

# The global financial crisis impact on kuwait economics essay



**ASSIGN  
BUSTER**

The global economic crisis that strikes the whole world in 2008 is a vital issue that needs to be discussed and focused on from present and future studies. Knowing the real reasons and causes for this tragedy should be studied and future recommendation and direction should be considered. The current project attempts to discover and enlighten the causes and the effects of world financial disaster that hit the state of Kuwait. Many financial figures appear in the media and argue that this crisis born and grew in united state of America, as a result, it's impossible to study this crisis here in Kuwait while we isolated the effects other nations. I will clarify how this crisis has developed initial from USA mounting to consume the whole world, and the state of Kuwait. To accomplish the purpose of this project, I will identify the term ' recession' and explain its causes, history and effects on economies. Then the project will discuss mortgage as a main reason for economic crisis that his Kuwait and the entire world. Possible outcome and future requirement to better develop the financial system then discussed. Finally my conclusion stated at the end.

Successive periods of business expansion and contraction in the United States and several other countries, has been identified by The National Bureau of Economic Research in the course of its study in business cycles. Business cycle peak dates indicate the ending of a period of expansion and the starting and begin of a period of contraction and cutback; trough dates signify and suggest the end of a period of contraction followed by the start of a period of expansion. For the United States, the chronology can be traced back in time until we reach year 1854 on a monthly and quarterly basis, and to 1834 on an annual basis. Between 1854 and 1981 (which was last peak or

climax date) some thirty peaks and thirty troughs have been known and recognized. These dates identify thirty expansions and twenty-nine contractions. The contraction periods are commonly identified as recessions.

Literatures give us real explanation about the recession, that it is a period of general economic decline, which is defined usually as a contraction in the GDP for six months (two consecutive quarters) or even longer. Noticed by high unemployment rate, drop in retailing sales, and stagnant wages, a recession generally does not last longer than one year and is much milder than a depression, which can be seen as Alleviative depression, that will not stay for long. Although recessions are considered as a normal part of a capitalist economy, until now, there is no one unanimity and agree from economists on its causes ([http://www. businessdictionary. com](http://www.businessdictionary.com)).

Recession is a part of a normal business life cycle when an economy that grows over a period of time tends to slow down. After growing for 6 to 10 years, economy is expected to prone into a recession. Consequently, we can put it together and say that economic recession is a drop phase of the business lifecycle. In this paper, I'm going to elaborate on the reasons of recessions in general and the possible reasons credited for the current recession. In addition, I will explore into the effect of this recession on developing countries and the possible policy responses.

## **1. 1. REASONS OF RECESSION**

Recession can be attributed to several major factors which can arise concurrently. It can be attributed to either significant drop in prices, or significant increases in prices. The first indicates that the GDP is decreased

when people may spend less money. On the other hand, an increase in price may also diminish private and public spending and as a result, decreasing the GDP. Few of the major causes of recession are inflation, currency crisis, speculation, national debt, and so on.

There are the external reasons of recession which can be attributed to wars and other factors which are beyond the control of a particular economy. Aside from these reasons, other reasons can be high oil prices (as most countries depends upon oil import for industrial growth), weather conditions, some kind of national calamities among others. Several other economic factors also affect recession factor like, lower interest rates which adversely affect savings of households and accordingly banks. Since there is very little savings, banks cannot afford providing loans and that causes severe bottle neck for major infrastructure project which as a final point lead to slow economic growth and impending recession.

Even though the precise causes of recession are still a enigma, it is commonly agreed that recession is primarily caused by the actions taken to control the money supply in the economy. Thus, in the United States many economists think the reason that we went into recession was because of the Federal Reserve. This is because that it is the Federal Reserve responsibility and job to sustain an ideal balance between money supply, interest rates and inflation.

There is another theory which ascribes the causes of economic recession to the events that hurt particular firms or industries rather than events that impact the entire economy. The reason that makes economists support this

theory returns to the negative effect of recession on some industries while other industries seem to thrive during these hard times. The economists believe that this happens because either a major innovation or a change in the price of a key item can adversely affect some firms. This adverse effect leads them to lay off workers and reduce their production, which slows down that industry even further because their demand is greatly reduced. It is also believed that each recession has a unique cause, while others think those recessions usually only have a single cause. Moreover, there are some economists who believe that globalization has changed the nature of the business cycle and this is what is caused recession.

