Worldwide Impact of Economic & Credit Crises 2007-2009 (With special reference to the U.S., U.K. and India)

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Economic and Credit Crises are characterized by sharp and steep decline in valuation of one or few of the assets and the speed of decline is so fast that majority of asset holders are not able to liquidate their position except at huge losses. The losses in turn results into economic showdown which elongates the misery in economic environment. However, history has shown that majority of people do not take lessons from such events and same mistakes are repeated again and again. With improvement in economic conditions the asset valuations also start northward march and people are again attracted towards taking position in the asset. Upto this point, there is no serious behavioural irrationality. But after this stage, the capital gets exhausted and the greed pulls borrowed funds into assets. Aggressive buying of assets shoots up asset prices further and hence igniting the engine which is self-fuelled.

This is the situation we commonly known as “bubble”. As the sanity returns, the bubble bursts, resulting into economic and credit crises. Through this paper I make an effort to go through literature on various historical economic crises in brief and identify scenario or events which acted as prelude to the respective crisis. We also analyze role of greed, leveraging and cheap money policies of Government in inflating an asset bubble. The paper is intended to serve as refresher to keep reminding fallacies of human behavior, especially greed.

The root Causes of the credit & Economic Crisis

The roots of the financial problems of the last two/three years can probably be traced back to the deregulation of financial markets in the US the UK and the Western European economies that started in the 1970s and gathered pace in the early 1980s. Deregulation swept away many of the governmental/regulatory controls and freed up organizations to trade across a wider range of activities and territories. Prior to 1970, banks, investment banks (known as merchant banks in the UK at that time), building societies, stockbrokers and insurance companies operated very much in their own specialized trading spheres. In some countries there were also geographical constraints allied to these sector trading constraints: in the US institutions were often restricted to trading in certain states and in Europe, to trading in their own country. In the case of banks, there were tight controls on cash and capital ratios and, specifically, on what percentage of depositors' funds could be lent out of customers.As these controls were relaxed and governments allowed these different financial institutions to raise funds from money markets across the world and not solely from depositors, financial services businesses were able to grow much more rapidly than had been previously possible. The effect was to liberalize credit (i.e. make it easier to borrow money) and effectively to fuel a massive expansion of personal debt, including mortgage debt.

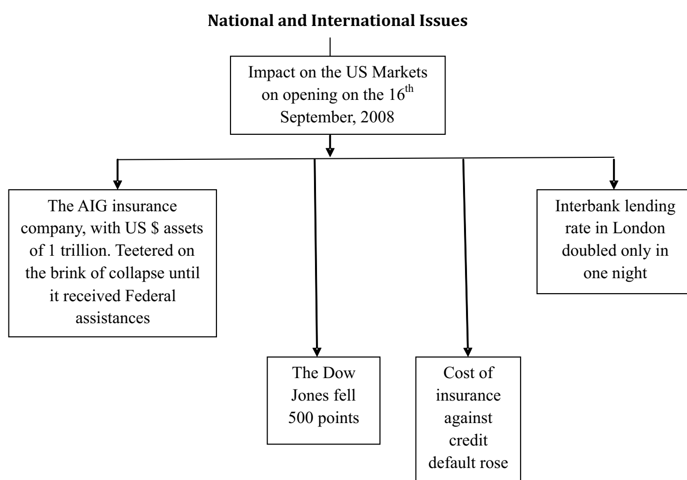
Impact in the Property Sector and Banks

With almost unbroken rises in property values since deregulation the home mortgage markets and the 'buy to let' markets became both very large and very profitable to banks worldwide.Thus some lenders, anxious to retain and expand market share, offiered loans that were often more than the face value of the underlying property and were sometimes and high as six or seven times the borrower's income.

