Box 3. Sensitivity scenario on the public health crisis

In the current context, macroeconomic forecasts are surrounded by unprecedented uncertainty, mainly owing to assessments of the duration and intensity of the public health crisis and, implicitly, of its impact on the evolution of the economy. The baseline scenario is based on the assumption of keeping the epidemic under control, which would help avoid the reintroduction of broad-based administrative social distancing measures in the future. From a medical perspective, relevant probabilities are associated with both more favourable developments than those assumed in the baseline scenario, and developments indicating a relative deterioration of this situation and a resurgence in infections, respectively. However, considering the recent notable advance in the number of SARS-CoV-2 infections (relatively broad-based at global level), there seems to be a higher likelihood of materialisation of a scenario in which the pandemic would spike, owing also, in probabilistic terms, to the coming cold season (2020 Q4)[1]. In this context, the present Box looks at the sensitivity of the macroeconomic projection to a more downbeat evolution of the public health crisis compared to the assumptions incorporated in the baseline scenario.

The worsening of the pandemic with the start of the cold season is expected to bring about the reintroduction of relatively broad-based administrative measures on social distancing both domestically and internationally, for a relatively similar length of time as the measures in the first part of the year, with a strong impact particularly on the evolution of the economy in Q4. The contraction in economic activity foreseen for this quarter, albeit notable (with real GDP recording a quarterly decline for both Romania and its main EU trading partners[2]), is forecasted to stand, however, lower than in 2020 Q2, given the authorities' growing experience in managing the crisis, as well as the adjustment of the economic agents' behaviour. Nevertheless, the annual growth rates of Romania's GDP are seen to remain below those in the baseline scenario until the end of 2021, significant influences coming from the adverse evolution of external demand for local products, as well as from households and corporates probably showing overall a reluctant consumer and investment behaviour, respectively.

The worsening of economic activity as against the baseline scenario is anticipated to reflect the developments across all GDP components. Thus, a step-up in uncertainty, leading to a larger risk premium, and, implicitly a higher exchange rate of the leu, *inter alia* amid the emerging unfavourable prospects for the twin deficits, is expected to impact the dynamics of investment in the economy (and, consequently the potential GDP trajectory), as well as the pace of increase of private consumption. The latter will reflect labour market developments – conducive to a fall in disposable income and more notable increases in

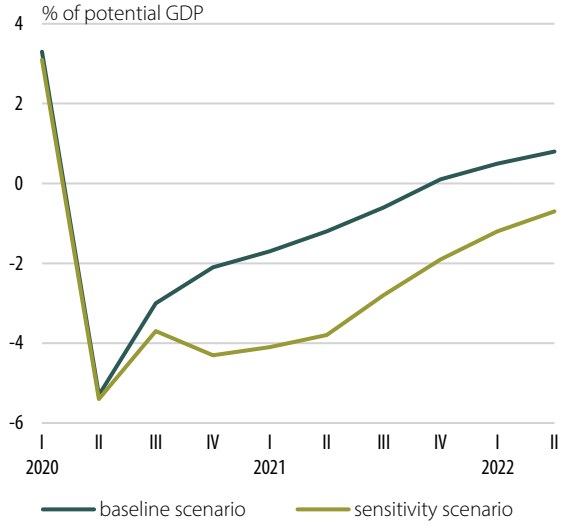
1 Such a scenario was subject to review by other international institutions and central banks – see, for instance, *June 2020 Eurosystem staff macroeconomic projections for the euro area*, or the *Inflation Report* of May 2020 and June 2020 released by the Czech and Hungarian central banks, respectively.

2 The assumptions on the economic growth of Romania's EU trading partners were based on the scenario in the *OECD Economic Outlook* (June 2020) regarding a spike in the pandemic and imply a slower EU effective GDP growth rate by 2.7 percentage points in 2020 and by 2 percentage points in 2021 versus the baseline scenario.

unemployment rates alongside a drop in the number of job vacancies. Net exports are anticipated to post a more pronounced worsening than that in the baseline scenario, with the reintroduction of broad-based restrictions at European level being expected to generate new disruptions in global value chains, therefore weakening yet again the production framework across the world. Under these circumstances, this year income losses on aggregate are anticipated to exceed those recorded at the peak of the 2008-2009 economic crisis, whereas the economic revival expected for 2021 is seen to be much slower compared to the baseline scenario (below the average annual rate of growth since 2010). Moreover, given the large-scale, persistent effects on economic activity of a surge in the pandemic, Romania's production capacity would then be more significantly affected than in the baseline scenario, which would be mirrored in a notably slower growth rate of potential GDP over the medium term.

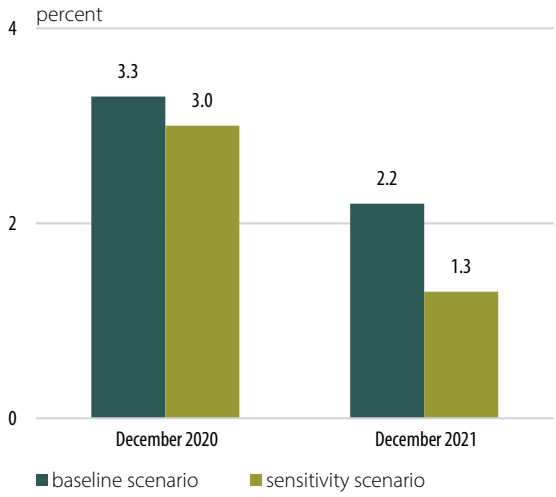
In the short run, inflation rate is assumed to stay at relatively elevated levels, in the context of a series of developments similar to those that marked the outbreak of the epidemic (increased demand for food items, additional costs associated with the health care measures put in place and lower productivity given the measures implemented by economic agents to prevent infection) and show relatively little response to the additional worsening of economic activity. Subsequently, however, the disinflationary impact of aggregate demand (Chart A) is expected to be more visibly and relatively persistently reflected in core inflation (Chart B). Thus, the annual CPI inflation rate for end-2021 is seen to stand below the projection in the baseline scenario by approximately 0.6 percentage points.

Chart A. Output gap in the sensitivity scenario compared to the baseline scenario



Source: NBR calculations and assessments

Chart B. Annual core inflation rate in the sensitivity scenario compared to the baseline scenario



Source: NBR calculations and assessments

Mention should be made that this simulation was based on a "no policy change" assumption, i.e. no additional economic support measures were considered as having been adopted by the authorities (the Government of Romania, the National Bank of Romania, the European Central Bank) apart from those included in the baseline scenario, in order to isolate the economic effects solely associated with the pandemic. Nevertheless, the contraction of the economic activity would most probably lead to a new rise in the budget deficit, in parallel with an additional deterioration of the current account deficit compared to the baseline scenario. In this illustrative context, the escalation of macroeconomic imbalances could heighten the risk of bottlenecks in the orderly financing of deficits, possibly leading to a step-up in the negative economic effects described in this Box.