



FINANCIAL CRISIS. CHALLENGES FOR ROMANIA

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Rezumat

Economia românească este pe cale să experimenteze o recesiune ca rezultat al propagării efectelor crizei financiare internaționale. Într-o economie globalizată trebuie să admitem faptul că ceea ce este bun și rău în fenomenul globalizării transcede cu mai mare ușurință spre economiile individuale, iar România nu poate fi izolată acum când este angajată în procesul de integrare europeană, una dintre dimensiunile acestui proces fiind chiar integrarea financiară. Cu contul curent deplin liberalizat, cu o monedă convertibilă și o economie deschisă din punct de vedere al comerțului internațional, fără îndoială că vulnerabilitățile recunoscute economiei românești sunt resimțite mai puternic de investitori și economiști, în contextual unei crize de o asemenea răspândire geografică. Credem, însă, că într-o astfel de situație este important ca abordarea factorilor interni aflați sub presiunea șocurilor venind pe canalele de transmisie să se facă într-un mod echilibrat, dacă dorim să judecăm cu obiectivitate sporită posibilele manifestări, în propria noastră economie, ale impactului actualei crize în plan financiar și economic.

Abstract

Romanian economy is on the verge to experience a recession as the result of the spilling over of the effects of the international financial crisis. We have to admit the transcendence of the good and bad things of the global economy to the individual economies, Romania not being an exception. At a time when Romania is fully engaged in the process of the European integration, one dimension of it being the

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financial one, it can not be secluded from the crisis impact. With a fully current account liberalized, convertibility and high openness of the economy towards world economy, in terms of foreign trade, during a crisis with such a geographical extension, there is no doubt that some well known vulnerabilities are perceived strongly by investors and analysts. A balanced approach of internal factors which can be under the pressure of the transmission channels bringing external shocks is more appropriate for the judgement of the possible domestic outcomes of the present crisis, either in financial field or economic one.

Keywords: crisis, globalisation, financial system, risk, transmission channels

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Romania, same as the economies of many countries, is jammed by the current financial crisis whose consequences cross unhindered state borders. No matter small or large, apparent or real, may be the discomfort to these consequences, the quasi general lack of trust accompanying a financial crisis spares no one of worry. This feeling grows acute more so as the necessity of a perspective is more stringent, either because of an ending strategy which demands another, or because of the election cycle.

The foundation of an economic perspective, irrespective of the future term of reference – short, medium or long-term – must evaluate the past from at least two dimensions: that of the trends which may influence the future and that of the conjectural evolutions which either confirm the trends, or modifies them abruptly.

The use of methodology is done exclusively because of the need for a synthetic characterization of the medium-term impact of the financial crisis on the Romanian economy, 2007 bringing “surprises”, somehow announced, both for the world and for the domestic economy. The conjectural evolutions of 2007, marked by the onset of the financial crisis, not only didn't interrupt the trends of the past 10 years, but even forced them through an inflexion point with special characteristics.

First, this inflexion point, which can not be compared strictly with the reversing of an evolution, seems to have ended a stage of a certain progress of the world economy, structured in strongly industrialised countries and in emerging economies, just because of their increased interdependence due to the increasing liberalization of the international commercial and financial flows.

Second, the progress of the emerging countries, characterized by the increase of their capacity of production and export of goods and services and of capital, resulted in a specialisation of the strongly industrialised countries, which reached the limits of “danger” in terms of the external macroeconomic misbalances.

Third, they say that a cycle of world economic growth ends, which was based on low interest rates and low inflation, which may open a new, tougher, competition for the cost of goods and services.

Fourth, the favourable economic evolution increased the appetite of the investors for risks. It is interesting that, unlike other periods, the build up of financial tension was located in the most developed state of the world, the USA, and the world financial interconnections and integration caused the shock of the financial turbulences, produced by the subprime mortgage crisis, expand, first, to the developed European countries.

Fifth, the initial acuteness of the financial turbulences overlapped the crisis of the agro-food products, which has both structural causes (reduction of cultivated agricultural land, conversion to bio fuels) and climacteric reasons displaying a long-term trend (global warming, el Nino, greenhouse effect).

