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The Global 2008-2009 Financial Crisis: Origins, Patterns, Consequences, and Policy Responses

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Abstract

The global 2008-2009 financial crisis played a significant role in global financial history. Analyzing it is of vital importance to prevent such a crisis from happening again. The paper is based on the global financial crisis and aims to analyze its origins, patterns, consequences and policy responses. The paper consists of six parts. The first part is the background of the crisis, providing some basic information. The second part mainly analyzes the origins of the crisis. The third part is the patterns of the crisis, illustrating how the crisis evolved. The fourth and fifth parts provide information about the consequences and policy responses of the crisis in America and global areas respectively. In the end, a conclusion is drawn based on the above analysis.

Keywords: global 2008-2009 financial crisis; origins; patterns; consequences; policy responses

1. Background

On March 13, 2007, the New York Stock Exchange required a trading halt for New Century Financial Corporation, the second largest subprime lending institution in America, due to its imminent bankruptcy. This event marked the formal onset of the subprime lending crisis. Then the subprime lending crisis intensified gradually, and quickly spread from the United States to global areas and eventually evolved into the international financial crisis.

The global 2008-2009 financial crisis, triggered by the American subprime lending crisis, not only greatly affected America but also affected other economic entities such as the European Union, the United Kingdom, Japan, Korea, and China... The impact of the global financial crisis extended to financial, economic, political, and social aspects. A large number of enterprises and banks closed down, the stock market experienced constant downturn, and the unemployment rate rose sharply... Facing the impact of the global financial crisis, all the countries had to adopt corresponding measures to address and mitigate its effects.

2. Origins

Considering the origins of the financial crisis, there are several factors contributing to its existence. To sum up, the main factors are ineffective supervision, incorrect monetary policy, dollar-based international monetary system, the lack of professional ethics of financial institutions and credit rating agencies, and credit crisis.

Ineffective supervision. A lack of coordination among different regulatory bodies resulted in regulatory loopholes. The regulatory bodies just focused on individual financial institutions and individual business, ignoring the links among different financial institutions and different financial markets. Also, the regulatory bodies overlooked the systematic risk, the transformation from unsystematic risk to systematic risk, the connection between financial system and the real economy, thus weakening the effect of financial supervision in the overall economic system. Besides, the supervision on investment banks, subordinated bonds and other financial derivatives was not sufficient, which led to an overall crisis faced by the credit market and caused the subprime lending crisis eventually (Jiang, D. Z., 2008). The variety of financial instruments and derivatives also increased the difficulty of supervision.

Incorrect monetary policy. Since the beginning of 2001, America had always implemented low interest rates policy. However, from 2004 to the end of 2006, America successively raised interest rates 17 times. Because most of the people who bought subprime loans chose floating rate to repay money, the costs increased sharply, and repayment pressure of borrowers also increased accordingly (Cao, Y. Z., 2007). As a result, default rate was soaring continually and housing prices fell further, houses buyers were difficult to sell their houses. Even they could sell houses, the money they got was also less than to repay the remaining loan. The subprime lending market was further deteriorated, financial institutions generally appeared loss and lent to one another, the global money market once lacked liquidity.

Dollar-based international monetary system. The leading role of USD in the international monetary system led to a significantly different economic development mode of America compared with other countries. For America, the dollar as the base currency can be infinitely printed. If there was debt problem in the international payment, it can be temporary solved by increasing the amount of currency issuance. Since the late 1990s, the American current account deficit continued to increase substantially, and the global economic imbalance was increasingly serious as a result. In order to compensate for the large current account deficit, a large number of capital inflows were needed. What America did is to attract global capital by utilizing a variety of financial derivatives.

Other countries cannot solve the international debt problems in this way. Instead, for the sake of the nation's economic security, USD was needed for them to serve as foreign currency reserves. And those countries tended to select investment tools with relatively higher profit so as to acquire more foreign exchange reserves, thus causing large amount of funds flow into the subprime lending market.

