THE IMPLICATIONS OF THE INCREASE IN PUBLIC DEBT AND OTHER RISK FACTORS IN FINANCIAL STABILITY

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Abstract:
Financial stability appears more and more often in discussions of money and capital market analysis, the financial banking system and financial education in Eastern EU countries. The uncertainty hanging over the national economy due to the war on the eastern border, as well as the increase in the total debt of the country as a result of the state budget imbalances influenced by the increases in budget expenditures, the energy crisis, poor financial education and the increase in the inflation rate are only part of the causes. which periodically creates problems for the monetary authority regarding the financial stability of Romania. Financial stability and price stability are two sides of the same coin. We must always consider both sides. In this sense, the statistical information provided by the banking financial system has an important role in the analysis of financial stability and price stability.

Keywords: financial stability, public debt, macroprudential policy, systemic risks, inflation.

Classification JEL: *G28, G58*

1. Introduction

Financial stability is the quality of the banking financial system that gives it the ability to withstand shocks, so as not to interrupt or significantly decrease its banking intermediation function, so that it continues to provide the financial services and products necessary for the activities of the real economy. In addition to the classic systemic risks, there are other risks such as state budget imbalances that represent another major risk regarding price stability and implicitly financial stability.

All the risks of the banking financial system can interact with each other and amplify each other's impact, which makes their management and monitoring essential for the stability of the financial system.

The National Bank of Romania has continuously strengthened its cooperative relations in the field of financial stability and macroprudential policies with the competent European and international authorities (European Central Bank, European Systemic Risk Committee, European Banking Authority, European Commission, etc.). Thus, there are periodic consultations regarding the implementation of macroprudential policies through the participation of central bank representatives in periodic meetings of working groups organized by European and international structures. [[1]]

Mainly, the European Central Bank and National Bank of Romania define systemic risk as the risk associated with threats to financial stability and the entire financial banking system. Systemic risk refers to the possibility that events affecting a part of the financial system will spread and have a severe impact on the entire economic and financial system, thus including financial institutions, financial markets and the real economy.

Empirical research shows that systemic risk can come mainly from:

- *Major economic events* such as: economic crises, collapse of real estate markets or other significant economic events can cause systemic risks;

[1] https://www.bnr.ro/Stabilitate-financiara---Rolul-BNR-3114.aspx

- *External shocks triggered by a series of factors* such as: international crises, wars and pandemics or sudden changes in the global natural and economic environment, which can have a severe systemic impact on the financial stability of the EU;
- *Interbank settlements, interconnections and international relations between financial institutions* are factors that generate the rapid spread of systemic risk;
- Fluctuation of operations, volatility of assets and disruptions in the financial markets may result in transmission of risk to other sectors of the financial system;
- Mismanagement in risk management, which causes major difficulties for important financial institutions, can have a significant severe systemic impact on the stability of the entire financial and economic system;

Compared to those specified, the systemic risks that threaten financial stability in Romania can be found in different forms:

- severe systemic risk determined by global uncertainties, in the context of the energy crisis and the war in Ukraine;
- high systemic risk resulting from the deterioration of internal macroeconomic balances, including as a result of geopolitical and international developments;
- moderate systemic risk determined by the risk of non-payment of loans contracted by the non-governmental sector.

Without prejudice to the fundamental objective of ensuring and maintaining price stability, the BNR aims to ensure the stability of the banking system and supports the general economic policy of the state. The role of the NBR in maintaining financial stability is a predominant one, due to the major share of the banking sector in the financial system.

Considering the fundamental objective of the NBR, price stability is often considered as an indicator of the credibility of the monetary policy and the national currency. An unstable currency can affect investor and consumer confidence in the economy, which can lead to financial volatility.

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Significant price increases such as occurred in electricity lead to social tensions and can affect social and political stability, which in turn can have repercussions on financial stability.

This paper, through an empirical study, makes the connection between the macroprudential supervision of the banking system, inflation targeting and the elimination of major risks that could influence the degradation of banking intermediation and implicitly financial stability.

2. Procedure of the work

To ensure financial stability, the BNR closely monitors and regularly analyzes *systemic risks* in order to impose appropriate supervisory and regulatory measures and for Romania to contribute to maintaining financial stability in the euro area. Thus, through specific interventions and appropriate policies, the BNR aims to prevent or minimize the impact of adverse events on the entire financial and economic system

Macroprudential policy on strengthening financial supervision, as well as microprudential policy, together can lead to a normal functioning of the financial-banking system, to the increase of banking intermediation and digitization for the purpose of financial stability.

