

Romania

Walking on a tightrope

Romania's economy has become gradually unbalanced in recent years, ending 2019 with significant twin deficits, i.e. both a fiscal deficit and a current account deficit. An accommodative fiscal policy has stimulated growth and should continue to do so. Even so, Romania will not avoid a contagion effect due to the COVID-19 pandemic's economic fallout. The country is bound to slip into recession even though growth has already dwindled. Though foreign currency liquidity is still sufficient, its relatively low level could constrain monetary policy: a stable exchange rate is key for an economy that still has a significant amount of euro-denominated debt, albeit much less than before.

■ Romania will not avoid recession

In 2019, Romania's economy showed a few signs of cyclical overheating, with strong wage pressures (+11.6% y/y in November 2019), a resolutely expansionist fiscal policy, and a current account deficit that swelled to 4.7% of GDP in 2019.

Before the COVID-19 shock, however, growth was already beginning to wind down, notably due to the slump in the European automobile sector (23% of Romania's merchandise exports), which carried over to Romania's industrial production, with automobile production declining 4.3% y/y (3-month moving average for the period ended 31 January).

According to cyclical surveys available through March, household spending should weaken as consumers take into account their past and future loss of purchasing power, which should lead them to scale back plans for durable goods purchases. In 2019, household consumption contributed 4 percentage points (pp) of the country's 4.2% growth.

The COVID-19 shock will squeeze exports, which have already been in the midst of a slowdown (+1.9% in 2019 vs. +8.1% in 2018). Sluggish European demand (77% of Romania's merchandise exports) was already accompanied by plant closures, especially in the automobile sector. The expected decline in exports is likely to cut GDP growth by 4 percentage points. Faced with this environment, investment should contract by nearly 10% in 2020, after increasing 5.6% a year during the two previous years. Wage growth is also expected to halt abruptly, straining household consumption. Tourism will also be affected, but at 3% of GDP, its weighting is relatively small despite the sector's vibrant growth in recent years.

All in all, Romania is likely to report negative growth in 2020, estimated at -4.8%. Running a current account deficit, however, growth is dependent on the international situation, notably for financing. The main cyclical support factor will be the decline in oil prices, which are expected to average USD 38 a barrel this year, down from USD 65 in 2019. This should help hold down inflation to 2.8%, which would give monetary policy a little more leeway.

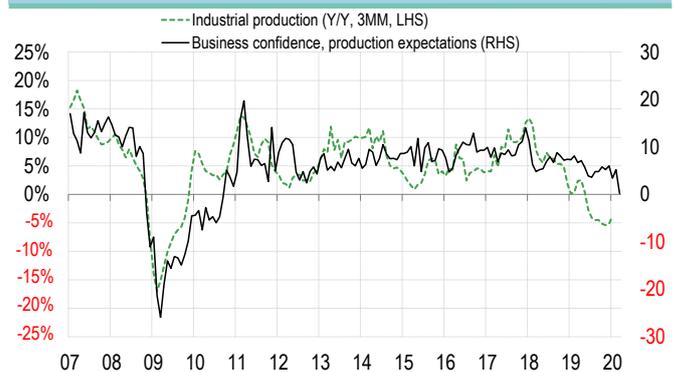
Yet the existence of major twin deficits at a time when financing will be much harder to secure implies a downside risk in terms of economic growth.

1- Forecasts

	2018	2019	2020e	2021e
Real GDP growth (%)	4.5	4.2	-4.8	6.3
Inflation (CPI, year average, %)	4.6	3.8	2.8	3.0
Budget balance / GDP (%)	-3.0	-4.2	-7.5	-5.9
Current account balance / GDP (%)	-4.4	-4.7	-1.9	-3.6

e: BNP Paribas Group Economic Research estimates and forecasts

2- Industrial production and production expectations



Source: Eurostat, DG Ecfm

■ Fiscal policy further at play

In 2019, Romania's public finances were marked by a fiscal deficit of 4.2% of GDP, which exceeds the 3% limit set down in the European treaties. The prospects of another budget overrun would have triggered an excessive deficit procedure. But with the COVID-19 crisis and the fiscal policy responses EU member states have taken, there is likely to be more leniency towards the 3% rule. Consequently we expect to see Romania's fiscal deficit continue to widen.

The first reason is that the ruling coalition led by Prime Minister Ludovic Orban's National Liberal Party (PNL) managed to stay in power, and a new government was formed in March 2020 (legislative elections are scheduled for December 2020). Last year's decision to increase pensions by 40% should take effect in September 2020. The second reason is the economic stimulus package that was adopted to cope with the impact of the COVID-19 crisis (2% of GDP). The stimulus includes funding for partial unemployment (to maintain 75% of wages), guaranteed loans for



SME (RON 10 bn initially, 1% of GDP), and the deferral of corporate tax payments due in the second quarter.

