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In-Depth Review for Romania

in accordance with Article 5 of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

Accompanying the

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

Economic policy coordination in 2021: overcoming COVID-19, supporting the recovery and modernising our economy

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CONTENTS

| | |
|-------------------------------------------|----|
| Executive summary | 1 |
| 1. Assessment of Macroeconomic Imbalances | 2 |
| 2. Thematic Issue: External Position | 9 |
| 3. Thematic Issue: Competitiveness | 14 |

LIST OF TABLES

| | | |
|------------|---------------------------------------------------------|----|
| Table 1.1: | Assessment of Macroeconomic Imbalances Matrix - Romania | 6 |
| Table 1.2: | Selected economic and financial indicators, Romania | 8 |
| Table 2.1: | Selected external sector indicators, Romania | 13 |
| Table 3.1: | Selected cost competitiveness indicators, Romania | 17 |
| Table 3.2: | Selected trade performance indicators, Romania | 17 |

LIST OF GRAPHS

| | | |
|------------|------------------------------------|----|
| Graph 2.1: | Thematic Graphs: External position | 12 |
| Graph 3.1: | Thematic Graphs: Competitiveness | 16 |

EXECUTIVE SUMMARY

The 2021 Alert Mechanism Report concluded that an in-depth review should be undertaken for Romania to examine further the persistence of imbalances or their unwinding. In February 2020, under the previous annual cycle of surveillance under the Macroeconomic Imbalances Procedure, the Commission identified “macroeconomic imbalances” in Romania. These imbalances related to risks of cost competitiveness losses, a deteriorating external position and a widening current account deficit, in a context of expansionary fiscal policy and an unpredictable business environment. The analysis shows that these vulnerabilities remain. It should be noted that the context of the assessment of vulnerabilities in this year’s in-depth review (IDR) for Romania is markedly different from last year. Also, the evolution of the COVID-19 pandemic, the strength of the recovery, and possible structural implications of the crisis are all still surrounded by high uncertainty, requiring caution in the assessment. In general, policy action over the past year focused on cushioning the impact of the COVID-19 shock and facilitating the recovery. This has added to indebtedness but should support adjustment in the medium-term. Looking forward, the Recovery and Resilience Plan provides an opportunity to address imbalances, investment and reforms needs.

Main observations and findings of this IDR analysis are:

- **This IDR is informed by the 2021 spring forecast, which expects a recovery in economic activity in Romania with the easing of the COVID-19 crisis.** After the steep drop of 3.9% in 2020, real GDP is projected to increase by 5.1% this year and 4.9% next year, allowing the economy to recover its pre-pandemic level already in 2021.
- **The external position remains weak.** The current account deficit deteriorated marginally to 5% of GDP in 2020, and is forecast to remain close to that elevated level in 2021 and 2022. The negative net international investment position (NIIP) worsened somewhat to -47% of GDP in 2020 and is projected to slightly worsen again this year and next. The composition of the NIIP is favourable, as it consists mostly of foreign direct investment. Yet net external debt has increased more recently.
- **The fiscal position has continued to deteriorate and accounts for a significant part of the large external financing needs.** The fiscal stance was already clearly expansionary in the years of marked economic growth before the COVID-19 pandemic. The government deficit increased in 2020 to 9.2% of GDP but it is forecast to improve this year and next, largely on account of the economic recovery and reflecting also some reining in of spending. The government plans to bring the deficit below 3% of GDP by 2024. Government debt is still contained at some 47% of GDP in 2020 but is expected to increase until at least 2022, and a significant share of it is expected to continue to be financed from abroad and in foreign currency.
- **Cost competitiveness pressures seem to be dissipating.** Those pressures originated mostly from double-digit wage growth in the pre-COVID-19-crisis years of strong economic growth and of low and falling unemployment. Unit labour costs still grew markedly in 2020, reflecting the impact of reduced productivity against a backdrop of a drop in output. However, unit labour costs are forecast to grow markedly less in 2021 and 2022 than in the years before the COVID-19 crisis. That reflects an upsurge in productivity on the back of the recovery in activity and a moderation in wage growth that started in 2020 and that is getting more visible. Other competitiveness measures also suggest that further losses may occur in 2021 and 2022 but are likely to be small.
- **The banking sector remains well capitalised, liquid and profitable but some challenges going forward cannot be excluded, while legislative unpredictability persists.** Private sector debts are very contained, but part of those debts, especially on the corporate side, is denominated in foreign currency, which makes debt service dependent also of the evolution of the domestic currency. Non-performing loans decreased slightly in 2020 from already moderate levels but may increase once measures to support corporates and households in light of the COVID-19 crisis are phased out. Threats to financial stability and investment from past legislative initiatives have abated, but overall legislative unpredictability persists.

1. ASSESSMENT OF MACROECONOMIC IMBALANCES

Introduction

In February 2020, over the previous annual cycle of surveillance under the Macroeconomic Imbalances Procedure, the Commission identified “macroeconomic imbalances” in Romania. These imbalances related to risks of cost competitiveness losses, a deteriorating external position and a widening current account deficit, in a context of expansionary fiscal policy and an unpredictable business environment. The 2021 Alert Mechanism Report published in November 2020 concluded that a new in-depth review (IDR) should be undertaken for Romania with a view to assess the persistence or unwinding of imbalances.

The context of the assessment of vulnerabilities this year is markedly different from last year's IDRs, which took place before the COVID-19 pandemic. The evolution of the pandemic, the strength of the recovery, and possible structural implications of the crisis are still surrounded by high uncertainty requiring caution in the assessment. Policy action over the past year focused on cushioning the impact of the COVID-19 shock and on facilitating the recovery. While this supports adjustment in the medium-term through stronger fundamentals, it also has added to indebtedness. Follow-up to country-specific recommendations from 2019 and 2020, including those that are MIP-relevant, is taking place in the context of the assessment of the Recovery and Resilience Plans (RRPs). The analysis of policies in the present report was finalised before the formal submission of RRP and does not draw on information included in RRP. It is therefore without prejudice to the Commission’s assessment of RRP, which is ongoing at the time of publication of this report.

The assessment follows a similar structure as the IDRs that were included in Country Reports in recent annual cycles. This chapter presents the main findings for the assessment of imbalances, also summarised in the MIP assessment matrix. The assessment is backed by selected thematic chapters that look more at length at the external position and competitiveness developments. Spillovers and systemic cross-border implications of imbalances are also taken into account. In addition, also assessments of structural issues made in previous IDRs and in the context of fiscal assessments are considered if relevant.

Macroeconomic context

In 2020, the recession in Romania was milder than in most other EU economies. GDP contracted by 3.9% in real terms, with private consumption collapsing during the spring lockdown and external demand shocks and supply chain disruptions hurting exports. The strict lockdown measures introduced in the first half of the year to contain the COVID-19 pandemic were particularly damaging for consumer spending, the economy’s main growth driver in recent years, which for the year as a whole declined by less than in most other countries. Investment, by contrast, made a significant contribution to GDP, due to the strong performance of construction activity through the year. A smaller decline in imports than in exports resulted in a further deterioration of the trade balance, and the current account deficit also worsened. Despite the milder recession and a moderately sized emergency support package, the budget deficit deteriorated significantly. The government deficit increased to 9.2% of GDP in 2020 from 4.4% of GDP in 2019. Much of this deterioration was driven by pre-existing expansionary measures, especially increases in pensions (by 15% as of September 2019 and by a further 14% as of September 2020). The fiscal situation was inevitably affected also by the combined impact of the economic downturn and of the measures to tackle the COVID-19 pandemic and its economic and social consequences (including employment support schemes, support to the health sector and some tax incentives). The Commission Spring 2021 forecast expects the fiscal deficit to improve slightly to 8% of GDP in 2021 and 7.1% of GDP in 2022.

The economy is expected to grow above its 2019 levels already in 2021. Real GDP growth is forecast to be around 5% in both 2021 and 2022, which means that economic activity is expected to exceed its pre-COVID-19 level in the current year. Private consumption is expected to recover as the vaccination

roll-out progresses and social distancing measures are gradually lifted. The phasing-in of projects under the RRP is set to lend new impetus to investment growth. After a sharp contraction in 2020, exports are expected to rebound in 2021, supported by the gradual recovery of global trade, while higher consumer spending should spur import growth. Overall, the contribution of net exports to growth over the forecast period is set to remain negative. The current account deficit is expected to decline slightly in both 2021 and 2022. In 2020, policy measures to limit job losses helped containing the rise in the unemployment rate to only 5% from 3.9% in 2019. Unemployment is projected to slightly increase in 2021 as headcount employment is likely to be almost stagnant while the labour force is growing, while in 2022, the unemployment rate is expected to decline on the back of a rise in employment. Nominal wage growth is projected to be relatively steady over the forecast horizon, but clearly lower than the double-digit rates seen in recent years.

