A functional overview of financial crises development and propagation

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FUNCTIONAL OVERVIEW OF FINANCIAL CRISES DEVELOPMENT AND PROPAGATION

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Abstract

The U.S. sub-prime crise developed in the last few months as a dangerous syncope for the entire international financial system, recall for the rethinking of market functionality, revealing the international institutional weakness in financial system supervision on global scale. The mortgage volatility induced by the international dereglementation and derivates contemporary burst, correlated with a relaxed supervision framework, transformed progressively the credit market into a system "bubble", making possible the distortion of real estates values toward those levels forced by creditors. Throughout a weakness chain, many financial institutions, determined by a savage competition on this sector, left away the prudence and borrowed money from different investors, guarantying the long terms transactions, with short time derivates from speculative short-term market, supplying the bubble. In this context, the paperwork is meant to recall for reinventing the risks models, so that the crises to be anticipated earlier than its development moment.

Keywords: globalization, financial crise, global economy, monetary system, international management

The study is centered on the liquidity risk, considered as far, the most important pillar of crises propagation chain, being in the same time the most facile element in determining the market pressure as an efficient early warning system. Credit risks, exchange rates risks or real values depreciation risks are connected to liquidity lacks, the money need being the first moment for crise burst as the liquidity is the first step in market stabilization process. The hazardous behavior is practically determined by the creditor's fear to loose the possibility for drawing back their investment at those sufficient levels to protect their values.

The credit risks, exchange risks or value market risks are fundamental reasons conducting toward liquidity risks, being as well the main transmission channels in case of a those crises. The market falling and market bubbles start to develop released by credit, exchange rates or real values deformation, into a liquidity crise as an effect for market equilibrium tendencies. In fact, starting from this point of view and describing this situation as a model, the liquidity running provokes the market shocks, feed by the speculation behavior for investment protection, conducting finally toward market values correction.

Aglietta M. has been observed that „... *the market sensibility is perennial*" at least such time as the financial transactions volume exceeds a hundred times the real economy transactions volume [1]. If the transaction's maturity, base on speculation, is shorted more than the market can support in terms of liquidity, especially in case of real values reappraisal, with disconnecting the long term perspective to short perspective, the market will fall facing with an avalanche of closing the derivates options. The tendency of short or long position closures on financial markets will require huge volumes of liquidity throughout a short time interval. Transmitted as a contagious disease, the appearance of a system crise will be inevitable and the market will ask for and "ultimate borrower" [1].

Starting from the idea that nobody is able to manage separately a market behavior, as sub-prime crise recently underlined, the international financial system is a must to improve its institutional possibilities for a immediate "*financial pull*", based on central banks system coordinated by international financial organizations (as International Monetary Fund or Bank for International Settlements) [6].

In this perspective, is needed first to redefine, on a theoretical level, the mechanism of crise appearance and development. In figure

1 it have been concentrated representatively the main components of a systemic crise from global perspective, putting together the national, regional and international components, under the governance of international financial institutional architecture.

