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IM. STANISŁAWA STASZICA W PILE**

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# **Progress in Economic Sciences**

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**Rocznik Naukowy Instytutu Ekonomicznego  
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w Pile**

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# Public finances in Romania during and after the economic crisis 2008–2009

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## Introduction

Public finance is the study of the role of the government in the economy. It is the branch of economics which assesses the government revenue and government expenditure of the public authorities and the adjustment of one or the other to achieve desirable effects and avoid undesirable ones.

The purview of public finance is considered to be threefold: governmental effects on (1) efficient allocation of resources, (2) distribution of income, and (3) macroeconomic stabilization.

The term financial crisis is applied broadly to a variety of situations in which some financial assets suddenly lose a large part of their nominal value. In the 19th and early 20th centuries, many financial crises were associated with banking panics, and many recessions coincided with these panics. Other situations that are often called financial crises include stock market crashes and the bursting of other financial bubbles, currency crises, and sovereign defaults. Financial crises directly result in a loss of paper wealth but do not necessarily result in changes in the real economy. Many economists have offered theories about how financial crises develop and how they could be prevented. There is no consensus, however, and financial crises continue to occur from time to time.

Romania has a developing, upper-middle income market economy, the 17th largest in the European Union by total nominal GDP and the 13th largest based on purchasing power parity. The collapse of the Communist regime in 1989, reforms in the 2000s (decade) and its 2007 accession to the European Union have led to an improved economic outlook. Romania has experienced growth in foreign investment with a cumulative FDI totaling more than \$170 billion since 1989. Up until the late 2000s financial crisis, the Romanian economy has been referred to as a “Tiger” due to its high growth rates and rapid development.

Until 2009, Romanian economic growth was among the fastest in Europe (officially 8,4% in 2008 and more than three times the EU average). The

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country is a regional leader in multiple fields, such as IT and motor vehicle production. Bucharest, the capital city, is one of the largest financial and industrial centres in Eastern Europe.

The aim of this article is to present Romania's problems and solutions during and after the economic crisis of 2008–2009. The paper starts with the definitions of public finances and economic crisis and also a brief description of Romania's economy, continuing with a deeper analysis of what happened and what was expected and concluding with some general statements. The financial assessment of Romania's situation in the broader EU context can be understood by looking at the GDP and the country's economic activities in relation to it, and by trusting the information supplied by the National Bank of Romania and others. The article is a review of selected sources and literature, as well as the personal opinions of the author.

### **Economic vulnerabilities exacerbated by the crisis**

According to the most recent available data, the global financial crisis appears to have hit Romania and the other Central and Eastern European (CEE) countries particularly hard. Although analysts [Van der Voet et al., 2005] at first believed in a “decoupling” of the new EU members, the effects of the global crisis are now visible.

For many years the CEE countries benefited from strong capital inflows and high demand for goods and services. But this abundance disguised vulnerabilities and reduced incentives to diversify economies and implement reforms. During the boom years, countries became increasingly dependent on foreign financing, while the broadening of production structures and the development of local capital markets lagged behind. Once external funding dried up, these problems were not only exposed but made the impact of the crisis even greater.

The severity with which the crisis hit Romania took many people by surprise [Barysch, 2009], but certain unsustainable evolutions of the macroeconomic indicators suggest specific weaknesses that preceded the crisis. Consequently, not all the problems of the Romanian economy can be fairly blamed on the global crisis.

Despite the fact that Romanian people are not prone to taking loans or living in debt<sup>1</sup>, during the transition years a proclivity towards indebtedness

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<sup>1</sup> The debt-free culture is “as old as the hills” among Romanians, this propensity taking a particular form during the past two hundred years, since money-lenders and incipient banking became fairly common in the Romanian territories. However, the financial institutions were considered “parasites” – taking into account that the banks in Romania have never in history been Romanian (this is also true at present, when over 90% of the capital of the banks operating in Romania is held by foreign shareholders) and never tried to save

gradually developed. As a result, Romania's external deficits grew almost exponentially between 1998 and 2007, with the current account deficit rising from €2,6 billion to €16,7 billion (6,3 times) and widening from 3,7 percent of GDP in 2000 to 12,3 percent in 2008. The medium and long-term external debt of the private sector also increased from 12,9 percent of GDP in 2004 to 25,6 percent of GDP in 2008. During the period 1998–2007 the GDP leaped from €37,4 billion to €123,7 billion (3,3 times). These data illustrate that every GDP unit added required a doubling of the foreign deficits. These trends could be also explained, at European and international level, by the earlier deregulation that gained ground in the European Union particularly after 1980, encouraging the free movement of goods, services, labour and capital.

