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An Analysis Of The Financial Crises Of The Past Century

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I. Introduction

A situation in which the value of financial institutions or assets drops rapidly is called a financial crisis. Financial crisis is often associated with a panic or a run on the banks, in which investors sell off their assets or withdraw money from savings accounts with the expectation that the value of those assets will drop.This paper analyses what the key characteristics of certain specific financial crises were and identifies the common traits of most of the financial crises which occurred in the past century.

Before the financial crisis of 2008-09, there have been 71 systemic banking crises since 1870 across 14 different countries. Focusing on the recent crises, in the last two decades, a number offinancial crises have taken place in both the advanced as well as emerging economies of the world. A crisis often leadsan economy towards recession and its effects are quite devastating. Financial crises are usually unfortunate part of the global industryand according to bankers as well as financiers, who are into small or large businesses, thesecrises are actually unavoidable. Many financialcrises have occurred in last 30 years that haveled to excessive exuberance, dodgy system of accounting, along with high commonality. Economic history has important insights to offer on the role of different micro and macro-economic factors which have led to these crises.

The financial crises which have been observed in the past expose the fault lines within the macro-economics of country from where they originate.Among the different economic criseswhich have taken place in the past,Great Depression of 1930was one of the most severe depressions for the entire world.Great Depression was the deepest, longest as well as the most widespread depression that took placein the 20th century. The after effects included the reduction of theinternational GDP by 15% between 1920 and 1932. United States of America was the first country to be hit by this Great Depression wherein the Stock market was hit in FY1929, which then heavily impacted both the developed and developing countries. The Great depression had very adverse effects on the world economy,including reduction in tax revenue, prices, per capita income and profits of the major industries.During the recession period,unemployment in America increased by 25%,and in other countries, by 33%.

As soon as the world recovered from this Great Depression, a number of countries were hit by the oil crisiswhich started in 1970. This was an effect of the proclamation initiated by Arab Petroleum Exporting Countries (OAPEC) onan oil embargowhich led to the increase in the cost of oil from $3 per barrel to around $12 per barrel. The oil crisis had many short and long term impacts on both the international politics and economy. After the crisis, OPEC stressed oil companies to raise their payment, and in 1974 oil prices increased to around $12 per barrel. The major effects ofincrease in oil prices were seen on the oil exporting nations, such as those in the Middle East. Nearly half a decade later, the 1997 financial crisis broke out in Asia.The baht collapsed in Thailand, when governmentstressed to float it in open market. Furthermore, their inability to pay back the huge debt taken from foreign entities caused their currency to plummet. This crisis had a negative influence on other Asian countries like Hong Kong, South Korea, Malaysia, Laos, and Indonesia. The Asian Crisis necessitated around US$40 billion bailout through the International Monetary Fund (IMF). Next in line came the dot com crisis in FY 2000 when the artificially inflated stocks of the IT companies crashed, leading to the dot com bubble burst. Positive sentiments and high rates of return led to unrealistically high valuations of the stocks of the IT companies. Individuals wanted to become millionaires by buying the stock of the companies such asAmazon and eBay. However, by the end of the year 2000, the economy slowed down and the hikes in interest rates diluted the money whichcame from these companies. As aresult,several dotcom companies were liquidated.

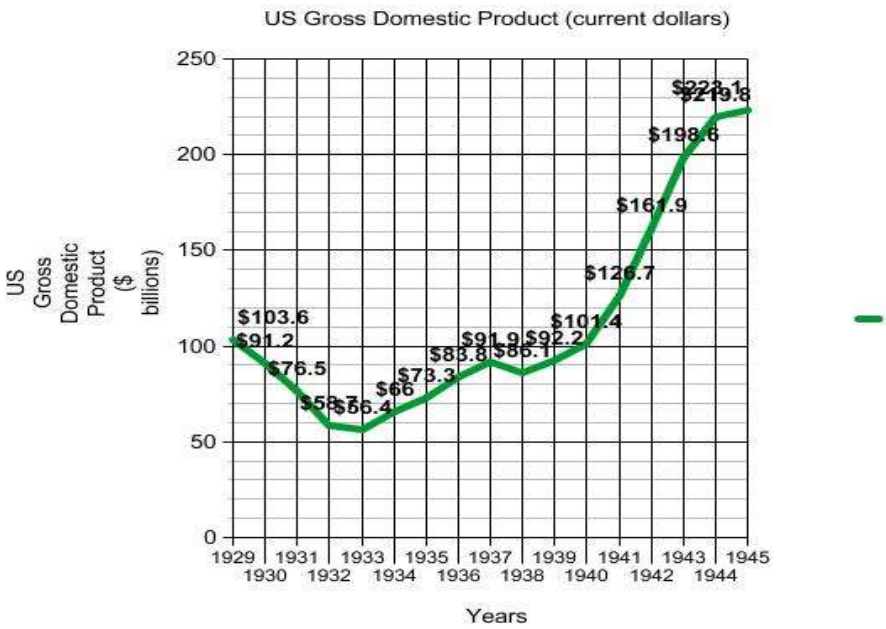
More recently, in FY 2007-08,the Global Financial Crisis, also known as the Hamburger crisis, impacted the global financialmarketsleading to a loss of billions and slow down of the international economy. This crisis led to the collapse of various financialinstitutions. There are many reasons behind its occurrence, but the main reason was the crash of housing market of US.

