FINANCIAL CRISIS IMPACT ON CONSTRUCTION AND REAL ESTATE SECTORS IN ROMANIA

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Abstract

This paper presents the evolution of construction and real estate sectors in Romania in the context of current financial crisis, highlighting the internal and international economic climate. The evolutions of the main macroeconomic indicators and sectoral factors of influence on them are presented. Construction and real estate sectors are particularly affected by the worsening perception of the risk, of financing difficulties, doubling the risk of liquidity with the solvency one.

Keywords: financial crisis, construction sector, gross domestic product, added value, liquidity

JEL Classification: G01, E01, L74

1. Introduction

World economy is in crisis. The shock is even more brutal as this crisis succeeds a powerful growth registered in recent years (4% between 2001 and 2007), encouraged by the development of international trade. Today the world economy is destabilised by major phenomena : real estate crisis (which has generated the most serious financial crisis since 1929 in the United States, quickly sent to Europe), accelerated growth of the raw materials prices, which involves a food crisis and oil shock, unprecedented pollution of the environment etc..

Financial crisis, which started in July 2007, has its roots in the search of an ever-increasing profitability, most investors always wanting more. Thus, real estate loans were granted to people becoming less responsible, considering that a possible reimbursement could be effectuated by resealing of the respective building, whose price could be only increasing. But the reality was different...

If we can speak of an inseparable couple in finance, that concerns risk and profitability. The growing profitability can be achieved only with the price of a growing risk. And if the risk is at growth, also the probability for it to materialise is also amplified.

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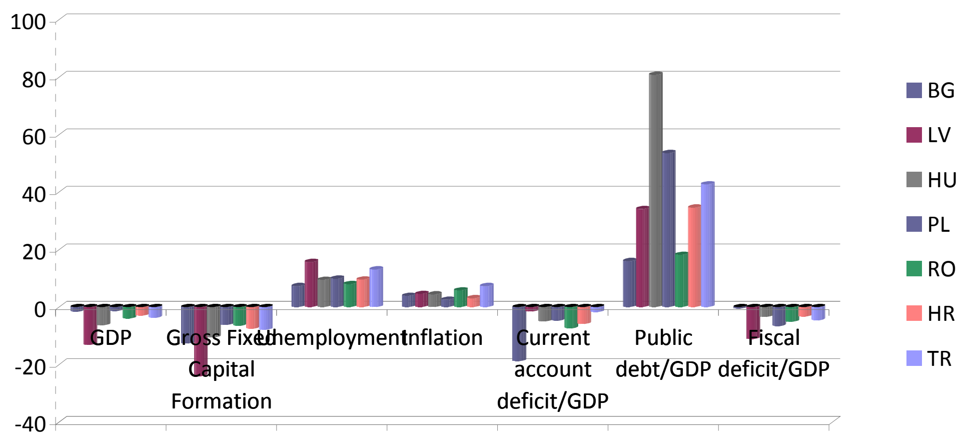
2. International context

The cost of financial crisis was estimated by the International Monetary Fond to 4000 billion dollars. The worldwide economic progress forecasted for 2008 of 3.2% is expected to be replaced by a decrease of 1.3% in 2009[67].

At first, the crisis affected particularly the developed countries. Aversion to risk in these countries transmitted rapidly to emerging areas. Countries of Central an Eastern Europe have entered a zone of high risk, forecasts for the region being pessimistic: economic decline are generalized, companies disinvest and unemployment increases, current account deficits adjust, even brutally in some cases, fiscal deficits increase significantly (chart 1).

