ROMANIA

PERSISTENT TWIN DEFICITS

Romania recorded a softer economic growth in 2023 but remained one of the best performing economies in the region. The short-term outlook is strong. The gradual fall in inflation since the end of 2022 should pave the way for an accommodative but cautious monetary policy. The persistence of twin deficits remains a major concern. So far, the country has been able to rely on a certain resilience in capital flows to partly offset the current account deficit. Fiscal consolidation is one of the government's short-term priorities, although there is limited room for manoeuvre this year given the busy electoral calendar. Public debt is sustainable in the short and medium term.

GOOD ECONOMIC GROWTH PERFORMANCE

In 2023, the Romanian economy experienced the strongest growth in the region at +2.1% on average. By comparison, GDP grew by 1.1% in Slovakia and 1.9% in Bulgaria. Poland narrowly avoided a recession.By contrast, economic activity in the Czech Republic and Hungary contracted by 0.2% and 0.7% respectively.

In Romania, GDP growth nevertheless slowed down markedly in 2023. It was mainly driven by investment, while consumption, which is usually the main driver of growth, made a smaller contribution than in previous years. This was mainly attributed to tighter credit conditions and strong inflationary pressures in the first half of the year.

Economic growth is expected to accelerate over the next two years. Consumer spending will benefit from the fall in inflation, the expected increase in wages and pensions this year, and a relative easing in credit conditions. Retail sales and import volumes have already improved since the end of 2023. Furthermore, if the gain in confidence in industries observed in March (European Commission index and PMI index in the manufacturing sector) is confirmed, industrial production, which has remained sluggish in recent months, should pick up. Public investment will probably be supported by European funds. By contrast, projections for private investment are mixed this year, with projects likely to be postponed while awaiting the forthcoming elections on one hand and the confirmation of the improvement in domestic and foreign demand on the other hand.

Economic activity will nevertheless be constrained by a cautious monetary policy (against a backdrop of strong wage pressures) and by a fiscal policy geared towards consolidating public accounts in the years ahead. It should be noted, however, that a degree of fiscal flexibility is expected this year in view of a pivotal election year.

A CAUTIOUS MONETARY POLICY AHEAD

Inflation, calculated from the harmonised price index, gradually fell to 6.7% y/y in March 2024, after peaking at 14.6% in November 2022. However, this figure is well above regional inflation. By way of comparison, it was 2.7% y/y in Poland over the same period, 2.2% in the Czech Republic and even 3.6% in Hungary, the country with the highest inflation rate in 2023.

Headline inflation is mainly driven by core inflation, with a contribution of 5.4 points. The situation has reversed compared to 2023, with food and energy making a marginal contribution this time. One point to highlight is that year-on-year core inflation has been higher than headline inflation since July 2023. This is mainly due to strong wage pressures. In 2023, the minimum wage was raised twice, from 2,550 lei to 3,000 lei, and then to 3,300 lei last October. Meanwhile, wages across all sectors rose by an average of 14.5% in 2023. In the short term, wage pressures will likely persist, in a context where the labour market remains tight, with a relatively stable unemployment rate of 5.6% over the last twelve months. As a result, Romania is likely to record the highest inflation rate in the region this year.

Monetary authorities in Romania have adopted a cautious policy with the key rate being maintained at 7% since January 2023. In the short term, the central bank is likely to move towards monetary easing.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, %	5.7	4.1	2.1	3.0	3.1
Inflation, CPI, year average, %	4.1	12.0	9.7	5.6	4.0
General gov. balance / GDP (%)	-7.2	-6.3	-5.7	-5.4	-5.2
General gov. debt / GDP (%)	48.6	47.2	48.9	50.4	52.2
Current account balance / GDP, %	-7.2	-9.3	-7.0	-6.5	-6.0
External debt / GDP, %	56.7	50.5	52.3	51.8	50.8
Forex reserves, EUR bn	45.8	52.3	66.0	72.0	77.0
Forex reserves, in months of imports	5.9	5.3	6.9	7.1	7.3

TABLE 1 e: ESTIMATES & FORECASTS SOURCE: BNP PARIBAS ECONOMIC RESEARCH

ROMANIA: INFLATION

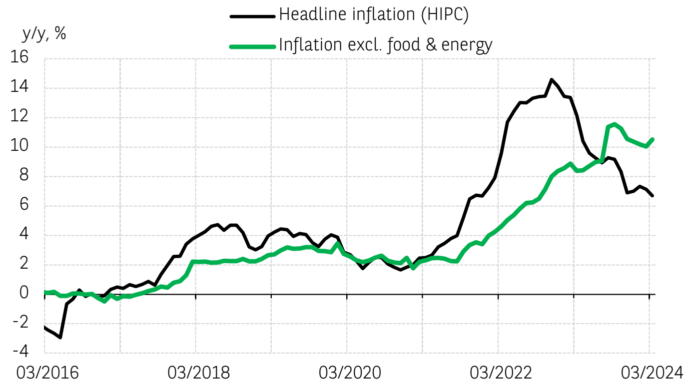

CHART 1 SOURCE: EUROSTAT, BNP PARIBAS

However, it will probably be measured, given strong wage pressures alongside with an inflation, which is still expected to be well above the official inflation target (1.5-3.5%) this year. By comparison, Hungary and the Czech Republic have already started their monetary easing cycle. The Central Bank of Poland, by contrast, has returned to a monetary status quo since the end of 2023, after two key rate cuts in September and October.

