

Romania's Economy : Six Lessons from the Recent Business Cycle

Presentation delivered for Deloitte Romania

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Before the crisis

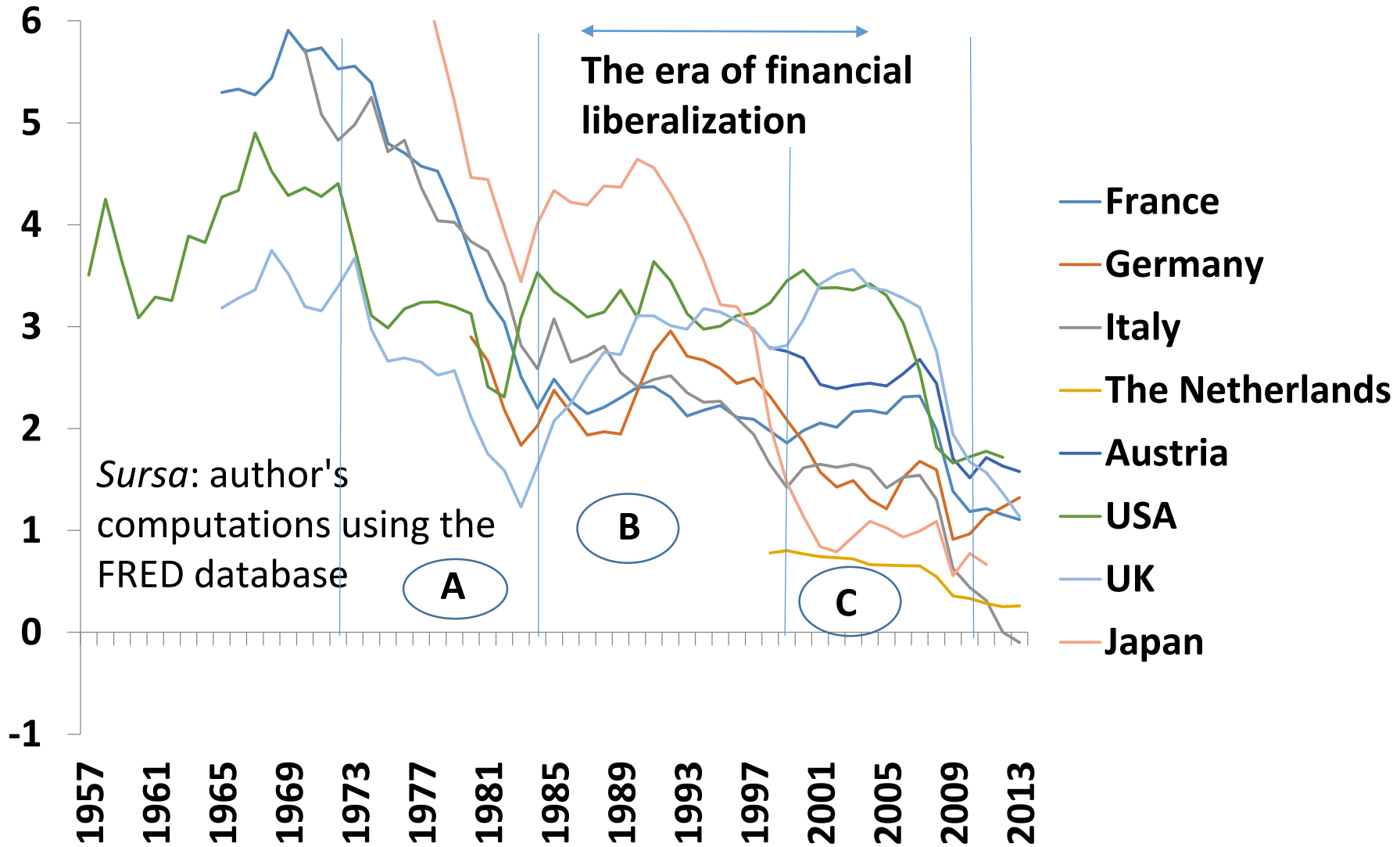
- Rapid GDP growth in 2001-2008 (6.5% average annual growth) fuelled by large capital inflows:
 - ✓ A **real-estate** and **consumption** boom emerged as **credit** and **wage** were increasing rapidly
 - ✓ An **expansionary fiscal policy** further contributed to the overheating of the economy starting in 2005
- Large imbalances were building up, rendering the economy vulnerable to negative shocks
 - ✓ **Unsustainable structural fiscal imbalances** doomed Romania to fiscal consolidation when the crisis hit
 - ✓ **Sizeable external disequilibrium** (the current account deficit peaked at 13.4% of GDP in 2007)
 - ✓ **External debt increased** from euro bn. 30.9 in 2005 to euro bn. 72.4 in 2008