The lack of professional ethics of financial institutions and credit rating agencies. Faced with increasingly professional financial investment, some individuals and institutions lack the ability to understand the financial products and the way to make investment. Therefore, the principal-agent mode is a must for them. Due to the existence of information asymmetry, some financial institutions agent pursued short-term profits at the expense of professional ethics and consumers' interests. In the process of selling financial derivatives, some financial institutions did not conduct necessary risk assessment for investors and just for the purpose of selling products as many as possible. Accordingly, a vast number of investors suffered losses in the crisis.

In America, there are three major credit rating agencies: Standard & Poor's, Moody's and Fitch. The rating results of these three major rating agencies have been recognized by American regulatory bodies and used as an important indicator to supervise financial institutions for a long time. But in order to obtain high profits, rating agencies posted the security label on high-risk bonds, which resulted in ineffectiveness in revealing the underlying risk of financial products and an increase of non-cautious investment (White, L. J., 2010).

Credit crisis. Credit is significant in America, for the popularity of loan consumption. However, this consumption pattern seriously overdraft future money, and extended from the real estate market to stock market, insurance market and other areas concerning personal assets. With the fast speed of financial innovation, the credit scale expanded without restraint and the risk was also spread. Once the price of assets declined, the credit chain eventually broke in the domestic real estate market and rapidly spread to upper levels and global areas through various channels.

3. Patterns

The global 2008-2009 crisis, in fact, is a crisis resulting from the American subprime lending crisis. This crisis can be subdivided into three stages: latent stage, emerging stage and the deteriorating stage. Through these stages, the subprime lending crisis gradually evolved into a global financial crisis. The crisis was not a sudden outbreak, it happened after a certain period of time. In the beginning, the adverse effect caused by the subprime lending crisis was not impossible to solve, however, failure to take effective measures immediately further expanded the crisis.

The latent stage: real estate market. In America, the low-interest rate policy led to the sharp rise of demand for housing, resulting in the prosperity of the real estate market accordingly. In order to gain more benefits, the financial institutions in America began to issue subprime loans. As the subprime loan was easy to get, it was favored by an increasing number of housing buyers (Zhen, W. J., & Zhou, X. Y., 2010). Under the circumstance of rising housing prices, investors were attracted to speculate in real estate market, which led to the excessive development of subprime lending market and related financial derivatives (Beker, V. A., 2013). So when the Federal Reserve raised interest rates, there was a sharp decline in the real estate market. As a result, borrowers were unable to repay their loans, leading to the bursting of the real estate bubble. In the year of 2007, more than 30 subprime lending companies in America were forced to close down, and then the subprime lending risk evolved into a systemic crisis. Moreover, due to insufficient attention from the American government, the crisis spread.

The emerging stage: from real estate market to financial market; from America to globe. The subprime lending crisis accelerated the turbulence in American financial markets and caused large fluctuations in the stock market. The debt market, currency market and other related derivative product markets were all affected as a result of the subprime lending crisis. Because the American subprime derivatives cover the markets all over the world, and many large financial institutions expanded business into overseas markets, this subprime lending crisis not only influenced America greatly but also influenced other countries in the world.

On July 10, 2007, the Standard & Poor's lowered the subprime loans rating, causing a large shock in the global financial market. Most of the world's stock indexes fell. And with the spread of the crisis, major financial institutions suffered serious losses and more and more financial institutions were involved. On September 15, 2008, Lehman Brothers, the fourth largest investment bank in America, was deeply caught in serious financial crisis and announced for bankruptcy protection, leading to the loss of confidence in financial markets and financial institutions (Adrian, T., & Shin, H. S., 2010). After that, the crisis spread from American financial market to European and emerging markets. The financial crises in individual countries officially transformed to the global financial crisis.

The deteriorating stage: from financial market to real economy. The crisis did not stop in the financial markets and further affected the real economy through a variety of channels instead.

