CAUSES, EXTENT AND WAY OUT OF THE GLOBAL FINANCIAL CRISIS

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Abstract: *There is no clear and unequivocal conceptual content of the term crisis, but there are many and often mutually different interpretations.*
Crisis phenomenon has aroused the attention of a large number of researchers from different fields (economics, history, politics, medicine, ecology, psychology, etc.) so the concept of crisis is often used in different meanings for different research fields: psychology of the crisis of personality, medicine on a crisis as the peak of illness, and the ecology of thought to the critical vulnerability of the environment, and so on.
The financial crisis has primarily occurred with the collapse of the U.S. mortgage lending market, quickly spread around the world, and in addition to the financial and affected real sector too. Causes of the crisis range from systemic characteristics and institutional characteristics of the economy up to the inadequate economic policies and the greed of some groups, in particular financial institutions and companies. In today's world, financial transactions far exceed the value of world trade, a phenomenon known as the financialization, which results in a transfer of income from the real to the financial sector. Measures taken to overcome the crisis are of historic importance because the future configuration of the global financial and economic system will depend on their effectiveness.

Keywords: *management, financial crisis, budget deficit, financialization, risk, research fields, economy science, psychology*

1. INTRODUCTION

Pol t'Hart gave the contemporary definition of crisis: Crisis is a serious threat to the basic structures or the fundamental values and norms of the social system which, in terms of time pressure and highly uncertain circumstances, requires making critical decisions."
This definition has two important characteristics.
First, it states that it can be applied to all kinds of disturbances (environmental threats, economic crisis, conflicts within states, riots, wars, explosions, factories and natural disasters).
Second, this definition focuses our attention on decision-making: the crisis is seen as an opportunity to make critical decisions.
Although this definition is the most acceptable one, it is not perfect. Who has the power to decide whether a process is an improvement or disruption of normalcy? It is loaded with

the return to normalcy and order. It does not solve the problem of subjectivity, because we can talk about the crisis only if the participants perceive the given situation as a crisis (so-called Thomas's theorem).

A crisis occurs when the institutional structure of the social system experience relatively strong decline of legitimacy, while its central service functions are weakened. During the crisis, political and social trust disappears relatively quickly. It is not understood as an almost state (the result), but as a process that has no clear beginning. The crisis can be felt in the future. The process of the disorder is rooted in a combination of exogenous and endogenous factors. For an organization, the crisis is an environment in which cannot normally operate. The crisis threatens the viability of the organization, preventing achievement of goals, and even survival in some cases.

2. CHARACTERISTICS OF CRISIS

The main characteristics that are common to all crises are:

Unexpectedness

When a crisis occurs, it is certainly unexpected, although some features of a crisis could be clearly visible prior to its creation. Few crises act without any warning or sign. The degree of predictability varies as to whether the leadership really cannot predict the crisis, or is unaware of upcoming danger. Among the crises that leadership cannot easily predict are terrorist attacks. There are crises that are surprising for leadership that are not prepared in their immediate vicinity, but outside of it, for example, in the media, government, and others.

Unreadiness

Managers are often reluctant, sometimes unaware of the crisis, which significantly contributes to the fact that the environment is both complex and not sufficiently reliable. In the modern world full of information, managers hardly get enough quality information for decision-making. In order to reduce reluctance and uncertainty as much as possible, they often use statistical assessment of potentially hazardous and critical events. They must then take into account the fact there are events that are unlikely, but bear crisis with major consequences.

Time pressure

The crisis is a test of management skills because in the conditions of unpreparedness and the apparent unexpectedness, decision-making faster than usual is required from manager, which is a highly stressful situation. Therefore, for successful crisis management it is necessary managers to be aware of and comply with them in designing appropriate management programs - primarily at building a system to facilitate the detection and emergency planning. [1]

Following the greatest economic crisis of all time, known as the Great Depression, which lasted from 1929 up to 1933, the crisis are occurring often: big debt crisis in 1982, Wall Street crash in 1987, Scandinavian crises (Sweden, Norway, Finland) in 1991, Mexican Tequila crisis in 1994, The Asian crisis (Japan, Thailand, Indonesia, South Korea) in 1997, the

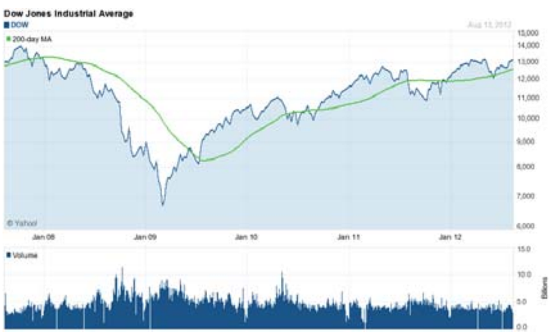
[1] Oskar Kovač, "Uzroci i mogući koncepti rešavanja svetske finansijske krize", *NSPM*, oktobar 2009.

