

THE ANATOMY OF A GLOBAL FINANCIAL CRISIS

Ona Gražina Rakauskienė

Department of Economics, Faculty of Economics and Finance Management
Mykolas Romeris University
Ateities st. 20, LT-80303 Vilnius, Lithuania
E-mail: ona.rakaus@mruni.eu

Eglė Krinickienė

Department of Management Theory, Faculty of Strategic Management and Polic
Mykolas Romeris University
Ateities st. 20, LT-80303 Vilnius, Lithuania
E-mail: egle.krinickiene@gmail.com

Abstract. The article deals with the fundamental reasons of the formation of global crises as well as their consequences. In spite of different economic and social conditions under which crises occurred during various periods of history, particular features common to all crises are revealed. The situation of Lithuania in the context of the global crisis is discussed. Social inequality and the absence of moral-ethical values are considered as factors determining the occurrence of the global crisis of today. The measures to overcome the crisis suggested by the European Union are discussed. Two major points in the process of dealing with the financial crisis are emphasized in the European action plan: the first one is restructuring the banking system and the real sector; the second point emphasizes the importance of joint actions of the 27 Member States of the EU.

JEL classification: E30, E62.

Keywords: global financial crisis, fundamental causes and consequences of the crisis, social inequality, moral-ethical values, global risks, the EU response to the crisis.

Reikšminiai žodžiai: pasaulinė finansų krizė, fundamentinės krizės priežastys ir pasekmės, socialinė nelygybė, moralinės-etinės vertybės, pasaulinė rizika, ES atsakas į krizę.

Introduction

All over the world economic and financial analysts, politicians, publicists, experts and government representatives investigate the reasons for the global financial crisis, which began in 2008 and transformed into an overall economic crisis.

Widely known world economists approach the situation differently. Some of them cannot find reasonable explanations for its occurrence and claim that an impossible thing happened. However, they still believe in the strong power of market self-

regulation (A. Greenspan, M. Friedman, L. Balcerowicz) and expect that the market itself will balance the situation in the future. On the contrary, the other panel of economists (J. Stiglitz, G. Soros, L. Thurow, K. Schwab, J. Sacks) treat the current case as a failure of the neo-liberalism doctrine and the monetary economic model.

However, it is clear that the world market as the most effective means of allocation of resources cannot properly regulate itself. It must be subject to supra-national and national adjustment and constant-

ly kept under control. As a consequence, a question arises: how and to what extent?

In order to find an answer, it is crucial to understand the reasons for the crisis.

1. Fundamental Causes of the World Economic Crisis

There are a number of articles by various academics and analysts providing different judgment on the reasons for the current crisis as well as its character and factors. However, in general, two groups of factors that influenced the financial crisis are distinguished. Firstly, there are structural factors which allowed the crisis to develop and spread by creating favourable conditions, and secondly, there are cyclic factors which have, in fact, caused the crisis.

Structural factors are the following¹:

- a considerable growth of the role of capital markets (non-bank financial institutions) in the financial intermediary activity and a growing complexity of financial markets;
- enhancing uncertainty of the financial markets;
- intensity of the globalisation process;
- inadequate quantitative methods of risk evaluation employed in decision-making;
- the surplus of savings in a number of countries (particularly in China) as well as the redistribution of assets and income to the exporters of consumer goods;
- over-reliance on the success of the market self-regulation mechanism;
- excessive use of new and complex financial instruments; it transferred all the possible risks to the international level and reduced the transparency of the markets².
- and the most significant - inadequate and old-fashioned structure of the world finance supervision and regulation due to which the volume of the general loan and credit risk has sharply increased;

Cycle factors involve³:

- too low interest rates for non-risky assets in the course of all the periods of the leading world economies (the U.S., the European

Union, Japan). Yet, a higher U.S. interest rate could have reduced fund supply for real estate credits; however, it must have been foreseen. Furthermore, after the first signs of the crisis the increase of the interest rate would have worsened the situation and the state economy would have been depressed;

- insupportably low margin of the credit risk for all the instruments;
- the bank system being under a low level of regulation and poor supervision. This credit structure is developing, dynamic and constantly introducing new derivative investment products of high complexity. The risk of these products must be estimated as well as a constant control over new instruments and institutions distributing them must be kept.

In our opinion, **three fundamental groups of the reasons** for the global crisis could be distinguished.

The first is the cyclic development of the world economy and the national economies of the developed countries as well as the increasing synchronicity of these processes in the major world economic centres such as the U.S., the EU and Japan. It is evident that globalization processes shorten the cycle as well as the duration of the phases of the global economic boom and stability.

The first indications of the current crisis of the global economy appeared in 2001 after a sharp fall in fund exchange indexes. Namely, this period is considered to be the end of the economy boom which is linked to the receptive global computer and communication market, including the mobile phones market. In 2001 a stormy growth in the mentioned markets stopped and the economic boost turned into the phase of decline. On the eve of economic recession, central banks of various countries in the world started applying the classical means to maintain economic activity, i.e. reduction of the interest rates. In addition, fund supply was increased. If by that time the global economy had experienced a recession of an average duration cycle, these means would probably have been sufficient to stimulate the economic growth. However, under the circumstances of a long-term decline of technological development, the “cheap money” policy fostered the appearance of speculative soap bubbles in stock and real estate markets as well as the increase in the volume of fictitious and speculative capital.

The second is the emerged global financial system which does not meet the modern requirements and conform to the present realia; further-

1 Daianu D.; Lungu L. (2008). *Why is this financial crisis occurring? How to respond to it?* ALDE conference material, [accessed on: 15-01-09]. Available from: <http://www.alde.eu>.

