

FISCAL AND FINANCIAL STABILITY IN ROMANIA – AN OVERVIEW*

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Abstract

The recent financial crisis has seriously shaken economies around the world, and raised serious doubts about the long-term viability of the public policies to remedy market imperfections. The effect has been pronounced for Romania, a newly transitioned country with a fragile market economy due to political, economic and social consequents. This paper examines the correlation between fiscal policy and financial stability in Romania in the period from 1990 to 2011. Specifically, we analyze the country's main monetary and fiscal policy decisions and their associations with macro-economic variables, highlighting the requirements for a sustainable macro-economic policy and whether such requirements have been met in Romania. Based on the results, we further outline recommendations to improve Romania's public policy initiatives, considering the specific correlations between monetary and fiscal policies. The results for the period under study indicate that fiscal and monetary policies promoted in Romania have not been consistently harmonized, at times lacking necessary mutual support, or even generating conflicting outcomes favorable to the manifestation of fiscal and financial instability.

Keywords: fiscal policies, government debt, monetary policies, financial stability, Romania.

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1. Introduction

Government intervention in economic and social activities has not been questioned in its substance since the 1929 Great Depression. Today, doctrinal differences target rather the amplitude and instruments of public intervention. The need for government intervention to regulate economic and financial activities, stabilizing, re-launching, tuning or moderating the pace of the economy, is unanimously recognized, being requested especially during times of economic crisis. In this context, the financial policies promoted by public authorities cannot be limited to providing public goods such as defense, education, culture etc. Instead, these policies must necessarily be oriented towards ensuring the long-term stability of social and economic systems. According to this view, fiscal and monetary policies appear to be foundational to achieving social and economic goals. Their specific decisions, therefore, should be convergent and complementary. Lack of agreement between adopted fiscal and monetary measures can generate serious dysfunctions in the economic and financial mechanism, with negative effects on the progress of society. The prerequisite for ensuring the necessary agreement between the two policies consists in a full rationality of the components under discussion (Altăr *et al.*, 2010, p. 22).

Particular to economic systems that are insufficiently consolidated, as it is the case of Romania, the inconsistency and frequency of change in adopted measures appears to be a highly negative factor. We believe that this inconsistency may be based on the lack of a long-term and clearly stated vision, proved in some cases by the absence of an official development program, and frequently under the pretext of political considerations, such as changes in the mandates of elected authorities. Moreover, the Romanian experience shows that periods of economic prosperity are favorable for accumulating vulnerabilities at the financial and monetary level, as public authorities show little concern for conceiving or updating mechanisms to manage potential economic crises (Dumitru and Stanca, 2011; Altăr *et al.*, 2010, p. 19).

In such a context, it is often easier to persuade the government, as a promoter of fiscal policy, to relax taxation and create advantages for a certain class of taxpayers, at the price of creating or worsening the fiscal or monetary instability. For instance, repeated decisions to maintain unproductive public economic entities due to social reasons, public salary increases without connection to productivity, social assistance aid taken from the state social insurance budget instead of the state budget, and disregarding the correlation between inputs and outputs, all contribute to financial crisis. On the contrary, financial and economic stability is generally achieved when policies are articulated with a reserved and balanced stance, such as the policies enumerated by the Central Bank.

We analyze the correlations between fiscal and financial stability in Romania in the period between 1990 and 2011, according to fiscal and monetary policies promoted by Romanian authorities, and in view of contributing factors such as economic transition, European integration, and financial crisis.

2. Objectives of the research, methodology and literature review

The main objective of this research was to examine the way and the extent to which fiscal and monetary policies were correlated in Romania following the transition to a market economy in 1990. We assume that the policies were adopted in order to achieve fiscal and financial stability goals. From such a perspective, our analyses track both alignments between the implemented measures and the stated or committed objectives, and their compatibility with accepted theoretical requirements of such policies.

Given our research objective, we highlight the major qualitative inconsistencies of public policy in Romania, and employ the results of a quantitative analysis of the macro-economic variables to make a series of fiscal and monetary policy recommendations. This is done with the goal to improve the quality of public governance in the country. We divide the analysis by significant time stages and by categories (e.g. macro-economic policies, regulation, adopted strategies etc.). In addition, we identify inefficacy characteristics and causes that led to the development of improper policies. We use a set of official studies, as well as the opinions expressed by specialists, to check and validate our conclusions. Finally, we employ official information published in the Official Journal of Romania, budgetary laws, reports of the National Bank of Romania and of the Fiscal Council, and statistics offered by the National Institute of Statistics, the National Forecasting Commission, and the Ministry of Finance to examine the legislative aspects of the policies implemented by the public authorities.

Fiscal and financial stability issues are not new topics in the public finance literature, although the re-emergence of these studies is noticeable in the post 2008 financial crises era. While there is a voluminous literature on the theoretical foundations of fiscal and financial stability, the number of studies concentrating on fundamentals and correlation analysis of fiscal and financial stability is limited. In most instances, applied research papers merely concentrate on general issues, such that their conclusions are applicable to a group of states, not to a particular state, specifically Romania.

Brunner (1986), regarding the fundamentals of fiscal and monetary policy correlations, argued that instituting a monetary rule must be supplemented by instituting a fiscal rule, sustaining the necessity of an integrated vision when conceiving the financial strategies and functional relationship between fiscal and monetary policy makers. Hansen (1936) and Hicks (1949, 1953) suggested a correlation analysis approach that combines the effects of the changes in the fiscal and monetary policy in the framework of the Investment-Savings / Liquidity-Money (IS-LM) model. The analysis offers a good theoretical background for the research in the field, however, his results do not explain entirely the effects and correlations between the fiscal and financial stability.

In line with such theoretical bases, many authors believe that the way and the extent to which monetary and fiscal policies supplement each other leads to the enhancement of outcome, depending on effectiveness of these policies. For instance, Dodge (2002) noted that in setting interest rates, the Central Bank should consider the effects of fiscal policies on aggregate demand and inflation, just as the government

should consider the impact of fiscal policies on inflation and interest rates. Dodge identified the link between the size of the public debt, the anticipations of the agents involved (e.g. consumers, manufacturers, tax payers, banks) and its effects on the fiscal and financial planning, especially from the perspective of the capacity to monetize the public deficit. As argued by Mishkin (1999), financial instability reveals the inability of public policy makers to allocate resources towards practical and constructive goals, which may lead to financial crises.

Financial stability in many cases is characterized in accordance with the indicators developed by the International Monetary Fund (IMF) in 2006, for which there are no particular controversies (Hawkins and Klau, 2000; Nelson and Perli, 2005; Gray *et al.*, 2007). There are, however, several authors who also formulated approaches to achieve and to maintain stability, proposing various fiscal or monetary methods (Kamps, 2001; Giammarioli *et al.*, 2007; Price, 2010). The subject of fiscal and financial stability in Romania can be found both in papers related to financial and monetary policies (Cerna, 2006; Cerna, 2008; Dinga, 2010), and in related economic studies (Isărescu, 2006; Cerna, 2009; Popa *et al.*, 2009).

