The Origins of the Global Financial Crisis and Its Impact on Romanian Economy

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ABSTRACT

Asymmetric information theory says that individuals who cooperate in different situations have different levels of knowledge on a subject. The main role of a financial system is to direct funds to individuals and companies that have good money investments. To do this correctly, participants in financial markets should be able to make correct opinions on which investment opportunities are in some measure efficient. This is where the problems of information asymmetry occur: moral hazard and adverse selection. So financial crisis are triggered when these problems become particularly acute, and financial markets are unable to perform this crucial role of channeling funds to those who have the most efficient investments. Recent financial crisis, triggered in the U.S. and spread globally, has not spared Romania, and the present paper tried to highlight its main effects on our economy.

1. The Asymmetry of the Information

A financial system has to cope with the asymmetry of the information because a contracting party can hold less information than the other party. In funding process, the debtors, are usually better informed than their creditors on the profit and the risk associated to the investment they are going to accomplish. Asymmetrical information leads to two deviations of the financial system: adverse selection and moral hazard (Mishkin (2001)).

Adverse selection refers to a situation in which buyers/sellers have relevant information that sellers/buyers lack, about some aspect of product quality. It is a sociological phenomenon in which those persons with the most dangerous investment are the most likely to borrow money. Adverse selection may also occur if those persons conceal or falsify relevant information when they apply for the credit. This has the potential of economic hardship for creditors. So the adverse selection arises before the transaction takes place, when the risky debtors are precisely the ones ardently searching for a loan. The ones willing to take the higher risks are probably those who are most determined to borrow money, even at high interest rates, because they are less preoccupied by refunding the loan. Thus, the creditors should be worried of the fact that those most likely to produce an unfavourable result are the ones selected for being granted the loan. In this case, the creditors should avoid granting credits at high interest rates since they know they are well informed on the quality of the borrowers and there is a high probability of the latter not to pay the loan. In order to avoid this risk, creditors should evaluate the quality of the debtors. Mishkin (2001) warns that this process is inevitably imperfect and the fear of an unfavourable selection leads to a decrease of the number of loans granted.

Moral hazard occurs when a person or institution may not assume the consequences of his actions, and therefore is not as careful as should be, leaving another party to hold some responsibility for the consequences of those actions. Krugman defines moral hazard as the situation in which one person makes the decision about how much risk to take, while someone else bears the cost if things go badly. So, moral hazard arises after the transaction takes place and this is due to the fact that the debtor is encouraged to invest in high risk projects: should the project be successful, the gain is the debtor's, but should it fail, the creditor suffers the biggest loss. At the same time, the debtor is tempted to embezzle funds in its own interest not making to much effort in investing in profitable projects. Thus, there is the risk for the debtor to invest the money badly, increasing the probability for the loan not to be refunded. Creditors often impose restrictions to the debtors, which are yet limited. The potential conflict of interests between creditor and debtor, arising from the moral risk, leads to the fact that a great number of creditors will loan less then usual and the result is a level bellow optimum of credits and investments.

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Both theoretical and empirical literature have treated currency crisis, but most problems have not been solved, each crisis bringing about completely new elements. Yet, one should fix the boundaries of „financial crisis” in relation to „financial crah”. A market cycle is characterized by two intervals: Bull Market and Bear Market. The “Bull Market” period starts when the market is week, the population pessimistic and most of the investors sell. It is the moment when the market is underrated, which means that stocks sell under their fundamental value, being the best buying opportunities. Wise investors, also known as “smart money”, initiate the so-called accumulation process: they buy gradually so that the infusion of capital does not cause sudden moves on the market. Those are usually market professionals, far better informed than the rest of the public. As a result of accumulation, the prices rise, drawing the attention of mutual funds, which amplify the rising tendency of the market. While “smart money” have accumulated a substantial profit, major investors are still skeptical. Once individual capitals are launched on the market, one can witness a real euphoria. A lot of small investors get rich, the optimism reaches its highest and soon the market will crush due to excessive speculation. At this point the “smart money” initiate the distribution process, in other words they gradually start selling the overrated stocks to naive investors. When the market is up greed reaches its highest. After mutual funds and individual investors have invested all they can, the market is oversaturated. From this point onwards the market can only go down and all it needs is a few negative rumors to witness the “Bear Market” fase. When the sale panic starts, the falling is always more accelerated than the raising. At this point nobody is interested in buying which can be disastrous for margin users.

