

IMPOSSIBLE CONVERGENCE? A COMPARISON BETWEEN ROMANIA AND KOREA

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Abstract: Economic convergence toward the level of prosperity enjoyed by western economies should be the strategic objective of Romanian policymakers. However, slow average economic growth makes this objective an elusive target. In this paper we compare the post 1990 economic performance of Romania with the development pace of Korea, and show that unless economic growth is not accelerated in a sustainable way, Romania will fail to follow the convergence path described by Korean economy and will remain in the periphery of European economy, as it happened to mediteranean countries like Greece or Portugal.

Keywords: Romania, Korea, convergence, economic development, slow growth.

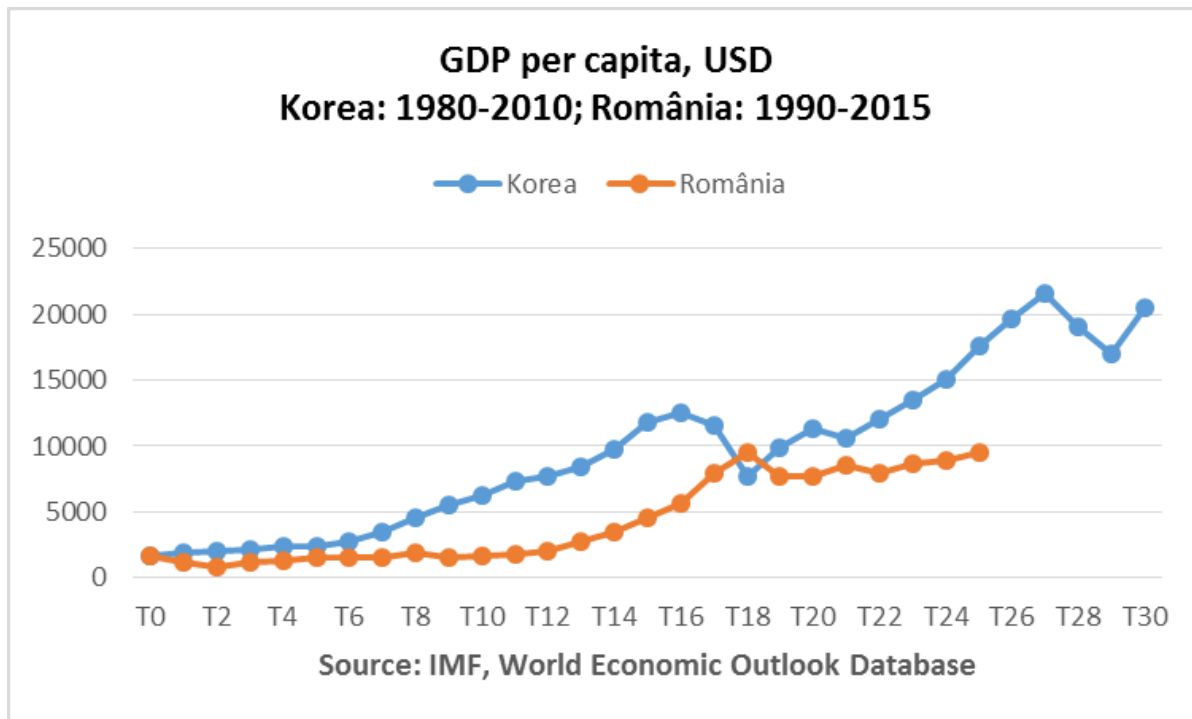
Introduction

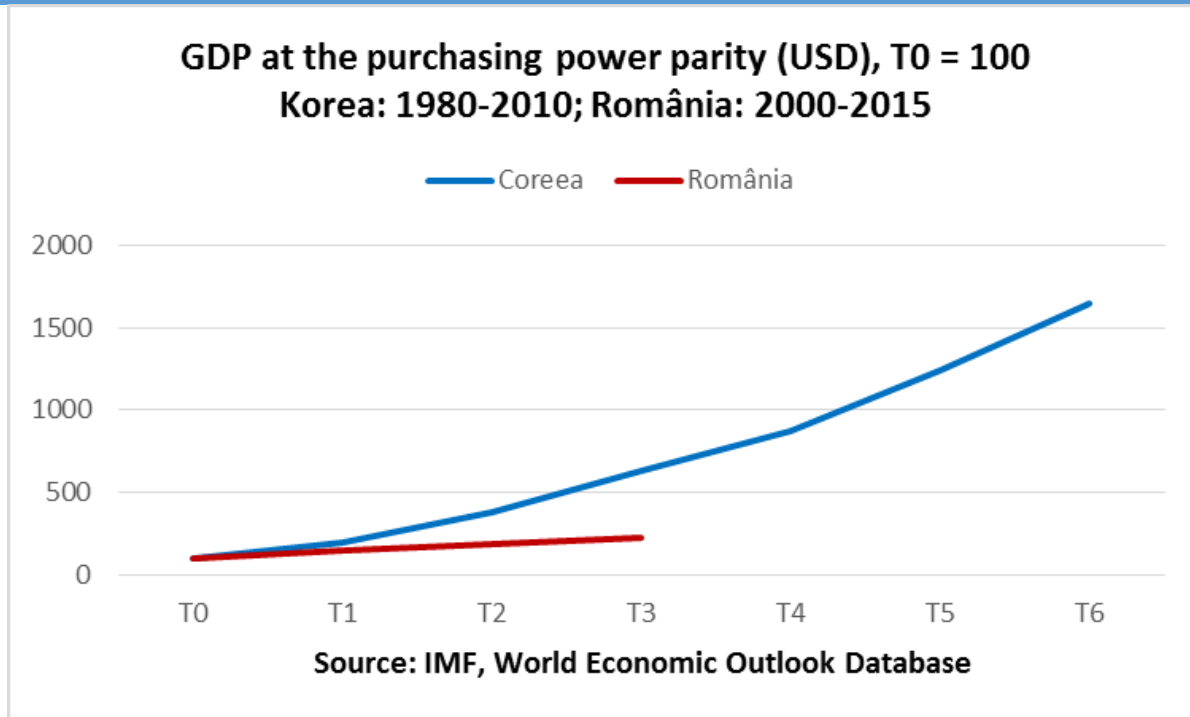
In 2016 Romania's GDP is forecasted to grow by approximately 4%, a pace which is considered too fast by some economists, and above the potential GDP growth rate. From 1990 to the present the average annual rate of growth was slightly more than 1,5%, that is three times smaller that that of Korea. It is noncontroversial that with such low economic growth Romania will have a hard time catching up with developed countries.

In the present paper I will document the different growth performance of the two nations and investigate one reason for this anomaly: economic freedom. The next section puts the economic dynamics in historical perspective. Then I will show how differences in economic freedom go hand in hand with variations in the growth rate. The last section concludes the paper.

Strong development vs. anemic growth

In 1990 per capita GDP in Romania was very similar to the value Korea experienced in 1980: 1631 versus 1688 dollars. However, because of higher rates of growth, in the following decade Korean GDP/capita increased by a factor of 4, to 6307 dollars, while Romania stagnated. The Asian Crisis marked a big drop in Korean economy, but in 2000 its GDP was still consistently higher than that of Romania after two decades from the collapse of communism. Needless to say, in the following years Korean GDP/capita has continued to climb, while Romanian GDP/capita barely managed to recover from the 2009 crisis. After 25 years from the starting point of our comparison, Korea's standard of living is almost double that of Romania.





