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The Causes, Dynamics, and Effects of the Global Economic Crisis

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Abstract
This paper examines the financial crisis that started around the middle of 2007 by looking at the causes, dynamics and effects at the global, African, and Nigerian levels. Various literatures were perused, all blaming America's financial system as one of the causes, if not the main cause of the crisis. With the global dimension, its effects has been characterised by the failure of key businesses, decline in consumer wealth, substantial financial commitments incurred by governments and a significant decline in economic activity. Other indicators of the global financial crisis were in stock markets crash, collapse of large financial institutions or bailout, and governments in even the wealthiest nations having to come up with rescue packages to bail out their financial systems.
Keywords: financial crisis, financial system, toxic mortgages, contagion theory, meltdown, emerging economy

1. Introduction

The financial crisis that began around the middle of 2007 has been called various names. For instance, HIS Global Insight Press Desk called it the most serious financial crisis since the Great Depression. Developments in ICT seem to have added to the publicity as it is said that such development has made the world a "global village." With the global dimension, its effects has been characterised by the failure of key businesses, decline in consumer wealth, substantial financial commitments incurred by governments and a significant decline in economic activity (Bailey and Elliot, 2009). Reinforcing this position, Shah (2013) says that this global financial crisis symptomized in stock markets crash, collapse of large financial institutions or bailout, and government in even the wealthiest nations having had to come up with rescue packages to bail out their financial systems.
The organization of the paper is as follows. Section 2 presents the causes of the global economic crisis. Section 3 gives the dynamics of the global financial crises going back to basic principles of the contagion effect. Section 4 provides the effects of the crisis generally and on Nigerian economy in particular. Section 5 describes how political countries have dealt with the crisis. Conclusion is presented in Section 6.

2. Causes of the global economic crisis

Flowing from Joseph Stiglitz's statement in The Guardian, September 16, 2008, Shah (2013) blamed the America's financial system for the crisis, because they failed in two crucial responsibilities – managing risk and allocating capital. Indeed this has been the position of so many commentators world over. The question that has agitated some minds, including the author of this short paper, has been, "could this America's fault be the one and only cause for this level of global upheaval?" However, and turning on the regulatory authorities for ineptitude, Shuttleworth (2008) avers that their weakness lies in their being poorly paid or they don't have the best talent; lack independence or are unduly influenced by industries they supervise. He further believes the regulators may not have the courage to face hostility that is common to them generally. In a similar vein, Stiglitz (2008) says the crisis was 'made in America' in a number of ways. First, "America exported its toxic mortgages around the world, in the form of asset-backed securities. America exported its deregulatory free market philosophy. America exported its culture of corporate irresponsibility – non-transparent stock options, which encourage bad accounting that has played a role in this debacle, just as it did in the Enron and Worldcom scandals a few years ago. And finally, America has exported its economic downturn."

The Economist, in its editorial of September 7, 2013, entitled "The effects of the financial crisis are still being felt five years on", lists the following causes of the crisis: First, for the financiers, "especially the irrationally exuberant Anglo-Saxon, who claimed to have found a way to banish risk when in fact they had simply lost track of it. Secondly, the editor blamed central bankers and other regulators, for it was they who tolerated this folly. Thirdly and on the macroeconomic backdrop, that featured the "Great Moderation" – years of low inflation and stable growth – fostered complacency and risk-taking. A fourth cause is a "savings glut" in Asia that pushed down the global interest rates. Fifthly, European banks which borrowed generally in American money markets before the crisis and used the funds to buy dodgy securities. Altogether these forces led to an upsurge in debt in a world that has become less risky.

On the folly of the financiers, prior to the crisis witnessed an avalanche of reckless mortgage lending in the U.S. Loans were churned out to subprime borrowers with poor credit records who laboured to repay them. These risky mortgages were passed on to the big banks, who converted them into apparently low-risk securities by putting large numbers of them together in pools. Pooling works when the risks of each loan are uncorrelated. The big banks argued that the property markets in different American cities would rise and fall independently of one another. But this proved wrong. Starting from 2006, America suffered a nationwide house-price slump.

