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Editorial

THE GREATEST FINANCIAL CRISES AND THE ECONOMIC THEORIES

*Aurelia Ioana Logojan**

Abstract

The financial crisis erupted in 2007 caused disruptions on the others markets and then was followed by economic recession. This article present the explanations provided by economic theories about the main consequences of the greatest financial crises on the economy, form XIX century till today. The conclusion of the paper is that the main changes in the economic theory should be about the role of human and a more ethical view of economy.

Keywords: financial crisis , depression, economic theory,

JEL Classification: A10, B51, E00, E12, E13, E49

Introduction:

Some financial crises have little effect outside of the financial sector, but other crises, like the crisis form 1819-1825, 1873, 1929 and 2008 had recessionary or depressionary effect on the rest of the economy In this paper I tried to present the main theories about the financial crisis and their aftermaths.

The financial crisis that erupted in 2007, continues in 2009 and likely continues longer, is in need for explanation by economic theory. The monetary authorities and financial regulators provide us with a series of explanations and measures but there is a lack of overview. The lack of convincing theory and strategy becomes especially worrying when we see the crisis affecting the real economy. Since the financial crisis turn into economic recession, there is little guidance from economic theory on how to solve it. This crisis provides a test on existing theories and allows us to identify which theories are relevant and which are not.

The main financial crisis and their aftermath over the economy

The greatest financial crisis and their consequences on the economy raised the problem of the viability of economic theories. The search for causes is closely connected to the question of how to avoid a future depression. The even larger question is whether it was largely a failure on the part of free markets or largely a failure on the part of government efforts to regulate interest rates, curtail widespread bank failures, and control the money supply. The answer of this question is a debateble one, those who believe in a large role for the state in the economy believe

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it was mostly a failure of the free markets and those who believe in free markets believe it was mostly a failure of government that compounded the problem.

Current economic theories may be broadly classified into three main points of view. First, there is orthodox classical economics: monetarist, Austrian Economics and neoclassical economic theory, which focus on the macroeconomic effects of money supply, how central banking decisions lead to overinvestment (economic bubble), or the supply of gold which backed many currencies before the Great Depression, including production and consumption.

Second, there are structural theories, most importantly Keynesian, but also including those of institutional economics, that point to under consumption and overinvestment (economic bubble), malfeasance by bankers and industrialists, or incompetence by government officials. The only consensus viewpoint is that there was a large-scale lack of confidence. Unfortunately, once panic and deflation set in, many people believed they could make more money by keeping clear of the markets as prices got lower and lower and a given amount of money bought ever more goods.

Third, there is the Marxist critique of political economy. This emphasizes the tendency of capitalism to create unbalanced accumulations of wealth, leading to over accumulations of capital and a repeating cycle of devaluations through economic crises. Marx saw recession and depression as unavoidable under free-market capitalism as there are no restrictions on accumulations of capital other than the market itself.

The first major financial crisis 1819-1825

The first major financial crisis, started in 1819 in the United States, had occurred after the nation faced a depression in the late 1780s, and another severe economic downturn in the late 1790s following the Panic of 1797. In those earlier crises, however, the primary cause of economic turmoil originated in the broader Atlantic economy. In contrast, the causes of the Panic of 1819 largely originated within the U.S. economy. The resulting crisis caused widespread foreclosures, bank failures, unemployment, and a slump in agriculture and manufacturing.

In the same period, european demand for american foodstuffs was decreased because agriculture in Europe was recovering from the Napoleonic Wars, which had decimated European agriculture. War and revolution in the New World destroyed the supply line of precious metals from Mexico and Peru to Europe. Without the base of the international money supply, europeans needed all the available specie. This caused American bankers and businessmen to start issuing banknotes and expand credit and by the end of 1819, the banks would call these loans . American bankers, who had little experience with corporate charters, promissory notes, bills of exchange, or stocks and bonds, encouraged the speculation boom during the first years of the market revolution. From 1825, because the evolution of european economy, of northen american and latin american countries and it was triggered the British crisis, which become on of the greatest international crisis.

Different economists have offered explanations for the Panic of 1819. Keynesian economist suggest that the Panic of 1819 was the early Republic's first experience with the boom-bust cycles common to all modern economies, but this view could be not complete, this panic seems to be more complex. It was a failure of the banking system following the War of 1812 and combined with the issue of the depression and over speculation, it became the first *failure* of the market economy in America. The Panic of 1819 marked the beginning of a new phase of American economic history, where mature market institutions would continue to move cyclically from boom to bust.

Austrian school economists view the nationwide recession that resulted from the Panic of 1819 as the first failure of expansionary monetary policy. This explanation is based on the Austrian theory of the business cycle. Government borrowed heavily to finance the War of 1812, which caused serious strain on the banks' reserves of specie and led to a suspension of specie payments in 1814. The suspension of the obligation to redeem spurred the establishment of new banks and the expansion of bank note issues. This inflation of money encouraged unsustainable investments to take place. It soon became clear the monetary situation was bad, and the Second Bank of the United States was forced to call a halt to its expansion and launch a painful process of contraction. There was a wave of bankruptcies, bank failures, and bank runs; prices dropped and wide-scale urban unemployment began.

The financial crisis form 1873

The Long Depression started after the financial crisis of 1873 and it was considered, a long time, a worldwide economic crisis though there is some controversy over whether it should be labeled a depression or recession. The Long Depression, labeled The Great Depression (until the Depression of 1930s), was felt most heavily in Europe and the United States, which had been experiencing strong economic growth fueled by the Second Industrial Revolution and by the american civil war. It is often considered that United Kingdom have been the hardest hit and during this period it lost some of its large industrial lead over the economies of Continental Europe

In the United States, the Long Depression began with the Panic of 1873 and the causes of the this depression are debated, mainly because it was not a production depression; it was a price depression. The most immediate cause, and the date that is often used as the start of the Depression, was the collapse of the Vienna Stock Exchange on May 9, 1873. Others have argued the depression was rooted in the 1870 Franco-Prussian War and the Treaty of Frankfurt (1871), that forced French to make large war reparations payments to Germany. The primary cause of the price depression in the United States was the tight monetary policy that the U.S. followed to get back to the gold standard after the Civil War. The U.S. was taking money out of circulation to achieve this goal, therefore, there was less available money to facilitate trade. Because of the monetary policy described above the price of silver started to fall causing considerable losses of asset values, however, by most accounts, after 1879 production was growing, thus further putting downward pressure on prices due to increased industrial productivity, trade and competition.

In America the speculative nature of financing due to both the greenback which was specie issued to pay for the US Civil War and fraud in the building of the Union Pacific Railway up to 1869. Railway overbuilding and weak markets collapsed the bubble in 1873 in USA and in UK.

Because of the Panic of 1873, governments depegged their currencies, to save money. The demonetization of silver by European and North American governments in the early 1870s was certainly a contributing factor. The Coinage Act of 1873 in America was met with great opposition but were Americans who advocated the continuance of government-issued fiat money to avoid deflation and promote exports. The resumption of the US government buying silver was enacted in 1890 with the Sherman Silver Purchase Act.

Some economic historians argue that the Long Depression was actually a deflationary period but not a time of falling production and GDP. The deflation thesis has led to the claim that the Long Depression was not truly a depression at all because production and real GDP grew throughout the period. The confusion comes from the fact that prices were falling (hence, deflation) because of greater industrial productivity and the presence of sound money (gold and silver).

In the modern view, the Long Depression was actually a period of great economic growth, but that many Americans at the time were confused because of falling prices and increasing income inequality, as the living standards of the wealthiest Americans were increasing at an even faster rate.

Monetarists believe that the 1873 depression was caused by shortages of gold that undermined the gold standard, and that the 1848 California Gold Rush. Other analyses have pointed to developmental surges, theorizing that the Second Industrial Revolution was causing large shifts in the economies of many states, imposing transition costs, which may also have played a role in causing the depression.

The Great Depression

The Great Depression, originated in United States was a worldwide economic downturn starting in most places in 1929, after the stock market crashed of October 29 and ending at different times in the 1930s or early 1940s for different countries. It was the largest and most severe economic depression in the 20th century, and is used in the 21st century as an example of how far the world's economy can decline. The depression had devastating effects in virtually every country, international trade plunged by half to two-thirds, as did personal income, tax revenue.

There were multiple causes for the first downturn in 1929, including the structural weaknesses and specific events that turned it into a major depression and the way in which the downturn spread from country to country. The causes of the crisis are considered to be structural factors like massive bank failures and the stock market crash, but other opinions had pointed to the Britain's decision to return to the Gold Standard at pre-World War I parities.

During the Great Depression, Keynes had published his most important work, The General Theory of Employment, Interest, and Money. Keynes argued in his work that lower aggregate expenditures in the economy contributed to a massive decline in income and to employment that was well below the average. In this situation, the economy might have reached a perfect balance, at a cost of high unemployment. The basic basic idea of his theory was simple: to keep people fully employed, governments have to run deficits when the economy is slowing because the private sector will not invest enough to increase production and reverse the recession. Keynesian economists called on governments during times of economic crisis to increase government spending and/or cutting taxes increasing individuals' incomes. As incomes increased, they would spend more. As they spent more, the multiplier effect would take over and expand the effect on the initial spending. Keynesian economists assumed poor people would spend new incomes; however, they saved much of the new money; that is, they paid back debts. Keynesian ideas of the consumption function were upset in the 1950s by Milton Friedman and Franco Modigliani.

Monetarists, including Milton Friedman[1] argue that the Great Depression was caused by monetary contraction, the consequence of poor policymaking by the American Federal Reserve System and continuous crisis in the banking system. In this view, the Federal Reserve, by not acting, allowed the money supply as measured by the M2 to shrink by one-third from 1929 to 1933. Friedman argued that the downward turn in the economy, starting with the stock market crash, would have been just another recession. The problem was that some large, public bank failures, particularly that of the New York Bank of the United States, produced panic and widespread runs on local banks, and that the Federal Reserve sat idly by while banks fell. He claimed that, if the Fed had provided emergency lending to these key banks, or simply bought government bonds on the open market to provide liquidity and increase the quantity of money after the key banks fell, all the rest of the banks would not have fallen after the large ones did, and the money supply would not have fallen as far and as fast as it did. With significantly less money to go around, businessmen could not get new loans and could not even get their old loans renewed, forcing many to stop investing. This interpretation blames the Federal Reserve for inaction, especially the New York branch. One reason why the Federal Reserve did not act to limit the decline of the money supply was regulation. At that time the amount of credit the Federal Reserve could issue was limited by laws which required partial gold backing of that credit. By the late 1920s the Federal Reserve had almost hit the limit of allowable credit that could be backed by the gold in its possession. This credit was in the form of Federal Reserve demand notes. During the bank panics a portion of those demand notes were redeemed for Federal Reserve gold. Since the Federal Reserve had hit its limit on allowable credit, any reduction in gold in its vaults had to be accompanied by a greater reduction in credit.

[1] *A Monetary History of the United States, 1867-1960.* Princeton University Press

Recent work from a neoclassical perspective focuses on the decline in productivity that caused the initial decline in output and a prolonged recovery due to policies that affected the labor market. This work, collected by Kehoe and Prescott[2], decomposes the economic decline into a decline in the labor force, capital stock, and the productivity with which these inputs are used. This study suggests that theories of the Great Depression have to explain an initial severe decline but rapid recovery in productivity, relatively little change in the capital stock, and a prolonged depression in the labor force. This analysis rejects theories that focus on the role of savings and posit a decline in the capital stock.

Another explanation comes from the Austrian School of economics. Theorists of the "Austrian School" who wrote about the Great Depression include Austrian economist Friedrich Hayek and American economist Murray Rothbard[3], who wrote *America's Great Depression* (1963). In their view and like the monetarists, the Federal Reserve, which was created in 1913, shoulders much of the blame; but in opposition to the monetarists, they argue that the key cause of the Depression was the expansion of the money supply in the 1920s that led to an unsustainable credit-driven boom.

One reason for the monetary inflation was to help Great Britain, which, in the 1920s, was struggling with its plans to return to the gold standard at pre-war parity. Returning to the gold standard at this rate meant that the British economy was facing deflationary pressure. According to Rothbard, the lack of price flexibility in Britain meant that unemployment shot up, and the american government was asked to help. The United States was receiving a net inflow of gold, and inflated further in order to help Britain return to the gold standard. Rothbard says American inflation was meant to allow Britain to inflate as well, because under the gold standard, Britain could not inflate on its own. In the Austrian view it was this inflation of the money supply that led to an unsustainable boom in both asset prices (stocks and bonds) and capital goods. By the time the Fed belatedly tightened in 1928, it was far too late and, in the Austrian view, a depression was inevitable.

According to the Austrians, the artificial interference in the economy was a disaster prior to the Depression, and government efforts to prop up the economy after the crash of 1929 only made things worse. According to Rothbard, government intervention delayed the market's adjustment and made the road to complete recovery more difficult. Furthermore, Rothbard criticizes Milton Friedman's assertion that the central bank failed to inflate the supply of money. Rothbard asserts that the Federal Reserve couldn't do his job because the lost of faith in banking system of American population and their preference for cash. The potential for a run on the banks caused local bankers to be more conservative in lending out their reserves, and this, Rothbard argues, was the cause of the Federal Reserve's inability to inflate.

[2] *Great Depressions of the Twentieth Century.* Federal Reserve Bank of Minneapolis

[3] *America's Great Depression.* Mises Institute. 5th edition

Two economists of the 1920s, Waddill Catchings and William Trufant Foster[4], popularized a theory which states held the economy produced more than it consumed, because the consumers did not have enough income. Thus the unequal distribution of wealth throughout the 1920s caused the Great Depression. According to this view, wages increased at a rate lower than productivity increases. Most of the benefit of the increased productivity went into profits, which went into the stock market bubble rather than into consumer purchases. Say's law no longer operated in this model (an idea picked up by Keynes). As long as corporations had continued to expand their capital facilities, the economy had flourished. Under pressure from administration of that time and from business, the Federal Reserve Board kept the discount rate low, encouraging high (and excessive) investment. By the end of the 1920s, however, capital investments had created more plant space than could be profitably used, and factories were producing more than consumers could purchase. According to this view, the root cause of the Great

Depression was a global overinvestment in heavy industry capacity compared to wages and earnings from independent businesses, such as farms. The solution was the government must pump money into consumers' pockets. That is, it must redistribute purchasing power, maintain the industrial base, but reinflate prices and wages to force as much of the inflationary increase in purchasing power into consumer spending. The economy was overbuilt, and new factories were not needed.

Irving Fisher[5] argued that the predominant factor leading to the Great Depression was overindebtedness and deflation. Fisher tied loose credit to over-indebtedness, which fueled speculation and asset bubbles. He outlined 9 factors interacting with one another under conditions of debt and deflation to create the mechanics of boom to bust: debt liquidation and distress selling, contraction of the money supply as bank loans are paid off, a fall in the level of asset prices, a still greater fall in the net worths of business, precipitating bankruptcies, a fall in profits, a reduction in output, in trade and in employment, pessimism and loss of confidence, hoarding of money, a fall in nominal interest rates and a rise in deflation adjusted interest rates.

Many economists have argued that the worsen of depression was due to the sharp decline in international trade after 1930 helped to, especially for countries significantly dependent on foreign trade. Most historians and economists partly blame the American Smoot-Hawley Tariff Act for worsening the depression by seriously reducing international trade and causing retaliatory tariffs in other countries.

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[4] *Foster and Catchings: A Reappraisal*, Journal of Political Economy

[5] *The Debt-Deflation Theory of Great Depresion* , Federal Bank of Saint Louis

The financial crisis of 2008

The prezent financial crisis, started in 2007 has been called the most serious financial crisis since the Great Depression, with its global effects characterized by the failure of key businesses, declines in consumer wealth estimated in the trillions of U.S. dollars, substantial financial commitments incurred by governments, and a significant decline in economic activity.

The immediate cause of the crisis was the bursting of the United States housing bubble which peaked in approximately 2005–2006. High default rates on "subprime" and adjustable rate mortgages (ARM), began to increase quickly thereafter. An increase in loan incentives such as easy initial terms and a long-term trend of rising housing prices had encouraged borrowers to assume difficult mortgages in the belief they would be able to quickly refinance at more favorable terms. However, once interest rates began to rise and housing prices started to drop moderately in 2006–2007 in many parts of the U.S., refinancing became more difficult. Defaults and foreclosure activity increased dramatically as easy initial terms expired, home prices failed to go up as anticipated, and ARM interest rates reset higher.

From 2007, significant amounts of foreign money flowed into the U.S. from fast-growing economies in Asia and oil-producing countries. This inflow of funds combined with low U.S. interest rates from 2002-2004 contributed to easy credit conditions, which fueled both housing and credit bubbles. Loans of various types were easy to obtain and consumers assumed an unprecedented debt load. As part of the housing and credit booms, the amount of financial agreements called mortgage-backed securities (MBS), which derive their value from mortgage payments and housing prices, greatly increased. Such financial innovation enabled institutions and investors around the world to invest in the U.S. housing market. As housing prices declined, major global financial institutions that had borrowed and invested heavily in subprime MBS reported significant losses. Falling prices also resulted in homes worth less than the mortgage loan, providing a financial incentive to enter foreclosure. The ongoing foreclosure epidemic that began in late 2006 in the U.S. continues to drain wealth from consumers and erodes the financial strength of banking institutions. Defaults and losses on other loan types also increased significantly as the crisis expanded from the housing market to other parts of the economy. Total losses are estimated in the trillions of U.S. dollars globally.

While the housing and credit bubbles built, a series of factors caused the financial system to both expand and become increasingly fragile. Policymakers did not recognize the increasingly important role played by financial institutions such as investment banks and hedge funds. These institutions as well as certain regulated banks had also assumed significant debt burdens while providing the loans described above and did not have a financial cushion sufficient to absorb large loan defaults or MBS losses. These losses impacted the ability of financial institutions to lend, slowing economic activity. During September 2008, the crisis hits its most critical stage. There was the equivalent of a bank run on the money market mutual funds, which frequently invest in commercial paper issued by corporations to fund their operations and payrolls. Withdrawal from money markets were $144.5 billion during one week, versus $7.1 billion the week prior. This interrupted the ability of corporations to rollover (replace) their short-term debt.

The crisis rapidly developed and spread into a global economic shock, resulting in a number of European bank failures, declines in various stock indexes, and large reductions in the market value of equities and commodities. Moreover, the de-leveraging of financial institutions, as assets were sold to pay back obligations that could not be refinanced in frozen credit markets, further accelerated the liquidity crisis and caused a decrease in international trade.

It seems to that the economic theory was not enough to describe and to prevent the present crisis. Although the economists have proposed as solutions to strengthen the regulations and enlarge supervision to avoid the futures financial crisis, I don't thing it is the correct solution. In my view it is necessary to rethink the role of the human in the economic theories and to propose a ethical concept of economy could mitigate the cyclical greatest financial crisis. I think that investors will always find the ways to escape form the regulation and it is necessary to requires a general economical ethical cod.

Conclusion

The implicit view behind standard models is that markets and economies are inherently stable and that they only temporarily get off track but this view failed to warn policy makers about the threatening system crisis. As the crisis has unfolded, economists had to abandon their standard models. In this period the common-sense advice is a poor substitute for an underlying model that can provide much-needed guidance for developing policy and regulation.

Although it could be seen as a failure of popular models, I think the real problem is the lack of historical memory, the greatest financial crisis (from 1825, 1873, 1929 and 2008) have had the the same main features along the time despite their particular features. If we try the visualize the economic history we can see the real problem - the human greed. The main problem is not just the economic theory but a continuous human desire to have more than it needs which allows speculations and thieves. The solution in my vision is a more ethical and moral way to conceive the function of economy.

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FROM THE WORLD CRISIS TO RECOVERY

Alexandru Sălceanu[*]

Abstract

After more than 50 years of economic growth, we are witnessing a world economic crisis generated by a multitude of economic, political, social and other factors. Banks have contributed to the starting of this crisis, especially by making some speculative investments with a high level of risk, as a result of the sub-regulated financial system in which they carry out their activity. It is possible to get out of this crisis by applying a reformation of the way in which the financial sector in regulated and monitored.

Keywords: financial market, economic growth, new regulations, interest rate, reimbursement risk, credit expansion, inflation policy, sub-regulated financial system, monetary excess, monetary relaxation, toxic financial products.

JEL codes : E 44, E 52, F 43, G 32, O 16.

Banks and their role in the economic growth

After the Second World War and after the settlement of the main issues referring to the world and areas of influence division, we have witnessed, year after year, the global economic growth phenomenon, defined as the ascendant evolution of the macro economical outcome (GIP) or as a country's long-term increase of the global national product and per capita, as an increase of the production capital of a country, identified by the continuous increase of the real national income during several years. Out of the factors that contribute to the economic growth we mention: the material resources, the capital, the technological equipment, the human resources. The global economic growth generates important theoretical questions to economists and arises numerous discussions and questions to governments and enterprises that are invested with the responsibility of coordinating the national components with the purpose of coping with the challenges of the contemporary world.

After more than half a century of economic growth, noticed after the Second World War, we are witnessing a global economic crisis, similar to the one between 1929 and 1933, but different at the same time due to the causes that generated it and to the amplitude of the unbalances it created.

The world economic crisis we are currently witnessing started in 2007 or even earlier and its ending is uncertain due to a multitude of elements which influence it and especially due to the measures which the economic, political and other factors must take in order to surpass it. There is an official explanation of the crisis, provided by public institutions, according to which it originates in the inadequate

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behaviour of economic operators and in the impossibility of the market to function normally, in order to guarantee the appropriate distribution of resources. The economic experts in the field, among whom Daniel Daianu, claim that *"a sub-regulated financial system is at the basis of the current crisis. The deregulation waves in the financial industry brought into the market a lot of appealing products whose risks were superficially understood".*[6] In fact, this crisis represents a failure of little or not at all regulated markets and demonstrates once more that the financial market cannot regulate itself. Just as the road traffic needs to set up and observe some rules, so the market economies must be regulated by exact rules that must be observed by all the participants, including by banks, in order for crises to be avoided and potential consequential damage to be limited. The crisis period the whole world has to cope with demonstrates that Keynes's idea, the great British economist who supported the importance of governments' intervention to avoid unbalances, is more current than ever.

"Banks are some awesome things when they work properly. And, usually, so it happens. But when it doesn't, hell on Earth may unleash – so it happened in the United States and in almost all the countries during last year".[7]

The main error of the monetary policy (Bogdan Glăvan – 2009) is that one regarding a monetary excess, doubled by a process of artificial decrease of the interest rate, these two factors, as well as others, contributing to the unprecedented credit expansion. The factor that generated this crisis is the inflationary policy of the U.S.A, who decided to reduce the interest rate by money issue at the beginning of 2000, with the intended purpose of obtaining a so-called 'monetary relaxation', which was intended to be, at least in statements, the driving force of economic growth.

As a result of this decision, the interest rate decreased from 6.25% at the beginning of 2000 to 1.75 at the end of the same year, reaching a level of 1% in 2003, which was the same until the end of the year. In the same period, Bank of Japan adopted a similar policy, lending money with zero interest at all to the subordinate banks, whereas the Central European Bank reduced the interest rate by almost 2%, keeping it at this level for four years. This way, the interest rate was kept in the euro zone and Japan at a level close to zero. The Central Bank of England was no exception either, keeping the credit interests at a very low level.

The outcome of this policy, which generated economic growth, is represented by the real estate boom that occurred in the USA and the euro zone, as well as in the former socialist countries towards the end of the period. This situation, of investing capital flows in investments with fewer assets and less risky by their nature, such as real estate investments, generated very high profits for investors as long as the market kept on growing. When the subprime panic broke out, the dynamics of deposits ceased to keep up with the evolution of credits, and the banking system accumulated, very rapidly, debts amounting to about 250 billion dollars, most of them at short interest. Great amounts of the money obtained from the Western

[6] Daniel Daianu , *Capitalismul încotro? Criza economica, mersul ideilor, instituții*, 2009
[7] Paul Krugman, *Întoarcerea economiei declinului si criza din 2008*, 2009

banks under highly advantageous conditions were invested in the developing countries, with very high profits but under risky conditions.

The world capitalist system is under a continuous transformation

In the last decades of the 20th century, major changes occurred in the capitalist society by the occurrence of non-corporeal capitalism, as a result of the technological revolution in the information field. The ideology of the non-corporeal capitalism may be identified in the communication domain and, due to this reason, it allows the cross-nationalization of technologies and communications that move very easily, thus producing globalization. In this situation, brand values became very important, that is why at the end of the last century, the total value of the first ten world brands exceeded, according to statistics, 392 billion dollars, with a clear increasing tendency.

Under the form it developed in the first ten years of the 20th century, this type of capitalism generated major unbalances, especially in the financial field. Thus, in this field, value could be artificially created by means of the so-called toxic financial products, resulted from the fact that banks, in their chase for profit, undertook huge risks by increasing the number of assets that were launched on the market, thus generating major unbalances in their way of operation. To be able to continuously increase profits, banks offered credits without meeting some mandatory conditions, thus contributing to the increase of the risk level, which occurred very often, generating the impossibility of cashing the credits offered and their afferent interests. The phrase "credit only with the ID card"

The major weakness of this type of development, which seemed to generate economic growth, is that it is not sufficiently regulated. The deregulation under Reagan was tacitly accepted as a method to avoid a crisis at the beginning of the non-corporeal capitalism. When non-corporeal assets purchased in the daily basket exceeded the value of the corporeal assets acquired and in order to avoid a crisis there was required the stimulation of some industries that employed many people who, otherwise, could have been unemployed, as well as the identification of some new fields of activity. Out of these industries, the construction and the automotive industries were chosen, and the industry of alternative energy was promoted as a new domain. The construction industry was stimulated by means of the easy access to crediting and by encouraging purchasing 2-3 estates that should guarantee and support each other through the incomes from rentals by their owners. The automotive industry was stimulated by facilitating the access to credits, by stimulating the development of new types of car with special design, displacement, level of pollution, as well as by renewal programs of the rolling stock. The industry of alternative energies was stimulated by means of special advertising that drew attention upon the depletion of oil and gas reserves, as well as upon the danger of global warming, generated by the use, on a large scale, of hydrocarbons. In order to sort out these issues, the programs regarding the alternative energy were encouraged by easier crediting.

All these factors that contributed to the unprecedented development of credit demand generated the exceeding of certain thresholds, a situation that could raise some questions for banks and governors if they had been granted the appropriate attention. Out of these we mention:

- A longer crediting period than the active period for credit requirement;
- A longer crediting period than the redemption period for the asset purchased on credit;
- The person who received a credit ceases to be employed and becomes a pensioner;
- The share of non-corporeal assets higher than the share of the corporeal assets in the capital of the business enterprise.

By exceeding these thresholds, the reimbursement risk of the credits to debtors increased, thus creating major unbalances in the activity of banks, which represents one of the factors that generated the current world financial crisis. To cope with this crisis, it is necessary to rethink new rules and mechanisms for the functioning of economy and consequently of its financing, and not to take useless administrative measures.

In order to surpass this world financial crisis, we must take into consideration the idea that, no matter severe it might be, it cannot last for ever. Consequently, it is necessary that the experts in this field should set up new rules and mechanisms adapted to the particularities of each field of activity and to each country. In support of this assertion there are the actions by means of which the state, as well as other banks, took over a part of the bankrupt banks between 2007 and 2009, without triggering spectacular reactions at the international level. In this situation there were Lehman Brothers Bank, American International Group and others, which were a breath of fresh air required for the attenuation of the outcomes of the crisis. The main objective of the assistance programs given to the banks and economic operators, financially supported by governmental programs and by IMF and other international banks, is that of preventing some collateral outcomes produced by this crisis, such as unemployment, inflation etc.

Taking into consideration the particular aspects of the crisis in each state, according to the characteristics, particularities, level of development etc. of each one, the governmental programs must be coordinated with each other as well as with the programs of other countries or regions, so that they should not block each other. Governments must develop new regulations concerning the monitoring way of the sectors affected by the crisis, which must be supported by means of national programs. Globalization, with all its positive and negative aspects, cannot be ignored any longer, and isolation, nationalism, protectionism etc. must be left aside, as a first step towards surpassing this crisis.

Developing new rules to avoid future financial crises

The current crisis which occurred in the financial markets all over the world demonstrated that it is time to discuss the necessity of a reform of the regulation and monitoring way of the financial sector in EU. In this respect, the new legislation in this domain will have as its main objective the improvement of the risk management in order to prevent the future recurrence of another financial crisis. In this respect, a commission of a group of experts was set up, under the chairmanship of Jacques de Larosière, whose main purpose is the analysis of the way in which the financial institutions in the EU countries are organised, with a view to achieving the following objectives:

- ensuring prudential strength;
- creating the best conditions for a better functioning of capital markets and a better collaboration among the EU countries as regards the control of the financial stability;
- creating some suitable mechanisms for the fast warning and management of crises, including for the management of cross-border and inter-sector risks;
- improving the cooperation between EU and other important jurisdictions outside it, with a view to ensuring financial stability at global level.

In order to achieve the necessary level of convergence and cooperation as regards EU monitoring, as well as to achieve the stability of the financial system, it is necessary to integrate the monitoring activities, with a view to sorting out the following issues:

1. High interbank exposures

Taking into consideration that, today, interbank exposures are not risk-free, they should be managed with a higher level of prudence. In this respect, the commission put forward the limitation of all interbank exposures to 25% of their own funds or an alternative limit of 150 million euro, taking into consideration the higher of the two levels.

2. Capital demands and risk management for safety positions

The problem of the potential conflicts of interest from the pattern of the type "originate to distribute" should be settled by guaranteeing that the initiators and the sponsors of credit risk transfers retain a part of the subscribed risks. Out of this reason, it is necessary that investors should make sure that initiators and sponsors retain a material part of the risks. As a result of the agreement within EU between the Parliament and the Council concerning the percentage retained from the total value of the sold secured product, the initial proposal calculated in percentage of 5% of the investment total value was taken into consideration again, so that the initiators and sponsors should be effectively obliged to retain a part of the risks. At the same time, the aim is the setting up of a more rigorous and firm securing frame, which should include additional precaution measures, which should contribute to a more responsible subscription and to the avoidance of huge costs by investors and financial institutions.

3. Setting up monitoring boards

With a view to consolidating the efficiency of monitoring the cross-border banking groups, there was decided the setting up of some monitoring boards, whose purpose is that of offering competent and responsible help to the authorities in the host state that are responsible with monitoring. In connection to this aspect, the deputies in the European Business Commission within EU consider that this measure represents a first step, to be followed by others, towards the setting up of a solid integrated monitoring system. In this respects, the deputies require the European Commission to put forward a legislative proposal that should comprise provisions referring to the strengthening of the EU role regarding the monitoring system of cross-border banking groups.

4. Hardship clause

As a result of the negotiations within EU between the European Parliament and the Council, a hardship clause was introduced, which requires the European Commission to present, before the end of 2009, a legislative proposal that should stipulate an increase of the retention level in the securing process.

Particular aspects of the financial crisis in Romania

Romania, already in recession, because its GIP is decreasing for the second consecutive term, is no exception and is facing now the same financial crisis that blocked the real estate market, generating major unbalances as concerns both the construction activity and the branches connected to it.

In order to unblock dwelling selling, the new political power came up with a program called "The first house", whose purpose is that of achieving at least three objectives:

1. To facilitate the access of the interested persons to an advantageous credit that should allow them purchase a dwelling (the first house), with an advance payment of 5% of its value;
2. To unfreeze credit activities;
3. To stimulate the economic activities in the construction field, with positive outcomes upon unemployment, inflation etc.

According to the law, the bank shall issue a unilateral crediting proposal, provided that the state gives a guarantee promise of up to 60,000 euro. On purchasing the dwelling, the beneficiary shall get the money to pay it to the builder, and the dwelling turns into a mortgage of level I in favour of the Ministry of Finances. This program resembles very much with some programs used in the USA, during Bush's administration, which did not have too much success, because it pushed on the prices and deepened the financial crisis, being a helping hand to the groups of interests and less to the low-income families.

The guarantee of mortgages with public money can lead only to moral hazard, as demonstrated by the American crisis. In the USA, this task was incumbent on the companies with federal support Freddie Mac and Fannie Mal, their guarantees being a stimulant for the various real estate leasing companies to continue giving risky mortgage credits on the subprime segment. Between 2004 and 2006, the two companies purchased bonds covered by mortgages in value of 434 billion dollars, thus allowing the crediting extension to sub primers. These guarantees generated unbalances in the financial activity of the two companies, saved from disaster by the American federal authorities. This phenomenon is reflected in the share quotations of the mentioned companies, which were transacted below one dollar a piece between 2008 and 2009, while the price in the subprime crediting "golden years" was between 55 and 80 USD per title.

The guaranteeing of some credits for families that did not prove solvable on long term, as well as the capacity to save, demonstrated by the absence of the necessary amount of money for the advance payment, represent a risky game with the money of rate payers, generating the use of some fraud methods against the state by means of a clever shuttle between banks, real estate developers and political factors.

The simplest and healthiest option, both for the national economy and for those who need "The new house", would be that of leaving the market regulate itself, without trying to re-ignite the real estate segment by means of suspicious methods that may generate the decrease of prices. In order to help the young, we do not need to look for all kinds of miraculous solutions, but we must let the real estate balloon deflate, so that the price of dwellings should return to bearable levels by decreasing undeserved profits that some would like to obtain and which society is no longer willing to pay. At that moment, for sure, those who will be able to get an income and save some, without waiting for help that may be disadvantageous for all of us, will be able to solve the dwelling issue in a less expensive manner.

Conclusions

The future regulations that may contribute to the recovery of the financial markets and, implicitly, to the decrease of the banks' risk level, must take into account the transparency, capital adequacy, the elimination of conflicts of interest, the introduction of new monitoring systems for the activity of banks. As regards the banking institutions that practise leveraging, that is which carry out operations that exceed by far their own capital, they must fall under the incidence of regulations, in order to stop these practices. In this respect, there must be taken into consideration the recommendations of the Basel II Agreement, according to which the capital must be adequate according to the risk level, so that money for difficult times should be saved.

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ECONOMIC EVOLUTIONS IN ROMANIA AND IN THE EUROPEAN UNION IN CRISIS CONDITIONS

Alina Hagiu[*]

Abstract

The global economic crisis is magnifying every day, and Romania began to increasingly feel the economic recession, to which economists from the whole world fail to find an antidote. Economic crisis will hit Romania fully. And there will not be a little crisis, as some still say, but will be a system crisis, an economic crisis, which if we don't understand and don't treat properly, will produce devastating effects.

Is the same as in the years '29 -'33, when the capitalist system of manufacturing bankrupt and it was replaced at that time with a capitalist financial system. Today, the financial capitalism is too in bankruptcy and must be replaced by another system. What will it be? The world is looking for it.

For Romania, in the present situation, it is extremely important to be aware of the crisis in its true dimension and try to keep manage.

Regarding European Union, in many ways the current economic crisis is a severe test for it. There is no secret that until now the national interests prevailed in all essential matters, beginning with that of energy security. But despite this, rhetoric typical of Brussels has managed so far to alleviate asperities moving tactically discussion in areas where septic joint positions are more easily obtained. The process will be much more difficult now. Already due to political and economic pressures at home, governments of all member countries appear less willing to take into account the views of Brussels map.

So far the European Union authorities have officially recognized that the Euro zone fell into recession after the third quarter of 2008 was the second consecutive quarter of negative growth estimating that GDP will decrease more in 2009.

On these coordinates we intend to analyze the effects of economic crisis on Romania and the European Union in general, also trying to formulate possible ways to follow for decreasing the negative effects as long as their removal does not seem possible.

Key words: recession, unemployment rate, funding, human resources, budget, GDP.

JEL classifications: O11, E01, F01

Introduction

It has already been some time since the economists started to worry about the rapid propagation on the real economy of what was initially a financial crisis and send signals of distress to policy makers. In many developing and emerging countries, those signals were not taken seriously by politicians - sometimes comforted by local

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economists - because the crisis was perceived as something far away, which concerned only developed countries. The argument was always the same: developing and emerging economies are not financially integrated with the world system; consequently, these economies will not be contaminated. When the impact on real economy was questioned, the same confidence prevailed, based on high rates of real growth recorded in the past few years by those countries.

Similarities and differences between the crisis of 1929 and the current one

In 1929, at the end of a golden decade that dimmed the memory of the First World War, the crisis hit full in Romania. Scholarships were collapsed, large companies began to stagger to the ground, and "unemployment" became, from a simple word, a daily reality alarming.

It have been almost eight decades since then, and Romania beats at the gates of a new economic crisis of proportions, and the comedy and tragedy still up dough from which the country is prepared the anti-crisis solutions.

Wall Street entered in collapse the first time on 24 October 1929. In Bucharest, news get more difficult to people. Internet was not yet processed thousands of miles away-in seconds. Three days later, the biggest Romanian newspaper of the time, "World", dedicated, finally, a "box" event: "The Exchange effects in New York were trading on a number of about 14 million shares. The meeting went extremely rugged and partly in an atmosphere of panic, with considerable decreases in huge classes of most papers.

No "Morning", the newspaper political of the Left side is not very much in a hurry. Only on November 1 on the first page they are announcing "catastrophic spill from Exchange in New York, describing in detail the chaos in the American stock exchange.

When it comes to Romania, optimism is in bloom. Crisis is always "them", others, always elsewhere: "In general, the National Bank's balance sheet shows that the economic situation began to focus on a very thorough and entitles the hope that, as we will capitalize the new harvest, improvement to stress. Furthermore, on November 7, it was held in Bucharest Extraordinary General Assembly of the Industrialists, in this meeting is absolutely nothing mentioned about the crisis.

Officially the economic crisis lasted from August 1929 until March 1933, and the evolution of U.S. GDP was as follows: 1929 - $ 87 billion; 1930 - $ 75 (-13%), 1931 - $ 59 (-21%), 1932 - $ 42 (-29%), 1933 - $ 40 (-5%).

To see this crisis and its influence on other developed economies, we will present the table below where it can be seen the evolution of industrial production index related to each country during the crisis period, 1929 is taken as reference (100).

Table no.1 The evolution of industrial production index

	1927	1928	1929	1930	1931	1932	1933	1934	1935
Britain	95	94	100	94	86	89	95	105	114
Canada	85	94	100	91	78	68	69	82	90
France	84	94	100	99	85	74	83	79	77
Germany	95	100	100	86	72	59	68	83	96
Italy	87	99	100	93	84	77	83	85	99
Sweden	85	88	100	102	97	89	93	111	125
U.S.	85	90	100	83	69	55	63	69	79

Source: *Industrial Statistics, 1900-57* (Paris, OEEC, 1958).

As a result of industrial activity decline, in 1933 approximately 25% (15 million) of Americans able to work were unemployed and average income of those who were still working fell with 43%. Regarding the banking sector, if in the years proceeding the crisis banks appeared with a rate of 4-5 per day, during the crisis have bankruptcy on average, two per day.

The current crisis may be similar to that in 1929-1933 in terms that this crisis was caused by excess venture of financial assets, particularly shares and real estate (let's not forget, sub-loans that have triggered economic crisis), assets whose price has risen completely out of control in the past 10 years and now, when their price is closer to normal values, we discover that the richness of the world decreased by 30,000 billion dollars. In addition, it is obvious that various governments and regulatory institutions have not kept pace with the times, and the existing legislative framework in some areas is completely overcome.

On the other hand these two crisis are different because now there is more wealth, the world economy situation is incomparably better than it was 80 years ago and governments have funds to fight against this crisis. The most pessimistic analysts point for 2009, year regarded as representing a crisis peak, a decrease of U.S. GDP of 3-4% while unemployment rate will not pass from 8-9%. If we compare these figures with those of 80 years ago and we will see neither why the situations are nor comparable if we talk in percentages. In absolute numbers, however, losses are much higher, given that in 1929-33, a decrease of the exchange by 80% led to losses of tens of billions of dollars while now, a decline of 40% of Dow Jones Industrial Average has led to losses of thousands of billions.

And if the current economic crisis began with the blockage of scholarship in America, the war with Iraq, followed by blockage in the real estate market, instability of the European currency euro, which in 2008 saw dramatic fluctuations, increasing unemployment and other implications other plans.

And Romania as in the case of crises there has begun to counter the crisis when it almost loom. What could rehabilitate Europe at this time? What is the origin and nature of the sources of instability in Europe?

A hawk-eyed about our current situation reveals that the sources of instability such as military, in Europe, are currently extremely low, almost non-existent, no state had an interest in confronting a gun in his hand.

Territorial claims, although they have disappeared completely - the case of former Yugoslav Federations - are heard more rarely, from groups with a strong extreme-nationalist character, what makes us say that there is a high degree of territorial stability, Poland, Czech Republic, Hungary, Slovakia, Romania cases.

An area requiring attention in the coming period is the economic-financial, economic imbalance - still existing between Western and Eastern Europe (in especially when states of the former sphere of influence of the USSR, among which Romania) - can become a source of instability that could lead to a crisis proportion in the EU. This should be encouraged that the eastern part of Europe out of the Cold War, characterized by a strong economic instability. Signs of economic weakness were felt on the line in Poland, Hungary, Romania and Bulgaria, when involved in the pre-accession, these countries have made significant economic delays, some up today, persisting in - Romania and Bulgaria.

Also is known the Europe's dependence of external energy resources, it is said here the state of instability can be generated by separate or combined action of agents whose nature may vary from bomb attacks to cyber attacks.

Oil prices in particular and energy in general are very sensitive, any possible conflict may generate an excessive increase in prices, the effect is triggering a crisis, major, if an energy system such as Europe, which is forced to import the much energy.

Economic evolution in Romania and the European Union Forecast of the Romanian Economy in crisis conditions

"Financial holds" a favorite phrase from the beginning of the decade past reappears. In 1995 the economy was blocked by huge amount of outstanding payment from not reorganized industrial colossi, which spread throughout the economy. Fifteen years later, the problem of forgotten arrears becomes again topical.

National Bank of Romania mentions in the situation report in January 2009 that have already occurred difficulties in collecting the value of production sold to companies in the chemical industry, construction materials industry, the extractive industry, means of technical computing industry, machinery, equipment and apparatus (percentages between 29 to 100%) and 25% of companies in the construction sector.

The government included in the anti crisis pan several measures that will contribute to streamlining the movement of money, such as compensation of value added tax. These measures are beneficial, but they may not be sufficient for the market at this time.

While the abrupt cooling of domestic demand will dampen import growth, the economic slowdown in Romania's main export markets is expected to allow only a gradual reduction of net external borrowing from just below 13% of GDP in 2008 to about 12% of GDP in 2009 and 11% of GDP in 2010, in spite of improved competitiveness.

In 2009, the general government deficit is set to increase to 7/% of GDP from an already high deficit of some 5/% of GDP in 2008. This reflects an unfunded increase in pension benefits and the full impact of the 2008 cuts in the social security contribution rate as well as the cost related to the second pension pillar. Public sector wage increases are assumed to remain high. Furthermore, tax revenues will be affected by the economic slowdown as well as various tax changes (e.g. removal of taxes on certain capital and interest gains, preferential tax treatment for R&D expenditure, reduced VAT for social housing).

The new government announced but not yet approved revision of the 2009 budget is not included in the forecast. The public deficit is projected to increase further to around 8% in 2010.

The higher deficits together with rapidly increasing yields on government debt will result in the debt-to-GDP ratio rising from 15/% to 26%% between 2008 and 2010.

Table no.2 Main features of country forecast – ROMANIA 2007 Annual percentage change

billion RON	Current prices	% GDP	92-04	2005	2006	2007	2008	2009*	2010*
GDP at previous year prices	412.8	100.0	1.6	4.2	7.9	6.2	7.8	1.8	2.5
Private consumption	277.8	67.3	3.5	10.1	12.7	11.6	8.0	1.9	2.9
Public consumption	64.3	15.6	1.8	3.8	-4.1	1.6	3.5	3.4	3.2
Gross fixed capital formation	125.6	30.4	6.5	15.3	19.9	29.0	18.1	1.4	3.0
of which : equipment	60.8	14.7	8.4	18.9	23.5	27.1	18.0	0.7	2.2
Exports (goods and services)	121.9	29.5	11.3	7.6	10.4	7.9	10.7	1.3	1.9
Imports (goods and services)	179.7	43.5	11.6	16.0	22.6	27.2	15.2	1.7	3.4
GNI at previous year prices (GDP deflator)	398.0	96.4	1.3	5.5	7.4	6.0	7.5	2.0	2.6
Contribution to GDP growth :	Domestic demand		4.7	10.9	12.9	15.7	11.4	2.2	3.3
	Stock building		-1.8	-2.3	1.4	0.1	-0.2	0.0	0.0
	Foreign balance		-1.0	-4.5	-6.3	-9.5	-3.5	-0.3	-0.9
Employment			-2.1	-1.5	0.7	0.4	1.1	0.0	0.5
Unemployment rate (a)			6.5	7.2	7.3	6.4	6.2	7.0	6.9
Compensation of employees/head			73.1	28.6	12.4	22.4	22.5	9.0	8.9
Unit labor costs whole economy			66.8	21.6	4.9	15.7	15.0	7.0	6.8
Real unit labor costs			-1.3	8.4	-5.1	2.6	1.3	-0.3	0.3

Savings rate of households (b)	-	-	-	-	-	-	-
GDP deflator	68.9	12.2	10.6	12.7	13.5	7.3	6.4
Harmonized index of consumer prices	-	9.1	6.6	4.9	7.9	5.7	4.0
Terms of trade of goods	2.3	12.2	12.7	10.3	6.1	1.4	2.2

(a) Eurostat definition.

(b) gross saving divided by gross disposable income.

(c) as a percentage of GDP.

Evolution of unemployment in Romania

In Romanian statistics, the number of unemployed is determined in two variants:

- ***Registered unemployed*** are persons who have declared that in the reference period were entered the offices of the labor force and unemployment, whether or not receiving the allowance support, unemployment or other forms of social protection.

- ***Unemployed B.I.M[8] in effect***. are persons 15 years and over who during the reference period while satisfying the following conditions:

1. Have no job and no activity in order to achieve revenue;

2. Are looking for a job, using the last 4 weeks in various ways to find: the registration of employment and unemployment agencies or private placement, arrange to start work on your own ads or publication responses to ads, calling on relatives, friends, trade unions etc.;

3. Are available to start work in the following 15 days, if you would immediately find an employment;

4. Are also included: Persons without jobs available to work, waiting to be recalled to or who have found a job and is to begin work on a later date the reference period;

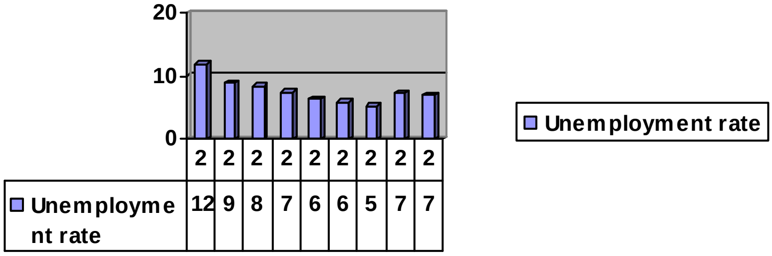
5. People who usually are part of the population of inactive (students, retired persons), but said they are looking for a job and are available to start working.

The relative values that the intensity of unemployment is one of the most key of macroeconomic indicators: the unemployment rate. This is determined by reporting total number of unemployed to active population and is expressed as a percentage. The rate of unemployment and development is one of indicators depending on who is taking some measures to protect social or economic policy decisions.

It is noted in the chart bellow that the unemployment rate has tended to increase from 2006 to 2008, while unemployment in the period 2000-2005 has been controlled in the sense of a decrease.

[8] International Labor Office

Figure no.1 Unemployment in Romania. Period 2000-2008:

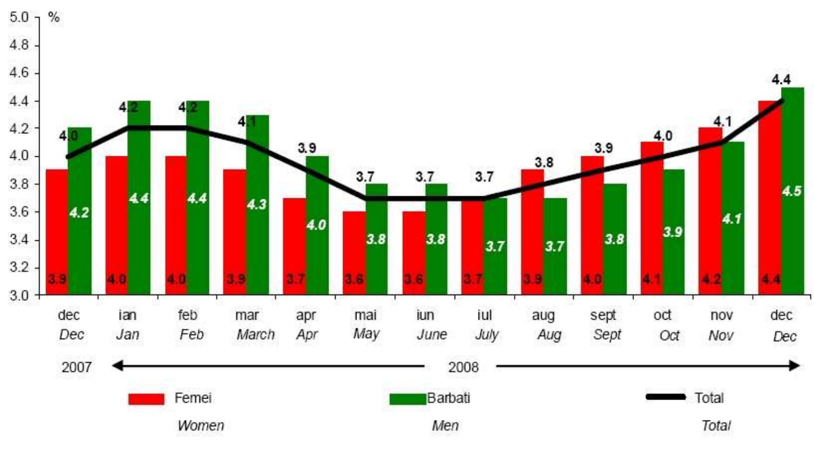


Source: The Annual Statistics of Romania

Unemployment rate recorded at the end of December 2008, at the national level was 4.4% higher than the 0.3 percent in December of 2007 and than in November 2008. The labor market in Romania was characterized by a constant rate throughout the year 2008 with a slight increase in December the annual average was 4.0%.

This shows again the direct link between socio-economic characteristics of each area and the development of unemployment, regional disparities that can be solved only in time, efforts and providing necessary resources.

Figure no.2 The unemployment rate in Romania, in 2008.



Source: The monthly statistic bulletin no.12/2008.

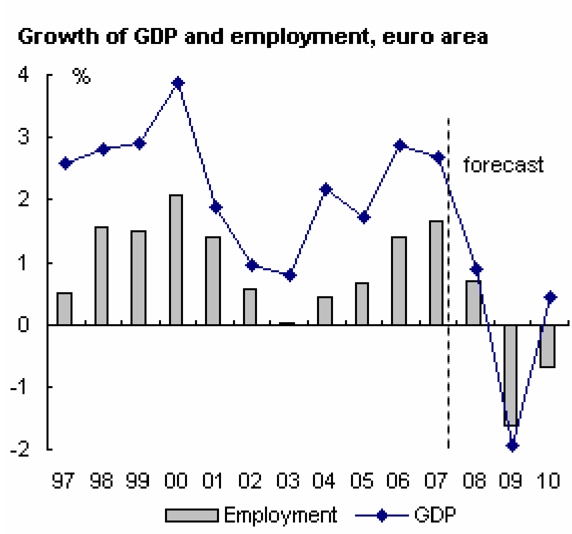
Evolution of unemployment in the European Union

According to Eurostat[9], unemployment in the euro area reached 7.2% in October compared to 7.3% in September. In the EU, the unemployment rate was in October, 7%, as in September, but 0.8% less than in 2006. The lowest

[9] Eurostat is the Statistical Commission of the European Union, the Romanian National Institute of Statistics of Romania.

unemployment rate in October was 2.9% in Denmark Netherlands and 3.15 and the highest in Slovakia was 11.2% and Poland 8.8%.

Figure no.3 Growth of GDP and employment in the Euro area



Source: www.europa.eu

The labor market situation started to worsen in most Member States in 2008. Reacting with a certain lag to changes in GDP growth, employment growth is expected to turn negative this year, with EU employment falling by 3½ million jobs. The unemployment rate is expected to increase to 8¾% in the EU in 2009 (and 9¼% in the euro area), with a further increase in 2010.

Evolution of GDP in Romania and the European Union

During the economic recession, a higher tax reduces aggregate demand and hence investment, leads to the redistribution of resources through occult parallel formal economy, and increases size of illegal economy. Rather, the stages of economic boom, the consumption is over, a tightening of fiscal measures is appropriate to reduce the phenomenon of "warming" of the economy and thus to circumscribe inflation in controllable limits.

With regard to the budget of Romania since 2009[10], article 2, paragraph (2) State budget income is set at the amount of 103,856.6 million lei, and expenses in the amount of 117,032.3 million lei, with a deficit of 13,175.7 million lei.

The state budget for 2008[11] shall be revenue amounting to 67,004.7 million lei, and expenses amounting to 78867.9 million lei, with a deficit of 11,863.2 million lei.

[10] LAW of the state budget for 2009, Chapter I General Provisions, published in the Official Monitor.
[11] LAW of the state budget for 2008, Chapter I General Provisions, published in the Official Monitor.

It notes that the current slump, revenues have almost doubled, while costs decrease by one third, to achieve the rationalization of public ban, the budget deficit increased very little.

Regarding the conditions of funding, currently Romania expects receiving loan from the International Monetary Fund, to begin unlocking the banking market, in this case the relaxation of loans, a resumption of lending activities, financing and restart economic activity overall.

Gross Domestic Product estimated for the quarter 2008[12] was 159,430.4 million RON current prices, up - in real terms - by 2.9% over the 2007 quarter.

Gross Domestic Product estimated for the first half of 2008[13] was 195,764.1 million lei, up 8.8% over the first half of 2007. In second quarter 2008 gross domestic product was 109019.1 million lei in current prices (GBP) growth in real terms by 9.3% over the same quarter of 2007.

Gross Domestic Product estimated for 2007[14] was 404708.8 million lei, up 6.0% over 2006. In IV quarter 2007 gross domestic product was 137768.5 million lei in current prices (GBP) growth in real terms by 6.6% over the same quarter in 2006.

Gross Domestic Product estimated for 2006[15] amounted to 342,418.0 million lei current prices (USD), increasing in real terms by 7.7% compared to 2005.

In IV quarter 2006, Gross Domestic Product was estimated at 112,475.7 million lei current prices (USD), with 7.7% higher than the same quarter of previous year.

The situation of public finances has been shown to be significantly better than expected in the autumn, because the average budget deficit fell from 2.3% of GDP in 2005 to 1.7% last year in the EU (from 2.4 % to 1.6% in the euro area), mainly due to higher revenue from taxes. This should have a positive impact throughout the forecasting period, showing a decrease in the deficit to 1.2% of GDP this year in the EU (1% in the euro area). It provides a further decrease for 2008 to 1.0% in EU and 0.8% in the euro area, the usual assumption on maintaining existing policies. It would be the lowest deficit since 2000 until now.

Despite this overall improvement, five Member States, including a country in the euro area, it still faced with a deficit exceeding 3% of GDP this year.

Forecast of the European Union Economy in crisis conditions

The economic and financial crisis represents a reality not only for Romania but for the whole world. Although it appeared in the United States, the crisis included the world economy, its effects being felt in different ways, for most states.

If until recently there were still opinions that supported the idea that national economies may evolve independently from each other, or that an imbalance in a domestic macroeconomic indicators in a country can remain isolated in that region,

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[12] PRESS RELEASE, No.41 of 4 March 2009, National Institute of Statistics.
[13] PRESS RELEASE No. 172 of 1 September 2008, National Institute of Statistics.
[14] PRESS RELEASE No. 44 of 4 March 2008, National Institute of Statistics.
[15] PRESS RELEASE No. 41 of 6 March 2007, National Institute of Statistics.

the current evolution of the international economic scene is the supreme counterargument for such an idea.

The European Commission had to adjust their forecast for spring to adapt to new trends and economic realities. As can be seen from Table no.3, the adjustments of macroeconomic indicators are more visible in the investments.

Table no.3 The evolution of macroeconomic indicators of EU during 2008-2010

Annual change (if is not specified otherwise)				Autumn forecast 2008			Differences from the spring forecast 2008	
	2005	2006	2007	2008	2009	2010	2008	2009
GDP	2,0	3,1	2,9	1,4	0,2	1,1	-0,6	-1,6
Private consumption	2,0	2,3	2,2	1,1	0,2	0,8	-0,5	-1,4
Public consumption	1,6	1,9	2,1	1,8	1,3	1,2	-0,1	-0,4
Total investments	3,6	6,1	5,4	1,2	-1,9	0,9	-1,6	-3,9
Employment	0,8	1,5	1,7	0,9	-0,5	0,1	0,1	-1,0
Unemployment rate	8,9	8,2	7,1	7,0	7,8	8,1	0,2	1,0
Inflation	2,3	2,3	2,4	3,9	2,4	2,2	0,3	0,0
Deficit (%GDP)	-2,4	-1,4	-0,9	-1,6	-2,3	-2,6	-0,4	-1,0
Public Debt (%GDP)	62,7	61,3	58,7	59,8	60,9	61,8	0,9	2,5
Current account deficit (%GDP)	-0,2	-0,8	-0,7	-0,9	-0,7	-0,6	-0,2	0,0

Source: Autumn forecast of the European Commission 2008, http://ec.europa.eu/economy_finance/publications/publication13290_en.pdf

As can be seen, forecasts are not too optimistic. For 2009, the Commission forecast a growth of 0.2% at EU level and an increase of 0.1% for the Euro area. Visible results are expected in the year 2010, when is estimated a GDP growth of 1.1% for the EU and 0.9% for the euro area.

Conclusions

It is clear that the financial system of the United States failed in two important directions: first, controlling risks and secondly, the allocation of capital. In regrettably way, many of the defective financial leverage in this system were exported / imported (for) to other states.

Given the current crisis, in my opinion, Romania will overcome this Regarding European Union, in many ways the current economic crisis is a severe test for it. There is no secret that until now the national interests prevailed in all essential matters, beginning with that of energy security. But despite this, rhetoric typical of

Brussels has managed so far to alleviate asperities moving tactically discussion in areas where septic joint positions are more easily obtained. It will be much more difficult now. Already due to political and economic pressures at home, governments of all member countries appear less willing to take into account the views of Brussels map.

So far the European Union authorities have officially recognized that the Euro zone fell into recession after the third quarter of 2008 was the second consecutive quarter of negative growth estimating that GDP will decrease more in 2009.

