

# Why do crises arise?



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BETTER AND WORSE TIMES



ECONOMIC FLUCTUATIONS



CRISES



CENTRAL BANK'S ROLE AND  
CRISIS PREVENTION





# Better and worse times

## Why do they occur?

Bible: seven years of plenty and seven years of famine

### Natural disasters

- Droughts, floods, earthquakes etc.

### Wars and military conflicts

- Sadly they have accompanied humankind for centuries, and still do ☹️

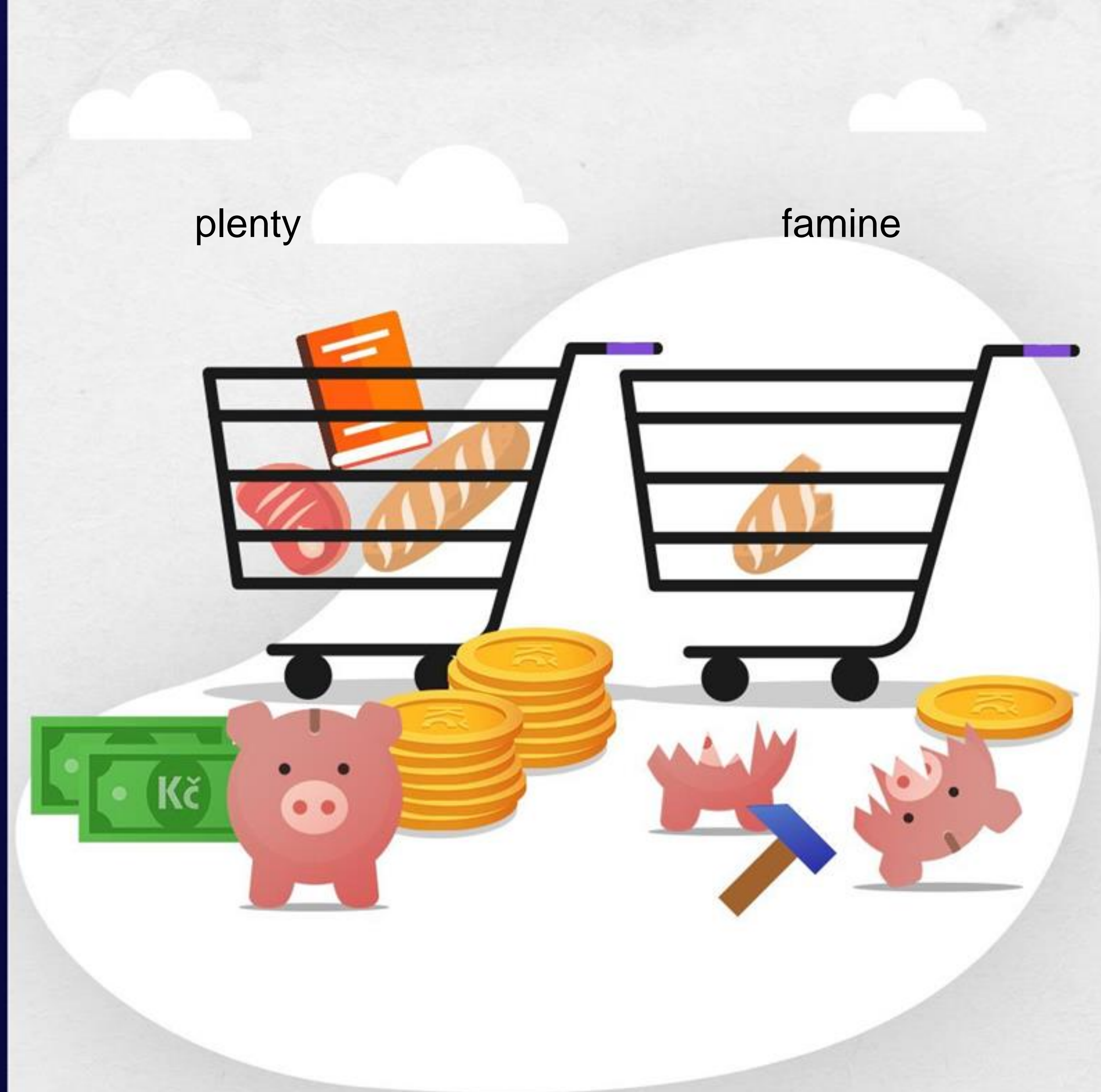
### Diseases

- Plague, cholera, Covid-19

Is it normal that we are better off at some times and worse off at others?

- Yes, it's natural.

