Financial and Economic Review, Vol. 20 Issue 3, September 127–137.

What Happened in the Neighbour? The Past Decade of Romania's Economic Convergence*

Katalin Kis

While further enhancing Hungary's convergence strategy, one should take a look at the convergence process of other countries in the Central and Eastern European (CEE) region, as well as the underlying reasons, the achievements, the issues encountered, the structure of growth and the development of balance indicators. The economic convergence in Romania is a good example of the benefits and drawbacks in this process. In the decade prior to the coronavirus crisis, Romania exhibited one of the most rapid convergence in the CEE region in terms of level of development. Starting from 51.6 per cent in 2010, the country reached 69.4 per cent of the European Union's level of development by 2019, coming close to Slovakia. In the years leading up to the Covid-19 crisis, Romania was among the top performers in economic growth in GDP terms. This growth was based on the significant expansion of disposable real incomes, the dynamic rise in household consumption, growing investment due to the stable investment climate and the government's housing market programme as well as a major improvement in productivity, partly related to the ICT sector. Nevertheless, improving productivity often conceals overheating, and after 2015, wages increased more than productivity. In addition, the deterioration in the current account deficit, together with the increasing deficit and government debt related to the coronavirus crisis, all point towards a negative trend in balance developments. The fact that Romania was able to converge in terms of GDP per capita as measured at purchasing power parity was due to dynamic growth, a substantial population decline and statistical effects.

1. Economic convergence in Romania – GDP per capita and what lies behind it

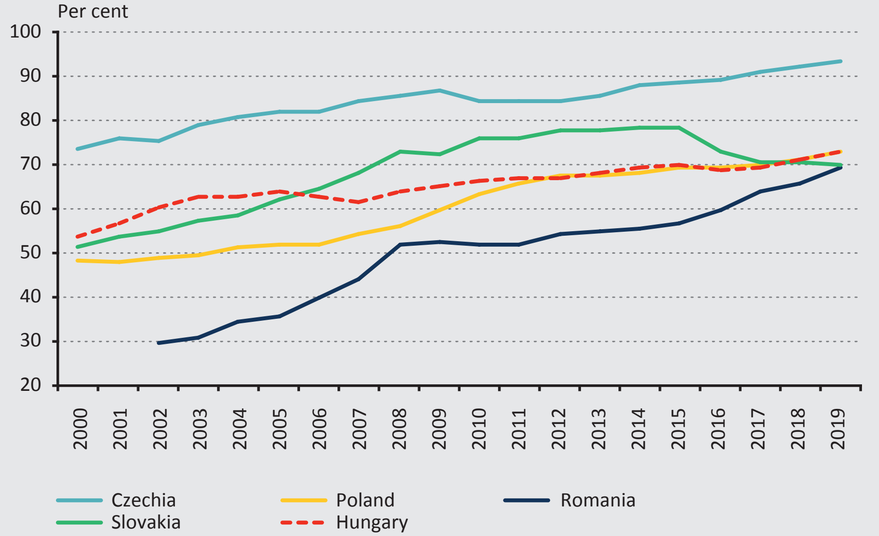
In the decade prior to the coronavirus crisis, Romania exhibited one of the most rapid economic convergences in the CEE region. Thanks to this fast growth, the country's level of development rose from 29.6 to 51.6 per cent of the EU average between 2002 and 2008. However, in the years prior to the global financial crisis, the period of rapid growth led to a build-up of imbalances and an overheating of the economy. Therefore, as the impact of the 2008–2009 economic meltdown started to be felt, real economic convergence was interrupted in Romania, too. The crisis

* The papers in this issue contain the views of the authors which are not necessarily the same as the official views of the Magyar Nemzeti Bank.

