Structural reforms proposed by the International Monetary Fund and their impact on Romanian economy during the last financial crisis

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Abstract. The international financial crisis during these last years has provided the effects in the most economies of the world, forcing the affected countries to grow the credit demand to mitigate the impact of this financial crisis into their economy. The International Monetary Fund (IMF) extended the opportunity for Member States to obtain a financial support from the Fund with the recipient country must meet certain indicators of macroeconomic stability.

Our paper aims to present the effects of the stand-by agreement with the IMF signed by the Romanian government to alleviate the crisis of the Romanian economy and out of the economic recession that our country faced during the 2009-2010 years.

Keywords: macroeconomic stability indicators; financial policies; financial international crisis; International Monetary Fund; Romanian economy.

JEL Codes: B22; E42:E44; E52; E61;F01;F33;G18;G28

1. Introduction

During the recent years, when the international financial crisis took effect in the economy of the most countries of the world, the countries have intensified the demands for obtaining the credit from the IMF, as a result of the financial crisis impact in the economy of these countries.

The IMF financial assistance has as beneficiaries the Member States, which are facing the balance of the payments difficulties and granted the right to buy the foreign currency with the national currency and the obligation to repurchase the national currency in a given time, at a higher price, the price difference is the operation cost.

The sources of the current financial crisis can be found in the consecutive years of the economic growth and the low interest rates, which have fuelled the optimism and increasing the risk-taking that ultimately led to some series of failures, both in the commercial, financial, macroeconomic policy and a global financial overvaluation.

The global financial system has expanded massively and created more and more instruments, which seemed to provide increasing financial rewards to lower risk, a situation that proved, at least, misinterpreted, and when, “the soap bubbles” began to break, the effects were uncontrolled.

Understanding the causes of the crisis is the starting point for restoring the balance and avoids any future crisis of such intensity, rebuilding a stronger global financial system.

In 2009, the economic crisis increase was made at a stronger rate than expected, leading to a major contraction of the cash income. Starting from the collapse of credit, when the person indebted beyond the personal power, could not pay their loans, the crisis quickly spread to other sectors of the global economy with increased effects of the lower consumption and business confidence.
Throughout the period of 2009, the IMF has mobilized all the resources towards covering the money needs of the Member States provided to adopt the suitable macroeconomic policies. Consequently, the IMF has adopted emergency some structural policies, applicable to both international and national level for the Fund Member:

- Restoring the balance sheets of the affected financial sectors - refers to those actions taken to recapitalize banks and restore their balance sheets for the credit recovery in the economy, aiming to the economy revitalization eventually; until then, the restoration attempts have been numerous;
- Recognizing the importance of the monetary policy - as a component of the domestic demand;
- Transmitting the overall fiscal stimulus in 2009 and 2010 through the fiscal measures permission to exit from the crisis;
- Substantial increase of the international financial reserves to alleviate the pressure on the low-income country markets.

In April 2009, the G20 members decided to triple the Fund capacity to lend up to $ 750 billion, to double the resources for the underdeveloped countries and to expand the global liquidity with $ 250 billion through an allocation of SDRs. Consequently, in 2009 the IMF directives followed:

- **improving the financial regulation and supervision** to increase the regulation perimeter in order to avoid the new events that generate risks and imbalances. IMF does not want to establish its dominance, but to ensure that the adopted policies are respected. This oversight should extend to all sectors of activity; from the individual economies to the world markets (the commercial discipline must be recast). Also, the central banks should review its operating mode to increase the liquid reserves of the system;
- **adaptation of the financial arrangements** to prevent the Member States needs. IMF arrangements should be improved to a better suit to the circumstances of each country and to encourage states to approach the Fund;
- **improving the bilateral supervision** focused on the cash flow to avoid the systemic risk in the economy and a better macroeconomic and financial integration of the work sector;
- **improve the international cooperation and multilateral surveillance**.

IMF welcomes the oversight reforms proposed as the most important reforms to avoid the burden of the weak countries / underdeveloped with new restrictions and commitments. Also, optimizing the actions of the Member States in the policy adopted international cooperation plan is another field of action of the Fund.

Like other countries affected by the crisis Romania also needed the resources of the Fund, and in May 2009 the IMF Board approved a new stand-by agreement for 24 months, amounting to SDR 11.44 billion (12.95 billion euros).

