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Consequences and possible solutions of financial crisis

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Abstract. *Financial crisis do not end overnight, but it takes some time until all effects disappear. Most of the time, the period in which the consequences of financial crisis manifest is characterized by: persistent and deep collapses of stock market, deep cuts in production and employment and explosions of government debt whose main cause is, actually, the inevitable fall of tax revenue suffered by the State as a result of deep and prolonged output contractions in the economy.*

Thus, in this article we want to analyze the main consequences of the financial crisis and possible solutions offered by international institutions, especially monetary and fiscal policy decisions.

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Generally, financial crises are rather a mechanism that amplifies rather than triggers the recession (Reinhart, Rogoff, 2012). They are actually a change in direction for the production growth, leading to a series of insolvencies in the debts to the banks, to a restraint of other crediting activities, and reaching new production decreases, with new reimbursement problems. Moreover, banking crises are accompanied, more often than not, by other types of crises, such as exchange rate crises, internal and external debt crises, inflationist crises.

Almost invariably, banking crises lead to abrupt decreases of the revenues coming from taxation, while other factors leading to deeper deficits may include the application of automatic mechanisms of fiscal stabilization, contra-cyclical fiscal policies and higher interest rates, through the increase of the risk-related additional benefits and the downgrading to lower rating classes.

The financial safeguarding of the banking sector, the revenue decrease and the fiscal stimulation packages that accompany a great deal of the banking crises (including the latest one) involve the fact that there are growing budget deficits, adding up on top of the existing governmental debt stock. Consequently, it is no wonder that the *true heritage of banking crises* is a higher level of the public debt. And the main reason of the governmental debt explosion is the inevitable fall of the revenues from taxes triggered by the deep long-term contractions of the economic production.

Certainly, among the *consequences* there are also *deep and persistent collapses of the stock markets*, *obvious production and employment shrinking*, but along this article we will focus on the fiscal heritage of the banking crises.

If we were to analyze a little the fiscal policy practiced during the period 2003-2007, national governments have missed the chance of applying a more restrictive fiscal policy during a time when the private sector took more risk in the activity it undertook (Lane, 2012). In certain countries (for instance: Ireland and Spain), the employment and dwelling boom generated extra-revenues from taxation and in the Eurozone member countries, characterized by a rapid growth, the inflation reached a level above the Eurozone average, consequently leading to a stimulation of the revenues coming from taxation through the non-indexation of several categories of taxes. The revenues obtained improved the fiscal positions only partially, in the context of the existence of certain extra-public expenses. So, the fiscal policy became a little bit less anti-cyclical during this period.

One of the determining factors is the position of the national authorities and international organizations, focusing on the estimation of the budgetary balance, “adjusted cyclically”, without taking into account the distribution of the fiscal and financial risks associated to expansions of the external

imbalances, of the credit, of the sectorial debts and of the housing price (Lane, 2010).

The moment when the financial shock waves were felt in the Eurozone, the accent was placed mainly on the stability of the banking system, the fiscal risks specific for every country being pushed to the background. It was only when the fiscal revenues fell abruptly (especially due to the high sensitivity among taxation revenues, housing decline and assets price) that the attention was turned to fiscal risks as well (Mody, Sandri, 2012).

Moreover, the financial shocks had asymmetric effects on the Eurozone, the most affected becoming the countries that were most dependent on external funding, especially the markets with short-term international debts, as the moment when there appears a lack of financial flows, the investors repatriate their funds to their homeland markets and reevaluate their levels of international exposure (Miles – Ferretti, Gian, Tille, 2011). So, the countries facing significant capital exoduses are those situated at the outskirts of the Eurozone, such as Greece, Ireland and Portugal. Consequently, there is no wonder that these countries have recorded growths of their sovereign debt and it was necessary to come up with certain financial bailouts for them.

The bailouts allotted to them were realized according to the standard bailout patterns provided by the IMF (International Monetary Fund). Unfortunately, certain difficulties have shown up (Lane, 2012). First of all, the bailouts given by the IMF are conceived for a three-year period; yet, in the case of major macroeconomic, financial and fiscal imbalances, it is clear that the plausible adjustment time is beyond that three-year period. Then, a rapid fiscal consolidation may aggravate the deficiencies in the banking system. The decrease in production and the increase of the fiscal burdens will certainly lead to a substantial reduction of the household revenues and firm profits. The agreements made by the IMF involve a penalty tax to discourage the countries from making loans when such is not the case, making it harder for the return of the loan. However, in the case of the bailouts meant to cover sovereign debts, this penalty tax was eliminated in July 2011. The funds allotted by the IMF are provided only if the level of the sovereign debt is sustainable, and when it is not sustainable, according to the traditional practice, the private sector creditors are asked to agree with the reduction of the current value of the debt they are to receive (Lane, 2012).

Moreover, safeguarding funds are used for the recapitalization of the banking system, besides the covering of the “regular” fiscal deficits. While the recapitalization of the problematic banks, financed from public funds, may alleviate a banking crisis, this strategy becomes tricky if excessive public debt and sovereign risks growths occur (Acharya, Drechsler, Schnabl, 2010). And a

general precarious state of most of the European banks and the transboundary nature of the financial stability inside the monetary union supposes the fact that national governments are under international stress to safeguard the banks in order to avoid the contagion effects.

