

## **The Romanian Economy from Transition to Crisis. Retrospects and Prospects**

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*In the complex picture of the current global crisis Romania represents an interesting case study, given the fact that the difficulties of transition to the market economy and resulted imbalances have had a strong influence upon the reactions to crisis. This paper aims to demonstrate that, in Romania's case, the global economic and financial crisis only hastened the inevitable domestic crisis and raised its costs by adding to the pre-existing problems. It also discusses possible policy responses to crisis based on internal facts and international constraints.*

**JEL Codes:** O11, G01

### **1. Introduction**

The second largest consumer market in Central and Eastern Europe, Romania is a country of great economic potential: richly endowed with fertile agricultural lands, with an important engineering tradition, various energy sources (coal, oil, natural gas, hydro and nuclear), a well-trained work force and quite low labour costs, opportunities for expanded development in tourism and a prime strategic location on the Black Sea and Danube.

In 1990 Romania began the transition from a socialist economy with a largely obsolete industrial base but with the advantages of a lack of external debts and of an enthusiastic wave for change following the collapse of the communism. Yet these advantages were not sufficiently exploited in order to enhance progress, and the efforts towards a market-driven economy started with a drastic fall in GDP in the early 1990s. Romania faced the difficult task of restructuring an outdated industrial base and an inefficient agricultural sector inherited from the Communist regime. The pace of economic reform, including privatization of industry, the return of collectivized farmland to its original owners, and the removal of government subsidies for consumer goods, has been slower than in many other formerly Communist countries of Central and Eastern Europe partly because of its lower starting position. Much of the 1990s in Romania were

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## **Constantin, Goschin & Danciu**

marked by great economic hardship, including high unemployment, skyrocketing inflation, and shortages of consumer goods.

The economic recovery started in 2000, which was also the year when the accession negotiations with the EU were opened. Even if they went slower compared to the other accession countries, Romania entering the EU almost three years later, on January 1<sup>st</sup> 2007, the economic growth followed a constant, up-growing trend. It resulted in a period of economic prosperity with mid and long term optimistic expectations, despite serious warnings on some unsustainable growth co-ordinates. Thus, these expectations were sharply broken in the last quarter of 2008, firstly as a reaction to the external shocks of the global financial and economic crisis. While some former transition countries found the internal engines to cope with crisis challenges and have already passed the critical point in terms of recovery, Romania is still in the crisis turmoil and a modest, if any, economic recovery is expected only in the second half of 2011, given deep internal vulnerabilities that amplify the impact of international shocks.

Based on the above overall considerations this paper proposes Romania as a relevant case study for the manifestations of the current global crisis. It aims to examine how the hardships of transition and the weaknesses and imbalances in economic, social and institutional terms influenced the reactions to the global crisis, demonstrating that, in this case, the global crisis only hastened the inevitable domestic crisis and raised its costs by adding to the pre-existing problems. Reflections on the policy responses to crisis challenges are also provided, taking into consideration both the internal and international context.

The methodology consists in an empiric, exploratory inquiry into the main facts and figures provided by the national and EU statistics, combined with the interpretation of a series of relevant viewpoints expressed by experts and institutions for whom Romania's situation represents a specific concern study. The paper employs data provided by Eurostat and the Romanian National Institute of Statistics, covering the 1990-2009 period. This period has been considered appropriate for an objective analysis of the transition to the market economy (following the demise of the communist regime in December 1989), and for addressing pre-crisis situation and the subsequent evolutions, as well as for revealing possible future trends and solutions for recovery.

The paper is organized as follows. Section 2 focuses on the institutional, economic and social factors of the process of transition to the market economy in Romania, pointing out the drawbacks and negative consequences of the gradual transformation process on subsequent evolutions. Section 3 addresses the main factors responsible for the current crisis in Romania, analysing both the external influences and internal elements conducive to the massive recession. Section 4 explores the prospects for future development, followed by a discussion on the possible solutions for recovery in Section 5.

## Constantin, Goschin & Danciu

The paper contributes to the manifold debates on the economic and financial crisis proposing as a case study a country with serious difficulties in facing the resulted challenges. It argues that even if before crisis Romania used to display high growth rates and a promising economic and social prosperity, supported to a large degree by the accession to the European Union, the still unsolved issues from the transition period kept smouldering and had a shaking break out when the crisis started. Thus, it offers useful lessons for the policy-making related to future development strategies, which should carefully consider not only the positive signals transmitted by recent positive evolutions but also “forgotten” imbalances coming from the past.

