

# **ECONOMIC INTEGRATION OF ROMANIA. EVOLUTIONS AND PROSPECTS**

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## **Abstract**

*The January 1<sup>st</sup> 2007 represents an historical moment for the new member states of the European Union: Romania and Bulgaria. But practically, the official moment of the accession does not represent the achievement of cohesion or aligning to the European standards, not even at an average level. The convergence process is relatively long and has multiple connotations with impact on the institutional frame, on the nominal economy and also on the real economy.*

*Romania must adapt its programs for the achievement of the absolute priority of full integration within the structures of the European Union. The economic targets for the year 2007 and the following years reflect the firm undertaking of the commitment to achieve the full integration with the structures of the European Union.*

*The Romanian economy has a strong grip to the global economy and thus the evolutions or involutions of the latter are also felt at national level. The global economy still remains fragile facing possible risks of certain economy distortions. The vulnerability of a global economy is connected to the uncertainties that may occur in the evolution of the strong economies, and mainly to the heterogeneity of the global economy. In the context of the current international and domestic status, Romania must implement effective measures to prevent the adverse phenomena, to avoid missing some of the established economic targets.*

*The last positive trends registered by the Romanian macroeconomic features determined the improvement of the external perception on the country. The measures of capital account deregulation, introduction of the new domestic currency (RON), the growth of the foreign currency flows, the achieving of the one-digit inflation, the establishing of direct inflation targeting as objective for the monetary and foreign exchange policies are premises for ensuring a consistent and coherent macroeconomic background.*

**Key words:** *macroeconomic indicators, financing sector, current account, inflation, European integration*

## **Introduction**

Over the last decade and more, Romania has moved increasingly from the margins of the European integration process towards full inclusion in its central embodiment, the EU. As a final result of this process, on January 1<sup>st</sup> 2007, the European Union extended, by the joining of two new states, Bulgaria and Romania.

The convergence process is relatively long and has multiple connotations with impact on the institutional frame, on the nominal economy and also on the real economy. The economic targets for the

year 2007 and the following years reflect the firm undertaking of the commitment to achieve the full integration with the structures of the European Union.

The Romanian economy is connected to the global economy and the general trends could influence the national evolutions. The global economy still remains fragile facing possible risks of certain economy distortions. The vulnerability of a global economy is connected to the uncertainties that may occur in the evolution of the strong economies, and mainly to the heterogeneity of the global economy.

In the Euro zone, the latest evolutions, although marked by a certain volatility of the quarterly growth paces, show the fact that the main element sustaining the economic growth is the internal demand.

On middle-term, the perspectives regarding the economic activity remain favorable to a solid growth. In the context of the current international and domestic status, Romania must implement effective measures to prevent the adverse phenomena, to avoid missing some of the established economic targets.

## 2. Evolutions of the main macroeconomic indicators

### 2.1. Overall economic background of Romania

The Romanian macroeconomic features starting with the year 2005 were the return to moderate economic growth pace, one digit annual inflation and the slowing down of the disinflation process, a high current account deficit etc. Romanian economy may continue in 2007 the upward trend from the past few years (*table 1*) and ensure favorable macroeconomic image over the following years, although there are pressures especially regarding the inflation and the external deficit.

**Table 1. Evolution of the main macroeconomic indicators**

Indicators	2003	2004	2005	2006
Gross Internal Product - growth % versus the previous year	5.2	8.4	4.1	7.7
Industrial output - growth % versus the previous year	3.1	5.3	2.0	7.1
Consumer price index - growth % versus the previous year	14.1	9.3	8.6	6.6
Current account balance % in GDP	-5.8	-8.4	-8.7	-10.3
External debt - Eur bn	15.9	18.2	24.6	27.2
Gross international reserves - Eur bn	8.3	13.1	19.4	22.9
Non-governmental credit - RON mn	30,287.9	41,762.8	60,672.8	93,283
Unemployment rate - %	7.4	6.3	5.9	5.4
Inflation rate - % (Dec/Dec)	14.1	9.3	8.6	4.87

Source: National Bank of Romania, Yearly Reports 2004-2007  
<http://www.bnro.ro/>

During the year 2006, the Gross Domestic Product registered, on an inflation-adjusted basis, a growth of 7.7% compared with 4.1% in 2005.

