Global Financial Crisis: Causes, Impacts, and Policy Recommendations

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Abstract: The global financial crisis is going to be the major crisis in the world economy that has caused many distortions in the markets and has negatively affected many aspects of societies. This paper aims to analyze this crisis, its causes and its impacts and also have a look at preceding literature and most recent crises in financial markets. Reviewing the literature and previous crises and the lessons learned from the history, this paper is going to offer some policy recommendations and solutions to prevent the global crisis become worse.

1. Introduction

The world is facing with a major financial crisis in the current century. The evolving crisis has been transmitted throughout the global economy, causing severe social, political and economic impacts. This crisis is negatively influencing all countries, especially developing countries, and threatening the international financial system and architecture. Mishkin (1992) defines financial crisis as “a disruption to financial markets in which adverse selection and moral hazard problems become much worse, so that financial markets are unable to efficiently channel funds to those who have the most productive investment opportunities”. The global financial crisis started in the summer of 2007 (Foster and Magdoff, 2009) and was prolonged and even the situation became worse a year later (Taylor and Speaker, 2008). The IMF has described the current global situation as the result of ‘the largest financial shock since the Great Depression’ of 1930s (IMF, 2009a). The last major financial crises of the 1990s, that is, the 1994-95 Mexican peso crisis and the Asian financial crises of 1997 and 1998 have definitely affected the global crisis (Goldstein, Kaminsky, & Reinhart, 2000). There are lessons from other crises which shed light on the current crisis although the new one has some specific features.

2. Literature Review


The Asian financial crisis of 1997-1998 was one of the top ten financial crises across the world (Fair loan rate, 2011). It is believed that the contagion of financial and economic meltdowns conveys from large countries to smaller ones but the Asian crisis showed the possibility of financial distortion contagion from a smaller economy (that is Thailand) to bigger and developed economies (that is USA).

Three interrelated factors contributed to this crisis: the first and foremost factor was the weakness of financial divisions and banking systems in Asian countries. This factor caused a growth in bank and non-bank credit to private sector and this concentration on credit made Asian economies vulnerable to a huge shift in credit conditions. The second factor contributed to the 1998 crisis was the problems of the external sectors. In this case, too much investment in Asian countries was devoted to theoretical activities, unlimited and overambitious industries and financial projects. And the last factor was the contagion of financial disturbances across Asian countries as the Asian crisis began in Thailand and spread out to other countries across the region (Goldstein, 1998).

2.2. Global financial crisis of 2008-2011

2.2.1. Emerging markets Crisis of 2007

The financial crisis of 2008 was not an individual event but a chain of crises that con-veyed to the financial system and finally the economy (The Financial Crisis Inquiry Commission, 2011). In fact, the emerging markets crisis of 2007 was the most recent crisis to global crisis which started from US (Eichengreen, 2009) and some people consider year 2007 the started time of the global crisis also and do not separate the emerging markets meltdown as a separate event. When the 2007 crisis transmits to
middle in-come countries, they call it emerging markets crisis. Eichengreen (2009) simply mentions the main cause of the emerging markets crisis that is the banks and markets were global but the regulations and supervision was domestic. This crisis caused many negative effects on the markets as the trade rate fell down, the GDP rate declined and an un-balanced growth was seen in exporting and economy. Overall, this crisis caused many major changes in the structure of the global monetary system and these unbalances and changes led the world economy to face with the current global crisis.

2.3. The occurrence of the global financial crisis

Orlowski (2008) has determined five stages for the global crisis. It started with a crisis in the subprime mortgage market and devastating mortgage-lending standards spread the flame of contagion and crisis (The Financial Crisis Inquiry Commission, 2011). Then this contagion continued to other types of properties and widely affected companies, specialized banks and also universal banks. At next stage, the crisis accompanied by huge liabilities from the exposed banks which shifted the global liquidity allocations to commodity bubble effects. The last stage of crisis occurred when investment banking system in US faced an ultimate failure. There are different factors which contributed to the global financial crisis since 2008. The main factor was the rapid economic growth started from the Asian region and also the significance of export-biased growth in China and other emerging economies. The economic growth showed a dramatic increase in this region which was resulted from financial liberalization. After that the rate of imports increased and Asian economies were dependent on foreign capital to obtain investment. Asian banks started interacting while borrowing was in foreign currency but lending in their domestic currency. So, when the crisis spread widely, Asian banks faced severe financial losses (Buckle, 2009).

All these issues caused a bigger problem which was the global imbalance. Some corporations and also the government exceeded in savings and besides that the severe increase in oil prices for countries with an oil-based exporting economy were the results of the global imbalances. Another consequence of this imbalance which mainly caused by account surpluses of China and oil-based exporting economies made some countries like USA, UK, and Spain and some smaller developed countries like Australia and Canada consume and invest far more than their domestic income (Buckle, 2009). As Hunt (2008) implies prior to the time the global crisis occurs, emerging Asian countries faced a rapid growth in savings; in contrast, developed economies faced a secular decrease in the investment rates while their savings rates hugely fell down. Indeed, despite stronger investment growth in the emerging economies and a secular drop in investment rates in developed economies, the saving rates in emerging economies climbed while declined in developed economies (IMF, 2005).

