THE ECONOMIC – FINANCIAL CRISIS 2007 – 2009

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Abstract: *This article takes a look at the well known economical and financial crisis, which affected all the countries in the world. When comes to Europe, the most affected countries were the Baltic countries: Estonia, Latvia and Lithuania. The economy of these countries shrank enough, so that they cope with another wave of crisis.*

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1. INTRODUCTION

The roots of the current economic - financial crisis are so deep, whereas dates from 1977, when the American government approved the U.S. federal law, "Community Reinvestment Act," in order to help those poor people who could not afford a house. Under this facade of "equal opportunities" and "racial equality", banks have been forced to borrow low income individuals. Moreover, Fannie Mae and Freddie Mac have developed as institutions that were securing mortgages in the United States of America. This policy of "charity" was led by Bill Clinton, an advocate of the motto "A home for each American." Bush **speculated the potential in elections** and took over the reins of this policy in order to retain a part of the votes for the next election. And that's not all!

Alan Greenspan is also a "legendary hero, "as the economist Paul Krugman likes to names it, **but what percentage in good words?** Let's not blame him. However, in 1996, in one of his speeches he used the phrase "irrational exuberance." Of course nobody knew what Greenspan wanted to say, but this "irrational exuberance" was hiding in fact a speculative bubble of shares prices on the financial markets. Although he warned about this, Greenspan did not take the necessary measures: he did not increase interest rates and he did not require a necessary margin to investors. As a result, this speculative bubble, known as the "*dot-com crisis*"[4] demonstrated once again the insatiable greed of people.

The birth of a business model based on the new information technology was enough to start the race after profit, because, in a short while, the number of investors increased significantly. Indeed gains were substantial and shares prices were increasing more and more. Man was hearing all kind of stories about the healing effects of the new technologies, but these stories were merely "tickling stories for the psychological comfort of the audience” (Krugman, 2009, p. 168). Funds were flowing, prices were increasing, and as a result, the bubble finally burst out, shares prices have collapsed and have left a free path for the second Grennspan's speculative bubble, the housing bubble. Greenspan cannot be blamed for what happened in 2000, since his decisions have been sustained by many economists, but it should not be ignored the fact that he didn’t do anything to stop the bubble to burst out.

Greenspan tried to calm the situation by decreasing the interest rates, so that in 2003, he lowered the federal funds rate target from 6.5% to 1%. Meanwhile, this drawback of interest rate was supplying continuously the increasing prices of the American homes. At this point, **came also into play** the relaxing conditions of mortgage loans that have abandoned the traditional lending standards. More people and more people wanted to buy a house, so they ignored the fact that they could not afford to pay the rates. We are now speaking of individual families "irrational exuberance” who have seen the house prices increasing and still have decided to buy a house without worries that they will not be able to pay later" (Krugman, 2009, p. 170). In these circumstances subprime market arose.

Due to the high risks that these questionable loans were hiding, borrowers did not keep them into their portfolio, but sold them to financial entities that were specialized in high-risk operations (“hedge funds”[5]). The “placement" of these mortgages was made in chain, and investors did not know what they were buying. The fact is that these mortgages were promising high returns so they attracted more investors and more on the market. "The housing bubble was running on autopilot now, and as a snowball, was gaining in intensity" (Financial Week, 2009), but no one had awareness of it.

Warnings of some economists on the existence of a speculative real estate bubble were useless. Alan Greenspan was no longer in charge at FED. Even if he recognized the existence of a “speculative foam" on the real estate market, he has ignored the possibility of bubbles bursting and the possible disastrous effects on the entire world. Indeed, Mr. Greenspan was wrong again, so that

[4] Dot.com crisis - crisis caused by informational technology development, especially internet
[5] hedge funds – speculative funds

the speculative bubble burst out in 2006 and in 2007 it triggered, as we all know - the global financial and economic crisis.

If we are to look from outside, this crisis flowed as in **“the handbook**" because facts have developed according to Minsky's model. The exogenous shocks on the economy was, the development of a favorable environment for housing construction and a relaxed financial framework which offered access to credit to low-income population, when the crisis has burst out. The market reached to saturation, so that interest rates began to increase, and house prices to decrease. So when it came for the low-income population to pay the rent……where is the money? The signals of alert on the credit market were perceived as a threat by banking companies which have bought financial products. These companies have tried to capitalize their shares by selling them on the stock market, but the large number of real estate securities lowered the price. Many banks, investment funds, insurance companies were forced to close their doors.

