ROMANIAN FINANCIAL SYSTEM AND ECONOMIC GROWTH

Lecturer Ph.D. Student Bogdan FÎRŢESCU
"Al. I. Cuza" University of Iaşi, Romania
firtescu@uaic.ro

Abstract:

This paper wants to emphasize the relation between financial system and economic growth, as part of sustainable development. Recent papers stress the correlation between the financial system as a promoting factor to economic growth. Economic literature also discusses the issue related to some types of financial system (such as bank – based or market - based) and economic expansion. The article intends to summarize the debate on financial system development, financial system types and financing manners in promoting economic growth. The actual stage of Romanian financial system, related to banking system, financial institutions and financial market, is taken into discussion. The latest structural transformation of Romanian financial system since EU Accession is presented.

Key Words: financial system, economic growth, sustainable development, banking system, financial market.

1. THE APPROACH OF FINANCIAL SYSTEM AND GROWTH

"Does finance make a difference . . .? " , Raymond Goldsmith (1969)

The relationship between financial system and economic growth appears to be debated since XIXth century. During time, the authors came with pro and against arguments if the financial system truly have impact on sustaining the economic growth.

Some authors such W. Bagehot, in 1873, and more recently, J. Hicks, in 1969, emphasize that financial systems played a critical role in igniting industrialization in England by facilitating the mobilization of capital. At the beginning of XXth century, J.Schumpeter, in 1912, argues that well-functioning banks encourage technological innovation by identifying and funding entrepreneurs with the best chances of successful innovation.

On the other hand, many authors, such as J. Robinson, in 1952, argue that financial systems do not matter for growth and financial development simply follows or reflect anticipation of economic development. It is relevant the citation of the J. Robinson " "where enterprise leads finance follows"(1)

"In addition, the role of finance is often simply ignored in development economics. For example, N. Stern's review of development economics, in 1984, does not take into discussion the financial system.

The traditional neoclassical approach in literature related to growth does not take finance in discussion, suggesting that financial system is not important. The approach on *money*, viewed as a cover on real process supports the idea.

In this literature there are two main sources of growth: 1st – economic growth appears within the technological frontier caused by factor accumulation; 2nd - innovation causes the technological frontier to move outwards.

Innovation (such as research and development) is necessary for an economy to experience sustained growth for a long period of time. However, factor accumulation can still be a large component of growth particularly for emerging economies that are a long way from the technological frontier.

Economic models from the 60's – G. Solow (1956), M. Swan (1956), D. Cass (1965) and J. Koopmans (1965) - focus on factor accumulation as the bases of growth. In these models, reproducible inputs, such as physical and human capital, ultimately show diminishing returns.

This feature leads the models to predict the convergence of economies towards a steady state. Growth based on factor accumulation stops eventually. Long run growth takes place as a result of exogenous technological progress.

Moreover, some economists just do not believe that the finance-growth relationship is important. R. Lucas, in 1988, asserts that economists "badly over-stress" the role of financial factors in economic growth, while development economists frequently express their skepticism about the role of the financial system by ignoring it – A. Chandavarkar, in 1992. For example, a collection of essays by the "pioneers of development economics," including three Nobel Laureates, does not mention finance as suggested by G. Meir and D. Seers, in 1984.

The next step was to try and model how innovation occurs rather than assuming that it is exogenous. Endogenous growth models usually contain an innovation "production" process. Innovation is the crucial source for long-run growth. Innovative activity requires the use of scarce resources, and the incentives for innovation are provided by monopoly profits. Because of this imperfectly competitive market structure, the market solution is not usually Pareto-optimal.(2)

The majority of theoretical studies and empirical evidence suggests a positive, first-order relationship between financial development and economic growth, as R. Levine concluded.

2. FINANCIAL SYSTEM'S CLASSIFICATION, FUNCTIONS AND ROLE

"Finance is, as it were, the stomach of the country, from which all the other organs take their tone." William Gladstone (1858)

Approaches of "different" financial systems

In the financial system funds flow from those who have surplus funds to those who have a shortage of funds, either by direct, market-based financing or by indirect, bank-based finance. The economic literature indicate that the financial system comprises all financial markets, instruments and institutions. Romanian literature describes the financial system through its relationships between participants, through financial institutions, through financial funds, or through plans, viewed as management instrument (3), or like flow of funds.

Many economists view markets as the ideal mechanism for allocating resources. The most important markets in this matter are the stock markets and other financial markets. In the United States and United Kingdom, where many of the ideas concerning the desirability of markets were developed, financial markets are indeed important, and at first sight this characterization seems appropriate.

