

A REMEMBRANCE OF THE PREVIOUS FINANCIAL DISASTERS

***Florina BRAN^{a*}, Ioan I. GÂF-DEAC^b, Dumitru Alexandru BODISLAV^a, Mihai DINU^a,
Raluca Iuliana GEORGESCU^a, Radu Florian CHIOTAN^c***

^a Bucharest University of Economic Studies, Romania

^b INCE C. Kiritescu / Romanian Academy, Bucharest, Romania

^c Wallachia University, Targoviste, Romania

ABSTRACT

This research study takes a lighthearted perspective to how crises originate, evolve, and how we may develop a preventative mechanism against them. This piece of literature focuses on how shocks felt from asymmetrical information might develop into genuine economic or financial "storms." This is especially true when the "storms" are caused by the realization that political, economic, and financial factors may be to blame for a decrease in available resources, even if those resources are not depleted due to natural reasons. Throughout the study, a methodology was proposed that aimed to connect present demands for forecasting future crises with lessons learned in the past.

KEYWORDS: *financial crisis, economic growth*

INTRODUCTION

Economic crises are caused by times of instability, followed by periods of unpredictability, volatility, and a widening gap between the economic, political, and ideological components (Bran et al., 2023). The economic crisis is linked to the economic cycle, which is a period in which the economy accumulates and develops a surplus of goods that is incompatible with the purchasing power of the population, limiting the economic environment to a decline in output, rising unemployment, and bankruptcies. "These cycles correspond to financial crisis and are therefore inevitable in a market economy" (Peicuti, 2011).

The National Bureau of Economic Research (NBER) (2023) defines a crisis as "a major downturn in economic activity for many months, reflected in the decline in GDP, decrease in individual income, employment, and decrease in industrial output and consumption." Financial crises are characterized by periods of stagnation, inflation, and unemployment, all of which combine to create an unstable mix that gives little hope for the future and may even result in economic collapse.

1. 15 YEARS FROM THE PREVIOUS FINANCIAL CRISIS

Reinhart and Rogoff (2009) recognized different types of economic crises. They determined that there are seven sorts of crises, four of which are quantitatively defined and three of which are contingent on the occurrence of a particular event. Inflation crises, currency degradation, and currency crashes are three types of crises in which a currency's buying value declines dramatically. Prices rise as a result of "price bubbles for goods" crises, but banking crises reveal losses in low-value products, such as a reduction in the price of a specific capital or a decline in the net asset value of the banking industry. The crises of international debt and domestic debt are linked to budget deficits and governmental indebtedness, respectively. These seven forms of crises include currency crises, banking crises, and foreign debt crises.

* Corresponding author. E-mail address: florina.bran@eam.ase.ro

A currency crisis is described as a substantial depreciation of the national currency. The severity of impairment varies according to a country's degree of development. In developed countries, a 10% to 15% depreciation is regarded excessive, but a 20% to 25% depreciation is enough for a growing economy. According to Frankel and Rose (1996), the existence of a currency crisis is called into doubt when the national currency decreases by more than 25% year after year. Thus, currency crises are seen as costly owing to its repercussions and economic consequences. Increased exchange rate volatility has an influence on the real economy, including growth rates, unemployment, real investment, and real foreign debt (Georgescu, 2020).

Currency depreciation decreases the current account deficit by making exports cheaper, but the quantity of foreign debt acquired rises. Examine the transfer of wealth from a country in full growth mode to industrialized countries, who are typically the expanding countries' creditors. Eichengreen and Hausmann (1999) referred to the problem of growing nations borrowing in their own currency as "original sin" According to them, this ineptitude is at the heart of the structural issues plaguing many emerging countries. Even macroeconomic strategies meant to provide a palliative reaction to problems (devaluation) may have negative implications owing to original sin.

Foreign currencies (US dollars and euros) account for the vast bulk of loans in developing countries. Lenders from industrialized nations emphasize the denomination of their claims in their own currencies, fearing a devaluation or inflationary trend in the countries where they invest. Developed countries may instead borrow in their own currencies. For example, Italy's debt is denominated in euros, dollars, and yen. These countries will benefit from being allowed to hold foreign currency obligations and receivables in their own currency. If the United States faces an asymmetric negative shock to aggregate demand, worldwide demand for American-made goods will decline, but the weak dollar will restore equilibrium. This prevents unemployment impairment and depreciation (Dinu et al. 2016). The current account will improve as exports and imports increase. A depreciation of the US dollar in relation to other currencies would lower US debt while boosting receivables from other countries, resulting in a transfer of wealth from other countries to the affected country.

If global demand for a country's products declines, emerging nations would incur economic and financial losses. Obviously, a national currency depreciation decreases the current account deficit by lowering export prices, but it also raises foreign debt.

When a government defaults on its foreign debt, it often causes a balance of payments problem and, in certain situations, a financial disaster. Sometimes depleting foreign currency reserves are the only means to repay short-term external debt (Bran, et al. 2022). Assuming a stable parity, diminishing reserves suggest that sustaining a constant exchange rate over time will be unachievable. On the other hand, increased depreciation in reaction to a speculative attack may harm the balance sheets of banks with foreign currency receivables and payables denominated in national currency.

