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Analysis of Different Phenomena in Financial Cycles

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Abstract: This paper investigates the phenomenon of financial cycles, charting their history from the early modern period to the present. Financial cycles are repeating patterns of credit and investment expansion and recession. It has also had a huge impact on the economic histories of numerous countries. This essay begins by defining financial cycles and offering an outline of some of the important cycles that have happened throughout history, such as the subprime mortgage crisis and the East India Company. The essay then delves into the relationship between credit and financial cycles, suggesting that credit booms can fuel economic expansion and asset bubbles while simultaneously causing social instability and catastrophes. The paper also explores the influence of financial cycles on different countries, concentrating on the experiences of 18th-century Europe, as well as the United States and China in recent years. The article illustrates via these case studies that financial cycles may have deep and long-lasting consequences on economies and that understanding their dynamics is critical for policymakers and investors alike.

Keywords: financial cycle, subprime mortgage crisis, credit, global financial crisis, political instability

1. Introduction

The financial cycle is an ever-changing phenomenon that can be difficult to comprehend or anticipate. Regardless, certain patterns and facts continue to repeat themselves, providing some insight into what is happening now and what may happen in the future. In this essay, we will look at some of the most pressing concerns that develop during the financial cycle, why they persist, and what we can do to lessen their impact.

The way the financial cycle appears to repeat itself over and over again is perhaps its most noteworthy aspect. Booms and busts, or times of economic expansion followed by periods of recession or depression, appear to be an essential feature of the structure. Though the precise causes of these swings might vary greatly based on a variety of conditions, the system's core mechanics remain the same. Markets fluctuate, investors become thrilled or nervous, credit is provided or withdrawn, and so forth.

One major explanation for this repeat is that many of the same causes that generate financial issues reoccur [1]. (Haberler, G., 2017) When there is too much credit available and too much liquidity in the market, asset prices tend to rise quickly and in an unsustainable manner. When the bubble bursts and financing become scarce, prices collapse, resulting in a cascade of defaults and bankruptcies.

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2. Financial Cycles in Main Economic Regions

One of the greatest economies in the world, the United States has a significant influence on the global economy through its cyclical variations. The volatility of the stock and housing markets in the US is frequently strongly correlated with financial cycles. The US economy had a decade-long boom in the 1980s and 1990s, but a subprime mortgage crisis that erupted in 2008 contributed to the global financial crisis, which caused a severe recession in the US [2]. (Taskinsoy, J., 2019) The government's stimulus programs and monetary easing have helped the U.S. economy gradually recover, but the new crown epidemic's emergence in 2020 has once again caused a recession.

Europe is a region that has a sizable economy, and its cyclical movements are intimately tied to the economic and political developments in the eurozone. The financial crisis that rocked the euro region in 2008 had a significant impact, but thanks to the ECB's monetary policy and the EU's fiscal policy, the economy has been slowly recovering. High unemployment, political unrest, and immigration concerns are just a few of the obstacles that the Eurozone's economy still has to overcome.

Asia is one of the regions with the highest economic growth, and its cyclical shifts are intimately correlated with the trade and economic policies of powerful economies like China and Japan. Although China's economy has grown quickly in recent years, it still confronts several difficulties, including financial concerns, income disparity, and environmental degradation. The 1980s had a decade-long boom in Japan, but the 1990s saw a recession brought on by the bubble economic catastrophe [3]. (Uematsu, T., 1999) Although monetary easing and government stimulus programs have helped Japan's economy gradually recover, it still confronts problems from an aging population and global competitiveness.

3. Rise and Fall of Countries Related to Financial Cycles

The Dutch Republic and Great Britain in the seventeenth and eighteenth centuries are perfect examples of empires that were highly Influenced by the financial cycle. Both countries played important roles in the Age of Exploration and the subsequent colonization of many different regions of the world. One illustration of this was the East India Company, which was essential to the political and economic growth of both countries.

A group of English businessmen who had been granted a royal license by Queen Elizabeth I to conduct business in the East India established the East India Company in 1600 [4]. (Sivramkrishna, S., 2014) A few years later, in 1602, the Dutch East India Company (VOC) was established, and both businesses received trading monopolies with China, Japan, and the East Indies. These businesses were crucial in securing trade routes, establishing colonies, and creating trade networks, and they had a big impact on the colonization of Asia and the Americas.

