ROMANIAN MACROECONOMIC STABILITY BETWEEN THE BALANCE OF PAYMENT ASSISTANCE AND THE EUROPEAN SEMESTER

Gabriela **Dragan**
The Bucharest University of Economic Studies, România
European Institute of Romania, Bucharest

Abstract: *The first EU Alert Mechanism Report demonstrates the vulnerable macroeconomic external position of Romania, the current Romanian's balance of payments reflecting a severe need of financing and capitalization. On the other hand, the 2007-2013 programming period potentially provided a significant amount of EU money for investments (around 29 billion euro) through Structural Funds. However, five years after the beginning of the current financial framework, the level of absorption remains extremely low. The paper focuses on the main Romanian macroeconomic imbalances (the current account balance, international investment position) and on the most important sources for financing investments and development - the EU financial structural instruments: ERDF and Cohesion Fund.*

Keywords: economic and financial crisis, macroeconomic imbalances, EU funds absorption, balance of payments.
JEL Classification: F02, F36, F59

INTRODUCTION

When the financial crisis hit Europe, Romania was one of the most exposed countries from Central and Eastern Europe (CEE). Before 2008, the very rapid growth which stimulated the domestic demand was mainly the effect of foreign direct investments and capital inflows facilitated by foreign banks with subsidiaries in Romania. As a result of the reduction of capital inflows and sharp decline in export demand, the previous pace of growth has proved unsustainable and a very severe recession hit Romanian economy in the late of 2008 (Dragan, 2011). In order to avoid a possible banking sector collapses in CEE, the EU, the IMF and other International Financial Institutions (EBRD, EIB and the World Bank Group) created a new financial facility called *EU Balance of Payment Facility* (BOPF). Consequently, Romania, Hungary and Latvia, all of them non-euro EU member-states facing problems resulting from an "*unusual combination of external shocks and domestic policy mistakes*", received a common financial support package of around €50 billion**.** Romania signed its first agreement of multilateral financial assistance in May 2009 (for an overall amount of 20 billion euro) and an additional one in May 2011 (for around 5 billion euro).

The first *Alert Mechanism Report* on macroeconomic imbalances in the EU member states, published by the European Commission in February 2012, demonstrates the vulnerable

macroeconomic external position of Romania, which surpasses the indicative threshold in three out of ten indicators, all of them from the area of external imbalances and competitiveness. Although the FDI inflows in Romania have decreased due to prolonged economic recession of Western Europe, the EU funds allocated to our country for the 2007-2013 financial period should have had a visible impact on the Romanian BoP, offsetting this drop and supporting the external sustainability of the country. Unfortunately, the contracted and payment ratio are still very low in Romania comparing with the CEE average. Romanian"s poor absorption of EU funds represents a multifaceted reality, the causes ranging from a weak administrative capacity (managing structures and rules too complicated, inefficient procedures, institutions, etc) to the lack of co-financing, respectively of guaranteeing the national contribution, as a result of an acute shortage of financial resources both for public and private co-financing investments.

1. FROM THE EU BALANCE OF PAYMENT SUPPORT TO THE EUROPEAN SEMESTER

Carmen Reinhart and Kenneth Rogoff (2008, 2010), both former International Monetary Fund economists, have proved, using past country experiences, the striking correlation between freer capital mobility and the incidence of banking crises. As a general rule, a financial (banking) crisis is followed by a currency crisis, which in turn, exacerbates the banking crisis"s dimension. According to Reinhart and Rogoff (2010), data collected over a long period of time "confirms a strong link between banking crises and sovereign default across the economic history of great many countries, advanced and emerging alike" and the evidence that "banking crises (both domestic ones and those emanating from international financial centers) often precede or accompany sovereign debt crises", on average, public debt growing by around two-third in the years immediately following a banking crisis.

The collapse of Lehman Brothers determined, among others, a brutal disruption of international capital flows all over the world, including Europe, where the most exposed financial systems of the EU, confronted with significant risks of foreign banks withdrawals, were those of the Central and Eastern European countries. Consequently, at the end of 2008, large European banks, with systemic presence in these countries, decided to maintain their exposure there and to keep their

subsidiaries well capitalized, under the so-called Vienna Initiative[*]. The *European Bank Coordination Initiative* EBCI, launched in January 2009, brings together important IFIs (IMF, EBRD, EIB, World Bank Group), European institutions (EC, ECB as observer), country central banks, regulatory and fiscal authorities and the most important EU banking groups acting in the Eastern Europe, its aim being to "help […] banking system to better withstand the current downturn and return the economy back to a sustainable growth path" (Williams, EBRD, 2011). The EBCI"s motivation is to address, on the one hand, „the twin vulnerability of weak domestic capital markets and limited reliance on domestic sources of finance" and, on the other hand, to lend "borrowers without foreign exchange income" (European Commission, EUPress Releases, 2010a).

