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Types of Financial Crisis

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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.

Keywords: *Crises, Financial, Bubble, Banking.*

1.0 INTRODUCTION

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 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.

2.0 BANKING CRISIS

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 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. 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 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). As such, this has been the largest bankruptcy in the US history, and has come as a result of massive withdrawals of depositors, drastic losses in the value of stocks and immediate devaluation of assets by credit rating agencies as Standard & Poor's (S & P), Fitch Group and Moody's. Moreover, during 2008, twuenty five other banks have bankrupt because of the bank runs. The total value of their assets accounted for $ 373,578 milion (FDIC, 2010)

There is a general consensus that banking crises limits economic development of countries. While crises tend to occur in the declining economies, problems in the banking sector have also independent negative effects on the real economy. By analyzing the anatomy of financial crisis in 50 markets and developing countries, Cashin and Duttagupta (2011) concluded that factors that impact growth of banking crisis are: (i) very high inflation, (ii) bank deposits are combined with low liquidity, and (iii) banking low profitability that emphasizes that risk of foreign currency in the market, economic instability and poor financial sustainability.

According to the study conducted by Ariccia et al (2008), 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 (Krozsner et al. 2007). The author alludes to a significant systems in relation with the size of the economy, which provide economies with credit and other financial services to support the growth of industries. Moreover, Serwa's study (2010) advises that the size of the crisis is what dictates the level of the economic development.

3.0 SPECULATIVE BUBBLES AND DHE MARKET FAILURES

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. Consequently, situation of this nature allows individuals that have insider information to speculate the stock prices. Therefore, the difference between market price and the basic money market of an asset is called bubble (Tirole, 1985). 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 (Stiglitz, 1990). The presence of speculative bubbles increases the opportunity of the market failure given the investors commitment to buy shares while share prices rises consistantly. If at some point, most trades decide to sell their shares at the same time, there will be no buyers in the market. As a result assumed market prices will fail, and the value of stocks and shares will go down drastically.

Throughout the history of financial markets, speculative bubbles have occurred from time to time, even often with devastating effects. 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)

3.1 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. The sale of tulips blossoms during April and May, while tulips purchases and sales made during the year and that in the presence of notaries. The Tulip Exchange was created after the trading of tulips begin to be conducted through intermediaries and negotiators. The demand for tulips began to come from France, England and other places. In 1673, demand fillings became impossible, and thus the crisis errupted. The prices of tulips fell about 20 times. Buyers and producers either lost large amount of money or were totally destroyed. According to economist Charles Mackay, the moment of the explosion of this crisis was a tulip tuber bulb that was exchanged with 5 hectares of land. By analyzing this phenomenon, the economists underline that speciation occurs when popular imagination focuses on some things that look completely new.

3.2 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. The Jon Law's system represents a true revolution in the monetary field and constitutes the first step of abandoning the gold and silver as a means of payment. Mississippi bubble began in 1715 when French government was on the verge of bankruptcy under the burden of debts during the War of Spanish Succession.

Philippe d'Orleanes, a regend of French kingdom, to find an economical and fiscal solution for the country accepted the theory of John Law. This was an old monetary theory. It was hoped that implementation of this theory would regulate the debt issue and stimulate economic development for the country. The bank took the gold, silver deposits and notes issued "paper" bank in return

The Bank was recognized as such by the French public, because they had the official currency of France. Banque Generale built its reserves through the issuance of shares and profits earned through financial management of the French government.

In 1717, John Law believed that the activity of this bank can based on a commercial activity, where the Mississippi company was appointed as the company "Compagnie d'Occident" (Company of the West), and it was granted a monopoly on trade with America along the river Mississippi. While in the year 1719 "western company'' as a result of a merger with the East India Company, the French Company of India created by calling the company as the eternal company of India. The capital of the company consisted of 100 millions of pounds and livery which was divides in shares becoming subject to numerous speculations.

While the bank of Law Jon was producing and distributing money and selling shares in bulk, the capital and investments were in reverse proportion to the value of distributed shares and bank notes. During the last months of 1720s, the bank printed and distributed more than 1 billion shares, and their price went from 500 to 20,000 livery. While the holders of these shares such as Bourbons Duke and Prince de Conti publicly demanded that their shares be converted to paper currency or silver field. Despite the attempt to attract their paper currencies, financial crisis broke out in which many depositors and shareholders lost their investments. As a result, the entire French financial system collapsed by 24 March 1721. Consequently, this marked the official blocking of this system (Garber, 2001).

3.3 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. As a result of loan debts, the market operators appeared to be weakened and thus declared major financial troubles. During the year 2000-2005, the whole sector of telecommunications' equipment went into a severe economic recession and was called "winter traffic''. In this period, many accounting irregularities and noncompliances were registered in many companies operating in this industry. Some of them were engaged also in concealment of accounts. Only a few companies such as Google, Yahoo, Ebay and Amazon could escape the impact of the Internet bubble. Those companies had a rapid development after 2000s and managed to be key players in this sector (Delong dhe Magin, 2006).

