GLOBAL FINANCIAL CRISIS AND REVERBERATIONS ON CAPITAL MARKET

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Abstract

Crises can be defined as situations characterized by a pronounced instability, therefore they are accompanied by volatility and a growing incertitude. The stock market is the barometer of the economy and it trades businesses of different sizes and from different sectors. The main purpose of this paper is to identify what reverberations has the current financial crisis on the financial market, especially on the stock market. The approach of this topic is done by tree perspectives (effects on financial institutions, effects on the stock volume and quotes, effects on the invertors' behavior on the market, effects on capital market regulation) matching Romanian financial reality with international issues. What are the lessons that Romanian investors would have to learn from experiencing this global economic crisis?

Keywords: economic crisis, effects of financial crisis, capital market

JEL Classification: G01, G14, G29

Introduction

Crises can be defined as situations characterized by a pronounced instability, therefore they are accompanied by volatility and a growing incertitude. In a crisis situation (no matter what form it may take) we find ourselves in a permanent state of restlessness and uncertainty about our future, fear and even panic. The problem with defining a crisis consists in specifying how severe the volatility and downfall of the market must be to frame such an evolution as a crisis. Conventionally it was established that there is a recession when after two successive quarters we are dealing with the dropping GDP of a country or region. National Bureau of Economic Research (NBER) defines crisis as a significant decline in economic activity for several months reflected in lower GDP, lower individual income, reduced employment levels, reduced industrial production and consumption". It is difficult to make assessments about when a financial crisis becomes an economic one or if an economic crisis generates a financial one or vice versa. Basically we always talk about an economic crisis generated by financial, political or social reasons.

The financial crisis is a form of the economic crisis and reflects a misstrust in the financial system, a significant decrease in the volume of the transactions on the stock market, a disorder of market mechanisms. The stock market is the barometer of the economy and it trades businesses of different sizes and from different sectors. The

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financial crisis of 2007 - 2008, initially called "the credit crisis" by experts, began in mid 2007 with the loss of investors' confidence in financial assets based on portfolios of securitized mortgages issued in the U.S. market. This led to a liquidity crisis followed by an infusion of liquidity into the system by U.S. and European authorities. Investment banks that have encountered problems were either nationalized (Northern Rock) or went bankrupt (Bear Streams, Countrywide Financial Corporation, IndyMac Federal Bank, Fannie Mae şi Freddie Mac, Lehman Brothers Holdings Inc).

Reverberations on capital market

Many economists have offered theories about how financial crises develop and how they could be prevented. There is little consensus, however, and financial crises are still a regular occurrence around the world. The financial crisis of 2007–present is a financial crisis triggered by a liquidity shortfall in the United States banking system. It has resulted in the collapse of large financial institutions, the "bail out" of banks by national governments and downturns in stock markets around the world. It is considered by many economists to be the worst financial crisis since the Great Depression of the 1930s.[1] The crisis rapidly developed and spread into a global economic shock, resulting in a number of European bank failures, declines in various stock indexes, and large reductions in the market value of equities and commodities. It contributed to the failure of key businesses, declines in consumer wealth estimated in the trillions of U.S. dollars, substantial financial commitments incurred by governments, and a significant decline in economic activity.[2] The crisis itself has a number of dimensions but three in particular are crucial. The first is the build-up of debt, both corporate and household debt, but especially household debt. Linked with this is the likelihood of a return to international monetary instability and of the refusal of the rest of the world to fund US (and UK) trade deficits. The third factor is the effect of the ecological crisis on the world economy, which brings with it the prospect of an end to two decades of low commodity prices.

