Petar Goshev: Brief overview of the financial crisis and its impact

Opening speech by Mr Petar Goshev, Governor of the National Bank of the Republic of Macedonia, at the international economic forum “Faster towards the European Union”, organized by the Economic Chamber of the Republic of Macedonia, Ohrid, 2 November 2008.

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Honorable President Azevski,

Dear presidents, business leaders, honorable excellencies, ladies and gentlemen.

Let me thank Mr. Azevski for the given honor to speak in front of you this evening, in this exceptionally turbulent, exciting and at the same time challenging period in the economic and financial history of the world. From the invitation I can read that I have the honor to address representatives of ten countries in the region, primarily people who face all sorts of challenges in solving the puzzles from the real economic life, every day. From the statistics I looked through, I may conclude that I have the pleasure to speak in front of representatives of nearly 64 million citizens (63.89 in 2007), whose GDP was around 507 billion Euros altogether in 2007, as opposed to the GDP of 40,000 billion achieved by the world (i.e. 1.27% of those 40,000 billion), in front of the representatives of the 64 million citizens who during the same year exchanged goods and services with the rest of the world in the amount of 295 billion Euros, as opposed to the 20.4 thousand billion of realized foreign trade of the whole world, i.e. a share of 1.43%. Since the European Union has realized GDP of 12.34 thousand billion of the world's 40,000 (which means around 30%), our share, i.e. the share of the 10 countries, participants in tomorrow's conference, in the GDP of the 27 EU Member States, equals 4.5%.

Ladies and Gentlemen,

I do not present these figures for pure statistical reasons. It was agreed with president Azevski to give you a brief overview of today's hottest issue, "the financial crisis in the world". Management of this crisis, as well the response of each of us individually and jointly of the region, is directly related to the answer to the question in the focus of tomorrow's conference: How to go faster towards the EU? The figures that you are very well aware of, and I only reminded of them, indicate that: we were not in a position to cause the latest world financial crisis, that we are not in a position to solve it, but that we are definitely bearing the consequences from it for a simple reason: borders are open. Balance of payments current accounts are 100% liberalized. Varying from country to country, the export and import of goods and services participate with over 50%, up to nearly 100% in the domestic GDP. Capital accounts are also 100% liberalized in some of the participants in the conference, the others are close to that. Both individually and all together we are absorbers of the shocks coming from the rest of the world, and that rest of the world is 98.75% of the world population (we are only 1.25%); 98.57% of the foreign trade, 98.73% of GDP in 2007. Therefore it is important for us to penetrate as close as possible to the nature of the current financial crisis, to the necessary and true answers to the question how it should be managed, which are primarily sought and ought to be found by the developed countries, what lessons are to be drawn from this crisis, what will be the damage for the region, what is the best way to cushion part of the inevitable impact as successfully as possible.

What has actually happened?

Starting from August 2007, the world was lapped by an intensive financial disorder, turmoil. Once again the trigger was pulled with a severe downward turn in the USA. First, "Fannie Mac" and "Freddie Mac" were taken into conservatorship. The following weekend "Lehman Brothers" turned out to be incapable of finding a buyer and they went bankrupt. This shocked the market, which expected that it will be saved by the government, as it was the case with

"Bear Stearns" in the beginning of the year. Then, "AIG" had to be rescued after the rumors about the size of its losses incurred by agreements for commercial debt securities. Hence, the pressures increased enormously for the other dealers in securities. Then, Secretary Paulson revealed the initial plan of 700 billion $ for purchasing assets in order to support the banking sector. However, this did not eliminate the doubts.

The pressures grew in Europe, too. In September, Dexia, Fortis and Hypo Real Estate had to receive an urgent capital injection, mainly from the governments. In England, the authorities facilitated the quick consolidation in the mortgage sector by having Abbey Santander buying Alliance and Leicester, they supported some mergers in the construction sector and suggested a merger of LTSB and HBOS. Finally, at the end of September, the transparent authorities in England intervened in order to solve the rising difficulties in Bradford and Bingley, by transferring the deposits and the branch network to Abbey Santander and by undertaking the remaining assets and liabilities in public ownership, and subsequently closing them in an organized manner.

