What we know from the Last Two Economic Recessions. Lessons from the Romanian Experience

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Abstract

Now, at the end of 2018, Romania enjoys its eighth consecutive year of robust economic growth after the last recession, which marked the years 2009-2010. Is it much? Is it time to once again expect a recession after seven good years? How long would the correction take? If such questions could be answered, they would be of great help for busineses, for public policy decision makers and for individuals and households. Romania's impressive economic growth seems to cool down, as private consumption growth slows and the negative contribution of net exports to growth worsens (European Commission, 2018). The domestic demand was the main engine for the economic growth starting 2012. However, no "authorized"/credible source - domestic or international - signals that the Romania's economic growth in the near future will turn negative.

However, rather than rallying to an already increasing number of experts prophesizing the next incoming recession, this article aims to encourage those interested in the subject to focus more on what we know or could learn for Romania from the past episodes of economic recession. Basically, this is what the economists do, when trying to formulate the best possible assumptions which later are to be verified in their effort to explain what is happening.

The last years of the 1990's and the ending years of the first decade of the 2000's were years of severe economic recession for Romania. What are the lessons we could learn, what could have been avoided, but wasn't avoided, what could be eventually avoided in the future?

Keywords: recession, fiscal adjustments, fiscal policies, budget deficit, budget revenues, budget expenditures, interest rates, public policies

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1. The background

It is often said that when it comes to predict the future, the economists are not to be trusted too much. With his well known sense of humour, but also pragmatism, former U.S.A. president Ronald Reagan once said: "I hope you'll keep in mind that economic forecasting is far from a perfect science. If recent history's any guide, the experts have some explaining to do about what they told us had to happen but never did." (Ronald Reagan, January 21, 1984)

We know that the economy fluctuates -- periods of expansion and growth are followed by corrections and recessions – fortunately around a positive trend. Some economic statistics are going in the same direction (for instance, the GDP and companies' sales or average household income), while other always diverge (such as GDP and unemployment rate).

Unfortnately, economists also know that depressions (long recessions) could not be acurately predicted. That's why, we argue in favour of better understanding the fundamentals, the past (more or less recent), and for having flexible institutions capable to adapt to the new conditions and thus to allow companies and individuals/households to change their behavior and to better respond to incentives.

2. Comparing the last two economic recessions in Romania: 1997-1999 and 2009-2010

Differences

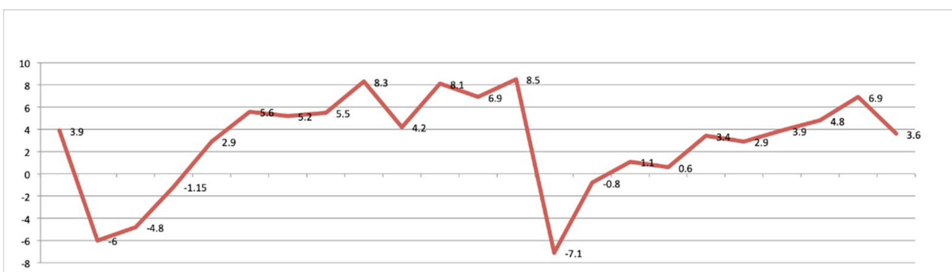
One of the main differences between the last two recessions experienced by Romania after the failure of the centralized economic system is how the society perceived the magnitude of the economic contractions. The general well being in the Romanian society was higher in early 21st century against that followed the collapse of the communism and the centrally planned economy in 1989. This, and having in place a relative good social protection system addressed to the most vulnerable categories of population made possible an unexpectedly good social result during and immediately after the recession: poverty reduction. In other words, the most poor categories of population suffered the least during the recession. (World Bank, 2012)

In contrast, during the 1997-1999 recession, when Romania engaged with great delay (compared with other comparable countries – Poland, Hungary, Czechia) in the neccessary structural reforms and finalizing the most part of the liberalization process after the collapse of the centralized economy, poverty increased and the poorest categories of population suffered the most (Doltu &Duhaneanu, 2011).