## **1. 2. HISTORY OF RECESSION**

The first recession of the United States can be traced back to the period between 1797 and 1800. It was called the panic of 1797, and it was primarily caused by the deflating effects of the Bank of England as they crossed the Ocean to American soil. The commercial real estate markets were greatly affected by this recession. Britain's economy was in a strained state already, because it was fighting France in the French Revolutionary wars at the time. This indicates how the effects of recession on one country can travel quickly to another.

Between 1807 and 1814, the next recession occurred. It was called the depression of 1807. This depression was primarily caused by the Embargo Act of 1807, signed into effect by then President Thomas Jefferson. This act destroyed a good part of the shipping related industries, and it was fought hard by the Federalists, who allowed smuggling to take effect in New England as a result of the Act.

<https://assignbuster.com/the-global-financial-crisis-impact-on-kuwait-economics-essay/>

Later, following the panic of 1819, this was considered the first major financial crisis to uncover itself before the relatively new U. S. economy. This panic resulted in widespread foreclosures, failing banks, huge unemployment rates, and a gigantic slump in manufacturing and agriculture that caused havoc among Americans. This recession also marked the end of great economic expansion that had taken place following the War of 1812.

Recessions continued to plague not only America, but the rest of the world as well. Countries like Kuwait, KSA, Oman and Bahrain have all had trouble with recessions. In the year 2001, the early 2000s recession hit America. The collapse of the dot. com bubble was truly the cause of these recessions, as well as the attacks that occurred on September 11th on the World Trade Center Towers in New York City.

## **2. THE CURRENT RECESSION**

Many factors should be taken into account in order to date the beginning and end of a recession. The unemployment rate is one of the hall marks that directly involve individuals and families. The U. S. unemployment rate stood at 6.7 percent in November 2008 and is sure to climb in the coming months (U. S. Bureau of Labor Statistics, 2008). Between 1995 and 2007, the annual unemployment rate was below 6 percent in every year except in 2003.

However, in the period between 1974 and 1994, the average unemployment rate topped 6 percent for 16 of those years and 7 percent for 11 of them.

The annual unemployment rate exceeded 9 percent during the worst years 1982 and 1983. During the 1974-75 and 1980-82 recessions, the

unemployment rate's decline coincided with the end of the recession. But

the downturns of 1990-91 and 2001 saw unemployment continue to climb  
<https://assignbuster.com/the-global-financial-crisis-impact-on-kuwait-economics-essay/>

even after the recessions ended; declining only a year or more after the economy had started growing again.

The current financial crisis had its origins in an asset prices bubble that interacted with new kinds of financial innovations that masked risk. The increase in the prices of homes each year from the mid 1990s to 2006 was a significant indicator in inflating house prices. Also, the rapid rise of lending to subprime borrowers helped inflate the housing price bubble (Baily Martin et al, 2008).

Thus, The US credit crisis began as a result of negligence and irresponsibility, whether by the people they or the companies related directly or indirectly to the problem of the credit crisis and the housing mortgage. People were allowed and even encouraged to buy homes they could not afford, and were advised they could re-finance later. People did not think deeply enough about the problem and thought that the worst thing to happen was they will be allowed to refinance or sell their homes later, and that if the matter got worse, they would be able to give up their houses and start renting their homes again (Crane, 2007).

Figure (1) US Total New Privately Owned Housing Units Started.

## **2. 1. THE SHIFTING COMPOSITION OF MORTGAGE LENDING**

After recovering from the 2001 recession, the expansion of mortgage lending was in conformable and other prime mortgages, but as the boom proceeded, a larger fraction of the lending was for so-called ‘ non-prime’ lending that consists of subprime, Alt -A and home equity lending (Baily Martin et al, <https://assignbuster.com/the-global-financial-crisis-impact-on-kuwait-economics-essay/>

2008). Subprime mortgages are loans made to borrowers who are perceived to have high credit risk, often because they lack a strong credit history or have other characteristics that are associated with high probabilities of default. Having emerged more than two decades ago, subprime mortgage lending began to expand in earnest in the mid-1990s, the expansion spurred in large part by innovations that reduced the costs for lenders of assessing and pricing risks. In particular, technological advances facilitated credit scoring by making it easier for lenders to collect and disseminate information on the creditworthiness of prospective borrowers. In addition, lenders developed new techniques for using this information to determine underwriting standards, set interest rates, and manage their risks ( Bernake, Chairman, 2007).

