PUBLIC FINANCE AND MONETARY POLICY IN ROMANIA 1911-1913

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Abstract: *The interest for macroeconomic policies was revived by the 2007 financial crisis and the economic downturn that followed. The purpose of these policies was debatable considering there was little space to manoeuvre with the key interest rate close to 0% and the excessive public debt frustrating fiscal activism.*
In a similar manner the gold standard, which functioned in 1911-1913 Romania, did not allow for too much monetary and public finance action because the convertibility principle had to be observed.
This essay will try to analyse the monetary policy and public finance of 1911-1913 Romania considering the complex and contradictory economic and politic realities.
Keywords*:* Romania, public finance, monetary policy, gold standard, Balkan Wars
JEL Classification*: B13, E25, H6, H12*

1. Introduction

The 2007 financial crisis and the economic downturn that followed revived the interest for macroeconomic policies - monetary and budgetary (fiscal and debt) policies. The abilities of these policies were debatable especially in the EU countries that struggled with the sovereign crisis because there was little space to manoeuvre with the key interest rate close to 0% and excessive public debt frustrating fiscal activism.

Presently it is considered that an economy cannot grow and develop when there is high and volatile inflation doubled by external shocks

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(Isărescu, 1995). Macroeconomic policies have to act in response to short term shocks in order to prevent aggregate demand volatility, which negatively influence long term growth and creates social costs.

Under the gold standard monetary and fiscal policy had little room for manoeuvre because they had to observe the convertibility principle. The convertibility principle refers to the fixed price of a currency against gold and practically makes the money supply inelastic. Therefore, under the gold standard the domestic economy is mostly influenced by the international flow of gold and less by domestic policies. In this framework of exogenous monetary conditions the domestic economy self-regulates when unbalances occur. This does not mean that there are no short-term deviations but that economic variables tend toward long term averages.

The only event that triggered public policies activism under the gold standard was a state of war. Otherwise, non-activism was the rule and the crisis stage of the business cycle was left to the self-regulating mechanism of the economy. The monetary policy altered the money supply only as a consequence of a change in the gold stock. The budget had to be balanced or to have a surplus and excessive public debt was prevented through the international flow of gold.

Monetary policy and public finance were conducted in an environment of complex and contradictory economic and politic realities in 1911-1913 Romania. This article will try to portray the monetary policy and public finance decisions considering the limits imposed by the gold standard in 1911-1913 Romania. The essay is divided in three sections. The first one, a brief theoretical background, outlines the objectives of the monetary and budgetary policies under the gold standard, while the second one insists on the budget and public debt evolution in 1911-1913 Romanian. The last part of the paper tries to imagine the solutions present day Romanian decision makers would have if confronted with troubles like those of 1911-1913 Romania.

2. Theoretic background

Economies around the world functioned on the principle of gold convertibility between 1881 and 1913 (Bordo and Jonung, 2001)[1]. The

[1] The two authors state that throughout history existed two types of monetary regimes (which they define as a relation between the public at large and the state based on rules and expectations), one based on convertibility into specie and the other based on fiat.

definition of the currency as a fixed price relative to gold represented the anchor of the monetary system. The monetary and budgetary policies were subordinated to maintaining the stability of the currency price relative to gold. Monetary policy dealt with the manipulation of interest rate and gold reserves, while the budgetary policy handled the budget deficit and the financing of the public debt.

The essence of the gold standard (as highlighted by the Currency School and the Austrian School) was the axiom that the economy does not grow faster if the money supply is extended constantly and with a variable pace (Schlichter, 2011). In a gold standard economy the very nature of money as medium of exchange allows an infinite number of transactions (within the rational limits of coinage division).

Money supply elasticity had a different meaning for the above mentioned schools of thought than what is accepted today. Thus, during the gold standard money supply elasticity referred to the fact that banks issued banknotes or created deposits without having the corresponding gold in their vaults. This is presently known as fractional reserves and it was officially initiated by the Bank of England Act in 1844.

The gold standard had at least two consequences on the budgetary policy. First, active budgetary policy (intended to influence the production side of the economic activity) was carried out only in the event of a war. The objective of such meddling was to decrease the effort of financing the war by distributing the costs over a longer period of time. Thus, governments borrowed more in times of war and increased the taxes in the following peace period to enable debt repayment. Active budgetary policy was not possible during peace time as it would trim down economic activity (Bordo and Jonung, 2001). The convertibility principle, due to the inelastic money supply, forced governments to have balanced budgets and discouraged public excessive debt (Bordo and Rockoff, 1996). Excessive public debt under the gold standard tended to push off investors and gold outflows affected the currency stability.

