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Romania – The Macroeconomic Impact of the Covid-19 Crisis

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Summary

- Macroeconomic imbalances in Romania were deepening even prior to the Covid-19 crisis. The income-led growth policy, pursued vigorously by the authorities since 2015, triggered the re-emergence of twin deficits (i.e. fiscal and current account). Fiscal sustainability has become a serious issue, brought about by a drop in fiscal revenues and increased borrowing. Romania has the largest borrowing cost among EU countries and the highest sovereign risk. The short term direction of structural changes in demand can be inferred by the behavior of the Beveridge curve and vacancies dynamics across the economics sectors.
- Over the last four years in particular, labor productivity growth consistently lagged behind growth in the costs of labor.
- April data shows that, barring the manufacturing of tobacco, all other industry sectors recorded a monthly fall, some much more than others. On an annual basis, industrial production dropped by 38%. In the services sector, hotels and restaurants were particularly hard hit; in April the sector was operating at around 5% of its capacity. The retail trade sector, which employs 806 thousand saw its turnover falling by 19.5% in April year on year with fuel sales falling by -48.4%, non-food sales by -22.9% and food sales by -4.7%. As expected, the annual contraction got milder in May in most sectors, except manufacturing of machinery and equipment, printing and reproduction of recorded media, and manufacturing of computers, electronic and optical equipment.
- The authorities' plans to revive the economy focus largely on investments. Infrastructure, energy and healthcare are among the main sectors which will benefit from these. Measures will have to be coordinated with those mentioned in the integrated national energy and climate plan for 2021-2030, submitted by Romania to the EU in April 2020 (i.e. energy security, decarbonization, energy efficiency, the energy internal market, and research, innovation and competitiveness). EU funds also constitute an influential financing source for projects relating to green energy or digitalization. However, the institutional ability to absorb these funds in a timely manner might be an issue.
- The crisis has highlighted the importance of digitalization for future economic growth. Domestic economic recovery policies would need to be tailored in order to support the priorities laid down in the European Green Deal. The envisaged transition towards cleaner energy would need to be accompanied by a technological revolution. Given Romania's current economic structure, the energy transition cost should be properly quantified and the transition path adequately thought of in order to avoid unnecessary future social and economic strains.

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1. Introduction

The Covid -19 crisis represents, without doubt, one of the greatest threats the global economy has faced in the last century. Most of the governments across the world have imposed lockdowns. Although these have been considerably eased in most EU countries by the end of May 2020, they have generated, simultaneously, both a supply and a demand shock, as a large part of business' activities slowed down and customers buying habits changed due to mobility restrictions and the loss of income. But these effects have had an asymmetric impact both across countries and economic sectors, influenced by the countries' economic structure and their initial economic conditions.

This analysis attempts to provide a snapshot of the Romanian economy in the period either during or immediately after the end of the lockdown[1]. It starts by highlighting the macroeconomic disequilibria which has been already present before the crisis[2] and concludes by advancing several potential actions that would aid domestic economic recovery. One of the consequences of the crisis has been a change in structural demand. This highlighted the vast importance of digitalization for future economic growth. Domestic economic recovery policies would also have to be tailored in order to support the priorities laid down in the European Green Deal. The envisaged transition towards cleaner energy would need to be accompanied by a technological revolution. And, given Romania's current economic structure, the energy transition cost should be properly quantified and the transition path adequately thought of in order to avoid unnecessary future social and economic strains.

In the very short term, it is worthwhile noticing that the speed of the recovery will play an important role in restoring the macroeconomic imbalances. Second quarter economic data will make little sense in the broader macroeconomic picture. The evolution of the economy over the next year or so, together with that of the virus, will determine how fast growth could resume. The countries' response to the Covid-19 crisis depended, to a large extent, on the existing economic conditions[3]. Romania had a low fiscal policy space when the crisis hit. The budget deficit to GDP ratio reached -4.3% at the end of 2019[4], the highest in the European Union, exceeding the limit imposed by the Growth and Stability Pact. It led to the opening of the excessive deficit procedure against Romania at the beginning of March 2020, even before the lockdown was enacted.

Macroeconomic imbalances were deepening prior to the Covid-19 crisis. Over the last decade economic growth was solid, averaging 3.2%. But, prudent macroeconomic policies, adopted in the wake of the 2008 financial crisis, had gradually given way to expansive and procyclical fiscal policies (Fig 1). The income-led growth policy, pursued vigorously by the authorities since 2015, triggered the re-emergence of twin deficits – the current account and the public sector budget. The current account deficit, fueled by

[1] Depending on published available data.

[2] The period chosen for the historical analysis covers the last decade. It captures the revival of the economy following the 2008 financial crisis and, subsequently, the accumulation of disequilibria.

[3] See for instance Enrique Alberola-Ila, Yavuz Arslan, Gong Cheng and Richild Moessner, BIS Bulletin, No 23 (2020), "The fiscal response to the Covid-19 crisis in advanced and emerging market economies".

[4] In ESA terms. On a cash basis the budget deficit was -4.6% of GDP.

increased consumption, exceeded the ''alert'' level of -4% of GDP in 2018 edging towards -5% at the end of 2019.

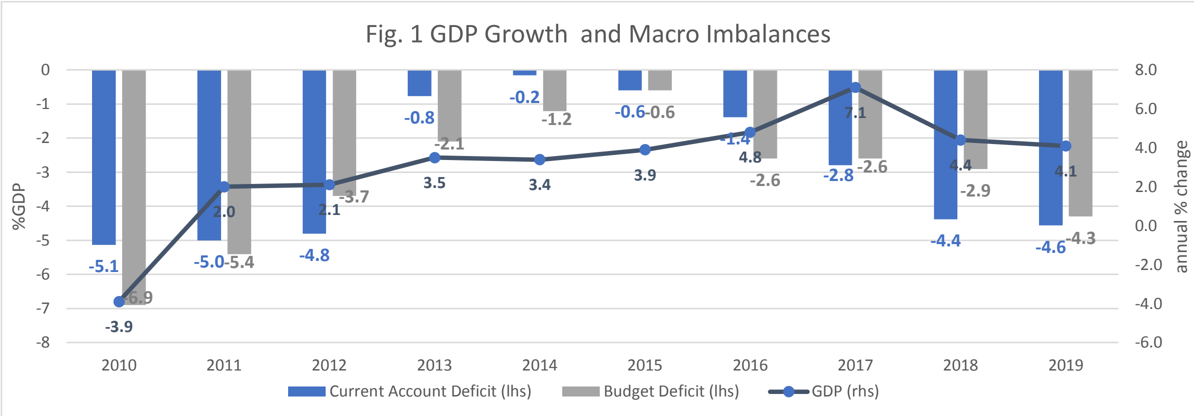


Fig. 1 GDP Growth and Macro Imbalances

Source: Eurostat

The twin deficit persisted during the first part of 2020. The budget deficit, calculated as a cumulative value for 12 months up to May 2020, to GDP ratio increased to 6.7%, already reaching the authorities' full year target[5]. For the year-end target to be fulfilled, monthly deficit over the remaining seven months of the year should be around RON 4.8 Bn (in the first five months the average monthly deficit was RON 7.8 Bn).

The economic effects of the income-led growth policy – which envisaged substantial annual double-digit increases in both public sector and minimum wage levels – became more visible in year 2016. Since then, labor productivity has been consistently outpaced by increases in wage costs (Fig 2). Over the last four years in particular, the gap between labor productivity growth and increases in the costs of labor was rather wide. Such a large discrepancy could not have continued for long, as companies that derive their revenue mostly from export activities would, eventually, become less competitive. The labor productivity-cost gap appears to have started to diminish in the first quarter of 2020 and this trend could continue over the next quarters of this year as companies reassess their economic cost structure.

