The Romanian Economy in the Current Global Crisis

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1. Romanian economy before crisis. The causes of the crisis in Romania

As a young member of the European Union, which it joined in January 1st, 2007, and NATO member from March 2004, Romania is the seventh largest EU member state, a middle-sized country located in the southeastern part of Europe with a population of 21.5 million inhabitants (as of January 1st, 2009, ranking 9th in Europe). While its population is equivalent to 6.6 % of the EU-15 population and its territory is the equivalent of 7.5 % of the EU-15 territory, Romania only produces 1.4 % of EU's Gross Domestic Product (GDP)[1]. It means that the Romanian economy is lagging significantly behind many European economies. In 2009, the Romanian GDP per capita recorded in purchasing power standard was $14.198 just 45 % of the EU-27 average[2].

In the 20 years since the fall of communism in Europe, Romania has experienced three periods of economic recession, the last one starting in autumn 2008. First recession was in the years 1990-1992 and it was considered as normal for the period of transition from the centralized economy to the market economy. A second recession occurred between the years 1997-1999 as a result of economic changes, a period marked by a difficult reform program and a series of privatizations of the State enterprises which succeeded only in a small way. During the period1990 - 2000 six in ten years were years of recession.

The year 1999 was followed by a recovery period from 2000 to 2003 and then a period of soar growth from 2003 to 2009, when GDP increased over the potential GDP of 6.1% per year calculated by the central bank[3]. This period totalized nine years and was considered by Romanians the most prosperous period after

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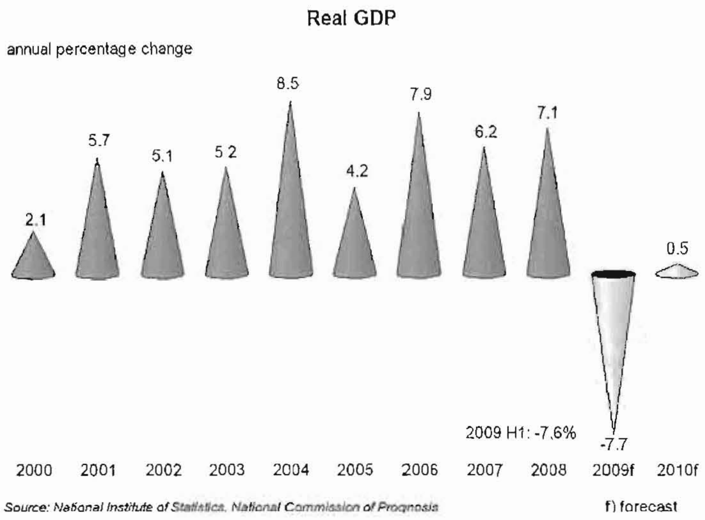
1 Eurostat yearbook 2010, National accounts, electronic version, p.88.
2 Eurostat: GDP per capita in PPS for EU Member States 1995-2009.
3 National Bank of Romania, Financial Stability Reports, 2008-2009.



1989. The main growth factors were: consumption of households (10-15% per year) and gross fixed capital formation (20-30% per year)[4].

Throughout this period of economic growth, a series of macroeconomic imbalances began to emerge in the Romanian economy, beginning less, then more pronounced, mainly as a result of economic policy measures taken at government level. These measures were aimed to meet EU membership criteria, better said the recovery of important differences from western European economies.

In 2001-2004 there has been implemented the capital account liberalization leading to foreign capital inflows, largely speculative capital. These capital inflows influenced the appreciation of the exchange rate against the euro and, therefore, to cheaper imports. Due to this measure an increase in trade deficit and hence a current account deficit increased from 4% of GDP in 2002 to 14% of GDP in 2007[5]. Another factor stimulating the growth of current account deficit was the high level of short-term interest rates in national currency, which influenced the rise in foreign savings in Romanian banks.

On the other way, non-government credit grew dramatically from the 10% of GDP in 2001 to 39% of GDP in 2008 (a 4-fold increase in relative terms) taking into account, however, that GDP has also risen over four times in nominal terms in national currency. Growth in household credit was too high - over 200% in 2003 and over 70% in 2006 and 2007. Loans to households have come to represent at the end of 2008 around 70% of disposable annual income of the population, seven times more than in 20016[6].

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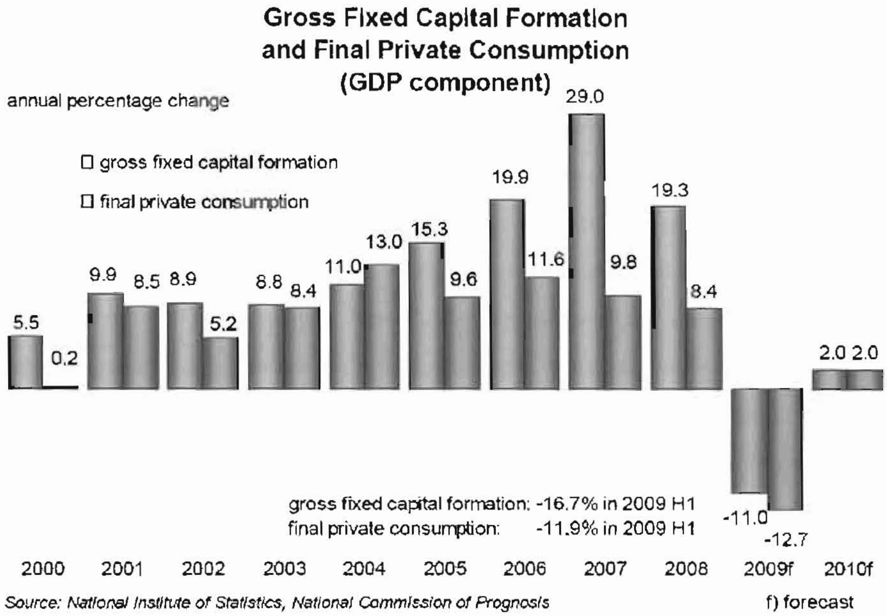
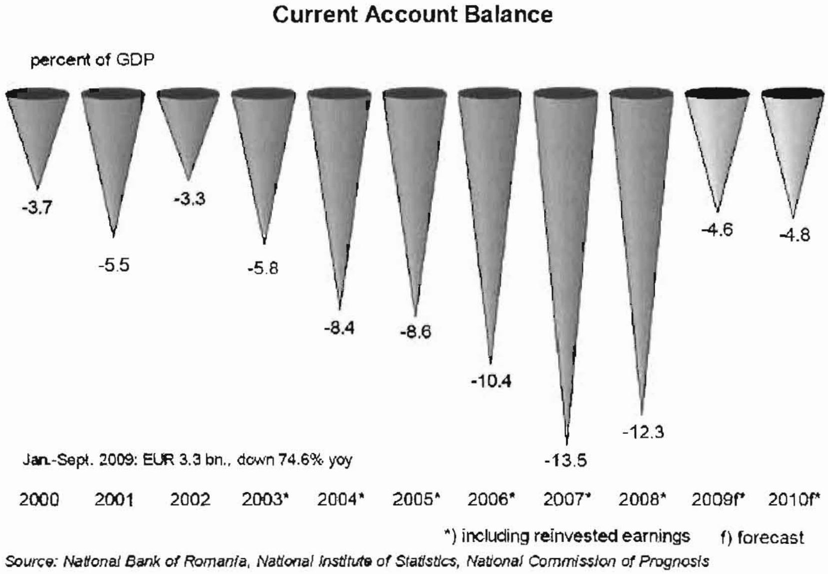
[4] National Institute for Economic Statistics, *Annual Statistical Reports, 2003-2009.*

[5] National Bank of Romania, *Financial Stability Report, 2007.*

[6] National Bank of Romania, *Survey on population lending and non-financial companies, 2001-2007.*





The financing of domestic consumption was provided by the increase in total external debt that rose from 18 billion Euros in 2004 to 72 billion Euro in 2008. At the end of the third quarter of 2008 (at the height of economic growth since the economic slowdown started in Romania) short-term external debt represented

20,6 billion Euros (near BNR's international reserves), of which 99% of private debt. Before the crisis started, every Romanian owed an average debt of 3,000 Euros [7].

