

FINANCIAL STABILITY OR ECONOMIC STABILITY?

Prof. Ana POPA, PhD

Assoc. Prof. Laura GIURCĂ VASILESCU, PhD

University of Craiova

1. Introduction

As first aspect, there are still many difficulties in the analysis and administration of the economic-financial correlations, thus it is not easy to appreciate when a financial crisis generate or put out an economic crisis or if an economic crisis generate a financial crisis.

The second aspect is that the crisis phenomenon manifest synergetic, thus the deterioration in the macro and micro-financial environment is joined by reduced growth prospects.

The evolutions indicate that an economic crisis is more comprehensive than a financial crisis and a correct analysis underlines the fact that the present day crisis is more serious, because it is generated by a combination of economic and financial causes, but also social and political ones.

<Economic stability versus financial stability> is one new vision post-financial crisis. European Union has underlined the numerous recovery measures in order to support the real economy. In addition, there is the Nobel winners' vision in 2009 – E. Ostrom and O. Williamson - about our overconfidence in institutions that are important to the functioning of the economy and about the present day economic governance.

2. Financial stability against the crisis

The concept of financial stability has gained new importance, considering the geometric growth in the size of financial

transactions, and the ever increasing costs of financial crises.

The first finding is that it has always been easier to consider that the mistakes from the financial field caused the economic crisis.

The reasons behind the problems within the financial systems of advanced countries were:

(i) the significant liquidity surplus in the context of low interest rates which promoted higher risk taking for larger yields;

(ii) the development of financial innovations, without adequately understanding the risks assumed and without implementing adequate risk management methods;

(iii) the transparency of placements in innovative products, as well as the related regulatory framework were insufficient.

The financial crisis translated into a severe contraction of credit and loans to companies and households. The main drivers were the negative economic outlook, but also the impact of banks' ability to obtain financing in the market. At the same time, the slump in business and consumer confidence contributed to decreasing the demand for credit and loans. The tightening of credit standards for loans to enterprises in the euro area increased significantly in the third quarter of 2008 (by 22 percentage points from the previous quarter to 65%).

The Financial Stability Forum (FSF), consistent with the statement by the Basel Committee on Banking Supervision, notes that recent market reactions regarding capital levels have

been highly procyclical [8].

Currently, in the European Union and Romania there is a concern for aggressive action against financial instability.

Central banks responded in a timely manner [2]. The immediate measures consisted in the followings: the emergency provision of liquidities, the resort to new financing facilities beyond those provided via current monetary policy operations and, in some cases, the cut (aggressive, in the case of FED in USA) of monetary policy rates.

Members of the Financial Stability Forum reaffirmed the commitment of their governments to support systemically important institutions.

Important is to restore stability to financial systems and promote credit extension, with a particular focus on measures to recapitalize financial institutions and strengthen balance sheets. The FSF will continue to monitor the impact of these measures both within and across jurisdictions and seek opportunities to promote the consistency of these actions.

3. Investment collapse on the real economy in European Union

The crisis has hit investment activities severely. The EU Commission's Spring 2009 forecast [6] points to a contraction of 10.5% in 2009 in the EU, following a flat growth in 2008; investment growth is also forecast to remain negative in 2010 (-2.9%). (See the Figure 1).

The fall is particularly acute in equipment investment (-16.4% in 2009 and -3.6% in 2010 in the euro area), though growth in construction investment will also remain in the red (with an expected contraction of 6.5% in 2009 and of 2.5% in 2010). As a result, the current fall in total investment growth is more severe than in previous downturns.

Specifically, investment in equipment has been hit by weakening demand, reduced availability of funding and

waning confidence. In turn, investment in construction is negatively affected by the large downturn in the housing market, particularly in Member States. All in all, the expected slump would have been higher had it not been for public investment stimulus measures. Indeed, public investment in the EU is forecast to reach 2.8% of GDP in 2009.

Short-term prospects are not particularly promising and the managers expect weak demand for some time, which could translate into further reduced investment. Although some confidence indicators have improved in 2010, they still point to continued weakness in economic activity.

4. The European Economic Recovery Plan to support real economy

For Romania, are very important the EU measures. The European Economic Recovery Plan (EERP) has recognized the need for public intervention to support of businesses during the crisis for several reasons.[7]

It is recognized that, beyond the measures to restore the normal functioning of credit markets, which remain distressed, additional government intervention, can help ease the specific financing constraints facing companies. Also government may have a role in providing or supporting specific credit services (e.g. export credit insurance) which markets are temporarily unable to provide, at least at economically viable conditions and prices.

