# FINANCIAL STABILITY – PREREQUISITE FOR THE PROPER FINANCING OF THE REAL ECONOMY[1]

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*"By its instruments, the monetary policy can have systematic influence on price stability only"*
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**Abstract**

The interventions done by central banks in order either to provide liquidity or to help the recovery of economic growth, during the lasting effects of the recent financial crisis, have again brought into the light the question how the monetary policy is serving the best a sustainable growth. Beyond the fact that in Europe, especially within the European System of Central Banks (ESCB), we still stack on the independent mandate of price stability connected with that of the financial stability, there still exists the propensity to think in a different way the contribution of a central bank to the stated issue through its monetary policy conduct. I think that we cannot compare National Bank of Romania`s mandate with those of FED or other central banks issuing international reserve currency, but we also cannot totally neglect that between the monetary policy effects and the economic growth there is a link. The difference is that many believe that this has to be on purpose, e.g. the central banks instruments are ex ante calibrated for economic growth, while a correct approach is that the monetary policy conduct responding primarily to price stability is creating ex post the potential for a sustainable growth. Accepting that, we can start from financial stability to explain better how the monetary policy has a role in economic growth by not diluting the mandate and the independence of the central bank.

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***Clarifications on the role of the monetary policy***

The Central European bankers are insistently asked, particularly during these days marked by the effects if the financial crisis, what they can do to boost the economic growth. The term used was "*what they can do"*, because there still is awareness on the mandate of a central bank within the European System of Central Banks (ESCB), and on the fact that this mandate must be accomplished under conditions of full independency. The statement of ECB President, Mario Draghi that *he will do what it takes to save the Euro* might have caused some confusion, but the subsequent actions in this direction have shown that what is necessary is not always pleasant for a central bank.

Indeed, we are experiencing, due to the extensive quantitative easing (QE) mentioned among the non-standard measures of a central bank, a serious incertitude of the effects of giving it up, and the mere intention of the FED to use them less already disturbed the financial markets. However, the problem of the role of the monetary policy for the economic development is a current issue, at least because the steady and convincing revival of the economic growth in Europe, in the absence of the fiscal space, is yet to come.

I think that a correct revelation of this relation is displayed better by the financial stability, a subobjective of the central banks which is closely related to the main objective of price stability. Therefore, the reference to the financial stability is more comprehensive and allows understanding how the monetary policy can influence the economic growth and that it includes a picture that captures better this correlation.

The National Bank of Romania released in 2013 its 8$^{th}$ annual report on the financial stability; the content of this report is increasingly targeting the business sector in general, not just some financial specialists. Why? Because such report distinguishes the assembly of the financial relations between the economic actors, creditors or debtors, financial and non-financial entities or individuals, how the financial obligations are paid, the level of indebting, all these being useful information for both sides when we are speaking of the potential of a solvable demand for goods, services and financing.

More than ever we have to define or redefine the role of the monetary policy so as not to interfere into the mandate of the central banks directed towards price stability and not to diversify uselessly the action of their instruments, which are few but efficient, towards effects for which they were not designed. We will not make comparisons with the behaviour of particular central banks, such as the FED, or those that issue currencies used by other countries to make international reserves (Bank of England). As EU member state, we can only follow ECB pattern, which issues the Euro, currency which forms the bulk of our international reserves and to which the Leu is rated.

NBR, by its law of functioning (312/2004), harmonized with the main operational principles of the ECB (mandate and instruments), struggled against a strong hyperinflation and this is why the objective of price stability is still running and consolidating. However, even with strict mandate, completed with the financial stability, the role of the monetary policy must be understood properly. There is an impact on the economic growth, but not in the way desired by those thinking that a central bank can credit the economy directly, can capitalize economic entities directly, can cover the budget deficit directly by monetization and may use parts of the international reserves directly in public, even private investments.

Usually, the intention of such forced correlation is done *ex ante*, in a wrong manner in terms of using the monetary policy instruments, when we should actually judge *ex post* the impact of the monetary policy, benefitting of their properly guided effect, i.e. whether price stability creates favourable conditions for sustainable economic growth.

From now on we have nuances, which are absolutely necessary, our expectations being divided between the short-term, medium-term and long-term influence of the monetary policy. On the short-term, the monetary policy acts on the economic growth by regulating the aggregate demand using own instruments, aiming to flatten the large upwards and downwards oscillations of the economic cycle. The upwards oscillations reveal an excess of demand with positive gap compared to the potential GDP, situation in which the inflationist pressure builds up and endanger the general stability of prices, which causes the so-called conjunctural overheating. Since the regulation of the aggregate demand is usually included in the prudential policy of the central bank, the conjunctural overheating defines an exuberance, either by a higher attractiveness of the investors towards risk, or by the procyclicality of the fiscal-budgetary policy of the public sector in the situation when the drive of the economic growth is already firmly ensured by the private sector.

