ROMANIA

FISCAL CONSOLIDATION IS THE PRIORITY

Very dynamic to date, economic growth is now expected to weaken, and the authorities will face several challenges in 2023. Consolidation of public accounts is a priority in the short term, failing which, Romania could be subject to further disciplinary measures by the European Union. Inflation remains high although it has fallen since the end of 2022, which should encourage monetary authorities to favour a status quo. The current account deficit widened to nearly 10% of GDP in 2022, but should ease in the short term due to the drop in energy prices. Despite the size of current account and budget deficits, Romania continues to attract foreign capital flows.

SLUGGISH ECONOMIC ACTIVITY IN H1 2023

Real GDP growth slowed significantly in Q1 2023, standing at +0.2% q/q after reaching +1.0% q/q in the previous two quarters. The economy weakened further in Q2, judging by the economic indicators published recently. Retail sales fell -1.5% y/y in April, even though they had held up well until then. The country has been seeing a downward trend in industrial production for several months now. At the same time, the decline in volumes of imports of consumer goods and intermediate goods indicates that the slowdown is not just affecting exports. The real estate market is also losing momentum. The demand for new home loans has declined due to the increased cost of borrowing. Mortgage rates stood at 8.3% in April 2023, compared to 4.3% on average in 2021. In addition, households have faced an increase in their monthly debt repayments, as mortgages are primarily granted at variable rates. In H2, consumption should nevertheless continue to prove resilient. Once more in positive territory since April, real wages will be a factor supporting household purchasing power, as long as the drop in inflation continues.

Among Central European countries, Romania will probably see the strongest growth in 2023, even if this growth slows. Hungary, the Czech Republic and Slovakia are more exposed to fluctuations in external demand. Usually holding up better than its neighbours, the Polish economy is expected to see a more significant slowdown this time, due to the downturn in the real estate sector. In addition, investment projects are likely to be postponed after the general election next autumn.

In 2024 and 2025, the Romanian economy should recover and then gradually converge towards its estimated potential growth of around 3.5% in the medium term. However, the likely move towards greater fiscal discipline over the next two years suggests limited support for investment and household consumption.

GRADUAL DROP IN INFLATION

Based on the harmonised price index, inflation reached a high in November, then gradually fell to 9.6% y/y in May. This figure is comparable to figures seen in Central European countries, with the exception of Hungary, which is still struggling with very high inflationary pressures (+21.9% y/y in May).

In Romania, the decline was mainly due to a lower contribution from the "food" and "energy" items. However, disinflation will be slow, due to relatively strong wage pressure. Furthermore, core inflation slightly accelerated to 8.7% y/y in May.

The Central Bank is unlikely to move towards monetary easing any time soon. It will undoubtedly favour a monetary status quo this year, after having increased the key policy rate by 475 basis points cumulatively to 7% until January 2023.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, %	-3.2	5.9	4.2	2.5	4.0
Inflation, CPI, year average, %	2.3	4.1	12.0	9.6	5.5
Gen. Gov. balance / GDP, %	-9.2	-7.1	-6.2	-4.7	-3.7
Gen. Gov. debt / GDP, %	46.9	48.6	47.2	46.8	46.3
Current account balance / GDP, %	-4.9	-7.2	-9.3	-6.7	-4.4
External debt / GDP, %	57.5	56.7	50.5	48.5	45.5
Forex reserves, EUR bn	42.5	45.8	52.3	54.0	57.0
Forex reserves, in months of imports	6.7	5.9	5.3	4.9	5.2

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

ROMANIA: GOODS IMPORTS IN VOLUME

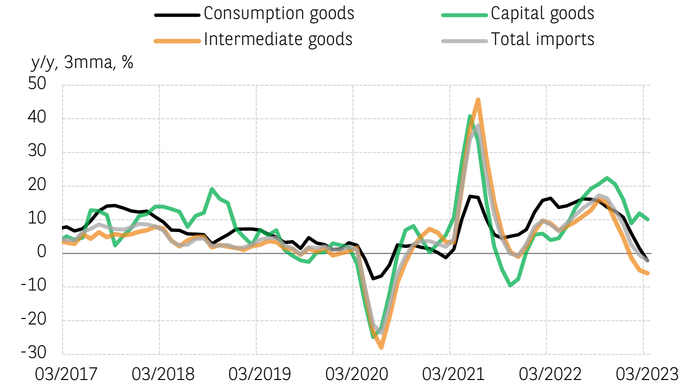

CHART 1

SOURCE: EUROSTAT, BNP PARIBAS

BUDGET RECALIBRATION REQUIRED

Despite the improvement in the debt-to-GDP ratio in 2022, public accounts are showing some fragility. In fact, the budget deficit has remained high as a result of successive shocks to the economy since 2020. This deficit was -6.2% of GDP in 2022, after reaching -7.4% in 2021 and -9.2% in 2020. In the short term, the debt burden in the government's budget will increase, although it remains relatively low for the time being, at 7.3% of tax revenues (4.7% in 2021 and 6.3% in 2022).

In 2023 and 2024, the budget deficit will be reduced, but it should remain above the EU's target of 3% of GDP.

