ICEG European Center

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Southeast European Monitor

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MONETARY POLICY RATE HIKE IN ROMANIA

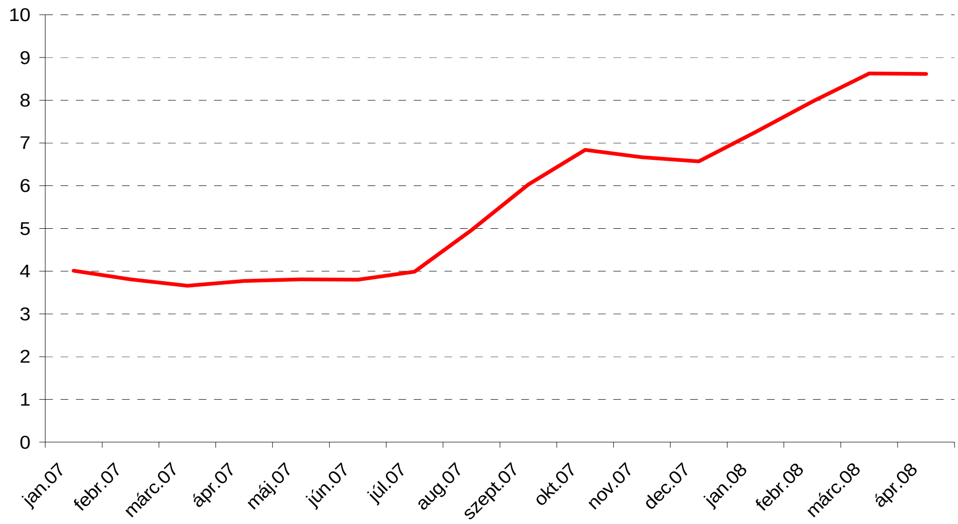
After four tightening steps from the National Bank of Romania since last autumn, in its meeting of May 6 2008, the Board of the National Bank of Romania also decided to hike the monetary policy rate by 0.25 percentage points up to 9.75 percent. That means an amount of 2.75 percentage points increases since October.

In the press release, the monetary authority justifies the decision by the climbed inflation rate of 8.63 in March related to the 6.57 percent in December 2007.

FACTS

As the following chart shows, the monthly, year-on year inflation jumped to an upward tendency in the third quarter of the year 2007, and increasing steadily. In the firs quarter of 2008 the 12-month inflation rate reached 8.63, which is fairly above the upper limit of the central bank's inflation target band of 3.8±1% for 2008.

CHART 1. EVOLUTION OF THE CPI INFLATION IN ROMANIA, 2007-2008 (%)



Source: National Bank of Romania

One could distinguish four main factors of the inflation developments, as the National Bank of Romania do as well in its Inflation Report. All of these determinants contribute to the shifts upward in the inflation movements and strengthened the upside risk around the central forecast projection.

SUPPLY SIDE FACTORS

From the mid of 2007 many worldwide, supply side shocks appeared, which had been a very persistent effects on the open economies. The increasing prices of raw materials, the crude oils and the food price jumps also meant a worsened international inflation circumstances. Furthermore, the annual growth rate of the administrated prices reached 8.5 percent in March 2008. In addition, the subprime mortgage crisis, began in the United States, has a huge uncertainty-enhancing effect.