### 2. Main Institutional, Economic and Social Factors of the Process of Transition to the Market Economy in Romania

In December 1989 the Romanian revolution determined the fall of communism, which offered the opportunity to perform the transition to a democratic society and market economy. The chances of success were represented by two fundamental facts. One of these facts refers to the lack of external debts, which was the result of Ceausescu's obsession to pay them as an expression of Romania's independence in foreign relations. The other one was the huge sympathy and support coming from all over the world, making the Romanian people open to a maximum transforming effort (Pohoata, 2007).

Nevertheless, the transition was very stressful and painful, Romania ranking at present the last but one among the EU-new member states. A plausible explanation offered by many analysts is **the gradual transformation process** that took place instead of applying an effective shock therapy<sup>1</sup>. In fact, Romania has been considered an intermediate reformer, ‘situated below the leaders of transition (Hungary, Poland, Slovenia, the Czech Republic and the Baltics) but above the laggards of the Former Soviet Union’ (Rosu, 2002, p.2).

The factors that shaped the Romanian transition pattern are usually addressed in connection with the components of the process of change from the centrally-planned economy to the free market, the private property rights being the basic element. These components mainly address **liberalization, macroeconomic stabilization and related tight budget discipline, restructuring and privatization, legal and institutional reforms**.

In terms of liberalization, the repressed inflation between 1987-1990, accompanied by the black market premium and trade dependence in 1990 acted as unfavorable initial conditions. They were “supported” by the lack of favorable conditions, referring to previous market reforms, existence of civil society, proximity to the West, previous democratic traditions, etc. (Rosu, 2002). As a result, the successor of the communist party and its leader, Ion Iliescu stayed in power together until 1996, making equally slow and difficult processes such as price liberalization, lowering trade barriers for reconnection to the price structure of the world's market economies, stabilization, privatization.

## Constantin, Goschin & Danciu

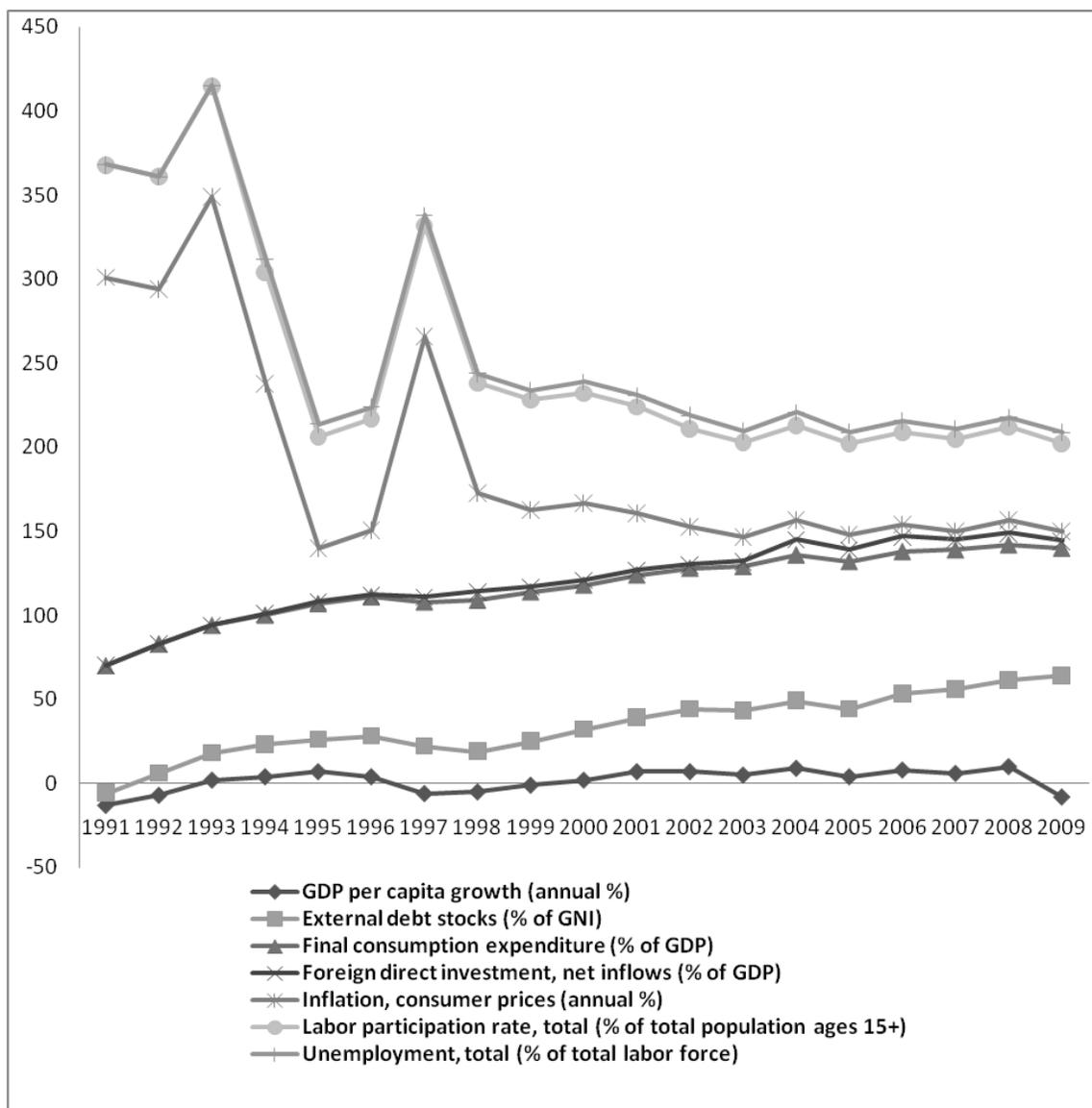
As far as the budget deficit is concerned, the true fiscal balance was hidden to a large extent so as to reduce the official budget deficit: the quasi-fiscal operations specific to the so-called “virtual economy”, such as subsidised credits, tax arrears, inter-enterprise arrears, barter, etc. were applied in the attempt to rescue loss-making state-owned enterprises and even privileged private firms.