Katalin Kis is an Economic Analyst at the Magyar Nemzeti Bank. Email: kiska@mnb.hu

forced the country to make significant consolidation efforts, which entailed the signing of a standby arrangement with the International Monetary Fund and the introduction of reforms. After 2011, the Romanian economy was once again on track for growth, before changing gears in 2013 to become one of the top performers in European convergence. The level of development increased by 17.2 percentage points in the past decade, and by 2019 it came close to Slovakia, at 69.4 per cent of the European Union's level of development (*Figure 1*).

Figure 1
Evolution of relative development in relation to the EU



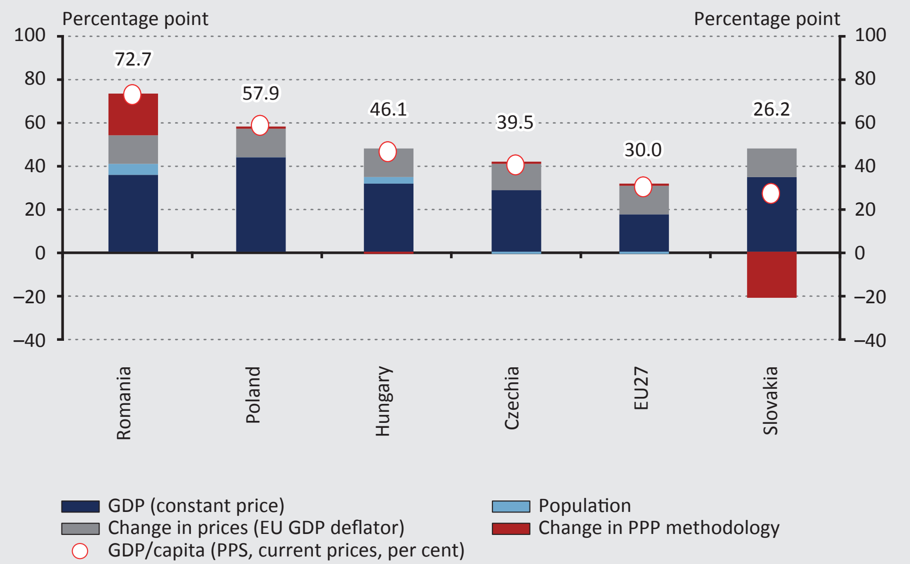
Note: Based on purchasing power parity data at current prices
Source: Eurostat

GDP per capita at purchasing power parity grew by almost 50 per cent in Hungary between 2010 and 2019, while the same figure was almost 75 per cent in Romania. Romania's convergence progressed at a faster pace than economic growth, due to dynamic growth, a substantial population decline and statistical effects (*Figure 2*).

In the past decade, one of the largest population declines in the European Union was registered in Romania. The population of Romania diminished by around 5 per cent, whereas the same figure was 2.5 per cent in Hungary. Approximately 75 per cent of this decline is attributable to emigration. In 2019, 18.4 per cent of Romanian citizens were living abroad, typically employed in lower-skilled jobs as migrant workers in Italy, Spain, Germany or the United Kingdom (*OECD 2019*). The connection maintained by the workforce abroad to the home country is crucial, and the question is whether the economic growth and increasing welfare can entice Romanians to return home from abroad. According to an *OECD* (*2019*) survey, in 2015–2017 the employment rate of the low-skilled and moderately skilled Romanians returning was higher than those who had not emigrated, while the reintegration of graduates was less successful. The former could be explained by the younger age structure of the emigrating population, while the latter is probably attributable to the differences between the economies of the host country and Romania. It remains to be seen whether the growing productivity of the Romanian economy and the rise of the ICT sector[1], which now produces greater value added, will contribute to the reintegration of higher-skilled Romanians into the domestic labour market.

