

THE CURRENT ECONOMIC CRISIS AND ITS IMPLICATIONS ON THE WORLD ECONOMY

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Abstract

The evolution of the world economy is a sinuous one, periods of prosperity and economic growth alternating with decline and recessions. Despite the acceptance of this reality, the outbreak of economic crises as turning points in economic activity, always raise questions that have been given various answers. In recent decades the world economy experienced a series of severe financial and banking crisis, which through growing interdependences between countries had seriously put into discussion the global stability. However, the current economic crisis is by far the most serious in the light of both its amplitude, but mainly by the negative effects on the world economy.

Keywords: Economic crisis, housing credit, monetary expansion, world economy.

JEL classification: O11, O16, O23

1. INTRODUCTION

The current economic crisis is a new stage in the long series of economic imbalances that have been manifested over time in the global economy. After the Second World War and until present the world economy has gone through several financial and economic crises, of which four have a special importance. The first was the external debt crisis for many least developed countries at the end of '70s and early 80's of the last century. The second was caused by the collapse of Exchange Rate Mechanism of the European Union in the period 1992 -1993. The third was the crisis of '97 – '98 of the last century from East Asia and Latin America when the economies of these countries have gone through strong financial shocks, which involved an economic crisis which put into question the "miracle" of some of these economies.

The last was initiated in July 2007 as a crisis on the mortgage market in the U.S. but it have been transmitted gradually in an increasing number of countries and get a previously unthinkable scale. After two years, which was initiated being defined as only a temporary "financial turmoil", gradually became an economic crisis affecting all the countries in the world.

Looking back, such a crisis seemed inevitable, given the earlier economic developments. Milton Friedman had denounced in this sense that government interventions have become increasingly intense, using taxpayers' money to save businesses and banks, thus preparing the ground for future crises. While previous crises were concentrated in certain geographical areas and groups of countries, not embracing the world economy as a whole, the last is much wider, affecting the entire global economy.

2. THE ROOTS OF THE CRISIS

Started in the U.S., the country with the greatest economic potential in the world, the current crisis consequences are felt throughout the global economy, which is explainable, at least in part, by the economic globalization. Currently, due to the processes of liberalization and deepening of the global division of labour, national economies have become increasingly interdependent. Increased international trade and international financial flows, increasing importance of multinational companies and accentuated international transfer of technology, especially information and communication technologies in an increasingly knowledge based society, resulted in unprecedented intensification of economic interdependences between countries and their expand to scale planet. A direct consequence of this process on the countries was to increase the global influence and the potentiation role of external factors in the domestic economies. The impact of external factors is felt both by the possibilities they offer in terms of better exploiting national resources and broadening of internal growth, but also by the harmful effects of imbalances and economic crisis spreads from one country to another through this channel of interdependences.

Even if in some stage of development some countries felt they were shelter from the adverse effects of economic crisis, the current conditions these effects are no longer stopped at the borders of the countries. Some of the problems caused by the current economic crisis seems to be like those of the past crisis, but the price paid became larger. Many economists and politicians consider the current global economic crisis as the most serious threat to the global economy since the Great Depression of '30 years of the last century, after some of them even stronger. Its causes are both microeconomic and macroeconomic. Although there are quite many who argue that the current economic crisis has its roots in dramatically lowering of the cost of housing in the U.S. or in the real estate credit collapse, its fundamental causes are more deep. Being such a complex phenomenon, the crisis has generated a series of theories that attempt to explain the causes of its occurrence [1].

A first theory refers to real estate prices in the U.S. and other developed economies such as Spain and Ireland which at the end of 2006 have reached extremely high levels. Gradually, banks became increasingly reluctant to grant increasing loans, and these reduced the demand for houses and apartments. Construction companies began to reduce the number of new projects and real estate prices fell more. At the same time, the low volume of transactions and the stock exchange rates of the financial titles generated significant losses for some investors. Companies that invested large sums in the initiation or development of business, some of them even in high tech industries, have faced a significant limitation of

market share, both internally and externally. Although losses were sometimes very large it could not be understood the need for structural reforms, both at the national and the global economy levels, in order to avoid such situations.

