University for Business and Technology in Kosovo

UBT Knowledge Center

UBT International Conference 2021 UBT International Conference

Oct 30th, 12:00 AM - 12:00 AM

Types of financial and economic crisis

Burhan Rexhepi
University for Business and Technology - UBT, burhan.rexhepi@ubt-uni.net

Follow this and additional works at: https://knowledgecenter.ubt-uni.net/conference

Part of the Business Commons

Recommended Citation

Rexhepi, Burhan, "Types of financial and economic crisis" (2021). *UBT International Conference*. 559.
https://knowledgecenter.ubt-uni.net/conference/2021UBTIC/all-events/559

This Event is brought to you for free and open access by the Publication and Journals at UBT Knowledge Center. It has been accepted for inclusion in UBT International Conference by an authorized administrator of UBT Knowledge Center. For more information, please contact knowledge.center@ubt-uni.net.

Types of financial and economic crisis

Burhan Rexhepi "UBT - Higher Education Institution". Prishtinë Kosovë

email: burhan.rexhepi@ubt-uni.net

ABSTRACT

Financial crises have caused much debate among different economists. They have attempted to explore any possibility of detecting and preventing crises before they cause the damages that will require way more time and energy to repair the situation and bring the economies back on the right track of sustainable development. The purpose of this study is to analyze different types of financial crises that have affected the economies of the world in order to draw lessons from their experiences. Analysis of this study is divided into four types of financial crises: Banking crisis, speculative bubbles and the market failures, international financial crisis and the broader economic crisis. The methodological approach in this research is of qualitative nature. The materials used are derived from various books and academic journals of academics and professionals who have expertise in the area of financial crisis. This study concludes that appropriate monetary and macroeconomic policies are fundamental basis to detect and manage eventual crises that might occur. This research reveals that countries in transition and those moving from closed system of economy into the market economy are more likely to be attacked by speculators in comparison with countries that have more developed capital markets. In addition, this study shows that

integration of capital markets among countries have an impact on their economies if any of them face financial crisis due to chain effect[1].

Keywords: Crises, Financial, Bubble, Banking

INTRODUCTION

The term **financial crisis** is applied broadly to a variety of situations in which some financial assets suddenly lose a large part of their nominal value. In the 19th and early 20th centuries, many financial crises were associated with banking panics, and manyrecessions coincided with these panics. Other situations that are often called financial crises include stock market crashes and the bursting of other financial bubbles, currency crises, and sovereign defaults. Financial crises directly result in a loss of paper wealth but do not necessarily result in changes in the real economy[2].

Many economists have offered theories about how financial crises develop and how they could be prevented. There is no consensus, however, and financial crises continue to occur from time to time.

In recent decades, financial crises have stopped the momentum of economic development of many countries around the world. In some cases, they have destroyed almost completely different

[1] https://en.wikipedia.org/wiki/Financial_crisis
[2] http://www.whatiseconomics.org/the-global-financial-crisis/what-is-a-financial-crisis

financial systems. The financial crisis' term refers to the situation where financial assets have lost a large part of nominal value. The purpose of this study is to analyze the types of financial crisis and the impact caused in the countries that have experienced them. This study reveals four types of financial crisis: banking crisis, speculative bubbles and market failures, international financial crises and broader economic crisis[3].

1. Banking crisis

When a bank suffers a sudden rush of withdrawals by depositors, this is called a *bank run*. Since banks lend out most of the cash they receive in deposits (see fractional-reserve banking), it is difficult for them to quickly pay back all deposits if these are suddenly demanded, so a run renders the bank insolvent, causing customers to lose their deposits, to the extent that they are not covered by deposit insurance. An event in which bank runs are widespread is called a systemic banking crisis or banking panic.

Banking crisis is a financial crisis that affects the activity of banks in how they manage assets, liabilities and the equity in their possession. During crises, banks are exposed in the so called phenomen "bank run", which means that bank depositors suddenly rush to withdraw their savings and capital (Fratianni and Marchionne, 2009). The action comes due to the the panic caused in the financial market because depositors believe that banks will soon go bankrupt, and as a result they

[3] https://en.wikipedia.org/wiki/Financial_crisis

may lose their capital accumulated over the years. Some of the examples of the runs are the case of the Bank of America in 1931 and of british bank Northern Rock in 2007 (Shin, 2009).

As a result, British government offered emergency loans through Bank of England to cover short-term liquidity problems. However, this did not help to improve and stabilize the situation, and British Government was forced to nationalize Northern Rock bank. Due to systematic banking crisis, financial and corporate sectors in a country experience financial difficulties in their payments. As a consequence, loans related problems arise, and most of the capital of the banking system weakens. This situation is accompanied by increased interest rates, slowdown or reversal of capital flows, and the depressed prices of assets including capital and real estate (Valencia dhe Laeven, 2008). A similar situation prevents banks to pay back deposits if are required suddenly by their customers. Banking crises that have emerged in the past decades have presented many challenges and problems for many bankers, policy-makers, researchers and analysts in different countries of the word to manage banking activities more effectively because of the need to protect financial stability[4].

