# ORIGIN AND IMPACT OF GLOBAL ECONOMIC CRISIS

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## ABSTRACT

*The global economic crisis originated in the United States in the year 2007 as sub-prime mortgage crisis. As a result, the country plunged into recession in the year 2008. Then it quickly spread to United Kingdom, Japan, other developed countries and then to the developing countries. The major factor is the large imbalance in the current account of some of the largest economies in the world. Many Asian countries and Oil producing countries invested the surplus money in the financial markets of United States. Another critical factor is the inadequate regulation of the players in the financial market by the government agencies in the United States and the United Kingdom which followed the persistent trend towards deregulation. Failure on the part of the market players such as banks, insurance companies and credit rating agencies in performing their intended functions was the other core factor. The new financial products were innovative and it was next to impossible for the investors to assess their real worth. As the economic crisis has spread to the whole world, slump in demand, severely curtailed production, acute unemployment and the resultant loss of income have been experienced by people all over the world.*

**Keyword:** *Economic Crisis, financial market and world economy.*

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## 1. INTRODUCTION

The term financial crisis refers to a situation in which the financial assets suddenly lose a large part of their nominal value. When it has a severe impact across the nations, it is referred to as global financial crisis.

The global financial crisis began in 2007 in the United States, when default rates on mortgages began to rise and the values of the houses plummeted. The crisis manifested itself strongly in the subprime mortgage market in the US.

It quickly spread to Europe with the breakdown in the market for credit default swaps which is a huge, unregulated and thoroughly opaque market. Then, the crisis spread to other countries from mid 2007 to mid 2008, through banks that had taken on risks similar to those taken on by the large banks in the US. This led to the general collapse of the markets for securitised instruments across the global financial system.

Several US global financial institutions at the core of the US housing finance market perished or had to be bailed out by the state. When US regulators failed to financially assist Lehman, which the world had earlier assumed they would do, shock waves radiated quickly across the world, as the bank represented a key link between mortgage bankers, the mortgage securitization market, the US housing finance agencies, and of particular importance, the insurance industry.

The fear emanating from the entire global financial system cut down capital market financing activities for several weeks. This intractable insolvency issue led to a plenty of insolvent borrowers, insolvent lenders, insolvent builders and insolvent shadow banks. The United States went into technical recession in late 2008, reeling from the effects of the sub-prime woes and, more importantly, the serious loss of general confidence and trust in its banking and financial system.

It worsened significantly in September and October 2008, triggering massive disruptions to the fragile global credit markets and spilling over with almost unprecedented speed to the real economies in the world. The United Kingdom, Japan and other leading economies followed, resulting in the onset of a global recession. It quickly spread around the globe to other industrialised countries, to the emerging economies and even to the poorest countries.

It was a synchronized shock for almost all the countries around the world, which led to substantial output losses and long-lasting crises. Furthermore, the recessions led to unemployment problem and government debt crises in many countries. It is now clear that the global economy is facing the worst economic and financial crisis since the Great Recession.

## 2. UNDERLYING REASONS

There are many critical factors underlying this economic crisis. The first factor is the large imbalance in the current account of some of the largest economies in the world. These imbalances were mainly caused by fundamental distortions such as the excessive saving rates in many Asian countries and in some of the oil exporting countries, and the fiscal deficits and inadequate private savings rates in the US and Europe.

The global capital imbalance among the major countries also grew significantly during this period. Many oil-producing countries built up large national reserves as a consequence of high oil prices. At the same time, many Asian countries achieved surplus through their highly successful export-led economic strategies. High national reserves were also maintained as buffers to be used in case of financial pressures similar to the Asian Financial Crisis which occurred in 1997. As a result, the global financial system was flooded with liquidity.

At the same time, the economies United States and United Kingdom experienced severe and persistent budget deficits and were badly in need of capital inflows. The transmission of capital from surplus to deficit economies was facilitated by globalization and financial deregulations ensured as result of the strenuous efforts of the global economic organisations such as World Bank and IMF.

Therefore, from the oil-producing countries and the Asian countries, the balance of payment surpluses headed for the US capital and financial markets as their own markets were still in their nascent stages of development. This could have been a win-win partnership, but flawed monetary policies and microeconomic failures in the United States and United Kingdom could not sustain such a symbiotic relationship.