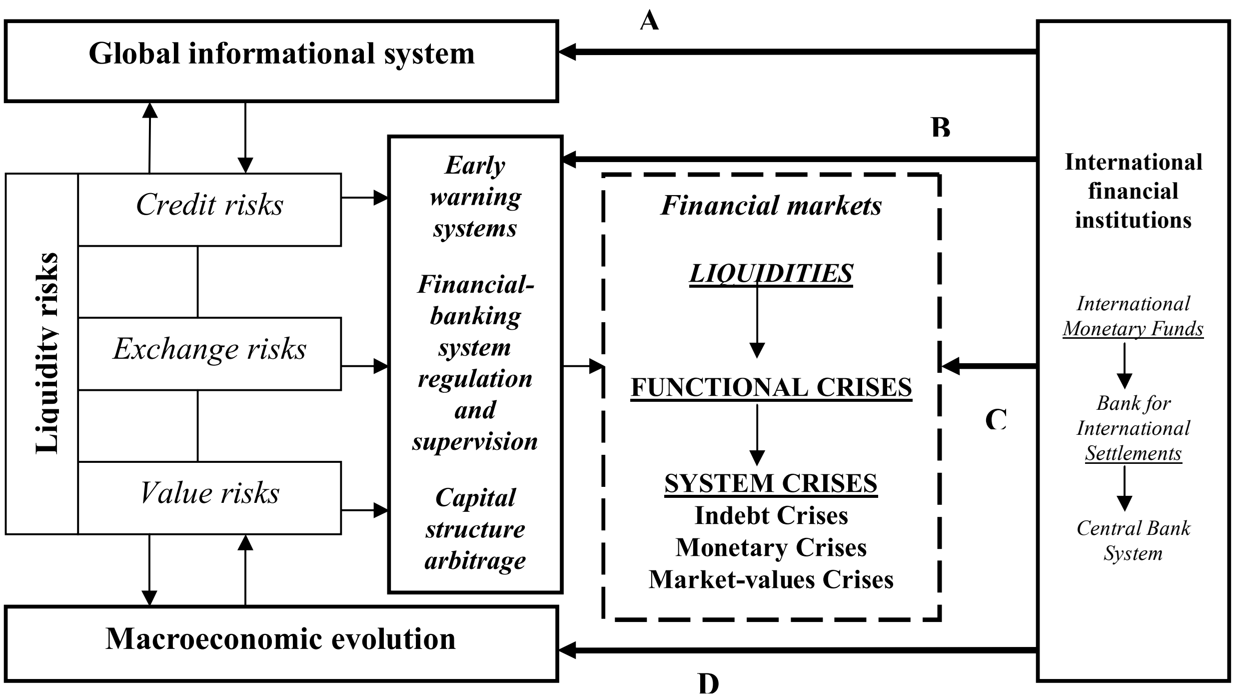

Figure 1: The financial crises functional model

Facing with this conceptual global risks mechanism, the international financial institutions have only two strategies. First to improve the *supervision policies* and instruments for a proper detection of those risks capable to evolve into liquidity syncope, and second to conduct the global market interventions, before or in time of a crise happening. The crise acting behavior (in terms of prevention, crise governance and finally decrement of negative effects), is explained by an ensemble of an international policies and strategies, based on four market priority vectors, as follows: global information symmetrical system (A), supervision policies (B), intervention mechanism (C) and global macro economical supervision and adjusting mechanism (D).

The *preventive attitude* should be based more on global criteria for warning against speculative behavior deviations on markets in relation with reasonable values limits for titles or mortgages. If we understand the financial world as Soros G. presents in his last work ("*The New Paradigm of Financial Markets*"), being a reflexive sum of speculative behaviors, then the preventive attitude should combine the supervision with active governance based on a Central Bank System action, unfortunately inexistent as a coherent structure for now.

The prevention should take as main pillar the supervision of financial system policy in terms of Basel II Accord, but in a different perspective. The capital requirements should be harmonized with traditional values in new risk limits, without any chance for hiding the market bubbles in appraisal. Derivates should be interdicted in guarantying credit processes and the specialized option market should be separated from banking system action. In fact the main reason itself for present financial crise is the miss-understanding of the separation between real economy and financial markets in terms of speculation and investment ration of financial instruments.

The bad mix of long term titles designed for investment's credit with speculative derivates meant to protect in chain the same values, conducts inevitable toward an over appraising of guarantees brought in business and finally toward a functional crise of indebts. On the edge between real economy, hungered for investments, and the financial system, with a huge appetite for speculation, the information asymmetry and macro-economical positive statistics can provoke a market "euphoria", corrected finally in case of a liquidity syncope, through a general price falling as a **functional crise**. The generalized bad loans collection process over the international banking system (the last element of the weakness chain), together with the liquidity running will conduct toward a **system crise**. The banking system fundamental role in a moment of crise is to guarantee the loans and the deposits with long term values, liquidities or mortgages, not on the speculative bases as today does. A functional crise is able to transform itself into a system crise just starting from banking system weakness as the main transmission agent of a contagious need for liquidity.

The immediate solution for global financial system problems is to reinvent the solid credit base through banking system responsibility in according their capital to fundamental values with no interference with derivates market or generally with financial short term market, sensitive to speculation. The Basel II Accord should approach more profound the capital structure from the isolate perspective of banking system itself as loan and deposits cautioner not like a speculator of investors' money. The return to the financial basis theory about the primordial role of banking system is the most important pace toward simplicity as a requirement into a global world.

Between real economy and speculative dimension of financial markets exists, like a connection interface, the banking system governed by central banks. So first, for improving the crise prevention and response, we need a coherent trilogy, separately identified trough three distinct level of market action, market governance and policy framework, as follows: <"*International Banking System*" ↔ "*Central Bank System*" ↔ "*International Financial Institutions*">. These three systems working together could assure the stability of international financial system better than are doing for now on global level. In this perspective the operational actions could be attributed to the International Banking System ("healthy" returned to the primary value of credit), the governing policy should be assigned to a possible Central Bank System, the entire mechanism being harmonized from political point of view by the international institutions architecture as a cautioner responsible for global equilibrium.

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