# STABILITY OF THE FINANCIAL SYSTEM - CHALLENGES AND THREATS

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***Abstract:***
*This paper deals with the stability of the financial system as a whole in the Eurozone, analyzed in 2018, as well as the parallels of the European financial system in relation to other global financial powers.*

***Key words:*** *financial system, risk, financial policies*

***JEL classification:*** F21

Financial stability is the state of the financial system (consisting mainly of intermediaries, markets and market infrastructure) which gives it the ability to withstand shocks without interrupting or significantly affecting its financial intermediation function and to continue to provide financial services and products necessary to real economy entities and activities.

Financial stability is affected when one or more risk systems are realized. In this regard, local and international responsible authorities use macroprudential policies and instruments whose main objective is to safeguard financial stability and mitigate or eliminate systemic risks.

The effects of systemic risks can manifest both on the evolution of the economy (eg the level of GDP) and on financial intermediation. In a common classification by risk categories, the components of systemic risk can be identified as market risk, credit risk, concentration risk, liquidity risk, solvency risk, operational risk etc.

At European level, the supervision of the financial system is the responsibility of the European System of Financial Supervision (ESFS), which has been set up as a decentralized, hierarchical system of micro and macro-prudential authorities to ensure financial supervision in the European Union in a consistent and coherent manner.

Following the financial crisis of 2008-2009, the Member States of the European Union, through the common institutional framework that was created to monitor and regulate the financial system, sought to define and implement policies to address this category of risks.

A first step was to identify the vulnerabilities of the financial system and the operational definition of systemic risks. Subsequently, the effort continued with the setting of intermediate macro-prudential policy objectives, as well as the creation of appropriate instruments to be made available to the competent authorities, to provide a framework for managing identified vulnerabilities.

The macroprudential policy aims to:

• prevent the excessive accumulation of risks resulting from external factors and market failures, smooth the financial cycle,

• increase the resilience of the financial sector to shocks and limit the effects of contagion, and

• encourage the adoption of a broad perspective on financial regulation in order to create the right incentives for market participants.

At the local level, the macro-prudential policy on the financial system is the responsibility of the National Committee for Macroprudential Supervision, consisting of the National Bank of Romania, the Financial Supervisory Authority, the Ministry of Public Finance and the Bank Deposit Guarantee Fund.

The fundamental objective of the Committee is to help safeguard financial stability, including by strengthening the capacity of the financial system to withstand shocks and by reducing the accumulation of systemic risks, thereby ensuring a sustainable contribution of the financial system to economic growth.

Regarding the analysis of the local and international macroeconomic and financial context, in the first two months of 2019, economic and financial developments at European and international level were generally characterized by high uncertainty and volatility, especially as a result of geopolitical events (e.g. trade tensions between the US and China, uncertainties about how to resolve the process of Britain's exit from the European Union) with medium and long term impact on economic activities and balances and short-term effect on the variables that characterize financial markets.

Although financial conditions at European level remained stimulating, economic developments have been oscillating, characterized by inconsistencies and significant differences in pace between the Member States of the European Union. However, investor risk aversion has remained low, markets continue to show little concern about a possible increase in risk premiums in the medium and long term. Domestically, economic growth has remained robust, significantly above the European Union average, given a low level of total debt and external debt and a development within the accepted limits of the budget deficit, but also accompanied by a widening of the current account deficit (with moderate effects on the exchange rate for the time being) and an upward recovery in inflation .

Global economic growth in 2018 was + 3.6%, with a slight slowdown compared to 2017 of 3.8% which marked a peak of the economic cycle (advantageous trade, favorable lending conditions, liquidity higher in the financial markets).

