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The dimensions of the global financial crisis

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Abstract. *The Global Economic Crisis has shaken the global economic system to the ground determining the economists all over the world to try hard to get the causes and mechanisms of the crisis right. Worldwide timing impact of the crisis was caused by the deterioration of aggregate demand, the uncertainty of the business environment, the rate of financial constraints and market collapse of assets. Considering that the current crisis featured some close similarities to earlier ones we try to answer two questions of the major global crisis: what are the similarities and how costly is the current crisis.*

Keywords: economic crisis, global economics, financial cost.

JEL Classification: E44, F23, G32.
REL Classification: 10I, 10J.

1. Introduction

The global financial crisis that erupted in 2007-2008, is considered, by some authors, the most complex crisis of all times, in particular through the causes that generated it, except in terms of its effects (Moldovan, Popa, 2012, pp.131-140).

Although the ongoing global crisis has shaken the world, we believe that the reason for the extension of the current crisis is based on the complete misunderstanding of its roots.

Without this understanding, how the crisis progresses, eventually made the things worse. Therefore, this paper examines some major ideological causes, and provides supporting arguments to show how they have led to a worsening situation for the long-term prospects. The insight into causes can lead to solutions and directions for progress, which is a long-term benefit in treating correctly the global crisis.

We note that the global economy is recovering from the deep recession in the post-World War-II era, being triggered by a severe financial crisis in key advanced economies that coincided with the freezing of global financial markets and the collapse in the global cash flow. While the crisis quickly resulted in deep recessions in a number of advanced economies, the emerging markets and developing economies were also seriously affected, but the impact varied across regions and countries.

Crisis management involves many aspects that should be considered in addition in terms of economic, political, educational and legislative decision-making. The decision making process should take into account the socio-cultural, ethical, psychological, technological, technical, organizational and managerial aspects and also educational aspects concerning the environment. The economists' view is that each business cycle can not be explained without referring to the other one. This close relationship implies that if an external shock occurs, a high impact would be felt by the economy.

Although the process of global economic recovery is already underway, the nature and implications of the crisis have still been at the center of academic and policy discussions.

Globally, there has been an intensive discussion about the similarities and differences between the latest crisis and the past episodes, but the latest crisis was different both in intensity and scale.

Another dimension of the ongoing discussions about the crisis has focused on its global spread and cost.

The crisis originated in the United States, but it took place in a highly integrated global economy where the widespread use of sophisticated financial instruments along with massive international financial flows facilitated its rapid spread across markets and borders. Although it was not surprising that a global crisis led to a significant decline in global activity, the extent and duration of this decline have been a major area of research. Recessions associated with the global financial crisis, while displaying similar patterns with previous recession episodes, reflect an unlikely confluence of factors. Specifically, current recessions are associated with serious financial disruptions, including credit crunches, house price busts, equity prices busts and outright banking crises, in some countries.

In order to analyze this crisis we should address three major questions, namely: how costly is this crisis? How different is the crisis from earlier ones? How can we come out of this global crisis?

The story of winners and losers remains an important and hotly debated topic in the social sciences. In this context the key question is: how does the structure of the world-economy impact economic development and the wealth/poverty of nations? The key point of contention revolves around two views of the role that the international division of labor plays in the development of individual countries. As Evans (1995) argues, “the international division of labor can be seen as the basis of enhanced welfare or as a hierarchy”.

Our basic conclusion is that the massive financial crisis that has gripped the global economy over the past two years is a result of a multitude of factors. Some of these factors are similar to those observed during the buildup to past financial crises, but some others are distinctly new. Thus ranking the relative contributions of these various factors is difficult, it helps us to explain the considerable scale of crisis.

2. How costly is and how different is the current crisis?

The severity and the globalization of the current crisis included surprising disruptions and breakdowns of several markets in the fall of 2008; the crisis was different than previous ones because of a widespread use of complex and opaque financial instruments; the interconnectedness among financial markets, nationally and internationally were dysfunctional.

The current U.S. recession is clearly an outlier in many respects confirming the severity of the ongoing recession. The sheer size of the U.S. financial market and its central role as investment destination contributed to the spreading of the crisis, any shock to the U.S. financial markets is bound to have global effects. The crisis also triggered an unwinding of imbalances in other countries, because of closer international financial integration, financial and macroeconomic conditions, notably. This led to the spread and synchronization of global crisis and has shown the limits of policy measures in dealing with financial meltdowns and the fact that a greater coordination between macroeconomic and financial policy is needed.