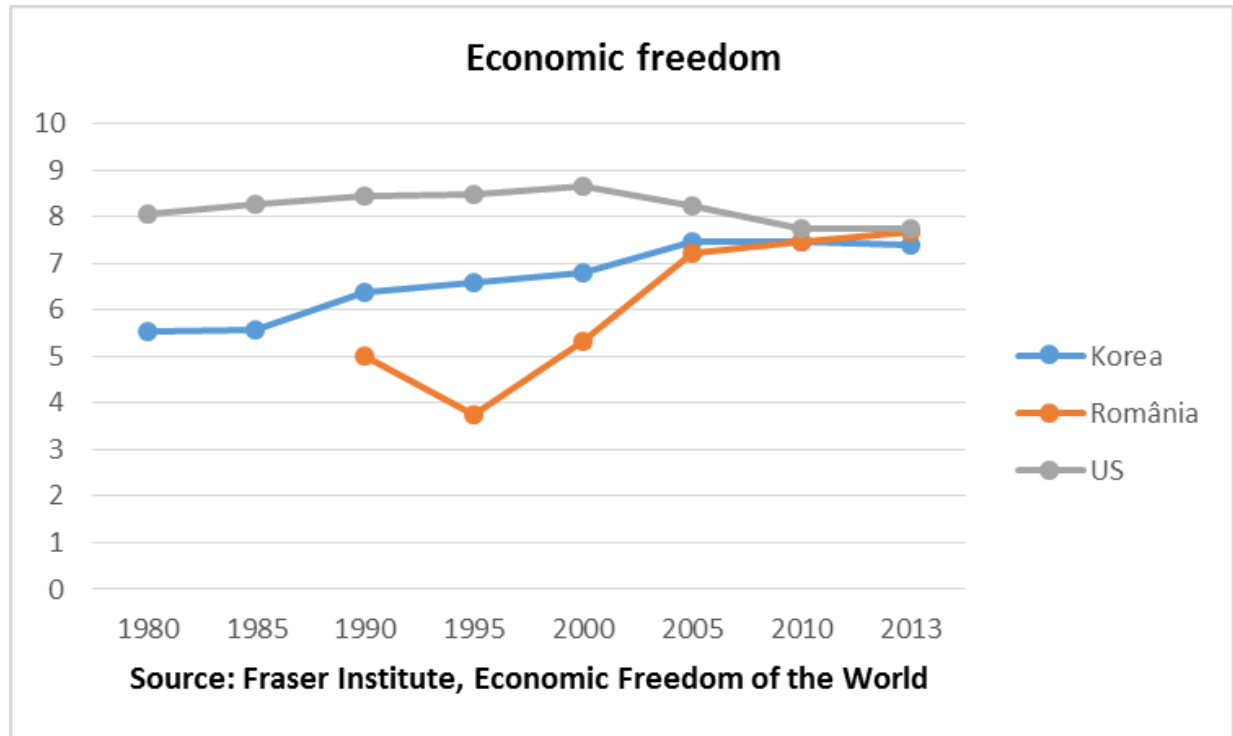
As I have said, at the origin of this asymmetric evolution is the much higher growth rate of Korean economy. From 1980 to 2010 Korea's real GDP increased by 6,7% (average). This is much more than Romania's average 1,5% economic growth after the Revolution and the demise of the socialist system.

Economic freedom

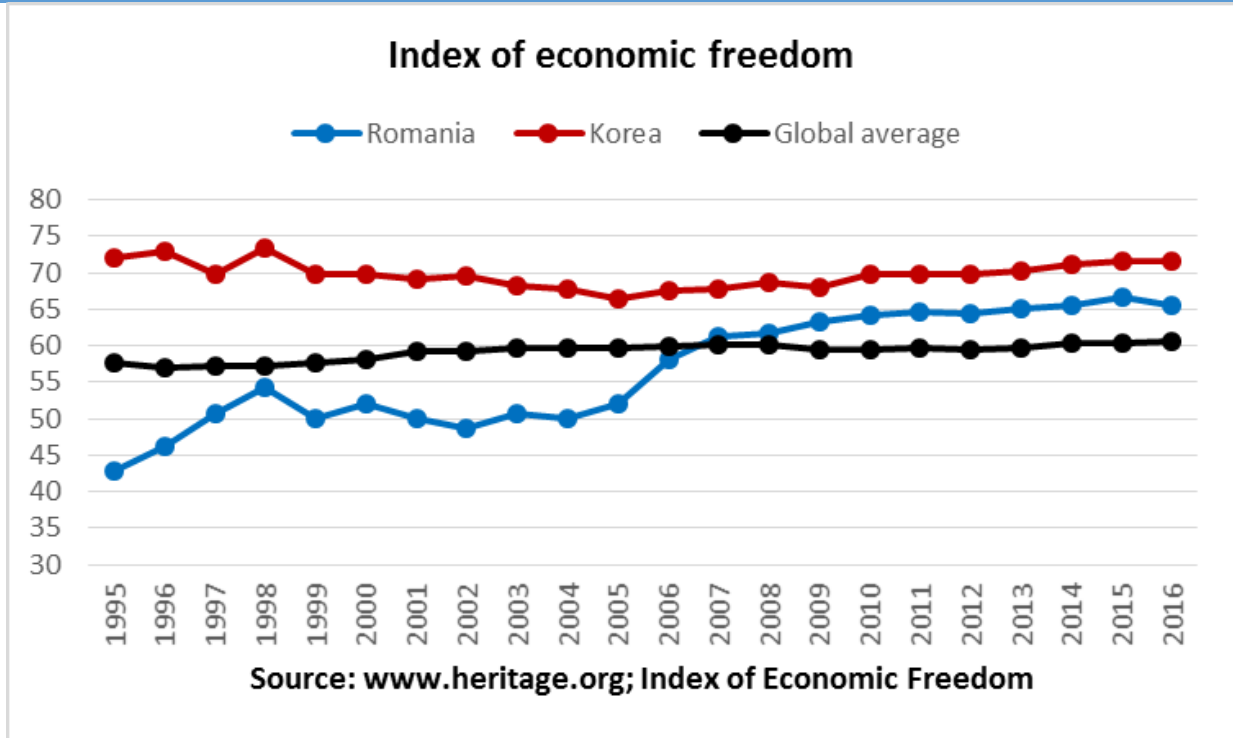
It is widely known that there is a positive relation between economic freedom and growth. Free markets, small government and inclusive institutions are the key to greater production and economic performance. As the next figure shows, it is no wonder that Korea surpassed Romania in terms of growth, given that it has enjoyed a much higher economic freedom, for most of our recent history.