Adjustments in the wake of the crisis

- The **current account** deficit plunged to sustainable levels (4.4% of GDP in 2012, 0.4% of GDP in 2014)
- Sharp fiscal consolidation brought the **budget deficit** from about 9% of GDP in 2009 to 1.5% of GDP in 2014
- The **public debt-to-GDP ratio** increased rapidly during the crisis, but it is still one of the lowest in the EU and is estimated to stabilize below 40% of GDP over the medium term
- Total **external debt increased** to euro bn. 100 in 2012 and decreased to euro bn. 63 in 2014

Lesson No.1 (I): Responding to financial crises with overregulation is impairing economic growth

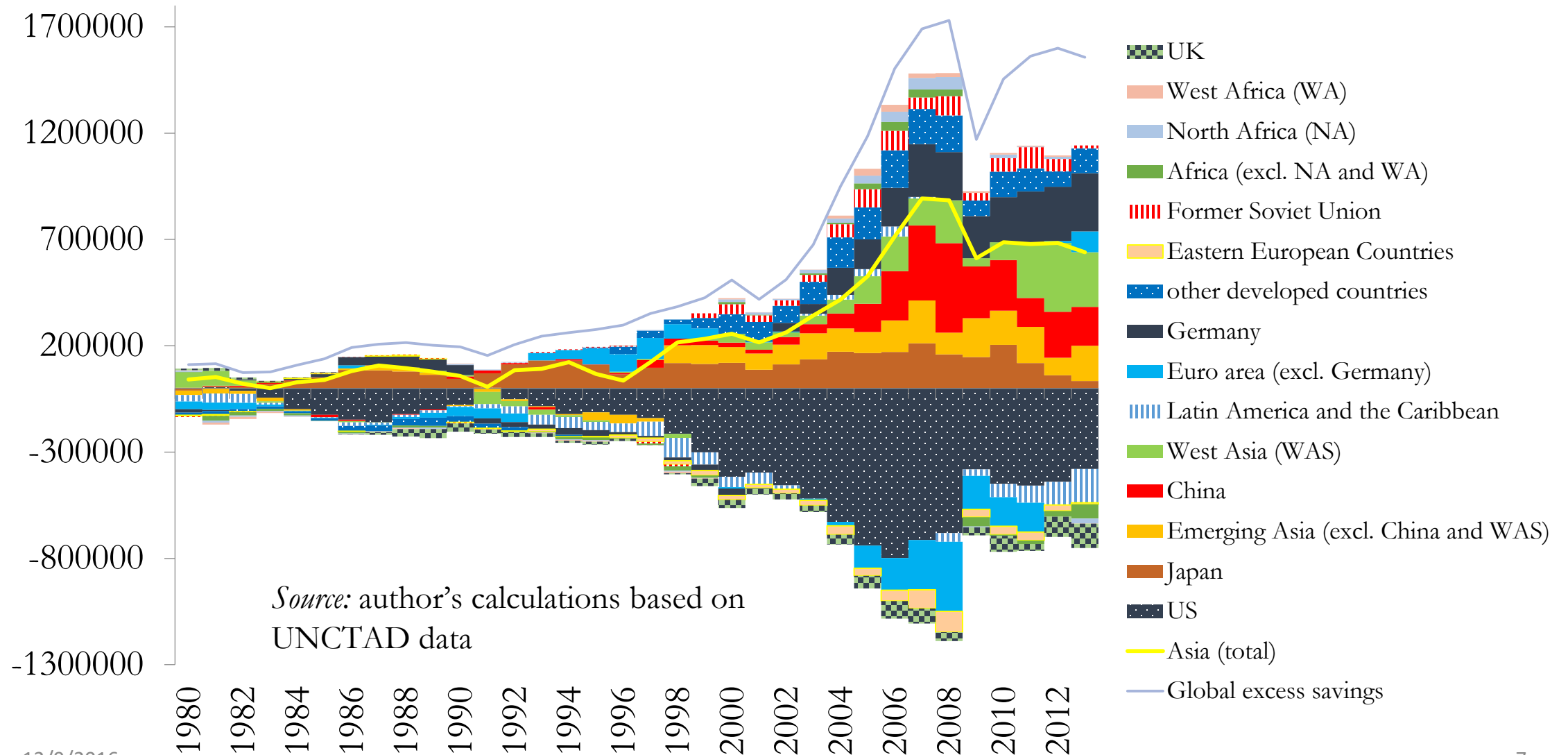
Lesson No. 1 (II): GDP growth rates in selected developed countries (10 year-moving averages, %)