Prudential regulation has to acquire a macro system-wide dimension. The global nature of the financial crisis has also shown that financially integrated markets have benefits, but also risks, with large real economic consequences. It also has shown that the international financial architecture is still far from institutionally matching the closely-integrated financial systems. The crisis has had major financial and economic repercussions for emerging markets and developing countries, however, the crisis has highlighted some challenges specific to financial sector reforms in emerging markets and developing countries.

Economic crisis can be defined as a situation characterized by a marked instability, which leads to volatility and increased uncertainty. It is difficult to making any assessments when a financial crisis becomes an economic one or if an economic crisis generates a financial crisis, or vice versa. Basically we refer to an economic crisis caused by financial, political or social reasons. The financial crisis is only a manifestation of the economic crisis and reflects a confidence in the financial system, a significant decrease in the volume of transactions on the stock market, a disturbance of market mechanisms.

In literature are found many points of view on the causes of the crisis, propagation effects and economic policies, more or less appropriate to the conditions of crisis. Thus, before the crisis, it had adopted policies to reduce the interest rate, given the existence of an extra liquidity into the economy, which has led to encouraging mortgage credit. Emphasizing financing through capital markets in the U.S. in terms of extending deregulation, would have required changes in the system of incentives and in the rules of market surveillance, changes that have not been made yet.

The expansionary monetary policy has energized an "excessive" consumption, considered as a real "harmful" to the economy, creating major structural imbalances. The main cause of why the crisis quickly spread worldwide is explained by some economists through the globalization, which brings a wave of liberalization of capital flows, investment, trade and labor, in the context of intensification of international competition. It makes the economic developments of a country to influence and to be influenced by the economic developments of other countries.

3. The global financial crisis

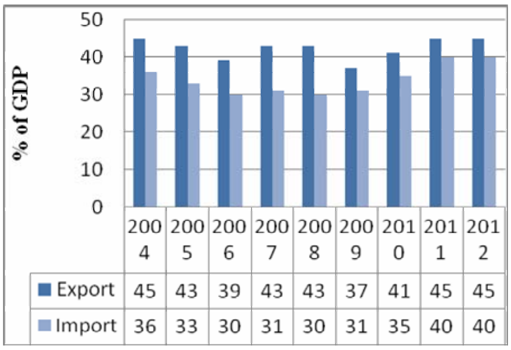
With the intensification of the financial turmoil in the autumn of 2008, global economic activity fell abruptly, resulting in a strong decline in the global trade in goods back to 2005 levels. The decline was sharp and rapid: world trade in goods fell by almost 17% between September 2008 and February 2009. Global economic activity declined abruptly, with output levels falling by 1.2% in the fourth quarter of 2008 and by 1.4% in the first quarter of 2009.

However, trade volumes fell by much more than expected given the size of the overall decline in final demand. This can be partly explained by a number of factors.

First, the composition of the global demand shock contributed significantly to the disproportionately large decline in trade relative to output. Global activity in the manufacturing sector contracted considerably with the intensification of the financial turmoil, while activity in the services sector was much less affected. Consequently, the decline in global demand primarily affected trade in goods, which accounts for a much larger share of trade than of GDP.

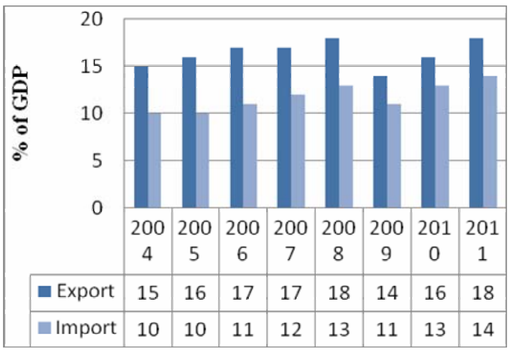
Moreover, the recession led to a shift away from trade intensive GDP components, such as investment, to other components, such as government consumption, while the fall in exports also exacerbated the decline in trade as they are highly import-intensive.

However the financial crisis and the simultaneous confidence shock also led firms to abruptly reduce their inventories and their investment in capital goods. As a result, trade in intermediate and capital goods contracted much more than trade in consumer goods, driving a wedge between developments in trade and those in GDP.



Source: Database-World Bank.