From the perspective of the need of fiscal and financial stability, the effort of governmental politics needs to insure the sustainability of public finance on medium and long term. This would mean that during the period of time considered, there are also possible (accepted) some disequilibriums (gaps), sometimes even provoked (this being the case of accepting and financing the budgetary deficit through public borrowing), provided the fact that it is able to sustain itself.

Alvarado *et al.* (2004) defines the sustainable fiscal policy as being a set of policies that will not lead to payment incapacity for the government in the future or to the necessity to monetize the budgetary deficit, or to a major fiscal correction in order to avoid bankruptcy or to monetize the public debt and deficit. Within the context of European integration, the sustainability of public finances for a state is evaluated by the fulfillment of the fiscal rules established through the Stability and Growth Pact and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, also known as the Fiscal Compact (budgetary deficit lower than 3 percent of the GDP, public debt lower than 60 percent of the GDP, structural public deficit lower than 0.5 percent of the GDP), even if the viability of these levels for all the states might be questionable.

The sustainability of public finances in Romania was the subject of several studies, from different perspectives (the sustainability of social insurance, of public debt, of public deficit etc.).

Zaman and Georgescu (2009) identify some factors that led to the actual crisis: there was an uncontrolled credit boom, a rapid price growth in the real-estate sector, there was also a wide spread of the 'originate-and-distribute model' in financial markets, global imbalances, excessive appetite for profits that fueled demand for assets with high risk, and, finally, there was inadequate corporate governance and inadequate managerial incentives.

Altăr *et al.* (2012) frames the problem of the fiscal and financial stability (of the sustainability, respectively) in the context of the European semester, considered as a fundamental component for improving the economic governance at European level. The study starts from the prerequisite that in order to obtain/maintain the stability of public finances, the free movement of the automatic stabilizers is more efficient, and the discretionary public finance policies should not disturb its manifestation and effects, because 'there is a government's tendency to spend the earnings generated in the positive cycle phase and then to finance fiscal costs of the recession by borrowing' (leading to increased levels of budget deficit). Analyzing the Romanian situation, the authors of the study highlight the main sources of instability at financial and fiscal level, with its corresponding challenges, among them: the low level of tax collection, the chronic deficit of the pension system, the quasi-fiscal deficit in the sector of state owned enterprises, the unsustainable structure of public spending and the low efficiency of spending public money, the lack of prioritization in public investments as well as the lack of true multi-annual budgeting and soft budget constraints at the level of local authorities.

From the point of view of the rational need and prudence, that should characterize the public financial policies, some studies (Ilzetzki and Vegh, 2008; Alesina, Campante and Tabellini, 2008) highlight a trend for developing countries to use procyclical fiscal policies, diminishing the fiscality and increasing the public expenses in periods of economic prosperity, as a result of growth euphoria, tendency that manifested also in Romania.

3. The general framework of the fiscal and monetary policies in Romania after 1990

Romania's shift toward a democratic regime and market economy in 1990 necessitated a series of changes in the long-existing social and economic landscape. Transitioning to a functional market economy with a course of 'gradual therapy' did not prove to be best, as the transition was rather long and at a low speed, with an expected completion date in 2004. During the 1990 to 2004 period, reform in the public economic sector was carried out through policies of closing or privatizing most of the country's largest public enterprises, making the sector more competitive. Strategies implemented to stimulate the development of the private sector dragged on excessively, and economic performance (implicitly, fiscal and financial stability) was consistently negatively influenced. For a long time, gross domestic product (GDP) growth had negative real values, although in nominal terms, GDP grew while inflation increased at a fast rate. Figure 1 depicts the evolution of the GDP in real terms.

As Figure 1 shows, until 2000, GDP growth in some short periods did not outweigh its decline. This evolution had its origins in governmental commitments and inconsistencies, the disparities that several of these commitments created, and through an immature focus on 'strategic' short-term issues over longer-termed concerns.

During the earlier years of Romania's transition to a market economy, prevailing decisions in public finance were determined by the particularity of the state's involvement in economic activity. Some public entities were reorganized as independent companies or limited companies with public capital. This form of privatization was

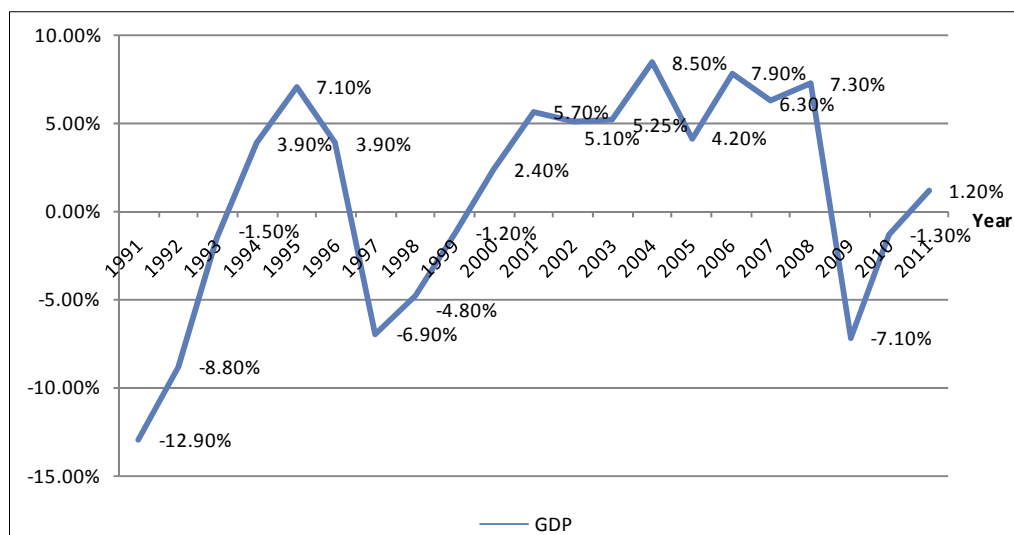


Figure 1: Romanian real GDP growth, 1991-2011 (percent)

Source: Romanian Statistical Yearbook, the national forecasts and the reports of the Fiscal Council

generally an acceptable means to discharge government budgets of considerable expenditures in the financing of public entities; however, the process dragged on for relatively long time as the state incurred higher expenditures for the development and modernization of infrastructure, the environment, social security issues etc.

According to 'The Strategy for Implementing the Market Economy in Romania' (1990), the main reform in the country's public policy was the gradual reduction in public funds allocated from the state budget for economic goals. With this reduction, a larger amount of funds were available to be directed towards action straight through market mechanisms. In addition, the state allocated more of its budget towards education, health, culture, public order, national defense, general public services, and general economic objectives (Văcărel, 2001). Nonetheless, in the absence of both an authentic, uniquely designed, and innovative fiscal reform that was not only tax-related, but also budget-related, and an optimum ratio between current and capital expenditures, a potential economic crisis was likely to occur in Romania. Growing macro-economic and sector-structural imbalances, continuous excesses in supply and demand, and a decline in labor productivity furthered this potential (Dăianu, Kallai and Lungu, 2012a).

