Issue 4
June 2011

7 Romanian Vulnerabilities in the Current Financial and Economic Crises Context

Author: Corina-Maria ENE, Hyperion University from Bucharest, Romania, corina.maria.ene@gmail.com

---

The current global economic crisis was ignited in the financial markets of the major developed economies but soon the real economy was affected. The developing world, Romania in particular, has not been isolated from its impact. International trade and capital flows serve as a transmission mechanism that illustrated that the hypothesis of a de-coupling between the developed and developing world does not hold. Romanian economy mostly does not have fully developed financial systems and is less integrated into the global financial market, hence the initial expectation in some circles that our national economy would be isolated from the contagion of the crisis. This paper argues that this was an unrealistic presumption and that the disease had a serious fall-out in Romania. Consumer spending was cut back, investment plans were cancelled and stock levels were run down. The economic situation is serious. GDP has shrunk, the unemployment level is rising, investments are still slowing, lending is tight and budget deficits are growing fast. Fiscal policies implemented by our country are subordinated to our lack of necessary funding and access to. However, that generated a monopoly on this sector of the IMF. Also, a social crisis became imminent.

Keywords: *system financial instability, financial and economic crises, recession*

JEL Classification: *E6*

Introduction

The financial instability triggered by the United States subprime crisis, which began in summer 2007, has led to a progressive deterioration of economic situation. The reasons that led to the crisis are manifold. Increased innovation in structured finance products, willingness by lenders to take excessive risks, low interest rates and investors' greed allowed complex investment products to be sold to an ever-wider range of investors. Economic world has not been protected from its impact and various indicators during the first half of 2008 already suggested a decline in world growth prospects.

After the first eight months of 2008, a brutal crisis erupted again, when first, major United States financial firms, then European financial institutions and a number of banks showed signs of insolvency. No policy maker, banker or economic and financial analyst has experienced anything as serious as this before. The crisis then expanded in magnitude, and full-scale turmoil ensued in financial markets, buffeting many developed and emerging economies. The global financial and economic crisis became the worst economic setback since the Great Depression of 1929-32. A number of emerging economies such as Hungary, Romania, Latvia and Ukraine, as well as Iceland, had then to turn to the International Monetary Fund (IMF) for assistance. The often-imagined gap between the financial sector and the so-called real economy was bridged with the financial woes being transformed into real economic regression; again the world was reminded that the dichotomy between the financial and real world does not exist. The unusual magnitude of the on-going crisis is raising major concerns about the future of the world economic outlook.

The decline in the propensity to invest

Credit has become less abundant and more expensive. It is more difficult for non-financial companies to invest in foreign operations or to make cross-border deals. Also, poor earnings of large companies in a broad range of industries, as evidenced by declared or projected profits from the third quarter of 2008 onwards, reduce the companies' self-financing capabilities. According to estimates, global FDI flows in 2008 fell by 21%.

This evolution is due to early global economic downturn, tighter credit conditions, declining corporate profits and uncertain prospects for global economic growth short term.

In 2008, the inflow of FDI attracted by Romania registered value of 9.024 billion euro, up by 24.4% compared with precedent (7.25 billion Euros). Considering the period 1990-2008, the flow of FDI attracted by Romania in the last year is very close with value registered in 2006, being only 36 million less compared with the record of 9.06 billion euro.

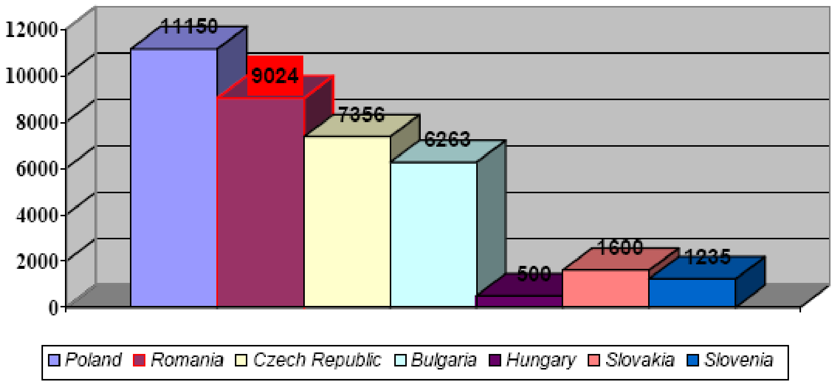

Figure 1: FDI evolution in Romania in the regional context, in 2008 (Million Euros) Source: www.wiiw.ac.at