Imbalances and their gravity

Romania's current account deficit has been large and widened continuously since the middle of the past decade. The current account deficit reached 4.7% of GDP in 2019 and increased to 5% of GDP in 2020 (figures based on national accounts). Romania's current account deficit therefore continues to be the one of the highest in the EU and significantly worse than fundamentals-based benchmarks, which suggest a small surplus. This evolution was mainly the result of an increasing deficit in the trade in goods, spurred by a consumer boom in times of high GDP growth over the past half decade. That higher demand partly leaked into higher imports, leading to the large current account deficits. The financing of that growing current account deficit through the net income balance (notably flows linked to FDI) and the capital account has declined markedly in recent years and debt financing has become more relevant. At the same time, after almost a decade of uninterrupted improvement, the net international investment position (NIIP) started deteriorating in 2020 reaching -47.3% of GDP at the end of 2020, which is worse than what fundamentals-based measures would have predicted and close to prudential levels. Past improvements in the NIIP were mainly due to very strong nominal GDP growth more than offsetting the growing current account deficits.

Continuously high fiscal deficits have worsened Romania's external position. For a number of years already before the outbreak of the COVID-19 crisis, the government run expansionary fiscal policies in times of strong GDP growth, leading to high government deficits that had to be increasingly financed from abroad. Those expansionary policies contributed also to the high demand and in that way reinforced the consumer spending boom and the worsening of the current account. The external debt of the government increased from almost 18% of GDP at the end of 2019 to 26% of GDP at the end of 2020. While the bulk of it consists of long-term loans and debt securities, the financing of a high debt stock is a potential source of risk that deserves monitoring, also in light of Romania's comparatively high government bond yields.

The pre-COVID-19 years were marked by very strong unit labour cost growth that led to cost competitiveness pressures. Most of the second half of the last decade was marked by strong wage increases significantly outpacing productivity growth and leading to a marked acceleration of unit labour costs. Private sector wages increased markedly in a very tight labour market, on the back of repeated minimum wage hikes and possible spillovers from strong public sector wage increases. Those large cost competitiveness pressures eased somewhat in 2019 but in 2020 unit labour costs increased again as major output losses dented headline productivity while employment was broadly preserved, also thanks to government-financed support schemes. Both public and minimum wage increases, which in the past fuelled the economy-wide strong wage increases, moderated in 2020. In a longer-term perspective non-cost factors such as skills shortages and the high share of the labour force with low skill levels, the quality of infrastructure or the perceived unpredictability of policymaking have prevented non-cost competitiveness gains.

Legislative unpredictability remains a concern for the business environment. The lack of clarity about the direction of certain public policies, if protracted, may heighten the perception of an unstable business environment and have negative repercussions on the country's financing costs, whilst relatively strong GDP growth rates have helped to counterbalance investor's concerns. A number of legislative initiatives in recent years may have dented the confidence of international investors. Among others, measures concerning the banking sector, if not subsequently corrected, could have had a negative impact

on bank profits and balance sheets. Moreover, the uncertainty surrounding the 40% increase of pensions which was due to be legislated as of September 2020 and the associated implications for the fiscal outlook of Romania also had potential repercussions for credit ratings. Overall, while policy-driven risks were largely mitigated by subsequent corrective policy action, legislative unpredictability continues to weigh on the broader business environment, the fiscal outlook, and on the perceptions of investors.

Evolution, prospects and policy responses

The current account deficit is expected to remain large. The COVID-19 pandemic seems to be leading to only marginal changes to the external financing needs of Romania, with the current account deficit increasing from 4.7% of GDP in 2019 to 5% of GDP in 2020. According to the Commission's 2021 spring forecast, the current account deficit is expected to slightly decline to 4.9% of GDP in 2021 and 4.6% of GDP 2022, as on the one hand the gradual opening up of the economies in trading partners is expected to stimulate exports, while on the other hand the recovery of consumption at home is set to give a new impetus to imports. At the same time, the fiscal deficit is projected to start narrowing but to remain significant at 8% of GDP in 2021 and 7.1% of GDP in 2022. The persistence of a current account deficit of sizeable magnitude could also imply a further increase in the NIIP as a share of GDP in absence of a sufficiently strong recovery in nominal GDP growth.

High fiscal deficits continue increasing government debt and external financing needs. The high fiscal deficit pre-dating the COVID-19 crisis coupled with the fiscal effort required to respond to the health crisis and support the economy have resulted in a sharp increase in the economy's external debt. Government debt has been rising fast even if remaining moderate, from 35.3% of GDP in 2019 to 47.3% of GDP in 2020 and is set to further increase, reaching almost 50% of GDP in 2021, and adding to external financing needs. Moreover, the latest debt sustainability risk analysis confirms that the country is at *high* risk in the medium-term⁽¹⁾. Government financing needs stood at around 15% of GDP in 2020. The budget deficit is projected by the Commission to decline this year and next, while the Government aims to reduce it to below 3% of GDP by 2024. Government bond yields remain among the highest in the region. In spring 2020, and in a context of heightened risk aversion and a flight to safety in international financial markets, a sudden jump in government bond yields (to about 6%) coupled with a few failed bond auctions have raised concerns about Romania's ability to finance its growing deficit⁽²⁾. The National Bank of Romania (NBR) started intervening on secondary markets in April 2020 bringing about a relative easing of funding conditions against a backdrop of lowering tensions in international markets following the support by major central banks across the world, including the ECB.

Cost competitiveness losses are expected to halt in the aftermath of the crisis. In particular, unit labour costs growth is expected to be subdued in 2021 and 2022. The growth rate of unit labour costs is forecast to decline significantly compared to the pre-crisis situation, mainly as a result of clearly more moderate wage growth. That reflects also policy actions, namely, a freeze in public sector wages in 2021 and minimum wage increases only in line with inflation. After the decline in 2020, productivity is expected to recover in 2021 and beyond as economy activity gradually recovers. However, some long-term productivity growth bottlenecks are expected to remain a challenge. Notably, skills shortages in a context of rapid demographic decline, combined with weaknesses in the education and training sector are an important factor that could limit future growth. The country also continues to be affected by the limited availability of infrastructure, both in quantitative and qualitative terms, the low innovative capacity and a cumbersome business environment.

The financial sector has remained resilient during the COVID-19 pandemic. The banking sector remained well capitalised and liquid, with the total banking sector capitalisation increasing from 19.2% in March 2020 to 21.4% in September 2020. Bank profitability declined somewhat from 13.8% in March 2020 to 11% in September of the same year while remaining at comfortable levels. The controversial

⁽¹⁾ See SWD(2021) 530 accompanying the Commission recommendation for a Council recommendation under the excessive deficit procedure and "Debt Sustainability Monitor 2020" available at https://ec.europa.eu/info/publications/debt-sustainability-monitor-2020_en for detailed methodological aspects.

⁽²⁾ By spring 2020, all the three main rating agencies had revised the outlook to negative, linking the revision of their rating to the evolution of the country's fiscal policy. In mid-April 2021, S&P revised the outlook from negative to stable, as it considered that short-term fiscal risks in Romania had abated. Fitch on the other hand maintained the negative outlook citing the country's poor track record of fiscal consolidation as well as the very high budget rigidities.

bank tax introduced by Government Emergency Ordinance 144 at the end of 2018 was abolished in early 2020. The sovereign-bank nexus has remained significant, with local banks' government exposure remaining around 20% of their assets, one of the highest shares in the EU. After an increase to 4.4% in the second quarter of 2020, non-performing loans (NPLs) declined somewhat to 4.1% in September 2020. However, the withdrawal of government support to companies and individuals in the aftermath of the COVID-19 pandemic could result in an increase of NPLs and would require a solid insolvency framework to effectively deal with them. Private sector debts are very contained, but part of those debts, especially on the corporate side, are denominated in foreign currency, which makes debt service dependent also of the evolution of the domestic currency.

Overall assessment

Romania's external position deteriorated in the pandemic crisis and remains a vulnerability. The COVID-19 crisis does not seem to have fundamentally changed the external sector dynamics. The current account deficit is forecast to remain elevated in 2021 and 2022 and beyond what would be suggested by economic fundamentals. The main factor behind the increase of the current account deficit in recent years has been the expansionary fiscal policy, stimulating an already fast growing economy through repeated wage and pension increases. The recent fiscal consolidation measures adopted in 2021 are going in the right direction, but concrete measures for future years (for example the pension reform) would have to be implemented in order to bring the fiscal and current account deficits on a sustainable path. The NIIP is set to deteriorate further, under the current forecast assumptions. External financing of the Romanian economy has become reliant on debt accumulation. That happens against a backdrop where that external borrowing for public and private sector can become more costly in case of exchange rate movements.

High government financing needs from abroad remain a possible source of risk. A long-awaited fiscal consolidation started with the adoption of the 2021 budget. Yet government deficits are likely to remain high over the next couple of years, implying a rising government debt burden. It is also expected that domestic savings will continue to be insufficient to finance those continued high deficits, implying a need to borrow significant amounts from abroad and raising Romania's external debt. While financial market tensions and external financing risks have quickly declined after the COVID-19 crisis outbreak, the financing of a growing stock of debt against the background of Romania's relatively high and volatile borrowing costs raises concerns and warrants close monitoring.

