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Post-crisis internal conditions that may affect the monetary policy in Romania

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Abstract: *The monetary policy is judged to be robust enough to withstand the possible macroeconomic shocks, irrespective of their international or internal origin. Nevertheless, the internal conditions may play an important role in the manner of designing and orienting the monetary policies. This article aims to identify the main internal conditions that may outline the possible challenges to the Romanian monetary policies. During the surveyed period, 2007-2014/2015, and subsequently, the evolution of the risks showed ups and downs, being currently manoeuvrable in terms of the financial stability perspectives.*

Keywords: *internal coordinates, financial stability, monetary policy*
JEL Classification: *E52, E65, E63*

1. Introduction

Monitoring the internal post-crisis conditions, we may notice that the economic growth contributed to the decrease of the lag between the real and potential GDP, the shift of inflation towards negative area and the increase of some incomes, increased the purchasing power of the population, the current account deficit consolidated at an extremely low level, while the monetary policy interest rate reached historical low levels; the cost of financing the public debt showed a decreasing trend, a 1% structural deficit being reported in the end of 2014, meeting thus the medium-term budgetary objective (MTO) (BNR, 2015 – Report on the financial stability, 2015). According to the Report on the financial stability, from April 2015, the 3.7% economic growth for 2015, although rather high at the European level, relies most on a higher consumption.

The recent positive elements that we just mentioned have been determined rather by policies of austerity or conjectural adjustment, than by policies of sustainable growth (planned and thought for the medium-term). For instance, the economic growth has been boosted mainly by the consumption, the decrease of inflation was due to the lower VAT rate for foods and to the lower international price of fuels; the budget savings occurred as the previously programmed investments failed to be implemented. The incapacity to use the European funds made some sectors of the national economy to lag behind, while the banking sector, which is currently cleaning the balance sheets and reducing the interest rates margins, still is under the strong influence of the foreign market, despite the lower proportion of the foreign currency loans and, therefore, of the level of population debts in foreign currencies (for instance, due to the foreign currency risk, the debtors in Swiss Francs and in US Dollars incurred important losses, or were even unable to pay back the loans, as these foreign currencies appreciated versus the Euro). Furthermore, if the increase of consumption continues this trend, it may become a real risk for the increase of the commercial deficit and even of the current account deficit.

All these internal conditions, rather conjectural than structural, might put pressure on the Romanian monetary policy, as the possible reductions of the monetary policy interest rate might be delayed. Furthermore, even if BNR will decrease the monetary policy interest rate, or if the symmetric corridor around the monetary policy interest rate (between the interest rate for the credit facility and the interest rate for the deposit facility) will be narrowed, several structural elements of the Romanian economy (labour market status, high young unemployment rate, poverty, structure of the foreign trade, structure of the production, public debt and deficit etc.), and of the banking system (still high volume of non-performing credits, low capacity of the commercial banks to enlarge the range of customers, still insufficient implementation of the banking regulations requiring a consolidated financial stability etc.) will continue to create real difficulties in the transmission of the monetary policy impulses towards the real economy. Moreover, on the background of the lingering negative interest rates during the first half of 2016, BNR decided to maintain the monetary policy interest rate at 1.75%.

2. Literature review

The literature often identifies the influence of the internal or external conditions in the evolution of the different public policies, the monetary policy included. Besides the field studies, many international, regional and national reports, including BNR report, capture the importance of these evolutions in changing the institutional behaviour of the state, and of the monetary policies coordinators – the central banks. The National Bank of Romania is permanently linked to the realities of the international, regional and national framework, changing its monetary policy strategy so as to respond as much as possible to the external and internal challenges. Therefore, the analysis of the internal evolutions and of their possible future trends is very important both for the academia, and for the monetary policy practices and decision-makers.

3. Methodology of research

The article uses the comparative method, besides reports and studies; it uses the BNR data and World Bank data covering the period 2000-2014(2015), as well as subsequent data, to provide clarity for its analyses. The article is a partial deliverable of the 2015 research theme “Directions and challenges of the Romanian monetary policy under post-crisis international and national conditions” (coord. Milea, C.) of the Centre for Financial and Monetary Research „Victor Slăvescu”. The analysis surveys three periods: pre-crisis, 2007-2008; crisis, 2009-2011 and post-crisis, 2012-2014/2015, as well as recent evolutions, focusing on the last period without, however, neglecting the possible explanations yielded by the previous context (pre-crisis and crisis).

