The Romanian economy - four years after the EU accession

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Abstract

The first four years of Romania's membership confirmed that the accession to the EU had, overall, positive effects on the economy. Although the pace of structural reforms had slowed down after 2007, they picked up again after the start of financial crisis, at the end of 2008. Households' wealth and purchasing power have increased despite the recent drop over the last two years. Looking ahead, Romania's economy will need to enhance its competitiveness and pursue a growth model which would make it less dependent on external shocks. Economic strategies leading to both physical and human capital accumulation would need to be clearly defined and supported by all political parties. With monetary policy aimed at maintaining price stability, fiscal policy would have a defining role in preserving and enhancing competitiveness. The pursuance of sound fiscal and monetary policies would be paramount in achieving sustained growth in the years to come.

Keywords: Romania, EU convergence, monetary and fiscal policy

JEL Classification: E20, E50, E61, E62

1. Introduction

On January 1, 2007 Romania joined the European Union (EU), seven years after it had started accession talks. Romania's EU membership yielded quite a few benefits as deeper integration of product, labour and money markets led to increased wealth and capital accumulation. On the other hand, some decisions such as the required full liberalisation of capital account facilitated the build-up of disequilibria in domestic asset markets during the post EU accession years. Daianu et al (2004), among others, drew attention to the risks such an action carried and suggested a more gradual approach towards capital account

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liberalisation[1]. Therefore, assessing the exact benefits and costs of the EU accession taking the accession date as a reference point, would prove to be misleading for at least two reasons. First, important policy decisions were made prior to Romania's accession to the EU[2]. These policies had a deep impact on the subsequent evolution of the economy, in the medium term. Second, any inferences drawn are likely to be distorted due to the effects of the current global financial crisis. The width and breadth of the current crisis are large enough, compared to historical standards, to render any conclusions on the EU accession benefits biased. It is for these reasons that, when it comes to comparing the evolution of macro variables, the analysis considers a larger time span, and looks at the 2003-2010 period[3].

The literature addressing Romania's performance after EU accession is rather limited. There are regular reports on international institutions such as the European Commission (EC) or the International Monetary Fund (IMF) which present latest developments[4]. A few analyses such as Pauwels (2009) offer a macroeconomic view but they are primarily based on data prior to the EU accession. There are several studies which focus on specific sectors or the evolution of specific variables over a time period.

The individual sections in the paper address issues related to general macroeconomic aspects and the economic policies pursued[5]. The paper is structured as follows. The next section looks at the general economic conditions in Romania. Section 3 and 4 address the issues of fiscal and monetary policy respectively. Finally, section 5 highlights some challenges and opportunities ahead.

2. General economic conditions

The last economic growth cycle started a few years prior to Romania's EU accession, in 2001, and was based primarily on consumption and construction-oriented investments, mostly in the residential sector. As Graph 1 below shows,

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[1] Some important preconditions for a full capital account liberalisation were missing. Among these were the incomplete restructuring of the financial system, the insufficient level of macroeconomic stability and the absence of a fully operational antitrust policy.

[2] Besides the decision to fully liberalise the capital account there was the introduction of flat tax in 2005.

[3] Thus it includes periods of similar length of four years on either side of the accession date.

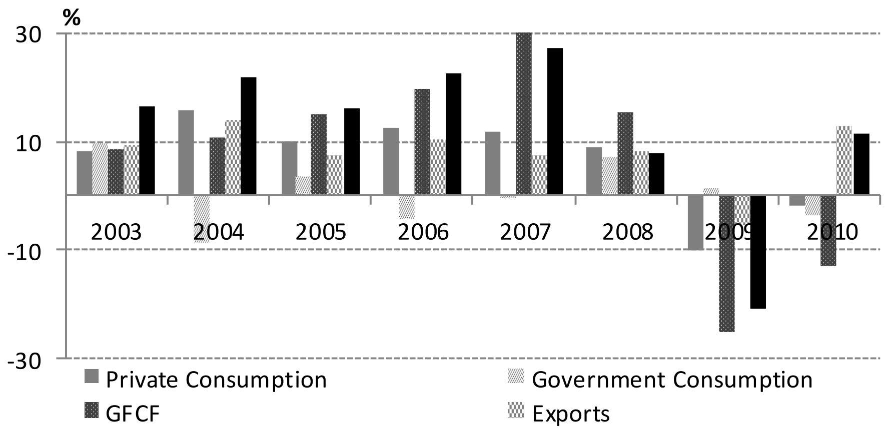
[4] See for instance IMF(2008), IMF(2011) or EC(2010), EC(2009), EC(2010a).

[5] There are other dimensions of the EU membership such as the impact on migration, education, agriculture, and infrastructure or in the area of freedom, security and justice as well as the influence on decision-making procedure and the EU policy and legal acts within European institutions. These aspects, while extremely important, do not make the object of the current analysis.

the increase in domestic consumption was the main engine of growth up until 2008. Household investments in both durable goods and housing rose fast after 2003 as the share of these in households' total wealth was low. The increase in demand for durable goods and housing was facilitated by increased credit availability and rising purchasing power.

