

The International Financial Crisis: Impact on the Romanian Economy and Future Prospects

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I.

The Global Financial Crisis

I. The global economy is facing the deepest – and probably longest – recession of the post-war period

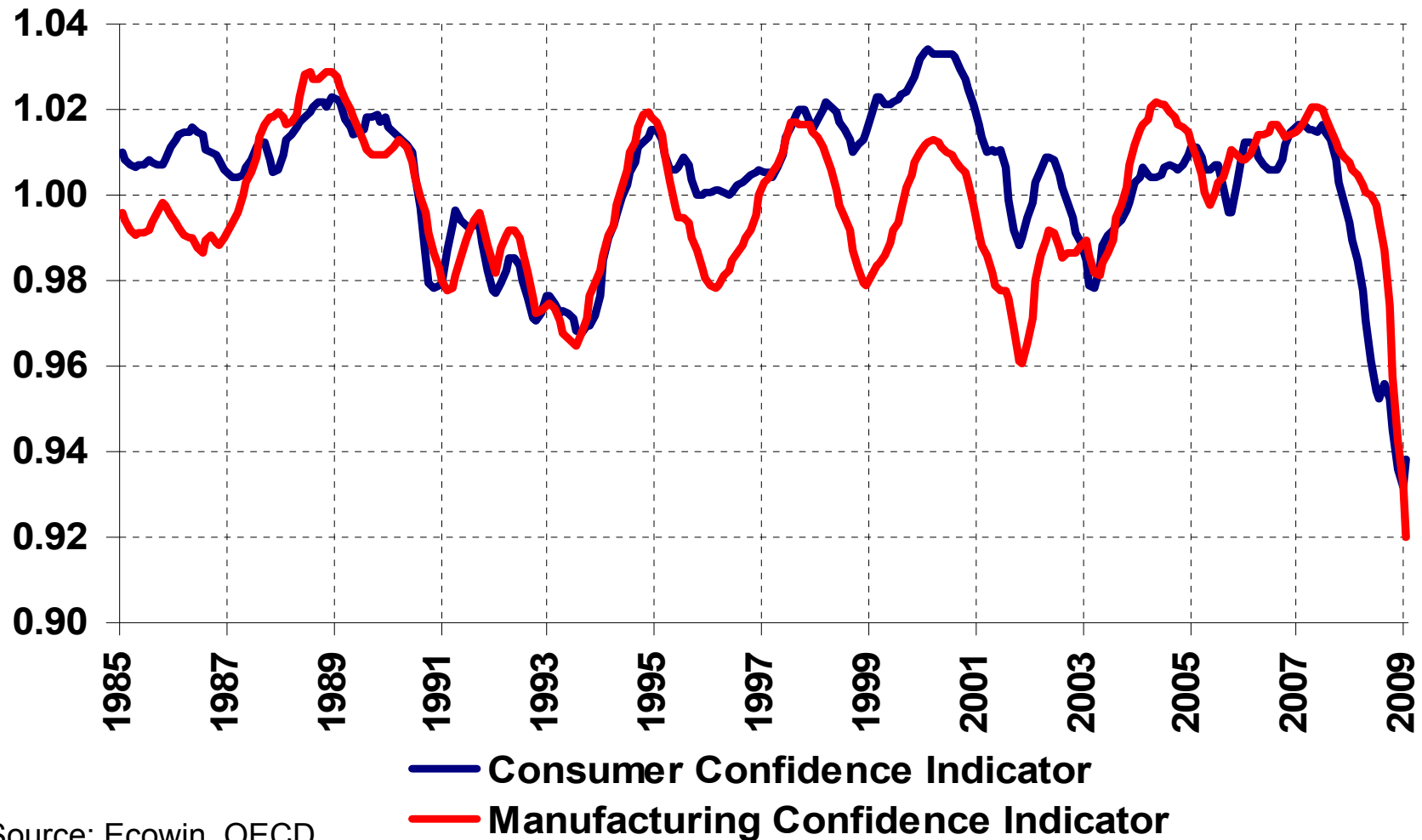


Source: EFG Eurobank Research

- ✓ We expect a significant deceleration in 2009 and a sluggish recovery in 2010

I. Global Leading Indicators collapse

OECD Confidence Indicators of households and manufacturing enterprises



Source: Ecowin, OECD

I. A slowdown in every country

	2007	2008F	2009F
Real GDP Growth (% y-o-y)			
Global GDP growth	3.8	2.2	-0.5
US	2.0	1.3	-2.0
EA	2.6	0.7	-2.2
UK	3.0	0.7	-2.5
Greece	4.0	2.9	0.5
Japan	2.4	-0.3	-3.0
China	13.0	9.0	6.0
Russia	8.1	6.2	-0.5
India	9.2	7.5	5.0
Brazil	5.7	5.8	1.5

Three sources of the global slowdown:

- ✓ Decline in growth of exports attributed to the weakening global demand
- ✓ Lower credit expansion
- ✓ The slump of asset prices (stocks, real estate, commodities) plus FX devaluations in some countries

Source: Eurobank EFG

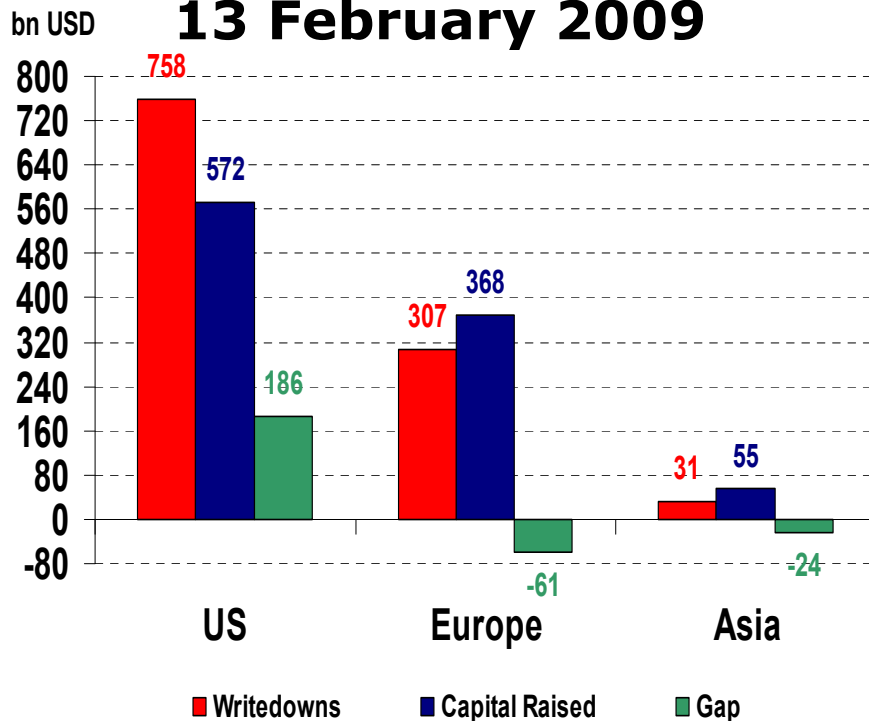
I. FI Insolvency: The biggest global risk

- ✓ The gap between total write-downs and capital increases has declined sharply due to governments' recapitalizations.
- ✓ **IMF** estimates that total write-downs will reach \$2.2 trillion.

All Financials*

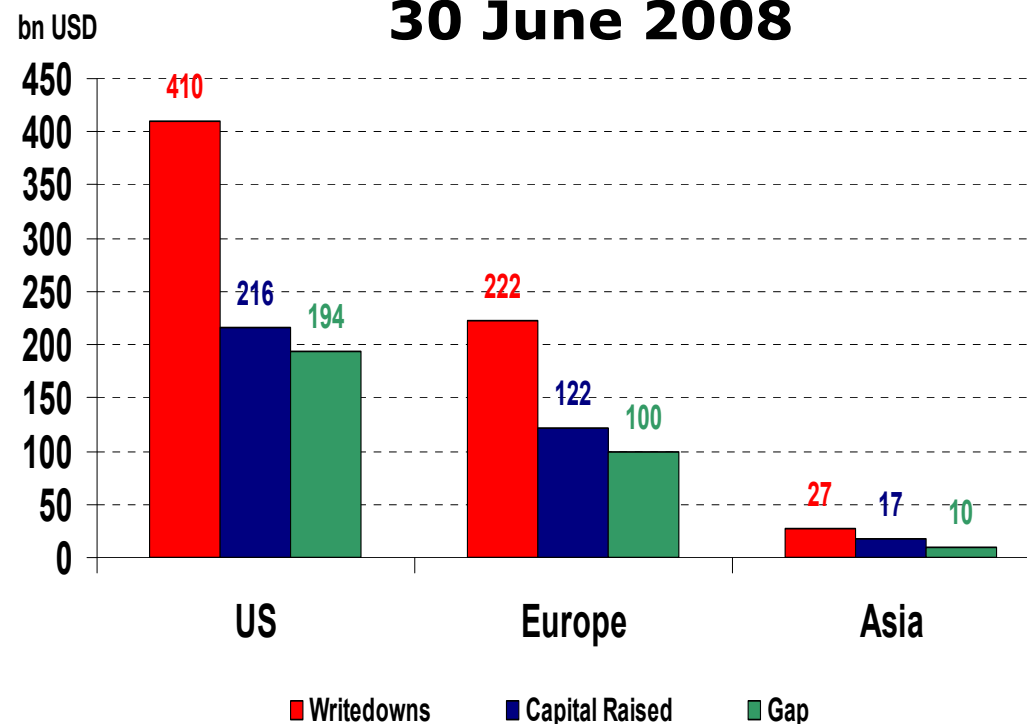
Total Write-downs: \$ 1096.3
Total Capital Raised: \$ 995.5
Total Gap: \$ 100.8

13 February 2009

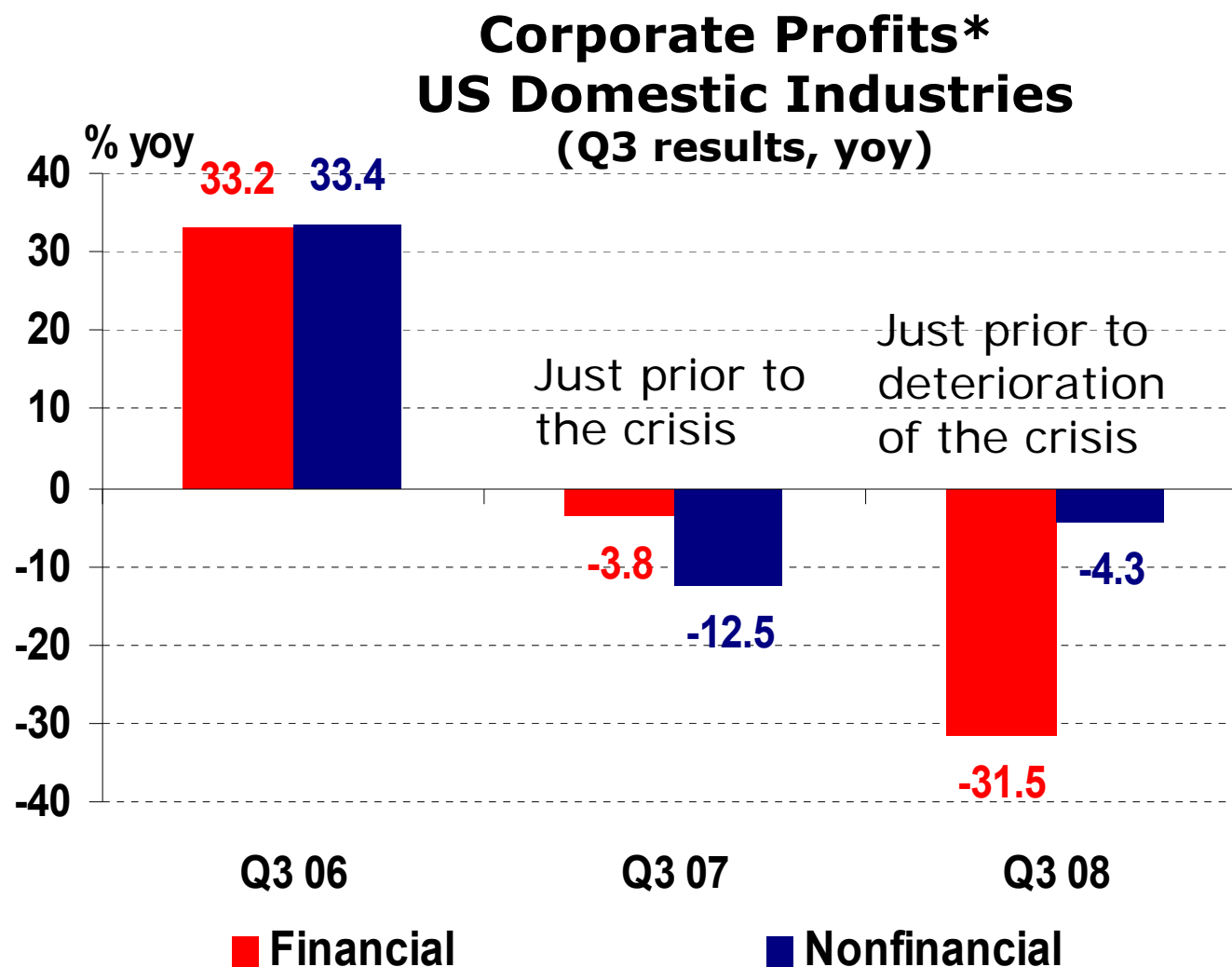


Total Writedowns: \$ 658.5
Total Capital Raised: \$ 355.3
Total Gap: \$ 303.2

30 June 2008



I. FI profits deteriorate

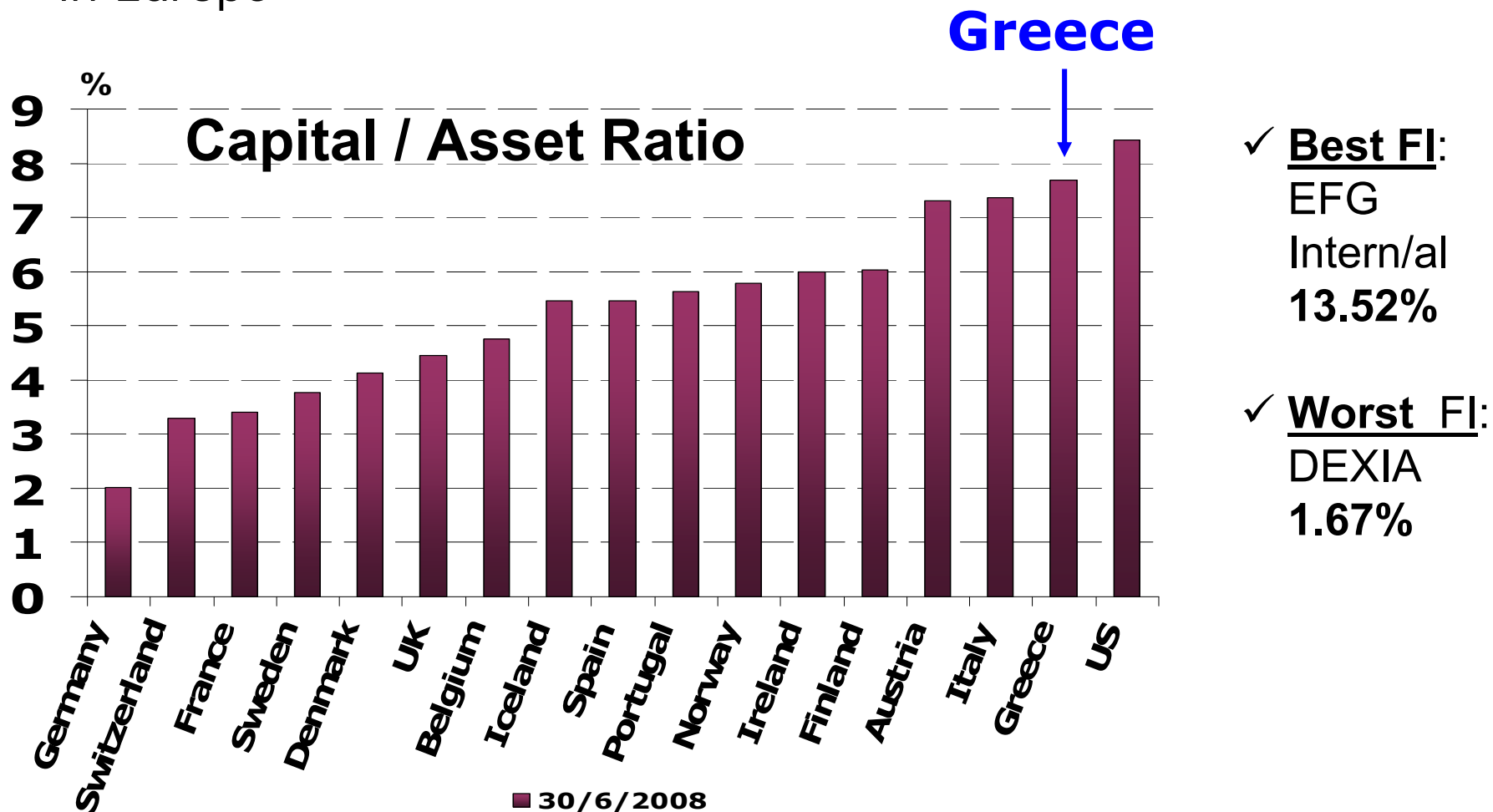


- ✓ Asset losses now affect the Income Statement
- ✓ Effort to hide losses by dressing up the Balance Sheet is longer feasible as the crisis prolongs for 19 months

