

REGIONAL ECONOMIES

**THE FINANCIAL AND
ECONOMIC CRISIS:
DEVELOPMENT AND
WAYS TO OVERCOME IT
IN TRANSITION ECONOMIES**

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Introduction

For transition economies, as for the entire global economic system, the current economic crisis is not only creating problems and threatening economic growth, it is also opening up a window of opportunity. The extent to which these

countries will be able to take advantage of the new opportunities depends on how deeply and adequately they understand the nature of the crisis, its specifics in their particular country, and the changes to be made based on the lessons learned.

Pre-Crisis Situation

Prior to the current crisis, almost every transition economy, including the post-Soviet, was experiencing a period of economic growth, although its rates varied. The rates and nature of this growth largely depended on the extent to which the particular country, while reducing new risks, was able to take advantage of the additional opportunities that emerged during globalization. This growth was expressed in particular in an annual increase in GDP (see Table 1).

Table 1

**Annual GDP Growth
in Transition Economies**

Country/Year	1992	1995	2000	2001	2002	2003	2004	2005	2006	2007	2008
Armenia	58.2	106.9	105.9	109.6	113.2	114.0	110.5	113.9	113.2	113.8	106.8
Azerbaijan	77.4	88.2	111.1	109.9	110.6	111.2	110.2	126.4	134.5	125.0	110.8
Georgia	55.1	102.6	101.8	104.8	105.5	111.1	105.9	109.6	109.4	112.4	102.1
Belarus	90.4	89.6	105.8	104.7	105.0	107.0	111.4	109.4	110.0	108.2	110.0
Kazakhstan	94.7	91.8	109.8	113.5	109.8	109.3	109.6	109.7	110.7	108.9	103.3
Kyrgyzstan	86.1	94.6	105.4	105.3	100.0	107.0	107.1	99.4	102.7	108.2	107.6
Moldova	71.0	98.6	102.1	106.1	107.8	106.6	107.3	107.1	104.0	103.0	107.2
Russia	85.5	95.9	110.0	105.1	104.7	107.3	107.2	106.4	107.7	108.1	105.6
Tajikistan	70.0	87.6	108.3	110.2	110.8	111.0	110.6	106.7	107.0	107.8	107.9
Ukraine	90.1	87.8	105.9	109.2	105.2	109.6	112.1	102.4	107.0	107.3	102.1
Czech Republic		112.5	103.6	102.5	101.9	103.6	104.5	106.3	106.8	106.0	103.3
Croatia	88.3	101.7	102.9	104.4	105.6	105.3	104.3	104.3	104.7	105.5	102.4
Lithuania	67.9	100.5	106.9	108.1	106.5	107.2	108.7	110.6	112.2	110.0	95.5
Latvia	78.7	103.3	104.2	106.7	106.9	110.2	107.3	107.8	107.8	108.9	103.0
Estonia		105.0	109.6	107.7	107.8	107.1	107.5	109.2	110.4	106.3	96.4
Slovenia	94.5	104.1	104.4	102.9	104.0	102.8	104.3	104.4	105.9	106.8	103.5
Slovakia		107.5	101.4	103.4	104.8	104.7	105.2	106.5	108.5	110.4	106.4
Poland	103	117.1	104.3	101.2	101.4	103.9	105.3	103.6	106.2	106.6	104.9
Rumania	91.3	107.1	102.1	105.8	105.2	105.2	108.4	104.1	107.6	106.3	107.3
Hungary	96.9	101.5	105.2	104.1	104.1	104.2	104.8	104.0	104.1	101.1	100.5
Bulgaria	92.8	102.9	105.4	104.1	104.9	105.0	106.6	106.3	106.3	106.2	106.0

But the increase in GDP reflects in full only quantitative economic growth and not the dynamics of the country's socioeconomic development as a whole. And the nature of this development has undergone significant changes in the era of globalization and information technology. In the future, development will be defined by such criteria as urban population density, the state of the external and internal environment, the level of culture, and so on. And it is impossible for all of these factors to be taken into account and expressed in the GDP index.