Several analysts, including Altman, Buiter and Blanchard support the theory that the main causes of the current crisis are more deep, having roots not only in the housing prices decrease in and in lower housing loan market in the U.S., considering this approach as an incomplete one. They see the abundant liquidity created by the major central banks in the world (FED, ECB, BOJ) and the oversaturated savings, generated mainly by increasing integration into the global economy of China and South Asia - East, which have created resources for investment including investment in sophisticated financial instruments, the deep causes of this crisis. An important factor in this regard was the inflationary policy taken in the early 2000. With the terrorist attacks of 11 September 2001, when the feeling of uncertainty of economic actors reached its peak, the U.S. monetary authorities have thought they were facing a strong recession. Advised by Ben Bernanke (the current FED governor), Alan Greenspan decided to reduce the interest rates by additional monetary issue [2]. With this relaxation of monetary policy, interest rates fell from 6.25% in early 2001 to 1% in 2003 (this being the nominal interest rate, the real rate being even negative for two and a half years, as prices increased). In these circumstances, banks have taken more money from the FED, money that they channel into the economy, entailing the expansion of mortgage credit. But the U.S.A. was not the only one who promoted this policy. Until 2006 the real interest rate in the euro area and Japan was on the same trend. This coordination of the economic policies of major countries (in the sense of generalizing inflation) determined the expansion of economic imbalance on a global scale. This proved once again what governments understand by coordination: scoring concentrated inflation [3]. With this cheap money, obtained by contracting loans, economic actors have started business, in some cases unsustainable.

The decrease interest rate was not due to changing preferences in society, in sense of increase savings, but bank credit expansion, which resulted in a significant increase in monetary base in circulation, increased aggregate demand and thus higher prices of goods and financial assets exchange rates. The process was conducted in a cumulative manner. The extent to which the financial markets, especially the international one got, was due, in particular, to the "multiplier" process which earlier amounts of money have generated, especially those located outside of origin countries, by repeated credit operations based on the same amount; a credit loans involved another, becoming an important factor of the expanding market and speculative capital. Thus have appeared an increasing gap between savings and investment. Apparently, entrepreneurs have more resources, but they are only "nominal", paper money.

At this situation was added, for the U.S.A., the government involvement in improving the housing situation of the population started in 1934 by establishing the Federal Housing Administration (FHA), with the mission to guarantee mortgage loans and encourage banks to offer credits for housing. If at its beginning the FHA was calling those who got loans for housing construction to provide an advance of at least 20% of the mortgage value, in 2004 it reached only 3%. Some of the mortgage lending activity has been acquired by a new institution - Ginnie Mae. This developed the concept of bonds covered by mortgage - mortgage based security (MBS), through which the government has outsourced a part of the public debt by transferring it to private investors [2]. In 1970 was created the Federal National Mortgage Corporation (Freddie Mac) with the role to transform the conventional mortgage

loans into securities. These institutions attracted resources from the capital market and used them to take mortgage loans from banks. They bought more mortgages and targeting mainly to low income families. Their assets were resold in the form of bonds secured by mortgages - instruments that were successful since offering market participants the opportunity to invest in securities with low risk. The two institutions have become the most important buyers of subprime mortgage loans (loans granted to borrowers who do not meet the standard criteria to be accepted to finance).

The cheap money has given rise to a boom in the housing market, an explosion of acquisitions of companies with lend money and other excesses. Real estate creditors fell their loan standards and invented new ways to stimulate the business. Investment banks have developed a variety of new techniques for transferring credit risk to other investors such as pension and mutual funds, wishing to gain more and more profit. Banks have sold their high risk mortgages, presenting them as securities called guaranteed payed bonds. Quickly and easily it have been created synthetic securities, which mimed real credit risk. More and more banks were involved in the distribution of extremely complex financial products and in the sales of loans that had behind mortgages with high risk.

Therefore, the current economic crisis has been mainly generated, by the rapid and significant expansion of bank credit, especially the subprime mortgage. Under these conditions it have often been ignored the rational behaviour of economic agents, which have made increasing investments in a market that has become increasingly risky. Prices of goods and financial assets have reached a high level, which made a part of economic agents to pursue the conversion of over-estimated assets into cash or investment in industries considered of perspective. This phenomenon generated a running from those risky and overvalued assets, which led to large losses for some banks and bankruptcy of many firms. The same phenomenon has involved the removal of several economic agents on the market, falling prices, panic, etc.. As a result, banks have granted loans more difficult, creating a credit crisis that has become an important factor triggering the economic recession.

Low interest rates, appetite for assets with high returns, low vigilance against the risk masked the signals of the financial markets and led to poor understanding of the risks involved. Cheap credits have encouraged people to increase consumption and increase investment in financial assets. Thus, resulted a continuous and artificial increase of the financial assets whose value could not be converted into cash and which did not reflect the actual increase in productivity of capital and labour. This phenomenon is known in literature as "bubble" because of its unsustainable growth.

