Romania

Sonia George, Kendall Hodgkins, Steven Panorese & James Hart

Romania, a country roughly the size of Oregon, has a deep history, rich culture, and an interesting economy. Romania is located in the southeastern part of Central Europe and shares borders with Hungary to the northwest, Serbia to the southwest, Bulgaria to the south, the Black Sea to the southeast, Ukraine to the east and to the north and the Republic of Moldova to the east.

The focus of this report will be the effects of the 2008 global financial crisis on Romania. Romania had gone through significant changes in the recent years leading up to the financial crisis and was not prepared to handle the chaos that came with the financial crisis. Some of these changes included the reinvention of the Romanian currency in 2005, their accession into the European Union in 2007, and a few other minor modifications.

History

Romania's history is one that starts back as early as the Paleolithic Era. Over the centuries, Romania has been the location of various migrations and conquests. The principalities of Wallachia, Moldavia, and Transylvania were established and then broken up and divided between the various surrounding territories until Wallachia and Moldavia united to form the national state of Romania.

Throughout the early 19th century, Romania was controlled by a variety of rulers and kings. When World War I began, Romania entered and sided with the Triple Entente (France, Great Britain, and Russia) in hopes of regaining their lost territories. Post World War II, Romania was a communist-bloc nation and become part of the Russian system. After Stalin's death in ’53, Romania began to distance itself from Moscow and protested against the communist leadership which led to the overthrowing of Dictator Nicolae Ceausescu in 1989. Then in 1991, Romania was finally established as a republic after voting for a new Constitution. The new Constitution established Romania as a republic with a multiparty system, market economy and individual rights of free speech, religion and private ownership

Economy

For many centuries Romania's economy was based on agriculture. Throughout the 1930s, Romania was the predominant producer of wheat, corn, and livestock and was considered the “bread basket of Europe.” The 1950s saw the development of heavy industry and there has been a push towards it since then. However, agriculture is still an important part of the economy and is responsible for employing a third of the workforce and accounts for 6 percent of the GDP.

Even though Romania has a range of natural resources like oil, coal, natural gas, timber iron ore, and petroleum, it imports most of its raw materials. Their more notable industries include machine manufacturing, mining, construction materials, food processing, textiles, clothing, and metal production and processing. Industry consists of 26.4 percent of Romania’s GDP.

Other factors that comprise Romania’s GDP are the service industry (47.6%), construction (8.9%), and trade. Exports make up a considerably large portion of the GDP. In 2010, Romania earned $48.8 billion which is approximately 30 percent of their GDP. Romania’s exports include textiles, chemicals, light manufactures, wood products, fuels, processed metals, machinery and equipment. They import machinery and equipment, textiles, fuel, coking coal, iron ore, machinery and equipment, and mineral products.

On January 1, 2007 Romania officially joined the European Union, which signified Romania's transition from the Communist party to a free market. While Romania was experiencing record economic growth prior to joining the European Union, the global recession hit and affected several countries in Europe which adversely impacted Romania as well.

Analysis

Due to Romania's accession into the European Union in 2007, there was an enormous increase in the current account deficit (See Figure 2). However, this doesn't seem abnormal because there has been a historical pattern of countries that were newly added to the European Union increasing their current account deficit. Since these new members are now able to trade and borrow from other countries, it is standard to see a large current account deficit for a short period of time (Robert C. Shelburne). However, in Romania's case there was a gradual increase in the current account deficit leading up to their accession, and then after the accession the current account deficit plummeted.

Since the current account is the difference between national savings and investment, it is questioned whether the deficit is due to a decrease in national savings or an unusually large amount of investment. In the years leading up to the accession, 2004 – 2006, Romania had an abnormally large amount of investment that was overpowering their national savings. However, once Romania became an official member of the European Union, Romanian citizens became confident in their country and reacted by decreasing private savings and increasing consumption. Due to this persistent and large current account deficit, Romania was given a 20 billion euro macroeconomic stabilization package from the IMF, EU, and other financial institutions. With this financial support, Romania has been able to decrease their deficit and begin moving in the right economic direction.

