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New Europe Economics & Strategy

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Tuesday, May 11, 2010

Focus Notes: Romania

Romania: President Basescu announces corrective fiscal measures

- ✓ Romanian President Trian Basescu announced in a public address on May 7th an ambitious fiscal consolidation programme, which aims to facilitate fulfillment of the new IMF-backed fiscal targets
- ✓ The fiscal package includes, among others, the following measures: a) effectively from June 1st (and until, at least, January 1' 2011) the public sector wage bill will be cut by 25% b) pensions and unemployment benefits will each be cut by 15% for the same period as wages c) public subsidies will be drastically limited to low income families and d) the government will impose taxes on real estate transactions and will also raise property taxation.
- ✓ In its latest review of Romania´s stabilization program, the latest IMF mission (officially scheduled to leave Bucharest on May 10), revised downwards its GDP growth forecast for 2010 to ''flat or even negative'' from 0.8% expected earlier. In line with that revision, the Fund raised its fiscal deficit target for Romanian in 2010 from 5.9% of GDP to 6.8% in 2010.
- ✓ In order to ensure fulfillment of the revised target, the IMF requested additional fiscal measures to be taken before any new disbursement of funds is approved.
- ✓ Opposition parties and public sector unions reacted negatively to the IMF demands. The main opposition party PSD announced that its plans to vote against the proposed fiscal package. The minor opposition party NPL criticized the government as well, though it was not immediately clarified whether it will vote for or against the measures. Trade unions have already announced that they are organizing a general strike against the package.
- ✓ The consolidated budget deficit came at RON 8.22 billion in Q1 2010, within the RON 8.25 billion deficit target set at the IMF loan agreement. However, as we have repeatedly stressed in the past the implementation of this year's budget may well prove a Herculean task. In our latest *New Europe Economics and Strategy monthly* issue (April 2010), we listed a number of potential risks to the 2010 Romanian fiscal outlook.
- ✓ The government had earlier committed, but not entirely specified, how it would plan to achieve tough unpopular spending cuts (in 2010?) equivalent to 2 pps GDP. From that point of view, the

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announcement of auxiliary fiscal measures helps to clear out some uncertainty with respect to government´s fiscal consolidation program.

- ✓ According to some preliminary calculations, the announced corrective measures will provide immediate savings of around €1.7 bn (approximately 1.4% of GDP) in 2010. Additionally, the Ministries will need to proceed with a considerable number of lay-offs before the end of this year so as to facilitate attainability of the new fiscal targets. The press has repeatedly mentioned that the latter would necessitate some 100,000 layoffs in the public sector. The IMF has brought the number of potential public sector lay offs up to 250,000.
- ✓ On the other hand, the achievement of the ambitious target for budgetary expenditures hinges upon the completion of significant reforms, including the pension reform, and the unified public wages scheme. Adoption of these reforms is still pending. Originally scheduled for the end of 2009, the introduction of the pension reform is now due by the end of June 2010. Although the government appears to be committed to a major overhaul of the pension system, considerable implementation risks lie ahead. The activation of the uniform wage law requires the adoption of additional legislation that will not be fully implemented before September. On a more positive note, the government has already adopted the fiscal responsibility law.
- ✓ In our view, the adoption of the recently announced fiscal measures entails a number of significant implications. **First of all, the timely implementation of the corrective measures should not be taken for granted**. The package needs to be endorsed by the parliament in which the government enjoys only a slim majority. As a result, the government may encounter significant resistance from opposition parties which may well test the cohesion of the government coalition.
- ✓ Moreover, the package may be legally challenged in the Constitutional Court. Consequently, the implementation of the fiscal package may be subject to significant time delays. Provided that the fiscal package is implemented on time, the IMF will not disburse the release the next loan installment of €850 mn until July instead of the original schedule in June. In this way, IMF wanted to make sure that the government has enough time to enact the changes
- ✓ **The second implication is that** fiscal austerity may have impact 2010 GDP growth negatively. Total consumption which holds a prominent share in economic activity (81.1% of Romanian GDP in 2009), is going to be negatively affected.
- ✓ **The third implication is that tax hikes cannot be ruled out of the agenda** From an economic policy point of view, the government chose wisely to cut down on public expenditures instead of raising taxes. At this point, this decision gives more flexibility to the private sector. 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 don't live up to expectations. In our view, this is still a relatively medium probability scenario to happen.
- ✓ Markets and analysts reacted positively to the news of the fiscal corrective package. RON benefited at the same time from the positive news on European Stabilization Financial Mechanism

as well. The RON strengthened up to 4.1648/€ on Monday, May 10th against 4.1990/€ on Friday, May 7th.

- ✓ Last but not least, the latest negative news flow on weak growth outlook ensures that the Central Bank will maintain its easing bias for a longer than originally anticipated. We still see room for rates to reach 6.0% (currently from 6.25%) by the end of 2010.

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