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The Romanian Economy

Recent Developments and Prospects

Románia gazdasága

A legújabb fejlemények és kilátások

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Abstract: The recent dynamics of the global, European and regional macro-financial indicators confirm the maturity of the post-crisis cycle. On the one hand, we point out that the escalation of the US–China trade tensions may precipitate the end of this cycle, as the downward trade for the global exports is already impacting the manufacturing sector (the engine of the economy) with unfavourable spill-over effect for the investment climate. On the other hand, the Digital Revolution has been gradually incorporated in both developed and developing countries, generating positive shocks in terms of total factor productivity. Overall, the expansionary policy-mix measures recently signalled across the main economies of the world (the USA, China, Euroland) express prospects for a normal end of the cycle. Looking at the European Union there can be noticed the performance of the Romanian economy during the post-crisis cycle, the country managed to double the nominal GDP from 2006 to 2018 and to increase the GDP/capita to above EUR 10,000 last year. In this paper, we implement standard econometric tools and use the Eurostat database in order to assess the recent developments and to identify the mid-run prospects for Romanian economy.

Összefoglalás: *A globális, európai és regionális makroszintű pénzügyi mutatók napjainkra tapasztalható dinamikája megerősíti azt a hipotézist, miszerint a növekedési ciklus elérte a csúcsát. Elemzésünkben egyrészt rámutatunk arra, hogy az Amerikai Egyesült Államok és Kína közötti feszültségek fokozódása e ciklus végét hozhatja el, mivel a globális export lefelé irányuló trendje már a gazdaság hajtóerejét, a feldolgozóipart befolyásolja kedvezőtlen irányba, ami hatással van a befektetési környezetre is. Másrészt a digitális forradalom fokozatosan teret hódít mind a fejlett, mind a fejlődő országokban, pozitív sokkokat generálva a teljes tényezőtermelékenység szempontjából. Összességében kijelenthető, hogy a világ legfontosabb gazdaságaiban (USA, Kína, euróövezet) bejelentett expanzív szakpolitikai intézkedések a ciklus nem sokkszerű végét sejtetik. Az Európai Unió szempontjából észrevehető teljesítményt ért el a román gazdaság a válság utáni növekedési ciklusban: az országnak 2006 és 2018 között sikerült megdupláznia a nominális GDP-jét, így az egy főre jutó bruttó hazai termék tavaly 10.000 euróra növekedett. Az elemzésben ökonometriai eszközöket használunk, az Eurostat adatbázisaira építve, hogy bemutassuk és elemezzük a legutóbbi időszak fejleményeit, és azonosítsuk a román gazdaság középtávú kilátásait.*

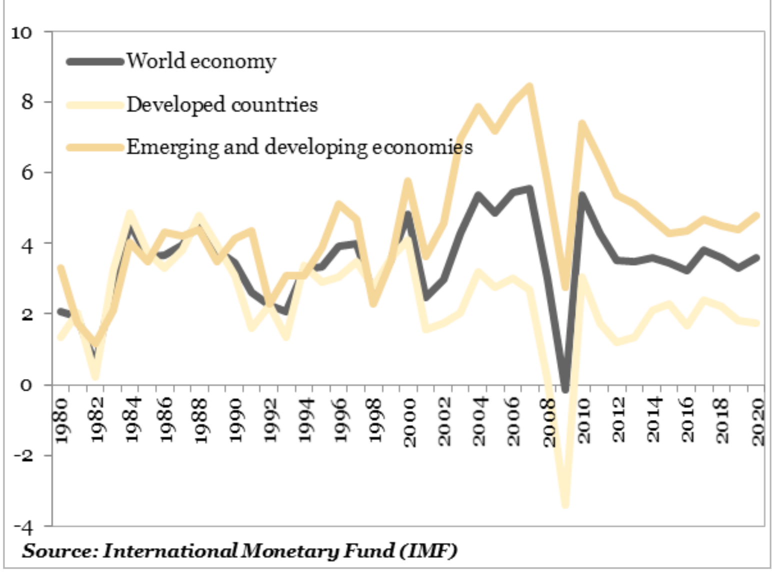
Global and European Macroeconomic Climate

The global economy has recently manifested a trend of slowing down, due to the unfavourable impact of trade tensions on the manufacturing sector and the maturity phase of the post-crisis investment cycle.