Sixth, the shock of basic agro-food offer highlighted even stronger the “energy shock” manifested by the continuous increase of oil price over the past two years, which peaked at 147 USD a barrel, in July 2008.

Romania, as EU member state, as actor of the global economy, is exposed to the mentioned evolutions, some of them intrinsic to the option of market economy, other deriving from the contractual relations, principally focused on the values of the political and

economic democracy. In technical terms, the connections to the world economy, regarded inclusively by preferential regional groups, such as the affiliation to the European Union, also interpreted at the same time as transmission channels of the world economic phenomenology, refer to the types of liberalization: foreign trade; prices of goods and services; capital investments; capital account; national currency convertibility.

Leaving from the premises of knowledge of the causes of the current financial crisis, its acutization towards late 2007 and early 2008, displayed by the bankruptcy of systemic financial institutions and selective interventions to save them both in the USA and in European countries, puts us in front of accepting the evidence of realities in relation to which the feeling of immunity or invulnerability gets fluctuating connotations. At such a moment of perceptions, dominated by incertitude and lack of trust, any level of defiance or comfort in front of a possible adverse impact should better remain within the boundaries of rationality. This has several qualities: (i) acknowledgement of the intrinsic existence of the channels for crisis propagation; (ii) correct evaluation of the reception capacity of the propagation effects of the crisis through normal transmission mechanisms; (iii) existence of filters which deflect the frontal blow, consisting in regulation, conduit of the macroeconomic policies (fiscal-budgetary and monetary); (iv) financial reserves for intervention; (v) capacity to coordinate the specific measures on the horizontal of the institutions with similar responsibilities of the foreign partners.

As far as Romania is concerned, the analyses of the central bank or of independent banks show the existence of a certain resistance of the internal financial stability to the international financial turbulences, both through the **indirect channel** (impact on the real economy), and through the **direct channel** (impact on the banking sector and on the financial markets), although some adverse evolutions might affect much stronger Romania, such as interbanking interest rates volatility or speculative attacks on the exchange rate.

Reason, especially concerning the equilibrium of an objective message within the context of the crisis, in which the worst effect is deviation from the lack of trust to panic, directs us to an academic analysis. I have to note, here and now, that most of us witness a

“chattering” approach in the mass-media by which, under the mask of sincere worry of the analysts of all kinds, exactly the perceptions which this moment of the crisis doesn’t need, are propagated.

I feel, as researcher, and as responsible official in the field, it is my duty to show in what consists the resistance of the Romanian banking sector to the severe impact of the international financial crisis. The limited impact we are speaking of, is due to some specific traits of the Romanian financial environment, and to the prudential measures, to the monetary policy measures, to the measures of strengthening the financial stability enforced in time by the central bank. I will try to define those which I regard essential, milestones, in order to be able to weight with solid arguments the mentioned limited risk of contamination of the Romanian banking system due to the current turbulences on the international financial markets:

- Most of the banks operating in Romania, including those with foreign capital, are legal persons submitted to licensing, regulation and prudential monitoring by the National Bank. These banks, as much as, the branches of the foreign banks with headquarters in other EU countries, submit to the same, Basel II, prudential and capitalisation standards.
- The banking system has the highest proportion among the financial institutions operating on the Romanian market, in terms of the volume of assets as percentage of the GDP, exceeding 85%;
- During the formation of the Romanian banking system in the present configuration and during the development of the financial intermediation, National Bank regulations have been many times more restrictive than Basel II standards. I remind you that the requirements for the initial capital to licence banking institutions in Romania were almost two times higher than the minimum level imposed by EU regulations;
- NBR representatives are involved, at the level of the competent community structures, in the process of analysis and improvement of the community regulations concerning the architecture of the financial system;