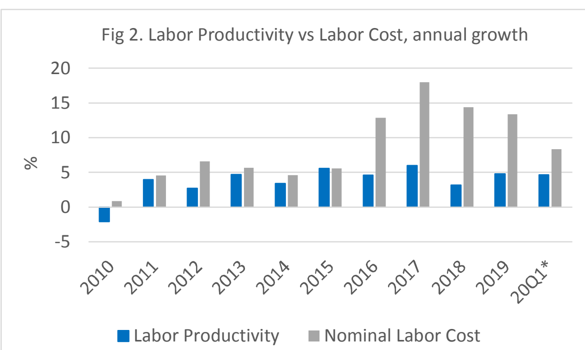


Fig 2. Labor Productivity vs Labor Cost, annual growth

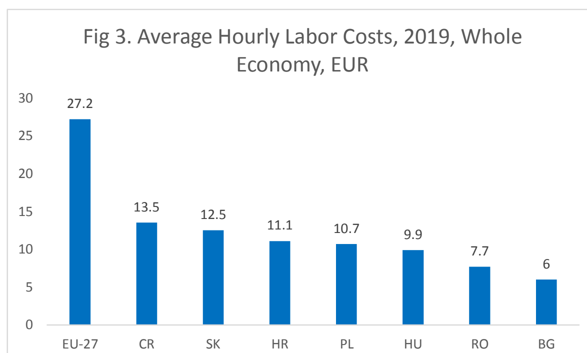


Fig 3. Average Hourly Labor Costs, 2019, Whole Economy, EUR

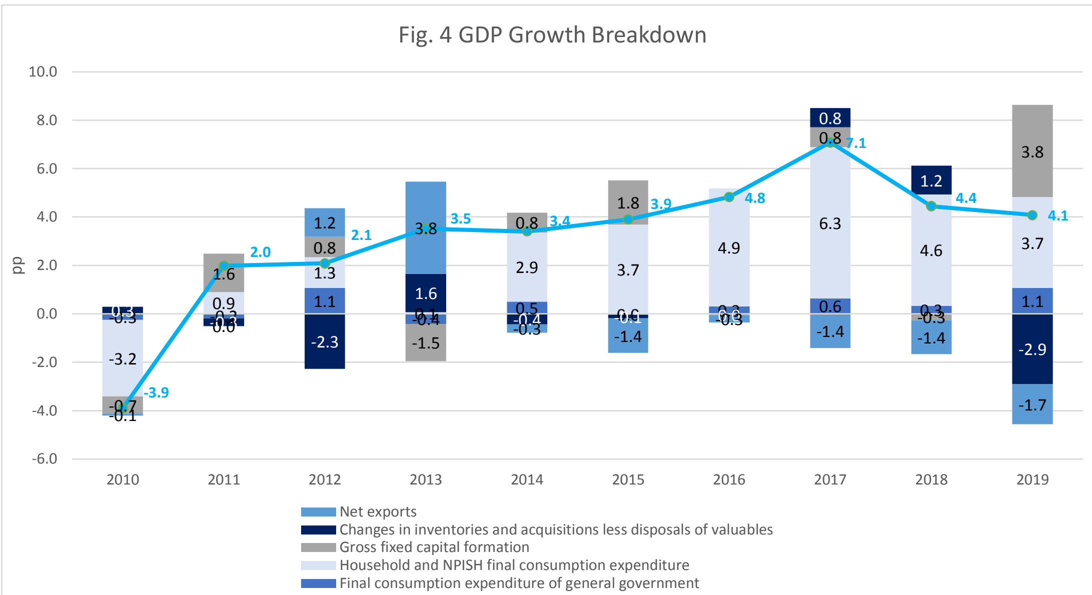
Source: Own calculations from Eurostat and ECB *- estimated

One of the reasons productivity growth has been lagging behind growth in wage costs was the relatively low level of domestic hourly labor costs, which have been catching up with those of surrounding countries.

[5] See also section 2.3.

At EUR 7.7 average hourly labor costs in Romania were still second lowest in the region in 2019 (Fig 3). Hourly labor costs were between 25-40% higher in other countries in the region, i.e. Hungary, Poland, Slovakia, Croatia or the Czech Republic.

The increase in income levels led, inevitably, to higher consumption. In fact, domestic consumption was the main engine of growth since 2014 (Fig 4). Investments' contribution to GDP growth was only marginal. Public sector investments have been on a downward trend since the start of financial crisis in 2008. Increased public sector wage expenditures and the need to maintain the budget deficit below -3% seriously restricted public sector investment disbursements. These were consistently used as a residual item in the government budget balance.



Source: Eurostat

In turn, private sector investments have been affected by legislative uncertainty. Although gross fixed capital formation reached in 2019 its highest contribution to GDP growth since the financial crisis, the relatively large negative contribution of inventories rendered the net investment effect in the economy rather small. Given growing macroeconomic imbalances, especially since 2015, the Romanian economy was poised for a rebalancing even before the Covid-19 crisis emerged. The next section looks into more detail at how the Covid-19 crisis has impacted the economy so far[6], focusing mainly on three aspects: the impact on economic sectors, labor market and the sustainability of fiscal policy.

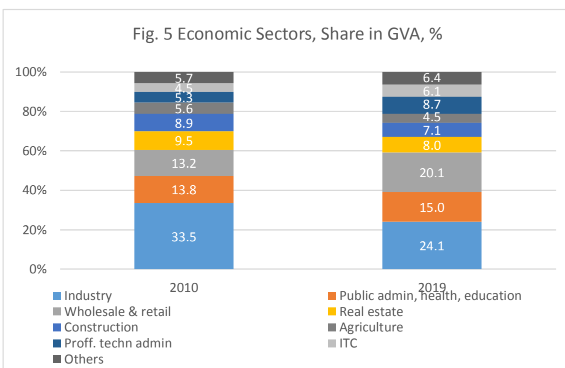
[6] The analysis used the latest available data at the time of writing.

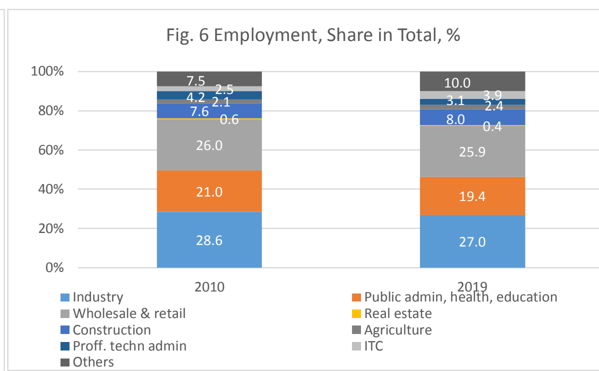
2. How Has the Covid-19 Crisis Impacted the Romanian Economy So Far?

2.1 The Economic Structure

The structure of the economy plays an important role in evaluating how the economy responds to the Covid-19 shock.

Fig. 5 below shows the decomposition of 2019 gross value added[7] (GVA) across the main sectors of the economy, highlighting the contribution of each one of them to total GVA. To capture changes in the economic structure in time, a comparison is made against year 2010. As the GDP/capita continued to grow during this period, the structure of the economy changed with services gaining more share in total GVA at industry's loss. The 2019 economic structure shows some notable differences when compared to a decade ago: the industry, although remaining the most relevant sector in the economy, reduced its share in GVA from 33.5% to 24% today – a significant drop. Wholesale and retail, which includes also transport, hotels and restaurants increased its share in GVA to 20% in 2019, from only 13% in 2010. This represents a vulnerability in the current pandemic context as it is precisely these two sectors of the economy, which have the largest contribution to GVA, that were among the hardest hit by the Covid-19 crisis[8].





Source: NIS

Public sector's share in GVA, which includes health care, education and defense, rose to 15% in 2019 from 13.8% in 2010. This is a sector that has benefited, so far, from the crisis due to the fact that incurred higher spending and investments – especially in the healthcare sector – with the employees not being affected - in general - by either the loss of income or jobs. The employment's structure is presented in Fig 6. Here, the changes in employment are not as large as those observed in the GVA shares' changes.

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[7] GVA was used instead of GDP to eliminate the potential distortionary effect of net taxes.

[8] Some parts of the food retail sectors performed reasonably well during the crisis but overall, the sector was affected largely by the closure of the restaurants, hotels, disruption of transports and reduced consumption for non-food goods.

2.2 Potential Winners and Losers from Covid-19 – A Very Short-Term Analysis

At the time of writing, towards the end of June 2020, the generalized lockdown has been gradually phased out across EU countries[9]. The assessment of economic destruction will be a gradual process, as events continue to unfold and be quantified by statistical data. Some of the destruction in certain sectors of the economy could be permanent[10].

During the first phase of the crisis the immediate policy objectives were twofold:

- to ease the burden of the income loss generated by the imposed lockdown and
- to support the health care system.

The first objective was tackled by the government with special unemployment assistance for those with suspended jobs, the option for loans reimbursement moratorium for debtors, tax breaks, public investments, and fiscal backstops, such as public guarantees or credit lines. Help has also come from the European Commission, which launched a support scheme for short-time working, a pan-European guarantee fund to support small and medium-sized enterprises (SMEs) via the European Investment Bank, and pandemic crisis support for Member States via the European Stability Mechanism. Below, we look at the main sectors of the economy and assess how they have been affected so far by the Covid-19 crisis. Although it is too early to draw definite conclusions – given the availability of published data – some inferences on the economic impact of the crisis can still be made.

A. <u>Manufacturing</u>

The analysis for the manufacturing sector is done in a simple framework which assesses the risk to production and demand. Consequently, three broad categories of risk can be envisaged:

- the decline of foreign demand for exporting sectors,
- the fall in foreign production for importing sectors,
- the decline of internal demand.

Different manufacturing sectors might face one or a mix of the above risks. Producer price outlook depends on the balance of downward pressures from the demand shock and upward pressures from the supply shock. As a rule of thumb, the move of industrial output when in line with the move of producer prices is an indication that the demand shock is stronger than the supply shock. Consequently, the move of industrial output in opposition to the move in industrial prices signals that the supply shock was stronger than the demand shock. The demand effects on prices of non-energy goods should dominate the supply side effects. So far, downside effects of lower demand are only partially mitigated by the upside

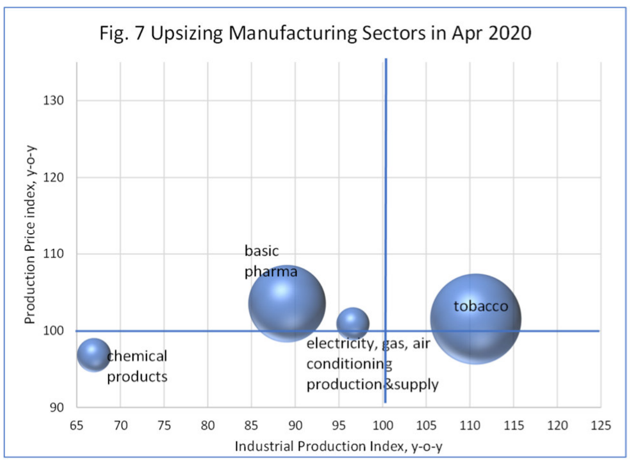
[9] However, the Covid-19 virus is still present and partial lockdowns are still enacted in various EU countries which are facing an increasing number of daily infections. In Romania for instance, the number of daily infections in early July was at its highest level since the onset of the crisis.

