CONSIDERATIONS REGARDING THE MOST IMPORTANT CRISIS OF THE 21st CENTURY

Mărgărit, Monica-Ionelia[1]

Abstract:

This article aims to introduce the concept of financial stability and to identify the most important crises that have occurred since 2000, both at a global and at an European level, in order to identify the measures taken by central banks as a result of the outbreak of those crises.

Throughout time, world economies have been subjected to events that have drastically changed the attitude of central banks and have had significant effects on the economic environment. After the outbreak of the financial crisis of 2007-2008, central banks adopted a series of expansionary monetary policies in order to support the banking system and/or to avoid a strong economic downturn. However, despite the measures taken by central banks (extending the conventional monetary policy instruments) to stimulate the economic growth, they have proved to be ineffective therefore central banks had to introduce a series of unconventional monetary policy instruments. The second part of this article focuses on the European Debt Crisis while the third part focuses on the actual pandemic crisis and the measures taken by the central banks in order to prevent an even bigger economic crisis.

Key words: *monetary policy, central bank, monetary policy instruments, unconventional policy*

JEL Classification: E52, E58

Introduction

Financial stability is a widely discussed concept in the literature and has become a major concern of central banks, especially as a result of the global financial crisis of 2007-2008. Schinasi G. (2004) believes that „a financial system is a range of stability whenever it is capable of facilitating (rather than impeding) the performance of an economy, and of dissipating financial imbalances that arise endogenously or as a result of significant adverse and unanticipated events. FED (2021, on-line) sees the financial stability as being „about building a financial system that can function in good times and bad, can absorb all the good and bad things that happen in the U.S. economy at any moment". European Central Bank (2021, on-line) defines financial stability as „a condition in which the financial system – which comprises financial intermediaries, markets and market infrastructures – is capable of withstanding shocks and the unravelling of financial imbalances".

Throughout time, world economies have been the subject to events that have drastically changed the attitude of central banks and which had significant effects on the economic environment. After the outbreak of the financial crisis of 2007-2008, central banks adopted a series of expansionary policies in order to support the banking system and avoid a strong economic downturn. However, despite all these measures taken by central banks (extending the conventional monetary policy instruments) to stimulate the economic growth, they have proved to be ineffective therefore central banks had to introduce a series of unconventional monetary policy instruments.

1. The Financial Crisis of 2007-2008

The quick spreading of the global financial crisis in the fall of 2007 left deep scars on the world economy. Even though most countries have overcome the shocks caused by the outbreak of this crisis, the effects are still visible, several of the affected states being unable to rise to the financial strength they had before the crisis.

The global financial crisis of 2007-2008 did not come out of nowhere: it was the consequence of several monetary measures and, in particular, because of cheap lending. The

[1] Ph.D. student, University of Craiova, e-mail: margaritmonicaionelia@gmail.com

most important measure taken by the FED in this regard was reducing the federal funds rate from (05.2000-06.2003), from 6.5% to 1%. Even though this measure had good intentions, the results were not as expected: the population took advantage of the decrease in loan rates and proceeded to buy houses, their price experiencing an upward trajectory that showed no signs of slowing down. As a result, FED began to raise federal funds rates, which remained at 5.25% until August 2007.

All of these caused great difficulties to the US population: owners could not sell their houses because their prices were too low compared to purchasing prices which meant that even if they tried to sell them, their earnings could not be enough to pay their debts and for those who had flexible or indexed mortgages, their costs increased as their house value decreased. Subprime lenders began to go bankrupt one by one, and by August 2007 it was already obvious that financial markets could no longer control this subprime lender crisis, and moreover, this problem became international.

By the beginning of 2008, the US economy was in a complete recession. Even though FED reduced its reference rates by 0.75, the bad news continued to flow. The climax of the recession was marked by the collapse of Lehman Brothers, the largest bankruptcy in US history. Also in the same month, financial markets were in free fall, and most US indexes suffered the largest losses to date.

As a result of the bailout plan which included measures like acquisitions of toxic assets by the government or making huge investments in bank securities, the US economy was revived. However, the effects of the financial crisis have been devastating for the US economy: unemployment rate grew to 10% and more than 3.8 mil Americans lost their houses because of enforcement.

