"How is the World Different After the Financial Turmoil?"

Conference organised by the National Bank of Romania

Romania in the Context of the Global Financial Crisis: An Overview

Mugur Isărescu
Governor
National Bank of Romania

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From financial turmoil to financial crisis

- What began as a turmoil with the bursting of the US housing bubble and the first sub-prime credit induced losses in the summer of 2007 turned into a full-fledged crisis once Lehman Brothers went bankrupt in September 2008
- Major changes in investors' behaviour occurred – amid increased risk aversion there has been a shift from global excess liquidity to liquidity crunch
- There are both direct and indirect effects of the crisis:
  - ✓ Direct effects from banks' exposure to "toxic assets"
  - ✓ Indirect effects caused by changes in the availability of capital and liquidity conditions ⇨ less external financing

Romania – Overview of the Global Financial Crisis Effects

No direct effects…

The banking system is fundamentally sound

- Lack of exposure to "toxic assets" which lie at the root of the crisis
- Traditional banking products dominant due to their high profitability
- Prevalence of the "originate and hold" paradigm

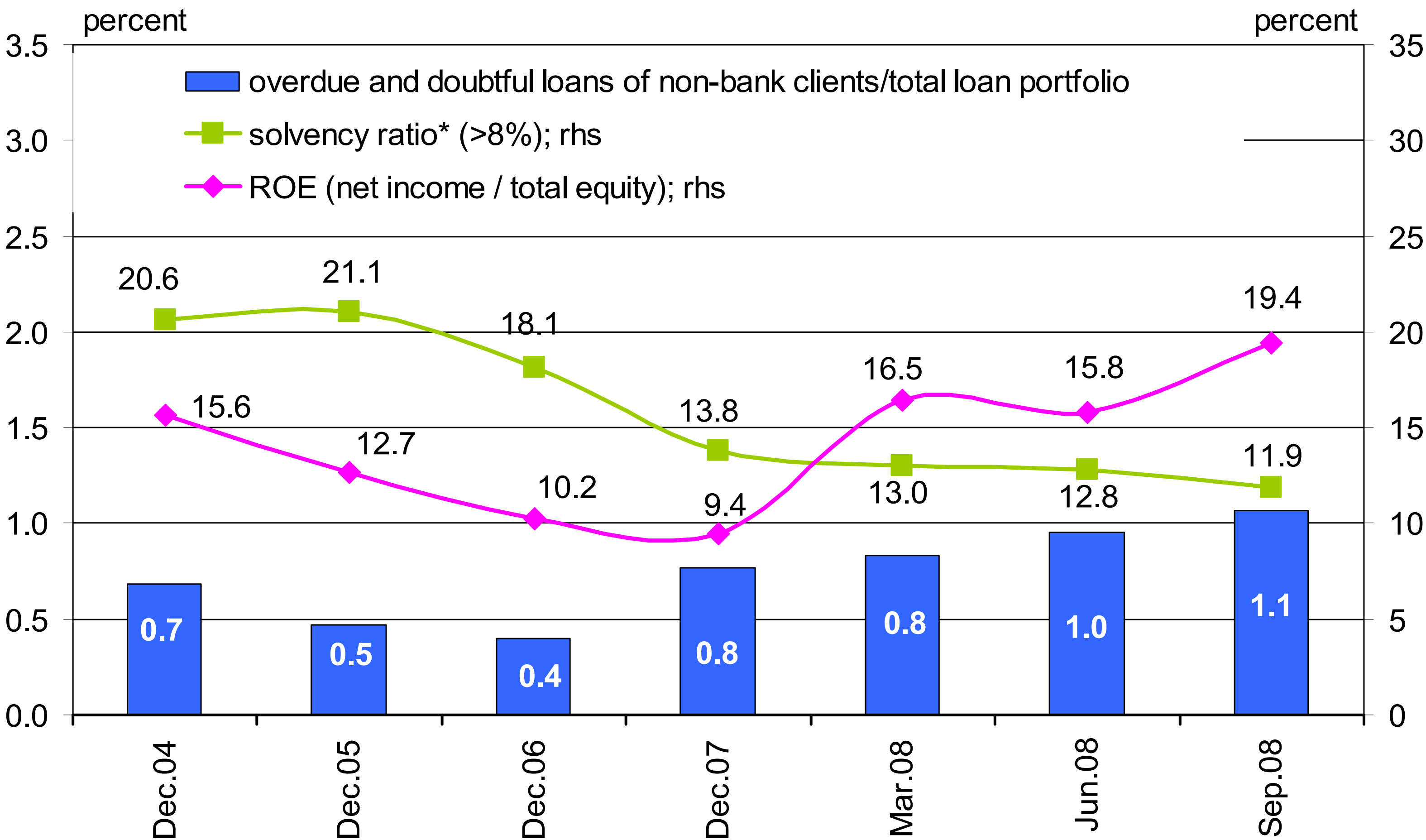
…yet the indirect effects are significant

