An Analysis of the Romanian Macroeconomic Conditions that Favored the Economic Crisis

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Abstract: The paper treats a number of aspects of economic errors made in the management of Romanian economy that favored economic crisis. It identifing an excessive propensity to consume of population, an economic growth which has not led to improved openness of the Romanian economy, a pronounced development of non-tradable sector, services (trade) and construction and a more difficult development of the tradable sector: industry and agriculture and a mismatch economic policy mix with the cycle phases.

Keywords: crisis; GDP; inflation

JEL Classification: E44; O11

1. The Propagation of Crisis in Romanian Economy

Since 2008, the world economy is facing with the biggest financial and economic crisis since the Great Depression. In the last twenty years, the emerging economies have been economic and financial crisis, the magnitude of which being smaller and also the economic recovery being faster. Causes of the current financial and economic crisis should not be sought in the behavior of emerging countries, but in periods of monetary expansion promoted by the Federal Reserve Bank (FED).

Interest promoted by FED, reached historically low, encouraged and discouraged borrowing and consumption savings, debt burden but a real threat to the economy. To stimulate growth, the same policy of cheap money has been promoted by the Bank of Japan and European Central Bank. U.S. financial crisis has rapidly become one global affecting both developed and emerging countries. First, developed countries have been affected due to the high degree of exposure of the banking system, especially the European one, to U.S. toxic assets. Once the crisis included the real sector, emerging countries were not spared, the most affected being the countries of South Eastern Europe.

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Strong financial and trade links between the countries of the world were the main channel for transmit the economic crisis to the emerging countries, vulnerable to external shocks. Countries whose vulnerability was increased and already faced with structural crises longer, imported by the contagion effect the financial crisis originating in the United States of America. (Rijckeghem &Weder, 1999)

Thus, despite efforts to shelter through various economic policies, most emerging countries have been affected by the sudden contraction of credit and capital flows as a result of the economic crisis. The connection of the Romanian economy to international economic flows and also endogenous causes, favored the spread of the financial crisis on Romania. An emerging economy like Romanian, opened to the international market, vulnerable, with an artificially sustained annual growth rate, could not be affected by adverse economic circumstances.

The economic crisis facing Romania is an internal crisis, of structure and of over-consumption, superposing the international crisis, being only the trigger. The correct identification of the economic crisis transmission channels is particularly important in the adoption, by responsible decision makers, of efficient economic policies, designed to limit the negative effects of the financial crisis before it irreversibly affecting economic structures.

Analyzing the Romanian economy connections to the global economy, the actual crisis has spread in the country through several transmission channels targeting both the real economy and nominal economy:

1. **through the financial channel**, was limited the access to external financing and lending volume shrank affecting the financing capacity of the domestic private sector which, in the last, led to disequilibriums at the real level of economy. Relatively high share of foreign capital in the Romanian banking system made a vulnerability to Romania with reduced funding from parent banks. Reducing the liquidities in the banking system was due, also, to tighter credit conditions on the international money market, this being reflected in the increased cost of internal non-governmental credit. Also, the reduction of external financing reflected in national currency depreciation, felt in the first months of 2009, leading to an increase in interest rates for loans. Most of the non-governmental loans were denominated in foreign currency, which is a further application for income households with debt, generating also a decrease in disposable income.

2. **through the trade channel**, Romania's exports fell due to the economic difficulties experienced by major trading partners, especially from the euro area. This meant that the national economy was a decrease in growth rate and consequently a lowering of imports. According to the National Bank Financial Stability Report for 2009, in the first quarter of 2009, Romania's exports were less affected compared to countries in Eastern Europe. In late 2009, the exports reduced compared to 2008 by 5.5%, while imports had diminished more drastically, by

20.6%. A consequence of the reduction in exports was deteriorating trade balance, with negative impact on the current account and external debt. The decline observed on international financial markets have resulted, also, the reduce of foreign direct investment in Romania, with negative impact on the labor market.

