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REPORT ON GOVERNMENT DEFICIT

8 May 2018

The budget started 2018 on a weak note; keeping the deficit at 3% will not be effortless; declining public debt ratio could come to an end

- In 2017, Romanian authorities managed to keep the ESA deficit a touch below the 3% ceiling (more precisely at 2.9% of GDP; see Chart 1). This level corresponds to a modest improvement compared to Q3's 3.2% (data calculated on 4Q rolling basis), and it was virtually unchanged relative to 2016's 3.0%. We note that near-3% deficit levels are quite common in emerging economies across the world, and it is also in line with Romania's long-term track record. However, the 2017's 2.9% gap was achieved in very favourable economic conditions and by means of sacrificing public investments. It should be noted that Romania ran a significant positive output gap last year (3.6 percentage points according to the NBR, while the EC had a more conservative estimate of around one pp). This means that the cyclically adjusted deficit exceeded the 3% limit. Moreover, last year's outcome was in sharp contrast with the trends seen in the European Union (Chart 3), as only Spain (3.1%) and Portugal (3.0%) recorded higher deficits. Timelier cash-basis statistics indicated that the government balance started 2018 on a weak note (Chart 1). The good news is that in 2017 Romania's public debt shrank by 2.4 percentage points, to 35.0% of GDP. This was one of the lowest levels in the EU (Chart 2 & 4).
- We recall that in the period of 2010-2015, Romania's budget deficit shrank remarkably on the back of painful austerity measures and the reviving economy. However, the government balance marked a turning point in 2015, as policy-makers started to utilize the fiscal room to implement a series of aggressive stimulus actions, including several tax cuts and important wage increases. In the past two years, the widening deficit was mainly offset by scaling back public investment as well as by several one-off tools. Due to the budget's strongly pro-cyclical feature and its unfavourable structure, fiscal policy became the key macroeconomic risk of the country.
- After the significant drops in the past quarters, revenues apparently stabilised slightly above 30% of GDP in Q4 2017 (Chart 5), helped also by the strength of the labour market, which provided a boost for inflows from net social contributions. The collection ratio has been as low as that since the turn of 2009-2010, when the global financial crisis put an enormous load on the country's economy. This implyes that the revenue side remained a particularly important soft spot of the government budget, pointing to a large gap relative to the EU average (Chart 6). In Q4, revenues from VAT remained unchanged, near 6.2% of GDP, but other production taxes eased despite the fuel excise duty hikes in September and October 2017 (Chart 7).
- Overall, total expenditures eased further in Q4, to 33.4% of GDP and, accordingly, played an important role in keeping the deficit below the 3% limit (Chart 5). Nevertheless, the details continued to paint a worrisome picture. The compensation of employees and social transfers rose significantly, while these increases were mainly offset again by lower public investments (Chart 8). To a lesser extent, tight control over intermediate consumption also helped to reduce general government expenditures. We reiterate that Romania's public wage bill is broadly in line with the levels seen in other EU countries (on average, near 10% of GDP) and, undoubtedly, it is also an important tool to retain highly-qualified workforce, particularly in health and education. However, given the very soft revenue side of the budget, the swiftly rising salaries put significant pressure on the deficit. It should be noted that, compared to revenues, Romania's wage bill became the most expensive in the European community in Q4 2017 (Chart 9). Simultaneously, total capital expenditures slipped below the EU average (Chart 10), a very unpleasant outcome for a country like Romania, with sizable need for infrastructure improvement.
- This year's 3% deficit target seems to be challenging, particularly as Q1 cash-flow-based budget statistics were rather disappointing (Chart 11). Personal expenses, social transfers, expenditures for goods and services as well as borrowing costs posted double-digit annual growth rates. At the same time, public investments also picked up sharply, fuelled by recovering EU fund absorption and the acquisition of the Patriot missile system. Revenues posted a robust increase as well, but they were not able to keep pace with expenditures. Moreover, it seems that the deceleration of the country's economy started to weigh on revenues, with inflows from VAT barely increasing in Q1. Beside base effects, this can be explained by a significant setback in household consumption (Chart 12). We recall that the VAT gap (the difference between the theoretical and actual VAT revenues) is particularly wide in Romania. Therefore, it would be desirable to improve collection efficiency. The example of several countries in Central and Eastern Europe shows that well-designed online cash register and electronic toll systems can generate remarkable and quick results.