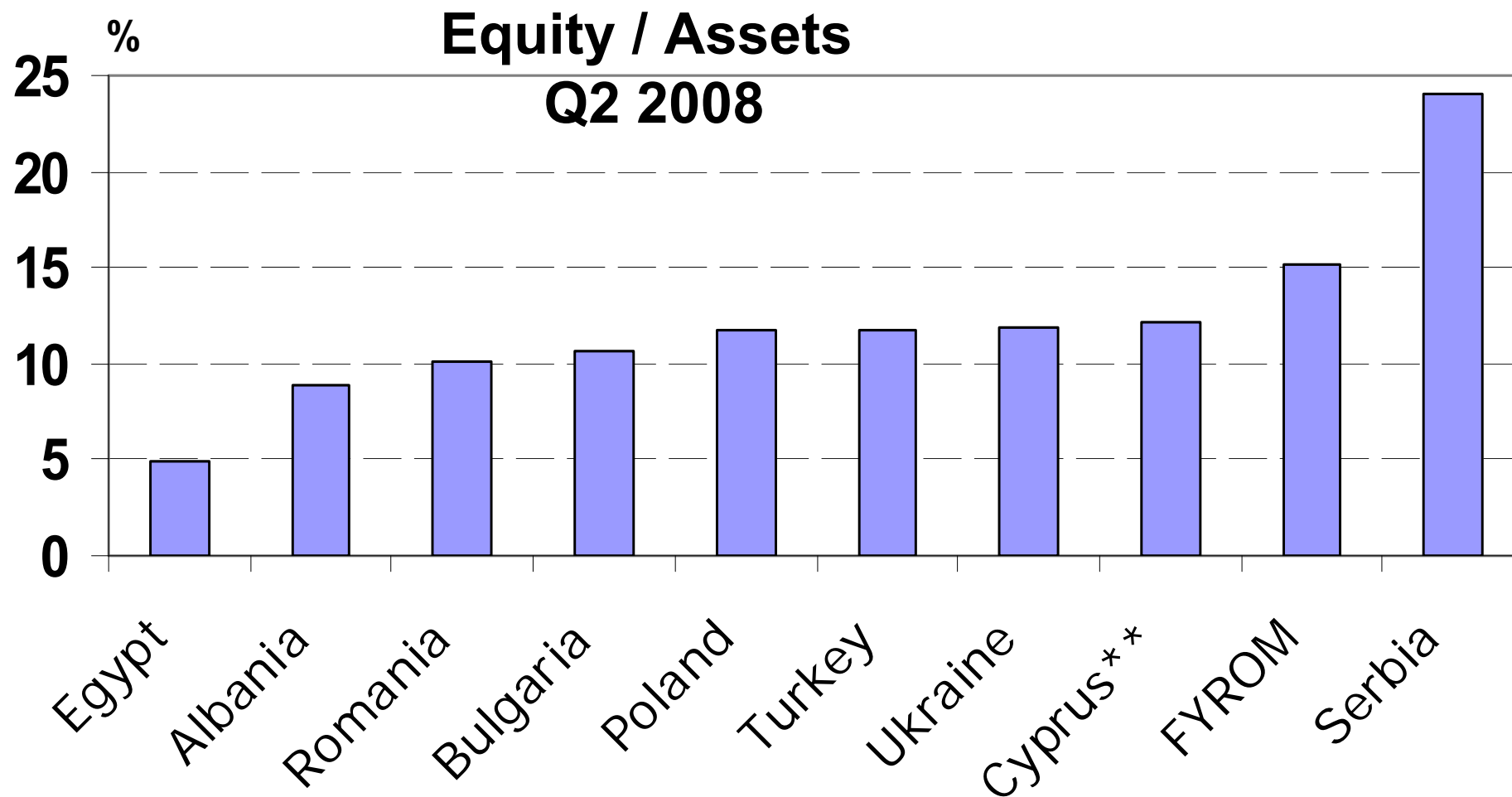
Source: US Department of Commerce, Bureau of Economic Analysis, National Economic Accounts

I. Greece: The strongest FI capital base in Western Europe

- ✓ Greek large banks have the strongest capital/asset ratio in Europe



I. Banks in New Europe have a stronger capital base than in Western Europe

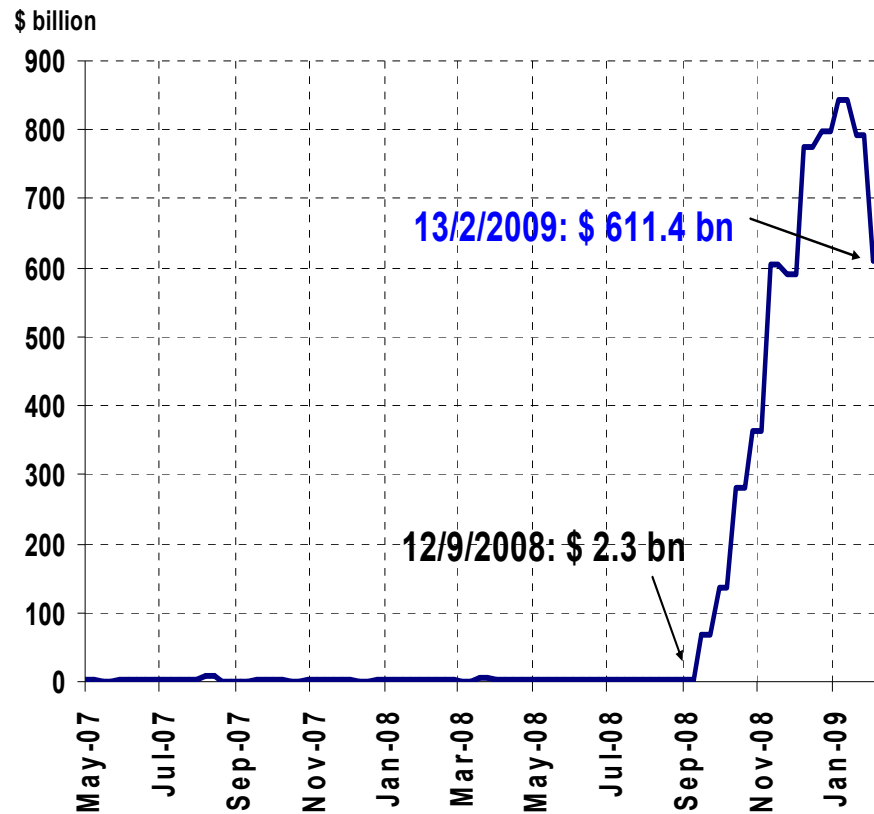


* Albania, data as of December 2007

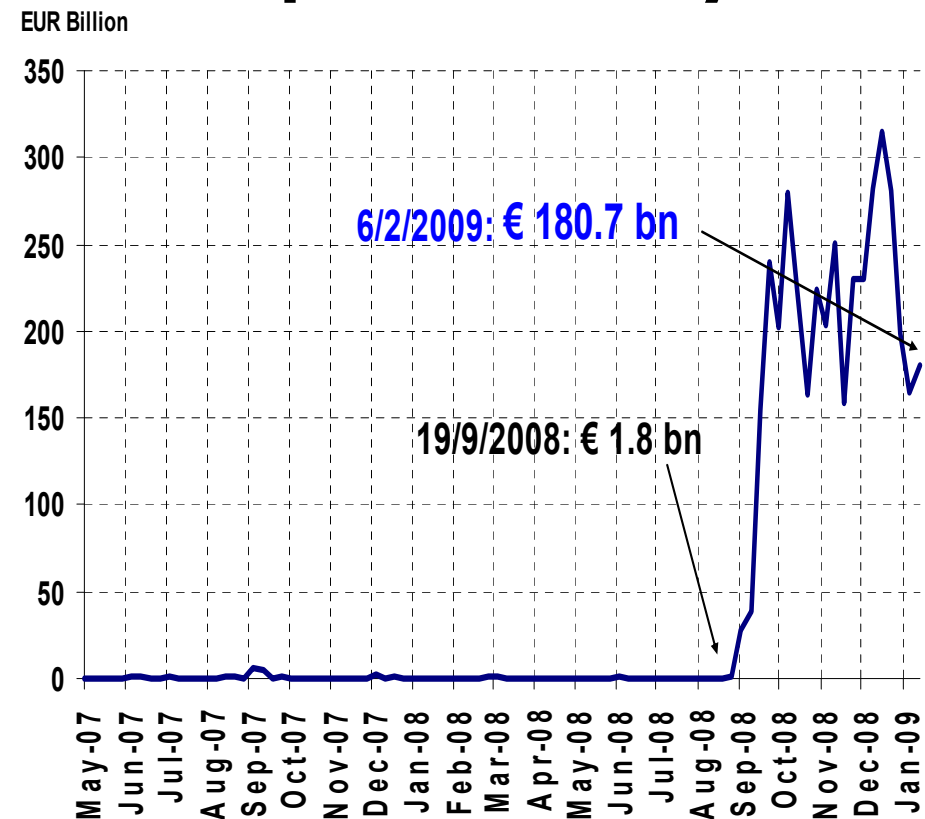
** Cyprus, data refer to Tier I Capital

I. Lack of liquidity

USA Excess Reserves



Euro Area Deposit Facility



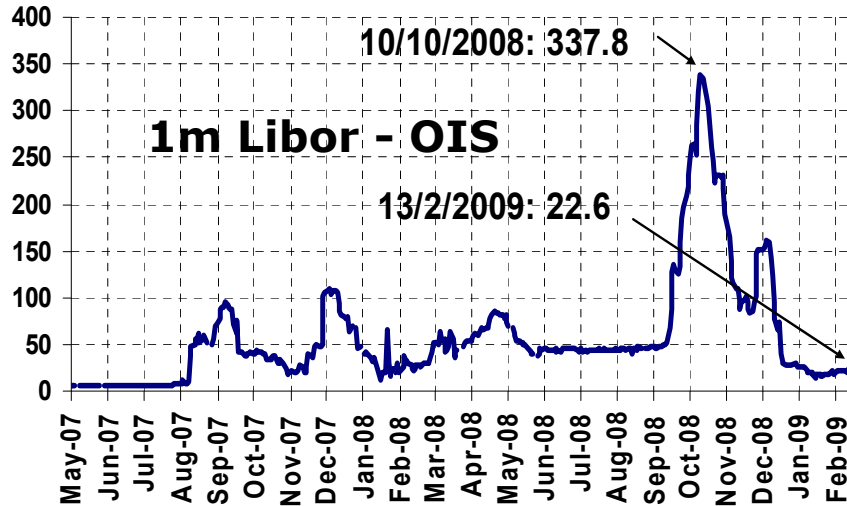
✓ US & European banks are hoarding cash

Source: Federal Reserve, ECB

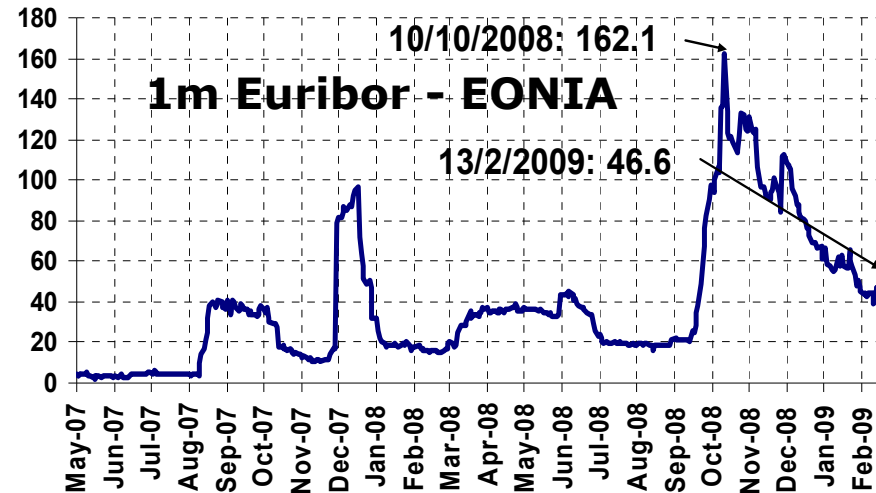
I. Lack of liquidity

US

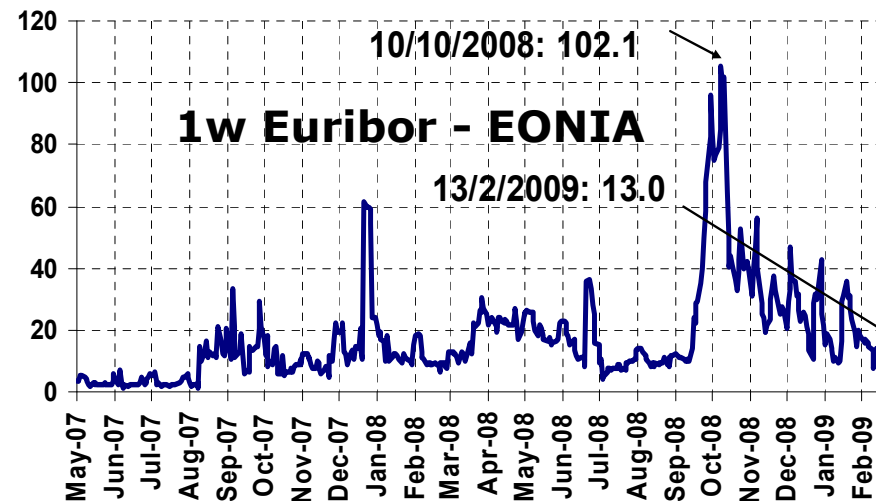
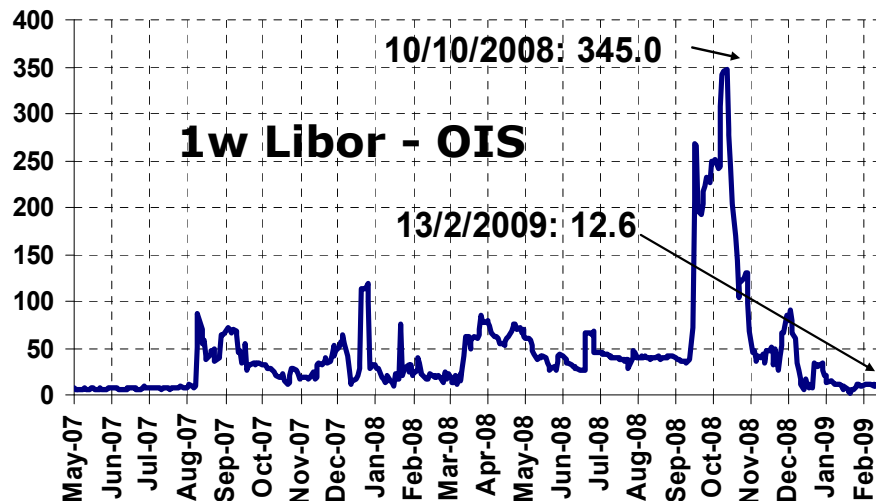
Uncovered minus covered 1-month inter-bank rates