4.0 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 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. Consequently, such a regime of monetary exchange has highlighted the fragility of the system and the inability to protect against speculative attracts (Pilinkus et al. 2011).

In the last three decades, serious crises that affected financial system and sovereign debt were rare. Since 1980, crisis began to spread out. Several main groups of crises are distinguished: The debt crisis of the 1980s in developing countries, the 1990 Tequila crisis, the Asian financial crisis of 1997, the Russian crisis of 1998, and the EU financial crisis. All of these countries have been supported by IMF programs to overcome their crises.

4.1. Debt Crisis

Inspired by theoretical and practical vision of developed countries, many developing countries in Africa, Asia and Latin America looking to consolidate their countries during 60s of the twentieth century took credit greatly from IMF and World Bank. As such, both IMF and World Bank funded them to overcome their financial situation and stimulate their economies. These loans were made in three ways:

a) From western banks to the banks of developing countries
b) In the form of state loans for exports
c) Loans with low interest rate to stimulate their exports in Western countries. Loans taken were not used for investment purposes, for what they were initial allocated. But, they were rather used to cover their budget deficits.

The crisis erupted in 1982 after Mexico declared that could not repay back its debt. The epidemic of the financial bankruptcy spread out very quick and thus it was called '' Debt Crisis''. Seeing the likelyhood that loans given out could be lost, IMF and World bank created the program called ''structural adjustment'' that was aimed to reduce public expenditures, removal of subvention for local products and privatisation of public sectors.

Many developing countries were forced to accept these conditions because they were already heavily immersed in debts and were in desperate need for investments support from both IMF and World bank programs. Implementation of reforms was been conducted in a successful manner. However, countries that were in debt were unable to repay back their obligcation, and thus this was posing great danger to the world's financial system. Western countries made the decision to adapt new ideas and programs to either block or reduce the debt levels. As a result, the American program called Brady Plan was created and adopted. According to it, part of debt was forgiven and deeply indebted countries had to buy 50% of their debt. For the implementation of this program, $34 billions were provided by IMF, World Bank and Japan. Morever, another $34 billions were allocated from Mexico's national budget. The remaining part of debt was converted into the long-term obligations, and it was was desgined to be paid with very low interest rates. This plan was sucessfully materialized especially through intense negetiations of Mexico with its creditors. In the coming years such as in 1996, 1999, 2005 and 2009, similar new initiatives were adopted and programs were called '' Poor Countries with high Debt Levels'' to enable them overcome their financial problems and put back their economies in the right directions (Civici, 2011).

4.2 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. The main cause of this crisis that initially began as a typical crisis is the extraordinary devaluation of Asian currency. It is estimated that from 1960 to 1990, Asia suffered a significant economic turnaround that began its economic boom. This development also spread to five major countries like Thailand Vietnam, Malaysia, Indonesia and the Philippines. Hence, these countries were called '' Asian Tigers''.

After flourishing economies, IMF and WTO pressured the so called Asian Tigers to liberalize their financial markets in order to facilitate reciprocal movement of capital. At a time of economic prosperity, these countries fell deep into crisis. Causes of a deep crisis soon began to become apparent: Firstly. as a result of interesting interest rates and the availability of international financial markets. A massive amount of investments and capital entertered in Asia. Second, Asian countries without exception applied fixed exchange rates regimes for their currencies in relation to the dollar. Thirdly, weakening of export levels as a result of the strengthening of the dollar, thus making Asian goods less competitive.

It became obvious that these countries were going through catastrophe. Financial bubbles burst in Thailand. Faced with the departure of foreign capital and massive selling of domestic currency, Thai authorities attempted to protect the exchange rate through an operation that cost 23 billion dollars, but again without success. A special role in the deterioration of the crisis seems to have played the IMF orientations and its obligations under the aid to these countries. IMF with delay began the negotiation process imposing cessation of any kind of state intervention in the economy in crisis. In the past, state interventions appeared to be successful because of the impact in economic growth of these countries (Krugman, 2000).

4.3 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). Russian crisis clearly identified the mechanisms and financial mistakes that can shake not only a great place like Russia, but the whole global financial markets. The new development of Treasury bonds market was considered the origin of Russian crisis. In the past, the old soviet system did exclude this form of financing.

Russia's biggest shock followed by removal of tax on raw materials as required by the IMF in 1994. As such, direct consequence was the creation of disequilibrium or large budget deficit among income and expenditures. After the outbreak of the Asian crisis, the deficit required to cover domestic debt through emission of treasury bonds increased significantly the rate of treasury bonds from 30% in early 1988 to 60% in the first days of June. The need for rubble (domestic currency) forced Russians to emit treasury bonds also in foreign currency. Since March 1998, it was announced that the Russian financial market is not in condition to provide a solution to the colossal public debt.

At the moment of explosion of crisis, the Russian banking system was weak and poorly structured. Main financial resources were secured through short-term transactions, but not from the central bank. The latter applied restrictive monetary policy in order to limit the level of inflation. In 1996, the collapse of interbank market occurred, the situation was downgraded further due to deterioration of two important macroeconomic balances. The balance of payments was influenced negatively by increased import levels, as well as lowering the prices for raw materials. From this crisis, the entire Russian society specially middle and low classes of society were hit very hard (Komulainen, 1999).

