SURPASSING THE CRISIS AND RESUMING THE ECONOMIC GROWTH – MAIN OBJECTIVE OF THE MONETARY POLICY PROMOTED BY THE NATIONAL BANK OF ROMANIA

Elena Enache, Camelia Vechiu, Geanina Tudose[*]

Abstract

In 2008, the global financial crisis has generated a feeling of distrust from investors and significantly increased their risk aversion. The size of current account deficit, the relatively high external financing needs and the dependence of the banks on it, the high ratio between loans in foreign currency and deposits in foreign currency made of the Romanian economy, a risky destination for investors. In these conditions, since the end of 2008 and throughout 2009, the government's economic program was focused on reducing the external deficit in both public and private sector, on minimizing the effects of recession, on avoiding a crisis of the exchange rate and on cooling the inflationary pressures.

Keywords: monetary policy, exchange rate, external financing, budget deficit

JEL classification: E30, E58, E65.

1. Introduction

The financial system in Romania has evolved under circumstances powerfully marked by the increasing manifestation of the global economic crisis. At the beginning of the crisis, the Romanian economy had passed through a period of many years of high economic growth, at the same time accompanied by the accumulation of a relatively important foreign deficit and by the increase of the short term foreign debt.

The banking sector has withstood those pressures well due to its dominant position in the financial system. The financial stability was submitted to a new challenge, that is, the volatility of the foreign financing.

The consequences of the deterioration of the foreign economic environment manifested themselves with a small delay upon the Romanian economy, with negative effects upon the credit portfolio, with profound implications upon the crediting risk.

Under the circumstances, The National Bank of Romania, as a surveillance authority, has reacted by promptly assuring liquidities, monitoring the banks more strictly, taking measures to improve the framework of prudential adjusting and signing some financing agreements with the International Monetary Fund and The European Union.

[*] Elena Enache, Camelia Vechiu, Geanina Tudose are at the "Constantin Brâncoveanu" University, Piteşti. E-mail: _enache2005@yahoo.com, cameliavechiu@yahoo.com, geanina1c@yahoo.com.

2. Economic Evolutions Registered in 2008

In 2008, the global economy decreased his growing rhythm due to the expansion of the effects of the financial crisis and its transformation in an economic crisis. The global production increased by 2%, comparatively to 3.8% in 2007. Halfway through September, the global economic conditions deteriorated rapidly, against the background of the diminishing of the consumers' trust and of the corporatist sector, the restrictions regarding the global crediting conditions and the decrease in the prices of the houses and the stocks value.

The influence of the financial crisis upon the real activity resided in a moderation of the global trade, which registered an increase of 4.4% in 2008, comparatively to 6.3% in 2007.

The Euro zone[1] has known a significant economic decrease from 2.7% in 2007 to 0.8% in 2008 due to the worsening of the economic conditions starting with September, together with the intensification of the tensions on the financial market. The reduction of the economic growth has come from the majority of the components of the Gross Domestic Product. The domestic demand has been considerably tempered due to the reduction of the real incomes of the population's house-holds under the circumstances of the growth of the international prices of merchandises in the first half of the year. To this one can add the decline of the residential investments (affected by the fall of the real estate markets) and of the productive investments (because of the harshening of the financing conditions). The foreign demand was limited to a decrease of the economic growth in both the advanced economies and the emergent ones. The exports of goods and services of the Euro zone have tempered the increase from 5.9% in 2007 to 1.0% in 2008 and the imports of goods and services from 5.8% to 1.0%, as a reaction to the evolution of the domestic demand. From a sector perspective, the decrease of the economic activity was reflected in all domains, especially in the manufacturing industry – determined by the decrease of the foreign demand, by the rapid diminishing of the order stock and by the reduction of activity in the auto industry.

