
**MODEL EXPLAINING THE LIKELY IMPACT OF ECONOMIC
CRISIS ON AN ECONOMY**

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(India).DOI: <https://doi-doi.org/101555/ijarp.9990>**ABSTRACT**

This paper is a conceptual and theoretical paper where author tried to develop and propose a model explaining the likely impact of economic crisis on an economy. Discussion on the Model is suitably supported through the relevant literature to justify this model's path progression of the economic crisis. This Proposed Model shows the probable path of progression of economics crisis and explains how the Economic crisis affects an economy and further the authors identified the strategies and policy options available to mitigate the effects and impact of the crisis.

JEL Classification: E320, E370, E62

KEYWORDS: Economic Crisis, Impact of Economic Crisis, Progression Path of Economic Crisis, Model.**INTRODUCTION**

Knowles et al. (1999) suggest that the crisis provides a rare opportunity to learn and understand how existing social systems function in duress. The experience gained during the Crisis can provide a useful guide to policymaker. In the present crisis due to covid-19, it becomes significant to understand the how the economic crisis caused by COVID-19 and lockdowns worldwide, can affect the various sectors of the economy. Covid-19 created unprecedented crisis and left the world in great economic stress affecting both lives and employment. The global economy has faced an unprecedented slump and it produced a great contraction in demand. According to Keynes when demand for goods and services falls, production is adjusted accordingly. Wages are lowered and people are laid off to cut costs

due to lower production and sales. As unemployment starts to rise, the people who lose their jobs further cut down consumption and the economy traps in a vicious cycle.

According to International Labour Organisation year 2020 Accounted for 71 per cent of global employment losses. While according to Congressional Research Service Report (CRS, 2020) in USA in April 2020, the unemployment rate reached 14.8%—the highest rate recorded since data collection started in 1948 and labour force participation rate declined to 60.2% in April 2020, the highest levels since early 1970s.

According to UN, the crisis caused by COVID will push global unemployment over 200 million mark in 2022. ILO in its World Employment and Social Outlook: Trends 2021, (WESO Trends) also projected a “jobs gap” increase of 75 million in 2021. According ILO five years of progress for eradication of working poverty were wasted due to Economic Crisis by COVID-19. The worst-hit regions in the first half of 2021 were Latin America and the Caribbean, Europe and Central Asia. There have been estimated working-hour losses exceeding eight per cent. Compared to 2019 an additional 108 million workers worldwide were categorized as “poor” or “extremely poor” –living on the less than \$3.20 per person per day.

Social policy focussing on assistance provided by public financing at a high cost may have limited impact in poverty reduction, in fact there are intrinsic limitations to such policy which leads to fragmented and ineffective programs (Castillo *et al.*, 2016). It is very important to take appropriate measures to minimize the negative impact on the employments of the poor and their incomes. It is advisable to implement some programmes for creating employment and protect the incomes and improve the living conditions of the poor during any economic or financial crisis (Islam, 1998).t is also advised that firms and entrepreneur should become resilient. Resilience is the hallmark of an entrepreneurial skill that helps companies to survive, sustain and grow stronger in the times of challenges and crisis (Castro & Zermeño, 2020)

