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ECONOMIC CRISES: NATURE, CONSEQUENCES AND CHALLENGES

This paper examines the nature and consequences of economic crises by analyzing the past few major crises in Asia as well as other parts of the world. Many factors contributed to the formation of economic crisis, but the underlying reasons can be traced back to imbalances in the economic system and policy failures which cause loss of confidence in the economy. Thus, the main challenge in managing economic crises is to restore confidence in an economy, as confidence deficit brings about uncertainty and panic action which causes interruption in economic activities and resulted economic crisis.

Keywords: *global financial crisis; nature; consequences; confidence trap.*

JEL Classification: H12.

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ЕКОНОМІЧНІ КРИЗИ: ПРИРОДА, НАСЛІДКИ ТА ВИКЛИКИ

У статті вивчено природу та наслідки економічних криз на базі аналізу останніх великих криз в Азії та інших частинах світу. На формування економічної кризи впливає багато факторів, але основні причини — дисбаланси в економічній системі та прорахунки у політиці, що спричинили втрату стабільності в економіці. Таким чином, основним завданням у боротьбі з економічними кризами є відновлення стабільності економіки, оскільки нестача стабільності призводить до непевності та панічних реакцій, що спричиняють переривання економічної діяльності та, відповідно, економічну кризу.

Ключові слова: *глобальна фінансова криза; природа; наслідки; пастка стабільності.*

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ЭКОНОМИЧЕСКИЕ КРИЗИСЫ: ПРИРОДА, ПОСЛЕДСТВИЯ И ВЫЗОВЫ

В статье изучено природу и последствия экономических кризисов на базе анализа последних больших кризисов в Азии и других частях света. На формирование экономического кризиса влияют много факторов, но основные причины — дисбалансы в экономической системе и просчеты в политике, которые повлекли потерю стабильности в экономике. Таким образом, основным заданием в борьбе с экономическими кризисами является возобновление стабильности экономики, поскольку недостаток стабильности приводит к неуверенности и паническим реакциям, которые вызывают прерывание экономической деятельности и, соответственно, экономический кризис.

Ключевые слова: *глобальный финансовый кризис; природа; последствия; ловушка стабильности.*

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Introduction. The word "crisis" is often used to describe an unsteady and uneasy situation where critical decision is needed to make a turning point (Okposin and Cheng, 2000). Crisis is a multifaceted phenomenon where there is no "one size fits all" definition that could be used to describe the non-uniformity of the nature, process as well as the consequences of the event (Tourres, 2003). It is believed that the word "crisis" was first used in medical science to signify an acute moment of a patient, but it has been quickly adopted by economists, sociologists, psychologists and politicians to denote a critical situation in respective fields of study. An economic crisis refes to a situation when normal economic order is distorted, where interruptions in production, distribution and consumption led to general market disequilibrium and "blockage" in capital accumulation as well as the flow of goods and services, inputs, credit and money caused inflation, debt accumulation and bankruptcies or unemployment (Okposin and Cheng, 2000; Touress, 2003).

Without doubt, "crisis" has steadily turned out to be a part of our life ever since early 1970s, numerous crises are taking place in different parts of the world at an increasing regularity. From Argentina, Russia, Mexico to Thailand, Korea, Indonesia, Malaysia, Europe and the United States, these crises emerged one after another, beit small or large, country-specific or global in nature, brought us through the roller-coaster of an increasingly shorten lifespan of business cycle. These crises evolved from various forms of interruptions, for instance, oil shock, stock crash, credit crunch, currency vulnerability and financial turmoil. Regardless its causes, the eventual effect of a crisis is slowdown in economic activity and recession in real economy. There is no lack of crisis stories and no country could safely say that it is free from crisis. World Bank has estimated that about 112 crises happened in 93 countries between 1970s and 2000s, while according to the study conducted by Eichengreen and Bordo (2002) as cited in Wolf (2009), 95 and 44 crises occurred between 1973 and 1997 in emerging and developed economies respectively. We heard, we experienced, we learned and we anticipated the next shock to happen soon. When this article was written in August 2011, the stock prices at major markets plunged to the record low level due to the downgrading of the U. S. credit rating by the Standard and Poor's. Another round of crisis is expected, even though we are doubtful that we have gone out of the previous crisis. What is happening? What went wrong and why is crisis happening so rampantly and finally what can we do? This paper attempts to gather information from diverse sources and analyze the nature, consequences and challenges of economic crises in a descriptive manner, in order to shed some light on the issues puzzling us these days.