A significant contribution to this fever of consumption was a speculative bubble on the Romanian real estate market. Most loans were taken by people who were aiming cash loans to purchase durable goods (72%), but most times they were guaranteed by real estate. The increase of the value of homes as a result of real estate boom has made a false appearance of enrichment effect, an illusion of wealth. A private real estate index for Romania - Colliers International - showed a 284% increase in the price of housing between 2005 and March 2008, when there was the top of the real estate boom [8]. Believing that they possessed some wealth, people found that they could have access to loans of higher value, and this situation was influenced by the Romanian banking environment and the psychology of the Romanians, which had been deprived of the opportunity of consumption both during the communism and the post-communist recession periods, last of them characterized by high interest rates.

The monetary policy, conducted by the National Bank at the beginning of economic growth 2001-2005, was also an important stimulus for growth of bank loan-based consumption, leading to the form of credit based on the ID (identity) cards. During the time, there appears such a contradiction that peoples has become to pay increasingly more for assets whose value decrease over time (due to physical and moral depreciation). After 2006 the monetary policy of the National Bank of Romania has been characterized as a prudential one, as a result of increasing signs of overheating: widening external deficits and persistent core inflation.

In addition to its objectives of ensuring price stability and financial stability, National Bank of Romania has directed the monetary policy decisions in order that our country to achieve accession to the European Economic and Monetary Union (Euro zone), in adopting the euro as currency. The initial considerations for timing the euro adoption at the beginning of the crisis was taken into account the following: more catching-up necessary in *per capita* GDP; a business cycle synchronization with the developed European countries; need for diversified macroeconomic and structural policy toolbox in order to effectively manage disequilibria throughout pre-euro adoption period (monetary & exchange rate flexibility). At that time and in that context, the ERM2 entry was planned for 2012 and the Euro zone entry was established for 2014.

In fact, the monetary policy has been anti-cyclical, but the anti-cyclical nature has low efficiency in terms of capital account liberalization (large inflows of foreign capital and credit in foreign currency have eroded the monetary policy restrictions).

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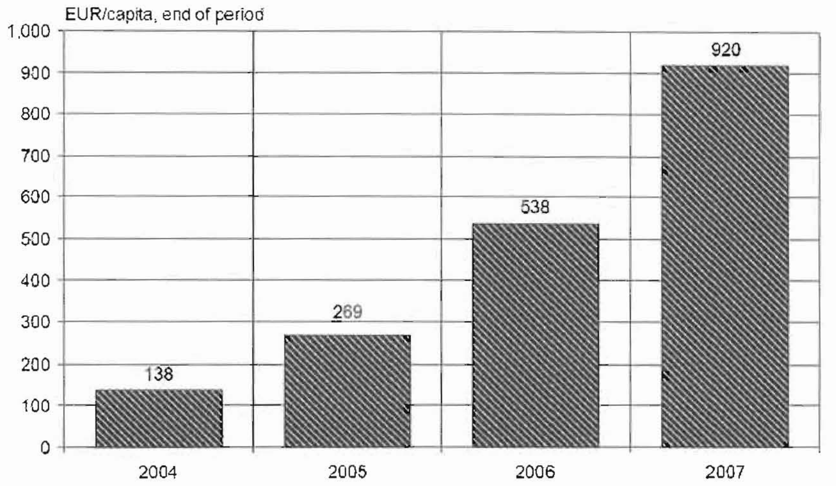
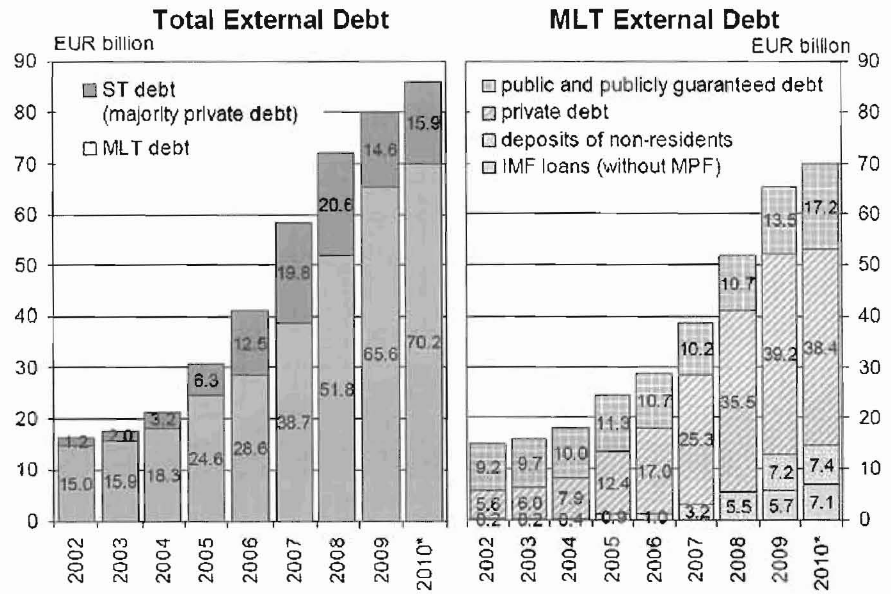
[7] Voinea L., "The end of illusion economy", *Publica*, Bucharest, 2009, p.69.

[8] Colliers International, *Real Estate Review*, Romania 2008, Bucharest.