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THE LABOUR MARKET AND THE SOCIAL SECURITY SYSTEMS IN THE CONTEXT OF ECONOMIC CRISIS

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Motto**:** "The egoistic attitudes of the parts of a closed system bring about the system's destruction.*"(*Michael Laitman - Founder and president of the Bnei Baruch Kabbalah Education & Research Institute)

Abstract:

The globalization phenomenon and the creation of an economically and structurally strong Europe could not last forever. Knowing the economic phenomena' cyclicity, the following question arises: Which will be the starting point of a new global crisis? Identifying the causes and culprits upon which the international committees and economic and political analysts focus on, we briefly deal with them in this article, because it is essential to concentrate on the measures and the crisis impact over social security.

The goal of this article is to illustrate the crisis impact over the social security and labour market fields, the measures took in this field in Europe, around the world and in Romania. We bring in a synoptic table of the causes, effects, measures taken and incurring tendencies. The labour market's issues and the Social Security System's difficulties can be solved by vigorous measures, of which the authors recommend the ones resulting from the comparative study realized on a group of European countries and from Romania's economic tendencies.

How will the new economy look like, which will the new world leaders be, these do not matter for the small and vulnerable economies. We conclude that intelligence and professional qualification should outrun over the measureless accumulation of wealth and properties, which in our opinion means that a global economic crisis has its purpose and that it was predictable.

Keywords: Social security, labour market, economic crisis, unemployment

JEL Classification: J45, J01, J65, J64, H83

Introduction

The global economic crisis scenario of 1929-1933 seems to repeat itself nowadays. The global economic crisis unleashed in the 25th of October 1929 in USA began because of the massive offer of 19 million titles, while the crash of New York's stock exchange has led to collapses of the exchange rates and to dramatic decreases of the goods' prices.

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The crisis became global, and two years later other European countries were lured into the crisis' whirlpool. What we know is that the great economic depression ceased in different moments for the world's countries. Programs of reconstructions were conceived in most countries and most of them went over different politic changes.

Vigorous measures were necessary for surpassing the crisis.

Starting with 2008, the global economy already registered a dramatic and sudden decrease. This phenomenon became the theme of peculiar interest for analysts, politicians, competent institutions and ordinary people. Everyone tries to discover the starting causes of the global crisis, to search for explanations and find the optimal solutions for fighting against its effects.

The Central American bank's president, Ben Bernanke, recommends out-of-ordinary measures and the economic agents' evolution's control, so that we won't assist to a Brownian movement of economic agents' collapse.

To maintain the national economy, the economic agents' overseeing is very important. The conjunctural investigations carried by INSSE of Romania, which are based on the estimations of enterprises' managers, show that the economic decrease will also continue in the third semester in the sectors of processing industry, constructions, retail commerce and services.

At the same time with the economic decline of the economic agents, the social negative effects are emphasizing realities which must be counteracted by vigorous measures. In our opinion, it is important to oversee the economic agents, but also the families', households' and peoples' incomes.

If we refer to the cyclic character of crisis and to the similarity between today's crisis with the one from 1929-1933, we notice that while USA prepares itself to surpass the crisis by using investment stimulants launched into the economy, Romania still advances to the maximum point of the descending phase.

Causes and explanations

If we would keep the global economic crisis' scenario of 1929-1933, we should agree with the general opinion that the banks are guilty of the crisis' taking place, and its starting is voluntary, on purpose. The banks are guilty of giving loans beyond the real power of repayment of the loan-takers. The immovable credit organisms are added to the banks, it is shown into a report published by Center of Public Integrity, American organization of investigation journalism. The report says that American and European banks are guilty of deliberately producing this crisis, but also the 25 immovable credit organisms that find themselves to the crisis' origin.

„Mega-Banks" „have facilitated the loans' financing which now threaten the financial system", Buzenberg added (Valentin Vioreanu, 2009).

Professors Chow Fah Yee and Eu Chye Tan show that „the current financial meltdown that swept across the globe jolt to memory the importance of a sound and efficient banking system" (Chow Fah Yee, Eu Chye Tan, 2009). In a global economy, „managing financial instability and shocks" is very important (Akyuz Y., 2004)

We consider that the banking system's liberalization, but also the fluent giving of loans, led to an increase of the obligations rate of the agents and population beyond the real power of loans and interest' repayment. This corresponds to the dispossession of investment sources and work capital of the economic agents, but also the financial resources of subsistence of the population.

Attracting in the loan game people and agents with no real capacity of repayment was encouraged by the strategy, in accordance to which the profits are realized only in risk cases and only with others' money, which is loans.

We witness to a policy of finding the crisis' culprits and to a crisis' investigation by setting up global-level Commissions. In fact, there is a defocusing to the crisis' essence, which is to administrate the economic and social effects and to find solutions of surpassing more rapidly the crisis than other countries. Considering that the crisis' overcoming does not depend on the national strategy is in fact the desertion of the economic agents and the population to hazard's way.

Another cause identified by economic analysts is lending the poor – the so-called sub-prime credits – following USA government's older policy of increasing the number of landlords. An expansion of residential construction took place, but also an increase of non-achievement loans' rate. Repeating the population's lending for houses in nowadays Romania is an invitation to the poverty deepening by contracting new credits.

The attitude towards the banking system should be well-balanced. Romanian analyst, Liviu Voinea, appreciate that maintaining the banking system is very important, and the banks will not repatriate their capital also because of the convention signing in Vienna, of the mother-banks, which clearly states that they have agreed to keep the financing lines towards Romania's branches (Adrian Panaie, 2009). The capitals' repatriation would mean losing the profits in Romania, which were registered since the beginning of the year, although decreasing against the year before.

Understanding the state of things, but also accurately understanding the past and concentrating on strategies is the solution of administrating the social effects and diminishing them by equitable allocation. (Bogdan Glavan, 2009).

The crisis impact on the social field

A phenomenon of such scope has implications upon the entire specter of arrays, fields of life, from financial-banking, economic, industrial etc., to the social, personal ones. It is an imminent chain of weaknesses.

Socially speaking, major implications may be found also in the field of labour force employment and migration.

Thus, at European level, the number of unemployed workers rose by 3 millions in February 2009, if compared to the same period of the previous year. Spain registered the highest rate of unemployment: 17%. Experts forecast a total rate of unemployment in the Euro-Zone of over 10%.

- **At European level:**

In Austria the economic crisis has led to an unemployment increase of 28.8% if compared to last year. Therefore, a record budget of about 1 billion Euros has been allocated. Focus will be on programs for young people and on professional qualification and further training. 35 million Euros are annually allocated to increase the SPO capital for the unemployed professional formation (especially women qualification). Also, subsidies are used to temporary reduce the working time, combined with the possibility of professional qualifying. Other measures are still debated on, such as: raising the unemployed indemnity, reforming the allocations scheme for the old, granting a partial holiday for studies/professional improvement.

In Belgium the accent falls on the temporary unemployed persons' formation, measure which cancels or postpones the economic-based dismissals. The measures adopted by the Chamber of Representatives aim at the reduction of work performing and at the avoidance of dismissals in this period. The measures are grouped as follows:

1. Temporary adjustment of the working time – the collective reduction of the working time for the enterprise's employees or for a specific category of workers.

2. The adjustment of work volume by individually and temporary reduction of working performances, by temporary and collective regime of total or partial abeyance of executing a work contract, or of part-time regime for a specific number of employees.

Also, the worker that became unemployed because of the enterprise's bankruptcy, abolition or closing, will benefit of the restructuring receipt's advantages. The employer, who recruits this person, in the validity period of the receipt, benefits from a temporary reduction of paying dues. Also, for 3 quarters, the employee profits by the reduction of personal social security contributions.

In Bosnia and Herzegovina the crisis especially affected the field of constructions, auto parts, metal processing, where dismissals have been announced. The unemployment rate has reached 40.1% (recorded unemployment) and 24.4% (BIM unemployment). From SPO perspective, the funds allocated for compensations rose, but the ones for active measures lowered, new programs of assisting the ones that lost their job being necessary, including co financing programs of independent occupation.

Bulgaria raised the capital spending by 20%, up to 5.6 billion leva (3.66 bill. $), supporting projects of infrastructure, repairing public buildings and also health and education.

In the field of Public Services of Occupation (PSO), Bulgaria has adopted a national program („*New employment opportunities”)*, which has as objective fighting against unemployment and assuring a new workplace for the dismissed persons. To implement this program, 4 million Euros have allocated in 2009, subsidizing the occupation of about 3000 people. The measure of compensating the transition from a full-time to a part-time job, an employee may receive about 60 Euros/month for 3 months at the most.

The Czech Republic doubled the economy stimulating package's value up to 73 billion CZK (3.3 billion $), which represents 1.9% of the GDP.

In Croatia the number of unemployed rose by 4.6% in March 2009 if compared to the previous months. A new law was adopted, regulating the allocation of unemployment subsidy, its value being of 70% of the previous salary in the first 3 months and 50% afterwards. The people with more than 32 years work experience have the right to receive unemployment subsidy up to retirement, but after the first year they receive 40% of the previous year, in Romania this measure being comparable to the retirement for reaching the age limit.

France presented a package of economic stimulus in value of 26 billion Euros, equivalent to 1.3% of the GDP. The minister of economy stated that these stimuli will lead to the creation of 80.000-110.000 jobs, counteracting the loss of 90.000 workplaces due to the crisis.

In the field of PSO, measures with immediate action were announced for the vulnerable categories, especially the youth.

➢ Measures for the young people:

- formation of unskilled young people;
- developing alternative formulas, which should accompany the occupation and formation and which proved to be efficient (especially the professionalization contract);
- supporting the youth by a supply of specific services of French PSO, adapted to them, and by strengthening local level actions;

➢ The control of public assistance given to the enterprises.

In the enterprises with at least 50 employees, the direct public assistance (State, territorial collectivities, EU) will be the object of a report and consultation of the enterprise's employees committee, right after their granting.

➢ Creating a social fund for investments.

This will be created for coordinating the efforts of professional occupation and formation, by attracting different sources of financing of the State and social partners. Its role is to ensure the coherence of financiers' interventions, to follow the action programs, to propose adjustments and to ensure evaluation.

➢ Instructions which will be applied after debates between State and social partners or after the negotiation between unions and employers.

A crisis and applied social-economic policies' evaluation committee will be created. Also, to support the occupation in the economic context, the Government has adopted, in consent with the social partners, 3 measures aiming at:

- raising the part-time activity indemnity up to 90% of the net salary, by conventions between State and branches or enterprises: improving the conditions for using part-time activity, emphasizing the professional formation in the case of part-time activity;
- a premium of 500 Euros for disadvantaged employees (the ones with determined period contracts or the ones employed by a temporary work agent);

- a flat premium of 500 Euros will be received by the persons joining the search for a workplace, starting with the 1st of April 2009 and for the ones that worked between 2 to 4 months.

In Germany, the upper chamber of the German parliament approved a package of economic stimulus valuing 50 billion Euros, which includes infrastructure investments and tax reductions. Previously, the authorities have approved a measures-plan in value of 31 billion Euros, whose goal is to generate investments of 50 billion Euros and to enable the settlement of new contracts for the economy.

In the field of PSO, the creation of 5000 additional workplaces has been planned for the placement agencies (Occupation Treaty).

At present, the total number of unemployed persons being paid by the Federal Agency for Work is 3.642 millions. The Institute for International Economy Studies of Hamburg appreciates that, by mid-2010, 4.251 million unemployed will be in Germany.

The immediate consequences of these negative evolutions are a new wave of restrictions on the access of foreign workers and a more rigorous control of the underground work, taking some strict measures against the ones that use these modalities.

In Great Britain, in the field of PSO, the Jobcentre Plus budget was supplemented with 1.3 billion £, for offering support to the unemployed persons.

In Netherlands, in order to prevent unemployment, PSO created 20 mobile centers, for supporting the people threatened by unemployment, by mediation of another workplace (transfer, temporary workplaces).

At the end of 2008, the unemployment rate in Serbia was 14.7%. Among the active measures financed by the budget, there are: the apprenticeship program, public works, subsidies for the creation of new workplaces, for developing businesses etc. It is also in plan the implementation of some projects to lessen the crisis effects over the labour market, financed by EU or UNO.

The number of recorded unemployed in Slovenia in March 2009 was 80,000 persons. There was also a decrease in the supply of workplaces. For supporting the ones affected, PSO created mobile units of intervention. The State has allocated funds for unemployment indemnities, programs of active measures and for the partial subsidies of reducing the time of work.

In Hungary, the Government raised the VAT to increase the revenues, with the purpose of reducing the tax on revenue. In November, Hungary announced a plan of 1.400 billion Forints (6.9 billion $), which spreads over two years, for promoting economic growth, but which does not include supplementary expenditures from the budget.

In the field of PSO, the Parliament adopted the first anti-crisis measures. The main elements aim at reducing the budgetary expenditures by:

- canceling the 13th pension;
- gradual increase of retirement age from 62 up to 65 years;
- deleting the 13th salary for 2009;

- reducing the temporary incapacity of work's indemnity from 70% down to 60%;

- raising the VAT from 20 up to 25%.

To lessen the economic crisis effects, respectively for maintaining the workplaces, the authorities have allocated the amount of 260 million Euros for 2009. The allocation for maintaining the workplaces given by the Occupation Agency is nonrefundable, being meant to the employers that intend to reduce the number of employees. This allocation is given for 1 year at the most, and its value is comprised between 25% and 27% of the net salary or between 50% and 90% in the case of minimum-wage employed persons, the ones with disabilities or the ones employed for 4-6 hours/day.

Italy has adopted a package of measures through which households and enterprises affected by the crisis would be helped. Prime-minister Silvio Berlusconi stated that the measures go up to 80 billion Euros, but economists specified that the majority of measures use already-existing funds.

The measures stipulated for households and enterprises are:

- Bonus granted to families (bonus included in 200-1000 Euros granted to families, subordinated workers and pensioners that achieved annual revenue comprised between 15.000 and 22.000 Euros). 2.4 billion Euros were allocated. The petitions for obtaining the bonus could be handed in early since the first months of 2009. Family allocations**:** the resources level was raised for the family allocations, which are given to the autonomous workers. The likely savings from the 350 millions assigned to supporting the variable interest loans' beneficiaries will be distributed to family allocations. A decree will assign the allocations' sums in accordance with the levels of revenue.

- Social dampers: 1.2 billion were allocated. The social fund for occupational and formation resources could be utilized to support the revenues, but the unified conference's consensus and EU accord will be needed to begin with. The supporting measures are enlarged also over the workers that were excluded up to present (for ex. unspecific workers whose last year from all years' revenue was acknowledged). Regarding the mobility, the allocation's quantum cannot vary because of the latitude, but the financing may be changed because of the region.

Great Britain will spend 500 million £ (754 million $) fighting against unemployment, which will help the companies by 2.500 £ for every new employed working at the respective firm for more than 6 months. This is part of a wider plan of fighting against the crisis effects, it has a value of 20 billion £, which include tax reductions and capital spending valuing 3 billion Euros. Also, the VAT will be lowered from its present value of 17.5% down to 15%.

Norway presented a package of fiscal stimulus in value of 20 billion NOK (2.87 billion $), of which 16.6 billion NOK will represent extra budgetary expenditures and 3.3 billion will be used for tax dispensations.

Portugal announced in December a package of about 2.2 billion Euros for increasing the GDP with 0,7 percentage points in 2009. This package will centre upon investments in schools, technology and alternative energy development.

Slovakia approved a package of economic stimuli valuing 332 million Euros. The measures include partial and temporary reduction of the tax on revenues, subsidies to create new workplaces and raising the nontaxable revenue.

Slovenia expected the package of stimuli for the economy to rise up to 800 million Euros or to 2% of the GDP. This package gives subsidies for companies that reduced working hours following the demand decrease. Also, fiscal stimulants were raised.

Spain announced different measures for buffing the impact of economic drop and the unemployment raise, of which there is a package of stimulus in value of 38 billion Euros. This includes tax reductions valuing 6 billion Euros and 4 billion Euros for relaunching the lending. The Government announced that it will spend other 11 billion Euros for public works.

In the field of PSO, the plan of fighting against the crisis includes measures of orientation, professional formation, and shim on the labour market.

In March 2009, the Council of Ministers has adopted new measures for reactivating the economy, protecting the unemployed persons and creating new workplaces:

- the enterprises that will employ unemployed persons will receive a 100% allowance considering the payment of social security rates, by receiving the quanta that should be obtained by the workers in the moment of settling the contract;

- if they will hire workers affected by collective temporary abeyance of the work contracts, the firms will receive a 50% allowance;

- the firms that cannot handle the payments to the social security system have the possibility of fractionizing or delaying them, in the case they manage to maintain the existing workplaces this way.

In order to persuade foreign workers to go back home and protect the domestic labour market, Spain is willing to pay in advance 40% of the unemployment help if the foreigners go back home and another 60% from one month pay after the workers reached their country of origin.

The European Committee proposed on the 26th of November 2008 a package of fiscal stimulus amounting to 200 billion Euros or 1.5% of EU's GDP.

- At global level:

The World Bank Group (WBG) and the International Monetary Fund (IMF) have also adopted a series of measures.

The crisis lead 50 million persons to extreme poverty, and WBG and IMF have taken a series of decisions for acquitting their assumed commitments.

In the Washington assembly, WBG and IMF showed clearly their support for the measures already taken and the initiatives fighting against the crisis effects. Thus, for protecting the poorest debtors, IFC, the investigation division of WBG, created the facility of increasing the micro financing.

With a view to support infrastructure development and creation of new jobs, WBG launched the Infrastructure Recovery and Assets Platform program, through which WBG will lend 15 billion USD annually.

At the middle of next year, in 2010, these special effects will tend to expire, suited to the experts, and the structural crisis will strongly act again. The dramatic obliging of many states and private individuals from the USA and parts of Europe would manifest at a level of economic conjuncture and would weigh on the actions' parameters. Vorndran expects a long phase of weak economic growth, the same with smash of Japan's "bula", at the beginning of the '90s (Marinela Gheorghe, 2009).

There, the market prices never reached since the maximums before, and the market crawls for almost 2 decades, interrupted by short periods of ascensions and quick collapse. The comparison is suited because there are similar causes. In Japan too, the cause was the super estimated immovable market's collapse, and the crisis has affected mostly the banks. There are important differences regarding Japan. Their government needed many years to clean the banks, meantime the crisis affected the entire economy, and the country became prisoner of a deflation which it did not surpass so far.

On the contrary, the governments reacted quickly now and do everything to avoid a deflation. This aspect differentiates the present crisis from the great depression of the '30s. This time, the governments collabourate at international level and support the economy with billions of dollars, Euros or yuans.

Besides all these, there is now another factor, Stefan Schilbe, head-economist of HSBC Trinkaus, declared that "he puts certain hopes in China (Marinela Gheorghe, 2009).

The State coerced the banks there to massively extend giving credits, and the government stimulated investments of vast proportions. Because of this, Schilber expects a 7.8% growth in China this year, considering that the Peoples Republic, although it cannot save the world economy this way, has a pegging effect upon it. But even if we are not threatened by a depression like the Japanese one of the 1930s, we could expect a future collapse of the Exchange, as in 2002. Then, the market prices revived after the 11th of September 2001, followed by new and more frequent collapses, which last 12 months.

Schilber still considers a possible rebound – the return to Dax values of 4100 or 4200 points, the expert considering that better entry possibilities on the market would exist, when Dax registers 5000 points. In any case, he does not believe the old minimum values from the beginning of March, of about 3650 Dax points, will be again surpassed beneath. This would be a clear difference against the course's evolution in 2002/2003.

There is still something showing that the worst part has gone, even in the case the stock exchange would suffer rebounds. Slowly, says Vorndran, the investment alternatives purely shorten. For the monetary market deposits there are no miniinterests, the State obligations are overestimated, the companies' obligations already rolled, and the gold price remains steady. Who wants some profit, that one has only the stocks alternative.

✍ In Romania:

Ahead of a crisis announced since the beginning of 2008, the macroeconomic indicators of Romania have suffered serious depreciations.

In Romania, in the field of PSO, three general priorities have been established:

•The assurance of maintaining the existing workplaces;

•The assurance of (re)integration into the labour market;

•The support of vulnerable groups (persons employed on short length contracts, dismissed workers, the old, the youth)

Although the crisis was announced early at the beginning of 2008, Romania remained vulnerable and unprepared as far as taking measures, so Romania's macroeconomic indicators have suffered serious depreciations in 2009.

Concrete measures taken by the Government so far:

• Social measures for the persons affected by the economic crisis – Normative act (OUG 28/2009) which specifies prolonging by 3 months the period of granting the unemployment indemnity, dispensation from the payment of social insurances' contributions both for employers, but also for the employees which benefit by the indemnity of minimum 75% of the base salary corresponding to the occupied workplace – on the temporary interruption's length of the employer's activity, for a period of maximum 3 months. Concomitantly, this indemnity of 75% shall not be included into the wage revenues and it is not taxable, for a period of 3 months at most in 2009.

• Adopting a memorandum regarding the reduction of the number of taxes and tariffs

• Constituting the Counter-Warrant Romanian Fund – The Counter-Warrant Romanian Fund was created as a specialized financial institution, whose unique object of activity is to counter-warrant the guarantees given by the warrant funds, judicial Romanian persons, for credits and other financing instruments obtained by the SMEs from the commercial banks and other sources. Through this Fund, in value of 100 million Euros, the maintenance and creation of new workplaces is followed.

• Introducing the minimum guaranteed social pension – Starting the 1st of April 2009, the minimum social pension will be 300 Lei and will be followed by a rise up to 350 Lei, beginning with October 2009.

Regarding the measures imposed at the labour market level and the public services of occupation, the following objectives are a first priority:

•Improving the exploration of the labour market dynamics (dismissals performed against the existing vacant workplaces, regional tendencies, vulnerable groups);

Improving the occupation services' capacities of providing services (the service of an additional inflow of persons searching for a workplace, the appearance of new profiles for the persons searching for a workplace, the creation of services that would ensure a quick and efficient reaction, adjusting the necessary resources);

• Adjusting the services' supply (realizing investments in human capital, the contribution to the creation of workplaces synergic to the companies, realizing partnerships with other factors of decision on the labour market);

• Realizing a correspondence between the objectives and the strategies pursued by policies and clients' needs.

The crisis needs commune, not apportioned, commitments for solving the longer-run challenges. It is necessary to tackle with the unemployment by investments in human resources and for the most vulnerable groups. These groups (poorly qualified, dismissed workers, workers in precarious conditions of occupation, young and old people, persons with disabilities and minorities) risk to the be the most affected by the economic decrease and the EU labour market segmentation. The migrant workers come close to these disadvantaged categories, as they are not monitored and their countries of origin do not make any investments in their social protection.

Labour institutions must focus on modernizing the labour markets and have quick, flexible and coordinated reactions.

Tendencies in the field of Romania's labour force occupation

From data communicated in July 2009 and resulted from the conjuncture investigation of INSSE Romania, a sudden decrease is estimated in the following industrial branches: metallurgy; other industrial activities; engineering, production of equipment and apparel (conjuncture balance accounts -63%, -44% and, respectively, -43%). The managers will try to maintain the number of employees, the employees' rhythm of dismissing will be slower than the decrease in the production volume, the conjunctural balance account being of -22% on total processing industry (-30% for very large enterprises, with 500 employees and over), while the employees' period of maintaining into activity is prolonged by the effect of prices' relative stability (conjunctural balance account 1%).

Constructions will be framed into the moderate decrease of the production volume (conjunctural balance account -11%), as well as the stock of contracts and orders (conjunctural balance account -15%), but it is estimated a more emphasized decrease of the number of employees both totally (conjunctural balance account – 20%), but also on groups of enterprises by size, in conditions of the prices' relative stability (conjunctural balance account +2%).

Services will be situated in the third place considering the decline**,** the conjunctural balance account being estimated at -8%. The services staff's dismissing are maintaining at the level of moderate decrease in the number of employees (conjunctural balance account -15%), especially by the very large enterprises. The services will maintain the prices' stability (conjunctural balance account +1%).

Of all the branches of Romania's economy, commerce is situated on a relatively good position, and for fighting against the decrease in sales' consumption we assist to a policy of price gradual increase (conjunctural balance account +11%).

The active population registered at the same date was 4590 thousand persons. The number of unemployed with indemnities at the middle of 2009 amounted to 266.477 persons. To these, there can be added a number of 260.326 unemployed persons without indemnities.

The tendencies resulted from the conjunctural investigations and the compression already existing of Romania's economy will make harder and harder the resources' accumulation for maintaining the social insurance system, the unemployment funds and the funds assigned to the social assistance and public health.

Conclusions

To interrupt the economic decline, the majority of the world's countries have undertaken as first measure stirring the national economy by investment stimuli.

The packages of measures included the economic agents' monitoring and supporting them by reducing costs for maintaining the workplaces and attracting funds by indirect taxes (VAT) and consumption taxes (for activities and luxury products).

The labour market is strongly monitored. Maintaining workplaces, supporting the dismissed people and monitoring the families for assuring the subsistence means are the prevailing measures in Europe. Fighting against unemployment and professional formation is supported by the programs.

The social insurance systems found in great difficulties, reformed in the last 4-5 years and because of the negative effects of the 3 factors of influence (population aging, labour force migration and employment rate decrease), are strongly affected in the context of crisis. Because of the unemployment increase, the ratio contributor-beneficiary decreases implicitly, and the social insurances systems' accumulations diminish.

We conclude that monitoring should comprise two priorities: the economic agents and the families.

Raising the social contributions in the context of tax increasing for small economic agents that manifests in Romania will lead to a directional destruction of the small entrepreneurs.

The number of dismissed employees from these small enterprises alongside the small bankrupted private entrepreneurs will increase the country's financial effort to support the social field.

Romania's priority to assure the budgetary salaries and pensions is a wrong vision.

In our opinion, the priority is to maintain the economic agents, who were not asking anything from the State, but also paid what they had to as contributions and taxes, contributing to the maintenance of their own employees and offering sources of revenue for other workplaces.

The legislative rigidity is not suited anymore to this period of crisis. The European and world countries' measures compete in ideas and effects, Europe conceiving "mobile cells" and focusing on the family and dismissed or disadvantaged persons.

Romania must focus on fighting against "young" unemployment and on employing the superior education's graduates. Otherwise, the future labour force will constitute a cheap supply for the countries importing superior and free qualified labour force, in the context of the limitations on the labour market.

In our opinion, the act of donating the Romanian intelligence must cease through measures aiming at encouraging the youth to establish their own businesses and attracting them to develop their ideas.

Whenever the technological potential of a country is low, the human potential must counteract the adverse factor of production, because economic growth is achieved by the simultaneous actions of the two factors: technical and human.

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LEU VERSUS EURO IN THE LIGHT OF ROMANIA JOINING E.M.U. AND THE GLOBAL FINANCIAL CRISIS

Iulia Andreea Bucur[*]

Abstract:

The european single currency has marked and will continue to mark significant changes for all european countries, including those who are not yet included in the euro area, but which apply to European economic and monetary integration. The status of member state of the European Union from the 1st of January 2007 supposes that Romania will align the Economic and Monetary Union's requirments in the frame of assuming the adopting of the european single currency in time horizon 2014. The present paper aims to offer an overview of the euro/romanian leu exchange rate evolution having as departure point Romania's adhesion moment to European Union, the 1st of January 2007, outlining the main factors of influence that have led the trend of appreciation or depreciation of the national currency against european single currency under the economic and financial crisis. In the frame of the current international crisis Romania's adhesion to the Economic and Monetary Union (EMU) in 2014 might be affected, resulting in increased effort it involves the performance criteria for nominal convergence.

Keywords: european single currency, Economic and Monetary Union, euro/leu exchange rate, global financial crisis

JEL Classification: E4, E44, F31, F33

Introduction

The appearance of the european single currency in 1999 is clearly the most important financial event since the International Financial System, whose consequences continue to be commented, observed and expected. Monetary integration and the implications of the single currency have resulted in the exponential growth of discussions on this theme, the approaches on the concept of Economic and Monetary Union (EMU) and the single currency have developed explosive, both in the international and national literature. Adopting a single currency led to an economic system which has proved to be a successful one in which increasingly many countries wish to join, including Romania. Romania's EU accession on the 1st of January 2007, led to the primary place of the dollar to be made by the euro. National Bank of Romania (NBR) has passed from a policy focused on US dollars exchange rate to a policy in which a significant share returns to the european single currency.

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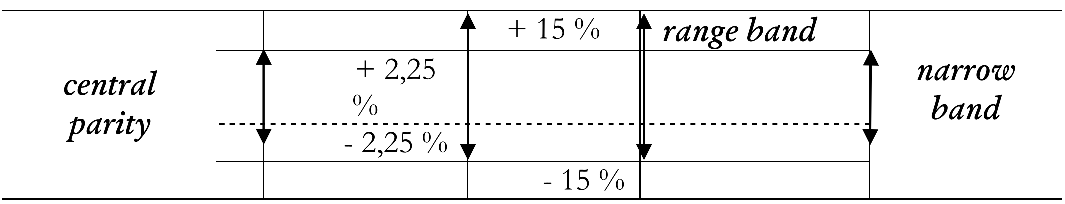
Issues on stability rate as applied criterion for accession to E.M.U.

Legal basis of the european single currency, the Maastricht Treaty (developed on the 9^{th}-10^{th} of December 1991, signed on 9^{th} of February 1992 and entered into force on the 1^{st} of November 1993) provides that, in order to access to Economic and Monetary Union (EMU), national economies must be prepared to face all its requirements, this training follow to be appreciated using the convergence criteria which were the main areas of national economic policy, namely: fiscal policy, monetary policy and exchange policy.

The convergence criteria for participation in Economic and Monetary Union means the economic test for assessing the country state of preparation to participate in the third stage of Economic and Monetary Union. One of the criteria established by the Maastricht Treaty refers to the *stability of the exchange rate*. The exchange rate must remain within the margins of fluctuation in the exchange rate mechanism (ERM II) for a period of at least 2 years without severe tensions, especially without a deal on its own initiative to devaluing the national currency against the euro. The new exchange rate mechanism (ERM II) replaced the ERM in January 1999 and aims to fix currencies of the Member States which are not part of the euro area by establishing, by common consent, a central rate, fixed but adjustable front euro and a standard fluctuation band of ±15%. A band narrowest bandwidth can be established by agreement, as is making progress in terms of convergence. The "reception entry" in the euro area mechanism ERM II (Exchange Rate Mechanism II) is characterized by a central parity, around which there exist a "narrow" band (±2,25%) and a "range" band (±15%). [Lazea, (2003)]



Central parity of the national currency against the euro once fixed (at the beginning of the 2 years be spent in ERM II), it may not consider or be depreciated in nominal terms beyond the band edges.

Provisions of the Maastricht Treaty on the evolution of the exchange rate include: Article 121 (1) third indent as follows: *"respect the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years without devaluing the currency to that of another Member State"*, and Article 3 of the Protocol on the convergence criteria mentioned in Article 121 (1) of the Treaty states: *"the criterion for participation in the exchange rate mechanism of the European Monetary System referred to in Article 121 (1) third indent of the Treaty, means that a Member State has respected the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System without severe tensions for at least the last two years before the* *examination. In particular, the State has not devalued its own initiative, the bilateral central exchange of its currency against the currency of another Member State the same period".*

The Treaty refers to the criterion for participation in the mechanism of the European Rate Mechanism (ERM until December 1998, replaced by ERM II from January 1999).

First, the European Central Bank (ECB) consider whether the state has participated in ERM II "for at least two years before the time of examination" as specified in the Treaty.

Secondly, as regards the definition of the "normal fluctuation margins", the European Central Bank (ECB) refers to the official opinion formulated by the Council of European Monetary Institute Council in October 1994 and the declaration published in November 1995 Report entitled "Progress towards convergence". Opinion formulated by the Council of European Monetary Institute in October 1994 stipulated that "the fluctuation range band contributed to a greater degree of stability of exchange rates within the ERM", that "in view of the Council of the European Monetary Institute, it is recommended the maintenance of currently agreements" and that "member states should avoid further exchange rate fluctuations by targeting their policies to ensure price stability and reducing budget deficits, thereby contributing to meeting the requirements contained in Article 121 (1) of the Treaty and relating Protocol".

In November 1995 report entitled "Progress towards convergence", the European Monetary Institute has recognized that "when drafting the treaty, the "normal fluctuation margins" were at ±2,25% around the bilateral central parities, while a fluctuation band of ±6% represent a derogation from the rules. In August 1993, it was decided to widen the fluctuation band to ±15%, and interpretation criteria, particularly the concept of "normal fluctuation margins" has become less clear". At that time was also proposed to be taken the "great evolution of the exchange rates of the European Monetary System (EMS) since 1993" in carrying out an ex post analysis. In this context, when it considers the evolution of the exchange rate is near the emphasis on exchange rates of central parities in the ERM II.

Thirdly, the issue of a "severe tensions" is generally approached by examinating the exchange rates degree of deviation from central parities in the ERM II to the euro. This can be done using indicators such as short-term interest rates diferential versus the euro area and their evolution, and taking into account the foreign exchange market interventions.

Exchange rate regime of Romania's national currency

Under Article 2 of Law no.312/2004 status NBR, one of the main tasks of the National Bank of Romania is the development and implementation of monetary policy and the policy rate.

Exchange rate means the price of a monetary unit expressed in another currency, price, reflecting the economic factors, political, social and institutional, internal and external assessments which may cause different rates of other currencies.

The exchange rate is the price of a currency against another currency, its balance on the open market is established, mainly based on supply and demand for currency, which in turn are influenced by the global market size of investment, trade, speculative, experts in arbitration and other rate [Ignat, (2006)].

The *exchange rate regime* is the way a country manages its currency in respect to foreign currencies and the foreign exchange market. It is closely related to monetary policy and the two are generally dependent on many of the same factors. Floating rates are the most common exchange rate regime today.

The current exchange rate of the flotation is controlled (managed), which is consistent with the use of inflation targets as a nominal anchor of monetary policy and allowing a flexible response of this policy to unexpected shocks that can affect the economy. Therefore, flotation (change) the course is not left entirely up to the market, the National Bank may intervene, but clearly very rare.

The influence factors and trends of the euro/leu exchange rate evolution after Romania's adhesion to the European Union

According to the NBR Report of inflation in February 2007, the exchange rate continues to fall and the downward trajectory before the moment of Romania's accession to the European Union, national currency amplifying substantially appreciation gained against the single currency *(Figure 1)*.

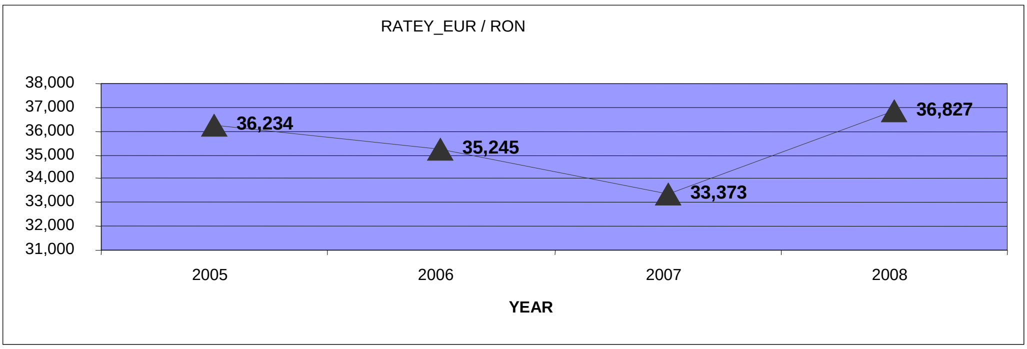


Figure 1. *Evolution of annual average exchange rates EUR / RON*

Starting the 1st of January 2007 – date of accession to the EU – until the 18th of April 2008, the Romanian leu did not participate in ERM II, but was traded in a flexible regime of exchange rate. In the reference period 19th of April 2006 – 18th of April 2008, the Romanian leu has been subject to pressures of depreciation by mid July 2006. Subsequently, it has appreciated significantly to the euro.

Strengthening of the national currency has been possible mainly due to different categories of speculative capital entries, caused by favorable conditions of the internal market and the anticipation of an accentuation of the downward trend of the exchange rate euro/leu. In this context, the appreciation of national currency gained against the euro over the year 2006 has doubled compared with that recorded during the first nine months of the year (7,2% in nominal terms and 12,4% in real terms).

However, the appreciation rate has been sustained and capital inputs in the form of financial loans, especially in the banking sector and portfolio investment (according to data published by the Bucharest Stock Exchange in October, the net purchases of non residents documents were nearly 20 times higher than in September), which have grown as a result of approaching accession of Romania to the European Union, of improving the country rating (on October the 6th Moody's Agency announced the improvement rating for investment category in Romania) and maintaining a relatively high interest rates.

Speculative capital massive entries led to the widening pressure on exchange rate appreciation on the Romanian leu, but at the same time, it boosted the risk of a sudden later correction, the depreciation of the national currency. This, the more the experience of countries which have acceded to our country prior to the European Union shows that, after integration, the expectations regarding the assessment of national currencies begin to fade.

Average rate continued in the first half of 2007 *(Figure 2),* the national currency gaining ground very fast in front of European single currency, where economic fundamentals are rapidly deteriorated: foreign trade deficit grew strong after the 1st of January 2007 and wages have increased well above productivity growth, case in which the Romanian leu was overvalued. Officials of the National Bank have agreed at the time of unsustainable appreciation rate to 3,11 lei/euro in the spring of 2007 and more praising national currency as "the king of exchange".

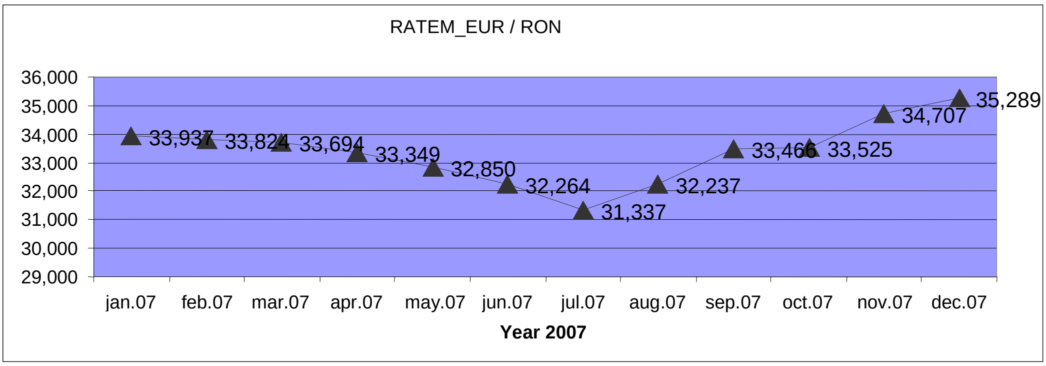


Figure 2. *Evolution of average exchange rate EUR/RON in 2007*

Since mid 2007, however, the national currency registered a significant depreciation and, thus cancelling all the added record in the first months of the year. Correction in this period was necessary, being stimulated by unfavorable context of world crisis caused by the mortgage market in the United States of America, which added to the weak economic fundamentals Romanian leu.

More specifically, since August 2007, national currency recorded a accentuated depreciation on the context of increased aversion to risk on international financial markets as a result of financial turmoil and concerns about the intense growing current account deficit and inflation inflammation. Generaly, most of the reference period, the Romanian leu was quoted at levels above the average net rate of exchange against the euro made in April 2006 with a relatively high degree of volatility. However, short-term interest rates diferential over EURIBOR three months have been tempered, easily exceeding 2 percentage points at the end of 2007, before increasing to 5,1 percentage points during the three months ending in March 2008. In March 2008, the rate of real effective exchange rate against the euro stood at a level above the average historical net recorded in the last ten years, and the real bilateral compared to the same currency easily exceeded these values.

However, real economic convergence makes it difficult any assessment of the historical evolution of real exchange rate. Regarding other external developments, since 2002, Romania has recorded a gradual increase in the deficit on current account and capital balance of payments, which stood at 13,5% of GDP in 2007. Although significant external deficits may be partially generated by the alignment of an economy such as Romania, deficits of such magnitude raises questions of sustainability, especially if they persist for long periods. It appears that very large deficit recorded recently have been caused also the overheating economy.

From the financing perspective, net inflows of direct investment covered almost entirely by external deficit in 2006. However, recently, a significant part of the deficit was financed by net inflows of other investment in the form of foreign loans contracted by the banking sector and the non-banking one. In this context, the net international investment position of Romania has deteriorated from -19,3% of GDP in 1998 to -46,6% of GDP in 2007.

In November 2007, the national currency has experienced a trend of increased depreciation. Thus, if on the 1st of November, the euro was quoted at 3,3157 lei on 23th of November, the exchange rate gone to 3,6221 lei for one euro, which depreciated by almost 11% in nominal terms.

The evolution rate of the latter part of 2007 can be explained on the one hand the flow predominantly negative domestic economic news: the strong increase of current account deficit (approximately 13% of GDP in Q2 of 2007 compared to 10,3% of GDP in Q4 of 2006), and funding in an increasingly small proportion of foreign direct investment (only 38,7% during January-July 2007 compared to 91% in same period in 2006) and on the other hand of slowing economic growth in the first half of 2007 (largely explained by the prolonged drought) and the annual inflation rising rapidly (from a historical minimum of 3,7% in March 2007 to 5% in August 2007). Also, and more importantly can we say that the national trend has been influenced by a significant increase in inflationary expectations.

In this context, the macroeconomic indicators have taken a negative turn in Romania, non-resident investor sentiment towards Romania has changed from very positive one by one rather negative.

Early 2008 comes with a depreciation rate of over 9% in the first two weeks of the year. Evolution of the national currency falls in the trend that started in September 2007, when negative sentiment towards Romanian leu began to grow following the turmoil on the international level. The causes of currency depreciation related to the deterioration of macroeconomic parameters, the poor functionality of the mix of fiscal-monetary policy and currency speculations. In 2008, however, the trend rate has been influenced by local investors.

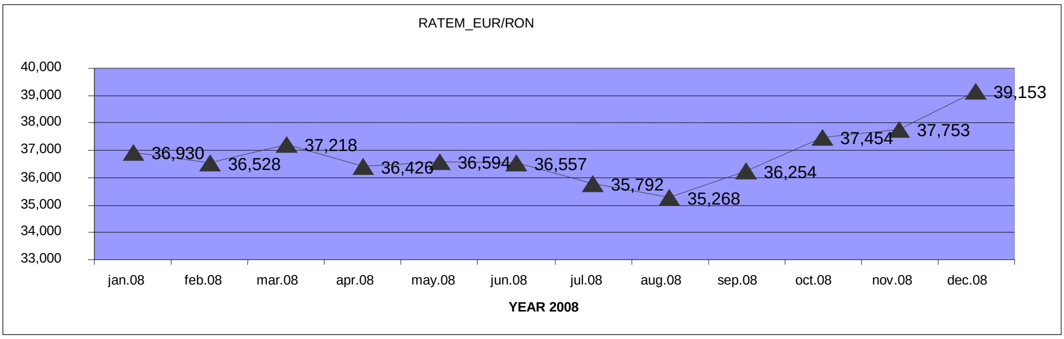


Figure 3. *The evolution of average exchange rate EUR/RON in 2008*

Growth rate euro/leu stimulates imports, leading to correcting the trade deficit and to a certain level the European currency depreciation neafectând the repayment of loans from the population.

April 2008 has been the best period of the early exchange rate euro/leu, the national currency stabilized around the threshold of 3,5640 in April 21 in descent from 3,6759 in early. Thus, in percentage terms, Romanian leu appreciated by over 4%, giving those who have borrowed in foreign currency the chance to rate you pay less in loans, after several consecutive months of negative classes. At this fragile national currency appreciation has contributed a number of factors. International situation has improved, which made all the currencies in the region to consider, including the lion. In addition, the national currency and was helped by high interest rates on the domestic money market, which temporarily reduced the pressure of depreciation. Robor rate at one month climbed up to 12,8%, compared to only 8% at the beginning of the year. High interest rates attracted more money from abroad for a change in national currency, which was the euro/leu down.

The trend appreciation of the national currency has continued. Increases after repeated interest rate by the NBR, the Romanian leu began to strengthen, reducing the unexpected, so that on the 7th of August, the National Bank of Romania announced the lowest level of the euro/leu exchange since 2008: 3,4719.

During August, the Romanian leu has gained 2,5 percentage points compared to the european single currency. Assessment was based on the reference growth rate by the NBR up to 10,25%.

Interest rates on leu is one of the factors that influence the exchange rate sensitive. The interest is higher, the currency tends to become stronger. Romanian leu high rates make the national currency investments more attractive for foreign investors and in order to make deposits in lei, they should sell the currency to buy lei, which considers the Romanian leu from the currencies.

However, there is no basis for a sustained appreciation of the national currency against the euro, the current account deficit is still being a very high level.

The threshold rate of euro/leu recorded in August 2008 has not been proven to be sustainable in the long term, but rather involved a speculative component of the moment. Boosted by the emerging trend of exchange and the European single currency depreciation, the lion was considered, although overall, the Romanian economy has not improved, even in a situation similar to last year. Thus, the assessment can not be considered a sustainable, because not based on an improvement in macroeconomic indicators. While flows of funds that determines the movement of a financial nature are most likely when sudden movements, and trade, as an expression of competitive imports, for example, the movement can not be a sustainable.

September 2008 comes with a depreciation rate of approximately 5%, the trend seen in the currencies of other countries in the region affected by the international financial crisis. With the beginning of September, the Romanian leu began to rapid depreciation against the euro. If at the end of August – early September, one euro bought approximately 3,55 lei, at the end of September is traded around the value of 3,73 lei.

Fall rate is based on the global financial crisis, increasingly acute as that caused investors to withdraw from the markets which are of greater risk.

In the context of the global economy affected by the crisis generated panic American depreciation rate was fulminant, the euro/leu has increased reach in a very short time in transactions on the interbank market at very close to 4 lei for one euro.

Most affected by this development were those who get income in lei, but record debt in foreign currency, often rate bank loans.

Depreciation rate was based on the difficulties which have arisen at several banks throughout Western Europe. In such an economic climate, investors withdraw from emerging markets because preceput risk is higher. Investors are dubious about the ability of Romania to finance the large deficit the current account, which is why they avoid investments in lei, leading to currency depreciation.

Intervention in October 2008, the central bank that has sold directly to market about 40 million euros, helped Romanian leu to recover, the euro/leu in the range 3,75-3,80. One of the factors that have influenced this evolution could be populism of government, announced salary increases based on unsustainable economy having a negative impact on investor confidence in domestic currency.

Since November 2008, Romanian leu began to suffer seriously the strong depreciation against the euro. In only a month and a half, the national currency has lost more than 10 percentage points, the exchange rate jump from 3,5 to nearly 4 lei for one euro.

Once the crisis penetrate more into the real economy, meaning that the effects are felt at enterprises and then pockets of each of us, the macroeconomic situation of Romania is getting worse. The budget deficit and current account are the main reasons of the depreciation rate. Government deficit has reached alarming levels (in

October 3% of GDP) due to high government spending and the trend is all one has to increase. In addition, we continue to deal with negative feelings induced foreign investors in both the economy and the political instability in Romania.

Early 2009 to an exchange rate of the European single currency against the lion over 4 lei, tapping in a few days all records last years. On the 8th of January, the National Bank announce a rate of 4,1385 lei for one euro, level situated at a few tenths ban of the maximum of 4,1438 recorded in 5 years ago, namely on the 6th of January 2004. From this moment on, the euro/leu has continued to grow fulminant interbank market.

Passive attitude of the central bank in this period started in 2009 has dramatically affected the number of clients of credit institutions that have borrowed in foreign currency. That at that time, loans in foreign currency attained the level of 57% of total lending, may be the result, largely, a failure of monetary and fiscal policies of the Romanian authorities.

After a period of continuous depreciation of the national currency *(Figure 4)* towards the end of January 2009, the euro/leu exchange rate stabilized. Impairment of aggressive rate can be explained by investors' perception of the risk. Romanian currency is a risky one and when markets are volatile, investors withdraw from markets with high risk. Exchange fell from 3,7 lei/euro to 4,34 lei/euro level includes practically all the fundamental economy.

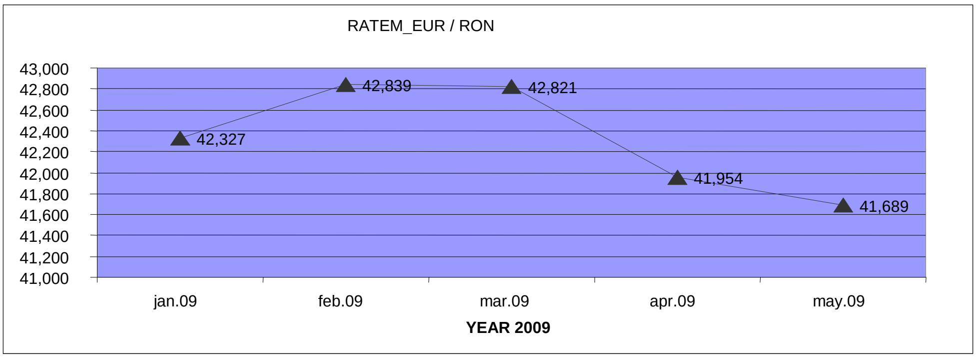


Figure 4. *The evolution of exchange rate average EUR/RON in 2009*

According to the NBR study in early 2009, much of external debt accumulated by the private sector can not be refounded this year,"the research shows that the government has the capacity to self founding on the foreign exchange but in the NGO sector is a goal out of funding: capital inputs are lower than outputs". The solution found by central bank is the government to borrow more than is needed to alleviate any tension that may have on foreign reserves funding gap that is prefigurează private sector.

External debt of private sector medium and long term is almost 40 billion, and including interest rates falling due is estimated at around 10 billion euros in 2009. And greater problems arise when short-term debt in November 2008 the balance was 24 billion. These debts will be paid, and if the companies concerned do not have the resources in foreign currency, they will be forced to buy foreign currency, which would create additional pressure on the exchange rate, leading to the depreciation rate.

Given that market liquidity is very low, to continue the course at 4,3 lei/euro is mainly due to the central bank interventions. Also, small volumes traded interbank foreign exchange market facilitated NBR position.

After almost two months (early 2009), the euro/leu remained around the 4,30, negotiating the agreement with the International Monetary Fund (IMF) has improved the perception of investors towards our country and support the national. Until the mid 2009, the euro/leu entered a downward trend, reducing it from 4,3 to 4,1-4,2 lei for one euro.

Conclusions

It is difficult to estimate the evolution of the national currency against the euro as long as things are uncertain at the level of international economies. In the following period, is expected to maintain the exchange rate euro/leu in the currently coordinates, but it is possible even a slight appreciation of the Romanian leu. The most difficult time for the national currency is the following assessment from the IMF, when will the conditions imposed here targeting single wage law, pensions law and changes in tax, the issue held the second money. Breaking these conditions would lead the euro/leu up, in other words a "debacle" of the national currency.

In the current financial crisis and international economic integration in the European Monetary Union in the 2014 time horizon might be affected because of the effort that it involves the performance criteria for nominal convergence. Romania could achieve economic convergence delay which means the postponement of accession schedule to the euro area. If we look at the monetary unification process in the frame of the global crisis through its benefits, then adopting the euro currency is the best thing for the Romanian economy because it will be a wall of protection crisis fund to protect companies volatility of exchange rates, a strong factor for monetary stability.

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AN ACCOUNTING PERSPECTIVE ON A CRISIS PERPETUATED THORUGH THE CAPITAL MARKET

Carmen Giorgiana Bonaci and Dumitru Matis[*]

Abstract:

Our paper analyzes the current financial crisis starting with some recent developments and reactions in the field of accounting. We find that involved parties within the financial system naturally look for a "scapegoat" instead of dealing with reality. Moreover, they try to avoid regulations that would reflect their current financial position and performance. Meanwhile, what reality reveals us is that we are dealing with a crisis of value, or better said valuation, framed by significant changes of paradigms. Starting with thoughts and reactions within trade literature and financial environment, we analyze some mechanisms of credit derivatives that propagated the crisis within the global financial system. Finally, we prove our point in defending fair value accounting and identify key aspects that allow future improvements. The need for informational transparency is emphasized through the whole paper.

Keywords: Financial crisis, fair value, derivatives, mortgages, informational transparency, capital markets.

JEL Classification: A12, G01, M40, M41

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Introduction

One way of looking at the current financial crisis is that it represents the first great recession affecting developed countries since the reorientation of the value creation system from goods' production towards creating intangibles. If we are to analyze the situation considering an economic theory's perspective, this could be Schumpeter's theory[16], the current "destructive creativity", as some see it, having to determine the establishment of new limits within the value creation process. We are now being confronted with a certain state of facts, within which those economies that relied on intangibles as a competitive advantage, in times when what is considered to represent value is not guaranteed through any form of tangible assets or products, are faced with the collapse of financial networks, and even evaporation of the fictitious capital that allowed the development of the new capitalism. What our paper accomplishes is to analyze the reactions of those involved within the accounting information market under such difficult circumstances, what is the truth as revealed by analyzing the facts, and some reactions within trade literature. All these represent in our opinion chain reactions to a new lesson that the capital market and its mechanisms seems to have persisted on making us realize.

Methodological approach

Considering the purpose of our paper, that is to give an accounting perspective on the current financial crisis, the starting point of our analysis is naturally the accounting information market. It is there that we found many voices considering fair value accounting to be significantly responsible for the current state of facts. Furthermore, the structure of the paper is implicit. We have first considered some main opinions within trade literature on fair value in connection to the current situation, and then proceeded to performing a closer analysis of the situation. This required presentation of precise attitudes and requirements that appeared in the field of accounting under the pressure of such stressful circumstances. Afterwards, we performed an incursion within the credit derivatives market where the roots of the current financial crisis can easily be identified. Following these findings, we see how the crisis was then perpetuated worldwide. This approach allows us to see the big picture while emphasizing accounting issues.

Some thoughts within trade literature

As mentioned above, what we have tried to accomplish through the literature review section is get some insights into what current researches state concerning the concept of fair value and its usefulness during financial crisis that affect capital markets around the world. By doing so we show that the role of fair value accounting

[16] Economic theory that took the name of the Austrian economist of the XXth century, Joseph Schumpeter, showing, unlike other modern theories on development, that this could be explained through innovation and entrepreneurial spirit.

within this process is just to capture the changes appeared in the market prices. Even though the utilization of inadequate assumptions for the initial valuation of the mortgages has surely contributed to mastering the current problems, this represents finally an error of valuation and not a problem caused by the application of fair value accounting *per se*. That which fair value actually does is to bring the true dimension of these errors of valuation, in the eyes of the investors, in a short interval of time (Wallace, 2008). The main difference between recognizing an asset at its fair value or at its depreciated cost is represented by the recognition of some unrealized losses or gains in the alternative of fair value. However, these losses or gains represent in fact changes in the value of future generated incomes by the considered asset. As a following, coming back to the current financial crisis, the losses that banks are ought to confess under the option of fair value, captivates in fact the true impact (upon the present and future incomes) at considering a higher degree of underwriting the mortgage credits that had been already given.

Even if this impact is quite significant, what we must acknowledge is that it only represents a repercussion of a vicious circle previously formed. Concerning the decrease in the investor's interest for structured derivatives linked to mortgage credits, it is true that the drawback from these products is nourished by their fair value measurement, but we consider this the normal reaction that investors should have had from the beginning towards these products of financial engineering. In other words, current fair value measurement does nothing but imposes banks to recognize the existence of some real problems created earlier, and making it possible to take actions, since they will not disappear by themselves irrespective to the postponement period. Moreover, when these problems are not recognized, the mechanism could continue, enrolling other investors as naives as the previous ones (Matis and Bonaci, 2009).

Despite all critics brought to the concept of fair value, especially during such problematic times, those voices that are arguing for the restriction of its application remain unconvincing for at least three reasons. They don't bring any viable alternative, while ignoring the negative impact that should result from the loss of some information that are presently offered within financial statements, and also altering the distinction between accounting and prudential concerns, which have in fact different objectives and they should be separated with great attention (Veron, 2008). The opponents of fair value loose this dispute from the very start, because they do not manage to materialize their arguments through actual solutions, or in other terms, they are missing a "counter-offer". If it is easy to identify and underline fair value accounting's deficiencies, it is not so easy to find a better alternative that brings together the characteristics of relevance, credibility, comparability and intelligibility that a large consensus and a series of principles attributes to the actual standards in the domain.

Another important aspect emphasized within trade literature is that such a severe crisis like the current one is not, and could not, be the fault of any one set of parties, but involved the entire economic system failing to appreciate the risks of the rapid growth in risk-layered subprime mortgages, the inevitable reversal of home price appreciation, and unprecedented global market liquidity (Ryan, 2008). It was all these factors that brought out the undisciplined behaviors in lenders, borrowers, and investors, making them ignore what common sense would have pointed, and that is not to forget about 'fair valuing' the real risk. As Ryan (2008) points out, "economic policy, bank regulation, corporate governance, financial reporting, common sense, fear of debt and bankruptcy, and all of our other protective mechanisms were insufficient to curb these behaviors". The author also finds the explanation for this type of irrational behavior displayed by investors within Keynes (1936) description of behavior underlying upswings in economic cycles:

Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits—a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities (Keynes,1936).

Fair value accounting or any other valuation method has no chance in eliminating such behaviors (Ryan, 2008). Where fair value plays an essential role, is in informing relatively rational and knowledgeable market participants on an ongoing basis, and providing a common set of information upon which market participants can recalibrate their valuations and risk assessments when the economic cycle turns. This recalibration is essential to occur as quickly and efficiently as possible, as it should nowadays. Ryan (2008), as many others mentioned before, also notes that any form of historical cost accounting would drag out these recalibrations over considerably longer period, likely worsening the ultimate economic cost of the crisis.

Matis and Bonaci (2009) empirically dimension various opinions on fair value within recent trade literature by analyzing all papers comprised within the 2005-2009 issues of the 16 international journals in the field of accounting belonging to the Thomson Reuters Master Journal List. They document the fact that in the field of financial instruments most of the authors sustain fair value accounting, especially through results obtained within empirical studies. Moreover, they find that even those studies who argue against fair value within empirical studies, explain their position by some of the concept's shortcomings in cases when objective data coming from active markets are not available. Another important finding of their study is that opinions within the analyzed trade literature have not been significantly affected after the crisis became noticed, the 'pro studies' recording a constant number through the 2005-2009 period, while 'against studies' were even fewer after year 2007.

