FINANCIAL CRISIS OF XXI CENTURY – CAUSES, EFFECTS AND PROPOSALS TO SOLVE THE PROBLEM

Janusz Soboń[1],
Agnieszka Przybył[2]

Summary

Market imbalances and speculative bubbles are tightly connected to each other and shall be regarded as the major causes of global financial instability. Financial globalization contributes to global financial imbalances within the current monetary and financial system. The researchers dedicated a lot of papers on market imbalances leading to global economic crises. Most of the highest admired researchers explain the causes and effects of the financial crisis and/or present reflections from the point of view of the U.S. There are much less papers developed by European economists - showing their approach to the issue and indicating how to solve the problem. We present the causes and effects of the financial crisis in 2008 and its influence on the state of global finance, based on U.S. and European literature review. The approach and methodology applied entail presentation of theoretical background of the concept of economic crisis in general, followed by explanation of the meaning of the terms "financial and economic crisis" and the cause-effect chain leading to the crisis. Then we analyze the visible and predicted effects of the global financial crisis and propose amendments to solve the problems.

Keywords: financial crisis, financial globalization, market imbalances, speculation bubbles

[1] Prof. Hab. PhD, University of Applied Sciences in Gorzów Wielkopolski, Poland.

[2] PhD student at Warsaw School of Economics (Doctoral Programme in Management and Economics).

Introduction

Today's businesses are highly dependent on their environment, including the group of factors relating to the state of the economy, wherein they act. The overall economic situation in the country and abroad is in turn dependent on the current phase of the business cycle. Contemporary cycles are flattened compared with the classical business cycle, which means that the extreme points are not as sharp and spectacular (Zienkowski 2008). It also shortens the time and reduces the amplitude of the fluctuations. While the classical business cycle lasted 8-10 years, the contemporary shrunk to 5-6 years (Mączyńska 2009). Consequently, this means the risk of more frequent occurrence of recessions. Crises that affect individual countries, can in the conditions of globalization quickly spread to the economy of more countries and become a cause of great economic crisis. Human society has seen a lot of these struggles appear and disappear, but globalization made them spread fast, affecting all involved countries, and, as almost all economies participate in a global race for development and welfare, no one is excused or safe. (Popescu, Mada, Mihut 2012). This phenomenon is facing the world in the beginning of the twenty-first century. The recession initiated in the U.S. affected and continues to affect the condition of the global market.

Financial and economic crises

The crisis is understood as a conclusive moment, landmark, breakthrough (Tokarski1980). In the context of economics, crisis can be seen as rapid reduction in economic activity in the economy and businesses. According to Zimniewicz (Zimniewicz 1990, p. 223–224), the crisis is a process requiring usually action under time pressure. Moreover, he adds that a crisis is threatening the existence of the company or prevents its existence Today, the crisis is seen as a "permanent part of the game", inscribed in the everyday economic activity (Wieczerzyńska 2009, p.17). Besides negative consequences crisis has a positive connotation as a turning point meaning changes which carry not only threats but it can also be a source of new opportunities for the company. In the economy crisis is a sudden solstice of disease and disappearance of symptoms, which result in elimination of imbalances and comes to restoring of the economic balance. According to some researchers (Carmassi, Gros, Micossi 2009) speculative bubbles and busts are recurring events and the periods leading to large financial crises are often very similar. The crisis which has affected the world economy at the beginning of the twentieth century, began in the financial sphere with the crash in the

New York stock market. The Great Depression was developed under conditions of a free market and of the "invisible hand of the market". This was consistent with the classical theory of economics, according to which the state should not interfere in the economy, but only play the role of guardian who has to ensure an internal order and external security. The immediate cause of the recession in the years 1929-1933 was a surplus of global supply over global demand. The size of the surplus in the U.S. economy in the late twenties of the twentieth century was a result of a cause-effect chain that ran according to the following simplified scheme:

ECONOMIC GROWTH → INCREASE IN DEMAND → PRESSURE TO INCREASE IN SUPPLY→ OVER DEVELOPMENT OF THE MANUFACTURING POTENTIAL → SURPLUS OF GLOBAL SUPPLY OVER GLOBAL DEMAND (STATE OF THE MARKET IMBALANCES CAUSING CRISIS).

