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Economic Crises in the Era of Global Financial Integration: Causes, Transmission Mechanisms, Impacts and Policy Responses

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Abstract. With the deepening of global financial integration, economic crises are frequent and far-reaching, which seriously impact global economic and financial stability. This paper focuses on the causes of economic crisis, global transmission mechanism, economic and social impact and policy response. The results show that excessive credit expansion, asset bubble, complicated financial innovation and lack of supervision are the core causes of the crisis; Crisis is transmitted through bank credit contraction, global capital flow linkage, investor behavior contagion and financial network, and the speed is far faster than trade channels; The crisis has caused Gross Domestic Product (GDP) loss exceeding 8%-10%, unemployment rate soaring, social inequality expanding, and a large number of small and medium-sized enterprises closing down, which has caused lasting damage to long-term productivity and social cohesion; Unconventional monetary policy and large-scale fiscal stimulus can alleviate short-term shocks, but it is easy to lead to rising risk appetite, asset bubbles and hidden dangers of fiscal sustainability. The research can provide theoretical and empirical support for improving global financial supervision, building a risk prevention and control system, strengthening international policy coordination, and helping to reduce the probability and impact intensity of future crises.

Keywords: Economic crises, global financial integration, causes and transmission Mechanisms

1. Introduction

Economies have long been regarded as one of the serious problems in modern times due to various negative effects on the growth of the economy, employment and financial stability. There are always problems in history, and the Great Depression and the 2008 financial crisis are typical cases of how financial problems spread across the globe to harm society. These crises have also shown that there are deficiencies in financial institutions and the regulatory system, and now they are worrying the entire world's economy.

The causes of the economic crisis generally fall into the following categories: excessive debt, market failure, speculation and poor supervision. In today's highly connected world, economic problems are spreading from country to country quickly via trade, capital movement, changes in

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investor behaviour, and thus are harder to contain. The various types of crises, such as banking, debt and currency crises, have also been manifested in different ways and thus cannot be attributed to a single cause.

The reasons for how they are spread, and what other harms they cause have all been shown by studies abroad and by history. Monetary and fiscal policy responses to this problem have also been investigated in other studies, and in terms of strengthening regulatory systems, risk management, international cooperation, etc., to reduce financial vulnerability in the future are also being explored.

2. Causes of economic crises

Economies are not the result of a single cause; rather, structural deficiencies and behaviour in the financial system are typically the reasons for these economic crises. One of the main reasons is that too much credit has been extended, and there have been many cases of financial trouble as a result. Given the upcoming period of economic expansion, banks will probably increase the scale of credit and reduce credit requirements to facilitate the flow of funds and support development. Although the above measures will boost economic growth in the short term, they are prone to increasing debt and raising system risk. Evidence from the IMF shows that a sudden increase in the credit-to-GDP ratio is often associated with a higher risk of financial distress in emerging economies, but some scholars do not think that credit expansion alone is the cause of this unevenness [1].

Hyman Minsky's theory of financial instability is still used today to study the reasons for this instability. According to Minsky's theory, in the long run, when the economy has been stable for a long time, people and institutions may become complacent and engage in excessive risk-taking; thus, the level of risk in the financial system will increase. Over time, the system will be less stable and thus more prone to errors. Present empirical data supports the above arguments. Jordà, Schularick and Taylor have demonstrated in their research that an expansion in credit lending will significantly heighten the risks of an impending financial crisis at the level and depth of the economy, and further studies by the Bank for International Settlements have also shown an adverse link between these debt-making-and-repaying cycles and broader systemic risk [2, 3].

Another cause of an economic downturn is a speculative bubble in assets, and this phenomenon has manifested differently around the world at different times. The 2008 Financial Crisis is a typical case in recent history of an economic crisis triggered by inflated asset prices. In recent years, due to the expectation of rising house prices, people took on too much debt to buy houses. As a result of the decline in housing prices, mortgage-backed securities were widely dispersed around the world and then collapsed. The same problems have been raised again recently. While an increase in housing prices can be due to economic development, too fast a rise might also be the result of speculation and an over-heated economy [4].

Credit expansion and asset bubbles are also the result of financial innovation in recent years. At first, the development of complex financial instruments, such as derivatives and securitisation products, aimed to enhance efficiency and allocate risks more widely. However, recent studies by the Bank for International Settlements have shown that these innovations have often increased the lack of transparency and interconnectedness in financial markets and thus may be more difficult to identify and address during periods of market stress [5].

Institutional deficiencies and insufficient regulations have worsened the above problems. According to all the data from the International Monetary Fund, countries with weaker regulatory systems are more prone to financial crises [6]. This is in line with previous occurrences, such as the Asian Financial Crisis; at that time, loose bank regulations and a high level of foreign debt led to a serious financial crisis. Claudio Borio has also pointed out that weak macroprudential supervision at the global level is a serious problem in financial governance [7]. This is likely one of the reasons why, due to structural imbalances and other deficiencies in behaviour and institutions, systemic financial risks continue to rise. Thus, a financial crisis can be regarded as a long-term failure of the current financial system rather than a one-off event.