The conditions on the work market from the Euro zone have deteriorated in 2008 too, after 2 years of substantial improvements. The rate of unemployment which followed a descendent trend starting with 2005, began to increase from the second trimester, reaching to 8.2% from 7.3% at the end of the precedent year. The budgetary deficit of the Euro zone was majored to 1.9% from the Gross Domestic Product, from 0.7 in 2007, against the background of the evolution of the financial crisis and the deterioration of the macroeconomic environment. The rate of the public debt in the Euro zone increased by 3.3% in 2008 in comparison with the previous year to 69.3% from the Gross Domestic Product, as an effect of the

[1] The states referred to are the 15 members of the European Union situated in the Euro zone at the end of 2008: Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, Malta, Holland, Portugal, Spain and Slovenia.

government's interventions to stabilize the financial system.

As far as the countries members of the European Union **outside the Euro zone**[2] are concerned, these have witnessed a decrease of the economic growth in 2008 to 1.3% from 3.6% in 2007. In general, the domestic demand of these countries was affected by the deterioration of the foreign environment and the intensification of the financial crisis which have weakened the trust of both the consumers and the representatives of the business environment. The highest growth rates, of over 6.0% were realized by Romania, Bulgaria and Slovakia, while Latvia, Estonia, Denmark and Sweden have registered negative rates. In 2008 the annual average rate of inflation has increased in most of the country's regions (with the exception of Hungary), against the background of an ascendant trend registered in the first half of the year in the majority of countries. On the average, the countries members of the European Union outside the Euro zone have recorded an annual inflation rate of 4.7% in comparison with 2.9% in 2007. The highest rates of inflation, between 10.6% and 15.3%, have been registered in the Baltic states and in Bulgaria, followed by Denmark, Poland, Slovakia, Sweden and Great Britain (with 3.3-3.4%). Beside the main cause of the evolution of inflation – the increase of the global prices to food and energy, one can identify factors with a differentiating action from one country to another, such as the depreciation of the national currencies, the increase in the administered prices and the indirect taxes.

In the same context, the fiscality evolution has continued to be heterogenous in 2008, the whole region recording an average number of the budgetary deficit of the Gross Domestic Product of 3.3%, comparatively to 1.5% in 2007. Three of the European Union states outside the Euro zone (Bulgaria, Denmark and Sweden) have registered budget savings and the other nine have ended the fiscal year with a deficit.

In 2008, the global financial crisis generated a feeling of distrust from the part of the Romanian investors too and their adversity to risk increased substantially. The dimension of the deficit of current account, the relatively high demand of foreign financing and the banks' dependence on this type of financing, the high ration between currency credits and currency deposits have turned Romania's economy into a risky destination for investors.

Under the circumstances, from the end of 2008 and throughout 2009, the government's economic agenda was centered on the reduction of the foreign deficit both in the public and the private sectors, on minimizing the effects of recession, on avoiding a crisis regarding the exchange rate and on tempering the inflation pressures. The same requirements are to be found in 2010 too all the more so as our country has obtained important borrowings under severe circumstances.

[2] The states referred to are the 12 members of the European Union situated outside the Euro zone at the end of 2008: Bulgaria, The Check Republic, Estonia, Latvia, Lithuania, Great Britain, Poland, Romania, Slovakia, Sweden and Hungary.

3. The Deficit of Current Account and its Financing

The accentuation of deficit of current account brings forward the possibility of its important adjustment, a thing which began to materialize at the end of 2008.

The correction of the deficit of current account could be done through two important challenges: (1) the deterioration of the financial situation of the companies, especially of those with an import-export activity and (2) the risk of the adjustment taking place especially through the diminishing of the investments.

As far as the first challenge is concerned the companies of foreign trade have felt the effects of the diminishing of the activity overseas, including through the deterioration of the paying capacity of the obligations to the financiers.