On the other way, there are a number of different approaches: in most countries, stock markets are unimportant. Financial markets are primarily markets for government debt. Often the external funds firms need for investing are obtained from banks. A second problem is that in all countries, including the United States and United Kingdom, internally generated funds are very important. In countries such Japan, France or Germany (4) , named as bank – based, the importance of finance and channeling the funds refers to banks.

A comparison of different countries' financial systems indicates that the focus of standard economic models on financial markets as a means of allocating resources is misplaced. Financial systems are crucial for the allocation of resources in a modern economy, They channel household savings to the corporate sector and allocate investment funds among firms. They allow smoothing of consumption by households and expenditures by firms. They allow both firms and households to share risks.

An overview of financial system could be represented as follows:

Table no. 1 – Overview of financial systems

	United States	United Kingdom	Japan	France	Germany
Financial markets	Central	Central	Developed	Fairly	Unimportant
Banks:	Competitive concentrated →	→	→	→	→
External	Hostile	Hostile bank	Main bank		Hausbank

corporate governance	takeover		system		system

Source: F. Allen, D. Gale – Comparing Financial systems, MIT Press, 2000, p. 4

These functions appear to be common to most developed economies. When we Different countries, however, have very different financial systems, which we describe in some detail in later chapters. The United States and Germany can be viewed as polar extremes. In the Uni ted States financial markets play an important role in allocating resources, while in Germany they are relatively unimportant. When it is referred refer to "financial markets," the literature means organized markets for securities such as stocks, bonds, fu tures contracts, and options.) Instead, in Germany banks play by far the most important role. The three major universal banks - Deutsche, Dresdner, and Commerzbank dominate the allocation of resources in the corporate sector. In contrast the United States has long pursued a vigorous policy of promoting competition among banks. As a result, the banking system is less concentrated than in Germany, particularly with regard to providing services to the corporate sector. Universal banking is prohibited by the Gl ass-Steagall Act, so the commercial and investment bunking sectors have been separate.

As table 1 indicates, other major industrial countries fall in between these two extremes. In the United Kingdom financial markets hive a long history and also play a ce ntral role, but in contrast to the United States, the domestic banking industry is highly concentrated, wilh four major banks—Barclays, National Westminster, Midland, and Lloyds —traditionally dominating the market. Although there is no equivalent to the Gl ass-Steagall Act and universal banking is allowed, commercial and investment banking are in practice separate in the United Kingdom. Japan has sophisticated financial markets, but for most of the past fifty years, a concentrated banking system has played the dominant role in allocating resources. Finally, France is much like Germany in that banks have traditionally dominated and markets have been unimportant for the corporate sector. The main difference in France is that the government has been much more im portant than in other countries through its direct ownership of major banks and other financial institutions at various times.

The differences in institutions and markets across countries also have implications for corporate governance. In the United State s and United Kingdom, the equity markets provide a market for corporate control. In particular, the possibility of takeovers is assumed to be a device for disciplining managers. A raider can buy up the shares of a badly managed company, replace the management, and make a capital gain. Hostile takeovers are legally possible in Japan and Germany, but they do not occur in practice. It has been widely suggested that monitoring by the banks performs the same external oversight rule as hostile takeovers. In Japan this is known as the main bank system, and in Germany it is called the "hausbank system".

The current trend is toward market-based systems. As a matter o policy, France has deliberately chosen to increase the importance o financial markets since the mid -1980s. Japan is planning a "Big Bang reform of its financial system to make it more efficient and enable the Tokyo markets to compete with those in New York and London. The European Union is moving toward a single European market, which will increase compet itiveness and exposure to financial markets. Latin American countries, such as Brazil, are implementing changes to create US like financial systems.(5)

Financial System Functions

In actual modern economies, financial systems can have two main *functions*: 1st – the allocation of savings to investment opportunities and 2nd - distribution and allocation risk between economic agents. I will address each in turn before concluding with some thoughts on the role of central banks.

It is generally recognized that financial development contributes to higher long-run economic growth. There is a debate however, as to whether some financial structures are more efficient than others in allocating savings to investment.

Funds can move from lenders to borrowers by a secon d route, called indirect finance because it involves *a financial intermediary* that stands between the lender-savers and the borrower-spenders and helps transfer funds from one to the other. A financial intermediary does this by borrowing funds from the lender-savers and then uses these funds to make lo rower -spenders. A function attributed to financial system, generally speaking, is to *reduce the cost of financing*. Financial intermediaries can substantially reduce transaction costs because they have develop ed expertise in lowering them and because their large size allows them to take advantage of economies of scale, the reduction in transaction costs per dollar of transactions as the size (scale) of transactions increases. But some problems occur: *asymmetric information*, *moral hazard and adverse selection.*

The presence of transaction costs in financial markets explains, in part, why financial intermediaries and indirect finance play such an important role in financial markets. An additional reason is that in financial markets, one party often does not know enough about the other party to make accurate decisions. This inequality is generally called *asymmetric information*.

