CAUSES AND EFFECTS OF ROMANIA DEEPENING FINANCIAL CRISIS. SHORT TERM MEANS

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Abstract: Deepening and expanding financial crisis triggered in October 2008 in the U.S. and other countries is the event that has caused the utmost concern of the policy makers in the economy and society. Forecasts for Romania show a slowdown in economy. As the current global status indicates the likelihood of a major global economic crisis, we attempt through this study to identify the real causes of this deepening crisis in Romania. As well as public policy priorities to counteract the effects of the crisis and restore confidence of financial institutions and investors to Romania.

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Introduction

The global financial crisis from 2009 has destabilized the business community, causing companies to remain in position, if they can, while 2010 is the year when survivors recalibrate their position (Deloitte, 2009). There are still no winners, while the macroeconomic crisis is getting deeper as shown in studies of international financial institutions.

IMF says that losses from the global financial crisis will be around 1500 billion dollars, given that in September 2008 estimated a loss of 1300 billion. Preliminary figures are of course subject to further review, primarily because of bad loans and unsecured assets.

In Romania, uncertainty continues to affect economic prospects and the most recent indicators confirm that the contraction was resumed in the second half of this year. Based on the economic surveys conducted, Oxford Economics does not anticipate that GDP growth in Romania to come back until the second quarter of 2011[1]. The institution foresees a decrease in GDP of 2.7% this year followed by a 1% contraction in 2011, more pessimistic forecasts than those made by the IMF and the European Commission of 2% this year, respectively plus 1.5% next year. Based on these considerations, this study aims to identify the real reasons behind the deepening financial crisis in Romania and to identify public policy priorities that must be targeted to counteract the effects of the crisis and restore confidence of financial institutions and investors regarding Romania.

The current situation in Romania

Latest international reports (UNCTAD, 2010) indicate that Romania risks losing a source of money that could help it emerge from the recession in favour of neighbouring countries being much more attractive to business.

Bankers and financial analysts consider that the situation must be improved quickly, even if Romania is known as a country with a lack of fiscal predictability. Strategic investors are looking at countries like Poland, which has not entered into a recession, to Hungary, Czech Republic and even Bulgaria. In 2009 foreign investment was 6.3 billion dollars in Romania, an amount that places Romania on 14th place among European Union countries, according to the World Investment Report 2010. In the first five months of 2010, foreign direct investments were 1.43 billion or 31.5% lower compared with the same period in 2009.

According to the report, foreign direct investment in Poland was 11.3 billion dollars in 2009, USD 2.7 billion in Czech Republic and USD 4.4 billion in Bulgaria, while foreign investors withdrew USD 5.5 billion in Hungary.

According to statements made by officials of the central bank and other financial institutions there is no bank in Romania having a serious situation, there are no liquidity problems due to international financial crisis. Bank solvency is at a good level (13%) and weak assets have a relatively small proportion of total assets (less than 1%). Prudent growth in lending and foreign exchange reserves of Romania are sufficient arguments to support they view that international crisis delivers only indirect impact on the local financial market in Romania.

Viewed from another perspective, global economic recovery has slowed since the beginning of the year and the trend is more pronounced in countries of the Organisation for Economic Cooperation and Development (OECD)[2]. “Recovery is fragile” says a report published by the OECD that preceded the G20 summit in Seoul on 11-12 November this year. “Increasing economic and trade activities have declined from earlier this year because the expiration incentive programs and the

[1] http://www.mediafax.ro/economic/oxford-economics-economia-romaniei-se-va-contracta-si-anul-viitor-7689246

[2] http://www.wall-street.ro/articol/International/94718/Redresarea-economiei-mondiale-se-lasa-asteptata.html

slowdown in OECD countries are higher than expected."

According to the National Statistics Institute (INS), Romania's trade deficit in first quarter of 2010 was 2.81 billion euros, 329.8 million euros lower than in the first quarter of 2009. Analysis of the product groups indicated that Romania imports was more than exports in chemicals, fuel and food, recorded net export surplus in raw materials, and a near-zero balance in group of machinery and equipment transport. Exports in the first three months of the year were 10.8 billion euros, while imports totalled 13.6 billion euros. Comparing these data with those in the first quarter of last year, the INS concluded that exports increased by 19.4% values expressed in lei (23.4% in euro) and imports increased by 10.9% values expressed in lei (14.4% in euro).

