

# Causes and Effects of the Global Financial Crisis - A Comparative Analysis of Previous Financial Crises

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**Abstract.** The purpose of this paper is to analyse the causes and effects of the global financial crisis and to reveal its common features and unique factors by comparing financial crises in different historical periods. The study shows that excessive leverage, inadequate financial regulation and international capital flows are the main causes of the crisis, while policy failures, external shocks and internal vulnerabilities are the unique background of each crisis. Financial crises had far-reaching macroeconomic, financial market and socio-political impacts, leading to slower economic growth, rising unemployment, collapsing market confidence and social unrest. In order to effectively respond to financial crises, countries should strengthen financial regulation and risk control, improve the international financial system and enhance national economic resilience. Through the implementation of comprehensive policy measures and enhanced international cooperation, the global economy can better respond to the challenges posed by the financial crisis and lay the foundation for long-term prosperity and stability.

**Keywords:** financial crisis; macroeconomics; financial regulation; international cooperation.

## 1. Introduction

The frequency of global financial crises has had a profound impact on the world economy, society and politics. Financial crises, which are usually accompanied by economic recession, rising unemployment and social unrest, pose a serious challenge to Governments and international organizations. Although the specific causes and manifestations of various types of financial crises differ, they often share certain common features and regularities. By studying and comparing the causes and impacts of successive financial crises, we can not only deepen our understanding of the nature of financial crises, but also help to formulate effective prevention and response strategies. The purpose of this paper is to sort out and analyse the causes and consequences of typical financial crises over the years, and to explore their intrinsic links and differences, so as to provide reference for future financial stability policies. Using historical analysis and comparative research methods, this paper will focus on the Great Depression of 1929, the Asian financial crisis of 1997 and the global financial crisis of 2008, in an attempt to reveal the commonalities and uniqueness of these crises, analyse their far-reaching impacts on the global economy, and put forward corresponding policy recommendations.

## 2. Theoretical framework of the financial crisis

### 2.1. Basic concepts and types of financial crisis

A financial crisis is a phenomenon in which there is a dramatic upheaval in the financial markets, leading to serious problems in financial institutions, asset prices, market liquidity, etc., which in turn has a significant negative impact on the entire economic system [1].

#### (1) Banking crisis

A banking crisis, also known as a banking crisis, is a situation in which there are serious problems within the banking system that result in a large number of bank failures or the need for an emergency government bailout. Banking crises are usually triggered by non-performing loans, balance sheet imbalances, and liquidity shortages, which may further trigger a run on depositors and cause the



collapse of the banking system. Classic examples include the Savings and Loan crisis in the United States in the 1980s and the 2007-2008 global financial crisis.

## (2) Currency crisis

Currency crises refer to large-scale speculative attacks on a country's currency, leading to a sharp depreciation of the currency or a sharp decline in foreign exchange reserves. Currency crises are often associated with the failure of foreign exchange market interventions in countries with fixed exchange rate regimes, and are often accompanied by balance-of-payments crises and capital flight; the European Exchange Rate Mechanism (ERM) crisis of 1992 and the Asian Financial Crisis of 1997 are typical examples of currency crises.

## (3) Debt crisis

A debt crisis is a phenomenon in which a country or countries are unable to repay or refinance their debts on time because of excessive debt burdens, leading to turmoil in international financial markets. Debt crises are usually associated with high levels of external debt and fiscal deficits and can trigger a tightening of international credit markets and abrupt changes in global capital flows. The Latin American debt crisis and the European debt crisis are major examples of debt crises.

## **2.2. Theoretical explanations of the financial crisis**

### (1) Classical Economics and Keynesian Perspectives

Classical economics considers financial crises to be the result of market failures, with excessive speculation and asset bubbles occurring in financial markets due to information asymmetry and flaws in the market mechanism. When the bubbles burst, asset prices fall sharply, triggering a chain reaction that leads to financial crises. Keynesianism, on the other hand, emphasises the lack of effective demand and underinvestment as the key to financial crises. Keynesians believe that the market cannot restore equilibrium spontaneously and requires government intervention through fiscal and monetary policies to stabilise the economy.

### (2) Monetarist and neoliberal views

The monetarist school of thought argues that financial crises are primarily caused by an over-expansion or tightening of the money supply. Monetarists emphasise the key role of central banks in maintaining the stability of the money supply and believe that monetary policy failures are an important cause of financial crises. The neo-liberal view, on the other hand, attributes financial crises to excessive government intervention and inadequate regulation, and favours deregulation to encourage free market operations, but also acknowledges the limited capacity of markets to self-regulate and the need for moderate regulation to prevent systemic risks.