Among the measures classified as supporting real economy, and first of all, industrial sectors, business and companies, two thirds aim at **easing financing constraints for business** (see figure 2). These comprise the extension both in terms of volumes and conditions of credit guarantees, including export credit, particularly for SMEs and the increase in the capital of public development banks to bring this about; easing conditions for access to and

repayment of loans; temporary tax reductions and exemptions; and changes in depreciation rules favoring SMEs.

Sectoral measures (both demand support measures and direct subsidies) account for almost one quarter of total number, but are concentrated in a number of Member States with industries that are particularly hard-hit by the crisis.

Sector-specific demand support is provided through temporary tax breaks, permanent changes, and other financial incentives for purchases of sector-specific products in support of environmental and innovation policy objectives; easing regulatory requirements and financing conditions for homeowners and first-time buyers; sectoral liberalization measures; and the handout of coupons for the consumption of certain goods and services.

Sector-specific supply measures (including direct subsidies) provide direct financial support, such as tax reductions and direct state aid payments as well as measures aiming at complementing the deterioration of financial conditions (guarantees and loans with subsidized interest rates) .

Non-financial business support (e.g. regulatory reforms) relate mainly to the reduction in administrative burdens for businesses, in particular SMEs, but also to the provision of advice services to business in export activities and trade fair participation.

5. <Economic stability versus financial stability>

In the last ten years, it saw a dramatic shift in influence away from entrepreneurship in the real economy to speculation and gambling in the financial sector. This causes serious problems at once for the real economy, and later on for the social economy as well.

Many economists and ECB show that the current IMF approach asking for pro-cyclical policies in crisis countries is inadequate [4].

The United Nations Conference on Trade and Development (UNCTAD) has long argued that multilateral coordination is the only viable solution.[5]. The idea of a cooperative global financial and monetary system would be to ensure, on a multilateral basis, the same rules of the game for all parties, just as multilateral trade rules apply to all trading partners.

The fiscal and monetary policies put in place to address the crisis worldwide are unprecedented in both scale and scope.

A new vision is about economic versus financial stability and price-level targeting versus inflation targeting.

The one lesson from the financial crisis is that all the actors have overconfidence in institutions that are important to the functioning of the economy. [3]

The research of the winners of the Nobel price in 2009 – E. Ostrom and o. Williamson- reveal how critically important it is to understand these so-called non-market institutions such as companies, governments, regulators and courts.

Concretely, Ostrom showed how common resources — forests, fisheries, oilfields, grazing lands and irrigation systems — can be managed successfully by the people who use them, rather than by governments or private companies.

Williamson is focused on how companies and markets differ in resolving conflicts. He found that companies are typically better able than markets to resolve conflicts when competition is limited.

One new point for consideration that has emerged from this crisis relates equally to ethical, social and political aspects. [5]

6. Conclusions

European Central Bank underlined that the key challenge in order to reinforce sustainable growth and job creation is to accelerate structural reforms. In particular, reforms are

urgently needed in the financial sector, where an appropriate restructuring of the banking sector should play an important role.

UNCTAD has long argued that multilateral coordination is only viable solution.

A new economic philosophy is about the economic stability versus the financial stability, but the financial crisis put pressures on the every management functions. It has underlined that the investment decisions should be close connected to financing.

European Union – EU and International Monetary Found –IMF have instituted a new vision, especially, about the planning and controlling.

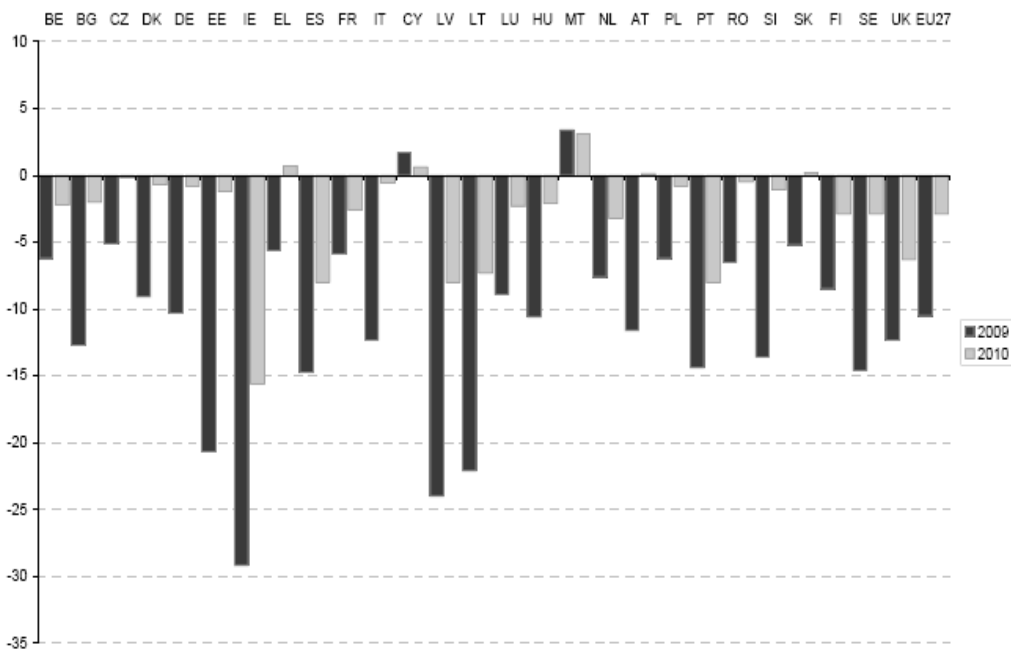
For Romania, the great problem is that the Romanian economic boom led to overheating and unsustainable imbalances.