Cost competitiveness pressures are set to ease in the aftermath of the COVID-19 crisis. Going forward, unit labour costs are forecast to grow much less compared to years before the COVID-19 crisis in 2021 and 2022 (around 1.35% on average over the two years) amid a recovery in labour productivity and a moderation in wage growth, well below the double-digit growth of pre-crisis years. The extent to which past cost competitiveness losses will affect future export and investment performance remains to be seen. Moreover, some non-cost factors hampering competitiveness may remain an issue at least in the near term.

Table 1.1: Assessment of Macroeconomic Imbalances Matrix - Romania

| | Gravity of the challenge | Evolution and prospects | Policy response |
|--------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Imbalances (unsustainable trends, vulnerabilities and associated risks) | | | |
| External balance | <p>The current account deficit has deteriorated from a nearly balanced position in 2014 to 4.7% of GDP in 2019 and 5% of GDP in 2020. The widening deficit has been driven mainly by a worsening trade deficit in goods, which rose from 4.3% of GDP in 2014 to 7.8% in 2019 and 8.6% in 2020. The current account norm suggests a small surplus of 0.3% of GDP for Romania.</p> <p>The current account deficit is largely accounted for by the large government deficit, with private sector net lending mitigating it only partially.</p> <p>The financing of the government debt requires external borrowing. Romanian sovereign debt is currently rated at the lowest investment grade by the main rating agencies and borrowing costs are comparatively high, raising concerns about the financing of a growing stock of debt.</p> | <p>The current account deficit is expected to remain elevated at 4.9% of GDP in 2021 and 4.6% of GDP in 2022, driven by a persistent trade deficit.</p> <p>The coverage of the growing current account deficit by foreign direct investment and the capital account continued to decline in 2020 and relying more on portfolio investment.</p> <p>NIIP improved gradually over several years to -41% of GDP in Q1-2020 but subsequently started reversing to -47% of GDP in Q4-2020, which is worse than what fundamentals would suggest.</p> <p>Romania's external debt increased significantly in 2020 to 41.5% of GDP, pushed up mainly by the government sector.</p> | <p>The widening of the current account deficit has been in large part linked to a consumption boom, fostered by a persistently expansionary fiscal policy in times of strong GDP growth, through successive indirect tax cuts and substantial pay increases.</p> <p>Heavy net borrowing by the government sector, already before the COVID-19 crisis, has indeed been a major contributor to the large and persistent current account deficit. The government deficit has continuously deteriorated in recent years reaching 9.2% of GDP in 2020. However, the 2021 budget includes a number of fiscal consolidation measures. The government targets a deficit of around 7% of GDP in 2021 and 3% of GDP by 2024 (cash terms). According to the Commission spring 2021 forecast, the government deficit is expected to decline somewhat to 8% of GDP in 2021 and 7.1% in 2022.</p> |
| Competitiveness | <p>Between 2016 and 2019, economy-wide unit labour costs grew by an annual average of about 8%. That marked ULC growth was driven by wage growth, with productivity continuing to improve at significant rates. Nominal compensation per employee increased by an average of 13.5% between 2016 and 2019.</p> <p>Non-cost factors such as skills shortages, deficient infrastructure, particularly in poorer regions, and a cumbersome business environment, fuelled by political and legislative uncertainty and unpredictability continue to negatively impact Romania's competitiveness.</p> | <p>In 2020, unit labour costs accelerated again by 8.8%, due to the temporary productivity deterioration associated with falling economic activity while keeping employment. As a result, the unit labour costs based real effective exchange rate started appreciating in 2020.</p> <p>In 2021 and 2022, unit labour costs are expected to decelerate visibly, growing only by an average of less than 1½% per year, notably in light of more moderate wage growth compared with the years before the COVID-19 crisis and due to higher labour productivity thanks to the recovery in activity.</p> | <p>Repeated ad-hoc public wage and minimum wage increases drove the strong wage growth in the overall economy until 2020. The gross minimum wage more than doubled between July 2015 and January 2020. However, the increase in the minimum wage adopted in January 2021 was much more limited, with the 3% growth rate broadly in line with inflation. Wages in the public sector grew by more than 75% between 2015 and 2018, significantly outpacing the private sector. However, public-sector wage increases moderated in 2019 and 2020 and were frozen in 2021.</p> |

(Continued on the next page)

Table (continued)

| | Gravity of the challenge | Evolution and prospects | Policy response |
|-----------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Business environment | <p>The lack of clarity about important legislative changes impacts negatively the business environment and the perception of international investors. In recent years, a number of policy measures contributed to the lack of predictability of policy action. This concerned inter alia measures affecting the banking sector, even if largely reversed afterwards, and measures affecting the growth of government spending.</p> | <p>Legislative unpredictability persisted in 2020. Notably, the reversal of certain fiscally unsustainable measures was marred by delays and uncertainty even as sovereign debt credit rating downgrades were looming and bond yields were under pressure.</p> <p>The banking sector remained well capitalised throughout 2020. Its profitability declined somewhat but remained at comfortable levels. The sovereign-bank nexus remains significant, with local banks' government exposure remaining around 20% of their assets, one of the highest in the EU.</p> <p>The share of non-performing loans fell to around 4% after several years of strong economic growth and thanks to support measures adopted during the pandemic but are likely to increase again after the expiration of these measures.</p> | <p>In January 2020, the government cancelled the most damaging provisions of Government Emergency Ordinance 114/2018 (tax on banks' assets, higher minimum capital requirements for second pension pillar funds, the possibility to opt out of the second pillar after 5 years - with the exception of the construction sector).</p> <p>In the aftermath of a marked recession, an increase in the number of bankruptcies can be expected. In that context, the ability of the insolvency regime to efficiently deal with that can have implications for the allocation of credit in the economy and ultimately for investment.</p> |

Main takeaways

- The current account deficit has been large and continued to deteriorate in 2020. The high fiscal deficit has significantly contributed to the current account deficit as well as increased government debt, while borrowing costs have remained relatively high, also when compared with countries in the region. Cost competitiveness pressures accumulated over the pre-COVID-19 crisis in a context of strong GDP growth. Threats to financial stability and investment from past legislative initiatives have abated, but overall legislative unpredictability persists.
- The current account deficit is expected to remain elevated in the medium term, reflecting the continued stronger performance of imports as private consumption is expected to recover markedly. The financing of increasing external borrowing needs could become more uncertain, as illustrated by the sudden, but mostly temporary, spike in government bond yields in March 2020, with the government borrowing costs receding afterwards following central bank interventions. Lower wage growth is expected to ease pressure on cost competitiveness. However, non-cost factors could continue to hamper competitiveness. The unwinding of the COVID-19 crisis could see the number of insolvencies increase sharply. That may also affect the banking sector, which is also marked by a significant exposure to the sovereign.
- Recent policy action could start addressing the accumulated vulnerabilities for the Romanian economy. After several years of expansionary fiscal policy leading to large and widening government and current account deficits, fiscal consolidation is underway in 2021. The freezing of public sector wages and a very limited increase in the minimum wage in 2021 should help easing cost competitiveness pressures too. Legislative unpredictability continues to weigh on the broader business environment and may impact confidence and risk premia demanded by creditors and international investors.