The structure of the economy is another significant condition that distinct the two recessions. A larger and more flexible and powerful private sector in 2009 as against 1990's made a significant difference, along the more deeper and sophisticated financial sector – mainly the banking system – and the incomparable presence and activity of the foreign companies. More than 2 million Romanian citizens (about 30 pecent of the active population) which chose to work in Western European countries as soon as Romania joined the European Union (January 1, 2007) generated a considerate volume of remittances, which obviously helped the ballancing the current account of the balance of payment. The EU membership by itself significantly reduced the political and economic associated country risks.

Of course, there are many other differences between the two recessions. They could be categorized by various caracteristics – from the values of macroeconomic statistics (GDP growth, inflation rate, unemployment rate) to various constraints for the government macroeconomic policies (the size of the budget deficit, current account deficit, the foreign exchange official reserves, interest rates for govenment borrowings). Many other criteria could be defined and use to compare.

Figure 1. Romania's GDP growth between 1996-2018



Year	GDP growth (%)	Year	GDP growth (%)	Year	GDP growth (%)	Year	GDP growth (%)
1996	3.94	2002	5.18	2008	8.45	2014	2.9
1997	-6.05	2003	5.52	2009	-7.06	2015	3.9
1998	-4.81	2004	8.35	2010	-0.79	2016	4.8
1999	-1.15	2005	4.17	2011	1.05	2017	6.9
2000	2.92	2006	8.05	2012	0.64	2018*	3.6
2001	5.59	2007	6.86	2013	3.39	2019*	3.9

Source: IMF, World Economic Outlook Database, April 2015, World Bank national accounts data and European Commission, Autumn 2018 Economic Forecast – Romania; * European Commission estimate (Autumn 2018 Economic Forecast – Romania)

3. Some Common Features

The most common features among these two recessions arise from the Government decisions and actions taken under the pressure generated by the need of external financing.

In 1999, after two consecutive years of negative economic growth (-6.1 percent in 1997 and -4.8 percent in 1998), on the background of a negative market perception vis-a-vi of meeting the external payment obligations, the Government chose to implement fiscal and budgetary adjustments in the form of increasing taxes and cutting expenditures. Thus, the Government increased the social contributions, excise duties and property taxes, reducing at the same time the expenditures with wages in the public sector and the capital expenditures. Various fiscal privileges – previously granted as „fiscal incentives" for large investors, aimed at attracting significantly big foreign direct investments – were also cancelled. (Doltu, 2002)

The fiscal and budgetary adjustments were followed by major structural reforms aimed at reducing the operational losses in the state owned companies– including the banking system. The immediate result was an increase of the budget revenues by almost 4 percentage points (from 27.9 percent of the GDP in 1998 to 31.9 percent of the GDP in 1999). The significant increase of the budget revenues was explained by the increase in fiscal revenues, mostly social contributions and excise duties. The budget expenditures decreased from 35.1 percent of the GDP to 37.1 percent of the GDP, most affected being the wages in the public sector and capital expenditures. Thus, the budget deficit was reduced by more than 3 percentage points, to only 2.1 percent of the GDP, from 5.4 percent of the GDP in the previous year. For both years, 1998 and 1999, the domestic borrowings were the main financing source of the deficit. However, the privatization revenues and sales of the distressed assets of the state owned banks were used as special instruments to finance the budget deficit. This strong adjustment explains the GDP's 1.2 percent contraction in the third consecutive year of that recession.

In 2010, one year after the Romanian economy entered recession and confronting the perspective of continuing contraction on the background of worsening the terms for external financing, the Government -- similarly as in the previous recessions -- adopted fiscal and budgetary adjustments: cutting the expenditures and increasing the taxes. Indirect taxation (increasing the VAT) was used this time along with the cutting wages in the public sector and reducing the capital expenditures in the public sector. The government also tried to improve the fiscal discipline and the governance in the state owned companies. These actions were by far less tough compared with those the government was forced to adopt during the previous recession. While the number of closely monitored worst performance state owned companies which generated financial losses was reduced to only 10 companies, no significant privatizations or closures took place. The the budget deficit was decreased simply by reducing the expenditures and increasing the revenues by tax increases. However, the GDP contracted and the economic growth in 2011 was negative.

