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Triggers of the Economic Crisis

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Abstract

Trade war, stagnation, distrust of institutions and the effects of the political turmoil that change the international business environment, have intensified the empirical research over the enhanced instability of the economic systems. The present research highlights the warning signals of the slowing down economy and triggers of financial crises, the authors rationalising them, trying to find out whether a financial crisis is approaching or not, based on recent crises. Financial crises analysis leads towards asking questions about whether we can determine, predict or prevent crises and finding solutions for preparing for such events.

Key words: financial crisis, black swans, trade war, slowing down economy, recession.
J.E.L. classification: F650, G01, J00, K24, O20.

1. Introduction

In this research paper, the authors are studying the warning signals of the slowing down economy and triggers of financial crises, rationalizing them, trying to find out the main characteristics based on most of the crises from the last 20-30 years. Early signs can warn the policymakers and regulators about forthcoming financial crises (Diks et al., 2019, pp. 1201). The economic crisis is explained by the businessdictionary.com by a sudden downturn of the economy of a country, in a form of recession or depression, caused by a financial crisis.

Thinking about weather crises can be predicted or not, economists might identify the causes of crises, firstly by taking in consideration the risk factors, and afterwards analyzing the accumulation of factors that can lead to a potential crisis. Also, crises might be predictable, occurring in economic cycles, at every 8 to 10 years, or unpredictable, caused by the black swans events.

The former governor of Bank of England, Mervyn King, considers that global economy is leading towards a new financial and economic crisis, because of the economic stagnation, and too less spending, actually a low growth trap, after the 2008-2009 recession, comparing it with the economic growth that succeeded the Great Depression (Eliott, 2019). Also, he raises an alarm signal over the fact that the global economic crisis will be disastrous for the free market economy.

2. Theoretical background

Generally speaking, in the occurance of a financial crises, there are several predictable risk factors that can trigger a crisis, from which we can state some:

- Low-interest rates on loans
- Overvalues assets
- External shocks
- Manipulating the markets
- Shadow banking

- Cyber attacks on banks and stock exchanges.

Black swans events are impossible to predict, with dramatic and unexpected consequences and that are rationalized only afterwards. We can draw examples of different black swans that led to crises in the past, such as:

- The *Asian financial crisis in 1997* - consisting of currencies devaluations, that started in Thailand, after the government decided to stop pegging their local currency, Thai Baht to the US dollar. But Thailand was strongly relying on foreign debt and the currency market failed, which led to stock market decline in entire East Asia (Thailand along with Indonesia, Malaysia, Philippines, China, South Korea and Japan). In the end, World Bank and the IMF helped in solving the Asian crisis but even Europe, Russia and the US also felt the market declines.
- Another black swan triggered the *2000s* with the *Tech Bubble Crash.* Preceded by low-interest rates, telecom companies made huge investments in infrastructure technology, bought 3G licenses and ended up in debt. In the attempt to gain in the customer's competition process, the telecom providers greatly reduced their prices, which ended up in the Dot-Com Crash.
- In *2001, the Fukushima nuclear disaster* happened, when a strong earthquake, followed by a tsunami, meltdown the reactor. The nuclear accident led to huge economic costs, on compensating businesses and residents, cleaning and evacuating the area, the damages wreaked over farming and fishing in the area, and the cost numbers will get to 3 trillion$, according to Michael Barnard (2019).
- *The Great Depression and Global Financial meltdown in 2008* – the biggest economic disaster since 1929. The abundant liquidity and oversaturation of savings created resources available for investments. The low interests rates and their low volatility led to a higher appetite for high-earning assets, and underestimating the risks, a very low vigilance concerning low margins prices and not understanding the risks involved, also the cracks in the business models of rating agencies – the accumulation of these factors triggered the greatest financial meltdown.
- *The 9/11 crash* - 19 terrorists from the al-Qaeda Islamic terrorist group have planned the attacks, hijacking four American passenger airliners and crashed them over the World Trade Center towers and Pentagon. Over 6000 people died, the insurance losses were more than 40 billion$, the US stock lost 1,4 trillion $ in one week, and two wars started afterwards the Afghanistan and Iraq wars.
- The *2014 Crude oil crisis* – the oil price fell from 110$ per barrel in 2011 to 29$ per barrel in 2016 (Ellwanger, 2017), due to offer and demand factors, oil production largely expanded while the consumption did not grow enough.
- *2015 The Black Monday in China* that resulted in over 4 trillion$ losses – the stocks got overvalued in a period when the Chinese economy was going down.
- *2016 Brexit* – the cost in three years is over £66 billion and it’s just starting.

