



Weekly Briefing

**Romania Economy briefing:
Outlook for 2018 in the Economic Field
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Outlook for 2018 in the economic field

The keyword for 2018 in the economic field is uncertainty. The last major legislative changes on the Fiscal Code adopted at the end of 2017 and the tightening of the monetary policy foreseen for this year will have major impacts on the economic development of Romania.

The economic growth will increase in 2018, but at an inferior pace as compared to 2017. The Romanian Government is optimistic for this year, expecting an economic growth of 5.5%. All the important international institutions increased Romania's growth forecasts for 2018 in the last period, but to inferior levels as compared to that of the Government. The World Bank considers that Romania will have an increase of 4.5% in the economic growth in 2018, as compared to an expansion of 3.7% forecasted in June, according to the latest report "Global Economic Prospects" launched in January. The European Commission changed its forecasts since November, from 3.7% to 4.4% for 2018. The International Monetary Fund did a similar revision, upgrading its estimation from 3.4% to 4.4% for this year. If Romania follows this path, 2018 will be the third year when the economic growth is among the largest in the EU (the first or the second highest).

The economic and financial analysts are considering that Romania is in an **overheating economic period**, signaling the return to a situation similar to that of 2008. In that period, Romania had impressive but unsustainable growth rate, suffering afterwards a strong hit of the economic crisis. The main need is that of investments, but there is a lack of domestic investments while the unpredictability of the political changes that affect the business environment also lead to a reluctance of foreign investors. Instead, the economic growth was based on consumption and, due to the fact that the internal market could not handle the increase of wages and other fiscal requirements in this acute lack of investments, relied on imports. The increase in imports, though, is strongly

affecting the trade and current account balances, which will lead to the depreciation of the national currency, increasing of the interest rates and of the inflation, which will eventually affect consumption. 2018 is the year when all the negative consequences of measures encouraging consumption will take effect, thus affecting the living standard. At the same time, the economic growth was enhanced by the fiscal easing promoted in the last years. These two types of combined measures put significant pressure on the national budget and determined the changes in the Fiscal Code in a manner that significantly affects the private environment.

An opinion barometer of the Keysfin company was conducted in December 2017 and gathered the view of 150 business men from various fields of activity. The major conclusion is that their optimism decreased, while the uncertainty related to the economic development went up, as compared to the previous edition of the barometer, launched in the summer of 2017.

More than three quarter of the participants in the study (76%) consider that **the Fiscal Code and its changes** are the main source of uncertainty. The unpredictability that is generated in the business environment will have a significant cost for Romanian in the year that just begun. Under these auspices, the business investments and expansion plans were canceled. The situation is concerning, given that there is also the risk of an increase in the lending costs, as seen by 38% of the participants in the same study. The companies see considerable and costly administrative effort in the implementation of the measures, that will otherwise lead to the distortion of the competitive conditions, the increase of the tax burden, the discouragement of the investments and the sponsorship by eliminating tax incentives, inequalities on the labour market between the public and the private environment, the decline in attractiveness for foreign investors. All these problems could lead to extremely serious consequences and blockages that may occur in the Romanian economy.

On the second place in the top of concerns for the business men in the Keysfin barometer is the **increase of inflation** (65% of the respondents). This

tendency started at the end of 2017, the increase in prices continuing in December, when the year-on-year inflation rate reached 3.3% as compared to 3.2% in November. The highest increases as compared to December 2016 were registered for non-food products (4.11%) and food products (4.07%). The Romanian National Bank (RNB) revised its inflation forecast for 2017 at 2.7%, from 1.9% previously. For the end of 2018, the forecasted inflation is 3.2%, with higher increases in the first semester of the year. Still, the inflation target is 2.5%.

The expectations of rising inflation over estimates and the increase in deficits will also draw a tightening of the monetary policy this year. Already, the key interest rate rose to 2%, as compared to a stable interest rate of 1.75% since May 2015. The rising inflation and interest rates for loans will erode the pension and wage increases. In these conditions, it is possible that Romanians will receive less money as salaries, which are further affected by the changes in the Fiscal Code. The reduction of the revenue tax will not be felt in the net wages due to the fact that the companies refuse to cover the decrease generated after the transfer of social contributions from the employer to the employees. The problem is more delicate for the Romanians having loans in the national currency, which will have to pay higher rates.

For this year, RNB decided to intervene and to reduce consumption, acting for restricting the consumer credit. The RNB already signalled that the applicant degree of indebtedness surpassed 70% in some cases, a double level as compared to the admitted threshold, and the volume of granted loans for consumption is higher than in the period 2007-2008, which again confirms that Romania risks repeating the economic situation before the financial crisis.

The **evolution of the national currency and its depreciation against the euro** is considered another major uncertainty and source of concern by 53% of the participants in the study of Keysfin. Official data indicate that the average euro / leu exchange rate in 2017 had the highest increase in the last five years, of 1.72%, and the value at the end of the year, signalling a growth of 2.61%,

registered the most consistent advance in the last eight years. Even if such fluctuations do not seem high, they are important in the specific case of Romania's economy. Moreover, during 2009-2017, the variations were quite small, around 1%.

In Romania, the leu is under controlled float as regards the current exchange rate regime, under the supervision of RNB. Inflation targeting is also used as an instrument of the monetary policy. Generally, this type of policy allows for flexible actions in case of unforeseen shocks that may affect the economy. At the beginning of the year, RNB announced that it accepts a fluctuation of 5-6% in the exchange rate, thus admitting a higher fluctuation margin as compared to the evolution in the last year. The decision is considered to be in the advantage of the Romanian companies.

Romania runs the year of 2018 in the circumstances of an **unsustainable public budget**, which received many critics from the President, the opposition parties and the private environment. The main reason of dissatisfaction is the lack of reliable estimations and calculations regarding the impact of certain measures. The rate of economic growth on which the construction of the budget is based is considered too optimistic, while the slowdown of the consumption is sure, due to the RNB measures and the other evolutions presented above. The estimations for the volumes of both the revenues and the expenses are independent as compared with the levels which have been achieved in 2017, thus throwing an unrealistic shadow on the construction of the budget. Instead, Romania has major problems in the collection of tax revenues, as proven in 2017, and risks not to reach the established target.

This will potentially lead to exceeding the budgetary deficit target of 3% of GDP; the estimated level for 2018 is 2.97% of GDP. It seems that the budget is not taking into account the recommendations related to the correction of the significant deviation of the budget deficit made by the European Commission at the end of 2017. The correction is related to a structural adjustment of 0.8% of

the GDP; without it, and due to the measures meant to increase the wages and the pensions, the European Commission forecasted an increase of the budgetary deficit of 3.9% of GDP in 2018 and of 4.1% of GDP in 2019. If the thresholds are not respected, Romania risks that the EU infringement procedure will be triggered. Romania already records the largest deviation of the structural deficit among all the countries of the EU. The situation is alarming, given the high economic growth rates.

On the side of budgetary expenses, critics are related to the low level of investments. The private environment draws the attention at the reduced support for the programmes that target the small and medium-size enterprises. Important infrastructure projects are underfunded, which keep them blocked. The budget allotted for the road infrastructure is less than needed, even if some highways in work should be completed this year.