National Bank of Romania Management in Time of Financial Crisis

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Abstract

According to the objectives pursued in preparing Romania's accession to the European Union (E.U), the National Bank of Romania (N.B.R.) acted in line with Romania's constant efforts aiming to adapt - institutionally, structurally and operationally - the Romanian economy to the E.U. requirements.

The E.U. requirements on financial crisis management ask for an agreement of co-operation between all national financial supervisors, central bank and finance ministry.

The current financial and economic crisis started at the end of 2008 and appears to be unprecedented in the last century. For 2009, N.B.R. tried to stay consequent in its economic growth projection bringing the following arguments:

- *lower ratio of exports to Gross Domestic Product (G.D.P.);*
- *lower level of financial intermediation;*
- *the fact that Romania has a nearly balanced energy balance;*
- *exchange rate flexibility;*
- *large volume of structural funds which may be attracted to Romania.*

Keywords: *management, finance, bank sector, economic crisis.*

JEL classification: G21, H12

1. Introduction

Enlargement Strategy of the European Union (EU) seeks to integrate new members while harmonizing domestic and foreign policy objectives in all Member States, through observation and implementation of common principles. Taking all of these principles by Romania based its candidacy to EU membership.

According to the objectives pursued in preparing Romania's accession to the European Union, the National Bank of Romania acted in line with Romania's constant efforts aiming to adapt - institutionally, structurally and operationally - the Romanian economy to the EU requirements. Thus, the NBR has constantly had in view to: (i) harmonize the Romanian banking legislation with the EU acquis and (ii) strengthen its institutional capacity, by developing and increasing the efficiency of the monetary policy instruments, increasing the efficiency of banking supervision, strengthening the legislative and regulatory framework and setting up a distinct

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department charged with the coordination of the preparation for accession, namely, the "European Integration and International Relations Department" that took over the tasks of a former division. By setting up the new department, the NBR aimed to ensure a more effective and transparent coordination of the adoption of the acquis communautaire in the central bank's specific fields of activity as well as a better monitoring of the commitments assumed by the NBR through the Europe Agreement and the Position Papers for the three above mentioned chapters.

In order to meet the commitments assumed by Romania through the Europe Agreement and the official Position Papers, the NBR had to implement the measures agreed under the following negotiation chapters: Chapter 3 - Free Movement of Services, Chapter 4 - Free Movement of Capital and Chapter 11 - Economic and Monetary Union.

Within the process preparing Romania's accession to the EU, the NBR participated in the elaboration of the sections included in the programming, reporting and negotiation documents elaborated by Romania, according to its tasks and competences, as follows:

- the Pre-accession Economic Program (PEP), which represents the main instrument enabling the candidate countries to participate in the policy coordination procedures prior to accession;
- the Priority Action Plan for EU Accession;
- the Report on the Progress in Preparing the Accession to the European Union, that provides the basis on which the European Commission evaluates Romania's readiness for accession and presents Romania's progress towards accession;
- the documents submitted by Romania to the EU-Romania Association Committee, the EU - Romania Sub-committee II (Internal Market) and the EU-Romania Sub-committee IV (Economic and Monetary Issues, Capital Movement and Statistics). These forums examine regularly the state of play concerning the observance of the commitments assumed by Romania and represent, according to the Europe Agreement, constant contact points between the European Commission and the Romanian institutions involved in the preparation for accession;
- the Position Papers, the Complementary Position Papers and the Supplementary Information Documents (as the case may be) drawn up by Romania in view of accession negotiations on Chapter 3 - Free Movement of Services, Chapter 4 - Free Movement of Capital and Chapter 11 - Economic and Monetary Union.