Romania is a country with an immense amount of potential, due to its plentiful agricultural land, various energy sources (coal, oil, natural gas, hydro, nuclear, and wind), a large manufacturing base, and endless opportunities for expansion and development. Romania proved their potential with extensive GDP growth between the years 2004 and 2008, a typical pattern of a “catching-up” country. This boom in Romania’s GDP occurred for several reasons. First off, there was a large increase in the agriculture and construction industries. Also, Romania relied heavily on exports during this time, in order to receive hard currency and increase their level of GDP. Another stimulus for the GDP resulted from the increase in domestic consumption and foreign direct investments (Trading Economics). However, this economic growth was extremely fast and was unsustainable, resulting in a sharp decline in GDP by 8.9% in mid-2008 (Figure 1). The main driver in the decrease of GDP was the decline in external demand for exports. Romania relied heavily on exports to increase GDP and stimulate growth, so once this external demand dropped, it immediately and significantly decreased GDP. Also since the global crisis nearly froze the international financial market, there was a huge lack of access to credit, which hindered Romania’s ability to grow.

The international economic crisis had reached Romanian’s economy by the last quarter of 2008. The initial factors of the recession were external to Romania, which resulted in a large decline in Romanian exports, Foreign Direct Investments and created concerns about private foreign debt. The combination of the global crisis and the unsustainable economic growth before 2008 caused the extreme severity of the current recession that Romania is experiencing.

In 2009 GDP begins to flatten out and plateaus into 2010. This stop in economic decline is due to the macroeconomic stabilizer of 20 billion euro Romania received from the IMF, EU, and the other financial institutions. In addition to this aid, Romania is reforming their economy in order to increase efficiency and balance. Romania is beginning to realize that there is a trade-off between economic growth and stabilization. Hopefully Romania will be able to find a happy medium between these two options and be able to return to the level of GDP achieved prior to the global financial crisis.

Throughout the 1990s and 2000s, Romania suffered greatly from hyperinflation. This was due to their inability to collect taxes and to maintain their protective exchange rate regime. In the early 2000s, Romania began breaking out of these ways through disinflation and their inflation began to decline but still remained on the high side. Disinflation brought inflation down from over 40% in 2001 to 4.9% in 2006. However, there was a spike in the interest rate in 2007 due to the accession into the European Union followed by the global financial crisis.

In 2005, Romania proposed inflation targeting and has been doing so ever since. Under the inflation targeting policy, the central bank of Romania estimates and makes public a projected or “target” inflation rate and steers actual inflation towards the target as best it can. Romania guides actual inflation toward the target through changes in the interest rate and other monetary tools. If the actual inflation appears to be above the target, the Romanian central bank is likely to raise interest rates. This in turn will slow down the economy leading to a decrease in inflation. While if inflation appears to be below the target, the central bank will most likely lower interest rates. Lowering the interest rates stimulates the economy, leading to an increase in inflation. (What's the Fuss Over Inflation Targeting). However, even with the inflation targeting, Romania still has one of the highest inflation rates of the European Union (See Figure 8). The high interest rates that followed the financial crisis kept inflation rates on the lower end (Figure 5).

The increase in the value added tax in 2010 is a major reason why annual inflation is exceeding the proposed target. The VAT increased from 19% to 24% in hopes of improving the budget balance and had a large impact on the inflation rate. This effect due to the increase in the VAT is due to subside in the second half of 2011, which will slow inflation and allow for a decrease in future years. (Romania Inflation – A moving Target) Romania's inflation rate for 2012 is expected to be between 2 and 4 percent, which is in the central bank's target range (Bloomberg).

In compliance with Romania's inflation targeting policy, Romania maintains a float exchange rate regime. The Romanian currency, the Leu, has a managed floating exchange rate against the euro. The managed float allows Romania to have a greater flexibility of the exchange rate while having fewer interventions of the National Bank of Romania in the foreign exchange market (Nicu Marcu). Also, the managed float regime is extremely compatible with Romania's inflation targeting policy. Romania has had a relatively stable exchange rate over the past few years, which is important to achieve their goal of adopting the euro in 2014 (See Figure 4).

Romania has experienced many drastic valuation changes in their currency within recent years. Beginning in 2005, Romania went through a currency reform from the old Leu (ROL) to the new Leu (RON). This reform was intended to bring back the purchasing power of the Leu in order to get back in line with other Western currencies. This reform was a total reinvention and the currency change was drastic, 1 RON was equal to 10,000 ROL. In September 2011, the central bank deputy governor Christian Popa stated that the Romanian currency is one of the most stable in the region (xe.com). Romania's M2 has also been steadily increasing since 2004 (See Figure 6). This stability and increasing M2 is important since Romania is looking to adopt the euro in the near future.

