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Weekly Briefing

Romania Economy briefing:

Economic Development in Romania

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Romania has enrolled on an economic path that seems to produce growth economic rates above expectations, due to new improved reassessment of economic growth forecasts for both 2017 and 2018. Economists and international institutions draw the attention to the overheating risk, considering that Romania experiences a consumption boom, and indicate the need of changing the economic growth model towards more investments in the road infrastructure and an accelerated absorption of the EU funds. The latest decisions of the National Bank of Romania related to the increases of the monetary policy interest rate are also meant to hamper consumption and temper inflation.

Improved economic growth forecasts

The National Commission for Prognosis (NCP), an institution under the Government's authority, radically changed its forecast for the economic growth in 2017, from 6.1% in its last autumn forecast to 7.1%, according to the latest document recently published. Since the autumn of 2016 until present, Romania had the biggest revaluation of the economic growth in its history, from +4.3% to +7.1%. Moreover, the economic growth for 2018 has also been revised upwards from 5.5% in the previous autumn forecast to 6.1%, even if the reporting basis given by the GDP result for 2017 increased significantly.

In fact, the private actors (the largest banking companies) indicated towards a GDP increase for 2017 at around 7.1% -7.2% since the beginning of 2018, thus exceeding the NCP forecasts. As regards the evolution for 2018, the resemblances end here. While the NCP has an optimistic view of the economic indicators in 2018, the major banks are much more cautious and have more reluctant prospects because of the pressure of interest rates and the depreciation of the national currency. The pace of economic growth is set to fall to 4% in 2018, according to banks' estimates. Private actors are more in line with international institutions' forecasts, like IMF, World Bank and the European

Bank for Reconstruction and Development, who indicate towards an economic growth of 4.1% - 4.2%.

Besides the changes announced by the NCP, the European Commission, in a document launched this week, also improved its economic growth forecast for Romania in 2018 to 4.5%, but to a much lower rate than NCP. In this way, Romania would have the second largest economic growth in the EU in 2018, after Malta (estimated at 5.6%). Instead, the economic growth forecast for 2019 was slightly worsened, to a level of 4%. Individual consumption was the main reason of the economic growth, due to tax cuts and wage increases in both the private and the public sector, which led to an increase of imports. This evolution is expected to be hampered due to an increase in inflation which will affect real revenues. After a decline in 2016, total investment began to rise again in 2017, but at a slower pace, mainly due to the sharp decline in public investment for the second consecutive year. In fact, the National Statistics Institute points that households' expenditures had the largest contribution to the economic growth registered by Romania in the first three quarters of 2017.

The need for a new growth economic model

Under these circumstances, the European Bank for Reconstruction and Development signals that Romania has to adopt a different economic model if it wants to avoid a crisis caused by the current consumption boom and to enrol on a more sustainable economic development path. This would mean two major strategic directions: increasing investment in infrastructure and improving the absorption of the European funds.

The discouragement of investments, enhanced by the political turbulences, had a negative effect on the quality of Romanian road infrastructure, ranked by Eurostat on the last place in the EU. The gap in the infrastructure quality risks endangering convergence. Still, the manoeuvring space for new investments is also limited, due to the fact that the budgetary deficit is near the limit set by the European Commission, of 3% of GDP. Developing infrastructure is a major need of the Romanian economy. Among the priorities of the new Prime Minister, Viorica Dancilă, is the use of European funds in order to finance large investments for building at least 350 kilometres of new highways, as well as 250 kilometres of new railways, several schools, kindergartens and hospitals by 2020.

The concerns related to the absorption of the European Funds are more and more pressing. The signals from the European Commission indicate that the cohesion policy will focus on the Member States that are able to enhance efficient absorption and use of the funds. The forecasts of the National Bank of Romania for the medium term, until 2022, point that Romania needs an absorption rate of 95% of the European funds for gaining an additional increase of 1.7 percentage points in economic growth. This is the path for obtaining a potential GDP of 5%, which is the reference value for Romania's conditions in order to ensure a stable economic growth. The actual effective absorption rate, related to the amounts reimbursed by the European Commission, is amounted to only 10.07%

Romania's economic development rose to 60% of the EU average

Good news for the Romanian economy is its performance in reducing the gap in the economic development as compared to the rest of the EU. The economic growth estimated to score 6.5% in 2017 is with 4 percentage points higher than that of the EU. This contributes to a Romanian GDP per capita estimated at more than 60% of the EU average, indicating towards a convergence tendency, accentuated in the last period, from a level of 58.2% in 2016. The economists' calculations estimate an increase in the relative living standard, measured by GDP per capita, of nearly 55% in the 11 years of EU membership. Romania even managed to reduce the gap during the economic crisis. While Romania is responsible for two thirds of the efforts for recovering the gap, one third is due to the positive spillovers enhanced by the European integration.

Instead, the level of development is not evenly distributed at regional level. Bucharest-Ilfov, the region including the capital of the country, has a development level similar of Berlin or Lisbon, and is the main contributor to the achieved development. The inequalities with which Romania started its road in the EU were amplified between and within regions of the country, leading to severe abnormalities in internal distribution. The further absorption of European funds at high rates is a solution for both keeping the pace of recovery and for a more equitable distribution of economic development at regional level.

New increases of the monetary policy interest rate

The National Bank of Romania (NBR) decided this week to increase the monetary policy interest rate to 2.25%, after an increase from 1.75% to 2% just a month ago. The NBR also decided to raise the interest rate for the deposit facility to 1.25% from 1% per year and the lending facility rate to 3.25% from 3% per year. This decision comes as a result of rising inflation and the associated uncertainties, mainly from fiscal and revenue policy. The declared aim of NBR is that price rises not to be passed on to the expectations of the population and companies, which would lead to a much higher interest rate. This means that the goal is to temper inflation, if not interest rate will rise even more.

The main consequence of this decision is the increasing of the financing cost in the whole economy. Romanians are already confronted with increases of the ROBOR – the average of three-month interbank interest rates – in the last period, the main indicator which is used for calculating the variable interest rates for loans in national currency. This means that their credit rates will also see an increase. ROBOR is at present around 2%. While the NBR assures that the following inevitable ROBOR rises will not be large and the hike of the loans in national currency will only be marginal, it is quite difficult to control the ROBOR variations.

Moreover, Romanian and foreign analysts expect that NBR will continue to rise the interest rate up to the threshold of 3%. Under these assumptions, increasing the cost of financing could become dangerous for many Romanian companies if ROBOR will exceed 4%. An estimation of Coface shows that half of the Romanian companies would no longer be able to pay their loans to banks. In addition, the large majority of granted loans are denominated in the national currency. At present, only 38% of the loans contracted by business and individuals are in foreign currency. Romanians having a mortgage will be the most affected; in fact, in Romania there is a national programme named "the First House", through which people who do not own a dwelling could access a loan having the state guarantee. For these types of loans, the credit rate is calculated using ROBOR. An increase of ROBOR to 2.25% would lead to an increase of the rates by about 50 lei (over 10 euro). One of the gloomiest forecasts – in the hypothesis of an increase of ROBOR to 6%, the highest historical level – means an increase of about 630 lei (almost 137 euro) of the monthly loan rates, compared to the actual level.