

# **Revisiting the economic growth model in Romania – some lessons from the crisis**

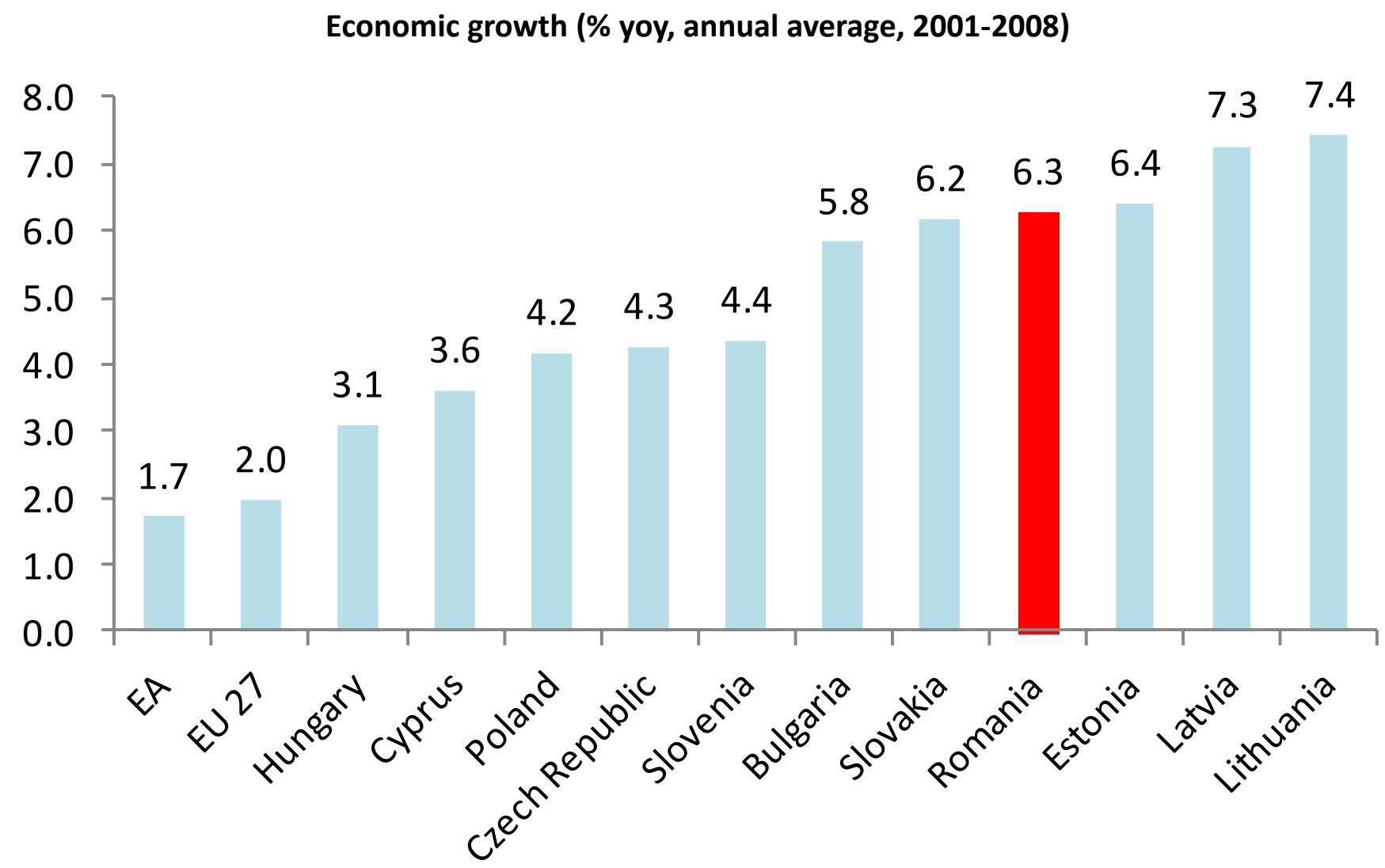
**Ionut Dumitru**

**President of the Fiscal Council and Chief-Economist at Raiffeisen Bank\***

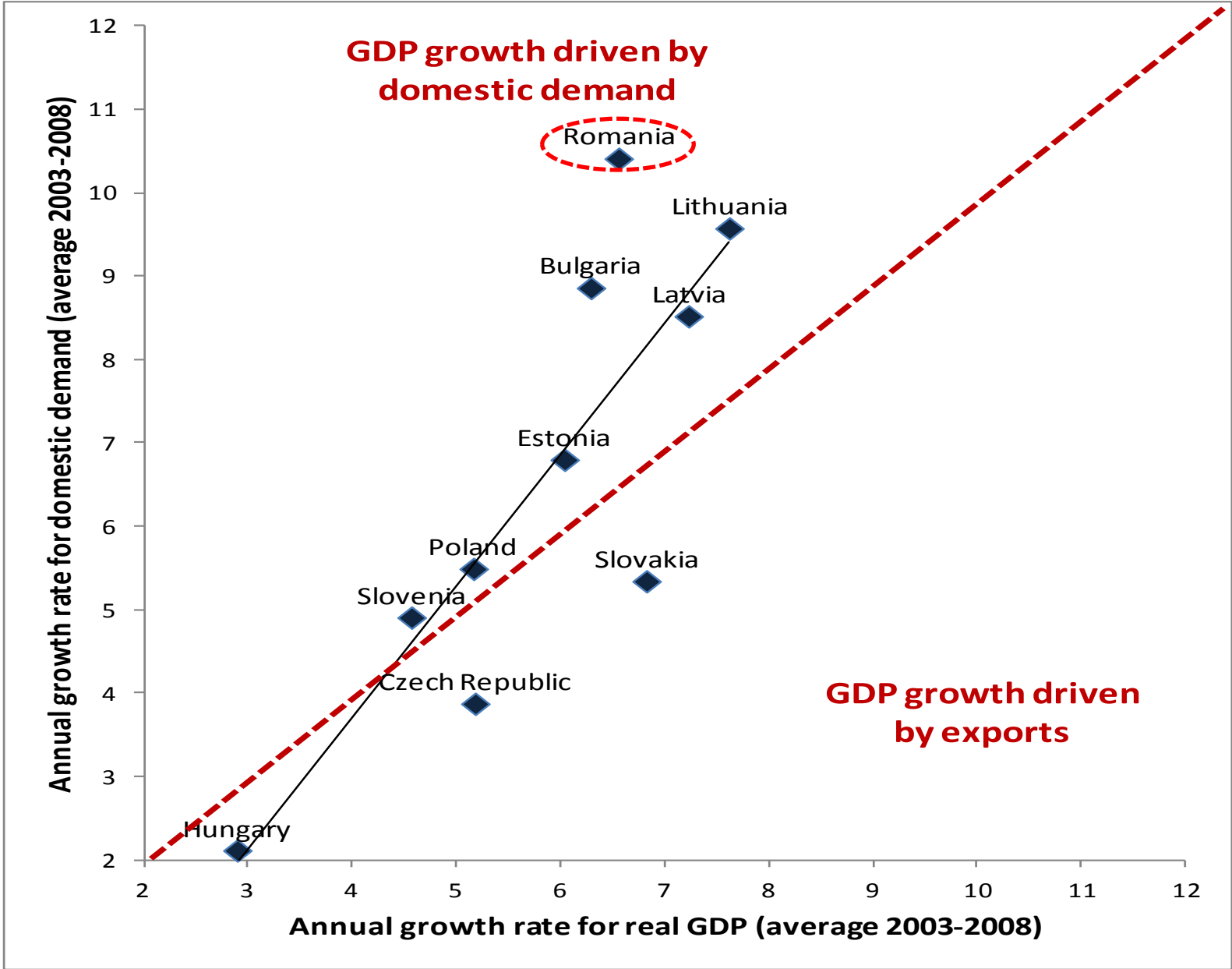
**11 September 2012**

\*The opinions expressed here are those of the author and do not necessarily reflect the positions of the institutions the author is associated with

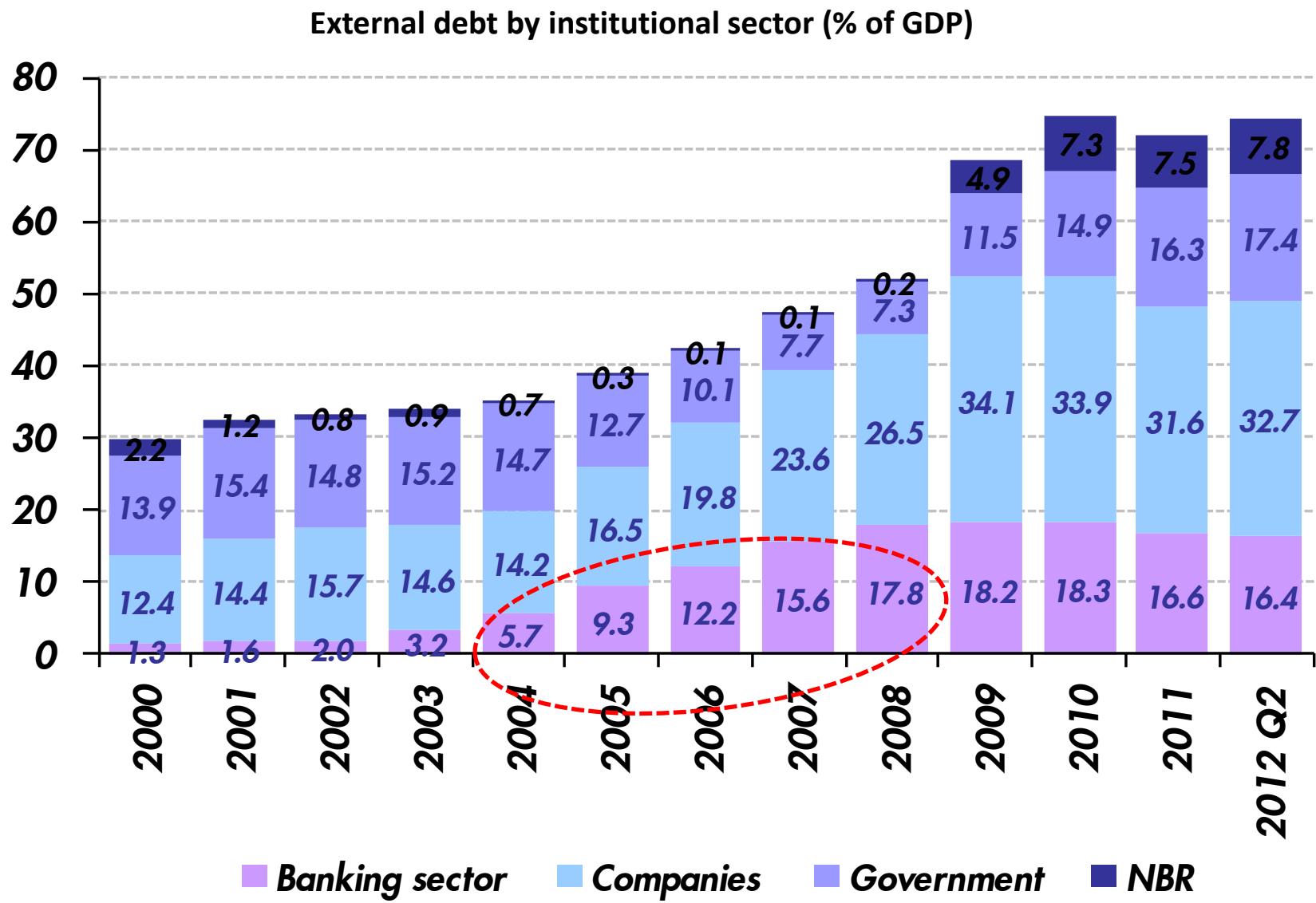
# High growth rate in the pre-crisis period ...



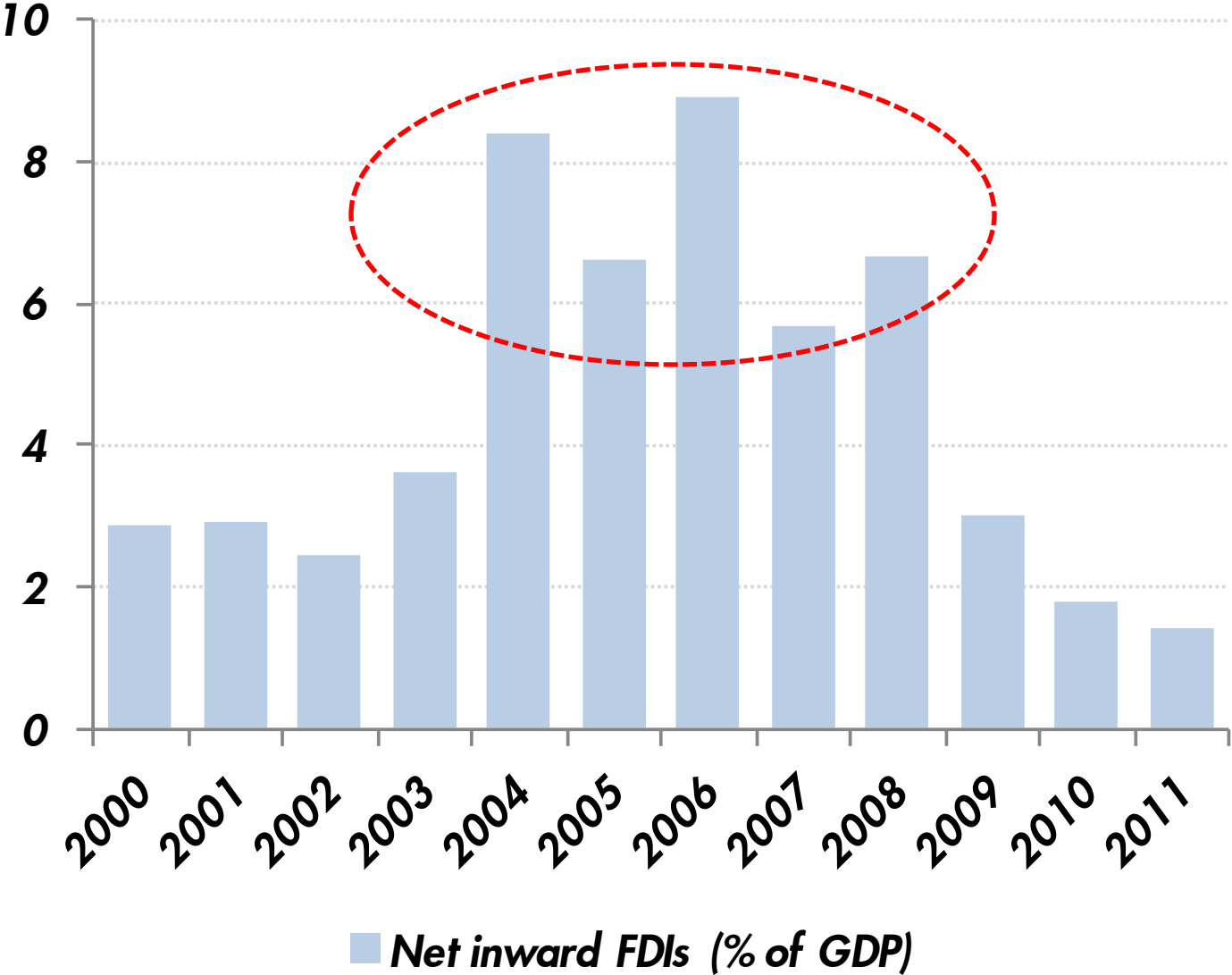
... driven by domestic demand (unbalanced growth)...



