SIGNIFICANT ASPECTS RELATED TO FINANCIAL INSTABILITY IN ROMANIA, UNDER THE CONSTRAINTS IMPOSED BY THE EUROPEAN INTEGRATION

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Abstract: *This article pertains to the series of articles related to European integration and is addressed to all who are interested in this field, particularly to those who work within public or non-governmental sectors, and who have to gain a true vision of the macroeconomic situation in its entirety. My research includes both quantitative and qualitative aspects, which are based on my own opinions. I believe the added value of my work derives from summing up the components: raising awareness on the importance of the theory of financial fragility in Romania's case, the constraints imposed by reaching the indicators related to the quantification of our country's degree of economic convergence to the Euro Zone, clearly defining the main areas of systemic risk in Romania, and the conclusions. The article begins by drawing clear delimitations on the theory of financial fragility and by understanding the definite European constraints related to entering the Euro Zone, and it continues with some elements specific to Romania. The final conclusion takes note of a significant macro systemic weakening of our country, which should be taken into account when projecting different types of national strategies.*

Keywords: *European integration, financial fragility, Romanian instability*

JEL classification: *F36, F62, G01*

1. Introduction

After World War II, the financial services sector has been developing all over the world, in parallel with the real economy (which includes material output and non-financial services). The growth of the financial sector was meant to support the general dynamics of real economy. The macroeconomic flow aimed at stimulating savings, collecting money from economic units and from the population, on one hand, and on the other hand, channeling the money for financing the economy and satisfying social needs, by ensuring the necessary cash flow and investments.

However, the growing complexity of the financial system's structure, and the multiple liberalizations that occurred after 1990, have generated multiple problems over time, especially functional ones. Left without a solution, or only partially or belatedly solved, all these issues have contributed to the growing fragility of the financial system.

On EU and, mostly, on EMU level, the financial crisis of 2008-2013 has shown serious institutional anomalies. These arise from the following well-known situation that remains still unsolved: once they joined the EMU, i.e. once they gave up on their national currency and adopted the euro, the 17 member countries *have relinquished their national sovereignty on monetary polic*y. Their monetary policy has been taken over by the European Central Bank. Yet, *as regards taxation and budgeting, each country has kept its sovereignty, by applying their own policies*. This duality creates systemic fragilities, by depriving both national governments and the European Commission of their financial and economic instruments that they need in order to control macroeconomic and financial balances (Iancu 2013). This new construction did not go all the way in adapting the financial mechanisms to the new requirements and in passing desirable regulations. In other words, there is still a fundamental contradiction, represented by the traditional segregation between the financial system (which is insufficiently regulated as regards the control of speculative capital flow) and the fiscal and budgetary system. This deepens the disequilibria and the financial instability/fragility.

2. The constraints of the European integration of emerging countries and the related indicators

Right now, European integration means economic convergence, which is quantified by certain relevant macroeconomic indicators.
After the evolutions determined by the financial crisis, there was powerful criticism against the cognitive value of the five compulsory convergence criteria set by the Maastricht Treaty. The criticism was also aimed at their economic predictability for monitoring and fixing possible EU macroeconomic disequilibria. Managing concrete aspects taking place within the EU, has shown the complexity of applying the convergence criteria on specific, local cases, which occured amid an economic foundation that was weakened by the crisis.

Upon the accumulation of practical local or regional experiences during 2004-2011, within EU and EMU member states, a conclusion was reached – that the Maastricht Treaty criteria were no longer sufficient for a thorough analysis and a correct evaluation of EU macroeconomic evolutions.

Without excluding these criteria, as they are still valid, the new EU regulations on economic governance were added (the set of six regulations), on two components: fiscal and macroeconomic supervision. The *Macroeconomic Imbalance Procedure* is an instrument that helps detect and correct risky economic trends, since it is only through thorough analysis that it can be established whether there are disequilibria and whether they are harmful or not. Today, the scoreboard of the Macroeconomic imbalance procedure contains 11 real and nominal indicators: current account balance, international investment position, real effective exchange rate, shares of world export, nominal unit labour costs, deflated house prices, private sector credit flow, private sector debt, government debt, unemployment rate, financial sector liabilities.

Reaching the values set by the EU is an issue that still evolves differently from one country to another, according to multiple local asymmetries.