Romania has grown dependent on loans in a relatively short time. The causes of this development have been twofold. First, the Romanian government's economic policies have been strongly oriented towards sustaining a level of growth much in excess of the country's internal supply capabilities. Secondly, the low competitiveness of domestic products and the consumer preferences for quality stimulated demand for consumer imports. As this occurred in the context of a low purchasing power of the average Romanian consumer due to low wages and salaries, the result was an orientation of trade towards low priced imports. Further, consumers' purchasing power was stimulated through credits which enabled the development of a market of imported goods generally tendered by hypermarkets.

Like other East European countries, Romania witnessed massive capital inflows before the crisis. The surge in capital flows was controversial from the standpoint of its effects upon an emerging economy like Romania. On the one hand, it fostered economic growth, confirming Mishkin's (2007) opinion, according to which financial development and economic growth are strongly linked. The great volume of incoming FDI enabled the country to benefit from higher capital accumulation, acquire expertise in dealing with financial issues and upgrade the financial services sector. On the other hand, capital mobility across boundaries created high risks for the Romanian economy: beside potential speculative attacks on the national currency, the menace of macroeconomic destabilization existed due to portfolio investors' unexpected behaviour. When "hot money" flows in, the effects are positive: the cost of capital for local companies will edge down while wages and salaries will be driven up; when "hot money" flees the country, it will leave a currency crash in its wake, throwing the economy into recession (Frankel, 2005).

Initially, the capital inflows in Romania led to an appreciation of the exchange rate in both real and nominal terms. The "leu" appreciated in nominal

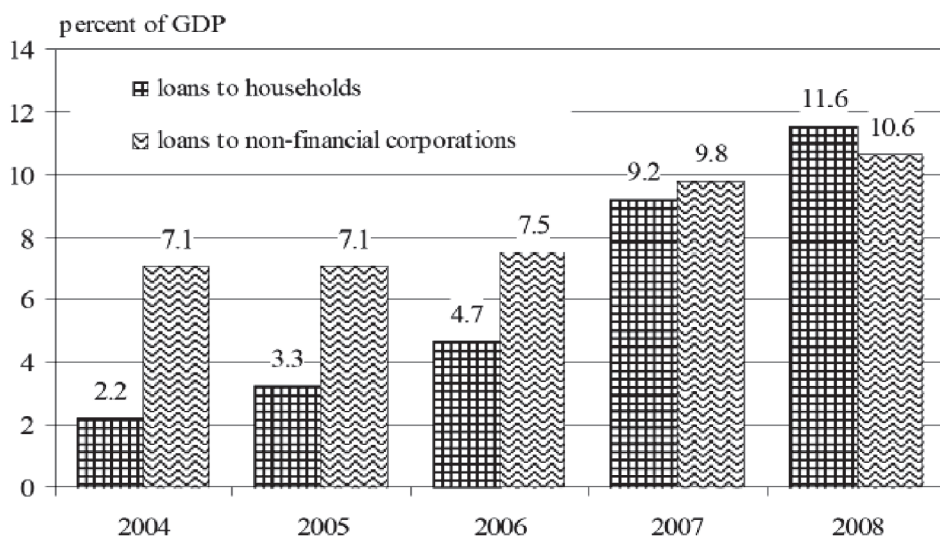
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their clients in debt. In modern times, the resentment to being indebted was kept alive in the 1980s through the excessive efforts made by Ceausescu's regime to pay off the foreign debt.

terms from nearly RON/EUR 4,1 in January 2004 to RON/EUR 3,1 in July 2007 (about 24 percent). The large capital inflows became a matter of serious concern regarding the implementation of inflation targets adopted in August 2005. While facilitating 107 disinflation, the “Leu” appreciation was so strong that it tended to affect Romania’s external competitiveness.

The appreciation of the domestic currency and the surge in banks’ foreign currency holdings boosted lending in foreign currency. Loans expanded at annual growth rates ranging from 60 percent to 80 percent in real terms. The share of foreign currency-denominated loans to households grew more than five times, from 2,2 percent of GDP in December 2004 to 11,6 percent of GDP in 2008. The share of foreign currency-denominated loans to the corporate sector also grew substantially (see figure 1).

**Figure 1. Breakdown of foreign currency-denominated loans granted by financial institutions**



Source: National Bank of Romania, 2009, website: [www.bnr.ro](http://www.bnr.ro), (access date: 10.12.2014).

The negative effects of the crisis translated into the real economy. Loans denominated in foreign currency became more and more expensive, thus weakening the possibility of repayment. The immediate impact was the increase of doubtful and loss making loans in the bank balance sheets. The delays or even inability to repay the loans led to a sharp fall in house prices.