We can conclude upon analyzing opinions within trade literature that identify serious issues related to practical aspects of fair value accounting, the main problem being actually related to the fact that it affects the income statement through unrealized gains and losses, by ironically going back to what Solomons (1961) was predicting concerning to the importance carried out by profit measurement, that might record a descending evolution:

Each one of us undoubtedly thinks of the future in a different manner. However, my own suspicion is that, as for where the history of accounting is concerned, the next 25 years may afterwards be seen as the twilight of results' measurement (Solomons, 1961, p. 383).

We also join Georgene B. Palacky[17]'s opinion, who as a representative of the investors and their interests stated:

I wish I could see people giving up talking about fair value as being the problem within this situation, and focusing on fundamental problems: lack of market discipline, underwriting process and practices within the subprime sector, and the rewards obtained by actually challenging risk … it is too much noise for something that does not represent the real problem. It is just a manner of distracting attention from actually dealing with real issues (Georgene B. Palacky, director of CFAI).

After clearly pointing that trade literature actually supports fair value accounting even thorough such difficult times, we must now go to those aspects that started our research. That is some unjustified reactions among parties involved in the credit derivatives market that will actually be proven self interested when blaming accounting and not taking responsibility for their own implication.

First reaction - naturally identifying a "scapegoat"

As stated before, the concept of fair value and its merits have always determined strong debates, especially in the field of financial instruments. Still, the current financial crisis has clearly generated an intensification of these debates. It seems that combining the accounting fair value principle and the rules on banks capital adequacy, also having strong connections with accounting, might have had a pro cyclical effect. Some banks and insurance companies' managers reacted by blaming accounting standards for the actual state of facts. This is easy to understand since it is much easier to blame accounting standards rather than rules within the banking system, considering that they are still under close observance of bank supervisors. An important and significant aspect we consider the fact that the participants at the G20 summit did not blame the principle of fair value in November 15, 2008. The public declaration following it did not refer to fair value, although accounting authorities were asked to … work on improving the guidance for securities' valuation, considering some complex, illiquid products, especially during difficult periods (Rérolle, 2008).

All debates on fair value measurement intensified during recent periods, big financial institutions having to recognize within their financial statements losses of more than 150 billion $, mostly under the use of market values (Beller *et al.*, 2009).

[17] Director of the Group for Financial Reporting Policies within the Chartered Financial Analyst Institute – CFAI.

Meanwhile, SEC[18] is investigating the possibility of use, by some entities under research, of different market values for the same securities. From this perspective, nobody can deny the fact that the use of fair values involves some problems, especially in extremely difficult periods from the market's point of view. For all that, the defenders of fair value bring as an argument, its capacity to ensure a certain connection to reality, associated with another aspect of reality, namely own shortcomings of alternatives for the market value. We refer here to the fact that, neither the reflection value of some elements only in their costs, under the historical cost principle, would not provide investors a better image concerning the problems that financial institutions are now confronting (Matis and Bonaci, 2009, p. 126).

Nevertheless, since the end of September and beginning of October 2008, Wall Street Journal published a series of articles that described how the banking industry is revolted against fair value accounting, bringing a series of criticisms, mainly because these would impose them to diminish their assets' value within the balance sheet, often going lower than values showed on the market. It seams that the financial institutions militate for an elimination of the fair value, seen as a partial solution for the banking industry nuisances. Wall Street Journal presented a letter of the American Bankers Association – ABA, asking SEC to recognize that fair value has no significance within illiquid markets.

Meanwhile, remarkable personalities belonging the banking industry (such as Martin Sullivan, the former executive director of AIG and Henri de Castries, executive director of AXA) considered fair value and the use of market based valuations on a large scale to be a major factor of the current financial crisis (Hughes and Tett, 2008). As a reaction to these statements, the European Commissioner Charlie McCreevy also expressed, in last year's spring, his concern regarding the impact of market based valuations in those cases when markets become generally illiquid and irrational (McCreevy, 2008).

The only way we can argue against these unjustified reactions is by analyzing the credit derivatives market and showing where things really went wrong and which were those factors that determined the current state of facts.

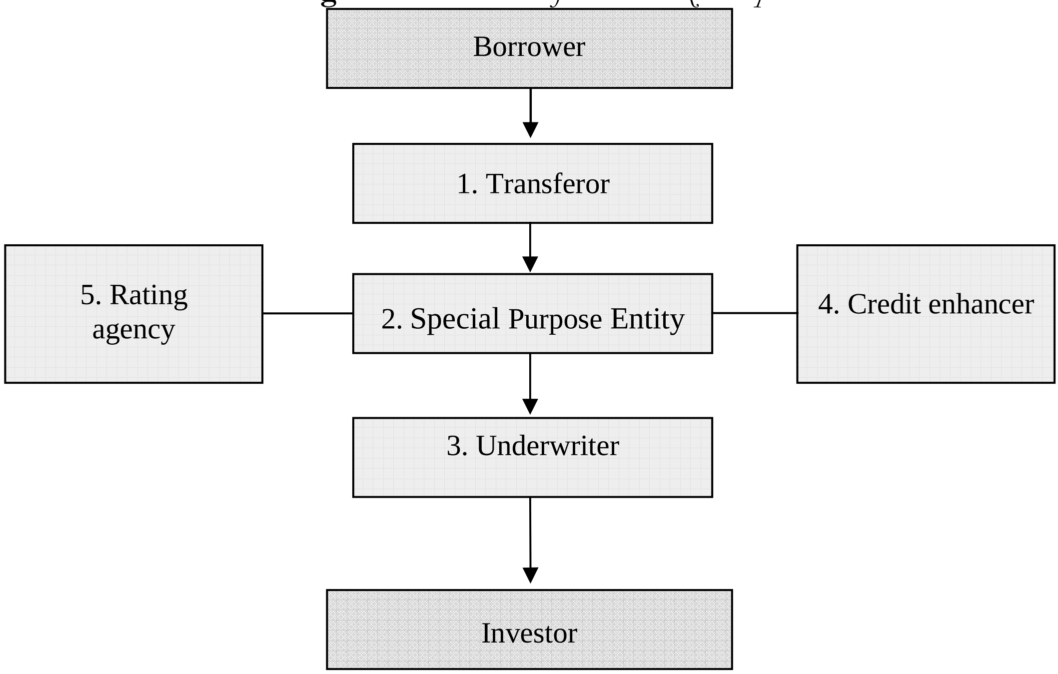
Looking for the truth within the mechanisms of credit derivatives

Determining the degree to which the current financial crisis can be connected to fair value measurement can only be judged after a short introspection within those, mechanisms, which in time, have created an extremely problematic situation raised within capital markets around the world. That is why we have to start with the origin of the problems appeared on credit markets, and more specific, mortgage backed securities and different financial instruments, more or less complex, further structured from them. We will therefore refer to the technique of securitization, which consists in transforming the existent credits in titles on the capital market.

[18] ***Securities and Exchange Commission.***

Presented from an accounting point of view, securitization represents a financial technique through which a financial institution or a company (the transferor) creates a separately legal system (the already well-known Special Purpose Entity - SPE) to which it transfers financial assets, such as loans and receivables (towards a debtor). The following figure presents all elements that need to be considered from an accounting perspective:

Figure 1. *Illustration of the securitization process*



Source: Kendall (1998) quoted by Niu (2007) and Abd Allah (2009)

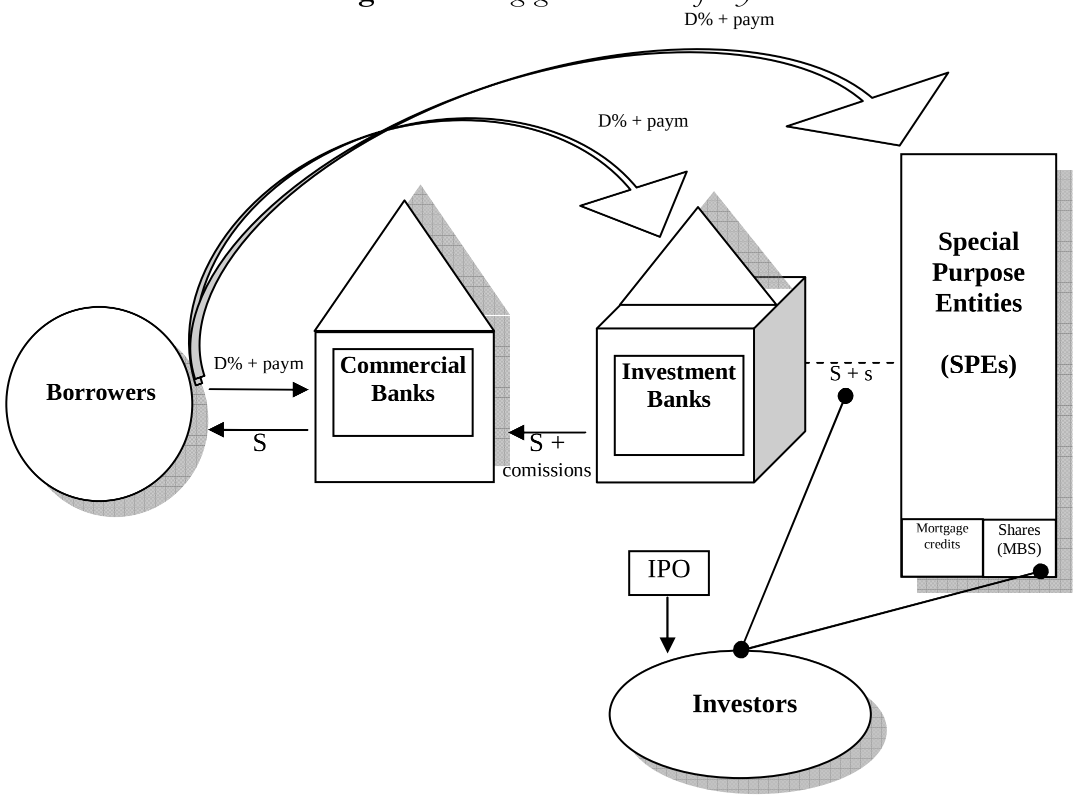
The Special Purpose Entity is the one issuing securities that are then offered to investors, being launched on the market and given prices by the underwriter, usually an investment bank. The Special Purpose Entity will transfer the money paid by investors who purchase the structured derivatives to the transferor (who transferred the financial assets). The process often involves a credit enhancer that is supposed to attract investors and a rating agency that should reduce risks assumed by investors from their point of view.

Abd Allah (2009) quoted this year some previous studies whose statements now have a different dimension and attract special attention, after the lesson has been personally delivered to us:

While the market for securitization is growing and getting more popularity for the collective benefits obtained by the participating parties in the process (Jobst, 2006), the technique should devote much caution so as not to lead to financial crises because of its complexity (Engdahl, 2008).

We will furthermore detail the securitization process in order to better analyze it. Special Purpose Entities' assets are therefore formed by receivables, materialized in mortgage credits overtaken by the investment banks from the commercial banks. These new SPEs will surely issue their own shares that will be sold on the market, at as higher prices as possible, surely higher than the value of the corresponding assets (materialized in mortgage credits). It is these shares issued by SPEs that are known as Mortgage Backed Securities (MBS). For a long period of time, this sell was possible due to the fact that investors' appetite was maintained through the increase in the support assets' prices of those certain securities, especially in real estates that represented the mortgages for the credits. SPEs' shares were sold on the capital market through Initial Public Offerings. Through such a sale, investment banks recovered more than they have paid to commercial banks in order to overtake the mortgage credits, this way obtaining a profit. Meanwhile, the mortgage credits, as assets (receivables) of the new opened SPEs became a receivable held in fact by those investors who purchased shares. The next figure makes a synthesis of the role of the investment banks:

Figure 2. *Mortgage credits' transfer system*



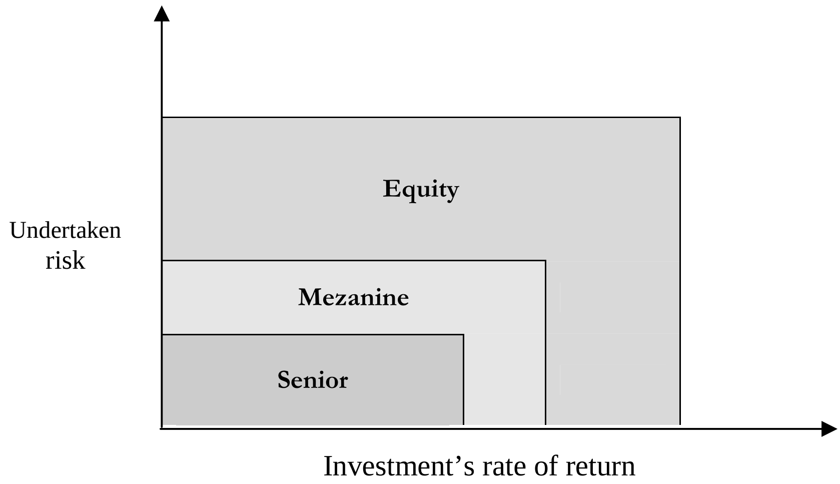
Source: Matis and Bonaci (2009, p. 142)

Those shares issued by these SPEs are well known within trade literature as Mortgage Backed Securities, representing in fact securities backed up by mortgage receivables. Furthermore, we will refer to them as MBS. They represent securities that can be transitioned by the entity, offers the entity the right of encashment of rates and interests, encashment guaranteed through mortgage. In this situation, if one of the mortgage credits' beneficiary could not face up the payments, the entity has the right to sell the mortgage property in order to recover the investment. It is shown in this way how the intermediary chain in mortgage credits gets longer and longer, each link following its own profits through the creation of its own joint point, when, in fact, the main connection is between the beneficiaries of the loan (borrowers) and the ones who actually finances the loan, the investors that buy securities like MBS. Considering the investors' point of view, this approach is different from simply granting a loan because by owning the MBS, the investors have the right to receive the rates and interest the beneficiaries owe, but in the same time they guard a low share resulting from the fact that this securities can be sold according to the circumstances (Matis and Bonaci, 2009). In other words, the securities assure the investors a certain liquidity regarding the market within which they are transitioned. Still, a real accounting issue is valuating these MBS, this being influenced by a series of factors that have to be taken into consideration, such as the probability that the mortgage credit's beneficiary could not make the payment on time, that they will pay back the credits in advance, the evolution of the interest on short term, all of these needing complex valuations based on models, more ore less well used.

It is also a well-known fact that investors on the capital market have different profiles. Therefore we must consider investors that will accept a lower income if they can benefit of a certain safety for their investment, but also investors that can be attracted only by the possibility of obtaining a high revenue, proportional with their expectations and assumed risks. It is also possible that in the considered situation of credit derivatives, some of the investors will have certain boundaries related to the perceived risk being imposed by law, as for example mutual funds. The way of answering the interests of as many as possible investors is through the creation of an instrument derived from the securities issued by the special purpose entities (MBS). In fact, this is also the role of derivatives, obtained by the division and structuring of an asset in such way that risk dispersion is made through an asset derived from the original one.

We will maintain the same circumstances previously mentioned in order to explain the mechanism for developing such a derivative, with the only difference that, the SPE will not emit MBS having the same characteristics, but, first, it will structure these securities in three big categories or trenches. These three trenches are known within trade literature as Senior, Mezanine and Equity. That which differentiates the investors in the three groups is the undertaken risk and the gained reward or the investment's rate of return, combined as shown within the next figure. Moreover, the created structure has the form of Collateralized Debt Obligations (CDO), more precisely Mortgage Backed Collateralized Debt Obligations. Such a derived structure could be accomplished with any kind of loan guaranteed by an asset.

Figure 3. *CDOs structure*



Source: Matis and Bonaci (2009, p. 144)

An even more complicated derivative, with major contributions to the current financial crisis, allowing easy and quick transfer of mortgage credits, and therefore encouraging banks to assume bigger risks and completely forget about prudence, is the Credit Default Swap (CDS), representing the derivative financial instrument with the fastest ascension in the financial sector.

For banks, transferring those risks associated with their financial assets has the ability to generate multiple favorable effects, such as better risk management, establishing some differentiated capital requirements, as well as improving their credit ranking. Moreover, improving their credit ranking also involves lower financing costs because the bank's risk profile is one of the considered elements when calculating the interest rate for their financing. Meanwhile, credit rating represents an evaluation of the bank's solvability, based on the history of its previous borrowings and reimbursements, as well as on its objective possibility of encashment regarding its receivables from its debtors, and therefore be able to settle its own financial obligation. The specific manner in which banks can transfer credit risk that is associated to their financial assets is represented by the so-called credit derivatives (Radocea, 2005, p. 21).

Creation of the capital markets' practice within the Anglo-American space, credit derivatives are standardized contracts that make the object of over the counter transactions. As their own name shows it, the value of such a financial instrument derives from valuating the credit risk that is associated to the portfolio of financial assets (Radocea, 2005, p. 21). We must therefore consider the frame contract set up by the International Swaps and Derivatives Association - ISDA, with its 1992 and 2002 versions, or the so-called European Master Agreement of the European Banking Federation – EBF.

CDS actually represent contracts through which a financial institution (the one buying the protection) pays a premium to another entity (the one selling the protection), the later committing to pay a previously established amount in case one of the borrowers (debtors of the buyer) will not follow his obligations, namely will not pay the accumulated debt. The main difference between a CDS and an ordinary guaranty agreement or insurance considering credits, is the fact that the operation is done without the borrower's knowledge, without modifying the initial agreement signed with the client. The premium paid by the buyer depends on a number of factors such as the debtors' credit rating, the product's maturity and possibilities of the borrower defaulting on obligations. For the buyer of the protection, CDS allows him to cover his risks by transferring them upon the seller of the protection.

Consequently, when an insurance company issues such an instrument in order to cover the risk first undertaken by the one granting the loan, the whole package becomes insured since insurance companies should issue this type of instruments based on justified reasoning. This should also be guaranteed through the rating given by rating agencies (such as Standard & Poor's and Moody's) to insurance companies. In other words, the default risk does not refer to the beneficiary anymore, but to the insurance company whose status is reflected through its rating.

Aiming to obtain as many premiums as possible, insurance companies issued far too many such derivatives, without maintaining sufficient capital in case they should honor their commitments. They rather ignored the worst scenario when a large number of borrowers would default on their payments, again the responsibility for signalizing the cumulated risks belonging to rating agencies. Moreover, hedge funds, or any other investors as a mater of speaking, analyzed the CDS's market and identified situations in which CDS addressed extremely risky debtors, therefore interested in purchasing such CDS while betting on the debtor's default, this meaning the insurance company would have to compensate the investor. Therefore, instead of directly lending the borrower who would impose a higher risk, the new investor would rather[19] buy CDS issued by the insurance company (which imply

[19] The attractivity of these derivatives for investors relies on the fact that they only assume paying (usually quarterly) a premium that is calculated as a percentage of the instruments' notional value, while the debtor's default involves the owner of the instrument receiving from the insurance company the entire notional value of the contract, his gain only being therefore diminished by the value of the premiums that were already paid. That is how the investor hopes on the debtor's default while the insurance company bets on the debtor's ability to handle all his commitments, this bringing encashment of premiums without any effort on its behalf. Meanwhile, the real problem in this game of financial engineering is creating some values that are not connected to reality as real value added supposes. Another reason for CDS market doubling from year to year since 2001 to 2007 is owed to the fact that the buyer of the protection doesn't need to own receivables toward the debtor in order to buy CDS. Everything the investor needs to do is bet on a debtor's default, pay the premium towards the seller and wait. For a matter of facts, most CDS contracts are bets on debtors' ability of honoring

lower risks) hoping that the debtor will default on his obligations and the insurance company will compensate him in accordance to the foresights of the purchased instrument. Furthermore, the naivety of insurance companies is predictable, them being tempted by the thought of collecting even more premiums, and considering that the risk won't happen. This is how they ended up issuing CDS whose values are larger than the value of the corresponding credit contracted by the debtor.

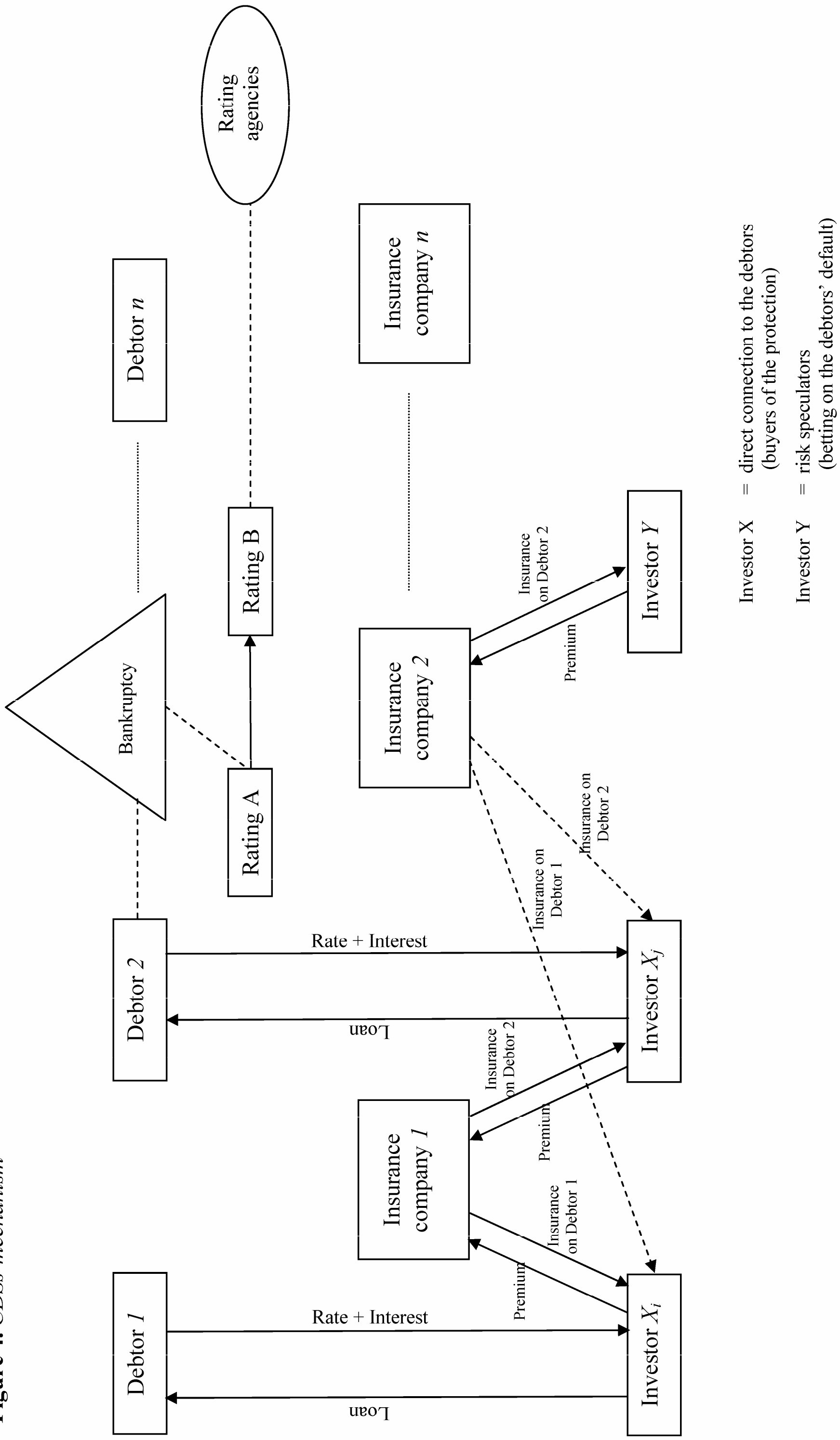
The attractivity of these instruments created in the market unthinkable connections. The big problem is that one debtor[20]'s default can implicitly generate for the insurance company obligations towards a series of investors who bought CDS on that debtor, the value of the sold derivatives sometimes surpassing the value of the credit that was initially contracted by the debtor. Even when considering an optimistic scenario that supposed the insurance company being able to respect its commitments, this could significantly affect its capitalization and therefore bringing a lower rating and decreases in the value of the already signed contracts. Furthermore, the reaction of those investors in CDS that had direct relations with the debtors (the ones actually buying protection) is again predictable since the insurance on the debtor's debts now becomes more riskier for them.

Insurance companies possibility of issuing contracts with uncontrollable values without meanwhile maintaining the adequate level of capital, correlated with the interests of different investors on the market, all framed within two essential assumptions, namely that ratings given by rating agencies were correct and that insurance companies are able to honor all commitments corresponding to all issued CDS, created an extremely dangerous environment, waiting for the sparkle to launch the disaster. The collapse of a large company can therefore attract a domino effect that would bankrupt hundred of other institutions and entities, being connected through CDS and similar derivatives. However, maybe this is what Warren Buffett (2003) was thinking about when he said that derivatives represent financial weapons of mass destruction. The next figure illustrates how CDSs work:

their commitments. Therefore, a product meant to be a hedging instrument became a possibility for investors to bet on almost any transaction within the credit market.

[20] The presentation of the derivative was simplified in order to simplify its understanding, but the real phenomena took significantly larger proportions.

Figure 4. *CDSs'mechanism*



Source: authors' projection

As we can see, the same loan contracted by the borrower (debtor) can in the same time be structured into complex derivatives through securitization and subjected to issuing CDS, therefore generating an extremely high risk. What we must always keep in mind is that each contract involves two parties, one still recording gains. What is clear though, is the fact that all these facts are not the result of fair value accounting. It is our opinion that even through difficult times information provided within financial statements must reflect what is happening on the market. Providing adequate information concerning the techniques and assumptions used in determining fair value represents a good way of insuring informational transparency that is vital for investors (Seidman, 2008).

From mechanisms to consequences: the propagation of the financial crisis

It is nowadays obvious that the crisis' effects have been propagated even within those economies that first saw optimistic scenarios, hoping that a certain shortcoming of their national capital markets that were less developed would turn into an advantage, the low market efficiency theoretically representing an obstacle in transmitting information. The first signs of the crisis became known by the middle of year 2007, on the subprime market segment that represented 15% of the total mortgage credit market and which is responsible for more than half of all credit defaults (Tarus, 2008). Another factor stimulating the crisis was financial institutions' loose policy in the USA, who used low interest rates by 2003 – 2005 in order to help the market recover after the IT crisis in the '90s.

After the looses investors recorded through IT investments, many of them started to look for what they considered to be safe investments, without properly analyzing the products they were buying. They were only assuming that real estate, which was quite tangible for them in comparison to the value of securities of an online portal, represented a safe investment, ignoring the possibility of a number of factors interacting and sometime generating significant price decreases. High level of demand for real estate on the market implicitly generated the prices in that field to rise.

From hereafter, the chain reaction operated on different levels: high prices for real estate determined the raise of demand for mortgage credits, while creditors were more and more willing to accept exotic derivatives, which were flexible, but also riskier. We are referring here to credits with low initial interests and no advances required, but which in time imposed high burdens for the borrowers who did not afford the rates that became larger. The vicious circle was therefore created based on unconscious loans undertaken by the beneficiaries, but also on irresponsible lending policies of financial institutions (Tarus, 2008). However, once the beneficiaries could not handle their commitments any more, all problems came to the surface. The incorrect valuation of risks associated to these debts became obvious and implicitly the real estate market fall, further inducing a domino effect upon all derivatives they were backing. Even when borrowers gave up the mortgaged assets, banks were not able to recover the loaned amount since prices on the real estate market were extremely low, houses being less valuable than the credits they carried.

This virus of the mortgage credits on the subprime market was projected within the entire global credit system through the above presented derivatives that reached portfolios around the world. All these risks becoming acknowledged further induced a confidence crisis, once again propagated within the whole global credit market. This determined loans on international markets to be very expensive, now creating a liquidity crisis because of the fact that banks were limited the access to cash necessary for them to carry out their lending activities.

This was how the crisis first started on the subprime market in the USA managed to find its way into the global credit market, national banks being forced to deal with raising costs for the money borrowed from creditors outside their country. Translated for credit beneficiaries, this means credits that are more "expensive". This does not mean that developing countries did not also promote irresponsible lending policies on their own, but often on different levels. Panic and lack of trust that was this way generated on the market is just even by only thinking of world wide well known financial institutions, mostly banks, which went bankrupt during the crisis.

Going back to current circumstances, it is quite difficult to delimit which are the actual problems and which are the causes. It is certain that in the financial system, the one that should mobilize financial resources with the purpose of adding value in the economy by assuring the transfer of the disposable capital between the investments or the projects, nowadays stopped to accomplish this function, being more interested in self-preserving. The main factors that led to this situation are, really, those derivatives, now called toxic assets, created based on complex structures, but which depend in fact of mortgage credits offered by banks and the previously described mechanism. In the moment the interest rates grew, the beneficiaries started not to pay their rates and interests at time, this being a mass phenomenon, it is explicable why the real estates' prices fell. In this phase, already there was a series of banks that had portfolios of derivatives such as CDOs, whose value has constituted a major problem for banks. A significant decrease in the value of this type of assets, now toxic, could evidently lead to a lower value of the assets related to the bank's debts, and implicitly to negative equity. A comparison can be made here between the situation of the beneficiaries who now own houses at a value much lower than the contracted mortgage credit, and the situation of the banks that in a similar manner through the same effect, has now an asset portfolio much less valuable than their debts, both reaching as a conclusion to a negative equity (Matis and Bonaci, 2009). Moreover, market prices of the banks' shares fell significantly, resulting in liquidity problems and nobody trusting the bank loans.

Data presented by the World Bank showed that after only 10 years from the appearance of CDS derivatives, the market for CDS contracts reached 54,6 billions $, while the global economy Gross Domestic Product in 2007 was only 54,3 billions $. We therefore remember professor Tinker's words (2008), who said that starting from the false premise considering some institutions are *Too Big to Fail* we ended up to circumstances showing us that they are actually *Too Big to Save*.

Concluding remarks

What is now obvious is the fact that the current financial crisis has opened for discussion certain areas within the capital market that are less regulated and controlled, such as mortgage markets and derivatives markets. A clear effect the financial crisis has is the rethinking and reforming of the financial systems through the introduction of new measurement systems and valuation of financial risks but also through higher control on behalf of regulatory institutions, where investment funds, pension funds, life insurance funds and mortgage credits are concerned (Paun, 2008). We therefore find it appropriate that, under normal circumstances, assets should be valuated at what they are worth from the market's point of view, the market being the only valid standard of value. On the other hand, we do not know exactly what to do when the market does mot function normally … what standard do we apply then? (Wallison, 2008).

Our pleading in favor of the concept of fair value is not meant to argue that this concept is flawless, in the same time being aware that current standards will for sure be further amended to better suit the accounting information market's needs, as even IASB[21]'s president suggested not long ago (Tweedie, 2008). The goal given to fair value accounting and market based valuation, does not seem so exaggerated if we integrate it in the whole picture that presents financial markets' characteristics in a constantly developing environment that keeps facing us with lessons learned from past crisis. Restricting the use of fair value accounting not only that it would not heal the wounds of the actual financial crisis, but on the contrary it would risk to make them worse, diminishing the trust level that investors have in financial statements of financial institutions (Veron, 2008). Other changes are necessary for facing the crisis' challenges, changes that should solution the deficiencies revealed at different levels.

However, beyond the fair value concept itself, it would be advisable to approach the implementation aspect, often underestimated, especially at Europe's Level (Veron, 2008). The quality and consistency at an international level, regarding the implementation of an accounting referential are vital to assuring a financial stability, as the Banking Supervision Committee shows within Euro system, still before the first signs of the crisis (European System of Central Banks – Banking Supervision Committee, 2006).

It is our belief that the current orientation towards market-based valuations, in risk management as well as in accounting purposes, which we consider will persist at international level, also solicits certain abilities of the valuators, abilities that should be proven. The institutions would have to prove the capacity of performing intelligent and justified valuations of assets and liabilities within the balance sheet, these including complex derivatives as the ones found in the centre of the current

[21] International Accounting Standards Board.

financial crisis. As in the case of a driver's license, these proves have the role to offer the entity's auditors a reasonable assurance that the valuator has sufficient knowledge and abilities in order not to create any damage towards any implied parties (Deventer, 2008). Unfortunately, the current financial crisis brought to surface severe cases, where no valuation at all is done before committing to an investment and where alternatives were not even searched for achieving some kind of estimations upon the market value, when the considered derivatives were less traded. To these we can add those cases in which inadequate valuation models were used, without giving any helpful information in taking a fundamental rational decision.

What the current financial crisis has confirmed regarding fair value, is that the most dangerous situation is created when the entire valuation process is based on the entity that transactions the securities, without existing any independent confirmation of the created values, from an auditor or from an entity responsible for risk management (Deventer, 2008). We refer here to the 3rd level input data that is allowed only as a final alternative, in the impossibility of applying the previous two. In addition, in this case, accounting standards solicit the disclosure of information that would fully permit the investor to give a certain trust degree to the valuation process, taking the best decision in the given circumstances.

As for the banking industry's argument that fair value would be irrelevant within inactive markets, this would mean that using fair value accounting would not offer any type of useful information to investors, regarding the true economic value of the concerned derivatives. Nevertheless, as it was previously shown, the decrease in fair values of those derivatives issued in the last years is fully correlated with the significance of the default degree in comparison with what was expected at the initial moment of the issuance. Since these fair values have the capacity to estimate the impact of a higher degree of defaults upon the future and present earnings generated by these derivatives, we assume that we cannot consider them lacked of significance. Also based on these assumptions, we consider that a present or future limitation of fair value accounting would just 'hide' current realities, only making the mechanism's effect that has triggered the financial crisis longer.

In a valuator's opinion, one of the positive effects of the current financial crisis is that of bringing some light upon those debates that concerned the concept of fair value, from two key aspects' point of view, urging us to give up a certain accounting utopia that kind of took over the current environment, and get back to financial realities (Rérolle, 2008). The first aspect refers to the fact that from a conceptual point of view, creating a balance sheet that has the ability or that needs to offer a true and fair view of the market value of the entity is a great ideal, while the market is far too complex in order to be captured by an accounting system.

The second aspect is that the valuation process involves a high degree of subjectivity, and framing this process by a series of accounting rules may be dangerous. (Rérolle, 2008) appreciates that luckily, restrictions imposed to patrician valuators were quite relaxed. Therefore, simply offering larger and more powerful doses of fair value within accounting trade literature did not necessarily generate a more realistic image of the entities. Even more necessary is the acknowledgement of both limits of accounting through its nature, and complexity of economic reality whose reflections needs to be accomplished.

Placing value in the center of accounting standard setting bodies' reasoning may induce some assumptions regarding to information being efficiently transmitted within the market, generating securities' prices that represent a true and fair reflection of the entities' performances. All these are happening while each financial crisis brings significant doubts concerning the above-mentioned association. We therefore can state that we are dealing with a valuation crisis

…from many points of view, the current financial crisis is connected to valuation (Noyer, 2008),

but at the root of this crisis we actually find the growing complexity of the value creating mechanism, the recurrent dynamic between market value and fundamental value, and last, but not least the amplification of the gap between our own intellectual models concerning value and the new paradigm of value. Fundamental value of an entity mainly depends on how its assets are put into good use, but we cannot ignore the opportunities the entity might hope to have in the future based on her position or strategy.

In order to create value, a company must generate and maintain decisive and long lasting competitive advantages that allow it to put its assets into good use, exceeding the cost of its capital (Rérolle, 2008). In a global economy, that involves intangibles, competitive advantages can be difficult to recognize (Rérolle, 1998). Economic benefits and costs of an alliance or temporary understanding with a business partner or even a competitor cannot be clearly identified. Uncertainty towards the origin and beneficiaries of future cash flows is determined by the intangibility of some assets and of the offer itself (Davis and Meyer, 1998).

We consider that all these issues that are nowadays raised on improving transparency where fair values are concerned will lead towards the origins of the problems, making us acknowledge basic theories of capital markets. Another aspect of the truth we cannot forget is that investors make their own adjustments upon available information while using it for their own needs. This approach would reduce to a certain degree the importance of the information first being processed by entities and trapped within accounting regulations. As Rérolle (2008) quite properly puts it, the market needs transparency to a greater degree than it needs standards.

We conclude our pleading by saying that fair value can under no circumstances be considered guilty for the current financial crisis, but only its messenger. This would also explain some of the reactions connected to accounting information, since we all know what the general reaction towards the messenger is. Fair value has the role of bringing us closer to reality, but it can only be done through correct implementation and high level of transparency. As for its shortcomings, we consider they can be reconsidered and adjusted in time, financial markets being extremely favorable for developing a series of innovations that must be closely monitored.

As we are all currently witnessing, derivatives can easily have negative effects. That does not mean that we should forget their ingenuousness in offering the opportunity to separate risks from their source and lead them to parties that are willing to bear them while getting a chance to a matching reward. The simpler a derivative is, the fewer places for manipulation it leaves, but this does not mean that derivatives should be completely eliminated. Where do these instruments become toxic? Exactly where they lack transparency and therefore information, and we cannot think of a better concept of value that aims at offering more information than fair value does. How this will actually be done remains to be seen, but one thing is for sure. We cannot sacrifice such a concept in order to find a "scapegoat" for the current financial crisis. The precise process through which fair values are reached needs to be acknowledged to investors in order to regain their trust, as current international accounting regulations also require.

Once again, we will all have to learn from the crisis, while each chain of the financial system must review its role, attributions and responsibilities, permanently encouraging informational transparency. If this entire pleading still didn't succeed in bringing you over to the side of fair value, we conclude by saying about fair value accounting what Churchill said about democracy, namely that it is the worst system with the exception of all others.

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THE IMPACT OF FINANCIAL CRISIS ON THE UNIVERSAL BANK MODEL

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Abstract

Universal banks are financial conglomerates that offer simultaneously underwriting and insurance services and also act like commercial banks; this business model first seen at the end of the XIX century had experienced difficulties once first major financial crisis hit in early 1930'. In US their existence was marked by a series of strict regulations which didn't allow "too big to fail" model to develop; in the late 1990' it encountered a more lax legislation which culminated, in the current subprime turmoil, with the pinnacle of the type in order to accommodate the new challenges of financial globalization.

This paper tried to identify potential conflicts of interest within universal banking and find evidence of the means which generate them within institutions that offer multiple financial services and create possibilities of exploiting synergies and economies of scope.

It followed the evolution of the regulatory framework and the impact on the financial institutions' structure, trying to identify remedies to avoid and eliminate conflicts on the selected field. Using a series of examples, it found evidence of the channels through which these conflicts influence market's informational flows and substantiated the long term implications within financial markets.

Keywords: *conflicts of interest, universal banking, informational flow, Glass-Steagall Act*

JEL Classification Code: G01, G14, K22, N22

In the case of conflicts of interest that take place within the banking field, the accent was put on its organizational structure and regulatory framework. Until several years ago, due to the separation between different banking categories, each with its own regulation and supervision, this problem seemed solved; when the barriers between investment banks, commercial banks and insurance companies were lifted once the Sarbanes-Oxley Act was enforced in 2002, this issue was brought into light once again within US financial system.

Even though different types of financial institutions emerged as separate entities, throughout the time it became obvious that by simultaneously offering multiple financial services, economies of scope could be reached. Since their conception, when the cost of information was high, banks used their privileged position of having access to clients' books to counterattack the problems of adverse

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selection and moral hazard. In the absence of standardized accounting and rating methods, banks had an important advantage because the relationship with their clients provided them with detailed information regarding their financial statements. Once a company was given green light regarding a credit line, this would send a positive signal to the market; a company with good credit can borrow cheaper from the capital market.

Economies of scope can be found in the reputation of financial institutions; if a universal bank can use its good reputation in one field to gain business in another field, it will have an advantage over specialized banks. Economies of scope can also be found in the fact that information from insurance, brokerage and investment banking fields overlap taking into account the size of the data base regarding their clients. Confidential information regarding the credit lines and stock/bonds issues of their clients led to an increase of the quality of universal banks' data base but also led to a decrease of the costs of providing financial services. Taking into account that a series of activities serve different departments within a bank, there are several potential conflicts of interest[22]:

- If the potential revenues within a department rise, there will be an incentive for its employees to distort information for their own clients advantage (e.g. issuers who are underwriting department's clients will profit from an aggressive sale, while potential investors, also bank's clients, expect for an unbiased advice);
- A bank manager can promote other bank's division products or can hide the losses of an unsuccessful issue by redirecting the funds to bank's trust accounts;
- A bank which granted a credit line to a company whose creditworthiness is not the best can encourage its underwriting department to issue debt for that respective company so that it can repay its loan;
- A bank can grant loans under the current market price to a series of investors so that the last ones to be able to purchase securities offered by an other division within the group;
- A bank can influence or force the client to work with an insurance company which is part of same group.

When, during the US financial crisis which started in 1929, one out of five American banks went bankrupt, the general public and the politicians considered that speculations made by banks were the main cause for the distress. In 1933 US Senator Carter Glass and Congressman Henry Steagall passed the law that carried their names which tried to limit the conflict of interest created by commercial banks offering clients consultancy in debt issue field. A series of conflicts were made public at that time following a public outcry so that banks had to choose between the investment bank and commercial bank status. This act increased Federal Reserve's control on

[22] Crocket, A., Harris,T., Mishkin, F. S., White, E. N. (2003), "Conflicts of Interest in the Financial Services Industry: What should we do about them?", Geneva Reports on the World Economy 5, pg. 56

credit institutions and established Federal Deposit Insurance Corporation – F.D.I.C. (whose main purpose was to guarantee clients' deposits).

In 1956 the Banking Act was passed and it extended the restrictions imposed on banks (they could not engage in non-banking activities and could not acquire banks located on other federal states). Starting 1960's, banks started lobbying US Congress in order to gain access to municipal bonds market and in 1970's several brokerage companies started offering banking services to their customers: checking accounts, deposit account, debit and credit cards. There were several attempts in 1984 and 1988 of the US Senate to lift a series of restrictions imposed by Glass-Steagall Act but every time the House of Representatives issued a negative vote. In 1991 Bush administration, backed by US Senate and House of Representatives Banking Committees, tried to restate the issue, but once again House of Representatives repealed the request.

In December 1986, Federal Reserve, which was banking system's supervision body, reinterpreted Glass-Steagall Act's 20th Section (which forbade commercial banks to underwrite securities) by letting them to obtain maximum 5% of the revenues from investment banking activities. In august 1987, Alan Greenspan, a former director within JPMorgan, became Federal Reserve's chairman and indicated that he intended to raise the limit from 5% to 10%; this will not happen until January 1989 and, in 1990, JPMorgan became the first commercial bank to offer investment banking services. In December 1996, with the support of Alan Greenspan, a fervent supporter of financial system deregulation, Federal Reserve raised the limit to 25%.

In April 1998 a $70 billions stock exchange between Travelers (an insurance company which previously acquired Salomon Brothers, an investment bank) and Citicorp (Citibank's parent) created world's biggest financial conglomerate in the most important merger in the history until that time. It was mandatory for the transaction to comply with the existing regulations (i.e. Glass-Steagall Act and Banking Act) which were conceived in such a way so that to prevent the creation of this kind of financial conglomerates (an insurance company, an investment bank and a commercial bank acting all together under the same group). At the time of conception, the merger offered the oversight authorities three options:

- Changing the existing regulations;
- Stopping the merger;
- Forcing the new created structure to give up the activities that were not in compliance with the regulations.

The management of the two institutions had to structure the merger in such a way so that the new formed company to comply with the banking laws and the last interpretations of the Glass-Steagall Act. If US Congress wouldn't have changed the legislation or loosen up the restrictions, Citigroup would have had a deadline of two years to sell Travelers' insurance division; thus the merger had place based on the presumption that the regulations will be changed.

In May 1998, the new regulations which tried to abolish Glass-Steagall Act passed the House of Representatives with 214 votes for and 213 against and in September it passed the US Senate Banking Committee with 16 votes for and 2 against. Despite this success, the proposal was almost rejected in the Senate hearings but White House support made it pass on October 22nd, 1999. Thus, after 12 attempts within the last 25 years, the Glass-Steagall Act was finally repealed, paying off those almost $300 millions spent on lobby; the final variant was sign into law on November 4th the same year[23].

A conflict of interest arose immediately after when Robert Rubin, US Treasury secretary and a former co-president of investment bank Goldman Sachs announced that he accepted a vice-president position within Citigroup. Rubin, using the position held until that time, was able to decisively contribute to the repealing of the Glass-Steagall Act and the successful merger between Travelers and Citigroup. When he quit Federal Reserve there were suspicions that he contributed to that respective law repealing aware of the fact that he will join soon Citigroup team.

At the beginning of the XX century, the rapid technological changes led to the expansion of capital markets, new companies and financial conglomerates finding themselves in a quest for new sources of capital; the method was the new issuance of stocks and bonds. Financial institutions which wanted to hold a share of the new created securities market, organized themselves in such a way so that they could profit from the advantages of the economies of scope and scale. When the capital markets collapsed, the financial conglomerates which simultaneously offered consultancy services in investment banking, insurance and also acted as commercial banks had to face public outcry, being accused of exploiting conflicts of interest.

Starting 1890', the creation in US of big industrial companies led to an exponential growth of capital demand which could be supported mainly by bond issuance. The size of the issues and the risk embedded made obsolete the choice of a single investment bank acting as a promoter for an issue thus leading to the creation of syndicated issues, based on a consortium of specialized banks. As commercial banks were prohibited in holding issuers' shares, insurance companies became the main investors in the new issues taking into account that they had steady liquidity flows. In US, the biggest insurance companies were closely tied to investment banks:

- New York Life had connections with JPMorgan holding in its portfolio important shares of railroad bonds underwritten by the last one;
- Mutual had important commercial relations with First National Bank;
- Equitable held in its portfolio railroad bonds underwritten by Harriman and Kuhn Loeb[24].

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23 Public Broadcasting Service (2006), "The Long Demise of Glass-Steagall", http://www.pbs.org/wgbh/pages/frontline/shows/wallstreet/weill/demise.html, Accessed on April 26, 2009

24 Crocket, A., Harris, T., Mishkin, F. S., White, E. N. (2003), "Conflicts of Interest in the Financial Services Industry: What should we do about them?", Geneva Reports on the World Economy 5, pg. 57

The connections didn't cover only bonds acquisitions, insurance companies being also one of the main liquidity suppliers of investment banks to whom they use to lend important amounts of money through their affiliates; the main connection was made at the managerial level: the managers of the insurance companies were partners within investment banks and the bankers had seats in the boards of insurance companies.

In a bull market, conflicts of interest were ignored, but when the capital market collapsed for the first time in 1903, in the quest for possible explanations, the issue of conflicts of interest caught public attention; institutional relations and managerial practices were revealed and the public and investors were surprised to see their dimension.

Dissemination of confidential information at that time raised a series of issues: if investment banks benefited from insurance companies and if the last ones profited from their shareholders. Insurance companies saw in syndicated issues an opportunity to invest in bonds but they weren't treated as members with equal rights, having only the possibility of purchasing bonds at the IPO's level, while some of their managers had the possibility of investing at preferential prices.

A conflict of interest was put on scrutiny at that time when a syndicated issue led by JPMorgan in behalf of International Mercantile Marine failed to subscribe entirely and the syndicate members were forced to buy the remaining issue. To hide the transaction, New York Life (a member of the syndicate) sold the bonds to JPMorgan on December 31st 1903 just to buy them later on January 2nd 1904; this operation so called "window dressing" was done solely to remove the bonds from New York Life's balance sheet at the end of the year and hide the failure of the issue. Some of the insurance companies' managers used the opportunity to protect themselves from losses due to uninspired investments. G. W. Perkins, New York Life's vice-president invested in a series of issues underwritten by the insurance company he was leading. When the issues failed to be fully subscribed, he sold to New York Life its share in order to avoid future losses[25].

A source of conflicts of interest was that of managers in one financial field holding positions in the board of companies from another field. Management structure and the transactions made by managers weren't made public but some companies had a shareholder structure based on the majority of one shareholder which led to a bigger probability of moral hazard occurrence, where the supervisor authorities and other shareholders weren't unable to monitor management activity.

Following those conflicts a series of regulations were enforced within the field (Armstrong Act in 1906) imposing a series of restrictions with the purpose of diminish the potential conflicts of interest:

- Banning insurance companies to perform underwriting activities;

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[25] Wigmore B. A. (1985), "The Crash and Its Aftermath: A History of Securities Markets in the United States, 1929-1933", Greenwood Publishing Group, pg. 174

- Forcing insurance companies' managers to withdraw from banks' boards and vice versa.

After the First World War, US economy entered a growth period backed by a strong capital market mainly due to the new issuances of stocks and bonds in the technology field. Following this trend, the underwriting business met an exponential growth while the revenues from classic commercial activity remain steady; consequently banks started offering underwriting services to take advantage of the trend.

Initially, the underwriting business was performed by commercial banks through their internal departments in charge with bond trading. McFadden Act passed in 1927 which allowed banks to act as underwriters didn't lead to the development of bonds departments within commercial banks but to creation of a series of separate entities, whose main purposes was offering underwriting services[26]. Even though they act as separate entities, their names were derived from the parent bank and often shared the same offices. Usually they were tied to the parent bank by one of the following methods:

- Each shareholder of the bank became shareholder pro rata of the new entity;
- The bank appointed several trustees to hold the affiliate's shares;
- The bank held entirely the shares of the new entity which was seen as an investment.

Following the new market structure development, the number of banks offering underwriting services grew from 62 to 123 between 1922 and 1931 while the number of affiliates grew from 10 to 114 within the same interval. The percentage of issues underwritten by independent investment banks fell from 78% to 55% between 1927 and 1929 while commercial banks' grew from 22% to 45% within the same interval[27].

Taking into account the severe recession and the capital market collapse, the solution of completely separating commercial banks from its affiliates seemed the best at that time in order to face investors demand for an increase market regulation; the public perception was that affiliates hurt banks and affect their reputation. The solution was later transposed in 1933 into what we know today as Glass-Steagall Act[28] which contained several sections, out of which some worth mentioned regarding conflicts of interest:

- Section 16 – allowed commercial banks to trade securities only in the name and clients accounts;

[26] Johnston V.B. (1983), "The McFadden Act: A Look Back", Federal Reserve Bank of San Francisco, Research Department

[27] Kroszner R. S., Rajan R. G. (1994), "The Role of Firewalls in Universal Banks: Evidence from Commercial Bank Securities Activities before the Glass-Steagall Act" Center for the Study of the Economy of State, University of Chicago, pg. 29

[28] The Wall Street Journal (1998), "Understanding How Glass-Steagall Act Impacts Investment Banking and the Role of Commercial Banks", http://www.ratical.org/co-globalize/linkscopy/GlassSteagall.html, Accessed on April 12, 2009

- Section 20 – banned banks to have affiliates who were offering underwriting services;
- Section 21 – banned investment banks in accepting deposits and commercial banks to engage in any financial activity with financial institutions that offer underwriting services;
- Section 32 – banned commercial banks in having representatives in investment banks' boards.

By developing a long term relationship with its clients, commercial banks hold confidential information not accessible to the general public, superior to those held by investment banks. Universal banks, by combining the two categories, are superior from the information production standpoint, which gave them a special status in underwriting field; following the created synergy, investors should be willing to accept a lower return on bonds underwritten by universal banks.

A commercial bank can exploit the superior information acquired during its course of business by providing funds to the clients with the highest creditworthiness and providing underwriting services to those with a not so good tracking record. When the market suspects that a commercial bank profits from exploiting conflicts of interest, the last one will get penalized by investors who will charge a higher return for the issues it underwrites. If lending and underwriting activities are performed within the same bank, the general public will not be able to recognize if there are conflicts of interest between those two departments. Creation of an entity separate from the bank will help improve public perception but at the same time will reduce economies of scope.

A series of studies[29] rejected the theory which stated that the issues underwritten by universal banks were penalized by investors by charging a higher return. As we can see in the below table, the percentage of the issues underwritten by affiliates grew between 1927 and 1929 from 12.9% to 41.4% while those underwritten by internal departments fell from 9.2% to 4.0% and investment banks' decrease from 77.9% to 54.6%; thus, investors saw universal banks as being the most capable to perform underwriting activities, with their volume increasing significantly.

Table no. 1
Underwriting services providers' market share within 1928 - 1929

Financial type	1927		1928		1929	
Investment banks	4.567	77.9%	2.924	70.4%	1.586	54.6%
Commercial banks:	1.296	22.1%	1.229	29.6%	1.319	45.4%
Affiliates	755	12.9%	970	23.4%	1.204	41.4%
Internal departments	541	9.2%	259	6.2%	115	4.0%
Total bonds issues		5.863		4.153		2.905

[29] Kroszner R.S., Rajan R.G. (1994), "The Role of Firewalls in Universal Banks" Evidence from Commercial bank Securities Activities before the Glass-Steagall Act", Center for the Study of the Economy of State, University of Chicago, pg. 31

An analysis made on a series of industrial bonds within 1921-1929 period[30] showed that the average yields of issues underwritten by affiliates were smaller than those underwritten by universal banks' internal departments; the market considered that separation of different activities as a positive signal in the course of eliminating conflicts of interest.

Table no. 2
Underwriters issues' returns

Type of underwriter	Initial yield average	Initial yield median	Number of issues
Affiliates	2.02%	1.99%	328
Internal departments	2.37%	2.50%	113

Once the financial crisis hit in 1930's, the quality of bonds (in conformity with Standard & Poor's and Moody's rating standards) decreased for all classes of underwriters even though the affiliates issued, on average, better rated bonds; within the affiliates there were registered fewer cases of issues default, quantified both as nominal and quantity.

Still there was a difference between the issues underwritten by universal and investment banks: universal banks didn't look at small companies' issues which carried a bigger probability of default. Investors, not being able cu spot conflicts of interest within universal banks, acted in conformity with Akerlof theory referring to the so called "lemon market": they tried to protect themselves against conflicts of interest by charging a discount to bonds issues. Ratings are good indicators of default probabilities of issues underwritten by universal banks but they are not reliable for those issued by universal banks' affiliates; universal banks tried to compensate this by underwriting only the issues with above average quality whose price are less sensitive to market fluctuation.

Despite the access to the bond market and information, commercial banks concentrated on underwriting smaller issues and, in time, their average size became even smaller. If a small issue is considered of having a size smaller than $75 millions, then 31% of affiliate's portfolio consists on small issues while the proportion within investment banks portfolio was only 8%. This fact shows the important role commercial banks play within the financial system: helping small companies to raise capital.

One of the modalities used by commercial banks to gain market share is to offer clients credit lines, thing that investment banks weren't allowed to do. This brought back the issue of cheap credit lines: a bank finances a company which will reimburse

30 Kroszner R.S., Rajan R.G. (1994), "The Role of Firewalls in Universal Banks" Evidence from Commercial bank Securities Activities before the Glass-Steagall Act", Center for the Study of the Economy of State, University of Chicago, pg. 31

the credit by raising capital with the help of bonds issuance, structure that increases systemic risk within the financial sector.

Under these circumstances, universal banks seemed to offer advantages for both supervisory bodies and shareholders:

- For authorities, big diversified financial institutions, even if look stable, they carry systemic risk. Funding via deposits is cheaper because a part of deposits are guaranteed by specialized institutions; this measure to protect clients can lead banks into taking bigger risks;
- For shareholders, a financial institution model whose investments aren't market-to-market raises suspicions taking into account that its portfolio can accumulate risky positions, which, in the case of using the "banking book" method, will not reveal the true risk embedded. UBS and Citigroup shareholders aren't happy at this moment (when their portfolios are wiped out by the current financial crisis) knowing that the universal bank model is still valid just following the simple argument that both institutions are still standing.

Table no. 3
The benefits vs. risks of the universal bank model[31]

Benefits	Risks
- using deposits taken in underwriting activity; - revenues diversification; - increased synergies: • leads to costs cuts; • opportunities of "cross-selling".	- swapping risks to activities with bigger risk aversion; - mergers have inherent integration difficulties; - the size of the new created financial conglomerates represents a problem itself.

The benefits of the universal bank model are obvious to investment bankers that operate with risky and volatile trading positions and for whom the current market turmoil represent a serious threat (at the beginning of 2008 they reported a leverage of 30 while commercial banks' was only 11)[32]. The constant revenues of commercial and retail divisions can compensate the losses recorded by underwriting activities; this model has also the possibility of offering cross-selling services as a potential source of additional revenues. Banks that offer at this moment these kind of services are "one stop shops" where clients can have access too all services within one location. The model can bring benefits through synergies, not just by boosting

[31] S. Sankar (2008), "Is It Time To Embrace The Universal Banking Model?", http://www.dailymarkets.com/stocks/2008/09/25/is-it-time-to-embrace-the-universal-banking-model/, Accessed on March 26, 2009

[32] Brown A. (2008), "The End of An(other) Era", Bullish Bankers Magazine, http://www.bullishbankers.com/the-end-of-another-era/, Accessed on March 26, 2009

revenues, but by cutting costs also (UBS claims that 10-15% of its market value was created by the group's synergies, with CHF 2.5 billions in extra revenues and just CHF 1.5 billions in expenses)[33].

A major risk is implied by the merger of two distinct activities, especially in the context when banks found easier to acquire small local banks or regional entities; the problems they can face can range from the technological ones to the ones regarding corporate culture. The "too-big-to-fail" model seems over now in the actual market conditions when banks are nationalized in order to avoid bankruptcy due to their exposure on subprime market (diversification means nothing when the correlation tends to one). At this moment investment banks will make a mistake if they will not choose to transform into commercial banks which, aside from steady clients flows, will bring a loosen supervisory from the authorities bodies.