Additional public policy in Romania consisted of the government's commitment to multi-facet tasks to reform public expenditures by reducing current expenses on one hand, while increasing capital investments on the other hand. This was done mainly to finance the modernization of the public companies, but also to subsidize some giant public companies that had become unprofitable, arguing that they were essential for the national economy. The increase in public spending created a significant budget deficit that had to be financed by public borrowings and loans with the hope that the loans would be repaid during periods of economic growth and stability.

During the years that followed, however, no positive effect of this ‘deficit financing’ policy on sustainable growth of GDP was observed. Government and public authorities seemed to promote sustainable economic growth through ‘increasing the budget for social benefit projects and reducing subsidies and capital expenditures in the total budget’. Unfortunately, the resulting policies were contradictory and inconsistent (Văcărel, 2001).

The economic policy ‘Memoranda’ adopted in 1997 and 1999, likewise, perpetuated inconsistencies of the policies that were meant to reform the fiscal process regarding public spending and revenue. This led to detrimental instability in overall public finances and implicitly of public budgets. In these conditions, Romania experienced a paradoxical situation from the perspective of the rationality of formulating policies, ‘because the government advocated a social policy that committed the State to cover public expenditures on a large scale; however, the gross domestic product was not sufficient enough to support the deficit for many years in a row and each year smaller amount from the gross domestic product could be allocated to cover the deficit’ (Văcărel, 2001, p. 182).

After 2000, Romania’s GDP grew in real terms, and a longer period of economic growth took place. During the 2001 to 2008 period, Romania’s gross domestic product experienced large growth, exceeding the average of the European Union. Additionally, the Romanian economic growth was positive until 2008, but the country faced a real decrease of 7.1 percent in 2009, 1.3 percent in 2010 and only 1.2 percent increase in 2011 (European Commission, 2010, p. 132).

Despite the growth of public spending out of the general consolidated budget, Romania experienced continuous deterioration of the economic and social conditions in the early part of the period between 1990 and 2011 (Table 1). This forced the government to undertake serious measures to reform the infrastructure, social protection and security etc., in the context of a real increase of the GDP after 2000.

Table 1: The evolution of general consolidated budget (GCB) public expenditures in Romania during 1990-2011

Year	GCB expenditures (mil. RON)	percent of previous year (nominal value)*	GCB expenditures (percent of GDP)
1990	32.3	...	37.7
1992	249.7	773	41.4
1994	1664.2	667	33.4
1996	3777	227	33.2
1998	13257.7	351	35.5
2000	31225.6	236	38.6
2002	53221.1	171	35.0
2004	83003	156	33.6
2006	122500	148	35.5
2008	202200.6	165	39.3
2010	210154.8	104	40.1
2011	219127.8	104	37.9

*Note: For the period 1990-1994, the extreme growth rates recorded are explainable through the high level of inflation (see Figure 7).

Source: Romanian Statistical Yearbook and Eurostat

From the perspective of the relationship with the monetary policy, fiscal actions targeted at economic stabilization using expansionist-type of policies, were major factors that generated and maintained inflation at high levels for several years. There were no legal provisions to prohibit budget deficits to be financed by borrowing directly from the National Bank of Romania until 2001. Especially at the beginning years of the transition, from 1991 to 1993, covering public spending by printing money created a quick-rising inflation, with obvious long-term social costs.

4. Fiscal policy and fiscal vulnerabilities in the 1990-2011 period in Romania

In 1991, Romania initiated a series of institutional, economic, and administrative reforms that had a direct impact on the country's fiscal condition. In the case of compulsory levies, considerable alterations were carried out in direct and indirect tax structure, but the resulting tax system was incoherent and exposed to certain inequities. Thus, income tax structure was successively changed by replacing profit tax with tax on the return generated by economic units, separated based on the rate of return and the ownership form. Three years later, an unpopular amendment was introduced by instituting 67 taxation tranches that were immediately removed by retaining only two tranches and two rates, 30 percent and 45 percent. However, taxes on private business, the engine of economic growth, rose by 25 percent, while large public-loss-generating enterprises were given an advantage of tax break from 45 percent to 77 percent. Following more changes (38 percent and 25 percent) in 2005, the single rate of 16 percent was instituted, both for corporate and personal income.

In the case of individual salary tax structure, the tax on wages was replaced immediately after 1990 by a progressive tax system, initially ranging between 6 percent and 45 percent, and between 18 percent and 40 percent in 2004. Taxes on dividends were put into effect in 1991, initially targeted at the profit distributed among foreign shareholders of a company that are partially or entirely financed by foreign capital. The rates of taxes on dividends were reviewed several times, ranging from 5 percent for individual and 10 percent for legal entities, up to 16 percent currently. For indirect taxes, the major changes were: a) the value-added tax replaced the tax on the circulation of goods in 1993, b) the rates applicable to excise taxes, and c) the structure and the rates applicable to customs duties.

Even if the general consolidated budget (GCB) revenues exhibit an upward trend in nominal terms, their share in the GDP has been relatively constant from 1990 to 2011, as can be seen from Figure 2.

The figure shows a tortuous growth of the revenues, while the trend is steady after 2007. There are several factors explaining such levels. It must be noted that in 2010, solvent public companies benefited from 37 percent of the total subsidies, while at the same time generating almost 66 percent of the total losses of the public sector. The bureaucratized and inefficient tax collecting system, as well as a tax structure with abundant loopholes, resulted in a high level of tax evasions and low level of tax collections. According to the 'Doing Business 2011' report of the World Bank and the

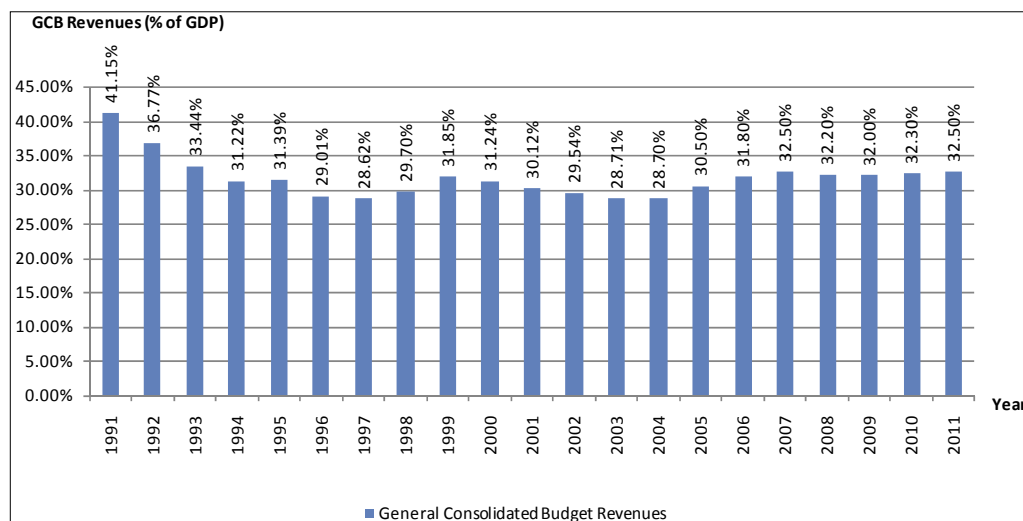


Figure 2: Share of the revenues of Romania's General Consolidated Budget in the GDP (percent, 1991-2011)

Source: Calculations based on the data included in the Romanian Statistical Yearbook, the national forecasts and the reports of the Fiscal Council

International Finance Corporation, Romania was ranked next to last among 183 countries, according to the number of corporate tax delinquencies (World Bank and the International Finance Corporation, 2010).