#### Figure (2) volume of Mortgage Lending

In 2001 there were \$2. 2 trillion worth of mortgage originations, with 65 percent of these in the form of conventional conforming loans and Federal Housing Administration (FHA) and Department of Veterans Affairs (VA) loans. An additional 20 percent were prime jumbo mortgages, issued to those with good credit buying houses that were too expensive to be conforming, meaning that 85 percent of originated loans in 2001 were prime quality. There was a huge expansion of mortgage lending over the next couple of years, and in 2003 nearly \$4 trillion worth of loans were issued, but the share of prime mortgages remained steady at 85 percent as the volume of conformable mortgages soared ( Baily Martin et al. 2008. P. 14). The total volume of mortgage lending dropped after 2003, to around \$3 trillion a year



in 2004-06 but the share of subprime and home equity lending expanded greatly.

Total Mortgages organizations by Type: with share of each product; billions, percent. The increasing defaults in the summer of 2007 on mortgages signaled that the subprime market was in crisis. The prices of houses and financial stock started to drop. As a result, the value of household wealth in the US is dropped by trillions. These defaults and drops in house and stock prices were the main reason for the solvency of Fanny Mae and Freddie Mac as well as a number of well known international financial institutions ( Naude, Wim, 2009, P. 3). Therefore, on 7 September 2008, the US government nationalized Fanny Mae and Freddie Mac (ibid). After that, on 15 September 2008, the firm of Lehman Brothers filed for bankruptcy; with US\$639 billion in assets, it was the largest in the history of the US (ibid). This resulted in a great financial panic with large scale selling of stocks.

## **2. 1. 1. THE SUBPRIME MORTGAGE CRISIS**

The subprime mortgage crisis is considered among the most serious economic events affecting the United States since the Great Depression of the 1930s. Subprime mortgage lending is considered a financial innovation. Subprime mortgage lending arises because of three factors (Bernanke, 2005). The first factor is related to the existence of previously undeserved borrowers and investors. Subprime borrowers were desirous to use mortgage loans to finance home purchases. Meanwhile, large numbers of investors were also desirous to earn the relatively high interest rates promised on U. S. subprime mortgage securities. The second factor which contributed to the emergence and expansion of subprime mortgage lending is the catalyst of <https://assignbuster.com/the-global-financial-crisis-impact-on-kuwait-economics-essay/>

advances in technology and know-how. State-of-the-art tools are applied to securitize subprime mortgage. The third factor is the creation of a benign and even encouraging regulatory environment. In spite of the fact that U. S. mortgage lenders are faced with a complex system of state and federal regulations, few of these regulations impeded the evolution of subprime loans. In addition, the existing system of commercial banks capital requirements provides banks with strong incentives to securitize many of the subprime mortgage loans they have originated.

There are some benefits gained from subprime mortgage lending. It is estimated that subprime mortgage lending has funded more than 5 million home purchases. This included first time acquisition of homes for about more than 1 million households. Young and minority households have been among the primary beneficiaries (Jafee, Dwight, 2008. P. 3). these are the basic benefits gained from the long-standing U. S. policy goals for increased home ownership. Increased homeownership has consequently contributed to a rapid increase in new home construction.

## **2. 1. 2. LOAN MODIFICATIONS FOR DEFAULTING BORROWERS**

Home mortgage lenders and servicers didn't accept the idea of modifying loan terms as they were afraid that all borrowers (current and future) ask for such changes. Servicers also face contractual limitations. In spite of all this, lenders and servicers were subject to current government plans because the resulting loan modifications can be characterized as one-time emergency transactions.

Since defaulted borrowers were unable to pay their default debts, the costs imposed by subprime loan foreclosure were limited as they simply gave up their home in lieu of making the mortgage payments. The incomplete disclosures and securitization process caused investors to be involved into purchasing high-risk subprime mortgage securities. However, the purchasers of these securities include only the most sophisticated institutional investors worldwide. In summary, the securitization process per se was not a fundamental source of the subprime mortgage crisis.

