The Evolution of the Romanian Economy. Past Experiences and Reactions to the Current Crisis

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Abstract: - This paper proposes Romania as a relevant case study for the manifestations of the current global crisis. It aims to examine how the hardships of transition and the weaknesses and imbalances in economic, social and institutional terms influenced the reactions to the global crisis, demonstrating that, in this case, the global crisis only hastened the inevitable domestic crisis and raised its costs by adding to the pre-existing problems. Reflections on the policy responses to crisis challenges are also provided, taking into consideration both the internal and international context.

Key-Words: - Romanian transition, global crisis, domestic crisis, factors, prospects, solutions

1 Introduction
After a stressful and often painful transition to the market economy, the economic recovery that started in Romania in the year 2000 and the accession to the European Union (EU) on January 1st 2007 resulted in a period of economic prosperity with mid and long term optimistic expectations, despite serious warnings on some unsustainable growth coordinates. Thus, these expectations were sharply broken in the last quarter of 2008, firstly as a reaction to the external shocks of the global financial and economic crisis. While some former transition countries found the internal engines to cope with crisis challenges and have already passed the critical point in terms of recovery, Romania is still in the crisis turmoil and a modest, if any, economic recovery is expected only by the end of 2010, given deep internal vulnerabilities that amplify the impact of international shocks.

Based on the above overall considerations this paper examines how the hardships of transition and the weaknesses and imbalances in economic, social and institutional terms influenced Romania’s reactions to the global crisis, demonstrating that, in this case, the global crisis only hastened the inevitable domestic crisis and raised its costs by adding to the pre-existing problems. It aims to suggest some policy responses to crisis challenges based on both internal and international circumstances.

The paper is organized as follows. Section 2 deals with the factors that shaped the process of transition to the market economy in Romania, revealing the negative consequences of the gradual transformation process on subsequent evolutions. Section 3 explores the main factors responsible for the current crisis in Romania, analysing both the external influences and internal elements determining the massive recession. Section 4 focuses on expectations for future development, followed by some reflections on possible solutions for recovery in Section 5.

2 Factors that shaped the transition to the market economy in Romania
The December 1989 Romanian revolution, which triggered the fall of the communist regime, found this country with two major chances of success for its transformation to a democratic society and market economy. First, the transition started without external debts, that could have been a great advantage
compared to other CEE countries, such as Poland or Hungary. Second, immediately after the collapse of the totalitarian political system, the internal enthusiasm wave and desire of change as well as the world-wide immense sympathy and support made Romanian people open to a maximum transforming effort [1].

Nevertheless, Romania underwent a more stressful and often more painful transition and even at present it ranks the last but one among the EU-new member states. Many analysts offer as a plausible explanation the gradual transformation process that took place instead of a more effective shock therapy. In fact, Romanian has been considered an intermediate reformer, ‘situated below the leaders of transition (Hungary, Poland, Slovenia, the Czech Republic and the Baltics) but above the laggards of the Former Soviet Union’ [2].

The factors that shaped the Romanian transition pattern are usually addressed in connection with the ingredients of the changing from the centrally-planned economy to the free market, with the private property rights as the most basic element. These ingredients mainly address liberalization, macroeconomic stabilization and related tight budget discipline, restructuring and privatization, legal and institutional reforms.

However, these efforts were burdened by the delays and “shadows of the past”, so that the annual reports of the EC could not indicate fully satisfactory results. For example, the 2003 EC report recommended ‘a decisive continuation’ of the progress in building-up a functioning market economy. Under these circumstances the negotiations for responding the 31 chapters of *acquis communautaire* were closed only in December 2004, Romania’s (and Bulgaria’s) accession being postponed. Then, it took two more years of EC monitoring on the state of privatization did not yield the expected benefits. Unlike the situation in advanced reformer countries, where privatized enterprises improved their economic performance, in Romanian the progress was quite disappointing: the ownership was transferred to former employees of managers without changes in economic incentives, management practices, ties to government or dependence on budget support [3].

The year 2000 is not only the year when the Romanian economy took an encouraging growing trend: it is also the year when Romania started the accession negotiations with the European Commission. From this year on a major emphasis was put on the efforts to meet the Copenhagen accession criteria, of which the economic ones envisaged two key dimensions, namely the existence of a functioning market economy and the capacity to cope with the competitive pressure and market forces within the EU.
preparedness for EU membership to become an EU country, starting with January 1, 2007.

Thus, after nearly 20 year-long transition – from one of the most authoritarian regimes in Europe to a democratic society and market-based economy, Romania has entered a period of consolidation [4]. At the end of 2007 Romania recorded a 6% GDP/capita rate and 10400 euro per capita at PPS in absolute terms (that is 41.6% of the EU average), one-digit inflation rate (6.57%), a 6.4% unemployment rate, and over 50 billion euro FDI stock. Though, important challenges still have to be faced, such as struggle against corruption, the implementation of some of the EU laws, the strengthening of the newly set up institutions, the improvement of the absorption capacity of the EU Funds, etc. Also, the economic crisis has started to produce serious concerns.