As a result, we can say that before 2009, the main foreign capital in Romania consisted of direct foreign investment (especially capital ownership as a result of privatization), and other investments (loans and grants border from parent banks), while investment portfolio were generally low. After the global financial crisis, the contribution of FDI is reduced, despite the fact that Romania has remained an attractive business destination.

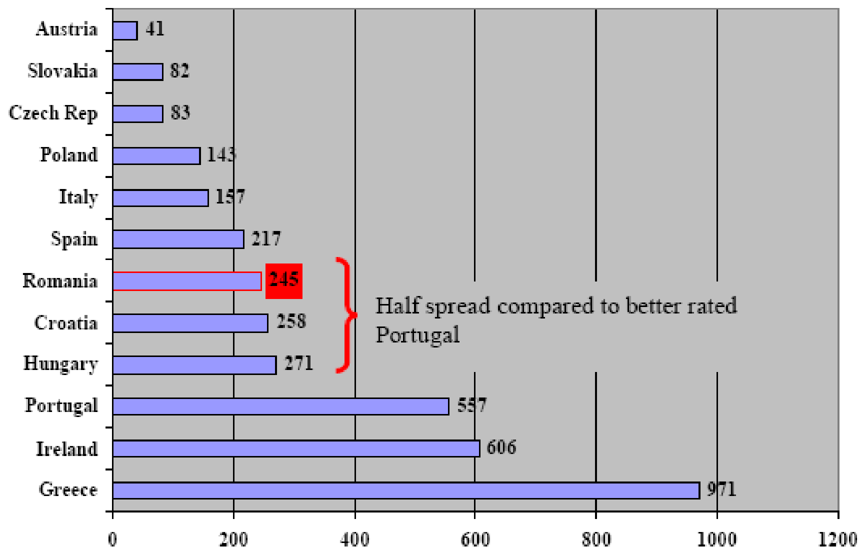

Figure 2: FDI evolution in the regional context, in 2010
Source: Bloomberg, Erste Group Research

As the global economy recovers from recession, Romania could benefit from new contributions of FDI in areas such as industrial goods, agriculture and food industry, the IT sector and renewable energy, while the current account decreased reduced external vulnerability Romania in the future.

Difficulties for Banks

The economic decline that resulted has created difficulties for banks, especially because of their heavy loan concentrations in credit for commodity-related industries, housing finance and durable goods financing. These are all markets that also had experienced boom periods, which in times of lower economic growth are likely to increase the problem of imminent debt write-offs.

Under these conditions, banks are also forced into a position of tightening credit provisions with the commensurate knock-on effects on demand in the economy. A growing bubble inevitably bursts, but a characteristic of the current crisis is the contagion that set in with a number of booming asset and commodity markets crossing a precipice into record-breaking falls in prices and values. The outcome has been the creation of financial and economic events unknown in the living memory of all economic agents, from ordinary households to supposedly astute bankers and asset and risk managers. Many bankers, including the largest and most respected in the world, found themselves with balance sheets severely crippled by distressed assets to a point of technical insolvency, and consequently in dire need of recapitalization.

Consumer spending was cut back, investment plans were cancelled and stock levels were run down. Worldwide, investors ran for the cover of safe havens and, where this was not possible for small-scale investors, money market investments became dominant.

Negative Economic Growth

In 2009 all EU-27 Member States, except Poland, have ended the year with negative growth, compared with the previous year.