3. **through the distrust channel** were affected both nominal and the real variables of the economy. Following the analysis of the rating agencies which place and still places Romania among the countries with a high vulnerability to the effects of the financial crisis (below investment grade), the limiting of the external financing was due mainly to the skepticism of the international lenders in to provide the necessary liquidity. According to Eurostat data, the reducing of the investor confidence in the markets of Central and Eastern Europe, led to the drastic reduction of investments in these countries. In Romania, the incomes of foreign direct investments were recorded at 6.8% in 2008 (percentage of GDP), knowing a continuous decrease over 2009 (2.9% of GDP) and 2010 (1.8% of GDP) and in 2011 (according to IMF forecasts) were seen in a rebound shy (2.9% of GDP). The feeling confidence not only diminished among lenders and investors, but also among the population, severely damaging one of the main engines of economic growth – the consumption. Also due to mistrust foreign, the exchange market has become increasingly vulnerable, exposed to speculative attacks, such as in October 2008, which damaged the structure of liquidity flows between commercial banks and hence a higher volatility in the interbank market.

2. The Analysis of the Macroeconomic Context during 2000-2008

In late 2008 and early 2009, on the deteriorating economic and financial situation, the Romanian economy, after a period of growth at high rates, has seen the first signs of the financial crisis. Signals marked the beginning of the economic crisis in Romania were currency depreciation, rising external debt, current account deficit increased on the background of deteriorating trade balance, the decline in foreign investment, limiting lending and stock market volatility.

Economic growth of the Romanian economy to onset of the crisis was accompanied by accumulation of external deficit and also the increase in external debt, which which facilitated the spread of the crisis, with negative consequences for the economy and the financial system, highlighting the unsustainable nature of the policies applied in previous years. The main engines of the Romanian economy: consumption, construction and industrial production were affected.

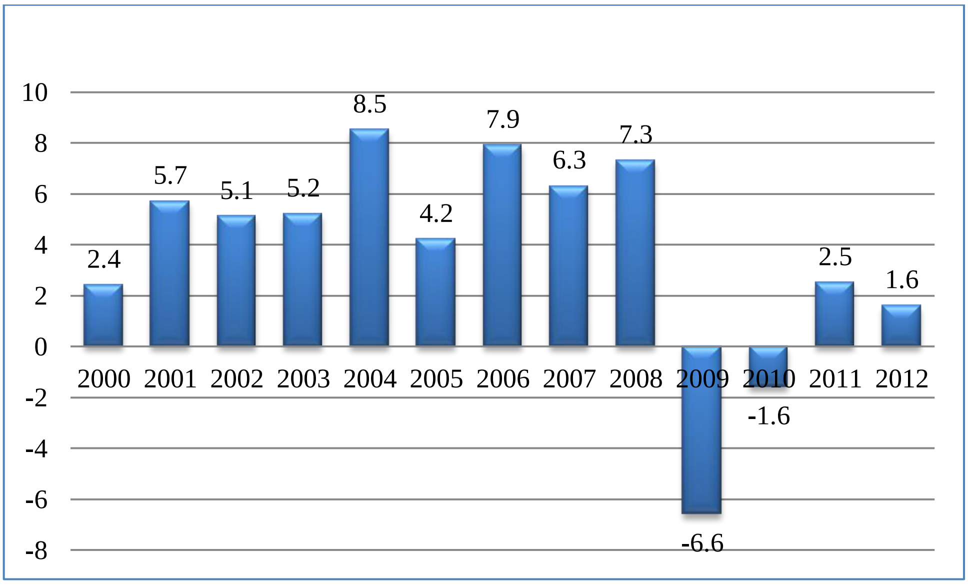

Figure 1. The evolution of the growth rate of GDP in Romania during 2000-2012 (%)

Source: Eurostat

Based on data from Figure 1, after calculating the average growth rate after the formula $r = \sqrt[n]{(1+r_1)\ldots(1+r_n)} - 1$ is obtained for n=9 (for the period 2000-2008) r = 5.83%.

We also note that the highest growth rates were recorded in 2004, 2006 and 2008. Propagation crisis in the Romanian economy has led to a significant decrease in economic growth in 2009 and 2010, the upward trend being resumed in 2011, the prediction for 2012 placing economic growth under the previous year.