During the transition to the market, an abrupt economic slump and decrease in consumer supply and demand caused the economic potential of transition economies to plummet. Correspondingly, the

main task was to restore the former economic level, and economic growth was mainly of a quantitative nature (although significant qualitative changes were also seen).

The situation created was aggravated even more by the world economic crisis. Today, it is very important to correctly assess the opportunities of the new economy, study the current situation comprehensively and more objectively, and determine ways to withdraw from the crisis and the prospects for further economic development.

Crisis Manifestations and Possible Alternatives of Post-Crisis Development

The current financial crisis is unprecedented in scope and developed more rapidly than ever before in the past, whereby its signs were evident in advance (as early as 2007-2008). It is still progressing, and attempts to activate previous mechanisms are only complicating the situation. But *the challenges posed by the crisis are giving rise to new opportunities*, which should be taken advantage of as much as possible.

Crisis Manifestations: General and Specific Features

Crisis manifestations have both specific and general features.

The structural crisis that began in 2008 is essentially the result of rapid global development in a neo-liberal environment; it is unprecedented in scope, depth, and diversity of its manifestations.

Any economic crisis has its own characteristic features, but *all crises always have one thing in common: they emerge in the wake of a disruption in economic equilibrium*, which has an impact on production volumes, price levels, employment, income, ratio of the real to the financial sectors, and so on.¹

In the present crisis, the *unprecedented rapid growth in the financial sector compared with the real sector* that began in 2006 was the main cause of this disruption in balance.

The ratio of assets of the financial sector to the GDP in Belgium amounted to 341%, in Austria to 312%, in Germany to 263%, in Italy to 192%,² and so on.

The same situation also developed in *transition economies*: in Estonia, this index amounted to 116%, in Slovakia to 113%, in the Czech Republic to 98%, in Latvia to 88%, in Ukraine to 81%, in Kazakhstan to 76%, in Russia to 48%, in Georgia to 32%, in Armenia to 20%, in Azerbaijan to 18%, etc., whereas just ten years ago it was equal to 92-100%.³

Some transition economies have come close to the level of Western countries; in the past 10-15 years their financial markets have grown 3-5-fold faster on average than the other macroeconomic indices.⁴

¹ See: *Kurs ekonomicheskoi teorii*, ed. by M.N. Chepurin, 1999, pp. 387-388.

² See: *Vestnik McKinsey*, No. 20, 2008, p. 7, available at [www.vestnikmckinsky].

³ See: A.G. Aganbegian, "Ob osobennostiakh sovremennogo mirovogo finansovogo krizisa i ego posledstviy dlia Rossii," *Dengi i kredity*, No. 12, 2008, p. 5.

⁴ See: *The Global Competitiveness Report, 2008-2009*, World Economic Forum, Geneva, 2008, p. 84.

At the end of 2008, in the U.S., the GDP of which amounts to \$5 trillion, the aggregate cost of securities amounted to \$482-510 trillion.⁵

The volume of mortgage loans also abruptly increased, amounting to 100-200% of the country's GDP in 2008.⁶

But such steady growth in the financial sector could not compensate for the growing shortage of resource support of the real sector, since it was largely virtual; the financial market increasingly spiraled out of control.

In this situation, the financial service sphere began to have an effect on the development of the real sector of the entire economy, raising prices on goods that enjoyed particular demand (oil, metals, grain, food products, and so on). But even then, the increase in the financial sector was 1.5-2-fold greater than the increase in prices for oil and other raw materials. The demand for U.S. dollars as a means of payment in international trade rose again and this, in turn, led to their *overproduction*, which can be regarded as the main prerequisite of the crisis.

Another important reason for overproduction of the dollar was the artificial increase in its supply.

Between 1970 and 2008, the dollar supply in the world increased ten-fold, becoming many times larger than the world volume of actual real goods. For example, the U.S. GDP amounts to 20% of the world GDP, but the country uses 40% of the goods produced in the world.⁷

Other countries of the world paid for this difference, selling their goods for unsecured paper. This resulted in redistribution of the world's wealth in favor of one country (in this case, the U.S.).