Global economic activity moderated, especially in the second half of 2018. China felt a slight slowdown in growth (from 6.8% in the first quarter to 6.4% in the fourth quarter) amid the effect of external trade barriers and tightening domestic financial regulations on the shadow banking sector, while in Japan natural disasters have affected the evolution of the economy. In the US, GDP accelerated in 2018 to the maximum of the last three years (+ 2.9%) due to domestic demand and fiscal incentives, but their effect will dissipate in the next period.

| | Trimester 2 2018 | Trimester 3 2018 | Trimester 4 2018 | 2017 | 2018 |
|---|---|---|---|---|---|
| UE 28 | 2,2 | 1,9 | 1,5 | 2,5 | 2,0 |
| Euro Zone | 2,2 | 1,7 | 1,2 | 2,4 | 1,9 |
| Romania | 4,3 | 3,9 | 4,0 | 7,0 | 4,1 |
| Bulgaria | 3,4 | 3,1 | 3,2 | 3,8 | 3,1 |
| Hungary | 4,8 | 5,3 | 5,0 | 4,1 | 4,9 |
| Poland | 5,3 | 5,6 | 4,6 | 4,8 | 5,1 |
| Czech Republic | 2,4 | 2,5 | 2,7 | 4,4 | 3,0 |
| Germany | 2,0 | 1,2 | 0,6 | 2,2 | 1,4 |
| Great Britain | 1,4 | 1,6 | 1,4 | 1, 8 | 1,4 |
| France | 1,9 | 1,5 | 1,2 | 2,3 | 1,7 |
| Spain | 2,6 | 2,5 | 2,3 | 3,0 | 2,6 |
| Italy | 1,0 | 0,5 | 0,0 | 1,7 | 0,9 |

Source: Eurostat (percentage change compared to the similar quarter of the previous year-seasonally adjusted data);

The European Union experienced a sharper slowdown in annual growth to 1.5% in the 4th quarter of 2018 (from 2.4% in the 1st quarter), as a result of weakening consumer and business confidence under the influence of trade of external factors; limiting production by extending supply terms for input enterprises; staff recruitment difficulties affecting the production of cars in Germany by the introduction of new carbon standards; reducing investment in Italy as sovereign spreads increased; the weakening of activity in the services sector in France amid repeated social protests.

At present, less favorable global conditions related to trade tensions have intensified, prompting the European Commission to warn of possible vulnerabilities which, if not corrected, could trigger certain imbalances in the future.

Regarding macroeconomic and financial developments regarding the Romanian economy, a sustainable growth rate (+ 4.1%) can be observed in 2018, around the potential one, followed by the reduction of the short-term GDP deviation, mainly due to the moderation of the domestic demand.

| | Q2_18 | Q3_18 | Q4_18 | 2017 | 2018 |
|---|---|---|---|---|---|
| UE - 28 | 2,2 | 1,9 | 1,5 | 2,5 | 2,0 |
| Zona Euro | 2,2 | 1,7 | 1,2 | 2,4 | 1,9 |
| România | 4,3 | 3,9 | 4,0 | 7,0 | 4,1 |
| Bulgaria | 3,4 | 3,1 | 3,2 | 3,8 | 3,1 |
| Ungaria | 4,8 | 5,3 | 5,0 | 4,1 | 4,9 |
| Polonia | 5,3 | 5,6 | 4,6 | 4,8 | 5,1 |
| Cehia | 2,4 | 2,5 | 2,7 | 4,4 | 3,0 |
| Germania | 2,0 | 1,2 | 0,6 | 2,2 | 1,4 |
| Marea Britanie | 1,4 | 1,6 | 1,4 | 1,8 | 1,4 |
| Franța | 1,9 | 1,5 | 1,2 | 2,3 | 1,7 |
| Spania | 2,6 | 2,5 | 2,3 | 3,0 | 2,6 |
| Italia | 1,0 | 0,5 | 0,0 | 1,7 | 0,9 |

*Sursa: Eurostat (variație procentuală comparativ cu trimestrul similar din anul anterior-date ajustate sezonier); Prognoza de vară 2019 a Comisiei Europene*

Balancing real growth around potential growth is beneficial and ensures medium-term sustainability, as long as the investment contribution is positive. On the usage side, private consumption registered a continuous decrease until 2018 compared to 2016. The second most important contribution was the accumulation of stocks (2, 3pp), but with a decreasing influence (from 3.2pp in Q4), being offset by that of investments. Thus, the contribution of gross fixed capital formation became a positive one (0.6pp from -0.7pp in Q4), with an increase in volume by 3.9% annually, given the expansion of construction works.