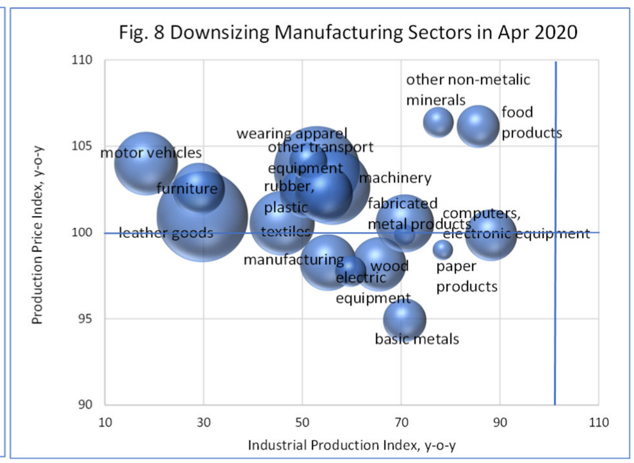
[10] Also, lives taken by the coronavirus represent an irreversible loss for the society. As of June 29, 2020, there were 26,582 registered persons infected and 1,634 persons deceased due to Covid-19 in Romania.

effects from the disruption of supply chains. Downward pressure on inflation is reinforced by the large drop in oil prices and a deteriorating labor market situation.

The growth index of industrial production and the growth index of industrial producer prices in April 2020[11] reveal the following situation (Fig. 7 and Fig. 8):

- Sectors with increasing production and prices: tobacco. This sector hires 2.5 thousand employees and is a clear winner, its demand increased and might require investments if the favorable demand is perceived as lasting.
- Sectors with declining production and increased prices, employ 80.2% of employees from manufacturing, namely: food, beverages, textiles, wearing apparel, leather goods, rubber and plastic products, other non-metallic mineral, fabricated metal products, machinery and equipment, motor vehicles, other transport equipment, furniture, repair, maintenance.
- Sectors with declining production and declining prices employ 19.5% of employees from manufacturing: wood, coke and refined petroleum, paper and paper products, printing and reproduction of recorded media, basic metals, computers, electronic and optical products, electrical equipment.

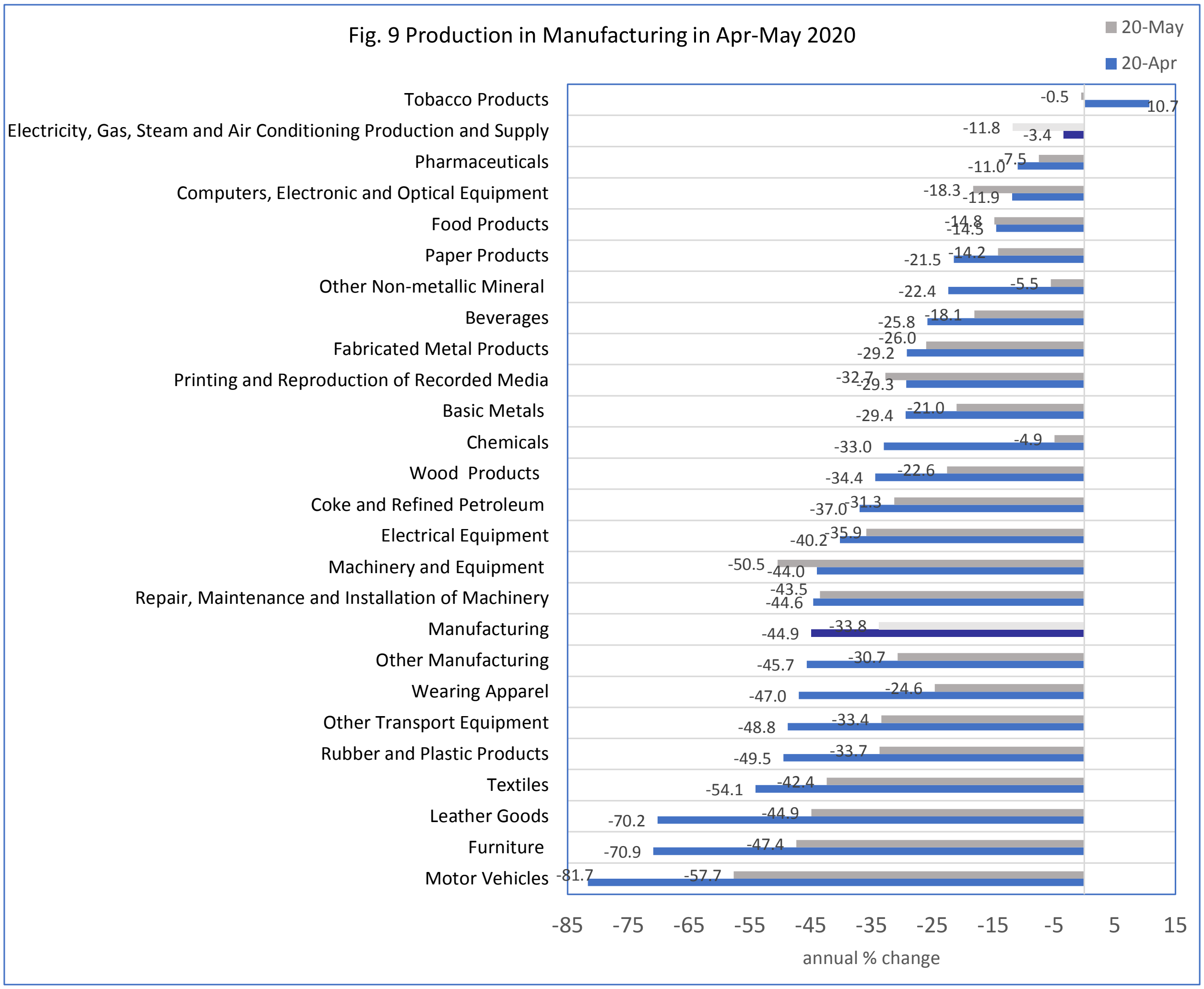




The size of the bubble reflects the annual percentage change of employees in April 2020, positive in the case of upsizing and negative in case of downsizing sectors.

Overall, the Romanian industry sector has been on a downward trend for more than a year, affected by the slowdown of industry across the EU, notably in Germany. The Covid-19 crisis exacerbated the monthly fall in industrial production. Measuring the annual dynamics of industrial production by using April 2020 data reveals the complete monthly cost of the lockdown. Except the manufacturing of tobacco all other industries recorded a sizable monthly fall. As expected, the annual contraction got milder in May in most sectors, except manufacturing of machinery and equipment, printing and reproduction of recorded media, and manufacturing of computers, electronic and optical equipment (Fig 9):

[11] Still at an early stage given that the lockdown was imposed in Romania on 16 of March and lasted for 2 months.



Source: NIS (National Institute of Statistics)

The manufacturing of motor vehicles suffered the largest annual drop as most of the production facilities were almost fully closed in April.

B. Energy, Gas and Air Conditioning

Within the energy sector, oil and gas has been suffering the worst collapse in prices for over 20 years. A long period of uncertainty will likely see upstream companies deferring large capital investments until oil and gas prices stabilize. The liberalization of gas prices for the households, starting July 2020, might put some downward pressure on the price charged to retail consumers, although it might happen that many unaware customers accept the ongoing offers. There is the risk of customers and SMEs not paying or deferring bills in the near term and standalone retailers being unable to meet obligations to energy wholesalers.

In March 2020 the sector had higher production, but lower prices than one year ago and employed 53.1 thousand employees (+1% y-o-y). In April 2020 production fell by 3% compared to Apr 2019.

C. Services

The lockdown of retail units and the restrictions imposed on the move of people outside the close neighborhood hit strongly a large part of both retail and business services.

C.1. Retail, consumer, leisure

- The wholesale and retail sector employs 806.1 thousand and its turnover fell by 19.5% y-o-y in April, the largest decline being recorded in fuel sales (-48.4% y-o-y), non-food sales (-22.9% y-o-y) and food sales (-4.7% y-o-y). The evidence confirms the expectations for an immediate uplift of demand for non-discretionary consumer goods categories as the population stays home - mainly for food & beverages. Also, demand for discretionary goods remains restricted as consumers limit spending considering the immediate loss of income and uncertain outlook. Forced closure of retail outlets had severe impact on retail businesses. Stronger players may now find it easier to re-shape their sales strategy real estate portfolios to fit a digital environment. Online sales will likely be favored through the crisis, but almost all non-food retailers will be impacted by lower levels of consumer expenditure.
- Hotels and restaurants have been heavily impacted by closures. This sector has 214 thousand employees and its turnover declined by 42.5% in March 2020. By April the sector was operating at around 5% of its capacity. Delivery services offered a temporary respite, but their increasing consumer penetration and expansion of services could raise some other challenges in the medium term (i.e. referring to logistics, economies of scale, customer preference changes, supply chains).
- There was an immediate impact on tourism with widespread travel restrictions in place. Arrivals of foreign visitors halved in March, compared to a year ago, as did departures of Romanians visitors. Tourist arrivals fell by 70%. Arrivals in the main establishment of touristic reception with functions of touristic accommodation declined by 70%. Consumer caution on both expenditure generally and travel specifically means post-crisis recovery would likely be slow.

