

# FINANCING OF ROMANIAN ECONOMY UNDER CONDITIONS OF FINANCIAL MARKETS IMBALANCE

## Istrate Luminita Gabriela

*Academy of Economic Studies, Bucharest, Romania Faculty of Finance, Insurance, Banking and Stock Exchange Ale.Micsunelelor nr.5 , Bl.31, Sc.3, Apt.60 , Loc.Braila, Jud.Braila Email : istrateluminita@yahoo.com Phone number : 0766642170*

*Financial system represents the engine of the economy. Any disequilibrium of this has an impact on the whole economy.*

*Lately, in spite of the firm interventions of authorities, the feeling of distrust of the investors persists, thing that makes more segments of the financial market, particularly those referring to security and financing in long term, to remain vulnerable. Increase of the risk premium and the rise of financings, affect directly and indirectly a large range of economic "actors", having consequences to the level of real economies which give clear signs of slowing down of economic increase or even of recession.*

*On conditions that the Romanian banks do not have exposures on the financial instruments being at the origin of the actual problems from the international financial markets, the turbulences from these markets can affect the financial stability from Romania directly, on the way of the real economy and of banking liquidity.*

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## 1. Foreword

Responding to the challenges of currency, the banks, as institutions whose activity was initially bound by the monetary creation, have passed through decisive phases with impact upon operating the economies along decades.

The last trimester of 2008 registers an important point in the dynamics of internal economic activity, reacting by a substantial diminishing of external demand for Romanian products, as well as by difficulties increased by financing the economic agents, which during October-November led to significant diminishing of the values of some indicators as: industrial production, confidence index in industry, turnover in the field of services performed for people, rhythm of increase of the turnover in the retail trading.

In October 2008, the Romanian National Bank decided holding the rate of monetary policy interest to 10,25% per year, aiming the accomplishment of the medium-term objective of disinflation in a sustainable way. In the same time, it has been decided the diminishing of the rate of minimum reserves mandatory and applicable to the liabilities in Lei from 20% to 18% stating with 24<sup>th</sup> of November to 23<sup>rd</sup> of December 2008. In case of amplifying the international financial crisis and of curtailment of the liquidity surplus from the Romanian banking system, the measure was for the improvement of liquidity management from the inter-banking monetary market with the purpose of insuring a sustainable financing of economy.

In the following, we shall try to notice the role and importance of the financial services as a source of financing the economy, in overtaking the financial crisis and starting the economic revival.

Besides its own savings, the banks are or should be in a healthy economy, the main financing source. The role of a bank within an economy can be analyzed, mainly, using the concept of mediation between the debtor and creditor agents from economy.

Is the Romanian banking system ready to confront the challenges imposed by recession?

Is it solid enough to support the enterprises by their financing in advantageous conditions so that the economic blockings not to increase?

We shall try to find pertinent answers to these questions in the following lines. Having a general look, the identified causes of the problems from the financial systems of the developed countries were: the significant surplus of liquidities

in the context of some small rates of the interest, development of the financial innovations that were accomplished without a proper understanding of the assumed risks and without implementation of some corresponding methods of administration of the risks and transparency of placements in the innovative products, as well as within the appropriate framework of rules which were insufficient.

The effects of the international financial and economic crisis are more and more present by decrease in exports and external financings, by an increased volatility on the currency market, correlated to tendencies from the region and to lack of appetite towards the risk of the foreign investors. The analysis of the data show that the dispersion of these effects is already reflected in reduction of the credit given to the private sector with effects on decline of the economic increase, maintaining further on a high degree of uncertainty regarding the importance of these effects.

## **2. A priority for a viable business: attraction of financial resources**

A good planning of the economic development also implies the insurance of money funds needed for financing from internal sources (banks, investment funds, cooperative institutions of credit, factoring and insurance companies, credit agencies, governmental and non-governmental organizations) or from external sources (World Bank, International Monetary Fund, The European Bank for Reconstruction and Development (EBRD, European Bank of Investments).

The fact that financial resources, as well as the currency or material resources are limited, and the destinations are challenging, requires their usage in conditions of maximum efficiency. Accepting the charges of expenses for accomplishing an objective or an action, there must be carefully analyzed all susceptible solutions to be taken into consideration to choose the optimum variant which has the most advantageous report between the required effort and the obtained effort. The financial policy must follow the systematic increase of efficiency of all expenses.