Regarding indirect taxes, the introduction of the single tax rate had positive effects on the taxpayer compliance with the payments, causing a higher collection rate, but yet lower than in other European Union countries. The attempt to consolidate public budget revenues, affected by the economic contraction specific to periods of crisis, was based mainly on raising the VAT level from 19 percent to 24 percent; however, the difference between the implicit tax rate and the legal rate is just 58 percent, compared to Bulgaria which had a difference of 71 percent. Similarly, in the case of social security contributions, the ratio is 64 percent, which is a disappointing figure. The policy of increasing VAT rate is another reason for the decline in collection efficiency. In 2010, the collection rate remained at the same level as in 2009.

Changes in public expenditures were marked by the need for public intervention to reform various aspects of the social and economic life. As can be seen in Figure 3, the general trend of the share of public expenditures in the GDP was almost constant from 1992 to 2004, with an upward trend from 2004 to 2009, after which decline is observable.

The figure shows the partial similarity of the trend of public expenditures with the trend of the revenues of the general consolidated budget. However, the difference is that more pronounced increases and lack of consistency are observed in the last part of the period, which can be justified by the need for a more substantial intervention during the crisis. Following controversial issues of the public expenditure policy in Romania, the main drawbacks were the lack of accuracy and performance-orientation

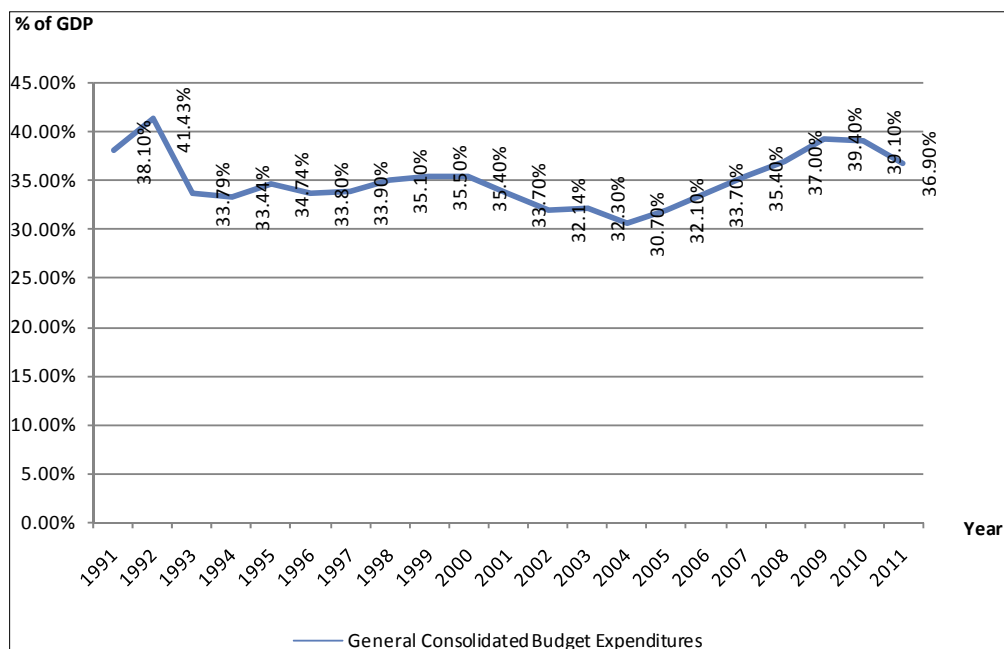
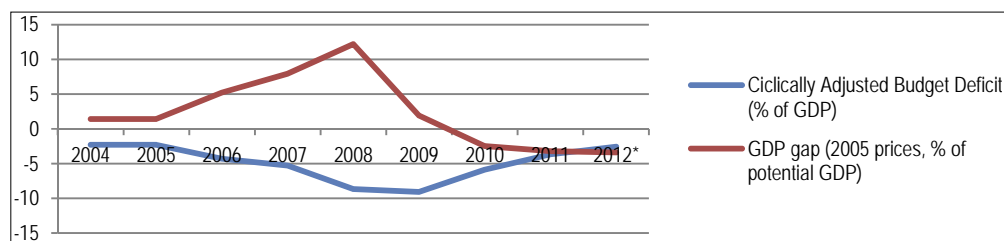


Figure 3: Share of the expenditures of Romania's General Consolidated Budget in the GDP (1991-2011)

Source: Calculations based on the data included in the Romanian Statistical Yearbook, the national forecasts and the reports of the Fiscal Council

in the budgeting process (Ruffner, Wehner and Witt, 2005), the allocation of subsidies to public loss-generating enterprises (Ahrend and Martins, 2003, pp. 331-356), and raising the salaries of public employees without factoring their productivity (Dăianu, Kallai and Lungu, 2012a, pp. 46-50).

Globally, the Romanian fiscal policy fitted in the tendency recognized in the financial literature for developing countries, using the procyclical policies (Ilzetzki and Vegh, 2008; Alesina, Campante and Tabellini, 2008), which diminished considerably the maneuver margin when the financial crisis started (Figure 4).



*Estimation

Figure 4: Dynamics of the Ciclically Adjusted Budget Deficit (% of GDP) and the GDP gap (2004-2012)

Source: AMECO, [Online] available at http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm

Figure 4 sustains the idea that basing the fiscal policies on conventional budget deficit and not on structural deficit and its cyclical component is at least questionable,

because it does not offer a real global image. Using a general representation on the reality of public deficit (as results from the following table), would make up a serious anchor in guiding the public financial policies, if appropriately used.

Table 2: The cyclically adjusted budget deficit in Romania (2004-2012)

Indicators	2004	2005	2006	2007	2008	2009	2010	2011	2012*
The cyclically adjusted budget deficit (percent of GDP)	-2.3	-2.3	-4.3	-5.3	-8.7	-9.1	-5.9	-3.7	-2.6
The cyclical component of the budgetary deficit (percent of GDP)	1.1	1.1	2.0	2.4	3.0	0.1	-1.1	-1.1	-1.1
Conventional budgetary deficit (percent of GDP)	-1.2	-1.2	-2.2	-2.9	-5.7	-9.0	-6.9	-4.9	-3.7

*Estimation

Source: AMECO, [Online] available at http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm

Even if the global deficit figures seemed satisfying, as compared with the admitted level (3 percent of the GDP), data from Table 2 confirm that Romania tolerated in the period before the crisis, important and growing structural budgetary deficits.

