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CAUSES AND CONSEQUENCES OF FINANCIAL CRISES IN 2007-2009

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ABSTRACT

This article provides an asymmetric information framework to understand the nature of financial crisis. It provides the following precise definition of a financial crisis: the best investment opportunities. As a result, a financial crisis could move the economy away from equilibrium with high output, where financial markets perform well to an equilibrium in which output falls sharply.

KEYWORDS: *Financial Crisis, Housing Industry, Collateralized Debt Obligation, International Monetary Fund, MBS, Federal Reserve.*

1. INTRODUCTION

In today's world, it is impossible to imagine our world without an economy. However, due to the global financial crisis of 2007-2009, economic stabilization has slowed significantly. The effects of this financial crisis are still having a profound effect on the global economy. The financial crisis enters the derivatives' marketplace. The creditors of the residence loans determined to convert their mortgages into Mortgage Backed Securities so that you can pool the danger of default into the marketplace and will earn greater with the aid of using promoting those securities. So they went to the funding banks, who took those mortgages from the loan lending business banks and created worthwhile portfolios of those CDOs (Collateralized Debt Obligation). These CDOs have been designed and being supplied with inside the marketplace for the buyers to buy. Based on their danger possibilities the buyers sold those wherein their payoffs come from the loan bills made with the aid of using the debtors. And it did now no longer forestall here. Next comes the advent of Credit Default Swap (CDS). Here enter the coverage companies. They presented CDSs, a coverage like scheme, to the buyers which assured the fee for the buyers in case the debtors default. So, CDSs have been being organized maintaining the CDOs as underlying assets. Meanwhile, the housing costs become growing insanely and began out being a burden at the debtors. This resulted into the debtors being not able to pay the loan bills and that they began out defaulting. The entire marketplace become gambling with those loan bills. So, this default affected the entire credit score marketplace. The banks have been going for walks out of price range because the buyers have been soliciting for their proceeds and new CDOs have been in no way sold with the aid of using the buyers which stayed with inside the banks debts as terrible debts. This in the long run made the dwelling requirements with inside the United States of America excessive and progressively created unemployment problems. The problem of the study lies in identifying the effects of the global financial crisis on the financial sector in general and its constituent sectors in particular.

2. LITERATURE REVIEW

There are many papers and publications regarding the global financial crisis. A recent study made by Manoj Singh discusses every single aspect of the crisis. **[1]** His work on the website of Investopedia goes through causes of financial crises, who is to blame for the Great Recession and it also mentions all the bank's which were failed in 2008. It revealed that a number of smart investors made money from the crisis, mostly by picking up pieces from the wreckage. He identified that low-interest rates and low lending standards fueled a housing price bubble and encouraged millions to borrow beyond their means to buy homes they couldn't afford.

Brian Duignan identified that over a two-year period (June 2004 to June 2006) the Fed raised the federal funds rate from 1.25 to 5.25 percent, inevitably resulting in more defaults from subprime borrowers holding adjustable-rate mortgages (ARMs). Partly because of the rate increase, but also because the housing market had reached a saturation point, home sales, and thus home prices, began to fall in 2005. **[2]**

We also used the information from Wikipedia which explored the background of financial crises. There is written that U.S. consumption accounted for more than a third of the growth in global consumption between 2000 and 2007 and the rest of the world depended on the U.S. consumer as a source of demand, lack of investor confidence in bank solvency and declines in credit availability led to plummeting stock and commodity prices in late 2008 and early 2009, and The International Monetary Fund estimated that large U.S. and European banks lost more than $1 trillion on toxic assets and from bad loans from January 2007 to September 2009. **[3]**

And in our research you may find some information from the article of Mausikar Khan which identified that banks relied too much on derivatives, they sold too many bad mortgages to keep the supply of derivatives flowing. **[4]** That was the underlying cause of the recession. This financial catastrophe quickly spilled out of the confines of the housing scene and spread throughout the banking industry, bringing down financial behemoths with it. Among those deemed "too big to fail" were Lehman Brothers and Merrill Lynch. Because of this, the crisis spread globally. **[5]**