Exports FOB achieved in the period 01/01 to 04/30/2010 were 44530 million lei (10811.5 million euros) and CIF imports were 56117 million lei (EUR 13624.7 million euros). Compared with the period 01/01 to 04/30/2009, exports increased by 19.4% values expressed in lei (23.4% in euro) and imports increased by 10.9% values expressed in lei (14.4% in euro). For a detailed analysis see the Figure 1A.

FOB-CIF commercial deficit in the period 01/01 to 04/30/2010 was 11587 million lei (2813.2 million euros), with 1748.7 million lei (329.8 million euros) less than in the respective period of 2009 (Figure 1B).

Trade value of goods during 1.1-30.4.2010 was 32839.6 million lei (7975.8 million euros) and deliveries 40535.1 million lei (9846.8 million euros) for entries, representing 73.7% of total exports and 72.2% of total imports. The difference between the dynamics based on the values expressed in lei and the values expressed in euro was due to the appreciation of the national currency in January-April 2010.

During the 1.1-04.30.2010, significant weight in the structure of exports and imports was taken by groups of products: machinery and transport equipment (42.6% to 34.6% in export and import) and other manufactured products (34.7% to 30.4%).

Short-term remedies to deal with financial crisis

The effects of the current financial crisis on public finances are still difficult to gauge. Deteriorations in headline balances appear in most, if not all, new Member States. Overall, this further strengthens the case for sound public finances in the medium term. However, at the current juncture some limited discretionary loosening may also be appropriate in some countries. Indeed the budgetary deteriorations are partly caused also due to participation in the European Economic Recovery Plan, which focused on 2009 but also covered 2010. This participation is proportionately weaker in the new Member States, given the fact that in some of them growth has been resilient, while others have no fiscal space (indeed, Hungary and Latvia benefit from financial assistance). Therefore, the only new Member States which have launched fiscal stimulus packages so far are Poland, Czech Republic, Slovenia, and Malta. Conversely, in Latvia, Lithuania, Hungary, Slovakia, Romania, and Bulgaria such packages have been non-existent or their size has been negligible (European Commission, 2009).

The exchange rate regime also matters for fiscal policy. Where monetary policy autonomy is maintained with floating exchange rates, it is important to slow the build-up of borrowing denominated in foreign currency which could expose economies to balance-sheet risks. Where the new Member States relinquish domestic control of interest rates for fixed exchange rates, there could be a greater risk of any instability spreading.

The economies of the new Member States as well as their public finances appear to be more volatile than those of the old Member States. Since accession, however, volatility has been declining. The variability of the interest rate on public debt, in particular, has diminished significantly thanks to the anchor of stability that the EU policy framework provides (Table 1).

A stronger view would be that prudent fiscal policy may trigger higher growth even in the short run, especially through credibility effects (Rzonca and Cizkowicz, 2005). Actually, in terms of investor confidence in Romania's fiscal policy should probably all start with fiscal predictability. Even if Romania can be attractive through prudential banking policies, with a low rate of corporation tax / income (16%), frequent changes in tax legislation creates a chaos that investors fear. It is therefore necessary to provide stability and predictability of tax and budgetary policies in process of overcoming the financial and economic crisis. One argument of this approach is demonstrated by the recommendations of IMF and European Union to implement tough economic measures, essential for economic recovery though socially unpopular. Reduction of social protection will help the state to concentrate its efforts and resources in the only area that can take Romania out of crisis - the real economy.

The economy might remain in recession when political instability prevails, and the public sector arrears to the private sector increase. Romania most likely will not come out very quickly from recession, but if the right decisions will be made most likely the investors will appreciate such decisions. For international investors the economic prospects are more important, not necessarily economic recovery that it would soon appear.