2 McCreevy, C. (2008). ALDE conference material, [accessed on: 07-01-09]. Available from: <http://www.alde.eu>.

3 Daianu D.; Lungu L. (2008). *Why is this financial crisis occurring? How to respond to it?* ALDE conference material, [accessed on: 15-01-09]. Available from: <http://www.alde.eu>.

more, it is unable to self-regulate. Globalization is one of the most complex phenomena of the global economy and is little investigated as a finance innovation. Presently, the negative aspects of globalisation are quite obvious. Globalisation relies on a single prevailing currency, i.e. the U.S. dollar. It is archaic as it ignores even the most cardinal changes in the financial sphere; it is neither able to prevent the rising finance disproportions and asymmetry nor manage the constantly rising risk of speculative (virtual) operations. The existing financial system is considered to be faulty as the extent of financial processes is inconsistent with the usage of economic resources.

Basically, these processes stimulate the formation of the policy of a global monopoly and do not promote competition in the sphere of financial capital. In other words, dependence on a single dominant currency is a threat to the entire global economy. The U.S. exports dollars worldwide and imports capital. The dollar emission is unlimited. During the World Economic Forum in Davos in 2009 the President of France, N. Sarkozy, expressed concern about a situation when a single state dictates terms to the whole world. He emphasized that a shift from a unipolar world to a multi-polar one is necessary.

The third group of reasons includes social factors, such as increasing social polarization, social-economic inequality, and a crisis of moral-ethical and spiritual values.

In many liberal-minded countries a considerable attention paid to business has caused an increase in social inequality and an unprecedented stratification even in the developed countries. During the recent years this problem has been becoming particularly relevant. Social-economic inequality has led to the crisis. In the EU this was noticed earlier; therefore, the EU announced being responsible for the social policy in the globalization process.

During the World Economic Forum in Davos in 2009 a message was sent inviting the members of the global community to return to moral values. Business must serve the society, not vice versa.

A number of world economists, experts, politicians (the well-known financier George Soros, German Chancellor Angela Merkel, Director of Institute of Europe Russian Academy of Sciences Prof. Nikolai Shmeliov, famous Polish economist Grzegorz Kolodko and others) emphasize that the global crisis first of all exists “in the heads”. Even more, it is the crisis of moral-ethical, cultural and spiritual values; this crisis manifested itself in a disordered system of personal and social values, such as personal identity, family institution, professional attitude and many others. Fundamental human values, such as honesty, kindness, propriety, sympathy, sense of responsibility, patriotism, service to homeland, had lost their significance.

Without culture in the society there is no morality. Poor morality means poor (ineffective) economy. If no common sense of morality exists, laws are ineffective in politics, economy, and in the social sphere; science and innovations cannot progress either. A low level of morality, an increase in criminality and corruption make fruitless the efforts and attempts to improve the situation in the spheres of economy and politics, public life, education and science, international economic relations and business. In the context of a crisis, social justice as well as moral, spiritual and cultural values are of particular importance.

2. Economic Development Cycles

In the theory of economy it has been established that economic growth consists of periodical cycles which differ from each other in duration and intensity. Crisis is one of the phases of economic cycle during which plenty of business enterprises are unable to remain in the market and go bankrupt, the

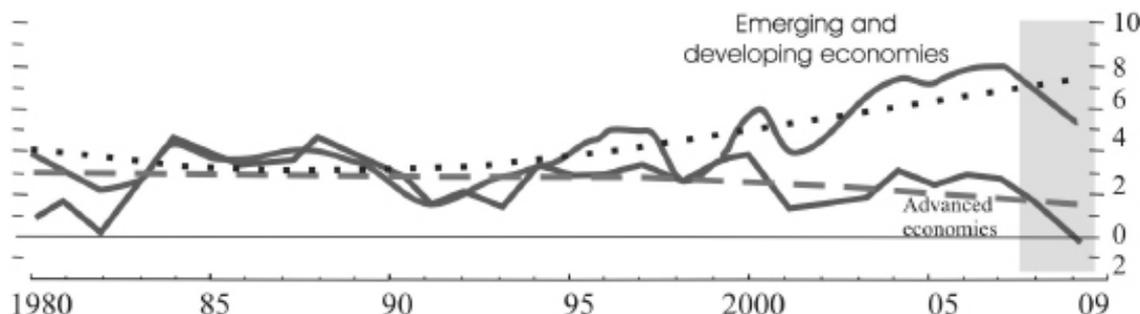


Figure 1. Real GDP growth and the trend (percentages)

(Source: <http://www.imf.org/external/pubs/ft/weo/2008/update/03/index.htm#table1>)

state collects less revenue to the budget, the level of unemployment increases, the income of the entire population is reduced, the output of production (GDP) and its variation factors are changing. Traditionally, the following major production factors are distinguished: capital fund, labour, and general efficiency of production factors (or technological progress). The most significant GDP declines in the world were reported exactly during the periods of financial crises, i.e. during the financial crisis in Asia (1997), the Russian crisis (1998) and the forecast recession of the recent years (2008-2010) when the global financial markets have been hit by the global financial crisis (Figure 1).

However, every crisis has some aspects in common with other crises as well as its own peculiar features and outcomes. The current crisis has paralysed the activity of the developed financial markets, ruined the expectations of investors and forced world governments to reconsider the trends of fiscal and monetary policy. Moreover, the crisis has attracted attention to the state regulation of economy.

Recently, the issues of problematic financial systems and instability of markets became particularly relevant. The changing situation of financial markets is being analysed and economic indicators of the world countries are being projected in order to

find out the causes of the financial crisis, to foresee the potential consequences, to construct a strategy for overcoming it as well as to identify means to prevent such crises in the future.