C.2. Business Services

New paradigms for the workplace and consumption such as remote & flexible working, e-commerce & delivery place greater emphasis on digital capabilities – i.e. remote workforce management and collaboration, etc. Supply chain resilience needs to be maintained in many sub-sectors, such as construction, and there is an increased need for working in partnership as prime-contractors need to determine how to extend support to an increasingly fragile supply chain and sub-contractors have to overcome delivery issues.

In April 2020 empirical data, in terms of turnover and employees' evolution, compared to April 2019 reveals the followings (Fig. 10):

1. Sectors with contracting turnover and downsized number of employees: real estate, telecom, land and air transport, professional activities.

a. For telecommunication, with 45.3 thousand employees, the remote working, school closure and travel restrictions resulted in increased data usage at home and a higher demand for quality broadband connectivity products. On the other hand, the reduced business travel lowered the international roaming with negative impact on revenues. To benefit from the reinforced role in this new "digital normal" telecommunications need to quickly adapt their customer and product strategy and re-prioritization of expansion plans (5G prioritized in residential areas).

b. Air transport with 4.5 thousand employees, was particularly hit by the restrictions on international travel. The arrival of foreign visitors in Romania by air transport declined by 99.4% y-o-y, while the departure of Romanians abroad via air transport declined by 94.3% y-o-y in Apr 2020.

c. Land transport with 155.9 thousand employees, was the main channel through which goods were transported cross border. The use of e-commerce and delivery will imply resilience and growth. Operators will be challenged by labor supply and may need to resort to increased sub-contracting to provide flexibility as short-term volumes increased.

d. Real estate with 16.9 thousand employees is impacted through the wait and see attitude the main clients might take.

e. Professional activities with 149.8 thousand employees face a reduced demand in strategy & transactions, although there will be increases in restructuring, operational transformation and business continuity planning.

2. Sectors with expanding turnover and downsized number of employees: publishing and administrative activities.

   a. Administrative activities with 286.3 thousand employees require digitalization. On digital public services Romania has the lowest performance in the EU.

   b. Publishing activities with 31.6 thousand employees face a needed conversion towards online activity (e-books, e-paper).

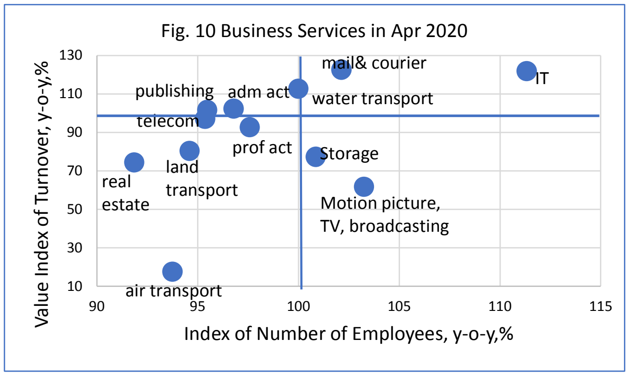
3. Sectors with expanding turnover and upsizing the number of employees: administrative activities, mail & courier services, water transport, storage services, motion picture, TV and broadcasting, IT.

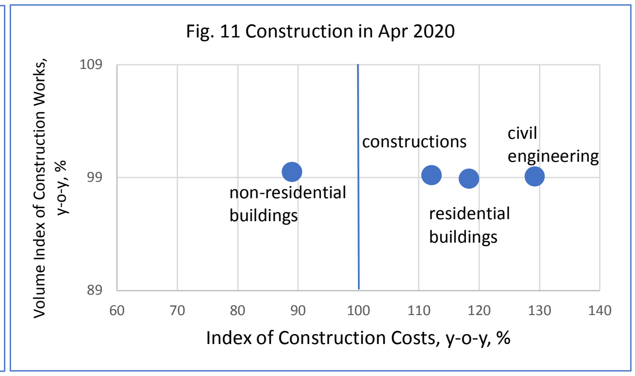
   a. Water transport with 3 thousand employees might substitute part of land transport during the engagement in the transition towards a greener society.

   b. Mail & courier services with 38.5 thousand employees faces an increased demand due to the boost of e-commerce.

   c. IT with 101.3 thousand employees is a clear winner due to the forced digitalization and the growing remote working enablement imposed by social distancing, which abruptly increased the demand for these services.

4. Sectors contracting turnover and upsized number of employees: storage activities and motion picture, TV and broadcasting
    a. Storage services with 58.8 thousand employees has expansion opportunities due to the development of e-commerce.
    b. Motion picture, TV and broadcasting with 15.9 thousand employees faces increased demand due to social distancing and the increased time spent home by the viewers. Studios may further utilize new movies release options such as pay-per-view.





Source: NIS

D. Construction

Construction sector, which employs 402.6 thousand, had an outstanding performance in the first quarter and even in the month of April 2020, when there was a full lockdown. The construction works were up by 12.1% y-o-y in April 2020 (26.5% y-o-y in Jan-Apr 2020) as construction work on most of the public construction sites went ahead as normal (Fig. 11). If the buoyancy of the activity in the sector, which started in 2019 when the minimum wage was increased to RON 3000 (48% higher than the average minimum wage) could be maintained, it would become an important pillar of the recovery post lockdown. At the time of writing the authorities are on course to announce an economic recovery plan, centred around public sector investments. The infrastructure works could boost the development potential of the whole economy in the coming years but one issue would be the identification of resources to finance these projects.

2.3 The Labor Market Impact

The crisis impacted the labor market as large parts of the economy were closed. At the end of 2019, the unemployment rate stood at 4%[12] (close to 360 thousand people) and, by the end of May 2020 it edged up to 5.2 % (above 460 thousand people). The measures taken by the authorities, to pay 75% of gross wages for employees who were technically unemployed[13] during the period of the lockdown, were in line

[12] Measured according to International Labor Office (ILO) standards.

[13] Technically unemployed are the employees with suspended work contracts.

with those taken by other states in the EU and had an important role in preventing a drastic increase in unemployment. Oher measures also helped the labor market (see Annex 1).

At the beginning of June almost 1 million work contracts were still either suspended or ceased – almost 20% of total (Fig. 12 and Fig. 13). Later in the month, on 26 June, the number of ceased work contracts were down to 142 thousand[14]. The sectors most affected by temporary layoffs were manufacturing – accounting for 28% of the total suspended work contracts - hotel & restaurants (17%) and retail trade (16%). Almost half of the ceased work contracts were in manufacturing (18%), retail trade (15%) and construction (15%). These sectors seem to have borne the largest impact of the lockdown.

Fig. 12 Suspended Labour Contracts

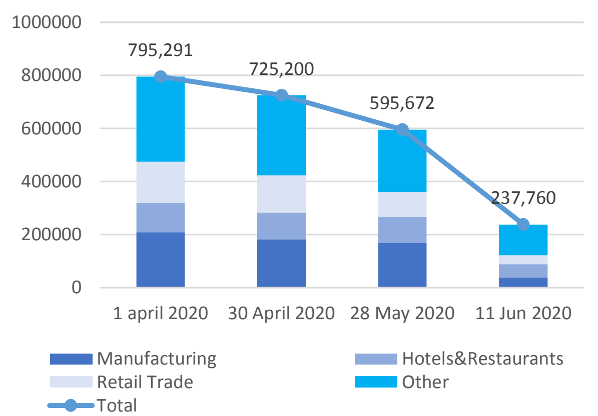
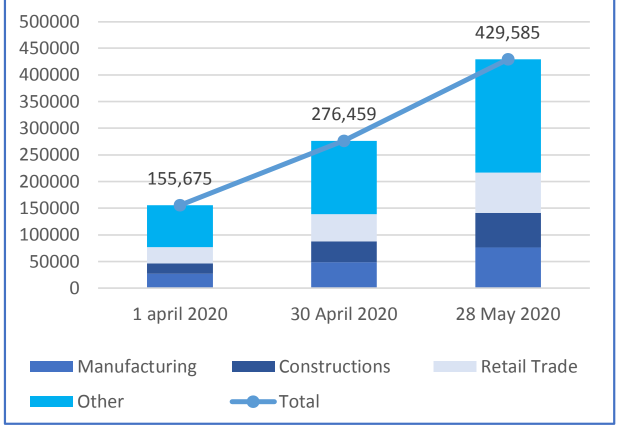


Fig. 13 Ceased Labour Contracts



Source: Ministry of Labor and Social Protection

The authorities' decision to further subsidize wages[15] for an additional period of three months, starting June 2020, appeared to have stimulated the return to work. On June 11 the number of suspended contracts halved in hotels & restaurants, declined by 64% in retail trade and dropped by 78% in manufacturing.

A useful tool to evaluate the state of the labor market – and implicitly the intensity of aggregate demand – is the Beveridge curve. This displays the relationship between unemployment and the vacancy rate in the economy. During economic contractions unemployment is high and the number of vacancies falls while during expansion the opposite is true.

It can be seen from Fig 14 below that in the ''boom'' years, those preceding the financial crisis, unemployment was relatively high, in tandem with the vacancy rates. It highlighted the ongoing structural change in the economy at the time. During the crisis years, 2009-2010, and the recovery stage, roughly from 2011-2014, the expected negative correlation between vacancy rates and unemployment is clearly visible. Between 2015-2019, as demand increased and the economy was running close to its full capacity, unemployment rate continued to fall.

[14] A comparison which would include the terminated work contracts was difficult to made as, starting early June, the Ministry of Labor stopped publishing this number.

[15] By up to 41.5% of the gross average wage with the employers' obligation to keep the employees in work until the end of 2020 at least.

The fall in vacancy rates was already visible in 2019. And, the drop became more pronounced in the first quarter of 2020. Given that the unemployment rate was already at 4.8% in April, the trajectory of the curve towards the recession cluster years of 2009 and 2010 is easily identifiable.