According to the PMI Composite indicator computed by JPMorgan and Markit Economics, in May 2019 the global economy grew at the slowest pace since 2016, and a contraction of the manufacturing sector has been noticed for the first time since 2012. Furthermore, the main economies of the world have presented divergent dynamics recently. On the one hand, the US economy, the largest economy of the world, with a nominal GDP exceeding USD 21 trillion, accelerated to 3.2 percent YoY in 1Q2019 (the best pace since 2015), an evolution that has been supported by an expansionary policy-mix. On the other hand, the YoY dynamics of the Eurozone (Romania's main economic partner) consolidated at 1.2 percent in 1Q2019, the slowest pace since 2014, given the trade tensions and the fading out of the impact of an unprecedented expansionary monetary policy. At the same time, in 1Q2019 the Chinese economy grew by 6.4 percent YoY, the slowest pace since 2009.

According to the forecasts of the International Monetary Fund (IMF), the global economy will decelerate from 3.6 percent YoY in 2018 to 3.3 percent YoY in 2019 (Figure 1). This evolution will mainly be determined by the slowing-down process across developed economies (from 2.2 percent YoY to 1.8 percent YoY, the minimum since 2016). At the same time, the GDP of emerging and developing economies will decelerate from 4.5 percent in 2018 to 4.4 percent in 2019, the slowest pace since 2015.

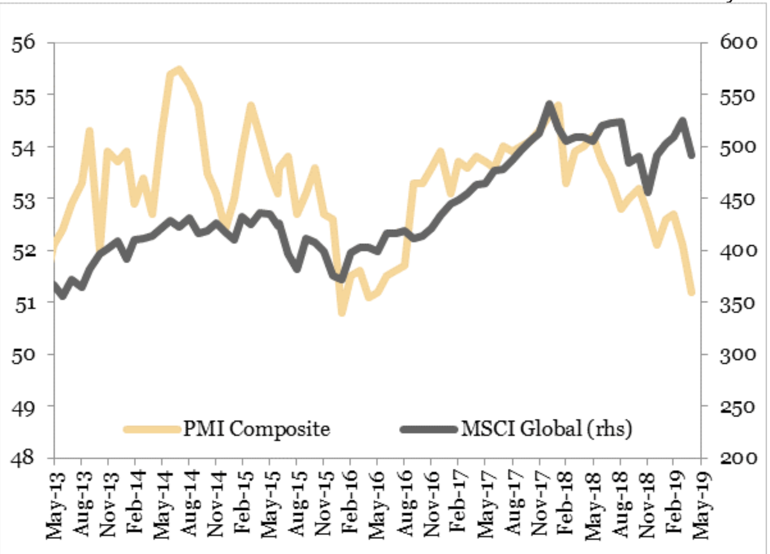
Figure 1
GDP Dynamics (%, YoY)



Source: International Monetary Fund (IMF)

As regards the financial side of the global economy (Figure 2), risk perception intensified in May 2019, after a strong momentum during January–April 2019 (Bloomberg), influenced by the USA–China trade negotiations and the recalibration of the monetary policy in the USA. Volatility in the global financial markets is expected to remain high in the short run, given the end of the post-crisis cycle and the macro-financial challenges across the main economies of the world (the USA, China, and Euroland).

