23. ROMANIA

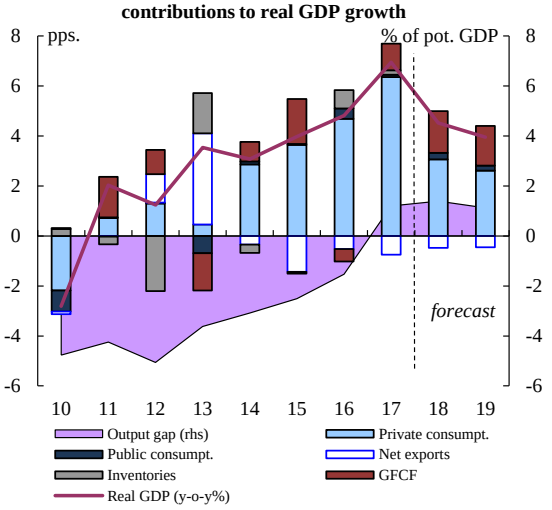
Strong growth set to decelerate

Real GDP growth rose again in 2017, driven by a boom in private consumption boosted by expansionary fiscal policy. Growth is forecast to decelerate in 2018 but will remain robust. The labour market is expected to remain tight over the forecast horizon. Inflation picked up in late 2017 and is set to rise further in 2018 before tempering somewhat in 2019. The budget deficit is projected to increase significantly, mostly due to public sector wage increases.

Growth set to slow down but remain robust

Romania's economic boom intensified in 2017, with real GDP increasing by 6.9%, a post-crisis high. The main driver of growth continued to be private consumption, which expanded by around 10% in real terms. The private consumption boom was spurred by expansionary fiscal policy measures including cuts to indirect taxes and public sector pay rises. After contracting in 2016, investment returned to growth in 2017 on the back of rising private investment in both machinery and equipment and residential construction. Public investment, however, fell sharply for the second consecutive year. The growth in private consumption also boosted imports. As a consequence, net exports have worked as a drag on real GDP growth, despite continued export market share gains.

Graph II.23.1: **Romania - Output gap and contributions to real GDP growth**



Looking ahead, growth is expected to decelerate but remain robust. Private consumption is forecast to slow down in 2018, as nominal wage growth moderates and inflation increasingly weighs on real disposable income, but will remain the main driver of growth. Investment, however, is likely to further strengthen in 2018 on the back of a pick-up in the implementation of projects financed by EU funds. Overall, real GDP growth is expected to be 4.5% in 2018 and 3.9% in 2019. The output gap is estimated to have turned positive in 2017 and is forecast to remain relatively stable over the forecast horizon.

Imports are projected to continue rising faster than exports in 2018 and 2019. Accordingly, net exports will remain a drag on real GDP growth. The current account deficit has been widening progressively since 2014, when it was close to zero, mainly on account of a weakening trade balance. The current account deficit widened to 3.5% of GDP in 2017 and is forecast to be 3.6% of GDP in 2018 and 3.9% in 2019.

Unemployment rate in Romania dropped to a 20-year low of 4.9% in 2017. The tight labour market, together with a 16% minimum wage hike in February 2017 and substantial public sector pay rises, led to an acceleration of wage growth. Average compensation per employee increased by 15% in real terms in 2017. Wages are expected to continue to grow in 2018, albeit at a slower pace, due to further increases in public wages and an additional 9% increase in the net minimum wage which took effect in January.

Inflation picks up

After two consecutive years of falling consumer prices, inflation turned positive in 2017, despite being dampened by VAT rate cuts and lower excise duties on fuel. Inflation started to accelerate in the second half of the year mainly on account of rising food and energy prices, the latter caused both by higher global fuel prices and the reversal in October 2017 of the January cut in excise duties. Inflation further accelerated in early 2018 as the effect of the January 2017 tax cuts faded away, reaching 4.0% by March. It is forecast to be 4.2% for 2018 as a whole and to decline to 3.4% in 2019 as energy price inflation moderates. Core inflation is projected to increase from 0.8% in 2017 to 3.3% in 2018 and 3.5% in 2019. As inflation re-entered its target band (2.5% ± 1 pp.), the National Bank

of Romania has started to tighten its highly accommodative monetary policy. In January and February this year, the key monetary policy rate was raised by a total of 0.5 pps. to 2.25 %, the first rate hikes since 2008.

Risks to the growth forecast

The gradual tightening of the central bank's monetary policy in response to emerging inflation pressures and a widening output gap could dampen the outlook for private investment. Investment could also be adversely affected if the government were to further cut public investment in order to reach its budgetary deficit targets. A continuing increase in unit labour costs, due to wage growth outpacing productivity growth, may also curtail Romania's exports. More generally, uncertainty regarding the government's policies could hamper growth.