Regarding the public funds, to get a better efficiency in their usage, besides the dimensioning and the judicious distribution, it is necessary the stimulation of the beneficiaries by financing and administration methods or by other specific instruments. This thing can be done by choosing an adequate method of financing: self-financing with own resources regarding the credit, self-financing with completion of the own resources regarding the budgetary allowances, full financing with definite and non-returnable security from the budgetary funds or extra-budgetary funds, as needed.

Non-refundable financings are meant to support some important activities for certain segments of the company or for general development of the economic and social system, in fields for which, due to the conjuncture situation there are not enough financial resources to be accessible permanently (for example the rehabilitation of infrastructure in poor areas, professional requalification, support of developing the ONG sector in the capacity of partner of the public authorities) or from domains in which there is a need of financial resources more than the liquid assets.

The currency has also serious implications upon financial stability (as well as upon macro-economic stability): external financing of the banking sector is increased, population and companies practically make loans equally in national currency as well as in foreign currency (moreover, the companies make loans from exterior on a large scale). Volatility of the national currency is increased (comparing with the volatility of currency from the region), being also explained by structural features of foreign exchange market, which distinguish it from other regional markets: quite small volume, maturity of operations is most of the time on short term, small weigh of derived financial instruments (held almost entirely by non-residents). This quite

raised volatility of the leu rate, with its implications mainly negative, can be reduced by development of the foreign exchange market, but especially by hardening the coherence of macro-economic policies.

The private consumption continued to record a real rhythm extremely raised (over 19%) on one hand, and on the other hand, the appeal to borrowed funds has substantially decreased – trajectory suggested by a new slowing down of the dynamics proper to the balance of consumption credit allowed by commercial banks (more evident in the segment of the foreign exchange credit), as a result of raising the interest rate and depreciation of national currency.

### **3. The world of banks in the new world – quality versus quantity**

Permanent preoccupation of the central bank of achieving a safe, modern and competitive banking system which insures a well mediation and generates the confidence of public, is effected, among others, in systematic monitoring of the internal market and banking products and services and of tendencies recorded in the European banking sector.

The identified causes that are at the origin of the problems from financial systems of the developed countries were: significant surplus of liquidities in case of some small rates of the interest that promoted the assuming of higher risks to get higher efficiency, development of financial innovations that were created without an adequate agreement of the assumed risks and without implementation of some corresponding methods of administration of the risks and transparency of the placements in the innovative products, as well as the appropriate regulation framework which were insufficient.

Capital market can take over the role of financier of real economy with limits in case of some disequilibriums of banking sector, although it benefits of a good capacity of absorption tested at the level of subscription of the public offers. Companies of services of financial investments have a determinative role regarding the mediation on stock exchange market, but the number of assets held by these entities is low.

The low level of economic training, and especially banking training of the effective and potential consumers of products and banking services, as well as the professional preparation still in deficit as average per banking system of the staff of the credit institutions, stops an efficient communication between the two parts. Thus, on one hand, many economic agents with necessities of financing do not appeal to banks but only at last, and on the other hand, there are still banks that do not pay enough attention to the aspects regarding the entry in their offer of the services of consultancy destined to the customers.

One of the factors that might affect stability of the financial system is the majority weight of foreign capital in financing institutions. On calm periods, on the European financial markets (the main area of origin of foreign investments in domestic financial system), non-resident investors bring a surplus of stability and support development of domestic financial market. But, under present conditions of turbulences and high incertitude on external markets, the foreign capital can transmit a part of risks towards the Romanian financial system by contagiousness.

It becomes more and more evident the fact that the banks allowed credits on medium and long term without a thorough analysis of the effects generated by crediting the population without being correlated with the power of absorption of the real economy.

This thing has repercussions on Romanian economy by difficulties as liquidities reduction in financial-banking sector, simultaneously with the increase of the cost of internal and external financing, hardening the conditions of credit access for population, economic agents, but also for the public sector, raise of persons who are in the impossibility to return the rates and the interest to the banking credits, decrease of internal production with negative effects upon labor income, keeping the jobs, as well as upon the profitability of companies, decrease of the purchasing power and life quality.