In a related matter, the conclusion of the U.S. Financial Crisis Inquiry Commission has it that the crisis was avoidable and was caused by:

1. Widespread failures in financial regulation, including the Federal Reserve's failure to stem the tide of toxic mortgages;
2. Dramatic breakdowns in corporate governance including too many financial firms recklessly taking on too much risk;
3. An explosive mix of excessive borrowing and risk by households and Wall Street that put the financial system on a collision course with crisis;
4. Key policy makers ill prepared for the crisis, lacking a full understanding of the financial system they oversaw;
5. A systematic breaches in accountability and ethics at all levels;
6. Government deregulation.

3. Dynamics of the global economic crisis

As Amonlirdviman, Getmansky, Kumar, & Lo (2004) inform that the volatile nature of financial and economic crises results in economic hardship, political instability and the toppling of a few governments. What is more agitating is the way the crises spread from one country to the other in an inexplicable manner. Such problem will usually trigger off calls for application of various remedies from capital control to restrictions in the flow of foreign direct investment. The authors develop a model for such contagion of financial crises used to explore the paths a crisis can take through different countries starting with the initial country in crisis.

The dynamics of the global financial crisis could be explained away by the contagion theory – in this particular case, financial contagion. Financial contagion refers to the spread of financial crises from one country to one or more countries. Characteristically, the spread is indicated by a significant deterioration of several macroeconomic and financial variables such as a fall in an index of the stock market, a depreciation of the currency, decreased or negative GDP growth rate, net outflows of foreign investment, and the collapse of property prices. Other types of contagion are default, political and stock.

Literature on contagion addressing mode of transmission of financial crises identify two types: fundamental links among economies and the behaviour of investors (Dornbusch, Park, & Claessens, 2001). "The fundamental links often cited as conduits of crises are trade and capital flows. Others point to rational and irrational investor behaviour as another mechanism of crisis transmission". There seems to be a consensus that the current global financial crisis began in the U.S. subprime mortgage and spread throughout the world as the world has turned into a global village, as it is usually said.

Economic globalization is the foundation of our well-being, but the increasing connectedness of our economies makes economic crises ever more difficult to isolate and manage. The situation demands a more exact understanding of economic globalization and of its impact on national economies and on citizens themselves. Discussions of theory are no longer adequate. To identify and evaluate better economic actions and reactions, more complete data, quantitative predictions and estimates of economic impacts under different conditions are needed. (http://www.bfna.org/page/global-economic-dynamics).

The global economic meltdown has extensive and varied effects on the economies of the world. For example, Eme and Nzekwe (2010) inform that "the U.S.A., EU Zone, Asia and African countries are experiencing severe closures of companies, job losses, crash in share prices, squeeze in consumer credit facilities, crumbling mortgage facilities, among others."

4. Effects of the crisis on major economic variables

In examining the effects of the crisis, we shall look at it from the global, African and Nigerian perspectives. The effect of the global economic crisis on the global economy is multidimensional. What started as a financial problem in the United States ended up affecting the entire economies of the world, sparing none. The reason for this extensive impact is because of globalization of the world economy. With reference to developing economies, Nigeria being one of them, the consequences are visible in the areas of crash in share prices, falling revenues, reduced foreign direct investments from developed economies, dwindling remittances and aids from Nigerians abroad and donor agencies and the erosion of foreign reserves.

The global financial crisis impacted negatively on the macro and micro levels of the Nigerian economy. Previous reforms and oil revenue volatility management strategies initiated earlier in the decade have strengthened the country's capacity to manage crises and avert the boom-bust pattern characteristic of past oil cycles. The GDP growth rate was 7.0 in 2007, 6.0 in 2008 and 2.9 in 2009 (IMF, World Economic Outlook, 2009), clearly reflecting the influence of the Global Financial Crisis (GFC). The budget balance as a percentage of GDP was 3.8 in 2008, but declined to -5.2 in 2009 and -2.8 in 2010. Current account as percentage of the GDP has similarly decreased from 21.1% in 2008 to 11% in 2009 (Data from National Bureau of Statistics, domestic authorities and IMF).

The Central Bank of Nigeria injected funds into the banking system in August 2009 when five banks became financially distressed as a result of excessive lending to the energy sector and the decline of the stock market. The Nigerian stock market fell in 2009 because of the global economic meltdown and the all-share value index stood at 26,860 in June 2009, compared with 55,949 in June 2008. The foreign exchange market was hit by speculative activity triggered by a fall in external reserves in the wake of the global recession. Flows of foreign exchange into the economy shrank as a result of the drop in crude oil earnings.