The International Monetary Fund estimated that large U.S. and European banks lost more than $1 trillion on toxic assets and from bad loans from January 2007 to September 2009. These losses are expected to top $2.8 trillion from 2007-10. U.S. banks losses were forecast to hit $1 trillion and European bank losses will reach $1.6 trillion. The IMF estimated that U.S. banks were about 60 percent through their losses, but British and euro zone banks only 40 percent.[3] Governments and central banks responded with unprecedented fiscal stimulus, monetary policy expansion, and institutional bailouts. The total amounts that governments have spent on bailouts

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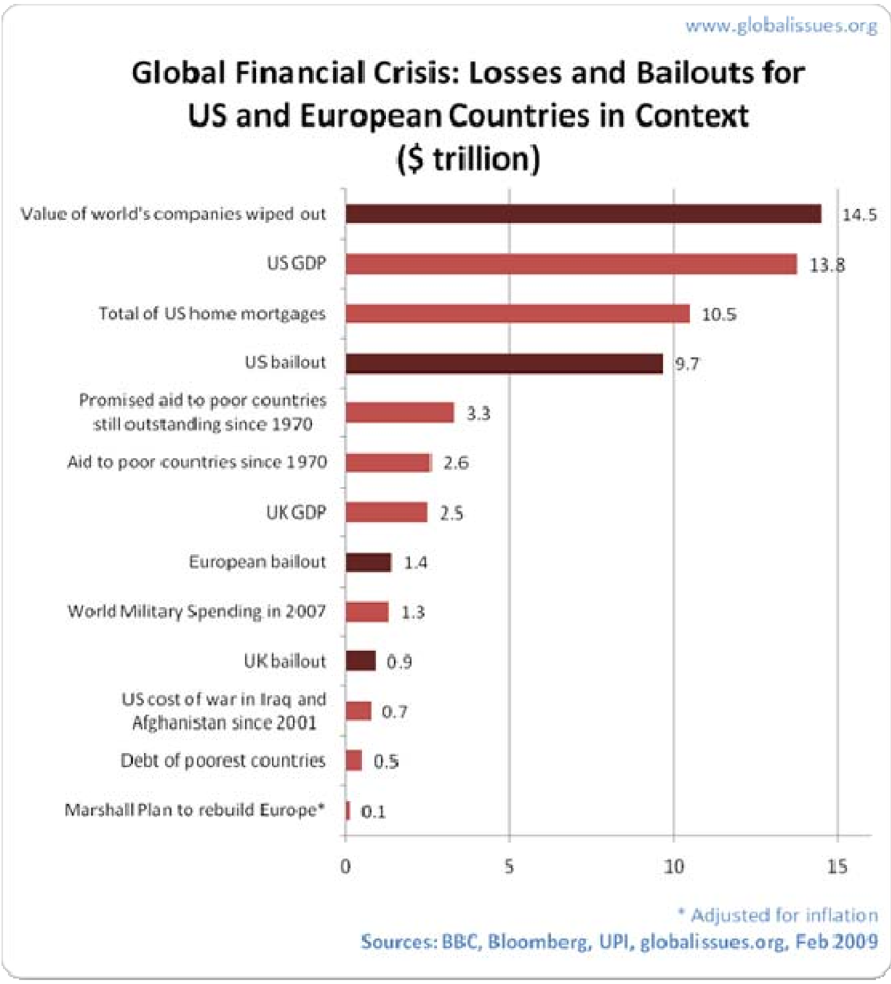
[1] Business Wire News 2009, Reuters, 2009-9-30, http://www.reuters.com/article/idUS193520+27-Feb-2009+BW20090227

[2] Martin Neil Baily, Douglas J. Elliott, *The US Financial and Economic Crisis:Where Does It Stand and Where Do We Go From Here?*, Business and Public Policy at Brookings, June 2009

[3] http://www.reuters.com/article/idCNL554155620091105?rpc=44

have skyrocketed. From a world credit loss of $2.8 trillion in October 2009, US taxpayers alone will spend some $9.7 trillion in bailout packages and plans, according to Bloomberg.[4] $14.5 trillion, or 33%, of the value of the world's companies has been wiped out by this crisis. The UK and other European countries have also spent some $2 trillion on rescues and bailout packages. More is expected. It is also important to recognize that the immediate impact of this government spending is only a small part of the projected increases in budget deficits in the medium term. More important is the loss of tax revenue and the extra expenditure resulting from the slowdown in growth arising from the crisis.



