Causes and effects of the 2008 financial crisis

Introduction

The financial crisis of 2007 to 2009 sent the global economy into shock as a global recession ensued due to the breakdown of the financial institutions where the predicted ‘ mild recession’ was far larger than any forecasts predicted. (Mishkin, 2011, p49). During this essay, the causes and effects of the crisis will be discussed where the causes of the crisis consisted of poor risk management, models and government interventions whereas the effects need to be looked at through the view of the United States along with the Western world through the ripple effects that occurred in their interconnected economies.

There were a vast number of causes of the financial crisis such as the financial securities surrounding the US housing market at the time, whilst the effects on the economies will be explored through certain macroeconomic indicators. Another aspect examined is whether the causes and effects were predominately management or economic issues by looking at the issues from both sides. However, deciding which issue outweighed the other the severity of the issues themselves need to be reviewed to truly be able to understand which issue mainly stood out during and after the financial crisis.

Main Body

Causes

(Jorion, 2009, p931) expresses the views that ‘ institutions failed to develop their own valuations models for these complex structures and instead relied on credit ratings’, hence showing the nature of the management not taking

responsibility themselves. The overreliance on credit ratings from financial institutions strongly impacted the growth of the collateralized debt obligations (CDOs) before the collapse of the financial crisis. CDOs are a selection of mortgage loans bunched together which were issued with an apparent low risk as the securities were rated highly by the agencies. These CDOs were problematic as they issued riskier mortgages where defaulting was inevitable whereby the lenders didn't receive the money for their loans causing large debts for firms. Therefore, CDOs show the management's poor decision of disregarding the safety of these securities which have been conveyed throughout the work of Jorion (2009) whereby the thought process can be narrowed down to the ignorance of the management in the financial market.

Another major cause of the crisis stems from the unregulated market of credit default swaps (CDS) where Jorion (2009) suggests that when there are weaknesses in their models the risk managers need to adapt and change the models such as the models of pricing the CDS. CDS are defined by Cao, Yu and Zhong (2010) as derivatives where the buyer pays a premium and gains a payoff from the seller if a credit event should happen such as a default or bankruptcy but the CDS market was heavily unregulated. The CDS market broke down as Murphy (2008) explores how the CDS being under-priced whilst ' the payments on credit default swaps didn't even cover expected future default losses' which shows the extended risk to the institutions of losses being larger than gains. (Murphy, 2008, p8). According to Luo, Wu and Wu (2017), the mispricing of the CDS was due to the statistical models used which failed to accurately represent the complex risk, therefore by the end

of 2007, the CDS amount stood at an outstanding $62. 2 trillion. This displays the lack of reaction from the management as they lose the reliability of their models while also gravitating towards a more egotistical approach from individuals.

Sometimes in financial institutions, corporate greed can outweigh altruism, this creates a management issue as interests can intervene such that Pavlovich and Krahnke (2011) describe how altruism in organisations can ' assist us to live in a paradigm that goes beyond self-interest and individual ego'. (Pavlovich and Krahnke, 2011, p136). This behaviour can be seen through the subprime mortgage loan situation as individuals loaned out riskier loans for their own self gain, which Bianco (2008) reported on the size of the problem that was said to be $1. 3 trillion in subprime loans outstanding in 2006 whereby workers in Wall Street said this was encouraged to provide these high-risk loans. Their greed can be seen through the complete oppression of the workers who issued these risky mortgage loans knowing the struggles that would eventually arise, which is shown in the Center for Responsible Lending study in 2007 which showed that ' one in five subprime loans issued during 2005-2006 would fail'. (Bianco, 2008, p13). As the housing bubble shattered the default rates on mortgage loans made to higher-risk borrowers with lower incomes or worse credit history was higher than it was on prime borrowers meaning higher interest was paid from people who couldn't afford the loans in the first place. Hence emphasising the ethics which have been embedded into the institutions from the management which has been a clear reflection on the worker's greed that has led to the financial crisis in 2008.

Economic issues have been seen in other causes of the financial crisis such as in the liquidity crisis as there was an element of government failure that contributed towards the crisis. As stated by Le Grand (1991) government failure is ‘ the production and distribution of a commodity through a competitive market in which all the relevant agents are pursuing their own self-interest will result in an allocation of the commodity that is socially inefficient’. (Le Grand, 1991, p423). Blundell-Wignall, Lee and Atkinson (2009) present the theory that the governments along with financial institutions played a key part of the crisis as government policies such as the shortcomings of Basel II accords which lacked liquidity requirements which enabled financial institutions to take on higher risk. However, in the case of Northern Rock, the corporate greed’s luck ran out as they decided to grow assets by primarily borrowing in wholesale markets rather than being funded by deposits which left them vulnerable that as the credit crunch hit the liquidity then ran short. The bank ‘ grew assets at a rate of over 25 per cent per annum in the few years preceding the collapse’. (Blundell-Wignall, Lee and Atkinson, 2009, p19). In consequence to this, the bank couldn’t cover their liabilities and so the bank was taken into public ownership instead of bankruptcy which shows the government attempting to rectifying their own mistake but the damage had already taken effect.