3. Romania and the financial fragility

The fragility of a system refers to the lack of stability of its internal components (both within their interaction, and as regards each of them taken separately), as well as the lack of general sustainability within a certain time frame, under the influence of some external factors or of some internal tensions, which determine the occurrence of vulnerabilities or disequilibria. Within this internal dynamics, we define *financial sustainability* as that distinct part of the general sustainability, which refers to the degree in which the economy can have at its disposal sufficiently diversified resources in order to ensure that all its activities are being carried on. Derived from this, *financial instability* occurs when the financial system becomes incapable of mobilizing and allocating money efficiently, thus weakening its resistance to shock, which may eventually lead to damages for the real economy.

3.1. Relevant aspects in building the theory of financial instability

G.W. Friedrich Hegel considered the premise that ideas develop within their contraries, by claiming that the entire progressive dialectical process is characterized by *instability;* it encompasses imperceptible gradual quantitative accumulations and discontinuous qualitative leaps or violent changes. K. Marx kept a part of Hegel's way of thinking, by changing idealism into dialectical materialism. A. J. Schumpeter's endeavour was based on the model of *general equilibrium* of Leon Walras, which analyzes, through antithesis, the “circuit” and “evolution, by considering that the fundamental difference between these two notions relates to “innovation”. The neoclassical economic theory meant deepening the analysis of the way the economic system functions and of the factors that influence economic adjustment, as well as researching the *sate of equilibrium* from within the economic system. Due to *the theory of economic exchange and economic balance*, A. Marshall’s doctrine has developed within a presumably perfect competition environment, although he was aware of the fact that competition is frequently imperfect within real economies; without having built a fully original concept, he considered that equilibrium can be “stable”. K. Wicksell’s work is an important part of building the theory of financial fragility, due to the following important aspects arising from it: the active role of banks in the functioning of any economy (an idea which was later developed by J.M. Keynes and H. P. Minsky) and the idea of “cumulative” processes, of expansion and recession, which will later be the fundament for the notion of “spiral” evolution.

Since J.M. Keynes defines capitalism as “an economy of monetary production”, his intuition is that the economy is dynamic because of banking, by analyzing the two courses of action on the interest rate: direct monetary creation and free capital flow.

In the postwar period, H.P. Minsky has associated *instability* with the result of modern financial capitalism – speculation: there is an intrinsic fundamental instability within the capitalist economy that is characterized by massive financial speculation. Thus, according to Minsky, the source of disturbance may be an increase in interest rates, discontinuance in financing, not fulfilling some obligations, a natural disaster, or other “shocks” that influence the cash inflows or outflows (global financial commitments) of an economy. Studying the hypothesis of H.P. Minsky’s financial instability benefits from an essential observation: there are investment assets within any economy, whose main attraction to their holder derives from their ability to generate profit in the future. The demand for such goods will thus depend on the psychological expectations regarding this potential future income, and, obviously, these expectations may rapidly change. Consequently, when there are optimistic expectations regarding future profits, the price of investment assets will tend to increase. Investors may interpret this as a confirmation of the psychological anticipation regarding future income. This will further lead to a new increase in prices, in a continuous spiral. Minsky’s theory introduces an essential element which generates instability: *financial intermediation done by banks,* the first step towards a financialization process, which has become more and more complex and ramified during the last 20 years. This complexity has lead to an increase in interconnectivity and in the risk of multiple contaminations, amid systems weakened by the crisis.

3.2. Instability characteristics of the current Romanian economy

Through a multifactor accumulation during 2007-2013, Romania confirms three hypotheses of financial fragility:

3.2.1. Systematic indebtedness, the most risky type of financing for the real sector. This was the general characteristic of the evolution of the Romanian economic macrosystem, especially during 2007-2011. Considering the continuous increase in in the loans granted to the private sector, the economy has gone through a continuous phase (ascending trend) of accumulating debt (indebtedness) (figure 1).

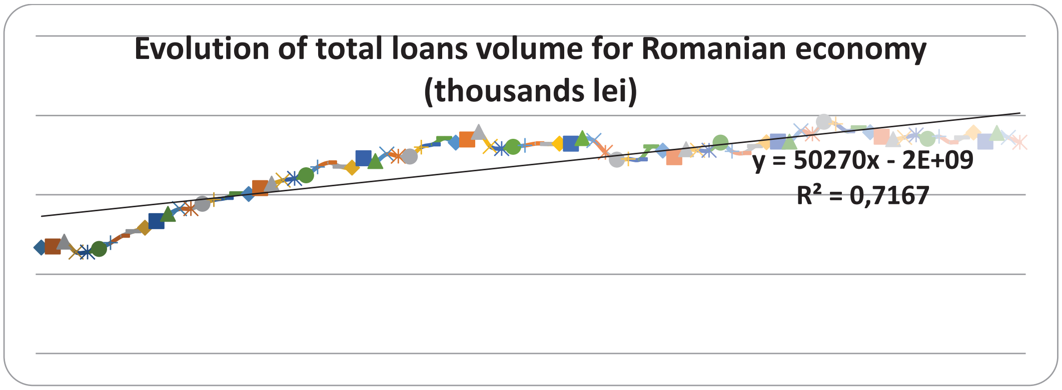

Figure 1

Author's processing after Romanian National Bank data, extracted on February 2014, online