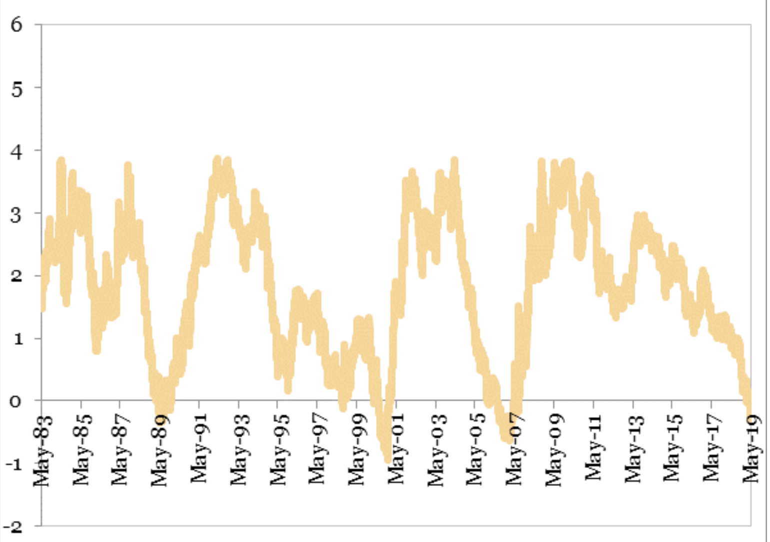
Figure 2
The Real and Financial Sides of the Global Economy



Source: Bloomberg

In this context, we emphasise global trade tensions as well as the lack of room for manoeuvre in terms of economic policy during the following shocks. The end of the post-crisis cycle (the longest one after World War II for the United States, the largest economy of the world, representing 25 percent of global GDP) is also reflected by the inverted yield curve, as can be noticed in Figure 3.

Figure 3
10YR–3M Spread in the USA

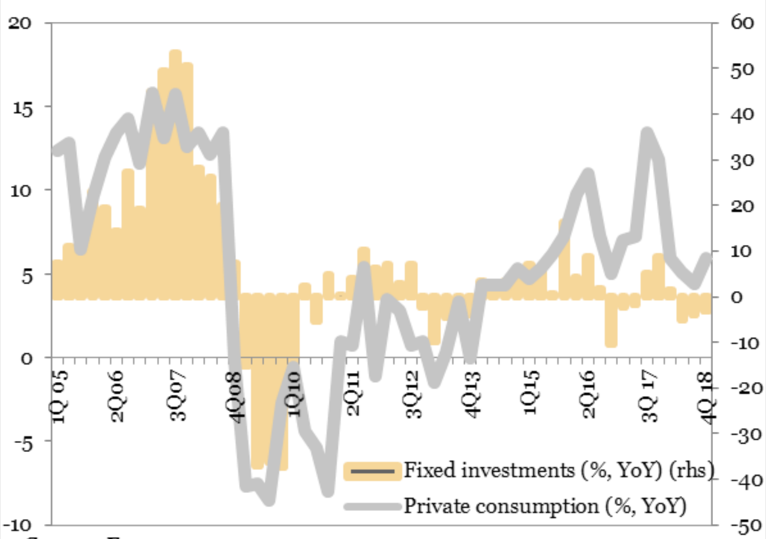


Source: Federal Reserve (FED)

Recent Macroeconomic Developments in Romania

In Romania, the post-crisis cycle continued in 2018 – the GDP grew by 4.1 percent YoY in 2018, slowing down from 7 percent YoY [in 2017](#) (Figure 4). This evolution was determined by the deceleration of domestic demand and the decrease of net foreign demand. On the one hand, the pace of private consumption normalised (5.2 percent YoY in 2018 vs. 10 percent YoY in 2017), given the fading out of the Fiscal Act and the acceleration of inflation.

