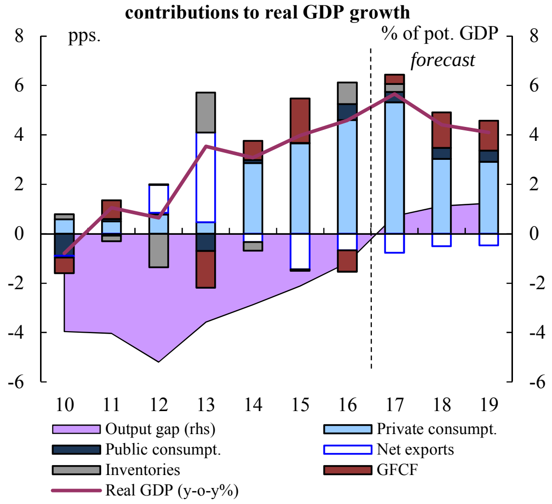
23. ROMANIA
Consumption-led growth

Real GDP growth accelerated in 2017, driven mainly by private consumption. Looking ahead, growth is set to decelerate but remain above potential. Unemployment fell to its lowest levels in more than twenty years in 2017 and is expected to remain low over the forecast horizon. Inflation has turned positive and is set to further pick up as the output gap widens. The budget deficit is projected to increase due to public wage increases projected in the unified wage law.

Private consumption is booming

Growth accelerated in 2017, with real GDP expanding by 5.8% (y-o-y) in the first half of the year. The pick-up in growth has been mostly driven by private consumption, spurred by tax cuts, significant hikes in both public and private wages, and low rates of inflation. Changes in inventories also made a substantial positive contribution to growth in the first half of 2017, while investment remained subdued mainly due to a slow uptake of projects financed by EU funds under the 2014-20 programming period. The booming private consumption also drove an acceleration of imports. As a consequence, net exports have worked as a drag on real GDP growth, despite relatively strong export growth.

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



Growth set to decelerate but remain above potential

The output gap is estimated to have closed in 2017 and is projected to expand in 2018 and 2019, with GDP growth slowing down but remaining above its potential growth rate. GDP is forecast to grow by 5.7% in 2017, 4.4% in 2018, and 4.1% in 2019. Private consumption is projected to decelerate in 2018, as inflation increasingly weighs on real disposable income, but is expected to continue acting as the main growth driver. Furthermore, investment is forecast to strengthen on the back of a pick-up in the implementation of projects financed by EU funds.

The current account deficit widens

Import growth is projected to continue outpacing that of exports, in line with strong private consumption. Accordingly, net exports will remain a drag on real GDP growth over the forecast horizon. The weakening of Romania's trade balance is expected to lead to a gradual widening of the current account deficit, which is forecast to reach 3.1% of GDP by 2017, 3.2% in 2018 and 3.4% in 2019.

Labour market tightening and inflation picks up

The economic expansion has prompted a continued improvement of the labour market, with the unemployment rate dropping to its lowest levels in more than twenty years. This low unemployment rate, coupled with a declining labour force and persistent skills shortages, has led to very tight labour market conditions. Wage growth has accelerated in 2017, also driven by a 16% minimum wage hike which took effect in February, as well as by public sector wage increases. This trend is projected to continue in 2018 given approved increases in public wages.

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. For the year as a whole, HICP inflation is expected to stand at around 1%. Headline inflation is projected to further pick up as wage hikes pass through to consumer prices and the effect of tax cuts fades away – or, in the case of excise duties, the cuts themselves are reversed. HICP inflation is forecast to re-enter the National Bank of Romania's target band (2.5% ± 1 pp.), reaching 2.9% in 2018 and 3% in 2019.

Risks to the growth forecast

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

The fiscal stance remains expansionary

In 2017, the general government deficit is projected to remain at 3.0% of GDP. Tax cuts (in particular a cut of the standard VAT rate by 1 pp.) have reduced tax revenues. On the expenditure side, public wages and social benefits were considerably increased. On the other hand, public investment was cut significantly in the September's budget rectification.

