The End of Illusion Economics.

Crisis and anti-crisis in Romania: a heterodox approach

Abstract

This paper argues that the crisis that occurred in some new EU member states – including Romania – is different from the global economic crisis. The economic crisis that hit Romania in 2009 was a typical crisis determined by an excessive current account deficit, where foreign savings temporarily financed the excessive domestic consumption of imported goods. The global crisis and the domestic crisis overlapped due to the transmission mechanism: the cut of private financing was visible in the severe adjustment of the current account deficit. Yet, the economic crisis in Romania has a domestic nature; it would have appeared even in the absence of the global economic crisis. The latter only acted as the trigger for the domestic economic crisis.

This paper discusses some unexpected implications of financing large current account deficits through foreign direct investments and the effects of pro-cyclical fiscal and budgetary policies in the years before the crisis. This paper has a critical heterodox perspective on the exit strategies enforced by the IMF, which focus on the expenditures' control by cutting wages and pensions.

Key Words: current account, economic crisis, foreign direct investment, Romania, IMF

JEL classifications: E20, E60, F32

1. Introduction

There is a widespread view regarding the uniqueness of the 2008 global economic crisis: there is one global crisis, that started in the US and it hit by contagion the rest of the world. This perspective is shared not only by the mainstream economics headed by international organisations such as IMF (Blanchard, 2008) or EBRD (Transition Report 2009), but also by many heterodox economists.

While acknowledging the varieties of capitalism, Wade (2009) discusses about global imbalances and global reorganisations. Frenkel and Rapetti (2009) agree that the current global crisis affects both developed and developing economies. However, they consider that the crisis in developing countries has an important exogenous component associated with the implementation of new macroeconomic policies, while the crisis in developed countries depends on endogenous factors. The distinction between developing and developed countries under this aspect is arguable, in particular if one thinks of Dymski (2009). He states that the heterodox economy sees the sources of economic crisis as being endogenous (internal to the economic system), as opposed to the orthodox economy which sees the sources of economic crisis as being exogenous (external to the economic system). Frenkel and Rapetti (2009) do not embrace the exceptionalism theory, but they rather blame a set of neo-liberal macroeconomic policies for the crisis in developing economies. In this regard, they have a point.

The current account liberalization has a central role among neo-liberal policies, promoted and imposed upon emerging economies by international organisations such as IMF, World Bank, European Union. However, the real economies are different from perfect markets as the goods markets in the recipient country may be monopolies, the labour market may be rigid, the state intervenes in the allocation of resources, and corruption and the speculative behaviour are the norm especially in the emerging economies. The heterodox economics sees the current account liberalization as a factor enhancing instability (Arestis and Singh, 2010). There is a growing empirical support for this assertion even from mainstream economists (Eichengreen, Rose and Wyplosz, 1994; Rossi, 1999; Demirguc-Kunt and Detragiache, 1998). The financial system in emerging economies is usually underdeveloped, the financial market is illiquid and it lacks depth, the prudential supervision is weak, and risk management is absent. When the sudden liberalization of the capital account takes place against such a background, the massive short-term capital inflows leads to credit expansion and to a nominal and/or real exchange rate appreciation increasing the vulnerability of the economy.

In the case of Romania, the current account liberalization was necessary for EU integration. It happened in a short period (2001-2004) and it was followed by massive foreign capital inflows (see the next section) and a surge in the current account deficit. A legitimate question is whether the latter could have been contained. Grabel (2001), in a counterfactual analysis of the Asian crisis from 1997-1998, found that the introduction of some prudential measures could have prevented or tempered the effects of the crisis. The theory that predicates the absence of alternatives is more comfortable, but fundamentally wrong.

The opening of the capital account has facilitated the process of coupling the business cycle in emerging economies with the business cycle in developed economies. In a recent article on India (Ghosh and Chandrasekhar, 2009) the GDP growth owes to global integration, which the authors see as a weakness; financial deregulation stays at the origin of a retail credit boom for the richest quintile of the population.

Kotz (2009) identifies four types of economic crisis. In the first type, the economic growth leads to lower unemployment and enhanced employees' bargaining power, with salaries rising faster than productivity, making growth unsustainable at some point. The second type is under-consumption (the opposite of the first type), when real wages diminish and a crisis appears if public expenditures do not increase. The third category is overinvestment, which comprises the expansion of productive investments under the competitive pressure leading to an excess of production capacity. Overinvestment here is not similar to Hayek and Mises's view; it can happen in the absence of an expansionary monetary policy, and it is not necessarily followed by overconsumption (which corresponds to the first type of crisis). I would include in the overinvestment category not only the productive investments, but also the pressure towards the financialization of the non-financial companies, contributing to an excess of financial investments, based on the money illusion. A fourth type of crisis originates from speculative bubbles; Kindleberger (2005) described the universal scenario for speculative bubbles from opportunity – credit – boom – financial disaster – opportunity. The neo-liberal financial reforms increased the access to finance and the opportunity to trade assets, creating a speculation-led economy

(Grabel, 2009) where productive investments cannot compete for financing because they cannot generally offer higher rates of return than speculative investments.