To properly evaluate the causes and the processes of the current crisis, the stages of its development as well as the possibilities to overcome it, historical considerations and detailed analyses of the reasons for the major previous crises (Table 1) are of utmost importance.

Although the abovementioned crises occurred in different periods of time, under different economic and social circumstances and due to different reasons, they share some general features, such as low interest rate, high liquidity, an increase in financial flows, weak supervision and regulation of financial institutions. Review of the historic events provides us with significant clues about the policies of supervision institutions of the financial markets and central banks. These policies are considered to be ill-timed and insufficiently effective. The subprime mortgage crisis which emerged in the U.S. involved the economies of numerous countries worldwide and pointed to the global nature of the financial system; what is more, the question of the safeguard of financial system stability was raised, concern regarding the need to reform the global financial system and

| Period of the Crisis | Causes | Consequences |
|---------------------------------------|---|---|
| The Great Crash, 1929-1933 | Unbalanced economic growth. Inadequacy of demand and supply of commodities in the market | New rules for stricter control and regulation of the monetary policy of financial institutions |
| „Black Monday“, 1987 | Variant comprehension of the investment strategy and the market | A dramatic slump in stock market |
| The Asian Crisis, 1997 | Unbalanced Asian economic growth, speculative currency flows | Increased interest rates, reduced budget deficit, devaluated currency of Asian countries |
| The Russian Financial Crisis, 1998 | Large capital flows from the country, decline in raw material prices and growing debt | Devaluated rouble, plenty of enterprises went bankrupt; the policy of the domestic debt was revised |
| The Dot-com Bubble, 2000 | The US intensive economic growth and high expectations caused a boom in the IT stock market | Bankruptcy of the majority of IT companies, the U.S. economy slowing |
| Terrorist attacks, September 11, 2001 | Terrorist attacks against the U.S. | Slowing economy of the U.S. |
| Enron Scandal, 2001 | Conflict of interests. Falsified financial reports | Systematic impact on creditors, banks, other companies. |
| Global crisis, 2008-2010 | Real estate “bubble” collapsed. Subprime mortgage crisis | Bankruptcy of financial institutions, recovery of world economy |

Table 1. The causes and the consequences of the global crises (Source: designed according to Daianu and Lungu, 2008)

consider the level of the state influence to the market economy was expressed.

The current crisis, similarly to the previous crises, has been caused by a huge difference between paying back and capital input as well as the irresponsible borrowing⁴. According to the International Monetary Fund (IMF), the current crisis, which started in 2006 in the segment of subprime mortgages in the U.S., is the most significant financial crisis of this century and will be the most costly throughout the history⁵. The previous crises had more domestic (local) influence, whereas the present one has dramatically expanded and, of course, its anticipated volume will be much larger and the consequences will be more serious. The question is: how could it happen that the increase by 3 per cent in deferred subprime mortgage, which enhanced the problematic credit part by 34 million dollars, was able to balance out the U.S. financial system with the turnover of 57 billion dollars and, in addition to that, caused the global financial crisis? (Dodd, 2007)⁶.

It should be stressed that global and social crises are a characteristic feature of organic market development. The history of such crises dates back to the 17th century when a sound market system developed and, needless to say, crises are unavoidable in the future.

The first classical economic crisis hit in 1823. Since then crises have been occurring regularly every 15-20 years; eventually they became an object of academic research. In the post-war period crises were more frequent and until 1990 they used to occur in every decade. However, the last two cycles of the years 1993-2000 and 2003-2008 show a tendency for crises to become shorter in time, i.e. the duration of a stable global economic growth cycle is reducing.

Thus, a crisis is regarded as a market system phenomenon because financial system loses its balance due to slumping production volumes. Financial sector also reacts to that.

In the Lithuanian market economy the current crisis is the second (after the crisis of 1998-1999); whereas it is the third considering the conditions of globalization.

Actually, the first crisis was the collapse of the Soviet system which was followed by a dramatic de-

cline of economy in many post-Soviet countries as in 1990 GDP dropped by 40 per cent in comparison with the previous years. Furthermore, a powerful economic crisis hit Eastern and Western Europe as well as the U.S. in 1992-1993. The cycle of economic rise lasted for a period of 1993-2000 in the main economic centres, i.e. the great triad (the U.S., the EU and Japan).

In 2001 the U.S. economy, similarly to the economies of the EU countries, entered into a new economy decline cycle. Dramatic economic crisis of the U.S. coincided with the tragedy of 11 September 2001. In fact, it was the second global crisis. In 2002 a slow economic growth started and the economy entered the stage of rise.

6 years passed and the world experienced a financial and economic shock again. However, globalization processes obviously shorten the global economic cycle and the duration of boom and stability phases.

After the Asian crisis in 1997 a general conclusion was drawn regarding the limitations of the liberal monetary ideology. Liberal monetary model was believed to be the most suitable for highly developed and emerging countries, meanwhile developing countries with rapidly growing economies were expected to implement the Keynes's policy, i.e. to strengthen the state role and increase budget expenditure. But the latter global crisis raised doubts about the first thesis: due to the process of globalization, the international neo-monetarism as a methodology of economic policy became inapplicable.

In the U.S. and the EU rapid measures were taken to improve the situation of financial credit institutions as well as industry and business companies. These measures were the classical anti-crisis policy instruments of Keynes's theory: tax reduction, stimulation of production, activation of economic processes, increasing of employment and, generally, improvement of the population's situation. The decisions of separate countries and all the measures taken change the overall system of global finance, thus, it undergoes a quality change.

