

MONETARY POLICY AND THE BANKING INDUSTRY

Lucian Croitoru

ROUND TABLE DISCUSSION

Risk Management – Implications for Romanian Financial Institutions

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Bucharest

I. Some challenges to monetary policy in 2010 and 2011

Seemingly substantiated demands for sharp cuts in the policy rate

- Romania: output gap 7.2 percent
- CORE3 inflation: from 6.3 percent
in Dec. 2008 to 1.93 percent in Jan. 2010

Some developments might be reversed in 2010-2011

- Romania's growth expected to resume this year influenced by:
 - ✓ Renewed growth in the USA and other major economies
 - ✓ Increasing confidence worldwide
- Rebound in capital inflows

Are there real chances for capital inflows to recover? (I)

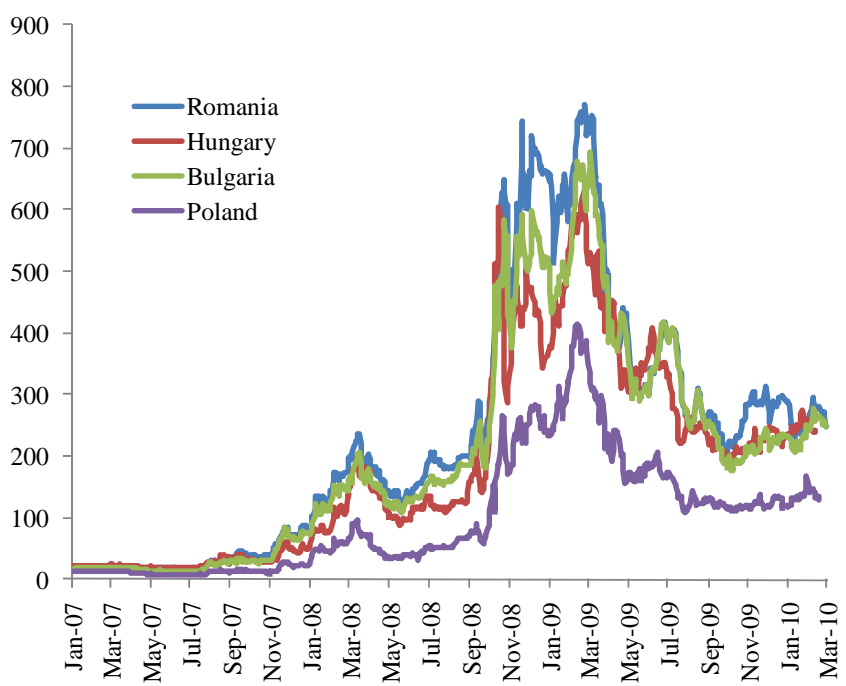
- The financial crisis corrected the global imbalances, but it is uncertain whether they are at trend
- Underlying determinants of imbalances still present:
 - ✓ In the US, the CA deficit has been narrowing over the past three years, but good prospects can reverse the saving process
 - ✓ In South-Eastern Asian economies more exchange rate flexibility is still needed
 - ✓ In the EU structural rigidities that hamper growth are present

Are there real chances for capital inflows to recover? (II)

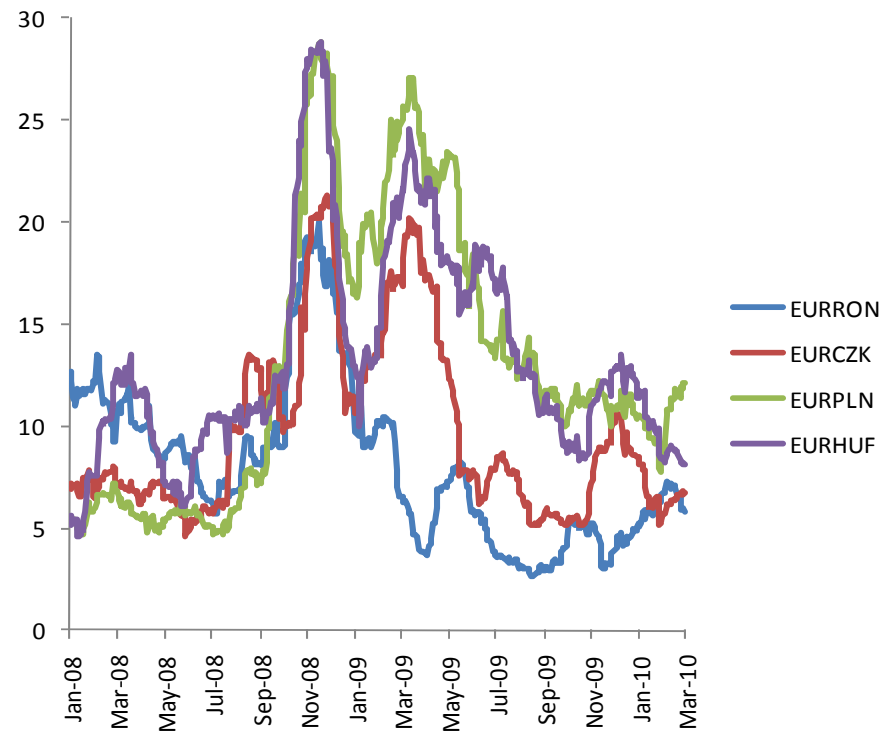
- Before the crisis, such a combination of structural factors generated capital inflow bonanza
- Its potential for capital inflow resumption is relatively high, given the huge monetary injections and a resulting abundant liquidity, which might stimulate the search for yield
- But a new factor emerges: GREECE

Risk perception in CEECs remains elevated...

CDS (basis points)



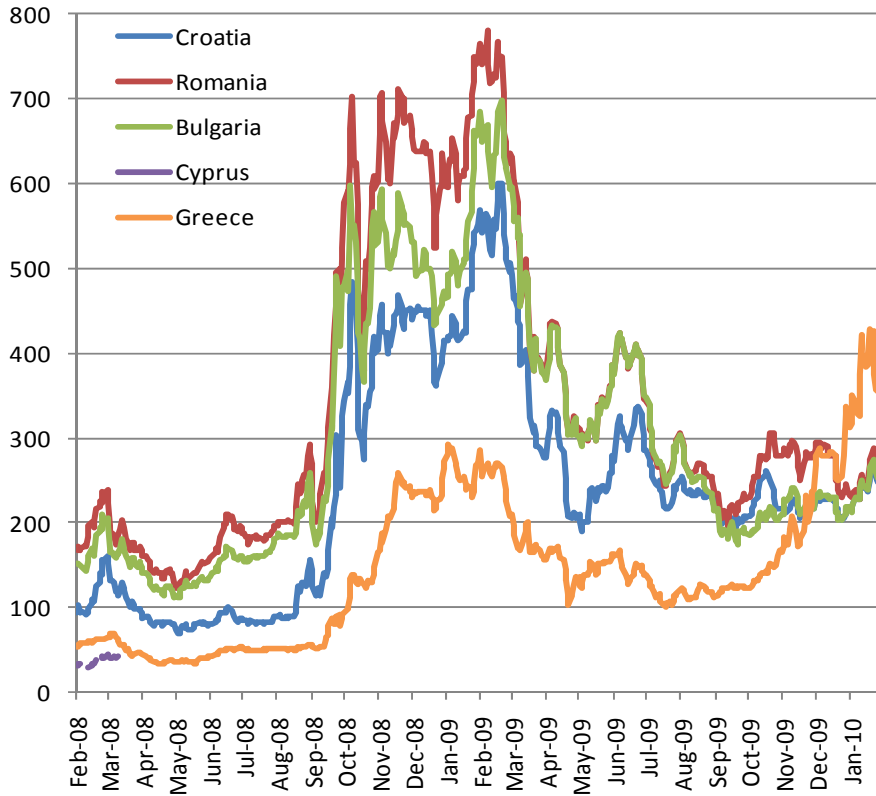
Annual exchange rate volatility (%)



Source: Bloomberg, NBR calculations

...and so it remains in SEECs...

