BS235 - The Economics of Financial Crises

Individual Assignment –

World Financial Crisis of 2008-2009

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Table of Contents

1.0 Executive Summary

This short paper begins by highlighting the nature of the global financial crisis. The trends in perceived credit and inflation are briefed upon and a chronological history is given of which highlights the sequence of events during the crisis in question. Bible citations are made reference during this paper in order to illustrate the significant importance of religion to the modern day crisis.

The paper highlights other examples that may be juxtaposed to the current global financial crisis; these include references to debt-deflation trends as proposed by Fisher (1933), and supporting evidence in relations to the involvement of the central bank as a lender of last resort in order to rescue the economy. Economic trends are also illustrates thus displaying the variance in subprime lending and change in GDP. The liquidity operations of the market, including housing bubble correlation, are highlighted before a personal postulation is given at the end of this essay.

2.0 The global financial crisis

The financial crisis of 2008-2009 actually began in July 2007, at which time a loss of confidence of securitized mortgages, by investors in the U.S., lead to a liquidity crisis that further encouraged a substantial rescue package by the United States Federal Reserve, European Central Bank and the Bank of England. There was a spike in the TED spread (TED = indicator of perceived economic credit) in July 2007 which remained unstable for over a year before rising even higher in September of 2008 (CrisisHelper.com 2009). The TED spread reached a record of 4.65% on October 10, 2008, and later in September the crisis deepened to such an extent that stock markets around the globe crashed in such a volatile manner that resulted in numerous mortgage lenders, insurance companies and banks to fail in insolvency (CrisisHelper.com 2009).

A rise in inflation of asset prices ensued instead of a general increase in the price level of all services and goods. This trend could be better described as a sharp positive slope on the yield curve which took place over a prolonged period. The rise of imports from BRIC countries (Big four: Brazil, Russia, India, China) prevented any collateral inflation, but the excess money was channelled off into various assets. This scenario could possibly only have been achieved in a globalized economy and it did have the effect of leading the United States into a housing bubble that began in early 2002 and peaked in 2005 (CrisisHelper.com 2009).

During the crisis period financial instruments (such as securitization) played a huge role as banks transformed their loans into sellable assets in order to offload their risk onto others – the problem with such financial instruments is that the investment is usually tied up for decades, thus they were they were turned into securities where the buyer gets regular payments from all the mortgages whilst the banker offloads the risk (Shah 2010). The tightening of monetary policy caused by the incumbent exuberated the rising short term rates and impeded the long-term borrowing and the economy growth (CrisisHelper.com 2009). Central bank intervention may also have given path to what is known as the ‘Austrian Business Cycle Theory’, in which credit provided by the central bank gives rise to what is known as an ‘artificial boom’ which inevitably leads to a bust in the economy (CrisisHelper.com 2009).

The global financial crisis can also be highlighted by the following sequence of events that acted collaterally (World-Crisis.net 2008):

25 Nov 2008 - US announced $800bn rescue plan
26 Nov 2008 - 200bn euro plan to save European economy
01 Dec 2008 - US Manufacturing index hits 26 years low
01 Dec 2008 - World economy at its lowest level since 1930s
02 Dec 2008 - US Home sellers suffer from a wave of foreclosures
02 Dec 2008 - Asian stock markets fall again
02 Dec 2008 - US recession began in December '07
04 Dec 2008 - Increasing number of foreclosures is hurting US economy
05 Dec 2008 - Global recession: oil prices hitting a 4 year low
05 Dec 2008 - Foreclosures hit new highs
05 Dec 2008 - Consumer borrowing $3.6B down in October
06 Dec 2008 - European stock markets fall sharply
09 Dec 2008 - Recession in Japan deepening
09 Dec 2008 - Airlines are expected to lose $5bn in 2008
09 Dec 2008 - World Bank predicts global economic decline
09 Dec 2008 - Investors bought U.S. government debt at zero return
14 Dec 2008 - $50 billion Ponzi scheme uncovered
15 Dec 2008 - Treasury bailout money to be used to save automakers
17 Dec 2008 - The US Federal Reserve cut interest rates to virtually zero
18 Dec 2008 - OPEC cut its production to stop falling oil prices
19 Dec 2008 - France and Germany are pumping in more money to fight recession
22 Dec 2008 - China's GDP growth will be lower than expected
24 Dec 2008 - US consumer spending continues to fall
29 Dec 2008 - Industrial output plunges in Japan
05 Jan 2009 - Stock markets start 2009 on a positive note
06 Jan 2009 - China's industrial output continues to decline
12 Jan 2009 - Stock Market: back to reality
13 Jan 2009 - US Job Market had its worst year since 1945
19 Jan 2009 - Bleak future for European car manufacturers
21 Jan 2009 - Stock markets in the US fall sharply