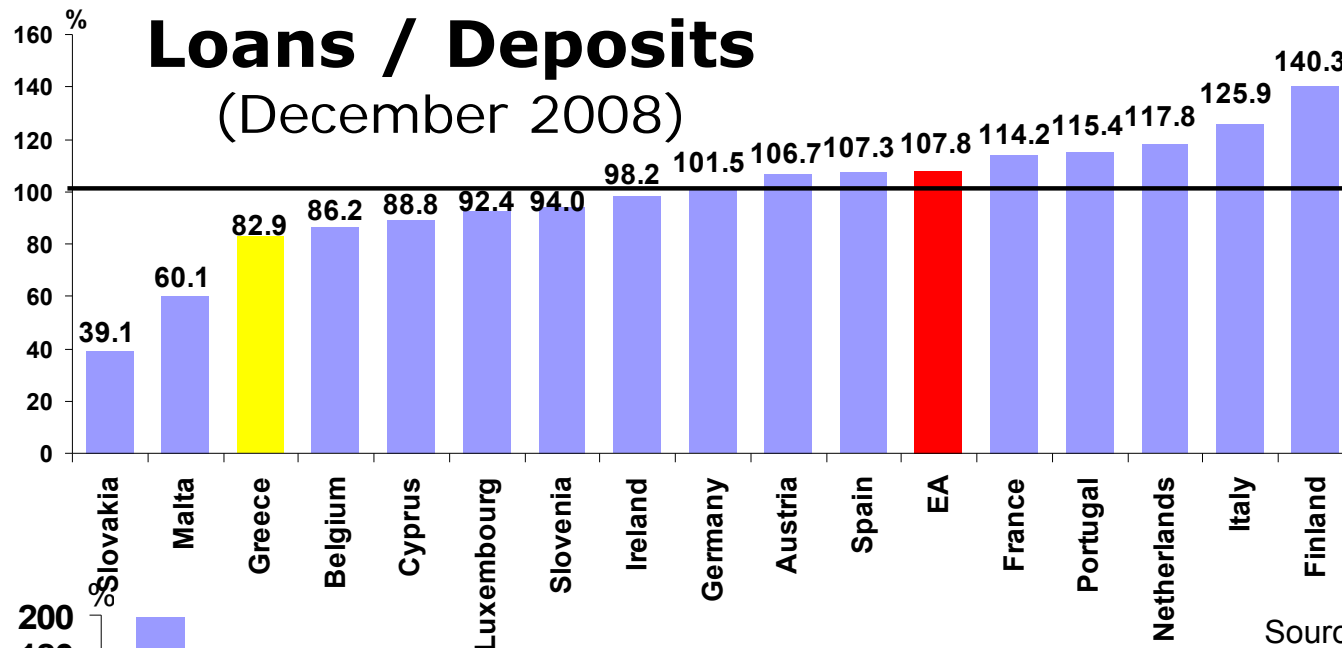
Euro Area



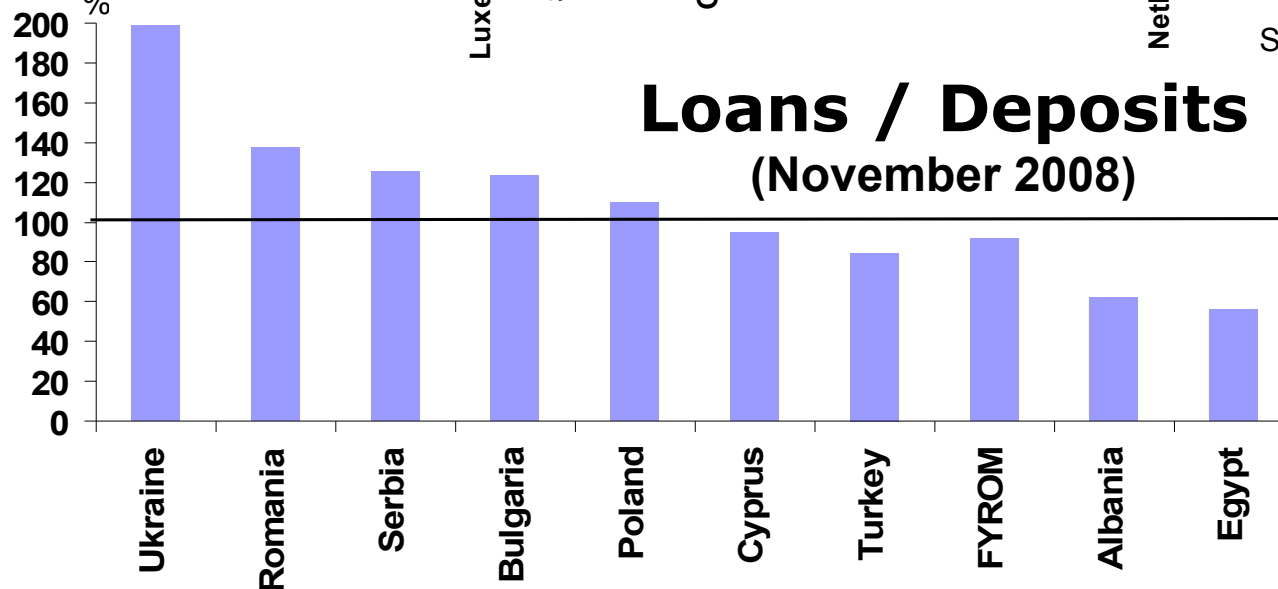
Uncovered minus covered 1-week inter-bank rates



I. Liquidity: Abundant in Greece, lacking in some New Europe countries



Source: ECB, Balance Sheet Items data



Source: Central Banks

I. Rescue measures

	Package Amount*	% of 2009 GDP
Italy	€ 52 bn	3.2%
Belgium	€ 19.6 bn	5.5%
Greece	€ 28 bn	10.8%
Norway	NOK 350 bn	13.5%
Portugal	€ 24 bn	13.9%
USA	\$ 2,600 bn	17.9%
France	€ 360 bn	18.0%
Germany	€ 500 bn	19.5%
Spain	€ 250 bn	22.4%
Finland	€ 54 bn	27.3%
UK	£ 500 bn	33.8%
Austria	€ 100 bn	34.2%
Netherlands	€ 237 bn	39.1%
Sweden	SEK 1,565 bn	49.3%
Ireland	€ 410 bn	220.0%
Total EU-27	€ 2,737 bn	21.2%

US Rescue Plans

- ✓ Initial Rescue Plan
“**TARP**” → \$700 bn, 5% of GDP

- ✓ New Rescue Plan
“**Financial Stability Plan**” →
\$2 trillion, 14% of GDP

Nationalizations	
Countries	Financial Institutions
Ireland	Anglo Irish Bank, Bank of Ireland, Allied Irish Bank
UK	RBS, Bradford & Bingley, Northern Rock, Lloyds
Germany	Commerzbank
Iceland	Landsbanki, Kaupthing
US	Fannie Mae, Freddie Mac, AIG

* Includes capital injections, asset purchasing and guarantees on debt issuance

I. Fiscal Packages

	Amount	% of 2009 GDP
US 2008	\$ 168 bn	1.2%
2009-19	\$ 789 bn	5.5%
EU-27 2009-10	€ 200 bn	1.5%
China 2009-10	CHY 4 tr	15.0%

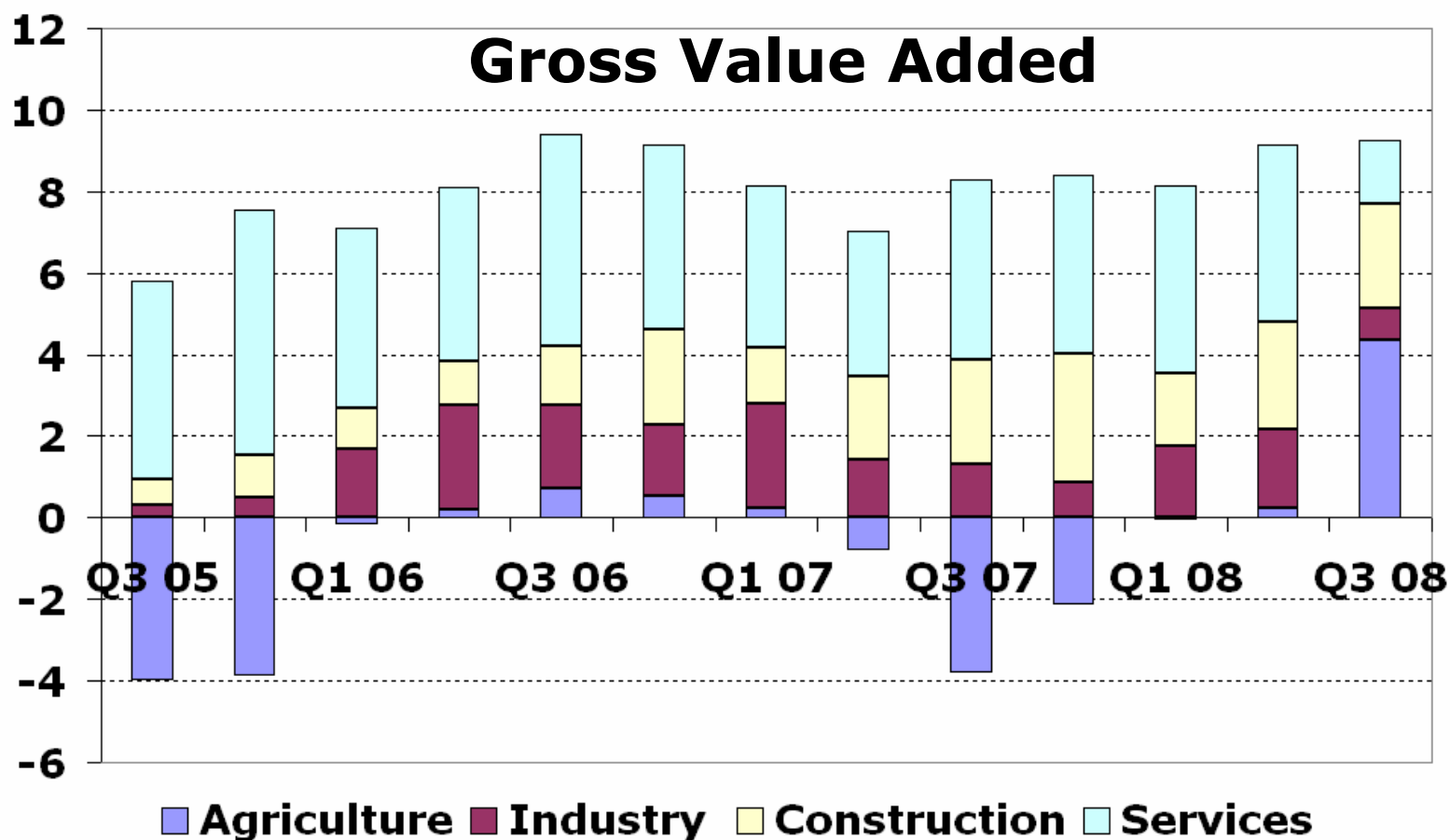
	Fiscal deficit (as % of GDP)	
	2008	2009
US	-3.2%	-8.3%
EU-27	-2.0%	-4.4%
China	-0.1%	-2.8%

Source: European Commission, Congressional Budget Office, Economist

II.