CDS spreads for SEECs (basis points)



Source: Bloomberg

Rating changes since 2009

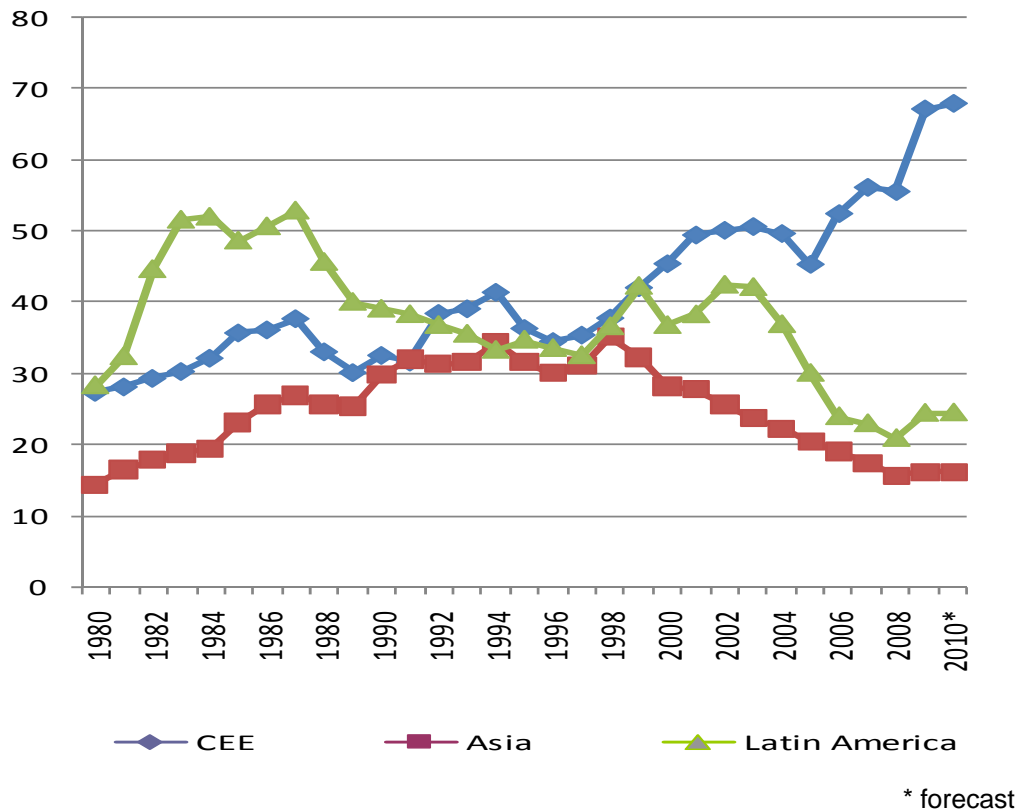
Country	Montenegro	Macedonia, Former Yugoslav Republic of
Date	4/30/2009	4/30/2009
Agency	Moody's	S&P
Rating change	from Ba3 to B1	from BBB- to BB
Outlook	Negative	Stable

Source: Bloomberg

Note: In red are negative changes

...mostly explained by large foreign debt and high dependence on external financing

External debt in emerging economies (% of GDP)



Source: WEO (October 2009)

Are there chances for capital inflows to recover? (III)

- Three arguments to be considered in relation to the budget crisis in Greece:
 - ✓ **Liquidity**: this is a problem and might determine Greek mother banks to repatriate funds from their Romanian daughters...

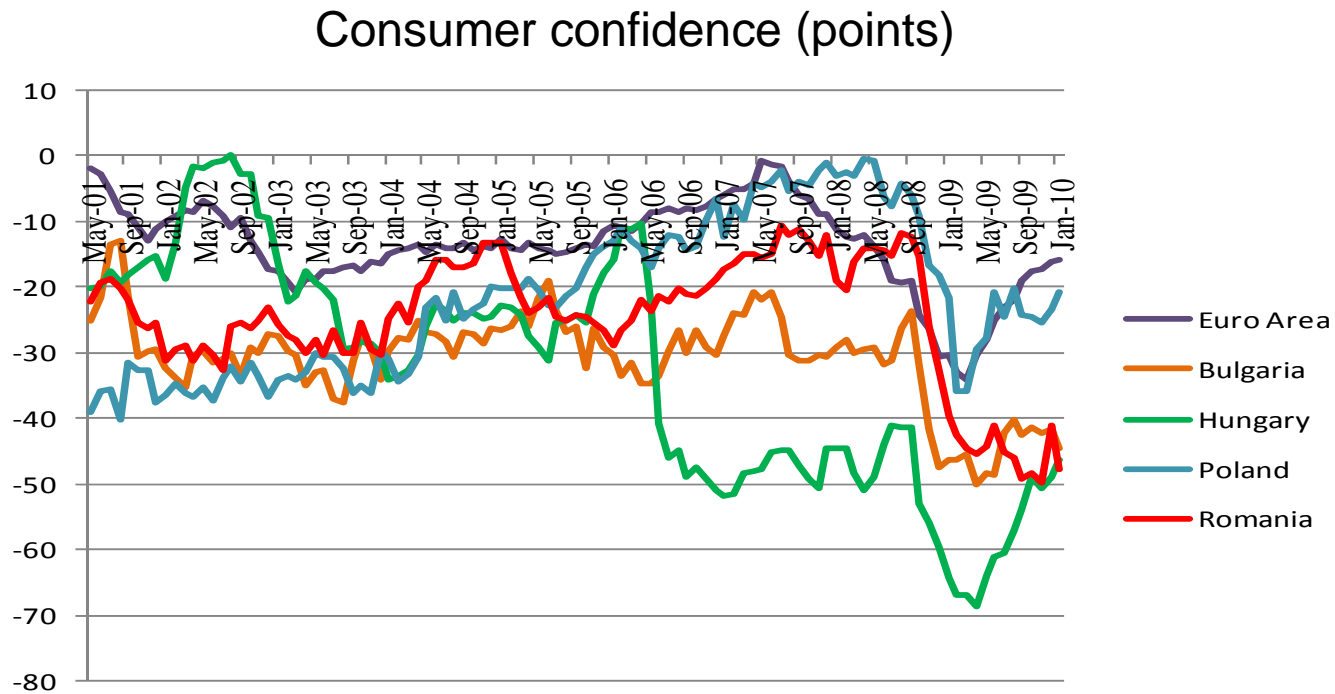
BUT:

