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Romania economy briefing:

The risk of overheating was diminished for the Romanian economy, but the struggle with the deterioration of twin deficits continues

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Romania's GDP growth slowed down this year and will be situated around 4%, thus decreasing the risk of an economic overheat. Still, the macroeconomic balances are under pressure, as the twin deficits deteriorated. The risk of a budgetary deficit of over 3% of GDP seems more real, while the current account deficit increased due to lower amounts of foreign direct investments and higher levels of imports than exports. At the end of the year, after the decision of increasing the minimum wage, the members of the Parliament are on the edge of adopting a new pension law, with favourable outcomes for the actual retirees, but which will put further pressure on the state budget on the medium term.

Although characterized by large instability, mainly driven by changes on the political stage and interventions on the side of fiscal laws, the expectations formulated at the beginning of the year by either the analysts or the IMF delegation which visited Romania in March 2018 were mostly accomplished.

After the exuberance of one of the highest economic growth rates in EU in 2018, the economic growth this year will certainly range below the initial estimations of 5.5% of the Government. The economic growth rate reached 4.1% in the third quarter this year as compared to the similar period in 2017, the seventh highest increase in the EU Member States for which data are available. Although Romania had the second largest increase of GDP as compared to the previous quarter, the GDP advance was reduced on a year-on-year basis due to the fact that last year, in the same period, Romania had a record growth of GDP, of 8.8% compared with the third quarter in 2016. The same is expected to happen in the last quarter, therefore a GDP growth of 4.5% in 2018 – according to the latest revisions – is difficult to be achieved. In fact, the latest IMF forecasts indicate an economic growth of 4%.

The expectations towards raising inflation were mostly correct for this year. Romania's problem with inflation, after the increases in pensions and salaries, ranked the monthly inflation levels among the highest ones in the whole EU. Still, the annual inflation rate in November dropped to 3.4%, from 4.3% in October, which is now framing in the National Bank of

Romania's (NBR) target range of 2.5% plus or minus one percentage point, even earlier than initially estimated by the Central Bank.

All in all, on one side, several positive outcomes were achieved during this year. The risk of overheating of the Romanian economy diminished and this year is expected to be the sixth year in which the economy is growing by over 3%. The public debt decreased by one percentage point to 34.1% of GDP in June 2018, while the unemployment rate also had a decreasing trend, reaching 4.2% in the third quarter this year.

On the other side, Romania is still confronting several vulnerabilities. There is still a large pressure on the budgetary deficit. Taking into account the latest data for the first ten months of 2018 which point to a budgetary deficit of 2.2% of GDP, almost three times higher than in the same period of 2017, the prospect for the end of the year are not encouraging. According to estimates, the expenditures should be reduced to only one third of the amounts of money used to be spend from the state budget in the last two years. Such measures will have significant repercussions for the beneficiaries of funds, who will encounter difficulties in executing in good conditions the works contracted from public funds. IMF forecasts a budget deficit of 3.6% of GDP, above the target of 3% of GDP for both 2018 and 2019. The main problem that generated this situation is the higher rate of expenditure than that of incomes to the state budget. In this context, the divergent evolution of the structural deficit from the commitments under the medium-term budgetary objective should be monitored, as the European Commission forecast indicates a value of -3.3% of GDP for this year.

Less expected, but with a negative contribution to GDP, was the evolution of foreign trade. In the summer of this year, the National Bank of Romania considered that net exports will have a positive contribution to GDP. Still, the favourable evolution of exports, which surpassed the volume of imports in the first six months of 2018, was soon reversed in the following months. Now, according to the latest data for the first ten months, the trade deficit reached 11.8 billion euro, which is 15.6% (or 1.6 billion) higher compared to the same period last year. According to the National Institute of Statistics, it is the highest deficit registered in similar periods of the year since 2009. It should be noted that Romania registered record volumes for exports, but surpassed by even larger volumes of imports, based on the increase of revenues in the public sector and the rigidity in adapting the domestic market to the increased demand. While such a tendency, on one side, is a proof for restoring the confidence in the economy, on the other side, due to the fact that imports are used for consumption and not for investments, it has negative consequences, especially that the performance in attracting foreign investments was also low. The amount of foreign direct investments reached 3.5 million euro in the first nine months of 2018, which is 5.7% lower than in the same period of 2017. This will lead to further worsening the current account and enhanced pressure on the national currency. Although the current account deficit is still under the long-term average value, its amount and behaviour are significantly different than in the rest of the EU countries, where current account surpluses are recorded in most cases.

An important economic event this year was the decision of the Government to increase again the minimum wage, but this time differentiated according to the level of education or the work experience. As compared to the initial draft of the project, the executive finally decided to modify the minimum wage scheme so that the number of beneficiaries is drastically reduced compared to the formula originally presented, as the first draft would have been unbearable for most employers due to the supplementary high costs. In fact, the small and medium size enterprises (SME) test on the effects of raising the minimum wage, carried out at the end of November, revealed the fact that more than half of the managers in SMEs (53%) would have been forced to lay off some of the employees, 44% would have seen decreasing productivity, while 74% of participants in the online survey stated that firms would face difficulties in the case of raising the minimum wage,. Therefore, the new project was radically modified so that the minimum wage for seniority was removed and new conditions which also reduce the number of beneficiaries with higher education were imposed. The condition for an employee with higher education to benefit from the highest level of the minimum wage is the obligation to be employed on a position which requires higher studies and to have at least one year of experience in the area of his studies. The measure will take effect from the first of January for 1.4 million persons, out of which 0.35 million with higher education. The stakeholders agreed that the new version is more favourable for society in general. The one year experience in the field of study gives young people the chance to achieve the needed competences and to be promoted after this period. The exclusion of differentiating the minimum wage based on seniority is protecting the medium age workers who, otherwise, would have become expensive on the labour market through an administrative decision and had the risk of being replaced by those with less experience, which were paid less. The analysts consider that the state is the one who will be the main winner following this move, as the money collected to the state budget will increase, and the largest amount of incomes will come from the private environment. Instead, the additional earnings of the employees will be reduced due to inflation.

The new pension law, which was in work during this year, is suffering the last changes during these days in order to be assumed by the end of the year. The project was strongly disputed, being accused that puts new pressure on the budget through the new increases in the pensions that are forecasted on the medium term. The president of the National Trade Union Bloc, which negotiated aspects of the law with the representatives of the Government, considers that the project has, on the one hand, some favourable elements for the actual retirees because, through recalculations of the pensions, they could obtain an average increase of about 20% of their revenue, but on the other hand it is a law which penalizes those who will retire after its entering into force. Therefore, in its actual format, the following generations will receive the same amount of pension even if the contributions were different. The fragile majority of the actual coalition in the Chamber of Deputies led to a postponement of the vote on the pension law for the following weeks.