Romania: Loans to Households per Capita (1)



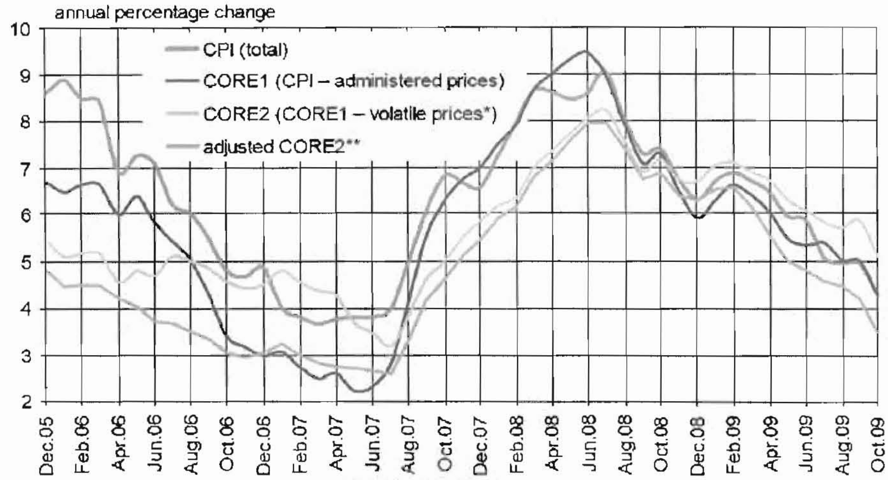
Source: National Bank of Romania, National Institute of Statistics



Source: National Bank of Romania *) March

Unlike monetary policy, the fiscal policy and the budgetary policy in Romania before the crisis (2006-2008) were characterized by pro-cyclicality, exacerbating business cycle fluctuations. Thus, in the period of economic growth after 2000 and especially after 2005 was an increase in public expenditure, on the one hand due to wastage of public money and on the other hand because of the exponential growth of budgetary wages. Nominal increase in salaries over the period 2005-2008 was 86% of GDP at the end of 2008 (the cumulative inflation below 30%).

Headline Inflation and CORE Inflation

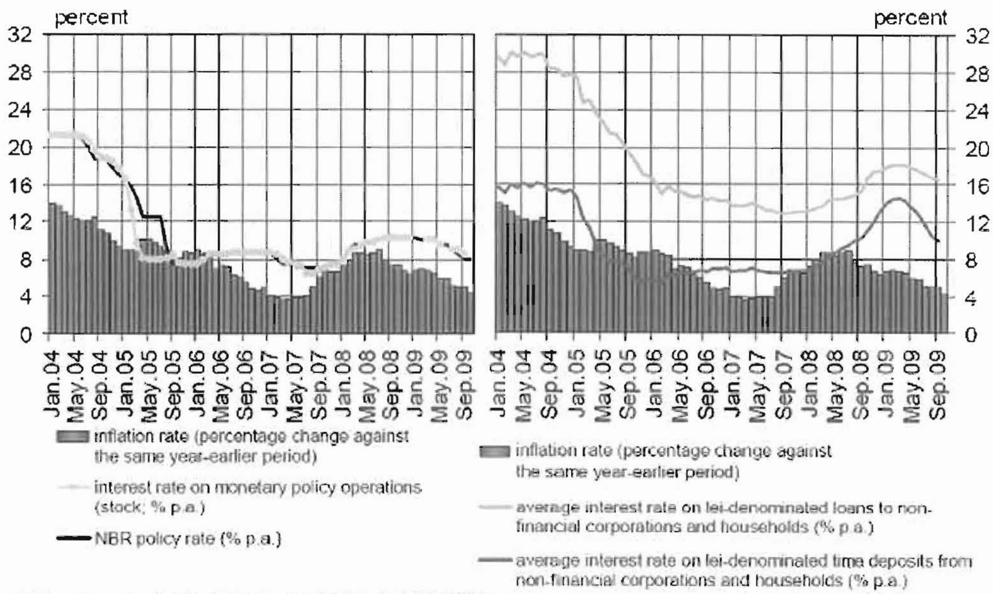


*) products with volatile prices: vegetables, fruit, eggs, fuels

**) excluding tobacco and alcoholic beverages

Source: National Institute of Statistics, National Bank of Romania calculations

Inflation Rate and Interest Rates



NBR policy rate: 8.0% starting with September 30, 2009

Source: National Bank of Romania, National Institute of Statistics

Maastricht Criteria
(Nominal Convergence Indicators)
- 2007 -

Nominal Convergence Indicators	Maastricht Criteria	Romania	Czech Republic	Hungary	Poland
Inflation rate (HICP) (percent, annual average)	<1.5 pp above the three best performing Member States (2.8 percent*)	**4.9**	3.0	7.9	2.6
Long-term interest rates (percent per annum)	<2 pp above the three best performing Member States in terms of price stability (6.4 percent*)	7.1	4.3	6.7	5.5
Exchange rate (vs. euro) (maximum percentage change vs. 2-year average**)	+ / -15 percent	**+10.8 / -9.6**	+13.0 /-0.9	+7.7/-6.6	+13.0 /-4.8
General government deficit*** (percent of GDP)	below 3 percent	**2.5**	1.6	5.5	2.0
Government debt*** (percent of GDP)	below 60 percent	**13.0**	28.7	66.0	45.2

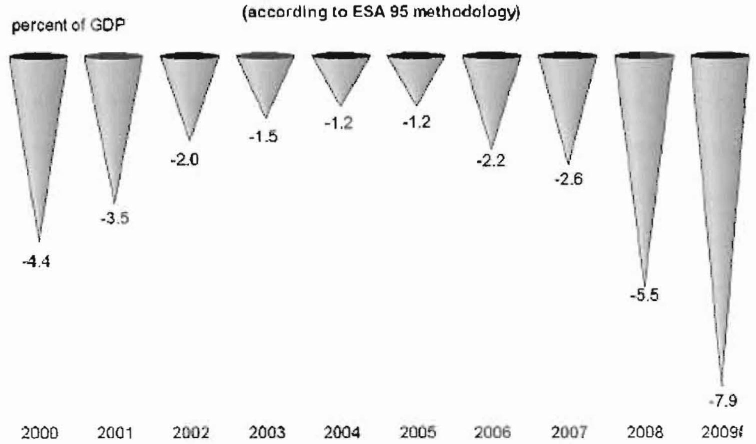
*) Reference level

**) Maximum percentage deviations of the bilateral exchange rate against the euro from its April 2006 average level over the period 19 April 2006 to 18 April 2008 based on daily data at business frequency. An upward/downward deviation implies that the currency was stronger/weaker than its exchange rate level in April 2006 according to ECB's Convergence Report, May 2008.

***) according to ESA95 methodology

Source: ECB, Eurostat, National Institute of Statistics, National Bank of Romania, European Commission

General Government Deficit
(according to ESA 95 methodology)

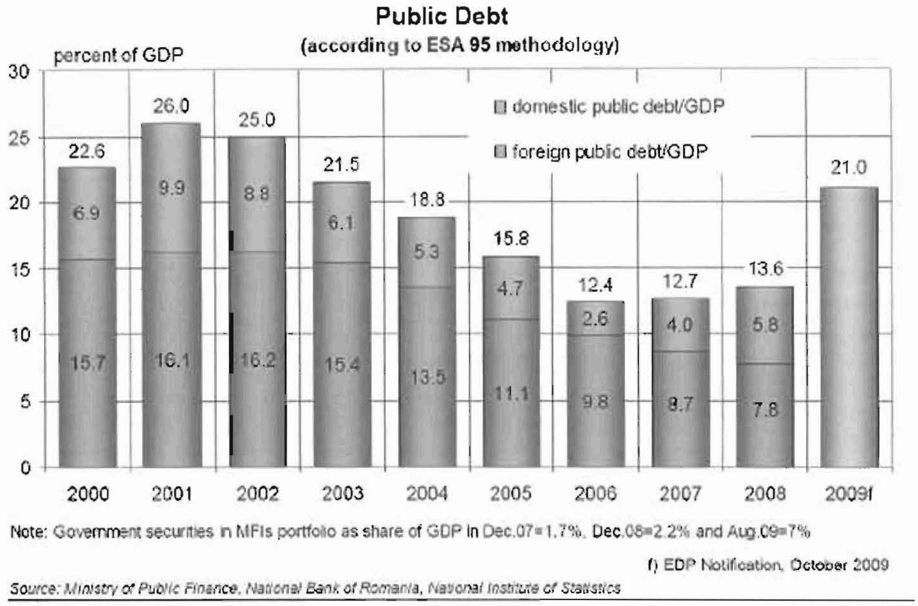


f) EDP Notification, October 2009

Source: Ministry of Public Finance, National Institute of Statistics, National Commission of Prognosis

Thus, the major structural budget deficit, became manifest at the end of 2008 (5% of GDP), undermining the advantage of relatively low public debt (less than 20 percent of GDP).