The boom continued until the autumn of 2008, when the effects of the global economic downturn, triggered by the 2007 US subprime crisis, impacted negatively on Romania's economic growth. Large existing macroeconomic imbalances were penalised by investors as global liquidity dried up and uncertainty rose sharply in the world financial markets. International credit rating agencies reacted, with two of the main three agencies, Standard & Poor's and Fitch, downgrading Romania's rating to non-investment grade status.

Graph 1. GDP demand components, annual real - % change

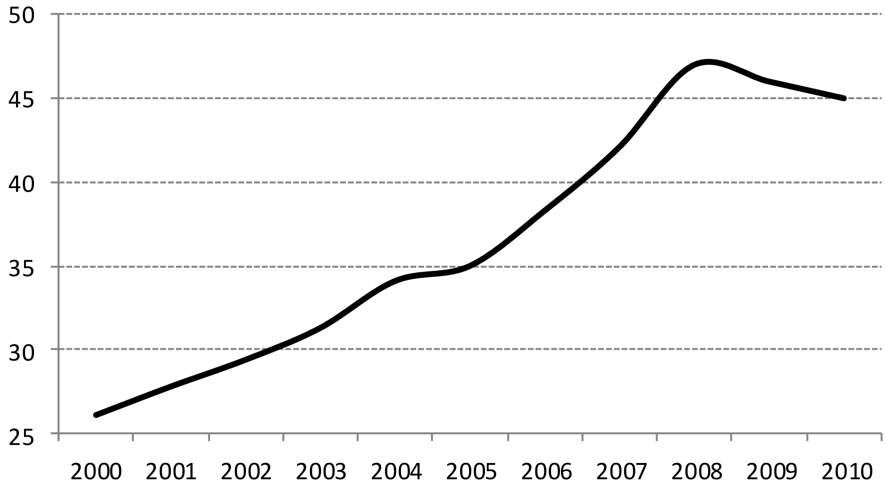


Source: Eurostat

Even so, Romania's GDP/capita, expressed in PPS terms, has grown relatively fast. It rose from 26.1% of EU-27 in year 2000, when Romania started EU accession talks to 38.3% at the end of 2006, prior to the country entering the EU, reached a peak of 47% in 2008 before falling slightly to 45% of EU-27 in 2010 (see Graph 2). The rise in GDP/capita is in line with the economic convergence theory whereby countries with lower incomes would benefit from the EU accession via increased productivity.

The increase in purchasing power is consistent with economic theories of growth whereby in an economic area with free movement of capital and labour, income should tend to converge across member countries. In Romania, however, average wage in the economy rose at a pace much faster than justified by inflation and productivity developments both during the pre-accession and the membership period. Nominal net wage increased from EUR 245 at the end of 2006 to EUR 334 at the end of 2010 although over the last three years it actually fell slightly.

Graph 2. Romania, GDP/capita in PPS, EU-27=100



Source: Eurostat

Strong wage rises, an increased volume of remittances and a rapid expansion of non-governmental domestic credit pushed private consumption on an unsustainable path, leading to an overheated economy. In fact, excess demand accelerated sharply even after 2004, when Romania's EU accession become a certainty, going into double digits and reaching a peak of 15.7% of the GDP in the first quarter of 2008. This dynamic was also helped by the introduction of the 16% flat tax on income and company's profits back in 2005. In retrospect, this had the negative downside of operating pro-cyclically.

Table 1 below provides an overview of the behaviour of selected macroeconomic variables for the chosen period. As it can be seen, GDP growth rose much faster in the four years leading to accession, averaging 6.4% annually, than during the membership period, when it rose by an yearly average of just 1.2%. While the latest result is clearly influenced by the effects of the crisis it also highlights the diminished capacity of the Romanian economy to absorb external shocks.

Table 1. Selected macroeconomic indicators, Romania 2003-2010

	2003	2004	2005	2006	2007	2008	2009	2010	Avg. 2003-2006	Avg. 2007-2010
GDP Growth,%	5.2	8.4	4.2	7.9	6.0	7.3	-7.1	-1.3	6.4	1.2
Consumption Growth,%	8.3	11.2	9.7	10.1	10.3	8.7	-7.8	-2.1	9.8	2.3
Savings Rate,% of GDP	16	13.9	16.5	16.1	17.3	19.7	21.1	22.3	15.6	20.1
Investment Rate, % of GDP	24.6	25.3	26.3	27.3	30.1	31.3	25.3	26.5	25.9	28.3
Nominal Net Wage Growth,%	25.4	22.5	23.7	16.8	21.0	22.9	7.7	1.8	22.1	13.4
Real Credit Growth,%	47.5	23.1	34.3	47.4	50.3	24.0	-4.5	-1.3	38.1	17.1
Inflation, Avg.,%	15.4	12.0	9.1	6.7	4.8	7.9	5.6	6.1	10.8	6.1
Unemployment rate, %,eop, ILO	8.5	8	6.7	7	6.2	5.8	7.5	7.3	7.6	6.7
C/A Deficit, % of GDP	-6.2	-7.6	-8.9	-10.4	-13.9	-11.6	-4.2	-4.1	-8.3	-8.5
Trade Balance, % of GDP	-7.5	-8.7	-9.9	-12	-14.6	-13.7	-5.8	-4.9	-9.5	-9.8