This ratio compares to one that generally pertained in the tighter regulatory era where lenders would typically only lend a couple with two incomes and amount equal to twice the higher income plus the lower income. With high returns available on this type of business but, perhaps underestimating the higher element of risk involved, some organizations started to raise funds by selling off 'bundles' of their mortgage and loan deals to other lenders, who were largely unaware of the original, underlying transactions.This process was known as 'securitization' During early-mid 2007 the oil price began to rise sharply, causing worldwide fears of a trade recession. Rising unemployment triggered the beginning of a sharp rise in mortgage defaults, especially in the US where many mortgages were secured on run-down inner city properties and mobile homes.

These poorer quality mortgages were styled, in the money markets, as 'sub-prime' mortgages (these are type of mortgage characterized as being taken on by a borrower with a low credit rating and often secured on a low value property. Lenders will change higher interest rates than for conventional mortgages as they seek to compensate for carrying higher risk). Banks became worried about both the value of their own mortgage books and particularly the value of the mortgage-securities investments they had bought from other institutions with the result they became reluctant to lend to other banks in the short-term money markets. This crisis of confidence led to major liquidity problems for many banks and insurance companies worldwide. Liquidity means the ability of institutions, in-duding banks, to meet their short term obligations in-duding repayment of short term loans. The oil price eventually peaked at $147 per barrel in mid 2008.

The Bank of England had to provide financial support to the Northern Rock Building Society in the latter part of 2007, to prevent a run on the society's cash by depositors. It became necessary to formally nationalize Northern Rock in February 2008 (i.e. the Government became its major shareholder, having used taxpayers' money to support it). Early in 2008 a major US investment bank, Bear Stearns, had to be rescued by JP Morgan with US Government Support. The crisis deepened in the summer of 2008, two major US mortgage finance operations, Fannie Mae and Freddie Mac, also had to be rescued by the US Federal Government.The, on the 15th September 2008, the biggest bankruptcy in the world to date took place when Lehman Brothers Bank failed with liabilities of US $600 billion.The US Government declined to step in to save Lehman Brothers, in order to show markets that they could not and would not rescue every troubled financial institution.



Impact on the UK and the US :

In the UK there was a large fall in retail sales, especially in the furnishing and DIY sectors. Businesses, already hit by falling sales and profitability, faced increasing problems in securing bank support for continued trading. Several well known brands either went out of business or had to close a substantial number of outlets, for example MFI, Woolworths and Blacks. Unemployment rose, especially in the 18-24 age groups.

Falls in retail sales and rises in unemployment mean falling taxes revenues for governments worldwide, The UK was no exception. In the 4th quarter of 2008 UK Gross Domestic Product (GDP) fell by 1.5% and the country officially entered a period of recession. The recession continued through 2009. However signs of recovery became apparent in the final quarter of the year.Perhaps one of the most reflective and incisive comments on the crisis period as a whole was that, at the time of their respective failures, the Northern Rock was building society trying to act like an investment bank and Lehman Brothers was an investment bank trying to act like a building society!

Impact on Indian Economy :

India faced a very critical situation with depleted forex reserves and out of control fiscal deficit in 1991. India's current account position worsened during the period starting from 1985 by the mid of 1991. External borrowings doubled from $35 bn to $69 bn in the abovementioned period. The Gulf War in 1991 resulting in ballooning of oil import bill and simultaneous slowdown of world economy resulted in worsening of India's balance of trade (Cerra & Saxena, 2002). India had to pledge its gold reserves with IMF and Union Bank of Switzerland to obtain $202 bn funding with a condition to initiate economic reforms. The currency was significantly devalued in July, 1991 vis-a-vis basket of major foreign currencies. Fiscal reforms put India on recovery path and a full blown crisis was averted. Monetary expansion was not the primary reason for the crisis. It was more of fiscal indiscipline and regulatory environment rather than monetary expansion. The greed to grow faster resulted into the Asian Currency Crisis of 1997. Many South Asian countries such as Thailand, Indonesia, Malaysia, etc. had increased their interest rates to attract foreign capital. However, there was no corresponding increase in factor productivity (Krugman, 1994) resulting into capital getting channelized towards speculative activities which created asset price bubbles. These countries were also maintaining fixed exchange rates which made the monetary policy ineffective and hence pushing up the cost prices and severely impacting the export sector. High interest rates prompted borrowings from outside country and subsequent lending in domestic market leading to unhedged debt exposure susceptible to exogenous shocks. This resulted in a highly leveraged economy which could have been jolted with slight downturn in activity (Corbett & Vines, 1999). When the reverse capital flow started, it started hurting domestic economies and putting further pressure on pegged exchange rates and balance of payment status. Unable to manage the fixed rates, the currencies of Asian counties like Thailand, Indonesia, etc. were allowed to float against dollar resulting into 50% drop in the exchange rate with Thai Baht depreciating 100% against US Dollar (Kawai, 1998).

