2. ECONOMY

MID-2003 MACROECONOMIC HIGHLIGHTS

Focus

Romania's target date of admission in the European Union is 2007. At the last summit, in Thessalonica, the EU leaders restated their encouragement for and support to Romania so that it joins the Union by 2007. Likewise, they nudged the Romanian government to pursue unrelentessly required reforms with regard to industrial restructuring, public administration and the judiciary system.

This analysis aims at presenting a succinct overview of economic developments in Romania and likely immediate prospects at the end of the first half of 2003. In order to make this brief assessment it pays to consider some premises which are rooted in the economy's dynamics.

Macroeconomic Premises

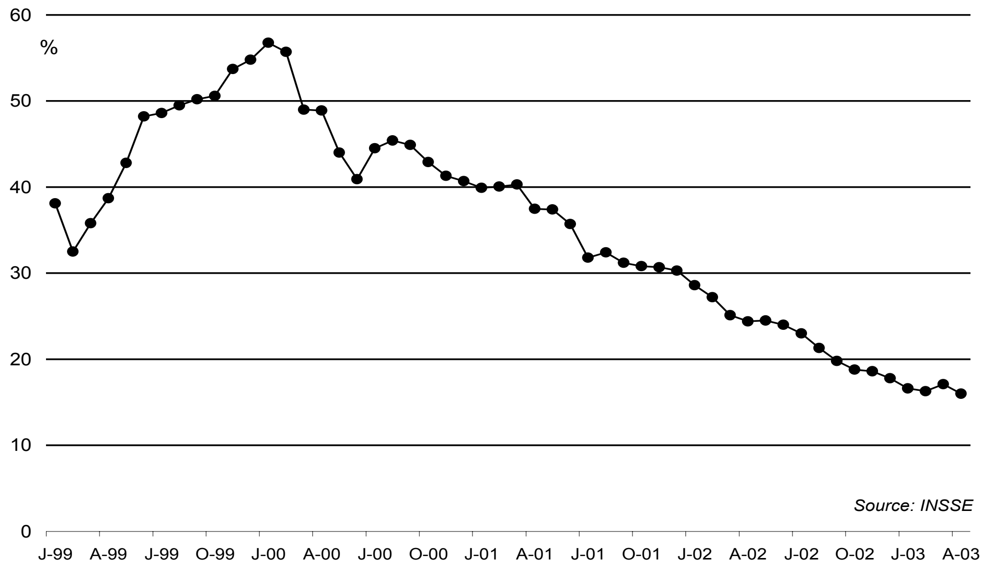
Economic recovery has continued after years of massive decline of overall production and a drastic balance of payments adjustment in the late 90s. The rise in the GDP has been quite rapid in the last couple of years, which matches an evolution one encounters in other accession countries as well. The increase of the GDP in the first quarter of 2003 was estimated by the National Institute of Statistics at 4.4%, albeit a question mark arises in this respect in view of the slowed down pace of industrial production and services during that quarter (these sectors have grown by 2.5 and, respectively, 3.6% in the same period).

Disinflation has been well underway (Fig. 1) and the economy is moving toward the single digit frontier, which would mark a major achievement as against the past decade. Arguably, the USD depreciation (vis-à-vis Euro) in 2002 played a significant role in mitigating inflationary expectations and a quasi-exchange rate based stabilization program operated last year

Romania has been running relatively small current account deficits in recent years – below 4% in 2002 (Fig. 2); these deficits have bolstered the country's credentials to get improve ratings and access more cheaply foreign capital markets. As a matter of fact, Romania received better ratings from the main agencies in 2002 (BB-), but is still several notches below an investment grade. Budget deficits of around 3% were registered in the last few years, which meet the benchmark set by the Maastricht criteria for EU accession; in 2002 the budget deficit was –2.67%. The economy has a low external indebtedness, of cca 30% of GDP (Fig. 3) and a small part of it is short-term; this fact helps to access foreign capital markets.