Slowdown in Romania ante portas

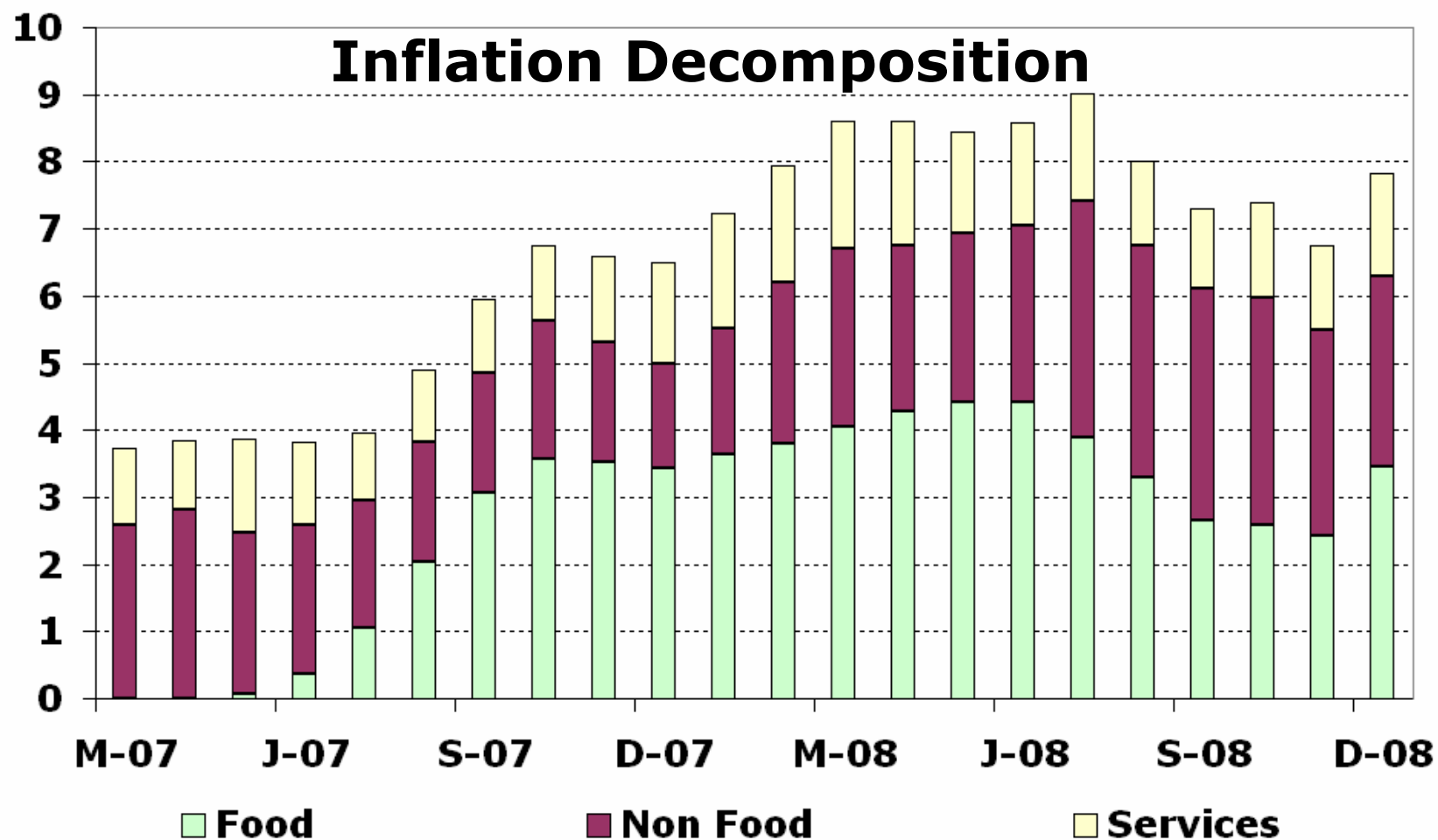
II. High Growth Rates in Romania



Source: INSSE

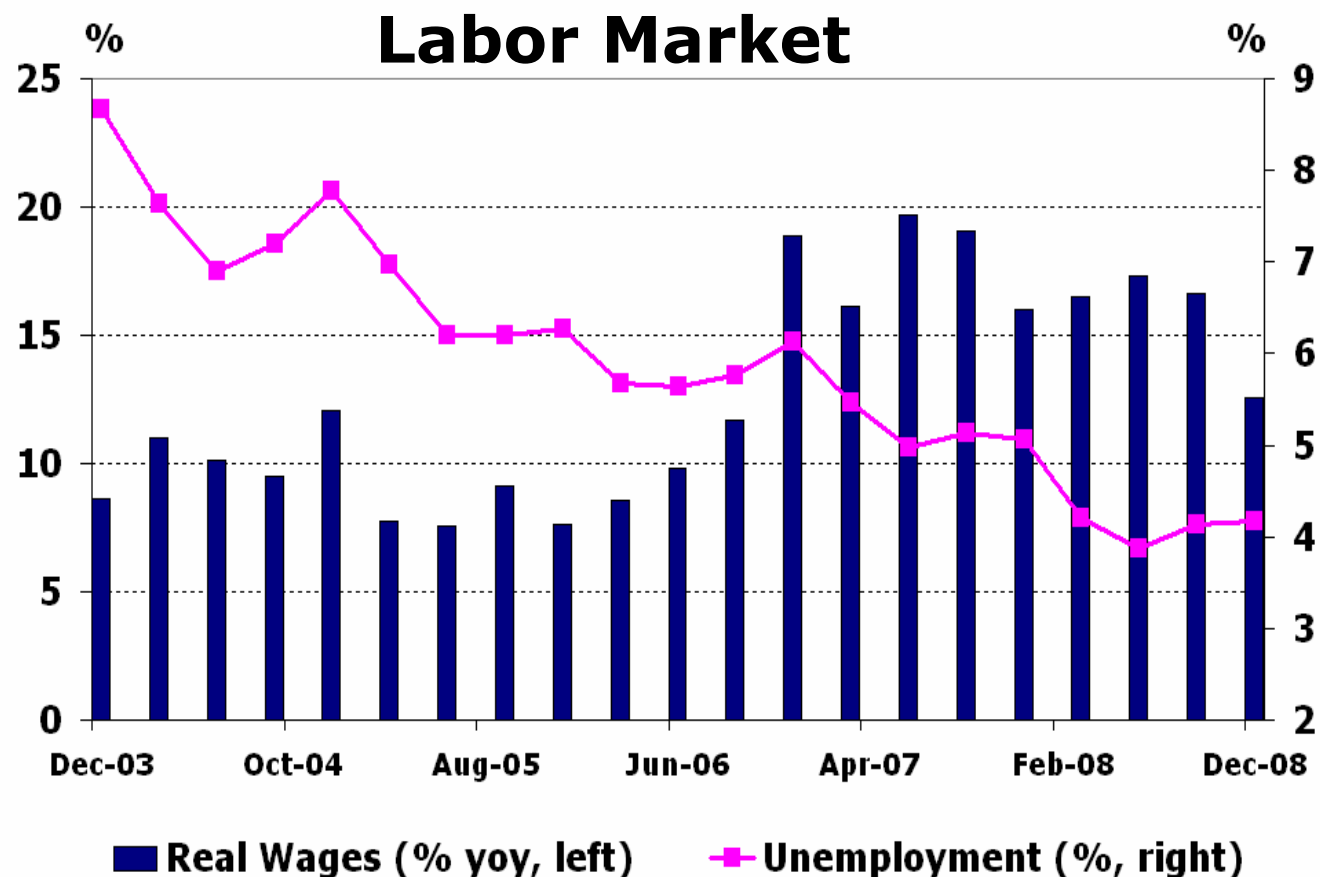
- ✓ The rebound in the agricultural sector in Q3-2008 masks the early stages of the slowdown

II. High Rates of Inflation



Source : National Bank of Romania

II. Economy was overheating until H1 2008



Source: INSSE

- ✓ In H2 2008, a slowdown in real wages plus a slight increase in unemployment from its historical low levels
- ✓ Unemployment is expected to increase and real wage growth to decelerate further

II. European Commission Forecasts

	2008	2009	2010
GDP	7.8	1.8	2.5
Private Consumption	8.0	1.9	2.9
Public Consumption	3.5	3.4	3.2
Gross Fixed Capital Formation	18.1	1.4	3.0
of which: equipment	18.0	0.7	2.2
Exports	10.7	1.3	1.9
Imports	15.2	1.7	3.4
GNI	7.5	2.0	2.6
Current Account Deficit	12.9	11.9	11.1
Unemployment	6.2	7.0	6.9

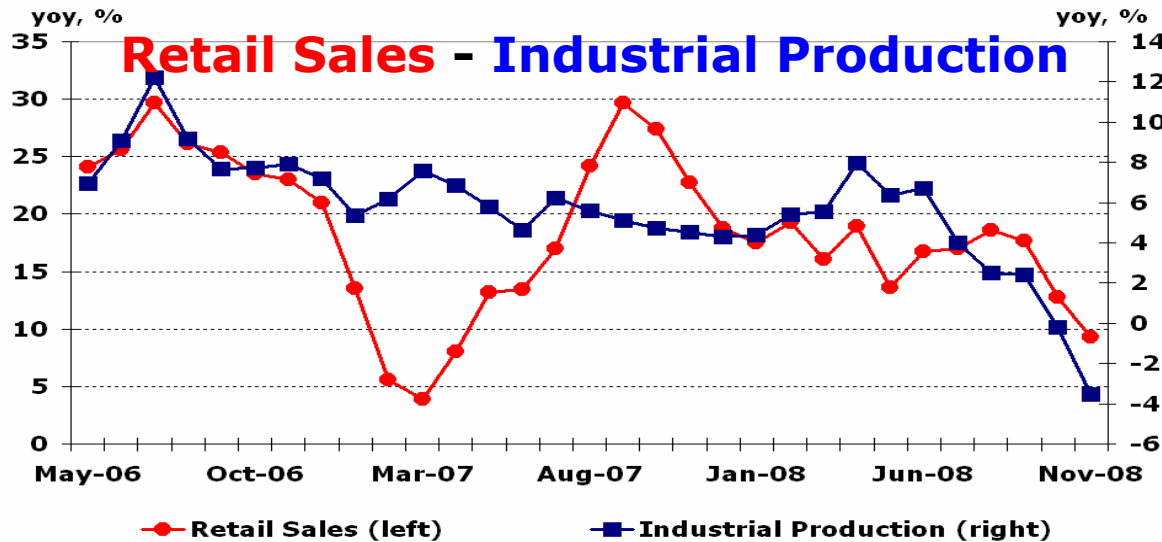
GDP Decomposition	
Private Consumption	67.3
Public Consumption	15.6
Gross Fixed Capital Formation	30.4
Of which: equipment	14.7
Exports	29.5
Imports	43.5
GDP	100

***A large proportion of public consumption reflects transfers to households**

II. Impact of the crisis on Romania

- ✓ Impact became visible in Romania after the collapse of Lehman Brothers
- ✓ Channels of the crisis transmission to the real economy:
 - Through the reduction of growth in exports
 - Through financial market pessimism (high interest rates, FX depreciation, lower credit growth to the private and public sector) ⇒ drop in consumption and investment growth
- ✓ A second wave of negative pressure on bank profitability and solvency, as the slowdown in the real economy raises NPLs