In Romania, *the increase in GDP per capita was greatly influenced* in recent years *by a major statistical factor, namely the 'adjustment' of purchasing power parity.* The time series development of GDP per capita data measured at current prices and purchasing power parity (PPP) is shaped by real GDP and population shifts as well as by changes in relative prices and the methodology. The PPP methodology had a varying effect on the countries of the CEE region: in Slovakia, for example, it pushed down GDP per capita considerably, while lifting it significantly in Romania in the past decade. Accordingly, when assessing real economic convergence, this should also be borne in mind, as it is uncertain to what extent the change in the PPP methodology reflects an actual shift in welfare, since it may simply show the difficulties in capturing the value added of the ICT sector that has expanded considerably in recent years.

Figure 2
Decomposition of the cumulative change in GDP per capita between 2010 and 2019



Source: Eurostat

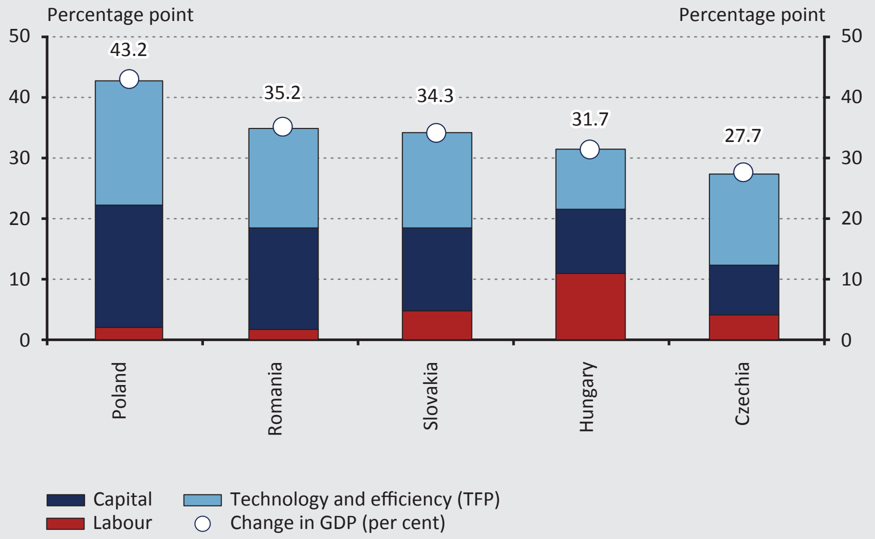
[1] Information and communications technology

The biggest factor in Romania's convergence has been the dynamic expansion in GDP. In the years preceding the coronavirus crisis, economic growth in Romania was *exceptional* both in Europe and in the CEE region, *putting Romania among the top performers in GDP terms.* GDP in Romania grew by over 35 per cent between 2010 and 2019. This growth was based on the significant expansion of disposable real incomes, leading to a dynamic rise in household consumption, growing investment due to the stable investment climate and the government's housing market programme as well as a major improvement in productivity, therefore the focus of the paper will now be shifted to take a closer look at these.

2. The structure of Romania's growth

In 2010–2019, the rise in Romania's GDP *was dominated by capital deepening and increased productivity* (*Figure 3*). On average in the past 10 years, the investment rate was at 24.5 per cent, slightly higher than in Hungary (21.8 per cent), although in recent years Hungary has been able to overtake its peers in the region again thanks to an investment-driven growth model. A breakdown by sector shows that the investment activity of Romanian households contributed substantially to growth. In Romania, the demand side of the housing market has been supported by government-guaranteed preferential loan products since 2009. In that year, the *First Home* programme was introduced, mainly focused on providing preferential loans to those purchasing their first home. The loans were granted with an own contribution of 5 per cent and a 50 per cent state guarantee, allowing the beneficiaries to access loans at below-market rates. Until the end of 2018, the state guaranteed over 264,000 loan contracts, totalling RON 23 billion (HUF 1,700 billion). In 2019, an amended housing loan programme was launched called *New Home,* mainly aiming to enable beneficiaries to purchase larger homes. On the supply side, labour force migration has been a serious problem in the Romanian construction industry in recent years, therefore the government increased the minimum wage for construction workers in January 2019, and it also introduced tax breaks in the sector.