The global system is favorable to financial capital, which has the liberty to move where it is better rewarded, leading to a rapid development of global financial markets. The result is the appearance of a giant circulatory system, which absorbs

[4] Mark Pittman, Bob Ivry, *U.S. Taxpayers Risk $9.7 Trillion on Bailout Programs*, February 2009 http://www.bloomberg.com/apps/news?pid=washingtonstory&sid=aGq2B3XeGKok

capital through markets and financial institutions at the center, then delivers it to the outskirts, either directly, in the form of loans and portfolio investments, or indirectly through multinational corporations. However, the system is profoundly deficient. Earning money has priority over all other social considerations[5] . In the analysis of the crisis of 2008, George Soros[6] starts from the following idea: we are in the middle of the most serious financial crisis since the 1930s. In some ways, it resembles other crises that have occurred over the past 25 years, but there is one big difference: the current crisis marks the end of an era of credit expansion. But let's take notice of some reverberations of the current crisis on the capital market.

The effects of the financial crisis on the capital market can be structured as follows:[7]

1. Direct effects on financial institutions: the financial crisis has given rise to stunning bankruptcies, restructuring of companies and financial institutions, takeovers and mergers, direct financial support with significant funding from the government. Many of these institutions are or were listed on the stock exchanges, their removal from the market affected not only the credibility of the capital market but also stock trading volume, price volatility, efficiency levels. One of the first victims was Northern Rock, a medium-sized British bank. Several major institutions either fell, were acquired under duress, or were subject to government takeover. These included Lehman Brothers, Merrill Lynch, Fannie Mae, Freddie Mac, Washington Mutual, Wachovia, and AIG.

a. Financial institutions assisted, supervised or taken over by the government: Bradford & Bingley (part nationalized in September 29,2008 and part sold to the Abbey bank from the Spanish bank group Grupo Santander), Fortis (taken over by the Belgian government in October 5, 2008 and sold to BNP Paribas), Dexia (on September 30, 2008 the governments of Belgium, France and Luxembourg have announced they will support thus bank with funding of 20.4 billion euros), Kaupthing (suspended from trading on October 8, 2008 and subject to supervision by the government of Iceland through the Icelandic Financial Supervisory Authority), ING Group (received on October 19, 2008 funds of 10 billion euros from the Dutch government);

b. Financial institutions bought or taken over by other financial institution: Countrywide Financial (taken over by the Bank of America for 4.1 billion USD on January 11, 2008), Bear Stearns (taken over in March 2008 by JP Morgan Chase after having first received a loan from the U.S. government), Merrill Lynch (bought by the Bank of America), HBOS (becomes in January 2009 part of the Lloyds Banking Group), Lehman Brohers (part sold to Barclays PLC and Nomura Holdings, part declared bankrupt).

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5 Silvia Marginean, *"George Soros: de la criza capitalismului global la criza creditelor ipotecare",* Euroeconomia XXI, nr. 194 / 28.11.2008

6 George Soros in his book "*The New Paradigm for Financial Markets",* May 2008, has described a "superbubble" that was built in the last 25 years and is ready to explode, providing financial crisis. (Born in 1930 in Hungary, emigrated to the USA, known for its wealth gained from speculation on the stock exchange in 1992).

7 http://cristianpaun.finantare.ro/2008/12/23/pietele-de-capital-si-criza-financiara/

c. Institutions declared bankrupt: Terra Securities (Norwegian financial company specializes in selling various financial instruments), Kaupthing Singer & Friedlander (British bank, part transferred to the ING Group, part went bankrupt), Yamato Life (Japanese insurance company went bankrupt on October 10, 2008).

d. Institutions that are being restructured: ACC Capital Holding (American savings bank specialized on mortgage loans).

2. Effects on the stock volume and quotes: the volume of stock transactions is slightly decreased but the crisis had the strongest impact on the volatility (risk) and on the associated stock performances, especially on the variable income instruments.