- Availability and cost constraints of external financing
  - ✓ Major impact on the availability of foreign-exchange denominated credit
- Decline in the volume of FDI inflows
- Increased likelihood of profit repatriation, in the context of an ongoing process of international deleveraging
- Negative impact on foreign demand, affecting Romania's exports
- Increased exchange-rate volatility amid the significant decrease in investors' appetite for risk on emerging markets

However, there are some alleviating factors…

- NBR's prudent policies provided a cushion for the banking system:
  - ✓ High level of reserve requirements
    - allows for the gradual adjustment of banking system liquidity, depending on the evolution of market conditions
  - ✓ Prudential and administrative measures
    - slowed down the expansion of credit to the private sector
    - supported lending in domestic currency to the detriment of forex credit
    - limited overall risk exposure
- Low share of overdue and doubtful loans in total loan portfolio (1.1 percent as of September 2008)
- Confidence boosting measures:
  - ✓ Starting 15 October 2008, the guaranteed level for bank deposits (per individual and per credit institution) is EUR 50,000 from EUR 20,000 previously
- Continental-type financial system, dominated by banks
  - ✓ Moderate impact of declining stock prices on corporate financing

Analysis Ratios for the Banking System



* Starting with 2007, according to Regulation No.13/2006 and Order No.12/2007; (>12%) until end-2006.

Source: National Bank of Romania

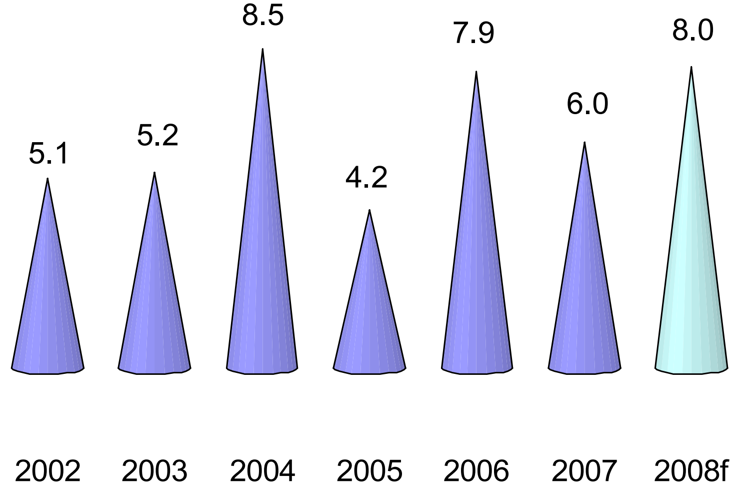
Romania – Macroeconomic Consequences of the Crisis

Wide external imbalances are no longer acceptable

- High economic growth in recent years and even disinflation have come at the price of an ever larger current account deficit
  - ✓ There is a tight relationship between the fast expansion of domestic absorption, fuelled by rapidly growing personal incomes and credit, and the widening of the external gap
- The crisis will have an ambivalent impact on the magnitude of the current account deficit
  - ✓ Exports will decelerate following the trend in external demand
  - ✓ Imports will also decelerate, as a consequence of the decline in investment activity and exports
- The likely decrease in the FDI flow will make financing more expensive and significantly less available
  - ✓ However, higher deposit rates should stimulate saving and would, therefore, reduce the gap between saving and investment
- There are mitigating factors with regard to the availability of financing resources:
  - ✓ Alternative financing sources
    - credit lines from international financial institutions such as EIB, EBRD, World Bank, etc.
    - better absorption of EU structural funds
  - ✓ Credit lines from parent banks to their local subsidiaries will not be discontinued
    - a decrease in their generosity is however likely