In order to successfully and easily transition from the Leu to the euro in the future, it is important for Romania to be building up their reserves. This build up in reserves implies that Romania's balance of payments is in surplus. In Figure 7, it is shown that Romania's reserves have been on a steady increase since 2006, which hopefully forecasts a rather simple transition when Romania decides to adopt the euro.

Throughout the years of Romania's extreme economic growth, 2004 – 2007, there is a continuous decline in the real interest rate (See Figure 5). This low interest rate guaranteed the availability of funds for investment and consumption that is necessary to stimulate the economy. Lower interest rates increase the availability of credit cards and mortgages as well. This cut in the interest rate also results in an increase in inflation, due to an increase in demand (See Figure 8). In 2008, right as the effects of the global recession are beginning to set in, the central bank raised interest rates in hopes of controlling inflation. Raising the interest rate tends to slow both economic growth and inflation in the period immediately following. This is due to a decrease in demand and a contracting of the economy. This increase in the interest rate resulted in a decrease in consumption and investment, since citizens have an increased incentive to save and a decreased incentive to consume. In 2009 a slight drop in the interest rate is seen to ease the credit freeze and to instill hope in the Romanian citizens that the economic recession is almost over.

One potential solution to help Romania recover is to increase Foreign Direct Investments. Foreign Direct Investments have an impact on development through the creation of new production capacity and new jobs, stimulating domestic consumption and increasing competition. Romania could wait for the European Union to provide financial assistance, although that seems unlikely because Romania isn't their top priority right now. Currently, Romania is re-evaluating their economic governance quality, which aims to reduce the risk of crises and deal with the consequences should a crisis present itself. Economic governance can affect employment, increase capital, and regulate various industries which could help mitigate future crisis.

