



MARCH 2017 – ROMANIA: STRUCTURAL IMPEDIMENTS IN AUTOMOTIVE INDUSTRY TO REMAIN A LOW PRIORITY AMID GROWING POLITICAL INSTABILITY, ANTI-CORRUPTION BACKLASH

A political crisis that shook Romania in January and February has taken a serious toll on the newly elected centre-left government. More than half a million Romanians took to the streets to protest against the government's bid to curtail anti-corruption efforts after it issued a decree that would have decriminalised certain corruption offences for public officials. At the heart of the crisis lies an issue that spans the political, social and corporate sphere: the country's praised fight against corruption, and the political backlash against it.

Small-scale protests have persisted since the demonstrations peaked in early February as the government has continued to probe ways to restrict anti-corruption efforts and increase its influence over key judicial bodies. The situation has highlighted common themes in Romanian politics: opportunistic, unstable governments; opaque policy-making; and a disregard for the longer-term challenges that the country is facing.

As a key export, growth and employment sector, the automotive industry is likely to continue to enjoy a broadly favourable investment environment in Romania. The sector has grown substantially in the last decade and is gradually catching up with its more established automotive peers in Central and Eastern Europe, such as Hungary and the Czech Republic.

The country has a tradition of automotive manufacturing dating back to before 1989, and foreign investors have benefitted from existing plants and infrastructure. Successive governments have offered incentives to attract foreign investment in the automotive sector. At the same time, the country has a large and educated workforce. It also has among the lowest tax rates and labour costs in the EU, making it an attractive destination for labour-intensive industries.

Growing political, fiscal uncertainty

Despite the generally favourable attitude to the automotive industry, temporary political and government instability and ad hoc changes in policy are likely to influence the broader regulatory and policy environment. The government's actions remain divisive and further outbursts of public opposition to the government are likely. Relations between the government and President Klaus Iohannis are poor, increasing the risk of a deeper institutional crisis and policy disruption in the forthcoming term. The government is likely to introduce short-term policy measures to please its core supporters and counter its declining popularity.

Such moves could inadvertently affect the automotive sector. The government in January scrapped an environmental tax that has been an important factor in the growth of the domestic market and the replacement of the country's aging car fleet. Meanwhile, a very optimistic budget – expecting 5.2% GDP growth in 2017 – has been met with caution by

domestic experts and international institutions, and the government is likely to struggle to meet the EU-stipulated 3% of GDP deficit limit. This could have an impact on the stability of planned investments and increase uncertainty regarding broader fiscal stability.

Third party, reputational risks amid anti-corruption backlash

Although the automotive sector is likely to remain largely shielded from direct government intervention, the situation surrounding anti-corruption enforcement is likely to affect the development of the sector in the coming years. There are strong incentives for the government and parliament to curtail anti-corruption efforts, not least because of the large number of politicians and public officials who have been or are at risk of being investigated for corruption offences. The government will continue to probe legal, institutional and financial means to accomplish this, focusing particularly on the National Anti-corruption Directorate (DNA), which is the country's key anti-corruption institution.

While the government is likely to face fierce resistance – from the public, President Klaus Iohannis, foreign partners and companies – its initial agenda sends a clear signal to corrupt officials and companies in a country still grappling with pervasive corruption in both the public and private sphere. For the automotive sector, corruption and third party risks are likely to be most pronounced in relations with local partners, suppliers and contractors, as well as public sector officials. As a result, operational and reputational risks for companies in the sector are likely to persist.

Structural impediments a low priority

In the longer term, a prolonged political crisis could also detract attention away from structural issues that continue to impede the sector's development, including underdeveloped infrastructure and growing labour and skills shortages. The government in its 2017 budget has increased planned investment in transport infrastructure projects, to address persistent deficiencies. However, the government's expansive fiscal agenda – with pledges of significant increases in wages and pensions, and cuts in taxes – means that it is likely to face growing fiscal pressures already in 2017. This increases the likelihood that important public infrastructure projects will be delayed as the government seeks to cover its increased spending. Meanwhile, the government's heavy reliance on EU funds for infrastructure projects could prove difficult, as the country lacks the administrative capabilities to accelerate EU funds absorption. Persistent corruption and lack of transparency in procurement processes further reduce the chances of rapid improvements in infrastructure.

Although the country has a strong and well-educated work force, longer-term issues around skills and labour shortages in the automotive sector are likely to grow in the coming years. Shortages have become a serious problem in the automotive industry for other countries in the region over the last year or so, reflecting the loss of both skilled and unskilled staff to higher-wage countries in Western Europe. A similar trend is emerging in Romania, which has even lower average wages than Hungary, Czech Republic and Slovakia. Shortages of staff in the automotive industries in neighbouring countries could accelerate structural problems with labour shortages in the Romanian automotive industry, as Central and Eastern European countries increasingly compete for the same workforce. This is also likely to increase pressure for higher wages and better conditions in the sector.

The recent political turbulence has made it evident that, despite its relative stability and favourable investment climate, Romania's business environment will remain complicated. Corruption and third party risks, alongside an unpredictable regulatory and policy environment, will remain hurdles for companies in the automotive sector. Meanwhile, the short-sighted policy preferences of successive governments mean that improvements to address structural impediments in the sector will remain sluggish.

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