Concerning fiscal policy, 16% flat tax on income and profits adopted in 2005 led to stimulating demand rather than supply. The money obtained by the companies and population has been thrown out of the market, for consumption. Budget revenues have become increasingly dependent on consumption taxation through VAT and excise duties due to the fact that revenues from taxes on income and profits have declined as a



share of GDP from 2005. Budget revenues have never exceeded 32% of GDP in 2008 - the lowest level since the European Union (compared to Bulgaria and Poland - 38% in 2008).

Some of the structural problems unresolved and worsening was: the income received from the budget in 2008 was 30-32% of GDP, but a much higher tax burden for taxpayers (people, firms). This was the result of: insufficient taxation of land and property in rural economy, smuggling and tax evasion, many legal exemptions from taxes and modest contributions from non-tax revenues. On the other hand, there was a low efficiency of public spending, inadequate budgetary allocations and public investment instability and rigidity in the structure of public expenditure (salaries, pensions, welfare) because of laws promoted during the economic boom9 [9].

The budgetary deficit was also based on: incorporation in legislation of too many social programs in relation to available budgetary resources; social security budget strongly unbalanced (the ratio of the contributors to the social security budget and the beneficiaries of it has deteriorated continuously from 2.2 payers to one beneficiary in 1990 to 0.8 payers to one beneficiary in 2008); the relatively high contributions and the legislation discourages economic activity and encourage tax evasion, making social programs more difficult to finance.

The economic growth in the years 2005-2008 was based mainly on consumption: the consumption went up population growth, and the government used it to turn on salaries and pensions10 [10]. But high growth

9 Isarescu M. (Governor of the NBR), "Romania: the answer of economic policy to global crisis", NBR Presentation, 2010.

10 Voinea L., "The end of illusion economy", *Publica*, Bucharest, 2009, p.74.

rates achieved was emerged in large budget deficits. Increasing the budget deficit was a process that started in 2005. Structural budget deficit in 2007 exceeded the limit imposed by the Treaty of Maastricht 3% of GDP and in 2008 exploded to reach 7% of GDP. Thus, after years of pro-cyclical policies in a period of economic growth and Romania arrived to implement also pro-cyclical policies in a recession period (from 2009) through the public spending cuts and taxes increases.

An important aspect is that the early developments of global crisis, the Romanian politicians held the idea that the country would not enter into a crisis when other European countries had already, from the theory of decoupling: Romania decoupled from the rest of the world, especially Europe and it went on its growth path, which actually was not a performance or a pride thing, but on the contrary, the proof of an economic left behind to the West. This position led to the postponement of preventive measures implementation and increasing imbalances in the economy.

As a conclusion, the causes of economic crisis in Romania are based primarily in the Romanian economy itself and secondly as a result of globalization and they can be list as the following:

- Too quickly liberalization of capital account;
- Fast growth in consumption, based on short-term external financing;
- Implementing policies such as pro-cyclical fiscal policy and budgetary policy, in conditions of economic expansion;
- Postponement of structural reforms in some sectors and in the central and local administration;
- Inconsistent measures at the political level and inconsistency in making and applying laws.

2. The impact of the global crisis on Romanian economy

2.1 Major influences of the global economic environment on Romanian economy

The international economic and financial environment has deteriorated ever since, whereas future developments are surrounded by high uncertainties. The external environment in 2009 leaves its mark on Romania by (a) the worsening of risk perception of the country, including the contagion effects from regional evolutions; (b) the contraction of foreign markets; (c) external financing difficulties; and (d) at microeconomic level, the coupling of the solvency risk with the liquidity risk[11].

First, the deteriorating market sentiment towards Central and Eastern European countries, including Romania, has tended to weigh on the dynamics of financing costs spreads and of exchange rates of these countries. Second, the contraction of foreign markets has had a bearing on the Romanian exporting companies,

[11] NBR, *Financial Stability Report 2009*, p.7-9.

which was holding a significant share in banks' portfolios. However, Romania's exports have been less affected in 2009. Third, external financing has had become less available and more expensive, illustrating foreign creditors' enhanced risk aversion and the competition for resources generated by governments. Finally, the persistence of the global crisis has lead to the contraction of economic activity, including firms being forced out of the market.

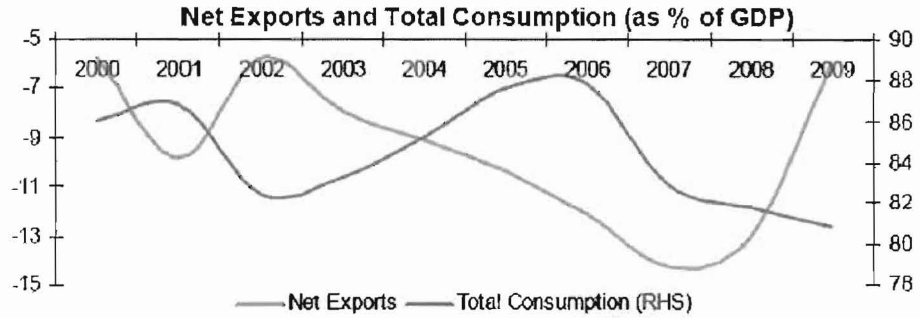
The economic contraction, materialized in the first quarter of 2009, has represented a new vulnerability, which corresponds to the deterioration of the financial position of companies and to a rise in unemployment. This has had significant negative repercussions on the financial system, particularly on banks. On the other hand, the current account deficit was narrowing relatively fast and therefore was less harmful to financial stability, particularly if the adjustment does not cause a decline in investment and exports. Another new challenge has originated in the banking sector itself: the less available domestic and external financing sources that generated serious constraints on the repayment of debts by companies.

According to the European Commission *(European Economic Forecast - spring 2010),* high external and fiscal imbalances increased Romania's exposure to the global economic downturn. With an average annual real GDP growth of 6.8% between 2004 and 2008, Romania was one of the fastest growing EU Member States. However, this strong growth went hand in hand with growing external and fiscal imbalances. The sudden increase in risk aversion during the financial crisis caused market participants to become increasingly concerned about these imbalances. Capital inflows fell and the exchange rate of the RON against the euro depreciated by more than 30% between August 2007 and January 2009. In 2009 the Romanian economy experienced one of the sharpest contractions in its recent history. Tighter access to financing, balance-sheet effects of the currency depreciation, and the sharp decline in exports due to the slump in global trade triggered a strong contraction of real GDP, which fell by 7.1% in 2009.