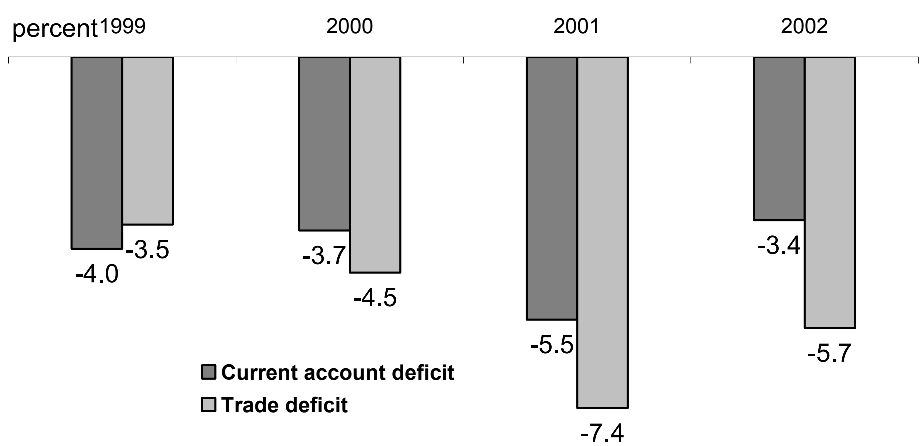
There has been a large expansion of trade in recent years, but low value added products continue to hold a major share. Likewise, domestic credit has grown quite rapidly in the same period of time, which supported the growth of the non-governmental sector, of the economy in general. Capital account liberalization is programmed to be completed, in the main, by 2004. Two restrictions are, however, put in place; one regards transactions in the Romanian money markets by non-residents and purchases of land by non residents.

Fig. 1. Inflation Rate (CPI)
change against the same period of the previous year



Source: INSSE

Fig. 2. Current account and trade deficit, % of GDP



Source: National Institute of Statistics, National Bank of Romania

Fig. 3. Macroeconomic indicators

		2000	2001	2002	2003*	2004*
Real GDP, % change		2.1	5.7	4.9	4.5(?)	4.5(?)
Inflation (CPI)		40.7	30.3	17.8	13(?)	10(?)
Budget deficit		-3.5	-3.3	-2.7	-2.7	-3.5
Current account deficit		-5.7	-5.6	-3.6	-4.5(?)	-5
Official reserves (bn USD)			4.8	7.1	7(?)	
Total ext. debt…	% GDP,		31	35	32	34
	% of exports		81	85	85	
Interest payments, % of exports			4.1	3.8		

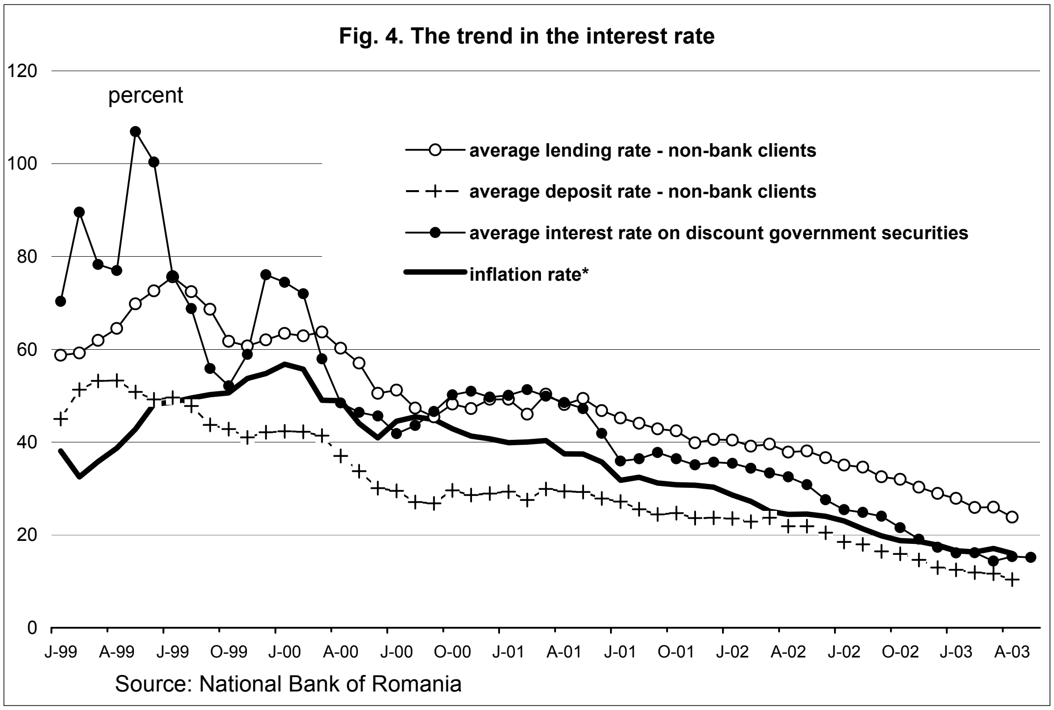
*Source: National statistics and own estimates; *forecast*