The Nature of Crises. From Karl Marx's capital theory and Jevon's sunspot theory developed in the 19th century, to Hawtrey, Hayek and Fisher's monetary theory, Keynes' demand-side management and Lucas's rational expectation in the 20th century (Okposin and Cheng, 2000), many theories were built with an attempt to understand the nature of economic crisis so that the right prescription could be applied to prevent the recurrence of future crises. However, just like the complexity of the definition "crisis", the causes of crisis are no less complicated.

Economic crises evolved from different sources and are normally named after the cause of the crisis. For instance, the economic crisis in 1973 and 1975 was called the Oil Crisis as it evolved from a sudden and sharp increase in oil price due to the

abrupt cut of oil supply by OPEC. The oil price had increased by 127.6% for the period between January 1, 1973 and January 1, 1974 (Okposin and Cheng, 2000) and affected the world economy adversely, particularly the oil importing and industrialized countries, as high oil prices translated into high production costs, hence high inflation. Superhigh inflation rates caused panic and loss of confidence which led to contraction of major economic activities globally.

Another example is the Asian financial crisis which ruined most of the Asian economies in 1997 and 1998. It is called "financial crisis" as it is generally accepted that the crisis has its roots in the currency and banking sector. The crisis started when massive short-term capital flew from Thailand in early July 1997, causing the Thai baht to depreciate swiftly and squeezed liquidity in banking institutions. The panicking investors lost their confidence in the region and quickly withdrawn their capital from neighboring countries, adversely affecting other countries in the region, including Malaysia, Indonesia and South Korea. Besides the panic explanation, it is also believed that part of the reasons for the adverse change of expectation in these economies had to do with the deteriorated economic fundamentals and policy inconsistencies in these economies. Therefore, the crisis was an outcome of structural problems, policies failure and confidence deficit.

The current global financial crisis, erupted in the United States in the summer of 2007, resembled many facets of the Asian financial crisis, with the exception that the contagion effect is much larger and deeper as compared to the Asian crisis. The crisis is said to trigger from the subprime crisis and housing bubbles in the U.S. and spread rapidly to other parts of the world in a relatively short period of time. Careful examination of the development of global financial crisis reveals interesting chain effects.

Everything started because of the availability of excess liquidity in the U.S. economy before the outbreak of the crisis. From 2001 to 2004, the U.S. Federal Reserve adopted an easy monetary policy as a measure to restore the economy from 2001 recession (Kawai, 2009). Abundant liquidity plus foreign capital inflows led to lower costs of borrowing and induced households to borrow money for their spending. Most of the finances went to the purchase of houses, causing an overheating real estate market and the formation of housing bubbles. At the same time, sophisticated financial products, such as mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs) were invented for risk-appetite investors. Excessive risk taking activities and failure to detect the limit of these activities by regulators and rating agencies caused the system to be vulnerable to any unexpected events. When the housing prices started to decline after reaching its peak in mid-2006, default of subprime loan started to rise and affected other consumer credits, including prime loans (Kawai 2009). Many financial institutions were caught in the trouble of credit squeeze and started to face liquidity shortage. Loss of confidence and financial panicking exacerbated the situation further. As the global financial market is highly integrated, what had started out as a local crisis in the U.S. was quickly transmitted to the rest of the world. The effects of a domestic subprime crisis in the U.S. are spreading quickly across the globe to other asset markets and generating a ripple effect in the real economy. In short, the current crisis is a result of both the market and regulatory failures which led to confidence and liquidity crisis. International trade and capital flows

acted as the mediums to transmit the crisis from one country to another. Hence, the outcome is a global crisis.

