Romania: Coronavirus impacts on real GDP in 2020 could increase the need for structural reforms

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

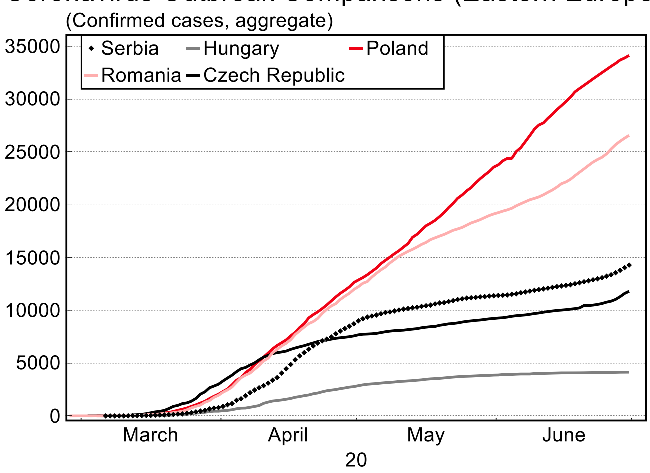
MUFG Bank, Ltd.
A member of MUFG, a global financial group

10 JULY 2020

The IMF forecasts a fairly severe recession in 2020 due to the impacts of coronavirus and containment measures on supply chains and the demand-side effects on private consumption and investment. This comes despite a relatively low number of confirmed coronavirus cases in Romania to date (26,313 confirmed coronavirus cases as of 29th June this year[1]) thanks to the relatively early implementation of containment measures as a result of concerns over the existing capacity of the healthcare service.

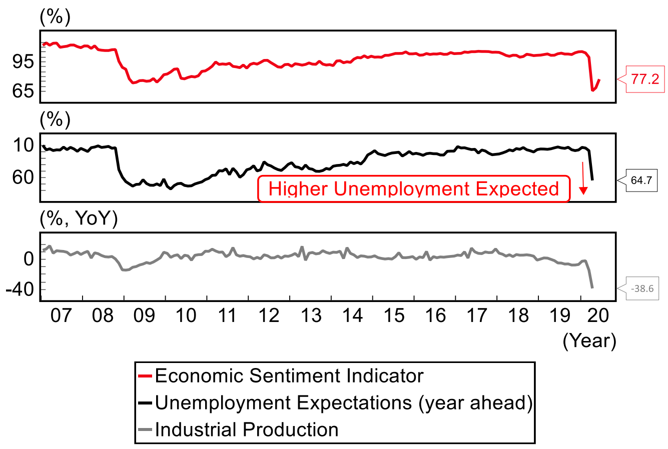
The government declared a 'state of emergency' on 16 March and implemented a nationwide lockdown, school closures, and a ban on public gatherings. The government also increased healthcare spending, introduced tax relief for affected companies and a limited income support system, to prevent a deeper recession, and lay the foundations for the economic recovery, expected in the latter part of 2020. The National Bank of Romania (NBR) also reduced its main policy rate and introduced a limited version of Quantitative Easing (QE) to support the secondary government bond market.

Coronavirus Outbreak Comparisons (Eastern Europe)



Source: WHO, Macrobond, MUFG Bank Economic Research Office

Selected Economic Indicators: Broad Decline



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

[1] We note while one of the lowest levels in Europe, this is higher than Central and Eastern Europe (CEE) peers.

