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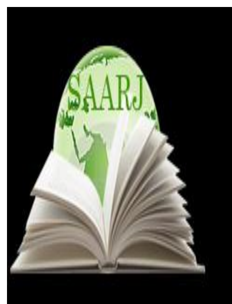

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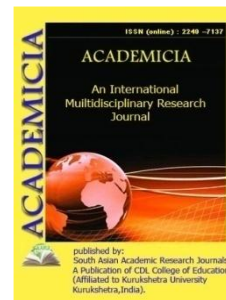

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FINANCIAL CRISIS AND HOW TO PREVENT IT

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ABSTRACT

The article identifies the main stages of the crisis, which include: a series of foreshocks that began in August 2007, followed by an economic downturn that lasted until August 2008, when the liquidity problems could not be solved by three large US financial institutions ; a serious financial shock in September 2008, in the last few months of 2008; end of financial shock and panic; early 2009 financial recovery and recovery period in the real sector of the economy. The article examines the main factors of the emergence of the crisis, which together reflect all the reasons and their interconnections; therefore, they can reveal the full picture.

KEYWORDS: *Financial Crisis, Economic Crisis, Financial Markets, Credit Bubbles, Mortgage Bonds, Financial Activity, Credit Risks.*

INTRODUCTION

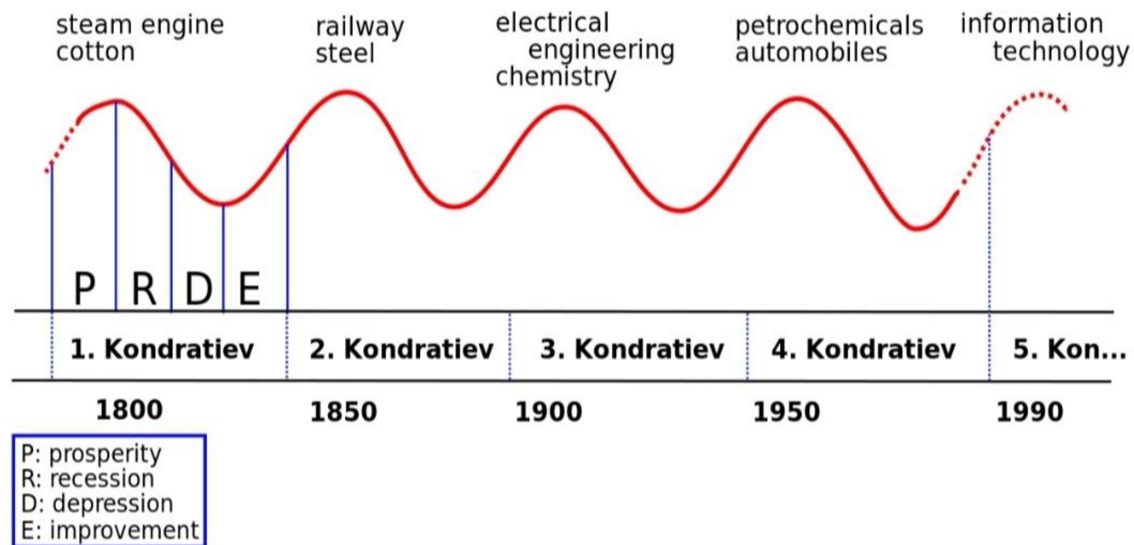
There are several points of view about the cause of the 2008 financial crisis, but each of them is supported by one reason. Some economists believe that the cause was international capital flows or monetary policies [1], others that it was caused by housing policy [2], others that it was insufficient regulation of the banking sector, or the greed of those who functioned in the financial sector and had political influence in Washington [3]. In any case, these arguments, if used as the only explanation, are too simplistic and incomplete. While all of these factors are undoubtedly important causes of the crisis, each of them is insufficient as an autonomous explanation. The approach of most other experts who try to explain the crisis suffers from the opposite problem -

it is too broad [4]. Not everything that went wrong during the financial crisis triggered the crisis, and while some of the causes were significant, others had only minor impact. Not every change in the housing or financial system before the crisis was the cause of the crisis.

The hypothesis that the crisis was caused by insufficient regulation [5], and the opposite opinion that too strong regulation caused the crisis [6], is also oversimplified. The emergence of a crisis cannot be a measure for determining the effectiveness of regulation. Financial regulation is needed to address specific failures in the financial system. For example, high-risk nontraditional mortgage lending by non-bank lenders flourished in the 2000s, but with ineffective regulation caused enormous damage and led to a financial crisis [7]. Poorly designed government housing programs have distorted the market and contributed to the creation of unjustified mortgages. Irresponsible lending across the country and the massive losses of the American insurance corporation AIG in the face of the bankruptcy of Lehman Brothers were partly due to ineffective regulation and supervision. While the failures of mortgage agencies Fannie Mae and Freddie Mac were the result of government policy, they confused public goals with personal gain, which led to negative consequences [8].

