THE IMPACT OF THE FINANCIAL CRISIS ON THE CURRENCY AND THE MONETARY SYSTEM

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Abstract

The present-day economic and financial crisis (depression) appears unprecedented in the last half century. The international financial crisis has been extended to the Romanian economy. However, in terms of direct impact, the Romanian banking system was less affected by not being exposed to toxic assets, and because of prudential and administrative measures taken by the NBR.

Indirectly, however, the international financial crisis and especially its obvious consequence – the recession in developed countries - has expanded to the Romanian economy, on several channels. The shopping channel slowed export growth and even reduced them. The financial channel has limited the access to external financing, and thus restricted the lending volume, generating private external debt service difficulties.

On the exchange rate channel, the reduction in external financing reflected in national currency depreciation. On the confidence channel, there was a withdrawal of investors from Eastern Europe countries.

Among the measures adopted by the central bank, the most notable were targeting inflation and currency interventions. By adopting inflation targeting, the central bank opted to make more room in establishing foreign exchange market, and after the onset of the current international financial crisis, including the 2009-2010, adopted a controlled floating exchange rate. This does not mean intervention in the forex market on a discretionary basis.

NBR policy on foreign exchange intervention has been guided by the philosophy that high exchange rate volatility is harmful for both the inflation target and the financial health of the real and financial sector.

Key-words*: financial crisis, targeting inflation, currency interventions, monetary system*

JEL Classification: G_{01}, G_{18}, G_{28}

1. Introduction

The scientific communication is a measure related to the drives of the international financial crisis, mainly the one in Romania. They are of macro-economic and micro-economic nature, as specialists like Altman (2008) and Blachard (2009) pointed out.

The profound reason of the international financial crisis has been the abundant amount of cash created by the main world banks (FED, BOJ) and the desire of the oil-exporting countries to limit the currency appreciation.

Likewise, there was an oversaturation with savings, derived from the surging integration into the global economy of some countries (China, South-Eastern Asia) with high accrual rates, and also a global distribution of the assets and income to the goods exporting countries (oil, natural gas, etc.)

A series of micro-economic causes seemed menacing in this environment, namely the rational externalizations from a private point of view, but socially insufficient, and the international competition, known for de-regulations.

The issue under scrutiny is important, as the international crisis has affected Romania too at various levels: commercial, financial, exchange rate and, last but not least, the trust – the European investors have withdrawn from our system.

The paper will continue with presenting the RNB measures that have been adopted, in order to lower the impact of the crisis upon the currency and the monetary system – the most crucial is the inflation and the foreign currency interventions.

The author gives his opinions about the RNB policy, mainly in agreement with them, but also states his personal views, supported by pertinent arguments.

2. **Specialist literature**

The works in this field are indeed diversified and, most of the time, sides with the topic, as a result of its interests, proven by how the specialists put down or praise the RNB policy.

One thing is certain: during this harsh time of a profound economic and financial crisis, including the post-1989 interval, RNB has proved itself as a stable pillar (especially by its foreign currency policy), able to involve in limiting the crisis effects upon the national economy.

3. **The content of the article**

The present financial and economic crisis seems to have no parity for the last half century. The economic recession has expanded to the USA, Europe and Japan and it models as even more painful than the economic downturn in 1981-1982. A massive trust drop at both the business and the consumers' level, translated into expenses lowering, is in full swing. The government of USA and some executive bodies in Europe, have nationalized parts of their financial sectors, in their attempt to regain stability, a contradiction for the modern capitalism. The entire world seems to go a different direction, where the state role will be higher than the private sector's.

Many people believe that the current financial crisis is rooted in the dramatic fall of the housing price in the USA or of the credit market for housing. This vision is quite incomplete. The fundamental causes of the financial crisis are even deeper, macroeconomic and microeconomic in nature, as specialists think: Altman (2010), Blanchard (2009). The two types of causes have intertwined in bringing about the crisis.

The profound reason of the international financial crisis has been the abundant amount of cash created by the main world banks (FED, BOJ) and the desire of the oil-exporting countries to limit the currency appreciation. Likewise, there was an oversaturation with savings, derived from the surging integration into the global economy of some countries (China, South-Eastern Asia) with high accrual rates, and also a global distribution of the assets and income to the countries exporting goods (oil, natural gas, etc.) The plenty amount of cash and the oversaturation with savings have generated resources available for investments, including sophisticated financial tools, which some investors do not grasp very easily.

The consequences of all that cash were the very low interest rates and their reduced volatility. Together, such consequences have triggered desire for assets with great earnings. Plus, the low volatility on the market has created the trend of under-estimating the risk and a true lack of vigilance on the investors' side.

