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THE CURRENT GLOBAL CRISIS: CAUSES AND SOLUTIONS

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Review

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Abstract

In recent years the global economy has been facing a very severe economic and financial crisis. The leading economies of the world are going through a period of deep recession. The aim of this article is to emphasize the causes of the current crisis as well as the measures taken to counteract its effects. In order to achieve this purpose, representative articles on the subject have been analyzed. Compared to other crises, the current crisis is based on totally different causes. That is why the countries affected by the crisis should take unusual measures for the recovery of their economy. However, whatever measures had been already taken, the economic crisis is not over, predictions in this regard being mostly pessimistic.

1. INTRODUCTION

The global economic crisis began with a financial crisis that originated in the United States, at the end of 2007. Depending on the nature and strength of the U.S. economic ties with other countries, the crisis has spread rapidly taken by them were sufficient to maintain financial stability and economic prosperity. The financial crisis has affected the real economy almost immediately the

A large number of articles from prestigious international journals have discussed the economic crisis, focusing particularly on identifying the causes of the crisis and how the effects of the crisis can be combated.

2. CAUSES OF THE CURRENT GLOBAL CRISIS

There are many theories on the reasons behind the outbreak of a crisis. For instance, Yao and Zhang (2011) consider that a crisis is based not only on one financial bubble, but on many financial bubbles [24, p.775]. Also, there are voices that blame financial globalization for the producing of financial crises, but because of inappropriate policies. On the contrary, financial globalization can play an important role in encouraging development of institutions so that financial markets can effectively perform the crucial function of getting capital to its most productive uses, which is the key to generating growth and reducing poverty. [13, p.287].

The current global crisis has begun in United States, with a real estate crisis, becoming soon a crisis of the entire banking system, moving towards a monetary-financial market crisis. This has affected almost immediately the entire economic activity. All economic sectors have been reached by this depression.

Even though the real estate credit crisis has been caused by the bursting of the speculative bubble of the great real estate market, the actual causes of the

since its onset, leading to reduced economic activity in the whole world, affecting all levels of the economy.

Most economists haven't predicted the global crisis. Even when the financial system began to collapse, central banks have argued that the situation was under control and that the measures consequences being currency devaluations and increased imported input prices and production costs, deflation and increased unemployment.

global crisis are deeper. Real estate bubble refers to the unprecedented increase in housing prices, which have generated more speculative activities, based on the buyers' belief that prices could not fall. As a result of this balloon deflation, the banks have begun to take losses caused by the large number of people who stopped paying, at the same time, the mortgage. This has created doubts about the solvency of many of these banks. Consequently, there have been massive withdrawals from banks, which endangered the financial system.

The economic literature has identified many causes of this crisis. First, a study shows that a long period of deregulation and globalization of financial markets combined with a rapid pace of financial innovation and moral hazard caused by frequent rescue plans of governments, have contributed to creating the conditions that led to this financial crisis [5, p.576]. From this point of view, the economic and financial crisis has brought into question the functionality of the current economic and financial system.

At least in the United States, the financial crisis has been facilitated by policies of domestic and international liberalization accompanied by however well-intended financial innovations, such as complex derivative securities, "conduits" and "structured investment vehicles", which were not regulated at all. Other innovations in risk management worked in the same direction. This has happened because commercial and investment banks and hedge funds have

been encouraged by the dynamic development of the financial market to use more leverage and their counterparties have been inspired to provide it by the development of mathematical models and methods to quantify and hedge risks. These new models, which were rigorous and promised to provide “exact” information, have encouraged market participants to believe that the additional leverage was safe since participants used scientific techniques and were convinced that they could manage it. Taking into account that these models used data from recent periods, events, which should have been modeled or simulated, like a sharp drop in housing prices, were not captured in these models. As a result, investors have taken financial decisions based on these models, considered safe [21, p. 321].

Second, another explanation of the current crisis is that the crisis has been caused by omissions in its regulation system. Higher levels of the regulation system were not present so they could not suggest and constrain lower levels to sustainable as well as livable choices. This presented itself as the loss of the system’s ability to check and filter out bad quality borrowers from greater supplies of borrowers [20, p 495]. Although this may be true, Revier and Lewin (2012) assert the belief that the deregulation of markets has been a cause of the crisis, is unfounded. In fact, the banking system is one of the most regulated sectors in the U.S. economy. Actually, they blame the excessive regulation of the system, which channeled the easy money policy of the Fed into real estate, thus distorting the physical capital structure of the economy [17, p.46].