- ✓ Romanian daughters are making **profits** in Romania
- ✓ **Costs of borrowing**: higher in Greece, as shown by CDS spreads

Are there chances for capital inflows to recover? (IV)

- There is a great chance for capital inflows to rebound in 2010
 - ✓ Exports are growing
 - ✓ Confidence is being restored
 - ✓ FDIs are estimated by “The Economist” at EUR 8 bn., but could be even higher
 - ✓ NFA target over-performance: EUR 5.1 bn. in 2009
 - ✓ Interest rate differential still favorable

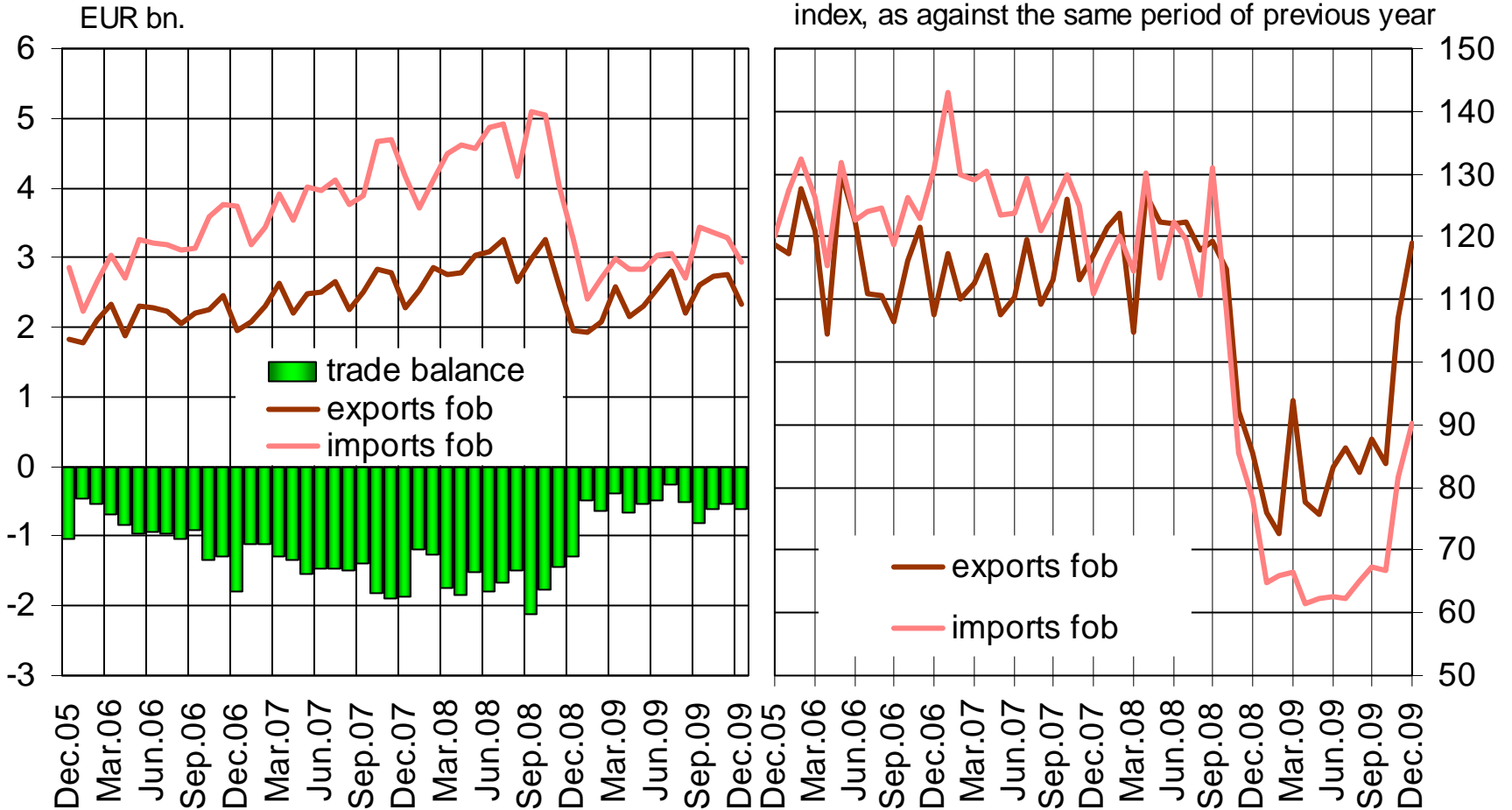
Consumer confidence in CEE still hovers around humble levels



Source: European Commission

Trade Balance

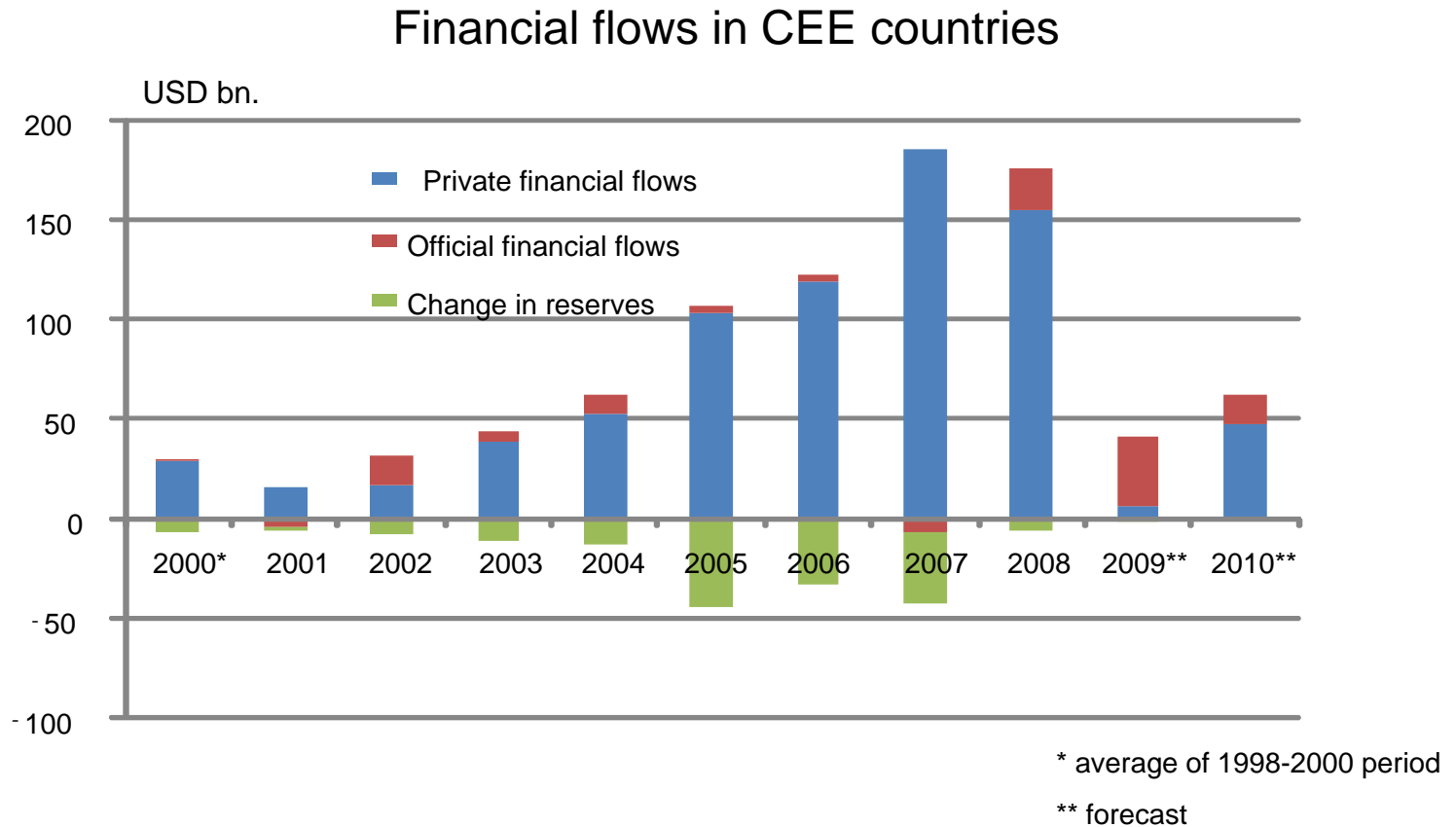
(monthly data)



