



## **SOME EFFECTS OF THE FINANCIAL AND ECONOMIC CRISIS ON THE REAL ECONOMY**

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### **Rezumat**

Studiul se dorește a fi o incursiune succintă în problematica unor efecte pe care actuala criză financiară și economică internațională le exercită asupra principalelor variabile macroeconomice specifice economiei reale. În acest scop, sunt evaluate influențele directe și indirecte, pe termen scurt și pe termen mediu ale crizei asupra investițiilor directe (interne, respectiv externe), asupra ocupării, asupra creditului bancar neguvernamental. De asemenea, studiul evaluează condițiile constitutive ale capacității de reziliență ale economiei românești, capacitate care se reflectă în potențialul economiei naționale de a depăși constrângerile impuse de criză și de a reîncepe, în cel mai scurt timp, creșterea economică.

### **Abstract**

The study aspires to accomplish a succinct incursion into the sphere of the effects that the current international financial and economic crisis is exerting on the main macroeconomic variables which are specific of the real economy. For this purpose, the short and medium-term direct and indirect influences of the crisis on the direct investment (internal as

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well as external), on employment, on the non-governmental credit are valued. Also, the paper assesses the constitutive factors of the resilience capacity of the Romanian economy, that is translated into its potential to get out of the constraints imposed by the crisis and, consequently, to resume, as soon as possible, the economic growth.

**Keywords:** financial crisis, employment, resilience, direct investments

**JEL classification:** E22, E24

In order to study the impact of the crisis on the real economy we will focus on four macroeconomic variables of this sector of the economic activity: a) direct investments; b) occupation; c) economic growth; d) economic deficits.

This paper approaches just the first two variables.

### ***1. Impact on the direct investments***

The dynamics of the direct investments in the national economy depends on the resulting dynamics of the following factors:

1. dynamics of the non-governmental banking credit for non-banking clients;
2. proportion of the non-governmental banking credit for non-banking clients intended for direct domestic investments within the total non-governmental banking credit for non-banking clients
3. dynamics of the foreign direct investments.

#### **1. Dynamics of the non-governmental banking credit for non-banking clients**

The phenomenology of the non-governmental banking credit for non-banking clients may be described as follows:

- a. There is a „V”-shaped curve of the nominal volume of this category of credit, generated by the following factors:

- blockage or strong reduction of the supply of liquidity (financing) of the domestic branches of the foreign banks due to the liquidity shock taken by the latter, shock favoured by the “toxic assets” from their portfolio which started the current financial and economic crisis;

- the excess of prudentiality of the banking<sup>1</sup> system in granting non-governmental credits in their attempt to protect the existing liquidity by eliminating the risk of credit<sup>2</sup>;

- the negative expectations (anticipations) on the restoration of the banking system, which creates an artificial penury of liquidity by including these anticipations in the decision making models of the commercial banking system;

b. At the moment when the analysis was done (May-June 2009) we appreciate that the dynamics of this phenomenon is close to the inflexion point of the “V”-shaped curve mentioned earlier, with certain perspectives of closing to the ascending side of the curve, which results from the following considerations:

- the evaluations of the international financial organisations regarding the dynamics of the national economy in 2010;

- the evaluations of the different international or regional<sup>3</sup> institutions and organizations regarding the capacity of the world economy to absorb the effects of the financial crisis and to block or diminish drastically its transfer into crisis of the real economy (which is a persistent, self-maintained crisis) in 2010;

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<sup>1</sup> *As it is known, the banking system includes commercial banks and resident branches of foreign banks.*

<sup>2</sup> *Of course, the excess of prudentiality generates the adverse selection of the non-banking clients which, in turn, preserves the excess of prudentiality (we have here again a vicious circle – or positive feed-back).*

<sup>3</sup> *See for instance, the evaluation of the head of the European Central Bank in this respect, as well as the statements of some American officials.*

- the specific structure of the banking assets from the Romanian banking system (the portfolio of banking assets doesn't include financial derivatives<sup>4</sup> and the securitization of the doubtful real estate mortgages didn't allow risks to develop)<sup>5</sup>;

- the securitization of the existing performing real estate mortgages within the banking system is not yet sufficiently developed, which creates premises for the identification, using this "product" of fast ways of restoration, even increase of the liquidity within the banking system and on the interbank market<sup>6</sup>, of course.

c. We estimate that the inflexion point of the "V"-shaped curve will be crossed between October 2009 – April 2010, so that the non-governmental bank credits (for the non-banking clients) will be resumed, which results from the following considerations:

- the banking system is symbiotically integrated within the processes of the real economy; it can not remain autonomous for a too long time, or too much in relation with the requirement of credits for the real economy; this evaluation of the relation between the nominal economy (represented here by the banking system) and the real economy is structural-functional, which means it can only be eluded by condemning the nominal

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<sup>4</sup> *The existence of the financial derivatives in the assets portfolio of the banking system would have negated sui generis "geodesics" of transfer of the international financial crisis into an internal financial crisis (it is about the impossibility of a direct transfer, because an indirect transfer – for instance, through liquidity, as mentioned earlier, took place, of course).*

<sup>5</sup> *Even though the securitization of the mortgage credits (which "packed" secondary mortgages) was one of the causes of the financial crisis which burst out in August 2007 in the United States, it is also the securitization of the mortgages (of the prime mortgages this time) that may become a way to increase the liquidity of the banking system, as condition for the gradual but fast resorption of the financial crisis.*

<sup>6</sup> *The investment funds need to have an increased appetite to buy such mortgages (for instance the pension funds pillar 2 and pillar 3).*

economy itself<sup>7</sup>; the source of the banking system profit lies, preponderantly, in the real economy, in the non-governmental banking credit<sup>8</sup>;

- the value of the banking assets depends essentially on the value of the real support assets (for instance, in the case of the financial derivatives); the banking system is therefore extremely interested that the real economy resumes its cruising trajectory which “guarantees” the prosperity of the banking system itself;

- although the passive interest rate is not sufficiently directly linked to the monetary policy interest rate<sup>9</sup>, we consider that within 6-8 months the central bank will “acquire” permanent and obvious characteristics of net creditor in relation with the banking system, which may generate the formation of a clear feed-back function of the passive interest rate and (through the marginal interest rate) of the active interest rate.

## 2. Proportion of the bank credits for direct internal investments

In our opinion, during the next period we will witness a spectacular increase of the proportion<sup>10</sup> of the non-governmental bank credit for

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<sup>7</sup> Indeed, between the real economy and nominal economy there is a permanent mutual informational evaluation (similar to the mutual evaluation between the buyer and the seller in a usual economic transaction).

<sup>8</sup> Of course, the non-governmental bank credit also includes the interbank credits, but ultimately this also is refinancing whose end purpose is to grant credits to the non-banking non-governmental clients.

<sup>9</sup> The character of creditor of the central bank in relation with the banking system still is oscillating (for instance, the central bank continues to sterilise the monetary mass existing in the economy), which obstructs the coherent functioning of the transmission channel of the monetary impulse through the variation of the monetary policy interest rate.

<sup>10</sup> This means that the “effort” of resuming the economic growth will still be born by the volume of the non-governmental bank credit or, in other words, we will not witness a reconstitution of the non-governmental banking credit for at least 1-2 more years.

direct internal investments within the total non-governmental bank credit given to non-banking clients, due to the following reasons:

a. the consumption will continue to support, in a decisive manner, the domestic demand, particularly since it has a direct impact on the demand for investments (more precisely, on the demand for bank credits for investments);

b. the banks don't have too strong criteria of economic rationality so as to prefer granting non-governmental credits for investments at the expense of the consumption<sup>11</sup> credits; therefore they don't have express responsibility for the structure of the non-governmental bank credits; furthermore, the established myopia of the economic rationality of the banking system will continue to favour the short-term credits for consumption;

c. the demand for investments will have a stronger inertia than the demand for non-governmental bank credits either because of the delay in resuming the production for export (due to the continuing negative growth in the euro zone or due to the difficult resumption of the economic growth in the EU), or because of the "dead zone"<sup>12</sup> that will emerge between the resumption of the demand for consumption and the reaction of the domestic offer;

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<sup>11</sup> *The observation that in principle, the collaterals of the investment credits are safer than those of the consumption credits is not too significant, because the risk analysis of the credit doesn't weights in a different manner (or should not weight in a different manner) the certitude of the collaterals function of the credit destination, because it is an impersonal risk analysis.*

<sup>12</sup> *The „dead zone“ is the time interval in which the variation of a cause-variable doesn't produce an effect on the effect-variable. This is a classical case of the necessity to reach a threshold or a critical mass of the variation of the cause, so that the effect may produce. We may observe, among other, that this out-of-phasing of the inertia associated to the cause and to the effect, may be a nice explanation of some characteristics of economic cyclicality.*

d. regarding the mortgages, we consider that the lingering financial and economic crisis may maintain the reluctance of the banking system towards the idea of reinstating or increasing the importance of this category of credits, as mentioned previously; mortgage securitization might become again an important and current source of refinancing within the banking system, on condition of eliminating the possibility to pack together prime and sub-prime residential mortgages.

