23. ROMANIA

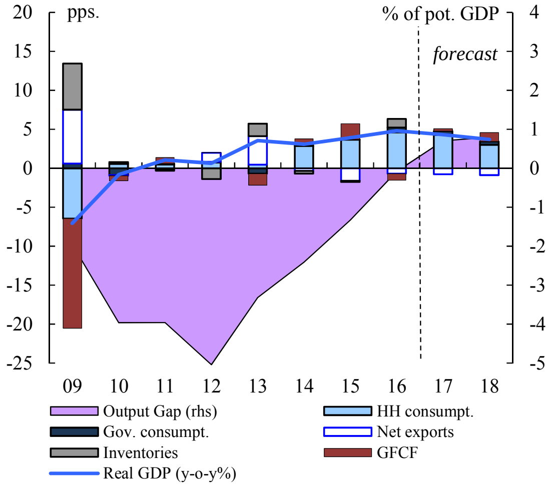
Growth momentum maintained amid fiscal deterioration

Real GDP growth is projected to remain strong, on the back of fiscal easing and wage increases. Unemployment fell significantly in 2016 and is expected to remain at a low level in 2017 and 2018. With a positive output gap, inflation is set to pick up. The budget deficit is projected to continue increasing due to tax cuts and higher public spending. The draft unified wage law poses a significant downward risk to the fiscal forecast.

Growth is accelerating

In 2016, GDP growth rose to an eight-year high of 4.8%, driven mainly by consumption, which was boosted by pro-cyclical fiscal policy and wage hikes. Private consumption, which rose to a nine-year high, and a notable increase in inventories contributed strongly to growth. Investment, by contrast, contracted as public investment fell due to a slow uptake of new projects financed by EU funds under the 2014-2020 programming period. The contribution to growth from net exports was also negative, on the back of strong consumption growth, as import growth outpaced that of exports.

Graph II.23.1: **Romania - Output gap and contributions to real GDP growth**



Consumption to remain the main growth driver

The output gap closed in 2016 and growth is projected to remain above potential in 2017-2018. The additional fiscal stimulus planned in 2017 is projected to continue to boost domestic demand but growth is forecast to slow as the transitory effects of the fiscal impulse wear out. Accordingly, growth is expected to remain consumption driven, boosted by tax cuts and increases in public wages and pensions. Investment is forecast to make a modest contribution to growth as the implementation of projects financed from EU funds gradually picks-up.

The current account is widening

Romania's current account deficit is estimated to have deteriorated significantly in 2016 on the back of strong consumption which boosted the goods trade deficit. The current account deficit is forecast to continue widening due to strong domestic demand and import growth. Export growth is expected to remain moderate, in line with GDP growth in main trading partners and because of an erosion of competitiveness as wages increase ahead of productivity gains.

The labour market is tightening further

The labour market continued to improve in 2016 on the back of strong real GDP growth. Unemployment dropped to a historical low in 2016. Low unemployment, combined with a shrinking labour force and persistent skills shortages, led to a tighter labour market and economy-wide wage increases. Total employment decreased in 2016 as the decline in self-employment more than offset the increasing number of employees. Total employment is set to grow at a moderate pace in 2017 and 2018, driven by strong growth, while the unemployment rate is projected to continue declining.

The growth of compensation per employee accelerated in 2016. The minimum wage was increased from February 2017, 16% above the previous level, set in May 2016. In addition, public sector wages were increased by 15% in the health and education sectors from January 2017 and by 20% in local administration from February 2017. Accordingly, wages rose ahead of labour productivity, leading to rising unit labour costs.

Inflation to pick up

The impact on headline inflation of successive VAT reductions and low imported inflation has so far outweighed the upward pressures on prices from the surge in domestic demand and higher wages. However, inflation is set to gradually increase and re-enter the central bank's target band (2.5%±1 pp.) due to robust domestic demand, additional wage hikes in a tight labour market and additional fiscal stimulus. Annual average inflation is therefore forecast to turn positive in 2017 (1.1%) and increase further to 3.0% in 2018.

The main risk to the outlook is the possibility of further fiscal stimulus, which may boost domestic demand in the short-run, but at the expense of the sustainability of public finances. The delay or absence of structural reforms to support competiveness gains may have a downward effect on export growth and in turn worsen further the external balance.