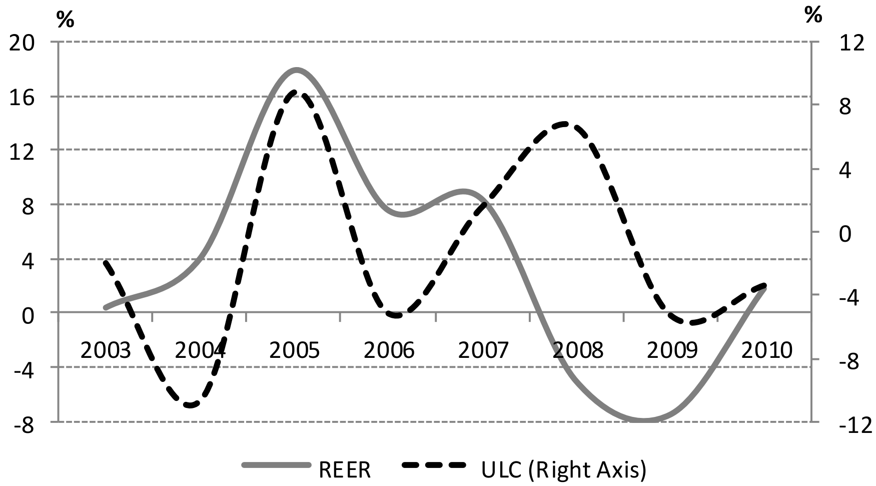
Source: IMF various Country Reports, NBR and Author's Calculations

Ever since Romania acquired the status of a functioning market economy, prior to 2007, the pace of structural reforms slowed down[6] visibly. This, in turn, weakened considerably the economy's ability to build productive capacities able to compete internationally. Although investment rates actually rose during the membership period, averaging 28.3% of GDP, a large part of these were directed towards non-productive areas such as residential sector construction. This, together with private consumption were the main engines of growth until the end of 2008, when a collapse in both led to an abrupt fall in economic growth. Except for the last two years, nominal wage growth was far above its sustainable trend value. Real wage growth[7] was rising at an average of 11.3% annually during the pre-accession period and slowed down to 7.3% during the membership period. Unemployment[8] had been on a downward trend until the crisis effects were felt in the economy, in 2009. The fall in unemployment rate together with higher migration put an upward pressure on real wages[9]. This trend was reversed after 2009 when jobs, in Romania and across Europe, became

[6] As acknowledged by the IMF and EU country reports.
[7] Computed here as nominal wage growth less CPI inflation.
[8] As measured by International Labour Organisation (ILO) standards.
[9] Although real wage growth has been high in most non-member states, it was more so in Romania over the last years – see for instance Christou (2007).

scarce. And, as it can be seen from Table 1, the latest result was particularly influenced by the crisis years when real wage[10] growth turned even negative[11]. This has helped the economy to regain some of the competitiveness[12] it lost during the first two years of EU membership[13] (see Graph 3 below).

Graph 3. Competitiveness, REER and ULC, annual change,%



Source: IMF and Eurostat

Using the Real Effective Exchange Rate (REER) approach, Romania's competitiveness yields slightly different results. Based on this, the appreciation of REER during the pre-accession period continued throughout the first year of the EU membership. These losses were partially reversed in 2008 and 2009. However, the REER approach has its drawbacks as, at times, the NBR intervened in the foreign exchange markets to stabilise the RON/EUR rate. According to Vitek (2011), the assessment of REER at the end of 2010 does not seem to suggest significant exchange rate misalignment. The three

[10] Here real wages were calculated using the CPI. Bosworth et al. (1994) and Feldstein (2008) show that the choice of deflator as price deflator for real wages and productivity allows consistency in the data. They suggest that the GDP deflator is the correct price to be used in the construction of real wages. However, the choice of a deflator is unlikely to change much the inferences made here as the trend is the same in both cases.

[11] This occurred due to a fall in demand for labour as well as the increase in inflation, mainly due to the VAT raise in July 2010.

