

# EXTERNAL BORROWING – A SOLUTION IN OVERCOMING THE CURRENT ECONOMIC CRISIS?

Maria Pascal (căș. Andriescu)

“Alexandru Ioan Cuza” University of Iași

**Abstract:** *The government decisions to call, in recent years, more and more reimbursable financing gave birth to fierce reactions among politicians and economy specialists. The present article aims to analyze how the external borrowing may be a solution to overcome the difficult situation where we are.*

**Keywords:** government, financing, external borrowing, economic crisis

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## 1. ECONOMIC DEPRESSION

Signs of global economic crisis became visible in February 2007 in the U.S. market in real estate. Bad mortgage loans were to lead to bankruptcy of major U.S. banking institutions. On September 15<sup>th</sup> 2008, Lehman Brothers collapse occurs. Lehman Brothers was one of the largest investment banks worldwide and its bankruptcy was the biggest bankruptcy in U.S. history. It fell as an American icon. Institution debts totalled a record amount of 613 billion dollars.

On October 24<sup>th</sup> the same year, Iceland asks International Monetary Fund an official aid to 2 billion dollars to deal with the crisis which destroys the banking system. At that time, Ukraine also requested a loan of 16.5 billion dollars.

Meanwhile, the euro reached its lowest level against the dollar in April 2006. IMF, EU and World Bank have granted 20 billion loan to Hungary.

## 2. CRISIS AT THE GATES OF ROMANIA

In November 2008, Moody's, a ratings, research and risk analysis company announces that Romania could enter into recession in 2009. Also now enters into force central bank decision to reduce minimum obligatory reserve to 18% for RON.

Even though the most opinion leaders in Romania believe that our country will be bypassed by the economic crisis hurricane, in reality crisis not only eluded us but it also hit the most.

In these circumstances, the Romanian Government decided to seek external funding package that includes funds amounting to 12.95 billion EUR from IMF, 5 billion EUR of the EU, one billion Euros from World Bank, as well as one billion Euros from the European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB) and the International Finance Corporation (IFC).

### 3. FUNDS ALLOCATION

Agreement with the IMF concluded in May 2009 is of the stand-by type. Romania opened the credit line amounting to 12.95 billion Euros without being obliged to draw the whole amount. Romania has used since 1972 IMF resources in eleven occasions as financial support for the government's economic programs.

About the IMF loan Mugur Isarescu said that *"loan must not be received as a safety belt, but as a complex, a bridge which gives us time to do what we didn't do at the proper time: structural reforms."*

At the date of contracting financing package the destination of the funds was traced as follows:

- 12.95 billion EUR from IMF to the central bank (NBR) to support the country's foreign reserves;
- 5.00 billion EUR from the European Union to support investment projects;
- 2.00 billion EUR from World Bank and European Bank for Reconstruction and Development to support the banking system.

So far, Romania has drawn funding from this package as follows:

- 9.2 billion Euros from F.M.I.;
- 2.5 billion Euros from U.E.;
- 300 million Euros from the World Bank.

Destination of funds held was as follows: 7.10 billion Euros to strengthen central bank reserves and 4.90 billion Euros to cover the state budget deficit.

#### 4. ROMANIA'S PUBLIC DEBT VALUE

In 1980 due to unpaid outstanding loans, Romania reaches in partial cessation of payments which led to blocking by the creditors of the accounts opened in other countries.

At that time, Romania's foreign debt amounted to 13.9 billion \$ level without taking into account the 6 million \$ representing the interest payment period. In these circumstances, the only way to follow was the negotiations with International Monetary Fund, World Bank, Paris and London Clubs for external debt rescheduling.

Following negotiations with the London Club, Romania succeeded in signing agreements for the rescheduling of the foreign debt totalling U.S. \$ 3.8 billion from Western creditor banks. Also, by Paris Club was able to negotiate on two occasions rescheduling debt worth 536 million dollars (Călin, p.33).

Unfortunately, rescheduling was neither full nor under favourable terms for Romania but quite the contrary. This reality has led the Ceausist regime to start a harsh policy of decreasing indebtedness by foreign debt repayment in advance.

This resulted in (Calin, 2006, p. 33):

- massive reduction of imports in order to eliminate the outwards foreign currency payments.

Following this decision was low tech of the Romanian economy and production of the uncompetitive products for the foreign markets. There were gradually reduced down to total elimination food imports. Foods have been streamlined making a drastic economy on any plan.