In 2009, yoy decrease of exports and imports was 13.9% and 32.3% respectively.

Source: National Bank of Romania, National Institute of Statistics

High dependence on external financing



Source: WEO (October 2009)

Capital inflows press for nominal appreciation

- A nominal appreciation of the leu could:
 - ✓ Help disinflation
 - ✓ Reduce the cost of borrowing in foreign currency
 - ✓ Erode external competitiveness

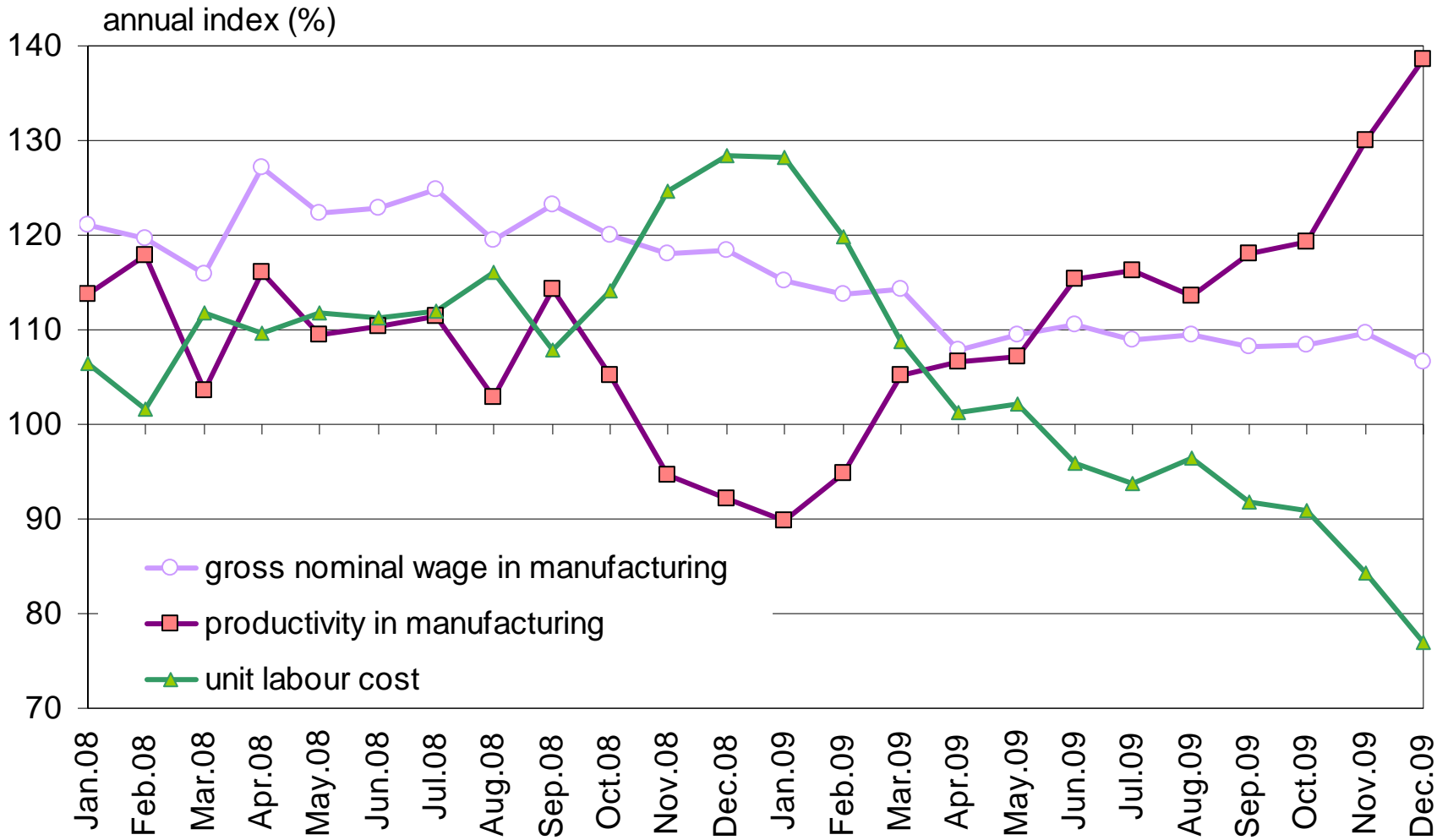
Apparent conflict in the effects of interest rate cuts on the exchange rate channel

- A reduction in the interest rate does not help disinflation (an objective of the NBR)...
- But it helps prevent...fast foreign debt accumulation and balance-sheet currency mismatches (which relates to NBR's second objective: securing the financial stability)
- ...And an erosion in the external competitiveness

Are the three elements posing an interest rate dilemma?

- NO
- Nominal rigidities that do not allow for a depreciation to be transferred into significant disinflation. → A reduction in the interest rate does not imply significant costs in terms of inflation if the exchange rate channel is considered alone.
- Interest rate cuts are needed... to reduce the cost of leu denominated borrowings
- ...And possibly without eroding external competitiveness as significant unit labor costs reductions have taken place since June 2009.