Moral hazard is the problem created by asymmetric information after the transaction occ urs. Moral hazard in financial markets is the risk (hazard) that the borrower might engage in activities that are undesirable (immoral) from the lender's point of view because they make it less likely that the loan will be paid back. Because moral hazard l owers the probability that the loan will be repaid, lenders may decide that they would rather not make a loan.

The problems created by adverse selection and moral hazard ar e important impediment to well-functioning financial markets. Again, financial intermediaries can alleviate these problems (6).

3. ROMANIAN FINANCIAL SYSTEM – STAGE OF DEVELOPMENT AND INDICATORS

"Nevoia de capital a unei economii nu poate fi judecata in termeni abstracti, ci prin raportarea la PIB-ul pe locuitor sau nevoia de infrastru ctura", Mugur Isarescu (2008)

The Romanian financial system is still a bank – based one. Te explanation can be found in transition and poor development of financial market. But the situation can change over time. Probably, like other EU countries, moving toward a single European market could transform these attributes. The actual stage of Romanian Financial system can be summarized as follow:

Table no. 2 – Stage of Romanian Financial System Structure

					Percentage in GDP (%)
	2002	**2003**	**2004**	**2005**	**2006**
Credit institutions (1)	31,0	30,8	36,6	44,6	50,6
Insurance Companies (2)	1,5	1,8	1,9	2,2	2,5
Investment Funds (3)	0,1	0,1	0,2	0,2	0,3
Financial investment companies (4)	1,4	1,4	1,3	1,8	2,3
Leasing companies (5)	1,5	1,8	3,0	3,6	3,4
Other financing institutions (6)	0,4	0,4	0,6	0,9	1,3
Total	**35,9**	**36,3**	**43,6**	**53,3**	**60,4**
Other credit institutions					
BVB (7)	6,1	6,2	13,9	19,5	21,5
RASDAQ (BER) (7)	4,0	4,0	3,2	2,9	3,1

Sources: BNR, CNVM, CSA, ALB, INS (provisory data for 2006)

The evolution of internal credit is expressed in the table below, that express an increase over the analyzed period:

Table no. 3 –Evolution of Romanian Domestic Credit

Year	2000	2001	2002	2003	2004	2005
Total	11288.6	14324.5	20022.1	30122.6	36518.7	54592.3
Non-government credit - total	7500.7	11825.5	17872.8	30287.9	41762.4	60672.8
Lei credits - total	3041.1	4753.4	6.7279	13504	16386.7	27910.7
Short term credits - total	296.4	3990.5	5042.4	7296.4	8191.5	12128
Medium and long term credits - total	521.7	762.9	1630.5	6207.6	8195.2	15782.7
Medium-term credits - total	411	631.7	1404	5735	7412.1	10554
Long-term credits - total	110.7	131.2	226.5	472.6	783.1	5228.7
Convertible currency domestic credits	4459.6	7072.1	11199.9	16783.9	25375.7	7072.1
Government credit, net - total	3787.9	2499	2149.3	-165.4	-5243.7	-6080.5

Source: INSSE, Chapter 21 – Finance, www.insse.ro

The latest development on financial market is presented on the table that follows, suggesting a market growth in latest time:

Table no. 4 –Evolution of Romanian Capital Market Indicators

Year	Volume	Value	Transactions	Capitalization
2007	14.234.962.355	13.802.680.643,7700	1.544.891	85.962.389.148,60
2006	13.677.505.261	9.894.294.096,7200	1.444.398	73.341.789.545,86
2005	16.934.865.957	7.809.734.451,6048	1.159.060	56.065.586.984,76
2004	13.007.587.776	2.415.043.849,1847	644.839	34.147.400.000,00
2003	4.106.381.895	1.006.271.130,0979	440.084	12.186.600.000,00
2002	4.085.123.289	709.765.149,5788	689.184	9.158.000.000,00
2001	2.277.454.017	381.277.021,0330	357.577	3.857.300.000,00
2000	1.806.587.265	184.291.655,0130	496.887	1.072.850.800,00

Source: B.V.B., www.bvb.ro

These tables suggest that Romania, as European trend, there is an increasing in the role of financial market in financial system structure. Also, Romanian financial system remain an bank - based one, but for the future, the circumstances could change, because of financial market expansion.

Economic growth expressed in the evolution of GDP is shown in the tab le below:

Table no. 5 – Economic Growth in Romania (GDP variation)

Year	2000	2001	2002	2003	2004	2005
GDP Value	80377.3	116768.7	151475.1	197564.8	246468.8	288047.8
Growth *(7)*	-	*45.28%*	*29.72%*	*30.43%*	*24.75%*	*16.87%*

Source: INSSE, www.insse.ro, personal c alculations

Some correlation has been calculated: between GDP and internal credit the value is *0.97462;* between GDP and market capitalization the value is *0.93616;* both values suggests a strengthen relation between variables taken into discussion.

