

THE HIGHER CREDIT RYTHM REPRESENTS: FINANCIAL DEVELOPMENT OR ANXIETY REASONS ?

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Abstract: The present paper analyses, the causes of nongovernmental credit rapid expansion in Romania, to quantify its implications over financial macroeconomic stability and to identify the solutions of which the authorities dispose, for the counteraction of negative effects concerning this phenomenon.

Financial transitioning is based mainly on the financial deepening and is well conducted with a priority in the moment of refueling the turbulences on the extern markets.

Key words: rapid credit growth, financial and macroeconomic stability, credit risk, prudential supervisory

Introduction

Through the past years, the Eastern and Central European countries, respectively Romania, have registered a rapid growth of the nongovernmental credit. The credit rapid expansion, determined serious preoccupations regarding the analysis of the causes and effects related to this event especially when there have been pointed out financial turbulences on the extern markets..

Related to the countries from the ex-communism sector, the most important component of the financial market is represented by the banking sector, which assures the financial sources for the economy, mainly after the elimination of restrictions on capital accounts²⁴⁶.

Numerous serious and trustworthy working papers²⁴⁷ warn us that a boom credit may conduct to major macroeconomic unbalances and to worst situations in the banking sector, also to macroeconomic and financial crises.

Thus, the authorities must maintain an equilibrium between the macroeconomic stability and the financial one and the credit expansion . If this evolution is determined by a financial development or if it represents a dangerous expansion for the economy.

In the first situation, the growth of the credit cannot affect, the macroeconomic evolutions being mostly compensated through the growth for currency request. The credit expansion is mainly determined by the growth for credit request, which happens as a result of the optimistic anticipations regarding the income dynamic and taking into consideration the process of integration in the Euro – zone.

Also, the growth of the credit offers is determined by the presence on the Romanian banking market and on the Central and Eastern European banking sector of foreign banks and institutions, which are interested in accomplishing important market ratings by promoting attractive packages.

Incoming capitals have big advantages for the banking sector. The presence of this foreign operators on the banking market, determines a more pleasant and stable financial environment, a bettering of the corporate governance and for the capacity of managing the risks.

It can be explained that the credit expansion partially represents an amplification of the process of financial intermediation, based on the convergence process of catching up, which exists between the ex-communist countries and the western countries, related to the level of development of the financial superstructures.²⁴⁸

However, the credit growth has numerous negative effects which can affect the normal functioning of the economy. It is reasonable to consider, that the credit rapid expansion can outcome the bank's capacity to

²⁴⁶ The banks own 85 percent of all the financial actives, according to Backe, Egert and Zumer (2006)

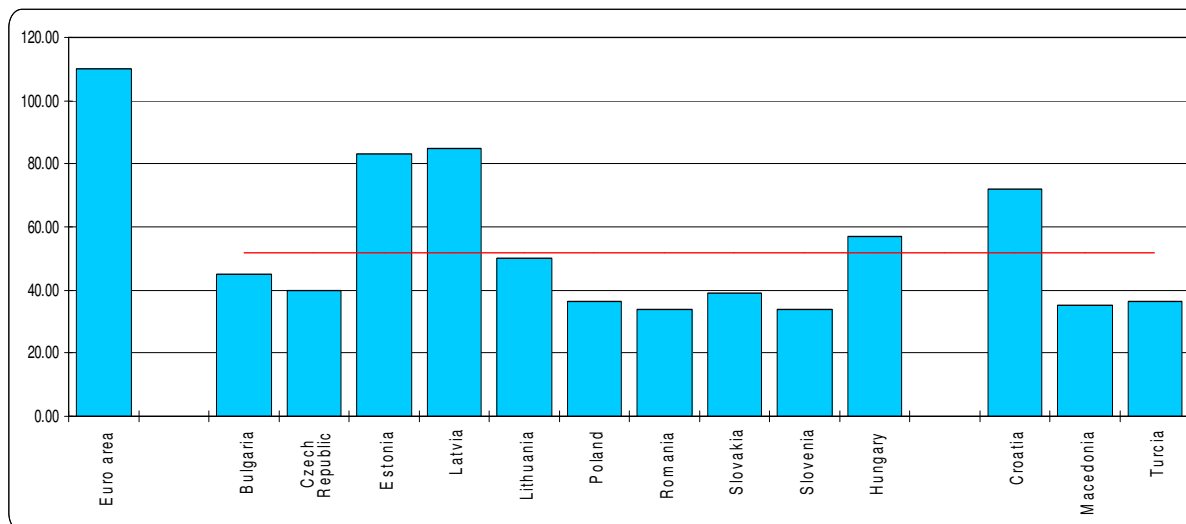
²⁴⁷ Kaminsky, G, Saul Lizondo and Carmen Reinhart, “*Leading Indicators of Currency Criss*”, IMF, Staff Paper vol.45, No.1, Neagu F, A.Mărgărit, M. Copaciu, I. Răcaru, R.Mircea, A. Andrassy, *Non government credit in Romania: perspectives and implications*, Study Books NBR, No.15, 2006