In countries with emerging economies, there is a factor of financial instability which is not common for developed countries, namely unpredictable depreciation of exchange rates. Due to the uncertainty regarding the future value of the national currency, many of the companies acting on emerging markets choose foreign currency credits. In this case, if there is an anticipation of the depreciation of the national currency, the debt burden raises for domestic companies because the property value is denominated in national currency. Thus, the chain of phenomena resulting from the asymmetry of information continues with a decrease of investments and of the economic activity.

Financial crisis on emerging markets face different stages of evolution (Mishkin,(2001)). There is an initial stage, when there is a weakening of financial and non-financial balances, a second stage, that of deterioration of the exchange rate resulting in a worsening of the financial and non-financial imbalance, which generate the third stage when the economy is thrown into a financial crisis with devastating consequences.

2. U.S.A.’s recent crisis

The existing crisis on the world’s financial markets, originating in the crisis of the segment “subprime” on USA’s mortgage market, has rapidly spread onto other segments of the world’s financial market, being already considered one of the harshest financial crises in the history. The impact on the real economy will probably be greater than estimated so far. Giant financial institutions almost collapsed, which imposed a rapid intervention by drawing new capital either from stock holders or other investors, or by governmental capital injection.

J. Ackermann (2008) underlined that these turbulences on the financial markets have been preceded by a period of unusual economic growth and low inflation rates. These translated into extremely favorable conditions for the world’s banking system, with low default rates, big profitability, high capital return, rapid increases in the volume of transactions and financial innovations. This combination of positive factors has caused the banking system to fall down from an unusually strong position and probably, this favorable background played a part in starting this crisis by helping at least part of the market traders to show exaggerated confidence and to ignore the risks. J. Ackermann stated that the crisis of the “subprime” market has been accentuated by two connected factors: the boom on the American real estate market, on the one hand, and the liquidities on the financial markets, on the other hand.

The raising of prices on the American real estate markets were partially justified by the demographic growth, but were increased by convenient monetary policy and mostly by innovations in mortgage financing. One of these innovations was “subprime” mortgage credits who’s percentage out of the total amount of mortgage credits had increased from 6% in 2001 to 15% in 2006 (Ackermann (2008)).

“Subprime” credits were hazardous both for borrowers and for creditors because of the combination between high interest rates, inadequate history of the debtor and mainly because of unfavorable financial circumstances. The term “subprime” refers to the borrower’s status as debtor (not a very good one, under‐optimum) and not to interest rate. Subprime credits have always been controversial because they were based on the idea that the financiers in this case, engaged in predator‐type lending practices, by deliberately granting loans to persons unable to fulfill their obligation which inevitably lead to default and foreclosing on the mortgage. The high risks creditors took, were further passed on by using the securitization mechanism, instrumented by the investment banks, mechanism which caused the contagion effect. These instruments, acquired by securitization, initially called synthetic assets, were considered toxic after the crisis began.
Towards the end of the period of credit expansion, standards deteriorated even more by the introduction of preferential interests (lower for the first or first two years of mortgage), by loans granted based on declared income or by “ninja” loans granted to debtors without income, job or property. Some creditors continued granting loans even to such clients relying on the fact that houses’ prices would continue to rise. Standards eroded leading to “cov light” (loan agreements which do not contain the usual protective covenants for the benefit of the lending party) and PIK(payment in kind) credits – whose installments and main value are not refunded in cash but in debt supplements added to the initial debt. The banks assumed risks which exceeded their expertise and basic capital, reaching unsustainable positions when the investors’ appetite for risk decreased.