Many factors contributed to the formation of a crisis. Any attempt to identify and explain the causes is demanding and sometime may prove to be futile. Globalization and financial liberalization made the effort more challenging as the waves of crises that go beyond the domestic economy are much more connected and complicated. However, a general examination of the above three recent crises and other economic crises happened in the past three decades revealed some common trends. Regardless the causes of a crisis, be it externally-driven or domestically-generated, oil shock, debt, currency or banking crisis, housing bubble or credit crunch, crisis may result from one or a combination of the following factors:

1. Imbalances in the economic system;
2. Policy failures.

Imbalances in the economic system. A stable economy is an economy that keeps a decent balance of all the forces operating in the economy. Some important forces that need to be kept in balance include saving and investment, consumption, circulation and production, trade and capital flows as well as economic activities and economic institutions (Kilmister, 2008; Tourres, 2003). Although not all imbalances are necessary bad, especially if imbalances are driven by productivity differences which reflect more efficient allocation of resources, normally when an economy is out of its general equilibrium, it gives opportunity for excessive leverage, risk-taking and speculative behavior to dominant the economy, causes uncertainty and loss of confidence on the "self-healing power" of an economic system. Once the confidence trap is formulated, any interruption in economic activities will result in a crisis.

Kilmister (2008) explained that the creation of crisis is the result of the "breaking-up of the interlocking set of arrangements that governed the economy" and the "contradiction within capitalism" which caused growing income inequality. When profits earned from production activities are not matching with profits realized from circulation and exchange in goods and financial markets, debt will be accumulated in household and corporate sectors. When the expected value of the debt does not meet with its actual value, bad debt results and lending is contracted, causing liquidity problem and squeezing credit, consequently, economic slowdown is inevitable.

Policy failures. Economic policies such as monetary and fiscal policies are used by governments to cushion any disequilibrium forces experienced in the economy. However, very often, while solving the existing problem, these policies have in turn become the source of the next immediate crisis. For instance, loose monetary policy, fiscal stimulus packages and financial incentives are useful in maintaining the stability of the economy, stimulate domestic demand, rebalance sources of growth and restore the confidence when the economy is in recession. Nevertheless, if not carefully managed, these policies may become the sources of economic turmoil. Policy failures due to lax monetary policy may create abundant liquidity and cause excessive risk taking, adverse selection and moral hazard activity in the economy and lead to unsustainable booms and bubbles in the economy, as what happened in the recent global financial crisis, while lax expansionary fiscal policy may create excessive government debts. Many reasons contributed to such policy failures. It could be due to inadequate assessment of economic problems and poor risks assessment, wrong pol-

icy responses, weak regulation and supervision and lack of policy coordination and, most importantly, lack of accountability for wrong decisions made.

Coping with Crises: Controversial Policy Actions. Monetary policy is playing an important role in fixing the economy after crisis, especially crisis caused by financial disturbances. Thus, the first set of policy responses is no other than implementing loose monetary policy to increase the liquidity of the economy. In fact, in the aftermath of the recent global financial crisis, central banks of crisis-hit countries responded by executing loose monetary policy to ensure the availability of liquidity in the financial markets at low level of policy interest rates. However, as argued by Khor and Kee (2008), "abundant liquidity and excessive, imprudent credit expansion" triggered both the Asian financial crisis and the subprime crisis, indicating that credit and money growth remains the key suspect of financial crises. Indeed, a number of studies have revealed that the monetary policy action in itself could become the activator for a serious recession (Khor and Kee, 2008). Therefore, a sensible effort in designing and implementing an effective monetary policy framework should be taken more seriously than any attempt to enhance the stability of financial sector, inflation and economic development.

The effects of financial crisis were transmitted internationally via the international financial system, which had resulted in seizing up of financial institutions and banks, the stock markets crash, credit markets froze and socio-political instability. In addition, household consumption was down, capital expenditures plunged, unemployment rose while international trade was collapsing, corporate bankruptcies were multiplying and global growth was contracted (Brummer, 2008; Shiller, 2008). Therefore, a second set of responses is related to implementation of various effective fiscal packages to cope with the adverse effect of the crisis and to ensure and enhance the long-term competitiveness in the world markets. For example, stimulus packages in China, Japan, Malaysia, Singapore, South Korea and Vietnam have exceeded 10% of GDP. As a consequence, these economies are on speedy recovery paths and already back to their precrisis growth rates after going through a short period of economic contraction (Grimes, 2009).