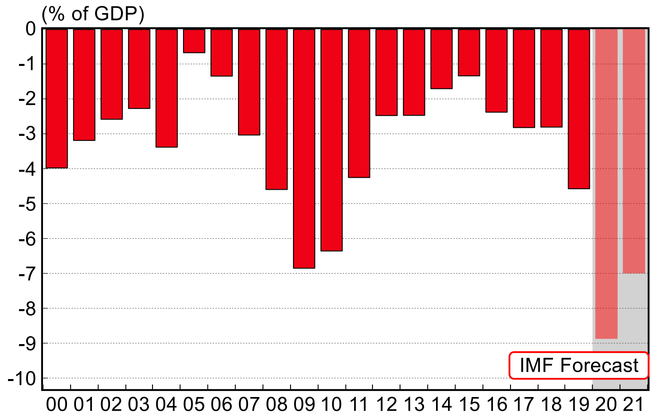
Nonetheless, given recent events, the medium-term outlook has clearly weakened and is subject to great uncertainty. Indeed the impacts of coronavirus on the private sector could lead to second round-effects on the economy later on if not properly handled. We also note, leading into 2020, Romania had a large fiscal deficit of 4.5% of GDP, current account deficit (CAD) of 5.0% of GDP in 2019 (the largest it has been since 2013) and inflation of 3.9% YoY (above the NBR's targeted inflation rate of 2.5 +/- 1%), which has put the country in a weaker position to deal with the impacts of the coronavirus outbreak.

Is the Economic Policy Response Enough?

As stated, to prevent a sharper contraction of real GDP and pave the way for a smoother recovery, the Romanian government have introduced a limited fiscal package that will be partly responsible for a forecasted fiscal deficit of 8.7% of GDP this year, according to the IMF. The government fiscal package is expected to account for an extra RON 13 billion of spending (roughly USD 3 billion) with the SME Invest Program guarantees potentially amounting to another RON 15 billion (USD 3.4 billion), while budgeted revenues are expected to decline by RON 19.5 billion (USD 4.4 billion) due to the impacts of the recession.

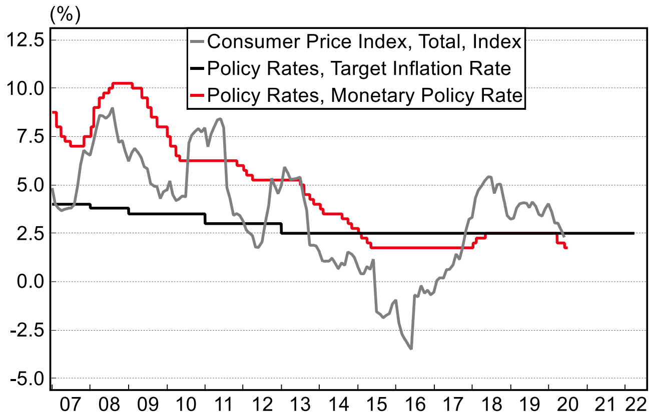
Meanwhile the National Bank of Romania (NBR) introduced a limited version of Quantitative Easing (QE) earlier this year and reduced the main policy rate further from 2.0% to 1.75% on 2nd June. The accumulative policy rate cut this year now totals 75bps. To support access to euro liquidity should it be needed, a repo line worth up to EUR4.5 billion was also signed with the ECB. Added to this, deliberations over the wider EU recovery fund have also made some progress in recent weeks albeit slow. If finalised, Romania would be set to benefit quite significantly over the next few years given its lower level of GDP per capita relative to the EU average. Early estimates suggest an overall gross fund of up to EUR 31 billion (around 15.2% of GDP in 2020), with funds for longer-term projects such as roads, railways and education.

Net Lending/Borrowing (Overall Balance)



Source: IMF Fiscal Monitor, Macrobond, MUFG Bank Economic Research Office

Policy Rate Reduction and CPI



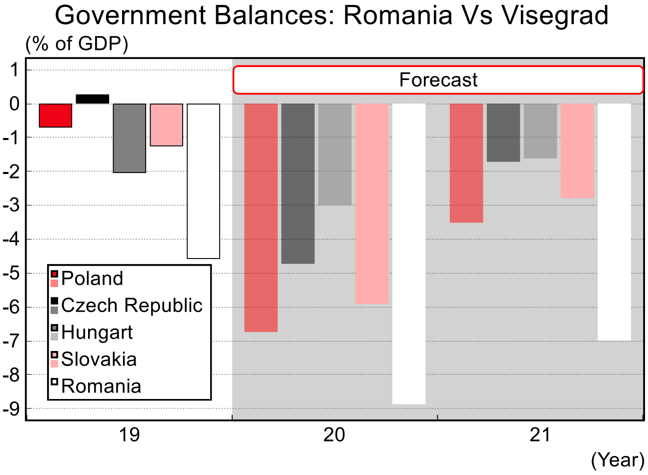
Source: National Bank of Romania, Romanian National Institute of-Statistics, Macrobond, MUFG Bank Economic Research Office