With asymmetric information, as shown by Stiglitz and Weiss (1981) The resulting adverse selection problem also leads to credit distribution. Borrowers are denied credit, even if they are willing to pay higher interest rates evaluation. This occurs because individuals and firms with the riskiest investment projects are exactly those who are willing to pay the highest interest rates since if the high-risk investment succeeds, they will be the main beneficiaries. Thus a higher interest rate leads to even greater adverse selection; that is, it increases the likelihood that the bank is lending to a bad credit risk. In fact, as Mankiw (1986) has illustrated, a little rise within the riskiess interest rate can lead to a really huge diminish in lending and indeed a conceivable collapse in the market. Jaffe and Russell (1976) showed the second type of credit allocation. The lender takes out a loan, but limits it to a smaller size than the borrower wants. The reason for that The larger the loan, the greater the incentive for moral hazard involving the borrower. Activities that reduce the likelihood that a loan will be repaid. **[6]**

Banks also have an advantage in reducing moral hazard because, as Diamond (1984) has demonstrated, they can engage in supervision at a lower cost than individuals, and because, as Stiglitz has shown pointed out and Weiss (1983), they have the advantage of applying restrictive covenants. Because they may use the threat of a loan suspension in the future to improve borrower behavior. The existence of the Free rider problem and the natural advantages of banks in mitigating moral hazard explain why banks play such an important role in financial markets by transferring capital. for those with productive investment opportunities. **[7]**

3. RESEARCH METHODOLOGY

1) ***Scope of the research***: in our paper we investigated the history and impact of financial crises on the global level using different materials from our books and internet. We also tried to find the answers to our questions by discussing with each member of our group about the situation which took place during the crises.
2) ***Data collection***: we found a lot of useful information from different sources such as books and sites as Wikipedia or Investopedia.
3) ***Data analysis method***: we analyzed data taken from different websites and summarized that data in our graphics and charts.
4) ***Comparison method***: in our research paper we also compared some data given for different years and summarized it in our graphs. For example, we may see GDP of some countries during the crisis.

4. RESULTS AND ANALYSIS

1. US house prices fell, borrowers missed repayments: The catalysts for the GFC were falling US house prices and a rising number of borrowers unable to repay their loans. House prices in the United States peaked around mid-2006, coinciding with a rapidly rising supply of newly built houses in some areas. As house prices began to fall, the share of borrowers that failed to make their loan repayments began to rise. Loan repayments were particularly sensitive to house prices in the United States because the proportion of US households (both owner-occupiers and investors) with large debts had risen a lot during the boom and was higher than in other countries.

2. Stresses in the financial system: Stresses in the financial system first emerged clearly around mid-2007. Some lenders and investors began to incur large losses because many of the houses they repossessed after the borrowers missed repayments could only be sold at prices below the loan balance. Relatedly, investors became less willing to purchase MBS products and were actively trying to sell their holdings. As a result, MBS prices declined, which reduced the value of MBS and thus the net worth of MBS investors. In turn, investors who had purchased MBS with short-term loans found it much more difficult to roll over these loans, which further exacerbated MBS selling and declines in MBS prices.

3. Spillovers to other countries: As noted above, foreign banks were active participants in the US housing market during the boom, including purchasing MBS (with short-term US dollar funding). US banks also had substantial operations in other countries. These interconnections provided a channel for the problems in the US housing market to spill over to financial systems and economies in other countries.

4. Failure of financial firms, panic in financial markets: Financial stresses peaked following the failure of the US financial firm Lehman Brothers in September 2008. Together with the failure or near failure of a range of other financial firms around that time, this triggered a panic in financial markets globally. Investors began pulling their money out of banks and investment funds around the world as they did not know who might be next to fail and how exposed each institution was to subprime and other distressed loans. Consequently, financial markets became dysfunctional as everyone tried to sell at the same time and many institutions wanting new financing could not obtain it. Businesses also became much less willing to invest and households less willing to spend as confidence collapsed. As a result, the United States and some other economies fell into their deepest recessions since the Great Depression.