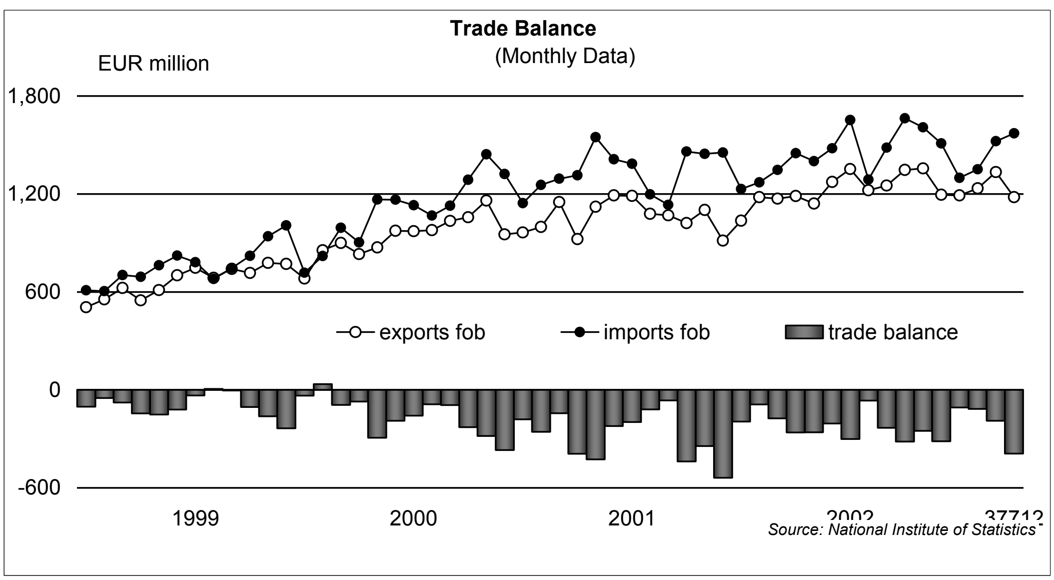
The macroeconomic premises underlined above need to be judged against the background of a series of structural features of the Romanian economy which condition its future dynamics:

- whereas the private sector accounts for more than 66% of GDP, financial indiscipline continues to be quite high –arrears afflict the energy sector in particular (the losses in this sector amounted to cca 2% of GDP in 2002, according to some estimates);.
- there is an ongoing crisis of social security, which is due primarily to the stark imbalance between active and retired population and its aging;
- while the banking sector is much cleaner currently (as evidenced by the small share of non-performing loans) than in the late 90s, there is heavy dolarization of the economy (60% of deposits are hard currency denominated)
- monetization is low (M2 is only 25% of GDP), which exposes the economy to the impact of large swings of capital flows and implies high costs of sterilization for the Central Bank; the low monetization reveals some pitfalls of a two fast liberalization of the capital account;
- the low current account deficits of recent years have been enhanced by rising remittances from abroad (over 1.5 billion USD in 2002) --Romania has become a significant exporter of both skilled and unskilled labor.

Macroeconomic Policies in 2002 and 2003

In order to continue disinflation simultaneously with economic growth macroeconomic policy has relied on a special complexion of its mix. The main traits of this policy mix have been: (a) keeping the budget deficits low and relaxing the tight monetary policy, so that the latter supports economic recovery (Fig. 4); (b) a real exchange rate appreciation as against a currency basket, in order to help disinflation; and (c) declining lending interest rates in ROL (the domestic currency) in order to enhance domestic credit, at a time when hard currency denominated credit grew, arguably in excess.