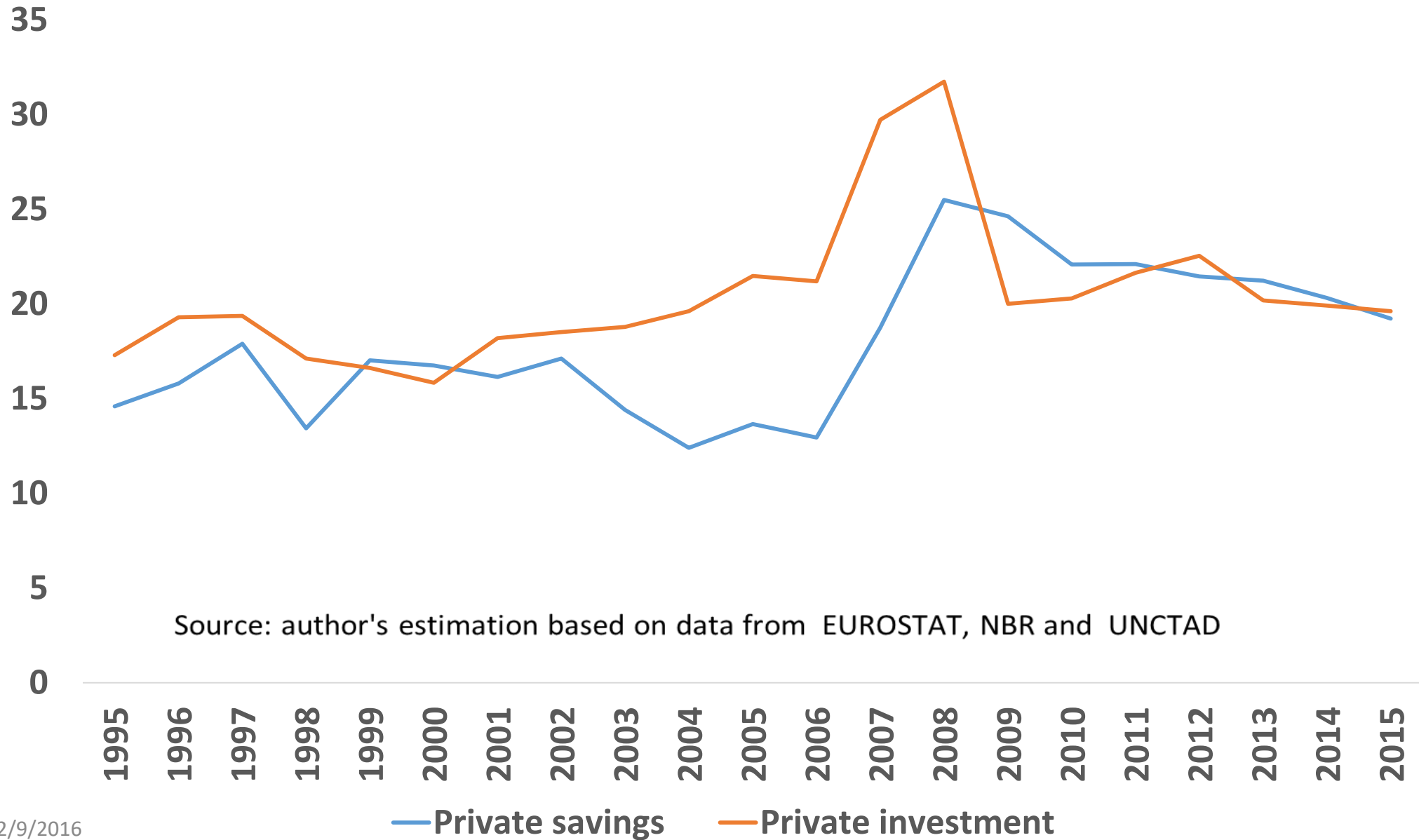
Lesson No.2 (I): „SECONDARITY”:countries understand that excess investment might be dangerous and tend to move towards excess savings

- **Secundarity**: the global surplus of savings is generated in an increasing number of countries, whereas the overwhelming part of the global deficit of savings is located in the US (Croitoru, 2015d)
- The US are far better equipped to accommodate swift capital outflows, currency depreciation, an abrupt decline in domestic asset prices, banking system weakening, and the flagging domestic demand

Lesson No. 2 (II): Illustrated secondarity: the history of savings-investment imbalances across major countries and regions (USD mill., current prices)



Lesson No.2 (III): Romania-The private sector reduced savings and increased investment during the boom and reduced them both in the aftermath (% of GDP)

