REASONS CAUSING FINANCIAL CRISIS AND ITS THEORETICAL BASIS

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Abstract

Under conditions of market economy, finances are not definitive for dynamic development of business. During absence of finances there will be economic deformation and incorrect management of finances will create crisis and destabilization. From the second half of 2008 Global financial crisis began to aggravate by unseen scales and temps after great depression of the past century. It achieved its peak in September of 2008, and on October 13, 2008, according to many economists, global financial system appeared to be on the verge of ruins. As a result of world crisis, almost all developed and developing countries appeared to be in economic recession. In comparison to 2007, in 2008 world economic growth was reduced to 3.1 percents. Global recession has sensitively reduced volumes of the world trade, reduction of demand on the most important markets of the world, mainly in the USA and EU zone caused reduction of international prices. Together with reduction of world production decrease of international prices has assisted disinflation processes, and many countries appeared before the challenge of struggle with deflation[1]. Financial and economic crisis has conditioned taking of unprecedented measures by many countries of the world. They began to conduct not only monetary policy, but also realization of fiscal stimulation programs. As a result, nowadays, question of stability of the world financial system is not under danger.

Keywords: Financial crisis, Financial stability, Housing Bubble, Subprime Crisis

Introduction

Globalization offers new challenges to the world economy which becomes more depended on unprecedented growth of financial assets by the world scale. Availability of information and development of technologies significantly increased the movement of capital in the world and the role of money and markets in the economics. From 1980 to 2007, global financial assets increased from 12 trillion USD to 206 trillion. In 2008, despite of suspension during the world crisis, growth was continued and in 2012 achieved a peak indication – 225 trillion USD, among them capitalization of stock markets – 50 trillion. If in 1980 the world financial assets made up 120% of total internal products of the world, in 2012 this index was equal to 312% (Lund, Daruvala, Dobbs, Harle, Kwek Ju-Hon, Falcon 2013).

For many decades in academic and business circles people do not stop to investigate and dispute in order to explain what are historical backgrounds (origin) of financial crisis, current significance and future trajectory.

Explanation and understanding of current financial crisis depend on understanding of crisis in historic context and study of their models.

According to **Veblen,** during making decision in business the profit is definitive and its level on its own side affects economics of the country[2].

[1]Financial stability report, National Bank of Georgia, Tbilisi, 2009, pg. 9.
[2] Thorstein Veblen, *The Theory of Business Enterprise* (New York: Charles Scribner's Sons, 1904), esp. Chapter VII, "The Theory of Modern Welfare. pp. 177-78,86, 92 and Chapter VI, "Modern Business Capital.

Mitchell's analysis of financial crisis is based on statistical analysis of changes of economic variables in direction of movement of business cycles.

"Hypothesis of Financial Instability" of **Minsky** is interpretation of general theory. Theoretical bases of Minsky are constructed on reinterpretation of Keinz's works.

Hypothesis of financial instability of Minsky is based on two thesis: **1. Capitalism is endogenously inclined to growth. 2. This growth will be endogenously turned into financial instability and financial crisis**[3].

In connection with credit limitations it is interesting opinion of practical economists **Wojnilover and Sinai.**

According to Wojnilover, credit crisis does not create only recession. For recession the credit crisis is necessary[4].

In the second half of 2007 and in the first half of 2008, important events were developed in the world history. Among them there shall be marked crisis of immovable properties of the USA and global limitation of credits, depreciation of USD and strengthening of inflation processes. These global events seriously affect financial stability. It is known that crisis of real estate of the USA was transferred to other countries too, but it applied to developing countries in lesser extent. Although, it does not mean that risk of financial crisis caused in the country by real estate sector is reduced to zero.

Why are finances necessary and why finances have inclination to crisis?

In order to answer this question it is necessary to examine the main characteristics of financial system.

Financial system is a pyramid of promises which is based on believe of reliance. Non-realization of promises may often be in direct interests of persons who give them. Formation of belief toward the complex structure from the part of humans is based on existence of strong and reliable institutes which are functioning within the framework of law. In case of correct management of financial system it brings an important benefit, and in case of incorrect management it may be followed by catastrophic consequence. I.e. according to "Financial Instability Hypothesis" of Minsky, 1) capitalism is endogenously inclined toward growth and at the same time; 2) growth will be endogenously turned to instability and financial crisis.

