CAPITAL FLOWS LIBERALIZATION IN ROMANIA

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Abstract:
Capital flows liberalization is a highly controversial subject, but its importance is not controversial at all. The capital flows liberalization in Romania has been made according to the EU criterions, between 1991-2006. The liberalization decision involves benefits and risks, also. We hope that the liberalization process will bring more benefits to the Romanian economy.

Key words: *capital flows, liberalization, Romania, European Union;*

JEL classification: *F21, F32*

The unique market is the most important realization of the European Union, being based on the four fundamental freedoms: the free circulation of people, goods, services and capitals.

One of the pre-conditions of the unique currency´s adoption and of the entrance in the euro zone is the liberalization of capital flows. The community acquis in the field of free circulation of capitals bases on the provisions of the Treaty of the European Community, as well as on a series of directives, recommendations and communications, but it does not contain precise obligations and does not impose the procedural steps regarding the way of phasing the liberalization of the capital fund.

The capital flows liberalization process was adopted by many countries in all the world, the way of using it being very different. It is a vast process, of a high importance, due to the impact it has on the general macroeconomic setting.

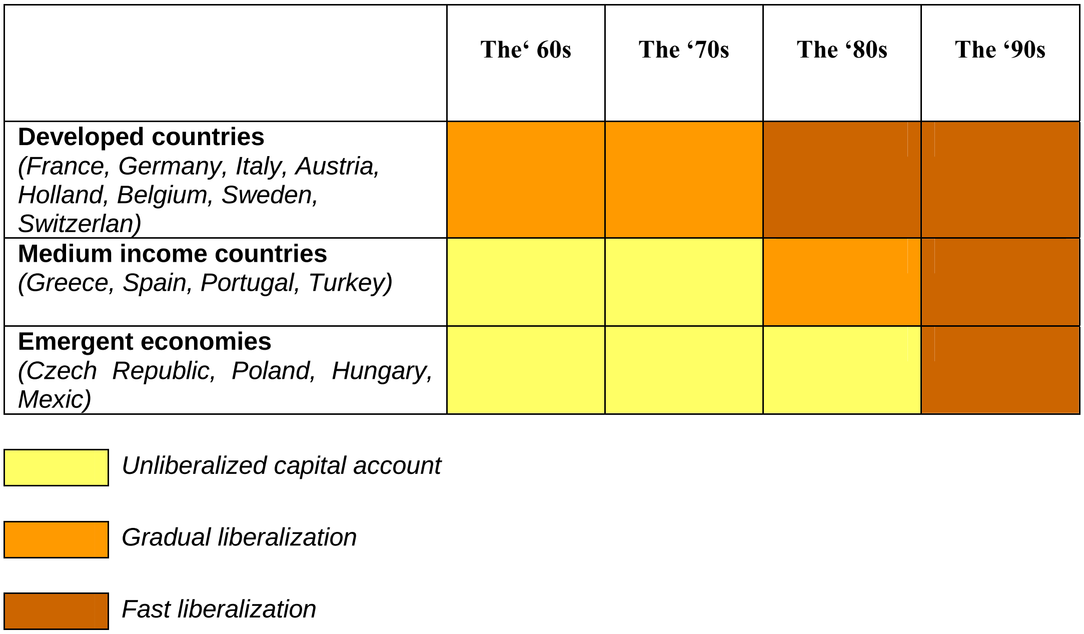
In the speciality literature, the notion of *″capital flows liberalization″* means the *″reduction or the abolition of the administrative restrictions and controls on the international financial transactions″*[1].

Influenced by the main international financial organizations (the International Monetary Fund, the World Bank, the World Trade Organization, the US Treasury, etc.), many emergent economies followed the tendency of capital flows liberalization and removed gradually the existent restrictions. The collapse of the communist economical systems in the Eastern Europe boosted even more this evolution.

The ´80s and the beginning of the ´90s were years of intense economic activity during which governments from all the world proposed the reduction of the barriers on the international market of the capital.

[1] Bakker A. F. P., "*The Liberalization of Capital Movements in Europe: the Monetary Committee and Financial Integration, 1958-1994"*, Kluwer Academic Publishers, London, 1996;

Figure no. 1: *The speed of the capital flows liberalization*



Source: Isărescu Mugur - *Capital Flows Liberalization*[2];

Over the time, it has been remarked that a period during which restrictions on the capital movements were imposed was followed by a period of removal of these restrictions and vice-versa. Thus, the liberalism of the 19th century was followed by the imposition of severe restrictions on the international circulation of the capital and the extern commerce in the interwar period. The post-war period includes three different phases: a phase immediately following the end of the war, when a series of liberalization measures of the capital movements was adopted; the end of the ´60s, when this tendency is reversed and a great number of countries impose again restrictions to the capital flows; the ´80s, when the orientations is again changed in the opposite direction.

