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Global Economic Crisis and Challenges

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Abstract. *A global economic and financial crisis affected the world by the increasing inflation and unemployment rate. It affects billions of people living in developing countries, these crises have strengthened the overall state of crisis comprised by propagate poverty and extreme poverty. The crisis had its origin in the richest countries, but it creates greater impact on emerging developing countries. The threatening crisis creates lot of social impact and visible effects such as slowing global economic growth, contracting world trade, job losses. It's important to analyze the global economic and financial crisis to find out the root cause of the emerging economic and financial crisis and provide possible solutions based on past available historical economic and financial crisis data.*

This economic and financial crisis comprises of key elements such as macroeconomic policies, financial-sector supervision and regulation, financial engineering, and the global activities of large private financial institutions. A key lesson from the global financial and economic crisis is that we need to rethink the policies for economic growth which have existed over the past few decades.

Keywords: economic and financial crisis, financial institutions, government regulations.

JEL Codes: E4, E5, F6, G2.

1. Introduction

In almost all countries economic recession has deep-rooted that led to mass unemployment and starvation of millions of people. The financial market meltdown during 2008 and 2009 was the result of institutionalized fraud and financial manipulation.

This crisis is deepening with the risk of disrupting international trade and investment. All major sectors of global economy are affected. Financial Crisis and recession is becoming very common nowadays.

People in different countries are starving as a result of global market. The price of essential commodities for living has shot up dramatically in the recent years globally. Globalization affected millions of people under hunger and starvation.

2. Background of Economic and Financial Crisis

The main reason for this is that banks create too much money, by making loans, in short periods and used them to push up house prices and speculate on financial markets. Lesser portion of the money that banks created went to business outside of financial sector. As Banks start to lend more money in property market house prices shoot up along with personal debts [Fig. 1]1

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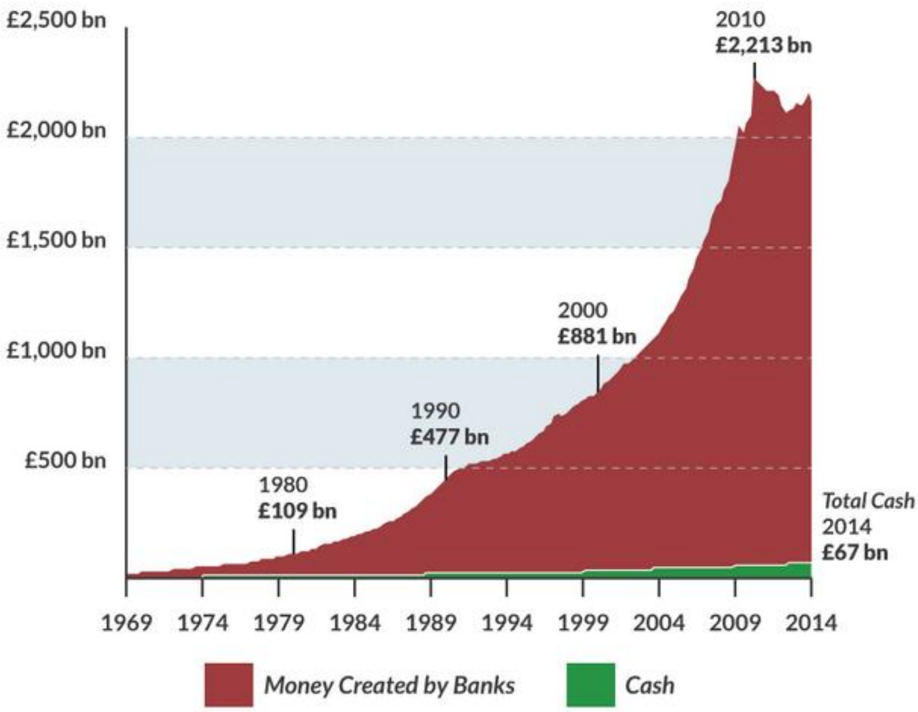

Fig. 1: Money lend by banks

Millions of people could no longer afford repayment due to Unemployment and they either tried for foreclosure on mortgage payments or walk away by returning keys to the banks. The effect of financial crisis was felt all over the world. This process caused financial crisis. [Fig. 2]

In the summer of 2008, the US financial sector suffered one of the most damaging events in its history. The volatile stock market, induced by the subprime market, led to the default of Lehman Brothers, and subsequently to a massive global crisis.