Financial crisis which caused a serious damage to countries by the world scale began in August of 2007 by blowing of assets prices and was connected to financial innovations of a new type[5]. John Marthinsen named four reasons of economic and financial crisis of 2008-2009 and called it four paradoxes of financial crisis, particularly paradox of saving, paradox of Leverage, diversification paradox and paradox of financial innovations [6].

Mishkin examines dynamics of financial crisis in three stages: first stage revealing reasons of creation of financial crisis, particularly incorrect management of financial liberalization, financial innovations and blowing of assets prices and bursting. The second

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[3] Hyman P. Minsky, "Policy Pitfalls in a Financially Fragile Economy," in U.S. Congress, House Committee on Banking, Finance and Urban Affairs, Employment Risks from Present Credit and Business Liquidity Conditions, Hearings before the Subcommittee on Domestic Monetary Policy of the House Committee on Banking, Finance and Urban Affairs, 97th Cong., 2d. sess., 1982, pp. 75-76. Minsky, "Financial Markets," p. 14.

[4] Wojnilower, "The Central Role of Credit Crunches, p. 324.
Wojnilower, "The Central Role of Credit Crunches, pp. 277-78.
Wojnilower, "The Central Role of Credit Crunches, p. 278.
Wojnilower, "The Central Role of Credit Crunches, p. 278.

[5] Martin N. Baily, Robert E. Litan., Matthew S. Johnson. The origin of the financial crisis. Lessons from the financial crisis: Causes, Consequences, and Our economics future. 2010. Jonh Wiley&Sons, Inc.

[6] John Marthinsen. Four Paradoxes of the 2008-2009 Economics and Financial Crisis. Lessons from the financial crisis: Causes,
Consequences, and Our economics future. 2010. Jonh Wiley&Sons, Inc

stage is related to the bank panic, and the third stage – to the blowing up of debts[7]. Asset bubble is phenomenon of price elevation during a long period of time which then ends with crash. In the USA and the world prices on living houses were increased equally from 2002 to 2007 and then began their sharp decrease.

Assets bubbles cannot explain financial crisis although they are important component of compositional dynamics which created problems in economics and prolonged economical recession.

Therefore, we can mark out three basic direct reasons which conditioned financial collapse and further recession

- Prices "bubbles" – artificial and sharp increase and reduction of prices on defined commodity or asset, which at first has sharply increased and then sharply reduced cost of dwelling houses.
- Boom of "substandard" hypothec credits which deepened size and influence of bubbles and defaced stimulus of financial sector which has caused substandard boom.

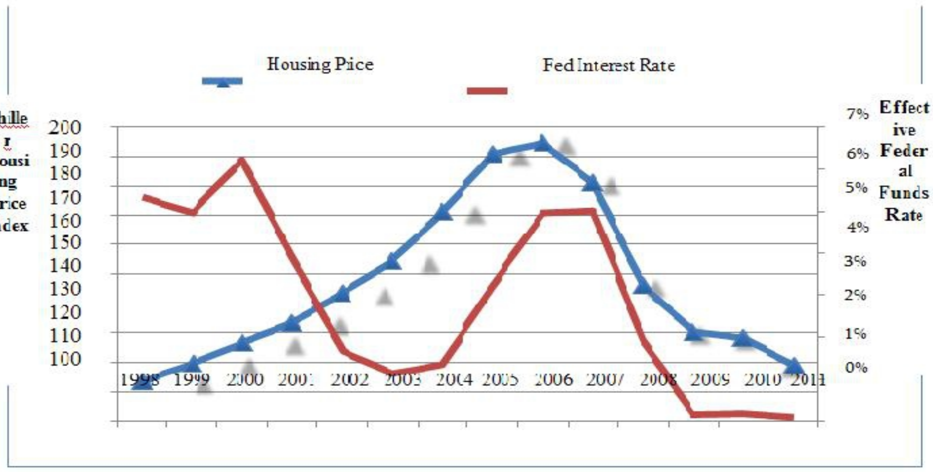
Real estate crisis in the USA was preconditioned by stable increase of prices on real estate during a long period of time. From 1997 to 2006, prices for dwelling house increased twice [9].

