EUROPEAN
COMMISSION

Brussels, 24.5.2023
SWD(2023) 642 final

COMMISSION STAFF WORKING DOCUMENT

In-depth review for Romania

Accompanying the document

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN CENTRAL BANK, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE, THE COMMITTEE OF THE REGIONS AND THE EUROPEAN INVESTMENT BANK

2023 European Semester – Spring Package

{COM(2023) 600 final} - {SWD(2023) 628 final} - {SWD(2023) 629 final} - {SWD(2023) 630 final} - {SWD(2023) 631 final} - {SWD(2023) 632 final} - {SWD(2023) 633 final} - {SWD(2023) 634 final} - {SWD(2023) 635 final} - {SWD(2023) 636 final} - {SWD(2023) 637 final} - {SWD(2023) 638 final} - {SWD(2023) 639 final} - {SWD(2023) 640 final} - {SWD(2023) 641 final} - {SWD(2023) 643 final} - {SWD(2023) 644 final}

European Commission

Romania

In-Depth Review 2023

On the basis of this in-depth review for Romania undertaken under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances, the Commission has considered in its Communication "European Semester – 2023 Spring Package" (COM(2023) 600 final) that:

Romania continues to experience imbalances. Vulnerabilities relate to external accounts, linked to large government deficits, while overheating pressures have increased. The large current account deficit worsened considerably after the pandemic-induced recession and makes the economy vulnerable to external funding shocks. The continuation of large current account deficit risks driving the NIIP further into negative territory. Signs of overheating are clearly visible, with core inflation uncomfortably high, wage growth well in double digit territory and a relatively low unemployment rate. Cost competitiveness indicators are expected to stabilise, but structural issues persist. The exchange rate appears to be above the level suggested by fundamentals and remains heavily managed. The government deficit has been large for several years and has accounted for much of the excess of demand and of the subsequent external deficits; even if improving, the government deficit is forecast to remain significant this year and next. The narrowing of the government deficit in 2022 was mainly driven by marked nominal GDP growth, which in turn rests much on overheating domestic demand. Risk premia and sovereign borrowing costs are significantly higher than in the pre-pandemic years. Given the ongoing tightening in global liquidity conditions, it will be important to reverse ongoing trends. Going forward, fiscal adjustment should be the preferred way to bring demand more in line with supply and to contain domestic and external deficits. Full implementation of tax and pension reforms included in the RRP as well as adherence to fiscal targets under the excessive deficit procedure would go a long way in containing current dynamics.

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1. INTRODUCTION

In 2022, over the previous annual cycle of surveillance under the Macroeconomic Imbalance Procedure (MIP), the Commission identified "macroeconomic imbalances" in Romania ([1]). These imbalances were related to external accounts, linked to large fiscal deficits and to competitiveness issues that were re-emerging. The 2023 Alert Mechanism Report published in November 2022 concluded that a new in-depth review (IDR) should be undertaken for Romania with a view to assess the persistence of imbalances or their unwinding ([2]). The AMR concluded that in Romania, concerns related to external sustainability and the government deficit continue increasing. The current account deficit widened in 2021 and 2022. The government deficit has improved and is forecast to continue narrowing but remains high. Nominal unit labour costs are forecast to increase, in a context of high inflation, labour shortages and strong nominal wage increases, resulting in some competitiveness concerns.

Growth remained robust in 2022, driven by strong domestic demand, as restrictions unwound and household consumption reflected pent-up demand. Despite headwinds caused by the energy price shock and the global monetary tightening, real GDP increased by 4.7% in 2022. Domestic demand was the main growth driver, with private consumption increasing by 5.5% and total investment 8%. However, some signs of overheating started to emerge during the year: the labour market tightened, the unemployment rate reaching a level close to pre-pandemic lows, core inflation increased markedly, and imports grew at a very fast pace leading to a further widening of the current account deficit. The general government deficit remained elevated, at 6.2% of GDP in 2022, significantly contributing to the large current account deficit. The economic growth is set to be resilient in 2023 and 2024, albeit slower than last year. ([3]) Activity should be supported by major investments and reforms included in the recovery and resilience plan (RRP) and other EU funded projects, notably under Cohesion Policy Funds. Moreover, the impact of the energy shock on the economy is expected to gradually recede, supporting private consumption, also taking into account the extension of the energy prices cap scheme until 2025. Inflation probably peaked at the end of 2022 and is expected to gradually decline in the coming two years, while remaining above the National Bank of Romania's (NBR) target interval (2.5% ±1%) for most of the time. The high inflation coupled with skill and labour force shortages are set to keep wage growth at an elevated level. Going forward, the main risk comes from unexpected external shocks that could adversely affect the current account balance.

This in-depth review presents the main findings of macroeconomic vulnerabilities for Romania. The assessment is backed by a thematic section on the fiscal-external nexus. Vulnerabilities related to external balances and competitiveness in Romania are also discussed in

([1]) European Commission (2022), European Semester Spring Package 2022, COM(2022) 600 final.

([2]) European Commission (2022), Alert Mechanism Report 2023, COM (2022) 381 final.

([3]) European Commission (2023), European Economic Forecast: Spring 2023, Institutional Paper 200.

horizontal thematic notes that were already published ([4]). The MIP assessment matrix is published in the 2023 Country Report for Romania ([5]).

([4]) European Commission (2023), Inflation Differentials in Europe and Implications for Competitiveness: Thematic Note to Support In-Depth Reviews, European Economy: Institutional Papers, 198. European Commission (2023), External Sustainability Analysis: Thematic Note to Support In-Depth Reviews, European Economy: Institutional Papers, 196.

([5]) European Commission (2023), Country Report Romania 2023, SWD(2023) 623 final.

2. ASSESSMENT OF MACROECONOMIC VULNERABILITIES

Gravity, evolution and prospects

There has been a build-up of vulnerabilities in recent years in Romania. After two years of robust growth, there are signs that the Romanian economy could be in the early stages of overheating. The significant post pandemic rebound in private consumption and investment, favoured by easy monetary and financial conditions until the start of 2022, together with relatively supportive fiscal policy, contributed to an absorption boom in Romania, with domestic demand growing faster than GDP over the past two years. The economy has absorbed most of the slack that emerged during the COVID-19 recession and the output gap is closing rapidly, recent estimates (Banca Națională a României, 2023) already indicating a positive output gap. The unemployment rate is gradually closing the gap with the pre-pandemic low (5.6% in 2022 vs. 4.9% in 2019). Wage growth, especially in the private sector, is almost keeping up with high inflation and is now well in double digit territory, consistent with a strong negotiating position of employees in a relatively tight labour market. Core inflation reached 12.1% in December 2022 and is expected to stay high.