http://www.bnro.ro/Raport-statistic-606.aspx

Of course, not any type of loan produces distrurbances; a thorough analysis is essential for determining the depth of the minskyian process. In Romania, considering each component, the internal lending has evolved as follows:

3.2.1.1. Lending to householders. Over-indebtedness of the population has reached alarming numbers: in 2013, 4.5 million individuals (around 50% of Romania's active population) had taken out around 6 million loans (figure 2). Loans in foreign currency was consistently higher than loans in lei, which is an important fragilizing systemic risk, due to exchange rate risk.

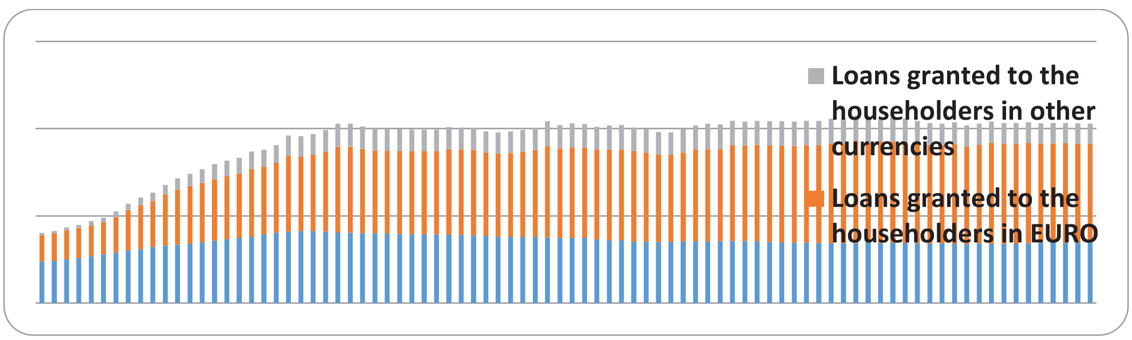

Figure 2
Author's processing after Romanian National Bank data, extracted on February 2014, online
http://www.bnro.ro/Raport-statistic-606.aspx

The volume of loans granted to the population for buying homes has increased by 85% between February 2009 and September 2013. Apart from that, since such loans are granted for long term (20-30 years), they attract additional systemic risks, related to finalizing the loan contracts in good order, without any reimbursement incidents during all those years of being carried out. On the other hand, consumption loans have decreased in volume by 29,6% in December 2013, as opposed to February 2009 (figure 3).

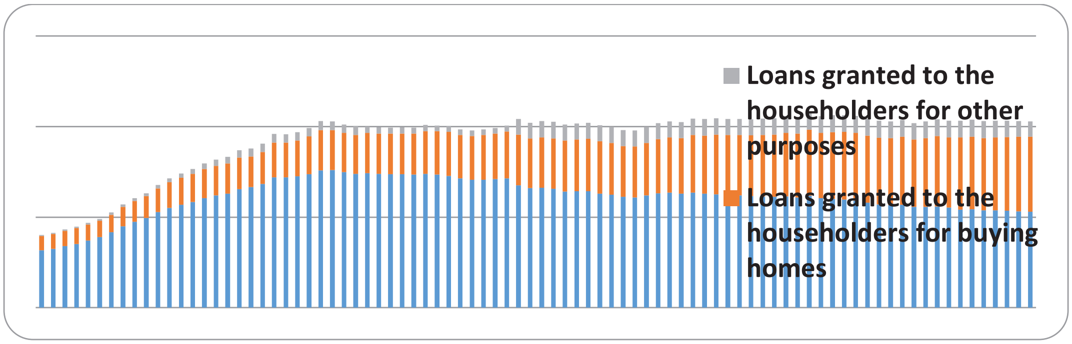

Figure 3
Author's processing after Romanian National Bank data, extracted on February 2014, online
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3.2.1.2. *Lending to non-financial companies* confirms continuous indebtedness on this segment as well, mostly in foreign currency: an accelerated growth of loans in euros – 131% during 25 months (January 2007 – February 2009). The associated risk is the currency risk, which makes future reimbursements more difficult (figure 4).

