ARGUMENTS TO STRENGTHEN THE FISCAL STANCE IN ROMANIA IN TIMES OF ECONOMIC CRISIS

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Over the past six years Romania's economic growth has averaged 6.4 percent, accelerating the economic convergence with the EU. But this good performance has been shadowed by the accumulation of high imbalances since the economic boom has been driven by domestic demand. At the end of 2008 the current account deficit reached 13.5 percent of GDP.

High external borrowing has led to a rapid build-up of external private debt, rendering Romania vulnerable to external financing.

- Many banks have become dependent on foreign funds.
- And significant balance sheet currency-mismatches have been growing both in the household and the companies' sectors.
- Moreover, the private sector dissaving was accompanied by rising fiscal deficits. The 2008 budget deficit is estimated at 5 percent of GDP, almost double the target.

These imbalances warrant a rapid and appropriate treatment. It is not only the magnitude of the imbalances that requires a rapid action. It is also the international economic and financial crisis' spillovers that spread and makes Romania's external vulnerability even worse. Like many other countries, the international economic crisis is spreading to Romania on four channels:

- On the trade channel, exports growth is shrinking in response to recession in countries that import from Romania;
- On the financial channel, some private external financing lines has been reduced and some will not be renewed, which will result in lower foreign exchange denominated credit;

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- On the currency channel, less external financing resulted in higher volatility in the foreign exchange market and in the leu depreciation;
- And last, on the confidence channel, there were moments of panic and speculative attacks in the forex and money market, like those in October 2008, when there were increased capital outflows. At that time, the NBR intervened to restore confidence.

EXTERNAL CONSTRAINT

On the above mentioned channels, the financial crisis spreads to the real sector in many developed economies, which reduces investors' resources and investment appetite. This is already affecting many economies. It is my view that Romania has not seen yet the full impact of such a change in investors' behavior. I expect that external financing will be less available for Romania in the period ahead. With less external financing, the current account deficit will adjust downward and growth will slow. The challenge is for policies to secure an orderly adjustment of the external imbalance so that the economy remains stable and growth will decelerate from today's high rates towards more sustainable paces.

I expect that, in 2009, foreign financing will be lowered by decisions to:

- Reduce FDIs and increase profit repatriation;
- Diminish short and long-term loans, including those extended by mother-companies to their daughters, and repatriate income from interest rates;
- Renew short-term external private debt partly;
- And cut portfolio investment in Romania**.**

Hence, deficit financing of both the public and the private sector will become more difficult and costlier.

ADDRESSING ECONOMIC CRISIS IN ROMANIA

There are already lots of measures designed to address the current economic crisis all over the planet. For instance, in the US and the EU, measures were taken to improve liquidity, to guarantee some loans by governments, to recapitalize some private banks with public funds, to reduce interest rates in a coordinated manner, etc. One may think that this kind of measures is in

contradiction with traditional economic principles, but at least they are consistent with macroeconomic frameworks and imbalances specific to those countries. However, there is a great chance that other countries be tempted to imitate some measures without having in place those conditions that would make the imitation appropriate. Romania should avoid imitating some "rescue measures" developed by the EU since its macroeconomic problems differ significantly from those that are currently faced by Western economies. Let me underscore some differences:

- Economic growth in the EU-15 area is zero or negative, while in Romania growth is estimated at 8 percent in 2008 and 3-5 percent in 2009;
- Inflation in the EU-15 is around 2.3 percent, as compared to 7 percent in Romania;
- The EU-15 average budget deficit is 1.2 percent of GDP, as compared to 3.5 percent in Romania;
- Credit extended to the private sector increases by less than 10 percent a year, as compared to more than 35 percent a year in Romania;
- The current account deficit in the euro-zone is almost zero, as compared to 14 percent in Romania;
- The banking model is the "originate and hold" model, with virtually no exposure to toxic assets;
- Reserve requirements are still high, offering a buffer for liquidity management;
- Euro is a reserve currency whereas the leu is not.

Many private entities are lobbying today for the Romanian authorities to adopt a "rescue package" similar to that designed recently by the European Commission. It is my view that, given the above differences, this would be totally inappropriate.

WHAT SHOULD BE DONE

Private decisions to reduce external financing have to be anticipated starting in 2009 by an economic program aimed at reducing the current account deficit in an orderly manner. This would prevent an abrupt correction induced by international markets by sharp cuts in Romania's external financing.

The program should be front-loaded, with difficult measures being implemented from the beginning to secure its credibility. Macroeconomic policies have to be consistent with the general objective of reducing both domestic and external imbalances. The adjustment has to take place both in the public and in the private sectors.

Most of the adjustment (as a percent of GDP) has to come from the public sector since this is under direct control of the government. Specifically, in the public sector policy measures have to be designed to strengthen the fiscal stance by:

- Increasing the budgetary revenues as a percent of GDP;
- Reducing public expenditure as a percent of GDP, including the public wage bill;
- And, finally, by increasing the share of public investment as a percent of GDP, which would be reflected in job creation.

It is worth mentioning that the recently announced economic program by the Romanian government is very much focused on strengthening the fiscal stance along the above mentioned lines.

In turn, I anticipate that the private sector will reduce its external deficit in response to a lower credit growth that emerged as mother banks lowered their financing made available to their daughters, and in response to higher interest rates paid by banks to attract new deposits. But it is also necessary that the minimum wage remains at the negotiated current level if the private sector response is to be further strengthened.