The second factor is the inadequate regulation and supervision by the government agencies in the United States and the United Kingdom which followed the persistent trend towards deregulation.

For example, in the case of the subprime mortgage crisis, the mortgage originators held virtually none of the debt they created; they sold it off as fast as possible after the mortgage was signed. As a result, they had little interest in the quality of the credit. By allowing mortgage originators to shed risk by selling loans, disintermediation significantly increased the amount of lending to riskier borrowers.

Then, the mortgages were quickly sold to Wall Street to be bundled with other mortgages into securitised instruments to be sold to investors. Those doing the bundling received their fee and like the mortgage originators, had little interest in the quality of the credit.

Wall Street profited enormously from this business and quickly developed a voracious appetite for mortgages to slice and dice into more and more exotic instruments, putting further pressure on the originators to deliver more and more mortgages. The compensation structure in the banks and other institutions was based on the short term payoff and these institutions were insulated from the longer term risks.

The rating agencies, which should have cared about the quality of the credit, and had a fundamental responsibility to have such concerns—received their fees from those who had bundled the mortgages and were trying to market them. If the rating agency did not provide the rating wanted by the issuers, it would lose the business to a more willing agency.

If those investors saw some risk in the instruments they were purchasing, there were other institutions that readily sold the credit default swaps to insure against default. But those institutions saw virtually no risk of default and failed to make sufficient provision against those possible losses. They even sold insurance to investors who did not own the underlying instrument they were betting against.

The biggest problem of the US housing sector has become the default rate on prime mortgages, either because of rising unemployment, or because home owners are abandoning their houses when their value falls below the remaining cost of the mortgage. There are two reasons: One is inability to pay, due, increasingly, to unemployment. The other is the abandonment of houses when the remaining payments costed more than the value of the house.

Toxic assets had a pivotal role in causing the near collapse of the banking system and consequently the world economic crisis. Toxic assets are those for which the market value crashes and the market participants no longer know how to value them. This causes wealth erosion to the investors. Also, when the assets in the portfolio of a bank turn toxic, the ratio of its assets to its liabilities may fall below the legal requirement with the consequence that the bank, unless bailed out, would be closed.

During 2007, when the crisis was still primarily a US mortgage crisis, the assets that were regarded as toxic were collaterized debt obligations. CDOs are derivatives that bundle and repackage primary income producing securities. CDOs are divided into 'tranches' with different risk. In case of defaults on the primary securities, investors in the different tranches are paid out in the order of seniority. Investors in tranches with lower seniority received higher returns to compensate for the higher risk.

As the financial crisis unfolded, it became clear that another derivative asset, that was quantitatively even more important, was becoming toxic and was threatening the international financial system: credit default swaps (CDSs) and their more toxic variant, naked CDSs. An ordinary CDS insures a creditor against the default of the debtor, in principle a reasonable financial instrument. The issuers of CDSs, above all AIG, began to sell CDSs freely to anyone who demanded them, regardless of whether they were actually creditors of the company against whose default they were buying insurance. These 'naked' CDSs were simply bets on the default of the company in question.

And the situation was made much worse by the fact that financial deregulation had removed the prohibition against short sales when the price of a stock is already declining. If a company is in some trouble and the price of its stock is declining, then a speculator can short sell the stock, thereby accelerate the decline, and perhaps encourage more speculation against the stock. The company's reputation is impaired and it may be driven into a bankruptcy it could otherwise have avoided.

During the years of the US housing boom, CDOs were wonderful money making instruments. Banks sold subprime mortgages to families that could not afford them, convinced that they would pass on the risk to the investors in CDOs. Investors who bought the CDOs did not understand the risk and were lulled into a false sense of security by the ratings given to CDOs by the rating agencies that also profited handsomely. The banks themselves invested heavily in CDOs so that the risk that was supposed to be passed on, in the end largely stayed with them.