The financial cycles of each country's economy had a significant role in determining the success of the East India Company and the VOC. The Dutch Republic was one of the richest countries in Europe in the 17th and 18th centuries, and the VOC was the biggest corporation on earth. The Dutch were able to generate significant sums of money to fund their international endeavors because to their well-developed financial markets and robust banking system. They also possessed a powerful navy and were pioneers in shipbuilding, which helped to defend their investments and secure their trading routes. Despite not being as affluent as the Dutch in the 17th century, Great Britain did have a robust industrial base and a developing middle class. The British were successful in gaining a foothold in Asia by utilizing their economic and military might. This was made possible by the East India Company, which established British commerce and political supremacy in the area. Additionally, the British possessed a strong banking structure that enabled them to finance their international business enterprises and expand their empire.

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Both countries' financial cycles were a major factor in the fall of their respective empires. The Dutch Republic started to endure economic collapse in the latter half of the 18th century. The VOC had mishandled its finances and was deeply indebted, which caused a fall in profits and a loss of investor trust. The Dutch government was unable to provide the VOC the assistance it needed since it was likewise deeply in debt. The Dutch economy suffered as a result, and the VOC ultimately failed. On the other hand, the 19th century saw a distinct sort of financial cycle in Great Britain [5]. (O'Brien, P., 2000) The British economy was now the most powerful in the world because to the Industrial Revolution's transformation. However, this resulted in an abundance of commodities and overproduction, which decreased prices and profits. The Napoleonic Wars left the British government with significant debts as well, which caused a financial crisis in the 1820s. The East India Company was likewise deeply in debt, had descended into corruption, and had been run poorly. Investors eventually lost faith in the firm as result, and it eventually failed in 1858. the growth and collapse of each empire were significantly influenced by the financial cycles of Great Britain and the Dutch Republic. The financial stability of their governments was a major factor in the East India Company's and the VOC's success, and those countries' economic and political difficulties were reflected in those organizations' collapse. These businesses left a lasting impact since they were instrumental in shaping the contemporary world and the global economy.

4. Credit Risk and Inflation

4.1. Factors Introduction

Credit risk and the financial cycle are two significant ideas that are highly correlated. In nature, credit risk is the possibility that a borrower may not pay back their loan, whereas the financial cycle is the predictable pattern of growth and contraction of the financial system [6]. (Rajan, R. G., 2006) These two ideas are especially pertinent in the context of inflation since inflation can have a big impact on credit risk and the financial cycle. Credit risk must take inflation into account because it has an impact on a borrowers' capacity to pay back their obligations. When inflation is strong, living expenses rise and it may be harder for debtors to make their loan payments on time. For instance, if inflation increases quickly while a borrower receives a regular income, such as a wage, their real income may decline, making it more difficult to pay back their debt.

Because it impacts interest rates and credit availability, inflation also has an impact on the financial cycle. In order to lower demand and manage inflation, central banks may raise interest rates when inflation is strong. Borrowers pay more for loan when interest rates are higher, which reduces the amount of credit available and slows the financial cycle. In contrast, when inflation is low, central banks may reduce interest rates to boost demand and promote borrowing, which would increase the amount of credit available and quicken the financial cycle. A credit risk assessment's quality is also impacted by inflation. Since inflation impacts borrowers' capacity to repay their debts, lenders may find it more challenging to appropriately determine credit risk when inflation is high.

4.2. Related Cases

Reflecting these two elements into recent facts, nowhere is this more apparent than in the real estate market. Two representative illustrations of the effect of credit on the financial cycle and the real estate market are the US subprime mortgage crisis and China's housing price issue.

US subprime mortgage crisis. First, consider the subprime mortgage issue in the United States. As a result of the United States' housing boom and credit market expansion in the early 2000s, banks and lenders began issuing high-interest-rate subprime loans, colloquially known as "subprime loans," to people with bad credit [7]. (Myers, 2008) However, the repayment ability of these subprime mortgages was low, and a huge number of defaults and loan defaults quickly followed. This

catastrophe not only caused the US financial market to collapse and a global financial crisis, but it also had a significant influence on the US economy and social environment. Millions of people were laid off or lost their homes, housing prices collapsed, and consumption and investment fell.

