POLICY MIX DIFFICULT TO CALIBRATE

Romania's economy slowed sharply in H2 2021, with rising inflation causing wages to decline in real terms for the first time since 2010. Growth also remained imbalanced and both public- and private-sector debt increased between 2019 and 2021. Monetary tightening started too late in 2021 and has remained very limited since the start of 2022. The external shock caused by the conflict in Ukraine will only make the slowdown worse. Any improvement in the budget deficit will be delayed by the cost of dealing with refugees. It will be the task of monetary policy to ensure financial stability in the current exceptional circumstances.

GROWTH IS STALLING AND REMAINS IMBALANCED

Romania's economic recovery has stalled. After rebounding between mid-2020 and mid-2021, GDP growth slowed significantly in Q3 and activity was flat in Q4. Unlike other Central European countries that are EU members, Romania has seen a decline in domestic demand. The contribution of foreign trade has become positive again, mainly due to a fall in imports. Weaker GDP growth is mainly due to a slowdown in consumer spending. Wage growth slowed from 8.1% y/y at the end of 2020 to 7.1% at the end of 2021, while inflation surged from 2.1% in December 2020 to 8.2% a year later. The increase in Covid-19 case numbers between January and September last year also affected consumer confidence.

Moreover, slowing growth remains imbalanced, with falling exports and investment partly offset by private-sector consumption and general government spending. Private and, above all public indebtedness have increased. In 2021, loans to households rose much more quickly than nominal wages (11% versus 7%), and the gap between the growth rate in lending to businesses and nominal GDP growth was even larger (21% versus 10%). Fortunately, between 2015 and 2020, gaps were inverted so debt ratios fell significantly.

Now, the public-sector debt ratio is much higher than it was in the mid-2010s. That is largely due to the 2020 recession and the fiscal plan. However, in 2021, the general government budget deficit remained too high to stabilise the debt ratio, despite nominal growth exceeding sovereign bond yields. In addition, not even the economic contraction was able to reduce the current-account deficit, which continued to deteriorate, rising to almost 8% of GDP in H2 2021.

At the end of 2021, therefore, the twin deficits were well above warning thresholds. For the moment, they are covered by surplus domestic savings (the ratio of bank deposits to bank loans was 109% in September 2021 as opposed to 104% at the end of 2019, producing additional resources equal to 2% of GDP between those two dates), as well as by EU funding and FDI flows (3% of GDP each). External liquidity is not a source of concern because the usual metrics (coverage of imports and of short-term debt by foreign exchange reserves) remain satisfactory. However, the general government's external debt has significantly increased since 2019 – from EUR 39.8 bn in December 2019 to EUR 47.6 bn in September 2021 – in order to fund the budget deficit. It now makes up around 45% of total public-sector debt as opposed to around 40% at end-2019.

THE DRAG ON GROWTH WILL LAST

The war in Ukraine has not adversely affected Romania's exchange rate, since the RON has remained practically stable against the euro since mid-February. However, the local currency 10-year sovereign bond yield has risen by 140 bp to 6.8%. That increase is 2.7 times the increase in official interest rates, which reflects both the presence of non-resident investors in the domestic debt market and their more selective approach in times of stress.

As for most countries in Central Europe and the Balkans, the conflict in Ukraine is likely to have a greater direct effect on foreign trade than in most of emerging countries. However, unless major contagion effects are seen within the EU, the impact on Romania's economy could be limited, because exports to Russia and Ukraine amount to only 3% of total exports.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth, %	4.1	-3.4	5.8	1.5	3.0
Inflation, CPI, year average, %	3.8	2.6	5.0	10.0	5.0
Gen. Gov. balance / GDP, %	-4.4	-9.3	-8.0	-6.9	-6.6
Gen. Gov. debt / GDP, %	35.3	47.3	50.5	53.0	55.6
Current account balance / GDP, %	-4.6	-5.2	-6.2	-7.0	-6.5
External debt / GDP, %	49.2	57.7	56.0	55.0	52.0
Forex reserves, EUR bn	31.7	36.2	37.1	36.0	36.0
Forex reserves, in months of imports	4.5	5.6	4.9	4.2	4.0