At the same time, the amplification of financial education and prudence measures, together with a wide range of fiscal consolidation measures, by the financial-monetary and government authorities are just a few steps for financial stability.

But periodically, the main problem of the Romanian state is the restoration of the budget balance, which determines an additional demand for monetary aggregates from the economy and leads to the increase of the internal public debt, or to the fulfillment of this demand through external loans. So, for these loans, the increase in the interest of paying them to the public debt enters a vicious circle and will put more and more pressure on the state's ability to implement economic and social policies for the well-being of citizens.

It should be noted that public debt is often considered a component of sovereign debt. Public debt represents an important part of a state's financial obligations, but it does not always encompass the whole picture of sovereign debt.

So, sovereign debt can also include other financial obligations of the government that are not in the form of public debt, such as direct loans from other governments or international organizations, or sovereign guarantees given for loans of other entities. Sovereign debt includes both domestic and foreign public debt.

For example, between January and May 2023 [[2]], the total external debt increased by 12,533 million euros. During the period mentioned in the structure:

• the long-term external debt amounted to 110,784 million euros on May 31, 2023 (70.5 percent of the total external debt), increasing by 13.4 percent compared to December 31, 2022;

• the short-term external debt recorded on May 31, 2023 the level of 46,310 million euros (29.5 percent of the total external debt), decreasing by 1.1 percent compared to December 31, 2022.

In the same context, *the long-term external debt service rate* was 12.9 percent in the period January - May 2023, compared to 16.2 percent in 2022. The degree of coverage of imports of goods and services as of May 31, 2023 a was 5.1 months, compared to 4.4 months on 31 December 2022. The degree of coverage of short-term external debt, calculated at the residual value, with foreign exchange reserves at the NBR on 31 May 2023 was 90.1 at percent, compared to 80.2 percent on December 31, 2022.

To cover the budget deficit, the Romanian government is authorized to contract, through the Ministry of Finance, internal and external state loans from the financial markets, for the periodic balancing of the state budget, always increasing the sovereign debt of the Romanian state. So, for various reasons, in the first 11 months of 2023, Romania's total external debt[[3]] (public and private) increased by 20 billion euros compared to the level at the beginning of the year, reaching a total of 164 billion euros, according to published data by the NBR. From the total amount, the external debt of the public administration reached 73 billion euros, with a jump of 28% compared to December 2022

At the same time, according to BNR statistics, the evolution of the stock of debt securities issued by the Public Administration includes the influence of the increase in the prices of state securities, amounting to 2.9 billion euros. And, of the total volume, the external debt is 118.9 billion euros and the intra-group loans represent 45 billion euros.

Therefore, updating the collected data, it is observed that the long-term external debt amounted to 116 billion euros on November 30, 2023 (71.3% of the total external debt), an increase of 18.6% compared to December 31, 2022. Related of these aspects, the long-term external debt service [[4]] rate was 16.9% in the period January - November 2023, compared to 17.9% in 2022. The degree of coverage of imports of goods and services on November 30, 2023 was 5.5 months, compared to 4.4 months on December 31, 2022. And, the degree of coverage of the short-term external debt, calculated at the residual value, with foreign exchange reserves at the NBR on November 30, 2023 was 96%, compared with 82.4% on December 31, 2022.

The internal governmental public debt is the part of the governmental public debt that represents the totality of the financial obligations of the state, coming from loans contracted directly or guaranteed by the state, from natural or legal persons resident in Romania, including the amounts temporarily used from the availability of the general current account of the State Treasury

[2] https://www.bnr.ro/page.aspx?prid=22857
[3] https://www.bnr.ro/Publicatii-periodice-204.aspx#ctl00_ctl00_CPH1_CPH1_19966_lnkTitle
[4] https://www.bnr.ro/Datoria-externa---BPM6-11333.aspx

for the temporary financing of budget deficits. At the same time, the internal public debt represents an unconditional obligation of the state, to repay loans contracted in lei, to pay interest and other related costs.

The external government public debt is the part of the government public debt representing the totality of the state's financial obligations, coming from loans contracted directly or guaranteed by the state from natural or legal persons not resident in Romania. At the same time, the external public debt represents an unconditional and irrevocable obligation of the state to repay loans contracted in foreign currency, to pay interest and other related costs.