In consideration of the cyclical economic development it is important to emphasize that the situation of separate states is ambiguous. The world economy has already been demonstrating its cyclical development for two centuries, while the strategies of economic development of separate countries are being projected on the basis of the concept of constant economic growth and macroeconomic stability. It is essential to point out that Lithuania is not the only country having no strategies and programmes to deal with cyclic economic fluctuations. This allows

4 Daianu D.; Lungu L. (2008). *Why is this financial crisis occurring? How to respond to it?* ALDE conference material, [accessed on: 15-01-09]. Available from: <http://www.alde.eu>.

5 International Monetary Fund. (2008). *World Economic Outlook*, [accessed on: 03-01-09]. Available from: <http://www.imf.org/external/index.htm>.

6 Dodd, R. (2007). Sub-prime: Tentacles of a crisis. In: *Finance and Development*, 44(4).

to make a conclusion that one of the inner reasons of the Lithuanian economic crisis is the disregard for the cycle, especially while designing the long-term economic development strategy.

Therefore, while projecting strategic plans first of all potential crises should be considered, period cycles in the global and national economies should be identified and investigated. Also an answer should be found to such questions as, for example, why the world economy is linked to the phases of rise and decline. Secondly, the features of national economy should be identified; this, actually, enables to evaluate the probability of a crisis in the country. And only then preventive measures should be taken in order to avoid negative consequences of the crisis or to reduce it to a minimum. If these problems are not solved, the following crisis will strike in the same unexpected way.

Why did the crisis start in the American real estate market? Construction of private houses is an important economic sector as well as an essential part of the whole social policy in the U.S.. On the basis of a comparatively stable real estate development during the recent years, the government exercised a target economic policy in this field by providing the population with comparatively easy access to bank credits via mortgage system.

The collapse of Fannie Mae and Freddie Mac shocked the whole American society. The assets of these mortgage banks comprised approximately 6 billion U.S. dollars. It is clear that without the state's interference the extent of their crisis would have been much larger.

The second shock for Americans was the collapse of such major investment banks as Lehman Brothers (operated for 160 years) and Merrill Lynch (operated for more than 100 years) which belonged to the top 5 of investment banks. As the extent of their activities was particularly large all over the world, the decrease of their share value influenced the whole global financial system.

The U.S. government and the representatives of the financial sector were forced to take an active position. The government took prompt and decisive action.

Thus, Lehman Brothers was partially nationalized. In order to avoid its inevitable bankruptcy multi-million sums were allocated from the Central American Bank, i.e. the Federal Reserve System. Besides, insurance guarantees were taken under the state's control.

However, the expansion of the crisis continued further. In a few days the third wave hit the world's biggest investment group, American International

Group Investments (AIG). The companies of the group managed assets of U.S.\$ 753 billion all over the world (in more than 60 countries) and had control over credits and mortgage loans of U.S.\$ 300 billion.

The bankruptcy of such a gigantic unit could have destroyed the global financial system and the U.S. government could not allow that to happen. The group was partly nationalized applying the same scheme as in the case of Fannie and Freddie. Furthermore, a chain of investment banks' bankruptcies continued and they were also saved by the state. Actually, all these banks were nationalised. The government projected a financial system rescue plan, the so-called Paulson plan. Under the provisions of the plan, the government required the U.S. Congress to allocate U.S.\$ 900 billion for the abovementioned objectives.

The plan was approved after debates and substantial amendments. The government of the President of the U.S. G. W. Bush received the "green card" for the financial-bank system to be reorganized with much interference of the state.

It is important to emphasize that, unfortunately, all the actions taken to secure the giant American financial system failed to save it from the deepening economic recession. The economy growth stopped and the majority of companies continued to face considerable problems.

In the process of the crisis the financial sector experienced huge losses.

Several key consequences of the current financial crisis can be distinguished. First of all, the U.S. financial sector has lost its status and has changed beyond recognition. Secondly, massive bank bankruptcies, their merging and artificial salvations have developed mistrust in the financial sector in general. It had negative influence on the interest rates and tariffs of the company mortgage security. It became popular to invest into state treasury bills, precious metals and etc., rather than search for safe investments in the financial markets. A deepening financial crisis stimulated a more rapid deceleration of the U.S. economy: real estate prices decreased, unemployment increased.

The recent financial crisis spreading beyond the U.S. has clearly demonstrated the tight interdependence of globalization and financial system. The financial crisis has paralyzed the movement of money flows and has impacted the slowdown of the global economy.

Table 2. Financial sector losses, U.S. \$ billions (Source: <http://www.bankofengland.co.uk/publications/fsr/2008/index.htm>)

| | Outstanding amounts | Losses April 2008 | Losses October 2008 |
|---|----------------------------|--------------------------|----------------------------|
| The United Kingdom | | | |
| Prime RMBS – Prime residential mortgage-backed securities | 346,8 | 14,7 | 31,3 |
| Non-conforming RMBS – Non-conforming residential mortgage-backed securities | 70,1 | 3,9 | 13,8 |
| CMBS – Commercial mortgage-backed securities | 59,3 | 5,5 | 7,9 |
| Investment-grade corporate bonds | 808,6 | 83 | 155,4 |
| High-yield corporate bonds | 26,9 | 5,3 | 11,8 |
| Total | | 112,7 | 220,3 |
| The United States | | | |
| ABS (c) – Home equity loan asset-backed securities | 757 | 255 | 309,9 |
| ABS CDO – Home equity loan ABS collateralised debt obligations (CDOs) | 421 | 236 | 277 |
| CMBS – Commercial mortgage-backed securities | 700 | 79,8 | 97,2 |
| CLO - Collateralised loan obligations | 340 | 12,2 | 46,2 |
| Investment-grade corporate bonds | 3308 | 79,7 | 600,1 |
| High-yield corporate bonds | 692 | 76 | 246,8 |
| Total | | 738,8 | 1577 |
| EURO Area | | | |
| RMBS - Residential mortgage-backed securities | 553,4 | 30,7 | 55,6 |
| CMBS – Commercial mortgage-backed securities | 48,6 | 4 | 5,9 |
| CLO - Collateralised loan obligations | 147,3 | 9,7 | 32,6 |
| Investment-grade corporate bonds | 7613,3 | 405,8 | 919,3 |
| High-yield corporate bonds | 250,3 | 41,6 | 108,5 |
| Total | | 492,1 | 1122 |