Chart1. Forecast of percentage change in 2009 of main economic indicators of countries in the region

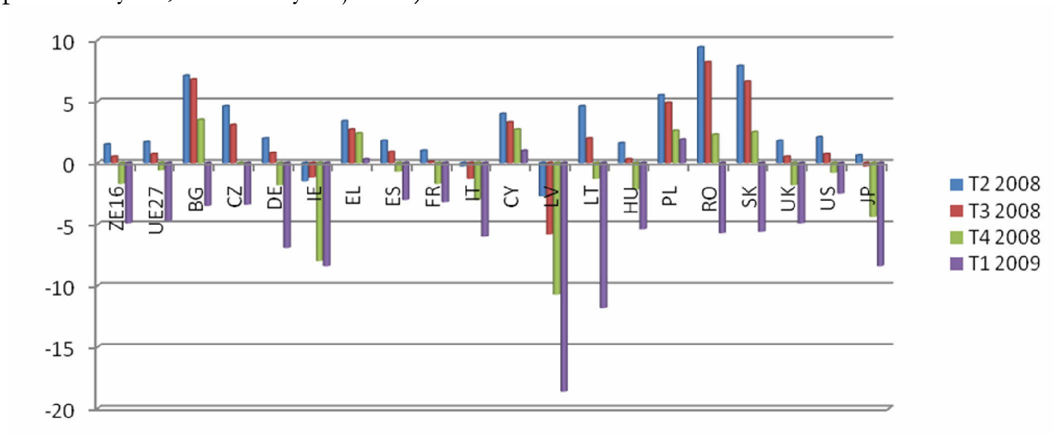


Source: European Commission, Spring forecasts, May 2009

According to Eurostat estimations, in the first quarter of 2009, GDP in the euro area decreased by 2.5% compared to previous quarter, and in the EU27 one by 2.4%. In rapport of the first quarter of 2008, the reduction registered by the GDP was 4.9% for the euro area and 4.7% for the EU27. The first quarter of 2009 has meant also a reduction of investments of 4.1% in the euro area and of 4.5% in the EU27. Household final consumption decreased by 0.5% in the euro area and by 0.6% in the EU27. Exports registered a rebound of 8.8% for the euro area and 8.3% for the EU27, while imports decrease was 7.6% for the euro area and 7.8% for the EU27. In the United States and Japan, the decline GDP recorded in the first quarter of 2009, compared to the same period of 2008, was of 2.5% and respectively 8.4% (Chart 2).

[67] FMI, Crisis and Recovery, World Economic Outlook, April 2009

Chart 2. Growth rates of GDP in volume (grownth over the same quarter of the previous year, seasonally adjusted)



Source: Eurostat

Regarding the constructions sector, output adjusted with seasonal variations recorded in May 2009 a reduction of 2% in the euro area and of 2.7% for the EU27, compared to the previous month. Following May 2008 rapport, production fell in May 2009 by 8% in the euro area and by 9.6% in the EU27. Most emphasized decreases were registered in Romania (-23.7%), Slovenia (-21.1%) and UK (-17.9%).

3. Perspective of overall situation of the Romanian economy

At the beginning of the crisis, the Romanian economy had crossed a period of several years of economic growth, but accompanied by the accumulation of a significant external deficit and external debt increase in short term.

The current external climate imprints on the economic environment in Romania through[68]:

a)by worsening perception of risk, including through association with regional developments;

b) contraction of the external market outlets;