4. Results

If we read Eurostat data, the European economic growth showed three stages during the surveyed period: overheating, in 2007-2008, recession, in 2009-2010, and modest recovering, in 2011-2015. The average economic growth for 2007-2014, calculated using Eurostat data, shows that Romania, with an average economic growth of 1.94%, can “brag” of exceeding the German average for the same period (1.11%), but the results can be deceiving if we don’t take into account the structure of the Romanian national economy. First, the economic growth must be determined by a state of consolidation of the investment process and by an important support from the foreign trade, as well as by a predictable, “friendly” (lower administrative burden and lower bureaucracy) and balanced (with rather anti-cyclic influences) fiscal-budgetary policy, but these elements have been accomplished only marginally or, in the best case, circumstantially. Despite the higher rate of economic growth, the real convergence of Romania towards the economy of the Euro zone still is a distant target. The economic growth of Romania has been also supported by a rather satisfactory evolution of the foreign sector, on the background of a better structure of the exports (for instance, more exports which include high added value and a high level of innovation). However, the increase of the current account deficit may be a concern for the economic growth and financial stability.

According to the World Bank data on the annual rate of GDP growth for some European countries (Figure 1), we may notice that, in the recent years, all the surveyed countries followed rather the same trend, Central Europe and the Baltic States displaying a higher rate due to the catching-up process, while the old EU member states and the Euro zone member states, such as France, slowed down.

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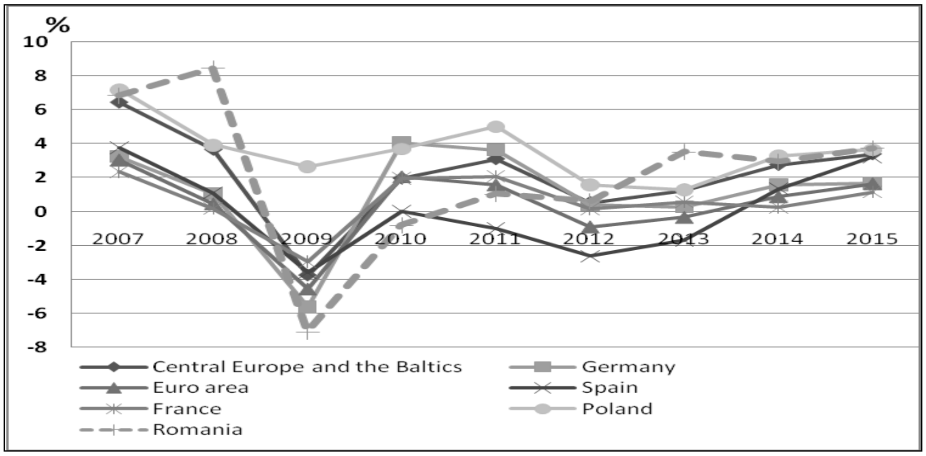
According to World Bank data, the GDP per capita, expressed in US Dollars, for the developed countries of the European Union and for the Euro zone, was rather high in 2007-2014, but below the threshold of \$50,000/capita. The Central Europe states and the Baltic States still didn't exceed the threshold of \$15,000 capita, Romania still being below the threshold of \$10,000 capita. According to the 2015 Report on the financial stability, the "GDP per capita (at the purchasing power parity) currently is of about 50 per cent of the corresponding value for the Euro zone, compared to 38 per cent, in the year when Romanian joined the EU". If we take into account the fact that the population of Romania decreased dramatically during the recent years, the level mentioned in the report proves to be irrelevant, actually being rather similar to the 2007 level, when Romania joined the European Union.

Figure 1. Annual GDP growth rate in some European countries, in 2007-2015 (%)



(*Source:* World Bank, World Development Indicators, data updated on Oct. 4, 2016)

According to World Bank data, the inflation rate in Europe fits rather well within a convergence area in the interval [-1%, 1%] (Figure 2). The Central Europe states, the Baltic States and Romania, although started from high inflation rates before the crisis, managed gradually to temper the inflation, currently being below, but in the proximity, of the Euro zone average. This allows us to say that, in Romania, the risks regarding the evolution of the inflation and of the economy seem rather balanced.