Source: European Commission Services

Table 1.2: Selected economic and financial indicators, Romania

| | 2004-07 | 2008-12 | 2013-18 | 2019 | 2020 | forecast | |
|-------------------------------------------------------------------------------------------|---------|---------|---------|-------|-------|----------|------|
| | | | | | | 2021 | 2022 |
| Real GDP (y-o-y) | 7.6 | 0.6 | 3.2 | 4.1 | -3.9 | 5.1 | 4.9 |
| Potential growth (y-o-y) | 6.2 | 2.3 | 2.4 | 4.6 | 2.7 | 2.6 | 2.7 |
| Private consumption (y-o-y) | 12.8 | -0.1 | 6.1 | 4.1 | -5.2 | 6.1 | 5.9 |
| Public consumption (y-o-y) | 1.9 | 1.2 | 2.0 | 6.9 | 2.0 | 3.5 | 2.4 |
| Gross fixed capital formation (y-o-y) | 23.6 | -3.7 | 1.1 | 13.0 | 6.8 | 5.8 | 7.5 |
| Exports of goods and services (y-o-y) | 13.9 | 7.0 | 10.4 | 4.6 | -9.7 | 9.8 | 8.7 |
| Imports of goods and services (y-o-y) | 27.9 | 1.3 | 10.5 | 6.8 | -5.1 | 11.4 | 10.1 |
| Contribution to GDP growth: | | | | | | | |
| Domestic demand (y-o-y) | 15.2 | -1.2 | 2.6 | 6.5 | -1.3 | 5.8 | 5.9 |
| Inventories (y-o-y) | -1.4 | 0.0 | 0.5 | -1.2 | -0.9 | 0.4 | 0.0 |
| Net exports (y-o-y) | -6.4 | 1.4 | 0.0 | -1.2 | -1.6 | -1.1 | -1.0 |
| Contribution to potential GDP growth: | | | | | | | |
| Total Labour (hours) (y-o-y) | -0.8 | -1.1 | -0.2 | -0.2 | -0.5 | -0.5 | -0.6 |
| Capital accumulation (y-o-y) | 2.1 | 2.3 | 0.6 | 1.7 | 0.9 | 0.9 | 1.0 |
| Total factor productivity (y-o-y) | 4.8 | 1.1 | 1.9 | 3.1 | 2.3 | 2.2 | 2.3 |
| Output gap | 4.9 | -0.8 | -0.1 | 1.6 | -5.3 | -3.6 | -2.1 |
| Unemployment rate | 7.3 | 6.7 | 5.8 | 3.9 | 5.0 | 5.2 | 4.8 |
| GDP deflator (y-o-y) | 13.4 | 6.1 | 3.6 | 6.8 | 3.8 | 3.2 | 2.7 |
| Harmonised index of consumer prices (HICP, y-o-y) | 8.1 | 5.7 | 1.6 | 3.9 | 2.3 | 2.9 | 2.7 |
| Nominal compensation per employee (y-o-y) | 15.8 | 7.9 | 6.3 | 10.8 | 7.3 | 5.8 | 6.1 |
| Labour productivity (real, person employed, y-o-y) | 7.8 | 2.5 | 2.8 | 4.2 | -2.1 | . | . |
| Unit labour costs (ULC, whole economy, y-o-y) | 7.4 | 5.2 | 4.5 | 6.3 | 9.6 | 0.9 | 1.9 |
| Real unit labour costs (y-o-y) | -5.3 | -0.8 | 0.9 | -0.4 | 5.6 | -2.2 | -0.8 |
| Real effective exchange rate (ULC, y-o-y) | 9.1 | -3.0 | 3.0 | 1.2 | . | . | . |
| Real effective exchange rate (HICP, y-o-y) | 8.5 | -2.9 | 0.3 | -0.2 | 1.4 | 0.2 | 0.4 |
| Net savings rate of households (net saving as percentage of net disposable income) | | | | | | | |
| Private credit flow, consolidated (% of GDP) | 14.0 | 3.0 | 0.0 | 2.0 | . | . | . |
| Private sector debt, consolidated (% of GDP) | 43.7 | 70.7 | 56.8 | 46.8 | . | . | . |
| of which household debt, consolidated (% of GDP) | 12.0 | 21.4 | 17.3 | 15.5 | . | . | . |
| of which non-financial corporate debt, consolidated (% of GDP) | 31.8 | 49.3 | 39.5 | 31.3 | . | . | . |
| Gross non-performing debt (% of total debt instruments and total loans and advances) (2) | 1.4 | . | 10.7 | 3.3 | . | . | . |
| Corporations, net lending (+) or net borrowing (-) (% of GDP) | -2.7 | 8.0 | 11.7 | 8.9 | 8.3 | 8.7 | 8.9 |
| Corporations, gross operating surplus (% of GDP) | 26.6 | 31.7 | 30.7 | 29.8 | 28.0 | 28.9 | 29.7 |
| Households, net lending (+) or net borrowing (-) (% of GDP) | . | . | . | -7.8 | -2.1 | -3.8 | -5.1 |
| Deflated house price index (y-o-y) | . | . | 2.6 | -1.6 | 2.3 | . | . |
| Residential investment (% of GDP) | 2.0 | 2.9 | 2.4 | 2.3 | 2.6 | . | . |
| Current account balance (% of GDP), balance of payments | -10.3 | -6.3 | -2.2 | -4.9 | -5.2 | -5.1 | -4.9 |
| Trade balance (% of GDP), balance of payments | -11.4 | -7.5 | -1.8 | -4.1 | -4.5 | . | . |
| Terms of trade of goods and services (y-o-y) | 7.5 | 0.9 | 0.6 | 0.2 | 3.4 | 0.7 | 0.0 |
| Capital account balance (% of GDP) | 0.5 | 0.6 | 1.8 | 1.3 | 1.9 | . | . |
| Net international investment position (% of GDP) | -37.4 | -61.7 | -52.9 | -43.6 | -47.2 | . | . |
| NENDI - NIIP excluding non-defaultable instruments (% of GDP) (1) | -5.0 | -22.2 | -11.1 | -4.1 | -7.5 | . | . |
| IIP liabilities excluding non-defaultable instruments (% of GDP) (1) | 36.1 | 57.8 | 44.3 | 33.7 | 42.3 | . | . |
| Export performance vs. advanced countries (% change over 5 years) | 84.1 | 69.1 | 25.7 | 15.8 | 26.7 | . | . |
| Export market share, goods and services (y-o-y) | 13.9 | 2.3 | 4.7 | 1.6 | 2.7 | 1.8 | 3.2 |
| Net FDI flows (% of GDP) | -7.1 | -2.8 | -2.2 | -2.2 | -0.8 | . | . |
| General government balance (% of GDP) | -1.7 | -6.1 | -2.2 | -4.4 | -9.2 | -8.0 | -7.1 |
| Structural budget balance (% of GDP) | . | . | -2.1 | -4.7 | -7.5 | -6.9 | -6.4 |
| General government gross debt (% of GDP) | 14.8 | 27.0 | 36.6 | 35.3 | 47.3 | 49.7 | 52.7 |
| Tax-to-GDP ratio (%) (3) | 28.8 | 27.3 | 26.9 | 26.8 | 26.7 | 26.5 | 26.4 |
| Tax rate for a single person earning the average wage (%) (4) | . | 28.5 | 28.5 | 36.9 | 36.9 | . | . |
| Tax rate for a single person earning 50% of the average wage (%) (4) | . | 25.4 | 25.7 | 35.1 | 35.9 | . | . |

(1) NIIP excluding direct investment and portfolio equity shares

(2) domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.

(3) The tax-to-GDP indicator includes imputed social contributions and hence differs from the tax-to-GDP indicator used in the section on taxation

(4) Defined as the income tax on gross wage earnings plus the employee's social security contributions less universal cash benefits, expressed as a percentage of gross wage earnings

Source: Eurostat and ECB as of 2021-05-05, where available; European Commission for forecast figures (Spring forecast 2021)

2. THEMATIC ISSUE: EXTERNAL POSITION

Output, demand and sectoral net lending/borrowing

In 2020, the fall in output was somewhat stronger than the decline in aggregate demand, leading to a small widening of the already large trade deficit. After a period of fairly aligned output and demand between 2013 and 2016, aggregate demand started expanding at considerably faster pace amid a context of fast economic growth and the trade deficit gradually widened over recent years (Graph 2.1(a)). The COVID-19 shock caused a contraction of both demand and output, with the latter shrinking somewhat more strongly than the former, leading to a further small increase in the trade deficit in 2020. The fall in domestic demand was driven by a decline in private consumption amounting to 5.2%. Lower domestic demand led to a decline in imports, which was however less pronounced than the drop in exports. The trade deficit is forecast to slightly worsen by 2022.

The fiscal deficit increased strongly in 2020, contributing to the large net external borrowing needs of the Romanian economy. The government deficit reached 9.2% of GDP last year, pushed up by the fiscal effort needed to fight the COVID-19 pandemic but also by past legislated measures leading to strong expenditure growth. However, Romania's fiscal position had started deteriorating before 2020, due to an expansionary fiscal policy unrelated to the COVID-19 crisis, and the 2019 budget deficit outturn amounted to 4.4% of GDP. At the same time, the position of households is estimated to have improved somewhat, although it remained negative, while the estimated net lending of corporations moved down only slightly in 2020. The government's deficit position is expected to improve somewhat in 2021 and 2022. Thus, the fiscal deficit is forecast by the Commission to slightly narrow to 8.0% of GDP in 2021, supported by expenditure cuts and a recovery in economic activity, and to improve further to 7.1% of GDP in 2022. The budget adopted by the government was built on a deficit of 7.16% of GDP for 2021.

External flows dynamics

While the net borrowing position of the Romanian economy recorded a small improvement in 2020, the current account and trade balances slightly declined. From the Balance of Payments perspective (Graph 2.1(b)), the improvement in net borrowing position was brought about by the higher capital account balance in 2020, as the current account deficit marginally worsened, in accordance with the trade balance developments. While the long-standing surplus in services trade (mainly transport services, computer services, and manufacturing services on physical inputs owned by others) increased by around 11%, due mainly to a significant reduction of the deficit in travel services brought about by the travel restrictions, the downward trend in trade in goods deficit continued leading to a marginally larger overall trade deficit. Energy prices slightly cushioned the worsening of the trade balance as the deficit in energy goods trade improved⁽³⁾. The surplus of the secondary income balance increased from 0.7% of GDP in 2019 to 0.9% of GDP in 2020 on the back of a strong increase in EU transfers that more than offset the decline in remittances, but was countervailed by a deterioration of the primary income balance.