2008 was the worst year in BVB's recent history – the steepness of the downward trend probably being enhanced by the downgrade of sovereign rating for Romania from BBB (investment grade) to BB (non investment grade) at the beginning of November 2008. This action of lowering Romania's sovereign rating came from all the 3 main rating agencies (Standard & Poors', Fitch and Moody) in almost the same period of time. The economic outlook for Romania, as expected, was considered negative, and the combined information had a further negative impact on investors' attitude toward BVB. The steep decline registered at BVB during 2008 was induced by the financial crisis that started to show its first acute signs during the first quarter of 2008 and generated the world market turmoil since September. As expected, foreign investment funds redrew most of their money invested in Romania and the domestic investors followed their behavior. [8] BVB's perspectives for 2009 are pessimistic. As the financial crisis evolved in an economic crisis, Romania's economic outlook looks poor. The foreign investors' attitude toward the Romanian capital market is excessively prudent and influenced by the fact that the country is not in the 'investment grade' category by the main rating agencies.

Table no. 1 Romanian Stock Market Capitalization[9]

Data	Capitalization BVB - RON -	Capitalization Rasdaq - RON-
24.12.2009	80.074.496.089,64	12.345.344.834,23
30.09. 2009	80.432.614.828,83	12.868.187.477,14
30.06.2009	56.214.944.935,20	12.359.818.472,99
31.03.2009	38.453.215.429,03	11.799.297.770,07
23.12.2008	45.701.492.618,85	12.099.865.128,89
30.09.2008	87.228.690.259,97	15.985.353.929,42
30.06.2008	110.449.659.649,22	18.498.366.047,96
31.03.2008	116.817.385.616,18	19.885.521.740,79
21.12.2007	85.962.389.148,60	24.410.022.239,33

[8] Cornelia Pop, Cristina Curutiu, Partenie Dumbrava, *Bucharest Stock Exchange – The Effects of the Current Financial Crisis*, Interdisciplinary Management Research Journal, Vol. no. V, 2009, pg. 815-816

[9] Processed data www.bvb.ro Bucharest Stock Exchange

Late 2008 and early 2009 is marked by a sudden drop of stock quotes, the capitalization of BVB recording at the end of the first quarter 28.453 million lei, that is only 34% of the value recorded the year before, more than 110.449 million lei. We can see that the OTC market value did not depreciate as much as the stock market. The Rasdaq market reached in the first quarter of 2009 only 61% of the level reached in the same period of 2008.

The Stock Exchange, pressured by economic problems and, above all, political instability, no longer follows the direction given by the international capital markets in October. The political crisis currently affects the stock exchange more than the economic one. The instability of the government acts and the presidential elections have reduced in October, the degree of correlation between Bucharest Stock Exchange (BVB) with the New York Exchange and U.S. indices. According to the calculations of Intercapital Invest, the correlation degree between the Bet index, which follows the evolution of the most important 10 companies from BVB, and S&P 500, the most representative American index, has dropped from 0.97, the score for October 2007-prezent, to 0.78, in the period since early October (a score of 1 represents a similar trend).[10] Shares of financial investment companies, the most liquid shares on the BSB, have been affected more seriously - the correlation coefficient dropped to only 0.23 from 0.95. The lack of correlation between BET-FI, the index of the five SIFs, and S&P 500 is also caused by the investors waiting for a signal to increase the threshold for holding SIFs. The evolution of the international market, justified by the signals of the end of the recession, helped the local stock market to rise, despite deepening economical problems. The change from last year's perception was based on the fact that scenarios which have foreseen a collapse of financial and economical systems were not justified. The S&P 500 index has depreciated by 52.5% between October 2007- February 2009, it recovered over 60% of the loss. Investors' optimistic expectations reflected on the Romanian market through the foreign acquisitions in last months. The uncertain evolution of quotes in the current quarter is due to the political crisis. The absence of a legitimized government to adopt next year's budget, which also led to the delay of the installment from the International Monetary Fund, forced the investors to be precautious, at least until the end of the presidential elections.