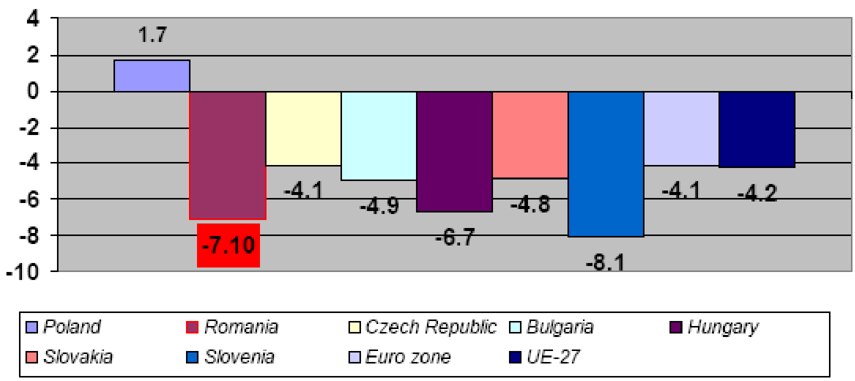

Figure 3: Negative growth
Source: European Commission

Romania was among the last seven EU based on this decline. On the other side, international developments confirm that this crisis, which began as a financial one, has become an economic one and it is characterized by lower GDP.

In 2008 and 2009, the cumulative effects of the crisis based on relative change in real GDP, provides the following recorded values.

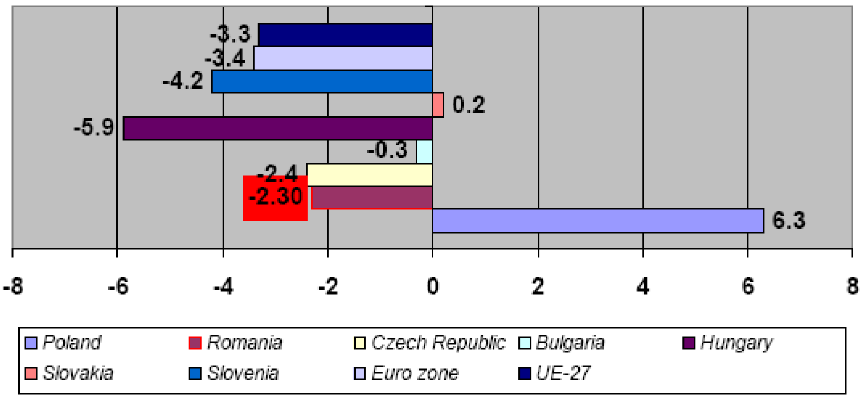

Figure 4: Relative change in real GDP in 2010
Source: European Commission

Romania was given by European Commission with an increase of 0.8%, but this value is expected to take determined without account of recent decisions wage decreases and increases in taxation. Latest forecasts from IMF give to our country an estimated rate of -2%, which shows the inefficiency of governmental measures.

Labor Market

Although the Community market proved to be more resistant to recession than expected (mostly due to short-term policy measures, past reforms and continuing employment in some Member States) in all Member States of the EU-27 unemployment rate increased in 2009 compared to that recorded in 2008, unemployment being negatively associated with this economic and financial crisis.

According to estimates, in 2010 and 2011 is expected following values of unemployment rate:

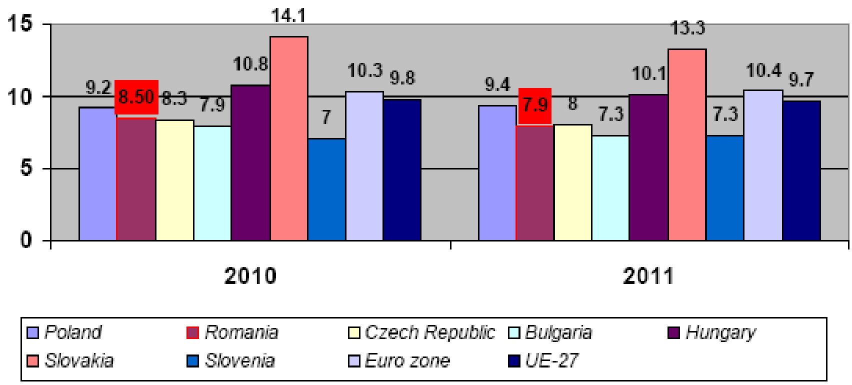

Figure 5: Unemployment Rate
Source: European Commission

It is expected to stabilize this imbalance for 2011, once economic recovery consolidating. Unfortunately, Romanians hopes are minimal.