Second, a budgetary policy based on continuous deficits had only two possible outcomes. On one hand, gold outflows were followed by a speculative attack sparked by investor realization that gold reserves were not enough to maintain the currency price expressed in gold. On the other hand, financing the budget deficit by government bonds pushed the cost of borrowing higher. The cost of borrowing rose up to the point investors

considered it encompassed the worst case scenario – the probability that in the foreseeable future the government will not raise taxes. The end would also be a speculative attack (Bordo and Schwartz, 1996).

Under the gold standard monetary and fiscal policy had little room for manoeuvre because they had to observe the convertibility principle. The convertibility principle refers to the fixed price of a currency against gold and practically makes the money supply inelastic. Therefore, under the gold standard the domestic economy is mostly influenced by the international flow of gold and less by domestic policies. In this framework of exogenous monetary conditions the domestic economy self-regulates when there are unbalances. This does not mean that there are no short-term deviations but that economic variables tend toward long term averages. Inflation rate was close to zero and there was no long term unemployment in the case of the 11 European countries studied by Bordo and Jonung (1996) under the gold standard.

The only event that triggered public policies activism under the gold standard was a state of war. Otherwise, non-activism was the rule and the crisis state of the business cycle was left to the self-regulating mechanism of the economy. The monetary policy altered the money supply only as a consequence of a change in the gold stock. The budget had to be balanced or to have a surplus and excessive public debt was prevented through the international flow of gold.

The structure of the budget revenues and expenditures reveals the extent of the non-activism at that time[1]. The small weight of the public sector in total economy during the gold standard mirrored the type of relation individuals and companies had with the government at that time. This relationship was the result of political evolution within the states and it spread from the more developed countries towards the new independent nation-states in the rest of Europe.

There were four main lines of thinking regarding public finance at the end of the 19th century in Europe. In fact there were two major interpretations – the German cameralism and the English classic liberal – with two departures from each– the Italian cameralism and Swedish view of Knut Wicksell.

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[1] Bordo and Jonung (2001) show that the rate of government expenditure to national income was less than 8% for each of the 11 European economies they studied.

The German cameralism pictured the state as representing the commonwealth ("res publica") to which each and every individual participated in order to complete his wellbeing and to take advantage of his actions on the market (Backhaus, 2002). Thus, the state was innate to its members. The Italian cameralism maintained that the state did not exist outside the community of individuals, but the same individuals that perform exchanges on the free market participate also in the relationships with the state.

The English classic liberalism, deeply anchored in the philosophy of natural rights, considers the state as an alien entity from the point of view of the community. The individual has to defend his living space against the state. The relationship between the state and the individuals is a zero-sum game and each individual must defend his freedom from the Leviathan.

Knut Wicksell insisted on the institution of parliament as the entity representing individual needs and wishes. He considered the state in general and the public sector in particular the expression of general valid needs, therefore public expenditures had to address general needs. These were defined as needs recognised by each and every individual of the society represented in the parliament. This representation of needs secured the unanimous vote on government revenues and expenditures (Wicksell, 1967).

To sum up, the gold standard functioned because all participating adhered to the principle of convertibility and it determined the dominance of monetary policy over budgetary policy within the limits of policy non-activism, which in turn resulted in long term stable prices, balanced public budgets and low taxes. Crisis resolution rested on the flow of gold reserves, which meant a secondary role for the budgetary policy. Public debt was a sensible subject in case of war.

3. Monetary and budgetary policies in 1911-1913 Romania

The analysis of the monetary and budgetary policy decisions of the Romanian authorities during the 1911- 1913 period goes along the two conditions of the gold standard – currency stability and policy non-activism.

Monetary policy and public finance were conducted in an environment of complex and contradictory economic and politic realities in 1911-1913 Romania. Complexity was a result of the combination of economic risks (a good agriculture harvest but impossible to benefit of because of adverse weather conditions, a monetary liquidity crisis both domestic and

international, the costs of the Balkan wars) and political risks (strategic political power changes in the region as a result of Turkey's decline). Contradiction emanated from the economic side (economic results deteriorated abruptly after five years of uninterrupted growth) and from the political one (Romanian was supposed to choose the best possible alliance within the new political power landscape).

Europe was in a political turmoil since 1905 when Germany and France quarrelled over Morocco. The 1906 peace treaty froze the conflict. Afterwards the diplomatic and military provocations raised the steaks until the whole issue burst out as the Agadir Crisis. This political event incorporated a significant economic element for the near future evolution of European inter-states relations. Germany did not go to war against France over this event because the gold reserves of the German central bank (Deutsche Reichsbank) were too small to maintain the currency stability[1] (Ahamed, 2010).