### 3. Dynamics of the foreign direct investment

The decision of the foreign investors to transfer capital into direct investments in Romania depends on several factors: a) trust in the resilience capacity of the Romanian economy to the structural effects of the international financial and economic crisis; b) analysis of the opportunity cost of the decision to invest in the Romanian economy under the new financial and economic conditions from the states affected by the international financial and economic crisis (particularly in the case of the EU member states, especially in the case of the states members of the Economic and Monetary Union); c) economic prospects of the residence states of the potential foreign investors. Following is a brief evaluation of the impact of these factors:

a. Resilience capacity of the Romanian economy. Several conditions specific to the Romanian economy might contribute to the establishment of the trust of the potential foreign investors in the capacity of the Romanian economy to cope with the effects (real or induced by anticipation) of the current international financial and economic crisis:

- the recent foreign credit granted to Romania by IMF (about 13 billion euro) and by the World Bank (about 7 billion euro) provides guarantees for the non-escalation of the public budgetary deficit, on the one hand, and on the non-escalation of the national currency depreciation, on the other hand;
- the inexistence of the toxic assets within the assets portfolio of the Romanian banking system provides guarantees

on the non-escalation of the deficit of liquidity within the Romanian banking system, implicitly within the real Romanian economy;

- the quite high “temperature” of the Romanian economy (following 10 years of sustained economic growth) provides guarantees on the non-escalation of the deflation risk, supporting the conditions for an acceptable margin of profit of the business<sup>13</sup>;

- the determination of Romania to stick to the calendar of adhesion to the euro zone (January 1<sup>st</sup>, 2014) provides guarantees on the maintenance of the economic dynamics under the control of the public policies of macroeconomic adjustment, which supports the non-escalation of the nominal and real variables above the values imposed by this calendar or above the values accepted as manageable by the economic theory and practice.

b. Opportunity cost of the investment in the Romanian economy. The Romanian economy has some strong points which keep a quite low opportunity cost of the foreign direct investment, which might be a *sui generis* attractor for this category of investments for 2009-2012. Following are a few of these strong points:

- the quite low cost of the work force<sup>14</sup>, which provides a quite attractive margin of profit for the foreign direct investors,

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<sup>13</sup> Here resides one of the reasons why the monetary policy of the National Bank of Romania seemed somehow “out of phase” in relation to the monetary policy of the European Central Bank. The attempt of the European states from the euro zone to relaunch the economy by increasing the monetary mass within the economy is as justifiable as the prudence of the National Bank of Romania in piloting the monetary mass (we have here an example of possible adverse effect of the common monetary policy under the conditions of different financial structure or different standing on the “scale” of the economic dynamics).

<sup>14</sup> The quite low cost of the work force is not determined decisively by a high unemployment rate, but it is the result of the level of the cost of living (partially covered



comparable to the margin obtainable in their countries of origin;

- a certain rigidity of the internal offer, which results in the immediate establishment of the market (demand) for the foreign direct investments; this cuts considerably the time and cost of market penetration for this category of investments;

- inexistence, at least for the medium term, of the deflation risk, which supports an adequate and safe remuneration of the foreign direct investment;

- existence of a certain pressure on the balance of the foreign account, which provides good premises, on the medium term, for reorienting the results of the foreign direct investments towards export, with the purpose to compensate for the possible insufficiency, on the short term, of the domestic demand;

- a very low rate, compared to other EU member states, of profit taxation; which supports a clearly higher net profit compared to other regions;

- considerable decrease over the recent years of the bureaucracy afferent to the registration of new economic business (more generally, of the bureaucracy afferent to the entry/exit on/from the market);

- permanent institutional pressure to avoid, limit and control corruption in business;

- the Romanian economy is an emerging economy, which means the existence of important reserves for development and growth, at least for the following reasons:

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*by informal, non-crime activities) and of the general union culture focusing on job safety. This strategy of the Romanian unions (not to focus on the management of the job offer) has several adverse consequences both on the level of the average wage and on the process of economic reform, in general.*

