Euler Hermes Economic Research

Country Report

Romania

Fiscal stimulus is boosting growth but puts earlier fiscal consolidation success at risk

General Information

GDP	USD178.0bn (World ranking 52, World Bank 2015)
Population	19.8mn (World ranking 58, World Bank 2015)
Form of state	Republic
Head of government	Mihai TUDOSE (Prime Minister)
Next elections	2019, presidential

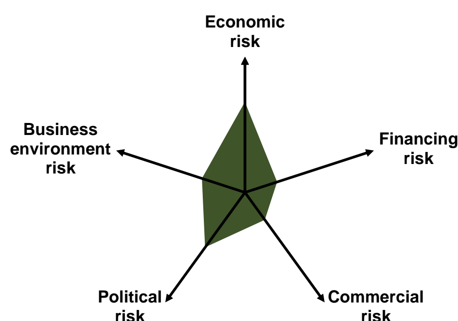
Strengths

- EU membership and fairly good international relations
- Prudent monetary policy
- Much reduced exchange rate volatility since 2012
- Low public debt
- Low annual current account deficits since 2013 which have been covered in full by net FDI inflows until 2016

Weaknesses

- Government instability
- Failure to make progress on EU-required judicial reform and anti-corruption measures
- Arrears of state-owned enterprises
- Excessive, pro-cyclical fiscal stimulus since 2015
- Banking sector vulnerabilities
- High private-sector debt (notably in foreign currency)
- High external debt burden

Country Rating B1



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
Germany	19%	1	19%	Germany
Italy	8%	2	10%	Italy
France	6%	3	8%	Hungary
Hungary	6%	4	5%	China
Turkey	4%	5	5%	France

By product (% of total)

Exports		Rank		Imports
Electrical Apparatus	13%	1	7%	Electrical Apparatus
Vehicles Components	8%	2	5%	Miscellaneous Hardware
Cars And Cycles	6%	3	5%	Engines
Engines	5%	4	5%	Plastic Articles
Miscellaneous Hardware	4%	5	4%	Vehicles Components

Source: Chelem (2015)

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Economic Overview

Growth is among the highest in the EU

Substantial fiscal stimulus boosted economic growth to +3.9% in 2015, followed by +4.8% in 2016 and +5.8% y/y in H1 2017. Vigorous domestic consumption has been the key growth driver, with private consumption up by +7.7% y/y in H1 2017 (+7.4 in full-year 2016) and government consumption up by +3% y/y (+4.5% in 2016). In contrast, fixed investment has been weak for a long time, declining by -3.3% in 2016 and -1% y/y in Q1 2017, as the government has been slow in taking up new projects financed by EU funds under the 2014-2020 programming period. But it finally resumed modest growth of +2.4% y/y in Q2. And, inventories made positive contributions to growth in H1 (+1pp) and 2016 (+1.1pp). External trade activity accelerated in 2016 and Q1 2017 but eased somewhat in Q2. On average in H1 2017, exports rose by +8.7% y/y and imports by +10% y/y so that net exports subtracted -0.6pp from H1 growth (-0.7pp in 2016).

We expect the growth momentum to slow somewhat in the next 18 months, especially as the build-up in inventories should wane. We forecast full-year GDP growth of about +5.5% in 2017 and +4% in 2018.

From deflation to moderate inflation

Monetary policy is officially based on inflation targeting but, in practice, the National Bank of Romania (NBR; the central bank) also aims at a certain degree of currency stability and, since 2009, attempts to steer credit growth and liquidity. Indeed, the key policy interest rate has been steadily lowered since March 2009, despite considerable inflation volatility until mid-2013.

Since September 2013, headline consumer price inflation has rapidly fallen and has been below the NBR's inflation target of 2.5%±1pp (set at the start of 2013) since early 2014. Moreover, inflation was in negative territory from mid-2015 to end-2016 as a result of a series of tax cuts (mainly VAT). As the base effect of these cuts faded, positive inflation has resumed in early 2017, as expected. But it has remained relatively moderate (1.4% y/y in July) as compared to peer countries owing to a further 1pp across the board VAT cut and the abolition of an extra excise duty on fuel. Going forward, buoyant domestic demand and rising wages should exert some upward pressure on prices. We expect inflation to edge up to about 1.6% at end-2017 and to average 2.5% in 2018.