The issue of new EU member states (NMS) facing the crisis has received little attention in the economic literature, maybe due to the ongoing process of reform in those countries. However, countries like Romania, Bulgaria or the Baltic States were among the ones most severely hit by the economic crisis. However, did the global economic crisis push them into recession? Alternatively, were their domestic imbalances so large that a crisis would have occurred anyway?

This paper challenges the conventional view that there is one global economic crisis. I argue that there are many local crises; the global economic crisis acted as a trigger for them. Nevertheless, the trigger could have been different, and the local crisis would have been unavoidable anyway. Countries that run twin deficits prior to the crisis (current account deficit and budget deficit) faced a sudden reversal of fortune in foreign capital inflows, irrespective of the reasons for that. „Coupling" is important in this process, as it allows the free movement of capital, but it is not the main cause for the crisis in many emerging or transition economies. This paper deals with Romania - the 7th largest EU member state in terms of population and the 2nd largest NMS. The Romanian economy received little attention in the international literature, but there is a substantial common ground with other countries in the region.

The remaining of this paper is as follows. The next section dismantles the myth of financing the current account (CA) deficit through foreign direct investments (FDI) – a favourite topic for neo-liberal adepts, which contributed to the crisis by allowing the accumulation of a large CA deficit. The third section presents the main argument of this paper, that the economic crisis in Romania has a domestic nature, and that the global economic crisis was just the trigger for it. The fourth section has a critical approach of the IMF orthodox adjustment program in Romania. The last section presents some concluding remarks.

2. The myth of financing the current account deficit through foreign direct investments

There is an orthodox myth, also known as the Lawson doctrine (named after a speech given by the British Chancellor Nigel Lawson in 1988), stating that large current account deficits which are privately financed should not be a cause of concern. The supporters of this doctrine, many of them being decision-makers, hold that any level of the current account deficit is acceptable as long as FDI, which are autonomous capital flows, finance it.

On the one hand, for Romania, a transition economy with scarce local capital, FDI inflows are of paramount importance for development, knowledge transfer and technology absorption. Following trade and capital liberalization and in the wake of EU accession (which took place in 2007), annual FDI inflows in Romania increased tremendously from 1 bn. Euro in 2002 to 4 bn. Euro in 2004, over 9 bn. Euro in 2006 and cca. 7 bn. Euro in 2007 and 2008. By the end of 2008, the FDI stock reached 37.7% of GDP, compared to 15.4% of GDP in 2002. The CA deficit worsened in the same period from below 5% of GDP in 2002 to 8.5% in 2004, 13.5% in 2007 and 12.5% in 2008 (a 20% depreciation of the local currency in 2008 did little to cut the deficit). FDI inflows covered more than half of the CA deficit (76% in 2005, 85% in 2006, 42% in 2007, and 54% in 2008). This share was even larger in other NMS (Bulgaria or Slovakia). The year 2006, when it was the largest financing of the CA deficit through FDI, had two particularities: it was the last year before Romania's EU accession – which caused some euphoria – and it marked the privatization of the largest Romanian commercial bank in the largest ever sale of a state owned company in Romania.

On the other hand, the contribution of FDI to the CA deficit has also a negative component. First, the incomes from foreign investments appear as outflows in the current account; for Romania, they represented on average 30% of the CA deficit in the period 2005-2008. This means that almost one third of the CA deficit relates to FDI; in fact, FDI finance an additional CA deficit created by FDI.

Second, a large part of these incomes from FDI actually leaves Romania back to the country of origin. Repatriated incomes represented half of total FDI incomes in 2005 and more than two thirds of them in 2007 and 2008 (with a peak of 69.6% in 2007, more than double than the 28% recorded in 2003). According to WIIW (2009), other countries in the region recorded comparable levels in 2008 (Slovakia 82%, Bulgaria 77%, Croatia 66%).

Third, FDI have an indirect contribution to the size of the CA deficit through imports of technology and products. Even the investments in the productive sectors (tradables) determine a short-term increase in imports (equipments, raw materials, and intermediary products are imported). Nevertheless, the investments in non-tradables increase imports in the long run, fuelling consumption. FDI in the manufacturing industry represented only 32% of the total FDI stock in Romania in 2007, down from 46% in 2004. In turn, FDI in real estate increased from 5.6% of the total stock in 2004 to 10.5% in 2007. Only in those three years the ratio between FDI in manufacturing and FDI in the others economic sectors declined from 1:1 to 1:2. FDI in financial intermediation (23.3% of the stock), retail (14%) and real estate (10.5%) stimulated imports and the real estate boom either directly or indirectly (through loans). The annual pace of growth of imports was over 30%; between 2004 and 2007 alone Romania's imports doubled in nominal terms from 24 bn. Euro to 46 bn. Euro.