In Fig 15 the vacancies dynamics can be traced by economic sector over the last five quarters. It clearly shows that the decline in the industry sector started more forcefully in the second quarter of 2019. And, during the first quarter of 2020, specific sectors affected by the Covid-19 crisis such as hotels and restaurants – which were in the expansion mode in the last quarter of 2019 – recorded a drop in vacancies. This, together with other sectors impacted negatively by the crisis, such as transport, professional activities and the worsening outlook for the industry led to a sizable drop in the vacancy rate in 20Q1.

Fig. 14 Beveridge Curve

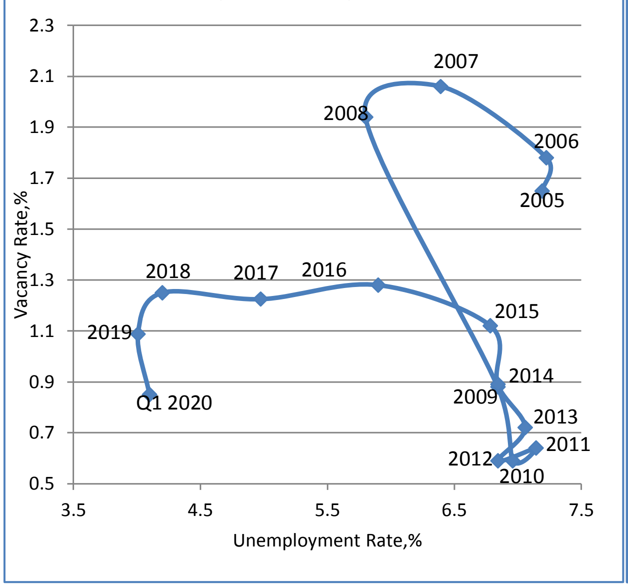
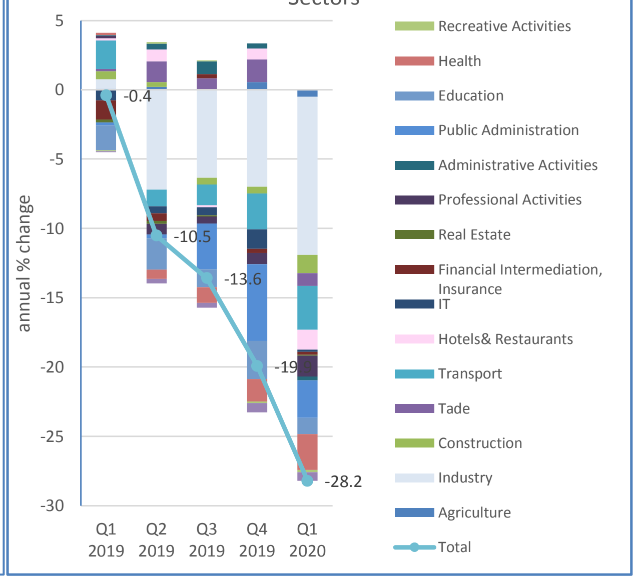


Fig. 15 Vacancies Dynamics, Contributions by Sectors



Source: NIS

Looking forward, it is likely that, given the expected structural changes in demand, the labor market structure to be modified slightly in the near future. The development of the labor market over the coming months would shed more light over the direction of these structural changes.

2.4 The Impact on Public Finances

As in the other EU countries, the economic impact of the Covid-19 crisis on public finance will be large. The collapse in budgetary revenues coupled with limited adjustments in total government spending – so far – would require a sizable increase in government borrowing this year[16]. Public sector borrowing requirement was recently revised upwards by the authorities to RON 120 Bn., the equivalent of around 11.5% of GDP, based on the current official GDP growth projection of -1.9% for this year. But this may turn out to be too optimistic given that international rating agencies and institutions such as the EC or the IMF

[16] The issue related to the sustainability of Romanian public finances has been analyzed recently in various documents by the international rating agencies, European Commission, *Coaliția pentru Dezvoltarea României* or the Fiscal Council.

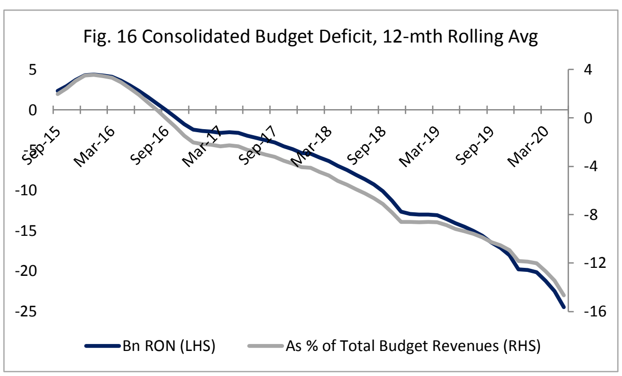
forecast a contraction of around 5-6% of GDP this year. This could easily add anything between RON 15-30 Bn. to the borrowing needs this year.

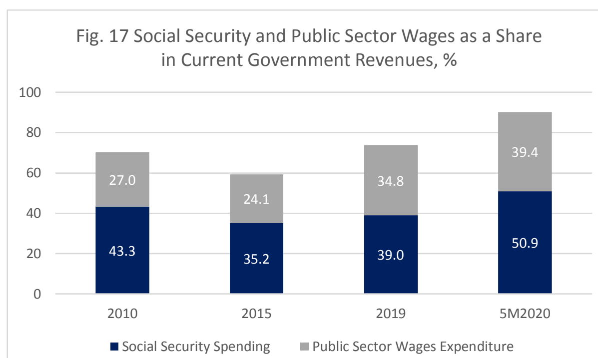
Prior to the outburst of Covid-19 crisis, Romania entered into the excessive deficit procedure, which meant an engagement into a reduction path of budget deficit monitored by the European Commission. According to the authorities' Fiscal Strategy 2020-2022, the plan was to lower gradually the budget deficit (in cash terms) from 4.6% of GDP in 2019 to 3.6% in 2020, 3.3% in 2021 and 2.5% in 2020[17]. However, this has all changed now although Romania still needs to take effective action and report in detail to the EC the consolidation strategy that is envisaged to bring down the budget deficit by 15 September 2020.

Currently, European Commission (2020) expects a budget deficit of 9.2% of GDP in 2020 and 11.4% of GDP in 2021, and gross general government debt at 46.2% of GDP in 2020 and 54.7% of GDP in 2021, up from 35.2% of GDP in 2019. These estimations assume no-policy change and the significant increase in both deficit and public debt in 2021 is due to the full-year effect of the 40% increase in pensions in September 2020, an additional upward pension recalculation scheduled for September 2021, and the doubling of child allowance payments.

Although the Covid-19 outbreak made the European Council activate the general escape clause to accommodate a more general fiscal policy support throughout the EU[18], domestic consolidation of fiscal position is still required given that a sizable component of Romania's budget deficit is not related to the crisis[19]. There are several risks to the sustainability of public sector finances:

- The recovery in government revenues to take place slower than envisaged due to lower GDP growth. Fig 16 below shows that the budget deficit has already reached 15% of total revenues in May. Measures to arrest this decline should include actions on both sides of the budget components. On the revenue side, apart from the digitalisation of ANAF, concrete fiscal measures to remove system distortions (eliminating income tax exceptions in IT and construction for instance, re-thinking the VAT structure, etc.) will be necessary.





Source: Calculations from the Ministry of Finance data

[17] European Commission (2020), Economic Forecast Spring

[18] This effectively suspends, temporarily, the fiscal adjustment recommended by the Council in case of a severe economic downturn in the euro area or the EU as a whole.

[19] A list of the fiscal measures related to the Covid-19 crisis, which would affect mostly the revenues side, is presented in Annex 2.

- On the expenditure side the authorities' approach during the crisis led to a situation which has put the budget deficit under a tremendous pressure. Over the first five months of 2020 social security spending together with public sector wages accounted for over 90% of current revenues[20], a situation which did not happen even during the financial crisis[21] (Fig 17). Moreover, the planned increase in public pensions[22] becomes extremely costly for the economy, not only this year but for the coming years as well. An appropriate policy would be to simply maintain the pensions' purchasing power this year, implying a standard indexation with the inflation rate. Additional savings can be made by taxing special pensions and bringing them in line with a ''fair value'' to be aligned with the contributions paid. Total public sector wage expenditure would also require an adjustment. Keeping these virtually unchanged when private sector wage costs are already in the process of full adjustment would delay the recovery in revenues, threating growth and maintaining upside pressure on the country risk premia.
- The need for a relatively large borrowing requirement induces a serious vulnerability on the future sustainability of public debt, given both its composition and structure. According to international institutions, the country's public debt/GDP ratio could increase by 10 percentage points this year to around 46% of GDP. Romania's country risk, measured by the country's credit default swap (CDS) has already increased since the beginning of the year (Fig 18 and Fig 19), in contrast with other countries in the region[23]. The risk aversion of foreign investors could change suddenly in response to financial global conditions bringing to the forefront both the interest rate and exchange rate risk to public debt sustainability.

