Romanian Journal of Fiscal Policy
Volume 6, Issue 1(10), January-June 2015, Pages 54-62

Arguments in the Debate Austerity vs. Growth in Romania[♦]

Bogdan Andrei Dumitrescu
Department of Money and Banking, Bucharest University of Economic Studies

ABSTRACT

The fiscal policy response to the consequences of the financial and economic crisis consisted either in adopting expansionary policies to stimulate the aggregate demand, or in promoting fiscal consolidation programs designed to restore the sustainability of the public finances. This paper examines the options of the Romanian authorities regarding the fiscal policy decisions in the immediate aftermath of the crisis, and subsequently as the fiscal consolidation program initiated in 2010 has advanced. The paper concludes that the advantages and disadvantages of both approaches cannot be analyzed without taking into account the short-term constraints and the solution adopted by the policymakers, namely to realize the fiscal adjustment was inevitable.

Key words: fiscal consolidation, economic growth, crisis management

JEL Classification: E62, H12, H60

1. Introduction

The magnitude of the economic and financial crisis that hit the global economy since 2007 has generated profound consequences on the European Union economy both at the level of the main macroeconomic variables, the financial system, but also socially or in terms of the institutional architecture of the EU. This unfortunate event represented also a stimulus for the economic research regarding the influence of the fiscal policy on output, given that its use was seen either as a way to mitigate the effects of the crisis or as a way to restore the

[♦] This paper was presented at the International Finance and Banking Conference FIBA 2015 organized by the Faculty of Finance, Insurance, Banking and Stock Exchange from the Bucharest University of Economic Studies jointly with SIF Banat-Crișana, The Romanian Association of Finance and Banking RoFIBA and The Center of Financial and Monetary Research CEFIMO, March 26-27, 2015, Bucharest, Romania.

macroeconomic equilibriums, respectively by initiating fiscal consolidation programs in the countries characterized by major risks to the sustainability of the public finances.

If in a first phase, several EU countries have promoted in 2009 fiscal stimulus measures in response to the economic and financial crisis, but the Eurozone sovereign debt crisis led to the widespread adoption of the austerity policies aimed to restore the public finances solvency. In this context, it appeared at the European level a heated debate regarding the proper economic policy measures, respectively the choice between an austerity program versus fiscal stimulus measures that could support the weak economic recovery observed after the abrupt economic fall from 2009. Romania was among the first EU countries that have implemented ambitious programs of fiscal consolidation starting with the second half of 2010, but there were some voices who advocated for alternative policies based on maintaining the fiscal policy stance in order to not adversely affect the economic advance. These voices intensified in the coming years as the fiscal consolidation program has advanced and Romania approached the target set through the medium term objective. This research aims to contribute to the debate related to austerity versus economic growth in Romania by presenting how the fiscal policy can affect real GDP growth, the arguments in favor for each type of policy in the case of Romania and by analyzing the existing constraints at the local and European level that influenced the Romanian authorities' options. This research also proposes to assess the current state of the fiscal consolidation program in Romania and its future prospects.

The paper is structured as follows: the next section describes the theoretical approaches on the impact of fiscal policy on output, followed by the analysis of the macroeconomic context in Romania before and after initiating the process of fiscal consolidation in 2010. The last section debates the arguments of practicing an austerity policy in Romania versus a growth-oriented one, respectively with lower and slower adjustment of the accumulated imbalances and shows the possible implications for the policymakers.

2. Theoretical Perspectives Regarding the Impact of Fiscal Policy on Economic Growth

According to the classical macroeconomic theory, which most of the economists consider that adequately describes the behavior of economy in the long run, the output depends on the ability of an economy to provide goods and services, which is dependent on the supply of factors of production - labor and capital - and the available production technology. The price flexibility is a crucial assumption of the classical theory, based on the immediate adjustment of the prices so that the amount of required goods must to equal the quantity offered. However, the economy works differently when the prices are sticky; in this case the production depends also on the demand for goods and services. Furthermore, the aggregate demand is influenced by monetary policy, fiscal policy and other factors. Thus, given the ability to influence production that monetary and fiscal policy have, it is natural that they are used to stabilize the economy in the short term. Beyond the reasons that underlie price rigidity, this hypothesis is widely accepted by economists who use different models to explain how the economy works in the short and long term. The Keynesian theory, which underlies the IS-LM and Mundell-Fleming models focuses on how monetary and fiscal policy affect the aggregate demand, the implicit assumption being that they have no impact on the aggregate supply, which is a vertical curve that depends only on the factors of production and the technology available. If in regard to the effect of the monetary policy on the