**NB! Not every setback is the beginning of a crisis 😊**



# Better and worse times

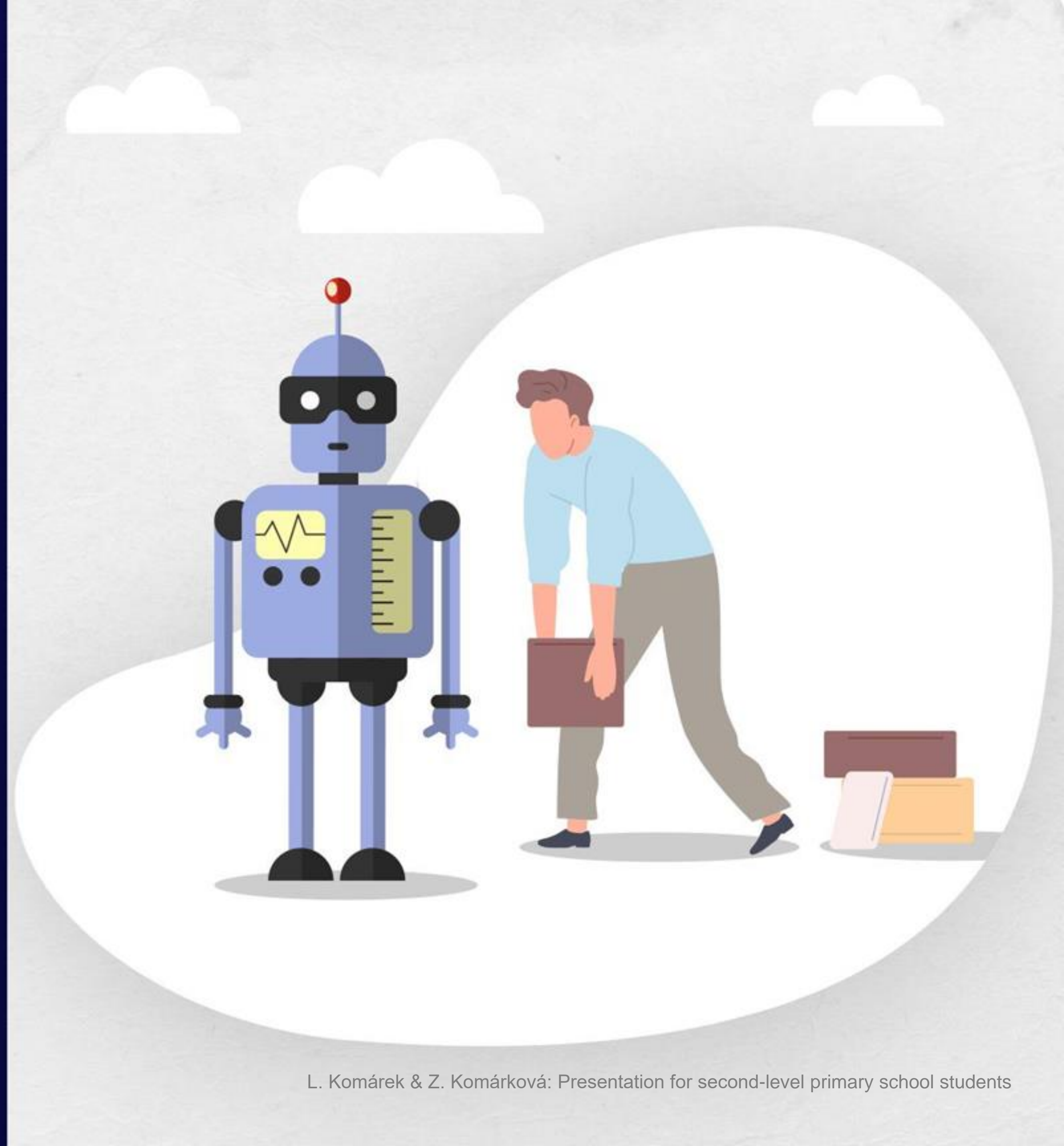
## Why are we sometimes worse off?

### We work less

- We humans are a bit lazy “by nature” 😊
- However, laziness has often led us to wonder how we might do things better and make progress
- We can work less, but in that case we have to be more efficient

### We fall behind the times

- People: poor computer literacy or knowledge of foreign languages...
- Firms: use of outdated production processes (**technology**), low interest in products made or services provided...
- Countries: misgivings about establishing trade links, politics put above economics...





# Better and worse times

## Why are we sometimes worse off?

We isolate ourselves (and don't work together)

- People: two people working together achieve more than two individuals (**synergy**)
- Firms: trade and cooperation lead to more efficient production of more interesting things (**efficiency**)
- Countries: involvement in international trade (such as EU membership) fosters growth in living standards (**cooperation**)

We make wrong choices and have bad luck

- People: born in poor and underdeveloped countries... 😞
- Firms: “bet” on wrong production programme

**NB! Fortune favours the prepared 😊**





# Economic swings

## Can we prevent them?

Unfortunately, market mechanism cannot prevent swings between better and worse times. They are natural

- There are shorter or longer alternating periods of **peak**, **contraction**, **trough** and **recovery**
- It's rather like the four seasons of the year, which also keep alternating in our country

On average, we should be better off in a few years than we are now (unless a crisis arrives)

- Trend curve (arrow) shows we produce more and get better off as time goes by, although sometimes it may not seem so to the individual





