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Emerging Markets Queries in Finance and Business

Fiscal Policy and Performance of Banking Systems Interactions: the case of Romania

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Abstract

This paper considers the role of fiscal policy as a component of stabilization policy in Romania, based on the assumption that some relevant relations exist between credit cycles and fiscal policy over the business cycle. The paper analyses the relations between the banking sector fluctuations and taxation and public spending during 2008-2011. Our research is based upon market values of performance assessment – Residual Income, Market Value Added, Earnings per Share, and Price to Earnings ratio - which offer a more realistic view regarding the evolution of banking institutions value reflecting investor's decisions and anticipations. Connecting the theory to Romanian banking system data we find that some of the bad financial performance associated with this period is to be explained by the contraction of the demand and not necessary with the earnings obtained by the Romanian listed banking institutions. According to our study, the evidence supports claims that Romanian fiscal policy is pro-cyclical and hence destabilizing over the analysing period. The aim of the paper is to provide some empirical basis for the argument that pro-cyclical fiscal policy does not assist in repairing the financial system.

Keywords: pro-cyclical fiscal policy, financial performance, banking institutions

1. Introduction and Literature Review

The current global crisis has focused attention on how far fiscal policy can support demand in a recession.

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Indeed, since 2009, many emerging economies have used various combinations of fiscal instruments to dampen the demand shock. Some governments have opted for pro-cyclical fiscal policy, despite the expert's opinion regarding its ineffectiveness.

According to the literature, pro-cyclical fiscal policy means the policy which is expansionary in booms and contractive in recessions, being generally regarded as potentially damaging for welfare (Serven, 1998; World Bank, 2000; IMF, 2005). Keynes (1936) defines a contractive fiscal policy as a government policy of reducing spending and raising taxes. The above cited studies argue that pro-cyclical fiscal policy raise macroeconomic volatility, depress investment in real and human capital, hamper growth, and harm the poor. Beginning with Keynes (1936) a lot of researchers recommend the countercyclical fiscal policy arguing its stabilizing effects (Cohen and Follette, 2000; Taylor, 2000). According to Baldacci et al., 2009, countercyclical fiscal policies are able to reduce the crisis duration by almost one year. There are also researchers who argue that in economic downturns, countercyclical policies increase government indebtedness, raising future debt service obligations underlying that counter-cyclicality is a necessary but not a sufficient condition for sound macroeconomic policy (Gordon and Leeper, 2005). There are some discussions in the academic literature about government interventions to boost private sector credit and domestic demand, warning that such actions could leave the economy exposed to the risk of high-inflation and lower private investment growth (Baldacci et al., 2009).

Regarding the pro-cyclical character of fiscal policy in emergent countries, the literature points to the weakness of automatic stabilizers and the pro-cyclical bias of discretionary policies of those countries, caused mainly by the low tax elasticity, the low share of taxes to GDP, the large proportion of fixed expenditures and the general absence of (expensive) unemployment insurance (BIS, 2003; Kraay and Servén, 2008).According to a study made by the Bank for International Settlements, the standard theoretical Keynesian case for using countercyclical fiscal policy is not always applicable in emerging economies subject to large shocks, as small, or even negative fiscal multipliers may result if confidence is damaged and interest rates rise, crowding out domestic investment (BIS, 2003). By using econometric tools, some researchers find evidence that in some European Union new member states, fiscal consolidation made economies grow faster already in the short term, explaining the effects of fiscal contraction on private consumption and investment – whether the latter were boosted or restrained - through so called non- Keynesian effects (Rzońca and Ciżkowicz, 2005). The authors claim that the source of the non-Keynesian effects is said to be the fall in enterprises' costs brought on by reducing government expenditure. As a result, business profitability increases, and secondly, their competitiveness on international markets goes up, concluding that the governments in question gained credibility and attracted foreign direct investments, since they were in a better position to pay their bills.

Reviewing the literature in the field it can be concluded that there is no consensus yet about what should be the appropriate role of fiscal policy over the business cycle in emergent countries, during a recession.

Regarding the banking system's cycles, the literature suggests their strong correlation with business fluctuations, both for size (measured through banks' total assets as a proxy) and activities (credit supply is measured through a loans on-liabilities ratio as a proxy), even if the profitability of the banking sector is not correlated to business cycles at all - even if measured as a long-term profitability through variations of capital requirements, i.e. net worth capital (Piluso and Ricciuti, 2008). As regards to the relatively small subset of saving banks the above cited researchers argue that government expenditure has a significantly negative effect on the loans-to-liabilities ratio, no effects on total assets, while taxes have significantly negative effects on loans and total assets (Piluso and Ricciuti, 2008). The conclusion of such a study is that saving banks seem more affected by fiscal policy than the whole banking system and, in particular, they are negatively affected by taxes.

Based on the assumption that the interaction between macroeconomic and financial variables can play major roles in determining severity and duration of the recession (Claessens et al., 2008; Akitoby and Stratmann, 2008), the aim of this paper is to highlight some pro-cyclical fiscal policy effects on the banking profitability in Romania during 2008-2011.

The rest of the paper is structured as follows: Section 2 provides a brief characterisation of Romanian fiscal policy suggesting its pro-cyclicality during 2008-2011, using IMF and Romanian Ministry of Finance - statistical data. Section 3 presents the data and study methodology, section 4focuses on the results of the study and the last section concludes.