Why were more dollars produced than was necessary for the normal functioning of the world economy, and why was consumption stimulated? Let us take a closer look at this question.

The enormous financial supplies and burgeoning consumption made it possible to acquire goods for money that had still not been earned, that is, on credit. Whereby in order for tempestuous issuing not to devalue money, a significant volume of the dollar supply was frozen in so-called virtual goods via the securities market. This led to a dramatic increase in the financial sector compared to the real sector: an increasingly larger amount of financial services began servicing a relatively smaller amount of the real sector of the economy.

The savings activity of the population and investment activity are closely interrelated. Personal savings went into bloated funds, investment banks, and so on, which in fact were not financing development of the economy; their bankruptcy frequently led to certain individuals getting rich, while household savings turned to dust.

High technology also added to the difficulties of the crisis. The latest technological innovations, which are extremely capital-intensive and have long recuperation periods, have essentially been inaccessible to developing countries; this has slowed down innovation progress, which has had a negative effect on economic growth.

In addition, achievements in information, digital, and nanotechnology, as well as in other spheres, made it necessary for the world to redistribute the material wealth that had been created.

Observations show that the economy is gradually becoming all-encompassing, which implies corresponding responsibility of the markets. But the situation in the world has developed in such a way that the real economy has become decentralized, while the financial markets, vice versa, have become highly centralized and uncontrollable from the outside.

The crisis is progressing in different ways in different countries, but its main principles and consequences are approximately the same everywhere.

⁵ [www.worldcrisis.ru].

⁶ See: *Zakat imperii dollara i konets "Pax Americana,"* available at [http://paxamericana.narod.ru/book/].

⁷ See: "Prichiny mirovogo finansovogo krizisa, ili Kak kupit ves mir," *Globalist*, available at [www.citibank.ru].

<i>Reasons (financial and economic)</i>	<i>Consequences (socioeconomic)</i>
removal of restrictions from banks' access to financial resources and access of resource owners to banks due to liberalization of the financial sphere in recent years	increase in amount of dollars acquired by banks
unprecedented rapid increase in internal lending ⁸	loan boom
granting large loans to unreliable borrowers	large increase in the number of bad loans
granting high-risk loans and poor management of their return	unbalanced loan portfolios of banks: bad loans and high-risk debts
rapid slowdown of the lending process caused not by insufficient liquidity but by the high-risk factor of these loans	increase in interest rates
mass non-return of debts by borrowers, bankruptcy of banks	sharp decrease in bank capital
deterioration of financial state of companies and drop in indices	increase in price and inexpediency of acquiring financial resources by issuing securities
increase in competitiveness as a result of economic growth and unprecedented activation of the financial sector	bankruptcy of companies in the new competitive environment
increase in risk of exchange rate	dollarization of financial resources of banks, ubiquitous restructuring of deposits into dollar accounts and so on
strong dependence of the country's currency on other currencies (usually on the American dollar or a basket of several currencies)	deformation of the monetary system
severe economic slump, cutback in export	transition of the financial crisis into an economic crisis
reduction in the number of jobs and increase in unemployment	transition of the economic crisis into a social crisis
loss of savings, continuous drop in income and decrease in consumer demand	intensification of the social crisis

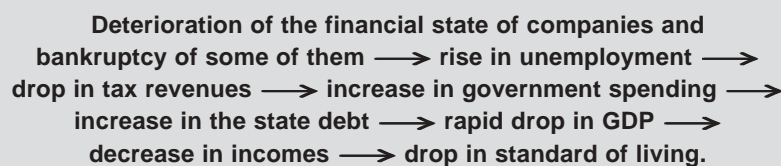
⁸ The relevant statistics are given below.

Along with this, the most serious socioeconomic changes are also seen everywhere:

- social tension is increasing;
- the state is becoming the largest property owner;
- global institutions cannot perform their functions;
- the architecture of management is changing and the importance of the national management conception is increasing;
- there is redistribution of the regional-territorial power centers and resources;
- regional-territorial opposition is intensifying and expanding;
- the system of values, success criteria, and so on are changing.

