# THE CURRENCY CRISIS TRIGGER OF THE ROMANIAN FINANCIAL CRISIS OF 2008

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**Abstract**

This paper analyses the ways the financial crisis started to manifest into the Romanian Financial System, through the exchange rate channel. The focus of this Paper is on how the Romanian decision makers contributed in triggering the financial crisis (that would have been triggered anyway). The paper will determine the trigger (the first obvious event) for the Romanian Financial Crisis (the debut) and it will prove that the consequences of this trigger could have been anticipated - it is in line with similar triggers for the debut in other currency crises. Therefore, one of the main conclusions of this paper is that while a global crisis starts to manifest the local economy should limit the exuberance of the decision makers in order to smooth the effects of the crisis.

**Keyword:** Exchange Rate, financial crisis, currency crisis, balance of payment Crisis.

**JEL Classification:** E52, E58, G01

## 1. Premises of the Romanian currency crisis (2008)

By the fall of 2008, the Romanian current account deficit was set to reach 13% of GDP so the question was not if Romania is heading towards a balance of payment crisis, but when. The crisis debuted in Romania, after the fall of The Lehman Brothers but the trigger was not the fall of the investment bank. By the end of 2004, the Q4 dynamics of GDP was -13% comparing with + 9% growth in Q1-Q3.

The main factors for the widening of the current account deficit (exports and imports) are revealed in the Figure 1:

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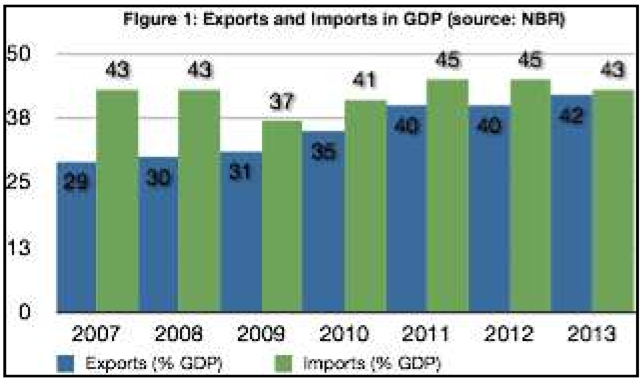
**Figure 1**




*Source: National Bank of Romania*

Romania entered the crisis with a miss match of the foreign debt. According to the National Bank of Romania Governor, Mugur Isărescu, the financing need on the short term at the beginning of the crisis (2008) was up to 16 billion Euros (7.5 billion - 16 billion)[1]

## 2. Conceptual and theoretical context:

Krugman (1979) and Flood&Garber (1974) explain how the currency crises develop especially after and inadequate economic policy mix - mainly by persistent high fiscal deficits and by trying to maintain a fix exchange rate regime. The inconstancy may be just partially compensated if the Central Bank has enough foreign exchange reserve, but when the reserves become inadequate, the speculators try to force the depreciation of the exchange rate by the selling of the domestic currency[2]. Krugman (1979) states that the speculators will attack a currency as soon as such an action might have a success. In this condition, the false conclusion we might draw is that the currency fall was provoked by the speculators and would not have been justified by fundamentals.

Krugman (1996) defines a model for market manipulation. The scenarios are generated even by rational expectations that eventually

[1] *Isărescu, Mugur - ,,Finanţarea dezechilbrului extern şi ajustarea macroeconomică în condiţiile crizei financiare. Cazul României'', BNR, Bucureşti, 2009, p.20 - 27*

[2] *Krugman shows that an economy that is subject to persistent and predictable deterioration will face a currency crisis. The logic for a currency crisis is that it will happen before the deterioration of the fundamentals would have driven anyway to a fall in the exchange rate (even in the absence of a speculative attack).*

lead toward self fulfilling crises or by the irrational horde effect. Both of these scenarios leave enough room for profit for the speculators.

The model defined by Krugman takes into consideration that a country is vulnerable by abandoning the deposits in the local currency of the foreign investors. The investors will assume that the local authorities will abandon the peg or the managed floating regime once a speculative attack is triggered or they copy their actions. So, a big investor might register significant gains by shorting on the currency (a bet on the depreciation of the local currency) and by triggering the crisis intentionally. This attitude, according to Krugman might include a mix of public statements and "show-off" selling of the domestic currency (as George Soros did during the attack on the pound in 1992).