Other contributing factors for the controversial public expenditure policy in Romania can be listed as the boost of social benefit expenditures due to lack of any rigorous guidelines, the increase of social insurance cost without any strict correlation with contributions (Preda, Doboş and Grigoraş, 2004), deficient control over local government expenditures and administrative transfers system (Gómez, Martínez-Vazquez and Sepúlveda, 2007), and inadequate association between expenses and capital expenditures. Overall, all these factors related to public revenues and expenditures have played a role in the chronic deficits of the GCB that needed to be financed by public borrowing.

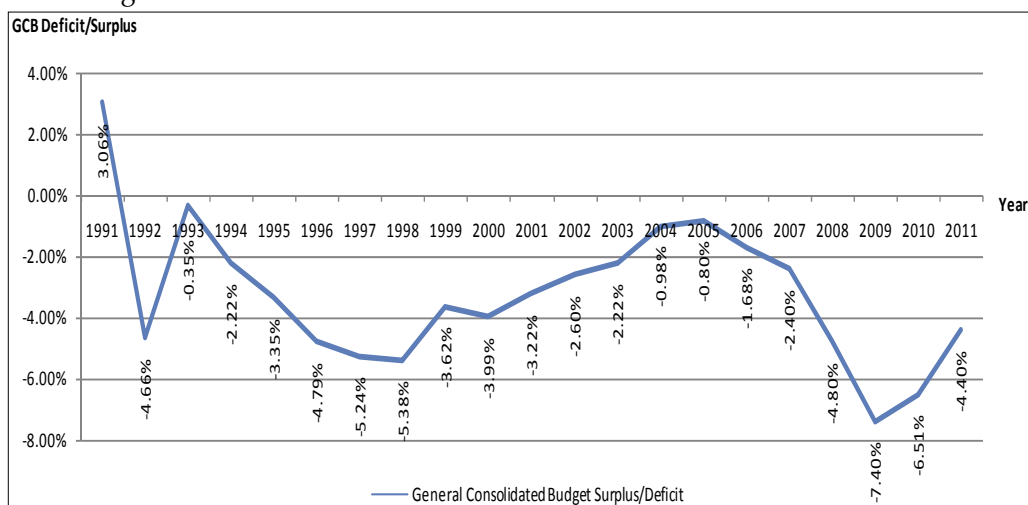


Figure 5: Deficit/surplus of Romania's General Consolidated Budget (1991-2011, percent)

Source: Calculations based on the data included in the Romanian Statistical Yearbook, the national forecasts and reports of the Fiscal Council

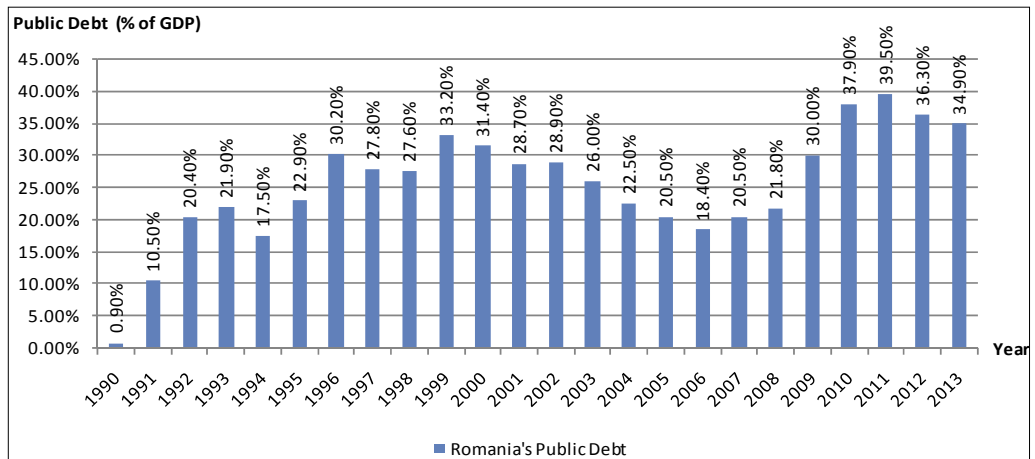
Figure 5 displays Romania's GCB evolution. As can be seen, the budget was continually in deficit due to various reasons. The Romanian inter-administrative transfer system oscillated between extremes over the period of analysis. Throughout the transition period there was practically no coherent decentralization strategy. During subsequent years, a massive administrative decentralization was initiated, but without support, as the financial decentralization process was being adopted. The administrative transfers system not only proved to be unstable and unpredictable, but also turned out to be less transparent. In addition, it gave rise to discontent and inequity (Institute for Public Policy, 2001, p. 55; Oprea, 2011, p. 315). Thus, on one hand, the absence of objective criteria to determine the amounts of the equalization transfers made it almost impossible to track and to control the efficiency of the transferred revenues until 1998. On the other hand, changes in some of the criteria for the equalization transfers and the determination of their amounts through the annual budget law affected the real ability of local decision makers to make coherent investment plans, or carry out programs affecting local development.

Even in its current condition, Romania's lack of an aggregate index of the local fiscal effort that should include, for example, local revenue collection rates is subject to criticism in the literature concerning the size of transfer payments to local budgets from the state budget (Oprea, 2011, p. 118). The plurality of transfer types was combined with highly specific weights of conditional transfers, thus preventing the budget system to function properly. A particularly relevant example is financing social expenditures by the transfer of revenues from the state budget to local budgets, with verification of the beneficiaries' eligibility being the responsibility of local authorities. This approach led to a certain passivity of local authorities who determined the eligibility of assisted individuals, and approved the claims without question, using the central budget's resources.

Due to the lack of a permanent synchronization, administrative decentralization surpassed the financial decentralization, which induced consistent dysfunctions in local budgets and negatively affected the operation of many local public services (Institute for Public Policy, 2001, p. 55; Oprea, 2011, p. 233). Since local budget revenues came mostly from state budget allocations, local agents' responsibility was not stimulated; thus they adopted, in many cases, a passive attitude towards the identification of new revenue sources, or exploited existing sources.

Another aspect that can be criticized is the Romanian inter-administrative transfers system related to the presence of transfers for co-financing. These transfers are insignificant compared to their potential and necessity at present (Oprea and Bilan, 2011, p. 168). Covering the deficits resulting from such inconsistencies has naturally led to the creation of public debt. Although before 1989, Romania's tremendous efforts and sacrifices to reimburse public debt brought the nation to a comfortable zone, with a substantial margin for maneuver, the indebtedness policy after 1989 has proven to be quite incoherent. The negative real increases in the GDP for several years in a row, which are reflected in the amount of collected public revenues, are associated with the

state undertaking increased public expenditures. To achieve a range of reforms, public debt as a percentage of the GDP has experienced, with a few exceptions, a general upward trend, rising from 0.9 percent in 1990, to a maximum of 39.5 percent in 2011, as can be seen in Figure 6.