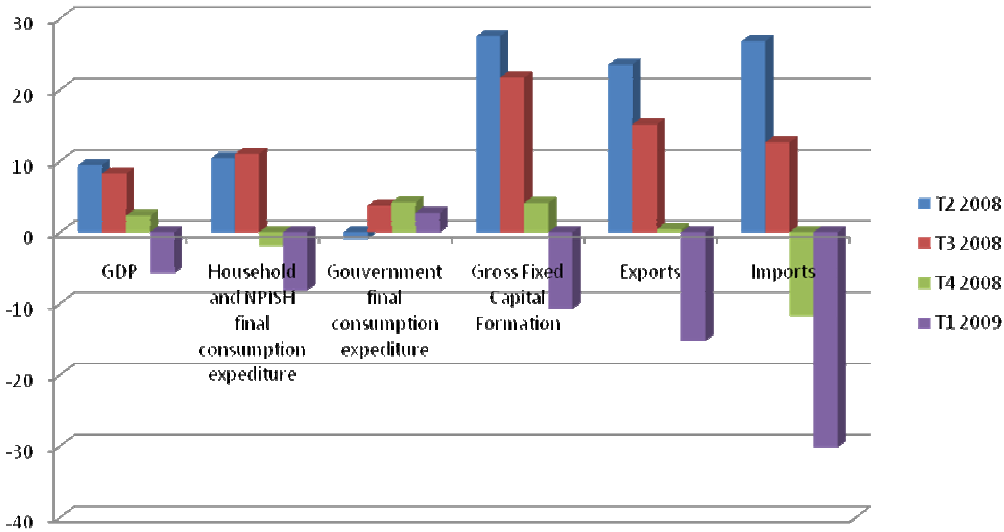
c) difficulties in external financing;

d) doubling of liquidity risk with the solvency one at microeconomic level.

The Romanian economy declined in the first quarter of 2009 with 6.7% compared to the first quarter of 2008, over the value in the euro area (-4.9%), this slowdown being even more problematic following the low level of GDP / inhabitant in Romania (chart 3).

Chart 3. GDP and expediture components (grownth over the same quarter of the previous year, seasonally adjusted, chain-linked volumes) - Romania

[68] Rapport on the financial stability, BNR (Romanian National Bank), 2009



Source: Eurostat

The risk is that this reduction of economic activity to determine disinvestments and the increasing of unemployment, endangering the real convergence process on medium and long term.

Once triggered financial crisis, the capital market in Romania has followed a downward trend of foreign markets. Capital market in Romania registered, similar to other stock exchanges in the region an increased volatility, a reduction in equity market capitalization, but relatively constant exchange liquidity.

BET index recorded in 2008 a decrease by approximately 70% and the stock exchange capitalization reduced by 47%, reaching by end of year the value of 57.8 billion lei. Traded value on the Bucharest Stock Exchange has fallen significantly, the daily transactions average in the last quarter being of 22 million lei compared with 72 million lei, the recorded value in the same period of 2007. However, exchange liquidity remained relatively constant with a value of about 8%.

Romania's trade deficit in the first four months of 2009, of 2.9 billion euros, reduced 2.5 times more than compared to the same period of 2008, after the fall of imports by 36%, and while exports have decreased by 20%.

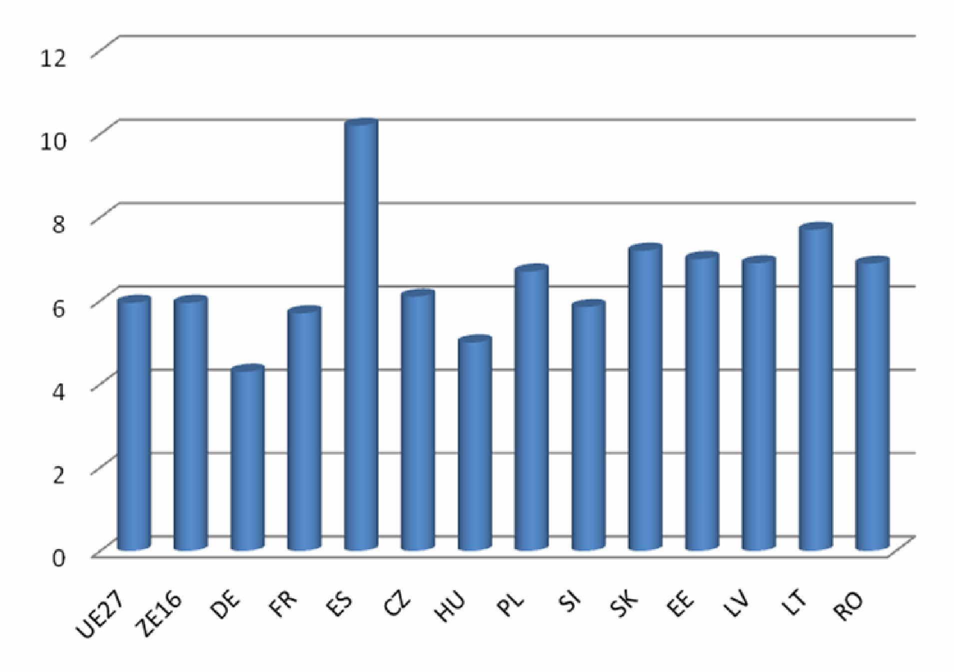
Perception of risk for Romania is judged differently by the rating agencies: since October 2008, S&P and Fitch, since November 2008 considered that Romania has a higher risk, above the threshold of investment grade (BB+, negative perspective); agencies Moody's (Baa3, stable perspective, since of October 2006) and JCRA (BBB- since December 2008) considers that the risk is similar to the level of the investment grade.