The analysis of domestic macroeconomic environment in the period 2000-2008 is essential in understanding the causes of domestic economic crisis superposed global economic crisis. During the eight years of economic growth, we observe a period of macroeconomic stability, 2000-2003, but which are prerequisites for economic expansion next period, 2004-2008.

After three consecutive years of negative economic growth rates, 2000 is the first year that there has been a growth of 2.4% (yoy change). Also, in 2000 there was an improvement in international macroeconomic environment, particularly in the developing countries and those in transition in Central and Eastern Europe.

The acceleration of the transition in Romania led to the strengthening of the private sector, occupying the largest share, since 1996, in GDP (from 16.4% in 1990 to

70.3% in 2009). In the following years, 2001, 2002 and 2003, the real growth of GDP has not fluctuated major hovering around 5%.[1]

In conditions of an apparent macroeconomic stability in this period, it can be argued that the economic policies adopted at the national level were perfectly harmonized. Monetary and fiscal policies play an important role in controlling nominal and real macroeconomic variables, having an important role in smoothing the business.

During that period, mismatch economic policy mix was reflected in high levels of inflation well above the inflation target set by the Central Bank of Romania.

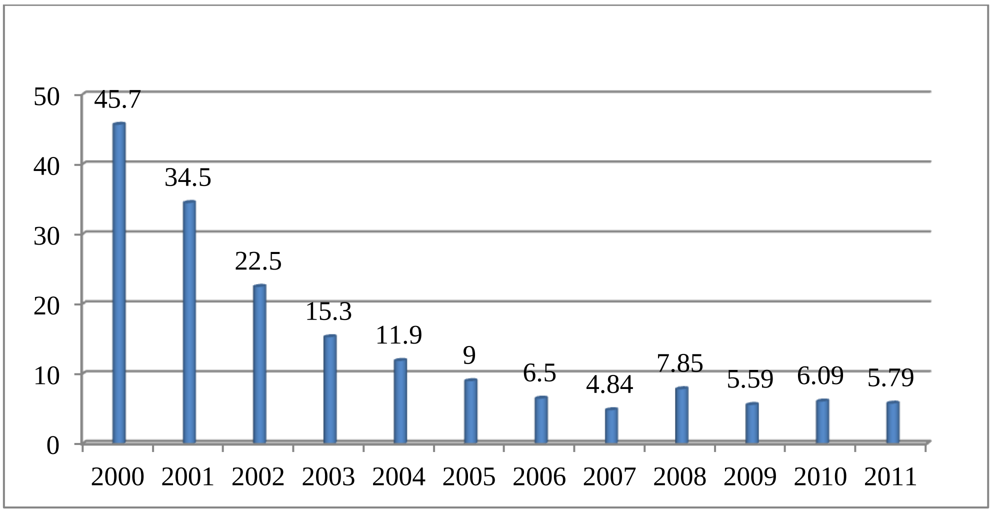

Figure 2. The annual inflation rate during 2000-2008

Source: INSSE

In 2005, the Central Bank of Romania officially adopted inflation targeting strategy, because the use of the exchange rate as a nominal anchor anti-inflationary, was abandoned as a result of capital account liberalization.

According to economic literature and previous factual evidence, in the relationship between price stability and financial stability, inflation is considered the main source of financial instability (Rijckeghem & Weder, 1999).

Authorities failure to achieve the objective in terms of inflation was caused by the compromise made by less restrictive economic policies, especially fiscal and income policy, characteristic of the elections calendar (2000, 2004, 2008). One factor that may influence the disinflation process was the appreciation of the domestic currency against the currency of reference, even if the effect is

[1] Banca Națională a României, Raportul anual 2004/National Bank of Romania, Annual Report 2004.

asymmetric, meaning that domestic currency influences less consumer price index, while the depreciation is much stronger. (Benetrix & Lane, 2010) Thus, the depreciation of the national currency held positive gap between the actual level of inflation and inflation by the Central Bank's objective.