aggregate supply there is consensus among economists that, in the long term a higher growth of the money supply will have an impact only on the price level and there is no impact on the supply, the findings are divided when it comes to the impact of the changes in the fiscal policy coordinates (through taxation decisions or regarding budget expenditures) on the aggregate supply. Beyond the short-term effects on the output generated by the increased expenditure or shifting the tax system, they have the potential to influence the ability of the economy to produce goods and services in the long term. A new current of the economic thinking, respectively economists who focus on the impact of the economic policies on the aggregate supply showed that an increase, for example, in the labor taxes may discourage the participation rate given the compromise between the leisure and the work time that influence the decision of the household to provide labor. Thus, beyond the short-term effect on the production given by the change in the fiscal policy, there can be also long-term consequences. Therefore, the fiscal policy decisions have a complex impact both on the short and long term on the production level. However, the fiscal consolidation is usually expected to generate short-term contractionary effects on output, given the positive fiscal multipliers of the Keynesian theory.

The determinants of the fiscal multipliers were synthesized by Spilimbergo et al. (2009) and they concluded that the impact of the fiscal stimulus on GDP growth is higher if losses are limited. The prerequisites for this to happen are based on: greater efficiency of the fiscal impulse in terms of increases of the government spending compared to tax reduction given that a larger or smaller part of this reduction will be saved depending on the marginal propensity to consume; targeting by the fiscal stimulus of those consumers who consume the largest part of their income or access credit with difficulty; small share of Ricardian agents, respectively those who diminish their present consumption in anticipation of higher taxes in the future which will finance the current fiscal stimulus. The authors also concluded that a higher fiscal multiplier is present in less open economies where consumers obviously have a lower marginal propensity to import, in case of the economies with a reduced size of automatic stabilizers so that a possible fiscal stimulus is not accompanied by a substantial increase in paid taxes, which would act to the contrary or while the positive fiscal impulse is generated in periods in which the output gap is negative and the central bank does not respond to this by increasing the reference rate. Also, the exchange rate regime is a significant factor that influences the size of the fiscal multipliers, a fixed rate potentiating the effect of the fiscal policy as the stimulus does not lead to the appreciation of the exchange rate with negative consequences on the dynamics of the net exports. Therefore, the fiscal policy effectiveness is diminished in open economies characterized by a floating rate regime, especially since when the monetary policy strategy envisages inflation targeting. In the latter case, the increase in interest rates due to the fiscal stimulus will cause a crowding-out effect, with additional negative impact on real GDP growth.

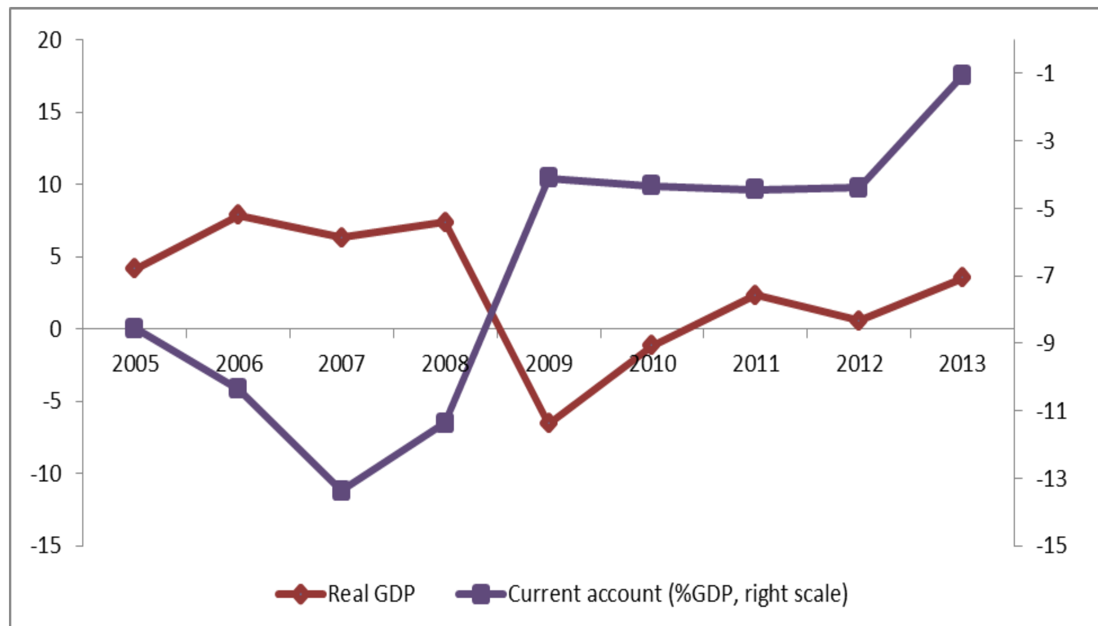
Implementing a fiscal stimulus cannot be achieved independent of the degree of public finance sustainability; a high level of public debt can represent a constraint difficult to overcome given that an expansionary fiscal policy is based on further increasing the public indebtedness, with possible negative consequences on the real GDP growth. Thus, the impact of higher risk premiums claimed by investors that involve higher interest rates for all borrowers in the economy and possibly an increase in savings due to precautionary reasons act towards reducing the production and may even exceed the positive impact on aggregate demand generated by the fiscal stimulus, as showed by Kirchner et al. (2010) and Nickel and Tudyka (2013). Moreover, the possibility of a negative relationship between expansion/fiscal consolidation and production is sustained by the more recent research regarding fiscal adjustment which leads to economic growth - expansionary fiscal contractions (Alesina and Perrotti (1996), Alesina and Ardagna (2009)).

