What Drives the Romanian Economic Growth?

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Plan Of the Presentation

- Romania – Macroeconomic Overview
- Competitiveness – could it be sustained? The relevance of micro factors
- Savings and Investment Macro Balance
- Domestic Credit Growth – a way of building up domestic capital
- Concluding Remarks

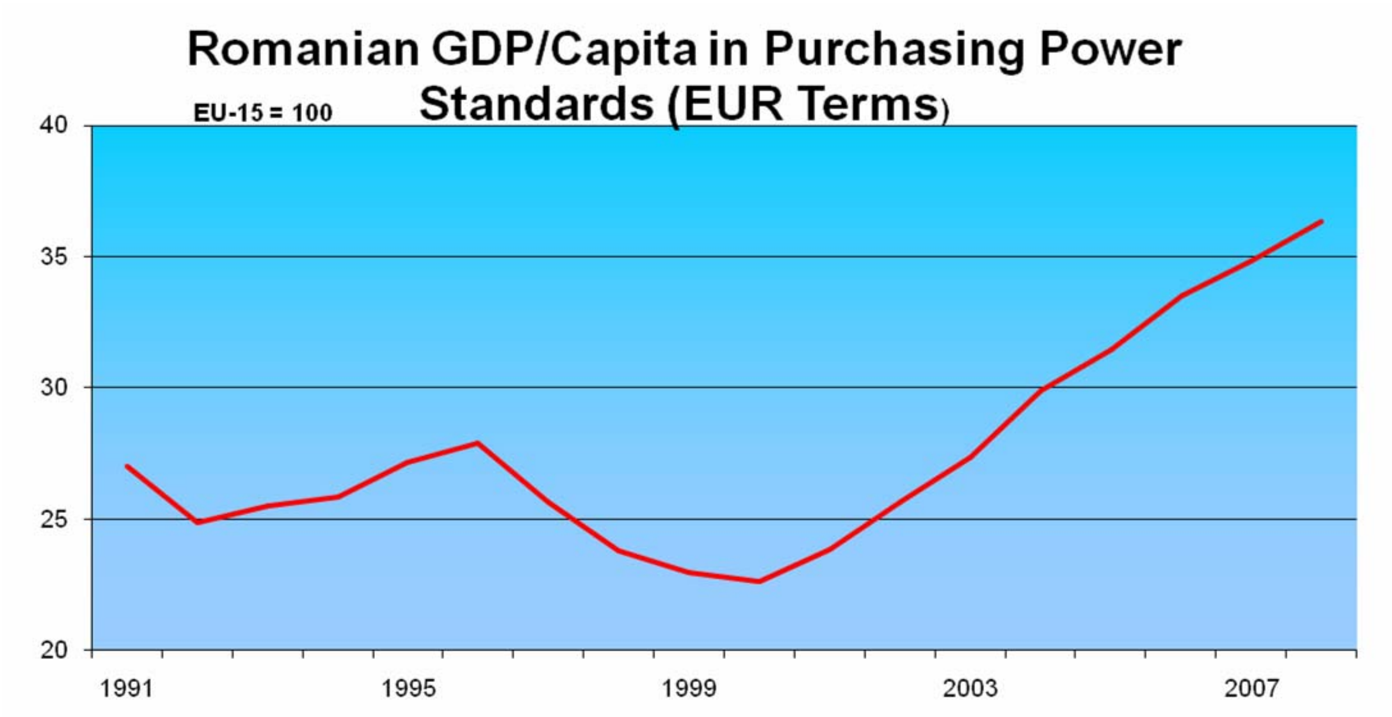
Romania – Macroeconomic Overview (2007 data)

- GDP growth: 6.0%
- GDP per capita: a third of EU average
- End-year inflation: 6.0%
- Budget deficit: 2.4% of GDP
- Low public debt: 18.9% of GDP
- Current account deficit: 14.2% of GDP
- First investment grade from S&P's, Fitch and Moody's but recent changes in outlook from positive to negative

Romania – Macroeconomic Overview (Cont'd)