The most important aspect of the myth of financing the CA deficit through FDI lies, however, in the structure of FDI inflows themselves. FDI inflows fall into three categories: equity, reinvested profits, and intra-company loans. While the first two categories comprise autonomous capital flows, the intra-company loans are non-autonomous flows as they create debt. In Romania, the share of intra-company loans reached half of the total FDI flows in 2007 (51.1%) and 2008 (49.6%) – the two record years for the CA deficit (WIIW, 2009). This share was on an upward slope, from 10% in 2000 and 13.5% in 2004. A determinant factor was the high rate of return on investing in the local currency; the reference interest rate was in the two figures territory (18% in 2006), despite a one-digit inflation rate and the local currency appreciated in nominal terms by 35% between November 2004 and August 2007.

The data above show that one third of the CA deficit came directly from FDI incomes and that there were additional mechanisms through which FDI lead to higher CA deficit. The FDI finance only half of the CA deficit, but only a half of that financing is autonomous – the rest of it creates short-term foreign private debt. Between 2004 and 2008 Romania's foreign debt increased by 4 times, most of it being private (cca. 90%) and short-term (cca. 50%). This is a typical FDI behaviour, oriented towards short-term profit maximization, unable to finance a high CA deficit in a sustainable manner. The solution is not to have large FDI flows to finance a high CA deficit, but rather to contain the CA deficit within a reasonable margin. Romania, like many other emerging economies, cannot sustain a CA deficit higher than 10% of GDP. In 2009, the CA deficit adjusted sharply to 5.5% of GDP on the background of a severe drop in consumption and imports.

This myth is important because the entire rhetoric about Romania's economic development and catching-up with core EU countries builds on the massive FDI inflow, regarded as a source of increasing external competitiveness and as a guarantee against a rising CA deficit. While some FDI indeed enhanced competitiveness in particular in the car industry and the steel industry, the bulk of FDI had a speculative nature. The Romanian economy suffered from the Dutch disease that describes the effects associated with a very rapid GDP growth due to massive foreign capital inflows, irrespective of their source (exploiting natural reserves, financial aid or FDI). The consequences of such massive foreign capital inflows are the appreciation of the local currency, the fast rise of imports, and the faster development of the non-tradables sectors as compared to the tradables sectors. Romania had all these signs of the Dutch disease. Apart from the currency appreciation and the fast rise of imports, Romania faced a process of deindustrialization, best seen in the cut of carbon emissions compared to 1992 (the reference year for the Kyoto protocol) and in the shrinking share of industry in GDP formation. The speculative boom in the real estate (a non-tradable sector) made this sector more appealing than productive sectors.

The main engines of economic growth in Romania after the current account liberalization were households' consumption (with a growth rate of 10-15% every year) and gross fixed capital formation (with a growth rate of 20-30% every year). The gross fixed capital formation includes constructions and car sales, foreign and domestic investments. Having said that the FDI inflows were mainly speculative and that they fuelled consumption, we remain with one major source of growth in the pre-crisis period: households' consumption. As the next section argues, the economic crisis that hit Romania in 2009 was a typical crisis determined by an excessive CA deficit, where foreign savings temporarily financed the excessive domestic consumption of imported goods.

3. The economic crisis in Romania is different: a crisis of overconsumption

The economic crisis that hit Romania in 2009 is different from the global economic crisis that started in US and propagated itself in developed economies such as UK, Germany or

France. A typical CA deficit crisis occurred in some emerging economies, new EU member states – including Romania – and some former cohesion economies. These two different crises overlapped due to the transmission mechanism: the cut of private financing was visible in the severe adjustment of the CA deficit. The economic crisis in Romania (as well as in some other emerging economies and new EU member states) differs from the economic crisis in US and Western Europe under the following aspects.

First, the economic crisis in Romania has a domestic nature; it would have appeared even in the absence of the global economic crisis. The causes of the economic crisis in Romania are different from the causes of the economic crisis in the US and the core of EU. The Romanian economic crisis is the crisis of a development model based on overconsumption. The global economic crisis only acted as the trigger for the domestic economic crisis.

Second, the transmission mechanism of the crisis was different in Eastern Europe (most new EU member states) from Western Europe, although their effects overlapped.

Third, since both the causes and the transmission mechanism differ, the exit strategies in Romania cannot replicate the exit strategies in US or core EU countries.