The “meltdown” (a term used by economist Mishkin), was the reversing of the trend of monetary policy of Federal Reserve, which gradually increased interest rates, starting from 1% at the middle of 2004 up to 5.25% in 2007.

The information asymmetry problems caused the massive spread of the risk and of default to take place later, in 2007, although default rates, especially on subprime segment, had started to increase since 2006.

If the crisis set off can be ascribed to the deregulation of the credit granting system and to some extent to FED monetary policy, its spreading was ascribed to two trends: globalization and securitization. The “repackaging” into guaranteed financial instruments, made it possible for the risks on the American mortgage loans to be distributed worldwide, which to some extent is constructive, but also caused the spreading of the crisis’ impact at the same time (Ackermann (2008)).

Securitization should allow the risks to be distributed to investors outside the banking system, and that should be a stabilization factor. But, in reality, precisely the banks were the most active investors in these synthetic assets. Many specialists believe that the model “originate and distribute” has failed and that the future of banking industry consists in going back to the origins, to “healthy” transactions, included in the balance sheet. Yet, the benefits of this model are so great for banks, customers and investors simultaneously, that will probably prevail. Securitization is the way to go when an institution (bank) borrows “short-term and liquidly” (liabilities) and extends credits “long-term and not-liquidly” (assets). This is the “originate and hold” model. This combination on liabilities and assets is vulnerable to an attack of the depositors upon the banks. In order to counterattack this vulnerability there have been created instruments of protection and support for banks considered important from the systemic point of view, which although solvable, become illiquid: deposit guarantee systems, last resort credits. Instead, banks accepted the credits to be controlled and supervised but used securitization techniques in order to make liquid heir non-liquid credits. This is how the “originate and distribute” model emerged in the 80’s.

3. Current crisis in Romania

During the first three months of 2009, Romanian companies survived to a certain extent, based on the accrual of previous years and on contracts in progress (both domestic and exports). Starting with April, most of these premises disappeared and the economic environment became more hostile. Exports crushed due to dramatic decrease of demand in the EU area, fiscal pressure increased, interest rates remained high, and domestic consumer demand dropped off a lot faster than estimated.

At the macroeconomic level, the evolution was kept under control. The national currency was to some extent stabilized, after a depreciation of approx. 15% at the end of 2008. The context offered by a consistent agreement with the IMF discourages potential speculative attacks on the Romanian currency, and inflation in 2009 did not accelerate its raising, although the estimations for 2010 have been exceeded.
National Bank of Romania had to raise the inflation forecast both for 2010, to 7.8%, as well as for 2011, to 3.1%. In its forecast, BNR has taken into account several elements, such as delays in implementing or incomplete putting into practice of the measures agreed upon with IMF, with negative effect on prices also, and the shocks generated by the raising of VAT rate. The governor of BNR drew attention to the fact that although the effects of VAT increase are temporary on inflation, the effects on prices are permanent. Due to the fact that this is a fiscal inflation, BNR is not able to mediate.

The current account deficit has experienced a positive correction, after the last two years when it was the weakest link of the balance of payments.

According to the National Institute of Statistics, the commercial deficit went down during the first nine months of 2010, by 3.45% as compared to the same period of 2009 and reached 6.89 billion Euros, by 2.46 billion smaller than last year.

At the microeconomic level, on the other hand, things look far worse. Thousands and tens of thousands companies, have closed their business, at the same time with the inherent firings in almost all large companies and at the same time with the draining of the job offer abroad. Unemployment rate continuously grew from the beginning of 2009, mainly in the private sector, which faced a lot of problems because of the demand reduction, but public sector wasn’t also spared. At the time being, priorities are structured as follows: macroeconomic balance (currency and banking system), large companies, but also a third priority, namely the small business which during this difficult period has been neglected by the authorities.
According to the central bank, approximately half of the 43 banks operating on the local market have recorded loss during the first trimester of the last year, for the first time during the last two decades. “Less than half of the banks operating in Romania have recorded loss during the first trimester, being thus forced to increase their capital. At system level, the cumulated loss is up to 50 million Euros”, explained for Business Standard, Mr. Nicolae Cinteza, director of Supervision Department within RNB. The increase of provisions was made in order to protect the evolution of bad loans portfolio, especially in customer area of SME and of real estate small developers, strongly affected by the global financial crisis.