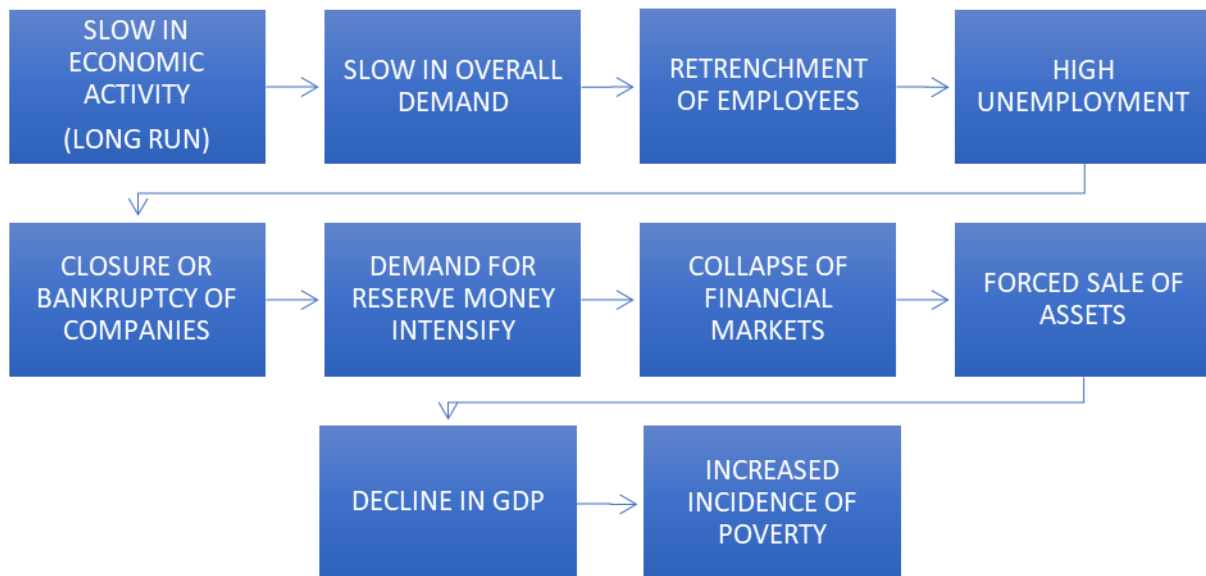


Figure 1: Model Explaining the Likely Impact of Economic Crisis on an Economy.

Progression of the Model: Unemployment increases manifold during crisis. Due to slow in overall demand and economic activity, companies start retrenchment or laying off employees which has multiplying effect on unemployment ultimately economic crisis leads through various stages to decline in GDP and **increased incidence of poverty**.

Discussion on the Variables of the Model

Slow in Aggregate (Overall) Demand: Slow in overall demand is generally a precursor of recessions and economic crisis. Economic crisis caused by COVID-19 led to slow-down in domestic demand (Kumar Das & Patnaik, 2020).

Slow in Economic Activities: Economic Activities significantly slow down during economic crisis which impact the revenue and ultimately the profitability of the business organisation. (Papatheodorou, & Arvanitis, 2014) study in Greece confirmed that during deep recession caused by financial crisis deep recession significantly affected the majority of economic activities in all sectors of the economy, vis. primary, secondary and service sector. During crisis business activities may be offshored to low cost and low wage areas to bring economies in the operations.

Retrenchment of Employees: Economic crisis leads to large scale of redundancies in job market, particularly in industries specifically in manufacturing consumer durables (Blažek *et al.*, 2020). Which forces job losses even furthering repayment defaults rates in affected

regions. Job losses and decline in labour input has serious consequences as lower output and income was observed in some advance economies (Ohanian, 2010). Economic crisis led job contraction in some sectors in United States (Papadetriou & Terrazas, 2009). Bratsberg *et al.* (2010) study showed that disability insurance claims in Norwegian economy could be attributed to job losses or displacement and other shocks to opportunities of employment.

High Unemployment: Economic slowdown or economic decline increases unemployment rate (Munangagwa, 2009). Economic and financial crisis not only increases the rate of unemployment but also underemployment (Islam, 1998). Job and income losses, pose strains on households' livelihoods and thus exacerbate the challenge of job-creation specifically in the formal private sector (World Bank, 2020). Also, the crisis has negative effects on national and regional development indicators (Đokić, & Rašić Bakarić, 2016). Even the financial crisis negatively impacts the overall economy and labour market. Abdullah & Nagah (2009) investigated the Malaysia economy and found that the global financial crisis negatively impacted the overall economy and the labour market. Hall (2010) examined the relationship between output and employment after a financial crisis and found that output and employment remains low for many years after the crisis.