Crisis Development and the Price of the Crisis

The crisis is causing the recession in the world to gain momentum. This process can be presented by means of the following flow diagram:



It stands to reason that it will require enormous amounts of money to rectify this situation. In the U.S., Europe, Russia, and several transition economies, the funds allotted to fight the crisis exceed 10-15% of the GDP.⁹ World history has never before known such large-scale anticrisis programs. Whereby the situation has still not dramatically changed.

At the end of the 1990s, the funds spent on post-crisis restoration in Switzerland and the U.S. amounted to 4-5% of the GDP, while in Indonesia this figure was as high as 40%.¹⁰ Many developing countries have had to spend 15-20% of the GDP on anticrisis measures.¹¹ How much will ultimately be spent to overcome the current crisis? This question is difficult to answer; the crisis is still not over, but, according to the estimates of world financial institutions,¹² the world has already spent \$10 trillion, that is, as *Frankfurter Allgemeine Zeitung* writes, every resident on the planet accounts for \$1,500 in spent funds, and “people have also lost hope along with their money.”

This means that enormous targeted efforts are required to rectify the situation, since *a crisis is also an opportunity to affect a new upswing and progress based on new initial conditions.*

The comparative advantages that each country finds in this situation are very important, as well as how efficiently it uses them in its further development.

⁹ See: A.G. Aganbegian, op. cit., p. 3.

¹⁰ See: *Vestnik McKinsey*, No. 20, 2008, p. 4.

¹¹ See: D. Barton, R. Newell, G. Nast, G. Wilson, “Surviving an Economic Crisis,” *The McKinsey Quarterly*, No. 4, 2000.

¹² Estimates of the International Monetary Fund and Asian Development Bank.

In this way, *the main question is whether or not countries can take the necessary steps and, more important, what steps in particular should be taken.*

One thing is clear: attempts should not be made to save everything at any cost, particularly since this is impossible. For example, when attempts were made to save bad assets, the financial crisis became even more aggravated, since the enormous amount of spending not only failed to justify itself, but was even detrimental.

Nor is it absolutely necessary for all the countries of the world to find a common solution to the crisis, particularly since its manifestations vary from country to country.

In particular, the negative consequences of the crisis in transition economies are not as evident since their financial market is underdeveloped. But we should not ignore the following: *the more the underdeveloped financial market will restrict a spread in the crisis, the more it will prevent recuperation of the economy in the future.*

Alternatives of Post-Crisis Development and Anticrisis Measures: Approaches and Criteria

Alternatives of Post-Crisis Development

Depending on the nature of their pre-crisis situation, development level, social conditions, and so on, the countries of the world are taking different steps to overcome the crisis and prevent a drop in economic growth rates. Their efforts are aimed at easing the tax burden, raising the availability of investment and loan resources, stimulating supply and/or demand, and rendering assistance to small and medium business, as well as to backbone companies.

In so doing, it is becoming increasingly difficult to make assessments of the crisis as a whole, since the measures being implemented in different countries are yielding different results:

- the economic slump has slowed down, while in some countries economic growth is observed;
- the economic slump is worsening;
- the crisis is drawing to an end;
- a new, more severe stage of the crisis is expected, and so on.