Figures

Figure 1 - GDP

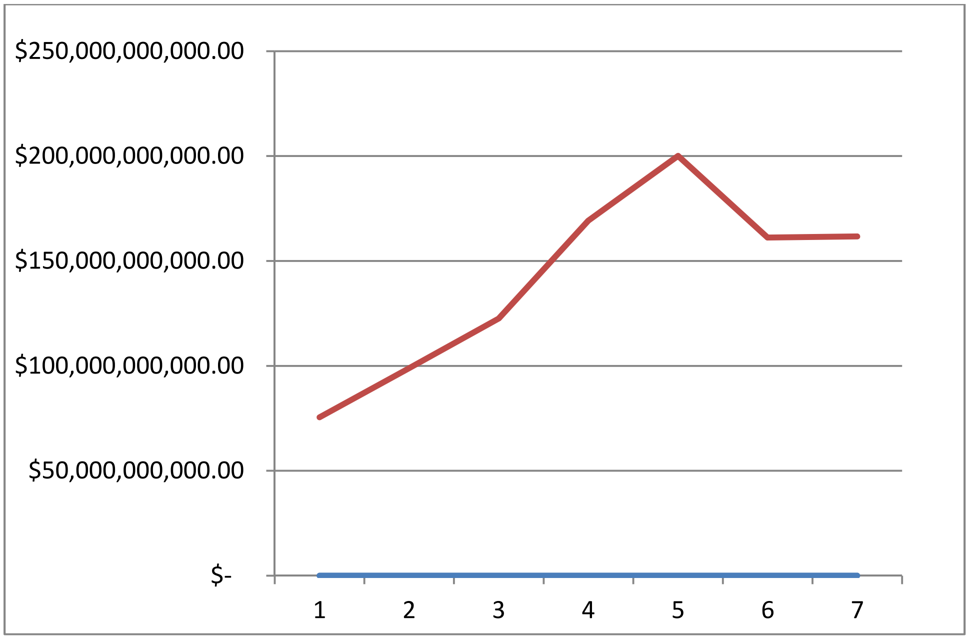


Figure 2 – CA

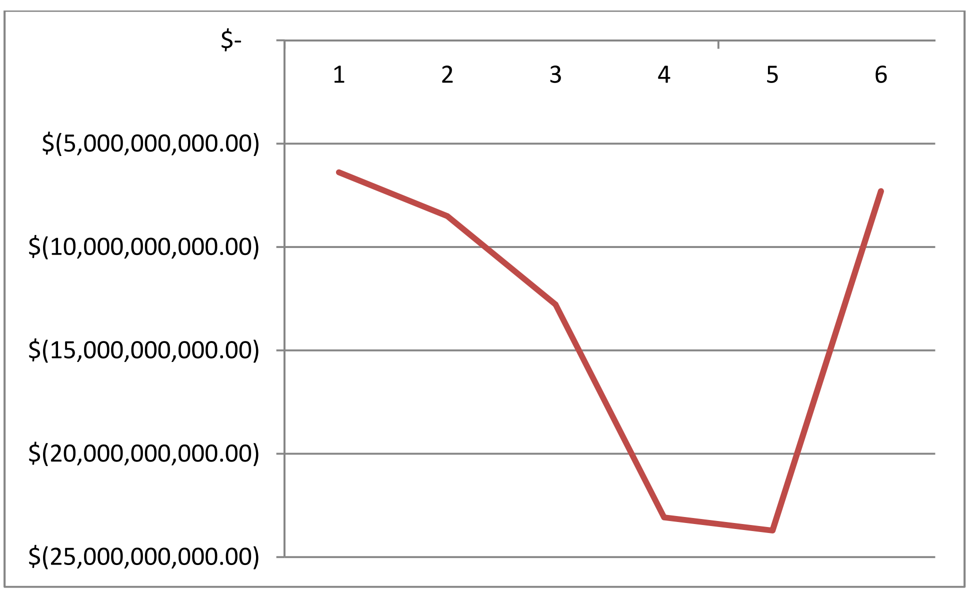


Figure 3