This situation made worse as the value of external debt in terms of domestic currency increased significantly. This triggered further bankruptcies and near collapse of financial system. IMF had to intervene to restore the battered currencies and bail out financial system of affected countries.

Worldwide other Impacts :

1. In the UK the Bradford and Bingley Building Society was effectively nationalized in late 2008 and then

partially sold to the Spanish Group Santander Bank. Also late in 2008 the UK Government partially nationalized the struggling Royal Bank of Scotland Group, initially taking a 58% stake, but eventually by late 2009 raising this to some 84%.

2. The UK Government also effectively forced the UKs largest mortgage lender, Halifax Bank of Scotland (HBOS), which was deep trouble, into the Lloyds TSB group and, in January 2009, took a 43.4% sake in the combined business. Other UK banks, such as Barclays and HSBC, although not nationalized, were forced to raise capital by new share issues to preserve their capital ratios.

3. Governments in Belgium, France, Germany, Ireland, Spain and Switzerland took similar actions to the UK to save several of their now illiquid and undercapitalized banks. Iceland effectively lost its previously heavily aggressive banking sector. In the US a total of 25 banks failed in 2008.

4. Despite a sharp cut in centr5al bank interest rates worldwide, interbank lending rates remained stubbornly high (showing the banks' lack of confidence in each other's financial security), which in turn lead to a severe reduction in both personal and corporate credit and a rapid downturn in the housing and construction markets.

One of the classic examples of herd behavior resulting into bubble and its subsequent bust was the dot-com bubble of 2000. USA had experienced tremendous economic run in the decades of 80's and 90's. The value of stocks climbed vis-à-vis GDP rose from 0.6 times in 1982 to 3 times in 1999 with stock market failing only in 1 year in the aforementioned time period. Almost all the vital economic parameters improved with unemployment reducing and growth rate improving. However, the trade deficit widened and domestic saving rate declined alarmingly. Technology revolution reduced cost of transaction dramatically and internet trading attracted millions of Americans who became the home based day traders. Technology revolution was fuelled by venture capitalists putting funds for new ideas and selling their share via IPO when the venture became profitable. Almost all the IPO's were getting listed at price which was significantly higher than issue price.

The gap in issue price had three consequences :

1. There was rush of investors to invest in IPO's.
2. It attracted even more venture capital.
3. More and more investment banks were attracted with the fees of bringing firms to public.

The phenomenon also resulted in pricing IPO's at lesser price so that the price gap on listing is high. However, promoters used to issue very less quantity of shares at that price. Less price and constrained supply pushed the price gaps. This resulted in high valuation of shares remaining with them and hence giving significant boost to their 'book wealth'. Due to aftermath of Asian currency crisis and collapse of Long Term Capital Management, the monetary policy in US was eased which fuelled the mad rush. Within one year after June 1998, market valuation of stocks traded at NYSE rose by 40% and those of NASDAQ (primarily information technology stock) jumped by a whopping 90% indicating 'irrational exuberance' (a term coined by Chairman by US Feb Allan Greenspan in 1996).