The technical feasibility of adopting an expansionary fiscal policy cannot be determined in the absence of an analysis regarding the financial market's characteristics. Thus, in the situation when the state's financing needs cannot be sustained by the market, a strong crowding out will manifest with negative consequences on investment, or, on the contrary, in the presence of captive pension funds which are required to invest a significant share of their resources in government bonds, the fiscal stimulus program will be supported with the fiscal multiplier being higher in this last case.

3. The Macroeconomic Framework in Romania Before and After the Initiation of the Fiscal Consolidation Process in 2010

In the period 2000 – 2008, Romania's economy has experienced an accelerated growth as the real GDP increased on average with about 6.2% annually, the sustained economic advance being accompanied by the accumulation of severe macroeconomic imbalances. Thus, the economic growth model based on domestic absorption and capital inflows was equivalent to practicing high current account deficits, surpassing 10% of GDP in the period 2006-2008, partially financed by direct foreign investment, but also by considerable foreign loans. The period of sustained economic growth, above potential, ended abruptly with the plenary emergence in Romania of the global financial and economic crisis since the fourth quarter of 2008, the cumulative economic downturn in 2009-2010 being around 7.7%. At the same time the current account deficit adjusted sharply from the pre-crisis levels of above 10% of GDP to about 4% of GDP and the national currency depreciated sharply against the Euro by about 25-30%. The direct foreign investment also collapsed from an average of about 8.6 billion Euros in 2006-2008 to less than 3 billion Euros in 2009-2010, still failing to cover the current account deficit. As a consequence, Romania was facing a shortage of external financing, accompanied by economic decrease and a hostile financial environment and the country turned to an external financial loan from the International Monetary Fund, the European Commission and the World Bank of about 20 billion Euros, fazed over several years. It is important to consider the entire context that led to the implementation of a comprehensive fiscal consolidation program starting with 2010 and the external imbalance generated by the large current account deficits partly financed through foreign direct investment and mainly by increasing the external indebtedness played a key role in influencing the Romanian authorities' choices.