The amplification of the nominal economic sphere by increasing operations with derivatives, speculative operations, fluctuations in exchange rates, etc. have accelerated even more the imbalance between the real economy and the nominal one, generating the current economic crisis (fig. 1). We have to emphasize here that the present international trade is just over 2% of all interbank transactions. The volume of foreign exchange transactions amounted about 2500 billion dollars per day, about 12 times higher than in 1986, while overall volume of exports of goods and services is less than 50 billion dollars per day. The New York's Wall - Street or the London's City have millions of people in the financial industry moving easy via computer or phone money from a place to another. The large gains obtained in this way have led to the invention of more sophisticated products, without taking into account that in this way will be opened Pandora box.

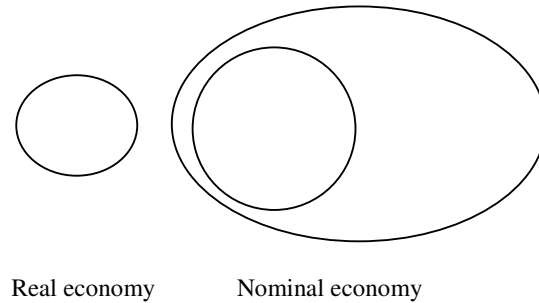


Figure no. 1 The actual relation between real economy and nominal economy

Once the crisis was triggered by the occurrence of failure to pay rates for housing loans, the financial market has become non-transparent. The installing of investors' mistrust placed quickly the securities issued in the risky ones category and refinancing became impossible. Demand for liquidity in combination with a loss of confidence between banks has triggered a rush after cash money and the effective interest rate cash began to grow. In the U.S.A. and some countries in Europe governments and central banks have responded by increasing liquidity, providing government guarantees for loans, recapitalization of financial institutions or reducing interest rates. Although such measures were applied, after two years of the start of the crisis the market has remained non-transparent, which magnified the crisis and facilitate its passage into the real economy, first in the U.S. and then in other developed or less developed countries.

The collapse of some big financial players in 2008 (Fannie Mae, Freddie Mac, Lehman Brothers, AIG, etc.) resulted in the loss of confidence in the financial system, on the background of an excessive pessimism and a general uncertainty following the contraction of the capital market and of the real economy. It began to appear then serious systemic problems such as illiquid financial assets, capital shortages, protectionist measures etc. which resulted even into a deeper and stronger recession, reduced GDP, increased unemployment and public spending etc.

Government intervention to rescue some financial institutions from bankruptcy induced on the market the sentiment of moral hazard. Saving financial institutions (like investment bank Bear Stearns, AIG) has encouraged large corporations to believe that in case of serious problems the authorities will intervene because their collapse would mean the collapse of the entire financial system, hence the expression "too big to fail". But shortly after the managers of those large corporations had to see that things can not go this way. In September 2008 the U.S. Treasury and Federal Reserve have allowed the collapse of investment bank Lehman Brothers, which has discouraged the idea that the insolvent institutions will be saved by the government intervention.

Nobel Prize laureate for economics Pal Krugman believes that the main cause of crisis is a failure in regulating the "shadow" financial system, increasingly loose. "Given that this shadow banking system starts to rival and even to overcome the importance of the conventional one, politicians and government officials should have been aware this was the same kind of financial vulnerability that made possible the emergence of the Great Depression ... In these circumstances, they would have to respond by extending the rules on this new institution, too. The influent persons should militate for a simple rule: any institution which

carries out similar activities to those of banks should be regulated as a bank [4]. This lack of authorities' control over the financial markets is defined in the paper cited as a "malignant neglect."

3. THE EFFECTS OF THE CRISIS ON THE WOLD ECONOMY

The effects of economic crisis are more serious as it covers a longer period. Irving Fisher highlights some of the effects of an economic crisis [5]. Of these, the most important are: a contraction of money supply as a result of more expensive loans, a decrease in the level of asset prices, a sharp decrease of the net value of companies (which prolonged may lead to bankruptcies), a decrease in profits, a reduction of production and hence a decrease in trade and an increase in unemployment, a generalized feeling of pessimism and a loss of investors' confidence in financial markets.

The current economic crisis has effects that are felt not only in areas directly involved in its triggering, such as financial and real estate, but also throughout the economy. In the financial market the crisis was felt first by the English Northern Rock bank, which due to large loans made during the period 2006 - 2008 has been exposed to strong oscillations in the international financial market and has requested support to the Bank of England. This fact generated panic among investors who tried to withdraw their funds. In the absence of an offer to purchase from the private sector, the English government nationalizes the bank in February 2008. These problems of the English bank were only a preamble to those who were to face financial institutions around the world. Affected, at first, were only the institutions involved in real estate projects financing (for example, the investment bank Bear Stearns, which became bankrupt and was bought by JP Morgan. Others have been nationalized, such as Fannie Mae or Freddie Mac). Gradually, the crisis wave propagated to companies that had nothing to do with real estate, large financial institutions around the world entering the vicious circle created. In 2008 the U.S. saw a decline in economic growth, many industries reducing their activity and personnel.