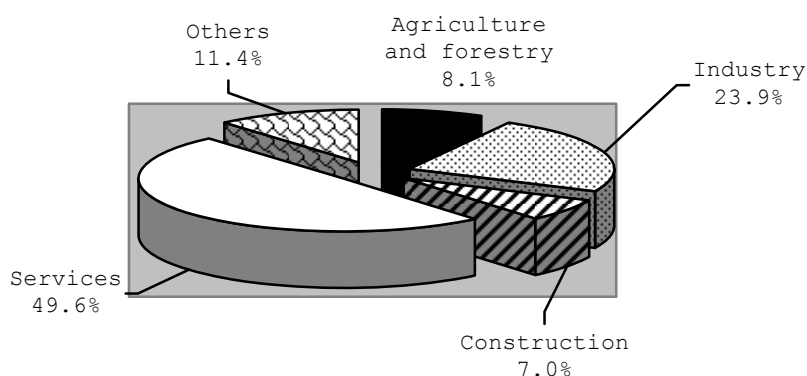
The industrial output registered a growth of 7.1%, in 2006 comparing to 2005 while the processing industry registered an even larger

growth: 8.5%. Of most importance is that the labor productivity in industry registered a growth of 11.1% during the same period.

By the end of 2004 the inflation was of 9.3%, and at the end of 2005 it was 8.6%, meaning that in 2005 the disinflation process slowed down, the inflation decrease accounting for less than one percent. In 2006, the evolution of the inflation is characterized by an index of 104.87% compared to the year 2005, the inflation decreasing under 5% for the first time in the last 16 years.

Special anti-inflation measures were needed in order to meet the set targets during the following years. Considering the economy's interdependences, the impact of the industry prices' evolution must be assessed, for they exceeded the consumer prices growth during the period December 2005 - December 2006 by approximately 6.73%.

The GDP by economic sectors in 2006 was dominated by services (49.6%) and industry (23.9%) while construction held just 7.0% and agriculture and forestry 8.1%. The forecasts are that the industry, retail trade and services will grow during the next few months, while the construction and agriculture will face a moderate decrease.



**Figure 1. Gross domestic product by economic sectors (%) 2006**

Source: National Bank of Romania, Yearly Report 2007

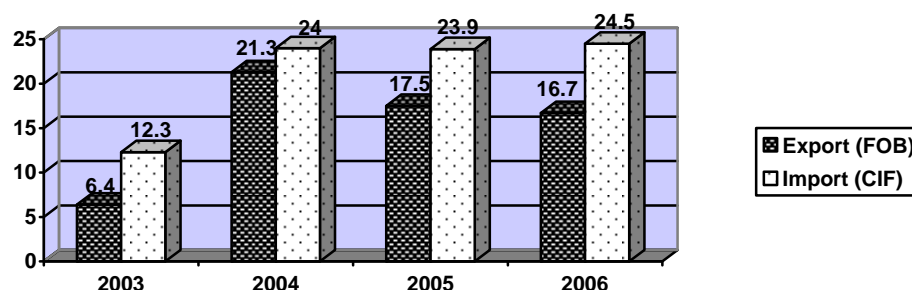
<http://www.bnro.ro/>

The Romanian financial system where the banks hold an important position, has developed significantly during the last period, although the degree of financial intermediation is still reduced (27.2% in 2006) compared to the one from the Central and Eastern European countries. The increases registered by some components of the non-governmental credit reflect a natural process of convergence with the situation from other countries, but a much too rapid convergence might imply a series of macroeconomic risks.

## 2.1. Foreign trade

During 2006, the foreign trade has continued to register relatively high growth paces, respectively 16.7% for exports and 24.5% for imports compared to 2005 (difference in the favor of imports being 7.8%) (figure 2). The foreign trade field's results were obtained having as background the national currency's appreciation and an international context derived from the fact that the European commercial partners registered less increases than forecasted ones.