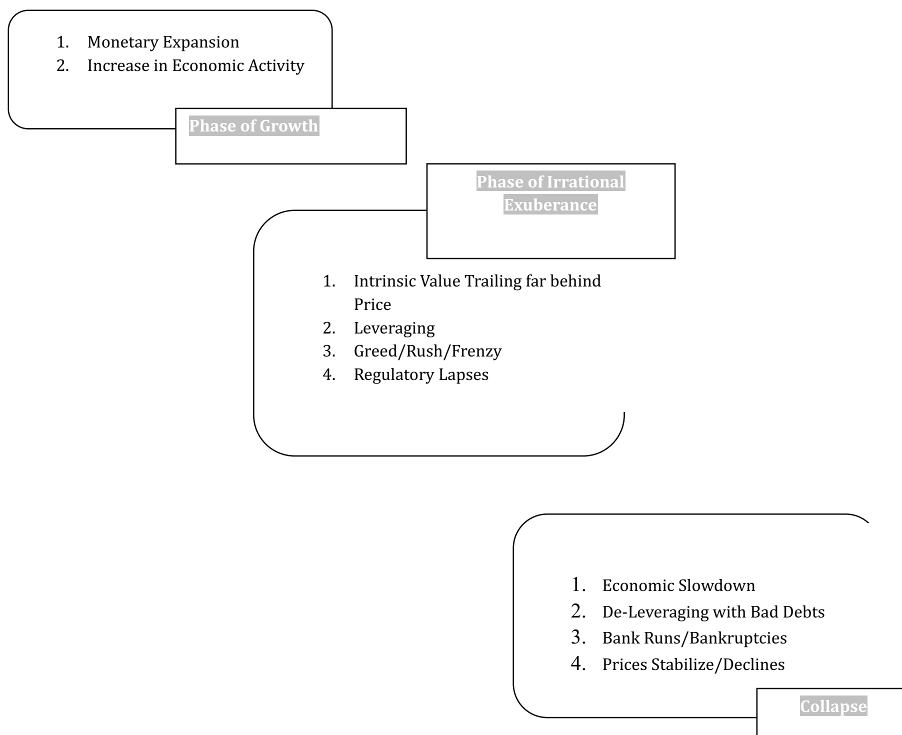
The inflow of capital into US pushed up prices of dollar denominated securities, appreciated US dollar and reducing inflation as foreign goods became cheaper. As the liquidity was subsequently reduced to balance the fiscal position and deficits, the bubble went bust resulting into massive bankruptcies, especially, in IT sector and as capital and savings were evaporated, the economy entered into recession in the new

millennium (knidleberger & Aliber, 2005). The dot-com bubble is often cited as one of the best examples to study the impact of behavior biases resulting into creation of bubbles.

Global economy went through one of the scariest phases, since The Great Depression, during the sub-prime crisis of 2007-09. The list of factors which led to sub-prime crisis seems to be infinite. It was a deadly combination of greed supported by financial innovation, regulatory lapses, monetary expansion and global inter-linkage. Unlike in other crises (except the Tulip Mania) the derivative instruments had multiplier effect on leaveraging of the US economy.

To make the matter worse, the collateral for the leverage were the sub-prime loans, which had increased multiple times to their long term average levels (Iqbal, 2010). One can imagine the weakness of inverted pyramid with the lower most building blocks being fragile. As the real estate prices collapsed the loans started turning bad. This is a general and expected phenomenon. But the defining factor was that the financial institutions had created multiple times leverage based upon those loans with help of derivative instruments like Credit Default Swaps (Petrova,. 2009). The losses on account of extremely high leveraged position wiped off capital of large financial institutions and the dominos effect threated to deterge to American financial system. The shockwaves from the crisis were felt across the global stock markets and global economy slowed down (lee, 2012). The crisis resulted in some of the largest bankruptcies ever, including the notable one of Lehman Brothers. The painful deleveraging of excess provided a new insight on risk management practices and regulatory structure to curb the excesses. Once again, greed played a spoil sport in the global economic progress.

