



Weekly Briefing

**Romania Economy briefing:
IMF Warns Fragility of the economic growth
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The IMF delegation in Romania warns about the fragility of the economic growth. Statistics indicate concerning increases of the budgetary and trade deficits

The economic situation in Romania is under surveillance and monitoring, as the consequences of some controversial decisions related to increases of salaries and pensions and other measures with fiscal implications start to be felt in the society and are evidenced by statistical data. According to specialized institutions, Romania's budget entered the deficit after only two months in 2018 and the trade deficit is growing continuously, even if the exports had a good performance. Under these circumstance, Romania risks not to respect the deficit targets until the end of the year and to mitigate its economic growth. The IMF delegation visiting Romania in March draw the attention to the need of consolidating economic growth, enhancing efforts for increasing the budgetary revenues, conducting structural reforms and continuing the fight against corruption.

An IMF delegation visited Romania at the beginning of March, this year, in order to conduct the regular consultations established in the Article IV of the Statute of the Fund, representing a supervisory exercise which is mandatory for all the member states. The aim of these consultations is to examine the financial and economic situation at national level and to formulate general recommendations on monetary, financial and economic policies for ensuring stability and a positive evolution of the economy. The visit of the IMF specialists was expected by both policy makers and specialists in economics due to the evolutions in the Romanian economy in the last period and the forecasts related to a higher growth of the budgetary deficit than expected.

The main issues notices by the IMF delegation were related to:

- **The fragility of the economic growth**

There are some positive evolutions at the economic level, related to the highest growth of the GDP in the EU, the fall of the unemployment rate to record low rates and an improvement in the financial sector. Still, the IMF specialists consider that the economic growth is threatened to weaken without policy changes, caused by the actual situation of a lack of investment and the increase of the budget gaps as a consequence of the wage raises and tax cuts. Therefore, from a 7% increase last year, which was based on consumption, Romania will register an economic growth of 5% in 2018, and in the coming years the GDP growth rate will drop at 3%, according to the IMF estimates.

•The difficulties in increasing the budgetary revenues

Despite the fact that Romania has the highest economic growth in the European Union, the volume of the tax revenues collected at the state budget eroded. This signals the fact that the National Agency for Fiscal Administration (NAFA) current technology system is out-dated and this affects tax collection. This problem related to the NAFA IT system is also evidenced by the World Bank, which offered 360 million lei for its modernization. Still, NAFA did not spend yet any money for the modernization, but only purchased consultancy services. Therefore, upgrading the IT system should be one of the priorities.

The low and declining level of tax revenue as a percentage of GDP in Romania highlights the importance of effective revenue mobilization and expenditure management. Under these auspices, the IMF recommends more predictability of the fiscal changes and the avoidance of new tax cuts. Moreover, the financial institution suggests that the collected revenues should address the major needs in priority areas such as infrastructure, education and health, and to respond the medium-term challenges related to unfavourable demographic developments. In addition, a full review of the taxes and of the tax system should be carried out, including the rationalization of tax exemptions and reforming the tax administration, especially regarding the VAT.

•The deficit target risk to be violated

Although the Romanian authorities consider that there is enough space for reaching the budgetary targets, the IMF delegation is worried that the volume of the revenue has been overestimated. Romania accumulated large deficits during periods of economic growth, which usually tends to cause internal and external imbalances, which could force stronger adjustment in the event of a recession. For preventing such a situation, the budget deficit should be reduced to below the neutral cyclical level in the following period in order to have a budgetary deficit of only 1.5% of GDP by 2020. This would ensure a slight return to the medium-term budgetary objective in Romania, in line with the commitments made to the EU and would avoid forcing more solid adjustments during the periods of decline in the economic activity.

The fiscal and external deficits could be reduced by using a mix between a prudent fiscal consolidation and tightened monetary policies and would also avoid the overheating of the economy. This is why IMF appreciated the decisions of the National Bank of Romania related to the increase of the monetary policy interest rate.

Until now, it seems that the concerns of the IMF are confirming. The statistical data of the Ministry of Finance point that, after many years, the state budget is on deficit after the first two months of 2018. This is a rare case, as the rule in the last period has been that, regardless of the projected budget deficit, this was achieved in the last months of the year. The explanation is that much of the investments made by local authorities were settling in the last months of the year. In the first two months of 2018, the budgetary deficit reached 0.59% of GDP, which is higher by 5.9 billion lei as compared with the same period in 2017. The problem was that the increase of the revenues was not enough for covering the expenses. Revenues increased by more than 21%, but the state's spending had an advance of over 38%, an important part being allocated for the payment of salaries and social assistance, where pensions are included.

Recently, the data related to the trade deficit were also published and indicate an increase of the trade deficit by 30% as compared to the same period

from 2017. Although the exports registered new records, by increasing with 7.6%, the growth of imports was of 10.7%. This puts pressure on the leu-euro exchange rate and will finally have a negative contribution to the formation of the GDP and ultimately to the economic growth. Therefore, the economic balance should be carefully approached in the rest of this year.

•The need for conducting structural reforms

Structural reforms, as the ones related to the corporate governance of the public enterprises, should be kept and any weakening of the existing corporate governance legislation should be avoided. Therefore, the restructuring and privatization of state-owned enterprises is recommended to be resumed. Only in this way, the improvement of the financial performance of public enterprises could be achieved.

In the same rhetoric, the IMF delegation supported for the avoidance of legislative initiatives that affect the financial system, such as the recent proposals related to the capping of the interest rates on loans to households and the prices at which individuals recover debt acquired by third parties. The capping of the interest rates was launched in a project under discussion in the Parliament and raised fierce debates in the society between the main stakeholders. This is why the Romanian Banking Association and the Romanian Banking Employers' Council requested the Parliament to ensure a real and constructive dialogue in debating the draft laws on interest rate capping. The project law related to this issue is going to be debated in the following period and a decision will be made. The main envisaged risks are related to the reduction of the credit to the population, decreasing consumption and negative impact on investments, leading to a mitigation of the economic growth. The IMF specialists adopted a similar position regarding this subject.

•Fighting against corruption

IMF specialists also emphasized the need for continued efforts for the fight against corruption, because this will help to improve the government revenue,

increase spending efficiency and enhancing competitiveness. The fight against corruption should be based on judicial independence and the rule of law.

The IMF delegation will draw a report based on the conclusions of their visits on Romania in which the detailed situation they encountered will be presented and further recommendation for consolidating the economic growth will be provided.

The economic situation remains under careful monitoring from both international institutions and Romanian public policy-makers. A representative of the National Bank of Romania launched the subject of a potential crisis due to the fact that Romania has the second largest current account deficit in the European Union after the United Kingdom. Therefore, after the UK's exit from the EU, Romania remains the most exposed EU state to a potential economic crisis. The Minister of Finance refuted this possibility and maintains an optimistic attitude. While he believes that a great risk for Romania is the very high dependence on the EU, seen in the volume of the trade with EU which reaches about 80% of total trade, a solution would be the increase of investments. Also, the minister tempers the concerns related to inflation, which reached 5% in the last period, and ensures that inflation will drop in the following period, reaching the estimated level of 3.1% at the end of the year.