However, in view of the overall impact of financial crisis, a number of urgent short term measures are required to be taken by the Romanian government to counter immediately with a worsening crisis and restore confidence in financial markets and institutions.

Healthy growth in credit is a key support for the catching up process, but it is important to guard against excessively strong cycles in credit, asset prices, the external current account and the real exchange rate, which could jeopardise stability.

Banking supervision can play a valuable role here, and so can monetary policy.

Prudent fiscal policy can also make an important contribution to stability by moderating any credit booms (European Commission, 2005). In particular, it balances strong private investment which causes a widening of the external current account deficit. On the other hand, additional fiscal headroom can prove useful under conditions such as those of the current financial crisis, which threaten confidence.

It is extremely urgent to identify sectors that represent a competitive advantage over other countries. IT and renewable energy may be considered as the two examples of these sectors. The state should give tax incentives for the development of the competitive sectors. Through trade policies compatible with European ones, Romania needs to recapture export markets in the East and the Middle East.

Last but not least, we believe that Romania has the important task of matching the main measures taken immediately by Member States in the ethical plane.

Good governance in the tax area is equivalent to the principles of transparency, exchange of information and fair tax competition. In the internal market rules are common, including company law and taxation, which enable individuals and companies to benefit from open borders. These rules have beneficial effects, particularly in terms of reducing compliance costs and encourage cross-border investment.

Member States have sufficient rights under Community law to design their direct tax systems in a way that meets their domestic policy objectives and requirements. However, during the last decade they have reached common agreement on several ways of tackling with the erosion of tax bases and investment allocation distortions. In doing so, they have acknowledged that individual national and bilateral measures can only partly address tax erosion problems and that EU-wide cooperation is vital (COM, 2009).

Member States have agreed on a number of measures to promote better governance in tax matters within the EU. Administrative cooperation is a directive on "mutual assistance" (Council of the European Union, 2004) which provides for exchange of information between tax authorities on direct taxation. A directive on tax recovery (Council of the European Union, 2008) sets up a regime whereby a Member State may request assistance from another Member State for the recovery of taxes and fees.

The Directive regarding taxation of savings income (Council of the European Union, 2003) provides that the tax administrations must to exchange information automatically. Although it applies only to savings income in the form of interest payments made by individuals, and three Member States were authorized to apply, on a transitional basis, a withholding at source.

The legal instruments of administrative cooperation are complemented by a political agreement among Member States to combat harmful tax competition in business taxation. "Code of Conduct on Business Taxation"[1] defines harmful tax measures as measures (including administrative practices) which affect or may significantly affect the location of a commercial activity within the Community and providing a tax rate far lower than the levels that generally applicable in the Member State concerned.

Conclusions

The contraction in economic activity in the second half of this year due to the impact of higher VAT and wage cuts from the public sector is fully felt by the population. Consumer and investor confidence is already low, virtually collapsed after the announcement of austerity measures proposed by the Government with the approval of 2011 budget.

The greatest challenge for Romania is currently connected with the needs to legislate fiscal sustainability, without altering growth. But in the medium-term there are three major risks - tax policy, chaotic unpredictability and political instability. Romania must lead to an end the reforms in order to prove to investors that the Romanian market is the one having relatively high yields and macroeconomic stability.

There are data showing that manufacturing will continue to have a decisive role in economic development, whereas other sectors are unlikely to demonstrate the same perspective. The state should give tax incentives for the development of urgent global competitive sectors. Further developing of IT industry and renewable resources could be two major directions for action. Through trade policies compatible with European ones, Romania needs to recapture export markets in the East and the Middle East. A first step should be made towards the granting of tax relief for the goods exported (exemption, reductions or refunds of taxes on products circuit), and financing and guaranteeing export loans should follow-up without delaying.