3. Global transmission and financial interdependence in economic crises

As a result of the expansion of the integrated financial system, the economy has begun to be integrated. Banks are also a link in the chain of crisis transmission and, having taken on the responsibilities of credit expansion and liquidity supply, have played a pivotal role in this regard. When the bank is in financial difficulties, it will generally raise the credit threshold and decrease the amount of extended credit. Based on data from the World Bank, during a banking crisis, the amount of credit provided by banks generally falls significantly, sometimes exceeding 10% of GDP in real terms [5].

There will be many problems due to a reduction in credit. According to a study by the Bank for International Settlements, although tighter financial conditions may reduce the rise in prices to some extent, they often restrict investment and consumption during an economic downturn [3]. Enterprises with high borrowing costs will be unable to expand and will cut jobs; at the same time, households in a tight financial situation will have to reduce their spending and increase savings. A fall in demand will lead to an economic recession, and highly indebted countries that have too many foreign-funded corporations and individuals will bear a considerable burden.

Through integration of the financial system, economic crises are now more likely to spread across countries through international financial channels. Increased global integration has connected the world economy more closely, so problems in one area may be spread to others more rapidly. Rey and others have shown that the world is currently in a stage of financial cycles driven by large-scale monetary policy adjustments in major economies, such as the United States [8]. Moreover, data released by the Bank for International Settlements (BIS) indicate that capital movements around the world often occur in unison and are closely linked [3]. However, the impact of these pathways will differ according to the extent of financial opening and economic stability in individual countries.

History also shows that foreign transmission is worth doing. A reduction in the world economy and protectionist trade policies during the Great Depression significantly reduced international trade and thus made the recession around the world worse. Recently, due to the above problems, financial links have started to transmit shocks through the economy faster than trade links. The crash in financial markets did not follow the full extent of the damage to the real economy from the spread of COVID-19. IMF data show that emerging economies experienced an unusually large capital outflow in a short time, and thus financial uncertainty has spread abroad more rapidly [6].

Behavioural Factors may also be contributing to the spread of the economic crisis. Investors also have certain expectations for the economy and, therefore, will be willing to take risks in the financial market. Based on Shiller's study of narrative economics, when people spread stories and beliefs, they can also affect the economy by changing investors' behaviour in the face of risk [9]. During times of economic turmoil, negative narratives spread rapidly, causing investors to lose confidence in the market and thus reduce investment or sell off stocks. This will increase the risk of market fluctuation and may lead to an extended spread of the financial crisis.

Secondly, the structure of the financial system has been developing increasingly complexly. Recently, some studies on financial networks have demonstrated that risks may spread among institutions and markets through several channels. The Bank for International Settlements has indicated that, in an integrated financial system, a relatively small shock will have a more extensive

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spread across the economy and be harder to foresee and manage in tandem at the level of multiple risks. Although some parts of the modern financial system have shown improvement in terms of efficiency, they are also more complex and thus more prone to risk during an economic downturn.

4. Economic and social impacts

Economic and social harm resulting from a financial crisis may be widespread and persistent in years following the first decline. A problem is also that of the economic depression following the financial crisis. IMF data show that the loss of output after a major financial crisis is often in the range of 8-10% of pre-crisis GDP, and in some cases, recovery may take many years [6]. This may be one reason why some economies have been unable to regain their former growth speeds following periods of financial instability. Although the economy will eventually recover, it will still be relatively low in terms of productivity, investment and confidence for some time.

The labour market will be damaged by economic problems at the same time. According to data released by the International Labour Organization, the considerable reduction in working hours during the COVID-19 pandemic resulted in the loss of millions of full-time jobs around the world [10]. An increase in unemployment is likely to reduce household income, lower consumption by consumers, and thereby slow down economic recovery and weaken aggregate demand. Research by the OECD has also shown that young people, women and those with low-skilled employment are generally more exposed to economic recessions because they are often in unstable or higher-risk employment situations [4]. However, the extent of the negative effects varies among countries due to factors such as their labour protection systems and government support measures.

Financial crises will also exacerbate the problem of social inequality for the poor. According to data released by the World Economic Forum, households with low incomes are generally more exposed to economic fluctuations because they have less savings and are weaker in financial terms [11]. The International Monetary Fund (IMF) has also pointed out that, during a period of economic decline, if a country lacks an all-encompassing social insurance or other weak social protection systems, income inequality tends to increase [6]. In fact, such an increase in inequality may cause social unrest and restrict social mobility for all sections of society during the economic downturn.