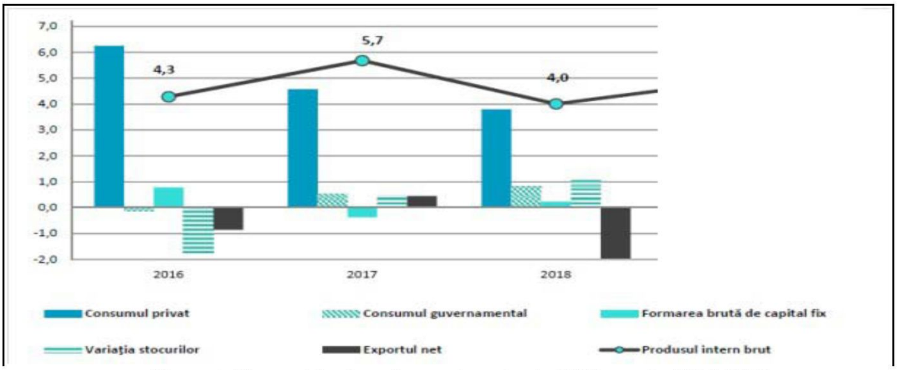
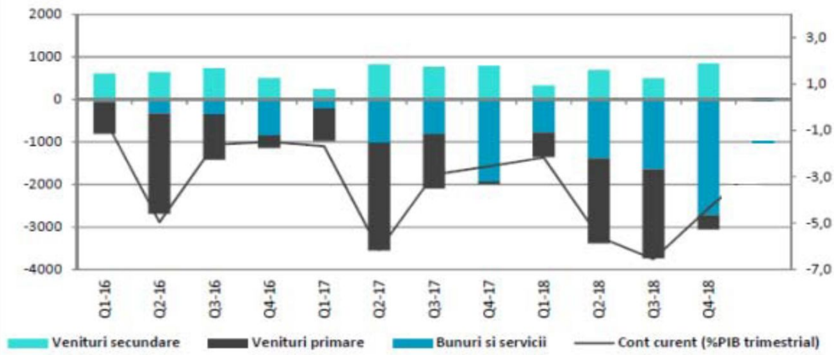



Figure 1 The contribution of use categories to GDP growth 2016-2018

Source: INS, calculations ASF

*Figura 1 Evoluția contului curent pe componente (mld. euro)*




*Sursa: BNR, calcule ASF*

However, these corrections counterbalanced the unfavorable effect of net exports, which increased its contribution to halting growth (-2.5pp from -1.9pp in Q4) amid a sharper slowdown in exports of goods and services.

The sustainability of the degree of indebtedness is ensured in the medium term, the share in GDP of the total external debt follows a decreasing trend in the last 9 months of 2018. Unlike Romania, the developed countries of the Eurozone fall on average with a percentage of external debt 120% of GDP. It should be mentioned that Romania has the lowest private debt (of households and non-financial companies), as a share of GDP in the European Union, along with Lithuania, around 50%, significantly below the level accumulated by the Eurozone economy, of about 163%. From this point of view, the risks of financial slippages of the banking sector are much lower, Romania allowing itself to evolve for a medium period of time with higher budget and current account deficits, but being necessary later a return below the references of 3% and 4% of GDP (ensuring long-term balance).