In 2006, significant import rises above the average of 24.5% were registered by the metallurgy products (+38.5%), means of transportation (+36.1%), machines and mechanical equipments (+29.1%). For the export, significant growths were registered at means of transportation (+46.3%) and machines and mechanical equipments (+34.8%).



**Figure 2. Foreign trade - growth % versus the previous year**

Source: National Bank of Romania, Yearly Report 2007

<http://www.bnro.ro/>

Also in 2006, the weight of the exports to the EU25 in total exports has been of over 68.1% which is 16.7% higher compared to 2005. The value of the imports from the EU25 was of 62.5%, which is a 24.6% increase compared to 2005.

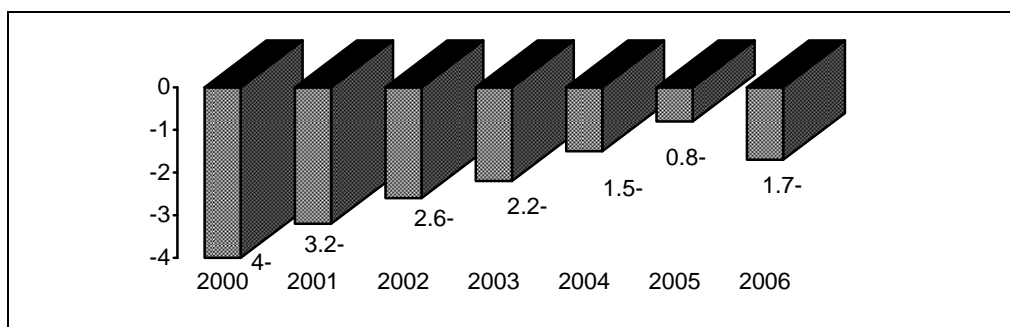
Taking into consideration that the significant import decrease can not be achieved on short term because it implies energy resources, raw materials, fuels and equipment needed by the economy, it results that the only serious way to reduce the commercial deficit and ensure the long term sustainability of the economic growth is to export competitive products and services.

Starting from January 1st 2007, the date when Romania joined the EU, the common commercial policy of the EU is applied, mainly consisting, of the common custom tariff, the generalized preferences scheme, measures of the commercial defense and the cooperation with third countries. The customs duties in the relationship with the EU were cancelled, thus highly improving the commercial relationship with the EU states.

### 2.3. State budget deficit

Within the mix of policies applied during the previous years, it is worth mentioning the fiscal performance, illustrated by the reduction of state budget deficit, which also resulted in the aggregated demand's reduction (figure 3). The policy of fiscal relaxation and the establishing of a flat taxation rate had a favorable effect on the economic-financial performances of the companies and improved the viability of the firms since the first implementing year.

The limitation of the state budget deficit reflects an improvement of the state treasury management. There are necessary measures to increase the budgetary incomes. The public authorities must set measures to improve collection, inclusively by reviewing the legal frame against fiscal evasion, which is preferable to increasing taxation.



**Figure 3. State budget deficit/GDP (2000-2006)**

Source: National Institute of Statistics, Statistical Yearbook  
<http://www.insse.ro/cms/rw/pages/index.en.do>

The policy of cutting down both the budgetary deficit, and the quasi-fiscal ones should be emphasized in 2007 and during the following years in order to reduce the aggregate demand's excess, to reduce the pressure on the current account deficit and to maintain the disinflation process. The main short and medium term goal of the budgetary taxation policy should be the sustaining of the nominal and real convergence process.

#### **2.4. Financial banking sector**

According to some recent surveys in the financial banking sector, the banking market of Romania is the most dynamic in the Central and Eastern Europe. The main catalyst for the development of the banking market in this region continues to be the corporate segment, but the retail sector is becoming more and more attractive for the banks. In the past, the banks in Romania focused mainly on corporate customers, while starting with 2003 the consumer loans and consequently the mortgage and housing loans showed a significant growth, the retail segment evolving towards the share held in developed countries.