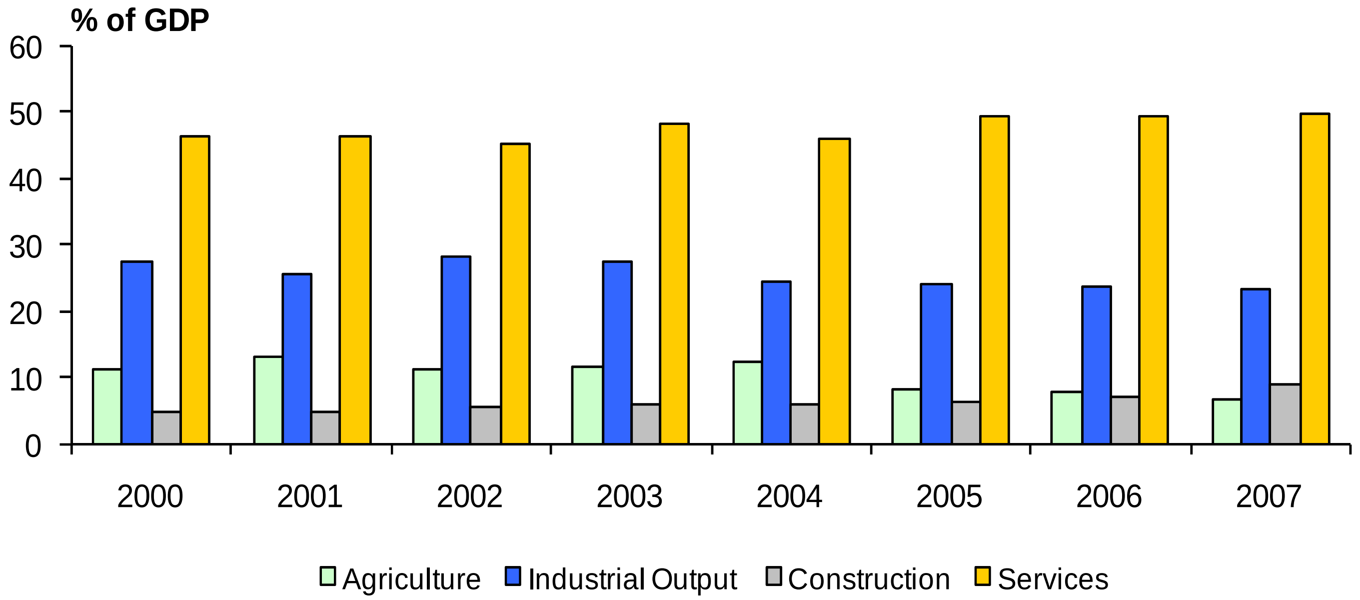
- Capital account opening and EU accession have induced large capital inflows
- A floating exchange rate regime and "soft" inflation targeting
- Economic growth driven by domestic consumption – wages and financial liberalisation effects
- Rising excess demand => so far growing current account gap.
- Growth in non-governmental credit partly lies behind increasing external deficits - limited ability of budget policy to control external deficits
- FDI inflows and privatisation receipts have financed the rise in the CA deficit, but is it sustainable over the longer term?

Romanian GDP Growth, PPS, EU-15=100



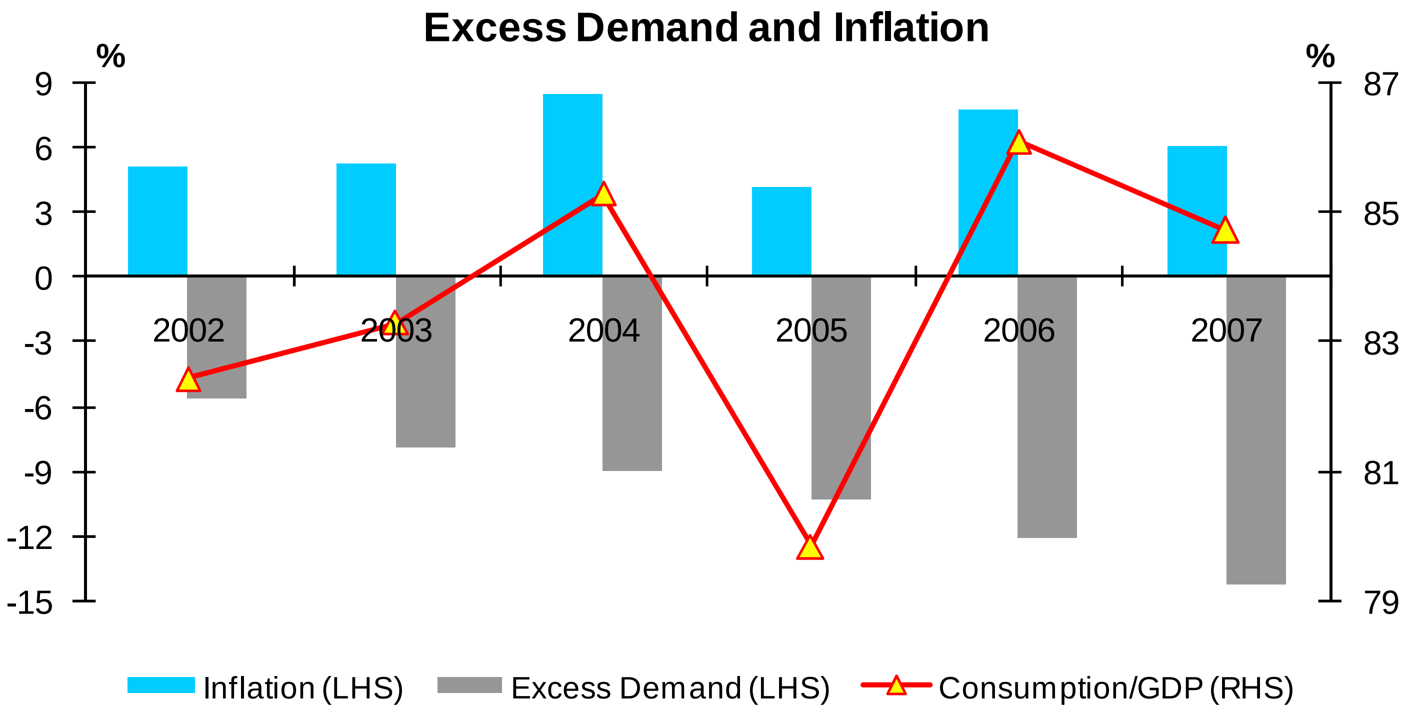
- ➢ Convergence story holds in the Romanian case – expectations of EU accession has played an important role
- ➢ Being a EU member – strong anchor. Coherence and consistence of economic policies