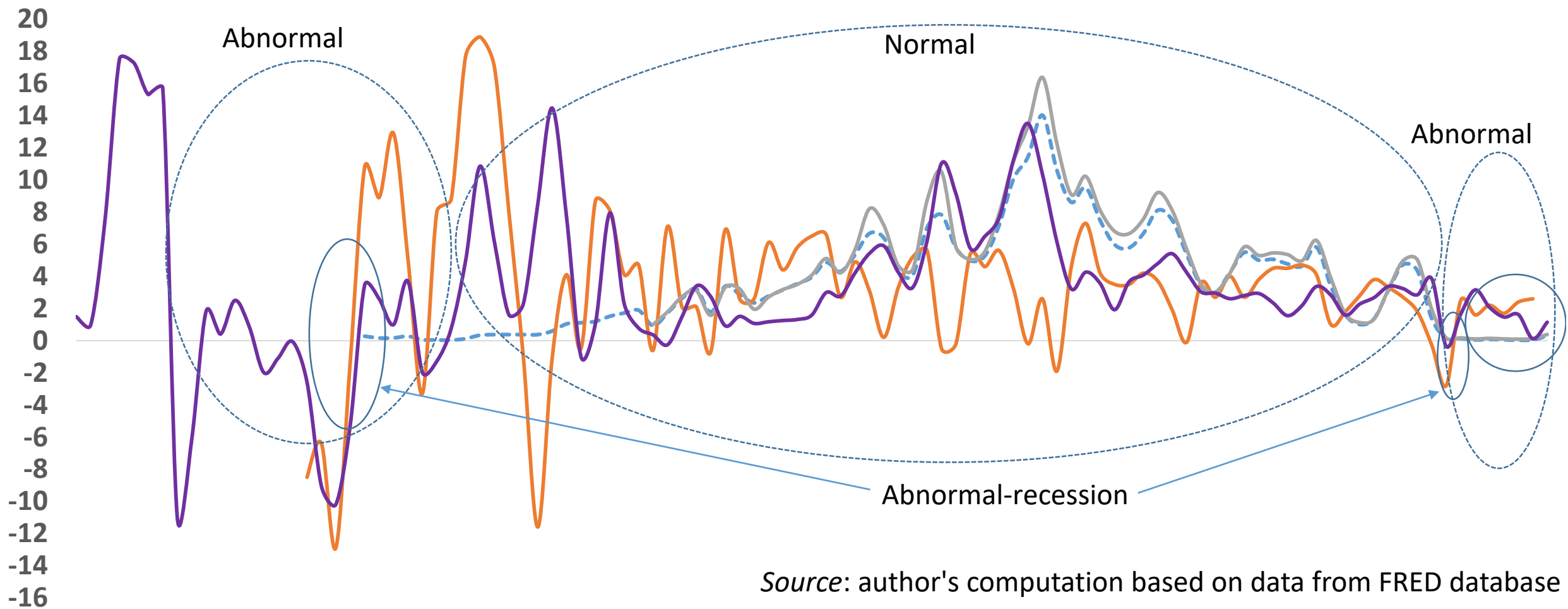


Source: author's estimation based on data from EUROSTAT, NBR and UNCTAD

Lesson No.3 (I): Business cycle is much more complex than we thought. It has a „normal” phase and an „abnormal” phase (Croitoru, 2016i)

- In the „normal” phase, interest rates are positive; in the „abnormal” phase interest rates are zero or negative
- Both „normal” and „abnormal” phases have expansions and recessions, so that there are 4 distinctive phases:
 - normal-expansionary
 - normal-recessionary
 - abnormal-recessionary (recession or very low growth;
 - abnormal-expansionary

Lesson No. 3 (II): „Normal” and „abnormal” business cycle’s phases in the USA



Source: author's computation based on data from FRED database

--- 3M T-bills secondary market rates (annually) — GDP growth rates — Fed rates — CPI annual inflation

Lesson No. 3 (III): Business cycle is much more complex than we thought. **There are implications for the policy mix:**