September 15, 2008—the date of the bankruptcy of Lehman Brothers and the takeover of Merrill Lynch, followed within hours by the rescue of AIG—marked the beginning of the worst market disruption in postwar American history and an extraordinary rush to the safest possible investments. Creditors and investors suspected that many other large financial institutions were on the edge of failure, and the Lehman bankruptcy seemed to prove that at least some of them would not have access to the federal government's safety net. Panic and uncertainty in the financial system plunged the nation into the longest and deepest recession in generations. The credit squeeze in financial markets cascaded throughout the economy.

As the housing bubble deflated, families that had counted on rising housing values for cash and retirement security became anchored to mortgages that exceeded the declining value of their homes. They ratcheted back on spending, cumulatively putting the brakes on economic growth—the classic "paradox of thrift," described almost a century ago by John Maynard Keynes.

After this, banks discourage offering loans and this slowdown in lending caused prices in property market to drop. Banks started to cut lending. This led to economic crisis.

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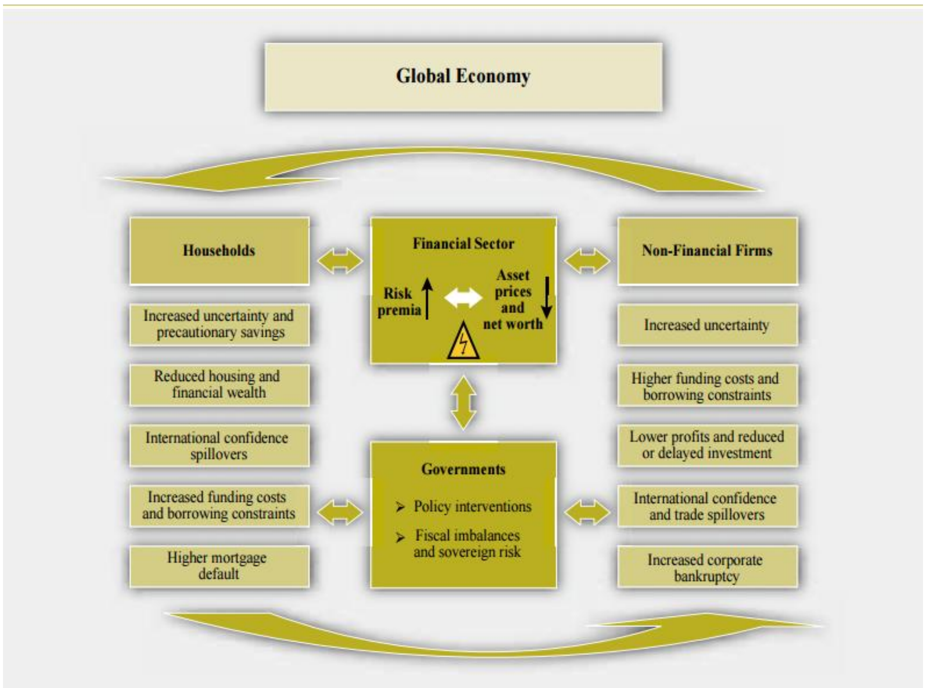

Fig. 2: The 2007-10 financial crisis: key trigger,propagations nd mplification mechanisms

Globally, interest rates have been extraordinarily low for an exceptionally long time, in nominal and inflation-adjusted terms, against any benchmark. Such low rates are the most remarkable symptom of a broader malaise in the global economy: the economic expansion is unbalanced, debt burdens and financial risks are still too high, productivity growth too low, and the room for maneuver in macroeconomic policy too limited. The unthinkable risks have become routine and being perceived as the new normal.

Thus, the financial factors played key role in triggering macroeconomic effects of the crisis are:

1. rise in overall financing costs within the financial sector for firms and households, and
2. the more general deterioration in asset markets beyond the US housing market.

Following a significant deterioration of conditions in the US housing market, a sharp increase in perceived default and liquidity risk precipitated a dramatic global re-pricing of risk. The result was an outbreak of turbulence in global money markets in August 2007; a development which signaled the onset of the financial crisis. [Fig. 3].

Although the financial crisis that began that time is a global crisis, and many countries – especially Europeans– have been affected by the financial turmoil.