Figure 4
Private Consumption vs. Fixed Investments



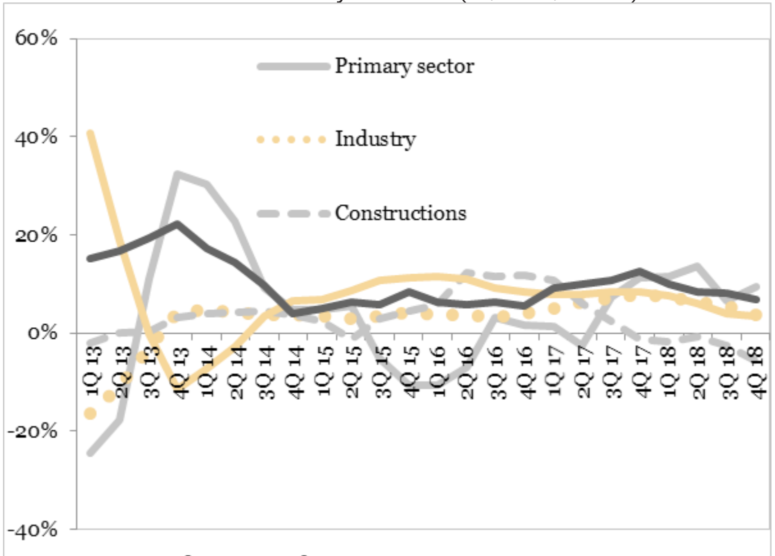
Source: Eurostat

On the other hand, fixed investments contracted by 3.2 percent YoY, due to the intensifying challenges in terms of macroeconomic equilibria and the policy-mix. Public consumption rose by 1.8 percent YoY, given the expansionary fiscal and income policies implemented by the Administration. At the same time, the increase of inventories contributed heavily to the growth pace in 2018 (2.9pp). However, net foreign demand had a negative contribution to the GDP growth pace in 2018, as imports advanced by 9.1 percent YoY, while exports rose by 5.4 percent YoY.

As regards the supply side, an increase of 10 percent YoY in 2018 can be noticed in the value-added in the primary sector (Figure 5).

At the same time, the value-added in IT&C (the "star" of the post-crisis cycle) advanced by 7.2 percent YoY last year. The value-added in the Romanian industry rose by only 4.1 percent YoY in 2018. The cyclical component wholesale and retail trade/repair of motor vehicles and motorcycle/transport & storage/HORECA increased by only 3.9 percent YoY. On the other hand, the construction sector adjusted by 5.6 percent YoY in 2018.

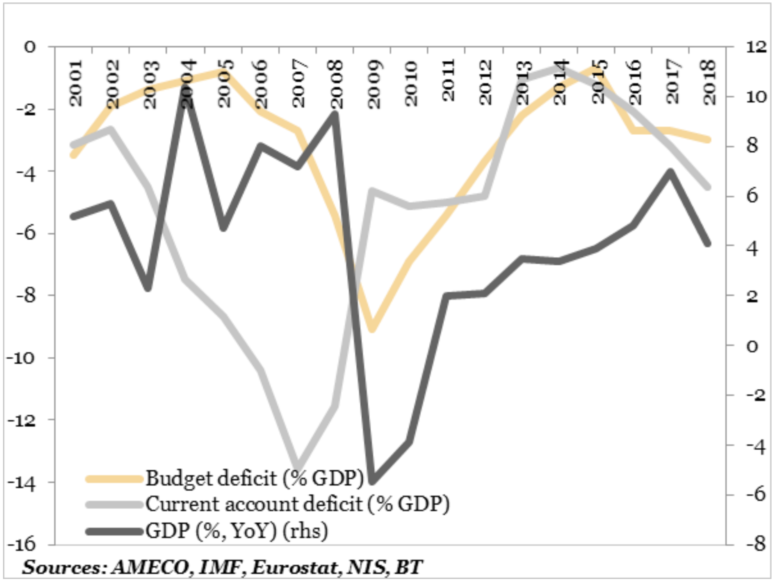
Figure 5
Value-Added by Sector (%, YoY, MA4)



Source: National Institute of Statistics (NIS)

As regards nominal GDP (Figure 6), Romania outpaced Portugal in 2018 (after outpacing Greece in 2017) and became the 15th largest economy of the European Union, with a GDP of EUR 202.9bn. The labour market continued the trend of improvement in 2018, an evolution also influenced by the migration of the active population: the average rate of unemployment decreased to 4.2 percent, the lowest level since 1991. Moving to the financial side of the economy, the acceleration of inflation can be noticed, to an average level of 4.1 percent on a HICP basis in 2018, the highest level since 2011, due to the supply-side shocks and the expansionary policy-mix. In this context, last year the National Bank of Romania (NBR) hiked the monetary policy rate three times, by 25bp to 2.50 percent. However, real financing costs remained low and affordable for both the household and the corporate segments.