Romanian GDP Structure



- The GDP is becoming ‘lighter’
- Construction and services - main drivers of economic growth
- At the regional level the effects are more visible

Romanian External Balance

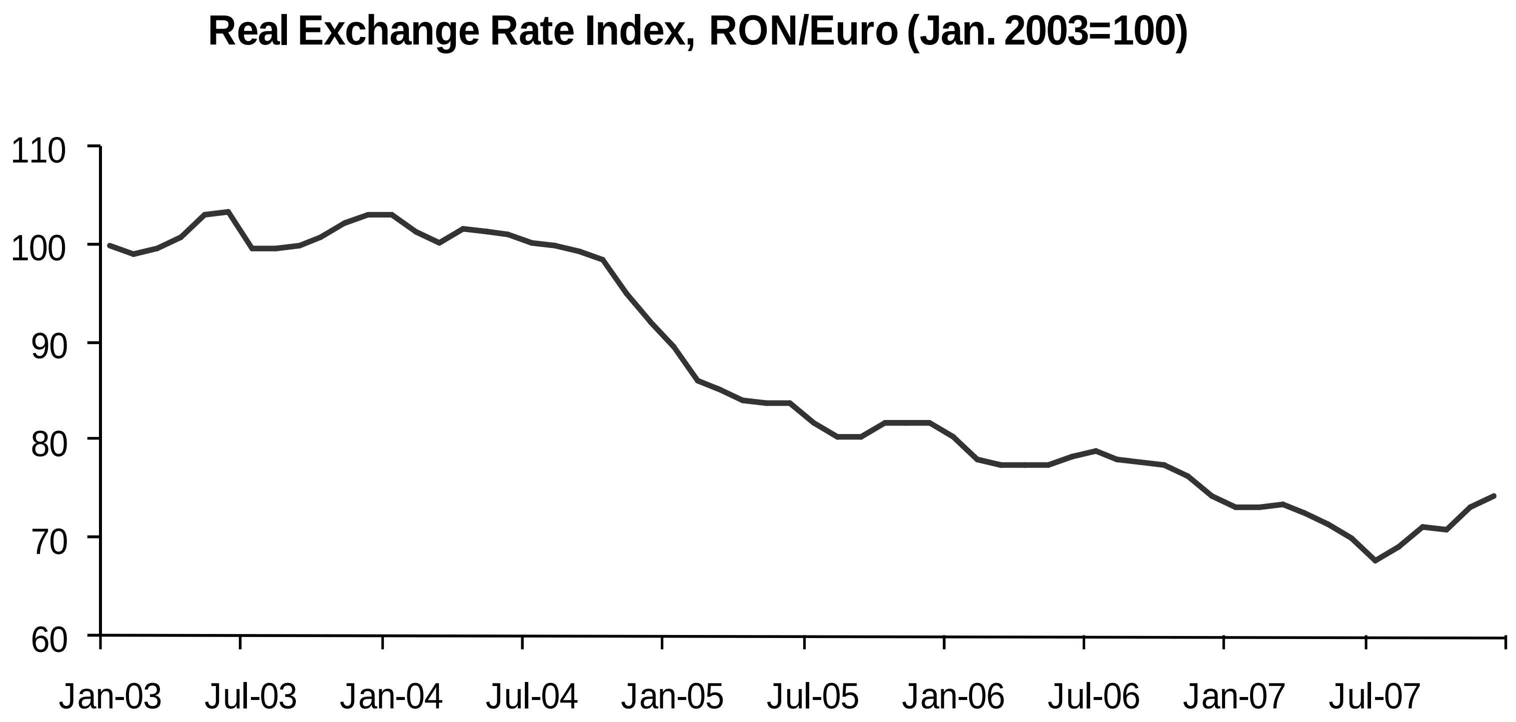


- ➢ Excess demand has been growing fast but early signs in 2008 tend to suggest a mild slowdown
- ➢ Consumption to GDP ratio higher than economic theory would predict

