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Dealing with the Challenges of Capital Inflows: The case of Romania

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Abstract: In the context of the global financial crisis, many emerging countries experienced a significant degree of volatility in the foreign capital inflows. Sudden stops of capital inflows and increases in risk premia caused significant negative consequences to their economies. In this paper was examined the Romanian case. Were identified the main challenges which had been brought by the massive capital inflows to real and financial sectors of domestic economy and were examined policy-makers responses to maintain macroeconomic and financial stability of the country.

Keywords: capital flows, liberalization, real exchange rate, inflation, macroeconomic stability

1 Introduction

Massive capital inflows can be a real challenge for the recipient economies. Benefits and cost of the capital account liberalization have been a controversial subject in economic literature for many years. Some authors considered that foreign capital inflows can stimulate the economic and financial development of the recipient country (Mishkin (2008). Others looked at the massive capital inflows as a potential source of macroeconomic disequilibrium (Rodrik and Subramanian (2009)).

In my study I showed that, on the one hand, massive capital inflows contributed to the sustainable long-run growth of the Romanian economy and development of the financial market, but, on the other hand, determined a build-up in the financial and economic country fragility.

The paper was organized as follows: in first section were highlighted the main determinants of the capital inflows into Romania. In the second section were analyzed the challenges of the massive capital inflows and finally were examined the Romanian central bank actions oriented to prevent the economic and financial fragility of the domestic economy.

2 Main determinants of the capital inflows into Romania

The main determinants of the capital inflows into Romania were: financial account liberalization, favorable macroeconomic context, abundant liquidity in high developed countries and large interest rate differential between domestic and foreign interest rates.

In Romania financial account liberalization was realized in three stages. First, the foreign direct investment flows were liberalized in 2001, then, in order to prevent potential disequilibrium into domestic economy, due to large inflows of the speculative capital, were liberalized the portfolio investments in 2005 and 2006.

As we could see from the figure below, massive capital inflows in Romania started in 2004, the net foreign investment position growing steadily in 2004-2007.

We can see from the figure below that, the foreign direct investment was much superior, than the portfolio investment. In 2006 and 2008, the foreign direct investment had two of about 9 billion euros, due to the privatization process of some large industrial companies.

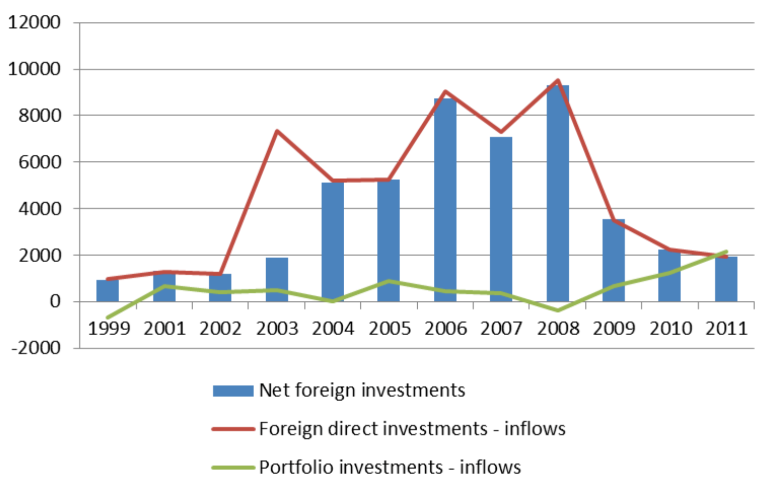

Figure 1
Composition of the capital inflows (mln. euros)

The portfolio investments growth was relatively moderate during the analysed period of time. Due to higher sensitivity to shifting conditions in the global buiness cycles and global risk tolerance, a fast growth of this type of invetments can be noticed only in the last three years, in the context of the international financial crisis.

The massive capital inflows were favourized not only by the capital account liberalization, but also, by the macroeconomic context. Romanian economy had made some important progresses by 2003. The growth rate of the domestic product exceeded the average growth rate of the United States and Euro Zone countries; the share of the gross external debt in GDP, was below the level of 10%; the annual inflation rate decreased substantially from 45, 80% in 1999, to 23,8% in 2003 and to 11,87% in 2004. Also, the current account deficit not exceeded the level of 10% in GDP, in 2003 and 2004.

Also, the abundant liquidity in high developed countries and low interest rates determined foreign investors to look for high yield in emerging economies.

