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Qualitative Aspects related to the Current Financial Crisis and its Impact

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Abstract

The current crisis was in many respects predictible. The long-termed and strong economic development all over the world, the increase in capital flows, against the background of stable prices and financial system, all these have encouraged the participants on the market to take greater risks to achieve greater efficiency, without observing risk management practices and cautious approaches. Low standards as regards supervising the financial institutions have damaged the visibility of the faulty risk management procedures, and the new financial products which have been complez and not very well understood by most investors have created false expectations for possible earnings. As a result, the vulnerable points within the financial system have increased and all the described developments have resulted into the greatest crisis ever known by global economy, although there have been serious debates as regards the most appropriate moment when action should be taken in case the 'bubbles' phenomenon becomes noticeable down the market.

Key words: *crisis, financial system, risk management, vulnerability, effects, uncertainty, trust*

JEL Classification: *D53, E44, G01*

The Most Important Causes of the Crisis

Just before the completion of FED's ex-president mandate, Alan Greenspan, there had already started a debate among economic analysts regarding the American real estate market's inflation phenomenon as compared to the reticence of decision makers responsible with the monetary policy to act before the exaggerated values balloon bursts. In short, the debate focused upon deciding the best moment when action could be taken to cut out the exacerbation once the first signs of the “bubble” phenomenon are noticed or after its ending.

The current situation – initially euphemistic characterized by financial turbulence developed into a real international financial crisis – shows us those who have “won” were those decision makers who considered that it was necessary first to burst the balloon and then to apply the necessary measures. Both this issue and the opponents' critics have not led to establishing the truth, as the evolutions that preceded the crisis were much more complex, due to the obscurity of some financial mechanisms as well.

By the aforementioned debate, we simply had the review of an announced crisis that was hardly believed in, and when it happened it was already too late. Too late, because the downfall was of large proportions – notice the huge losses still growing with each day – the crisis spread at great speed exceeding imagination, and its spatial dispersion affected everyone, directly or indirectly.

Comparing the actual crisis with previous ones, especially with the 1929 great depression, remains mere rhetoric, in which case it is relevant to notice that old lessons translated into a global world have already been forgotten.

It is obvious that we can not forget the cause (high risk mortgage loans) and the deflagration's starting point – the US economy bringing to the fore the deviance from liberal economic moral and the gullibility raised to art level that a real economy might sustain a financial economy thousands of times greater. However, beyond these somehow philosophical opinions, deregulation, as an American phenomenon, lax and state divided prudential surveillance, financial indiscipline, fuelled by an almost unlimited tendency to ignore risks, and financial innovation that lack the required transparency are just a few of the major causes that stirred the USA economic crisis. It has been the unilateral, reciprocal, bi-univocal, direct, indirect, of large and small size exposures, as volumes or unending chains of changes in the guarantees of financial institutions involved in crediting and investment, within a global network of securities, which did all the rest.

If, from a technical point of view, the crisis stopped the loaning because of liquidity lack, it disrupted the procedures of the monetary and currency markets, it created volatility within interbanking interest rates, it shuttered the raw materials market, induced wonders to atypical hedging behaviours of assets that have still maintained their value etc. It psychologically spread, at the speed of light, two of the most serious human states that appear when it comes to money and its functional investment: uncertainty and distrust.

Here is how two human states, of great impact on normal functioning of financial markets, have been set almost instantly in contrast with other euphoric human moods – luring earning by taking greater and greater risks. The most serious fact is that people's trust was betrayed by the informatics technology itself, the absolute hope of our trust in the efficiency of any system, including the financial one. Indeed, the loan securitization made by means of more and more complex financial instruments, harder for many to explain and comprehend – the well known financial derivatives – was supported by IT benefits, and it seems that this innovation was due to famous economists.

However, in a liberal-democratic world pleading for transparency, the financial crisis brought to the fore the fact that the known limits of the financial markets have been exceeded with areas of great opacity, arising either from ignorance, or from great trust in derivatives, or because of their introduction as infallible panacea. It is obvious that we have globalization and innovation dimensions adverse to stable balance, whose conveyance vehicle to be stopped was emphasized by the crisis.