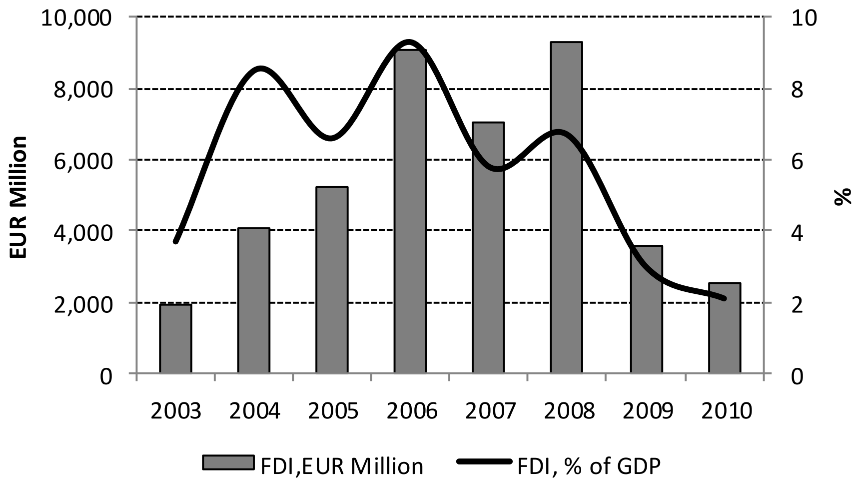
[12] Using the Unit Labour Cost (ULC) approach.

[13] Grafe and Wyplosz (1997) show that transition countries generally started convergence from drastically undervalued real exchange rate levels.

methodologies employed[14] yield estimated ranging from undervaluation of -0.1% to overvaluation of 5.2%.

Romania's attractiveness as a destination of capital flows is clearly visible during the pre-accession years (see Graph 4 below). FDI amounted to an annual average of 7% of GDP during the pre-accession period and only 4.4% of GDP between 2007 and 2010.

Graph 4. FDI in Romania over the 2003-2010 period



Source: Author's calculation using NBR data

However, in nominal terms, over the four years, annual average FDI was slightly higher after Romania gained EU membership, EUR 5.6 bn. versus EUR 5.1 bn. during the pre-accession period; this in spite of the fact that the privatisation receipts were overall lower after 2007.

The consumption boom and the appreciation of the RON against the EUR between 2004 and 2007 exacerbated disequilibria of both internal and external balances. The C/A deficit reached a peak of 13.9% of GDP at the end of 2007 and, apart from being on an unsustainable path, was clearly exposed to a reversal of capital flows. (Similarly, the cyclically adjusted budget deficit widened continuously over the same period – see next section). Thus, the emergence of the crisis found the Romanian economy in a difficult position for rolling over debt and forced the authorities to resort to IMF's help to secure the necessary funds for financing current account and budgetary needs. The 2-year Stand-By

[14] The macroeconomic balance approach, equilibrium real exchange rate regressions and the external sustainability approach which stabilises NFA at -66% of GDP.

Agreement (SBA) worth EUR 12.9 bn[15], signed in May 2009 was subsequently extended for another two years[16], until the spring of 2013. The objectives of the SBA were three-fold: first, to smooth out the effects of the sharp drop in private capital inflows. Second, to mitigate pressures brought about by both external and fiscal imbalances while strengthening the financial sector. And third, to ease pressures on the exchange rate which could have caused major balance sheet effects on the corporate and household sectors, which would have deepened the recession and imposed additional strains on the banking sector.

The criteria set out in the agreements envisaged the adoption of structural reforms aimed at sorting out budgetary imbalances and ensuring the long-term sustainability of public finances. The adoption of the fiscal responsibility law brought about a more disciplined way of pursuing fiscal policy while limiting public sector wage increases. There are other reforms which are currently under way, namely sorting out the arrears of central and local governments, reforming the health care system, restructuring ANAF[17], and implementing structural reforms in the domestic energy sector through privatisations, management change and energy price liberalisation.

Overall, the IMF agreements proved to be beneficial for the economy[18]. They enhanced Romania's credibility abroad and provided a timely framework for implementing a coherent programme of macroeconomic policies. The latter was an important element in reducing macroeconomic imbalances as Romanian political parties generally lacked the necessary economic knowledge and vision to deal with these aspects in the midst of the crisis.

The macroeconomic picture is an outcome of the economic policies undertaken over the last years. The next two sections highlight the relevant changes in fiscal and monetary policy respectively and comment on their implications on the economy.

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[15] The IMF support has been coordinated with that of the EU and the World Bank, bringing the total amount available to Romania to EUR 19.5 Bn.

[16] As a Precautionary SBA worth EUR 3.6 Bn. in conjunction with additional EUR 1.8 Bn. support from EU and the World Bank.

[17] Agentia Nationala de Administrare Fiscala (The National Agency of Fiscal Administration) – the institution responsible for tax collection.