The downwards oscillations of the cycle bring about the danger of recession and the monetary policy acts on the insufficient liquidity and on the cost of money, establishing the conditions for normal crediting. On both amplitude oscillations of the economic cycle, upwards and downwards, observing the establishment of a positive or negative gap of the aggregate demand compared to the potential GDP, the instruments used by the central bank are the monetary policy interest rate, the minimum reserve requirements ratio, liquidity management which may also impact on the exchange rate, however, within the stated exchange rate policy of the central bank, known by the business sector.

On the long-term, the monetary policy targets the general stability of the prices, and its systematic influence is to preserve this stability. This price stability, achieved by the behaviour of the monetary policy, has a direct impact on the long-term economic growth by decreasing as much as possible the incertitude that may affect business plans predictability and the normal operation of the markets. The persisting incertitude will stimulate speculations, will deter the formation and correct allocation of resources for development, all these eroding the potential of a sustainable economic growth created by price stability.

Thus, **the monetary policy cannot influence directly the level and rate of economic growth, but it determines, on the long-term, the inflation rate within the economy**. Many, older or more recent, studies support this conclusion, such as those of Laurence Meyer (1996) and Milton Friedman (1970). Meyer doubts that the monetary policy can lead directly to the growth of the GDP: *“Would it be possible to generate long-term economic growth by mere printing money, we would have long time ago create much higher standards of living by monetization”*. Friedman, on the other hand, warns on the danger of increasing the monetary mass without the support of economy: *“Inflation is always and everywhere a monetary phenomenon in the way that it is the mere result of a faster expansion of the volume of money than of the production”*. These truths have been demonstrated by the economic growth of most countries.

It is correct to see the long-term effects of the monetary policy of our central bank by its prudent and anticyclic character, which was much criticised. However, the thing that many saw as exaggerations (high rates of the minimum reserve requirements, recommendations regarding the credits in hard currency, particularly in the *exotic currencies*, warning on the developing bubble in the real estate sector etc.) saved us from the financial crisis. Leaving aside the debates regarding the intensity of prudentiality used by the central bank, we may say that we benefitted of the buffers created by such behaviour, with the specification that all decapitalizations of some commercial banks were repaired exclusively by their shareholders, who remained in the front-line for readjusting their balance sheets.

Following EU and ECB recommendations regarding the *stress tests*, the Report on financial stability for 2012 (ECB, 2013) allowed thorough analyses which concluded that the financial stability in Romania is now staunch, with all the significance of this term. By this characterization, before going into relevant details, we synthesize that: (1) the resilience and resolution of the financial system are above the international standards; (2) the resilience of the financial system is not endangered if the normal crediting of the economy is resumed; (3) resilience id sufficient to control possible adverse evolutions external to the national space, tested with strict prudential filters. Are these conclusions on the financial stability resulting from a monetary policy directed with priority towards price stability, relevant for a sustainable economic growth? I wish that the answer to this question is found by those who will read patiently the above-mentioned report.

***Financial stability and economic growth***

We are all aware about the disturbance which the financial crisis caused to the ability of the financial sector to ensure finances for the medium- and long-term investments, under the influence of the climate of incertitude and risk aversion generated by the poor global macroeconomic situation. Specifically, the small and medium enterprises (SMEs) still suffer from this, and, as a formally acknowledged of this critical situation, the EU member states, individually and within the European institutions, explore the possibilities to find new ways to facilitate SMEs financing, particularly by designing new instruments which guarantee their crediting.

The concern starts from a strong economic reason, that the support of SME during this period is necessary because of their potential to restore the economic growth and to create jobs by short- and medium-term active measures. We are therefore in front of an emergency whose approach responds a political creed pertaining to the establishment and consolidation of the middle class within the context in which countries with experience in this field are concerned by the polarization of their societies, with the erosion of the middle class and of its capacity of private economic initiative.

NBR, which, within the limits of its mandate, participates and monitors this action, has taken all measures necessary to strengthen the domestic financial stability, as confirmed by the evaluations of the international financial organisms. The monetary policy, which combines inflation targeting with the subobjective of financial stability, established the conditions for a lower cost of the credit in national currency and an ambience which favours the collaboration of the credit institutions with the beneficiaries of such credits, so that the real economy starts to be financed in a fluid, normal manner.