The agreement is part of an international financial package, which also provides for the allocation of: 5 billion euros from the European Union to support Romania’s balance of payments, one billion euros in the loan programs earmarked for the World Bank development policies and 1 billion euros more granted by other international financial institutions.

After several years of economic growth, in 2009, Romania was strongly affected by the global economic downturn. Currently, the production is decreasing, exports were reduced and the large capital inflows that financed the boom fell gradually. The effects of the global collapse were aggravated by the weakness of the Romanian economy.

Romania was forced to seek such a loan due to the effects of the deepening financial crisis on the economy of our country. To a better understand why our country has come to use such loans from the Fund a proper understanding of the Romanian economic context in the pre-crisis period is necessary.
2. Structural reforms implemented by Romania under the impact of the “Stand-By Agreement” signed with the International Monetary Fund

2.1. The Romanian economy challenges during the last international financial crisis

- During 2003-2008, the Romanian economy experienced a boom that led to overheating and unsustainable imbalances.

The average GDP growth in Romania between 2003-2008 stood at over 6.1% per year, the foreign direct investment and the capital inflows are factors with the significant contribution to increase the consumption and investment. The robust growth of the exports to EU countries reflected a process of increased integration with the Western European economies. But the domestic demand growth was even faster, resulting increased deficits in the current account, which peaked at 14% of GDP in 2007.

The overheating of the economy and the rapid capital inflows have complicated the monetary policy, which entailed the NBR inability to achieve the inflation target despite the increase of the interest rates and the minimum reserve required.

The fiscal policy has played a strong role and the budget deficit increase from less than 1% of GDP in 2005 to almost 5% of GDP until 2008 (see graphic 1).

- The credit rapid growth that fuelled this boom has produced a large exposure of Romania to the global financial difficulties and the volatility of the exchange rate.

The foreign borrowing of the Romanian banking system led to a rapid increase of the domestic credit, which reached an annual average of 50% in the last four years. Over 50% of the domestic private loans were in the foreign currency and most belong to the population or to the companies’ exposure to the risk, which generated a substantial indirect exposure of the banks to the currency risks, even if, in the bank balance sheets there were no large currency disparities (see diagram 2).
The National Bank of Romania took a series of important measures to reduce the inflation and to limit the credit expansion, particularly the currency credit.

During 2004-2008, by the actions implemented by the National Bank of Romania the following results were obtained:

- increase of the monetary policy rate (10.25%) and the minimum reserves required (18% for liabilities in the national currency and 40% for liabilities in the foreign currency);
- measures to limit the exposure of the population debt, especially in terms of the mortgage debt;
- strengthening of the prudential regulations to limit the foreign currency lending to the households and to the companies exposed to the currency risk and tightened the restrictions on the public debt limit. All these measures have helped to a later braking of the household credit growth, however, the pressure induced by the expansionary fiscal policy and by the capital inflows could not pass the inflation target proposed by the National Bank of Romania for 2007 and 2008 (see diagram 3).

Lax policies on the tax and income contributed to the overheating of the economy and supported its current vulnerabilities.
The excessive growth of the expenditures, especially with the wages and pensions was the main problem and helped to supply the domestic demand growth.

- The Romanian industrial production continued its downward trend in 2009 and the inflation remained relatively high.

The real GDP growth fell from an average of 9% in the first three quarters of 2008 to a decline of 13% in Quarter IV/2008, a situation considered by the specialists one of the steepest upheavals among the emerging markets. The decline was caused by a domestic demand decrease.

It should be noted that in 2007, after Romania's EU accession, the industrial production registered an average growth rate of over 15% and in 2009 when the financial crisis was first experienced in Romania, the industrial production registered a sharp decrease ranging rate on the negative values (-20%). These developments have been determined mainly by the lower domestic demand and external demand due to diminished activity in the most sectors of the global economy and the national economy of Romania (see diagram 4).

- The financial markets and the asset markets have been hit hard by the recession of the Romanian economy and the global crisis.

The Bucharest Stock Exchange, as all the international financial markets, has been severely hit, losing 65% of its value from a peak in August 2008. The international country rating of Romania at the end of 2008 was reduced (to below the investment grade for the Fitch agency) with a margin greater than that of other countries in the region, reflecting the concerns of the international market for the sustainability of the Romania’s current account large deficit, the uncertainties surrounding the prospects for the fiscal policy.