For residents, the wealth held by them decreased due to falling value of financial assets. The consumption was therefore restrained, and people tend to purchase less. As people just bought the necessities that they need and greatly reduced expenditure on recreation, other goods such as durable goods, luxurious goods and leisure industries were seriously hit. Eventually, the economy entered a recession.

For enterprises, the significant drop of market value restrained their motivation to make new investment and their financing ability. As investment is the basis of market vitality, lacking enough investment certainly slow the economic development. If an enterprise does not possess sufficient fund to expand its business and make innovation, how can it make sustainable profits?

4. Consequences

The consequences brought by the global financial crisis covered a wide range of areas, from America to Britain, Japan, China, France and other countries all over the world. Although the specific consequences were different in various countries, the common thing for them is that it would take all of them a long time to recover from the bad consequences caused by the crisis. Specifically, the consequences of the crisis in America and those in global area were illustrated as follows.

a) Consequences in America

The global financial crisis imposed great influence on the financial market, real economy and residents of America.

Firstly, the crisis brought dramatic damage to banking industry and insurance industry in America. Affected by the subprime lending crisis, the five biggest investment banks in America declared bankruptcy or being purchased successively. And there were a number of other banks and financial institutions closing down. The largest insurance company in America—AIG suffered serious losses and was on the verge of collapse, finally being taken over by the American government.

Besides, the stock market was greatly influenced as well. In September 2008, the Dow Jones Industrial Average and S&P 500 Index plummeted 7.87% and 9.03% respectively, which were the largest one-day drop since 1987. The NASDAQ also fell down by 8.47%.From October 6th to October 10th, the Dow Index fell nearly 1900 points, a percentage of 18.2%.

Secondly, after the burst of real estate enterprises bubble, the real estate economy fell sharply. The two largest mortgage companies Fannie Mae and Freddie Mac in America were nationalized and taken over by the American government (Thakor, A. V., 2015). The construction industry, directly affected by the need for houses, started to shrink. Besides, some other industries such as cars and steel manufacturing industry were also negatively affected.

Facing the adverse effects of the subprime mortgage crisis, the industry had to begin laying off employees, which caused the rising unemployment rate. According to data from the U. S. Department of labor, the September 2008 saw a decrease of 15.9 million non-farm employees in America. The unemployment rate reached 6.1%, the highest number within five years.

Thirdly, with the increase of unemployment rate, the unemployed lost economic sources, the employed had to undertake more work than before without paying more money and faced pressure of being fired at any time in the future. As a result, people's sense of happiness dramatically declined.

Due to unemployment, the disposable income of people reduced and led to the decline of purchasing ability accordingly. What’s more, the closure of enterprises and economic downturn caused a serious blow to consumers’ confidence, people began to reduce consumption and save money, which made the retail industry in America greatly affected and brought a further blow to the real economy (Barth, M. E., & Landsman, W. R., 2010).

b) Consequences in the global area

Other than the bad consequences caused in America, the financial crisis also extended its influence to the global area.

Firstly, the financial crisis inflicted great damage on the global financial market. After the outbreak of the financial crisis, global stock market appeared unprecedented massive underselling. Especially for some large companies, the decline was even serious. In October alone, the 52 stock markets all over the world fell by 20.7% on average, a total loss of about $5.79 trillion (Lan, Y. G., 2008. 11. 4).

Besides, a large number of banks were nationalized or purchased by others. For example, the largest mortgage bank in Britain—Halifax was purchased by the Lloyds TSB Group. Also, the global financial assets shrank seriously, the liquidity of capital market declined, and in many countries, particularly in Europe, the debt rating was falling (Thakor, A. V., 2015).

Secondly, the crisis hindered the economic advancement in the global area. According to the World Economic Situation and Prospects (WESP) 2009 Report issued by the UN Department of Economic and Social Affairs, the global GDP growth rate dropped from 3.8% in 2007 to 2.5% in 2008. Specifically, the influence of the financial crisis on the global economy is mainly reflected in the trade, industries, employment, enterprises and investment etc.