Therefore, the government is authorized to guarantee internal and external loans only through the Ministry and Finance, contracted for purposes provided by law. In each financial year, the repayment of the *internal and external financial obligations* of the state is ensured from loans specially contracted for the refinancing of the public debt, from resources of the General Account of the State Treasury, as well as from other resources established by legal provisions. The repayment of capital installments, the payment of interest and other costs related to the total public debt have priority over other obligations of the state.

To cover the financial risks arising from the state's guarantee of loans contracted by legal entities, from credit institutions, as well as from loans contracted directly by the state and sub-lent to final beneficiaries, *the risk fund* is established.

Government public debt instruments include, but are not limited to: state securities issued on the domestic or foreign market, state loans from banks, from other credit institutions, Romanian or foreign legal entities, state loans from governments and foreign government agencies, international financial institutions, or from other international organizations, temporary loans from the availability of the general current account of the State Treasury, state guarantees. State guarantees can only be granted for loans whose repayment is expected to be made exclusively from own sources, respectively from local budgets, in the case of local public administration authorities.

Therefore, solving the budget deficit is an important problem of the state, being an essential condition for the healthy development of the national economy. To solve this problem, the government uses inflation as a tool to indirectly help increase state revenues.

But compared to what has been stated, to the extent that inflation continues to rise, it will produce a series of very serious risks to financial intermediation and in all economic spheres, and the economic return to a sustainable and sustainable path will be of increasing duration.

Inflation reduces the ability of money to perform its functions, it has negative effects on economic growth and the welfare of society. Although empirically identifying the costs of inflation is difficult, it is indisputable that a high inflation rate causes serious allocative distortions, which slow down economic growth. Important to note is that these effects are especially long-term. [[5]]

Also from the NBR reports, it can be seen that the annual inflation rate calculated on the basis of the harmonized index of consumer prices (IAPC – inflation indicator for EU member states) decreased to 6.9 percent in November, from 9.2 to hundred in September. At the same time, the average annual rate of CPI inflation and that calculated on the basis of HIPC decreased in November to 11.2 percent and 10.3 percent, from 12.6 percent and 11.4 percent in September [[6]]. The annual rate of inflation accelerated its decline in the first two months of the fourth quarter of 2023 more than expected, falling to 6.72 percent in November from 8.83 percent in September, as food and energy price increases continued to slow.

In this vicious circle of periodic loans for budget balance, through which the state takes over through the credit granted from internal available resources, it will negatively influence financial intermediation and economic relations that will lead to a decrease in population consumption, an increase in interest rates and a decrease in investments.

[5] Silviu Cernea, Monetary policy, Romanian Academy Publishing House, Bucharest, 2014
[6] https://www.bnr.ro/page.aspx?prid=23723

Reflecting the past of international financial relations, the link between the financial sector and economic growth has been analyzed in numerous specialized studies over several years. Based on an analysis of 80 countries over a period of 30 years, these studies demonstrate that financial intermediation creates the necessary conditions for future economic growth. [7]

After 10 years, the cycle of financial relations and the history of the "link" between the factors that determine financial stability and economic growth is repeating itself. In the same way of research, we found that Romania's economy was growing, in 2022 above the global economic growth average, above the US economic growth and above the "euro zone" states, maintaining growth compared to the EU "zone" in 2023 and a sustainable growth is forecast for 2024 as well. (see table no. 1.)