The fiscal stance remains expansionary

In 2016, the general government deficit rose to 3.0% of GDP, from 0.8% of GDP in 2015. Tax cuts, particularly the four percentage point cut in the standard VAT rate, had a negative effect on tax revenues. On the expenditure side, public wages rose considerably.

In 2017, the general government deficit is projected to further deteriorate to 3.5% of GDP. The standard VAT rate was cut by an additional one percentage point and the extra excise duty on fuel and the special construction tax were abolished. The 2017 budget contains large increases of public wages and social benefits, including an additional pension increase of 9%, on top of the standard indexation, which is scheduled for July 2017. The deficit is projected to further widen to 3.7% of GDP in 2018.

As a consequence of fiscal easing, Romania's structural deficit is forecast to increase from around half a percent of GDP in 2015 to around 2½% in 2016 and 4% in 2018. Despite strong GDP growth, the debt-to-GDP ratio is thus projected to rise from 38% of GDP in 2015 to 40.9% in 2018

The draft unified wage law poses a significant risk to the fiscal forecast, with a potential impact on the general government balance of up to -2% of GDP in 2018. Its final form and schedule was not known at the cut-off date of this forecast.

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		711.1	100.0	2.5	3.5	3.1	3.9	**4.8**	**4.3**	**3.7**
Private Consumption		440.5	61.9	4.5	0.7	4.7	6.0	**7.4**	**6.9**	**4.7**
Public Consumption		97.5	13.7	0.3	-4.6	0.8	0.1	**4.5**	**3.7**	**3.0**
Gross fixed capital formation		176.1	24.8	5.2	-5.4	3.2	8.3	**-3.3**	**1.3**	**5.2**
of which: equipment		74.5	10.5	6.2	4.8	-5.1	9.0	**1.5**	**1.0**	**6.9**
Exports (goods and services)		292.3	41.1	8.7	19.7	8.0	5.4	**8.3**	**6.9**	**6.2**
Imports (goods and services)		296.7	41.7	10.9	8.8	8.7	9.2	**9.8**	**8.6**	**7.9**
GNI (GDP deflator)		697.5	98.1	2.5	3.0	4.0	3.0	**3.8**	**4.7**	**3.8**
Contribution to GDP growth:	Domestic demand			4.6	-1.7	3.8	5.7	**4.4**	**5.1**	**4.6**
	Inventories			-0.2	1.6	-0.3	-0.2	**1.1**	**0.0**	**0.0**
	Net exports			-1.8	3.6	-0.3	-1.6	**-0.7**	**-0.8**	**-0.9**
Employment				-1.6	-0.9	0.8	-0.9	**-0.9**	**0.1**	**0.4**
Unemployment rate (a)				7.0	7.1	6.8	6.8	**5.9**	**5.4**	**5.3**
Compensation of employees / head				27.9	3.8	6.7	0.9	**10.3**	**9.5**	**6.5**
Unit labour costs whole economy				22.8	-0.6	4.3	-3.8	**4.2**	**5.0**	**3.1**
Real unit labour cost				-1.6	-3.9	2.6	-6.0	**2.0**	**3.4**	**0.2**
Saving rate of households (b)				-5.5	13.3	14.5	15.5	**15.7**	**15.3**	**14.9**
GDP deflator				24.9	3.4	1.7	2.4	**2.2**	**1.5**	**2.8**
Harmonised index of consumer prices				23.6	3.2	1.4	-0.4	**-1.1**	**1.1**	**3.0**
Terms of trade goods				3.1	0.8	0.8	3.2	**0.5**	**-0.7**	**0.8**
Trade balance (goods) (c)				-8.0	-4.0	-4.3	-4.9	**-5.5**	**-6.7**	**-7.3**
Current-account balance (c)				-6.5	-0.6	-0.1	-0.6	**-2.4**	**-2.8**	**-2.9**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-6.0	1.5	2.5	1.8	**-1.5**	**-1.3**	**-0.8**
General government balance (c)				-3.8	-2.1	-1.4	-0.8	**-3.0**	**-3.5**	**-3.7**
Cyclically-adjusted budget balance (d)				-3.8	-1.0	-0.5	-0.3	**-3.0**	**-3.8**	**-3.9**
Structural budget balance (d)				-	-1.0	-0.6	-0.6	**-2.6**	**-3.9**	**-4.0**
General government gross debt (c)				21.5	37.8	39.4	38.0	**37.6**	**39.3**	**40.9**

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