››› Romania – an attractive location with infrastructure deficits

No. 10, 16 February 2016

Author: Dr Tobias Rehbock, phone +49 69 7431-2686, research@kfw.de

Economic Situation		**Solid growth performance**
Real growth	neutral	Romania is growing at an average pace compared with the large emerging economies. Growth was around 3.5 % in 2015 and is expected to be around 4 % in 2016 (IMF). In 2015 private consumption made the highest contribution, combining a high consumption ratio with respectable growth of 5.6 % (Q1-Q3). The current inflation rate (target: 2.5 % +/-1 percentage point) is much too low (-2.1 %) and core inflation, at 1.6 %, is just barely within the target tolerance band.
Private consumption (y-o-y)	good	
Inflation rate	very good	
Growth financing		**External accounts are balanced**
Public debt / GDP	good	The high current account deficit of the past (13.5 % of GDP in 2007) is now almost completely reversed (0.4 % in 2014). Public finances have also been consolidated. At 1.8 % of GDP, the budget deficit is now below the three per cent mark but planned tax cuts will raise the deficit again. Net FDI inflows have fallen but are still within the average of the large emerging economies.
Current account balance / GDP	good	
Direct investments / GDP	neutral	
Growth resources		**A changing industrial location with opportunities**
Share in service sector	good	The share of manufacturing is slowly declining as Romania's economy is turning more towards services and innovation. In the past 10 years, the number of patent and brand applications jumped by almost 100 % – a rate surpassed only by China and India in the comparison group of emerging countries. Labour market participation has potential and needs to increase.
Patent / brand applications	good	
Labour market participation	neutral	
Economic relations with Germany		**Bilateral trade is immensely important**
German share of goods exports	very good	Romania ships approximately 20 % of its exports to Germany and receives around 20 % of its imports from that country. Germany is thus by far Romania's most important trading partner. Romania ranks fifth among Germany's Eastern European trading partners behind Poland, the Czech Republic, Hungary and Slovakia. As a destination for German direct investment, Romania has some catching up to do.
German share of goods imports	very good	
FDI inflows from Germany	very weak	

Legend (see p. 5 for detailed explanation of methodology): very good, good, neutral, weak, very weak

Investment climate – assessment by our local experts

Romania's EU membership, its balanced economic structure, high manufacturing expertise and low labour costs make it an attractive investment location for enterprises. The large domestic market of 20 million inhabitants also makes Romania an interesting destination for exporters. Its manufacturing tradition is coupled with a competitive services industry, particularly in the IT sector. Poor transport infrastructure and inefficient administrative structures, however, are the main obstacles to investment.

Continued on p. 2

Focus: Transport infrastructure is a major weakness in Romania

Romania has neglected upgrading its transport infrastructure. The railway infrastructure and, in particular, the road network are no longer competitive, even lagging far behind the standard typical of Eastern European countries. The Romanian government has recognised the problem and is planning massive investment. Success will depend on whether Romania is capable of improving its absorption of EU funds, among other factors.

Continued on p. 2

Investment climate: Assessment by our local experts

Romania impresses with a diversified economic structure and highly skilled workers. It is a traditional industrial location with an economic structure similar to that of Germany. In manufacturing (including construction), which contributes around 35 % to value added, the dominant sectors are engineering and plant construction, automobile construction (including suppliers), the textile industry, the chemical industry and oil production. This development is coupled with a very highly trained workforce. The combination of a relatively low wage level – even for Eastern European standards (since July 2015 the minimum wage has been RON 6.23/h, or around EUR 1.30/h) – and increased legal security resulting from EU membership provide very good investment opportunities. As South-eastern Europe's biggest economy with a domestic market of 20 million inhabitants, Romania is an attractive destination for German exporters. Moving on from its industrial basis, Romania has evolved into an economy with a modern structure and a high proportion of services, which contribute approx. 65 % of value added. Most prominent in the area of services is information technology, a sector that is gradually transitioning into an innovation-based driver of growth. International IT enterprises such as Infineon, SAP or Ubisoft are present in Romania. The generally good business prospects are also reflected in real annual GDP growth of 3.2 % in the past three years – slightly above the Emerging Europe market average.