23 Jan 2009 - *UK automobile production fell 50% in December*

26 Jan 2009 - *Microsoft will lay off 5,000 employees*

02 Feb 2009- *Sales of newly constructed homes hit record lows*

03 Feb 2009- *US companies will cut 100,000 jobs*

06 Feb 2009- *French government will provide 6.5bn euros to its carmakers*

09 Feb 2009- *Nissan will cut 20,000 jobs worldwide*

11 Feb 2009- *Russia's economic growth is weakening*

18 Feb 2009- *EU leaders support regulation of financial markets*

24 Feb 2009- *Job losses to reach 7.2 million in Asia*

04 Mar 2009- *Insurance giant AIG reports $61.7bn in losses*

08 Mar 2009- *Federal Reserve chairman warns of stagnation*

16 Mar 2009- *Norway government pension fund lost $92bn*

20 Mar 2009- *US budget deficit will reach $1.8 trillion*

28 Mar 2009- *UK government debt hit £750bn in 2008*

03 Apr 2009 - *WTO predicts global trade to fall 9%*

It is evident that the global economic current crisis was not just about the "collapse" of the USA or its financial systems but rather the manipulation of the US Global Financial Conglomerates and 'American Financial Crisis' into creation of a New Financial World Order – this concept can be highlighted and juxtaposed with examples from the bible – see Appendix A (Mivule 2008). The economic meltdown of the United States had immense impact in virtually all worldwide markets which may exemplify further the 'abomination' of which a powerhouse economy may have onto Earth's people (as illustrated in Revelations).

3.0 Debt-deflation correlation

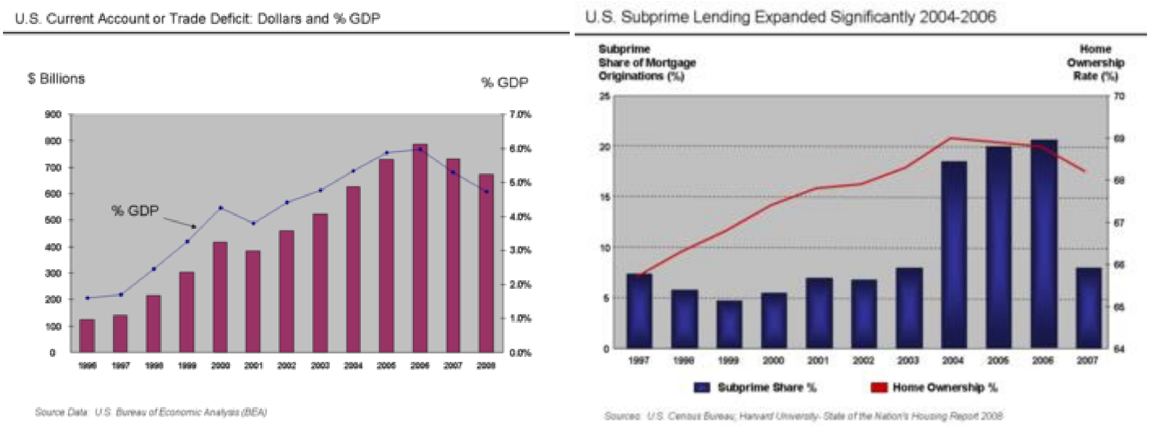
Irving Fisher, as cited in Fisher (1933), identifies numerous criteria's that (in his cycle theory) can be contrasted to the Global Financial Crisis of 2008/09. Summarized:

- Supply and demand could not be accurately predicted due to 'illusions'
- Economic disequilibrium ensued which resulted in intervention by a central bank
- Debt liquidation, and the fact that investments were locked up in long term return investments, lead to a distress in selling
- Complicated disturbances in the rates of interest caused a rise in real asset prices and commodities
- The paying off the accrued loans cause a slowdown in the velocity of circulation which inevitably leads to a long recession
- Hoarding of long term assets and investments may have attributed to the slowdown effect of circulation
- A rise in the level of prices caused a higher amount of imported goods which led to dependency on other countries which were consequentially hard hit by the crisis originating from within America. A de-swelling of the dollar was counter acted by the economy by moving the price of assets up
- Pessimism and a loss of confidence by trustees lead to retardation of the velocity of circulation
- Precipitating bankruptcies erupted with failure of the economic system due to the artificial boost provided by the central banks and the failure to think of financial short alternatives/solutions
- A loss of profits was made by failing to accurately predict the loaned institutions' capability for debt repayment

Fisher (1933) also highlighted that overconfidence alone could not be a significant part of a depression, and indeed the resulting accrued debts are of key importance – "I fancy that over-confidence seldom does any great harm except when, as, and if, it beguiles its victims into debt" (Fisher 1933, p.339). Fisher made strong reference to aspects of economic sustainability through clearing of debts and that markets should have the quantity of goods supplied to be equal to the quantity demanded this in order to be effective.