A third set of responses is related to the reforms in regulation of the financial system. Most crisis-hit countries have focused on stabilizing their financial sectors by strengthening their legal and financial market regulations, relaxing monetary policies, reducing key interest rates and minimum reserve requirements (IMF, 2009a; World Bank, 2009). These measures are aimed to prevent the collapse of domestic banking and financial institutions as well as to establish confidence among savers and investors. For example, Malaysia sets up the deposit insurance system in September 2005 administered by Perbadanan Insurans Deposit Malaysia (PIDM) in order to protect depositors and strengthen confidence in domestic financial institutions, Islamic and commercial banks.

A fourth set of responses to enhance close cooperation and coordination between governments, central banks, large financial institutions and financial sector regulators is crucial to bailout banks and financial institutions with financial support from governments. As soon as the financial crises occurred, central banks of major developed economies (like US, UK and Europe) and crisis-affected developing countries responded promptly and decisively to prevent a collapse of the domestic

banks and financial markets. For example, in dealing with the serious impact of the global financial crisis had on global economy, there were several meetings at the levels of finance ministries and heads of governments among the members of G-20. Simultaneously, some international financial institutions (IFIs) such as International Monetary Fund (IMF) and the World Bank intensified their operations and assistance to crisis-affected countries to ensure stability of their internal and external sectors.

A fifth set of responses relate to the resources, role, governance and representation of developing countries in international financial institutions such as the International Monetary Fund (IMF) and the World Bank. As revealed by Broome (2010, p. 37): "IMF experienced a slow-burning institutional crisis led by a decline in the organization's practical legitimacy, controversy over the distribution of voting power on the IMF's Executive Board, and widespread criticisms of the stringent policy conditions attached to IMF loans." These challenges have prompted developing countries to avoid compromising their economic sovereignty via IMF loan programs at all costs. Simultaneously, some developed countries (like the United States and the United Kingdom) sidelined the involvement of IMF in the formation of new global financial standards and regulations. In April 2009, however, the G-20 heads of government meeting in London agreed to increase the lending capacity of IMF from US$250 bln. to US$750 bln. Moreover, the Communique of the IMF's International Monetary and Financial Committee stated that it agreed to boost the organization's resources through the possibility of market borrowing (IMF, 2009b). Therefore, the IMF again emerged as an important external financial support for developing countries and emerging markets under financial distress.

Consequences of Economic Crises. The economic meltdown affects the livelihood of almost everyone. In this section, the effects of crises on important sectors of the economy, namely household, private sectors (banking and financial institutions), and global economy will be analyzed.

Household. The global financial crisis is hazardous as it disabled or distorted the main components of the financial infrastructure and instruments that Western countries depend on to allocate capital and manage risk efficiently. In addition, it led to increasing personal insecurity worldwide. During the period of financial crisis, the households are not only worried about losing their jobs, but they are also risking of losing their real property or houses (especially in the USA). Worse still, given the ballooning fiscal deficits, households are legitimately concerned about the erosion of their social security benefits and pensions.

In many crisis-hit countries, the crisis resulted in substantial redistribution of income and wealth, which has led to a rise in poverty. The high income group has experienced a fall in well-being resulting from the financial and wealth effects of the crisis. The low income group has probably not been influenced very much relatively – some might even gain if they have low income but their minimum expenses decreased resulting from the reduction in world food and energy prices. However, the lower and upper middle income groups might be the main victims of the crisis as their wages fell in real terms or they may have lost their jobs. Unemployment issue became the global major concern during global financial and economic crisis especially in the Group of Eight industrialized economies. As shown in Table 1, by the end of 2009, unemployment rate in most of the industrialized economies grew more than 7.0%. For

example, from 2006 to 2009, the unemployment rate in the United States was doubled, going from 4.6% to 9.3%.