The effects of the financial crisis started to be felt in the Romanian economy during the fourth quarter of 2008[1 2]. Large existing macroeconomic imbalances were penalized by the markets as global liquidity dried up and uncertainty rose sharply in world financial markets. International credit rating agencies reacted with two of the main three agencies, Standard&Poor's and Fitch, downgrading the country's rating to junk status.

The perspective of a sudden stop of capital implied that finding rapid alternatives for financing lines was a priority. Thus, in early 2009 the authorities turned to the IMF. In March 2009, the Romanian government concluded talks for a EUR 19.5 bn stand-by agreement with a group of international institutions led by the IMF. Romania received the support of the EU, IMF, WB and EBRD through an SBA for a period of 24 months (May 2009 - May 2011) in an amount equivalent to EUR 19.95 billion. This amount includes EUR 12.95 billion from

[1 2] 6th GEA Report on Romania and the Lisbon Agenda, *Romania and the Europe 2020 Strategy*, Bucharest, 2010, p.3.



Source: GEA. based on INSSE

IMF, EUR 5 billion balance of payments financing facility from EU and other multilateral commitments of EUR 2 billion from World Bank and EBRD.

As a result, the country managed to avoid any potential shortfalls in financing its external and internal deficits. Moreover, the IMF program detailed the necessary changes needed to be implemented by fiscal authorities in order to make fiscal policy more transparent and accountable. The rapid response of international authorities was paramount in staving off a foreign capital outflow. In addition to that, through the so-called Bank Coordination Initiative, the IMF started a dialogue with the foreign banks operating in Romania whose objective was to prevent the closure of refinancing credit lines.

The International Financial Institutions' conditionality[13] was:

A) Strengthen fiscal policy: i) gradual reduction of the fiscal deficit from 7.3% (2009), 6.8% (2010), 4.4% (2011) to 2.9% (2012);

B) Enhance monetary and financial sector policy: i) bring inflation within the NBR's target range and keep it there; ii) improve safety net; iii) continue to improve the banking supervisory and regulatory framework; iv) ensure sufficient resources to cover any potential shortfalls revealed by the stress tests, maintain adequate bank capitalization (above 10% over the program) and liquidity;

C) Secure adequate external financing through improved confidence. Under Vienna Initiative the parent institutions of the 9 largest foreign-owned banks in Romania (about 70% market share) jointly committed to maintain their overall exposure (as of March 31, 2009) to Romania, objective which has been observed.

The slowdown in global demand had profound implications for the Romanian economy. Unable to sustain its demand internally, the Romanian economy plunged into recession. In 2009 private consumption dived by 9.2% year-on-year as the shock to real incomes influenced household purchasing patterns. Prior to the financial

[13] Georgescu Fl., *Macroeconomic Indicators and Financial Sector Development in the Recent Crisis Context*, NBR Presentation, 2010.

crisis, the GDP growth was powered by domestic consumption (see Figure below). The net exports adjusted sharply, contracting from around 15% of GDP in 2007 to a little over 5% of GDP at the end of 2009 [14].

Gross fixed capital formation, a measure of the how fast the capital stock is being replaced at the economy level, fell by almost a quarter compared to 2008. The construction sector suffered the most among all sectors of the economy, with activity here dropping by more than 17% year-on-year. Activities in the wholesale and retail sectors fell by 11.2% while industrial output slowed down by 4.3% compared to 2008.

In 2009 inflation fell outside the NBR inflation target band for the third year in a row. However, elements outside the control of NBR, such as the course of fiscal policy, played an important role in the evolution of inflation.

Throughout 2009 monetary policy stance was predominantly loose. Over the year the Monetary Policy Council gradually reduced the NBR benchmark interest rate from 10.25% to 8%. Although at the early stages of the relaxation cycle the reduction in NBR's benchmark interest rate was relatively slow to feed into commercial banks' lending rates, at the end of 2009 and early 2010 this process has already started to gather pace.

Overall, monetary policy was rather prudent. Although the economy was contracting abruptly, the NBR's benchmark interest rate was only gradually reduced. With inflation falling, real interest rates in the economy were too high to help firms easing their borrowing needs.

Forced to adjust, companies shed parts of their labour force, which caused average wage growth to plunge into negative territory at the beginning of 2010. This in itself is a remarkable event, as nominal wages were growing at rates above 20% for the last two decades. The dramatic fall in wages reduced one important source of inflation pressure and, if sustained, could raise competitiveness.

The companies that benefited from FDI weathered the crisis better than the rest of the economy [15]. Their performance indicators deteriorated at a slower pace. These companies may contribute to a more sustainable convergence to the euro zone, as (i) they proved their structure allows them to withstand shocks more efficiently, (ii) they play a key role in generating value added in the economy (almost 40 percent of value added of non-financial companies) and (iii) account for more than 75 percent of Romania's exports. Nevertheless, these companies might have a smaller contribution to the short-term resumption of domestic lending, as in 2009 they showed a propensity for external financing (up by more than 20 percent), while their resort to domestic bank loans declined by almost 2 percent.

Total indebtedness stock of companies and households with financial institutions (banks and

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[14] *Ibidem*, p.4.

[15] NBR, *Financial Stability Report 2010*, p.8.

non-bank financial institutions – NBFIs, both domestic and foreign) rose slightly in real terms (December 2008 - June 2010). The debt-to-GDP ratio reached 63 percent in June 2010, particularly due to the base effect following the economic contraction. In June 2010, corporate and household financial indebtedness totaled to about 310 billion lei, with domestic banks accounting for two thirds, local NBFIs for 9 percent and external creditors for 24 percent. Since the outbreak of the crisis, the loan supply for companies and households tightened in terms of both cost and volume, in line with a similar tightening in the region, with variations depending on the source. On the other hand, the demand for loans declined markedly. Against this background, the exposure of banks operating in Romania fell steadily – in annual real terms – from September 2009 to May 2010, with the first positive real annual increase (+2 percent) being recorded in June 2010, whereas the NBFIs` exposure decreased substantially. On the other hand, the loans granted by external lenders grew by 20 percent (December 2008 - June 2010)[16].