Romania's current account deficit is approaching 10% of GDP. On 5 April 2023 the Commission presented two horizontal thematic notes on competitiveness and external balances, which also cover Romania ([6]). The notes show that Romania's external position has worsened since 2015. The current account deficit reached 9.3% of GDP at the end of 2022 ([7]), up from 7.2% of GDP in 2021 and close to 5% in 2020, as both trade and primary income balances moved further into negative territory. In 2022, the current account widening partly reflected the impact of the energy shock, which accounted for around 0.8% of GDP, Romania being among the smallest net importers of energy in the EU. While cost competitiveness indicators stabilized lately, the inflation differential relative to the rest of the EU increased significantly in 2022. The increasing inflation gap between Romania and the EU is mostly explained by domestic factors, with Romania's internal price dynamics looking firmer and more persistent than in many other countries.

The current account deficit is expected to improve over the short to medium term but remain sizeable. According to the 2023 Commission Spring Forecast, in 2023 and 2024 the current account deficit should remain around 8% of GDP, as the fiscal balance is expected to remain in deficit and domestic demand to stay strong, fuelling imports. These levels cannot be sustained in the long term – the Commission estimates Romania's current account "norm", i.e. the current account level implied by economic fundamentals, at around zero. IMF estimates point to a current account "norm" of around -2% of GDP, still well above current levels. Against this backdrop, the NIIP-to-GDP ratio remained negative in 2022 at –41% of GDP (See Graph 2.1a) and under the baseline scenario is expected to continue declining in the coming years (see Graph 2.1.b).

([6]) European Commission (2023), External Sustainability Analysis: Thematic Note to Support In-Depth Reviews, European Economy: Institutional Papers, 196.

([7]) The horizontal note on external sustainability takes into account the data until Q3 2022. The information here has been updated with the observations for the whole 2022, which became available in the meantime. The main messages do not change.

The large current account deficit reflects, to a large extent, a still sizeable fiscal deficit. The deterioration of the external deficit, which started before the pandemic, is mainly rooted in fiscal imbalances. The headline deficit declined in 2022 to a still high 6.2% of GDP, from 7.1% in 2021 and 9.2% in 2020, but given the decent rebound in growth, high inflation and "tax rich" growth composition, the fiscal stance was only marginally restrictive in 2022. The cyclically adjusted balance improved by ½ pps. of GDP, and probably even less so when considering the impact of the growth composition on government revenue (see Section 3). In 2022 the Romanian government introduced additional economic and social support measures, including food vouchers to vulnerable households, pensioners and students, partially financed with EU funds, subsidies for fuel, increases in military pensions and allocation for reimbursement of sick leave, on top of the energy compensation scheme. The latter was broadly financed by the increased revenues due to taxation of extra profits and of trading margins in the energy sector, and by the higher profitability of energy SOEs.

There are indications that the widening of the current account deficit is not just a "fiscal/competitiveness only" story. More recently, the private sector contributed to the widening of the external deficit. Savings – Investment balances have started to deteriorate, particularly for households. There are no publicly available households' savings rate data in Romania, but sectoral and survey data allow for reasonable estimates. Households' savings obtained as a residual between savings of the total economy and the sum of all other sectors indicate a considerable decline since 2020, suggesting that household spent a large share of the pandemic related saving buffers. Survey data obtained from the National Statistical Institute ([8]) (see Graph 2.1.c) confirm this assessment ([9]) and suggest households' savings peaked (at around 18% of total revenues) at the height of the pandemic (in Q2 2020), before declining to close to 12% as restrictions unwound, activity picked up and the inflationary shock eroded savings buffers. These estimates are confirmed by a recent IMF study (2022) and a series of experimental statistics by Eurostat ([10]), which also indicate that Romanian households have the third highest propensity to consume in the EU (at around 95% of the disposable income for 2015 – latest available data).

Romania is not experiencing difficulties in financing its current account. Romania's still strong economic fundamentals underpin its ability to finance its current account deficit. Foreign exchange reserves stand above prudential levels (representing more than four months of imports and above 100% of short-term debt ([11])), external and government debt levels remain low, and the banking sector is well capitalized, liquid, and profitable. The Common Equity Tier 1 ratio marginally diminished to 17.6% in Q3 2022 but remains well above the minimum recommended threshold for Tier 1 capital of 6%. Gross non-performing loans represented 2.9% of total loans, a slight improvement since the end of 2021. The profitability of the banking system is above that of the euro area, with a 12.1% return on equity. Given these solid fundamentals and positive medium term growth prospects, Romania continues to attract large FDI inflows, which in 2022 covered about a third of total external financing needs (Graph 2.1.d). Finally, large inflows of EU funds also contribute to alleviate external financing pressures.

Financing conditions could however become more challenging in the medium term. The economy remains dependent on the availability of external financing and the sovereign-banks nexus is one of the highest in the EU, with government debt securities and loans representing more than 20% of total banking assets as of December 2022 ([12]). Despite a recent decline, Romanian

([8]) National Statistical Institute Tempo database - Households budget survey (HBS).

([9]) Defined as the difference between households' total revenues and total expenditures.

([10]) Eurostat - Aggregate propensity to consume by household type - experimental statistics.

([11]) IMF - Romania: 2022 Article IV Consultation.

([12]) Commission Services own calculations spreads remain materially higher relative to levels that prevailed before the war in Ukraine, probably partly reflecting worsening external deficits. Global monetary tightening could make the financing environment for Romania more difficult in the quarters and years ahead. Romania is rated at the lowest investment grade by rating agencies. In this context, and given the large current and fiscal deficits, a successful implementation of policies guarded by the EU, under the RRP and the EDP is key. While the effect of EU funds and cooperation on market signals is hard to quantify, it probably reduces the immediate financing costs associated with growing external vulnerabilities.

Monetary policy was significantly tightened, leading to a slowdown in credit growth. The National Bank of Romania (BNR) raised its key policy rate from 1.75% in early 2022 to 6.75% in December ([13]). While rate hikes came later and were overall less aggressive than in peer countries, BNR also used liquidity instruments effectively as a complementary tool to policy rate hikes. As a result, lending growth to households and non-financial corporations started to slow but remained positive, the stock of credit to households and corporates being respectively 11.7% and 20.9% higher at the end of 2022 than a year before ([14]). With headline inflation showing signs of peaking, liquidity tightening was reversed towards the end of 2022. This is mainly attributable to large government expenditures in the last months of the year and lack of intervention from BNR. The central bank confirmed this shift in policy by stopping to mention “firm control over money market liquidity” at their December 2022 and subsequent board meetings. As a result, the monetary policy stance has become a touch easier of late.