Among the *possible solutions* that could be useful in solving the sovereign debts crisis there are: *the creation of a new independent international institution*, meant to help elaborate and apply certain international financial regulations, a solution supported by Reinhart and Rogoff in 2008. Their reasoning relies not just on the need for a better coordination between the regulations of different countries, but also on the imperative that the regulations should be to a larger extent independent from political pressure.

Another solution would be the *Fiscal Compact*, due to come into force in 2013. Its main aim is to reinforce fiscal discipline, mainly in the Eurozone, being built on the basis of the revised Stability and Growth Pact (according to the Monthly Bulletin of the European Central Bank, May 2012). The compact is made up of two main modules: a rule of balanced budget, including an automatic correction mechanism and a reinforcement of the excessive deficit procedure. In other words: a fiscal balance near to zero "along a cycle" and the fact that high debt levels menace fiscal stability (Lane, 2012).

Under the first module, the contracting parties assume the implementation, in their national legislation, of a fiscal rule involving a balanced or overloaded governmental budget. In fact, this supposes a structural deficit of 0.5% of the GDP and 1% of the GDP in case the public debt is significantly lower than 60% of the GDP and long-term risks related to fiscal stability are low.

The balanced budget rule needs to include a corrective mechanism, automatically triggered in case significant deviations from the medium-term goals or the adjustment strategy are noticed. The mechanism aims to correct the deviations, including the cumulated impact on the cumulated debt dynamics and should also be applied to the temporary deviations justified by exceptional circumstances.

Exceptional circumstances refer to unusual events outside the control scope of the respective country, with a major financial impact on the state budget, or refer to periods characterized by severe economic declines for certain Eurozones or for the entire European Union (according to the Monthly Bulletin of the European Central Bank, May 2012). The above elements will be introduced in the national legislations. Consequently, the Commission is in charge with proposing some common principles for the correction mechanism, but also with the role and the independence of the responsible institutions on a national level in monitoring the submission to all the provisions concerning the balanced budget rule.

The second module aims to consolidate the excessive deficit procedure, in particular by increasing the automatism if a Eurozone country breaks the deficit criterion. Moreover, the countries submitted to the excessive deficit procedure need to present economic and budgetary partnership programs, including a detailed description of their structural reforms, the aim being to assure an effective long-term correction of the excessive deficit. Moreover, the fiscal compact covers the legal obligation of the countries with a high governmental debt and the risks associated with the financing of the debt. So the countries need to correct the excess of a governmental debt larger than 60% of the GDP.

Yet, there are, however, several potential difficulties related to its implementation.

A first problem would be that a difference between the cyclical and the structural deficit should be realized, almost in real time. The actual budgetary deficit is made up of two components: a cyclical one (automatic stabilizers) and a structural one (discretionary policies). As an example of budgetary revenues and expenses influenced by the economic cycle we could have: during an economic recession, the unemployment rate increases, leading to a growth in the number of unemployment benefits, which in turn stimulates the aggregate demand; at the same time, during a period of economic recession, the budgetary revenues decrease because less taxes are collected, which stimulates the aggregate demand, leading to an increase of the GDP (Dumitru, 2012). So, through the Fiscal Compact, governments are requested to adopt a mechanism which requires adjustments if the prevision errors for the structural budget balance cumulated over a period of several years attain a significant level (Lane, 2012).

Another potential difficulty consists in the fact that the primary source of the fiscal discipline will lie on a national level. As we were saying on the previous pages, through the Fiscal Compact, the fiscal rules are written in the national legislation, and independent national fiscal councils will need to monitor the observance of the specific fiscal rules. Our hope would be that the discipline on a national level may be more efficient than the external supervision since it avails itself of a greater political legitimacy. However, external supervision and external sanctions remain a second possibility, if a deviation from the fiscal behavior is observed.

Moreover, excessive imbalances are to be supervised by means of certain indexes, such as: credit increase, housing price and external imbalances. The intention is for a country faced with severe difficulties to be able to take action to prevent the crisis occurrence risk (Lane, 2012). However, it is not clear if national governments have the ability to correctly identify severe imbalances and to launch effective policies to control these risk factors.

Among other *possible solutions* there is also the creation of a *banking union,* representing an institutional framework that will have three segments/ branches: a single supervision mechanism, a common structure of analysis/ resolution and a common deposit guarantee (Benoit, 2012). The supervision mechanism should bring all the supervision decisions concerning the Eurozone banks under a single roof, namely the Central European Bank, consequently allowing considering the externalities and the general exposures to systemic risk. The second branch has in view a unitary analysis regime and a single resolution background, consequently aiming at an efficient management even in the case of the banks developed on a transboundary level. By means of the last element, we have in view the need to reassure the deposit-makers that their money is safe in any bank from the Eurozone, regardless of the country in which the operations are carried out or their legal domicile.

Certainly, by means of these possible solutions, the aim pursued is to obtain a more advanced level of fiscal union.

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