2.2 Crisis influences on Romanian economy competitiveness

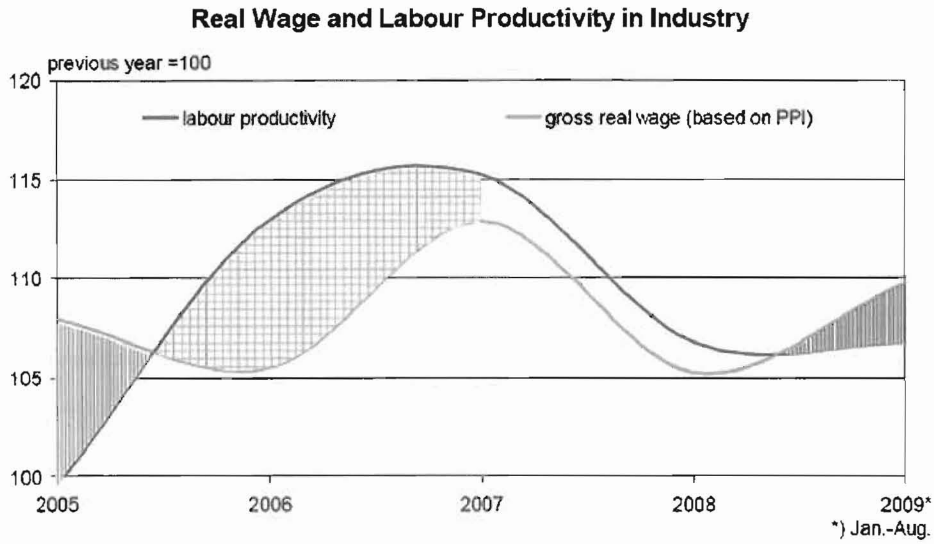
An important aspect for Romanian economy today is the competitiveness. The economic literature identifies four types of stages of development of an economy[17]: i) the economy based on factors (inputs); ii) investment-based economy; iii) innovation-based economy (R & D expense and innovation), high degree of sophistication of the market; and iv) economy based on wealth (where redistribution has become a priority, which reduces the overall competitiveness of the economy - the case of Scandinavian countries).

Romania has been an economy based on factors, particularly natural resources and cheap labor. During communism, Romania, along with other Eastern countries, tried to be a "premature welfare state", meaning that redistribution excess the accumulation of national wealth. In the first decade of XXI century, Romania has taken important steps towards an economy based on investment, if we consider the stock of foreign direct investment (which exceeded 50 billion euros) and very high growth rate of gross capital formation formation (investment rate). Investment rate has far exceeded the savings rate during the boom and the trend began to reverse when the crisis began in late 2008.

But the investment boom, many of them in retail or real estate and cars respectively (considered as fixed assets), has left some unsolved issues related to production factors, notably infrastructure and human resource education. There is a natural limit to growth in the absence of a developed infrastructure investment and, subsequently, a natural limit to the value added investments in the absence of a proper education of the human

16 NBR, *Financial Stability Report 2010*, p.10.

17 GEA, *Romania's Reindustrialization: Politics and Strategies*, Bucharest, 2010, p.10.



Note: Data recalculated according to NACE Rev.2 and to the change in the base year (2005 instead of 2000) and weighting system.
Source: National Institute of Statistics, National Bank of Romania calculations

factor. The economic crisis has reduced the amount of investment and put back the question of inputs, notably infrastructure and education.

On the demand side, Romania has the advantage of market size, which must of course in conjunction with purchasing power, it dropped in 2009, when household consumption was reduced by over 10%, but there are prerequisites for a resurgence in the coming years. Romania's competitive disadvantage on the demand side comes from the low level of sophistication of buyers, which brings customers the low orientation of the sellers. In other words, Romanians still buy (almost) anything, competition in the local market is not based primarily on innovation and technological advancement, but rather on price, foreign companies don't bring flagship products in Romania (with some exceptions on specific market niches Luxury), and Romanian companies are not encouraged to invest in research and development because the market does not require new, technologically advanced products.

Regarding the strategy of firms, the results are consistent with the situation on the demand side: modest and unsophisticated buyers do not require a special development of marketing, the latest available technology does not require absorption and do not put pressure in changing the nature of competitive advantage. Expenditure for research and development of the Romanian companies are at a chronic competitive disadvantage (in the last decade they have remained stationed in the area's 0.2% of GDP) and local capacity for innovation is in direct relation to local demand for innovation, it is reduced.

However, they must be noticed the perception of the existence of a competitive advantage on quality education in mathematics and sciences, which could be an indication of the potential for innovation, higher than current levels. The role of government in this regard may be to stimulate the local expression of this potential, one of the means being the procurement of advanced technology products, but offset the imposition of conditions.

With regard to the fiscal and budgetary policy, Romania has a competitive disadvantage on the efficiency of public spending, the burden of administrative regulations and the extent and effects of taxation, but the intensity of this disadvantage is normal. If tax rules remain the main obstacle to the business environment in Romania, it is related very closely to qualitative aspects of governance, namely public policy instability, inefficient bureaucracies and corruption. Other competitive disadvantages also occur already highlighted as access to finance, inadequate infrastructure, inadequately educated workforce and regulations that limit the flexibility of labor. It is no less true that Romania has a competitive disadvantage on the side of budget revenues, not expenditures. Thus, Romania has the lowest share of GDP, government revenue (below 32%) of all EU-27 countries (European average is over 40%).

A solution would be to increase the competitiveness of the increase in public investment. But a problem for investment growth is given by the ratio of marginal productivity of capital and interest rate[18]. As long as the marginal productivity of capital is higher than the interest rate prevailing speculative investments, not the productive, private sector and public sector investment will refrain from this because they would do with a borrowed capital more expensive. As long as the government will be dependent on expensive loans (those on the domestic market are more expensive, and in 2009 Romania has borrowed more money than domestic IMF), will do massive public investment. To reverse this relationship, we need either an increase in the marginal productivity of capital by calling the new technology, but it takes time, or a drastic reduction in interest rates. Of course, the interest rate is constrained by high inflation, but there are historical moments where the benchmark interest rate is below inflation, in order to stimulate the economy.

Another problem is the public investment, as we have already noted, the lack of financial resources. Alternative solutions must be found in the context of EU funds or financing such as public-private partnerships.

Monetarist policies may bring short-term macroeconomic stability, with many casualties, together with a combination of policy-oriented resume lending and stimulate consumption, increased public investment and increasing the absorption of structural funds, it is possible to have a resumption of economic growth Romania, but not a sustainable high growth rates. It may be possible that the resumption of lending to avoid the liquidity trap (injection of liquidity into the economy which are not reflected in the sustained growth of credit) and Japanese trap (consumption in Japan has remained in negative territory after two decades of real estate and

[18] Voinea L., "The end of illusion economy", *Publica*, Bucharest, 2009, p.161.

banking crisis of the late '80). It may be that public investments to overcome the trap Portuguese (Portugal's economic growth remained well below potential since 2001, despite massive public investment program). But the structural imbalances of the economy remain in place.

The European Union strategy named Europe 2020, launched in March 2010, continuing the Lisbon Strategy, highlights the role of industrial policy. This does not necessarily mean that the government should choose the winning industries (champions) and invest in them. The role of government is mainly that of facilitator. Thus, one of the pillars of the new European strategy is called "An industrial policy for an era of globalization". Nationally, the role of governments, as defined in Europe 2020, consists of:

- improving the business environment especially for innovative SMEs, including through public procurement to support innovative initiatives;
- improving the conditions of intellectual property protection;
- reducing administrative barriers and improve legislation on companies;
- cooperation with stakeholders (representatives of employers, unions, consumers, academia, NGOs) to identify and resolve any faults.

2.3 Romanian industry analysis in the recent crisis context

The literature defines the phenomenon of deindustrialization by reducing the share of industry in economic activity. To make an analysis of this process in Romania, we will highlight in a first phase the economic branches share in GDP.