4. Manifestation of financial crisis in the construction and real estate sectors

In terms of increase of construction and real estate sectors' role for the Romanian economy, the financial crisis hits, maybe with priority, these activity fields.

The development of the construction sector can be assessed on the basis of its contribution to the formation of value-added in economy, with approximately 12% in 2008 compared to 6% in 2004, above the average of European Union (chart 4).

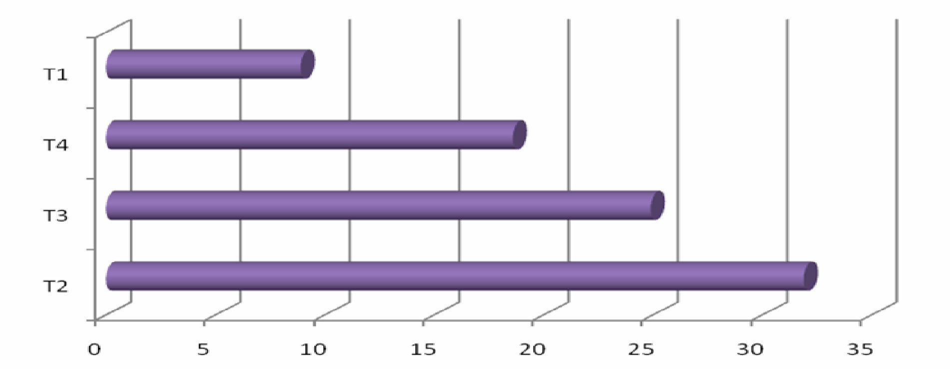
Chart 4. Contribution of construction sector to GDP formation, average 2000-2007 (Euro zone, EU27, some EU countries)



Source: Eurostat

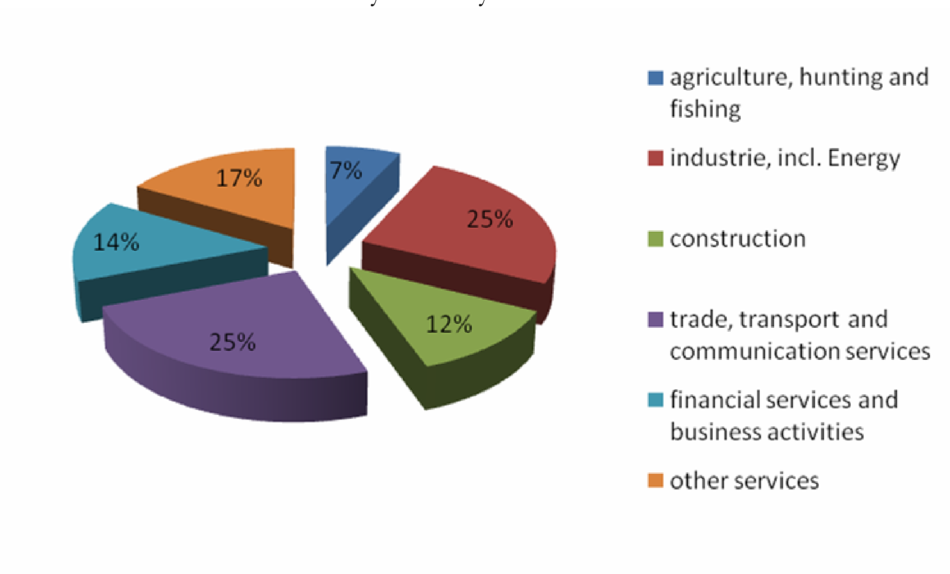
Even against the backdrop of financial crisis, the construction sector creates, in the first quarter of 2009, an added value of 3366.6 million euro, higher by 8.9% compared to the one created in the same quarter of previous year (chart 5). The construction sector succeeds thereby to generate in the first quarter of 2009, 12.17% of total value added of the Romanian economy (chart 6).