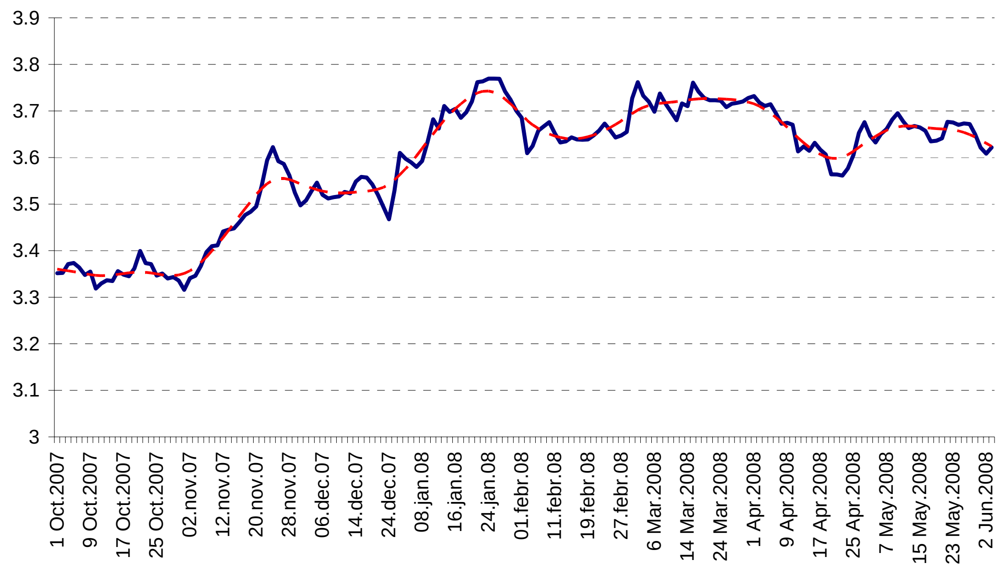
DEMAND SIDE FACTORS

In the last quarter of 2008, the Romanian economic grew by more than expected, 6.6 percent, compared to the previous year's fourth quarter. It caused an output gap widening and a demand-side pressure from excess demand. The enhancing demand is mainly underpinned by three key elements: the stable growing government spending, the increasing household income and the boost of the credit lending to the private sector.

RON/EUR EXCHANGE RATE DEVELOPMENTS

Since last autumn, the home currency has depreciated from the 3.3 RON/EUR level to 3.6 RON/EUR. It means about 9 percentage point depreciation.

CHART 2. THE RON / EUR EXCHANGE RATE DEVELOPMENTS (DAILY) AND TREND EXCHANGE RATE*



Source: National Bank of Romania

As we know the mechanism between the inflation rate and the exchange rate, the depreciating currency - through the import prices – leads the home consumer price index to grow through time.

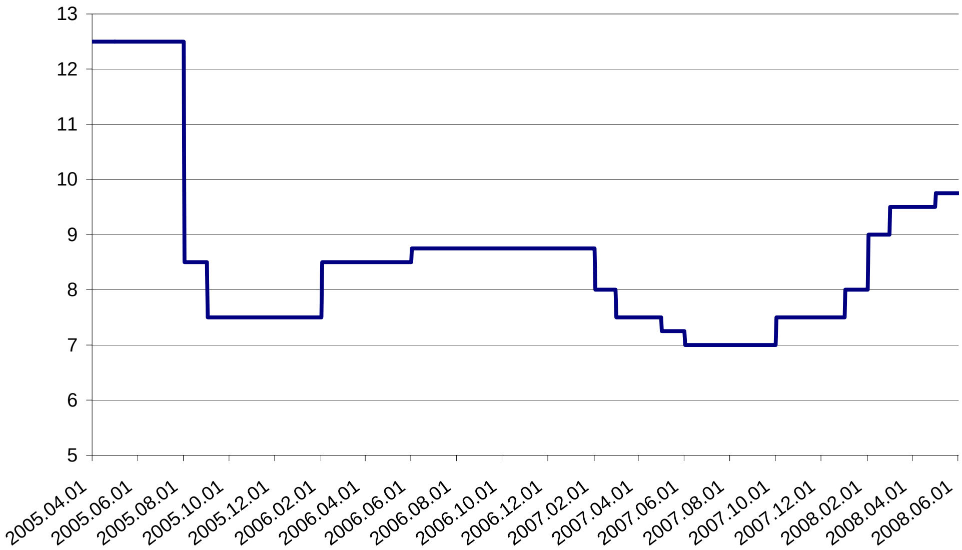
INFLATION EXPECTATION

Worsening inflation expectations is a very crucial factor of inflation considering the latest inflation developments. As it was mentioned, the subprime crisis has an impact on the whole world by enhancing uncertainty around future developments in the financial markets. This uncertainty together with the negative effects of the exogenous shocks since 2007 fuelled the inflation expectations of the economic agents.

Summarising the inflationary effects of the whole inflation-related factors detailed above, the only and most important consequence is: all the national and international economic processes strengthened the inflation pressure sine last autumn. And as the Board of the National Bank of Romania couldn't see any favourable sign of a turning point in May, they voted for rate's hike.

* HP-filtered time series

CHART 3. THE EVOLUTION OF THE MONETARY POLICY RATE IN ROMANIA



Source: National Bank of Romania

FUTURE PROSPECTS

As Romania has been following an inflation targeting system since August 2005, the increasing actual inflation hampers to reach the inflation target as well. The inflation target is set at the level of 3.8% for 2008 and 3.5% for the year 2009 with a tolerance band of ±1%.

Considering the Bank's forecasted baseline scenario (after the revision in May) for 2008 and 2009, the headline inflation is expected to be in the tolerance band from the second quarter of 2008 and reach the target till the end of this year. But any further positive risk factors related to the inflation should force the National Bank to increase its rate.