International trade. Under the negative impact of the financial crisis, international trade was seriously affected. It was particularly disastrous for countries with greater dependence on import and export trade. Japan is one of them. During the four-month period after the crisis, Japan's exports fell by 27% and imports fell by 14%.

Industries and employment. In addition, the industries also experienced some adverse influences. The global housing prices and car sales witnessed various degrees of decline in different parts. And driven by the decline of the automobile industry, the whole world manufacturing industry was also in bad condition. As a result, there was a rapid decline in employment positions and a rapid increase in the unemployed population. Among them, Sweden Volvo Car Corporation announced a second layoff of 900 employees in 2008, and France's Renault and Peugeot Corporation announced a layoff of at least 600 people.

Enterprises and investment. Getting loans from banks is an important method for enterprises to gain fund. Due to the decreased loans of commercial banks around the world, the scale of enterprise financing was greatly reduced, which resulted in a lack of sufficient funds to support their economic activities. Besides, the financial crisis not only led to the reduction of overseas investment that developing countries can get but also forced financial institutions in developed countries to recycle the funds had already invested in developing countries (Durusoy et al., 2015).

5. Policy response

Facing the bad consequences of financial crisis and taking into account economic situation, different strategies were adopted by different countries to deal with the crisis.

a) America

For America, the main strategies adopted are monetary policy, creative financial instruments, and some others.

Monetary policy. From August 9, 2007 onwards, the Federal Reserve frequently opened market operations (Adrian, T., & Shin, H. S., 2010). On November 1, 2007, the Federal Reserve injected $41 billion into banking system, and on November 15th injected another $47.25 billion. The Federal Reserve also affected the interest rate level of the overall financial system and market liquidity by reducing the benchmark rate. From September 18, 2007 to April 30, 2008, the Federal Reserve had lowered the benchmark rate for seven times. Besides, in order to intervene and influence the market interest rate as well as the supply and demand in monetary market, the Federal Reserve reduced the discount rate. On August 17, 2007, the Federal Reserve reduced its discount rate from 6.25% to 5.75%. Until December 2008, the accumulated decline in the discount rate reached 575 basis points.

Creative financial instruments. The American government created some innovative financial instruments to facilitate financing channels, which were Term Auction Facility (TAF), Primary Dealer Credit Facility (PDCF), Term Securities Lending Facility (TSLF), the

Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), Commercial Paper Financing Facility (CPFF) and Money Market Investor Funding Facility (MMIFF) respectively (Thakor, A. V., 2015). By doing so, the liquidity of the market increased, a number of financial institutions were prevented to close down, the normal financial transactions were promoted and the confidence on market was stimulated to restore.

Others. The American government strengthened the supervision of financial institutions and regarded complying with the market rules, disciplines and promoting the international cooperation as the basis of the reform of financial supervision system. The government also provided assistance for those financial institutions that played an important part in American economy and society, by ways like purchasing preferred stock so as to offer financial support or offering loans directly. What's more, the unemployment relief was extended from 26 weeks to 39 weeks, involving $8 billion.

b) Other countries

In order to overcome the adverse effects caused by the crisis, Japan, Korea, Britain and China also took respective policies. Details are as follows.

Japan. Faced with the crisis, Japan carried out tax reform to further expand domestic demand, such as reducing the related tax of elderly people in the purchase of houses to help them buy their own house; adjusting the relevant tax to support the economic activities of the small and medium-sized enterprises to ensure their financial needs. On October 30, 2008, the Japanese government proposed a total $269000 trillion yen program to stimulate the economy, which included offering cash subsidies to all families, reducing highway tolls, increasing subsidies for farmers, providing credit guarantee for small and medium-sized enterprise in trouble etc. On December 12, the Japanese government proposed another program with an amount of 230 billion yen to stimulate the economy, provide unemployment relief funds, offer financial support to corporations by buying corporate bonds and reduce the tax on housing loans and investments in equipment.

