FINANCIAL CRISIS AND ECONOMIC COLLAPSE

Haris MUMINOVIC[1]

haris.muminovic@ibu.edu.mk

Abstract

The beginning of the world financial crisis from 2008 until today, continued with the global health pandemic Corona 19, caused a financial collapse at the world level and caused a large percentage of unemployment and indebtedness of the Government to the International Monetary Fund and the World Bank. This short scientific paper will point out all the phenomena and facts in the financial world forwarded with legal norms and regulations.

A financial crisis is generally defined as any situation where significant financial assets – such as stocks or real estate – suddenly experience a sharp decline in value. They are often preceded by periods of economic boom and overextension of credit to borrowers. Economic recessions that follow a financial crisis are usually significantly more severe than recessions that are not preceded by a specific financial crisis.

Sovereign debts are debts taken up by a government to finance capital-intensive infrastructural projects. However, when the government takes on too many debts and is unable to pay principal and interest obligations when they fall due, it increases the risk of defaulting on its existing debt obligations and going bankrupt.

A global currency crisis involves the loss of value of a major currency that is used in cross-border trade transactions between individuals, corporations, and governments. For example, the US dollar is used as the world reserve currency in the Bretton Woods institutions, which means that if the US dollar depreciates in value, it may trigger a global economic crisis.

Key words: Financial Crisis, Ecominic Collapse, Capital Contorls.

What is a Financial crisis?

A financial crisis is defined as any situation where one or more significant financial assets – such as stocks, real estate, or oil – suddenly (and usually unexpectedly) loses a substantial amount of their nominal value. Common examples of a financial crisis include financial market crashes – either widespread or within specific industries – housing market crashes and bank runs. A bank run happens when large numbers of bank depositors panic and seek to withdraw, all at once, all their funds on deposit with their bank. In the United States, over the past couple of centuries, financial crises of one sort or another occur roughly every 25-30 years. Recent examples include the Global Financial Crisis of 2008 and the dot-com speculative bubble bursting around the turn of the century.

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[1] Haris Muminovic is an assistant professor at the International Balkan University, Faculty of Law, Department of Legal Studies.

crisis. While various financial crises differ in both their nature and their severity, there are some common conditions that typically accompany such crises.

One is that a financial crisis is often preceded by, accompanied by, or followed by periods where there are widespread credit problems. The 2008 Global Financial Crisis was no exception. It was largely precipitated by a massive boom in subprime mortgage lending, which created a large stack of mortgage loans that were virtually doomed from the start to end up in default.

Subprime mortgage loans are loans granted to homebuyers with relatively lower credit scores – in short, large loans given to people who are likely to encounter difficulty making the loan payments. According to several studies of financial crises, the rapid expansion of available credit, followed by a shorter period of sharp credit tightening, frequently provides an early warning indication of a coming financial crisis. Financial crises are nearly invariably followed by a period of severe credit tightening, where lenders seek to curb their risk exposure by only extending credit to borrowers with stellar credit ratings.

Another fact about financial crises is that although they don't happen very frequently, they do seem to occur with relative regularity. Over the past century and a half or so, the United States has experienced on average, some type of financial crisis about once every 25 to 30 years. However, the most recent history shows financial crises arising a bit more often. The U.S., for example, suffered a major stock market meltdown in 1987, then the dot-com bubble in the early 2000s, and then the 2008 Global Financial Crisis.

Financial crises are often difficult to foresee, and one reason is the fact that the triggering cause may be a relatively small event or series of events. For example, the dot-com bubble that happened around 2000-2002, while it was cataclysmic for many investors in the rapidly growing tech industry, initially involved a relatively small proportion of the overall stock market. Despite the failure of numerous companies, several dot-com companies, such as Amazon and Google, enjoyed massive growth in the ensuing years.

Finally, a financial crisis commonly leads to a notably severe period of overall economic recession. An economy's gross domestic product (GDP) typically declines by up to 50% more during a recession that follows a financial crisis, compared to a "normal" recession that is not preceded or ushered in by a particular crisis.

The Next Financial Crisis?

The world may be on the verge of another major, global financial crisis in the wake of the Covid-19 pandemic (if we're not already in one). However, it's difficult to see, as of mid-2020, what the ultimate economic consequences of the virus and the widespread quarantine lockdowns may be. It is, in part, because many lenders are currently practicing credit forbearance – that is, not pressing debtors who are falling behind in making their loan payments.

