

BUDGET DEFICITS AND THEIR SOCIO- ECONOMIC CONSEQUENCES: THE ECONOMIC AND FISCAL CRISIS IN ROMANIA



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The economic crisis in Romania: main causes

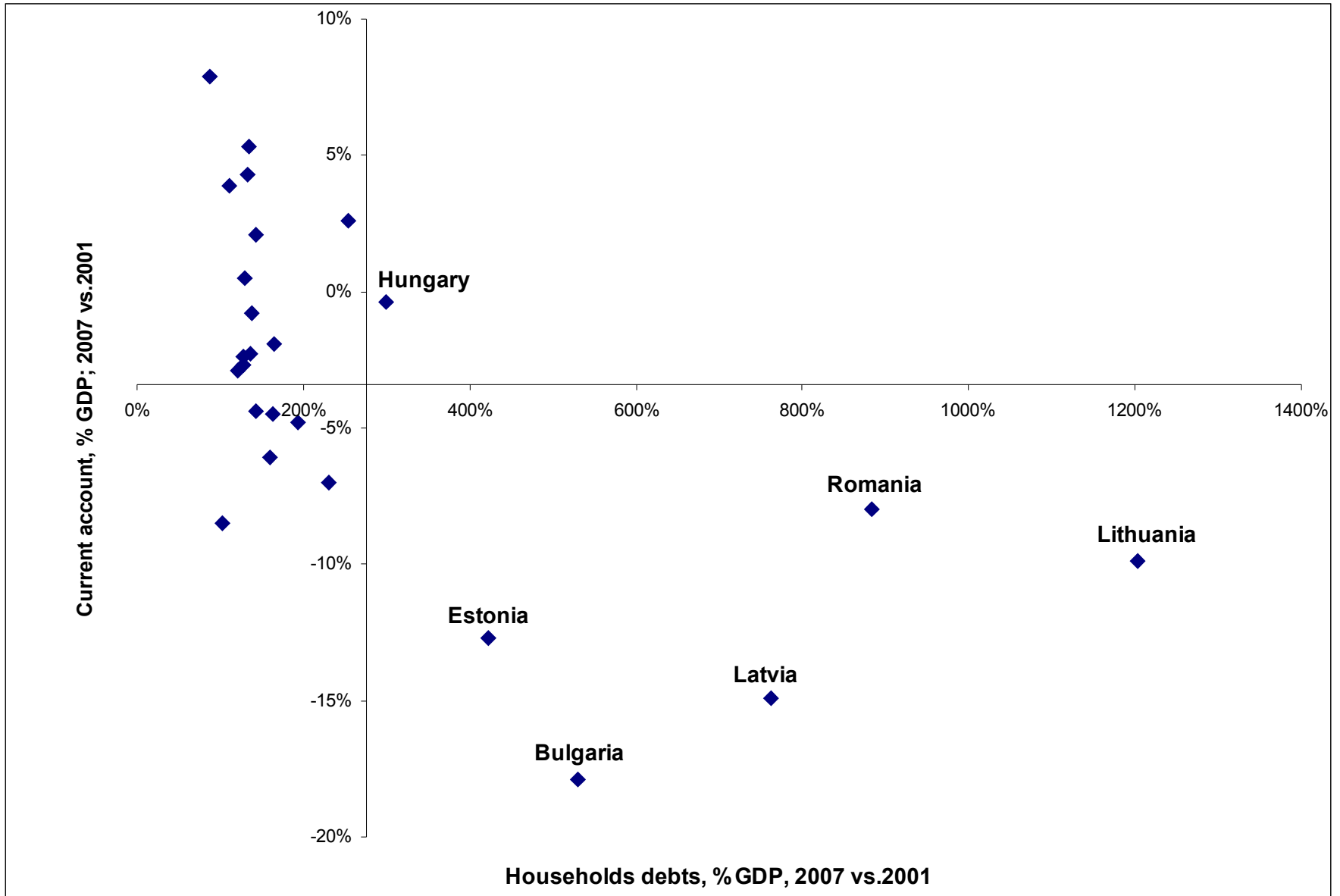
Domestic crisis, triggered by the global crisis;
different causes and different transmission
mechanism

The domestic crisis would have appeared even in the
absence of the global crisis

Main causes:

Excessive consumption financed by short term
private foreign debt. Supporting factors: fast
liberalization of capital account and real estate boom
non-govt. loans: 10% of GDP in 2001 to 39% of GDP
in 2007;

Households loans: +200% in 2003, +70% in 2006
and 2007. By 2008, households loans reached 70%
of households disposable income and exceeded
deposits by 4 bn.euro.



