THE GLOBAL FINANCIAL CRISIS: SOME SPECIAL FEATURES, POSSIBLE RESPONSES

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Abstract

The global financial crisis has now moved from containing the contagion to coping with the global recession. This paper identifies some special characteristics of the current recession. First, it began as a crisis of debt and of asset price inflation. Second, it represents a regulatory crisis. The explosion of complex (and unregulated) financial instruments in a high debt environment exacerbated the crisis of debt. Following immediately from this and, third, it represents a massive imbalance in the global economy and a credit crunch. Forth, it represents a collapse of demand and, following from that rising unemployment. Finally, the rising unemployment exacerbates the debt crisis. This completes a vicious cycle. This paper, also, explains the crisis in the view of Kondratieff cycle. It identifies also some possible response to the financial crisis.

Keywords: global financial crisis, debt crisis, Kondratieff wave cycle

JEL Classification: E20, E32, E66, O33

Introduction

The financial crisis crossed national boundaries and spread from individual financial institutions to wider economy. The global financial crisis resulted from a confluence of factor sat processes at both the macrofinancial level (across financial sectors) an at the microfinancial level (the bevavior of individual institutions and the functioning of specific market segments). This joint influence of both macro and micro factors resulted in market excesses and the emergence of systemic risks of unprecedented magnitude and complexity.

Some special features of the current global financial crises

Both the trigger of the global financial turmoil that started in the summer of the 2007 and its proximate causes were essentially financial in nature, and originated in a specific segment of US financial markets. However, when we look at how the crisis spread rapidly across markets and then progressively affected the real economy, not just in the industrialised world but globally, it is immediately clear that only a much broader set of interrelated factors – macroeconomic as well as financial – could have generated a crisis of these proportions.

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In attempting to disentangle these factors, one should avoid the temptation to look for simple reductionist approach, leading to mono-causal explanations. The global financial crisis has now moved from containing the contagion to coping with the global recession.

There are some special characteristics of the current recession. Unlike recent episodes of recession this is not just a case of an asset bubble bursting with implications for some financial institutions and an accompanying contraction of demand which could be addressed by automatic stabilizers on the fiscal side and a monetary policy that cut interest rates. This recession is a far more complicated entity. First, there was an asset bubble caused by a glut of savings in the global economy and the US`s inexhaustible appetite for debt. Thus the savings glut which led to low interest rates largely financed excessive US consumption – not investment. This led to a substantial hike in asset prices (particularly home prices), aided by the commodities boom following strong growth performance in emerging economies . the debt spiral that this resulted in has been well discussed in the literature – suffice it to say that when bad mortgage debt started being recalled (the so called subprime crisis) it was quickly realized that there was a general credit crisis following from the existence of vast sums of toxic assets in the balance sheets of banks and other financial institutions. As a result, the collateral backing of many credit advances started being questioned and credit froze. This led to a collapse of demand and rising unemployment – all in a vicious cycle. In a series of influential papers, Carmen Reinhart and Kenneth S. Rogoff have studied the historical record of countries experiencing severe financial crises. They report that real housing price declines average 35 percent stretched out over six years from peak to trough, while equity price collapses average 55 percent over a downturn of about three and a half years. The unemployment rate rises by an average of 7 percentage points over the down phase of the cycle and output falls by an average of over 9 percent. The real value of government debt tends to explode, rising an average 86 percent, because of lost tax revenues. [Carmen Reinhart and Kenneth S. Rogoff, (2009)]. Reinhart and Rogoff also find that the historical patterns of banking crises in middle-to-low-income countries have been similar to those in rich countries. [Carmen Reinhart and Kenneth S. Rogoff, (2008)].

Thus, as distinct from most recessions in the recent past the current deep recession represents a combination of many factors:

- **a crisis of debt and of asset price inflation** (easy access to credit, relaxed lending standards)
- **a regulatory crisis**: inadequate regulations (regulations did not keep pace with innovations in financial products, leading to much higher complexity, poor transparency and greater risk)
- **complex credit derivatives**: the invention an duse of complex derivating such as CDOs (Collateralized Debt Obligations) made it difficult to identify and contain the subprime problem, once default rates began to rise.

- **Increasing use of new global financial instruments** – spread out risk (but heightened risk) + reduced transparency (opacity of markets: the counterparty risk)

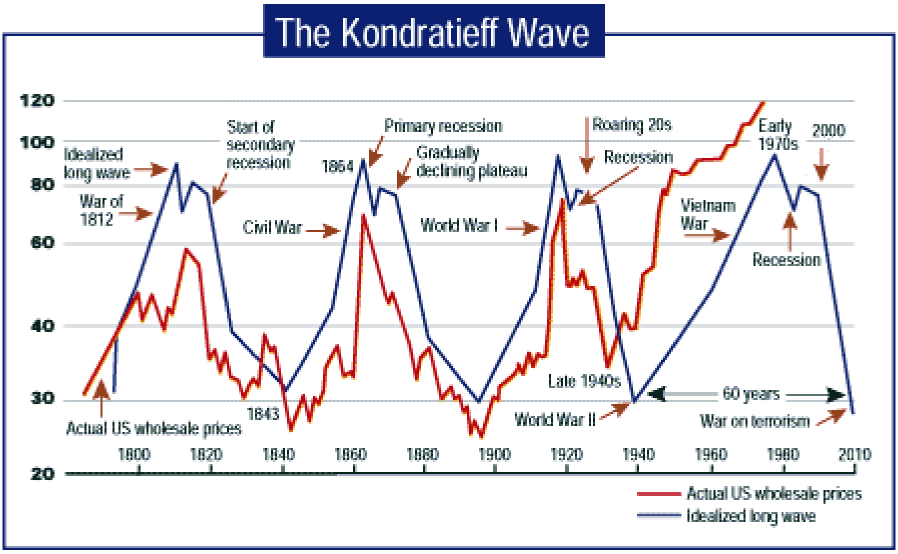
Another explanation of the financial crisis in the view of Kondratieff Wave