WORK EMIGRATION, LABOUR SHORTAGES AND RISING WAGES IN ROMANIA

Labour migration from Central and Eastern Europe has gained momentum after the EU-accession. One of the main sources of migration in the region is Romania, where now due to robust economic growth and vast labour migration some bottlenecks have become severe in many sectors. According to different estimates more than 10% of the population has already left the country for better salaries. Fast rising wages and labour costs, decreasing unemployment, employment shortages and mounting remittances from abroad are typical today.

WHO AND WHERE TO EMIGRATE?

Labour migration from Romania along with Poland and Bulgaria started already before the EU accession. In the case of Romania three distinct migration periods can be identified after the change of regime[1]. Between 1990-1995 emigration rate was 3% and main destinations were Israel, Turkey, Italy, Hungary and Germany. Between 1996-2000 7% of emigration rate was registered and main target countries changed to be Canada, Italy and Spain. In 2002 the Schengen short-term visa restriction was abolished and labour migration increased to 28%. The Romanian work emigration is estimated to 2.5 million persons[2] and Spain and Italy have been the main destinations. On the mental destination map of the migrants the target countries are[3] Italy (31%), Spain (17%), Germany (8%), the United States (5%), Hungary (4%) and France (4%). According to OECD statistics, influx of Romanian citizens into Spain was more than five times, in Italy three times higher in 2005 than in 2000. Respectively, 9 and 13% of the total foreign labour force of Spain and Italy has been Romanian originated. About half of the foreign labour force in Hungary consists of Romanian citizens. In the 2000s the ratio of women, who left Romania to work abroad has become close to that of men. Young people from rural areas and urban citizens aged 30-54 tend to emigrate principally. People graduated from vocational and high school, as well as from secondary school have dominated work emigration flows.[4]

According to statistics of Ministry of Labour, Family and Equal Opportunities[5] in the course of 2007 more than 17 thousand work agreements abroad were obtained through private agents. The most typical sectors are searched abroad: agriculture, hotel and restaurants, health, construction and transport.

DECREASING UNEMPLOYMENT AND LABOUR SHORTAGES

Romania has experienced high economic growth since 2001. Gross domestic product grew by 8.2% in the first quarter of 2008 making it the most significant growth in the last 18 years. On the production side this has been fuelled mainly by construction and services. On the demand side investments and private consumption has remained high. Foreign direct investments have

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[1] J.Traser-T. Venables: Who is afraid of the EU's latest enlargement? ECAS, Jan. 2008, http://www.libertysecurity.org/article1874.html

[2] Growing concern over labour shortage due to migration, http://www.eurofound.europa.eu/eiro/2006/11/articles/ro0611049i.htm

[3] Á. Hárs –E. Sík: Szempontok a román – bolgár EU csatlakozás magyar munkaerőpiacra gyakorolt hatásának értékeléséhez. TÁRKI, Budapest 2006, http://www.tarki.hu/adatbank-h/kutjel/pdf/a908.pdf

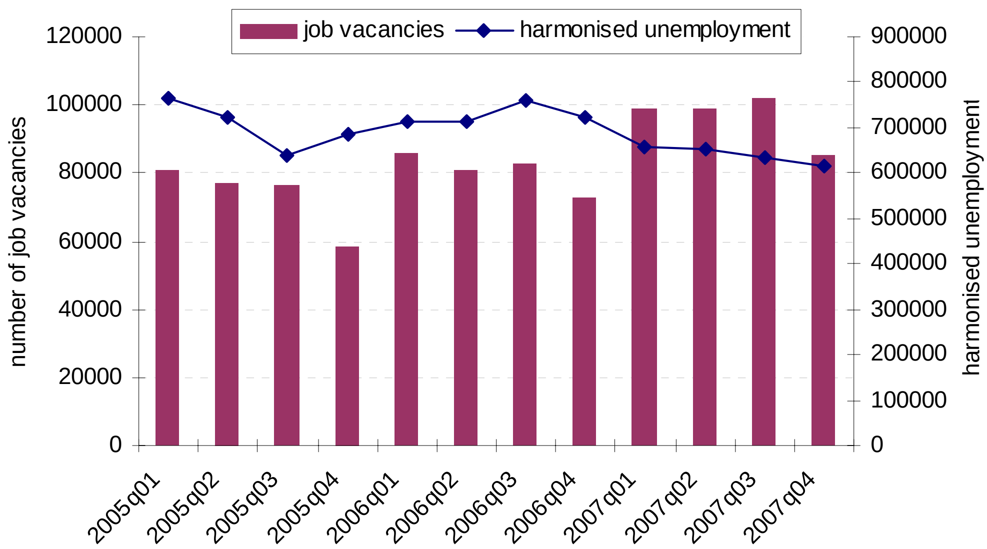
[4] D. Sandu: Exploring Europe through work migrations: 1990-2006 p. 30 In: Open Society Foundation: Living abroad on temporary basis, Nov. 2006