All analysts perceived the events on the financial markets as something unseen ever since the great financial crisis in the period 1929-1933 of the previous century. As early as in the second half of September the companies and non-banking financial institutions accelerated their withdrawal even from the short-term financing of the banks, and the banks were increasingly losing the confidence for extending loans to each other. The costs of financing grew tremendously. Many institutions could make only overnight borrowing. The credits to the real sector almost stopped. On the financial markets, the trust to the others plummeted to a point below which the investors sought their way out mainly in the government instruments, for example US Treasury Bills, which at a certain point had a negative yield. Distrust went much further than the sub-group of vulnerable banks. The reports reveal that USA and Europe have registered market losses from the asset loans of nearly 3 trillion US Dollars.

Regardless of the fact that all these losses will not encumber the banks and can overemphasize the losses of those able to keep the debt until the maturity, the investors and their partners became very concerned about the amount of the actual losses in the banking and trade portfolio in broader scope of the institutions and their capability to continue financing their business. The focus of the concern moved from prospective profitability to prospective survival. That is why the CDS premium increased to unprecedented ranges, the prices of the banks' shares plunged, while the money market overdried. The interbank lending margin deepened dramatically, the lending, as I mentioned previously, reduced to only overnight loans. Around October 6 and7 even the overnight loans stopped.

How did the central banks of the countries in the crisis' epicenter respond?

In the beginning, the central banks were committed to provide liquidity as much as necessary. The volume of the liquidity support from the central banks of USA, England, Europe was without precedent in the history so far. It included a wide spectrum of measures, including the long-term repo based on broad spectrum of collaterals and introduction of special liquidity patterns enabling the banks to swap illiquid assets for Treasury Bills for a period of up to three years. Incredible, unseen till now. However, some knew, others maybe did not, that is far from sufficient. That the liquidity injecting has vital role only to delay, prolong the immediate, forthcoming collapse. That such steps can help to overcome the crisis only until the elimination of the actual reasons that were spreading the distrust. Also, to help understanding the severity of the fundamental problem and to postpone the inevitable day for calling to account. "Exactly as the high temperature, the fever (as Mervin King wrote) is by itself a symptom for the basic condition, thus the freezing of the interbank and money markets was a symptom for deeper structural problems in the banking sector". That is why another group of measures had to follow. The new, additional measures were designed to eliminate the fear arising from the thought and the facts that the banks are insolvent. To ensure that the banks have enough capital to survive the harsh economic plummeting and hence, to enable them to continue lending on normal criteria for the good credits. With a fully solvent banking system, guarantees may be given without exposure of the tax payers to unacceptable risk (just to mention that the British tax payers currently have larger claims in the form of bank assets, as collateral maintained by the Bank of England, than the total value of the banks' capital in England). That is the reason why the morning of October 8, the Prime Minister of England and the Minister announced the plan for recapitalization of the banking system, which was then, one way or another, followed by others in the world, primarily USA and Europe.

More precisely, why did this radical plan have to follow?

When the financial turmoil commenced (in August 2007), the markets of numerous financial instruments, including the MBS (mortgage-backed securities), ceased functioning. They dried out. Most of the analysts thought that it is on a temporary basis. But, the time passed and the markets failed to reopen. It became clear that the problem is much bigger. The concern that insolvency is in question was rising and it was verified. Actually, it became evident that the main problem is solvency and sustainability of the financing model. That is why the liquidity injecting was only intended to buy some time. The securitized mortgages, polling of mortgages sold through securities, including the infamous US-sub-prime mortgages, were traded on the market during the upward trend in the prices of apartments and houses, and when the interest rates were low, it disguised the risks of the core loans. With securitization of mortgages in such a volume, the banks have transformed the liquidity in their loan portfolios. They financed that by wholesale borrowing. But when the defaults multiplied, and the prices of the apartments dropped, firstly in the USA, and then wider, the investors had to reassess the risks inherent to these securities. Observed as more risky, they lost their value. The demand for these securities plunged. For the same reasons, the value of the mortgage portfolio went down. The value of their assets reduced, whereas the value of the liabilities which remained unchanged. The negative effect increased with the very high level of borrowing compared to the capital (or the so-called leverage), with which many banks worked, and with the fact that the banks have purchased a large quantity of securitized and more complex financial instruments from one another. Not only the real evaluation was difficult, but the distribution of the losses through the financial system was vague. The price of the banks' shares dropped. The capital became restricted. The market has sent a clear signal: the banks' capital was insufficient. The message? Recapitalize them immediately.

What does the latest news from the market say?