This has occured because financial stability is crucial to support economic development of individual countries in order for them to be more competitive in regional and global markets. Banks are considered to be curcial in business activity within a given market. Consequently, during the financial disress, banks are supported by their respective Governments through emergent liquidity or other related forms to ensure protection of the economic cohension (Ariccia et al. 2007). Many

[4] http://www.whatiseconomics.org/the-global-financial-crisis/what-is-a-financial-crisis

economists consider that in case of systematic crisis, banks are too big to fail because of the accompanying negative effects that might occcur, which will cause a lot more damage with higher costs for the individual economies. US Government in such way has helped its banks several times through different established programs during banking crises (Congleton, 2009). The rescue program in 2008 was the biggest in the US history woth of $ 700 billion because of the financial crises that occured in the same year. As a result of emerged crisis, many financial institutions in US did banrkupt including " Lehman Brothers", which was the fourth largest bank in US (Fernando et al., 2010).

1.1 Factors that impact growth of banking crisis are

Factors that impact growth of banking crisis are – 1. very high inflation, 2. bank deposits are combined with low liquidity, and 3. banking low profitability that emphasizes that risk of foreign currency in the market, economic instability and poor financial sustainability. According to the study industries which are economically dependent perform worse during banking crises as opposed to industries that are not dependent on foreign funds. On the other hand, the study results indicate that growing negative effects of financially dependent industries is much higher in countries with deeper financial systems[5].

[5] https://www.imf.org/external/pubs/ft/wp/2013/wp1328.pdf

2. Speculative bubbles and crashes

A speculative bubble exists in the event of large, sustained overpricing of some class of assets. One factor that frequently contributes to a bubble is the presence of buyers who purchase an asset based solely on the expectation that they can later resell it at a higher price, rather than calculating the income it will generate in the future. If there is a bubble, there is also a risk of a *crash* in asset prices: market participants will go on buying only as long as they expect others

to buy, and when many decide to sell the price will fall. However, it is difficult to predict whether an asset's price actually equals its fundamental value, so it is hard to detect bubbles reliably. Some economists insist that bubbles never or almost never occur.

Black Friday, 9 May 1873, Vienna Stock Exchange. The Panic of 1873and Long Depression followed.

Well-known examples of bubbles (or purported bubbles) and crashes in stock prices and other asset prices include the Dutch tulip mania, the Wall Street Crash of 1929, the Japanese property bubble of the 1980s, the crash of the dot-com bubble in 2000–2001, and the now-deflating United States housing bubble.[4][8][9] The 2000s sparked a real estate bubble where housing prices were increasing significantly as an asset good.

Valuation of assets in terms of true value has been an old concern in economics. Many individuals that have an interest in this issue wonder if there is a rational foundation for the current prices of : gold, land, shares, house or the value of money before an investment decision is made. Basic theory of finance based on the underlying market assumes that price of an asset is

equal to the present value of its future cash flows. In principle, in an economy with a certain number of traders, assets must be valued on the basis of the fundamental values of the market. Such conclusion can not be sustained given that traders do not have the same information about real situation of companies, whose shares they trade. This refers to the short and long term plans of firms.

Therefore, the difference between market price and the basic money market of an asset is called bubble . In other words, bubbles refers to the prices movements that are based on unexplained fundamentals. Speculative bubbles allude to a situation in which the price of securities or stocks rises above its real value. Such trend continues until potential investors believe that the prices are not linked with the market value. Until then, they usually buy shares because they believe the share prices will continue to rise to the extent that they execute profit when you decide to sell them out. . Some of the historical cases of speculative bubles and market failures are : Dutch Tulip Bubble (1637), Missisipi Bubble (1719-17200), South Sea Bubble (1720), Bull Market (1924-1929), Japonese Economic Bubble (1984- 1989) and The explosion of the internet bubble (2003)[6].

[6] https://poldev.revues.org/144

3. Dutch Bubble

Dutch Bubble In the history of financial crises and in various writings. "Tulip Crisis" is considered the first financial crisis and deserves to be called as the birth of financial speculation. In Netherland, in the 17th century, tulips became the symbol of luxury and wealth. The more rare and unique the latter were, individuals who possess them were considered more wealthy (Wang dhe Wen, 2009). As a result of increased prices of tulips, many investors, munufacturers and traders were destroyed, and the Dutch economy was increasingly falling into crisis.

3.1 Mississippi Bubble

Mississippi Bubble (1719-1720) Mississipi bubble is an economic buble that started in the early years of 1700s in France and was developed parallel with disastrous British bubble of South Sea. The first organizer of this bubble was Scottish Jon Law. who is considered the first international

civil adventurer in the field of money and finance. He is known as the father of finance and the use of paper money instead of gold coin or silver[7].