A BUSY ELECTION YEAR

This year's political calendar is packed with the European and local elections, followed by the presidential elections (first round on 15 September and second round on 29 September). But the main focus will be on the parliamentary elections scheduled in December. The interpretation of opinion polls on the parliamentary elections is premature at this stage, but whatever the outcome of the elections, the reforms currently under way should continue. Romania, which has been a member of the European Union since 2007, has made significant progress in terms of convergence (GDP per capita at 72% of the EU average) and is pursuing its integration within the EU. Indeed, it partially joined the Schengen area on 31 March 2024. The future government will also face serious challenges in terms of both public and external accounts.

A HIGH CURRENT ACCOUNT DEFICIT BUT PARTLY OFFSET BY FDI INFLOWS

The current balance is structurally in deficit. The deepening in the deficit observed in 2021 and 2022 was led by a deterioration in the energy balance. In 2023, it remained at a level well above the pre-Covid-19 period, although it fell slightly due to an easing in commodity prices. In the short term, the deficit is unlikely to improve significantly due to the expected rise in imports, driven by the improvement in consumption and investment.

The current account deficit has been deteriorating for several years, but has largely been covered by capital inflows, especially foreign direct investment (FDI) and European funds. In 2023, net FDI inflows covered 28.8% of the current account deficit. The coverage ratio rises to around 60% when European funds are included. In addition, foreign exchange reserves have continued to rise since 2019, reaching EUR 66 bn in 2023. In the short term, the country is an attractive destination for FDI inflows and is benefiting from the reorganisation of production activities by euro zone companies (nearshoring). Similarly, portfolio flows (EUR +14.4 bn in 2023) should be supported by relatively high yields in the region.

EXCESSIVE DEFICIT PROCEDURE LIKELY TO CONTINUE

Since 2020, Romania has been under an excessive deficit procedure by the European Commission due to the permanent spending measures introduced by the government in 2019, which has increased the budget deficit. The successive shocks to the Romanian economy have worsened this deficit since 2020. In 2023, the deficit remained significant even though it fell very slightly to -5.7% of GDP (compared with -6.3% in 2022, -7.2% in 2021 and -9.3% in 2020). Last year, the increase in the tax rate for certain companies and the end of tax breaks for certain sectors helped to contain the deficit. The pension reforms, introduced in November 2023, are designed to bring pensions back onto a sustainable path in the medium term. However, this will also lead to an increase in pensions of around 40% in 2024. Similarly, large-scale consolidation measures are likely to be limited this year, given the large number of elections to be held. As a result, the budget deficit is likely to be around 5% of GDP this year, which means that Romania will inevitably remain under the excessive deficit procedure. The escape clause, which allowed EU Member States to deviate temporarily from the Stability and Growth Pact during the Covid-19 pandemic, expired in December 2023.

ROMANIA: GOVERNMENT DEBT AND FISCAL DEFICIT

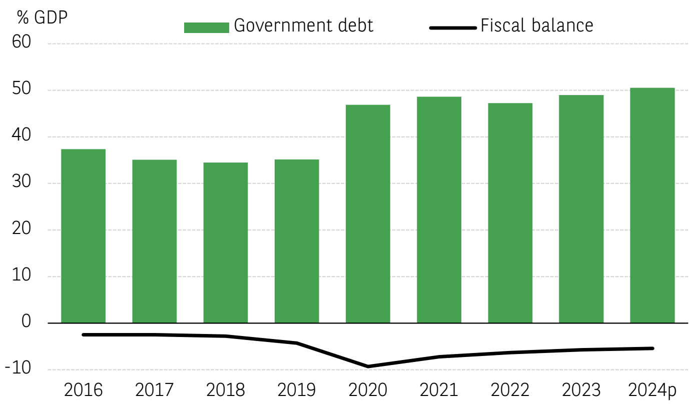

CHART 2 SOURCE: MINISTRY OF FINANCE, EUROSTAT, BNP PARIBAS

However, financing the budget deficit is not a major problem, due to the inflow of European funds and a certain resilience of foreign demand for domestic debt. Public debt is sustainable in the short to medium term and is not expected to exceed 60% of GDP over the next five years. Fiscal consolidation could accelerate after the elections, given Romania's commitments under EU's Stability and Growth Pact. In the short term, broadening the tax base is a priority, especially as tax revenues as a share of GDP are structurally low (31% of GDP in Romania in 2023, compared with 39.8% in Poland and 41% in the Czech Republic).

Despite an increase in funding costs on bond markets over the last two years, the interest burden on the debt expressed as a percentage of tax revenues was contained at 5.9% in 2023. One point of caution concerns the size of the government's foreign currency-denominated debt, which accounted for 53.8% of the total in 2022 (25.4% of GDP). However, the relative stability of the Romanian exchange rate against the euro (as part of an administered exchange rate regime) limits the government's

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