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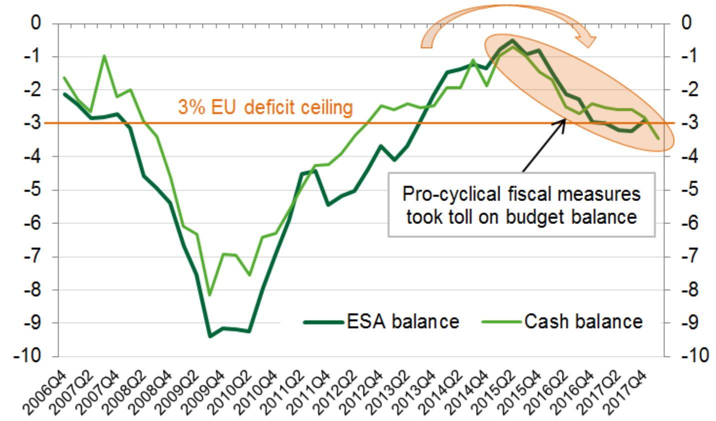
- Given this context and also taking into account the government's plans to further raise pension benefits and public wages, as well as owing to the moderating economic growth, we think that this year's budget deficit may reach around 3.8% of GDP. Nevertheless, the government seems to be committed to its deficit target. Therefore, similarly to 2017 correction measures could be implemented in order to keep the gap near the 3% ceiling. Admittedly, dividends from majority-state-owned companies may provide some relief again, but likely other solutions will be put on the agenda too. We note that the Ministry of Finance hinted that the pension system could be modified in the following period, but no further details will be revealed before end-June.
- With presidential (2019) and general elections (2020) in the pipeline, we see slim chance for a remarkable reduction of the deficit in the years ahead. This, together with slower nominal GDP growth and higher financing costs, is expected to result in an inflection point in the trajectory of Romania's government debt ratio.

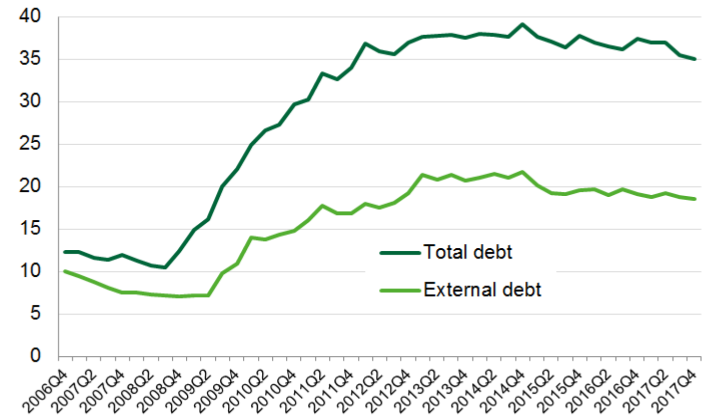
Chart set:

Chart 1: Consolidated general government balance
(as % of GDP, 4Q rolling)



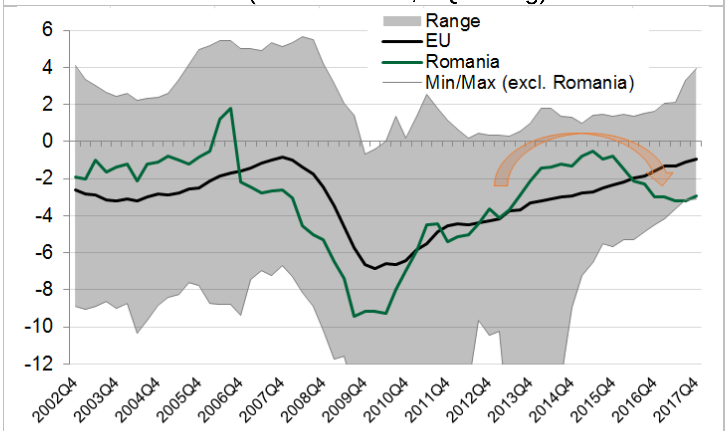
Sources: Eurostat, Ministry of Finance, OTP Research