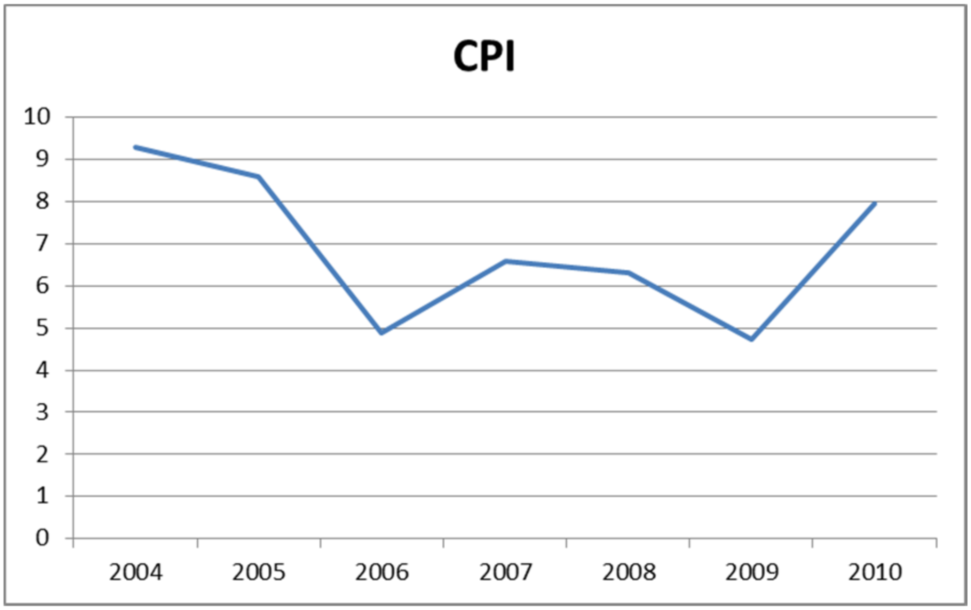


Figure 4

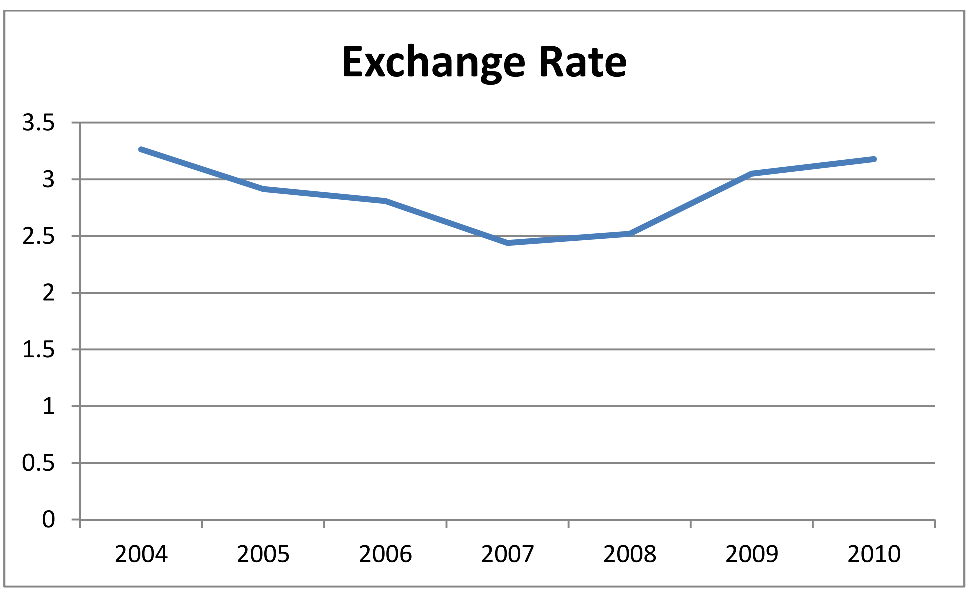


Figure 5

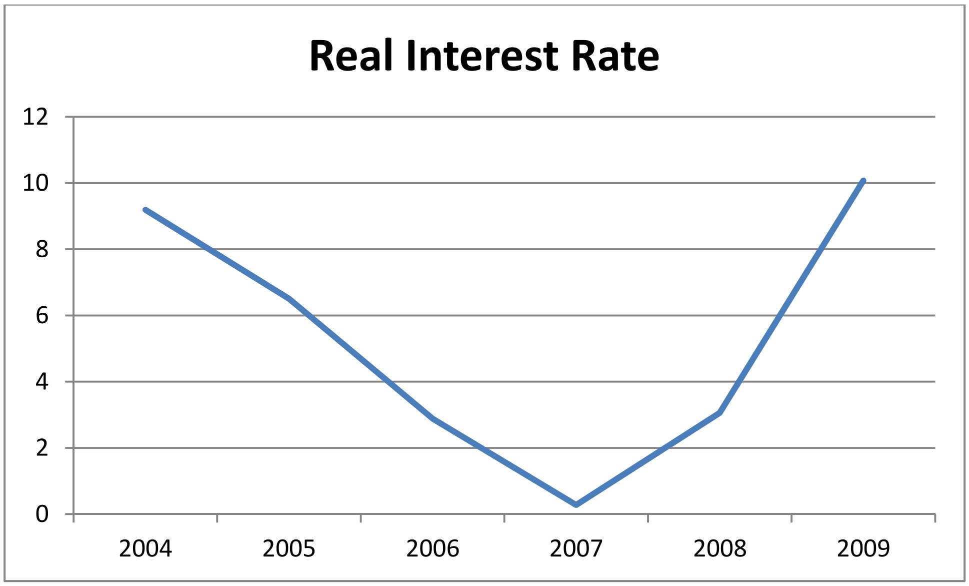


Figure 6