Last but not least, we must mention the rating agencies which are relevant for some characteristics of the financial crisis. Their behaviour has come under serious scrutiny due to the ratings given to some financial institutions, even shortly before their bankruptcy. Rating classes awarded in those situations have been doubted, raising serious questions about the used methodology, but also about the honesty of the analysts that granted them.

By its causes, effects and related implications, the current financial crisis is actually a great crisis of trust which includes not only the financial system – represented by the institutions, markets and players – but also the momentary rescuers personified by the governments. The entire world is looking forward to the nature and background of measures taken by governments and central banks, but the current hopes are still crumbled by the daily evolution of markets and stock exchanges, the peaceful moments being overrun by worrying overnight falls. We are still watching the metaphoric alternation between agony and ecstasy that reflects the true dimensions of distrust.

Both the crisis and the lack of confidence have spread at their usual high speed. What is certain is that in the great uncertainty created by the crisis, as proved by theory and practice, trust recovery requires a long time.

The presentation of what I considered the main causes of the financial crisis can be interpreted as rising against a system. Far be it from me to blame the free market, being aware of its limits, but as a free researcher I only synthesize, and not only, the perception of an economic reality in which we all live.

Even if Europeans consider that bankers have the greatest responsibility as regards the global financial crisis, they do not consider that the capitalist system has failed, but that it has been subjected to abuse, as it has recently been mentioned in a Financial Times editorial.

The Post Greenspan Era and the Financial Crisis

Qualitative feedbacks of general concern related to the causes of the current financial crisis can not be dissociated from the conduct of some macroeconomic policy with global effects. Under these circumstances, we cannot overlook the Greenspan's legacy regarding the way he led the American monetary policy.

The traditional and current span of the American monetary policy must be assessed not only by the almost pure character of the market economy – USA being the most fervent advocate of free enterprise, of deregulation and competition – but also by the international role of the American dollar, as a payment means, as a spare currency and investment refuge. As a result, FED's policy has already exceeded the American interest for a long time, and FED's decisions "thrill" an entire world, especially now, through the expectations it creates.

Many analysts wondered what will stand for the "Greenspan's monument" after he had been stripped of the overwhelming praises, however praiseworthy at the end of a successful career in a sensitive and critical domain as the monetary policy. Actor – method – object, a tripartite unit which in Greenspan's case can be considered a complete control panel, maybe the most coveted by a professional, Greenspan's merit seems to consist less in results and mainly in the management itself of the monetary policy under the most various circumstances: the collapse of stock exchange in only two months after he was installed followed by the USA decline, from the point of view of economic growth, as compared to Japan and Western Europe, for a few good years; the contribution to the recovery of global economy after the crises in 1987, 1998, 2000-2001, until the remarkable performances of American economy unchallenged until 2007; significant decrease of inflation; two of the longest expansion periods known in recent history, and all these having taken place in only 18 years of his mandate.

By comparison, the 18 years before Greenspan's era brought along four crises, hard to handle, two of which were comparable with the 1930's depression in terms of harshness.

But, just because he passed through so many challenges, the reveries after the financial crisis re-evaluate its management, noticing in hindsight that Greenspan brought to the fore and under scrutiny not only the myth, but something from the monetary policy short-sightedness.

Reaching the need for normality and objectivity in judging the American monetary policy led by Greenspan, we have drawn in hindsight some interesting *conclusions* for practice and theory, confirming the results of some older empiric studies or urging to reflection, choice and even innovation:

- The inflation decrease in USA (the one called "core rate of inflation") expanded within the limits registered in all industrialized countries from OCDE's group, confirming the fact that global deflation's exerted pressure eased up, until one point, the fight against inflation for all central banks;