Labour Cost Adjustment in Manufacturing



Source: National Institute of Statistics

It is the need to properly anchor inflationary expectations that poses a dilemma

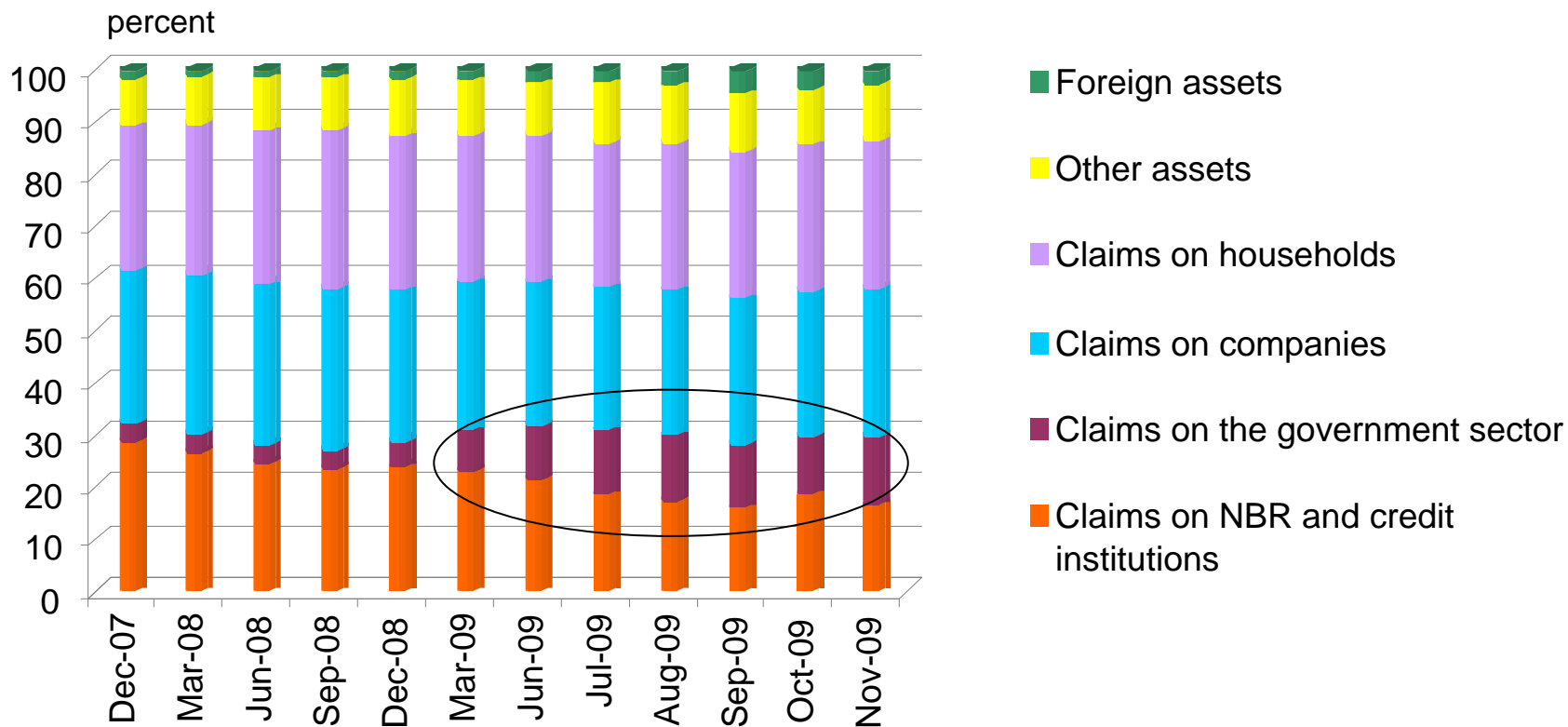
- Recent increased contribution of some supply-side factors to the headline inflation
- This led to increased inflationary expectations
- More money from increased capital inflows will also fuel inflationary expectations
- A relatively low interest rate, needed to tame capital inflows, might prove insufficient to reach inflation targets in 2010 and 2011.
- Thus, monetary policy might face an interest rate dilemma

Challenges to monetary policy in 2010-2011

- The main challenge: to reach inflation targets while maintaining the financial stability of the system.
- Specific challenges to liquidity management:
 - ✓ Increased role for interest rates in taming capital inflows since a reversal in minimum reserve requirements is not acceptable
 - ✓ More capital inflows mean more money. This means more sterilisation efforts and hence losses for the NBR. More losses mean higher inflation
 - ✓ Increased reserve accumulation if capital inflows are not tamed by interest rate cuts
 - ✓ More capital inflows might make the NBR a net debtor again
 - ✓ An increased coordination effort with the fiscal policy, since a slippage in the fiscal area might amplify the interest rate dilemma

II. The Romanian banking sector

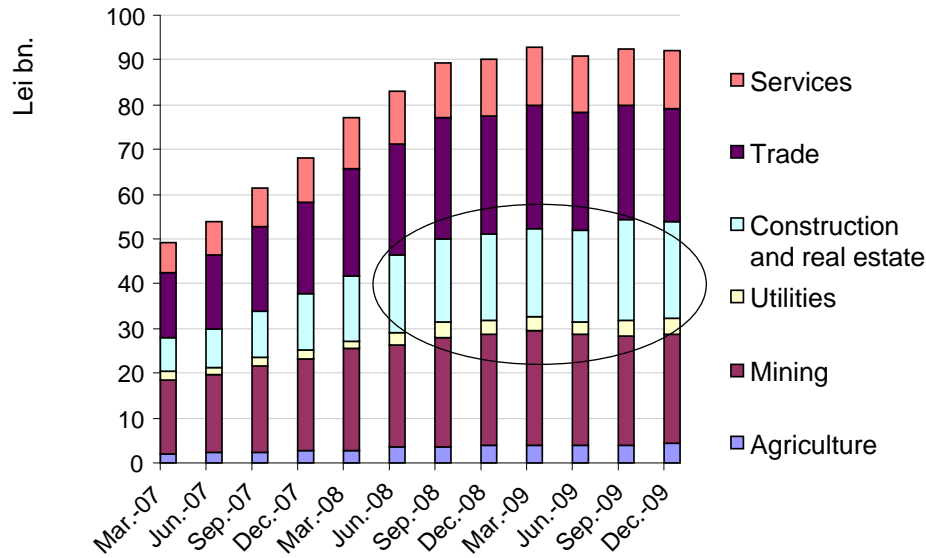
On the asset side, the exposure to government assets increased at the expense of loans to companies and households



Source: NBR

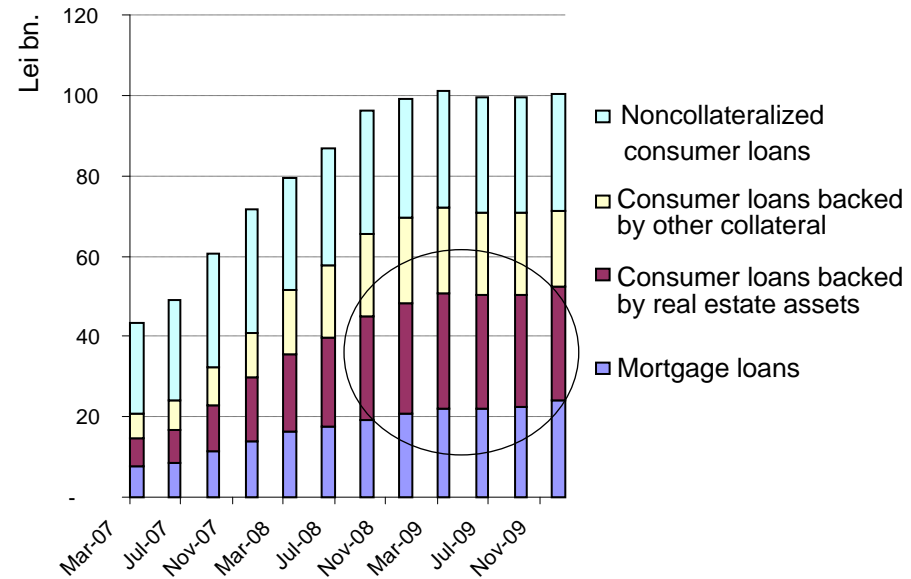
Loans to companies and households tied-up to the 2008 levels...