The current account balance remains well below the levels explained by economic fundamentals. The 'current account norm' suggested by the economic fundamentals amounts to a small surplus, while considerable current account deficits have been recorded over the last three years, both in headline, as well as in cyclically-adjusted terms (Table 1)⁽⁴⁾. Out of the non-fundamental variables that affect the current account, it was mainly the negative contribution from the net international investment position (NIIP) that has been keeping the current account below the norm over the last decade.

⁽³⁾ The statistics on international trade in goods show a small deterioration of balance of trade in goods in 2020, driven by a decline in exports (as a share in GDP) that slightly exceeded the fall in imports, mainly of intermediate goods, which is the largest category of imported goods.

⁽⁴⁾ Current account norm is the current account balance that can be explained by fundamentals. It is based on the empirical setup similar to IMF's EBA. Fundamentals are slow-moving variables including: demographics, relative income, natural resources, manufacturing intensity, and reserve currency status. See Coutinho et al. (2018) "Methodologies for the assessment of current account benchmarks", European Economy, Discussion Paper 86/2018, for the description of the methodology.

The coverage of the current account balance by non-debt generating flows has been declining. While in 2017, foreign direct investment (equity component) and the capital account together covered more than 100% of the current account deficit, this ratio declined to around 73% in both 2019 and 2020. Going forward, the current account is forecast to marginally improve but remain nevertheless elevated reflecting both the strong projected economic recovery in trading partners as well as at home. The capital account surplus is projected to continue offsetting around one-third of the current account deficit. The large inflows of EU funds expected in the coming years could help finance the current account deficit.

In 2020, the net external financing needs were mostly met by increases in the government's external debt liabilities amid the high government financing needs, after years of reliance on foreign direct investment. The Romanian economy has long been receiving significant foreign direct investment (Graph 2.1(c)). Partly in parallel, especially during the period between 2013 and 2016, substantial net debt outflows were recorded, which largely included reduction in external liabilities by the monetary and financial institutions and the central bank. This trend weakened by 2019 as net debt inflows were recorded in the later part of the year, along the still considerable direct investment. In 2020, however, incurrence of portfolio debt liabilities increased significantly to around 6.5% of GDP, mainly by the government, which more than compensated for a decline in the net direct investment inflows (partly due to reduction in inter-company debt liabilities).

Throughout 2020, the government was able to meet its external financing needs despite increased uncertainty right after the COVID-19 shock and temporary financial market tensions. The external debt of the general government reached EUR 57.8 billion in December 2020, up 45.6% from one year earlier, the bulk of it consisting of long-term debt securities, with external liabilities accounting for 50.9% of the total government debt. To cover the increasing financing needs, the government tapped foreign markets for a total of EUR 8.8 billion and USD 3.3 billion last year. The COVID-19 outbreak was followed by external borrowing tensions also for Romania amid higher risk aversion in global financial markets and capital flights. After the 10-year yields on Romanian sovereign bonds increased in March 2020 to above 6%, the National Bank of Romania started intervening on secondary markets. That happened also against a backdrop of lowering tensions in international markets following the support by major central banks across the world, including the ECB. Over one third of the debt issued in 2020 was used to refinance maturing external government debt. Funding conditions eased somewhat after the National Bank of Romania intervention, with yields at around 4% by the end of June and declining further to 3.1% towards the end of the year. In 2020, reserve asset flows amounted to 2.6% of GDP.

Romanian sovereign debt is currently rated at the lowest investment grade with a negative outlook by two of the three major rating agencies. By spring 2020 all three major rating agencies had revised their outlook from 'stable' to 'negative', citing concerns about fiscal sustainability and in particular the 40% pension increase that was due to take place in September 2020. However, downgrade risk was averted in 2020 as pensions were increased by only 14% following the budget amendment adopted in August. The government is currently working on modifying the pension law. In April 2021, S&P improved the outlook for the Romanian sovereign from 'negative' to 'stable', while maintaining the investment grade, on account of a reduction in short-term fiscal risks, following the adoption of the first fiscal consolidation measures by the government. Fitch however maintained the 'negative' outlook on account of Romania's poor track record of fiscal consolidation and high share of rigid expenditure in the budget. The general government debt increased from 35.3% of GDP in 2019 to 47.3% of GDP in 2020 and it is forecast to reach 49.7% of GDP in 2021 and 52.7% of GDP in 2022. Despite the still relatively low government debt-to-GDP ratio, Romania faces substantial fiscal sustainability risks in the short and medium term. Moreover, there are risks stemming from the high share of government debt held in foreign currency (about 46%) and from the high share held by non-residents (41%).

Developments in external stock positions

The negative net international investment position of Romania worsened in 2020, for the first time in seven years. After reaching a trough in 2012 of nearly -68% of GDP, the NIIP gradually improved afterwards to -44% in 2019 (Graph 2.1(d)). While the economy as a whole was a net lender over the 2013-2016 period, the NIIP improvement was mainly driven by nominal GDP growth. The importance of GDP growth in improving the NIIP became even stronger in recent years, notably after 2016, when the Romanian economy turned into a clear net borrower from abroad. It was monetary and financial

institutions and the rest of the private sector which managed to improve their positions the most over this period (Graph 2.1(e)). In 2020, the NIIP worsened to -47.3% of GDP by the end of 2020 driven by the declining position of general government, which deteriorated by around 9 percentage points of GDP. The decline in the NIIP during 2020 has almost exclusively been driven by negative current account flows, while the contribution from the nominal GDP growth and the valuation effects turned only slightly negative. The NIIP is now mildly lower than the prudential threshold, but considerably worse than the 'NIIP norm', which currently is at -11% of GDP (Table 1). In addition, both the recent and the forecast current account balances are considerably below those required to halve the gap to the 'NIIP norm' in ten years (Table 1) ⁽⁵⁾. Given the large inward direct investment stock, the NIIP excluding the non-defaultable instruments (NENDI) is much more favourable at -7.5% of GDP.

During 2020, the foreign exchange reserves increased. This holds true both as a share of GDP, from slightly less than 17% at the end of 2019 to 19.5% of GDP end of 2020, as well as in terms of months of goods and services imports coverage (5.6 months at the end of 2020 versus 4.5 months end of 2019). The increase has mainly been driven by reserve assets flows (around 2.6% of GDP), but was also supported by higher gold price. Short-term external debt assets exceeded short-term external debt liabilities by 2.9% of GDP at the end of 2020 (up from 0.6% end of 2019).

Relatively high shares of both domestic and external debt assets and liabilities are denominated in foreign currencies. As for the most sizeable positions, the share of government debt denominated in foreign currency amounted to 46% at the end of 2020 ⁽⁶⁾, while for bank's loan assets and deposit liabilities concerning the domestic private sector, it equalled 30% and almost 40%, respectively. As for the external liabilities, 84.6% of external debt liabilities was denominated in foreign currency in 2019. The nominal effective exchange rate of the Romanian Leu remained rather stable during 2020, which is relevant given those exposures to foreign currencies.

Outlook

Latest forecasts point to continuous large external financing needs going forward, driven by the significant net borrowing by the general government. Fiscal deficits are forecast to remain sizeable going forward, being estimated at 8% of GDP in 2021 and 7.1% of GDP in 2022 in the Commission spring 2021 forecast. On the other hand, the private sector should maintain a positive net lending position, thus partly attenuating the external financing needs of the economy. For 2021, the government's total financing needs are estimated at RON 130.8 billion ⁽⁷⁾ (EUR 26.8 billion) or around 11% of GDP. The government plans to raise funds both on the internal and the external market, with external issuances so far in 2021 amounting to EUR 3.5 billion. The next significant debt repayments are due on 11 June 2021 and 27 October 2021 (each above RON 9 billion, around EUR 2 billion).

Under currently forecast external flows and GDP growth, the net international investment position is set to deteriorate going forward. This is depicted under the baseline scenario (Graph 2.1(f)), where the NIIP is projected to decline to below -60% of GDP by 2030. ⁽⁸⁾ Alternative scenarios presented therein are based on more optimistic assumptions, especially Scenario 1, where the current account balance is assumed to converge to its norm by 2030 through improvements in the trade balance. Scenario 2 describes a hypothetical situation in which capital account balance is 1 percentage point of GDP higher in the period 2021-2026 than in the baseline. In parallel, real GDP growth is higher by 0.5 percentage point, while the trade balance is lower by only 0.1 percentage point of GDP over the same period.

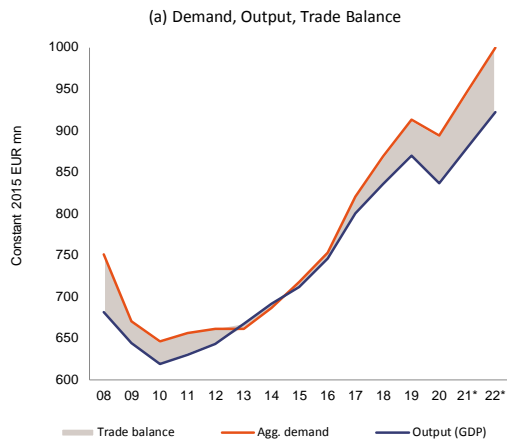
⁽⁵⁾ The country-specific prudential benchmark denotes the NIIP level beyond which the probability of an international economic and financial crisis becomes higher. The NIIP level explained by fundamentals ('NIIP norm') represents the NIIP that would result if a country had run its current account in line with fundamentals since 1995. For details see Turrini and Zeugner (2019), "Benchmarks for Net International Investment Positions", European Economy, Discussion Paper 097/2019.