- The sustained deflation process, despite the inflexion during the second half of 2007 due to the shock of the offer, outside the central bank control (increased prices for energy and agro-food products on the background of local draught), imposed a particular restrictivity of the monetary policy, including because it was not accompanied by adequate budget policies;
- The level of the compulsory minimal reserves remained high for a long period, much higher than the standards of the European central banks: 20% for the liabilities denominated in lei, with due date up to two years and 40% for those denominated in foreign currency. Besides the role of moderating the rate of credit increase, the compulsory minimal reserves play the prudential role of preserving an adequate level of liquidity by the credit institutions;
- The credit institutions in Romania are not exposed to subprime products. This is due to the high proportion of credits in classical banking products, while credit expansion benefited from the profitability ensured by the wide interest rate margins applied on the domestic market;
- The measures intended to moderate the rate of credit increase, recently adopted by the National Bank, permanently aimed a sustainable long-term growth of credits, proved by the fact that the monetary policy focused on deflation allowed a constant increase of the financial intermediation, the progress towards a mature financial system;
- Although the liquidity within the system of the credit institutions in Romania decreased compared to the previous years, it still is at an adequate level for a proper functioning of the markets. The relative decrease of the liquidity is also due to the repositioning towards normality of the Central Bank's role within the financial system, from net debtor, to net creditor;

- These circumstances ensure NBR comfort to have available the instruments and mechanisms required to ensure the liquidity in agreement with the related European norms.

Some evaluations made within the context of the mentioned circumstances, lead to noteworthy assertions in terms of the principal approaches to the effects of the crisis. If we refer to the direct transmission channel, represented by the international trade, foreign investments, exchange rate, interest rates to the lines of credit in foreign currencies taken by the financial and non-financial societies, the following are to be mentioned:

- The degree of influence on the economic growth and of the foreign trade activities of Romania must be analysed in terms of the economic openness towards the global economy (still marginal in the commercial relations with the USA, where the subprime crisis started) and in terms of the prognosis for economic growth reviewed downwards, both in the USA and particularly in EU countries, where 70% of our foreign trade goes;
- According to a *stress-testing* simulation on companies, a 10% or 20% shock to the exchange rate would produce a *first round effect* direct loss of 0.22% and 0.87%, respectively, of Romania GDP, because of the higher financial expenditure to pay back the credits taken in foreign currency or to pay for the imports included in the production;
- Current account deficit financing would be more difficult if the access to foreign liquidity of those interested in direct capital investments becomes increasingly restrictive in terms of availability and therefore, costs;
- The attempts to improve liquidity on the monetary markets entices almost immediately the risk appetite for speculation, while the investors with long-term interests identify buying opportunities for the depreciated shares;

- The crediting conditions for the companies and population become volatile on the side of interest rates and fees, under the influence of the exchange rate volatility and of the interbanking interest rates;
- The survey of trust in the economic operators displays a decline, with pessimistic expectations for the next 12 months, bearing significance on the consumption and investment decisions;

The following effects coming through the direct channel are noteworthy for the banking sector and for the domestic financial markets:

- Distortion of the bank assets guaranteed with mortgages whose securitization would be lost on other markets disturbed by the subprime mortgage crisis. As far as we are concerned, there are some comfortable realities shown by the fact that: (i) in Romania there are no securities guaranteed with mortgages; (ii) the mortgage credits granted by the Romanian banks have a very good quality and still are solidly guaranteed; (iii) the proportion of the mortgage credits within the total non-governmental credit is still low (8%), but we should not forget that there are long-term consumption credits which finance real estate projects; (iv) the level of bank capitalization is high and may cope with possible unexpected losses;
- We should note, however, a decreasing trend of the price for real estate assets and of the intention of the population to buy new such assets, the real estate market being on the verge of blockage;
- On the liabilities side, the Romanian banking sector enjoyed a good foreign financing due to the aggressive crediting policy within an active competitive environment representing over 25% of the total bank liabilities in 2007, compared to 5% in 2000. The lower liquidity on the external financial markets stimulated the domestic saving, assisted by the high monetary policy interest rate too;