The maximum growth of GDP was took place in 2001, and the minimum in 2005, that suggest the descend trend in latest years.

For financial development, some steps must be taken to build an institutional infrastructure that will ensure a well-functioning financial system.

There are some requirements for a sound financial system, regarding financial institutions approach and restructuring:

- *Develop strong property rights*. Strong property rights are needed to encourage productive investment because it will not be u ndertaken if the returns on investment are likely to be taken away by the government or others ;

- *Strengthen the legal system*. A legal system that enforces contracts quickly and fairly is an essential step in supporting strong property rights and financial development;
- *Reduce corruption*. Government is often the primary source of financial repression in developing countries;
- *Improve the quality of financial information*. High-quality financial information is essential to well-functioning financial markets;
- *Improve corporate governance*. For people to be willing to buy stocks, another way to channel funds to business, rules must be established to ensure that the managers of corporations act in the stockholders' interest;
- *Develop sound, prudential regulation and supervision of the banking system*. Banks are the main institutions that allocate credit in developing countries. The skills necessary for bank officers to assess risks and make good lending decisions are critically important and often scarce.

One of the most powerful weapons for stimulating institutional development is globalization. Wealth is not something that can be attained by remaining closed off to the rest of the world. Poorer countries would do better by embracing globalization --that is, opening their financial markets and their markets for goods and services to other nations so that funds, goods, and, often, the ideas that accompany them can flow in. Such inflows can help them achieve reforms that build productivity and wealth that will benefit all their citizens. Of course, countries need to take care that the foundations of the fundamental institutions discussed above are in place, and they must monitor the pace of reform. (8)

Financial globalization is still now far from complete, but as the FED Governor Frederic S. Mishkin emphasizes: "*international capital generally does not flow to poor countries … creating the necessary financial infrastructure in developing countries -better property rights, institutionally and oversight - would not be an easy task*".

NOTES:

(1) Levine, R. - Financial Development and Economic Growth: Views and Agenda, Journal of Economic Literature Vol. XXXV (June 1997) pp. 688–726, p. 2
(2) Allen, F., Oura, H. - Sustained Economic Growth and the Financial System. IMES Discussion Paper Series 2004-E-17, p. p. 1-3
(3) see Filip, Gh. – "Finante publice", Editura Junimea, Iasi, 2002, Vacarel I, - "Finante publice", Editura Didactica si Pedagogică, Bucuresti, 2000 e.g.
(4) latest literature suggests that Germany could not have a bank – based system, Krahnen, J.P., Schmidt,R – The German Financial System, Oxford University Press, 2004, p. 21
(5) Allen, F., Gale D. – Comparing Financial systems, MIT Press, 2000, p. 2-4
(6) Mishkin, S.F. – The Economics of Money, Banking and Financial Markets, 6th Edition, Columbia University, p. 33 – 35
(7) calculated by the formula: $(GDP_{t+1} - GDP_t)/GDP_t$, in percentages
(8) Mishkin, F.S. To the New Perspectives on Financial Globalization Conference in Washington, D.C. (Governor Mishkin presented identical remarks at the Econometric Society at Duke University Lecture, Durham, North Carolina, on June 23, 2007)

BIBLIOGRAPHY:

[1] Allen, F., Gale D. – *Comparing Financial systems*, MIT Press, 2000
[2] Allen, F., Oura, H. - *Sustained Economic Growth and the Financial System*. IMES Discussion Paper Series 2004-E-17
[3] Dăianu, D. – *Stabilitatea sistemului financiar*, http://www.bloombiz.ro/business/stabilitatea-sistemului-financiar
[4] Duisenberg, W.- *The role of financial markets for economic growth* (Central Bank Articles and Speeches), http://www.bis.org/review/r010601b.pdf

[5] Demirguc – Kunt, Levine, R. – *Financial Structure and Economic Growth,* MIT Press, 2000
[6] Filip, Gh. – “Finante publice”, Editura Junimea, Iasi, 2002
[7] Levine, R. - *Financial Development and Economic Growth: Views and Agenda* , Journal of Economic Literature Vol. XXXV (June 1997) pp. 688–726
[8] Mishkin, S.F. – *The Economics of Money, Banking and Financial Marktes, 6 th Edition,* Columbia University
[9] Mishkin, F.S. *To the New Perspectives on Financial Globalization* Conference in Washington, on June 23, 2007
[10] Noyer, C – *Financial System for Economic Growth,* www.bundesbank.de