As a matter of fact, the private sector adjusted its external deficit last year by 4.2 percentage points, whereas the general budget deficit went in a wrong direction. From a budget deficit of 2.3 percent in 2007, the 2008 budget deficit reached almost 5 percent of GDP.

A rapid and firm implementation of appropriate measures will convince foreign private investors to reduce their financing by less. The more rapid and comprehensive the adjustment initiated by the authorities, the lower the risk of a sharp reduction in Romania's external financing. Credible

adjustment measures to reduce the current account deficit will reduce the external vulnerability of the Romanian economy, thus increasing the program's credibility.

In what follows let me please present two scenarios to underscore that a greater benefit in terms of higher external financing and faster economic growth comes from measures that secure a larger reduction of the current account deficit. This is a view that is not largely shared by politicians and some analysts.

TWO SCENARIOS TO ADJUST THE CURRENT ACCOUNT DEFICT

In describing the two scenarios I start from the prevailing views among politicians and analysts on what should be done to help the economy avoid slowing its growth rate dramatically or going into recession next year. One view is that a larger budget deficit would help the economy to stay out of problems. But such a view can be easily rejected given the external financing constraint. A larger budget deficit would further deteriorate the current account deficit. Foreign investors would be reluctant to invest in a country whose fiscal policy adds to external imbalances. Romania's external debt reached almost EUR 70 billion, of which only EUR 10 billion are sovereign debt. While there are currency mismatches in the private sector, we should prevent the public sector from going in the same direction.

The other view is that the reduction in the current account deficit should be relatively small since a larger adjustment would result in relatively lower growth rates and a weaker leu. Specifically, it appears that many analysts share the view that a relatively small reduction in the current account deficit from the current level of 12.5 percent of GDP, would be appropriate for Romania given the circumstances. Thus, my first scenario explores this view. I call this scenario the "shy" adjustment scenario.

It assumes that in 2009 the private sector current account deficit is further reduced by 2 percentage points. The general budget deficit in this scenario is adjusted by only one percentage point to 4 percent of GDP in 2009. Under this scenario, the leu/euro average exchange rate would stay above 4 RON/EUR, and the growth rate would be below 2.5 percent. The current account deficit would be reduced from an estimated 12.5 percent in 2008 to 9.5 percent in 2009.

The main risk associated with this scenario is that it could not produce enough credibility for the economic program. If materialized, this would translate into a significant loss of external financing. Moreover, regaining credibility might warrant an import of credibility by making arrangements with international financial institutions.

As an alternative to the first scenario, which is not sustainable, the second scenario assumes that an adjustment of 5 percentage points in the current account deficit produces the needed credibility of the program. I call this scenario the “strong” adjustment scenario. Under this scenario, the private sector reduces further its external deficit by 2 percentage points, as in the “shy” scenario, but the authorities reduce the budget deficit from 5 percent in 2008 to 2 percent in 2009, as planned by the current government. Associated with this scenario is an increased credibility of the program and, thus, a less sharp narrowing in the external financing. Hence, the depreciation pressure is lower and the leu/euro exchange rate remains around an average of RON/EUR 4. With more external financing, the economic growth is about 2.5 percent, higher than in the “shy” scenario. In other words, an economic program that increases tax revenues and reduces the public spending appropriately renders the country with more available resources than an unorderly adjustment in the external financing does.

Let me now further refine the “strong” adjustment scenario by taking into account those fiscal measures that were adopted or entered into force after the 2009 budget was drafted. The effect of those measures totals an additional budget deficit of 2.5 percent of GDP. Let us not forget that the 2009 budget deficit assumed that the economy would grow by 6 percent, as compared with our estimate of 5 percent in the second scenario. This adds to the budget deficit another 0.5 percent of GDP. The result is that the government sector has to adjust by almost 6 percentage points, from a budget deficit of 8 percent of GDP to a deficit of 2 percent of GDP to produce the needed credibility of the economic program.

CONCLUSIONS

The view that measures that produce a larger reduction in the current account deficit would result in relatively lower growth rates and a weaker leu is wrong. Our second scenario proves that a larger orderly adjustment of the current account deficit can produce a higher growth rate and strengthens the leu as compared to an insufficient adjustment.

Although it appears to be difficult from a political and social point of view, a relatively large orderly adjustment of the current account deficit is warranted to alleviate the cut in Romania's external financing.

The current economic crisis makes capital inflows less available internationally. On this background, an insufficient adjustment of the current account deficit would be accompanied by significant reductions in Romania's international reserves since almost half of them are banks' minimum reserve requirements. With insufficient adjustment, banks' foreign liabilities would decrease as loans from mother banks mature.

An insufficient orderly adjustment of the current account deficit might result in an unorderly adjustment, given the less available foreign financing. This unorderly adjustment might be larger than in the "strong" adjustment scenario and costlier in terms of the leu and higher subsequent inflation. This would mean more problems for everybody. But who would like to buy problems?

To avoid such an instance, the 2009 budget deficit has to be around 1 percent of GDP, interest rates have to remain at levels consistent with the needed adjustment in the current account deficit, and the flexibility in the foreign exchange market needs to be preserved.

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