3. The Issue of Social Inequality and a Crisis of Moral-ethical Values

Usually an economic crisis is perceived as the decline of macroeconomic indicators in the national and international economy caused by internal and external reasons. However, bearing in mind numerous factors determining the instability and disbalance of macroeconomics, attention should be paid to the amount of receivable income which affects the overall macroeconomic demand. The majority of working people are employees who receive salaries. In recent years GDP (or national income) growth has mainly been conditioned by the profit growth. It appears to be a natural trend and the market drive. But such disproportional income distribution causes an increase in social-economic inequality in the developed and emerging countries.

In Europe the unemployment rate has been increasing during the recent 20 years and has exceeded 10 per cent. In the U.S. during the last 25 years a huge income distribution was observed, i.e. a gap between

the wealthy and the poor which show a tendency to rise. Income of two thirds of Americans (mainly representatives of the middle class) decreased by 20 per cent, while only 20 per cent of the wealthy felt an increase in income. During the recent decade the real wages in Latin America decreased by 50 per cent.⁷ Thus, serious social problems emerged.

According to Henri Guano, former chief commissar of the French plan, a high rate of unemployment, a sense of insecurity and instability, stagnation of purchasing power, tight burden of taxes for the middle class households, social exclusion are the aspects that have been prevailing in France during the last 15 years. Actually, fiscal and budget dogmatism has been depressing France for more than 15 years. It should not be surprising because the present orthodox policy priorities are the fight with inflation and deficit reduction, but not the stimulation of economic growth or the creation of workplaces.

⁷ Rakauskienė, O. G. (2006). *Valstybės ekonominė politika*. Vilnius: Mykolo Romerio universitetas.

Even in such a socially-oriented country as Germany a rising tendency of social inequality is very distinct. According to experts, during the period of recent 20 years social-economic inequality has been as high as it is at the present moment.⁸

Professor Louis Emery (former special adviser of the U.S. Bank for Reconstruction and Development) is surprised by the reports and selection of economic indicators provided by the Organization for Economic Co-operation and Development (OECD):

Should economy be measured by macro financial indicators (such as inflation, budget deficit and the interest rate), hence the economy state may seem rather optimistic, however, taking into consideration other macroeconomic indicators, e.g. unemployment, a level of criminality, income distribution, economy itself might appear quite in a pessimistic light.

The global crisis made the governments to reconsider the events of the past and take into account the social function of a state. For instance, the German Chancellor Angela Merkel is in favour of rehabilitation of social economy and socially balanced market principles across the world and Europe. In her speech during the summit of Christian Democrats in Stuttgart (2008) the social market economy was interpreted as a panacea for the global financial crisis, as food encouraging affected citizens' trust in economy and politics. The Chancellor spoke about the strengthening of social market as "a magic mixture which today is more valuable than in any other time"⁹.

In the World Economy Forum in Davos (January, 2009) Angela Merkel expressed the same attitude emphasizing the idea of the "realization of the happy medium between socialism and capitalism, and to strengthen the role of the state in order to handle and manage the crisis processes, whereas the global economy should be regulated". In addition, she suggested establishing the UN Economic Security Council.

In the contemporary fast-changing world there is an increase in discussions regarding the directions of the contemporary state regulation, the extent of the state interference and its social functions.

Certainly, a mere following of history does not guarantee a successful management of the crisis. The actual economic conditions call for adequate stabilizing measures. However, it is obvious that a growing society polarization where the middle class disappears (or becomes rather scarce) is the key

reason of the crisis; this phenomenon must receive sufficient attention of the state since it fosters social tense as well as society cataclysms (social threats) and may disturb economic growth.

Investigation of the social market economic theory and practice should be an essential part of the state's anti-crisis plan.

A considerable income distribution in Lithuania (Coefficient decile Cd=10) is one of the most important issues. Unless it is successfully dealt with, no long-term strategies or mid-term programmes will be realised. Lithuania should have its own economic model designed considering the Lithuanian history, mentality and identity, nature, social and economic conditions, and other country-specific features; such a model would facilitate the stabilization of the economy at the present moment and help to find a successful way to secure a long-term economic growth.

Material and financial propaganda in the formal economic doctrine of the XX – XXI centuries encouraged the depreciation of cultural, moral-ethical and spiritual values.

It is obvious that big capital business models and radical attempts to refuse market regulation contradict the concepts of social justice, equality and democracy, ruin traditional ethics and morality, turn a human being into a slave of money, deny the importance of individuality and personal freedom.

There is misconception of morality in the society; boundaries between the good and evil disappear. Individual pragmatism, cynicism and self-benefit orientation prevail. A cult of cruelty, aggression and violence is forming amongst the youth; senses of sympathy and humanity disappear.

According to sociologists, psychologists and church representatives negative moral-ethical principles are constantly spreading and influence all the strata of society. It has an impact on the behaviour of the whole society and family. The main reason for alcoholism, drug addiction, high rate of criminality and suicides in Lithuania is considered to be spiritual vanity, loss of sense of life, vague moral and ethic values. Actually, this is a pay for consumer ideology, the cult of material welfare, a shortage of spirituality and loss of ideals.