Banks came to rely heavily on external financing, while the mismatch between foreign currency denominated assets and the foreign currency liabilities of companies and households increased. In 2004, the excess of foreign currency denominated loans over deposits in the non-financial corporate sector of around 5 billion lei, increased sevenfold by March 2009 to 34 billion lei.

For households, an excess of deposits of 5 billion lei turned to an excess of loans of 28 billion lei over the same period (National Bank of Romania, 2010). These imbalances between foreign currency denominated assets and foreign exchange liabilities of companies and households constitute one of the greatest vulnerabilities in Romania's economy. These are in fact the main channels through which the halt in external financing caused by the global financial crisis leads to exchange rate depreciation [Isarescu, 2009b].

These developments reinforced each other, so that during 2005–2007 there were periods when inflation expectations (caused by strong pro-cyclical pressures, the flat tax of 16% and high wage rises, which increased revenues available to both individuals and firms) coexisted with a markedly stronger domestic currency. Therefore the central bank was confronted with a serious dilemma in terms of the newly-adopted monetary policy regime. Policy rate hikes, required for bringing expectations in line with the inflation target, attracted further foreign capital, which entailed the appreciation of the leu. During 2005–2008, the National Bank of Romania had to make discrete interventions in currency markets by purchasing considerable amounts of foreign currency in the attempt to prevent the fast appreciation of the leu. The appreciation was likely to cause a dangerous erosion of the external competitiveness and to lead to a fall in inflation, in an unsustainable manner.

Another vulnerability of the Romanian economy was the pro-cyclical conduct of fiscal policy, which added to excess demand. Romania opted for an imprudent fiscal policy in the interval 2004–2008, as the authorities believed that “good times” would last for ever and that excessive government spending was permitted. Moreover, 2008 was an election year, which contributed extra pressure on the national budget. The natural result of the subsequent economic downturn was thus a severe fiscal contraction.

In effect, Romania had to confront both a global economic crisis and a self-inflicted budgetary one, brought about by poor public governance and irresponsible resource allocation [Romanian Academic Society Yearly Forecast, 2009]. It was to be expected that allowing large budget deficits while the economy was expanding would end in failure. Romania would have found it much easier to weather the global financial crisis had the national budget been in surplus, or at least in a smaller deficit, in the previous two years [Isarescu, 2009a].

## **Recovery potential and perspectives**

As recent studies [Kittelmann et al., 2006] have shown, in the case of Romania and the other new EU member states the majority of crises of the last ten years have been generally caused by inconsistencies in the domestic policy mix, which contributed to the deterioration of the country's macroeconomic



condition. Unfortunately, policy makers in these countries lack the degree of sophistication required to identify and apply those economic policies that are likely to be most effective during downturn periods. In any case, it is anticipated that Romania would probably see a gradual economic recovery in the period to come. A positive economic growth of at least 0,5% was expected in 2010, as compared to minus 8% in 2009. In 2011, the trend has apparently been maintained, given the European Commission's forecast of 2,5% economic growth in Romania. The expected developments in the Romanian GDP, inflation and current account deficit are presented in Figure 2. In keeping with the commitments made to the international financial institutions with which it signed loan agreements, Romania would ensure a budget deficit of a maximum of 5,9% in 2010 and 3% in 2011.

Different EU member states seem to have coped with the crisis in different ways and anti-crisis measures have been specific to each country. In Romania, the crisis had to do with too much consumption and too little savings, so restrictive measures had to be implemented. Romania now has to reduce interest rates. This does not translate, however, into a burden on the state budget, but a better coordination between political actors and decision makers in the economy. No country can overcome a crisis, regardless of its nature, if it maintains a reference interest rate of 7–8%. In the euro zone, this rate stands at a mere 1%.