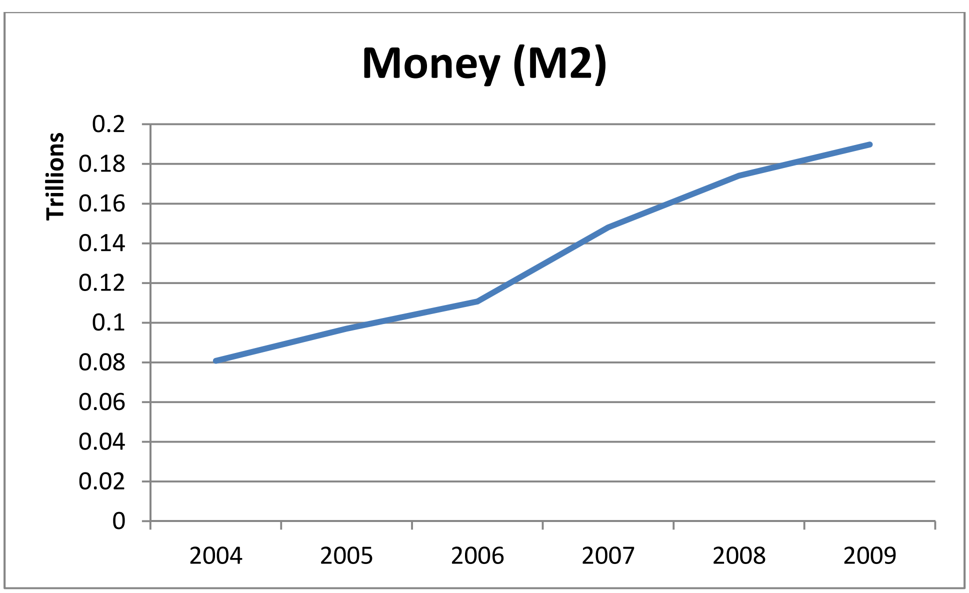


Figure 7

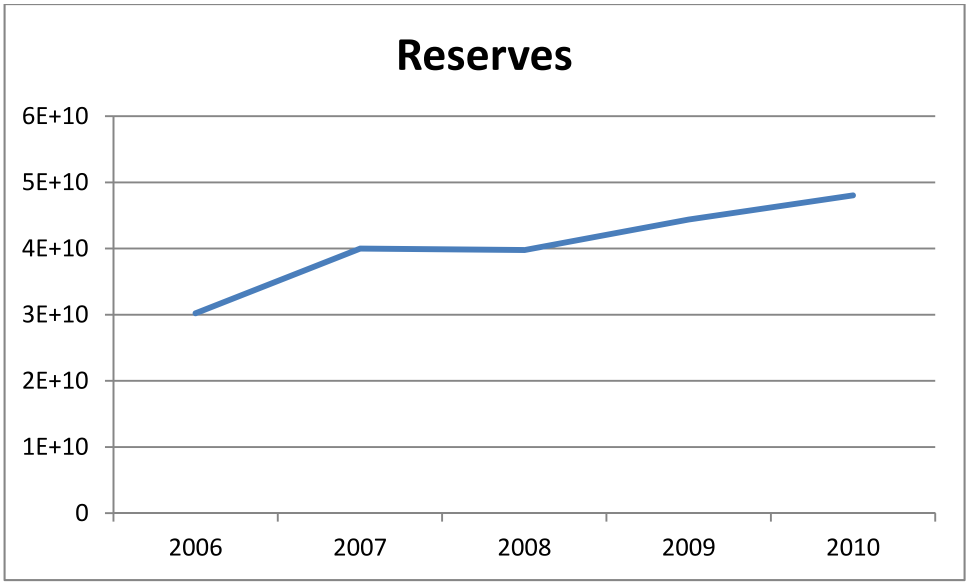


Figure 8

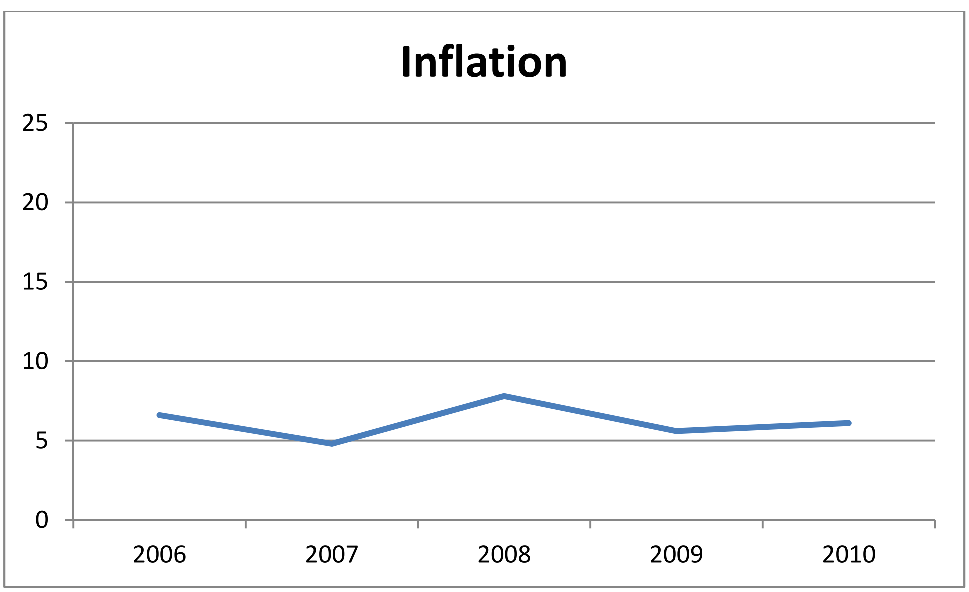


Figure 9