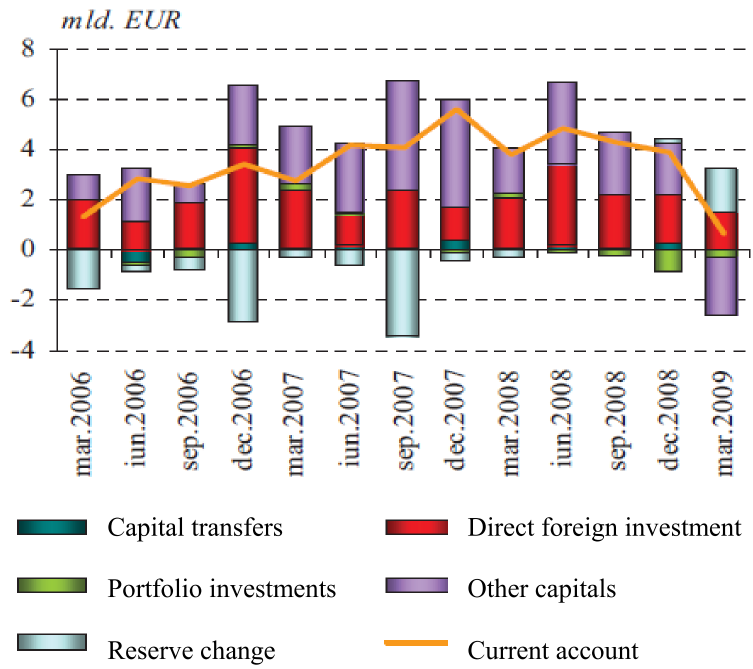
The manufacturers of intermediary goods engaged in the activity of import and export have suffered a rapid deterioration of the economic activity. The reduction of the foreign demand has lead to an important decrease of the exports of these companies contributing by 90% to the correction of the exports from November 2008 to February 2009. The financial stability of these firms was deteriorated too. The quality of the domestic bank credit witnessed the most rapid and significant worsening (the rate of the arrears has increased more than three times in a few months from 2% in June 2008 to 7.5% in March 2009). The implications on the Romanian bank sector are relatively limited because these companies own 6% from the total of given credits. On the other hand, the foreign creditors could be more affected because 85% of the financial resources of these firms come from abroad.

The trade companies with an activity based exclusively on import (which reach 30% of the imports and represent over 50% from the number of importing firms) have been confronted with a diminishing of the profitability rate ever since the first half of 2008 (from 15.6% in June 2007 to 10.3% in June 2008). The business turnover started adjusting considerably and decreasing by 40% in the case of the cars trading firms (Ist Trimester 2009 compared to Ist Trimester 2008). The companies based exclusively on imports have been mainly financed by means of domestic currency credits which represent over 50% of the total financing from local and foreign creditors.

Although the turnover of the companies based exclusively on import has diminished, the negative impact did not affect the honoring of the duty service too. The rate of the arrears has increased at a slower pace than the average one in economy; the fact remains that the level was already low (0.6%, March 2009). The more difficult access to financing, especially to commercial credits, continued to be a challenge for the importers. Short term foreign commercial credits decreased by over 73% (respectively by 2.7 billion Euros, September 2008 - March 2009).

As for the second challenge which the adjustment of the deficit of current account might trigger, we could say that all economic sectors (companies, population and authorities) have accumulated financing deficits in the last years, deficits which have been replaced by foreign saving. In the context of the crisis this could not be applied to Romania. The portfolio investments and other capitals were the first to retire at the end of 2008 (Chart 1).

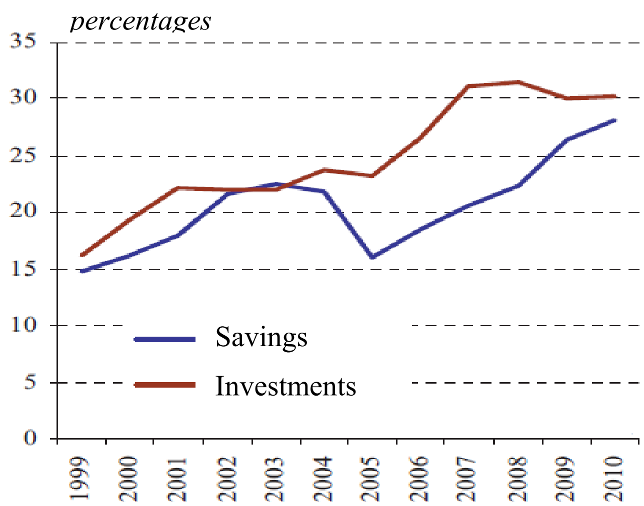
Chart no. 1. The Capital Cost and the Deficit of Current Account (unadjusted trimester data)