²⁴⁸ *Assessing and Managing Rapid Credit Growth and the Role of Supervisory and Prudential Policies*, IMF Working Paper 05/151/2005, p.10

evaluate the risks, which can lead to a growth in information asymmetry, resulting a higher level of repayment. All in all, in this zone, the model which banks use to make business hasn't developed from the basic type "initiate and hold" in the balance sheet, to a more sophisticated type, "initiate and distribute", outside the balance sheet, and the region hasn't been confronted with the problem of "frenetic security".

The Evolution of nongovernmental credit

The higher credit rhythm has been determined, mainly by the reforming process in the banking sector, which is in a continuous competition, by the bettering of the macroeconomic frame and by request growth in total dischargement of capital account. This was a condition for joining the EU and also for maintaining the interest differences positive. However, the financial intermediation degree in most of the countries from Central Eastern Europe, compared to the countries in the Euro Zone, has a very low level, under 50%, as it is displayed in figure 1:



Source: FMI – IFS, BNR

Figure 1 The weight of nongovernmental credit in GDP

At macroeconomic level, the growth of rapid expansion of the credit, stimulates the aggregate request, which generates inflationist pressures which also contribute to the extern unbalances. These extern unbalances have been accentuated in the Baltic states, Bulgaria and Romania and also in countries which have registered the most rapid credit growth in the past 5 years.

The rapid credit growth in countries from Central and Eastern Europe may be justified by the initial low levels of financial intermediation.

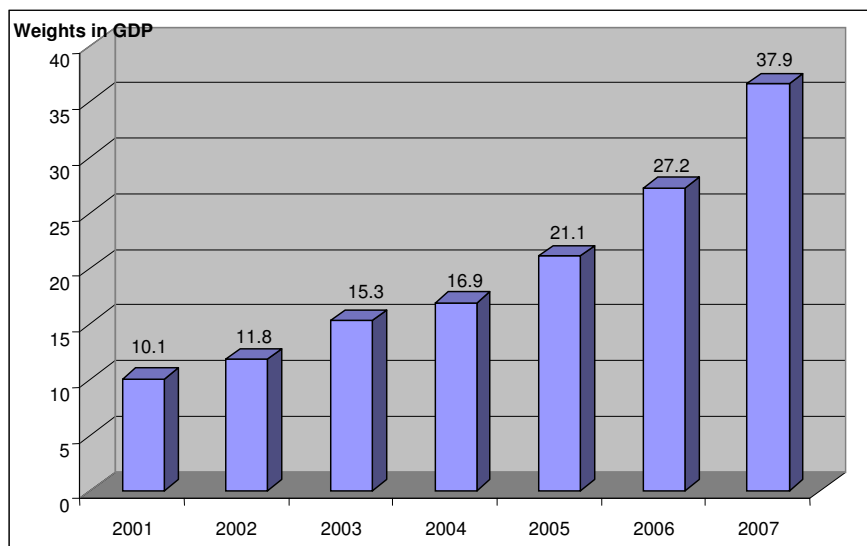
The economic literature confirms the fact that the alert credit expansion shows alarming signals regarding the appearance of financial riots, but without outlining a real depression. So, the standard limit of growth warming and also the annual growth of financial intermediation rhythm with five GDP points on a five year plan (Dominique – Kunt and Detragiache, 1997) represents the possibility for a potential financial crisis. This limits have been outcome at the Baltic levels of the countries: Slovenia, Bulgaria and Croatia.