Small and medium-sized enterprises (SMEs) in the economy are also likely to face serious problems during times of economic difficulty. According to the World Bank, many SMEs have been seriously affected by the recent economic downturn and are suffering from a lack of funds and credit at present [5]. Since many countries' SMEs are crucial for employment, a prolonged shutdown of these businesses could lead to increased unemployment and a slowdown in the overall economic recovery. At the same time, the extent of these changes will be different based on government support policies and financial assistance availability.

Economic Problems will also have significant Political and social problems due to the financial crisis. Funke and others have shown in their research that economic insecurity and a decline in living standards can lead to increased discontent among the public towards the government, which in turn may result in social unrest or other political turmoil. The World Bank has also pointed out in its research that, in the face of an economic slowdown, poverty and educational disparity are likely to be exacerbated, especially in developing countries that have limited access to resources.

There will be extensive damage in the years ahead of the financial crisis. IMF data show that after a serious economic crisis, the economy does not necessarily return to its previous high growth rate; some are slower in terms of productivity and have experienced a downturn in long-term development [6]. A lower level of investment in education, infrastructure and innovation will further

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restrict economic opportunities over time. Therefore, the financial crisis is not a short-term upswing and downturn but rather a prolonged crisis for the whole country's economy and people.

5. Policy responses and risk management

The responses of various regions to the economic crisis in the past 20 years have been quite different, especially since the 2008 Global Financial Crisis and the COVID-19 pandemic. Governments and central banks have been increasingly willing to intervene in the financial markets to prevent instability and support recovery, as well as a sense that traditional policy instruments will be inadequate in the face of a severe economic crisis.

A typical new kind of loose monetary policy has been used recently: quantitative easing (QE). Based on the Bank for International Settlements, central banks have been using asset purchases and forward guidance more and more frequently to maintain market stability and provide liquidity during times of crisis [8]. The IMF has also reported that quantitative easing programmes have reduced borrowing costs and stimulated investment through increased market confidence [6]. Research by Altavilla et al. has shown that asset purchase schemes in developed countries have improved financial stability, especially in bond markets, at the expense of future financial risks [12, 13].

Fiscal policy also reduced the damage caused by the economic crisis in 2020 and 2021 during the COVID-19 pandemic. The government released an all-round financial relief plan for the people, enterprises and medical institutions in light of the recent economic problems. According to the IMF, the total fiscal support provided worldwide reached over 10% of global GDP and, at the same time, represented one of the largest-scale coordinated policy responses in recent years [6]. Autor and others have also shown that the government provided some support during the pandemic to reduce unemployment and limit the damage from the economic downturn.

Policy responses will also pose problems for the long run, despite being short-term benefits. According to the OECD data, a long period of monetary easing may be conducive to an increase in risk-taking and higher asset prices; thus, financial imbalances will gradually accumulate over time , and at the same time, the growth of public debt has also caused alarm in countries already bearing substantial debt from a fiscal standpoint [14, 15]. As shown by the IMF, in recent years there has been an increase in interest rates, thereby boosting debt repayment pressure and reducing the policy space for the government during an economic downturn [6].

Diversification can still be implemented to reduce financial risks, and bonds are generally considered relatively stable assets in a recession. Based on evidence from the Bank for International Settlements, it is believed that government bonds serve as safe-haven assets during times of market turbulence to protect investor capital and reduce portfolio fluctuations [8]. Recently, however, some serious deficiencies in bond markets have also emerged. Since 2022, rising interest rates around the world have caused a drop in bond prices and thus raised interest-rate risk exposure. The IMF's data also show that during times of uncertainty, liquidity conditions in bond markets are likely to decline sharply and thus cannot serve as protective assets [6].

Although the policy response has reduced the extent of short-term instability to some extent, there are also other trade-offs. Therefore, the management of future crises will require all-weather, comprehensive measures, and prompt responses will be inadequate; strengthened regulation, prudent fiscal planning and all-weather financial risk management will need to be implemented.

6. Conclusion

The reasons for the continued problems of the economy and society at present are not clear. As shown in this essay, the cause of a crisis is rarely due to a single factor; rather, it is usually the result of all sorts of causes such as an increase in credit, financial instability, weak regulation, and increased interconnectedness in the global economy. In recent years, the Great Depression, the 2008 Financial Crisis, the European Debt Crisis and the spread of COVID-19 have all shown that financial problems in one country can rapidly spread to others and cause widespread economic damage.

As shown in the above discussions, the impact of a crisis often extends to all sectors of the economy. Increased unemployment, slower economic growth, greater income disparity and political instability will all cause long-term damage to both society and the economy during a crisis. Money and taxes will be able to solve the current problems for a short time, but other serious issues will still arise, such as an increase in debt and financial instability.

Therefore, dealing with the future crisis will not be solved by a single short-term policy. Strengthen supervision, improving risk control measures, foster overseas partnerships, reduce financial risk and promoting long-term economic development. Although there will be economic crises to some extent, people can study the causes of these problems better and reduce both their frequency and severity of damage.

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