Table 1. **Unemployment Rate in Selected Crisis-hit Countries (% of Total Labor Force)**

Country Name	2006	2007	2008	2009
Canada	6.3	6.0	6.1	8.3
France	8.8	8.0	7.4	9.1
Germany	10.3	8.6	7.5	7.7
Iceland	3.0	2.3	3.0	7.2
Italy	6.8	6.1	6.7	7.8
Japan	4.1	3.9	4.0	5.0
Portugal	7.7	8.0	7.6	9.5
Russia	7.1	6.1	6.3	8.2
United Kingdom	5.3	5.2	5.3	7.7
United States	4.6	4.6	5.8	9.3

Source: World Bank (2011), World Development Indicators 2011 CD-ROM.

Private Sectors: Banking and Financial Institutions. The global financial crises affected major financial institutions and investment banks domestically and internationally, and brought the massively over-levered financial structure tumbling down at global financial markets. As a consequence, a number of major financial corporations such as Morgan Stanley, Bear Stearns, Lehman Brothers, AIG (insurance company), and Merrill Lynch spiraled downward to the brink of insolvency or collapse. As these major banks and financial institutions hold the lines of credit for small banks and financial institutions, they will be forced to pull their lines of credit in order to survive when they find themselves in difficulty during the crisis period. This will lead smaller banks and financial institutions to fail (Okimoto, 2009). Hence, the collapse of major banks and financial institutions instigated panic among international investors and loss of confidence in international financial markets because of its extensive cross-border exposure to counterparty risk. According to the website of Mortgage Lender Implode-O-Meter, 286 major lending institutions in the US imploded since late 2006 and 14 are ailing and on the verge of collapse. As shown in Table 2, there is a great fluctuation in market value of the largest G10 banks during the crisis period. The loss in market values ranges from 62% and 327% in the UK and globally. Obviously, the consequences of the crisis were tough for financial markets globally as it substantially reshaped the contours of global finance.

Global Economy. The crisis-hit countries have been particularly vulnerable to the impacts of the global economic crisis. The crisis wreaked havoc with the IMF forecasts on the growth rate in the global economy (World Bank, 2009). The IMF predicted that the growth rate of the global economy in 2009 would be 3.8% in April 2008 and then revised this forecast slightly to 3.0% in October 2008. Within less than a quarter, the IMF had again revised its outlook, decreasing its prediction for global economic growth in 2009 to 0.5% and subsequently downgraded its estimate to -1.3% in April 2009.

Many countries around the world are not free from negative effects of the global economic crisis. For example, the countries in Central and Eastern Europe grew on average, by -5% and 1.8% in 2009 and 2010, respectively, compared with -2.5%

(2009) and 2.9% (2010) for Latin America and the Caribbean. The OECD countries contracted by 3.4% in 2009 and 1.3% in 2010. Nevertheless, the countries in Caucasus and Central Asia and Sub-Saharan Africa are slightly better than the countries in other regions, with an average economic growth rate of 1.3%-1.5% and 4.1%-5.1% in 2009 and 2010, respectively (see Table 3). In contrast, emerging economies in Southern and Eastern Asia continued to grow at positive rate of economic growth with 5.0% and 6.8% in 2009 and 2010, respectively.

Table 2. **Changes in market values of largest G10 banks (in US$ bln.)**

	2005	2006	2007	2008[a]
USA	-20.8	187.8	-358.1	-58.8
Japan	204.2	-49.1	-122.2	20.2
UK	-17.5	130.5	-108.4	-61.9
Switzerland	22	55.6	-44.5	-35.9
France	13.1	108.6	-31.6	-14.6
Sweden	0.7	26.7	-4.3	-4.3
Germany	14.8	34.3	-3.6	-7.6
Netherlands	0.1	0.5	0.5	-0.1
Belgium	20	54	5.5	-1.3
Canada	37.2	31.1	12.2	0.5
Italy	46.8	61.9	73.1	-19.7
G10 total	46.8	61.9	73.1	-19.7
Global	522.9	1225.2	-134	-327.3

Source: OECD, "The Recent Financial Market Turmoil, Contagion Risks and Policy Responses", Financial Market Highlights, May 2008.
Note: [a] Till 14 May 2008.