Figure 3
Cumulative changes in economic growth (2010–2019)



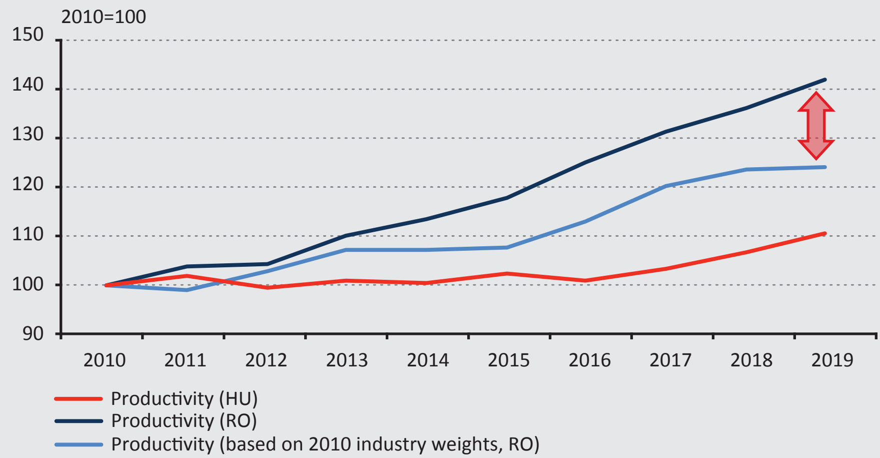
Source: Calculations based on Eurostat and European Commission data

The growth in capital-intensive industrial sectors was also driven by FDI. In recent years, Romanian FDI has been stable, similar to Hungary's, at around 40 per cent of GDP. In 2019, EU countries accounted for 87.5 per cent of Romanian investments. The country has a stronger southern orientation than Hungary, and besides German, Austrian and Dutch investors, a large portion of FDI comes from France, Greece and Cyprus. In the Romanian car industry, the largest players are the French Renault and the German-owned (or indirectly US-owned) Ford, while car industry suppliers are mostly German and American firms. Italian textile enterprises were among the first to move their production to the country to take advantage of cheap Romanian labour, while Austrian companies played an important role in Romanian privatisation even before EU accession (*Adarov et al. 2021*).

From a geopolitical perspective, Romania's *value is raised by its mineral deposits,* and it is *strategically situated* between the Balkans and the Black Sea. Hungary's eastern neighbour has boasted substantial oil and gas production in the recent decade, even by EU standards, and the sector is largely dominated by foreign multinationals. The potential economic advantages of the close cooperation with NATO and the United States were already seen in the past decade. These were mainly related to the military modernisation of Romania, investments in military facilities and the revival of the defence industry. The US is the largest FDI investor in the country outside the EU, although defence developments, important from a geopolitical perspective, are not dominated by this form of financing (*Adarov et al. 2021*).

After 2015, *Romania's labour productivity increased considerably by regional comparison,* and by 2019 it had surpassed Hungary and Slovakia. Nevertheless, *half of the productivity advantage* relative to Hungary is *attributable to the composition effect* (*Figure 4*). Overall, Romania's manufacturing output has lower value added than in Hungary. In manufacturing, both countries are dominated by the production of transport equipment. In technologically advanced industries, such as pharmaceuticals, electronics and battery production, Hungary is more specialised. The relative underdevelopment of manufacturing is offset by the services sector. The share of Romania's services sector within economic output has increased by over 10 percentage points in the past ten years, and the economic restructuring was also felt in rising productivity. In Hungary, this restructuring was performed earlier, therefore around half of Romania's advantage in improved productivity comes from the composition effect (*Figure 4*). All in all, the productivity of Romanian services is higher than in Hungary. Approximately 65 per cent of Hungarian workers are employed in the services sector, while only 48 per cent work there in Romania.