II. Prospective slowdown: A drop in Production & Consumption growth



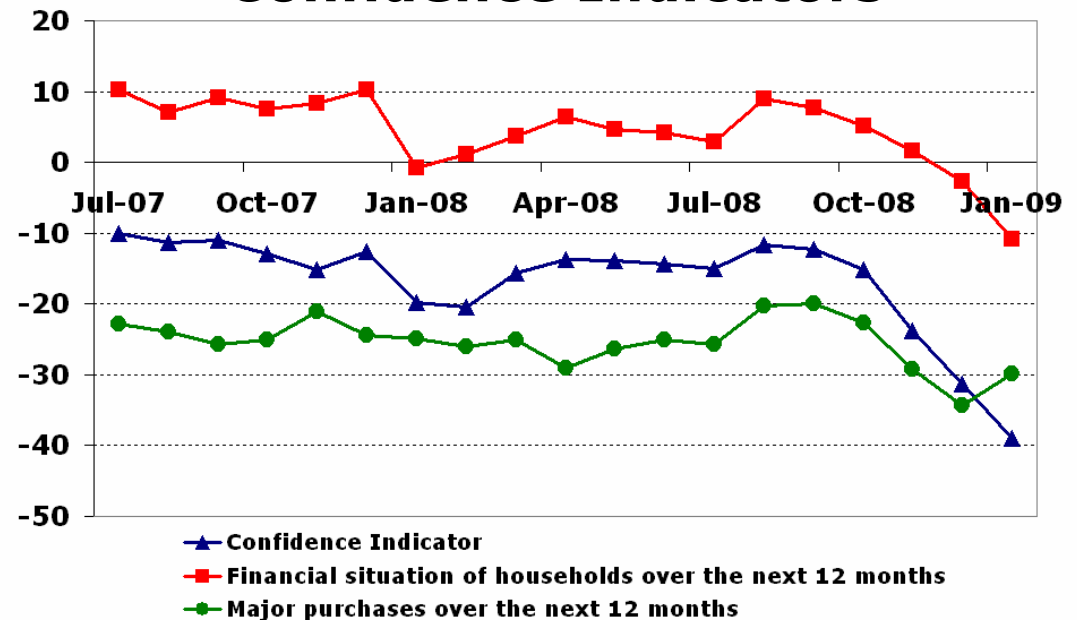
✓ Industrial production slumped in Q4

Source : INSSE

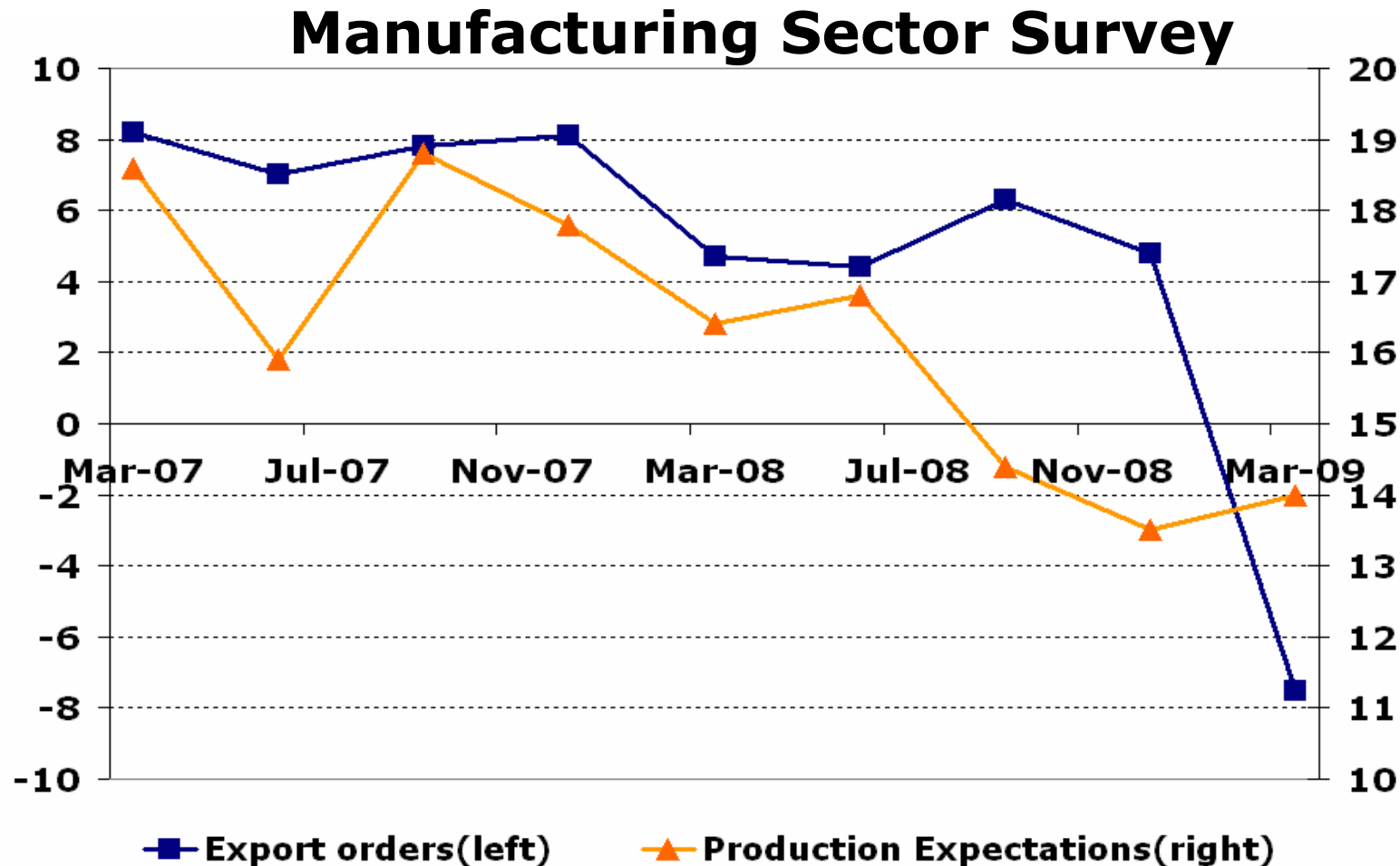
✓ Consumer confidence plunging

Source : DG ECFIN Survey

Confidence Indicators

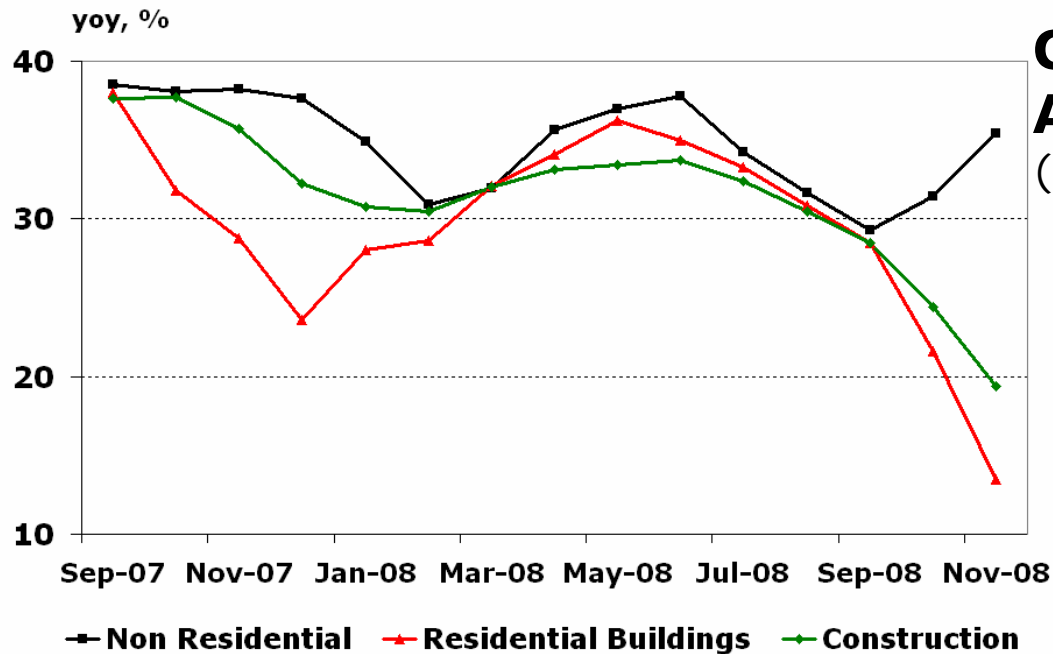


II. Expected drop in manufacturing

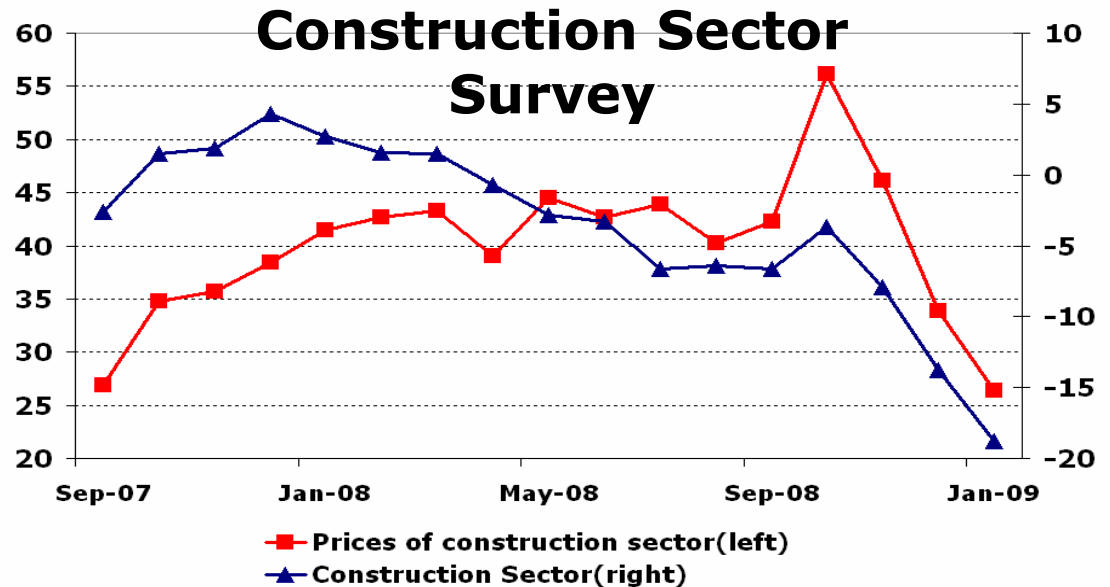


Source: DG ECFIN, Business Surveys Manufacturing Sector

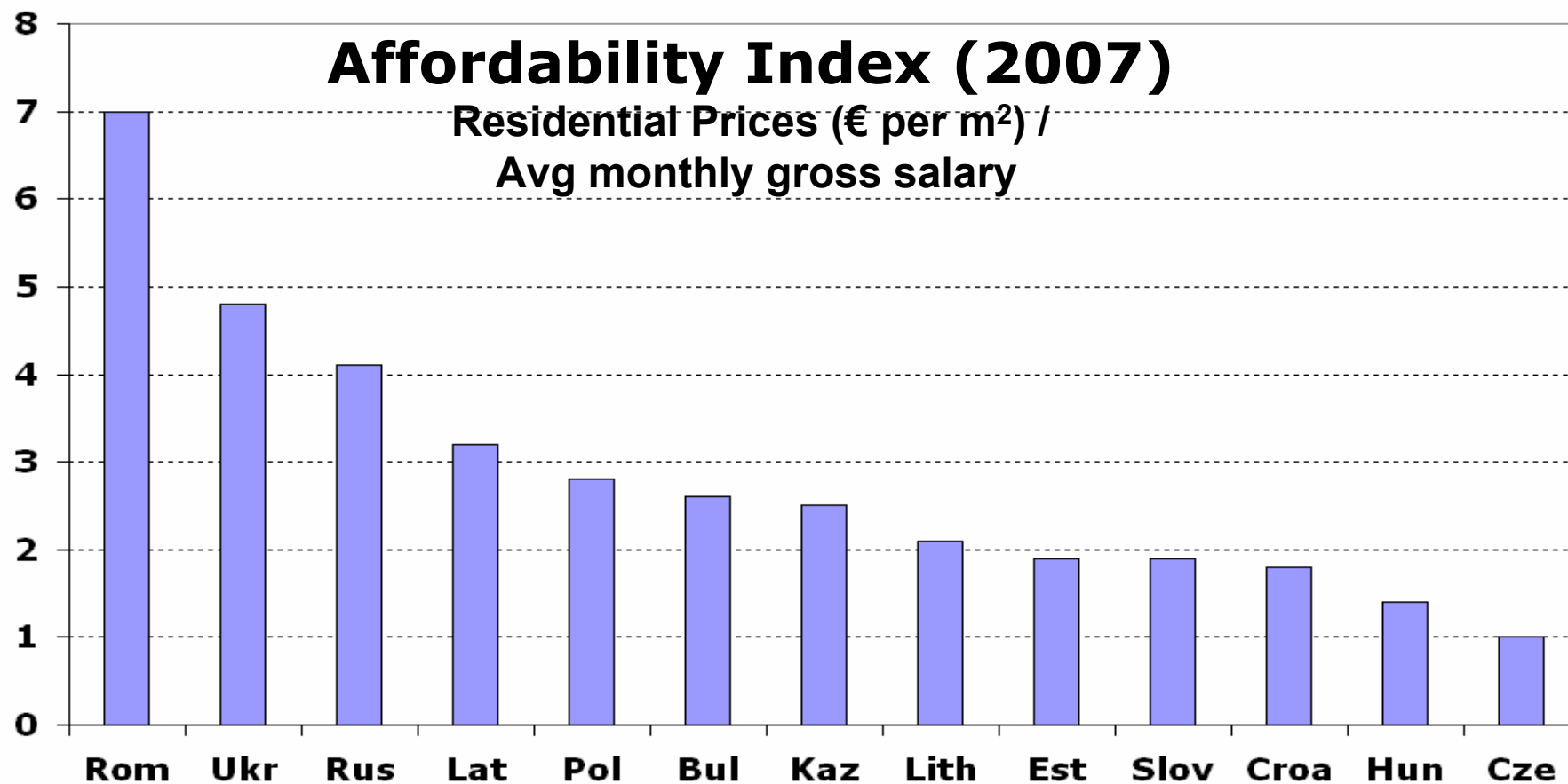
II. A drop in the construction sector



✓ Expectations for a deterioration in construction activity



II. Real estate prices reached high levels



Notes: 1) Latvia, Lithuania as of 2006

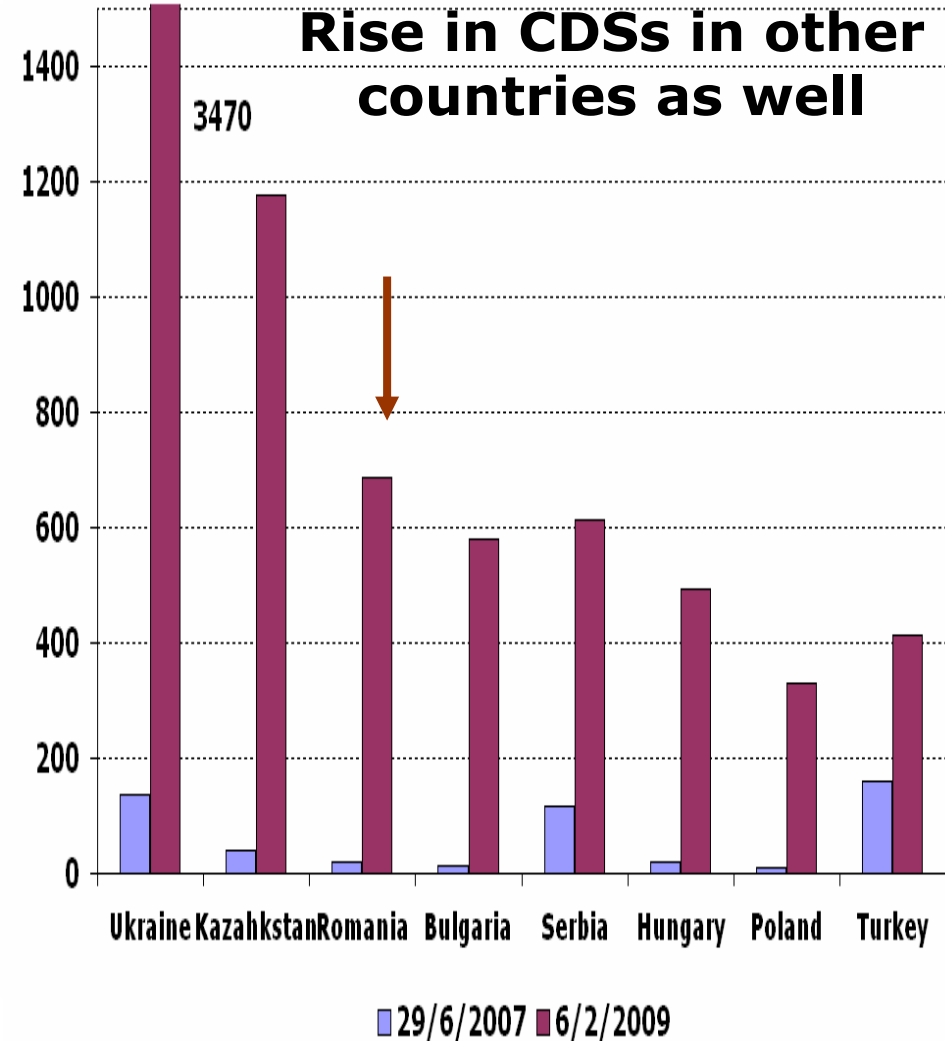
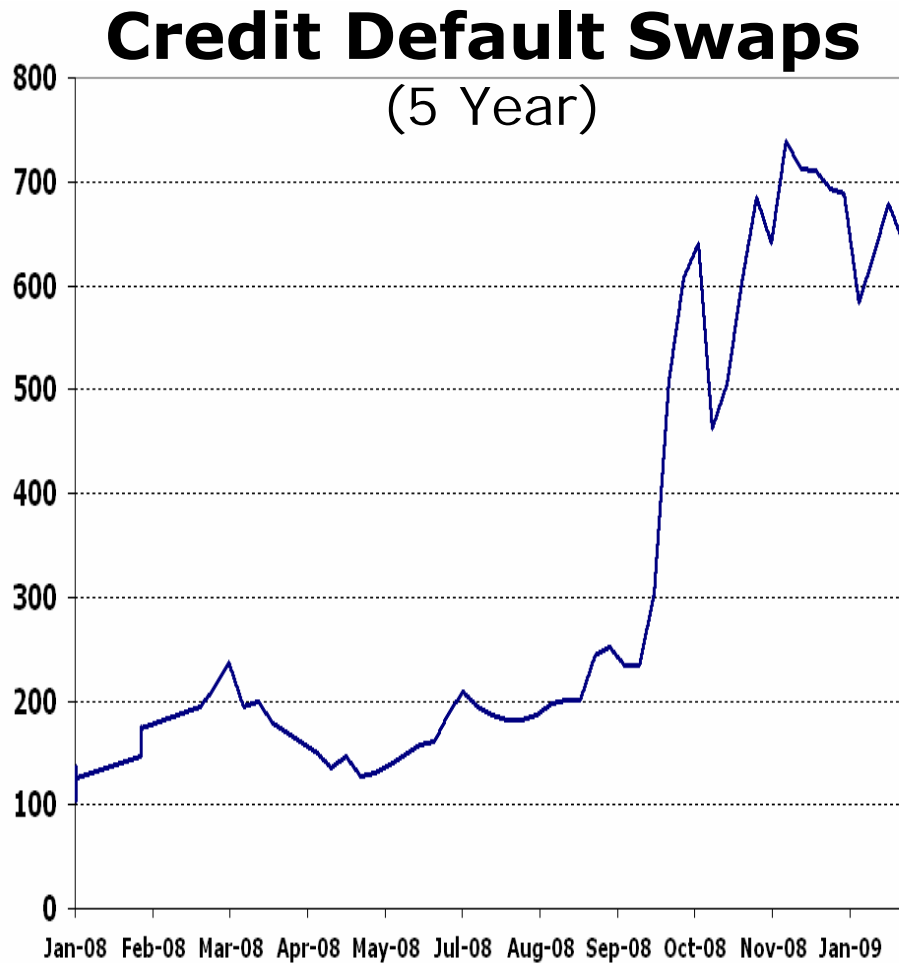
2) The prices for "old" EU countries, Latvia and Romania refer to their capital cities

Source: Unicredit Group

III

Risks arising from the international financial crisis

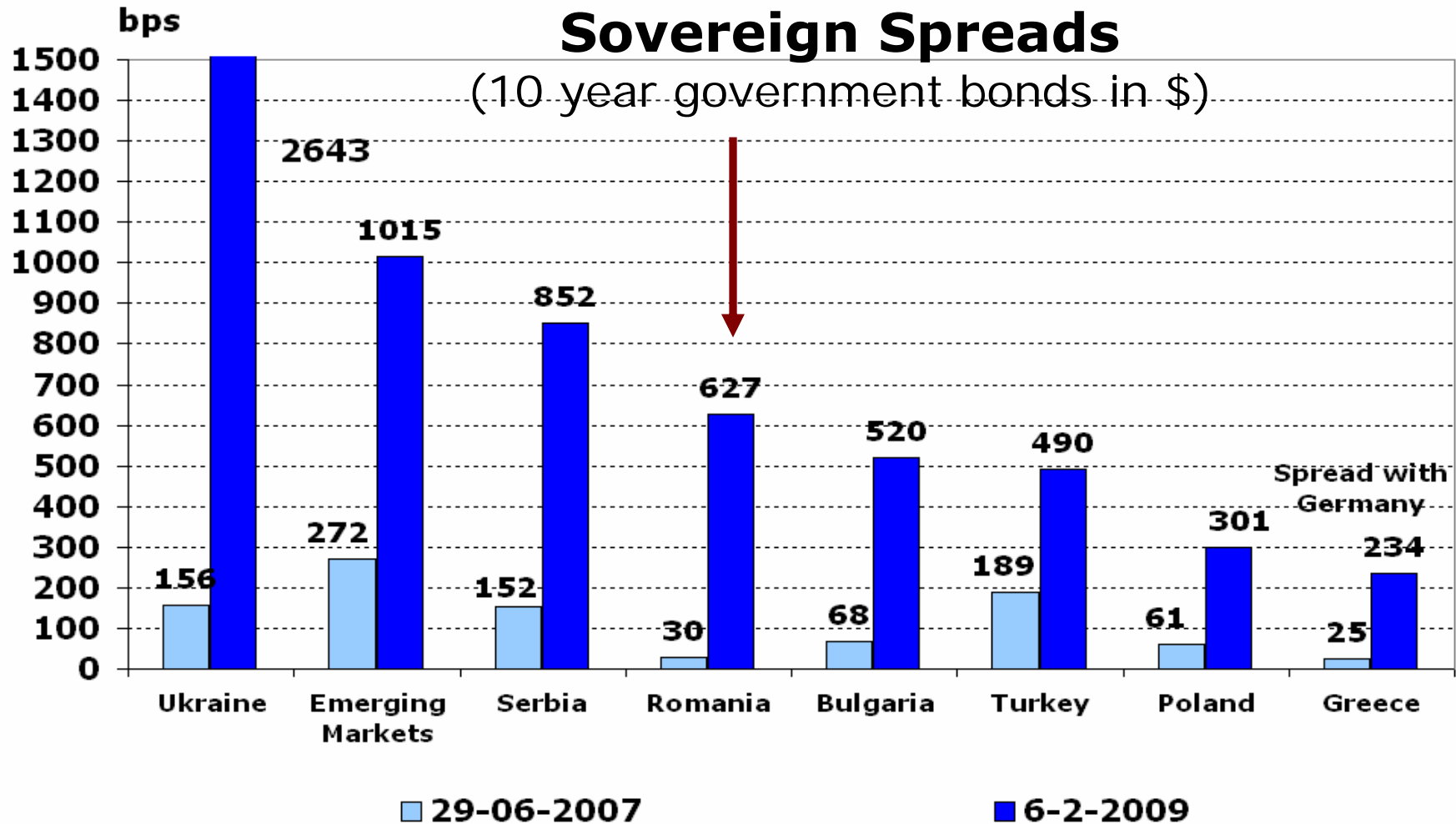
III. After the crisis, country risk premia increased in Romania



