

# **The Global Financial Crisis: Causes and Solutions**

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This paper describes the process that caused the financial credit crisis. It also analyzes the factors that led to the crisis and corrective measures that were taken to face the financial challenges. Financial market deregulation and lack of supervision has caused the mortgage market bubble that led to the credit crisis and forced the insolvency of many banks in the U.S. and the world. Imbalance in the world trade, United States consumption pattern, and world dependency on the US\$ currency, and the complex US financial derivatives market, were among the leading factors for the crisis. To face the crisis governments implemented different financial saving plans, spending stimulus packages, and aggressive monetary policies. To avoid future crisis financial markets must be effectively regulated and supervised. The global trade must be balanced and a better financial system must be implemented by the IMF.

## **I. Introduction**

Presently, the world is experiencing a severe economic recession with a rising unemployment and lower industrial output due to business failures and low consumer spending. This recession is the outcome of the global financial crisis that has originated in the United States and extended to the rest of the world in 2008. The financial crisis has forced the insolvency of many banks and financial institutions in the U.S. and the world. This paper will examine how the financial crisis happened and the factors that led to the collapse of the financial system. The paper will be divided into the following sections. Section two will describe the process of the collapse of the credit market. Section three will give a background to the factors and issues that led to the financial crisis. Section four will describe what has been done to contain the crisis. Section five will present few correction measures and recommendations to get out from the crisis. Finally, section six will present conclusions and recommendations for the global financial crisis.

## **II. Collapse of the Financial Markets**

The credit crisis was a direct result of failure of the mortgage market in the U.S. The problem has started in 2001, when the Federal Reserve of America (FED) decided to lower the interest rate to 1%, in order to overcome the negative affect of September 11 on the growth of the economy. The FED action accompanied with influx of money from growing China and the Middle East has resulted in abundance of credit in the United States. Financial investors represented by the Investment Banks and Wall Street companies were looking for solid return on their investment beyond the FED 1% interest rate. They capitalized on the opportunity presented by the growing mortgage market in

the States. The abundance of credit has encouraged many Americans to buy their own houses by obtaining loans from Mortgage Lenders such as Fannie May and Freddy Mack. The excessive lending has increased demand for new houses as more Americans entered the mortgage market. The result was a boom in the Real Estates market from 2002-2006, with houses prices almost tripling during this period. Mortgage companies packaged these loans and sold them to Investment Banks which in turn has categorized these loans according to their risks and sold them as financial derivatives under different names and returns to investors around the world. In essence, the risk has been shifted from mortgage lenders to Investment Banks and then to financial investors. The scheme was risky, but as long home owners are paying their monthly installment, everything seemed normal and acceptable.

To keep the process smooth, Mortgage Lenders started to run out of credit worthy applicants, and began to attract risky applicants with bad credit history. They used schemes such as no down payment, no proof of income, and no credit check to lure new risky applicants. The venture into Sub-Prime loans has positioned the mortgage market for the burst (explosion). The justification behind Sub-Prime loans was that even if some risky applicants defaulted, their collateral (houses) can be sold to someone else for a higher price. This can be true only if few applicants will default frequently. However, the default rate with Sub-Prime loans was higher than anticipated and Investment Banks were holding to many houses but no buyers can be found. The excess of supply over demand has burst the bubble, and houses prices started to plunge. The decline in prices has also induced Prime Loan owners to default, since it is not worthy to make payments on cheap houses. As defaults on payments swept the country, Investment Banks and investors ended up with huge loans (borrowed to finance house sales) and worthless houses. On the other hand, Mortgage Lenders can not find new applicants and cannot sell their loans to investors. **In a nutshell, the whole financial system was frozen.** The collapse of the financial system has resulted in many bankruptcies and foreclosure of financial firms in the United States and around the world (Jarvis 2009).

### III. Factors Influencing the Financial Crisis

It is very hard to determine the main cause of the financial crisis. However, economists and analysts indicate that a combined effect of many factors has led to the explosion in the credit market in the United States and later to the rest of the world (Rida, 2009). These factors can be summarized in the following:

- **Imbalance in world trade:** China has benefited a lot from joining the World trade Organization (WTO) in 2001. It has utilized the advantages of the new global trade system and flooded the world with cheap exports. By keeping the exchange rate of the Yuan very low, Chinese exports were very competitive in the global market. This allowed China to accumulate huge trade surpluses while the rest of the world particularly the US increased their trade deficit. For example the deficit in the United States Trade Balance has tripled from 69 Bil US\$ in 1999 to more than 256 Bil US\$ in 2007. Hence, production of industrial and consumer goods has declined sharply in the USA and the American economy has shifted to a service economy.
- **Consumption pattern in the United States:** The US economy did not adjust for negative affect on its trade balance. High consumption of imports and declining output continued. The deficit in the trade balance and public budget was financed by extensive borrowing. The borrowing was mainly China, which reinvested its huge financial surpluses in buying US treasury bills and bonds. This simultaneous process has worsened the trade deficit and increased the deficit in public budget to around 1.5 Trillion in 2007.
- **Excessive deregulation of financial markets:** Since 1980s, the United States led the world in financial market liberalization. To achieve this, the financial market was

heavily deregulated and the government and FED supervision and monitoring was relaxed. Over the last two decades, the concept of market liberalization swept the world with a push from the GATS agreement. This allowed the United States to expand its role in as a dominant player in providing financial services. Many financial products and derivatives were introduced as a result of increasing global trade and liberalization. The involvement of many financial and investment banks in the mortgage market (securities and loans) is an example of the affect deregulation and liberalization. Such an expansion led to the bubble that burst and froze the credit market.