Chart 2: Romania's public debt
(as % of GDP)



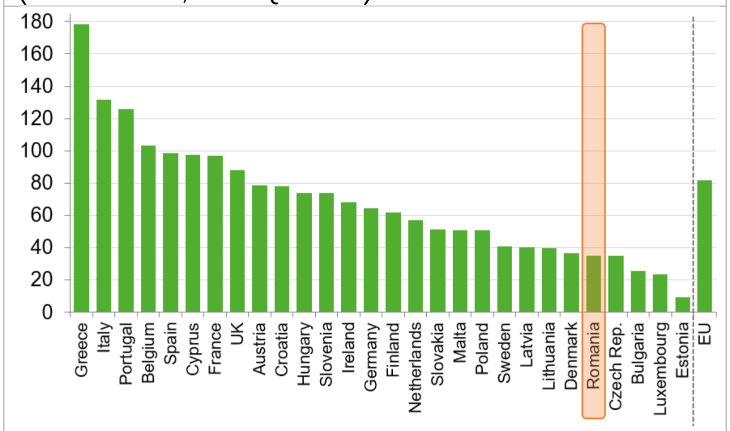
Sources: Eurostat, NBR, OTP Research
Note: external debt data based on BPM5 methodology until 2012 Q4

Chart 3: Consolidated general government ESA balance in the EU (as % of GDP, 4Q rolling)



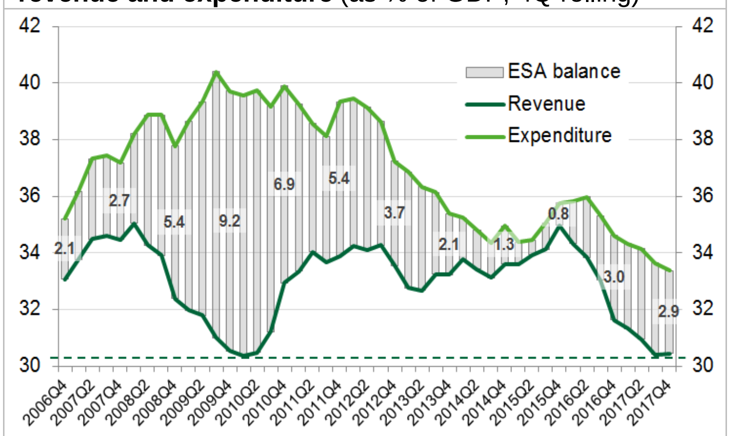
Sources: Eurostat, OTP Research

Chart 4: Public debt in the EU
(as % of GDP, as of Q4 2017)



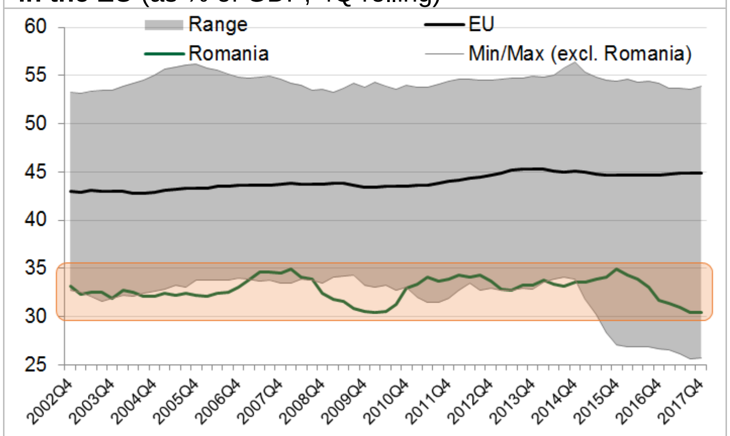
Sources: Eurostat, OTP Research

Chart 5: Consolidated general government balance, revenue and expenditure (as % of GDP, 4Q rolling)