Real GDP

annual percentage change

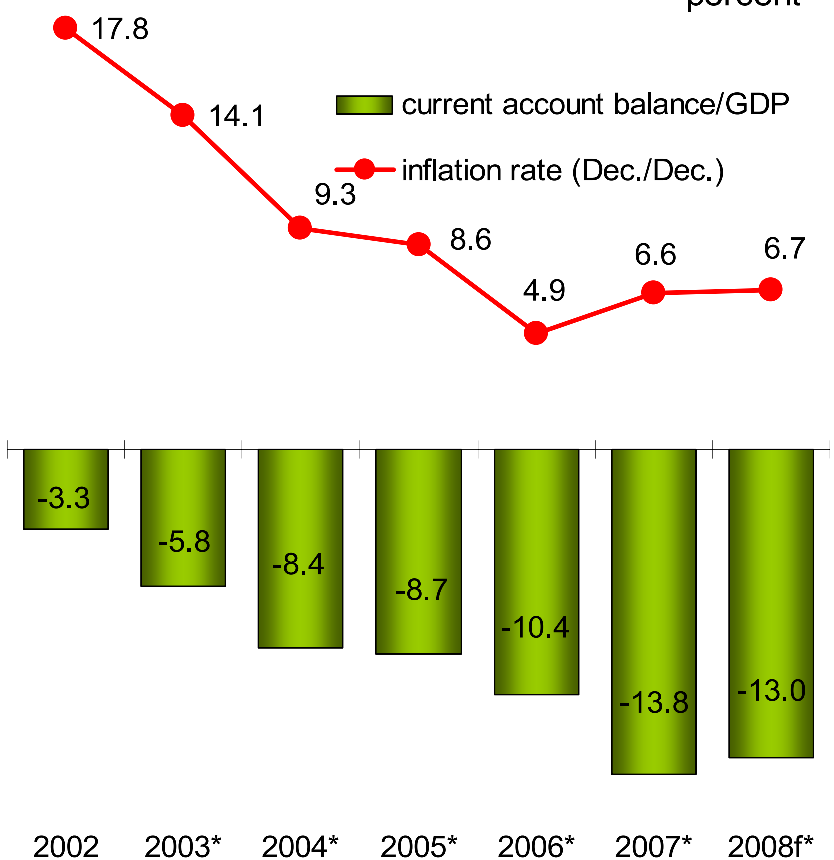


2008 Q1: 8.2%; 2008 Q2: 9.3%;
2008 Q3: 9.1%; 2008 Jan.-Sep.: 8.9%

Source: National Institute of Statistics,
National Bank of Romania

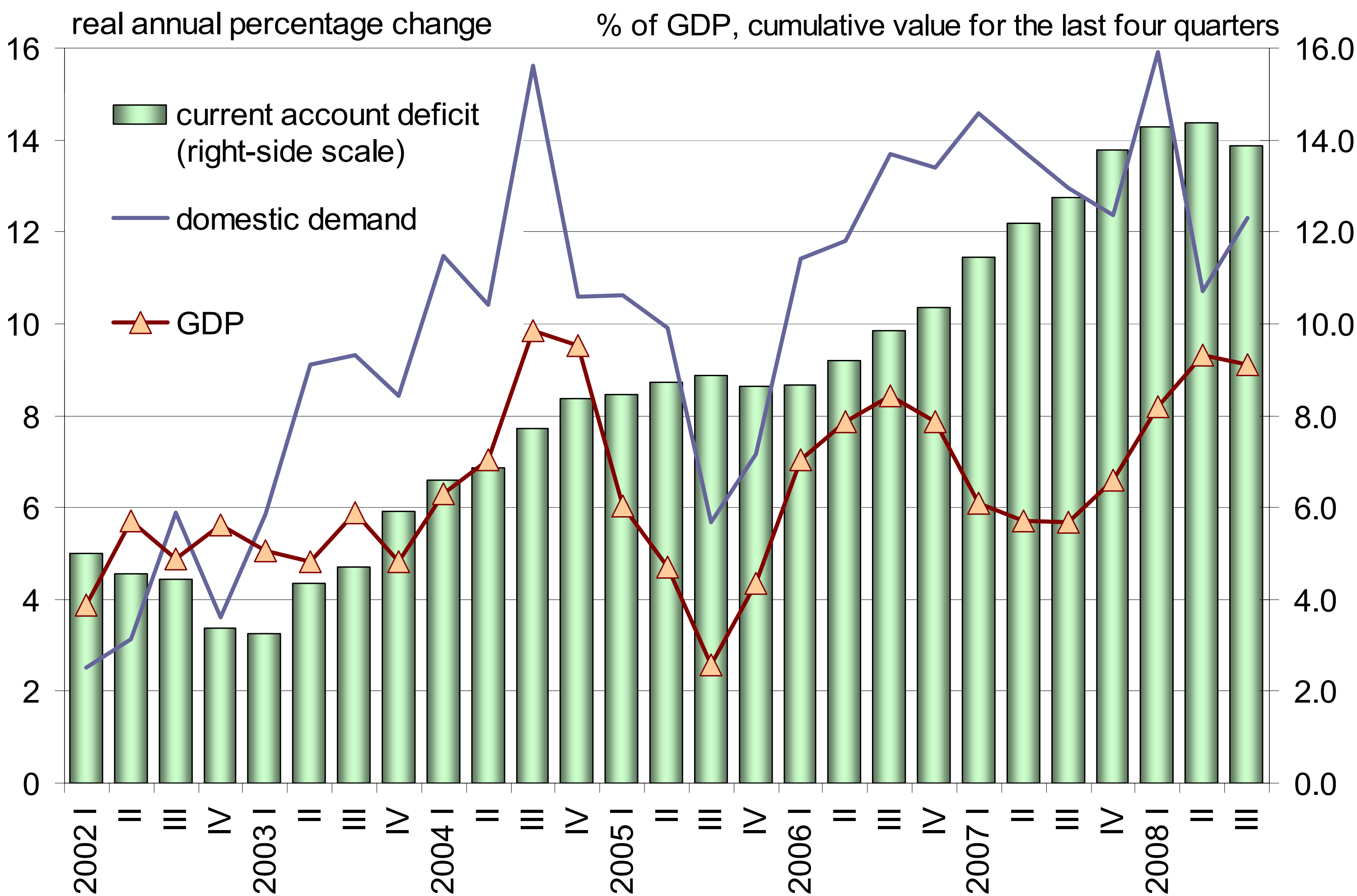
Inflation Rate and Current Account Balance