Real estate prices are not constant. They are always changing. They always pass in boom and bust cycles. Therefore, the main reason in the moral hazard of subprime mortgage lending is the failure of lenders, investors, the credit rating agencies, and the monetary authority to recognize that mortgage lending booms almost inevitably end in crashes ( Jaffee, Dwight, 2008. p. 4).

The credit rating agencies (CRAs) systematically underestimated the risk on subprime mortgage pools, attributing too much weight to FICO scores and too little weight to the likelihood of falling house prices and its powerful effect in creating mortgage defaults. For similar reasons, the CRAs also underestimated the risk on collateralized debt obligations (CDOs) that were backed by subprime securitization tranches. The major CRAs announced plans to modify their rating methodologies for subprime mortgages pools and CDOs.

The losses which inflicted many subprime mortgage investors are the direct result of the concentration of those risks by leveraging their positions with

borrowed funds. The use of ten leverages for example, can transform a 10 % loss for a given initial capital. In addition, many of the positions were funded with very short-term loans. This strategy parallels that of the savings and loan associations of the 1980s, who also used maturity mismatched and leveraged portfolios, and with similarly dire results (Allen, Franklin, and Douglas Gale, 1994).

## **2. 1. 3. TRANSMISSION OF THE CRISIS TO THE DEVELOPING WORLD**

There are many conditions which contributed to the transmission of the financial crisis from the US to the developing world. The echo of the financial crisis which inflicted the US caused tremendous fear in the developing world in both direct and indirect ways. Banks in developing countries can be affected to the extent to which they hold assets contaminated by subprime mortgages.

Many developing-country banks had limited interrelationships with international banks. Foreign owned banks are not significant players in most countries in Latin America and Africa (Naude, Wim, 2009. p. 4). The exposure to subprime mortgages of United States origin in China, where the financial sector is largely controlled is minimal. However, there is a more serious indirect threat represented by declines and deterioration of stock market prices and housing prices.

As a result, the capital of banks is reduced. This might cause certain problems where they don't hold sufficient levels of their capital in cash. In these situations, it is likely that banks will reduce lending in order to support

their capital. Worse than that is that banks might face solvency problems and may require their governments to recapitalize them. Reduction in investment will be the direct result of reduction and shortage of capital. This will lower growth rates and increase unemployment rates which in turn will reduce economic growth further.

The second factor which contributed to the transmission of the crisis is reduction in export earnings. In recent years, most developing countries are basing their economies growth on exports. The most significant cases include China, India, Japan, Korea, Malaysia, and others. It is likely that the crisis will lead to a substantial decline in the countries' export earnings. The IMF expects growth in world trade to decline from 9.4 per cent in 2006 to 2.1 per cent in 2009. The expected declines will come through a combination of a decline in commodity prices, a decline in demand for their goods from advanced economies and a decline in tourism (Naude, Wim, 2009).

Export earnings are deeply affected by declines in commodity prices. The World Bank predicts that non-energy commodity prices shall decline by 19% in 2009 (Naude, Wim, 2009). A large proportion of countries which depend on commodity prices are in Africa. Over the past seven years, the prices of commodities, including copper, nickel, platinum and petroleum have risen to record highs, and contributed significantly to good growth in these countries.

The third factor is financial flows. The global financial crisis will have significant effects on international financial flows, with private financial flows developing countries expected to fall rapidly from record highs in 2007. The

latest research of Massa and Te Velde (2008) indicates that net financial flows to developing countries may fall by as much as \$ 300 billion over two years which is equivalent to \$ 4. 500 billion in two years (Massa and Te Velde, 2008). Some countries, including successful African countries, are more vulnerable than others. Various types of international resource flows will be affected as a result of the impact of the financial crisis. This will include private capital flows such as Foreign Direct Investment (FDI), portfolio flows and international lending; official flows such as development finance institutions; and capital and current transfers such as official development assistance and remittances.

The World Association of Investment Promotion Agencies anticipates a 15% drop in FDI 2009. FDI to Turkey has already fallen 40% over the last year and FDI to India dropped by 40% in the first six months of 2008. FDI to China was \$6. 6 billion in September 2008, 20% down from the monthly average in year 2008 so far, and mining investments in South Africa and Zambia have been put on hold (Velde, Willem, 2008).