Source: Bloomberg

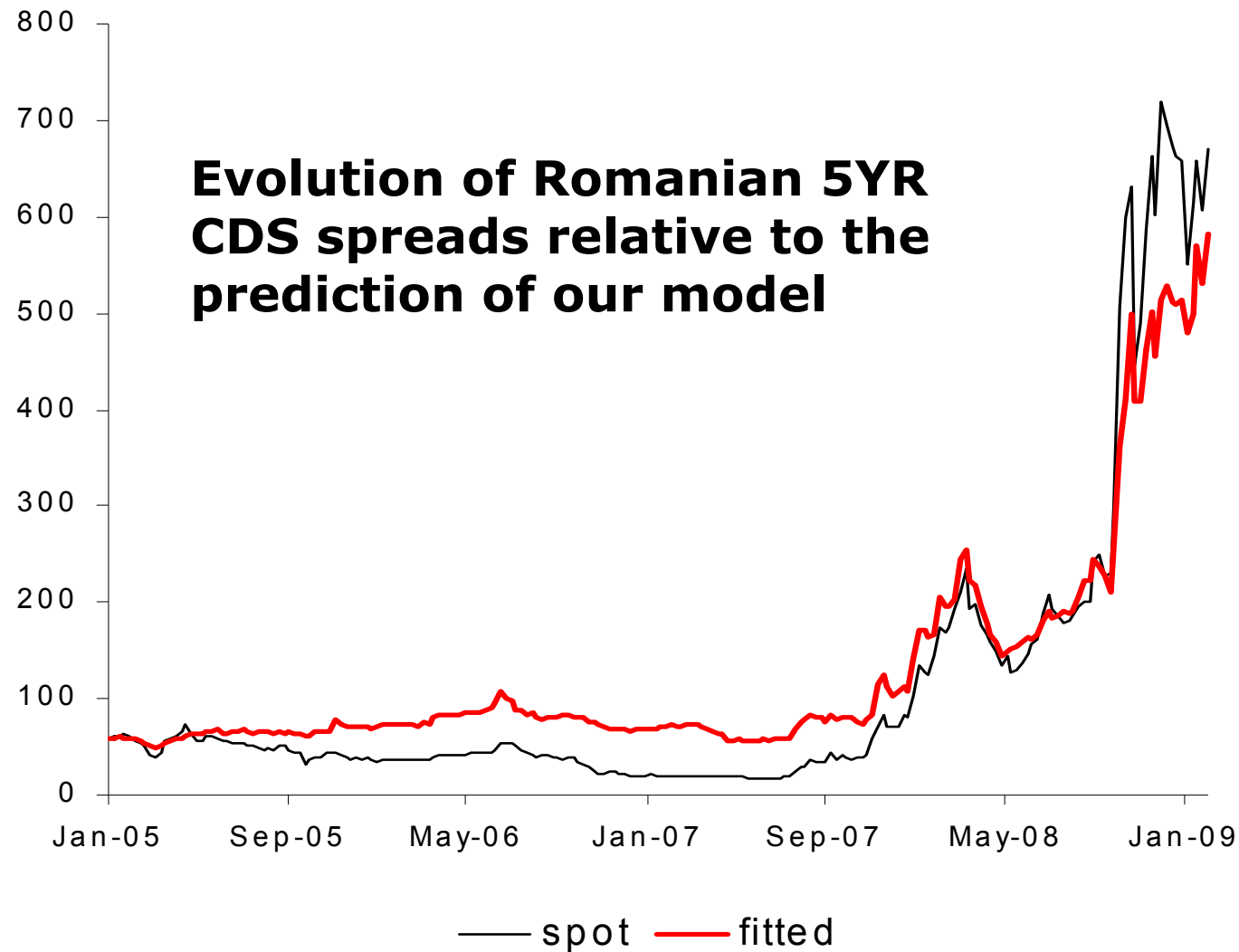
- ✓ Downgrades from S&P, Fitch at 27/10/2008 and 10/11/2008 respectively

III. A similar rise in country risk premia across New Europe



Source : Bloomberg, JP Morgan EMBIG

III. The increase in country risk is a global phenomenon



- ✓ Global risk aversion has a negative impact on Romanian spreads
- ✓ A small idiosyncratic component remains

III.1 What are markets afraid of?

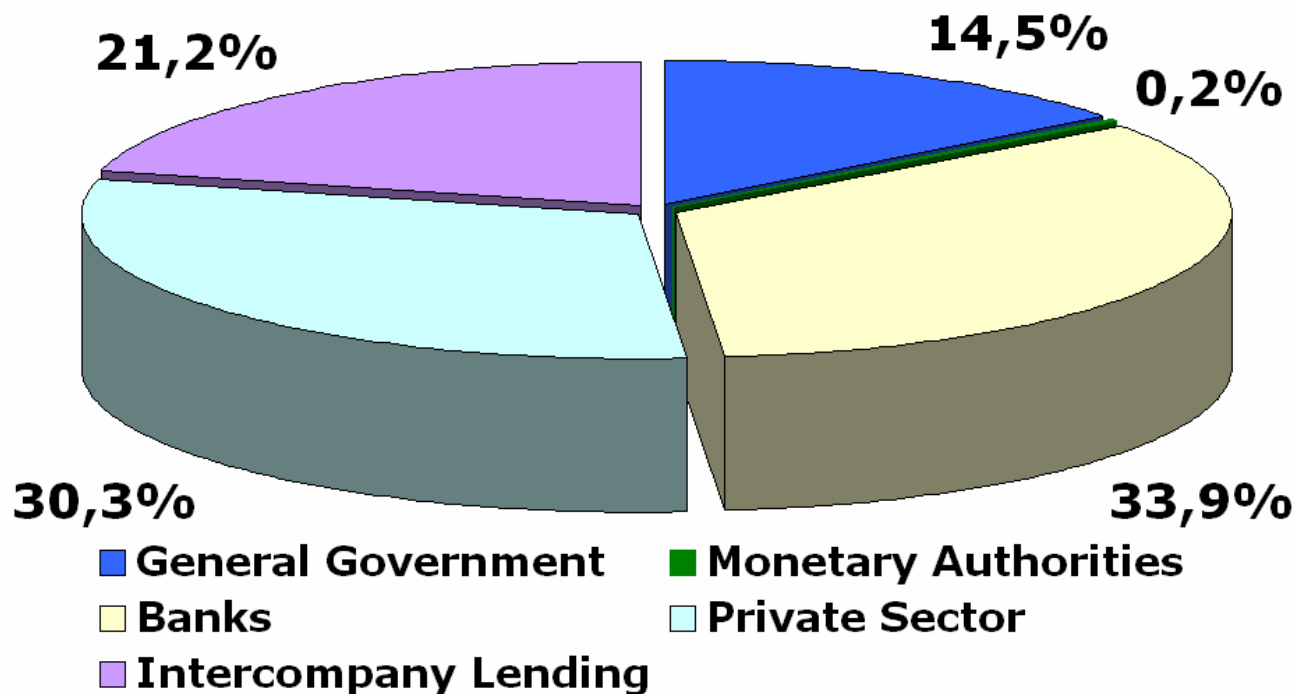
(a) The financing of external debt

Total External Debt: € 70.135,2 bn

External Debt/GDP: 52%

External Debt Decomposition

(Q3 2008)



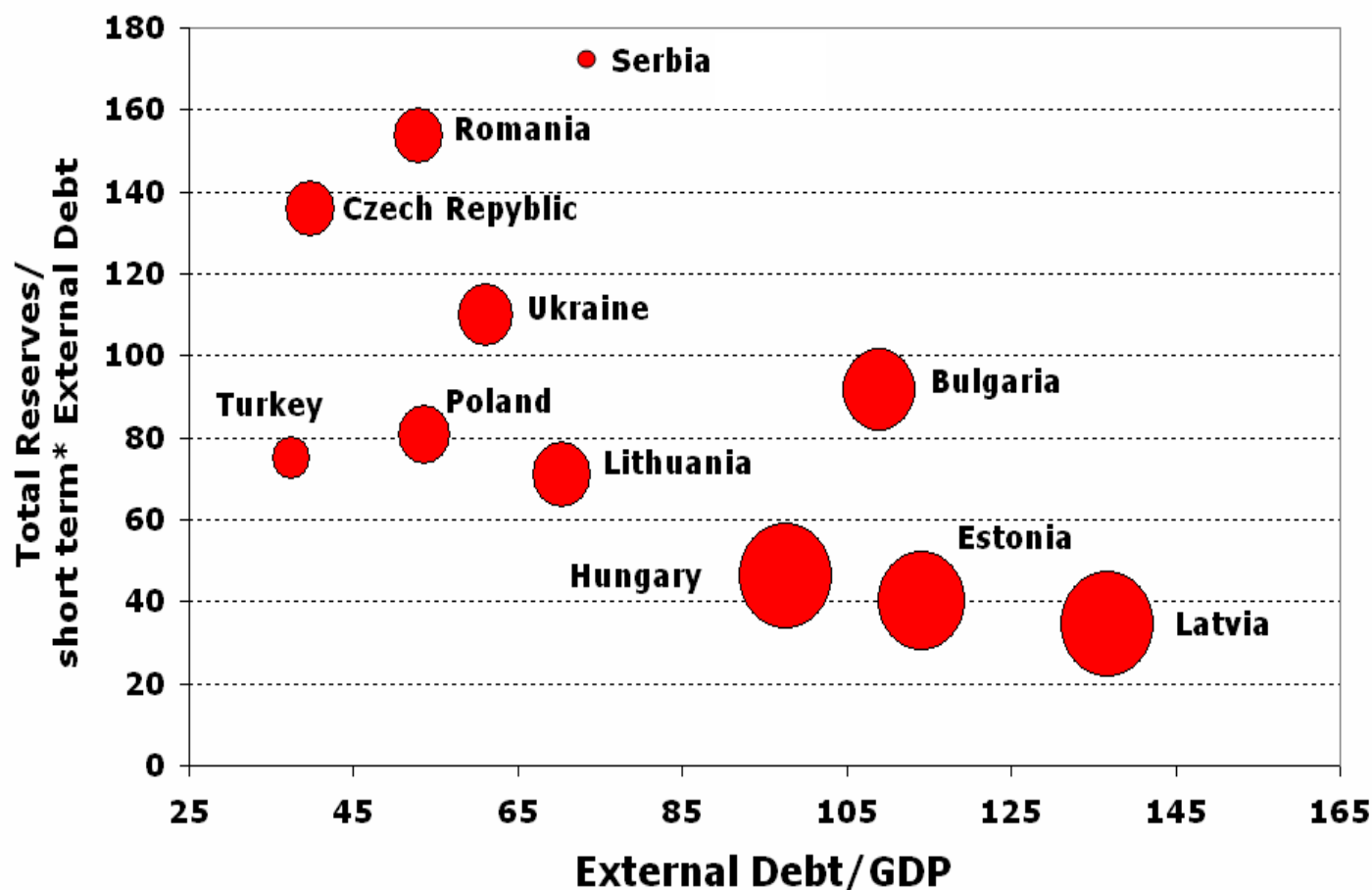
✓ Short term debt accounts for about 1/3 of the total external debt

III.1 The financing of External Debt

Amounts in bn. Euros		
<u>Demand for capital inflows</u>	<u>Q3 2008</u>	<u>2009</u>
Current Account Deficit (2008)	16.8	17.5
Total External Debt	70.1	
Short-term External Debt	18.3	
Long-term External Debt	37.0	
Intercompany Lending	14.8	
External Debt due in next 12 months	0.5	35.1
<u>Supply of capital inflows</u>		
Net FDI inflows		?
New Lending-Refinancing of maturing debt		?
International Reserves (including gold)		28.0
External Financing Requirement		24.6

III.1 The financing of External Debt

External Long & Short-term Debt and FX Reserves, Q3 2008



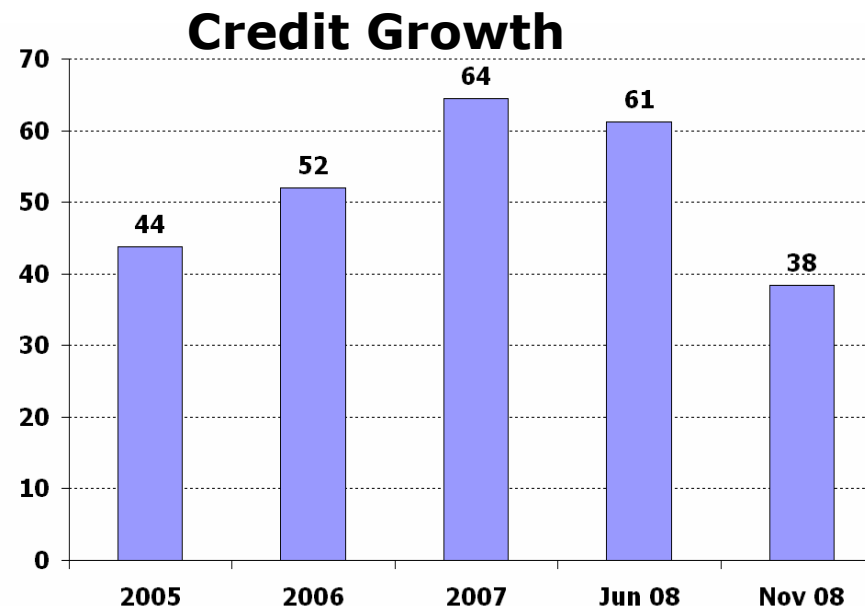
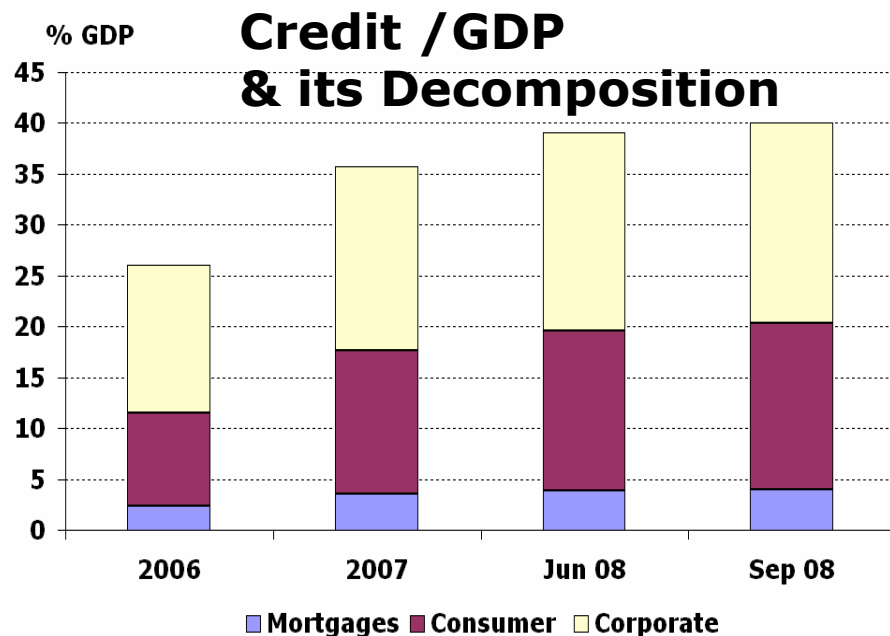
Notes:

- ✓ The area of each pie represents the \$ amount of short term debt
- ✓ Total external debt (horizontal axis) includes inter-company lending
- ✓ Short-term external debt (vertical axis) excludes inter-company lending

* Short Term Debt defined by Original Maturity up to 12 months

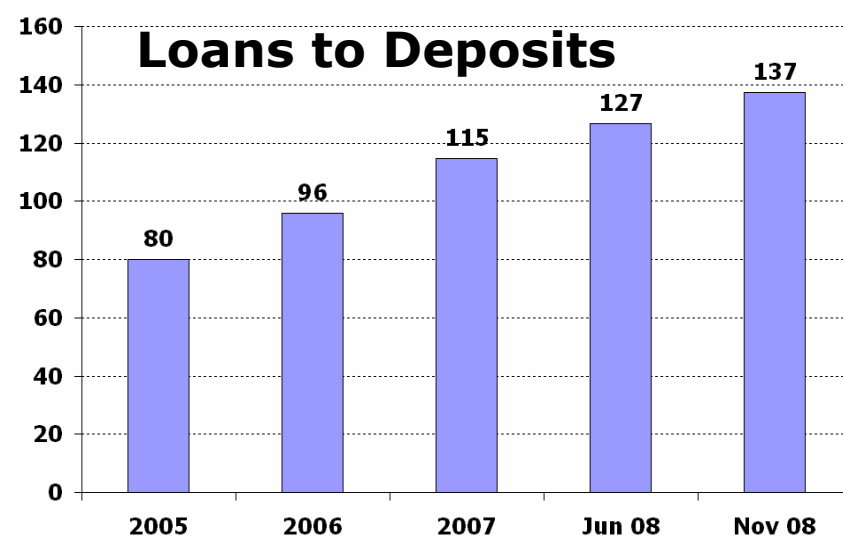
III.2 What are markets afraid of?