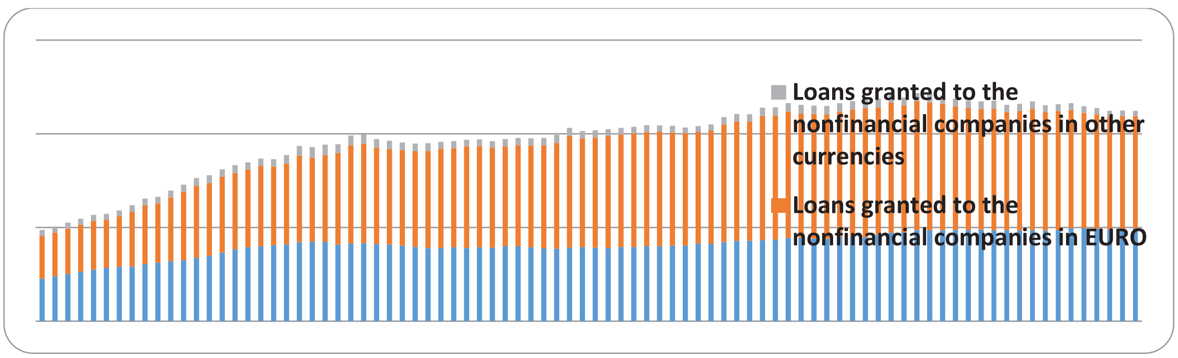

Figure 4
Author's processing after Romanian National Bank data, extracted on February 2014, online
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3.2.1.3. *Lending to non-monetary financial companies, to the public administration and to nonresidents* have taken a significant toll on economic indebtedness. Lending to nonresidents represents a risky situation, which has had an oscillating evolution during 2009-2013 (figure 5).

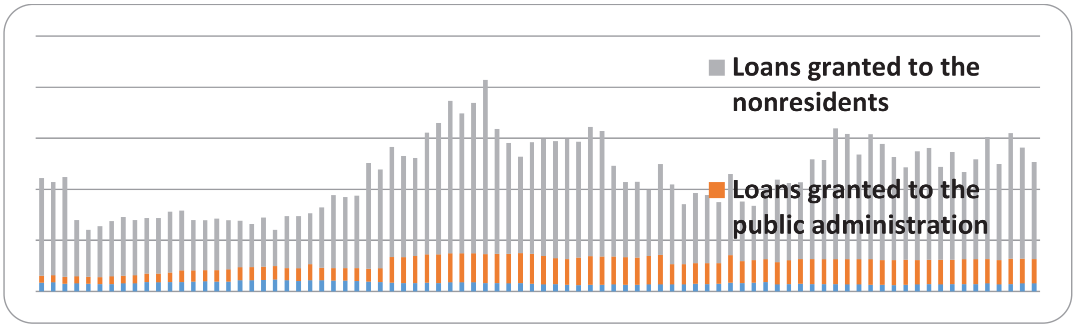

Figure 5
Author's processing after Romanian National Bank data, extracted on February 2014, online
http://www.bnro.ro/Raport-statistic-606.aspx

3.2.1.4. We take note of an additional component compared to the minskyan classic perspective on indebtedness: the Romanian banking system is currently facing the issue of *outstanding loans;* the rate of unperforming loans as of September 30, 2013 is 21,6 % of the total loans granted (figure 6 until 31.12.2012).

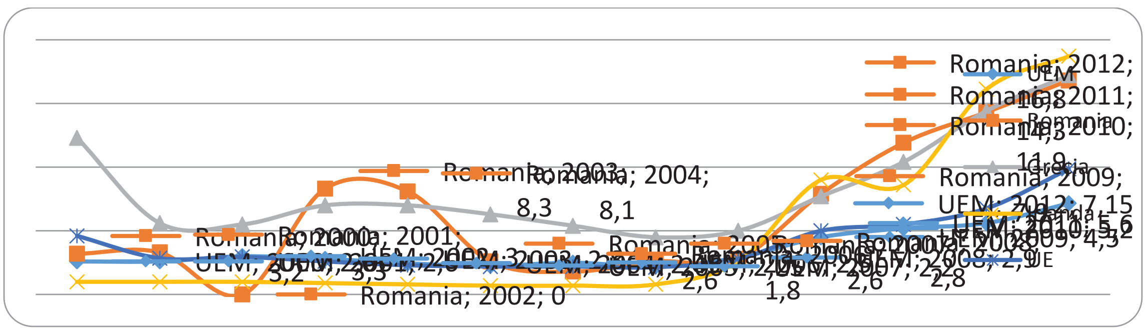

Figure 6
Author's processing after data The World Bank, extracted February 2014, online on http://data.worldbank.org/indicator/FB.AST.NPER.ZS/countries?display=default