Table 3. **IMF Forecasts for Economic Development by Regions, 2008-2010**

World Regions	Real GDP Growth (% of GDP)		
	2008	2009	2010[e]
OECD countries	0.6	-3.4	1.3
Caucasus and Central Asia	6.6	1.5	5.1
Central and Eastern Europe	3.0	-5.0	1.8
Latin America and Caribbean	4.2	-2.5	2.9
Emerging economies in Southern and Eastern Asia	6.7	5.0	6.8
Sub-Saharan Africa	5.5	1.3	4.1

Sources: EC (2009); IMF (2009a, 2009c, 2009d).
Notes: [e] = estimate

Challenges. The economy that we experience today is much more complicated and integrated than the one we experienced a few decades ago. As the global economy moves towards globalization and most of the developing countries are embracing export-led growth strategy, global economy is more vulnerable to uncertainties generated from either the domestic or the international front. Any shock that started as a small local event could evolve into a major international crisis through various channels, particularly through trade and capital transmissions. As mentioned earlier, two major causes for crisis to happen are imbalances and policy failures. Therefore the main challenges are to manage two interrelated issues, uncertainties and imbalances.

There is a number of uncertainties to manage in today's economy. They arise from the risks associated with economic, societal, environmental, technological and/or geopolitical incidents. The underlying factor for these risks and uncertainties is "policy". The past few crises have highlighted that the failures in financial markets are the main reasons for the outbreak of economic crises. However, the root of the problem is not simply a matter of money; it is about the fundamentals of the economy and the quality of the institutions that build confidence in the economy. It is also about achieving quality growth, maintaining stable and sustainable growth, controlling of unexpected inflation, and containing moral hazard activities as well as to enhance transparency in policy-making and implementation. With politicking and distorted decisions being made while regulatory institutions are weak, the level of uncertainty increases. In the study aimed at examining the relationship between transparency and liquidity uncertainty at firm level, Lang and Maffett (2011) found that greater transparency is associated with lower liquidity volatility and higher firm value. Thus, the challenge is on creating quality institutions to ensure rational and consistent policy-making process as well as efficient and transparent implementation and monitoring of processes that take place in the global economy. Ultimately, creating and maintaining a required level of confidence in policy makers, institutions and the economy is necessary to create a stable and sustainable growth.

Due to changing ecological system and global environmental degradation, there are increasing constraints on production capacity. A key uncertainty that should not be neglected, which arises from environmental and climate change, not only caused energy prices to increase, but most importantly, escalating food and commodity prices led to greater uncertainty in future economy. Thus, it is predicted that future crises will result more from real economy rather than from financial markets. Thus, the challenge is in identifying ways to adapt to climate change and minimizing the adverse effects from environmental problems.

Furthermore, as we have seen recently, the imbalances between the profits earned in the real economy resulting from the production of goods and services and the profits earned at the financial markets explained the meltdown of financial market and the recurrence of financial crises over and over again. The financial crises reveal only the symptoms of the problem while imbalances explain the root of the problem. However, when dealing with economic imbalances, the real challenge lies in the difficulty to examine the nature of the imbalances. In addition, the nature of the imbalances changed over time and there are different interpretations to the nature as well as the consequences of the imbalances which led to different conclusions and the need and scope of policy action. A number of factors is needed to explain the evolution of imbalances over time. Moreover, the attempts to correct imbalances may fall into the problem of "disruptive adjustments" as the best policy option is often inobvious.

Conclusion. Today's headlines are occupied with news from economic crises. On the one hand, discussions on crises are going on; on the other hand, there is no ending to the debate on their nature, consequences and challenges, as well as ways to fix the problem and to revive the world economy. This paper provides a brief overview by collecting information from diverse sources and different schools of thought and by analyzing the issues from different perspectives in order to understand the problem

better. Overall, the main culprit of crisis is "confidence deficit". When the economy is caught in the confidence trap where people lose confidence in the economy, either due to imbalances of the economy or lack of confidence in its policy responses, it brings about uncertainty and panic reaction. The responses to loss of confidence deepened the problem further and caused a contraction in economy activity.

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