Nevertheless, one can identify common aspects between the crisis originating in the US and the Romanian crisis. One common cause is the process of dereglementation. However, given the different level of financial depth, dereglementation referred to different things. While in the US and later in Western Europe the dereglementation allowed the expansion of dangerous financial innovations, mainly the securitization of sub-prime loans, in Romania the share of real estate loans is below 5% of total loans, and the secondary market for mortgages is virtually inexistent. The derivative instruments, although liberalized in 2004 as part of the capital account opening, are also heavily under-developed. While Romania liberalized an under-developed market, the US deregulated a highly developed market and innovated new, unregulated, markets.

Inequality in income distribution is a determinant factor for the crisis according to Watt (2008) amd Palma (2009), a factor recognized by the heterodox theory. Romania also witnesses income polarization, as it has the highest level of income inequality among EU members, according to Eurostat data for 2008. The Romanian society comprises of a very small upper class, a thin middle class drowned in debts and a majority of the population that receives various forms of social assistance. Furthermore, the flat tax introduced in 2005 acted as a catalyst for inequality of income distribution (Voinea and Mihaescu, 2009).

Another resemblance is the real estate bubble, but its causes were similar to those in Spain or the Baltic States rather than the US.

From the heterodox perspective, the main cause of the economic crisis that originated in the US and spread-out globally is the excess of financial investments. Watt (2008), who observes that the rising share of profits to national income in many developed economies advances much faster than the rise in productive investments, blames the financialization of the American economy. Non-financial companies moved towards financial investments in order to get higher short-term profits.

From the same heterodox perspective, what happened in Romania was a first type of crisis (according to Kotz's taxonomy), determined by wages increasing faster than productivity, booming consumption and booming private debt to finance the dramatic deepening of the CA deficit. Romania has been facing a crisis of overconsumption.

Consumption was the main engine of economic growth in the pre-crisis period, fuelled by the households' loans which increased by cca. 60% every year following a 200% increase in 2003. The ratio of non-governmental credit to GDP increased from 10% in 2001 to 39% in 2007, despite high rates of GDP growth during that period; households' loans represented more than half of the total non-governmental credit. By year-end 2008, households' loans represented 70% of the households' incomes, 7 times more than in 2001. Figure 1 illustrates the vulnerabilities induced by this type of development.

Figure 1 here. Household debts and current account, % GDP, EU-27 economies, 2007 against 2001

On the horizontal axis, there is the ratio of households' debt to GDP. In Romania, this ratio increased from 2.9% in 2001 to 25.6% in 2007. The nominal level remains modest when compared to other EU economies, but the pace of growth of households' debts (which multiplied 10 times in only 6 years) is worrying. The fast worsening of the CA deficit, shown on the vertical axis, reflected this fast increase in households' debts. While the level of the CA deficit itself was comparable or lower than in other EU states (Bulgaria 25%, Latvia 22.5%, Estonia 18%, Lithuania 14.6%, Greece 14.2%, Portugal 12.2%, Spain 10%), the rhythm of growth was a cause of concern. In Figure 1, the axis met at the average value of their data series. Romania, Bulgaria and the three Baltic States appear distinctly in the lower right window, as a separate story from the other EU countries (Hungary appears in the upper right window but close to the axis because the adjustment process started there ahead of the global crisis). A current account crisis was becoming unavoidable in these new member states.

With a newly gained sense of richness, due to higher wages and higher asset prices, people enjoyed an easier access to financing. This illusion of a personal welfare was the reflection, at the microlevel, of the illusion economics that Romania experienced at the macrolevel, based on speculative capital flows that financed imports. One needs a historical perspective though: Romanians faced consumption deprivation during communism, as well as during the first two post-communism recession episodes (1990-1992 and 1997-1999). The loosening of the monetary policy and the real estate boom after 2003 represented major factors stimulating consumption. However, the consumption frenzy went so far that "the ID loans" appeared – loans granted only based on an identity card, with no guarantees and no proofs of revenues. Banks became households' loans shops only and retail stores turned into banks. Rational choice did not govern the economy. People felt the social pressure to overspend because everybody else did the same – the typical scenario of an overheated economy (Akerlof and Shiller, 2009).

The government also overspent. The fiscal and budgetary policy was pro-cyclical before the crisis (see Figure 2). The weak budget constraints in good times, when the real GDP growth exceed the potential GDP growth, led to an increase in the structural budget deficit.

Figure 2 here . Fiscal stance and output gap, Romania, 2004-2010

Regarding the fiscal policy, the introduction of a 16% flat tax on income and profit in 2005 stimulated demand, not supply (as in theory). According to a study by Voinea and Mihaescu (2009), 82% of the flat tax gains went into spending on current consumption goods. Moreover, the budgetary revenues became increasingly dependant on consumption taxes such as VAT and excise duties. Budgetary revenues decreased in the first year of reform and marginally increased since 2006 after increasing various other taxes (such the tax on dividends) to compensate for the initial loss. Budgetary revenues have never exceeded 32% of GDP in Romania, the lowest level among EU members (Latvia has 35%, Bulgaria and Poland have 38%, Czech Republic has 40%).