Thus, the structure of credit dynamic presents supplementary risks related to financial stability, besides the risks that devolve from the normal credit expansion. Consequently, the household credit growth has outcome the investment credit growth in this region. This shows that the risks are prevalent associated, to the population segment, which presents a high rate of obligement.

Another aspect is based on the high rate of obligement for the foreign currency credit, which comes from the real and nominal tendencies of appreciations, and from the available funds in foreign currency because of the capital, incomings. All those could lead to the appearance of currency risk, also keeping in mind the depth of extern unbalances.

Financial intermediation has grown substantially through the last years, in Romania has reached 37,9% of GDP in 2007, getting really close to the Poland's level, taking into consideration the conditions of national currency depreciations and the maintenance of a high inflation.

The weight of population credits has reached the same level with credit granted to no financial firms.



Source: NBR; ISN

Figure 2 –Financial intermediation in Romania

Rapid expansion, in Romania, was determined by numerous factors:

1. Better business conditions, the economy entered the upward faze of economic cycle, the consuming proclivity has grown and also the population's residential investments;
2. The banking system was reshaped and sold to investors, bettering the corporative governance, generating a cruel competition between the credit institutions;
3. Positive anticipations regarding the evolution of incomes and business cycle.

If the credit level has an upward rhythm, the Romanian's savings are at the lowest level in Europe (20%), this fact is backed by the low weight of savings in GDP (14%). Until the end of 2007 there had been a really low level of interest from the Romanian banking system in attracting the population's savings, because these were mostly financed from the exterior only in 2008 this offered to the population better efficiencies , up to the level 10,5% (April).

The analysis of credit growth

The economic literature²⁴⁹ presents many causes for the appearance of expansion phenomenon:

- a) the process of economic growth, which most of the time requires a rapid credit growth and also a development of the financial deepening;
- b) the faze of investment growth and firm's production expanses, using bank loans with the "accelerator" concept;
- c) financial liberalizations which means inadequate reactions from the market participants and also the manifestation of some risks. The change of attitude, meaning anticipating the future, becomes pessimistic, the prices for pledged goods and financial assets decrease, in this way the debtors are in impossibility of payment for the loans and the respective interest;
- d) the reduction for financing requests regarding the public sector, determined by consolidation of the fiscal position;
- e) the implementation of a macroeconomic stabilization program through fixing the exchange rate, in the case of emerge ting countries with a fixed currency rate;
- f) the liberalization of capital account determines ready money excess.

249 *Are Credit Booms in Emerging Markets a Concern?*, World Economic Outlook, Chapter IV, IMF, 2004

It is really hard to make a clear distinction between the cases of healthy financial development and those of dangerous credit expansion.

In this sense, there have been used more methods of credit growth level determination with relative results, in practice. In this way, the studies' results²⁵⁰ conducted at The National Bank of Romania level related to, the credit dynamic and also to the associated risks conclude in Romania's case, that the credit portfolio is of good quality and on a short term prognosis there haven't been identified risk factors that can affect the portfolio. But there is a slight increasing tendency of growth for credit risk, if the credit activity maintains very high. These tendencies need a constant information monitoring activity. This activity refers to the credit²⁵¹ volumes and structures on specific debtor types, on economy sectors, the crediting conditions, the bank's exposure risks, the prudential measurements that these use the national currency exposure level or foreign currency. This process also needs some special macroeconomic data: the inflation rate, the economic growth, the real account, difference, the unemployment rate, the resistance level at some vulnerability tests and also some quality information, the level of national legal frame harmonisation with the international standards, the level of financial system trust.