3.2 The Explosion of the Internet Bubble

The Explosion of the Internet Bubble – 2000 Internet bubble began in 1995 at the time of when Internet and Netscape emerged. Within few years, the service sectors of telecommunication became a battleground for major companies. Besides large companies, also the new operators saw the opportunities in this emerging business due to easy access in investments. Before the outbreak of the bubble in 2000, some enterprises had good financial indicators, but banks and some other investor exaggerated their evaluations and questioned their balance development. The shares of companies in this sector grew rapidly within a day. They were many times larger than the actual value. In the March of 2000, the internet or dot-com bubble explodes, heavily a affecting Stock Exchange and provoking an economic recession not only in the dot-com sector but in all the sectors of the economy worldwide[8]

4. INTERNATIONAL FINANCIAL CRISES

International financial crises that have emerged in different countries have caused chaos within the respective economies. Such crises have generated social dissatisfaction, reduction in employment

[7] http://www.whatiseconomics.org/the-global-financial-crisis/what-is-a-financial-crisis

[8] http://www.whatiseconomics.org/the-global-financial-crisis/what-is-a-financial-crisis

rate, credit rating cuts by various agencies, the fall of shares in stock exchanges, decline in foreign direct investments, and privatization of public assets and industries. Measures taken by Governments which have fallen into financial crisis aimed to stabilize markets and to rebuild their economies. Monetary crises due to the devaluation of currencies and failure to pay sovereign debt has resulted in state bankruptcy. As such, these are very common crises that affect the international financial system. The issue of preferred currency exchange regime has evolved considerable for developing economies in the recent decades. During early 1990s, adaption of fixed exchanged rate system pegged to a strong international currency was very common, specially for countries that have gone through transitional phases from centralized economies to liberal ones. Impact of speculators has led many countries to devalue their currency due to successive attacks. Decreased foreign capital inflows has affected the balance of the payment system, and leading to a monetary collapse[9]

Wider economic crisis

Negative GDP growth lasting two or more quarters is called a *recession*. An especially prolonged or severe recession may be called a *depression*, while a long period of slow but not necessarily negative growth is sometimes called economic stagnation.

[9] http://www.whatiseconomics.org/the-global-financial-crisis/what-is-a-financial-crisis

Some economists argue that many recessions have been caused in large part by financial crises. One important example is the Great Depression, which was preceded in many countries by bank runs and stock market crashes. The subprime mortgage crisis and the bursting of other real estate bubbles around the world also led to recession in the U.S. and a number of other countries in late 2008 and 2009.

Some economists argue that financial crises are caused by recessions instead of the other way around, and that even where a financial crisis is the initial shock that sets off a recession, other factors may be more important in prolonging the recession. In particular, Milton Friedman and Anna Schwartz argued that the initial economic decline associated with the crash of 1929 and the bank panics of the 1930s would not have turned into a prolonged depression if it had not been reinforced by monetary policy mistakes on the part of the Federal Reserve, a position supported by Ben Bernanke.

The Asian Financial Crisis Asian crisis is considered as a very serious economic and financial crisis that affected other South-East Asian countries in 1997. Later on, crisis spread out to China, India, Russia, and Argentina. Russian Crisis and its Consequences The crisis that affected Russia in 1988 is considered a very serious financial shock. This occured as a combination of the its currency devaluation and the inability of Russian government to pay domestic debt in the form of short-term treasury bonds called GKO(Gosudartvennoe Kratkosrochnoe obyazatelstvo) Great Depression (1930) Great depression started in 1930s and lasted almost 15 years. This economic

crisis that has affected countries consecutively in different years. As such, the crisis was the most profound, the largest and the widest in the past century[10].

CONCLUSION

The purpose of this study was to analyze the types of financial crises and their impact on the economies of different countries. The analysis in this study is divided into four types of financial crises that have affected global markets in recent decades. This study has shown that the causes

[10] https://en.wikipedia.org/wiki/Financial_crisis

that have stimulated financial crises, and the government actions taken to curb them. Lessons drawn from this study are that adequate macroeconomic and monetary policies are crucial to regulate well functioning of markets in order to curb financial crises. This research also shows that economies in transition should be very careful when moving from a closed economy to liberal economy because of more the opened possibility of speculators to attack their markets. This does not mean that liberal markets are immune towards speculators. Furthermore, from this study, it can be concluded that the integration of global markets affects well-functioning of other places if a single economy experiences a financial crisis, recession or depression because of the effect chain.

Literature

1. https://en.wikipedia.org/wiki/Financial_crisis
2. **http://www.whatiseconomics.org/the-global-financial-crisis/what-is-a-financial-crisis**
3. **https://www.imf.org/external/pubs/ft/wp/2013/wp1328.pdf**
4. **https://poldev.revues.org/144**