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[1] http://ec.europa.eu/taxation_customs/taxation/company_tax/harmful_tax_practices/index_en.htm#code_conduct

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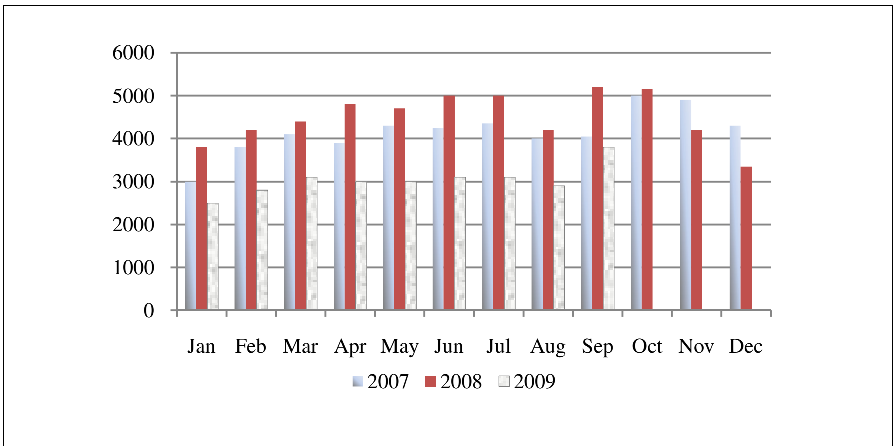
Appendix:

TABLE 1. VOLATILITY IN FISCAL VARIABLES, 2004-2008

	Revenues		Primary expenditures		Primary deficit		Implicit interest rate on debit		Debt	
Standard deviation	99-03	04-08	99-03	04-08	99-03	04-08	99-03	04-08	99-03	04-08
BG	0.5	0.8	0.6	1.1	1.4	0.5	0.9	0.5	14.0	95
CZ	1.0	0.6	2.3	1.5	1.4	1.0	1.0	0.2	6.0	1.4
EE	0.7	1.0	2.2	2.6	1.9	1.8	0.9	0.3	0.5	0.6
CY	22	34	33	0.8	1.8	2.8	0.4	0.1	4.4	9.0
LV	2.2	1.5	3.0	1.7	0.9	0.9	1.4	0.8	1.0	2.0
LT	2.2	0.9	2.7	1.5	0.8	1.0	1.2	0.1	1.0	0.9
HU	0.7	1.5	2.6	1.3	3.2	2.3	2.1	0.7	2.9	3.0
MT	1.4	0.6	2.6	1.1	1.8	1.1	0.7	0.1	5.3	4.6
PL	0.9	1.4	1.4	0.7	1.6	1.4	0.6	0.2	4.2	1.6
RO	6.3	1.2	3.3	2.3	3.7	1.1	13.5	1.0	1.9	2.7
SI	0.4	1.0	0.4	1.6	0.5	0.7	1.5	0.5	1.7	2.6
SK	1.5	1.4	3.5	1.3	2.9	0.7	1.6	0.4	3.5	5.2
EE, LT, LV	1.7	1.1	2.7	1.9	1.2	1.2	1.1	0.4	0.8	1.2
CZ. HU, PL, SI, SK	0.9	1.2	2.0	1.3	1.9	1.2	1.4	0.4	3.7	2.8
CY, MT	1.8	2.0	3.0	1.0	1.8	1.9	0.5	0.1	4.8	6.8
BG, RO	3.4	1.0	2.0	1.7	2.5	0.8	7.2	0.8	8.0	6.1
NMS	1.7	1.3	2.3	1.5	1.8	1.3	2.1	0.4	3.9	3.6
OMS	1.0	0.8	1.2	1.1	1.8	1.2	0.6	0.3	3.3	3.4