Consequently, the solution found for most vulnerable non-euro member states was to place them under the umbrella of a common financial support provided by the EU and IMF plus other international financial institutions (EBRD, EIB and the World Bank Group)[†]. For the EU, this financial assistance is called the *Balance of Payment facility* (BoP) and has been made available for those member states outside the Euro area, "*seriously threaten with difficulties*" in their short-term balance of payments as a result of "*unusual combination of external shocks and domestic policy mistakes*" (European Commission, 2009).

Table 1 - Outline of the joint IMF-EU current balance-of-payments assistance programmes

Country	Total international financial assistance/ EU financial assistance	Period covered by EU assistance	Status of the programme (June 2010)	Main areas of policy conditionality
Hungary	€ 20.0 bn / € 6.5 bn	Until November 2010	Quasi-precautionary (the authorities decide on a case by case basis whether to draw)	Fiscal consolidation Fiscal governance reform Financial sector regulation and supervision reform Other structural reforms (mainly related to transport sector)
Latvia	€ 7.5 bn / € 3.1 bn	Until January 2012	Active (disbursements continue), although part of bilateral funding will be treated as credit lines	Fiscal consolidation Fiscal governance reform Financial sector regulation and supervision reform Structural reforms, business environment Absorption of EU funds
Romania - I -	€ 20.0 bn / € 5.0 bn	Until May 2012/ Until June 2011	Post programme surveillance Disbursements completed	Fiscal consolidation Fiscal governance reform Reform of public wage system Pension reform

[*] In January 2009, the nine banks with high exposure on Eastern Europe (Erste Group Bank, Raiffeisen International, Eurobank EFG, National Bank of Greece, UniCredit Group, Société Générale, Alpha Bank, Volksbank, and Piraeus Bank) launched the *European Bank Coordination Initiative* (EBCI), known as *"Vienna initiative"*.

[†] The IFI have committed to make available up to €25 billion under this Joint IFI Action Plan.

				Financial sector regulation and supervision reform Absorption of EU funds
Romania – II-	€ 5.0 bn / € 1.4 bn	Until March 2013	Precautionary (not activated)	Continued fiscal consolidation Fiscal governance reform Financial sector regulation and supervision reform Product market reform with a focus on energy and transport sectors Labour market reform Absorption of EU funds

Source: European Commission, Economic and Financial Affairs, Balance of Payments Assistance, available on http://ec.europa.eu/economy_finance/eu_borrower/balance_of_payments/index_en.htm.

One may note, however, that almost all countries from Central and Eastern Europe had experienced a very difficult period due to the crisis, but only three of them (Hungary, Romania and Latvia) received financial support through three joint EU-IMF programs which were strictly connected with very strict austerity measures. On the other hand, even though fears that foreign banks would make large withdrawals of capital from the region have so far proved unfounded, there is still a possibility that a return of financial difficulties in Western Europe could lead to parent banks diverting capital to their home markets (Hoey, 2010) and make necessary new EU financial interventions.

The EU BoP programme has recommended Romania to bring the general government deficit below 3% of GDP by implementing fiscal measures. Among the austerity measures implemented in 2010 and 2011 by the Romanian Government, in line with the policy conditions imposed under the balance-of-payments support programme, the expenditure cuts represented a priority: public sector wage cuts and freezes, cuts in public spending on goods and services, pension freezes, subsidies cuts, all of these measures meaning to contribute to a cut in expenditures of around 2.2% of GDP. However, the Council"s comments on the Romanian Government programme has underlined political and social difficulties of carrying out some of the reforms envisaged, especially in the field of EU funds" absorption (mainly, because of the lack of effectiveness and efficiency of public administration, both at the central and local level) but also the fact that "the impact of these measures is partially offset by expenditure increases elsewhere" (EC, 2010b, pp. 3-4).