From its inception in 2007 until the early months of 2010 the crisis revolved about the threatened insolvencies of financial and industrial enterprises leading to massive bailouts, takeovers and bankruptcies. In early 2010 markets began to be increasingly concerned about the possibility of default on the part of sovereign states. The initial focus was on Greece. Greek statistics had been massively manipulated to enable the country to join the European Union. The European Statistical Office estimated that while the reported Greek deficit was an EU conform less than three percent of GDP, the true deficit was near 12 percent. It became known that Goldman Sachs had sold complex financial instruments on behalf of the Greek government, with the purpose of enabling it to hide current liabilities.

## 3. IMPACT

According to the report from the International Labour Organisation published in the year 2009, the economic crisis is the greatest challenge to the world economy since the Great Depression. Global output is falling, trade flows drying up and jobs disappearing around the world and 61million people became unemployed as a result of this crisis.

A study by Masciandaro revealed that the countries with the most liberalized financial system were hit the hardest by the crisis. At the same time, the depths of the recessions and the degrees to which the countries have been affected varied significantly.

Rose and Spiegel inferred that the Countries with higher income per capita have experienced the most severe output losses. An empirical cross-country analyses of the post 2007 recession indicate that countries with higher income and looser credit market regulation seemed to suffer worse crises.

The World Bank in its report published in 2009 concluded that while the low-income countries were not as affected as the developed world by the first wave of the financial crisis, the resulting impact on market confidence saw the transmission of the crisis through falling trade, investment and remittances. The flight from risk has seen a rapid decline in net capital flows to developing countries – expected to fall from $1.2 trillion in 2007 to $363 billion in 2009. The Investment Finance Corporation estimates that 450 investment commitments in African infrastructure projects were cancelled in 2008 alone.

According to a report published by IMF in the year 2009, alongside this capital flight, world trade volumes have fallen by perhaps as much as 12 per cent in 2009 compared with the previous year. The collapse of trade has particularly hit Southeast Asia, where recent impressive growth rates have largely been export led. In Vietnam, where the value of exports is equivalent to 77 per cent of GDP, the government estimates that as many as 400,000 people – most of them from the textiles and garments industries have lost their jobs throughout the course of 2009.

Yet the impact of falling trade has also reached Africa. Twelve African countries receive over 75 per cent of their export earnings from nonfuel commodities. Year on year, the International Monetary Fund's (IMF's) index of nonfuel commodity prices has fallen by 23 per cent from 2008 to 2009 – with real impact on employment prospects across Africa.

The global recession has hit an important form of income for the poorest families – remittances. Globally worth over $300 billion a year, remittances are significantly larger than the global aid flows. Because 80 per cent of remittances to developing countries come from high-income countries, this source of income is vulnerable to economic crises – and indeed is expected to have fallen by between $25 billion and $66 billion over 2009.

World Bank has claimed that this collapse in economic activity – from investment to trade and remittances – has turned the financial crisis into a social crisis. For the poorest people in the least developed countries, this comes shortly after the rise in food prices in 2008 that is estimated to have pushed between 130 and 155 million people into poverty.

United Nations has estimated that the worldwide recession has pushed 100 million more people below the poverty line (UN, 2009). That could set back progress towards meeting the first of the Millennium Development Goals – to halve extreme poverty – by up to three years.

Major stimulus programmes have been announced in the US, China, Japan, Germany, the UK and other countries and they have impacted government spending in significant ways. Monetary policy has been eased, with policy interest rates approaching zero in many countries and quantitative easing being attempted by a number of central banks.

New facilities to help stabilise the credit markets are being developed by the Federal Reserve and other central banks almost on a weekly basis. And there is recognition in some of the major countries, of the need to coordinate their debt issuance so as not to de-stabilise the financial markets.

## 4. CONCLUSION

Massive deregulation, inspired by the neoliberal ideology, has been largely responsible for the severity of the crisis that we are experiencing. In prosperous times the deregulation of markets is supported with the claim that this leads to efficiency and economic growth. In a time of crisis the argumentation is reversed; now it is claimed that the governments must come to the aid of failing entities, be they banks, enterprises or even sovereign states. The most disastrous consequences are predicted if the aid is not forthcoming. The market solution for a failing firm is bankruptcy and for an insolvent state it is renegotiation of its debt.

The large scale intervention of governments on behalf of failing enterprises, banks and sovereign states is a relatively new approach. Its effectiveness in solving the economic crisis is being carefully monitored all over the world.

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