The mentioned studies show, that a rapid foreign currency credit growth in the population segment, especially those for household use, may have some negative effects on macroeconomic stability, because this determines the growth of the aggregate request compared to production resulting, the increase of inflation, the current account deficit and also the depreciation of the national currency.

The inappropriate evolution, on a long term period regarding the payment balance in Romania's case (in 2007, the extern deficit represented 14% of GDD), has increased the national currency exchange rate vulnerability, taking into consideration that our country, needs extern investments to finance the extern deficit.

Temperation measurements for credit dynamic

The higher credit rhythm determines the authorities to conduct monetary policy measurements and prudential measurements to stop a potential expansionist credit process and for stimulating the financial development.

Monetary policy measurements

At the decisive moment regarding a monetary and prudential adequate policy, the authorities will take into consideration the macroeconomic and structural factors, respectively the existence of macroeconomic unbalances, the solidity and the financial system structure, the financial debtors situation and the quality of the prudential supervision process.

Regarding the Central and Eastern European Countries, where the liberalisation of the capital movements is almost complete, appear some difficulties using the monetary policy measurements.

The increase of interest rate conducted to discourage the credit process, determines incoming important capitals, which²⁵² lead to the increase of monetary flow.

Consequently applying combinations of monetary policy instruments and of currency exchange rates (management floating) lead to the excessive increase of foreign currency credit. This determined NBR to change to a more flexible exchange rate, in this way they would stop the mentioned effects.

In the process of curbing the credit expansion, the authorities have adapted administrative measurements also. Thus in many ways, NBR increased the minimum reserves, for the passives in lei and also for those in foreign currency²⁵³.

Prudential supervisory measurements

The prudential supervision of the banking system represents a complex process which is being realised from the authorisation, through the closing of that activity.

²⁵⁰ *Financial stability report*, 2006, NBR, p. 108-114

²⁵¹ Cerna Silviu, *The rapid credit growth: dangers or solutions*, Rev. Oeconomica, No. 3/2006

²⁵² According to the NBR report dated 26 March 2008, the interest rate for monetary policy was 9,5%

²⁵³ Now, Romania has the highest level of interest rate for foreign currency deposits 40% and for lei it is of 20%.

The prudential supervision measurements are necessary in the case of credit expansion, and mostly when the financial stability is in dangerous or when it is necessary to harmonise the national laws with the international ones.

In this way NBR adopted a series of normative legislative papers to temperate the increasing record rhythm of 74% for the foreign currency²⁵⁴ credit.

At the present, NBR and also the other banks are preoccupied with the implementation of the European request regarding the New Capital Agreement, which will have as a result the strengthening of the risk management capacity and to assure financial stability. Simultaneously the laws adopted at the beginning of 2006, permitted NBR to exert the supervisory process upon the financial nonbanking intermediaries, regarding the suitable capitals.

Conclusions

The high increasing credit rhythm, in Romania's case, can be explained partially through the process of "financial deepening", and also by the amplification of financial intermediation process, justified by the very low initial levels.

The authorities must follow the maintaining of equilibrium between the macroeconomic stability and the credit expansion, which can become very dangerous. In this way it is necessary to improve the supervisory systems.

The measurements ordered by the monetary authority will not have the wished results, if it won't have the necessary support from the fiscal authority.

To maintain the turbulences on the extern financial markets claims for a reevaluation of the entire regulations frame, so in this way the risks from financial innovation can be supervised.

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²⁵⁴ The adoption of prudential measurements at 26 March 2008 by increasing the foreign currency deposits destined to the debtors exposed to currency risk.