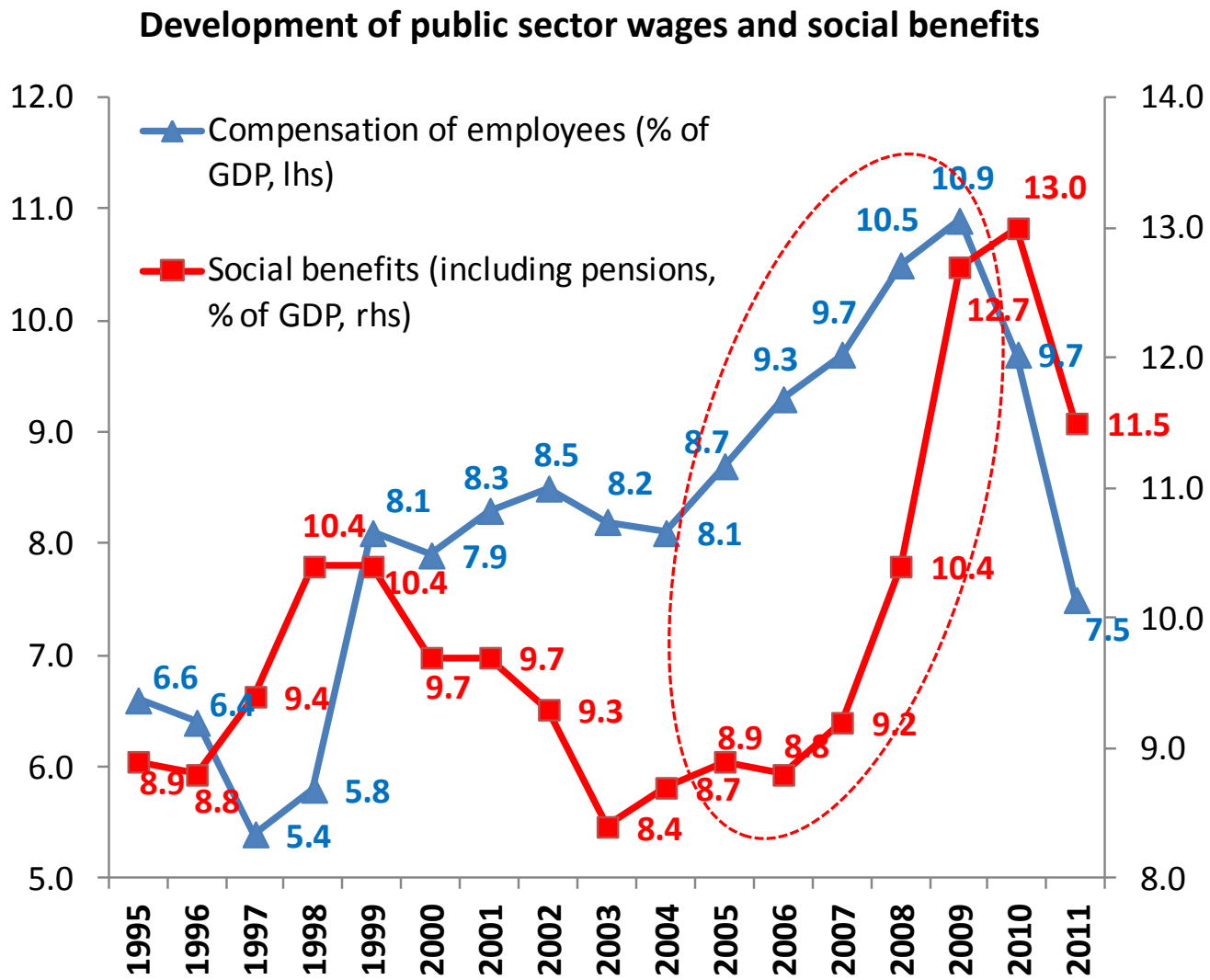
# ... financed by debt-generating capital inflows...



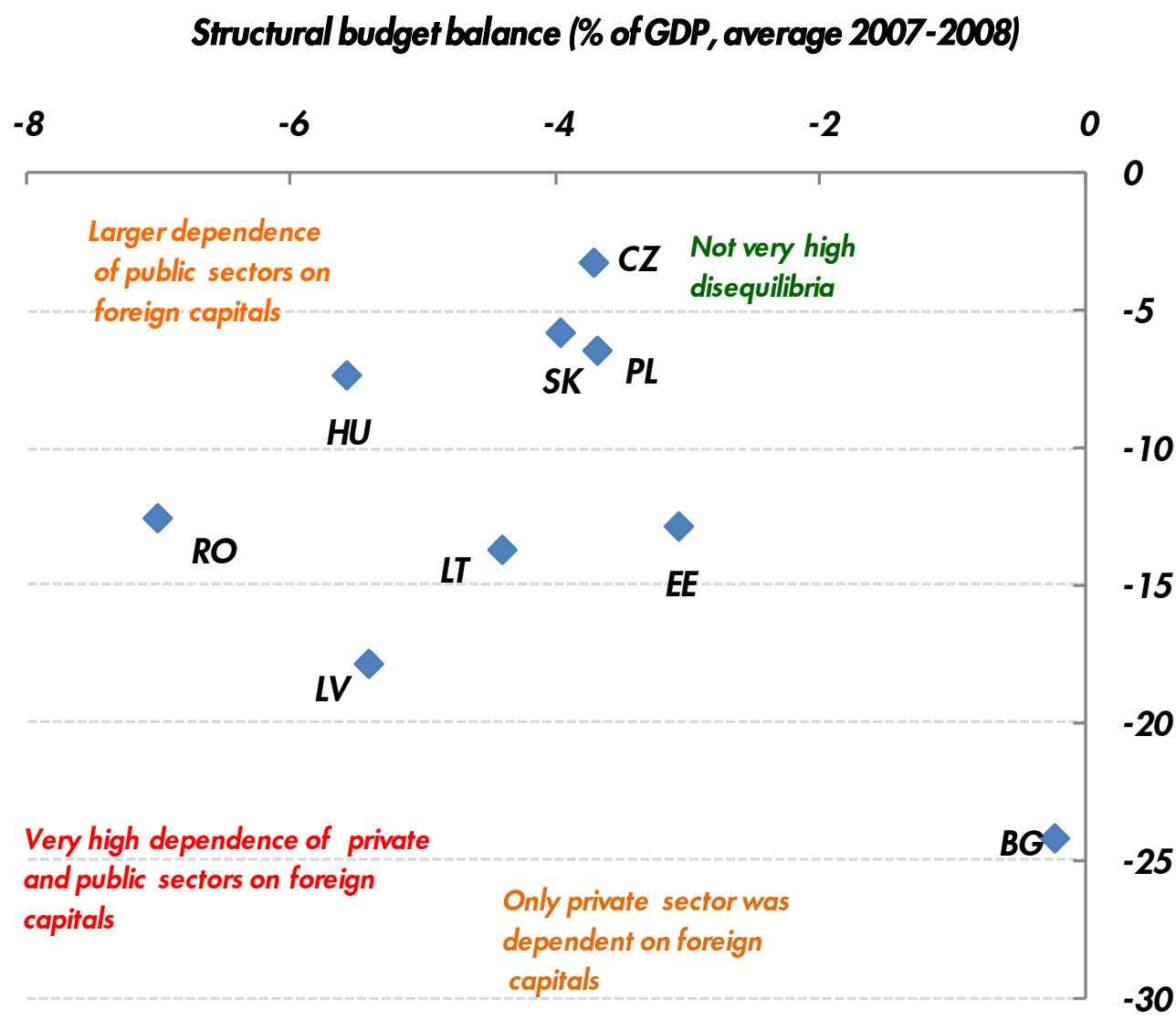
... and FDIs...



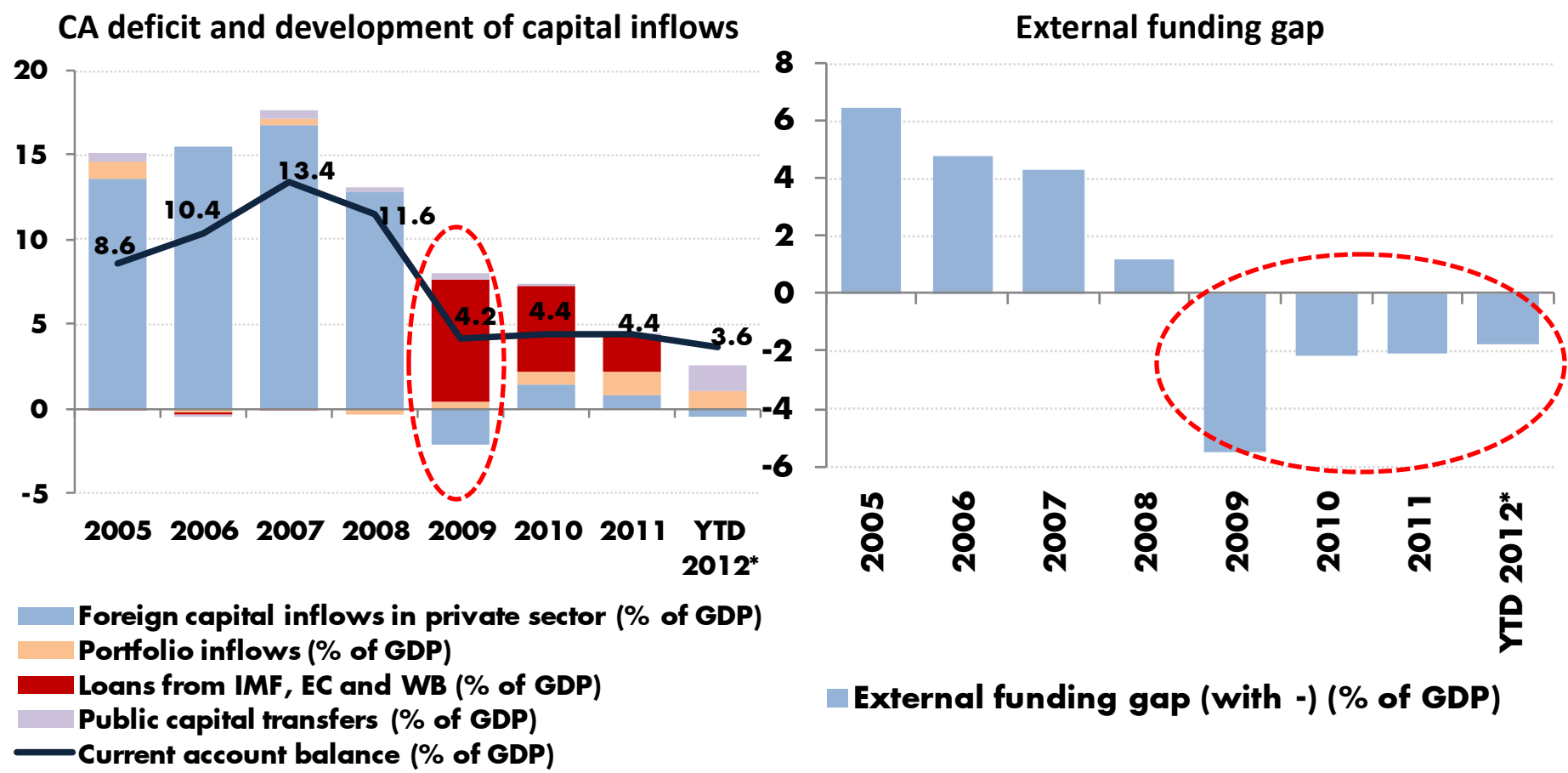
...public expenditures increased very rapidly, fueling the overheating...