- a. quite low level of *financial intermediation*;
- b. quite low level of *banking activities*;
- c. very low level of *physical infrastructure*;
- d. quite low level of *environmental protection*;
- e. very low level of *technological endowment*;
- f. very low level of *tourist exploitation*;
- g. very low level of *agricultural modernization*, etc.

c. Economic prospects of the residence states. As it is known, the risks of economic stagnation or recession are considerably higher in the euro zone and in many EU member states which are not members of the euro zone than in Romania. This conclusion results first from the two arguments mentioned earlier, then from the fact that the “prognoses” of the International Monetary Fund (related to the loan agreement concluded with the Government of Romania) obviously are excessively prudential<sup>15</sup>. Many independent analysts (including the governor of the National Bank of Romania) doubt that Romania will have a 4.1% negative growth of the GDP in 2009, as accepted in the recent budget rectification under the influence of the negotiations with IMF<sup>16</sup> (even IMF evaluated a zero economic growth of Romania

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<sup>15</sup> *The current debates to reconfigure the role, functions and methodology of the International Monetary Fund (and of other international financial organisations and institutions) under the impact of the financial and economic crisis which started in 2007, must generate, of course, radical changes in the economic philosophy of the Fund, including giving up the static perspective of the financial planning g which claims an excess of prudence and which, it seems, that has never produced the best results for the countries included in thy kind of international assistance.*

<sup>16</sup> *We might ask why is it so bad to be prudent in making macroeconomic evaluations, particularly since an outcome which shows that the prudence was not necessary may be a pleasant surprise for all. The problem is that the unjustifiably prudent evaluations create pessimistic expectations that may block resources, initiatives and driving behaviours at the macroeconomic level. As mentioned many times, within the pattern of*

for 2009); this wide oscillation of the real GDP rate over just three years – from about 8% in 2008, to about -4.1% in 2009 and then to 0% in 2010 – is somehow unlikely. Therefore, this factor too may be an important attractor for the foreign direct investments during the following period.

## **II. Impact on the employment**

During the period 2009-2014, employment will be one of the key factors to put an end to the financial and economic crisis. The dynamics of employment might have the following characteristics:

a. The trend of the non-financial enterprises to cut down (or optimise) the variable costs, particularly the costs with wages, because of the lower domestic and foreign demand for the domestic production, by reducing the number of the staff. There are several modalities to make this trend operational:

- *definitive job termination* (including for trained staff), that is loss of the job with the company

- negative impact:

o at the level of the non-financial firm: future costs may be incurred to recover this category of staff when the demand for domestic production will resume;

o at the level of the Romanian society: the fired staff which will not manage, in the short-term, to get new trainings or to get a similar job elsewhere, may undergo consistent losses, possibly irreversible, of competency (knowledge, aptitudes, attitudes);

- positive impact:

o at the level of the non-financial firm: increased competitiveness through price (on condition that the

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*individual economic rationality, the anticipation (expectation) is one of the most powerful variables forming the economic decision and behaviour.*

jobs terminated definitively are not from the departments that are essential to the activity of the firm)

- at the level of the Romanian society: increased flexibility of the labour market by the inter-professional and, possibly, inter-regional mobility of the work force.

- *temporary job termination*, that is the partial use of the staff (by “rotating” it in activity, the rest of the staff being considered in technical unemployment)

- negative impact:

- at the level of the non-financial firm: the turnover decreases and the employed staff is stressed, which has a negative impact on work productivity and on the quality of the output;

- at the level of the Romanian society: a pessimistic anticipation is generated regarding job security and income, a state with unstimulating effect; this doesn't make the people to start looking for a new job, which increases, to a certain extent, labour market rigidity..

- positive impact:

- at the level of the non-financial firm: the employees are not lost definitively, avoiding thus the cost to recover them when the economic activity resumes at the initial parameters or at higher parameters than the current state;

- at the level of the Romanian society: the actual unemployment doesn't increase (the social expenditure with unemployment doesn't increase, which has a positive impact on the consolidated public deficit).

- *extend part-time employment*, that is acceptance by the employees of a concomitant (usually proportional) decrease of job duration and of the wage<sup>17</sup>

- negative impact:

○ at the level of the non-financial firm: in principle there is no adverse impact for the non-financial firm, particularly since the measure is proportional to the decrease of its turnover caused by the decreasing demand or by the increase of the inter-firms commercial arrears;

○ at the level of the Romanian society: smaller amount work delivered, with direct impact on a lower GDP, on a lower taxation basis; higher negative balance of the consolidated public budget;

- positive impact:

○ at the level of the non-financial firm: the employees are not lost definitively avoiding thus the costs incurred to recover them when the economic activity resumes at the initial parameters or at higher parameters than the current state;

○ at the level of the Romanian society: the unemployment rate remains low because more than one person work for 8 hours of activity; furthermore, the phenomenon is beneficial for the labour market because it encourages the competition for jobs.

