The current financial crisis revisited. Causes and remedies.

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The present financial crisis is the outburst of tensions accumulated in time in the banking and financial systems. Though its causes resemble past crisis it has certain characteristics that demand a new approach. The high contagion effects as well as the implications on the real economy need different solutions from those used in the past. The paper tempts to identify the main causes and possible remedies in order to stabilize the markets and induce economic growth.
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1. INTRODUCTION

1. The symptoms of financial crisis

1.1 What do past crises teach us?

For a considerable time, the financial world has experienced a certain degree of stability, allowing financial intermediaries to perform in a relatively undisturbed environment. But reaching stability on financial markets means an undivided attention to all the details concerning institutions, markets, infrastructure, and environment[1].

[1] Donath Liliana, Cismas Laura, Determinants of financial stability, The Romanian Economic Journal, nr.3/2008

The globalisation that started more than 25 years ago had, in time, significant positive as well as negative consequences on the economic and financial activity. Recent empirical researches show that the deepening and intensification of financial flows through the international markets brought unquestionable benefits to developing countries by stimulating economic growth and inducing a sustainable financial stability for the developed countries. But the positive effects of financial flows appear if a number of preconditions already exist:

- a macroeconomic environment allowing growth,
- structural imbalances are mitigated,
- market mechanisms allow competition,
- a sustainable operational and supervised financial system,
- well functioning financial institutions and mechanisms,
- globally integrated markets.

If these conditions exist, then the domestic market allows the entry of healthy capital and is less vulnerable to speculative ones seeking high profit. Nevertheless, the globalization may induce vulnerabilities by contagion and import of vulnerabilities:

- the interaction of markets also means a high exposure to risks that are often difficult to deal with,

- fuelling of instability all over the world because of risk contagion, information asymmetry, *herd behaviour*,

- speculative attacks on national currencies,

- creates often unsustainable imbalances.

1.2. Setting a diagnose. Lesson that have not been learned

Undoubtedly, crises do not occur unless a number of preconditions exist in the economic and financial environment. The tensions accumulated in time, led to financial turmoil and possibly to crisis, built up starting from relatively obvious determinants: *asymmetric information, moral hazard and adverse selection*. The presence of low transaction costs in financial markets explains the great part played by intermediaries in the financial flows. Under these circumstances, information is a crucial factor for all the parties involved in the financial process, i.e. *lenders – intermediaries – borrowers*. Therefore, in order to function well, markets need complete and transparent information enabling participants to make the right decision. But, actually, markets are characterized rather by inequality of information, known as asymmetric information. Obviously, then, when one party is better informed about the potential returns and risks associated to investments creates problems from two perspectives: before and after the transaction takes place. Thus, before the transaction takes place, asymmetric information leads to adverse selection, meaning that potential borrowers are envisaging undesirable outcome (i.e. bad loans) induced mainly by inappropriate and unfair behaviour (high propensity toward risk that will be shared with the bank). In the aftermath of the transaction, the moral hazard may occur when the lender is subject to the hazard that the borrower engages in undesirable investments that may turn in loss for the lender, and therefore the latter becomes reluctant to grant loans making them more expensive.

Starting from these facts, the main identified determinants of financial crises can be summarized as follows:

1. Expectations of interest rates' increase. According to adverse selection and moral hazard, debtors engaging in risky projects are the most inclined to accept high interest rates. As interests start having an upward trend, either because of a shrink in the

loan supply or as a result of an increase of loan demand, borrowers engaging in low risk investments will renounce contracting loans, while high risk investors will continue to increase their demand for high interest loans, jeopardising the financial position of the banks.

2. Decline of stock prices. A decline in the assets' market value means a decline of the value of collateral, impeding the lending activity of banks. Banks become reluctant to grant loans bearing low value collateral thus raising the cost of lending. As a consequence, investments and consumption shrink reducing the economic activity. Moreover, the low level of assets means a decline in the stocks' price high risk borrowers being induced to accept, as an alternative, high interest loans.
3. Unanticipated reduction of prices inducing a reduction of assets' value, housing and mortgage and to increasing the cost of debts.
4. Increase of uncertainty. The bankruptcy of financial institutions determines a stock crunch and the inability of lenders to judge the quality of borrowers. The impossibility to solve moral hazard problems leads to more expensive loans reducing investments and aggregate economic activities.
5. Bank panic. Under bank failure the intermediation shrinks, savings are withdrawn, reducing the available lending funds and restraining the economic activity.