Economic crises have a far-reaching impact on all elements of economic activity (Bodislav et al., 2020a). Depending on the features of each country, the source of such crises might be a sudden halt (capital withdrawal) in the currency market (such as a speculative attack) or vulnerabilities in the financial system, which can record a range of shocks. These variables may have an impact on the stability of the national currency (Bodislav et al., 2020b). Rising energy prices, poor living conditions among a country's neighbors, trading partners, or even the country itself can all have a detrimental impact. A country with a fixed exchange rate that is destabilized by an internal shock, such as a decline in GDP, would see a decrease in currency demand, placing downward pressure on its local currency. As a result, the central bank will be obliged to intervene in the market to reverse the decline until the local currency reaches a level sufficient to meet the demand for money. The central bank will sell foreign currency reserves in certain circumstances.

An additional categorization is the shock generated by the worldwide increase in interest rates. To reverse the depreciation trend, the central bank would sell foreign currency reserves, causing monetary contraction and rising interest rates (especially in the domestic money market).

2. WHAT IS THE ACTUAL ECONOMIC STATUS?

From 1981 to 1983, the global economy experienced a severe slump. A favorable atmosphere emerged, influencing emerging nations' capacity to service their foreign obligations. The United States' robust anti-inflationary effort, which resulted in a rise in interest rates for the US dollar, was cited as a contributing reason to the 1979 recession. Interest rates have risen over the world as a result of various currencies' peg to the dollar. Negative aggregate demand in developed countries was primarily sustained by three channels: an increase in the value of dollar-denominated external debt; an increase in the interest rate on contracted loans taken by emerging countries; and a decrease in global price levels (due to a drop in global demand). The quantity of money from exports declined. The crisis began in August 1982, when Mexico's central bank declared that it had spent its foreign currency reserves and would be unable to satisfy its international loan obligations. Because of the economic similarities across Latin American countries, international investors have opted to remove their cash from the whole area, including Argentina, Brazil, and Chile. Banks were Latin America's major borrowers at the time. The decision was made to cut credit lines and repay debts. These actions caused Latin American countries to default on their debts. African nations have comparable debts to international financial organizations such as the IMF and the World Bank. Asian nations have not fulfilled their financial obligations (Georgescu et al., 2023). By the end of 1986, forty countries were experiencing major foreign financial issues. A high frequency of global banking crises was linked to a high share of government debt in total foreign debt.

As with financial crises, the value of national debt began to grow with the outbreak of World War I and fell throughout the Great Depression and World War II. The decades that followed were mostly tranquil, until the 1980s and 1990s, when the debt crisis struck emerging countries.

Banking crises in advanced economies have a considerable impact on global economic trends (Bodislav et al., 2019). A slowdown or total contraction in economic activity has a disproportionately negative impact on exports, reducing the availability of foreign governments that cause instability in developing markets and damaging their capacity to service foreign debt.

David Kotz (2022) categorizes recessions into four types based on his unusual viewpoint. "In the first category, economic expansion leads to a drop in unemployment and an increase in workers' bargaining power, so that real wages grow faster than productivity, which becomes unsustainable at some point" (Voinea, 2009); however, contrary to Marx's thesis, re-entering the workforce while the economy is thriving changes the relationship between labor and capital; however, these effects are linked to the presence of market competition. Where there is competition, business earnings do not decrease dramatically because wage increases may be managed, and hence a recession does not arise. However, without similar increases in real wages and productivity, the public sector remains a potential source of economic disaster, especially considering that it employs a substantial fraction of the state's overall workforce. "The second form of crisis is suboptimal consumption (opposite of the first type of crisis); a reduction in real wages may generate a crisis if it is not countered by a rise in public expenditure" (Voinea, 2009, at p. 4). "The third category is the investment surplus, which may be explained by the effects of neoliberal policies on competitive principles and institutions. We include the expansion of productive investments with the goal of increasing market share, resulting in an excess of productive capacity" (Voinea, 2009). "Speculative bubbles represent the fourth sort of calamity. A speculative bubble is a scenario in which high public expectations of an asset's future price cause its present price to rise (Voinea, 2009). Profit rise in comparison to wage and family income growth has resulted in an increase in investable capital, which often outstrips investment prospects (Georgescu et al., 2021). This offers ideal circumstances for the formation of asset bubbles, with such funds suitable for the acquisition of real estate or equities. Once those investable funds enter a speculative bubble, further expansion need a financial system eager to lend cheap money to feed the bubble in the event of a deregulated market with a short-term vision, such as neoliberalism. Following the 2000 financial sector deregulation drive, new mortgage lending methods focusing on

a large quantity of loanable money for home purchases emerged, giving essential support for the current real estate speculative bubble.

CONCLUSIONS

Crises are periods when we realize the truth. No matter how much an economy expands or what it can accomplish over time, everything eventually breaks apart. As with an inflated balloon, you don't know how much air it can hold until it bursts. As a result, it is vital that the economy reviews all incoming flows until the bubble bursts, determining what created it and how it might be prevented in the future. Seizures, while regarded unpleasant, are always beneficial to growth. Any form of crisis is noteworthy, and the subsequent trend will be beneficial.

Each economic crisis that has occurred in the last several centuries has resulted in a revolution in economic philosophy, as a crisis indicates a failure of logic. Regardless of an economic theory's initial plausibility, as demonstrated by its applicability and usefulness, when the economy experiences a crisis, another economic theory will emerge to demonstrate what was previously overlooked, resulting in the existence of a superior theory to replace the previous one.

In the era of globalization, an economic crisis is more devastating than if it occurred in a single state or union. Although the crisis will affect all states with economic links, the severity will vary by country. Least developed countries that rely on strong nations will feel the pain more severely; these countries will confront more challenges and must respond with greater resolve and sacrifice.

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