(b) A deceleration in credit expansion



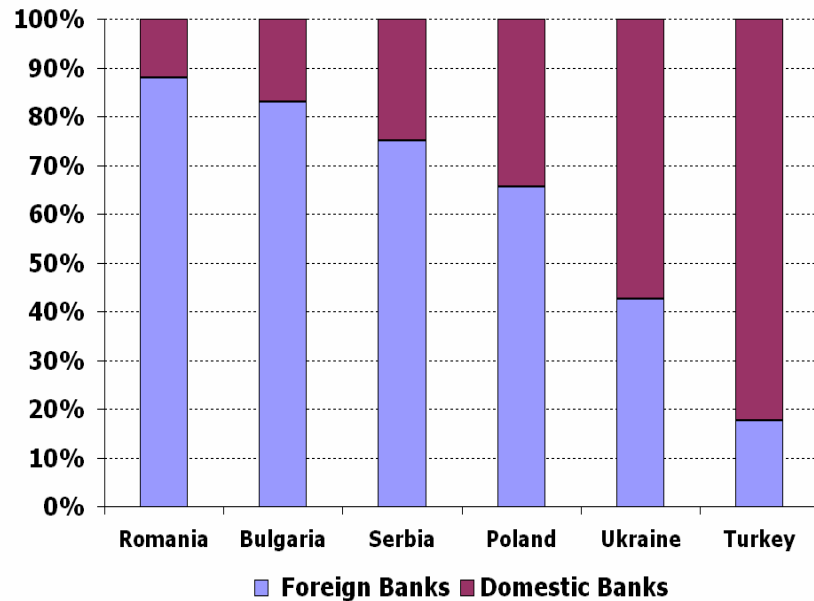
November 08 RON bn

Total Loans	208,2
FX Loans	109,6
RON Loans	85
Total Deposits	142
FX Deposits	49,4
RON Deposits	92,6



III.2 A diversified banking system by country of bank origination

Market Share of Foreign Banks

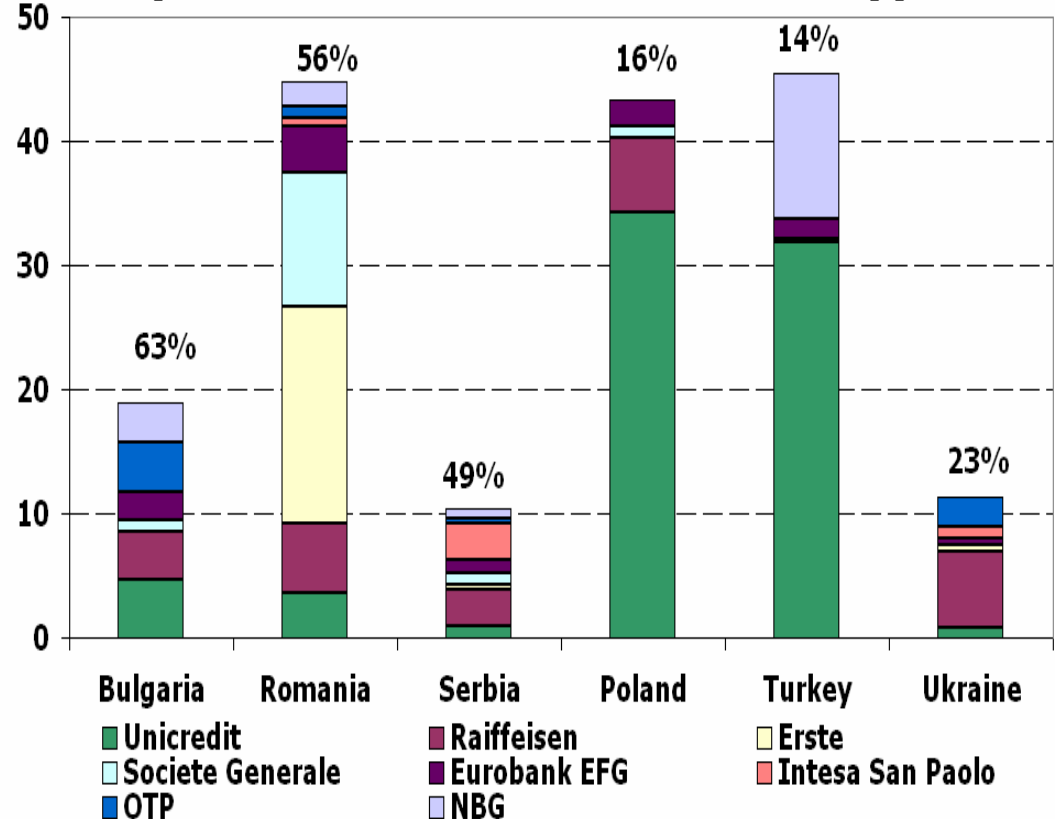


Source: Central Banks

✓ Diversification among foreign bank origination is higher in Romania than in other NE countries (certainly the Baltics)

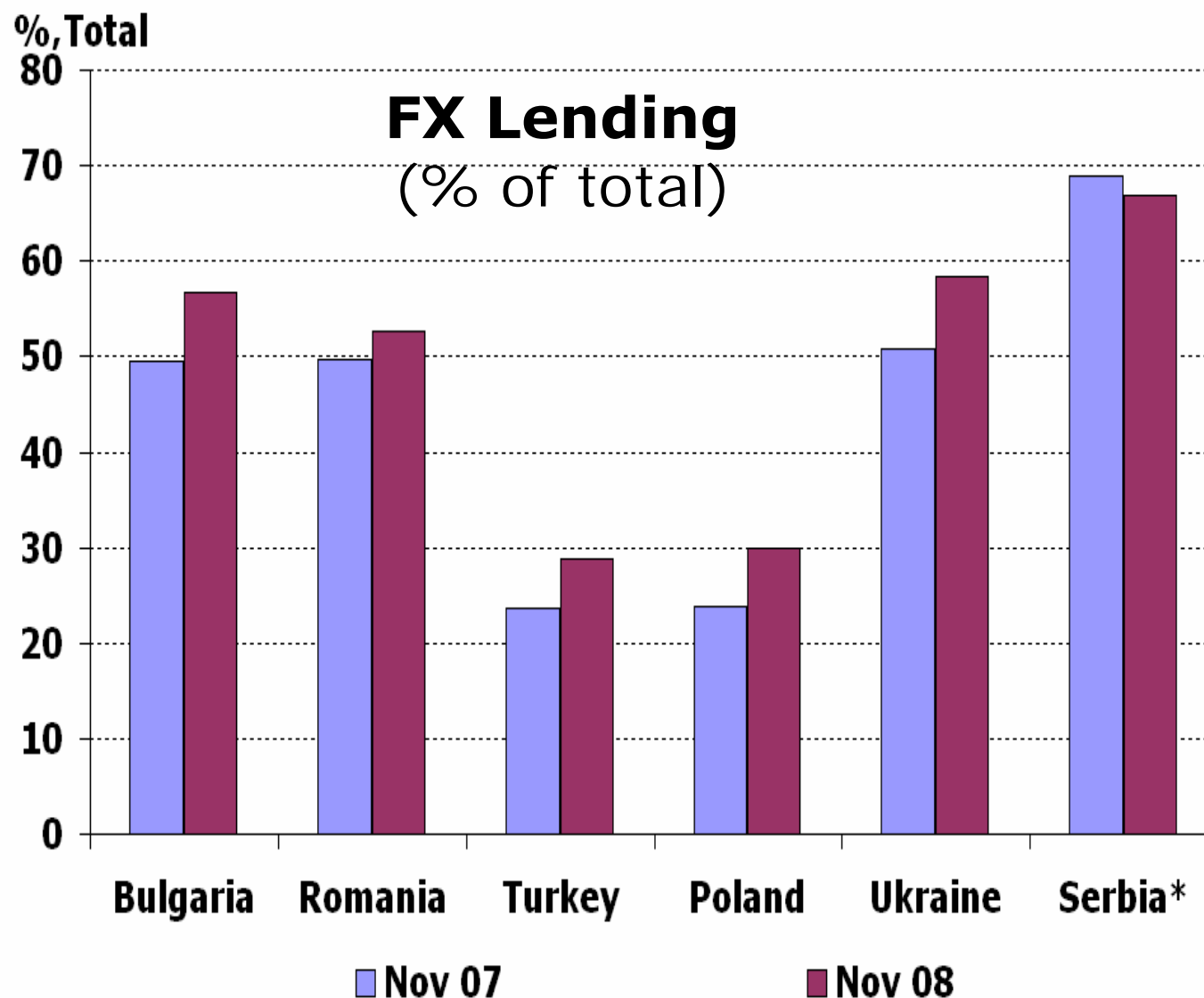
✓ Foreign ownership is higher in Romania than in other NE countries

Assets of key players in CEE countries (Market shares in each country)



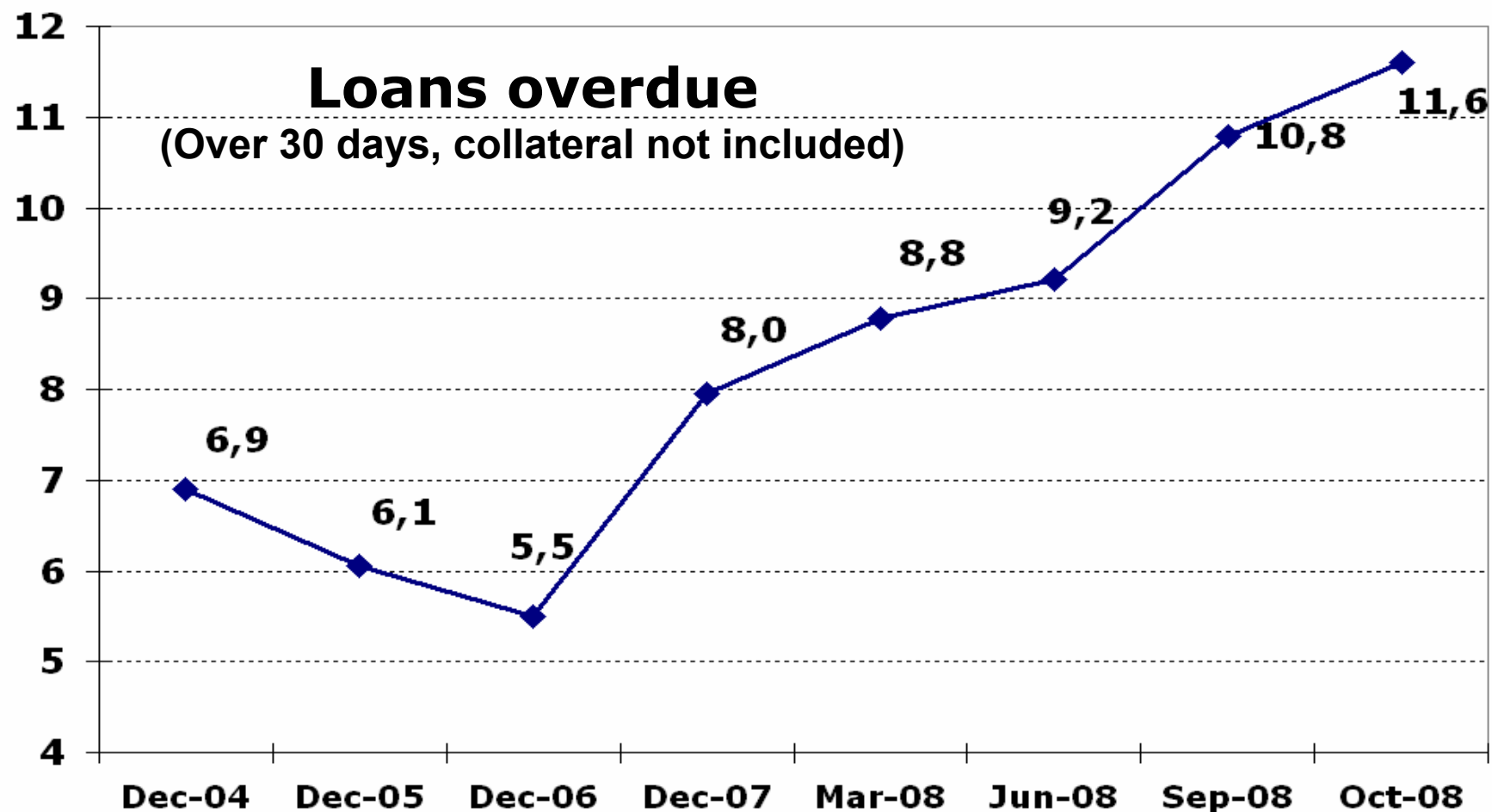
III.3 What are markets afraid of?

(c) An increase in defaults



✓ RON depreciation can result in a rise of NPLs

III.3 Loans overdue are on the rise...