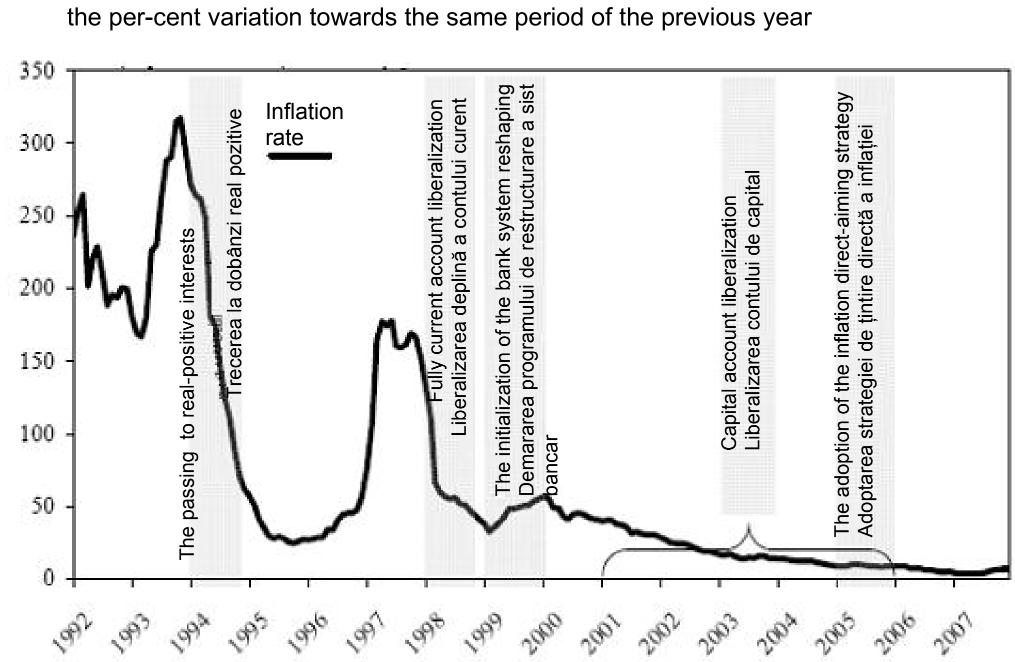
The cyclic modification of the capital circulation system corresponds partially to the cyclic evolution of the world economy. Indeed, in the periods of depression, the authorities tend to adopt restrictive measures, in order to prevent the capital exit caused by the lower interest rates established to stimulate the internal demand.

In the context of the adherence process to the EU, the Central European countries began the liberalization of the capital movements in the first part of the ´90s, ending this process after about a decade (Poland: 1991-2001; Hungary: 1991-2001; Slovenia: 1992-2003; Czech Republic: 1994-2001; Slovakia: 1996-2004).

In Romania, the capital flows liberalization began in 1991 by the adoption of a foreign investment law, but the process was accomplished with a delay in comparison with other Eastern and Central European countries.

[2] This paper was maintained at the FINMEDIA Conference, in 15 March 2005;

Figure no. 2: *The chronology of the measures adopted by BNR for the promotion of price stability and financial stability*



Source: BNR, INS;

The reasons of the delay of the liberalization process were multiple. First of all, the gradual approach concerning the structural reforms and the macro-stabilization program of the ´90s was reflected in the increase in inflation and interest rates, in comparison with other neighbour countries or the member states of the EU. Secondly, the capital account liberalization was delayed until the moment when, as a result of the banking system restructuring, the financial domain became strong enough to face the capital flows with a high potential of reversibility. Thirdly, it was necessary that the central bank reach a satisfying level to cover the imports through the national reserves, this objective being accomplished in the first half of the 20th century.

The process of capital flows liberalization in Romania, began in **1991** by the adoption of the Foreign Investment Law, included the following moments[3]:

- **On the 25th of March 1998**, Romania accepted the obligations stipulated in art.VIII of the FMI status: *liberalization of the current account operations*; non-introduction of other restrictions in the future; the system of monetary exchange shall not suffer significant modifications; creation of more favourable conditions to the relaunch of the economic reform.
- **1999:** liberalization of the entrance of foreign capital on a medium and on a long period.
- **2001-2002:** capital flows liberalization with low impact on the balance of payments (European Institut in Romania, 2005), including:
    - direct investments, also in property values made by residents from abroad;
    - admission of national value titles to the cote on the external market;

[3] Dăianu Daniel (coord.), „*Deschiderea contului de capital în România: cât de mult şi cât de repede?*”, SSRN Working Paper, 2002;

- mortgages from the part of the foreigners applied to the residents;
- movements of the personal capital;
- credits on a medium or long term for the commercial transactions or the services offered by the residents to the non-residents.