Romania has the third highest rate of unperforming loans in Europe (outstanding for more than 90 days), which is the dominant risk threatening financial stability, after Greece and Ireland, and 135% higher than the EMU average rate. The steep growth occured between 2008-2009, from 2.9% to 7.9%, and it reached 16.8% between 2009-2012. NBR statistics confirm a further increase of 5.1% between December 2012 and December 2013.
For the purpose of this study, the exogenous causes of the increased volume of loans are less relevant; they are related to the nature of the monetary offer, i.e. the availability of long-term financing in foreign currency, which were mainly resources attracted from the parent banks, as well as the difference in interest rates between foreign currency loans and loans in lei.
The financial fragility occurs as a result of the deterioration of the fundamental economic variables; this situation can be worsened by some factors that influence the population's trust, information asymetry and some institutional factors. (International Monetary Fund, 2000). Figure 7 shows the specific case of Romania, by comparing the evolution of the weight of unperforming loans within the total loans.

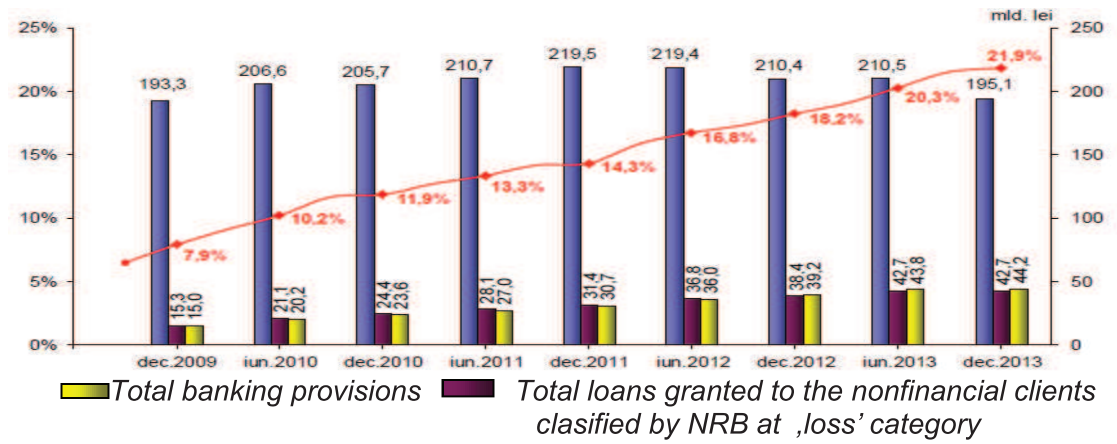

Figure7
Author's processing after National Romanian Bank data, extracted February 2014

The issue must be approached from two opposite points of view: the risk associated to over-indebtedness, as well as increased possibility of systemic paralysis due to the lack of financing. Local banks currently have outstanding loans in their portfolios of over 10 billion Euros (at 31.12.2013, according to Central Credit Register of Romania), which is a potentially high risk situation. From the other point of view, if banks do not recover their loans and they end up in a difficult situation, lending operations could potentially be massivly diminished, and so the entire economic activity will be slowed down. We take note of the fact that, in Romania, financial intermediation has been disconnected for years (2005-2011) from the internal savings, which was a weakening factor for the economy. The advancement, and also the recoil of the degree of financial intermediation was mainly lead by the evolution of lending to householders.

4. Conclusions

Without clear knowledge of the systemic imperfections of Romanian economy, one cannot build a correct economic development strategy. Neglecting financial fragility aspects, added to the lack of consistency in applying economic principles, may create important damages and disequilibria, that would generate a prolongued lack of sustainability, considering the fact that it is compulsory to meet strict crietria in view of European integration. Yet, today, Romania is a country that has a fragile economy, susceptible to react to temporary exogenous and edogenous factors. Should foreign banks and investment capital undergo an uncontrolled process of exiting the market, that would lead to a severe shortage of liquidity or credit, to pressure on the balance of payments and loss of reserves, a significant depreciation of the currency exchange rate, i.e. to general negative effects on the economy. The financial crisis that started in 2007-2008 was a reminder of the risk represented by the economies whose development models are based on accumjulating debt, over their limits of sustainability. From this point of view, it is important that Romania can prove that once it will enter the Euro Zone, it will not create a risk for the stability of the prices in this zone, as a result of the convergence of the prices in Romania to the ones in the Euro Zone.

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