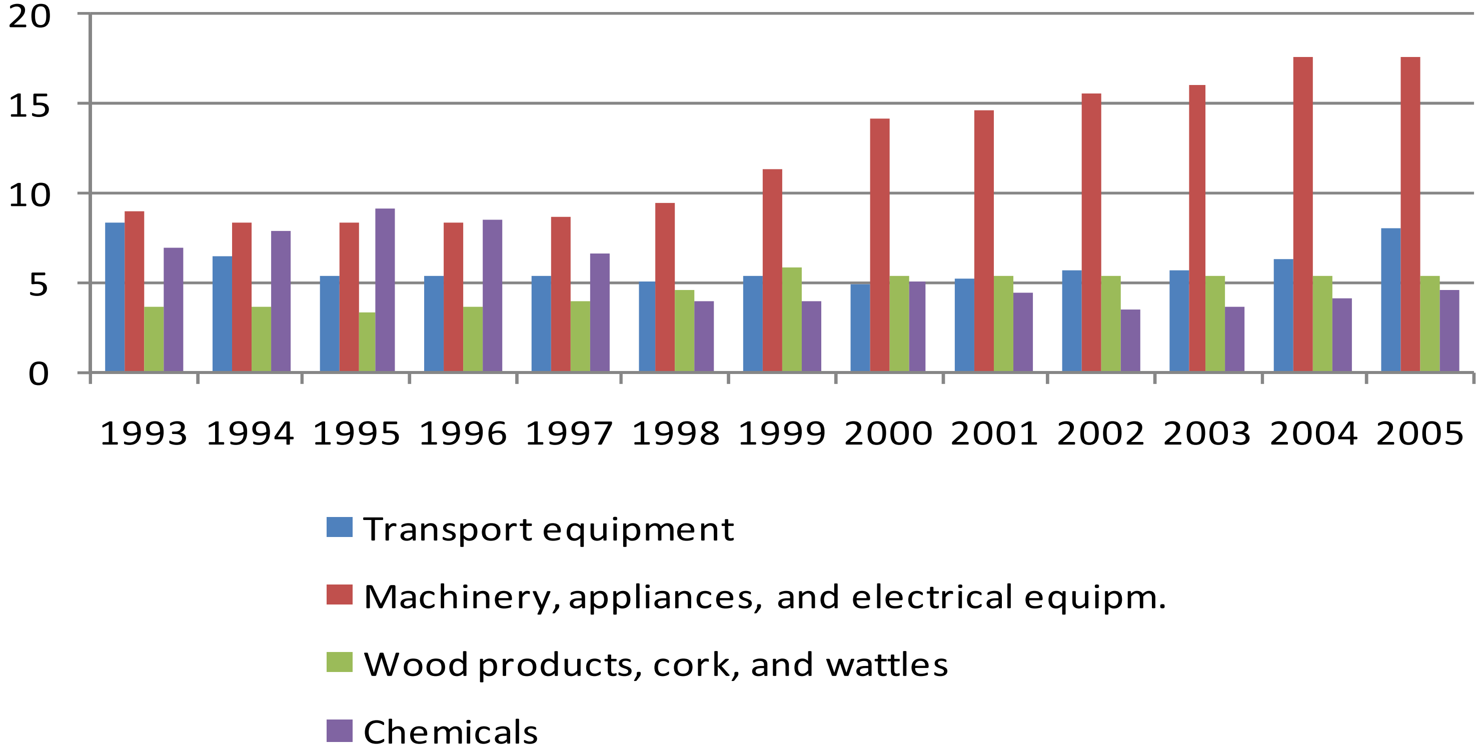
Competitiveness

- A precondition for increased investments in capital
- Romania ranks 73rd on World Forum Competitiveness Index – but intra-domestic regions aspects relevant
- Labour costs
- Real exchange rate
- Tax system (regional aspects)
- Land prices – ‘initial’ pre-2004 values
- Legislation
- Infrastructure?