"The market must be cleared – and cleared with respect to every interval in time... the debts must be paid" (Fisher 1930, p.495)

Intervention by the Federal Reserve lowered funds rate from 6.5% to 1.0%, between 2000/3, this in order to counter the dot-com bubble effect. A flood of funds reached USA via foreign funds, the danger with this is that it indeed was placing the country in further debt and to worsen the crisis there was the matter that financial institutions were placing these foreign funds into mortgage-backed securities, thus locking up investments into long term tenures. Intervention by the addition of Federal government, between July 2004 to July 2006, contributed to a further artificial increase in the bubble caused by government's intervention.



Figures 1: Obtained from Wiki, 2010.

During the bubble subprime lending also ran rampart – this in turn refers to those lending practices in which borrowers had histories of which placed them at a greater default loan risk than should normally have been authorised. The very fact that the government intervened by acting as a lender of last resort meant that institutions were prepared to take more risk upon themselves in all undertakings.

3.1 The Bible and Laissez-Faire

A biblical Calvinist interpretation can be given to complete abolition of all socialism and ideals (such as government intervention). As a Presbyterian personally, Calvinist ideals dictate we believe in the Sovereignty of God. "Calvinists believe that every individual, every voluntary association, every family, every business – even every nation-state, every empire, and every other organized criminal syndicate – is morally (Biblically) obligated to bring every area of life under the jurisdiction of God and His Word" (Vine & Fig Tree 2010). Having a society operate under Laissez-Faire ideals does not only work in conjunction with bible 'Laissez-Faire Theocracy' principles, but it would also avoid any government intervention undertakings associated with any economic crises.

3.2 Proponents to central bank involvement

There are few events within the history of the United States that can rival the Great depression of 1929-1941 – and given similar, albeit different, analogies to the Global Financial Crisis of 2008/09 we shall highlight aspects that led to a change of governance by the government. In the Great depression investor speculation was excessive, and once the bubble popped it put into effect a severe decline in economic activity throughout the United States. There was no operational central bank to act as prime lender of last resort at the time and ironically, as a result of the 1930/33 crisis, the Fed was granted greater control and responsibilities over banking. In other words, political failure was justified to expand the government power (Pongracic 2007).

At the time of the Great depression various bad policies were put into place that was later corrected for through legislation. Examples of these policies are as follows:

- Price and wage control policies (i.e.: National Recovery Administration) distorted relative market prices.
- A peacetime tax was put into place after the war which inhibited industry growth
- The Federal government increase expenditure on wasteful 'public works'
- The 'Smoot-Hawley Tariff Act 1930 was passed which resulted in a decrease in demand for US exports (thus loss of benefit in division of labour)
- The Fed increased bank reserve requirements (instead of providing a central bank to act as a lender of last resort) leading to a significant decrease in money supply, thus the 1937/38 recession (Pongracic 2007).

The idea of a central bank as a last resort was put into effective practice as a recovery mechanism after the Great depression. However, “Federal Reserve lending to undercapitalized banks has the potential to impose higher resolution costs on the Federal Deposit Insurance Corporation (FDIC)” (Goodfriend & Lacker 1999, p.1). The central bank should therefore be liable for lending large amounts in short notice, and credit measures have to be put into place so as to discern when to deny credit. Consideration aspects include:

- The line of credit (loan commitments)
- Agency problems (complexity, moral hazards, control rents, and etc…)
- Credible commitments (contractual terms)
    - Loan covenants (right to acquire by liquidation)
    - Collateral (for nonpayment)
    - Monitoring (by information gathering)
    - Safeguards for the borrower (contractual preliminaries)

3.3 Liquidity of system essential as aftermath

Banks and their respective structured investment vehicles (SIVs) have, as a result of the Global Financial Crisis, become more reliant on wholesale money and the short term commercial paper markets in order to fund longer dated investments. Frank & Hesse (2009) state that this effect in fact raised the risk of systemic funding illiquidity due to geographic correlations associated in these markets. Policy makers have since been confronted as to whether ascertaining an adequate level of maturity mismatch and securing liquid assets, this in conjunction with banks holding a reserve to ensure operational efficiency and ensure short-run funding commitments. Furthermore, access to liquidity has since been provided through by a broad new range of potential counterparties in the United States as highlighted in Frank & Hesse (2009).