Moral standards are important criteria, in other words, they are regulators of economy and politics. Eternal cultural values should be respected in Lithuania and regarded as a vital objective. One of the main purposes is to re-establish a full-fledged Lithuanian culture comprising both material and spiritual values. Only following this way corruption would be prevented, the ethical level of state servants would

⁸ <http://www.neblog.econ>.

⁹ <http://www.neblog.econ>.

be increased and at the same time economic efficiency would be raised.

4. The Financial Crisis and Global Risks

According to Professor Klaus Schwab, Founder and Executive Chairman of the World Economic Forum, this financial crisis is identified as the crisis in an interconnected world.¹⁰

Over the past 18 months, a crisis that began in a small segment of the US housing market evolved into a global credit crisis of systematic proportions. After the demise of Lehman Brothers and the near-collapse of AIG in September 2008, credit markets became dysfunctional and capital flows that had already slowed ground to a halt. As global banks continued to reduce leverage, the impact of the crisis began to engulf households and businesses around the world. By the end of 2008, most advanced economies were simultaneously in recession for the first time since World War II, reducing growth prospects in emerging markets due to lower demand for export goods. As a consequence, global growth is expected to remain below potential in 2009 and 2010.

The speed at which these events unfolded was unprecedented. Panic was identified as an element of the anatomy of a systemic financial crisis that in this case exacerbated pressure on asset prices and induced contagion effects to the rest of the financial system and around the globe. In this sense, 2008 served as a reminder of how the world and its risks are highly interconnected. Contagion not only arises through linkages in trade and finance, but also through the often complex interaction of risks that increases uncertainly and renders decisions more difficult.

The collapse of asset prices marked only the beginning of a complex chain events that exposed numerous systemic vulnerabilities and triggered other risks and potentially adverse developments. The salient risks likely to affect the global economy through 2009 include:

a. Deteriorating fiscal positions. The U.S., United Kingdom, France, Italy, Spain and Australia are all already running high deficits. Massive government spending in support of financial institutions and growth are threatening to worsen fiscal positions that are already precarious in many countries. The convergence of this decline with rising health

and pension costs in industrialised economies due to demographic trends will place further fiscal pressure on governments.

b. A further significant reduction in China's growth. The decline in export demand has led to a substantial reduction in China's overall economic growth, increasing considerably the risk of a hard landing that would stress the financial system and could generate social tensions within China and beyond as other economies face similar declines. Over recent years, China built up nearly U.S.\$ 2,000 billion in foreign reserves to prevent the renminbi appreciating. Although starting mid-2007 China began to allow a moderate appreciation, the trend reversed towards the end of 2008 with the rapid rise of the U.S. dollar relative to most other currencies.

c. Continued depreciation of asset prices. Although global equity markets have declined on average by more than 50% in a very short time, the vicious circle between falling asset values, write-downs and attendant pressure on the capital position of financial institutions and continued deliver aging appears to be unbroken. This vicious circle is now affecting manufacturing, services and households around the world and the credit crunch has generated a substantial weakening of economic activity and growing credit losses.

d. Deflation replaces inflation as a key concern. The impact of high energy and food prices in combination with rapid credit growth were strongly linked to concerns about inflation. A year later, uncertainty in the financial sector, falling asset prices, poor credit conditions, weak demand and rising unemployment could create a deflationary spiral. However, the short-term risk of deflation must be seen in the context of a long-term inflation risk caused by the large monetary stimulus in pursuit of financial and economic stability and the risk posed by the growing public debt. Economic history is littered with periods during which governments reduced their debt burden through inflation.

As Professor Klaus Schwab underlines, 2009 will be a year of learning the lessons of the financial crisis; a year where its reach in terms of time and scope becomes more evident; a year that calls for a new financial architecture to be shaped. At the same time, it will be a year that will test the resolve and willingness of world leaders to collaborate and take action to move beyond this crisis. The global risks landscape is a crowded one and the window of opportunity we have to address some of the largest challenges of our time is narrow.

¹⁰ Global Risks 2009. (2009). World Economic Forum, [accessed on: 12-01-09]. Available from: www.weforum.org, p. 9.

5. European Union Responses

The EU Chair, the President of France N. Sarkozy initiated the so-called “anti-crisis” summit of the EU Member State leaders in Paris (September, 2008) where he proposed a European market stabilization plan. The plan anticipates the formation of the General European Fund (EUR 300 billion) to protect problematic European companies.

On 11-12 October 2008 in Washington the summit of Finance Ministers of the Group of Seven (G7) took place. A 5-point plan to restore confidence and restore credit markets was approved:

- To reach a common understanding of the root causes of the global crisis;
- To review actions that countries had taken and will take in the future to deal with the current crisis and strengthen growth;
- To agree on common principles for reforming their financial markets;
- To launch an action plan to implement those principles (ministers were asked to develop further specific recommendations that would be reviewed by leaders at a subsequent summit);
- To reaffirm their commitment to free market principles.

These general principles signal a transition of the whole financial system into a new direction of development.

Several practical solutions allowed to reconstruct the entire architecture of financial system. The essence of these reforms comprises three measures.

The first. The U.S. Federal Reserve System, European Central Bank, Swiss National Bank announced the elimination of any barriers to increase the national bank liquidity by April, 2009. The Bank of Japan also joined them.

The second. The abovementioned banks announced the first auctions at once.

The third. European Central Bank announced three auctions with unlimited funds of U.S.\$ until the year 2009 (whereas the traditional policy always limited it). This measure is of great importance.