Consequently, the exchange rate depreciated from 119 Nigerian naira (NGN) to the US dollar (USD) in 2008, to NGN 150 in 2009. The inflation rate for 2009 was 12.1%, reflecting several sources of inflationary pressure, including a loosening of monetary policy (FSDH Economic and financial Outlook and Prospects 2010, p. 21).

Unemployment increased from 14.6% in 2007 to 19.7% in 2009. Nigerian inflation dropped from 18.9% in 2001 to 5.4% in 2007 but has increased to 11.6% in 2009, and 12% in 2010. Other effects of the global financial crisis include reduced remittances from abroad (Nov 2008, US$5,327.3m, Dec 2008, US$3,282.7m and Jan 2009, US$1,721.1m). Net Foreign Direct Investment (FDI) moved from $2.1 billion in 2004 to $7.25 billion over 2005-2007 to $13.95 billion in 2009 and is expected to continue to rise on account of investment opportunities in the oil and gas sector as well as the planned privatisation of the electricity sector. Contrary to this expectation, Net FDI dropped to $4.7 billion in 2008 and further declined in 2009 and 2010. The bulk of FDI goes into oil and gas, banking and telecoms, so a sharp slowdown was not surprising. At any rate, less than proportionate employment is often created in the oil sector because the capital intensive nature and intensity of the production process favours technology and is significantly not employment-friendly.

Oil accounts for about 80% of fiscal revenues and 95% of exports. Oil revenues fell by 7.8 percentage points of GDP in 2009, moving the fiscal accounts from a surplus of 3.8% of GDP in 2008 to a deficit of 5.2% in 2009. The banking sector also faced difficulties. And as a result of slowing credit growth and the large oil price decline, which places limits on public spending, non-oil GDP growth slowed to 4 per cent over 2009 and 2010 compared to 9.5 per cent in 2007 and 7.7 per cent in 2008. This development exerted deleterious effect on decent jobs and decent pay.

As Eme and Nzekwe (2010) further reported, Nigeria began feeling the impact of the meltdown (notwithstanding assurances from the supervisory body, Central Bank of Nigeria, that the country will not be affected, Abdullahi, 2009), about March 2006 when companies' shares started unprecedented losses in value. This was preceded by the pulling out of funds from the market by foreign investors who needed to beef up investments in their home countries, (Aluko, 2008). Besides the securities market, Nigerian banks were quite hard hit by the crisis. Again Eme and Nzekwe identified the following ways the banks were affected:

1) The tightening of liquidity;
2) non-renewal of offshore credit facilities;
3) depression of the capital market and the credits advanced by the banks to investors;
4) potential exchange rate risks on foreign lines/credits obtained by banks from multilateral financial institutions;
5) rise in domestic interest rate due to liquidity pressures; and
6) cessation of bank lending and recall of existing loans.

Eme and Nzekwe (2010) point at the insurance industry as another sector affected by the economic crisis. Insurance purchase nosedived while there was income glut from the money market and real estate instruments where the sub-sector operators are good players. The growth witnessed by the industry following recapitalization and consolidation was regrettably eroded by low patronage attributable, directly or indirectly to the global meltdown.

5. Dealing with the recession

"We are all Keynesians now. Even the right in the United States have joined the Keynesian camp with unbridled enthusiasm and on a scale that at one time would have been truly unimaginable", Gould (2008).

For three decades, Keynes advocacy for market regulation was fought and "rubbished" by "market fundamentalists", who are now turning around to call for government bailout (they are too big and too important to let go under); in other words, market regulation. Where lies their market jingles? There seems to be a consensus among the free market advocates that their "belief that markets are self-correcting" was wrong. So also the so-called "efficient markets" model, which holds that prices fully and efficiently reflect all available information, as well came in for a bashing; so did inflation targeting.

At recession, governments attempt to stimulate the economy. Standard macroeconomic policy includes policies to:

- Increase borrowing;
- Reduce interest rates;
- Reduce taxes; and
- Spend on public works such as infrastructure

It is important that government does whatever it can to kick-start the ailing economy as a panacea for coming out of recession.

6. Conclusion

The financial crisis that began in the US around mid-2007 quickly attained a global dimension, sparing no country at all. Emerging economies like Nigeria have had a fair share of the upheaval and are all recovering. Various doses of economic panaceas were administered on these economies to quicken recovery.

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