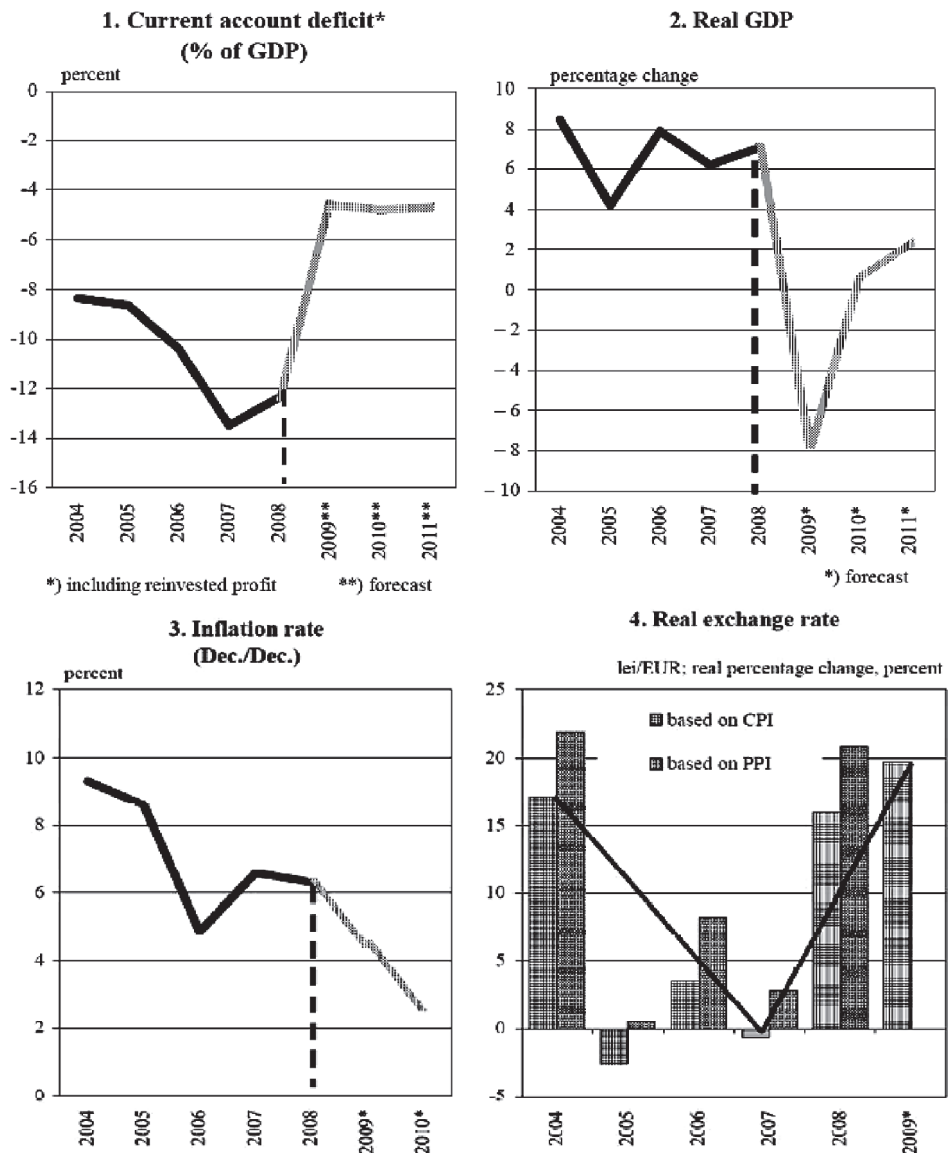
Romania should not necessarily follow the example of those states that can afford to spend a lot on stimulus packages, nor wait for the large EU economies to overcome the crisis expecting that this will help the country overcome its own crisis as well.

The greatest problem for the Romanian economy lies in the management of public money. The macroeconomic balance cannot be restored in the absence of a sustainable fiscal position. The approach to the fiscal position should be consistent with the present economic situation, supporting an adequate adjustment program. It means placing the high performance of publicly financed activities at the centre of public policy and allocating public funds strictly on efficiency criteria [Donath & Cismas, 2008]. If the government fails to finance productive investments (e.g. infrastructure, which is necessary in the long run, in order to fight unemployment) and continues to channel funds towards loss making areas, it will only contribute to deepening the crisis.

As far as the banking system is concerned, its position has proven relatively strong. This is due to the tight monetary policy led by the Central Bank, which involved high reserve requirements acting like a cushion for banks with temporary liquidity problems.

For a country like Romania, irrespective of the global financial crisis, the medium-term reform challenges remain the same, namely streamlining the social security system and increasing investment in education, research and development. Such structural reforms are needed if the country is to continue

**Figure 2: The developments in the Romanian GDP, inflation and current account deficit according to the National Bank of Romania's prognosis**



Sources: National Bank of Romania, National Institute of Statistics, National Commission of Prognosis 2009, website: [www.bnro.ro](http://www.bnro.ro), (access date: 10.12.2014).

to catch up with West European income levels and to survive the fierce current global competition.

At the end of March 2009 Romania signed a deal for 20 billion Euro in loan: 12,95 Billion Euro from the IMF; 5 Billion Euro from the European Union; 1,5

Billion – from the World Bank and about 1 Billion – from other international financial institutions. The interest paid by Romania was 3,5% per year. In return for the loan, Romanian has committed to severe cuts in public spending and wages. One year later, the government cut civil servants wages by 25%, while thousands of state jobs were axed and VAT was increased by 19% to 24%.