At the moment, the most urgent task for the Europe and, as well for Romania, is to restore confidence in the future by preventing a vicious cycle of unsustainable debt and low economic growth. In order to ensure a sound fiscal consolidation in the EU, the European Commission decided to implement, among other measures, a more rigorous instrument of monitoring the

programming of national budgets, the so-called "*European Semester*". The Alert Mechanism Report is part of this new EU surveillance procedure and will be discussed in the following section.

2. MACROECONOMIC IMBALANCES IN THE ROMANIAN'S EXTERNAL POSITION

The *European Commission Alert Mechanism Report* on macroeconomic imbalances in the EU member states (February 2012) is based on a scoreboard (including indicators and thresholds) and represents the first phase of the new EU surveillance procedure, being part of the new introduced instrument the "European Semester". The main goal of the Report is to allow the EC to find out internal and external imbalances of the analyzed countries and, if it is the case, to "propose policy recommendations, either under the preventive or the corrective arm of the procedure" (AMR, 2012). The report demonstrates the vulnerable macroeconomic external position of Romania, which surpasses the indicative threshold in three out of ten indicators, all of them from the area of external imbalances and competitiveness, specifically on the current account balance, international investment position and nominal unit labour costs (Table 2).

The Report shows that at the EU level, as a result "of a sharper drop in private sector demand and a corresponding contraction in imports", the crisis has determined "a significant reduction in external imbalances" in most of the EU member states, particularly in those EU countries "which entered the recession with large current account deficits", (AMR, 2012). Consequently, the high current account deficits decreased in the majority of EU member states. However, there are a number of EU member states, and among them Romania, where the scoreboard indicator on the ***current account balance (CAD)*** has been surpassed. Nevertheless, even if the AMR threshold of 4%/ +6% for "the 3 year average Current Account Balance" (as a % of GDP) has been slightly exceeded in Romania, where the average is - 6.6 %, the situation is even worse for countries like Bulgaria (-11.1%), Greece (-12.1%), Cyprus (-12.1%) and Portugal (-11.2%).

Table 2 - The Romania's Macroeconomic Imbalance Procedure (MIP) scoreboard for 2010

External imbalances and competitiveness				
3 years average of CAD (% of GDP)	Net International Investment Position (%of GDP)	% change (3 ys) of Real Effective Exchange Rate with HIPC deflators	5 change (5 ys) in Export Market Shares	% change (3 ys) in Nominal ULC
EU Thresholds				
-4/+6%	-35%	+/-5% & +/- 11%	-6%	+9% & +12%
The Romania MIP scoreboard				
-6.6	-64.2	-10.4	21.4	22.1
Internal imbalances				

% y-o-y change in deflated House Prices	Private Sector credit Flow (% of GDP)	Private Sector Debt (% of GDP)	Public Sector Debt (% of GDP)	3 years average of Unemployment
EU Thresholds				
+6%	15%	160%	60%	10%
The Romania MIP scoreboard				
-12.1	1.7	78	31	6.6

Source: Author, on the base of the EC, Alert Mechanism Report, p.4

Romania‟s external deficit (the CAD) declined from a peak of around 13% in 2007 to an average of around 4% since 2009 and, according to the 2012 European Commission Spring Forecast, it will remain below 5% of GDP in the next period 2012-2013 (EC Spring Forecast, 2012). The decrease of CAD over the past three years was mainly the result of a significantly decrease of trade deficit, due to a sharper decline of imports on the back of the domestic demand‟s turn down.

Theoretically speaking, the potential vulnerability created by the current account deficits could be diminished if these deficits are financed through relatively secure means, such as FDI or capital transfers, including capital inflows from the EU funds. In a balance of payment, the financial account shows how an economy‟s BOP transactions are financed: if an economy‟s savings exceed its investment, the surplus must be reflected in net financial outflow or net financial investment in the rest of the world and if an economy‟s savings are less than its investment, the economy will be a net importer of nonfinancial assets from the rest of the world and these net imports should be financed by a net financial inflow from the rest of the world (IMF textbook, 1996). According to the evolutions registered by the Romanian‟s balance of payments, the net FDI has sharply decreased as a result of the crisis and uncertainty felt by the foreign investors, from a peak of 8.9% in 2006 to less than 2% after 2010 (Convergence Report 2012). However, the position "net other inflows" (including financial derivatives) remained positive during the crisis due to loans from IMF and EU. As we presented in section 2, a substantial official international BoP assistance totaling up to 20 billion euro was provided to Romania for the period 2009-2011 and, in spring of 2011, an additional programme was made available, accessible until early 2013. However, at the same time, the level of gross external debt, has significantly increased, from about 40% of GDP in 2006 to more than 70% after 2010 as a result of disbursements of international financial assistance and international bond issues (in June 2011, a first euro-denominated issuance of 5-year bonds and in January 2012, a new US dollar-denominated issuance of 10-years bonds).

