

THE CRISIS GOES ON: HOW TO RESPOND?

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Abstract. *The world seems to suffer the first crisis of the globalization. Prior to this, individual country or regional experience has been accumulated on financial crisis, which taught policymakers how to design remedial policies, but there has not been a World financial crisis in most people living memory. The most developed economies have witnessed less ambitious economic cycles while financial cycles have not calmed down, but had even grew. The impact of this financial instability with the economic growth is a potential risk which will never be underestimated in the future. Current national or G-20 responses to the crisis have started to reshape the global economy and to shift the balance between the political and economic forces at play in the process of globalization. We should look equally to the imbalance of the dynamism of financial leverage versus poor regulation, as to the disequilibria issued from financial globalized markets politically addressed with a constellation of conflicting national regulations. The major quest now is the need for a reconciliation of the democracy with the market. People has been largely disappointed by the freedom that some financial instruments played only to the aim of raising profits, while elected politicians were lately asking for more taxes to protect deposits. Hence, no further political debate will leave aside those matters. Both at home and international.*

Keywords: *financial crisis, ECB, risk, credit, National Bank, credibility*

After the first interventions of the ECB and the FED to pump liquidity into the money market¹, in August 2007, everyone thought it was just a hiccup in the everlasting upward trend. Almost two years after, how does it feel to have real estate bubble burst, growth suppressed and equity markets dragging their feet in a gloomy economy?

This question rests on a few points that I intend to address. We should all start from the mere reality that the world suffers the first crisis of the globalization. Prior to this, individual country or regional experience has been accumulated on financial crisis, which

taught policymakers how to design remedial policies, but there has not been a World financial crisis in most people living memory. According to the theory, a financial cycle exists involving both the credit growth and the prices of financial assets. However, this cycle does not necessary reflect the cycle of the real economy. Over the last quarter, the most developed economies have witnessed less ambitious economic cycles while financial cycles have not calmed down, but had even grew. The impact of this financial instability with the economic growth is a potential risk which will never be underestimated in the future.

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¹ On August 9, 2007 ECB has intervened with Euro 95 bn and FED with USD 24 bn.

Current national or G-20 responses to the crisis have started to reshape the global economy and to shift the balance between the political and economic forces at play in the process of globalization. From prominent political leaders, such as Nicolas Sarkozy of France, to ECB bankers, all recognize that something went wrong, and we should look equally to the imbalance of the dynamism of financial leverage versus poor regulation, as to the disequilibria issued from financial globalized markets politically addressed with a constellation² of conflicting national regulations.

Firstly, there is a question of how deep is the present financial crisis. Secondly, there is a problem of how long the crisis will last, noting that it spills over the real economy with virulence and tendency of engulfing it all. Thirdly, there is a concern related to how hard the landing will be in the European emerging markets. We should not forget that until autumn 2008 it was hoped that economies immune from the direct fallout of the subprime crisis would be able to stay unaffected and even to prove enough strength to pull along the entire world economy. But it only did not go that way. Finally, there is an issue of how able are monetary and supervision authorities to deal with these events.

In Romania, almost all along 2008, most of the voices were hoping that „*their crisis will not hit us*”. But the risk aversion mounted and a sudden stop of capital inflow threatened the emerging markets immediately after the collapse of Lehman Brothers which pushed to the surface the fact that while US banks

suffered 57 percent of the financial sector losses on US-originated securitized debt, the European banks were liable for 39 percent and the Asian institutions for the rest³. Indeed, the crisis has not been originated in the emerging markets, but they are equally hit in the absence of buffer funds for intervention. And this is not only the consequence of the pure financial crisis, but also the result of the fact that this crisis challenges globally integrated companies. Hence, dependence on foreign markets cannot be avoided if measured by contribution to domestic growth of net exports, FDI flows and jobs created by FDIs. It is exactly because of this that responses to the crisis cannot rely simply on national measures that lead to economic and financial fragmentation, but on the contrary we need stimulus programs and aid packages that support globalization rather than undermine it.

