The compulsory full liberalization of the capital account of Romania has been undertaken with EU Accession Treaty and put into practice since September 2006. This allowed free entry of capital in the Romanian economy, the financial sector being the main beneficiary. Moreover, the central bank decided to stop using the lever prudential and administrative measures employed to mitigate the growth of private sector credit (reserve level policy). The effect of these measures was the excessive growth of the private sector credit volume in Romania. The objective of this paper is to present the consequences of these actions, the ultimate goal being to identify induced risks to the stability of the financial system.

Key-words: capital account liberalization, risks, capital inflows

1. Introduction

About the causes and mode of transmission of a crisis Luc Laeven and Fabian Valencia state that "some crisis proved to be very contagious, spreading to countries apparently non vulnerable. Among the many causes of financial crises there have been a combination of unsustainable macroeconomic policies (including large current account deficits and unsustainable public debt), excessive credit boom, large capital inflows, the fragile balance of payments, all combined with a paralysis policy, leading finally to multiple political and economic constraints (1)."

Romania seems to have fully met the above scenario. A result of an erroneous policy, the macroeconomic development in Romania was totally inadequate. Romania's economic growth during 2005-2008 has been not fueled by external demand (exports), as it would have been desirable, but by domestic demand (population consumption, government consumption and largely unproductive investments). Such an economic growth model leads to overheating and favours the development of an environment suitable for the emergence of major risks to macroeconomic stability. In a speech at the Royal Academy of Economics and Finance, on February 21, 2008, BNR Governor, Mugur Isarescu, pointed out that "one of the main channels leading to overheating of the emerging economies is the credit, given the dominance of banks within the financial system and increased volume of capital accessible after removal of restrictions on capital account (2)."

The present study aims to present the impact of capital account liberalization on the Romanian economy. The paper is divided into three chapters and conclusions. Chapter 1 summarized the Romanian economy's vulnerability to the current crisis. Consequences of capital account liberalization and induced risks to the Romanian financial system stability is presented in Chapter 2. In Chapter 3 are compared various opinions about the Romanian capital account liberalization.

2. Consequences of capital account liberalization and induced risks to the financial system stability

Capital account liberalization has been achieved since September 2006 (action stipulated in the EU Accession Treaty), which established the legality of foreign capital inflows, being possible making investments in a transparent. Until then, capital arrived in the country in the form of deposits especially through SPV (special purpose vehicles) which were actually legal entities established in order to exploit capital in Romania (3). Following capital account liberalization there was an increase in the foreign direct investment (FDI) in Romania, the main beneficiary being the financial sector. The maximum level in this sector was recorded in 2007 (Chart 1).
At the same time, the central bank decided to give up in the first quarter of 2007 to use the leverage prudential and administrative measures to temper growth in the private sector credit (reserve level policy). According to this BNR approach, ensuring the appropriate level, in next period, of monetary conditions would be achieved only through specific monetary policy operational framework of inflation targeting strategy, the main contributions being those of the real interest rate developments and real exchange rate dynamics of the national currency (4). Following the measures taken by the central bank in the upcoming period, both targets, inflation and exchange rates, have been missed, although in 2007 the best values were reported. Excessive growth of private sector credit has resulted in stimulating aggregate demand, which on a short term, lead to inflation (Chart 2). Much of the demand due to credit expansion, unable to be met by domestic supply, led to increased demand for imported goods. Thus there were pressures on the exchange rate (Chart 3).
Capital account liberalization and central bank decision to abandon the use of leverage prudential and administrative measures were passed to the net position of non-banks clients in relation to the banking system. Thus, in 2007, households and firms have become net borrowers of banking, loan / deposit ratio reaching 125 percent in 2008 (chart 4).

If we look at net position of population towards banking sector depending on the currency denomination (Chart 5) we see two things: population net creditor position until mid-2006 for both RON and foreign currency, followed by changing position in foreign currency (February 2007 - net debtor), which resulted in a change in total net position (debtor). Foreign currency credit growth rate represents a serious risk to macroeconomic stability of Romania as threatens the central bank monetary policy, its efficiency being changed inversely with the size of this component of the non-government credit.
The net debtor position of the private sector is due to investment credits, mostly unproductive (real estate and durable goods). In the chart below we can see the high share of non-financial assets in the total assets of the population, the maximum value being reached in 2007. Increasing the value of these assets has stimulated supplementary the crediting because many of these assets served as collateral for bank loans and therefore have increased the ability to lend of the firms or people.