Russian crisis in 199, the Brazilian crisis in 1999, the dot-com speculative bubble in 2000, Argentina's crisis in period 2001-2002, and the latest global crisis in 2008. Most crisis since the Great Depression had a local or regional character, and the most recent crisis, in 2008 was primarily developed in the United States and spread worldwide. Many are entitled to ask whether it is possible that the departure from the scene of most of the witnesses of the environmental severity and scale of the Great Depression the world has forgotten the consequences and easily allow that situation again, expressing concern whether the economics lost its instinct for danger, or has not developed mechanisms for the anticipation of the crisis indicators and measures for its effective prevention. The question is whether the future is, especially the crisis, possible to predict one of the intriguing questions of our time. As recognized by Robert Lucas, Nobel laureate, economists do not have a formula to reliably predict the moment when a financial bubble is going to burst, and if they have, that would change nothing, because the information people would immediately incorporate into their decisions, and so the crisis would occur when the model indicated.
Finally, it should be noted that the effects of the crisis are asymmetric, both geographically and territorially.[2]

3. KNOWN INDICATORS OF GLOBAL EQUITY INDEXES

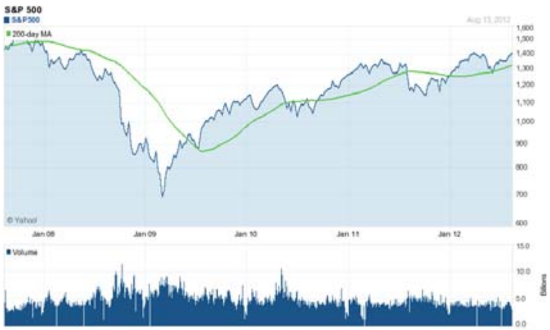
If you look at the two, perhaps the most important global equity indexes, Dow Jones Industrial Average's, which shows stock prices of the top 30 U.S. companies (Figure 1), and the broader index S&P 500 (Figure 2), which includes shares of the top 500 global companies, their comparison with simplest technical indicator of moving average 200 (Moving Averages - MA 200), which indicates a change of trend that is changing when the index starts to move above or below the MA 200, it can be seen that in mid-2008 both indices are entered in the primary negative trend. The negative trend continued until august 2009, when once again primary upward trend was recorded, with fluctuations in the mid-2010, but with the continuation of the trend. Since august 2011, the stock market, as measured by these indexes, was falling again for two months, after which got into a slight, but unsure growth.

Figure 1: Dow Jones Industrial Average's (www.Yahoofinace.com, 2012.)



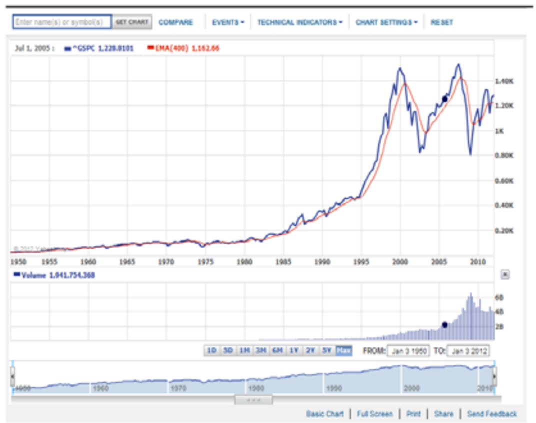
[2] Dragana M. Đurić, "From crisis to crisis?", *International journal of economics and law*, Vol. 1, No. 1 (April 2011): 36.

Figure 2: S&P 500 (www.Yahoofinace.com, 2012.)



Historically, S&P 500 shows a steady moderate growth in the ‘90s of the twentieth century, and since 1995, the market began to grow rapidly, resulting in the collapse of the dot-com stocks in 2000. From 2003, the market continued to grow, until the new fall in 2008, and the re-growth in august 2009. Figure 3 is using MA 400, in order to better understand the trend. It is interesting that in the period 2000 – 2007, there have been formed double figures of the top and the bottom of almost identical values, and it remains to be seen whether the new trend will surpass previous peaks, which would mean further market growth.

Figure 3: S&P 500 and MA 400 (www.Yahoofinace.com, 2012.)



Not ignoring the shortcomings of technical analysis that indicates the change in trend, the approach towards the moving average of the index and fall of its value below the moving average, indicates a change of a trend or a change in the expectations of market participants. In other words, technical indicators can identify changes in the expectations of market participants, where the prevailing pessimism results in a drop in prices (downward trend), and the optimism results in a growing trend.

