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FINANCIAL AND CURRENCY CRISES OVER TIME

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This paper starts from the theoretical concepts of financial market, and approaches, in the beginning, the financial system "trilemma: Capital mobility - Exchange rate - Monetary Policy ", faced by an open economic system. The article also presents an overview of the principles on which relies the classical models of crisis, and some aspects of the recent financial crisis, and finally ends with a series of lessons that should be learned from the experiences of recent years.

Keywords: financial crisis, currency crises, information asymmetry, moral hazard, adverse selection, exchange rate

JEL Code: E44, G01, G21

1. Introduction

There are currently two views on financial market: anglo-saxon concept and continental-european concept. According to the anglo-saxon concept, financial market includes money market, which attracts and places short-term capital through the: interbank, discount, effects of trade, certificates of deposit and exchange markets and capital market (securities market), which provides investment capital in the medium and long term.

On the other side, continental-european concept believes that the financial market is a component of the capital market, namely long-term capital market, which is buying and selling financial assets without changing their nature, together with the money market, the short and medium term capital represented by the interbank market and negotiable debt securities market.

Romania adopted the anglo-saxon conception, therefore the stock market is a component of the financial market, which is publicly trading, medium and long term instruments. Investors purchase securities as an alternative to bank deposits on the money market, and issuers can attract capital, without resorting to loans, by issuing securities.

The exchange market has the role to provide participants in the economic exchanges between countries, alternatives for obtaining credit and payment resources.

2. Capital mobility – Exchange rate – Monetary Policy

The problem of choosing the macroeconomic policy in open economies, raised first in Obstfeld (1998), follows from the fact that an open capital market deprives the government of the country by the ability to target an exchange rate, together with the use of monetary policy to achieve other economic objectives.

The choice problem occurs because a macroeconomic policy regime may include no more than two of the following three: complete freedom of capital flows, fixed exchange rate, and an independent monetary policy oriented to internal objectives.

Currency crisis theories attempt to explain through various models, the massive flows of capital exit and rapid depreciation of exchange rates.

The first generation models are based on the negative spectrum of fundamental indicators, monetary and fiscal policies, overly expansionary and unsustainable in the case of a fixed rate. If In the first generation theories, fundamentals play a major role in analyzing the crisis, the second generation models, however put emphasis on investor expectations. So the question arises, if these currency crises can strike even when there is a real support of the internal fundamentals.

A financial system plays the key role to direct funds to individuals and firms that have investment opportunities. To do this correctly, financial market participants should be able to make correct opinions about the investment opportunities, which are more or less safe. This means that the financial system must deal with information asymmetry, a contracting party having less complete or accurate information

than the other party, as is the case of borrowers who typically have better information about profit and risk associated with their investments than their creditors. Asymmetric information leads to the major problems of the financial system (Mishkin (2001)): adverse selection and moral hazard.

Adverse selection on loans markets means that loans that are most likely to produce an adverse output will most likely be selected. Those who borrow to finance investment projects with high risk will win if their projects are successful, and thus, they are eager to get the loan, but they are the least desirable credit applicants by the banks, because of the great possibilities to be unable to repay the loans.

Moral hazard exists on lending markets because borrowers may be prone to engage in activities that are undesirable from the banks point of view, and so banks will be subject to bankruptcy hazard. Once applicants have obtained a loan, they are tempted to invest in high-risk investment projects that generate large profits if successful, but high risk makes unlikely the return of the loan.

3. The classification of theoretical models for financial crisis

Regarding theoretical models of financial and currency crises have existed over the years several approaches. ***First generation models*** presented crises as the consequences of macroeconomic policies inconsistent with maintaining a fixed exchange rate. The attempt of the monetary authority to finance fiscal deficits through domestic credit expansion decreases the reserves, which in the end will make it impossible to maintain stability. Therefore, these models suggest that the solution to avoid financial crises is the intervention through policy implementation consistent with maintaining currency stability.