Loans to non-financial companies



Source: NBR

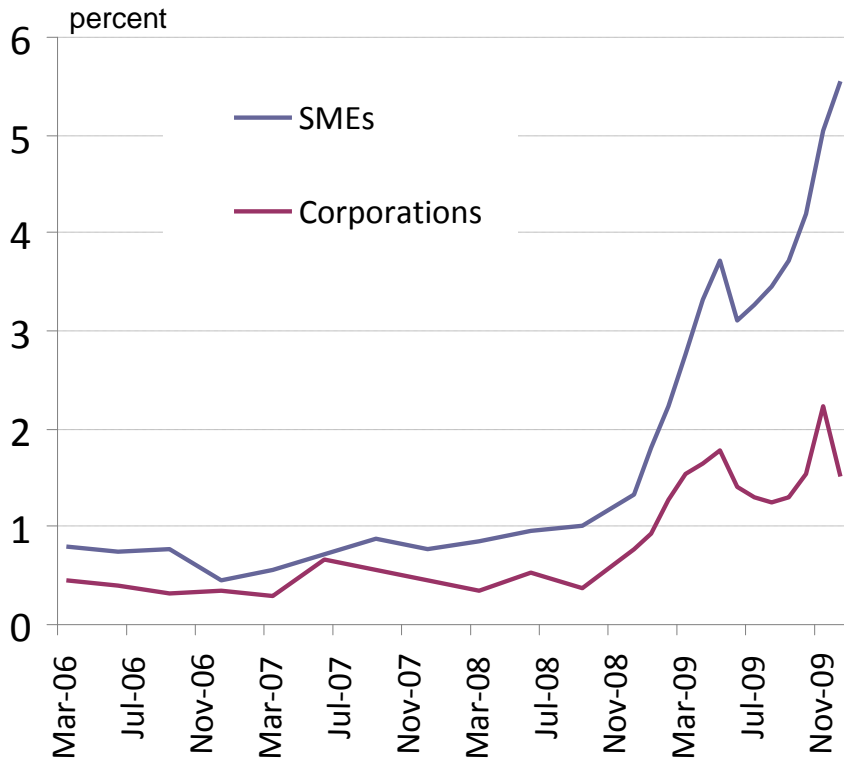
Loans to households



Source: NBR

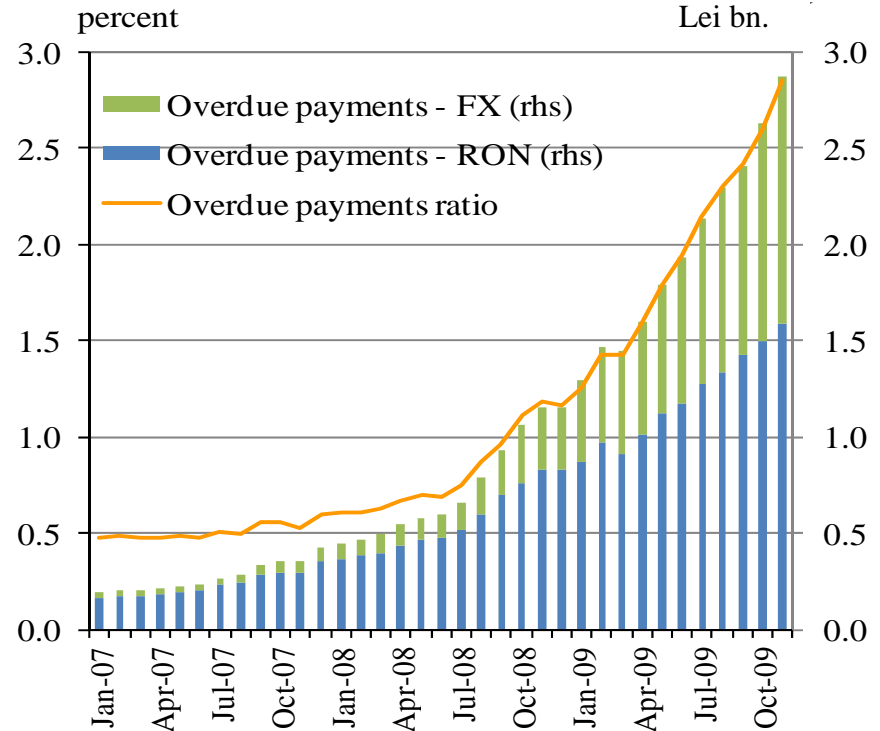
...while the portfolio quality deteriorated for both corporate and household exposures...