### (3) Behavioural finance and psychological factors

Behavioural finance explains financial crises from a psychological perspective, arguing that irrational behaviours and psychological biases of investors, such as overconfidence, herd mentality and risk aversion, are at the root of financial market volatility and crises. Behavioural financiers believe that the emotional and psychological states of market participants can cause asset prices to deviate from their fundamental values, leading to the formation and eventual bursting of bubbles and the triggering of financial crises. Psychological factors play an important role in explaining market sentiment, investor behaviour and the sudden onset of financial crises.

## **3. Historical review of financial crises**

### **3.1. The Great Depression of 1929**

The Great Depression of 1929 was one of the most serious global economic crises of the 20th century, which started in the United States and spread rapidly around the world. Its main causes included

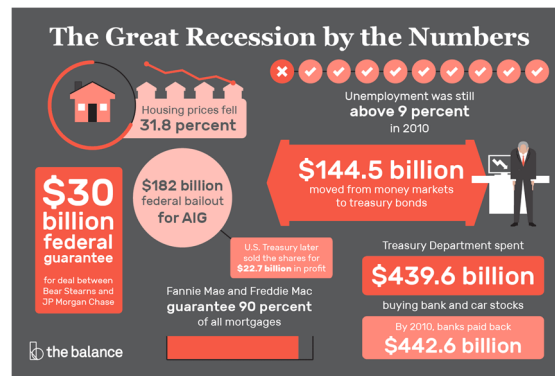
excessive speculation in the stock market, the fragility of the banking system, and economic policy failures. In the 1920s, the United States stock market experienced a prolonged bull market, which attracted a large number of speculators and created a huge asset bubble. In October 1929, the stock market crashed, and investors sold their stocks in droves, leading to a panicked decline in the market. At the same time, the U.S. banking system was extremely fragile, with many banks lacking sufficient reserves to cope with large-scale withdrawals. After the stock market crash, bank runs were frequent and thousands of banks failed, further exacerbating the crisis in the financial system. In addition, the severity of the Great Depression was exacerbated by an inadequate government response. The Hoover administration insisted on a tight fiscal policy, cut public spending and failed to implement effective stimulus policies in a timely manner. The Great Depression led to a worldwide recession, with industrial production plummeting and unemployment soaring. In the United States, the unemployment rate reached over 25 per cent in 1933 and millions of people lost their jobs and homes. The Great Depression also triggered social and political upheavals and the rise of extremist ideologies around the world, with far-reaching effects on the global political landscape.

### **3.2. The 1997 Asian financial crisis**

The 1997 Asian financial crisis, which began in Thailand and spread rapidly to several countries in South-East and East Asia, caused severe economic and financial turmoil. Its main causes included the fixed exchange rate system, high external debt, and excessive liberalisation of capital markets. The trigger for the crisis was Thailand, where the baht was grossly overvalued and foreign exchange reserves were rapidly depleted because of its insistence on a fixed exchange rate system. Under massive attacks by international speculators, the Thai government was forced to abandon the fixed exchange rate system in July 1997 and the baht depreciated sharply. The devaluation of the baht triggered a chain reaction that led to speculative attacks on the currencies of countries such as Malaysia, Indonesia, the Philippines and South Korea. These countries generally faced heavy external debt burdens, weak financial regulations and structural imbalances in their economies. The sharp devaluation of currencies triggered severe financial market turmoil and banking crises, massive capital flight, massive bankruptcies of enterprises and banks, and a sharp rise in unemployment. At the peak of the crisis, Indonesia's economy almost collapsed, with social unrest and frequent regime changes; while South Korea accepted emergency assistance from the International Monetary Fund (IMF) and implemented stringent economic reform measures. The entire South-East Asian region experienced a dramatic economic downturn, with a sharp decline in GDP and a serious increase in poverty and unemployment.