Source: NBR

The expectations are that the adjustment of the current account to be attained by the capping of the investments rate and the stimulation of the domestic savings (Chart 2). As a matter of fact, the increasing investments rate drastically decreased in the IVth Trimester 2008 (to 2.3%, the IVth Trimester 2008 compared to the IVth Trimester 2007).

Chart no. 2. The Savings and Investments Rate (share in the Domestic Gross Product)



Note: The broken line represents the estimated values, and the values for 2009 and 2010 are foreseen.

Source: Eurostat

The investments could be financed by means of both domestic and foreign saving, but the excessive use of foreign financing is not sustainable on the long term. The balance between the domestic and foreign saving could be altered by many factors, among which the massive foreign capital inflow, essential since it discourages the domestic savings. Romania's experience is mixed. During the period of massive capital inflow, the savings rate increased by 15.3% of the Domestic Gross Product in 2004 to 19.1% of the Domestic Gross Product in 2008. Nevertheless, the savings rates were relatively small if we compare them to the average global savings rate which oscillated between 21 and 25% of the World Domestic Gross Product since 1980 until today.

A survey of the countries with the highest convergence rate shows that the accelerated process of the savings increase is preceded by an investment period strongly financed by foreign savings. The rise in deposit interest represents a part of the present monetary policy in Romania. Since the deposit accounts carry the income tax and the current accounts do not, the banks have oriented themselves towards methods to attract the clients, that is: current accounts with interests higher than those in the case of deposits.

As for the companies, the reduction of the profit perspectives against the background of diminishing the domestic and foreign demand could have mixed effects upon savings. The firms beneficiating of a solid financial position could delay the investments decisions and save the resources thus released. The companies indebted with investments projects in course will try to finalize or freeze them in conformity with their financing capacity. The bank savings of the companies was more volatile and the expectations are in the sense of the increase of this volatility if the difficulties in getting liquidities will be amplified.

Against this background, in 2008, the deficit of current account (16 897 million Euros) was covered in proportion of 58.4% through direct investments and capital transfers and the difference by means of other capital investments.

Table no. 1. Financing the Deficit of Current Account

Millions EURO

	2007	2008
Deficit financing	16 677	16 897
Net capital transfers	704	602
Net direct investments	7 047	9 272
out of which:		
- direct investments of non residents	7 251	9 085
⇨ capital participation	2 220	2 992
⇨ reinvested profit	1 327	1 585
⇨ intergroup credits	3 704	4 508
Net portfolio investments	482	-834
Other capital investments	12 949	7 819
- long, medium term credits	5 228	6 130
⇨ entries	11 113	12 497
⇨ returns	5 885	6 367
- net long and medium term credits	156	48
- net short term credits	604	-1 025
- others*	6 961	2 666
NBR reserve assets (“-“shows growth)	-4 505	38

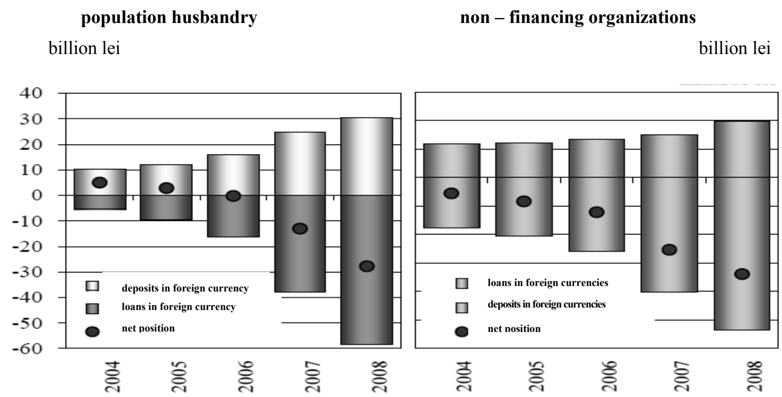
* includes the following net positions: intangible / non-financial assets, financial derivatives, cash and deposits, other assets, other liabilities, errors and omissions