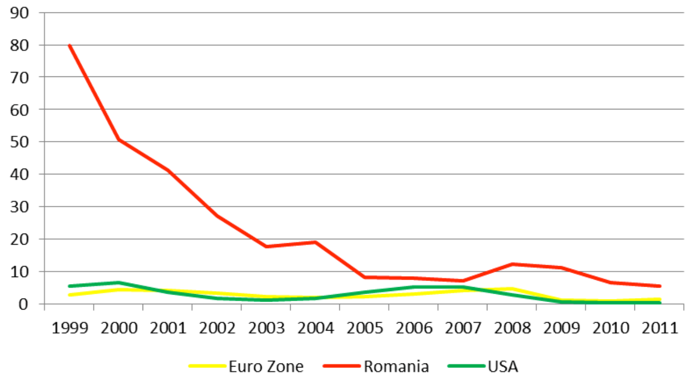

Figure 2
Nominal interest rates (%)

As we can see from the figure above, before 2004 existed a large spread among the nominal interest rates in Romania, United Stated and Euro Area, which determined foreign investors to invest massively in Romanian economy.

3 Challenges of the massive capital inflows

Large capital inflows can bring many benefits to the beneficiary countries: allow countries with limited saving rates to finance productive investments, contribute to the development of the domestic financial markets, foster economic growth in the long-run and enhance consumption smoothing,

But, besides many benefits, a surge in capital flows can, also contribute to: economy overheating, loss of external competitiveness through excessive appreciation of the real exchange and build-up of the financial sector fragility.

Often a composition of the capital inflows was a source of concern for recipient economies.

Is considered that foreign direct investment can faster the productivity growth and contribute to sustainable long-run growth of the domestic product. The foreign direct investment (fdi) are ussualy concentrated in the productive sectors of the economy oriented to exports. A significant inflow of fdi, ussualy stimulates the imports of new technologies and ”know-how”, extending the productive capacity of the companies in the tradable sector. The portfolio investment are considered more volatile and more dangerous to the recipient economy, because their major driver is a high spread between interest rates in advanced and recipient countries and this volatility can translate into significant macroeconomic volatility in the domestic economy. (Ghosh, 2010) Also, portfolio investment, unlike foreign direct investment, have a larger impact on the demand for non-tradable goods. Due to the fact, that supply of non-tradable goods is less flexible, the prices will growth, in order to offset the increasing demand. According to Harrod-Balassa-Samuelson effect, the price growth in the non-tradable sector can contribute to the excessive appreciation of the real exchange rate and rise of domestic inflation.

In Romania, in 2003-2009, the foreign direct investment flows made up the largest chunk of total inflows. As we can see from the figure 1, domestic economy exposures to the macroeconomic volatility risks increased only in the last two years (2010-2011), in the context of significant deacrease of the foreign direct investment and raise of the portfolio investment.

Also, capital account liberalization can stimulate excessive credit growth. External borrowing by domestic banks allow them to expand their credit activity at lower costs. The possibility to borow at lower cost, will stimulate the consumption, investment and finally the asset price booms. A raise in the asset prices, in turn can increase the wealth of the borrowers, which can be used as a collateral for further borrowing. A growing demand for credits in foreign currencies, on the one hand, will stimulate banks to increase their borrowings from abroad, fuelling the currency and maturity mismatches in their balance sheets, and on the other hand will determine banks to raise their exposures to risky sectors of the economy, increasing in this way the external vulnerability of the financial sector of domestic economy.

Massive capital inflows are challenging for the economies with low levels of the financial depth. In Romania, the financial depth (M3/GDP) was relatively low, being about 28% in 2003-2004, compared to the level of 71,76% in USA, 40% in Poland, 54% in Czech Republic, and 48% in Hungary. As a consequence, rapid capital inflows had a significand and imediat effect on the macroeconomic outcomes of the Romanian economy.

As we can see from the figure below, in the period of increased capital inflows into Romanian economy, the domestic credit had a very high rate of growth, especially in the private sector of economy, due to the appreciation of the leu and accessible financing from abroad ar lower costs.

