

Causes and effects of gfc economics essay

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Introduction

Aim

The aim of this report is to analyze situation related to collapse of the financial market in the U. S. A. after the Global Financial Crisis (GFC), which began in 2007. This research is addressed to U. S. Department of the Treasury, in order to improve this issue by introducing new policies in order to prevent this process in future.

Background

The slump of U. S. A. financial market began after mid-2007 as soon as GFC accelerated after the Lehman Brothers crash in September 2008 (Elmeskov, 2009). This crisis was concerned as the worst financial crisis after the Great Depression in 1930's (Pendery, 2009). The financial crisis of 2007-12 has some familiar key points to previous crises, however it is different by the fact that banking system was affected adversely by the amount of losses it bore (Mora, 2010). After 2007 countries all over the world felt the bad effects of it on their economies and market, lots of financial institutions collapsed during the period from 2007 till present time. The worst suffers were experienced by banking spheres and employment rates went down dramatically. It is very important to analyze this issue because of what happened in USA played a significant role for the countries all over the world and there are still huge impacts on them. So there is a strong need to identify the main problems and generate solution in order to stabilize this situation and to avoid it in future.

Scope

The time range of this report begins from 2007 till 2012, in order to show the start of GFC and its effects in present.

Methodology

All the materials used in this report come from reliable sources, such as Deakin University databases, books and Internet resources.

Plan

Firstly, the overview of the problem will be introduced, including background information about the main problems related to GFC. Secondly, the findings and discussions will be presented in order to show the results of investigations. Thirdly, there will be conclusion with brief summarises of the main findings from the second part of this research. Finally, the recommendations will be introduced in order to show practical solution for the problem, which was investigated during this report.

Findings and Discussions

2. 1. Causes and effects of GFC

In this report there are some reasons and consequences, which particularly connected with each other, and one cause is led by another. The reasons are subprime mortgage crisis, bubble economy and employment downturn, which is in reality is the consequence affected by GFC.

2. 1. 2. Subprime Mortgage crisis

From 1990s there was the solid progress of the subprime mortgages, which had increased national attention. (Chomsisengphet and Pennington-Cross,

2006) In 2002-2004 the U. S. banks experienced profits due to millions of people who took mortgages. The number of subprime loan rose sharply in the period of 2005-2006 (see Figure1). People wanted to obtain real estate despite of the fact that the risks were very high. After the collapse of the real estate market, many borrowers defaulted and declared about the insolvency on mortgages. The commercial banks were borrowers also, part of the funds granted to legal entities and individuals were borrowed by them. Soon the banking sector found itself in a situation when banks cannot pay to creditors, thereby the default was announced. In order to manage this situation, the bank's debts were sold on the stock market. Nevertheless it did not bring the expected result, and soon the crisis has only strengthened. Cause of the financial crisis in the U. S. was that the banks were handing out a large number of high-risk loans; this was due to the downturn of housing sector, which is discussed below. Figure 2 shows the return of assets and equity from 1985-2007 and it is seen that in 2007 both the equities and assets go down dramatically and reach its edge at point equals to less than 1%. It means that the situation in banking sector went in worse direction; there were no mortgages given and no payment on them received.

year

Figure 1

Source: based on the report " Real Estate Bubbles: A Historical Perspective", n. d.

Figure 2

Source: adapted from the report " Profits and Balance sheet Developments at U. S. Commercial Banks in 2007", written by William Basset and Thomas King, 2008

2. 1. 3. Bubble economy

Housing bubble has emerged as a natural result of the boom in the real estate market. More and more people took out loans, as in recent years; there was a tendency in increasing prices at the property market. People had a steady income for buying a house, which was not a primary necessity, rather than a great option for investment as in recent years, prices have shown growth. David Lereah, chief economist at the Realtors association once asserted "Americans are treating real estate as a viable alternative to stocks and bonds," and they trying to buy even more than one house (Rich, 2005). Due to improper distributions of subprime mortgages, problems with the real estate market appeared. The number of loans dispersed in real estate caused the effect when prices on houses have fallen significantly. For example, the national average price which was above 5% in spring 2006, has fallen to nearly 10% in one year, in 2008, in Washington D. C. prices decreased by 20 %.(Zandi, 2009) Prior to that, borrowers believed that they can repay the loans by selling the collateral property, but have lost hope, as the prices and demand for housing fell instantly. Many people were in a

critical situation, when found that they were not able to repay the loans. In light of this, the strong need has emerged for policymakers and economists to reweight the information about asset value and what they really need to do to manage its effects. (Evanof, 2012)% of price growth Figure 3. Housing Price GrowthSource: adapted from Zandi, Financial Shock; A 360 Look at the Subprime Mortgages Implosion, and How to Avoid the Next Financial Crisis, 2009The graph above (see Figure3) shows the situation with the prices on the U. S. A. real estate market during the period of time from 1995 to 2007. It is clear that from 2005 the housing sector reached its growth peak at point equals nearly 16% and falls dramatically till the end of 2007. This period of time is called crash, because the growth rate of prices reaches its lowest point at approximately -10%.