The net foreign financing out of borrowings and short term and medium term credits totalized 6 130 million Euros, growing with 17.3% compared to 2007, an evolution determined by the increase of the credits contracted by the real economy, the public administration and the bank sector. In 2008 there was a net outflow from borrowings and short term credits of 1 025 million Euros, in comparison with net influxes of 604 million Euros in the previous year.

4. The Policy of the Exchange Rate and its Implications upon the Financial Stability

Supported by the global financial crisis, the evolution of the Leu rate has raised major problems. As in the period 2005-2006, the currency incomings have overestimated the Romanian national currency way above the level indicated by the fundamental factors of the exchange rate, the reduction of the foreign financing and the incertitude have afterwards determined an unjustified depreciation of the Romanian Leu. In spite of the high acquisition of currency in the anterior period, The National Bank of Romania has managed only to attenuate the unsustainable appreciation of the Leu, although the challenges in the bank system were very big. In the period 2004-2008, the continuous dynamics of the currency credits would have created negative effects at the level of the bank system under the circumstances of a rapid and excessive depreciation of the Leu (Chart 3).

Chart no. 3. Deposits and loans in foreign currencies



Source: National Bank of Romania

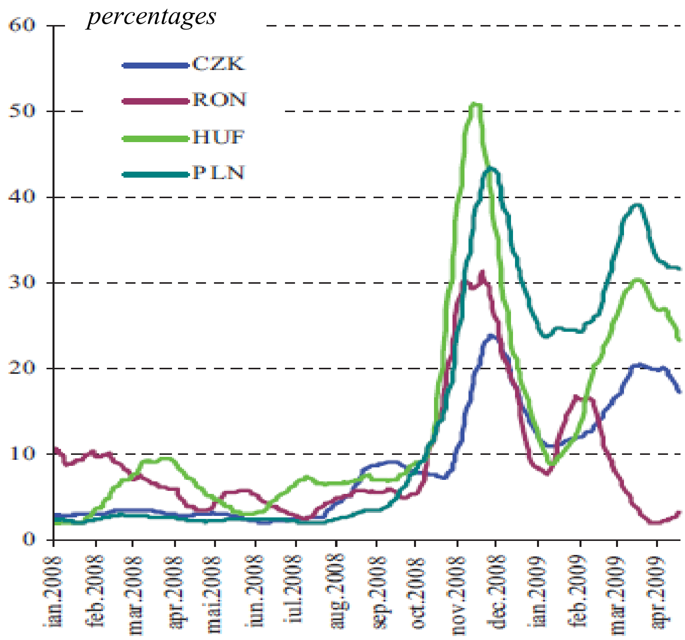
Between October 2008 and April 2009, the Leu depreciated by 12% in comparison with the Euro (and by 21% in comparison with the Dollar), while the volatility exceeded 30% (Chart 4). These powerful contrasts between the two periods of 2008 could not have been anticipated, considerably affecting the reaction of the members of the economic environment and the business plans.

The factors which contributed to this interruption in the dynamic evolution of the exchange rate were: **global** – a high incertitude regarding the situation of the global monetary system and the possible repercussions upon the emergent countries and **specific** – the worsening of Romania's qualification credit (of sub-investment) by two rating agencies (Fitch Ratings and Moody's).

As one can notice from Chart 4, the volatility of the national currency, although in a significant progress, has remained under the level of other currencies in the region, and at present it registers some of the lowest values.

In this context, the policy of the central bank concerning the **interventions on the foreign exchange market** was oriented by the idea that a higher volatility of the exchange rate is detrimental to both the objective regarding inflation and the solidity of the real and financial sectors. Even more as the Romanian economy considered to be of small dimensions and with a high degree of openness is permanently exposed to the danger of some unfavourable capital movements at the level of the financial and especially the foreign exchange market.