*Estimated data for 2010 and forecasted data for 2011-2013

Figure 6: Evolution of Romania's public debt (1990 -2013)*

Source: Authors' own calculations based on Ministry of Public Finance (2012) and Ministry of Public Finance (2010)

Although it cannot be denied that public debt had objective causes including budget deficit mainly generated by the existence of structural economic deficiencies, especially in the transition period, we must note that recourse to extraordinary financial resources and their use should have been adequately accompanied by proper reforms. This is true especially in case of resizing the state economic sector. The use of the funds borrowed, especially those borrowed to finance current needs while various reforms were dragging on, actually artificially prolonged the existence of unviable public economic entities. In fact, that was the characteristic of the subsidies, in real terms, employed to cover losses of struggling entities. Beside this phenomenon, there are several other factors that have contributed to budget deficits that required Romania's government to borrow. The low level of revenue collection, large-scale of tax evasion (Zaman and Georgescu, 2011; Dăianu, Kallai and Lungu, 2012b), the low level of investments, questionable social expenditures and lack of fiscal discipline (Isărescu, 2006; Dumitru and Stanca, 2011), can be listed as a few examples.

As in many other developing countries, the borrowing strategies to finance budget deficit practiced by Romanian public policy makers have been oriented towards borrowing from abroad in most cases. The choice of this strategy might be due to the lack of a developed domestic capital market that is able to satisfy both the needs of the private and public sector. Deficit financing policies of this nature generated potential vulnerabilities and exposed the economy to various risks, such as exchange rate risk, liquidity risk etc. Romania's debts, especially to the banking sector in the period of

1992 to 2000, was cited as a cause for inflation given that financing budget deficits using loans from the National Bank of Romania were legalized quite late (Isărescu, 2006, p. 24-25).

From the perspective of the legislative framework, a factor that contributed to the lack of coherence in the indebtedness policy was the lack of an express regulation of the maximum level of indebtedness, namely of a series of warning systems regarding the sustainability of the medium and long-term debt (Price, 2010). It is concerning that Romanian authorities took over public debts and obligations from non-competitive economic entities, in the conditions where they showed reserves to grant guarantees to viable economic entities (Oprea *et al.*, 2012). Favorable premises were, therefore, created for the manifestation of public debts, which made stabilization and growth harder to reach, rather than being an acceleration factor. The 'economic syncope' in 1999, when the peak of public debt was difficult to manage, is a relevant example in this regard.

The above arguments should bring no doubt about the effectiveness of promoting fiscal deficit policy, but the position of the Romanian officials in the last few years does fully confirm the lack of efficacy. The increase of Romania's public debt from 21.8 percent in 2008 to the forecasted level of 39.5 percent of the GDP at the end of 2011, which is almost double, must be interpreted as a net deterioration of Romania's fiscal situation, where no serious recovery signs are in sight. The actual possibility of repaying public debt must not be judged based on today's potential, but on future and global events, which, unfortunately, forecast a negative outlook. Nonetheless, it can be easily observed that the paradoxical attitude of public decision-makers who invoke Romania's secure position resulted from the comparison of the current debt level with the maximum limit of 60 percent of the GDP in spite of established norms indicating that governments of developing countries encounter more economic difficulties at lower levels of the public debts given their ability to keep their economic commitments (Becker, Deuber and Stankiewicz, 2010).

5. The monetary policy and financial stability in Romania from 1990 to 2011

Romania's monetary policy has been considerably influenced by the legislative structure, the fragility of the banking system, the degree of independence of the Central Bank, and inefficient and imperfect capital markets (Cerna, 2008). Due to these flaws, achieving monetary policy objectives has often been unsuccessful, especially objectives aiming at keeping monetary and exchange rate policies in balance.

The first year in which Romania's macro-stabilization policy had certain success through control of monetary expansion and rise of interest rates was 1994. The development of demonetization, dollarization or disintermediation, which had an unfavorable impact on financial and monetary stability, came to halt. As a result, the money base, credit and savings, increased in real terms, and the velocity of money was stabilized. Indicators of an explicit objective were noted in 1995, when the National Bank of Romania committed to lower the inflation rate to 30 percent; however, this objective

could not be achieved due to the deterioration of the balance of payments at the end of that year. The pressures on the National Bank of Romania to finance public deficits through direct loans, the subsidized interests, and the appreciation of the national currency in the context of severe deterioration of the real economy, quickly counteracted the initial positive effects obtained in 1994. As result, the national savings and re-monetization stagnated, and the dollarization increased in 1996. For such reasons, the success of the monetary policy was limited until the end of 1990s, only eliminating the danger of hyperinflation. In fact, the inflation rate did not become a single digit in 2004 (see Figure 7).

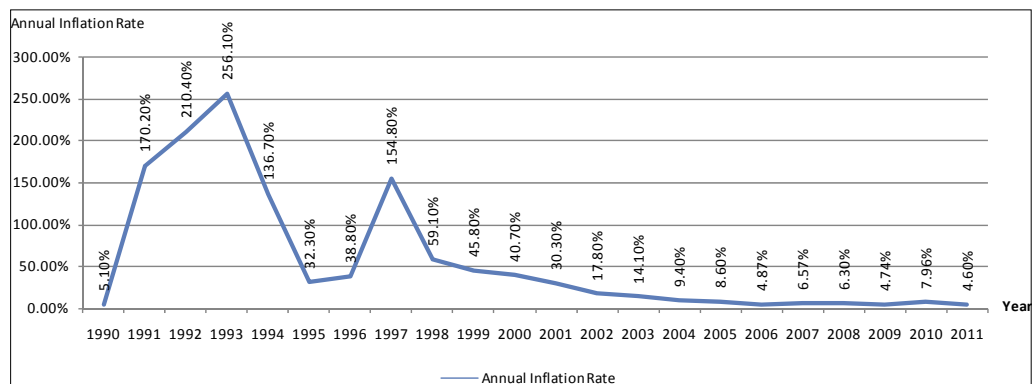


Figure 7: Annual inflation rates in Romania, during 1990-2011 period

Source: Romanian National Bank, Annual Reports

The National Bank of Romania adopted the modern strategy of inflation targeting in 2005 (Popa *et al.*, 2009). At the same time, it consistently consolidated banking regulations and prudential surveillance, to ensure necessary stability of the banking system. In addition, in 2005, the denomination of the national currency took place to guarantee the needed support for the disinflation process. This increased user trust in the national currency, and the stability of the monetary issuing structure. These measures helped the National Bank of Romania to bring about the end of high and oscillating inflation. However, the ability to reach the annual inflation targets has proven to be a challenge, so that Romania has come to a decision to adopt a stationary inflation targeting at the level of 2.5 percent, with a variation range of 1 percent beginning in 2013 (see Figure 8).

