MONETARY AND FISCAL POLICY SHOULD SUPPORT AGGREGATE DEMAND IN THE EUROPEAN COUNTRIES DURING THE CRISIS

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Abstract:
Economic activity has taken a particularly sharp turn for the worse in many emerging European economies. Because of their heavy reliance on all kinds of capital inflows—notably funding from Western banks to sustain local credit booms—these economies have been much more severely affected by the financial crisis than emerging economies in Asia. As Western export markets contracted and the flight from risk became generalized during fall 2008, the outlook for local exports, growth, and government revenues worsened drastically, causing sovereign spreads to jump up. The result could be a financial and real sector collapse in most emerging and a few advanced economies, with major feedback effects on the other economies. Fiscal policy has now joined monetary policy in combating the recession in many advanced and emerging economies, even though a number are facing constraints from tough capital market conditions.

Key words: *financial crisis, financial sector, monetary and fiscal policy, banking sector.*

JEL classification: *E58, E61, G01, G12, G21, O23*

1. INTRODUCTION

Inflation fears are a fast-receding memory, and central bankers around the world are now on the front lines in the fight to sustain demand in the face of financial disruptions. In advanced economies, the task is magnified by the rising threat of deflation and the constraint of the zero interest rate floor. In such circumstances, it is crucial to act aggressively to counter deflation risks. Although policy rates are already near the zero floor in many countries, policy room still remains in some regimes (such as the euro area) and should be used quickly.

Nonetheless, the firepower from conventional policy instruments is unlikely to be sufficient—the zero floor constrains room for further cutting, and the impact of lower policy rates is reduced by credit market disruptions. In these circumstances, lowering interest rates will need to be supported by increasing recourse to less conventional approaches. Many central banks have already introduced an array of new instruments, including purchases of long-term government securities and more direct measures to support intermediation. In the current circumstances, such approaches may be particularly effective if they help unlock illiquid or disrupted markets—so-called credit easing. Support provided in the form of short-term liquidity facilities can be quickly reversed when market conditions eventually normalize, but operations involving longer-maturity assets could be harder to unwind.

Emerging economies also have tended to borrow more heavily in foreign currency, so large exchange rate depreciations can do severe damage to their balance sheets. Thus, although most central banks in these economies have lowered interest rates in the face of the global downturn, they have been appropriately cautious in doing

so in order to maintain incentives for capital inflows and to avoid disorderly exchange rate moves or a full-blown capital account crisis.

Section 2 presents the features of the financial systems worldwide and shows some monetary markets developments in European Union's new member states during the crisis; Section 3 underline the monetary and fiscal policy developments in this area, Section 4 shows the features of the Romanian financial policies during the crisis and Section 5 concludes the paper.

2. FEATURES OF FINANCIAL SYSTEMS WORLDWIDE AND THE MONETARY MARKETS DEVELOPMENTS IN THE NEW EU'S MEMBER STATES

The crisis in European financial systems is unlikely to change their basic structure, but European banks are generally more leveraged and will need to undergo a stronger adjustment of their balance sheets.

The basic structure of the financial system of most emerging countries should not change significantly, as banks still play a dominant role and capital markets are generally less developed (Table 1).

Table 1 Total financial assets of banks and non-banking financial institutions, means by income group

Total financial assets of banks and NBFIs, means by income group

	Deposit Money Bank Assets/GDP	Non-bank Financial Institution Assets/GDP	Total Financial Assets/GDP	Deposit Money Bank Assets/Total Financial Assets	Total Loans/ Total Deposits
US	0.62	1.87	2.50	0.25	2.73
HIC	1.03	0.91	2.07	0.61	1.23
MIC	0.46	0.19	0.69	0.78	0.82
LIC	0.20	0.01	0.23	0.92	0.76

Sources: IFS, FSAP, FIAP, OECD, AXCO, ICI, various national sources, Financial Development and Structure database by Beck, Demirgüç-Kunt and Levine.

However, it is important not to place all emerging countries in the same bucket. Those middle-income countries that are more financially integrated will bear more the direct fallout from this crisis, at least in its first stages.