The 2008 financial crisis revealed the deficiencies of different banking models. Trying to face subprime crisis, the biggest independent investment banks gave up on their business model either by bankruptcy or by their sale to a universal bank. The below graph shows how US banks evolved in the last century; it can be noticed that in 2008, even though a decade ago the separation between the commercial and investment banks was lifted, market development determined the extinction of the last ones. Is interesting to observe that the changes that took place in US financial market were influenced by the major crisis from the last century:

- The Great Depression in 1930's;
- The financial crisis from 1997-1998;
- The subprime crisis which started in 2008.

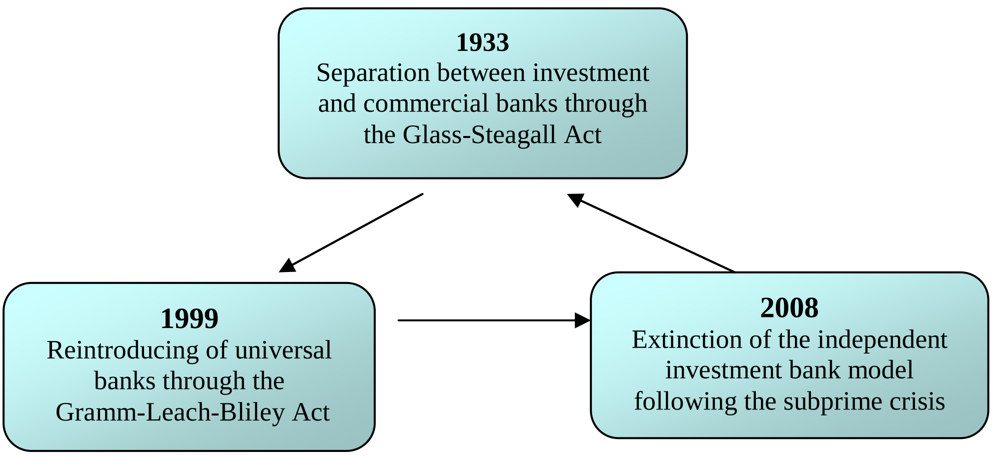

Fig. no. 1
The evolution of US banking model[34]

[33] Slater S. (2008), "UBS universal bank model breaks, rivals defiant", Reuters News, http://www.reuters.com/article/ousiv/idUSLC49736620080812?sp=true, Accessed on March 12, 2009

It is a myth that the deregulation of US financial markets failed and that new regulation within the field are necessary; beside the healthcare system, financial system is the most regulated field of the US economy[35]. There was not even a single type of activity that managed to avoid regulatory oversight; in US there were several governmental bodies in charge with regulating financial markets (e.g. Federal Reserve, Securities and Exchange Commission, Federal Deposit Insurance Company etc). Certainly regulators carry a part of the blame for the current financial turmoil, but for sure lack of regulations is not one of them.

One of the most affected by financial crisis was UBS which decided in middle of 2008 to separate its investment banking unit (responsible for most of the losses connected to subprime lending) and the wealth management unit from the rest of the group; its strategy to offer multiple financial services within the same group (e.g. retail, underwriting, wealth management, mortgages and fund management) didn't have the expected results.

In May 2008, following numerous claims from investors who lost their savings in the financial crisis, Vikram Pandit, Citigroup CEO, stated that "…we have offices in 106 countries and we strongly believe that the most adequate business model at this time is that of the universal bank". On the other hand, UBS chairman, Peter Kurer, stated the same year in August that "… looking retrospectively we discovered the weaknesses associated with the universal bank model"[36].

Looking at the statements above the following question arises: "who is right and who is wrong?" The problems identified by UBS refer mostly to its incapacity of properly assessing the complexity and the risk embedded in its securities portfolio while a shareholder of Citibank stated that "… in the last ten years we had 41 chances (i.e. 41 quarters) to notice that universal bank model isn't paying off"[37]. UBS didn't have a clear picture of the risks and didn't benefit from an adequate supervisory oversight which in the end led to a separation of its businesses. Is not the model that is responsible for the losses faced during the crisis but its management's inefficiency; the crisis didn't do anything but to bring into spotlight a series of deficiencies at the management level. To make a parallel between the strategies adopted by UBS and Citigroup, blaming universal bank model as a business model is like blaming the car and not the driver for producing an accident.

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34 Demirgüç-Kunt A., Huizinga H. (2009), "Bank Activity and Funding Strategies: The Impact on Risk and Return", European Banking Center Discussion,

35 O'Driscoll G. P. Jr. (2009), "Lessons from the Subprime Crisis", Cato Policy Report

36 Kiviat B. (2008), "Is universal banking over? Should it be?" Time Magazine, http://curiouscapitalist.blogs.time.com/2008/08/12/is_universal_banking_over_shou/, Accessed on March 12, 2009

37 An Investment Banker's Take On Life (2008), "Some Thoughts on the Universal Banking Model", http://www.investmentbankeronlife.com/2008/08/some-thoughts-on-universal-banking.html, Accessed on March 13, 2009

Universal banks are market's answer to the financial needs of global corporate clients; this model cannot be blamed because its employees took additional risks in their quest for profits. Universal banks have the role of:

- Reduce the fragmentation in financial intermediation;
- Ease companies' access to capital resources;
- Enhance economies of scale;
- Reduce the cost of financial flows within banking system;
- Promote a better management of financial flows.

In the case of universal banks, the accent was put on the reduction of the degree of regulation with the purpose of gaining economies of scope without inducing the incentive to exploit conflicts of interest. This was a natural step because, in the case of US financial system, the Glass-Steagall Act represented an extreme remedy for eliminating conflicts of interest, through a complete separation of activities.

There are several modalities that can constitute remedies for the conflicts of interest within universal banks, as following:

1. separation of activities

The gains from economies of scope and the potential costs implied by conflicts of interest depend of the degree of separation and the organizational structure. There are three degrees of separation:

- separation of internal departments;
- creation of an entity affiliate to the parent bank whose object of activity will be offering underwriting services;
- banning all other combinations of activities under any organizational structure.

Complete separation removes any conflicts of interest but at the same time it removes also any benefit of economies of scope. Glass-Steagall Act provisions introduced complete separation leading in time to a reduction of US bank competitiveness. In time, this determined authorities to allow the establishment of affiliate entities with their own management and accounting standards; this change was implemented effectively by the Gramm-Leach-Bliley Act in 1999. This degree of separation is not a warrant of affiliates' independence from the parent bank because:

- business strategies are conceived at the group level;
- banks have the interest to protect affiliates fearing that a weak reputation of the last ones will affect group reputation;
- banks can support affiliates through loans, exchange of information flows and services.

2. solving the issue of managerial compensation

The possibility of US financial managers before 1933 to participate in their own name, through a series of partnerships, to syndicate loans (the only purpose being solely the profit) created an incentive for exploiting conflicts of interest. Managers' compensations weren't tied to company's performance and allowed them to obtain extra revenues without a proper transparency towards the shareholders.

A conflict arises just from the fact that managers and shareholders have different time horizons regarding their expectations; while shareholders look at company's long term evolution, managers follow target prices, so if a division will produce superior revenues, it will be preferred over other departments.

3. enhancement of the degree of transparency in information dissemination

Empiric evidence showed that commercial banks were repaid for their capacity of performing other activities different from the standard ones (i.e. lower returns required by investors in bonds underwritten by commercial banks). Market and supervisory agencies' capacity to adequately monitor financial institutions depends also on the quantity of information the last ones are able to disclose. Relationships between affiliates and parent banks should be made public in order to eliminate any suspicion regarding the exploitation of conflicts of interest (in the case of merger and acquisitions this disclosure is not recommended as it may give competition an advantage and jeopardize the whole process).

In the last period, regarding the control of the risks incurred by financial activities, the accent was put on monitoring the operational risk; a bigger weight was given to banks' internal control procedures and managers' compensational structure, concentrating on identifying activities and procedures that favor exploitation of conflicts of interest.

Conclusions

The main issue raised by conflicts of interest for capital markets is represented by the reduction of information flows in the system which makes difficult solving the problems of adverse selection and moral hazard and determines a part of financial flows to be channeled to unproductive investments. The existence of conflicts doesn't imply necessarily a reduction of information flows because the incentives for its exploitation can be insufficient; when conflicts are obvious and perceived so by the market, their exploitation will imply a reputation risk for the respective company whose demand for its services will decrease, thus its profitability.

On the long run, losing reputation represents a risk big enough for the company to try to avoid but on the short run it depends only of the company's transparence and its internal compensational structure. Universal banks have interest to sell securities issued by the companies that experience financial difficulties because in this way the companies will be able to repay their debt towards the bank and the bank will earn additional fees.

Financial markets have the tendency to self regulate and there is evidence in this respect; as we noticed, the market penalized accordingly the conflicts of interest within universal banks: issues underwritten by bonds department within commercial banks were perceived as less attractive by investors comparing to those underwritten by affiliates. Is to be remarked that market adjusts itself to the current global conditions but it should be mentioned that the solutions are not yet applicable because there is a delay between the moment when the problem is identified and the implementation of the solutions. Conflicts of interest are opportunities to exploit the excessive growth of capital markets, but they aren't the cause of financial bubbles. There have been several moments during history characterized by speculative bubbles and which were marked by changes in regulatory framework:

- 1929-1932 – US Great Depression which led in 1933 to passing the Glass-Steagall Act and marked the complete separation between the investment and commercial banks;
- 1998 – the financial crisis from Asia and Russia and the bankruptcies of some US hedge funds led to the repealing of Glass-Steagall Act;
- 2009 – US subprime crisis put universal banking model into spotlight and marked the extinction of the independent investment bank model.

Conflicts of interest can be eliminated by a complete separation of different types of financial activities but this can induce an additional cost on financial intermediation by reducing economies of scope. Passing Glass-Steagall Act after the financial boom of 1920's was an excessive response to market problems, response that brought along the time a significant cost for financial intermediation.

We can conclude that the market, when there is evidence of conflicts of interest, can act to control them by using a series of methods that can start from simple sanctions (losing reputation and future business) and finishing with pecuniary penalties. Is to be remarked also that market solutions work on the long run while those imposed by supervisory authorities function only on short term; on long term they jeopardize market's efficient development and its possible solutions to the problem.

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THE GLOBAL FINANCIAL CRISIS: SOME SPECIAL FEATURES, POSSIBLE RESPONSES

Cristina Tănăsescu[*]

Abstract

The global financial crisis has now moved from containing the contagion to coping with the global recession. This paper identifies some special characteristics of the current recession. First, it began as a crisis of debt and of asset price inflation. Second, it represents a regulatory crisis. The explosion of complex (and unregulated) financial instruments in a high debt environment exacerbated the crisis of debt. Following immediately from this and, third, it represents a massive imbalance in the global economy and a credit crunch. Forth, it represents a collapse of demand and, following from that rising unemployment. Finally, the rising unemployment exacerbates the debt crisis. This completes a vicious cycle. This paper, also, explains the crisis in the view of Kondratieff cycle. It identifies also some possible response to the financial crisis.

Keywords: global financial crisis, debt crisis, Kondratieff wave cycle

JEL Classification: E20, E32, E66, O33

Introduction

The financial crisis crossed national boundaries and spread from individual financial institutions to wider economy. The global financial crisis resulted from a confluence of factor sat processes at both the macrofinancial level (across financial sectors) an at the microfinancial level (the bevavior of individual institutions and the functioning of specific market segments). This joint influence of both macro and micro factors resulted in market excesses and the emergence of systemic risks of unprecedented magnitude and complexity.

Some special features of the current global financial crises

Both the trigger of the global financial turmoil that started in the summer of the 2007 and its proximate causes were essentially financial in nature, and originated in a specific segment of US financial markets. However, when we look at how the crisis spread rapidly across markets and then progressively affected the real economy, not just in the industrialised world but globally, it is immediately clear that only a much broader set of interrelated factors – macroeconomic as well as financial – could have generated a crisis of these proportions.

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In attempting to disentangle these factors, one should avoid the temptation to look for simple reductionist approach, leading to mono-causal explanations. The global financial crisis has now moved from containing the contagion to coping with the global recession.

There are some special characteristics of the current recession. Unlike recent episodes of recession this is not just a case of an asset bubble bursting with implications for some financial institutions and an accompanying contraction of demand which could be addressed by automatic stabilizers on the fiscal side and a monetary policy that cut interest rates. This recession is a far more complicated entity. First, there was an asset bubble caused by a glut of savings in the global economy and the US`s inexhaustible appetite for debt. Thus the savings glut which led to low interest rates largely financed excessive US consumption – not investment. This led to a substantial hike in asset prices (particularly home prices), aided by the commodities boom following strong growth performance in emerging economies . the debt spiral that this resulted in has been well discussed in the literature – suffice it to say that when bad mortgage debt started being recalled (the so called subprime crisis) it was quickly realized that there was a general credit crisis following from the existence of vast sums of toxic assets in the balance sheets of banks and other financial institutions. As a result, the collateral backing of many credit advances started being questioned and credit froze. This led to a collapse of demand and rising unemployment – all in a vicious cycle. In a series of influential papers, Carmen Reinhart and Kenneth S. Rogoff have studied the historical record of countries experiencing severe financial crises. They report that real housing price declines average 35 percent stretched out over six years from peak to trough, while equity price collapses average 55 percent over a downturn of about three and a half years. The unemployment rate rises by an average of 7 percentage points over the down phase of the cycle and output falls by an average of over 9 percent. The real value of government debt tends to explode, rising an average 86 percent, because of lost tax revenues. [Carmen Reinhart and Kenneth S. Rogoff, (2009)]. Reinhart and Rogoff also find that the historical patterns of banking crises in middle-to-low-income countries have been similar to those in rich countries. [Carmen Reinhart and Kenneth S. Rogoff, (2008)].

Thus, as distinct from most recessions in the recent past the current deep recession represents a combination of many factors:

- **a crisis of debt and of asset price inflation** (easy access to credit, relaxed lending standards)
- **a regulatory crisis**: inadequate regulations (regulations did not keep pace with innovations in financial products, leading to much higher complexity, poor transparency and greater risk)
- **complex credit derivatives**: the invention an duse of complex derivating such as CDOs (Collateralized Debt Obligations) made it difficult to identify and contain the subprime problem, once default rates began to rise.

- **Increasing use of new global financial instruments** – spread out risk (but heightened risk) + reduced transparency (opacity of markets: the counterparty risk)

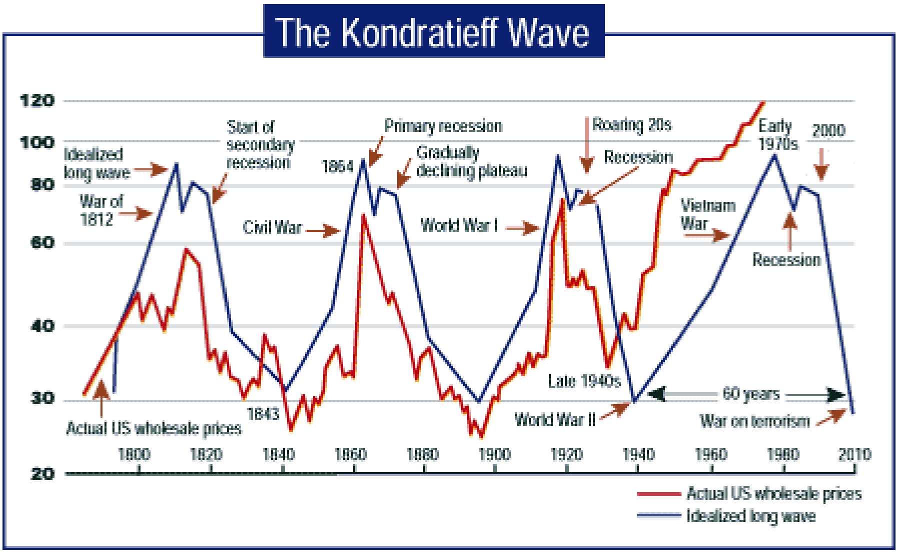
Another explanation of the financial crisis in the view of Kondratieff Wave

The economic literature debates about crisis as a turning point of the economic cycle. The Kondratieff wave cycle goes through four distinct phases of beneficial inflation (spring), stagflation (summer), beneficial deflation (autumn), and deflation (winter). Since, the last Kontratieff cycle ended around 1949, we have seen beneficial inflation 1949-1966, stagflation 1966-1982, beneficial deflation 1982-2000 and according to Kondratieff, we are now in the (winter) deflation cycle which should lead to depression.

A simplified and somewhat updated sequence of Kondratieff Waves can be seen as follows;[38]

Period	Date	Innovation	Saturation point
First Industrial Revolution	Circa 1800 – 1850	Cotton based technology; spinning weaving etc.	1810 –end of Napoleonic Wars
Second Industrial Revolution	Circa 1850 – 1900	Age of steam; railways, shipping, heavy industry, iron and steel etc.	1870s
Third Industrial revolution	1908 – 1947	Petrol chemicals, internal combustion engine, electrification.	Inter-war slump 1920s and 30s
Post-war Boom	1947 – 1991	Consumer goods, electronics, etc	1973
Contemporary Era	1991 – present	The Internet, mobile technologies, bio-technologies etc	2010s

38 http://en.wikipedia.org/wiki/Kondratiev_wave



The current cycle most likely peaked in 2000 with a possible winter phase beginning in late 2008. The Austrian-school economists point out that extreme price inflation in the absence of economic growth is a form of capital destruction, allowing either stagflation (as in the 1970s and much of the 2000s during the gold and oil price run-ups) or deflation (as in the 1930s and possibly following the crash in commodity prices beginning in 2008) to represent a recession or depression phase of the Kondratieff theory.

Probably Kondratieff's greatest contribution to the science of investment is not his observation the world economy operates in long cycles. Cycles would suggest a repetitive nature to events. While the underlying economic conditions will repeat over time due just to the physical nature of our world, our reactions will always be tempered by knowledge and experience. The history of man has been one long climb higher. Kondratieff recognized progress as the irreversible trend.

Imposed upon our progressive nature are the physical limits of life. It is the interaction of these physical limits with our dreams and aspirations that creates the constant push pull of the economy known as the Long Wave.

Some responses to the financial crisis

Immediate and short-term policy responses are required to ensure that (1) the financial crisis is contained, (2) that confidence in financial systems is restored and that (3) the impact on the real economy is minimized. Over the longer term, countries should focus on strengthening their financial systems within the context of reforming the global financial architecture. Domestic financial development depends on a better global financial architecture and vice versa.

Table 1
Summary of responses to the financial crisis

Timeframe	Objective	Policy options
Immediate	Containment of financial panic	• Guarantee bank deposits • Guarantee interbank loans • Provide liquidity to banks • Forbearance on regulations
Short term	Resolution measures Monetary expansion Fiscal expansion Trade expansion	o Recapitalize banks o Mergers and aquisition in financial sector o Reductions in the costs of borrowing o Raise inflation targets o Increase in spending on social safety nets, including conditional and unconditional grants and public works o Lowering of protective measures o Maintain competitive exchange rates
Longer term	Domestic financial development Reform of international financial architecture	▪ Increase the access to finance ▪ Improve domestic resource mobilization ▪ Improve efficiency of banking sector ▪ Avoid financial repression ▪ Improve supervision and regulation ▪ Strengthen property and contract rights, judiciary and rule of law ▪ Proceed, but with caution, with financial openness ▪ Move to a more inclusive system of global financial governance ▪ Reform bretton Woods Institutions

Source: Wim Naude, The Financial Crisis of 2008 and the Developing Countries, UNU-WIDER, Discussion Paper No.2009/01.

Conclusion

There has been an increasing disconnection between the real and financial economies in the past few years, with the latter growing at a much faster pace.

There is no denying that weaknesses and failures in financial markets played a major role in the build up to the crises. Over the last decade, financial innovation has been organized to transform illiquid and risky instruments into – apparently – safe and liquid assets. That unsustainable process has abruptly come to an end with the burst of the credit bubble. During that period, rating agencies, accounting rules, unregulated and off balance sheet entities as well as very poor risk management all contributed to fragilize our financial systems. Those weaknesses are at the origin of the crisis. Thus, as distinct from most recessions in the recent past the current deep recession represents a combination of many factors. First, it began as a crisis of debt and of asset price inflation. Second, it represents a regulatory crisis. The explosion of complex (and unregulated) financial instruments in a high debt environment exacerbated the crisis of debt. Following immediately from this and, third, it represents a massive imbalance in the global economy and a credit crunch. Forth, it represents a collapse of demand and, following from that rising unemployment. Finally, the rising unemployment exacerbates the debt crisis. This completes a vicious cycle. And, more, if you look at the place that global economy occupies in the view of Kondratieff Wave (this has already anticipated the crisis), we have the whole picture of the current period.

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THE EUROPEAN FUNDS – AN ANTI-CRISIS MEASURE AT THE MOMENT

Daniela Florescu[*]

Abstract.

The European funds do not represent an inward purpose, but instruments in reaching the objectives established at the level of the European Union, of the EU member state, based on the implementation documents. The access to Social and Cohesion Funds offers Romania a possibility to develop the regions which are lagging behind, to modernize transport and environment infrastructure, to support rural development, to create new employment opportunities, to sustain social policies which will lead to the growth of the standard of life. The non-reimbursable structural assistance is more the support replaces an important part of the financial effort that should be done by a state on its own, the more helpful and precious is. This research work displays diverse aspects concerning the implementation modalities of irredeemable funds. Furthermore, the existence of a strong institutional structure was absolutely necessary, capable to ensure the formulation and application of public policies, to keep the coordination processes inside ministries going, the implementation of national programs, increasing the application capacity of partnerships between local administrations.

Keywords: structural funds, irredeemable financing, management authorities, regional operation programs, absorption capacity, convergence.

JEL Classification: F36, F35, O29

Categorically, the financial crisis, started worldwide about two years ago, creates big problems to the entrepreneurs who either benefited from a credit line and now they are hardly coping with the debts, or are at the very beginning and, since they no longer find financing sources, they are about to take a step back or even to definitely give up the project.

Today, every one talks about the crisis, even the astrologers make fuzzy forecasts. On everyone's lips one can read questions such as: What is the propagation speed of the crisis? Up to what level shall we see its effects? How does the crisis affect our business? What is the good direction to turn to, so that to be less affected? In short: What's to be done?

If that's how things really were, we only have one solution: to find a cheap financing source, that would allow us to develop new businesses, adjusted to the new requirements and to the new conditions. This particular source is represented by the structural funds, Romania being able to benefit from non-redeemable funds in amount of Euro 32 billions for the period 2007 – 2013.

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The structural funds are post – adhesion funds paid from the European Union budget, whose main objective is to provide support for the member states so that the economic and social disparities between the European Community regions diminish. They are used to support investments in: education, health, development of IMMs (small and medium sized enterprises), infrastructure and transport, environment, energy sector, agriculture, tourism, research, professional training etc.

The prioritized objectives of the European funds for the period 2007 – 2013 are:

- objective Convergence, which promotes the structural development and adjustments of the regions with delays in development;
- objective Regional Competitiveness and Employment, which supports the regions not eligible for the objective Convergence;
- objective Territorial European Cooperation, which supports transnational regions, counties and areas.

Which to concern the structural assistance allocated to the Member States from the EU27 for 2007-2013 is of 308 billion euro, which represents 35% of the EU budget of an 862 billion euro value. The amounts allocated to the new Member States for the 2007-2013 period are significantly larger than in the first exercise. For the EU8 plus Romania and Bulgaria, the total amount allocated is of 175 billion euro, representing more than half of the entire budget allocated for the cohesion.

In 2009, Romania can engage from the European funds, through the operational programs, non-redeemable funds in total amount of Euro 4,168,964,971, as follows:

- through the National Rural Development Programme: 1.442.871.530 euro;
- through the Regional Operational Program: 441.135.485 euro;
- through the Environment Regional Operational Program: 578.507.217 euro;
- through the „Human Recourses Development” Sector Operational Program: 452.584.803 euro;
- through the Program „Growth of the Economic Competitiveness” Sector Operational (POS – CCE): 386.097.057 euro;
- through the „Growth of Administrative Capacity” Operational Program: 40.850.990 euro;
- through the Transports Regional Operational Program: 770.539.727 euro;
- through the „Technical Assistance” Operational Program: 26.221.919 euro.

When it comes to such amounts, everyone is questioning the manner of improving the capacity to manage the structural funds. Even the President of the country thinks that the absorption of the structural funds must represent a first degree priority nowadays. Moreover, the President is not happy by the fact that 85% of the money received as advance down payment ware not spent, considering that in the years 2007 and 2008, the European Union transferred into the Treasury accounts of the Ministry of Finance (the management authority) advance down payments of Euro 1.85 billions coming from structural funds, out of which only Euro 200 million were spent on quite insignificant projects.

According to European Innovation Scoreboard 2007, Romania is ranked last among the European countries as far as the innovation capacity is concerned. The states who propounded a more explicit objective with regard to the innovation shall have the possibility to create a cohesion and concentration for the investments in the field. Romania, by not specifying the innovation, also in the case of the economic competitiveness objective, shall not register significant transformations, but it could lessen the investments effort. Comparative to other states, we chose the JROP type funds allocation model by regions, a centralized national program respectively, with financial allowances differentiated by regions depending on the development level. The regional program does not provide the possibility to differentiate the development objectives for each region, it only established a number of national priorities that are to be implemented at the regional level, allowing for a funds re-allocation depending on the absorptive capacity of each region, fact that brings into question the final objective concerning the reduction of regional differences.

With regard to the actual stage of the European funds absorptive process, by regional programs, at Jun 30th, 2009 the status is as follows:

OPERATIONAL PROGRAMS	Reporting period	Total funds allocations mil lei	PROJECTS SUBMITTED			PROJECTS APPROVED		
			Number of projects	Total allocations (mil lei)	Total assistance EU (mil lei)	Number of projects	Total allocations (mil lei)	Total assistance EU (mil lei)
Regional Operational Program	31.01.09	4.964,78	1.418	14.038,68	8.881,63	64	2.134,30	1.515,36
	30.06.09		1.960	20.556,555	13.559,559	541	4.390,120	3.007,556
Environment Regional Operational Program	31.01.09	5.441,03	69	5.789,97	3.844,63	32	4.185,41	2.796,66
	30.06.09		113	6.688,440	4.433,595	42	5.407,856	3.575,852
Transports Regional Operational Program	31.01.09	5.523,20	16	4.401,61	1.535,71	6	127,17	28,49
	30.06.09		33	7.703,162	2.921,422	12	321,335	63,395
Growth of the Economic Competitiveness Sector Operational Program	31.01.09	3.084,50	2.880	16.721,61	8.221,13	337	1.787,57	1.221,70
	30.06.09		3.361	18.840,637	9.079,889	850	2.435,866	1.367,519

Human Resourses Development Sector Operational Program	31.01.09	4.205,64	2.834	10.180,65	8.254,10	249	1.586,97	1.272,4
	30.06.09		3.005	10.424,194	8.408,404	648	3.003,550	2.398,856
Growth of the Administrative Capacity Sector Operational Program	31.01.09	376,58	206	318,95	270,39	30	54,31	44,06
	30.06.09		353	438,973	349,951	49	103,770	84,723
Technical Assistance Operational Program	31.01.09	238,05	7	73,56	45,46	5	62,39	37,76
	30.06.09		16	144,830	94,652	12	124,040	79,252
TOTAL	31.01.09		7.430	51.525,030	31.053,050	723	9.938,120	6.916,430
	30.06.09	23.833,78	8.831	64.796,791	38.847,472	2.154	15.786,537	10.577,153

Absorption capacity January – Jun 2009
Source: Authority for Coordination of Structural Instruments

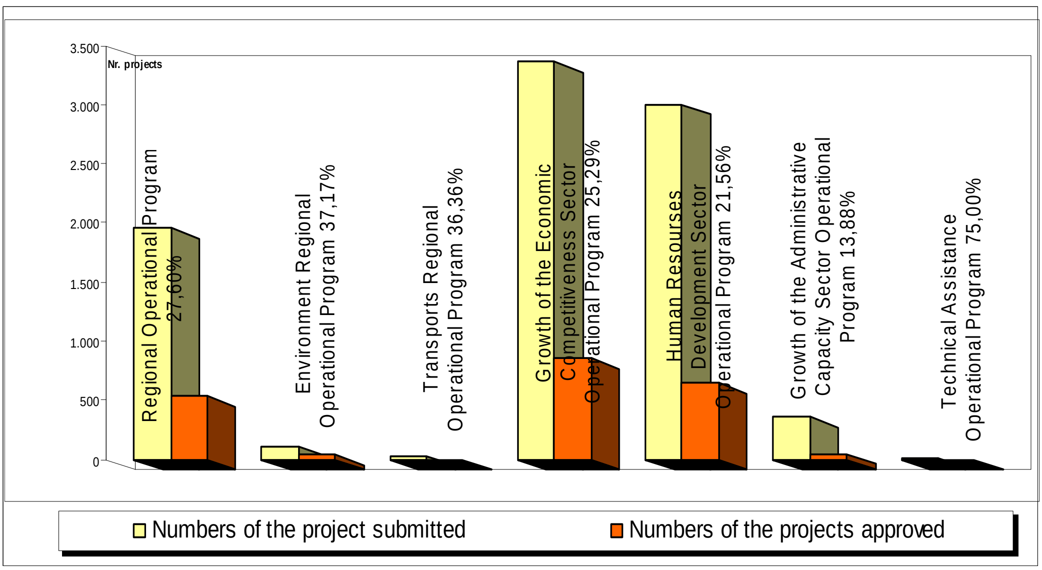

Fig 1. Situation of numbers the project approved in numbers of the projects submitted

Tracking down the events' chronology, we can only draw one sole conclusion: something is wrong. We have projects exceeding, in some cases, twice the amounts budgeted by the program, such as the Regional Operational Program, Growth of the Economic Competitiveness Sector Operational Program (294%), Human Resourses Development Sector Operational Program (200%), but so far, within the POR projects we could only engage amounts up to half of the allocations: Regional Operational Program (61%), Growth of the Economic Competitiveness Sector Operational Program (44%), Human Resourses Development Sector Operational Program (57%).

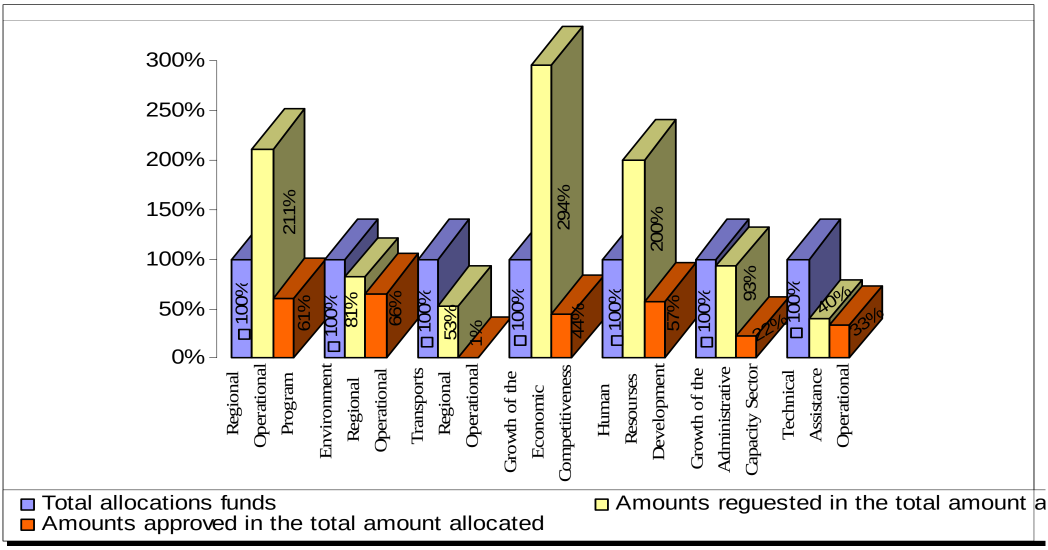

Fig. 2. Situation of amounts requested and amounts approved in the total amount allocated

On a careful analysis of the situation, it can be noted that Romania is facing a whole chain of problems. Although the projects were submitted more than one year ago, they have not received a solution yet. The explanation of the representatives of the competent authorities is simple: they have a small number of available personnel, working on the signing of the contracts and preparing the Guide for launching the financing line of this year. The previous Government approved a staff increase by 30 jobs for each management authority, but everything was cancelled once the expenses diminishing policy of the actual Government was implemented.

This is a vicious circle. Everyone knows it, but no one has a solution. Nobody wants to officially complain about this problem. This is a system problem, but nobody cares to solve it. If the budget expenses cannot increase in 2009, because the deficit must be kept under control, it is obvious that other solutions need to be sought for. That is because, naturally, there are no public servants working free of charge, no pro-bono evaluators or projects already evaluated. Every time, the Government people take pride in the methods of simplifying the funds accessing procedures, but the solutions prove to be unreliable. A huge gap was created between the period when the projects were submitted and the time when they get solved, a gap which caused many of the entrepreneurs to give up, while others made the impossible to maintain their initial activity and investments plan.

The staff issue is not singular; there are much more swoons co-working in the delaying of the absorption of the structural funds:

- excessive bureaucracy (for instance, the signing of the documents in black ink triggers the rejection of the financing application, the pages should only be numbered in the upper right corner, etc.);
- lack of inter-cooperation between the management authorities for planning and coordinating the general activity. Although, at the beginning of this year, an Inter-ministerial Committee was created, the coordination between the operational programs is missing;
- the programs are not focusing on truly important problems;
- lack of professionalism of the management authorities specialists, who can barely handle the bureaucratic paperwork (at the beginning of 2008, less than 40% of the personnel was experienced in working with the European funds)
- modification of the Applicant's Guide during the projects assigning tenders;
- lack of prior notifications;
- the reduced number of partners invited to discussions, on the occasion of diverse events on the theme of the European funds;
- too little time for expressing opinions or the lack of feedback after discussions , etc.

Romania is not the only one facing problems related to the absorption of European funds. Therefore, the European Committee established a new target: to simplify certain rules in the management of the European funds in order to support the regions in fighting back its negative effects.

Concretely, considering the rapid growth of the unemployment in all the European Union member states, in a moment when their budgets are really tight, it was decided to give the opportunity to pay back 100% of the costs declared by the member states for the projects financed from the European Social Fund (FSE) in 2009 and 2010. The member states are not required to contribute with a national co-financing, which allows a speed-up of the implementation of the projects supporting the employment. This option does not re-open the discussion on the distribution of funds among the member states, or the total value of the funds and raises not liabilities on the member states to contribute with a subsequent co-financing.

This modification is mainly focusing on facilitating the implementation of 455 programs in the sphere of cohesion policy for 2007-2013, representing total investments of EUR 347 billions, which means more then one third of the community budget. The objective is to accelerate the flow of investments mainly directed towards those who complete the projects and towards the Europe citizens most affected by crisis.

With regard to the slow start-up of the big infrastructure projects, caused by the complementary financing difficulties of the European investments faced by the public finances of the member states and regions, measures were taken in order to clarify and simplify certain daily management norms of the European funds; among these, a tremendous importance is shown for:

- establishing one category of „ major project". Previously, the European Committee approved all projects whose total cost exceeded Euro 25 millions in case of environment projects, and Euro 50 millions for the projects in other sectors. From now on, the minimum approval value was set to Euro 50 millions for all fields. Consequently, the environment projects of smaller importance could be started faster;

- the norms of „income generating " projects (for example, paid highways or projects involving the rental or the sale of land plots) are also simplified, in order to reduce the administrative tasks undertaken by the member states;

- programs in the sphere of cohesion policy could be reviewed by the member states in a simpler manner, in order to able to take the new reality into account. On the other hand, certain dispositions concerning the obligation to maintain the investments for a period of five years will no longer be applicable for the commercial companies went bankrupted;

- investments in sectors related to the energy effectiveness and the use of the regenerative energies for accommodations shall be encouraged, due to their important potential in generating increase and work places;

- modification on increasing the flexibility of the disengaging norms. For example, the financial allocation for a major project will be fundamentally protected once the member state sends the project to the Committee. Presently, they are not protected unless the Committee approves the project;

- FEDER will be able to support accommodation refurbishing or building activities to the favor of the communities challenging social exclusion, both in rural areas, and in urban areas. Previously, the construction of accommodations was not eligible for FEDER financing and only accommodations in urbane areas could be subject to refurbishments.

The storm on the financial markets will slow down, but the loans will be more and more expensive. This is the reason why the European funds become very important for our development.

Therefore, it can be estimated that there is a set of terms which beneficiaries of this type of financing must accomplish, in order to have a good absorption rate. Among the first terms is programming the public investments programs as effective as possible, which would allow a full integration of structural funds in the public finance systems. The second conclusion which can be drawn out of the experience of the states is related to the partnerships which the local administrations have to fulfil with the representatives of the civil society. Mostly, in these regions, the local administration has a limited capacity and partnerships with non-governmental subjects allow co financing the projects and implicitly generates the rising of the level of accessing structural funds.

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THE BUDGETARY DEFICIT – BETWEEN THE PERMISSIVE SIDE AND THE ACTUAL ECONOMICAL REALITY

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Abstract

A budget deficit is a common economic phenomenon, generally taking place on governmental levels, and occurs when the spending of a Government exceeds that of its financial savings. In fact, budget deficit normally happens when the Government does not plan its expenses, after taking into account its entire savings. At the level of the European Union, the budgetary deficit of the member states was established through the Maastricht treaty: budget deficit level that must be lower than 3% of GDP. According with the restriction regarding the budgetary deficit, there was elaborated an excessive budgetary deficit procedure, annexed to the treaty.

The agreement convened by Romania with the FMI and the European Commission states complying with four conditions, mentioned in the paper. At the European Union level the diversity manifests also regarding the financial result recorded by every member state; from a total of 27 member states ,only 9 member states fulfill the criteria regarding the budgetary deficit, and those are: Belgium, Czech Republic, Germany, Estonia, Italy, Slovenia, Slovakia, Austria, and Portugal, the others confronts themselves either with EDP or with the situation of budgetary excess.

Keywords: budgetary deficit, excessive deficit procedure, FMI agreement, fiscal measures

JEL Classification: H 62, H 68, F 36

Introduction

The budgetary deficit represents a negative situation with which the public budget can face itself with. Although the budgetary deficit was not accepted by the classic finance theory, nowadays the possibility of elaborating the state budget with deficit and accepted practice and often met at the level of most states, accentuated also by the effects of the worldwide economical crisis, the condition that actually represents the object of study of this paperwork. A budget deficit is a common economic phenomenon, generally taking place on governmental levels. Budget

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Deficit occurs when the spending of a Government exceeds that of its financial savings. In fact, budget deficit normally happens when the Government does not plan its expenses, after taking into account its entire savings. Budget deficit means net borrowing as defined in the European System of Integrated Economic Accounts.

1. The budgetary deficit and the excessive budgetary deficit procedure

What does actually mean the budget deficit? The budget deficit is the consequence of the fact that the incomes made at the level of a public budget are inferior to the expenses made. At the level of the European Union, the budgetary deficit of the member states was established through the Maastricht treaty, this treaty was concluded in February 1992 and it stipulates five criteria of convergence that a European Union member state must fulfill in order to adopt the unique currency. Thus, these criteria make reference to[39]:

a) **Inflation** – in order to be eligible to become a member country of the monetary union, the inflation must not exceed by more than 1.5% the average of the three EU members with the greatest price stability.

b) **Long-term interest rates** must not exceed by more than 2% the average in three EU members with the greatest price stability.

c) **The exchange rate** between the applicant country's national currency and the euro must not fluctuate by more than +/-15%

d) **The fourth convergence criteria** is of budgetary nature and it makes reference to the budget deficit level that must be lower than 3% of GDP. This 3% level of the budgetary deficit was established starting from the Germany's system that worked following the principle that the budgetary deficits are allowed only if they comply with the public investment expenses, because these actually represent a future economical growth source, in this way being able for the contracted loans to be financed. Germany also thought that the public investments rise up to approximately 3% of GDP.

e) The last but not least criteria states that **Government debt** must be lower than 60% of GDP.

According with the restriction regarding the budgetary deficit, there was elaborated an excessive budgetary deficit procedure, regulated by the article 104c from the setting up treaty of the European Union and in the protocol regarding the appliable procedure for the excessive deficits, annexed to the treaty. This procedure consists in scrolling a set of stages, as it follows[40]:

1. When an European Union member state does not comply to the two requirements above mentioned, or one of them, the European Commission elaborates a report in which it analyzes if the value of the public deficit is superior to the value of the public investment expenses, taking in account all the other relevant

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[39] Economia integrării europene – Baldwin Richard, Wyplosz Charles, pg. 371 - 372

[40] The institution Treaty of the European Union, article 104c

factors, including the economical and budgetary position on a medium term of the state in question.

2. The Economical and Financial Committee approves the Commission's report.

3. The Commission, if it considers that there is an excessive public deficit, or the risk of it happening, the commission send a notice to the Council.

4. The Council, based on the recommendations of the Commission and on possible observations of the state in question, adopts a decision through majority regarding the existence of an excessive deficit.

5. If the Council finds an excessive public deficit, it forwards recommendations to the member state in order for it to end the existing situation in maximum 6 months; these recommendations are not made public.

6. If they find that no action wad made for straightening out the situation, followed by favorable results, the Council can make public the recommendations.

7. When a member state persists in not following the recommendations of the Council, the Council can decide to unemploy the member state in order to take measures of reducing the deficit, in a deadline. It can also ask for the state in question to present some reports following a precise calendar, in order to examine the efforts that were made for adjusting the deficit situation.

8. The Council will abolish some or all of its decisions if it thinks that the excessive deficit was corrected.

9. If it is not intervened in the margins stipulated by the establishment and growth Pact, if the state in question is not a part of the zero zone, the Council can decide to partially or fully suspend the commitments of the Cohesion Fund for the state in question, starting from the first of January of the next year following the suspension decision, if the state member has not taken effective measures in accordance with the recommendations made by the Council[41].

The Member States shall report their planned and actual deficits and the levels of their debt promptly and regularly to the Commission.[42] The member states report to the Commission their planned and effective public deficits and the levels of the public debt; this is made twice a year, first before 1 April of the current year (n year) and second before First of October of the n year.

2. The budgetary result of the European Union member countries between two poles apart

While the American people learn what a trillion is, the USA budgetary deficit exceeds 1.000 billion dollars after the first 9 months of the fiscal year 2009[43], numerous states from the European Union have as we speak deficits over 3% of GDP. As a result of the sharp global financial and economic crisis EU public

[41] See the Note regarding the excessive deficit procedure for Romania, from 5.05.2009, elaborated by the Department for European Affairs

[42] http://europa.eu/eur-lex/en/treaties/selected/livre335.html

[43] http://www.zf.ro/zf-24/americanii-invata-ce-este-trilionul-deficitul-bugetar-al-sua-a-depasit-1-000-miliarde-de-dolari-dupa-primele-noua-luni-ale-anului-fiscal-2009-4638676/

finances are under stress. The crisis brought about a decline in tax revenues and a rise in expenditure (e.g. in unemployment benefits). The existence of special circumstances which entailed a collapse of exports, a sharp tightening of mortgage loans and corporate loans, which also contributes to quickly rising unemployment rates, determinates the European authorities to initiate the EDP.

In the euro area the government deficit to GDP ratio increased from 0.6% in 2007 to 1.9% in 2008, and in the EU27 it increased from 0.8% to 2.3%. In the euro area the government debt to GDP ratio increased from 66.0% at the end of 2007 to 69.3% at the end of 2008, and in the EU27 from 58.7% to 61.5%.[44]

There are nine EU countries for which the Commission makes budgetary correction recommendations in 2009. Four are already in EDP: France, Greece, Ireland and Spain that joined Hungary and the United Kingdom which were the only two countries under heightened budgetary surveillance before the crisis intensified.[45] Alongside Latvia, recommendations on another four - Malta, Lithuania, Poland and Romania were considered by the EU finance ministers on 7 July 2009, together with new recommendations under article 104.7 addressed to Hungary.

Table 1: Government deficit / surplus % of GDP in EU Member States

Member State	Government deficit (-) / surplus (+) % of GDP			Government debt % of GDP		
	2006	2007	2008	2006	2007	2008
Belgium	0.3	-0.2	-1.2	87.9	84.0	89.6
Bulgaria	3.0	0.1	1.5	22.7	18.2	14.1
Czech Republic	-2.6	-0.6	-1.5	29.6	28.9	29.8
Denmark	5.2	4.5	3.6	31.3	26.8	33.3
Germany	-1.5	-0.2	-0.1	67.6	65.1	65.9
Estonia	2.9	2.7	-3.0	4.3	3.5	4.8
Ireland	3.0	0.2	-7.1	24.9	25.0	43.2
Greece	-2.8	-3.6	-5.0	95.9	94.8	97.6
Spain	2.0	2.2	-3.8	39.6	36.2	39.5
France	-2.3	-2.7	-3.4	63.7	63.8	68.0
Italy	-3.3	-1.5	-2.7	106.5	103.5	105.8
Cyprus	-1.2	3.4	0.9	64.6	59.4	49.1
Latvia	-0.5	-0.4	-4.0	10.7	9.0	19.5
Lithuania	-0.4	-1.0	-3.2	18.0	17.0	15.6
Luxembourg	1.4	3.6	2.6	6.7	6.9	14.7
Hungary	-9.2	-4.9	-3.4	65.6	65.8	73.0
Malta	-2.6	-2.2	-4.7	63.7	62.1	64.1
Netherlands	0.6	0.3	1.0	47.4	45.6	58.2

[44] Eurostat. Newsrelease. Euroindicators, Eurostat Press Office, No. 56 / 22 April 2009, http://ec.europa.eu/eurostat

[45] Europe Press Release IP/09/1069, Brussels, 2 July 2009, pg 2

Austria	-1.6	-0.5	-0.4	62.0	59.4	62.5
Poland	-3.9	-1.9	-3.9	47.7	44.9	47.1
Portugal	-3.9	-2.6	-2.6	64.7	63.5	66.4
Romania	**-2.2**	**-2.5**	**-5.4**	**12.4**	**12.7**	**13.6**
Slovenia	-1.3	0.5	-0.9	26.7	23.4	22.8
Slovakia	-3.5	-1.9	-2.2	30.4	29.4	27.6
Finland	4.0	5.2	4.2	39.2	35.1	33.4
Sweden	2.5	3.8	2.5	45.9	40.5	38.0
United Kingdom°	-2.7	-2.7	-5.5	43.4	44.2	52.0
	-3.1	*-2.7*	*-2.8*	*41.9*	*42.7*	*43.2*

° Data refer to calendar years. Data referring to the financial year (1 April to 31 March), are shown in italics.

For the United Kingdom, the relevant data for implementation of the excessive deficit procedure are financial year data.

Source: Eurostat Newsrelease No. 56/ 22 April 2009, Eurostat Press Office, pg. 4-7

2.1 The first pole: countries that have an excessive budgetary deficit

Romania - The global economic downturn has resulted in a sharp drop of private capital flows to Romania, leading to a significant deceleration of activity since the fourth quarter of 2008. According to data notified by the authorities in April 2009 and validated by Eurostat, the general government deficit reached 5.4% of GDP in 2008, thus exceeding the 3% of GDP reference value, while the general government debt stood at 13.6% of GDP in 2008.[46]

The general budgetary consolidated rose up in Romania, after the first four months at 9,4 billion lei, respectively 1,78% of GDP, from the 1,5% of GDP that was recorded at the end of March 2009.[47] Reentering in the margins prefigured by the Stability and Growth Pact represents one of the main objectives of the financing agreement between Romania and FMI and CE. Within this context, the main budgetary political elements on a short term – in the 2009 year – and on a medium term – 2010 and 2011 endorses[48]: reducing the budgetary deficit by 1,1% of GDP up to 4,6% for the general budgetary deficit stabilized next to a scenario based on 5,7% that took into consideration the economical decline from 2009; reducing the primary budgetary expenses, exclusively the interests, with approximately 0,85% of GDP, in comparison with the 2009 year's budget and increasing the additional incomes with 0,25%; The follow-up of the fiscal consolidation and reducing the deficit so that in 2010 the budget's deficit to be about 3,7% of GDP and in 2011 under the threshold

[46] Romania -Report from the Commission prepared in accordance with Article 104(3) of the Treaty SEC(2009) 647, Brussels, 2009, pg. 3

[47] http://www.zf.ro/zf-24/deficitul-bugetar-a-urcat-la-1-78-din-pib-dupa-patru-luni-4294626/ mai 2009

[48] Nota privind Procedura de deficit bugetar excesiv in cazul Romaniei data de Departamentul de Afaceri Europene a Guvernului, 05.05.2009

of 3% of GDP just as the Stability and Growth Pact states. The government engaged before the International Monetary Fund, within the financing agreement in total value of 20 billion euros (from which 13 billion euros from the FMI), to situate itself in certain budgetary deficit targets in each trimester, so that, at the end of December the budgetary deficit will not exceed 24.36 billion lei (which represents 4.58% of GDP, that was estimated at 531.3 billion lei for 2009). For the end of the II trimester it was established a target of 14.51 billion lei (2.73% of GDP), and for the third trimester 18.61 billion lei (3, 5% of GDP)[49]. In the first of July, the ministry of finances stated that according to the first evaluations the budgetary deficit has reached, after the first six months of this year, 2.7% of GDP, slightly under the quarterly target that was convened with the FMI.

From 2009 onwards, fiscal policy aims to correct the significant external and internal imbalances that have been allowed to develop in the economy.

The Commission recommended that Romania corrects the excessive deficit by 2011 in view of the large imbalances and the economic and financial situation and an average annual fiscal effort of at least 1½% of GDP starting with 2010.[50] It should implement the fiscal measures as planned in the February 2009 budget and the April 2009 amended budget, especially in the area of public sector wages and pension reform; take further corrective action if needed to achieve the 2009 deficit target in order to ensure compliance with the commitments undertaken under the programme supported by EC balance of payments assistance.

Poland According to data notified by the Polish authorities in April 2009, the general government deficit reached 3.9% of GDP in 2008.[51] This was significantly more than the expected 2008 outturn of 2.7% presented in the December convergence programme. Poland's general government deficit over the past five years averaged 4.3% of GDP, at the same time as GDP growth on average exceeded 5%.[52] The Polish authorities announced that the general government deficit may significantly exceed the 4.6% of GDP planned for the current year in the Spring 2009 EDP notification. The Polish authorities should put an end to the excessive deficit situation by 2012 at the latest. This implies an average annual fiscal effort of about 1¼ -1½ percentage points of GDP starting in 2010.[53]

Lithuania had a general government deficit of 3.2% of GDP in 2008.[54] The deterioration of the fiscal position in 2008 was mainly due to expansionary fiscal policy and, to a lesser extent, lower-than-budgeted tax revenue, reflecting the

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49 http://www.realitatea.net/geoana-spune-ca-deficitul-bugetar-ar-putea-depasi-in-acest-an-nivelul-convenit-cu-fmi_555242.html 4 iulie 2009

50 Europe Press Release IP/09/990, Brussels, 24 June 2009, pg 8

51 Poland- Report from the Commission prepared in accordance with Article 104(3) of the Treaty SEC(2009) 650, Brussels, 2009, pg. 5

52 Europe Press Release IP/09/752, Brussels, 13 May 2009, pg. 2

53 Europe Press Release IP/09/990, Brussels, 24 June 2009, pg 7

54 Lithuania - Report from the Commission prepared in accordance with Article 104(3) of the Treaty SEC(2009) 649/2, Brussels, 13.5.2009, pg. 3; Europe Press Release IP/09/1069, Brussels, 2 July 2009, pg 6;

slowdown of the economy in the second half of the year. Although the deficit was close to the 3% Treaty reference value, the excess was not considered as being due to exceptional circumstances nor considered to be temporary. In view of the very weak economic situation in Lithuania and the size of the deficit, 2011 is the deadline year and it implies an average annual fiscal effort of at least 1½% of GDP over the period 2009-2011.

Malta On 18 February 2009, the Commission adopted a report based on a planned deficit of 3.3% of GDP in 2008 and gross debt of 63.8% of GDP, according to data notified by the authorities in September 2008.[55] The report highlighted that the excess of the deficit over the 3% reference value was small and no further steps under the excessive deficit procedure have been taken at that time. However, according to data notified by the authorities in March 2009, the general government deficit in Malta was revised upward to 4.7% of GDP in 2008, while general government gross debt stood at 64.1% of GDP. The Commission adopted on 13 May 2009 a report for trigger the first step in the excessive deficit procedure. The Commission recommends to the Council that Malta puts an end to the excessive deficit situation by 2010 in a credible and sustainable manner by rigorously implementing the budgetary measures planned for 2009 while avoiding any further deterioration in public finances.

France has been hit by the global economic crisis, including the collapse of world trade since the fourth quarter of 2008. The budget deficit is expected to have reached 3.4% of GDP in 2008 and the targets for 2009 and 2010 have been revised up to 5.6% and 5.2%, respectively, according to French estimates in March 2009.[56]The government has adopted a series of measures that are timely, targeted and temporary, and which, together with the free play of particularly strong automatic stabilizers, explain this budgetary evolution. An excessive deficit exists in France and it must be corrected by 2012.

Greece After reaching 3.5% of GDP in 2007, the general government deficit of Greece is estimated at 3.7% of GDP in 2008, thereby exceeding the 3% reference value in both years. The deficit is expected to remain above 3% in 2009 and to exceed 4% in 2010 on a no-policy-change basis.[57] The country should implement additional permanent measures in 2010 in order to bring the headline deficit clearly below the 3% of GDP with a view to recovering competitiveness losses and addressing the existing external imbalances. Greece is invited to strengthen substantially the fiscal consolidation path already in 2009, especially if economic conditions turn out better than expected in the programme, through well-specified permanent measures curbing current expenditure, including a prudent public sector wage policy, thereby contributing to necessary reduction in the debt-to-GDP ratio.

[55] Malta - Report from the Commission prepared in accordance with Article 104(3) of the Treaty, SEC(2009) 651 final, Brussels, 13.5.2009 , pg. 3; Eurostat Newsrelease, IP/09/274, pg 6 18 February 2009

[56] Europe Press Release, IP/09/458, Brussels, 24 March 2009

[57] Europe Press Release IP/09/458, Brussels, 24 March 2009

Ireland After more than a decade of strong economic growth, Ireland is now going through a severe recession.[58] The downturn was caused by the financial crisis, the sharp correction in the housing market and the recession in Ireland's main trading partners, the US and the UK. While general government debt in Ireland stood at 40.6% of GDP in 2008, government deficit is set to have reached 6.3% of GDP. According to the Commission's January forecasts, the deficit is expected to widen further to 11% in 2009 and to 13% of GDP in 2010 on a no-policy-change basis.[59] Ireland is invited to limit the widening of the deficit in 2009 and specify and rigorously implement a substantial broad-based fiscal consolidation program for 2010 and beyond. Ireland must bring the deficit below the 3% of GDP reference value by 2013.

Spain In 2008, for the first time in several years, Spain is estimated by the Commission to have recorded a budget deficit estimated at 3.4% of GDP. Public debt, which had been reduced to 36.2% of GDP in 2007, increased to 40.3% of GDP in 2008 and is expected to grow above 50% of GDP in 2010.[60] In this context, a careful assessment of the budgetary impact of discretionary measures will be crucial to ensure the improvement of the medium-term budgetary position, as well as of the long-term sustainability of public finances. The Spanish authorities must bring the general government deficit below 3% of GDP by 2012. They are also invited to ensure that consolidation towards the medium-term objective of a balanced budget is sustained after the excessive deficit has been corrected.

Hungary An excessive deficit procedure was opened in July 2004 right after EU accession that recommended the country to bring the deficit below 3% of GDP by 2008. The recommendation was repeated in March 2005 and again in October 2006 in view of the inadequate action taken by Hungary. In October 2006, the Council also extended the deadline for the correction of the excessive deficit to 2009. Since mid-2006 Hungary has made marked progress to correct its fiscal imbalances. The nominal deficit targets were overachieved by large margins as the deficit was reduced from over 9% of GDP in 2006 to 3.4% in 2008. However, the impact of the current financial crisis has heavily affected the Hungarian economy. Against this background, the Commission recommends to the Council to ask the Hungarian Government to correct the excessive deficit by 2011, which seems to be appropriate in view of the exceptional situation characterized by the depth and length of the current recession and the fragility of the financial sector.

The United Kingdom is under the excessive deficit procedure since July 2008, when the Council recommended to bring the general government deficit below 3% of GDP by 2009/10. But since then the budgetary situation has worsened substantially on account of the sharper-than-expected economic slowdown and the deficit-increasing discretionary measures adopted by the UK. According to the 2008

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58 Europe Press Release IP/09/274, Brussels, 18 February 2009

59 Europe Press Release IP/09/458, Brussels, 24 March 2009

60 Europe Press Release, IP/09/458, Brussels, 24 March 2009

update of the UK's convergence programme, the deficit in 2009/10 is projected to reach 8.2% of GDP, with the discretionary loosening accounting for around one-third of the increase over the previous year. The UK authorities have not taken effective action to end the excessive deficit situation by 2009/2010; hence a new deadline was setting for the 2013/14 financial year to correct the deficit below 3%.

Latvia The Council, in the context of the excessive deficit procedure, set a deadline of 2012 for Latvia to reduce its budget deficit below 3% of GDP. The deadline is consistent with Latvia's ongoing process of economic and budgetary adjustment and its medium-term euro adoption aim, which is the anchor of its strategy.[61] Latvia's very high current account deficits accumulated in recent years and the high indebtedness of the domestic sector in foreign currency made it particularly vulnerable when the global economic and financial crisis intensified last autumn.

2.2 The second pole: countries with budgetary excess

Cyprus has adopted a significant stimulus package for 2009 in line with the European Recovery Plan that is expected to result, in the programme, in a budget deficit of nearly 1% in 2009 as opposed to an estimated surplus of roughly the same amount last year.