### **3.3. The 2008 global financial crisis**

The 2008 global financial crisis, the worst economic crisis since the Great Depression of 1929, had complex causes involving multiple factors, including financial markets, regulatory failures and macroeconomic imbalances. The trigger for the crisis was the collapse of the subprime mortgage market in the United States, which experienced a sharp rise in the early 2000s, with the massive issuance of subprime loans (loans to less creditworthy borrowers) creating a huge housing bubble. Through financial innovation, financial institutions securitised sub-prime loans into complex financial derivatives that were widely sold to global investors[2]. As a result of the fall in house prices, a large number of subprime loans defaulted and the value of subprime mortgage-related securities plummeted, leading to huge losses for financial institutions. Large financial institutions such as Lehman Brothers went bankrupt one after another, market confidence collapsed, credit markets froze and the global financial system was paralysed. The crisis spread rapidly around the world, and financial markets in Europe and Asia were also hard hit. Governments and central banks took urgent measures to implement large-scale financial rescue and economic stimulus programmes. The Federal Reserve and other major central banks tried to stabilise the financial markets by lowering interest rates and providing liquidity support. Governments have also launched fiscal stimulus policies to curb economic recession and unemployment.



**Figure 1.** The 2008 global financial crisis

## 4. Comparative analysis of successive financial crises

### 4.1. Common causes of the financial crisis

#### (1) Excessive leverage and speculation

Excessive leverage is one of the key common causes of financial crises. In times of economic prosperity, financial institutions and investors often resort to leverage to expand the size of their investments in pursuit of high returns[3]. This overreliance on borrowing makes the financial system significantly more risky, and when markets are volatile, leverage can magnify losses, leading to the bankruptcy of financial institutions and sharp market fluctuations.

#### (2) Inadequate financial regulation

Inadequate financial regulation is also an important reason for the frequency of financial crises. Many countries tend to deregulate their financial markets when they experience an economic boom, leading to a lack of risk management by financial institutions. The lack of effective regulation makes financial products less transparent and prevents investors from accurately assessing risks, ultimately leading to market failures. For example, the lack of necessary regulation in the subprime market prior to the 2008 global financial crisis led to the massive issuance of high-risk financial products.

#### (3) Impact of international capital flows

The liberalisation of international capital flows, while promoting global economic integration, has also increased the risk of financial crises. Against the backdrop of the liberalisation of capital flows, the rapid inflow and outflow of short-term capital can easily lead to instability in financial markets. Particularly when the economic situation changes, large-scale capital outflows can lead to the depreciation of national currencies and a fall in asset prices, which in turn can trigger financial crises. The Asian financial crisis is a typical example, in which the rapid flow of capital caused the financial systems of South-East Asian countries to be severely affected.

### 4.2. Unique causes of different financial crises

#### (1) Policy failures and governance issues

Policy failures are an important and unique cause of financial crises. Governments and regulators may adopt inappropriate policies in the face of changing economic conditions due to poor judgement, leading to instability in the financial system. For example, in the 2008 global financial crisis, the failure of United States regulators to effectively identify potential risks in the subprime market led to a proliferation of high-risk financial products. In addition, governance issues, such as political corruption and policy opacity, may weaken the robustness of the financial system and make it more vulnerable to external shocks.

#### (2) External shocks and internal vulnerability

External shocks are another unique cause of financial crises. In the context of globalisation and the increasing interconnectedness of economies, external events, such as fluctuations in international markets, geopolitical conflicts or natural disasters, can have a significant impact on national economies. For example, the 1997 Asian financial crisis stemmed in part from the vulnerability of dependence on foreign capital. At that time, the financial systems of some Asian countries were overly dependent on short-term capital flows, which, in the face of external economic fluctuations, could easily trigger large-scale capital flight and cause financial market crashes. At the same time, internal vulnerabilities should not be overlooked. There may be structural problems in the financial systems of some countries, such as high indebtedness and inadequate capital adequacy of banks, which can be rapidly exposed when external shocks arrive, thus exacerbating the extent of the crisis. For example, prior to the 2008 financial crisis, many financial institutions were extremely vulnerable to market pressures due to high leverage and inadequate risk management.

### **4.3. Transmission mechanisms and patterns of financial crisis**

#### **(1) Chain reaction in financial markets**

Chain reactions in financial markets are an important mechanism for the transmission of financial crises. When a financial institution runs into problems or the price of an asset falls, market participants tend to become distrustful of other related assets or institutions, leading to increased selling behaviour. For example, during the global financial crisis of 2008, the collapse in the prices of financial products related to subprime loans led to severe losses for financial institutions holding these assets, thus triggering concerns about the stability of the financial system as a whole. This panic spread rapidly, causing stock markets to plummet and credit markets to freeze, creating a chain reaction of crises.