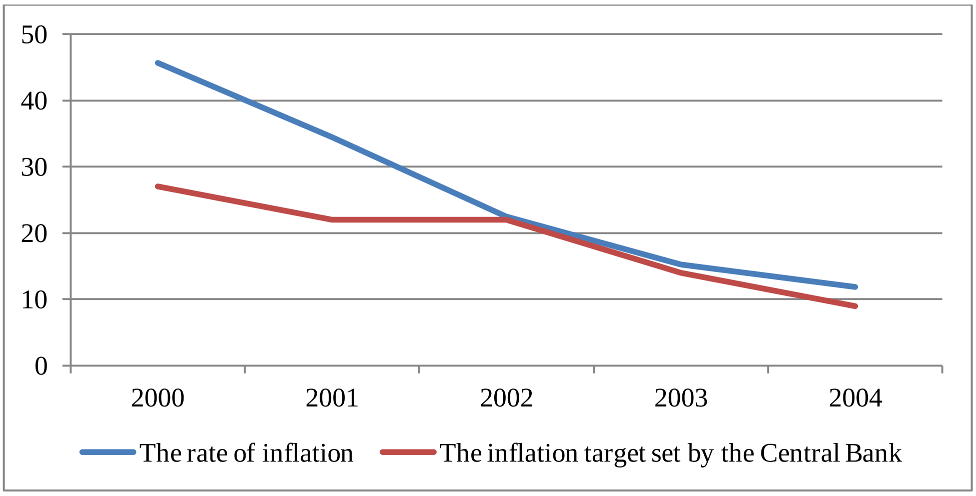

Figure 3. The difference between the actual rate of inflation and the inflation target set by the Central Bank

Source: INSSE, BNR

The achieve of the inflation target in 2002, was attained mainly due to the real appreciation of the national currency against the default basket of currencies (60% EUR, 40% USD) of about 4.4% in real terms compared to 2%.[1] in the previous year and due to wage moderated increases which are not generate inflationary pressures. Despite an apparent period of macroeconomic stability, Romania was bypassed by FDI, it is true, first because of external factors (the sovereign debt crisis in Russia), but also because of internal factors such as lack of a sound macroeconomic framework, situation perceived as unfavorable for investors interested by our country.

[1] Banca Națională a României, Raportul anual 2002/National Bank of Romania, Annual Report 2002.

3. The Analysis of GDP by Category of Resources during 2000-2008

As regards the real economy, the GDP formation, the most important sectors (as a share of GDP) were in services and industry. Other resources that contributed to GDP were net taxes (taxes on products minus the subsidies on products), agriculture, construction and trade.

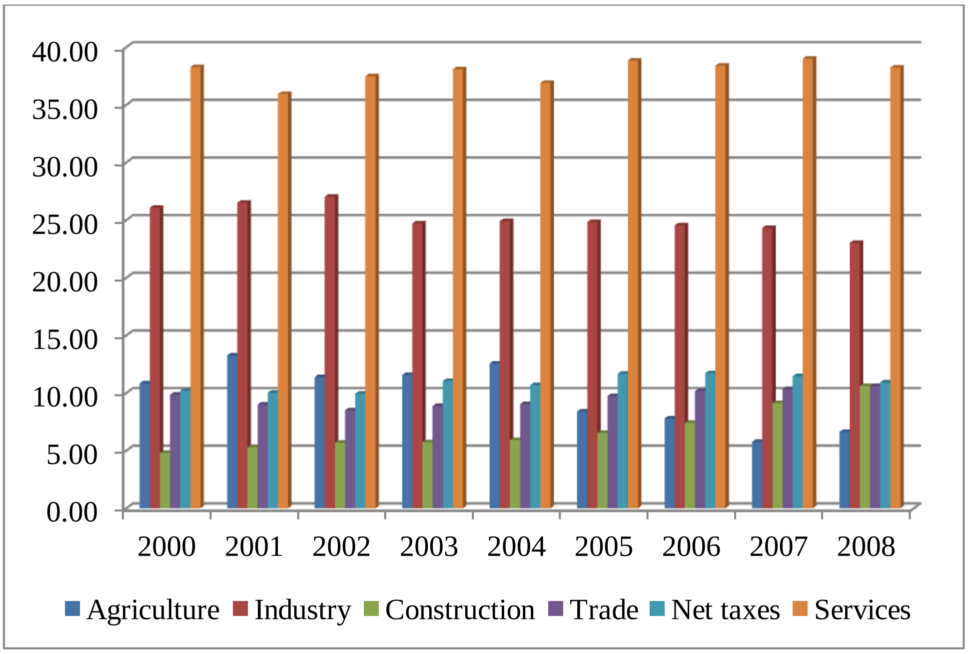

Figure 4. Contributions to GDP growth by resource category in 2000-2008 (% of GDP)