Bulgaria budgetary strategy aims at maintaining a budgetary position reflected in the high targeted general government surpluses of 3% of GDP. GDP growth has been high in Bulgaria at over 6% per year since 2003, accompanied by a widening external deficit and high inflation.[62] Bulgaria's fiscal policy is geared towards maintaining investor confidence and preserving macro-economic stability. The government's focus on structural measures to strengthen the economy's resilience also represents a timely and adequate response to the current economic outlook.

Denmark - after a period of strong economic activity and sizeable budgetary surpluses, Denmark's economic slowdown in 2008 was rapid and pronounced, as the cyclical downturn has been exacerbated by the global economic and financial crisis.

Finland - after GDP growth above potential in 2006 and 2007 (4.9% and 4.2% respectively), the Finnish economy decelerated rapidly in 2008 and is expected to be negative in 2009.[63]

The Netherlands - economic activity is expected to decrease sharply in 2009, as the Netherlands is set to be severely hit by the sharp fall in world trade and the financial crisis. The country aims at achieving and maintaining stable budgetary surplus between 2008 and 2011.

Sweden - large surpluses in good times have created space to allow fiscal policy to play an active role in the current downturn, not only by boosting demand in the short term but also by strengthening the economy's long-term growth potential.

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[61] Europe Press Release IP/09/1069, Brussels, 2 July 2009, pg 1
[62] Europe Press Release IP/09/273, Brussels, 18 February 2009, pg 2
[63] http://ec.europa.eu/economy_finance/thematic_articles/article13960_en.htm

Luxembourg - the government surplus declined from 3.6% of GDP in 2007 to 2.6% in 2008. This surplus it may be into a deficit in 2009, due not only to the impact of the crisis on government revenues and on unemployment outlays but also to the tax cuts decided in the 2009 budget before the aggravation of the crisis and implemented since the beginning of this year. The deficit could reach 1½% of GDP this year and widen to about 2¾% of GDP in 2010, as a result of the delayed effects of the recession on tax revenues and social transfers.[64]

3. The implications of the agreement between FMI and Romania over the actual and perspective economical situation

The agreement convened by Romania with the FMI and The European Commission states complying with four conditions, respectively adjusting incomes and budgetary expenses and elaborating laws regarding unique remuneration, the fiscal responsibility and the reform of the pension system. Romania convened over a stand-by agreement of a period of 2 years with the FMI for 12, 95 billion euros, the total package of external financing, from the Fund, the European Union, BM and BERD that was going to reach up to 19,95 billion euros.

According to the agreement concluded between Romania and the FMI, the budgetary remuneration will not grow in 2009. Also, the government took the job of compensating some increasements with personnel reduction in force, reducing the employees' number, through replacing a single workplace of 7 workplaces that become vacant. The Bucharest Executive also stated that he will adopt until the 30th of October 2009 the law of unique remuneration in the budgetary section. This will mean a stage that will imply at most 3 years for the step by step implementation of the new stipulations. The intent letter and the stand-by agreement with the FMI says: "The introduction of bonuses that are not of money nature is forbidden. The money bonuses will be consolidated, eliminating a great part of these or introducing them in the basis remunerations", this letter was signed by the ministry of public finances, and the BNR governor, and was transmitted to the general director of the FMI.

The Romanian authorities commit themselves to unify and simplify the calculation grid for remuneration, as well as the bonuses system that are applied in the public sector, and for each employee the total of the ne-remunerated incomes will have legal cover-up. On the other hand, until the 31st of December the legislation regarding pensions is going to be revised. According to the agreement, the age of retirement will be increased, especially in the wimin sector, and the pensions will be indexed with the inflation and will limit the possibilities of discretionary increasing them.

Furthermore, the obligation of paying the retirements contributions will slowly broaden for the public employees categories that are currently excluded.

Until 30th November 2009, the government must present to the Parliament the legislation regarding the fiscal responsibility and will prepare an implementation plan

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64 http://ec.europa.eu/economy_finance/pdf/2009/springforecasts/lu_en.pdf

of it. The new law will set up, in coordinates with the FMI and the Worldwide Bank, procedures for improving the multi-annual budgeting, limits for budgetary revision during one year, rules respecting expenses, the public debt and the primary deficit and will establish a frame for issuing and managing warranties and other unplanned debts. If there will exist difficulties regarding the budgetary incomes, the Romanian authorities will be obliged to consult themselves with the FMI. If there are differences between the real budgetary deficit and the one stipulated by the Fund of over 200 million lei, the ministry of finances will be forced to consult itself with the Fund's management. Actually, this means that the prices must not increase much, and the state is not allowed to imprint money. Also until 30 December, Romania must modify laws regarding banks and insolvability, this means that the Romanian National Bank will have a higher implication in initiating insolvency and liquidity procedures, and the special administrator will have increased power regarding insolvency. The special administrator's authority will be extended in order for him to be able to promptly implement a large restructural measurements series, including buying and taking over, selling assets, transfer of deposits and reducing the capital for covering losses, according to the technical understandment memorandum signed by the Romanian authorities with the FMI. Moreover, initiating insolvency procedures according to company laws will need the prior approval of the BNR. The legislation will be modified to ensure that the deposits in the limit of the guaranteed sum will have a special priority rang in case of insolvency, and the Bank Deposit Guarantee Fund will be able to subrogate these rights. Also, future regulations will strengthen administrator's attributions with the power of all decision unities from the bank, including the general gathering of the shareholders. The law will establish that certain provisions prefigured in the general law of insolvency will be eliminated if they don't meet prompt implementation of restructural measurements, like immediately transfer of a substantial active part and reducing the capital for covering losses. In addition, the law will offer protection to the special administrator for the activity that he was signed in.

The budgetary deficit negotiated with the FMI is settled for this year at 24, 36 billion lei, the technical memorandum indicating quarterly targets. The fund also established limits for the budget payment that have not been defrayed in a period of over 90 days. According to the FMI statistics, at the end of the last year there were floaters engagements from the budget that exceeded the date of payment settled in total value of 300 million lei.

By the end of the year, the authorities must reduce bad debts like this with 150 million lei, and as the year 2010 goes by they will be eliminated. Also, the Government will not accumulate in the period of the program bad debts for external debts. The annual inflation rate from each quarter is a performance criteria in the agreement with the FMI, and exceeding with two percentage points the central level established will require taking measures, like the obligation to continue the program, according to the technical memorandum. The indicative target for 2009 was fixed at

4, 5% +/- one percentage point, according to the technical memorandum of agreement signed by the Romanian authorities with the FMI[65].

The FMI considers that it is possible that mother banks will not maintain financing lines in Romania, despite signing the undertaken engagements, taking into consideration the dimension of the regional financial crisis and the operations of each institution. "The support from the commercial banks that work in Romania is crucial for avoiding serious difficulties in the financial sector and to ensure an adequate financing of the balance of payments. With almost 90% of the banks system owned by foreign banks, involving mother banks and local authorities must play an important role in the efforts of stabilizing Romania", according to the agreement with the Fund. On the other side, the net international reserves of the BNR could decrease this year with maximum 9 billion euros, unlike 25, 53 billion euros calculated for the end of 2008, according to the stand-by agreement. Furthermore, the brute external liabilities are represented by all the residents and non-residents debts and by the credits from the Fund that are rolling now. The Fund agrees with a possible reduction of the net international reserves of as much as 7,6 billion euros by the half of the year. For September the limit is of 8, 72 billion euros, and for the end of the year it was set at 9 billion euros. FMI established that the net international reserves can be reduced with only 500 millions euros in 2010.

According to the technical memorandum that the government has signed with the FMI at 1st of April 2009, the Fund has imposed roofs for the budgetary deficit, inflation, governmental warranties and streamlines for the state companies. The deficit and the inflation must be reported quarterly, but a series of dates, such as public debt, state warranties and spending the European Union's funds, must be reported monthly, by the ministry of finances to the FMI. According to the agreement with the FMI the budgetary deficit will be monitor quarterly, on the basis of the cash balance of the general consolidated budget. The authorities will confront with the FMI over some corrective measurements in case there are difficulties regarding budgetary incomes and financing. In this way, the quarterly performance criteria present themselves as it follows: the end of June: 14,508 billion lei; the end of September: 18, 612 billion lei; the end of December: 24, 363 billion lei.

If the difference between the budgetary deficit and the roofs imposed by the FMI exceeds the sum of 200 million lei, in each of the quarters, and only those that will be settled for the year 2010 in the set of the second revising of documents, the ministry of public finances will consult with the staff of the FMI. According to the inflation monitoring covenant, included in the technical memorandum, BNR must consult with the FMI staff if the inflation rate increases over the quarterly margins mentioned below:

- June 2009: between 4, 4 and 7, 4%
- September: between 3, 7% and 6, 7%
- December: between 2, 5% and 5, 5%

[65] The technical memorandum between Romania and the FMI from 1st April 2009

Criteria of performance that limit governmental warranties granted to the private non-financial sector and to the public companies, also, quarterly; and the roof settled was of 6 billion lei for each trimester of 2009.

And for the governmental expenses, except those related to the European Union funds, there were settled quarterly ceiling: the governmental expenses (cumulative values) must be of maximum 87.505 billion lei, at the end of September: 132,3 billion lei and at the end of December of maximum: 182,7 billion lei.

The FMI imposed conditions regarding the monitorization of state companies: the ministry of finances and the work ministry and other resort institutions must offer information that certify that a monitoring system of the public companies will be functional until the first revision of the agreement. On the period of the program, information will be provided that certify that actions like – reducing remuneration or dismissals of companies' management – were adopted, if the reorganization target of these entities are not met.

The government must report monthly the dates regarding European financing (advance payments and reimbursements), expenses and subventions covered by European funds or eligible for payment, in the approved projects for financing by mutual agreement with the European Union.

The monthly preliminary situation of the state budget must, also, be reported by 25th of the following month. Similar, the dates concerning governmental warranties and public debt will also be reported monthly. Other information must be reported quarterly.

Hereinafter are presented the commitments of the government stipulated in the intent letter addressed to the FMI:

- BNR will continue to improve the legislative sector and will consult with the FMI staff before introducing any new or revised regulation for banks.
- Romania also commits to rise the accountancy standards to the international practices, as they are reflected in the International Accountancy Report Standards (IFRS). This will reduce coercion in regulation for the transnational banks and for corporations.
- The National Bank is definite to bring inflation gradually to the official target of 3.5% +/- 1%. In this program, the evolution to this target will be monitor through the consulting stipulation over inflation.
- The losses from the BNR stock that exceed 2 billion euros in a period of 30 days, during the program, need consulting with the FMI staff.
- The procedures for guaranteeing deposits will be modified in order to simplify and accelerate the payments. Through the modified legislation it will be ensured the payment of the warranty in a period of 20 days, in lineup with the European Directive that involves guarantee tactics.
- The first revision of the program will take place on 15 September 2009 and the second on 15 December 2009.

Commitments regarding legislation are:

- Adopting unique remuneration law of the budgetary people: 20 October 2009.
- Adopting amendments to the bank law in order to strengthen the ability of BNR to ask the shareholders of the banks to increase capitalization and limit the profit distribution: 30 June 2009.
- Adopting amendments concerning the deposit warranty legislation: 30 August 2009.
- Presenting fiscal responsibility legislation and the implementation plan, in the Parliament: 30 November 2009.

4. The excessive budgetary deficit situation in Romania and the recommendations of the Ministry Council to reduce it

The Ministry of Finances Council from the European Union has opened the excessive deficit procedure regarding Romania on the basis of a report of the European Commission. Romania has the year 2011 as a deadline in order to correct the deficit, or it will be sanctioned.

The excessive deficit procedures aim to bring the deficit, through precise recommendations, under the figure of 3% from GDP foreseen in the European Stability Pact. In 2008, Romania has overcome this figure with 2 percentage points.

If this stipulation is not respected it can end up even to financial sanctions against the states in question. If Romania doesn't take measures of correcting the deficit on a period between 6 months and 2 years, she could be financially sanctioned.

The document adopted by the ECOFIN is based on a project edited by the European Commission in June and will recommend Romania[66]:

- to make up budget-frame on medium term, an independent fiscal council;
- to introduce limits concerning budgetary revisions over the year;
- to reorganize the remuneration system in the budgetary section;
- Improving the way taxes are collected through the administration reform and widening the tax base.
- adopting fiscal measurements foreseen in the modifications for the 2009 budget, adopted in April, "especially in the public sector and in the pension reform system";
- Accelerating the pension's system reform, especially regarding indexing and retirement age, in order to reduce substantial growth of costs that involve old persons and to "reduce risks concerning the sustainability of the public finances".

The European Committee stated that the last year budgetary deficit, of 5, 4% of GDP, was caused mainly by the expenses spent with the budgetary remuneration, and the global economical crisis participated in a small percentage to the deficit.

[66] Miniştrii de finanţe din UE aplică marţi procedura de deficit excesiv împotriva României, Adevărul, July 2009

According to the convergence program, Romania commits to reduce the deficit to 5.1% of GDP in 2009, to 4, 1% of GDP in 2010 and fewer than 3% in 2011. Not respecting these commitments could lead to postponing the adherence of Romania to euro, foreseen in 2014.

5. Conclusion

At the European Union level the diversity manifests also regarding the financial result recorded by every member state. Therefore, from a total of 27 member states, 9 member states fulfill the criteria regarding the budgetary deficit, and those are: Belgium, Czech Republic, Germany, Estonia, Italy, Slovenia, Slovakia, Austria, and Portugal. The negative impact recorded by every member state resides over the public budgetary incomes and expenses recorded by every member state of the European Union, leading to the growth of the budgetary deficits of them and to a faster setting of the excessive budgetary deficit procedure.

In the euro area the government deficit to GDP ratio increased from 0.6% in 2007 to 1.9% in 2008, and in the EU27 it increased from 0.8% to 2.3%. In the euro area the government debt to GDP ratio increased from 66.0% at the end of 2007 to 69.3% at the end of 2008, and in the EU27 from 58.7% to 61.5%.

In the case of Romania, the Commission recommended that Romania corrects the excessive deficit by 2011 in view of the large imbalances and the economic and financial situation and an average annual fiscal effort of at least 1½% of GDP starting with 2010. It should implement the fiscal measures as planned in the February 2009 budget and the April 2009 amended budget, especially in the area of public sector wages and pension reform; take further corrective action if needed to achieve the 2009 deficit target in order to ensure compliance with the commitments undertaken under the programme supported by EC balance of payments assistance. The agreement convened by Romania with the FMI and The European Commission states complying with four conditions, respectively adjusting incomes and budgetary expenses and elaborating laws regarding unique remuneration, the fiscal responsibility and the reform of the pension system.

Under the conditions in which the worldwide economical crisis affects more and more all the countries, it can be appreciated that recording a budgetary excess or a budgetary deficit by a country doesn't represent a normal situation. Furthermore, a compensated situation at national level can be considered also when it records a budgetary deficit in the limit of 3% of GDP on the count of some national level investments expenses, that exceed the collected incomes, and not on the count of the current budgetary expenses.

The European Union is a giant mechanism that could not work under normal parameters withought all the participants respecting certain rules, leaving from this appears the seamless monitorization and the permanent biannual reports from the member states that are send to the European Commission. Thus to prevent some difficult situations that can affect all the members of this mechanism, each member state reports not only dates regarding the actual deficit achieved in the past years or estimated for the current year and the following years, but also updated dates or figures that explain the apparition of their public deficit.

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*** *The technical memorandum between Romania and the FMI from 1st April 2009*

*** *The institution Treaty of the European Union, article 104c*

FINANCIAL CRISIS IMPACT ON CONSTRUCTION AND REAL ESTATE SECTORS IN ROMANIA

Florina Mocanu[*]

Abstract

This paper presents the evolution of construction and real estate sectors in Romania in the context of current financial crisis, highlighting the internal and international economic climate. The evolutions of the main macroeconomic indicators and sectoral factors of influence on them are presented. Construction and real estate sectors are particularly affected by the worsening perception of the risk, of financing difficulties, doubling the risk of liquidity with the solvency one.

Keywords: financial crisis, construction sector, gross domestic product, added value, liquidity

JEL Classification: G01, E01, L74

1. Introduction

World economy is in crisis. The shock is even more brutal as this crisis succeeds a powerful growth registered in recent years (4% between 2001 and 2007), encouraged by the development of international trade. Today the world economy is destabilised by major phenomena : real estate crisis (which has generated the most serious financial crisis since 1929 in the United States, quickly sent to Europe), accelerated growth of the raw materials prices, which involves a food crisis and oil shock, unprecedented pollution of the environment etc..

Financial crisis, which started in July 2007, has its roots in the search of an ever-increasing profitability, most investors always wanting more. Thus, real estate loans were granted to people becoming less responsible, considering that a possible reimbursement could be effectuated by resealing of the respective building, whose price could be only increasing. But the reality was different...

If we can speak of an inseparable couple in finance, that concerns risk and profitability. The growing profitability can be achieved only with the price of a growing risk. And if the risk is at growth, also the probability for it to materialise is also amplified.

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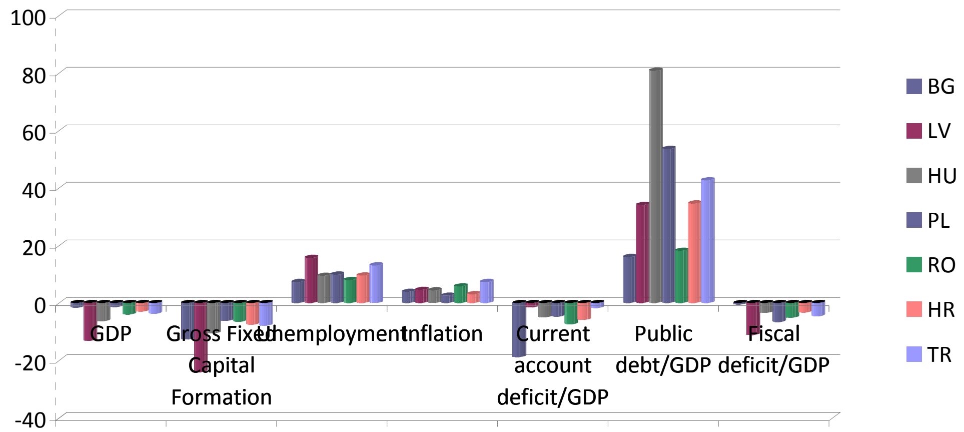
2. International context

The cost of financial crisis was estimated by the International Monetary Fond to 4000 billion dollars. The worldwide economic progress forecasted for 2008 of 3.2% is expected to be replaced by a decrease of 1.3% in 2009[67].

At first, the crisis affected particularly the developed countries. Aversion to risk in these countries transmitted rapidly to emerging areas. Countries of Central an Eastern Europe have entered a zone of high risk, forecasts for the region being pessimistic: economic decline are generalized, companies disinvest and unemployment increases, current account deficits adjust, even brutally in some cases, fiscal deficits increase significantly (chart 1).

Chart1. Forecast of percentage change in 2009 of main economic indicators of countries in the region

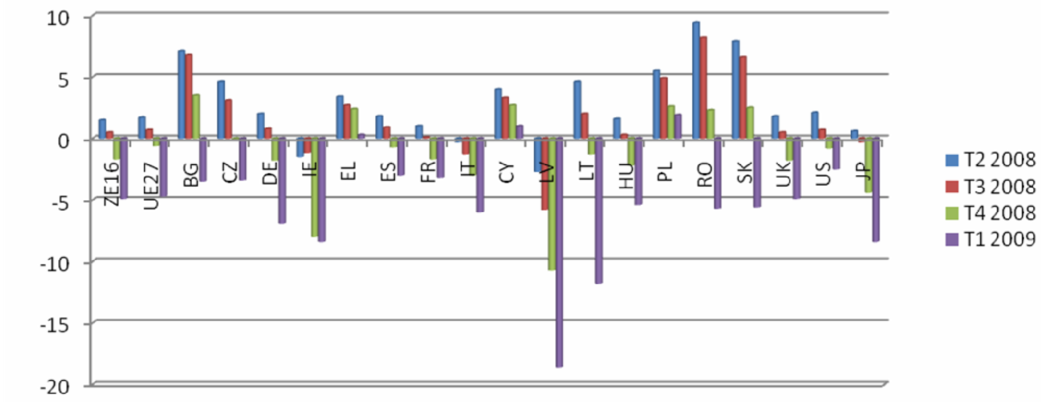


Source: European Commission, Spring forecasts, May 2009

According to Eurostat estimations, in the first quarter of 2009, GDP in the euro area decreased by 2.5% compared to previous quarter, and in the EU27 one by 2.4%. In rapport of the first quarter of 2008, the reduction registered by the GDP was 4.9% for the euro area and 4.7% for the EU27. The first quarter of 2009 has meant also a reduction of investments of 4.1% in the euro area and of 4.5% in the EU27. Household final consumption decreased by 0.5% in the euro area and by 0.6% in the EU27. Exports registered a rebound of 8.8% for the euro area and 8.3% for the EU27, while imports decrease was 7.6% for the euro area and 7.8% for the EU27. In the United States and Japan, the decline GDP recorded in the first quarter of 2009, compared to the same period of 2008, was of 2.5% and respectively 8.4% (Chart 2).

[67] FMI, Crisis and Recovery, World Economic Outlook, April 2009

Chart 2. Growth rates of GDP in volume (grownth over the same quarter of the previous year, seasonally adjusted)



Source: Eurostat

Regarding the constructions sector, output adjusted with seasonal variations recorded in May 2009 a reduction of 2% in the euro area and of 2.7% for the EU27, compared to the previous month. Following May 2008 rapport, production fell in May 2009 by 8% in the euro area and by 9.6% in the EU27. Most emphasized decreases were registered in Romania (-23.7%), Slovenia (-21.1%) and UK (-17.9%).

3. Perspective of overall situation of the Romanian economy

At the beginning of the crisis, the Romanian economy had crossed a period of several years of economic growth, but accompanied by the accumulation of a significant external deficit and external debt increase in short term.

The current external climate imprints on the economic environment in Romania through[68]:

a)by worsening perception of risk, including through association with regional developments;

b) contraction of the external market outlets;

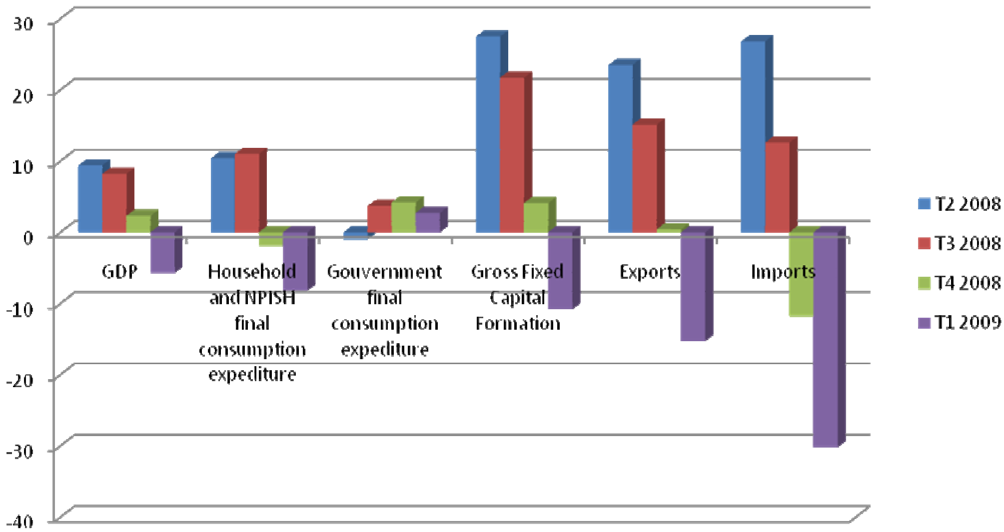
c) difficulties in external financing;

d) doubling of liquidity risk with the solvency one at microeconomic level.

The Romanian economy declined in the first quarter of 2009 with 6.7% compared to the first quarter of 2008, over the value in the euro area (-4.9%), this slowdown being even more problematic following the low level of GDP / inhabitant in Romania (chart 3).

Chart 3. GDP and expediture components (grownth over the same quarter of the previous year, seasonally adjusted, chain-linked volumes) - Romania

[68] Rapport on the financial stability, BNR (Romanian National Bank), 2009



Source: Eurostat

The risk is that this reduction of economic activity to determine disinvestments and the increasing of unemployment, endangering the real convergence process on medium and long term.

Once triggered financial crisis, the capital market in Romania has followed a downward trend of foreign markets. Capital market in Romania registered, similar to other stock exchanges in the region an increased volatility, a reduction in equity market capitalization, but relatively constant exchange liquidity.

BET index recorded in 2008 a decrease by approximately 70% and the stock exchange capitalization reduced by 47%, reaching by end of year the value of 57.8 billion lei. Traded value on the Bucharest Stock Exchange has fallen significantly, the daily transactions average in the last quarter being of 22 million lei compared with 72 million lei, the recorded value in the same period of 2007. However, exchange liquidity remained relatively constant with a value of about 8%.

Romania's trade deficit in the first four months of 2009, of 2.9 billion euros, reduced 2.5 times more than compared to the same period of 2008, after the fall of imports by 36%, and while exports have decreased by 20%.

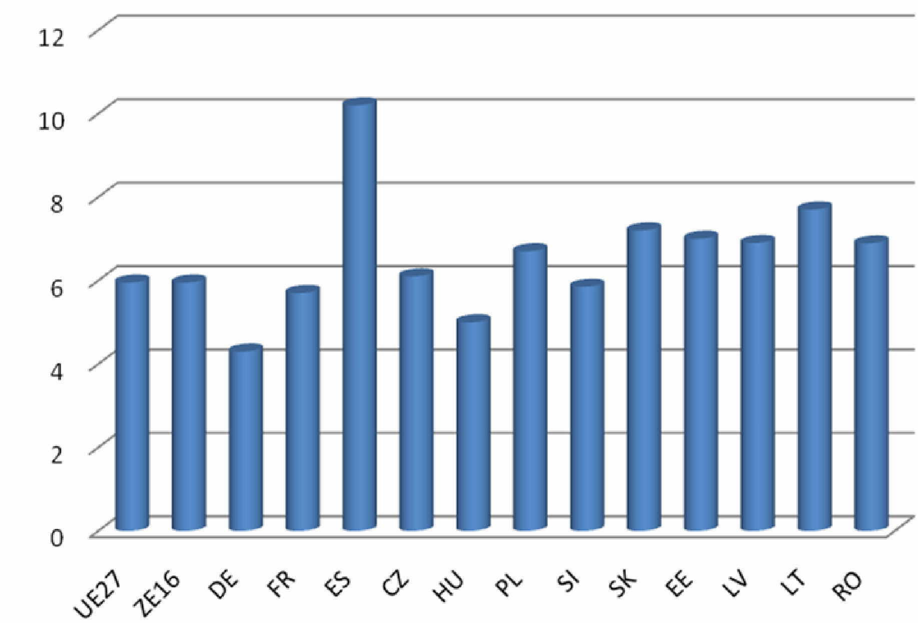
Perception of risk for Romania is judged differently by the rating agencies: since October 2008, S&P and Fitch, since November 2008 considered that Romania has a higher risk, above the threshold of investment grade (BB+, negative perspective); agencies Moody's (Baa3, stable perspective, since of October 2006) and JCRA (BBB- since December 2008) considers that the risk is similar to the level of the investment grade.

4. Manifestation of financial crisis in the construction and real estate sectors

In terms of increase of construction and real estate sectors' role for the Romanian economy, the financial crisis hits, maybe with priority, these activity fields.

The development of the construction sector can be assessed on the basis of its contribution to the formation of value-added in economy, with approximately 12% in 2008 compared to 6% in 2004, above the average of European Union (chart 4).

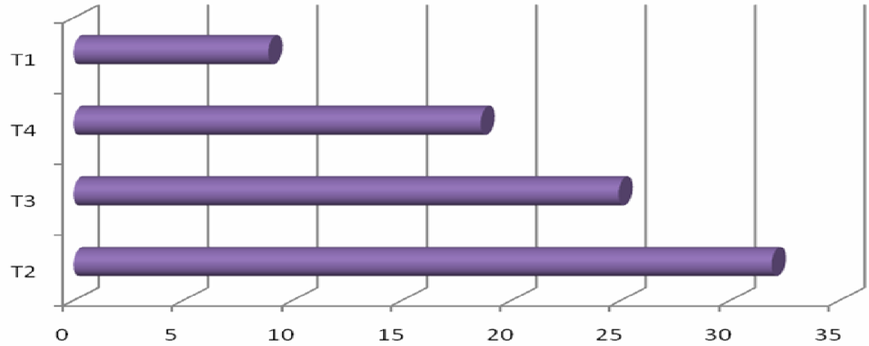
Chart 4. Contribution of construction sector to GDP formation, average 2000-2007 (Euro zone, EU27, some EU countries)



Source: Eurostat

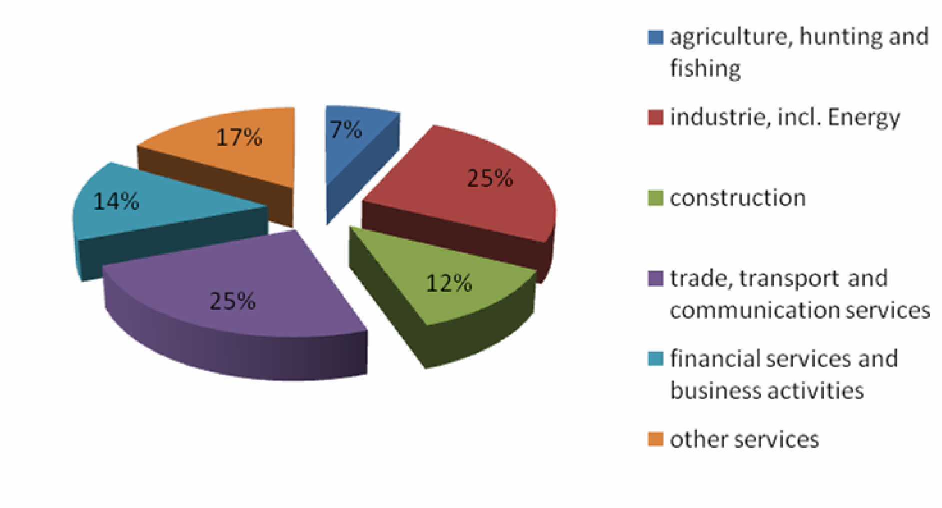
Even against the backdrop of financial crisis, the construction sector creates, in the first quarter of 2009, an added value of 3366.6 million euro, higher by 8.9% compared to the one created in the same quarter of previous year (chart 5). The construction sector succeeds thereby to generate in the first quarter of 2009, 12.17% of total value added of the Romanian economy (chart 6).

Chart 5. Gross value added by Construction (grownth over previous quarter, seasonally adjusted, chain-linked volumes) - Romania



Source: Eurostat

Chart 6. Gross value added by industry - Romania



Source: Eurostat

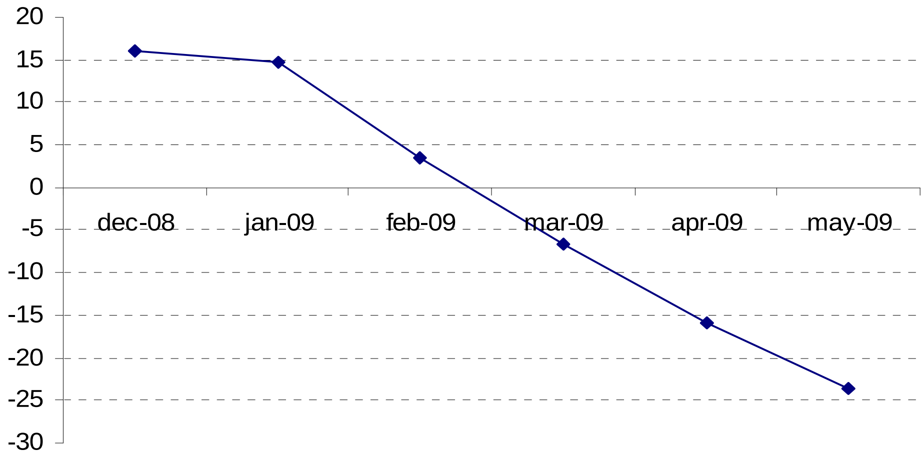
At the level of June 2008, the number of employees in constructions represented 13% of the total employees in economy, and companies in the field owned 8% of total assets.

The real estate sector has a small share, of 1% in total turnover, but holds 12% of total assets in the economy (at June 2008).

In recent years, one have built more and more, investors staking on demand increment, but the economic crisis caused a radical change of attitude from the customers, these now being more reluctant in buying before prices stabilize. Even if demand is low, one continues to build, the number of completed dwellings in the first quarter of 2009 being only 2.8% below the same period of the last year. The main explanation of this situation relates to the large number of buildings in progress.

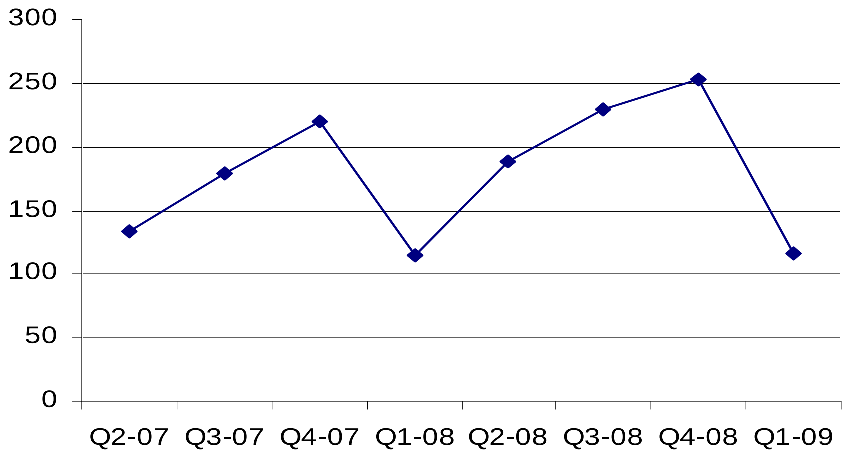
However, Romania presented in May 2009 the most drastic decrease in production of the construction sector in the EU, of 23.7% (chart 7). The status of the construction sector is reflected also by the development of the quarterly index of production, which, in first quarter of 2009 decreased to the value of 116.8 (chart 8).

Chart 7. Construction output – annual variation (% change compared with same month of the previous year)



Source: Eurostat

Chart 8. Quarterly production indices for total construction, working day adjusted (base year 2005)



Source: Eurostat

Financial situation of enterprises in the construction industry was relatively good in 2008, as well as their ability to absorb moderate shocks. Deterioration of economic activity in the latter part of 2008, which is manifested also in the first quarter of 2009, however, aggravates service to banks, the situation being more difficult since these enterprises require to an increasingly large extent short-term financing.

Access to finance of these companies has become more difficult and more expensive, following the bank's reluctance to provide liquidity and to attract resources towards the government to the detriment of the private sector. A special issue of the construction firms in the construction and real estate domain is raised by level of external debt, of 40% of medium and long-term debts and belonging to the non-financial companies; also 38% of outputs and 46% of the entries scheduled for 2009 from the external debt in short term residual belong to these enterprises.

In recent years the construction cost of new houses recorded an upward trend, well above the European average, which now enables companies from the sector to improve the costs in order to be maintained on the market. The number of building permits granted has not decreased significantly until March 2009 when there was a reduction of 17.7% compared to March 2008. Intentions to purchase a house in the next 12 months, though have deteriorated, are situated at the beginning of 2009 above the EU average. Under these circumstances, there are conditions that this crisis in the construction sector to be managed more easily.

5. Conclusions

Before triggering the crisis, investors' aversion to risk had fallen and preliminary analysis had become superficial. Thus, ABN Amro could create, in August 2006, a new financial product, CPDO (Constant Proportion Debt Obligation), considered by rating agencies as an asset without risk (AAA), with a rate of return greater with 2% than the state loans. This product currently worths between 40% and 70% from its issue price, which shows that it is not an asset without risk ...

Currently, access to liquidity and financial flexibility are clearly more important notions than the hypothetical reduction of capital cost resulted from indebtedness. Moreover, Almeida and H. Th. Philippon, established late 2007 that the value of bankruptcy-related costs connected to debt is relatively equal to the tax economy due to the deductibility of interest, practicably neutralizing the leverage effect of indebtedness.

The EU believes that addressing the crisis at national or European level is not sufficient, requiring global coordination. Thus, during the G20 Summit, held in London in early April, the EU has advocated for the purpose of:

- implementation of measures of economic stimulation in sustainable way;
- determining what concrete steps should be taken to strengthen the financial markets' supervision;

- strengthening the mandate and capacity of international financial institutions, as guardian of global economy stability, but also as a forum for equitable representation of emerging and developing economies.

Currently, the resumption of economic growth in Romania can not be accurately anticipated by specialists, international comparisons suggesting that, in the conditions of the global crisis, countries with high growth rates will suffer important decreases. A sustainable growth should be based on increasing public investments and of competitiveness of Romanian enterprises, a significant role, at sectoral level, reverting to the construction and real estate sector, due to the dynamics, to the weight in the economy and to the dependence of their internal and external financing.

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INVESTORS' TYPES OF BEHAVIOUR DURING CRISIS

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Ruxandra Vilag,
Ilie Vasile,
*Stela Toader**

Abstract:

Given the present economic situation the subject regarding the propagation mechanisms of financial crisis is of present interest. In these mechanisms, investor behaviour seems to be one of the propagation's causes, and that's why we think that the study of inventors' types of behaviour during crisis might bring light on this controversial subject. Does any kind of behaviour make a financial market "contaminate" other markets? Sometimes, during crisis, the investors behaviour seems to be unforeseeable. In this article we will analyze how the investors behaviour may influence the power of the financial crisis propagation using the example of the Romanian capital market and we'll try to identify the types of investor behaviour on this market, the Romanian capital market.

Keywords: investor behaviour, financial crisis, financial contagion, propagation, capital market

JEL classification: G01, G11, E44

1. Introduction

The phenomena of financial crisis propagation, namely the crisis that began on the United State financial markets, mostly its spread all over the world, drew again the public eye on the problem of the propagation of financial markets. Macroeconomic, politics and trade links between countries makes the shocks suffered by an individual country or region to affect other countries or regions, which most likely are in the same geographical region. Weak economic bases of the second country, macroeconomic similarities, and exposure to certain types of financial agents and associated transmission channels can be considered as the main factors leading to an increased risk of sudden impact of financial shocks suffered by other countries. The stage of development of the international financial system it may also play a very important role in this transmission mechanism. Although, much

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of the propagation of the financial crisis phenomenon is not caused by the irrational behaviour of investors, this type of behaviour being only an insignificant factor (or so the theoreticians thinks till now), it still remains a mystery what makes countries vulnerable to crisis and the precise mechanisms that makes the crisis transmit.

2. The propagation

A phenomenon that affects the international capital markets in general, both developed, as well as least developed seems to be the increasing markets' volatility. It is clear, however, that volatility will remain a problem as long as it delays the adoption of specific actions taken at national and international financial level, measures that may be necessary to reduce these risks and to limit their impact. First, the high volatility of international capital flows on the emerging markets and the limited capacity to cope with this volatility make the "beneficiary" country vulnerable to excessively high shocks and crises, frequently and in a disturbing manner. Secondly, the international capital markets appear to be extremely susceptible to financial shocks because of the high integration degree.

During financial crisis, the way the shocks are transmitted seems to uncover a different transmition mechanism and this difference appears to be an important one. Although we known very little about the importance of macroeconomic and institutional factors in the propagation of financial shocks, empirical studies have helped to identify the types of links between countries and other macroeconomic conditions that makes a country vulnerable to contagion during financial crisis. At the same time, empirical research has helped identify the countries that risk to be exposed to contagion and some interventionist policy that can diminish these risks, although they were identified in a way that is too general to be helpful.

When a country is hit by a financial shock, the reduced market's liquidity may compel investors to withdraw capital invested in other countries or markets that are not initially hit by the crisis. Because many financial transactions are based on investment decisions rather than on theoretical financial principles of individual investors, problems in investors' stimulation may also play a role in triggering volatility. The decision to withdraw the funds invested in multiple markets may also reflect coordination problems among investors and mechanisms insufficient developed at the international level, mechanisms that might supervise advice and possibly assist countries with problems of liquidity. In reality it is very difficult to make the difference between forms of investors behaviour. Volatility can be transmitted from one country to others through common creditors and investors that are acting in international financial centers.

Contagion refers to the migration of market disturbances - mostly those who have a negatively impact on the market - from one country to another. This process can be observed through the evolution of exchange rates, prices of shares, bonds, and capital. The causes of contagion can be divided conceptually into two categories. *The first category* focuses on cross-border influences arising from the normal interdependence between open economies. This interdependence makes shocks, whether globally or locally, to be transmitted between countries, because of the real and financial links existing between them. *The second category* involves a financial crisis, which is not linked to any observed changes in macroeconomic bases or other fundamental bases, but it is only the result of the investors behaviour or other financial agent's behaviour.

The propagation of financial crisis depends on the degree of financial market integration. If a country is completely integrated into the global financial market, or if the financial markets in a region are very well connected, assets prices and other economic variables will evolve in parallel or in a similar manner. The higher is the integration degree, the greater would be the contagion effects of a shock from another country. Conversely, countries that are not financially integrated, mostly because of the limited access to the capital markets or the lack of access to the international financing, are, by definition, immune to contagion. In this sense, the financial markets would facilitate the transmission of shocks, but it wouldn't cause them. Actions of investors, who are ex-ante individually rational, and also collectively rational, even if they lead to volatility and may require policy changes, should be considered to be fundamental causes.

Therefore, in the context of the recent financial crisis, was supported by some experts that foreign portfolio investors (being the ones that are investing in multiple markets) may have been those which by their reaction (which had the same effect as the market trends) have led to the propagation of the crisis that began in the United States (egg, rushing to buy when the market is growing and rushing to sell when the market is declining), and by their mutual desire to copy the behaviour of other investors, ignored the information on the economic fundamentals of the countries' markets on which they were investing. We can also add that even the national investors (the ones that invest only in national assets) had a big negative influence because they tend to mimic others actions without a proper thinking.

2. 1.Study

Investors, like every other man, are characterized by over-exiting and exaggerated reactions, both on rising and falling markets. Most of the investors tend to buy or to expend their investments when the market is growing. Simultaneously these investors tend to sell their investments in short-term assets with a low performance. As a result most of the investors will be holding assets from the category of those who had the best performances on short-term. By making that, their assets price will be over evaluated, and when corrections will take place on the market, investors will suffer important losses.

During a correction on the market, investors tend to panic because of there believe that they will loose most of the invested money, and then the most normal reaction is to sell everything, in order to minimize their losses. These actions will make the market drop even more, much more than the needed correction.

To complicate things even more, the market doesn't react at all or it doesn't react in a predictable manner when we look at the short-term evolution. And if investors react this way when small corrections are made on the market, we can only imagine what they will do when some important financial crises will appear. It is a known fact that the biggest financial crises where also amplified by the massive sell of assets, induced by the investors' panic. It is true that the first turbulences appeared because of some problems of the financial system, but investors' reactions made the turbulences propagate to the other countries with same characteristics as the one already in it. The most important thing investors should know is that short-term bias has nothing to do with the long term investment climate. And so, we could state that the market short-term prediction is the same thing with investors' behaviour prediction, a thing very hard to accomplish.

The best period to make changes in ones portfolio is in the ascending period of the market, because investors adjust their assets portfolios only when they are in favorable position. It is practically impossible to predict the best changing period, but the changes will take place as long as the investors are situated in a favorable position. A favorable asset transaction doesn't mean selling assets with taint evolution and buying assets with a high profitableness, but it means selling profitable assets for gaining profit.

It is necessary for investors to be conscious about their tolerance to risk before making any investment in order to make the right decisions. Knowing own level of risk tolerance is one of the most important things we should know before starting to invest on long-term assets. Investing in portfolios that don't characterize owner's intolerance to risk lead investors, during market correction, to make important changes and so losses rise. It seams like its human nature to make these corrections during the declining market. To prevent these kinds of manifestations, investors should try to develop investment strategies by taking into consideration, besides financial goals and aims, risk tolerance.

So, it's clear, that emotions shouldn't have anything to do with financial market's investment, when the aim is getting a profit. As long as these will be part of the investment strategies, it will be hard to predict the market's reaction as a whole during crises periods.

To analyze the influence of investor behavior, we chose to pay attention to the reaction of Romanian financial market during the last financial crisis or as some say the current one. The current financial crisis' starting point was the fall of sub-prime market in the United States in August 2007. This fall had triggered a series of negative effects on the global financial market: first the U.S. government had to enter the financial markets by helping financial institutions in difficulty and then lowering FED's (Federal Reserve System) reference interest rate in order to relaunch the real economy. However the measures taken could not stop the propagation of financial crisis on other financial markets.

Being an open market, the Romanian capital market, can be influenced by external events, meaning that by definition could be the country hit by the contagion effect. However, to measure contagion influences in Romania during the current financial crisis we also have to take into account the links with other countries such as trade links, macroeconomic links and policy links. If the Romanian financial market reacts in the same manner in which other countries did, countries that are linked to Romania in this way, it not shows contagion but only shows the interdependence between Romania and this others countries. We can consider the evident dependency between Romania and the European Union. Past studies shown that the correlation between Romania and EU is approximately 0,5 (see *„Contagion causes – rational or irrational behavior”*, 16th International Economic Conference – IECS 2009, R.D.Vilag et al.).

The period of data collection for Romanian and European indices is of 2 years, from 21 February 2007 on 19 February 2009, daily recordings (without weekends and holidays). We used this period in order to include both the period before the beginning of the crisis on US sub-prime market and the period extended till after the last drop in the global stock exchange, i.e. 15 October 2008.

If we analyze the behavior of the Romanian market and that of the Euronext market (we can consider this particular market representative for the European Union). We can see from the fist part of the figure no.1 (until first of August 2007) that although the general trend of the two indices is the same, namely it shows a growth, the two indices do not evolve in an identical manner. There are common points only when price falls and the last part of the BET graph recorded a higher growth than the Euronext index. We can also compute the correlation between the two indexes, and we obtain 0, 56 that shows an average correlation between the two markets. This correlation can be determinate by the classical links: trade, policy and macroeconomic bases or by simply looking at the capital market.

On the middle part of this figure (until first of June 2008) we can see that the two indexes are starting to evolve in the same manner. In fact computing the correlation between them we obtain 0, 91. This shows a very strong correlation between the two markets. Given the fact that the classical link channels did not change in this period, we can make the assumption that this is due to the influence of investors behavior. In fact if we watch trading statistics on BVB we see that both residents and non-residents investors react to the financial crisis. If in 2007 we had a total sum of purchasing stocks of almost 14.000 millions lei, in 2008 this sum dropped to almost 6.700 millions lei (half of 2007 total).

At the end of this figure we see that the indexes' evolution is almost the same. The correlation reached the value of 0,98; that is almost a perfect correlation between the two indexes and of course between the two markets.

If we add to this the fact that the residents withdraw almost half of their investments between 2007 and 2008 and the non residents almost disappear from the market we can see that this rising in correlation is given by the investors behavior.

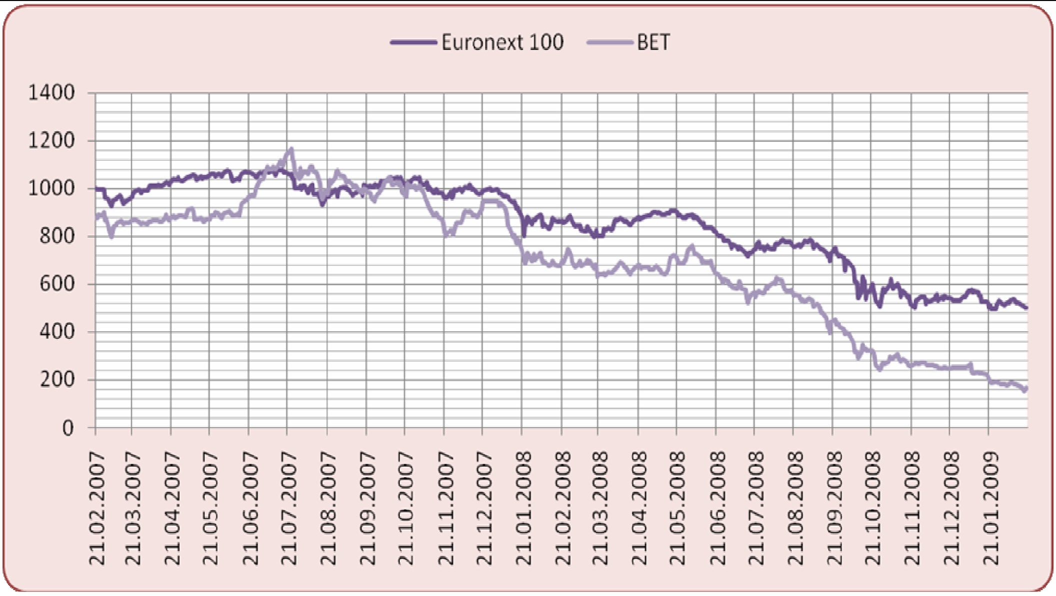

Figure no.1 "The evolution of the two indexes between 21 February 2007 and 19 February 2009"

So our study over investor behavior has an important starting point and we can easily identify different emotions aroused on the Romanian market.

2.2. The influence of emotions

2.2.1. Ambiguity adverse

Ellsberg paradoxes (Ellsberg 1961) suggested that people are ambiguity adverse, and by being that they determine the apparition of irrational choices. As Camerer (2008) suggested ambiguity adverse could lead investors to demand a growing risk premium, more ever, when investors are being presented with new financial opportunities, because of the uncertainty of the economic environment and of the resulted incomes.

In financial crises' case, ambiguity adverse is shown by the fast transactions, made by those who want to sell the stocks with massive losses, without waiting for the situation to clarify. This phenomenon can be observed only when the capital market is falling.

So, in order to make our point, we can monitories the reaction of the investors who were on BVB – Romanian capital market (Bursa de Valori Bucuresti) - during the falling of the American sub prime market. Before the fall, in July 2007, the situation on the market, shows that the only ones who have trade and by doing that, "gain" loses, at the end of the month, were the residents institutional investors, with a total loss of 135.448.730,06 lei. Still the market summarized a net gain of 105.075.202,12 lei. In august 2007, when the crisis started the only one that gained were individual residents investors with a total of 86.789.243,70 lei. In august the market summarizes losses of 86.089.428,64 lei. So the situation of trading fast, without waiting to see what will happen made the Romanian market decapitalize as a result of this investor behavior.

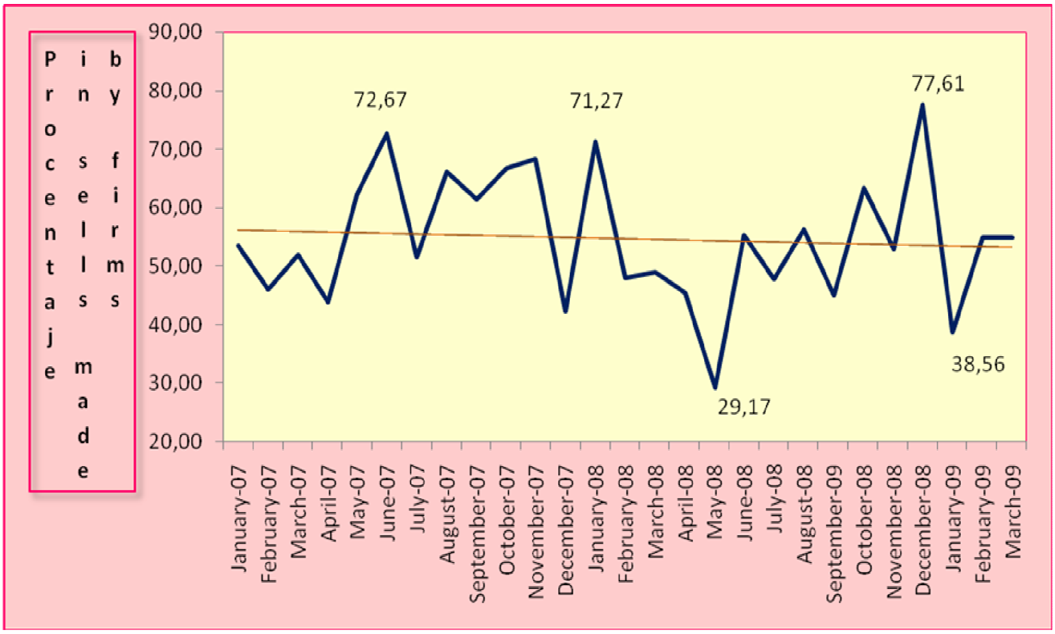

Figure no.2: "The percentage of nonresidents firms sells in total sells of firms"

The figure above shows the evolution of non-residents firms sells on Romanian market from January 2007 through March 2009. For this period, non-residents firms had an average of 54,67% in total sells of participants firms on Romanian market. The figure also shows the tendency or the trend line and as we see these non residents firms are moving somewhere between 60 and 50 %. By computing the standard obtain a figure of 11,35; that means that most of the values will have a deviation of ±3,37 pp from the average. On the chart are easily observed the higher and the lowest value, meaning 77,61% in December 2008 and 29,17% in May 2008, which makes our standard deviation seem to big.

So we can draw some conclusion based on this figure:

- The non-resident firms are not following a long term strategy, their are just "going with the flow" (that's way the swings in the chart);

- the non resident firms are ambiguity adverse that way the biggest sell on November 2008 when the Romanian capital market, like others, have just been hit by the latest boom and the Romanian political and economical climate was unstable.

2.2.2. Moods and feelings

The aversion toward risk, suffering or losses can reflect a calculated avoidance of future unpleasant feelings. Still, the moods and the emotions felt today by people affect their perception regarding risk choices tomorrow. Generally good-tempered people are much more optimistic about their choices and their judgments, than bad-tempered people. The decisional process can also be affected by sensorial senses and cognitive experience.

Affective moods contain information that can be used to conclude on the surroundings. For example it is possible that a person in a better mood to have the patience to make better decisions when the market is dropping, knowing the fact that the change of portfolio content must be made when the market is expanding.

Again, we can exemplify on the Romanian market to. If we look to the monthly net purchase/sell wee see that in that year (2008) the individual investors, whether residents or non-residents, will have 11 of 12 month ended with loses since the crises began.

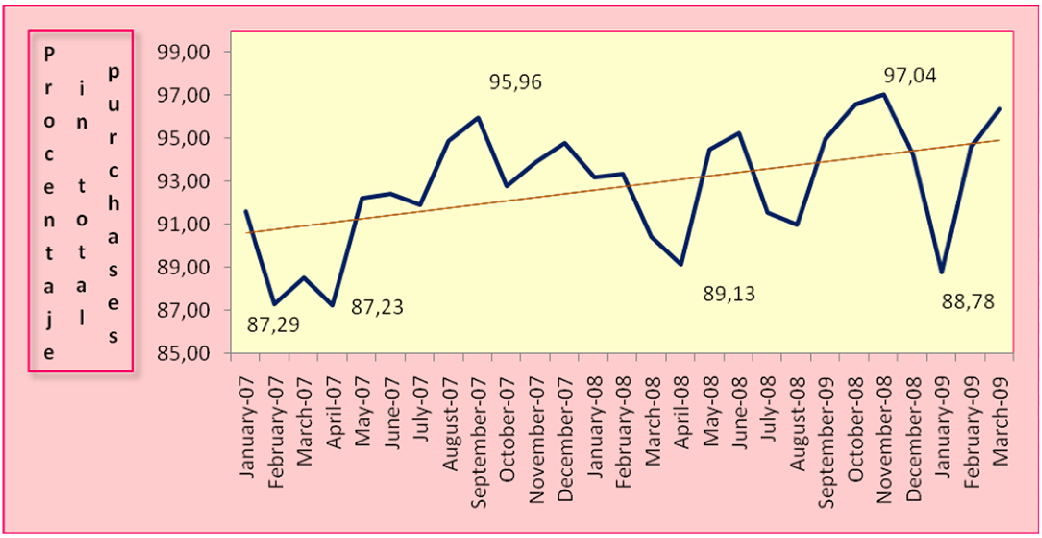

Figure no.3: "The percentage of residents non-firms in total purchases of non-firms"

If we take a quick look at the figures no.3 and no.4 we can draw the conclusion that non-firms are trading based on moods and feeling. Why? Because the range of values of purchases is between 87,29% and 97,04% in total non-firms, but the range of values of sells is between 91,38% and 97,63% in total non firms. We can see that massive purchases in one month are followed by massive sells in another as the example of september-octomber 2007 shows as; Romanian investors had 95,96% of purchases of nonfirms in September and in October when the crisis started to propagate had the biggest share is sells of nonfirm for the entire period of analysis.