Figure 6. Household net wealth

The result of this analysis is the identification of a vicious circle of bank credit stimulated by foreign capital entered in Romania as a result of capital account liberalization. Schematically it can be illustrated as in Figure 1.
Increase of lending stimulate aggregate demand for goods and services leading to inflation. Much of the demand due to credit expansion, unable to be met by domestic supply leads to increased demand for imported goods, which causes pressure on the exchange rate. The result of the combined action of inflation and currency devaluation is to increase asset prices, which usually serve as collateral for securing new loans, thus increasing the capacity to borrow of the firms or people. Thus, lending is further stimulated by the appearance of new credit applications.

The major risks induced by such an investment model is due to the nature of capital flows that entered in the Romanian banking system and of the currency of denomination in which the private sector lending was done. In the 2004-2008 period, foreign investment in the banking sector was performed mainly through short term intra-group loans and the loans in foreign currency exceeds 60%. The speculative capital flows have widened the current account deficit and increased short-term external debt of Romania, these, together with the large size of foreign currency lending are some of the biggest risks to the Romanian financial system stability (6).

3. Opinions about capital account liberalization

Unpredictable behavior of capital flows in conditions where there is complete freedom of movement, affecting Romania fully once with onset of the financial crisis in 2008, the impact on the economy being disastrous: "during a single year the economic growth fell from 7% to minus 6.5%, capital flows were blocked, the currency depreciated rapidly, central bank reserves fell sharply, threatening the stability of the financial system" (9). Mugur Isarescu says that the financial system stability "has become a crucial component of macroeconomic stability, as the capital flows exploiting vulnerabilities of the financial system promptly punish errors or inconsistencies in economic polic" (10). As regards the possible negative implications on Romania due to capital account liberalization, Daniel Daianu said in 2004 that "the liberalization of operations for non-residents on the money market will increase considerably the speculative inflows, which is undesirable. [...] We have an interest in the financing the current account deficit to be done mainly through direct investment, not by speculative capital or short-term debt" (11). A different point of view about financial liberalization have Laura Kaminsky and Sergio Schmukler who believe that "financial liberalization is followed by booms only on short term. On a long-term institutions improve their work and financial markets tend to stabilize " (12). Isarescu’s solution to the problem of the volatility of capital flows "is the combination of macroeconomic policy, quality macro and micro prudential" (13). A similar view expressed José Viñals, director of the FMI, who emphasizes in his speech to a conference held at "Financial Integration and Stability" held on 2 May 2011 in Brussels that "no matter how performing macroprudential policies would be they can not be a substitute for good macroeconomic policies" (14).

Future research directions shall pursue studying the impact of capital account liberalization on the performance of the Romanian banking system
4. Conclusions

Romanian capital account liberalization has been achieved since September 2006 (action stipulated in the EU Accession Treaty), which established the legality of foreign capital inflows, investments being made in a transparent. The result was increase foreign direct investment in Romania, the main beneficiary being the financial sector.

The major risks to the financial system stability is due to the nature of capital flows that entered the Romanian banking system and currency of denomination in which the private sector lending was done. In the period 2004-2008 foreign investments in the banking sector were achieved mainly through short-term intra-group loans and the loans in foreign currency exceeds 60%.

Speculative capital flows have widened the current account deficit and increased the short-term external debt of Romania.

With pressing international financial crisis that has been affecting Romania since 2008 it increased the risk of potentially destabilizing capital outflows.

In circumstances in which capitals have full freedom of movement, the authorities should promote prudent and sustainable policies that offer foreign investors confidence in the economic outlook, necessary both in boom periods and in the recession, so they do not reduce their exposure to the host country.

References
(3) BNR Calet de studii 29, 2011, p. 13,17,18
(4) BNR Raport anual 2006, p. 35
(5) BNR Raport anual 2010, p. 34