Figure 4. U. S. Zillow Home Values Index

yearAmount in U. S. dollarsSource: based on the report " Home Values Continue to Rise; May Marks Third Consecutive Month of Increases", written by Humphries, 2012The Figure 4 represents how the home values, measured in Zillow Index, have increased from the period of time from 1997 till 2013, and the index is represented due to the May, 2012. It is clear that the peak is in 2005-2006 when it is valued for nearly \$200, 000. As it seen, after 2007 there is a sharp decrease in real estate values and in the second decade of 2012, it is equal to \$148, 000.

2. 1. 4. Employment downfall

Due the above mentioned causes in this report, the difficulties in the employment market appeared. Because of defaults and the collapses in the financial markets, there have been huge cuts of workers. Thousands of

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people lost their jobs, along with the inability to repay loans. Demand in the labour market has increased significantly, and the supply fell on the contrary, as the company could not provide enough jobs due to financial difficulties. By May 2009, there were 3 million jobs available and more than 14 million people who were without working places (Gordon, 2009). It got to the point when the family did not have any person who worked. Employment cuts affected not only the small and mid-sized business; furthermore large corporations were involved in order to reduce its costs. Beforehand, people who occupied a good position and then lost it, were agreed to any kind of work to be able to pay with the debts and support their families. Another interesting fact is in allocation of unemployment among different ranges of age and degrees. For example, approximately $\frac{1}{4}$ of people at age 16-19 were unemployed, also joblessness rate for person who had college diploma was 4.4%, in contrast, people without this were on 9.3 percents higher than the first ones (Magdoff, 2001).

Figure 5. Percent of Job Losses in Recessions.

Source: based on calculated from ALL employees; Total nonfarm employees (PAYEMS) downloaded from Federal Reserve FRED database, <http://research.stlouisfed.org>, cited in MagdoffThe Figure 5 demonstrates job losses measured in percents during the recession in different years, for example 1974, 2001 and 2007. It is clear that its lowest point at approximately -6.5% on 23rd month after peak. On 39th month the situation has positive perspective, there is a slight increase, which means the number of people who loss jobs declines.

Conclusion

This report represents the causes and consequences of the global financial crisis. One of it is the subprime mortgage crisis, which is considered as unevenly distribution of income loans for real estate market which, in turn, collapsed after a seemingly stable growth. This whole situation has led to a decline in the labour market and millions of people lost their jobs. The most interesting is that the situation in the U. S. has had the strong impact on the world. Once the strong country with a stable economy was almost on the edge. On this subject has been written various types of articles, publications and books in order to find out where it all began and where it will lead. The report aims is to explain the effects of the global financial crisis in very simplified way, using some of these materials. There will also recommendations, which theoretically would stabilize the situation and the solutions to some problems that still exist in the U. S. financial market.

4. Recommendations

4.1 Proper risk management

As it is already know from the part findings and discussions, one of the main causes of the crisis is the improper distribution of loans in U. S. banks. It can be assumed that a more careful distribution of the loans can help the banking system to go out from the emerged situation and accelerate the recovery process, which is gradually yet slowly gains a momentum. In a detailed verification of the borrower's history should be included detailed analysis of the possible risks associated with a loan, as well as the purposes of the particular one. Besides, banks should convince client to insure the

borrowing payments. All of these items are likely to establish as the part of the so-called protocol aimed to minimize the bank's risks.

4. 2 Government control

State should provide control over the financial and housing markets, as it last one was the another main cause of the global financial crisis. The government should be involved in aspects of these markets in order to ensure the absence of speculation, collusion and fraud, such as the artificial change in the market in order to enrich a certain group of people. State should be interested in a healthy economy, as it involves the development, investment and sustainable future economy.

4. 3 Appropriate Skills and Support of Labour Market

One of the solutions to the problems in the labour market is that people with specific skills continue to develop in this direction, despite the fact that these activities are already quite busy and do not need a lot of staff. Most people trying to get a degree in finance, accounting, where, regardless of the crisis, there was always a lot of competition. In the U. S. and around the World, there are areas with the shortage of labour and people should pay attention to it. There some opinions are raised by several economists that there is a disparity between the skills which are in demand of employers and in supply of employees (Boushey, 2012). Also there is a need in government support, controlling over the market of employment and the provision of jobs, as the government has a big impact on almost all sectors of the economy. One of the example is to create new jobs, to create 150, 000 new vacant job it is need to increase the healthy economic growth to nearly 3% and it is enough to keep employment in stable (Amadeo, n. d.). It should be noted that the <https://assignbuster.com/causes-and-effects-of-gfc-economics-essay/>

provision of free training courses will allow people to change the activity without difficulty. Whereas the education, including a second education and re-training, is very expensive and not every person can afford it and stay unemployed.