As a result, significant consolidation efforts will be needed in the short term to comply with EU budgetary rules. Failing this, Romania may be subject to further disciplinary measures. On 30 June, the country received a warning from the European Commission of a possible suspension of European funds if public accounts were not quickly put back on track. We should remember that European funds represent a significant source of financing for the country, estimated at around EUR 10 billion per year (3% of GDP). In addition, Romania has already been the subject of an excessive deficit procedure since 2020, due to new expenditure (increases in pensions, wages, etc.) deemed unsustainable by the EU.

At the end of May, measures were adopted by the government to reduce public spending, but they are marginal (0.3% of GDP). More radical measures will be required to significantly contain the budget deficit, which already reached 2.7% of GDP over the first five months of the year. However, fiscal consolidation will prove difficult in the short term, with several elections (presidential, legislative and local) due to take place in 2024, which should be accompanied by an increase in spending.

SLIGHT DECLINE IN THE CURRENT ACCOUNT DEFICIT

Romania has posted a structural current account deficit for several years. The persistence of deficits stems from strong domestic demand, itself generated by the succession of expansionary budgetary policies implemented in recent years. In 2022, the current account deficit widened further to 9.3% of GDP. The increase in the energy bill alone represented 30% of the deficit. The income balance remained in the red. The services balance surplus only marginally offset the deterioration in the trade balance.

Financing the current account deficit did not pose a major problem. In 2022, the current account deficit was broadly covered by non-debt flows, including foreign direct investment (FDI) and European funds. These two sources of financing combined represented EUR 21 billion in 2022 and reached 78.3% of the deficit.

External liquidity is at comfortable levels thanks to the accumulation of foreign exchange reserves covering more than five months of imports. Furthermore, the ratio of external debt to GDP has not deteriorated; it even fell slightly by 2.1 points to 48.4% in 2022.

In the short term, external accounts should benefit from lower energy prices, but the current account deficit will remain relatively high due to the structural deficit in the trade balance, even excluding energy.

AN ATTRACTIVE DESTINATION FOR FOREIGN INVESTMENT

The persistence of twin deficits in 2022 did not damage the perception of risk, judging by the slight appreciation of the Romanian leu against the euro over the period. The prospects for high yields on the bond markets favoured net inflows of capital. Portfolio investment flows saw a strong rise to EUR 9.7 billion in Q1 2023, after reaching EUR 0.3 billion and EUR 1.4 billion in the two previous quarters. Over 2022 as a whole, these investment flows amounted to around EUR 5 billion despite the uncertainties linked to the war in Ukraine. Furthermore, Romania remains an attractive destination for FDI, which stood at EUR 2.3 billion in Q1 2023 after reaching EUR 9.6 billion in 2022 (i.e., 3.4% of GDP). As a comparison, this ratio was 2% on average over the period 2010-2020.

FDI and European funds have helped Romania catch up with developed countries since it joined the European Union in 2007. The gap between

ROMANIA: CAPITAL FLOWS AND CURRENT ACCOUNT BALANCE

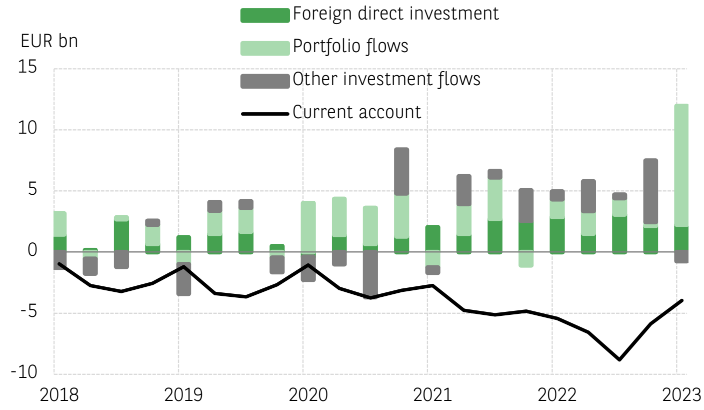

CHART 2 SOURCE: NATIONAL BANK OF ROMANIA, BNP PARIBAS

Romanian GDP per capita and EU GDP has narrowed considerably since then (70% in 2022, compared to 49% in 2007). A continued catch-up will remain on track in the coming years. Like its neighbours in Central Europe, Romania could benefit from the reorganisation of production in the euro area, as a result of the large supply shocks caused by the Covid-19 crisis and, more recently, by the war in Ukraine. Furthermore, sanctions against Russia and Belarus, which led to industrial site closures, could benefit all Central European countries. According to the Romanian authorities, several projects are under consideration to relocate these sites.

Romania's many plus points are its geographical proximity to the euro area, a developed infrastructure network and a diversified industrial base. In addition, the relative stability of the leu against the euro, observed in recent years, mitigates currency risk. The managed exchange rate mechanism has resulted in a very small deviation of the nominal effective exchange rate from its long-term trend. The prospects for joining the euro, within (at least) 5-10 years, will result in a total removal of this currency risk for manufacturers based in the euro area.

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