Most of the 20th century crisis may be set in the above framework. While in the 1980s the Tokyo and New York stock exchanges collapsed, the following decade underwent several forex and financial crisis. The early 1990 witnessed the turmoil in the EMS that led to the exit of the British pound, the Italian lira and the Portuguese escudo from the "tunnel". It was followed by the collapse of the Mexican peso in the fall of 1994 which emphasized the frailty of the financial system aggravated by the funding of public deficit by short term loans.

It is worth mentioning the South Eastern Asia great financial depression triggered by the collapse of the Thai bacht in the fall of 1997. This crisis with aggravating consequences spread all over the world, weakening even countries with high growth rates and strongly revealing the perils of the contagion effects. Russia faced a deep crisis in 1998, stopping the reimbursement of bonds on the domestic market (GKO) and affecting financial markets worldwide including the Latin American ones and demanding the intervention of the Federal Reserve System to prevent a contagion of the American banking system already weakened by the LTCM hedge fund crisis.

Because the most affected by the 1990s crisis were the developing countries, economists argued that an emerging country should not liberalize the capital account until a number of fundamental preconditions are fulfilled:

- the inflation is manageable (preferably a single digit inflation rate has been reached), the exchange rate is stabilized and there is a considerable external credibility,

- the inflow of funds can be absorbed in the economy,

- the public deficit and extra budgetary funds are sustainable,

- the external public and private debts are manageable,

- the financial system is sufficiently developed allowing the entry of healthy capitals and rejecting speculative flows,

- prudential supervision regulations exist,

- there is a loyal competition policy,

- there is an efficient IT system allowing to prevent operational risks, and an effective statistical evidence.

Facts show that an untimely liberalization of capital account may induce the concentration of speculative inflows that seek high profit, housing bubbles, forex fluctuation, may trigger financial instability and, eventually, an apparent economic growth and enthusiasm can be

followed by long crises and stagnation. The depth of the current crisis is given, among others, by the aggravating factors forsaken in the past. While in the last decades we can say that the turmoil affected more or less local or regional markets, without a serious impact on the global market, nowadays the crisis is largely extended affecting developed as well as developing countries and is about to become also an economic crisis.

2. Characteristics of the present crisis. Does it differ from the previous ones?

The symptoms of the present crisis were felt long before it burst out once Lehman brothers went bankrupt in September 2008[1]:

- the volatility of asset prices and the restlessness on different stock exchange indices worldwide,
- low scoring of borrowers and sub prime mortgages,
- the rising price of oil and of gold,
- the housing price bubbles followed by a sharp fall of house prices,
- changes in investors' behaviour towards risk aversion etc.

All these aspects announced the same outcome: an inherent crisis proving that no financial institution is too big to fail.

It is generally believed that the housing bubble and the losses induced by the sub-prime loans are the causes of the present crisis. It is true to a certain extent, but we believe that this only the tip of the iceberg and that the roots run much deeper. A brief survey on the worldwide statistics over the last years shows:

[1] In March 2008 a first episode of the crisis is felt when the financial giant Bear Sterns is on the brink of bankruptcy. In order to prevent it, the FRS asks for a merger with JP Morgan at a price of 2 $/share (far less than the former 80$/share market value). After hard negotiation between the two institutions the value is set to 10$/share

- large global imbalances,

- a great volume of liquidity flowing through financial markets in search of high returns, but disregarding risks (turning into cheap money),

- increase of consumption and of consumer's credit and low savings (thus feeding money supply),

- securization and it's sophisticated and non-transparent layers,

- a rift between domestic and international markets (given that domestic markets are often highly regulated and supervised whilst the international markets lack regulatory and supervision measures),

- the often arguable assessments of the rating agencies.