#### **(2) Impact path of the real economy**

Financial crises affect the real economy through multiple pathways. First, financial crises often lead to a credit crunch, with financial institutions reducing lending to businesses and individuals because of concerns about future risks. This credit contraction dampens investment and consumption, which in turn leads to slower economic growth. Second, financial crises can also lead to a decline in consumer confidence. Rising unemployment and shrinking wealth have reduced consumer spending by households, further exacerbating the recession. Volatility in the financial market affects the cost of financing for enterprises, which, in the face of financing difficulties, tend to cut investment, lay off staff or reduce output, all of which increase the downward pressure on the economy. Thus, the impact of the financial crisis is not limited to the financial markets themselves, but also has far-reaching effects on the real economy in a variety of ways, including through the credit channel and the consumption channel.

## **5. Impact and consequences of the financial crisis**

### **5.1. Impact at the macroeconomic level**

The macroeconomic impact of financial crises is far-reaching and wide-ranging, and is usually manifested in a number of ways, including economic growth, employment, inflation and international trade. Financial crises usually lead to slower economic growth or recession. In the context of financial market turmoil and credit crunch, businesses are less willing to invest and production capacity declines, thereby dampening overall economic growth[4]. Taking the 2008 global financial crisis as an example, many developed countries and emerging markets experienced a pronounced recession in the aftermath of the crisis, with a significant decline in GDP growth. Rising unemployment was also one of the major impacts of the financial crisis. Enterprises, when faced with financing difficulties and declining market demand, often resort to measures such as layoffs, wage cuts or cessation of hiring in order to reduce operating costs. This has led to soaring unemployment and reduced household income, which in turn has increased social instability. Financial crises can also lead to inflation and price volatility. In some cases, monetary easing policies adopted by the Government in

response to the crisis may lead to higher inflation, affecting the cost of living of the population. Conversely, against a backdrop of economic contraction and lack of demand, price levels may face downward pressure, resulting in "stagflation" in the economy.

## 5.2. Impact of financial markets

The impact of financial crises on financial markets is usually immediate and far-reaching, in a number of ways, including market confidence, asset prices, liquidity and the regulatory environment. Financial crises often lead to a rapid collapse in market confidence. Investors, sceptical about the prospects of the market and the stability of financial institutions, have sold their assets, resulting in sharp market volatility. For example, during the global financial crisis in 2008, there was an unprecedented plunge in global stock markets, with stock indices in many countries sliding by more than 30 per cent in a short period of time. A sharp fall in asset prices triggered by a financial crisis can put enormous pressure on the balance sheets of financial institutions. The plummeting value of risky assets and securitised products held by banks and investment institutions has led to a decline in their capital adequacy ratios and increased the risk of insolvency. This situation prompts financial institutions to cut back on credit, further exacerbating the liquidity crisis in the market, creating a vicious circle. Liquidity shortages also affected the normal functioning of financial markets. During the crisis, the trading volume of many financial instruments and assets declined and the liquidity of the market was reduced, leading to a widening of the gap between bid and ask prices and increasing transaction costs. Investors became more cautious in an uncertain market environment and liquidity was curtailed.



Figure 2. Impact and consequences of the financial crisis

## 5.3. Impact of social and political dimensions

The impact of financial crises on the social and political levels is often far-reaching and complex, involving many aspects of social stability, people's lives, political systems and public policies. Financial crises often lead to rising unemployment and declining household incomes, putting enormous pressure on the lives of ordinary people. Unemployment, wage cuts and rising costs of living expose many families to economic hardship and increase social discontent, which in turn may lead to protests, demonstrations and social unrest. For example, in the aftermath of the global financial crisis of 2008, large-scale protests erupted in many countries, and popular discontent with Governments and financial institutions intensified. Financial crises often lead to a decline in political trust. Emergency bailout measures taken by governments during crises, such as providing financial support to large financial institutions, may be perceived by the public as favouring the rich and powerful groups, leading to a decrease in trust in government. The rise of political extremism and populism is also often associated with financial crises, and voters may be inclined to support extremist parties or candidates who promise to reform the status quo, thereby changing the political landscape.

Financial crises may also prompt governments to make significant adjustments to their economic policies. In the face of social pressures, Governments may pursue policies that focus more on social welfare and income redistribution in order to alleviate social tensions. For example, some countries have stepped up investment in areas such as education, health care and housing in the aftermath of the crisis in order to improve people's living standards and social security.