While the announced measures should help to limit a deeper recession given the unprecedented crisis this year, they will not prevent a sharp drop of real GDP in the near-term due to the effect of the lockdown measures on private consumption and investment.

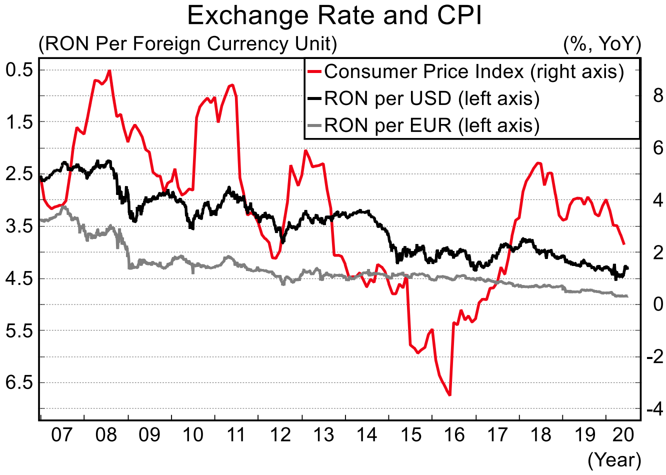
Moreover, given weakened public finances and elevated inflation leading into 2020, the policy response has been more restrained than in other eastern European countries. For instance, in

Poland and Czech Republic, the fiscal policy response has been greater. Initial estimates suggest direct fiscal measures, as a percent of GDP, will amount to 3.0% in Poland and 2.0% in Czech Republic this year versus just 1.3% of GDP in Romania. Including other fiscal measures, total fiscal packages in both Poland and Czech Republic will be much higher. The softer Romania response could, depending on the extent of the damage done to longer term real GDP growth potential, weaken the recovery and longer-term potential real GDP.

QE policy in Romania has also been more constrained in its magnitude versus some of the larger economies in Eastern Europe, despite similar policy goals in some instances[2]. The NBR have clearly reacted more conservatively due to concerns over pre-existing economic vulnerabilities as well as other risks. For instance, the risk that if QE policies are deemed too excessive by markets this could have implications for exchange rates. There may also be implications for inflation through the exchange rate pass-through, although inflation is likely to remain muted over the coming months as a consequence of lockdown measures.



Source: IMF Fiscal Monitor, Macrobond, MUFG Bank Economic Research Office



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

Given both the fiscal and monetary policy response therefore, a key concern this year will be whether the policy response is big enough to sufficiently mitigate all the longer-term economic implications of coronavirus on companies and individuals. If the effects on the private sector are more severe than expected, clearly this could hinder longer-term real GDP growth, public finances and real GDP per capita catch-up.

Recovery Trajectory Dependent on Impact on Private Sector

It will be a while until we know the full extent of the economic loss caused by the coronavirus crisis, but key data that highlights this should be available over the coming months, such as company insolvencies and labour market indicators, once restrictions have been lifted and assuming no second wave. Longer-term, key questions will revolve around the impacts of coronavirus on consumer behaviour and whether or not there will be permanent shifts in behaviour, (away from the travel and hospitality sectors for example), that could lead to a

[2] A limited version of government bond buying (QE) has been introduced to support the secondary government bond market. The benchmark 10-year government bond yield increased to 4.8% in April this year but has subsequently declined to 4.5%. Meanwhile, CDS spreads increased to 258.5 basis points on 18th March, but have subsequently fallen to 112.0 bps on 16th June.

persistent decline of demand. The outcome of these questions will be crucial to evaluate the longer-term damage.