# Economic swings

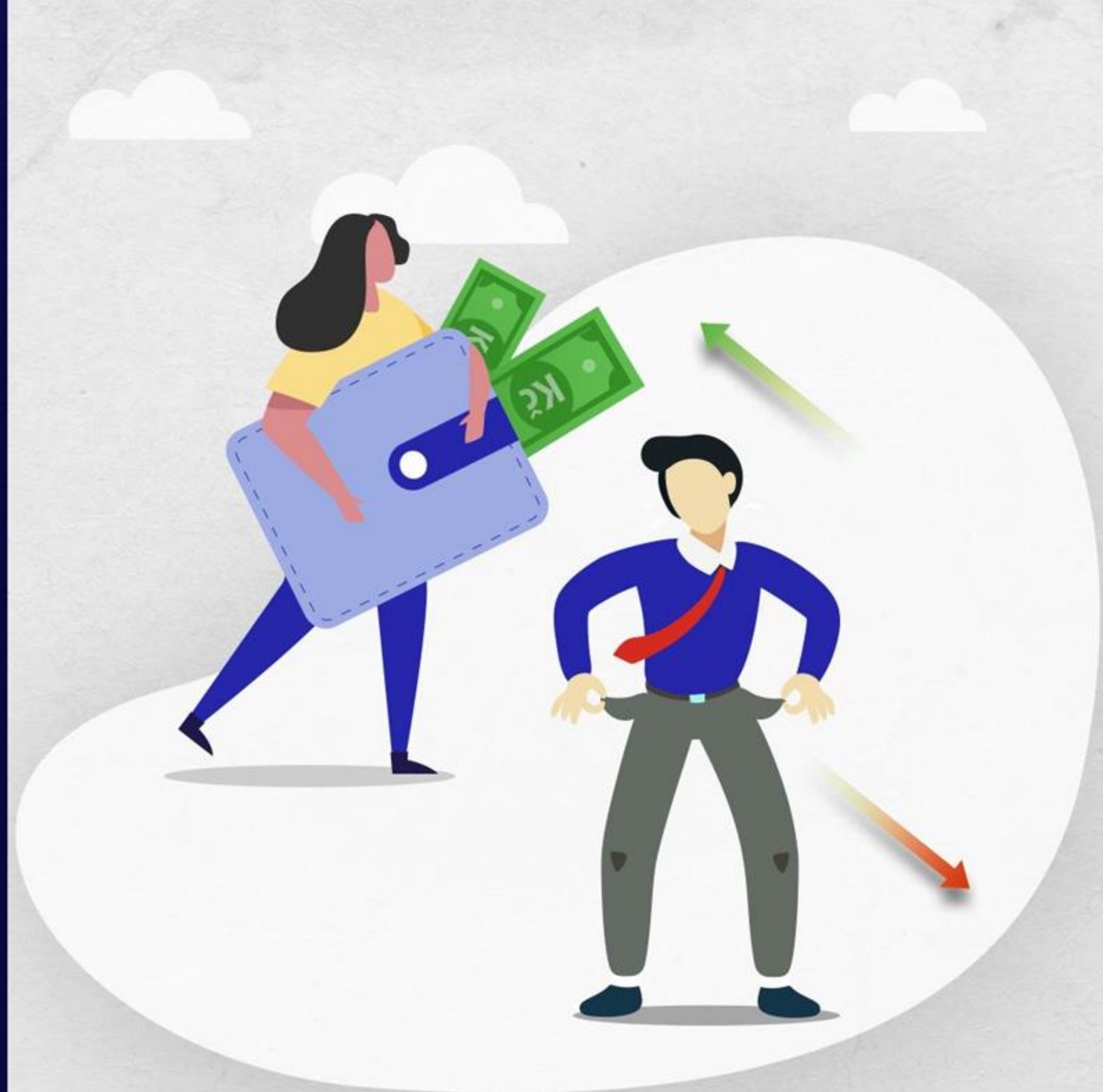
## Why does economy fluctuate?

Because households' consumer expenditure and firms' investment expenditure fluctuate

- People's spending rises → firms increase production (employ more people and invest) → **growth phase**
- People's spending falls → firms cut production (employ fewer people and don't invest) → **contractionary phase**

## Why do they fluctuate?

- Fluctuations in expenditure of people (consumers) are related to how we view future
  - **positive view** → we spend more
  - **negative view** → we save more
- Fluctuations in expenditure of firms are likewise related to firms' optimism and profitability of planned investments, need to replace "old" investments (machines) with new ones, (in)correctness of previous investment decisions, and domestic and foreign economic outlook





# Crises

## What is a crisis?

What situation is officially regarded as a crisis?

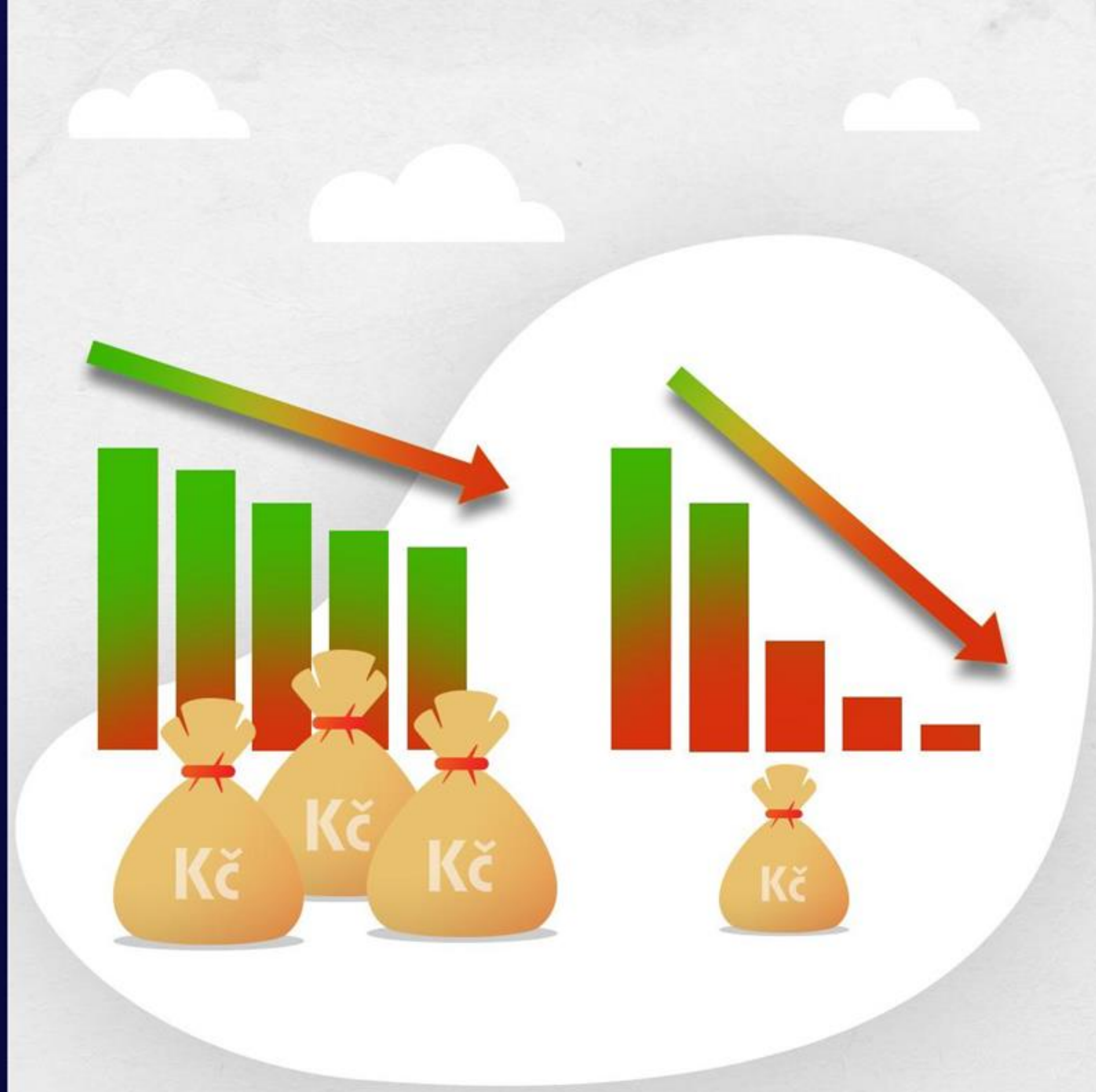
- **recession**: if contraction lasts at least two quarters
- **crisis**: if contraction lasts more than four quarters