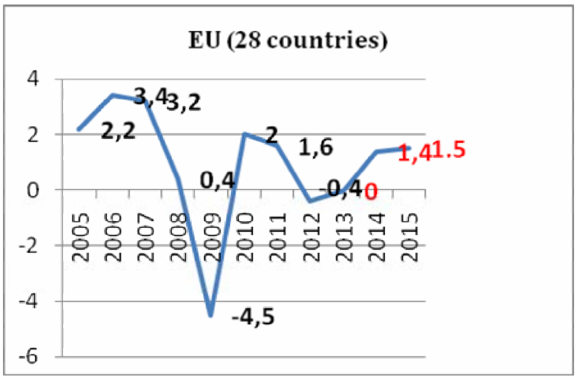
Figure 1. *Imports and export of goods and services – Romania*



Source: Database-World Bank.

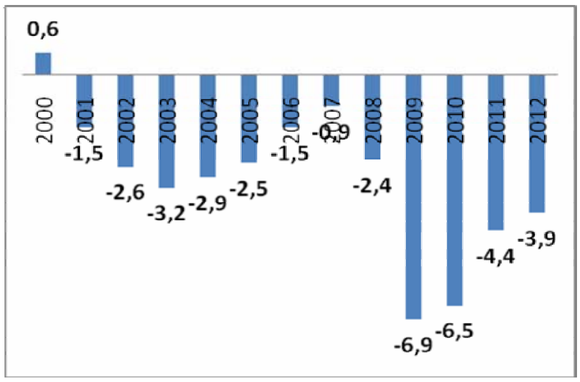
Figure 2. *Imports and export of goods and services - USA*

Internationally, for the first time in the last three decades it recorded a contraction of global GDP (-0.6%), which was higher in Europe and the United States, while China and India recorded deceleration of economic growth. In the European Union, real GDP decline was much larger (over 4%), despite the unprecedented demanding measures implemented by governments and central banks. As a result of the implementation of these measures, the budget deficit recorded in the European Union increased to almost 7% of GDP, the public debt to GDP increased by 12 percentage points and the interest rate of the monetary policy in the euro area fell to a history minimum of 1% per year.



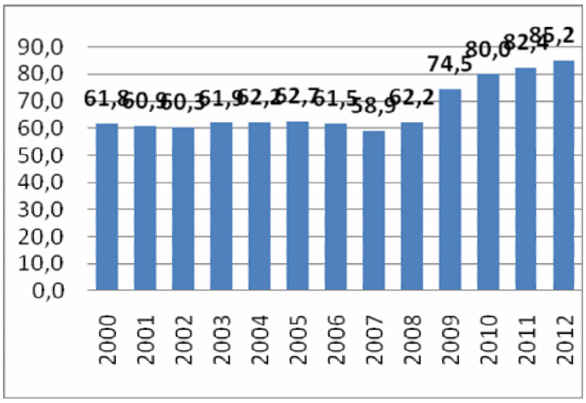
Source: Eurostat.

Figure 3. *Real GDP growth (%)*



Source: Eurostat.

Figure 4. *European Union government deficit (% of GDP)*



Source: Eurostat.

Figure 5. *European Union public debt (% to GDP)*

Second, the increase in the responsiveness of trade to fluctuations in demand may also be partly explained by structural changes related to the globalisation process. Empirical evidence shows that the elasticity of world trade to world income has increased over recent decades. In addition, the response of trade is estimated to be even higher during global downturns. This can be partly explained by the acceleration in globalisation trends over recent years, in particular the increased role of global supply chains in international trade.

The United States suffered the worst financial crisis after the World War II. The bankruptcy of investment bank, Bear Stearns, the fifth largest U.S. bank, has affected credit market instability, the trade deficit and falling exchange. Overall it has estimated loss of 800 billion dollars.

Being the world's largest economy, whatever happens in the U.S., has repercussions throughout the global economy and, in particular, the European Union and Japan.

The net capital inflows on the U.S. market have decreased by 48.5% from December 2007 to $ 37.4 billion, as private investors avoid U.S. assets. The amount of capital inflows was not enough to cover the U.S. trade deficit, which reached 58.2 billion dollars, and for a long-term that amplifies the dollar's decline.

In the U.S., the annual growth rate of real GDP of 2007 was 2.2%, by 0.7 percentage points lower than in 2006. The correction in the housing market was the main inhibitor element of GDP growth, which has tempered it with almost one percentage point by restricting residential investment. The turmoil on the capital markets has intensified since the summer of 2007, contributing to the slowdown of economic growth rate towards the end of the year.

Thus, economic activity was weak in the United States, and in 2009 as a whole the economy contracted at a rate of 2.4%, compared with growth of 0.4% in 2008. Real GDP continued to post consecutive negative quarterly growth rates in the first half of 2009, following the sharp downturn in the second half of the previous year.