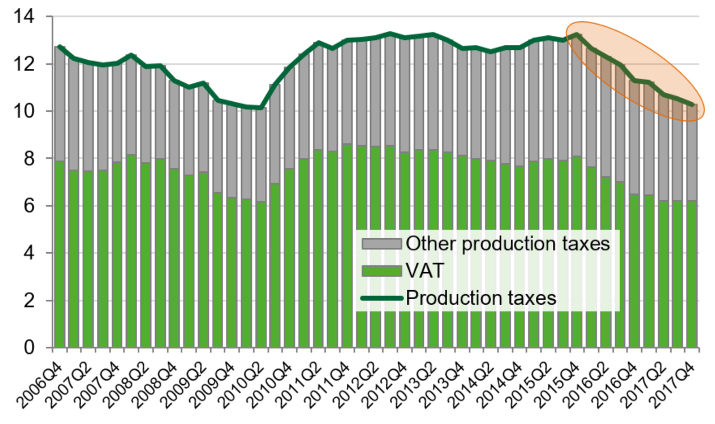
Sources: Eurostat, OTP Research

Chart 6: Consolidated general government revenue in the EU (as % of GDP, 4Q rolling)



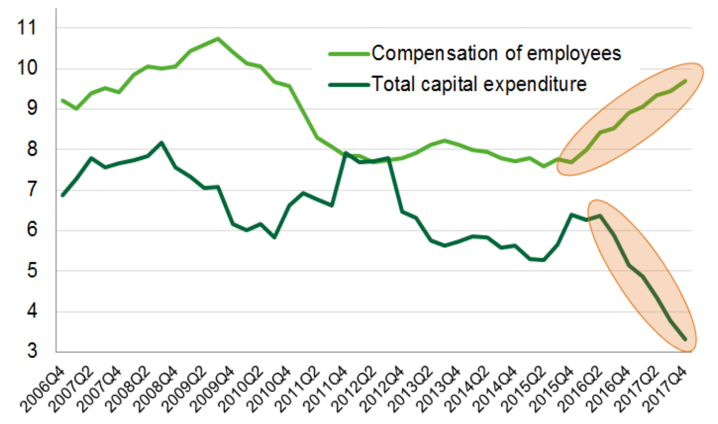
Sources: Eurostat, OTP Research

Chart 7: Production taxes
(as % of GDP, 4Q rolling)



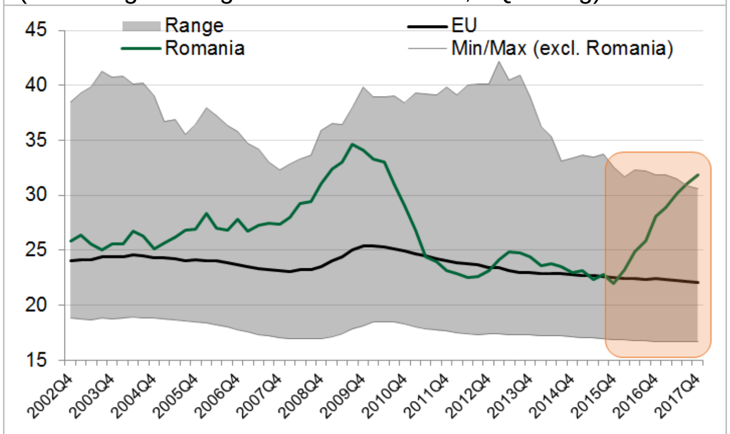
Sources: Eurostat, OTP Research

Chart 8: Compensation of employees vs. public investments (as % of GDP, 4Q rolling)