The mass privatization was delayed, with negative consequences on other components of reform. It started slowly only in October 1995, based on the MEBO (manager-employee buy-out) scheme, that is a privatization by insiders. It followed a centralized approach, which gave the government a considerable power for deciding the firms included in the mass privatization. By the end of 1996 approximately 3000 out of 5000 state-owned enterprises were sold off. Though, the process was poorly organized. The large enterprises were subject to direct sales later on.

The concern with protecting the enterprises that had to face the market forces, especially in the first part of transition, resulted in a slow restructuring pace and the progress in privatization did not produce the expected benefits. Compared to the situation in advanced reformer countries, where the economic performance improved in the privatized enterprises, in Romania the progress was quite disappointing since the ownership was transferred to former employees of managers without changes in economic incentives, management practices, dependence on budget support, etc. (Hughes and Lovei, 1999).

The pace of liberalization and privatization was poorly synchronized with the development of the institutions needed for a well-functioning market economy<sup>ii</sup>. Sometimes inadequate institutional arrangements induced distortions that were connected to interests were able to exploit, often at significant costs – not only economic, but also political, social and environmental ones. The resulted high levels of poverty and inequality have provoked disappointment with market reforms and further weakened the authority of government to establish effective institutions (Hughes and Lovei, 1999).

All this political, economic and social turmoil in the 1990s made a real advance of reform very difficult, Romania being severely criticised by the EU and international financial institutions for the drawbacks in restructuring and privatization, the incapacity to eliminate losses within the economy, the lack of real changes in public administration.



**Figure 1. The evolution of selected macroeconomic indicators for Romania, 1991-2009.**

Source: authors'

To summarise, three sub-periods can be identified within this decade (Figure 1), namely: 1990-1992 (the beginning of transition), when the GDP recorded a serious drop; 1993-1996, when a macrostabilisation programme was applied, with positive consequences upon economic growth, unemployment and inflation rate; 1997-2000, when the economic decline (until 1999) represented the first result of the massive restructuring and privatisation process - too much delayed, being followed by a slow recovery starting with 2000.

It is worth mentioning that **the year 2000** is not only the year when the Romanian economy took an **encouraging upward trend**: it is also the year when Romania started the negotiations for accession to the European Commission. Starting from this year the efforts to meet the Copenhagen accession criteria were clearly

## Constantin, Goschin & Danciu

stressed, the economic ones envisaging two key dimensions, namely the existence of a functioning market economy and the capacity to face the pressure of competition and market forces within the EU. However, these efforts were burdened by the delays and previous failures, so that the annual reports of the EC indicated unsatisfactory results<sup>iii</sup>. For example, in the 2003 EC report 'a decisive continuation' of the progress in building-up a functioning market economy was recommended. In the given circumstances the negotiations with regard to the 31 chapters of *acquis communautaire* were closed only in December 2004 and Romania's (and Bulgaria's) accession was postponed. Then, two more years of EC monitoring were necessary to become a EU country, with January 1, 2007.

Thus, after nearly 20 year-long transition, Romania has begun a period of consolidation (ESI, 2009). At the end of 2007 the Romanian statistics indicate a 6% GDP/capita rate and 10400 euro per capita at PPS in absolute terms (that is 41.6% of the EU average), one-digit inflation rate (6.57%), a 6.4% unemployment rate, and over 50 billion euro FDI stock. Nevertheless, important challenges still exist, such as the battle against corruption, the implementation of various of the EU laws, the strengthening of the new institutions, the increasing of the absorption capacity of the EU Funds, etc. Also, the economic crisis has started to manifest, producing serious concerns.