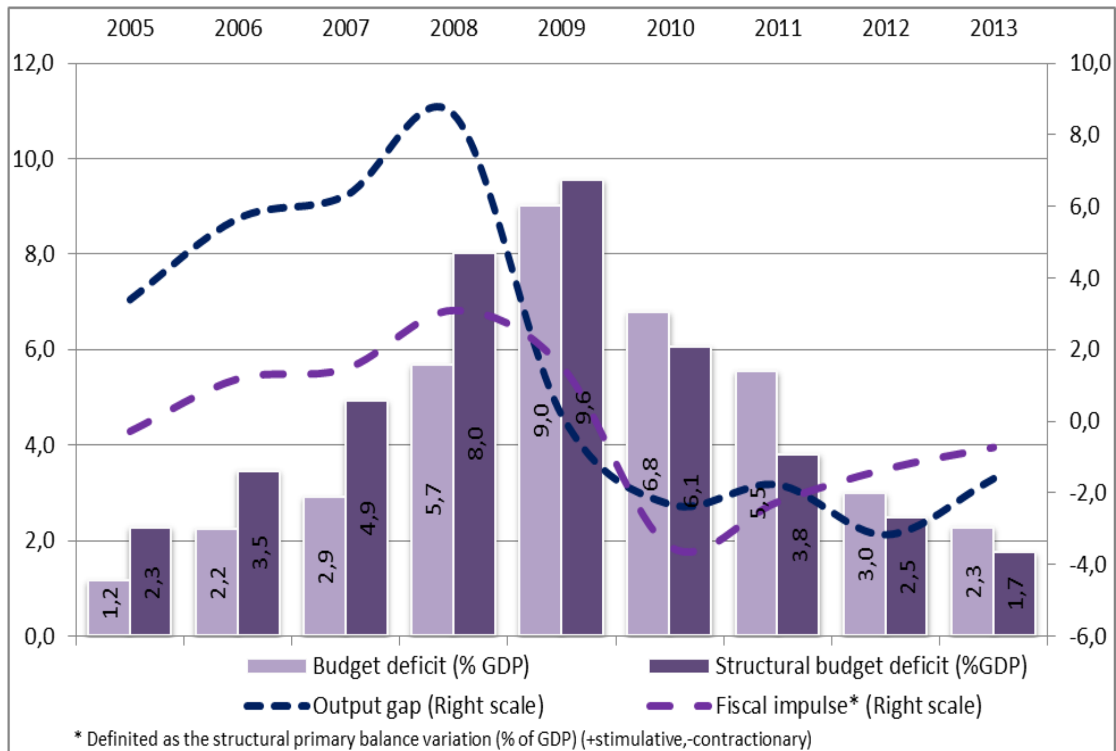
Figure 1 The economic growth rate and the current account balance in Romania in the period 2005 - 2013



Source: Eurostat

At the same time, the fiscal policy was pro-cyclical, the fiscal position deteriorating steadily, especially when analyzing the cyclically adjusted budget balance, the Government acting in the sense of additionally stimulating the economy, even if it advanced at a higher rate than its potential. The conduct of the fiscal policy in the period 2000-2008 and especially in the last 2 years of the interval mentioned, when the headline budget deficit recorded levels of 2.9 and 5.7% of GDP, while the structural deficit stood at 4.9%, respectively 8.1% of potential GDP, exhausted the fiscal space available for possible additional stimulation of the economy if adverse shocks occur. Thus, beyond the external imbalance and the financing deficit accompanied by a steep economic decline, Romania faced a very difficult position regarding the public finances. The consequences of the economic downturn in 2009, and also of the pro-cyclical measures adopted in 2008 have been translated into a budget deficit of about 9% of GDP, while the structural deficit widened to around 9.6% of GDP, with no consolidation measures implemented at that point.

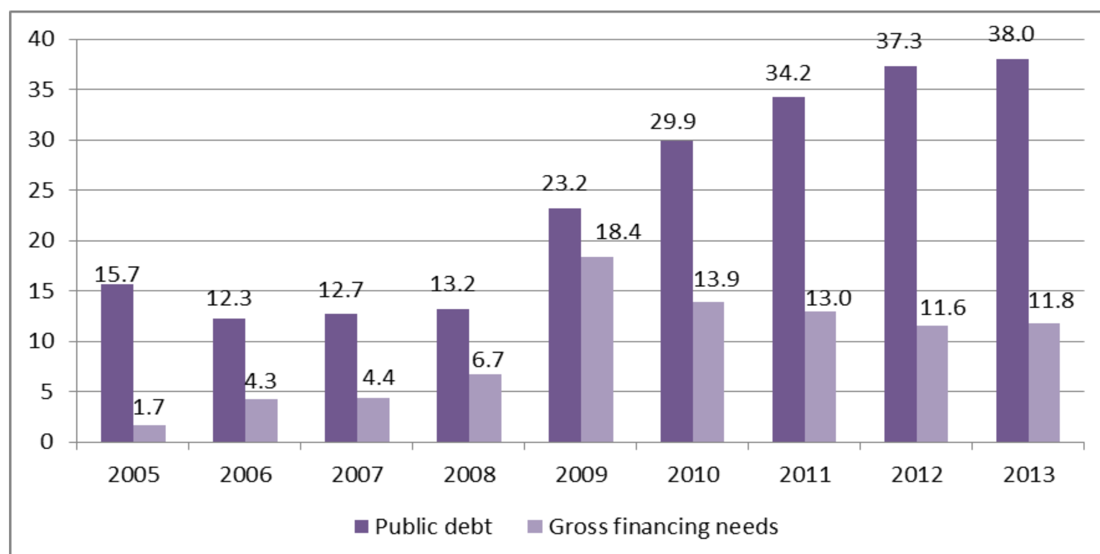
Figure 2   The headline budget deficit and the structural deficit, the fiscal impulse and the output gap in Romania during 2005-2013



