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THE RECENT FINANCIAL BUBBLE: AN OVERVIEW

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Abstract: *The main aim of this paper is to analyse the recent financial crisis and to make recommendations how to handle it in the best possible way. Financial bubbles, since the great depression, have been analysed and some recommendations have been made taking into account the internationalization of the world economy which behaves like a domino. The recent financial crisis in the sub-prime mortgage market creates new problems in the world market with unforeseen continuances. Deflation has been referred to as a possible continuance after a financial bubble because often but not always deflation follows. Deflation often results in financial and economic crises. Financial and economic crises affect the architecture of the monetary system, while a change in the system may affect the role of the dollar, the euro and the yen.*

Key words: *Financial crisis, world economy, monetary system.*

1. Introduction

Although, there is a tough debate between university professors, professionals and market analysts regarding the characteristics and the reasons behind the current financial bubble, the present paper considers that the crucial characteristics of this credit crisis is a combination of less available and more expensive credit in addition to a declining demand which eventually will hurt even healthy companies.

It is known that corporate financial decisions are driven by demand and supply factors. In that respect from the demand side the expected decline in demand and the likely fall in capacity utilization will cause companies to cut back on new investments in capacity and expansion, stalling growth further and reducing their need for external capital. From the supply side, the available credit is now scarce and more expensive than ever. Selective financing is possible with significantly higher spreads.

2. The Current Financial Crisis

The current financial crisis has affected almost all economic sectors hardly. Auto industry, shipping industry, construction industry, banking/insurance services and agriculture are in great danger. Thousands of cars of all types are parked in free-zone lots, ships are anchored and empty around the world, construction is low, letters of credit have disappeared from the market, while the market prices for most agricultural products are not fair.

We are facing a very tough environment and certainly a recession in many countries. The question is: How severe will it be? Some observers have argued that it will be relatively short and shallow. They point to the relative flexibility of the US economy and the rapid intervention of Obama's government.

In this scenario, the main issue that companies will have to content with is the increased risk aversion and tighter lending standards of banks. It might also take a while for confidence to return to the capital markets. This scenario favours companies with stronger credit profiles because they will still be able to raise funds, not just from banks in home markets but from

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global financial sources.

The IMF has studied more than 100 past recessions around the world and arrived at a clear conclusion. Recessions induced by a financial crisis are deeper and worse. Such recessions tend to be “two to three times as deep and two to four times as long” and to lead to “negative growth of 4.5% of GDP”. In the current situation, the overall high level of credit, the financial bubbles, and the highly leveraged consumers in the US, are the main reasons to be worried about. Therefore, real economies around the world need to be prepared for a serious recession in 2009 and 2010. They have to plan for a situation in which banks continue to fail, consumer demand continues to decline, and the unemployment rate goes up.

All developed economies will fall into recession. Under this development what, specifically, are most companies in the real economy likely to face? According to what most observers believe, we are going to face:

- Difficult access to funds accompanied with significantly higher cost of capital
- Weak stock markets with continued volatility
- Credit losses
- Significant balance-sheet risks, reduced cash flows and low profit margins
- More government intervention along with protectionism and re-regulation
- Shifts in consumer behaviour
- Every industry will be affected from a consolidation wave.

In such an environment, what will be the actions to be taken by financial institutions? A proper rescue-plan is certainly an immediate issue for the financial industry to make which must be consistent with the conditions of every economy in the world.

3. Reality and Prospects

Due to internationalization the world economy behaves like a domino. The recent financial bubble in the sub-prime mortgage market creates new problems in the world market with unforeseen continuances.

For example deflation is a possible continuance after financial bubbles because when financial bubbles collapse, often but not always deflation follows. Deflation often results in financial and economic crises while financial and economic crises affect the architecture of the monetary system. In this case, a change in the system may affect the role of the dollar, the euro and the yen.

If the resources of the US economy are sufficient to redefine financial markets, there will be a way to manage the outcome of this crisis. If the crisis becomes so large that even the resources of a $14 trillion economy mobilized by the state cannot do the job, then the world economy is in great trouble. If the latter is true, then all other discussions are irrelevant. Events will take their course, and nothing can be done. The world economy is going in a deep depression. If it is not true, that means that politics defines the crisis as it has other crisis. In that case, the US federal government can marshal the resources needed to redefine the markets. The federal government must act in due course, and an institutional resolution taking power from the Treasury will emerge as soon as possible.

The next question is how much time remains before massive damage is done to the world economy. If there is no time, events will take their course, and nothing can be done. We are going in a deep depression again. If there is still time events will take their course, and something can be done. We are going in a deep recession. Therefore, in any case be prepared for either a deep recession or a deep depression.

4. The How’s and the Why’s of the Financial Crisis

There are actually two possible ways to deal with the crisis. Allow the market to solve the problem over time or have the state organize the resources of the society to speed up the resolution. The market solution is more efficient over time, producing better outcomes and disciplining financial decision-making in the long run.

However, it is known that the market solution can create massive collateral damage such as high unemployment on the way to the superior resolution. The state solution, on the other hand, creates inequities by not sufficiently punishing poor economic decisions because it creates long-term inefficiencies that are costly and it has the virtue of being quicker and mitigating collateral damage.