There are several domestic and international developments which have provided the context of implementation and conditioned the efficacy of the policy mentioned above:

- a sharp appreciation of the Euro vs. the USD which has complicated the exchange rate policy and, probably, imparted an inflationary bias to this (the still high inflation rate in Romania and an exchange rate appreciation policy as against a currency basket makes it such that, when the Euro appreciates too sharply against the USD the implied ROL's depreciation against the single currency creates some inflationary pressure);

- the ongoing recession in the European Union, which cuts from the stimulus to Romanian exports (which have been driving economic recovery in 2001 and 2002);
- the great uncertainty in the world economy and the high risk aversion of investors, which makes them highly discriminatory among emerging markets; consequently. there has been more reliance on domestic demand for growth in 2003 (than in 2002);
- a growing current account deficit in 2003, which is not surprising in view of the economic recovery and bigger imports related to domestic investment;
- considerable arrears in a period of disinflation, which perpetuate substantial quasi-fiscal deficits and may imperil future public budgets;
- a nervous domestic foreign exchange market due to capital outflows, and, probably, less capital inflows (errors and omissions turned negative in 2002, to –776 million USD, and reached 654 million USD in the first quarter of 2003)

The goals of macroeconomic policy in conjunction with the developments highlighted above create a set of policy challenges for the second half of this year and 2004.

Challenges and Risks for Macroeconomic Policy in 2003

What can slow down economic growth?

The rise in the GDP was estimated at about 4.4% in the first quarter of this year by the Institute of national Statistics. More than this number in itself (which includes household and underground output, with these components evincing the most rapid expansion) the figures concerning industrial production and services – which, together, account for over 75% of GDP, give some pause for thought. It the dynamic of these sectors does not speed up, on average, in the other three quarters the official GDP target for 2003 would be hard to attain. In addition, the very likely poor agricultural output would make this outcome more probable. The bottom line is: the dynamic of the GDP needs to be examined in the context of the overall macroeconomic performance; what matters for Romania, essentially, is to have sustainable growth together with disinflation and easily financed current account deficits.

What can cause an inflationary slippage?

A possible cause of an inflationary slippage could be a continuing sharp appreciation of the euro (against the USD) in keeping with the exchange rate policy practiced by the NBR in the last couple of years. Some argue that this appreciation is not threatening since the USD would, still, shape inflationary expectations in Romania and a large portion of imports is dollar denominated. I find this argument insufficiently convincing for several reasons: already, many transactions and prices are related to the euro once the single currency became, officially, the reference currency on last March 1st; moreover, basic excises (especially for gasoline) are calculated in the euro, whose nominal and real appreciation vis-à-vis the ROL has been quite high in the first five months of this year. In the first five months of this year the ROL depreciated vs. the Euro by cca 8% in nominal terms and by more than 2% in real terms. At the same time the ROL appreciated both nominally and really vs. The USD. This is why it makes sense to think about how a possible negative influence can be counteracted?

There are two basic scenarios in this respect. One scenario bets on a USD recovery, which would provide an enormous bonus to disinflation in Romania by reproducing the circumstances of last year. In addition, a decline of the euro would relieve the pressure of the rise in various excises. But this scenario, although with a reasonable likelihood to occur in view of the growth differentials between the USA and the Euroland, is not a policy contingency plan per se.

The other scenario regards a further appreciation of the euro during 2003, however implausible it may seem to some. But policy making has to consider such a situation. Should it happen and should the Central Bank not resort to an excessive appreciation of the ROL (as a means to combat the inflationary pressure), a tighter monetary policy may have to be implemented. But a tightening of monetary policy would raise, or slow the decline of the cost of borrowing, which would impact growth negatively. On the other hand, higher interest rates would relieve the strain in the forex market (a negative effect would be, however, a further stimulus to demand for hard currency denominated borrowing). Consequently, the National bank of Romania would have to calibrate very cautiously its instruments so that it balances the simultaneous goals of sustained growth and disinflation; a good calibration would avert a too visible trade-off.

How appropriate is the level of interest rates?