Many people lost their employment and other sources of income as a result of the economy's slump and the drop in housing prices, which made it increasingly harder for people to pay back their loans. Lenders and banks have been forced to start forcibly seizing homes and auctioning them off as security for other properties. It will be challenging to get financial items like loans or credit cards in the future due to the significant number of American national credit records that have been impacted. This affects people's life in certain ways and makes it difficult for them to borrow money. From the standpoint of the banks, a lot of financial institutions hold a lot of subprime mortgage loans as a result of the over-expansion of the subprime mortgage industry. When these loans default, these institutions incur massive losses, and some, like the top five investment banks in the United States and life insurance giant AIA, risk bankruptcy. Companies were forced to conduct enormous layoffs, and unemployment skyrocketed throughout the crisis. The rise in the unemployment rate has also resulted in an economic recession, because an increase in the jobless rate equals a decrease in consumer power, which has an impact on the entire economic system. Because of increased unemployment and economic insecurity, many individuals have grown anxious. This causes an increase in social tensions, such as rises of social crime, domestic violence, and other concerns that have a direct influence on societal stability. This insecurity has a direct impact on society's general harmony and tranquility, as well as political and social contrasts and conflicts.

The subprime mortgage crisis in the United States has bred distrust in the banking industry and the government. Many people blame the banking industry and the government for the catastrophe, and they have lost faith in these institutions. Concerns about the country's political and economic systems have harmed its image and trustworthiness as a democracy [8]. (Anderson & Tverdova, 2003) More practically, the subprime mortgage crisis forced the government to conduct large-scale rescue measures. In order to prevent the financial system from collapsing, the government deployed a variety of rescue measures, including financial assistance to banks and financial institutions, interest rate reductions, and emergency loans. These relief efforts have placed a significant strain on the government's resources, compelling it to reduce spending in other critical areas including as education, medical care, infrastructure construction, and even scientific research and military investment [9]. (Vollmer, U., 2022) This will affects the public's quality of life, future economic progress, and civilization's evolution.

China's housing price issue. Next, consider the issue of China's home costs. China's real estate sector has always been a popular investment destination. The real estate sector has garnered a lot of attention and funds as a result of China's rapid economic growth and urbanization. However, in the early 2010s, the Chinese government became concerned about the potential of a real estate market bubble and began to implement a series of price-control measures [10]. (Cai et al., 2020)

These measures include enhancing real estate market oversight, limiting the number of houses acquired by home purchasers and the amount of loans, improving land supply, and cracking down on developers who break rules and regulations. The restrictions have caused housing market instability, with prices beginning to decline in certain places while continuing to increase in others. Such swings have an impact not just on China's real estate market, but also on the stability and growth of the Chinese economy as a whole.

The drop in house prices prompted many developers and investors to lose their capital chains and possibly go bankrupt, exacerbating the economic downturn and employment issues. At the same time, because the real estate business is so important, the drop in home prices will have a significant influence on associated industries such as construction, steel, furniture, and others. Furthermore, some people rely too heavily on borrowing to acquire homes, and it is difficult to repay loans when

house prices fall, exacerbating credit problems. Rising house prices, on the other hand, can be problematic. With the rise of housing prices, more and more people rely on high loans to buy houses, which increases the financial risks of individuals and banks. It would be difficult for these people to repay their loans, and banks would also face losses and credit risks if house prices suddenly fell.

In China's political context, abnormal variations in home prices have caught the government's interest, and somewhat aggressive measures have been implemented to curb real estate market fluctuations. The Chinese government has set mandatory limits on money flows and investment options. In the event of real estate market changes, some investors would attempt to gain large returns through the real estate market, resulting in capital flow instability. To combat this insecurity, the government has enacted a number of restrictive measures, including tightening regulations on second-hand housing transactions and prohibiting investors from owning homes in particular cities. On the other side, these policies limited investors' options, as well as the flexibility of the market economy.

5. Conclusion

Financial cycles are critical in determining a country's rise and fall. These cycles' booms and busts can cause rapid expansion and contraction, respectively, and highlight vulnerabilities in the country's economy and financial system. These vulnerabilities can have long-term consequences for a country's economic, social, and political stability.

Countries can enjoy rapid economic growth, rising asset prices, and credit expansion during the boom era. During this stage, optimism and confidence can lead to increased investment and spending. As the boom period proceeds, however, weaknesses in the economy and financial system emerge, potentially leading to imbalances such as excessive debt, overvalued assets, and inflated expectations. The bust phase begins when these vulnerabilities reach a tipping point.

The bust phase is marked by a reduction in economic activity, declining asset prices, and credit tightening. Countries may endure a loss of confidence and increased uncertainty during this stage. As a result, investment and consumption fall, resulting in a downward spiral in economic activity. The severity and duration of the bust phase might vary based on the underlying vulnerabilities and the country's policy response.

The impact of financial cycles on countries' development is significant and the social and political impact of financial cycles is obvious. During the boom period, income and wealth inequality can rise because the advantages of expansion are not dispersed equitably. This has the potential to cause social unrest and political instability. Job losses and reduced earnings can lead to increased social discontent and political populism during the bust phase.

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