The government has also postponed loan repayment scheduled for companies and households for the next nine months, and stipulated that the cost of the measure would be carried by public finances, and not the banks, which would not need to set aside provisions. This is an important measure because it ensures that Romania's banking sector will have the capacity to absorb the rise in non-performing loans. Non-performing loans are still substantial, accounting for 4.6% of loans outstanding in Q3 2019, even though they have fallen sharply from the 2013 peak of 22% of loans outstanding. The reduction in the loan to GDP ratio (from 40% in 2008 to 26% at year-end 2019) is a risk-mitigation factor, but it must be paired with another risk factor: the steady increase in household loans (+27% over the past three years).

The Central Bank has also cut its key rate by 50 basis points to 2%, and narrowed the interest rate corridor. This reduced the Lombard rate, the key lending rate, by 100 bp to 2.5%, which is designed to help pull down interbank rates. It also implies the stability of the deposit facility rate (1.5%), to avoid penalising the Romanian leu exchange rate (RON). Despite a few ups and down, the leu had only lost 1% against the euro at the end of March 2020 compared to year-end 2019. The central bank also declared that it would provide the banking system with as much liquidity as necessary, via repo operations and purchases of RON-denominated public debt, to maintain liquidity at satisfactory levels. The central bank also said it was considering easing monetary policy further, either through policy rate cuts or lowering the required reserve ratio of banks.

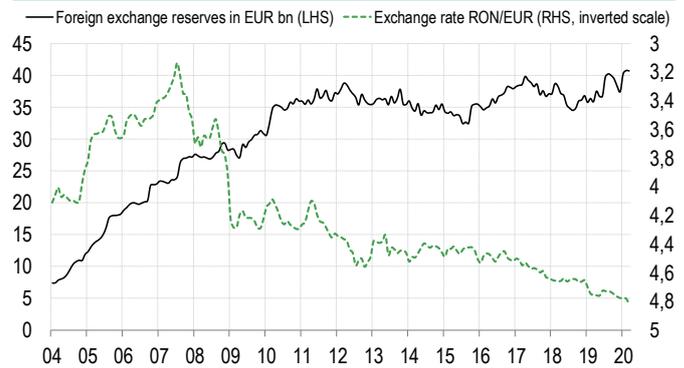
■ Twin deficits are limiting policy mix leeway

The public deficit is expected to widen sharply in 2020, to -7.5% of GDP, reflecting fiscal policy measures but also the impact of the probable increase in unemployment (4% of the active population at year-end 2019). Romania's twin deficits increase its vulnerability to a deterioration in financing conditions: 10-year yields on government local currency bonds rose to 5.8% on 16 March. Central bank purchases of public debt helped stabilise rates at 4.8% at the end of March, which is still high (close to the March 2019 level, even though inflation is lower now).

Until 2019, however, the widening of the fiscal deficit did not have a very big impact on the level of the public debt (36% of GDP in 2019), mainly because nominal growth was sufficient to stabilise the debt ratio. Things will be different in 2020 as the deficit widens and nominal growth declines. The public debt ratio could rise to 40% of GDP, which is still a reasonable level.

Yet the sharp drop in oil prices will reduce the current account deficit significantly, on top of a volume effect (fewer imports due to a contraction in domestic demand, notably due to a decline in investment). As a result, we are looking for a current account deficit of only 1.9% of GDP in 2020, vs 4.7% in 2019. This will limit the risk of a decline in foreign reserves, offsetting a possible contraction in capital flows. In September, Romania's sovereign debt will be incorporated in the Barclays Global Aggregate index, which should

3- Foreign exchange reserves and exchange rates



Source: CEIC

be supportive. Yet there is also the risk that the rating agencies could downgrade its sovereign rating due to the wider fiscal deficit.

Our central scenario still calls for a mild depreciation in the exchange rate towards RON 5 to the euro by the end of 2020 (from RON 4.83 at the end of March), even if there is further monetary easing. If the leu were to depreciate significantly, the risk would be much more moderate for households, whose foreign currency debt has declined from 60% of total household debt at year-end 2014 to 24% at year-end 2019. For non-financial companies, 42% of domestic credit is still denominated in foreign currencies (essentially the euro).

At 50% of GDP at the end of 2019, external debt has been cut back sharply thanks to debt reduction efforts following the 2013 crisis. It has begun to rise again in recent years for two reasons: government borrowing (EUR 40 bn in external debt) and intercompany loans (EUR 32.7 bn). Adding short-term debt to long-term debt reaching maturity in 2020, the total amount of external debt maturing in 2020 reaches USD 56 bn, the majority of which are intercompany loans. In a central scenario in which the financial consequences of the COVID-19 crisis remain moderate, this debt should be rolled over (since these loans are often tied to foreign ownership).

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