Romania - the crisis impact and future challenges

Keynote Speech by Cristian Bichi, Head of Financial Crises Management Unit, National Bank of Romania, on the occasion of the conference "Southeast Europe: Crisis and Perspectives", organized by the Centre for Progressive Policy Research (KEPP), Athens, 13 November 2009.

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Ladies and Gentlemen,

It is a great pleasure to be here in Athens to address such a distinguished audience. I would like to thank the Centre for Progressive Policy Research for organizing this special event. This morning, I intend to present to you how and to what extent the global economic and financial crisis spilled over to Romania and the policy responses to these developments. I will also make some remarks on the outlook for the Romanian economy and on challenges in the future period.

Economic downturn and policy responses

Starting position

During the early stages of the current global financial crisis, the Romanian economy performed well. However, with the deepening of the crisis in the fall of 2008, the collapse in global trade and the increase in risk aversion on the international financial markets, a period of five years of sustained economic growth in Romania came to an abrupt halt. Notwithstanding the robust growth of 7.1 percent registered in 2008 as a whole, the economic activity declined sharply in the last quarter of the year (-2.75 percent, quarter-on-quarter) and has fallen even further in the first quarter of the current year (-4.6 percent, quarter-on-quarter). The strong economic growth over the last few years, which was fuelled by large foreign direct investments and capital inflows, as well as by a domestic credit boom, has been accompanied by widening external imbalances. At the end of 2008, the current account deficit reached 12.3 percent of GDP. Loose fiscal and income policies also contributed to the increase in the vulnerability of Romanian economy to adverse developments, with the government deficit rising from 1.1 percent of GDP in 2004 to 5.4 percent of GDP in 2008. The relatively strong reliance of domestic banks on external funds and a high share of foreign currency loans in the loan stock added to the vulnerabilities of the country.

Economic reform program

In response to the perceived vulnerabilities and deteriorating prospects, the government and the National Bank of Romania have developed a comprehensive economic policy program comprising measures to address the external and fiscal imbalances and strengthen the financial sector. Its immediate objective was to facilitate an orderly adjustment of the external deficit, thus easing excessive pressures on the exchange rate which could otherwise cause severe balance-sheet effects on the corporate and household sectors, resulting in a sharper downturn and tensions in the banking sector. Specific program objectives aim at: (1) reducing the fiscal balance to bring the deficit below 3 percent of GDP by 2011; (2) maintaining adequate capitalization of banks and liquidity in domestic financial markets; (3) bringing inflation within the target range of the central bank by end-2009 and maintain it there; (4) securing adequate external financing and improve confidence.

In support of this program, a joint financial assistance of up to EUR 20 billion was provided to Romania by the EU, the IMF, the World Bank and the EBRD.

Banking sector measures

The Romanian banking system proved to be resilient during the crisis thanks to the absence of toxic assets, strong balance sheets in the financial sector and strict supervision by the central bank. It has so far weathered relatively well the shock generated by deeper than anticipated contraction in the economic activity. Although the non-performing loans (measured as the ratio of overdue and doubtful loans to total loans, at net value) have increased from 0.24 percent in September 2008 to 1.23 percent in September 2009, the profitability of the banking system remains in positive territory. As of end-September 2009, the average capital adequacy ratio was 13.7 percent, up 0.57 percentage points since March 2009, and all the banks recorded solvency ratios above 10 percent. On the same date, the liquidity indicator was 1.63, a level which is well above the prudential requirement of 1.

In the second half of last year and during the current year, the Romanian authorities took several actions aiming at enhancing the stability of the domestic banking system and underpinning public confidence. These actions included measures to ensure that the banking system will remain well-capitalized and sufficiently liquid, steps to strengthen the crisis management framework and improvements in the deposit guarantee legal and operational framework.

A key measure undertaken by the Romanian authorities was the preventive increase in own funds and solvency of fundamentally sound credit institutions operating in Romania in order to allow them to withstand the negative effects of the financial crisis. This capitalization program was also seen as a tool to strengthen the possibilities of these institutions to finance the real economy.

Under the program, the National Bank of Romania has used stress testing techniques to assess the vulnerability of the capital positions of 29 banks, Romanian legal persons. The stress tests were conducted in March-April 2009, in accordance with a methodology agreed with IMF. Based on the stress tests results, additional capital requirements were identified for a number of banks (subsidiaries of EU credit institutions and domestically-owned banks) in order to maintain at least a 10 percent capital adequacy ratio in the period September 2009 - May 2011. These banks were asked to ensure the required capitalization by-end September 2009 and end-March 2010. Under the so-called “Vienna Initiative”, the parent banks of the largest nine foreign banks incorporated in Romania, met in March, May, and August 2009, on which occasions they committed to maintaining their existing overall exposure to the country and to increasing capital of their subsidiaries as needed. The continuing involvement of these foreign banks (from Austria, Greece, France and Italy), representing more than 70% of the domestic banking sector assets, is crucial for the successful implementation of the macroeconomic reform program of Romania.

In the area of liquidity, the National Bank of Romania has required banks to put in place alternative financing agreements and/or to diversify their financial resources.

Other measures taken by the Romanian authorities concern the protection of bank deposits. In October 2008, in order to underpin public confidence in the banking sector, the Romanian government has increased the deposit guarantee ceiling for natural persons to the lei equivalent of EUR 50,000 (previously the lei equivalent of EUR 20,000 per account holder and per bank). Further amendments to the existing legal framework regarding the bank deposit guarantee scheme were introduced in June 2009, by government ordinance. The new legal provisions ensure the full transposition in the national law of the recent EU requirements in the field of deposit protection, providing for increasing the coverage level for small and medium size enterprises to EUR 50,000 (in lei equivalent) and reducing the payout delay to a maximum of 20 days. The ordinance also introduces a new mechanism of declaring deposits unavailability by the central bank and improves the financing regime of the bank guarantee scheme providing for a state loan, in extraordinary situations, when the resources of the scheme are insufficient.