But we know that no two “crises” are the same...

- **crisis**: I am badly off but my neighbour is quite well off (Czech Republic is faring badly, but, say, US, Germany and Netherlands are doing okay)
- **crisis**: I am badly off and other people are also much worse off than before (Czech Republic is faring badly and other countries are too)

How do they arise most often in modern times?

- No longer due to natural disasters or disease (except for Covid-19), but to **behaviour** of people, firms or financial sector (banks, insurance companies, pension funds...)





# Crises

## Why do they occur?

### Financial market collapse

- Crisis of confidence: breakdown of trust
- Examples: 1930s global crisis (Wall Street Crash), 2008 financial crisis

### Government bankruptcy due to excessive debt

- Country becomes unable to meet its obligations
- Examples: Argentina, Brazil, Venezuela

### Wars

- Local or global conflicts
- Examples: Balkans, Syria, Lebanon

### Anti-epidemic measures

- Temporary “lockdown” of economy
- Examples: Covid-19, Spanish flu, plague

**NB! Confidence is hard to win but easy to lose.**





# Crises

Often we have ourselves to “blame”...

## Government errs

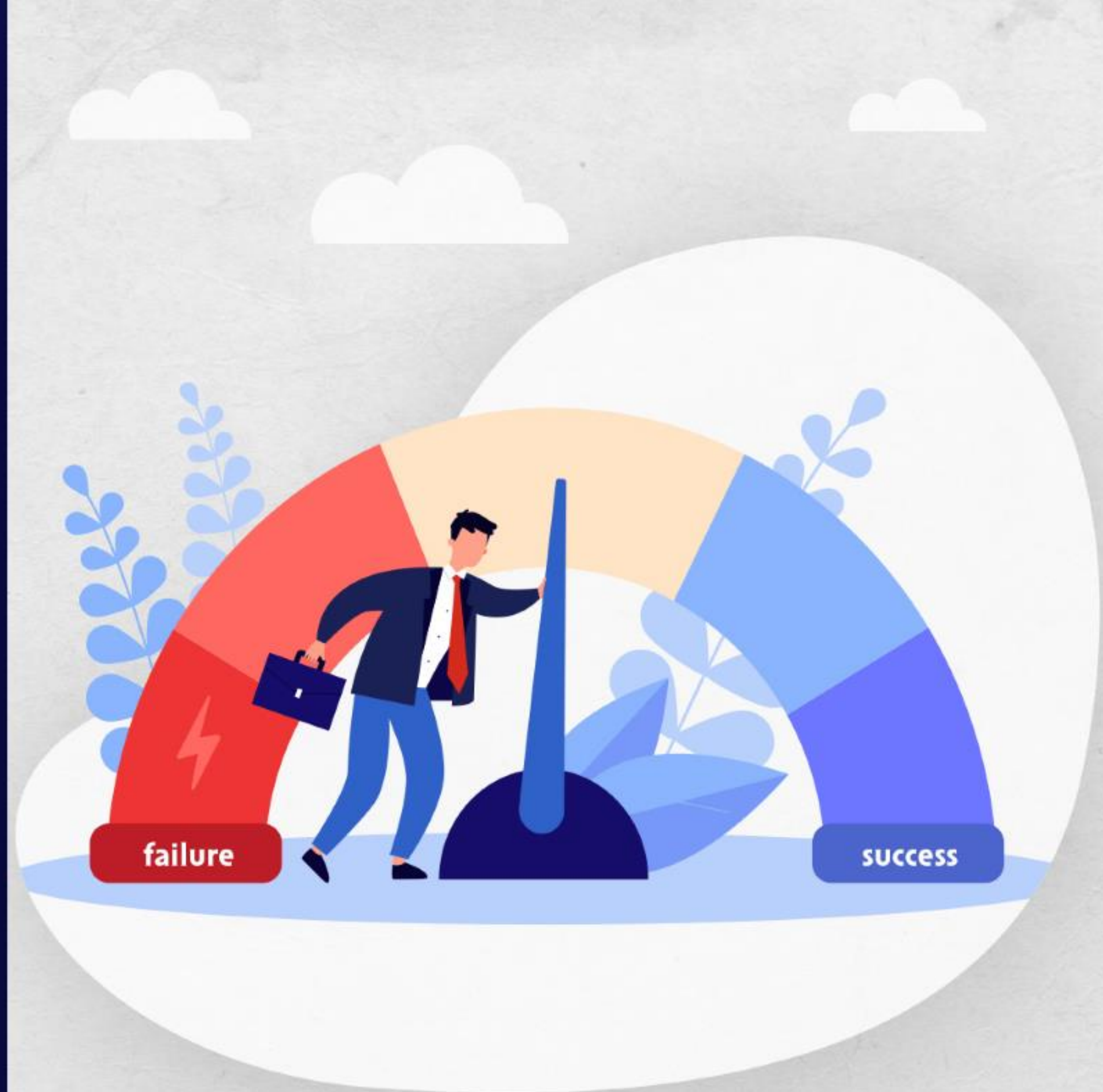
- Excessive debt, wrong tax setup, delayed pension reforms etc.