As all European powers followed the Agadir Crisis the decay of the Ottoman Empire was ignored. This opportunity was used by Italy, Bulgaria and other Balkan states in order to assert their power over the territory held by the Ottoman Empire.

Another essential event for the South-East European countries was the 1908 annexation of Bosnia by the Austro-Hungarian Empire. This created tensions between Russia and Austria. This did not lead straight to war because Germany made an explicit threat to Russia that it decided to stand by its southern neighbour (Austria).

With such high odds in favour of a European war between the big powers two ideas seemed to preoccupy the Romanian public opinion and both indicated a necessary increase of military spending. The first one indicated that the collapse of the Ottoman Empire will generate military tensions for the countries in the region since both Russia and Austria were interested in those territories (Maiorescu, 1995). The second one, which was more important as it was a long term strategic choice, was the realization

[1] The Reichsbank had only $ 200 million gold reserves in 2011, while in the same time the central bank of France (Banque de France) had three times that much gold to use. During the Agadir Crisis a panic started on the international markets which ended in a speculative attack on the German currency (an attack apparently manipulated by the French minister of finance). In order to resist the speculative attack the German central bank sold some of its gold reserves and at the end of that day they lost 20% of their gold reserves. (Ahamed, 2010)

that Romania needed to change its foreign policy orientation. Romania had to depart from its alliance with the Central Powers (Austria-Hungary and Germany, the powers that offered until that moment the much needed protection against the Ottoman Empire) and secure a pact with the Franco-Russian axis, which was supposed to guarantee certain pretentions for Romania as the Austro-Hungarian Empire was fading away[1].

Changing political alliances also had financial implications because small countries usually dealt with their financial needs – public debt roll over or bonds for financing investments and war - on the markets of the big powers that guaranteed their security. Romania borrowed mainly from the German market through syndicated loans done by the most important German banks in the period 1864 – 1913 (Banu, 2012). Sovereign finance was a diplomatic tool as efficient as any other for the powers with significant financial markets. Risk premium for the loans of small countries reflected the foreign policy interests of the countries where the banks resided (Flandreau and Zumer, 2004).

Romania had domestic economic problems besides the intricate international background. A certain exuberance regarding the economic growth prospects was felt following a five year period of no financial crisis at international level and no draught in the domestic agriculture. But 1912 dealt a blow with a serious domestic liquidity crisis that had causes both internal – the impossibility to harvest a very good cereals crop due to adverse meteorological conditions (heavy rains) – and external – the break out of the First Balkan War.

The National Bank of Romania’s intervention to prevent the liquidity crisis was swift. The Romanian central bank resorted to its standard set of tools (interest rate increase from 5 per cent to 6 per cent, gold reserves variations), to its statutory exceptional instrument (decrease in the rate of gold backup for the notes in circulation lower than the statutory 40%) but also to nonstandard measures (acting as lender of last resort by advancing liquidity or credit to the biggest banks in order to avoid a standoff of the whole system and a paralysis of solvent debtors).

The politicians of the time were disappointed by the government reaction when heavy rains ruined the agriculture production in the autumn of 1912. A member of the Senate House, I.C. Atansasiu, blamed the

[1] These ideas were clearly expressed by scholars like Constantin Rădulescu-Motru or Dumitru Drăghicescu in press articles at the end of 1912.

government not only for the lack of action but of aggravating the serious conditions in the rural area since the tithe was not enforced, which left farmers unable to store their part of the crop. The Interior Minister of the time, Take Ionescu, dissuaded such critics arguing that the government acted on priorities. In the autumn of 1912 the main important duty of the government was to prepare the country for the military tensions started by the First Balkan War while the government's duty in case of natural disaster was to provide only for the emergency relief (Senate Debates, 1913).

The Romanian government dimension, considered as the ratio of government expenditures to GDP, was about 13%, which put 1911-1913 Romania almost on a par with the European countries studied by Bordo and Jonung (2001), where the same ratio was on average 8%.

The structure of the government revenues in Romania during the two financial years (1911/1912 and 1912/1913 respectively) did not change much despite the two Balkan Wars (Ministerul Finanțelor, 1914). A quarter of total revenues were sourced by tariffs on public services – telecom, railways, ports, etc. – with the highest contribution from railways (20% of total government revenues).