The risk margins have also been very low and non-discriminatory. All these, the low interest rates, the appetite for assets with great earnings, the lack of vigilance towards risk and the small margins have somehow hidden the signals of prices on the financial markets and brought not enough understanding of the risks involved.

The consequence of the frantic securitization was that, once the crisis derived from failing in payment of the credit instalments for housing, the financial market became non-transparent. The investors' distrust has quickly placed the titles issued by the special vehicles (VSP) in the high-risk category (the quality of the assets being finances was not clear anymore) and the refinancing has become impossible. Due to the difference between the maturities on assets and liabilities, these VSP have started relying on financing lines from the sponsoring banks. Lastly, the liquidity request, along with the lack of trust in banks, has triggered the cash rush and, therefore, the actual interest rate has started going up.

In a nutshell, the main challenge is to find the solutions to re-establish the trust of the investors and consumers.

On a long term, the core issue is to adjust the principles guiding the reform of the international financial system, mainly referring to transparency, improvement of the regulations concerning the titles accounting, assurance of the financial markets integrity (in terms of market manipulation and fraud) and strengthening the cooperation among the financial institutions in the world (the updating of the IMF and World Bank governance structures). The business ethics is still on this list.

The international financial crisis has also touched the Romanian economy. Still, from the point of view of direct impact, the Romanian banking system was not deeply affected, as it had no exposure to toxic assets, due to the prudential and administrative measures adopted by the RNB.

But, indirectly, the international financial crisis and its obvious outcome – the recession in the developed countries – has extended upon the Romanian economy on various channels. For the commercial channel – exports have slowed down. The financial channel – access to foreign financing has been limited, therefore the crediting volume has reduced, generating difficulties in the private foreign debt service. As for the exchange rate, the lowering of the foreign financing has reflected into the depreciation of the national currency. For the trust, the investors have withdrawn from the eastern European countries.

The result was the emergence of panic and speculative attacks on the currency market (see the one in October in Romania, which required the RNB intervention). Finally, for the channel of wealth and balance effects, the net assets of population and companies have lowered, as a consequence of the increased percentage of foreign-based credits (correlated with the national currency depreciation) and of prices decreasing for the estate assets from speculative, non-sustainable values (‘*bubble’ type*).

The spread of such effects makes the uncertainty degree of the economic variables evolutions be extremely high. Therefore, the crisis is being increasing the diligence degree at the level of consumers and economic agents.

In Romania, the answer to the crisis adverse effects cannot be similar to the one in other European state or the USA. There are differences among these economies, which do not simply allow copying the measures packages from one country to another. In essence, we are talking about the fact that the Romanian economy has a large deficit of the checking account, which indicates its dependence on the foreign financing. We do have to choose between the orderly reduction of this deficit or its reduction via the market within this mistrustful and diffidence environment, with dramatic consequences for the exchange rate and the economic improvement.

Even if the development of the economic landing process cannot be planned in detail, the promotion of several coherent and credible economic policies might prevent from a hard landing. Thus, the government should avoid an emotional approach of the crisis, under the pressure of labor unions and patronages, which would lead to adopting some measures of stimulating the internal demand, and making more complicated the action of bringing the checking account deficit to a sustainable level. It is only a concentration of the combination among macroeconomic policies on the landing process of the foreign imbalance (the checking account deficit) and internal (budget deficit) that may support a soft adjustment of the economy and an improvement of the foreign investors’ perception.

In essence, it is necessary to have a significant strengthening of the fiscal and wage policy (to a large extent, it includes the bonuses and the quasi-salary awards).

To this purpose, the 2010 budget, recently approved, is a wonderful step taken, mainly due to the distribution of some relatively high funds for investments that have the potential to create ‘spill over effects’ upon the other sectors in economy. As it is being implemented, the possibility of gradual relaxation of monetary policy will emerge. Thus, a sub-optimal combination for the last years (less severe budget and wage salaries, i.e. a very ‘tight’ monetary policy) will be replaced with an optimal combination where all the policies (budget, wage and monetary) have a similar restriction degree and take to the economic activity to labour and productivity.

Moreover, the government may also contribute to the improvement of how the foreign investors perceive the situation, by measures aiming the enhancement of absorption ability of the European funds and the replacement of the private foreign financing with public foreign financing or by creating new employment places in underserved fields (infrastructure, tourism, agrifood) that will later turn into the engine of the economic growth. Generally speaking, the conclusion of several financial contracts with international organisms, starting with the European Commission and the European Bank of Investments, which will cooperate in order to greatly diminish the private capital input is very welcomed.

If all these steps are going to be followed, there is a high probability that the investors improve their opinion about Romania and prefer investing here rather than somewhere else in Central or Eastern Europe. The high probability does not equal certainty: it is quite impossible to avoid the scenario where the foreign investors will not react positively and they will still treat Romania discriminatorily, even if the local authorities are doing the right thing. But the awareness about such possibility should not lead to abandoning the so-necessary landing measures.

