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THE CRISIS OF THE FIRST DECADE OF THE 21ST CENTURY AND ITS INFLUENCE ON POLAND AND OTHER EUROPEAN COUNTRIES

Summary

The financial crisis broke out in 2008 in the United States, spreading on other countries to become global. The main objective of the article is to present how the financial crisis in the United States has influenced other countries, mainly Poland and other European countries. The author also presents theoretical views on the international transmission of crises, transmission channels and selected models. The aim of the presented article is an attempt to identify reasons for the current economic crisis, pointing out that it has brought about significant changes in the attitude of the governments of the most powerful countries in the world towards state interventionism and it has led to transformations in the course of economic cycle.

1. Introduction

Recently we have experienced a dramatic growth of financial markets powered mainly by globalization and technological progress [Sławiński 2006, pp. 11-12]. This global financial system, however, was upset by the crisis which appeared in 2008 on the American mortgage loan market and led to serious disturbances and uncertainties in the whole global financial market.

The purpose of this paper is to determine how the financial crisis which started in the first decade of the 21st century has influenced Poland and other, mainly European, countries.

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2. The essence of an economic crisis

The term 'crisis' comes from Greek and means choice, decision-taking, coping with, fighting, in which one must act under considerable time pressure. Crisis can be associated with such features as: urgency, trauma and its subjective consequences in form of negative experiences. From the very beginning of history people have encountered crisis situations. They may be caused by chance, personal and life failures. Everyone's life is marked by constant changes being the result of critical events. We live in uncertain surroundings and environment, where positive and negative values coexist and cause internal imbalance.

We cannot fully predict or control the human behavior. Nor can we predict the forces of nature. However, we can limit situations causing crisis and minimize its effects. Hard as we might try, we cannot completely eliminate them. Crisis is a special phenomenon, appearing within a general and sometimes very long process of changes happening around us.

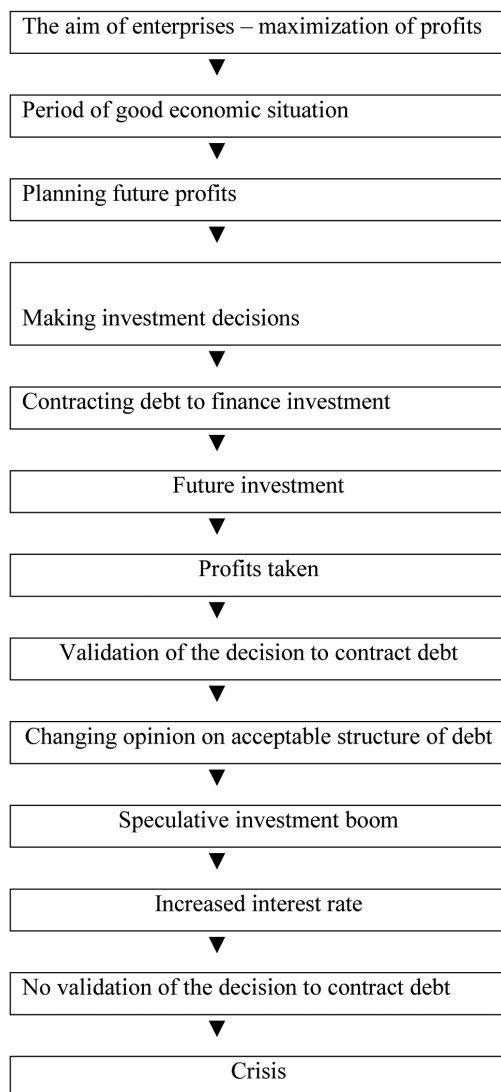
Economic crises, that is periodical slow down of economic activity, appear cyclically in the economy. In the past they were caused mainly by external factors, such as natural disasters, crop failure, epidemics or political phenomena, such as wars. Together with the development of market economy, natural phenomena have gradually become less important for the economic situation than economic factors [Morawski 2003, p. 9]. Economic crises are a frequent subject of articles and books, for example by M. Friedman, A. J. Schwarz, Ch. Kindleberger, H. Minsky, P. Krugman.