*Tabelul 3 Situația deficitelor și a gradului de îndatorare*

| Indicator | Q1_18 | Q2_18 | Q3_18 | Q4_18 |
|---|---|---|---|---|
| Soldul contului curent* | | | | |
| RO | -2,7 | -5,8 | -5,7 | -3,6 |
| Zona Euro | 2,6 | 2,5 | 2,9 | 3,5 |
| Deficitul guvernamental ESA* | | | | |
| RO | -4,4 | -1,7 | -1,4 | -4,7 |
| Zona Euro | -1,5 | 0,4 | -0,4 | -0,6 |
| Datoria guvernamentală** | | | | |
| RO | 34,6 | 34,3 | 34,2 | 35,0 |
| Zona Euro | 87,2 | 86,6 | 86,5 | 85,2 |
| Datoria privată (neconsolidată)*** | | | | |
| RO | 50,7 | 50,1 | 50,2 | 49,0 |
| Zona Euro | 164,1 | 164,4 | 164,2 | 163,1 |
| Datoria externă brută** | | | | |
| RO | 51,9 | 50,6 | 50,1 | 49,1 |
| Zona Euro | 125,3 | 126,3 | 125,8 | 122,5 |

**pondere în PIB trimestrial; ** pondere în PIB anual (suma PIB-urilor realizate în ultimele 4 trimestre); ***- % PIB - Calcule ASF pe baza datelor Eurostat; date neconsolidate (numerar & depozite, titluri de natura datoriei, credite) agregate pe gospodării și instituții nefinanciare*

The evolution of the monthly indicators highlights the sustained economic activity in the short term, a relatively modest growth in industry and a dynamization of constructions and services. The expectations of financial analysts are cautious, influenced by higher financial costs.

The annual pace of the manufacturing industry has remained modest since the second half of 2018, in correlation with the trend in Europe, but also against the background of difficulties related to competitiveness and domestic demand affecting the sectors of consumer goods. The services sector was highlighted by a more alert advance compared to the primary sector, a constant upward evolution during 2017 and 2018, noting the services for enterprises with a positive impact on the dynamics of the economy. Currently, the annual net employment flow is approaching the size observed in Q2-2014, being located on the descending part of the bell-shaped curve, with a maximum achieved in Q4-2016 (+161 thousand). The labor market has expanded significantly in the last 4 years, recovering post-crisis losses, currently bringing purchasing power by 54.5% above the level during the crisis (Dec. 2008).

The financial resources of the companies allowed in 2018 an increase in the average net earnings (calculated from monthly data) similar to the previous year. It is thus noticeable the compliance of the business environment with the fiscal policy regarding the transfer of social contributions to the employee, without eroding the net earnings.

Current favorable outlook for revenue growth has boosted consumer demand and induced some inflationary pressures. Thus, inflation followed a slight increase in the short term, with an anticipated delay in the downward trajectory, reflecting increases in volatile prices.

The annual inflation rate evolved in 2018 on a curved trajectory, similar to the NBR estimates, starting from 4.32% in January and up to 3.27% in December, with a maximum reached in May at 5.41%. Inflationary pressures have faded towards the end of 2018 as a result of the gradual dissipation of the base effect, in line with the declining price of Brent oil.