Fig. 18 Mediun term credit default swap (5Y)

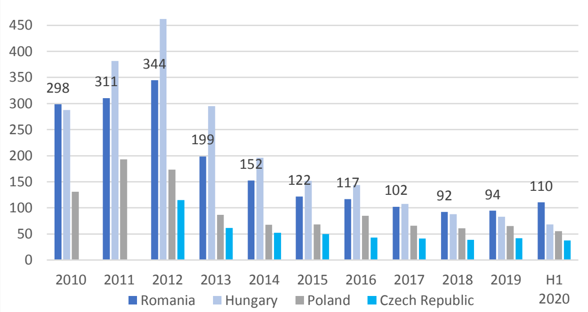
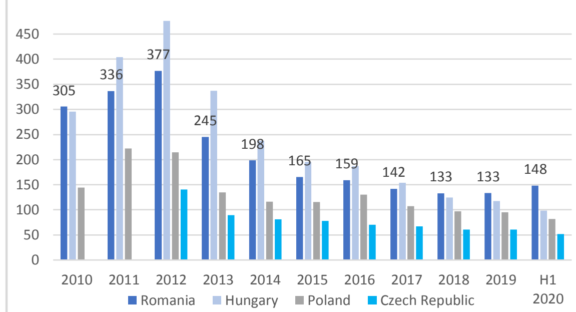


Fig. 19 Long term credit default swap (10Y)



Source: Thomson Reuters

[20] Traditionally, taken together, public sector wages and social security expenditures were less than 75% of current revenues. Even when taking into account the amount of tax deferral – estimated at around RON 12 Bn for the first half of the year – which should be paid to the budget by October 2020, the percentage remains very high, towards 90%.

[21] Part of the reason has been the drop in revenues together with authorities' decision to postpone the payment of some taxes until later in the year. Nevertheless, it still represents an extremely high figure.

[22] According to the current law public sector pensions are envisaged to increase by 40% in September 2020. Given the budgetary constraints the authorities aim to implement a lower raise, of around 10%.

[23] Other countries in the region have also lower CDSs. They benefit either from being in the Eurozone, such as Slovakia, which has a medium-term CDS of 52, or by being accepted in the ERM-2 mechanism, such as Croatia (medium-term CDS 74) and Bulgaria (medium-term CDS 43).

- The yield of euro bonds increased by 1-2 percentage points this year, more for longer maturity dates. The yield curve of government bonds issued internally on the primary market was kept below the yield curve of government securities issued last year, helped by the monetary policy loosening and a 0.75 percentage points cut in the monetary policy interest rate (Fig. 20). But the rising risk aversion is worrisome as the long maturity government bonds yield curve in the secondary market (Fig. 21) approaches the yield levels registered in the years when Romania was crowded out of the market and needed to ask for a financial assistance package from the EC, the International Monetary Fund and the World Bank (2009-2012).

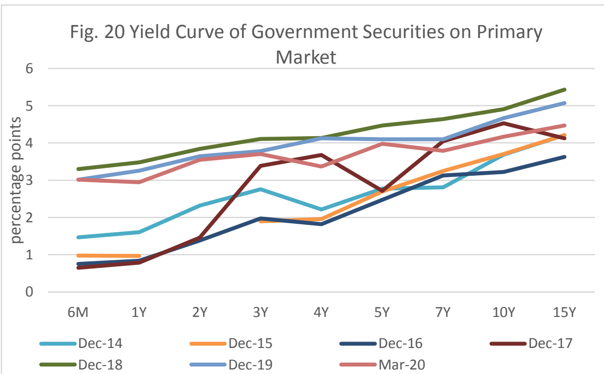


Fig. 20 Yield Curve of Government Securities on Primary Market

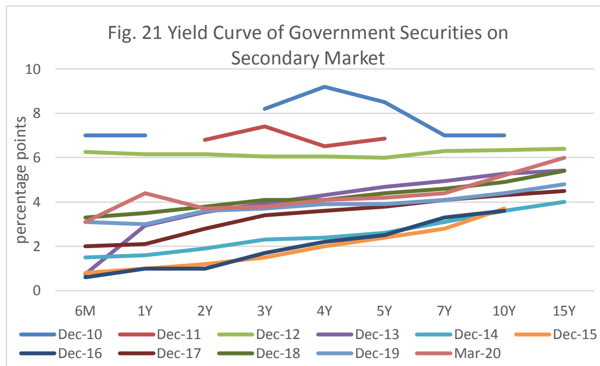


Fig. 21 Yield Curve of Government Securities on Secondary Market

Source: Ministry of Finance (Reports on Public Debt, 2010-2020)

3. How to Restart the Domestic Economy?

To restart the economy, the authorities have a choice of measures ranging from discretionary fiscal actions to legislative measures and specific projects financed by EU funds or borrowing. Discretionary fiscal measures have already been taken by the authorities and their effect will be protracted, helping the recovery. These were mostly designed for the short and medium term, to provide immediate support to the economy in dealing with the pandemics. Discretionary fiscal measures can be grouped into three categories:

- Immediate fiscal support, which effectively was directed towards buying medical supplies, partial wage payments for parents staying home during the period when schools were closed and supporting technical unemployment (see Annex 1).
- Tax payment deferrals, which helped maintaining liquidity for both consumers and companies. (see Annex 2).
- Liquidity provisions and guarantees (Annex 2). The set-up of IMM Invest aimed at providing a maximum of RON 15 Bn. guarantees—equivalent to 1.5% of GDP—for loan guarantees and subsidized interest for working capital and investment of SMEs[24].

Romanian recovery is tightly linked to the EU recovery, namely to the recovery in its main trading partners. 44% of the total foreign trade (imports and exports) with goods are with Germany, Italy, France, Spain and Netherlands. The faster the recovery will be in these countries the faster will be in Romania too. All these countries took sizable fiscal measures to support their economies[25] varying between 47.8% of 2019 GDP (up to June 3, 2020) in Germany and 12.6% of 2019 GDP (up to May 25, 2020) in Spain. In Romania the fiscal package amounts, so far, to around 3% of GDP and, by and large, has been appropriate given the existing fiscal constraints.

At 1st of July the government presented a massive EUR 100 Bn. investment plan[26], targeted for the next decade, aimed at helping the recovery and put the economy on a sound growth footing driven by investment rather than consumption, as it was in the recent past. Almost three quarters of the amount would be geared towards infrastructure building, over EUR 60 Bn for transport (roads, railways, subway, air and maritime) and EUR 12.5 Bn for the energy sector. The proposed investments for the energy sector target the development of both onshore and offshore wind parks, strategic investments in gas transport infrastructure, decarbonization of the coal fueled plants and increasing the nuclear capacity[27].

Given the sizeable forecast investment costs, maximising the use of EU funding streams will be a determinant factor for the development of these plans. Therefore, any such investment should try to

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[24] It could be supplemented to even RON 20 Bn., if the demand remains strong and banks' eligibility criteria is fulfilled.

[25] See for instance Anderson, Julia, Enrico Bergamini, Sybrand Brekelmans, Aliénor Cameron, Zsolt Darvas, Marta Domínguez Jíménez, Catarina Midões (2020), "The fiscal response to the economic fallout from the coronavirus," https://www.bruegel.org/publications/datasets/covid-national-dataset/#netherlands

[26] In a large part the investment plan consists of a list of sectorial investment actions, identified over the years as being priorities investments.

[27] Grants directed to digitalization and innovation for SMEs account for a relatively small share of total, EUR 0.5 Bn.

adhere to the new rigors of the EU taxonomy for sustainable activities and should be in line with the long-term priorities of the European Green Deal. The European Investment Bank (EIB), which has recently decided to pursue only sustainable investments from a climate perspective as of 2021, can also represent a source of capital for the proposed investments in the energy sector. By working with the EIB, funds from Next Generation EU could also be pursued. Finally, the issue of green bonds may also represent a further instrument through which such investments could be financed, both at local and national level.

While the investment plan addresses, by and large, Romania's stringent needs, there are several hurdles to be overcome on its road to full accomplishment. First, it is the issue of financing all these investments. Setting up new institutions, such as the proposed Romanian Investment Fund and the National Development Bank, as part of the investment plan, could channel some of the funds into the selected projects. However, the bulk of the financing would come from the budget while the EU funds are expected to play a large part in co-financing these initiatives (see below).

Second, there is the issue of Romania's absorption capacity of the EU funds. Given the country's past track record in absorbing EU funds, it is highly unlikely that this will change overnight[28], especially that there would some additional EUR 33 Bn. via the European Recovery Fund (ERF) to be absorbed over the next years (see below). Third, there is the crowding out aspect and the economic disequilibria which could emerge in the economy when faced with such a large investment stimulus on such an extensive period of time[29]. Fourth, such a plan would need continuity, as it is envisaged to cover two normal political cycles, so political agreement would be a prerequisite for its success.

Overall, the proposed amount to be invested seems rather large. In the energy sector for instance, state-owned companies such as Romgaz and Hidroelectrica, came up with investment plans whose future annual levels are between 3 to 6 times higher than the past ones[30] (Table 1 below).

Table 1. Past and Planned Investments in Select State Owned Energy Companies Until mid-2025

	Total planned investments, until mid-2025, RON Bn.	Implied yearly investments over the next 5 years, RON Bn.	Past annual investments RON Bn.
Hidroelectrica	7.6	1.5	0.25*
Romgaz	15.7	3.1	0.9**

Source: Company Strategy Reports. Hidroelectrica plans to invest RON 26 Bn over a longer time frame, out of which RON 7.6 Bn will be allocated until mid-2025. * average 2013-2018; ** in 2019.

A large part of these investment plans relies on EU co-financing and follows the European Green Deal directions while supporting the EU's 2050 climate neutral economy target. Hidroelectrica, for instance plans to invest in renewable energy projects such as onshore and offshore wind, solar or biomass. It also

[28] There are institutional, management, logistical and skills constraints.

