

# ARE ALL FINANCIAL CRISES THE SAME ? PREMISE FOR FURTHER RESEARCH.

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*Abstract: The entry of Romania in the EU has brought advantages and disadvantages. This fact made Romania prone to the influence of other economies especially from developed countries. The paper examines the possible correlation of Romanian economy with other economies and like this the effects that a financial crisis would influence Romania. In case of a financial crisis many emerging markets will suffer because the investment flows will move away, as an adjustment of risk aversion.*

*Keywords: Financial crisis, banking distress, emerging market, risk aversion*

## **Introduction.**

From the economic point of view, a change that is adopted, whether is within a company, financial institution or government, comes with advantages and disadvantages. As long as the sum of advantages is bigger than the sum of disadvantages the adopted change will be for the benefit of the firm or society and should be considered a positive change.

Like this, the entry of Romania in the EU came with advantages and disadvantages. The free movement of goods, persons and capital within the boundaries of EU, has brought advantages and disadvantages. These facts made Romania prone to the influence of other economies especially from other developed countries.

Recent events of the USA financial sector draw the attention of both specialists and nonspecialists to many of the problems related to the financial distress, how quickly and unexpected crises arise and spread over different sectors of the economy. Living in a globalize world the crisis will not remain within the boundaries of one country but will, in a very short period of time extend all over the world affecting more countries with different degrees of influence.

Banking crises have become common place during the past two decades, but the range of experience in terms of the nature of the crises, causes and effects, vary across countries and time periods. George Soros, a well known financier, said to be very acid in his predictions, states in his recent book (The New Paradigm for Financial Markets, 2008) that: “We are in the midst of the worst financial crisis since the 1930s.”... “The United States is facing both a recession and a flight from the dollar. The decline in housing prices, the weight of accumulated household debt, and the losses and uncertainties in the banking system threaten to push the economy into a self-reinforcing decline. Measures to combat this threat increase the supply of dollars. At the same time, the flight from the dollar has set up inflationary pressures through higher energy, commodity, and food prices. The European Central Bank, whose mission is to maintain price stability, is reluctant to lower interest rates. This has created a discord between U.S. and E.U. monetary policy and put upward pressure on the euro.”

The full impact of the banking crises on the American economy is unclear at this point, but even the most optimistic researcher would say that it is clearly substantial. Several papers have attempted to identify the key factors preceding or coincident with episodes of banking sector distress. The author of this article has developed a past research (銀行 {ぎんこう} の 破たんや 金融危機 {きんゆう きき} に対処 {たいしよ} する “Handle bank failure and financial crises”) conducted on the Japanese past banking crisis. At that point (2004) we investigated the causes and consequences of Japanese banking sector distress from 1992-1994 and if this can fit or not with the experiences of other countries. In addition to the macroeconomic developments we considered specific institutional characteristic that may increase the probability of a banking problem. And like the case of Japan, the new American crisis has emerged also from the drop of asset prices, but the cause of the drop in prices being a little bit different. Like Japan, USA has seen a steep rise in housing prices during the four years preceding the crisis, a steep rise in equity prices, a large increase in its current account deficit, and increase in public debt.

## Institutional characteristics. Data analysis.

An IMF (International Monetary Fund) report summarizes and identifies several general categories of problems frequently associated with financial crises, for example: unsustainable macroeconomic policies, weakness in financial structure, global financial conditions or political instability. But we can stress that macroeconomic instability and particularly fiscal policies within the asset price bubbles had been a factor in many episodes of banking sector distress, including the Japanese crisis of the 1992's and the nowadays financial problems from America. External conditions, such as large changes in terms of trade and world interest rates, have played a more important role in financial crises in emerging markets economies by affecting the profitability of domestic firms and thus have an impact on bank's balance sheets. These risks often appear in times of rapid financial liberalization and greater market competition when banks are taking new and unfamiliar risks on both assets and liabilities. An important role in assessing and controlling the risk should stay in the hands of supervisory and regulatory financial institutions which under weak policies create the circumstances for banks with low capital ratios to increase their risk position in newly competitive environments and allowing them to avoid full responsibilities for mistakes in monitoring and evaluating risk. Central banks have frequently failed to quickly identify institutions with problems or to take corrective action when problem arises, thus resulting in larger and more difficult crisis situations.

The above mentioned aspects suggest that several mutual characteristics of economies can be associated with financial crises. But do these aspects apply also to the emerging markets?

No need to mention that an emerging market can not stay away and not be affected by a financial crisis that arises in a developed economy. Several aspects can be good variables in order to analyze financial crises. Here we can mention Real GDP growth, Exchange rate depreciation, Real interest rate, Inflation, Real credit growth, Stock price change.

In the following, let us have a look at the movement of stock price index before and after beginning of the US financial distress, within the period of April 2007 and April 2008. In the following charts we can see the movement of the following index: Nikkei, for Japan, Dow Jones Industry Average for USA and FTSE 100 Index for the UK.