Exchange rate policy leaned towards preventing large movements in the leu. Despite turbulences caused by Russia’s war of aggression against Ukraine and the energy shock, the leu remained relatively stable, evolving in a narrow range against the euro, averaging 4.92 and 4.93 in 2021 and 2022 respectively. The currency, which continues to be heavily managed, appears overvalued according to several metrics – both Commission and IMF estimates point to the leu being overvalued by 11-13% on a real effective basis (International Monetary Fund 2022b). As a result of exchange rate policies and of large foreign capital flows into the country at the end of 2022, the currency appreciated by 6% in real terms ([15]) in the twelve months to February 2023, limiting the shock absorption capacity of the economy and hampering net exports growth. To a large extent, currency strength reflected policy preferences and somewhat contributed to contain inflation while the country was exposed to a global inflationary shock.

Cost competitiveness developments have stabilised but remain a concern. Wage growth reached 13.6% in 2022, well above productivity, but below national CPI inflation. ULCs increased by around 6.2% last year, and by 10.1% since 2019 (Graph 2.1e). Romania continues to attract robust FDI inflows and to gain export market shares, albeit at a slower pace than in the past. The nominal effective exchange rate (NEER) ([16]) remained virtually unchanged over 2022, while real effective exchange rates (REER) deflated by ULC and price index appreciated by slighlty more than 2%. The horizontal note on competitiveness ([17]) shows that the inflation differential between Romania and the rest of the EU has increased considerably in the last 3 years, with most of the gap being explained by domestic rather than imported inflation. Imported inflation, stemming mainly from high energy prices, is set to subside. However, the decline in domestic inflation may be more gradual, and past high inflation rates could eventually feed into higher wage demands, given that

([13]) Standing at 7% at the cut-off date

([14]) Not seasonally adjusted data. Source: BNR through DataInsight

([15]) Source: IMF through DataInsight

([16]) NEER and REER weighted against 42 trade partners

([17]) European Commission (2023), Inflation Differentials in Europe and Implications for Competitiveness: Thematic Note to Support In-Depth Reviews, European Economy: Institutional Papers, 198.

real wages fell in 2022. Such dynamics could have a negative impact on the cost competitiveness position of the economy.

Non-cost factors continue to weigh on Romania's competitiveness. Romania scores poorly in governance rankings when compared to EU peers. According to the Worldwide Governance Index, limited progress was made over the last decade and significant shortcomings persist regarding regulatory quality, control of corruption and government effectiveness. Moreover, an insufficient transport infrastructure hinders businesses' ability to ship merchandise both within and outside the country and jeopardises spatial cohesion. A shrinking labour force, skills shortages, limited capacity of the public employment services, a weak training and education system and low innovative capacity negatively affect the business environment.

Consistent with the widening in external deficits, economic growth is mainly driven by non-tradables sectors. Gross value added in sectors such as industry and manufacturing remained muted last year, being impacted by high energy prices and supply-side bottlenecks, while the one in agriculture dropped, as drought affected most of the crops. However, very strong growth rates were recorded in predominantly non-tradables sectors such as construction, retail, wholesale, accommodation, food services and real estate activities. Studies have shown that fast increases in output and productivity in non-tradables sectors, while good for output growth, can be associated with growing external imbalances (Dieppe et al. 2012) if wage spillovers from non-tradeable or public sectors generate a persistent increase in tradeable sector ULCs. Overall, current dynamics in Romania point to the risk of drawing scarce resources away from the tradables sector, which could end up putting more downward pressure on external balances. Against this background, Romania would benefit from increasing its domestic production capacity in the tradable sector.

Overall, under current trends, going forward, Romania could be left in a vulnerable position unless policy action is forthcoming. Given the continuous weakening of external accounts, on current trends, Romania's NIIP is projected to follow a steep negative trajectory and reach levels of around -73% of GDP over ten years under the baseline scenario (see Graph 2.1.b). Under a more positive alternative scenario as compared to the baseline, Scenario 1, the NIIP is expected to remain rather stable around -41% of GDP by 2032 ([18]). Conversely, more pessimistic assumptions than in the baseline, under Scenario 2, would lead to an NIIP of nearly -110% of GDP. Thus, should current trends continue, Romania may face more challenging conditions to fund its fast-growing external financing needs. Indeed, global liquidity conditions are tightening and in the medium-term official fund inflows, including from the EU, are likely to decline, leaving Romania potentially more exposed to exogenous shocks that could occur.

Assessment of MIP relevant policies

Delivering on fiscal consolidation and reforms would limit the cost of adjustment. Fiscal consolidation should be the preferred way to bring demand more in line with supply and reduce domestic and external vulnerabilities. This would also avoid putting unnecessary burden on other macro policy instruments, such as monetary policy, and reduce the medium-term cost of adjustment. Full implementation of reforms included in the RRP and adherence to fiscal targets

([18]) Alternative scenarios are defined as deviations from the baseline. A more optimistic Scenario 1 assumes full RRP implementation and strict adherence to EDP targets (positively affecting the trade balance and real growth while depressing inflation and domestic yields), and a more pessimistic Scenario 2 assuming only a partial RRP implementation and deviations from EDP targets (negatively impacting real growth, capital account and inflation, while putting upward pressure on domestic yields and trade balance).

under the EDP would go a long way in containing current dynamics. The RRP also includes measures that are conducive to higher productivity and improving cost and non-cost competitiveness, such as improving infrastructure, education, the business environment and the efficiency of the public administration, the legislative process, financial management as well as the judiciary, complemented by investments under the Cohesion Policy Funds.

Tax and pension reforms could help to address Romania's fiscal vulnerabilities. Romania's tax revenue-to-GDP ratio is one of the lowest in the EU and remains significantly below the average in other countries at similar stage of development. Moreover, Romania's tax structure, which relies heavily on consumption taxes and social contributions, is insufficiently supportive of growth and weighs on external competitiveness. The RRP includes key reforms to strengthen the tax system, make it more supportive of growth, and increase the revenue collected by the tax administration by at least 3% of GDP by 2026. On the expenditure side, the RRP includes an important reform of the public pension system through a new legislative framework to ensure its fiscal sustainability in an environment of ageing population, while correcting inequities. It also includes measures to enhance the efficiency of public spending, by increasing the transparency of the budget process, improving the monitoring and reporting system, and carrying out spending reviews in all public sectors. Full implementation of these reforms would support adherence to EDP targets and allow to build some fiscal space, which is currently very limited, to absorb potential shocks and stimulate growth when needed. It would also help reducing external vulnerabilities.