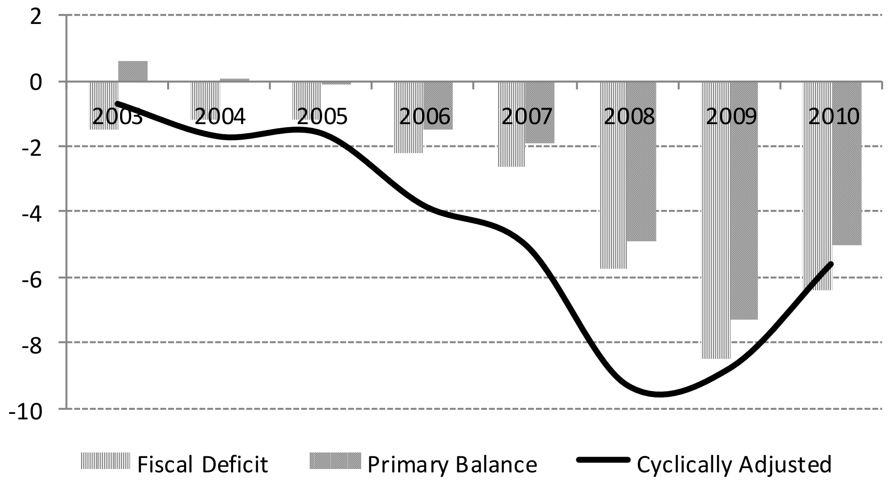
[18] Some views hold that the first IMF programme was controversial as it allowed direct financing of the budgetary deficit. But this exceptional move occurred only once, at a time when the need to roll-over public debt occurred during a period of high tension on international markets. As such, it could be seen as a one-off bridge loan aimed at maintaining public borrowing costs at minimum levels and thus aiding government's efforts in achieving fiscal consolidation.

3. Fiscal policy, from a pro-cyclical to a contractionary stance

Prior to the EU accession, the obligation to fulfil the Maastricht criteria disciplined government spending. Back in 2003, the authorities were even running a primary balance surplus. At the end of 2006, the general government budget recorded a -2.2% deficit, but even this low figure provided a distorted picture on the state of public finances due to the fact that the economic growth was above its potential. The cyclically adjusted deficit was already running at -3.8% and was about to embark on a rising trend in the years ahead (see Graph 5 below). It reached a peak of -9.3% of GDP in 2008 before falling to -5.6% in 2010, after serious budget cuts, implemented as a part of the IMF conditionality, forced the deficit down.

Even though fiscal policy was more disciplined prior to EU accession, it lacked a clear long-term strategy which would address the fiscal imbalances built up over time. The financial crisis has provided an opportunity to address these issues and, although several steps forward have been made, there is more to be done if the probability of fiscal slippages is to be reduced in the future.

Graph 5. General government deficit, % of GDP



Source: European Commission and Ministry of Finance

There were four main causes which led to the present situation. First, between 2005 and 2008 fiscal policy was notoriously **pro-cyclical,** the budget deficit widened as the economy was growing above potential. With government revenues boosted by an overheated economy, government spending rose in areas which were less productive, especially public sector wages[19] and consumption.

Second, p**olitical business cycle** played a very important role in deepening the budget deficit. Prior to Parliamentary elections in the autumn of 2008, government overspent an estimated 2.3% of GDP, pushing the deficit above its 3.1% target[20]. Subsequently, the financing needs necessary to cover this gap were added to those caused by the fall in government revenues due to the slowdown in economic growth. Together, they imposed a massive fiscal adjustment during both 2009 and 2010[21]. Third, there was a **lack of foresight** from the authorities. Fiscal profligacy is a characteristic of governments which have a poor foresight. As it is often the case in emerging and transition economies, fiscal policies adopted in favourable times appear to be implemented with a view that positive shocks are permanent[22]. Attention to cyclical adjusted budget deficits was overlooked by Romanian authorities. Moreover, once the economic sentiment turned around, the emerging gap in fiscal finances posed daunting adjustment efforts. Fourth, the successive **increases in pension point** pushed pensions spending beyond the level affordable in the long term. The sustained increases in public pensions point were the trigger which precipitated the public sector pension's crisis. Between 2006 and 2009, the pension point more than trebled in *real terms*. Such an outstanding increase in relative terms cannot be sustained unless exceptional productivity increases make such pay-outs possible – an improbable scenario, given the magnitude of the increases required[23].

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[19] For instance, between 2000 and 2008, in a period when European GDP was positive and on a slight upward trend, Romania was the only country in Europe which increased significantly its share of wage expenditure (in total government expenditure), from 21% in 2000 to 27% in 2008.

[20] In fact, 'political business cycles' have been the norm in Romania over the last two decades. According to Nordhaus' (1975) original model of the 'political business cycle', politicians stimulate aggregate demand before elections to increase growth and reduce unemployment, in order to maximize their popularity and the likelihood of their re-election.

[21] Fiscal policy became contractionary in 2009 when government spending, especially public sector wage costs, was cut. Tax increases followed in 2010, with VAT going up by 5 percentage points to 24%.

[22] Inflated revenue forecasts were used as a way to artificially create margins for higher spending increases.