In such circumstance, macro-economic internal weaknesses (outrunning of increase of labor productivity by the one of salaries, increasing deficit of the current account and predominance of financing by credits, economic increase based more on consumption and less on exports) started to be penalized.

Ascendant tendency from 2005-2007 was correlated to the positive evolution of other markets from the Central and Eastern Europe, and the total number of credits allowed by the monetary financial institutions from Romania exceeded 50% from GDP at the end of 2007. At the same time, the credits exclusively allowed to the resident financial institutions represented 17,70% from GDP, total weigh of allowed credits being the highest from the analyzed countries. Thus, the banking market has been characterized by a high degree of liquidity, under the capacity of absorption of the real economy, but with a slight tendency of decrease in 2007.

According to the provisions of NBR (National Bank of Romania), in trimester IV of 2008, the annual rate of inflation attenuated its deviation towards the superior limit of the variation interval of +/- 1% correspondent to the aim of 3,80% (from 2,4 to 1,5 percentage points), reaching at the end of the year the level of 6,3%.

During October-November 2008, the reduction of the annual real dynamics of the credits allowed to the population till an average level of 37,40%, seems to have been mainly determined by a series of factors of the offer of banking services, from which we could mention: decrease of banks access to the external financing in case of international crisis, limitation of the liquidity surplus from the banking system, increase of the prudential norms practiced by banks, as well as reduction of degree and eligibility area of the possible customers.

On the other side, also the dynamics of request of banking systems recorded significant modifications. Also, a constraining effect had the increase of interests rates to the new credits, but also to the previously contracted ones, and also depreciation of the Leu and the increase of uncertainties regarding the evolution of exchange rate. In their turn, the investments of the population in banks recorded a high decrease of the annual rhythm of raise in October-November 2008.

On the basis of intensification of ascendant movement of the inter-banking yield and of necessities augmentation of internal resources of the banks, but also of accentuation of prudence in case of reverberation of the effects of international financial crisis upon Romanian economy, the average rates of interests on credits and on new deposits on term, accentuated their increase during September – November 2008, accomplishing the most ample positive variations from the last two years.

During September-November 2008, the speed of increase of the credit allowed to the private sector continued to decrease rapidly, thus, reaching the lowest level from the last three years (-9,30%). The tendency of decline characterized both the loans in Lei and the credits in foreign currency, these representing the minimum of the last years. The foreign currency credits continued to be more dynamic than the ones in national currency, so that the average value of loans in foreign currency in the total credits allowed to the private sector recorded a top of the last three years (55,90%).

After 1990, in the developed countries, the banks started to be affected by orientation of the population preference for other instruments of saving, comparing to the deposits, and namely to the mutual funds, pension funds as well as the companies of investments, and the big economic agents are advantaged by procurement of resources from the capital market, comparing to the monetary market.

#### **4. Capital market – an advantageous option?**

The capital market can take over in a limited way, the role of financier of real economy in case of some disequilibriums of the banking sector, although it benefits of a good capacity of absorption, tested by the subscription level of public offers.

The structure of the financial mediation sector shows a native financial culture mainly oriented towards the banking system, while the investments on the capital market hold for the moment a low weight (Table No.1).

**Table no.1 – Evolution of assets of the financial system.**

	<b>percents in GDP</b>				
<b>Financial Mediators</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
Credit institutions (1)	30,80	36,60	44,60	50,60	61,50
Insurance companies (2)	1,80	1,90	2,20	2,50	3,00
Investment funds (3)	0,10	0,20	0,20	0,30	0,30
Financial investment companies (4)	1,40	1,30	1,80	2,30	2,80
Leasing companies (5)	1,80	3,00	3,60	3,40	5,00
Other non-banking financial institutions (6)	0,40	0,60	0,90	1,30	1,50
<b>Total</b>	<b>36,30</b>	<b>43,60</b>	<b>53,30</b>	<b>60,40</b>	<b>74,10</b>

Source : BNR, CNVM, CSA, ALB, INS

1) Net assets of credit institutions, including CREDITCOOP; 2) Value of total estimated assets; 3) Assets of the investment funds; 4) Net assets of the Companies of Financial Investments (CFI); 5) Net financed assets; 6) Total assets proper to the companies that develop activities of allowing consumption loan, of issuing guarantees and incurrence of liabilities, as well as proper to the ones that develop many activities of crediting.