3. Effects on the invertors' behavior on the market: in the conditions of a market that no longer offers certainty and stabile and slightly increasing efficiency, investors are moving away from the capital market and radically changing their investment options. This has a direct impact on the cost of capital and financial interests. Panic, fear, herd effect, hysteria are feelings that dominate the masses of investors which are faced with growing losses each day. The total number of investors in Romania is also shown in the Annual Report 2008 of the Investor

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[10] Aurel Dragan, *« Tot mai rupti de directia pietelor internationale »,* Ziarul Capital, 26.11.2009

Compensation Fund (ICF).[11] The report presents the total number of investment accounts in Romania as being 65,604 in 2006, 87,664 in 2007 and 92,865 by 31.12.2008. The number reported by ICF is higher than the actual number of investors from our country, because some investors have opened more investment accounts at BVB or other institutions of the capital market.

The major losses caused last year by shares listed on the stock exchange justify the reorientation of investors towards other instruments, with lower risks and acceptable efficiency. The financial crisis has changed the investment preferences. If in 2007 shares were the most wanted, offering a superior efficiency to bank interests and bonds, in 2008 there was a withdrawal of investors from risky investments and the acceptance of safer, even with lower efficiency.[12] Investment opportunities as a result of a strong decrease of share prices and also the perspectives of a revival of the global economy will be the ingredients which will, at some point, determine a halt to the negative trajectory of the capital markets.

In Romania, the economic crisis has led insurance companies to adopt the Polish model and to significantly reduce the investments on the capital market. In Hungary, for example, the investors chose to buy share, at a lower price, but which after overcoming this impasse will have a much higher value.

4. Effects on capital market regulations: the crisis has led to a series of lessons that have resulted in a series of measures to increase control over the areas which remained outside the jurisdiction of central banks or supervisory committees of capital markets. Simultaneously, were brought increasingly into question the criteria for grant funding and risk and rating methodologies used in the financing decision. Furthermore, state intervention in financial markets had also legitimated by a series of legislative measures unprecedented since the Great Depression. The financial crisis has called into question the status of areas (components) of the capital market less regulated and controlled (mortgage market, securitized asset market, derivatives market). One obvious effect that the financial crisis has is the reconsideration and reformation of financial systems by introduction new measurement and financial risk assessment systems and also by exercising greater control by the regulatory institutions in the investment funds, pension funds, life insurance funds and mortgages.

In this context, there have been taken measures to encourage investors on the Romanian capital market. After extended discussions between government representatives crisis solutions for BVB were found in order to boost capital market development in the context of international financial markets crisis. Thus, the state budget is deprived in 2009 and 2010 of incomes from capita gains made from stock transactions, both for short-term holding, as well as for those which exceed one year.

[11] Investor Compensation Fund, *"Annual Report 2008"*, Bucharest

[12] Rodica Orjanu, "Criza financiara deschide apetitul pentru obligatiuni", Saptamana Financiara, 16.01.2009

This is a temporary solution, which will take effect from January 1, 2009. Constantly blamed by capital market representatives for high fees levied even in conditions of crisis, CNVM decided to adopt a series of measures meant to limit the effects of the international crisis on the local stock market. Therefore, for a predetermined period (2008), the fees of 0.08% for the value of transactions with shares and 0.04% of that of bonds and preference rights were suspended, together with exemption from fee for companies launching public offers of sale for listing (IPO). Through this set of measures, CNVM has dropped more than one third of the incomes that they normally receive, in conditions in which decreased activity on the stock exchange has already affected the budget.

When investors on the Romanian capital market have lost almost all hope that they will see a extended increase in the BVB since this year, the saving hand of the government appeared, hoping to restore optimism. It is hard to believe that after record drops, investors still have the courage to buy shares on the Romanian stock market, even if they no longer pay tax on capital gains since 2009, they can carry forward losses and pay lower fees.