The crisis has expanded globally, entailing the collapse of some European banks, the decline of the largest stock indices, significant reductions of the shares values on the international financial market. These has accelerated the liquidity crisis and caused a decrease in international trade. Euro Zone, the second economy in the world, faced reduced economic activity, growing unemployment and inflation. Europe's economy declined in the third and fourth quarter of 2008 on average by 0.2% compared to the second quarter of the same year, this being the first decline since the introduction of the Euro in 1999.

The current crisis has important implications for emerging countries too, primarily due to increased interest rates on international monetary market from 3.6% in early 2007 to 5.3% today, this being the highest level since the end of 1994. This fact contributes to increased cost of funding the local banks from international financial markets and indirectly increases the interest rate, with negative effects on investment and overall development of these economies.

The next figures presents, based on information provided in the annual report for 2008 of the World Bank, the differences between the forecasted and actual level of some reference economic indicators for a number of less developed economies, reflecting the high degree the crisis affected all countries in the world. Regarding the evolution of GDP (fig. 2), if per overall less developed countries the differences were from 2% to 4.1%, the most sig-

nificant differences were recorded for the countries of Central and Eastern Europe, from about 8% to 4.2% and in Asia, from 6.2% to 4.3%.

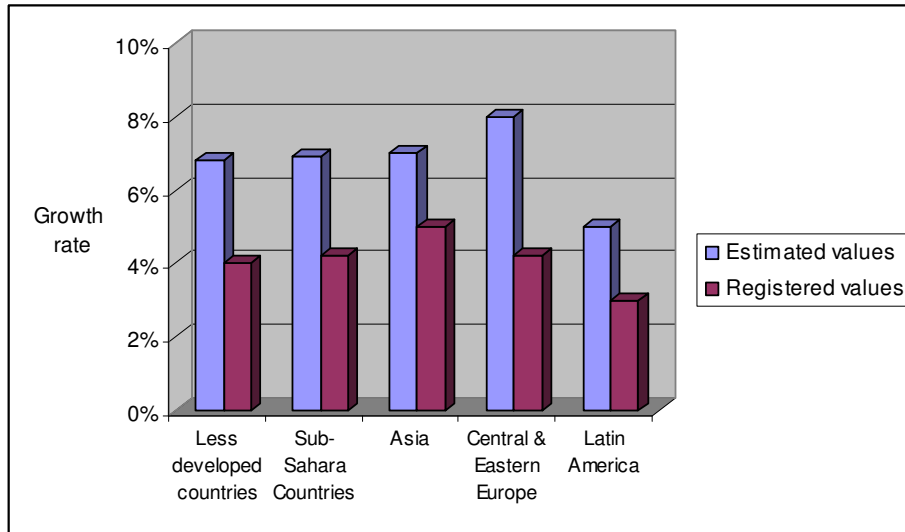


Figure no. 2 GDP growth (%)

Although in terms of inflation the differences per overall less developed countries were lower (fig. 3), the most significant have also been in the case of the countries of Central and Eastern Europe, from 8% to 8.3%.

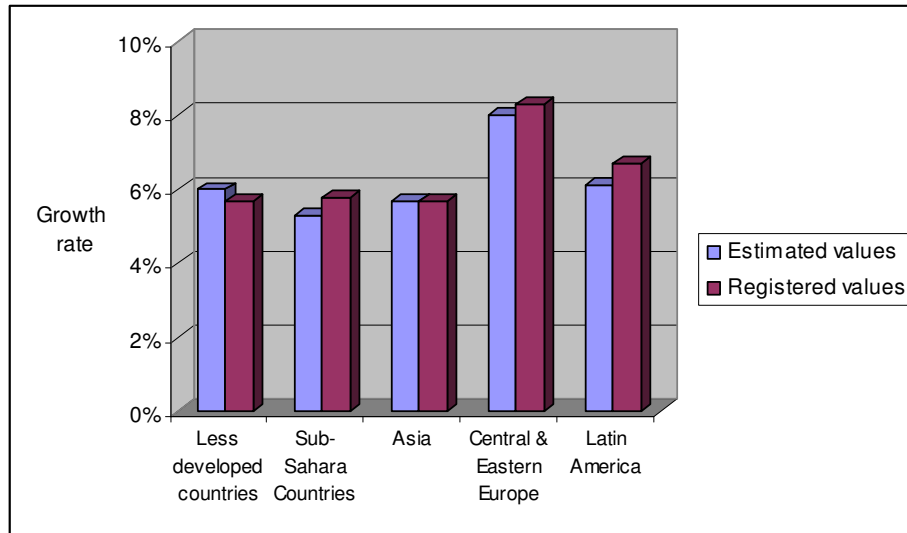


Figure no. 3 Inflation rate (%)

As regard exports (fig. 4), the actual values from those forecasted showed differences from 14% to 8%, the highest being for the countries of Asia, from 16% to 6%.

