# THE CAUSES AND CONSEQUENCES OF GLOBAL CRISIS

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Abstract

Process of greater interdependence which today is called globalization is multidimensional and complex phenomenon, which summarizes the intense political, social and economic interactions at both national and above the national level. Unstoppable process of globalization of world economy, accompanied by liberalization and deregulation in recent decades largely contributed to the outbreak and spreading global financial crisis, whose shape is manifested in the financial sphere striking them directly to financial institutions, soon to be transferred in the real sector. The aim of the research of this paper is consideration of the implications of the current economic crisis, as the most difficult economic crisis after that of years1929-1933, under the world economy and the role of the process of economic globalization into dinamization of the crisis. The results of the survey suggest on the fact that long-term effects of the crisis in the financial sector inevitably imply increased budget deficits, cumulating public debt and increasing pressure on interest rates. Long term effects of the crisis on the real sector are still uncertain. Despite the recovery of the U.S. economy, increasing of global output is likely to be weak in 2010 (the point of experience episodes of recession, accompanied by financial crises, by which the collapse of production usually takes two years), while the new trade protectionism which represents reality in the globalized world raises obvious contraction of the international trade.

## Introduction

Globalization as a process includes the entire spectrum of economic, ecological and social interdependences through a "cross border" transactions. These processes are supported by advanced telecommunications, information systems and transportation and also the spread of new technologies (satellites, computer networks, etc.). In the economic context globalization is manifested through the effects of trade liberalization or free trade. Certainly, the process of global integration basically incorporates economic and technological changes. Basic forms of manifestation of globalization are financial, investment and trade processes, and the basic strategy of its realization is both local and global, for reasons that it is a prerequisite for unifying the international standards of economic behavior. Looking for a genesis of the crisis, the answer may be required in the direction that they (the crisis) are inherent in market economies and they occur because of the hesitation in economic cycles. Global financial system as a segment of the global environment, is not immune to periodic financial crises, by which the most characteristic is the current crisis as the deepest financial crisis after the Great Depression and which push the global economy into recession.

## Economic globalization as a process of universalization, homogenization and unification of the world economy

Economic globalization is accompanied by highlighted interdependence of national economies arising from the imposed range of international exchange of goods and services, international movement of the capital and high rates of development of the technology. Key drives of the process of economic globalization are technological change, liberalization of international trade and investment in national economies. In that sense particular factors have affected, and that[1]:

- The growth of world output.
- The rapid growth of the global market.
- The emergence of the so-called Asian tigers - whose creation presents a global process of economic and technological progress and prosperity of the East and the weakening of the West.
- Acceleration of international flows of goods and capital.
- Strengthening of transnational companies - that do fulfill their power through control of market goods and services, financial markets and market information.
- The growth of foreign trade- by which is especially increased the export of goods where it stands out the information equipment, oil, gas, agricultural products, etc..

Economic globalization is accomplished in parallel with denationalization and liberalization of trade and financial flows, with the emergence of new forms of merging the various companies and buying other companies (which represent a way of survival and

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[1] http://www.worldpolicy.org/projects/trade_equity

strengthening of international competitive ability), and the emergence of global innovation boom in information and communication technology and transportation.

There are several ways in which occurs the economic globalization and they are: financial globalization, the globalization of markets, creation of global companies and banks, liberalization and standardization of production, the institutionalization of world trade and international economic relations, the emergence of global systems of communication and mass media etc.. The main promoters of economic globalization are transnational corporations, transnational banks, international financial centers of power, international and regional organizations.

## The global financial crisis and its characteristics

The world today is faced with the most difficult economic crisis after the one from year 1929-33. The crisis again, as in the year 1929 first appeared in economically the most powerful country in the world (USA). Initially it manifests itself as a financial crisis initiated by highly risked mortgage loans, and seemed to be relatively quickly defeated by an aggressive monetary policy of the United States' Central Bank and with strong liquidity injection by central banks of the other developed countries. But such reaction did not bear fruit. Highly risked mortgage loans first created problems in the secondary market of home loans, then other markets securities, which threatened the safety and liquidity of financial institutions and definitely caused turbulence in the real sector of the economy, i.e they knocked down the world economy into recession.

