

Unearthing the Roots of the Global Financial Crisis

TheCaseSolutions.com

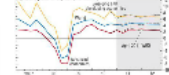


TheCaseSolutions.com
In the summer of 2007, the financial crisis started as the U.S. sub-prime crisis. Discuss how the housing crisis spread to other advanced economies.
Pre-crisis conditions included

- House prices inflated 1.5 years prior to the crisis, house prices rose rapidly in advanced economies e.g. in the UK and the EU with low interest rates
- An increase in credit which led to excessive debt burdens as financial institutions across countries
- The buildup of mortgage loans
- Loosely governed monetary policy and fiscal policy
- Systemic risk due to interconnectedness of worldwide banking for integrated areas which led to buildup of leverage

OVERALL CATALYSTS
 The excessive growth in house prices, excessive credit growth, high leverage and high leverage ratios, highly insured and low standards in lending standards, which facilitated a rise in subprime and residential loans, led to housing crisis. By the fall of 2007, the housing market was in a sharp decline. The fall in housing prices led to a sharp decline in house prices, which led to a sharp decline in house prices. The fall in house prices led to a sharp decline in house prices. The fall in house prices led to a sharp decline in house prices.

An Economist's Perspective



Fall in GDP is worse in advanced economies because of reduced consumption and investment. Taylor (2007) argued that in the United States, the demand for housing is sensitive to money market interest rates and that accommodative policy on the part of the Federal Reserve from 2001 was likely therefore to have contributed to the build-up in housing demand and asset prices.

TheCaseSolutions.com

What do you understand by Global Imbalances?

According to the European Central Bank global imbalances are defined as "external position of systemically important economies that reflect distortions or entail risks for the global economy". Rodrigo de Rato Figaredo refers to global imbalances as "As the large current account deficit in the United States and the matching surpluses in other countries such as Japan, emerging Asia, some oil-exporting countries, as well as other industrial countries, such as Canada".

USA, UK

TheCaseSolutions.com

Role played by imbalances

- According to Rato Figaredo, the capital flow increased due to the liberalization of international financial markets. This led to a large increase in capital flows from emerging economies to the rest of the world.
- Global imbalances are defined as "external position of systemically important economies that reflect distortions or entail risks for the global economy".
- The large current account deficit in the United States and the matching surpluses in other countries such as Japan, emerging Asia, some oil-exporting countries, as well as other industrial countries, such as Canada.
- The large current account deficit in the United States and the matching surpluses in other countries such as Japan, emerging Asia, some oil-exporting countries, as well as other industrial countries, such as Canada.
- The large current account deficit in the United States and the matching surpluses in other countries such as Japan, emerging Asia, some oil-exporting countries, as well as other industrial countries, such as Canada.

TheCaseSolutions.com

Concerns regarding Global Imbalances

- Gaps in growth performance between regions of the world.
- A 'savings glut' in surplus countries creates larger net capital outflows
- Insufficient supply of 'safe' financial assets at home which encouraged emerging market investors to accumulate 'safe' assets from advanced economies.
- According to the IMF, there is a world of high and emerging markets are expanding but not on external sources of growth.
- export led growth, and lack of social protection and the demand for the US Treasury bill.
- current concerns: instability in regions such as European union, US Fiscal cliff.

TheCaseSolutions.com

In the summer of 2007, the financial crisis started as the U.S sub-prime crisis. Discuss how the housing crisis spread to other advanced economies.

Pre-crisis conditions included

- House price bubbles (5 years prior to the crisis, house prices rose rapidly in advanced economies e.g in the UK and the EU with low interest rates)
- An increase in credit which led to excessive debt burdens on financial institution across countries
- The build up of marginal loans
- Loosely governed monetary policy and fiscal policy
- Systematic risk due to reduced cost of wholesale funding for intermediaries which led build up of leverage.

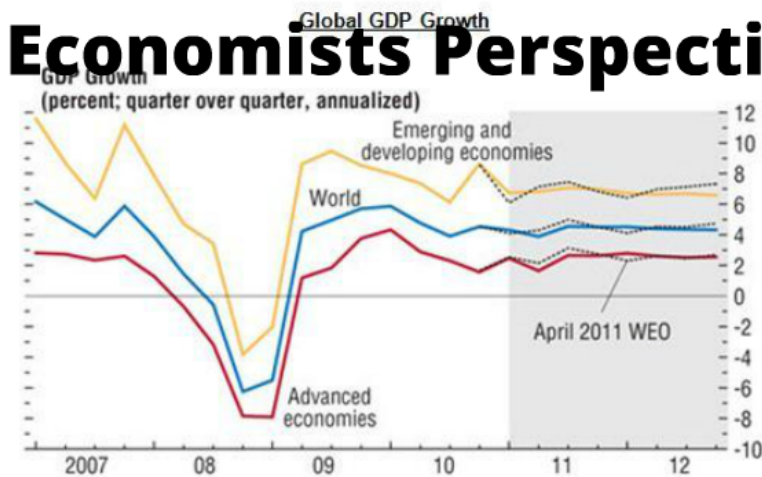
OVERALL CATALYSTS

The increase loans between financial institution means high leverage and higher leverage yields higher returns. There was also declines in lending standards which meant less supervisory and regulations. These catalysts facilitated a boom in house prices, which lead to financial crisis...

So the fall in housing prices in 2007 spread to a number of other advanced economies through...

- Direct exposures to sub-prime assets because they bought this loans (mortgage backed)
 - Gradual loss of confidence in number of asset classes
- Drying up of wholesale financial markets which led to financial spill overs
 - Large reliance on wholesale and short term funding in many advanced countries created systematic fragility (brunnermeier, 2009: Gorton 2008, 2009)
- The subsequent collapse in international trade because of the reduction in household wealth and consumption in the United States since it is the largest importing country.