> “It should be noted though that the design and implementation of these liquidity operations pose serious limitations and introduce the risk of commercial banks engaging in regulatory arbitrage” (Frank & Hesse 2009, p.27).

3.4 Housing bubble correlation

It can be argued that the housing bubble which began in 2002, and peaked in 2005, in the United States, had a significant impact onto the start-ups of the global financial crisis. Housing bubbles tend to occur on a periodical manner in both local and global real estate markets. It is more often characterized by a quick rise in valuations of real property until they attain a level that is unsustainable relative to incomes and economic factors – this effect causes a rapid decrease in price levels which in turn acted as a partial catalyst to the global financial crisis of 2008/09.

The Melbourne Banking crisis of 1892-3 serves as a parallel example of how a long boom may mutate into a bubble scenario. It can be said that both bubbles originally centered on real-estate. Established bankers were in effect caught up in exuberance causing funds to be advanced consequentially to land capital investments (Moore 2010). Banks continued to lend with land as collateral, and the support of government intervention had an effect of enhancing the magnitude of the consequences for when the bubble hit. In the 1892-3 bank runs the association of banks ‘bungled when they allowed one of their number to fail’ (Moore 2010). Likewise, the lending to subprime investors in American markets impeded the confidence of in banks, and intervention by the central bank lowered the funds rate to an extent which hindered economic development of the nation.

It could be said that the global financial crisis was indirectly impacted by asymmetry of information, where some banking institutions were aware of the fallacy of subprime lending whereas some were not.

4.0 CORRELATION

This paper has illustrated fundamental aspects of the global financial crisis. It is, however, my personal view that the worse of the crisis may not be over. The collapse of the US Treasury securities is a symptom of the current credit crisis, thus a decline in the yield of a ten and 30 year Treasury bond may seem to indicate that a bad deterioration in US and world economic conditions is about to occur. The cost of inflation on the coming days (in terms of cost of living for the average household) will ultimately overwhelm the power of the established interest which is held at artificially low positions.

5.0 REFERENCES

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APPENDIX A (MIVULE 2008)

Bible Prophecy shows that there is intrigue within this Global Government as long as the Woman Riding this Beast is still riding… This woman is described as Babylon the Great and she is a Financial Power House up to the point of her Destruction… When she is destroyed Global Trade comes to a halt… However, it is the Ten Kings that destroy her… Now Watch the relationship between the EU and the US…it is manipulative at best…

Revelation 17:3-5

> (3) So he carried me away in the spirit into the wilderness: and I saw a woman sit upon a scarlet colored beast, full of names of blasphemy, having seven heads and ten horns.
>
> (4) And the woman was arrayed in purple and scarlet color, and decked with gold and precious stones and pearls, having a golden cup in her hand full of abominations and filthiness of her fornication:
>
> (5) And upon her forehead was a name written, MYSTERY, BABYLON THE GREAT, THE MOTHER OF HARLOTS AND ABOMINATIONS OF THE EARTH.

Revelation 17:11-13

> (11) And the beast that was, and is not, even he is the eighth, and is of the seven, and goeth into perdition.
>
> (12) And the ten horns which thou sawest are ten kings, which have received no kingdom as yet; but receive power as kings one hour with the beast.
>
> (13) These have one mind, and shall give their power and strength unto the beast.

Revelation 17:16-18

(16) And the ten horns which thou sawest upon the beast, these shall hate the whore, and shall make her desolate and naked, and shall eat her flesh, and burn her with fire.

(17) For God hath put in their hearts to fulfill his will, and to agree, and give their kingdom unto the beast, until the words of God shall be fulfilled.

(18) And the woman which thou sawest is that great city, which reigneth over the kings of the earth.

Notice that Babylon's Economic Power House Collapses in One Hour!

Revelation 18:15-18

(15) The merchants of these things, which were made rich by her, shall stand afar off for the fear of her torment, weeping and wailing,

(16) And saying, Alas, alas that great city, that was clothed in fine linen, and purple, and scarlet, and decked with gold, and precious stones, and pearls!

(17) For in one hour so great riches is come to naught. And every shipmaster, and all the company in ships, and sailors, and as many as trade by sea, stood afar off,

(18) And cried when they saw the smoke of her burning, saying, What city is like unto this great city!