Major differences between the conditions of the two recessions are reflected also by the level of the inflation rates and the level of the interest rates for government borrowings. In 1998 and 1999, the inflation rates were 54.1 percent and 47.8 percent. In May 1999, the worsening of the market sentiment expecting Romania to default on meetnig its external obligations, the interest rates reached the highest level, 104 percent. They slowly moved downwards, and only after the the volume of the government borrowings decreased, to about 70 percent towards the end of the year. By comparison, in December 2010 – the second year of economic contraction during the next recession – the Government could get finance on the domestic market at interest rates around 7 percent, while the inflation rate remained sigle digit.

In both periods of recession, the investments were not much sensitive to the decrease of the interest rates. This could be explained by the negative market sentiment. However, the downward trend of the interest rates after May 1999 and early 2000, may explain the 4.6 percent increase of the capital accumulation in 2000 – the first year when the good signs of the adjustments operated in the previous year started to show up.

During 1999, the RON depreciated by 72.8 percent against the USD, well above the inflation rate (47.8 percent). This determined an adjustment of the trade balance, which explains the decrease of the current account deficit by USD 1.4 billion (representing 3.9 of the GDP). While exports increased by 2.2 percent (from USD 8.3 billion in 1998 to USD 8.5 billion in 1999), the imports decreased by 10.8 percent (from USD 11.8 billion in 1998 to USD 10.6 billion). In 2009 and 2010, there were also a sharp adjustment of the current account deficit, but this could be explained by other conditions then the RON depreciation. During 2009 and 2010, the RON was relatively stable on the background of a much lower inflation rate as against the late 1990s years.

4. What we know

Today, when the last two periods of recession are „recent history" we know for sure that at least in the short run the fiscal policy is a powerful instrument for the government to operate adjustments. Relatively quickly, the fiscal adjustments (lower expenditures and higher revenues by increasing taxes) could generate new equilibriums for the economy. These equilibriums may be easily understandable and recomended by the economists and experts. However, they are very costly to get by those who finaly pay the bill for the abrupt corrections (companies, individuals or households). Also, the results of such corrections could not be maintained in the long run if the fiscal adjustments are not followed by structural changes in the economy. Also, businesses, individuals and households must adapt and act differently then before when interpreting and considering the existing incentives. The faster they do this, the sooner they get out of a recession.

The new good results of the corrections could be consolidated only by other public policies than the fiscal policy – education, justice, infrastructure (institutions and laws are included here), health, social protection, pension system, etc. Undexpected shocks cannot be avoided, and a small open economy as the Romanian economy, will always follow the big waves affecting the world economy. We only know for the future that the more flexible and open to change the existing institutions are, the more rapidly and less painful a recession shall be coped with.

5. Something can be improved

Unfortunately, lessons well known from the 1997-1999 recession, were ignored before the next contraction occured ten years later. The last recession (2009-2010) even if it was one year shorter and less painful for the society as a whole (at least in economic conditions) and many differences exist between that one and the previous one confirms the validity of few lessons. We could name them as The Six Lessons from the Romanian Experience:

Lesson 1: The lack of reforms and the lack of flexible institutions impose high costs that are paid by the society as a whole;

Lesson 2: The lack of vision at the Government level cannot be offset just by "tehnical skills" of some officials and civil servants;

Lesson 3: Deep and necessary economic reforms fail to succeed if not supported by a strong political will;

Lesson 4: The efforts and the costs of restructuring the economy are much higher during a recession as opposed to adopting them when the economy is growing;

Lesson 5: The personal involvement of major decision makers is a key element in adopting and implementing important decisions for the adjustment. It assumes professional and political responsibility;

Lesson 6: In the actual political and administrative architecture of the Romanian public system, coordination between the Government and the President is needed. Current public policy decisions lay on the Government responsibility. However, the Government needs legitimacy support and even political protection. Without them, individual decision makers and the Government as a whole would not assume responsibilities besides their basic (administrative) duties and would not develop initiatives required to lead.

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