percent



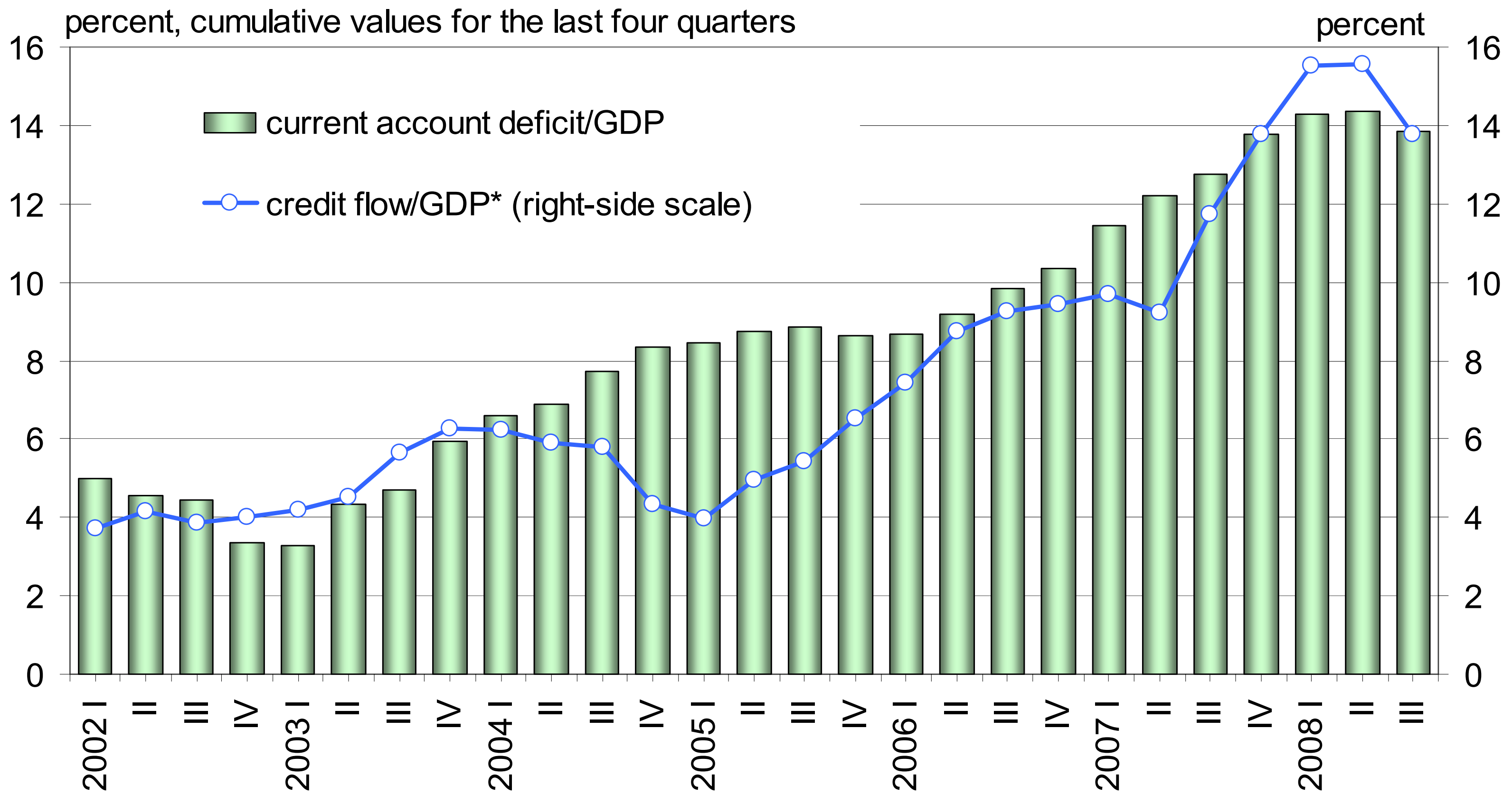
*) including reinvested earnings f) NBR preliminary estimate