The economic literature debates about crisis as a turning point of the economic cycle. The Kondratieff wave cycle goes through four distinct phases of beneficial inflation (spring), stagflation (summer), beneficial deflation (autumn), and deflation (winter). Since, the last Kontratieff cycle ended around 1949, we have seen beneficial inflation 1949-1966, stagflation 1966-1982, beneficial deflation 1982-2000 and according to Kondratieff, we are now in the (winter) deflation cycle which should lead to depression.

A simplified and somewhat updated sequence of Kondratieff Waves can be seen as follows;[38]

Period	Date	Innovation	Saturation point
First Industrial Revolution	Circa 1800 – 1850	Cotton based technology; spinning weaving etc.	1810 –end of Napoleonic Wars
Second Industrial Revolution	Circa 1850 – 1900	Age of steam; railways, shipping, heavy industry, iron and steel etc.	1870s
Third Industrial revolution	1908 – 1947	Petrol chemicals, internal combustion engine, electrification.	Inter-war slump 1920s and 30s
Post-war Boom	1947 – 1991	Consumer goods, electronics, etc	1973
Contemporary Era	1991 – present	The Internet, mobile technologies, bio-technologies etc	2010s

38 http://en.wikipedia.org/wiki/Kondratiev_wave



The current cycle most likely peaked in 2000 with a possible winter phase beginning in late 2008. The Austrian-school economists point out that extreme price inflation in the absence of economic growth is a form of capital destruction, allowing either stagflation (as in the 1970s and much of the 2000s during the gold and oil price run-ups) or deflation (as in the 1930s and possibly following the crash in commodity prices beginning in 2008) to represent a recession or depression phase of the Kondratieff theory.

Probably Kondratieff's greatest contribution to the science of investment is not his observation the world economy operates in long cycles. Cycles would suggest a repetitive nature to events. While the underlying economic conditions will repeat over time due just to the physical nature of our world, our reactions will always be tempered by knowledge and experience. The history of man has been one long climb higher. Kondratieff recognized progress as the irreversible trend.

Imposed upon our progressive nature are the physical limits of life. It is the interaction of these physical limits with our dreams and aspirations that creates the constant push pull of the economy known as the Long Wave.

Some responses to the financial crisis

Immediate and short-term policy responses are required to ensure that (1) the financial crisis is contained, (2) that confidence in financial systems is restored and that (3) the impact on the real economy is minimized. Over the longer term, countries should focus on strengthening their financial systems within the context of reforming the global financial architecture. Domestic financial development depends on a better global financial architecture and vice versa.

Table 1
Summary of responses to the financial crisis

Timeframe	Objective	Policy options
Immediate	Containment of financial panic	• Guarantee bank deposits • Guarantee interbank loans • Provide liquidity to banks • Forbearance on regulations
Short term	Resolution measures	o Recapitalize banks o Mergers and aquisition in financial sector
	Monetary expansion	o Reductions in the costs of borrowing o Raise inflation targets
	Fiscal expansion	o Increase in spending on social safety nets, including conditional and unconditional grants and public works
	Trade expansion	o Lowering of protective measures o Maintain competitive exchange rates
Longer term	Domestic financial development	▪ Increase the access to finance ▪ Improve domestic resource mobilization ▪ Improve efficiency of banking sector ▪ Avoid financial repression ▪ Improve supervision and regulation ▪ Strengthen property and contract rights, judiciary and rule of law ▪ Proceed, but with caution, with financial openness
	Reform of international financial architecture	▪ Move to a more inclusive system of global financial governance ▪ Reform bretton Woods Institutions

Source: Wim Naude, The Financial Crisis of 2008 and the Developing Countries, UNU-WIDER, Discussion Paper No.2009/01.

Conclusion

There has been an increasing disconnection between the real and financial economies in the past few years, with the latter growing at a much faster pace.

There is no denying that weaknesses and failures in financial markets played a major role in the build up to the crises. Over the last decade, financial innovation has been organized to transform illiquid and risky instruments into – apparently – safe and liquid assets. That unsustainable process has abruptly come to an end with the burst of the credit bubble. During that period, rating agencies, accounting rules, unregulated and off balance sheet entities as well as very poor risk management all contributed to fragilize our financial systems. Those weaknesses are at the origin of the crisis. Thus, as distinct from most recessions in the recent past the current deep recession represents a combination of many factors. First, it began as a crisis of debt and of asset price inflation. Second, it represents a regulatory crisis. The explosion of complex (and unregulated) financial instruments in a high debt environment exacerbated the crisis of debt. Following immediately from this and, third, it represents a massive imbalance in the global economy and a credit crunch. Forth, it represents a collapse of demand and, following from that rising unemployment. Finally, the rising unemployment exacerbates the debt crisis. This completes a vicious cycle. And, more, if you look at the place that global economy occupies in the view of Kondratieff Wave (this has already anticipated the crisis), we have the whole picture of the current period.

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