At the same time, EU Member States approved their national plans to save the financial system by means of subsidizing it. For that purpose the United Kingdom allocated U.S.\$ 980 billion, Germany – U.S.\$ 643 billion, France – U.S.\$ 540 billion, Italy – U.S.\$ 200 billion, Japan – U.S.\$ 150 billion, Sweden – U.S.\$ 120 billion, Russia allocated U.S.\$ 4 billion for Iceland.

It is possible to conclude that these global financial managing principles change the global financial system fundamentally. The main regula-

tion instrument nowadays is not the market or its actors but countries and their financial decisions.

This proposition is supported by the European action plan to deal with the financial crisis which was approved by the European Commission on 29 October 2008. In this plan the international financial crisis is treated as a real challenge for the EU.

Two major points in the process of dealing with the financial crisis are emphasized in the European action plan. The first one is a wider approach to overcoming the financial crisis in Europe: it is necessary to focus not only on rebuilding the financial and banking system but on the real sector as well. The second point stresses the difference between joint actions and an individual approach to monetary economic model. It was emphasized in the European action plan that the European banking system must be stabilized. However, as reported in the Communiqué, it is not enough. Since the financial crisis has spread very widely and had an impact on the whole economy by hitting, first of all, the household sector, real estate and labour market as well as business, special attention must be paid to the real sector of economy, to employment and social impact, to the acceleration of the reform and investment.

Europe’s strength lies in its solidarity and its ability to act together. All Member States will be affected, albeit in different ways and to different degrees, and it is likely that unemployment will increase, demand will fall and fiscal position will deteriorate. Acting jointly means a more effective and credible response. In contrast, if each Member State acts alone, their efforts will fall short. There is also a risk of unwelcome spill-over effects on other Member States.

The EU should build on this success and decide to tackle the next stages of the crisis in a united, co-ordinated manner turning these challenges into opportunities; adding selected short term measures to the Lisbon Strategy for growth and jobs. This paper sets out a three part approach which will be developed into an overall EU recovery action plan/framework:

- A new financial market architecture at the EU level;
- Dealing with the impact on the real economy;
- A global response to the financial crisis.

Formation of a new EU finance architecture concentrates on the following measures: steering the European financial sector out of crisis and ensuring reinforced regulation and supervision. In particular, there is a need for continued strong support for the financial system from the ECB and other central banks; a rapid and consistent implementation on the

bank rescue plans established by the Member States; decisive measures to limit the spread of the crisis across Member States.

To make the implementation of these measures possible, it is vitally important to reconstruct the bank system and transfer it to the private sector in the future. The EU has to redefine the model of regulation and supervision of the financial system. For that purpose the so-called Group of Jacques de Larousch consisting of well-known economists was established.

In this context **the Stability and Growth Pact** was adopted.

The Stability and Growth Pact provides the right policy framework, balancing short-term stabilisation needs and long-term structural reform requirements, notably supporting the adjustment process. Implementation of the Pact should ensure that any deterioration of public finances is accompanied by structural reform measures adequate to the situation, while ensuring that sustainable positions are being restored. Budgetary policies should draw fully on the degree of flexibility permitted by the Treaty and the revised Stability and Growth Pact and should take into account the following principles:

- Fiscal policy should be maintained on a sustainable course, anchoring expectations of an ordered resolution of the crisis;
- Country-specific differences in fiscal room for manoeuvre should be considered, conditional on strong and credible national budgetary institutions and medium-term budgetary frameworks;
- The level of ambition of the structural reform agenda should pay particular attention to those reforms that strengthen resilience and enhance sustainability over the long run;
- Reforms supporting demand in the short run should be timely, targeted and temporary.

Countering the effects of unemployment by offering Member States the possibility of reprogramming funds under the European Social Fund to support measures to quickly reintegrate unemployed into the labour market:

- Reviewing the effectiveness of the Globalisation Adjustment Fund;
- Helping the unemployed to start up a new business quickly and cheaply;
- Monitoring the impact of the crisis on different sectors affected by structural adjustments and using the scope offered by the State Aids regime to enable timely, targeted, and temporary support where appropriate;

- Pursuing flexure: in particular active labour market policy, tax and benefit reform, and reinforced matching of skills and jobs. The situation is likely to be particularly difficult at the lower end of the labour market, making it particularly important to ease the unavoidable restructuring and provide income and targeted social protection support.

In order to reduce the risk of a recurrence of financial crises in the future, a series of measures to reform the global financial architecture should be pursued. These should relate broadly to the following areas:

- Strengthening the international consistency and quality of regulatory standards, including implement reforms (as reflected in the ECOFIN roadmaps and FSF recommendations) and extend them at global level;
- Strengthening international coordination among financial supervisors;
- Strengthening macroeconomic surveillance and crisis prevention, bringing together macro- and micro-prudential aspects, enhancing financial stability and developing early warning systems; and
- Further developing the capacity to deal with financial crisis and resolution capacities, at the national, regional and multilateral levels.

The European action plan against financial crisis must be implemented in consideration of the principles of efficiency, transparency and accountability, representation of European Member States.

This crisis is a possibility for the EU countries to unite their actions and to make certain steps towards recovery. The EU has to show to 27 countries and European institutions that cooperating and working as a unit may lead to the welfare of all EU citizens.

Conclusions

1. Three fundamental groups of the reasons for the global crisis could be distinguished: the first, the cyclic development of the world economy and the national economies as well as the increasing synchronicity of these processes in the major world economic centres, i.e. the U.S., the EU and Japan; the second, the emerged global financial system which **does not meet the modern requirements and is unable to self-regulate**; the third, social factors, such as increasing polarisation of the world countries and societies, growing social economic inequality and a crisis of moral-ethical values.