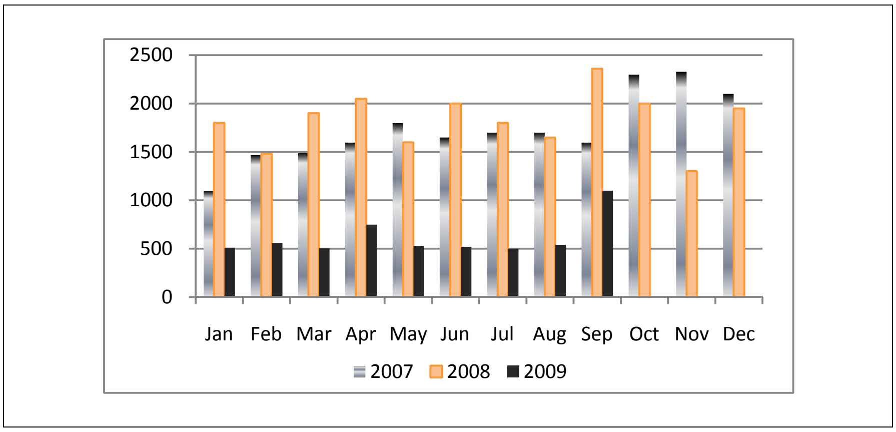
Source: European Commission, 2009. DG-EFA, Five years of an enlarged EU, Economic achievements and challenges, Directorate-General of Economic and Financial Affairs, Brussels