2.1 Possible resolutions for the crisis

Though the financial crisis (turned into an economic crisis) is far from being solved, and no obvious solutions can be given until the last part would have been played, it is mandatory that the international community (governments, international financial institutions, market regulators, monetary authorities) must cooperate. Nevertheless, a few possible approaches can be outlined. First and foremost, it is obvious that the international community has to come to terms with the fact that the functioning of the global economy will be set in a new frame, and a new economic order will exist and therefore they should agree on the principles regarding the coordination of economic and financial processes:

- enhancing prudential supervision and regulations of risk management,
- promoting transparency and accountability,
- encouraging savings and investments as opposed to consumption and waste, thus

- making resources available and granting loans to small and medium firms that can launch economic growth, employment and productivity.

Moreover, on a wider level, because of the high level of contagiousness of markets, the international financial institutions should agree on:

- procyclical policies,
- enforce global accounting standards,
- regulating derivative markets and clearing systems.

But all these long term measures can be considered only after the liquidity problem had been solved. The core issue of the liquidity problem is now the *lack of credibility* blocking the inter bank markets, affecting the availability of loans, the fuelling of funds into the economy, and economic downturn. For these reasons, we believe that what mainly distinguishes the present crisis from the previous ones is mainly the *lack of credibility of financial markets and the high contagiousness.* Therefore past approaches and solutions might be now either inappropriate or may be reconsidered in order to meet the present needs. Dealing with credibility might be a sensitive issue given its complexity due to behavioural and psychological aspects of risk management that are embedded (either risk acceptance or aversion), besides economic ones. Nevertheless, a correct approach of the liquidity problem is essential because it allows the proper functioning of financial markets, the flow of capitals and the up-swing of the economy.

3. How is Romania affected by the crisis?

The Romania economy is part of the global flows and it is affected to a certain extent by the turmoil on the external markets. We think that due to its specific characteristics, the effect of the present crisis on the Romanian economy is two folded.

On one hand, from financial point of view, the Romanian markets do not have strong connections with US and UK financial markets, that were most affected by the crisis, thus not being intensely exposed to the so called *toxic assets* that fuelled the crisis. The shield that prevented contagion is the financial market, *per se*, which is quite narrow, few foreign companies listing their stock at the Bucharest stock exchange, and the volume of transactions is relatively low. Moreover, the banking system is prevailing in the funding process of the firms and individuals, the products offered by the banking industry provide high returns and the market is closely supervised by the National Bank of Romania (NBR). The relatively strong position of the banking system is due to the tight monetary policy led by the NBR implying high reserve requirements which acted like a cushion for banks that encountered temporary problems because the lack of liquidity. Though often subject of controversy, the prudential measures enforced by the NBR (i.e. slowing down the lending toward the private sector, prudential risk management, timely and unannounced interventions on the foreign exchange markets, etc.), proved their efficiency in controlling the money supply and mainly the inflation rate, thus preventing the banking system from encountering major problems. Moreover, we should say that after a long time, when the NBR only sterilized the exceeding liquidity supporting the costs in its books, a turning point has arrived in implementing monetary policy, the NBR being able to actively use its tools in order to efficiently influence the market according to its objective (i.e. the stability of the national currency).

On the other hand, negative effects of the crisis occur in the real economy. From this point of view there are a few vulnerabilities worth mentioning. Firstly, most of the loans are denominated in foreign currencies that become more and more expensive and putting a stress on the possibility of reimbursement. Obviously the negative impact would be the increase of doubtful and loss making loans in the banks' balance sheet. The delays or even inability to pay the loans leads to a sharp drop of the housing market and of mortgage value. An impor-