In contemporary economic literature are made a number of parallels and comparisons and are carried out similarities and differences between the two serious economic crises, the one from years 1929-1933 and the current crisis of the year 2008. Generally speaking, this crisis has shown that increasing financial sector - understanding the traditional banks and the growing importance of parallel financial system consisting of non-banking intermediaries and the banks in shadow (off-balance sheet entities) - became very different than in the past. Causes of global economic crisis are segmented into several groups. In the first line, unbalance expressed in the global economy through changes in relative economic power among different regions and countries. Some Asian countries (China and India) realized the last decade a high rates of economic growth. The rate of national savings in China in year 2008 was 59% as a percentage of GDP and results in real investment boom, i.e. the level of investment in China in year 2008 as a percentage of GDP was 31.8%[2] Suficitits in payments balances have been traditionally present in Germany and Japan, and excess of liquidity in the member countries of OPEC, while the U.S. and Britain for years are creating deficits and have low rates of national savings. Excess liquidity in the countries which have created great wealth was directed in the form of various types of investments in the U.S.A. and other high developed countries and thus the huge inflow of capital was the starting basis for creating the initial conditions of the credit boom and for formation of bubbles in the U.S.A. economy and in other high developed states. Credit expansion was helped by expansive monetary policy especially in the U.S.A. where the interest rates reached a record low level- only 1%. Demand for

[2] Taki Fiti: Phenomenology of economic crises, Faculty of Economics, Skopje, 2009, pp. 257

housing in the United States grew much and the prices of apartments and other real estate began to grow dramatically. Makers and the main protagonists of the financial invention that operated in the direction of relaxing the restrictions in respect of borrowing and artificially reducing the initial cost of approved loans, approved mortgage loans for people with dubious credit's capability and low financial education under the assumption that prices of flats and other real estates will continue to grow.. However, the large drop in real estate prices marked the shooting bubble and with that the current value of real estates was very low compared with the high value of mortgage debt. Credit expansion ran into its own limits and the financial crisis was unavoidable.

On the other hand in the last two or three decades, major players in financial markets are so-called institutional investors: pension funds, insurance funds, investment trusts, investment banks, banks in shade and others that have a large amount of temporary free funds which invest in securities (stocks and bonds) in order to be fertilized. When it comes to the markets of shares and bonds, it is important to potential investors to have good information on economic and financial performance of companies wishing to invest (which they want to buy shares or bonds). Despite the great importance of regulation for the successful functioning of financial markets and institutions, the massive wave of deregulation and privatization of economic activity in the period after 1978 has affected financial systems of modern economies. Regulation in the U.S.A., and in many other countries is fragmented among a number of regulatory agencies responsible only for different segments, but when it comes to investment banks, dealers with non-banking derivatives and other, characteristic is that they never subject to regulation. These unmonetary financial institutions have caused fundamental changes in the structure of the U.S.A. financial system and as a result of "institutional insanity "of financial institutions and investors for a quick and easy earning high profits, had experienced a financial crash.

The crisis which emerged in 2007 with more specific signs began as a crisis in the U.S.A. mortgage market. It started so that some purchasers of securities based on mortgages could not be converted into cash, as a most quality shape, and then that amount of worthless securities to rise sharply. It is a question of financial derivatives in three types, which are conventionally marked as MBS (mortgage-backed securities), CDO (collateralized debt obligations) and SIV (structrual investment vehicles).

In early 2007 the crisis manifests itself as difficulty in one of the parts of the financial sector, that is arising from three sources, and they are mixing of this state in the part of the housing market, the policy of FED and stimulation of business bankers.