- Insuring the fluid evolution of economic cycles, in the years before the crisis started in the summer of 2007, was a concern and a common result of all central banks of developed countries. But if USA economy made a more dynamic growth than the one registered in other developed countries (the case of Japan or Germany), this is less due to FED's monetary policy, than to powerful structural changes inside the American economy;
- The increased potential of growing the American gross domestic product is attributed firstly to the growth of active population, so, to job creation and increased flexibility, firstly, on job market and then on goods and services market;
- The negative gap between the real GDP and the potential one was increased in the case of US than for the rest of OCDE states. But while the latter registered light recession, the low degree of volatility of US economy in the last two decades is due to massive development of services sector, less exposed to recession than goods production;
- Identifying in due time the accelerated growth of work productivity and incorporating this factor in FED's monetary policy conduct was really Greenspan's talent back in the 90's, theoretical correlation between high labour productivity and non-inflated economic growth being well-known.
- Greenspan had the courage, criticized actually by some of his opponents, to allow the economic boom to continue, by means of the monetary policy, leading the US unemployment rate to a historic minimum and attracting to labour some of the most disadvantaged categories of the unemployed;
- But this approach, with good effect on the short term, involved long term costs of increased monetary mass, resulting in the alarming current account deficit;
- What Greenspan is blamed for is that he allowed the biggest bubble phenomenon in the USA history to be produced in the real estate sector, but also in the stock exchange, which is now considered by the analysts as an effect of lack of cautiousness. Unfortunately, it was confirmed, in the end, that Greenspan's lack of reaction in due time brought major imbalances in the American economy, the negative saving rate being also signalled along with the current account deficit.

The last two conclusions stirred up the debates we referred to, asking Greenspan to explain the dilemma. He tried to bring three main arguments in favour of his way of conducting the monetary policy at the moment when those two bubble effect phenomena were ignored: (i) monetary policy must focus on inflation control and the economic growth potential assurance; (ii)it is never known if identifying a bubble is exactly what it is believed to be; (iii) the interest effect is harsh enough on the economy, it acts as a hammer over its entire structure, so over the stock exchange as well and over the real estate market, which is true for all mature market economies.

In Greenspan's opinion, it is supposed that an adequate increase of monetary policy interest rate focused on inflation control might not have an immediate effect (immediate on stock exchange, for example), but it is almost sure that an exaggerated increase of the monetary policy interest rate, through which the bubble type of phenomenon will be stopped, might cause a recession, which cannot be exclusively the responsibility of a central bank.

As a result, Greenspan said that it was better to leave that bubble type phenomenon, on stock exchange or the real estate market, to unfold ("explode") and then the monetary policy must be a bit relaxed for a soft resorption of the shock. Even after the beginning of the financial crisis, this argument has been taken over by FED under Ben Bernanke's presidency, who proceeded to relax monetary policy, by reducing the reference interest and refinancing rate of commercial banks.

Greenspan's opponents provided very good arguments for each of the three issues mentioned above. Firstly, the task of a central bank is to prevent inflation without endangering financial stability. In the case of low inflation, the interest manoeuvre, being itself at a low level, encourages the taking of higher risks on financial markets, and the liquidity excess can be distributed more on assets value, than on inflation in its traditional approach.

Secondly, an unsustainable growth of stock market value or assets on real estate market can be observed when it is fully detached from the fundamental factors, when there are indicators to show the excess request for loans, the important act being to follow what is purchased with these loans.

Thirdly, being known the effect of the change of monetary policy interest on the whole economy, the appearance of bubble type phenomenon should determine an increment (well established based on patterns) just above the decided interest as related to inflation, just to prevent the latter. According to the opponents' opinion, the Bank of England, Australian Bank of Supplies and the Bank of New Zealand proceeded to do this, using interests that are somewhat higher than the value that the inflation would justify, just to keep under control also the other markets than the monetary one.

Financial Crisis Evolution and Impact

High risk mortgage crisis that started in the USA, in August 2007, is in full operation in terms of consequences on American economy and a pronounced contamination and spread effect over other regions. Its end is still unpredictable, even if joint measures of many powerful central banks, naming FED, BCE and central banks of EU countries, Bank of Canada, Bank of Japan and Bank of New Zealand, to ensure the necessary liquidity needed in the banking system is supposed to have the necessary effect to slacken financial markets, but it is still far from re-establishing trust.