Source: Eurostat

Obviously, such high levels of budget deficits plus the severe economic downturn led to a sharp increase of the public debt in 2009, respectively of 10 pp of GDP, from 13.2% to 23.2%, and the trajectory was still indicating a fast growing indebtedness degree. Romania's chance was represented by the very low level of public indebtedness at the beginning of the economic crisis that allowed to a certain extent delaying the fiscal consolidation measures, possibly leaving room for the automatic stabilizers to operate countercyclical in 2009 and eventually to stabilize the public debt to a level below the average of Central and Eastern Europe countries.

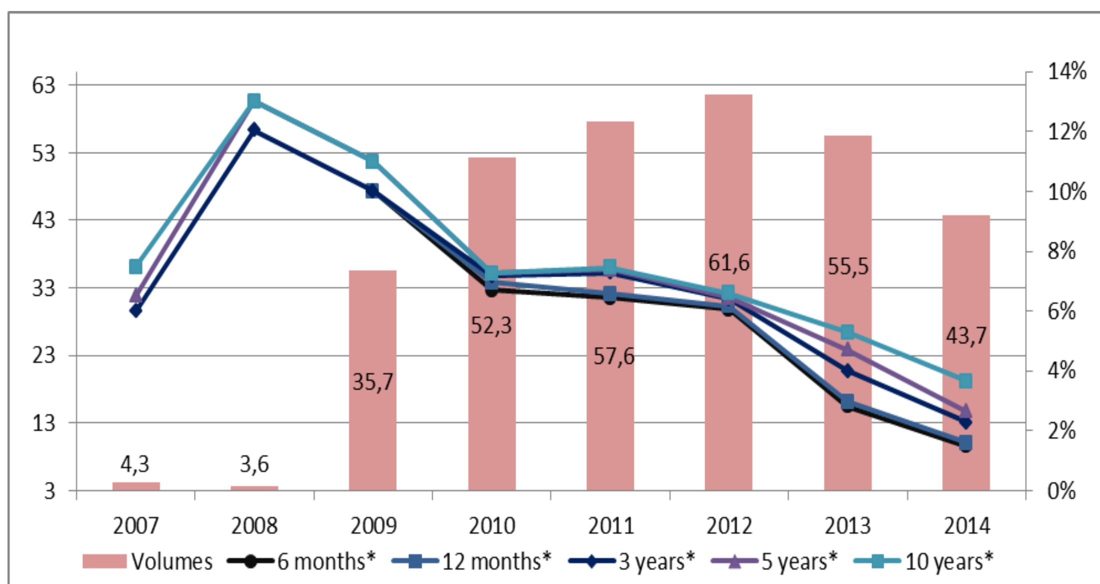
Figure 3 The public debt and the gross financing needs in Romania during 2005-2013 (% of GDP)



Source: Eurostat

However, a low level of indebtedness does not automatically mean the existence of a fiscal space. Thus, a high budget deficit or a possible increase of the budget deficit must be also funded through the financial markets. Moreover, the financing needs of a country includes also the part of the debt that reaches maturity and given a reduced average maturity of the public debt, as was the case for Romania in 2008, it may prove extremely difficult to find funding, especially in the conditions of an adverse economic and financial environment. In terms of covering the financial needs, Romania was at the end of 2009 in a situation where the foreign financial markets were almost impossible to access both because of the global economic crisis, but also as a result of the negative perception of investors about the magnitude of the accumulated imbalances in Romania, while the domestic bonds market was underdeveloped and unprepared to face such large needs of money. Moreover, the bonds yields, both on short and long term, were at prohibitive levels of over 10% in 2009 or 7% in 2010. Thus, the public financing need has exploded since 2009 and the pension funds, potential buyers of public debt were still in their early stages of development while the banking system was facing a liquidity deficit and this situation obviously represented a major challenge for the policymakers.