Therefore, the true level of financial distress experienced by many companies and individuals may not have reached its full effect. Many market analysts warn that, thus far, we've only seen the tip of the iceberg in terms of both corporate and personal bankruptcies – that there are likely many more to come.

Secondly, governments are doing everything they can think of to prop up their economies. However, while most governments are pledging to do "whatever it takes," their extraordinary efforts cannot be sustained forever. Although interest rates remain, for the moment, at record-low levels, there are already signs of lenders in the U.S. beginning to tighten up on credit. A severe credit crunch in the not-too-distant future is certainly not out of the question.

What is Economic Collapse?

Economic collapse refers to a period of national or regional economic breakdown where the economy is in distress for a long period, which can range from a few years to several decades. During periods of

economic distress, a country is characterized by social chaos, social unrest, bankruptcies, reduced trade volumes, currency volatility, and breakdown of law and order.

Due to the magnitude of the economic distress, government interventions for economic recovery can be slow to bring the economy back on track, and the delay causes even greater disorganization of the economy.

Causes of Economic Collapse

The following are some of the causes of economic collapse:

Hyperinflation

Hyperinflation occurs when the government allows inflationary pressure to build up in the economy by printing excessive money, which leads to a gradual rise in the prices of commodities and services. Governments resort to creating excess money and credit with the goal of managing an economic slowdown. Hyperinflation occurs when the government loses control of the price increases and raises the interest rates as a way of managing the accelerating inflation.

Stagflation

Stagflation refers to a situation in which the economy is growing at a slow rate while simultaneously experiencing high rates of inflation. Such an economic situation causes a dilemma among policymakers since the measures implemented to reduce the rise in inflation may increase unemployment levels to abnormally high levels. Stagflation and its effects on the economy may last for several years or decades.

For example, the United States experienced stagflation from the 1960s to the 1970s. During said period, economic growth was stagnant, and the inflation peaked at 13% per annum while the inflation rate in the United Kingdom was at 20% per annum. Once stagflation occurs, it is usually difficult to manage, and governments must incur huge costs to bring balance to the economy.

Stock market crash

A stock market crash occurs when there is a loss of investor confidence in the market, and there is a dramatic decline in stock prices across different stocks trading in the stock market. When a stock market crash occurs, it creates a bear market (when prices drop 20% or more from their highs to hit new lows), and it drains capital out of businesses.

Crashes occur when there is a prolonged period of rising stock prices, price earning ratios exceed long-term averages, and there is excessive use of margin debt by market participants.

Scenarios that Define an Economic Collapse

The following are some of the things that characterize an economic collapse:

- Rising interest rates

During periods of economic collapse, interest rates peak at abnormally high levels, and it limits the amount of money that is available for investors to invest. High interest rates hinder economic growth since investors, corporations, and the government find it costly to service existing debt obligations and take out new loans due to the high cost of capital.

When a major company declares its inability to finance its debt obligations and resorts to disposing of its assets to pay creditors, investors lose confidence in the company and will be hesitant to trade their money

during periods of financial distress.

- Sovereign debt crisis

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A sovereign debt crisis occurs during periods of slow economic growth, wars, political instability, drought, and when investors lose confidence in the government. Due to the large size of sovereign debts, a default by the government is likely to affect the global economy and cause spill-over effects on other jurisdictions.

- Local currency crisis

A local currency crisis occurs when the currency depreciates in value due to a loss of investor confidence. This occurs when foreign investors who have invested in a country and advanced credit to the government lose confidence in the government's ability to meet debt obligations or generate the agreed-upon returns.

In such situations, the foreign investors withdraw their investments in the country. The move increases the selling of the borrowing country's currency in the international market, resulting in currency devaluation. In return, the currency devaluation increases the country's international debts, resulting in the loss of the country's purchasing power.

Global currency crisis

A global currency crisis involves the loss of value of a major currency that is used in cross-border trade transactions between individuals, corporations, and governments. For example, the US dollar is used as the world reserve currency in the Bretton Woods institutions, which means that if the US dollar depreciates in value, it may trigger a global economic crisis.

What are Capital Controls?