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

ROMANIA: RATIO OF NET AVERAGE WAGE TO INFLATION

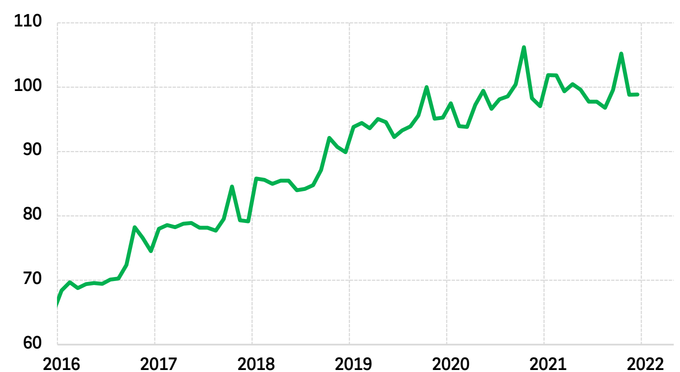

CHART 1 SOURCE: INS

However, inflation is likely to remain a drag on growth, since it has continued to rise, reaching 10.2% in March 2022. Yet, the unemployment rate hit a historically low level of 2.7% in March 2022, which suggests that a price-wage spiral could emerge again. The central bank did not start raising its key interest rate until early October 2021. It has only increased it by 175 bp so far, whereas inflation has risen 810 bp since the end of 2020.

UNJUSTIFIED HESITANCY IN MONETARY POLICY

The difficulty for the government and the monetary authorities is to calibrate economic policy correctly so as to bolster growth, reduce the current-account deficit, limit the budget deficit and thereby stabilise the public-sector debt ratio. Standard models for open economies with flexible exchange rate regimes suggest an accommodative monetary policy, because this stimulates growth while limiting the deterioration in external accounts due to the effect of currency depreciation on the trade balance in real terms (Romania's openness rate is relatively high at 57%). In the short term, however, a monetary policy of this kind requires a fiscal tightening to contain consumption (stimulated by low or negative real interest rates) and therefore mitigate the immediate increase in the import bill caused by currency depreciation and higher energy prices. In Romania's case, the tight labour market makes it reasonable to adopt this sort of compensatory fiscal policy, even in the current context of slowing global growth. In addition, foreign currency debt - not just the one of the State but also the one of corporates and households (respectively 32% and 17% of bank loans) - requires a stable exchange rate. Finally, there is very little scope for safely maintaining a loose monetary policy, which could potentially damage the solvency of all Romanian economic agents.

It is even less justified taking into account the budgetary stance and the exceptional public spending made necessary by the Ukraine conflict. Yet, before the war broke out, no major improvement was expected from budget laws and fiscal deficit forecasts. In November 2021, the European Commission forecasted a fiscal deficit equal to 6.9% of GDP in 2022 (6.3% according to Romania's revised budget law) and 6.3% in 2023. However, between 70,000 and 100,000 Ukrainians, mainly women and children, have now sought refuge in the country. The Romanian government will have to foot the bill – including accommodation, basic essentials, medical assistance and schooling for children – at least temporarily, until the EU's EUR 17 bn of emergency refugee funds[1] is paid to countries on the "front line" (including Poland and Romania). Although complacency is still be required of investors in Romanian sovereign debt this year, fiscal consolidation will have to take place in 2023. In the meantime, however, it will mainly be the task of Romania's monetary policy to ensure financial stability in the current exceptional circumstances.

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ROMANIA: INTEREST RATES & INFLATION

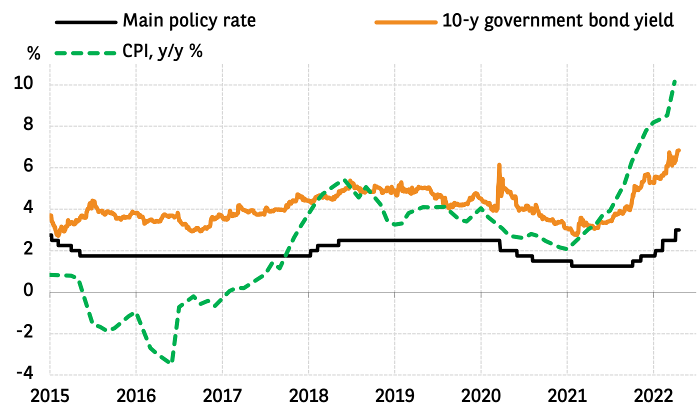

CHART 2

SOURCE: INS, BNR, MACROBOND

1 Exceptionally, 100% of the cost will be covered by cohesion funding (versus the usual 85%) until June 2022, funding provided for in the 2014-2020 budget but still unused is being released, and other earmarked funding is being reallocated (ERDF, REACT-EU).