The financial crisis had a significant impact on the world economy. Post-crisis effects have weighed heavily on the economic growth and financial stability. Next, we will briefly present the international effects of the global financial crisis of 2007-2008:

a). financial crisis in Africa - The financial crisis came at a time when African countries were beginning to emerge from the effects of the food and energy crises. Among the first effects of the crisis were: the tightening of credit, the decline in the purchasing power of African currencies and the decline in stock markets. However, the low level of financial integration in Africa meant that African economies were relatively isolated from the direct impact of the financial crisis because, compared to emerging countries, Africa's external financing was extremely low (4% in 2007). Poor financial integration indicates why Africa has not suffered heavy losses due to the global financial crisis and why not a single African country has announced a bank bailout plan on a scale comparable to the more developed countries;

b). financial crisis in South America - Latin America has been severely affected by the crisis. However, although financial conditions were deteriorated, the financial shock itself was less powerful than the ones faced during the two previous regional crises. Moreover, in the case of South America, there was more room for countercyclical macroeconomic policies. The measures implemented were quite wide and diverse because the effects of the crisis were different from one country to another, which required the use of different instruments;

c). financial crisis in Asia - The biggest and most immediate impact of the financial crisis could be seen on the financial markets: stock market indexes in the region were severely affected by the free fall of global financial markets. The highly trade-dependent Asian economies have suffered the most because of declining exports and imports. The collapse of demand was transmitted through the integrated supply chain, with dramatic effects on intra-regional trade. Even countries with large reserves, a comfortable current account position and a strong political framework, such as South Korea, were hit hard by the crisis. Since in many Asian countries monetary rates were very close to zero, they resorted to the introduction of unconventional monetary policy measures (Japan, South Korea). Moreover, most of the Asia

Pacific region governments have introduced multi-annual fiscal stimulus packages to support the economic growth.

As far as Europe is concerned, the global financial crisis has had a significant impact on all European regions. Of course, the effects and responses to the crisis have varied significantly from one country to another due to different economic circumstances and the significantly different degree of development of the European countries. Although the impact of the financial crisis was initially more pronounced in the United States than in Europe, the response to monetary and fiscal policy was much better in the first case.

Europe immediately adopted a series of measures to fight the crisis. Eurozone countries have implemented several massive reform. Some of them even received financial assistance from the European Financial Stability Facility (EFSF). The unconventional monetary policy measures implemented by the European Central Bank have also played an important role in the recovery of European economies.

According to the European Commission (2009), among the most important monetary policy actions of the European Central Bank following the global financial crisis of 2007-2008, between October 2008 and June 2009 were:

- reduction of the monetary policy interest rate by 50 pp. from 4.25% to 3.75% (October 2008);
- reduction of the monetary policy rate by another 50 pp. reaching 3.25% in November 2008;
- the European Economic Recovery Plan (November 2008);
- the process of lowering the monetary policy rate continued in December 2008 when it reached 2.50%;
- lowering the monetary policy rate to 2% in January 2009;
- March 2009: the value of monetary policy reached 1.50%;
- in April 2009 the European Commission proposed a series of measures to improve fiscal transparency;
- April 2009: monetary policy rate was reduced to 1.25%;
- May 2009: monetary policy drops to 1%.

However, in 2008-2013, 112 European commercial banks suffered from the global financial crisis and had to close their gates. Most banks failures could be observed in the United Kingdom where 31 bank were closed, followed by Italy with 20 bank failures and Iceland (15). Of course, there were countries that did not face bank failures (France, Norway, Bulgaria, Czech Republic, Poland, Romania, etc.). In terms of the annual number of bank failures in Europe, most of them were recorded in 2008 (27), followed by 2011 and 2012 (26 bank failures each). In 2009 there were 16 bank failures, while in 2010 only 15. The situation started to calm down starting with 2013 when only 2 bank failures were registered.

The European Central Bank initially gave a bigger importance to liquidity injection in order to restore the interbank activity. Starting 2010 the bank focused on the purchase of sovereign bonds as a result of the sovereign debt crisis known as the European debt crisis.

The implementation of unconventional monetary policy by the European Central Bank can be divided into three phases:

- first phase (09.2008-12.2009) – in this phase the ECB focused on providing support to the banking system;
- second phase (01.2010-12.2012) – the period in which the European debt crisis manifested and during this phase the European Central Bank focused on the purchase of government bonds;
- third phase (starting mid. 2013) – the Central Bank adopted a more aggressive monetary policy strategy with large-scale acquisitions, targeted lending policies and even negative interest rates.

The European Central Bank started using negative interest rates by charging the commercial banks for their reserves held by the central bank. The expected effects of this strategy were reducing the amount of money that commercial banks had in their reserves held by the central bank and use them for reducing the lending interest rate together with increasing the prices of the financial market products. Naturally, the adoption of such a strategy has brough with it a number of concerns regarding the effects that these negative rates may have on the commercial banks' profitability. However, the commercial banks found other ways to maintain their profitability, namely by increasing their fees.