...leading to increasing imbalances in the private sector, but also in the public sector



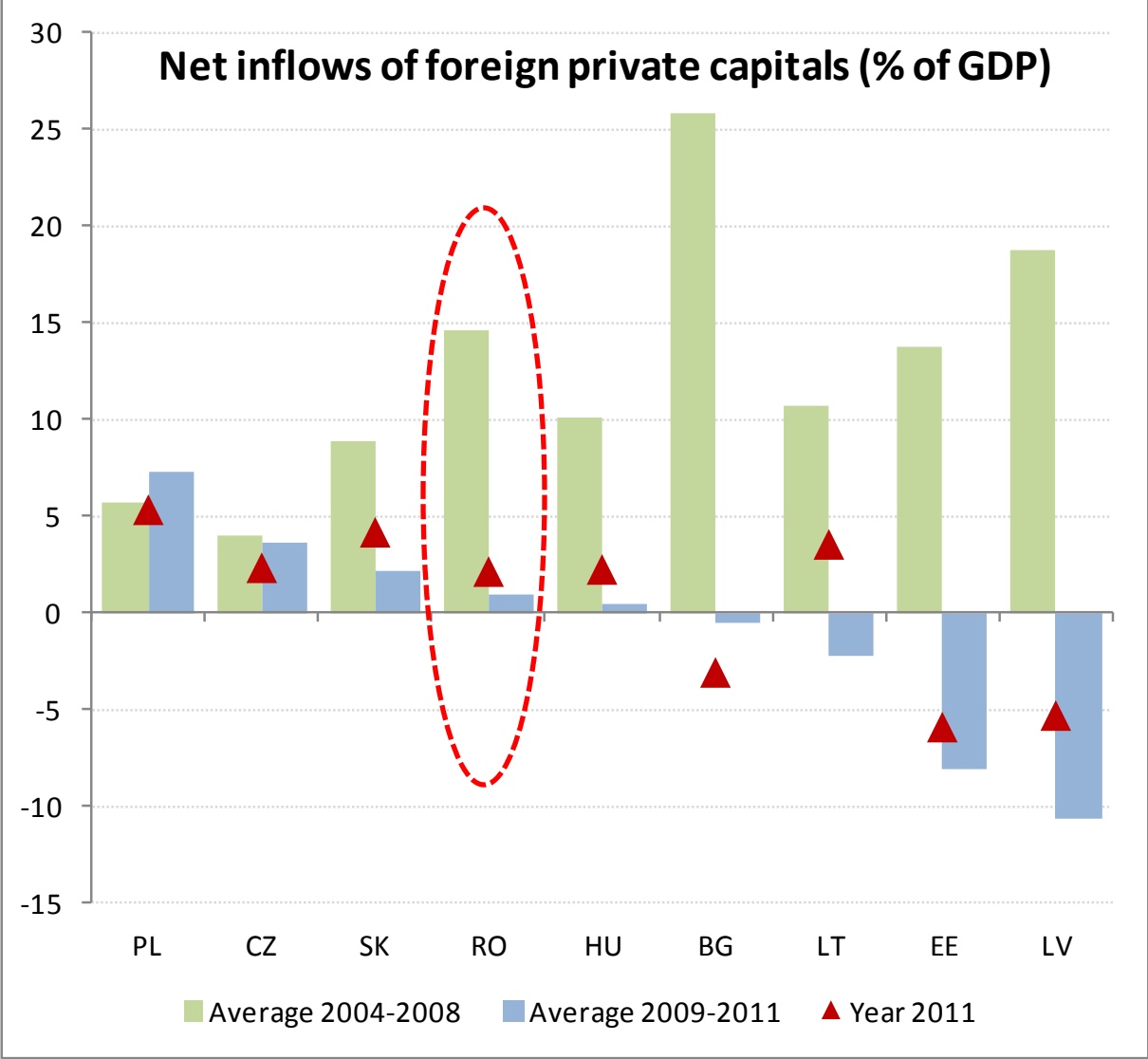
# Sudden stop of private capital inflows in 2009...



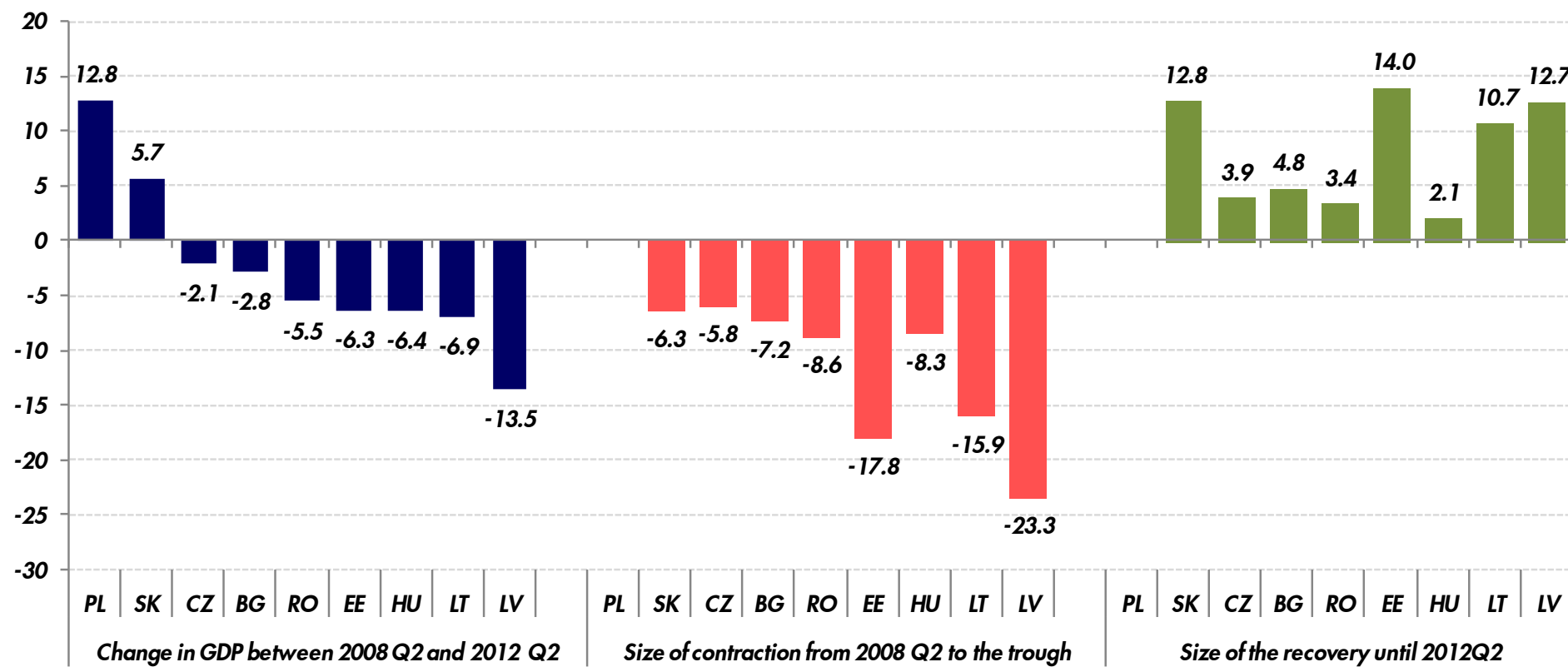
•Jan-Jun 2012  
•Funding gap= CA deficit+net private capital inflows  
•Source: NBR



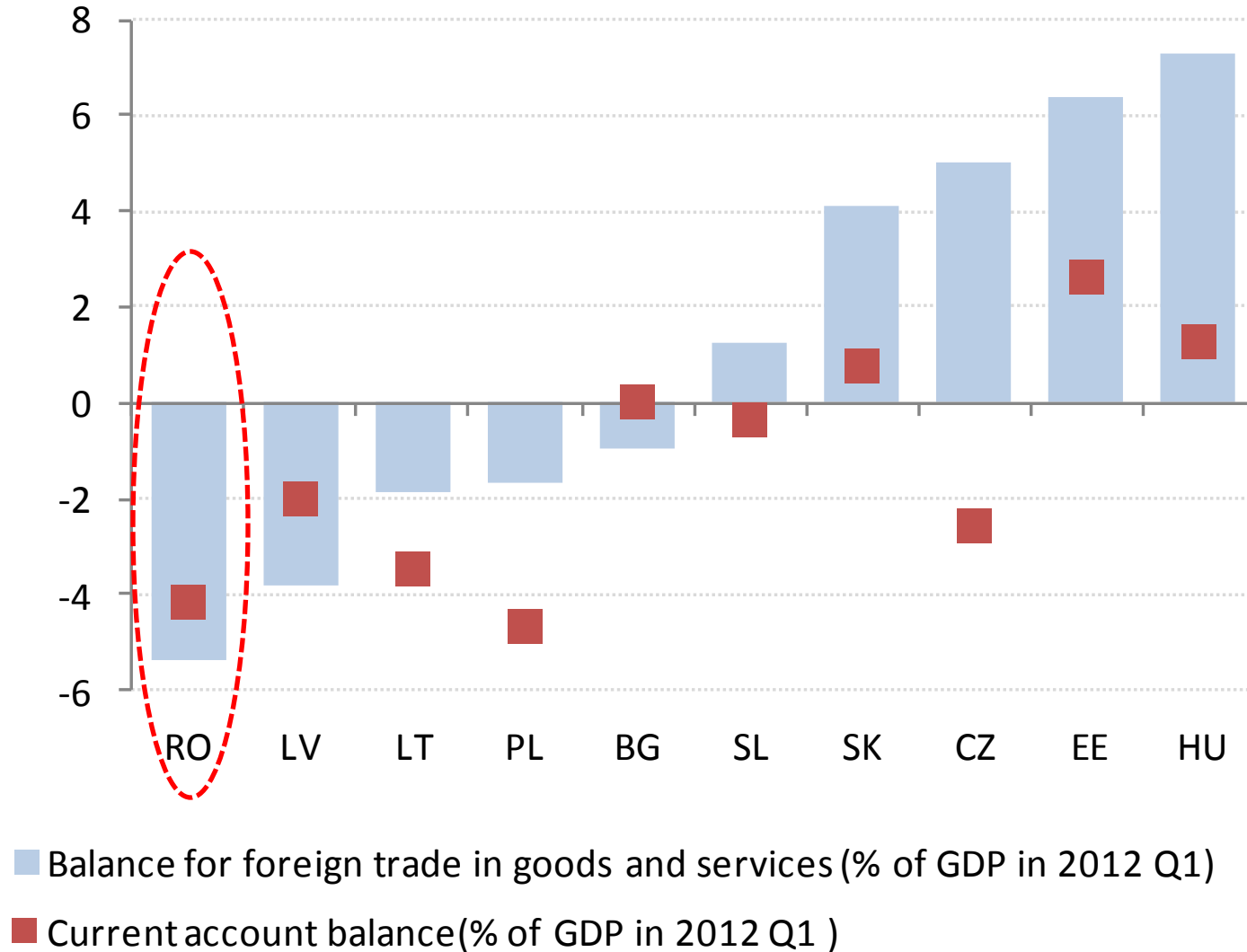
...a similar pattern was recorded in the other CEE countries...



# ...leading to a contraction in economic activity...



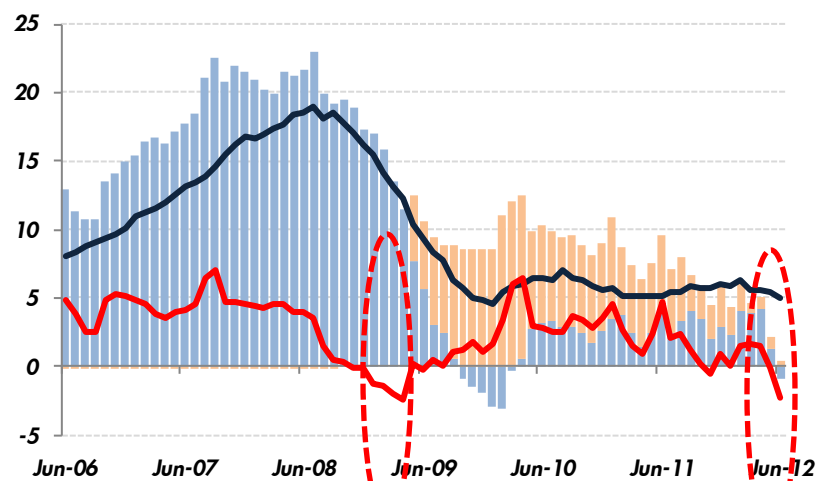
# The CA was adjusted, but the current level is still high compared with other CEE countries...



