Wilfried Martens Centre for European Studies

The EU's Reform Cycle IN FOCUS

Out with the old and in with the new? Romania and EU growth dynamics

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The EU's uneven recovery from the economic turbulence of recent years has highlighted a fundamental shift in Europe's growth dynamics. As much of 'old Europe' struggles to regain economic growth several of the 'new Europe' member states of Central and Eastern Europe (such as Romania) seem poised to drive economic activity forward in the coming decade. This shift, allied to the significantly improved medium term growth prospects of 'programme' countries (Ireland, Greece, Cyprus, Spain and Portugal), illustrates the positioning of more peripheral EU member states as reform leaders who may act as the catalyst for longer term growth in the EU.

The current crisis has resulted in a dramatic escalation in overall debt levels in the EU. This is particularly evident in many of the original signatories to the Treaty of Rome. France, Italy, Belgium and the Netherlands have all experienced dramatic increases in their national debt since 2007. This explosion in debt has not been limited to state finances. Ten EU member states in 2012 – including Belgium and the Netherlands– evidenced private, non-financial debt levels of over 200% of GDP[1]. 'Old Europe' may have survived the financial crisis, but it has left a legacy of debt and slower medium term growth prospects.

This escalation in debt could be alleviated by faster economic growth and a more flexible economic model. However, the European Commission has recently forecast maximum annual GDP growth of between 1.2% and 1.6% for Belgium, Italy, Netherlands and France up to 2015. This anticipated level of growth will not be sufficient to significantly reduce existing debt levels. Household deleveraging, coupled with relatively high savings rates continue to dampen consumer spending.

[1] All data from Eurostat unless stated otherwise.

Will Germany, therefore, continue to function as the motor for the EU economy in the longer term? On this issue, the signals are mixed. While Germany has been successful in minimising the debt and labour market implications from the financial crisis, it has been less successful in building on the labour market reforms undertaken by the Schroder government in the mid-2000s. Further labour market reform, particularly pension reform, is required if Germany seeks to maintain its competitive economic advantage while meeting the challenges of a rapidly aging population. In this context, the often forgotten opposition (both political and public) faced by Schroder in implementing his reforms should not be ignored as a key factor in stifling further change in Berlin in the medium term.

In the longer term, the peripheral member states that availed of official support programmes since 2010 - Ireland, Greece, Cyprus, Spain and Portugal – have the potential to contribute significantly to EU economic growth. This potential is mitigated by the dramatic increases in their debt levels which have occurred as a result of the current crisis. However, having benefitted from comprehensive reform packages, these re-balanced economies have strengthened significantly in the period since 2010. The recent surge in Spanish and Portugeuse exports highlighting the trade potential of these economies. In effect, by having no other choice but to reform – owing to pre-conditions set out in their support programmes - these member states have undertaken a level of economic consolidation which otherwise would not have been deemed publicly acceptable.

The contrast here with member states such as Belgium, France and the Netherlands is clear. These states, in the absence of a real market requirement to fully consolidate (at least up to now), have given support to Keynes assertion that 'If you owe your bank a hundred pounds, you have a problem. But if you owe a million, it has'. The Netherlands is projected to take six years (from 2010 to 2016) to reduce its annual budget deficit from 5% to under 3%; a level of budgetary consolidation undertaken in the programme countries in one year. This struggle to address state expenditure has resulted in still increasing debt to GDP ratios and an unavoidable requirement for deeper (and even more unpopular) reforms in the future.

However, there is one further group of member states which have the potential (and many of the underlying economic characteristics) necessary to act as an engine for economic growth in the EU in the medium to long term. These are the 'new Europe' member states which have joined the EU in the period since 2004. Of these states, Romania is an interesting example of a country which could act as a regional economic motor in the future.

Romania differs from the other newer member states owing to the fact that the impact of the economic crisis of 2008 quickly exposed underlying imbalances in its economy. The requirement to seek external financial assistance in 2009 (and maintain precautionary credit lines up to 2014) have resulted in a fundamental restructuring of the Romanian economy. The very significant fiscal adjustments undertaken by the Romanian government and the ongoing process of household deleveraging have resulted in a more efficient economic structure. In this context, Romania is at the forefront of the EU economic reform cycle.

The Romanian economy is well placed to grow strongly in the medium term. The European Commission estimates annual GDP growth of between 2.6% and 3.5% in the period to 2015. Romania's debt levels are very low compared to EU averages. With a national debt to GDP ratio of 38.9% in 2013 (less than half the level of Germany) and a household debt level of 73% of GDP in 2012 (less than a third the level of Belgium) Romania is well placed to support large scale co-financed investment programmes in the longer term. Even Romania's existing gross external debt (68% of GDP in Q4, 2013), which has long been a worry to economists, is now lower than that evidenced in comparable states such as Bulgaria, Czech Republic and Hungary.[2] The economic crisis has resulted in Romanian household debt levels falling by over 30% in the period since 2008.

The labour market in Romania also remains robust with unemployment stabilised (despite wide regional variations) since 2010. Recent labour market reforms – allied to a declining annual budget deficit – also leave Romania well placed to take advantage of any global economic upswing in the medium term notwithstanding recent concerns over Ukraine. The Romanian economy, like most of Central and Eastern Europe, has also benefited from a stronger level of cross-border banking ownership which mitigated the worst impacts of the recent crisis.[3]

It is important that the many challenges facing the further development of the Romanian economy are not underestimated. For example, the high emigration levels of many professionals, longstanding corruption and public administration issues, a still inconsistent approach to encouraging private investment, a relatively undeveloped approach to innovation and the need to evolve a more responsive bank funding model all indicate limits to growth prospects. However, viewed from a contrarian investment perspective, many of the fundamentals of the Romanian economy (and its position as an enforced 'reform leader') leave it well placed to deliver significant economic growth in the future.

The economic crisis fundamentally changed the requirement for further banking integration. It also, although it is not yet fully recognised, altered the future growth dynamics of the EU as a whole. In terms of measuring the reform cycle as an ongoing process it is clear that the reform leaders (such as Romania and Ireland) are far more advanced in pursuing necessary economic reforms than the 'old' member states which have traditionally driven EU economic growth. In this context at least, it may very well be a case of 'out with the old and in with the new'.

[2] ECB, *Monthly Bulletin*, data for developments outside the euro area, June 2014.
[3] See the recently published IMF series *Central, Eastern and Southeastern Europe – Regional Economic Issues.*