The crisis of the first decade of the twenty-first century began – like the crisis of the 20s during the twentieth century– in the U.S., which are considered to be the economic center of the world. The first symptoms of the bubbles have been seen in the U.S. in the early 2000s. The aggressive monetary expansion following the end of the dot.com asset price bubble was accompanied by massive foreign exchange interventions by Asian countries to resist the depreciation of the dollar. This in turn led to huge official reserves investments by these countries in US treasury securities that kept interest rates low, notably on long maturities, and fed complacency at the Federal Reserve. (Carmassi, Gros, Micossi 2009). However economists hold that the beginning of the crisis was the collapse of the U.S. substandard mortgage market in August 2007. The collapse was related to the bursting of a speculative bubble in the real estate sector. The specificity of the current crisis is also an imbalance in the market, but induced with higher global demand over the global supply. So we have here the following chain of causes and effects:

ECONOMIC GROWTH → INCREASE IN DEMAND → INCREASE IN SUPPLY → SECONDARY INCREASE IN DEMAND IN THE EFFECT OF CREATING MONEY GROWTH AND DEBT OF U.S. IN THE WORLD MARKET → SURPLUS ON DEMAND GLOBAL OVER GLOBAL SUPPLY (STATE OF THE MARKET IMBALANCES CAUSING CRISIS).

Causes of the crisis of the XXI century

As shown above, the main cause of the crisis is the imbalance between the global supply and the global demand. One of the factors placing the U.S. economy in a state of imbalance was the growing foreign debt – especially in China. By offering low interest rates China attracted a huge part of foreign investment, constantly increasing their own production capacity (Kaczmarek 2009). At the same time China manifested a very strong tendency to save [3], which in turn causes shrinking of the domestic demand. Therefore, Chinese goods began to be difficult to sell on the home market. In response to this problem China has adopted an aggressive export-oriented strategy, denoting pressure on the maximization of net exports relative to net imports. But because absorption of foreign markets is also limited due to the limited financial resources of consumers, China decided to lend consumption, primarily for the U.S. (Kaczmarek 2009). There was a clear division of roles on the international scene, the U.S. as the country consuming on credit and China as a country financing this consumption. America began to live beyond its means, because they could cheaply and without restrictions get into debt. The essential role was played by the U.S. dollar here, with the status of a dominant global currency. In this way, between the U.S. and China, was established the strongest correlation in today's economy. This correlation resulted in parity surpluses and deficits on the current accounts. As a result of this policy China accumulated huge foreign exchange reserves, while the U.S. dramatically increased the deficit in the trade balance. In 2009, the size of China's reserves amounted to almost $ 2 billion, of which $ 1.2 billion bonded the U.S. government (Bitner.2009). China has become the largest creditor of the U.S. The deepening of U.S. debt in China is increasingly dependent on the condition of the Asian economy. Meanwhile, China is a country that has a lot of unresolved issues: rapidly growing demand for raw materials, inefficient banking system, and the need for many social reforms. If China will face serious problems the troubles will affect not only China or countries in Asia, but they will seriously threaten the United States and the whole world. (Bitner 2009).

Surplus of global demand over the global supply in the United States was also caused by the growing supply of money on an unprecedented scale. The data shows that by 2008, the money supply in the market grew by an average of 14% during each year (Szymański 2009, pp. 87–91.) In the U.S. the economy has heavily developed a financial market offering products which were a substitute for money. The development of financial engineering