We may say, according to the local actions (monitoring and stress trials) and to the structural analysis of the relevant directorates within NBR, that the financial stability in Romania, at the consolidated level of the financial system, reached a fair level of robustness, which provides a considerably higher resistance or resilience than the current international standards. This resilience is not endangered by the release of a relation of normal confidence between the financial system and the non-financial sector; it is an important prerequisite that enables the local banking sector to cope adequately with the possible adverse (external) evolutions. The central bank will continue to support the evolution of the real economy at the level of its potential, which presumes sustainable growth.

The quality of the resilience is given by the fact that the maintenance of the financial stability was achieved under the conditions of challenges to it; the main vulnerabilities of the banking sector – high level of the non-performing credits and acceleration of the process of financial de-intermediation – remain within manageable limits. Solvability, the coverage of risks by provisions and the liquidity also were within adequate limits. They have the potential to resume crediting within sustainable conditions, on the background of a continuing and even intensifying process of financial de-intermediation and of the proper management of the banking assets quality in relation with the exposure of the credit institutions.

The successful finalization of the preventive financing agreement concluded with the European Union, International Monetary Fund and the World Bank, and the negotiation of a similar agreement which to ensure the continuation of the reforms necessary for the consolidation of the domestic macro-stability and of the domestic financial system, contribute to the maintenance and consolidation of the financial stability.

The Romanian **banking sector** continued to be properly protected against the different unfavourable evolutions, both local and international. The level and quality of the own funds maintained within satisfying parameters: (a) the **solvency rate** remained at an adequate level (14.7% in June 2013), significantly higher than the regulated minimal level (8%); (b) the **own funds** consist mainly of good and very good quality items (13.6% first grade own funds in June 2013), and (c), NBR decided to **maintain the use of prudential filters** when calculating the own funds and the indicators of banking prudency throughout 2013.

According to the results of the **stress testing** of the banking sector solvency covering the period 2013 3Q – 2015 2Q, overall, the credit institutions preserve a good capacity of coping with macroeconomic shocks. According to an adverse scenario characterized by 20%+ depreciation of the national currency and by persistent recession, under the conditions of non-reimbursement rates comparable with those from 2009, the decrease of the aggregate banking solvency indicator would be of about 4%, up to 10.8%, which is above the prudential limits set by NBR.

The level of coverage of the non-performing credits by IFRS provisions, also analysed in terms of evaluations using prudential filters, remains at a comfortable level (88.2% in June 2013), being among the highest compared to the countries in the region. Such prudent behaviour overlaps the constraints still affecting the financial results of the credit institutions. The decrease of the expenditure with provisions compared to the similar period of 2012, as well as the lower costs of financing on the background of a better perception of the sovereign risk of Romania, helped the banking sector in Romania to turn back to profit during the first quarter of 2013 (1.2 billion lei).

The **exposure of the mother banks** towards their branches in Romania decreased so far in an orderly manner, the 24% decrease

(December 2011 – June 2013 – from 20.3 billion Euros to 15.4 billion Euros) being compensated by the branches by drawing deposits from the local market. The effects of the de-intermediation have also been preponderantly corrective so far: the dependency of the banks ion the external financial resources decreased gradually, the level of indebting of the population decreased slightly, while the sectors of activity displaying a potential to change sustainably the pattern of economic growth of Romania generally received additional financing compared to the rest of the sectors.

In the hypothesis that the process of de-intermediation initiated by the large banking groups continues to speed up, its significant level generating in short time liquidity shocks within the local banking system, the latter would have a fair capacity to cope with those adverse evolutions, but some vulnerabilities cannot be omitted. According to the **results of the macroprudential stress testing for liquidities**, the challenges regard the transformation of the lei resources into Euro, the sales of assets and the impact on the credits for the real sector. The autochthonous banks with capital from Euro zone countries, perceived by the international markets as being affected more by the sovereign debts crisis, generally have higher solvency rates and higher coverage rates (with provisions) of the non-performing credits than the system average rate. However, the specific conditions confronting the mother banks from the country of origin claim continuous attention to evaluate the possible risks.

Besides the ordered continuation of the profess of financial disintermediation, other two challenges for the sustainable resumption of the credits for companies regard the maintenance of the recent trends of balanced evolution by currencies of the new credits and the consolidation of the favourable structural changes regarding the credits for the non-financial companies. The new measures implemented by NBR starting with 2011, motivated both by the poorer quality of the credits in hard currency compared to the credits in lei, and by the need to align to the requirements of the European Committee for Systemic Risk, contributed to a more balanced dynamics of the flow of new credits starting with September 2012 and to a more balanced evolution by currencies of the new credits.