Chart 5. Gross value added by Construction (grownth over previous quarter, seasonally adjusted, chain-linked volumes) - Romania



Source: Eurostat

Chart 6. Gross value added by industry - Romania



Source: Eurostat

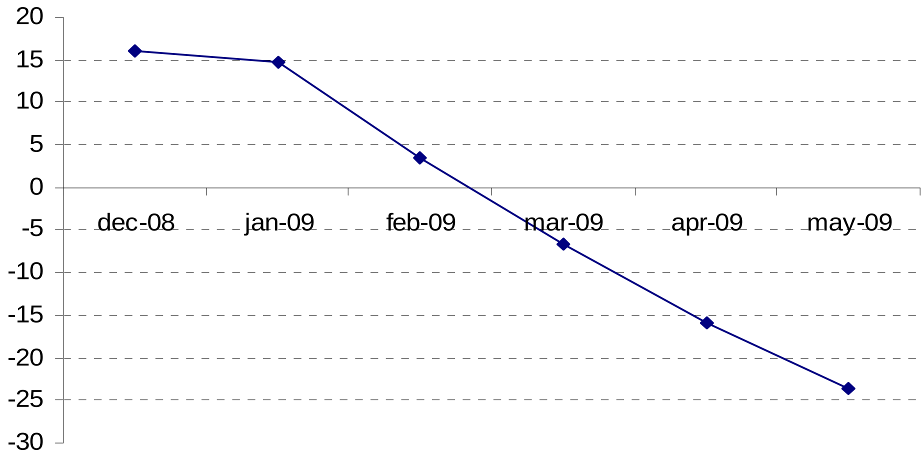
At the level of June 2008, the number of employees in constructions represented 13% of the total employees in economy, and companies in the field owned 8% of total assets.

The real estate sector has a small share, of 1% in total turnover, but holds 12% of total assets in the economy (at June 2008).

In recent years, one have built more and more, investors staking on demand increment, but the economic crisis caused a radical change of attitude from the customers, these now being more reluctant in buying before prices stabilize. Even if demand is low, one continues to build, the number of completed dwellings in the first quarter of 2009 being only 2.8% below the same period of the last year. The main explanation of this situation relates to the large number of buildings in progress.