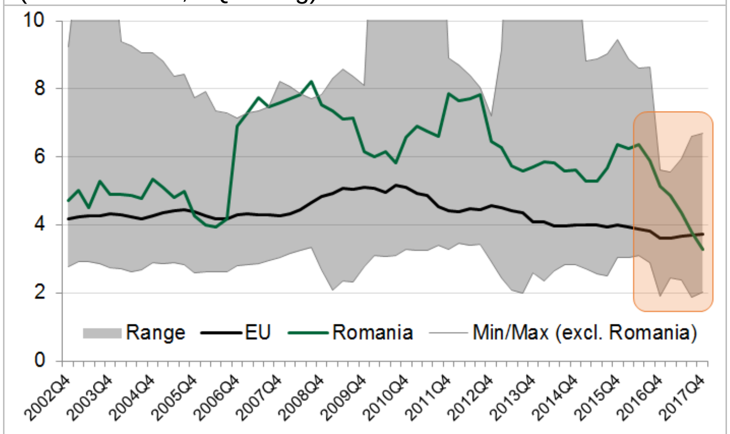
Sources: Eurostat, OTP Research

Chart 9: Compensation of employees in the EU
(as % of general government revenue, 4Q rolling)



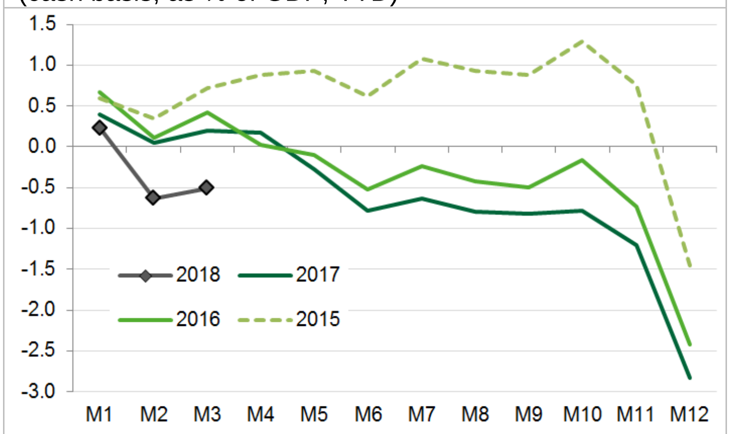
Sources: Eurostat, OTP Research

Chart 10: Total capital expenditures in the EU
(as % of GDP, 4Q rolling)



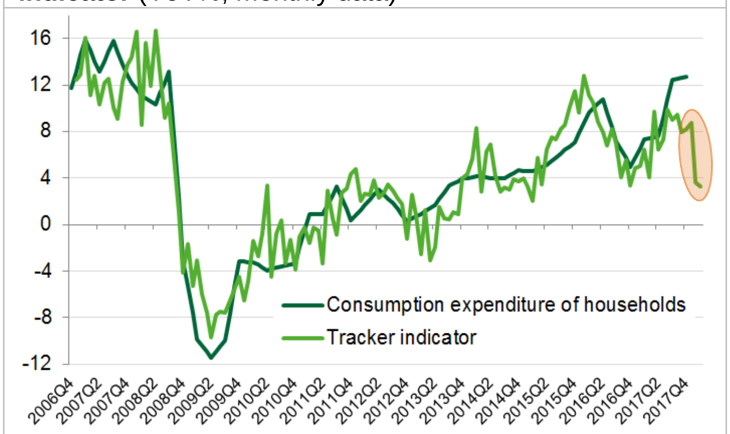
Sources: Eurostat, OTP Research

Chart 11: Consolidated general government balance
(cash basis, as % of GDP, YTD)



Sources: Ministry of Finance, OTP Research

Chart 12: Households' consumption vs. its tracker indicator (YoY%, monthly data)



Sources: NIS, OTP Research
Note: the consumption tracker is an in-house composite indicator based various high-frequency indicators, including among others retail sales and passenger car registration data

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