Capital controls are measures taken by either the government or the central bank of an economy to regulate the outflow and inflow of foreign capital in the country. The measures taken may be in the form of taxes, tariffs, volume restrictions, or outright legislation. They may be applicable to the whole economy, sector-specific, or industry-specific. The controls might be duration-specific, too (short-term, medium-term, or long-term flows). They affect the appreciation or depreciation of currency exchange rates, and equity and bond markets.

Capital controls are generally used to restrict access to foreign assets by domestic citizens or prevent foreigners from purchasing domestic assets. The former, where domestic citizens face the restriction, is known as capital outflow control. On the other hand, when foreigners face restrictions, the controls are known as capital inflow controls. It is generally seen that the controls are stricter in developing economies due to the vulnerability and volatility of their capital reserves, which are lower as compared to those maintained by developed countries.

Importance of Capital Controls for developing economies

Capital controls play a vital role in the development of a developing economy. The inflow and outflow of foreign capital in and out of an economy is a major aspect of globalization. At the same time, these inflows and outflows significantly affect the appreciation and depreciation of a country's currency, as foreign exchange reserves are directly affected. Hence, the management of such flows is an essential policy measure for the government and central bank. The main purpose of capital controls is to reduce the

volatility of currency rates in the economy and provide support and stability to it by shielding it from sharp fluctuations. Major disturbances in the flow happen from capital outflows, which lead to a rapid depreciation of the domestic currency.

Real-world Examples:

- India

Owing to a rapidly weakening currency in 2013, the Reserve Bank of India imposed capital outflow controls. Direct investment in foreign assets was reduced to one-fourth of the original. The limit on overseas remittances was reduced from $200,000 to $75,000 and special permission had to be obtained from the central bank for any exceptions to be made. The RBI excluded US dollar deposits from its reserve requirements, thereby incentivizing commercial banks to raise more deposits. All these measures were relaxed once the currency showed signals of stability.

- Argentina

The government of Argentina had been draining its foreign exchange resources since 2001-02 to make foreign payments and, by 2011, it reached a point where it could not sustain the practice any further. As a result, the government imposed strict capital controls. Argentina imposed strict restrictions on the purchase of assets by non-residents. Exchange houses and banks underwent strict monitoring. Inspectors were appointed specifically to oversee the implementation of these rules. Also, insurance and mining and oil companies were asked to return assets they held abroad. These capital controls were slowly relaxed in 2014.

- Russia

Following a sharp fall in the value of the Russian ruble against the dollar, the country's government introduced certain capital controls. Large, state-run exporting companies were asked to maintain their foreign exchange assets at a certain specified level and weekly reports were sent to the central bank. Currency trading was strictly monitored by newly appointed supervisors.

- Iceland

After the collapse of Iceland's banking system in 2008, the government introduced capital controls to stabilize the economy. The three main banks – Glitnir, Landsbanki, and Kaupthing – held assets that were ten times more than the GDP of Iceland. Investment in foreign assets was abandoned and even currency exchange for tourist purposes was strictly monitored.

- Greece

This is the most recent example in the world of capital controls. Greece introduced capital controls in 2015 when its bailout extension period came to an end. The European Central Bank did not agree to extend the level of Emergency Liquidity Assistance, which had been extended as support to Greek banks. As a result, the country's government was forced to halt the operations of commercial banks in the country for about 20 days. Heavy controls were put on bank transfers from Greek banks to foreign banks and a limit on cash withdrawals up to 60 euros was put in place. If not for the controls, the Greek banking system was close to collapse.

Monetary policy is an economic policy that manages the size and growth rate of the money supply in an economy. It is a powerful tool to regulate macroeconomic variables such as inflation and unemployment.

These policies are implemented through different tools, including the adjustment of the interest rates, purchase or sale of government securities, and changing the amount of cash circulating in the economy. The central bank or a similar regulatory organization is responsible for formulating these policies.

Expansionary Monetary Policy

This is a monetary policy that aims to increase the money supply in the economy by decreasing interest rates, purchasing government securities by central banks, and lowering the reserve requirements for banks. An expansionary policy lowers unemployment and stimulates business activities and consumer spending. The overall goal of the expansionary monetary policy is to fuel economic growth. However, it can also

possibly lead to higher inflation.

Contractionary Monetary Policy

The goal of a contractionary monetary policy is to decrease the money supply in the economy. It can be achieved by raising interest rates, selling government bonds, and increasing the reserve requirements for banks. The contractionary policy is utilized when the government wants to control inflation levels.

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