### 3. Causes of the Current Economic Crisis and Entailed Challenges

The international economic crisis reached the Romanian economy in the last quarter of 2008, after years of record economic growth. It firstly occurred as a reaction to external influences, as the deep recession in West Europe entailed a severe decline in Romanian exports. As the global crisis further limited the access to external financing, FDI also declined, difficulties concerning private foreign debt appeared, and a whole range of negative developments were brought about in the Romanian economy. Therefore, **the initial cause of the recession resides in the negative impact of the crisis in Euro-area, but Romania's own economic weaknesses and imbalances added to this and triggered a series of negative consequences.** Since the fourth quarter of 2008 a severe decline in economic activity took place: trade data and industrial output – and, after a lag, retail sales – have all contracted sharply. But outcomes could have been even worse. As a result of a combination of massive financial support from the IMF, the EU and others, and timely policy interventions, Romania avoided so far a major crisis and macroeconomic meltdown.

**The root cause of the current crisis is believed to be the unsustainable economic growth before 2008, based mainly on the consumption of imported goods, financed by foreign money.** Moreover, experts believe that the global crisis only hastened the inevitable domestic crisis and raised its costs by adding to the pre-existing problems. As an Romanian economic analyst, Ilie Serbanescu, points out:

## Constantin, Goschin & Danciu

*“The economic growth we recorded between 2004 and 2008 only boosted sectors of lesser importance to the economy, such as real-estate, automotive sales and home appliance sales. The economy could not be fed, and once foreign financing stopped for these sectors, they began to collapse. Downturns of 60 to 70 percent could not be blamed on the crisis, as they were the result of anomalies that existed before the crisis began.”* (RRI, 2010).

Other authors believe that Romania’s current crisis is not a temporary one, but rather a structural crisis, assigned to domestic causes, a real crisis of excessive consumption financed by short term private foreign debt, that would have inevitably come, irrespective of the international crisis (Voinea, 2009).

Pre-recession high consumption was stimulated by two main factors: the flat tax of 16% introduced in 2005 increased the disposable income and the high remittances of the Romanians working abroad, which raised to 4% of the economy in 2008. All this had fuelled an excessive demand for imports, putting trading balances at a deficit.

At first it was a **typical current account crisis**: the current account deficit was as high as 13.5% of GDP in 2007 and 12.5% of GDP in 2008. Following the breakout of the crisis in Romania, the economy has been rebalanced with current account deficit melting down to 4.4% of GDP, largely covered by FDI (97% coverage). The adjustment was not the result of specific policies addressing it, but rather by default: the falling demand in Western Europe led to a sharp drop in Romanian exports, but due to the diminished internal demand imports declined even steeper, narrowing the trade deficit (-65% year on year).

Current transfers, less affected by the crisis (-31% in 2009), and a sharp reduction in outflows on the incomes balance (-42%) also helped reducing the deficit. As external demand is expected to rise, boosting the exports, while the internal demand (and consequently the imports) will remain low, the narrowing of the current account deficit is likely to continue in 2010, but at a slower pace compared to the 2009 adjustment. Foreign direct investments could be similar to their 2010 levels, covering a large part of the current account deficit.

The current account crisis is now converting into a **public finance crisis**, as the structure of the foreign debt is changing from private to public. Total external debt (Figure 1) was up from 54% of GDP in 2008 to 70% in 2010, and an estimated exploding 82% in 2011, while total public debt increased from 20% of GDP in 2008 to 30% in 2009 and approximately 40% in 2010. The increase in debt was favored by the rapid liberalization of the capital account and by the real estate boom as well: non-governmental loans rose from 10% of GDP in 2001 to 39% of GDP in 2007, while households loans changed by +200% in 2003, +70% in 2006 and 2007, reaching in 2008 70% of households disposable income and exceeding deposits by 4 bn. euro (Voinea, 2009). As the crisis is forcing wages to adjust downwards and is generating more unemployment, while loan

## Constantin, Goschin & Danciu

payments are increasing, the mismatch between income and expenditures at households level amplifies.

An important cause of the macroeconomic imbalances was **Romania's expansionary, procyclical budgetary policy** based on unrealistic estimates of revenues and unsustainable public spending which led in 2008 to a current account deficit of twice the target, unacceptable considering the 7.9% economic growth achieved. Despite robust economic growth for eight consecutive years (2000-2008), the budget deficit continuously increased, reaching 5.2 % of GDP in 2008 and 7.4 % in 2009. Only 2010 marked a decrease to 6.5%.