Based on the explanations given by distinguished researchers, the current financial crisis can be attributed to at least 5 misleadings in the global economy.

- Lack of effective regulation in Investment Banking
- Market makers
- Risky innovative products (toxic products)
- Economy decline
- Globalization.

Some concerns about the crisis are still open for discussion. Beyond the uncertainties which the real banks face, there is mounting concern around the rest of the shadow banking system regarding Hedge Funds, Private Equity Funds, and other alternative investors. What has begun as a leverage crisis and a credit crunch has turned into a full-blown insolvency problem as well.

The globalization on US Treasuries with a rate close to 60% in 2008 may be the next weak point of the world economy. A huge amount of money in the US Treasuries depends on the kindness of strangers. The globalization on investments with a tremendous amount of capacity built up, a rate close to 23.5% of the global GDP in 2008 is another concern on how the crisis will be developing.

The huge growth in derivatives with the outstanding amount of open positions in OTC* (over the counter) derivatives markets reaching 35 times the US GDP in 2007 (about $525 trillions with $13,8 trillions GDP) while in 2004 it was 14 times ($162 trillions with $11,6 trillions GDP) and in 2001 it was only 6 times ($67 trillions with $10,1 trillions GDP) is also an important issue to watch for since the current outstanding amount of open positions in OTC derivatives markets is 35 times the US GDP.

Besides all the above, the changing face of the US economy with the consumer spending close to 73% of the total GDP may be the next weak point in the global economy.

5. Financial Pillars

Looking back to the crisis we have realised that the modern financial system has been affected mainly on its pillars. It is known that the MFS rests on three pillars:

- Capital
- Liquidity
- Confidence

Regarding the first pillar, capital, in the 12 months to August 2008 the reported losses have reached $250 billion in the US, $200 billion in Europe and $100 billion in Asia. These losses have depleted financial institutions' capital faster than they can raise new capital.

Regarding the second pillar Illiquid capital markets have made it hard for them to finance their own debt. For the third pillar, falling confidence has damaged inter-bank lending and made depositors jittery. As a result, it is not since the crash of 1929 that the global financial system has been subjected to such a severe shock.

The reasons behind the crisis are based on three widely held misconceptions:

That the creditworthiness of borrowers was strong, that investors were sophisticated, that credit risk was widely distributed. Unfortunately none of them was valid.

i. The creditworthiness of borrowers was strong

That was however, a dangerous circularity to the logic. Lender and investor perception of healthy homeowner credit drove spreads lower, causing marginal borrowers to appear to be more financially attractive than they were, in fact, and making it easier to justify providing them financing.

ii. Investors were sophisticated

Lenders and investors were assumed to be exceptionally sophisticated. Advanced financial technology meant that the risk could be finely tailored to their specific needs. Strengthened by credit insurance and blessed by rating agencies, this risk was assumed to be nearly bullet-proof. Consequently, the capital applied against it was minimized.

iii. Credit risk was widely distributed

Market participants believed that the risk was widely distributed among global investors. Even if credit worsened and analytics failed, the absence of concentrated risk would prevent systemic problems. This belief, more than any other factor, explains why people - instead of being worried of a market bubble - were under the impression that this time, it was different.

Financial markets worldwide are still unstable, harming the world economy hardly. They reflect ongoing deleveraging pressures amidst a deepening economic downturn. In spite of extensive policies, the global financial system remains under intense stress. The worsening economic conditions worldwide are producing new, large write downs for financial institutions. According to some analysts the new bank write-downs during 2010-2011, after offsetting the anticipated revenues, would result in a capital shortfall of another half a trillion dollars. In response, balance sheets are being cut back through asset sales and the retiring of maturing credits. These actions have increased downward pressure on asset prices and reduced credit availability.

6. Conclusions

Restoring the financial sector functionality and confidence are necessary elements of economic recovery. However, more aggressive actions by both policy makers and market participants are needed to ensure that the necessary deleveraging process is less disorderly.

A broad three-pronged approach including liquidity provision, capital injections and disposal of problem assets should be implemented to encourage balance sheet cleansing. At the same time, international cooperation will be required to ensure the policy coherence and consistency needed to re-establish financial stability. Are the main players in the world economy ready to cooperate?

Today, with the global financial system shaking what are the necessary steps to be taken, what are the new initiatives from the managerial and the financial point of view? The Proposed Initiatives to be taken and/or to be adjusted are:

From the managerial point of view:

- Introduce a crisis-monitoring team, which will monitor the key early-warning indicators and stress-test scenario planning, develop scenarios, evaluate the competitive landscape and implement measures
- Cost and organizational efficiency - implement new measures for cost and organizational efficiency that can be executed without risking major opportunities
- Plan for the upturn - investments that strong companies make in R&D, IT or new infrastructure will only come on stream once the recession is over.

From the financial point of view:

- Watch your trade credits
- Start working capital initiatives - improve processes to monitor working capital
- Look for opportunities and engage in selective M&As - recession changes some of the long-standing “rules of the game”. Take advantage of the weaknesses of competition in order to redefine the industry.

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