Nobody should fool around: in a deep recession, the temptation to export unemployment through beggar thy neighbour exchange rate policies inevitably arises. When I said that in January 2008 in a Vienna conference, most of the domestic media and some analysts rushed to criticize my position as a direct attack on “professionals”. Several months later when more fierce attack on the RON has repeated, the word „speculators” was on everybody’s lips.

On the gravity of today’s financial crisis I would like to quote Jean-Claude Trichet who acknowledged that “*The world is undergoing an abrupt downturn, as the adverse impact of the financial turmoil on real economic activity has*

² Helmut Schmidt, *The Future of Europe: Views from the Founding Fathers*, Frankfurt, 2 April 2009.

³ Jean Pisani-Ferry and Indhira Santos, “Reshaping the Global Economy”, *Finance and Development*, March 2009

been aggravated by a strong contraction in international trade"⁴. Indeed, he touched one of the core issues of pulling out of the recession, i.e. to preserve the trade integration, a key issue also for G-20. But on the condition that solution is sought in deeper multilateralism, rather than nationalism!

There are some factors that single out this crisis from all previous, but it was not entirely an unpredicted event. The current crisis exhibits all negative traits of the previous ones (except maybe for unemployment) but none of them at the levels that have determined the former crisis. Also, the crisis has a lag, not affecting every single economy at the same time and with the same intensity. However, although fiscal and monetary stimulus announced to date has been sizeable at the global level, its impact on spending has not yet become visible. With policy rates in several economies already closed to zero, a major debate has started about using unconventional tools to ease conditions in the financial markets.

The fundamental forces acting on global spending have proved, so far, to remain negative on balance. One such force is the continued tightening of bank lending, with the borrowing remaining difficult for most firms and households. The latest lending surveys suggest that banks have significantly reduced existing credit lines to their borrowers, with most of the lending being short-termed. A strong negative element against global spending spree is the rapid spread

of the recession to emerging market economies. The coincidence of a major real shock from declining exports and a financial system shock is leading to a highly synchronized downturn. In the words of the Governor of the Hungarian National Bank: *"Central Europe has been heavily hit by the current crisis, despite the fact that banking systems in the region are generally free from toxic assets. Due to our financial systems' high level of integration with the Euro-zone, the liquidity tensions quickly spread to the CEE markets, which have already been suffering from the global decline in the appetite for risk and the resulting high levels of risk premia. These negative developments mainly reflect a perceived increase in the risk of financing external debt"*⁵.

According to BIS, although comprehensive data on trade credit are not readily available, existing information suggests that international finance has been curtailed: syndicated loans for trade finance, in particular, have fallen sharply since mid-2008.⁶ In return, the fall in exports has raised questions about the creditworthiness of exporters, who are finding it more difficult to raise credit. Difficult external financing conditions, combined with the deteriorating growth outlook, have accentuated the vulnerability of those economies that have sizeable current account deficits and large currency mismatches from private sector foreign currency indebtedness. As a corollary, exchange rates have depreciated significantly and

⁴ Fondation Robert Schuman, European Interview no. 31, *"Exclusive Interview with Jean-Claude Trichet, President of the European Central Bank"*, 18 March 2009

⁵ Address by Mr Andras Simor, Governor of the Magyar Nemzeti Bank, to the 19th Meeting of the Macro-economic Dialogue at Political Level, Brussels, 3 November 2008

⁶ BIS - Recent economic and financial market developments, Basle, 3 March 2009

sovereign credit default swaps spreads have jumped to new high levels.