The main causes of this large deficit were (Glodeanu, 2009): excessive spending (30% increase in 2008 only) which was not channeled to productive activities; a reduced absorption of European funds; multiple budget corrections, increasing unsustainable expenditures; an asymmetric implementation of the budget – general consolidated budget expenditures were increasing, while revenues were decreasing; inefficient tax administration - despite economic growth in recent years, the share of budgetary revenues in GDP remained stagnant around 32%; increase in shadow economy (reaching 21% of GDP in 2008 from 14.5% of GDP in 2004); extension of tax evasion (e.g. VAT evasion reached 24 billion in 2008, up from 7.4 billion in 2004); inadequate public wage and employment policy - public wage bill doubling over 2005-2008. The budget deficit worsened in 2009, as the tax revenues diminished due to the crisis. Even if for 2010 a decrease to 5.9% was targeted, only 6.5% could be realized. Hence, the need for adopting structural reforms for reshaping the public sector: unitary wage law, revised pension legislation and reorganization of state agencies. Public sector wages for 1.4 million public servants have been already cut by 25% starting from July 2010, while pensions have been frozen. Consequently, social resistance might increase in the upcoming period.

Faced with a considerable external debt, Romania had no other choice than to borrow large amounts of money. In April 2009 Romania concluded a **stand-by agreement with IMF for 20 bn. euro serving mainly as a macroeconomic stabiliser, instead of a stimulus package to stop the economic decline**. This is a syndicated loan, led by IMF (which gives 12.95 bn. euro) alongside the European Commission (5 bn. euro), the World Bank (1 bn) and other international financial supporters. Difficulties magnified during the late 2009 elections that slowed down reforms sought by the IMF and prompted delays in the disbursements, but the agreement resumed in early 2010 after the political situation stabilised. By June 2010 Romania had already received about 9.3 bn euro from IMF, 2.5 bn euro from UE and 300 mn euro from the World Bank, while another 900 mn euro (the fifth tranche) is about to be disbursed by the IMF (early July). Due to this loans, Romania avoided a potential private debt crisis, as the National Bank of Romania was able to reduce the minimum mandatory reserves of the commercial banks. IMF has exceptionally agreed that part of its loan can finance the budget deficit – which shows the gravity of the problem. At present a

## Constantin, Goschin & Danciu

new loan is negotiated by the Romanian Government with the IMF, but this one is expected to be used exclusively for economic development re-launching.

The IMF and the European Commission demanded that the budget deficit be lowered to a 3% target, which is delayed until 2012. The Romanian government must therefore adopt austerity measures, including cutting its budget deficit, which leaves **little resources for stimulating the consumption as needed in order to revive the economy** and counteract the crisis.

Other factors aggravating the current crisis: **postponed structural reforms** (labour market, agriculture, competition, energy), **low absorption of EU funds**, **inefficiency** of an economy with underfinanced education and research systems.

The unsustainability of the consumption based economic growth and the consequent macroeconomic imbalances can explain the **severity of the negative reaction of the Romanian economy to the crisis**. The drop in both external and domestic demand first led to a slowdown in real GDP growth - from an average of 8.9% on an annualized quarter-on-quarter basis during the first three quarters of 2008 to an almost 13% contraction in the fourth quarter, one of the sharpest turnarounds among emerging markets, while the decline for the entire year 2009 stood at -7.1%. The worst affected economic activities were, in a first stage, manufacturing and financial activities, real estate, lending and services for enterprises. Other activities decreased as well, but managed to maintain positive growth rates. Manufacturing turned from a 4.9% increase in the first three quarters to - 7.7% in the fourth one, with the automotive industry and the iron and steel industry being hit hardest (Ernst and Young, 2009). Financial activities moved from +5.3% to - 1.5% in the same period.

The negative impact of the crisis in Euro-area has continued in 2009, the Romanian real GDP contracting by 7.1% in 2009, largely driven by the 9.2% drop in private consumption and 25.3% loss in investment. In 2010 the GDP recorded a much lower decrease, of only 1.2% compared to 2009.

Decreasing demand on the main Romanian export markets, combined with the FDI drop, triggered an overall decline in domestic manufacturing due to the reduction or even temporary stop of the activity in many of the production units. On the positive side, inventories and exports entered positive territory in the third and fourth quarter 2009, respectively, and this way softening the contraction in the second half of the year. More encouraging is the rebound of the industrial production, as industrial value added registered a positive 4% year on year growth in the fourth quarter that softened the previous quarters fall, resulting a - 4.3% overall change in 2009. The upward trend continued in 2010: at the end of this year a 5.5% increase compared to the end of 2009 was recorded.