[3] Macroeconomic saving rate in China is 50% of GDP

resulted in a rapid increase of the turnover in the Stock Exchange. In 2007 a record of daily transactions on Wall Street was $ 5.7 billion, however, without any financial supervision (Szymański 2009, pp.119–121). Investors, too optimistic about the market trends , were seeking for a more risky forms of investment in the capital market. As a result increased pressure on the creation of innovative financial instruments as a substitutes for deposits. This often led to speculation, which favored a widening gap between the sphere of management and the sphere of capital ownership. On the other hand, a managers motivating system favored risky investment decisions in the financial market because achieving a high level of return on investments was rewarded with very high premiums. Entities undertaking risky investments tried at the same time to transfer the risk to others and to scatter it. The American financial system began thus to form a very large financial investment insurance system. Emerging financial insurance instruments, however, did not reduce the risk but only relocated it to other institutions or people. What is more, the long-term investments were replaced by short-term investments. This phenomenon was conducive to speculations in the financial markets and disrupted their normal functioning (Szymański 2009, pp. 65). The creating of money also occurred in the interbank market. Before 2008 more and more banks began to increase the ratio of loans to deposits, because banks have treated derivatives as cash and on that basis they granted the loans. Money supply grew by the increasing credit expansion of U.S. citizens. Low inflation, reducing long-term interest rates, contributed to the low cost of credit and encouraged consumers to borrow money. Banks, in order to gain customers, lowered the requirements to be fulfilled in order to receive credit, which led to the giving of credits. By 1997 the annual volume of loans to businesses and individual consumers in the United States was about $ 700 billion.

Since 1998, the intensifying credit expansion caused the value of loans amounted to more than a billion USD, which meant that $ 1 of domestic product accounted for up to $ 5 of the loan taken (Kaczmarek 2009). E.S. Phelps says that the entire U.S. economy before the crisis was based on the financing of housing investments (Szymański.2009). The credit boom was leading to unsustainable leverage. Despite scant income growth, the autonomous role of declining savings rates and cheap credit to households in sustaining strong consumer spending in the United States throughout the 1990s and 2000s escalated in an environment of apparently ever-increasing house prices, households were encouraged by their banks to borrow up to the full value of their property, and to borrow more as soon as the value went up, with little regard to their ability to service the debt (Carmassi, Gros, Micossi 2009).

During the discussion about the causes of the crisis started in the U.S. in the first decade of the twenty-first century one cannot omit the issue of a free, unregulated market, which has the ability to restore the equilibrium in the economy. The modern market is characterized by increasing freedom of transfer of capital on a global scale and the change in the structure of capital flows. These phenomena resulted in a reduced ability to control and regulate capital flows by the State and - as a consequence - a significant reduction in the role of state power in shaping business relationships in the financial market

In the 90s of the twentieth century, Wall Street's banks had been released from all supervision of the state power. This meant that the banks could execute transactions with a very high degree of risk what in turn caused the deregulation of the credit policy (Smoczyński 2010). It can therefore be concluded that the contemporary crisis was also the result of weaknesses of financial supervision and control. For the U.S. economy the belief in a free, unregulated market and the exclusion of the need for state intervention was fatal. G. Soros points out that the current crisis has shown that the markets are wrong in principle and wrong in assessing the values (Soros, Żakowski 2009). It is therefore necessary for an arbitrator or a regulator, who will equalize the asymmetries between the market participants.

The effects of the crisis

The crisis has spread rapidly around the world and highlighted that the global economy has become interdependent. The effects of the crisis are felt to varying degrees in most parts of the world. Some countries - such as Iceland - due to the recession stood on the brink of bankruptcy. Other countries, such as the U.S., are facing a serious budget deficit, the negative trade balance and unemployment reaching 10% (Nagórski 2010). The decline of the dollar can determine that the United States will no longer be driving the global economy prosperity, and the major world power may become, for example, China. The crisis has dramatically accelerated the movement of the financial markets and centers of innovation to Asia (Żakowski 2009, pp. 9). There is also the problem of liquidity in international money markets. Customers no longer believe the banks, and the banks do not believe each other. Banks, were previously regarded as institutions of public trust. This trust failed because it turned out that the banks are not capable or willing to protect the interests of its shareholders. Moreover, the crisis has highlighted the problem of poor knowledge of banking supervision on bank's borrowers and partners. The crisis revealed the lack of adequate institutional architecture that on the global level could impose boundary conditions for operation on the financial market. it turned out that existing credit rating agencies do not perform the function entrusted to them, as they are often associated with different companies, from which they may be dependent (Szymański 2009, pp.107–108). The impact of the financial sphere on the real economy visible through the decrease in real estate prices and securities has revealed another phenomenon, the so-called psychological effect of impoverishment, which in a short time drastically reduced the demand. It is estimated that as a result of this phenomenon since June 2009 international trade shrank by 40% (Soros, Żakowski 2009). The recent crisis has shown, moreover, that economic collapse can occur at any time, without clear warning signs. This is because, through the development of the stock exchange and securities market, comes the formation of speculative bubbles. The bursting of the housing, monetary or trading bubble will always result with the destabilization of the economy. Moreover the crisis has highlighted the imbalance in the global economy - growing for the past 20 years - and the lack of specific tools to mitigate this imbalance. Ad hoc government reactions, and thus essentially stimulus plans, temporarily alleviates the effects of the crisis. However, if these plans are to be completed very quickly can return the imbalance problem of the economy (Żakowski 2009, pp. 8).