- **The dominant role of the US\$:** After World War II, the US economy was the strongest and the most stable. The Bretton Woods agreement in 1944 enabled the US to pig its currency to the gold and dominate global currencies. The growth in demand for US\$ and the fear of losing its stock of gold allowed the United States to adopt the system of Floating Exchange Rate in 1971. To meet the global demand for US\$, the US kept printing the dollar without any effective regulation or criteria. This process allowed the inflow of global goods and capital to the United States for exchange of the US\$. More importantly, it kept the United States consuming beyond its capabilities leading to a constant deficit in the Trade Balance. Over the last few decades, high import consumption lowered industrial output and shifted the traditional economy toward services. The influx of money to USA created the concept of "Cheap Money" and led to the abundance of credit that was used in unproductive activities that led to the financial crisis.

#### IV Corrective Measures

In response to the global financial crisis, governments and central banks took different measures to rectify the problems and put the financial markets and the economies back in the right path (Ramadhan 2008a). The most important of these measures are:

- **Financial rescue plans:** Since the credit crisis started in the United states, The American government arranged in Sept 2008, for an 800 Billion US\$ rescue plan to save the financial market. The aim was to save the most important investment banks and insurance companies from bankruptcies to prevent further financial deterioration. Many central banks around the world presented similar rescue plans with different scoop.
- **Central banks monetary policies:** central banks around the world have resorted to all monetary policies to contain the financial crisis. The most critical of these policies was to lower the interest rate drastically. The objective is to minimize the cost of borrowing for private businesses and consumers in order to stimulate commercial activities. Moreover, finance officials from the G20 nations appear to have achieved a preliminary consensus on a 24-point program intended to identify the growth of market bubbles and to insure that the world's banks operate more cautiously (Dixon 2009).
- **Public stimulus packages:** Governments around the world launched huge stimulus packages to pull their economies out of recession. As the financial crisis pushed the economies into deep recession, consumer spending has declined sharply due to fears and lack of confidence. As a result, industrial output declined and unemployment has been rising sharply around the world (expected job losses to be around 50 million jobs). Therefore, the stimulus packages aim to increase public spending on infrastructure projects. Public spending should create more jobs and stabilize consumers spending pattern. However, recovery from the current recession could be very sluggish. Production idle capacity and unemployment are on the rise. This makes it difficult for companies to hire workers which will keep demand at low levels and in turn increase idle capacity (Uchitelle, 2009).

## V. Recommendations and Measures

Based on the above analysis, this section will present a few recommendation and solutions that might help in correcting the mistakes that allowed for the financial crisis (Ramadhan 2008b). The following are some of these measures:

- **Reform of the WTO and global trade:** The WTO should play more active role in balancing global trade. Countries such as China should not be allowed to dominate the world trade by adopting unfair activities. Many countries suffered because of decline in their exports'. Moreover, China has enjoyed high economic growth (over10% annually) over the last decades relative to the world. This has accelerated the rise in the oil and food prices leading to disasters in the developing world and great imbalance between poor and rich countries. The unwarranted economic growth in China has led to abundance of surpluses that were channeled back to the USA and played a role in the credit crisis (Economists 2009).
- **G8 and G20 summits:** These summits are usually conducted to serve the interest of the main industrial countries. The assumption is what good for the developed world is good for the world. This view should change and the perspectives and concerns of many developing countries should be considered and incorporated into common policies that serve the whole world. No country should dominate the agenda of the meeting anymore. This was requested from American president prior to the attendance of the G20 meeting to be held in England in April 2009.
- **Government fiscal policies:** Government fiscal spending and stimulus packages are very important during recession periods. However public spending should focus on infrastructure and construction activities that can lead to economic growth. Excessive spending on bailouts, unemployment benefits, and subsidy programs, in order to increase spending will not have a long term impact. Short term objectives and spending will only worsen future growth.
- **Market regulation and supervision:** Governments and Central Banks around the world must be active in supervising and monitoring the activities of financial firms locally and international. Efforts in the short run must be directed to clean the balance sheet of financial firms from toxic assets. Credit lines should be provided for companies with good practices. A better process of monitoring the tax reports of financial companies is needed. It must be noted that, for many governments, the current financial system is very complicated to understand and control. Hence the expertise of financial specialists and central banks must be considered to formulate new policies and regulations.
- **New global financial system:** International Monetary Fund (IMF) should play a major role in regulating and auditing the global financial system. The IMF should both have more resources and play a broader role in the world economy than the past. New measures and regulations must be adopted to insure that the financial market mechanism will not permit for future collapses. Investment companies should be punished for conducting unfair practices in some countries (Tax Evasion) and financial practices must be consistent globally. China has proposed the creation of new global currency to replace the US\$. This proposal should be considered because the dependency of the world on US\$ is a major cause of the crisis (Economist, 4/8/2009).

## **VI. Conclusions**

The present global recession is the outcome of the financial crisis that has originated in the United States mortgages market and extended to the rest of the world. The financial crisis has forced the insolvency of many banks and financial institutions in the U.S. and the world. Governments adopted different policies such as; financial saving plans, spending stimulus packages, and aggressive monetary policies to contain the crisis. However, the negative spread affect of the crisis has extended to other sectors and industries (e.g. Motor Industry). The financial credit crisis has moved the US and the global economy into deep recession. Bankruptcies and foreclosure of banks and firms has caused huge layoffs. Increased unemployment coupled with decline of wealth and income of consumers around the world has lowered demand for consumer and industrial products. As production output declines, this will cause factories to lay off more labor. The spiral effect will take a period of time until new equilibrium is reached. To summarize, lack of supervision of regulatory agencies over the financial market, expansion of financial derivatives beyond acceptable norms, imbalance in the world trade, and greed of Wall Street has led to this exceptional global financial and economic crisis.

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