Indirect revenues contributed with 16% to total government revenues and custom duties represented 10% of total government revenues. The rest of 6% came from indirect taxes on oil, sugar and alcohol. Government monopolies (tobacco, paper, salt, matches and gambling) were a significant source for the public budget with a contribution of 15% to total revenues. Direct revenues represented on average 10% of total budget revenues. The most important source of direct revenues was the tax on land ownership, providing for 4% of total government revenues.

This structure of budget revenues indicates a closeness of Romanian public finances with the cameralist model, where the state is more an investor than an agent of redistribution. However, this also can be interpreted to be a transitory phase in the evolution of Romanian public finances since the country was in the midst of a modernisation process. The Romanian economy looked more like an open economy since revenues from custom duties were 10% of total revenues.

Budget expenditures from the studied period show two distinctive features. First of all, the lack of contingency planning in budget design forced emergency changes in expenditures when the each of the two Balkan Wars broke out. Thus, the 1912/1913 budget was sketched along the

structure of previous budgets and was heavily adjusted in the autumn of 1912 and at the beginning of 1913 to provide for additional military spending.

The typical structure of Romanian budget expenditures in that period shows that half of the spending was dedicated to investment in the companies that provided public services. Apart from this, 13% of total expenditures went to defence while domestic affair and education (including religious cults) were given each 9% of total spending.

The second distinctive feature was that the golden rule was enforced hence current expenditures matched current revenues. An interesting fact is that the government managed to save money because the revenues from tariffs on public services exceeded the costs of investment and maintenance for the companies that rendered such services.

The structure and execution of the budget highlights some difficulties of the government in understanding the functioning of the economy and the need for efficient public administration. Thus, each and every year of the period 1890 – 1913 the estimated revenues in the budget law were lower (with a rate of 2.5 – 10%) than those forecast as due to be paid, while the amounts effectively collected were lower than the forecast by almost 3% (Ministerul Finanțelor, 1913).

On the expenditures side, the 1911/1912 budget was designed with the same structure in terms of defence expenditure despite the fact that a regional war was imminent. Under these circumstances, the Romanian budget was caught off guard in the autumn of 1912 at the beginning of the First Balkan War. An emergency budget amendment raised the defence expenditures three times the original amount in the budget.

The boost in government expenditures was provided for through previous savings. In the absence of such reserves the government would have been in a tight spot considering the overall delicate situation of the economy with the liquidity crisis in the autumn of 1912. Moreover, foreign borrowing was risky as the liquidity crisis already engulfed the financial markets in Central Europe.

The government did not learn much from the lesson of 1912 and they had to supplement the budget in order to secure enough funds for the Second Balkan War in 1913. This time the Romanian government supplied the funds through foreign borrowing. Overall, Romania borrowed three times on the external markets in 1913 – in January (Lei 70 million) to equip the army, in August (Lei 40 million) to rollover the budget deficit and in November (Lei

200 million) to repay the bonds issued during the First Balkan War (Banu, 2012). The budget execution ended in surplus both in 2012 and 2013, while the burden of repaying the foreign debt was lower than during the past two decades (when there was no military confrontation).

Public finance abode by the principle of convertibility during the two Balkan Wars. The war effort was diminished by borrowing during the conflict period and increasing taxes in the aftermath of the conflict in order to repay the debt. Moreover, during the last quarter of 2012 the government used previous savings in order to cover for the increased defence expenditure demands.

The one year period (September 1912 – August 1913) offers interesting clues on the behaviour of monetary and budgetary policies since there were critical pressures. There was a liquidity shock for the monetary policy and the budgetary policy had to cope twice with the need of significant additional funds.

Political activism was almost impossible during the gold standard. Financial markets had control on government initiative because the convertibility principle had to be observed by the authorities. The monetary policy was restrained by the inelastic money supply and the government had to strictly control the level of public debt.

The core of the monetary decisions in that period was to postpone as long as possible the decision to increase the interest rate to prevent a degradation of the domestic credit (NBR, 1913 1914). This was possible only as previous years' excess foreign reserves at the central bank held. After that the central bank made use of the gold reserves in order to prop up the currency.

The budgetary policy decision was based on the idea that foreign borrowing was to be the last resort; otherwise the structure of the expenditure was preserved. A countercyclical budgetary policy at that time meant to prioritize the public expenditures according to the set of objectives the government had in the gold standard era – defence/order and industrial development.

The burden of the budgetary policy, measured as public debt/inhabitant, was relatively higher in Romania than in other European countries in 1914. The public debt/inhabitant in Romania was Lei 241 while the same ratio in England was Lei 362, or Lei 401 in Germany, though none compared to Lei 826 in France[1]. The relative high fiscal burden in Romania,

[1] These data represents own calculations based on information from Banu (2012), Axenciuc (2012), Broadberry and Klein (2011)

if the GDP/inhabitant of Lei 401 is also considered, could become a risk for the rollover of the public debt in case the currency stability was affected.

