Risk Factors of Contemporary „Financial Crisis“ and Their Influence on Future Development of World Economy

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ANNOTATION

The article deals with problems of contemporary "financial crisis". First of all, factors that lead to the crisis are identified, consequently, their influence on contemporary developmental trends, intruding operation of world financial system and endangering future development of world economy are analyzed.

KEY WORDS

Financial crises, risk factors, economic crisis, financial markets, global economy, market economy, critical factors, state regulation, quantitative easing

INTRODUCTION

There is a number of opinions on the causes and origin of contemporary "financial crisis"; these opinions are neither unanimous, nor clarifying. Nevertheless, it cannot be called into question that a deep economic crisis appears all of a sudden; its causes are formed step by step. As this is the most important crisis that arose since the Great economic crisis in 1929, it is necessary to analyze it in details. Unless its causes are eliminated, it might not be solved satisfactorily. And in case it is solved after all, it might come again in the future; considering ongoing globalization of financial system, functioning of global world economy might be totally endangered.

AIM AND METHODOLOGY

The goal of this paper is to specify the most important risk factors that lead to contemporary "financial crisis" and consequently to analyze how they participate in contemporary negative development trends that might seriously disrupt allocation function of the whole globalized world financial system and endanger functioning of world economy.

RESULTS

Despite economic crises evince many common features, each of them is specific. This applies also to contemporary "financial crisis" that started in 2008 by failure of financial system in the USA and consequently spread quickly to economically most developed countries of the world. It is undisputable that this crisis did not emerge suddenly; it resulted from a number of negatively impacting factors over a long period; as they were not solved, they developed into following negative development trends.

1. Process of growing indebtedness of economic subjects

This is an exceptionally important trend, very specific for contemporary "financial" crisis. Its importance is enhanced by the fact that it is connected with indebting of all kinds of economic subjects, households, companies as well as states.

- **Household indebting** is connected with the politics of governments of economically developed countries and their central banks to increase domestic consumption and to support economic growth on one hand, and with effort of companies to increase their revenues by means of sale support of goods and services on the other hand.

- **Indebting companies** is based on widely spread opinion that external funding resources are cheaper than internal funding resources on one hand and on demands of partners (shareholders) to maximize profit and payment of shares (dividends) on the other hand. This is the reason why most companies get indebted more and more and in case that economic situation worsens, they are more susceptible to bankruptcy.

- **Indebting of (most) states** is growing as a result of long term deficit fiscal politics of governments of individual states on one hand and as a result of the fact that expenses of regional governments are higher than their incomes[1].

It is clear that in case the trend of growing indebtidness of economic subjects keeps growing, it will be more and more difficult to fund them, since their debt costs will grow due to the growth of risk of possible insolvency. Finally it might result to the possibility that the investors might lose their confidence in their debt instruments, which would prevent them from having access to financial markets. This might result in household insolvency, bankruptcies of banks and other subjects or even to collapses of state finances of heavily indebted countries.

2. Growth of differences in economic and political power of individual subjects

This developmental trend is based on gradual growth of differences between states, corporations and even individuals (households) in terms of their economic and political power or their influence on human society:

- **Economic (political) power of states** is employed in their foreign policies; economically strong states enforce their will to weaker countries. This is made directly by means of bilateral contracts or by means of membership in international or supranational institutions, where important states usually have bigger power.

- **Economic power of corporations** becomes evident especially in case of "supranational companies"; many financial institutions belong among them. Their economic power is based on their economic results, as they are sometimes higher than VAT of smaller countries on one hand, and they get majority position in their fields on the other hand. This leads to restriction of competition and pushes market conditions to those of oligopoly in which they try to get as important position as possible on the other hand. It has been proved that gradual growth of size of corporations is connected with their growing economic power, which enables strong lobbing and might lead to political influence. Supranational corporations often move their production to developing countries with a goal to minimise production costs (especially payroll costs). This results in production restriction in home countries; goods produced abroad has to be imported to those countries and consequently decreasing number of job opportunities, creating business balance deficit. As it is possible to establish daughter companies anywhere in the world, legislative differences in individual countries are taken into account for this purpose to make use of „transfer pricing".

- **Dominant position of individual in society** represents an important factor that has developed into an important development trend. It can be characterized as always growing increasing of incomes[2] (and consequently value of owned property) of individual members of society. It results in growing number of "millionaires" or "billionaires", who so often enforce

[1] US public debt reached nearly 16 trillion USD; European Union debts have exceeded the value of 12 trillion €.
[2] In some cases, top managers in the US get salaries exceeding average salaries by many hundred times (eg. US).

special privileges within human society. This would not cause a problem in case that the differences in incomes of individuals were based on merit and contribution of individuals to their society. In fact, this is often made by means of breaking law (hidden) and bribery. In some countries, it can even be connected with misuse of state or business functions, possibly even without any possibility of personal sanction (immunity). The worst think is, that all those "tunnelled" values are consequently transformed to debts of individual states, which means to the back of "common" taxpayers.

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All above mentioned facts lead to the fact that market competition is declining. It means that fair prices are not created any more. Without fair (market) recognition, contemporary economy cannot work effectively.[3]

3. Creating new sorts of synthetic derivative instruments

New sorts of financial investment tools are presented and offered in the market. These are often not instruments that would be beneficial for the economy; these are mostly investment instruments made on purpose, bringing prosperity before all to their issuers. The most problematic factors we face in the process of creating new sorts of financial investment instruments are considered creating new sorts of derivative investment instruments (so called structured products), derived from many sorts of different underlying assets as well as calculated use (or misuse) of securitization:

- **Creating structured products** can be characterized as constructing new, often purposefully very complicated sorts of synthetic financial investment tools based on the principle of derivation from various underlying assets.[4] Even in case that there are specific regulation restrictions in different countries, these often rather risky instruments are almost without any restrictions offered to investors, due to liberalization and internationalization of contemporary financial market.

- **Purposeful utilization of securitization** is based on transformation of non-liquid financial investment assets (before all loans) to marketable securities. This is, of course perfectly all right, unless investors are disadvantaged. But in case these transformations are purposefully very complicated and nontransparent[5], they enable to transfer bad quality assets and for much higher prices than those negotiated for case of their direct sale.[6]

Creating new synthetic derivative investment instruments leads to growing number of securities that are not directly connected with real economy and represent only a certain intergrade without any real economic benefit. Most often, their issuers profit from them (mostly financial institutions) mostly to the detriment of investors. Issuing these obligations supports creating so called: „pyramidal superstructure". It grows or fails depending on the growth or fail of their basis, or, in other words, with growth or decline of prices (values) of underlying assets from which individual "superstructural" investment instruments are, directly or indirectly, derived.

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[3] see Zelený, M. *Geneze krize* [5].

[4] This means structured deposits, structured bonds, securities of collective investment structure funds and securitized derivatives - see Rejnuš, O.: *Finanční trhy*, s. 579-660 [2].

[5] Real value of securitized assets is only known to the relevant financial institution, where newly issued securities are usually divided into several, by rating differently assessed tranches.

[6] These are so called *„Assed Backed Securities"* [ABS] – see Rejnuš, O. *Finanční trhy*, s. 613-627 [2], or Jílek, J. *Finanční a komoditní deriváty v praxi* [1].

Based on previous analysis of the most important contemporary negative development trends, a question comes into mind, what essential measures were taken since the beginning of contemporary "financial crisis" in individual countries and supranational economic entities and whether they proved successful.

As far as indebtedness issues are concerned, the US government "solves" it, together with FED policy, by means of so called "quantitative easing", which is nothing but continuation of extreme state expenses. It leads to further increase of American state debt, which means this is not an effort to solve contemporary crisis. To the contrary, the European Union (primarily Euro zone countries) tried to solve the problem (until recently) the other way, by cost-saving fiscal policies of individual states. Of course, this threw the weakest countries into recession, that was accompanied by disproportionately high unemployment and was followed by social unrest. This led to strongly increased risk of their possible bankruptcy and failure to pay back their obligations, which would seriously jeopardize existence of many (chiefly European) banks and commencement of so called avalanche spreading of bank crisis. This is why the European Union management, together with European Central Bank and with support of the International Monetary Fund, started to implement similar supportive policy as the US.

As far as decaying market competition is concerned, this problem is solved neither in America and Europe nor in other parts of the World. On the contrary. Both the strongest countries of the World and important companies are trying to strengthen their dominant position. At the same time, influence of rich individuals is increasing; they are not only representatives of steering bodies of important corporations, they are represented in governments and parliaments of most countries and they often advance their own interests. This leads to distortion of market environment, without which contemporary economy cannot work[7] and, at the same time, the principle of equal rights of citizens is infringed.

As far as creating harmonized international regulation, focused on business activities of financial institutions and properties of publicly marketable instruments are concerned, this problem is not satisfactorily solved either. The European Union has established several institutions, but has not solved anything yet and the US have even cancelled the most supplementary regulation measures that had been accepted some time ago. It is clear that different legislation of individual states, that is based on different principles, makes the possibility of international harmonization of regulation principles much more difficult and that, without unified regulations, there will always be ways how to circumvent regulation in individual states.

It seems to be clear that the solution of all aforementioned crisis factors is highly problematic and cannot be successful without close international collaboration. However, now, individual countries and supranational economic associations[8] try to solve their economic problems very individually. The reason is, first of all, based in the fact that most politicians are concerned on their own political success and they prefer political success of their own countries or political parties and this is why the solutions they advance are not always optimal from the point of view of economy. Another factor is the way how parliamentary democracy works. The fact, that functional term of office of politicians (and it is the same in case of economic bodies of

[7] It is impossible to set fair (market) prices without market competition; economy cannot work effectively without them.

[8] Before all, European Union is concerned.

companies) is restricted, they prefer short-time solutions to long-term ones, to sophisticated strategies.[9] This leads to further worsening of economic crisis and postponing it indefinitely.

CONCLUSION

Above mentioned facts show that contemporary "financial crisis" will surely not be solved in the nearest future. On the contrary, we can reasonably expect that contemporary trends of European Union business policy (especially Euro zone) and the US will be more and more confronted with intentions of the most important Asian or other countries, where interests of „BRIC"[10] countries must not be undervalued. Since we can reasonably assume that politics of quantitative releasing of the US, enforced over a long period, and strong monetary expansion focused on rescue of European banks or bankrupting European Union countries will cause high inflation in the future, which will be followed by distinctive weakening of US dollar and Euro. It will give rise (even in case that the Euro zone will retain) to strong financial market shocks. It will lead to currency turbulences that will impact the whole world and consequentially will lead to global financial and global world economic crisis. It is supposed to be much more intensive than any other crisis in the past and it might bring immense consequences for the whole mankind.

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[6] http://usdebtclock.org

[7] http://www.google.com/publicdata/explore

[8] http://www.verejnydluh.cz/

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[9] Particular example of such nonconceptual operative decision making is decision of German government on cancelling nuclear power engineering for the sake of results of future elections.

[10] These are Brazil, Russia, India and China.