When "giants" such as Lehman Brothers, Bear Stearns, Merryl Lynch and AIG are on the verge of bankruptcy then panic occurs: "when Lehman Brothers has announced that they are bankrupted, everyone understood that crisis has burst out in the United States. Intervention of the Federal Reserve to rescue the insurance giant American International Group, also near to collapse, has failed to calm global fears. The prices of shares have fallen in the entire world, while customers were preparing to withdraw their policies" (Money Express, 2008). It did not take long until the panic extended in the entire world.

Injections of liquidity in the economy were considered the best solution for saving a part of insurance or financial companies such as AIG, under the pretext that they are "too big to be left to fall." The Bank of England’s Governor, Mervyn King was "booed" when he intervened on the financial market to support the mortgage bank Northern Rock, although he opposed to financial injections to save those firms and banks that have shown imprudence when coming to lending. The fact that FED, ECB and other major central banks have decreased interest rates, had no relevance to market loans. What did central banks do, is linked to the desire of avoiding recession in the U.S.A., in order to prevent the damaging of the financial systems" (Dăianu, 2009, p.152). If it was wrong or not when these decisions have been taken, is too late for something to be done.

So what did this crisis actually caused? If we had to analysis what happened until now, we can observe easily that population has lost her trust, her confidence in banks, confidence in job securities, and has lost confidence in the financial systems. Developing countries that have began to be familiar with economical growth, were the most affected. People who thought their lives have changed in better, had a shock when they saw themselves in debt or homeless.

According to Minsky's model, we can say that now we are in the final stage of crisis, when panic has dissipated, the consequences of disaster are evaluated and reconstruction measures are taken. We are now trying to find the guilty ones just to exonerate ourselves. It is said that we are now recovering, maybe yes ... but with the cost of a contagion that has spread throughout the international financial sector, packed with "financial security packages" and caused by mortgages.

Let’s be honest: **to no one has crossed his mind that a financial** - economic crisis will burst out in 2007. Actually, there were enlightened voices which have warned about this, and yet we did not prepare for it. We should have learned from the old crisis that occurred since Great Depression. These crises have occurred like flu symptoms and we ignored that: Headaches - Japan 1990, running nose - Mexico in 1955, fever - Thailand, Malaysia, Indonesia, and Korea in 1997, muscle pain - Argentina in 2002, until it puts you into bed - everyone in 2008. It’s time for those people responsible for the political governance around the world to take the necessary and fair measures, to save us, because this flu will not pass so easily.

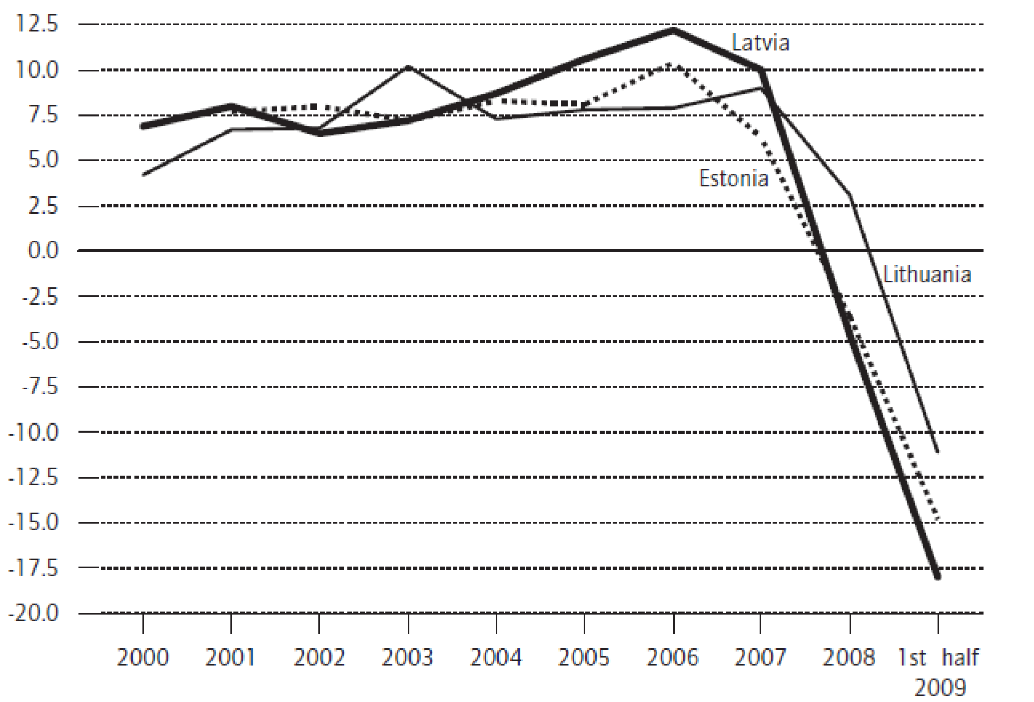
Lending is the first thing that should be considered. If at the beginning you were taking credit to buy a house even if you were working at a store as a seller, now are needed much more guarantees. People and institutions have withdrawn in their "shells" and refuse to do business with anyone. Capital reserves have disappeared. Now, debates among economists that we need our state that do not need our state or a well set monetary policy, have no sense. Now, are necessary those discussions regarding measures to stimulate individuals demand. But how can create sufficient demand using the economy as it is now? As Krugman says the decline of economy returned.

2. THE FINANCIAL CRISIS AFFECTED AND THE BALTIC COUNTRIES

Of all the E.U. countries, the countries that were hit the hardest by the economical financial crisis are the Baltic countries. After years of purchasing homes, cars, and lands consumers had realized that they have no money to pay their rates. It's hilarious because, shortly before the economical - financial storm, the Baltic countries have seen an economical increase. Between the years 2001 - 2007, GDP has maintained at an average of 7-8%, even higher than the GDP of some of the new European Union countries.

But the global crisis covered quickly the Baltic countries, so that in the year 2008 Latvia's GDP decreased with 4,6% and Estonia`s with 3,6%. The economies of these countries virtually collapsed and continued to collapse in first half of 2009, Estonian`s GDP reducing with 15.7%, Lithuania`s with 11%, and Latvia`s with 18.8%. These countries din not have the chance to enjoy their economic growth because they were hit by the wave of a full economic - financial crisis, which soon enveloped all the world states.

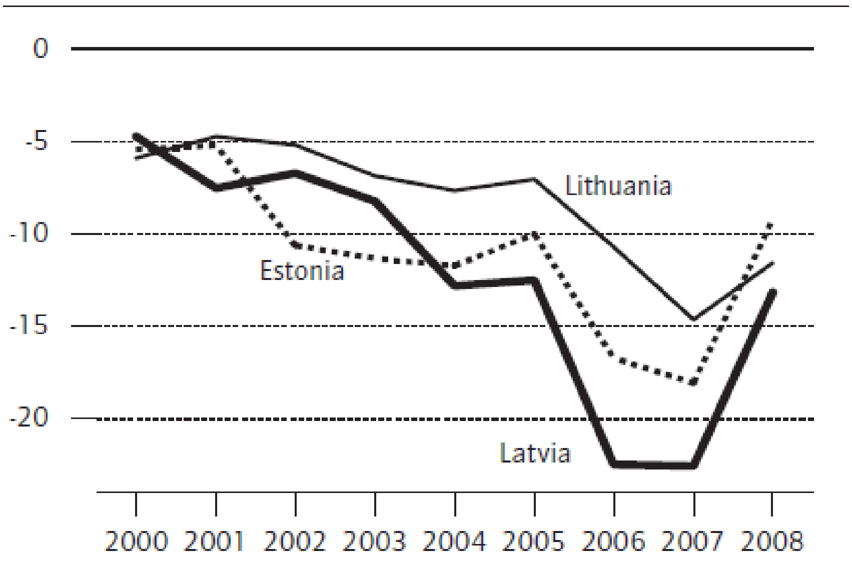
Graphic 1 Real gross domestic product in the Baltic States



Source: Alvarez and Engerer, 2009, p. 232

The increase of the strong demand in these countries, which followed the outbreak of the crisis, has been accompanied by an increase in the current account deficit, being largely financed by foreign banks as Sweden, Germany and Scandinavian countries, which owned important shares from the credit market. Their branches took loans from the mother companies and they oriented them to households and companies.

Graphic 2 Current account deficits in the Baltic States

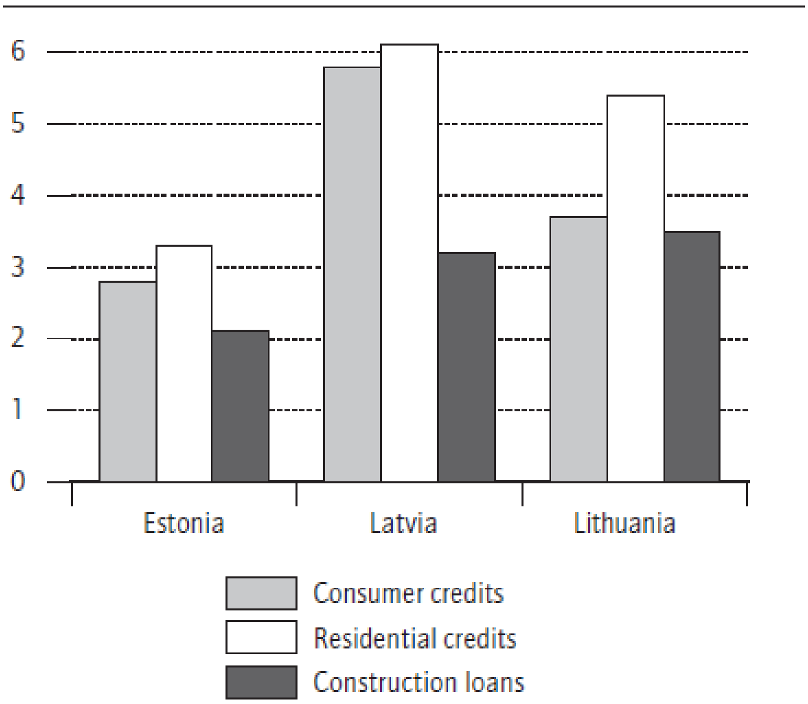


Source: Alvarez and Engerer, 2009, p. 232

The loans for householders grew faster than those granted to companies, but once with the increase in the mortgage lending's, the return rate increased in the same measure, even more. A big share of credits where given in euro, even if householders and companies that didn`t had incomes in foreign currencies, and these led to a big collapse of the housing market. The payment of the credits in national currency it became more expensive for local loaners. As regards of the credits in foreign currencies, at the end of the year 2008, Latvia estimated a percentage of 88, 4%, Estonia 85, 1% and Lithuania 60%.

From this point of view, Baltic countries were disadvantaged, because the economical – financial crisis led to the national currency devaluation, and precisely in the period of pre – accession to the Euro Zone. Practicing an exchange rate rigidly anchored to the euro, led to artificial increase in assets prices, and lower ranges of variation of the exchange rate made much more pressure on fiscal policy, the main tool for protecting economies from imbalances. Strict fiscal measures for exchange rate support from government's side are necessary as a repetition of the cycle grows- decline could not be supported by the Baltic countries.

Graphic 3 Corporate credits, residential construction loans and consumer credits in the Baltic States



Source: Alvarez and Engerer, 2009, p. 232

External debt was also affected by the economical – financial crisis in the Baltic countries, reaching at the end of 2008, in Latvia to reach at 42 billiard American dollars (124%), to 32, 5 billiard American dollars (118%) in Lithuania, and 27, 4% billiard American dollars (68%) in Estonia.

3. CONCLUSIONS

The financial – economic crisis affected countries around the world, but severe effects were felt in countries that have given credits way to easy. The Baltic countries choose to exceed the transition to capitalism through an easy credit policy. Compared with other European countries, the prospects of the Baltic countries for the next years are bleak. The chances of economic recovery in these countries will reduce a lot in the case of another economic crisis or in the case that it would be proved that the actual crisis is in W.

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ANNEX 1

Country	GDP (millions of USD)	Coverage in DRB (km²)	Transport fuel consumption in 1000 t	GDP achieved with 1000 t fuel consumed for transportation (million of USD) Col2/Col4
Austria	374.400	80.423	7994	46.835
Bosnia-Herzegovina	16.960	36.636	1122	15.115
Bulgaria	44.780	47.413	2560	17.492
Croatia	61.720	34.965	1902	32.450
Czech Republic	189.700	21.688	6569	28.878
Germany	3.235.000	56.184	61958	52.212
Hungary	124.200	93.030	4175	29.748
Montenegro	4.444	7.075	830	5.354
Republic of Moldova	5.328	12.834	1049	5.079
Romania	160.700	232.193	4204	38.225
Serbia	42.390	81.560	1790	23.681
Slovakia	88.300	47.084	1805	48.919
Slovenia	49.550	16.422	1469	33.730
Ukraine	115.700	30.520	2445	47.321