BETWEEN TWO CRISIS- THEIR AND OURS

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Abstract

Eastern Europe had a different evolution pattern after the fall of the communism. Local and global economic interests, the responsibility of politicians, the degree of economic culture, have been factors that have marked differences. Romania was noticeable in many chapters, not necessarily the ones it needed the most. Worldwide there are two crises, one started in the U.S. and expanded because of the toxic assets of non-American banks in highly developed countries, like Great Britain, Japan, Canada, France, and another crisis, specific to emerging economy of some new E.U. member states, including Romania, and former cohesion economies such as Spain, Greece and Ireland. Romania's economic crisis is internal and it would have occurred even without financial crisis triggered in the States, and if the causes and mechanism of transmission differs, exit measures cannot be similar with the American, German and French economy saving solutions. We analyze similarities and differences, as we map the potential solutions and their effects.

Key words: economic crisis, GDP, Romania

JEL Code: O11, E30

Introduction

The financial crisis, started with the fall of Lehman Brothers in USA is a highly debated issue in economics, administration and political sciences. Ben Bernake's opinion regarding the long term causes starts with the way „global patterns of saving and investment have evolved over the past decade or more, and how those changes affected credit markets in the United States and some other countries." (Bernake, Board of Governors of the Federal Reserve System, 2009) or „The proximate cause of the crisis was the turn of the housing cycle in the United States and the associated rise in delinquencies on subprime mortgages, which imposed substantial losses on many financial institutions and shook investor confidence in credit markets." (Bernake, Board of the Governors of the Federal Reserve System, 2009). A hugely significant research in crisis propagation is done by Josept Stiglitz, who has several articles on financial network role in the contagion of financial crisis. In his oppinion „the recent crisis has shown that in the absence of appropriate government intervention, privately profitable transactions may lead to systemic risk. (Stiglitz, 2010). Gallegati, Greenwald, Richiardi and Stiglitz, underline the difference between risk diffusion, impliyng the diffusion of shocks in networks and risk contagion impliying the multiplication of risks through networks (Gallegati, Greenwald, Richiardi, & Stiglitz, 2008). So, the complex financial instruments and networks designed to diffuse the risk actually propagated the multiplication of risks.

In 2007 the causes for this crisis were so alien to most Eastern European countries that its influence was considered minimal, as the financial systems involved (subprime, credit default swaps) were unknown and of small interest to all but an insignificant minority of financial researchers. In Europe, contagion research was conducted mostly in National Banks, as they were the most informed on interbank risk due to recent contagion cases in developing countries. Interbank contagion was to some extent a known issue, but supposed causes were more seen as regional and (Schoenmaker, 1996), (Dardac & Moinescu, 2006), (Iyer & Peydró, 2006), (Kali & Reyes, 2010). Published researches by south American researches were to some extent ignored, even if they have proven that even government bonds can be subject of contagion ” (Valdez, 1997).

Based on a consistent growth recent history, that was highly expected after years of painful reforms and profound changes in economy and society, and the recent accession to the European Union, Romanians were expecting to weather out the financial storms immune, maybe loose a percentage of growth, but not to get into recession at all.

At crisis beginning, little was done to prevent contagion, as the word was non-existent in political language and used only by a few economists, sometimes seen as weird by their colleagues.

1 Some comparative data

From a wide variety of data available we have chosen two data-sets, GDP/Capita yearly change, generated from Word Bank’s GDP/Capita constant 2005 PPP yearly values, and General Government final consumption expenditure.