The economic crisis in Romania: main causes (cont.)

Pro-cyclical fiscal and budgetary policy: rising budget deficit in good times, double the public wage bill between 2005-2008, stimulating consumption by flat tax

Postponed structural reforms (labour market, agriculture, competition, energy)

Low absorption of EU funds

Crisis denial before 2008 elections (late November)

One in all: a typical current account crisis (13.5% of GDP in 2007, 12.5% of GDP in 2008)

Current economic situation

Romania is in deep recession. Most likely, Q3 2009 will be the worst quarter, with two digits recession (as opposed to Q3 2008, which recorded the peak of GDP growth).

Current account deficit has adjusted sharply, from 12.5% of GDP in 2008 to 5% in 2009, but the adjustment was by default – not due to specific policies.

The budget deficit worsened (the cyclical component amplified the deficit), and it would exceed 8% of GDP in the absence of any reforms.

The structure of the foreign debt is changing from private to public. Total external debt is up from 54% of GDP in 2008 to estimated 71% in 2010. Total public debt is increasing from 20% of GDP in 2008 to 30% in 2009 and 34% in 2010.

Interest payments increased from 0.7% of GDP to 1.7% of GDP in 2009!

Current economic situation (cont.)

Inflation (4.6% yoy in September) is on a downward trend, due to lower demand, but we should analyse it within a context: it was the highest rate in EU as of July, and second highest as of August. The reason: monetary expansion (M3) through repo operations of the NBR to help finance indirectly (through commercial banks) the Ministry of Finance.

This explains the high level of rollover of short term foreign debt: 82%. Does this qualify us as a positive example?

A country can not reach a meaningful recovery from the crisis when the interest rate differential is huge (8% for RON vs. 1% for euro) and the exchange rate is quasi-fixed (at around 4.2 RON/euro since February 2009).

The banking sector remains exposed: non-performing loans were 11.8% in June 2009, compared to 4.8% in June 2008 – and most of them are not yet declared as such. ROE and ROA down close to 0%.

Key macroeconomic indicators

GDP (1 st half 2009 / 1 st half 2008)	-8.7%
Households consumption (1 st half 2009 / 1 st half 2008)	- 15%
Gross fixed capital formation (1 st half 2009 / 1 st half 2008)	-25%
Industrial production (July 2009/ July 2008)	- 6.9%
Current account deficit (July 2009 / July 2008)	-73.8%
Unemployment (August 2009)	6.6%
Budget deficit (8 months 2009)	-4.4%

Key macroeconomic indicators (cont.)

Estimates for year end 2009

	Official (IMF)	GEA estimate
GDP	-8.5%	-11%
Budget deficit	-7.3%	-8.5%
Current account deficit	-5.5%	-6%
Unemployment	9.6%	10%

estimate to be accurate, the 4th quarter should stop the decline, which in my view

The IMF loan

In April 2009 Romania concluded a stand-by agreement with IMF for 20 bn. Euro. It is in fact a syndicated loan, led by IMF (which gives 12.95 bn.euro) but also including European Commission and the World Bank. Due to this loan, Romania avoided a potential private debt crisis, as the National Bank (NBR) was able to reduce the minimum mandatory reserves of the commercial banks. First installment, in May 2009 – 5 bn.euro from IMF to NBR, second installment in September 2009 – almost 2 bn. Euro from IMF to NBR and Ministry of Finance. IMF has exceptionally agreed that part of its loan can finance the budget deficit – which shows the severity of the problem.

What started as a current account crisis is moving towards a public finance crisis.

The IMF loan comes with two sets of conditions: quantitative performance criteria; structural benchmarks.

Public wage bill reform is most difficult: from 4.8% of GDP in 2004 to 9% of GDP in 2009; it has to be cut to 7% of GDP by 2015.