Note: data cumulated over the last four quarters

Source: EUROSTAT

...being financed during the crisis mainly by the external financing package (IMF/EC/WB) and volatile private capital inflows

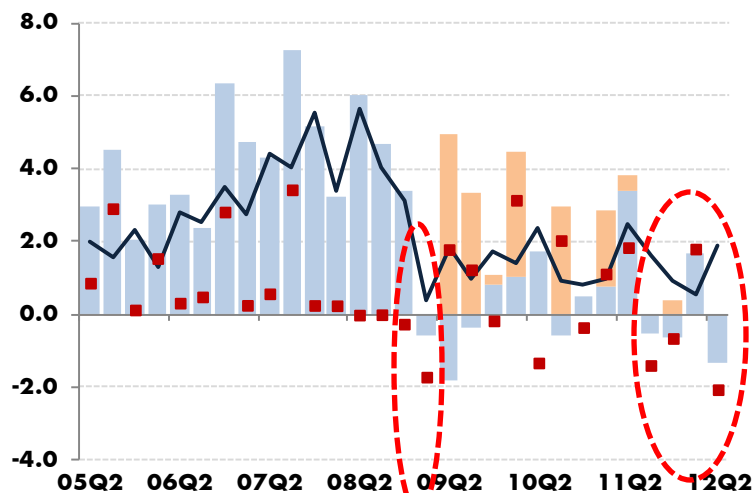


Net inflows of foreign private capitals (EUR bn, over the last 12 months)

Loans from the IMF/EC/WB (EUR bn, over the last 12 months)

Current account deficit (EUR bn, over the last 12 months)

Change in international reserves of NBR (EUR bn, over the last 12 months)

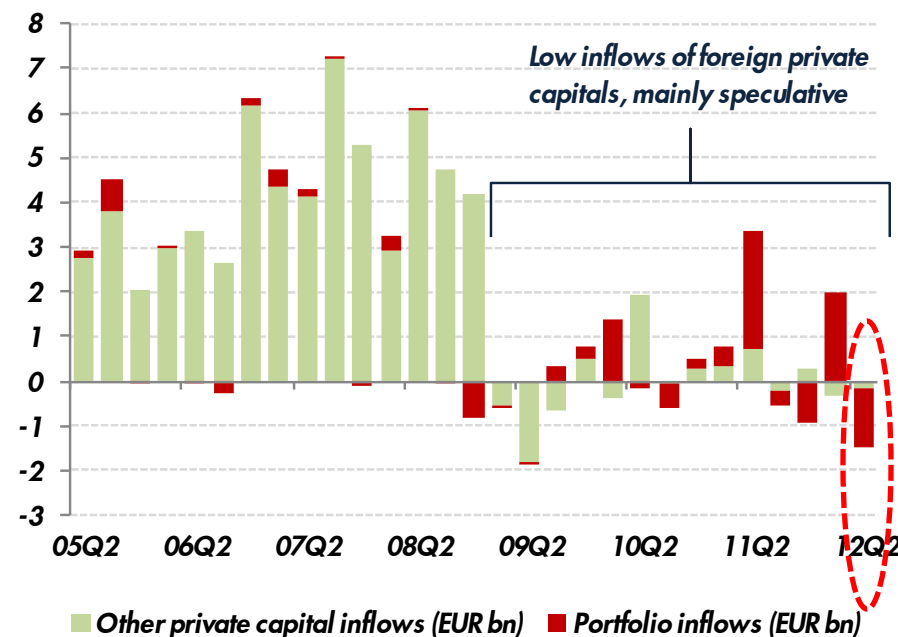


Net inflows of foreign private capitals (EUR bn)

Loans from IMF, EC and WB (EUR bn)

Current account deficit (EUR bn)

Change in international reserves (EUR bn)



Other private capital inflows (EUR bn)

Portfolio inflows (EUR bn)

# Lessons from the crisis

## 1. A new growth agenda is needed

- Pre-crisis growth model looks neither desirable nor possible in the future;
- **Asian style growth (investing only the local savings) or the capital inflows will resume?**

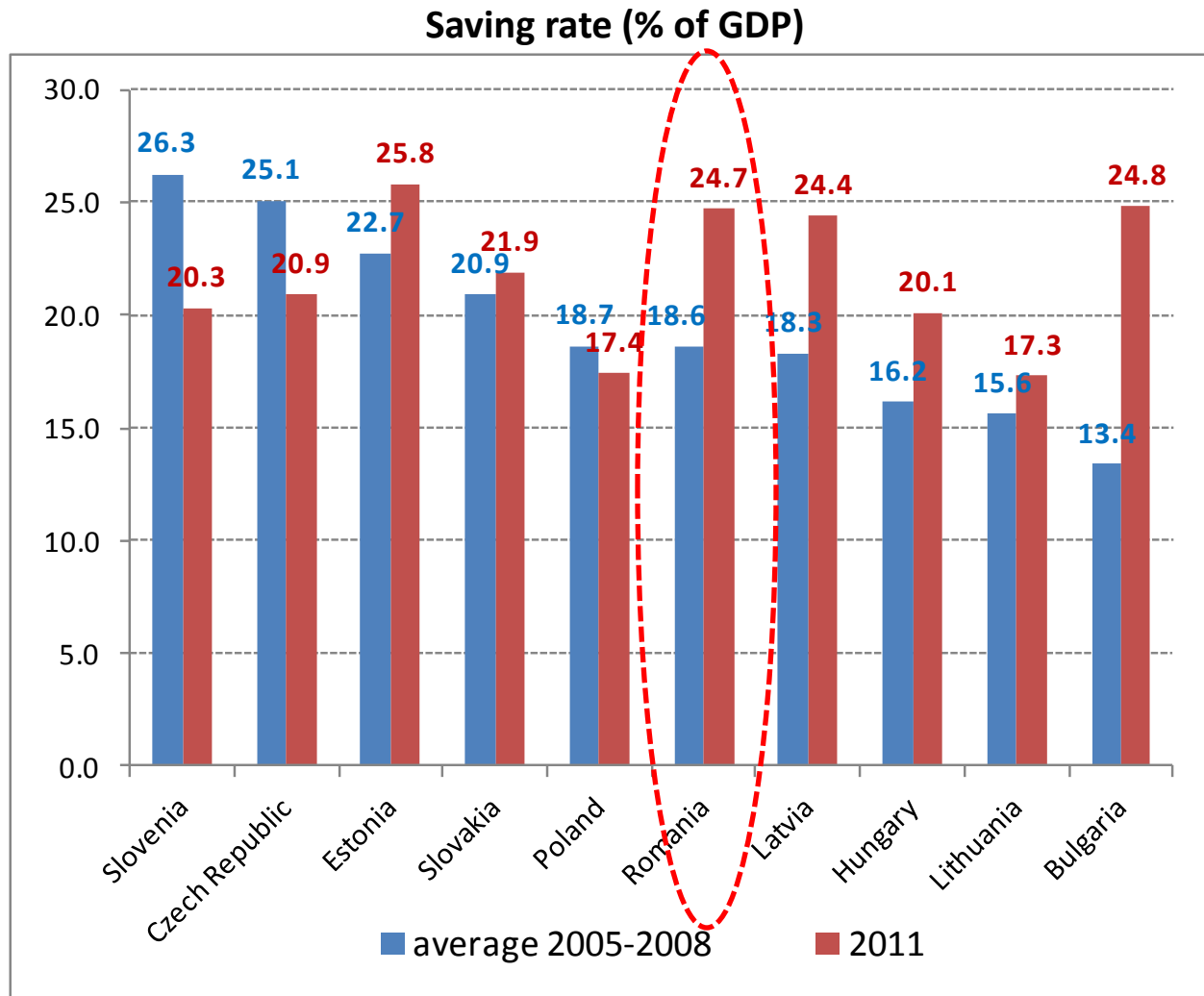
### Key pillars of the new growth model:

- Higher domestic savings and lower reliance on foreign savings;
- Higher employment rate and higher labor productivity;
- Limited real exchange rate appreciation and strict control of wage-productivity growth balance;
- Increasing EU funds absorption;
- Increasing reliance on tradable sector, expanding and diversifying exports;
- Accept immigration to offset partially the negative demographics;

# Lessons from the crisis

## 1. A new growth agenda is needed

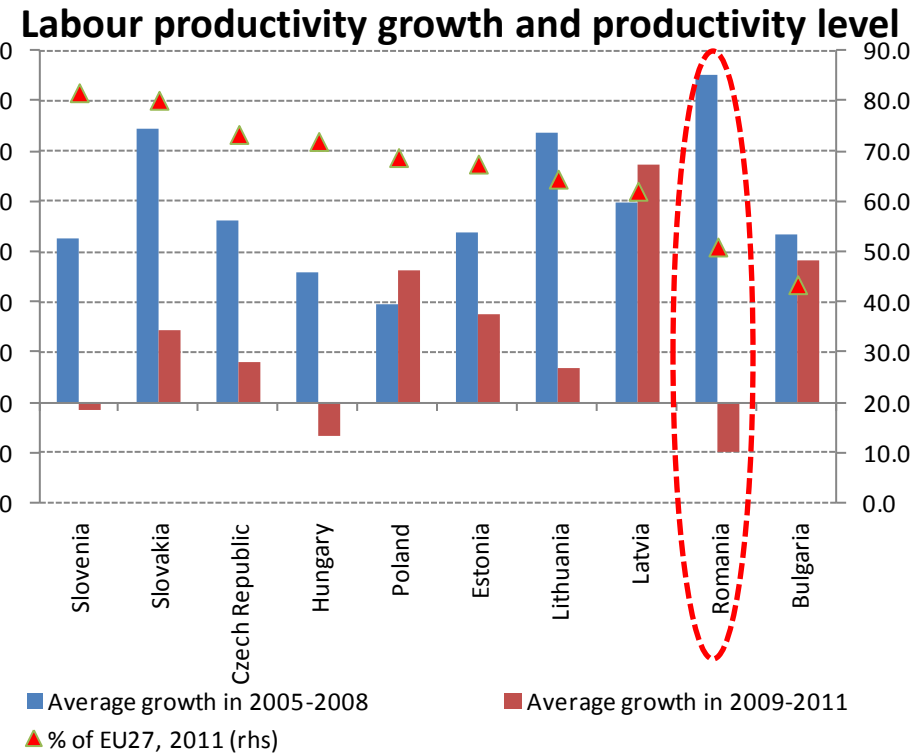
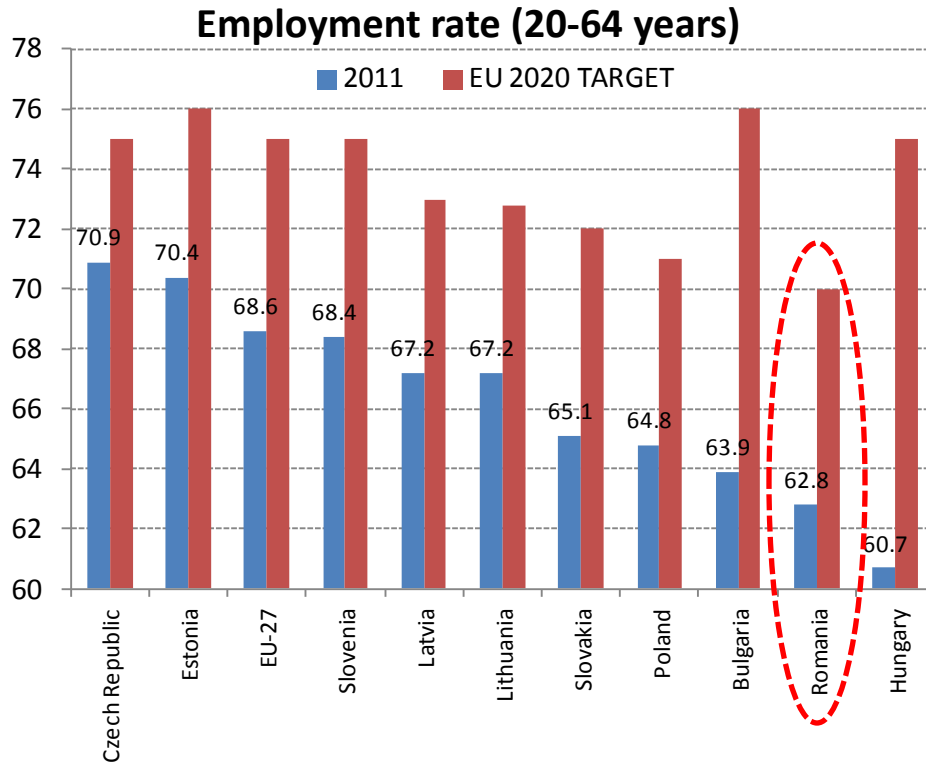
### 1.1 Higher domestic savings and lower reliance on foreign savings



# Lessons from the crisis

## 1. A new growth agenda is needed

### 1.2 Higher employment rate and higher labour productivity (1)

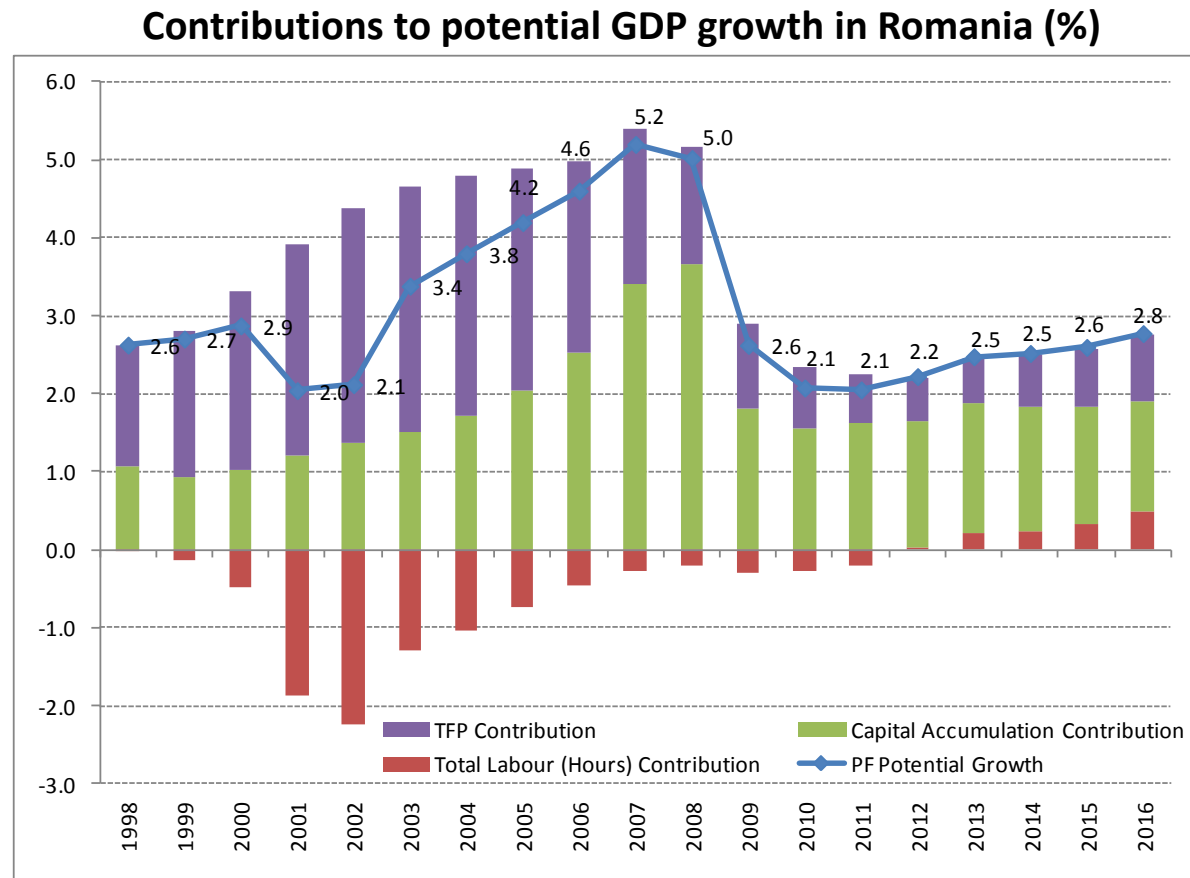


- Romania has one of the lowest employment rates in EU;
- Increase effective retirement age; education reform and lifelong learning; stimulate re-skilling and job search; re-attract Romanians working abroad.
- Increase efficiency of public administration (including through introduction of e-government).