Since the recapitalization packages and other measures have been announced, signs of improvement occurred. The credit default swap premium indicator, showing the markets' concern for the banks' solvency, which according to many experts is the most significant individual diagnostic statistics, started to decline. Especially the CDS premium (commercial debt securities premia) dropped significantly.

The progress with the guarantees, although gradual, is also encouraging, with more banks issuing bonds even without utilization of guarantee (government) being registered. The LIBOR spread also shrunk, and it is expected to "continue to narrow gradually compared to the period before the measures were undertaken" (this primarily pertains to England).

Many banks continue to face with deleveraging and rebalancing in order to lower the dependence on financing through the central banks.

The stronger capital and financial position of the banks will be possible in a period of several years. In wider terms, the financial system remains to be under acute clench, tension. The real economic sector bears the consequences.

The unemployment increases. The business financing is getting harder and more expensive. The economies' growth decreases. Also the so-called emerging economies started to feel decline in the growth. It seems that we are entering into recession. The central banks of the developed economies transfer the focus of their measures from the inflation control to recession prevention.

What conclusions can be derived from this crisis?

1. Nout Wellink, President of the Basel Committee on Banking Supervision and Governor of the Central Bank of the Netherlands, quotes Charles Kindleberger, saying in his famous book "Manias, Panics and Crashes", that the "financial crises are typically a result of extended accumulation of imbalances preceded by certain exogenous shock, or structural changes in the financial system. The examples are in the changes in the political environment, new regulations and financial innovations. These changes create new possibilities, but also, uncertainties and lack of awareness of potential risks from the so-called unknown-unknowns". In such environment, says Wellink, "the traditional checks and balances can become inappropriate and can easily result in excessive risk".

Really, we have faced:

- Fiscal and balance of payments deficits, which failed to be treated because there was no enough good will for that in the globalized world, and accordingly to discuss about the foreign exchange rates.
- Huge imbalances in the financial sector, the dimensions of which grew to explosion. While the savings rates were decreasing with a limited rise in the households' deposits being registered, the banks were filling in the gap between the retail deposits and the credit growth by using sources from the wholesale markets. For example, in England, the gap between the lending to clients and the deposits climbed from zero, in the beginning of the century, to over British Pounds 700 billion in the first half of 2008, says Sir John Gieve, Deputy Governor of the Bank of England.
- The expansion of the banks' aggregate balances, which became too padded out, exceeded the increase in the real economy.
- The structure of the liabilities excessively relied on the maintained availability of the so-called wholesale funding, the maturity of which was on a short-term basis.
- The discrepancy between the capital and liquidity on one hand and the risks on the part of liabilities, was constantly increasing.
- The financial innovations brought a lot of unknown-unknowns, together with the fast trend of globalization. It means that structural changes through financial innovations occurred. The best illustration for this is the so-called "originate-to-distribute" model, i.e. extending credits and claims distribution to chained financial intermediates and end-users, which replaced the so-called "originate-to-hold" banking model, i.e. issuance of credits and holding to their maturity. It really opened new possibilities for the financial system to broaden and manage risks and maturity mismatches. Some of the banks developed this model into a complete integrated business strategy and primary source of financing of their activities. They securitized the loans, transferred the risk to others in a short period of time, in order to borrow capital over and over again, in order to sell the claim again, and to benefit promptly, but it definitely lowered the lending standards.

2. What should be the medium-term agenda of response to the fundamental problems in the financial sector as a lesson from what we have witnessed so far?

- Neither macroeconomic nor sector imbalances, of which I have spoke before, must be tolerated for too long.
- The banks' risk management processes and procedures must be dramatically improved. This includes revision of the existing limits on the

banks' exposure to certain risks, improvement of the stress-testing procedures and elimination of the weaknesses related to risk management which arise from the investments in structural financial products. We, as National Bank of the Republic of Macedonia, have adopted new regulations related to these issues and we continue to work on that with our banks.