Macroeconomic rebalancing will also require keeping wage growth in line with productivity. In the last year, the minimum wage increased by 17.7% and the pension point by 12.5%. The nominal average wage increased by 13.6%. This compares with price and productivity increases of 14.1% and 4.4% over the period, respectively. Macroeconomic fundamentals, including high inflation and the relatively low level of wages as compared with EU peers, partly explain high wage growth in Romania, but recent large increases in nominal incomes contributed to fuel absorption, especially considering the very high propensity to consume of Romanian households, and to the build-up of domestic and external imbalances. Given these developments, it will be important to fully implement the RRP minimum wage setting mechanism reform, and to improve predictability in public sector wage policies. The objectives are to ensure that wage developments continue to reflect productivity gains and respond adequately to changing macroeconomic conditions, in order to protect the competitiveness of the Romanian economy, and ensure developments in household's income consistent with keeping external balances in check.

Monetary policy plays a crucial role in supporting the emerging declining trend in inflation. It is important to prevent higher inflation expectations from feeding through to wages, which seems to be already happening to some extent. Past monetary tightening steps are welcome and should continue to produce their effects in the coming quarters. However, with uncertainty on global prices being higher than usual, monetary policy flexibility and capacity to respond and adapt quickly to developments remains important. Given large fiscal deficits, macroeconomic rebalancing would be less costly if achieved through fiscal consolidation rather than through additional monetary policy tightening. A further widening of external imbalances should be avoided, including by closely monitoring bank lending to households and corporates.

With the leu estimated to be significantly overvalued, exchange rate policy deserves particular attention. Keeping the exchange rate on the strong side in 2022 had some advantages during the peak of inflationary pressures – stability helped control imported inflation, and Romania being a small energy importer there was less need to accommodate the adverse supply shock.

Conclusion

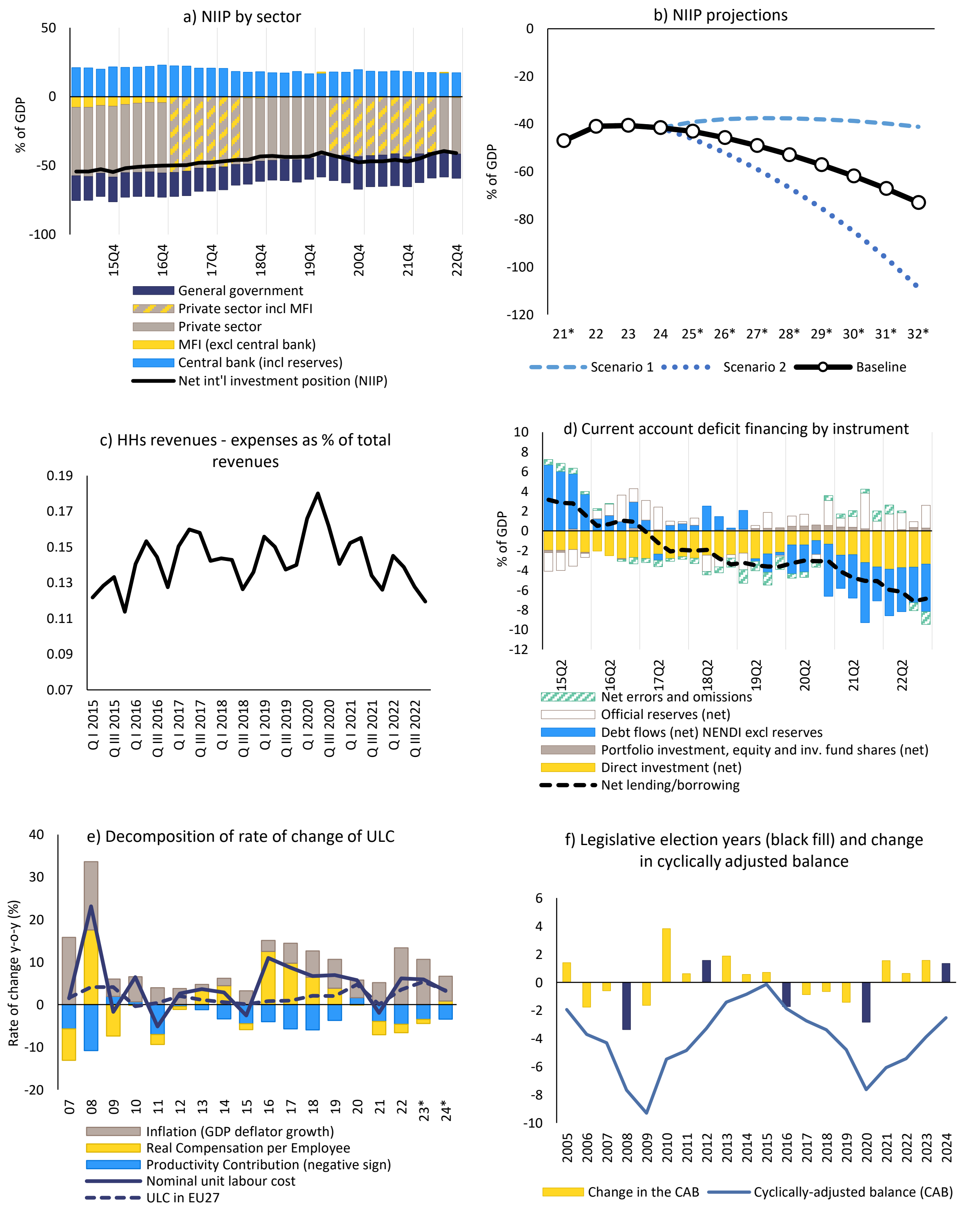
Romania is facing vulnerabilities relating to its external balance developments. Romania's strong growth in a difficult global macroeconomic context is welcome. However, the large current account deficit, which significantly worsened after the recession caused by the pandemic, makes the economy potentially vulnerable to adverse shocks. Moreover, some signs of overheating are clearly visible, with core inflation uncomfortably high, the labour market tight, and wage growth well in double digit territory. Romania's exchange rate is overvalued according to several metrics, and remains heavily managed. Cost competitiveness indicators have stabilized for now, but structural issues should still be addressed. In this environment, risk premia and sovereign borrowing costs have been volatile, but are higher than in the pre-pandemic period. With the current account deficit expected to remain elevated in the coming years, the NIIP moving further into negative territory, and given the ongoing tightening in global liquidity conditions, financing external deficits could become more challenging in the years ahead if adequate policy action is not taken.