In the area of crisis management, the NBR has introduced measures aiming at enhancing its enforcement powers. Under Government Emergency Ordinance No. 25/2009, amending the existing banking law, the NBR was granted the powers to request capital increases and restrict dividend distributions for credit institutions in distress. New amendments to the banking law and the special bank insolvency law are planned in the near future, with the objective to allow the Romanian authorities to take timely and effective measures to restore the viability of a troubled credit institution. The amendments will offer, inter alia, more powers to the administrators of banks placed under the special administration regime.

Monetary policy measures

The conduct of monetary policy during the current financial crisis has been characterized by a prudent management of interbank market liquidity, combined with successive reductions of interest rates and minimum reserve ratios. The downward trend of the monetary policy rate has been consolidated during 2009, its level being gradually decreased to 8 percent. The minimum reserve ratio (MRR) for FX-denominated liabilities with a maturity lower than two years was reduced down to 30 percent in two stages with equal magnitude of 5 percent, following the MRR reduction to 0 percent for FX-denominated liabilities with a maturity longer than two years in May of the current year. At the same time, the MRR for local currency liabilities with maturities lower than two years has been decreased in two stages from 20 to 15 percent, while the maturity of the main monetary policy instrument (auction-based repo operations) was increased up to one month. Through these measures – adopted in the context of persisting low volatility of the exchange rate of the domestic currency and ongoing economic contraction – the NBR aimed at calibrating the broad money conditions with a view to consolidating the inflation rate convergence towards its medium-term targets and to securing the necessary conditions for the sustainable revitalization of the lending process.

Fiscal policy measures

The economic program of the Romanian authorities includes also a strong fiscal policy package aimed at achieving a necessary short-term fiscal adjustment and introducing reform measures to make public finances more sustainable on the longer term. The government deficit target for 2009, initially established at 4.6 percent of GDP, was revised in August 2009 to 7.3 percent of GDP to take into account the larger-than-expected economic contraction. Achieving this objective will still require further significant adjustment efforts, including measures to reduce the wage bill and implementing the announced spending cuts in good and services. For the next year, the Romanian authorities are committed to taking further measures to bring the deficit to 5.9 percent of GDP.

Crucial for the success of the fiscal strategy are reform measures in the following areas: (1) restructuring of the public sector to reduce the budgetary staff together with a unified wage law to produce a less costly pay scale for public sector employees; (2) pension legislation reform; (3) implementation of a Fiscal Responsibility Law; (4) public enterprises reform; (5) restructuring of the financial relations with the local governments; (6) improvements in tax administration; and (7) streamlined social assistance programs. In early November 2009, two important laws concerning the fiscal reform package were promulgated. The first one, the unified wage law, would allow the public sector wage bill to be reduced to about 7 percent of GDP by 2015. The second provides for the restructuring of numerous state agencies in the government sector by either abolishing or incorporating them into relevant ministries. The fiscal responsibility law and the pension reform law, (agreed as structural benchmarks under the IMF assistance program, by 30 November 2009, respectively 31 December 2009) are still to be approved by Parliament.

Future challenges

Romania's macroeconomic outlook is improving, but there are still policy challenges facing the country.

The economy is likely to register a GDP contraction of -7.5 to -8 percent in 2009, and a slow recovery of 0.5 to 1 percent is expected next year. The external imbalances have also undergone significant adjustments. Through the first nine months of this year, the current account deficit stood at EUR 3.3 billion, reflecting a sharp fall by 74.6 percent compared with the same period of 2008. This current account deficit was covered by foreign direct investments inflows in a proportion of 106.4 percent. The significant narrowing of the current account has eased the concerns about the financing requirements and the vulnerability of the country to capital outflows. It also contributed to the easing of pressures on the exchange rate and inflation. The CPI inflation rate is projected to be 4.5 percent for end-2009, within the variation band of the central bank under the inflation targeting regime. In 2010, the inflation rate is forecasted to fall below the central target of 3.5 percent to as low as 2.6 percent. Currently, the key challenge that Romania needs to address is the successful implementation of its program of fiscal consolidation and of institutional reforms in the public sector. The political turmoil in recent weeks, preceding the presidential elections scheduled for 22 November 2009, with a run-off on 6 December 2009, led to an interim government. Currently, this government cannot legally submit a 2010 budget to Parliament. It also cannot undertake strong commitments on the rebalancing measures envisaged under the revised pension reform legislation in order to bring the 2010 deficit down to the fiscal target (5.9 percent of GDP) established in the economic program under the multilateral financial support package provided by the European Commission, the IMF and the World Bank.

Under the circumstances mentioned above, despite good overall performance under the economic program, the IMF and the European Commission decided, in early November 2009, to delay the next installments of the multilateral financial support package until a new government takes office.

Evidence suggests that there is a broad political consensus on the fiscal target for 2010, although differences of views remain on how to achieve this target. I am confident that the future government, to be nominated after the presidential elections, will show a strong commitment for reforms. This will allow for a rapid completion of the program review and a smooth disbursement of delayed financing. At the same time, the macroeconomic policy mix will benefit from a more efficient coordination.

Thank you for your attention.