According to the 2016 BNR Report on inflation, on the background of an international environment characterized by persistently low inflation rates, by the possible adverse or uncertain effects of the Brexit, on the background of domestic measures regarding the income policy and regarding fiscal relaxation, the evolution

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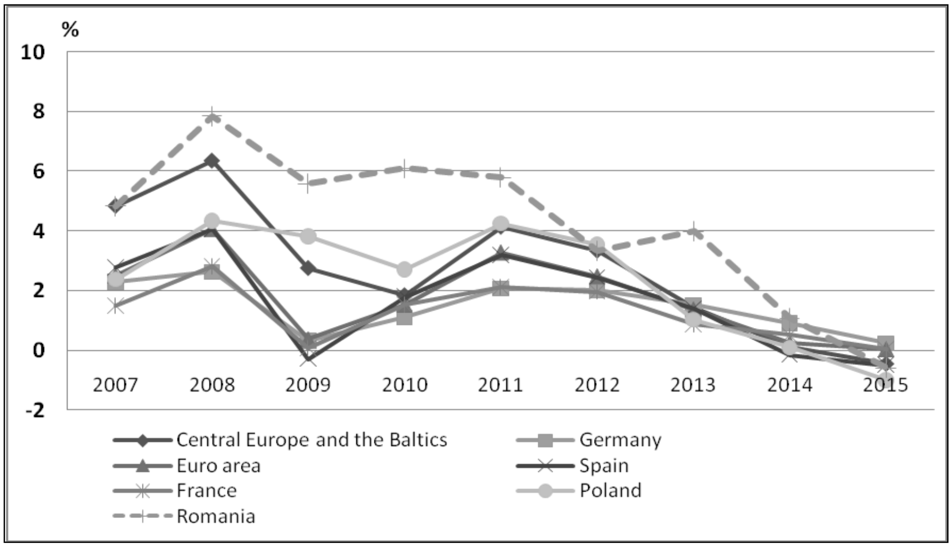
of CPI inflation is expected to hit negative values by the end of 2016, positive, but below the central inflation target (2.5%), values in 2017, and to reach 3% in 2018.

Figure 2. **Annual inflation (%) expressed in consumer prices in some European countries, in 2007 – 2015**



(Source: World Bank, World Development Indicators, data updated on Oct. 4, 2016)

The labour market in Romania maintained its structural weaknesses throughout the surveyed period (2007-2014), remaining in a state of certain stagnancy. This evolution reflects largely the persistent structural deficits of the educational system, mainly the lack of correlation between the educational system and the competencies required by the labour market. For instance, according to Eurostat data, the unemployment rate decreased rather little in 2007-2008 (from 6.4% in 2007 to 5.6% in 2008), increased rather strongly in 2009-2011 (from 6.5% in 2009 to 7% in 2010 and to 7.2% in 2011), oscillating in the proximity of the same level in 2012-2014 (6.8% in 2012, 7.1% in 2013 and 6.8% in 2014). The occupational rate of the people aged 20 to 64 oscillated around the value of 64%, still being in 2014 below the EU28 average (69.2%), and slightly increasingly in 2007-2014, from 64.4% to 65.7%, according to Eurostat. During the surveyed period, young unemployment rate remained high, above the EU average.

According to World Bank data, unemployment expressed as percentage of the whole labour force, increased in the Euro zone countries and in the Central European countries and in the Baltic States, starting with 2008, exceeding 10% in 2013, only to decrease slightly in 2014 (Figure 3).

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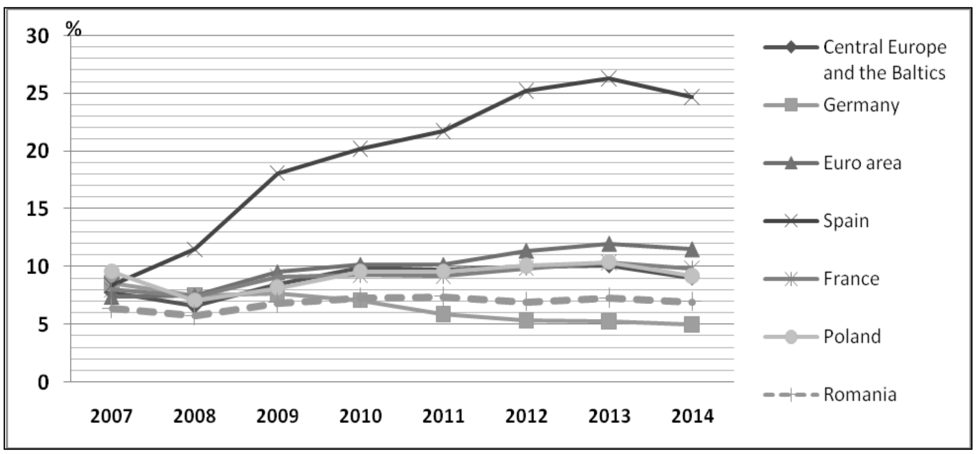
Analysing the World Bank data, we can notice a divergence throughout the surveyed period (2007-2014): the unemployment rate decreased strongly in countries with an intense industrial and commercial activity, such as Germany, and increased in countries with lower industrial and commercial performance, such as France and Spain. The statistics on unemployment and occupation must be interpreted within the context of the international migration, workforce immigration and the young ones particularly, also being a form of hidden unemployment or, better said, underutilisation of the local workforce. The decrease in the unemployment rate must not be necessarily interpreted in a positive manner, possibly only the increased rate of occupation. The deficit of demand on the labour market may limit, on the short term, the risk of inflation pressure due to the evolution of the workforce cost, but this is less true on the medium and ling-terms.