## Central bank errs

- Incorrect (sub-optimal) monetary policy when setting **interest rates** and **exchange rate**, regulation and supervision of financial institutions (banks) etc.

## Creeping (seemingly small) failures in country

- **Productivity** (how much we can produce at same cost and in same period) declines
- Domestic firms lose competitiveness (foreign **competitors** have greater success)
- Outdated legal rules (e.g. for employing foreigners)





# Crises

...while other things aren't our "fault"

**Openness of economy** should be major benefit for people, firms and whole country

Vast majority of countries cannot influence global trends, but global trends can influence them

- Price/trend takers – vast majority of countries
- Price/trend setters – only global powers such as US, China and euro area (to limited extent)

Indirect impact of crisis on small open country is often stronger than direct one

- Direct impact on Czech Republic: lack of interest in Czech products
- Indirect impact on Czech Republic: lack of interest in, say, German products containing Czech components





# Crises

## Stock market crisis (stock price slump)

One possible cause of financial crisis

Drop in stock prices

- Example: Onset of Great Depression: stock market collapse in 1929 → global crisis and an indirect cause of World War II
- Example: Drop in technology stock prices in 2000 to one-quarter of original price → stockprice collapse causes decline in wealth of investors (and also of ordinary citizens in countries like US) → funds withdrawn → people buy less and firms make less (and some go bankrupt) → recession → crisis





# Crises

## Stock market crisis (stock price slump)

Investors are increasingly investing regardless of geographical borders

- Positives: greater investment opportunities for investors, greater opportunities for domestic firms
- Negatives: potential “contagion” to domestic economy, greater anonymity
- Holds true for investment not only in shares, but also in government bonds, commodities (gold, oil, industrial metals), property, **cryptoassets** etc.

**NB! Investing in shares and other assets may generate higher returns but is associated with greater risk.**





# Crises

## Currency crisis

(drop in value of currency)

One possible cause of financial crisis

Reflects deeper problems in country

Very fast decline in currency's value relative to reserve currencies

- Currency weakening is “good news” for exporters and “bad news” for importers
- Currency may weaken for very many reasons, as exchange rate reacts to almost anything
- **Reserve currencies:** \$, €, ¥, £





# Crises

## Currency crisis

(drop in value of currency)

Sharp decline of currency causes widespread uncertainty

- Generally bad for business

Foreign currency debt = problem squared

- Sharp weakening of currency can be devastating for country, firms and people if debt is denominated in foreign currency (usually dollar or euro)

Sharp strengthening against reserve currencies is also bad for country, firms and people

- Strengthening of currency is “good news” for importers and “bad news” for exporters

**NB! Borrowing in foreign currency is much riskier.**





# Crises

## Mortgage crisis (drop in property prices)

One possible cause of financial crisis

Extremely low interest rates motivate people to borrow more

Property is often purchased not to satisfy own housing needs but to make money in future

- Very low interest rates inflate **price bubble**: more people can afford to buy property, so house prices keep rising
- Example: prices of property (land, houses, apartments) go up by 15% a year; people buy property to generate returns, not to live in themselves





# Crises

## Mortgage crisis (drop in property prices)

Many households don't realise that interest rate (at which they borrowed) may go up again

- Fast and substantial growth in interest rates has appreciable effect on households with mortgages
- Example from recent history: US central bank (Fed) hiked its interest rate from 1% to 5% → people gradually became unable to repay their loans → house sales dropped → house prices fell → houses were returned to banks (banks incurred losses) → banks went bankrupt → economy fell into crisis