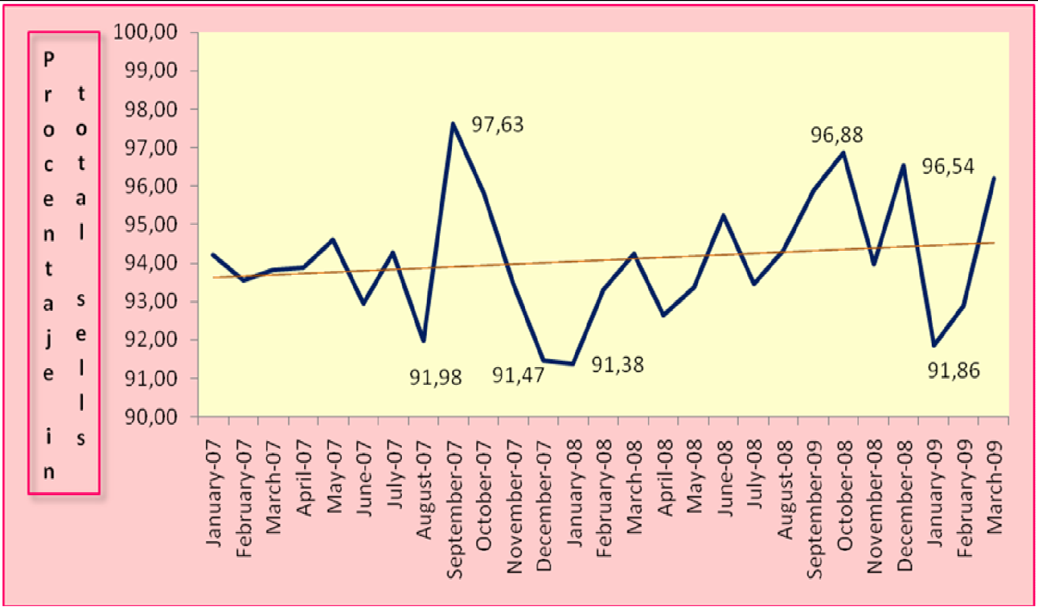

Figure no.4: "The percentage of residents non-firms in total sells of non-firms"

2.2.3. Self control

Assets investment for future gains (postponed consumption) implies self-control by being related to moods and feelings. Experimental studies suggest that people are inconsequent over time even when it comes to there choices. As the neuroeconomists (Glimcher et al. 2008) stated that may be the process of learning or simply a mood change. This causes choices' changes even when there isn't new information, either good or bad, about the investment. This type of reaction doesn't need any exemplification on the capital market, because is a well know subject.

2.2.4. Herding

Still, the most important influences have the mimic strategies by an investor from the others, making him to take the same actions.

Herding, on financial markets, refers to a situation when an investor or a group of investors assume others investors trading strategy. The reason for an individual to fallow this path is the fact that he believes that the others are getting new information, information that will help them to make better decisions. In the same category it is included the believe that others investor have better knowledge in this field.

Taking the case of a stable market, this behavior, might influence market's evolution in short term, but not in a substantially manner on long term. When faced with a financial crises, the herding can cause the collapse of some sectors or firms too week for handling this swings, and by doing that making the crises bigger.

From the biological point of view Prechter (2001) brings a new light on this behavior. He makes the connection between the herding behaviors in financial with an innate humane characteristic - surviving. He explains that when individuals are faced with a high emotional situation, impulse creates an unmeasured desire to seek signals from the others, regarding knowledge and behavior, and to line up their believes and convictions to the ones owned by the group. When a sufficient number of investors act in the same way, they will create a state of consensus. This will bring a security sentiment among the outsiders, creating a feeling large enough to collapse an entire market.

To make our point we can again use figure no.1. We can see that the BET index is following the EURONEXT index and this development is not given by the macro economical or political links. As we already stated the market correlation rises from almost 0,5 to 0,9 and this is only the investor behavior fault given the fact that the Romanian economy reacted some month later to the beginning of the crisis.

From behavioural finance point of view feeling like fear and greed are the ones which attract herding.

3. Conclusions

The contagion phenomena make a very important object of study in our days. The investors are using international portfolio diversification in order to reduce their risk. Because of the recent development of the financial market (the increased degree of integration) this diversification it can not be easily obtained.

Taking into consideration the above mentioned we can draw a very important conclusion about the international financial market, that is: the investor behavior has an important influence over the outgoing of this market and more, in time of crisis, when extreme behavior is accentuated.

This can mean only one thing: we need to take a closer look at the investor behavior; we need to count their behavior besides other elements that influence the global financial market. If we identify every type of investor behavior and the way that it influences the evolution of the market we can say that we have half of the solution of the present problem. The next step that we should take is the one regarding the way that we can limit this type of behavior or a way to predict them.

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CURRENT TRENDS IN GUARANTEEING LOANS – INSTITUTIONAL GUARANTEES –

Ioana Raluca Sbârcea[*]

Abstract

In this period, an often debated topic is related to credit risk, as more as it manifested lately and caused the trigger of the current crisis. Credit risk is not directly the subject of this work, but especially the ways of hedging credit risk. Therefore I examined in this paper the current trends in guaranteeing loans, respectively the institutional guarantees. Even if, in the other EU countries, loans guarantee funds work from many years in the case of Romania the activity of these funds is at the beginning. Therefore, the experience from other European countries, should lead to some measures that have to be taken in Romania in order to encourage the loans guarantee funds activity and to increase the confidence of the banks in the guarantees provided by this. This action may, on the one hand, facilitate the access of more companies to the credits provided by banks, and on the other hand a way to encourage lending, which can lead to an economic development and can contribute to the overcome of the actual economic crisis.

Keywords: loans guarantee funds, credit risk, SME's, economic crisis.

JEL Classification: E51, E59, H81

Introduction

Protection against credit risk materializes in three key directions[69]:

- risk prevention (cover loan and interest with the economic efficiency of the debtor);
- limiting credit risk by the formation of the specific risk provisions;
- cover loan and interest on the case of the debtor inefficiency.

Credit risk involves the assumption of bank that, at maturity, the customer will not be able to extinguish its obligations to her. For this purpose, the bank, through its specialists, must form an prudent opinion on the real possibility for the beneficiary to repay the loan, and it must take into account not only the first source of repayment for the payment obligation, but also a possible source of secondary recovery of the debt (which concerns mainly the material and financial guarantees of the client).[70]

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[69] Galiceanu, I., Stanciu, N., Cristea, M., *Gestiune bancară,* Editura Didactica Nova, Craiova, 1997, p. 375

[70] Rotaru, Constantin, Managementul performanţei bancare, Bucureşti, Editura Expert, 2001, p. 612.

Lately, due to the necessity of granting credits for small companies and enterprises, without very substantial assets, or for companies working in agriculture, which guarantees have a lower grade of merchantability, there became well-known institutional guarantees provided by Loans Guarantee Funds (LGF).

On the definition of LGF, some authors consider them to be non banking financial institutions whose role is to take the credit risk of a credit entity by guaranteeing a part of the debt of a client.

Other definitions emphasize the functionality of these funds in order to support SMEs or different branches of the economy, such as institutions that support entrepreneurs with viable projects but which do not have the necessary guarantees for obtaining a credit. International Monetary Fund states that guarantee funds[71] (including the deposits guarantee funds) are institutions that provide their clients against losses arising from financial companies or against financial loss of certain contracts. Under this definition, the guarantee funds:

i. have no assets in the form of technical reserves of insurance;
ii. dont't have extra-sheet positions;
iii. don't have to be regulated as insurance companies;
iv. may be limited to run only certain financial activities.

The given definitions reflect some common features for all the guarantee funds, respectively:

- *Risk sharing between creditors (credit institution) and LGF's*

This share is determined different for each case and guarantee funds can cover up to 100% of the loan requested. However, this case is very rare, because the risk assumed by the funds is maximum in this situation. In most cases, LGF take between 60% - 80% of the risk.

- *Targeting a specific segment of activity*

The main beneficiaries of most guarantee schemes are small and medium enterprises. In many countries, especially the emerging ones, guarantee funds are established and supported by the public institutions or companies operating as non-profit organization, which which emphasizes their participation in the process of economic development. Most of guarantee funds select their clients according to certain criteria of industry and / or number of employees, share capital or sales, values which must not exceed certain levels. Another way of filtering is to establish a ceiling on the guarantee, in absolute terms. This ceiling is set at a maximum level which is relatively small, making the large companies not interested in such guarantees.

[71] IMF, *Monetary and Financial Statistics Manual*, 2000

- *Support of viable projects and of projects with impact through the economy*

Projects must be viable because the debtor has to pay back his loan, and has to prove that his project is able to generate liquidity. Therefore, the projects involved must be carefully selected on the basis of economic and financial forecasts. Because the function of guarantee funds is to promote the development of certain economic sectors, this guarantees are given to the impact projects, developed in specific sectors of activity or in specific regions, or to the projects that offer environmental protection, etc..

Small and medium enterprises (SMEs) represent an important sector of any economy. However, SMEs contribute to a large extent to the Gross Domestic Product (GDP) and employs a lot of the labor force. Despite the growth and importance of the SME sector for economic development, they have to face many problems, especially regarding the access to finance through bank loans. According to a study of the European Commission[72] (EC), between 18% and 35% of SMEs have been refused a loan, in the European Union. Another study showed that EC[73], in Romania, the SMEs main source of financing for new projects is represented by their own funds, followed by bank loans and afterwords, by funds granted by the Government or by the European Union.

The main reasons of difficult access to bank loans for SMEs are:

1. from structural point of view, SMEs are more risky than large companies; they are more sensitive to economic shocks, with a lower capacity to absorb the variations than larger companies, which make, especially long-term loans, more risky;
2. in financial terms, SMEs can not sustain a demand for credit with appropriate collaterals, and banks are reluctant to accept personal guarantees;
3. monitoring costs are relatively high compared to the amount of the granted credit;
4. legislation is slow in terms of recovery the debts in the case of bankruptcy.

The existence of guarantee funds resolve some of these problems, respectively offers guarantees when the debtor has not enough and covers a part of monitoring costs, and this kind of intermediation is reducing the price of a loan. In addition, guarantee funds can provide professional evaluation of the projects, provides advice to SMEs on financial management, provides direct credits, etc. However, in considering LGF functions in facilitating the access of less wanted entities for financing, the question is whether this emphasis the pro-cyclical character of the lending. Thus, some authors show that the guarantee funds grow during periods with increase of loans, when the credit institutions would have extended their loan portfolio in a certain proportion to these entities (as a result of high liquidity in the

[72] *SMEs and Access to Finance,* Observatory of the SMEs in Europe, the Commission, Februarie 2003

[73] *SMEs in Europe 2003*, Raport pentru România, Observatory of the SMEs in Europe, the Commission, Iulie 2003

banking system, increased competition between credit institutions), making it difficult to separate the LGFs activity merit of the general business merit.

On how the Loans Guarantee funds operates, there are three main mechanisms for conducting the business of this entities:

- first variant, and the most common one, involves the analysis of each application for an institutionalized guarantee, which usually comes from a credit institution partner, when a client has a viable project, that can be finance, but it hasn't enough guarantees;
- second type assumes that the request comes directly from the clients, before they contact the credit institution for funding;
- finally, other funds work on a portfolio base. Thus, the guarantee funds enable the institution to provide credit guarantees of all businesses that meet certain conditions (the size of the project or associate risk). Because in these automated schemes the evaluation of the projects is made only by the credit institution, the guarantee fund will bear a smaller share of any loss, compared to the share that it would have supported for an application on an individual scheme.

For products and services, guarantee funds can charge fees, both annual, depending on the degree of risk involved in the project and according to the term of the guarantee and for the evaluation of the guarantee demands. These fees, although related to the guarantee risk, they often aim to cover the operational costs of the institution than to reflect the degree of the risk or to generate profit.

To achieve its aim of supporting funding for the entities the guarantees funds must provide confidence to credit institutions with which they have collaboration agreement. Dissemination of detailed pictures of the activities and results, complemented by a rigorous control (both internally and externally by an independent auditor), and a prudential supervision are items which could greatly contribute to the increasing of the confidence and acceptance of the guarantees offered by LGF.

Regulation and supervision of these funds is based on banking law, even if the guarantee funds do not attract deposits and they are using their resources in the activity. The main coordinates in exercising supervision refers to the risk management analysis, with emphasis on solvency. This indicator reports the entity's own funds to risk weighted assets and it is set at least 8% but the minimum level may be more restrictive.

A second large category regarding the regulation and supervision of this guarantee entities consider the LGF in the non-financial institutions group. LGF's are obliged to provide complete and accurate informations to the supervisor about their activity indicators.

Experience of international Loans Guarantee Funds

The structure of Loans Guarantee Funds varies depending on their funding. Can participate together in various forms, the banks, other financial institutions, and recipients of loans.

SC Garantinvest SRL, guarantee company that works in the Republic of Moldova considers the following elements as beeing essential to the success of Loans Guarantee Funds[74]:

- sufficient initial capital and prudent financial management;
- detailed and rigorous definition of acceptable risk level;
- capacity for assessing risk and a high degree of independence
- segmentation of different types of accepted risks;
- monthly tracking of risks;
- close cooperation and regular communication with the banks;
- level of investment guarantee limited to a maximum of 75%;
- the debtor participation in the financing;
- the existence of a company specialized in the fund management.

Providing and administrating of securities offered by the LGF's can be:

✓ active, in which case the loan proposal is considered by the guarantee fund and this is responsible for the quality of portfolio securities;

✓ passive, case in which the collateral security is granted automatically (based on a simple procedure) and the LGF is not responsible for the quality of securities portfolio.

At the European level there was created the European Association of Mutual Guarantees (AECM - European Association of Mutuel Cautionnement), which is basically an association of guarantee companies or loans guarantee funds from Europe. This association is formed by LGF's from 18 European countries[75], and from the analysis provided by this association, we found out that each country or regions is distinguished by certain features of guarantee funds.

Thus, in continental Western Europe, there was a real need of mutual guarantee companies, as a practical response to the financing SMEs needs when they did not have sufficient collateral to obtain loans. Mutual guarantee companies is not a direct source of funding, but an instrument through which this funding becomes cheaper and more accessible.

LGF's have emerged as a result of the combination of small entrepreneurs in an attempt to find solutions for the difficult access to the financing from some companies, event that usually appears during an economic crisis. Therefore, in the countries examined, the development of this guarantee funds was often due to an economic crisis or to the need for reconstruction. In most cases, this phenomenon

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[74] Garantinvest – Societate Interbancară de Garantare, "Garanţiile financiare, un instrument eficient de dezvoltare a antreprenoriatului"

[75] www.aecm.be

has been strengthened by the intervention of governments who were aware of the important role played by the SMEs in national economies.

The origin of mutual guarantee companies coincided with the emergence in France of organizations "Sociétés de Caution mutuelle", created under a law in 1917. Since 1929, similar companies have developed also in Belgium.

Later, during the reconstruction of Europe after the Second World War, a system of guarantee funds developed in Germany and Italy, although here, the developments have been different. Thus, the respective associations in Germany have developed rapidly and have been supported by the state, while in Italy, they have known a real development after the oil crisis triggered in 1973. In Spain, these firms have emerged as an instrument of economic policy and a measure of industrial promotion after 1977, in the beginning of the transition to a democratic society.

Mutual guarantee societies in the Western Europe shows a great disparity. In general, these companies have a mutual character, but there are notable differences from one country to another. They are often formed at national or regional level, but there is also the possibility of a combination of the two situations.

In Germany, there is a system with regional companies, with a multi-regional character, present as a national association. This organization gives to the every guarantee company independence, flexibility in making decision and this determines assuming the risk faster. Have relationships with banks and trading partner of the state, claiming the latter, provided that the business is viable. Since 1991, were assigned tasks and socio-political, such as helping create new jobs.

The guarantee companies have relationships with banks, they are partners of the state, and support the programs provided by the state, as long as this programs are viable. Since 1991, the guarantee companies were assigned also socio-political tasks, such as creating new jobs.

In Belgium there is a shift from a sectoral structure to a regional one. In Spain, there is predominant a regional structure, with a tendency, however, to one company per region. Here it also operate some sectoral organizations. France has developed a model based on the coexistence of two networks of companies: one is multiprofesional and the other is a national network of companies with a sectoral character.

Italy knows a very segmented model. There are over 800 companies with a wide variety of size, business diversification and degree of penetration.

Legal structures for guarantee companies are rather different largely in the EU countries. In Germany, they take the form of limited liability companies, with initial capital subscribed by private organizations such as chambers of commerce and industry, economic federations, professional associations, etc., representing up to 51%, and the remaining 49% it is formed by the capital of banks and savings. In Belgium, the guarantee companies are cooperative societies with limited liability. In Spain, this companies operated as open entities but a law passed in early 1994 turned them into financial institutions.

In France, there are two types of company: most f them, about 80% of the total, where created under the Law in 1917 as cooperative companies and the remaining 20% registered as financial corporations. In Italy, there are also two types of companies: some type of cooperatives, and others that take the form of consortia.

To encourage the business of guarantee companies in certain countries of Western Europe they receive tax incentives, namely:

➢ Germany: loans guaranteeing companies, defined like this by the banking law, are exempt from some taxes and duties;

➢ Spain: guarantee companies pay tax at a lower level compared to other companies. This companies are also exempt from paying other taxes.

➢ France: guarantee companies pay income tax but are exempt from paying taxes for risk provisions created for medium and long term.

➢ Italy: loans guarantee funds are exempt from paying taxes on reinvested profit.

In the countries of Central and Eastern Europe, have grown, in recent years, a number of institutions aiming at supporting SMEs. These institutions were constituted by the State (governments, ministries of finance) as banks of guarantees and development and the are involved in several activities aimed at financial support of the SME's. Guaranteeing loans is, for these institutions, only one of the activities and, in most cases, not the ain activity. Risks are assumed by the State, while losses are borne by the budget.

Romanian experience in developing and offering loans guarantee products.

Since the transition from a centralized economy to one based on market principles, Romania was confronted with the situation when small and medium enterprises, in part, have been removed from the country's financial circuit. The entrepreneurs have felt this thing when they wanted to access funds from banks and financial institutions, but did not have enough guarantees.

Given the reduced support for SMEs for developing their business led Romania to take the international experience in order to facilitate SMEs access to financial resources, which was reflected by the creation of 3 specialized financial institutions in granting loans guarantees:

1. Romanian Fund for Credit Guarantee (FRGC);
2. Guarantee Fund for Rural Credit (FGCR);
3. The National Credit Guarantee for Small and Medium Sized Enterprises

In Romania, the Loans Guarantee Funds have the legal form of stock company, which awarded them maximum flexibility in making decisions. The main founders of these organizations are credit institutions and financial companies in the proportion of 92% for FGCR and 84% for FRGC. The shareholder of FNGCIMM is only the Romanian state, represented by the National Agency for Small and Medium Enterprises.

The target for the granting of guarantees are:

➢ FGCR is the only fund in three specialized on a sector of the economy. Letters of guarantes can be obtained by individuals and legal entities, including start-ups companies, which are producers and processors of agricultural products, for loans provided for agricultural production and achieving investment in agriculture;

➢ FNGCIMM guarantes loans and other financial instruments that can be obtained by SMEs from financial institutions which meet the eligibility criteria established by the Fund (viable business plan, lack of outstanding loans, classification in standard, in observation and substandard category, according to the classification of National Bank of Romania, etc.);

➢ FRGC guarantes the vast majority of private entrepreneurs, including newly-formed, only if they have commercial and financial credibility.

Starting from the particularities of local market, the Loans Guarantee Funds have chosen the mechanism of active operation of the guarantee, which involves risk analysis for each client separately. Potential beneficiary of the guarantee requires financing from a bank and after the approval of the loan goes to the guarantee fund. Providing gurantees by the Fund is based on an analysis of its own, done after a "scoring" system, composed of economic and financial (quantitative) and some qualitative factors (eg.: SME's management, industry, competition, quality of debtors and creditors, etc).

Often, the requirements of the guarantee funds for SMEs are more severe than those of the banks, which can be explained by different degree of the effect of default on the bank and on the fund.

Loans Guarantee Funds, as well as credit institutions, use prudentiality indicators in order to cover against credit risk. These indicators are related to:

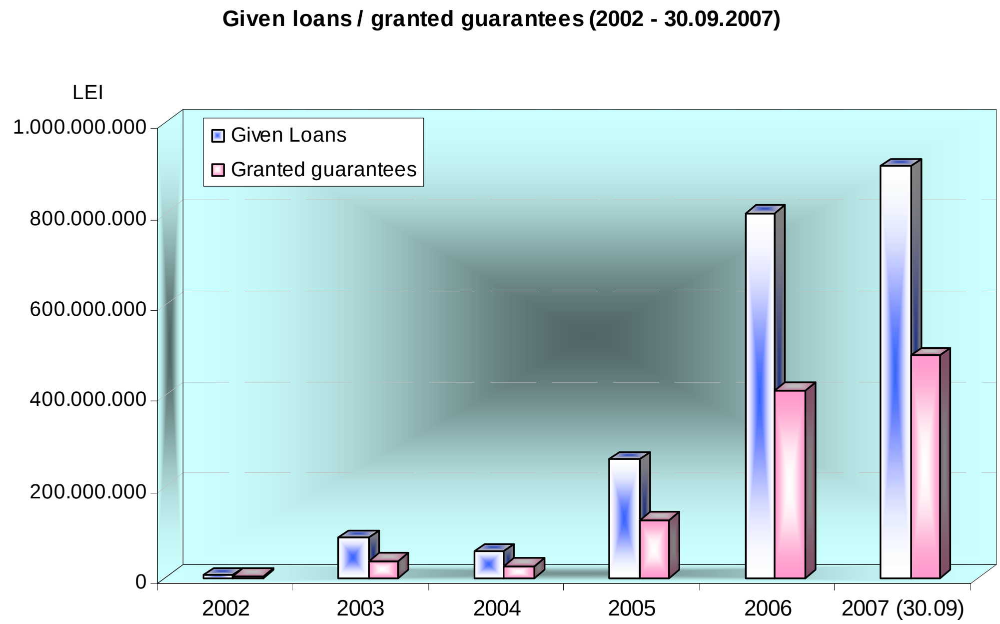
➢ maximum exposure to a single borrower, which in the case of the 3 credit guarantee funds is 20%, representing the ratio between the amount of exposure to a borrower and the level of its own funds;

➢ maximum exposure to a credit institution - all 3 funds establish the level for this limit annual, and in the case of FNGCIMM, maximum exposure to the credit institution may not exceed 40% of total granted guarantees;

➢ maximum weighted security against the loan amount, which differs from a guarantee fund to another, as follows:

- FRGC - up to 70%;
- FGCR - maximum 50% of the loans for short term and 70% of the loans to medium and long term, subject to a ceiling of 250,000 to 1,000,000 euros, depending on the type of customer, and can reach up to 100% of the exposure when lending to co-finance European funds;
- FNGCIMM - between 60% and 80% depending on the duration of the guarantee, seniority in the business of the recipient, and other indicators of internal analysis.

Regarding the number and value of guarantees, the information is offered only by FNGCIMM. This reflects an increase of the warranty offered since 2006. The performances of the FNGCIMM are as follows (graphic 1 and 2):



Sursa: FNGCIMM – The advantages of using FNGCIMM products for implementing the projects financed by the european funds, december 2007

This increase is determined mostly by the booms that took place on the loans market since 2006 as a result of the increasing appetite of the companies for investments, even if you do not have money or guarantees of their own.

In addition, even if some funds are functional from a large period of time (FGCR from 1994, FNGCIMM from 2001) their activity became known only in last years. This is due first to a lack of information to the customers and secondly to a lack of interest in promoting such guarantees from banks. This is caused by a lack of trust from banks in the guarantee funds activity due to the fact that until 2 years, guarantees provided by this funds could not be deducted from the loans, which cause an increase in provisions in case of such loans became outstanding . Not even now, banks don't have complete confidence in the institutionalized guarantees, which is why the guarantees could only be 50% deducted from the loan value when calculating the provisions.

Conclusion

I consider that this perception of the banks should change, because institutional guarantees represents a good option for economic development by facilitating the financing of the small and medium enterprises. This is even more important considering the general crisis that the economy is going through. Economic crisis has been caused by excessive growth of lending and that's why, now, the banks have an excessive prudntiality in terms of granting loans. At the same time, many specialists believe that overcoming this crisis can only be achieved if bank restart their loan activity in order to stimulate the companies investments. This is not possible without the support from the loans guarantee funds, because at this time other warranties (securities and real estate) no longer determine an appropriate risk coverage due to the reduction of their liquidity on markets affected by the economic crisis.

Thus, in several words country, as well as in Romania, one way of hedging credit risk are the guarantees. Experience in international lending has stressed the fact that in some areas, very important in developing countries economy, the guarantees offered by the beneficiaries of this credit are of lower quality, and so, they can not determine the reduction of the associate risks. Therefore, a solution found to solve this problem and facilitate access to credit was the creation of guarantee funds, as institutions that assume the risk of default of loans. In Romania these types of securities, although they exist from several years, they were not very good fructificate, as a result of the bank perception about them. Currently, securities issued by the Guarantee Fund start to increase, especially because the companies understood the fact that they facilitate the acces to bank loans and european funds. Still, I consider that this guarantees should be better promoted and supported by state and national bank in order to increase the contribution of this loans guarantees funds to overcome the economic crisis, and for this they should take the example of the facilities provided to these funds in other european countries.

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MARKETING COMMUNICATION IN THE BAKERY INDUSTRY IN ROMANIA IN THE CONTEXT OF CURRENT CRISIS

Olimpia Oancea *

Abstract

This year, the crisis still persists in all areas of business models in the market and its potential for growth, customer behaviour will change clearly. In this respect, the importance of efficiency will be materialized in the results and objectives. Cutting marketing budgets is not necessarily a solution for companies in this period. Romanian consumers are changing, and if it changes, and then business / SMEs must adapt and therefore communication must adapt. The purpose of this work is to highlight the importance to be given to a fair and consistent communication in time of crisis. This crisis could be an excellent opportunity for many companies who will be held successfully in the mind of the consumer. Therefore, any company must communicate more and better with its customers in time of crisis than in times of economic growth.

Keywords: marketing communication, market segments, crisis, budget marketing, the bakery industry.

JEL Classification: M31, M37, M39

Introduction

This year, the crisis still persists in all areas of business models in the market and its potential for growth, customer behaviour will change clearly. In this respect, the importance of efficiency will be materialized in the results and objectives.

Lately more companies have announced reductions in marketing budget, but at the same time argue that they remain as effective and efficient in dealing with customers. In principle, the "strategies" of these companies is related to communication channels cheapest (Internet instead of TV) or reduce the use of existing channels.

The question to ask is whether these strategies will be sufficient to successfully navigate through the current crisis. These strategies go on the idea of conducting activities as in previous years but with less money. Migration budgets communication channels to cheaper will not help significantly, because this strategy ignores one important thing.

Most markets in Romania were "seller markets" in which producers and traders did not have to apply concepts and strategies very sophisticated in order to stimulate sales. Demand grew from one year to another is determined primarily by increases and changes "uncontrolled" of consumer needs. This will not happen in 2009,

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consumers are not a homogeneous group to generate the same increase in demand as in previous years.

In particular companies that have a portfolio of complex and heterogeneous products or companies that sell the same products or services to multiple segments of customers should reconsider its strategy for sales and marketing.

The objective of such a strategy review is to find answers to the following questions:

- Which of the segments that you serve should focus?
- What are the products that we should focus?
- What is the potential for sales by product and market segment?
- What product segments and should resign in 2009?
- On what products and segments should allocate marketing budgets?
- What should be the criteria for prioritization in the allocation of budgets?
- What are the sales and what to do for them?

To find answers to these questions requires a clear segmentation of customers (in homogeneous groups according to specific criteria - age, consumption, region, industry, etc.) and structuring a portfolio of products. This will allow a more thorough and realistic performance of sales and marketing analysis and determination of indicators, for example the number of products sold on the product group and segment customers.

Such a structure usually involves harmonization of the various departments - sales, marketing, product management, top management - in terms of understanding and evaluating the market and clients. In many companies this internal harmonization doesn’t exist. From the perspective of sales, the market is usually structured by types of customers, while usually marketing consider only channels of communication and promotion campaigns, product management and has a perspective-oriented products. In such situations we can speak of a market, but several non-aligned strategy: a communication, a sales and a product which implies an inefficient allocation of budgets.

Correct segmentation of the market / customers is a basic requirement to allocate marketing budgets in a way the company to carry out its market potential. The question that seeks to answer is: "How to set strategy, sales targets and budgets aligned to the marketing potential of the market in 2009 with fair market segmentation?”

1. Evaluation of a potential market segment. This assessment is based on the potential of unexplored market segment and by product, growth rate on the product and market segment, and the inherent potential for growth and product segment. Sources of data for the first two assessments will be an analysis of the external market, while the third indicator may be determined by means of online surveys involving experts from all sales of the company.

2. Evaluation of a competitive market segment. This assessment is based on analysis of their positions in a market segment compared to competition on the profitability by product and market segment analysis and "customer fit" (how well

their products meet customer expectations). Assessment of position in a particular market segment can be addressed through surveys online sales teams. Profitability information is provided, usually the finance department, and evaluates "customer fit" can be done by conducting interviews or surveys with online clients.

Through this approach can identify four categories of market segments and products in terms of attractiveness and potential:

- market segments and products with growth potential over the market;
- market segments and products with growth potential once the market;
- market segments and products improve or divest(do not focus on the activities of sales or marketing);
- Market segments and products with potential.

The potential of a product or segment is the basis for setting priorities in the promotion strategy and marketing objectives for the next period and resources required to achieve objectives. Such an approach ensures use in a way indeed effectively marketing budgets by targeting products and segments with the greatest growth potential.

In times of crisis, the struggle for resources and competition between companies grows. The trend is to reduce budgets consumption and investment, and those who have cash are negotiating power because they have lots of choices from which to choose can. In this context, questions that seek to answer are:

1. How consumers choose?
2. How they decide who to give all his money, fewer and therefore more valuable?

In the mind of every potential customer has a ranking of brands according to their notoriety and prestige. Therefore remain on the market, companies that have created a name, and forgetting is equivalent to death of the company. Therefore, any company must communicate more and better with its customers in times of crisis than in times of good growth. Also, all companies should remind consumers that there is a permanent market for himself and his desires.

It is when the strong companies survive and healthy financial and managerial weaknesses and companies that lose money are eliminated. So each is trying to pen a strategy for survival in the hope of a revival after the crisis. Therefore, the crisis and recession for some is a threat and an opportunity for others.

The best survival strategy for crisis combines the image on the market consolidation - through constant communication with customers, reducing profit margins - by controlling and optimizing costs and an aggressive sales policy. Moreover people who are investing in brand conscious brand that they "take on wave.

A good communicator will respond to consumer confidence and uncertainty conveying messages of safety, strength, stability and strength. Therefore, panic may be reduced with demoting rumours arguments, figures and statistics. Prudent consumer, who wants to make savings companies seeking effective, and a clear message, sent the firm and at the right time it will reassure the customer that it will be convinced that it will win more than it spent.

In times of recession, companies tend to reduce their marketing costs that depend on their sales that do not have instruments to measure the effectiveness of these investments. Thus, in this situation not only marketing and advertising sales, but satisfy consumer desires in terms of profitability for the company.

Cutting marketing budgets is not necessarily a solution for companies in this period. Romanian consumers are changing, and if it changes, and then business / SMEs must adapt and therefore communication must adapt.

In time of crisis, a correct and consistent communication is absolutely necessary. Moreover, marketing is not a question of falling profits, but a source of growth, which they transmit the idea of consumers increased value of the product.

This crisis could be an excellent opportunity for many companies who will be held successfully in the minds of the consumer. Building and brand development through the adoption of effective brand strategies, marketing plans consistent, are measures that are a "must" for companies.

If the communication concerns a specific target audience, then the choice is right and will generate a positive and favourable image among those consumers. According to the analysis "Optimizing the Marketing Budget in Recession" made by Ogilvy would be continued investment in marketing and communication for the post-recession business is solid. Some companies have succeeded during recession. They see the crisis as an opportunity to develop. While competitors in panic, they make their point plan of growth through sustained investment. Optimizing budget marketing is just one of the problems that these companies face. Those who decide to continue to invest in marketing, benefit, usually for business development, even greater than in a normal period.

In time of crisis consumers are more careful in buying products. Therefore, it can be an opportunity to create effective products and brands. During the recession, companies have the opportunity to gain more market share "than in a normal period. If a company profitable, and would have spent the last cent to continue development. Companies that reduce costs will be difficult and will take longer to return to the pre-recession.

Companies that wish to recover costs in a year after the recession should spend about 60% more on marketing than the amount you have saved it and cut from the initial marketing. Competitors' weaknesses at a time when most consumers can still spend a good opportunity for new business, brands and ideas for companies.

Economic crisis and its impact on the bakery industry in Romania

Agriculture is among the areas that were affected by the crisis, mainly due to the grain exchange crash. The price of wheat and maize was reduced significantly at the end of 2008, approximately 30% -40% less than the previous, much cheaper than a few months before. This was because there were significant reductions in both the stock exchange in Chicago and the European exchanges.

Players in agriculture are of the opinion that in Romania cereal prices are much lower than in European countries. In this respect, an example may be that the price of wheat in Austria and Hungary is 220-235 Euros / tone and in Romania, tone of wheat can reach 111 euros. In the case of maize, it is sold in Hungary with 130 Euro / tone in Austria with 135 Euro / tone, while in Romania at 85 Euro / tone. These price decreases will lead to the elimination of stocks of cereals and implicitly, to call on imports.

In early 2008, specialists in agriculture estimated wheat production of 7.6 million tones and maize at 8 million tons. However, drought and floods in the summer of 2007 changed goes to farmers who have received only 5.6 million tons of corn.

Although prices on international markets have fallen heavily, at that time, in our country they were well below those values, which led to export about 30% -40% of total production.

Financial crisis has already affected farmers who have turned to loans in recent years and changed the development plans of some, and most of them have dropped several projects that were to run in the next period. The players in industry have delayed modernization projects as requiring large loans, and this period is not advisable to use them. In Romania are around 9.4 million hectares of arable land, of which the greatest 50 players operate about 4% working in the agricultural sector.

Agriculture has felt the effects of the crisis in 2009. Nearly 15% of farmers in Romania are out of business in 2009 because they have failed to resist the market after the financial crisis. In November, the Federation Agrostar asked the Ministry of Labor and Ministry of Agriculture as 50,000 employees to get unemployment technical and investment in the bakery industry has been affected by the economic crisis because of the limitation of access to credit.

The internal milling and bakery reached in 2008, 2 billion euros, up 15% compared to 2007. Consumption of bread dropped in Romania in 2008 to 1.5 kilograms per capita. Meanwhile, with decreasing consumption of bread has been an increase in confectionery products.

Economic crisis since the end of 2008, has affected investments in the bakery industry, estimated at 100 million euros for 2009. Many potential investors have had to resort to loans to make investments, a possible restriction or inability to obtain credit will lead to surrender to obtain them.

Another problem faced by the bakery industry, against the backdrop of economic crisis, is that the dealers who are granted merchandise credit; in the defense of problems in obtaining credit, they are unable to pay the freight and this strongly affects industry.

At the end of 2008 in Romania bread consumption has decreased by 1.5 kg, reaching 112 kilograms per capita per year. The tendency was to place us in the European context, where the average annual consumption of bread was about 80 kg per capita per year. The internal milling and bakery reached in 2008, two billion, up 15% over 2007.

Conclusions

The best survival strategy for crisis combines the image on the market consolidation - through constant communication with customers, reducing profit margins - by controlling and optimizing costs and an aggressive sales policy.

A good communicator will respond to consumer confidence and uncertainty conveying messages of safety, strength, stability and strength. Therefore, panic may be reduced with demoting rumours arguments, figures and statistics.

In time of crisis, a correct and consistent communication is absolutely necessary. Moreover, marketing is not a question of falling profits, but a source of growth, which they transmit the idea of consumers increased value of the product.

As regards the impact on the bakery industry in our country, the effects were the reduction of investments; one of the reasons is that access to credit has become increasingly restricted. And bread consumption has decreased; the trend is that of our place in the European context, where the average is well below average in Romania.

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THE FEDERAL RESERVE AND EUROSYSTEM´S BALANCE SHEET POLICIES DURING THE FINANCIAL CRISIS: A COMPARATIVE ANALYSIS

*Philipp Bagus and David Howden**

Abstract:

The balance sheet developments of the Federal Reserve System have received increased attention during recent events. The Fed has expanded its balance sheet and also changed its composition in order to support the financial system. As a consequence the average quality of the assets have, on average, deteriorated. In a similar way, the ECB has recently implemented novel balance sheet policies. In this article we compare the balance sheet policies of these two central banks. We assess the differences in policy strategies and deduct consequences concerning the quality of the respective currencies, as well as future directions of monetary policy.

Keywords: *Central Bank Balance Sheets, Quality of Money, Balance Sheet Analysis, Monetary Policy, Subprime Crisis.*

JEL Classifications: E31, E52, E58, E59, M40

Introduction

The developments of the balance sheet of the Federal Reserve System (Fed) have recently been analyzed in light of the recent economic turmoil (Cecchetti 2009, Bagus and Schiml 2009a, Brunnermeier 2009, Hamilton 2009). In addition, the media have pointed out the deterioration of the balance sheet of the Fed with dissenting voices warning of this development. The Fed expanded its balance sheet and changed its composition in order to support a faltering financial system. Consequently, the average quality of the assets on average has deteriorated. Similarly, the ECB changed its balance sheet policies in order to support the European banking system. In this article we compare the balance sheet policies of these two central banks. We assess the differences of their policies and deduct consequences for the quality of their respective currencies. In particular we analyze which central bank has deteriorated its balance sheet, and thereby the quality of its currency, more strongly during the financial crisis between June 2007 and March 2009.

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The Economic significance of central bank balance sheets

The analysis of balance sheets and balance sheet policies is an established research field in business studies and a practice conducted by investors, auditors, rating agencies, and stock exchange supervisors. While the theory of balance sheet analysis in business is well developed the analysis has been widely neglected in economic theory. The theory of balance sheet analysis used in business and resultant ratios thereof are helpful concerning the analysis of the Federal Reserve and Eurosystem's actions during the recent financial crisis.[76] Specifically, the connection between the balance sheet analyses found in business studies and the *quality* theory of money is fruitful.

The quality theory of money claims that the value of money is primarily determined by its quality. The quantity of money is *merely one* of several factors that influences its quality.[77] The quality of money can be defined as the capacity of a good to fulfill money´s main functions, i.e., to serve as a medium of exchange, a store of value and a unit of account.[78] Some of the factors that affect the function of money as a store of value are recorded in the central bank´s balance sheet. Therefore, the evolution of the balance sheet of the central bank, in particular changes occurring on its asset side, are important in understanding shifts in the *perceived* quality of money. The central bank´s assets back the liability side of the balance sheet. In fact, assets represent the means that the central bank can use to defend the price of its currency internally and externally through sales against its liabilities, i.e., the monetary base. The assets can also be used in policies to support a struggling financial system and inject confidence into it.

When the central bank uses its assets to defend its currency, this procedure represents a *de facto* redemption. The holders of the currency "redeem" it against these sold assets. The higher the quality the assets that a central bank owns, the more assuredly it can guarantee the long-term value of its currency and its function as a store of value.[79] Moreover, in the extreme case of monetary reform, the assets a

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[76] McKean (1949) provides an early exposition of the need to delve into the compositional holdings affecting the liquidity positions of central bank assets. Mishkin (1978) and Kiyotaki and Moore (2002) have provided more recent evidence that financial calamities are propagated and transmitted through balance sheet compositional shifts.

[77] The quality theory of money is found to date back to Mariana (1609), Menger (1871), and Jevons (1875). After a period of neglect following the popularity of the more conventionally used quantity theory of money, Hazlitt (1978), Cunningham (1992), and Bagus and Schiml (2009a) have brought forward renewed arguments for the former's superiority.

[78] For an intensive account on the quality of money and balance sheets see Bagus and Schiml (2008). For a case study concerning the quality of money during late eighteenth century America, see Bagus (2008).

[79] This distinction is different than the changes in the liquidity position. Negative qualitative shifts in asset holdings imply, for example, a shift from high to low quality bonds, while a shift in the liquidity

central bank owns can be used in order to sustain confidence in the reform and back the new currency. Hence, the evolution of the assets of a central bank determines the quality of a currency and, consequently, its purchasing power.

Thus, the analysis of a central bank's balance sheet is very important for the evaluation of the quality of the currency it backs. In fact, it is possible that the total of assets on the balance sheet *as well as* measured monetary aggregates do not change, while the composition of the balance sheet deteriorates substantially. This can cause inflationary pressures to build, as the assets backing the currency and consequently the currency´s quality deteriorate. Even in the face of quantitatively similar situations, qualitative changes can make remarkable differences in the overall value of a currency. As a result, it can also be seen that the balance sheet influences the foreign exchange rate. In our comparative example, the relative development of the balance sheet helps to explain part of the variations in the euro-dollar exchange rate.

Moreover, deterioration in the quality of central bank assets may indicate possible future developments of the monetary aggregates.[80] Thus, it is possible to read from the balance sheet the limits for swaps of good assets (i.e., high quality) against bad assets (i.e., low quality) to aid in stabilizing the banking system. When the amount of high quality assets shrinks, it becomes at some point necessary to expand the balance sheet to lend additional support to the banking system. This expansion will, in turn, influence the monetary aggregates. Furthermore, a deterioration of a central bank's balance sheet can indicate the necessity of an imminent recapitalization of the central bank by the government. The recapitalization entails the possibility of increases in the quantity of money to finance it, which may also negatively affect the quality of money.[81]

An analysis of the quality of the assets held by a central bank is especially useful in times when traditional tools to analyze monetary policy are limited. In fact, central banks of the world are now reaching what economists call “the zero-bound” of interest rates. The Fed has already reached the zero-bound while the Eurosystem is quickly approaching this point.[82] This makes an analysis of the central bank´s balance sheet increasingly important to aid future monetary policy as both qualitative and quantitative changes become the only policy tools available to the central banker to fight recession.

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position would entail a move from cash to bonds (Bagus and Howden 2009b). Note that while shifts in the liquidity position imply qualitative shifts, the converse need not necessarily hold true.

[80] Beckhart (1940) makes note of this fact – as a central bank's portfolio takes on assets of lower liquidity it becomes unable to exercise control through monetary policy (either quantitatively or qualitatively).

[81] Bagus and Schiml (2008; 2009a) introduce the term “qualitative easing” to signify those balance sheet policies that deteriorate the average quality of central bank assets. Although qualitative easing has received scant attention in comparison to its quantitative counterpart, recent attention can be found in Buiter (2009a; 2009b), Bagus and Schiml (2009b) and Bagus and Howden (2009b).

[82] The Bank of Japan has meandered along the zero-bound since February 1999. More recently, the Bank of Canada and the Swiss National Bank have also succumbed to the limitations the zero-bound imposes.

Eggertsson and Woodford (2004) demonstrate that liquidity traps obtain only at the zero-bound, as interest rate policy becomes ineffective. In response, alternative policy measures must be implemented. However, while central bank communications are widely seen as increasingly effective policy response in the face of the zero-bound (Bernanke, Reinhart and Sack 2004, Güraynak, Sack and Swanson 2005, and Rosa and Verga 2008), the *credibility* of these statements adds an instrumental component.[83] The quality of a central bank's reserve assets, as recorded on its balance sheet, gains increased importance as these represent the credibility that the communicated policies will actually come to fruition.[84]

An historical account of the current crisis as reflected in the Federal Reserve System and Eurosystem's balance sheet policies

During the financial crisis the European Central Bank and the Federal Reserve System each acted as "lenders of last resort" on an unprecedented scale. The dimensions of these new monetary policies manifest themselves on the consolidated balance sheets of the Eurosystem, i.e., the balance sheet of the ECB and the central banks of the member states that have introduced the Euro, and the consolidated balance sheet of the Federal Reserve System.[85] Let us first look on the balance sheet of the Eurosystem and then at the Fed's. When we compare the asset side of the balance sheets in June 2007 before the crisis broke out with the more recent position of March 2009 we can observe important changes.

[83] The past 20 years have seen a veritable explosion in research concerning what constitutes appropriate and effective central bank communication. For brevity, the reader is referred to Blinder et al. (2008) for a summary of these developments.

[84] Additionally, Bernanke and Reinhart (2004) argue that future policy responses will depend on future exogenous shocks, implying that policy responses will be conditional. The credibility of these conditional responses will directly depend on the assets at a central bank's disposal to maintain such future positions.

[85] Serrano Cinca, Mar Molinero and Larraz (2002) warn that international comparisons of balance sheets are fraught with peril owing to diverse accounting traditions and standards which vary from country to country. Studies focusing on this approach must rely on homogenous and reliable data. Every attempt has been made here to make the data as directly comparable as possible by employing similar criteria for asset valuation. McLeay (1991), Choi and Mueller (1992) and Sherman and Todd (1997) provide additional critical assessments of international comparisons of accounting standards. Calls for homogenized accounting practices date back at least to Henry Bailey's 1888 pamphlet, "A paper on balance sheets and how to prove them", while more recently the International Accounting Standards Committee has strove to homogenize practices across international borders (Hanks 1997).

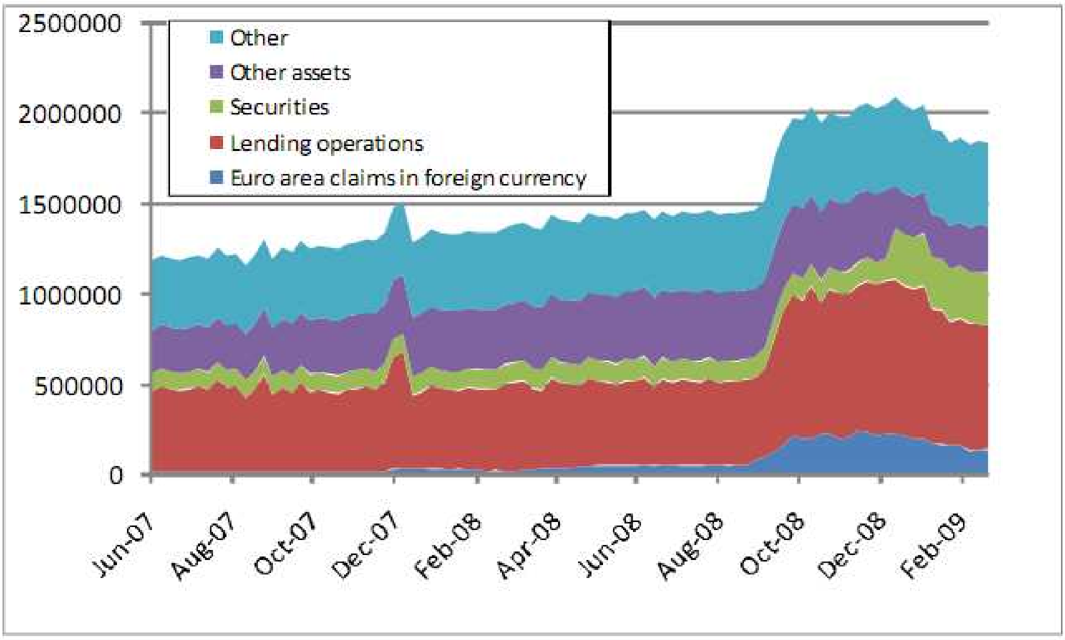

Figure 1: Asset side of the Eurosystem´s balance sheet (06/2007 to 03/2009)
(weekly, millions Euros)
Source: ECB *(2009)*.

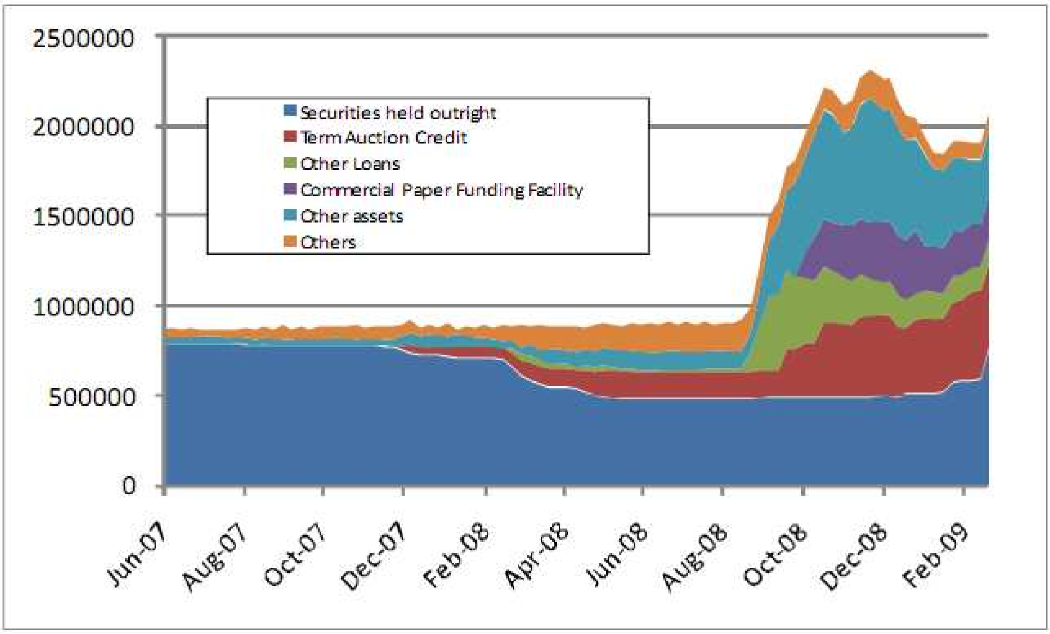

Figure 2: Asset side of the Fed's balance sheet (06/2007 to 03/2009)
(weekly, millions dollars)
Source: Fed *(2009)*

Most importantly, a dramatic quantitative expansion of both balance sheets occurred over the period. The balance sheet of the ECB increased approximately 60 percent from June 2007 to March 2009. The balance sheet of the Fed was expanded even more during the same period, by almost 240 percent. We can also see that both balance sheets commenced expanding at a much more rapid pace in September 2008, after the collapse of Lehman Brothers. Furthermore, both balance sheets reached their maximum size in December 2008 which has been followed by a slight contraction until the present. It is here where the similarities end.

Until September 2008 the balance sheet of the ECB increased while the Fed's remained constant, instead changing in composition. Thus, in the early stages, the ECB tried to fight the crisis by a balance sheet expansion and additional liquidity while the Fed fought the crisis by changing its balance sheet composition without injecting new liquidity but rather relying on injecting its liquid assets into the banking system, as can be seen in figure 3.

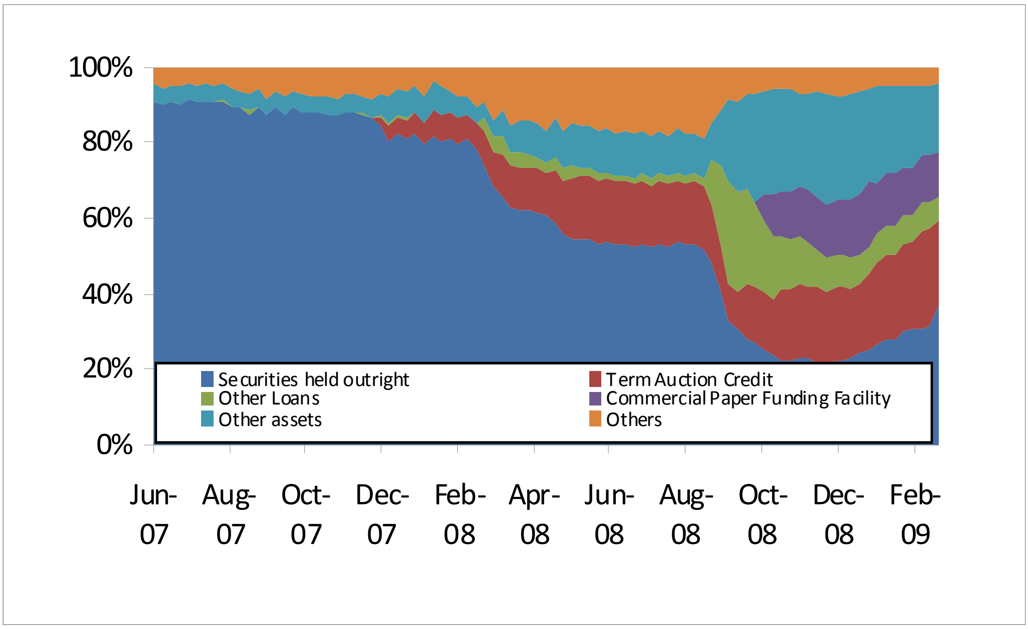

Figure 3: Asset side of the Fed's balance sheet (06/2007 to 12/2008)
(in %, weekly)
Source: *Fed (2008)*

In fact, from August 2007 to September 2008 the American central bank's balance sheet total did not undergo a substantial expansion (approximately 3 percent), while the quality of the balance sheet and, consequently, the quality of the currency backed by it, had been deteriorating considerably. This was the consequence of the Fed´s attempt to forestall a systemic crisis by deteriorating its balance sheet through sales of its quality assets, in exchange for less credit worthy assets from the banking system. The amount of high-quality and very liquid assets remained either constant (i.e., in the case of gold) or was reduced dramatically (i.e., in the case of U.S. Treasury bonds). Furthermore, beginning on March 27th the "Term Securities Lending Facility" (TSLF) was installed.[86] In this facility primary dealers can borrow U.S. Treasury bonds from the Fed by pledging as collateral lower quality securities. Thus, the banking system was provided with U.S. Treasury bonds that banks could themselves offer as collateral. This measure further deteriorated the position of the central bank (replacing high quality with lower quality assets), even though the lending does not appear on the balance sheet itself but as a memorandum item.

While the Fed sold its high quality assets, this was compensated by the increase in low quality assets. For instance, as a consequence of the rescue of Bear Stearns, the Fed acquired the dubious and illiquid assets of Bear Stearns that JP Morgan Chase did not want to inherit and add to its own balance sheet. These assets can be found on the Fed balance sheet in the position "Net portfolio of Maiden Lane LLC." The most important low quality asset positions were the "term auction credits". These loans were granted to the troubled banking system primarily via the newly installed "term auction facility" (TAF). The term auction credits are 28 to 35 day loans to a broader range of counter parties and against a broader range of collateral than the more conventional open market operations.[87]

Thus, the average quality of the assets backing the dollar substantially decreased. The balance sheet total remained constant because the reduction of the liquid Treasury bonds was compensated by the increase in other more illiquid and lower quality items.

It was only after the bankruptcy of the investment bank Lehman Brothers on September 15th 2008 that the Fed stopped sterilizing new loan issuances by selling Treasury bonds. Simultaneously the Fed increased its lending of Treasury bonds to the banks. As a consequence of these policies the balance sheet total increased more than 100 % from the 4th of September to the 12th of November. In fact, during the Lehman Brothers incident, the point was reached where there was no longer enough Treasury bonds left for sale or loan. If the Fed wanted to issue more liquidity to the banking system, it had to commence expanding its balance sheet quantitatively.

The additional assets on the Fed´s balance sheet are of questionable quality as they represent loans to a troubled banking system backed by potentially illiquid collateral. For instance, its new assets contained rescue loans to the insurance company American International Group (AIG) which have an embedded risk of being returned at a significant loss to their book value. Moreover, the Fed started the direct purchase of debt by Fannie Mae, Freddie Mac and the Federal Home Loan

[86] The Term Securities Facility appears on the balance sheet the first time on March 27th 2008. Before that date, they had been called "securities lent to dealers" which had, to that point, been a fairly small position on the Fed´s balance sheet.

[87] Additionally, on August 11th 2008 the Fed started to grant longer term auction credits of 84 days.

Banks and of mortgage backed securities issued by Fannie Mae, Freddie Mac and Ginnie Mae. By these purchases, the Fed has assumed a substantial amount of additional direct credit risk.

The strategy of the Eurosystem to aid the troubled financial system was starkly different. From the beginning it has pursued quantitative easing policies. Thus, it did not try to sterilize the new loans to the banking system by the sale of its high quality assets. Nevertheless, the composition of the balance sheet changed mainly by taking on proportionately longer-term assets as well as assets of lower liquidity as can be seen in figure 4.

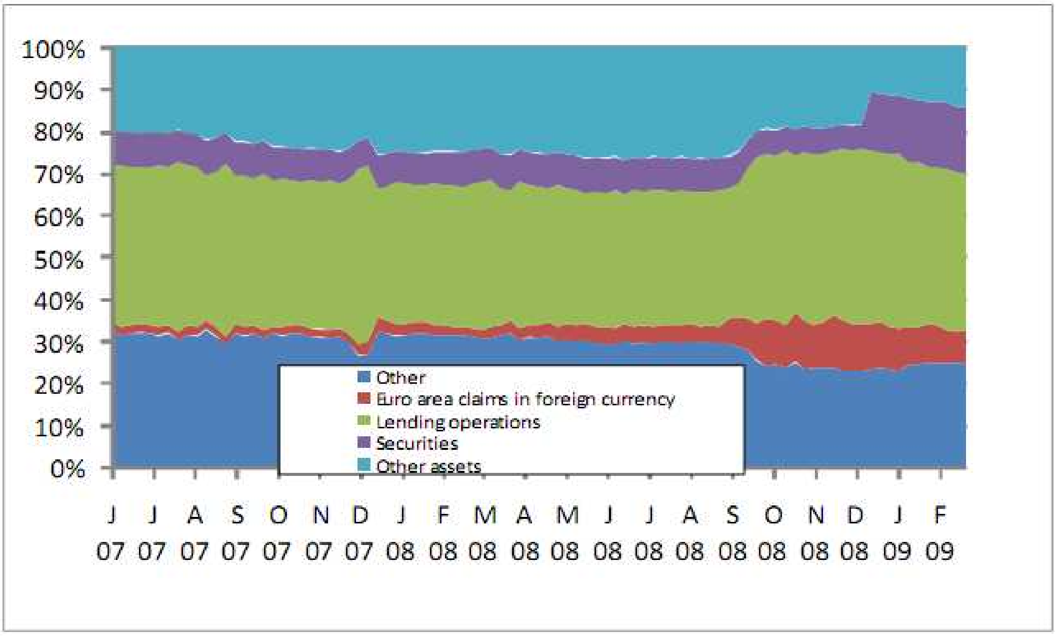

Figure 4: Asset side of the Eurosystem balance sheet (06/2007 to 03/2009)
(in %, weekly)
Source: ECB (2009)

Moreover, and in contrast to the Fed, the ECB expanded upon existing credit operations instead of introducing new facilities in order to provide liquidity to the struggling banking system. Thus, the composition of the balance sheet varied as the amount of lending operations to Euro area credit institutions increased with a tendency towards longer-term financing. As the term length on loans was increased, the counterparty risk of default increased, resulting in a lower average liquidity of its balance sheet assets. In fact, the ECB gave these longer-term credits because the counterparties, namely banks, were already in trouble and in need of longer-term funding for stability. The change in the composition of the specific lending operations themselves can be observed in figure 5.