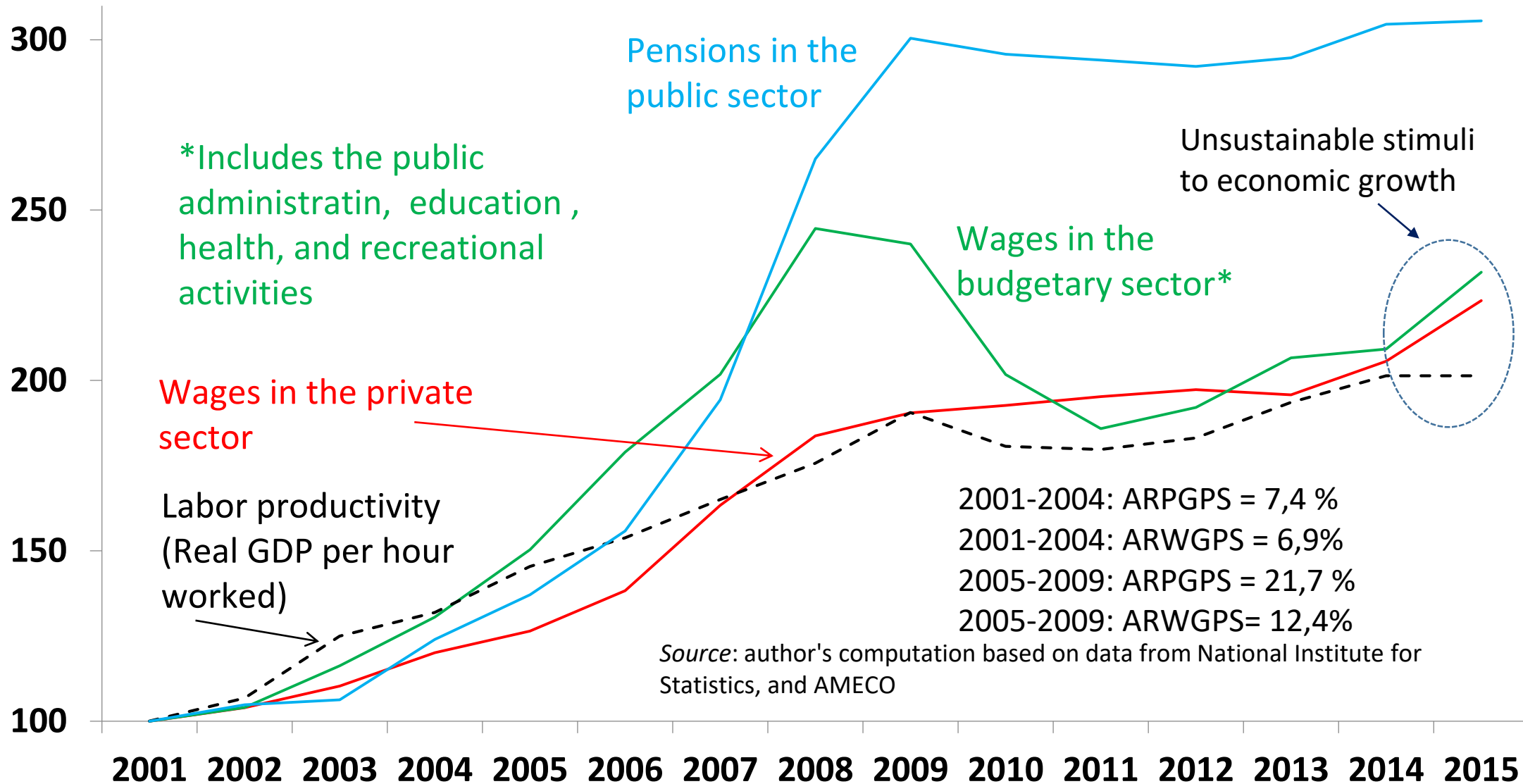
- When the economy is in its normal-expansionist phase of the cycle, it is monetary policy (MP) that has the central role in stabilizing the economy
- MP and fiscal policy (FP) can cooperate in a normal-recessionary phase
- **FP has the central role in an abnormal-recessionary phase; QE might be to the extent that fiscal policy is not available anymore;**
- An abnormal-expansionary phase would not exist if FP were used in the abnormal-recessionary phase. It appears if QE is implemented

Lesson No. 4 (I): Absent unsustainable stimuli, economic growth in Romania remains low. Structural policies to stimulate productivity is the only way ahead

Economic growth showed the following features:

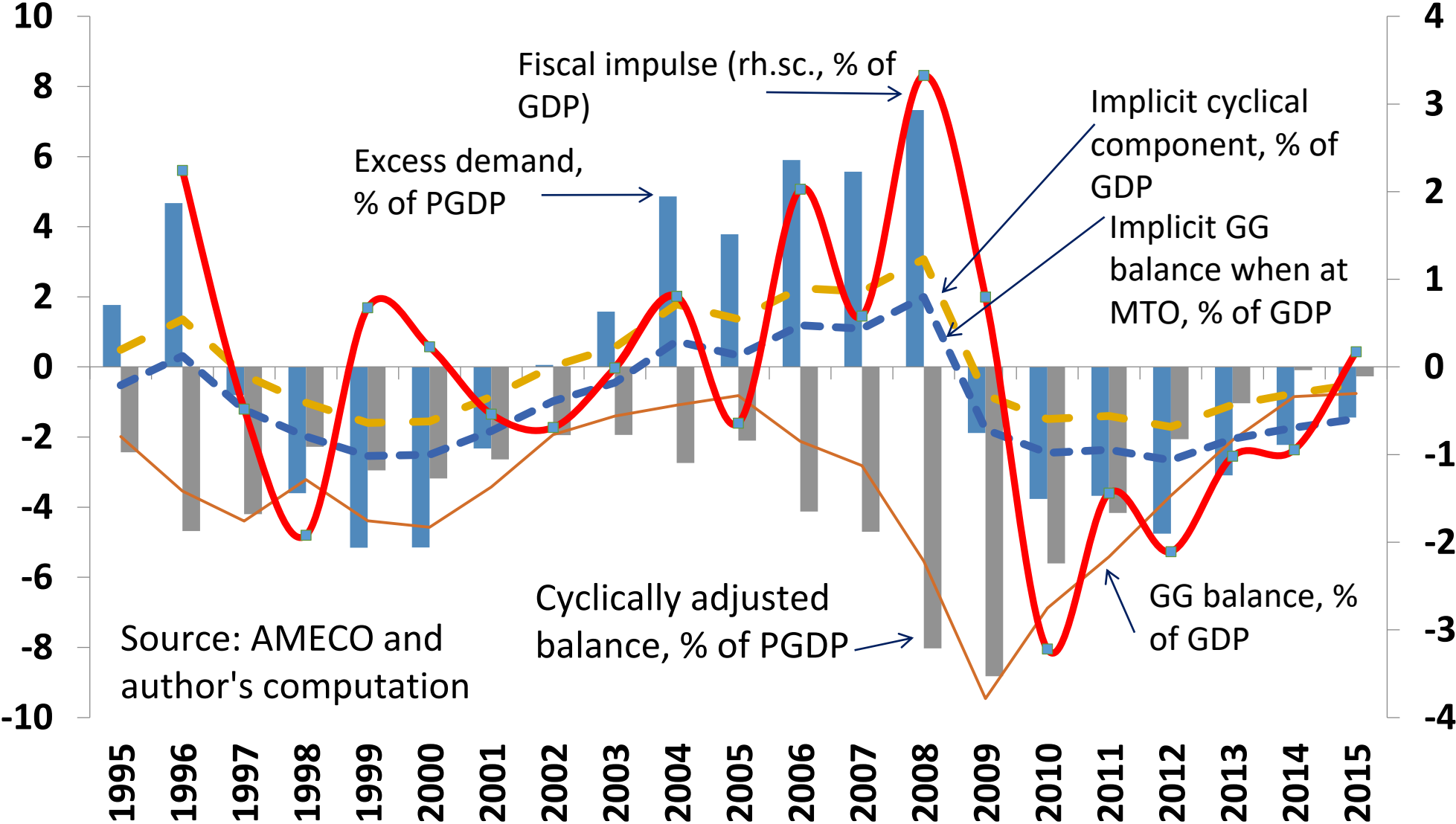
- Financial repression in the period 1990-1996
- Large capital inflows in the period 2000-2008
- Large fiscal stimuli since 2015 onwards

Lesson No. 4 (II): Cumulated percentage growth of real wages, labor productivity, and real public pensions (2001=100)