[5] www.mmssf.ro/website/ro/statistici/migratie61.pdf

contributed to gross fixed capital formation significantly and playing a major role in diminishing unemployment and GDP and export growth. GDP per capita in 2007 exceeded 40% of the EU-25 average, while it stood at 26% at the beginning of the century. The country joined the EU in 2007 has turned to be the most popular investment target in the region, because of quite large market, low wages and low taxation on incomes. High economic growth has raised the labour demand resulting in decreasing unemployment. Eurostat LFS statistics present a 6.4% unemployment rate in 2007. Registered unemployment rate stood at 4.3% in the second month of 2008. However, in contrary to other new member states Romanian employment rate hasn't improved in the 2000s. The employment/population ratio fell from 63% in 2000 to 59% in 2007.[6]

The job vacancy rate shows the strength of labour demand. Increase in vacancy rates has been experienced in almost all new member states in recent years, including Romania. Number of job openings is relative high in the Romanian economy as a result of increasing new investments and mass exodus of worked aged population. National statistics show the highest vacancy rates in public administration and the health care sector, 6.13% and 5.63% respectively, in the fourth quarter of 2007. Vacancy rates in agriculture (2.12%) and financial intermediation (2.63%) outpaced that of the whole economy (1.82%).

CHART 4. NUMBER OF JOB VACANCIES AND HARMONISED UNEMPLOYMENT IN ROMANIA 2005-2007



Source: Eurostat

According to the latest survey of Manpower Inc.[7] Romanian employers face the greatest difficulty worldwide in finding qualified personnel. 73% of the respondents have experienced labour shortages. Engineers, electricians, welders, bricklayers, managers, accountants, sales representatives, drivers, mechanics, restaurant and hotel staff, labourers and technicians are all bottlenecks in the Romanian economy according to 841 respondents took part in the survey.

[6] This can be explained by the fact that rural employment declined, while urban exhibited some upward trend.

[7] Talent Shortage Survey 2008 Global Results http://www.manpower.com/common/download/download.cfm?companyid=MAN&fileid=189693&filekey=9adcf817-96cf-4bb3-ac68-038e79d5facf&filename=Talent Shortage Survey Results_2008_FINAL.pdf

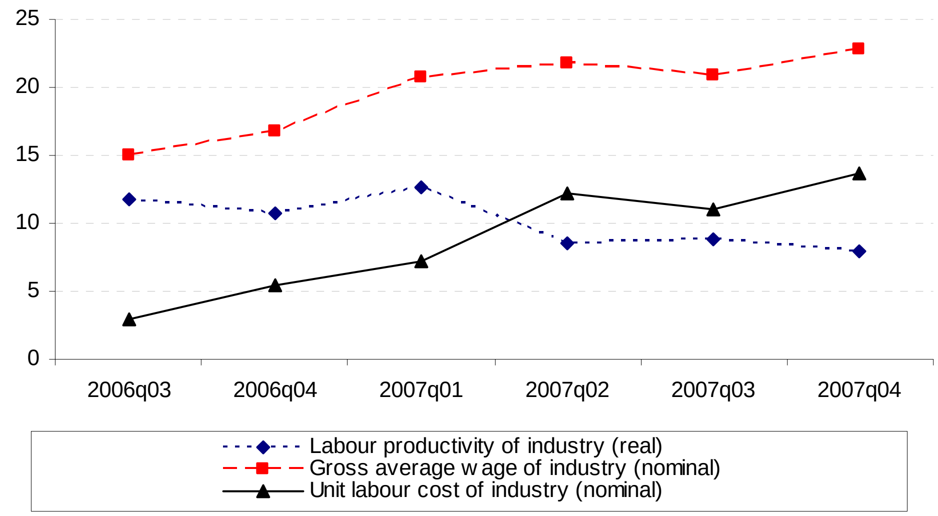
According to estimates labour shortages will be nearing to 400 thousand within two years [8], hampering economic growth. Solutions can be the stimulation of labour participation, importing workforce, retraining and support the return of emigrated workforce. However, the most important question remains whether unemployed and those who are not involved in the labour market are able to acquire new skills rapidly enough to fill open jobs.

RISING LABOUR COSTS AND WAGES

Escalating wages are another sign of an increase in labour demand. In the course of 2000s Central and Eastern Europe can be characterised by accelerated wage growth. Romanian minimum wage and average annual gross earning have doubled in the last three years. EUR 141 monthly minimum wage is still only a fraction that of Western European countries explaining clearly high outflow of Romanian workers. Forceful economic growth and labour migration has caused labour shortages, which are translating into mounting unit labour costs. Labour costs have never grown so rapidly and according to the National Commission of Prognosis's forecasts significant (166%) increase in average monthly gross salary by 2020 can be anticipated against this year's EUR 425.