2. N.B.R. accession to the European System of Central Banks

NBR's preparation for the accession to the European System of Central Banks (ESCB) is a priority for its Board. Immediately after the Accession Treaty was signed, the NBR became actively involved (as an observer) in the activities of all ESCB structures and substructures as well as in the EU structures. Consequently, the cooperation between the ECB and the NBR acquired new proportions by a concrete and pragmatic preparation of the participation in the meetings of the General Council and of the ESCB committees, working groups and task forces. In its capacity of coordinating unit, the European Integration and External Relations Department monitors and coordinates, in a centralized manner, the preparation for the participation in the works of the ESCB structures and substructures.

3. About the National Committee for Financial Stability

Subsequently, on 2006, March 10, the National Bank of Romania, the National Securities Commission and the Insurance Supervisory Commission signed a Memorandum of Understanding for co-operation in order to promote stability of the financial system as a whole and of its components. The Private Pension Scheme Supervisory Commission adhered to the above-mentioned memorandum on 14 December 2006. The Memorandum became invalid as of 16 February, 2009.The EU requirements on financial crisis management ask for an agreement of co-operation between all national financial supervisors, central bank and finance ministry. The major goal of the domestic standing group would be to ensure the exchange of information between the authorities, as well as to prevent, appraise and manage possible difficulties having a systemic impact. In order to comply with these requirements, on 31 July 2007, the Ministry of Finance, the National Bank of Romania, the National Securities Commission, the Insurance Supervisory Commission and the Private Pension Scheme Supervisory Commission signed, a Memorandum of Understanding for cooperation in the field of financial stability and financial crisis management, under which it was established the National Committee for Financial Stability. The Committee consists of the following members:

The Minister of Public Finance,
The Governor of the National Bank of Romania,
The President of the National Securities Commission,
The President of the Insurance Supervisory Commission and
The Chairman of the Private Pension Scheme Supervisory Commission.

The key responsibilities of the National Committee for Financial Stability are to promote a steady and efficient information exchange between the sectorial financial supervisors and the Ministry of Public Finance, and to appraise, prevent and, where appropriate, manage financial crises at individual financial institutions level, financial groups level or financial market as a whole. Mention should be made that co-operation under the Memorandum will be carried out without prejudice to the powers and responsibilities of the signatories, as arising from the legislation governing their activity.

In addition, the National Bank of Romania participates alongside other Member States to strengthen the framework set by the European Union in managing financial crisis. On 1 August 2007, the Governor of the National Bank of Romania signed the Statement of Adherence to the Memorandum of Understanding on high-level principles of co-operation in crisis management situations (signed by the EU countries in 2003) and to the Memorandum of Understanding on co-operation between payment systems overseers and banking supervisors (signed by the EU countries in 2001).

Furthermore, on 1 June 2008, came into force the Memorandum of Understanding between the authorities responsible for financial supervision, central banks, and finance ministries from the European Union members in the field of cross-border financial stability. On behalf of Romania, the Memorandum was signed by the National Bank of Romania, the Ministry of Economy and Finance, the National Securities Commission, the Insurance Supervisory Commission and the Private Pension Scheme Supervisory Commission. This memorandum replaced the Memorandum of Understanding on co-operation between the authorities responsible for financial supervision, central banks, and finance ministries from the European Union in the area of financial crisis management, which was signed in 2005. The new agreement encompasses: common principles for cross-border financial crisis management; a common analytical framework to assess the systemic implications of potential crises, with a view to ensuring a common terminology applicable to cross-border financial crises by all relevant authorities and laying the groundwork for the timely carrying out of the necessary assessments to facilitate the decision-making process in crisis situations; a crisis management practical guide, reflecting a common understanding of the stages and procedures in a cross-border crisis situation.

4. The financial crisis in the banking system

The current financial and economic crisis started at the end of 2008 and appears to be unprecedented in the last century. The economic crisis is expanding in the U.S., Europe and Japan and it is more painful than the economic collapse from 1981-1982. A massive reduction confidence both in the business sector and the consumers, both responding by restricting spending, is now underway. The whole world seems today that changes the course, heading towards a period the state's role will be higher, while the private sector will be lower. This is probably the most dramatic consequence of the current crisis. Many believe that the current financial crisis is rooted in the dramatic drop of housing price in the USA or in falling the credit market for housing. This vision is at least incomplete. The root causes of the financial crisis aredeeper, at macroeconomic and microeconomic level, as wasrecently mentioned by several analysts like Altman, Buiter and Blanchard.