Krugman motivates the seldom presence of such attacks, because a self fulfilling crisis scenario is rather limited: most of the currencies tend to be under attack as soon as they are vulnerable to such an action (that what was happening in Romania in 2008). Knowing this, the investors will try to anticipate the fall and to prematurely trigger it, so they will initiate an attack as soon as they see success probabilities. While everybody knows that a certain currency is vulnerable and they can capitalize on this, the investors will short sell the currency anticipating that somehow one of the biggest players will eventually succeed in undermining the exchange rate so they will force the collapse of the exchange rate.

The speculative attack is just the front entrance for a currency crisis. The full scale currency crisis will manifest through the exchange rate channel, by depreciation, that will trigger a huge discomfort in an euroized economy (where the loans are significantly made in a different currency than the local one). The depreciation will put pressure on the borrowers capacity to pay back the loans and we will have a different scale of the crisis.

## 3. The unofficial debut of the different crisis part of the World Great Recession of 2008

The international economic literature tries to define exactly the moments that different crisis were triggered and the actual trigger of the crisis (that would have come anyway). On Table 1 we describe the triggers of the credit crunch crisis (worldwide), the trigger of the financial crisis in the US, the one for the liquidity crisis and the European sovereign debt crisis. We will also set the date for the debut of the global financial crisis in Romania (through an attack on the currency) on September, 30, 2008.

**Table 1**

**The debut and triggers of the different crisis that were part of the Global Financial Crisis of 2008**

| The Crisis | Date | Trigger |
|---|---|---|
| The US Suprime Debt Crisis an the start of the worldwide Credit Crunch Crisis | August, 9, 2007 | BNP Paribas |
| The US Financial Crisis | March, 5th, 2008 | A hedge fund manager in Florida |
| The World Liquidity Crisis | September, 15th, 2008 | Lehman Brothers |
| The Romanian Crisis Debut | September, 30, 2008 | Legislation vote on wages |
| The start of the European Sovereign Debt Crisis | October, 10th, 2009 | Geroge Papandreu |

*Source: Author's data gathering*

Details:

* On August 9 2007, the French bank BNP Paribas announced that it will close three investment funds reasoning that they do not know how to evaluate their assets (Colaterlized Debt Obligations - CDO based on the slice and dice of the US subprime mortgages. It is the official start of the US subprime crisis. In the same day, the FED and the ECB inject 90 billion dollars in the panicked financial markets so we see the debut of the "credit crunch crisis"[3]

* March, 5th, 2008: A hedge fund manager sends a newsletter to his investors that include the following statement: "in my books, Bear Stearns is insolvent"[4]. Bear Stearns was ready to announce 115 million dollars profit for the first quarter and a stock of cash

[3] *The credit crunch is used for describing a situation when the commercial banks are reluctant to inter-banking lending and this provokes fears for the Central Banks that this signal will be suddenly transmitted towards companies and private persons.*

[4] *Cohen, William - ''House of Cards'', Ed. Doubleday, New York, 2009*

reserves of 17.3 billion Euros. Ten days after, Bears Stearns no longer existed. It is the start of the US financial crisis.

* September, 15th, 2008: Lehman Brothers goes insolvent and triggers a systemic risk for the World Banking System. Merril Lynch, the third investment bank worldwide is bought by Bank of America and the biggest insurer in the world, AIG need a financial bailout of 85 billion dollars. It is the debut of the World liquidity crisis;

* September, 30th, 2008: The Romanian Parliament votes the increase of public wages paid to teachers by 50%, starting next day, October 1st. It is the trigger of the speculative currency attack on the Romanian Leu (RON). On October 27th, S&P downgrades Romania to "junk" and on November 10th, 2008, Fitch rating agency does the same thing. On January 16th, 2009, Commerz Bank warns its clients agains the fact the Romania goes through a balance of payments crisis (as it happen to Hungary who avoided the BOP crisis by going to the IMF on October 8th, 2008). In March 2009, Romania signs for a 20 billion Euros loan from IMF, European Comission and the World Bank - through a stand-by arrangement.