2. The financial crisis is identified as a crisis in an interconnected world. A crisis that began in a small segment of the U.S. housing market evolved into a global credit crisis of systemic proportions. The impact of the crisis began to engulf households and business around the world. The most advanced economies (the U.S., the EU and Japan) were simultaneously in recession. As a consequence, global growth is expected to remain below potential in 2009-2010.

The speed at which these events unfolded was unprecedented. "Panic" was identified as an element of the anatomy of a systematic financial crisis.

Contagion of financial crisis not only arises through linkages in trade and finance but also through the often complex interaction of risks that increases uncertainty and renders decisions more difficult. The salient risks likely to affect the global economy through 2009 include: deteriorating fiscal positions, a further significant reduction in the world's (and China's) growth; continued depreciation of asset prices and deflation as a key concern.

According to the world analysts 2009 will be a year of learning the lessons of the financial crisis, a year that calls for a new financial architecture to be shaped.

3. The global financial management changes the financial system fundamentally. The main regulation instrument nowadays is not the self-regulating market and its actors but countries and their financial decisions. Two major points in the process of dealing with the financial crisis are emphasized in the European action plan/framework. The first one is a wider approach to overcoming the financial crisis in Europe: it is necessary to focus not only on restructuring the banking system but also on the real sector. The second point emphasizes the importance of joint actions of the 27 Member States of the EU.

To reduce future risk of a crisis, the following global finance architecture measures must be taken: formation of the new financial market architecture at the EU level, dealing with the impact on the real economy and a global response to the financial crisis.

References

1. Annual Report 2007-2008. (2008). World Economic Forum, [accessed on: 10-01-09]. Available from: www.weforum.org.
2. Bank of England. Financial Stability Report. (2008). London, [accessed on: 12-01-09]. Available from: <http://www.bankofengland.co.uk/>.
3. Commission of the European Communities. (2008). Communication from the Commission: From Financial Crisis to Recovery: European Framework for Action. Brussels, [accessed on: 06-01-09]. Available from: www.european.lt.
4. Daianu D.; Lungu L. (2008). *Why is this financial crisis occurring? How to respond to it?* ALDE conference material, [accessed on: 15-01-09]. Available from: <http://www.alde.eu>.
5. Dodd, R. (2007). Sub-prime: tentacles of a crisis. In: *Finance and Development*, 44 (4).
6. Global Risks 2009. (2009). World Economic Forum, [accessed on: 12-01-09]. Available from: www.weforum.org.
7. International Monetary Fund. (2008). World Economic Outlook, [accessed on: 03-01-09]. Available from: <http://www.imf.org/external/index.htm>.
8. Kodres, L. (2008). A crisis of confidence...and a lot more. In: *Finance and Development*, 45 (2).
9. Kolodko, G. (2008). *Wędrujący świat*. Warszawa: Prószyński i S-ka SA.
10. McCreevy, C. (2008). ALDE the conference material, [accessed on: 07-01-09]. Available from: <http://www.alde.eu>.
11. Rakauskienė, O. G. (2006). *Valstybės ekonominė politika*. Vilnius: Mykolas Romeris universitetas.
12. Rotemberg, J. (2008). Sub-prime Meltdown: American Housing and Global Financial Turmoil. In: *Harvard Business Review*, [accessed on: 06-01-09]. Available from: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1270173##.
13. Stiglitz, J. (2002). *Globalisation and its Discontents*. New York, London: W.W. Norton & Company.
14. <http://www.neblog.econ>.

PASAULINĖS FINANSŲ KRIZĖS ANATOMIJA

Ona Gražina RAKAUSKIENĖ, Eglė KRINICKIENĖ

Mykolo Romerio universitetas, Lietuva

Santrauka. Straipsnyje nagrinėjamos fundamentinės pasaulinės krizės susiformavimo priežastys bei jos pasekmės. Pasaulinės ekonomikos istorijoje krizės kildavo ne tik esant atitinkamoms ekonominėms-socialinėms aplinkybėms, bet ir veikiant tam tikriems bendriesiems veiksniams, kurie ir atskleidžiami straipsnyje. Nagrinėjama Lietuvos padėtis pasaulinės finansų krizės kontekste. Be kitų priežasčių, išskiriamos socialinės nelygybės ir moralinių-etinių vertybių stokos problemos, turėjusios didžiulės įtakos krizės atsiradimui. Straipsnyje taip pat vertinamos Europos Sąjungos priemonės, skirtos kovai su krize. Europos veiksmų plane išskiriami du esminiai dalykai: pirma, siekiant įveikti krizę būtinas ne tik bankų, bet ir realiosios ekonomikos sektoriaus restruktūrizavimas, antra, pabrėžiama visų 27 ES valstybių narių bendro veikimo svarba.

Ona Gražina Rakauskienė is a professor, Habilitated Doctor at the Department of Economics, Faculty of Economics and Finance Management, Mykolas Romeris University, Vilnius, Lithuania. Research interests: economic growth, gender economics, quality of life, export development, globalisation risk.

Ona Gražina Rakauskienė – Mykolo Romerio universiteto Ekonomikos ir finansų valdymo fakulteto Ekonomikos katedros profesorė, habilituota daktarė. Pagrindinės tyrimų sritys: ekonomikos augimas, lyčių ekonomika, gyvenimo kokybė, eksporto plėtra, globalizacijos rizika.

Eglė Krinickienė is a doctoral student, Department of Management Theory, Faculty of Strategic Management and Policy, Mykolas Romeris University, Vilnius, Lithuania. Research interests: gender economics, gender responsive budget.

Eglė Krinickienė – Mykolo Romerio universiteto Strateginio valdymo ir politikos fakulteto Valdymo teorijos katedros doktorantė. Pagrindinės tyrimų sritys: lyčių ekonomika, lyčiai jautrus biudžetas.