Figure 6
GDP vs. Twin Deficits



Sources: AMECO, IMF, Eurostat, NIS, BT

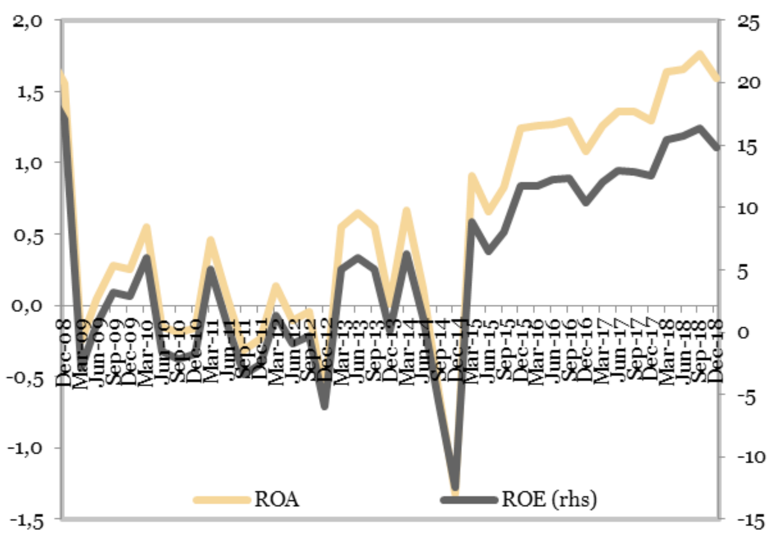
Last but not least, the RON continued its gradual depreciation trend against the EUR in 2018 (the average EUR/RON stood at 4.65, a record-high level), an evolution mainly determined by the deterioration of macroeconomic equilibria – accelerating inflation and widening twin deficits (as can be noticed in the figure on the right).

As regards the credit market, in 2018 non-governmental loans rose on average by 6.6 percent YoY, given the expansionary policy-mix and tough competition in the banking sector. On the one hand, household loans climbed by 9.4 percent YoY, an evolution supported by the First House Program (housing loans rose by 12.8 percent YoY) and the strong labour market climate (consumer loans advanced by 6.2 percent YoY). On the other hand, corporate loans inched up by 3.7 percent YoY on average, due to the low level of real interest rates. At the end of 2018, non-government loans stood at RON 251.1bn (around EUR 53.8bn), a record level. In 2018 non-government deposits increased on average by 10.8 percent YoY (the household and corporate segments rose by 10.9 percent YoY and 10.6 percent YoY, respectively), an evolution supported by the increase of disposable income and a prudent investment approach. Non-government deposits ended 2018 at RON 329.7bn (EUR 70.7bn), also a record-high level.

The LDR (loans-to-deposits ratio) stood at 76.2 percent in December 2018, a historically low level.

The financial performance of the banking sector (the main financing source of the economy) continued the upward trend in 2018, an evolution supported by the positive output gap, the low level of the real financing costs, and the decline of the non-performing loans ratio (Figure 7).

Figure 7
Banking Sector – Return Indicators (%)



Source: NBR

Total assets advanced on average by 8.4 percent YoY to RON 440.7bn (EUR 94.7bn), while the net aggregate profit climbed by 32.5 percent YoY to RON 7bn in 2018. Last year the ROE and ROA indicators stood at 14.85 percent and 1.59 percent, respectively, while the capital adequacy ratio ended 2018 at 19.66 percent, well above minimum requirements.