Source: Central Bank of Romania

✓ NPLs are lower than loans overdue

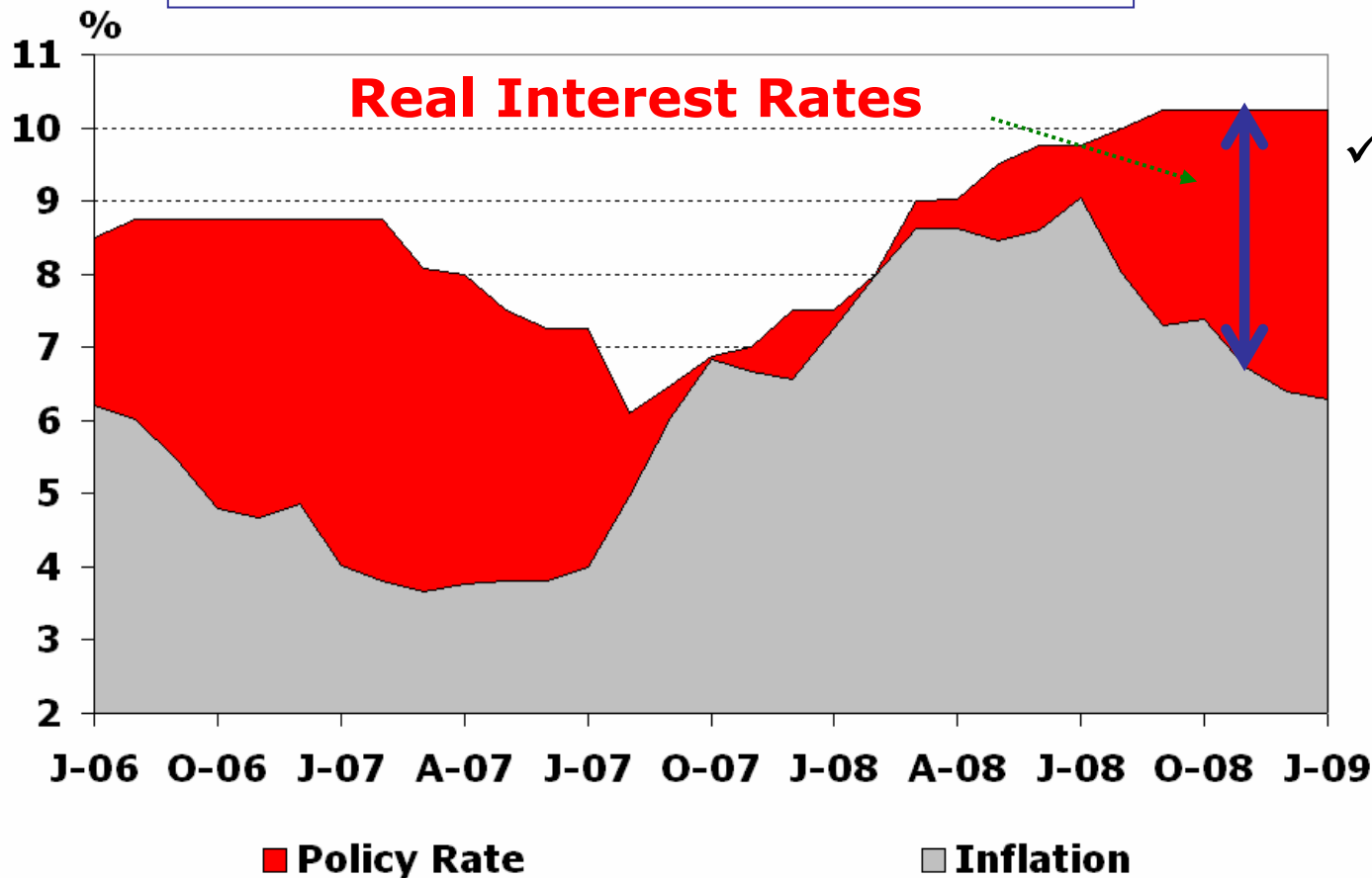
IV

Monetary and Fiscal Policy

IV. The monetary policy dilemma

Monetary Policy Targets

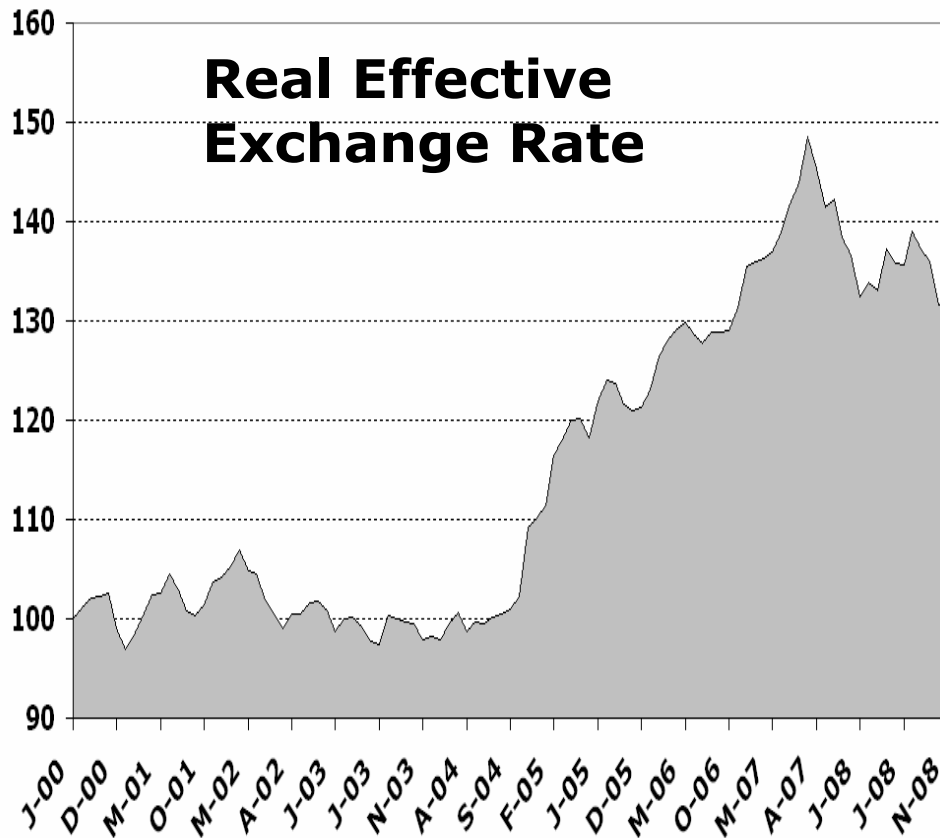
- Inflation 2009: 4.5% (+/- 1%)
- Inflation 2010: 3.5% (+/- 1%)



✓ High or low domestic interest rates? What should the NBR do?

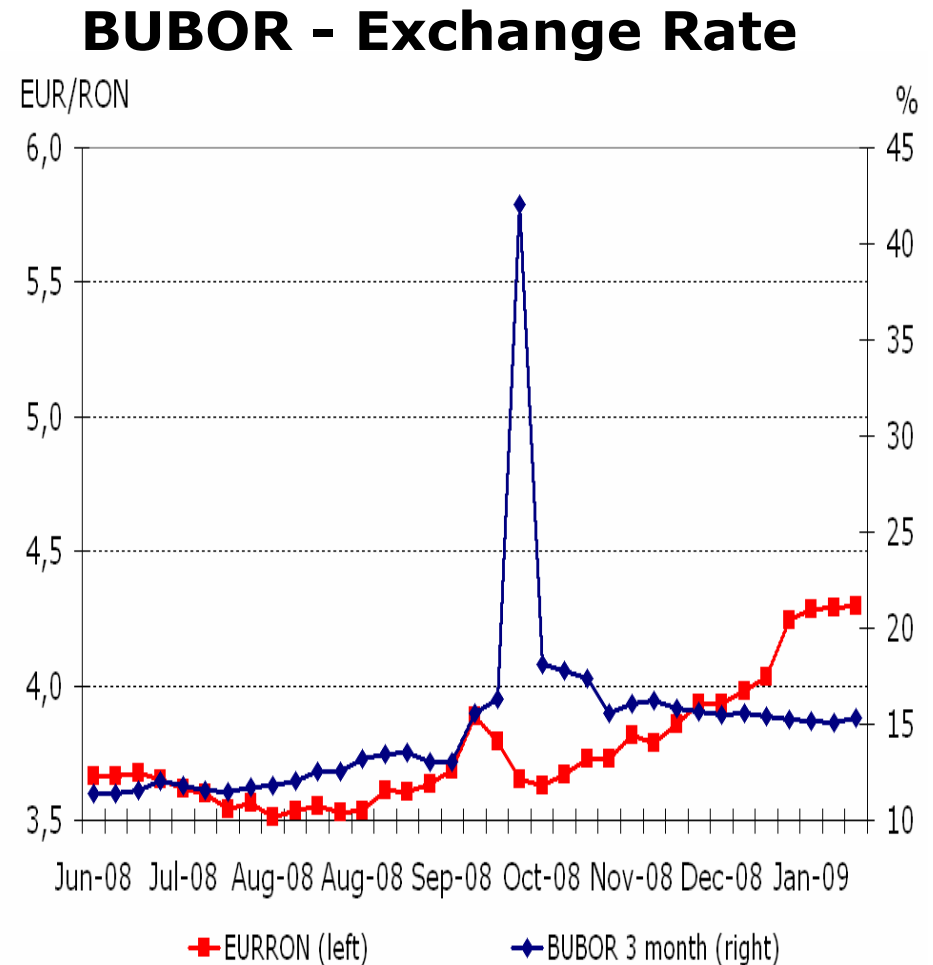
✓ Central Bank obliged to maintain real interest rates high to avoid further currency depreciation

IV. The monetary policy dilemma



Source: Central Bank of Romania

- ✓ RON relative overvaluation exerts pressure on interest rates



Source: Central Bank of Romania

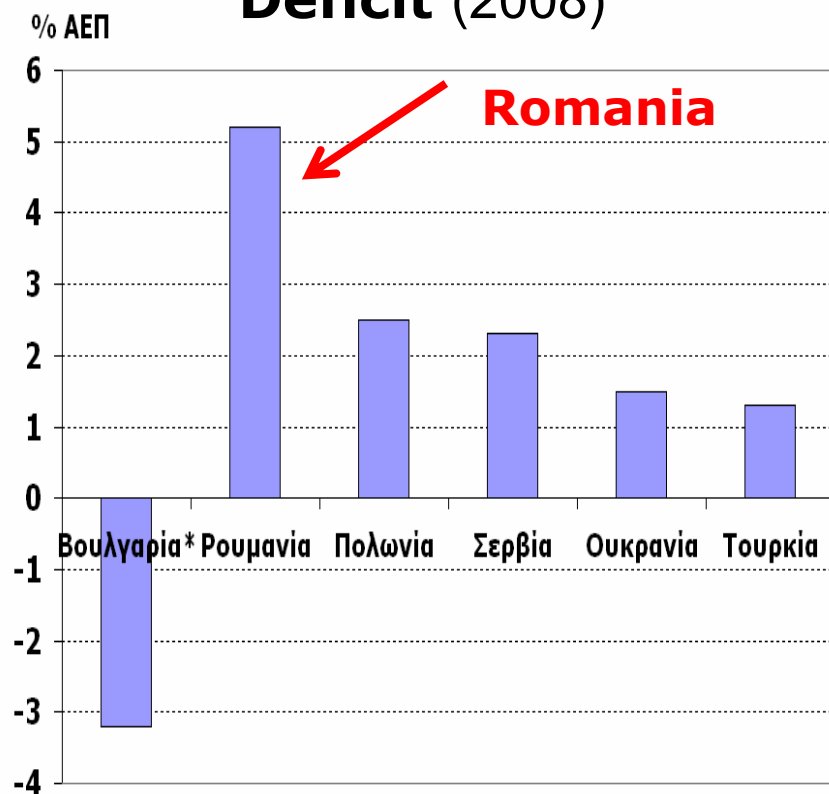
IV. Fiscal policy is expansionary

	2008	2009	2010
General Government Deficit	5.2	7.5	7.9
Cyclically adjusted budget balance	7.4	8.9	8.9
Current Account Deficit	12.9	11.9	11.1

Source: European Commission

IV. A comparison of fiscal policies across NE countries

General Government Deficit (2008)



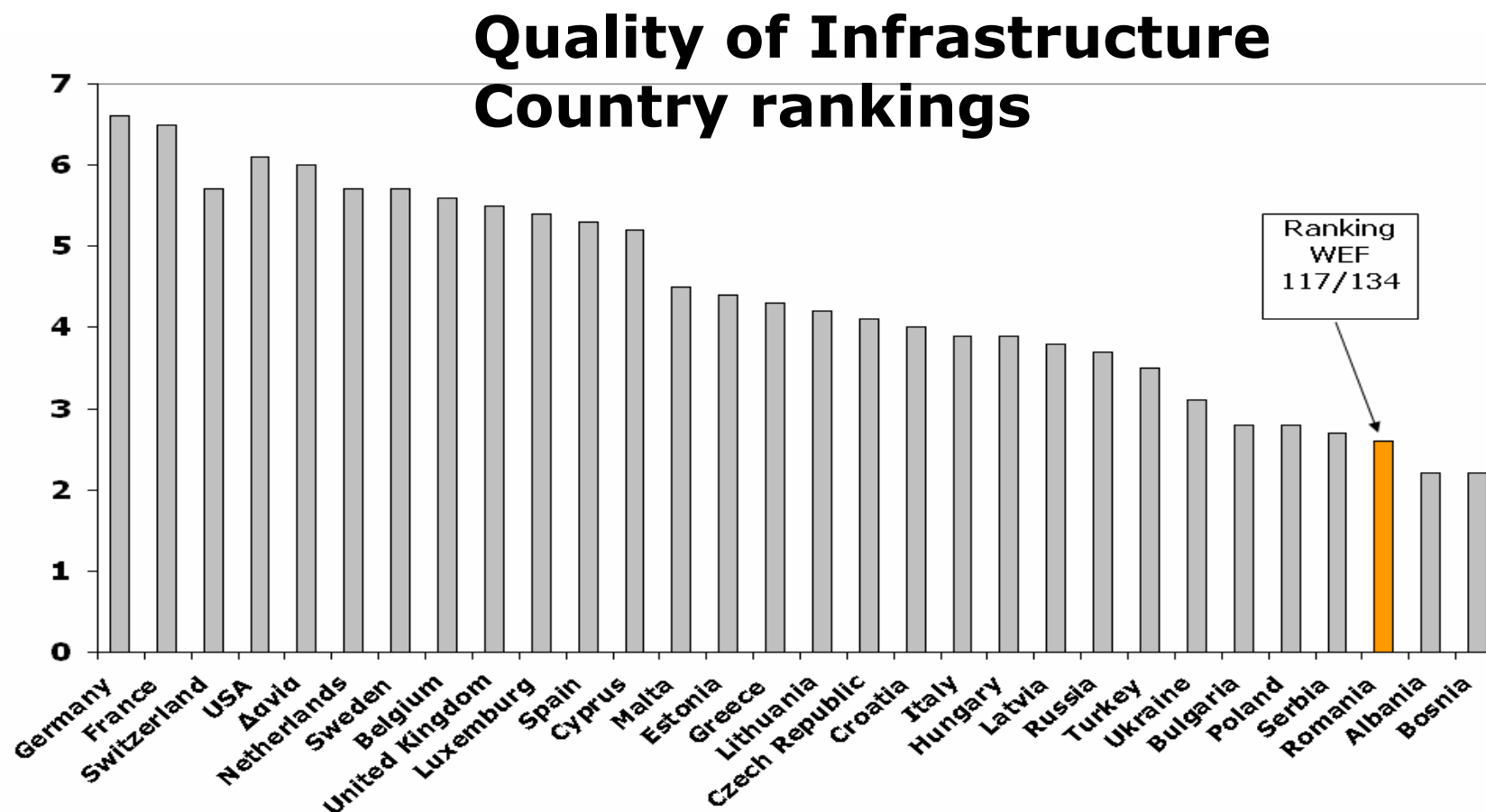
General Government Debt (2008)



Source: European Commission

- ✓ Romania has a small debt but huge deficits
- ✓ An IMF of EU rescue package will come with conditionalities on fiscal policy that would increase its credibility

IV. Fiscal policy priorities



Source: World Economic Forum

- ✓ **Infrastructure upgrading should be a policy priority**

V.

Summary and Conclusions

V. A summary of risks

- ✓ We are in the middle of the international financial crisis and do not know its end date yet
- ✓ As the long as the global crisis persists, the negative spillovers to Romania and other NE countries will multiply
- ✓ Growth in exports to decline
- ✓ An abrupt landing of credit expansion
- ✓ Defaults on the rise
- ✓ A reduction in capital inflows and a possible IMF or EU financial rescue package
- ✓ Cost of capital increases
- ✓ RON depreciation and FX becoming credit risk
- ✓ Questionmarks about the ability of the government to reduce the fiscal deficit without an external austerity program
- ✓ A possible deceleration in the rate of acceptance of new countries into the Euro Area would pose severe headaches to policy makers

V. Pluses of the Romanian economy

Long-term comparative advantages of the Romanian economy:

- ❖ EU member state \Rightarrow Fiscal discipline, easy access to credit
- ❖ Has a relatively big internal market (population of 21m)
- ❖ Under banked and underleveraged economy
- ❖ Has a low public debt to GDP ratio
- ❖ Its Central Bank is efficient and independent and has policy tools at its disposal

In today's global cycle, the following additional factors are helpful in avoiding a recession:

- ✓ Lower wages compared the Western Europe. The average nominal wage is approximately € 400 /month
- ✓ No short-run political risk: A new coalition government in place that represents a large fraction of the population
- ✓ Inflation is declining, allowing the central bank to reduce interest rates without risking devaluation of the RON

V. Conclusion: Romania has the ability to withstand the crisis

- ✓ Risks are short-term and a function of the external environment
 - ✓ Less vulnerable to the global crisis than other NE countries
 - ✓ A positive rate of growth in 2009 (*Baltic states are already in recession and others are entering it: Ukraine, Turkey, Hungary*)
-

- ❖ Dynamic long term prospects and real convergence to Western Europe
- ❖ Optimism is necessary for the macro-economy

THANK YOU FOR YOUR ATTENTION!

**My thanks to the Research Divisions of Eurobank EFG
for superb research assistance**