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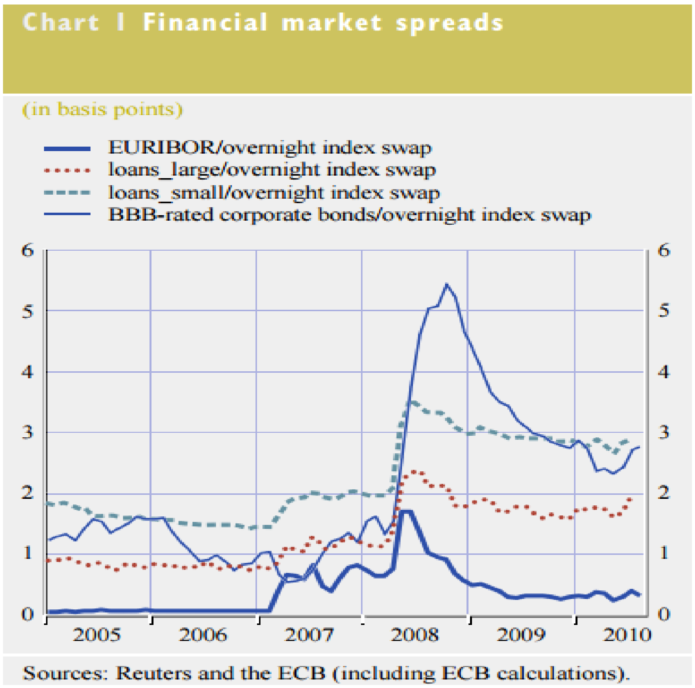

Fig. 3: Financial market spreads

Decline in stock and property prices worsened balance sheets of firms and reinforced negative dynamics associated with increased perception of risk and higher financing costs.[Fig. 4]

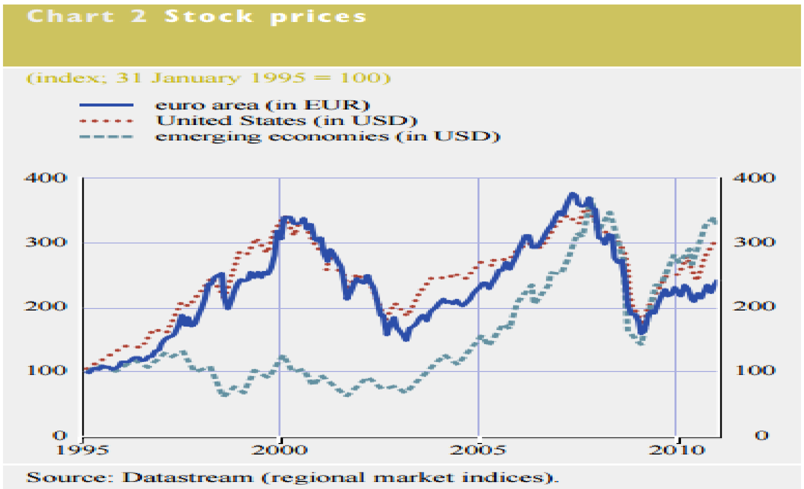

Fig. 4: Stock prices

2.1. Political Factors

Many governments have already fallen, and more will do so in the years ahead because of persistent unemployment and popular anger and distrust.

Concerning the process of deregulation –financial in particular and economic in general – in the US, we must point out that such process can be seen mainly as a political phenomenon brought about by – among other things– the increased power of giant banks and financial corporations, the resurgence of conservative

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thinking, etc. Besides tax reductions, the removal of price controls, and the curbing of collective bargaining rights and benefits of workers, the deregulation process began during the Carter administration and affected basically the financial, transport, communication and energy sectors, financial deregulation being the most important one.

2.2. Non-political Factors

Non-financial factors like generalized collapse in business and consumer confidence also play a significant role. The volume of Euro area goods exports declined on average by over 16% in 2009, compared with 2008.

As per IMF Global growth is set to slow this year to its weakest pace since the financial crisis as mounting threats from China to the Eurozone add to a long list of forces restraining the world economy.
The biggest worries are due to China's stock market turbulence and Greece's long festering debt.
The reason for Greece's economy issue is that the government gave maximum pension to public sector employees than their actual wages and it also favored business elites with tax-free status. Some of the state employees got their pay without actually going to work.

Profits as a share of business income are high in Greece, followed by Italy, France, Germany, USA and UK. In Europe Greece became the hardest place to start business.

Also, the demand for goods and services (actual GDP) was less than what the economy was capable of supplying (potential GDP). This output gap led to excess unemployment and idle productive capacity in business, which resulted in Recession.