3 Features of the current Romanian economic crisis

After years of record economic growth fueled by easy credit and high foreign investment, in late 2008 Romania, like many other East European countries, experienced a sudden reversal of fortune. The international economic crisis reached the Romanian economy in the last quarter of 2008, firstly as a reaction to external influences. The deep recession in West Europe led to a sharp decline in Romanian exports, and, as the global crisis severely limited the access to external financing, FDI declined, difficulties concerning private foreign debt appeared, and a whole range of negative developments were brought about in the Romanian economy. Therefore, the initial cause of the recession resides in the negative impact of the crisis in Euro-area, but Romania’s own economic weaknesses and imbalances added to this and triggered a series of negative consequences. Macroeconomic imbalances were reflected in high increases in private-sector foreign-currency debt and large current-account deficits that made Romania vulnerable. The downturn in activity since the fourth quarter of 2008 has been severe: trade data and industrial output – and, after a lag, retail sales – have all declined sharply.

The root cause of the current crisis is believed to be the unsustainable economic growth before 2008, based mainly on the consumption of imported goods, financed by foreign money. The global crisis only hastened the inevitable domestic crisis and raised its costs by adding to the pre-existing problems, but it is not the main explanation of the severity of the current recession.

Pre-recession high consumption was stimulated by the flat tax of 16% introduced in 2005 (significantly increasing the disposable income, especially for the upper middle-class) and was also favored by the high amounts of money sent by the Romanians working abroad, reaching a peak of 5.1 billion euro, or 4% of the economy in 2008. All this had fuelled an excessive demand for imports, putting trading balances at a deficit.

It all started as a typical current account crisis: the current account deficit was as high as 13.5% of GDP in 2007 and 12.5% of GDP in 2008. Following the breakout of the crisis in Romania, the economy has been rebalanced with current account deficit melting down to 4.4% of GDP, largely covered by FDI (97% coverage). The adjustment was not the result of specific policies addressing it, but rather by default: the falling demand in Western Europe led to a sharp drop in Romanian exports, but due to the diminished internal demand imports declined even steeper, narrowing the trade deficit (-65% year on year).

The current account crisis is now converting into a public finance crisis, as the structure of the foreign debt is changing from private to public. Total external debt was up from 54% of GDP in 2008 to an estimated 71% in 2010, while total public debt increased from 20% of GDP in 2008 to 30% in 2009 and an estimated 34% in 2010 [5]. The increase in debt was favoured by the rapid liberalization of the capital account and by the real estate boom as well: non-governmental loans rose from 10% of GDP in 2001 to 39% of GDP in 2007, while
households loans changed by +200% in 2003, +70% in 2006 and 2007, reaching in 2008 70% of households disposable income and exceeding deposits by 4 bn. euro [5]. As the crisis is forcing wages to adjust downwards and is generating more unemployment, while loan payments are increasing, the mismatch between income and expenditures at households level amplifies.

An important cause of the macroeconomic imbalances was Romania's expansionary, pro-cyclical budgetary policy based on unrealistic estimates of revenues and unsustainable public spending which led in 2008 to a current account deficit of twice the target, unacceptable considering the 7.9% economic growth achieved. Despite robust economic growth for eight consecutive years (2000-2008), the budget deficit continuously increased, reaching 5.2 % of GDP in 2008 and 7.4 % in 2009.

Now Romania aims at reducing the general government deficit to 5.9 % of GDP in 2010, therefore the need for adopting structural reforms for reshaping the public sector: unitary wage law, revised pension legislation and reorganization of state agencies. Public sector wages for 1.4 million public servants have been already cut by 25% starting from July 2010, while pensions will be frozen. Consequently, social resistance might increase in the upcoming period.

Faced with a considerable external debt, Romania had no other choice than to borrow large amounts of money. In April 2009 Romania concluded a stand-by agreement with IMF for 20 bn. euro serving mainly as a macroeconomic stabiliser, instead of a stimulus package to stop the economic decline.

The IMF and the European Commission demanded that the budget deficit be lowered from 7% in 2009 to 5.9% in 2010, with the 3% target delayed until 2012. The Romanian government must therefore adopt austerity measures, including cutting its budget deficit, which leaves little resources for stimulating the consumption as needed in order to revive the economy and counteract the crisis. Other factors aggravating the current crisis: postponed structural reforms (labour market, agriculture, competition, energy), low absorption of EU funds, inefficiency of an economy with underfinanced education and research systems.

The unsustainability of the consumption based economic growth and the consequent macroeconomic imbalances can explain the severity of the negative reaction of the Romanian economy to the crisis. The drop in both external and domestic demand first led to a slowdown in real GDP growth - from an average of 8.9% on an annualized quarter-on-quarter basis during the first three quarters of 2008 to an almost 13% contraction in the fourth quarter, one of the sharpest turnarounds among emerging markets, while the decline for the entire year 2009 stood at -7.1%. The worst affected economic activities were, in a first stage, manufacturing and financial activities, real estate, lending and services for enterprises.