# Lessons from the crisis

## 1. A new growth agenda is needed

### 1.2 Higher employment rate and higher labour productivity (2)



- the high potential GDP growth in the pre-crisis period was driven mainly by large capital inflows.
- The contribution of capital and TFP is expected to be much lower after the crisis;
- **The contribution of labour should increase.**



# Lessons from the crisis

## 1. A new growth agenda is needed

### 1.2 Higher employment rate and higher labour productivity (3)

- Fight undeclared work and reduce tax evasion;
- Legal tax wedge on labour is high in Romania, but implicit taxation is relatively low.

#### Legal tax wedge vs implicit taxation on labour (SSC and personal income tax)

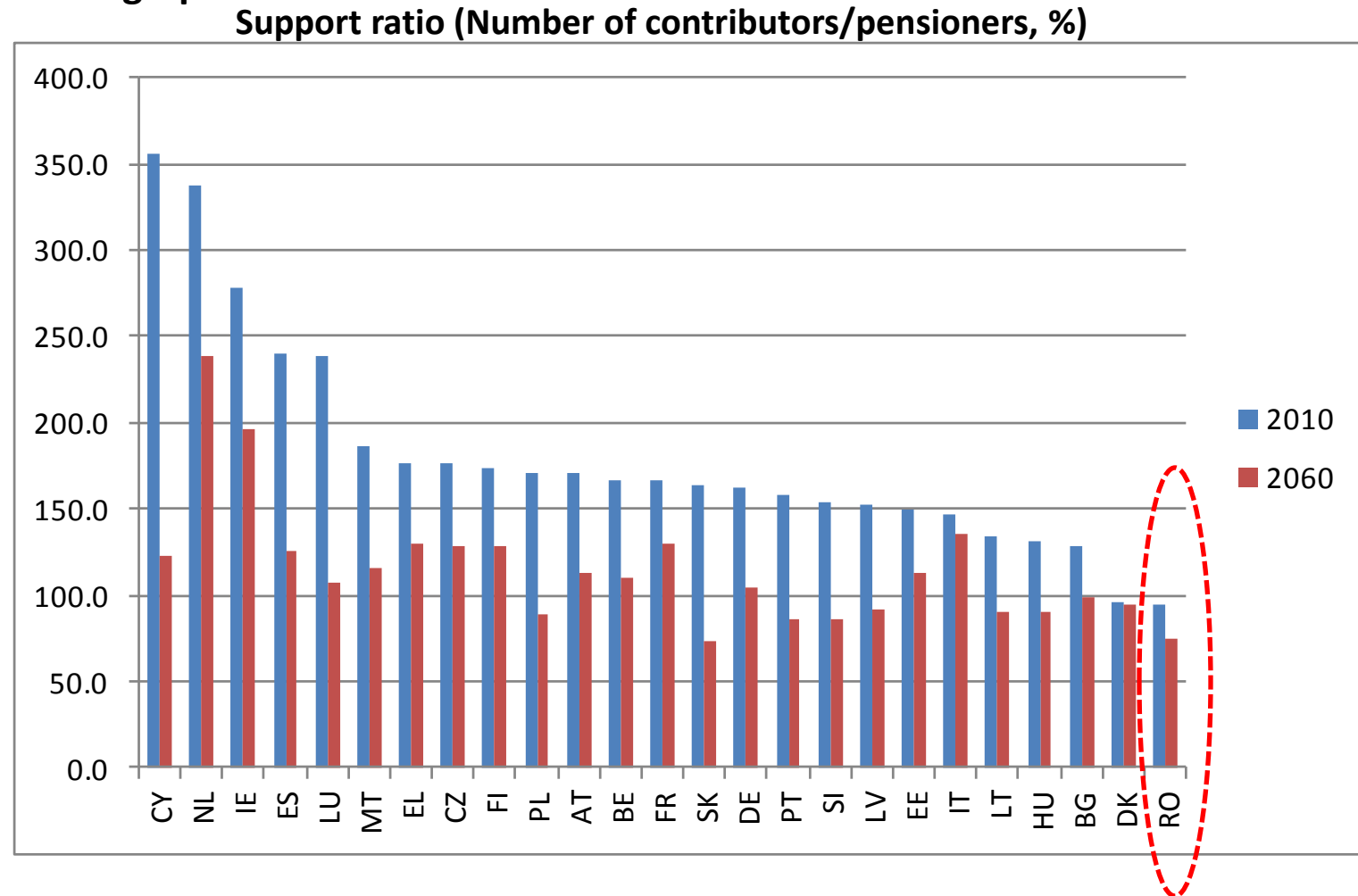


# Lessons from the crisis

## 1. A new growth agenda is needed

### 1.2 Higher employment rate and higher labor productivity (4)

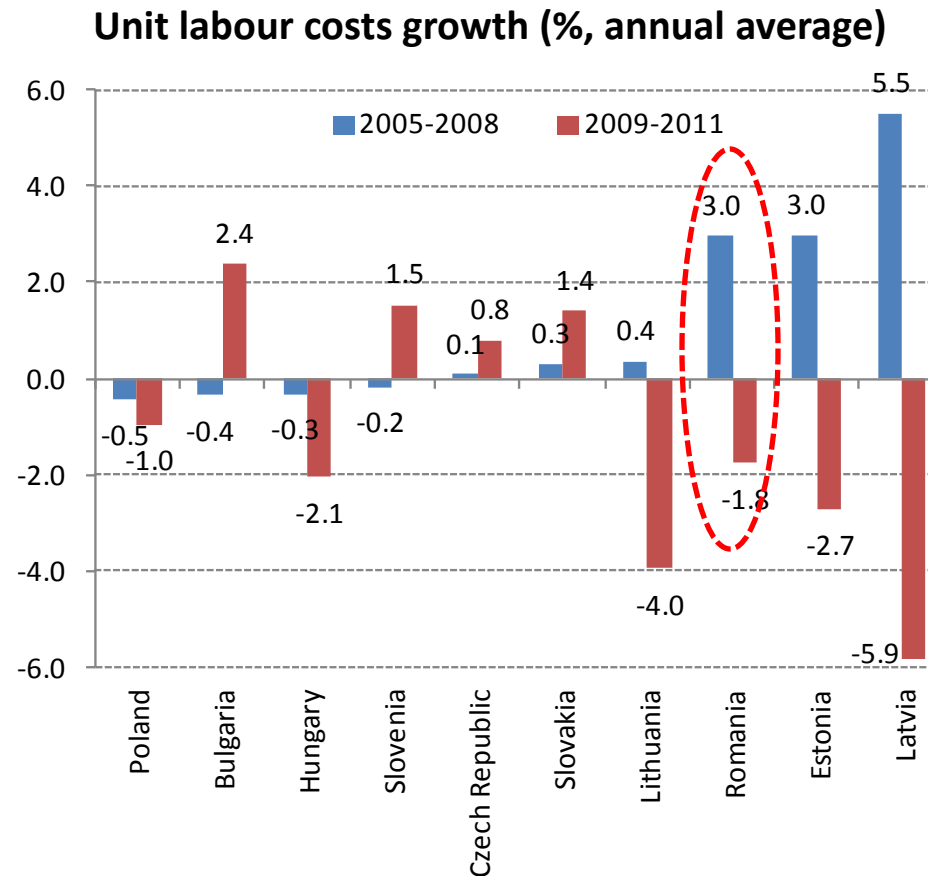
➤ An increase in employment rate is highly needed also to offset partially the negative impact of demographics.



# Lessons from the crisis

## 1. A new growth agenda is needed

### 1.3 Strict control of wage-productivity growth balance



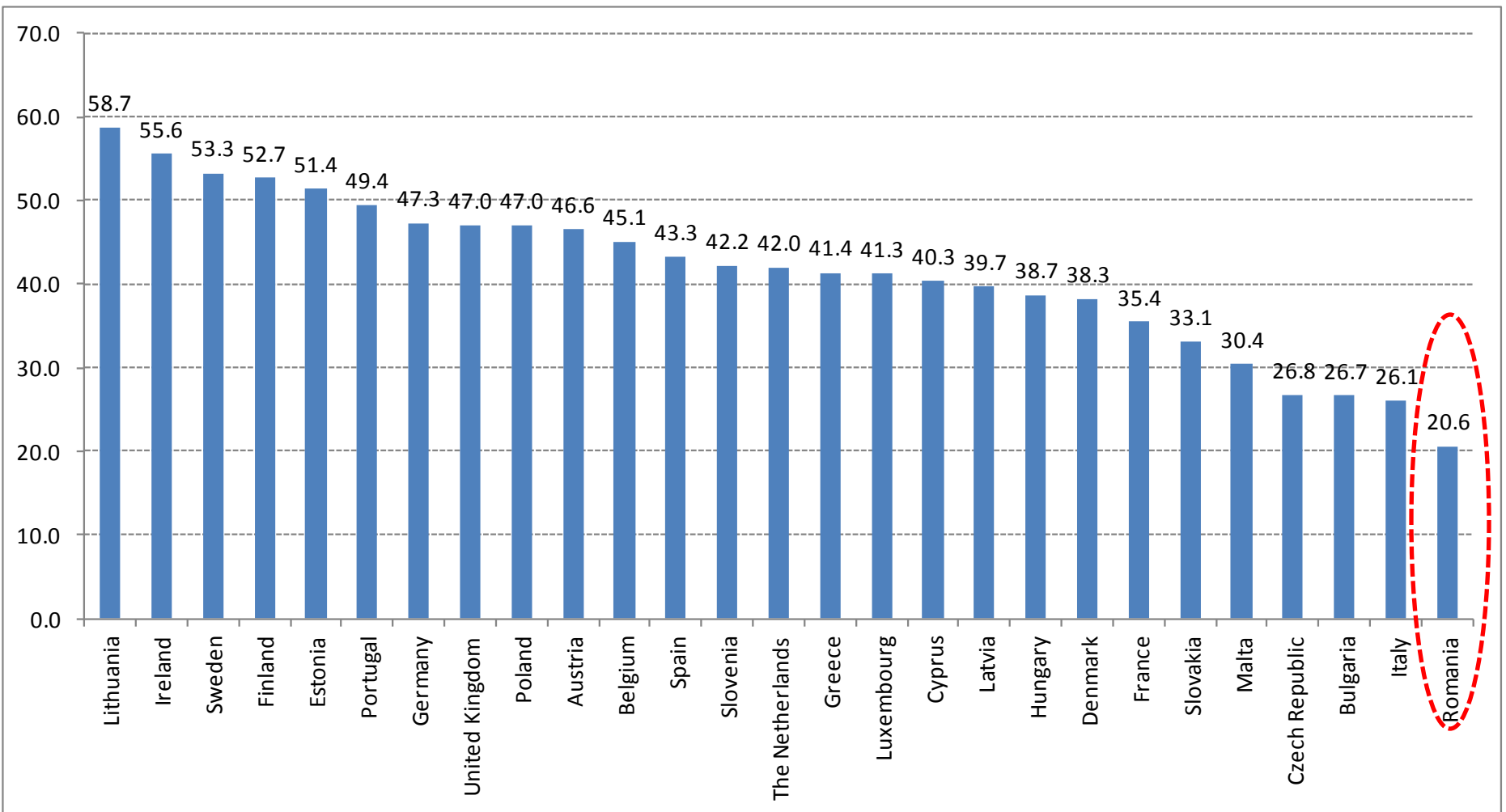
- ensure wage growth never exceed productivity growth –increase labour market flexibility; open labour market to immigration; strictly control increases in public sector wages.