Location problems are being increasingly addressed but a lot still needs to be done. For Romania, inadequate transport infrastructure is by far the biggest problem (see Focus). Improvements are also urgently needed in the areas of sanitation, waste and environmental management, while most of the telecommunications and energy infrastructure is up to modern standards. The shortcomings in some areas of infrastructure are part of a general investment weakness that formed in Romania after the economic and financial crisis of 2008/2009. Another major challenge is the need to improve the efficiency of public administration and, in connection with this, to fight corruption. The national Anti-corruption Directorate (DNA) and the National Integrity Agency (ANI) have recently succeeded in significantly reducing corruption. Higher efficiency in administration, in turn, will create conditions for more effective use of EU funds. The absorption rate of EU funds is the lowest across the EU (as at 2013) and one of the reasons investment growth was weak for a long time.

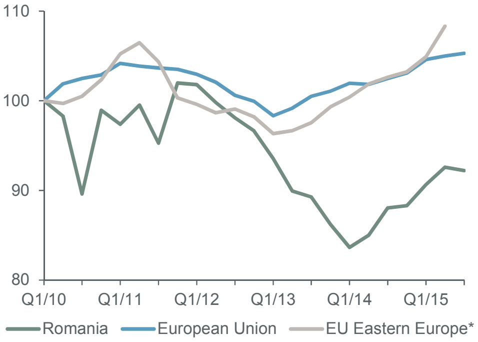
The phase of political instability appears to be over. Since crisis-ridden Prime Minister Victor Ponta resigned in November 2015, a transitional government of experts headed by Dacian Cioloș has been leading the country to the next parliamentary elections in December 2016. It has the support of a parliamentary majority and its primary aim is to secure political stability and continue ongoing reform projects. The overall challenge – also for the next government – is to establish a consistent and reliable economic policy that prioritises the urgent need to upgrade the infrastructure and modernise the structures of public administration.

Conclusion: The advantages of a single EU framework in combination with a skilled labour force, industrial diversity and low labour costs make Romania very attractive as a location for investment and as a destination for exporters. Nevertheless, foreign investors should be mindful that the standards they have grown accustomed to from Germany cannot be applied to some areas, particularly in the public sector.

Based on an interview conducted with Sebastian Metz (General Manager of the German-Romanian Chamber of Industry and Commerce, Bucharest), on 19 January 2016. ■

Figure 1: Real gross fixed capital formation

(Q1/2010=100)



*Bulgaria, Croatia, Poland, Slovakia, Slovenia, Czech Republic, Hungary.

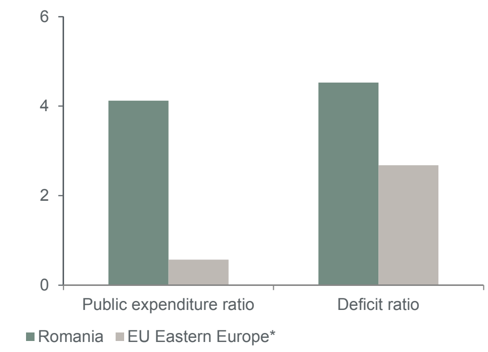
Source: Feri, own calculations

Focus on transport infrastructure: not enough roads, not enough rail

Since the economic and financial crisis, Romania has suffered from a pronounced investment weakness. The rate of investment is significantly below the EU average but also lags behind the average for its Eastern European peer group (Figure 1). Although investment accelerated in the past two years, the increase was not sufficient to close the accumulated investment gap. The overall economic investment ratio is currently just under 21 %, much lower than in 2009/10 at the end of the economic and financial crisis (2010: 26 %). At least it has roughly stabilised at this level as a consequence of the increased investment momentum of the past two years. This trend in investment is, of course, also due in part to the development of public finances. The government expenditure ratio has been on the decline since 2010, a result of the tangible consolidation of the national budget in the past years (Figure 2).