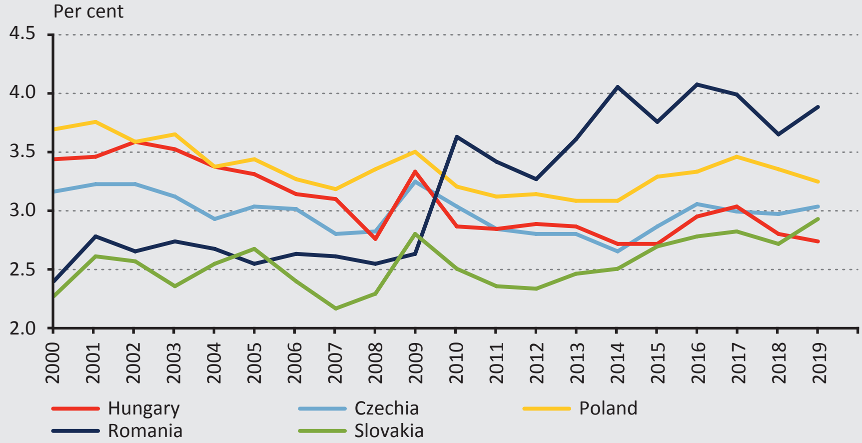
Figure 4
Evolution of productivity in Hungary and Romania



Source: Eurostat

Following a rapid improvement, the productivity of the ICT sector has far outstripped the EU average. The demand driving the enormous growth in the sector was the result of companies' intermediate consumption (*Figure 5*). After 2010, Romanian firms purchased much more products and services from the ICT sector than the businesses in the V4 countries[2]. Romania's ICT sector is based on programming. The proportion of people studying and graduating in ICT fields has jumped in recent years, while employment levels in the sector were up by more than 50 per cent in the past ten years. Furthermore, the strength of Romania's services sector lies in architecture and engineering, management consulting as well as advertisement and market research.

Figure 5
Share of the ICT sector in intermediate consumption

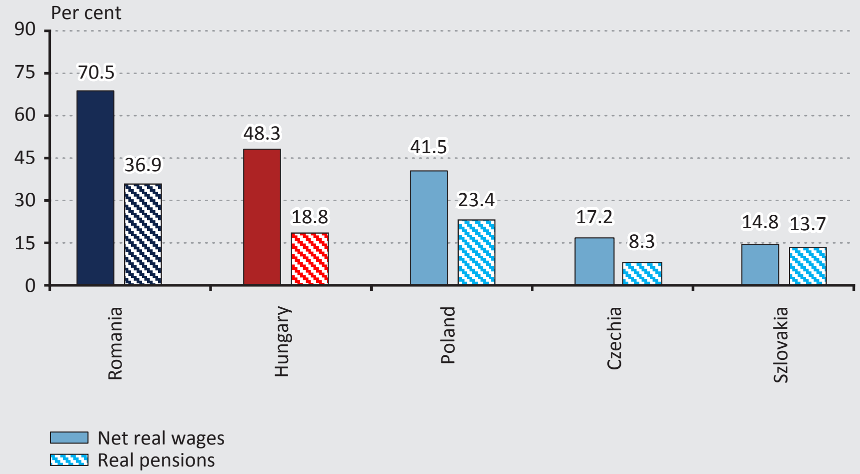


Source: Eurostat

Nevertheless, improving productivity often *conceals overheating,* and after 2015 *wages in Romania increased more than productivity.* Between 2010 and 2019, net real wages in Romania soared by almost 71 per cent, due to the minimum wage-raising cycle launched in 2016 and major state wage adjustments (*Figure 6*). Romania's participation and employment rates have also gone up in the past decade, although they still fall short of the region's average.