As shown in Figure 8, 2006 was the only year the inflation target was reached. This was probably due to policymakers' motivations and obligations, based on the accession to the European Union in January 1, 2007. Contrasting the preoccupations and manifestations of the financial policy decision-makers, we observe that while the National Bank of Romania had a moderate, cautious and consistent attitude to pursuit financial stability over the 1990 to 2011 period, the Romanian government often adopted a precipitate conduct, that repeatedly contributed to deviations from the inflation target.

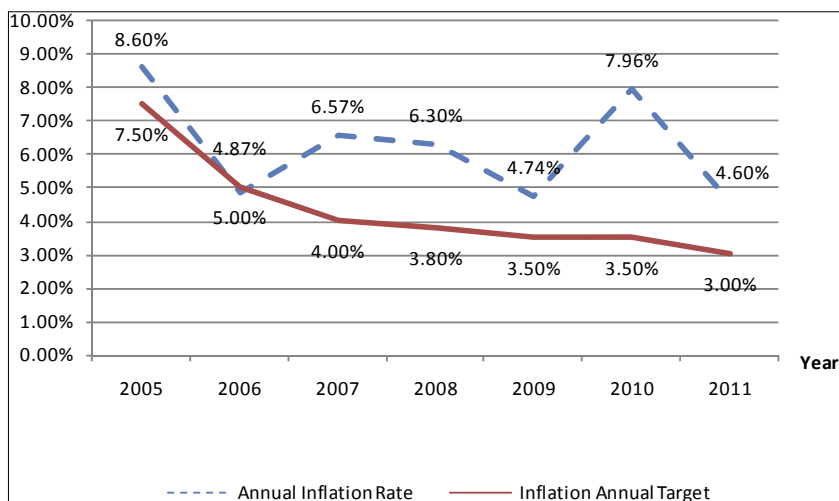


Figure 8: The inflation targets and the actual achievements in Romania, 2005-2010

Source: Romanian National Bank, Annual Reports

The issues described in the paragraph above contributed to fiscal instability, and obviously made the task of monetary stabilization more difficult. Because of the lack of harmony, monetary policy was not directed in association with fiscal policy as the financial literature recommends (Giammarioli *et al.*, 2007). This resulted in several controversial decisions regarding the reform of the financial system in order to maintain the financial stability, and to mitigate macro-economic tensions and vulnerabilities. One can argue that the mix of macro-economic policies in Romania was, at the least, questionable. Specifically, the more restrictive monetary policy associated with expansionist and pro-cyclical fiscal policy, the less there is margin for fiscal maneuvering necessary to tackle a crisis. The substantial growth of imports and the decline in exports immediately after the revolution of 1989, led to the official foreign currency reserve to be practically used-up in the first nine months of 1990. It was not recovered until 2000.

Credit ceilings were removed and interest rates were formally liberalized in 1991, however, the mechanism of the compulsory minimum reserves was not instituted in 1992, and the control of the monetary base was still complicated due to several problems. At the end of 1990, the financial resources of households were covered only 9 percent in goods, whereas public enterprises, yet in decline, took advantage from massive credits, worsening the monetary disequilibrium (Isărescu, 2006, pp. 18-19). Successive measures to reinforce the monetary policy were evaded by companies exploiting a too lax legislation. These companies operated on conditions of serious financial indiscipline, but nevertheless benefited from arrears which generated financial blockage and causing the condition to deteriorate even more. In the absence of meaningful links between public policies and complementary structural adjustments, monetary policy impulses have not entirely produced the intended effects, and financial instability has had favorable conditions to develop.

In the first part of the period currently under study, 1991 to 1996, the exchange rate of the national currency (ROL) against the US dollar underwent severe fluctuations. On the one hand, it was decided to depreciate the ROL to fight difficulties in financing the external deficit to discourage imports and prevent the loss of the foreign currency reserves, and improve the balance of payments. On the other hand, the overvaluation of the national currency was considered in an attempt to secure an anti-inflationary environment at the cost of deteriorating external accounts and the liquidity of the foreign exchange market. Practically, the monetary policy was constantly positioned between the simultaneous constraints of the inflationary pressure and of potential crises of external payments.

In 1991, the difference between the market and the 'artificially set' official exchange rate was about 500 percent, which led to an attempt to regulate the 'completely defeated' foreign currency. This policy was rejected by the public, as it was perceived to be an attempt to 'nationalize foreign currency', which in turn, affected the effectiveness of the monetary policy and financial stabilization (Isărescu, 2006, p. 29). The assumed inflation rate for the year 2000 was ambitious (27 percent), half of the rate experienced in 1999. This objective was not accomplished due to additional negative events, such as higher oil prices, drought, and the depreciation of the EUR against USD. Another harmful impact on financial stability came from the National Bank of Romania, as the lender of last resort, which injected into the system liquidity valued at over 1 percent of the GDP. The main reason for this action was to: a) assist a state owned bank, Banca Agricolă, to restructure, b) compensate individuals who had deposits at Bankcoop and Banca Internațională a Religiiilor (both private banks), and c) refund the deposits of individuals at Credit Bank. The collapse of the largest financial investment company, the National Investment Fund, in 2000 led to a substantial increase in repo transactions using government securities to provide banks with liquidity and to remove the threat over the entire financial system. Such injections of liquidity established, however, an accumulation of a surplus that later required higher absorption efforts.

During 2001, the improvement of macro-economic conditions and the reinforcement of the monetary policy, together with control of the budget deficit primarily through financing from external sources, led to financial stability and fiscal dominance of less intensity. However, structural reforms were not substantial, and the revenue policy promoted by the government, continued to have counterproductive effects, eventually ending in 2002.

The carefully implemented monetary policy and the consistent measures that were adopted brought about an economic growth of 5.1 percent in that year, and a decline in the rate of inflation by 4 percent. This was more than what had been expected. During the following years until the 2008 global financial crisis, the revenue policy followed by the Romanian government faced an undesirable show down in form of weak economic growth that made fiscal and financial stability vulnerable. The boost in revenues shored up the consumer preference towards loans (even 'loan for anything' was practiced), and the prudential regulations of the National Bank were con-

tinuously surpassed by the commercial bank sector to make more profit, thus creating potential for financial instability.

The symptoms of the 2008 financial crisis in Romania, as an emerging country, were critical. Romania felt the limitation of international liquidity, and, as a result, the reduction of external financing resources as the level of risk-aversion of investors rose. Moreover, 2008 was an election year and one of the peak years for the expansion of the government sector, as concerns the number of its employees (see Figure 9).