The negative international investment position has deteriorated as well, from -37% of GDP in 2006 to above 60% of GDP after 2009. The negative situation in the ***net international investment***

position (NIIP) is occurring when "financial liabilities exceed financial assets", an economy"s external financial assets consisting of "claims on non-residents and of monetary gold and SDRs held by the monetary authorities" (IMF textbook, 1996). The AMR scoreboard shows that the *net international investment positions*, calculated as a % in the GDP, have registered "high negative levels in many current account deficit countries", "due to persistent, although lower, current account deficits and also weak growth dynamics" (AMR, 2012). All new EU member states from CEE and some of the vulnerable older EU member states (Greece, Spain, Portugal, Ireland) exceed the indicative threshold of -35%. However, the degree of vulnerability is lower if the percentage of liabilities in GDP (respectively, the net external debt) that require repayment of principal or interest is low. At the moment, Romania registers a level of 38.3% of NED in GDP, as a result of a still low level of indebtedness. The risk to see this indicator rising on medium term is a real one, as well as the current account crisis converting into a public finance crisis, as the structure of the foreign debt is changing from private to public. Total external debt was up from 54% of GDP in 2008 to 70% in 2010, and is estimated to reach 82% in 2011, while total public debt increased from 20% of GDP in 2008 to 30% in 2009 and about 40% in 2010 (Constantin et al., 2011)

Hence, although the FDI inflows in Romania have decreased due to prolonged economic recession of Western Europe, the EU funds allocated to our country for the 2007-2013 financial period could have had a visible impact on the Romanian BoP, offsetting this drop and supporting the external sustainability of the country. The 2012 Convergence Report specifies that "Romania"s external position is expected to benefit from a higher absorption of EU funds, while supported by the precautionary EU-IMF assistance programme." (2012 Convergence Report, p. 140). The following section will focus on some evolutions concerning the EU funds absorption in Romania.

3. A GENERAL OVERVIEW ON THE ROMANIAN'S ABSORPTION IN THE FINANCIAL PROGRAMMING PERIOD 2007-2013

Romania is experiencing a rather paradoxical situation: while the macroeconomic indicators reflects a severe need of financing and, potentially speaking, an important amount of EU money is at its disposal, covering different category of investments (from infrastructure in transport and environment to human resources), so far, Romania has not been able to take advantage of it.

According to the latest KPMG report on the absorption of the EU funds (May, 2012), at 31 December 2011 Romania occupied the last position among the CEE countries, both in terms of contracted and paid grants. Specifically, of the 23.25 billion Euro allocated for the 2007-2013

programming period, the contracted amount was 14.61 billion (63%) and the EC disbursement of 3.15 billion Euro (14%) (KPMG Report, 2012). On the other hand, one should notice that a "better absorption of EU funds by national authorities" and, at the same time "a closer involvement of banks in the selection, prefinancing and co-financing of structural funds projects" could have generated new business opportunities and thus contributed to the recovery of the Romanian economy (Dragan, 2011).

Table 3 - The situation of EU funds absorption in CEE countries at 31 December 2011

Country	Available budget 2007-2013 (bn euro)	Contracted grants (bn euro/ %)	Paid grants (bn euro/%)
TOTAL (10 CEE)	***209,14***	***139,87/ (67%)***	***60, 84 / (29%)***
Bulgaria	8,02	6,33 / (79%)	1,51 / (19%)
Czech Republic	30,77	22,20 / (72%)	11,86 / (39%)
Estonia	4,10	3,85 / (94%)	1,81 / (44%)
Hungary	29,32	18,84/ (64%)	8,33 / (28%)
Latvia	4,94	4,27/ (87%)	2,15 / (44%)
Lithuania	7,43	5,80 / (78%)	3,23 / (43%)
Poland	82,87	52,44 / (63%)	23,09 / (28%)
Romania	**23,25**	**14,61 / (63%)**	**3,15 / (14%)**
Slovakia	13,6	8,66 / (64%)	3,84 / (28%)
Slovenia	4,82	2,86 / (59%)	1,84 / (38%)