tant vulnerability of the Romanian economy might be the decline of the FDI inflows, thus putting into peril the funding of the already deep current account deficit (13% of the GDP). Secondly, Romania is a part of the global economy, meaning that its exports will be affected with consequences on the level of production, unemployment rate, exchange rate, (forex rate already being adjusted to higher levels) and eventually growth. A big problem of the Romanian economy is the public money management. In the absence of a sustainable fiscal stance and waste of money through public spending mismanagement, macroeconomic balance cannot be restored. Therefore the approach of the fiscal stance should be consistent with the present economic situation, supporting adequate adjustment program. It means putting at the core of the public policy *the performance of financed activities* and allocating funds only on efficiency criteria basis. If the government fails to finance productive investments (i.e. the infrastructure, necessary in the long run, to fight unemployment) and will continue to channel funds towards loss making areas while not meeting its own debts towards private firms it will only contribute to the deepening of the crisis instead of using its fiscal tools as levers to boost economic activity. Romania has the chance to overcome the economic crisis, though a smaller economic growth than the one in 2008 is foreseen, which is to be expected after a long period of intense growth. Still, the Romanian authorities will possibly have to deal with the return of the labour force that worked abroad by creating job opportunities. A possible solution could be offered by supporting the development of small and medium sized firms, which so often proved to be an engine of the economic development.

Banks have already changed the development policies, relying on short-term savings for 2009 and resuming loan extension in the second half-year. Bankers believe that in 2009 both savings and loans will be in national currency (leu) and far less foreign currencies. The NBR officials explain that, "a fair and consistent analysis" of macro indicators proves that Romania's downgrading is not justified.

According to the NBR, Romania is still attractive for foreign investors, but extended infrastructure is necessary for such investments to further develop. We think that from this point of view Romania has to concentrate on its competitive advantage rather than on the comparative ones. Seemingly, in 2009, companies and banks will have to put in place cost control measures, liquidities must be use efficiently preventing waste, cost effective activities should be pursued. A considerable emphasis regards productivity and the increase of domestic supply of goods and services and a slowdown of imports to curb the deepening of the commercial account imbalance. It is expected that the sectors to experience the highest growth in 2009 will be the mutual funds (up 24 percent compared with 2008), insurance (12-15 percent), and courier services (10-30 percent). The retail, consultancy, PR and distribution sectors are predicted to rise by more than 10 percent. On the other hand, the car industry, household appliances, stock brokerage and agriculture might report slumps between 40 and 50 percent next year. Such plunges will be mainly due to Romanians' tendency to switch to the products they need at the most and the less expensive goods.

4. Instead of conclusions. Lessons to be learned

The present crisis rooted in the sub prime mortgage market is the result of a number of risky and irrational economic behaviour pursued in time by financial institutions, public decision makers and individuals, disregarding the risks and economic consequences that might have occurred by spreading through the open markets. The accumulating determinants spread by contagion to the whole world, eventually affecting the global economy and living standards.

Still, a number of lessons can be learned. Firstly, the crisis should not be treated emotionally but rationally, setting up a smooth restoration of macroeconomic balance. Consumption should be restored cautiously and preconditions for savings should prevail in order to mitigate the lack of external funding. Secondly, no financial institutions are

"too big to fail" so, prudential supervision of the financial markets should be revisited and adjusted to present conditions. Under these consequences, the fiscal stance becomes very important and public deficits' management should become a priority preventing the fuelling of money supply. Still the question remains: should the state intervene to bail out ailing financial institutions or should the market restore transactions according to its mechanisms and insulate these entities? The first approach may be considered given the high contagion effects of bank failure on other institutions thus preventing chain spill over of the default effects. The dilemma is even greater because of the high costs born by tax payers and the burden on public budget. On the other hand, the market approach has more long term profound effects, the solid and efficient financial institutions remain in the system, but the approach could be costly and painful for the intermediation process. Eventually, this is a problem of fine tuning between the state intervention and the market mechanisms in order to diminish the costs as much as possible.

Indeed, the public budget can positively contribute to the solving of the crisis by channelling funds to financially support the small and medium firms, to improve the infrastructure (thus decreasing unemployment, and increasing personal income and consumption) and lower non productive spending. As a consequence, fiscal space can be created allowing sustainable public deficits used to boost the economy.

Last, but not least, the credibility problem should be at the core of either of the above approaches because the national and as well as the international financial system cannot function, in a global environment, unless its conduct is transparent, accountable and most of all promotes credibility among partners.

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