Some vulnerabilities have not yet been addressed by policies. Correcting fiscal imbalances is a priority. There was some fiscal consolidation in 2022, but the government deficit remains high (6.2% of GDP in 2022) and its decline was mainly driven by continued strong nominal economic growth. Moreover, growth composition was dominated by domestic components, which resulted in high tax-to-GDP elasticities. Going forward, fiscal adjustment should be the preferred way to bring demand more in line with supply and contain domestic and external deficits. This would also avoid putting unnecessary burden on other macro policy instruments and reduce the medium-term cost of adjustment. Full implementation of tax and pension reforms included in the RRP and adherence to fiscal targets under the EDP would go a long way in containing current dynamics.

Based on the findings in this in-depth review, the Communication "European Semester – 2023 Spring Package" sets out the Commission's assessment as to the existence of imbalances or excessive imbalances in Romania, in line with Regulation 1176/2011. ([19])

([19]) European Commission (2023), European Semester Spring Package 2023, COM(2023) 600 final.

Graph 2.1: **Selected graphs, Romania**



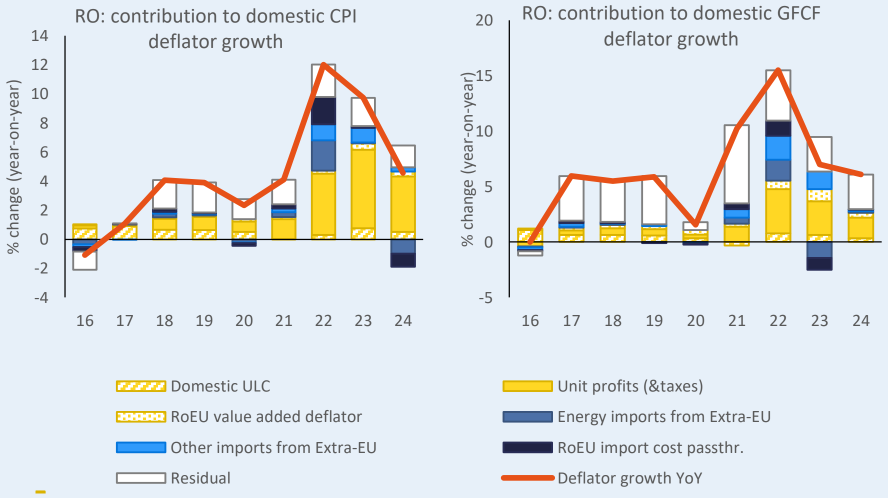
Source: European Commission services

Box 1: Inflation exposures and cross-border pass-through

This box sheds light on the sources of inflation in Romania and its spill-overs with EU partners. The period since 2021 has been characterized by pandemic aftershocks and global supply chain disruptions compounding global inflationary pressures and a surge in commodity prices triggered by Russia's war of aggression against Ukraine. As a result, inflation in Romania surged. In response, wages and profits also picked up across the EU, which further added to price pressures in Romania. With input-output data, domestic inflation can be decomposed into the contributions from key cost factors. Taking into account some data limitations, the framework can be used to attribute consumer and investment price changes to i) extra-EU import price changes, which include both directly imported inflation and inflation passed through from EU partners import costs ii) domestic unit labour cost changes iii) domestic unit profit changes, including indirect taxation changes and iv) rest-of-EU value added price changes. ([20])

Data suggests that much of inflation in Romania reflected both surging import prices as well as domestic factors in 2022. In 2022, as shown in Graph 2.2, energy inflation contributed substantially to the increase in consumer and investment inflation. However, domestic profits were the key factors behind surging inflation. In addition, price changes in extra-EU non-energy imports and costs passed through EU partners further lifted consumer and investment prices in Romania. Contribution from domestic unit labour costs has been smaller. Going forward, consumer and investment inflation is expected to be sustained mainly by domestic profits. Imported inflation, either directly or through EU partners is expected to subside. Spill-overs from value added inflation in other EU countries is expected to lift domestic consumer and investment inflation only mildly this year and next.

Graph 2.2: **Components of gross fixed capital formation deflator growth and consumer price inflation**



Source: European Commission services

([20]) The graphs below are based on national accounts data and the Commission's Spring 2023 forecast, combined with Eurostat input-output data. HICP is taken as the measure of the price of private consumption, including non-residents. Changes in import prices and value-added deflators are assumed to affect demand prices with a delay of 5 months. For further methodological details, see explanations in the 2023 in-depth review for Czechia, p. 16.