Korea is considered for decades as one of the most free economies in the world. This is a status Romania has enjoyed only very recently. Back in the '1980s Romania was one of the least free nations in the world and was not even taken into account in the Annual Report issued by the Fraser Institute, as it had a centrally planned economy and insignificant private property. Then, after the Revolution, in spite of

reforms and price liberalization, big budget deficits and hyperinflation kept Romania's economy at the bottom.



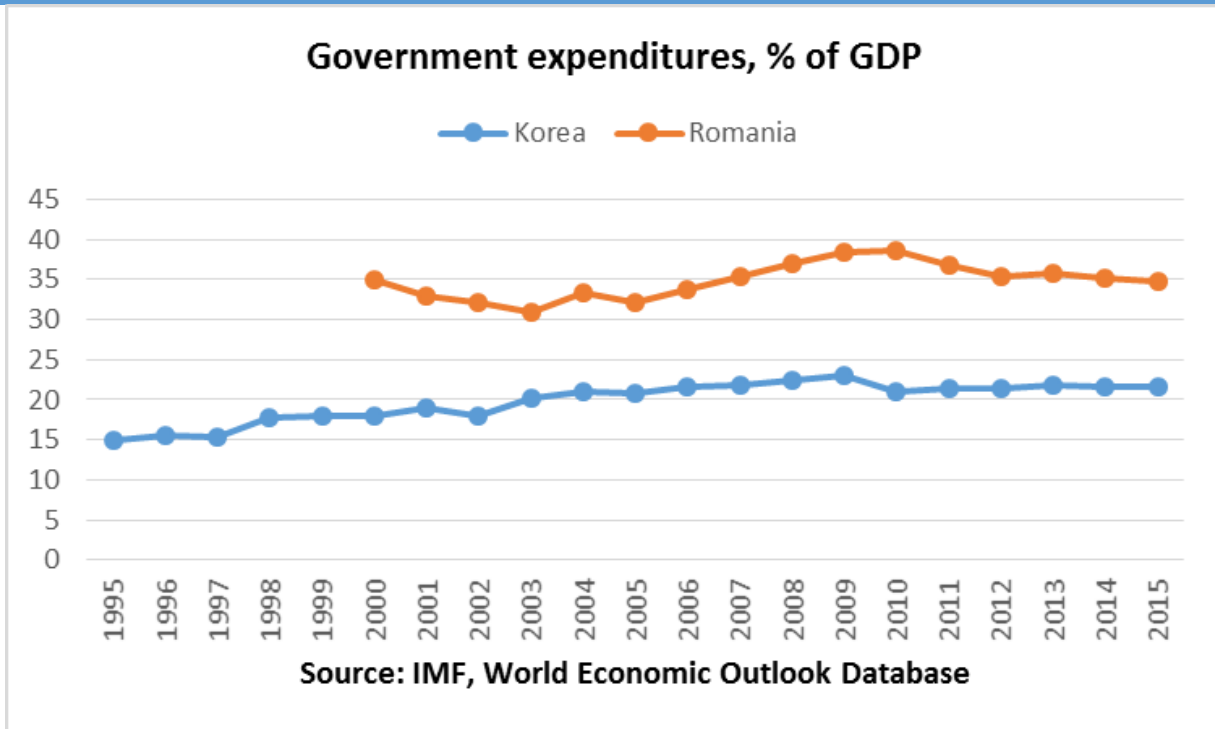
According to Heritage Foundation's Index of Economic Freedom, Romania still did not catch up with Korea. Although Romania has advanced in limiting the power of government and currently enjoys more fiscal freedom than Korea, as well as trade and investment freedom, it has big problems instituting the rule of law: private property is not effectively enforced and corruption is rampant; also, business freedom is severely impaired by ineffective bankruptcy procedures and burdensome regulations.