The proposed amendments

In an attempt to overcome the effects of the crisis one should not only focus on the search for symptoms, but primarily on the removal of the deeper causes of the crisis. This is thus the right place for the question for the direction of the proposed changes. The future changes will affect many areas. Among the many fields in need of transformation hereafter will be discussed a few only, whose importance for the future of the world economy is essential. The most urgent changes relate to the need for regulations of the financial system on a global scale, returning to the concept of state intervention, prevention of global imbalances and excessive divisions on the global market.

Please note that today's crises have an increasingly global dimension, therefore individual efforts of countries and banks will not help to solve the problem. Chaos that prevailed at the national and international financial markets confirmed the need for the introduction of responsible and competent banking supervision of financial institutions. For this reason, on November 15, 2008 in Washington, leaders of the OECD countries have been debating about foundations for a global central bank. The functions of such a bank would include the monitoring of risks on global markets and the supervision of large financial institutions, whose activity exceeds the boundaries of countries. The bank would act as a bankruptcy court when a bank with a global reach would require a global restructuring.

Other functions taken into account are the impact on exchange rates and cooperation with the biggest countries to better coordinating of national programs stimulating the economy in times of crisis and recessions (Kaczmarek 2009, pp. 186–187). The main weakness of the creation of supranational institutions that could and want to impose a boundary action conditions for the global market is the difficulty in enforcing introduced solutions. The countries should therefore work together with others countries or at least in the majority of countries in a uniform manner (Szymański 2009, pp.187). The most pressing issue is at the moment the solidarity of actions takes place. Romano Prodi states that the economic crisis can be solved only thanks to the political will of countries and escape from the national egoism (Baj, Bielecki 2010, p.22). If the great economic powers do not want to engage in consistent action to suppress economic imbalances the global market will be threatened again with very serious collapse. Economic imbalance on a global scale is a very dangerous phenomenon, because in the present century the greatest impact on the overall situation will have both the fast-developing countries of Asia and the dynamic demographically but poor countries of Africa or South America.

In the long term it is impossible to separate economic growth from the level of social cohesion (Żakowski 2009, pp20). If the developed countries do not help the economically weak countries the world order may be disturbed soon again (Goldstone 2010, pp.3). In turn P. Sloterdijk concludes that economic power should absolutely work out a new policy based on generosity towards the poor countries. If the attitude of economic power will not change if individual countries do not pass from the "economics of greed" to the "policy of sharing" the twenty-first century will be characterized by constant political and economic tensions (Szymański 2009, p.191).

The crisis has also made it clear that it does not make sense to escape from the concept of J.M. Keynes, who was a supporter of a strong state presence in the economy (Szymański 2009, pp.41–48). Neo-liberal economic ideas have not worked, proving that the invisible hand of the market has not coped with the global crisis, which is why the control by governments is necessary. J. Sachs argues similarly that people living in capitalist society do not realize how many regulations and institutions are needed to guarantee the well working of capitalism. So it is the right time to break the myth of a self-regulating market otherwise the economy will cause more serious crises (Sachs, Żakowski 2009). However, in today's global economy a simple application of Keynesianism does not work. Today we need to develop a new model, the so-called participatory model. Modern society needs both the state and the market operating on the principles of participation. In terms of political economy which is the essence of social relations and non-market production the social wisdom - needed to cope with the increasingly complex reality - is dispersed.

Hence, the general conclusion, that, in order to improve the coordinating and monitoring role of the state, it is not enough to change the economic doctrines. It is needed to adjust the mechanisms of financial globalization, what cannot be made by a single state but by the entire community of states.