- The behaviour of the local banks in the situation of crisis must orient from the market share towards an increased prudence in crediting;
- The speculative attacks of the non-residents on the exchange rate, on the background of vulnerability induced by the perception of the probable effects of a current account deficit, can not be excluded, which is what has actually happened, with the observation that we must not forget the role of the central bank as regulator of liquidity in such situations, its interventions on the monetary and foreign currency market being legitimate;
- The monetary market suffered a significant impact due to the speculative attacks, liquidity draining and insufficient collateral instruments of the Lombard credits – loans ultimately granted by the central bank – but with a blameable behavioural bias considering the level of the interbanking interest rates and the preference for so expensive overnight refinancing (up to 100%);
- The foreign currency market took a stronger impact than other sectors of the domestic market, because of a stronger reaction of the non-resident investors tempted to do speculative operations;
- The capital market endured the corrections from the developed markets, reflected otherwise in the indices of the Bucharest Stock Exchange, particularly on the segment of the securities of the financial entities. The effect of the turbulence has been favoured by the high level, in relative terms, of the stock price and by the decrease of the domestic market attractiveness (worsening yield to risk ratio), under the influence of lower liquidity and of the low number of public offers of bonds and shares, which to absorb the demand

A synthesis of the adverse effects which can not be overlooked because of the same reason of arguing the limits of contamination, must direct our attention to the following:

- The possible higher volatility of the exchange rate, similar to the trends from the other countries in the region, under the conditions of the lower appetite for risk of the investors from

the emerging markets;

- Continue increase of the cost of foreign financing and its lower volume;
- Possible moderation of the volume of autonomous capital inflows and possible anticipated repatriation of the fructified capitals;
- Possible deceleration of the demand for exports of Romanian goods and services, because of the perspectives of lower economic growth in the other EU member states.

All these considerations are far from being an idyllic plead and, so much more, they must keep us far from any temptation of euphoria in front of a reality of an unprecedented financial crisis in the post war history. Do not forget that it compelled and still compels the governments and central banks from the United States and the other developed countries worldwide to take, also unprecedented, measures. A full analysis must also include the short and long-term risks. These have to be identified, understood and included in action plans to be corrected, knowing that for the time being the timetable for shifting to euro didn't change.

On the short term, the dependence on the foreign financing is the main risk for bringing back the current account deficit to comfortable levels based on the development of the domestic offer. Judicious calculations showed that the foreign deficit should be reduced by 4-5 percent points of the GDP in order to remain sustainable and preserve a vigorous economic growth. This reduction of deficit may be ensured by decreasing the budget deficit by: compressing the current expenditure, wage increase in a proportion which not to exceed work productivity growth; moderate the rate of credit increase; stimulate domestic saving as source of financing investments.

The second risk is represented by the domestic demand still in excess, which may cause conjectural overheating, different between the different branches. If we consider the sector of constructions, it has all the signs of overheating, shown by high demand, fast increasing prices, deficit of resources, workforce particularly. In the agricultural sector, extremely volatile as performance, the growth from this year can not be interpreted as overheating, because the resources – land, workforce – are underused, the prices tend to

decrease.

If in the sector of constructions there is no need for further stimulants, agriculture needs additional supplements to fructify the natural potential and structural measures, such as the simplification of the property transfer and creation of a land market freed on the constraints of excessive bureaucracy.

On the long term I subscribe to the strong options to continue the structural reforms with the main purpose to increase work productivity and to reduce the gap to the average European level. The structural reforms require the simplification of the **system of taxes and dues**, by far the largest in EU, **reduction of bureaucracy in general**, which delays administratively all the infrastructure projects and **workforce market flexibilization**.

I left for the end this level of the structural reforms because they are essential for the economic future of Romania. Under the conditions of the current chronic workforce deficit, maintaining rigid regulations of excessive protection of the employees – which appeared when unemployment was high and the employees had to be protected against employer abuses – is not only an anachronism, but it acts against competition based on workforce quality, on higher work productivity, the main catch up factor we need in the process of real convergence. The barrier at employee outgoing is transformed in a barrier at employee incoming. In stead of stimulating job creation, even non-guaranteed but with the required mobility, the current work legislation pushed part of the population apt of work to go abroad.

The limited effect of contamination of the Romanian financial system from the international financial crisis doesn't exclude effects on the real economy due to its opening towards world economy. Any delay in starting structural reforms will make the shocks of the recession from other parts of the world to be more painfully felt by the Romanian economy and shatter the few consumption exuberances of millions of citizens after decades of privations, of bad allotment of the resources.