In order to draw lessons, from the financial crises, which have occurred in the past, this paper reviews the economic history of each of these crises which would enhance our understanding of factors responsible for these crises.

II. The Great Depression

The Great Depression (1929-39) was the most profound and longest-enduring financial downturn in the historical backdrop of the Western industrialized world. In the United States, the Great Depression started not long after the stock market collapse of October 1929, which sent the Wall Street into frenzy and wiped out a large number of investors. This was followed by reduction in customer spending, bringing about steep decrease in modern yield and rising levels of unemployment. By 1930s, when the Great Depression came to its epitome, nearly 13 to 15 million Americans were unemployed and a large portion of the national banks were on the verge of shutting down. The situation, however, changedwhen Franklin D Roosevelt got elected as president in 1932.

Roosevelt made quick moves to address the nation's monetary hardships, first declaring a four-day "bank holiday" during which all banksremained closed so that Congress could formulate new laws needed for reform. Apart from that, he addressed the general population over the radio in a progression of talks, and these supposed "fireside visits" went far towards restoring open certainty. InRoosevelt's initial 100 days,his organization passed legislations that were meant to balance out mechanical and farming generation, generate employment and make the economy recover. Roosevelt looked to change the money related framework with the establishment of Federal Deposit Insurance Corporation (FDIC) to ensure contributors' records and the Securities and Exchange Commission (SEC) to manage the share trading system and avert misuse of the kind that prompted the 1929 accident.

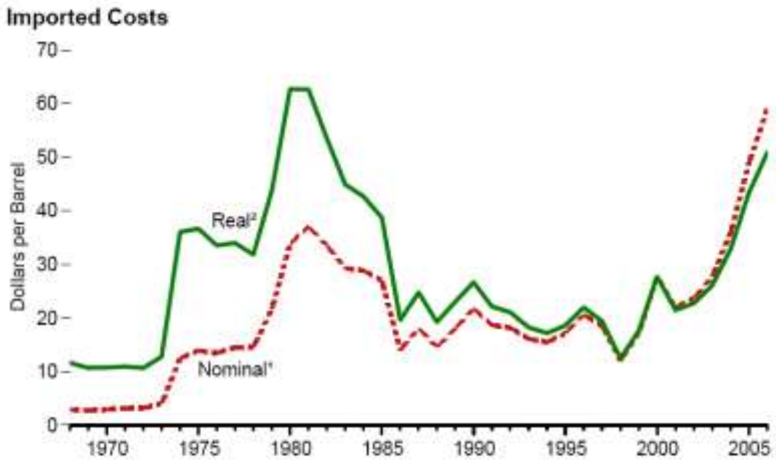


III. The Oil Crisis Of 1970s

In the early 1970s, the oil consumption demand rose in US and this demand could not have been met by oil which was generated locally. The decline in in-house production, soaring demand and dependence on oil import led to spike in overall oil costs. However, the situation was not alarming yet as policymakers in Washington trusted Arab oil exporters and believed that Arab countries couldn't bear the loss of income from the U.S. market. These presumptions were destroyed in 1973,when an oil ban forced by individuals from the Organization of Arab Petroleum Exporting Countries (OAPEC) prompted fuel deficiencies and extremely high prices for oil and gas in the following years.