Table 2.1:**Selected economic and financial indicators (Part 1), Romania**

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-18	2019	2020	2021	2022	forecast 2023	forecast 2024
Real GDP	6.5	1.1	4.1	3.9	-3.7	5.8	4.7	3.2	3.5
Potential growth (1)	5.9	2.5	3.5	4.2	3.4	2.8	2.9	3.3	3.2
Contribution to GDP growth:									
Domestic demand	13.3	-0.6	3.8	6.0	-2.0	5.6	6.1	4.0	4.5
Inventories	-1.2	-0.1	0.5	-0.6	-0.2	1.7	-0.6	0.0	-0.5
Net exports	-5.8	1.3	-0.3	-1.6	-1.5	-1.5	-0.7	-0.8	-0.6
Contribution to potential GDP growth (1):									
Total Labour (hours)	-0.9	-1.1	-0.2	0.2	0.1	0.0	0.0	0.3	-0.1
Capital accumulation	1.7	2.3	1.0	1.2	1.5	1.4	1.6	1.7	1.8
Total factor productivity	5.2	1.3	2.7	2.8	1.8	1.3	1.3	1.3	1.4
Output gap (2)	3.7	-0.6	-0.9	1.3	-5.6	-2.9	-1.1	-1.2	-0.9
Unemployment rate	8.8	8.5	7.4	4.9	6.1	5.6	5.6	5.4	5.1
Harmonised index of consumer prices (HICP)	9.5	5.7	1.4	3.9	2.3	4.1	12.0	9.7	4.6
GDP deflator	15.3	6.7	4.2	6.8	4.1	5.2	13.4	10.7	5.8
External position									
Current account balance (% of GDP), balance of payments	-9.5	-6.2	-1.9	-4.9	-4.9	-7.2	-9.3	-8.1	-7.9
Trade balance (% of GDP), balance of payments	-10.7	-7.3	-1.5	-4.1	-4.3	-5.7	-6.9	.	.
Primary income balance (% of GDP)	-3.2	-1.5	-1.3	-1.4	-1.5	-2.0	-3.1	.	.
Secondary income balance (% of GDP)	4.4	2.7	0.9	0.7	0.9	0.4	0.6	.	.
Current account explained by fundamentals (CA norm, % of GDP) (3)	-1.6	-0.9	-0.5	0.1	0.2	0.1	0.1	0.2	0.1
Required current account to stabilise NIIP above -35% of GDP over 20Y (% of GDP) (4)	-3.3	-3.8	-5.7	-5.2	-5.4	-5.2	-4.5	-4.1	-3.8
Capital account balance (% of GDP)	0.5	0.6	2.0	1.3	1.9	2.2	2.5	.	.
Net international investment position (% of GDP)	-37.4	-60.2	-52.8	-43.4	-47.6	-47.1	-41.0	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (5)	-5.0	-21.6	-10.7	-4.0	-7.0	-6.5	-4.2	.	.
Net FDI flows (% of GDP)	-6.4	-2.8	-2.3	-2.2	-1.3	-3.7	-3.4	.	.
Competitiveness									
Unit labour costs (ULC, whole economy)	10.6	4.6	6.0	6.9	5.8	-1.9	6.2	5.9	3.2
Nominal compensation per employee	18.0	7.8	9.3	10.9	4.0	1.9	11.1	9.6	6.7
Labour productivity (real, hours worked)	7.0	3.3	4.3	2.8	1.0	1.1	4.4	3.2	3.1
Real effective exchange rate (ULC)	7.4	-3.4	2.8	2.6	-0.4	-4.1	2.1	-0.2	-0.6
Real effective exchange rate (HICP)	6.2	-2.6	0.0	0.0	0.8	0.0	2.2	.	.
Export performance vs. advanced countries (% change over 5 years)	82.1	69.2	25.8	15.4	20.5	15.7	.	.	.
Private sector debt									
Private sector debt, consolidated (% of GDP)	41.8	69.0	56.7	46.5	48.0	47.9	44.0	.	.
Household debt, consolidated (% of GDP)	10.6	20.9	17.3	15.4	16.1	15.8	13.9	.	.
Household debt, fundamental benchmark (% of GDP) (6)	-1.8	0.1	3.9	7.4	10.0	11.5	12.8	.	.
Household debt, prudential threshold (% of GDP) (6)	88.6	78.8	86.2	97.4	68.3	57.7	55.2	.	.
Non-financial corporate debt, consolidated (% of GDP)	31.1	48.1	39.4	31.2	32.0	32.1	30.1	.	.
Corporate debt, fundamental benchmark (% of GDP) (6)	8.2	8.6	12.5	14.8	18.5	20.7	22.0	.	.
Corporate debt, prudential threshold (% of GDP) (6)	104.8	97.0	104.5	102.0	78.1	70.7	68.4	.	.
Private credit flow, consolidated (% of GDP)	12.8	3.0	0.1	2.0	1.3	3.8	3.3e	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-2.8	7.8	11.7	9.3	11.8	13.8	17.6	20.2	19.8
Households, net lending (+) or net borrowing (-) (% of GDP)	.	.	.	.	.	-14.8	-21.2	-23.5	-22.9
Net savings rate of households (% of net disposable income)	.	.	.	.	.	.	.	.	.

(e) estimate based on ECB quarterly data
(1) Potential output is the highest level of production that an economy can reach without generating inflationary pressures. The methodology to compute the potential output is based on K. Havik, K. Mc Morrow, F. Orlandi, C. Planas, R. Raciborski, W. Roeger, A. Rossi, A. Thum-Thysen, V. Vandermeulen, The Production Function Methodology for Calculating Potential Growth Rates & Output Gaps, COM, European Economy, Economic Papers 535, November 2014.
(2) Deviation of actual output from potential output as % of potential GDP.
(3) Current accounts in line with fundamentals ("current account norms") are derived from reduced-form regressions capturing the main determinants of the saving-investment balance, including fundamental determinants, policy factors and global financial conditions. See L. Coutinho et al. (2018), "Methodologies for the assessment of current account benchmarks", European Economy, Discussion Paper 86/2018, for details.
(4) This benchmark is defined as the average current account required to halve the gap between the NIIP and the indicative MIP benchmark of -35% of GDP over the next ten years, or to stabilise the NIIP at the current level if it is already above the indicative MIP benchmark. Calculations make use of Commission's T+10 projections.
(5) NENDI is a subset of the NIIP that abstracts from its pure equity-related components, i.e. foreign direct investment (FDI) equity and equity shares, and from intracompany cross-border FDI debt, and represents the NIIP excluding instruments that cannot be subject to default.
(6) Fundamentals-based benchmarks are derived from regressions capturing the main determinants of credit growth and taking into account a given initial stock of debt. Prudential thresholds represent the debt threshold beyond which the probability of a banking crisis is relatively high, minimising the probability of missed crisis and that of false alerts. Methodology to compute the fundamentals-based and the prudential benchmarks based on Bricongne, J. C., Coutinho, L., Turrini, A., Zeugner, S. (2019), "Is Private Debt Excessive?", Open Economies Review, 1- 42.
Source: Eurostat and ECB as of 2023-04-28, where available; European Commission for forecast figures

Table 2.2:**Selected economic and financial indicators (Part 2), Romania**

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-18	2019	2020	2021	2022	forecast 2023	2024
Housing market									
House price index, nominal	.	-12.5	3.0	3.4	4.7	4.4	7.2	.	.
House price index, deflated	.	-16.9	1.1	-1.9	2.3	-0.8	-6.2	.	.
Overvaluation gap (%) (7)	.	20.6	-11.3	-15.9	-13.3	-15.7	-21.4	.	.
Price-to-income overvaluation gap (%) (8)	.	44.2	-13.8	-32.7	-32.9	-34.7	-37.8	.	.
Residential investment (% of GDP)	1.9	2.9	2.4	2.3	2.4	2.5	2.7	.	.
Government debt									
General government balance (% of GDP)	-1.6	-6.3	-2.0	-4.3	-9.2	-7.1	-6.2	-4.7	-4.4
General government gross debt (% of GDP)	16.3	26.2	37.1	35.1	46.9	48.6	47.3	45.6	46.1
Banking sector									
Return on equity (%)	23.0	6.0	2.9	15.2	12.5	15.0	.	.	.
Common Equity Tier 1 ratio	10.9	17.1	18.7	18.4	20.1	20.0	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (9)	1.4	6.8	10.2	3.3	3.0	2.6	.	.	.
Gross non-performing loans (% of gross loans) (9)	.	.	11.1	4.3	3.9	3.4	2.9	.	.
Cost of borrowing for corporations (%)	.	.	5.4	.	.	4.6	10.0	.	.
Cost of borrowing for households for house purchase (%)	.	.	5.1	5.5	4.8	3.7	7.1	.	.