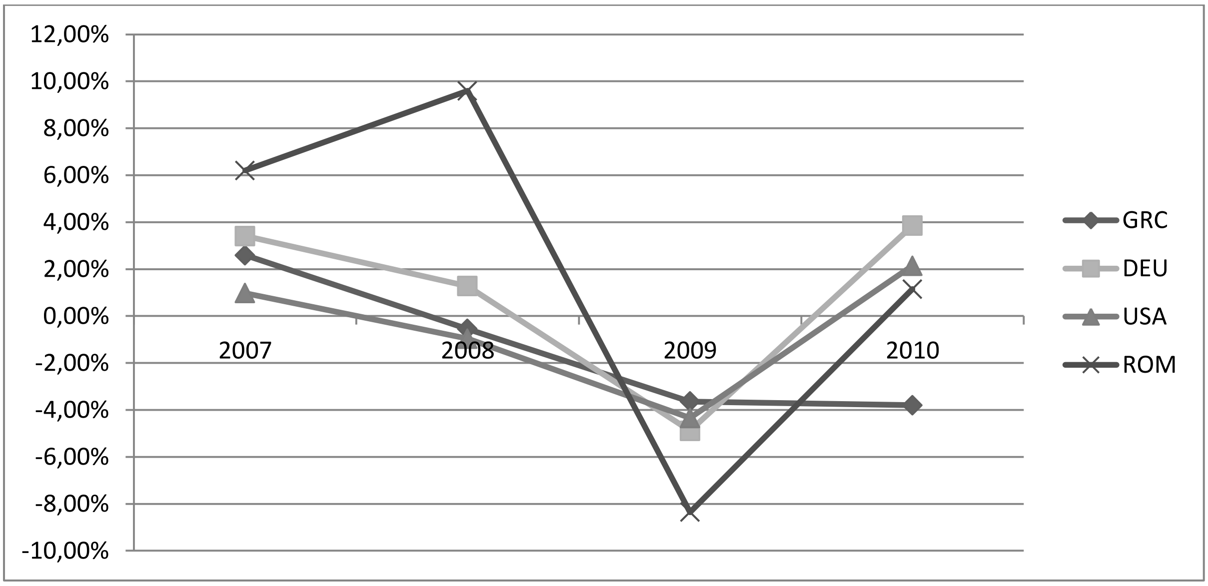
Table 1 and Figure 1 shows the values of GDP/Capita change, revealing the impact on GDP of the crisis. It is obvious that year 2009 is the most difficult year, and that 2010 shows a recovery in growth. Having presidential elections in 2008 explains the growth followed by decline in 2009 in Romania's case.

Table 1 Comparative GDP/Capita yearly change

	2007	2008	2009	2010
GRC	2,59%	-0,55%	-3,64%	-3,80%
DEU	3,41%	1,28%	-4,89%	3,85%
USA	0,98%	-0,96%	-4,34%	2,14%
ROM	6,20%	9,59%	-8,36%	1,15%

Source: World Bank (World Bank, 2012)

Figure 1 GDP/Capita Evolution



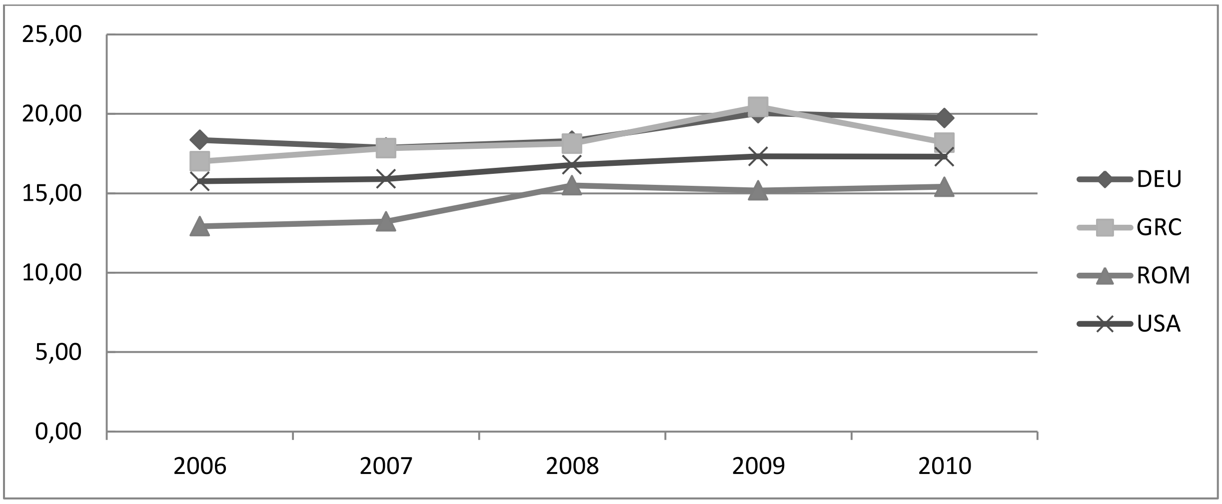
General Government final consumption expenditure is significant as it shows the public policy regarding budget expenditure during crisis. It is obvious that developed countries spend more at the beginning at the crisis compared to Romania and even more in 2010. This can be seen as a policy to substitute private consumption with public spending in order to maintain consumption at a constant level.