Kondratyev's cycles (K-cycles or K-waves) are periodic cycles of alternating ups and downs of the modern world economy lasting 48-55 years, described in the 1920s by Nikolai Kondratyev. The concept has been actively researched and developed throughout its existence, however, a broad consensus in the community of economists about its practical applicability has not been achieved: many researchers (especially in Russia) widely use Kondratieff cycles in their research, but a significant part of economists do not consider them or explicitly denies the existence of such cycles. The characteristic period of the Kondratieff waves is 50 years with a possible deviation of 10 years (from 40 to 60 years); the cycles consist of alternating phases of relatively high and relatively low rates of economic growth. Kondratyev noted four empirical patterns in the development of large cycles. The first - before the start of the upward wave of each large cycle, and sometimes at the very beginning of it, significant changes are observed in the conditions of the economic life of society. Changes are expressed in technical inventions and discoveries, in changes in the conditions of monetary circulation, in the strengthening of the role of new countries in world economic life. These changes, to one degree or another, occur constantly, but, according to Kondratyev, they proceed unevenly and are most intensely expressed before the onset of upward waves of large cycles and at their beginning. The second - periods of upward waves of large cycles, as a rule, are much richer in large social upheavals and upheavals in the life of society (revolutions, wars) than periods of downward waves. Third, the downward waves of these large cycles are accompanied by a prolonged depression in agriculture. Fourth, large cycles of the economic situation are revealed in the same single process of the dynamics of economic development, in which medium cycles with their phases of boom, crisis and depression are also revealed.

For the period after the industrial revolution, the following Kondratieff waves are usually distinguished: 1st cycle - from 1803 to 1841-1843 (the moments of minimums of economic indicators of the world economy are marked); 2nd cycle - from 1844-1851 to 1890-1896; 3rd cycle - from 1891-1896 to 1945-1947;



4th cycle - from 1945-1947 to 1981-1983; 5th cycle - from 1981-1983 to ~ 2018; 6th cycle - from ~ 2018 to ~ 2060 (forecast). However, there are differences in the dating of the "post-Kondratieff" cycles, for example, the following boundaries of the beginning and end of the "post-Kondratieff" waves are also given: 3rd cycle: 1890-1896 - 1939-1950 4th cycle: 1939-1950 - 1984-1991; 5th cycle: 1984-1991

Most experts believe the crisis could have been avoided if only the United States had applied tighter regulation and supervision of financial activities. This finding largely ignores the global nature of the crisis. For example [9]: 1) The credit bubble appeared not only in the United States, but also in Europe. Therefore, explaining the causes of the credit bubble should focus on factors common to both regions. 2) The credit bubble has manifested itself not only in the housing market, but also in the commercial real estate market. There were soap bubbles in Britain, Spain, Australia, France and Ireland, with some even more pronounced than in the United States. This suggests that it would not be enough to simply increase regulation of the US housing market. 3) Many financial institutions in Iceland, Spain, Germany and the UK and elsewhere did not rely on the US housing market, and in most cases they were tightly regulated, yet they also faced financial setbacks similar to those seen in the United States. These facts suggest that US housing policy itself is a non-exhaustive explanation of the crisis. It is impossible to explain the financial and economic crisis solely by insufficient regulation and supervision in the United States, ignoring international parallels, since there will be no prioritization of causes and no sufficient justification of cause and effect. Before identifying the main causes of the crisis, let us describe its main stages.

The United States is still in a recession, triggered by the financial crisis that manifested itself in August 2007 and ended in early 2009. The main causes of the financial crisis were the financial shock in September 2008 and the accompanying financial panic. The financial shock and panic triggered a severe downturn in lending in the fourth quarter of 2008. Some economists describe the situation as a recession that began in December 2007 and lasted until June 2009 and is only now beginning to recover. Recent events in the US can be described in the following stages [10]:
- A series of foreshocks began in August 2007, followed by an economic downturn that lasted

until August 2008, when the liquidity problems were not solved by three large US financial institutions. - Serious financial shock in September 2008, in which ten large financial institutions changed their institutional structures. - Financial panic and the beginning of a large recession in the real sector of the economy in the last few months of 2008. - The end of the financial shock and panic - early 2009 - the starting point for financial recovery and a period of recovery in the real sector of the economy. At present, the economy of the United States is still in its last stage, its financial system is still recovering and restructuring, trying to return to stable and rapid economic growth [11]. The following external and internal factors can be named that are important for explaining the causes of the financial and economic crisis:

Credit bubble. Since the late 1990s. China and other large developing countries, as well as large oil-producing countries, created large capital surpluses that were invested in the financial markets of the United States and Europe, causing interest rates to fall. Credit spreads have narrowed, which means that the cost of borrowing to finance risky investments has decreased. A credit bubble has emerged in the United States and Europe, most notably an increase in investment in high-risk mortgages. US monetary policy may have contributed to the credit bubble, but it did not. There are three main possible explanations for a credit bubble: global capital flows, risk reassessment, and monetary policy.

Housing bubble. Since the late 1990s.and in the early 2000s, a large and persistent US housing bubble formed. The bubble was characterized by large national increases in house prices and rapid regional boom-bust cycles in California, Nevada, Arizona, and Florida. Many factors contributed to the formation of the housing bubble, which, when it burst, caused huge losses for homeowners and investors. The relationship between short-term interest rates and home prices is very weak, so even if the Federal Reserve's (FRS) goal was to lower lending rates between banks, this cannot explain why thirty-year mortgage rates were too low [12].

Mortgage credit lending. There have been overly optimistic assumptions about US home prices, as well as problems in the primary and secondary mortgage markets. Trillion dollar risky mortgage loans were widely deployed through the financial system: mortgage-related securities were bundled together and then formed into other bundles and sold to investors around the world. When the bubble burst, losses of hundreds of billions of dollars shook the market, as well as financial institutions that had acquired significant amounts of these mortgages and used them as collateral to create a lot of debt. This happened not only in the United States but around the world. These losses were multiplied by financial derivatives such as synthetic securities [13].

Credit ratings and securitization. Errors in credit rating and securitization translate into bad mortgages, unreliable financial assets. Credit rating agencies erroneously rated mortgage-backed securities and their derivatives as safe investments. Securitization is an innovative form of financing that denotes a new technique for raising funds, it has gained widespread acceptance, first in the United States and then in Europe. This is a mechanism in which financial assets are written off the company's balance sheet, separated from the rest of the property and transferred to a specially created financial intermediary (SPV), and then refinanced in the money market or capital market. Refinancing is carried out either by issuing ABS (asset-backed securities), or by obtaining an Asset-Backed Loan (syndicated loan) [14].

When house prices fell and mortgage borrowers stopped making payments, mortgage standards began to decline. The Mortgage Securitization System supplied toxic mortgage loans from all

over America to investors around the world. Many mortgage lenders set the bar so low that they simply took any qualifications of borrowers on faith, often deliberately ignoring the level of the borrower's ability to pay. Nearly a quarter of all loans made in the first half of 2003 were interest-only loans, and 68% of floating rate, selectable mortgages made by US banks were formalized without paperwork or with limited paperwork [1H].

Financial institutions have purposefully increased risk. The executives of many large and medium-sized financial institutions in the United States have concentrated huge savings in highly risky financial instruments in the form of mortgage-backed bonds. Some have done this deliberately, betting on rising house prices, while others have paid little attention to the potential risk. This hastened the collapse of large financial institutions [16]. Severe corporate governance and risk management failures in many critical financial institutions were a key cause of the crisis. It was argued that the self-preservation instinct of the largest financial firms would protect them from fatally risky actions without the need for constant regulatory intervention, which firms argued would stifle innovation. Too many of these institutions have acted recklessly, taking on too much risk and with too little capital and too much dependence on short-term funding. In many ways, this reflected a fundamental change in these institutions, especially the large investment banks and bank holding companies, which increasingly focused on risky and profitable trading. They have made tremendous efforts to attract and support unreliable borrowers, as well as creating mortgage-related securities, collecting them in bundles, and then forming other packages and selling them for trillions of dollars, including synthetic financial products.

Financial institutions and rating agencies have enthusiastically used mathematical models as reliable risk prediction tools, in many cases substituting for common sense. Risk management has too often become an excuse for risky actions [17]. General shock. The short-term borrowing of huge amounts, combined with debt obligations that were not visible to other market participants, increased the chances of a rapid collapse of the system. The past thirty-odd years have seen the growth of a shadow banking system, opaque and overloaded with short-term loans, in size that rivaled the size of the traditional banking system. When the housing and mortgage markets collapsed, the lack of transparency, the extraordinary overload of debt, short-term lending, and risky assets all emerged and contributed. This caused panic.

