expenditures will increase risks that the government will be unable to meet capital expenditure targets, a key longer-term driver of economic growth. First, capital expenditures have fallen in recent years as the fiscal deficit has increased, and, as stated above, the quality of infrastructure in Romania is poor. Second, Romania has had difficulties absorbing EU structural funds, and with the next budgeting cycle (2021-2027) expected to be lower, there is the risk that Romania will receive less.

In terms of elections, on the 10th November 2019, Romania is due to hold the first round of presidential elections. If no candidate receives more than 50% of votes from all eligible voters in the country, the second round will take place on the 24th November. Regardless of the result, we do not expect any major change to the current fiscal trajectory at present.

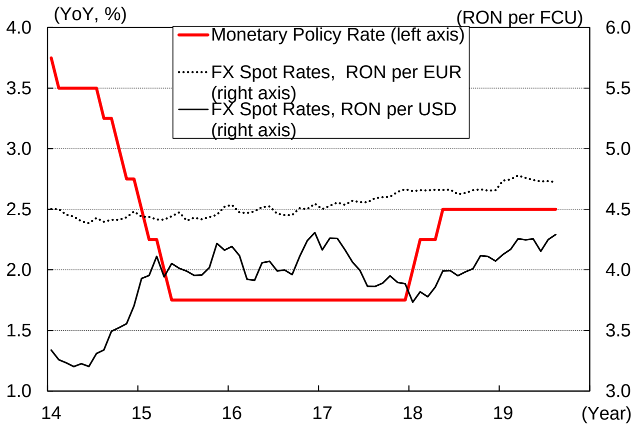
4. Monetary policy

The National Bank of Romania (NBR), which has an inflation target of 2.5 +/- 1 %, increased the policy rate three times in 2018 to 2.5% (Chart 7). Inflationary pressures were down to strong consumption trends, supported by robust private sector credit growth and the government fiscal stance, as well as currency depreciation. Over the first half of 2019, inflation pressures have picked up after a drop at the end of 2018, as food and services prices have increased and outweighed the pass-through from a decline in non-food products. The drop at the end of 2018 came after a period of robust reflation in 2018, which followed the VAT rate cut and sharp drop in the CPI YoY from mid-2015 to mid-2016 (Chart 8).

Looking ahead over the rest of 2019, the NBR anticipates that 'according to the latest information and analyses, the annual inflation rate would probably remain above the variation band of the target over the short time horizon, with some small fluctuations, and follow a trajectory compatible with that shown in the medium-term forecast'. On balance, risks are tilted to the upside in view of the strong fundamentals which are likely to be more inflationary over the short-term.

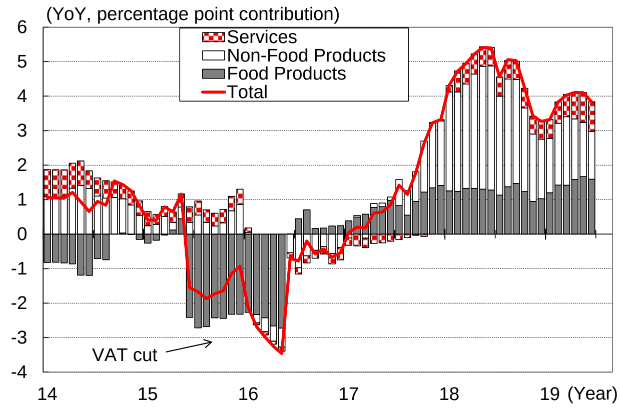
However, some downward pressures could result from a weaker short-term investment outlook that has been affected by a number of uncertainties recently, such as the weaker global outlook and increasing global trade tensions. Against this backdrop, the NBR will remain vigilant to the macroeconomic policy mix and any 'undesired effects', whilst monitoring longer-term inflation expectations.

Chart 7: Main Policy Rate and Exchange Rate



Source: National Bank of Romania (NBR), Macrobond , MUFG Bank Economic Research Office

Chart 8: CPI Contributions



Note: Data uses moving base, CPPY=100
Source: Romanian National Institute of Statistics, MUFG Bank Economic Research Office

5. Conclusion

All-in-all, real GDP growth has been strong in recent years, driven by private consumption. In turn, this has been underpinned by a strong labour market and further stimulated by expansionary government fiscal policy. Further ahead, despite weaker global growth, real GDP growth is still forecast to hit 3.7% YoY in 2019 before a decline to 2.8% YoY in 2020, as net wage growth YoY declines due to a deceleration of wage growth.

On the downside, as a consequence of the recent high real GDP growth, external and fiscal imbalances have increased. The CAD has widened with risks to the upside. The CAD is forecast to remain higher than its 5-year average in both 2019 and 2020. Added to this, the fiscal position of the country has worsened, and Romania is now set to exceed the 3% of GDP rule required by the Stability and Growth Pact (SGP), with gross general government debt on an increasing trajectory.

Overall risks are low at present but tilted to the downside, and subject to uncertainty. Global developments that could affect the CAD and consumer sentiment, together with the potential for a larger government fiscal deficit, will be the main risks, both of which are subject to a high degree of uncertainty. Longer-term, if the worsening trends witnessed in net external debt, government fiscal deficit and gross government debt are extrapolated, these risks are likely to rise from a low level to a more moderate level.