M. Friedman and A. J. Schwarz (1963) associated the financial crisis exclusively with the panic in banking sector. They attributed lower money supply to it, which led to serious weakening of economic activity. Such phenomena as serious decrease of asset prices or increased number of bankruptcies among enterprises were, according to them, not a serious financial crisis as long as they did not cause panic in the banking sector. Another definition of financial crisis was proposed by Ch. Kindleberger (1978) and H. Minsky (1972). In their opinion, financial crisis happens when we can witness one of the following phenomena: sudden and abrupt fall of asset prices, bankruptcy of many large financial and non-financial institutions, deflation, serious tension in the currency market. Many specialists assume in their works that the currency crisis is an element of the financial crisis (P. Krugman), while others believe that it may appear autonomously, without causing crises in other parts of the financial system, though currency crisis often precedes the financial one.

The financial crisis of the first decade of the 21st century accounts for more attention paid to the theory of financial instability created by H. Minsky. The economic mechanism used by Minsky to explain the process of endogenous generation of financial crises is shown in Figure 1 below. The most important

role in this mechanism is played by future investment. Decisions concerning investment are determined on the basis of predicted profits. In this element of his reasoning H. Minsky refers to the views of J.M. Keynes [Minsky 1984a, pp. 59-70].

Figure 1. Economic mechanism in financial instability theory



Source: own elaboration.

As Diagram 1 shows, the explanation of the financial crisis refers to several stages. At the beginning there is surplus of wealth, which leads to economic boom, and then inevitable breakdown. The latest crisis contained all these elements, namely there was a housing boom and breakdown leading to turbulences in financial markets.

3. The crisis in the USA

Global imbalance in financial markets at the beginning of the 21st century was caused by maintained high deficit in current exchange in the USA financed by the capital flowing from Japan, China and countries exporting oil. American households started to spend more than they earned, so they had negative savings. In practice it boiled down to financing consumption with taken loans secured with the mortgage on this part of property which had not been mortgaged yet. This was possible as long as the property prices grew. After the Great Depression of 1930s, loan offices supporting construction industry were established. Gradual liberalization of their control led to the situation in which they started offering mortgage loans without sufficient collateral. The money was cheap and easy to obtain. The US government supported the development of the housing industry through programs aiming at enabling its citizens to own their flats. These activities encouraged the lower control of the risk associated with granting subprime loans.

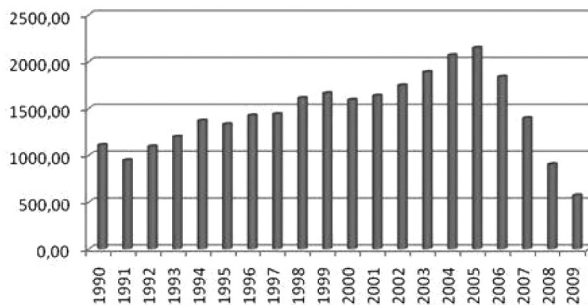
According to International Monetary Fund, subprime loan is a loan taken by the person who meets one or more of the requirements below [IMF, Global Stability Report, 2007] :

- bad credit history, resulting from payment delays or client's insolvency,
- weak credit scoring (point method of assessing credibility of a person applying for a bank loan) or high DTI ratio (debt-to-income ratio when financial obligations of a debtor exceed 50% of his gross income),
- no or partial credit history.

The constantly growing prices of real estate encouraged credit institutions to grant loans even to people without steady income, as it was assumed that the property itself is a sufficient security of the loan. These actions accelerated the demand for housing properties, increasing their prices to sky rocket levels, exceeding their real value.

Excess financial liquidity of the banking sector appeared in 2002-2004, and availability of cheap money translated into housing industry boom. As Figure 2 shows, the biggest number of properties were built in 2003-2005. In this period mortgage loans with variable interest rate which had the property as collateral were very popular, which caused subsequent periods of debt repayment with higher interest rate.

Figure 2 Number of private houses built in the USA (in thousands)



Source: own elaboration on the basis of data from US Department of Housing and Urban Development, Office of Policy Development and Research.

When excess liquidity appeared, monetary policy was not tightened early enough, but on the contrary, it was loosened by lowering interest rates. Monetary authorities for some reasons abandoned the monetary policy based on Taylor's principle. At some point, an increased number of debtors stopped repaying their debts not only due to high interest rates but also because they lacked motivation to pay the installments. Bank debtors started realizing that the amount of credit significantly exceeded the value of their properties, so they lost the willingness to pay back the debts. At the same time, artificially increased prices of properties started decreasing at the end of 2006, which was the first symptom of the crisis. In the middle of 2007, subprime bonds turned out to be unsecured.