Remains the dilemma of whether and how much would it be possible to avoid this crisis? Certainly, the crisis that began in 2007 hardly would get such depth measurements provided the state with its regulation has not encouraged and deepened. It does not made it directly, but indirectly through a system of incentives, after which funneled behavior of a part of business actors. If the state does not make the banks to invest in non-standard loans, the crisis would not have appeared. On the other hand, if the state would not broadcast more money, it would be hard the bubble to amounte these proportions. Furthermore, if the state via *Fanny* & *Freddie* has never appeared as a guarantor of loans, surely it would not contribute to the spread of moral hazard and negative selection. But whereas the state with the wrong incentives got into the creation and deepening of the crisis, it now with financial intervention is trying to return things to the previous condition, in that condition from the time when they functioned. The state practically tried to establish the economic *status quo ante*. But the attempt to establish the *status quo ante* is accomplished with the wrong allocation of resources which exactly constitutes a source of problems. In that case, of course, what was a source of problems may not be the solution. A solution consists of a new allocation of labor, capital and other available resources.

**Collapse of world trade as a consequence of the global financial crisis**

The collapse of global demand as a result of the biggest economic crisis in the last decades has resulted in a reduction of exports on average about 9% in 2009, in developed countries with regard to the largest contraction in exports in the period from WWII.[3] Newer predictions of leading institutions point to a contraction in global world output of 1 to 2% in 2009.

A preliminary assessment of the WTO, the growth of world trade by 2% in 2008 is significantly less than the prediction that it will be the hot growth of 4.5% in 2008.[4] This was due to unexpected and very sharp decline in global production in the fourth quarter of 2008 year. Expectations for the state of trade in 2009 are largely conditioned by the financial crisis that began in 2007 in the USA. The crisis dramatically intensified after the collapse of investment bank "Lehman Brothers" in September 2008, when the U.S. government made attempts to save a number of financial institutions in the U.S. and elsewhere. Tectonic relocations in the financial sector and credit shortages cruelly swept in the real sector. The decline in prices, the sudden drop in production and demand are transformed into dramatically reduce and in some cases negative growth in production and trade in many countries. Trade is also affected by the strict credit limits for financing imports and exports.

Restrictive trade policies i.e protectionist measures taken by states in terms of the global economic crisis result in a contraction of trade between countries, causing even greater prolongation and deepening of the economic crisis. Many governments confirm their intention to keep markets open, but still the monitoring of the WTO indicates significant risks. Application of protectionist measures are opposed to multilateral trade agreements within the WTO. According to WTO, the channels of trade must remain open despite the real economic catastrophe.[5] Globalization of the world economy and the growing interdependence of economies entails applying of less expressed protectionism in some other crises. The new trade protectionism involves application of legitimate safeguards to protect domestic industries and employment affected by the global economic crisis. In the group of these measures are classified: taking anti-dumping measures,

[3] http://www.wto.org/english/news_e/pres09_e/pr554_e.htm

[4] http://www.wto.org/english/news_e/pres09_e/pr554_e.htm

[5] http://www.wto.org/english/res_e/booksp_e/anrep_e/world_trade_report09_e.pdf

allowing subsidies and applying some subtle measures such as nontrade barriers. The biggest danger occurs because of excessive use of these measures by trading partners.

Although the crisis began in the U.S., financial institutions and economies in developed and developing countries are severely affected. Deteriorating of the economic situation reduces consumer's confidence and business and produces a negative feedback between the financial sector and the rest of the economy.

Collapse of trade in 2008 was terrible and it is necessary to adequately understand the reasons which caused the same.[6] There are several reasons that determine the restriction of trade. One reason is the fact that the fall in demand is much more widespread than in the past where the economy is slowing at a time in all regions of the world. The era of excessive consumption by Americans who moved the growth of world trade is done and prevails reduced spending of U.S. consumers who mostly spent their money outside their country, but now they repaid debts and essentially save more than before.

The second reason relates to the increasing presence of global supply chains in the total trade. Global corporations are multinational companies with a strategy for integrated global production and delivery. This supply chain is the key to global integration. This is part of a major transformation that comes from information and communication technology revolution. While globalization and technological advances in global supply chains have made all countries more dependent on trade, all that had much smaller effect on global GDP. Different degree of impact on global GDP and world trade offers an explanation of why the world trade registered a faster decline. Trade is no longer a simple transaction between two countries, but it involved a complex network between the countries in which each contributes differently to the process of preparation of the final product. When consumption falls, less is produced, and world trade falls faster than global GDP.