Figure 2: Reduction of public expenditure and deficit ratio in 2015 on 2010

Percentage points in relation to GDP

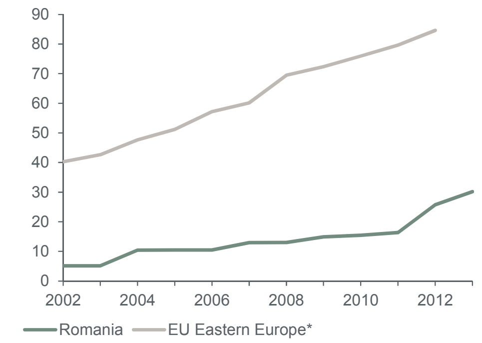


* Bulgaria, Croatia, Poland, Slovakia, Slovenia, Czech Republic, Hungary

Source: Datastream, own calculations

Figure 3: Motorway kilometres

Per 1 million inhabitants

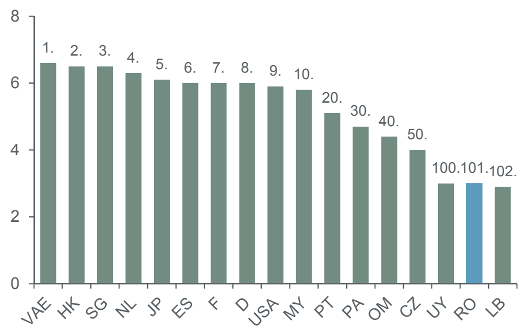


* Bulgaria, Croatia, Poland, Slovakia, Slovenia, Czech Republic, Hungary

Source: Eurostat, Feri, own calculations

Figure 4: Global Competitiveness Index

Transport infrastructure component, index points*



* Value above the bars: rank

HK=Hong Kong, SG=Singapore, MY=Malaysia, PA=Panama, OM=Oman, UY=Uruguay, LB=Lebanon

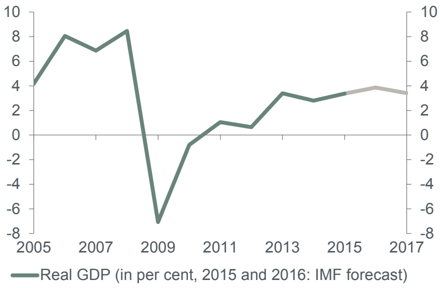
Source: World Economic Forum

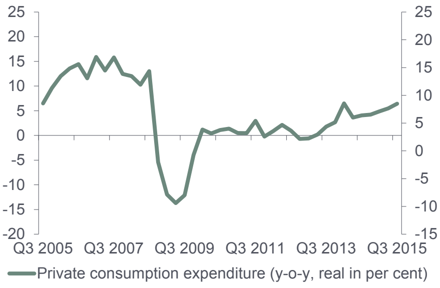
Expansion of the road and rail system was neglected. Compared with overall government expenditure in Romania, spending on transport infrastructure is not even particularly low, with a proportion of around 10.5 % (as at 2013). However, because the expenditure basis is relatively low in comparison with other Eastern European countries, transport nevertheless received below-average financing. As at 2013, Romania spent around EUR 245 per inhabitant on transport infrastructure each year while Eastern Europe (without Romania) spent an average of EUR 320. The result is a transport infrastructure that is inadequate in many respects. For example, the pace of motorway expansion (which was already on a low level) has remained significantly behind that of other Eastern European countries (Figure 3). The situation in rail infrastructure is hardly any different. While it is true that expansion has stagnated both in Romania and in the other Eastern European EU countries, in Romania it is on a much lower level. Hardly surprisingly, Romania's transport infrastructure was given very poor ratings both in the Global Competitiveness Index (GCI) and in business surveys. Romania currently ranks 100th out of 140 in the GCI transport infrastructure sub-indicator (Figure 4).

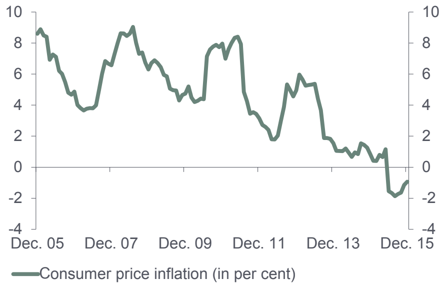
The problem is known, now the solution needs to be addressed. EU member states that wish to use resources from the EU Structural Fund are required to submit a General Transport Master Plan (GTMP) that summarises the strategic transport infrastructure development up to 2030. Romania also submitted a GTMP in 2014 which identified overall investment requirements of some EUR 45 billion. The roads system is to receive around EUR 25.5 billion and the rail sector EUR 14.5 billion. The plan prioritises expansion of expressways over motorways. It does not provide for new railway construction and is limited to line upgrades and electrification projects. However, the financing of these investment requirements is not yet finalised. The EU Financial Framework 2014–2020 includes roughly EUR 30 billion from the Structural Fund for Romania, of which some EUR 6 billion is earmarked for overall infrastructure. Implementation will crucially depend not only on Romania's ability to raise the remaining investment amounts itself but on how well it succeeds in improving its absorption of EU funds. According to IMF estimates, GDP growth would be half a percentage point higher in the medium term if Romania made full use of the available EU funds. In other words: by improving its absorption rate and solving its transport infrastructure problem, Romania will become a significantly more attractive industrial location and boost its growth rate. ■

