BEYOND THE LIMITS IN AMERICAN AND ROMANIAN FINANCIAL MARKETS

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Abstract
This paper focuses on few arguments backing up the idea that "beyond the limits" in American and Romanian financial markets implies, putting aside the semantic equivalence, an entirely different content: exceeding of a reasonable top limit, in the case of the USA, while for Romania it means the need of surpassing a bottom limit that reveals the actual underdevelopment of this market. However, beyond this huge gap, a common issue can be revealed: the failure of the central banks in both countries to foresee the developments and to take measures in due time in a market they supposedly carefully survey.

Keywords: *American financial market, Romanian financial market, central bank*

American financial market dimensions

Capital markets soared since 1980s. A crucial part in the spectacular growth of the financial markets was played by the investment banks and the exchange markets, while the last six years accelerated even more dramatic this evolution.

The stock of shares and public and private debt held in America grew from 2.4 times GDP in 1995 to 3.3 times in 2004 [1], while in Europe the increase was even more dramatic, albeit from a lower base.

Derivatives markets posted also impressive growth.

If we look at the exchange-traded derivatives, we will see that the global futures and options trading grew by 30% in 2003, by 9% in 2004, by 12% in 2005, by 19% in 2006 and by 28% in 2007. During that last year a number of 15 billion contracts were traded on 54 major worldwide exchanges, compared to the 6.2 billion contracts traded in 2002.

This explosive growth in 2007 was triggered by a sharp increase in the volatility of the stock markets and by the massive shift to commodity related derivatives.

Due to the fact that **stock-related derivatives**, including both index and single-stock futures and options, accounted in 2007 for 64% of the market, the American subprime credit crises substantially raised the volatility of quotations and triggered the boom of hedging transactions, in parallel with volatility speculation.

Commodity derivatives were booming in 2007 due to some factors like the widespread use of electronic transaction systems, the growth in precious metals and bio-energy transactions, the increased interest of institutional investors in this market and the steady development of commodity derivatives markets in some countries like China, which has become a giant worldwide player in metals and agricultural futures transactions, India and Hong-Kong where the volume of derivatives transactions doubled during the last year.

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An exchange submarket that exploded few years ago is that of the investment vehicles known as **ETFs – Exchange-traded Funds**. These instruments are quoted on the stock market and are structured on baskets of shares designated to track certain benchmarks offered by a wide range of assets and characteristics of these assets (oil, gold, Asian property, combinations of corporate financial data regarding sales, profits, dividends and book value which are meant to replace the traditional benchmark offered by the market value, and so on).

The first instrument of that kind was launched in 1993 and by 2000 ETFs had just $ 74 billion in assets. The real boom was recorded in the last five years so that by June 2007 there were more than 1,000 products with just over $ 700 billion in assets.

The success of this market, especially in the USA, is due to the fact that unlike index transactions, ETFs give investors flexibility in choosing exposure. This flexibility is offered by the investment funds as well, but not at that low cost that stock exchanges are able to provide due to standardization, volume of trade and non-invoicing the alpha (as a measure of a fund-manager skill).

If we look at the **over-the-counter derivatives**, we will see that their notional value has reached $ 370 trillion, based on International Settlement Bank data, showing a spectacular growth from the $ 258 trillion two years earlier. On the top of this wave are the earnings from capital market transactions of the first 10 investment banks which soared from $ 55 billion in 2004, to $ 90 billion in 2006.

It is important to notice that, in the last few years, the investment banks business registered **a significant shift from corporate stocks to "the mysterious world of debt"** which in many investment banks' trading accounts is known as FICC (fixed income, currencies and commodities).

So for the five big Wall Street firms (Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, Bear Stearns) taken together, revenues from share-trading were in 2000 twice as much as those from fixed-income transactions, while in 2006 figures reverted due to the boom in **fixed-income securities** transactions revenues, up to $ 44 billion, and to a slow growth of share-trading, to just $ 27 billion.

The variety of assets that can be seen in the FICC accounts today is vary large indeed: from American subprime mortgages to futures on copper, gold and Japanese yen, from corporate bonds to natural catastrophe insurance, foreign debt instruments of some African states, and so on. However, beyond this diversity, the structural dynamics of the recent years show a **stagnation of the corporate bond issuance** (the „direct debt" chapter) **and a rapid increase of securities issuance backed by other assets**, as for example by commercial or residential mortgages (the „collateralized debt" chapter).

The most profitable area has been the growth of **derivatives** and **structured credit products**, such as CDSs (credit-default swaps) and CDOs (collateralized-debt obligations).

These instruments have enabled banks to separate the credit risk of the underlying bonds from the movement of the interest rates and to create a secondary market activity.