(7) Unweighted average of price-to-income, price-to-rent and model valuation gaps. The model valuation gap is estimated in a cointegration framework using a system of five fundamental variables; total population, real housing stock, real disposable income per capita, real long-term interest rate and price deflator of final consumption expenditure, based on Philiponnet, N., Turrini, A. (2017), "Assessing House Price Developments in the EU," European Economy - Discussion Papers 2015 - 048, Directorate General Economic and Financial Affairs (DG ECFIN), European Commission. Price-to-income and price-to-rent gaps are measured as the deviation to the long term average (from 1995 to the latest available year).
(8) Price-to-income overvaluation gap measured as the deviation to the long term average (from 1995 to the latest available year).
(9) Domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.
Source: Eurostat and ECB as of 2023-04-28, where available; European Commission for forecast figures

3. THEMATIC CHAPTER: THE EXTERNAL - FISCAL NEXUS IN ROMANIA

The large government deficit is the main factor behind Romania's external imbalances. The primary cause for the large current account deficit in Romania is the large fiscal deficit and some specific fiscal policy measures that contributed to fuel recent large increases in domestic demand and imports. In a first step, this Thematic Chapter details how recent fiscal policy decisions contributed to widen the external deficit. In a second step, it argues that Romania's fiscal position is significantly worse than suggested by traditional fiscal surveillance indicators. Indeed, growth composition and the accounting of RRP grants both tend to flatter the assessment of the underlying fiscal picture. Finally, it concludes with general observations on Romania's fiscal challenges and the need for adjustment to reduce external vulnerabilities.

In recent years, fiscal policy has helped the economy absorb shocks. Large fiscal stimulus packages were introduced in the past two-three years, initially to shield the economy against consequences of the pandemic, and then to protect the population against the energy shock. While some of these measures were necessary and contributed to Romania's economy impressive resilience to shocks, especially during the pandemic period, measures to support the economy during the energy price shock could have been better targeted (e.g. there is a universal cap for gas prices, and most measures have been extended until the end of 2025). Moreover, most of the fiscal support was geared towards protecting households from the various shocks, which contributed to keep private consumption firm and non-tradable sectors (construction, in particular).

These policies contributed to a significant absorption boom in Romania. Supportive fiscal policy and very easy monetary and financial conditions until the beginning of 2022 provided a significant boost to domestic demand. Over 2021-2022, real absorption increased by 12.5% while real GDP increased by less than 11%. The difference is even more pronounced in nominal terms. The real absorption boom was largely anticipated in the Commission Spring 2021 forecast (Table 3.1), which was the basis for the last EDP Recommendation to Romania under Article 126(7), from 2 June 2021. But nominal developments were not, with nominal absorption ending up growing 17% more over 2021-2022 than expected in the Spring 2021 forecast. This translated into a large worsening in the current account deficit, which moved from less than 5% of GDP in 2020 to close to 10% of GDP in 2022, reflecting very rapid nominal import growth (almost 28% year over year in December 2022 in current prices), as opposed to a growth in exports of just 22%. Less than 1% of GDP of the current account widening over the period can be attributed to the increase in energy prices following the war in Ukraine (see horizontal note on external sustainability).

Periods of fast absorption growth tend to temporarily boost government revenue. Several academic papers have shown that growth composition can have a large impact on revenue elasticities and collection. Lendvai et al. (2011) concluded that episodes of real and nominal absorption booms, which are often associated with widening current account deficits, were typically associated with large positive surprises on fiscal revenue. The same authors show that, in many instances, developments in current account imbalances were aggravated by procyclical fiscal policy, with fiscal policy insufficiently "leaning against the wind". The 2019 Commission Report on Public Finances in EMU (2020) went further, showing that increases in absorption and household debt resulted in higher revenue windfalls. This paper also provided evidence that temporary windfall revenues often trigger permanent increases in spending or decreases in tax rates, contributing to a worsening in structural fiscal positions.

Romania's strong absorption growth fuelled a large increase in government revenue. Similar dynamics as those described in the academic studies mentioned above have been at play in recent years in Romania (Table 3.1). Over 2021-22, total government revenue increased by around 37% (VAT and corporate income tax were particularly strong), much more than the 17% expected in the Spring 2021 forecast. This larger than expected increase was much more pronounced than the inflation surprise, which was "only" around 11-13 pps, depending on the indicator (HICP or GDP deflator). The Romanian authorities used part of these unexpected revenue to boost spending. Indeed, the additional government spending over the past two years exceeded forecasts by a larger amount than inflation surprises alone can explain. Importantly, it is likely that a large part of the extra revenue associated with the recent fast increase in absorption should not be seen as permanent since they are, to a large extent, associated with an unsustainable widening in the current account deficit.

Romania's underlying fiscal position remains weak. Fiscal policy decisions over the past two years not only fuelled the increase in the current account deficit, they also contributed to significantly weaken Romania's structural fiscal position. Romania's government balance moved from -2.8% of GDP in 2018, to -9.2% of GDP in 2020. It was since then reduced to a still elevated -6.2% pf GDP in 2022, but this mostly reflected a decent post-COVID19 growth rebound, with GDP increasing well above its potential rate in 2021 and 2022, and higher than usual tax elasticities. The boost in tax elasticities associated with the absorption boom is not entirely captured by traditional indicators of fiscal surveillance like the cyclically adjusted balance, which erroneously tends to see it as structural. Romania's underlying fiscal position is therefore probably worse than suggested by standard fiscal surveillance indicators, and the contribution from the government sector to the external current account deficit larger.

In addition, the total fiscal impulse, including coming from the RRF, is likely underestimated by traditional fiscal indicators. In national accounts the time of recording of revenues from the RRF grants is matched to expenditures of the same amount. Therefore, there is no effect on the deficit of any expenditure that is financed by a grant payment. RRF grants do however provide a significant positive fiscal impulse, to the extent that they lead to additional spending relative to a counterfactual with no RRF grants. However, this impulse is not captured by traditional measures like the change in the cyclically adjusted balance. In case of full additionality (i.e. EU grants are fully spent, and add to already planned expenditure), fiscal indicators will therefore underestimate the impulse coming from fiscal policy.

It is possible to correct the fiscal balance for the impact of growth composition and EU grants. Given the significant widening of the current account over the recent years and the size of grants in the RRF, which are expected to fluctuate between 0.6% and 1.1% of GDP over the RRF lifecycle, the elements above have a significant influence on estimates of Romania's underlying fiscal position. It is possible to correct for these effects. For growth composition, we rely on the simple approach proposed by Lendvai et al. (2011). They construct a "cyclically and absorption adjusted" government balance, which provides an estimate of where the government deficit would be if the economy had no output gap and an external position in line with its "norm", i.e. the level explained by the economic fundamentals. ([21]) Regarding the impact of the RRF grants component

([21]) The main idea behind the fiscal indicator taking into account the impact of absorption booms and busts is that the definition of a well-founded benchmark for tax bases' composition can be naturally related to the need of countries to maintain prudential current account positions. In line with the approach proposed by Jaeger and Klemm (2007), the idea is to strip out from the actual balance the automatic effects of both output and absorption and not only output as assumed with the CAB. With cyclically and absorption adjusted budget balance (CAAB), "gaps" do not only refer to output but also to absorption. A meaningful notion of "absorption gap" should ideally capture the difference between actual and "potential" absorption, where by potential absorption is meant absorption in line with output being at potential and current account balances being in line with fundamentals. A common benchmark for current accounts consistent with fundamentals is on government accounts, an assumption is needed about the additionality of RRF investments relative to fiscal plans in a hypothetical scenario without RRF. It is assumed here that half of the projects and investments planned for the RRF years would have happened even without the RRF and associated grants.