Regarding the expenditures side, the public wage bill increased tremendously from 4.6% of GDP in October 2004, before the then electoral campaign, to 8.6% of GDP in 2008 (ahead of another electoral campaign) and even 9% of GDP, due to an inertial effect, in the first half of 2009. The average nominal increase in public wages was 86% between 2005 and 2008 (the aggregated inflation rate in the same period was below 30%). Between 2007 and 2008 the average pension also increased by 50%. Pensions increased from a very low level, indeed, but the magnitude of this rise was obviously unsustainable. There was further waste in spending on public infrastructure works not accomplished and in unnecessary public acquisitions at both public and local administration level. Following these pro-cyclical measures, the structural budget deficit exceeded 7% of GDP in 2008, before the crisis and over 8% of GDP in 2009.

The transmission mechanism in some NMS and some other emerging economies (Western Balkans, for example) was the current account, while in the US and core EU members it was the contamination of the banking sector with toxic assets. A country that runs a large current account deficit faces a high capital flows volatility risk. As long as the conditions are favourable and capital is flowing in, the current account deficit is financeable. When the international circumstances worsen and a liquidity crisis appears in the major economies, investors start to withdraw their money from risky economies, even though the crisis has not originated there. A sudden drop in foreign financing leads to a severe current account adjustment, ussualy followed by recession. It is noteworthy that in a paper published before the crisis (Algieri and Bracke, 2007) the probability of a current account adjustment in Romania was 88%, and 71% for a very severe adjustment based both on cutting domestic consumption and currency depreciation. By comparison, only Bulgaria and Hungary, among the NMS, had higher probabilities.

Since the causes of the crises are different, and the transmission mechanisms are different, the adjustment mechanisms need to differ as well. On the one hand, the developed economies introduced stimulus packages, leading to large budget deficits, intervened on the market and temporary took control of some private financial institutions; they implemented anti-cyclical Keynesian policies. On the other hand, Romania, like other emerging economies, implemented pro-cyclical measures. These countries cut public expenditures and miss the resources to stimulate the economy (quite the contrary, the government accumulates arrears towards private firms). Gligorov and Landesmann (2009) consider that the policies implemented in these countries are the exact opposite of those adopted by the US and Western Europe, a fact that deepens the recession. They affirm that such pro-cyclical policies, in hard times, do not necessarily lead to lower fiscal deficits and lower country risks; on the contrary, the fiscal deficits raise even when public expenditures decrease, because the budget revenues also fall and the cost of debt rises.

However, the anti-crisis plan in Romania follows the International Monetary Fund's orthodox approach. The last section has a critical perspective on it.

4. A critical view on the IMF's anti-crisis plan

Romania signed a stand-by agreement with the International Monetary Fund (IMF) in April 2009, part of a syndicated loan from IMF, World Bank and EU of 20 bn. Euro. This was the seventh IMF loan to Romania in the last twenty years, a fact that may cast doubts on the sustainability of IMF reforms.

The stand-by agreement imposed quantitative performance targets and structural reform conditionalities. The quantitative targets refer to monetary aggregates, arrears, inflation, reducing public expenditures, increasing foreign reserves. The structural reforms refer to passing new laws regarding unitary framework for public wages, for pensions, and introducing fiscal responsibility. One could remark that the rigidity of public wages, although advisable in tough times (however, there is a contradiction with the real convergence process towards the euro zone), is difficult to implement. Keynes (1936) noted that except for socialist societies, where the wage policy is set by decret, there are no ways to secure uniform salary cuts for each category of the working class.

Even these structural reforms have a monetary end as they intend to cut spending. The unitary public wages law aims at reducing the total public wage bill from 9% of GDP to 7% of GDP in a 5 years time. The fiscal responsibility law, which was implemented in Hungary as well, requires the central administration to run a primary surplus, and puts a 3% threshold on the consolidated budget, is in line with the Maastricht criteria. Nevertheless, it limits the government’s capacity to provide fiscal stimulus as an exit strategy.

In Romania’s program with IMF there is no explicit target regarding economic growth, employment level (which is the lowest among EU members, at 57%), or reducing poverty and social disparities. Romania’s case is no exception. The other Eastern European economies, with or without an IMF agreement, implemented the same fiscal philosophy based on austerity measures. Freezing or cuting public wages and firing public employees were among the most common measures in the region; moreover, the VAT increased in Hungary and Latvia.