The principal cause of the financial crisis was the abundant liquidity created by the main central banks around the world and the desire of the oil and gas exporting countries to limit currency appreciation. Also , there was a super saturation with savings, generated by the increasing integration into the global economy of some countries like China, South and East Asia in general, with high accumulation rates, but also by the global redistribution of the national wealth and income towards the exporters of goods (oil, natural gas).

The effects of the international financial crisis have been extended over the Romanian economy. However, in terms of direct impact, the banking system was less affected because it was not exposed to toxic assets, and because prudential and administrative measures were taken, in time, by N.B.R. Indirectly, however, especially the international financial crisis and its obvious consequence - recession in developed countries - is expanding on the Romanian economy in several channels. On the commercial channel, it slows down the export increase or even reduces the exports. On financial channel: limited access to external financing, and thus restrict the credit volume, and creates difficulties in private external debt service. On the exchange rate channel, the reduction of the external financing was reflected in the depreciation of the national currency- ron. On the trust channel, there was a withdrawal of investors from the Eastern Europe countries. The effect was the manifestation, on the monetary and foreign exchange market, of panic moments and speculative attacks , as the one from October 2008, from Romania, who made necessary the BNR intervention. In the end, on the national wealth and profit balance channel, it started the deterioration of the population and the company's net assets, as a result of the high share for the loans in foreign currency (related with the national currency depreciation) and as a result for assets price and capital values decreasing from speculative, unsustainable values ("bubble type").

For 2009, NBR tried to stay consequent in its economic growth projection bringing the following arguments:

- lower ratio of exports to GDP compared with other Central and Eastern European states and who nevertheless predicted a positive growth in 2009;
- lower level of financial intermediation (as governmental credit
- proportion of GDP), which implies, ceteris paribus, a smaller contraction of the economy due to the financial channel;
- the fact that Romania has a nearly balanced energy balance, not being neither in major importing energy countries situation (most Central and Eastern European countries), or in the situation of the major energy exporting countries in Eastern continent, which suffers as a result of oil price cut;
- exchange rate flexibility, which allows some exogenous shocks to dissipate over the nominal variables (exchange rate), than to affect real economy;
- large volume of structural funds (including those relating to fiscal years 2007 and 2008) which may be attracted to Romania.

Another set of arguments for continued growth in a positive trend starts from the analysis of the GDP components (consumption, investments and net exports):

- in terms of consumption, fiscal stimulus can not be ignored, injected in the economy in the last months of 2008, equivalent to about 3 percent of GDP, which takes effect in the economy in coming months;
- all on consumption, oil prices reduction is equivalent to a massive incentive for the consumer.

- in terms of investment, much of the private investment that are not done in 2009 will be replaced with public investment, if the approved budget structure will be confirmed in practice;
- on net exports, there is every chance that he make a contribution decreasing negative GDP growth: even though total exports will decrease, total imports will decline further in 2009.

5. N.B.R. strategy during the financial crisis

N.B.R. monetary policy strategy was based on inflation targeting, in close connection with the current financial crisis and the problems that our country face. One option was to adopt inflation targeting as a monetary policy strategy was justified by the need to achieve a sustainable disinflation. Strategy Implementation for inflation targeting was not easy even before the advent of financial crisis and fiscal dominance, massive capital inflows, net debtor position of the NBR to banking system and monetary policy transmission mechanism were combined so that between 2005 and 2007, there were periods in which inflation expectations and currency assessments coexisted. This raised a serious dilemma for the Central Bank. Rate increases needed to bring in line with the inflation target expectations , attract more foreign capital, holding unsustainable the national currency - ron.