Chart no. 4. The Conditioned Volatility of the Main Currencies EEC compared to the Euro (percentage, average on a period of 20 days)



Source: NBR calculations, Bloomberg

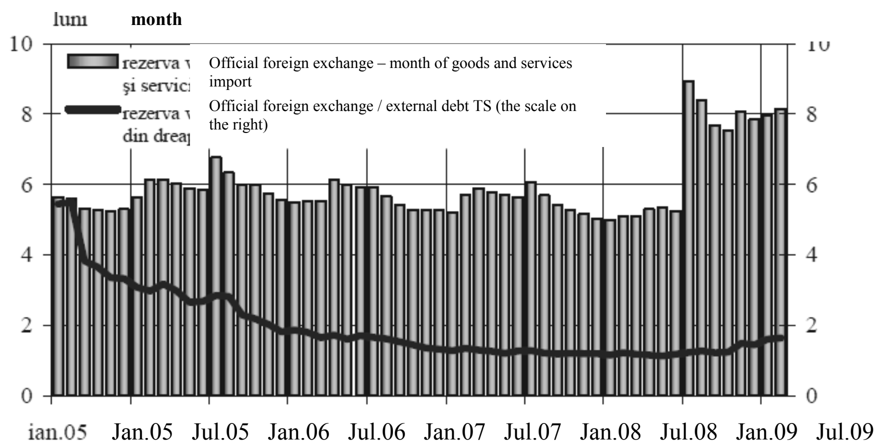
The option of the National Bank of Romania to intervene on the foreign exchange market was not singular in Central and Eastern Europe, the system of managed floating of the national currency being practiced by other Central Banks too, their foreign exchange interventions being amplified after the beginning of the global financial crisis. Under the circumstances, the National Banks from the Check Republic, Poland and Hungary, which have a flexible foreign exchange system have pronounced themselves against the excessive depreciation of the local currencies which could create destabilizing movements, promising, in their turn, to intervene in order to combat the phenomenon.

These interventions of the National Bank of Romania on the foreign exchange market have been aimed at the excessive depreciation of the national currency and the depreciation level was correlated to the progress registered by the adjustment of the current account.

These foreign exchange interventions were adjusted according to the **foreign exchange reserves** too. The foreign exchange reserves constituted due to the interventions from the period of overrating (2004-2008) and the sums received as a result of the financing agreement with the International Monetary Fund, the European Union and other international financial institutions have offered the central bank the possibility to support the national currency. Romania's National Bank aims at both the absolute value of the foreign exchange reserves and the derived indicators, respectively the foreign exchange reserve expressed in months of imports of goods and services and the report between the foreign exchange reserve and the short term foreign debt.

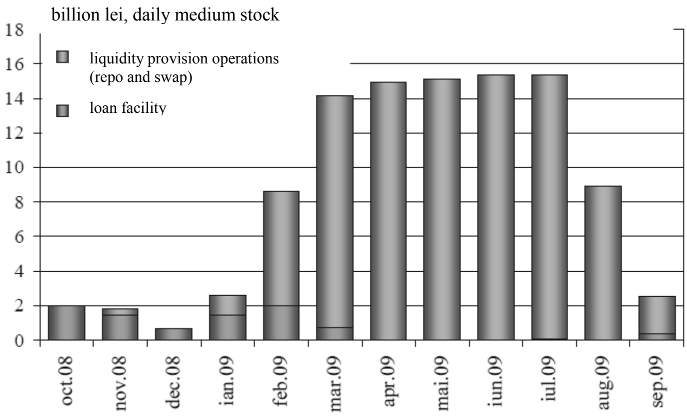
The strategy of the National Bank of Romania to reduce the effects of the crisis has been aimed at both the correlated **amount and the moment of the foreign exchange interventions** and **the liquidities control on the monetary market**, under the circumstances in which the financing of the budgetary deficit was mainly done through the usage of the sums received from the International Monetary Fund and the European Union. In 2009, the National Bank of Romania supplied liquidities to the banks after it had been a net debtor towards the bank system due to the liquidity surplus generated by the massive capital inflow in the Romanian economy in the period 2004-2008. The foreign exchange intervention generated by the National Bank of Romania had as a purpose the attempt to avoid the reversal of its position as a creditor towards the bank system, a situation which could have caused problems for the implementation of the monetary policy (Chart 6).