**NB! Property prices can also go down.**





# Crises

## Debt crisis (unsustainable debt level)

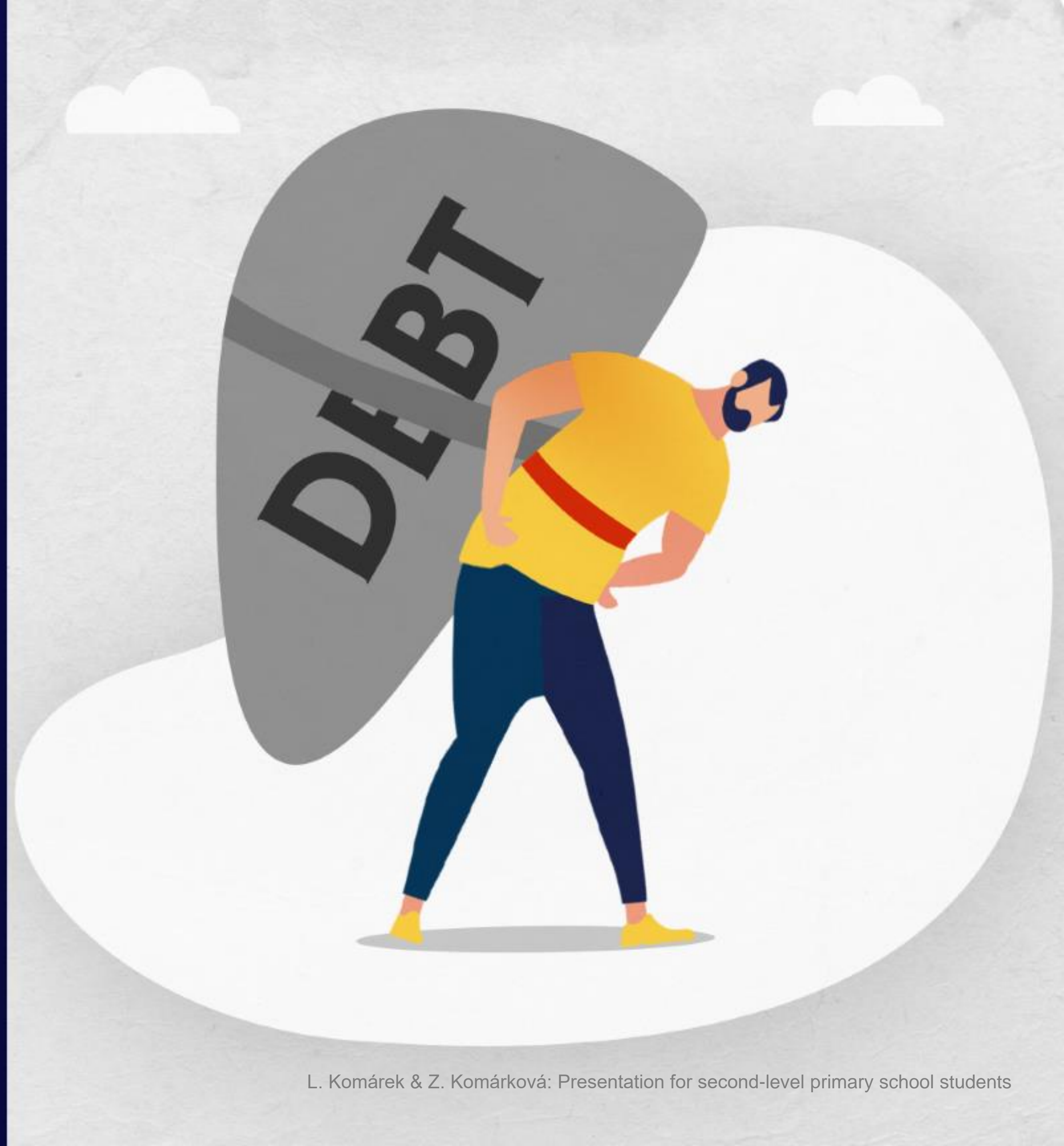
One possible cause of financial crisis

Irresponsible behaviour by governments  
= rising debt

- Debt is good servant but bad master

### Government bankruptcy:

- situation where government fails to repay its obligations in time or announces it will not repay them (fully or in part)
- Historically this has happened mainly after lost wars or political coups
- Historical examples: France (1815), Russia (1917)
- Recent examples: Argentina (2002), Iceland (2008), Ecuador (2009)





# Crises

## Debt crisis (unsustainable debt level)

Extremely low interest rates enable governments to take on more debt than necessary

- Government borrowing for investment: reasonable
- Government borrowing for consumption: unreasonable

### Debt:

- Prudent (up to 30% of value generated by country per year = GDP)
- Acceptable (up to 60% of GDP)
- Risky (around 100% of GDP)
- Unsustainable (over 150% of GDP)

**NB! Debt is a burden on overindebted countries and limits their development.**





# Crises

## Epidemic crisis

Dilemma between protection of individuals' health and running of economy

**Lockdown** is very costly in economic terms and unsustainable in long run

- Economy comes to halt or slows down → lower income of people, firms and government → job losses and less money in health care → worse health care
- Smart quarantine and vaccination are crucial
- High-risk groups and their protection
- General prevention of panic (fighting invisible enemy)

**NB! A virus knows no borders.**





# Central bank's role

What is the central bank required to do?

Maintain price stability and financial stability

- Stipulated in Czech Constitution and Czech National Bank Act
- In some countries divided between several institutions

**Price stability:** ideally 2% growth in prices in the economy

**Financial stability:** stability of financial sector as a whole (banks, insurance companies, pension funds) and property market





# Central bank's role

## Achieving price stability

Inflation is going to be above 2% and economy is going to overheat: central bank raises interest rates

Inflation is going to be below 2% and economy is going to overheat: central bank lowers interest rates

But what if interest rates cannot be lowered?

- Announce “verbal commitment”
- Weaken koruna exchange rate
- Buy **securities**
- Support corporate financing
- Negative interest rates (-X%)
- ...





# Central bank's role

## Achieving financial stability

Paradox: seeds of financial crises are sown in good times, i.e. times of plenty

Central bank can:

- make banks and other financial institutions create appropriate **buffers**
- affect housing and mortgage markets:

**LTV** ≈ am I taking out excessively large loan?

**DTI** ≈ will I be overindebted?

**DSTI** ≈ will I be able to repay?





# Crisis prevention

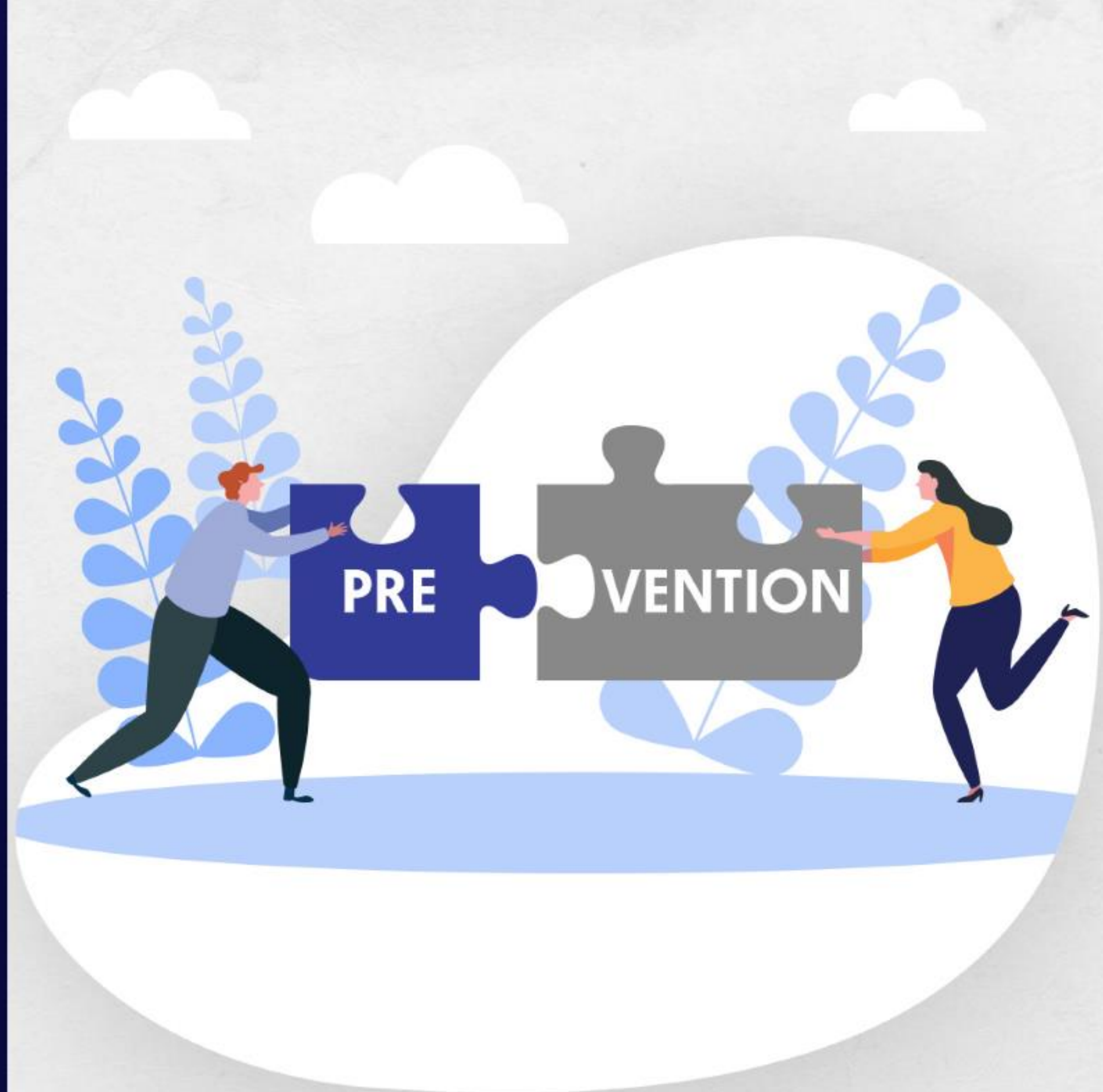
What has changed in 50, 100, 200 years?

## Globalisation and role of international trade

- In past: regional trade between neighbouring countries
- Now: worldwide trade
- Result: greater wealth (countries produce what they do best) but lower self-sufficiency
- Problem of costs and unfair dumping prices: insufficient pricing-in of current and future environmental costs associated with production, **fair trade**,...

## Information, digital era (internet)

- In past: very limited access to information (rising over time)
- Now: find out almost anything from mobile in mountains...
- Result: great opportunities, several times higher vulnerability and shock transmission





# Crisis prevention

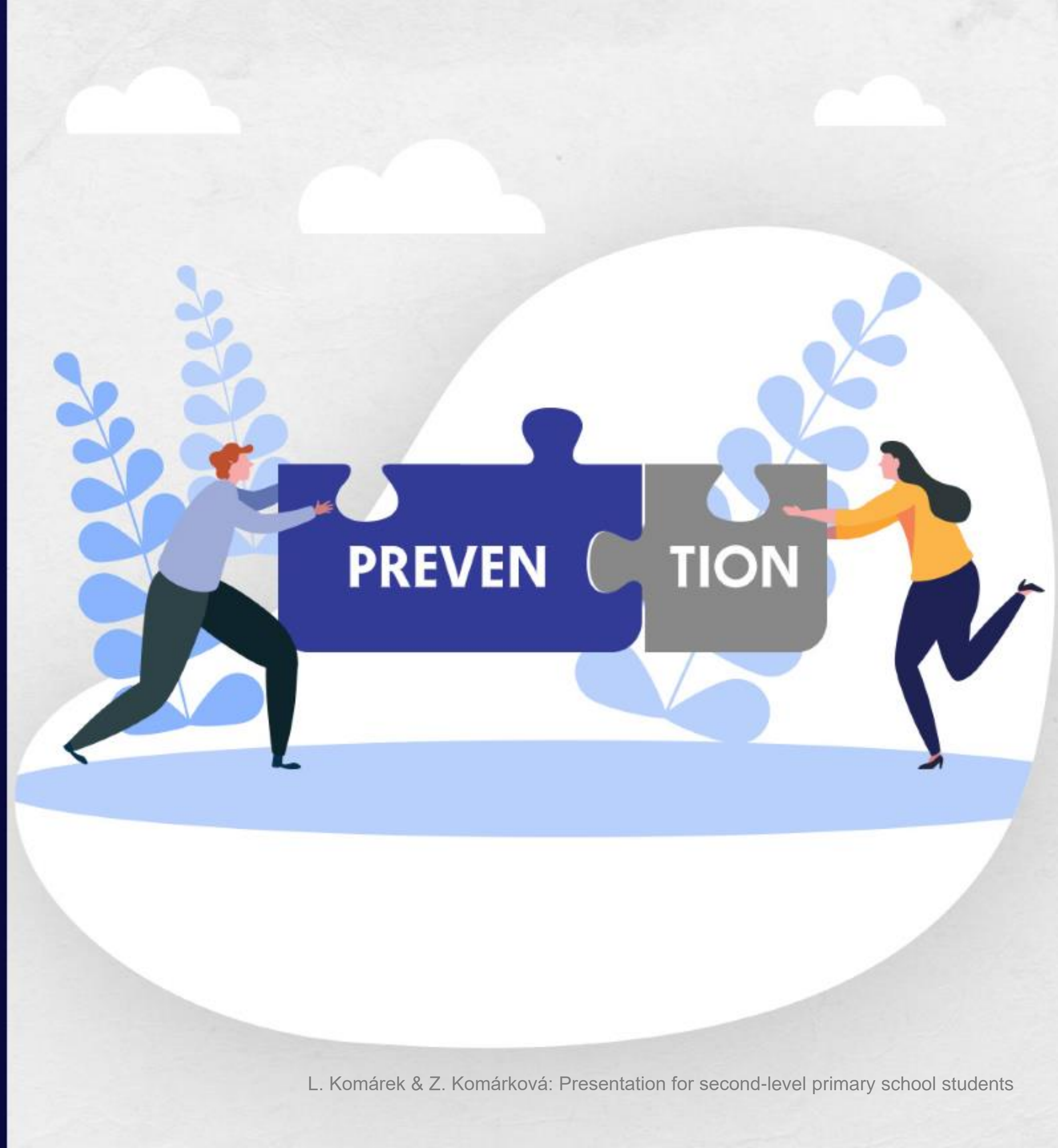
Individual, family, firm...