Another strategy approached by the European Central Bank was to use the forward guidance. Quantitative easing was another unconventional monetary policy decision taken by the ECB following the global financial crisis of 2007-2008. Quantitative easing refers to large-scale acquisitions of securities by central banks. As a result of the purchase programs implemented in 2009-2010 and 2011-2012, the European Central Bank created a total amount of 100 billion euros. Subsequently, at the beginning of 2015, the European Central Bank adopted the Asset Purchase Program (APP), which consisted of four securities acquisition programs (Corporate Sector Purchase Programme – CSPP, Public Sector Purchase Programme – PSPP, Asset-Backed Securities Purchase Programme – ABSPP and Third Covered Bond Purchase Programme - CBPP3). The Asset Purchase Program (APP) aimed to purchase monthly securities, summing up by the end of the programme an amount of 2,650 billion euros. After a period in which the program was stopped, during the meeting of the Governing Council of the European Central Bank, it was decided to restart the program, starting with November 1st 2019, with a monthly procurement rate of 20 billion euros. Other unconventional monetary policy actions taken by the ECB involved supplementary long term refinancing (SLTROs) and very long term refinancing operations (VLTROs), outright monetary transactions (OMTs) and securities markets programme (SMP).

2. The European Debt Crisis

The sovereign debt crisis has been fueled by excessive lending, speculative asset price bubbles and loss of competitiveness. One of the most important weaknesses of the European Monetary Union since day one has been the combination of a unique monetary policy with a decentralized fiscal policy. The monetary policies of the Eurozone is set by the European Central Bank and is the same for all Member States while fiscal policies are different for every EMU state. Member States are more prone to borrowing than other states, and when one of them is facing difficulties due to the very high level of debt, the consequences are spreading across the Union as well.

In order to fight this weakness, a framework of rules has been created. Among the most important principles included in this legislative framework are the one according to which the annual budget deficits must not exceed 3% of the gross domestic product and the one according to which the public debt of a state must not exceed 60% of the gross domestic product. The no-bailout principle also prohibits Member States from taking responsibility for another Member States' debts.

However, Member States' loans have not been properly managed. Following the outbreak of the subprime crisis in the United States, European countries experienced a series of systemic crises that broke out at various times in 2007-2011. In most cases, the sovereign risk was highlighted only later, after the materialization of the banking crises. Systemic crises initially emerged between 2007 and 2008, in countries where the banking system was more vulnerable to external shocks. During 2007-2011, 21 systemic episodes took place, ten of which involved significant adjustments to external positions, and eight of them involved the emergence of sovereign risk.

Regarding the countries that have suffered the most because of the banking crisis and the sovereign crisis, Spain, Portugal and Ireland encountered problems between 2008 and 2009, when a series of interventions to maintain financial stability took place. Another group of countries (Cyprus, Greece, Italy and Slovenia) experienced systemic crises in 2009-2011 due to the deterioration of the macroeconomic environment, the emergence of credit risk and sovereign risk, which affected the financial stability of these states.

At the end of 2009, the representants of Greece announced that the debts reported by the Greek authorities up to that date did not describe the actual situation of the state (they were much higher than the ones reported). Moreover, the debt values of countries such as Italy, Portugal and Spain have also become a problem for the European Union because their government debt-to-GDP ratio was very close to Greeks'. These countries have not been able to repay or refinance their government debt and have not been able to save their commercial banks without the help of European Central Bank, European Monetary Fund and European Financial Stability Facility.

Theoretically, a state cannot go bankrupt – that is why6 a lot of commercial banks, especially from Germany and France, bought and exposed themselves massively to Greek debts. These bond buyers assumed that any bond issued by an Eurozone state had the same degree of security as any other Member State. Because of the sovereign debts, since 2010, lenders have been demanding higher interest rates from European Monetary Union countries. These higher rates caused many difficulties in financing budget deficits and some of these countries have increased taxes and reduced budget spending to fight the crisis.

By far the most affected state by this sovereign crisis was Greece. Greece needed assistance from the Eurozone until May 2010 and received several bailouts from the European Union and the European Monetary Fund in exchange for some austerity measures imposed by the EU to reduce public spending, as well as a tax increasement.

These measures, together with the precarious economic situation, have caused social disorder, raising the possibility for Greece to leave the European Monetary Union. However, Greece eventually began to show signs of recovery, which kept the state in the Eurozone. Within five years, the Greek economy was recovered, the evolution of gross domestic product has reached from double-digit negative values to over 2%, while the unemployment rate has dropped from 27% to 16%.

Other European states affected have applied for bailout measures one after the another, as it follows: Ireland in November 2010, Portugal in May 2011 and Spain and Cyprus in June 2011.