	Dec 2008	March 2008	June 2009 prog	June 2009 actual	Sept 2009 prog	Sept 2009 revised	Dec 2009 prog	Dec 2010 prog
<i>Quantitative performance criteria</i>								
Cumulative floor on general government overall balance, mil. RON	25532	-3500	-7600	-5119	-8720	-8720	-9000	-500
Cumulative change in general government arrears (bn. RON)	0.3	...	0	na	0	0	-0.15	-0.15
Ceiling on general government guarantees (bn. RON)	0	...	6	0.02	6.0	7.3	7.3	8.2
<i>Continuos performance criterion</i>								
Nonaccumulation of external debt arrears	0	...	0	0	0	0	0	0
<i>Inflation consultation</i>								
Annualized inflation, center point (+/- 1 p.p.)	6.3	6.7	6.4	5.9	5.7	5.7	4.5	2.5
<i>Indicative target</i>								
General government current spending (mil.RON)	107202	25960		50365		74950	107000	107500

Structural conditionality - benchmarks

	Timing	Comments
Ratification by Parliament of fiscal measures equivalent to 1.1% of GDP	August 31, 2009	Met in April 2009
Passage of revised public compensation legislation	October 30, 2009	
Presentation of fiscal responsibility legislation and implementation plan to Parliament	November 30, 2009	
Passage of revised pension legislation	December 31, 2009	
Approval of fiscal responsibility legislation	March 2010	New conditionality
Approval of legislation and internal regulations regarding tax administration reforms	March 2010	New conditionality
Approval of institutional reforms measures to mitigate fiscal risks from local governments and SOEs	June 30, 2009	New conditionality
Passage of amendments to the banking law to strengthen NBR's power to request banks shareholders an increase in their share capital and limit profit distribution	June 30, 2009	Met
Passage of amendments to deposit insurance legislation to broaden grounds for activation of deposit insurance, expedite payouts and provide a line of credit from government	August 30, 2009	Met
Passage of amendments to the banking law to enhance the bank resolution framework	November 30, 2009	Moved to March 31, 2010

The (IMF) anti-crisis program

The IMF imposed structural reforms have a monetary end. They do not change the structure of the economy, but provide some savings for the public budget.

In addition to the structural benchmarks, wages and pensions will be frozen in 2010 (confirmed by letter sent by government to IMF), and a VAT increase is very likely.

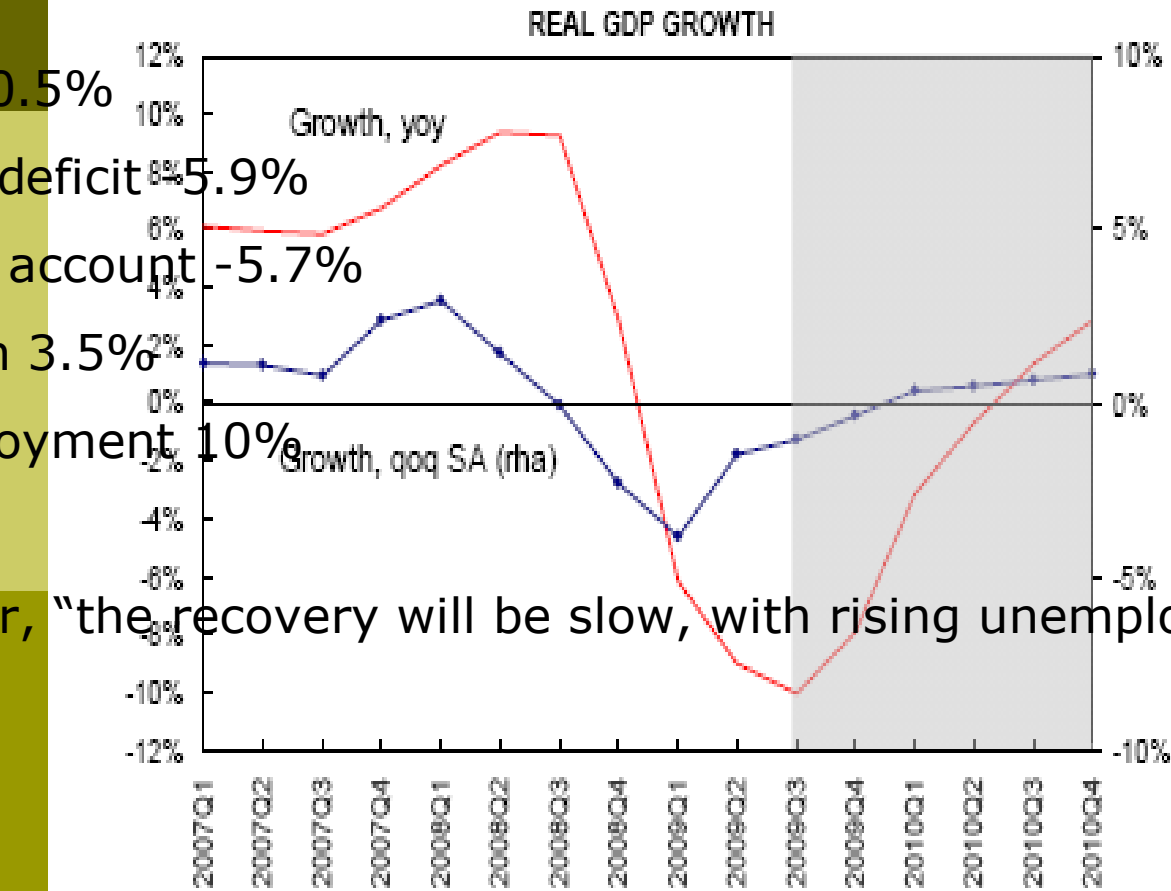
VAT increases were implemented in other countries with IMF loans (eg. Hungary), or in need of more fiscal revenues (Spain). Estimates with zero elasticity: for a 3 p.p. increase in VAT – 0.8% of GDP increase in revenues. However, tax evasion and inflation are more likely effects of such measure.