The NBR has kept its policy rate steady at 1.75% since May 2015. We expect this rate to prevail until end-2017 or so before gradual monetary tightening is likely to start next year.

Exchange rate remains fairly stable

The RON/EUR exchange rate has been quite stable since 2013, fluctuating by a mere ±3.7% around an average 4.46. The Emerging Markets sell-off in mid-2013 and early 2014 hardly affected the RON – similar to other currencies in the CEE region. Nonetheless, renewed exchange rate volatility cannot be ruled out with regard to ongoing vulnerabilities in the banking sector and what appears to be continued unsustainable fiscal stimulus.

Excessive pro-cyclical fiscal stimulus jeopardizes earlier fiscal consolidation

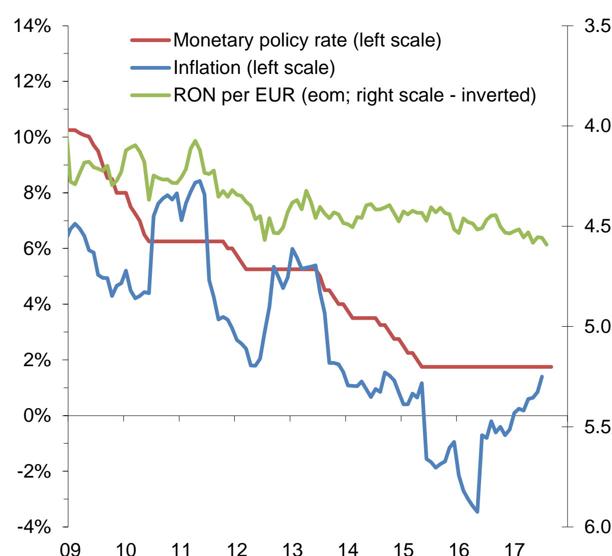
Supported by successive IMF/EU stand-by agreements, Romania achieved impressive fiscal consolidation, having reduced the annual fiscal deficit (ESA-2010 basis) to less than -1% of GDP in

Key economic forecasts

	2015	2016	2017f	2018f
GDP growth (% change)	3.9	4.8	5.5	4.0
Inflation (%, annual avg.)	-0.6	-1.6	1.0	2.5
Fiscal balance (% of GDP)	-0.8	-3.0	-3.6	-3.8
Public debt (% of GDP)	38.0	37.6	39.5	41.0
Current account (% of GDP)	-1.2	-2.3	-2.5	-3.2
External debt (% of GDP)	57.5	55.1	54.5	54.0

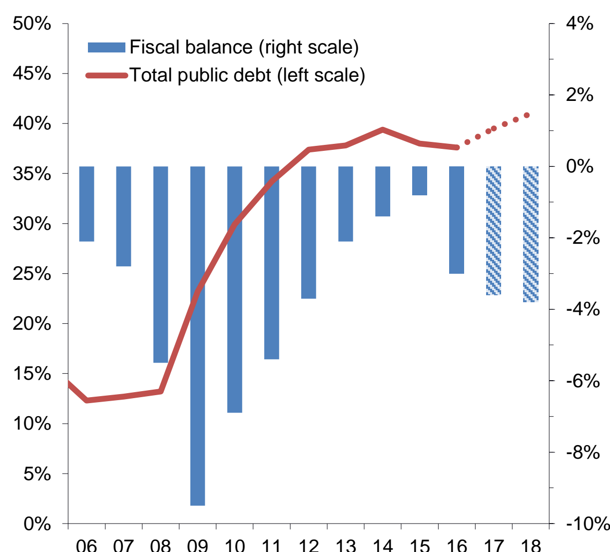
Sources: National sources, IHS, Euler Hermes

Monetary policy interest rate (%), inflation rate (y/y, %), and exchange rate



Sources: National sources, IHS, Euler Hermes

Public finances (% of GDP)



Sources: National sources, IHS, Euler Hermes

2014-2015 from -9.5% in 2009. Sound growth of tax revenues initially more than offset the impact of tax cuts such as the June 2015 VAT cut for food. The government did not seek renewal of the latest IMF program which expired in September 2015.

