23. ROMANIA

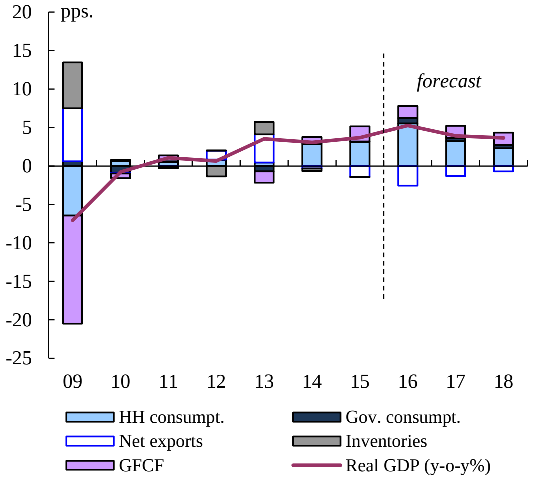
Loosening fiscal stance boosts growth to a post-crisis peak

Real GDP growth is currently among the fastest in the EU and is projected to remain robust over the forecast horizon, supported by fiscal easing and wage increases. Inflation is expected to increase as the output gap closes and the effects of previous tax reductions fade away. The general government deficit is projected to widen considerably due to tax cuts and public wage increases.

The upswing in domestic demand accelerates

Growth hit a post-crisis high in the first half of 2016 (5.2% y-o-y). The surge was driven by household consumption rising on the back of wage hikes, VAT reductions and low interest rates. Investment added to the momentum with a solid expansion of 7.4% (y-o-y), while net exports continued to detract from growth (-2.8 pps. contribution to growth) as rising domestic demand stimulated imports. Real GDP growth is forecast to remain robust and to post a rate of 5.2% in 2016. The current account deficit is expected to double this year, compared with 2015, to 2.2% of GDP due to the swiftly widening trade deficit.

Graph II.23.1: **Romania - Real GDP growth and contributions**



Pace of growth set to moderate in 2017-2018

Another round of fiscal stimuli is planned for 2017, but its magnitude is significantly lower than the measures enacted in 2016. As a result, and as consumer prices start to increase, household consumption growth is forecast to moderate somewhat. Total investment is projected to remain stable over the forecast horizon, supported by low interest rates and positive economic-growth prospects. Public investment is set to remain a drag on growth in 2016, but is expected to recover from 2017 onwards with the improved implementation of projects financed by EU funds in the 2014-2020 financing period. Accordingly, real GDP is forecast to expand by 3.9% in 2017 and by 3.6% in 2018.

The steady rate of export growth in 2016 and 2017 is projected to increase in 2018 as external demand strengthens. Import growth is set to remain strong over the forecast horizon, driven by robust domestic demand. The current account deficit is therefore estimated to widen further to 2.6% of GDP in 2017 and 2.8% of GDP in 2018 due to the deteriorating trade balance.

Inflation bottomed out and is set to rise further

Inflation hit a new historical low in May 2016 (-3.0% y-o-y) due to a sharp reduction in VAT rates and low imported inflation. As the base effect of the VAT cut is wearing out, inflation is picking up and annual average inflation is forecast to reach -1.0% in 2016. Inflation pressures are building up as the output gap is turning positive, tax-cuts effects are fading, domestic demand remains strong and wages are growing fast. Another cut of the standard VAT rate by 1 pp. from January 2017 will still moderate the pace of inflation, expected to reach 1.8% on average in 2017. In 2018, annual average inflation is projected to increase sharply to 2.9%.

Risks to the macroeconomic forecast are slightly tilted to the downside. The recovery in external demand could turn out slower than currently expected. In an electoral environment, new legislative initiatives and the stalling implementation of structural reforms add to the uncertainty. Risks to the inflation outlook are more on the upside.

Wages accelerate on a tight labour market

Strong GDP growth in 2016 has been mirrored by a rise in employment, leading to a tighter labour market. Consequently, the unemployment rate has fallen to an eight-year low. Employment is expected to continue growing over the forecast horizon driven by a robust economic outlook, while the unemployment rate is projected to decline moderately. Public and minimum wage hikes in 2015 and 2016 have pushed economy-wide wage growth (y-o-y) into double-digit territory. Unit labour costs are forecast to rise as productivity developments lag behind the evolution of labour compensation.

Pro-cyclical fiscal policy is set to substantially increase the public deficit

Despite robust economic growth, the headline deficit is projected to rise significantly during the forecast horizon due to tax cuts and expenditure increases.