Moreover, Eisenbeis (2009) has found three main causes of the crisis [6, p.458]:

- macro and fiscal policy errors;
- breakdowns in supervision and regulation;

- breakdowns in risk management and governance in financial institutions.

Next, financial innovations have been considered other cause of the crisis. In fact, Palmerio (2009) thinks that the development of financial innovations is the primary cause of the financial crisis. According to Palmerio, despite that in generally, financial innovations have positive goals, they have caused relevant negative effects to the financial system in the course of time. These effects occurred because financial innovations have contributed to change intermediaries, allowing them to modify the risk associated with their activity and their solvency without changing their external structure. The author believes that financial innovations that have developed as a result of the need to finance both the external debt of the United States and of the American families accustomed to ever more debt, the main cause of the economic and financial crisis [15, p.528].

Among other causes of the crisis there have been discussed in the economic literature, the lack of profitable investment opportunities in advanced capitalist systems [10, p. 917], the decline of the long term pattern of accumulation in the USA [3, p 31] and people’s overoptimistic behavior, producer of the speculative bubble, that lead to the financial meltdown [19, p. 292].

However, besides all the explanations described above, Revier and Lewin (2012) consider that the subprime crisis of 2008 closely fits with the Austrian business cycle theory of Ludwig von Mises and Friedrich von Hayek, with minor variations (the Austrian business cycle theory views business cycles as result of excessive growth in bank credit, accentuated by naturally damaging and ineffective central bank policies, which cause interest rates to remain too low for too long, resulting in excessive credit creation, speculative economic bubbles and lowered savings). According to this study,

the subprime crisis, or the “housing-bubble” is not an isolated incident. Rather, it is one of a number of related events whose origins can be found in the monetary policy that the Fed has adopted at least since 1980 [17, p 46].

3. THE PROPAGATION OF THE ECONOMIC CRISIS

The epicenter of the economic and financial crisis of 2008 has been in the United States, so many authors have studied the extent to which the crisis has spread to other countries.

The countries that were more exposed to the United States (those that depend on exports from the U.S.), have experienced seizures, but to a lesser extent [18, p.360]. But this is an optimistic perspective, suggesting that the crisis that started in the United States had the same intensity in all countries. Another study on the intensity of the crisis has revealed that the crisis has had a significant and permanent effect in most countries, the effect being more profound in smaller countries where the banking system has had several major financial imbalances [8, p.22].

Regarding the spread of the crisis, there is also the theory that the crisis has spread rapidly in developed countries due to the financial relationship between them, while in developing countries, this has happened more slowly, financial links these countries being weaker. Compared to other crises, this is different, precisely because it has affected practically the universe of financial intermediation in the United States. This has fostered an international propagation through financial links, in particular, those related to holding banking sites [11, p 351].

Nevertheless, other authors consider more channels through which the crisis has been transmitted such as price volatility and exchange rate volatility, these channels acting differently from

country to country [22, p 504], [2, p 652] . Another factor that has favored the spread of the crisis is related to the interconnection of banks. Given that banks are interconnected, the risky behavior of a relatively small number of banks has affected the global liquidity [9, p 1030].

In addition to previous theories, Claessens et al. (2010) have identified another model that explains how the crisis spread, depending on the specifics of each country and the nature of the relationship (real or financial) that existed between it and the United States in the pre-crisis period. Consequently, the financial sectors of countries with direct financial exposures to US assets have first been hit, but this has not necessarily translated into lower macroeconomic activity immediately. Secondly, the countries that were vulnerable because of home-grown bubbles and dependency on external financing have been affected. Finally, small open economies with extensive trade linkages and countries heavily reliant on exports have suffered from the decline in international trade and difficulty in financing trade. However, in most of these countries, the domestic financial sector has not suffered because of direct exposure to the epicenter or financial contagion, but has been influenced by a decline in domestic economic activity [4, p. 281].