A danger in implementing a such coherent strategy of orderly adjustment of the foreign imbalance is in the more and more gloomy forecasting, issued by various institutions in regards to the economic upturn in the 2010 Romania, even to predict a negative increase. The real threat is the fact that the political factor, upon believing such forecasting, might handle the issue in an emotional way and adopt measures of fiscal and wage easing, which only worsen the crisis.

Even if it is obvious that some areas, former drives for the economic progress until 2009 (real estate, financial-banking, car imports, metallurgy industry, chemical industry, car building industry) will witness a decrease in 2010, there are still some, like IT, telecommunications, food and pharmaceutical industry, public services) that may see some growth. At the same time, we need to consider an effort of regaining the consumers' trust in the economy progress, trust that was dramatically lost (as shown by the trust indicator in economy, published by EC), due to an emotional handling of the crisis.

As a conclusion, the private sector has already reduced the last year external deficit, which still stays high. The prediction is that the adjustment will be constant in 2010 as well. Similarly, the fiscal policy has been procyclical and contributed to the deepening of the external deficit of the Romanian economy. Right now, we need several measures that will provide an orderly adjustment cutback of the checking account deficit to sustainable levels, by reducing the budget deficit and a better adjustment of the policies mix to the limits of deficits. The percentage of the public expenses for investments should go up.

Likewise, the absorption of the European funds and adoption of financing agreements with international organisms (European Commission and the European Central Bank) should be looked closer at. The private sector needs to re-establish the relation between the wages and labour productivity, which will provide foreign competitiveness. Such policies will decrease uncertainty and will give back the trust in the future of economy.

Among the measures adopted by the RNB, the inflation targeting and the currency interventions are worthwhile to mention.

The option for adopting the inflation targeting has been justified by the need to achieve a sustainable disinflation. The implementation of the inflation targeting strategy has not been easy either before the emergence of the financial crisis, when the massive capital input, the position of net debtor of RNB towards the banking system and the mechanism of the monetary policy distribution have combined themselves and thus, between 2005 and 2007, there was a co-existence between inflationist forecast and currency strong appreciation. This was a serious issued for the central bank. The Increase of the interest rates, required to bring the anticipations in line with the inflation target, was attracting even more foreign capital, making the national currency more appreciated.

Since July 2007, along with the financial crisis, some of these requirements have disappeared. Today, RNB has the tendency to be a net creditor of the banking system, and the foreign capital input has slowed down a lot. But this will not make the monetary policy simpler. On the contrary, the financial crisis has increased the volatility on the monetary and currency market and had the tendency to amplify the deceleration of the economic activity. On the one hand, the reduction of the external financing and the existence of the high foreign imbalance have triggered the national currency depreciation, which fuels the inflation and makes necessary a relatively high interest rate. Moreover, the people with debts in EUR or other currencies are vulnerable to a significant depreciation of the national currency. On the other hand, higher interest rates would tend to prevent the economic growth and more, it would create costs for the people in debt, thus risking to unbalance the financial sector.

In these circumstances, the issue of the compromise between the monetary policy objectives emerges: the assurance of the prices stability and of the financial stability.

Phelps (1968) has shown that there is no long-term compromise between inflation and unemployment. Hence, the long-term objective of the monetary policy has to be reaching a low and stable inflation. One has noticed that the low and stable inflation helps the sustainable economic growth on a long term. Therefore, the low and stable inflation represents a purpose per se and a means of achieving a sustainable economic growth.

The efficiency of the monetary policy in reaching this objective is limited though, unless there is a financial stability. One of the basic macro-economic principles has stated that the divergence in the financial area substantially influences the business cycle. Today, this thing is obvious worldwide. The world central banks attempt to maintain the financial stability and avoid the recession and the economic depression.

The previous experiences seem to confirm the opinion that inflation is the main source of financial instability. On a usual basis, high inflation intervals are characterized by severe financial instability and banking system crises or followed by recession – as the authorities have adopted inappropriate measures of inflation smoothing.

Still, the recent specialist literature highlights the fact that a low inflation level is not a sufficient requirement to provide a long-term financial stability (Crockett, 2003). For the present economies, a low and stable inflation level has led to a new economic climate, which requires a thorough rethinking of the relation between the prices stability and the financial stability. To this purpose, the experience of several countries in Asia between 1997 and 1998 and the current economic and financial crisis are taking us to the reconsideration of the measure where the central bank holds the ability to provide a simultaneous stability of prices and financial one, where hypothetically speaking their achieving requires the adoption of contradictory measures.