Closure or Bankruptcy of Companies: During any economic crisis there is great pressure and distress on the business. It becomes rather impossible to sustain during such times, if there is not sufficient reserves available. During 2008-09 economic crisis, plants and companies were closed and even some were relocated to low cost- low wage producing areas (Pavlínek, 2015). Bankruptcies and closures are also reported during this economic crisis caused by the COVID-19 (Wang *et al.*, 2020).

Demand for Reserve Money Intensify: Demand for Reserve money that is money parked with banks and other financial Institutions within the country or with international financial institutions like country's reserve money with International Monetary Fund increases and intensify during any economic crisis, may be because credit creation capacity of banks collapses and even commercial bank credits and non-bank financing also reduces during economic crisis (Gunter, 2010). During the economic crisis, credit is constrained (Bartlett & Prica, 2011) and credit supply constraints aggravates the sharp decline of syndicated lending. Chui *et al.*, (2010) conducted an econometric analysis and confirmed that constraints of international banks' balance sheet played a significant role in the collapse of syndicated credit lending. During 2008–09 Economic crisis, consumer credit was severely restricted (Palvinek, 2015). Demand for international reserves emerges as a self-insurance when the economy becomes susceptible to sudden stops so that long-term projects costly liquidation

could be avoided (Aizenman & Lee, 2007). Crisis that increases the volatility of shocks and loss aversion, will significantly increase the demand for reserves also for international reserves (Aizenman & Marion, 2003).

Collapse of Financial Markets (Banks and Financial Institutions): During financial crisis of 2008-09 which caused economic crisis, many financial intuitions were collapsed and financial market fell to its knee (Acharya & Richardson, 2009) Economic crisis caused the COVID-19 pandemic also impacted financial systems through its enormous economic costs (Goodell, 2020).

Forced Sale of Assets: During economic crisis Of 2007-08, firms were forced to sell assets because of the banking panic, which reduced bond prices and created losses (Gorton, 2010). Forced sale value of financial or mortgage assets may not be as market value of the assets (Canesi, et al., 2016). Value of forced sale not only of mortgage assets but also of real states or houses is lower than the market value (Campbell *et al.*, 2011).

Decline in GDP: Economic crisis creates a great amount of uncertainty about GDP Growth rate, in fact GDP growth rate declines sharply during the crisis and have natural consequences for employments (Islam, 1998, and Said & Widyanti, 2002). The last global economic crisis which spread from the subprime crisis of United States of America into other developed and developing countries negatively impacted Nigerian financial markets, triggering instability in the banking and capital markets forcing Nigerian central bank to inject more than 2.72 billion US\$ to forestall systematic collapse of vulnerable banks (Igbatayo, 2011). During this global economic crisis, the world economy was hit hard by a decline in real GDP (Hein & Mundt, 2013)

Increased Incidence of Poverty: It is claimed that a fall in growth of 1% may force 20 million people into absolute poverty (Gunter, 2010, World Bank 2008). Economic crisis caused the poverty rate to increase significantly in Indonesia and even it led to increase chronic poor category (Suryahadi & Sumarto, 2003). Economic crisis particularly Global economic crisis causes fall in economic growth (Ahmed & Donoughue, 2010). Ahmed & Donoughue, (2010) results suggested that the poverty headcount ratio was also likely increased. Dagoumas & Kitsios (2014) assessed the impact of the economic crisis even on energy poverty in Greece. energy poverty is electricity consumption per capita which decreased due to economic crisis. Nambissan (2010) research suggested that the economic downturn had likely resulted in a large number informal sector workers slipped into poverty. Poverty increases during economic crisis or financial crisis (Skoufias & Suryahadi, 2000, Said & Widyanti, 2002 and Balisacan *et al.*, 2010). It is argued that the pace of poverty

reduction also slows down during the crisis (Bauer & Thant (Eds.), 2015). Due to the Covid-19 which slowed down economic activity worldwide and caused economic crisis in many parts of the world trapped almost one fifth population in developing countries particularly in Africa in extreme poverty. And many poor communities in various parts of the world suffered and faced very challenging situations of socio-economic with livelihood consequences (Buheji *et al.*, 2020).