## Individual and family

- work
- don't buy everything they want
- save for "worse times" = create financial reserve
- manage personal finances responsibly (**7:2:1 rule**)

## Firm

- invests prudently
- does business prudently (diversifies) and **spreads risk** ("don't put all your eggs in one basket")
- monitors market and competitors
- treats its employees well (especially key ones)





# Crisis prevention

## Government, central bank...

### Government

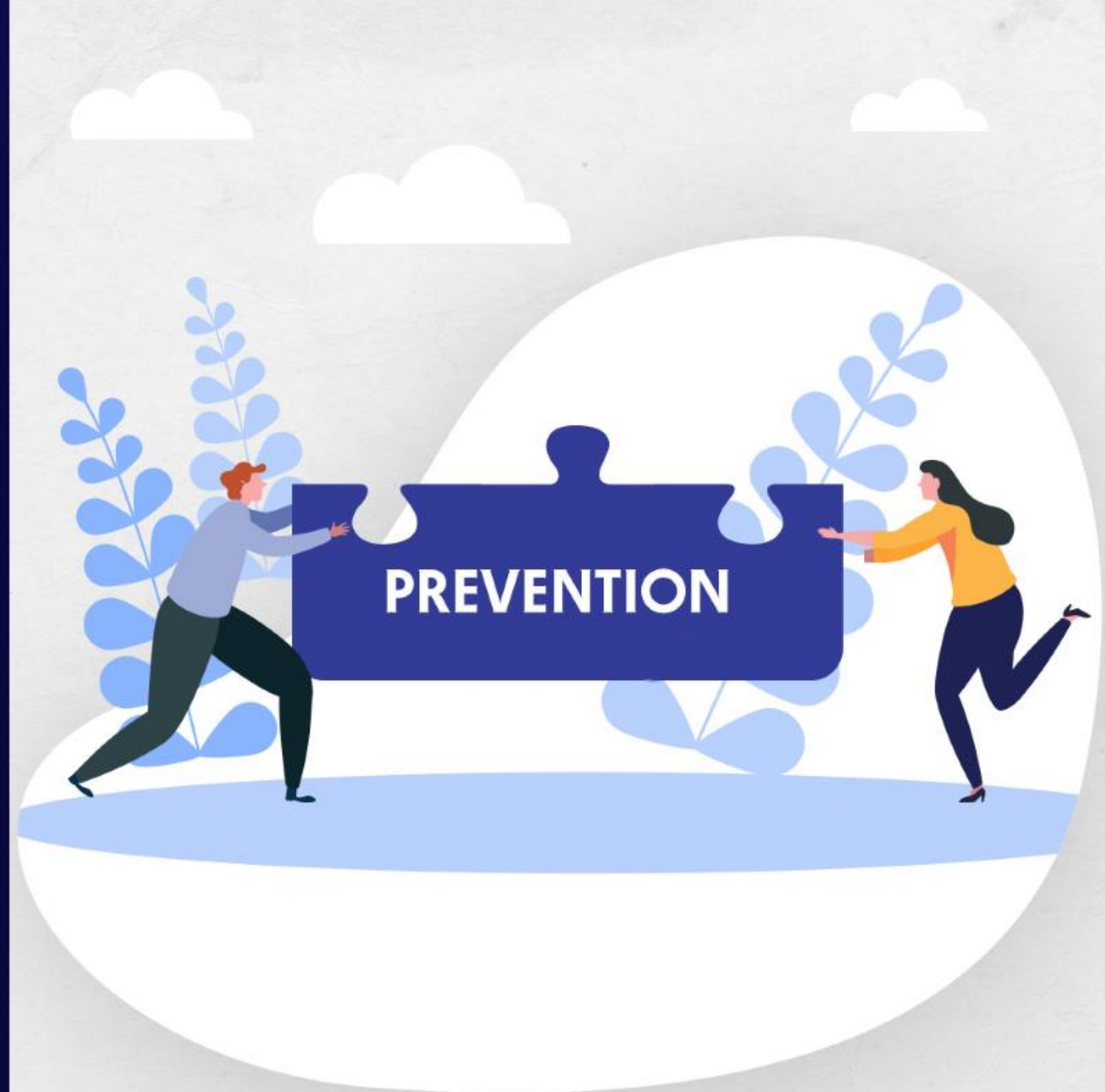
- maintains sound **public finances** (doesn't take on excessive debt)
- invests (environmentally)
- fights corruption
- looks to future = conducts countercyclical policy

### Central bank

- fulfils its mandate (price and financial stability)
- supervises carefully and regulates sensitively
- looks to future = conducts countercyclical policy

### International organisations

- help countries to sign agreements
- help solve global problems





# Authors of presentation

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