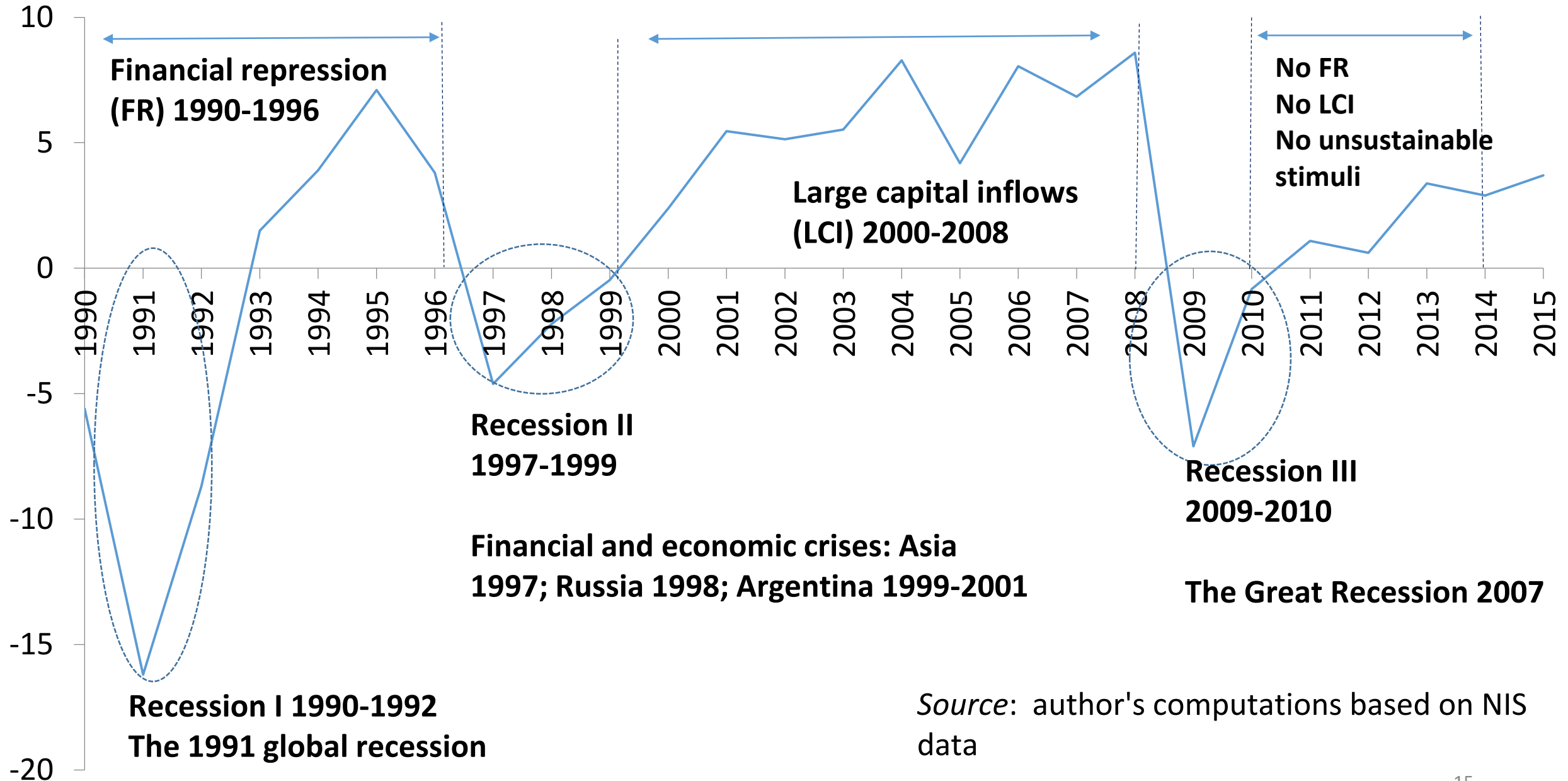


Source: author's computation based on data from National Institute for Statistics, and AMECO

Lesson No. 4 (III): Procyclical fiscal policy before and after the 2008 crisis



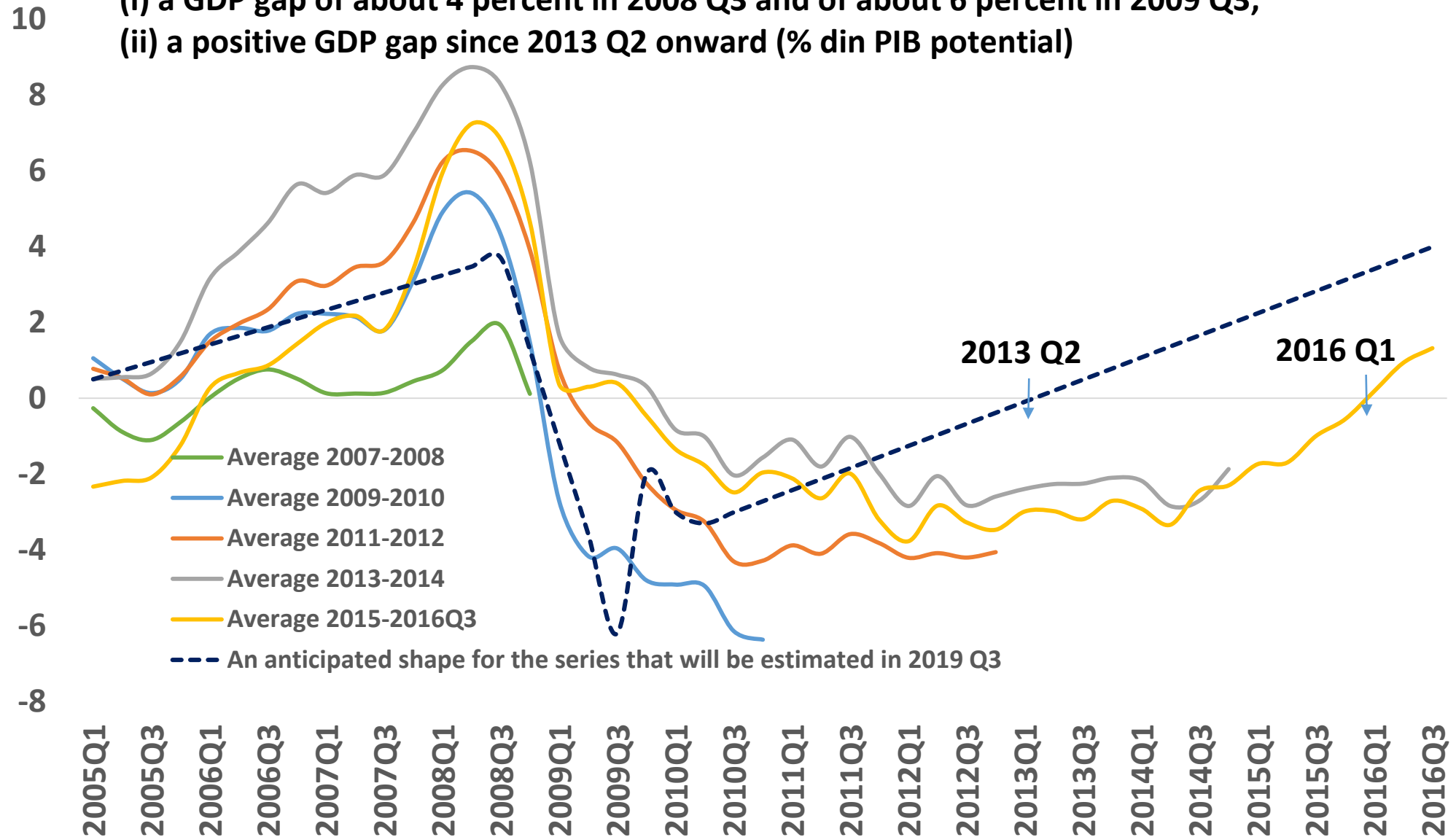
Lesson No. 4 (IV): Romania: Annual GDP growth rates (%)