In 2018, the general government deficit is projected to increase to 3.9% of GDP. The unified wage law (UWL), enacted in summer 2017, is set to increase all public wages by 25% in January 2018 and contains additional increases for doctors and teachers. Moreover, the personal income tax (PIT) rate is set to be cut from 16% to 10%. These measures are to be partially compensated by an announced shift of social security contributions from the current 22.75% for employers and 16.5% for employees to 2% (so-called solidarity contribution) and 35% respectively. The deficit is projected to reach 4.1% of GDP in 2019 under a no-policy change assumption.

As a consequence of fiscal easing and an increasing output gap, Romania's structural deficit is forecast to rise from around 2¼% in 2016 to around 3¼% in 2017 and around 4½% in 2019. Despite strong GDP growth, the debt-to-GDP ratio is thus projected to rise from 37.6% of GDP in 2016 to 40.5% in 2019.

No draft 2018 budget has been published at the cut-off date of the forecast and several of the announced measures still need to be operationalised. This represents a risk (positive or negative) to the fiscal projections. This is particularly the case for the changes to the social security contributions and to the PIT.

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		761.5	100.0	3.0	3.1	4.0	4.6	**5.7**	**4.4**	**4.1**
Private Consumption		470.8	61.8	4.8	4.7	5.9	7.4	**8.6**	**4.8**	**4.6**
Public Consumption		107.2	14.1	0.0	0.8	0.2	4.7	**3.0**	**3.0**	**3.0**
Gross fixed capital formation		172.6	22.7	4.8	3.2	7.4	-3.5	**1.6**	**6.5**	**5.5**
of which: equipment		65.4	8.6	5.5	-5.1	-3.8	-4.0	**2.5**	**3.0**	**6.5**
Exports (goods and services)		315.1	41.4	9.2	8.0	4.6	8.3	**8.3**	**7.3**	**6.7**
Imports (goods and services)		322.3	42.3	10.8	8.7	8.0	9.8	**9.9**	**8.1**	**7.3**
GNI (GDP deflator)		738.2	96.9	2.9	4.0	3.0	3.4	**6.4**	**5.1**	**4.2**
Contribution to GDP growth:	Domestic demand			4.7	3.8	5.5	4.4	**6.1**	**4.9**	**4.6**
	Inventories			0.0	-0.3	-0.1	0.9	**0.3**	**0.0**	**0.0**
	Net exports			-1.5	-0.3	-1.4	-0.7	**-0.8**	**-0.5**	**-0.5**
Employment				-1.7	0.8	-1.3	-0.9	**0.7**	**0.4**	**0.2**
Unemployment rate (a)				7.1	6.8	6.8	5.9	**5.3**	**5.1**	**5.0**
Compensation of employees / head				23.1	6.7	1.9	10.9	**13.2**	**10.9**	**7.8**
Unit labour costs whole economy				17.4	4.3	-3.3	5.0	**7.9**	**6.6**	**3.7**
Real unit labour cost				-1.0	2.6	-5.7	2.8	**5.8**	**3.2**	**0.4**
Saving rate of households (b)				-5.4	14.5	15.5	14.5	**14.8**	**14.8**	**15.1**
GDP deflator				18.7	1.7	2.6	2.2	**2.0**	**3.2**	**3.3**
Harmonised index of consumer prices				16.8	1.4	-0.4	-1.1	**1.0**	**2.9**	**3.0**
Terms of trade goods				2.7	0.8	1.0	0.5	**-1.3**	**-0.3**	**0.5**
Trade balance (goods) (c)				-7.9	-4.3	-4.9	-5.5	**-6.5**	**-7.1**	**-7.4**
Current-account balance (c)				-6.1	-0.1	-0.6	-2.3	**-3.1**	**-3.2**	**-3.4**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-5.6	2.5	1.8	-1.3	**-1.6**	**-1.5**	**-1.4**
General government balance (c)				-3.7	-1.4	-0.8	-3.0	**-3.0**	**-3.9**	**-4.1**
Cyclically-adjusted budget balance (d)				-3.6	-0.4	-0.1	-2.6	**-3.3**	**-4.3**	**-4.6**
Structural budget balance (d)				-	-0.4	-0.3	-2.2	**-3.3**	**-4.3**	**-4.6**
General government gross debt (c)				23.0	39.4	37.9	37.6	**37.9**	**39.1**	**40.5**

(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.