Romanian Competitiveness

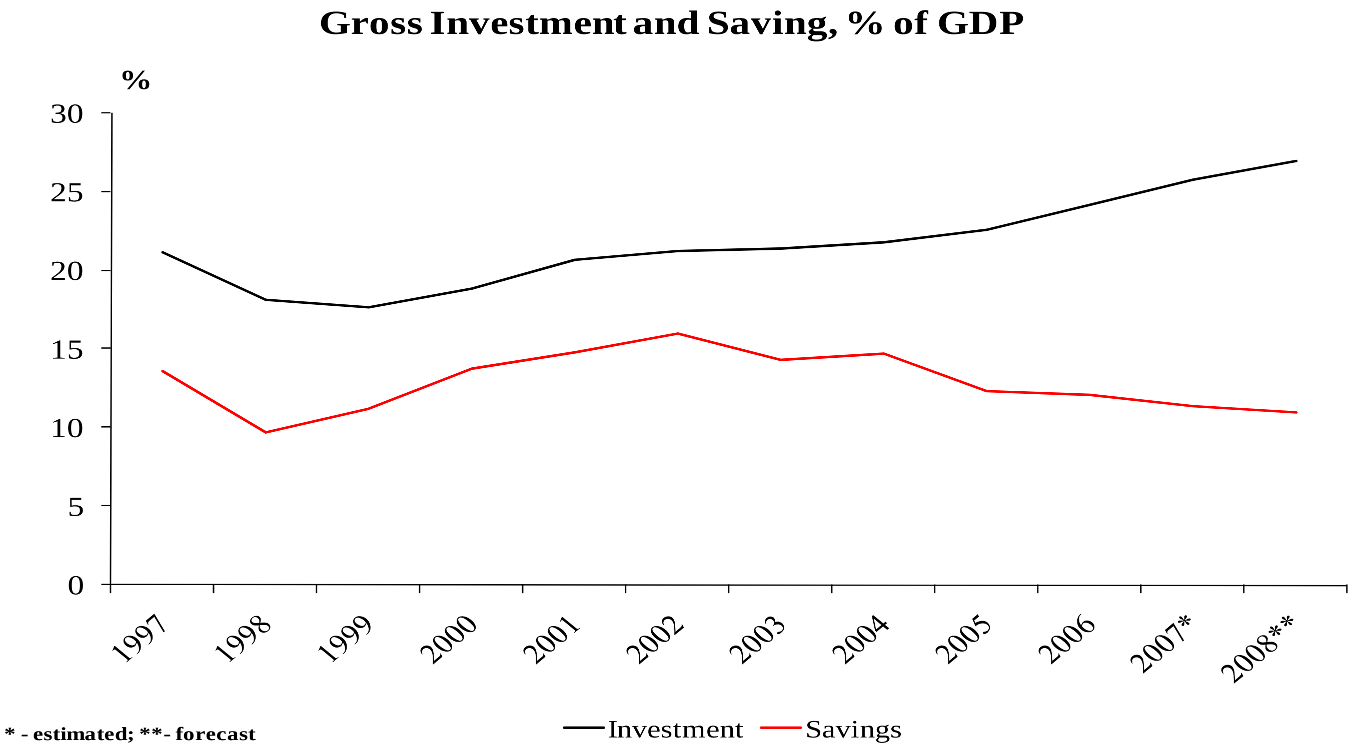


Selected Industries, Share in Total Exports



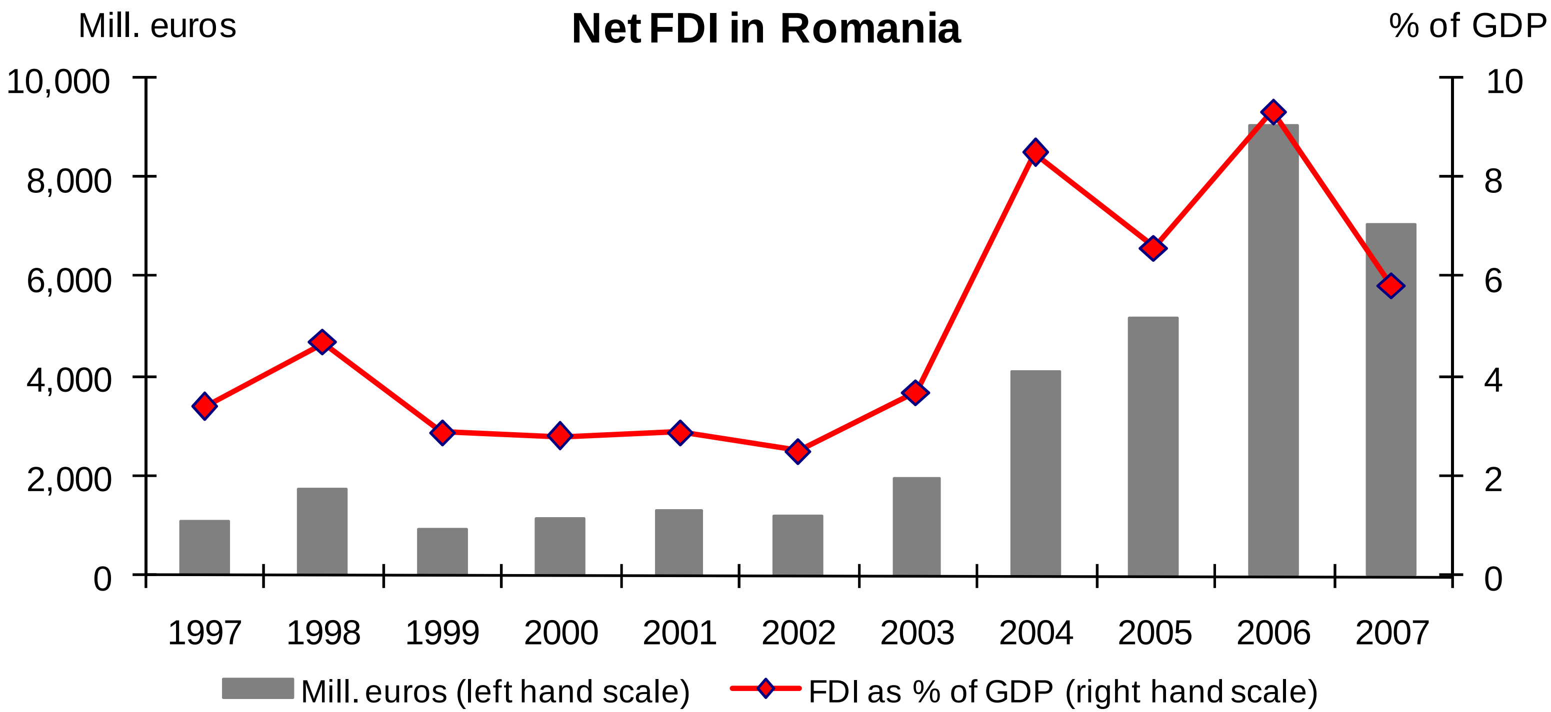
- Investment in selected sectors should have led – subsequently – to their increased performance
- Energy prices played an important role in delaying capital investments