[2] Czechia, Hungary, Poland and Slovakia

Figure 6
Cumulative increase in net real wages and pensions in the region, 2010–2019, in the national currency

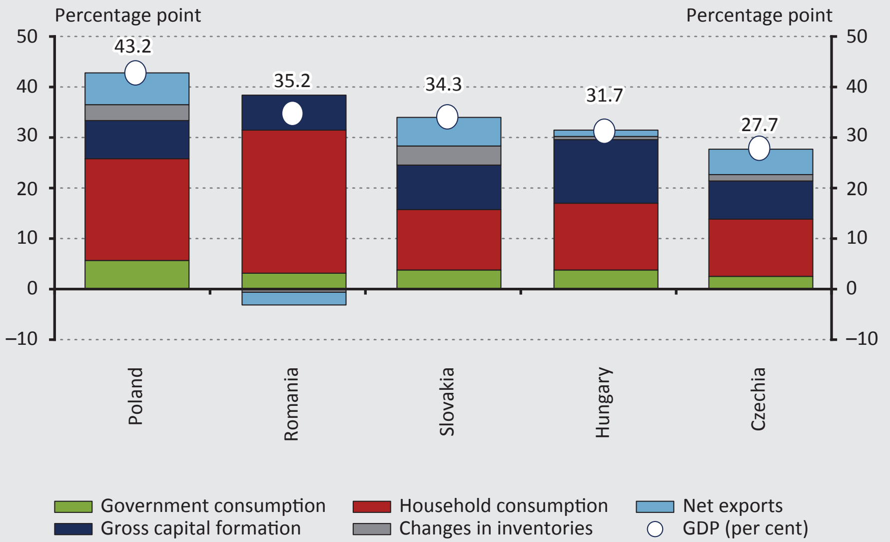


Note: Data on real pensions is available until 2018.
Source: Eurostat

As a result of the large wage hikes, household disposable income has increased quickly by international comparison. The expansion in incomes was also influenced by remittances, as the share of Romanian emigrants is high. The proportion of remittances relative to GDP was the highest in Romania in the CEE region, coming in at around 2.9 per cent of GDP in 2013–2019.

In line with the great expansion in incomes, the main driver behind Romania's economic growth was the uptick in household consumption, supported by a high propensity to consume (*Figure 7*). The consumption growth of 1–5 per cent in 2011–2014 had increased to 10.9 per cent by 2017, before returning to 4 per cent in 2019. The consumption rate has been extremely high recently, standing at around 63 per cent of GDP in 2019, compared to Hungary's 49 per cent. Within consumption, an especially large proportion (far outstripping the EU average) is attributable to Romanian households consuming food and communication services, which could suggest some statistical bias.

Figure 7
Cumulative changes in economic growth (2010–2019)



Note: Government consumption includes government consumption and the transfers from government and non-profit institutions.