Figure 3. **Unemployment in some European countries (% of the whole labour force), in 2007-2014**



(Source: World Bank, World Development Indicators, data updated on Oct. 4, 2016)

Many of the problems from the labour market are reflected in the level of population poverty. Thus, according to Eurostat, in 2014, over 40% of the population of Romania was affected by poverty, being at the limit of social exclusion, rate which can only be found in Bulgaria; moreover, over 30% of the households with at least one child are at risk of poverty, much over any other European country, being the double of the European average. Furthermore, this situation maintains Romania on the "top" position in terms of old people poverty and in-work at-risk-of-poverty rate, much over any other EU member state (19.6% in 2014, 10 p.p. over the 9.6% EU28 level). The in-work at-risk-of-poverty rate by working time indicator reflects an even more dramatic reality for 2014, with 62% for Romania, only 27.8% in Bulgaria and just 14.9% in Germany, the EU28 average being at 15.7%. The fact that the social value of the work doesn't cover the minimal level of human necessities, reflects adversely both in work productivity and healthcare, in children wellbeing and in the precarious education of the young people who are increasingly dropping out of school, returning and closing the cycle by disastrous short-, medium- and long-term results on the labour market.

According to Eurostat, in Romania, the general government deficit increased in 2007-2009 (from -2.8% of the GDP, to -9.5% of the GDP), decreasing strongly thereafter (2010-2015), from -6.9% of the GDP to -0.7% of the GDP; the forecasts for 2016 and 2017 show an increase of this indicator. In Germany, the general government deficit increased spectacularly in 2007-2010, but it decreased the same way in 2011-2015, reaching 0.75% of the GDP. The same trend was noticed in France and Spain, with the difference that although the general government deficit decreased in 2011-2015 and in 2013-2015, respectively, similarly to Germany, it still is over the limits imposed by the Pact of Stability and Growth.

In terms of the public debt, according to the Report on the Financial Stability of April 2016, in Romania, the public debt decreased to 38.6% of the GDP in December 2015 (from 39.8% of the GDP at the end of 2014). The decrease of the foreign debt (19.1% of the GDP in December 2015) supported strongly the decrease of the public debt, while the internal debt increased slightly to 19.4% of the GDP. The capacity of the banking sector to finance the public sector remains limited, due to the large exposure of the credit institutions towards the public administration. According to Eurostat, the public debt of Romania decreased in 2001-2006, from 25.7% to 12.3%, but increased in 2007-2014, from 12.7% to 39.8%, while de general government deficit, although it showed fluctuations, had an opposite evolution with that of the public debt. The strong connection of the state with the banking sector (the local commercial banks have, towards the public sector, a total exposure of about 70% of the total internal public debt, or over 20% of the total assets of the banking sector), may lead to blockages or imbalances both within the banking sector, and within the public system, when either of the two partners encounters problems of liquidity and/or solvency. The higher cost of financing by the banking sector may limit the access of the state to financing, but a better solution can come from the state, which should diversify and balance the portfolio of financing sources.

A positive aspect is that the commercial banks enhanced their role of creditor for the economy, more for the companies and the populations, and less for the non-banking financial institutions, most of the loans being in the national currency, less in foreign currency. The trend of 2014 and 2015 of credits in the national currency will probably continue in 2016 and 2017, on the background of lower interest rates and low inflation rate, particularly on the background of a moderate process of disintermediation and on the background of the easier conditions for loans.