Industrial production (in absolute value in billion, million lei - RON) had an increasing trend in the period 1997-2007, falling slightly from current financial and economic crisis in the year 2009 as can be seen the following figure.

In 2008-2009, however, the construction sector was one of the sectors affected by deep cuts in global activity, however, reduce the volume of construction output has subscribed to a downward trend of the whole economy, sector share is not affected dramatically. In December 2009, after the dramatic deterioration over the year, net production index in construction is still at a level of 172.2% compared to base year 2005 (Eurostat, 2010)[19]. In addition, Eurostat said that Romania (with Spain) is one of the few Member States where one can notice a revival of the construction sector in December 2009 compared to the previous month.

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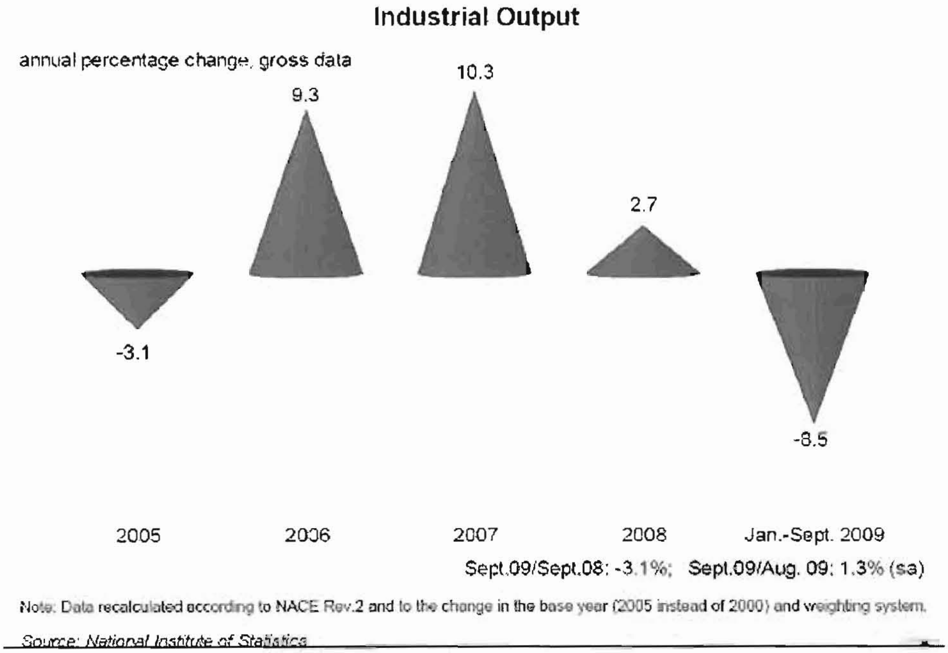
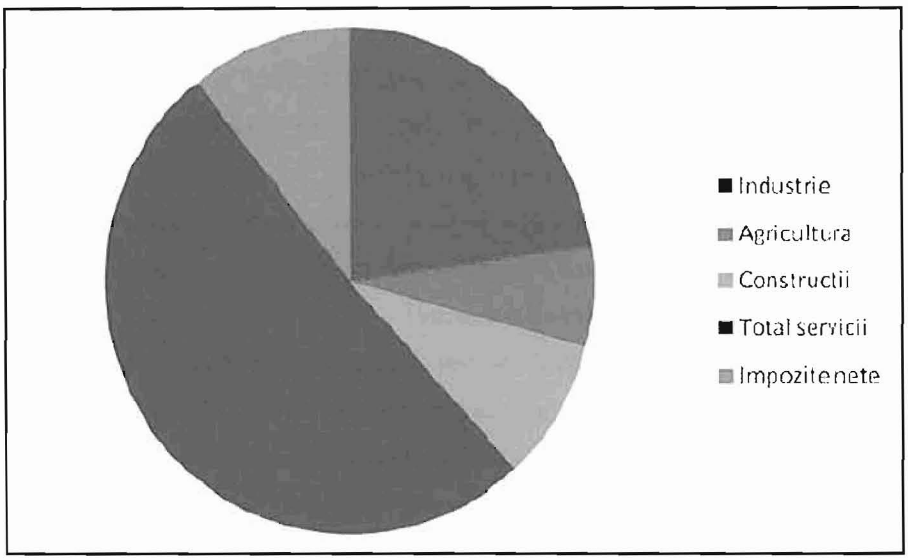
[19] Eurostat, 2010, Construction output up by 0.5% in both the euro area and the EU27, http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/4-17022010-BP/EN/4-17022010-BP-EN.PDF

To analyze the degree of industrialization, we see the evolution of percentage of GDP accounted for by industry, which declined relatively steadily, although with a reduced rate for the period 2000-2009, a trend that is expected to continue in the future.





Sursa: INSSE, 2009.

Source: ***National Institute of Statistics, 2009***

Services are the sector that should balance the decreased activity in agriculture and industry. However, compared to 1999, the share of services in GDP in 2007 was only 7% higher, which means that restructuring the economy through the transfer of business from industry and agriculture was made towards the construction sector rather than towards the tertiary sector, but the last one has the largest share of GDP, about 86% of production.

Looking at the same time at the GDP per product category, we see the following:

- GDP structure in 2009 reflects a major share for services (including construction industry). Total services own 51.2% of GDP, excluding construction. Including construction, the percentage increased to 60.2%;
- the share of agriculture in GDP is about 6%, representing 40% from the year 2001, which follows a clear downward trend;
- the share of industry (excluding construction sector) is about 22%, in moderate decline, representing only 87% of 2001 levels;
- on average, the share of industry in GDP has declined by one percentage point each year, revealing the process of deindustrialization. By the year 2014, they expect the industry not to decline more than 22%;
- if there is no differentiation between the construction and services sectors and their specific growth they may decide that we are witnessing a process of clear deindustrialization, at a moderate pace, affecting the national economy.

Regarding the evolution of the employment rate in statistics they can observe an increase of almost 42% of employed population from 1992 to 2001, and an increase of 34% from 2001 to 2007. The population was redistributed from agriculture, which fell by 30% compared to 2001 and from industry (excluding construction), which decreased by 5% from the same base year. The strong expansion of the construction sector in 2007 managed to attract 71% more people than in 2001.

Correlating information on GDP shares and the employment rate in the same referential, it can be concluded that Romania is going through a period of deindustrialization, aiming to develop the tertiary sector (services), especially the construction sector.

Industrial production has evolved differently by types of industrial sectors for the period 2008-2009. Food, tobacco, wood, plastics, electrical products, manufacture of motor vehicles and machinery maintenance and repair recorded increases of production indices, while other branches have fallen (base year 2005). Overall, the manufacturing sector as a percentage of total employment in the economy in 2008 was 25.72%, while in 2009 its share has declined, reaching 24.20%.

In the category of industrial activities with general difficulties they include those industries that have experienced difficulties in activity both in 2008 and the first part of 2009 so that the restriction of industrial production level can not be attributed to the crisis. Industries who had this type of development are mainly light industry, particularly clothing. These branches know, in fact, a last longer restructuring process. They take into account also the branch "extraction of crude oil and natural gas", an activity which, in fact, registered since 2001, successive reductions in production, an average of 4-5%.