Through a report, The Financial Crisis Inquiry Commission (2011) argues that the global financial crisis was avoidable as it was the result of the ignorance of warnings and risks management by the finance and economic leaders not a result of human action or inaction. The commission implies the failures and demises in financial regulation and supervision as the devastating reasons of financial systems.

2.4. Euro zone crisis of 2010

This crisis which was the result of downfall of the value of Euro currency in compare with the value of dollar by more than 15%, exacerbated the ongoing global crisis (Dyn-kin, 2010) and caused many destabilizations in the Euro zone. When this crisis occurred, the rate of GDP significantly fell down across the Euro countries and they confronted with an unexpected deficit. The rate of unemployment dramatically climbed across the zone and left governments with lots of expenditures. After a while, debt and borrowing services were so costly for the countries located in Euro zone (Prokopijević, 2010). Poor financial and economic performance and management intensified the problems and awing to the negative impacts of this crisis on the world economy, some people believe that it is a new wave of global crisis (Dynkin, 2010).

3. Methodology

3.1. Early warning systems and methodologies

There is a widespread interest in determining early warning indicators of financial crises. The main reason why there is such interest is that the financial crisis is really costly and also it will spread over a large region quickly via a financial contagion. Early Warning (EW) is a system provided by identified institutions which helps individuals to take immediate actions to tackle or reduce hazard harms. This system mainly comprise four elements including: risk knowledge, controlling and forecasting, distribution of information and knowledge and finally the response (Grasso, 2006). Goldstein, Kaminsky, & Reinhart (2000) discuss financial vulnerability systems which could be seen as early warning systems for emerging economies. According to Goldstein, Kaminsky, & Reinhart (2000), to create such an early warning system, the first step should be reviewing and analyzing preceding crises to identify lessons that can be
learned. Paying much attention to banking crises as to currency crises could be another guideline to create the system. The data of such crises could be gathered and analyzed permanently. In addition, the current warning indicators of financial crisis should be fully considered and relevant data should be regularly collected and then should be an attempt to try to forecast the probability of a crisis. Using this methodology to predict the financial crises could be of paramount help to the governments to prevent these meltdowns.

4. Results and Discussion

4.1. The International Monetary Fund (IMF) handling of the crisis

Through the Asian crisis, IMF had a plan with a number of objectives to prevent the expanding of the crisis. Its main objectives were to prevent the emergence of inflation in the region, to prevent a sudden fall in exchange rates, to prevent outcome decrease, etc. (Pilbeam, 2006). Now, IMF is also working on some ways to help its members to overcome the global financial crisis of 2008. They are devoting enormous amount of funds to track economic developments. So, policymakers can benefit from these developments with the most recent forecasts and analyses of the financial crisis. Also, IMF is assisting high income countries and emerging economies by funding them. They also have provided some recommendations for the industrialized economies to reorganize the systems of international regulation and governance (IMF, 2011).

4.2. The United Nations solutions for the crisis

Severe interrelated impacts of the financial crisis on different on various aspects of countries made United Nation to take some actions toward. Major actions have already been taken to keep macroeconomic stability and enhance and strengthen the international financial system. Urgent actions are needed to counter the impact of the crisis on the most vulnerable populations like least developed countries (United Nations, 2009).

4.3. The World Bank handling of the crisis

The recovery of the current deepened financial crisis is much hard. The high rate of unemployment and debt particularly in less developed countries and the low rate of economic growth in developed countries are the remarkable signs of the crisis. The World Bank is taking some actions to tackle the problems which the crisis caused widely. Hence, this corporate is committing $196.3 billion to developing countries to spend on their education, health, employment, nutrition and investments. During the crisis, the bank helped and supported poorest countries and more vulnerable groups of people such as children and women and spent a large amount of money for their schools, health, food, security, etc. Moreover, the bank has boosted financing support to agriculture part of countries (The World Bank Group, 2011). In addition, the bank projects to increase the global GDP growth from 3.2% in 2011 to 3.6% in 2012, and in 2008-2009 the GDP growth has the minimum percentage. This bank also aims to reduce the rate of inflation in next few years. As shown in Figure 1, the bank projects to decrease inflation rate to less than 2% in years 2013-2014 from its peaked rate in 2011 (12%).

![Figure 1. Projected inflation rate, 2009-2014](Source: The World Bank Group (2011))

5. Concluding Remarks

Financial crises have a long history which the most recent one is the crisis of 2008 onwards which is still continuing. Investigating Asian crises as the most recent crises to the global crisis showed that the main reason behind that were the distortions and imbalances which transmitted from a country to another through a financial contagion. So, prevention of occurring imbalances in the financial market could be the main lesson which the governments could learn from this crisis. But they did not learn it and the history repeated and a great widespread crisis occurred. Using IMF, The World Bank and United Nations solutions and recommendations to prevent the global crisis, this report is going to remark some recommendations here:

1. Governments should pay much more attention to the financial supervision and regulation policy. They should make a big attempt to regularly capture all systematic risks in the market and provide supporting data on prices, savings, bank lending, and investments.

2. They should take some macroeconomics policies and stabilize prices and also macro-financial markets.

3. The global financial architecture should be mainly considered. The multilateralism should be
persuaded and the establishing and spreading of multilateral institutions should be encouraged.

4. Governments should liberalize their finance as the economic growth is one of the key outcomes of trade and export openness and liberalization.

6. References