The Central Bank plays an important role in achieving economic growth of a developing country through the various measures. The important issues that central banks face as a result of Economic Crisis are:

- to establish relationship between asset prices and monetary policy
- bring in effectiveness of standard interest rate instrument, and
- design of non-standard monetary policy measures such as credit support

2.3. Perceptions of economic recession

- Initial impact of recession and short/medium term actions taken in response.
- Changes to business strategy as a consequence of recession.
- Barriers to future business growth and development
- Initial impact of recession and the short and medium-term actions taken in response

3. Current situation

The world economy continues to grow at a modest pace. The growth of world gross product is projected at 2.8 per cent in 2015, accelerating to 3.1 per cent in 2016. The growth divergence between various regions is widening in 2015, owing to differing impacts from the recent decline in the prices of oil and other commodities, as well as country-specific factors. [Fig. 5]

Current account imbalances in major economies narrowed slightly in 2014, continuing the trend of the past few years. The decline in the prices of oil and other commodities has contributed to this process, leading to lower deficits in several large commodity-importers and smaller surpluses or even deficits in major commodity-exporters, notably Saudi Arabia and other Gulf Cooperation Council (GCC) countries. The strengthening of the dollar could, however, presage some widening of global imbalances in the outlook period, albeit not to the levels seen in 2006-08.

This recession is regarded as an opportunity to implement strategic change that would otherwise not have occurred. Most firms adapt under recession conditions through judicious cost/asset-cutting behavior and through investment in product innovation and market development.

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Growth of world output, 2013–2016, annual percentage change

Annual percentage change					Change from January 2015 forecast	
	2013	2014[a]	2015[b]	2016[b]	2015	2016
World	2.5	2.6	2.8	3.1	-0.3	-0.2
Developed economies	1.2	1.6	2.2	2.2	0.1	-0.1
United States of America	2.2	2.4	2.8	2.7	0.0	-0.4
Japan	1.6	0.0	1.2	1.0	0.0	-0.1
European Union	0.0	1.3	1.9	2.1	0.2	0.1
EU15	-0.1	1.2	1.8	2.0	0.3	0.1
New EU Members	1.3	2.7	2.8	3.2	-0.1	-0.1
Euro area	-0.4	0.9	1.6	1.9	0.3	0.2
Other European	1.4	2.1	0.5	1.3	-1.7	-1.0
Other developed countries	2.0	2.6	2.4	2.8	-0.2	0.2
Economies in transition	2.0	0.7	-2.0	0.9	-3.1	-1.2
South-Eastern Europe	2.4	0.1	1.4	2.5	-1.3	-0.5
Commonwealth of Independent States and Georgia	2.0	0.7	-2.1	0.9	-3.2	-1.2
Russian Federation	1.3	0.4	-3.0	0.1	-3.2	-1.1
Developing economies	4.7	4.4	4.4	4.8	-0.4	-0.3
Africa	3.3	3.3	4.0	4.8	-0.6	-0.1
North Africa	1.0	1.0	2.8	4.0	-1.1	-0.3
East Africa	6.5	6.4	6.6	6.7	-0.2	0.1
Central Africa	2.0	4.1	3.4	4.3	-1.3	-0.7
West Africa	5.6	5.8	5.8	6.2	-0.4	0.1
Southern Africa	3.2	2.5	2.9	3.7	-0.7	-0.4
East and South Asia	6.1	6.2	6.2	6.1	0.2	0.1
East Asia	6.4	6.1	6.0	6.0	-0.1	0.0
China	7.7	7.4	7.0	6.8	0.0	0.0
South Asia	4.9	6.3	6.7	6.9	1.3	1.2
India[c]	6.4	7.2	7.6	7.7	1.7	1.4
Western Asia	3.1	3.0	3.0	3.6	-0.7	-0.7
Latin America and the Caribbean	2.7	1.0	0.5	1.7	-1.9	-1.4
South America	2.9	0.6	-0.4	1.1	-2.3	-1.7
Brazil	2.5	0.1	-1.1	0.5	-2.6	-1.9
Mexico and Central America	1.8	2.3	3.0	3.2	-0.5	-0.6
Caribbean	3.0	1.8	3.1	3.7	-0.7	-0.1
Least developed countries	5.3	5.2	4.9	5.6	-0.8	-0.3
Memorandum items:						
World trade[d]	3.1	3.2	3.8	4.8	-0.7	-0.1
World output growth with PPP-based weights	3.1	3.2	3.4	3.7	-0.1	-0.1
Africa excluding Libya	4.0	3.8	4.2	4.8	-0.3	0.0
North Africa excluding Libya	2.8	2.6	3.5	4.0	-0.1	0.0

Fig. 5: Growth of world output - annual % change (2013 to 2016)

The crisis has highlighted the need to pay greater attention to the international dimension of economic analysis, especially in the context of highly integrated international financial systems and more closely integrated production processes.