Domestic Demand and External Imbalance



Source: National Institute of Statistics, National Bank of Romania calculations

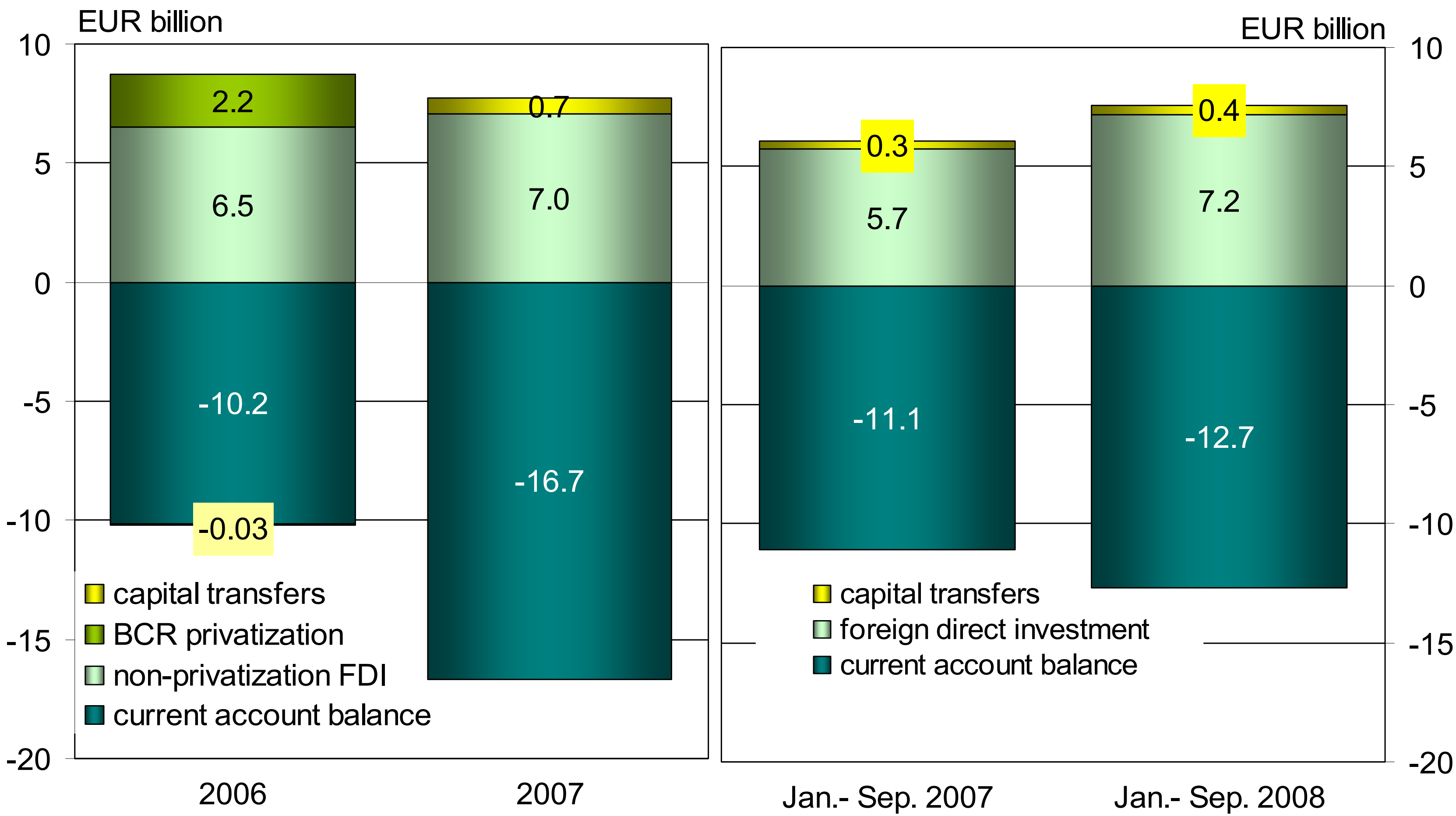
Correlation between Current Account Deficit and Credit Flow



*) Credit flow represents the difference between Q stock and Q-4 stock.

Source: National Institute of Statistics, National Bank of Romania

Current Account Deficit Financing via FDI



Current account financing via FDI (including capital transfers) amounted to 46.4% in 2007 vs 85.6% in 2006.
In 2007, net FDI decreased by 19% yoy.