Construction activity continued to deteriorate in Romania in 2009 and further in 2010, stronger than in the Euro Area. The high dependence on foreign contractors in developing and implementing new major projects made this sector

## Constantin, Goschin & Danciu

highly vulnerable to the crisis when liquidities became increasingly scarce. Moreover, sluggish mortgage lending added to the negative evolution, while private individuals became increasingly cautious as the prospects for lower income and rising unemployment loomed large. The "Prima Casă" ("First House") government programme gave a boost to mortgage lending, but that was not enough to prevent the fall in the residential segment, since it focused mainly on transactions, rather than new buildings. The more rapid decline in the price of old flats was supportive and fostered transactions. The government's focus on infrastructure, especially in a year when the crisis took a heavy toll on budget revenues, paid off somewhat and this segment recovered the most in the last quarter of 2009.

**A severe decline in both domestic net investments and foreign direct investments** amplified the gravity of the crisis. Net inflows of FDI dropped from 7 bn euro in 2007 and 9.3 bn in 2008 to only 4.6 bn euro in 2009 and 2.6 bn euro in 2010. Many important foreign companies (e.g. Unilever, Kraft Foods and Coca Cola) relocated their Romanian subsidiaries in cheaper workforce countries as Moldavia and Bulgaria, while only a few new companies decided to invest in Romania (for instance, PepsiAmericas, one of the world's most important fizzy drinks production companies).

**Labour market problems.** Until the financial crisis broke in, the Romanian labour market had performed relatively well. Annual unemployment rate had declined to 4.1% in 2007 and 4.4% in 2008 (Figure 1), supported by high rates of GDP growth over 2000-2008 and a decrease in the labour force owing to substantial out-migration for work (an estimated over two million Romanians are working abroad). The main problems in the labour market prior to the crisis were the low employment rate (59% in 2008, down from 61% in 2000, this rate being almost recovered (approximately 60.1%) in 2010), the persistence of long term unemployment, the young people unemployment, large employment in the underground economy, emigration and self-employment in subsistence agriculture.

The crisis aggravated all problems of the labour market: more unemployment, more underground economy, higher fiscal burden, less remittances. The scaling down of production capacities amid the economic crisis led to severe labour market adjustments. It translated into mass layoffs and a significant increase of unemployment reaching a rate of 7.8 % in 2009. The strongest staff cuts were recorded in industry and construction. A decrease of the unemployment rate to 6.87% was recorded at the end of 2010. On the other hand, labour shortages persist in some sectors, mainly due to large migratory outflows and skill obsolescence ( European Commission, 2009). The growing unemployment compared to the pre-crisis level has had an impact on the rapid growth of the shadow economy and on the deepening of social inequalities. One of the consequences of unemployment could be re-migration, mainly from big cities to villages or small towns – places of the migrants' origin and also the return migration from abroad.

**IMF agreed measures may deepen the recession.** The IMF loan came with two sets of conditions: quantitative performance criteria and structural benchmarks. Public wage bill reform is the most difficult objective to be attained: from 9% of GDP in 2009 (increasing from 4.8% of GDP in 2004) it has to be reduced to 7% of GDP by 2015. In addition to this, public sector wages are cut by 25% starting from July 2010, while pensions are frozen. The measures agreed with IMF target lower, easier to finance, deficits, but they represent mere reactions to the crisis, not solutions for it. 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. They may even deepen the recession, at least in the short-run. For instance, the increase in VAT from 19% to 24% by the 1<sup>st</sup> of July 2010, is likely to boost tax evasion and inflation (up to 8 – 8,5%), while the real economy may shrink by 2%, as an effect of this measure. The experience of other countries reveals that fiscal reforms based on cuts in expenditures are more likely to produce sustainable effects than those based on tax increases, provided that cuts in capital expenditures are avoided as much as possible. Tax increases are likely to produce short-lived results and may send a negative signal to the international business environment.

The economic decline was further deepened by the **severe drop in foreign investments**, decreasing by 48,4% in 2009, compared to the record levels of 2007 and 2008. According National Bank's statistics, in 2009 the investments were backing the current account deficit at a rate of 96,8%. A negative effect of FDIs in Romania comes from their strong unbalanced distribution among the regions, with the Bucharest-Ifov region concentrating 63%. As private investments are continuously shrinking and no fiscal stimulus were provided, positive influences for the Romanian economy recovery may only come from the revival of foreign demand and the implementation of the structural reforms.

