

THE TYPICAL SITUATION BEFORE THE CRISIS

Sabdenaliyev Berik

The crisis often occurs after a long period of economic growth, high employment and high activity. The situation for companies and individuals are typically as follows:

- The economic activity in the whole society is very high after a long period of growth, but is beginning to decline.
- Stocks are traded for historically high quotes after a long period of rise of 300% or more, they have reached an all time high level, but they are beginning to decline again.
- The prizes of real estate properties are also high after a long period of growth, 300% or more, but they also are beginning to decline after an all time high level.
- Companies are often over-established after aggressive investments for borrowed money. The investments have not yet shown profitable, but the companies estimate great profits from the investments because they think the general growth will continue uninterruptedly.

THE INITIAL STAGES OF THE CRISIS

The crisis usually has a slowly developing initial face. During this face the situation can reverse and the economy recover without great damages. In this initial period one can observe the following process:

- Steadily more companies realize that their massive investments do not pay back with the expected revenues and they have problems paying on their loans. They abruptly reduce further investments and begin selling off assets.
- Companies are getting steadily less orders, are selling less and have less to do because of reduced consume and investments.
- Earnings of companies and individuals are declining and many are downright losing money.
- The stock market values are sharply declining, often 20-30%.

THE FURTHER STAGES LEADING TO A FULL-BLOWN CRISIS

At some time there can be a critical turning point leading into the development of a full blown crisis that it is impossible to recover from in an easy way. This turning point occurs when a certain percentage, for example 10%, of individuals and companies realize that they do not have enough income to handle their debt, and that sell-off of properties and stocks will not nullify the debt. The full-blown crisis has these properties: Many companies experience massive losses.

- The number of companies and individuals with debt trouble is abruptly rising.
- The number of bankruptcies is abruptly rising.
- The unemployment level rises abruptly.
- Banks get into serious squeeze due to customers unable to pay on their debts and due to the decline in the value of properties serving as security for the loans.
- The troubled banks have to raise the interest rates by many percent to counteract the losses. But this act only increases the problems for other banks, individuals and companies and accelerates the crisis.
- A high percentage of the banks get unfunctional and bankrupt
- Now there will be massive sell-offs of properties and stocks. The sell-offs are exerted by individuals trying to free themselves from some of their debts and by banks trying to stop losses on loans.
- The stock market cracks down by an new 50% or more driven by the massive sell-offs.
- The real estate market also cracks down a new 50% or more due to massive sell-offs, but usually somewhat slower than the stock market.

THE END OF THE CRISIS

Before the crisis can end, all sell-offs to pay back on loans must be fulfilled. Then every actor in the society has to accept their losses. Debts that actors are not able to pay back must in some way be nullified. Then all the pieces remaining of the former companies must be fixed together again into new functional units. Then the society can slowly rebuild its strength.

THE CAUSES OF THE CRISIS

An important cause of the crisis are over-optimistic companies and individuals during the foregoing period of economic growth. They tend to believe that the general growth will continue forever without interrupting periods of economic decline. They also tend to overestimate themselves and think they will be a winner in the competition against other companies or persons, not a loser, not an average performer, but the winner.

This optimism, which is a general human property, make all actors borrow massive amounts of capital and invest them in homes, luxury objects and expansion of their business. This expansive behavior tend to accelerate for quite a long time until it meets the wall. Another cause are executives in banking companies tempted to lend out as much money as possible to the borrowers, regardless of the consequences for the bank and the borrowers, because this behavior gives the executives an enormous short term personal gain.

HOW TO AVOID FINANCIAL CRISES

Future crises can only be prevented by hindering financial institution lending out more money to anyone that the borrowers can pay back in a comfortable way. This can only be done by governmental regulations that set clear criteria that must be fulfilled when a certain amount of money is lent out. Also banks must be forbidden to establish employment contracts for their executives that reward them directly for the amount of mortgages they establish.

References:

1. Three top economists agree 2009 worst financial crisis since great depression; risks increase if right steps are not taken. (2009-2-29). Reuters. Retrieved 2009-9-30, from Business Wire News database.
2. 2008.http://www.economist.com/specialreports/displaystory.cfm?story_id=9972489. Retrieved 2008-05-19.
3. Fratianni, M. and Marchionne, F. 2009. The Role of Banks in the Subprime Financial Crisis available on SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1383473

Summary

Financial crisis - high food prices and real estate. This increase in layoffs in the commercial and public structures. This uncertainty in every person. This change in the realities of the world, new rules, conditions and trends.