The measures agreed with IMF are a proxy for an anti-crisis program. But are they effective?

They target lower deficits, easier to finance. This is adjusting to the crisis, not fighting the crisis. (Almost) no fiscal stimulus.

An “expansionary fiscal contraction” is not possible, because private investments are also shrinking (FDI dropped 45% in the first 8 months). The anti-crisis program is pro-cyclical and it will lead, in the short-run, to an even deeper recession.

2010 forecast – official (IMF)



...r, "the recovery will be slow, with rising unemployment, deleveraging household

2010 GEA forecasts

GDP -2%

Budget deficit – 7%

Current account -6%

Inflation 6% (impact of currency depreciation)

Unemployment 12% (impact of firings in the public sector)

Romania may start recovering in the second half of 2010, due to a number of factors such as: the recovery (although slow) of foreign demand, the base effect (when compared to a very severe recession in 2009), and the implementation of structural reforms.

Structural reforms unsolved: the labour market

The IMF agreement does not specifically target economic growth, nor employment rate.

The structural reforms are in fact monetary – the economy will not be in a better shape to deal with real structural issues. Most important of all: the labour market.

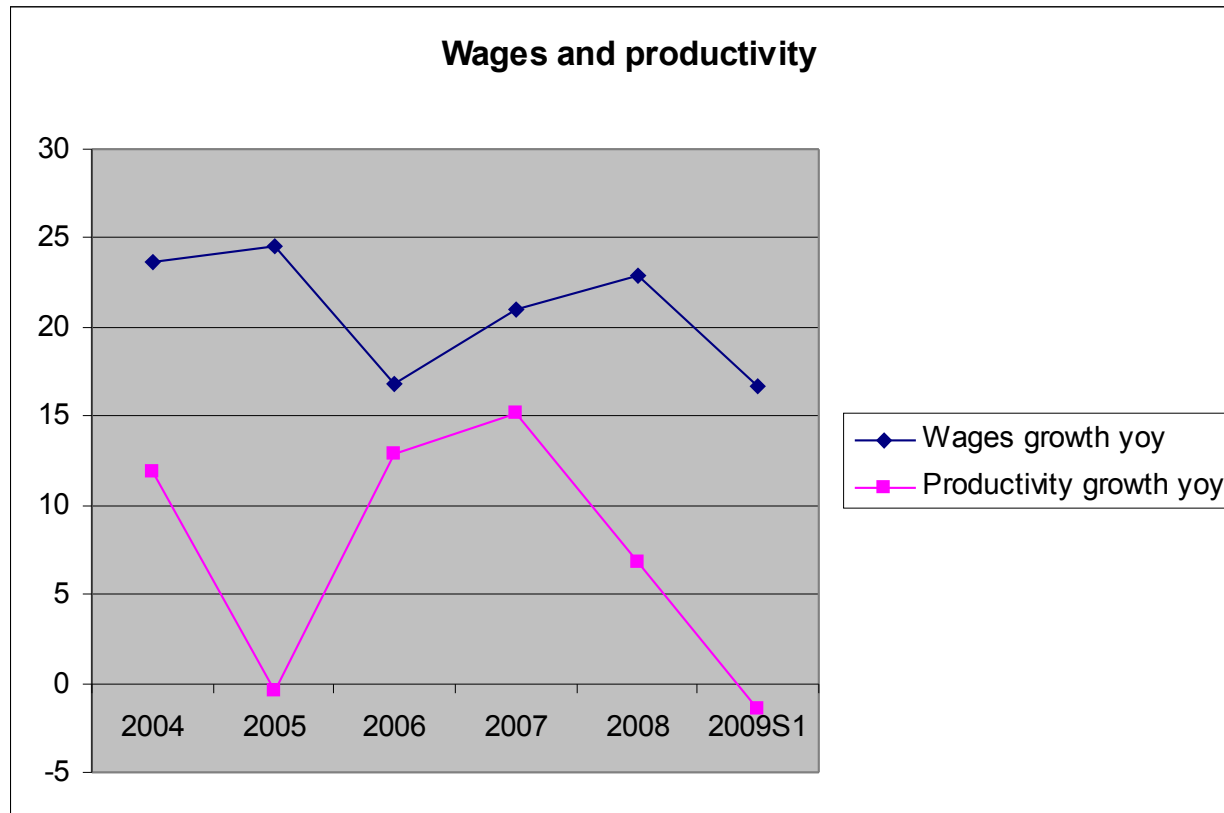
Main problems here:

Employment rate in 2008 was 59% (very low, and down from 61% in 2000), 52% for women

Long term unemployment, young people unemployment, underground economy, large emigration (cca. 2 millions), “self-employed” in subsistence agriculture.

Structural reforms unsolved: the labour market

High fiscal burden: 33% social contributions
pays over productivity



Structural reforms unsolved: the labour market

Over 80% of the population receives some type of social support

Remittances declined by 40% in 2009 (first 8 months)

Education, research & health systems, which were under-financed before the crisis, are now facing even lower budgets.