FIGURE 1A. ROMANIA: IMPORT, mln. euros



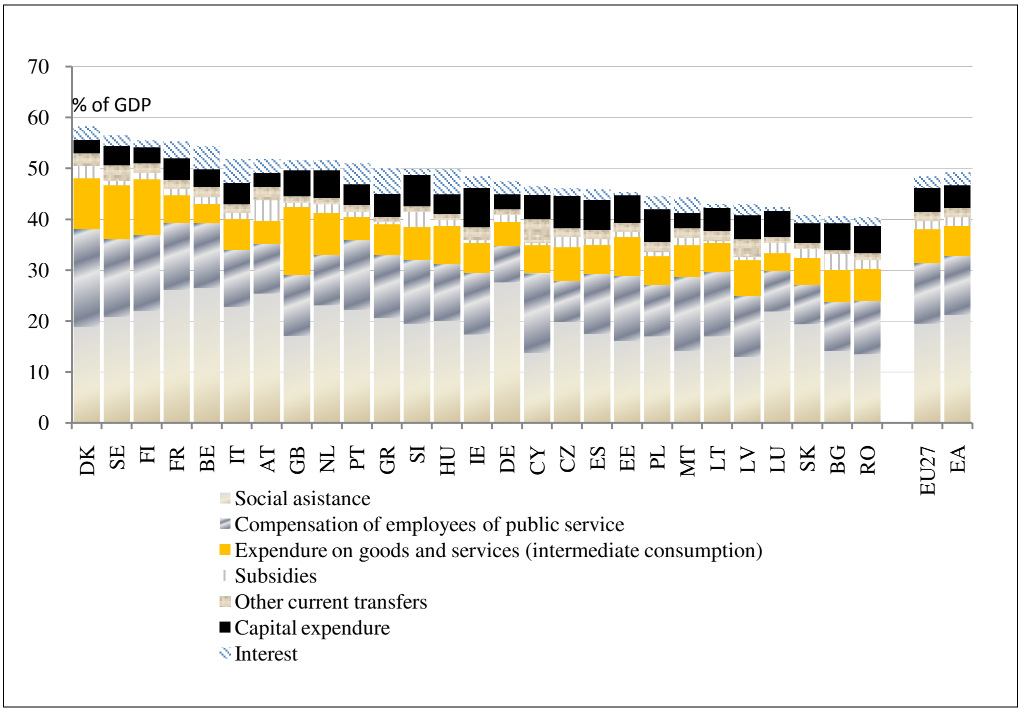
Source: www.khris.ro

FIGURE 1B. ROMANIA: TRADE DEFICIT, mln. euros



Source: www.khris.ro

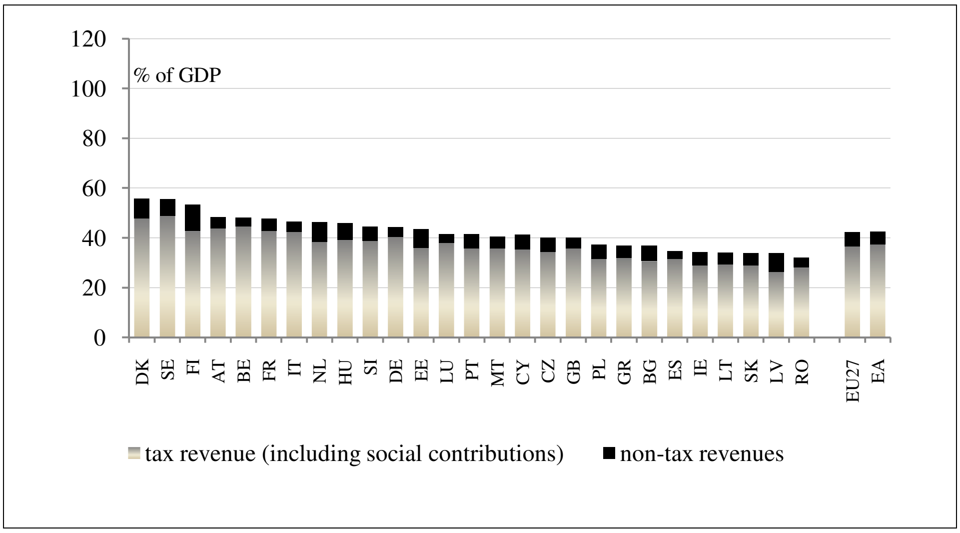
FIGURE 2A. THE STRUCTURE AND THE TOTAL EXPENDITURE OF THE GENERAL CONSOLIDATE BUDGET *
EU countries, 2009



Source: Council Tax - Report of Public Finance position in Romania, August 2010
Note: * ESA 95 methodology.

As is the second smallest in terms of tax revenue and last place in total budgetary revenues. Romania ranks last in the EU with 40.4% of GDP regarding public expenditure (82% of the EU27 average) and the last position in the group NSM10 at 85% of their average.

FIGURE 2B. TOTAL REVENUES OF CONSOLIDATED BUDGED*
EU MEMBER STATES, 2009

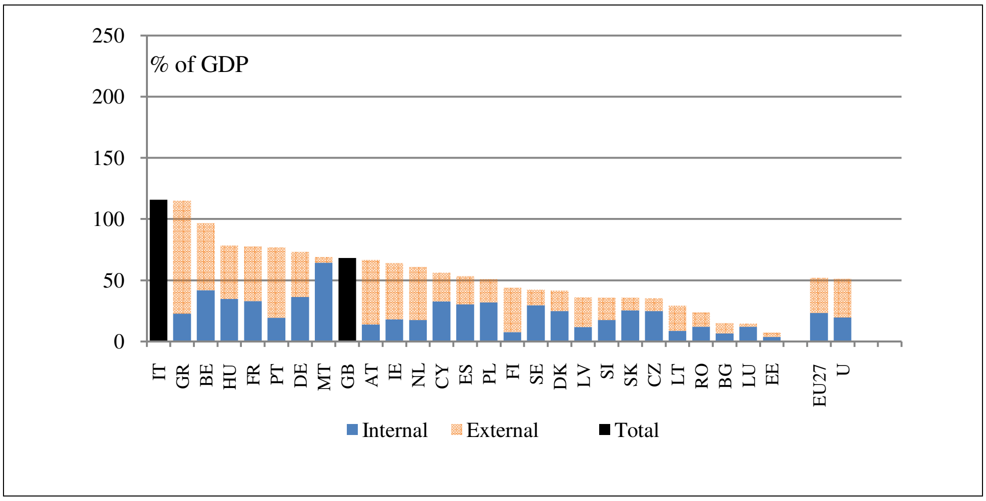


Source: Council Tax - Report of Public Finance position in Romania, August 2010
Note: * ESA 95 methodology.

The last place in total revenue, the second lowest in tax revenue in the EU27 and NSM10.

Place 23 non-tax revenues in the EU27 and the last position in the group NSM10.

FIGURE 2C. INTERNAL AND EXTERNAL PUBLIC DEBT*
IN EU COUNTRIES



Source: Council Tax - Report of Public Finance position in Romania, August 2010
Note: * ESA 95 methodology.

From the perspective of public debt. România ranks 24 among the EU27 countries (43% of the EU27 average) and eîght posîtion in NSM10 group (68% of their average).