Source: KPMG Report, 2012

For the 2007-2013 programming period, the overall EU financial support from the ERDF and Cohesion Fund amounts to an average of around 0.3% of EU GDP per year, with variation from 0.01% for Luxembourg or 0.02% in Denmark to around 3% or just over in each of the three Baltic States and Hungary (Expert evaluation, 2012). For CEE countries, the percentage is somewhere between 2 and 3% or below 2% in Romania and Slovenia (Table 3). In relation to the government capital expenditure, which might be at least indicative of capital expenditure on regional development, the proportion is much larger (over 25% of such expenditure in all CEE countries, with lower levels in Slovenia and Romania, of 25-27%, and more significant levels in Baltic States and Hungary, between 40% and 68%.

Table 4 - Allocation of ERDF and Cohesion Fund to Member States, 2007-2013 (average per year)

	Allocation 2007-2013			Funding remaining 2012-2015	
	EUR Million	% GDP	% Govt. capital expenditure	% GDP	% Govt. capital expenditure
Bulgaria	5,488.2	2.18	42.7	2.88	56.6
Czech Republic	22,475.2	2.15	31.7	2.74	40.4
Estonia	3,011.9	3.01	62.4	3.08	64.0
Latvia	3,947.3	3.14	41.2	3.68	48.3
Lithuania	5,747.2	2.98	58.3	2.71	53.0
Hungary	21,292.1	3.13	68.3	3.53	77.0

Poland	55,514.7	2.24	35.5	2.44	38.6
Romania	15,528.9	1.82	27.3	2.67	40.2
Slovenia	3,345.3	1.35	25.4	1.46	27.5
Slovakia	9,998.7	2.17	59.0	2.72	73.8

Source: Expert evaluation network delivering policy analysis on the performance of Cohesion Policy 2007-2013. Synthesis of national reports 2011, Belgium, February 2012

On the other hand, the annual amounts remaining for the period 2012-2015of the period are larger in relation to government capital expenditure in 2010, since the latter is assumed to be spread over 7 year and the former over the remaining two years of the period plus two additional years to allow for the n+2 rule. In this case, the remaining funding amounts to at least 40% of government capital expenditure a year, in all CEE countries (apart from Poland, where it is just under 40% and Slovenia with 28%). Romania had one of the lowest proportions of ERDF and CF allocations over the period 2007-2013, respectively less than 2 % of GDP (only Slovenia had a even smaller percentage).

Although the mentioned figures give us only an approximate indication of the size of EU funding in relation to the overall spending on regional development, they draw attention to its critical importance in this regard. In conclusion, the figures set out above reinforce the remark that for many EU countries the ERDF and the Cohesion Fund are critical sources for financing the development expenditure over the remainder of the programming period.

CONCLUSIONS

At the EU level, the differentiation between euro and non-eurozone economic policy measures is likely to become an issue and arise the question to what extent an EU with two speeds, one for the "core Europe" and one for the non-eurozone countries, could resist. The European Semester, however, is likely to become subject for new political debates concerning the power of national parliaments during the budgetary cycle. The mainly proposed measures in the field of fiscal consolidation, either under the EU-IMF financial assistance umbrella or under the other EU surveillance mechanisms (such us the European Semester), will have, in the short run, a twofold effect: a positive one, strengthening the financial stability and, a negative one, reducing the demand and the standard of living mainly in the geographical periphery of the EU. The threat is that the crisis „effects on the Europe"s Eastern periphery weaken the whole European integration process and this reality should represent the main concern for all EU policy-makers in the future (Dragan, 2011).

Romania is dealing with severe internal structural problems (inefficient institutions and economy, demographic decline, etc.) and a poor crisis management (one of the most debated measure during the first stages of the crises, the cut of salaries for the public sector, has mainly determined a sharp reduction of purchasing power and living standards of the population, reduction of internal demand and, finally, deepening of the crisis). Consequently, the time is now for Romania, even at the eleventh hour, to rediscover the utility of the EU Structural Funds which might represent the most important external impulse for economic growth. However, the condition is that Romania rapidly solves its constant "absorption problems" and become able to spend the remaining allocated funds.

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