3. Triggers of a potential economic crisis and Romania’s situation

The US war trade with China and other states, combined with imposed restrictions on migration, foreign direct investments (FDI) and technology transfers, all of them have negative effects on the global supply chain, followed by slowing down growth and rising inflation. Emergent market economies (EMEs) are the most sensitive in the case of the economic crisis, as they borrow in foreign currencies. Romania is one of these countries, as the national currency, the RON is not entirely convertible, like US dollars, GBP, Euro, Yen, Swiss francs. Central Bank being the lender of last resort (LOLR) for the commercial banks, can get vulnerable in the extent of flash crashes on a less liquid financial market.

The market economy in Romania is too recent to respect the usual economic cycles prognosis and it was drastically reformed; it was subject of a large number of shocks, which masks the cyclical crisis generated by the market.

There are several risk factors that, in the extent of accumulation, might lead to a potential economic crisis in Romania such as external shocks, markets manipulation, social and political factors and over evaluated assets.

- *External shocks* – Romania is connected to an international market. Every shock in the external market can generate a crisis here, and there are two major risk factors we can expose Brexit and China situation.
- *Brexit*. For sure the withdrawal of Great Britain from the European Union will affect the common market – the most important commercial partner of Romania. Even if the UE already implemented a series of measures, it is still possible to occur several unpredictable events or bottlenecks in production that can block entire branches of the European economy. Brexit is a new phenomenon with hard to predict consequences.
- *China* and the inevitable slowdown. China will not be able to grow in the same accelerated rhythm on the midterm, partly because of the trade war with the US. Companies tend to get more cautious and hold back on investments and even cutbacks, or slowing down hiring. The labour force that was always a strong advantage for the Chinese economy is raising a red flag for the future workforce. Furthermore, their leadership diversity is quite lacking, as board members of more than 80% of the privately-owned companies and over 90% of Chinese state-owned companies are Chinese nationals. That means that shortly, the solution is hard to come from a foreign workforce. A strong influence for the labour force reduction comes from the one-child policy, which led to a demographic shift and decreased overall workforce by 13,5% in 10 years, from 2008 to 2018 (Statista Research Department, 2019).

4. Eurozone crisis afterword

Banking crises negatively impacts the level of GDP, and subsequently the capital, productivity, with other words, the potential output reduces dramatically. A banking crisis leads to a deficit in the structural budget and public debt. In the short term, this translates into a recession of the public finances and the cost for rescuing the banks and, in the long term, by lower tax revenue because of the productive potential fall. To consolidate their finances and restore fiscal sustainability, austerity measures will be needed. The European debt crisis had significant consequences for many countries from the Eurozone. Mainly triggers of most financial crises are the regulators, governments, and banks practices; even though each country has specific economic conditions and reasons that led to the financial crisis.

- Greece, for instance, did not take measures for the prolonged period of corruption, the black market economy, tax evasion and high imports (Cabral et al., 2013).
- Ireland government has financed one of the biggest Irish banks (Bank of Irland) in a period when it seemed it was lacking liquidities, but it proved out that it was actual insolvent. Bank failures, bad banking practices happened because of a lack of regulatory surveillance, the bad implementation of regulation or improper risk management of the Irish financial institutions.
- The sensitive budgetary discipline of Italy,
- the revenue crisis in Spain,
- in Cyprus banks overleveraged local companies and the exposure of their financial institutions to Greece debt crisis, together with failure in paying the structural expenses on international markets and a week financial system.

Greece, Cyprus, Ireland, Italy, Spain and Portugal have all passed through similar steps:

1) occurring the financial crisis that led to government debts that could not be paid, followed by