Table 2 General government final consumption expenditure (% of GDP)

Country Code	2006	2007	2008	2009	2010
DEU	18,35	17,87	18,30	20,04	19,73
GRC	17,00	17,83	18,12	20,44	18,18
ROM	12,93	13,23	15,50	15,17	15,41
USA	15,75	15,90	16,79	17,32	17,29

Source: World Bank (World Bank, 2012)

Figure 2 General government final consumption expenditure (% of GDP)



2 Crisis in developed countries

2.1 Causes

The main causes for crisis in USA were a housing bubble covered and amplified by the subprime market lacking proper control and regulations. This has probably just exposed other weaknesses in US economy and financial systems that may have generated a crisis at a later stage. I include in those weaknesses a decline in industrial production, fiscal facilities for companies, over-extended government budget, a highly expensive health system, and probably a lot of states and local administrations having individual weaknesses. The crisis has revealed and augmented those problems, creating a really unstable financial environment with severe volatility and mistrust in financial markets.

Even so, USA is still the leading economy of the world in most directions, but, during the crisis it has lost much of its advantages to China, Brazil and South-American economies that had a cheaper labor-force and so attracted most of the manufacturing in their territory.

The Euro Zone countries had rather different issues, mostly related to high government budgets deficits, a lagging economic growth mostly related to over-standardization and over-regulation of economy. However the Euro-Zone had different countries with different approaches so it was hit in an asymmetric way. Some countries, like Greece, Spain, and Italy have fiscal fraud issues; others like Ireland had a risky banking system, others like France, Germany and Belgium had huge credit exposures to the other EU members. Great Britain with its financial engine jeopardized by the shaky international system managed to keep some stability as volatility fueled speculation continued to rush through its own system, acting like a channel between financial worlds. Even so, data on GB does not look optimistic.

2.2 Solutions

It is highly debatable if any of the measures used managed to tackle the crisis, or is just delaying the reckoning. US and UK are using quantitative easing, practically the Federal Reserve and Bank of England are absorbing financial assets by emitting money. This is to some extent a last resort after reducing the inter-bank interest rate to nothing. The quantitative easing, renamed LTRO was also used by ECB to increase the money supply in the Euro-Zone.

Flooded with cash the commercial banks should theoretically be forced to finance investments, and so increase employment and consumption boosting the economy. However, faced with huge deficits, governments take the most of this cash by emitting more bonds, and banks fearing risks are glad to provide credit, so instead of funding development the easing ends by allowing governments to keep deficit spending practices. Deficit spending was always seen as a tool to help the economy during crisis, so it's not all a bad thing. If a government is efficient and the deficit is well spent, like in Germany case, it may even work to their advantage. On the other hand, as the Greek case has shown, deficit spending linked with trade deficit and fiscal and spending irregularities it wreaks the economy.

This method is to some extent feasible as long as debts of the governments are mostly internal. Trade deficits due to industry being relocated to developing countries (mostly BRICS) give this "game" a different dimension. Feed by their success, they are developing a bubble of their own making as cash flows in before it can be converted into industry. As their own currency is flooded with cheap foreign currencies it has the tendency to be deflate, diminishing their competitive edge.

3 Crisis in Romania

3.1 Causes

Romania has undergone a severe and rapid change before 2007 in order to absorb EU administrative structures and transform itself in order to meet EU standards in economy. This has been done at a huge cost, that has been covered only in a small amount by EU funding and EU based investments.