Savings and Investment - Capital Accumulation and Financing



- Saving rate started to fall with the emergence of credit expansion
- Investment rate on a rising trend – low initial base of domestic capital

Net FDI in Romania



Savings and Investment

- Privatisation process - close to the end. Only a few large stakes left – predominantly in the energy and banking sectors
- Presence of several multinationals in various sectors – adoption of coherent development/investment plans
- Banking – Raiffeisen, Erste, Unicredit, ING
- Car Industry: Renault, Ford, Mercedes?
- IT/Telecoms – Nokia
- Energy – E-On, OMV, Gaz de France, etc
- Steel – Mittal
- For instance Petrom (OMV) plans to invest aprox. EUR 1.5bn over the next 3 years

Domestic Credit Expansion. Factors Affecting Credit Supply And Demand

A. Macroeconomic Performance. Reduces uncertainty about future income and consumption/investment. Lower interest rates and inflation also reduce debt service costs.

B. Financial Sector Development. Liberalisation, improved competition, easier access to credit.

C. Housing prices – relevant factor for Romania (high ownership factor)

D. Government/Central Bank Policies. Could restrict/give impetus to credit growth in various areas. Increased competition → lenders with well-developed consumer lending strategies.

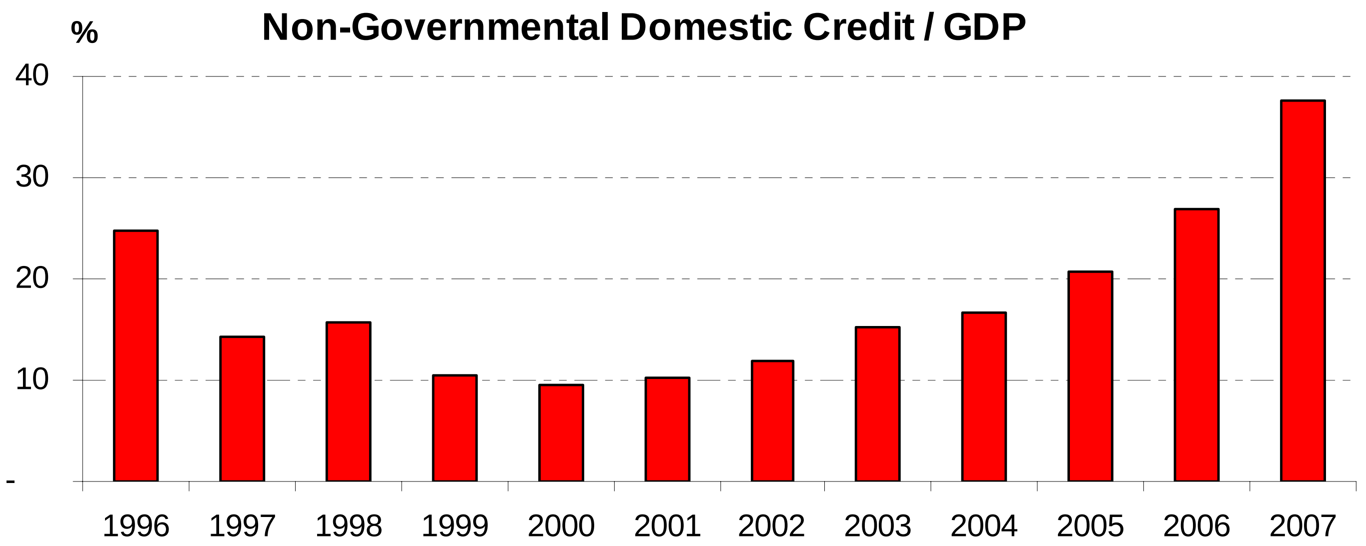
- For Romania: Favourable conditions for A and B, especially since 2001.

