



Matei Paun: Manias, Panics and Crashes

Matei Paun **17.08.2007**

Renowned hedge funds are being closed down after losing billions. Specialized mortgage lenders are going into bankruptcy. Stock markets fall. Some of Wall Street's oldest banks are threatened with collapse. Central banks pump over EUR 200 billion of liquidity into the market - more than after 9/11. What is going on, why is it happening, and what does it mean for Romania?

To understand where we are today, we need to look at the past. It all started on the back of another crisis - the collapse of the Internet bubble - in 2001. At the time, in order to ease the pain of the collapse of one of the largest speculative bubbles in history, the US Fed rapidly dropped its interest rates, in effect unleashing huge waves of liquidity, thus creating a relatively "soft landing" for the US economy at the time. What this also did, is create a series of more traditional asset bubbles, including, this time, in US real estate. In effect, the current crisis is in reality a continuation of the unresolved Internet Bubble.

At a general level, this amount of liquidity (meaning low interest rates, cheap money), was so huge, and kept up for such a long time, that it has seriously skewed financial investors' perception of risk. Brazilian or Romanian state debt was priced at nearly the same level as German government debt. Anyone could issue high yield junk bonds for whatever they wished. As this pool of money spread itself across the globe, it distorted prices across asset classes and reduced people's awareness of risk. In Romania, the results of this can be seen in the billions of Euros that have been speculatively invested in the real estate sector, bank deposits, the capital markets and government debt.

At the same time, US consumers, the most profligate spenders on the planet, had for years, been gouging on imports, just as exports were declining, leading to a ballooning and unsustainable trade deficit in the US. As Americans borrowed more than they saved, these imports were largely funded through home-equity loans. When interest rates were dropped to help during the Internet Crash, the real estate sector took off. With nearly free money, lax lending standards and ever increasing housing prices, the stage was set for the formation of huge debt pyramid.

This was further fuelled by newly invented instruments called CDOs (Collateralized Debt Obligations) - derivative instruments which sliced up and repackaged debt portfolios into tranches bearing different credit ratings. These instruments were then sold to eager investors greedy for the high returns and low risk they promised. These instruments also permitted the debt pyramid to expand even more, as much as 20 times, through cheap leverage. But it also took the game into a completely unregulated arena - the hedge funds. Derivative instruments are not tightly regulated or centrally cataloged - as a result no one really knows how much is out there and who own them. And worst - they are now highly illiquid, prices for many CDOs having effectively

disappeared.

So then, a toxic combination of consumer and housing debt, new and untested derivative instruments, opaque complex instruments and mis-priced risk has led us to where we are today. When interest rates started to rise - as prevention against inflation, the stage was set for a disaster.

Internationally, it is hard to say how bad things will get, because no one knows how widespread the disease is. New bank and hedge funds are coming out on a daily basis announcing massive losses and closures. The CDO pyramid is just beginning to unwind, as the rating agencies have begun rerating the instruments so as to reflect the increased risks. In March 2007 US foreclosures rose by 47% on an annual basis, and the trend is strongly accelerating. There are reports of widespread frauds and lax oversight related to US loan origination, which have yet to hit the markets. Many of the recently announced LBO deals - a important price driver on the capital markets - are having trouble raising the required debt, some will surely have to be canceled, thus hitting the stock markets.

In short, people are realizing that the tide has turned, and that the wave of liquidity is no longer here and that worse, massive insolvency is around the corner. Panic is ensuing as investors tend to overestimate the potential damage and as they all want to be the first ones out - only recently the opposite was true.

For Romania all this could mean trouble. Our exploding trade and current account deficits have poorly positioned us and will be treated with less understanding by the international markets. Our currency will be considered less stable, particularly as some of the billions that entered Romania in the past few years start to head home. The chances of currency depreciation and the ensuing inflation and higher interest rates have gone up. This could mean slower economic growth or even perhaps a decline. Stagnating real estate prices, particularly on the higher end of the market. Volatile capital markets. Higher budget deficits. Etc.

Romania's policy makers, now more than ever, need to get serious about putting order in their macroeconomic figures. Markets and investors will be less forgiving from now on. Money will no longer be cheap, but get increasingly expensive. Mistakes will be penalized.

Romania's citizens should be conservative in their private finances. They should not borrow in a currency to which they are exposed and whose future progress they do not understand. They should watch the RON and consider defensive alternatives (EUR, CHF). They should not expect massive rises in real estate values or in capital markets. They should save more.

Perhaps, they should also start considering buying a cheap American house - but not before the dust has settled - it took Japanese real estate values over 15 years to recover after their crash, in the late eighties.

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