The anti-crisis programmes in Eastern Europe focus on expenditures’ control, a typical orthodox approach. Lower real wages to help exports’ competitiveness is also a monetarist approach, just as the high interest rates that prevent credit activity to resume. This is the IMF’s Polak model, which treats an external disequilibrium by reducing the domestic credit, reducing the money supply, reducing inflation, reducing imports and reaching a new external equilibrium. This approach has its merits, especially regarding the short-term sustenability of deficits, but it also implies a deeper recession in the first phase. The measures directed towards cutting expenditures, although necessary, are pro-cyclical, leading to a further contraction of aggregate demand. The possibility of an expansionary fiscal contraction (which means that a country achieves economic growth only by improving the efficiency of public spending – see Agenor, 2004) is not feasible for Romania and other countries in the region because private investments are simultaneously shrinking as an effect of the economic crisis and hence they cannot replace the diminishing public spending.

In fact, the private sector boosts savings at the wrong time (Irvin, 2009). Companies change their behaviour from profit maximization to debt minimization. Households increase their savings as well when they notice that the real value of their houses (their main asset) decreases. This was visible in Romania, where the savings rate increased from 16% in 2008 to 19% in 2009. If the private sector is preoccupied with saving, the government can stimulate the aggregate demand as an investor of last resort. Unfortunately, the government is also preoccupied with saving, as it targets a lower budget deficit.

One year into the IMF agreement, the Romanian government decided to implement tougher measures, including a 25% nominal cut of all wages, a 15% nominal cut of all pensions, a 15% cut of all unemployment benefits, all child allowances, and so on.

The effort to cut public expenditures creates the savings paradox; as Keynes (1936) explained it, the more the savings a country is trying to achieve, the less the revenues it receives and the less the resources it has for savings. If one cuts expenditures, this will reflect in lower revenues in the future. Budget revenues from income tax and social contributions drop proportionally with the cut in wages, and VAT revenues drop proportionally with the drop in consumption. The aggregate savings from such measures are small, while the negative consequences are large. As consumption accounts for 60% of GDP formation in Romania, GDP will also fall as a direct result of these measures. The median family in Romania has one state employee and one private employee. A 25% cut in state wages means a 15% cut in family’s consumption. The share of families with one state employee in total consumption is 30%. The annualized impact of a 25% cut in public wages will be a 4.5% drop in aggregate consumption and hence a 2.7% drop in GDP.

Cutting wages and pensions prevent the credit activity to resume, hence deepening the recession. In this case, a lower wage bill is similar to a hike in the interest rates. In the case of Romania, the efforts of the National Bank which cut interest rates to a record low level (still well above inflation rate though) are outbalanced by the cut in public spending with wages and pensions.

There is also the issue of income distribution. The public wage bill reform through cutting both wages and jobs implies welfare redistribution from labour force to capital owners. Romania is an economy where the labour force has a higher share than capital in total income (mirrored by the fact that the state collects more revenues from the income tax than from the profit tax, although the tax rate is similar for labour and capital, at 16%). The labour force has a higher marginal propensity to consumption than capital owners have (see, among others, Kaldor, 1956 or Kalecki, 1968). The aggregate demand depends on income distribution (Goldstein, 2009). Cutting real wages in a wage-led economy is counter-productive (Sawyer, 2009), as it results in lower consumption.

5. Concluding remarks

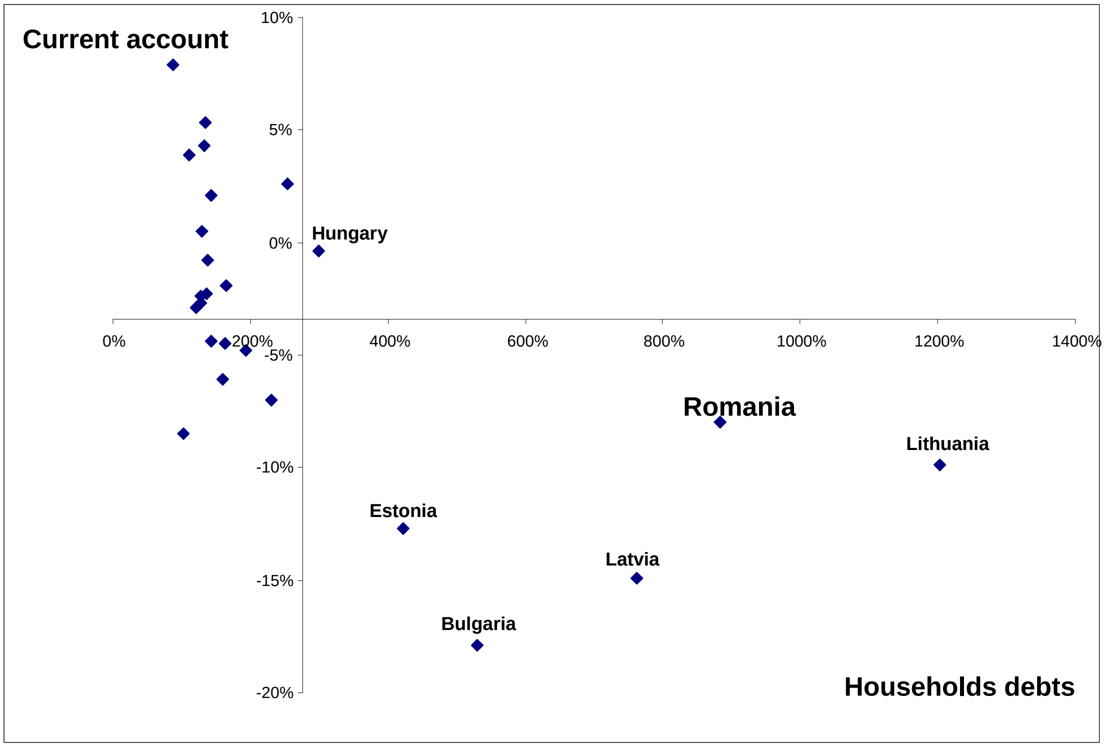
From a heterodox perspective, this paper holds that the economic crisis that hit Romania in 2009 was different from the global economic crisis. It was a current account deficit crisis, based on overconsumption of imported goods, fuelled by a credit boom. Foreign direct investments did not finance the deficit, but they actually helped it to increase as the section 2 of this paper describes in detail. Now that the bubble burst, the illusion of welfare disappeared, the main concern refers to the exit strategies.