Macroeconomic Issues Related to Credit Growth

- How fast should the rate of growth be? Difficult to come up with a number. Romania is in a catching-up phase, starting from an extremely low initial base.
- Is there an appropriate equilibrium level of growth? Again, difficult to say. It depends implicitly on the rate of growth of money supply growth (M2) and net foreign assets (NFA) of the financial institutions.
- Could cause inflationary pressures. Because of increased demand pressures.
- Likely to lead to large current account deficits. Especially due to domestic supply constraints – the case of Romania.

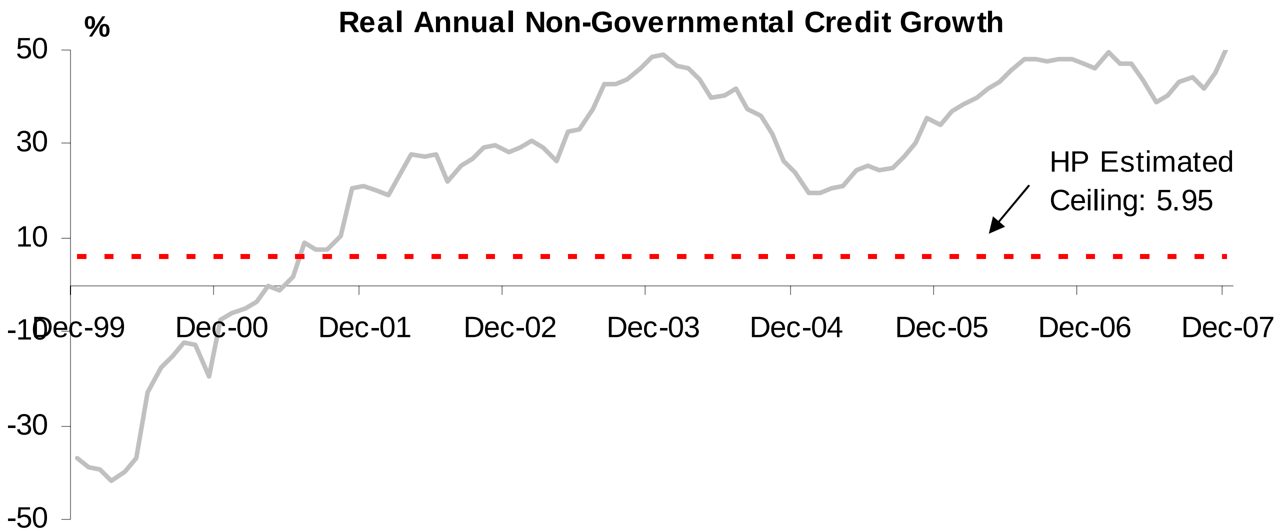
Domestic Credit Growth

- Focus on the non-governmental domestic credit (NGDC).
- Although NGDC/GDP ratio is going up, it is still very low compared to euro-zone economies (over 100%).



Domestic Credit Growth (Cont'd)

➢ Is the current NGDC growth deemed to be excessive? Looking at one measure, the HP estimated ceiling, probably yes since this is much lower than average NGDC growth. But …!



Domestic Credit Growth **(Cont'd)**

- The method does not yield accurate results since it does not look at other variables or the initial level.
- Moreover, although household consumption has been growing at a higher pace than GDP over the last 5 years, net average wages have been overtaking consumption growth!
- If durable consumption goods (i.e. cars, houses, household appliances) are considered as investment then high rates of NGDC growth can be rationalised!