- *Acceptance of „sacrifice”* by the staff, that is accept lower wages without job losses or fewer working hours<sup>18</sup>

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<sup>17</sup> Although the effect of this measure on employee income is similar to that of the measure of temporary lay off, the nature of the measure is not similar.

<sup>18</sup> The sacrifice is usually accepted, collectively, by agreements between the unions and the owners.

- negative impact:
  - at the level of the non-financial firm: possible loss of stimulation for work quality and work productivity;
  - at the level of the Romanian society: lower incomes (lower GDP and lower domestic demand – in agreement with the mean of the marginal inclination for consumption – corresponding decrease of the indirect fiscal revenues) and, concomitantly, lower direct fiscal revenues because of the lower basis for direct taxation.
  
- positive impact:
  - at the level of the non-financial firm: the employees are not lost definitively avoiding thus the costs incurred to recover them when the economic activity resumes at the initial parameters or at higher parameters than the current state
  - at the level of the Romanian society: the occupational level is maintained, easing the consolidated public budget of several expenditures with indemnities for unemployment, training and professional reinsertion on the labour market.
  
- *Employment reconfiguration:* refers to new training or to new assignments or to staff redistribution in a non-financial firm, without reducing the volume of work of the “production function” of the firm
  - negative impact:
    - at the level of the non-financial firm: upset activity with a possible, short-term, “U” shaped curve of the quality, productivity and activity;
    - at the level of the Romanian society: this phenomenon doesn’t seem to produce adverse effects.

- positive impact:

○ at the level of the non-financial firm: maintain the staff while performing a professional “ventilation” of it, in order to increase the output of the microeconomic production function;

○ at the level of the Romanian society: conservation or even, in terms of microeconomics, of the professional structure of the work force.

• *Reconfiguration of the business environment*: this refers both to the process of establishment/disestablishment of non-financial firms and to the reorientation of the existing firms towards new products or services<sup>19</sup>, either in response to a changing structure and intensity of the (domestic and foreign) demand for the domestic production, or anticipating or even creating deliberately (through marketing mechanisms) these changes of structure and intensity of the demand<sup>20</sup>. These reconfigurations of the business environment may have an important impact, both quantitative and qualitative (of the structure) on employment.

b. The phenomenon of re-migration of the autochthonous work force, which currently works abroad (especially in EU member states). This phenomenon is a contradictory one, its economic and social relevance depending on the result of the comparison between the speed and amplitude of resuming the economic growth in the destination states of this work force and the speed and amplitude of resuming the economic growth in Romania. The phenomenon of re-migration also depends on the

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<sup>19</sup> See further the recommendation to reorient the activity of the non-financial companies (recommendation valid, otherwise, for the financial firms too) towards «crisis» products, services and markets.

<sup>20</sup> The fiscal-budgetary policy may have a crucial, causal impact on this phenomenon (for instance the current measure to introduce the forfeiter tax or the possible return to the progressive taxation of the personal income and/or corporate profit).

preservation or not of the comparative advantage which generated the decision to migrate: this comparative advantage was, most times, the difference of wages. This difference may undergo important modifications function of the amplitude of the crisis effects on the country of origin. Furthermore, once the financial and economic crisis started, another variable emerged in the decision “equation” – the probability to find and securitize the job. The two factors have different weights in the pattern of economic rationality of each individual, which makes extremely difficult any prediction in this field. In our opinion, the following phenomena may occur during the immediate period in the field of re-migration of the migrated work force:

- A net input of migrated work force (particularly from the EU member states with high densities of Romanian migrants – Italy, Spain), of a higher quality in relation to initial structure (at the moment of emigration) in terms of: a) professional training; b) culture of work; c) organisational culture;
- The net re-migration of the autochthonous work force may create an additional pressure on the labour market, potentially eliminating in most cases positions occupied by stable employees. The employers might evaluate that the potential re-migrating workers have higher competencies and may bring a higher economic added value than the current employees, preferring thus the first ones;
- The possibility, within this context, of a latent conflict between the employees (and even the unemployed) which didn't migrate and those who re-migrated.