The fiscal stance remains expansionary

In 2017, the government deficit amounted to 2.9% of GDP, a slight drop compared to 2016. The decrease of the headline deficit was cyclical in nature and not due to fiscal consolidation measures. Indirect taxes were cut, while public wages were considerably increased. On the other hand, public investment dropped significantly.

In 2018, the general government deficit is projected to increase to 3.4% of GDP. The unified wage law, enacted in summer 2017, increased gross public wages by 25% in January 2018 and contains additional increases for doctors and teachers. The fiscal cost of this is set to be partially compensated by a shift of social security contributions from 22.75% for employers and 16.5% for employees to 2.25% and 35% respectively. Moreover, the flat personal income tax (PIT) rate was cut from 16% to 10%. The deficit is projected to reach 3.8% of GDP in 2019, driven by increases in social transfers and public investment.

As a consequence of fiscal easing, Romania's structural deficit has risen from around 2% of potential GDP in 2016 to around 3¼% in 2017 and is projected to reach around 4¼ % in 2019. Despite strong GDP growth, the debt-to-GDP ratio is thus projected to increase within the forecast horizon.

Table II.23.1

Main features of country forecast - ROMANIA

	2016			Annual percentage change					
	bn RON	Curr. prices	% GDP	98-13	2014	2015	2016	2017	2018	2019
GDP		762.3	100.0	3.0	3.1	4.0	4.8	**6.9**	**4.5**	**3.9**
Private Consumption		477.9	62.7	4.7	4.7	5.9	7.6	**10.1**	**4.9**	**4.2**
Public Consumption		108.5	14.2	-0.1	0.8	0.2	3.1	**0.7**	**1.7**	**1.3**
Gross fixed capital formation		175.1	23.0	5.5	3.2	7.4	-2.0	**4.7**	**7.4**	**6.9**
of which: equipment		72.6	9.5	5.9	-5.1	-3.8	5.2	**5.0**	**5.0**	**5.0**
Exports (goods and services)		315.1	41.3	9.3	8.0	4.6	8.7	**9.7**	**7.5**	**6.8**
Imports (goods and services)		322.0	42.2	10.8	8.7	8.0	9.8	**11.3**	**8.2**	**7.4**
GNI (GDP deflator)		739.8	97.0	3.0	4.0	3.0	3.7	**7.3**	**4.9**	**4.0**
Contribution to GDP growth:		Domestic demand		4.8	3.8	5.5	4.6	**7.5**	**5.0**	**4.4**
		Inventories		-0.2	-0.3	-0.1	0.7	**0.2**	**0.0**	**0.0**
		Net exports		-1.5	-0.3	-1.4	-0.5	**-0.7**	**-0.5**	**-0.5**
Employment				-1.7	0.8	-1.3	-0.9	**2.6**	**0.9**	**0.1**
Unemployment rate (a)				7.1	6.8	6.8	5.9	**4.9**	**4.5**	**4.4**
Compensation of employees / head				23.1	6.7	1.9	10.1	**16.0**	**8.7**	**6.7**
Unit labour costs whole economy				17.4	4.3	-3.3	4.1	**11.3**	**4.9**	**2.7**
Real unit labour cost				-1.0	2.6	-5.7	2.0	**5.7**	**-0.2**	**-1.3**
Saving rate of households (b)				-5.4	14.5	15.5	12.2	**10.9**	**9.1**	**7.7**
GDP deflator				18.6	1.7	2.6	2.1	**5.3**	**5.2**	**4.0**
Harmonised index of consumer prices				16.8	1.4	-0.4	-1.1	**1.1**	**4.2**	**3.4**
Terms of trade goods				2.6	0.8	1.0	0.6	**-1.2**	**0.0**	**0.3**
Trade balance (goods) (c)				-7.8	-4.3	-4.9	-5.4	**-6.3**	**-6.6**	**-6.9**
Current-account balance (c)				-6.1	-0.1	-0.6	-2.1	**-3.5**	**-3.6**	**-3.9**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-5.5	2.5	1.8	-1.1	**-1.9**	**-2.1**	**-2.1**
General government balance (c)				-3.7	-1.3	-0.8	-3.0	**-2.9**	**-3.4**	**-3.8**
Cyclically-adjusted budget balance (d)				-3.7	-0.3	0.1	-2.5	**-3.3**	**-3.9**	**-4.2**
Structural budget balance (d)				-	-0.3	-0.2	-2.1	**-3.3**	**-3.8**	**-4.2**
General government gross debt (c)				22.7	39.1	37.7	37.4	**35.0**	**35.3**	**36.4**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.