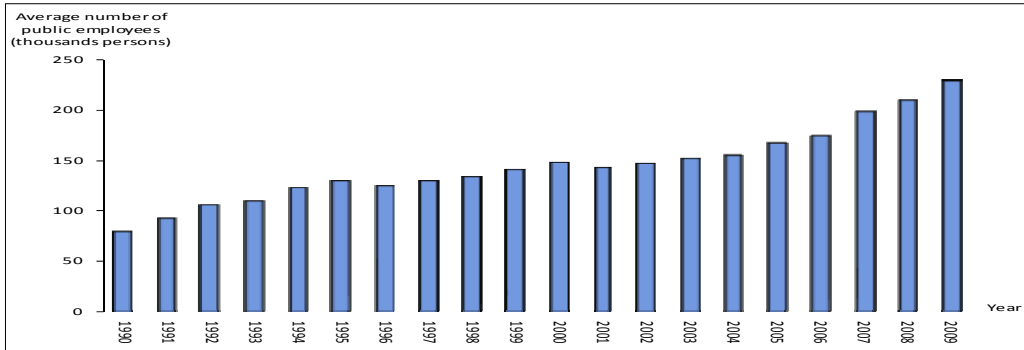


Figure 9: Average number of employees in the Romanian public administration, 1990-2009 (in thousands)

Source: Authors' own calculations based on National Institute of Statistics (2011).

Although indirectly threatened by the 2008 global crisis, fiscal and financial stability was upheld in Romania. One of the contributing factors in preserving the stability was that financial institutions in Romania preferred traditional products and were, therefore, less exposed to so-called 'toxic assets'. The impact of the crisis was, however, relatively powerful. The impact was transmitted in different channels including foreign trade, as drop in export (-5.5 percent in 2009, compared with 2008); financial market, as decrease in private external credit lines from the parent bank; asset market confidence, as increase in the level of risk-aversion of foreign investors (-63.3 percent in 2009, compared with 2008 in foreign direct investments and -36.4 percent in 2010 compared with 2009, according to Zaman *et al.*, 2011); foreign exchange market, as severe fluctuations in exchange rate (from 3.48 RON/EUR in August 2008, and 3.92 RON/EUR in September 2008, to 3.59 RON/EUR in October 2008 and 3.99 RON/EUR in December 2008, to 4.31 in February 2009, according to National Bank of Romania); and finally wealth and balance effects.

The pro-cyclical nature of the fiscal policy in previous years also contributed to the increase of the threat to financial stability, along with the reversal of private capital flows. The basic problem in this context was that fiscal adjustment actions started in 2008, with a quick effect only on private activities, those that set up for the public sector and have been in operation since 2009. The overall result can be classified as a significant decrease in GDP, an additional deterioration of budget deficit, a substantial depreciation of the national currency, and the significant reduction in the current account deficit. At the same time, the level of public debt as of the end of 2008 was 20.6

billion Euros, which was perceived as an element of vulnerability of the Romanian economy, and viewed as a dysfunctional one by the financial markets participants (Alexopoulou, Bunda and Ferrando, 2009; European Commission, 2010; International Monetary Fund, 2012). During 2010, the coordinated measures of monetary and fiscal policy were firmly applied, even in conditions where the margin for maneuver of the fiscal policy had previously been diminished due to its expansionary nature to maintain financial stability in Romania. However, the problem of structural imbalances was not fully solved and the ending of the crisis has not solved the problem of the structural deficit by itself. Loan agreements concluded by Romania with the European Union, the International Monetary Fund, and other domestic financial institutions, improved the trust of the players involved (e.g., manufacturers, consumers, and investors), which in turn lent hand to shore up the economic stability (according to Eurostat, the economic sentiment indicator rose from 81.2 in March 2009 to 89.7 one year later).

In sum, although the monetary policy contributed much more to bring about and to support stability rather than fiscal policy, it yet created several objectionable and controversial issues with a damaging impact on financial stability. All in all, the outcome was to assign quasi-fiscal mission to the National Bank vis-à-vis financing the budget deficits, subsidizing of certain sectors, granting special refinancing services, and employing a number of monetary policy instruments such as bid loan and required reserves etc.

6. Conclusions

The main conclusion to which our study leads is that during the period between 1990 and 2011, fiscal and monetary policies promoted in Romania were not properly correlated. The country's fiscal and monetary policies lacked the necessary mutual support, or even generated conflicting situations, favorable to the manifestation of fiscal and financial instability. For the first part of the period under examination, the monetary policy was inconsistent, which can also be explained by the fact that its promoter, the National Bank of Romania, did not benefit from the start from a solid status, being required to carry out quasi-fiscal tasks. The origin of the problem is that the structural reforms of the real Romanian economy were initiated with delay and were carried out slowly, opting for a gradual therapy, while social convulsions and the lack of trust of economic actors in their success or in the national currency often led the government or the National Bank to implement measures with a negative impact, and high long-term costs.

Concerning fiscal policy, the main conclusion is that its pro-cyclical manifestation, even in the situation of economic overheating, favored the enhancement of fiscal instability, visible mainly after 2008. This led to the need to make greater sacrifices to mitigate the effects of the crisis, often through tougher austerity programs. The evolution of the monetary and financial policies after the beginning of the crisis, their ambitious nature and their firm implementation, even in the conditions where the avoid-

ance reactions were high, and the results recorded up until now, show respectively that a consistent correlation of the fiscal policy with the monetary policy may lead to stability, making it easier to go through crisis periods.

Concerning monetary policy, we believe that maintaining the objective of entering the Euro area, and the strict compliance with the schedule may be a factor that favors financial stability, creating a rational framework from the perspective of the convergence criteria for the creation and promotion of monetary policy measures. Nevertheless, a formidable challenge at present is to keep public debt under control, and to avoid the monetization of the budget deficit. Monetization of the budget deficit is a threat potentially due to the emotional reactions of public fiscal policy decision-makers, in the conditions where 2012 was an election year. While the positive evolutions experienced during this year are fragile at the very least, the possibility of increasing the salaries of employees in the public sector and pensions by 5 percent has nevertheless been mentioned, as has a potential reversal of the austerity measures already implemented, both of which would be extremely dangerous.

It is not only necessary to maintain the austerity programs that have already been implemented, but to reconsider certain aspects concerning the collection of public financial resources and their allocation. Concerning public revenues, the extremely low and decreasing collection level must be a serious warning signal. Increases in the level of payment compliance depend on the improvement of legislation, but also on the reinforcement of the institutional system involved, which is currently not fully effective. Also in this framework, we believe that it is mandatory to mobilize forces to absorb European funds, the current situation being disappointing, to say the least, by simplifying procedures and creating and implementing proper influencing mechanisms.

At the level of public expenditures, fiscal stability depends, in the future, on expenditures being rationalized to the extent to which the ratio between transfer expenditures and capital expenditures would evolve. For the latter case, it is necessary for current investment in infrastructure, carried out in some cases only 'on paper' to be reconsidered so as to generate the multiplying effect which they might potentially have. It is also mandatory to strengthen fiscal discipline, to institute strong budget constraints, to reduce the government sector, and to generalize program budgeting and multi-annual expenditure frameworks and cost standards for certain public services. In the relationship of the central budget with other categories of public budgets, it is absolutely necessary to revise the inter-administrative transfer system, which is currently confusing and generates inadequate discretionary decisions. This should be done while instituting at the same time a better control on local loans, including by creating an early warning and limitation system for the local indebtedness when it is close to reaching the conventional limit of 60 percent of the GDP. Fiscal and financial stability can be simultaneously achieved if monetary and fiscal policies are smoothly correlated, as the crisis period proved it is possible.

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