Chart no. 5. Foreign exchange reserves at NBR: derivative indicatives



Source: National Bank of Romania, National Institute of Statistics

Chart no. 6. Liquidity provision operations



Source: National Bank of Romania

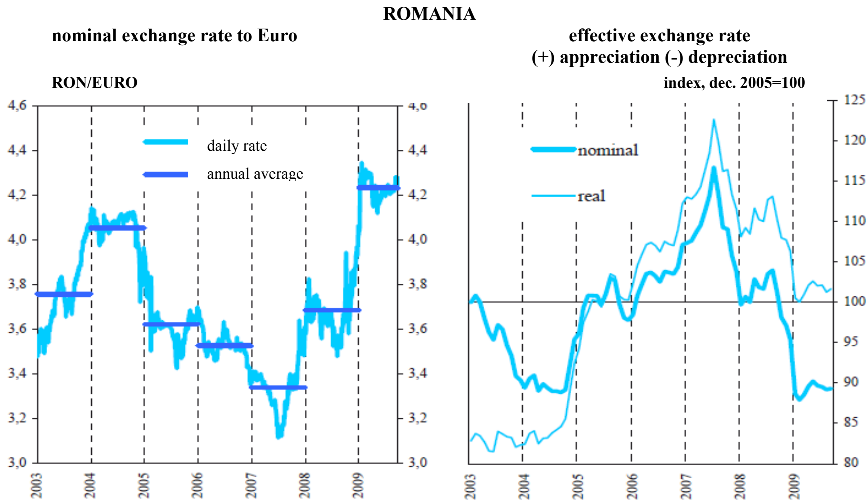
In this context, we can say that the foreign exchange interventions were necessary not only to maintain the exchange rate but also to properly manage the liquidities on the monetary market (Chart 7).

Diminishing the depreciation of the Romanian Leu and implicitly the inflation pressures which appear by means of the exchange rate together with the fiscal consolidation efforts have allowed the National Bank to pass on to the **cautious relief of the monetary policy** ever since the beginning of 2010. The National Bank has taken the following **measures**: decreasing the monetary policy interest rate to 6.5%[3] per year, maintaining the present levels of the minimum reserves rates applied to both domestic and foreign currency liabilities of the crediting institutions (15%, respectively 25%), firm administrating of liquidities in the bank system in order to consolidate the signals sent by the monetary policy.

The monetary policy interest is a targeted interest which leads the fashion on the market, but every national bank has its own specific set of interest and other instruments to establish the monetary policy and this set of instruments depends upon the conditions specific to every market (the repo rate, the deposits and reserves interest, the short term interest on the interbank market).

[3] During the meeting on 29 March 2010, the Administrative Board of Romania's National Bank decided to reduce the monetary policy interest rate to 6.5% per year.

Chart no. 7



Source: BCE, BRI

In the case of Romania, the National Bank has adopted a smaller monetary policy interest meant to attenuate its dispute with the commercial banks regarding the crediting of the real economy in the sense of resuming the crediting process.

From the perspective of the commercial banks, they try to reduce the risks through a more rigorous client selection, even if statistics were not exactly encouraging in this respect. The share of non-productive credits (listed as Losses because the recovery chances are minimal) in the credit portfolios of the banks significantly increased to over 9% at the end of 2009 compared to 3.5% in 2008. The credits listed under Losses and Uncertain represent 12.3% of the credits given by the bank institutions compared to 5% in 2008 and all the credits listed under Substandard, Uncertain and Losses reached 20.8% compared to 10.5%.

