An Investigation into the Global Financial Crisis Factors and a Snap Shot of Their Impact on Different Segments of Economy in a Developing Country: A Case of Pakistan

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Abstract

This study focuses to identify the factors which have affected the financial sector globally and to visualize the snapshot of their impact on the Pakistan. The recent financial crisis hit the Pakistan and the world negatively in following ways including remittance and migration, international trade, foreign direct investment, exchange rate, Interest rate, and foreign Aid but The economy of Pakistan deeply depends on relationship with the USA and internal factors including domestic policy and good governance. This Study helps to highlight the threats to the country’s economy and opportunities on which we can capitalize. Some solutions and recommendations are incorporated how to cope with such challenges.

Keywords: Financial Crisis, World, Economy, Pakistan

Introduction

The main purpose of this study to identify the factors which hit the world economy and their impact on Pakistan economy. This Study emphasizes on the threats to the country’s economy and opportunities on which we can exploit. The focal point study to provide information for the policy makers and decision makers to shape the policies according to current conditions, to avoid the threats to the economy, so that practical measures can be taken and making most benefit out of the opportunities linked with this global financial crisis can be accomplished.
Literature Review

Before the definition of financial crisis it seems necessary to be familiar with the term crisis. Different people define the crisis in different ways based on the perspective and context. According to Wikipedia “A crisis is any event that is, or expected to lead to, an unstable and dangerous situation affecting an individual, group, community or whole society. Crises are deemed to be negative changes in the security, economic, political, societal or environmental affairs, especially when they occur abruptly, with little or no warning”. In reference to the above definition economic condition is also affected by the crisis and banking crisis can be covered under this head. It is obvious the crisis which engulfed the economies of the world was abruptly and with no warning. As if there will be any warning than proactive measures can be taken. In this article we are interested to investigate what are the factors which have affected the financial institutions and could not be identified in time.

According to Oxford advanced learner’s dictionary (Oxford university press) a time of great difficulty or danger or when an important decision must be made e.g. financial/economic/political crisis.

In financial Crisis assets of financial institutions deprecate in their value up to a great extent (Khilgi, Farrukh, Iqbal, & Hameed, 2011).

The financial crisis may be categorized into two aspects i.e. Systemic and non systemic crisis. Systemic financial crisis is defined as the situation in which the corporate and financial sector face defaults and face difficulties to oblige the contracts on time, this situation might occur mainly due to two reasons one is depressed asset process before the period of crisis with the sharp increase in the real interest rates and secondly due to the depositors run on banks may also cause the situation for the banks which will result in bank default (Laeven & Valencia, 2008).

Financial crisis occurred at different intervals all over the world in different time periods, Asian crisis of 1990’s was the worst of its kind and has engulfed the emerging economies of the Asia. E.g. Malaysia, Thailand and Singapore (Radelet & Sachs, 2000).

Pakistan is a developing country and Pakistan’s economy was showing the phenomenal growth in the early years of this century i.e. 2001-2005. The banking assets of Pakistan rose to three fold during the period of 2000-2005 and industry size was around Rs. 4 trillion, banking sectors assets GDP ratio improved from 47.2% in 2000 to 55.6% in 2005. Before tax return on assets was improved from 0.2% to 2.6% in the period of 5 years (Akhtar, 2006).

Latest crisis greatly affected the eight countries of the world which were deemed financially very sound. The crisis has transmitted its effects to almost all the economies of the world. Some countries have survived the crisis e.g. India and China, however, countries around the globe especially the developing countries have also been affected by this crisis directly or indirectly.
After the eruption of this crisis our country has been affected in many ways. However, there is no systemic or major banking crisis reported in Pakistan in history, as, this argument is supported by the study about banking systems around the globe in which it is established that Pakistan is one of those countries who has not faced a single systemic or major crisis (Barth, Caprio & Levine, 2001).

Factors Of Global Financial Crisis

Some problems to be fatal for the global financial sector and relaxed policies are one of them, in the US there was a self regulatory system and there was no government check on that and it was considered best for the growth of the financial sector and in UK the same was with minimal government interference. Secondly in this period the financial institutions led by the inexperienced bank officials some wrong decisions like the long term lending was financed through the short term borrowing, which bounced back and the situation got worse in crisis and banks lost as a result (Clarkson, 2009).

The financial crisis as the cause of relaxed regulations in the financial sector along with other reasons. He reported that financial sector debt was increased to 22 % of GDP in 1981 to 117 % of GDP in the third quarter of 2008 and in the UK due to excessive reliance on financial sector total debt of the financial sector reached to 250 % of GDP (Wolf, 2009).

The financial and monitory rules and strategies has its role in dealing with the asset price bubbles. Relaxed financial and monetary policies and financial innovation, increased demand for the assets and this continue to increase and bust at some level which leads to financial crisis (Hayford & Malliaris, 2010).

The low interest rate approaches and strategies of state banks are the main cause of current global financial crisis (Adrian & Shin, 2010; Brunnermeier, 2009; Taylor, 2008).

The credit boom and asset price bubble are the main factors of the banking crisis (Reinhart & Rogoff, 2008a, 2008b, 2009).

The reason credit crisis is that funds were not properly allocated to real estate, in the mortgage business backing of real estate assets increased the illiquidity of the financial institutions. Flawed internal compensation and control, management created short term expensive debts instead of long term cheap ones. The Authors also have suggested three different strategies to overcome this illiquidity issue. One by buying the securities by the Govt. Second, by stabilizing the parts of the financial system by re capitalization of assets for those who have possibility of survival and mergers and closures for those who have not. Third is the mix of the first two where authorities buy the illiquid assets, even while the regulated financial sector (Diamond & Rajan, 2009).