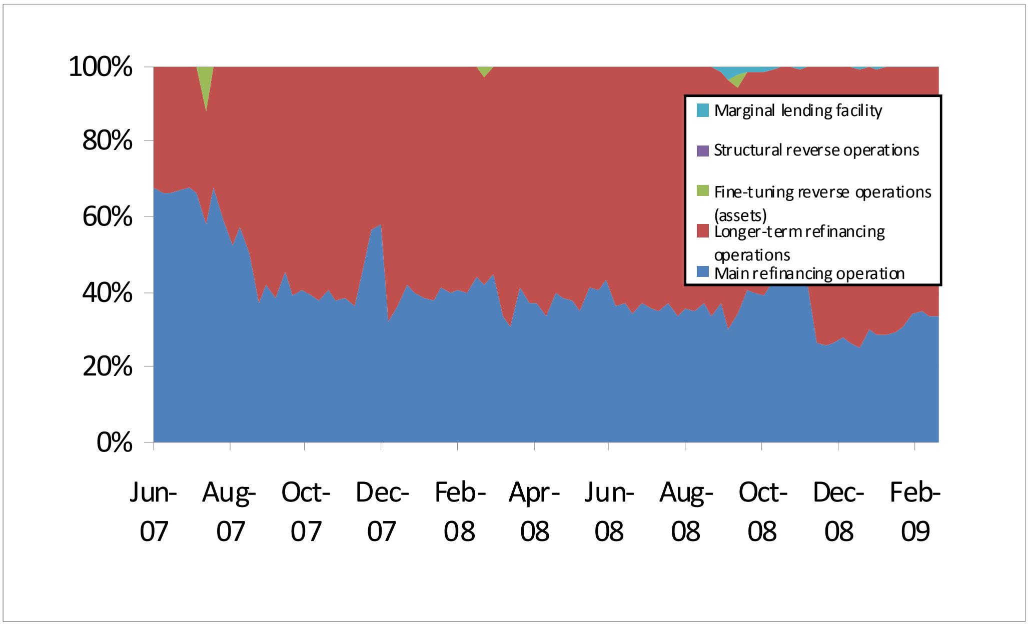

Figure 5: Lending operation to Euro area credit operation (06/2007 to 03/2009) (in %, weekly)
Source: ECB (2009)

The Eurosystem increased its longer-term refinancing operations while decreasing its shorter-term main refinancing operations resulting in a compositional change to this portion of the balance sheet. As a result we can observe in figure 5 that the portion of the more liquid main refinancing operations declined while the less liquid longer-term refinancing operations increased throughout the period. The Eurosystem also sold some of their high quality assets, though not to the extent of the Fed. Gold is a very liquid asset as it can be bought and sold in great quantities on the market even in times of crisis without strong increases in the bid-ask spread. The Eurosystem sold 42 tons of gold on November 30th 2007, followed by an additional 30 tons on June 30th 2008. Thus, the balance sheet policies of the Eurosystem deteriorated the average liquidity of the assets of the Eurosystem considerably during the first stage of the crisis until September 2008. These measures of increasing longer-term financing demonstrate the willingness of the Eurosystem to counter the tensions in the economic system with novel monetary policies.

In contrast to the Fed, the ECB did not change its strategy after the Lehman bankruptcy. In fact, it continued its extension of longer-term credit programs and liquidity provision through its balance sheet at a faster rate. From September 2008 the Eurosystem´s balance sheet expanded rapidly, making use of existing facilities while introducing regulatory changes that will be addressed shortly.

In sum, the evolutions of the balance sheets of the Eurosystem and the Fed during the crisis are quite different. Until September 2008 the Fed tried to assist the banking system by strong compositional changes to its balance sheet while the ECB pursued cautious quantitative easing while changing its composition moderately towards longer-term assets. From September 2008 the strategies of the Fed and the Eurosystem share the fact that both initiated more aggressive quantitative expansions. However, the Fed used new credit programs while the Eurosystem used existing ones, which were regarded as flexible enough to automatically absorb the lower quality collateral (Gray and Stella 2008). The composition of the respective balance sheets kept changing as the Fed increased its new positions and the Eurosystem increased the existing facilities most needed by the banking system. Finally, both central banks commenced periods of quantitative tightening from December 2008 to March 2009.

Regulatory measures affecting the balance sheet

Regulatory changes affected the quality of the assets of the respective central banks via changes in terms, collateral, counterparties and transparency. These changes are not reflected in the numbers of the balance sheets, nor in resultant balance sheet ratios. However, they indirectly affect the quality of the currencies. Even though a great deal of subjective interpretation is involved in these more qualitative changes, we do so by pointing out which monetary authority has deteriorated its position more severely.

1. Terms

Both central banks extended the maturity terms of existing credit programs. For instance on August 17th 2007 the Fed announced changes in its primary credit lending terms, extending the term of issued loans from overnight to up to 30 days. Moreover, concurrent with the measures to rescue Bear Stearns, effective March 16th the term of primary credit lending was again increased from 30 to 90 days.

As previously elaborated, the Eurosystem has made heavy use of existing facilities. It increased the 3-month refinancing operations and introduced for the first time a 6-month refinancing operation. Both are posted as the balance sheet positions "longer-term credit operations". The Eurosystem introduced two additional three-month longer-term refinancing operations of 50€ billion each and for the first time two six-month longer-term refinancing operations of 25€ billion each. Thereby, the trend towards longer-term assets on the Eurosystem balance sheet accelerated. The Eurosystem also introduced longer-term US-dollar funding. On October 13th 2008 the Eurosystem announced U.S. dollar funding at 7-day, 28-day and 84-day maturities at fixed interest rates for full allotment which meant that there was practically no limit on the amount of dollars to be used in swap lines. Thus, it seems that the Eurosystem, especially with the six-month facility, has increased the terms of their funding more than the Fed.

2. Collateral

Both central banks extended the range of accepted collateral in their credit operations. The Fed entered the crisis with more strict collateral rules, especially for its open market operations. In its repurchase agreements it accepted only Treasury securities, Federal agency debt, and mortgage backed securities *issued or fully guaranteed* by Federal agencies. Thus, at the beginning of the crisis the Fed was only accepting asset backed securities with a AAA rating or AAA rated Federal and Federal agency debts. To the contrary, the Eurosystem's rules on collateral were more flexible. Specifically, the rules allowed asset backed securities as collateral dependent on a case-by-case assessment of the haircut and a rating of at least "A -". Due to this flexibility, the Eurosystem in contrast to other central banks like the Federal Reserve did not have to introduce new facilities to allow for new types of collateral. The existing facilities of the Eurosystem were sufficient and flexible enough to satisfy the liquidity needs of troubled European financial institutions.

The Fed, due to its more strict collateral rules, had to institute new facilities in order to assist the banking system. For instance, on September 19th 2008 the Fed started the "Asset Backed Commercial Paper Money Market Mutual Fund Liquidity Facility" (AMLF). In this program "Asset Backed Commercial Papers" were accepted as collateral in order to sustain the liquidity of money market mutual funds. Hence, securities were accepted as collateral that were not traded anymore on the market or only traded at considerable discounts. On October 27th another credit program commenced, the "Commercial Paper Funding Facility" (CPFF), accepting unsecured commercial paper as collateral.

As the traditional collateral accepted by the Eurosystem was broader, the Eurosystem did not have to change its collateral rules. However, as the Eurosystem accepted lower quality collateral than other central banks, the danger for the Eurosystem was that during the financial crisis banks with international subsidiaries would use the relatively less strict rules and use their lower quality collateral to get financing from the Eurosystem.[88] As a result the Eurosystem announced a strengthening of it collateral rules on September 4th 2008, coming into effect on February 1st 2009. Thus, asset backed securities not denominated in Euros would be disallowed in order to prevent the shifting of lower quality assets on a world-wide scale by international banks to the Eurosystem. Moreover, the average haircut for asset backed securities was set at 12%. Finally the Eurosystem announced a penalty of an initial mark down of 5% for asset-backed securities and unsecured bank bonds valued according to a valuation model instead of by their posted market prices.

However, in contrast to these stated changes, after the deterioration of the financial markets in October 2008 the Eurosystem substantially increased the range of accepted collateral. On October 15th 2008 the list of assets eligible for credit operations was increased. For example, the Eurosystem started to accept as collateral

[88] Cochrane (2008) argues that asset-backed securities (ABS) were designed to receive financing from the Eurosystem.

in its credit operations marketable debt instruments denominated in currencies other than the Euro, namely the US dollar, the British pound and the Japanese yen, and issued in the Euro area coming into effect on November 14th provided that the issuer was established in the European Economic Area. An additional haircut of 8% was installed in order to compensate for currency risk.

Yet, the most drastic measure that the Eurosystem took, and which most strongly deteriorated the quality of the assets on the Eurosystem's balance sheet was as follows: The Eurosystem announced to lower the credit threshold for marketable and non-marketable assets from A- to BBB-, with the exception of asset-backed securities (ABS), and impose a haircut add-on of 5% on all assets rated BBB-. This move, which first came into effect on October 25th and was completed by November 14th 2008,[89] implied that all investment grade securities would be accepted as collateral in the credit operations of the Eurosystem. Moreover, the collateral framework was expanded further on November 17th by Euro-denominated syndicated credit claims.[90] Of course, the incentives for the banking system were to make liberal use of the less strict rules.

In sum, the Fed started from a sounder position because of its stricter rules concerning accepted collateral and term limits on loans. These stricter rules were broadened as the accepted collateral types were increased substantially. However, the Eurosystem´s acceptance of BBB- rated securities demonstrates that the Eurosystem continues to accept lower quality collateral than the Fed.

3. Counterparties

Both central banks increased the range of counterparties during the crisis. Thus, the Fed's term auction facility was installed with a broader range of counterparties than open market operations. Moreover, the primary credit dealer facility (PCDF) was installed. This facility enabled primary dealers to directly use the discount window. This was the first time that the Fed lent directly to investment banks. Finally, the "Money Market Investor Funding Facility" was established in order to provide increased liquidity to the money markets. This allowed money market mutual funds to receive indirect funding from the Fed.

The ECB had a broad range of counterparties both for the standing facility and open market operations, i.e., all banks holding minimum reserves with the relevant national central bank. Thus, counterparties were relatively more broadly defined than with the Fed. On October 3rd 2008, the ECB increased eligible counterparties for fine-tuning operations as all institutions eligible for open market operations based on standard tender were also made eligible for quick tender, the standard procedure for fine-tuning operations.

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[89] See REGULATION (EC) No 1053/2008 OF THE EUROPEAN CENTRAL BANK of 23 October 2008 on temporary changes to the rules relating to eligibility of collateral (Eurosystem/2008/11).

[90] This extension was subsequently suspended on November 26th 2008.

It is interesting to note that both central banks have each other as counterparties as they have entered into currency swap agreements and that both have assumed additional currency risk through these programs. In a common effort central banks around the world tried to improve dollar liquidity and instituted swap lines with the Federal Reserve. The average quality of the Eurosystem´s assets deteriorated further by the introduction of swap lines with central banks whose currencies were depreciating such as the Hungarian and Polish Central Banks. The Eurosystem also established a swap line with the Danish central bank exposing it to further currency risks.

In sum, the Eurosystem had a broader range of eligible counterparties prior to the crisis. During the crisis both central banks increased their eligible counterparties to similar extents. In absolute terms, the Eurosystem continues to accept a broader range of counterparties for its monetary policies.

4. Transparency

Both central banks lack transparency in their balance sheet positions and policies. The lack of transparency of current policies increases the uncertainty concerning the quality of the assets backing the currency and contradicts a basic principle of accountability.[91] Thus, one characteristic of the Fed's term auction facility (TAF) is its low transparency, which negatively affects the perceived quality of these credits. In fact, the exact quality of the accepted collateral remains unclear and names of borrowers have, to date, still not been released. The TAF has, consequently, led to complaints about the insufficient transparency of Fed policies.[92] Other new programs by the Fed are faced with similar problems. However, the Fed makes allowance for a minimal level of transparency, by posting new positions on the balance sheet.

In contrast, the ECB does not install new positions on its balance sheet, creating more problematic transparency issues than its American counterpart. Instead of posting new clear-cut credit programs, the ECB makes use of existing positions to extend their credit operations without separating new positions from old, thus exasperating the issue. Moreover, during the current crisis, the Eurosystem's positions of "other assets" and "securities" increased. The position "securities" entails marketable securities, which may potentially be used for monetary policy operations and entails a very broad range of securities of very different and potentially weak qualities. Likewise, the position "other assets" fails to provide more transparency. According to the ECB glossary it incorporates items used in the course of settlement, member State coins and other financial assets like equity shares,

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[91] Hayek (1925) criticized the accounting practices of the Fed regarding their transparency as early as 1924. Rothbard (2000) advances a similar critique in regard to the accounting practices during the Hoover administration. Recently, Dincer and Eichengreen (2009) argue that central bank transparency has increased substantially during the past decade, becoming the "greatest change in the conduct of monetary policy."

[92] See Pittman, Ivry and Fitzgerald (2008) and Pittman (2008) for a look at issues surrounding the nontransparency of current Fed policies.

participating interests, investment portfolios related to the central bank's own funds, pension funds and severance schemes or securities held due to statutory requirements. The position also contains tangible and intangible fixed assets, revaluation differences of off-balance-sheet instruments as well as accruals and deferred expenditures. Thus, these two positions lack transparency and *may* contain relatively low quality assets. In sum, the transparency of the Eurosystem´s balance sheet is lower than the Fed`s. This weighs negatively on the quality of the Euro in comparison with the dollar as the balance sheet entails the possibility of substantial unknown quality risks.

Comparison of balance sheet ratios

The changes in the balance sheet can also be analyzed calculating certain central bank balance sheet ratios as developed by Bagus and Schiml (2008). These ratios concentrate on important characteristics of the balance sheet and can, consequently, aid with the analysis. One of these ratios is the "defense ratio." This ratio portrays the capacity of a central bank to defend its own currency in the international currency markets by selling foreign reserves. It is calculated by dividing the amount of foreign reserves by the balance sheet total. In calculating this ratio for the Fed and the Eurosystem we did not count foreign currency swaps or gold as foreign reserves. The evolution of the defense ratio is depicted in figure 6:

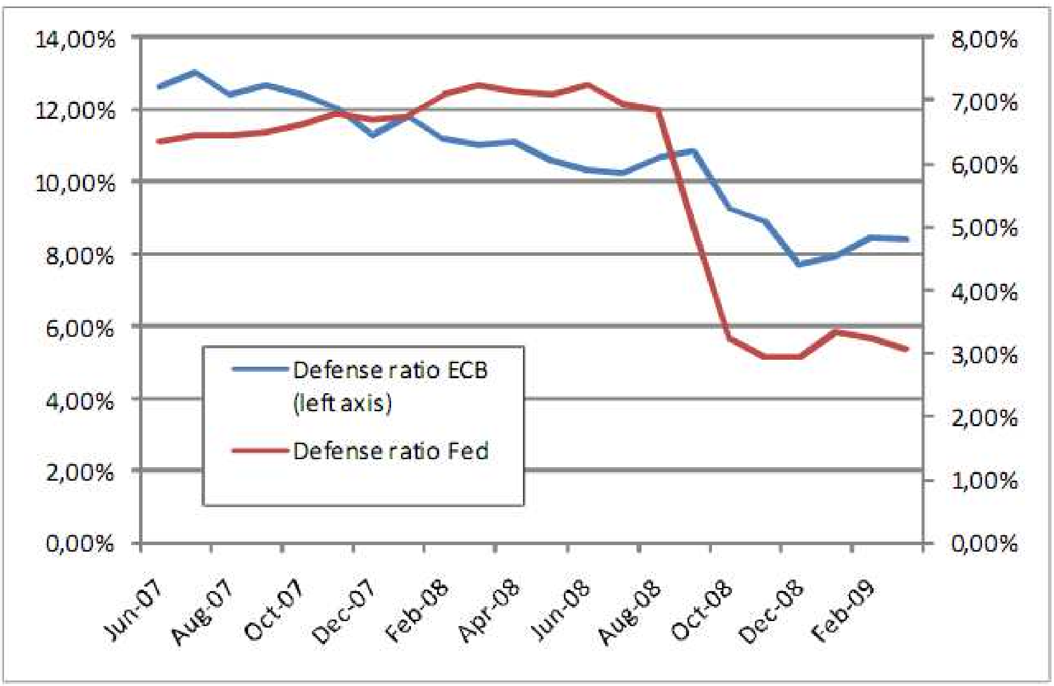

Figure 6: The defense ratios of the Eurosystem and the Fed (06/2007 to 03/2009)
Source: Fed (2009) and ECB (2009)

Both defense ratios declined during the crisis, however, he ECB started and ended at a better level implying a greater amount of foreign reserves available to inject into the monetary system during times of need.[93]

One important group of central bank balance sheet ratios are liquidity ratios that indicate the portion of liquid assets on the balance sheet in comparison to the total assets of a central bank. We define here the liquidity ratio as the sum of gold and foreign reserves in relation to the balance sheet total. The rationale for liquidity ratios is to show how high the portion of high quality assets is in relation to the whole of the balance sheet. These high quality assets tend to retain liquidity in times of crisis and can be used to maintain the value of the currency. For instance, gold is very liquid even in times of panic and historically increases in value during periods of increased uncertainty. Most foreign reserves also tend to be highly liquid assets. The development of the liquidity ratios are depicted in the following figure 7:

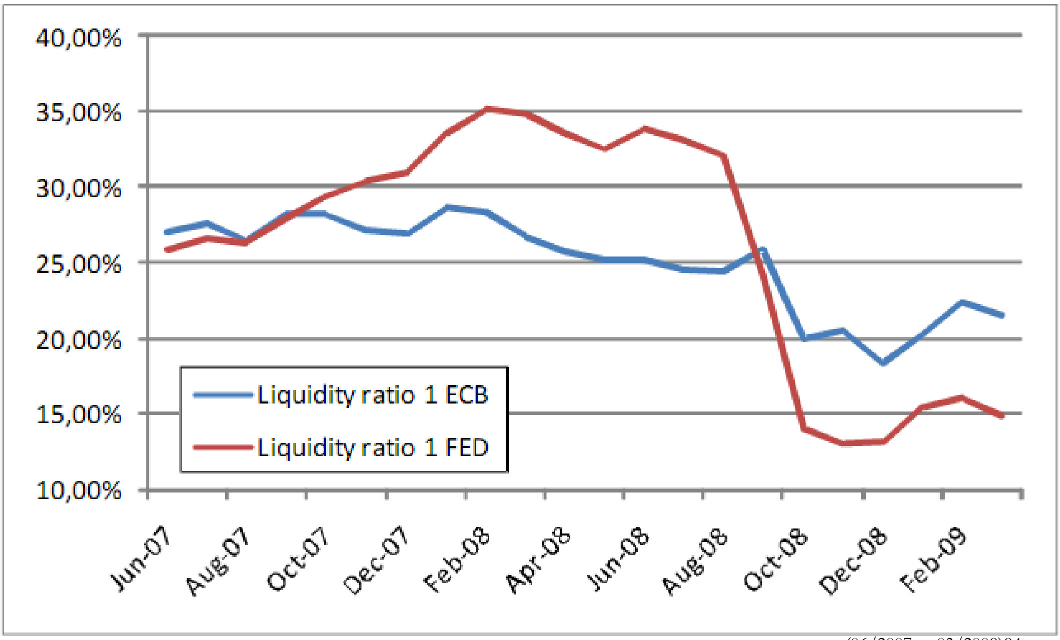

Figure 7: The liquidity ratios of the Eurosystem and the Fed (06/2007 to 03/2009)[94]
Source: Fed (2009) and ECB (2009)

[93] These foreign reserves also become important in providing liquidity for financial entities with foreign-denominated debt. Iceland's recent financial crisis was exacerbated due to a lack of a central bank capable of functioning as a lender of last resort in the foreign exchange which dominated the banking system's liabilities (see Bagus and Howden 2009).

[94] Both gold positions are valued at market. The Fed typically vlaues its gold position at $42.22 an ounce and not at the market price, as does the ECB.

As these liquidity ratios demonstrate, the Eurosystem performs somewhat better than the Fed. The portion of the most liquid assets of the balance sheet total remains higher with the ECB throughout the end of 2009Q1.

A last important ratio is the equity ratio which indicates the leverage of a central bank. Its importance lies in the function of equity to cushion losses. When the central bank suffers losses on their assets, equity can be utilized to absorb and offset the impact. A low or negative equity ratio makes a recapitalization by the government likely. This recapitalization would lead to an increase in the government deficit and enhances the probability of the monetization of this debt. The monetization of government debts increases the quantity of money and, thereby, negatively affects the quality of money.

Figure 8: Equity ratio of the Fed and the Eurosystem (6/2007-03/2009)
Source: ECB (2009), Fed (2009)

Both equity ratios deteriorated during the crisis and are currently very low. If the Eurosystem and the Fed suffer losses of only 4 or 2 percent of their respective assets, a recapitalization will become necessary.[95] Yet, both balance sheets contain (in some cases hidden) reserves that can cushion or increase the equity ratio. Thus, the balance sheet of the Eurosystem includes a revaluation account that contains unrealized gains related to price changes on foreign exchange rate movements. The Fed values its gold reserves at $42.44 per troy ounce implying considerable hidden reserves. If we adjust the equity ratio of the ECB with the revaluation accounts and the Fed's equity ratio to account for the hidden gold reserves at current market prices, we get a more realistic and comparable picture as depicted in figure 9.

[95] On the possibility of insolvency of central banks see Fry (1992) and Buiter (2008).

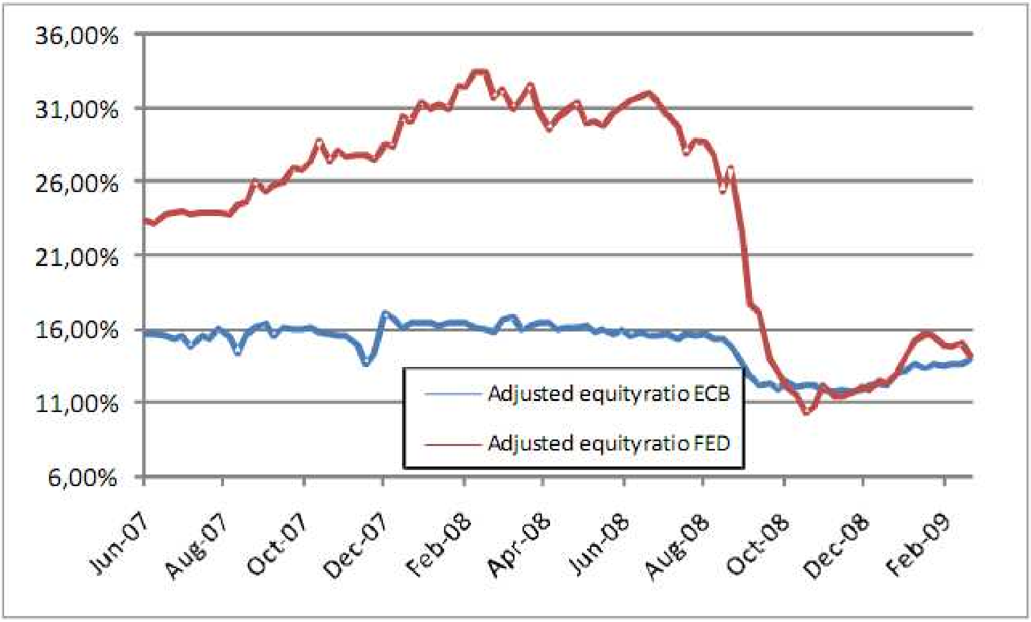

Figure 9: Adjusted equity ratio of the Fed and the Eurosystem (6/2007-03/2009)
Source: ECB (2009), Fed (2009)

Additionally, the balance sheet of the Eurosystem includes a revaluation account that contains unrealized gains related to asset price and foreign exchange rate movements. These gains can be due to the increase in the value of the gold reserves. In fact, the increase of the value of the gold reserve during the observed period was higher (78€ billion) than the amount of the Eurosystem´s capital itself (72€ billion). In other words, if the price of gold fell back to its pre-crisis level, an amount higher than the actual capital of the Eurosystem would be erased. The reserves hidden in the revaluation accounts would enhance the equity ratio if included in the capital position. The adjusted equity ratio as depicted in figure 9 would then be approximately 13%, indicating a much higher quality of the Euro than appears at first sight (i.e., approximately 4% as shown in figure 8).

As we can see, the Fed started from a better position than the ECB and maintained or increased its advantage until September 2008. The expansion of the Fed´s balance sheet in the last quarter of 2008 equilibrated the equity ratios of the Fed and the Eurosystem. Yet, there is still a very important advantage of the Fed's position in comparison with the ECB's. The Eurosystem faces a serious political problem when it comes to recapitalization. There is a sharing rule among the 16 national central banks (that, together with the ECB, make up the Eurosystem) concerning the sharing of losses incurred in the conduct of the common monetary and liquidity management policy. Yet, this sharing rule affects only the distribution and not the total amount of capital in the Eurosystem. In contrast to the Fed, where the Treasury ultimate provides backing, it is not clear how the Eurosystem would be capitalized if the need arises. This process would pose a political problem and the success of this endeavor is not ensured, implying severe problems for the Euro's long-term existence if the current situation persists. Therefore, the development of the equity ratio is problematic in relation to the value and the trust in the Euro.

Conclusion

Recent developments in monetary policy make the qualitative analysis of central banks' balance sheets important. New analytical tools are necessary for the evaluation of these policies, which have moved beyond the more conventional quantitative measures of the past. One such tool is the comparative balance sheet analysis such as is undertaken in this article. While the Fed`s balance sheet analysis has attained more attention, an analysis of the Eurosystem's positions has been neglected.[96] Our comparative analysis of the balance sheets of the Fed and Eurosystem from the beginning of the crisis in June 2007 to March 2009 has filled this gap and provided important insights pertaining to the quality of the respective currencies. While the Fed´s balance sheet policies certainly have been radical, the Eurosystem´s changes are no less so, even though they may appear so at first sight if concentration is focused solely on the quantitative expansion of the balance sheet. The changes in the balance sheet policies of the Eurosystem are more subtle by maintaining the established programs and softening collateral rules.

The Fed tried during the first stage of the crisis to stem a liquidity crunch with strong compositional changes only, while the ECB increased its balance sheet size and moderately changed its composition. In September 2008 both central banks started to expand their balance sheets while the Fed did so at a substantially faster rate.

These developments are also reflected in the observed balance sheet ratios. The defense, liquidity and equity ratios have declined for both central banks, especially during the second stage of the crisis. The Fed performs slightly better at the equity ratio, while the Eurosystem has a more advantageous position with the liquidity and the defense ratios. Hence, the Eurosystem has relatively more foreign exchange reserves to defend its currency and relatively more liquid assets available than the Fed. However, the Eurosystem has relatively less equity to cushion possible losses.

By only focusing on quantitative issues it appears as though the ECB has emerged marginally better throughout the crisis than its American counterpart. However, when it comes to the non-numerical regulatory questions, such as terms, collateral, counterparties and transparency, the Eurosystem´s balance sheet looks to be in much poorer shape than the Fed´s. In particular two issues weigh on the Eurosystem's balance sheet quality. First is the broadening of the accepted range of collateral (except for asset backed securities) in credit operations from A- to BBB-. Second, the problem of recapitalization can be much easier solved by the Fed than

[96] One notable exception may be found in Bagus and Howden (2009b).

by the ECB. These two issues took on increased importance after September 2008 when accepted collateral was broadened and the balance sheet expansion drove down the equity ratio accordingly. In fact, the stylized facts in our article suggest that during the first stage until September 2008 the Fed´s balance sheet deteriorated more than the ECB´s due to its massive compositional changes, while it was the other way around after the collapse of Lehman Brothers.

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CHALENGES FACED BY EU SMEs IN THE CONTEXT OF THE GLOBAL ECONOMIC CRISIS

*Sorin Visinescu and Dan Micuda**

Abstract

SMEs play a vital role in economic development. They offer the most economical use of capital in relation to job creation and provide the strongest growth channel for regional development. They are also recognized as the vehicle for growth in today's regionally and globally interdependent and competitive economy.

With a view at the global economic slowdown, it became apparent that economies in all regions of the world have significantly lost momentum which also affected SMEs.

This paper present the main difficulties faced by SME in the EU region on the context of the present global crisis and deliver some recommendation about the reaction governments should take in order to avoid a major crisis in this important economic sector.

Keywords: SME, financing, economic recession, bankruptcy,

JEL Classification: M21, E44, G01

Introduction

The national responses and other publicly available information provide some indications about the effective and expected movements in levels of sales of SMEs. SMEs in most countries report a clear demand downturn, if not a demand slump, in Q4-2008 and Q1-2009 and expect a further worsening to come. The magnitude of the reported shock is severe, but it differs from country to country, in part due to the differences in methods of assessment in each country.

Evidence suggests that the experienced and expected fall in sales is having a strong impact on SMEs. This is further supported by two additional stress indicators:

(a) increased payment delays on receivables which add –together with an increase in inventories - to an endemic shortage of SMEs' working capital and a decrease in liquidity

(b) an increase in reported defaults, insolvencies, and bankruptcies.

The economic indicators of the SME crisis

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Extended payment delays on receivables, especially in times of reduced sales, rapidly leads to a depletion of working capital and may entail frequent liquidity or even insolvency problems. Governments are aware that if SMEs cannot quickly obtain additional funding this will lead to insolvencies.

According to "Insolvencies in Europe 2008/09" (Creditreform), the total number of insolvencies increased by 11 percent between 2007 and 2008. In some countries like Denmark, Italy, Ireland, Norway, and Spain the surge in corporate insolvencies was higher than 25 percent when in other countries it remained stable between 2007 and 2008. These trends have to be interpreted with great caution because legislation on insolvency and bankruptcies differs greatly by country, and so do statistical reporting methodologies – which means that the figures may not capture short-term changes. In order to have a proper reading of such figures, they should be put in longer-term perspective.

The response of the surviving SMEs to the double pressure of falling sales and extended payment delays in a general context of bleak medium-terms perspectives is - in theory - three fold:

(a) cost-cutting to restore profitability and adjustment of production to lower demand levels, measures that materialize mainly in a reduced wage bill;

(b) search for additional sources of liquidity (extending own payment delays, reducing or suppressing dividends - if any);

(c) postponing of investment and expansion plans, when possible (including M&A activity for the small subset of high- growth SMEs). In case of entrepreneurship, this could simply mean the postponement or even the cancellation of new business ventures.

Among the possible SME responses to the demand shock for goods and services, cost-cutting and lay-offs and the subsequent labor market impacts are some options.

SME and credit availability in the new context

In October and November 2008 extensive surveys have been undertaken as well in industrialized and in less developed Countries on the impact of the financial crisis on credit policy by lending banks and the wider impact on the near future of SME business, exports, investments and development.

As a general result of such surveys approximately one third of the SME entrepreneurs briefed, stated that they are currently experiencing a tightening of credit policy by their banks (extreme restrictions have been decided e.g. in Iceland and in Central and East European Countries) and two third expect that in the short and medium term it will be more difficult to obtain credit – at least at economically acceptable conditions – for their business.

The assessment of credit demand is difficult from the methodological point of view. Some countries use the Bank Lending Survey (BLS) method to capture changes in demand as perceived by bank officials. These responses are weighted according to the relevant bank's market share and presented as a balance of opinions: the weighted percentage that sees an increase in demand minus the weighted percentage that see a decrease in demand. The evidence from countries applying this methodology clearly shows:

(a) the overall slump in credit demand is being experienced in all countries but one in Q4-2008 and is expected to last in Q1-2009 even if its severity varies from country to country;

(b) in all countries the reduction of credit demand for investment or acquisition purposes is extremely severe (50% or more of respondents);

(c) SMEs' demand for credit in Italy, and to a lesser extent Germany, did not change so dramatically when compared to their French, British and US counterparts.

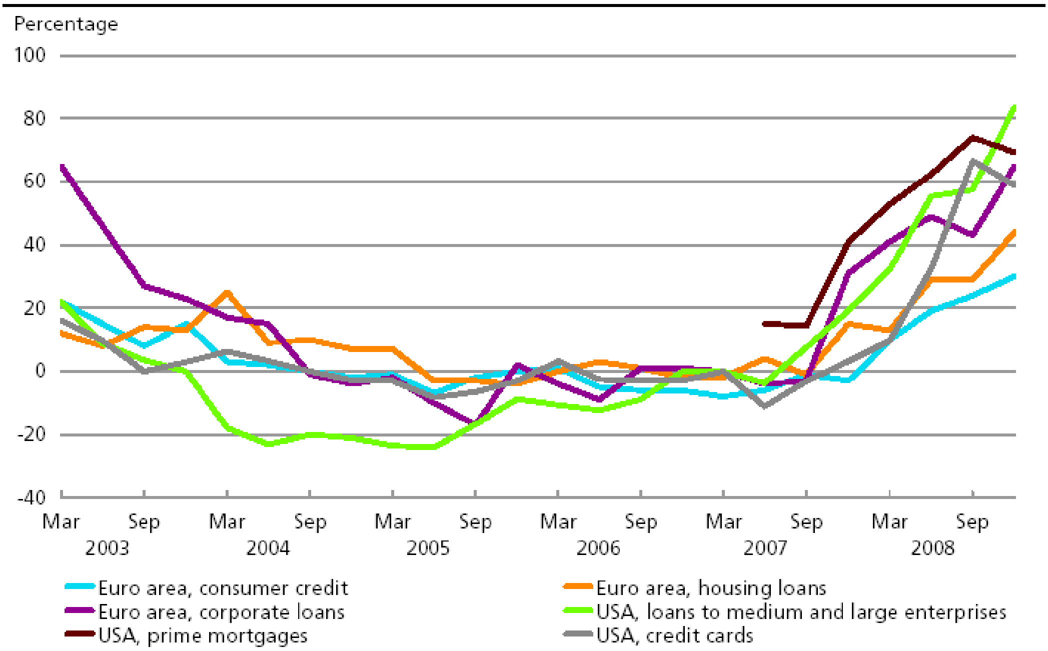
In countries either not using or not publishing BLS results, the evidence provided refers to the many SMEs that feel frustrated in accessing credit and not to changes in the level of demand as such: in the Netherlands, one out of five SMEs was looking for additional funding in 2008. In contrast, in Finland less than 10 percent of SMEs were facing major difficulties in obtaining working capital or investment funding.

The overall SME reactions that emerge from the available information suggest that entrepreneurs are not willing to increase their indebtedness despite the fact that sales fall and payment delays increase. Facing an uncertain future, this reaction is fully rational especially when these enterprises are confronted with tightened credit conditions imposed by banks and other creditors.

Loan conditions encompass many dimensions among which the most important are the spread between the banks and other financial intermediaries' cost of funds and interests levels, the commissions, the difference between the amounts granted and those demanded by the enterprises, the level of collateral required, the duration of the loans, and processing delays.

Figure 1 shows changes in banks' lending conditions derived from the BLS methodology for both the euro area and the US. It reveals that except for euro area lending to corporations, the present tightening in bank loan conditions does not have any recent precedent.

Figure 1: Banks with tighter lending conditions



Note: Calculations based on Senior Loan Officer Opinion Survey on Bank Lending Practices from the Federal Reserve System and the Euro Area Bank Lending Survey from the ECB. In these surveys, a number of high-ranking employees within the banks respond, on a quarterly basis, to a number of recurrent questions about the credit standards of their banks. The index is calculated as the percentage stating that they have tightened conditions.

Source: EcoWi n, in "Danmarks National Bank", Monetary Review, 4th Quarter 2008.

Indications from all countries converge and show a general tightening of credit conditions. Reductions in credit actually granted as compared to previous periods are visible for Denmark, the Czech Republic, and Belgium.

The above mentioned evidence suggests that:

(1) SMEs (and enterprises in general) have strongly reduced their investment projects financed by credit;

(2) SMEs demand for working capital and short-term loans has been reduced in some countries but not as dramatically as for investment purposes;

(3) banks have tightened their lending policies in terms of guarantees and amounts, but not exclusively towards SMEs;

(4) in some countries banks and other financial intermediaries have substantially increased the cost (and spread) of credit to all their clients, which may appear paradoxical in a situation of a general fall in interest rates.

In consequence, this evidence suggests that in addition to the demand shock described above, conditions under which SMEs can access credit have significantly worsened in some reporting countries. If this is true, then the enterprises in general and SMEs in particular are, de facto, exposed to two different shocks reinforcing each other: a demand slump or downturn and a financial shock due to banks and other financial intermediaries' reluctance to lend.

Three factors may have exacerbated the banks and other financial intermediaries' attitude towards lending to SMEs:

(a) poor SME economic prospects

(b) the stagnation in inter-bank lending and the increased cost of capital and

(c) balance sheet constraints.

In all EU countries, banks and other financial intermediaries are under pressure and are trying to preserve or strengthen their capital base. As part of this strategy they are seeking fully collateralized transactions that minimize the use of their economic (as opposed to regulatory) capital. In consequence, by choosing to keep only the strongest among their existing clients, banks and other financial intermediaries are contributing to a polarization process. In some countries, banks have reduced lending not just because risk has gone up, but also because they are having difficulty raising funds overseas and are directly affected by the substantially reduced access to short term inter-bank funding at other than very expensive rates resulting from a significant deterioration in banks' confidence in the banking sector's general level of solvency and credit rating.

The stagnation in lending is true even of banks in countries where governments have deliberately strengthened banks' balance sheets to allow them to grant additional credit to SMEs and/or where credit guarantee schemes exist. Most countries have not only recapitalized their banks but also extended the funds and guarantees available for SME financing. But the effects of the incentives to lend to SMEs put in place by governments in some countries (such as the provision of additional capital) have not yet yielded the desired results.

Some governments are closely monitoring this situation or have put in place "credit mediators" to ease the flow of credit to SMEs.

Alternative sources of financing

Confronted with worsening access to credit, SMEs are exploring alternative sources of finance such as mobilization of reserves and self-financing; self-financing and factoring. Although private equity and venture capital markets have not contributed to the global financial crisis, the extent of the impact the crisis has and will have on entrepreneurs, entrepreneurial firms and SMEs access to equity financing around the world remains unknown.

In terms of venture capital and private equity, the information provided is largely anecdotal and for many countries there are no official statistical data available covering 2008. However, new anecdotal information indicates that entrepreneurs, entrepreneurial firms and SMEs find it increasingly difficult to access financing for new projects.

The financial crisis has had a three - fold impact on venture capital and private equity markets:

1. exit opportunities are reduced.
2. fundraising activities seem to be shrinking.
3. invested capital has stagnated or even slowly started to decline, especially investments in new projects.

It is expected that invested capital will see further declines in the coming period.

The global fundraising activity has also slowed down between 2007-2008. The current economic situation and the global downward pressure on prices are expected to influence the future prospects for fundraising in the markets in the long run. Institutional investors providing funding will simply be less willing to supply new funds with fresh capital. As a result, the number of new venture capital funds could be lower than expected before the crisis.

If the private venture capital and private equity funds do not raise sufficient capital, they will have to reduce the number of investment managers. For many markets this will mean a significant setback in investment and have a negative impact on the development of investment expertise in the markets, and thus make it even harder for entrepreneurial firms and SMEs to survive and grow – in the longer run as well.

Under the influence of these trends, public funds (both direct and indirect investment funds) will be impacted as much as the private funds, if not more. In markets with public or semi - public investment funds, which provide capital to funds-of-funds activities, such public funds are likely to witness a more limited possibility for co-investment with private funds, simply because the private funds increasingly reduce their investment activities. As a result, public funds cannot be expected to provide the same leverage effect as before the crisis, unless supplied with more capital.

Policy responses of governments

Countries' abilities to deal with the crisis depend to a large extent on the margin provided by their respective fiscal and monetary policies. Many of the reporting countries have recently put in place anti-crisis packages combining in different proportions three lines of action: *stimulation of demand* (consumption packages, infrastructure programmes, tax policies); *credit enhancement* measures, including *recapitalization of banks* which, in some cases, include explicit provisions or mechanisms to preserve or enhance banks' capacity for financing SMEs such as public credit guarantees; and *labor-market measures* (reduced employment taxes or social security charges and extended temporary unemployment programs).

The anti-crisis packages and accompanying measures address, in many countries, more specifically the financing problem of SMEs. The measures put in place by countries can be classified in three different groups depending on the aspect of the

SME financing problem to which they are geared. Three main groups of measures can be distinguished:

(a) measures supporting sales, cash flows, and working capital;

(b) measures to enhance SMEs access to liquidity, mainly to bank lending;

(c) measures aimed at helping SMEs to maintain their investment level and more generally their capacity to respond in the near future to a possible surge in demand.

Despite the fact that in many of the responses, some of the largest banks have been recapitalized with public funds, the evidence from the economy suggest that banks have significantly tightened their credit policy. In order to alleviate the effects on SMEs of the twin shock of falling sales and more difficult access to funding, governments are using two different approaches to increase availability of credit:

(a) on the incentive side, the creation and extension of guarantee schemes for loans to SMEs, or direct public lending;

(b) on the discipline or sanction side, providing banks that have been recapitalised by public monies with specific targets concerning SMEs lending, putting them under administrative monitoring or putting in place specific procedures to solve problems between individual SMEs and banks.

Incentives: the loan guarantee schemes

Extension, diversification of public guarantee schemes or, in some cases, even direct lending by public institutions, are among measures being widely used by reporting countries. These policy measures aim at dealing with one of the key reasons that may explain banks reluctance to lend to SMEs that is, their constraint in terms of their capital requirements. Public guarantee schemes for SME credit are expected to be an incentive for bank lending to this segment of clients. For European Union member countries, the potential leverage effect of public guarantees on SME bank lending has been further extended by the decision of the European Commission to temporarily authorize Member States to ease access to finance for companies through subsidized guarantees and loan subsidies for investments. Almost all EU countries have enhanced, or put in place, a credit guarantee scheme either focused on SMEs or a general one.

In some countries, the governments have found the response of the newly recapitalized banks to the needs of SMEs unsatisfactory or insufficient. These countries have resorted to discipline measures that in some cases complement the incentives, in order to pressure banks to continue lending to enterprises. Belgium and France have appointed a credit mediator, who at regional and central levels, may intervene to soften and help solve divergences between enterprises that are seeking bank funding and banks.

Strengthening pro investment measures

In the context of bleak medium-term prospects amid falling sales, many SMEs have reduced or withheld their investment plans. In consequence, their demand for long term lending has significantly fallen. In order to prevent SMEs from losing their competitive edge in the medium term, and help them to remain ready for the upturn, some governments have put into place measures to strengthen their capital base or to develop their productive capacities, or both. These measures are mostly provision of specific funding possibilities such as grants (Germany) or credit (Austria, Czech Republic, Germany, Hungary, Spain). On the top of this, the existence of Structural Funds within the European Union gives to new-member countries a margin of manoeuvre to support SMEs investment projects in specific technologies, sectors or regions (Romania and the Czech Republic).

Strengthening the capital base, private equity and venture capital

Most of the measures described in this paper are very recent and thus have not been evaluated, in consequence it is impossible to identify best practices. This being said, extension of existing credit guarantee schemes is the most widely adopted measure. It has to be stressed that these measures help SMEs by solving their immediate liquidity problem, but if the macroeconomic situation continues to worsen, they may only postpone an insolvency problem. In some countries, measures aimed at solving the long-term problem of insufficient own capital base are being taken. They address the issue either by helping enterprises to strengthen their cash-flow and self-financing or by putting in place additional sources of equity capital.

Table 1: Policy responses in EU countries

	A. Measures supporting sales, cashflows and working capital (Annex 5)				B. Enhancing SME access to liquidity, especially to bank lending (Annex 6)		C. Strengthen-ing pro-investment measures (Annex 6)	D. Strengthen-ing capital base and private equity and venture capital (Annex
	Export facilitation	Alleviating working capital shortage in the	Easing tax payments	Easing procure-ment payment procedures	Creation and extension of loan & guarantee schemes	Mediation and monitoring		
Austria	•				•		•	•
Belgium			•		•	**Mediator**		

Czech Republic	•				•		•	
Denmark	•		•					•
Finland					•			•
France		•	•	•	•	**Mediator**	•	
Germany	•				•		•	
Greece					•			
Hungary					•		•	•
Italy	•	•	•		•	**Monitoring**	•	
Luxembourg	•				•			
Netherlands	•	•	•	•	•			
Spain	•				•		•	
UK				•	•			•
Estonia					•			
Romania					•			
Slovenia	•				•			•

Source: OECD survey Nov.2008

Conclusion

Clearly, SMEs experience additional difficulties today in achieving adequate levels of liquidity, but it is still unclear to what extent they are willing to borrow, on what terms and to what extent they are credit constrained. Indeed, increased borrowing today may result – in case of prolonged poor sales - in over indebtedness tomorrow. In such a situation the current liquidity problem would be transformed in the medium-term into an insolvency one.

Obviously, the banks' attitude towards lending is an important component of the issues addressed in this paper. Compelled to revise their business models and lines of activities, most banks are constrained by their poor capital base and sensitive to the fact that investors are putting a premium on the shares of financial institutions that are better capitalized.

In the new situation, some governments have had insufficient time and, in most cases, insufficient information, to base their interventions and measures on a solid diagnosis of the problems that SMEs – in their extreme heterogeneity of size, form and mode of operation – are facing. This being said, other governments, regardless of the incomplete evidence gathered on SMEs' financial difficulties, felt that the extraordinary circumstances required tailored responses, and they have adopted a number of measures to ease SMEs' financing conditions.

The most widely used measure has been until now the extension of loans and loan guarantees. These measures are also very heterogeneous in their modalities, in their cost and also target groups. Time is too short to draw conclusions about what are the "best practices" in the field of emergency measures and in the field of loan guarantees.

In terms of venture capital and private equity markets, worsened exit opportunities and declining fundraising activities are slowly resulting in lower investment levels. It is expected that investment levels – in particular new investment – will decline further in the coming period. In terms of policy interventions on the venture capital markets, it is uncertain whether the newly introduced policy instruments have been designed following the crisis or planned prior to crisis and since adapted to the new situation.

From the analysis of the data on the situation of SMEs and entrepreneurs regarding access to finance and the accompanying policy responses we consider the following recommendations:

Improving cash flow

- Governments could consider improving SME cash flow and working capital through such measures as accelerated depreciation, tax measures, factoring for receivables and improved methods for reducing payment delays. For example, some governments have cut their payment delays to ten days.
- While SME liquidity can be increased through lending and fiscal measures, ultimately it is the revival of demand that will sustain SMEs. Therefore, Governments could design their stimulus packages to ensure that they will have more direct and timely impacts on SMEs.
- Public procurement should be considered more systematically as a demand-side instrument to support R&D and production of innovative goods and services by contracting out to SMEs (in particular in the environmental, energy and IT areas).

Facilitating access to credit

- While guarantee programmes are a commonly used measure by governments, there appears to be a problem in their uptake by banks. Governments could consider making their guarantee programmes more attractive through more appropriate risk-sharing with private lenders.
- To ease the access to bank lending, particularly for SMEs, Governments could keep under review the role of credit mediators and monitoring and adopt such mechanisms if appropriate. Any revisions in Basel 2 should also be reviewed for

their impacts on SME lending

Fostering investment

• Due to worsened exit markets and declining fundraising activities, Governments could consider policy instruments aimed at improving exit markets and enhancing the supply of venture capital.

• Public equity funds can operate so as to help catalyze and leverage the provision of private risk capital. Governments and international organizations could establish or increase public equity funds to leverage private risk capital to prevent the complete collapse of new venture capital and its consequences for start-ups and innovative SMEs.

Promoting business services and SME engagement in the design of relevant policies

• To help SMEs confront the current financial and economic crises, Governments could improve their provision of information on SME-related government measures to business service providers or business associations. They could also facilitate the provision of business services to SMEs to assist them in their negotiations with banks and other financial intermediaries and in resolving their cash flow problems.

• In times of crisis, the managerial competencies of SMEs – especially in the field of finance –have to be supported. In order to improve the level of financial knowledge of SMEs, Governments could support, in the short-term, business development services and training programmes.

• SMEs should be engaged in the design of relevant policies from the outset, to ensure that their perspectives and needs are well understood and taken into account. Governments could communicate and consult regularly with the representatives of SMEs to assess both the extent of the impact of the crisis and the effectiveness of existing measures and programmes in helping SMEs survive.

Promoting the availability and diffusion of timely information

• There is a need for more timely and SME specific data on financing. The bank lending survey methodology appears as a possible best practice, especially if it could be extended to cover all other financing sources available to SMEs. Governments could also consider improving transparency in bank lending by encouraging the timely public disclosure by banks of the composition of their loan portfolios by size of firm.

• In order to be in a position to better distinguish – in times of crisis as today - what problems are extra-ordinary (i.e. linked to the present crisis) and, in consequence, could possibly be addressed by extra-ordinary measures, and what are the *usual* ones to be left to *"usual"* measures, Governments could put in place a policy oriented "SME Financing SCOREBOARD" based on different observation methods so as to obtain a comprehensive real-time picture that would also capture early warning signals. In order to support and nourish the "SME Financing Scoreboard", Governments could develop a set of sophisticated observation methods such as SME panels and cohorts.

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THE ECONOMIC CRISIS AND PROTECTIONISM

Florica Ştefănescu[*]

Abstract

It is altogether accepted that the economic crises are a reality which the local economies or the world economy face periodically. This doesn't mean that they manifest themselves through identical forms or that there are all-around valid crisis combat solutions or at least ways of alleviating its effects. On the contrary, every crisis has its own feature induced by the social-economical context in which it takes place, by the triggering factor, by those who establish anti-crisis measures and even by those who theorize it. Sure, there are common elements of the crises that permit the definition of the phenomenon, the analysis and the overcoming by appropriate methods but not their prevention.

This study is set out to analyze the relationship between the economic crisis and the resort to protectionist measures to overcome the crisis, underlining also the alternative measures with the same end. I have also performed a case study regarding the way the economic crisis is being understood by the economic agents from Bihor County. To this end I performed a qualitative research using the semi-structured interview as a main method.

Keywords: crisis, protectionism, economy, manifestations, solutions, case study

JEL Classification: E32, N10, P16

Introduction

Is protectionism a cape for bad weather? In other words, have there been activated protectionist measures, mainly state-controlled, only for the crisis period when the economies are being challenged? Can we talk about a circle of vice between the crisis and the protectionism relationship in the sense that crisis generates protectionism and the latter, even if solving some short term issues like the social ones, doesn't accomplish anything but increasing the effects of the crisis on long term? Which are the alternative solutions to protectionism during a crisis?

These and many others like these are the questions to which economists from different times and of different doctrine orientations have tried to find an answer for overcoming more easily the economic crises, for mitigating their impacts and even for proposing patterns for overcoming the crisis.

But what is protectionism?

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Protectionism, a national reaction to the classic liberalism

Protectionism is an economic doctrine derived from the political awakening of nationalism in less industrialized countries, which promotes the idea of the state's intervention in the economical life for protecting the interests of the economic agents against the free change inside or outside the country, they, at their turn, contributing financially to the support of the state's expenditures.

Most of all protectionism is interpreted as a reaction to liberalism and so it was at the beginning of the 19^{th} century. Alas we cannot overlook the mercantile substance of protectionism which not only precedes liberalism but it can be said that liberalism expresses from an economical point of view the liberation from the protectionist measures constrains imposed by state leaders like Richelieu, Colbert, Peter the Great, Cromwell and others, during the 16^{th}-17^{th} centuries, by their advisors (Giovanni Botero, J. Bodin, Luis Ortiz) or by great merchants and bankers (Th. Mun, J. Child, G. King, J. Law etc.), who supported measures of internal economical policy like fiscal policy, and external ones like the protectionist customs policies.

At the base of the mercantilist economy policy is the idea of the state's active intervention in the economy, both as an economic agent and mostly as a supporter of the other economical agents' activity at an internal level but more at an external one, through rigorous protectionist measures oriented towards the encouragement of endemic enterprisers and limiting foreign competition.

In a most natural and logic way, all these ideas appeared at the same time with the territorial states and will accompany, even if in a different form, the formation process of the national states also in the 19^{th} century. Newly formed, these states needed to defend themselves because "some win and some loose", as Montcheretien used to say. "One's gain is the other one's loss", as Montaigne used to say while Voltaire said: "It is clear that a country cannot win if another one doesn't loose" (Fernand Braudel, 1985, vol. II„ p. 231)

The evolution of the economic and social life at the beginning of the 18^{th} century will highlight a series of weak points in the mercantilist theory and practice. More and more economists contest the effectiveness of the protectionist measures, the priority of commerce, with emphasis on exports increasing, like identifying wealth by the precious metals owned by a country. The subsequent economical practice would show that commercial efficiency depends on the way the production is being organized, so the production efficiency conditions the efficiency of the external commerce.

Gradually, mercantilism becomes from protectionist, favorable to commercial freedom and to the elimination of prohibitive measures.

Protectionism – as an economic doctrine – would manifest itself with even more power in a coherent speech held by renowned representatives over the 19^{th} century.

The first and most important cause leading to the utterance of the protectionist doctrine and to its implementation with visible results was the conclusion that – in the middle of the 19^{th} century, in the heat of liberalism – the international economic exchanges had a non-equivalent character determined by the fact that the nations and states were at different levels of work productivity.

The protectionism followers question the pretence of liberalism universality demonstrating with historical and statistical data that the free exchange brought gain only to the industrially developed countries (even A. Smith would demonstrate that industrial labor productivity is superior to that of agriculture, with all the economic consequences of this fact), that at the beginning of their development these countries also promoted protectionist policies. England, for example, wasn't always a great power as it was perceived in the 19th century. In the 15th century it was a backward country, without the powerful navy, mostly with rural population and only two more important resources: a huge wool production and a strong industry of cloth, existent mostly in rural environment. But it was going to become soon an economic force, with solid handcraft corporations, with active fairs, a powerful monarchy, due among others to the protectionist measures taken. (André Maurois, 1970, vol. I, p. 225-226).

As a consequence, as the protectionism followers would affirm, the less industrially developed countries must not play the game of the developed countries because they have the right to protect their own national industry.

Another cause of the protectionist reaction against the liberal doctrine may be identified in the economic reality itself, in the poverty, filth and exploitation which not only weren't eradicated by the liberal politics but even increased them in certain geographic regions.

As a matter of course, the founders of this doctrine and then its most ardent sustainers came from countries where the principles of classic liberalism especially freedom of commerce and state non-interventionism prove to be unfit, even damaging in the conditions of the economical development stage they were in. They represent the echelons of lesser developed bourgeoisie from countries with a reduced economical potential which engaged later on to the market economy development, respectively at the end of the 19th century.

Preoccupied with the protection of some extra-European national states' interests, especially the USA, as well as of some central and eastern European national states (Germany, Romania, Russia, etc.) which have later constituted in modern states rather than of western European states confronting with a forceful competition fight on the world market, this reaction towards the classical economic liberalism was called "the national reaction".

The main representatives of the protectionist doctrine were: Frederich List, later followed by the members of the German historical school - W.G.F. Roscher, B. Hildebrand, K. Knies and by those of the new German historical school - G. Schmoller, A. Wagner, L. Brentano, the latter strongly influencing some 20th century masterminds, like Max Weber, W. Sombart, A. Spiethoff etc.; then there were the American protectionists like H. Ch. Carey, S. N. Patten, followed in the 20th century by the North-American institutionalists - Th. Veblen, J. M. Clark, W. Ch. Mitchell. Among the followers of the Romanian protectionism are the industrial bourgeoisie representatives from and out of the Liberal Party, scribes and politicians like - D.P.

Marţian, G. Bariţiu, M. Kogălniceanu, B. P. Haşdeu, P. S. Aurelian, A.D. Xenopol, E. Costinescu, I. N. Angelescu, V. Brătianu, M. Manoilescu, Mitiţă Constantinescu, etc.

Fr. List identifies the main problems with which Germany was being confronted on an economic level, and not only, coming with a proposal of a "Political economy national system", within which, in parallel with the criticism of what he considered to be the main lacks of the classic liberalism, underlines the virtues of Germany's protectionist policy. He demonstrates that the liberal policy favors the developed countries and disadvantages the backward countries.

The main economic liberalism's faults he speaks about are: cosmopolitism, consisting in globally treating the economic problem without consideration of the national interests; materialism, almost exclusively emphasizing the material side of life, overlooking the spiritual and cultural aspects; individualism, the exclusive attention to the individual and its interests to the prejudice of nation and the national interest (Fr. List, 1973, p. 113-121).

He even proposes a new science "nationaloekonomie" whose subject to be that of teaching us how a country should maintain or attenuate its economical position in a world context, starting from its national particulars; during the analysis of the economical problems it was to pass on from individual to nation, from political economy to the economic policy, from the individual interest to the national one. Even in the name of the new science he introduces the concept of nation, fundamental for explaining the economic life, every nation having different interests and unequal forces. In his opinion economy was no longer the science of wealth - as in the mercantilists or classics – but the science of the "productive forces" that create wealth. These comprise everything that exist in the German society and may be beneficially mobilized in the direction of progress: the social order as essential factor of empowering the creative work, peoples' spirit as a primary condition of the productive work, the forces of nature which may be attracted and efficiently used in the development process: "The peoples' productive forces are not only conditioned by industriousness, the spirit of economy, morality and intelligence of individuals or the possession of natural funds and of material capitals, but also by the institutions, civil, political and social laws and before all by the guaranties offered by the continuity, independence and their power of being nations" (*Ibidem*, p. 36).

Another novelty element in List' thinking is the use of the historical method in the analysis of the nations' evolution, establishing a succession order for the phases they cover. "In what the economical development is concerned, List says, we have to admit the existence of the following main evolution phases: the savage state, the pastoral state, the agricultural and manufacture state and finally, the agricultural, manufacture and commercial status" (*Ibidem,* p. 34).