When the prices of houses in the USA started to fall, in July 2007 two investment funds of Bear Stearns Bank went bankrupt. Banks encountered gravely serious, billion-dollars-worth losses. These losses proved to be so huge that in March and April 2008 the capitals of big US banks (Merrill Lynch, Goldman Sachs, Morgan Stanley, Lehman Brothers, Citigroup) were increased to prevent their bankruptcy. It was feared that bankruptcy could cause the domino effect, a wave of bank and enterprise bankruptcies and increased unemployment. The rescue capital came from currency reserves of various countries: Saudi Arabia, Kuwait, South Korea, Japan, China, Singapore. In return for the issue of shares, each bank received from a few to several billion dollars. These actions brought only short-lasting effects. On 5th September 2008, the fourth largest investment bank, Lehman Brothers, after a fruitless plea for help from US Central Bank, was forced to file for bankruptcy.

These were not all the causes whose accumulation led to turbulence of financial markets. The problems were magnified by passing the risk connected

with granted subprime loans to indirect creditors in the process of securitizing debt into bonds secured with mortgages. Rating agencies did not assess properly the risk carried by these securities. Not many people knew which of these securities were highly risky. We still do not know which banks possess the so-called 'toxic' assets in their balance sheets.

The collapse of the market accounts for low trust people had in financial sector and low trust it had in itself. Financial institutions and banks limited the activity of mutual lending. This caused lower liquidity and increased threat of insolvency of the institutions possessing assets based on subprime loans. Decreasing numbers of paid back loans forced the banks to take over mortgages and their sale at a loss as the property prices were constantly decreasing. Governments decided to provide liquidity to the market in order to stop further bankruptcies of large financial corporations, without noticing that the main problem was in the increased risk.

The next reaction of US monetary authorities to the threat was to loosen the monetary policy by lowering interest rates. This was associated by the weakening of the dollar and increasing prices of oil. However, all these events did not bring positive effect, as they translated into lower sales in car industry. The breakdown was very painful. It not only stretched for a period of more than a year, but also caused serious loan crisis with severe side effects, which, coupled with expensive oil and housing market breakdown, affected the whole economy. Moreover, the most globalized market of finance allowed uncontrolled spread of toxic assets and financial breakdown.

The question should be asked whether the conclusions from this bad economic period should be limited only and exclusively to providing liquidity and blaming the banking system for causing the crisis. Of course not. The whole complicated course and improper actions of state authorities, international organizations, central bank boards and financial institutions were neither coherent nor well thought-out.

4. Transmission of the American crisis into Poland and other European countries

The events that initiated the property market crisis in the USA turned out a global problem. Together with the development of the situation in international financial markets, subsequent institutions started revealing financial losses connected with disturbances appearing in the markets. At the beginning the information was directly related to subprime loans, but it soon turned out that this is only part of the losses.

Crisis phenomena affected badly especially the countries with advanced economies, mainly those with important role of banking systems. The outbreak

of the global financial crisis and its unprecedented power of spreading into next segments of financial markets and real economy made it necessary to initiate coordinated, worth billions of dollars government interventions in many countries all over the world, both developed and developing ones. The value of public aid assigned to fight the consequences of the latest crisis turned out to be the biggest in history, as far as the nominal value and GDP percentage of particular countries are concerned.

As a consequence of the bankruptcy of the fourth largest investment bank, Lehman Brothers, and the real possibility of bankruptcy of other large US and European banks, the inter-banking market experienced the crisis of trust. Banks stopped lending money among themselves as they worried about insolvency.

When in September 2008 Lehmann Brothers announced its insolvency, the effects of this immediately reached Europe, especially Germany. It manifested itself in lower share quotations at Frankfurt Stock Exchange. The government and financial sector representatives drew up a new rescue plan for Hypo Real Estate bank which was threatened with bankruptcy (it specializes in mortgage loans and in financing public projects). The bank's troubles had their source in a banking subsidiary company Depfa, which was affected by the consequences of lower value of debt connected with mortgage loans. The implementation of a sound anti-crisis package did not help. Financial institutions tightened their criteria of granting loans, which influenced the situation of enterprises, in addition, unemployment rose.

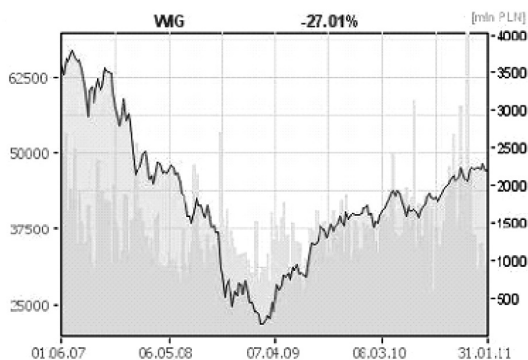
The governments of other European countries, in an attempt to avoid the development of the crisis, took immediate action. They tried to rescue financial institutions from bankruptcy. So, for example, the governments of the Benelux countries (Belgium, Holland, Luxemburg), some of the most urbanized and economically advanced countries in the world took control over the biggest Belgian bank – Fortis, also a banking and insurance institution – Dexia – was threatened with bankruptcy. Two most important financial entities – Fortis and Dexia faced aggravating problems which influenced the state of the whole banking sector. The government help did not prevent rapid plunge of bank shares, whose value decreased by 30% in September 2008. The crisis in the financial sector led to increased unemployment rate.

In 2008, the banking system of Iceland, the most developed branch of Iceland's economy, broke down. The consequence of this were the bankruptcies of four Icelandic banks (their liabilities proved too big for the GDP of such a small country) and a significant decrease of the Icelandic currency value. The government of Iceland asked IMF, USA, EU and Russia for help. From September 2007 to September 2008 the exchange rate of the Iceland's currency fell by over 70%. In order to defend the currency value the government used most of its financial reserves. According to the government the savings were

safe, but the foreign currency transactions were blocked. All these financial means were not sufficient to stabilize the endangered banking sector, the full control of which was taken over by the government. Prices in shops changed almost daily to catch up with ever-increasing inflation. As the situation did not improve, the country experienced some shortages in sales of fuel and imported goods.

On the other hand, in Russia and Ukraine, the payments from bank accounts were limited. There was some news about the troubles experienced by Hungary, Czech Republic and even Poland. All this was due to the significant number of loans taken in Swiss francs and in euro, which further weakened local currencies and threatened mortgage insolvency in the above countries and further expansion of the banking crisis. Poles experienced stock exchange decline associating the crisis (Figure 3).

Figure 3. WIG index quotation during the crisis. Value Turnover (in million zlotys)



Source: own elaboration on the basis of data from US Department of Housing and Urban Development, Office of Policy Development and Research.

As Figure 3 demonstrates, shares lost considerably in their value at the end of 2008 and at the beginning of 2009.

As Figures 2 and 3 show, lower demand and increased supply on the zloty market caused considerable fall of its value, mainly in 2008.

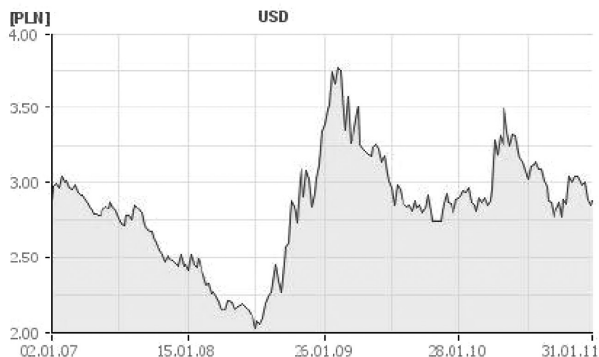
Figure 4. Changes of the zloty-euro exchange rate during the crisis



Source: EUR exchange rate, Money.pl, <http://www.money.pl/>.

Figure 4 shows that in July 2008, the euro exchange rate was close to 3.2 zlotys while in February 2009 it was only 0.08 zloty short of the level of 5 zlotys.

Figure 5. Changes of the zloty-dollar exchange rate during the crisis



Source: USD exchange rate, Money.pl, <http://www.money.pl/>.

In countries with liquid currency Exchange rates (Czech Republic, Hungary, Poland, Romania) the outflow of foreign capital caused the decrease of local currency value in relation to euro. Although it increased the competitiveness of export and attractiveness of these countries for foreign investors, it also brought about inflation-generating increase of imported goods prices and, more importantly, increased the debt level of enterprises, households and global debt expressed in foreign currency. Some countries (for example Czech Republic, Poland) decided that further loosening of monetary policy could lead to further devaluation of their currencies, therefore they reacted

to the crisis mainly through expansive budget policy. However, Romania and Hungary were much more severely affected by the crisis and had to ask for foreign support while introducing more restrictive budget policy. Slovakia and Slovenia, however, due to their membership in the euro zone (this was possible due to their internal and external balance) enjoyed a slightly better level of protection against uncertainty. However, these countries have to maintain their competitiveness in foreign trade now by real growth of productivity, not by depreciation of their currency.

Many other countries had established a fixed currency exchange rate to euro before within the ERM II mechanism (Bulgaria, Estonia, Latvia, Lithuania). They were all severely affected by the recession which ended the loan-based economic boom of recent years and caused export decline. The governments of these states decided to maintain fixed exchange rates of their currencies into euro (due to high national debt in foreign currencies) and are making efforts to keep low levels of public debt in order to enter the euro zone as soon as possible. This means that the correction is made through decrease of costs and remuneration and through increase in productivity. A restrictive budget policy was adopted, consisting in remuneration cuts in public sector, lowering retirement pension and social benefits and increasing taxes. In Poland the consequences of the crisis were mainly felt in restrictions in providing loans to entrepreneurs and households. In Czech Republic, Slovakia and Slovenia difficulties were mainly caused by lower demand for export goods and decreasing private investment, including direct foreign investment. Other countries (Bulgaria, Estonia, Latvia, Lithuania, Hungary and Romania) were more affected by the crisis, though. In the years preceding the crisis they all witness significant economic growth powered by access to EU markets and inflow of foreign capital, which led to the development of consumption-increasing investment, often based on loans taken in foreign currencies, in some countries leading to the loan-powered property boom. The financial crisis, however, encouraged capital to search for safer places for investment, which was reflected in frequent withdrawal of foreign capital from countries perceived as more risky and with limited financial liquidity being the consequence of restrictions imposed by foreign banks in provision of transnational loans.

In spite of considerable decrease of GDP in comparison to 2008 (5% to 1.7%), Poland was the only EU country enjoying economic growth in 2009.

Table 1. Real GDP growth (in percentage)

	2008	2009	2010	2011
U.S.	0.0	-2.6	2.7	2.2
EURO	0.3	-4.1	1.7	1.7
POLSKA	5.0	1.7	3.5	4.0

Source: OECD Economic Outlook, Volume 2010/2.

The GDP growth in Poland was positively influenced by increased net exports and total consumption, while negative influence was exerted by lower accumulation. The positive speed of GDP growth was also affected by the utilization of EU funds and investment related to our preparation to Euro 2012 championship.

Considering the prospects of economic boom in Poland we should pay attention to the fiscal policy, which, after a period of relaxation in 2008, in the next years became more restrictive. First of all, expenses, including remuneration in public sector, were limited. Adjusting the public finance imbalance is in the medium-term perspective vital for curbing the growth of public debt and meeting the obligations imposed on Poland within the excess deficit procedure.

It is interesting to note that while southern EU countries experienced problems with public finance, Turkey enjoyed a quick pace of economic growth.

Summing up, Central European countries, including Poland, fared better in times of crisis than other countries of Europe and Central Asia.

5. Conclusions

The global financial crisis spurred hot discussion on the role of fiscal policy in stabilizing the economic cycle. The experience of developed economies so far have not provided a uniform answer concerning the effectiveness of fiscal stimuli in moderating cyclical fluctuations. The state of public finance in a particular country is one of the most essential factors determining the effectiveness of fiscal impulse. High level of deficit and quickly growing public debt may considerably weaken the effectiveness of fiscal impulse. The influence of expansive fiscal policy on consumption will be then limited due to consumers' expectations concerning consolidation of public finance in future years – higher tax burden, resulting from the obligation to service and repay the contracted debt.

Moreover, the power of influence and acceptable scope of expansive fiscal policy are strongly determined by the possibilities of financing higher deficit by a particular economy, that is indirectly by the stage of development and the

situation on financial markets. The crisis accounts for the escape of investors to stable advanced economies, which considerably limited the possibility of using fiscal policy to stimulating final demand in most of new member states of the European Union.

The subject presented here is very wide and calls for further detailed studies.

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