- massive increase in exports of agricultural products and other raw materials;
- increase export of military production for Arab countries with which the regime maintained close relations of friendship.

Finally, the communist regime objective of extinguishing debt has been reached. The price paid meant the fall of the communist political system by Revolution in December 1989.

Whether in the early '90s, Romania's public debt was almost nonexistent, at present, according to the information posted on the official website of the Public Finance Ministry, data are: total public debt at 31<sup>st</sup> December 2009, reached the level of 148,055.1 million lei (30.14% of GDP), up 35% from a year earlier. Of the total public debt, government debt is 92.94% and the remaining 7.06% is the local public debt.

Romania recorded at the end of 2009 a budget deficit of 36,400.60 million, representing 7.20% of GDP. It should be made an indication that of total expenditure in 2009, current expenditure is 89.28% while investments cost only 12.00%.

## **5. IS IT GOOD OR NOT TO BORROW EXTERNALLY?**

Negotiations lead by Romania with international forums for accessing external loan instalments born strong reactions among people from the political environment and among economy specialists.

Rightly the debates have made the ordinary citizens to wonder which is the direction where Romania leads to?

In economic terms the external together with the internal loans contracted by the central government and local authorities forms the Romania public debt.

The measure of the loan must be examined both in terms of responsibility and positive economic effects and in terms of potentially adverse effects.

Also, a decision of such a nature shall be accompanied by a package of actions that are meant to pursue the use of the borrowed money in the productive segments of the economy and not for consumption.

The main argument for the state to use external borrowing is that the interest rates offered by financial institutions like the IMF are about to half comparing to the interests offered for a loan contracted from the domestic market.

However in case of an external borrowing it increases our dependence on external bodies and the internal financial policy needs to meet strict conditions imposed by lenders.

### **5.1 "Investing" money in salaries and pensions**

Money from loans are interest bearing. Their allocation to pay salaries and pensions guarantee a quick consumption of financial resources without the possibility of its regeneration.

This "investment" to satisfy a current and immediate need is catalogued in unison by the experts as an irresponsible allocation.

### **5.2 Investment in creating new jobs**

At a time of financial crisis, the government must continue to support state investments begun in the prior years and to generate new investment projects that will ensure stability and recovery of the economic engine.

### **5.3 Money use to stabilize the exchange rate**

National Bank is now depository of a significant percentage from the borrowed money in 2009. NBR may use amounts of its reserves to positively influence the exchange rate by realising liquidity to the market or not.

A pronounced imbalance of the RON-euro in the RON depreciation purpose would create significant damage to importers but would encourage exporters.

In a weak RON case importers would need more RON to buy in Euros the same amount of products while exporters would earn more RON for the same amount of exported goods.

Banking, for example, could become extremely demanding for customers who have signed a credit agreement in Euros at a lower cost of the euro and now for the same rate they must pay more RON for the Euros conversion.

## **6. POLITICAL CRISIS SUPERIMPOSED ON THE ECONOMIC CRISIS. IMPACT**

An economic crisis obliges the state to take important decisions in a shortest possible time.

In Romania, however, economic crisis overlapped with the political crisis. Political instability affects economic credibility with all the ensuing repercussions. Existing disagreements between local political forces make legislative measures to be characterized by delays.

A major risk of this instability is the delay in achieving the objectives contained in the memorandum with the IMF.

## **7. CONCLUSIONS**

One area of broad interest to countries that maintain a large portfolio of public titles is the public debt.

Although there are recommendations from international institutions to establish guidelines for public debt management, problems with contracting policies and public debt management should remain a matter of domestic policy. Depending on the degree of development and maturity of financial markets, of the interests of time, but especially for those of medium and long term, each country must establish and promote its own policy.

Public debt managers in times of economic policy elaboration should take into account the particular interests of the country, the economic situation on the international market, the world market trends and, not least, do not forget the experience of countries which have experienced multiple problems in contracting and public debt management.

Romanian State has not many options available to cover in a very short time a significant budget deficit which is amplified by the global economic crisis.

If the state decided to cover deficits by printing money without coverage, the result would be rising inflation and decreasing purchasing power of ordinary citizens. In social plan the decline of purchasing power would lead to major social movements.

If they would raise all taxes and other contributions, the state would still not be able to raise a significant amount of money in a short time. In addition, this measure would be likely to encourage the black economy.

I conclude by saying that the external loan is now the cheapest financial resource but we will finance the deficits in vain unless we will not stop immediately the unproductive expenditure.

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