Generalized Phases of an Economic Crisis



We witnessed Economic & Credit crisis where the greed took the next level. This time, the culprit was neither the public nor the institutions. This time the governments themselves were the culprit. The excessive expenditure vis-à-vis the GDP by Greece took its fiscal deficit to an extent where default of sovereign debt became imperative which would result into huge losses to financial institutions across the world holding those instruments. Similar situation was faced by other countries like Spain, Portugal and Italy. The Populists Governments did not have enough courage to control their fiscal deficit which resulted into their respective economies reaching on verge of bankruptcy (Haidar, 2012). Intervention by IMF and European Union has somewhat stabilized the situation in Europe but crisis is far from over.

Worldwide Impact on the Stock Market :

The **s**tock prices have been steadily declining since reaching their highs in November 2007, the selling intensified following the bankruptcy of Lehman Brothers in September 2008. When the U.S. House of Representatives failed to pass the Treasury's bailout plan on September 29, the S&P 500 fell 8.8%, its largest one-day percentage decline since Black Monday in 1987. That same day, total U.S. stock market losses exceeded $1 trillion in a single day which was a milestone as a history. The U.S., Europe and Asia saw major stock market declines, but some markets such as Hong Kong and Russia, fell even farther, In other words, investors seeking refuge from falling markets found nowhere to hide. Even Mexico had declined by more than 33% TYD as of November 2008 – and it was the best performer among large stock markets.

Erosion of Investor's Confidence and Trust :

Poor performances in the bond and stock markets were the most visible reflections of the credit crisis. It was not so visible, but more important that was happening to confidence of investor. At its most basic level, the modern financial system depends on trust and confidence among investors. Without this trust, a dollar bill is just another priece of paper, and a stock certificate holds no value. The important aspects of the credit crisis was that this trust began to erode as investors questioned the solvency of banks and other financial institutions.

London Interbank Offered Rate (LIBOR) :

One good indicator of the level of market confidence during the credit crisis was movements in the London interbank Offered Rate (LIBOR) LIBOR represents the rate at which large global banks are willing to lend to each other on a short-term basis. In normal times, large banks present little credit risk and therefore LIBOR closely tracks the level and movements of short-term U.S. Treasury securities. This is why LIBOR is rarely discussed outside the donfines of the bond market, despite the fact that an estimated $10 trilliion in loans are linked to it. At the height of the credit crisis however, LIBOR became an important topic of mainstream conversation and one of the best indicators of the global credit freeze. After remaining unchanged for more than three months, LIBOR spiked sharply following the bankruptcy of Lehman Brothers in September of 2008. This spike reflected an increasing unwillingness on the part of banks to lend to one another. In a global economy based on credit and trust, this was an extremely troubling sign, and prompted concern among policymakers that the global financial system faced a systemic collapse. And LIBOR fell dramatically in October 2008 as the combined actions of global policy makers helped to ease the fear among financial market participants. In fact because of central bank's interest rate cuts, LIBOR actually fell to below where it was.

Conclusion :

It becomes exceedingly clear that greed drives the rational interests to irrational exuberance. Governments play an active role in fuelling the greed by easing the money supply so that the 'abnormal' growth continues infinitely. However, while going through the euphoria, people, institutions and Governments forget a basic tenet of economics long run everything returns to 'normal'. Hence, abnormal growth will be neutralized by abnormal decline so the events are 'normalized'. It is desired that regulators preempt the overheating of economy and take necessary precautions that easy money is not available to fuel the bubble. Free markets promote efficiency and competitiveness but are also prone to wild swings in economic cycles. An effective and efficient regulatory system along with economic foresightedness will go a long way in protecting the people at large from pain of unwinding of economic excesses. I have given some of the market reactions to the global credit crisis. Investors who followed the markets during this period do not need to be reminded of the unprecedented volatility markets experienced or the dramatic declines in the values of a wide range of asset classes. However, the most troubling aspect of the crisis was the erosion of investor confidence and trust.

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