The years 2005, 2006 and the beginning of 2007 brought a series of achievements to the Romanian banking sector. There was implemented the national electronic payment system, that determined a sensitive reduction of the settlements time. The new architecture and functionality of the payment system are compatible with the systems from the EU, entailing increased transactions, security and an improved risk management. Most banks extended their networks, in order to be closer to their customers, the banks focusing on alternative channels to conquer the market. Internet banking services are developing accordingly with the European and global development trends of e-banking and e-finance services.

The measures adopted recently in order to limit the consumer lending expansion targeted the prevention of some economic imbalances, and the ensuring of the prices and of the foreign balance's stability. The evolution of the non-governmental loan, consumer loan and the housing and mortgage loan in the last period is shown in Table 3.

The consumer loan had a superior dynamic as compared to the non-governmental loan, respectively increased by 3.8 times compared to 2.3 times of the non-governmental loans. In the first part of the analyzed period, the most dynamic component of the consumer loan consisted in the loans granted in foreign currency, while afterwards, due to the

measures taken by National Bank of Romania, the situation reversed, the loan in national currency (Lei) being more dynamic.

**Table 3. Evolution of the non-governmental loan**

Elements		Jan. 2005	July 2005	Dec. 2005	May 2006	July 2006	Dec. 2006
Non-govern. credit	- RON mn	41,329.9	50,548.1	60,672.8	72,310.4	79,400.7	93,283.0
	-%(Jan 2005=100)	100.0	122.3	146.8	174.9	192.1	225.7
Consumer credit	- RON mn	5,576.9	7,746.5	10,969.8	15,746.5	18,070.9	21,393.4
	- %(Jan 2005=100)	100.0	153.3	195.6	269.1	310.8	378.7
Mortgage credit	- RON mn	2,972.6	3,852.2	4,664.7	4,927.3	5,527.7	6,780.4
	- % Jan 2005=100)	100.0	129.6	156.9	165.8	185.9	228.1

Source: National Bank of Romania, Monthly Bulletin, May 2007, [http://www.bnro.ro/def\\_en.htm](http://www.bnro.ro/def_en.htm)

Despite the increase trend from the last years, the consumer credit weight in GDP is 10 times lower than in the Euro zone where it weights more than 50%. The more and more steep evolutions of the commercial deficit and implicitly of the current account deficit are supported not only by the increase of the consumer credit, but also by the real economy, due to the low competitiveness of the Romanian products.

## 2.5. Current account deficit

The country's current account deficit and the foreign trade deficit are rapidly increasing, raising problems regarding the macroeconomic balance, with direct and indirect influences on the main economic ratios. In 2006 the current account deficit reached EUR -8,856 million, 44.8% higher than the one from the year 2005. During the year 2005, the current account deficit reached EUR -6,891 million, increasing by 35.1% as compared to the year 2004, when doubled the deficit registered in 2003.

The increase of the current account deficit during 2006 occurred despite the relatively high current transfers (EUR +3,521 million), increasing by 13.9%, versus the precedent year (when it registered +3,092). Without these foreign currencies inflows the current account deficit would have been higher.

The comparative situation for Romania, Bulgaria and Poland for 2005 and 2006, is presented in Table 4. The breakdown of the analysed data shows that the situation of the current account in Poland has another configuration that causes the deficit, compared to Romania and Bulgaria. In Poland, the cause of the deficit is not the Commercial Balance but the repatriation of some incomes, following the foreign investments.

The main cause of the current account deficit both in Romania and Bulgaria is the trade deficit that is not counterbalanced by a favorable balance of the current transfers.

As the foreign investments will mature, the repatriation of the dividends will become a serious cause for the continuing deterioration of the current account deficit in Romania, as well if determined actions are not taken to increase the exports and limit of the imports that are not strictly necessary.