The process of deleveraging may prove painful in the countries where banks are over-extended and reliant on foreign borrowing. Some of these countries are already experiencing funding problems (Hungary has resorted to an emergency credit from the European Central Bank). Banking systems in emerging countries may be further affected by price shocks (e.g. exchange and interest rates) and the slowdown of activity.

The current crisis may also have a negative impact on capital market development in emerging countries, as foreign investors had acquired a substantive participation in many markets and were contributing to their development.

Small and medium enterprises and households will generally face more constrained access to finance due to bank deleveraging and the slowdown of capital market development.

In countries where bank credit slows down and capital markets are not able to respond, governments may be tempted to enhance the role of state commercial banks and national development banks in order to promote access to finance.

As in previous crises, there will be increased financial system consolidation around stronger players in those emerging countries that experience a crisis. However, unlike most previous episodes, the process is not likely to be driven by developed

country banks but rather by the government via nationalizations and/or the absorption of failing banks by state-owned entities.

Financial markets in the EU10 have similarly been affected by global investors' sentiment and are even more volatile than those in advanced economies. EU10 financial markets have been vulnerable to deteriorating investor sentiment, leading to significant pressure for exchange rate depreciation (except for the Slovak Republic and Slovenia which are in the euro zone) and/or a decline in foreign reserves or huge fluctuations in prices of equity and fixed-income instruments.

Furthermore, looming recession in core markets is further affecting prospects for emerging markets, including the EU10, through the sharp slowdown in trade and private capital inflows. This is undermining growth prospects in the EU10, until 2009 identified as one of the safest regions across emerging markets but now seen as increasingly exposed to credit worries, recession in the euro zone and accumulating banking problems.

3. FINANCIAL POLICIES SHOULD SUPPORT AGGREGATE DEMAND IN THE WORLD AND IN THE EU'S NEW MEMBER STATES

A number of major banks in the United States and Europe were provided with public support in the form of new capital and guarantees against losses from holdings of problem assets. More broadly, authorities have followed multifaceted strategies involving continued provision of liquidity and extended guarantees of bank liabilities to alleviate funding pressures, making available public funds for bank recapitalization, and announcing programs to deal with distressed assets.

Policy rates have been cut sharply, bringing them to ½ percent or less in some countries (Canada, Japan, United Kingdom, United States) and to unprecedented lows in other cases (including the euro area and Sweden). However, the impact of rate cuts has been limited by credit market disruptions, and the zero bound has constrained central bankers' ability to add further stimulus.

Some central banks (notably, in Japan, United Kingdom, United States) have therefore increased purchases of long-term government securities and provided direct support to illiquid credit markets by providing funding and guarantees to intermediaries in targeted markets, with some success in bringing down spreads in specific market segments such as the U.S. commercial paper and residential mortgage- backed securities markets.

As concerns about the extent of the downturn and the limits to monetary policy have mounted, governments have also turned to fiscal policy to support demand. Beyond letting automatic stabilizers work, large discretionary stimulus packages have been introduced in most advanced economies, notably Germany, Japan, Korea, the United Kingdom, and the United States.

Although the impact of the downturn and stimulus will be felt mainly in 2009 and 2010, fiscal deficits in the major advanced economies rose by more than 2 percentage points in 2008, after several years of consolidation. Government debt levels are also being boosted by public support to the banking system, and some countries' room for fiscal action has been reduced by upward pressure on government bond yields as concerns about long-term fiscal sustainability have risen.

Reaction of the central banks (FED, ECB, Bank of England, Asian ones or even Australian one) to these events was prompt. Supplementary to the support granted to the financial markets, they have also taken some other concrete measures of injecting billions of dollars on the market. In September 2008, American financial institutions borrowed an average of 48 billions of dollars daily from FED and in the second half of October 2008 the amount rose to 437,53 billions of dollars daily.

