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Experiences of the Large Fiscal Adjustments in EU. Romania's Case[*]

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Abstract. *This paper presents the contagion mechanisms of the world financial crisis upon the Romanian economy, the analysis of the way in which the Romanian authorities have reacted during the crisis and the lessons to be learnt subsequently to the encounter with this crisis. Moreover, this work outlines, in a comparative manner, the main macroeconomic effects of the large fiscal adjustments recorded during the last 30 years in EU, as well as viewpoints referring to the fiscal correction in Romania.*

Keywords: fiscal adjustment; austerity; recession; crisis.

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1. Introduction

At present, we are probably in the middle of the toughest economic and social crisis which has ever been experienced by mankind. The loss of 30 million jobs in the entire world, the deep recessions, the increase of poverty and of the social polarization represent processes which are deeply deteriorating the bases of the European model and the operation of the global economy. The crisis regarding the choice of the concrete solutions for stimulating the economy indicate a much deeper crisis – the crisis of the economic science.

Romania encounters a series of overlaid crises – the external crisis over the domestic economic crisis, the political crisis and the social crisis, as well as the confidence crisis.

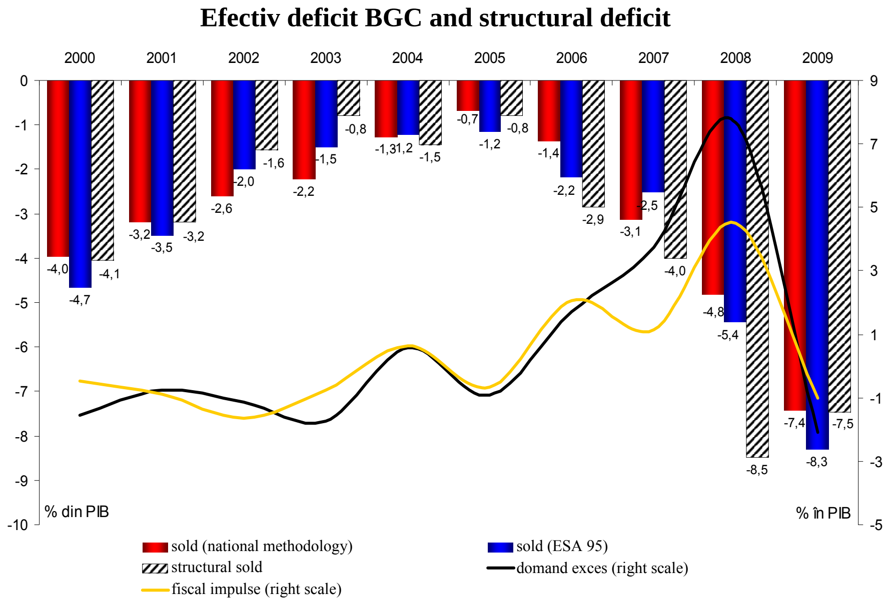
Our paper is structured in three parts: how we entered the crisis, how we reacted under crisis conditions and, perhaps the most important, what we have to learn from this crisis.

How we entered the crisis

The globalization of the world economy has made that financial imbalance produced in one of the major economic powers to transmit quickly in most countries. Especially emerging economies have felt the effect of cumulative causation – the external imbalance overlay over some domestic economic and social vulnerabilities, already manifest. The effect of herd has grown, capital flight from developing countries to developed countries back was done with alarming rapidity.

When entering the crisis, Romania has had an unfavourable macroeconomic situation. Besides Latvia, Romania has been strongly dependant on the foreign capital inflows, both in the public sector and also in the private sector. The issue of the high twin deficits (real budget deficit of 5.4% of the GDP and current account deficit of 13% of the GDP in 2008) resulted in a margin of maneuver which is too low to financially support the proper fiscal stimuli.

Romania has had an improper management of the macroeconomic policies. The pro-cyclic fiscal policies resulted in creating a fiscal space during the recession gap periods and in its running short during the expansion gap periods. Romania has made large fiscal adjustments when the economy used to function below its potential, opposite to the postulates of the macroeconomic theory, which recommends fiscal consolidation processes during the expansion periods.



Source: NBR data, Eurostat, 2010.

Figure 1. *The evolution of current budgetary deficit and structural budgetary deficit in Romania (2000-2009)*

Table 1

The evolution of the output-gap and of the structural budget balance

Year	Output-gap		Years	Structural budget balance
2000	-2.22		2000	-2.64
2001	-0.60		2001	-2.55
2002	-0.48		2002	-1.76
2003	-0.97		2003	-1.15
2004	1.04		2004	-0.43
2005	-1.09		2005	0.62
2006	0.81		2006	-2.11
2007	2.17		2007	-3.73
2008	6.20		2008	-7,71
2009	-2.95		2009	-6,84
2010	-3.46		2010	-4,40
2011	-3.92		2011	-1,90
2012	-2.13		2012	-1.30
2013	-0.10		2013	-1.40
2014	2.35		2014	-1.80

Source: Ministry of Public Finance, International Monetary Fund, 2010.

The dependence of the Romanian economy - and generally emerging countries – of foreign capital inflows that are common in the period before the 2008 financial crisis has created serious liquidity problems. There were outflows of capital to developing countries, safer, and especially amid the existence of a managed floating exchange rate with this process led to a depreciation of the national currency against major currencies. However, it is interesting that our country has not necessarily had to find a flight of capital from a high amplitude but rather a lack of capital inflows to the pre-crisis situation.

There were immediate signs of a recession: economic collapse, unemployment increasingly higher due to lower number of jobs, less revenue to the budget, increasing the risk of default by increasing CDS and increased social problems.