➢ **2003-2004**: capital flows liberalization with high influence on the real economy, that is:
  - capital transfers for the execution of insurance contracts;
  - transactions in currency made by the residents;
  - loans with a maturity of less of a year, offered by the foreigners to the residents;
  - financial loans and credits offered by the residents to the foreigners;
  - mortgages made by the residents to the foreigners;
  - admission of the cotation of the foreign value titles on the Romanian capital markets.

➢ **2005-2006**: capital flows liberalization with high influence on the balance of payments, that is:
  - deposit operations in the current account in national currency, opened in the national financial institutions by the non-residents;
  - operations with obligations and other instruments on the open market;
  - operations in the current account and on terms made by the residents abroad.

➢ **September 2006**: entire conversion of the national currency.

In Romania, the last rate control forms were abolished actually on the 1st of April 2005, when almost all the capital flows were liberalized – on a long term and on a short term.

The general principles being at the basis of the capital flows liberalization in Romania are:

- *The liberalization of the capital entrance shall take place before its exit*;

The application of this principle was due to severe necessity of external financing of the Romanian economy during the transition. The advantages are bound first of all to the reduction of the investment financing costs and consequently to the attraction of foreign investors into the main domains of the Romanian economy. Thus, new technologies would enter on the market, which would determine the increase of the capacity of production factors, mainly the workforce. It should not be neglected either the impact of the foreign investments´ entrance on the business sector, but also on the incomings to the national budget.

- *The capital flows liberalization on a medium and long term shall take place before those on a short term*;

Usually, the capital flows on short terms may be represented by speculative capitals, especially in the cases when they concern the access of the non-residents to the deposit accounts, in conditions in which there exists the possibility of a profit obtained from the difference between the practiced interest rates.

- *Direct investments liberalization before those in the portfolio*;

The Romanian capital market is one in formation, thus its capability to manage the value titles coming from the Portfolio Investment is a reduced one. Meanwhile, the important capital entrances, but especially the important retreats, could disturb the stock exchange activity, affecting intensely the real economy.

The taking of the liberalization decision is not easy at all, because it implies as well advantages and risks, too.

Thus, the main advantages are the following: rational allocations of the resources to the most productive applications; the reduction of the financial costs; the import of technology and the afferent increase of work productivity; improvement of the management of the companies; consolidation of the discipline in the field of macroeconomic policies; increase of budgetary incomings; development of financial system, etc.

But there are also many risks, such as: the excessive increase of the credit volume, with the afferent inflationist dangers and those of intensification of unequal balance of current payments; the exposure of the economy to sudden capital entrances and exits, as a consequence of the speculations allowed by the Portfolio Investment; the excessive appreciation of the national currency, with the impact this has on the deficit of the balance of current payments (but the appreciation of the currency has favourable consequences on the real disinflation and convergence).

To avoid the risk of excessive increase of the credit volume, the Romanian authorities took action to assure a careful orientation of the fiscal policy; consolidation of the banking system and adoption of some careful standards, generalization of the use of the international accounting standards; etc.

It´s been made an attempt to avoid the risk of economy´s exposure to the sudden entrance and exit of the capital through a confortable level of the official rate reserves and through a certain flexibility of the exchange rate.

The risk produced by the excessive appreciation of the national currency was counteracted by the increased implication of the fiscal policy, incomings and structural reforms, in order to reduce the external imbalance.

The avoid of risks was attempted also through a careful fiscal policy, interests policy and flexible administration rate policy within the system known as the ″managed floating″[4].

It´s been also made an attempt to maintain the level of foreign direct investments, in order to finance the current account deficit. The increase of direct foreign investments was encouraged by the following measures: reduction of the uncertainty concerning the economic environment (stability of prices, of interests and rates); coherence and stability in legal limits and correct application of the legislation; assurance of a stable, predictable and uniform fiscal framework; public administration reform and reduction of bureaucracy; infrastructure improvement; etc.

The theoretical considerations regarding these advantages and risks suggest that before these restrictions applied to the capital movement might be eliminated, it is necessary the accomplishment of some conditions and the respect of some principles.

Thus, an essential condition is the assurance of the macroeconomic stability, whose fundamental elements are: the stability of prices, national budgetary equilibrium and the equilibrium of the external balance of payments.

The liberalization of the capital movement in Romania took place according to the criteria of adherence to the EU. Despite the vulnerability caused by the capital flows liberalization, we hope that the advantages it conferes will be primary and the final effect on the Romanian economy will be favourable.

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