3. The Pandemic Crisis

The current pandemic crisis is an unique challenge, with severe economic and social consequences felt by the entire world. In order to prevent the spread of the virus, the affected states have established measures like social distancing and even quarantine. These measures have had major implications for the world economy.

Globally, central banks (in particular FED, ECB and BOJ) responded to the economic crisis that occurred as a result Covid-19 really fast by adopting a series of monetary instruments, both conventional and unconventional, in order to fight the possible recession that may occur. Central banks immediately started to inject money in order to provide liquidity to households and businesses. They maintained negative interest rates and aggressively expanded quantitative easing programs..

V. Shevchenko (2020) tried to identify the nature and types of economic shocks generated by the coronavirus pandemic in 2020 in Europe. According to him, the coronavirus pandemic created clusters of shocks like: psychological shocks - which caused stress and fears due to uncertainty about the spread of the virus and its effects on humanity - medical shocks, economic shocks - as a result of the restrictive measures taken worldwide, which led to contractions in the production and services sectors - financial shocks - the need to cover extraordinary expenses in order to fight against coronavirus - and social shocks - rising unemployment, work and online education .

Analyzing the US response to the current pandemic crisis, a complementary approach to monetary and fiscal policy can be seen, with FED buying extraordinary amounts of securities and US government running a deficit of around 17% of estimated GDP. As in the case of the global financial crisis of 2007-2008, FED brought the discount rate as close to zero as possible and stabilized financial markets by using emergency liquidity.

The economic effects of the coronavirus pandemic in the United States have been dramatic: the unemployment rate rose in April 2020 by 11.2 pp compared to February 2020, reaching about 15%, and real gross domestic product fell by more than 10 % in the first six months of 2020. To limit the impact of the economic blockade, the federal government has run unprecedented fiscal deficits. A key feature of public debt management was the acquisition of government securities, which began in March 2020.

In the United States, both fiscal and monetary policy responses have been beyond comparison when it comes to their scope, promptitude and effects. These measures provided support for US economy during 2020, unemployment rate dropping by 6% until March 2021.

The outbreak of the coronavirus pandemic in February 2020 had a significant impact on Eurozone economies. Even though the health crisis has manifested itself in all states at the same time, some of them have been affected sooner than others. All of these led to an asymmetry, which made the transmission of the European Central Bank's monetary policy less uniform. As a result of these obstacles, monetary decision-makers had to show up and support the economies.

According to Lagarde, C. (2020) "COVID-19 has delivered the largest shock to the European economy since the Second World War. Key macroeconomic indicators have plunged on a scale and at a speed previously unseen. Industrial production fell by 18% month-on-month in April. Durable goods production was down by almost 15% in the same period and new car registrations dropped by around 50%. If the ECB's baseline macroeconomic scenario for 2020 is borne out, the euro area will lose as much output in two quarters as it had gained over the previous 15 years – and growth will not recover in full until the end of 2022."

As we mentioned before, the response to the pandemic crisis was a quick one. In this regard, the European Union, together with the Member States, established four priority axes. According to the European Council, these were:

- "limiting the spread of the virus;
- ensuring the provision of medical equipment;
- promoting research for treatments and vaccines;
- supporting jobs, businesses and the economy."

The European Central Bank has adopted monetary policy and banking supervision measures to limit the effects of the health crisis. The Central Bank did change its main policy rates because their value was already very low: the monetary policy rate was at 0%, the deposit facility rate was 0.25% and the lending facility rate was 0.50%. Instead, the central bank used unconventional monetary policy instruments similar to those applied during the global financial crisis of 2007-2008 (quantitative easing, negative interest rates and forward guidance).

In March 2020, the European Central Bank announced the Pandemic Emergency Purchase Program (PEPP), with an initial value of EUR 750 billion and a current value of EUR 1.850 billion, which aimed to intensify the credit process by lowering lending rates. The Pandemic Emergency Procurement Program (PEPP) is an unconventional monetary policy measure initiated in March 2020 to counter the major risks that could affect the monetary policy transmission mechanism during the pandemic crisis.

The measures taken by the European Union in order to counteract the negative effects of the pandemic crisis have mostly had the desired effects, stabilizing markets and relaxing the existing financial conditions in early 2020. Throughout the pandemic, the euro area has seen a low level of the cost of lending, with economic agents and households being able to borrow at interest rates set at an all-time low of 1.46% and 1.32%, according to the European Central Bank (2020). All this has ensured favorable conditions for the recovery of European economies.

