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Focus Notes: Romania

Romania: No confidence vote fails to bring down government coalition

- ✓ The government coalition survived a no confidence vote by a narrow margin of 8 votes in June 15th. 228 parliament members voted for the motion with a majority of 236 votes needed, 197 against it while 13 abstained.
- ✓ The motion was initiated by the leftist main opposition party PSD in order to boycott the austerity fiscal package, when the government invoked an emergency situation to ask for endorsement of the package in the parliament. The opposition argued against the implementation of spending cuts would trigger a "social genocide". On the other hand, Prime Minister Boc emphasized spending cuts as a responsible decision, the only solution to continue servicing debt obligations
- ✓ The rejection of the no confidence motion was the main scenario the financial markets were discounting. Yet, the political volatility has contributed to the hikes of CDS spreads by 150 bps to 370 since the beginning of May. Initially, the RON edged higher to 4.2272/€ after the initial announcement of the failure of the no confidence vote.
- ✓ However, RON soon came under renewed pressure, ending last week at 4.2448/€, as it became apparent that the fiscal consolidation package will not be easy to implement under continued political instability and high public discontent. Thousands of trade unions members rallied outside the parliament to protest against the austerity package. The uncertainty over the government coalition's ability to implement harsh spending cuts pushed government bond yields higher to around 7%
- ✓ The Ministry of Finance accepted RON 343mn of 6-month T-bills on Monday, June 15th against an offer of RON 1bn. The average yield was 6.74%, up from 6.38% in the previous auction. Accordingly, in another bid for 5-year bonds, the Ministry accepted offers for half of the offered amount (RON 284m out of 600m) at 6.97%, 8 bps higher than in the previous auction
- ✓ The rejection of the no confidence vote does not necessarily mean that political jitters are over in Romania. The opposition party will challenge the austerity package bill in the Constitutional court. Local press reports that the Constitutional court will announce the decision on June 24th. This

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would be only 4 days before the board of directors of IMF decides upon the release of the fifth tranche of the regular stand-by agreement. The IMF has stressed that unless the implementation of the spending cuts is fully ensured and all legal obstacles removed, the release of the €850 mn tranche will not be allowed.

- ✓ On the other side, the endorsement of the package and the public criticism of the key ministers of the ruling party PDL by President Basescu have sparked rumors over an imminent cabinet reshuffle. However, according to his latest statement, President Basescu gave the current cabinet a deadline until September 1 to fully implement the required structural reforms. In addition, he warned that the ministers who would not complete them by that time would be replaced. In that sense, the threat of a cabinet reshuffle will give the productivity of the weak government coalition a boost.
- ✓ The fiscal austerity package cuts in expenditure came in response to the IMF request for reducing the fiscal deficit to a revised target of 6.8% of GDP in 2010. IMF assessed that in the absence of those corrective measures the fiscal deficit would spiral to 9.1% of GDP in 2010. The fiscal performance was already disappointing in the first four months of 2010. The fiscal deficit was 29% yoy higher, amounting to 2.2% of GDP.
- ✓ The government opted to reduce expenditure - rather than to increase taxes, or a combination of both – via a 25% cut in public wages and a 15% cut in pensions. In our view, the recently announced aggressive spending cuts will have a dampening effect on consumption, which is the main contributor to GDP in Romanian economy. Consumption accounted for 81.1% of GDP in 2009. As a result, we downgraded our previous GDP growth forecast from 1% to 0% in 2010.
- ✓ President Basescu said the IMF mission and the government had considered the option to raise the main VAT rate to 24% from 19% and the income flat tax to 20% from 16% instead of cutting wages and pensions. However, the governments committed to tax hikes in case spending cuts do not live up to expectations. For a more complete analysis of the potential repercussions of a tax rate hike, please see the in focus analysis "A note on fiscal policy" in our May issue of New Europe Economics & Strategy.

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