Source: INSSE

Among all the components of GDP formation by resource category, we remark a sinuous evolution regarding the agriculture. Regarding the annual percentage change in the composition of the major areas of GDP, the most dynamic were agriculture and construction.

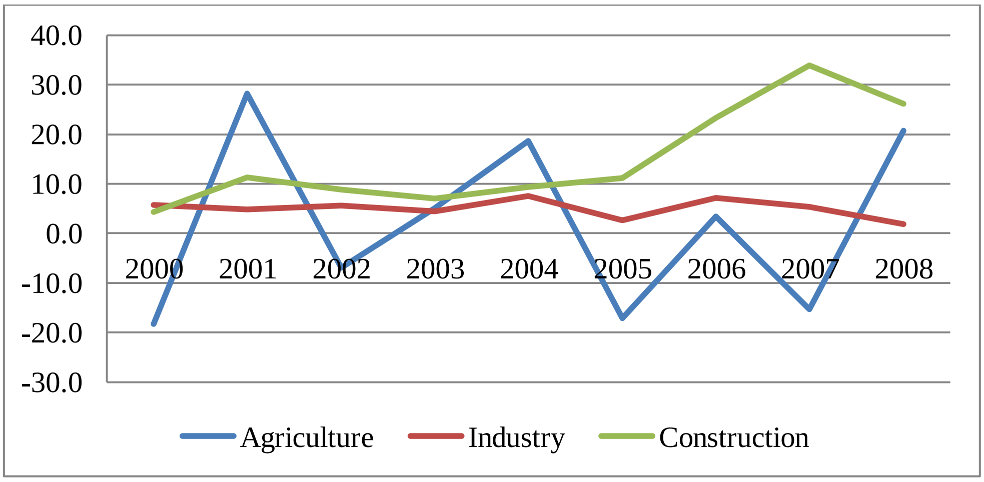

Figure 5. The dynamic growth of the main categories of resources in GDP composition (% yoy)

Source: INSSE

Looking at Figure 5, we see that the construction sector experienced a positive development in the eight years of economic boom. GVA growth in real terms (4.3% in 2000, 9.4% in 2004, 33.9% in 2007 and 26.2% in 2008), was mainly due to private sector and diversification of construction, all of which being supported by the expansion of domestic demand.

Unlike the construction sector, which has developed in parallel with the period of economic boom, in the case of agriculture, we see that the most volatile sector, recording significant growth in 2001 (28.2%), 2004 (18.7%) and 2008 (20.7%) and decreases as significant in 2000 (18.4%), 2005 (17.2%) and 2007 (15.3%). Fluctuations in this sector were less influenced by economic factors and more by exogenous factors such as meteorological conditions favorable or unfavorable to agriculture. In the years when gross value added in agriculture dropped sharply, there was an increase in inflationary pressures due to supply-side shocks. An objective radiography of the agricultural sector reveals that agricultural modernization could and can still lead to unlocking economic potential available to the sector. Thus, we have faced with a rigidity of offer under uncontrolled expansion of demand, which was to widen the negative balance of net exports, jeopardizing the anti-inflationary process.

Industry has fared somewhat uniform in 2000-2003 (between 4.4% and 5.8%), big fluctuations of the rate being observe in the period 2004-2008 (between 1.9% and 7.6 %). Slowing growth in industrial activity took place in 2005 to 2.6% and in 2008 to 1.9%.