⁽⁶⁾ According to the Ministry of Finance data: <https://www.mfinante.gov.ro/trezor/pagina.html?luna=02&anul=2021&method.arhiva=submit&c=trezordatoriegubernamentala>

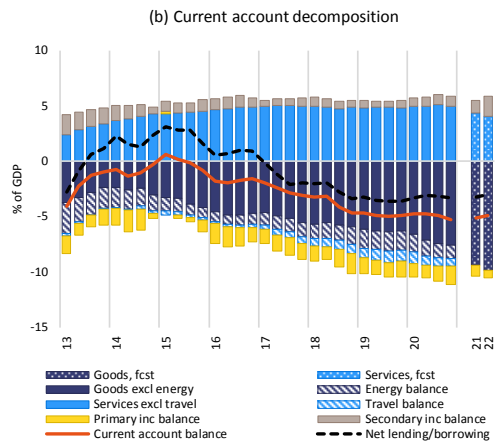
⁽⁷⁾ According to the Ministry of Finance

⁽⁸⁾ The baseline scenario is based on the Commission services' spring forecast for 2021 and 2022, and on the DG ECFIN t+10 forecast framework as well as debt sustainability monitor for subsequent years.

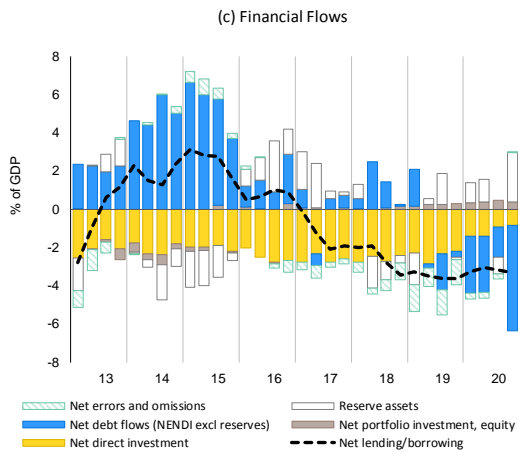
Graph 2.1: Thematic Graphs: External position



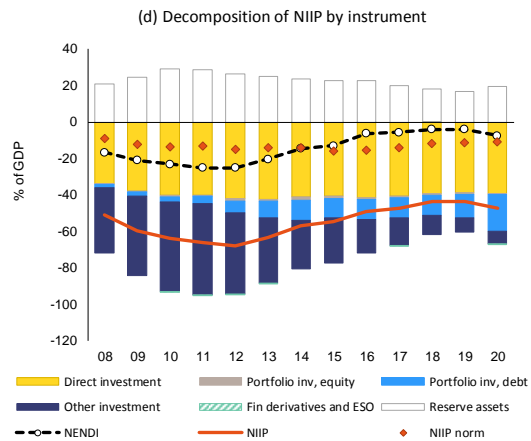
Source: Ameco



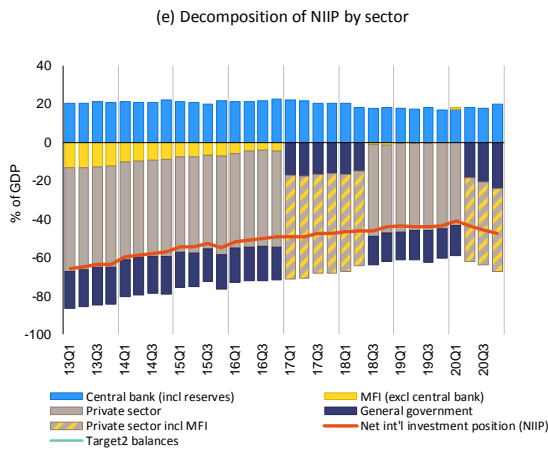
Source: Eurostat and Ameco



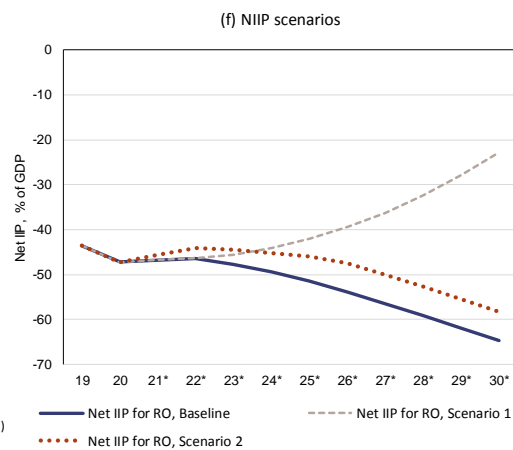
Source: Eurostat



Source: Eurostat



Source: Eurostat
Note: for the period between 2017Q1 and 2018Q2, and after 2020Q2, separate data for Private sector and MFI is not available.



Source: ECFIN staff calculations.
Scenario 1: trade balance improves after 2022 so that the current account reaches the current account norm in 2030.
Scenario 2: higher capital account balance (by 1pp of GDP), real GDP growth (by 0.5pp) and lower trade balance (by 0.1pp) in 2021-2026 than in the baseline.

Source: European Commission Services

Table 2.1: Selected external sector indicators, Romania

| | | 2003-07 | 2008-12 | 2013-17 | 2018 | 2019 | 2020 | 2021f | 2022f |
|---------------------------------------------------------------|---------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Flows ⁽¹⁾ | Source: | | | | | | | | |
| CA balance as % of GDP, NA | (b) | -9.6 | -6.3 | -1.1 | -4.4 | -4.7 | -5.0 | -4.9 | -4.6 |
| CA balance as % of GDP, BoP | (a) | -9.5 | -6.3 | -1.3 | -4.6 | -4.9 | -5.2 | -5.1 | -4.9 |
| Cyclically adj. CA balance as % of GDP ⁽²⁾ | (c) | -7.8 | -6.3 | -1.2 | -4.0 | -4.4 | -5.3 | -5.7 | -5.9 |
| CA req. to stabilize NIIP above -35% ⁽³⁾ | (c) | -3.3 | -3.2 | -4.5 | -3.4 | -3.3 | -3.2 | -3.3 | -3.2 |
| CA explained by fundamentals (CA norm) ⁽⁴⁾ | (c) | -2.1 | -1.0 | -0.5 | 0.1 | 0.2 | 0.3 | 0.3 | 0.4 |
| Required CA for specific NIIP target ⁽⁵⁾ | (c) | -2.3 | -1.6 | -2.4 | -1.1 | -1.0 | -0.7 | -0.7 | -0.5 |
| Trade bal. G&S, % of GDP, NA | (b) | -10.7 | -7.4 | -1.1 | -3.4 | -4.1 | -4.5 | -5.0 | -5.7 |
| Required TB for specific NIIP target ⁽⁵⁾ | (c) | -3.8 | -2.5 | -3.4 | -1.2 | -0.8 | -0.1 | 0.3 | 0.5 |
| Capital account bal. as % of GDP, NA | (b) | 0.7 | 0.9 | 2.4 | 1.2 | 1.5 | 1.6 | 1.6 | 1.7 |
| Stocks | | | | | | | | | |
| NIIP as % of GDP | (a) | -37 | -62 | -54 | -44 | -44 | -47 | -48 | -48 |
| Prudential NIIP/NENDI benchmark ⁽⁶⁾ | (c) | -28 | -33 | -36 | -42 | -44 | -44 | -44 | -45 |
| Fundamentally expl. NIIP benchmark (NIIP norm) ⁽⁶⁾ | (c) | -12 | -13 | -15 | -12 | -11 | -11 | -9 | -8 |
| NENDI as % of GDP | (a) | -6 | -22 | -12 | -4 | -4 | -7 | | |

(1) NA=National Accounts, BoP=Balance of Payments, CA=Current Account, NENDI= NIIP excluding non-defaultable instruments, TB= Trade Balance.

(1) Flow data refer to national account concept, unless indicated otherwise.

(2) Cyclically adjusted CA is the CA adjusted for the domestic and foreign output gaps, taking into account trade openness.

(3) The average CA needed in order to stabilise the NIIP in 20 years is based on T+10 Ecfm projections.

(4) Current account norm is the current account balance that can be explained by fundamentals. It is based on the empirical setup similar to IMF's EBA. Fundamentals are slow-moving variables including: demographics, relative income, natural resources, manufacturing intensity and reserve currency status. See Coutinho et al. (2018) "Methodologies for the assessment of current account benchmarks", European Economy, Discussion Paper 86/2018, for the description of the methodology.

(5) The CA or TB needed either to halve the distance to fund. NIIP benchmark, or to reach the prud. NIIP benchmark in 10Y, whichever is higher. Based on T+10 Ecfm projections.