[29] Annual average investment over the next decade comes to around EUR 10 Bn per year, the equivalent of ~5% of 2019 GDP.

[30] EU funds play a large co-financing role in these plans – which target green energy investments and decarbonization projects.

targets an increase in R&D investments and focus in decarbonization. Romgaz also plans to invest in renewable energy projects, but also allocated around a third of its budget to natural gas production activities.

Although the investment plans of the state-owned energy companies look rather optimistic, even if a fraction of these is accomplished in a reasonable time frame it will provide a boost to economic growth.

The post Covid-19 economy is likely to have a different supply/demand structure. At the EU level, the European Green Deal, in effect the new EU growth strategy, which aims to make the region carbon neutral by 2050, is aimed to be placed at the center of economic revival[31]. As such, financing the post Covid-19 recovery could see capital flowing into a ''new economy'' rather than in the old economic structure. Digitalization and transition towards less carbon emissions are the two key objectives of the recovery set by the EC. In both domains Romania is a laggard and needs large investments for development. Within the European 2021-2027 MMF some EUR 46 Bn might be allocated to Romania for investments[32]. It could be the most dynamic catching up period if properly prepared.

Subsequent to the Covid-19 crisis, the EC proposed a new recovery instrument, ERF, which will be linked to the European Green Deal and would channel resources to areas such as renovations of building and infrastructure, renewable energy projects and cleaner transport and logistics. The ERF, which will increase the EU budget temporarily, by EUR 750 Bn. is aimed to offer EUR 390 Bn. in grants and the rest in loans[33]. Romania would receive EUR 33 Bn. (out of which, a little over half of this sum representing grants and the remaining loans) beginning with January 2021 if the plan is approved by the European Parliament. The ERF will be financed through a range of additional taxes: 0.1% on large companies with turnover over EUR 750 Bn, a digital tax, tax on carbon emission, tax on unrecycled plastic and the doubling of custom duties) and borrowings from international markets. Discretionary fiscal measures communicated so far amount to 4% of Euro area GDP, while nearly 20% of euro area GDP has already been committed to loan guarantee schemes that reduce banks' credit risk.

Another important instrument for supporting companies in a post Covid-19 environment are the loan guarantees for SMEs (see Annex 3). In Romania the allocation for credit guarantees for SMEs amount to Ron 20 Bn (€4.1 bn), while the guarantees for large companies is intended to be around RON 8 Bn.

Legislative measures could also be employed to aid recovery as they will not have a direct budgetary impact and would generate future public revenue growth. These could focus on fiscal measures that would entice the private sector to invest, such as allowing for an accelerated depreciation or tax allowances for a certain period during the investment phase.

[31] The current debate on the European Green Deal investment plan is interwoven with the ongoing negotiations on the EU's 2021-2027 Multiannual Financial Framework (MMF), which needs approval from European Parliament and requires unanimity in the European Council.

[32] This is the gross amount. The net amount is obtained subtracting Romania's contributions to the EU budget, equivalent of ~ 1% of Gross National Income for each of the MMF's seven years, i.e. around EUR 17 Bn in total.

[33] At the time of writing the ERF still needed the approval of the European Parliament.

4. Concluding remarks

The Covid-19 crisis represents a massive shock to the global economy. Worldwide, the recovery phase will likely take around two years and is going to be conditional on containing the spread of the virus. The potential emergence of multiple waves remains real and could hamper recovery plans. However, it was the authorities' response to the emergence of the virus, through the imposition of country-wide lockdowns, thus shutting down their economies, that has caused a reduction in economic activity of such magnitude. As countries start to count the economic cost of their actions, the authorities' appetite for renewed country-wide lockdowns seems to have waned substantially across the world. In Romania for instance, the number of officially identified daily infections remains elevated (i.e. in early July), reaching its highest level since the emergence of the crisis[34]. The approach in dealing with the crisis has rightly evolved towards keeping the economy open, with the authorities favoring conditions defined by ''a state of alert'' instead of a generalized lockdown.

Measures to support Romania's current economic recovery and future growth are intertwined and should support each other. There are several points worth noting.

First, Romania's fiscal space to respond to the Covid-19 crisis is limited. Fiscal measures adopted by the authorities to support the economy amounted to the equivalent of some 3% of GDP, one of the lowest in the EU. While they have been effective in mitigating the first-round effects of the crisis, it is unclear how the economy will respond once the state payments for unemployment benefits cease or companies' fiscal obligations resume as normal. Also, in the short and medium term, some of the company loans backed by state guarantees could fall into the non-performant category, adding to budgetary costs.

Second, public sector investments would help economic recovery this year while limiting the size of economic contraction. But, the authorities' current strategy to spur economic revival through sizable investments over the next decade could become constrained in the near future by the level of borrowing costs, as the public debt to GDP ratio gets higher. Here, the availability of EU funds could prove crucial in providing the necessary co-financing to support these investments. A large part of Romania's EUR 100 Bn. proposed investment plan focuses on infrastructure, which is supported by the EU's new recovery instrument, Next Generation EU. However, more detailed plans would be needed to be put forward for domestic projects related to the other pillars of European Green Deal: renewable energy projects, including wind, solar and hydrogen, cleaner transport and logistics and the ''Just Transition'' mechanism – which includes the Just Transition Fund, the InvestEU funding stream and loans from the European Investment Bank backed by the EU budget. The European Green Deal could be an important driver in growth generation, both in Europe and in Romania. The state will, necessarily, play an increased role and a heightened attention should be paid to the transition period in order to avoid unnecessary future social and economic costs.

[34] Testing capacity has also increased substantially since March leading, potentially, to higher daily cases. However, other indicators such as R0, the basic reproduction number, or Re, which represents the effective reproductive number, are more relevant when forecasting the Covid-19 evolution. While estimates of these are in themselves important in attempting to predict the path of the pandemic, they are beyond the scope of this paper.

Third, given the importance of industry to domestic economic growth, its recovery would help the economy, overall. To a certain extent this will depend on how fast the activity in European industry will bounce back. But there is another opportunity to expand the industry's domestic capacity. Growing geopolitical tensions, especially those between the US and China could become a new a source of shocks adversely affecting the global economy. As a consequence of these, Europe itself could benefit from an inward shift of the supply chains. Romania finds itself in a good position to benefit from businesses' relocation to Europe, already gaining an increasing share in the supply chains in Europe after the 2008 crisis.

For that to happen, however, Romania will need to invest much more in energy, ICT & physical infrastructure. At the domestic policy level, talks should be raised onto the next level on topics such as digitalization, artificial intelligence (AI) or decarbonization and the debate should be positioned on the issues dealing with the structural transformation of the economy. For instance, a new study[35] reveals that, on average, Romania's share of jobs that can be performed remotely, at slightly less than 30%, is one of the lowest in Europe. The remote working potential represents a source of economic resilience and reflects the skills level of the workforce. Investment in the skills of the workforce, supported also by EU programs such as the Skills Agenda for Europe or the Digital Education Action Plan, could play an important part in driving future growth.

The focus on the short-term recovery measures and long-term economic growth plans should not, however, detract the authorities from dealing with the existing macroeconomic imbalances. In particular, the sustainability of public finances has become the most pressing issue. Government borrowing needs in 2020 are already sizable, the largest in recent history in nominal terms, and, depending on the magnitude of GDP drop this year, could go even higher. The current government policy which favors borrowing in order to finance public sector wages and pensions is not a viable long-term strategy. This is reflected in the high premium Romania pays on sovereign borrowing – the highest in the EU. Romania's country risk, measured by the country's credit default swap has risen since the beginning of the year. And, although its level is still low – roughly a third of what it was in 2010 – the trend is worrisome, Romania being the only country in the region to witness a sizable increase in credit risk since the beginning of the crisis.

Spending on social security and public sector wages represented over 90% of current revenues in May, highlighting the increased pressure the budget deficit has come under. In the very short term, adjustment in public sector spending is mandatory in order to reduce macro imbalances faster. Any increase in pensions this autumn, larger than the inflation rate, would put additional pressures on fiscal deficits in the years ahead.

Romania's future domestic growth potential remains high but, to exploit it properly, it requires coherent economic policies set by a strong and credible leadership within a framework of strengthened institutions.