- The exchange rate depreciated significantly since the beginning of the economic recession, marking the beginning of the reversal of accrued appreciation in the recent years.
By the end of 2008, RRES depreciated by about 7% of its maximum value in July 2007. In January and February 2009, RRES was also weakened by another 7% because of the lower nominal currency (called LEU).

- **Accumulated pressures to the banking system.**

  Access to the external sources of funding is currently limited and the liquidity in the interbank market was largely exhausted, the work is limited to the short-term maturities. Although the banks are well capitalized into this crisis, the bad loans started to accumulate, especially those granted in the foreign currency and the economic recession certainly deteriorated the quality of assets. Therefore, lending to the private sector began to fall from the fourth quarter of 2008, reflecting a combination of the demand and supply related factors.

- **The Romanian authorities have started to solve the economic vulnerabilities of the economy, but the economic policy options were limited by the severity of the recession and the fragility of the financial conditions.**

  The contribution of the foreign direct investment enterprises into the active processing regime to Romania trade balance represents 73% of exports and 62.6% for the imports in 2008 (see graph 5).

![Diagram 5: Romanian foreign trade evolution during 2008](image)

The rapid growth of loans conditioning the Romania exposure to the financial crisis and due to the global credit collapse, our country suddenly began to have problems in attracting the foreign capital. The exchange rate was affected, leading to a depreciation of over 15% of the national currency (RON)\(^1\) against the Euro since October 2008. Because more than half of the domestic private loans are in foreign currency, the weaker “LEU” entailed the situation when the companies and the consumers have to pay higher interest on loans.

\(^1\) LEU is abbreviated by RON.
The pressures over the balance of payments led to a depreciation of 15% of the national currency against the Euro since October 2008, generating pressure on people, the companies and banks' balance sheets (see diagram 6).

![Diagram 6: Romanian trade balance trend between 2005-2009 years](image)

2.2. Structural measures proposed by the Stand-By Agreement (ASB) signed with IMF for the Romanian economy

Based on the all determinants listed, Romania has appealed to the IMF loan and signed a Stand-By Agreement with the obligation to implement measures proposed by the IMF approved program for Romania.

The general objectives of the Agreement program were aimed to cushion the effects of the lower capital inflows in Romania, trying at the same time to resolve the external and fiscal imbalances of Romania and to consolidate the Romanian financial sector.

These objectives required:

- reducing the fiscal imbalances to bring the deficit back to below 3% of GDP until 2011;
- maintain an adequate capitalization of the banks and liquidity of domestic financial markets;
- bringing and keeping the inflation within the target range by NBR;
- ensuring a sufficient external financing and improving the confidence.

Representatives of the European Commission have worked with IMF staff during negotiations on the program and the EU has pledged to support SBA with financial assistance of 5 billion euros.

ASB program combines the drastic measures of the fiscal policy with and significant financial support and it is expected that these two pillars stabilize expectations in the major markets, thereby supporting the roll-over rates for the external debt and restore the confidence in the Romanian economy by the foreign investors.

The exceptional access criteria which must be met by Romania to receive the loan granted by ASB:

- **1st Criterion:** the member faces (or if possible) to face the exceptional pressure of the balance of the payments on the current account or the capital account that needs the Fund to provide funding that is not within the normal limits.

Romania suffers from a drastic reduction of the capital inflows, despite a strong contraction of the current account deficit, creates a financing gap greater than what can be funded in the normal range.

- **2nd Criterion:** a rigorous systematic review indicates a high probability that the member's debt to be sustainable over the medium term.

Romania's public debt is low (20% of GDP in 2008) and IMF does not expect to generate risks, despite a slight increase during the program, respectively 26% of GDP. The fund rationality is that the fiscal deficit will be reduced and the collateral potential payment obligations of the government are limited, including those results from the borrowing in the private sector. However, the financial sector is largely owned by the foreign capital, and the most parent banks can access the liquidity through the facilities granted by the European Central Bank (ECB).
• **3rd Criterion:** a member has opportunities to gain or regain the access to the private capital markets in the period in which the IMF resources are outstanding.

The Romania's loss of access to the capital markets is a consequence of the global financial crisis, although this loss was exacerbated by unsustainable domestic policies. As a member of the EU - Romania has a moderate external debt (53% of GDP at the end of 2008), "a strong potential for the long-term growth and an excellent history in terms of the external debt service, even in times of the tension balance of payments, and the prospect of potential entry in the Euro area, the access of Romania to the private financial markets should recover as the global financial difficulties improve" it is mentioned in the SBA agreement with the IMF.