Bank lending to the region has been cut back since mid-2008 and the reluctance of international banks to roll over some credit lines is likely to aggravate funding difficulties, forcing thus an even more rapid adjustment of domestic demand and external balances than previously envisaged. The IMF found in its April 2009 Global Financial Stability Report that net private capital flows to emerging markets will be negative in 2009 and that inflows are not likely to return to their pre-crisis level in the future⁷. As in the advanced economies, emerging market central banks will need to assure adequate liquidity in their banking systems. However, in many cases the domestic interbank market is not a major source of funding, as much bank funding has been sourced externally in recent years. Thus, central banks may well need to provide currency through swaps or outright sales. Alternatively, central banks with large foreign exchange reserves can draw on this buffer, but other means, such as swap lines with advanced country central banks or the use of IMF facilities, should also be a line of defence.

Because the vast majority of the rollover risk in emerging market external debt is concentrated in the corporate sector, direct government support for corporate borrowing may be warranted. Some countries have already extended their guarantees of bank debt to corporate, focusing on those associated with export markets. Within Europe, the strong cross-border dependencies make it essential

that authorities in both advanced and emerging economies work together for mutually beneficial solutions. Restoring credit growth is necessary to maintain the economic activity. Fiscal stimulus to support it and limit the degradation of asset values should improve the creditworthiness of borrowers and the collateral underpinning loans, and combined with the financial policies to bolster banks' balance sheets would enable sound credit growth.

Within the range of stimulative policies that are needed now, a number of countries have rapidly lowered nominal policy rate, while unconventional central bank policies to reopen credit and funding markets are used and should remain expand.

Despite large infusions of public funds into financial sectors in affected countries, market confidence has yet to be restored. Strategies need to improve transparency, risk control and incentive structures. This implies that financial sector require actions that keep sight of long-term goals, including an effective balance between prudential risk control and competition. These objectives will need to be pursued in a manner that does not exacerbate deleveraging or inhibit lending. While everybody understood that priority should be given to immediate short measures, which include positive stimulus effect from fiscal packages, these measures must be reconciled with sustainable, long-term growth. OECD outlines a number of broad fiscal measures and structural reforms that could yield the double dividend:⁸

⁷ IMF, *Global Financial Stability Report – Responding to the Financial Crisis and Measuring Systemic Risk*, April 2009

⁸ OECD, *The Road to Recovery – Update on the OECD's Strategies Response to the Financial and Economic Crisis*, 27 March 2009

- Introducing infrastructure projects
- Boosting spending on active labour market policies
- Cutting taxes on labour income, particularly for those with low wages
- Reforming anti-competitive regulations in product markets.

This crisis is similar in the widespread panic and growth deceleration to the 1929 - 1933 depression. What we can infer from the above is that the present crisis could have been predicted but some have treated it as a “black swan” because models used by financial markets do not apply counterfactual reasoning when computing risk.

Originally, we expected a short lived crisis costing no more than USD 400 billion in sub-prime market (an estimation of the delinquencies’ effect on financial institutions in USA of the sub-prime market). Now we speak that further disclosures of world-wide losses may raise the figure to some USD 4 trillion. Why? Because the initial belief - that we face only a credit crisis -, has turned into a global financial crisis which is just a component of a much larger phenomenon, along with the current crisis of the real economy.

Few years ago, the common understanding of the world economy was that the free movement of capital enables productivity gains in emerging economies. This in turn, allows prices to stay low, hence increasing profits and generating new capital. In a nutshell,

developing economies were specialised in commodities and were piling up reserves from trade, while developed economies were specialised in capital and were incurring debt from credit.

The cycle was renewed as long as capital was available in developed economies – that is interest rates were low and appetite for risk was high for a great number of investors. During the six year period of 2001-2007 this type of financial reasoning had trebled the banks’ international assets, according to BIS data⁹. But in late 2006 something changed and there were increasingly more delinquencies in the sub prime market.

The element that changed was risk appetite. Once there was a run on risky assets there was less and less capital available and this has slowly fed into the money market as higher interest rates. The capital did not become scarce immediately and equally all around the world because investors fled towards higher return asset classes, like FX in emerging markets.

