

The global financial system

[Literature](#), [Russian Literature](#)



The global financial system is experiencing banking and financial turmoil commonly referred to as the credit crunch that is said to be due to the pricking of a massive debt bubble, (Peston, 2009). There is no standard definition of the credit crunch; however, a credit crunch is generally described as an economic condition in which investment capital is difficult to obtain (Investopedia 2009). Credit crunches have been observed to follow recessions and do seriously stifle economic growth through decreased capital liquidity thereby reducing productive sector's ability to borrow.

When this situation arises, companies are not able to borrow in order to expand their operations and many may cease production altogether thereby resulting in bankruptcies. When such a situation arises, unemployment increases, homes are lost, banks close down and governments are forced to step in to contain the crisis, in most cases with limited success in the short run. This is not the first time that such a crisis has occurred. Records show that there was a crisis as early as 1622 and between 18th and 20th sixty two banking and financial crashes have been experienced (Henley 2007).

Among the chief credit crunches that took place in the 20th century are the Wall Street in the year 1929 and the Japanese financial turmoil in 1990s. Genesis of the crisis The genesis of the debt crisis is partly due to imprudent lending. An observation made by Liu (2008 p9), an individual without a job or reliable income and poor credit history gets a mortgage from a bank. That borrower's debt is partly sold to another bank that partly sells that debt to another bank that partly sells that debt to another bank perhaps a foreign bank. When the borrower fails to pay, all these banks get affected.

In the event that many such borrowers are involved banks will have a liquid crisis and will not be able to lend to needy customers thereby setting in motion a credit crunch. Britain as example AS stated above, massive borrowing and reckless lending is viewed as the major cause of the credit crunch and the situation is made worse when the money is from foreign countries. For Britain, if one aggregates together the consumer, private and public-sector debt, ratio of Britain's borrowings to her annual economic output is estimated at over 300%, roughly GBP 40000 bn Peston (2009 p1).

Households borrowed too much GBP 1200bn on mortgages alone. Gross foreign current liabilities of Britain banks rose from GBP 1100 bn in 1997 to GBP 4400 bn 2008. That is three times the size of Britain's annual economic output. Most of this cash were the savings from foreign country banks notably China, other Asian countries and the Middle East that were used to buy foreign currency assets in Britain, but the British used this to buy. The savings that were used to buy assets in Britain were made the poorly paid workers in those countries. The tilting of the economic balance could not be sustained for ever.

A return to equilibrium to a more balanced global economy had to come to pass at some point and this is currently what is happening with the western economies USA, Britain and others getting the pinch (Peston 2009) Credit crunch in the United States Zhou Xiaochuan, the governor of Chinese Central Bank said, " Over-consumption and a high reliance on credit is the main cause of the US financial crisis" Peston (2009 p2). Up to 2007, borrowers were financed 100% of the purchase price to buy assets without any serious scrutiny being done on the ability to pay.

The New Times of 19 February 20, 2009 reported that the credit crunch in US started way back in late 1990s. At the beginning of 2000, there was a decline in the stock market that made the US to slip into recession. This prompted the Federal Reserve Bank to lower interest rates to stimulate the economic growth. Lower interest rates made mortgage payments cheaper and increased demand for homes that lead to the souring of prices. At the same time banks lowered the refinancing rates which consequently lowered the quality of the mortgage but kept on increasing and finally led to the commencement of the defaults and delinquency in 2006.

The financial institutions were not able to balance two things that were simultaneously happening that is the rise in the purchase of assets and the corresponding demand for credit prompting the introduction of securitization (Liu 2008 p4). This susceptibility could not be contained, even with the introduction of securitization, resulting inevitably into the bursting of the bubbles. The outcome was the falling of asset prices that precipitated losses to those who borrowed to buy houses and these include hedge funds, private equity finds, billionaire's corporate raiders, banks and others.

The debts started to increase and the need to sell these assets to offset debts drove the prices down resulting in further losses. With banks not being paid, their resources were progressively depleted thereby halting 100% mortgage financing and other loans. This has the effect of driving prices further down that will lead to the contraction of the US economy as this vicious circle is bound to persist into the future. Business loans for the newly established companies that depend on credit are and will continue to be difficult to access (Tse, et al, 2008).

In addition, closing major deals is not proving easy either. The economists predict that the tightening of the credit to drag on the US economy for quite sometime. Size of debt A number of governments are in the process of formulating various policies and measures to be undertaken so as to contain the negative economic and social impact of the credit crunch. To achieve this, and in order to set in a recovery mechanism, an estimate of the size of the debt has to be carried out and this is by no means straight forward.

However, a rough calculation of the debt may be estimated by a jargon referred in financial circles, notably by Bank of England, as the customer funding gap (Peston 2009 p3) that is the difference what the US banks have lent and what they have borrowed from households, businesses and institutions that are considered too small to be major players in global financial markets. Conclusion The credit crunch, also known as liquidity crisis or squeeze, is as a result of too much borrowing and lending to undeserving individual and institutions especially in the USA and Britain.

This squeeze has constrained the banks ability to lend, scared away investors from buying debts thereby drying up money for borrowing. The liquidity crisis has reduced money available to spend by consumers and the business. The credit squeeze has triggered in serious ramifications for the USA economy, the developed economies and the entire globe in general. Works Cited: Henley, J September 2007. Show us the Money: The Guardian, September 19, 2007. Available at <http://guardian.co.uk/money/2007/sepember/19/business> accessed on 19 February 2009.

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