Apart from the discomfort caused to the consumers, the crisis was a colossal hit to the American car industry, which had for quite a long time started making a greater number of cars that would use more fuel and would now be outpaced by Japanese makers creating smaller and more fuel-efficient models.

The oil ban was lifted in March 1974, yet oil costs remained high, and the impact of the crisis could still be observed across different sectors. Apart from value controls and gas apportioning, the government imposed a national speed limit and daylight sparing time was embraced year-round for the time of 1974-75. Environmentalism became extremely important after the crisis and many energy related policies were now amended to incorporate this novel idea. Different demonstrations of enactment amid the 1970s looked to rethink America's relationship to fossil powers, from the Emergency Petroleum Allocation Act (initiated by Congress in November 1973, at the heightof the oil frenzy) to the Energy Policy and Conservation Act of 1975 and the making of the Department of Energy in 1977.



IV. The Asian Financial Crisis

The Asian Financial Crisis was a time of monetary emergency which influenced a large part of Asia starting in July 1997, and raised apprehensions of an overall monetary crisis (budgetary infection) and was thus also known as the IMF emergency.

The emergency began in Thailand with the financial breakdown of the Thai baht created by the decision of the Thai government to skim the baht, slicing its peg to USD, after comprehensive endeavors to bolster it in an extreme financial overextension that was to some extent driven by the real estate sector. At the time, Thailand had procured a numberof remote obligations that made the nation bankrupt even before the breakdown of its cash. As the crisis spread, a large portion of Southeast Asia and Japan saw drooping monetary forms, depreciated security exchanges and other resource costsand a steep ascent in private loans.Indonesia, South Korea and Thailand were among themost influenced nations by the emergency. Hong Kong, Malaysia, Laos and the Philippines were likewise harmed by the droop. The People's Republic of China, India, Taiwan, Singapore, Brunei and Vietnam were less influenced, albeit all experienced loss of interest and certainty all through the disaster.

Remote obligation to-GDP proportions ascended from 100% to 167% in the four biggest ASEAN economies amid 1993-1996 and shot up past 180% amid the worst times of the emergency. In Korea, the proportions ascended from 13-21% and after that reached as high as 40%, while the other Northern NICs (Newly Industrialized Countries) fared much better than the rest despite the downfall in the economy, Thailand and Korea were the only countries where the debt services to exports ratio increased.

Although most of the governments of Asia had apparently stable financial approaches, the International Monetary Fund (IMF) ventured to start a $40 billion system to settle the currencies of South Korea, Thailand, and Indonesia which were the worst hit economies. However, the endeavors to stem a worldwide financial emergency did little to balance out the local circumstances in Indonesia. After 30 years in office, President Suharto was compelled to venture down in May 1998 in the wake of boundless revolting that took place after sharp cost increments created by a radical downgrading of the rupiah. The effects of emergency continued through the year 1998. In the Philippines, development dropped for all intents and purposes in 1998. Only Singapore and Taiwan demonstrated moderate stability.However both endured genuine hits in passing, the former all the more so because of its size and presence in area between Malaysia and Indonesia. By 1999, investigators saw signs of recovery in the Asian economies which initiated the recovery process.

V. The Dot Com Crisis

Amid the late twentieth century, the Internet promptededa euphoric state of mind toward business and set up the basis for the eventual fate of online trade. Consequently, numerous IT based organizations (known as "dot coms") were propelled, and investors unrealistically expected that an organization that worked online would be worth millions.

However, numerous dot coms were not super successful, and most of these organizations were exceedingly overvalued. Therefore, a considerable lot of these organizations slammed, leaving financial specialists with substantial losses. It is believed that the breakdown within these Internet stocks hastened the 2001 securities exchange crash significantly,with a loss ofnearly $5 trillion. In the mid-to late1990s, the general public's desires of what the Internet could offer were implausible. From individual thinkers to significant organizations, internet business visionaries were fascinated with the idea of becoming website tycoons. These business visionaries were motivated by organizations like Amazon, eBay, and Kozmo. For each organization that developed to be a multi-million dollar business, many others failed.

Numerous speculators disregarded the principal tenets of putting resources into the stock exchange, which include examining Pricing Earning (P/E) ratios, concentrating on business sector patterns, and auditing marketable strategies. Rather, investors and business visionaries got engrossed with new thoughts that were not yet demonstrated to have market potential. Moreover, they overlooked the unmitigated signs that spoke the truth about the upcoming crisis.