Romanian Academic Society report states that the main factor that affected the business in Romania is the decrease of demand caused by a complex and co-dependent combination of aspects, out of which the most important are: availability of credits, instability of the exchange rate, emergence of arrears and of liquidities problems. Companies in the automobile industry, metal construction and metal products as well as the building materials industry, transports and textile industries are the most affected.

The above mentioned report also underlines the importance of national budget as an anti-crisis instrument, considering that the state continues to contribute to GDP by approximately 30%. Since the state still has such a contribution in the economy, the impact of poor management of public money is huge. However, Romania has become the EU state having the most volatile national budget.

The financial crisis has also influenced the evolution of the exchange rate. In a rather short period of time, the last three years, the Romanian currency has depreciated by approximately 30%. The stability on the currency market has been achieved in a context of restrictive monetary policy, having high interest rates and under a rapid deceleration of economic activity (Popa (2009)).

The currency reserves of the National Bank have reached record highs. On 28th of February 2010, the currency reserves of the National Bank were up to 29,739 million Euros, as compared to 28,037 million Euros on 31st of January 2010 (+ 1.7 billion Euros). As compared to February 2009, the currency reserves have increased by 3.8 billion Euros, respectively by 14.7%.

According to certain opinions, the transition to euro as national currency would be the right answer for Romania. However, euro adoption cannot replace adjustment policies. This conclusion became more evident once the crisis started in emergent economies. As long as the Romanian currency appreciated until the summer of 2007, the issue of euro adoption was not a current concern of the market traders. The crisis made it clear that our currency was overrated and the market made the necessary adjustment. Confronted with the crisis, with rather large volume of private foreign debt and with high instability of markets, certain market traders come to believe that early adoption of the euro can replace the efforts required for policy adjustments. However this is not possible because adopting the euro today, before taking the main steps for the junction with EU, could create serious problems in the future. Adopting the euro today would imply giving up the monetary policy before having ensured the junction’s sustainability. The result would be that the monetary policy would be ensured by the ECB (European Central Bank) which could be inadequate for the problems of Romanian economy (Isarescu (2009)). There could be the risk that facing possible high instability of output and inflation, the authorities might not have the right instruments to deal with it. This is strong enough reason for Romania not to adopt euro before eliminating the major unbalances of the economy and before having taken the steps forward for the junction.

4. Conclusions

In a world shaken by financial and currency crisis, the question is what can be done in order to prevent or at least reduce their effects. The issue of financial education is one of the things that European Commission
believes that can help in the prevention of the future credit crisis, and this subject was on the agenda since the summer of 2007.

One of the possibilities, highlighted by many economists, is that of coming back to the reality of the 60’s, when the capital was extensively controlled, which prevented the movement of massive fluctuations of capital or the emergence of financial innovations leading to crisis. Once the crisis is over, things will not come back to the way they were before, especially the banks’ ways of doing business. Banks will have to return to a strong regulation and surveillance of credit market, such as careful examination of debtors’ capacity of refunding the credits and a thorough evaluation of securities offered for investments will come back.

The models based on the presumption that there is a continuous financing availability proved to be unrealistic. The best defense against risk is a strong income source, able to offer an amortization against loss. Bank’s basic capital is the one absorbing, eventually, all losses, but an excessive growth of subscribed capital demand during a liquidity crisis, may dry out once again the financial market.

Another possibility would be for the countries to follow healthy and reliable policies, in order to avoid speculators’ attacks. Many crises seem to be the obvious result of the incompatibility between internal policies and exchange rate system, which allows speculative attacks to occur. The cause discovered by empirical literature, particularly in the case of self-fulfilling currency crisis, is not so much what is done now, but what markets suspect will be done in the future.

References