Macroeconomic Outlook of Romania

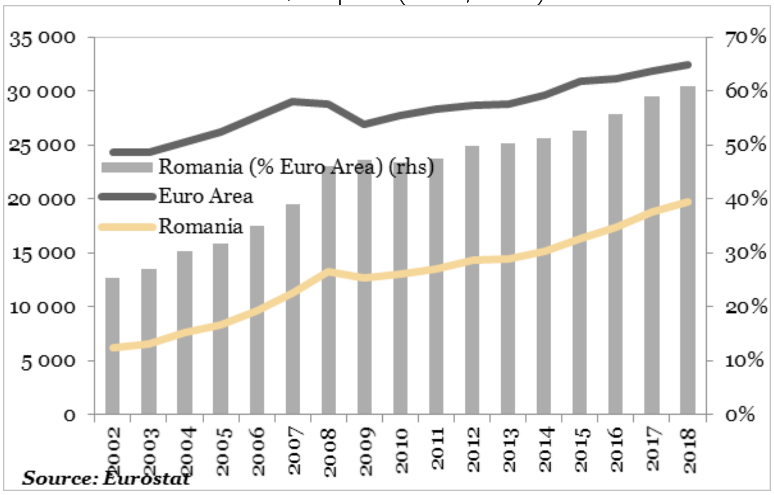
Among the main standard econometric tools implemented in this paper in order to assess the recent macro-financial developments and to generate a core macroeconomic scenario for Romania we mention:

- Comparative analysis;
- Standard OLS regressions;
- ARIMA equations;
- Cobb–Douglas production function in order to estimate the dynamics of the potential GDP and the contribution of the production factors to the YoY pace of the potential output.
- Eurostat database, annual data for Romania during the period 1996–2018.

According to the core macroeconomic scenario of Banca Transylvania, the Romanian economy will decelerate in the short run (a YoY average pace of 3.5 percent during 2019–2021), due to the rebalancing of the policy-mix and the end of the global post-crisis cycle.

However, the convergence process towards the EU average will continue in the medium term, after GDP/capita outpaced EUR 10,000 in 2018. In other words, the Romanian GDP is expected to increase at a higher rate than that of the EU (Figure 8).

Figure 8
GDP/Capita (EUR, PPS)

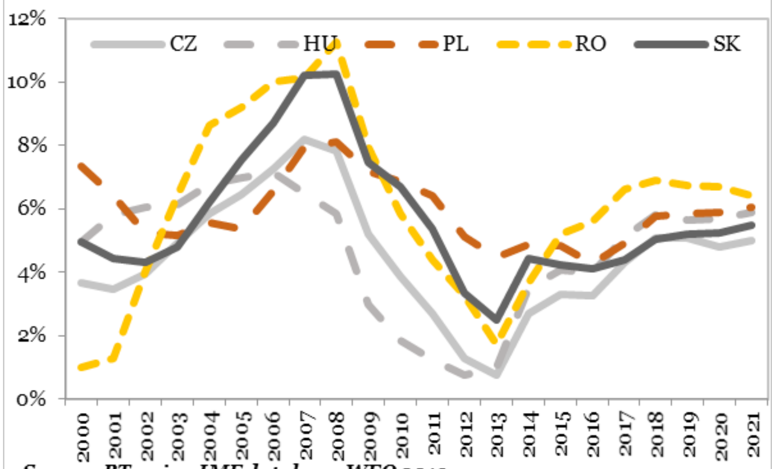


Furthermore, Romania will consolidate its position as champion of EU economic convergence. As can be noticed from the following figure (Figure 9), the GDP/capita in Romania (as a percent of the Euro Area) rose from 25 percent in 2002 to above 60 percent in 2018.