Table 3.2 provides estimates of Romania's underlying fiscal position capturing these effects. Column 1 shows the headline government deficit as a share of GDP – the scenario assumes a gradual return to a 3.0% of GDP deficit in 2024, in line with existing EDP recommendations. Column 2 shows the standard cyclically-adjusted balance (CAB). Column 3 shows the fiscal balance adjusted for the output gap and growth composition (CAAB). Column 4 shows the fiscal balance adjusted for the distance to the current account norm (AAB), i.e. where the government deficit would be if the current account was at its norm, ignoring the output gap. Columns 5, 6, 7, 8 show the same indicators as above but this time also adjusting for the statistical effect of RRF grants. Amounts already disbursed (grants) in 2021 and 2022 are taken into account and, for the following years, projections assume two full payments per year.

Overall, Romania's underlying fiscal position is probably worse than it looks. In 2022, the government balance reached -6.2% of GDP, but fiscal indicators correcting for the cycle, growth composition and the "grants impact" point to a structural fiscal position more in a -6% to -9% of GDP range. Indeed, Romania's output gap was close to zero in 2022, but the current account deficit was almost 10% of GDP away from its norm. Table 3.2 also shows that reaching the 3% deficit target in 2024 will require an important fiscal effort in 2023 and 2024 – of the order of 1.5% of GDP each year, according to most measures. This will only be achieved with continued strict expenditure control or higher revenues or a combination between the two, relative to the previous years, even though 2024 is a "super election" year with local, legislative and presidential elections being organised. One concern in this respect is that, on average during the last four legislative/local elections, the cyclically adjusted balance worsened by 1.5% of GDP. This average includes the year 2012 when a significant fiscal adjustment took place, in line with recommendations under the EU/IMF financial assistance program (Graph 2.1.f).

Even if Romania reaches its 3.0% nominal target in 2024, its fiscal position will remain weak. The achievement of the 3.0% of GDP mark is likely to be facilitated by a revenue to GDP ratio that, while still one of the lowest in the EU average, is inflated by excess absorption and, to a lesser extent, by the impact of EU grants. Calculations show that assuming a deficit of 3.0% of GDP

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provided by the computations of so-called "current account norms", namely current account values consistent with medium-term determinants of the saving-investment balance.

The CAAB is calculated as the difference between the actual budget balance and two terms reflecting temporary budgetary components: one linked to the output gap and the other linked to the absorption gap. Denoting by b the budget balance, by y and y* actual and potential output, by ygap and agap the output gap and the absorption gap, by a and a* absorption and potential absorption, by ca* the current account norm, and by it the sum of net foreign income and net transfers, the following equations can be derived:

(1) $CAB_t = (b/y)_t - \lambda\ ygap_t$

(2) $CAAB_t = (b/y)_t - \beta_t\ ygap_t - \gamma_t\ agap_t$,

(3) $agap_t = (a_t - a^*_t)/y^*_t$,

(4) $a^*_t = y^*_t - ca^*_t + it_t$.

In equation (1), λ_t is the standard budgetary sensitivity used in EU budgetary surveillance. In light of the previous discussion, the sensitivity parameter to absorption, γ_t in equation (2) is given by the share of indirect taxes in GDP. Given the unitary elasticity of indirect taxes with respect to absorption and the linearity of the CAB with respect to output it follows that

(5) $\beta_t = \lambda_t - \gamma_t$.

The "absorption adjusted" government balance (AAB) follows a similar approach. and provides an estimate of where the government deficit would be if the economy had an external position in line with its "norm".

in 2024, no further worsening in Romania's current account deficit, and RRF grants payments proceeding as scheduled, Romania's underlying fiscal deficit could still be in a 4.5 – 6.0% of GDP range in 2024. These estimates underline the importance of reaching fiscal targets in the EDP and implementing the fiscal consolidation measures planned in the RRP. Reaching those is not only crucial to rebalance the economy and reduce the external current account deficit, but also to correct a fiscal position that is structurally weak.

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Table 3.1:**Macro and Fiscal projections over 2021-22 vs. outcomes**

	Spring 2021 forecast	Observed data	Difference
Cumulative growth over 2021-2022			
Real GDP	10.2	10.8	0.6
Real Absorption	11.8	12.5	0.7
Nominal GDP	16.9	32.2	15.3
Nominal Absorption	18.2	35.4	17.2
HICP	5.7	16.6	10.9
GDP deflator	6.0	19.3	13.3
Total Government revenue	17.2	37.2	20.0
Government primary current expenditure	6.8	23.6	16.8

Source: European Commission services

Table 3.2:**Estimates of fiscal and fiscal stance indicators (assuming return to 3 pct deficit in 2024)**

	Non corrected for grants impact				Corrected for grant impact (50 pct additivity)			
Levels, pct of GDP	GG bal	CAB	CAAB	AAB	GG bal	CAB	CAAB	AAB
2020	-9.2	-7.4	-9.5	-10.9	-9.2	-7.4	-9.5	-10.9
2021	-7.1	-6.2	-8.0	-9.5	-7.5	-6.6	-8.4	-9.9
2022	-6.2	-5.8	-7.6	-9.2	-6.5	-6.1	-7.9	-9.5
2023	-4.4	-4.1	-5.6	-7.1	-5.0	-4.6	-6.2	-7.6
2024	-3.0	-2.8	-4.3	-5.7	-3.5	-3.2	-4.7	-6.1
Annual change	GG bal	CAB	CAAB	AAB	GG bal	CAB	CAAB	AAB
2020	-4.9	-2.7	-4.0	-4.9	-4.9	-2.7	-4.0	-4.9
2021	2.2	1.2	1.5	1.4	1.8	0.8	1.1	1.0
2022	0.9	0.4	0.3	0.3	1.0	0.5	0.4	0.4
2023	1.8	1.7	2.0	2.1	1.5	1.5	1.7	1.8
2024	1.4	1.3	1.4	1.4	1.5	1.4	1.5	1.5

Source: European Commission services