(6) The country-specific prudential benchmark denotes the NIIP level beyond which the probability of an international economic and financial crisis becomes higher. The NIIP level explained by fundamentals ('NIIP norm') represents the NIIP that would result if a country had run its current account in line with fundamentals since 1995. For details see Turrini and Zeugner (2019), "Benchmarks for Net International Investment Positions", European Economy, Discussion Paper 097/2019.

Sources: (a) Eurostat, (b) Ameco, (c) European Commission calculations.

3. THEMATIC ISSUE: COMPETITIVENESS

Romania recorded strong labour cost dynamics in the years before the COVID-19 crisis. Nominal unit labour costs (ULC) started increasing strongly in 2016 growing by 7.2% in 2016, by 9.5% in 2017 and 8.3% in 2018 before slowing down somewhat to 6.5% in 2019. This acceleration was driven entirely by compensation per employee, which increased by double digits in nominal terms between 2016 and 2019 (Graph 3.1(a)), while the evolution of productivity was clearly positive but more muted.

The main driver of unit labour costs were marked wage increases in pre-crisis years. Besides fast growing labour demand, low and falling unemployment and shortages of certain skills, government action contributed to the strong wage increase. Notably, public wages more than doubled over the past half decade and have significantly outpaced wages in the private sector. ULC in the public sector increased on average by more than 20% per year between 2016 and 2018 and slowed down to about 10% in 2019 and 8% in 2020. In addition, the government-set statutory minimum wage has also doubled over the second half of last decade and added to the wage pressures. That happened in the context of Romania having one of the lowest wage levels in the EU and a comparatively low labour share in national income. Yet the evolution of wages was well in excess of that suggested by wage benchmarks based on inflation, productivity growth, and the unemployment, which suggests that wage dynamics may have evolved out of sync with fundamentals and put competitiveness at risk (Graph 3.1(b)).⁽⁹⁾

Since 2016 and until the start of the COVID-19 crisis, wage increases have outpaced significant productivity gains. Productivity growth in Romania was among the strongest in the EU in recent years, albeit productivity increased from a very low level. Labour productivity per person grew on average by 5.3% per year between 2016 and 2019. Nevertheless, these productivity gains were insufficient to compensate for the strong wage increases and avoid ULC growing at marked paces for several years. ULC grew more strongly in areas less exposed to competition from abroad (non-tradables) but increases in more tradable sectors were also significant over the pre-crisis years. Thus, ULCs in the construction sector grew on average by more than 20% per year between 2017 and 2019, while ULCs in industry advanced on average by 6% per year during the same period (Graph 3.1(c)).

The cost competitiveness pressures were also visible in the evolution of the real effective exchange rate. The strong growth of ULCs between 2016 and 2018 was also reflected in a clear tendency towards appreciation of various metrics of the real effective exchange rate (REER) (based on ULC, HICP, GDP deflator, or exports prices). This appreciation started moderating already in 2019 and continued in 2020 (Graph 3.1(d)). A mild nominal depreciation of the Romanian Leu mitigated the real appreciations but did not prevent them from being significant.

Export performance remained relatively strong in recent years. Romania's export market share for goods and services increased by 8.9% in 2016, 2.8% in 2017, and a further 3.6% in 2018 but slowed down somewhat to 1.6% in 2019 (Graph 3.1(e)). Exports of services continued to be concentrated on transport and telecommunications. In 2020, as a result of lockdown measures and demand and supply chain disruptions, exports of goods and services declined by 9.7% compared to 2019. Double-digit declines in exports were recorded for mineral products and textiles while the decline in exports of machinery and transport equipment was more moderate.

⁽⁹⁾ The growth rate of nominal compensation per employee is compared to two benchmarks. Benchmark 1 (Predicted nominal compensation growth) reflects wage growth as predicted by developments in inflation, productivity growth, and the unemployment rate. The prediction is estimated through a panel regression over the period 1995 to 2018. Benchmark 2 (Compensation per employee growth consistent with constant ULC-based REER) reflects external competitiveness. It predicts wage growth consistent with a constant value of the REER, computed on the basis of ULC growth. See European Commission (2013), Benchmarks for the assessment of wage developments, European Economy, Occasional Papers 146, May 2013, for more details on these benchmarks.

Economic sectors potentially more exposed to foreign competition have grown less than the rest of the Romanian economy. Unlike in many other Member States, sectors less exposed to potential competition from abroad – both in terms of exports as well as import penetration in Romania – have grown more than the tradable sectors in the last few years (Graph 3.1(f) and Table 2).

Cost competitiveness pressures eased before the COVID-19 outbreak but ULCs increased again in 2020. Already in 2019, ULC moderated somewhat, while remaining above those of most Member States. In 2020, ULC posted a 8.8% growth, reflecting a robust albeit slower evolution of average compensation per employee and the productivity decline caused by labour hoarding amid the recession. In particular, in 2020, productivity declined by 1.3% y-o-y as a result of the sharp fall in production coupled with more contained job losses. As a result, the ULC-deflated REER, which had been subdued in 2019, picked up again. On the other hand, the REERs based on inflation, export prices and GDP deflator remained subdued in 2020.

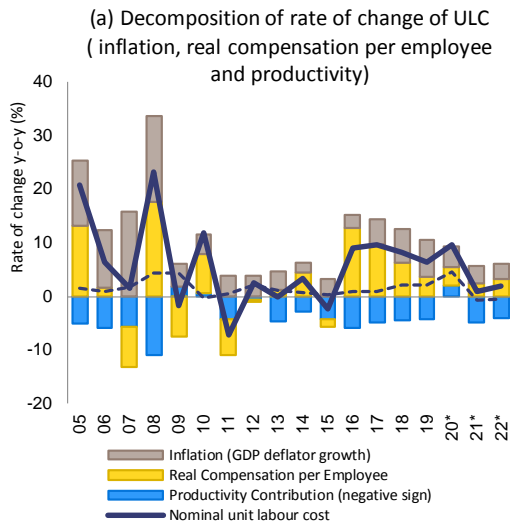
Wage dynamics slowed visibly in 2020 but remained robust. The fall in productivity was not mitigated by a similar wage moderation when the COVID-19 crisis set in. Compensation per employee increased by 7.3% in 2020, compared to nearly 11% in 2019. The minimum wage was increased by about 7% at the beginning of 2020 and by a further 3% in January 2021. Wages in the public sector displayed more moderate growth in 2020 than in earlier years, with compensation per employee advancing by 8.6%, slightly above that of the total economy. Turning to other sectors, after two years of double-digit growth, compensation per employee in construction, a sector that remained very dynamic during the COVID-19 pandemic, increased in 2020 by 4.3%, while in industry, Romania's main exporting sector, it remained slightly below that of the overall economy. Overall, wage developments often react to changing economic conditions with a certain lag, which could also have been the case in Romania in context of the COVID-19 crisis. Moreover, a significant part of pay may have been agreed or set before the crisis outbreak.

Cost competitiveness pressures are set to moderate in the aftermath of the COVID-19 crisis. In 2021 and 2022, the projected gradual recovery in economic activity is expected to imply a rebound in headline productivity, which should recover the losses of 2020. Moreover, wage growth has already moderated visibly and is expected to remain contained this year and next on the back of lower overheating pressures in the labour market and the economy in general. The minimum wage was increased in 2021 only in line with inflation while public sector wages were frozen at the level of December 2020. The authorities announced the intention to prolong the freeze of public sector wages also into 2022.

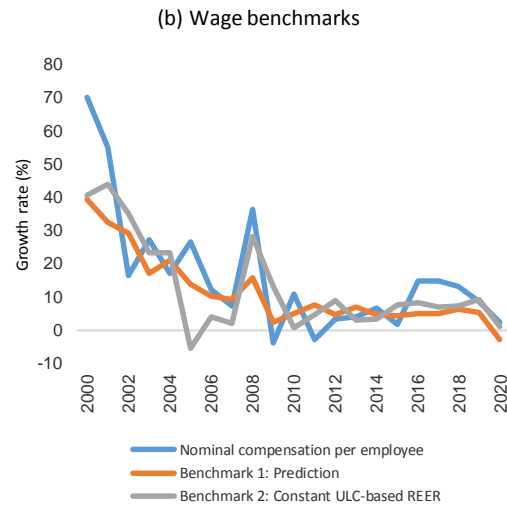
Unit labour costs are expected to grow only moderately in 2021 and 2022. ULC growth is forecast at just below 1% in 2021 and 2% in 2022. This is much less than in previous years, but still higher than in many other EU countries for which declines in ULCs are forecast over these two years. Other cost competitiveness indicators, such as REERs and inflation, suggest a similar pattern. Overall, gains in relation to trading partners are not expected this year or next. Export market shares are projected to still increase somewhat by a cumulative 5% in 2021 and 2022. However, the contribution of net exports to GDP growth is expected to remain negative in both 2021 and 2022.