In 2016, the headline deficit is expected to increase to 2.8% of GDP, from 0.8% of GDP in 2015. The tax cuts enacted at the end of last year, in particular the cut of the standard VAT rate by 4 pps., are set to have a negative effect on tax revenues. On the expenditure side, public wages were considerably increased while public investment is projected to drop this year due to a slow take-up of large projects in the 2014-2020 programming period of EU funding.

In 2017, the headline deficit is projected to deteriorate to 3.2% of GDP and to remain at this level in 2018 under a no-policy-change assumption. An additional cut in the standard VAT rate by one percentage point, the abolition of the extra excise duty on fuel and of the special construction tax are expected to have a negative impact on revenues.

The structural deficit is forecast to increase strongly from around ½% of GDP in 2015 to about 2½% in 2016 and 3½% in 2017 and 2018 as a consequence of the fiscal easing. Despite strong GDP growth, Romania's debt-to-GDP ratio is thus projected to rise from 38.9% of GDP in 2015 to about 41.5% in 2018.

This forecast does not take into account the additional expansionary legislative initiatives still under consideration in parliament at the cut-off-date of this forecast. They include a significant increase of old-age pensions, a cut by 5 pps. of social contributions, and a removal of around one hundred minor taxes and fees. These initiatives are the main downward risk to the fiscal outlook.

Table II.23.1:

Main features of country forecast - ROMANIA

		2015		Annual percentage change						
	bn RON	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP		712.8	100.0	2.5	3.5	3.1	3.7	**5.2**	**3.9**	**3.6**
Private Consumption		438.0	61.4	4.5	0.7	4.7	5.1	**9.0**	**5.2**	**3.7**
Public Consumption		96.2	13.5	0.3	-4.6	0.8	0.3	**5.3**	**3.0**	**3.0**
Gross fixed capital formation		176.2	24.7	5.2	-5.4	3.2	8.1	**6.3**	**6.4**	**6.5**
of which: equipment		74.5	10.5	6.2	4.8	-5.1	9.0	**9.0**	**7.0**	**6.9**
Exports (goods and services)		292.9	41.1	8.7	19.7	8.0	5.5	**5.2**	**5.2**	**5.9**
Imports (goods and services)		296.7	41.6	10.9	8.8	8.7	8.8	**11.2**	**8.1**	**7.2**
GNI (GDP deflator)		699.3	98.1	2.4	3.0	4.2	2.5	**5.3**	**3.9**	**3.7**
Contribution to GDP growth:	Domestic demand			4.6	-1.7	3.8	5.2	**7.8**	**5.2**	**4.3**
	Inventories			-0.2	1.6	-0.3	-0.1	**0.0**	**0.0**	**0.0**
	Net exports			-1.8	3.6	-0.3	-1.4	**-2.6**	**-1.3**	**-0.7**
Employment				-1.6	-0.9	0.8	-0.9	**1.8**	**0.8**	**0.6**
Unemployment rate (a)				7.0	7.1	6.8	6.8	**6.5**	**6.4**	**6.3**
Compensation of employees / head				27.9	3.8	6.7	1.3	**7.9**	**5.8**	**5.6**
Unit labour costs whole economy				22.8	-0.6	4.3	-3.1	**4.4**	**2.7**	**2.5**
Real unit labour cost				-1.6	-3.9	2.6	-5.9	**2.5**	**0.6**	**0.3**
Saving rate of households (b)				-5.5	13.3	-14.6	-13.2	**-9.1**	**-6.8**	**-4.8**
GDP deflator				24.9	3.4	1.7	2.9	**1.8**	**2.0**	**2.2**
Harmonised index of consumer prices				23.6	3.2	1.4	-0.4	**-1.0**	**1.8**	**2.9**
Terms of trade goods				3.1	4.7	0.8	2.5	**2.7**	**2.4**	**1.5**
Trade balance (goods) (c)				-8.0	-4.0	-4.3	-4.8	**-6.4**	**-7.1**	**-7.6**
Current-account balance (c)				-6.5	-0.6	0.0	-1.1	**-2.2**	**-2.6**	**-2.8**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-6.0	1.5	2.7	1.9	**-0.8**	**-0.5**	**-0.6**
General government balance (c)				-3.8	-2.1	-0.8	-0.8	**-2.8**	**-3.2**	**-3.2**
Cyclically-adjusted budget balance (d)				-3.8	-1.0	-0.1	-0.3	**-2.9**	**-3.4**	**-3.3**
Structural budget balance (d)				-	-1.0	-0.6	-0.5	**-2.6**	**-3.4**	**-3.3**
General government gross debt (c)				21.5	37.8	39.4	37.9	**38.9**	**40.2**	**41.5**

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.