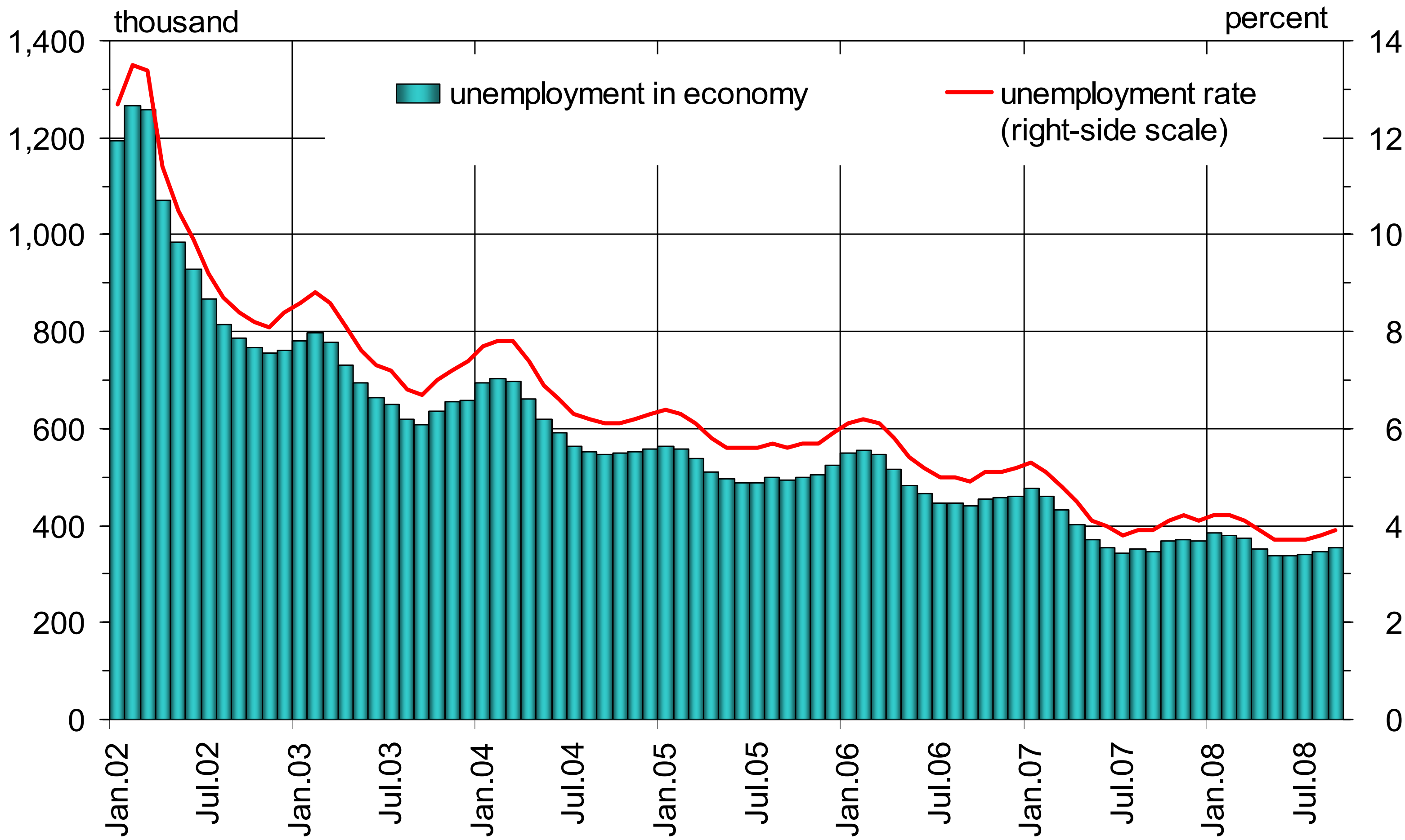
Source: National Bank of Romania

Current account financing via FDI (including capital transfers) amounted to 59.4% in Jan.- Sep. 2008 vs 54.9% in Jan.-Sep. 2007.
In Jan. - Sep. 2008, net FDI increased 25.5% yoy.

Economic activity will decelerate, but inflationary pressures will persist…

- Contracting external demand and subdued investment render a slowdown in economic growth unavoidable
  - ✓ Economic growth is sure to decelerate in 2009, but it will remain in positive territory
- A rise in unemployment will follow
  - ✓ Hardly a critical macroeconomic issue, given the very low current level
  - ✓ The added slack in the labour market will prove useful in curbing excessive wage increase demands
  - ✓ A more flexible labour market would facilitate the absorption of the recently unemployed
- Inflationary pressures are not likely to subside next year
  - ✓ Excess demand will still be there, fuelled by the recent hikes in personal incomes