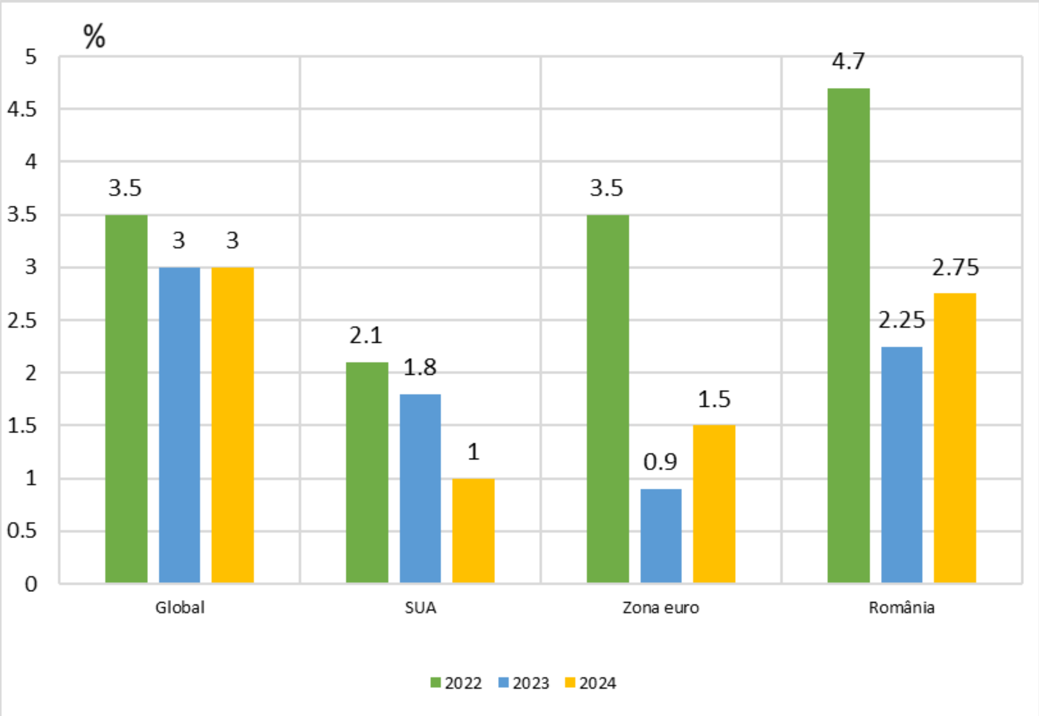

Table no. 1. Source: *World Economic Outlook (July 2023)*; IMF, *article IV (Romania)*

In order to achieve the growth of financial intermediation through the financial-banking system in Romania, as much financial education as possible among the population is necessary.

So, financial education plays an important role for increasing financial intermediation and implicitly for economic development as a whole. From this perspective, it is probably no coincidence that a study published in 2020 by OECD/INFE shows that the score regarding the level of financial education for the adult population in Romania is one of the lowest among the countries included in the analysis.

From the perspective of financial stability, the importance of financial education is widely emphasized in the report of the National Committee for Macroprudential Supervision, which was the basis of Recommendation no. R/3/2022 regarding the sustainable growth of financial intermediation.

[7] https://www.bnr.ro/Document Information "Financial intermediation and the entrepreneurial footprint of Romania"

3.Conclusions

The forecasting and detection of budget imbalances in the conditions of numerous factors generating major risks, for the sustainable and sustainable development of the economy of any EU country, largely depends on how macroprudential and microprudential supervision is carried out, for financial stability.

The monitoring of financial stability is based on the identification of risks and vulnerabilities both at the individual level and at the system level, in order to determine the impact on the institutions under the supervision of the NBR.

So, since November last year, the National Bank of Romania expected the inflation rate at the end of 2023 to decrease so that in the first decade of January 2024, the current inflation rate reached **6.61% compared to December 2023**.

Also, for the year 2024, financial institutions in Romania predict a decrease in the inflation rate, but at a slower pace than the one estimated before the introduction of the new taxes and fees, from the end of 2023, which will also be reflected in prices. Although the prices of gasoline and diesel at the beginning of 2024 have increased, still the BNR foresees an inflation target of 2.5%.

To this end, it can be said that the decline in inflation may be due to the actual dissipation of adverse shocks caused by the election year and the border war, especially on energy prices and bottlenecks in production and supply chains. In other words, the financial institutions' proposition of transitory inflation may be valid, despite its demonization due to the persistence of inflationary pressures. Another conclusion is optimistic generated by the absorption of funds based on PNRR. The projects to be implemented in 2024 would cause the economy to be influenced in a sustainable way by a positive productivity shock. In this scenario, against the backdrop of increased labor productivity, the economy will produce more with less resource consumption, which also leaves room for increases in goods and services, as well as decreases (or slower increases) in prices, and even for salary increases.

In the election year 2024, through judicious management of funds and good, convergent political decisions, it can be demonstrated that industry and services can increase their productivity, with the help of technology and public or private financial support. This hypothesis can be validated even despite data on labor shortages, high financing costs, geopolitical tensions or interference by politicians in the economy.

However, the main risks identified to financial stability are: the increase in internal and external public debt, the deterioration of investor confidence in emerging economies, the risk of non-repayment of loans contracted by the non-governmental sector, the tension of macroeconomic balances, the low payment discipline in the economy and further with all forecasts specified by financial institutions, inflation cannot be controlled. These risks can lead to major uncertainties and inappropriate investment or spending decisions, which can affect financial stability.

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