The shock felt by BVB in late 2008 – early 2009 in the context of the international financial crisis, has shattered any hopes of investors of seeing their portfolios bloom. After nine month of almost continuous decline, and only after U.S. authorities have announced the first set of measures to stabilize the situation on the financial markets, the Romanian authorities reached the conclusion that the local stock market needs a helping hand. Especially since 2008 has shown a paradoxical situation between the course of economy – with record-growths – and of the prices of listed securities.

The current financial crisis affects developing countries in two possible ways. First, there could be financial contagion and spillovers for stock markets in emerging markets. Stock markets across the world – developed and developing – have all dropped substantially since May 2008. Second, the economic downturn in developed countries may also have significant impact on developing countries. The channels of impact on developing countries include: trade and trade prices, remittances will decline, foreign direct investment (FDI) and equity investment will come under pressure, commercial lending (banks under pressure in developed countries may not be able to lend as much as they have done in the past), aid budgets are under pressure because of debt problems and weak fiscal positions, other official fows. Each of these channels needs to be monitored, as changes in these variables have direct consequences for growth and development.

The world financial crisis has some positive aspects. These positive effects on stock market may be[13]: 1. Financial crisis ushers in an end to the domination of the sole magnate in international financial relations, which was a major cause of the

[13] Robin Bal, *The Positive Effects Of A Financial Crisis*, October 2008, http://www.fortunewatch.com/the-positive-effects-of-a-financial-crisis/

crisis. 2. The financial crisis revolves around redrafting laws and rules that regulate global financial institutions, especially the International Monetary Fund (IMF), World Bank (WB), and the World Trade Organization (WTO). 3. The financial crisis leads to a change in the world investment map and more opportunities to be provided by the emerging investment hubs, which offer guarantees and opportunities for world capitals. 4. The next global financial and banking system will be strictly regulated and supervised by applying the measures of control, transparency and global governance. 5. Nowadays, the absence of giant financial institutions, which dominated stock markets in the world for long decades, is due to the financial crisis.

Conclusions

The downward that began in mid 2008 at BVB brought, in addition to losses, a number of benefits for investors in terms of culture, education and deeper understanding of the concepts of risk and investment psychology. Among the lessons that the Romanian investor ought to have learned from this period of decline there are:[14]

⇒ Lesson of realism: clearer perceptions on the concept of risk. If until now risk perceptions were not defined, the strong drops of quotes taught investors that the risks are higher than they imagined.

⇒ Lesson of wisdom: you can loose on the stock market. The stock market has its logical and natural cycles, ascending and descending trends. The stock market is not a financial institution where everybody makes lots of money fast. The capital market has its schedule, a cycle of highs and lows which must not be neglected.

⇒ Lesson of diversity: mutual funds – alternatives with lower risk. In case of a falling stock market, the necessity and benefits of diversification for limiting losses seems obvious and it can be achieved though portfolio approaches of a mutual fund. Focusing investments in a small number of shares can be risky, there are examples of securities on BVB which dropped well below the market average although in the past had an excellent performance.

⇒ Lesson of time: medium and long term investments. In addition, during all this period, patience, calm, and a large investment horizon helped many not to panic and sell or go after small profits in comparison with those gained when the trend turned around. A philosophy of the capital market states that medium and long term investments brought the greatest profits.

In conclusion, future market developments may give other examples from which investors can learn, that is not to sell when faced with drops or panic (global financial crisis) and not to remain outside the market.

The crisis settled in slowly, but it was anticipated some years ago. Its origin has been the explosion of the internet (internet bubble), in early 2000. However, the

[14] http://www.wall-street.ro/slideshow/Piete-de-capital/42023/Ce-am-invatat-din-criza-pietei-de-capital.html

current crisis has a totally different nature. Financial markets and financial authorities were very reluctant to admit that the real economy is directly related and will be affected. The crisis we are living is clearly financial, economic but is, above all, a crisis of confidence, a crisis of ethics which, if not overcame, may jeopardize the democratic organization of developed countries and the rise of others from underdevelopment.[15]

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[15] Rober Labbe, *"Criza! Da, dar ce...criza",* Euroeconomia XXI, nr. 196 / 12.12.2008