In 2005, the flat tax and capital account liberalization have argued appreciation in real terms by 15.1%[1] of the national currency against the euro, which are reflected in the loss of competitiveness of products from almost all industries to European markets. To these were added also contextual factors that affected the industry indirectly. The low annual growth rate of 1.9% (2008) already can be attributed to the economic crisis since at the end were visible signs of economic decline. According to the National Institute of Statistics, in the first nine months of 2008, the monthly growth rate of industrial production was between 2.7% and 13.3%, strong downward trend since October 2008 decreased by 3% to reach from 18% in December.

4. Analysis of GDP by Category of Use in 2000-2008

Regarding the composition of GDP by category of use, in the period 2000-2008, the most dynamic components influencing growth were final consumption and gross investment (gross fixed capital formation and changes in inventories), net exports having a negative trend.

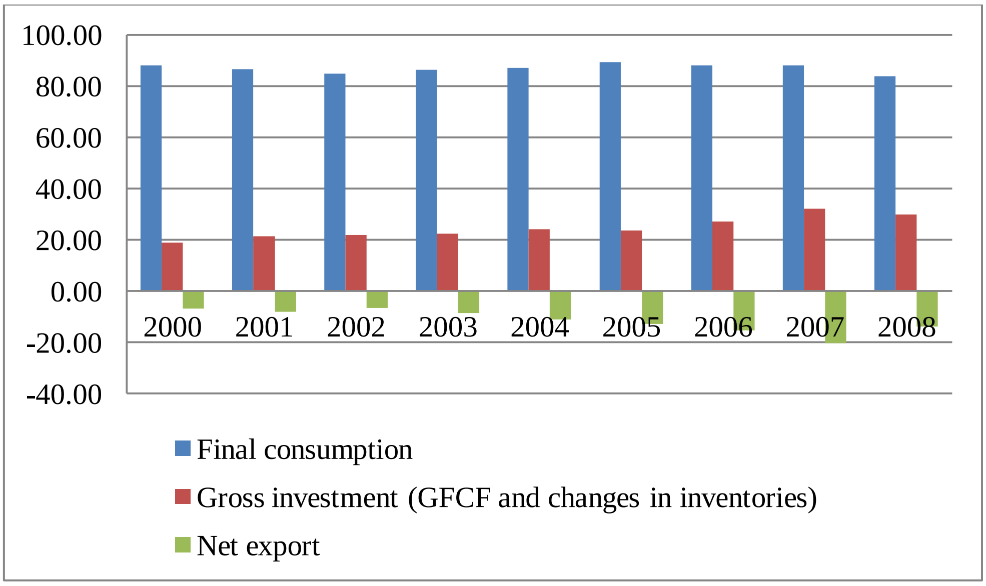

Figure 6. Contributions to GDP by type of use in 2000-2008 (% of GDP)

Source: INSSE

[1] Banca Națională a României, Raportul anual 2005/ National Bank of Romania, Annual Report 2005.

In terms of aggregate demand, its main component – actual final consumption of households, it increased significantly during this period, supported by measures to relax lending (particularly foreign), the expansionist policies of income and not finally, the political character of the business cycle.

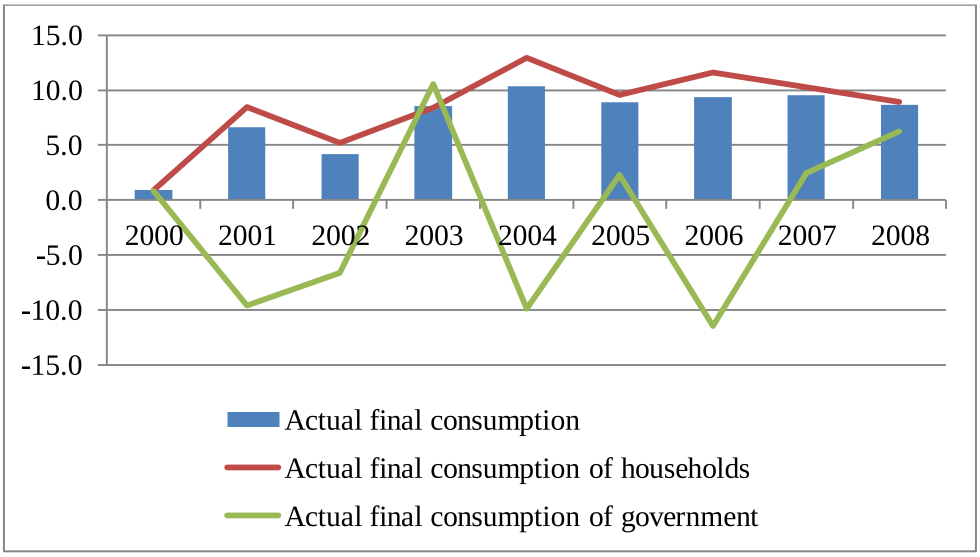

Figure 7. The dynamic evolution of actual final consumption growth (% yoy)

