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Past financial crises and early signal of future occurrence

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Abstract

This study examines the financial crises that rocked the world in 2008 focusing on the different economic challenges and downturns that were encountered during this period. It reflected on different strategies that were employed during this period to chart a policy course that could help prevent a re-occurrence of the past crises. While the overall conclusion from literature shows that excessive government deficit and credit market rationing combined with Central Bank credibility are major factors that trigger volatility in financial turmoil, it recommended regular bubble credit checks and fiscal discipline as strategic option to enhance stability of the financial system.

[Keywords]: Business Cycle, Macroeconomic policy, Financial crises

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INTRODUCTION

The calamity that trailed the world economies in 2008 has been cited frequently in recent literature following the emergence of the New Keynesian mandates that argued the need for a change in Central Bank's mandates from inflation to output. This study attempts to analyse the various economic issues and concerns that were brought to fore during the past crises of 2018 and provide a strategy for preventing future occurrence in the face of the new Keynesian framework, which seems intellectually appealing.

I begin my discussion using the 2008 US mortgage crises as my basis. This period witnessed a tremendous increase in demand for housing. As such, people began to see house as an investment rather than a home to live. This event generated some crises in the US that I attempt to unravel in this paper. To give a better perspective on this subject, I define and explain the concept of financial crises, causes as well as consequences. This aspect is crucial, since the lesson from the US financial crises in the previous years has provided an unresolved puzzle on how the shocks from a nation is shared by other nation(s) due to integration of global trade and financial market. It is interesting to note that most developing and emerging nations are always at the receiving end of the crises or most hit because they tend not to have control over their economies. In some instances, they fail to formulate monetary policies that can predict the influence of foreign shocks on their domestic macroeconomic variables due to evolution of international order that forbids them from closing their economy.

The rest of the paper is organized as follows: the next section presents the concepts and theoretical debate on financial crises, followed by the last section, which concludes the paper with some policy implications of my findings.

Theoretical Exposition

This section presents a short synopsis of the theoretical and empirical review on financial crises which provides the context for subsequent discussions.

I start this discussion by defining the term financial crises and its peculiarity, tracing the general framework as well as its technicality in view of the world economy. I staged the contending debate in the global New Keynesian framework, its implication and the focus of new monetary policy formation to provoke thoughts and rekindle interest. I then brought to fore discussions were I started by suggesting broad policy options for developing an emerging economy.

Financial crises occur when a speculation-driven economic boom is followed by inevitable bust cycle (Thomas, 2011). Financial crises are not just economic turbulence, they are characterized by slow growth, huge sovereign debt and erosion in the exchange rate accompanied by breakdown in stock market, which can lead to loss of investment in shares, bond and portfolios. In extant literature, there are two major channels through which financial crises can occur in an economy. These channels are the sovereign debt and the digit inflation.

Sovereign debt explosion

The sovereign debt crises or default occur when there is increase in government debt resulting to domestic currency crises, huge gap in balance of payment, hyperinflation as well as inability of the national Central Bank to formulate domestic monetary policy (Stamatopoulos, Arvanitis, & Terzakis, 2017). This channel can led to sharp increase in risk premia (Calomiris & Haber, 2017). Several studies have attempt to explain the challenges faced by a nation unable to meet up with its sovereign debt obligation and the political games associated with the channel. This often leads to strive punishment on such economy. Interestingly, most studies have reported mixed evidence with their findings on the execution or use of this channel. For example, Fontana and Scheicher (2016) compared the market pricing of Euro bond and corresponding credit default swap and reported that persistent negative deviation in government financing was a prominent factor that lead to financial turmoil among the countries examined. Similarly, Beirne and Fratzscher (2013) analyzed the drivers of sovereign risk for advanced and emerging economies and reported that sharp increase in sovereign yield among countries are transmission channel for financial crises occurrence in the region.

Hieu (2016) considered contagion as a change in the transmission mechanism of shock, illustrating co-movement among the sovereign credit default swap (CDS) markets of seven European countries and reported that no contagion during the debt crisis suggests that the reason for the sovereign risk's propagation was the conventional interdependence among countries, nor the greatness of the shock.

De Grauwe and Ji (2013) examined the drivers of government bond markets in the Eurozone and noted they are more fragile and more susceptible to self-fulfilling liquidity crises than in stand-alone countries. They reported that there is a significant part of the surge in the spreads of the peripheral Eurozone countries which is attributed to the underlying increases in the debt to GDP ratios and fiscal space variables and was associated with negative self-fulfilling market sentiments.