**Table 4. Current account balance - comparative situation for Romania, Bulgaria and Poland**

Elements	Romania		Bulgaria		Poland	
	2005	2006	2005	2006	2005	2006
Current account balance, from which:	-6,114	-8,856	-	-	-3,595	-4,686
- good and services balance	-6,977	-9,612	2,012.1	3,114.9	-385	-1,040
- incomes balance	-2,229	-2,765	3,162.5	3,956.4	-8,255	-9,347
- current transfers balance	+3,092	+3,521	+896.6	+756.8	+5,045	+5,701

Source: Data from National Bank of Romania - <http://www.bnro.ro>;  
Bulgarian National Bank - <http://www.bnb.bg/bnb/home.nsf/>;  
National Bank of Poland - <http://www.nbp.pl/Homen.html>

The problem of the current account deficit permanent increase is also the consequence of several structural factors' influence. An important part of exports is represented by low value-added products based mainly on work force of reduced or medium qualification. The products of high technological level, through the technological scissors, will win against the products incorporating a high volume of cheap labor, and also against those having the price as main competitive advantage.

The evolution of the current account during the last period reconfirms the persistence of some important deficits as an effect of the continuous presence in the economy of some negative phenomena. On the whole, the evolution of the current account reflects the background deficiencies of the economy, the solution for the mitigation of the big macroeconomic deficiencies being the acceleration of the reform processes.

## 2.6. Disinflation process

Inflation mitigation was achieved mainly by establishing an economic and monetary policy mix, which was adopted for controlling the economic balance.

The evolution of the inflation rate during 2000-2006, in Romania, compared to Bulgaria and Poland is presented in the table 5:

**Table 5. Evolution of the inflation rate (%-annual growth as compared to precedent year)**

Country	2000	2001	2002	2003	2004	2005	2006
Romania	40.7	30.3	17.8	14.1	9.3	8.6	4.87
Bulgaria	11.3	4.8	3.8	5.6	4.0	6.5	6.5
Poland	8.5	3.6	0.8	1.7	4.4	0.7	1.4

Source: Data from National Bank of Romania - <http://www.bnro.ro>;  
Bulgarian National Bank - <http://www.bnb.bg/bnb/home.nsf/>;  
National Bank of Poland - <http://www.nbp.pl/Homen.html>

The analysed data show that in Romania, inflation mitigation was accentuated during the last seven years, the inflationary pressure marking more than an eight-fold reduction.

As a result of the internal demand dynamic increase, effect of the non-sustainable consumption's expansion, having as background the non-governmental credit growth, National Bank of Romania decided to

increase the interest rate, from 8.5% to 8.75%, starting with August 2006, level maintained until February 2007 when it dropped back to 8.0%, and the increase of the minimum mandatory reserves. These measures of monetary policy, together with the maintaining of a firm control over the monetary market liquidities by sterilizing the liquidity excess, are considered to contribute to the consolidation of the disinflation process, so that the inflation's target for 2007, of 4%, is sustainable.

During the same period, inflation in Bulgaria and Poland dropped significantly, but the inflation level in 2000 in these countries is close to the inflation rate in Romania in 2004 or 2005. It is worth mentioning the fact that in 2006, the inflation in Romania has been below the one registered in Bulgaria and Hungary (6.5%).

The process of strengthening the monetary policy, started at the end of the year 2005 and accentuated during the year 2006, is meant to increase the restrictiveness of the monetary conditions and to keep the inflation in the established variation interval. The restrictiveness of the monetary policy is imposed by the need to temperate the aggregate demand, especially the dynamics of the population consumption, which represents a major factor for inflation.

### **3. Economic and financial perspectives**

Starting with January 1<sup>st</sup> 2007, after Romania's accession to the EU, the economic and financial perspectives of the year 2007 and of the following years are marked by the Romania's absolute priority to accomplish the full integration programs. The investment programs should be subordinated to this national goal in fields such as infrastructure, healthcare, education, agriculture and rural development, energy, environment, and especially in domains that will secure the continuation of the economic growth, and the increase of the exports, without affecting the inflation target and the macroeconomic balances.

Despite some malfunctions, specific for a developing functional market economy, but not fully competitive yet, Romania may continue to have a favorable period, if the economic growth rates are accompanied by a strong disinflation process, the financing of the current foreign deficits, the overall improvement of the financial discipline, and the substantial growth of the labor productivity.