VI. The Great Recession

The Global Financial Crisis started in mid-2006 when the subprime home loan market in the U.S. started to show an expanding rate of home loan defaults. In late 2006, these defaults lead to a decrease in US lodging costs after almost 10 years of astoundingly high development. By the late 2007, the prime home loan markets were demonstrating higher than typical default rates also.Collateralized Mortgage Obligations (CMOs) permitted these issues to spread from the home loan business to different areas of the economy, having widespread consequences for budgetary markets. CMOs were home loan supported securities issued by venture banks and other money related foundations. These securities were not regulated by the government, which led to the fall in home loans as well as the securities attached with it.

These CMOs turned into "dangerous resources" and the defaults in the home loan markets led to the breakdown in the estimation of CMOs, dragging down the accounting reports of the significant players in speculation. The breakdown in estimation of CMOs led to serious financial problem because noone was exchanging CMOs as the real value of these CMOs was not the same as before. These liquidity issues swung to bankruptcy in September 2008, when private lending solidified in various vital commodity markets like commercial paper. Subsequently, non-financial organizations were also not able to acquire the financing they needed to work ordinarily, leading to problems in the real economy.

The real signs of crisis within the economy started to reflect in early March 2006, when investment expenditure on private structures started to decrease. In mid-2008, this decrease spread to interest in business and buyer spending on strong merchandise. It was not until the mid-2008 that consumer spending and GDP started falling, leading to recession. While people in general had been worried about subsidence for a significant part of the year, it wasn't until the fall that the economy started to decay at more than a 6% annual rate. Congress reacted by passing theTroubled Asset Relief Program(TARP) plan to help falling money related foundations. This arrangement was intended to diminish the seriousness of the retreat by treating its reason: the financial crisis.

VII. Causes

Various factors have led to the occurrence and re-occurrence of financial crises, and the main cause as per the economic history is leverage. Academically, RaghuramRajan (2010) in his book, *Fault Lines* argued that inequality in the stagnating incomes within US was the main cause of financial crisis of 2008. Further supporting the argument, Galbraith (2012) analyzed the world economy for 40 years and concluded that income inequality has played a major role as the main cause of financial crises over the last 40 years. His research further argues that this phenomenon is not only restricted to US, but is applicable from Brazil to China. Furthermore, Fitoussi (2009) argued that the root of all the financial crises in the past is "*unprecedented rise of income and wealth in advanced economies*". He argues that inequalities in income depress the aggregate demand and in turn allow the private debt to increase beyond sustainable levels, leading to a crisis.

Further, excess leverage has also been indicated as one the main reasons behind financialcrisis. Leverage is more than balance sheets;itis also embedded in the instruments of off-balance sheets. The only solution to this problem isacceptance of consequences of government action that are not so harmful in comparison to a financial crisis. Apart from this the industry should be given independence to improve the accountancy and transparency to make more efficient estimates of capital requirements. If the high leverage hedge funds and banker funds profits get reduced, transaction volume could also get slow, the financial sector will shrink and also bonuses will follow the same path. Another cause of financialcrisis is mismatch of liquidity, which includes lending for long term and borrowing for short term.

Nowadays industries comprise of companies that are too big (which have maximum impact on financial crises)and therefore a systematic approach is required to govern and manage these firms with an altered system of architecture. Hence, it is important that every system should be balanced efficiently. Also the companies should improve their resilience through decentralization, immense diversity and bymaintaining excess buffers. There is no such profession that could tolerate the conflicts of interest. Stressing on the financial industry to go with line of business and type of customers will resolve the conflict issues through improving the resiliency of system by increase in firm diversity.

Another cause of financial crisis is tax policy that impacts cost as well as flow of capital and the present tax code, which even impact the finance needed. Therefore, taxes like FinancialTransaction Tax should be considered in order to discourage speculations for short termandfurtherlong term investments should be encouraged. Economies require progressive capital gaintax that impacts the long term investment less than speculations for the short term. It is evident that beneficial tax treatment of interest is quite absurd.Therefore, it's important to ensure that subsidy is offered to retail banks through the FDIC insurance, which could be recycled in the main stream economy instead of being used for subsidizing the Wall Street speculations. Currently, financial system has expanded and has had a spillover impact on the overall economy.If the exchange could be understood and properly governed, there is no way through which democratic civil society could try to increase frequency trading speculation in the financial market. This will make the economy more resilient to the crises but at the cost of more regulated market.