Budget Deficits and Public Debts

The public deficit has tripled in 2009 in EU-27, reaching 6.79% of GDP from 2.25% in 2008. This damage was caused, in part, by operation of automatic stabilizers and discretionary measures taken to support the economy, but reflects a stronger than usual fall in revenue to slow growth reaction.

Implementation of the 2010 consolidated budget ended with an estimated deficit of 33.5 billion lei, respectively 6.5% of GDP, below the deficit target, amounting to 34.6 billion, respectively 6.8% of estimated GDP for 2010.

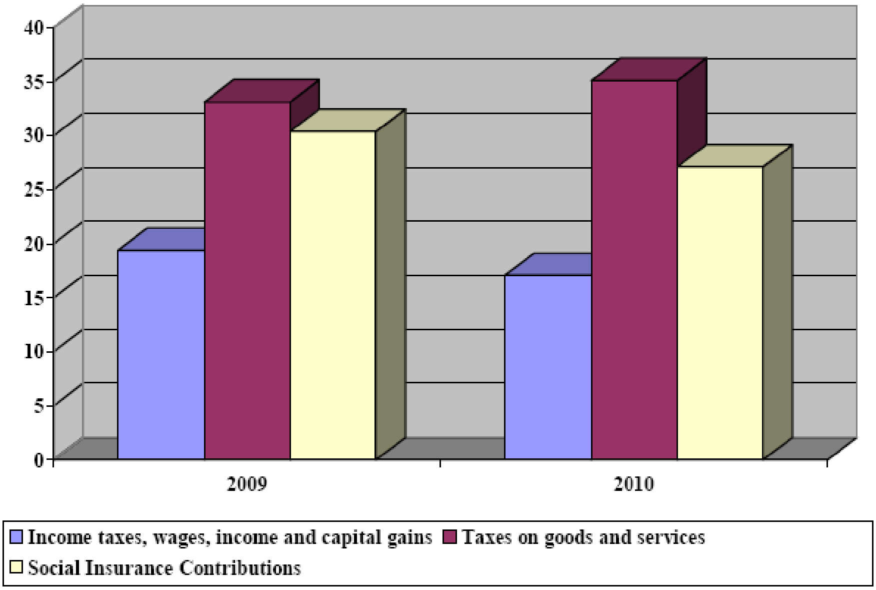

Figure 6: Structure of budget revenues (%)
Source: Ministry of Public Finance

The situation became critical in Romania due to an inability to increase in GDP share of budget revenues and reduce public spending (general consolidated budget deficit was 6.51% of GDP in 2010).

Our country has the lowest share of GDP of the EU, both budgetary revenue and expenditure budget. These costs are very small comparing with the actual financing needs of Romania (for infrastructure education, health, scientific research, environment protection). In these circumstances, public debt to GDP will continue to grow during 2010-2011.

Conclusions

How deep and long will the slow-down be; when can Romanian economy expects an end to the decline associated with the recession? This is a complicated question, which cannot be answered with any degree of confidence. Firms and households that face uncertain economic conditions, that have no access to credit and lack confidence in financial institutions will not invest and consume. A specific policy goal is the restoration of the credit system in which banks are the principal actors. Restoring confidence in the financial system and credit flows and increasing government expenditure typically do not have an immediate impact and will take time to work through to real economic activity, including growth in the demand for Romania's export commodities. But demand management has to be complemented by maintaining and expanding open trade and investment strategies and a serious commitment to assist the developing world in coping with the reversal in international capital flows.

References

[1] Gheorghiu Anda, Ene Corina–Maria, Cristea Dan–Gabriel, *Financial and Economic Crises: Romania Vulnerabilities, Econophisics*, New Economy and Complexity – ENEC International Conference, 26–28 May, Hyperion University, Bucharest
[2] Romanian Agency for Foreign Investment, *Annual Report 2008*
[3] UNCTAD, *Assessing the impact of the current financial and economic crisis on global FDI* flows, January 2009
[4] Bloomberg, Erste Group Research
[5] European Commission Dates
[6] www.wiiw.ac.at