As a result of the financial crisis, developing countries are suffering from a drop in bond and equity issuances and sell-off of risky assets. The average volume of bond issuances by developing countries was only \$6 billion between July 2007 and March 2008, down from \$ 15 billion over the same period in 2006. Between January and March 2008, equity issuance by developing countries stood at \$5 billion, its lowest level in five years. As a result, World Bank research suggests some 91 International Public Offerings have been withdrawn or postponed in 2008 ( Velde and Willem, 2008).

Figure 3: GDP growth in Developing and high income countries, 1981 – 2007

It is a well known fact that there is financial contamination and stock markets have fallen around the world, with the largest losses since the 1930s. This has triggered entrenchment by investors, with reports that they have withdrawn \$45 billion from Korea, \$6.1 billion from South Africa, and \$16 billion from India this year. Turnover on the nascent stock market in Uganda has fallen 60% this year. Remittances to Mexico (which depend almost exclusively on migrants to the USA) have decreased by 4.2%, with the strongest declines in August. Remittances to Kenya (which also depend on the US economy) have been hit even harder, with the Central Bank estimating a 38% year-to-year drop in August.

Export revenues are falling rapidly for many countries. Zambia has been affected with the price of copper falling by 40% since July 2009. Tourism bookings are down 40% in Cambodia. And visitor arrivals (and revenues) to Kenya fell 30% over the first 9 months of 2008. Many developing country policy makers suggest that the global financial crisis might by pass developing countries. However, it is now clear that all countries will be affected, with the effects varying by country. The year 2008 was the year of the global financial crisis and beginning of recessions in the UK, US and Germany. However, developing countries shall witness the fall out in 2009. Therefore, they should be prepared. They have to set up a crisis task force to gain a better understanding of the real and financial effects, followed by immediate action.

## **2. 2. TAKING THE TEMPERATURE OF THE CURRENT FINANCIAL CRISIS**

Colorful graph of the TED Spread are provided by Yves Smith Company, which has become the consensus indicator of the depth of the current financial crunch: Fig (4) Taking the temperature of the current Financial crisis.

The National Bureau of Economic Research indicated that the deterioration in the labor market throughout 2008 was one key reason why it decided to state that the recession began last year.

Payrolls have been trimmed by 1. 2 million jobs in the first 10 months of this year. The NBER considered certain measures such as real personal income, industrial production as well as whole sale and retail sales. All those measures reached a peak between November 2007 and June 2008. Moreover, the gross domestic product is also put into consideration.

The current recession is one of the longest downturns since the Great Depression of the 1930's. The last two recessions (1990-1991 and 2001) lasted eight months each, and only two of the 10 previous post-Depression downturns lasted as long as a full year, according to the NBER.

Figure 4: Taking the temperature of the current financial crisis

In a statement, White House Deputy Press Secretary Tony Fratto said that even though the recession is now official, it is more important to focus on the steps being taken to fix the economy. Tony Fratto also said that “ the most important things we can do for the economy right now are to return the



financial and credit markets to normal, and to continue to make progress in housing, and that's where we'll continue to focus," furthermore he add that "addressing these areas will do the most right now to return the economy to growth and job creation." The real concern for economists is that there is no end in sight for the downturn.

Thus we can say that because of the contraction of the housing market and problems in financial markets the degree of the current recession could be the most severe in decades, perhaps comparable to the great depression. There is a significant relation between the severity of the decline and the duration of the recession. These two measures are not independent.

### **2. 3. THE EFFECTS OF GLOBAL RECESSION ON KUWAIT**

The effects of global recession is not exclusive only to the business community, but among Kuwait's workforce as well. A good number of companies have reportedly already shed jobs. However, the banking assets in Kuwait increased 10. 6 percent in 2008 compared to previous year. The increase in banking asset value was 3. 2 billion Kuwait Dinars (about 11. 52 billion U. S. dollars), shooting up from 35. 5 billion dinars in 2007 to 39. 3 billion dinars in 2008.

All sector in Kuwait suffered the impact of global financial meltdown including the real estate sector. It has been affected by Laws 8 and 9 for the year 2008, which could prevent companies from doing business in the residential sector and prevent banks from offering finance for residential real estate market, he said. " Although Kuwait property sector has suffered from

inflation in prices, due to global recession, the time is now ripe for the market to begin recovery process”.