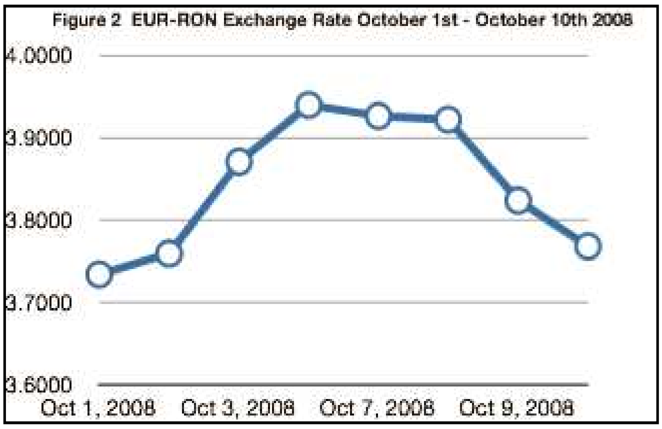
* October, 10th, 2009, the new Prime Minister of Greece - George Papandreu says that Greece has a public debt which is 100% bigger than the one previously announced. It is the debut of the sovereign debt crisis;

## 4. The currency crisis in Romania

As we stated. the debut of the currency crisis in Romania was triggered by the September 30th, 2008 announcement that Romania is going to increase the teachers wages by 50%.

As a strategy, the attack operated as follows: the speculators assumed the negative effect of the news that during a world financial crisis Romania wants to increase the public wages for the teachers by 50%. They tried to provoke and tot take profit on the RON depreciation. They shorted the RON (they borrowed RONs that were supposed to be paid back later if the depreciation will succeeded). The Central Bank resisted somehow to the depreciation pressures (they sold Euros against the RON so they sterilized the RONs in the market). Croitoru (2012)[5] states that the Central Bank intervened on the market by selling foreign currencies in order to absorb the RONs on the market and the NBR found counter parties for the foreign currency from different reasons:

**Figure 2**




*Source: National Bank of Romania, daily exchange rate*

* the biggest FOREX players (big banks) watch the fundamentals (huge current account deficit, increased fiscal deficit - that was estimated at that moment at 5% of GDP);
* the fundamentals showed that Romania was speeding towards a Balance of Payment Crisis;
* the only easy exit from a balance of payment crisis it is traditionally the depreciation of the exchange rate

So, following this mechanism, the Euro that was sold by the Central Bank for 3.7 - 3.8 - 3.9 Rons would have been a good profit opportunity for the big banks (not so far away when the RON would have been depreciated anyway). These Euros were treasured in order to sell them at different increased prices (4.2 or 4.3) by the time when the balance of payment crisis would have been fully revealed.

This mechanism succeeded because less than 3 months after, the Eur-Ron exchange rate was floating around 4.3 RONs for 1 Euro.

[5] *Croitoru, Lucian - „Politica monetară. Ipostaze neconveţnionale'', Editura Curtea Veche, Bucureşti, 2012*

On the short term, the Central Bank sterilized the RONs on the market so the speculators and toher borrowers were obliged to pay higher interests. As the price of the currency is its interest rate, the RON became more expensive (the interest rate on the money market rose from about 10% to over 50% per annum). At this cost, it was not rentable for speculators to borrow, so they started to sell back the RONs they bought, marking losses and the exchange rate came back to 3.76 on October 10th (similar to October 2nd RON-EUR exchange rate). Before this, the RON lost 5.5% percent against the Eur in just 3 sessions.

## 5. Conclusions on the influences of the currency crisis on the Romanian financial system

The speculative attack somehow failed and faded on October 10th. But the tensions were exported through the interest rate channel. Even if the interest rate shown on the money market where "interest shown" not "effective" (not everybody was lending/borrowing at these rates), the money market interest rate used to be references for commercial loans in RON (to companies and households). So, the "storm" on the money market was reflected in a significant increase of the reference interest rate for the loans made in RONs.

The Central Bank tried to limit these distortions by capping the money market interest rate ROBOR to a maximum +25% above the monetary policy interest rate (MPIR). By that time, MPIR was 10.25 so the cap was set to 14.25%, in order to limit the loans in RON to become much more expensive (then they already were).