The **financing of companies** displayed favourable structural evolutions from December 2011 to June 2013, the most note-worthy ones being: (a) the credits for the companies that produce high value added goods (*medium high-tech* and *high-tech*) increased by 4.3% compared to the 1% decrease in the case of the companies incorporating less value added in their products (*low-tech* and *medium low-tech*), (b) the sectors producing tradable goods received 0.6% more credits, while the companies producing non-tradable goods received 1.1% less credits and (c) according to the profile of the activity, agriculture stands out with 20.9% increase of the credits, followed by trade and the processing industry with 3.3% and 0.6% increase of the credits. However, the *knowledge-intensive* service providers displayed a 6.2% decrease, while the *less knowledge-intensive* service providers displayed a 0.2% decrease.

The **essential challenge** for the next years is to maintain the internal macrostability by a sound financial stability, so that the trust of the main players (resident and non-resident investors, consumers, the financial system etc.) in the Romanian economy consolidates. In order to preserve and improve macrostability and the financial stability, the structural reforms from economy must speed up, the labour market constraints should alleviate, and the economic development must increase. The fiscal consolidation must continue with a better discipline of the economic agents for the payment of all their obligations.

At the **level of the real economy**, the constraints on the economic and financial situation of the companies lessened slightly in 2012, the performance of the companies was heterogeneous, but one can see a process of change if the business pattern, but it is yet to become general. The causes reside in the slow progress for the payments of the duties, more acute insolvency phenomenon starting with 2012, a lower capacity of the companies to pay their debts to the bank (the rate of non-performing credits increase from 14.4% in December 2011 to 22% in June 2013).

Even under these conditions, the credit institutions hold adequate levels of capital and provisions necessary to cover the risks entailed by the financing of the companies, as well as administration techniques for these risks that have not yet used at their full potential. In turn, NBR implemented additional prudency measures, particularly for the debtors not covered for the hard currency risk, in line with the European recommendations.

The new economic program to be concluded for a period of two years with the European Union, International Monetary Fund and the World Bank, includes stipulations for the continuation of the structural reforms in economy, which will alleviate the vulnerabilities identified among the non-financial companies.

The delay of resuming the economic growth in the main EU countries, foreign trade partners of Romania, influences adversely the economic growth in Romania and may affect the ability of the import-export companies to cope with the different adverse evolutions. So far, these **risks have been limited**, particularly because of: (a) the capacity of the exporters to diversify the foreign market outlets, while reducing their exposure towards the Euro zone countries (by 1.5 percentage points in 2012) by identifying new markets; (b) maintenance of the access to finances of the foreign trade companies (for instance the non-resident mother companies increased by 10.6% their credits for the local net exporting companies from December 2011 to June 2013, and (c) maintenance at a rather good level of the economic-financial situation of the foreign trade companies, above the economy average.

The Romanian exports with high value added and with a high level of innovation continued to increase, the *medium high-tech* products being the most important category, by volume, of goods exported by the Romanian companies. The encouragement and stimulation of the innovative industries is an essential objective that derives from the implementation of Europe 2020 Strategy too, being desirable to be implemented with priority, because these industries from Romania have proved that they can cope very well to the crisis.

In turn, the progress of the proper administration of the capital flows presumes the consolidation of the foreign debt services sustainability, which will allow maintaining the access to proper foreign financing sources in terms of volume and costs. The improved structure of the foreign financing flows will consolidate a sustainable pattern of growth of the Romanian economy.

The image of the potential and capabilities of the financial sector that was briefly presented here may be completed by the study of the 2013 NBR Financial Stability Report. The non-financial sector should follow directly NBR policy from its periodical reports and communiques, in order to interpret with priority by the people using this information to develop own business plans. Such approach for the people from the real economy is accomplished by NBR through the multitude of economic seminars hosted to this purpose, which enjoys particular attention, as evidence of the trust in the partnership between the central bank and the business environment.

**Some conclusions**

The brief picture of the potential and capabilities of the financial sector can be completed by the study of the 2013 NBR Financial Stability Report. The non-financial sector should follow directly NBR policy from its periodical reports and communiques, in order to interpret with priority by the people using this information to develop own business plans.

The National Bank of Romania assists the actors from the real economy by a broad range of economic seminars that is hosted, and the large audience proves the trust that is being built between the central bank and the business environment.

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