This scenario is supported by several factors:

1. The improvement of fixed investments in the medium term (following slow dynamics in the post-crisis cycle), given the low level of the real financing cost, the consolidation of foreign direct investments (the labour force continues to be cheap despite the recent increase of wages), and the strong banking sector;

Figure 9
GDP/Capita in CEE Countries (USD, PPS, CAGR 5YR)



Source: BT, using IMF database, WEO 2019

2. The high potential for the improvement of the total productivity factor in the upcoming quarters.

On the other hand, we can point out several challenges for the investment climate in the short run, related to uncertainties in the policy-mix: the discontinuation of structural reforms, the fragile state of public finance, the increasing state intervention in the economy. However, the levels of twin deficits and the dependence on foreign financing are low compared to the end of the previous economic cycle; consequently, we do not expect a serious adjustment in Romania at the end of the post-crisis cycle.

As regards the financial side of the economy, Banca Transylvania forecasts the gradual convergence of inflation towards the NBR target – an average YoY dynamics of 3.8 percent in 2019, 3.0 percent in 2020, and 3.3 percent in 2021 (HICP). In other words, inflationary pressures will remain high in the short run, given the labour market tensions and the depreciation of the RON. In this context, the central bank is expected to tighten control over money market liquidity in the short run. Banca Transylvania forecasts the increase of nominal financing costs and the depreciation of the RON in the upcoming quarters, given the dynamics of inflation and the challenges in terms of macroeconomic equilibria and the policy-mix (including the fragile state of public finance).

Among the risk factors for the dynamics of the Romanian economy in the short run we can mention the global and European macro-financial climate, influencing the capital flows directed at emerging markets; the economic policy-mix and the public tensions in Romania; and the regional geo-political climate.

Conclusions

This paper analysed the recent macro-financial developments and presented the mid-run prospects for Romanian economy, the leader of the EU countries in terms of the economic growth pace and real convergence over the past two decades.

According to our results, Romanian economy is going to slow down in the following quarters, in convergence towards its potential, an evolution determined by the deterioration of the economic climate in Euroland (the main economic partner) and by the challenges in terms of macroeconomic equilibria in Romania (the widening twin deficits, their weight in the GDP climbing towards the highest levels since 2010). However, we do not expect a tough adjustment for the economy at the end of the cycle, a scenario supported by several factors:

1. the dependence on the foreign financing is very low;
2. the level of the twin deficits is lower compared with the pre-crisis level;
3. the household savings ratio is high, while the investment behaviour of the companies is very prudent;
4. the dynamics of the fixed investments during the post-crisis cycle was very low, below the Euroland level during 2013–2018;
5. the potential of growth is higher compared with the other countries in the region, an evolution also reflected by the positive dynamics of the total productivity factor.

In fact, we expect the Romanian economy to enter a new cycle in 2021 and to continue to outperform the countries in the region members of the EU in terms of both economic growth and real economic convergence. In this context, we point out the positive prospects for joining the OECD and the Euroland during the next decade, with strong favourable impact for both potential output and capital market development in the mid-run. However, we underline that these prospects are highly dependent on the rebalancing of the Romanian policy-mix, after the expansionary, pro-cyclical and unsustainable measures implemented since 2015.

In our view, an acceleration of the structural reforms is immediately needed in order to tackle the twin deficits and to contribute to a stronger synergy of the production factors. In this context, we mention the increase of investments in infrastructure (with a focus on quality and taking into account the priorities).

The improvement of the public infrastructure is needed in order for the private sector to resume new investments and for a better integration of the Romanian economy in the region, Europe and global economy.

Furthermore, we point out the implementation of quick measures in order to develop the capital market and to support the entry into the emerging category, which would generate positive impact for the macro-financial climate and for the economic development in the mid-run. Listing of additional state-owned companies and the measures to increase the interest of the retail investors would improve the liquidity, the last criteria that should be met in order to exit the frontier markets and enter the emerging markets.

We believe that an acceleration of the economic integration within our region with have positive impact for all the countries in the mid-run. In this context, we underline the role of the EU funds but also the projects under Belt and Road Initiative (BRI).