# Lessons from the crisis

## 1. A new growth agenda is needed

### 1.4 Increasing EU funds absorption

Percentage of structural and cohesion funds allocated per MS paid by the Commission (23/07/2012)



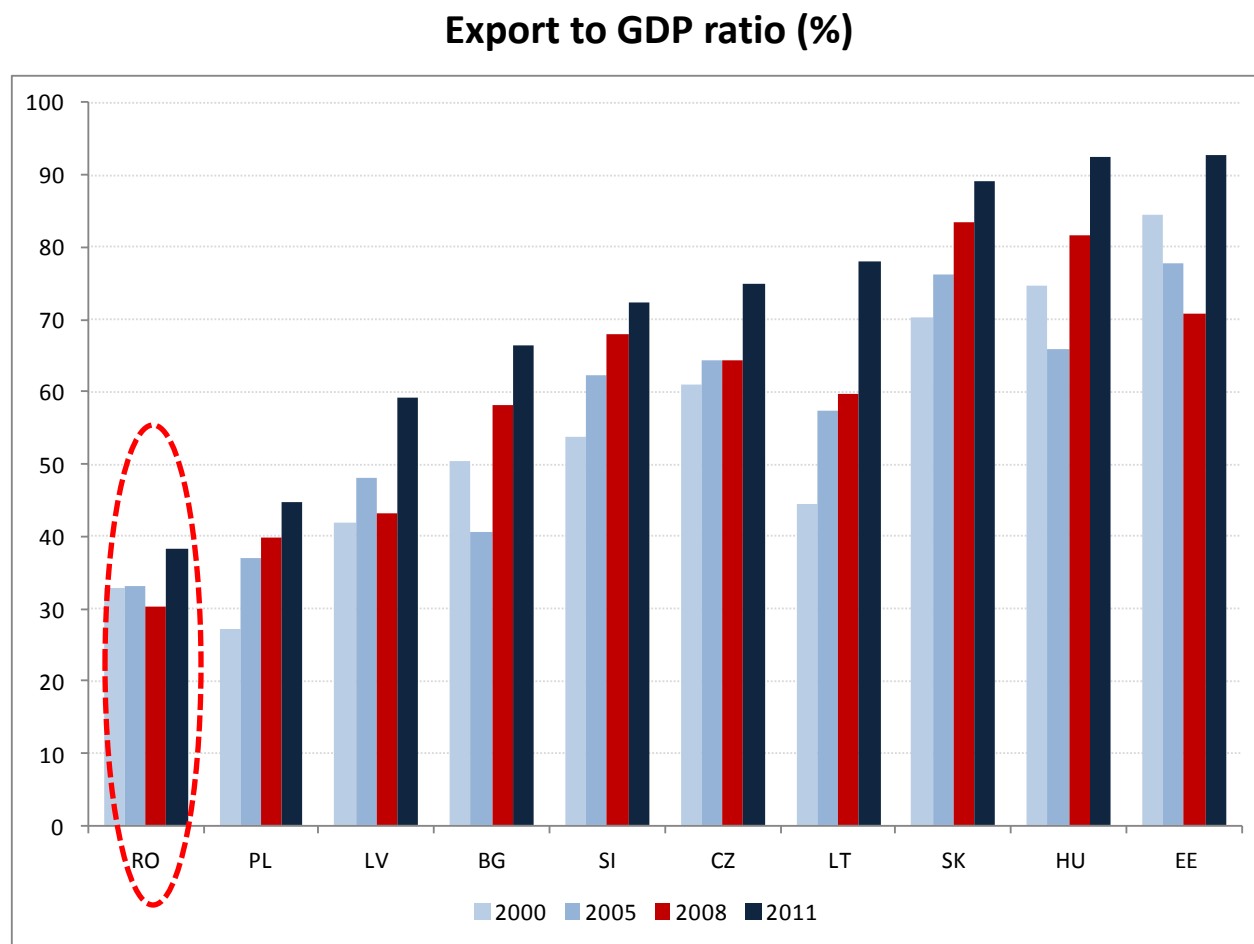
Data include advances paid by the European Commission

Source: DG Regio, European Commission

# Lessons from the crisis

## 1. A new growth agenda is needed

### 1.5 Increasing reliance on tradable sector (a more balanced growth), expanding and diversifying exports (1)

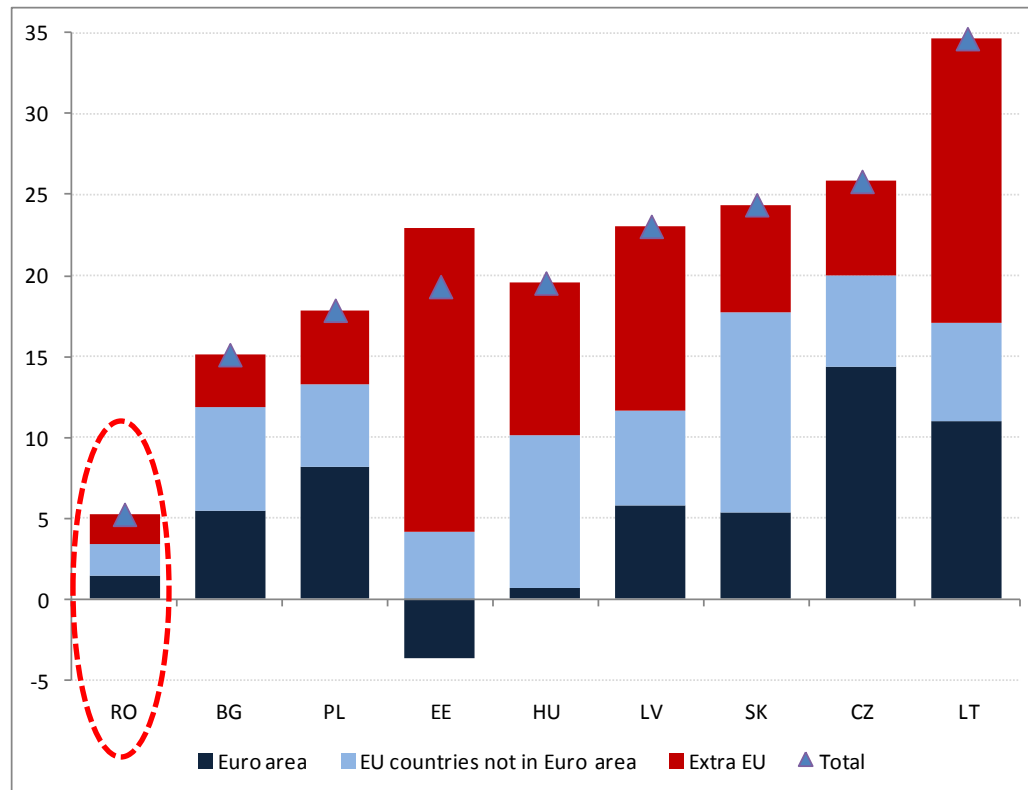


# Lessons from the crisis

## 1. A new growth agenda is needed

### 1.5 Increasing reliance on tradable sector, expanding and diversifying exports (2)

Exports of goods by destinations - change between 2000 and 2011 (in pp of GDP)



➤ Increase focus on extra-EU exports – restore economic relations with other emerging markets (BRICs, Arab countries, African Countries) promoting FDIs from non-EU countries in Romania in exchange to access to their domestic markets.

# Lessons from the crisis

## 1. A new growth agenda is needed

### 1.5 Increasing reliance on tradable sector, expanding and diversifying exports (3)

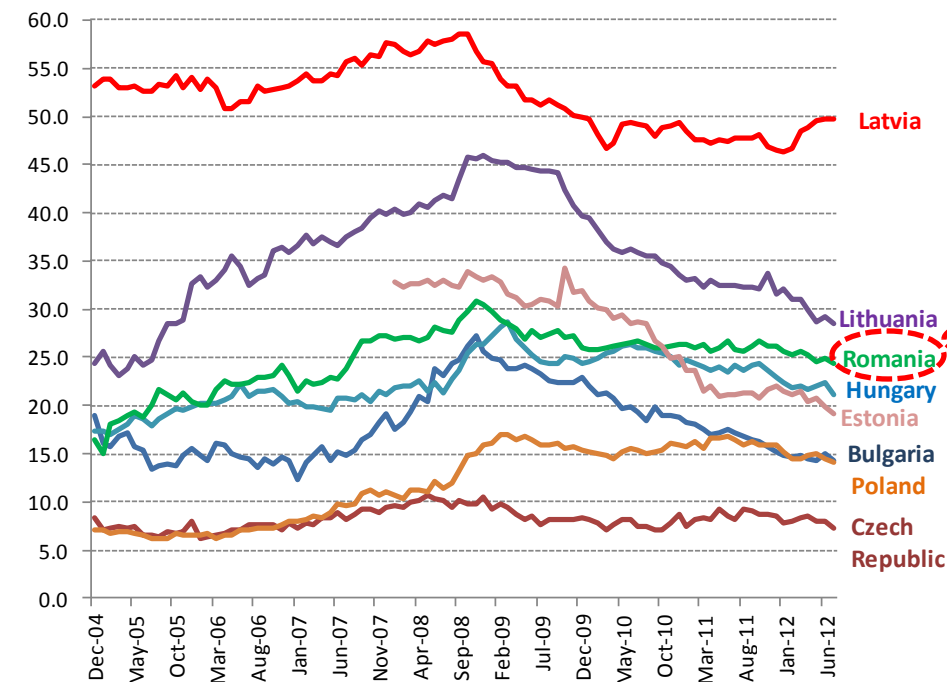
Top 20 export markets in 1991		Top 20 export markets in 2011	
Former Soviet Union	23.0	Germany	18.6
Germany	10.9	Italy	12.8
Italy	6.1	France	7.5
Netherlands	5.3	Turkey	6.2
France	4.1	Hungary	5.6
Former Yugoslavia	4.0	Bulgaria	3.6
UK	3.7	UK	3.2
Turkey	3.6	Netherlands	3.1
China	3.3	Spain	2.4
US	2.9	Poland	2.4
Austria	2.5	Russian Federation	2.3
Japan	2.3	Austria	2.2
Poland	2.1	Belgium	2.0
Liban	1.9	Ukraine	1.8
Hungary	1.9	US	1.8
Czech Rep.	1.7	Czech Rep.	1.7
Egypt	1.6	Slovakia	1.6
Switzerland	1.6	Serbia	1.5
Bulgaria	1.4	Greece	1.4
Syria	1.3	Republic of Moldova	1.3
<b>Total top 20</b>	<b>85.2</b>	<b>Total top 20</b>	<b>83</b>
<b>EU 27</b>	<b>44.3</b>	<b>EU 27</b>	<b>71.1</b>
<b>Former Soviet Union</b>	<b>23.0</b>	<b>Former Soviet Union</b>	<b>6.0</b>
<b>Arab countries</b>	<b>4.0</b>	<b>Arab countries</b>	<b>2.0</b>
<b>African countries</b>	<b>3.9</b>	<b>African countries</b>	<b>2.1</b>