However, the fiscal deficit increased to -3% of GDP last year (from -0.8% in 2015) as an across-the-board VAT cut in early 2016 reduced fiscal revenues by 1.6% of GDP. Despite strong economic growth, a further widening of the shortfall is expected this year as a result of additional consumer tax cuts and sharp public sector wage increases by around 30%. We forecast the annual fiscal deficit to reach about -3.6% of GDP in 2017 and -3.8% in 2018. In the short term this does not appear critical yet since gross public debt – although up from 13% of GDP in 2008 to 38% in 2016 and forecast at 41% at end-2018 – is still moderate by EU standards. Nonetheless, Romania's fiscal stance has resulted in warnings from the European Commission that compliance with EU fiscal rules is at risk.

Moreover, in the medium term the ultra-expansionary fiscal policy stance may result in an overheating economy, followed by rising inflation and deteriorating investor confidence. Moreover, some tail risks related to debt of state-owned enterprises (SOEs) remain, currently estimated at 7.5% of GDP (not included in the above debt figure), some of which is in arrears. However, progress on this has been slow. Close monitoring is required.

Current account deficit is deteriorating

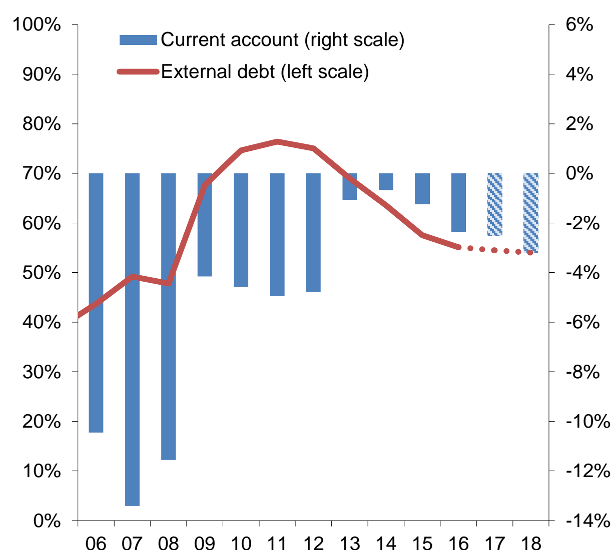
The annual current account deficit has also widened from -0.7% of GDP in 2014 to -2.3% in 2016 and is forecast to rise further to -3.2% or so in 2018, largely because fiscal stimulus has boosted imports. Until 2016, net foreign direct investment inflows covered the annual shortfalls in full, however, this has deteriorated to only 73% in the first five months of 2017. Hence the reliance on short-term capital inflows for financing the external deficits is rising.

Meanwhile gross external debt is gradually declining but remains high at about 55% of GDP. Short-term external debt accounted for 26% of gross debt in Q1 2017 (up from 20% end-2016). The external debt service ratio is estimated at 25% in 2017, still considerable but down from 34% in 2013.

FX reserves do not cover all external debt falling due in the next 12 months

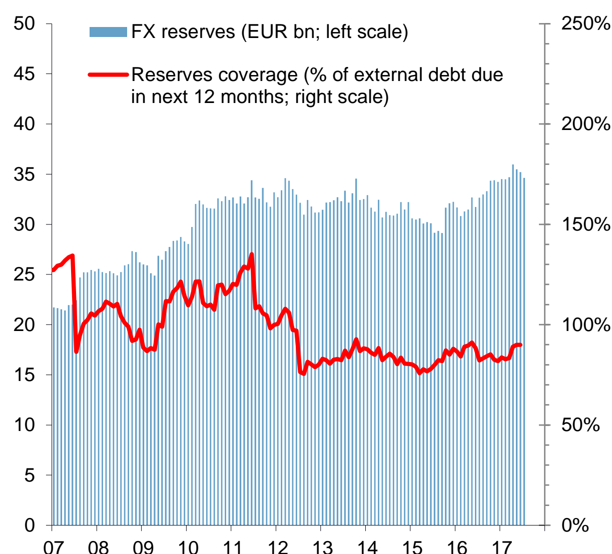
Foreign exchange (FX) reserves have moved sidewards over the past seven years, in the range of EUR29-36bn. The current level of reserves is comfortable with regard to import cover (about five months). However, reserves cover only 90% of the estimated external debt payments due in the next 12 months. While this is an improvement compared to 78% two years ago, the figure is still below an adequate level of at least 100%.

Current account and external debt (% of GDP)



Sources: National sources, IHS, Euler Hermes

Foreign exchange reserves and coverage of external debt payments falling due within 12 months



Sources: National sources, IHS, Euler Hermes

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