On the positive side, some parts of the economy held their grounds. Not only did the banking sector survive without bailouts, but also the foreign-owned banks reported even higher profits in 2009 than in 2008. Romania also remains attractive to foreign investors, largely because the crisis reduced the wage expectations of Romania's skilled, polyglot and adaptable labour force. A recent A.T. Kearney global ranking of countries in terms of their attractiveness to foreign investment placed Romania on the 16th spot. Boosted by cash-for-clunkers programs in Germany and France, the exports of the Romanian car manufacturer Dacia and of its numerous suppliers continued to grow.

#### **4. Prospects Regarding Future Development**

In experts view the economic growth of the world's leading economies, even if not so strong, is proof of the fact that these economies have passed their critical point in terms of recovery. This is not yet valid for Romania: it was assumed that there would be only a modest economic recovery in 2010, largely depending on export growth, but this target has been postponed for 2011.

## Constantin, Goschin & Danciu

The pre-crisis GDP level will be reached no sooner than 2012, as economic growth will stay below potential in the next few years. It seems that Romania will exit recession with a time lag of at least two or three quarters compared to the Euro zone. There is a risk of potential GDP fall to a long-term lower trajectory, due to several factors (EIU, 2010):

- prolonged unemployment in the workforce tend to lead to a permanent loss of skills;
- the strong decline in Romania's foreign direct investments (FDIs), and in the remittances of Romanian workers employed outside the borders as well, have reduced the available financing resources, thus lowering the chances for recovery; furthermore, the stock of equipment and infrastructure will decrease and become obsolete due to lower investment, with long negative effects on the economy;
- innovation may be hampered as spending on research and development is one of the first outlays that businesses cut back on during a recession.

The employment adjustment to the decline in economic activity is as yet far from complete. There is a concern that unemployment may not easily revert to pre-crisis levels once the recovery sets in. A major challenge stems from the risk that, if not adequately addressed by policy measures, skills erosion of the unemployed may contribute to unemployment persistency with long-lasting negative effects on the economy. Where the fall in GDP is large, but the rise in the unemployment rate is still small, the fall in hours worked is substantial. Some firms react to short-term decrease in turnover by reducing their activity, while allowing employees to keep their contractual relationship. This suggests that there might well be a trade-off between less unemployment today and more redundancies at a later stage.

Government consumption is to be strongly rein in, still in 2011, given the ambitious fiscal consolidation programme that must be followed by the government under the stand-by arrangement with the IMF. The need to cut budget deficit is putting pressure on both private and government consumption and is deterring the economic recovery. Fiscal tightening has reduced domestic demand by 1.4% of GDP in 2010, as a result of cuts in government current expenditure on wages, transfers and goods and services. Private consumption has remained depressed in 2010. Remittance flows fell by around 35% in 2009, equivalent to 2% of GDP, due to job losses, lower earnings, slower migration, and even return migration, especially from Italy and Spain and only a modest improvement has been noticed in 2010. There has been little prospect of a stronger recovery in foreign direct investment and other external inflows until 2011 (EIU, 2010).

All this implies that the prospects for growth in domestic consumption and investment remain poor, therefore growth in demand will depend mainly on external factors – the improvement in the global economy and the EU economy

## Constantin, Goschin & Danciu

in particular. A double-dip recession in Europe would have severe consequences for economic recovery in Romania (EIU, 2010).

Looking to the long term, the crisis will leave a longer-lasting negative impact on growth prospects, in the context of existing growth negative factors, such as continuing institutional problems, deteriorating demographic outlooks and weak innovation performance. The current downturn could leave in its wake a legacy of reduced financing opportunities and depleted human capital. The need for fiscal adjustment and the permanent reduction in income levels caused by the recession in 2009 will entail cuts in budgetary spending (one-half of which is on various forms of social expenditure in the region). This will affect the health and education levels of the workforce.

There is also the risk of serious social unrest in the next years, as fiscal austerity measures heavily impact on jobs and living standards. The political fallout from the economic crisis has so far been limited, but history shows that political instability resulting from big economic distress usually occurs with a considerable time lag. Romania, like many countries in the region, is vulnerable to social unrest and the risk of political instability thus remains high.

Although the crisis has resulted in a few positive developments for longer-term prospects, these have been more than offset by the likely negative consequences. Among the positives is the sharp adjustment in external imbalances and the correction in previously overvalued exchange rates. Some reduction in financial globalization may be a good thing in view of the lack of a positive relationship between economic growth and portfolio and debt inflows, as well as pressure for real currency appreciation that these flows have tended to generate.

### 5. Possible solutions for Recovery

Many analysts consider that the appropriate solutions for economic recovery in Romania are opposite to the current governmental policy of wage cuts and tax increases, in the direction of **consumption and credit stimulus**. Cuts in the public sector should aim primarily at overpriced purchase of goods and services and investments and not wages cuts and firings that reduce domestic demand. On the other hand, consumption should be stimulated.