Overview of figures

Economic situation

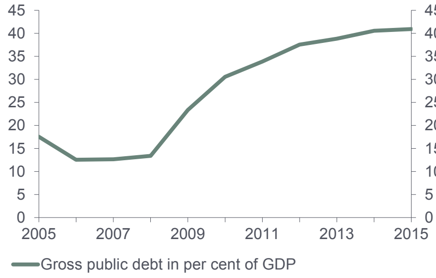






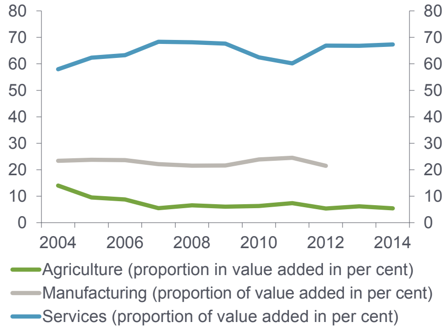
Source: Datastream; IMF, Eurostat, National Institute of Statistics of Romania; own calculations.

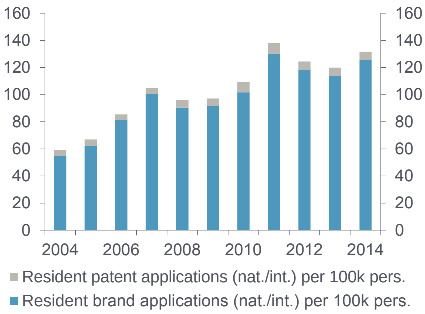
Growth financing

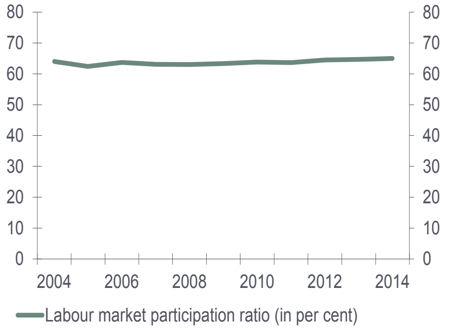


Source: Datastream; IMF, National Bank of Romania.

Growth resources

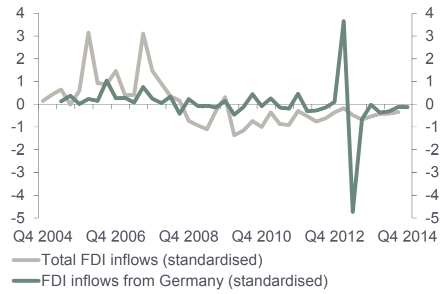






Source: Datastream; Worldbank; World Intellectual Property Organisation; own calculations.

Economic relations to Germany



Source: Deutsche Bundesbank; Datastream; IMF, OECD; National Bank of Romania; own calculations.

Methodology

In the Emerging Markets Spotlight, a selected country is analysed based on various macroeconomic indicators. These indicators are grouped into four categories: economic situation, growth financing, growth resources and economic relations with Germany.

Quintile 1
Quintile 2
Quintile 3
Quintile 4
Quintile 5

The indicators are used to compare the country's situation with its peers. The group comprises Brazil, China, India, Indonesia, Mexico, Russia, South Africa and Turkey. The comparison is based on a quintile ranking in five categories, which are labelled in different colours (see chart):

The country is assigned to a quintile of the country group for each indicator analysed. The best quintile may be different for each indicator. For example, higher growth rates are better, so here the upper quintile is coloured dark green, but higher debt rates are a negative factor, so here the upper quintile is coloured dark red.

Disclaimer

This paper contains the opinions of the authors and does not necessarily represent the position of KfW. Any data and information contained in this publication has been prepared to the best of KfW's knowledge. KfW does not assume any liability for the correctness, comprehensiveness or timeliness of such data and information. By providing this publication, KfW does not render any individual investment, legal or tax advice nor does this publication supersede such individual advice.