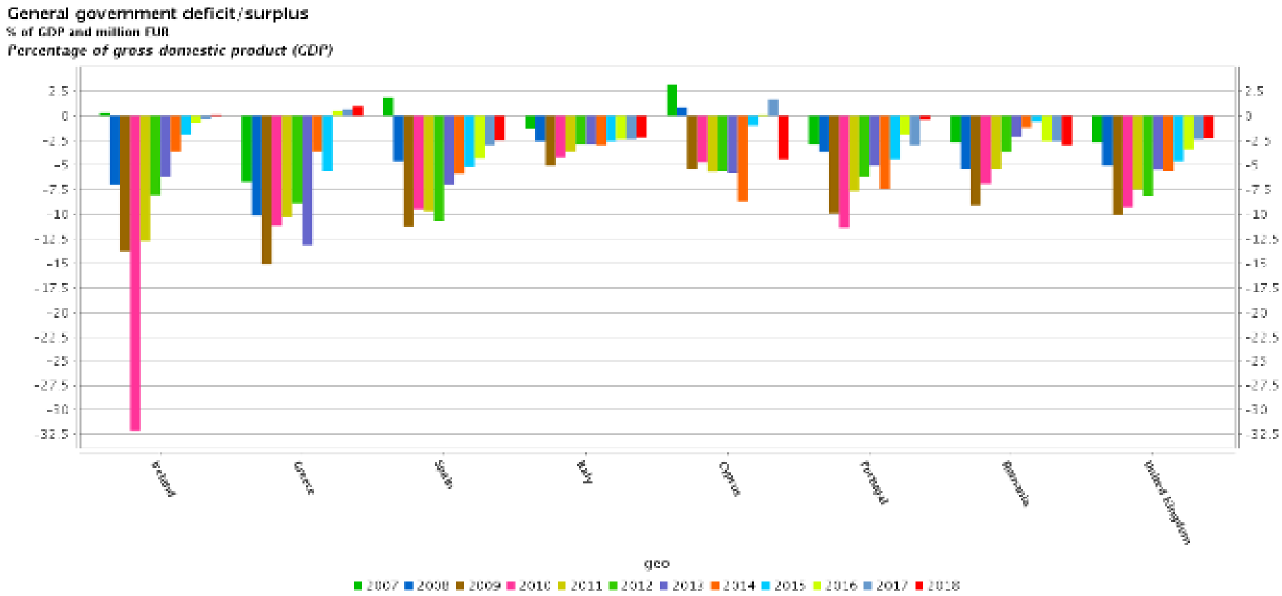
2) bail-out programs to save the excessive debt of banks and refunding their governmental debts, provided by the IMF and European Central Bank or other Eurozone countries,

3) implementation of austerity measures to payout the public debts.

In the end, Ireland, Cyprus and Portugal managed to regain access to the market in summer of 2014, also Greece ended their bailout program in 2018.

Below, we exposed the government deficit of these eurozone countries from 2007 until 2018, expressed in per cent of gross domestic product.

Figure no. 1 - General government deficit/surplus; % of GDP and million EUR in the period 2007-2018.



Source: Authors' extract from Eurostat

Prolonged austerity politics are reflecting in daily life and are usually followed by people discontent, in the beginning, and might end up in protests even with riots, and organizing reelections. As Crafts N (2019) suggests, the United Kingdom financial crisis and the extended austerity period led to political consequences like people's vote for the UKIP party and after the 2016 referendum for Brexit.

5. Conclusions

The financial markets liquidity is decreasing in the following directions: assets volatility downturn, deadlocks in executing trades, and decrease in financial market depth. 25% of the total global turnover on the foreign exchange (FX) and over the counter (OTC) derivatives market is in the EMEs, according to Bank of International Settlements (BIS 2019).

Today, the global financial system is much more precarious and unstable than it was before the 2008 financial crisis. The global debt exceeds overall levels, the possible hostile interest rate policy of US central bank, the turmoil in the Middle East, trade wars, and maybe Brexit, are likely to guide us into a global recession and financial crisis.

The democrat economies are not prepared for the consequences of another financial crisis. In the occurrence of a global financial crisis or recession, the most affected will be the emerging market economies (EMEs) but neither the advanced economies are not ready, due to their current level of public debt that would not allow them enough financial stimulus in such case.

A solution for financial stability would be an ease of the Federal Reserve restrictions in the US and the Eurozone would be the risk-sharing reform, to be implemented by the European Stability Mechanism, that would guarantee all the bonds of the European Economic Monetary Union, so all the public debts will converge into Eurobonds (Dosi et al., 2019).

The 21 century came in with transboundary challenges, like climate change, cyber crimes, high sovereign debt levels but in the same time, with globalization and technology that is shared broadly, and consequently, with an optimistic regard, we can say that they are helpful to prevent future crises and to effectively react to next recession and hope in building a flourishing future.

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