This move is depicted by BIS data which shows that in the fourth quarter of 2007 (when the crisis was consuming developed markets) the increase of total banks’ foreign claims was 92% due to emerging economies¹⁰. One year later, BIS reporting banks’ cross-border claims on all four emerging market regions decreased by a combined \$282 billion.¹¹ Certainly, Romania has not been spared from those developments, a visible trend in the fall of both short-term debt and the daily forex trade.

⁹ McGuire P. and Goetz P. von, “International banking activity amidst the turmoil”, *BIS Quarterly Review*, June 2008.

¹⁰ Baba N., McGuire P., Goetz P. von, “Highlights of international banking and financial market activity”, *BIS Quarterly Review*, June 2008

¹¹ Gyntelberg J., McGuire P., Goetz P. von, “Highlights of international banking and financial market activity”, *BIS Quarterly Review*, June 2009

However, emerging markets do not have too deep financial markets and various instruments to provide for profit margins but they can rely on their reserves. If one agrees that the crisis was determined by risk assessment and high interest rates on money market then the emerging markets are not the cure.

The end of the crisis will come when investors will perceive risk assessment as proper. After the crisis started to bite into the economic growth of several economies with high returns – usually emerging markets (like emerging Europe) everybody thought there will be a hard landing.

Early in 2007, global capital expanded trade of US assets for the high returns of the financial markets in emerging markets, also. The immediate effect was sharp appreciation of currencies, assets' prices hike and credit expansion, mirrored by widening current account balances. When it was evident that those economies were not able to keep the pace for too long the first effect was currency depreciation. However, the present exchange rate levels may well be in line with the long term equilibrium level.

The Romanian currency has not been spared from the contagion in the region and, consequently, has appreciated sharply in the first half of 2007 only to depreciate in the second part of the year and nowadays is at levels of fall 2004. Almost all of those countries have also faced a certain amount of asset price decrease. The stock exchange seems to have suffered the worst in the whole region. This has happened in Romania

too. The main index of the Bucharest Stock Exchange has reached its all time peak in August 2007 and has lost some 70% in the span of two years¹². However, as with other stock exchanges around the world, the present value is close to those in late 2003, long before the turmoil.

Real estate is by far less affected than stock exchange and this has to do with the liquidity. In Romania, there has been a clear slowing down of the activity on the real estate market from the frantic levels of the past years, this being a response of both credit squeeze induced by more severe prudential measures, but also of reduced propensity of household to borrow under weakness of job market. Accordingly, the bubble of the real estate market formed in areas nearing major cities is dispersing.

Credit expansion has been a major worry for emerging European countries long before the crisis debut. Credit was encouraged by economic prospects and by interest differential, but also by the soundness of the foreign banks that own most of the banking system in these countries. This holds true for Romania also. Another important fact was that banks in our region have had no exposure to the sub-prime mortgage market in the US.

In Romania, to the extent to which macroeconomic management requires an interest rate higher than in Euro land, there will be an incentive for financing through FX credit. However, the exchange rate risk must be highlighted.

On the same line, building higher than theory would suggest sustainable current account deficits is a problem older than the

¹² I remember being nailed by a reporter of the Romanian I&P magazine for warning against euphoria of the bubble stock exchange technology for customs purposes. COM/2007/0211 final –CNS 2007/0079.

financial crisis. In Romania, the financing of the current account balance suggests that the external resources are borrowed by local branches and subsidiaries of foreign banks and companies from their mothers abroad. The risk of finance stop is lessened because the mother companies would not shrink from financing their subsidiaries which have higher rate of returns than the headquarters. Therefore, the landing of the emerging economies and particularly of European emerging countries will be as soft as exchange rate/inflation risk will allow it.

Despite negative outlooks issued by the rating agencies (assuming a sudden stop of replenishment of short term borrowing), at least in Romania we have noted that such a development has not occurred. Moreover, capital increases were done by some Greek and Austrian parents well before the cooperative arrangement reached in Vienna between the major banks, IMF and the Romanian central bank.

Everybody expected supervisors and monetary authorities around the world to be able to cope with credit and inflation issues. How able are they in reality?