Not only are these causes connected with bad decisions taken by bankers, rating agencies, regulators or central bankers, but also with the policies already in place. Hence,planning should be done accordingly,learning from the past mistakes so that severe impacts of crisis could be reduced. Delving further on 2008 recession, it can be concluded that financial crises occur when banks create too much money in a short period of time,and then try to artificially push up the housing or stock prices in an effort to speculate and make quick money.

VIII. Measures Undertaken To Prevent Crises From Recurring

In order to avoid the crisis, it is not only important for the countries to befinancially strong but also tohavesound macro-economic policies. A sound macroeconomic policy framework is the one which promotes the economy's growth by keeping the inflation rate low, maintaining a small budget deficit and a sustainable currentaccount. In the case of debt dynamics, the present account sustainability relies on the growth rate of economy and the actual interest rate at which the organizations are borrowing funds. In any case, huge deficit ofcurrent account relies on the economy's growth rate.If this growth rate lies in the range of 5-8% of GDP, it is quite high and could be considered as a cause of concern.

The research in the past has focused on identifying factors through which the incidences of financial crisis could have been avoided, but the main concern is related to resolution of these crises. In the process of solving the financial crisis, apart from the economic condition, political leadership is alsoimportant component. Lack of strong leadership is also one of the factors which have a role to play during the period of crisis. There are many global examples, such as South Korea 1998, Brazil in 1994 along with Turkey in 2001, whereinfinance ministers developed programs which included strict measures which were properly planned and led totheir growth.Howeverthis same strong leadership has been lacking in Europe, which has faced many financial crises in the past.

Financial crises have depicted weak points in the present supervisory and regulatory framework. The present developments have also made it clear that swift action isneeded in certain areas in order to minimize the crisis risk. These include: better ways for assessing the systematic risk; expansion of cross border scope as well as cross-institutional regulations; enhancing the transparency as well as disclosure of risks which is collected from different market participants. After putting this data in a mechanism, the coordinated action plan can be undertaken. Effective regulations are required to be undertaken in order to understand the potential of financial markets.

International crisis often reflect over excessive risk taking as well as high leverage in context of financial institutions as well as economic agents. The main driving factor of an economy is that people should try to respond towards the incentives given to them in the market. Therefore, to minimize the probability of a financial collapse, the actual source of incentives must be understood. In this context the decision made by the individuals in speculating about the financial market should be closely studied and they should be advised so that they do not take wrong decisions in the future.

In conclusion, the policy makers will have to consider each financial crisis closely in order to insure against the risk of volatility of global financial flows. This would lead to the emergence of systematic financial stability. Further, since global capital market integration is dependent on the political and financial benefits to the countries, therefore it is important to focus on identifying the benefits of financial globalization which will outweigh the costs incurred due to financial crises.Financial crises are a destructive force in the economy, which cause widespread loss of money and assets and thus they must be avoided at all costs.

IX. Conclusion

The financial crises catalyze various responses that include exploring the causes, scapegoating, and huge injection of capital along with reworking on regulations. Without having the understanding about the causes, the solutions might be more devastating than the problem itself, and valuable upliftment in the financial tools might get lost. In order to respond to international financial crises in the future, we need solutionsof all the profound questions that relate to the past crises, which have resulted into the huge social as well as economic devastation.

The magnitude of the crisis has a direct relationship with its effects all over the world. While some crises remain limited to the country of origin, some become big enough to impact other countries as well. The bigger the crisis, the more impactful it will to the entire world. Though crises seem to be inevitable, there are a number of things that can be done to avoid them. Though there are a number of upcoming theories, it is best to learn from our past. Studies of the financial crises that have already occurred give us a good understanding of what went wrong during these times of emergency. These help us to see our present economic situation in a new light and to formulate policies that aim at avoiding the problems that have taken place.

This paper is helpful in understanding about different financial crisis taken place all around the world and how they have impacted different economies of the world. It also explores the major causes of these crises and what are the best methods for prevention. Since prevention is better than cure, it is better to prevent the financial crises before they even begin to appear in our economy.

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