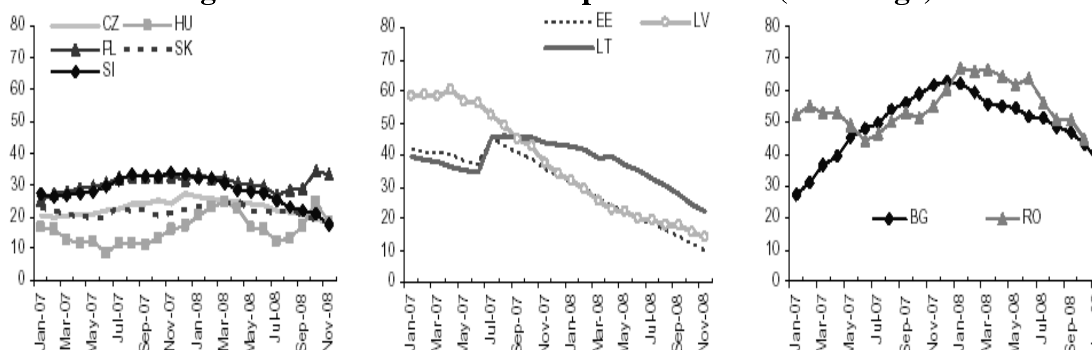
In this context, there has been build the idea of an escape plan of 700 billions of dollars, plan launched by the Bush Administration, by which it was requested to use these funds to buy some risky assets. Plan grants an increase of the guaranteed deposits from 100.000 dollars to 250.000 dollars and allows to the American Treasury to buy non-performing assets related to the mortgage credit market from banks. USA paid for the actual financial crisis as much as for the Iraq and Afghanistan wars together.

Something similar was needed in Europe as well. Sarkozy launched a 300 billions dollars plan for saving the European financial system, but it was rejected by several officials and even by the ECB's president. So, some separated measures were taken – Sweden Bank granted a credit line of 6,16 billions euro for the financial system, Great Britain announced that it will grant credits of 44,5 billions euro for the first largest banks in the country (HBOS, Royal Bank of Scotland, Lloyds TSB and Barclays). France offered 360 billions euro for banking sector stabilization, Austria 100 billions euro and Germany 500 billions euro. Italy has chosen a full package – guarantees for the banks bonds, support for refinancing, recapitalization according to needs and funds of 40 billions euro for buying some non-performing credits against some governmental bonds. Greece has also settled a package of 41 billions euro for achieving some participation titles to banks capital and for granting some governmental guarantees and funds. European Governments have been prompt and they have reacted from the first signs of crisis by increasing the limit of the guaranteed deposits. Initially these have represented separated measures of some states confronted with massive outflows of deposits and after that, it was a common action of the EU's states. Many European states overcame the limit of the guaranteed deposits from 20.000 euro to 50.000 euro, and they have opted for a higher level or even for a full coverage of deposits.

Although it was repeatedly emphasized that a non-intervention policy will only prolong the crisis, and the example came from Japan's experience of then years of agony, it is still debatable if, in the long run, costs won't be much smaller in this case. An argument for this scenario was represented by the fact that the governmental support will only make banks not to be prudent as well in the future.

Inflation easing in the CEE region is supported by a rapid deceleration in domestic credit, driven by more limited access to external funding, be it from parent foreign banks or from wholesale markets, and banks' reluctance to extend new credit (Figure 2). If the current trend continues in the Baltics, the stock of credit to the private sector will increase only by single-digit rates, if at all. In Bulgaria and Romania, the downward trend is also visible. In Visegrad counties and Slovenia, credit moderated slightly over recent months. This may be misleading in the case of Poland and Hungary, since taking into account the depreciation effect, the data show significant slowdown of credit activity. Some countries already report a deteriorating quality of bank portfolios. In Estonia, non-performing loans (NPL) rose to 8.1 percent of total loans in November, up from 6.5 percent in October (Figure 1).

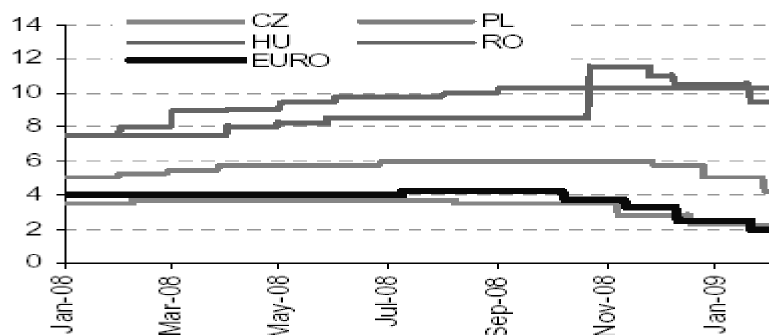
Figure 1. Growth on credit to private sector (% change)



Sources: Central Banks, World Bank Staff calculations.