4.4 The Crisis of European Monetary System

During 1990s, a wave of speculative attacts severely hit European Monetary System forcing countries like England, Finland, Italia, Sweden and Norway to move from fixed exhange regimes into floated exchange regimes. The latter determines the currency exchange in the international markets based on the supply and demand levels. The crisis that appeared at this time was a result of inadequate macroeconomic policies, but it was rather due to pure speculations because countries in the Europian Monetary System had full access in capital markets including domestic and foreign ones. Moreover, these countries did not need at all to monetize their deposits (Coulibaly, 2009).

4.5 Mexican Tequila Crisis

Tequila crisis has emerged as a new type of crisis. It was different in comparison with debt crisis that many Latin American countries were exposed. The latter was concerned with the inability of countries to repay back their debt. In the case of Mexico, the crisis had different character. From 1990-1994, Mexico had a positive balance and a fairly good payment capabilities. But, in december of 1994, financial crisis gripped Mexico as a result of currency depreciation that affected this idyllic image by destroying the Mexican economy. This crisis was otherwise called as Mexican tequila.

There are many factors that explain the reasons for the birth of the crisis and its devastating consequences. Large trade deficit of the 1988-1994 period was deepening from year to year. As such, this signaled liquidity issues that Mexico was encountering. Another factor that contributed to the crisis of Mexico was the withdrawal of foreign investors. Although, this was related to the liquidity crisis in the first 6 months after the outbreak of the crisis. The GDP declined by 10%, while the GDP per capita declined 8%, and the unemployment rate has tripled. This was the first time that a crisis of a country directly affected many other countries that were not tied to this place. The next day the Mexican crisis was also felt in Chile, Argentina, Brazil and the Philippines (Krugman, 2000).

5.0 BROAD ECONOMIC CRISES

Many times throughout history, economic crises with wider dimensions have sent a shock wave through different countries of the world. This has caused many large businesses, even those with international and transatlantic activity to suffer severe blow and failures as a result of the economic crisis with broader connotation (Rao dhe Naikwadi, 2009).

Crises with such proportions that affect individual countries or in block if they are under the single umbrella of economic union are called recession and depression by economists. Negative economic growth of the GDP for more than two consecutive quarters usually within a single economy is defined as recession. If economic growth continues with such negative rates for longer period is called depression (Begg dhe Ward, 2009). Historically, countries that fall under recession or economic depresion, beside negative economic growth, they have also experience increased unemployment rate in all of its economic sectors. On the other hand, economic stagnation is defined by economists as the situation when the pace of economic development slows down compared to the previous quarters although they are still positive. Some of the world know crisis with larger dimensions are the great depression of 1930s and the mortgage crisis (2008-2009) in the U.S..

5.1 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. It is a consensus among economists that the causes of the crisis has been the collapse or destruction of American Stock Market that occurred on November 29, 1929, known to history as the ''Black Tuesday''. In that day of the collapse, many people suffered drastic losses, and thus the entire financial system was shocked. As a result of the crisis, consumer spending has suffered significantly due to fear of crisis, inflation has increased, people were reluctant to borrow and sales in the automotive industry have also fallen. In this way, unemployment has had record levels. The decline of the American economy did cause a chain impact worsening economic situation across different countries like Germany, England and France. All economic indicators, including industrial production, wholesale prices and foreign trade have undergone drastic decline. As a result of the economic deterioration, individual states implemented policies to safeguard their economies by putting different tariff barriers in order to stimulate economic development. But these measures only exacerbated the collapse in world trade. At the end of 1944, these countries agreed to waive their protective economic measures and practices. They also established multilateral institutions like International Bank for Reconstruction and Development and IMF to regulate global trade and increase capital inflows and thus stimulate further economic prosperity amongst countries (Nerozzi, 2011).

5.2 Real Estate Crisis in US (2007-2009)

During 2000, the real estate buble impacted whole American market. Real estate prices began to grow extremely rapidly, increasing by 200 percent. Americans were involved in speculative flux. There were massive increases of prices similar with the internet bubble (Lavenson, 2006). The last phase of the before the eruption of real estate crisis was the rapid increased value of real estate prices. This was enormous compared to their normal values.

In a very short period of time, drastic decline of prices emerged, making the amount of the real estate loans significantly exceeding the amount of U.S. The American myth and widespread delusion was that '' The Prices of Houses will neve fall'' because investments in this sector are secure and more profitable than other sectors. The decline began in 2006 with the subprime crisis and continued without interruption until 2008.

The U.S. Minister Henry Paulson described this recession as "the most significant risk to the U.S. economy." President Bush and U.S. Central Bank president Bernanke responded more urgently and attempted to stop and control the negative effects, saving U.S. borrowers to pay their mortgage loans. The U.S. government allocated over 900 billion dollars in the form of payments or assistance to extract the country from recession (AFP, 2007).

6.0 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 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.

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