Financial crisis

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The world wide financial crisis has been identified to have several different causes, with the problems originating from the US causing shockwaves around the World, sending the World economy into a crisis. The impact of the financial crisis has been dramatic to the general business environment due to the increased uncertainty and risk that investments at this time bring with them and the failure of central financial institutions. The crisis has left many economies, businesses and people in the world in trouble and fighting for their existence.

Stock markets are down by more than 40% from a year ago, with immense losses for everyone involved, including workers who are being let go. Many investment banks have collapsed, with more in trouble and in need of rescue packages that the governments have started putting together. These rescue packages, aimed at helping out companies in trouble, total over 1 trillion Euros but are linked with strong guidelines which the companies have to follow. Many leading economies around the World have cut their interest rates in order to stimulate the economy and force off the nearly inevitable World-wide recession.

But what were the causes for this world-wide crisis? Origins of the Financial Crisis: The financial crisis was caused by many factors but it is widely understood that the financial crisis started with the Subprime Mortgage Crisis in the US in the summer of 2007. Americans could no longer afford their adjustable rate mortgages due to a shortage of new lines of credit. This caused loan defaults and foreclosures with many people losing their homes. This houses were nearly all over-priced due to the ‘ housing bubble’ in the US.

These loans were usually repackaged and sold as low-risk investments to banks and financial investors. These became sources of capital for for many investment banks and brokerage firms, who then sold them again to investors. The crisis took its start as big companies such as Lehman Brothers, Merrill Lynch and AIG were not able to find buyer for these repackaged sub-prime loans and were therefore unable to offload their debts. The companies were left holding mortgage backed assets which had dramatically depreciated in value and were not bringing in enough money to pay for their debts.

They did not have any money left and ended up even using up their cash reserves. This left them in a position where they were unable to make new loans, as their credit had dried up. This caused a shortage of new lines of credit, which stopped the money flow and slowed down the economic growth. The money used for buying and selling different assets was all of a sudden not there anymore. These companies in an effort to raise capital for investment started leveraging funds, further increasing the impact of the following crisis.

Companies such as Lehman Brothers and Freddie Mac leveraged money in order to buy and resell stocks, securities and other investments to make fast profits. This line of action failed as all of a sudden they were left in a position where they were unable to resell their investments. This in turn then created a problem with the Credit Default Swap market. CDS’s are basically insurance contracts covering losses on debt defaults on municipal bonds, corporated debt and other securities which anybody can buy. Due to a lack of regulation they can easily be traded and this caused a problem.

The holders of these contracts and their ability to pay off the debt was not clear due to the easy swapping of contracts which was very common. A contract could well change ownership 20 times with no record of this being kept. Commercial Banks were the main holders of these contracts and the subprime market collapse dealt a considerable blow to them. AIG (one of the biggest insurers) alongside many others invested heavily into CDS holding, went bancrupt due to their large CDS holdings and their inability to recover their money.

As a result of the CDS crisis, besides reshaping the financial world through a series of bankruptcies and mergers, loans have gotten harder to get due to banks not wanting to provide default insurance anymore. Effects of the Financial Crisis: Already a number of financial companies have gone bust with the high levels of debt they had accumulated. Goverments in the EU and US have rescued multiple banks and companies with financial aid packages, which are linked with considerable directives for the companies. Interest rates have been cut by the leading economies to encourage borrowing and stimulate the economies by increasing spending.

These measures are going to take time until an economic turnaround can be achieved which is why we will most likely see a global recession with the recovery taking up to two years. The US economy is moving towards a recession and thanks to this downturn, economies across the globe will feel the effects as they trickle down. An example of this can be seen in the Russian Stock market plummeting so fast that trading had to be halted twice to deal with the situation. It has lost 55% of its value by now, with further decreases to be expected.

In the same time the Chinese stock market has also fallen by 45%, largely due to the falling demand for its exports. Chinas economy and its rapid growth are highly linked with its exports which have fallen by 25%. The UK is already in a recession which is expected to last until the end of 2010 at the least, with the Eurozone looking at a slightly better prognosis of a slight recovery in 2010. The mergers between investment banks, commercial banks and brokerage companies was made necessary through the immense financial troubles some of them were in.

This has changed the dynamics of the investment industry in that in the future it will be much harder for individuals and small start-up companies to raise money for their needs due to the high risk of these loans. There will also be considerably less money available for aid, non-profit orgaizations and service industries. The amount of FDI will most likely fall as well due to companies having to re-evaluate their global strategy and investments due to the economic situation and the scarcity of loans for project realisations.
Effects on Developing Countries:

There are a couple of ways how the financial crisis could affect the developing economies around the World. The amount of FDI flowing into these countries is expected to fall due to corporate and project financing being harder to get in the current situation. Companies will also want to wait and see what the exact impact of the crisis will be on their sales and calculate the risk of investments from there. Companies have to act carefully at the moment in order to secure their survival and not make investments for which they might not have the money for.

Also the increased instability of developing economies has made it riskier for banks to lend money for projects in these countries due to increased risk of debt defaulting of the countries. The demand for the natural resources on which these countries at the moment still heavily rely on might slow down due to the decreasing trade from producing countries as the demand in developed countries has declined due to the lack of money and the rising risk of unemployment which makes people and companies watch their spending.

Developed countries will most likely also have to cut back on their foreign aid spending due to increasing debt levels and budget deficits, putting them in a weak fiscal positions. At the same the remittances from abroad into developing countries (eg. a big part of Indias GDP) will fall due to jobs and money being scarce around the World. This all could lead to such problems in developing countries as less income from exports, lower levels of investment and hence lower growth rates and higher unemployment.

Effects of all this could be lower govenment spending on such vital aspects as education, healthcare and infra-structure, all needed the raise the income levels of its population and decrease poverty. With a lack of money for this, an increase in poverty could be the consequence. There is however hope that the major developing markets such as those of China, India and Brazil have become strong enough to get through this crisis, even help stabilise the world economy and turn it around.

A lot of hope is put into Chinas hands to steer the World out of this crisis due to the size and strength of its market and the global players it does business

with. Conclusion: There are no one real solution for the financial crisis. The markets have to adjust to the current demand situation around the World and almost everybody has to watch out how they spend their money. Companies have been forced to let workers go due to decreases in demand for certain products and/or service they provide.

They are nearly all having to take a look at how to improve efficiency and minimise costs in order to survive through this crisis. Governments around the globe are trying their best to stabilise their economies and turn them around. They have introduced interest rate cuts and tax incentives in order to increase the spending and stimulate their economies. Many governments at the same time are trying to work in minimizing their budget deficits in order to regain a better fiscal position. At the same time they are though putting together rescue packages to aid their failing industries in order to protect thousands of jobs.

There is a cordinated effort from countries around the World to stimulate the economies by undertaking a variety of different measures and increased cooperation. They have also put measures under way in how to prevent such a crisis from happening again involving unified accounting and reporting principles. A tighter control will be exerted on the financial markets to prevent the crisis from renewing itself in the future. There is a long way until recovery but every possible effort towards it is being made. The success and speed of the recovery is very hard to judge, with estimates ranging from a year to five years.