Source: author's computations based on NIS data

Lesson No.5 (I): In real time, we systematically overestimate potential output and the natural interest rate. Hence, we systematically underestimate GDP gaps during boom periods and systematically overestimate GDP gaps during recession periods

Lesson No. 5 (II) : Averages of GDP gap series estimated during 2009-2016 Q3 and a stylized shape of GDP gaps' estimate in 2019 Q3 (dotted line), whose parameters are:
(i) a GDP gap of about 4 percent in 2008 Q3 and of about 6 percent in 2009 Q3;
(ii) a positive GDP gap since 2013 Q2 onward (% din PIB potential)



Lesson No. 5 (III): There are policy consequences of systematic overestimation of potential GDP:

- Monetary policy might be tighter than intended during boom periods
- Monetary policy might be softer than intended during recession periods
- The structural deficit is artificially underestimated or overestimated
- All these have an impact on employment

Lesson No. 6 (I): Despite progress in economic growth and economic freedom, the Romanian economy is suffering from unclear property rights and low property freedom

Lesson No. 6 (II) Romania's indexes of economic freedom for 2015 compare well to those of Germany, except for property rights, freedom from corruption, and financial freedom

Indicator **Romania** (65.6; ranks 61) **Germany** (74.4; ranks 17)

• Property Rights (RoL)	35.0 -	90.0 ~
• Freedom From Corruption (RoL)	43.0 +	79.0 +
• Business Freedom (RE)	66.1 -	90.0 +
• Labor Freedom (RE)	65.1 +	50.6 -
• Monetary Freedom (RE)	81.1 +	83.3 +
• Government Spending (LG)	65.6 +	41.3 +
• Fiscal Freedom (LG)	87.5 +	61.5 +
• Trade Freedom (OM)	88.0 ~	88.0 ~
• Investment Freedom (OM)	75.0 -	90.0 ~
• Financial Freedom (OM)	50.0 ~	70.0 ~

Source: Heritage Foundation

RoL=rule of law; **RE**=regulatory efficiency; **LG**=low government; **OM**=open markets; - indicates a decrease as compared to the previous year; + indicates an increase as compared to the previous year; ~ = stable

Lesson No. 6 (III): The underlying causes of unclear property rights and low property freedom:

- **Implicit political consensus** (Croitoru, 2015a; Croitoru, 2015b)
- **Or, in other words, the *de facto* insufficient separation of powers** (Croitoru, 2016a)

Lesson No. 6 (IV): Effects of unclear property rights and low property freedom:

- **Labor productivity cannot grow at relatively high levels** (Croitoru, 2015c)
- **Unsustainable gap/discrepancy between the two reduced freedoms and the other economic freedoms** (Croitoru, 2016b)
- **Emerging signs of a reduction in political freedom** (Croitoru 2016c; Croitoru 2014a)
- **Render the country's geostrategic position vulnerable** (Croitrou, 2014b)
- **Across the entire society, there is a fiercer "struggle between those who want a real (*de facto*) separation of powers... and those that do not"** (Croitoru, 2016a)
- **"Some politicians' struggle to halt the drift towards the *de facto* separation of powers tends to be the driving force behind political alliances..."** (Croitoru, 2016a)
- **Some politicians have conveyed explicit or implicit signals on reducing NBR independence** (Croitoru, 2016d, 2016e)
- **Truth as a social value tends to disappear through mechanisms related to the insufficiently free justice and to the low quality of the education process. This leads to structural changes across the population, which turns more lenient when it comes to any form of populism** (Croitoru, 2016f)

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