Bacchetta, Perazzi, and van Wincoop (2018) re-examined the potential for monetary policy to avoid self-fulfilling sovereign debt crises. They combined a version of the slow-moving debt crisis model proposed by Lorenzoni and Werning (2013) with a standard New Keynesian model, and reported that price rigidity implied more sustained inflation in sovereign debt default circumstances. Semmler and Tahri (2017) analyzed the external debt of three Euro area economies - Italy, Spain and Germany. Studying the effect of debt on the investment-consumption dynamics in those countries, they reported that the periphery economies moved toward a slow-moving debt crisis during the period observed. Roch and Uhlig (2018) investigated the scope for a bailout guarantee in a sovereign debt crisis and reported that defaults may arise from negative income shocks, government impatience as well as coordinated buyer strike. Mengus (2018) delve into sovereign debt sustainability in a model where domestic and foreign investors optimally select their portfolios and the sovereign decides over its default and bailout policies. The study shows that internal bailouts do not preclude sovereign borrowing when domestic private exposures to sovereign debt, direct or indirect, cannot be observed or inferred by the sovereign.

Eijffinger, Kobielarz, and Uras (2018) developed a model of sovereign debt and default and argued ex-ante that unknown monetary-union exit costs can generate the contagion of a sovereign debt-crisis from a troubled member state (such as Greece) to healthy members of a monetary union (such

as Portugal). Sánchez, Sapriza, and Yurdagul (2018) in their work developed a model of endogenous sovereign debt maturity that rationalized various stylized facts about debt maturity and yield spread curve. They argued that output volatility, impatience, risk aversion, and default risk episode are factors that cause financial crises. Ogrokhina and Rodriguez (2018) analyzed the inflation targeting experience of developing countries as an effective monetary policy framework to promote changes in the currency composition of international debt by using difference in differences and reported that erosion from international market impacted negatively on the other weaker nations.

Three-digit inflation channel

The three-digit inflationary pressure usually results from expansion in monetary growth and often occurs from the exchange rate volatility and banking credit rationing. This channel of financial crises is mostly attached to developing and emerging nations. This is because they are not only import consuming nations as well as deficit budget running countries. Many studies that have attempted to study the connection between inflationary growth and financial crises have recorded mixed evidence with varied factors. For example, Milton Friedman, the renowned monetary economist once admitted that inflation is caused when there is an excessive increase in money supply in relations to demand for it in the economy (Williams & Turton, 2014). Guth (1993) explained different classes of inflation based on variations-old inflation, new inflation, chaotic inflation, and extended inflation.

Boaretto and Da Silva (2019) analyzed services inflation dynamics in Brazil, focusing on the Services Inflation Persistence Puzzle, using time varying parameter (TVP) approach, via a Kalman filter, to estimate hybrid Phillips curves and compare inflation inertia for tradable goods and services inflation. They reported that cost-push pressures, due to wage increases in the service sector, are more important to explain service inflation than demand pressure in Brazil. Similarly, Miccoli and Neri (2019) showed that inflation surprises exert a significant impact on inflation expectations, which declines with their horizon. The magnitude of these effects has changed over time, becoming larger after the outbreak of the global financial crisis and during the sovereign debt crisis. Ghorbani Dastgerdi, Yusof, and Shahbaz (2018) argued that budget deficit is one of the most important causes

of inflation. Gupta (2017) analysed inflation rate of South Africa and cautioned against forecasting inflation to avert financial crises. Nagayasu (2017) investigation centered on the interaction of regional inflation in Japan; he reported that inflation varied based on geographical location.

Waal, Gupta, and Jooste, (2018) estimated the extent foreign monetary policy pass through by augmenting standard Taylor rules and comparing the results within the context of a Global New-Keynesian Dynamic Stochastic General Equilibrium (DSGE) model and reported that the relationship between foreign monetary policy shocks and South African interest rates is complicated. They also examined whether misspecification in credit market friction could be costly in the context of monetary policymaking.

Conclusion

The aim of this study is to examine the various forces that account for the persistence financial crises recorded in recent past and predict the occurrence of future ones. The study used secondary data from journal publications, conference and contemporary advanced macroeconomic text as basis for discussing the various issues surrounding the macroeconomic turbulence. The overall conclusion from literature shows that excessive government deficit and credit market rationing combined with Central Bank credibility are major factors that trigger volatility in financial turmoil. Therefore, the study suggests regular bubble credit checks and fiscal discipline as strategic options for enhancing stability of the system.

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