By 2006 the volume of American outstanding securitized (restructured, bundled up) loans had reached $ 28 trillion, and by 2007 almost 60% of the American mortgages and 25% of the consumer debt were bundled up and sold on.

The cornerstone of the new market are the **CDSs (credit-default swaps)**, a form of insurance contract linked to an underlying debt that protects the buyer in case of default. This market has almost doubled in size every year in the past five years, reaching $ 20 trillion in notional amounts outstanding in June 2006, far bigger than the underlying debt markets. Some 70% of these products are linked to individual issuers and are not much more complex than selling a bond short. The interesting part starts with the other 30% for which mathematicians have found

ways of bundling indexes of CDSs together and slicing them into tranches, based on riskiness and return. The most dangerous tranche exposes the holder to the first 3% of losses in exchange for a large portion of returns. At the opposite side, the risks and returns are much smaller, unless there is a systemic failure.

CDOs (collateralised-debt obligations) grew out of the market for asset-backed securities which took off in the 1970s and encompassed mortgages, credit card receivables, car loans and even recording royalties.

But the **structured CDOs** are a more complex variation using lots more leverage and bundling bonds, loans and CDSs into securities that are sold in tranches.

The USA market for CDOs was estimate dat $ 489 billion in 2006, twice the level of 2005. One-third were based on corporate loans and are known as CLOs (collateralized loan obligations), while the rest involves securities backed by mortgages, CDSs and even other CDOs (which become supertankers of leverage, known as CDO^2 and CDO^3).

Another component of the market of new financial innovations is the **SIV (structured investment vehicles)**, securities that are backed by corporate asset-backed commercial paper. This market brought some $ 136 billion to the accounts of the American investment banks in 2006 alone.

New players and new approach of the market. The 2000-02 bear capital market pushed the pension funds to search for widening their range of assets towards such alternative assets that could offer returns independently of the market index trend. This idea opened the door to private equity funds (PEF) and to hedge funds (HF).

Private equity funds invest in businesses that are not quoted on the stock market, betting on higher returns due to the fewer constrains existing outside the stock exchange and also due to the suitable incentives given to the managers in the form of share-options and the chance of o takeover through a leveraged buy-out process.

By some estimations 62% of the American private- equity assets in 2006 were in the hands of the top 20 firms and the market reached $ 700 billion, following an increase of 120% between 2000 and 2006. If we add the venture capital, which is the close cousin of the private equity fund, but concentrates on start-ups, the value of the managed funds exceeds $ 1,000 billion.

Selling the products offered by these large funds raised doubts regarding the ability of the unquoted firms to avoid the macroeconomic factors and to perform better, and recent studies revealed that the average investor in private equity has not seen particularly better returns compared with those available in the public market.

Hedge funds came with a different philosophy of management, if compared with traditional funds, even if they still mostly invest in the same types of assets – equities and bonds. What make them different are the following two aspects:

- their greater flexibility due to their ability to bet on a bear market, going short;
- the possibility of using borrowed money to enhance returns.

This was the reason to claim that hedge funds can produce an „absolute return” regardless of market conditions. The hedge funds market grew from $ 39 billion in 1990, to $ 500 billion in 2000 and to $ 1,000 billion at the end of 2007 (but allowing for the use of borrowed money, the total assets under management are estimated at $ 6,000 billion).

Hedge funds searched from the start to produce portfolios that are not correlated with the stock market indexes. Recent analyses show nevertheless a high and raising correlation between the returns of American hedge funds and the S&P 500 index.

Recently Bill Fung and Narayan Naik, professors at the London Business School, have analyzed the performance of the hedge fund industry over the last decade and identified eight factors that seem to produce the bulk of its returns. But fascinating was the conclusion of this

study, namely the fact that the bulk of these returns can be replicated in the normal market and at much lower costs than those charged by the hedge funds.

Investment banks embraced rapidly the idea and piled in to create **funds that clone individual hedge-fund strategies**. Hedge-fund representatives claim that these clones have no chance to capture the alpha of the industry as far as they are backward-looking instead of looking ahead.

Cloning represents also a particular threat to the representatives of the quantitative school of fund management (known as „quants”). They use computer models to identify patterns and correlations in the markets that have been profitable in the past. Their analyses aims to put aside any subjectivity arising from the quality of corporate management or the nature of competition and concentrates on numbers alone, trying to shorten to milliseconds the gap between computing the data and trading on the stock exchange.

These “quants” have been remarkably successful over the past decade, but in august 2007, paradoxically, within the space of just a week, many of their models ceased to work and some funds scored dreadful performances (for example Goldman Sachs’s Global Alpha fund lost 38% on a year).