One of the problems was the great loss of housing. This general shock meant that the problem was broader than one bankrupt bank - key large financial institutions were capitalized. Financial shock and panic. The bankruptcy of Lebman was unexpected, and the government tried too hard to save Lebman. In September 2008, the bankruptcy and restructuring of dozens of firms triggered a global financial panic. Confidence in the financial system began to wane with the collapse of large and medium-sized financial institutions in the United States and Europe. During the month, interbank lending rates rose, which indicates heightened fears that there was a threat of a complete freeze on lending. The panic was also caused by too short a time interval between the bankruptcies occurring.

The financial crisis is causing the economic crisis. The financial shock and panic were caused by large cuts in production and jobs in the real sector of the economy. The shock and panic ended in early 2009. Negative consequences for the real sector of the economy continue to this day [18]. Measures to be taken to overcome the consequences of the crisis To tackle the global financial

crisis, governments need to adopt a mixed strategy of short-term and long-term responses. There is also a need for concerted action around the world, based on similar policies (monetary expansion) pursued by national governments. These actions include the following [19]:

There is also a need to ease expectations of a subsequent recession, as they have a detrimental effect on consumer demand and investment spending. Increasing government spending or lowering taxes will not help restore confidence at this stage. Any financial incentive must be timely, temporary, and directed at those who are inclined to spend government-provided money. This is hardly possible given the current fear and distrust of financial markets. The need to rebuild financial systems and establish a banking union in the euro area, and develop and implement actionable mid-term fiscal adjustment and welfare reform plans in Japan and the United States, backed by concrete action. In addition, potential output needs to be increased, particularly in the euro area and Japan, including through reforms that level the playing field for existing and new labor market entrants and reduce barriers to entry into product and service markets. Another challenge is to prudently adjust the course of US monetary policy in response to changing growth prospects, inflation and financial stability.

Excessive tightening may be difficult to reverse later, and global growth may well be below and below medium-term growth and inflation forecasts. Measures should be taken to maintain financial stability, given the risks inherited from recent credit booms and the new risks posed by capital flows. Many countries need a new round of structural reforms, including investment in public infrastructure, removal of barriers to entry into markets for goods and services, and in the case of China, a reorientation of growth from investment to consumption. [21] The fact that financial markets are betting on a global economic recovery over the next two years is becoming increasingly evident. Investors refused to heed warnings that tech stocks were severely overvalued at the turn of the millennium. The head of the US Federal Reserve System Ben Bernanke has dispelled the idea that the US mortgage market was an accident and that the problem with American real estate could have global consequences. [22]

Suppose that the International Monetary Fund, the World Bank, and the financial markets are all wrong when they say that the US can achieve sustained growth over time, that Europe is on the mend, and that China can make the transition to a less centrally planned economy. At the same time, there is reason to think that the opinion is correct and that the outlook for several years is optimistic and there is an opportunity for sustainable growth (due to companies with a lot of cash, stimulating economic policy for more than half a decade, and having innovative products in abundance) ... But if this view is wrong, then the global economy remains subject to a seven-year rhythm of recurring financial crises. In these circumstances, three questions should be asked. First, where is the crisis most likely to occur? The economic situation in China is not always completely secure, as credit restrictions affect it.

Growth in the world's second largest economy is slowing down and probably slightly faster than official statistics show. Other emerging markets - India, Brazil, Turkey - look even more vulnerable, as they are more susceptible to the negative influence of US political moves. The rate at which the federal reserves decline and the government reduces the size of stimulus will depend on the situation in the US, not in the rest of the world. Capital outflows from countries with large current account deficits are a real threat [23]. The second question is, how will the government react if a second shock wave occurs long before the global economy recovers from

the first shock? Traditionally, central banks and finance ministries have used booms to replenish their arsenals. They raise interest rates so that later in difficult times it will be possible to lower them, and they also reduce the budget deficit so that demand can be supported through tax cuts or increased government spending.

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And the final question: What kind of impact will the second wave have on the already shaken global job market? Unemployment is rising and not enough jobs are being created to cope with the demands of a growing global population. There is every reason for social unrest, so businesses need to be encouraged to use the rising profits for productive investment rather than share buybacks. Prospects for the development of the world economy

Analyzing the history of crises, one can notice that at the root of almost all crises, without exception, lies the problem of excessive cheap financing provided in order to support the falling incomes of investors and banks [26]. The proliferation of instruments whose prices are based on complex calculations could be limited. The funding provided to bond buyers could be limited so that they do not buy tens of times more than their own funds allow, thereby inflating demand. All this could be done if a fundamentally new control system with qualified and motivated auditors was introduced.

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