The experience of Romania shows that the financial stability has a special importance in the prices setting. Romania has been deservedly criticised for delays in disinflation, due to the insufficient structural reforms. Our country had an average disinflation rate of 5.8% per year for 2000-2007, in parallel with maintaining the stability of the financial system. If RNB would have covered this lack of reforms by steeper increase of the interest rates, the companies' and households' financial situation would have deteriorated. And so would have the banking system. Lastly, the disinflation pace itself would have been smaller than the one being achieved. The lesson that we should learn is that, on a long term, the inability of maintaining the financial stability will only lead to a reinflaming of the inflation.

Upon adopting the inflation targeting, RNB has opted to make a larger room in setting the exchange rate. Still, there were times when the leu fluctuations were way outside the limits justified by the exchange rate fundamentals. This thing happened after the present international financial crisis emerged, including 2010.

These are the reasons why RNB has adopted a controlled push-up of the exchange rate, which is not similar to the discretionary intervention on the currency market.

The RNB policy concerning the interventions on the currency market has been guided by the philosophy that a high volatility of the exchange rate is dangerous both for the inflation-related objective as well as for the financial health of the real and financial sectors.

Following this philosophy, RNB has promoted a fluctuant exchange rate, which allowed it to use the free market valences and to discourage the speculative behaviours and avoid the excessive appreciations.

The consistent implementation of such philosophy required from RNB a relatively important currency purchase from the market for the 2004-August 2007 interval. Upon the currency purchase, RNB was criticised for not letting the rate appreciate in step with the market requirements. Today, this step proved to be right. The current financial crisis has introduced a steep inversion of the leu appreciation trend, with noteworthy episodes of volatility. As it happened in the past – the currency input over-appreciated the leu much more over the level indicated by the fundamental factors of the exchange rate, so did today – the decrease of the foreign financing and uncertainty are prone to determine the leu depreciation, not justified by the fundamental factors of the exchange rate.

The reserves that have been bought on the currency market during the over-appreciation moments are now useful for slowing down the leu depreciation.

4. CONCLUSIONS

Even the world economic growth continues, the dangers are still ahead. The effects of the profound crisis that affected Greece seem to impact the debts of the European states in arrears but going up and place in doubt the stability of the entire European Monetary Union.

The so-called contagion of the public debt crisis among the PIIGGS countries (Portugal, Ireland, Italy, Greece, Great Britain and Spain) worries Washington and Tokyo, the deepest in debt non-European governments. The EUR exchange rate has had a new depreciation and the international investors have withdrawn their money in Europe.

The critical situation of the EUR zone is the consequence of the so-called anti-crisis policies adopted by the European governments in the last two years. These governments have large budget deficits and public debt level, i.e the most vulnerable macroeconomic imbalance on the continent. As characterized by an overweight welfare state, a low productivity, asset bubbles, high current account deficit and a non-sustainable increase of the governmental expenses, the PIIGGS countries seemed to be, on the verge of crisis, in a situation somewhat similar to the EU member states (macro/economically speaking) in Eastern Europe. Still, the membership to the EUR zone or the traditional trust of the market in the London government economic wisdom, have succeeded to hide all these weaknesses of the PIIGGS countries. But, once the economic crisis begun, the macro-economic stability of these countries was shattered, as a result of the Keynes policies resuscitation of ‚fiscal stimulation'.

Even though the public expenses in use were already non-sustainable, the governments in the PIIGGS countries simply wrote down the losses in the private sector into the public sector, concluding that the entire crisis is only a sin of capitalism, nonchalantly overlooking the 'obsolete' rules mentioned in the Stability pact 20 years ago. Thus, the private sector in great debt, on the verge of bankruptcy, has been substituted by a public sector in a similar situation.

The EUR zone is now in an unprecedented situation and risks an implosion. The states with a better financial situation have to save from bankruptcy the ones that are about to be declared insolvent, and BCE – opposed to its own status – might have to turn to a direct monetization of the budget deficits.

The RNB representatives appreciate that Romania has continued to register an economic downturn for the first 3 months of this year, the main challenge for the economy being the budget deficit that needs to be lowered by speeding up the structural adjustments. Mugur Isarescu, the Governor, says that the economy recovery is not desirable, as long as the public sector fails to reduce the enormous deficit, either via drastic expenses cuts or taxes increase. This speaks indirectly about the need of implementing harsh measures of costs decrease by layoffs and cost cuts in the public sector.

The cuts in the public sector employees' salaries by 25% since June 1st, the decrease in the unemployment benefits and pensions by 15%, the dramatic lowering of the budget subventions, these are the main reform measures that the government has used to persuade IMF to drop the VAT and the single quote increase – where these reforms supplement the monetary policy measures of RNB with the purpose to go back to an economic progress, to reduce the deficit and to have Romania come out of recession.

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