4. SOLUTIONS TO THE CURRENT ECONOMIC CRISIS

The main problem the global economy has been facing since the onset of the crisis was to identify the manner in which the effects of the financial crisis can be counteracted. One of the solutions brought up emphasizes the need to liberalize trade during the crisis [7, p 2189]. In this respect, it is important to identify the nature of the crisis (internal or external). Thus, if the crisis has internal causes, trade liberalization could not be an effective measure. Liberalizations at a time of external (but not internal) crisis can

bring additional growth benefits by alleviating the constraints imposed by the crisis. However, because most crises have both internal and external causes, it is best that the liberalization of trade take place during a period of economic stability.

As a response to the crisis, the first reaction of governments has been to return to Keynesianism, using tax incentives, even in countries where Keynesianism had no support (Germany). Despite this, soon there has been a revival of anti-Keynesianism, finally, states adopting harsh austerity measures to save the economy [16, p 361]. Quiggin (2011) believes that austerity has been adopted in countries such as Great Britain and the United States where there hasn't been an immediate crisis of public debt. He also draws attention on European Union where austerity measures may lead to a new recession. The same negative outlook of the European Union is also subject to other studies, according to which European countries will take a long time to recover from this crisis [1, p 1175]. This is because Europe lacks a balance between the financial sector and other sectors of the economy.

Even though most countries adopted either the Keynesian solution, which promoted more government spending and higher taxes or the European solution, characterized of less government spending and higher taxes, Thornton (2013) talks about a different solution, called by him the "real austerity". This involves cutting government budgets, salaries, employee benefits, retirement benefits, and taxes. It also involves selling government assets and even repudiating government debt. The reason why this type of austerity works best with tax cuts is that while high taxes discourage production, tax cuts on investment and capital actually stimulate economic activity [23, p.1]. Of the three forms, only the third increases the size of the private sector relative to the public sector, frees up resources for private investment, and has actual evidence of

success in boosting growth. An example of country that followed this strategy is Latvia that between 2009 and 2010 cut government spending from 44% of GDP to 36%, fired 30% of the civil servants, closed half the state agencies and reduced the average public salary by 26% in one year. At the same time, pensions and social benefits were barely reduced and the flat tax on personal income was left untouched at 25 percent. As a result of these policies, the Latvian economy had a real growth of over 5 % per year in 2011 and 2012. Also, Latvia could repay its loan to the IMF three years earlier than it should have.

To counter the effects of financial crisis, there are studies that talk about the adoption of substantive changes to the financial system, requiring international coordination of fiscal policies, in order to have international supervision of systemically important financial institutions [6, p 466]. This approach is correct, but there is a problem, namely how to decide which institutions are systemically important to be subject of special treatment.

Another problem with the crisis is related to government intervention in favor of banks. Thus, banks that caused the crisis have not taken full responsibility for this. Consequently, states have helped banks to not go bankrupt because the bankruptcy of these banks would have produced serious economic and social problems [21, p.325].

Following investigations, Furceri and Zdzienick (2011) have concluded that fiscal policy is the most effective tool in combating the crisis, while the effect of monetary policy is rather modest. However, flexible exchange rates mitigate the impact of the crisis in the short and medium term, enhancing though the effects of the crisis on long term. Regarding the role of foreign aid (loans from the IMF) during the crisis, the authors noted that it is beneficial on the long term [8, p.22].

At the same time, Moshirian (2011) has come up with a surprising solution. He claims that an increase of the

level of globalization would lead to economic recovery worldwide. Consequently, he is calling into question concepts as global institutions, globally integrated financial system and global financial framework [14, 508].

5. CONCLUSIONS

The current review of the economic literature reveals many different causes of the economic crisis that started at the end of 2007. The fact that economists haven't reached a consensus, regarding the causes of the crisis, proves its magnitude. It is obvious that this isn't a regular crisis, but a crisis with significant and permanent effect on all countries.

Due to the various causes mentioned for the occurrence of the crisis, economists have proposed as many different solutions. Despite these solutions, the global economy takes a long time to recover. Until now, no one has come up with a solution meant to eliminate the causes that led to the occurrence of the crisis, to counter the negative effects of the current crisis and to produce economic growth all at the same time.

While there is much communality in terms of the kinds of solution needed, many of them focusing more either on the Keynesian solution, or on the austerity solution, less attention has been given to the substantive changes that are needed to capital standards and to regulatory incentives.

Whatever measures have been taken, it is clear that the current economic crisis is not over. According to most economists, its effects will be felt for a long time to come.

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