The monetarist policies focused on cutting pensions and wages may create a short-term economic stability, with many collateral damages among ordinary people. Yet the structural problems would persist. The monetarist anti-crisis approach cannot take the economy out of the crisis. It can provide a temporary adjustment at high social costs, but it cannot provide a healthy basis for medium and long-term growth. What are the alternatives? Rodrik (2009) thinks that non-orthodox solutions will be implemented, as an economy that failed by the precepts of the Washington consensus cannot get fixed by the same precepts.

For Romania, in the short run, the government should cut expenditures with public acquisitions, fight fiscal evasion, and eventually reintroduce progressive income taxation. In the medium run, the government should aim primarily at increasing the employment rate, the only sustainable way to reduce the budget deficit.

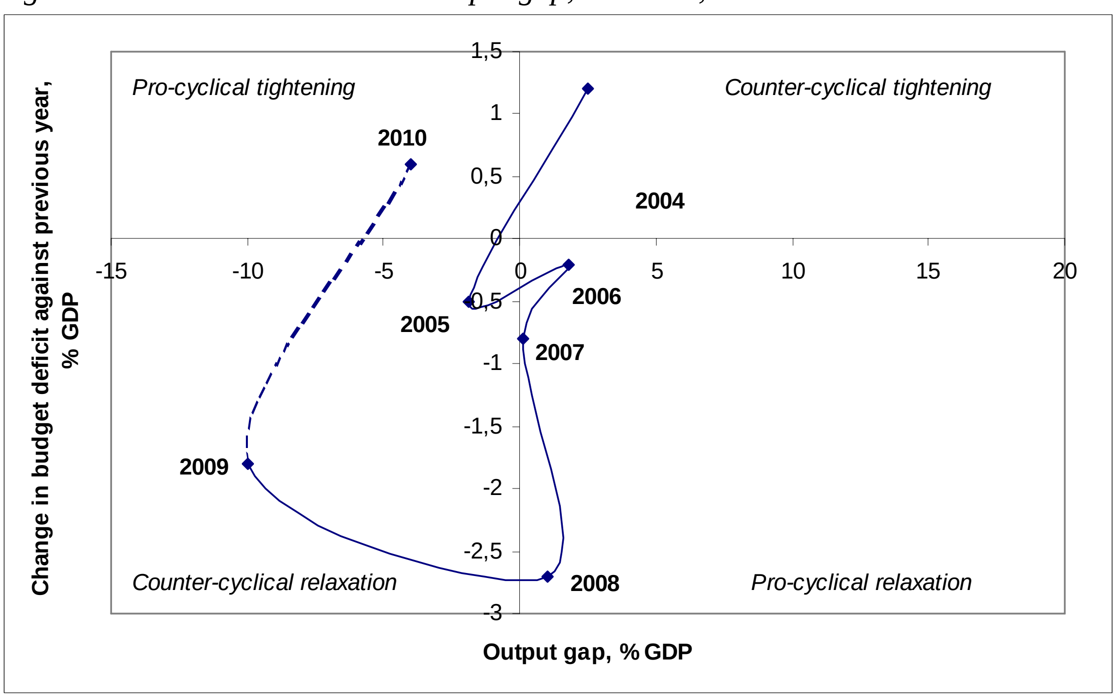
Figures in the text

Figure 1 here. Household debts and current account, EU-27, 2007 change against 2001