In 2007 nominal unit labour cost increased by more than 14% on yearly basis. This was even higher (17%) in the industry sector affecting Romania's competitiveness. Productivity growth has increased by around 10% or less per year in the whole economy, while wage increase has exceeded 20%. Labour productivity is still low, accounting only for 40.6% of the EU average (in terms of GDP per person employed).

CHART 5. LABOUR PRODUCTIVITY, LABOUR COSTS AND WAGES IN THE INDUSTRY SECTOR (PERCENTAGE CHANGE ON THE PREVIOUS PERIOD)



Source: wiiw

Due to continuing labour exodus Romania is likely to become an attractive destination for non-EU countries. Romanian firms have already been in contact with countries such as China, India, Pakistan and Kenya[9]. A clothing factory in Bacau for example hired 670 Chinese employees in 2007 after failing to attract local staff[10]. Moreover, in spite of lower hourly

[8] http://index.hu/gazdasag/magyar/vmro080603/

[9] http://www.euractiv.com/en/socialeurope/romania-skilled-labour-shortage-highest-worldwide/article-171920

[10] http://www.euromonitor.com/Romanian_migration_raises_concerns_over_labour_shortage

wages in Romania (EUR 2.86) compared to Hungary (EUR 6.84) thousands of people from Eastern part of Hungary are estimated to work in Transylvania, mainly in construction sector[11].

Conclusions

Migration keeps unemployment low and remittances high (estimated to USD 6.8 bn in 2007[12]) in the Romanian economy. However, this is only one side of the coin. Economic boom and outflow of work-aged population to more matured economies have caused labour and skill shortages. In the medium term labour shortfall can be an obstacle for maintaining high economic growth. Increasing wage pressures unaccompanied by productivity gains may cause inflation creep up again and lead larger external deficits. Encouraging labour participation, life-long-learning, retraining and the reform of education may lead to a more responsive labour force supply to market needs.

[11] http://index.hu/gazdasag/magyar/vmro080603/

[12] http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/0,,contentMDK:21352016~isCURL:Y~menuPK:3145470~pagePK:64165401~piPK:64165026~theSitePK:476883,00.html

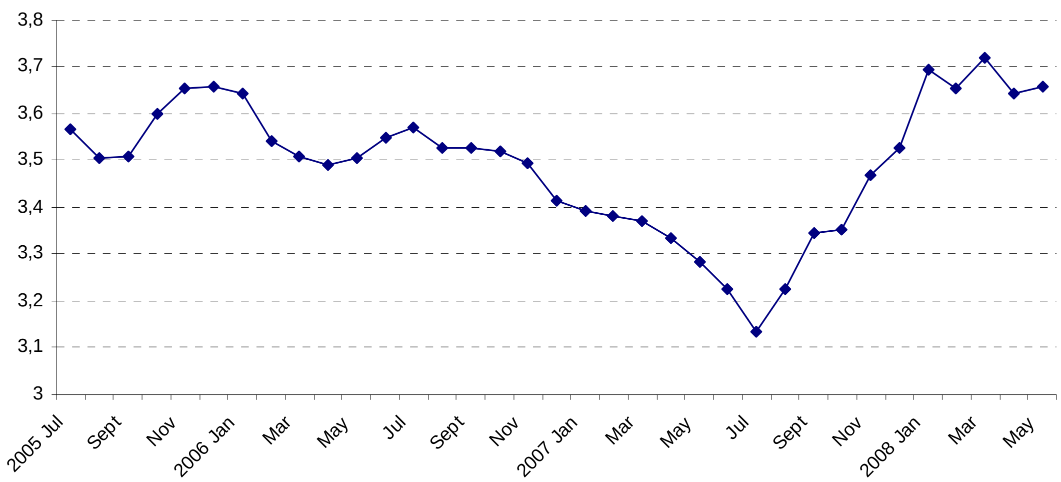
ADOPTION OF THE EURO IN ROMANIA – HOW CLOSE OR HOW FAR AWAY IS IT?

At the end of May the Romanian Finance Minister has claimed that the country could adopt the euro as of 1 January 2014, leaving the modality for shifting to this remaining to be decided by the National Bank. However the governor of the National Bank said late February that the schedule might not be met if the inflation rate does not go down in a sustainable way in the course of 2008 and 2009. According to analysts, the process of the adoption of the euro will depend on the economic reform and they consider the developments in the next three years essential for meeting the target. EU officials emphasise that in the absence of significant progress in terms of budgetary and fiscal policies effectiveness, the target seems hardly reachable. In view of the several opinions and recommendations it worth to overview the current state of completion of the convergence criteria (Maastricht criteria).