See for instance Milesi-Feretti and Moriyama (2004). Overly favourable growth and revenue assumptions help opportunistic governments to avoid the political cost associated with the implementation of consolidation measures.

[23] The financing of pension expenditures have been made more difficult by the pension reform, initiated a few years ago, which requires an increased share of total social security contributions to flow into private pensions funds in the years to come.

While the budget deficit pictures a snapshot of government's solvency, the path of public debt offers a long-term perspective of the sustainability of public finances. In the long term a country is perceived as being solvent as long as the rate of growth on public debt remains lower that the interest rate.

Otherwise, public debt will be growing fast up to a point where the government will fail to find a buyer for any yield it would be willing to offer on its debt. Until the end of 2006 this condition was largely fulfilled in Romania. However, in the subsequent years the growth rate of public debt rose dramatically. Starting from 2007, the annual rate of growth of public debt rose from 30% to 35% in 2009, before falling to 31% in 2010. These rates were far above the interest rate prevailing at the time. Moreover, the funds borrowed were extensively used to cover current expenditure, i.e. pensions, wages and government consumption and to a far less extent they were aimed at capital expenditure. It is clear that such a policy cannot continue without having a destabilising effect on public finances in the future. The adoption of Fiscal Responsibility Law in 2010[24] was aimed at making fiscal policy more forward-looking while increasing transparency[25]. But, containing the budget deficit and reducing the public sector debt on a sustainable basis would require the implementation of more structural changes in the economy.

4. Monetary policy, between inflation and exchange rate stability

Even before Romania's EU accession the task of monetary policy was not an easy one. As a precondition to joining the EU, Romania had to liberalise its capital account, a move which, in retrospect, should have been prepared more thoroughly[26]. The ensuing inflows of foreign capital into an economy with a low level of financial deepening[27] prevented an optimal response from the monetary authorities. And, the resulting appreciation of the domestic currency led to the accumulation of disequilibria in both asset and labour markets.

There can be identified several distinct moments which were illustrative for the way monetary policy was conducted. First, during the pre-accession

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[24] Law 69/2010, available at: http://codfiscal.money.ro/legea-692010-legea-responsabilitatii-fiscal-bugetare/.

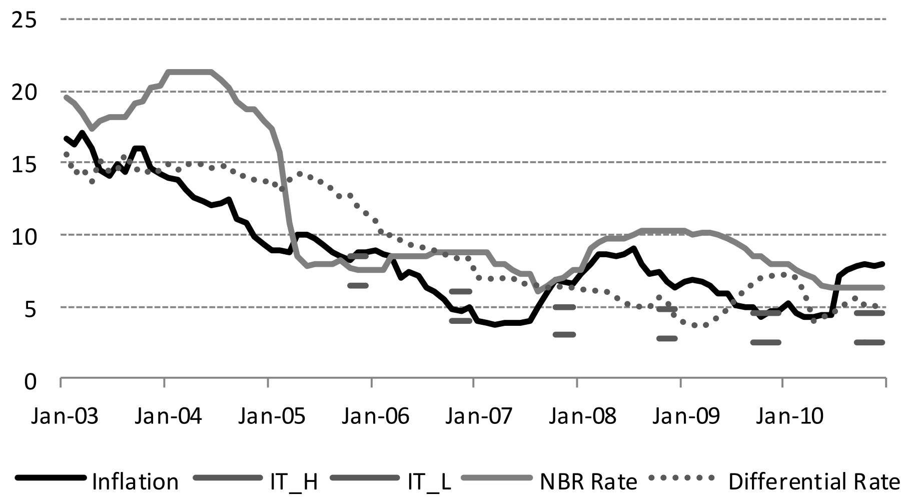
[25] This required setting up a binding medium-term budgetary framework, establish limits on budget revisions during a given year and use fiscal rules to improve budgetary implementation. It also led to the creation of Fiscal Council which provides an independent opinion on the budgetary strategy and processes.

[26] The analysis of the costs entailed by Romanian capital account liberalisation have been very limited. More should have been done at the time by estimating the effects such a decision would have on long term economic growth and development as well as the implications for the financial sector.

[27] Financial deepening, measured as the ratio M3/GDP was 40% at the end of 2010, compared to little over 100% in the euro zone.

period, in August 2005, the National Bank of Romania (NBR) moved towards inflation targeting. This represented a radical departure from the previous policy and entailed the use of new instruments to achieve its objective. Although the inflation targeting policy was more transparent, it also faced a number of challenges, especially at the operational level, as the transmission channel of monetary policy was not functioning optimally. The NBR missed its inflation targets for a number of years (see Graph 6 below) as exchange rate pass-through effects dominated the inflation path.