Conclusions

In this article we wanted to introduce the concept of financial stability and to identify the most important crises that have occurred since 2000, both at a global and at an European level, in order to identify the measures taken by central banks as a result of the outbreak of those crises.

The first chapter presents the most important information regarding the global financial crisis of 2007-2008 and the measures taken by the central banks in order to fight the secessions. Second chapter focuses on the European debt crisis while in the third one we talk about the current pandemic crisis.

In conclusion, we can say that during the analyzed period, the global economy faced a series of economic shocks which disturbed the financial stability. The economic environment continues to be characterized by uncertainty as a result of the current pandemic crisis but we believe that, like proven in the past, the actions taken by the central bank will bring the global economy back to being stabile.

References

1.Baily, M., Litan, R., Johnson, M., 2008, *The Origins of the Financial Crisis*, Fixing Finance Series, Paper 3, November 2008, The Brookings Institution, Washington

2. Bernanke, B., 2014, *Central banking after the great recession: A discussion with Federal Reserve chairman Ben Bernanke on the Fed's 100th Anniversary, Brookings Institution Press*, ISBN: 9780815726104

3. Beyer, A, Coeure, C., 2017, *Foreward – The crisis, ten years after: Lessons learnt from monetary and financial research*, Banca Centrală Europeană, Economics and Statistics, no. issue 494-495-4, pag. 45-64

4. Blundell-Wignall, A., 2012, *Solving the financial and sovereign Debt Crisis in Europe*, OECD Journal: Financial Market Trends, vol. 2011, issue 2

5. Chadha, J., Corrado, L., Meaning, J., Schuler, T., 2021, *Monetary and fiscal complementarity in the Covid-19 pandemic*, European Central Bank, Working Paper Series, no. 2588, ISBN 978-92-899-4811-1

6. Clarida, R., Duygan-Bump, B., Scotti, C., 2021, *The COVID-19 crisis and the Federal Reserve's Policy Response*, Finance and Economics Discussion Series: 2021-035, DOI: https://doi.org/10.17016/FEDS.2021.035

7. Francis, N., Jackson, L.E., Owyang, M.T., 2014, *How has empirical monetary policy analysis changed after the financial crisis?*, Federal Reserve Bank of St. Louis, Working Papers, no. 2014-19

8. Hanson, L., Essenburg, T., 2014, *The new faces of American poverty: A reference guide to the Great Recession*, ABC-CLIO, ISBN-10: 1610691822

9. Kuttner, K.N., 2018, *Outside the box: Unconventional monetary policy in the Great Recession and beyond*, Journal of Economics Perspectives, vol. 32, no. 4, pag. 121-146, ISSN 0895-3309

10. Lo Duca, M., Koban, A., et. al., 2017, *A new database for financial crises in European countries*, European Central Bank Occasional Paper Series, no. 194, ISBN 978-92-899-2856-4

11. Ocampo, J.A., 2009, *Latin America and the global financial crisis*, Cambridge Journal of Economics, vol. 33, pp. 703-724

12. Raj, F., Roy, S., 2013, *Impact of financial crisis in Asia*, Social and Behavioral Sciences, vol. 133, pp. 336-345

13. Schinasi, G.J., 2004, *Defining Financial Stability*, IMF Working Paper WP/04/187

Shevchenko V., 2020, *Economic shocks of the pandemic impact: The European case*, Three Seas Economic Journal, Vol. 1, No. 2, pp. 53-59

14. 1. Spulbar, C., Birau, R., 2019, *Emerging Research on Monetary Policy, Banking, and Financial Markets*, IGI Global USA (formerly Idea Group Inc.), 322 pp., ISBN13: 9781522592693, ISBN10: 1522592695, EISBN13: 9781522592716, DOI: 10.4018/978-1-5225-9269-3, https://www.igi-global.com/book/emerging-research-monetary-policy-banking/220042

15. African Development Bank, African Development Fund, 2009, Impact of the global financial and economic crisis on Africa, on-line https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=&cad=rja&uact=8&ved=2ahUKEwiQveCVofryAhVRgP0HHel9ARoQFnoECDMQAQ&url=https%3A%2F%2Fwww.afdb.org%2Ffileadmin%2Fuploads%2Fafdb%2FDocuments%2FKnowledge%2FFinancial%2520crisis_Impacts%2520on%2520Africa.pdf&usg=AOvVaw25ZQHk97myRZcb1mpflHEL

16. Lagarde, C., 2020, Europe’s response to the crisis, on-line https://www.ecb.europa.eu/press/blog/date/2020/html/ecb.blog200723~c06fafabb6.en.html

17.*****https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.mp190912~08de50b4d2.en.html

18.*****https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html

19.***** https://www.federalreserve.gov/