1. the rest of the world collectively

Economics

1. Global FinancialCrisis – An Overview Asstated by (Verick & Islam, 2010), the globalfinancial crisis of 2007 has cast its long shadow on the economic fortunes ofmany countries, resulting in what has often been called the ‘ Great Recession’. What has started as seemingly isolated turbulence in the sub-prime segment ofthe US housing market, mutated into a full blown recession by theend of the year 2007. This led the rest of the world collectively intorecession by mid-2008, as many of the important economies in the European Unionand Japan, which were dependent on the US foreign financial institutions wereaffected. Overall, since the 2nd world war, 2009 was the year thatthe world was in a great recession after the major prosperity years of2002-2007.

The global financial crisis has affected almost all countries inthe world. 2. Reasons ThatLed to the Crisis According to (Bosworth & Flaaen, 2009) the precise causesof the financial crisis remain surprisingly controversial. Much of the recentanalysis has emphasized the role of developments within the US housing andfinancial markets. Home prices began to rise rapidly in the late 1990s and, bythe year 2000, had far exceeded the growth in either incomes or rent values(Figure 1). At their peak in 2006, home prices were nearly 50% above a normdefined by their historical relationship to household income. Most analystspoint to the excesses of the subprime mortgage market in the US and thesubsequent transformation of those assets into exotic secondary marketinstruments as key factors that led to the housing price bubble.

Thebursting of this bubble and the subsequent collapse of the market for subprimemortgages initiated a chain-like collapse of markets for securitized assets anda crisis of confidence among financial institutions. Some

economists argue, however, that the excesses in the housing and mortgage-backed securitiesmarkets were merely proximate causes and point to what they regard as morefundamental determinants that created an environment in which the speculativeexcesses of the real estate and securitized asset markets could flourish. Theyemphasize either (i) a US monetary policy that remained simulative for too longafter the 2002 recession or (ii) excess saving outside the US that drove downglobal interest rates to levels that fueled the speculation. While bothof these hypotheses could serve to explain the consequent bubble in US assetprices, they do not provide an immediate explanation as to why defaults in arelatively small portion of the credit markets (subprime mortgages) had suchcatastrophic, system-wide consequences. 3. The Beginningof the Collapse The housing price bubble burst in mid-2006 and both housing pricesand housing demands began a long period of contraction.

With declining homeprices, borrowers were unable to refinance their loans and default ratessoared. Against this backdrop, problems in the markets for mortgages andmortgage-backed securities festered for over two years. The situation explodedinto a full-blown financial panic only in September of 2008 with three majorevents: the government takeover of Fannie Mae and Freddie Mac on 8 September, the Lehman bankruptcy on 15 September, and the Federal Reserve’s bailout of AIGon 16 September. In all three cases, the firms were unable to refinance theirdebt because of increasing investor/partner uncertainty. (Bosworth & Flaaen, 2009) 4.

The Mechanismof the Failure The following diagram illustrated by (Verick & Islam, 2010) clearly states themechanisms of the failure in the US market.

The mechanisms were a combinationof root causes that are categorized under Government causes, Financial /housing market, Households and Global causes. GovernmentCauses: Financialderegulation from 1990s onwardsLoosemonetary policy (2002-2005)Financial /housing market & Households Causes: Useof off-balance sheet entities (Structured investment vehicle (SIVs)) andover-the-counter transactionsComplexsecuritization of assets (Collateralized debt obligation (CDOs)) accompanied bylax risk analysis / assumptionsExcessiveleverage and reliance on short-term debt (repos)Remunerationincentives encouraged excessive risk-takingCreditratings agencies failure to accurately assess riskAggressivemortgage lending and poor lending standards Householdsborrowing beyond their means Global Causes: GlobalimbalancesInter-linkagesin global financial system 5. How the CrisisHit the US Economy and the Rest of the World The financial crisis that started in the United States in mid-2007eventually spread around the world to both advanced and developing economiesresulting in the worst recession since the Second World War.

Countries reacteddifferently towards the crisis and its severe impact summarized by themagnitude of economic contraction and deterioration of labor market. Thisparagraph reviews this variation in the impact in the context of countries’initial conditions and transmission channels. The United States was theepicenter of the crisis and its economy was hit directly by the meltdown in thesub-prime mortgage market along with the repercussions of the financial crisisand the ensuing credit crunch. The implication in December 2007 yielded arecession which reduced by 2. 7 per cent in2009.

However, this contraction issmaller than most G20 countries and smaller than the average for advancedeconomies (-3 per cent).

(Verick & Islam, 2010) Based onanalysis from the Bureaus of Economic Analysis, Bureau of Labor Statistics andFederal Reserve Flow of Funds the Real GDP percent fall from pre-recession peakis below the -5% while according to the US Department of Treasury 8. 8 millionjobs were lost and in $19. 2 trillion worth of household wealth was lost asreported in 2011.

The impact ofthe financial crisis was evident in two major financial institution collapsesillustrated in the following Federal Reserve Flow of Funds’ chart, the firstbeing Bear Streams’ collapse in March 2008, followed by Lehman Brothersbankruptcy in September 2008… a strong hit to the US financial system. Whereasthe impact on a global level was identified by IMF through its 2009 WorldEconomic Outlook Database as an overall deterioration in growth for all globalregions with the most impacted is the region of Commonwealth of IndependentStates and the least impacted was Developing Asia.