# Lessons from the crisis

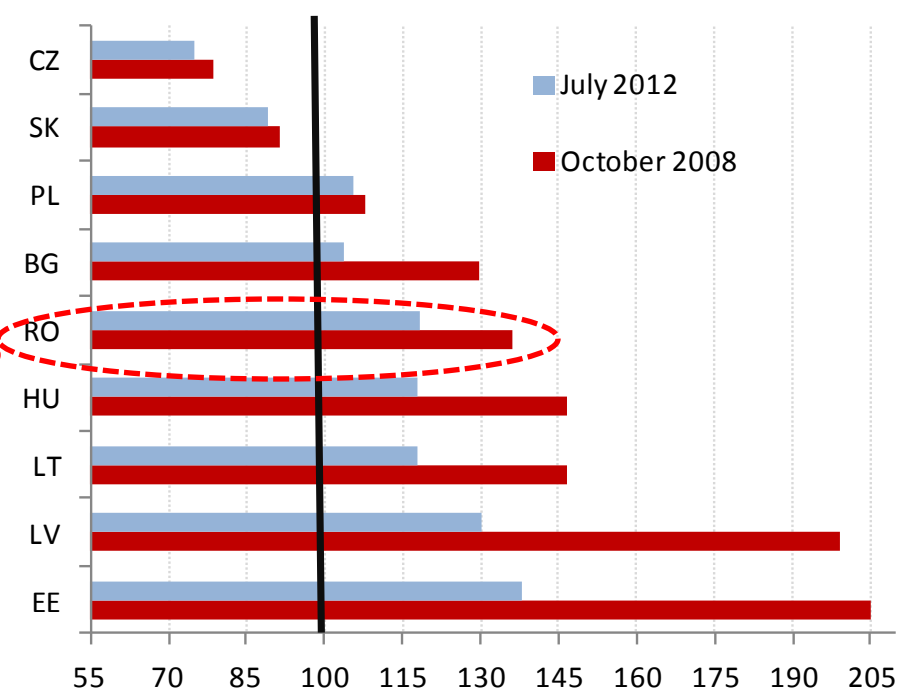
## 2. A new banking model is needed

### 2.1 More balanced funding model is needed...

Share of external liabilities in total funding



Adjustment in loan to deposit ratio



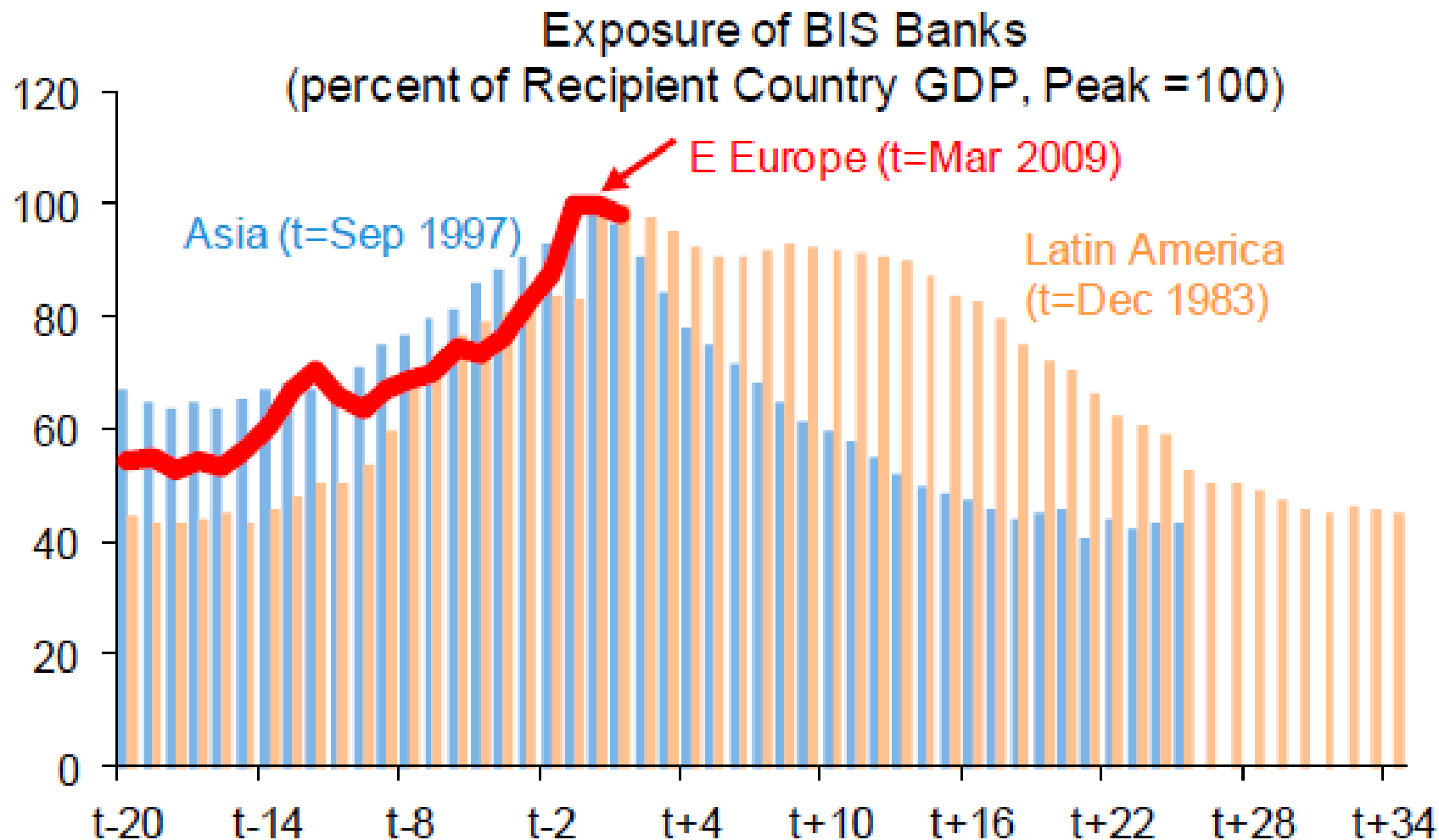
- Back to “basics” - era of cheap funding from abroad to fuel credit boom is over:
  - more reliance on LCY deposits and LCY loans;
- Developing local capital markets;
- Increasing cooperation and better management of supervisory bias/conflicts.



# Lessons from the crisis

## 2. A new banking model is needed

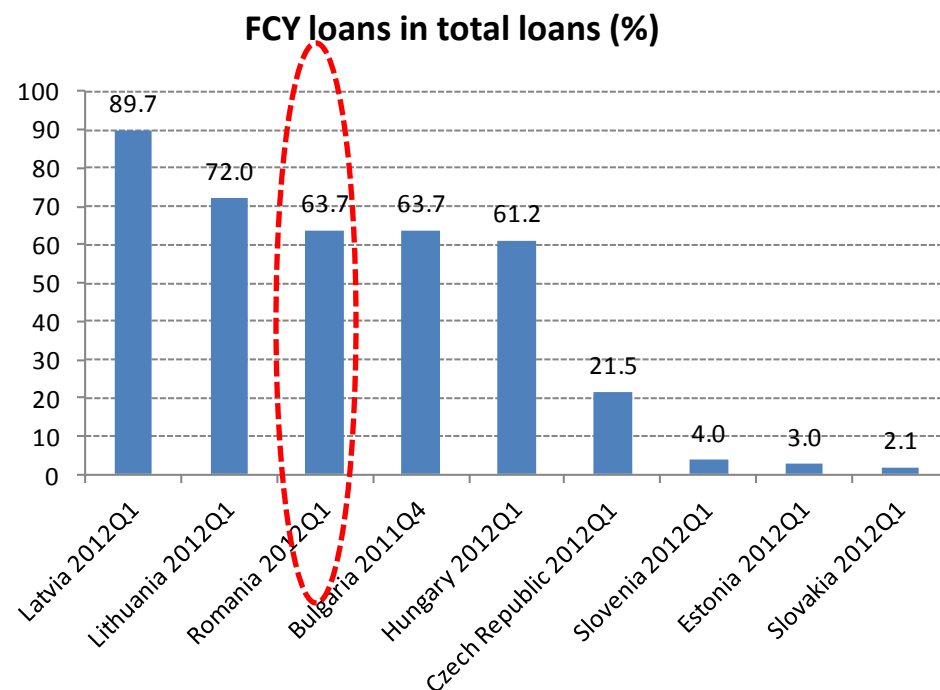
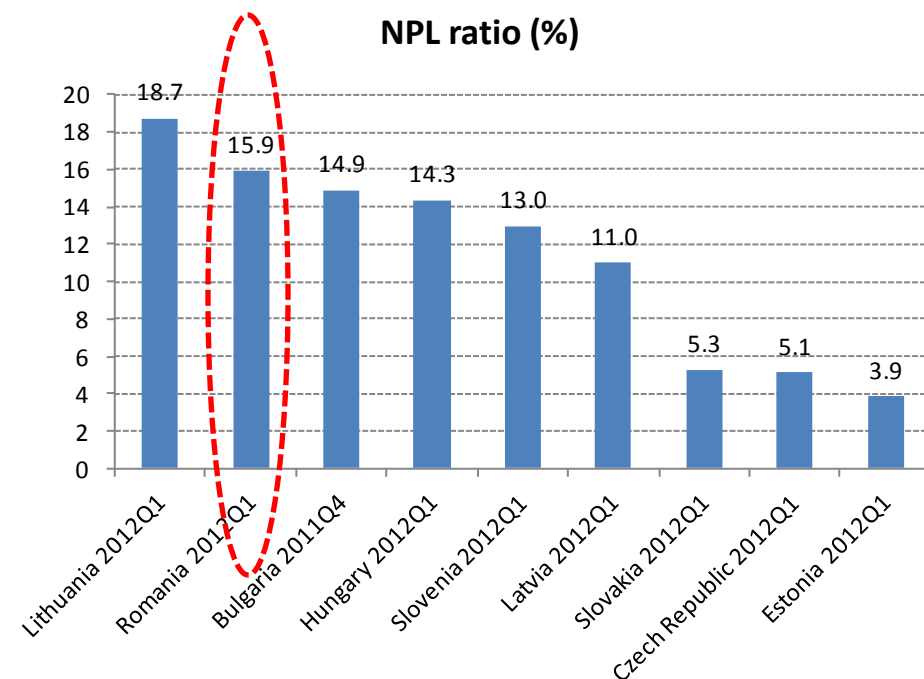
### 2.1 ...as deleveraging of EU banks is expected to continue



# Lessons from the crisis

## 2. A new banking model is needed

### 2.2 Clean-up balance sheets and discourage lending in FCY



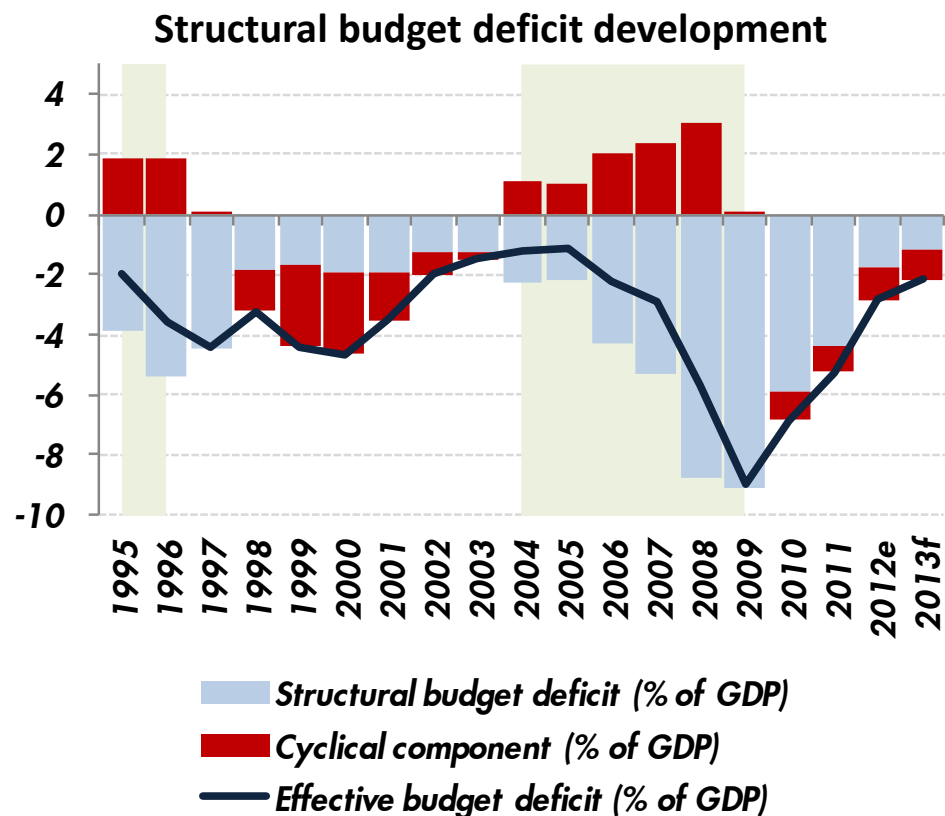
- NBR introduced in 2003-2008 tight administrative and prudential regulations to curb lending growth (especially in FCY for unhedged borrowers), but the impact was short-lived – loans started to be originated directly from abroad or exported abroad.
- An increasing cooperation and coordination between host and home countries supervisors is strongly needed.

# Lessons from the crisis

## 3. Prudent fiscal policy is strongly needed in the future

### 3.1 Countercyclical fiscal policy is crucial

- Countercyclical fiscal policy is highly needed - build fiscal buffers during good times – the new fiscal Compact at the EU level will help
- Implementation of fiscal rules and debt thresholds to improve longer-term fiscal sustainability.

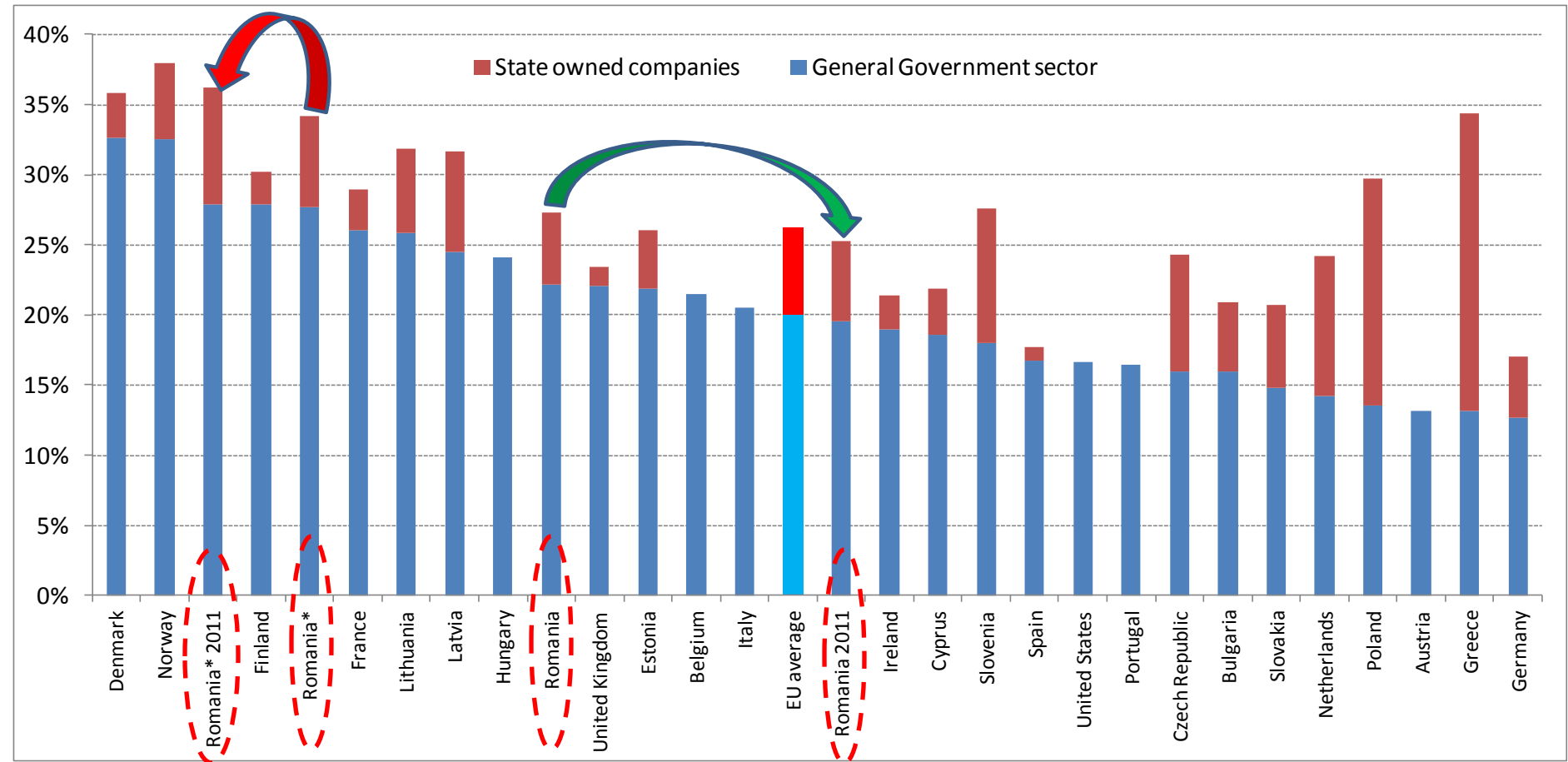


# Lessons from the crisis

## 3. Prudent fiscal policy is strongly needed in the future

### 3.2 Very prudent public wage and public personnel policies are a must

Ratio of public workers to total number of employees in the economy (%)