In what follows I will focus on two key macroeconomic aspects of economic repression – government spending and inflation – and I will show how differences in these two phenomena illustrate the general idea that Korea was a freer society than Romania.

The level of public spending in Korea during 1980-2010 was substantially lower than in Romania. During most of the 1980s public spending averaged 20-21% of GNP. It has increased steadily during the 1990s but never exceeded 23% of GDP, while in Romania government expenditures were, on average, 10 percentage points higher.

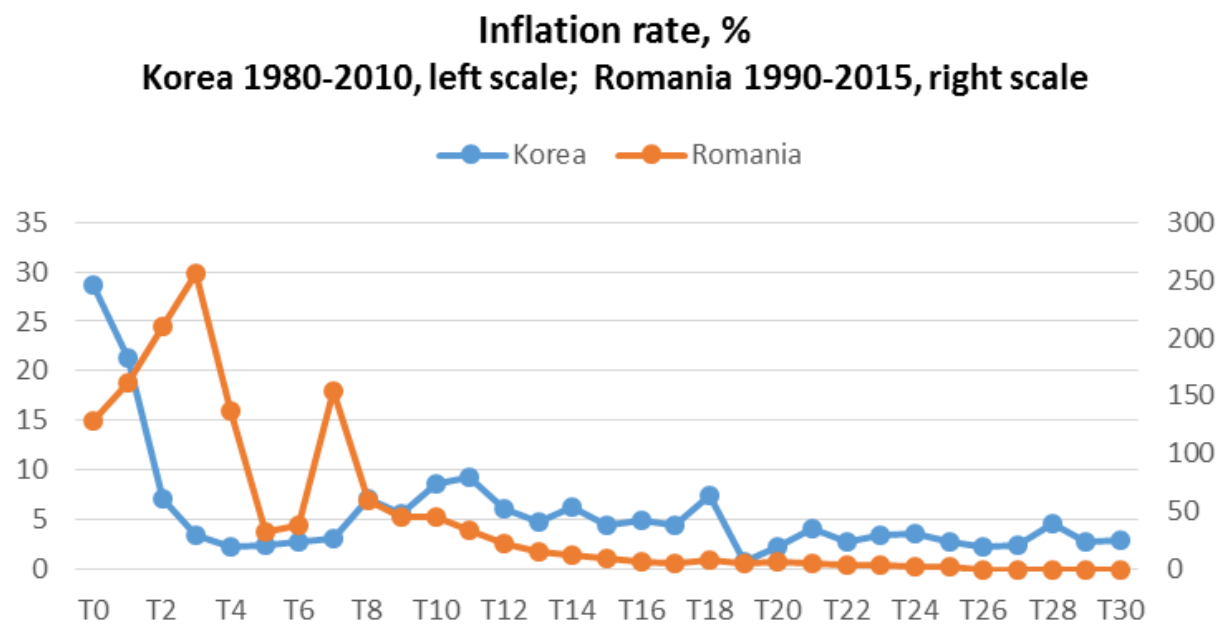
One particular feature of Korean public expenditure is the low fraction spent on public employees' salaries. In 1980s only 14.5% of government spending consisted in wages – by comparison, Romanian government spend more than 20% of its budget on paying salaries. Also, the overall share of transfers (pensions, social assistance etc.) in the public budget was smaller in Korea than in Romania.