Overdue credit* for the corporate sector



Source: NBR, MPF

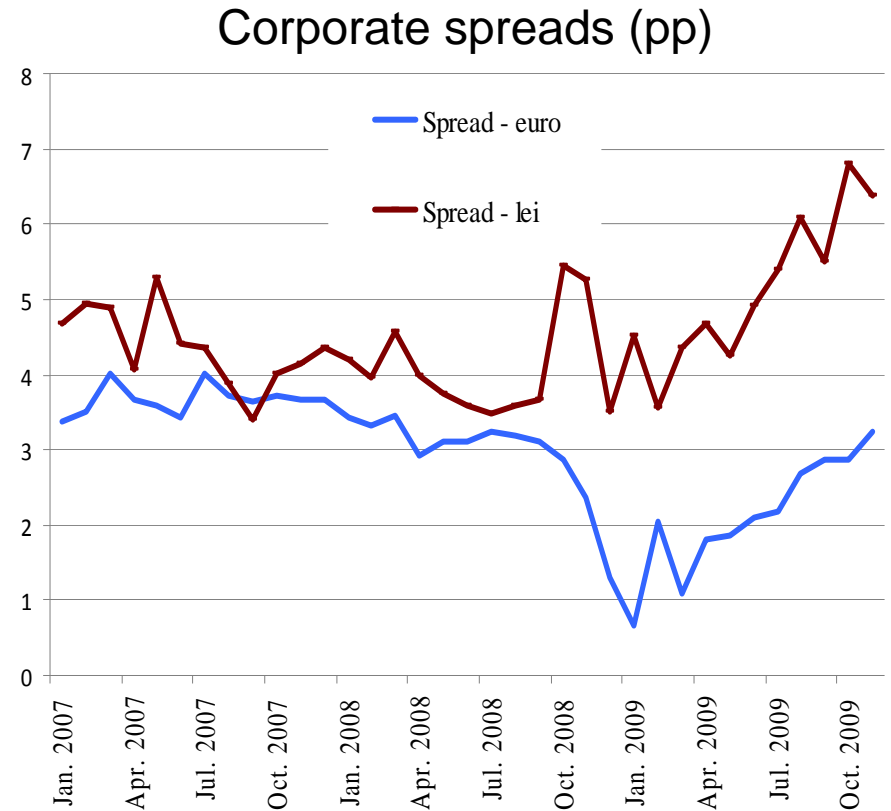
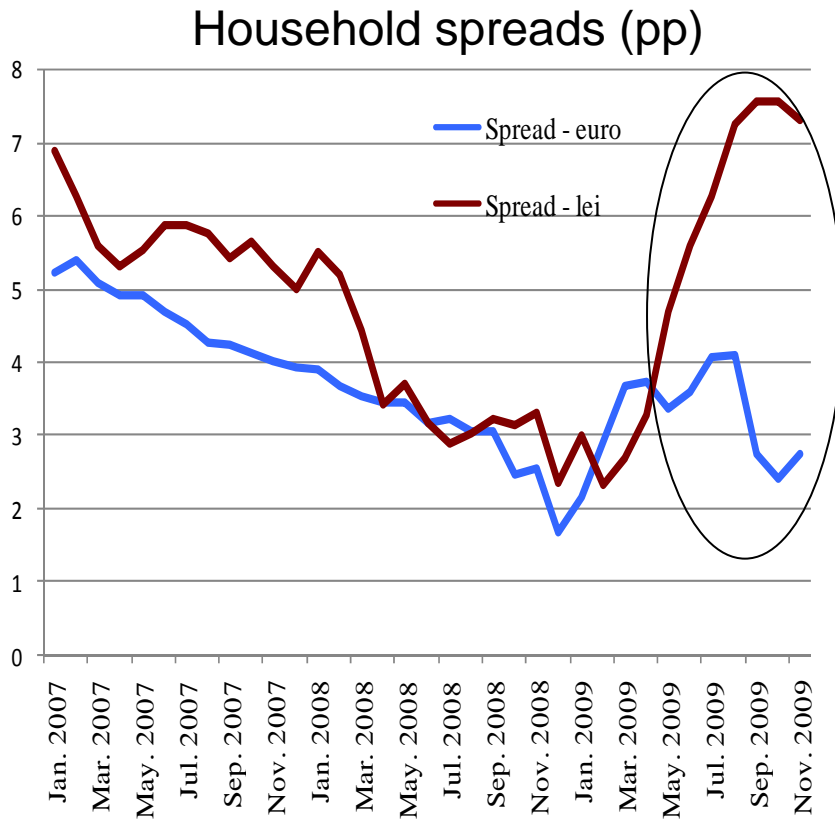
Overdue credit* for the household sector



Source: NBR (balance sheet data)

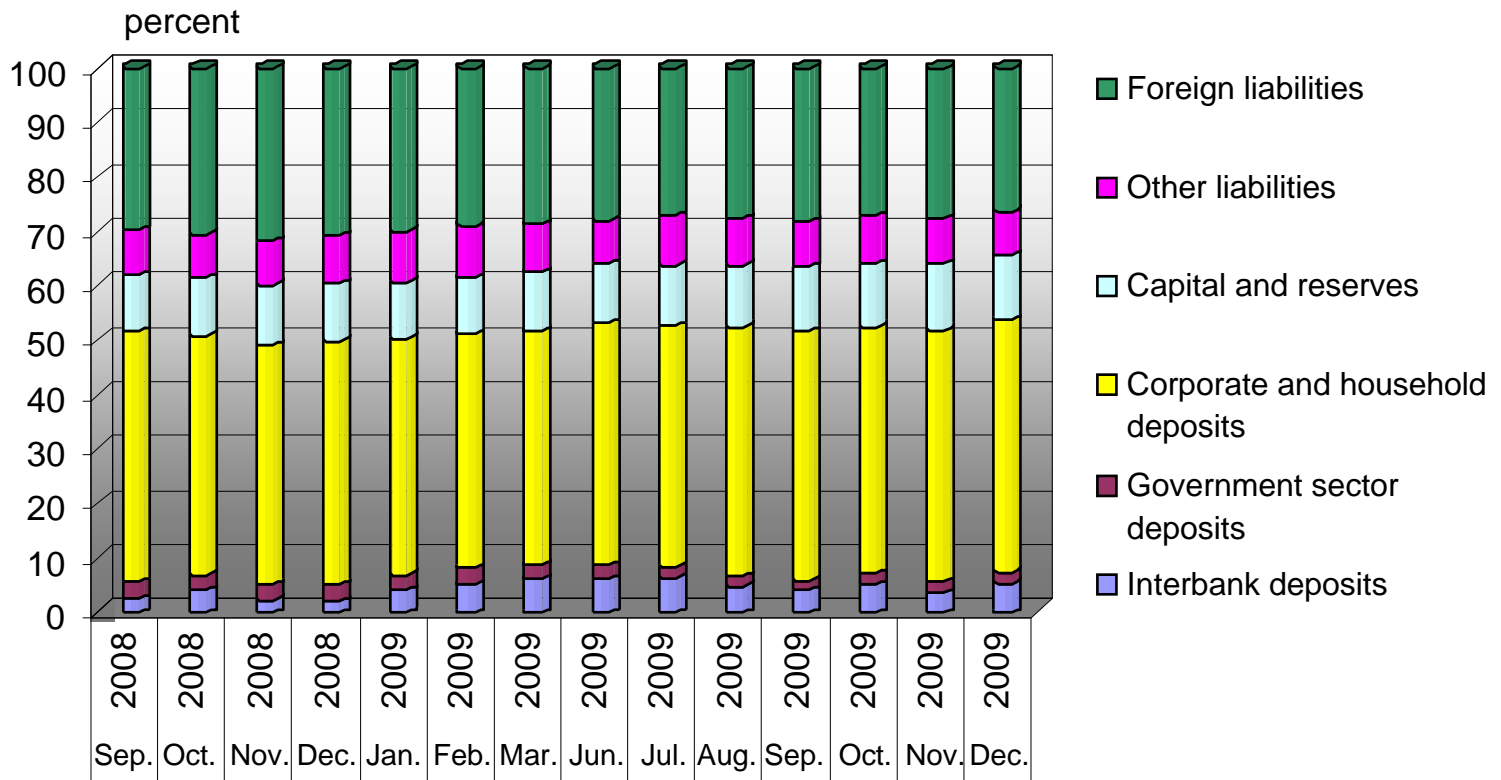
*) includes all overdue and doubtful loans (more than one day notice)

...triggering a re-widening of interest rate spreads



Source: NBR

On the liability side, banks slightly paid more attention to domestic resources...