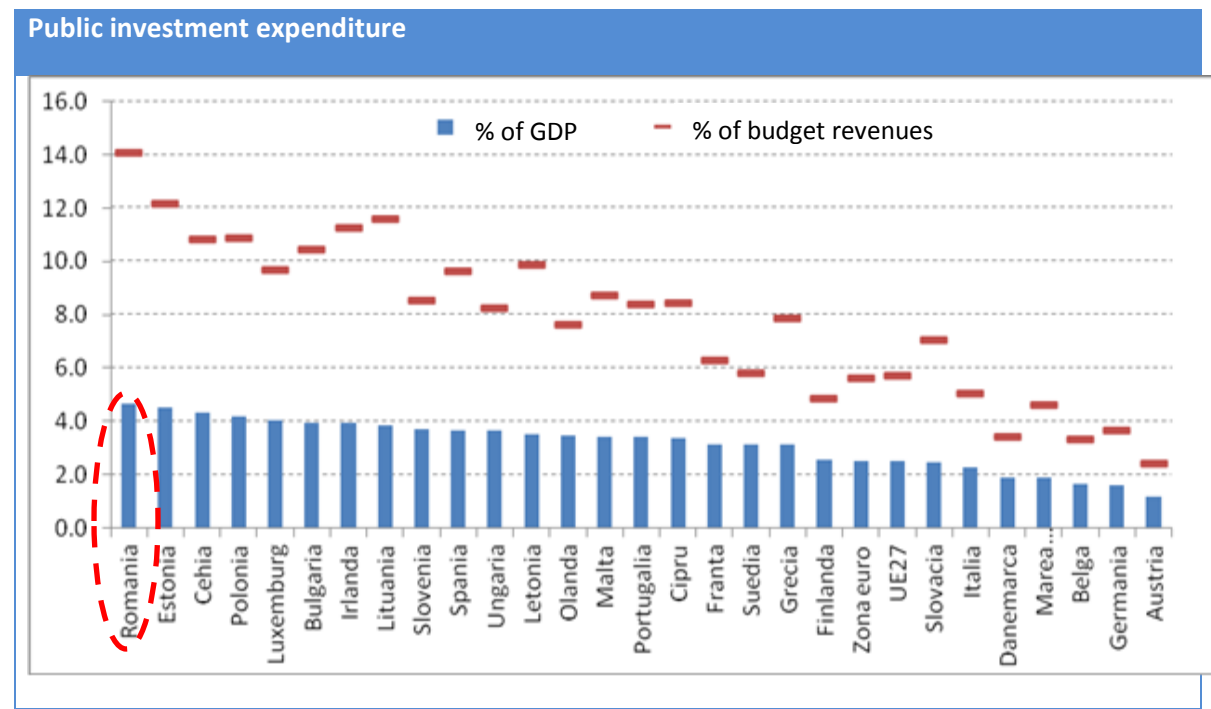


Note: Data for 2008 from LFS – Labour Force Surveys (including the employees from the informal economy)  
\*Calculation based on the number of employees officially reported by employers (only the taxpayers)

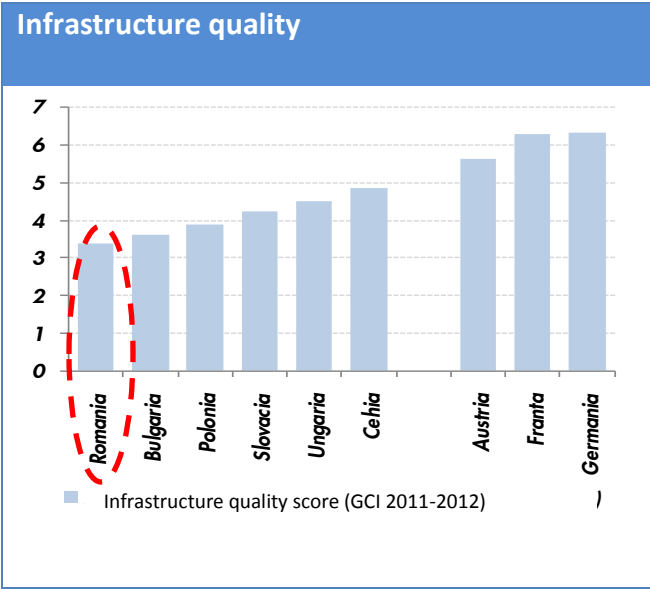
# Lessons from the crisis

## 3. Prudent fiscal policy is strongly needed in the future

### 3.3 Efficiency of public spending should increase significantly



Source: EUROSTAT, World Economic Forum, Global Competitiveness Report 2011-2012

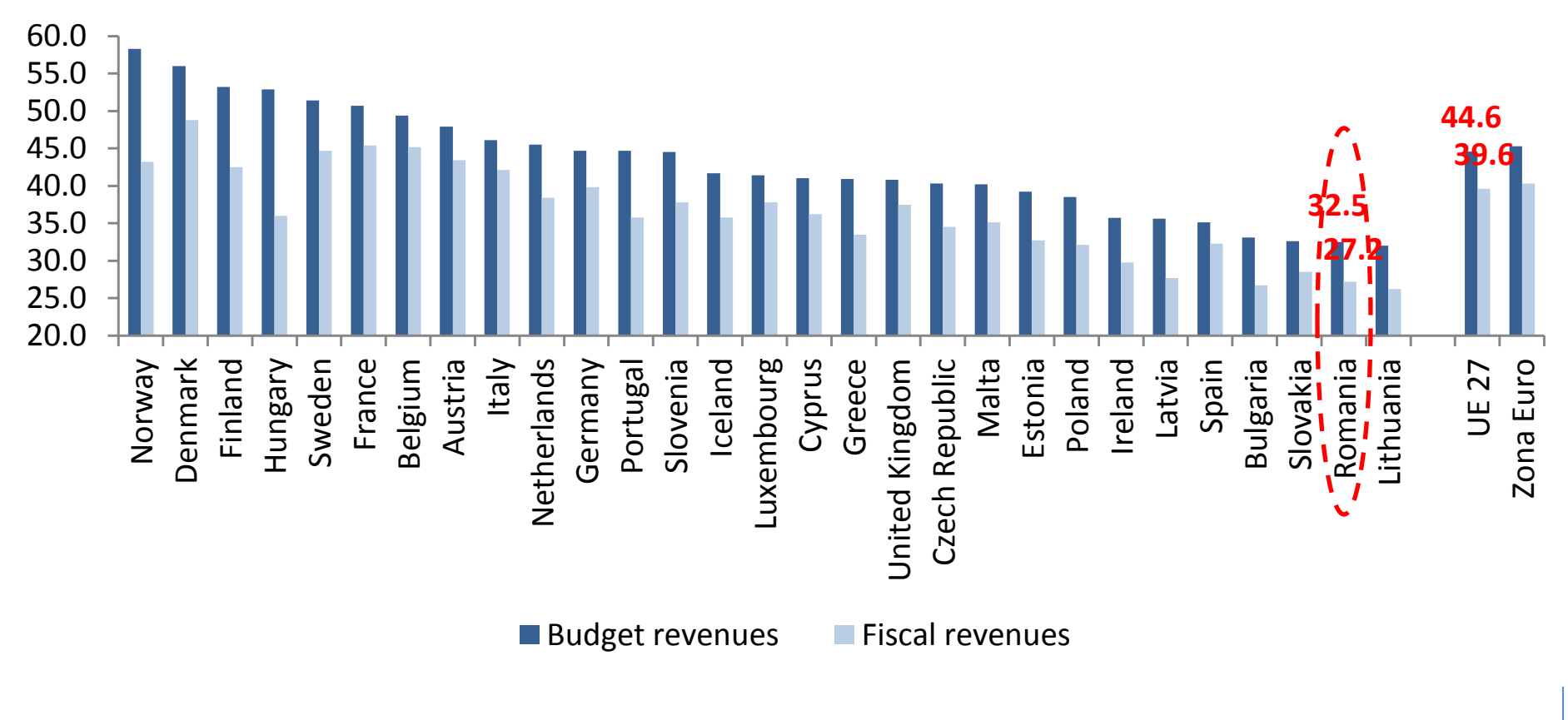


# Lessons from the crisis

## 3. Prudent fiscal policy is strongly needed in the future

### 3.4 Tax collection improvement is a must ...

Budget revenues and fiscal revenues (% of GDP, ESA 95, 2011)



Source: EUROSTAT; tax revenues include social contributions

# Lessons from the crisis

## 3. Prudent fiscal policy is strongly needed in the future

### 3.4 ...as the tax evasion is very high...

% of GDP	2004	2005	2006	2007	2008	2009	2010
Tax evasion from undeclared work:	3.7%	3.9%	4.3%	4.6%	4.6%	5.8%	5.9%
- personal income tax (PIT)	0.8%	0.8%	0.9%	1.0%	1.1%	1.3%	1.4%
- social security contributions (SSC)	2.9%	3.1%	3.4%	3.5%	3.5%	4.5%	4.5%
VAT fraud	3.0%	3.7%	4.8%	4.5%	3.8%	3.8%	3.6%
Tax evasion from informal economy (households)	0.6%	0.7%	0.8%	0.9%	0.9%	0.7%	0.8%
Total VAT, SSC and PIT tax evasion	7.3%	8.4%	9.9%	10.0%	9.3%	10.3%	10.3%
Unobserved economy gross value added*	14.5%	16.6%	19.2%	20.0%	19.6%	20.9%	21.5%

*Source: Fiscal Council's calculation based on Nation Institute of Statistics data*

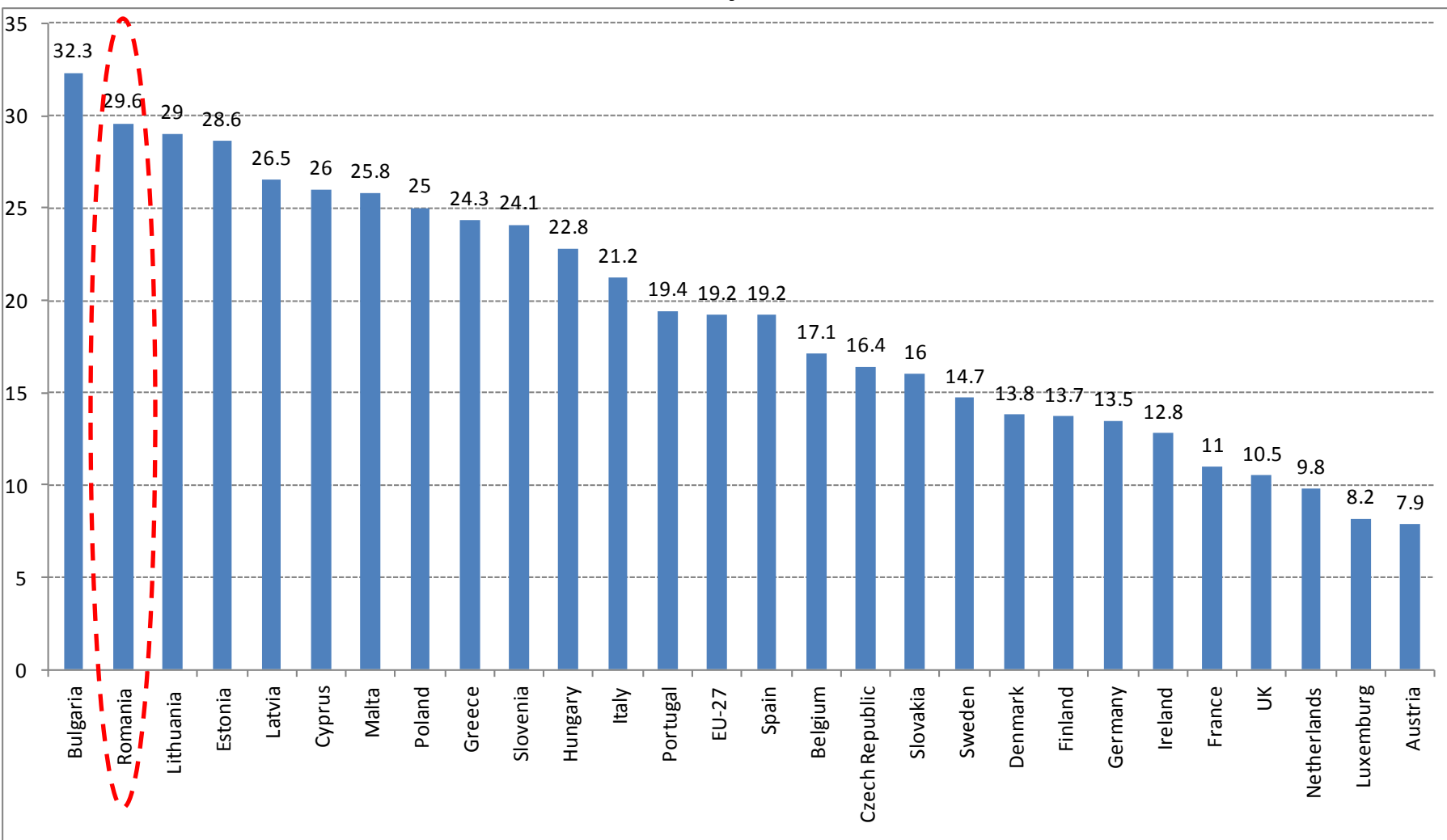
*\* National Institute of Statistics estimate*

# Lessons from the crisis

## 3. Prudent fiscal policy is strongly needed in the future

### 3.4 ...as a result of very high share of “shadow” economy

Share of shadow economy in GDP in EU-27 countries



Source: Schneider, F. (2012), "Size and development of the Shadow Economy from 2003 to 2012: some new facts"