What has conditioned extreme blowing up of "bubbles"? Basic answer is unexampled availability of credits in form of hypothec (for example dwelling houses loans). Average annual hypothec loans were increased from 0.2 trillion from 1993-1997 to 0.5 trillion to 1998-2002 and 1 trillion annually in peak years - 2003-2006.

Correlation between credit boom and price bubble was noticed for many times in historical retro perspective. Because of increase of loans has a tendency to stimulate increased demand on assets what, in its turn, increases prices. Indeed, stable availability of credit is usually considered as critical factor of economics functioning. Quick increase on domestic credit was accompanying and important determinant of financial crisis that happened in the world during the last decades. By blowing of short-term bubbles credit boom has an inclination to cause financial destruction. During examination of financial crisis of 2008, there was revealed that countries that gave credits in high quantities had inclination to acute economic conflict[8].

The Housing Bubble and Credit Access [9]

Figure 1



[7] Frederic S. Mishkin. Macroeconomics (policy and Practice). Pearson Education. 2012.

[8] Andrew K. Rose and Mark M. Spiegel, "Cross-Country Causes and Consequences of the 2008 Crisis: Early Warning. National Bureau of Economic research, working paper 15357, September.

[9] Graph assembled from data in Shiller, "Data" and "Historic Changes," Federal Reserve.

During the last two years market price of dwelling houses in the USA reduced by 6 trillion USD, what made up more than 40% of GDP of the USA. Collapse loss for each family made up approximately 53000 USD, reduction of prices for dwelling houses was gradually continued after 2009 and up to 2012 was constantly reduced at the time of which the price approached indexes of previous “bubbles”.

What assisted bursting of “bubbles”? As with all other bubbles increase of prices stopped by delivery of dwelling houses increase of which was based on increase of speculation demand, factually it exceeded demand[10].

According to Minsky’s opinion about financial crisis, the first important aspect of substandard crisis that happened in 2007-2008 is monetary policy. And the second important aspect is financial deregulation.

From the one part, federal reserve policy of these factors and from the other part, financial deregulation and innovational processes influenced availability of credit and generally weakened credit standards. General result that is schematically shown (scheme 1) has increased volume of credits (Crd) and debt of non-financial sector (Ind). This calls us to analyze what has happened in the real sector of economy.

By increase of credit availability basic benefits got family economies. The first result was increase of demand on long-term consumption commodity (C^d) and correspondingly-increase of income (Y). This caused growing spiral effect of known “consumption – income – consumption”. During the last decades, consumption between Europe and the USA maintained growing break. By the debt of family economies demand on dwelling houses was funded too. This conditioned creation of the second ascending spiral: Housing demand H^d increased prices P^h. Expectation for capital getting increase of prices on dwelling house P^h from its part stimulated demand on dwelling houses H^d. As it is known, just this fact has caused sub-prime problem.