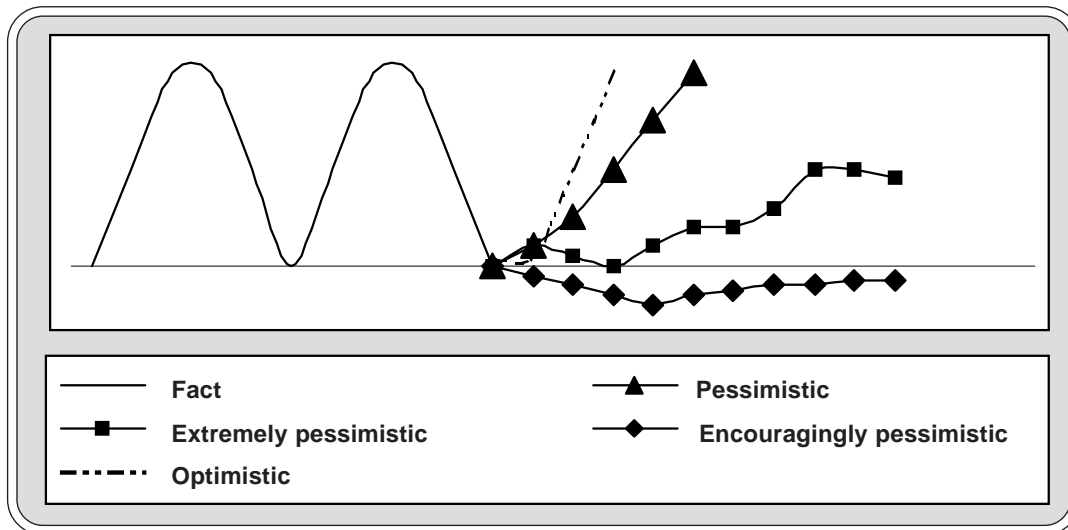
The forecasts about post-crisis development alternatives are just as contradictory; two main types can be singled out: optimistic and pessimistic.

According to the optimistic forecasts, the final phase of the recession will begin in 3-4 years, after which there will be an abrupt cyclic upswing with qualitatively new economic growth.

According to the pessimistic scenario, the crisis is mainly of a systemic nature. Both the extensive and intensive possibilities of system development have been exhausted; and a collapse of the capitalist system and global chaos are expected.

The second alternative has several different manifestations: pessimistic, encouragingly pessimistic, and extremely pessimistic, right down to a global change in the socioeconomic systems, demise of the human race, and the end of the world¹³ (see diagram).

¹³ See: G. Popov, "Globalnaia perspektiva krizisa 2008," in: *Problemy teorii i praktiki upravleniia*, No. 7, 2009, pp. 17-22; A.G. Aganbegian, op. cit., p. 3; G. Soros, P. Krugman, N. Roubini, "Kriziznye prognozy. Kogda i kak vse eto zakonchitsia," *Business Class*, No. 3, 2009, pp. 36-39.



Such pessimistic evaluations are based on several very serious systemic phenomena caused by geopolitical and geo-economic factors:

- the struggle of regional associations and countries competing among themselves for the shrinking sales markets and energy resources;
- intensification of territorial conflicts and opposition among certain countries;
- formation of different ideologies and conceptions, both centripetal and liberal, as a result of aggravated socioeconomic contradictions, and so on.

But, as we know, every problem has a solution; further development depends on how targeted the measures are to overcome the consequences of the crisis.

Alternative models of the prospects for global development are also possible. The best alternative is the one that provides an opportunity to learn the most productive lessons from the crisis; only this approach will make it possible to evaluate the crisis period as a stage of new opportunities.

Practical Manifestations of Anticrisis Measures

The anticrisis measures carried out have clearly distinguishable general features, but in so doing they are also specific for each separate country or region. The measures undertaken so far can be divided into several groups.

In the U.S., the anticrisis measures took two directions developed under the supervision of presidents George Bush and Barack Obama, respectively.

According to George Bush's policy, the state's reserves and the taxpayers' money were used to save the financial structure of the economy, which essentially meant saving the fat cats.

Barack Obama's anticrisis policy is based on pumping liquidity into the economy called upon to stimulate demand and supply and help the most diverse entities of the economy, from households to the largest banks and financial institutions. Some of the liquidity is being used to organize social work designed to help the least competitive part of the workforce on the labor market survive the crisis, an idea that was suggested by U.S. President Theodore Roosevelt in the 1930s.

France's experience is based on the anticrisis policy of President Nicolas Sarkozy entitled "return to the enterprising capitalism of the 19th century," which proposes sending help from the financial sector to the real economy, in particular rendering assistance to small and medium business.

The anticrisis measures being carried out in Germany are associated with Chancellor Angela Merkel; they envisage rendering assistance to consumers rather than producers, that is, rejuvenating the economy by stimulating consumer demand.