Figure 4 Romania's financing costs on the domestic financial market and the financing needs during 2007-2013



Source: National Bank of Romania, Eurostat

4. Conclusions and Implications for Policymakers

The debate regarding economic growth versus austerity in the context of formulating a response from the fiscal policy to the consequences of the economic and financial crisis is present, also in Romania, especially lately, following the progress of the ambitious fiscal consolidation program started in 2010. Thus, there are many voices that claim that the fiscal adjustment made by Romania in recent years largely solved the problem of public finances and the last part of this process, respectively the convergence towards the medium term objective of 1% of GDP for the structural deficit from around 1.7% of GDP at the end of 2013 should be more gradual compared to the current calendar. There was also some criticism on the extensive fiscal consolidation program initiated by Romania in 2010, arguing that it had a too strong negative impact on the economic growth.

Analyzing the macroeconomic situation during 2009-2010, characterized by the existence of large imbalances both in the current account deficit and in the public finances deficit, the choices of the Romanian authorities were limited in terms of fiscal policy measures possible to be adopted. Beyond the fact that a fiscal stimulus program was excluded given the very high budget deficit at that time, starting a fiscal consolidation program was inevitable in the context of very high financing needs, of adverse conditions in the financial markets and in the context of a need of adjusting the gap between saving and investment. Furthermore, the literature review argues in favor of fiscal adjustment when there is serious concern of investors about the debt sustainability of a country, a success of this program being likely to reduce the risk premiums, with favorable impact on interest rate at which both the state and the private economic agents borrow.

Moreover, the lower fiscal multipliers typical for small and open economies, as the one of Romania advocate in favor of frontloading a fiscal consolidation program so that most of the deficit reduction takes place in the first period, just as it happened in the analyzed situation. Although a reduction in government spending has a negative impact on GDP growth, the need to correct the imbalances accumulated along with short-term conditionalities such as for example the financing ones are likely to constrain the

policymakers' options towards a fiscal consolidation program. This is exactly what happened in Romania in 2010, as implementing an aggressive program of reducing the budget deficit was practically the only solution. It is true that the speed at which this process advanced, from a structural deficit of around 9.6% of GDP in 2009 to 1.7% of GDP in 2013, corresponding to an annual pace of fiscal adjustment of about 2 pp of GDP could be considered excessive, but the small fiscal multipliers and the fast reduction of interest at which the state was borrowing support the idea that this strategy was optimal.

Approaching the medium-term objective, along with the current position in the economic cycle are arguments for which the completion of the fiscal consolidation process within the calendar agreed with the international financial institutions is a suitable option at this time. Thus, given both the reduced gap between the current budget balance and the medium term objective and the small size of the fiscal multipliers, the earnings in terms of economic growth rate generated by stopping the process of fiscal consolidation are reduced. Moreover, the output gap narrowed significantly towards zero and a strongly expansionary fiscal policy could again prove to be pro-cyclical. The economic crisis has shown once again the importance of having a fiscal space during recessions and the boom periods should be used to build it. In addition, a reversal of the fiscal consolidation process, accomplished with many sacrifices from a social point of view, could cause a significant increase in interest rates that would affect all participants in the economic activity.

Acknowledgment

This paper has been financially supported within the project entitled „SOCERT. Knowledge society, dynamism through research", contract number POSDRU/159/1.5/S/132406. This project is co-financed by European Social Fund through Sectoral Operational Programme for Human Resources Development 2007-2013. Investing in people!"

References

Alesina A.F., Ardagna S., 2009. Large Changes in Fiscal Policy: Taxes Versus Spending. NBER Working Paper No. 15438.

Alesina A., Perotti R., 1996. Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects. NBER Working Paper Series, Working Paper No. 5730, August 1996.

Kirchner M., Cimadomo J., Hauptmeier S., 2010. Transmission of fiscal shocks in the euro area: time variation and driving forces. Research Paper 21/2, Tinbergen Institute.

Nickel C., Tudyka A., 2013. Fiscal Stimulus in times of high debt. Reconsidering multipliers and twin deficits. ECB Working Paper Series No 1513, February 2013.

Spilimbergo A., Symansky S., Schindler M., 2009. Fiscal Multipliers. IMF Staff Position Note, SPN/09/11.