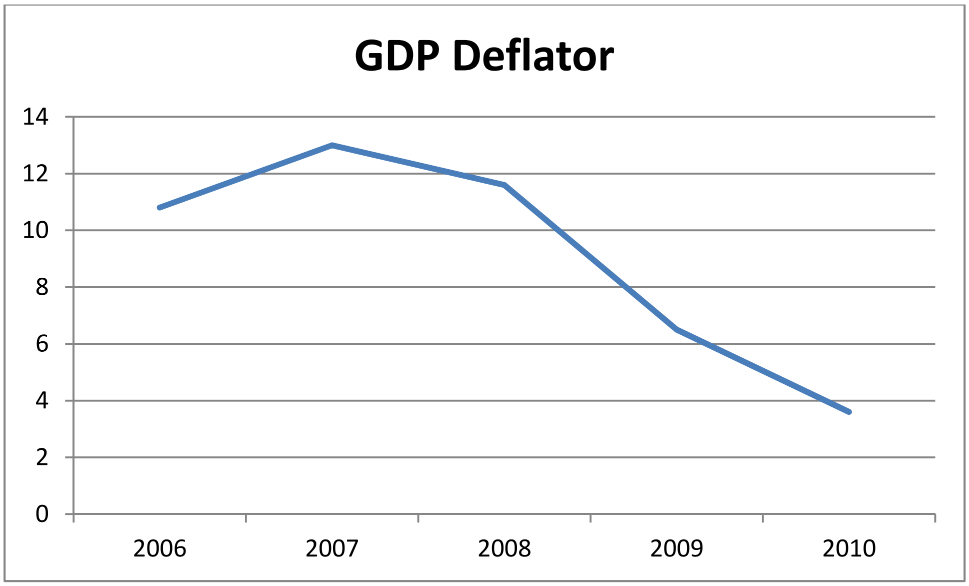
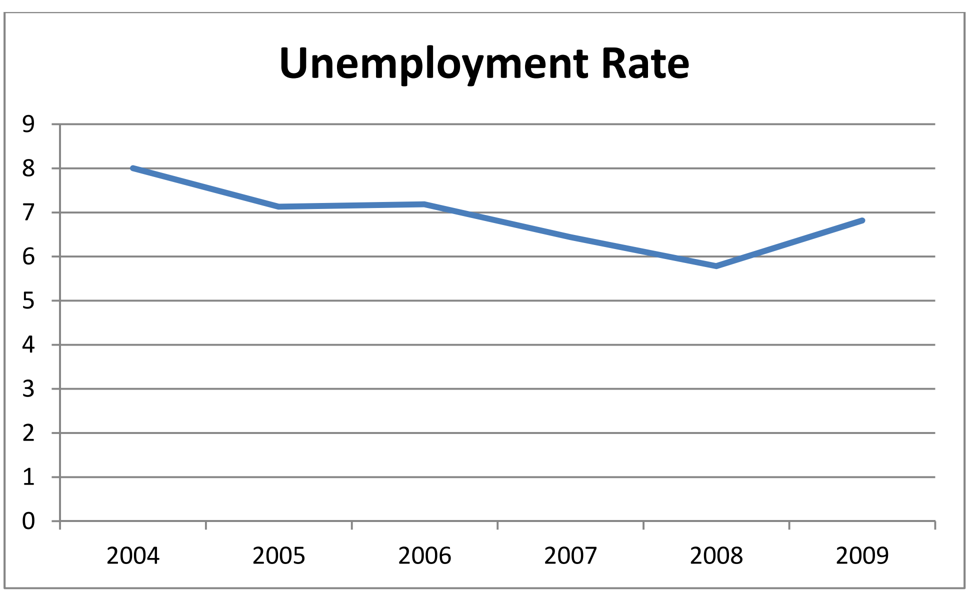


Figure 10



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