England has nationalized the bankrupt private structures, which means a return to the bureaucratic socialism of the 20th century with its "incurable diseases" (including to Soviet experience).

New Approaches and Conceptual Provisions Designed to Overcome the Crisis

There are many anticrisis prescriptions, but will they help to overcome the crisis? Most likely only a temporary effect can be expected.

In this respect, it is appropriate to quote something that Gerald Ford said about the 1929 crisis. To the question of whether a million dollars could make up for the million in losses, he replied that no, it could not, since the million would be going into the same system that caused those losses.¹⁴

In short, *an effective struggle against the crisis implies serious changes both of a theoretical-methodical and conceptual, as well as of an applied nature.* That is, in difficult crisis conditions, new approaches, new methods, new criteria, and new indices are needed.

For example, the foundations of the macro economy that formed after the Great Depression of 1929 are currently in need of detailed analysis and re-examination. The Keynesian and monetary approaches to economic regulation also need to be re-examined.

Today, the question has been raised of establishing the most generalized and integrated economic indices; today the GDP is used as one of the main indices, which essentially only includes parameters of economic development; perhaps it would be wise to move from value to physical indices. This approach would make it possible to fully assess the economic development processes going on, which would make it possible to find the most acceptable ways for withdrawing from the crisis.

In order to raise the efficiency of the anticrisis measures and quickly overcome the crisis, conceptual changes in the anticrisis approaches applied in practice are necessary.

These include in particular:

- Precise definition by state structures of the targets of the anticrisis measures and their order of priority keeping in mind that the economy is best stimulated by boosting consumer demand, while production and the financial system, in particular investments and/or loans, should act as a tool for ensuring adequate supply. This approach implies the following flow sheet of financial assistance: consumers-producers-services (nonproductive)-banking and financial sector.
- Application of new forms of nationalization in which society becomes the new property owner, and not some state official or structure (the experience of the 20th century shows that transferring the economy into the hands of one or several civil servants is extremely dangerous).

¹⁴ See: G. Popov, op. cit., pp. 17-20.

- Fighting unemployment with the aid of programs similar to social work, however not as this was done in the 1930s, but by redirecting the workforce into promising spheres of the economy.
- Application of adequate anticrisis tools, where a special place will go to granting interest-free, long-term, and other loans, payment deferment, and different measures to lower taxes.
- Coordination and transparency of anticrisis measures; this approach will make it possible to more effectively and rapidly overcome the crisis.

In light of the different alternatives of crisis development, elaboration of a new economic policy is also becoming extremely urgent. It, as before, should rely on liberal principles of economic development, but *take into account the importance of the state's regulating role*.

This approach should be applied in the following areas:

- In the financial sector, which is experiencing difficulties: the securities market is extremely bloated, the securities market, insurance markets, investment funds, and so on have spiraled out of control. Regulations and restrictions must be applied to reinsurance and interbank securities lending, and a new mechanism must be created for evaluating securities and their liquidity (taking into account that securities are not money). The issue of securities and their circulation should also be precisely regulated, as well as monitoring of their circulation on international financial markets.
- The crisis has raised the question of *radical transformation of state management of the economy based on a new national management conception*.
- In light of the future development of the crisis, the question of *re-examining the system of national values and inventorying available resources, as well as identifying potential and real opportunities* requires a separate discussion.
- The task of ensuring a realistic and optimal *combination of further action and opportunities and their targeted implementation using strategic and tactical levers* must be addressed.

In Lieu of a Conclusion

A crisis is not only a bad thing. It also provides an exclusive opportunity to create the most viable, dynamic, and modernized economy by bringing it into harmony with the best international standards. This particularly applies to transition economies.

A statement by South Korean President Kim Dae-jung about the 1998 crisis is worth quoting in this respect: "This crisis will be a lesson to us, and we will build a true market economy in the country."

Time has shown that this approach is the most viable. Indeed, only in this event is it possible to rapidly overcome the most difficult problem of transforming the economy.