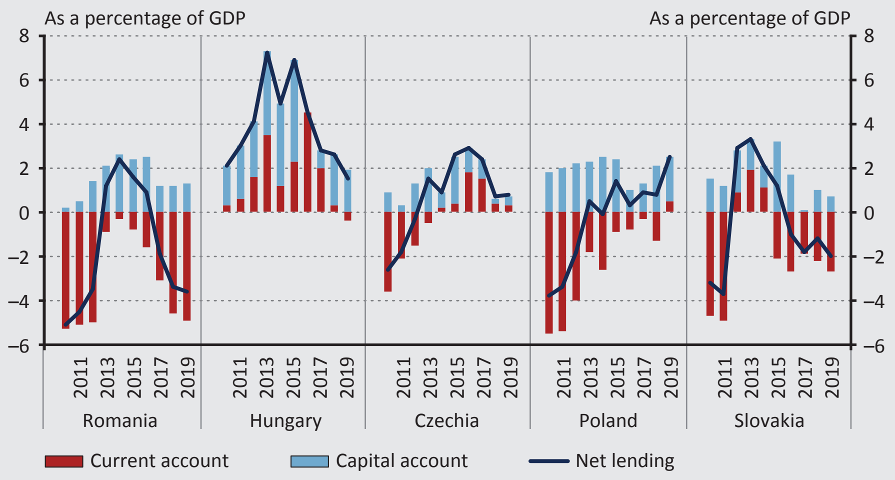
Source: Eurostat

3. The price of rapid growth – The build-up of imbalances

In addition to the growth in wages that exceeded the growth in productivity, the deterioration in the current account deficit, together with the increasing deficit and government debt, even before the coronavirus crisis, all point towards *a negative trend in balance developments.* Around 10 years ago, the global financial crisis hit the Romanian economy in quite a vulnerable state. GDP shrank by 5.5 per cent in 2009. To manage the crisis, Romania signed an approximately EUR 20 billion standby arrangement with the International Monetary Fund in March 2009. Many measures were taken to ensure the disbursement of the loan, mainly affecting the expenditure side of the budget. Owing to the austerity measures aimed at restoring balance, the ESA deficit of the budget declined steadily until 2015. However, the Romanian government pursued an expansionary policy before the coronavirus crisis, and the rising spending on pensions and the massive pay rise in the public sector all contributed to a swelling of the budget deficit. In terms of government debt, Romania's was the lowest in 2010 (at 30 per cent of GDP), and it increased only marginally until 2019. In 2020, Romania's deficit and debt grew due to the combined effect of the measures decided on prior to the crisis, automatic fiscal stabilisers and the steps taken in the wake of the coronavirus crisis. Their rise was checked by the fact that pensions were increased by only 14 per cent, instead of the promised 40 per cent, and the previously decided doubling of the child allowance was not implemented either.

The economic growth in Romania in recent years, which was spectacular by European standards, was mainly *supported by the dynamic rise in household consumption, which entailed an overheating of the economy and was coupled with increased external vulnerability of the country.* In Romania, the current account balance has been deteriorating since 2015 (*Figure 8*). The current account deficit relative to GDP rose from around 0 per cent in 2014 to 4.9 per cent in 2019, making it the highest in the CEE region, which is primarily due to the import-intensive nature of consumption (*IMF 2019*). Gross savings have recently diminished considerably, which suggests that consumption growth increasingly surpasses income growth. In the CEE region, the transfer balance typically supports the economy's external balance position. In Romania, the transfer balance was improved by the utilisation of EU transfers as well as remittances from those working permanently abroad. The deficit of the income balance is low in the country by regional standards, which may be explained by the low return on equity of foreign-owned companies. Net external debt diminished from 24 per cent of GDP to under 7 per cent by 2019, although the extent of the contraction fell short of that in Hungary on account of the large current account deficit.

Figure 8
External balance developments in the CEE region



Source: Eurostat

All in all, *Romania's economic convergence progressed at a fast pace* in the past decade, which, *however, led to a deterioration of balance indicators.* Convergence was faster than economic growth, due to dynamic growth, a substantial population decline and also statistical effects. The main driver behind Romania's economic growth was the uptick in household consumption, supported by large wage increases and a high propensity to consume, however, this resulted in a huge deterioration in the current account balance. Productivity increased considerably by regional comparison. The IT sector expanded significantly, and the associated demand was mainly generated by companies' intermediate consumption. This could be the key to the productivity of the Romanian corporate sector. However, half of the productivity advantage comes from the composition effect, and some of the productivity increase is due to an overheating of the economy.

References

Adarov, A. – Astrov, V. – Hunya, G. – Richter, S. (2021): *Romania's Successful Catching-Up Process: A Comparison with Hungary*. The Vienna Institute for International Economic Studies, Report, March.

IMF (2019): *Romania: 2019 Article IV Consultation-Press Release; Staff Report; Staff Supplement; and Statement by the Executive Director for Romania*. IMF Staff Country Reports No. 19/278, International Monetary Fund. https://doi.org/10.5089/9781513512341.002

OECD (2019): *Talent Abroad: A Review of Romanian Emigrants*. OECD Publishing, Paris. https://doi.org/10.1787/bac53150-en