In contrast to first generation model that combines a linear relationship describing the behavior of the private sector through the money demand function, with the linear relationship describing the behavior of the government, namely the growth of domestic credit (Flood R., Marion N., (1999)), ***the second generation model*** focuses on nonlinearities which may occur in government behavior, that lead to multiple equilibriums. Thus, these models take into account three factors: the government's temptation to abandon the fixed exchange rate, a reason why the government would want the fixing of the exchange rate and the cost of defending the fixed rate that increases when investors expect depreciation, so that the tension between them creates the possibility of multiple equilibriums.

This class of models focus on the speculative attack, which has a self-fulfilling nature because fixed regime falls, if attacked, but survives otherwise, collapse being possible not from an economic necessity, but from an average level of the basic variables (like government reserves), that are not strong enough to make impossible an attack, but not low enough to make it inevitable.

Third generation models take into account the banking sector as a potential source of instability. In contrast to previous models, they try to anticipate crises, not just explain them. Because these currency and banking crises are treated together, are called twin crises models (Kaminsky, G.L., and C.M. Reinhart (1999)). As long as the central bank assumes to maintain fixed exchange rate regime, and does not provide loans to commercial banks, there will be no currency crises related to banking crises.

The situation changes if the central bank decides to act as the lender of last resort, while is supporting a fixed exchange rate regime. The problem arises in choosing between saving domestic banks or keeping the exchange rate fixed. So if the decision is to keep the fixed rate, this will trigger a banking crisis, but if the decision is saving banks by increasing national currency amount, this will trigger the currency crisis.

However, there is another approach in the literature, different from the patterns which are divided into three generations models. It distinguishes between classes of models on the basis that some take as exogenous the policies through which renounces at fixing, others consider these endogenous policies (of type "escape-clause" - Jeanne O. (2000)). This classification appears to be consistent with the trends in macroeconomic theory, where the governmental policies have also evolved from exogenous variables position to explicitly modeled, as a result of a process, variables position, more or less constrained by optimization.

With regard to empirical studies, the most important are those who have tried to build a system of indicators that can provide warning signals, with a fairly large amount of time prior to the crisis so to allow the development of strategic reactions (Kaminsky G. L., (2000)). Most of these empirical analyses of the transmission of shocks between the financial markets have been developed based on European and Asian crisis episodes.

The rapid spread and major economic impact of these crises were attributed to spillover effects, and this multiplied the studies on transmission channels of the turmoil from emerging markets. Among the most important transmission path identified in the literature are (Taketa K. (2003)):

1. through trade links with a third market;
2. indirect financial relationship, achieved through a common creditor or on the interbank market;

3. global diversification of financial portfolios in the presence of asymmetric information.

4. Lessons to learn

The recent crisis on the world's financial markets, originating in the crisis of the segment "subprime" on USA's mortgage market, has rapidly spread to other segments of the world's financial market, being already considered one of the harshest financial crises in the history. It seems that globalization and securitization are two trends that led to the spread of the crisis. "Repacking" in guaranteed financial instruments has led to the distribution of global risk from U.S. mortgage market, which to some extent is welcome, but also led to the spread of the crisis impact at the same time.

In order to counteract, individually or collectively, the weaknesses revealed by the crisis, financial institutions were looking for remedies. A report of the Institute of International Finance, proposes the following priority areas for action: transparency, evaluation of complex financial products, risk management, market infrastructure, liquidity management.

During the same period, nor Romania was eluded, at microeconomic level the situation being characterized by hundreds of thousands of bankruptcies, while the foreign job offer was draining, which led to an increase in unemployment rate up to 6.6%, and by the end of 2009 rising even at 8%.