Late in 2007 and early 2008, investors moved into commodities because the risk associated with high current account deficits in emerging markets was too high. This move pushed up the price of oil, gold and other commodities to unprecedented levels. Both ECB and FED had repeatedly warned against risk being underestimated back in 2006. But financial investors chose not to listen.

After the start of the turmoil, the two central banks went along different paths

in dealing with tight money markets and inflation. The FED decided to aggressively cut the monetary policy interest rate, while the ECB opted for slower pace.

However, the solution to this crisis does not fall within the realm of monetary policy. If one agrees that today's problems are the result of risk measurement, than interest rate, which has to do with time preferences, is not the right tool to solve it.

In the same way, it is unlikely that supervisors could have prevented the crisis from occurring because rules were observed and the scale of the problem exceeds the power of national supervisors.

From the point of view of capital movement between US and Europe, BIS data suggests that there has been a reinforcing cycle from US towards EU and vice versa. Thus, US banks borrowed dollars from non-banks and used these funds on the inter-bank market, while European banks have borrowed dollars from the inter-bank market to fund non-banks¹³.

At this juncture, the problems that financial markets still face are the scarcity of liquidity, the high cost of funding and the availability of credit. The downside is that the lack of capital hinders the activity of the corporate sector and this threatens to provoke a hard landing for more economies. Various reactions have been noted, from direct injection of liquidity to corporate to guarantees issued by governments to lenders of funds to the real economy. If something is really big, than this is the lack of confidence, the mistrust among

¹³ McGuire P. and Goetz P. von "International banking activity amidst the turmoil", *BIS Quarterly Review*, June 2008.

the banks, among the banks and their clients in both ways. Hence, stress tests have become a common denominator for defence against a request for credit. A kind of supremacy dispute has surfaced when the financial economy, where the root of leverage stood, claimed that real economy is unsafe for lending to.

I would rather quote here a research published in 2001 by the Banque de France: *“This financial instability characterized mainly by a succession of bubbles into the stock or mortgage markets is not without risk for the economy, as the Japanese example tells for more than 10 years”*¹⁴. Indeed the capital markets witness a more prominent distortion of the market prices from their equilibrium level, or which can no longer be correlated to the real cycles of the economy. But, as Avouyi-Dovi and Jacquinet have proved, because the contagion and/or interdependence grew amongst the capital markets, the turbulent times are coinciding with an increase in the value of correlation coefficients between the European Exchanges, on one side, and between US and European markets on the other.¹⁵

Although policy makers were not able to prevent the crisis from occurring, this does not mean that they are not able to deal with the consequences. Resolute measures have been affirmed by G-20, but at the same time complaints were heard on both shores of the Atlantic that despite the liquidity injected (sometimes in excess?) outlook for growth has worsened. That brings us to the fact that any policy option has to be judged

against the cause of the crisis – risk measurement.

The National Bank of Romania (NBR) is responsible both for the monetary policy and supervision of the banking system. In terms of handling the monetary policy during the financial turmoil, the NBR has used the policy rate in order to communicate to markets the real cost of holding the currency. Thus, when foreign capital was flooding in the policy, the interest rate was lowered. Since October 2007, when capital has started to move out, the policy rate was increased, to view it only lately gradually reduced, in line with a deceleration of the inflation rate, but also following trends in Europe and other emerging economies. It has also played an active role in encouraging local banks to underwrite treasury bonds issued to compensate for an excessive fiscal deficit of 2008 and lack of budget revenues derived from lower VAT incomes, profit and income tax generated by the economic slowdown.