4. OPINIONS ON THE ECONOMIC SCIENCE TO CRISIS THROUGHOUT HISTORY

According to classical economic theory by Adam Smith (1723-1790), the "invisible hand" of the market is sufficient to ensure economic stability and full employment. Rational actors who carry out transactions of which have economic benefits manage the economy. Thus, an employee who is willing to work at a price that is less than the produced, provides business to itself and capitalist who was hired him to make a profit. On the other hand, those who are looking for an unreasonably high wages will only be out of work and such unemployment is voluntary. The moment they reduce their requirements, they will be employed. In other words, the mechanism of the free market is perfect and stable, so there is no need for the involvement of the state. There is a misconception that Smith, as a supporter of the market system, denied any state role. On the contrary, Smith believed that the government could bring great benefits to economic life, especially for the protection of contracts and patents, public education for the poor, infrastructure projects, ensuring peace, easy taxes and a proper administration of justice. Everything else, according to Smith, brings the natural order of things. Believing in perfect functioning of the invisible hand, Adam Smith did not bother to explain the ups and downs of the economy.[3]

According to the neoclassical school of economics, which occurs in the 19th century, the crisis in the real and the financial sectors, and macroeconomic imbalances are not possible because the rational behavior of economic entities and perfect functioning of the commodity and financial markets automatically remove each such imbalance. Neoclassics believe that on money and capital markets there is equal information to all stakeholders and there is no moral hazard, and that there is a perfect competition on the labor market, where no one can request and receive a higher salary than the equilibrium (or will remain unemployed), with a homogeneous and perfectly mobile working power. Producers and consumers are perfectly rational, perfectly familiar with all the constraints, structure of the market, and are able to reliably predict the future. Under the conditions of perfect competition, which includes the huge number of buyers and sellers who individually can affect price, perfect usage of the information, which means that everyone knows all the information on requested and offered products, assuming they all have equal opportunities to predictions, no one can gain a competitive advantage on the basis of above-average good anticipation of the future. Under these assumptions, the general equilibrium in an economy that does not require the intervention of economic policy is guaranteed. As the market is equal to the sum of the individual participants, participants seek to optimize their market position of a product tends to equilibrium. According to the neoclassical theory, recessions are possible and occur due to sectoral imbalances, but in these cases, the self-correcting mechanisms trigger that put back the market into balance. In other words, the problems at the macro level do not exist, because even though individual market may be out of balance, at the aggregate level, the balance is guaranteed. Since according to the neoclassical assumptions the markets are perfect, recessions are by definition short-lived.

Based on the study of the devastating effects of an unprecedented economic crisis called the Great Depression, John Maynard Keynes, 1883-1946 in his capital work „The General Theory of Employment, Interest and Money", opposed the neoclassical general equilibrium model. Keynes believed that not only rational individuals handle the economy, and

[3] Džordž Akerlof, Robert Šiler, *Životni duh* (Beograd: Službeni glasnik, 2010).

the overall (aggregate) consumption divided into personal, investment and government spending[4]. According to him, the investment is undertaken based on the profit that entrepreneurs expect. The drop in demand in the market of consumer products means fewer sales, and consequently falling profits, which results in lowering demand for investment goods. Less investment means less production, less employment, the population becomes poorer, which further leads to a decrease in personal consumption. The financial and economic crisis are the result of deterioration in the real sector of developed countries, which in the last decade recorded slower growth in gross domestic product. Thus, in the period 2002-2011 average growth rate of GDP in the U.S. was only 1.6%, in Japan about 1%, in the euro area 1.3%, while at the same time, China recorded an average increase of almost 10%. Decline in productivity in developed countries was recorded long before the onset of the crisis and the decline in employment and wage levels.

The volume of financial transactions is still well above the value of productive investments. Contrary to the ruling modern financial theory, according to which the basic functions of financial markets is efficient risk diversification and the efficient allocation of resources, financial markets have become a purpose of themselves. During the first eight decades of the twentieth century, financial assets grew at the same pace as the global GDP, followed by the ratio of the value of global financial assets and the annual world gross domestic product has increased, so has grown to nearly 442% in 2007. In other words, the volume of transactions in the global financial markets far exceed the value of world trade, which leads to the conclusion that the real economy has become “a satellite” of the financial sector. Separation between the real and financial sectors is called the financialization in the literature. The consequences of the financialization are growing income transfer from the real to the financial sector, increasing income inequality and the growing influence of financial incentive to manage companies. When the price of certain financial assets derive from relations with the prices of financial assets without any connection with the situation and developments in the real part of the economy, “bubbles” on the basis of unrealistic expectations create that mark the beginning of the financial crisis.