Despite a comfortable level of debts, according to the Basel III criteria, of the lower dependency on foreign financing, of an adequate liquidity and solvency, the Romanian banking system still has several problems, such as: high level of non-performing credits, the need to speed up the process of balance sheets cleaning, high level of credits in hard currency, the need to align to the European and international prudential requirements. All these may make harder launching the process of crediting the national economy, particularly in the case of the non-financial companies and the population. The high level of the interest rates and banking fees, the lack of products calibrated according to their needs, the value of the collaterals, as well as some unclear contractual clauses, or contractual clauses that might be to the disadvantage of the clients, are among the main difficulties of the companies and of the population trying to obtain financing from the banks.

Another aspect noticed by the clients of the Romanian banks is the lack of bank flexibility to negotiate specific contractual clauses which might disadvantage strongly the clients. For instance, in the case of the exotic currencies, such as the Swiss Franc, the debtors have been left to negotiate the debt burden directly with the banks, with no intervention from the Central Bank. Many debtors met reticence and lack of flexibility on the bank side, and this rigidness can make the population and the companies lose trust in the banking system, which may endanger the long-term prospects of these institutions. The redirection of the credit institutions towards the state sector may be a momentary solution, but the commercial banks will have to rethink their portfolio with products that accomplish their basic role: credit and support the national economy, the private sector particularly. The Romanian banking sector is still affected by the process of cross-border disintermediation at the level of the European banking groups and by the phenomenon of increased deposits in banks located abroad.

6. Conclusions and recommendations

The economic growth in Romania is higher than in other EU countries, this evolution is due mainly to: higher wage incomes, higher consumption, public and fording debts (expressed as proportion of the GDP) within rather normal limits, and decreasing, maintenance of a negative inflation rate with forecasts of moderate increase over the next two years, sustainability of the foreign balance, with positive structural changes and a higher confidence of non-residents in the Romanian economy. On the other hand, the global debt of the private sector remained almost unchanged, with some positive changes, however, of structure; the capacity of the commercial banks to grant credits to the real economy, particularly to the non-financial companies remains limited; the consolidation of the fiscal-budgetary policies shows a slight procyclical trend which might affect the sustainability of the budget deficit; the domestic competitiveness, the investment activity and the foreign competitiveness still are important vulnerabilities that bear on a sustainable economic growth.

The higher foreign competitiveness by larger exports that include a high level of innovation and high value added should be priorities. Moreover, since the diversification by varieties of exports and the geographic distribution of the exports are low, and since the exports outside the EU are low, the public policies in Romania should encourage higher exports towards non-EU countries or non-Euro zone states. Otherwise, if problems occur within the EU or within the Euro-zone, there is the danger of strong contagion and higher current account deficit for Romania, either by a higher vulnerability to shocks determined by the lower demand of the most important trade partners or by non-attractive export prices. At the same time, relying on the higher profitability of their business and on a satisfactory capacity of meeting the debt service, the exporting foreign trade companies should use loans from resident commercial banks, rather than loans from the mother-companies or from non-resident banks and financial institutions. This creates an opportunity for the local banking system to adapt its products and services to the financing necessities of these companies, particularly as this might improve the quality and the export of the products with high value added or/and which incorporate advanced technology.

In 2007-2014, the Romanian labour market maintained its structural deficiencies, remaining in a state of certain stagnation. This evolution reflects largely the persistence of structural educational deficits and, mainly, the lack of correlation between the educational system and the competencies required on the labour market. The unemployment and employment statistics must be interpreted within the context of the international migration; workforce migration, particularly the young workforce migration, also is a form of hidden unemployment, of underutilisation of the Romanian workforce. This show that the lower unemployment rate must not be necessarily interpreted as a positive sign; only the higher employment rate might receive this interpretation.

The Romanian banking sector shows high rates of solvency and liquidity; the dependence of the Romanian commercial banks on the financing from the mother-banks decreased, the high proportion of credits in foreign currencies decreased as the proportion of loans in the national currency increased and the rate of non-performing loans continued to decrease. The commercial banks increased their role of creditor for the economy, particularly towards the companies and the population, less towards the non-banking financial institutions. On the other hand, the Romanian banking sector still is affected by the process of cross-boundary disintermediation at the level of the European banking groups and by the phenomenon of increased rate of deposits in banks abroad; the decrease of the currency risk might be replaced by a possible future risk of adverse evolution of the interest rates.

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