5. The Agreements with the International Monetary Fund and the European Union - a Support for the Consolidation of the Macroeconomic Balance and the Financial System

Under the circumstances of a slow recovery from the crisis, the loan agreements negotiated with the International Monetary Fund and the European Union and with the Global Bank and other international financial institutions purport to financially support the Government's economic program of macroeconomic and financial consolidation. The agreement with the International Monetary Fund and the European Union indirectly aims at an ordered adjustment of the foreign deficit with direct positive effects upon the exchange rate and implicitly upon the financial position of the companies, the population and the bank sector. These agreements have a clear preventive character ensuring a higher degree of credibility to the

Government's economic program as well as the financial resources for the correction of the macroeconomic lack of balance.

Taking into consideration the general positive evaluation regarding the bank sector, the agreements with the International Monetary Fund and the European Union aim at ensuring the solvency of the Romanian banks in order to have a safety margin in front of some possible new pressures generated by the global financial crisis. For this reason, the solvency of the banks will be of at least 10% during the agreement (2009-2010) compared to 8% as it is stipulated.

The agreements with the International Monetary Fund and the European Union stipulate other temporary (2009-2010) or permanent measures too. The banks which commit themselves to maintain the exposure on Romania during the program and raise their own funds to ensure a solvency above 10% will no longer be expected to have minimum reserves for the subordinate loans coming from the action holders or the international financial institutions.

At present, Romania can not get a smaller interest than that demanded by the International Monetary Fund (3.5% per year) or by the European Commission (3.14 per year) from the foreign banks abroad. The Romanian Government's most recent loan from the local banks of over 2 billion Lei was contracted at an interest of 8.86% while for the loan of 1.42 billion Euros contracted in November 2009 the Government committed itself to pay an interest of 4.25% per year. Following in time the evolution of the loans contracted by the Romanian Government since the beginning of the crisis we note: in 2009 the Government borrowed no less then 18 billion Euros from the banks, five times more than in 2008. In 2010 the Government will have to borrow another 8.3 billion Euros in order to cover the budgetary deficit of 5.9% from the Gross Domestic Product, respectively of the difference between the Government's expenses and incomes.

The credibility acquired due to the influence of the European Commission and the International Monetary Fund ensured the financing of the Romanian economy, a financing which has reflected positively in a few directions: relatively hire investments comparatively to the situation in which the agreements would not have been closed; the attenuation of the Leu exchange rate depreciation in comparison with Euro and other currencies. Signing the Vienna Treaty by means of which the banks have committed themselves to renew the financing lines and preserve the capital rates at satisfactory levels.

6. Conclusion

Resuming the capital inflow in 2010 could mean increasing the amount of money in economy which has to be sterilized by the National Bank of Romania. Otherwise, if the capital inflow could not be sufficiently reduced, then the National Bank of Romania could be forced to increase the international reserves by means of purchases on the interbank market. At the same time, this process of resuming the capital inflow determines new requests of coordination between the monetary policy and the fiscal policy. In order to attenuate the inflation pressures, in 2010 the budgetary deficit should be diminished. Otherwise, the monetary policy would have to compensate the differences and adopt the necessary measures, among which the one referring to the dimension of the monetary interest rates.

Due to the process of foreign financing and capital inflow resuming, the adoption of political decisions in conformity with the European measures of pump priming represents a positive sign since the IIIrd trimester of 2010.

References

Isărescu, Mugur. 2001. *Reflecţii economice*. Bucureşti: Academia Română – Centrul Român de Economie Comparată şi consensuală.

Pocan, Ioana, Mihaela. 2008. *Politici monetare şi piaţa de capital din România*. Bucureşti. Editura Economică.

*** Business Magazin nr. 262, 263/2010;

*** Piaţa Financiară nr. 10, 11/2009;

*** Institutul Naţional de Statistică;

*** www.bnro.ro/Publicatii-ocazionale-3231.aspx;

*** www.bnro.ro/Publicaţii-periodice–Raportul stabilităţii financiare (2009)

*** www.bnr.ro Raport anual 2008

*** www.bnr.ro Balanţa de plăţi 2008

*** www.zf.ro