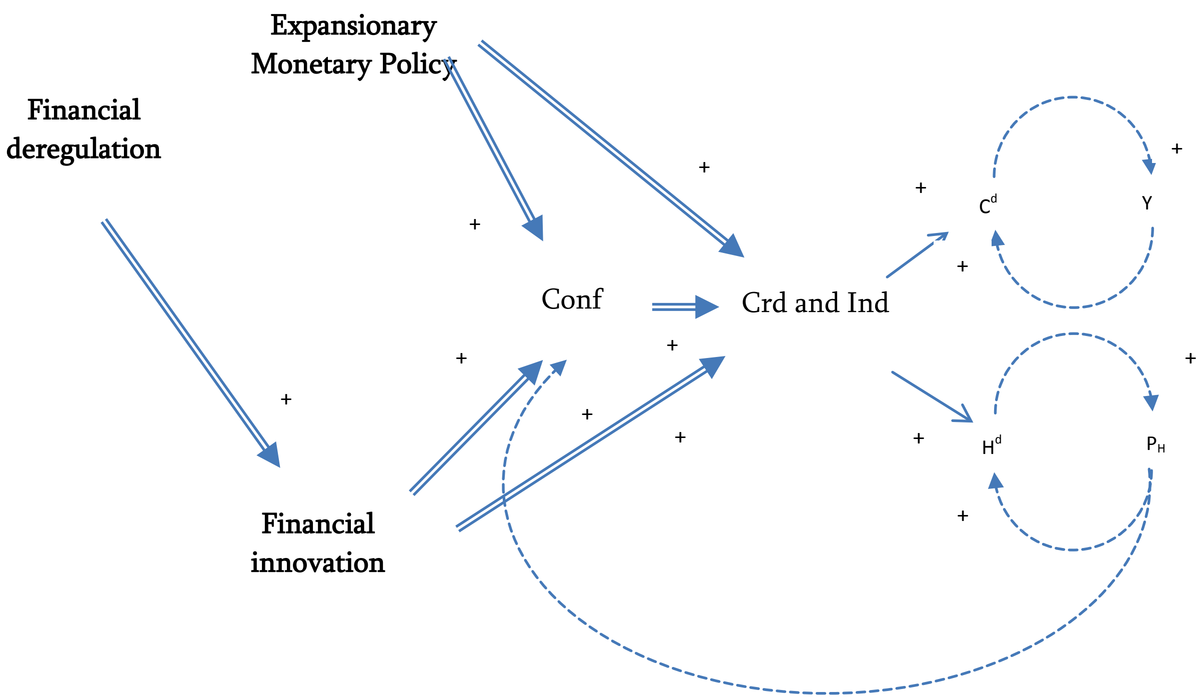
What situation is in Georgia in this regard

In the beginning of the second half of 2008, real as well as financial sectors of Georgian economics appeared to be in front of the biggest problems. Military aggression realized by Russian Federation in August of 2008 seriously impacted economics of the country. Important damage of infrastructure was accompanied by worsening of trust from the part of population toward banks and national currency. There was a danger for creation of “twin crisis“, bank and currency panic in the country. By influence of global financial crisis that achieved its peak in September of 2008, commercial banks of Georgia appeared to be before possible problem of average-term liquidity.

[10] Baker D. The housing Bubble and the Financial crisis. Real world economics review, issue no 46. 2008. P. 74.

Subprime Crisis: the antecedent facts

Figure 2

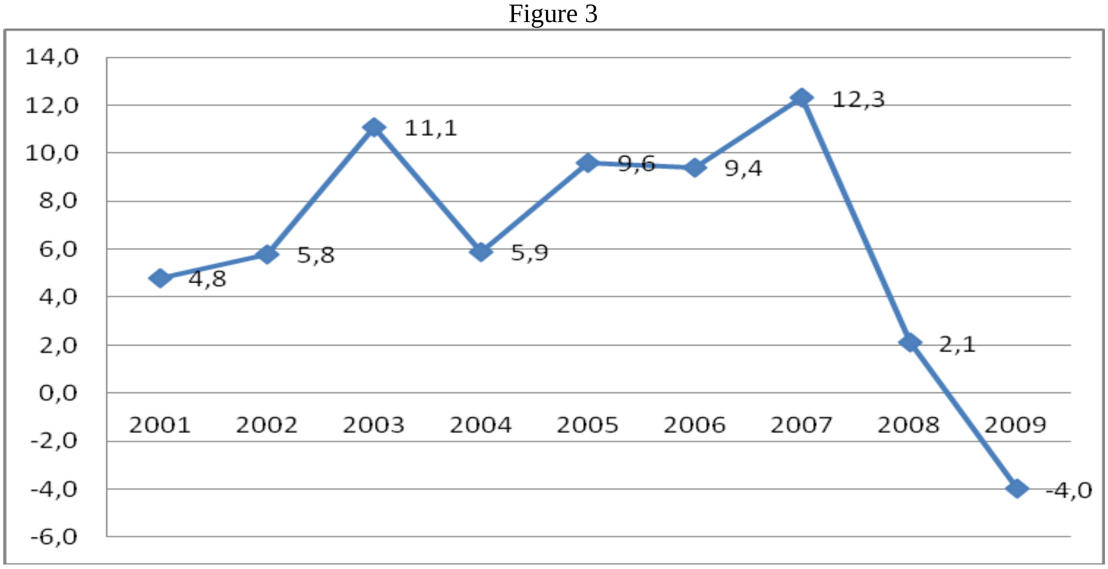


As a result of the world financial crisis, activity on financial markets where importantly reduced and crediting of private sector was reduced too; this caused global recession of real economics. World production was sensibly reduced and correspondingly - volume of world trade. Negative influence of the world crisis on Georgia was expressed in limitation of liquidity of commercial banks and reduction of export incomes.