• **4th Criterion:** the policy program provides a reasonable prospect of success, including not only the plans to adjust the country's economy but also its institutional capacity and the policy to make that adjustment.

The IMF financing program has three main areas: the fiscal consolidation, the banking sector reform and reducing the inflation to help restore the financial stability. Initially, the “monitoring program and operating conditions of the SBA” were as follows:

- **access:** SDR 11.443 billion;
- **available time:** 24 months;
- **steps:** 4.37 billion SDR made available after ASB approval by the Executive Board to cover the balance of payments needs in the quarter 2/2009 and for the stock replenishment. The seven quarterly installments will be paid from 15/09/2009 (The last on 15 March 2011) and will be in the amount of 7.07 billion SDR.

**The structural measures impact proposed by IMF for the Romanian economy**

- **the state-owned companies** must be restructured, closed or privatized, so that the State should not incur the losses generated. The economy achieved could exceed one billion euros, plus the release of arrears, i.e. taxes and the unpaid bills;
- **the budget unit** reduced the wage bill from 9% to 7% of GDP;
- **the budget revenue** synchronized with the spending in order to lower the budget deficit until to 3% of the Romanian GDP.

The last evaluation by the International Monetary Fund recognizes that Romania has been hit hard by the global financial crisis and worsened macroeconomic perspective because the slow recovery of the European economy with the possibility of its revival in 2011. During the 1st Quarter 2011, the Romanian economy marked the first signs of the economic recovery and by the end of 2011, Romania has to balance the public finances to avoid a new loan from the IMF in 2011, which would lead to 60% of debt GDP, compared to 30% as it is now.

**The spiral debt** could lead the country in the situation of Greece, not later than 2013 as President Traian Basescu said. This debt would be greater than 100% of GDP, the interest unbearable and the perspective of being unable to pay.

The Romanian authorities together with the IMF experts agreed that the additional fiscal measures would be necessary and to effectively redirect the social work programs to the truly vulnerable, broadening the tax base and combating the tax evasion.

According to the National Institute of Statistics of Romania, for the first time, the trade deficit exceeded one billion euros this year, but at the end of the first five months of 2011, the gap between exports and imports was 3.6 billion euros with 7.5% smaller than the corresponding period of the previous year.

**The best news during the first half of 2011 regarding the return of consumption of Romania:**

- **between January-March 2011** for the first time in the past two years there was an increase in sales of electronics, home appliances and IT over the same period of 2010. The Romanians bought durable goods worth 307 million euros (more with 10, 7% than 1st Quarter 2010). E-commerce, excluding the tourism segment and the payment of utilities, will arrive in 2011 to 350 million on the local market, compared to
300 million euros (2010) as CEO of ePayment estimates, part of the PayU Group, owned by African Naspers.

- the "stars" of the Romanian retail were structured by the sales category-type in the neighborhood stores, discount stores and hypermarkets:
  - Carrefour expansion has focused on the supermarket-network segment has increased with four new supermarkets located in Targoviste, Cluj-Napoca, Ploiesti and Galati cities and for this autumn two new hypermarkets are also announced, which will add the 23 old;
  - Rewe - a German retailer opened the 118 existing retail network in Romania in March 2010;
  - Profi, controlled by the investment fund of the Enterprise Investors has registered one of the most dynamic expansion, reaching to operate on a network of 94 supermarkets located in Bucharest and the rest of the country;
- the fastest growing retail network of grocery recorded by the “Mic.ro”, whose neighborhood chain stores expanded at a pace of 10 new units per week.

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Romania might face against challenges similar to those of 2005-2008 as L. Croitoru said in May 2011 at the CFA Forecast Dinner of Bucharest:

- In terms of developments:
  - increase capital inflows;
  - more portfolio investments since from North Africa look for new destinations. Low positive impact to growth but strong a look for new destinations;
  - credit and asset price booms;
  - external imbalances;
- In terms of policies:
  - policy interest rate dilemma –to manage domestic inflation;
  - competitiveness vs. quasifiscal costs of the Central Bank;
  - macroprudencial measures

3. References


[2] Romania International Monetary Fund, Request of Stand-By Agreement made by the European Department (in consultation with other Departments), approved by Paul Thomsen and Philip Gerson on April 24, 2009, pp. 56-57.