Unemployment and Unemployment Rate in Economy



Source: National Institute of Statistics

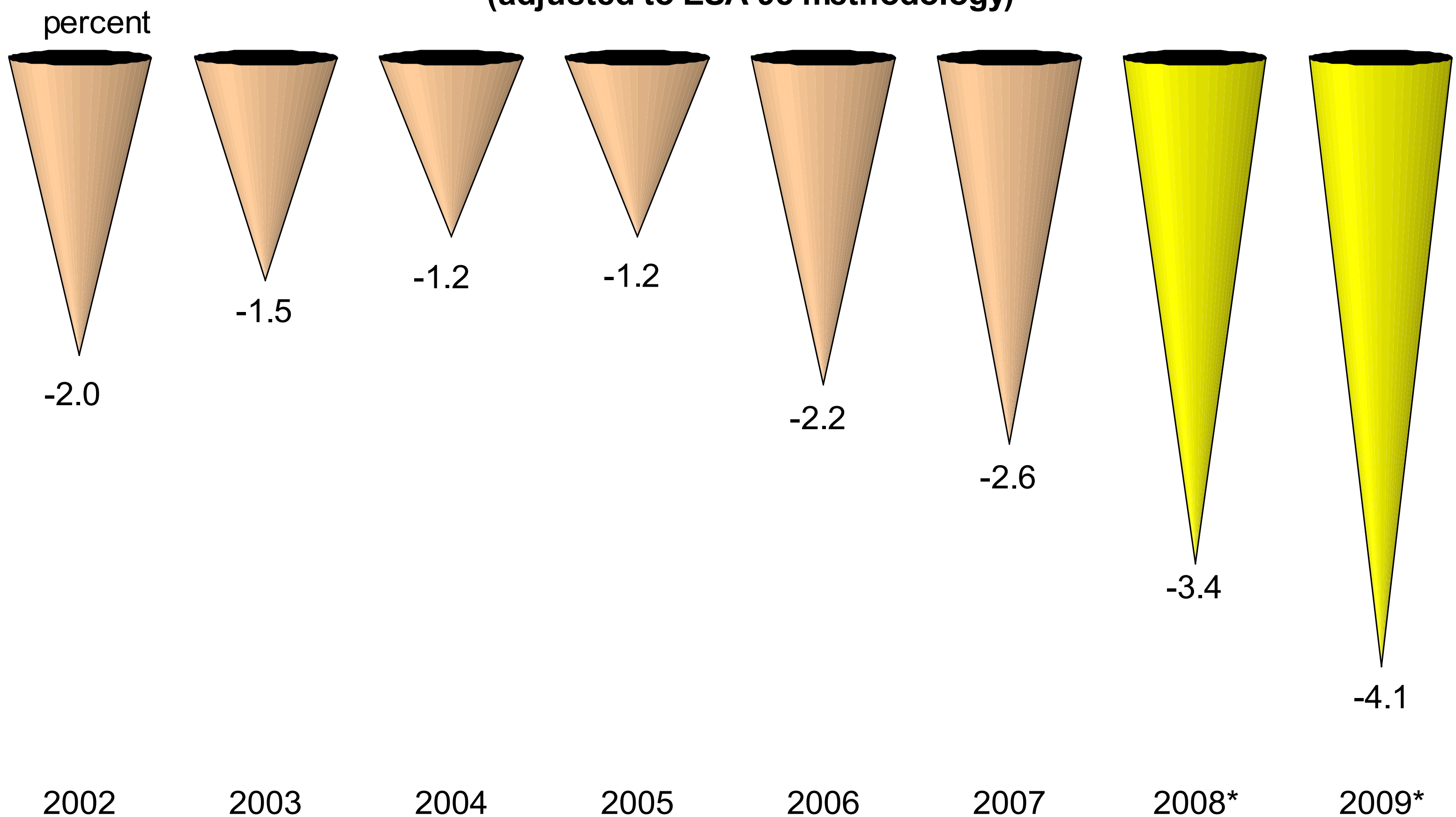
…while the fiscal position is likely to deteriorate in the absence of corrective action

- Decelerating economic activity will affect revenue collection in the context of recently legislated permanent hikes in current expenditures

- In the absence of timely measures, there is a high risk of breaching the Stability and Growth Pact (SGP) 3 percent of GDP threshold in both 2008 and 2009

General Government Deficit /GDP

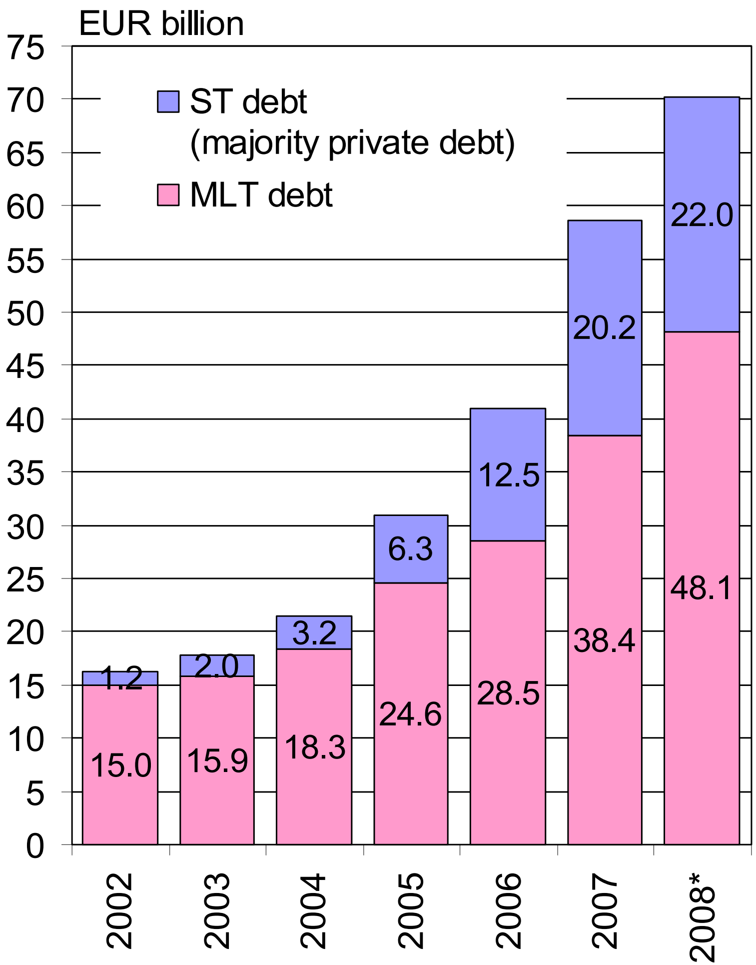
(adjusted to ESA 95 methodology)