In Japan, economic activity deteriorated significantly in the first quarter of 2009, before entering a recovery phase in the second quarter.

Table 1. *Real GDP growth rate(%)*

	USA	Japan	China	India
2005	3,1	1,3	11,3	9,3
2006	2,7	1,7	12,7	9,3
2007	1,9	2,2	14,2	9,8
2008	-0,8	-1	9,6	3,9
2009	-3,1	-5,5	9,2	8,5
2010	2,4	4,7	10,4	10,5
2011	1,8	-0,6	9,3	6,3
2012	2,2	1,9	7,8	3,2

Source: Database – World Bank.

The emerging economies of Asia showed notable resilience to the global downturn. In the first quarter of 2009 the collapse of foreign trade led to negative real GDP growth rates in the export-oriented economies of Hong Kong S.A.R., Korea, Malaysia, Singapore, Taiwan and Thailand. China, India and Indonesia, on the other hand, posted lower but still positive economic growth in the same period.

Boosted by large fi scale stimulus packages and expansionary monetary policy, emerging Asia began to recover in the second quarter and recorded annual real GDP growth of 5.7%.

Economic activity in Latin America contracted sharply during the first half of 2009, following a very similar pattern to that of the world economy. In year-on-year terms, real GDP for the region as a whole contracted by 2.8% in the first quarter of 2009 and by 3.9% in the second (although in quarter-on-quarter terms, it expanded by 0.4% in the second quarter).

The Baltic countries registered the depth of the decline in economic activity, the average annual growth recorded double-digit contraction, after the noticeable negative growth since 2008 in Estonia and Latvia. This pronounced economic slowdown reflects, in a great measure, the adjustment of significant macroeconomic imbalances, that were accumulated even before this global financial crisis, which increased the vulnerability of these countries to the effects of the international recession.

In all EU Member States outside the euro area, except for of the Baltic countries, the larger- than-expected decline in economic activity was driven by the collapse of external demand and external financing constraints. However, the decrease in consumer confidence and, in some instances, the negative wealth effects, that result from the mark-down assets, have led to the visible deterioration of domestic demand in most countries.

Poland was the only country that registered a positive growth (1.7%) in 2009, and may have reflected the relatively low degree of openness in the economy, financial sector soundness, early depreciation of the currency and the absence of major macroeconomic imbalances.

In Denmark, UK and Sweden, the three EU Member States outside the euro area that joined the European Union before 2004, economic activity shrank by about 5%. In 2008, in Denmark and Sweden, economic activity was in process of collapse, while in the UK, the economic activity continued to record lower growth rates.

In 2009, economic activity contracted significantly in the Czech Republic and even more in Hungary. In Hungary the decline partly reflected policies to ensure macroeconomic consolidation.

In Bulgaria and Romania, economic activity contracted by 5.1% and 7.1%, after, in 2008, it had reported the highest levels of growth of from outside the EU countries.

4. Conclusions

Our basic conclusion is that there is no unique balance model that includes all important strategies, financial and economic aspects needed to study the roots of the Great Depression. We provided a brief analysis which suggests that the global economy can be restructured and rebalanced in part, by economic and institutional changes that will promote higher savings and a new economic reform.

If we look at the origin of the imbalances mentioned above, we find out which is the direction we need to go. First, the economic and financial power must be divided, not worldwide overly concentrated, otherwise financial imbalances, that arose and spread in the U.S., will increase. Institutions that aim to control all global transactions must establish rules of the game and control financial transactions to exclude the speculative method. The global financial system should encourage only the profitable activities that generate goods and services able to support the company in the future.

Concerning the evolution of the world economy, it should also take into account some risks that might occur in future. In this context, we should not expect that the global economy has a significant increase or decrease in the future, but rather can bounce back and recover the temporary loss, maintaining unemployment and budget deficits. Thus it can be identified at least three risks that could lead to global economic slowdown. The first is related to policies of the stimulus, implemented by governments and central banks in a disorderly manner and that could lead both to a sharply long-term increased interest rate and a currency imbalance which is already lackluster. The second risk factor is that financial institutions would be unable to rebuild capital reserves and liquidity to cope with the financial and economic threats. The third, and probably the most negative risk factor is that of an unexpected decline in the dynamics of Chinese economic growth. However, expectations of Chinese economic growth appears to include a heavy and durable performance. This seems to be immune to cyclical pressure.

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