As already proved in the pre-crisis evolution of the Romanian economy, **FDI** can play a major role in promoting development, by creating new production capacity, by contributing to the creation of new jobs, stimulating domestic consumption and increasing the competition as well.

An important source of budget revenues might come from **reducing fiscal evasion** (an estimated 10% of GDP is lost only from VAT and excise duties tax evasion), and a fiscal reform based on solidarity and automatic stabilizers should

## Constantin, Goschin & Danciu

be introduced (Voinea, 2009). Additional resources may consist of property taxes and royalties which are now very low; asset prices are also undervalued.

The budgetary policy should be based on **multiannual budget programming**, which should include higher public investments, allocation of resources to projects with multiplier effect in the economy, ensuring debt sustainability and the use of external public debt as a source of economic growth; efficient absorption of structural funds as an important source for economic growth financing.

Many hopes are heading to **the potential contribution of the EU financial assistance via Structural Funds** for coping with crisis effects. For 2007-2013 Romania has been allocated 19.7 billion Euro Structural Funds, of which 98% for seven Operational Programmes under the “Convergence” objective (Government of Romania, 2007). Nevertheless, in the middle of the current EU financial exercise serious questions and even doubts are raised with regard to Romania’s capacity to use the allocated post-accession funds. In the latest Strategic Report of the EC (March, 2010) on the implementation of the 2007-2013 cohesion policy programmes Romania was subject of “name and shame” in the country-by-country comparisons, with its second-to-bottom absorption rate (14%, compared to 27% EU average). Important problems persist with regard to the administrative absorption capacity: the managing structures and rules are still too complicated, so that the project pipeline is weak and not enough applications come to the table. Also, the crisis has brought about additional difficulties with regard to ensuring the national contribution in the co-financing scheme: even if this contribution has to cover – as a general rule – just 15% (of which, 13% - state budget and 2% - local co-financing, for public institutions) of a project funding, in many cases there is an acute shortage of financial resources for public and private co-financing investment. Public/private joint ventures are seen as crucial for overcoming this situation.

On the EU side, the European Parliament has recently adopted new rules for a more rapid access to regional development funding in the case of those EU member states mostly affected by the economic crisis. Within the anti-crisis measure package will increase the advance payments level for projects able to contribute to new job creation in these countries. The new rules will be also more flexible with regard to the n+3 rule, allowing for a longer implementation period. At the same time, the so-called “major projects” will be getting eligible for financing from more EU programmes (Euractiv, 2010).

The current crisis has put into a new light the significance of **economic governance quality** as an essential ingredient for reducing the risk of crises and for dealing with their consequences. Economic governance institutions can affect full employment, capital accumulation, the regulatory regimes impact on performance in the gas, electricity and water industries.

## 6. Conclusions

In this paper a retrospective and forward-looking insight into the economic and financial crisis manifestations in Romania has been conducted. Specifically, it has aimed to explain how the tidal waves of the international shocks have amplified the consequences of a difficult, stressful and painful transition to the market economy and the unsustainable characteristics of the subsequent economic growth. Though, the authors admit that the findings have objective limitations determined by the shortage of statistical data on recent developments in this ongoing crisis.

As far as the solutions are concerned, in authors' view they should envisage consumption and credit stimulus rather than the wage cuts and tax increases, the reduction of fiscal evasion, a rational multiannual budget programming and a quality economic governance. The most important external impulse may come from the EU financial assistance via Structural Funds, provided that Romania rapidly solve the so-called "absorption problems" so as to be able to spend the allocated funds. In this respect there is still room for further research in order to point out those sectors vulnerable to crisis which could have the highest benefits from the EU funding and the ways to enlarge the project pipeline and speed up the implementation of the already approved projects.

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### Endnotes

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<sup>i</sup> As arguments in favour of the shock therapy are offered the negative correlation between inflation and growth during transition, the positive correlation between the cumulative liberalization index and inflation, the contribution of quasi-fiscal operations by public banks to large output declines (De Melo et al., 1996).

<sup>ii</sup> The creation of the appropriate institutions and specific legislation was a multi-track process, which occurred simultaneously with other transformations, so that mismatches between the new and the old could not be objectively avoided in some cases.

<sup>iii</sup> Based on the EC's annual reports in the first years of 2000s, the PricewaterhouseCoopers (PwC, 2002) developed an enlargement index seeking to measure the readiness of the accession countries to join the EU from a purely

economic perspective. The index included four groups of indicators covering macroeconomic stability, economic structure, infrastructure and economic integration with the EU. The results indicated that Bulgaria and Romania had made, on average, little progress to catch up the EU-15.

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