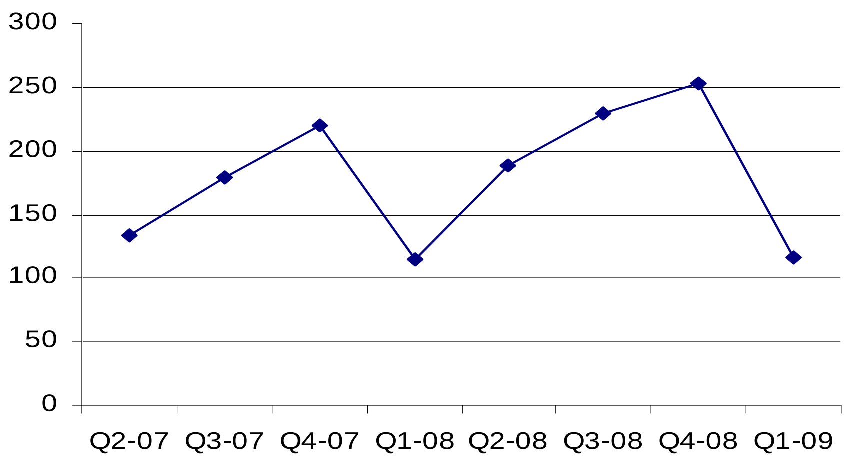
However, Romania presented in May 2009 the most drastic decrease in production of the construction sector in the EU, of 23.7% (chart 7). The status of the construction sector is reflected also by the development of the quarterly index of production, which, in first quarter of 2009 decreased to the value of 116.8 (chart 8).

Chart 7. Construction output – annual variation (% change compared with same month of the previous year)



Source: Eurostat

Chart 8. Quarterly production indices for total construction, working day adjusted (base year 2005)



Source: Eurostat

Financial situation of enterprises in the construction industry was relatively good in 2008, as well as their ability to absorb moderate shocks. Deterioration of economic activity in the latter part of 2008, which is manifested also in the first quarter of 2009, however, aggravates service to banks, the situation being more difficult since these enterprises require to an increasingly large extent short-term financing.

Access to finance of these companies has become more difficult and more expensive, following the bank's reluctance to provide liquidity and to attract resources towards the government to the detriment of the private sector. A special issue of the construction firms in the construction and real estate domain is raised by level of external debt, of 40% of medium and long-term debts and belonging to the non-financial companies; also 38% of outputs and 46% of the entries scheduled for 2009 from the external debt in short term residual belong to these enterprises.

In recent years the construction cost of new houses recorded an upward trend, well above the European average, which now enables companies from the sector to improve the costs in order to be maintained on the market. The number of building permits granted has not decreased significantly until March 2009 when there was a reduction of 17.7% compared to March 2008. Intentions to purchase a house in the next 12 months, though have deteriorated, are situated at the beginning of 2009 above the EU average. Under these circumstances, there are conditions that this crisis in the construction sector to be managed more easily.

5. Conclusions

Before triggering the crisis, investors' aversion to risk had fallen and preliminary analysis had become superficial. Thus, ABN Amro could create, in August 2006, a new financial product, CPDO (Constant Proportion Debt Obligation), considered by rating agencies as an asset without risk (AAA), with a rate of return greater with 2% than the state loans. This product currently worths between 40% and 70% from its issue price, which shows that it is not an asset without risk ...

Currently, access to liquidity and financial flexibility are clearly more important notions than the hypothetical reduction of capital cost resulted from indebtedness. Moreover, Almeida and H. Th. Philippon, established late 2007 that the value of bankruptcy-related costs connected to debt is relatively equal to the tax economy due to the deductibility of interest, practicably neutralizing the leverage effect of indebtedness.

The EU believes that addressing the crisis at national or European level is not sufficient, requiring global coordination. Thus, during the G20 Summit, held in London in early April, the EU has advocated for the purpose of:

- implementation of measures of economic stimulation in sustainable way;
- determining what concrete steps should be taken to strengthen the financial markets' supervision;

- strengthening the mandate and capacity of international financial institutions, as guardian of global economy stability, but also as a forum for equitable representation of emerging and developing economies.

Currently, the resumption of economic growth in Romania can not be accurately anticipated by specialists, international comparisons suggesting that, in the conditions of the global crisis, countries with high growth rates will suffer important decreases. A sustainable growth should be based on increasing public investments and of competitiveness of Romanian enterprises, a significant role, at sectoral level, reverting to the construction and real estate sector, due to the dynamics, to the weight in the economy and to the dependence of their internal and external financing.

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