Graph 6. Annual inflation and interest rates, %



Source: NBR Monthly Bulletins

Monetary base, M0, started to expand more rapidly, growing from 30% at the end of 2004 to over 50% in 2006 as money demand rose. M2 was growing as well, albeit at a slightly tempered pace. During this period, the macroeconomic conditions for rapid domestic credit growth were largely in place[28]. Commercial banks operating in Romania were fighting for market share, thus taking advantage of increasing household demand for borrowing funds. Between 2003 and 2007, the average real wage growth rate outpaced household consumption growth by 1.4%. As a consequence, a higher level of income increased household credit affordability.

[28] One explanation for such a rapid rise in domestic credit growth is the increase in GDP/capita. A higher GDP/capita, associated with increased economic development, usually leads to a higher ratio of credit to GDP.

The second moment refers to the post-accession period when the economy's elevated growth prospects continued to attract high capital inflows. The supply of credit reflected buoyant capital inflows channelled mainly through the banking system[29]. By now, the pace of non-government domestic credit growth reached triggered a response from the NBR, which adopted several measures to try to stem this increase in non governmental credit. In mid 2007 it embarked on a tightening cycle, raising both its benchmark policy rate, from 7.25% in June 2007 to 10.25% by the end of 2008, as well as reserve requirements ratio. Apart from these quantitative measures, the NBR adopted a string of prudential measures aimed at limiting both household debt exposure as well as bank lending[30]. Increasing inflows of foreign capital, driven by high interest rates and potential gains in the property market, led to a continuous appreciation of the RON. This, in turn led to an acceleration of imports, which rose faster than exports, widening the current account deficit to -12.3% at the end of 2008.

There were several risks associated with the existing level of credit expansion. One of them pertained to credit currency composition. With the opening of the capital account in 2004, household preferences started to switch away from RON denominated to foreign exchange denominated loans. At the end of January 2008, the share of borrowing in domestic currency for both firms and households fell to around 45% of total credit. The rapid rise in foreign currency lending to households could have left banks exposed indirectly to the exchange rate risk. This happened because households were, in general, unhedged and Romanian financial markets were relatively shallow. In terms of annual growth rates, household demand for RON-denominated credit seems to have been influenced to some extent by changes in regulatory measures imposed by the NBR.

The third moment involves the NBR's response during the current crisis, starting from the end of 2008. Over this period, the monetary policy proved to be supportive of fiscal needs. Although the National Bank of Romania officially targeted inflation, it also paid a heightened attention to the exchange rate developments – as part of its financial stability objective. During 2009, when government financing needs were high, the NBR reduced its foreign exchange minimum reserve requirements from 40% to 25%. This monetary loosening allowed domestic banks to buy public debt. The NBR's benchmark interest rate was lowered gradually from 10.25% in 2009 to 6.25% at the end of 2010. The growth rate of M0 dropped to zero at the end of 2010, after being in negative

[29] The capital account liberalisation played , undoubtdely, an important part. The effects of global low interest rates, prevailing at the time, exacerbated the inflows of capital which were in search of a higher yield.
[30] For instance NBR (2006).

territory throughout that year. As the demand for credit collapsed the extended measure of money, M2, fell to 6% annually.

The financial sector continued to remain relatively sound although an escalation of the sovereign debt crisis in Europe is likely to have repercussions on the Romanian banks' balance sheets operating in Romania. One of their important advantages however, was that these had little exposure to the so-called toxic assets. The main risk to banks' balance sheets came via non-performing loans and the exchange rate effect, although the latter had been greatly reduced following the BNR's preference for smoothing out fluctuations in exchange rate. The banking system was adequately capitalised during this period, with the NBR supplying the necessary liquidity. Most banks were able to cope with the economic downturn in spite of increasing non-performing loan ratios[31].

Overall, the monetary policy was rather prudent over the latest period. Although the economy was contracting abruptly in 2009, 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 ease their borrowing needs. The prudent approach of monetary policy can also be traced through the evolution of the exchange rate. Although the NBR targets inflation, concerns about large swings in exchange rate made the NBR adopt a pro-active stance, sometimes resorting to foreign exchange market interventions in order to stabilise the exchange rate.

5. Looking ahead: how to improve economic policy

The first four years of Romania's membership confirmed that the economy is still in need of adjustment. The accession to the EU had, overall, positive effects on the economy as the external pressure of international institutions made possible the implementation of economic reforms. Although the pace of these had slowed down after 2007, they picked up again after the start of financial crisis, at the end of 2008. The households' wealth and purchasing power have increased despite the recent drop over the last two years.

Romania's economy will need to enhance its competitiveness and pursue a growth model which would make it less dependent on external shocks. The current crisis highlighted the risk posed by an economy dependent on residential construction and private consumption boom. Economic strategies leading to both physical and human capital accumulation would need to be clearly defined and supported by all political parties. In fact, starting with 2008, there was a

[31] The so-called Vienna Initiative, through which banks pledged to maintain their exposure to Romania (and other transition economies), played an important part in preventing large capital outflows taken place during the crisis period.

deepening lack of communication among the three main political parties[32]. Political fight led to extreme actions which prevented reaching a consensus over general economic policies required to stabilise the economy. Thus, important decisions which could have reduced the fall in output were delayed excessively.