The analysts' question why this crisis started inside the greatest economy of the world has a simple answer: rising of the risk of some specialized loaning institutions in mortgages, against the background of perceived normal evolution in a medium term horizon, in a context specific to the American supervising system (regionally divided according to procedures), which proved its weaknesses.

All of a sudden, the lubricant of financial markets and economies, first the American one and then the contaminated ones due to their financial institution's exposure to the American ones, started to disappear, spreading lack of confidence between banks at first, without emphasizing the precarious situation of some of them as compared to others. The immediate effect was the increase in interest level and volatility on interbanking market in the case of loans for overnight liquidities, money becoming thus expensive and unpredictable to find.

Paul Krugman, columnist at The New York Times and economics professor at Princeton University, reminds us that confidence undermining was also due to the fact that in the context of financial crisis nobody knew "where the financial toxic residues were buried", a phrase that draws our attention, but creates a new trend. Krugman aims at the proliferation of "financial innovation", of complex financial instruments, strangely named (CDO, SIV, RMBS, ABCP, etc), aggressively promoted and sold as means of dispersal, coverage and risk insurance. Without being fully condemned, it is obvious that some of these financial innovations used the gullibility of some investors tempted to take more risks.

It is strange that, in the environment of the freest market economy, the high risk mortgage crisis, but with preference for payment before all other payments, especially because of the financial derivates, doubted, this time, the public authority ideology that the market is always right, accepting the necessity of an administrative intervention, and also at President Bush's recommendation, under the influence of possible social consequences for one category of debtors.

The involvement of the monetary authority from USA and Europe followed the normal way of creating and assuring liquidity on financial markets by the interest policy, and the measures of taking over/ nationalization of some financial institutions with systemic positions, attracting equally approval and disapproval. The question still rises as to when all “toxic financial residues” will come out, because it can be observed that any new facility leads to new consistent losses. Meanwhile new questions arise, so that the process of crisis cleansing should re-establish the loan flow for viable investments, in the context of questioning the aspects that should be emphasised according to the main objectives of the central banks through their monetary policies.

The optimistic prediction of IMF’s president, Rodrigo Rato, made at a presentation in September 2007, did not come true from the point of view of financial market’s stabilization speed, but it is sure that the implications on global economy are still in expansion. We must not forget the variable adjustment of forecasts, usually in a decreasing manner, concerning global or American and EU economic growth, due to the increase in cautiousness in case of loans, although reference interests of some central banks have already been reduced. Rato pleads to increase the prudence standards, when facing vulnerabilities which the financial market exposes through its own instruments and technological development, subsequently regulated however insufficiently and as a delayed reaction.

Developing countries from eastern and central Europe have a different and shocking reaction to the financial crisis, some of them already requesting the IMF intervention due to financial results draining and the depreciation of the exchange rates, and also as a result of speculative financial attacks.

The implications of the exchange rates flow in those countries, by changing the investors’ interests according to the geographic location, to currency and risk volumes are more visible, relying on the vulnerability offered by some fundamentals like the level of budget deficit and current account deficit and their real financing possibilities. Exchange volatility encourages also the residents to speculate, but some try to amass currency in advance for future payments, if they have the feeling of long-termed possible depreciation, which might elude the watchful eye of the central banks under focus.

It is obvious that any evaluation parameters of the financial crisis impact at this moment, structured on direct and indirect transmission channels within national economies and spreading to the global economy, must take into account the fact that we are in the midst of the crisis turbulence, but I believe we must be concerned with their methodology.

Supposed Remedies

We currently face the measures of crisis draining, whose effects are still contradictory, insufficient, even inconsistent, but even so dominated by the hope of global financial system stabilization, but without a clear time horizon.

The applied remedies urge us to remember some of the conclusions drawn by Willem H. Buiter, university professor, teaching among others at the European Institute, London School of Political Science and Universiteit van Amsterdam, during his lectures on the topic of current financial crisis.