With the financial crisis started, some of these conditions disappeared. Today, NBR tend to be net creditor of the banking system and foreign capital inputs have diminished significantly. But this not simplifies the implementation of the monetary policy. Financial crisis increased the volatility on the monetary and foreign exchange markets and tends to slow down the economic activity. On the one hand, external financing reduction and the existence of large external imbalances have triggered the devaluation of the RON, which feeds inflation and make necessary a relatively high interest rates. Moreover, those with debt in euro and other foreign currencies are vulnerable to significant depreciation of the national currency. On the other hand, higher rates interest rates tend to brake economic growth and, moreover, would create costs for those with debts, threatening to destabilize the financial sector. In these circumstances appears the delicate question of compromise between the objectives of the monetary policy: ensuring price stability and financial stability.

Friedman and Phelps showed that there is not long-term compromise between inflation and unemployment. The long-term objective of monetary policy must be achieving a low and stable inflation. It was noted that low and stable inflation helps steady long-term sustainable growth. Low and stable inflation is both an objective and a means of achieving sustainable economic growth (Bernanke, B.S., 2006).

Effectiveness of monetary policy in achieving this goal is limited by the financial stability. One of the basic macroeconomic principles states that frictions in financial plan affect the business cycle. Today, worldwide, this is very obvious. The world's central banks are trying to maintain financial stability and avoid economic recession and depression. Past experience seems to confirm the view that inflation is the primary source of financial instability. Usually, periods of high inflation were those with severe financial instability and crisis in the banking sector or were followed by recession following the adoption of inadequate measures by authorities for moderation of the inflation.

However, recent economic literature shows that low inflation is not a sufficient condition for long-term financial stability (Crockett, A., 2003). In modern economies, low and stable inflation led to a new economic climate that requires rigorously reconsideration of the relationship between price stability and financial stability. Romania's experience shows that financial stability presents a particular importance for price stability. Romania was rightly criticized for delays in disinflation. They were due to insufficient structural reforms. Our country made an average deflation rate of 5.8 percentage points per year over 2000-2007, while maintaining financial system stability. But if NBR would substituted this lack of reform by rises the interest rates, financial firms and households situation would be damaged. And it would be damaged the financial stability of the banking sector. Finally, the very pace of disinflation would have been, probably smaller than the one achieved. Lesson to be learned: on long term, if we fail to maintain financial stability it may lead inflation increase.

NBR policy on foreign exchange intervention was guided by the following philosophy: a high exchange rate volatility is harmful for both objective inflation and financial health of the real sector and of the financial sector . With this philosophy, NBR promoted a floating exchange rate, which allowed it to use free market valences and to discourage speculative behavior in order to avoid excessive appreciation. Consistent implementation of this philosophy has required relatively large purchases for foreign currencies from the market by NBR 2004 - August 2007. At that time, NBR currency acquisition, has been criticized because it not leaves the exchange rate to assess with the market requirements. Today it appears that this policy was adequate.

Conclusions

The developments posted over the last years by the Romanian financial system called for the co-operation among the authorities in charge of licensing, regulating, supervising and controlling the component markets of the financial system in order to ensure the transparency, stability and integrity of the whole system, the compliance with the applicable legal framework, as well as the expansion of the national financial stability framework. The effects of the international financial crisis have been extended over the Romanian economy. However, in terms of direct impact, the Romanian banking system was less affected because it was not exposed to toxic assets, and because prudential and administrative measures were taken, in time, by NBR. Indirectly, the international financial crisis is expanding on the Romanian economy in several channels: on the commercial channel, on financial channel, on the exchange rate channel, on the trust channel – it was a withdrawal of investors from the Eastern

Europe countries and the effect was the manifestation of panic moments and speculative attacks, as the one from October 2008 who made necessary the NBR intervention.

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