In the second half of 2008, in comparison with the past year, real whole domestic product was reduced by 3.2 percent, and in the first half of the year real growth made up 8.7 percent. Finally, in 2008, real growth of the whole domestic product was expressed by 2.1 percent. Such low index of economic growth was not fixed after 2000[11].

Real GDP growth %

Figure 3



[11] Financial stability report, National Bank of Georgia, Tbilisi, 2009, p. 13.

During financial crisis, most of all was damaged real estate sector. Demand for real estate was sharply reduced, what caused reduction in prices. When growing tendency of prices was noted, real estate was acquired for speculation purposes, because expectation of growth of future prices made investments at real estate markets very profitable. Complicated financial condition in real estate sector was directly affected quality of business loans issued to building sector. Volume of inactive loans in reporting period was significantly increased and according to June 30, 2009, it made up 52 percent[12].

Conclusion

From 2008 many spoke about the fact that crisis was caused by whole concession from the part of state of control over financial sector to the market. This thought has a logical continuation - the state shall toughen control. The last target is real estate market of America a bad debts of which brought the US economics to crisis.

Governments have new plan – with 90% insurance and assistance of the Government to avoid farther losses. Plan sounds good if not two problematic questions. First – it is difficult enough to think how the state can prevent risks. Second – what happened on real estate market of America was not caused by lack of governmental regulations at all; it was one of the most regulated industries in the world funded by taxpayers.

From 2008 began mass introduction of new rules. New regulations appeared for achieving more stability of financial sector toward liquidity and capital norms: as a result, US banks work by new leverage percent now.

Despite this fact, it is still highly felt that stability of financial market stands on state assistance and in case of danger nobody will give them the right of bankruptcy.

Theoretical evidence is grounded on historical factors too. During each crisis, regulators have to help more financial institutes. Five events of 1792-1929 can be considered as a base of modern financial system. This includes very successful innovations, starting from stock banks, ending with creation of the Federal Reserve System and formation of New York stock exchange.

Healthy financial system is moving axis of the economics; it applies needed resources in form of credits to different companies which need them. This ability makes the economics stronger and more competitive.

Modern financial world is more tendentious, where volume of savings is conditioned by applications between funding and taxes. Loan segment of real estate market becomes savage and investments in machineries and patents decrease, what hinders growth of economy.

“It is impossible to fully exclude from financial system of policy but it is real that interference of government should be more effective. Governments shall make funding of bank sphere more transparent, indexes of each bank shall become clearer, otherwise new crisis is irreversible” – consider western analyzers.

Such strong financial crisis as it was in the world does not happened directly in Georgia, but its results do spread to Georgia. Because liquidity was sharply reduced in the world, Georgian markets experienced difficulties in money loan. This was coincided with war; we can hardly define what was influenced the war and what influenced the crisis. Financial crisis in the world was quickly followed by economic crisis what was also expressed in Georgia by reduction of export demand and cheapening of import.

Solution of economic and political problems of Georgia depends just on the new world order and Russian-American relationships. Although here position of Europeans is

[12] Financial stability report, National Bank of Georgia, Tbilisi, 2009, p. 18.

very important for our country, we shall think about the fact that their new members became a very heavy load for Europe and instead of bringing in they take away sufficiently high means and this weakens the Europe. Creation of new economics offers new opportunities to countries like Georgia.

The new world economic system is formed, putting up with which is as difficult as with all novelties for leading European countries. Of course, the system will be changed in Georgia too, how?! It highly depends on the system – whether we will be a Free State, what will be our future and where our place will be on the world economical map.

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