## Conclusions

At present, Romania is in a fragile state. Economically, it has been seriously affected by the global financial crisis and everything is not over yet. According to Business Monitor International (2010), while the lowest point of the recession seems to have been left behind, instability is likely to continue to characterise any recovery efforts, at least for a while.

Indeed, the future may still hold pitfalls in which the economy may get trapped, due to its enhanced vulnerability to exogenous shocks created by financial globalization. The positive effects of the latter have partly been cancelled out by other, more perverse effects, such as increased consumption and capital outflows.

Global financial integration has had another disruptive effect, namely that of prompting the government to divert resources away from more urgent development priorities (such as education, public health, and industrial capacity) into seeking financial stability. The financial globalization process is beneficial but difficult to harness. As resisting globalization is not an option, good management and well-inspired economic policies are necessary for coping with the consequences of this crisis.

Our account of Romania's current economic situation identifies no less than seven major vulnerabilities. These 'seven capital sins' are:

- ❑ increasing dependence on foreign financing coupled with a lack of development of domestic capital markets and production structures;
- ❑ an unprecedented growth in household borrowing;
- ❑ the dominant market power of a small number of foreign companies, combined with the low competitive capacity of Romanian companies;
- ❑ the high risks involved in massive FDI, such as unpredictable portfolio investor behaviour and unregulated speculation against the national currency;
- ❑ the risk of the exchange rate fluctuations not necessarily determined by foreign capital inflows;
- ❑ a procyclical conduct of fiscal policy, which led to excessive government spending;
- ❑ a self-inflicted public money management crisis, caused by poor governance and lack of higher-order strategic thinking in complex policy design.

Nevertheless, the most recent economic performance indicators suggest that there is a potential for a slow (rather than spectacular) recovery and a reduction in public budget deficits, while the banking system will maintain a strong position. In addition, it is recommended that proactive measures should include the reduction of interest rates, superior allocation of public funds based on performance and efficiency, and focus on effective infrastructure development.

The analysis conducted in the present paper showed the need for a deliberate policy intervention to eliminate the tremendous inefficiencies created by the seven major vulnerabilities summarised above.

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## Summary

The aim of this article is to present Romania's problems and solutions during and after the economic crisis of 2008–2009. The paper starts with the definitions of public finances and economic crisis and also a brief description of Romania's economy, continuing with a deeper analysis of the determinants and symptoms of the recession in the country, as well as the perspectives for further development. The financial assessment of Romania's situation in the broader EU context can be understood by looking at the GDP and the country's economic activities in relation to it, and by reviewing the information supplied by the National Bank of Romania and others institutions and selected literature. The article is complemented by author's opinions.

**Key words:** public finances, Romania, economy, economic crisis, analysis

## Finanse publiczne Rumunii w trakcie i po kryzysie gospodarczym 2008–009

### Streszczenie

Celem niniejszego artykułu jest zaprezentowanie problemów gospodarki Rumunii podczas kryzysu ekonomicznego 2008–2009. Na wstępie przedstawiono definicje związane z finansami publicznymi i kryzysem gospodarczym oraz krótki opis sytuacji ekonomicznej Rumunii. Następnie przeprowadzona jest głębsza analiza przyczyn i objawów recesji w kraju, a także perspektyw dalszego rozwoju. Sytuację finansową Rumunii, jej Produkt Krajowy Brutto i aktywność gospodarczą ukazano w szerszym europejskim kontekście. Praca stanowi przegląd materiałów źródłowych Narodowego Banku Rumunii i innych instytucji, a także wybranej literatury przedmiotu i własnych opinii autora.

**Słowa kluczowe:** finanse publiczne, Rumunia, gospodarka, kryzys ekonomiczny, analiza

## Публичные финансы румынии в период и после хозяйственного кризиса 2008–2009 гг.

### Краткое изложение

Целью этой статьи является представление проблем экономики Румынии в период экономического кризиса 2008–2009 гг. В начале статьи представлены определения, связанные с публичными финансами и хозяйственным кризисом, а также короткое описание экономической ситуации Румынии. Затем проведен более глубокий анализ причин и признаков рецессии в стране, а также перспектив дальнейшего

развития. Финансовую ситуацию Румынии, её Отечественный продукт брутто и хозяйственную активность представлено в более широком европейском контексте. Работа представляет собой обзор материалов основанных на источниках Национального Банка Румынии и других институций, а также выбранной литературы, связанной с предметом представленной темы, и собственных высказываний автора.

**Ключевые слова:** публичные финансы, Румыния, экономика, экономический кризис, анализ

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