The negative impact of the crisis in Euro-area has continued in 2009, the Romanian real GDP contracting by 7.1% in 2009, largely driven by the 9.2% drop in private consumption and 25.3% loss in investment. Decreasing demand on the main Romanian export markets, combined with the FDI drop, trigged an overall decline in domestic manufacturing due to the reduction or even temporary stop of the activity in many of the production units.

A severe decline in both domestic net investments and foreign direct investments amplified the gravity of the crisis. Net inflows of FDI dropped from 7 bn euro in 2007 and 9.3 bn in 2008 to only 4.6 bn euro in 2009, equivalent to 3.8% of GDP, still a moderate decline in the current economic environment.

As no fiscal stimulus were provided and private investments are also shrinking, positive influences for the Romanian economy recovery may only come from the revival of foreign demand and the implementation of the structural reforms.

On the positive side, some parts of the economy held their grounds. Not only did the banking sector survive without bailouts, but
also the foreign-owned banks reported even higher profits in 2009 than in 2008. Romania also remains attractive to foreign investors, largely because the crisis reduced the wage expectations of Romania’s skilled, polyglot and adaptable labour force. A recent A.T. Kearney global ranking of countries in terms of their attractiveness to foreign investment placed Romania on the 16th spot. Boosted by cash-for-clunkers programs in Germany and France, the exports of the Romanian car manufacturer Dacia and of its numerous suppliers continued to grow.

4 Expectations for future development

In experts’ view the economic growth of the world’s leading economies, even if not so strong, is proof of the fact that these economies have passed their critical point in terms of recovery, but for Romania it is assumed that there will be only a modest, if any, economic recovery in 2010, largely depending on export growth.

The pre-crisis GDP level will be reached no sooner than 2012, as economic growth will stay below potential in the next few years. It seems that Romania will exit recession with a time lag of at least two or three quarters compared to the Euro zone. There is a risk of potential GDP fall to a long-term lower trajectory, due to several factors [6]:

- prolonged unemployment in the workforce tend to lead to a permanent loss of skills;
- the stock of equipment and infrastructure will decrease and become obsolete due to lower investment;
- innovation may be hampered as spending on research and development is one of the first outlays that businesses cut back on during a recession.

All this implies that the prospects for growth in domestic consumption and investment remain poor, therefore growth in demand will depend mainly on external factors – the improvement in the global economy and the EU economy in particular. A double-dip recession in Europe would have severe consequences for economic recovery in Romania [6].

Looking to the long term, the crisis will leave a longer-lasting negative impact on growth prospects, in the context of existing growth negative factors, such as continuing institutional problems, deteriorating demographic outlooks and weak innovation performance. The current downturn could leave in its wake a legacy of reduced financing opportunities and depleted human capital. The need for fiscal adjustment and the permanent reduction in income levels caused by the recession in 2009 will entail cuts in budgetary spending (one-half of which is on various forms of social expenditure in the region). This will affect the health and education levels of the workforce. There is also the risk of serious social unrest in the next years, as fiscal austerity measures heavily impact on jobs and living standards.

5 Reflections on recovery solutions

Many analysts consider that that the appropriate solutions for economic recovery in Romania are opposite to the current governmental policy of wage cuts and tax increases, in the direction of consumption and credit stimulus. Cuts in the public sector should aim primarily at overpriced purchase of goods and services and investments and not wages cuts and firings that reduce domestic demand. On the other hand, consumption should be stimulated.

An important source of budget revenues might come from reducing fiscal evasion (an estimated 10% of GDP is lost only from VAT and excise duties tax evasion), and a fiscal reform based on solidarity and automatic stabilizers should be introduced [5]. Additional resources may consist of property taxes and royalties which are now very low; asset prices are also undervalued.
The budgetary policy should be based on multiannual budget programming, which should include higher public investments, allocation of resources to projects with multiplier effect in the economy, ensuring debt sustainability and the use of external public debt as a source of economic growth; efficient absorption of structural funds as an important source for economic growth financing.

Many hopes are heading to the potential contribution of the EU financial assistance via Structural Funds for coping with crisis effects. For 2007-2013 Romania has been allocated 19.7 billion Euro Structural Funds, of which 98% for seven Operational Programmes under the “Convergence” objective [7].

Nevertheless, in the middle of the current EU financial exercise serious questions and even doubts are raised with regard to Romania’s capacity to use the allocated post-accession funds [8].

The current crisis has put into a new light the significance of economic governance quality as an essential ingredient for reducing the risk of crises and for dealing with their consequences. Economic governance institutions can affect full employment, capital accumulation, the regulatory regimes impact on performance in the gas, electricity and water industries.

6 Conclusions
This paper has aimed to demonstrate that the international shocks have amplified the consequences of a difficult, stressful and painful transition to the market economy and the unsustainable characteristics of the subsequent economic growth. In authors’ view the solutions should take into consideration consumption and credit stimulus rather than the wage cuts and tax increases, the reduction of fiscal evasion, a rational multiannual budget programming and a quality economic governance. The most important external impulse may come from the EU financial assistance via Structural Funds, provided that Romania rapidly solve the so-called “absorption problems” so as to be able to spend the allocated funds.

References: