

# Financial Crisis - Dynamics and Causes

Contributed by Knut Holt  
Monday, 17 November 2008

A financial crisis seems to occur with fairly regular intervals. Here you can read about the characteristics of an financial crisis and the reasons why such an event occurs.

{mosbotwordcount}

A financial crisis has happened with regular intervals throughout the last century, it happens again in the year 2008, and probably will happen in the future in much the same way. There is no fundamental differences between such crises in our time and former crises, except perhaps that they occur faster, occur more frequently, but fortunately also heal faster.

{bot\_wrgoogle}

## THE TYPICAL SITUATION BEFORE THE CRISIS

The crisis often occurs after a long period of economic growth, high employment and high activity. The situation for companies and individuals are typically as follows:

- The economic activity in the whole society is very high after a long period of growth, but is beginning to decline.
  - Stocks are traded for historically high quotes after a long period of rise of 300% or more, they have reached an all time high level, but they are beginning to decline again.
  - The prizes of real estate properties are also high after a long period of growth, 300% or more, but they also are beginning to decline after an all time high level.
  - Companies are often over-established after aggressive investments for borrowed money. The investments have not yet shown profitable, but the companies estimate great profits from the investments because they think the general growth will continue uninterruptedly.
  - Also the average individuals have high debts after having invested massively in their homes and in luxury objects. They have some beginning problems with payment on their debts, but think these problems soon will go away with an anticipated further rises of personal income.

## THE INITIAL STAGES OF THE CRISIS

The crisis usually has a slowly developing initial face. During this face the situation can reverse and the economy recover without great damages. In this initial period one can observe the following process:

- Steadily more companies realize that their massive investments do not pay back with the expected revenues and they have problems paying on their loans. They abruptly reduce further investments and begin selling off assets.
  - Steadily more individuals also realize they have a too great debt to handle with their private income. They reduce their consume and sell off properties and luxury objects.
  - Companies are getting steadily less orders, are selling less and have less to do because of reduced consume and investments.
  - Earnings of companies and individuals are declining and many are downright losing money.
  - The stock market values are sharply declining, often 20-30%.
  - The property prizes are sharply declining, often 20-30%.

## THE FURTHER STAGES LEADING TO A FULL-BLOWN CRISIS

At some time there can be a critical turning point leading into the development of a full blown crisis that it is impossible to recover from in an easy way. This turning point occurs when a certain percentage, for example 10%, of individuals and companies realize that they do not have enough income to handle their debt, and that sell-off of properties and stocks will not nullify the debt. The full-blown crisis has these properties:

- The activity and earnings of companies are abruptly declining.
- Many companies experience massive losses.
- The number of companies and individuals with debt trouble is abruptly rising.
- The number of bankruptcies is abruptly rising.
- The unemployment level rises abruptly.
- Banks get into serious squeeze due to customers unable to pay on their debts and due to the decline in the value of properties serving as security for the loans.
- The troubled banks have to rise the interest rates by many percent to counteract the losses. But this act only increases the problems for other banks, individuals and companies and accelerates the crisis.
- A high percentage of the banks get unfunctional and bankrupt
- Now there will be massive sell-offs of properties and stocks. The sell-offs are exerted by individuals trying to free themselves from some of their debts and by banks trying to stop losses on loans.
- The stock market cracks down by an new 50% or more driven by the massive sell-offs.
- The real estate market also cracks down a new 50% or more due to massive sell-offs, but usually somewhat slower than the stock market.

## THE CHARACTERISTICS OF AN ULTIMATE CRISIS

The ultimate stage of the crisis is seldom reached, because the governments will at some point take control of the financial systems and secure a minimum functionality.

In the ultimate crisis the production of goods and services in the society has fallen 30% or more and continue to fall. Investments or building activities have totally halted. There is mass unemployment, 30% or more.

The financial system has nearly totally collapsed, and is only able to support the daily payment for food, energy and other necessities. The production facilities and organizations of the society have fallen apart 30% or more due to lack of maintenance, which means that the society is not able to recover in a short time.

## THE END OF THE CRISIS

Before the crisis can end, all sell-offs to pay back on loans must be fulfilled. Then every actor in the society has to accept their losses. Debts that actors are not able to pay back must in some way be nullified. Then all the pieces remaining of the former companies must be fixed together again into new functional units. Then the society can slowly rebuild its

strength.

## THE CAUSES OF THE CRISIS

An important cause of the crisis are over-optimistic companies and individuals during the foregoing period of economic growth. They tend to believe that the general growth will continue forever without interrupting periods of economic decline. They also tend to overestimate themselves and think they will be a winner in the competition against other companies or persons, not a loser, not an average performer, but the winner.

This optimism, which is a general human property, make all actors borrow massive amounts of capital and invest them in homes, luxury objects and expansion of their business. This expansive behaviour tend to accelerate for quite a long time untill it meets the wall.

Another cause are executives in banking companies tempted to lend out as much money as possible to the borrowers, regardless of the consequences for the bank and the borrowers, because this behaviour gives the executives an enormous short term personal gain.

## HOW TO AVOID FINANCIAL CRISES

Future crises can only be prevented by hindering financial institution lending out more money to anyone that the borrowers can pay back in a comfortable way. This can only be done by governmental regulations that set clear criteria that must be fulfilled when a certain amount of money is lent out.

Also banks must be forbidden to establish employment contracts for their executives that reward them directly for the amount of mortgages they establish.

-----

Knut Holt is an internet marketer and consultant focusing at technical, health and scientific items. To find items like car equipment, remote control models, airsoft guns, chemistry sets, electronic kits and components, microscopes, binoculars, night vision instruments, music instruments, computers, PDAs and more: ---

<http://www.mydeltapi.com>

----Also health advices, fitness products and natural products to treat diseases, please visit:---

<http://www.panteraconsulting.com>