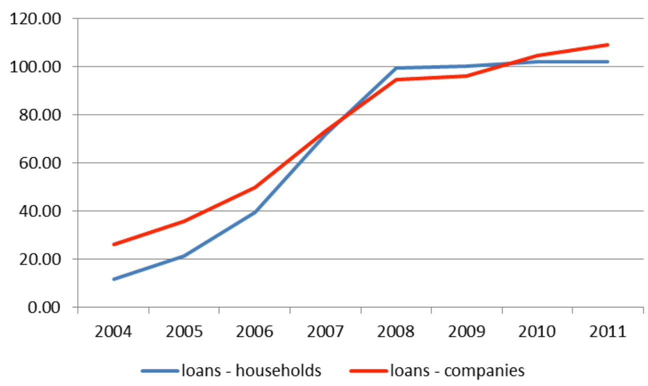

Figure 3
Private loans (mld. RON)

Also, as we mentioned above, in order to increase their profits, banks raised their exposures to the riskiers sectors of the economy and accumulated important portfolios with non-performing loans.

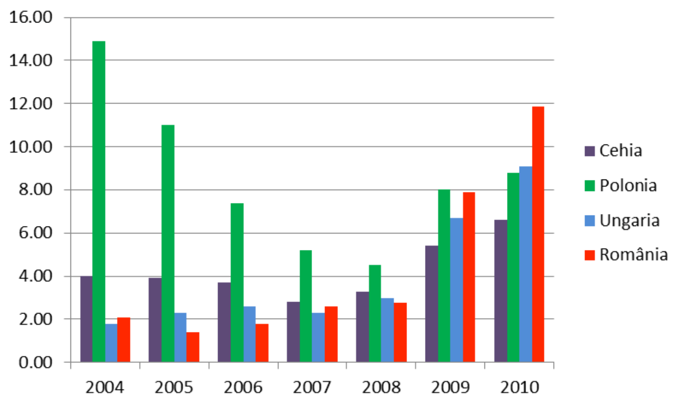

Figure 4
Share of the non-performing loand to total loans (%)

In Romania, the share of the non-performing loans increased substantially in the last two years (2009-2010), due to the accumulation of the large expossures of the banks to the riskiers sector of economy, before the financial crisis and leu depreciation.

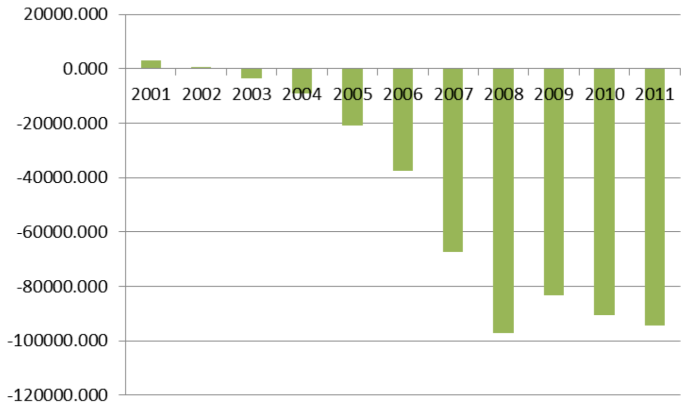

Figure 5
Net foreign assets commercial banks (mln. RON)

Also, in this period of time the net foreign asset position of the commercial banks, deacreased substantially and the growth rate of the banks foreign liabilities exceeded the growth rate of the total foreign assets.

4 Policy actions

Given the potential implications of the foreign capital flows on the macroeconomic stability of the real and financial sectors of economy, Romanian central bank actions were guided by the following objectives: to prevent economy overheating and potential build-up in financial sector fragility and to avoid an excessive appreciation of the leu, which would affect negatively the external competitiveness of the country.

In order to deal with large capital inflows, central banks usually have the following options: appreciation of the national currency, interventions on the exchange market and adjustment of fiscal and monetary policies.

Therefore, to avoid macroeconomic disbalances in real and financial sectors of economy, Romanian central bank used a mix of all three options, described earlier. The main challenges for the policy-makers were the external competitiveness of the Romanian economy and implementation of the inflation targeting strategy.

During the period of large capital inflows, the central bank gradually appreciated leu by the amount which would not affect significantly the external competitiveness of the country, but also, was forced to allow a gradual appreciation of leu, to avoid excessive costs and high risks, determined by large sterlized interventions in the foreign exchange market.

From the figure below we can see that in 2004-2007, the nominal exchange rate of the leu relative to the American dollar and euro, appreciated significantly.