A serious depreciation of the RON would put most debtors into risk of default, with important social implications.

The crisis aggravates all problems on the labour market: more unemployment, more underground economy, higher fiscal burden, less remittances.

The crisis is forcing wages to adjust downwards, to fit productivity levels (which is good), but as loan payments increase, the mismatch between income and expenditures at households level increases

Possible solutions for recovery and their caveats...no silver bullet

Stimulating consumption and credits	<ul style="list-style-type: none">- against orthodox IMF strategy;- public wages cuts and firings reduce marginal propensity for consumption.
Public investments	<ul style="list-style-type: none">-hijacked by political elite;- the Portuguese trap;- interest rate higher than marginal productivity.
EU structural funds	<ul style="list-style-type: none">-undeperforming track record;-allocations in danger to decrease for Romania, especially from 2014

What next? 2011 and beyond

Romania should target higher employment rate, should fight tax evasion (10% of GDP only from VAT and excise duties tax evasion), and should introduce a fiscal reform based on solidarity and automatic stabilizers.

Budget revenues must exceed the 31-32% of GDP barrier.

Cuts in the public sector should aim primarily at overpriced purchase of goods and services and investments.

Next budget should be based on multiannual budget programming...

The good news

The main problem (huge current account deficit) was solved – although the hard way

After presidential elections, there will be no excuse for implementing reforms mainly on the expenditure side of the budget

Romania has HUGE UNUSED POTENTIAL (X-efficiency reserves):

budget revenues could increase by up to 10% of GDP if fiscal evasion is dealt with adequately;

property taxes and royalties are very low;

asset prices are now undervalued;

agriculture can improve a lot (now is undersubsidized and underperforming);

more than 4 million working age people are inactive.