As part of national fiscal policy response to the Great Recession, governments and central banks, including the Federal Reserve, the European Central Bank and the Bank of England, provided then-unprecedented trillions of dollars in bailouts and stimulus, including expansive fiscal policy and monetary policy to offset the decline in consumption and lending capacity, avoid a further collapse, encourage lending, restore faith in the integral commercial paper markets, avoid the risk of a deflationary spiral, and provide banks with enough funds to allow customers to make withdrawals. In effect, the central banks went from being the "lender of last resort" to the "lender of only resort" for a significant portion of the economy. In some case the Fed was considered the "buyer of last resort". During the fourth quarter of 2008, these central banks purchased US$2.5 trillion of government debt and troubled private assets from banks. This was the largest liquidity injection into the credit market, and the largest monetary policy action in world history.

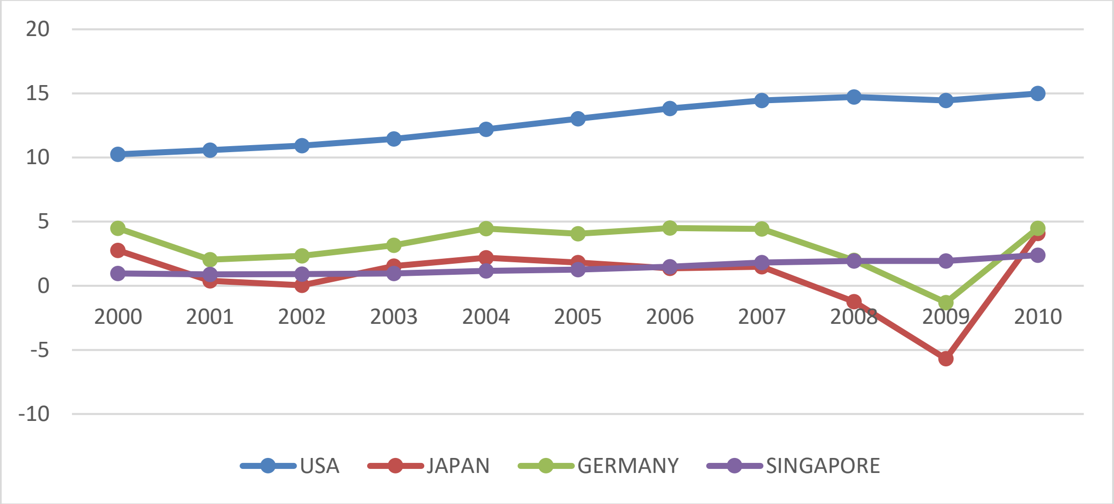

Diagram 3. GDP of four countries during ten years.

The line graph above shows that the GDP of these 4 countries in the period from 2000 to 2010. It is obvious that the GDP of the US has been growing from year to year since 2000. But U.S. GDP in 2009 was down 0.264 trillion dollars from 2008. This figure corresponds to the period of the financial crisis. Along with this, in Germany and Japan, the figure is as follows from the chart above during the financial crisis, with Germany's GDP falling to minus $ 1.3 trillion and Japan's GDP falling to minus $ 5.693 trillion in 2009. If we look at Singapore's GDP, this ratio may be much lower than in other countries. However, this figure rose from 2000 to 2010 and was not adversely affected by the financial crisis.

5. DISCUSSION

In 2012 the St. Louis Federal Reserve Bank estimated that during the financial crisis the net worth of American households had declined by about $17 trillion in inflation-adjusted terms, a loss of 26 percent. In a 2018 study, the Federal Reserve Bank of San Francisco found that, 10 years after the start of the financial crisis, the country's gross domestic product was approximately 7 percent lower than it would have been had the crisis not occurred, representing a loss of $70,000 in lifetime income for every American. Approximately 7.5 million jobs were lost between 2007 and 2009, representing a doubling of the unemployment rate, which stood at nearly 10 percent in 2010. Although the economy slowly added jobs after the start of the recovery in 2009, reducing the unemployment rate to 3.9 percent in 2018, many of the added jobs were lower paying and less secure than the ones that had been lost.

In addition, the following table shows how the ratio of several sectors of the economy has changed in several countries during the financial crisis.

The table above shows how much the economic crisis has affected some sectors of the economy in the USA, Japan and Singapore, with a single country Japan, with inflation fluctuating from minus to plus, and inflation in 2008 to 1.38 percent. We can see that it has grown in the United States as well. All other sectors have changed for the cons side during the financial crisis and have had a significant impact on the economic stability of all countries.