Source: NBR

...but even this solution entails some risks
(possibly higher than external financing)

Household deposits

(%)		EUR 0-5,000	EUR 5,001- 10,000	EUR 10,001- 15,000	EUR 15,001- 20,000	EUR 20,001- 50,000	EUR 50,001- 100,000	above EUR 100,000
Jun. 2006	No.	97.40	1.50	0.50	0.20	0.30	0.10	0.00
	Val.	39.10	15.50	8.10	4.60	11.20	5.90	15.60
Nov. 2008	No.	95,20	2.40	0.90	0.50	0,70	0.20	0.10
	Val.	24.80	13.50	8.90	6.0	16.70	8.30	21.30

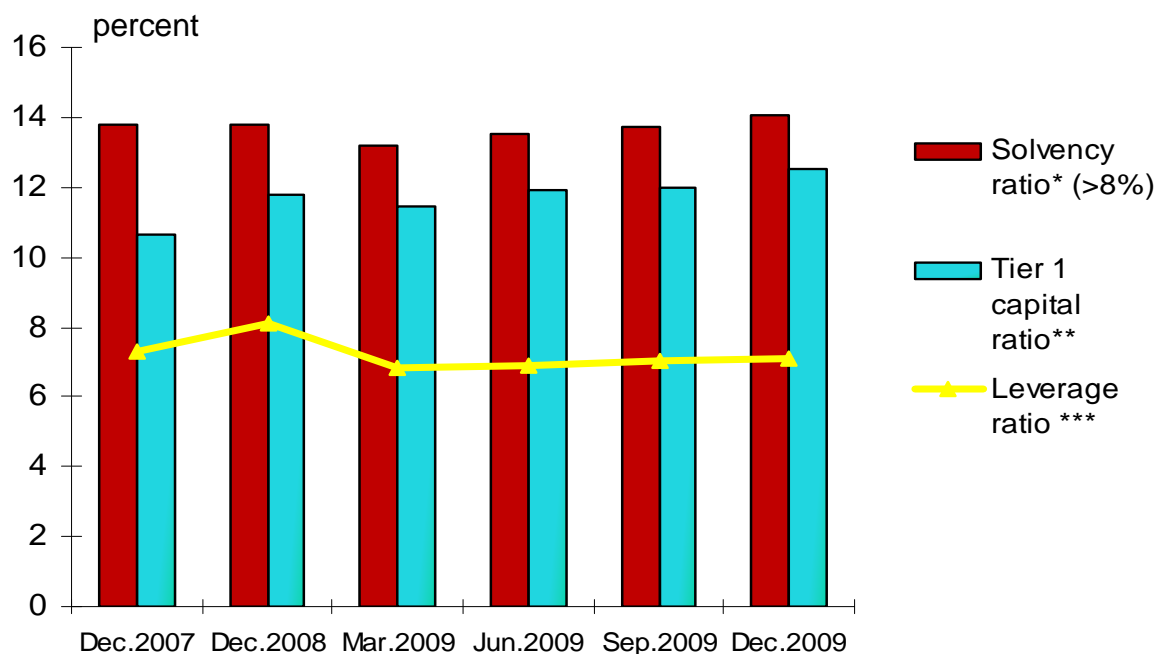
Source: NBR

Non-financial company deposits

(%)		EUR 0-15,000	EUR 15,001-20,000	EUR 20,001-50,000	EUR 50,001-100,000	above EUR 100,000
Jun. 2006	No.	95.00	1.00	2.10	0.90	1.10
	Val.	6.60	1.30	5.30	4.80	81.90
Nov. 2008	No.	92.60	1.30	3.00	1.30	1.80
	Val.	5.40	1.20	5.20	5.10	83.10

Source: NBR

Despite the challenges, the banking sector copes relatively well with the crisis: the solvency ratio went slightly up...



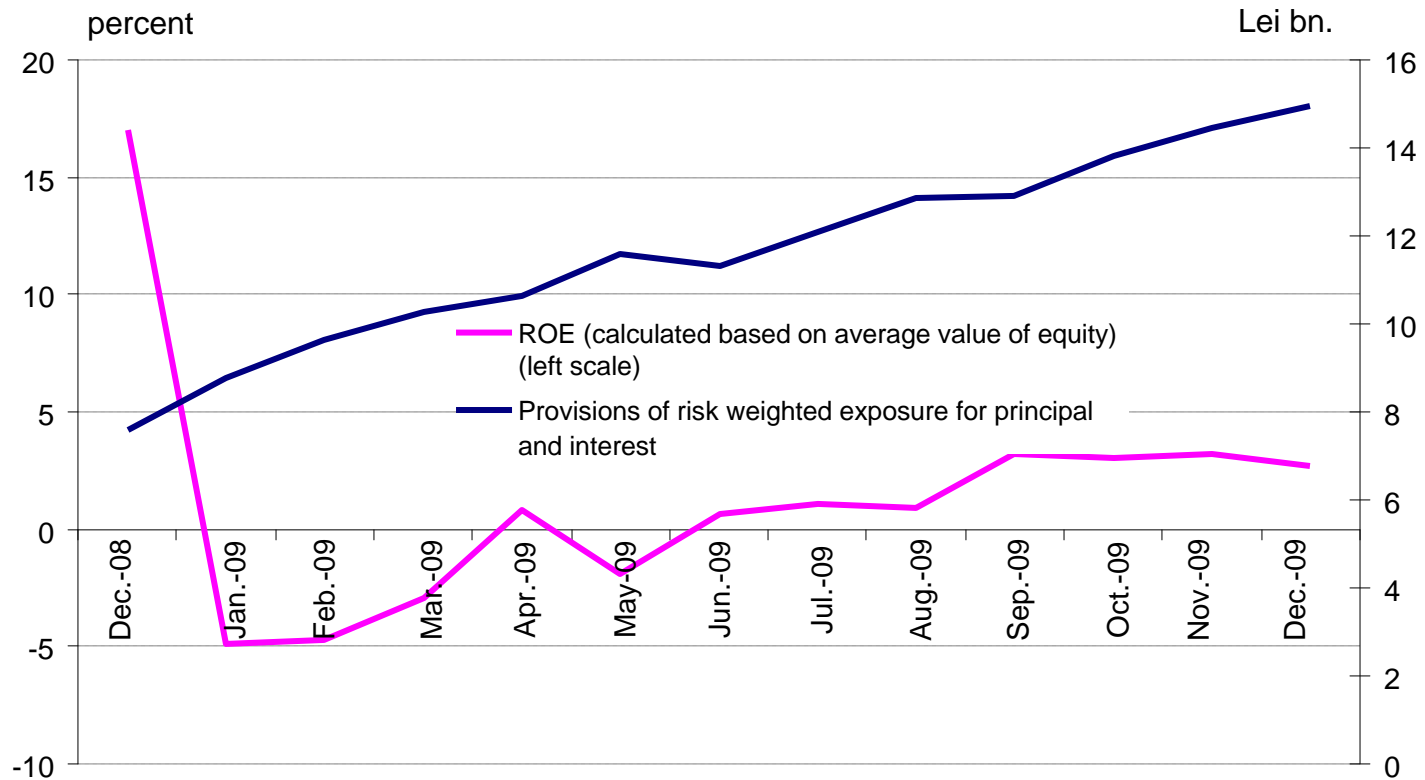
* Starting with 2007, according to Regulation No. 13/2006 and Order No. 12/2007; (>12%) until end-2006

** Tier 1 capital as share of total risk-weighted balance sheet assets and off-balance sheet items, net of provisions

*** Tier 1 Capital / Average assets

Source: NBR

...and profitability has returned to an upward trend, amid a significant increase in provisions



Source: NBR