**NIKKEI 225**



Source: Bloomberg

The Nikkei-225 Stock Average is a price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange.

**DOW JONES INDUS. AVG**



Source: Bloomberg

The Dow Jones Industrial Average is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry.

### FTSE 100 INDEX



Source: Bloomberg

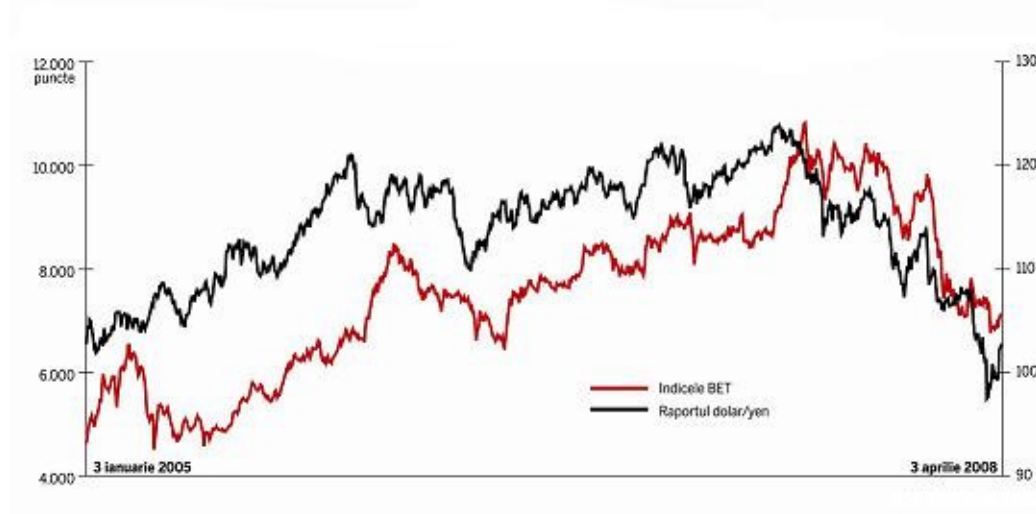
The FTSE 100 Index is a capitalization-weighted index of the 100 most highly capitalized companies traded on the London Stock Exchange.

As can be seen, striking similarities can be observed for the 3 presented models. Even the “bubble” pattern prior to the beginning of the distress as well as the reaction of the market during the period of the crisis has, in a certain degree of deviation acceptance, striking similarities.

It would be interesting to see if the recovery from the distress will follow a similar pattern. An important aspect to this will stay in the economic situation of the country prior to the beginning of the distress period.

One thing is sure, and that is that a financial crisis that appear in a developed country will, eventually, affect the other countries in a certain level of degree. And that includes also the emerging markets, and the case of Romania. Since the beginning to the US financial distress we were able to see sharp decline in stock prices in Romania, an increase in inflation and changes in the exchange rates. Although, some similarities between the movement of foreign stock exchange indexes and the Romanian indexes can be observed, the Romanian stock exchange market was affected in a higher degree due to the exit of external funds from this market, considered a more risky market. But a more risky market, an emerging market will bring higher returns, higher yields. Therefore we tend to predict that the recovery of an emerging market will be done in a shorter period of time compared to a developed one.

In a recent discussion on the website of “Bursa Noastra”, ([www.bursanoastra.ro](http://www.bursanoastra.ro)), a website dedicated for the investors on the Romanian market, Emil Pop, a freelancer in IT, posted a chart that presented a striking similarity between the evolution of the Romanian index BET and USD/JPY exchange rate.



What conclusion can we draw from here? Investors borrow “cheap” money from countries where the cost of capital is low (in Japan the official basic loan rate is 0.75%) and invest in countries where a higher yield can be obtained.

As the time goes by, more and more similarities between the movement of the Romanian market and the movement of foreign markets will be observed, as they will be more connected. The entry of Romania in the EU and the free movement of capital that came along with it, made Romania more open to the influence of other economies from other developed countries.

The US problems of the sub-prime market turn into a deeper problem that has affected the mortgage markets from UK, Spain and other countries and made the investors to be increasingly concerned about other forms of credit.

## **Conclusion.**

If massive capital will move away, following a brutal adjustment of risk aversion, many emerging markets will suffer because investment flows will decrease and credit conditions will worsen. Here we have in mind Central and Eastern European countries where high economic growth rates might be badly disrupted. And like this many countries might see their prospects for continuing economic recovery substantially affected.

Therefore, excess liquidity, over-borrowing, massive bets made by hedge funds, lack of transparency and poor regulations, improper valuation of investments, high risk acceptance, and the appearance of new financial trading instruments have created the premises for new financial problems. But there are also grounds to believe that a global crisis can be avoided. Many emerging economies have plenty of reserves and their exchange rates are more flexible. Risk diversification and better risk management techniques would help some institutions to avoid serious financial problems.

To sum up, if major crises should knock on the door at the economies of more and more countries, a perfect coordination among the main central banks, governments, and financial institutions should be created in order to avoid bigger losses and make a better damage control of the situations.

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