TABLE 1. INDICATORS OF THREE COUNTRIES DURING THE FINANCIAL CRISIS.

INDICATORS	Country	2002	2003	2004	2005	2006	2007	2008	2009	2010
Inflation (%)	USA	1.58	2,28	2,66	3,39	3,23	2,85	3,84	-0,36	1,64
	Japan	-0.923	-0,257	-0,009	-0,283	0,24	0,06	1,38	-1,353	-0,72
	Singapore	-0.392	0,508	1,663	0,425	0,96	2,10	6,62	0,597	2,824
Foreign Direct Investment (%)	USA	1.015	1.022	1.749	1.092	2.160	2.39	2.31	1.115	1.761
	Japan	0.276	0.194	0.154	0.113	-0.052	0.47	0.48	0.231	0.129
	Singapore	0.276	17.46	21.20	15.11	26.32	26.1	7.02	12.07	23.06
Savings (%)	USA	18.349	17.34	17.67	18.09	19.20	17.3	14.8	13.67	15.05
	Japan	24.653	25.03	26.29	26.81	28.04	27.8	27.0	24.89	26.19
	Singapore	38.428	39.39	40.61	43.62	48.16	49.9	44.3	43.86	50.59
Market Capital	USA	101.07	124.5	133.6	130.4	141.6	137	78.7	104.3	115.2
	Japan	49.471	65.34	72.70	94.64	100.2	94.5	61.0	62.50	66.46
	Singapore	109.66	152.0	189.0	201.3	258.5	297	136	247.8	269.8
Loans (%)	USA	50.279	51.45	53.34	55.26	57.15	59.4	59.7	54.00	52.47
	Japan	98.738	94.70	91.89	92.73	93.46	92.9	96.1	101.6	99.10
	Singapore	102.02	104.7	95.72	89.22	84.28	85.3	97.8	96.86	94.85

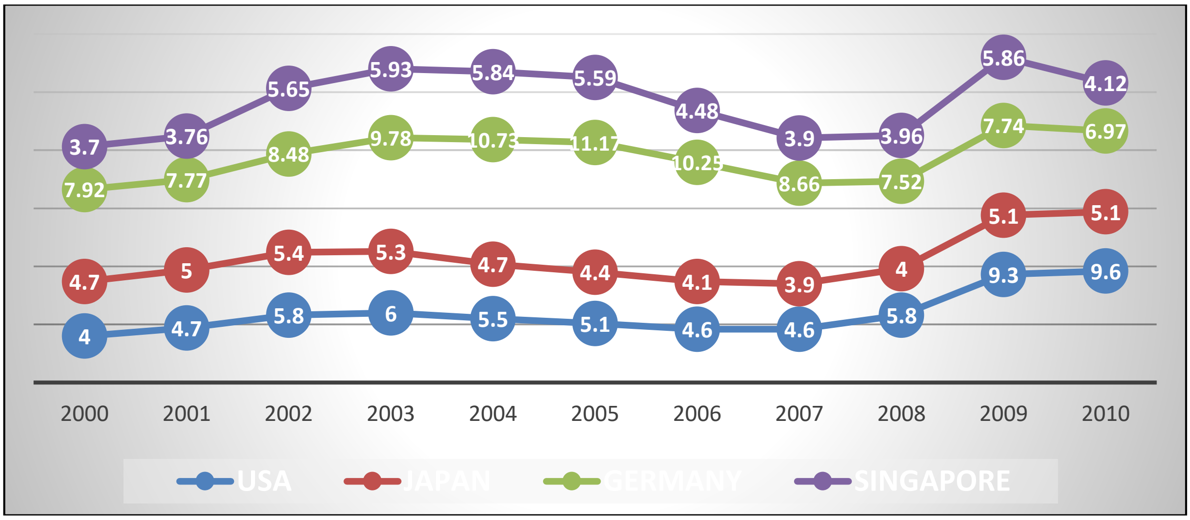

Diagram 2. Unemployment rate in four countries during ten years.

In the line graph, it can be seen that the unemployment rate has increased in all given countries since the financial crisis. Unemployment rose sharply in 2009, especially in the USA and Singapore. Unemployment rate was 3.5 percent higher than in 2008 in the United States in 2009. In Singapore, the ratio rose to 1.9 percent. In Japan and Germany, the figure is not significantly higher. However, it should be noted that in 2010 the unemployment rate fell again in all given countries except the United States.