Monetary authorities across the region have taken steps to maintain confidence and support the effective functioning of financial systems. These measures are aimed at preserving trust and liquidity in financial markets through the expansion of term liquidity management operations and foreign exchange swap operations (Poland, Hungary), the reduction of mandatory reserve requirements (Bulgaria, Latvia), FX interventions (Latvia, Romania), or increased availability of repo operations (in some countries together with a reduction of key policy rates). All countries strengthened their deposit guarantee schemes for households in line with EU-wide guidelines. Where feasible, monetary authorities have cut interest rates (Figure 2).

Figure 2. Policy interest rates



Source: Central Banks.

So far, fiscal policy has generally not been actively used by EU10 countries to support aggregate demand. Many of the governments in the region have decided not to strengthen automatic stabilizers with discretionary loosening of fiscal policy and have not offered discrete fiscal stimulus packages. Instead, the authorities seem to be counting on the effects from previously announced tax cuts (Czech Republic, Bulgaria, and Poland) or a reshuffling of existing plans rather than net new commitments, as well as accelerated absorption of EU funds (the latter in accordance with the European Economic Recovery Plan). On top of this, most of the national stabilization plans comprise various guarantees and loan subsidies. Moreover, in countries where the scale of the economic downturn is set to be particularly severe (Romania, Hungary, Lithuania, and Estonia), the governments have had no option but to enact sizeable fiscal restraint. The Romanian Government has approved a revised 2009 budget with a reduced deficit of 2 percent of GDP, driven by spending cuts, which would now place the country in the pro-cyclical group. Substantial expenditure cuts (Lithuania, Hungary), wide-ranging tax changes (Lithuania), and depletion of the fiscal reserves accumulated during boom times (Estonia) have more than offset the deterioration in the fiscal balances due to the financial crisis. Thus, for the countries mentioned, fiscal policy is likely to be a pro-cyclical and not a stabilizing force.

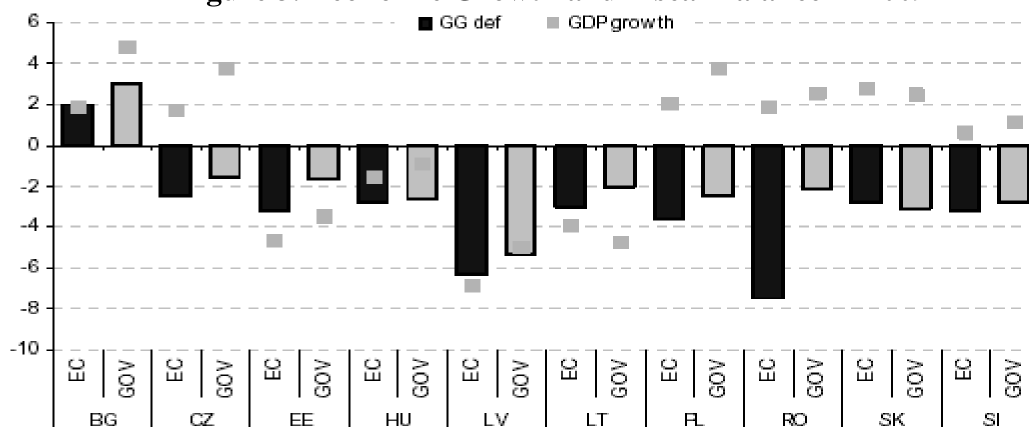
In contrast, Slovenia is offering some discretionary fiscal boost to its economies in 2009. This is reflected in a deterioration of its expected structural deficit. Slovenia is following the global trend and has adopted fiscal measures to cope with the financial crisis. The stabilization package, worth about 2 percent of GDP, includes both tax rate reductions and spending increases (subsidies for R&D, new technology investment, wages at the predefined companies.)