Physical infrastructure, energy and agriculture are only a few sectors which have a large growth potential. With monetary policy aimed at maintaining price stability, fiscal policy would have a defining role in preserving and enhancing competitiveness. The pursuance of sound fiscal and monetary policies would be paramount in achieving sustained growth in the years to come. In this respect, there are several aspects which are worth mentioning.

First, it is well acknowledged that strengthened fiscal institutions can play a key role in support of fiscal consolidation. The credibility of the Ministry of Finance (MF) has been damaged by the actions it took during the crisis. Namely, decisions to raise VAT[33] or cut public sector employees wages were taken hastily, without proper analyses of the implications these would have on the wider economy. Prior to that, the MF introduced in 2009 a minimum tax[34], payable by all business whether or not they made a profit. Again, this was effectively introduced overnight and it proved to be ill-timed, deeply counter-productive and was dropped in 2010.

Romania will need to enhance the formulation and implementation of its fiscal framework, fiscal monitoring and reporting along with spelling out explicitly budgeting practices along with improving government assets and liabilities management. Given the existing imbalances, the necessary fiscal adjustments would have to come primarily from fiscal structural reforms[35]. Although the set up of the Independent Fiscal Council - in charge with monitoring and expressing a view on budgetary developments - was an important step forward in enhancing public sector transparency, there is a need for more efforts in this respect. This could mean the pursuance of a sensible fiscal policy rule that accommodates cyclical fluctuations.

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[32] Political tensions reached a peak prior to November 2008 Presidential elections, in a period when the Romanian economy was starting to feel strongly the effects of the crisis. The Romanian currency, the Leu was under attack a month before and the economy was facing the prospects of capital outflows at a time when it needed to finance large budgetary and current account deficits.

[33] The VAT rise, from 19% to 24%, became effective as July 1, 2010 and was taken a few days before that date.

[34] The government Ordinance OUG 34/2009, available at http://www.dreptonline.ro/legislatie/grila_impozit_forfetar_2010.php

[35] For instance, IMF (2010) lists a series of actions which could be taken such as: reforms aimed at stabilising entitlement-spending-to-GDP ratio; measures to lower other primary spending in relation to GDP; or increased revenue, for instance by broadening tax bases but also tax rate hikes.

Second, the accumulation of knowledge at the level of public sectors decision makers responsible with the policy formulation and implementation would be paramount. This would allow the build up of a solid base of human capital which would inflict more professionalism in the fiscal policy formulation process while allowing more predictability to changes in fiscal policy.

Third, the political cycle of the economy should be avoided. The political business cycle has been the norm over the last two decades. With monetary policy outside government's political control, fiscal policy must be pursued in a multi-annual budgetary framework and avoid being pro-cyclical. This would ensure not only a pursuit of a more transparent and coherent set of co-ordinated economic policies but would prevent the political parties in power from implementing policies that would suit their immediate needs. Fiscal policy must be devised in such a way as to support monetary policy with its inflation targeting objective and also be sustainable in the medium term. Reducing political influence on the decision processes of public sector expenditure programmes is likely to enhance wealth for the average citizen. For instance, there are question marks over the high costs of large infrastructure projects which are often awarded to companies belonging to the political clientele. Such measures would also have large positive spill over effects in the economy, by building trust in public sector policies and allocating capital more efficiently. It will also reduce borrowing costs as increased competition would diminish the associated deadweight costs.

Government's investment plans in sectors relating to health, education and physical infrastructure should be clearly prioritised and planned under a medium-term framework, preferably over five years or more. Under-investment in these sectors would impinge on growth and the quality of life, which would create more incentives for the labour force to migrate. All this should factor in the need to co-finance EU funds and the reform of the public sector pension system. Further reform of public expenditure is a must, for there is still considerable misuse of public resources.

Increasing the absorption rate of EU funds should be a priority for any political party in power. These represent a one-off capital transfer from abroad and could, if used properly, enhance massively both human and physical domestic capital. Romania has the lowest rate of EU absorption funds among the EU accession countries. At mid 2011 Romanian managed to absorb only 3.7% of the total available funds for the 2007-2013 period. The use of these funds could increase economic growth potential of the economy in the long term.

Involving the private sector more in the debate on economic policies would benefit authorities by an increased poll of practical knowledge. For instance, a project initiated by the Foreign Investors Council (FIC) in Romania at the end of

2010[36] outlined several areas of action detailing specific measures aimed at re-launching economic growth. Subsequent cooperation between FIC members and government authorities led to implementations of several proposed measures. Enhancing the dialogue between private and public sector in this way could strengthen the process of decision making by delivering suitable economic policies which would support economic growth.

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[36] The programme listing the priority actions is available at http://www.fic.ro/FIC_engleza.pdf.

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