How we reacted under crisis conditions. The experience of the large fiscal adjustments

The freedom degrees provided to the macroeconomic policy decision makers from Romania have been low. The monetary policy has not a too large margin of maneuver under the terms of the existing inflationary shocks, such as the currency depreciation or the increase of the VAT. Also, no fiscal policy instruments were used to their full potential because of lack of financial buffers of Treasury strictly necessary to meet liquidity gaps caused by the reduction of external capital flows. On the other hand, low power automatic stabilization mechanisms – especially the lack of progressivity of taxation - led to exacerbation of budgetary problems, along with high tax evasion related imbalances, low collection of revenues from the state budget and so on. "Solving" structural problems by delaying to the future means what is called "Ricardian equivalence" that reduced confidence in the sustainability of the positive effects of stimulating the economy through measures of fiscal relaxation.

This problems called for fiscal adjustment. To solve liquidity problems, Romania has signed a multilateral financing agreement with the IMF, EC and WB option that led rapidly to reduce by half the risk of default on foreign markets and restored confidence in the positive development of Romanian economy. The main target of the adjustment program provided effectively achieving a budget deficit of 6.8% of GDP in 2010, 4.4% of GDP in 2011 and 3% of GDP in 2012, consistent compliance nominal convergence criteria set for joining the EuroZone.

However, Romania finds itself into vicious circles out of which it is difficult to get. The low budget revenues give the impression of enormous expenses for normal rights: entire wages, entire pensions, entire scholarships, family allowances, etc. We do not have too high budget revenues because those who should pay fees and taxes – the private companies – record a free falling. We do not have high budget revenues because the reforms in the pension system, in health, education, infrastructure, etc. are slow. We do not have budget revenues because there are not strong programs which help in creating jobs. Programs which help in attracting the 1.5 million illegal labourers and the two million labourers in agriculture caught in statistics as active population, who does not pay for social contributions. And the most important thing, we do not have budget revenues because the tax evasion is endemic.

Facing the dilemma related to deficits-economic re-launching, Romania proposed itself to implement an austerity budget program in order to provide the sustainability of the public finances.

Romania has the most ambitious program for the fiscal correction in EU, as it makes a comparative analysis between the experiences of the EU countries acquired during the last 30 years regarding the large fiscal adjustments (corrections).

Table 2

Large fiscal adjustments in EU – past experiences

Countries	Adjustment (fiscal correction) period	Years	Cyclically adjusted primary budget balance, per year (in % of the GDP)
Denmark	82-86	4	2.5
Greece	89-94	5	2.2
Sweden	93-98	5	1.8
Ireland	85-89	4	1.5
Portugal	86-92	6	1.4
Italy	89-97	8	1.3
Great Britain	93-99	6	1.2
Finland	92-2000	8	1.0
France	93-97	4	0.9
Belgium	81-90	9	0.9
Austria	95-2001	6	0.8
The Netherlands	90-2000	10	0.4

Source: European Commission (AMECO), 2010.

The analysis made for the above table outlines a series of important things. The first one refers to the fact that the fiscal adjustments last for an average period of six years. The second one refers to the fact that the average adjustment speed (taking into account the decrease of the cyclically adjusted primary budget deficit) is 1.3-1.4% of the GDP, which is an annual average.

The third important thing – the successful fiscal adjustments should be made during a period when there are not deep financial crises in the world, in order to be able to use the export engines and the increase of the direct foreign investments in trying to re-launch economy.

Table 3

Large fiscal adjustments in EU – future experiences

Countries	Cyclically adjusted primary budget balance for 2008 (% of the GDP)	Cyclically adjusted budget balance for 2011 (% of the GDP)	Cyclically adjusted primary budget balance, per year (% of the GDP)
Estonia	-3.9	-0.5	1.1
Greece	-5.0	-2.4	0.9
Hungary	-0.9	+1.1	0.7
The Czech Republic	-3.4	-2.6	0.3
Latvia	-5.8	-5.4	0.1
Romania	*-7.71 IMF (-7.5 EC)*	*-1.9 INF (-4.4 EC)*	*1.9 IMF forecast (1 EC forecast)*

Source: The European Commission, Spring Economic Forecast, 2010. For Romania, the FMI forecast (September 2010) and the EC forecast (April 2010).

The forecasts for the cyclically adjusted primary budget balance for the next years confirm the toughness of Romania's austerity program. From the European Commission's spring economic forecast, we have selected the countries which have a low sustainability of the public finances (a high structural deficit) and which have the experience of the austerity packs. As they do not have sufficient fiscal space, the measures for the economic re-launching are rather pale.

However, it is obvious that two scenarios may happen:

1. The austerity program will be successful. We will have a better position on a medium term from a macroeconomic point of view, only if the program is accompanied by strong measures for increasing the budget revenues and by well elaborated structural reforms.
2. The program will not be successful. The speed of the fiscal correction is too high. The measures are too tough for the Romanian business environment and for the Romanian citizens. The social risk gets deeply increased and we pass from a shock therapy to a gradual one. We extend the fiscal adjustment (consolidation) on a medium term, as we can see from the experience of the last 30 years in EU.

Moreover, the program can provide errors due to the uncertainty existing in the entire world.

What we have to learn from this crisis

There are many lessons that we can be aware of this crisis.

The first is that to have macroeconomic stability must macroeconomic policies – monetary and fiscal – are characterized by prudence, consistency and credibility. Macroeconomic volatility reduction can only be achieved by setting up financial reserves in Treasury and adequacy of international reserves of the central bank at a level above defined thresholds of sustainability .

The second lesson is related to the definition and implementation of monetary policy effective macro-prudential policy.

The third lesson is related to immunization economy so that the negative effects of future crises to be marginal. In addition, we believe in the necessity of applying equitable adjustment program.

Aknowledgement

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