Effects

The systematic risk that occurred due to the breakdown of financial institutions where management issues were seen through the failure to govern whereby moral hazard was apparent due to the dependency on the banking industry as a part of the US economy. Moral hazard has been

depicted as ‘ any misallocation of resources which results when risks are insured’ which in terms of the financial crisis was the risk taken by the institutions that relied on a government bailout. (Marshall, 1976, p880). Mishkin (2011) shows how American International Group (AIG) fell victim of this where they had issued over $400 billion in CDS in which they had to pay-out when the mortgage securities failed by which the US government and Federal Reserve loaned over $170 billion to AIG in total to mitigate the effects of the collapse. Essentially the government were seen as a safety net by many institutions which had taken money away from welfare to subsidise the banks however the ‘ bailout of Bear Sterns had extended the government safety net outside the banking system to investment banks’ leaving the US government and Federal Reserve to fear the growth of moral hazard in the industry. (Mishkin, 2011, p53). The breakdown of these financial institutions led to impacts on the US economy as a recession hit a result of the banking industry collapse.

The Keynesian theory explores consumption and investment both being a ‘ key driving force behind economic fluctuations’ which was proven in the wake of the financial crisis. (Gali, 2013, p983). Bianco (2008) examines the stock market’s role in the recession where Dow Jones had fallen below 13, 000 in August 2007 which discouraged investors from the stock markets that in turn contributed towards the recession causing an economic issue throughout the country. As a result of the reduced investment the economy gradually suffered where according to Mishkin (2011) the GDP rate stood as low as -6. 4% in the first quarter of 2009, which was during the recession, this recession registered as ‘ the worst economic contraction in the United

States since World War II'. (Mishkin, 2011, p56). The damage of the US' economic turmoil had already occurred where there was low confidence from businesses and consumers leading the economy to deteriorate in this period. Along with the economy falling the rate of employment also fell as less confidence from businesses would mean cutbacks on their operations hence being less willing to employ people.

After the recession had begun there was a surge of unemployment which along with the mortgages defaulting resulted in the employment trap increasing, Brown (2003) shows how the opportunity trap works similarly in that they expose ' further limitations to individual freedom'. (Brown, 2003, p150). This theory arises as unemployment can lead to homelessness whereby the employment trap is created in which workers can't get a job due to their living conditions whilst not having homes because of their working conditions. Conforming to the views of Katz (2010) the unemployment rate nearly double to 10. 0% in the fourth quarter of 2009 and remained at 9. 7% in 2010, this shows the how large the unemployment problem was in the US during this time as the percentages remained high over 3 years showing little improvement. Therefore, this has social impacts on society as living standards decreased due to fewer people working which furthered the recession making it harder to overcome the previous economic issues.

Fjærtoft (2015) discusses the impact areas can have on whole industries through the multiplier effect, which can be compared to the financial institutions in the US creating a ripple effect in the banking industry which contributed to the downturn of other economies, especially in the Western

areas. As mentioned previously Bianco (2008) discussing Dow Jones falling below 13, 000 which consequently caused stock prices to fall elsewhere such as a 7% drop in Germany and 5. 5% drop in Britain as of January 2008, highlighting the how the crisis affected other economies besides the US. For instance, the banking sector is a large part of the UK's economy so when the financial institutions collapsed this massively impacted the UK as they entered into a recession where ' GDP fell by over 6 per cent' which goes against their ideal 2% growth showing the huge impact this had on the European countries at the time. (Gregg and Wadsworth, 2010, R62). Therefore, the impacts weren't completely mitigated against as the economic issues still affected the Western world but the argument that can be made is that the sheer shock of the US' economic breakdown blindsided most of the Western world so just like the US it was realistically too late to completely prevent hence why a global recession occurred.

Conclusion

The financial crisis resulted in and was caused by a vast number of issues, both economic and management issues, whereby the management of individuals and the industry were tested along with the economic aspect of the crisis. An argument that can be made for both cases is that there are an equal amount of management and economic issues discussed however to conclude which one outweighed the other the severity of the issues should be targeted. For example, the causes were predominately management issues such as risk management and the individual's level of altruism whilst the effects were predominately economic issues such as global recessions and the welfare of society.

Nonetheless, it is imperative to remember that there are elements of management and economic issues throughout both the causes and effects, which can be detected after the recession hit as they had to then manage the economy to mitigate the damage. As seen in the case of the UK where they experienced their GDP drop over 6% according to Gregg and Wadsworth (2010) which then led to years of austerity and expansionary monetary measures to boost consumption in hope to achieve positive economic growth. Therefore, the UK had to manage their economy and construct a plan to overcome the damage but there were management issues during this time such as regulations being put in place to financial institutions to prevent the situation from reoccurring from the initial source.

Overall the severity of the management issues slightly outweighs the economic issues as poor managers within the industry contributed largely to the causes of the crisis whereby risk management and models discussed in Jorion (2009) initially created the crisis itself. Which shows how the crisis of management was the largest factor in the wake of the crisis but by the time the US had been affected the economic issues were too large to manage completely hence why the multiplier effect examined by Fjærtoft (2015) ensued and led to the breakdown of the Western world. Comprehensively the financial crisis was caused by management issues from individuals' actions and the industry as a whole, however, the effects were furthered through the economic issues of the economies as their overreliance on the US economy can be questioned, where management after the crisis could not have prevented the damage that had already arisen.

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