[35] Ozguzel et all (2020) – Potential for Remote Working Across Different Places,
retrieved from https://voxeu.org/article/potential-remote-working-across-different-places (on July 2020)

Annex 1. The Labor Market – Measures Taken During the Lockdown and April Net Wages

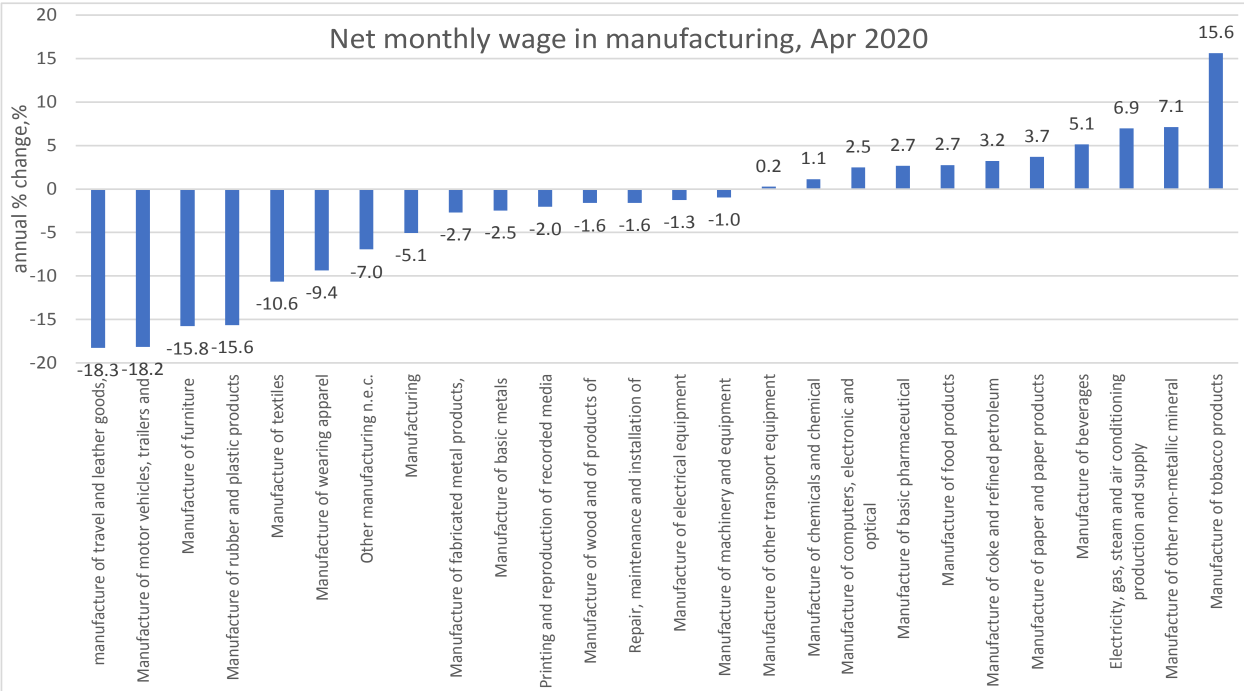
The government took the following measures to protect the income of workers unable to work:

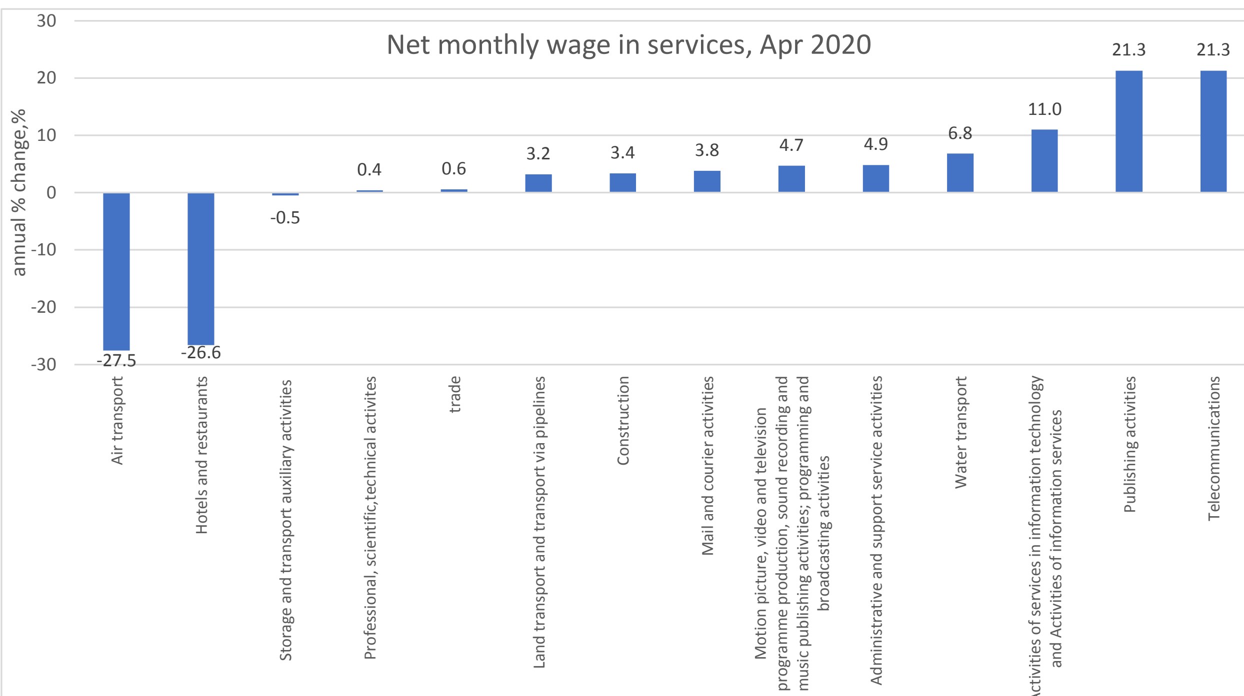
- A benefit of 75% of wage but no more than 75% of the average wage to parents who cannot work remotely and have to stay home with kids younger than 12years. The budget amendment of 17 April provides RON 1.4 billion for this purpose.
- The government adopted on 18 March - and published - on 21 March an emergency ordinance (OUG) 29/2020 on supporting local businesses in the context of the crisis caused by the coronavirus, along with OUG30/2020 that amends existing regulations to bring them in line with the current conditions. According to the statements by the government, the package of measures presented on 18 March (including technical unemployment and Intervention Fund) represents a budgetary effort of 2% of GDP.
- Based on the ordinance 29/2020, the state will pay the technical unemployment benefits on behalf of the companies who send their employees home and suspend their activity due to the restrictions imposed by the authorities for limiting the coronavirus outbreak or because of financial problems caused by the Covid-19 crisis. It amounts to 75% of the gross salary (as much as the monthly unemployment benefit), but not more than 75% of the (national) average salary. The budget amendment of 17 April provides RON 4 billion for technical unemployment benefit and RON 3 billion of additional emergency funds which could be redirected for this purpose. Technical unemployment continued to be paid after the end of the state of emergency, 15 May, until 1st of June. For companies whose activities are impacted by the restrictions that will have to remain in place, it could continue after 1 June.
- Emergency ordinance 30/2020 also gives a possibility for the state to pay the minimum wage to those who cannot claim technical unemployment, like self-employed or micro/family enterprises. The budget amendment of 17 April provides RON 1.9 billion for this purpose.

In April 2020, for the first time since 2011, the annual growth of net monthly wage fell below the annual inflation. In several sectors wages contracted by 10-20% compared to the year before. These sectors are, for the time being, the very short-term losers from the Covid-19 crisis. The sectors where wages have increased could be interpreted as being the winners in the very short term.

However, it is far too early to draw a definitive conclusion regarding the behavior of wages for the remaining of the year. It may be that the potential drop in consumption would affect other sectors in the coming months, which, in turn, will be forced to adopt wage or job cuts policies.

Net Monthly Wages in Manufacturing and Services in the First Full Month of Lockdown:





Source: NIS

Annex 2. Fiscal Measures Aimed at Providing Liquidity to Firms

Beyond increasing expenditures, the following tax measures have been taken to propel firms' survival during the lockdown.

- Speeding up VAT reimbursements.
- Suspending (or not starting) the forced execution of amounts due to the state budget with the exception of amounts resulting from a court decision in criminal cases.
- The deadline for the payment of the tax on building, land and transport equipment (local taxes) was postponed from 31 March to 30 June.
- Based on a government emergency ordinance (GEO) 29/2020, during the state of emergency and +30 days after it has ended, tax obligations that become due and are not paid on time are not considered as being outstanding tax obligations (no interest nor penalties are charged for non-payment and enforcement measures are not used by the tax administration).
- On 26 March the government approved a draft GEO (33/2020) with a rebate for taxpayers who pay the corporate income tax by the April 25 deadline (for the first quarter of 2020), as follows: 5% for large taxpayers, 10% for remaining taxpayers. On 23 April the parliament extended the 10% rebate to all CIT taxpayers and also to the payments due on July 25, 2020 for the second quarter and October 25, 2020 for the third quarter.
- The draft GEO of 26 March also provides that during the period of emergency and 30 days after the cessation of emergency, VAT is no longer required for imports of medicines, protective equipment and other medical and sanitary devices that can be used to prevent, limit and combat COVID-19. Impact on cash flow.
- Exempting the hospitality industry from the specific tax for 90 days.

Annex 3. Table A3 – Loan Schemes in Select Countries in the Context of Covid-19 Crisis

		DE	FR	IT	ES	NL	RO
Size of the guarantee	Euro Bn	822	300	450	100	25	4.1
	% 2019 GDP	23.9	12.4	25.2	8	3	1.9
	% bank assets	9.9	3.2	12.1	3.7	1	4.0
	% NFC loans (stock)	86	28.4	71.3	23	8.3	17.5
Pricing guarantee		in line with EC	in line with EC	partly free, partly with cost to firm	20-125 bps paid by banks	one-off of 1.5% to a maximum annual interest rate of 0.4%	in line with EC
Share of loan guaranteed		80/90% limited amounts up to 100%	90/80/70% depending on from turnover	from 70% to 90% for new loans, limited amounts up to 100%	80% for SMEs % self-employed, 60-70% for large NFC	67.5% to 100%	90%/80% for microenterprises/SMEs;
Max. amount per borrower		25% of 2019 turnover	25% of 2019 turnover	up to 25% of 2019 turnover	up to 2x last annual wage bill or 25% of 2019 turnover	150 Mill Euro	up to the average of working capital in the last 2 years
Eligibility Criteria		different for different schemes; in line with EC framework	in line with EC framework (company not in solvency proceeding as of 31 Dec 2019)	different for different schemes; in line with EC framework	in line with EC framework	different for each scheme for large and medium sized companies in line with EC framework	all SMEs and micro enterprises

Sources: ECB staff and national authorities.

Disclaimer

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