Currently Romania meets three of the five criteria, namely the value of the consolidated budgetary deficit, gross government debt and exchange rate fluctuations. First the recent developments of the exchange rate is discussed which may be formally evaluated only after the country's entrance to ERM II. Then the Romanian data for the four other criteria are presented in a common table together with their reference values.

The Romanian leu has been subject to rather large fluctuations in the past two years. From mid-2006, positive sentiment by financial market towards the region, a robust economic growth (7.9% in 2006 and 6% in 2007), significant inflows of FDI and wide interest rate disparity exerted upward pressure on the Romanian currency, which appreciated by 15% from 3.54 leu per euro in June 2006 to 3.13 leu per euro in July 2007. Subsequently the upward trend was reversed and the Romanian leu depreciated sharply vis-à-vis the euro owing to increased risk aversion in financial markets, growing concerns related to the widening current account deficit and rising inflation. In the last two months the leu strengthened somewhat, from the value of 3.72 leu per euro in March to 3.65 leu per euro in May.

CHART 6. ROMANIAN LEU: NOMINAL EXCHANGE RATE DEVELOPMENT AGAINST THE EURO (MONTHLY DATA, JULY 2005 – MAY 2008)



Source: National Bank of Romania

Looking at the developments of the current account in more detail, the deficit increased from 10.4% in 2006 to 14.1% in 2007, which may be mainly explained by the widening trade deficit. While good imports increased by 24.4%, export rose by only 13.2% in euro terms, accordingly the trade deficit increased by 46.7% in 2007. The robust growth in imports is fuelled by domestic demand, both by private consumption and investments. A gradual decline in the income balance, related to increasing profit payments to foreign investors, also contributed to the widening of the current account deficit. The present high external deficit is partly a result of Romania's catching-up process, but if deficits of this magnitude persist over a longer period, then sustainability issues will arise. It is also a problem that FDI inflows finance a decreasing share of the CA deficit: while net FDI inflows covered 90% of the 2006 deficit, this proportion decreased to 42% in 2007 as the volume of FDI shrunk by EUR 2 bn last year.

Returning back to the recent fluctuations of the nominal exchange rate, according to the Convergence Report of the ECB in the two-year reference period from 19 April 2006 to 18 April 2008 the deviations from the April 2006 average exchange rate – which is used as a benchmark for illustrative purposes in the absence of ERM-II – had not exceeded the ±15% band. The maximum upward deviation from that benchmark was 10.8%, while the maximum downward deviation amounted to 9.6%. However in view of the recent depreciation and the above-mentioned potential risks, reforms are needed in order to reach the goal of joining the ERM-II in 2011-2012, as it is currently planned.

Regarding the four other criteria – price stability, fiscal sustainability (which consists of the consolidated budgetary deficit and the gross government debt) and long-term interest rates – recent data also indicates the need of certain policy measures to be made.

TABLE 1. FULFILMENT OF THE MAASTRICHT CRITERIA IN ROMANIA

	Price stability (HICP, %)	**Fiscal sustainability**		**Long-term interest rates** (%)
		Consolidated budgetary deficit (% of GDP)	Gross government debt (% of GDP)	
	May 2008	2007	2007	May 2008
Romanian data	8.50	2.5	13.0	7.26
Reference value	4.43	3.0	60.0	6.24

Source: Eurostat, ICEG EC

The annual rate of HICP inflation has rose from around 4% between January and July 2007 to 8.5% in May 2008 owing to several factors. On the supply side a severe drought during last summer has significantly raised food prices, which was reinforced by the global trend of increasing commodity prices. The latter also includes the increase in the world market prices of crude oil and raw materials, which have infiltrated to the industrial sector as well, further aggravating the inflationary pressure. On the demand side booming domestic demand was fuelled by strong wage and credit growth as well as pro-cyclical fiscal loosening. In connection with growing wages it worth to highlight that while the increase in compensation per employee reached 20.2% y-o-y in 2007, the labour productivity amounted only for 4.7%, thus the unit labour cost rose significantly (from 6.6% in 2006 to 14.9 in 2007).

The recent depreciation of the leu and the rising inflation expectations stemming from both the exogenous shocks and the uncertainty on the global financial markets have already had unfavourable effects on the inflation rate. However these factors together with the further increase in commodity prices on world markets and the continuing wage pressures in Romania will likely to exert a negative influence also this year. The upcoming general elections in the end of the year may not only rise fiscal spending but also shift its structure towards items with greater inflation-generating potential (e.g. pensions, public sector wages).