Source: the author, based on Eurostat data

Figure 2 here . Fiscal stance and output gap, Romania, 2004-2010



Source: the author, based on National Bank of Romania data and own calculations

References

Agenor PR.2004. *The Economics of Adjustment and Growth*, Cambridge and London, Harvard University Press

Akerlof GA, Shiller RJ. 2009. *Animal Spirits*, Princeton, Princeton University Press

Algieri B, Bracke T. 2007. Patterns of Current Account Adjustment and Growth. Insights from Past Experience, European Central Bank Working Paper Series, no.762

Arestis P, Singh A. 2010. Financial globalisation and crisis, institutional transformation and equity, *Cambridge Journal of Economics* vol.34, no.2, pp.225-238

Blanchard O, Spilimbergo O, Symansky S, Cottarelli C. 2008. "Fiscal policy for the crisis", IMF Staff Position Note SPN/08/01

Demirguc-Kunt A, Detragiache E. 1998. "The Determinants of Banking Crises in Developing and Developed Countries", IMF Staff Papers, vol.45 no.1

Dymski GA.2009. "Does Heterodox Economics Need a Unified Crisis Theory?", in *Heterodox Macroeconomics* (Goldstein JP, Hillard MG, eds.), London, Routledge

Eichengreen B, Rose AK, Wyplosz, C. 1995. "Speculative Attacks on Pegged Exchange Rates: An Empirical Exploration with Special Reference to the European Monetary System", NBER Working Papers 4898, National Bureau of Economic Research

European Bank for Reconstruction and Development (EBRD). 2009. Transition Report 2009: Transition in Crisis?, EBRD, London

Frenkel R, Rapetti M. 2009. A developing country view of the current global crisis: what should not be forgotten and what should be done, *Cambridge Journal of Economics*, vol.33, no.4, pp. 685-702

Ghosh J, Chandrasekhar CP. 2009. The costs of 'coupling': the global crisis and the Indian economy, *Cambridge Journal of Economics*, vol.33, no.4, pp.725-739

Gligorov V, Landesmann M. 2009. "What is to be Done? A Policy Note", WIIW (The Vienna Institute for International Economic Studies), March 2009

Goldstein JP. 2009. "An Introduction to a Unified Heterodox Macroeconomic Theory", in *Heterodox Macroeconomics* (Goldstein JP, Hillard MG, eds.), London, Routledge

Grabel I. 2001. Averting Crisis? Assessing Measures to Manage Financial Integration in Emerging Economies, paper presented to the conference "Financialization and the Global Economy", PERI Amherst, December 2001

Grabel I.2009. "Neoliberal Finance and Third World (Mal)Development", in *Heterodox Macroeconomics* (Goldstein JP, Hillard MG, eds.), London, Routledge

Irvin G. 2009. Global Recession: Spending Cuts Are Not the Answer, Center for Development Policy and Research, University of London, *Development Viewpoint* no.14

Kaldor N.1956. Alternative Theories of Distribution, *Review of Economic Studies* no.23

Kalecki M.1968. Trends and the Business Cycle, *Economic Journal*, vol.78, pp.236-276

Keynes JM. 1936. *The General Theory of Employment, Interest and Money*, Macmillan Cambridge University Press, Royal Economic Society

Kindleberger C. 2005. *Manias, Panics and Crashes: A History of Financial Crises*, Wiley, 5th edition

Kotz DM. 2009. "Economic Crises and Institutional Structures", in *Heterodox Macroeconomics* (Goldstein JP, Hillard MG, eds.), London, Routledge

Palma JG.2009. The revenge of the market on the rentiers. Why neo-liberal reports of the end of history turned out to be premature, *Cambridge Journal of Economics*, vol.33, no.4, pp. 539-562

Rodrik D. 2009. *One Economics, Many Recipes*, presentation to Sir Arthur Lewis Distinguished Lecture, March 2009

Rossi M. 1999. “Financial Fragility and Economic Performance in Developing Economies: Do Capital Controls, Prudential Regulation and Supervision Matter?”, IMF Working Paper no. 99/66.

Sawyer M. 2009. “The Central Core of Heterodox Macroeconomics”, in *Heterodox Macroeconomics* (Goldstein JP, Hillard MG, eds.), London, Routledge

Voinea L, Mihaescu F.2009. The Impact of Flat Tax on Inequality. The case of Romania, *Romanian Journal of Economic Forecasting*, vol.XII, no.4, pp.19-41

Wade R. 2009. From Global Imbalances to Global Reorganizations, *Cambridge Journal of Economics*, vol. 33, no.4, pp.539-562

Watt A. 2008. The economic and financial crisis in Europe: addressing the causes and the repercussions, *Munich Personal RePec Archive* (MPRA) *Paper* no.12337

WIIW.2009. *Database on Foreign Direct Investment*, WIIW, Vienna