Under the circumstances in which many of the preceding investment instruments showed their limits when put under the stress of a crises, investors started , beginning with the second half of 2007, to look more eager for **alternative investments**. Among these we can mention:

1. **Investments in “frontier markets”,** known also like “emerging markets”, made in the hope that countries like Kazakhstan or Vietnam will eventually achieve growth rates comparable with those in China or India,

2. **Investments in the so-called “exotic beta”**, a class of assets which includes weather derivatives, derivatives on carbon dioxide and sulphur dioxide emisions. The main attraction of these products is that the factors that move the prices of these contracts are so remote from the forces that drive the S&P 500 index that any correlation between them is more than unlikely.

3. **Investments in “event-loss swaps”**, a natural disaster version of the credit-default swap.

4. **Investments in the so-called “mortality catastrophe bonds”** through which investment banks bundle up life insurers risks in the form of bonds linked to life insurance and mortality rates and sell them to hedge and pension funds. This market has reached $ 5.4 billion in 2006. Despite the fact that trading the catastrophic risks on the capital market was under discussion for at least a decade, investment banks have been slow in delivering this opportunity. However the market for insurance-backed bonds rose to $ 25 billion in 2007 and there are estimations that it could reach at least $ 150 billion by 2015.

5. Investment in instruments backed by receivables from credit cards, car loans, loans for students, sport and fast-food franchises, royalties from audio-video productions, intellectual property rights and many others.

On such a trend of capital markets expansion and matchless diversification of the investment vehicles, an American study covering a period of time from 1990 to 2006 suggests that the increase of “securitization” resulted in a series of positive effects among which the lower spreads in consumer credits and the softening of interest-rate shocks for banks, especially smaller ones.

At the same time the subprime crises in the USA exposed at least 4 **deep flaws in the practice of securitization:**

1. By splitting the direct link between those who scrutinize borrowers and those who undertake the risk when they default, securitization has lead to a lack of accountability on behalf of the lending banks. Suggestions for overcoming this shortage vary from establishing of adequate capital provisions, to issuance of “origination certificates” guaranteeing the quality of the underwriting, or to just neutralizing the exposures through derivatives markets.

2. The difficulty of understanding of some investment instruments. Overcoming the lack of transparency, particularly for those in leveraged structures such as CDOs, would be essential and could be reached, among other ways, through the opening of a central trade-quoting facility. CME Group, which runs the world's largest futures exchange, intends to answer these demands by expanding its clearing operations to over-the-counter securities.

3. The poor structuring of some securities, often because their risks were not fully understood.

4. The over-reliance on the rating agencies data while neglecting own evaluations of risks.

Conclusions

The distribution of financial risks is by all means a necessity and has turned into an attribute of modern markets. But a measure of rationale is badly needed on this field.

Wall Street is moving along a spiral of excesses which seem to broaden its frequency and amplitude. In the 80's the investment banks created a large array of new products, with junk bonds among them, developed markets for these securities and then abused these markets in their own benefit. This scheme repeated itself in the 90's when banks rushed to take advantage of the boom of internet transactions, amplifying another illusion for the investing public. "There is always someone that misses the moment when a limit is reached" said a broker at that time. The subprime credits crises showed in 2007 that the one who missed the moment and was taken by surprise as well as in 2001 was no one than Fed itself, the supreme authority in the market.

During the unusually benign economic climate characterized after 2001 by an euphoria that struck consumers, investors, banks, funds, stock exchanges and market authorities, the financial market seemed to respond better and better to the investment boom through the rapid diversification of investment tools. There were developed more and more sophisticated markets for the distribution and redistribution of risks and returns. The increased possibilities of risk redistribution (through derivatives and financial repackaging) has brought a sizable surplus of risks on the market, on top of the rational ones (through the risky lending in the mortgage industry, through the import of exotic risks or through the increase of the financial instruments leverage).

Bringing new risks in place for the sole purpose of profit making, without necessarily responding to some overall needs, proved to be threatening the entire system. When the lending institutions subsequently redistribute these risks without any accountability and without any honest disclosure of the risks involved in their investment products, the issue turns into a moral one too.

A public morality can be also revealed when the state, in a way or another, through regulation or deregulation, patronizes such games and their effects become wide or even social. When sentences like: "It is a free market and the investors should bear the risks and be careful" are heard from governors of central banks, they are certainly out of scale in such a context. References to be made are the American financial crises or the fall down of the National Investment Fund in Romania which was endorsed by the state through CEC, a state-owned savings house.

When talking about the responsibility of the institutions enforced with the surveillance of the financial and banking markets, fortunately some positive effects of the recent financial crises can be foreseen.