For most Americans, recovery from the financial crisis and the Great Recession was exceedingly slow. Those who had suffered the most - the millions of families who lost their homes, businesses, or savings; the millions of workers who lost their jobs and faced long-term unemployment; the millions of people who fell into poverty - continued to struggle years after the worst of the turmoil had passed. Their situation contrasted markedly with that of the bankers who had helped to create the crisis. Some of those executives lost their jobs when the extent of their mismanagement had become apparent to shareholders and the public, but those who resigned often did so with lavish bonuses (“golden parachutes”). Moreover, no American CEO or other senior executive went to jail or was even prosecuted on criminal charges - in stark contrast with earlier financial scandals, such as the savings and loan crisis of the 1980s and the bankruptcy of Enron in 2001. In general, the key leaders of financial firms, as well as other very wealthy Americans, had not lost as much in proportional terms as members of the lower and middle classes had, and by 2010 they had largely recovered their losses, while many ordinary Americans never did.

6. CONCLUSION

The IMF statistics on the real GDP of U.S.A clearly indicates that the output recession in U.S.A did not begin until the fourth quarter of 2008. Japan got hit harder by the recession than U.S.A but Japan's decline in real GDP started before the U.S.A economy entered the recession. The United Kingdom experienced a decline in growth in 2008III and finally a decline in real production in 2008IV, but generally the pattern is very much the same as for U.S.A.

Due to the recession, U.S. demand took a fall resulting in lower exports by European companies, as well as lower sales and profits for European firms such as BMW, Unilever, and others that produce everything from cars to consumer products in U.S.A. A weaker dollar caused the value in euros of European investments in the U.S.A to suffer a major capital loss. Furthermore, high oil prices were also a problem.

The United States: A weaker dollar led to the reduction in export competitiveness of American trade partners while U.S. competitiveness had received a boost. American firms benefitted from more exports to the rest of the world. Lower home prices were also good news to the renters and investors who were able to rent or buy at much affordable price tags. Importers in Europe, Japan: The recession and global economic slowdown eventually led to a sharp fall in the price of oil, energy, and other commodities. So the heavy importers in these areas particularly Europe, Japan had sectors to benefit from despite suffering the share of loss due to the recession. European Shoppers: American goods became very cheap for people with euros. Loads of European tourists hunted for bargains from a weak dollar. These European crowds grew even larger as the savings on luxury goods, clothes, and shoes climbs higher and higher.

There are several conclusions that can be drawn from the facts listed above. The timing and the pattern of the data in the episodes studied here seem to fit an asymmetric information interpretation of financial crises. Rather than starting with bank panics, most of the financial crises begin with a rise in interest rates, a stock market crash and the widening of the interest rate spread. Furthermore, a financial panic frequently is immediately preceded by a major failure of a financial firm and the beginning of the recession which increases uncertainty in the marketplace. The increase in uncertainty and the rise in interest rates magnify the adverse selection problem in the credit markets, while the decline in the stock market increases adverse selection and moral hazard problems, both of which are reflected in the rise in the spread between interest rates for low and high-quality borrowers. The increase in adverse selection and moral hazard problems would then lead to a decline in investment activity and aggregate economic activity. Only after these problems have manifested themselves in financial markets do we find that a bank panic occurs. The bank panic raises interest rates further, causes the stock market to decline even more and worsens adverse selection and moral hazard as manifested by a further widening of the spread between interest rates for low versus high-quality borrowers.

Finally, the sorting out of solvent from insolvent firms and banks occurs. the crisis would then subside, the stock market undergoes a recovery, interest rates would fall, and if economic uncertainty and deflation were not too severe, adverse selection and agency problems would diminish, leading to a decline in the interest rate spread between low and high-quality borrowers. In episodes in which a substantial deflation does not occur we then expect and do see a rapid decline in the spread between interest rates for low versus high-quality borrowers. However, in episodes in which a substantial deflation sets in, we see evidence of a debt-deflation process in which there is a prolonged continuation of a large spread between interest rates for low and high-quality borrowers. It is exactly in these episodes that we see aggregate economic activity depressed for a prolonged period of time.

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