- Strengthening of the principles for liquidity risk management, especially in crisis. Internationally, steps have already been undertaken. In April 2008, FFS prepared a Report and defined 67 activities for strengthening the markets and the resilience of the institutions. The Report pays special attention to liquidity, and on September 28, the Basel Committee on Banking Supervision announced the new Principles for Sound Liquidity Risk Management and Supervision. The responsibility is located with the banks and supervisors. We, as National Bank, have already passed new regulations for defining the main elements which the liquidity risk management system of each bank must incorporate. The aim is to ensure level of liquidity which the banks will be able to use as source for covering.
- The transparency of the operations of the financial institutions must increase through the type and the scope of the data these institutions will disclose. This will lead to increasing the confidence in the financial system. The Basel Committee on Banking Supervision and the Board for International Accounting Standards have already undertaken certain activities.
- The regulation on determining and measuring banks' solvency deserves special attention. The appropriate level of capital is the main anchor for a stable banking system. When this issue is discussed internationally, primarily a reference is made to the New Capital Accord, the so-called BASEL II. It is being criticized even before its full implementation and therefore it is inappropriate to refer to it as one of the reasons for the current crisis. However, it is important to mention that draft amendments have already been prepared as a response to the new developments. Those are, inter alia, the following:
  - Improvement of the manner of covering the risks arising from the use of structural financial products.
  - Changes in determining the capital necessary for covering the risks from banks' trading portfolio, especially of those instruments characterized with lower liquidity on the market.
  - Measures for reducing the effects from the economic cycles on the level of the capital requirement. The purpose is: to allocate more reserves in periods of expansion in order to provide sufficient capital for covering the losses in times of crisis. This is Spanish experience, known as "dynamic provisioning".
  - Expanding of the type of data which the banks will be obliged to disclose. I would only like to mention that the National Bank has commenced the activities for implementing BASEL II in the Macedonian banking system.

Does and will this crisis have an impact on our economies?

It already has and it will have an additional impact depending on its duration. The first blow is for the real sector. In all of our countries, depending on the structure of the economy, the export sector will be most severely hit.

Consensus Forecasts of October 2008, envisages that the growth of the US economy will equal 1.4% and in 2009 it will be 0%, with a projected fall of the personal consumption and faster decline in the investment consumption.

The growth of the EU economy for 2008 has been adjusted downward (1.4%) and for 2009 it is 0.6%. For an illustration, 60% of the Macedonian export is in the EU countries. The trading conditions have already deteriorated and we project further deepening of the trade and the current account deficits, whereas the increased minus between the exports and the imports will act toward reducing our growth rate. We expect a negative impact also in the capital and financial accounts, but at this moment it is difficult to quantify it. Banking will not be hit directly. There is no exposure in risk-bearing financial instruments. Deposits are dispersed according to the regulations. It will be very important for the banking in the region to work as hard as possible on preserving the confidence in the institutions, in the banks. To prevent as much as possible the speculations which may cause panic with the depositors. The region should respond to the world financial crisis and recession movements with increased mutual cooperation. Both economic and political. The reduced export demand in the developed economies could be partially offset with the increased trade and mutual increase in the private crediting in trading or financial terms. Tomorrow's conference has a chance to give its contribution to that.

I**s the world financial crisis going to create larger innovations in the international financial system and order** and are there any developments, redistributions in the international financial architecture and power in sight?

I personally think that it is quite possible. Almost inevitable.

From the one hand, it is becoming very clear that globalized markets and the total globalized economy require global and efficient international institutions where efficient and timely coordinated responses to the economic and financial risks and crises will be agreed.

Just for example, Switzerland was obliged to support UBS and Credit Suisse. However, the problem is that they exceed its capacity, as in that case, and in many new such cases, with the financial giants in many other countries.

Bush and Sarcozy have met, and the issue was nothing less than an entirely new world financial system, immediately encompassing China, India and Brazil. These countries are included in order to help the West to overcome the recapitalization problems.

The British Prime Minister Gordon Brown strongly supports new "Bretton Woods" Agreement for the international monetary system. The freedom that the New York institutions for residential sector financing enjoy currently, will vanish.

It seems that the Arabian countries and Russia are not ready to discuss in this direction, **or it just seems like that**. But Putin, during his visit to China, suggested the Chinese leaders to initiate trade in their national currencies, showing explicit non-confidence in the US Dollar.

The Persian Gulf countries are planning a monetary union. Will they take this step?

According to all this, dear Ladies and Gentlemen, we are living in an exciting historical period. Yes, it is crisis. But, probably, it is not by chance that the wise Chinese have two signs for the crisis. The one denotes the danger, and the other one, possibilities. This crisis is a real possibility to learn a lot, in this case from the mistakes of the developed ones, in order to build a financial system and an economy which will be less vulnerable to any future shocks.

Thank you!