Annual Real Growth	2003	2004	2005	2006	2007*	**Average 2003-2007**
GDP	5.2	8.4	4.1	7.7	5.6	**6.2**
Consumption	6.3	12.8	9.1	12.6	8.9	**9.9**
Net Average Wage	9.4	11.5	12.8	10.7	12.7	**11.4**

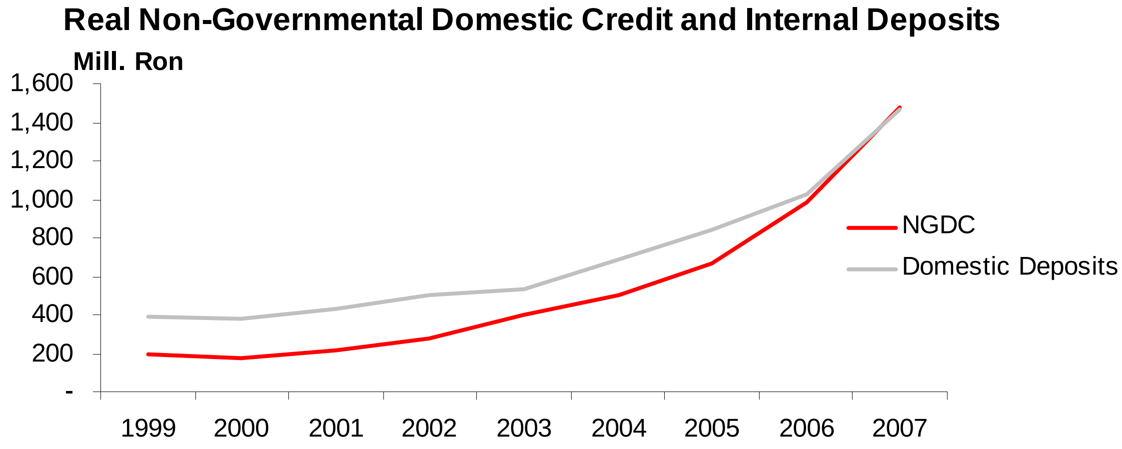
Domestic Credit Growth **(Cont’d)**

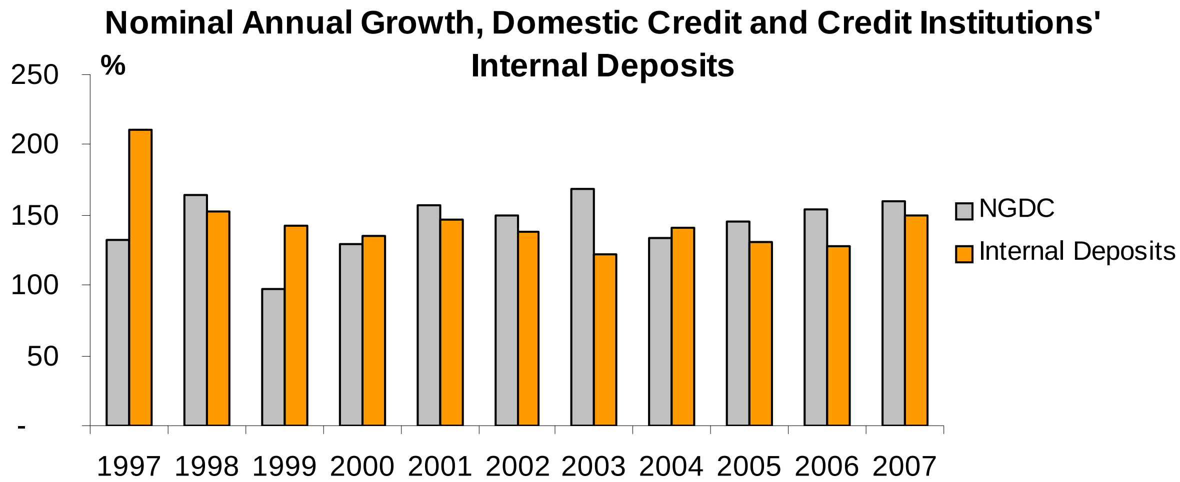
- The share of household credit in total NGDC has been growing continuously reaching 50% at the end of 2007.
- Explained by lower inflation/interest rates, anticipation of Romania joining the EU, increased macroeconomic stability.
- Household real domestic credit growth had a peak at the end of 2003 and afterwards have been growing at above 60% per annum.

Financing NGDC Growth

- It depends a great deal how expansion in domestic credit is financed because of its exposure to different types of risk.
- Possible channels of financing:
  - Foreign inter-bank deposits
  - Debt securities
  - Traditional (internal) deposits
- Romania’s NGDC growth expansion has been financed so far by the increase in the latter i.e. internal deposits. Preferred option since it entails a lower liquidity risk than the other two!

Financing NGDC Growth (Cont'd)





Concluding Remarks

- At the economy level investment in capital formation is still strong – spill over effects
- Physical infrastructure and energy needs in particular important
- Compliance with environmental requirements leads to investments which could lower companies' operating profit
- Domestic credit growth still high – but residential and office construction demand still outpaces supply
- Wage differential still high – competitiveness advantage
- Capital tax levels
- Capital market role – the effect of the privatisation of the pension system

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