The decision and execution of budget provisions had many weaknesses. Two of these deficiencies were previously highlighted (revenue forecast and tax collection). The other important one was the fact that there was no ex post control of budget execution. There was a very serious debate on this issue in the Senate in March 1913 when the representative of the Conservatives, Theodor Rosetti, heavily criticised the messy budgetary process and also advised against rolling over the public debt by borrowing abroad (Senate Debates, 1913).

The Romanian public debt management based on privileged relations with the big political and economic powers of the time was put under severe stress in the case of the November 1913 credit. Romania tried on this occasion to send a message about its foreign policy realignment towards France by seeking to borrow money from a syndicate of French banks. The project was known and approved by the French authorities. The amount to be contracted was supposed to be big enough to cover also for the repayment of the German bonds from January 1913 (Lei 70 million). However, the French banks did not want to contribute to the repayment of a Romanian debt towards German banks and instead suggested that Romania goes for two distinct but concomitant credits in Paris and Berlin respectively. This was unacceptable considering the Romanian financial capacity. In the end some German banks offered to the Romanian Government a credit of Francs 200 million (Băicoianu, 1939).

To sum up, the monetary and budgetary policies during the period 1911/1913 observed the principle of convertibility, yet the budgetary policy was less anticyclical than the monetary one. Thus, the budgetary policy was weakened in case risk factors manifested over a longer period of time.

4. A look to the macroeconomic policies of 1911/1913 from the present point of view

The shocks that affected the Romanian economy during the last quarter of 1912 could be reinterpreted from today's point of view since there are some factors that make the gold standard similar to the present situation. The first factor is that there was fiat money. The money supply was not completely inelastic since notes had to be backed up with gold only up to 40%. Second, the government was not entirely non-active. The

country, built as a nation-state, was supposed to be active at least in order to cover the fields of national culture and national religion.

In the present world, the monetary and fiscal policy mix targets macroeconomic stabilization. This is the key for achieving long term economic growth on the background of stable prices and low unemployment. In order to achieve the macroeconomic stabilization the monetary policy deliberately varies the money supply and the fiscal policy changes the budgetary variables.

The Romanian situation during the last quarter of 1912 could be interpreted in today's terms as a balance of payments problem (a supply shock that determined a significant capital outflow). Such a situation asks for IMF assistance. The IMF addresses such issues by calculating the amount of foreign reserves a country needs in order to service the foreign debt while the restructuring of the public sector expenditures allows for the non-inflationary growth of the economy, without crowding-out the private sector.

Thus, a country faced today with the situation that Romania had in the last quarter of 1912 would have to borrow from the IMF an amount equivalent to the Lei 96 million gold that the NBR sold in 1912 in order to stabilise the currency. This would be topped up with the amount the Romanian Government of that time had to repay as public debt (Lei 99 million). The IMF would ask for the adjustment of public expenditures through reforms like increasing tariffs for public services. Another IMF condition could be that the country postpones military expenditures that the Romanian Government of 1912 engaged in.

In the absence of the IMF, as it was the case in 1912, the role of provider of additional reserves was the central bank. Central banks all over the world were supposed to build up enough reserves during the boom period in order to withstand during crisis and to shelter the economy from shocks.

In the absence of the inelastic money supply in today's world the power of the monetary policy and of central banks faded away and it is difficult to shield the economy from the shocks induced by the procyclical behaviour of the public sector and/or the exuberance of the private sector.

5. Conclusions

This article tried to analyse the monetary and budgetary policies of 1911/1913 Romania from two perspectives – the obligation to preserve the currency stability and the need to refrain from political activism. The budget

and public debt data from that time shows that the two objectives were more or less achieved especially through the efforts of the monetary policy. There were weaknesses in the budgetary policy but not serious enough to endanger the currency stability.

The policy analysis against the difficult background of that period (the size of Romania, the strategic position of Romania, the political situation of the region) suggests that budgetary policy was not simply an economic policy decision. It also had diplomatic implications that had to be weighed thoroughly.

The similar economic situation interpreted from today's point of view would be solved in the same way (using reserves) the difference being only the provider of the additional reserves which is no longer the country itself (that would be more responsible) but an international institution (the IMF).

The comparison between the solutions to the same economic problem in 1912 and respectively in the present was considered only from the point of view of a supply shock. Future research might address the problem from the demand shock point of view.

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