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Romania Economy briefing:

Romania's economic growth is slowing down

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Romania's economic growth is slowing down

The Romanian economy slowed down in the first quarter of 2018, registering a GDP growth of 4,1%, after the peak of 6.9% in 2017, the highest after the economic crisis. The main cause is attributed to the price increases, which reduced the consumption of the population and eroded the real value of the incomes, although the wages raised in nominal value. Romania also adopted in the last period the offshore law, regulating the exploitation of the gases from the Black Sea. The final form of the law has generated some controversy and potential new regulations are expected in the following period.

The European Commission has revised downwards the forecast for the economic growth of Romania, at a level of 4.1%, as compared with the spring forecast of 4.5%. The decrease of the economic growth from 6.9% in 2017 until 4% in the first quarter of this year is mainly caused by the contraction of private consumption, as the higher inflation has a negative influence on the real incomes. Moreover, the European Commission expects that the GDP growth will continue to slow down, reaching 4.1% in 2018 and 3.8% in 2019. Still, Romania would have the fifth highest economic growth in the EU this year, after Ireland (5.6%), Malta (5.4%), Poland (4.6%) and Slovenia (4.4%), but well above the EU average, estimated at 2.1%. The forecast is under the sign of potential significant downside risks, which could further lower the GDP growth, as these ones have boosted since spring and their magnitude already started to be captured by the statistical indicators.

The European Commission points that the main driver of the slowdown was a contraction of private consumption. In addition, revenues increased faster than the GDP growth. In fact, the data of the National Institute of Statistics from Romania indicate that the living standard of households has considerably increased in the first quarter of 2017 compared to the same quarter of the previous year. According to the analysts' estimations, the living standard increased by 20.3%, while the GDP advance was of only four percent. Therefore, the revenues of a person in household rose 5 times faster than the GDP growth. As compared to the similar period of the previous year, the same comparison indicates an increase of 10.2% for the living standard and of 5.7% for the GDP.

Romania also has an important problem with rising inflation, as already mentioned in the European Commission report. Although the nominal increase in revenues, the real situation points to weaker purchasing power. The earnings in May diminished as compared with the previous month, while the increase of the earnings index in May 2018 as compared with May 2017 was lower than that in the previous two months (the increase was of 8.5% in May on a year-on-year basis, as compared to 10.1% in March and 9% in April). Moreover, the real reference wage also diminished. The National Institute of Statistics calculate the index of the real reference wage, expressing the money purchasing power in the current period related to the one in October 1990; based on this indicator, the values for May reached 193.5%, considerably lower than in March (195.7%) and April (193.5%).

The inflation stagnated at 5.4% in June, as a consequence of the measures of the National Bank of Romania, which raised the benchmark interest rate, but was affected by the external shocks, such as the administered and fuels prices. The inflation is expected to fall below 4% by the end of this year, once with the disappearance of these shocks, but will have to be kept under control, according to the analysts of the OTP Bank.

Under these circumstances, the European Commission warns that the real increase in wages will be tempered by higher inflation and expects wages to continue to rise in nominal terms due to higher wages in the public sector and the 9% increase in gross minimum wage as of 1 January 2018. Still, it could be possible that the growth structure would become more balanced as a result of the moderation in private consumption growth and the strengthening of investment, driven by progress in the implementation of EU-funded projects.

In addition, the representatives of the National Bank of Romania draw the attention on the risks in the real estate market, as the prices growth of the real estate was 6% in Bucharest and 4% in the rest of the country. The European Systemic Risk Board established a signal threshold of 6% for the increases of prices and Romania situated around this benchmark in the last two years, which could point towards a possible future real estate bubble.

The economic growth over the potential leads to the accumulation of tensions and the widening of deficits; the acceleration of the real estate prices could worsen this situation. Romania was already warned by the Council of the EU at the end of June 2018 to take measures for correcting a significant budgetary deviation by 15 October this year, for avoiding a potential overcoming of the budgetary deficit limit set by the EU at 3% of GDP. It is for the third consecutive time since June 2017 when Romania receives such a warning. The EU Council considers that Romania's structural balance deteriorated by -3.3% of GDP, while the Government spending was well above the benchmark set by the Council. In December, the Council asked for the limitation of the government spending to a maximum of 3.3% in 2018 and 5.1% in 2019. The budgetary deficit of 0.88% of GDP in the first five months of 2018 was, still, four times larger than the one in the same period in 2017, due to an increase by 18.4% of the consolidated general government expenditures and by 22.3% of the personnel expenses, driven by wage increases. Fitch Ratings warns that the budget deficit could reach 3.4% of GDP in 2018 and 3.6% in 2019.

The Members of the Parliament (MPs) also adopted the offshore law in the last period, regulating the exploitation of the gases from the Black Sea. The law will require operators to pay progressive taxes on extra income, while 50% of all production will have to be traded on the Romanian market, and the amounts obtained will be directed towards public-private partnerships. The aim of such stipulations was to grant energy independency for Romania in the near future and to direct important amounts of money to the state budget. The estimations of the leader of one of the government parties indicate that the total amount received by the Romanian state will exceed 20 billion dollars in the next 20 years, due to the tax on the extra income that was introduced again in the law and the royalties that are due to the state.

The offshore law has the role of regulating the technical and financial framework of oil and gas exploitation in the Black Sea. Companies that have leased the Black Sea perimeters invested around 2 billion dollars in exploration works and found significant gas fields, but they have expected the offshore law for over a year in order to be able to make the final investment decision and to start the extraction work, as they needed details related to framework for cooperating with the authorities.

The law was postponed several times and the public debate was limited. The amendments adopted last week raised some controversies as they suffered several changes on the last mile, and the parliamentarians of the opposition abstained from voting, accusing the lack of an impact study for the present law.

The representatives of the main companies exploring gas in the Black Sea consider that the proposed and voted amendments to the offshore law significantly increase the tax regime and hamper the decision for adopting a positive investment decision, therefore advocated for a stable tax regime during the period of the investment.

Still, the level of the royalties is between 3.5% and 13%, similar to the year of 2008, therefore maintain their competitive level as compared to the one in Bulgaria (25%), Germany (between 18 – 40%) or Austria (between 19 – 22%). Moreover, the tax on the extra incomes is between 30% and 50%, lower than in the Netherlands (50%), Norway (53%) and United Kingdom (62.5%), according to the analysis of an independent MP[1]. The law also provides the right to deduct additional earnings up to a maximum of 60% of investment in exploitation and production, meaning that the tax on the extra income could be applied for only 40% of the supplementary revenue. This provision would allow companies to reduce their tax burden. Still, the actual provisions states that the deduction

[1] https://www.digi24.ro/stiri/economie/energie/borza-despre-legea-offshore-cainele-nu-pleaca-de-la-macelarie-963323

would be made at the value of investments in the upstream segment achieved in the month in which the natural gas for which the tax on additional revenue is calculated was sold. Therefore, the deduction of investments would be made in the month in which the sale is actually made. Companies are claiming that investment must be done before the actual sales. The Ministry of Finance started to look for a solution to address the problem of deductions for investments, therefore the law could be followed by an emergency ordinance to regulate the situation. In addition, under this amendment related to deduction, the revenues to the state budget could be less than the previous estimations.