The appreciation of the RON against the EUR after the speculative attack was temporarily (between October 10th 2008 - January, 20th, 2009 the EUR reached a new historical high against the RON (4,3127 lei on January 20th, 2009 comparing with 3,7690 lei). In 14 weeks, the RON lost 14.4% of its value agains the Euro putting transmitting pressures on other channels (interest rate channel, commercial channel, trust channel, financial channel, wealth channel). These channels would have been activated anyway (by a different trigger and on a different dimension) but the currency crisis accelerated and amplified the tensions and the effects.

As the main lessons of the currency crisis in Romania we identified:

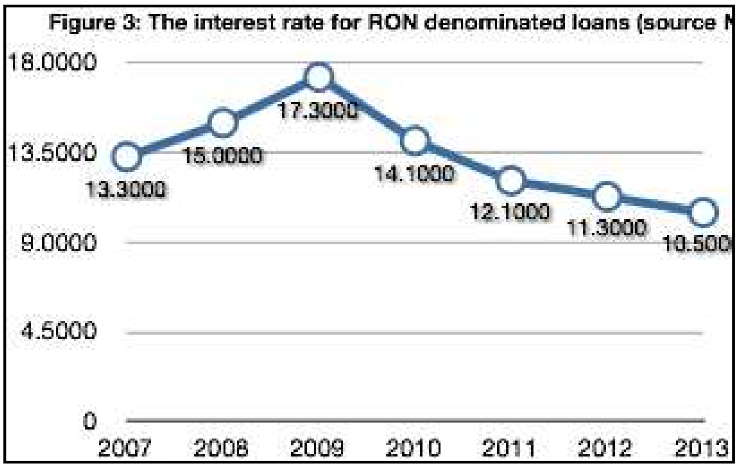
a) when a global crisis in on-going, there is a terrible mistakes for the local authorities to feel and act as the local economy will be isolated;

b) there is a strong urge for the policy mix authorities to coordinate their policies in order to assure a ‟soft landing" (that means in terms of the exchange rate a smooth depreciation of the national currency˝

c) even if the depreciation of the local currency is a proxy for repairing a balance of payments crisis, in order to assure the smooth landing it is desirable to be pro-active and re-establish strong ties and commitments with the Institutional lenders of last resort (IMF, European Comission, The World Bank). Such an agreement will prevent the appetite of speculators to attack a vulnerable currency;

d) when a balance of payment crisis is unavoidable their is a huge mistake to be addicted to short term borrowings for financing the public debt need. This creates a crowding out effect (the states targets the same limited amount of money that is available on the market as the companies and other private borrowers having as an effect a more expensive price for the loans) (Figure 3);

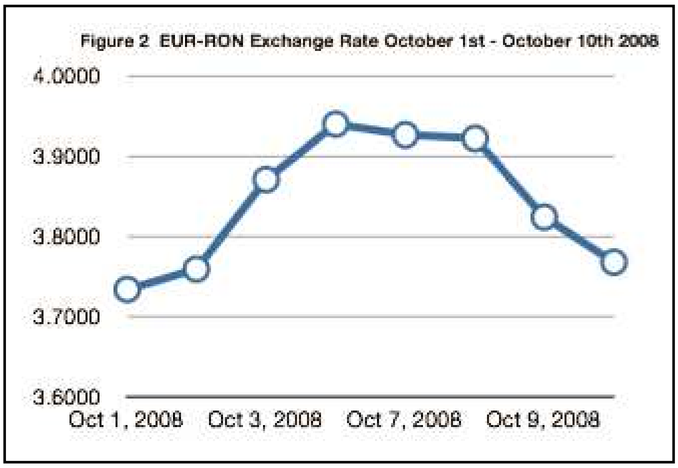
**Figure 3**




*Source: National Bank of Romania*

e) an overshooting in terms of depreciation will put additional pressure on the non-performing loans, that might affect the stability of the banking system, especially in an euroized credit enviroment (Figure 4).

**Figure 4**




*Source: National Bank of Romania*

f) even if you resist a currency attack, sooner or later the depreciation will be driven by the fundamentals. Knowing this, policy-mix authorities should try to prevent some major disturbances in other sectors (for instance the peg between the ROBOR rate and the actual interest rate perceived for loans in the national currency). Capping the ROBOR has proved to be a ration decision but by the time it came into effect, the disturbance on the money market has been already transmitted in the price of loans (the interest rate for RON denominated loans increased in some cases from 12% per annum to 24% per annum).

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