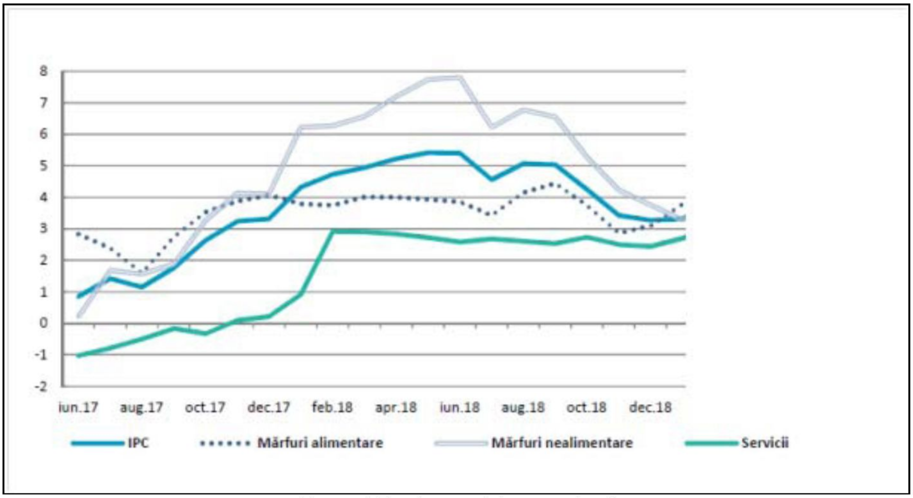



Figure 2 Evolution of the annual inflation rate
Source: INS, calculations ASF

Regarding future developments, the NBR estimates indicate a likely level of inflation of 4.2% in December 2019 (+ 1.2 percentage points compared to the previous forecast), after which it will continue to decline to 3.3% at the end of 2020. The current influences will act throughout 2019, being more obvious those related to the volatility of vegetable prices at European level, the increase of the excise duty on tobacco products, the slight increase of the surplus of aggregate demand. Events related to international trade disputes and the slowdown in the dynamics of the global and European economy have had a minimal impact on investor sentiment.

The European Commission's growth forecasts for 2019 have been revised downwards, with EU GDP growth forecast at 1.5% (down from 2.1%) in 2019. The pace of quantitative easing has been a key factor of market expectations in recent quarters. The ECB and the US Federal Reserve have now signaled that they will put interest rate hikes on hold. The ongoing global reform of the IBOR (Interbank offered rate) incorporates a range of risks that could have an impact on the EU financial system. These risks are mainly associated with the long-term sustainability of IBOR rates and the transition to new risk-free rates, such as the Euro short-term rate (ESTER), denominated in euro.

In response to the risks and vulnerabilities identified at European level, the Joint Committee of European Supervisory Authorities has recommended a number of actions, which generally address the possible risks in the event of a BREXIT without agreement:

- EU financial institutions, market participants and their counterparts, as a result of the UK's withdrawal from the EU, it is important to adopt contingency plans in a timely manner. These plans must address the relevant risks that would result from an inconclusive conclusion of the withdrawal terms negotiations, including the increase in market volatility resulting from such a scenario;
- European insurance supervisors and entities operating in this industry must ensure that the risks of a potential abrupt revaluation of risk premiums and low interest rates are properly monitored and assessed and that appropriate mitigation actions are taken;
- Against the background of the potential for a sharp rise in risk premiums and financing costs, the development and regular use of stress tests in all sectors remains crucial.

De asemenea, EIOPA a solicitat firmelor de asigurare și autorităților naționale de supraveghere să elaboreze planuri de urgență și să ia măsurile necesare pentru a asigura continuitatea serviciilor în ceea ce privește contractele de asigurare transfrontaliere în cazul în care nu există o înțelegere concludentă cu privire la acestea post-Brexit. În unele state membre asigurătorii cu cea mai mare deschidere transfrontalieră pun deja în aplicare măsuri de urgență. Totodată, în luna februarie 2019, EIOPA a emis recomandări autorităților naționale de supraveghere cu privire la tratamentul aplicabil asigurătorilor care și-ar putea pierde autorizația de a activa pe teritoriul UE în cazul unui Brexit fără acord. Aceasta va contribui la ameliorarea vulnerabilităților rezultate din activitățile de administrare a activelor și la furnizarea de noi instrumente pentru prevenirea sau atenuarea potențialelor noi surse de riscuri sistemice.

EIOPA also called on insurance companies and national supervisors to draw up contingency plans and take the necessary measures to ensure the continuity of services with regard to cross-border insurance contracts in the event that there is no conclusive agreement on them post-Brexit. In some Member States, insurers with the largest cross-border opening are already implementing emergency measures. At the same time, in February 2019, EIOPA issued recommendations to national supervisors regarding the treatment applicable to insurers who it could lose authorization to operate in the EU in the event of a Brexit without an agreement. This will help alleviate vulnerabilities resulting from asset management activities and provide new tools to prevent or mitigate potential new sources of systemic risk.

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