In the rest of the countries, fiscal policy is likely to be broadly neutral after adjusting for the cyclical component and taking into account a margin of possible error.

To sum up, the expected deterioration in the EU10's public finances in 2009 is likely to be driven by cyclical and structural shortfalls rather than by discretionary

government activism. Still, given the optimistic growth assumptions embedded in many budgets, fiscal balances are likely to deteriorate in almost all countries, as growth disappoints and inflation eases more quickly (Figure 3). Romania and Latvia are facing substantial deteriorations in fiscal deficits, with Lithuania a more moderate deterioration. EU10 countries are, however, embarking on a range of other policy initiatives to counter the crisis, as discussed earlier. It is too early to assess the effectiveness of these other policy actions.

Figure 3. Economic Growth and Fiscal Balance in 2009



Sources: GOV = Convergence Programs, for Romania Budget 2009, for the Slovak Republic most recent MOF 's forecasts, EC Interim Forecast January 2009.

4. FINANCIAL DEVELOPMENTS IN ROMANIA

The rapid increase of credit which "feed" the economic boom determined a great exposure for Romania to the world financial difficulties and to the exchange rate volatility. The external borrowings of the banking system determined a rapid rise of the domestic credit, it reaching an average of 50%/year in the last four years. Net foreign liabilities of the banks rose from -2% of GDP in 2003 to +19% in 2008. The access of the companies to the external credits also contributed to the boom, increasing from a net of 4% of GDP in 2005 to almost 11% in 2007. Moreover, over a half of the domestic private loans are denominated in foreign currency, a large part of these belonging to the population or to the corporate exposed to risk, and this will determine an indirect substantial exposure for banks to the exchange risk, even if in the banks' balance sheets there are not large exchange disparities.

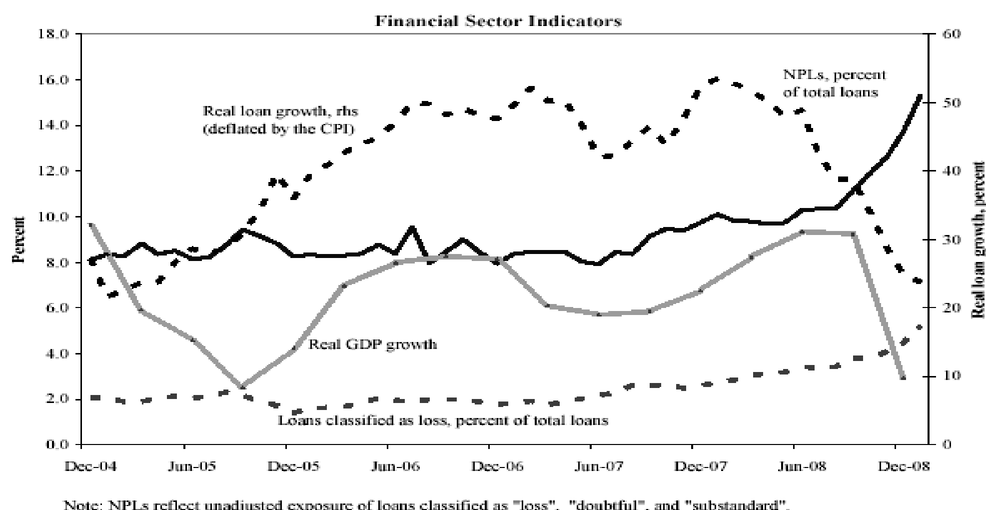
National Bank of Romania (NBR) has also taken some important measures to reduce inflation and to limit the credit expansion, especially for the credit denominated in foreign currency. These measures contributed to the further diminishing of the credit rise for the housekeepers but the pressure induced by an expansionist fiscal policy and by the capital inflows made NBR to miss its inflation targets in 2007 and in 2008.