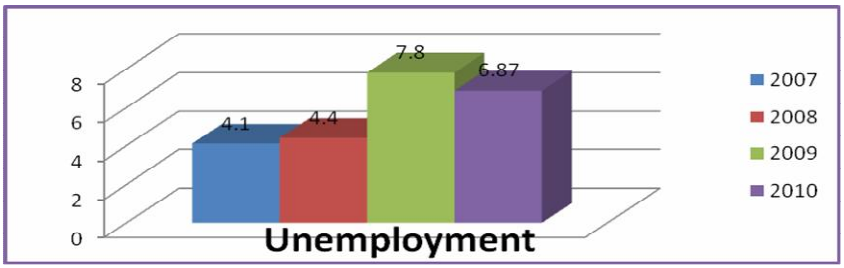

Fig.1. Unemployment rate in Romania

According to Lupasc(2012), although in the period 2000-2008, the economic situation of our country has experienced an upward trend, no action to exploit the favorable situation was taken, meaning the creation of reserves for crisis circumstances.

The IMF loan restored confidence in the national currency and in the central bank's ability to defend the exchange rate, foreign exchange reserves reaching record highs. On 28th of February 2010, the currency reserves of the National Bank were up to 29,739 million Euros.

Romanian Academic Society report stated that the main factor that affected the business in Romania was 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 were the most affected.

Emerging economies, as is Romania, have an additional influence factor, namely the political factor. For example, in 2012, during June and July, when there were tensions between the government and opposition, the euro has increased 2.7% in a month.

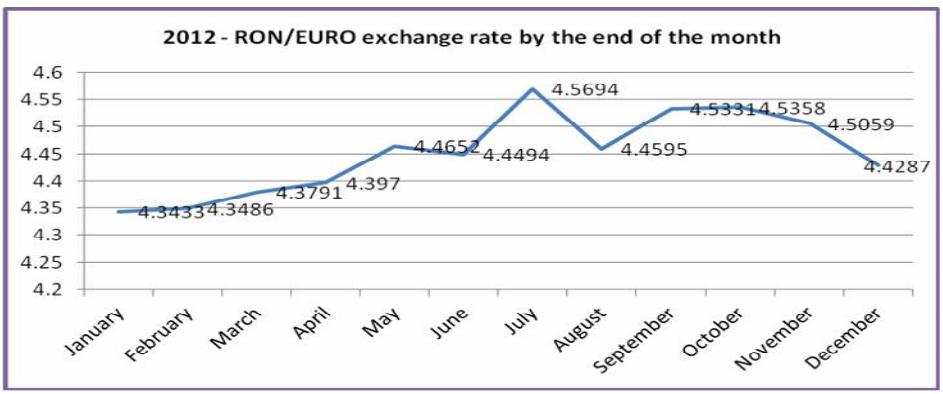

Fig.2. RON/EURO exchange rate by the end of the month in 2012

Returning to the global context, this crisis has led to a paradigm shift. According to Soros, the theory that financial markets tend towards equilibrium, is false and misleading. The same author states that our recent problems are largely a consequence of the development of international financial system based on this misleading paradigm, based on the theory of perfect competition and on the idea of perfect knowledge. In fact traders base their decisions more on their subjective perceptions, which decisively influence the conduct on the market, and are then reflected in prices. These perceptions and decision generate "self-fulfilling" processes.

Also Daianu (2008) stated that at the origin of the crisis was also the fact that not enough has been learned from the crisis episodes in the last two decades. In these crises have been, also, periods of euphoria, massive increases in the prices of assets (the so-called "bubbles"), of relaxation of prudential standards and greed beyond measure. There were prestigious names in finance, such as Alexander Lamfalussy and Paul Vocker who warned on the type of financial innovations (securitization), which created enormous uncertainty and increased systemic risk.

Governor Isarescu presented on 15 April 2009, a number of lessons learned from the development up to that time of the global financial crisis [31]:

- The low level of inflation is not a sufficient condition for long-term financial stability. Recent global financial crisis emerged after nearly two decades of relatively low and stable inflation. A number of factors caused low inflation to coexist with abundant liquidity. This led to the changing of the model of bank intermediation from "originate and hold" to "originate and distribute". Governor conclusion was that the ample liquidity changed the financial system to the extent that monetary policy became trapped. Inaction would have led to higher inflation and the action led to financial instability.