As industrial activities most affected by the crisis are the industries with production for export. The effects of financial and economic crisis on those industrial branches can be structured as follows:

- restriction of overseas markets due to economic crisis in Romania's main partner countries (Italy, France, Germany etc..)
- restrictions of granting loans to commercial operators by banks as a result of prudential rules imposed by the National Bank;
- reduction in construction activity, leading to decreases in industrial production related activities;
- reduction of activity spread horizontally in the industrial branches with coupled effects of the activity (eg, reduction of activity for both vehicles, to the rubber processing, machinery and equipment electricity, metallurgy, etc.).

Among the industries most affected by the crisis, the steel industry has been most pronounced reduction of activity in this period, the production being 49.9% below that of the first five months of 2008 as well as non-metallic mineral products industry (building materials) where production was 31.4% lower than the first five months of 2008. Manufacture of rubber and plastic, horizontal activity coupled with the manufacturing of motor vehicles, has decreased production by 16.6% over the same period comparability.

Real estate market has declined, particularly as the effect of restricting lending by commercial banks, and has induced a decrease in construction activity with direct effects on the manufacture of other non-metallic mineral products (building materials), an activity which has seen a severe decline in production (-31.4%) over the first five months of 2008.

As industrial activities that were not affected by the crisis they were included: food industry, who scored in the fourth quarter 2008 a production growth of over 9% versus the same period a year earlier. In the first five months of this year there was a reduction in food production around 4.2%, compared with the same period of 2008. This evolution is correlated with restricting consumption, but medium-term domestic demand for local food products will remain relatively constant. A similar situation is found in case of manufacture of beverages or tobacco products.

2.4 Romanian economic policies in time of crisis

As a result of macroeconomic evolution many problems remain to be solved. Exiting the recession is proving slow, because the government has left few instruments of fiscal policy to boost economy. Correction from a growth model based on excessive consumption to one based on sustainable consumption, investment, exports and attracting European funding takes time. Budget correction is socially painful and difficult in term of adopting and implementing legislation; it cannot only resolved through economic growth, but by treating the underlying causes of the structural deficit, where they are rooted. The high dependence on foreign currency loans are difficult to solve, under the lack of long-term savings in national currency.

a) ***Fiscal policy and budgetary correction*** The budget deficit rose to 2.5 percent of GDP in 2007 to 5.4 percent in 2008, 8.3 percent in 2009 and tends to 10 percent of GDP in next years so that a budget correction is inevitable. Romania had no room for tax cuts (which is depleted pro-cyclical policies of previous years). Financing a higher fiscal deficit leads to a rapid growth of public debt, interest rates and financial expenses in the budget. In this respect, a tax increase would be ineffective in the absence of expenditure reform, would increase recession both by reducing consumption and by discouraging investment and should be preceded by broadening the tax base by eliminating exemptions.

b) Monetary policy There have been relaxed major components of monetary policy at the same time with lowering inflation: interest rate was reduced from 10.25 percent in October 2008 to 6.25 percent today, it was improved banking system liquidity and has been gradually reduced the reserve ratio of the banks. Prudential regulations and capitalization of the banking system were strengthened, which provides a sound basis to resume lending.

The reformulation of economic policies (monetary policy, fiscal and budgetary policy and structural policy) try to correct macroeconomic imbalances:

- the external deficit was reduced from 13.4 percent of GDP in 2007 to 4.5 percent of GDP in 2009;
- cyclical movement of private capital flows has been offset by inflows from financial institutions and the Vienna Agreement with the parent bank's nine largest banks with foreign capital in Romania;
- official foreign currency reserve increased from 25 billion euros in March 2009 to 32,4 billion euros in April 2010;
- short-term foreign debt, mostly private, declined from 20.6 billion in December 2008 to 14,600,000,000 Euros at the end of 2009;
- the pressure on national currency has weakened and monetary and currency markets have been stabilized.

3. Conclusions

The main macroeconomic corrections were made relatively controlled, less budgetary correction, which is delayed. The consistency of economic policies (fiscal, budgetary, monetary and structural) is critical for the resumption of economic growth on a sustainable basis. The budgetary correction is inevitable and it is preferable to make it orderly and mainly on the expenditure side. Also, the confidence in economic policies and business climate is an essential asset.

In the medium term economic policies should be geared towards achieving macroeconomic stability and, implicitly, to fulfill the Maastricht criteria. Current plans envisage Euro adoption in 2015. For this to happen, Romania would need to enter into the Exchange Rate Mechanism two years prior to that. That leaves an extremely short period of time, less than 3 years, for resolving current macroeconomic imbalances.

1. The most important challenge is to bring fiscal policy on a sustainable path. This will be severely constrained in the medium term, especially in 2010 and 2011, as government revenues would still be low. Government expenditures will need to be trimmed considerably if 2010 end year budget deficit target of 5.9% of GDP is to be met.

2. Apart from maintaining a tight control on its finances, the government would have to pass unpopular legislation in 2010. One test for the government would be to find the consensus to implement unpopular measures at a difficult time.

3. The challenge for the Romanian labour force is quite high. On the one hand private sector is still adjusting, virtually all created unemployment was done by this. On the other hand, the required reduction in public sector wages would necessary conduct to necessary adjustment in number of public employees. A conservative figure would put at 100,000, or around 8% of the total public sector employees, the number of people to be laid off. This would put an increasing strain on the labour market as well as on the social security costs. Thus, the risk of social tensions remains elevated as pressures to reduce public sector wage costs build up. Unemployment rate could continue to rise in the first months of 2010 although it is likely to remain lower than the EUaverage, below 10%.

4. Regaining investment grade status should be a priority for the Romanian authorities. This would translate not only in lower borrowing costs but it would also show a more positive image of the Romanian economy. Recently, Standard & Poor's revised Romania's long term ratings from negative to stable. The rating revision could open the door for a reassessment of Romania's overall risk, which would place the country into the investment grade category. For this to happen however, the government would have to continue its public finances reform.

5. Repayment of the IMF loan in the years ahead could create strains in the foreign exchange market if fiscal policy was not on a sustainable path and macroeconomic stability was still uncertain.

6. The building of an effective administrative capacity. According to the public opinion barometers citizens' opinions on the public administration's performance are negative. The public administration is perceived to be

weak and corrupted. There is no surprise that Romania is placed in the 85th position out of 159 countries regarding the perception of corruption in the world. One of the big problems facing the Romanian government is the lack of clarity on allocation of responsibilities and financial resources between the county and the local councils.

7. The development and more efficient use of human capital. Romania understands that the entire world is living in a knowledge society. In this respect, Romania has to provide better education and training to its citizens, and to improve the health care services. The modernization of the education and training infrastructure is needed to raise the quality of the educational system. Since 1999, awareness of the Bologna Process has constantly increased during the last years within the Romanian higher education institutions. In order to become more competitive, they have created and developed quality assurance departments and established quality assurance strategies.

8. The latest concerns about the state of public finances in several EU countries have raised the question of how the situation there would affect the Romanian economy. High levels of government debt and large budget deficits observed especially in Spain, Portugal, Ireland and Greece could affect domestic financial markets and from there, spread to other EU countries.

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