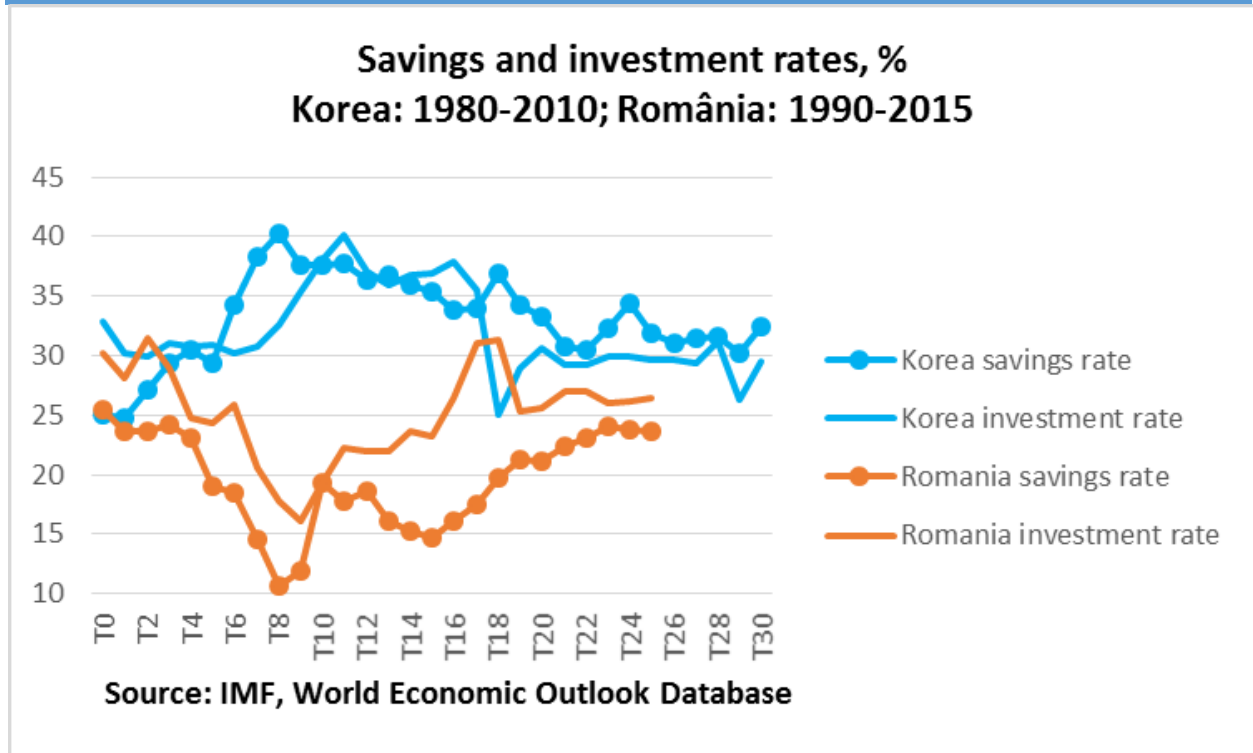
Monetary freedom is essential for a well working market economy. In a monetary repressed economy the inflation rate and the negative rates of interest prevent people from saving and accumulating wealth. Therefore, in a repressed financial system capital accumulation and investment will be lower, and the economy will either stagnate or grow very slowly.

The following figure shows that Romania had throughout the period of its transition from socialism to capitalism a considerably higher rate of inflation than Korea. The latter did not experienced hyperinflation, as the former did in the 1990s, and generally had a much better monetary management.

Unsurprisingly, both savings and investment rates were consistently lower in Romania than in Korea. The following figure clearly shows the depressing impact of hyperinflation on savings and investment in Romania in the first decade after the Revolution. Then, as the process of disinflation advanced so did the savings rate. The inflow of foreign capital helped Romania to bridge the gap between domestic savings and investment in the 2000s but it eventually evaporated after the Crisis of 2008.



Source: IMF, World Economic Outlook Database



Conclusions

In this paper I have documented the different economic growth in Romania and Korea in the last decades. Incidentally, in 1990 when Romania embarked on the road to a free market economy, its GDP per capita was equal to the one measured for Korea in 1980. Although emerging economies are naturally expected to display high rates of growth, the following decades witnessed a major difference between the two countries. To put it simply, Korea has a much faster economic growth than Romania.

Since development correlates with economic freedom, I have analyzed whether variations in the latter can explain the poor performance of Romania. Indeed, Korea enjoyed a significantly higher economic freedom than Romania. More exactly, as I showed in the paper, two macroeconomic aspects of economic freedom, the size of the government and the inflation rate, suggests that Korean economy exhibited more incentives for savings and capital accumulation, which explain the faster development of the Asian country.

In light of this analysis, the recipe Romania should follow if it wants to accelerate its development is simple: increase economic freedom by acting on all of their pillars: reducing corruption and enhancing the rule of law, cut the fiscal burden and the bureaucracy, stimulating investment and entrepreneurship.

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