The credit crisis was caused due to lack of moral standards of financial sector officials. Bankers issued the risky mortgage loans to the poor residents (Calomiris, 2008).
The financial institutes did not have sufficient measures to deal with the bank crisis (Tett, 2009). The Bank failures are contagious due to the reason that the assets of the bank have less liquid; this illiquidity leads to bank crisis. This illiquidity is in reference to the nature of the business of banks. Banks finance illiquid assets with demandable claims (Friedman & Schwartz, 1963; Diamond & Rajan, 2003).

The factors affecting the crises are “Domestic macroeconomic policies, external macroeconomic policies, the exchange rate regime, Domestic financial structure, problems of supervision and regulations”. They are of the view that the crises in emerging and developing countries are mostly due to external aspects (Eichengreen & Rose, 1997).

Immoral financial channels play a role in financial crisis; there is a correlation between intensity of corruption and exposure to the crisis. Fraud occurs when the attitude of the monetary authorities is too accommodating (Blanque, 2002).

The financial distress indicators can be different across the regions and countries. Small GDP rate, lofty real rate of interest, soaring inflation increases the likelihood of systemic problems. The security situation is also relevant. Decreasing capital yield ratio, quick decline in the real rate of exchange, unfavorable trade shocks. Rapid increase in credit expansion and consumption has considerable distress effect (Demirgüç-Kunt & Detragiache, 1998).


Good corporate governance has a positive impact on bank financial performance and vice versa, this increases the return on stock as compared with other banks in the post crisis period (Ammann et al. 2011; Bebchuk et al. 2009; Bhagat & Bolton 2008; Brown & Caylor 2006, 2009; Chhaochharia & Laeven 2009; Cremers & Ferrell 2010; Gompers et al. 2003; Johnson et al. 2009; Renders et al. 2010).

**Impact Of Crisis On World And Pakistan**

The global recession affects the economies of developing countries through the following channels i.e. Remittance and migration, international trade, foreign direct investment, exchange rate, Interest rate, and foreign Aid (Khawaja, Mahmood, and Qadir, 2010). The international rate of trade growth slowdown due to global financial crisis from 6.4% in 2007, 2.1% in 2008, but the 12.2 % reduction in 2009 (WTO, 2009).
Foreign direct investment cut down by 39% from US$1.7 trillion in 2008 to US$1.1 trillion in 2009, in 2010 at US$1.1 trillion and in 2011 FDI flows to be between US$1.3 trillion and US$1.5 trillion (UNCTAD, 2011).

The impact of global financial crises on the four sectors of Pakistan Economy i.e. Financial sector due to commodity price hike, unstable political conditions of the country and real estate turmoil, Capital flows and worker’s Remittances have witnessed the increase in the remit of the 19.5 from July–April 2008-2009 however other Asian countries witnessed the decline in remittances. Commodity prices and trade have a net positive effect due to global slowdown of the demand and on account of external financing the options for the capital raising rising has been reduced (Usman, 2010).

Ex-governor of state bank of Pakistan Yaqub (2011) argued that the economy of the country was not managed on the as required, as ours economy needed the investment and saving but the governments in the history tried to give the boost to economy by the relaxed money policies and increased consumption, secondly the natural disasters like earthquake and floods also hit very hard on the economy of the country and there was no proper water management, and foreign Aid for earthquake areas could be the opportunity for the country however the funds were not used properly. The world bank and IMF aid were all short term nature and no long term plans instead Lack of good governance is also the cause of economic crisis in Pakistan and any good economic infrastructure cannot be implemented without good governance. He has also identified the two macro-economic factors which are leading to economic crisis in Pakistan are slow and erratic economic growth and huge budgetary deficit. Growth and development of Pakistan depend on affirmative alliance with the USA (Ali, 2008). The global financial crisis slows down the growth of manufacturing sector after 2008 in Pakistan (McCartney, 2011).

Conclusion

Pakistan is a developing country and has its own set of problems which has been enlisted by the different researchers and experts. The current financial crisis hit the Pakistan economy indirectly together with the decline in remittances of migrants, international trade, foreign direct investment, exchange rate, Interest rate, and foreign Aid. The internal factors including political issues and government reforms are heavily linked with lower GDP than the external factors including the global financial crisis.

Solutions And Recommendations

- There should be proper check and balance system from the government side about the financing policies of the organization because the self regulatory system may cause the financial crises.
- Financial institutions should put keen considerations to hire specialized decision makers about financial activities because less mature decision makers led to financial crises because of their Generalisability.
• Firms should formulate an investment plan before investing in different portfolio having different risks and returns.
• The capital structure of the firm should be a balanced combination of debt financing and equity financing although debt financing is a cheaper source of financing but the firm should maintain proper capital structure.
• Bankers should issue the risky mortgage loans without favoritism or any other moral deficiency because if they make any dishonesty it will cause crises of that organization.
• The government should make those policies which are less volatile from the factor affecting financial crises. Government should maintain proper Periodic observations of economic condition, stock market, law and order situation and exchange rate fluctuation and give necessary relaxations in special circumstances.
• Imprudent mortgage lending could lead to problems if interest rates rise or property prices falls and it will cause the non performing loan, moreover, it will lead to financial crises of those institutions. So institutions should make alternative financing to overcome this factor.
• Firms should invest in productive businesses instead of investing in property and real estate.
• Firms should make different policies to maintain good governance because good governance is that factor which help to reduce the effects of these [crisis] factors which may cause the financial crises mentioned in our literature.
• All sectors should be taxed, country development expenses should be reallocated in energy and water resources as ours is agriculture country, resource allocation should be efficient and funds should be allotted for the skill development of the young generation.

References