Source: INSSE

From the data, transposed graphic above, we see that the largest growth rate of household consumption was recorded in 2004 (13%). The increase of final consumption, as mentioned above, was based on a growing demand, driven by fiscal and budgetary policies, the continuing appreciation of the national currency and the strengthening of anti-inflationary process. In this year (2004) the currency loans was increased by 56.7% because people perceived them as more attractive because the difference of interest between them and credits in national currency. To counteract inflationary pressures, Central Bank policy was restrictive in early, increasing the real interest rate. A positive effect of this decision was the resumption in 2004 of the process of saving people, and another effect, less positive, was speeding forex loans. In response to forex loans, the Central Bank raised the reserve ratio on foreign currency deposits.[1] Financial intermediation (NGO's credits GDP) increased from year to year, modifying the structure of loans, for loans in national currency, or foreign currency for credit. To better manage foreign exchange effects due to massive capital inflows, beginning with the second

[1] Banca Națională a României, Rapoarte anuale 2000-2010/ National Bank of Romania, Annual Reports 2000-2010.

half of 2004, the Central Bank lowered the benchmark interest rate gradually, going from 21.25% in January 2004 to 17 % since the end of the year. Massive inflows of foreign capital in Romania were due mainly to improve investor sentiment on the Romanian economic environment with integration of Romania in the North Atlantic in April 2004. Excessive growth of domestic consumption, which can be an engine of growth in normal economic conditions, represented a major risk for the control of inflation and external balance. In terms of growth of general government final consumption effectively, it decreased, except in 2003 when its growth rate exceeded that of final household consumption. This increase was driven by grant programs and grant payments from public sector layoffs. Alongside the final consumption, the most dynamic component of aggregate demand was the gross fixed capital formation, changes in inventories having a negligible contribution to GDP growth. Accelerate capital accumulation occurred mainly in the private sector, a process that was generated from the access increasingly larger at the internal resources and external financing.