The second half of 2002 and the first five months of this year have witnessed a rapid decline of interest rates. Aside from the need to bolster economic growth the decline of lending rates for ROL-denominated credits was seen as a tool to mitigate the risks of excessive hard currency denominated borrowing. But passive interest rates declined, arguably, too rapidly and this has showed up in a drop of ROL denominated deposits in the second quarter of this year (which may reflect. Moreover, the fall in domestic interest rates may have increased the propensity of some capital to flow out of the country, against the backdrop of capital account liberalization. The lesson is: there is need for caution with the speed of lowering interest rates so that bank deposits (n ROL) be not harmed and the balance of payments not strained exceedingly.

Has the expansion of hard currency denominated domestic credit been too rapid?

While the expansion of domestic credit (by more than 25% in real terms in 2002) was widely hailed early on some alarm was expressed by NBR officials lately with regard to the rapid increase of hard currency denominated lending. The concerns revolve around exchange rate risk in view of the wild gyrations on currency markets and the lack of routine of Romanian companies to use hedging for forex risk protection. Some commercial bankers have contended that the NBR's stance in this regard is overcautious since –they assert – most lending is done out of deposits made by residents. However, they seem to overlook that the distinction between domestic credit based on foreign borrowing vs. that based on deposits made by residents is fundamentally dented when the capital account is liberalized – which is the case with current program of KAL in Romania.

Is the rise in imports worrying?

The first five months of 2003 showed a significant rise in imports, which have grown to over 8.7 billion USD, while the trade deficit went beyond 2 billion USD. If this trend continues the current account deficit may approach 5% this year. This level of the deficit should not be of concern were the biggest portion of additional imports made up of capital goods and their financing were done easily. What surprises, however, is that imports have increased so much while the pace of growth of industrial output and services (which make up most of the GDP) was not impressive in the first quarter of this year. It may be that this pace accelerated in the second quarter.

Do arrears pose an increasing threat?

Financial indiscipline continues to plague the Romanian economy and it shows up in substantial arrears. For instance, the losses in the energy sector amounted to about 2% of GDP in 2002 (according to some estimates). Arrears do create quasi-fiscal deficits, which may imperil future public budgets unless addressed in due time. Data for this year are quite scarce, so that an adequate judgment is hard to make in this regard. It is clear, nonetheless, that disinflation strains the balance sheet of inefficient companies, for the latter (and not only) used inflation as a weapon to cut their liabilities in real terms. The evolution of arrears needs to be watched carefully by policy-makers.

Risks in 2004

There is a series of areas of possible concern in 2004, which demand policy makers' attention. Prominent among these is the danger of excessive populist macroeconomics in an election year. Populism may take also the form of imprudent wage policy (unjustified pay rises in the public sector); dangerously declining interest rates, which may fuel again inflation; leniency towards tax offenders, which may worsen financial indiscipline, etc.

The Ministry of Finance has aired the idea of a larger budget deficit in 2004 (of cca. 3.5%), in order to finance additional infrastructure projects. Can Romania afford a higher budget deficit? The IMF would likely oppose such a move in view of the disinflation effort and the need to reduce crowding in the economy. The Maastricht criteria would also point against such a rise. However, there may be leeway for the Government to increase the budget deficit assuming that: financial discipline improves in the economy and quasi-fiscal deficits go down; most of the rise in the budget deficit is financed externally and, thereby, crowding out is limited; and last, but not least, the rise in the budget deficit is used exclusively for the purpose of infrastructure work. All this said, the Government would have to realize that increasing the budget deficit, unless it is accompanied by a remarkably disciplined policy making, poses significant risks –especially in an election year. And major slippage, of any sort, would undermine credibility, in a critical period for improving Romania's credentials to join the EU and bring her rating nearer to an investment grade.

Another area of concern is the fragility of the non-bank financial sector, which asks for resolute action and a strengthening of supervision activity. Should capital outflows go on at an excessive pace a reassessment of the current program of capital account liberalization would be needed.

As a matter of principle, policy makers should have at the very top of their agenda Romania's not losing contact with other EU accession countries in terms of economic performance. 2004 is the year of EU entry for seven Central European countries and Romania needs to do much better economically so that 2007 become a realistic admission date.