The important idea is that EU and IMF-supported program for Romania combines strong policy measures with sizable financial support, and social protection.

Romania is in a contradictory position because, on one hand, it has an emergent economy, vulnerable to crisis, but, on the other hand, it can absorb the new practices, overtaking the old stages.

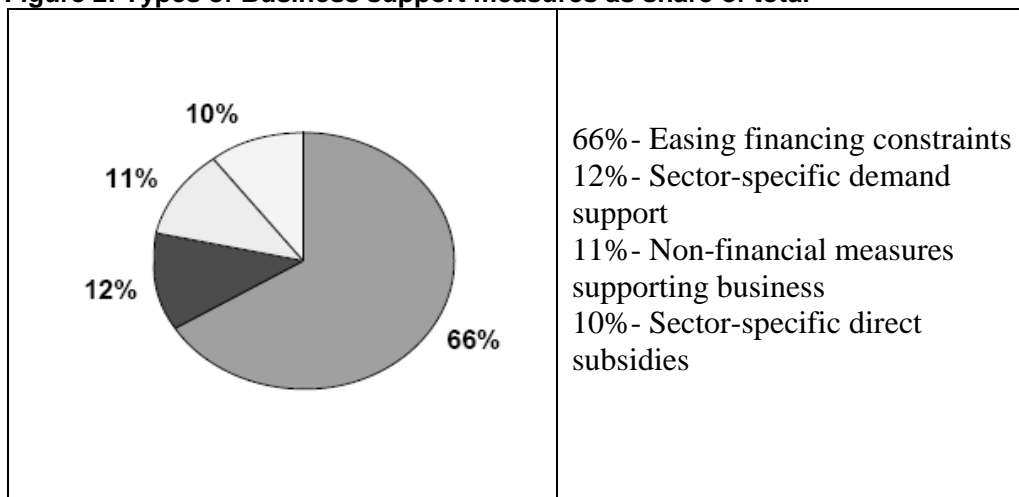
A coherent policy mix is essential for a smooth restoration of macroeconomic equilibrium.

Figure 1: Total investment, volume (% change)



Source: Commission's Spring 2009 Economic Forecast.

Figure 2: Types of Business support measures as share of total



Source: European Commission, *The EU's response to support the real economy*, 2009.

REFERENCES

| | |
|--------------------------------------|---|
| Giurcă Vasilescu L., Popa A., (2008) | <i>Profitability and Risks of the Romanian Banking System</i> , Annual Journal issued by the Faculty of Economics, Skopje, Macedonia, 2008, TOM 43, pp. 113-125; |
| Popa A., Băndoi A. (2009) | <i>The financial stability problems and the Romanian monetary policy</i> , Journal of International Scientific Publication, Economy & Business, Volume 3, Part 2, p.209-216; |
| Popa A., Giurcă Vasilescu L., (2007) | <i>The Binomial Democracy-Sustainable Development between Macro and Micro Decisions</i> , Annuaire de l'Universite de Sofia "St. Kliment Ohridski", Journal of the Faculty of Economics and Business Administration, volume 6, 2007, p.253; |
| ***** | European Central Bank (2009) <i>Annual Report 2009</i> ; |
| ***** | UNCTAD (2009), <i>The Global Economic Crisis: Systemic Failures an Multilateral Remedies</i> , Report by the UNCTAD Secretariat Task Force on Systemic Issues and Economic Cooperation, New York and Geneva, 2009; |
| ***** | European Commission (2009), <i>Economic Forecast Spring 2009</i> , European Economy, 3/2009; |
| ***** | European Commission (2009), <i>The EU's response to support the real economy during the economic crisis: an overview of Member States' recovery measure</i> , Occasional Papers 51, July 2009; |
| ***** | Financial Stability Board (2008), <i>Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience</i> , available at www.fsforum.org . |