Korea. First of all, Korea adopted different strategies to boost exports and increased subsidies for enterprises participating in overseas exhibitions. Second, Korea also improved the foreign investment environment and actively carried out investment activities to promote foreign investment. Third, for the purpose of supporting small and medium enterprises, restrictions were reduced and the scale of financial support was expanded. Fourth, rectifying unprofitable enterprises and making structural reform. Fifth, Korea provided capital support for small-scale craftsmen, traders and low-income groups to create new job positions and expand employment opportunities. Besides, Korea government increased fiscal expenditure, reduced tax, provided holiday funds and implemented the fiscal budget in advance. What's more, Korean central bank cut interest rates for many times to keep market interest rates stable.

Britain. The British government exempted the stamp duty of those housing transactions that cover more than 175000 pounds for one year and allocated 6.5 billion pounds for the public housing program for the next three years. Besides, to provide financial support to thousands of housing buyers faced with mortgage default risk, interest-free loan was offered to buyers purchasing their first house and with annual income less than 6 million pounds. The highest amount was equivalent to the one-third of value of new house, and the longest period reached 5 years. The British government also provided capital for the eight largest banks through the purchase of preferred stock and offered guarantees for loans between banks. The British Central Bank reduced rediscount interest rate for eight times since December 2007 and with a number of 1% on February 6, 2009. On March 5, 2009, the rediscount interest rate dropped to 0.5%. Also, the British Central Bank continued to utilize various monetary instruments to increase the amount of the money supplied Chen, Y., & Chen, J. D. (2009).

China. In order to cope with the negative influence of the financial crisis, China implemented the Ten Industry Revitalization Plan and the economic stimulation program with an investment of 4 trillion yuan (Du et al., 2008). Specifically, the ten industries include auto industry, steel industry, shipbuilding industry, textile industry, equipment manufacturing, electronic information industry, light industry, petrochemical industry, non-ferrous metal industry and logistics industry. The four trillion investment plan mainly focused on railway, roads, electricity and other large infrastructure fields. By increasing investment in these areas, the plan was designed to further strengthen the infrastructure construction in China, alleviate the employment pressure and promote the increase of income, solve overcapacity problems in current steel and cement industry, maintain social stability, and promote the sustainable development of society. In the aspect of monetary policy, Chinese Central Bank reduced interest rates as well as reserve requirement ratio, and increased the money supply and credit scale so as to provide strong financial support for investment. In addition, Chinese Central Bank also reduced the frequency of bills issued. And in the aspect of fiscal policy, Chinese government expanded public investment and implemented structural tax reduction, which mainly focused on the transformation of value-added tax and the increase of the export rebate rate.

6. Conclusion

Based on the above analysis, some conclusions can be obtained.

First of all, form a correct understanding of financial innovation. Admittedly, financial innovation can make contributions to promote economic development. However, at the same time, it also brings some risks. And because of the operation mechanism of financial market, financial risk is often more serious than other risks. Therefore, financial innovation should not be conducted just for the purpose of profits and regardless of the hidden risk. It means that the appropriate financial regulatory mechanism should be institutionalized whiling making financial innovation, and the risk should be placed in the controllable range (Mishkin, F.S., 2001).

Secondly, properly deal with the relationship between the virtual economy and the real economy. Virtual economy is developed on the basis of the real economy, which must be compatible with the real economy (Jiang, D. Z., 2008). If the virtual economy and real economy adapt to each other, virtual economy will benefit the development of the real economy, otherwise economic bubble might be created, further causing false prosperity of economy and even crisis if severe enough.

In addition, strengthen the control on international capital. The accumulation of foreign capital will inevitably cause the international expansion of financial capital, imposing influence in global areas, especially for developing countries. As a result, in the face of the excessive accumulation of the financial capital, it is imperative to take effective measures to regulate so as to avoid the occurrence of financial crisis.

Finally, increase the independence of domestic financial development. With the globalization of economy, the connections among different countries are increasingly close, which also lead to the rapid and extensive spread of financial crisis. Therefore, while opening to the outside world, countries should also enhance the independence of finance and form awareness of risk prevention in the meantime.

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