- At given periods, the regulation and supervision of markets are lagging behind. Markets still find solutions to satisfy the demand, even if administrative barriers are placed. The governor gave the example of NBR, which tried to reduce the fast pace of lending in foreign currency, using administrative barriers, but their effectiveness was limited and were found to have side effects which exceed their benefits.

- In the EU were missing institutions such as the European Systemic Risk Council**.** It should collect information about macro-prudential risks and vulnerabilities of the financial sectors in the EU. The Council will issue warnings about the risks and adopt policy recommendations. Another proposed institution was the European System of Financial Supervision, which by three new authorities: the European Banking Authority, the European Securities Authority and the European Insurance will have increased powers in the supervision and authorization of specific institutions scale EU.

- Wage incentives in the private companies were not adequately correlated with risk management. Financial innovations, unregulated and unsupervised, allowed accumulation of large short-term profits while taking great risks.

- People forget crises during periods of prosperity and neglect the development of crisis management mechanisms. Governor conclusion was that there should be a regular process of updating the management mechanisms of crisis.

- The IMF has acquired a greater role, after being criticized for not having foreseen the Asian crisis. In the period leading up the crisis, the IMF's role decline was expected in that economic context. But the recent crisis seems to have rediscovered the role of the IMF in this context. His funds were increased to cope with the demands that come from different countries, for financial support and technical assistance.

- Expansionary measures should be accompanied from the beginning with the exit strategies. The governor draws attention on the 70s lesson, namely that prolonged expansionary policies have produced high inflation and public debt, which required reducing restrictive policies that have made the average growth to remain relatively weak.

- It is important to avoid macroeconomic imbalances and to pursuit a sustainable growth slope supported by substantial structural reforms, especially in emerging economies. Isărescu pointed that the main challenge for Romania is the convergence with the EU, while maintaining macroeconomic stability.

- Euro changeover cannot substitute adjustment policies. While RON appreciated until summer 2007, issue of euro adoption was not a concern of economic agents. The crisis has made it clear, that RON was over-valued, so the market has done the necessary correction. The governor said that the central bank will respond to the new conditions using monetary and fiscal policy. Adopting the euro today would mean giving up monetary policy before insuring the sustainability. The result would be that monetary policy will be done by the European Central Bank (ECB), which may be inappropriate in terms of the problems of the

[31] http://www.wall-street.ro/slideshow/Economie/62896/Cele-9-lectii-oferite-de-criza-financiara-guvernatorului-Mugur-Isarescu.html#slide_title

Romanian economy. Thus, Romania cannot adopt the euro before removing imbalances in the economy and before sufficient progress in convergence.

5. Conclusion

Classical economic theories were based on some unrealistic axioms such as that the economic agents act rationally, in the sense of maximizing profit, or that markets are efficient, and the prices strictly reflect all available information.

The new theories are based on relationships rather nonlinear, with a high sensitivity to small changes in the economic context. The financial system is such a sensitive system and reacts to the smallest changes in the environment. The fact that financial series are generally leptokurtic, with "fat tails"(meaning that there is a wide deviation of the extreme values from their mean), shows that the risk of extreme events is higher than that assumed by the theory of efficient markets.

According to Peters(1996), financial market stability is ensured by the participation of investors with different investment horizons, but supporting the same level of risk. Lately, if regulation and supervision would have prevented excessive risk accumulation by investors, raising interest rates would not have lead to financial instability. Therefore the main lesson to be learned from the recent crisis, that emerges from financial crisis literature, is that monetary policy and regulation or supervision must work efficiently, which has not happened in recent years in some major economies of the world, much less in emerging economies.

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