Structural Reform Agenda

Clearly given that real GDP is unlikely to be completely unscathed by the impacts of coronavirus this year, a swifter roll-out of structural reform measures may be needed to support Romania's longer-term potential real GDP growth rate. Reforms could also help to limit pre-existing risks, which include the CAD and weaker public finances. In fact, the IMF noted last year, that the structural reform agenda in Romania had stalled and that investment lagged wider economic growth.

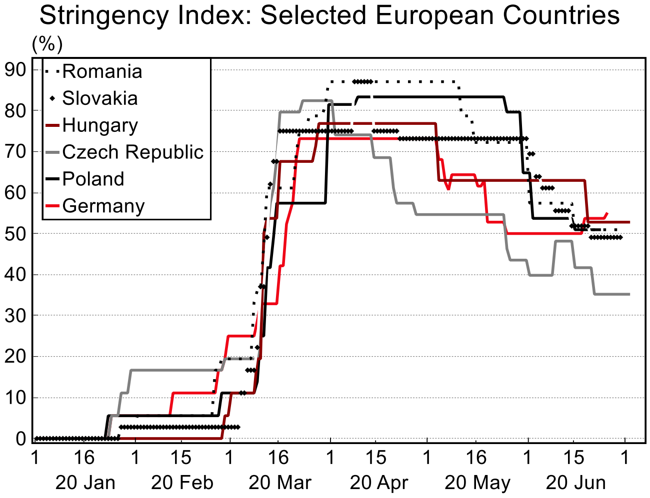
Perhaps, the most likely policy changes might be on the fiscal policy front given government debt will undoubtedly rise this year. Some form of government expenditure restraint may be needed, which in-turn could provide more fiscal room for public investment.

As stated last year in our previous report[3], the quality of road infrastructure in Romania is weaker compared to other countries in Central Eastern and South-Eastern Europe (CESEE). Policies that focus on the improvement of infrastructure would therefore be positive for Romania's longer term growth prospects. Given the deliberations over the recent EU recovery funds, these are definite options, and we note that the quality of infrastructure in Romania has been an issue (ranking 119 out of 141 economies for quality of road infrastructure in the latest 2019 World Economic Forum Competitiveness Index). For now, this all remains clearly hypothetical, and we will continue to monitor the situation and change our outlook accordingly.

Outlook: Severe Real GDP Drop in 2020, Recovery in 2021

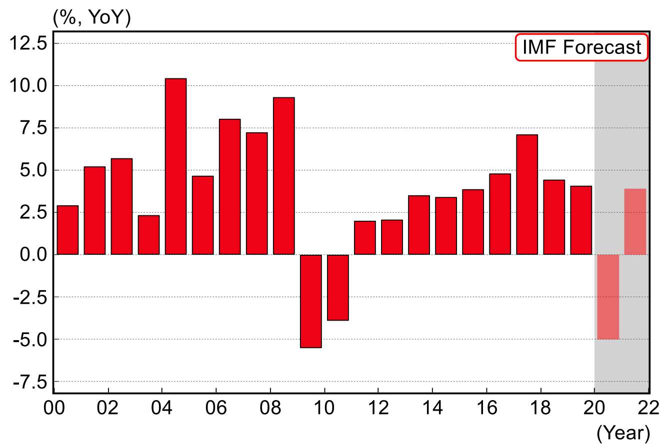
All-in-all, in the absence of a second wave of coronavirus this year, we expect quarterly real GDP growth will recover from 3Q 2020, as containment measures are eased, but risks will remain firmly to the downside and real GDP will decline overall in 2020.The IMF forecasts a decline of real GDP of -5.0% YoY this year followed by a recovery of 3.9 YoY in 2021.

Stringency Index: Selected European Countries



Source: Macrobond, MUFG Bank Economic Research Office

Real GDP Growth



Source: IMF WEO, Macrobond, MUFG Bank Economic Research Office

3 https://www.bk.mufg.jp/report/ecoeu2019e/specialreport_20190911.pdf