In Romania, the banking system's reform overcame the economy's reform as a whole, which may give the banks an important role in the future economic development.

The projections made by specialized institutions for the future period regarding the dynamics of the main macroeconomic indicators are shown in the table 6. The analyzed data reflect (for the 2007-2010 period) the continuation and consolidation of the economic growth process which started in 2000.

The full deregulation of all the operations related to the capital account since September 1<sup>st</sup> 2006, the denomination of the domestic currency in progress since July 1<sup>st</sup> 2005 and the adoption by National Bank of Romania of the direct targeting of the inflation as strategy as well as the progress of the accession process and its completion



through the effective accession will directly influence the financial area.

**Table 6. Future evolutions regarding the main macroeconomic indicators**

Indicators		2007	2008	2009	2010
Gross Domestic Product	% change vs previous year	+6.5	+6.3	+5.9	+5.6
Industrial production	% change vs previous year	+4.7	+5.1	+5.3	5.5
Net export (contribution to the real growth of GDP)	% change vs previous year	-2.9	-2.3	-2.1	-2.0
Current account	EUR bn	-10.0	-11.1	-12.2	-13.2
	% from GDP	-9.2	-9.1	-9.0	-8.9
Inflation rate	%	4.0	3.0	3.0	2.5
Unemployment rate	%	5.3	5.1	5.0	4.9

Source: National Prognosis Commission, <http://www.cnp.ro/ro/prognoze>

The current account deficit, the delays in the structural reforms, the establishment of flat taxation rate, act together towards limiting the operating margin of National Bank of Romania for counteracting the inflationary pressures in 2007 and the following year as well. This situation is accentuated by the expansion that progressively included elements of the aggregate demand, mainly investments, exports and the population's consumption, based on the real growth of the income and of the banking loans despite all the restrictive measures of the monetary policy.

#### 4. Conclusions

During the following stages the economy restructuring must continue, having as a main result the cancellation of the destabilizing potential at a macroeconomic level, given the integration within the market economy of the segments with a high monopolization degree, including the intensive energy consumer economic sectors.

It is necessary to secure a strategy for increasing the work productivity, the quality and the competitiveness, which should lead to the strategic objective of reducing the gaps by ensuring a growth pace higher than the European average.

The fiscal reform over the following period must have as objective the consolidation of the competitiveness gains obtained from the flat taxation rate and to continuing of the alignment to the provisions of the *acquis communautaire* having also as goal the supporting of the economic reform and macrostabilisation by maintaining the budgetary deficit at a prudent level.

The high attention paid by the banks to the retail segment is justified at present. The limited character of this segment will determine the banks to focus on financing, in domestic currency, of companies and even of agriculture. The funding in foreign currency, which justifies the denomination of the loan in foreign currency, is represented by the mortgage loans and those for imports and exports.

The population's savings, considering the lack of a profitable alternative, will be held in the credit institutions. Most of the

banks encourage the long-term deposits, which secure a safe gain, even if not significant. Investments on the capital market or in real-estate properties require significant amounts, less affordable to individuals.

The lending capacity of the banking system could increase significantly given the current banks' capitalization if it would be a real demand for the loans from the companies, i.e. if they would promote major investment projects.

The weight of the loans in the GDP showed an increasing trend in the last years, but the level reached is still far behind other countries in the region. The same trend registered the the banking intermediation which increased from 15.9% of the GDP in 2003 to 30% in 2006, but this level is still reduced, as compared to the average of the EU [NDP].

The development of the real economy implies the gradual re-monetization of the economy, by increasing the monetary basis on a non-inflationary basis.

Over the following period, significant economic growth must be secured, together with the accentuation of the phenomenon of strengthening the national currency to secure the recovery of some part of the existent gap between our country and the other EU states. In these circumstances, for the year 2025 we can forecast the reaching of a degree of real convergence, equivalent to the one of the new EU member states. In an optimistic scenario, for the year 2025, it is possible that the GDP/capita, at the standard purchase parity in Romania, became close to the average of the EU.

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