Strategies and Policy Options to mitigate the effects of economic crisis

Once we identify that there is a crisis in the economy particularly caused by low demand and slow in economic activities not caused by other external phenomenon (like major sudden outbreak of disease such as COVID-19 and SARS etc or War, and it could be any phenomenon), We need to have some strategies or policies in place which can reduce, mitigate or eliminate the losses caused by the economic crisis.

Author has identified some strategies and policy options which can help to minimise the risk associated with the crisis which are given in the following diagram and described below:

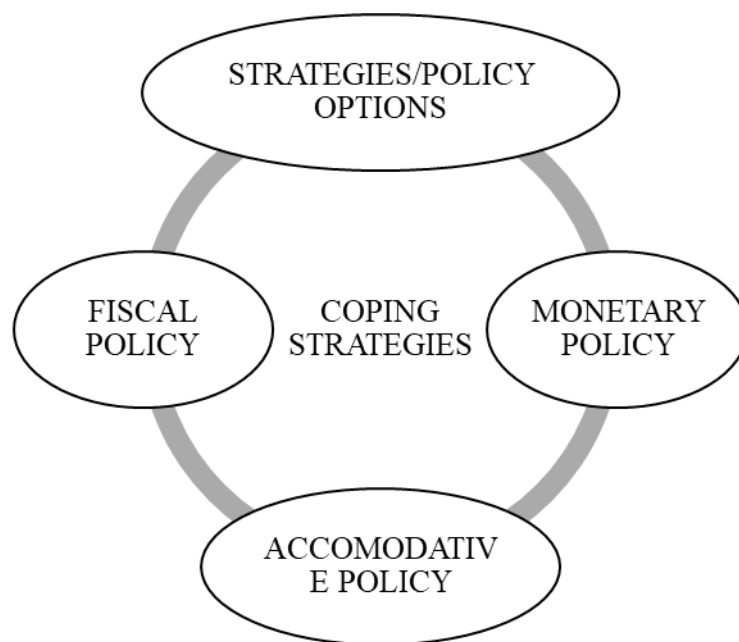


Figure 2: Strategies To Mitigte the Effect.

Monetary Policy: The monetary policy, which is the responsibility of the Central Bank, includes:

- Interest rates,
- The cash reserve ratio, and
- The statutory liquidity ratios.

Lower interest rates stimulate the economy by increasing the demand for interest-sensitive spending which includes:

- Investment spending,
- Residential housing, and
- Consumer durable.

Further lower interest rates would stimulate the economy by reducing the value of the currency which would lead to higher exports and lower imports.

Fiscal policy: Fiscal stimulus can take the form of higher government spending (direct spending or transfer payments) or tax reductions.

Accommodative Policy Measures: Accommodative policy measures are also adopted by the national Government such as:

- Substantial liquidity support,
- Explicit government guarantee on financial institutions' liabilities and
- Forbearance from prudential regulations.

Coping strategies: Sumner and Wolcott (2009) explored the diverse coping strategies that poor people may adopt for survival, such as:

- Reducing consumption of food,
- De-schooling and
- Postponement of medical treatment.

CONCLUSION & SUGGESTIONS

Understanding how to act and make strategies in the times of crisis becomes very important and significant and is vital for the firm survival, and for the firms' and nations' competitive advantage even after the recovery from the economic crisis (Brzozowski & Cucculelli, 2016). This proposed model/framework has not yet been tested for validity or exact path progression but it helps to understand the impact of the crisis on an economy. This framework could be tested and validated through Confirmatory Factor Analysis using Structural Equation Model (SEM) by taking Economic crisis as construct with Variables of the framework (Slow in Economic Activity, Slow in overall demand, Retrenchment of employees and Increased Incidence of Poverty).

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