Although the continuation of the catching-up process is likely to have a bearing on inflation, these pressures can be alleviated by several measures. The completion of the liberalisation process in the case of network industries and the amelioration of energy efficiency would reduce prices on the product markets. Another important issue is that wage increases should reflect labour productivity growth and the latter should be improved by such measures as shaping the education to the labour market requirements, ensuring greater flexibility in labour contracts, providing better incentives for regional mobility and developing vocational trainings for the rural population. The implementation of a sustainable and credible fiscal consolidation path would curb demand-induced inflationary pressures and reduce macroeconomic imbalances.

The latter is essential also for the stable fulfilment of the consolidated budgetary deficit criteria as the deficit is projected to reach 3% in 2008. The main reason behind the recent increase of the budget deficit is that the cyclical factors which had overall a deficit reducing impact on the budget balance in recent years, have been outpaced by the non-cyclical expansionary policies of the government in the last two years (the consolidated budgetary deficit has grown from 1.2% in 2005 to 2.2% in 2006 and further increased to 2.5% in 2007). As it has been already mentioned the upcoming general elections may boost fiscal spending as well.

The 2007-2010 Convergence Programme foresees the stabilisation and subsequently the reduction of the budget deficit by 0.5 percentage point of GDP by 2010. In order to achieve this goal several measures should be taken. One of them is changing the institutional framework of the fiscal policy (e.g. suspending the practice of financing additional current expenditure from unused capital spending items) or restraining public sector wage increases. It is also important that while the government supports structural reforms with fiscal incentives, these measures have to be accompanied by cuts in expenditures (e.g. in the case of tax incentives for employment creation).

The gross government debt to GDP ratio had been continuously decreasing throughout the previous years (from the level of 26% in 2001 to 12.4% in 2006), mainly due to the significant growth rate / interest rate differential. As a result the current level of the GDP proportional gross government debt (13%) is well below the reference value and it is among the lowest in Europe (only some of the Baltic countries have lower debt levels e.g. Estonia (3.4% in 2007) or Latvia (9.7% in 2007)). Furthermore competitors such as Bulgaria still have higher levels of debt (18.2% in 2007). However the previous downward trend of the debt level seems slightly to change now as it reached 12.7% in 2007 and it is projected to grow to 13.5% by 2009 as its level is negatively affected by the decelerating growth rate and the increasing interest rates.

Long-term interest rates are above the reference value and this gap may be widening this year due to the raise of the monetary policy rate by the National Bank of Romania. The Bank had increased the rate in five steps since October 2007 by a total amount of 2.75 percentage points. The long-term interest rates may converge again towards the reference value in the following years if both the policy rate and the inflation rate ease.

On the whole currently the inflation is the most significant obstructive factor regarding the adoption of the euro, not only because it is almost two times higher than the reference value, but it negatively affects other factors (e.g. exchange rate, interest rates etc.) as well. However it is essential to pay enough attention also to the increasing budgetary deficit, although currently it is in line with the reference value, only a sustainable and credible fiscal consolidation path can ensure the fulfilment of the Maastricht criteria in the coming years as well. All in all regarding the target date of 2014 for the adoption of the euro, it seems that even if the formal criteria may be fulfilled by that time, significant structural problems and macroeconomic tensions would be under the surface. Thus – in the case that the formal criteria are fulfilled – the question is still there whether it is worth to reckon on the advantages of the euro zone membership in the process of the institutional-structural transformation or it is more favourable to carry out these changes with the help of a more independent monetary and a more unhampered fiscal policy outside the euro zone, before the accession.

CAR INDUSTRY IN ROMANIA

Romania is not a newcomer to the automotive industry: it has produced motor vehicles for more than half a century. Dacia was a legendary car in the communist countries however it was a low-quality construction. Following the aftermath of the communist regime, Romania's car industry began to rally in the early 2000s, galvanised by the robust growth of the national economy, and a huge influx of foreign investment. Romania's accession to the European Union in 2007 made a secure and favourable business environment, so the country became very attractive for new investors.

GOOD CONDITIONS

The automotive industry requires special conditions from a country: sufficient skilled worker; wide domestic supplier network; good infrastructure and transparent taxation system with low tax rates. In every respect Romania is adequate to these expectations, because both the labour cost and the tax rates are low;[13] and the economic policy supports industrial investments. By now the automotive sector has already become one of the fastest growing in the country, with significant share of total employment.