Al-Haddad explained that the real estate companies listed on the Kuwait Stock Exchange (KSE) are among those, whose shares are being actively traded, which implies that the sector involves confidence of traders and investors. Signs of easing in property market have already commenced with courts exempting Islamic Banks from constrictions of Law 8 and 9, enabling them to resume funding for residential real estate market again, he concluded.

## **2. 4. THE POSSIBLE OUTCOMES**

The current world concern is to anticipate the possible results of banking failures and reductions in domestic lending, reductions in export earnings, and reductions in financial flows to developing countries. It is anticipated that this will result in reducing private sector investments and household consumption. Government expenditures will be reduced as governments will now face the higher costs of raising funds coupled with less tax income. Low investment, consumption and government expenditures could sell higher unemployment and poverty across the developing world.

The IMF forecasts average world growth to decline to 3. 0 per cent in 2009, down from 5 per cent in 2007 (IMF 2008) (Naude and Wim, 2009). The United Nations baseline forecast for world growth projects a decline from 2. 5 per cent in 2008 to 1 per cent in 2009. Their worst-case scenario sees a contraction of 0. 4 per cent in the world economy in 2009.

As far as developing countries are concerned, the World Bank has revised its estimate for growth downwards from 6.4 to 4.5 per cent for 2009 (World Bank 2008). For Africa, home to many of the least developed countries, growth expectations are also down, given the continent's dependence on exports and commodities. However, as Harsch (2009) shows, many of these countries are more resilient than before, and expectations are that African countries will continue with good growth in 2009, of around 4.7 per cent according to the IMF forecasts and 4.1 per cent according to UN-DESA forecasts (Naude and Wim, 2009). Also, the expectations of GDP growth of two of the largest economies, China and India, are also down, although these countries are still expected to continue growing at high rates of around 7 to 8% in 2009 (Naude and Wim, 2009).

Thus, developing countries are paying an enormous economic price for a crisis that evolved at the center of the world's financial system. They have to study carefully how to protect themselves from external financial shocks. In addition, most developing countries are striving hard to build a more functionally efficient financial system. Therefore, this crisis should be seized as an opportunity to expose the hidden risks of financial development and how more sophisticated financial systems require more, not less, regulation.

During 2008, the United States stock market lost about 35 per cent of its value. Compared with other industrial countries and with the largest emerging markets, it did relatively well. All large emerging markets had dollar returns which were well below those of the United States (United Nations Conference on Trade & Development, 2009).

Figure 5: Equity Market Dollar Returns, 2008

Figure 6: Emerging Market Spread, January 2007 – December 2008.

## **2. 4. 1 FINANCIAL DEVELOPMENT REQUIRES MORE AND BETTER REGULATION**

The financial system of the developing countries is less efficient than that of the developed ones. Recognizing the importance of finance for investment in fixed capital and growth, many developing countries adopted ambitious structural reform programs which aim at modernizing and improving their own financial systems. However, there are serious doubts as to whether these pro-market policies were successful in their aim of increasing the social efficiency of their financial sector (UNCTAD, 2008).

The financial system of developing countries is often characterized by a non-competitive financial system in which banks make good profits by paying low interest on deposits and charging high interest rates on loans which are only paid to super-safe borrowers. Shareholders and bank managers are highly satisfied with rents emerging from limited competition, but the financial system is hardly conducive to investment in fixed capital and to economic development. Credits will be limited and unlikely to flow to potentially high-return investment projects in the productive sector. The task of reforming the financial system will not be an easy one. Even if policymakers recognize that financial instruments that may have high social returns in a more developed country may not be appropriate for their less developed economy and try to target the reform process to the real needs of their country, financial regulators will soon start facing new problems. By reducing

bank margins, the reform process leads to a whole new set of incentive problems.

Although the old system was inefficient, it was easy to control. A more competitive environment changes the incentive structure of bank managers in two ways (Ragan, 2005). First, as their compensation now depends on ROI, bank managers are prone to face more upside risk-taking. This is problematic if bank officers are used to operating under the “3-6-3 risk management rule” (borrow at 3 %, lend at 6%, and be on the golf course by 3 PM) and end up assuming risk that they don’t understand. Along similar lines, regulators used to an inefficient but stable banking system may not understand the new risks and vulnerabilities.