That is, the growing role of China in world trade illustrates this. When the U.S. economy was in expansion, increased spending led to higher imports because the U.S. has not increased production, but relied on cheaper supply from Asia, which increased its dependence on imports. Japanese companies, meanwhile, among others, joined to build factories in China because of cheap labor. Japan exported capital goods in China to build factories, then exported components that were an integral part of the production of finished products in factories in China, for the finished products manufactured are exported to consumers in the United States. Value added in China is 50% of the total value of exports in the U.S.. If Japanese companies manufactured all at home and exported manufactured goods in the U.S., the value of Japanese export will be the same as Chinese export, but overall trade will reduce the value of capital goods and components necessary for production of finished products that will not be exported from Japan to China.

Meanwhile, newly factories in China allow employment, while increasing of production and export lead to higher trade surplus. As its economic growth is growing and domestic liquidity is increasing, China invested a lot in infrastructure and real estate, for

[6] http://www.international-economy.com/TIE_Sp09_WorldTrade.pdf

which used the resources that are imported from countries that are rich with such resources. But now, the global economic climate is changing i.e. the world trade is in collapse and that is as a result of limiting spending of American consumers.

The third reason for the restriction of trade is precisely the lack of funding for trade implementation. Although production also requires some degree of external financing, its dependence is much smaller than it is the case with trade and the fact when funding is reduced, trade reacted much strongly than global output. This is a very big problem, and therefore encounter the same attention by the international institutions and governments. For this purpose, the World Trade Organization plays a key role in establishing business contacts and providing accessibility to finance trade.

The fourth reason that contributes to the restriction of trade is protectionism. Any increase of protectionist measures results in endangering the possibilities for renewal and also with the continuation and deepening of the crisis. Therefore, all countries especially the G-20 and the other in a gesture of goodwill in respect of the G-20 should accept a proposal by Washington and London to avoid new protectionist measures. This must include all those who technically apply the rules of the World Trade Organization and other trade agreements. All countries should also respect the obligation of the G-20 to avoid the competitive devaluations of currencies that are actually an attempt of trying to escape from crisis.

Financial turbulence, speculative forces that affect the food prices and oil and the apparent failure of the foreign exchange markets in relation with exchange rates, are reflecting a shift in the international competitiveness of countries and indicate that there is an urgent need to redesign the existing system of global economic management.

## Conclusion

The process of acceleration of the economic cycle, in terms of global economic crisis on a global scale is very slow. Undoubtedly, this crisis has hit hard economically developed countries, with few exceptions, a softer hit emerging economies (growing economies), primarily due to their shallower and less diversified financial systems. Negative effects of the crisis in the field of finances were terrible as a result of what came to cumulating the huge losses, on different bases at the banks, from the collapse of big banks, to stopping of lending and to practically complete destabilization of the financial systems of industrialized countries. The world's largest exporters (USA, Germany, Japan) experience a substantial contraction in exports, which directs to closure of their markets for products from the countries in rising. Economic globalization, development, diversification, complexity of the international financial system and the rapid transmission of crises from country to country, forced the leaders of economically most developed countries in the world, as well as those of growing economies, to take joint coordinated action to rescue the global economy. Recent experiences of distribution of the financial crisis and the capture of the entire global economy, should be sufficient reason to reconsider the role of state intervention and its impact on the market at both national and international level. One of the reasons for the current situation in the global economy is the short term of the system of global economic governance, and especially the lack of coherence between the international trading system which is driven by internationally defined rules and regulations and the international monetary system, which is not.

What more should be done to overcome the crisis? There is an opinion that the solution is in a new allocation of labor, capital and other resources. Of course, that to this will come after settling the cost of adjustment. The choice only would be whether that cost to be paid immediately or later. With state intervention in the U.S. and other countries, the first option come out of the electoral opportunity. What remains is that the cost will be first paid through a prolonged crisis, or a crisis with two bottoms and then through inflation. According to U.S. economist Nuriel Rubin (the man who gained a worldwide reputation after accurately announced current global financial crisis), there will be another crisis, financial, and even after it starts recovery of the global economy.

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