For List protectionism is not an aim in itself, only a set of measures meant to support the states left behind from an economic point of view, to eliminate or diminish the delays after which those countries may engage with a comparable force in the fight of the free exchange with the developed countries. "Protectionism is the way and the free exchange is the aim/scope", he said.

Beyond the contestable aspects of List's thinking his work has influenced the economic thinking of his epoch and even the minds of the 20^{th} century thinkers but most importantly it proved its efficacy through the practical measures of economical policies which contributed to Germany's economic burst.

Synthesizing the protectionist doctrine we might express it using three fundamental concepts: protectionism, industrialism, nationalism. The promoters of this current attacked theory, methodology and the economic policy foreseen by the classical liberalism.

a) For the protectionists wealth was discovered in the nation's productive forces, because the existing goods as they say, disappear by consumption and the nation may go poor; if instead, attention is put on the development of the productive forces, one may see that these are capable of reproducing and increasing richness. In other words, richness is the power to create richness in ever bigger proportions and work is the main engine of economical function and revaluation.

b) Protectionists criticize the pretence of universality for the classical liberalism practical and theoretic postulates which used to ignore the local particularities, and so, the national ones. They propose the study of these particularities so that depending on the clear conditions of one country or another, to be able to formulate realistic appreciations and to apply the suitable practical measures. Thus, it is understood that protectionism denies the existence of generally valid objective economical laws.

c) The protectionist doctrine reproaches the economic liberalism classics the exaggerated attention to the individuals and to the spontaneous establishment of common good, ignoring the link between the individual and society: the nation.

d) Industry was considered the most fertile productive force of a nation, capable of constantly increasing the material and intellectual values, to increase the economic efficiency, to harmoniously develop the national territory, to contribute to the emulation between individuals, to the national independence and liberty. In addition, the industrial structures being superior to the agricultural ones in the conditions of free interchangeability, the industrial countries subordinate the agricultural ones. That's why, industry must be part of the national economic complex, based on the principles of maximum efficiency of the entire nation's activity.

e) The protectionists have criticized the deductive methods and the abstractions of the classical liberals, considering this a way of simplifying reality till deformation, thus rejecting also the robot image of the economic agents known as "homo oeconomicus"; they present as a change the inductive and historical method, the economy study starting from the multitude of concrete facts followed along time, so historically.

f) Substituting the static classical conception with a dynamic one, of nations' prosperity, the role of booster goes to the state, which is not a sum of individuals - as Bentham would affirm – but a different body and bigger than its parts having the role to stimulate the productive forces (Fr. List, 1973, p. 121-131).

g) It contemplates an external protectionist policy contrasting with the free exchange or free competition, going from the major differences between the economical potentials of the world's countries, that gives and advantage of the free exchange for the developed countries over the damage of the underdeveloped ones. "Part of humanity is tormented and on the brink of death so that the other party to stuff itself on the brink of bursting". So they propose an external policy based on the customs protectionism which would help the underdeveloped countries to strengthen their productive forces, to enhance their economic potential in order to participate afterwards at the world market competition. (Sultana Sută-Sălăgean, 1994, p. 120-122).

We must, indeed, make a difference between the external protectionism "at border", consisting in measures to reduce imports by raising the customs taxes or by import contingents and the internal protectionism consisting in subventions, state orders, reductions, staggering or exemptions from state budget payments for some economic agents, as well as in the policies of state intervention in the economic life.

If external protectionism flourished in periods anterior to the 20th century, in the case of fragmented economies, relatively independent, the internal one, handled by Keynes and known as nationalism or interventionism proved its efficiency in many economic crises through the 20th century and some crisis theoreticians (P. Krugman, 2009) see it as viable in the near future. In fact, Keynes relates to protectionism, especially mercantilism, highlighting its valences and merits and disapproving the exaggerated aspects in relation with the maintenance and attraction of bigger and bigger quantities of precious metals as an expression of a country's wealth, also mentioning that the "pretended advantages are evidently national advantages and it is highly unlikely that the world in general will benefit of them". (Keynes, 2009, p. 404 - 444).

Keynes' theory comprised also in his well-known work "The General Theory of Employment, Interest and Money" (1936), is a construction meant to replace the old English classical approach and to justify the active economical policies and the necessity of state's intervention, in a differentiated manner, based on the phases of the economic cycle, through the available assets like the budgetary, monetary and fiscal policy.

The pattern introduced by him is based on some fundamental concepts: consumption orientation, marginal productivity of capital, interest rate and full occupancy.

In the introduction to the Romanian edition of this paper from 2009, Paul Krugman stated that John M. Keynes has lost the "seductive, but certainly false idea of the business cycle being a game of morality and of the economic depression, a necessary purgative after the excess of a prosperity period" (J.M. Keynes, 2009, p.47).

Keynes moves the invoked causality of crises from the zone of the interest rate into that of marginal productivity of capital: "We were used to explain crisis by emphasizing the increasing tendency of the interest rate under the influence of the increasing demand of money, both for commercial and speculative reasons. At some point, this factor may certainly play an aggravating role or, occasionally, an initiative one. But I suggest that the more typical explanation and, probably often predominant, of the crisis is not especially an increase of the interest rate but a sudden collapse of the marginal productivity of the capital." (*Ibidem*, p.385).

El considers that when economies confront a drastic drop of aggregated demand, the involuntary unemployment is produced and the market's intervention in this unbalance exactly when it takes place is slow and difficult. So the intervention of the government is necessary in order to stimulate the demand and reduce unemployment. Thus, not always the increase of money offer will bring the expected results, governmental expenses being necessary. "I expect to see the state, which has the possibility to calculate the marginal productivity of the capital assets on a long term and based on the general social advantage, take on a great responsibility to organize investments in a direct manner", stated him (*Ibidem*, p. 228). It is about both internal and external investments which form together the aggregated investment.

In what the solutions for overcoming the crisis is concerned, Keynes rationalizes a concept that explains the logic of the state's intervention necessity in the economy: during a crisis the need for consumption drops, production is contracted and the involuntary unemployment takes on; in order for this not to trigger an even bigger drop of consumption, given the smaller incomes, it is necessary to reduce the interest rate, to increase the governmental expenses (state investments), to reduce the fiscal policy and equilibrate the commercial balance for decreasing unemployment and fully occupying the labor force: "... the investment scale is promoted by a low interest given the fact that we don't try to stimulate them this way beyond the point where we register full occupancy. Thus, it is in our advantage to reduce interest rate until that point related to the function of marginal productivity of the capital where there is total occupancy." (*Ibidem*, p. 448). And he also continues writing that: "In a society where current investments are not in question under the wing of the public authorities, the economical objectives which the government should reasonably be preoccupied with are the internal rate of interest and the commercial balance" (*Ibidem*, p. 406).

He considers all these measures "as being the only way to avoid destruction of the economic formations existent in total as well the condition for the individual initiative to function successfully" (*Ibidem*, p. 453).

There are enough issues imputed to Keynes, virulent attacks coming mostly from neoliberals and monetarists: the consideration of the episode 1930 as being a trend that would persist for an undetermined period of time; underestimation of the capacities of the economies to prevent the decreasing outputs; overestimation of the demand role; he didn't foresaw persistence of inflation and, thus he didn't create the instruments to control it, (P. Krugman, in J. M. Keynes, 2009, p. 53-58), an incorrect vision of unemployment and an unjustified fear of accumulation; he elaborated a short term theory of balance; "the actual core of the Keynesian system remains static in essence" (J. A. Schumpeter, 1984, p. 417); his theory is a cure for the disease but it is killing the sick person; the conjunctional policies he foresees are not efficient.

Even so, Keynes, being also the initiator of macroeconomy, had a word to say in the history of universal economic thinking of the 20th century and in the economic practice of governors from different countries of the world, especially during a crisis. Time magazine wrote in 1999 that "born in 1883, when Karl Marx has died, Keynes probably saved capitalism from itself" (Keynes, 2009, p. 8), in the conditions when the Big Crash could have destroyed both capitalism and democracy.

Economic crisis and protectionism

From the physiocrats on the economic organism was often compared with the human one from the aspect of its functioning as a system. An economic organism also faces "diseases" which may be diagnosed and in several cases cured if the disease is discovered on time and if the most efficient medication is being used. With the specification that modern medicine insists on the patient who may react differently from other to the same disease, depending on their biological characteristics, or they may react differently in time depending on the state of the body at that moment. So, an individualized is called for in order to treat the sick person and not the disease.

The economic crisis may be defined as an accentuated deterioration both of the present economical situation and of the economy in perspective. By its manifestation diversity and its phases, with longer or shorter periods, it also is an economic disease whose causes have been identified by economists in different zones, thus the anti-crisis measures proposed were different. Such economic crises have succeeded over the entire 19th century up to the First World War, culminating with the Big Crash from 1929-1933 and continuing with the two energy crises from 1973 and 1979, with the local crisis from Mexico, South America, Japan from 1990, only that in 2008 to burst out the present international crisis. There were also periods of sustained economical growth, longer especially during the post-war period, until the beginning of the 70's, in the industrialized countries generating doubts among economists regarding the viability of the economic cycle idea. (Krugman, 2009, p.19)

Regarding the 1929-1933 Crash, almost all economists appreciate that if not triggered, it was surely enhanced by the drastic reduction of the effective demand and by lack of liquidities. On the other hand, in what the anti-crisis solutions is concerned, the economists' opinions are shared: some think that the protectionist measures helped overcome the crisis and restart the economy, others think that these measures have aggravated the crisis and even that they allowed instauration of fascism and Nazism triggering the Second World War. Finally, there are economists who consider that firm protectionist measures taken in due time would have prevented this "senseless tragedy". If Herbert Hoover hadn't tried to balance the budget facing an economical depression; if the Federal Reserve hadn't have protected the etalon – gold – to the prejudice of internal economy; if authorities hadn't have urgently supported the crash prone banks with liquidities thus calming down the panic gradually installed 1930-1931; Then the stock market crash from 1929 would have lead only to a "common gardenlike recession soon forgotten..." (P. Krugman, 2009, p.7)

The contemporary economic crises may be resembled to pandemics due to the strong interdependencies appearing in the process of globalization and, implicitly, the quick spread of this disease. Under these conditions, the local and regional measures are still efficient? Anyway, it may be observed that "in spite of the contemporary gain of refinement and degree of sophistication, the tendency to follow patterns has not disappeared, but it has only metamorphosed..." (J. Gray, 1998, p.1-2). For example, in 1990, Bundesbank increased the interest rate in order to control inflation determined by the reunification of the country. This measure produced perturbations in all Western Europe and even conflicts of interest. With no global governing a harmonization of the commercial and monetary policies is imposed.

Or, "whilst cooperation in the field of international commercial policies is a well established tradition, cooperation in the field of the international macroeconomical policies is a new and much more uncertain subject." (Paul R Krugman, Maurice Obstfeld, Achille Hannequart, 2003, p. 8)

By largely simplifying things, I would set the anti-crisis solutions in two big categories: solutions related to the market functioning (non-interventionism, liberalism) and economic policies (state interventionism, protectionism). While the liberals think that the market has the necessary mechanisms to adjust the unbalances issued by the economical crises, protectionists sustain that free economy must be reformed or at least that the state's intervention in the economy is imperiously necessary.

On the trail opened by his physiocrat precursors with the famous urge: „Laissez faire, laissez passer, le monde va de lui meme" (Gournay, acc. J. B. Say, 1840, p. 555), Adam Smith, the father of classical liberalism formulated in 1776 the no lesser renowned syntagm of the "invisible hand", expression of the market's self regulator capacity.

As the civil society state of mind and economical and political thinking trend, liberalism was the expression of aspiration to social progress, its spreading being favored by two factors: extension of the international economic relations in the 17^{th} – 19^{th} centuries and discovery of printing. All these made liberalism the main mega tendency of the modern contemporary economic thinking extending its domination on a planetary level.

Andre Piettre (1957) identifies three types of reaction against liberalism: the social reaction, materialized in the different orientations socialist doctrine; the national reaction, materialized in the protectionist doctrine; the intellectual reaction, materialized in the marginal or neoclassical doctrine.

Mutations in the liberal economic thinking appeared also on the background of the changes in the western economies and the world economy, determined by the industrial revolution, at the same time with the reiteration and accentuation of some economical unbalances under the form of overproduction crises, some of them with world character, highlighting disparities in the assignment of the national income, by worsening the competition fight and the fight for the external markets, by sharpening contradictions between metropolises and colonies. Some economists define this new reality surfacing in the USA and based on the liberal logic, "turbo-capitalism" (Edward N. Lutwac, 1998) establishing as main dimensions: privatization, deregulation and internationalization.

In consequence, although in the 19th century the economic freedom was triumphant and suitable for a period of expansion, offering a market to every new manufacturer, "it would prove dangerous as soon as the labor force or production markets become saturated. Then free competition will give birth to some evident setbacks and it will be seen how in England as all over the western world would start a protectionist, nationalist and autarkical reflux, totally surprising to Quesnay and Adam Smith" (André Maurois, 1970, p. 191). Between the years 1900-1940 we witness the "great makeover" (Karl Polany, 1944) of the 19th century economic system built on "four institutions: the system of powers balance, the international etalon in gold, the self regulating market and the liberal state" (M. Beaud, G. Dostaler, 2000, p.58).

Especially during the post-war period, under the pressure of the responsibility for the countries' reconstruction and economies modernization, the political men from the industrialized countries go for economical policies which target objectives like: improving the social protection system, health and education and as a corollary the raising of living standards. Thus, the state interventionism as a national interest becomes a form of solidarity with those affected in a greater degree by the crisis, these being offered support from the state budget.

Starting with the '70's we see acceleration of the economical globalization process, fact that limits the capacity of states to efficiently intervene (the crashing down of the myth of "the state of providence") and reactivates the ideology of "the minimal state" and "minimal governing", embraced after 1989 also by the Eastern European states after the nationalism and communism experience which led to a kind of "anarchic-capitalism" (J. Gray, 1998, p. 240). In fact, there are economists who, treating the globalization effects on an economic level, underline that this leads to "Richesse du monde, pauverte des nations" (Daniel Cohen, 1997).

On a often exaggerated optimism basis, we assist to a great economic growth not only in the advanced countries but also in those less developed which would trigger the raise by 3 times of the oil in 1973 and twice more in 1979, which, for a oil-based economy couldn't have not started a powerful crisis, with long term consequences. The same went on, as Paul Krugman thinks, also in 1990 when the excessive trust in the informational technology profit potential and the "growing sense of security regarding economy, the belief that the severe recessions' era was over" pushed the prices of stocks "up to dazzling levels" (Krugman, 2009, p. 167)

In all crises registered over the 20th century and the beginning of this one, the resort to protectionist measures was quite evident. Since the Smoot-Holly law of 1930 that followed the protection of the American industry by raising the customs taxes, up to "Buy American" from 2009 – a project of the American state to stimulate economy by using US made products.

This is due, on one hand, to the fact that protectionism gave short term results, and on the other hand, the national level political factors saw in such measures a way to attract citizens, in other words, revaluated them from an electoral point of view. If on a national level and short term the protectionist measures prove their efficiency, on long term and internationally speaking there are serious malfunctions created, consisting in some national protectionisms races, which often turn on those provoking them. The most badly hurt come out the less developed countries which cannot hold the pace with the subventions race and are forced to resort to greatly overwhelming loans. Also, the countries with emergent and export-based economies have a great deal to suffer.

The present economical-financial crisis also starts large pro and con disputes over the protectionist measures among economists and politicians altogether. The first category stress the fact that the protectionist measures have affected the Big Crash from 1929-1933 and even brought on the Second World War, and in the case of the present crisis such measures are even more damaging in the conditions of globalizations, being capable of triggering a true commercial war (see Canada and the European Union's reactions and subsequently Japan's to the "Buy American" project). The liberal economists see the overcoming of crisis by stimulating entrepreneurs (not of those who lost but of the viable ones), by investment, innovation and full freedom of the commercial exchanges, going up to reducing to zero the customs taxes and not by protectionist measures. They see in such kind of measures an anti-globalization policy, a going back to the national isolation with heavy consequences on the population's living standards.

This doesn't mean that in the present economical-financial crisis the protectionist measures weren't present. Following the "Buy American" model, various countries have adopted similar programs to support the national economy: France started a plan of supporting the automobile production, The Lower Countries enticed their citizens to spend their vacations in their country to help boost the economical restart, etc. Such measures not only were encouraged by the other camp economists, but were even considered scarce.

Paul Krugman, laureate of the Nobel prize for economy in 2008, states that in order to overcome the lack of trust in the banking system, cumulated with the lack of cash, a massive and rapid intervention of the state is necessary in order to put back on track crediting and costs stimulation. On a long term, the state should see to the prevention of appearing in the economy of "speculative balloons" be them real estate, financial, stock market or of another nature, which would burst at a certain point with repercussions regarding investments, consumption, general demand, unemployment growth and diminishing of the living standards. (P. Krugman, 2009, p.79 and p.173-175). He also calls for attention to the more careful regulation of the banking activities and to the stopping of "shadow banks" activities, warning in the same book about the coming back of the "economy of decline".

As a consequence, liberalism or protectionism represents crisis solution? Or is there an alternative to the two contraries? Because "liberalism is poorly endowed to face the postmodern period dilemmas" (J. Gray, 1998, p. 4-5), and protectionism is unsuitable, the state having to limit itself to securing a stable background for the development of market operations, the market being the only mechanism fit for efficiently managing the allocation of resources. (Milton Friedman, 1948).

I personally consider that there are no universally valid and saving models and solutions. In a global economy of such complexity, measures should be differentiated by types of countries and economies, by phases of the crisis emphasizing the prevention measures. There were cases when the protectionist measures had results (1929-1933), others when the legislative regulations proved to be very useful, (in the post-war period, speaking about the banking regulations) and others when exports have contributed to the overcoming of the crisis (in 1990, the Japanese crisis). Important is that the adopted measures to regard not only the national interests but also the avoidance of dysfunctions at the world economical level.

Case study. The perception of crisis by the economic agents from Bihor County

The case study has been performed using as research method the interview based inquiry of several economic agents from in the period between the 1st -15th of July 2009. Several private company managers of different sizes have been selected (small - 6, middle - 4), with various activities (commerce - 4, production - 3, construction and installations - 3), as well as from different backgrounds: 2 from the rural 8 from the urban background.

I tried to catch the way in which the economic agents from Bihor perceive the financial-economical crisis they undergo at the moment, under the aspects of manifestation, intensity and ways of overcoming it.

Asked if they feel the economic crisis, the managers from Bihor all answered positively. The main forms of manifestation reside in sales and orders dropping – in the case of commercial and service provision companies, respectively reducing of production and personnel layoffs, unpaid leaves, salaries reduction – in the case of production and construction companies. Also in the case of production and construction companies are being invoked as crisis forms of manifestation, the financial blockings (refusal of suppliers to delivery materials with payment on term, difficulties in cashing in invoices). A major problem for the construction companies is lack of financing the pending works, which aggravates chain financial blockages. The consumption based company accuses profit diminishing, which impairs the E.U. imposed program of modernization. One of the commercial companies suffers from loss of profit in the conditions of income diminishing but still the same costs.

The interviewed managers say they didn't ask for help yet only from the banks with which they negotiate the increasing of the credit level. In the case of the smallest of companies this request was rejected due to its small turnover and dropping profit. The food supply company intends to access European funds and one of the constructions companies intends to turn to justice for support in recovering debts from bad payer beneficiaries.

The answer to the question about how and whom do they think can help them overcome the difficulties they face, the answer was the same: the state through programs of rendering low interest credits (for the middle companies), respectively reducing taxes (VAT, and salary taxes), or even eliminating some of them, debts installments (for the small companies), which would determine, in the opinion of the managers, costs reduction, prices diminishing and increase of the purchase power of population. The food company even accuses the state for delaying payments to economical agents. I focused on one construction company manager's opinion who considered that the state should help the economic agents by reducing the number of budgetary personnel, their salaries and bonuses especially, this bringing on a reduction of the taxes paid by the economic agents of up to 30%. Another interesting idea coming from the answers given by small company managers refers to the necessity to adopt a legislation which favors the profitable enterprises "which pay their dues to the state and support the state budget and eliminate the "foolish tax called contractual, which only gives theft an official aspect."

In what the end of crisis estimation is concerned, the interviewed managers don't express themselves in a categorical manner and, most of all, don't back up their answers very good. Some of them are more optimistic hoping for a soon termination (around the middle of 2010), but most of them think that it will take longer than that (between 3-5 years): due to the economic sectors interdependence an the countries interdependence, due to the "speculations, manipulations and the misleading of population by the politicians" or because of their ignorance and to the big commissions and interest rates practiced by the banks. All these have as a main consequence the dramatic diminishing of the economic agents' trust not only in the governors but also in their partners, banks and implicitly in the economic future of the company and the activity it develops.

It can be observed that there are in Bihor County's economy signs of the economical-financial crisis manifestation. The forms they dress up in are quasi-present in almost all crisis affected economies: production reducing, profit drop, orders and selling drop, growth of lay off employees, difficulty in accessing credits by small companies and financial blockages.

Confronted with the crisis generated problems managers surprise by the lucidity in identifying the practical solutions that might help them cut their losses and continue to go on. They think that all these solutions are at the hand of the state which should show responsibility in applying them. If things stand like they do, it is either due to ignorance or the corruption of the political class which undermines the economic agents' trust. There is also realism in approaching the relation with the banks, which prove to be less available to understanding of the agents' difficulties or to accept profit reducing.

We could say that the Bihor County managers' option to overcome the crisis is a protectionist one, somehow to be expected under the conditions that the outlook on the state's maximal role from the communist period still lingers. Alas, the differences of thinking between the present managers and that of the 1989 ones are essentially different, in the sense that they approach the relation with the state both from their personal interest angle and from the social responsibilities for the companies they run.

What really surprised me was the feeling of a social tension waiting to explode, between the society's direct productive class and the budgetary class. This tension is fueled no doubt also by the information and media debates contents but is probably also the result of the analyses that every manager does when, faced with the income diminishing, he has to fight with the sometimes excessive fiscal policy. I consider this a novelty that should preoccupy authorities more in order to prevent a possible deepening of the strain between the two social categories in the future.

Conclusions

- State interventionism varies in intensity, modalities and efficiency based on the concrete historical conditions in which it takes place: "The sphere and limitations of governing cannot be prior described. Time, place and historical circumstances are of utmost importance in determining the area and character of the state's intervention in the civil society" (J. Gray, 1998, p.67)
- At the same time with the complication of the international economical relations, the crises seem to appear at smaller intervals, under more varied forms, with ever growing impact, the local or regional crises alternating with the global ones, and the efficiency, at least long term, of the anti-crisis measures proves to be weaker and weaker.
- The combination of the economic and politic aspects makes protectionism be the first option of the politicians in the case of an economic crisis (a liberal used to recommend to do nothing in the case of a crisis, only the politicians can't help themselves).
- In a global world where the interdependencies between the national economies are stronger, protectionism may have positive effects on short term, while on long term it produces dysfunctions at the level of the international commercial relations.
- At a local level, the economic agents see salvation also in the state's actions backed up by those of the banks. They prove a better understanding of the reality they live trying to overcome it by a moderate optimism regarding the end of the economic-financial crisis.

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ANALYZING THE ROMANIAN RESIDENTIAL MARKET UNDER THE GLOBAL ECONOMIC CRISIS EFFECT

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Abstract

As the financial crisis effects continue to spread around the world, Romania is no exception to the global economic climate, as the country continues its attempts to better integrate into the European Union.

To what extent is the Romanian residential market affected by the United State financial crisis? What are the causes and effects of the Romanian crisis? How has the crisis evolved so far and our prognostics regarding it? These are some of the questions to which we answer in the present article.

We will take into consideration factors such as the residential market of both new and old products, comparing their evolution up until March 2009 and studying their prices, units sold, and latest projects focused on our nation's capital. Our prognostics estimates that the residential market will start the process of revitalization by Q4 2009 – Q2 2010, when the great demand will be sustained by good bank credit loans.

Keywords

mortgage subprime loans, the contagion effect, the cumulative causality effect, the herd effect, reference interest rate, credits, fiscal facilitation, developer financing, real estate transactions, constructions, sales prices, demand, offer, BREI-N, BREI-V, speculative investments.

JEL Classification: E30, E44, L74

Introduction

Over the last few years, prosperity reigned over the Romanian residential market, attracting local, as well as foreign investors. The year 2007 was particularly successful in that the sales of both old and new apartments was on a continuously rising slope. Such was not the case with 2008, and a change for the worse arrived that year.

The highest market prices of the Romanian residential products peaked in March-April 2008. The prices stagnated in July, after which they went into a downward slope starting August. The effect of the global financial crisis was finally hitting the residential market even in Romania. Romania had been enjoying record

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sales growth well into 2007, even as the global financial markets and mortgages were collapsing.

Crisis causes

To get a better idea of what caused this crisis nationally, we must gain an understanding of how it all started in the US and just how it made its way all the way to Romania. As a result, we have identified the following categories of causes: macro- and micro-economic, organizational, legislative, financial, and monetary.

SUA, The Economic Crisis Starter. Over the last twenty years, the US was considered the driving engine of the global economic growth. Authorities encouraged consumer spending and brought in rapid growth through fast and easy crediting. The Federal Reserve, however, warned in 2007 that consumer debt stemming from unpaid mortgage rates had $ 100,000 billion dollars.

Thus, the first warning signs of the crisis came as early as 2007, as numerous small credit institutions went bankrupt from mortgage subprime loans. Then came the collapse of the bigger companies, banks and investment funds who were citing the same reasons for their losses. Still, financial analysts insisted there were no reasons to panic.

In Europe, the first effect of the crisis was felt on August 9, 2007, when BNP Paribas, the bank with most assets on the Euro territory, cancelled its paying of three debt funds. The reason? The funds could no longer be evaluated due to their exposure to the US mortgage subprime loans. Up until fall 2007, the crisis spread across Europe, affecting the banks from England (Northern Rock went bankrupt), Germany and even the Switzerland through the losses suffered by UBS AG and Credit Suisse Group.

At the end of October, 2007, BNR increases for the first time its reference interest rate, and governor Mugur Isarescu announces that some assets' prices can be "inflated." One month later, Standard & Poor's lowers Romania's rating due to the increase in the foreign deficit, and the Euro goes over 3,5 Lei.

Despite efforts from both the EU and the US Federal Reserve to prevent the crisis from worsening, the end of the year 2007 brings yet more bad financial news from banks such as UBS, Citigroup, Merrill Lunch, and Morgan Stanley. In January 2009, the financial markets continued to suffer and the stock markets worldwide were declining significantly. In Romania, the reference interest increased from 7,5% to 8%, and the national currency continued to lose its value (e.g. 3,61 Lei per Euro in December versus 3,13 Lei per Euro, its lowest value that year).

In 2008, the US implemented fiscal and monetary strategies to stimulate consumer spending and economic growth. [Congress approved a federal bailout of the US financial system and the Federal Reserve System (FDS) lowered its reference interest rate. However, the banks used the bailout money to cover for their losses. In April 2008, 55% of the banks operating on the US territory made it more difficult for consumers and businesses to obtain credit, which went against the initial goal of the Federal Reserve.

In April, the Standard & Poor's agency also publicized its analysis results, according to which Romania was one of the most vulnerable countries in the face of the US economic crisis, next to Libya and Turkey.

Crisis Propagation Causes into Romania. The internal causes of Romania's exposure to the foreign crisis are related, on the one hand, to the current funds deficit, the inconsistencies in Bucharest's stock exchange, the interest on the bank deposits held by the Federal Reserve, the low sustainability of the public finances, as well as the increase in foreign debt.

On the other hand, the extent to which the American crisis affected Romania is based on three types of effects:

The Contagion Effect—the spread of the instability from one region to another—seen as a result of globalization, leads to the similarities between the economic cycles of the world's biggest economic powers (US, Europe, China and Japan).

The Cumulative Casualty Effect: the imbalance occurring in one region compensates the imbalances in other regions, leading to shock waves.

The Herd Effect: The managers of high-risk investments compete against each other simultaneously over the same territories. Thus, they also simultaneously leave these territories when the potential for profit decreases.

European Causes. Along with the globalization and European factors, which are related to Romania's dependency on Europe and Europe's dependency on the US, there are also the institutional factors that we take into consideration in this context.

These factors arise from the lack of certain regulatory institutions at the European level when it comes to financial risks. To fix these aspects, the European Union (EU) restructured its internal composition and implemented CERS and SESV.

Another shortfall compensated by the Larosiere Report is the lack of the mechanisms which deal with crisis.

When it comes to global institutional causes, we may include the absence of a timely warning about the macroeconomic and financial risks, and the appropriate solution provided by the FMI. According to G20, this one will work closely with Financial Stability Board in order to archive it.

Even so, if we were to learn a lesson from the harsh reality of the current economic crisis it is that regulations and supervisions can co-exist even with all the modernization of the financial markets. Speaking of which, another cause for the current crisis is at the level of companies and private individuals and it is called responsibility. On one hand, risk management could be bigger of a priority for the big companies; on the other, the population at large (each one of us) could limit its consumption as to not exceed the limits of the household budget.

Causes of the Mortgage Crisis in Romania.

The construction industry rates in third in the bankruptcy statistics for all industries, and this is for a good reason. It is the first sector to be affected by the crisis due to the stalling of the housing market, the banks decision to cut credits for construction-related expenses, late payments from the state budget owed from the last months of 2008, as well as some of the investors announcing to delay or stop their housing market investments. In other words, starting halfway through the year 2008, it became very obvious that construction companies were having a difficult time paying their debt and accessing their finances. Supply chain problems made problems with the cash flow even worse, since companies were not receiving payments from their clients and, in turn, could also not pay what they owed.

The rising cost of construction materials also had a negative impact on the activity of the construction companies. Along with assumptions made by investors, it also became obvious that land price and construction-material cost contributed to the rise in the housing prices and to the halt mentioned above. The second half of 2008 brought in a significant decrease in prices. In particular, the forged-steel products' prices decreased by 40 to 50%.

The fact that the year 2009 brought a rise in bankruptcy for the housing market comes as no surprise to anyone. After all, at the end of 2008 it was almost impossible for the construction companies to pay their debt, and this did not change well into 2009. Moreover, state budget payments have yet to be completed, credits are almost impossible to obtain from the banks, and investments in the financial market are not to be expected anytime soon.

Crisis effects

The effects over the Romanian Residential Market rise in the development of the following indicators: transactions, prices, production, bankruptcies, crediting, credit debts.

Bankruptcies. Between January 1st and November 17th, 2008, the number of bankruptcies in building-materials and construction industries nearly doubled compared to a similar period in the previous year. Of the total number of bankruptcies recorded by ONRC in the 2008 period mentioned, 84.7% were recorded by the Romanian capital companies.

The construction industry recorded 1.200 bankruptcies in 2008 (compared to 525 in 2007), followed by the housing transaction-related bankruptcies with 900 (compared to 448 in 2007).

Ten percent of the real estate members who are part of ARAI declared bankruptcy between October 2008 and March 2009. The rest of the real estate members, having no properties to sell, make a living out of renting or consulting. Some of them have also developed auxiliary businesses, such as housing administration, interior design, moving services, or cleaning service (this according to the ARAI).

The rise in bankruptcies was caused, up until October 2008, by the creditors' desire to recover their investments as soon as possible, which means that the insolvency process represents the fastest way of legally recovering investments from debtors.

Credit debts. Credit debt increased by 48.4% in the first two months of 2009, up to 4.252 billions Lei (991 millions Euros). On December 31st, 2008, the Romanian population at large as well as the Romanian firms had leftover debt owed to the banks summing up to 2.865 billions Lei (719 millions Euros).

On the foreign currency side, the leftover debt has now reached 1.831 billions Lei (426.8 million Euros), increasing by 84.4% from the end of 2008 when it was at 993.3 millions Lei (249 millions Euros). These numbers were influenced by the depreciation of the Leu (by 7.7% between the end of December and February 28th), considering that the Central Bank releases its statistics in Lei equivalents.

The leftover debt increased at a slower pace (29%) during the first two months, from 1.872 billions Lei (469 millions Euros) up to 2.421 billions Lei (564,25 millions Euros), according to BNR. As a result of the increase in unpaid debt, the overall leftover debt stemming from bank loans reached 2.05% at the end of February, from 1.44% at the end of 2008 to 0.82% on Febrary 29, 2008.

Both companies and the population at large carried leftover debt that increased by 72% during the first two months of 2009 and reached a value of 1.42 billions Lei (330.4 millions Euros); of this amount, 70% was borrowed in foreign currency. Coming in second place after Bucharest, the largest amount of leftover debt was recorded in Brasov with 195.11 million Lei (45.47 million Euros), followed by Timis with 174.16 million Lei (40.6 million Euros).

Crediting. Starting September 2008, banks increased their costs significantly for mortgage loans in Euro, the annual interest rates increasing from 8.23% annually up to 11.3% in January 2009, according to the Central Bank's statistics.

In November 2008, the International Ratings Agency Fitch lowered Romania's ratings for long-term, foreign currency loans, from BBB to BB+, and for long-term loans in Lei from BBB+ to BBB-. This evaluation is based on the agency's concerns regarding Romania's macroeconomic politics and the country's capacity to avoid a severe economic and financial crisis. Fitch's decision pulls out Romania from the category of states that received "investment grade"-type of scores, says Reuters. This also comes after Standard & Poor's lowered Romania's ratings as well at the end of October.

February 2009 was the first in the last seven when the interest rates decreased. The rate of the banks' annual interest rate for the Euro decreased as well, from 11,30% annually in January to 9.26% annually. Local banks relaxed their terms for foreign loans in February, under the anticipation that the IMF would sign for the borrowing from foreign financial institutions. This also led to decreases in interest rates for the banks from their lenders, which, in turn, led to decreases in interest rates for the banks' clients. This better cash flow at the monetary market level, which led to a decrease in interest rates for crediting among banks, also allowed for the decrease of interest rates for loans in Lei.

In February, the leftover debt from the credit awarded by non-government institutions rose by 0.2% (-.7% in real terms) compared to January 2009, up to 206.890,1 million Lei, according to data released by the BNR. The credit in Lei maintained a steady slope in February (in real terms, it decreased by 0.9%), while the credit in foreign currency expressed in Lei increased by 0.4% (in Euros, the foreign currency credit increased by 0.1%).

At the end of February the credit awarded by non-government institutions recorded an increase of over 30.7% (22.2% in real terms) compared to February 29th, 2008, due to the increase by 17.3% of the Lei component (9.7% in real terms), and by 41.7% of the foreign component expressed in Lei (in Euros, the rise of the foreign currency value was 23.1%).

Between April and May 2009, banks are forced to go back to crediting after the banking system recorded losses in the first two months of 2009, and two of the nation's biggest banks reported a drastic decrease in profits for the year's first trimester. UniCredit Tiriac Bank announced the adjustment of its interest rate by 3% for private individuals' credits, a trend started by other big banks, such as Transilvania Bank, Raiffeisen Bank, and GarantiBank.

In May 2009 BNR reduced the nationally-imposed interest rate from 10% to 9.5% annually, after in February 2009 another 0.5% decrease had been made. BCR anticipated this decrease to go down to about 9% in the following months. BNR, however, decided to maintain the minimum reserve requirement for the passive investments in foreign currency to 40% and, for the passive investments in Lei to 18%.

In March 2009, the Romanian government borrowed 12.95 million Euros from the IMF (International Monetary Fund), as part of a foreign financing plan worth 20 billion Euros, to which the European Commission and other international financial institutions participate. While Fitch appreciated this intervention, they cautiously proceeded with the changing of their rating and kept an eye out for how the local authorities follow through with their promises.

Tranzactions. Real estate transaction number for December 2008 was only 33,007, 50% less then December 2007.

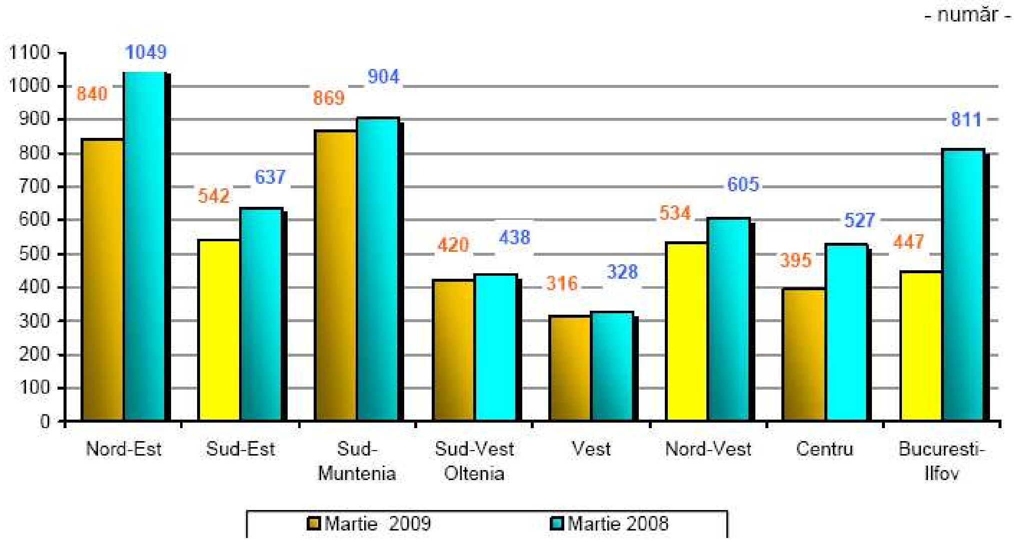
In January 2009 transaction number also decreased by 50% compared with January 2008, from 33,400 to 17,300 sales, but November reached the minimum level, with a 54% decrease, after only 15% in September and November. (National Union of the Public Notaries of Romania, UNNPR).

Per total, in 2008, 484.765 transactions have been made (UNNPR), 7% less then 2007 when 521.636 transactions were closed. For the first two months of 2009, a

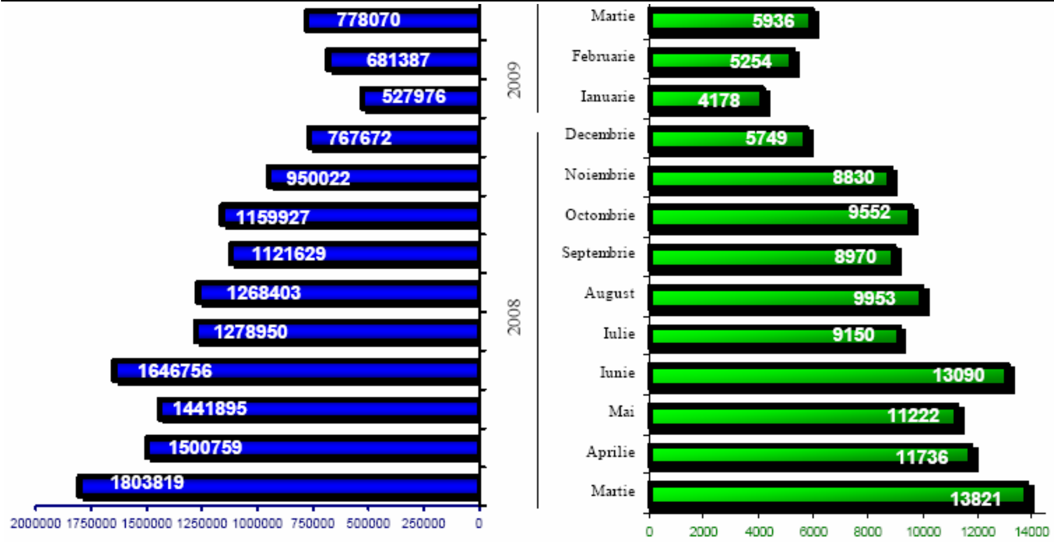
26% transactions decrease was reported compared to the similar period of 2008. Decreases of real estate operations have been registered throughout the country: Ilfov (minus 36%), Constanta (minus 33%), Timis and Arad (minus 23%).

Production. In Q1 2009, 10571 construction authorizations for residential buildings have been issued, 10.5 % less than Q1 2008. In Q3 2008, 11806 construction authorizations for residential buildings have been issued, 13.1 % more than Q3 2007. The most relevant decreases were in the areas : Bucharest-Ilfov (-692), Center (-263), Nord-Vest (-153) and North - East (-104).

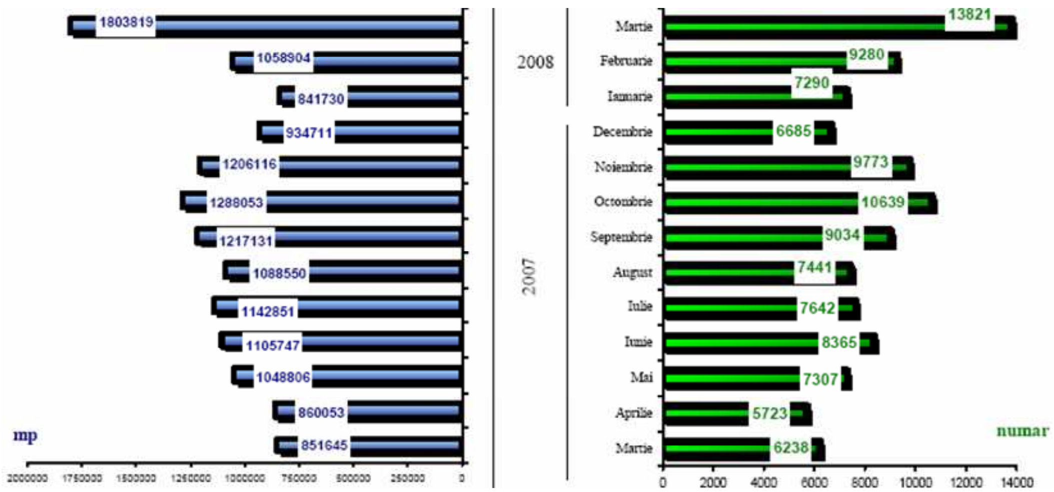
In March 2009, 4363 construction authorizations for residential buildings have been issued, 16,7% more than February 2009and 17,7% less then March 2008. The most relevant decreases were in the areas: Bucharest-Ilfov (-364), Nord-Est (-209) and Center (-132).



Graphic 1: Construction authorizations for residential buildings, by areas, March 2008 versus March 2009



Surface Area (sqm) Residential Authorizations (no)



Graphic 2: Construction authorizations for residential buildings number and area evolution, March 2007- March 2009.

Prices. In order to analyze residential products price dynamics under crisis influence, we chose the Bucharest market quantification

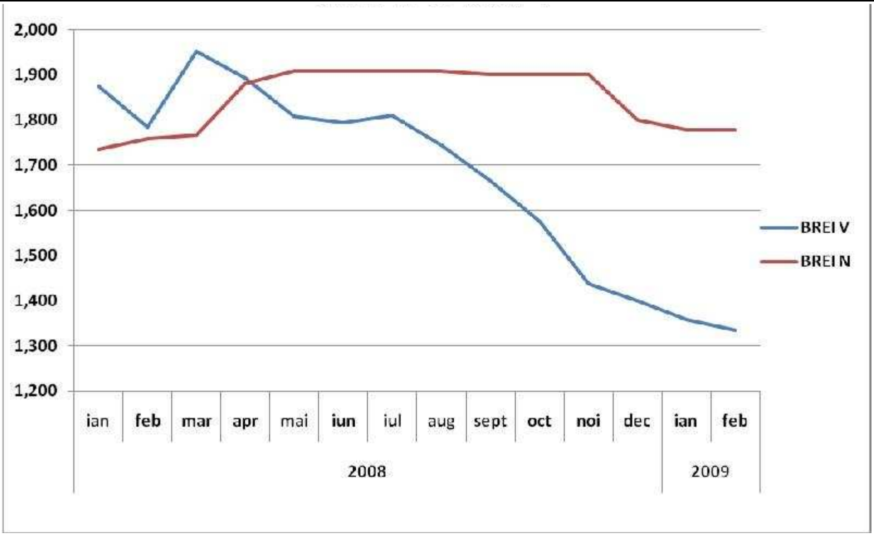
After the last years and a 2007 characterized by a continuous upward trend of the residential market, for both new and old apartments, 2008 was strikingly different. The pick of price evolution on the residential market was reached in months 3-4 of 2008, all values after that being on a descending trend. Q2 2008 brings stagnation followed in Q3 and Q4 by a monthly fall, down to 15 % in 6 months.

The difference between the extreme values in 2008 (Maximum in April and minimum in December) is 350 Euro/mp*, a decrease by 20% in nine months according to BREI index.

Old residential versus new residential price evolution. The striking difference between these 2 markets comes on the first place from the difference between the people who make offers on the market. On the new apartments residential market, the offer comes from developers – companies that have previous experience on other international markets, access to financial resources and a split exposure on the real estate market, not only on the residential market. On the other hand, the offer on the old apartments residential market comes from owners, in most cases natural persons on their first selling transaction of an apartment and with an immediate need to sell. Moreover, developers ask for an "objective" price, based on hard cost, soft cost and a desired profit margin, whereas the price of old apartments is "subjected", influenced by rumors on the market. Its decreases and increases do not reflect a growth or fall in the real property value.

Even though BREI-V was way under BREI-N at the beginning of 2007, it registered a spectacular growth throughout the year. It surpassed BREI-N with 140 units reaching 1.875 Euro/mp* in January 2008, a 29% increase. Despite some sudden falls in February, BREI-V remained on top of BREI-N for the whole first trimester of the previous year. This situation changed starting with April, when BREI-V was under BREI-N. For the rest of 2008, BREI-V had a descending path, which was only interrupted by a period of constant values in summer.

For BREI-N the year was split in 2 periods: a growth period, for the first 5 months and one of constant values in the next six months. The end of the year brings the first decrease of BREI-N, even though this decrease was sensed from September. We decided to introduce the effect of promotions on prices in BREI, after a 6 month period of constant promotions from the developers. We have considered that the "asking price" was thus being affected. In previous years, these price reductions were specific for periods when the number of transactions diminished, as in summer.



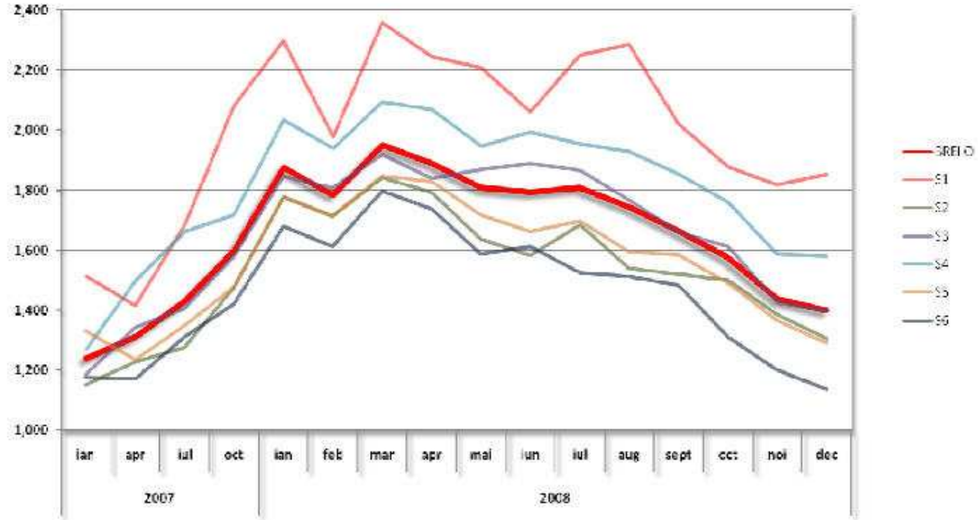
Graphic 3: Comparative price evolution on old and new residential in Bucharest according to BREI-n, BREI-v (2008-Feb2009)

Price dynamics by sector. For BREI-V every district's evolution was correlated with the general index evolution. The most affected was district 6, with a decrease by 32%, over 500 Euro/sqm*. It is the most exposed because it targets middle class clients, who were most affected by the crisis. Moreover, district 6 has no luxury area, it is mostly influenced by the evolution in 2 areas: Militari and Drumul Taberei, both with a constant big offer that had to deal with a constant smaller demand.

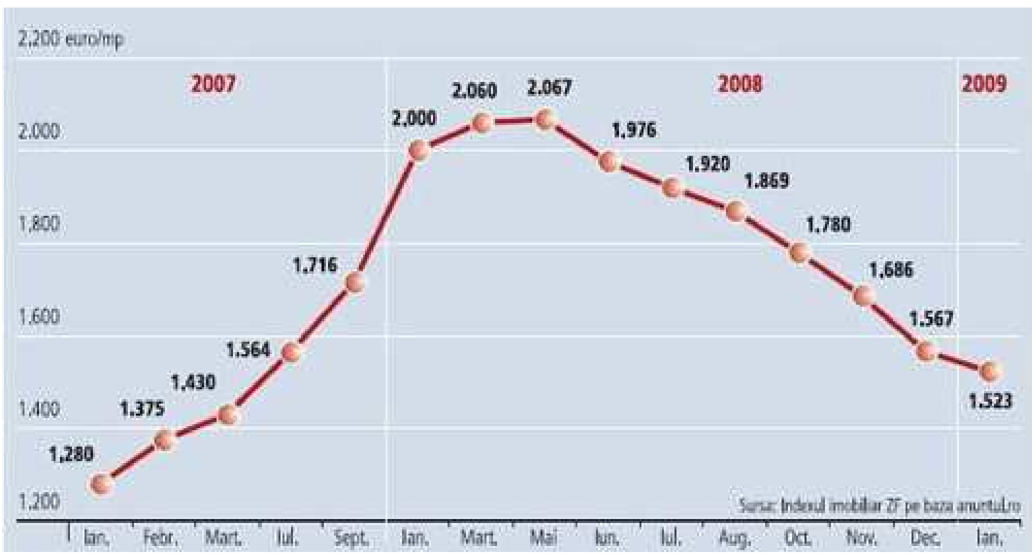
Mostly formed of luxury areas, prices in the 1st district decreased least in the previous year, by only 19%. It remains the most expensive district, with a medium price of 1.855 Euro/sqm*. The other districts decreased with appreciatively the same percent, 25% in December as compared with January.

Table 1: Old residential prices by sector conf to BREI-v (Bucharest in 2007-2008)

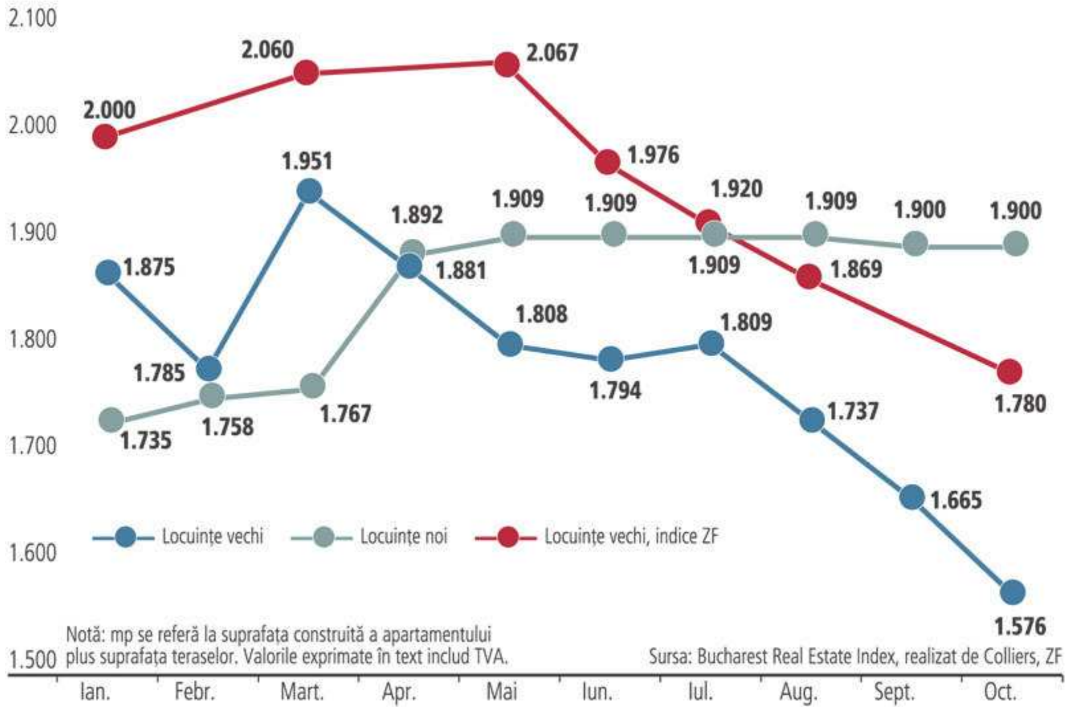
	2007				2008											
	ian	apr	iul	oct	ian	feb	mar	apr	mai	iun	iul	aug	sept	oct	noi	dec
BREI V	1,241	1,312	1,429	1,599	1,875	1,785	1,951	1,892	1,808	1,794	1,809	1,744	1,665	1,576	1,438	1,400
Sector 1	1,514	1,418	1,686	2,080	2,297	1,978	2,359	2,245	2,208	2,061	2,250	2,285	2,022	1,878	1,818	1,855
Sector 2	1,151	1,229	1,276	1,477	1,777	1,712	1,843	1,794	1,637	1,584	1,685	1,540	1,521	1,501	1,386	1,306
Sector 3	1,185	1,343	1,406	1,580	1,848	1,807	1,920	1,840	1,870	1,891	1,867	1,767	1,660	1,612	1,424	1,397
Sector 4	1,273	1,498	1,663	1,718	2,034	1,941	2,096	2,069	1,948	1,995	1,955	1,929	1,856	1,760	1,588	1,582
Sector 5	1,331	1,235	1,348	1,477	1,776	1,715	1,847	1,829	1,716	1,661	1,698	1,595	1,585	1,489	1,365	1,290
Sector 6	1,175	1,171	1,310	1,419	1,680	1,614	1,798	1,737	1,589	1,612	1,525	1,514	1,484	1,310	1,199	1,135



Graphic 4: Comparative price evolution sectors conf BREI (2007- 2008)



Graphic 5: Price evolution 3 rooms apartments in Bucharest according to sell prices registered on anuntul.ro website (Jan 2007 – Jan 2009)



Graphic 6: Comparative price evolution on old and new residential in Bucharest according to BREI-n, BREI-v and anuntul.ro (2008)

Conclusions and prognostics

Construction sector had a spectacular evolution in 2008 with an increase of 56% insolvencies. But also, the same sector in Romania had the biggest increase from UE, 16.1% in 2008. The increase was due to a large number of residential and commercial projects launch in 2007 and Q1 2008 witch generated an important business volume in the first part of 2008, as the crisis reached Romania later then the rest of EU.

Real estate transaction sector brought a 31% insolvencies increase in 2008, showing crisis begging witch will advance with the first part of 2009. UNNPR indicates 123.392 real estate transactions in 2008 and a DTZ Echinox study estimated that they fall by 45% in 2008 comparing to 2007. The first part of 2008 registered already a decline of residential transactions, mainly due to price level witch seemed to reach a braking maximum point.

External financial crisis shock waves combined with price levels in Q2 2008 and low bank credit toward developers got to a blocking residential market with Q3 2008. In this context, NBR's change in credit policies – increase - towards population (with effect on mortgage loans) in Q4 2008 had a powerful influence on this market, without baring the one fault for it.

Residential market crisis was to be an upcoming moment in Romania, due to price level and speculative market character. This anticipation of it, due to external crisis contamination brings not only an important price reconfiguration (20-50%up to April 2009) but also the overall market reconfiguration and maturity, with a decreased in developers number but an increase in their quality offer.

Prognostics. Even if prestigious real estate consultants have pessimistic prognostics over the residential Romanian market, (four years), associating it's manifestation to the one in Asia, we consider decisive for Romania's case the offer/demand rapport, witch hasn't been saturated on either dimensions.

Demand. The most affected by the demand were the investors , witch freezed their aquisitions due to financing problems and descending price expectation. This fact determins a gap beteen the existing offer and the potential demand on new appartments segment. The gap is enlarged by the last estimations of an up to 70% aquisitions by investors during 2005-2007. Consequently, the demand market will be on the future dominated by final and it shall register a diminueshed volume (2000 units per year in Bucharest).

Mainly for the final consumer, the demand depends by good bank credit offers. Theoretically, as an effect of lowering the reference interest rate by NBR, successively in February and May 2009,from 10,25 to 9.5 % (and we estimate 9% by summer 2009) the credit rates (including mortgage credit loans) should go down. But, as lately banks have already diminished credit rates in order to re launch credit market, a new one is not to be predicted unless the minimum mandatory reserve is to be kept at the same level by the NBR. So, the effects of this February-May lowered rate by NBR is to take effect in bank's policies by Q3 2009, with full effect on T2-T3 2010.

Offer. New appartmens to be on sale will come from two sources. The main will remain direct sales from developing projects. This part of the offer is to be restricted to 6,000 – 7,000 de units (forseen to be delivered in the next 12-18 mounts) compaired with the 12,000 units anounced (Octombrie 2008), as developers should prospone projects or fases of them. Those urged to move in a new apartment will have acces to a second selling source: the appartments put on re-sale by investors witch seek a fast excape from the market and by the final users witch give up their appartments due to financing problems. This new source is to bring on the market up to 5,500 de apartaments in finished or almost finished apartmens.

Medium pesimistic scenario (of the offer absortion). The scenario who sees the investors re selling their residential products, determining continuous moderate descending prices. and market rehabilitation in four-five years, when the actual offer would be absorbed, considering that the announced projects in 2008 were mainly suspended.

Optiomistic scenario (of the market psichology). An optimist scenario estimates the residential market will start the process of revitalization by Q4 2009 – Q2 2010, when the great demand will be sustained by good bank credit loans. This scenario bets on the buyer physiology of “catching” the price curve’s minimum; when that should be felt of being close, the hold actions until now should manifest. As the actual prices are perceived to be determined mostly by psychological reasons not by the real offer/demand balance. It is unlikely that during this period another important residential project would be launched. There will come a period of stabilizing the market and finalization of the projects in an advanced stage of construction.

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