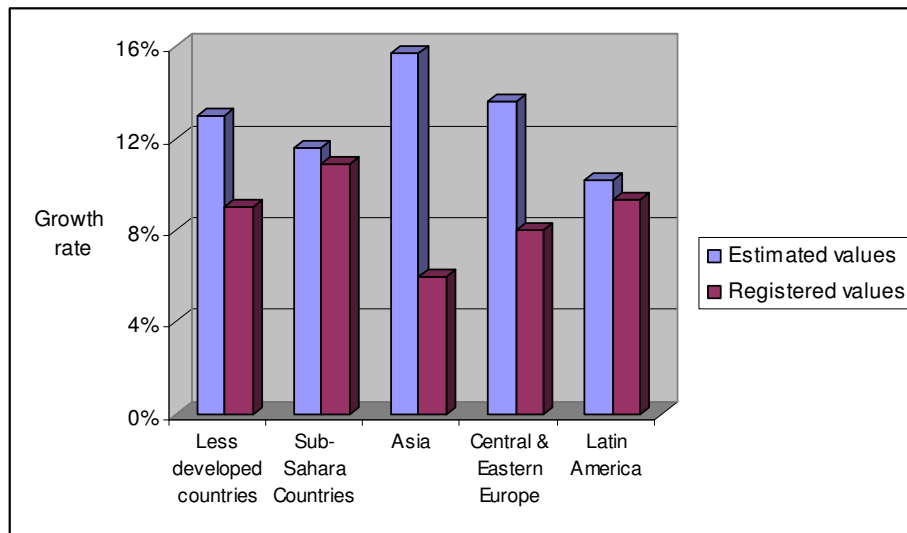


Figure no. 4 Exports volume (%)

Regarding the current account deficit, determined as a percentage of GDP, the differences between effective and forecasted values were over the less developed countries from 7% to 10%, the most significant ones being for the Central and Eastern Europe countries, from 2% to 7% and for those in sub-Saharan Africa, from 8% to 12%.

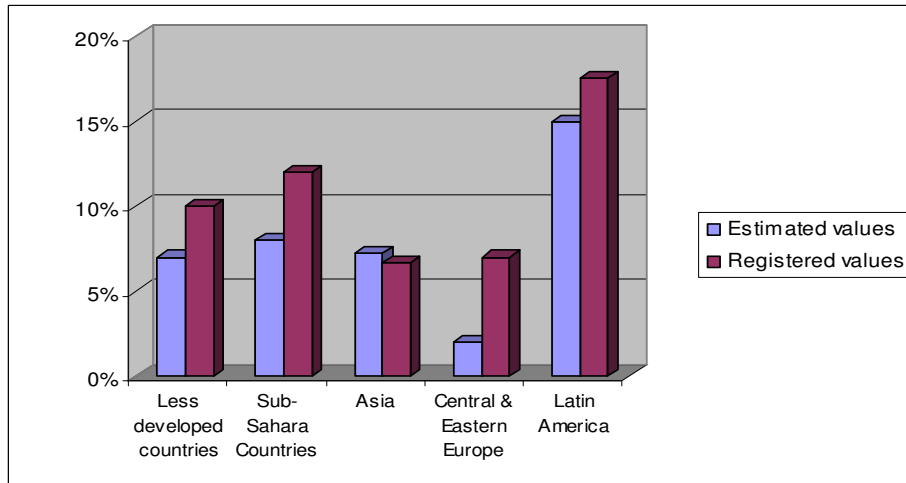


Figure no. 5 Current account deficit (%)

The social dimension of the crisis is an extremely important one, whereas a more important part of the world's population faces massive unemployment and high rates of inflation. World Labour Organization has estimated that about 20 million people worldwide will lose their job by the end of 2009.

The problem of the current crisis is also one of confidence. It began from an excess of confidence of the people and businessmen in the "benefits" of financial institutions and it will end with a delay of several years because of the lack of confidence that was born once with the crisis release.

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