Agriculture changes, industry changes, administration (both local and central) have been both radical and rapid. The beginning of the crisis has found the Romanian companies with new productive assets, but indebted and focused on EU markets for consumption. The banking system was almost completely taken over by EU based banks, so have been taken also the main companies in energy, oil, industrial production.

So, in 2007, even if economy was booming, the capitals were mainly of foreign origin, some being Italian or Greek. As foreign banks centrals were hit by the financial crisis, their Romanian subsidiaries were at risk of being bled dry of capitals.

The EU funding, the hope of funding further development, were badly designed and focused. The bad design is obvious in terms of cash-flow, as most projects approval takes up to a year to obtain approval and another year or more to obtain the actual money, the formal requirements are generating a huge and costly paperwork. Some of the companies that obtained approval and started the investments even got bankrupt because of delays in payments. Even so, EU funding has not been available to any kind of help for companies in distress, so it did little to help absorbing the shocks.

In terms of workforce, Romania was bleeding both young and middle age workers, diminishing the available and taxable wage income. The money supply flowing from workers abroad to their families was decreasing.

Some bad ideas like changing the SME income taxation had mixed with uncertainty and pessimism have pushed over 60.000 SME's into insolvency and stopped investments in SME's for some time.

In 2008, faced with difficulty and high cost to refinance loans, lagging EU funding, and a high interests of the financial markets the Romanian Government had a grim perspective of default ahead on medium term.

3.2 The solutions

The first priority has been to avoid the default perspective. This has been done using IMF and WB funding, obtained with a promise to diminish the budget deficit. This has been done rapidly by increasing the Value Added Tax from 19% to 24%, diminishing public sector employees by 25%, and by decreasing the number of employees in the public sector, to some extent. The immediate effect was indeed a better balance of payments; however, it has also cut consumption further increasing pressure on SME's. Recession, caused the diminished consumption has begun, however, as industrial investments started before and during 2007 begun to produce for export, it was less severe.

In Romania quantitative easing is both useless and un-productive, as most government debt is external, and because banks are subsidiary to foreign banks capital flows may go abroad as soon as they are released.

At this time, both the National Bank and the Government's Treasury are holding huge reserves in foreign currency and gold, in order to absorb shocks generated by a foreseeable Greek default, credit market, and other dangers lurking ahead.

Austerity as a public policy is now an imperative, as Romania has bound itself both to meet Euro-Zone accession requirements, and the Treaty for Stability, Co-ordination and Governance, both enforcing strict rules on public spending and inflation.

So there is little maneuver space for the Romanian government, as the basic tools of protection, customs, currency and budget expenses (subsidies, deficits) are bound by treaties with WTO, EU and others.

The solution to difficult times ahead may rely on improved usage of natural resources, as Romania has oil, natural gas, copper, gold, and other valuable raw materials. Due to the food crisis expected, and the huge potential for agriculture production growth, some of it may be unlocked thus improving both trade balance and budget income.

The most critical aspect to be solved, and still lacking both desire and solution is the emigration of workforce. Both hand and brain drain is a huge issue, even if it is not yet so perceived. This phenomenon increases dramatically the long term budget deficit perspective of both social and health services.

Conclusions

East European economies, like Romania have fewer instruments available for absorbing and dissipating shocks, but probably have the ability to take severe measures unthinkable in developed countries (25% wages cut, 19% VAT growth).

As financial shocks is propagating trough the financial network it reveals weaknesses and generate the propagation of different shocks. Even if sub-primes do not exist in Romania, contagion has occurred by different channels. Even if Romania does not have public deficits and debts comparable to Greece, a shock can influence the Romanian Economy, unless systems are in place able to absorb the shocks.

Shocks dissipation means are not comprised in international treaties, generating severe restrictions regarding available measure for Governments, especially EU members. Bound to respect deficit rules, trade rules, and currency rules, such governments need to channel the shock to own population and economy in order to absorb-it. Reserves are mandatory in order to avoid such cases.

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