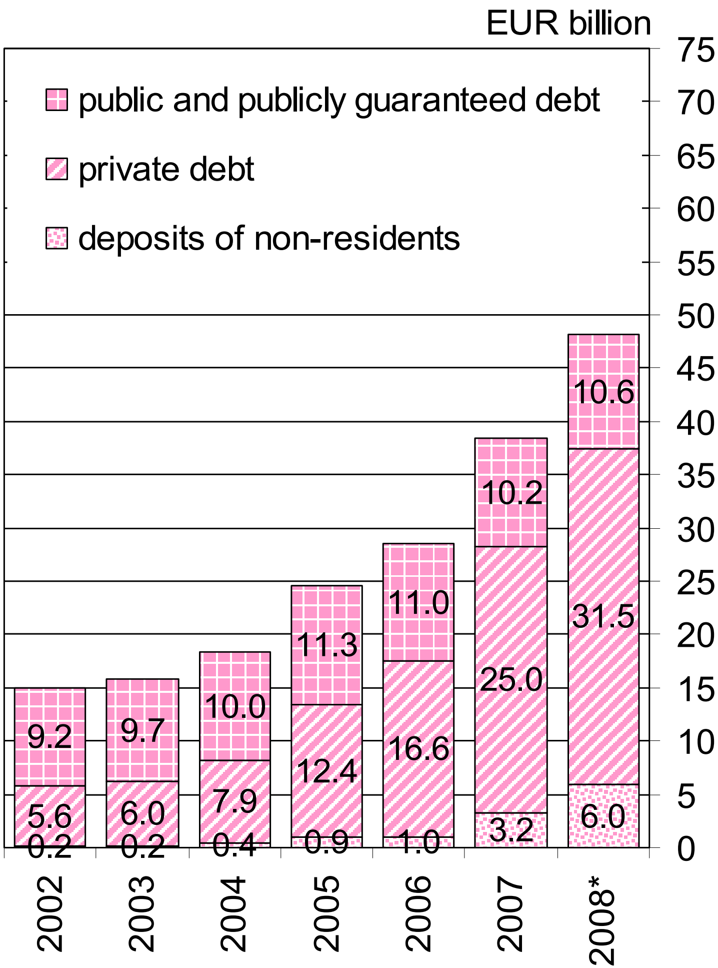
Source: Ministry of Economy and Finance, National Institute of Statistics, European Commission Autumn 2008 Economic Forecast

*) forecast

Total External Debt



MLT External Debt



Source: National Bank of Romania, Ministry of Economy and Finance

*) September

What Needs to be Done?

The current account deficit must be brought down through adequate policy measures

- There is no alternative to an adjustment of internal absorption able to significantly narrow the external imbalance
  - ✓ While Romania still enjoys significant economic growth there is room for a relatively smooth correction
  - ✓ A restrictive monetary policy alone cannot accomplish this task – only a comprehensive and coherent policy mix will do
- The adjustment burden must be borne by both private and public sectors
- Structural reforms are needed in order to:
  - ✓ Add more flexibility to the labour market
  - ✓ Boost productivity
  - ✓ Stimulate external competitiveness

A large budget deficit must be avoided

- Large deficits will be penalized by both the EC and financial markets:
  - ✓ Entry into Excessive Deficit Procedure, which may lead to:
    - financial penalties
    - restricted access to EU funds
  - ✓ More expensive or even rationed access to financing
- Fiscal policy should:
  - ✓ Avoid further expenditure expansion
  - ✓ Focus on public investment
  - ✓ Aim at increasing the efficiency of public spending
  - ✓ Be designed with a view to the medium to long-term consequences (multiannual budgeting)

In the absence of an adequate adjustment program …

- … a disorderly adjustment will occur and it will be neither smooth, nor reasonably sized

- … a massive drop in foreign capital inflows is likely to follow
  - Reduction in international reserves
  - Loss of international credibility

Summing up

- An accurate macroeconomic diagnosis is required:
  - ✓ An emotional approach of the crisis may lead to inadequate measures giving rise to an unwarranted stimulus to domestic demand

- A coherent policy mix is essential for a smooth restoration of macroeconomic equilibria