5. POSSIBLE SOLUTIONS TO OVERCOME THE GLOBAL FINANCIAL CRISIS

Upon the occurrence of the insolvency of major U.S. banks and other financial institutions, a stabilization of financial markets with a number of measures has been attempted. Government intervention included the provision of guarantees for interbank transactions and loans to large companies, increasing the amount of guaranteed deposits, issuing government bonds. Re-capitalization of banks and fiscal stimulation of demand in the real economy has led to an increase in the budget deficit to gross domestic product of the United States. Because the U.S. dollar remains the world’s main currency in international payments, is main currency in foreign exchange reserves of many countries, and the fact that over 70% of the issued $100 bills never come back to the U.S., funding of the huge trade deficit is possible by printing dollars without the risk of inflation. Therefore, the dollar in a way has become the most important U.S. export product, and the U.S., due to the huge market, the largest trading partner of many countries. In other words, the U.S. can

[4] Ognjen Radonjić, „Keynesova teorija konvencionalnog odlučivanja na finansijskim tržištima“, *Sociologija,* Vol. LI, No. 4 (2009).

afford large trade deficits and balance of payments because other countries like to go with them to the surplus thus increasing its foreign exchange reserves.[5]

It can be said that after the Great Depression, the measures of fiscal policy (public spending, taxation and debt management), then promoted by John Maynard Keynes in this crisis regained its importance. The fiscal policy of many countries in this crisis is aimed at stimulating economic activity by increasing the demand, job creation and investment in infrastructure (roads, energy, gas, etc.), fostering the development of small and medium-sized enterprises, encouraging consumption by reducing taxes and contributions on personal income, subsidizing consumer loans and corporate loans of citizens, social assistance to unemployed and socially vulnerable category of people. In some countries, an important part of recovery plans was an allocation of significant resources to research and development, technology and education projects.

The crisis has highlighted the need for the constitution of new global representative body at the level of heads of state and government to coordinate the functioning of the global economic system (to direct economic and social development, competition, regulation of financial markets, environment, global warming, etc.). It also raised the question of the necessity of reforming institutions such as the World Bank and the International Monetary Fund. There was the need for harmonization of regulatory systems to ensure the reliability of financial products, particularly financial derivatives. Particularly important is the regulation of financial markets, which should adequately protect the investors. It is necessary to take care not to stifle “creativity” in these markets. A fuller and more effective regulation should include the credit rating agency, where you can hear the voices that indicate to the necessity of forming a reputable institution of this type in the euro zone.

In order to provide a better system of protection against risks than foreign exchange reserves, a new global reserve system based on the significantly increased role of special drawing rights is proposed. In particular, it focuses on the role of central banks in ensuring price stability, maintaining the financial stability of capital flows, the adequacy of exchange rates of national currencies to the achievement of sustainable economic growth. In order to reduce the volume of issues in the international financial system, it is necessary to establish a commonly accepted mechanism for restructuring the debt of states and harmonize national rules on resolving disputes regarding cross-border investment.[6]

Five necessary measures necessary for the euro zone to survive are (1) making programs to reduce excessive government debt, (2) aggressive plan to reduce the budget deficit in the near future, 3) support for the monetary policy by the European Central Bank (4) the introduction of mechanisms to encourage long-term fiscal sustainability, and (5) institutional changes that reduces the scope for excessive borrowing and causing instability in the financial sector.

6. RESUME

The global financial and economic crisis has brought a lot of trouble: a decline in production in many countries, especially the decline in housing construction and other related industries, the decline in employment, the outflow of foreign capital, a lack of trust in

[5] Stephane Dees and Arthur Saint-Guilhem, “The Role of the United States in the Global Economy and its Evolution Over Time,” *Working Paper Series* No.1034, European Central Bank, Mart 2009

[6] Strauss-Kahn, Dominique, “Lessons from the Financial Market Crisis: Priorities for the World and fort he IMF”, *ICRIER*, New Delhi, India, February 2008.

financial markets and the consequent fall in prices, stagnant growth and decline of social products in many countries. As the financial and economic crisis has affected many countries, the elimination of its consequences should provide global solutions. In conditions of high flow integration in the world economy, it is necessary to establish competent authorities and to establish methods and standards to prevent and deal with the effect of financial and economic crises.

Many countries immediately after the outbreak of the crisis promptly responded easing monetary policy by pumping large amounts of money at very low interest in insolvent banks and other financial institutions. Fiscal policies have encouraged economic activity, but for the long-term recovery, the overall stabilization of the financial system is necessary, creating conditions for faster economic growth and its encouragement of investment in infrastructure and human resources as key factors in the long-term growth and reducing unemployment. Elimination of the macro-economic imbalances is essential to reduce the possibility of the recurrence of crises in the future.

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