Chapter 16

Waves of Financial Crisis: History Repeats Itself?

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ABSTRACT

Historically, stock-market crashes and the resultant panic have ended in ultimate devastating impact on the real economy. Proper macroeconomic management and accomplishing macroeconomic objectives require, in terms of depth and width, sound health of financial system. Financial fragility is often taken as a prime factor in generating and aggravating crises. Moreover, with extensive economic integration, crises in one market immediately affect others through dynamic interlinkages or “contagion”. Hence, at this juncture, inquiry into market dynamics becomes crucial. This chapter intervenes here focusing on two past significant stock-market crises namely, the dot-com bubble and the melt-down of 2007-08. The chapter found significant volatility transmission channels primarily through past-volatility impacts. In recent era of fluctuation and instability, stock-markets are more integrated through strong and positive innovation and past-volatility impacts. The news-impacts, however, are less intense than past-volatility impacts. Moreover, even with increasing financial integration, there remains a basis for global portfolio diversification.

INTRODUCTION

The old debate on finance-growth nexus started with Bagehot (1873) and Schumpeter (1912) who emphasized financial sector’s potential in promoting economic growth. Subsequently, a school of thought emerged that hailed the finance-growth nexus where financial development leads future growth, capital accumulation, and technological change. Gurley and Shaw (1955), Goldsmith (1969), McKinnon (1973), and Levine and Renelt (1998) shared and emphasized this view. An antithetical view however always ran parallel that conjectured finance to be a “side-show” of growth: any correlation between financial development and growth results only from growth-leading-development. Recent era is witnessing resurrection of the issue. Recent global stock market crashes, the resultant panic and their ultimate devastating impact on the rest of the economy has sparked enthusiasm among researchers regarding the dynamics of the financial market. Economic literature often

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hails that proper macroeconomic management and accomplishing macroeconomic objectives require, both in terms of depth and width, sound health of the financial system. Financial fragility is often identified as a major factor in generating and aggravating crises. It shatters participants’ confidence and impedes the ability of financial markets to act as intermediary between the savers and investors. Moreover, given the high degree of trade and financial integration, crises in one market set in motion turmoil in others through long-term and short-term dynamic inter-linkages. These justify the exploration of market dynamics. The price generating mechanism, the factors determining stock-prices, the possibility of having bubble-determined prices, stock-price volatility and its possible propagators are gaining analytical as well as policy significance, particularly after the East-Asian crisis, the dot-com bubble and particularly, the first financial melt-down of the twenty-first Century.


THE TWO FINANCIAL CRISES OF RECENT PAST

The last few years of the twentieth century witnessed significant development of knowledge and knowledge-based products and services that