The first conclusion is that even when all possible measures have been taken, having in mind the very bitter lessons of the past, we will not achieve a system devoid of moments of systemic instability in which loan institutions do not go bankrupt.

The second conclusion regards capitalism, based on private property and decision decentralization, which is a cyclic and greedy system, lacking the possibility of any institutional form able to completely eliminate its periods of explosive/expansive behaviour, either in real estate value, or on financial markets. Humanity tried to eliminate those capitalism excesses and it arrived to centralized economies whose fate is known (in this case Hayek and Keynes were right!).

The third conclusion focuses on regulation which is called to mitigate as much as possible the excesses of a decentralized and capitalist market economy, but – attention – "without killing the golden egg goose".

Concerned about the crisis effects on Great Britain's economy, Buiter sustains that oscillation between the de-regulation and self-regulation must stop its excesses, which, in the situation produced by the actual financial crisis, calls for the national regulation of financial markets at EU level as an important step. Maybe after such a step, the concept of "intergovernment", understood as a form of cooperation between regulators and fiscal authorities at national level (or maybe supranational), should take over and observe to what extent a continuous climbing of regulation will not disparage financial globalization and also the benefits and the challenges of integration/globalization.

No doubt the current crisis needs urgent remedies, but their soundness in time, in a continuously moving and globalized world, may always bring other surprises, which need unfortunately unknown lessons. To focus the debate on the effects of some simulated remedies to this crisis, in economic research laboratories, would be beneficial as long as it could be centred upon a changing vision as well.

The solution to pump out real money in the financial system, regardless of the way – the normal one of ensuring the liquidity by the central bank through the last resort lender feature and ensuring the role of money market stabilizer or under administrative form of rescue plans financed from public funds - , is endowed with the gift of operating with the effects of the financial crisis with questionable medium and long term results. What do we do to deal with the causes?

From this point of view, the general opinion is that we must return to the optimal extent of state regulations and intervention, not by changing the market system, but by preserving its virtues sustained by the property regime: free enterprise, competitivity, fair competition, strict rules of state aid, consumer protection.

Beyond technical remedies that fight against crisis effects, we face the spreading of some ideas concerning changes of a different kind that can be brought to the fore by the lesson learnt from crisis initial causes and the later attempts to drain it.

Political, geopolitical and even geostrategic implications in a globalized world arouse the real interest of those with long term societal visions. Personally I am convinced that this approach to the crisis impact by implications of before-mentioned nature is absolutely necessary in terms of planetary evolution scenarios and the future place of this country.

Within a globalised world, the crisis' spreading terms, sharing more and more the same values related to what should be an international financial system, namely concerned with the steady progress and economic development in the world, at least reaching the global mean and not the system's lowest manifestation point, aiming to remove the still endemic poverty in some regions and to light the hope for a civilized life, all these determine me to state that, in the fight to drain this crisis – the crisis being the signal of global organism necessity to recover - , we must not find either winners, or losers, but success. Why? Because the former case would involve some of us, or some others, while the success is beneficial to everyone.

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Unele considerente calitative privind criza financiară şi impactul acesteia

Rezumat

Actuala criză a fost predictibilă în multe privințe. O prelungită și puternică creștere economică în întreaga lume, amplificarea fluxurilor de capital - pe fondul unei stabilități a prețurilor și sistemului financiar, de asemenea prelungită – toate acestea au indus participanților pe piețe curajul de a risca din ce în ce mai mult pentru randamente mai mari, neglijând managementul riscurilor și exercițiul prudențialității. Standardele scăzute în ceea ce privește supravegherea instituțiilor financiare au obturat vizibilitatea managementul defectuos al riscurilor, iar noile produse financiare complexe și puțin înțelese de majoritatea investitorilor au creat așteptări false în câștigurile posibile. Ca urmare, vulnerabilitățile sistemului financiar au crescut, iar toate evoluțiile descrise au degenerat în cea mai mare criză cunoscută de economia globală, deși au existat dezbateri serioase cu privire la momentul când ar trebui acționat atunci când fenomenul de "bule" (bubbles) devine deja observabil în funcționarea piețelor.