Non-cost factors that could potentially affect Romania's competitiveness negatively have not been addressed. Public policy making remains relatively unpredictable, affecting the business environment, together with persistent inefficiencies in the public administration. Skills shortages and the high share of the labour force having only low and very low skill levels, against a background of negative demographics, together with weaknesses in the education sector are also important factors potentially limiting Romania's growth. The state of rail and road infrastructure remains poor affecting businesses effectiveness in moving goods across borders, limiting labour force mobility and aggravating regional disparities. While less pressing during periods of reduced mobility, the poor quality of the infrastructure risks putting a strain on the country's recovery as more economic activities return to a normal functioning. In addition, cumbersome administrative procedures for setting up businesses, as well as high regulatory requirements imposed on service providers, including regulated professions, impede further market development. The economy's low innovative capability is another key factor limiting competitiveness.

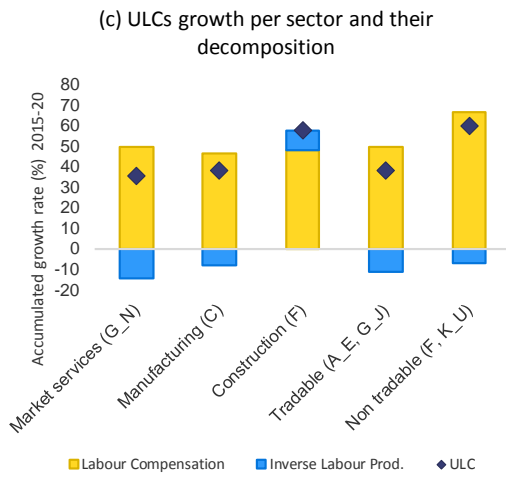
Graph 3.1: Thematic Graphs: Competitiveness



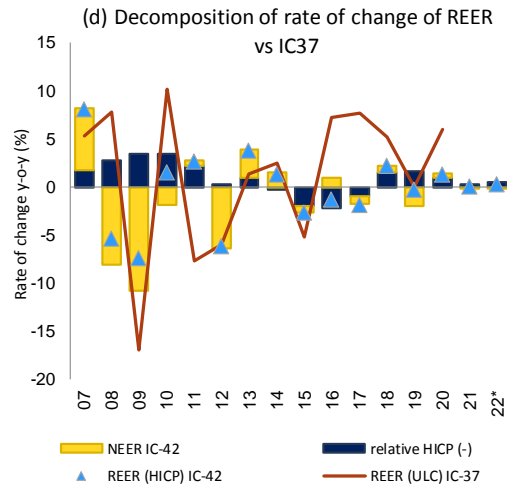
Source: Ameco



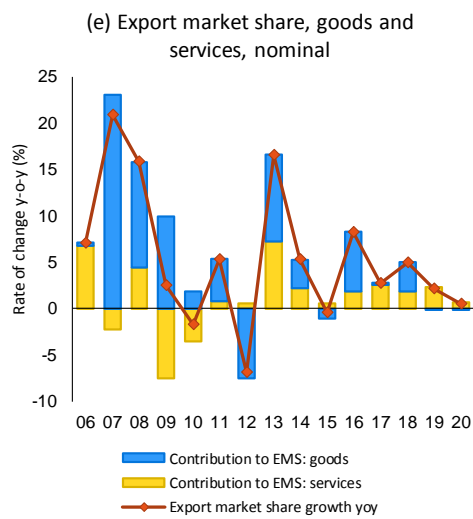
Source: DG EMPL



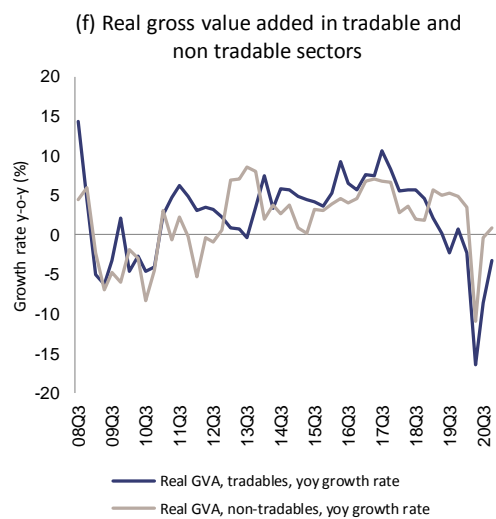
Source: Ameco



Source: Ameco



Source: Eurostat



Source: Eurostat

Source: European Commission Services

Table 3.1: Selected cost competitiveness indicators, Romania

| | 03-07 | 08-12 | 13-17 | 18 | 19 | 20 | 21' | 22' |
|-----------------------------------------------------------|-------|-------|-------|------|------|------|------|------|
| Nominal ULC, yoy % change | 10.6 | 5.2 | 3.8 | 8.2 | 6.3 | 9.6 | 0.9 | 1.9 |
| Labour productivity, yoy % change ¹ | 6.9 | 2.7 | 4.5 | 4.4 | 4.2 | -2.1 | 4.9 | 4.1 |
| Inflation (GDP deflator growth), yoy % change | 15.3 | 6.1 | 3.1 | 6.2 | 6.8 | 3.8 | 3.2 | 2.7 |
| Real compensation per employee, yoy % change | 2.3 | 1.7 | 5.2 | 6.4 | 3.7 | 3.4 | 2.5 | 3.3 |
| Nominal compensation per employee, yoy % change | 18.0 | 7.9 | 8.5 | 12.9 | 10.8 | 7.3 | 5.8 | 6.1 |
| Wage benchmark (nominal compensation growth) ² | 14.3 | 7.1 | 5.4 | 6.4 | 5.5 | -2.7 | - | - |
| Wage benchmark (constant ULC-based REER) ² | 8.9 | 10.9 | 5.9 | 7.4 | 9.4 | 1.1 | - | - |
| REER_GDP, yoy % change | 11.6 | -2.1 | 2.0 | 4.0 | 2.2 | 1.8 | 0.8 | 0.5 |
| REER_ULC, yoy % change | 8.0 | -3.0 | 2.6 | 5.2 | 1.2 | - | - | - |
| NEER, yoy % change | -0.2 | -5.4 | 0.8 | 0.7 | -1.9 | 0.4 | -0.1 | -0.1 |

Notes: (1) Labour productivity contributes to ULC with a negative sign (not shown in the table): For instance, high productivity reduces unit labour cost growth.

(2) Wage benchmarks: DG EMPL provides two benchmarks for the growth rate of nominal compensation per employee. Benchmark 1 (Predicted nominal compensation growth) reflects wage growth as predicted by developments in inflation, productivity growth, and the unemployment rate. The prediction is estimated through a panel regression. Benchmark 2 (Compensation growth consistent w. constant ULC-based REER) reflects external competitiveness and is consistent with a constant value of the real effective exchange rate (REER), computed on the basis of unit labour costs (ULC). Abbreviations: REER_GDP = Real effective exchange rate based on GDP deflator, Performance relative to the rest of 42 industrial countries; double export weights (2010=100), REER_ULC = Real effective exchange rate based on ULC, Performance relative to the rest of 37 industrial countries; double export weights (2010=100), NEER = Nominal effective exchange rate, Performance relative to the rest of 42 industrial countries; double export weights (2010=100).

Source: REER and ULC: AMECO; wage benchmarks: DG EMPL

Table 3.2: Selected trade performance indicators, Romania

| | 03-07 | 08-12 | 13-17 | 18 | 19 | 20 | 21' | 22' |
|-----------------------------------------------------------------|-------|-------|-------|------|--------|--------|------|------|
| Export market share (goods and services), yoy % change | 13.0 | 2.3 | 6.7 | 3.6 | 1.6 | 2.7 | 1.8 | 3.2 |
| Export market share (goods and services) - volume, yoy % change | 4.4 | 4.1 | 7.8 | 1.6 | 3.6 | -1.6 | - | - |
| Exports (goods and services), yoy % change | 23.5 | 16.1 | 10.2 | 10.5 | 7.4 | -8.1 | 13.5 | 10.9 |
| Exports (goods and services) - volume, yoy % change | 12.8 | 7.0 | 11.4 | 5.3 | 4.6 | -9.7 | 9.8 | 8.7 |
| Trade balance (services), % of GDP | 3.8 | 1.7 | 4.3 | 4.1 | - | - | - | - |
| Trade balance (goods, except energy products), % of GDP | -12.6 | -4.5 | -4.7 | -5.9 | - | - | - | - |
| Trade balance (energy products), % of GDP | -2.8 | -2.3 | -1.2 | -1.6 | -1.7 p | -1.2 p | - | - |
| GVA (Tradables), in % of total GVA | 57.1 | 56.9 | 57.4 | 56.1 | 54.6 | 53.0 | - | - |
| GVA (Non-tradables without construction), in % of total GVA | 36.2 | 36.3 | 36.9 | 37.8 | 38.7 | 39.7 | - | - |
| GVA (Construction), in % of total GVA | 6.7 | 6.8 | 5.7 | 6.1 | 6.7 | 7.3 | - | - |

Source: GVA, Exports and imports, Terms of trade: AMECO; EMS growth and trade balance: Eurostat.