Consumer spending is likely to grow just in pace with the economy. Few consumers are stretching beyond their incomes, and few are withdrawing from spending. As incomes rise, their spending rises at about the same rate.

4. Solutions

Serious efforts to reform the international financial system must consider the broad lessons of the current crisis for financial market regulation, specific steps to take to make future financial stability more likely, and the reshaping of the international financial system, including its architecture and governance, so that it better serves the needs of the underlying real economy. Such efforts should begin with the recognition that the social costs of financial instability on the emerging market and developing economies – and on the poor and the working classes more generally – are immense

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Situation and diagnosis: The US "subprime" financial market meltdown is having severe adverse social effects on the developing world. Nations with well-ordered and regulated economic, trading and financial systems have been brought into the turmoil through its second- and third-order effects. Thus the crisis is no longer a US-centered financial crisis, but a global economic crisis. A crucial part of the problem is the interaction between the financial system and the "real" economy during the downturn. The diagnosis is simple: existing financial market regulation is pro-cyclical, inconsistent, outdated and incomplete, deficient in its concern for banks' short-term liabilities and liquidity needs, and based on the erroneous assumption that one can trust the market's assessment of systemic risk.

Financial stability: To make future financial stability more likely, concrete steps must be taken to remove or at least abate the existing system's pro-cyclicality, bring every institution, market, instrument, and economy under a clear and simple system of regulatory control, address banks' liquidity needs, and aggressively control systemic, aggregate market risk and few other solutions as follows:

- Allow markets to work and bankrupt bad banks, whilst maintaining their institutional knowledge
- Co-ordinate a global interest-rate cut to almost zero. Inflate means to try and boost aggregate demand in the economy to create higher economic growth. For example, in a recession, the Central Bank could cut interest rates, print money or pursue quantitative easing. This leads to an increase in the money supply and can help to stimulate economic activity; it is also likely to cause higher inflation also makes it easier for the government to pay back its debt. In fact inflating away your debt is seen as a kind of a partial default. The government finds it easier to pay back debt and bond holders lose out because their savings are worth less.
- Temporarily fix exchange rates (implement capital controls. Devaluing exchange rate makes exports cheaper which helps boost growth. In the case of the Euro, one possibility is for Greece to leave the Euro and restore their own currency. This would lead to an effective fall in their exchange rates and help economy become more competitive.
- Create growth through an agreed global investment plan supported by the good banks and scaled to maintain effective demand.
- Reduce the risks of regulatory capture by a global regulatory authority
- Reform international company law and standards to reduce costs of decarbonizing the global economy. It refers to the decision by government to stop repaying part or all of its debt. This will make it difficult for government to borrow in the future, but it means they don't have to aggressively cut spending to reduce borrowing. When government borrowing as a % of GDP increases rapidly, it becomes quite difficult to control borrowing. In order to meet interest repayments, and reduce the debt burden, the government may be forced to pursue fiscal austerity (cut spending, increase taxes). However, cutting spending in a recession can make it worse. e.g. the attempts by Greece to cut spending have failed to reduce their budget deficit. The deficit continues to rise and it has created social instability; they are also likely to default anyway. A better option may have been for Greece to admit they were going to struggle to repay debt and default on their bonds earlier. It means investors in Greek bonds would lose some money. However, it gives Greece a chance to enable economic growth and in the long run this may be a better deal for bond holders.
- Governments should possess 'Tight' monetary policy and fiscal policy which will lead to cost cuts, higher taxes and also it reduces the level of government borrowing. e.g. many countries in the Euro area have been trying to solve their fiscal crisis by reducing government spending.

5. Conclusions

Any solution must take the social costs of the crisis as its starting point, because these are disproportionally affecting the developing countries, as well as the poor and labor more generally. A viable and stable global banking and financial system is a means to an end, not an end in itself, and the ends that

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matter are social. The merit of the banking and financial system should not be judged merely in terms of the stability that it promotes or in terms of the growth, innovation, and investment that it may encourage.

The systemic arrangements should also be judged in terms of how effectively they promote social justice. For this reason, representative global institutions – not ad hoc groupings without democratic legitimacy must be at the center of any reform effort. The IMF, BIS, and other related bodies may have a role to play in the new system, but proposals that lack democratic legitimacy will go nowhere.

Finally, these reforms must necessarily establish a new balance between the economic and the political, a new balance that favors the democratic state over the financial market, the public interest over private gain, and an accountable government over unaccountable speculation.

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