By the end of '90s Paul Krugman draw the attention on the increasing risks due to financial innovations, argueing on the lack of insurance tools for the non-bank financial institutions similar to those made operational for commercial banks through the Basel 1 agreement. The situation recently changed by the enforcement of the Basel 2 agreement in 2007 in the European Union and in 2008 in America.

But the American crises showed that this important regulation turned itself into a crises fostering factor due to the fact that its trickier provisions encouraged banks to make more use of credit derivatives (CDOs) to diversify their credit portfolios, selling the granted loans into the capital markets.

It is a proper moment to remember that the remarkable Alexander Lamfalussy stressed since 2000 the necessity of an undelayed compromise between financial innovation and the stability of the system as a whole. In addition, we point out that financial innovation must be kept within rational limits and the stability of the system must be managed more adequate and through a closer relationship between financial market authorities and the private sector, in order to achieve a real control of the systemic risks induced by financial innovations.

The Romanian exchange-market

The exchange trading in Romania started and developed shy and slow:

- stock-trading started in 1995 on the BVB and in 1996 on the RASDAQ;
- derivatives-trading started in 1997 on the Sibiu BMFM;
- municipal and corporate bonds trading started in 2001 on the BVB.

In 2007 the size of these markets is still far from impressive:

- stock-trading on the BVB reached 4 billion Euros, and on the RASDAQ just 1.2 billion Euros;
- derivatives-trading reached 5 billion Euros in notional value, with futures accounting for 70% and options 30%. Even the number of derivative instruments is small – just 35 (28 on shares quoted on BVB and RASDAQ, 3 on exchange rates, 2 on indexes, 1 on interest rate and 1 on gold).
- Municipal and corporate bonds trading reached 230 million Euros.

Conclusions

Year 2007 has put two stress-tests and also major goals in front of the Romanian government and the central bank: to avoid the inflation slippage and to reduce the current account deficit from the 13% of the GDP.

Observing the rule that crises situations always reveal better the existing shortages, the above mentioned stresses, on top of the international financial turmoil, draw the attention on the following two facts that seem to relate directly to the Romanian financial market:

- the lack of a strong and articulated monetary policy;
- the lack of sufficiently developed primary and secondary financial markets.

While in the USA it was the financial market that has developed a "speculative balloon" in the real estate sector by tolerating the idea that the market will show exclusively an upward trend, in Romania it was the Central Bank itself that fostered the creation of an "irrational balloon" of money supply which has lead, in the second part of the 2007, to the sharp depreciation of the national currency and to sizable price increases in a moment when everyone knew the bank was fighting with inflation. The NBR regulation of march 2007 relaxed the lending terms for private citizens and pushed up the aggregate M_2 money supply by 33% in a moment when the inputs of foreign capital were also increasing after the capital accounts liberalization and the integration of the country in the European Union.

Is that wise to raise the money supply not having in place enough absorbing investment vehicles or not developing liquid markets for these vehicles?

These instruments, and first of all treasury, government and public authorities securities, should have been diversified and quoted on the stock exchange long before 2007, with the effect of a diminished sterilization effort on behalf of the Central Bank.

As an excuse, the NBR was greeting itself in 2008, when the effects of the American financial crises were widespread, in the same way it did in 1998 when the financial crises in Russia produced international effects, that the underdevelopment of the Romanian securities market has helped Romania to avoid the turmoil of the foreign markets.

Developments on the market pointed out that this assessment was also false. The exit of foreign capital from Romania, triggered by the subprime credit crises in the USA, was not significant and was limited to those banks and funds that were forced to undertake a restructuring process. Investments stay in places that offer good and stable returns and the investments placed in Romania recorded vary attractive returns in the last period of time. A new wave of international investment funds is on the way to Romania this year and will rise their number from 22 to 60. They invest in shares, bonds and domestic monetary assets which, in spite of their increased sensitivity to foreign capital markets volatility, are still in a closer correlation with the domestic and European economic climate, than with the markets of financial innovations. The market for basic securities, traded on primary and secondary capital markets, will certainly be contagious, to some extend, to the international turmoil, but it is and always will be analyzed through the particular investment opportunities.

The shortage of liquidity absorbing instruments can be observed in the currency exchange market too. Although there are examples in the nabourhood to be followed, such as Poland which gave up the practice of market interventions since 2000, the NBR continues to build up intervention reserves and to intervene on the market, unfortunately mostly post-factum and through non-transparent measures.

We can consequently conclude that for Romania the matter of “exceeding the rational limits” consists of the need of developing the actual immature financial market towards treasury, government, public securities and commercial paper, as well as to derivatives and other financial innovations that can be met on mature markets. It would certainly have been more decent to hear the financial market institutions of Romania commenting on the negative impact of the financial markets globalization upon Romania only after they would have put in place the proper instruments and markets and would have implemented a better mix of policies.

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