The access to external financing sources in currently limited and the liquidity on the inter-banking market is almost over, the banking activity being now limited to maturities on short term. Although the banks faced this crisis well capitalized, the non-performing loans started to accumulate, especially those denominated in foreign currency and the actual recession will surely deteriorate further the assets quality. As a result, the loans granted to the private sector started to diminish in the fourth quarter of 2008, reflecting a combination of factors of both demand and offer.

The Romanian banking system entered into the global financial crisis with a strong solvency position. All 32 banks fulfill the 8% ratio for capital adequacy and the average for the capital adequacy was of 12,3% at the end of 2008 (Figure 4). Most

banks are owned by foreign investors (87% of assets) and most of their aren't banks are in the euro zone and they have access to liquidities offered by the ECB's facilities. The parent banks of the main banks that operate in Romania committed to continuously support their branches, to maintain their global exposure to Romania during the program with IMF and to re-capitalize their branches according to their needs. NBR together with the banking supervising institutions in the home country will closely monitories this commitment.

Figure 4. Financial sector ratios



Sursa: Romania's Intent Letter to IMF, April 2009

Although the banking system is stable and safe in the present, the banking legislation and the bankruptcy regulations will be improved, after some discussions with IMF, for responding rapidly and efficiently in case that some banks face difficulties. A main objective of this improvement will be to rise the abilities granted to the special administrator to deal with the banks that are in a fragile financial position (this represents a structural objective by the end of November 2009). Moreover the banks reshape procedures, the NBR's intervention abilities will increase by regulations that will grant the power of requesting to the major share-holders to rise the subscribed capital and to sustain financially the bank and to forbid or limit the profit distribution (by the end of June 2009 – structural objective). Romania is aware of the necessity to simplify and perfect the bankruptcy legal procedures and intend to further intensify its efforts in this area.

Another crucial element for insuring trust in the banking system is represented by the deposits guarantee system. In 2008, European governments, including Romanian government, acted to strengthen these systems by increasing the guaranteed limit to 50.000 euro. For a further improvement of the activity of this system, Romanian Deposits Guarantee Fund will be further financed by the privatization incomes kept into the Treasury account at NBR. In the same time, the procedures will be simplified in order to accelerate the payments. According to these changes, the guaranteed amount should be paid during a period no longer than 20 days (structural goal).

NBR should further adopt a prudential policy and should avoid the aggressive interest cuts, when the fiscal policy "rises some questions".

Government could excessively base on the financing from the local banks, but the assets of the banking sector are owned by the foreign parent banks and these could change their strategy and fear of risk, so the state financing through these channels would be reduced in such circumstances.

5. CONCLUSIONS

Emerging economies are especially exposed because factors that are generally pushing banks to retrench from cross-border positions, such as swap market dislocations and the high cost of foreign currency liquidity, are exacerbated. Banks that have been a dominant source of funding in emerging Europe could start to cut exposures, and rollover rates for maturing short-term credits could fall sharply, as occurred, for example, during the Asian crisis. To date, subsidiaries of foreign banks operating in emerging Europe have largely maintained their exposures, given long-term business interests in the region, but the situation could shift quickly as conditions deteriorate.

Sudden stops in external financing could trigger dangerous repercussions, because liquidity problems could rapidly become threats to solvency, as has happened too often in the past. Corporations that previously relied on foreign funding may try to shift to domestic funding markets, adding to pressures on smaller local enterprises. Rapid exchange rate depreciation would add to pressure on balance sheets, particularly for borrowers with large foreign currency exposures.

Countries facing particularly difficult external conditions—including large current account deficits to be financed, large rollover requirements, a reliance on fragile inter-bank flows, and dwindling reserves may have to tighten monetary policy to preserve external stability, despite adverse consequences for domestic activity. Access to official financing—including both regional and bilateral credit lines and contingent financing from the IMF—can play an important part in reducing such painful trade-offs.

Turning to the post-crisis world, a key challenge will be to calibrate the pace at which to withdraw the extraordinary monetary stimulus now being provided. Acting too quickly would risk undercutting what is likely to be a fragile recovery, but acting too slowly could risk a return to overheating and new asset price bubbles. In some cases, achieving a smooth transition may call for new instruments, such as allowing central banks to issue their own paper to soak up excess liquidity.

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