## **6. Policy recommendations to address the financial crisis**

### **6.1. Strengthening financial regulation and risk control**

Strengthening financial regulation and risk control is an important measure for preventing financial crises and aims to improve the stability and resilience of the financial system to risks. An effective regulatory framework can reduce the vulnerability of financial markets by identifying and responding to potential risks in a timely manner. Regulators should enhance the supervision of financial institutions to ensure their compliance with key indicators such as capital adequacy, liquidity and risk management. Systemic risk could be reduced by setting stringent regulatory standards to prevent excessive leverage and risky investments by financial institutions[5]. Regular stress tests and risk assessments can help identify potential risk points and take countermeasures in advance. Transparency is an important aspect of financial regulation. Requiring financial institutions to disclose more financial information and risk profiles to enhance market participants' understanding of their operating conditions can effectively boost market confidence. Increased transparency also helps reduce information asymmetry and speculative behaviour. In addition, cross-border regulatory cooperation should not be overlooked. With the globalisation of financial markets, the financial systems of various countries are becoming more interconnected. Regulators from various countries need to strengthen information sharing and cooperation, coordinate their response to cross-border financial risks and form synergies to deal with possible systemic risks.

### **6.2. Improving the international financial system**

Improving the international financial system is an important strategy for dealing with the financial crisis, aimed at enhancing the stability and risk-resistance of the global financial system. With the development of global economic integration and the increasing interconnectedness of financial markets, it is particularly important to establish a more sound and effective international financial system. There is a need to strengthen the role of international financial institutions, such as the International Monetary Fund (IMF) and the World Bank. These institutions should play a more active role in global economic governance by providing technical support and policy advice to help countries cope with economic challenges, especially in times of crisis. At the same time, they should expand the coverage of their financial assistance to help those vulnerable economies to restore stability. Promoting international cooperation and coordination was key to improving the international financial system. Countries should strengthen policy coordination and ensure mutual coherence in macroeconomic policies, especially in monetary and fiscal policies, in order to cope with global economic volatility. In addition, countries should work together to develop and implement international standards on anti-tax avoidance and anti-money-laundering in order to reduce financial risks and inequality. The establishment of a global financial risk early warning mechanism is also an important improvement. Through cross-country data-sharing and risk assessment, potential systemic risks can be identified in advance so that appropriate countermeasures can be taken to avoid the outbreak of crises.

### **6.3. Enhancing national economic resilience**

Enhancing the resilience of national economies is a key strategy for coping with financial crises and other external shocks, aimed at improving the adaptive capacity and resilience of economic systems. By implementing effective policies and measures, countries can reduce the negative impact of financial crises on their economies and ensure sustainable economic development.

Countries should enhance the diversification of their economic structures. A monolithic economic structure is vulnerable to external shocks, especially in resource-based or export-oriented economies. By promoting the development of various industries, supporting small and medium-sized enterprises and encouraging innovation, countries can reduce their dependence on specific industries or markets and increase the resilience of their economies. Establishing a sound social security system is crucial for enhancing economic resilience. A sound social security system can provide necessary support to the unemployed and low-income households and mitigate the impact of economic volatility. Such support not only helps to maintain social stability, but also helps to promote consumption and investment during the recovery period, thereby accelerating economic recovery. Strengthening infrastructure development is also a key factor in enhancing economic resilience. Good infrastructure not only improves the efficiency of economic performance, but also increases resilience to natural disasters and other emergencies. Countries should invest in transport, energy and digital infrastructure to promote sustainable economic growth.

## 7. Conclusion

The causes and effects of the global financial crisis are a complex and profound subject involving a wide range of economic, social and political factors. Comparative analyses of successive financial crises show that common factors, such as excessive leverage, inadequate financial regulation and international capital flows, are often the main catalysts of crises. Policy failures, external shocks and internal vulnerabilities, on the other hand, are unique triggers of financial crises, and these factors have intertwined in different historical contexts to create a complex risk environment. The financial crisis has had far-reaching macroeconomic, financial market and socio-political implications. Issues such as slowing economic growth, rising unemployment, collapsing market confidence and social unrest all pose a threat to the stability and development of countries. Therefore, in responding to the financial crisis, countries should focus not only on short-term economic recovery but also on long-term structural reforms. In order to effectively prevent future financial crises, countries need to strengthen financial regulation and risk control, improve the international financial system and enhance the resilience of national economies. This is not only a requirement for financial market stability, but also an important guarantee of social equity and sustainable economic development.

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