As banking sector supervisor, NBR has decided in 2008 to increase the safeguards that the banks have to provide for when considering households' loans. Provisions regarding households' forex denominated loans were altered in order to minimize mismatches and adjust households' revenues for certainty and continuity and to increase provisions banks have to make for these loans. Also, a new matrix for computing the risks associated with exchange rate movement, interest rate change and income variation has been discussed with the banks in order to increase their

¹⁴ Le cycle financier: facteurs amplificateurs et réponses envisageables par les autorités monétaires et financières, *Bulletin de la Banque de France*, no.95, 2001

¹⁵ S. Avouyi-Dovi, P. Jacquinet: *Où en sont les corrections sur les marchés d'actions?* Centre de recherche de la Banque de France, septembre 2001

own capacity of stress testing. Romanian supervisors have conducted several crisis simulation exercises involving all of the financial system, with the conclusion that the system is able to cope with a liquidity problem in a systemic bank.

In the spring of 2009, Romanian authorities searched for a pre-emptive financial package from international financial institutions, including the IMF, the European Commission and World Bank, EBRD and European Investment Bank for an amount next to Euro 20 bn, accompanied by a voluntary commitment of foreign banks to replenish short term credit lines opened for the 24 month duration of the arrangement. This is the outcome of a pure case of contagion of risk aversion supported by the procyclicality policies of election years. Indeed, major rating agencies were either downgrading Romania, or affirming a negative outlook, even and despite of a 7.1 p.c. GDP growth in 2008, which was well above the potential level. Hence, against the fear of hard lending, due to a sharp and uncontrolled adjustment, the choice made seeks to provide a soft lending under unpredicted environment in Europe and around the World. Very likely, without the risk aversion amplified by the crisis for the emerging markets, it is hard to say if an arrangement would be sought just because the current account deficit was still high but with clear downward trend or the fiscal deficit derailed in an election year. Otherwise, the Letter of Intent stated that "The Romanian banking system entered the period of global turbulence with a strong solvency position".

For some analysts, the preoccupation for soft lending policies has clearly emerged since the 4th quarter of 2008, concurrently with the spill over of the

combined effect of the fall of Lehman Brothers on financial markets and the emergence of the crisis in the real economy of Western Europe which has dramatically curtailed new orders to Romanian companies. Since then, all structural imbalances of the local economy have emerged as aggravating factor of slowdown. Undoubtedly, the IFI's cushion is not enough to generate growth along the other European economies, but as one of the carriage attached to the long train of the 27 member states. Responsible policies require Government to sideline with the economy, in a very clever approach of combining short-term interventionism with mid and long term policies, aimed to restore market confidence, including via its active role of guarantor. But, since the crisis has thoroughly affected the credibility of the financial sector, it left to the Central banks to assume the task of last resort credibility "dispenser".

However, credibility, at large, can be restored only once consumers will be confident about their future purchasing power, thus implying the quasi stability of the cost of money. Hence, the Central banks short-term measures, while responding to this demand should be consistent with the mid term targets of financial stability. Hence, providing liquidity in volumes needed and at due time require resolute measures against abnormal hikes of passive interests which indicate directly the liquidity available in the banks' safe for new credits.

The way the crisis has been handled internationally, including by the Euro zone, remembers of double standard: with strict market rules to be applied by the emerging markets and "temporary" interventionist measures applied by major players, more or less co-author of

the crisis. I remember a talk with Hans Tietmeyer¹⁶ who was very explicit about the pro-cyclicality of “marked to market” accounting system which is profit making biased and an incentive to leverage. The huge volume of losses posted worldwide from one quarter to another speaks clearly about the dimension of leverage and the gap existing between global markets, global instruments and lax regulation which let derivatives and hedge funds to dominate over the classic financial deals. The price paid and to be still paid for a long time is incredible high and this leads to a thorough revaluation of principles of the new economy. This is going to take

time, probably much time and it is too early to believe that only supervisory amendments to the financial framework will deliver lasting effects of stability.

Indeed, the major quest now is the need for a reconciliation of the democracy with the market. People has been largely disappointed by the freedom that some financial instruments played only to the aim of raising profits, while elected politicians were lately asking for more taxes to protect deposits. Hence, no further political debate will leave aside those matters. Both at home and international.

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¹⁶ BIS-Bimonthly Governor’s Meeting, Sao Paolo, November 2008

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