The degree of financial mediation from Romania has accelerated its increase starting with 2007, on the basis of substantial advance of the volume of allowed credits, but also of the investments on the capital market.

The companies of services of financial investments have a determinative role regarding the mediation on stock-exchange market, but the volume of the assets held by these entities is low. The modern financial theory was grounded almost exclusively for a long period on the hypothesis that the financial markets are efficient. The concept of the efficient financial market, introduced and developed by the American professor Eugene Fama, is grounded on the idea of integration in the stock-exchange price of the shares issued by a firm of all information regarding the issuing company. In this respect, each person interested in this field creates a correct evaluation of the financial securities and of the firms in general, on the basis of some fair judgments regarding their perspectives.

Due to these premises, no investor from the market can get earnings from speculations of some disequilibriums between the stock-exchange price and the real and correct value of the security. Any rational agent shall aim the maximization of the earning. What differentiates the investors is the attitude towards the risk. The risk in the financial field can be defined at least in two ways: either as possibility of apparition of a loss or as an incertitude. In fields as the banking one or the insurance one, the risk usually has an acceptance exclusively negative: a risking phenomena is unpleasant and thus, it must be avoided. But, in theory and practice of private finances, of financial markets, of portfolio administration, the risk term is mainly used as incertitude.

Property value represents for the issuing firm, an instrument used in attracting external spare capitals. In this respect, it is highly important the insurance of an increasing trend of the stock exchange price which confirms the favorable evolution of the performance indexes proper to the firm. On an efficient market from informational point of view, one of the most sure signs of the performance of a firm is its stock exchange price, an increase of price being interpreted as an anticipation by investors of some performances in a continuous improvement and vice-versa. Even if the level of stock-exchange price is a veritable “barometer” of future performances of the

firm, there should not be missed the possible effects on it due to some causes external to the enterprise. Financial markets can be characterized, at least in some moments, by irrationality, that might imply a under-valuation or, on contrary, an inexplicable super-evaluation of the securities, taking into consideration the performances of the firm. Moreover, the supply and demand for some securities, different liquidity of them can constitute real problems for insuring the balance between the stock-exchange price and the value of the securities.

## 5. Conclusions

The rapid economic growth, which we have heard about lately, generated mainly by the request of consumption and is characterized by a strong negative supply of net exports, proved to be evidently unsustainable.

In January 2009, the current account of payment balance recorded a deficit of 525 million Euro, decreasing by 54,60% in comparison with January 2008. Determinant influence upon the decrease of current balance had the deficit of commercial balance which amounted 385 million Euro, in decrease with 66,40% in comparison with January 2008.

Taking into consideration the several challenges which the Romanian economy must face, NBR emphasized many times the necessity of adequation of the macro-economic policies of mixes to the changes occurred in economy.

This mix of macro-economic policies implies: continuation of the structural reforms, so that it stimulates the growth of labor productivity and external competitiveness of the Romanian products and services, the raised restrictiveness of monetary policy, a more severe fiscal policy, destined to correction of macro-economic disequilibrium by measures as improvement of budgetary planning by approving the multi-annual budgets, insurance of a uniform and predictable budgetary execution, limitation of increase of budgetary expenses, their direction mainly towards investments, a policy of adequation of evolution of salaried earnings to that of labor productivity.

There should not be missed either the fact that the state, in a market economy cannot interfere directly in activity of the commercial companies, but it can bring into action, by several measures and by its action instruments, the orientation of the commercial companies towards a national policy of sustainable growth.

Prevention of the financial crisis is based on adoption of micro- and macro-prudential measures. Regulation and surveillance represent the most important instruments of micro-prudential kind, aiming the maintaining of financial stability, instruments which allow early detection of the possible problems which the individual financial institutions can face. Besides the micro-prudential instruments, prevention of the banking crisis must be also consolidated at the macro-prudential level, both to the market level and implementation of the international standards and codes, as well as the improvement of the performances of the financial system.

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