TABLE 2. KEY STATISTICS OF ROMANIA'S CAR INDUSTRY (2007)

Automotive employment	87 524
as share of total manufacturing[14]	5,20%
Production of motor vehicles	241 712
of which: production of passenger cars	*234 103*
Car fleet (in 1000)	4 501
Car density (per 1000 population)	204

Source: ACAROM

The motorisation index of Romania is under the European Union average and the age structure of the car stock is very antiquated. High growth rates in the construction and services sectors should also stimulate demand for passenger cars and commercial vehicles.

The French Renault was the first important investor and made a number of sizeable investments in Dacia Pitesti plant since 1999. Following the French giant, other automobile constructors, tyre producers (Continental, Michelin) chose Romania and spent considerable amounts of money into automotive industry. Renault is currently Romania's biggest provider of automotive FDI, but there are more than one hundred companies[15] including such big names as Volkswagen, Ford, etc.

[13] This year the Commission (EU) forced Romania to reduce car registration fee.

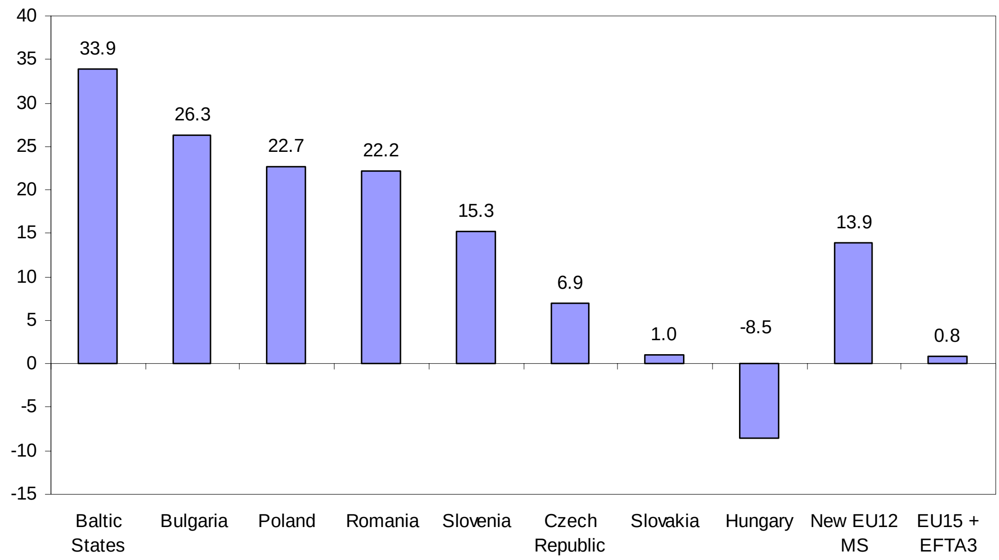
[14] Only direct employment; total number could be five times higher.

[15] According to ACAROM (Auto Constructors Association of Romania) that means 119 companies.

Regional Centre

There is a strong competition among the countries of Central and Southeast Europe, how to attract the foreign capital, but Romania has a good position, because it lies in the heart of the region. Production rates in the automotive sector have shot up in recent years, soaring 241,712 units in 2007; a 13.2 percentage point increase on the previous year. The positive trend will continue, because the economic growth of the region boosts the demand for automobiles. Whilst the automotive market stagnates in Western Europe, the number of new car registrations is increasing quickly in the New Members of the European Union (*Chart 1.*). Previously the automotive sector of the region produced automobiles mainly for export, but now the companies have to supply the increased home demand.

Chart 7. New car registrations in the European Union, Jan-Dec 2007 / Jan-Dec 2006 (%)



Source: ACEA

The big manufacturers recognized that the local presence is very important and build up not only the factory and productive unit but also full brand service centres with complete repair background and auto components supply. The national network of auto parts supplier will expand over the coming years creating solvent demand for commercial vehicles.

Future investments

Renault announced that it plans to invest around EUR 100 million over the next two years and hit actual 220 000 up to 400 000 units (new Dacia Logan construction) per year at the end of 2009.

Michigan-based TRW Automotive Holdings Corp has also announced plans to double the size of its Timisoara facility, representing an initial investment of EUR 12 million.

The Ford Motor Company will be the next big automotive manufacturer in Romania, which purchased the Daewoo Automobile Craiova in March 2008. The deal was the end of a long negotiations[16] between the Romanian government and the automotive giant, Ford bought

[16] Ford has to pay fine (27 million EUR), because it violated regulations by illegal state aid, according to the Commission (EU).

72.4% stake in the Romanian company for EUR 60 million and pledged to pump in EUR 675 million in the Automoblie Craiova plant. The plant will boast of a capacity of 300 000 vehicles (Ford Transit Connect) and 300 000 engines (starting in 2009).

Through the new investments the production of the Romanian automotive industry could reach the 1 million cars per year in the near future.

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