Conclusions

The global financial crisis which occurred in 2008-2009 was one of the biggest financial crises in the history of the world economy. The crisis started in the United States but it had an impact on the economies of almost all countries around the world. The effects of the crisis are being felt still today and it is not known when or even if the global economy will get back to the level before 2008. One cannot specify only one cause of the crisis.

It was caused by several factors jointly including the relaxation of the rules related to mortgages, the errors made in fiscal policies pursued by the Fed and the unreasonable assent for development of uncertain securities. The process of the crisis was a standard model - described by many scientists[4]. The effects of the crisis were painful, not only for the economy of one country but for the whole world. Many large banks and financial institutions have gone bankrupt and some of those that survived had to receive a capital injections.

The stock markets collapsed particularly in the U.S., UK, euro area countries and Asian countries. Market securities based on mortgages ceased to exist and this resulted in the lower performance of investment and pension funds, which deteriorated rapidly. Global trade broke down and the some happened to investments or consumption. These negative consequences for the world economy were also reflected at the micro scale, i.e. in households and businesses that have suffered due to the collapse of production, rising unemployment, a decrease in income and difficult access to credits particularly mortgages. In 2010, the world economy accelerated slightly, but in 2011 there was again a slowdown that persisted in 2012.

[4] noteworthy here is the Hyman - Minsky's model of crisis

References

1. Baj L., Bielecki T., 2010, *Grecja trzęsie Europą (Greece shakes Europe).* „Gazeta Wyborcza".
2. Bitner M., 2009, *Rezerwy walutowe Chin a problem dolara. (China's currency reserves and the issue of the dollar),* http://www.finanse.egospodarka.pl/40380,Rezerwy-walutowe-Chin-a-problem-dolara,3,48,1.html.
3. Carmassi J., Gros D., Micossi S., 2009, *The Global Financial Crisis: Causes and Cures, "*Journal of Common Market Studies". Blackwell Publishing Ltd.
4. Goldstone J.A., 2010. *Nowa bomba demograficzna (New demographic bomb). „*News-week".
5. Kaczmarek T. T., 2009, *Globalna gospodarka i globalny kryzys (The global economy and the global crisis),* Difin, Warszawa.
6. Mączyńska E., 2009, *Sytuacje kryzysowe w przedsiębiorstwach (Crisis situations in enterprises),* Nauka o przedsiębiorstwie. Wybrane zagadnienia, Oficyna Wydawnicza SGH, Warszawa.
7. Nagórski A., 2010, *Strachy amerykańskie (U.S. fears), „*Newsweek", http://www.news-week.pl/ artykuly/sekcje/swiat/amerykanskie-strachy-,55460,1
8. Popescu G., Mada F., Mihut M., 2012, *Financial Derivatives and world economic crisis*, "Review of Economic Studies and Research" Virgil Madgearu.
9. Sachs J., Żakowski J., 2009, *Nauka przetrwania (Learning how to survive),* „Polityka".
10. Smoczyński W., 2010, *Słowniczek kryzysowy (Glossary of crisis terms),* „Polityka".
11. Soros G., Żakowski J., 2009, *.Łagodnie szukamy dna (Gently looking for the bottom*), "Polityka".
12. Szymański W., 2009, *Kryzys globalny, pierwsze przybliżenie (Global crisis - the first approximation),* Difin, Warszawa.
13. Tokarski J., 1980, *Słownik wyrazów obcych (Dictionary of foreign words),* PWN Warszawa.
14. Wieczerzyńska B., 2009, *Kryzys w przedsiębiorstwie (The crisis in the enterprise)*. CeDeWu Sp. z o.o., Warszawa.
15. Zienkowski L., 2008, *Polska gospodarka musi zwolnić, żeby się nie wywrócić (Polish economy needs to slow down so as not to tip over),* „Gazeta Wyborcza" http://www. pte. pl/pliki/2/1/pte30vzienkowski.pdf
16. Zimniewicz K., 1990, *Nauka o organizacji i zarządzaniu (The science of organization and management)*, PWN Warszawa.
17. Żakowski J. 2009, *Zawał, zrozumieć kryzys (Heart attack, to understand the crisis),* Polityka, Spółdzielnia Pracy, Warszawa.