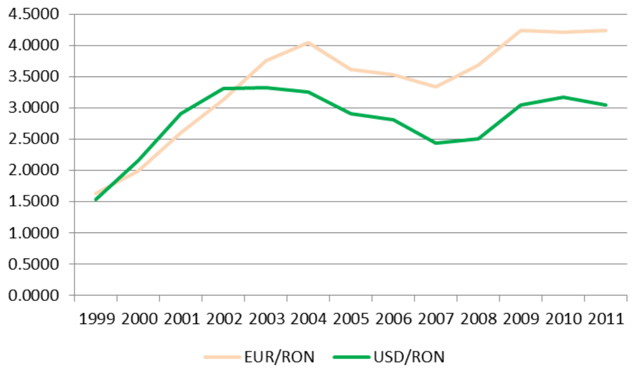

Figure 6

Nominal exchange rate of RON relative to USD and EUR

Also, in the period of large foreign capital inflows Romania accumulated an important stock of foreign exchange reserves, which started to increase steadily from 2004, indicating large interventions of the central bank on the foreign exchange market. To avoid inflationary preassures were used the sterilized interventions on the foreign exchange market.

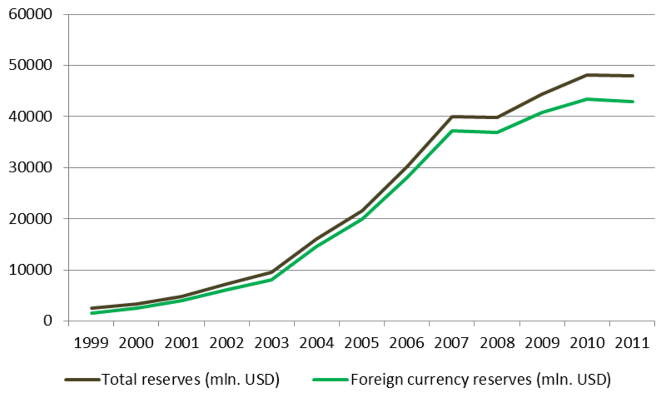

Figure 7

Stock of official international reserves (mln. USD)

To discourage growthing capital inflows central bank raised gradualy from 20% in 2002 to 40% in 2006, the ratio of reserve requirements for bank's foreign currency-denominated holdings, and undertook some measures to reduce the spread between domestic and foreign interest rates. From the figure 1 we can see an alignment of the domestic and foreign interest rates in 2005 – 2007.

After sharp decrease of the capital inflows in the context of international financial crisis, the adjustment of the Romanian economy followed the scenario proposed by Reinhart and Reinhart (2008). The real effective exchange rate depreciated by 5% in 2008 and by 7.5% in 2009, the annual growth of GDP declined sharply in 2009 by 8.5%, inflation raised to 7.84% level in 2008 from 4.83% in 2007, after wich declined to 5.58% in 2009 and the current account deficit, relative to GDP, declined from 13.63% to 11.85% in 2008 and to 4.31% in 2009.

In the context of large amount of the current account deficit and net foreign liabilities of the domesic banks, increasing external debt and declining GDP growth, the foreign investors wilingness to invest declined noticeably. Lower infows of the foreign capital and supraevaluation of the leu during the period of large capital inflows, led to the depreciation of the domestic currency. To prevent sharp depreciation of the leu and, consequently, the inflationary preasures and a build-up in the financial fragility of the domestic banks, the Romanian central bank interventions on the foreign exchange market increased considerably.

But, as we can see from the figure 7, the amount of the official international reserves did not declined sharply, on the one hand due to the additional financing received from International Monetary Fund and European Union and, on the other hand to prudential strategy chosed by the central bank: to correlate the amount of interventions with the position of the current account balance, holdings of the official reserves and liquidity on the monetary market.

Conclusions

As we could see, massive capital inflows besides some benefits, can create a range of significant risks to the recipient economy.

For Romania, large capital inflows contributed to the development of the productive sector of the economy and financial market, but also, bringed many challenges for policy-makers.

As I showed, during the period of large capital inflows, increased the fragility of the financial sector due to excessive expansion of domestic credit and accumulation of large portofolios with risky loans, by commercial banks. Also, blowed-up consumption and investments, which sustained the risk of economy overheating.

From the exchange rate and monetary policy decisions, we could see that the National Bank of Romania opted for prudential strategy, considering the stability of financial and real sectors of domestic economy as the main priorities. Bur, although the Romanian central bank was cautionary in its policy decisions, the macroeconomic shocks were not avoided entirely, but their damages to the domestic economy were not disastrous.

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