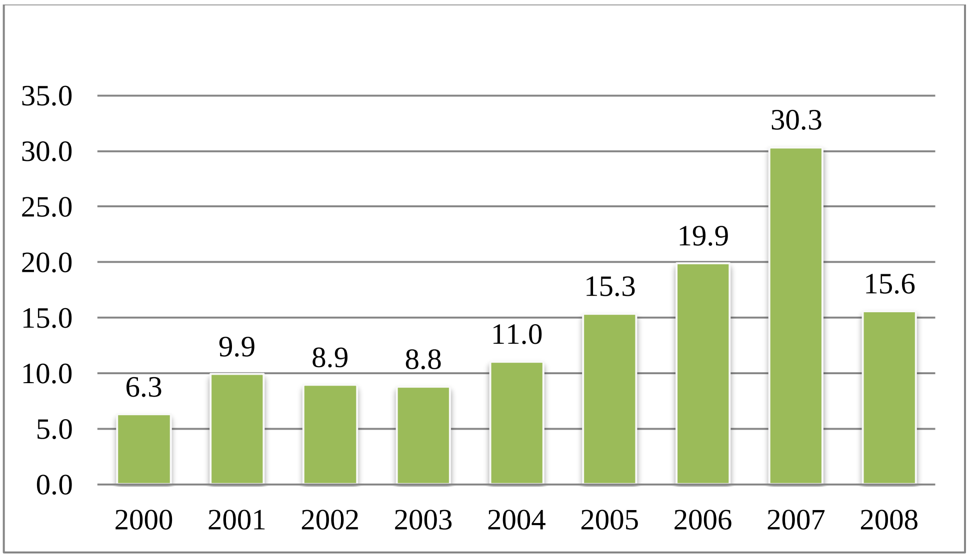

Figure 8. Annual percentage change in gross fixed capital

Source: INSSE

From the above, we see that since 2004 (second quarter), the economy showed visible signs of overheating, GDP actually hovering over actual capacity factors of production. According to estimates by experts NBR, the potential GDP based on production function method, the annual growth rate of potential GDP in 2003-2006 was projected between 5.5% and 6.4% to around 6% in 2007-2008. The potential GDP is that GDP level that can ensure sustainable growth in terms of efficient use of production factors and without generating macroeconomic imbalances (inflation pressure and accumulation of deficits). The main role played in overheating was the aggregate demand which could be controlled through prudent economic policies and at the same time anti-cyclical. While monetary policy was often prudent, its effectiveness was weakened by easing fiscal policy, wage policy, non-governmental credit expansion that added during this period an increase of remittances.

The mismatch economic policy mix in our country can be identified as the main cause of macroeconomic imbalances and non-sustainability of economic growth, taking into account the following aspects:

- the excessive propensity to consume of population was not reflected in this period of economic boom in stimulating domestic production, imports covering most of the demand, while the demand was rigid;
- the economic growth has not led to improved openness of the Romanian economy (measured as the ratio of exports adds with imports and GDP), this being on a position inferior to the countries of Central and Eastern Europe. The support openness by exports was below 40%;
- from the analysis of GDP by type of resources, we observe a pronounced development of non-tradable sector, services (trade) and construction and a more difficult development of the tradable sector: industry and agriculture;
- the mismatch economic policy mix with the cycle phases.

Fiscal and wage policies, influenced by elections calendars, favored a failure correlation between labor productivity in all sectors of the population and increasing disposable income, an important indicator that shows the competitiveness of an economy. In 2007, this correlation has been violated, the growth of net real wage growth outpacing labor productivity.

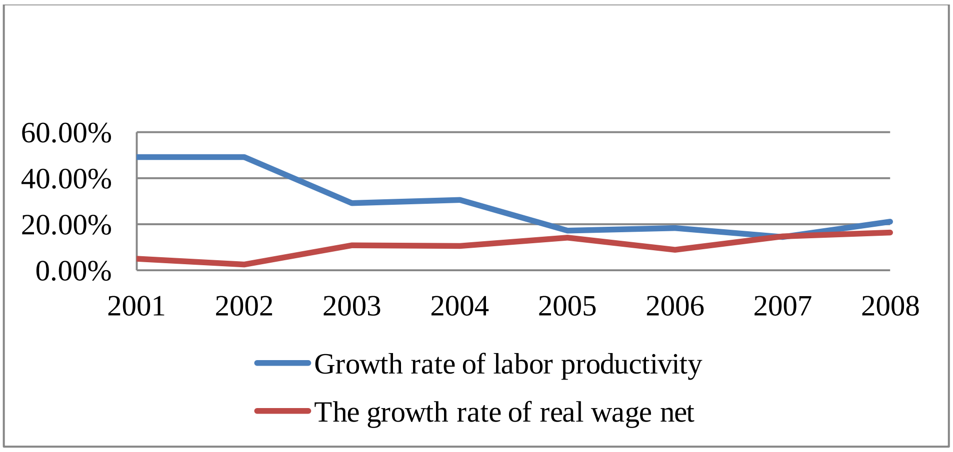

Figure 9. The evolution of labor productivity and average real net wage (% yoy)
Source: INSSE, Own calculations

5. Conclusions

The objectives of economic policy (fiscal policy, budget policy, monetary policy, structural reforms) have not targeted a healthy economic growth and macroeconomic stability. Thus, the pro-cyclical nature of fiscal policy in the period 2000-2008 was a major risk factor of particular relevance during the peak of the economic crisis (2009, 2010) and even to this day. (Benetrix & Lane, 2010) In the economic context discussed above, in late 2008, the economic and financial crisis hit Romania, demonstrating the inability of institutions supervision, inadequate management of the boom period and market realities.

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