An Economists Perspective



(Source: IMF)

Fall in GDP is worse in advanced economies because of reduced consumption and investment

Taylor (2007) argued that in the United States, the demand for housing is sensitive to money market interest rates and that accommodative policy on the part of the Federal Reserve from 2001 was likely therefore to have contributed to the build-up in housing demand and asset prices.

TheCaseSolutions.com

What do you understand by Global Imbalances?

According to the European Central Bank global imbalances are defined as “external position of systemically important economies that reflect distortions or entail risks for the global economy”

Rodrigo de Rato y Figaredo refers to global imbalances “As the large current account deficit in the United States, and the matching surpluses in other countries such as Japan, emerging Asia, some oil-exporting countries, as well as other industrial countries, such as Canada” E.g of surplus countries: china, Germany E.g of deficit countries: USA, UK



TheCaseSolutions.com

<http://www.imf.org/external/np/speeches/2005/062005.htm>

<http://www.ecb.int/pub/pdf/scpops/ecbocp78.pdf>

Role played by Imbalances

- According to Mervyn King Capital flow increased due the imbalances. There was an 'uphill' flow of capital from the dynamic, labour-abundant emerging economies to the mature advanced economies
- Increased capital flows raised global output to the extent that they seek out the most productive investment opportunities
- transferring savings from countries where the marginal product of capital is low to countries where the marginal product of capital is high.
- an insufficient supply of 'safe' financial assets at home which encouraged emerging market investors to accumulate 'safe' assets from advanced economies
- The scaling back of government-provided social safety nets and provision of health and education services, which encouraged households to build up saving buffers
- China have a fixed currency so this enables their export prices to be low.
- These growing flow imbalances have been accompanied by growing stock imbalances.
- The US debt quadrupled in size in the course of a decade, rising to USD 3.5 trillion in 2008 (25 per cent of GDP).
- Japan and Germany rose by around USD 1.7 trillion and USD 0.8 trillion respectively (around 35 per cent and 25 per cent of 2008 GDP) over the same period,
- Chinese net external assets reached USD 1.5 trillion, a third of GDP, in 2008.
- The current account United States and the main surplus country, China this was due to export led growth, and lack of social protection, and the demand for the US Treasury bill

TheCaseSolutions.com

Concerns regarding Global Imbalances

- Gaps in growth performance between regions of the world.
- A 'savings glut' in surplus countries created ever-larger net capital outflows
- Insufficient supply of 'safe' financial assets at home which encouraged emerging market investors to accumulate 'safe' assets from advanced economies.
- According to the IMF, there is a world of high debt and emerging markets are expanding but depend on external sources of growth.
- export led growth, and lack of social protection, and the demand for the US Treasury bill.
- current concerns: instability in regions such as European union, US Fisical cliff.

TheCaseSolutions.com

Rodrigo de Rato y Figaredo, M.D, I.M.F

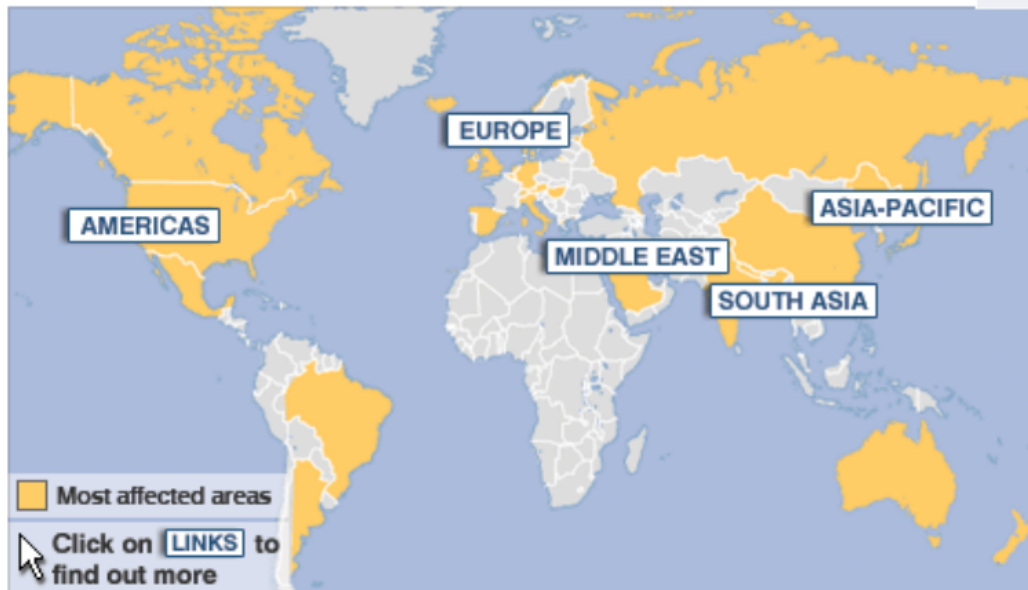
By referring to relevant studies and examples, discuss how the impact of the crisis varied among countries.

The three that are going to be looked at are; Brazil, China and the Eurozone. All the countries impacted by the recession entered differently and at different points with different impacts. The study "Global linkages and global policies" looks at this.

1 st quarter 2008	2 nd quarter 2008	3 rd quarter 2008	4 th quarter 2008	1 st quarter 2009
Ireland Estonia	UK France Germany Italy Netherland	Spain Austria Luxembourg Portugal Slovenia	Belgium Greece	Cyprus
			Brazil China Russia	

TheCaseSolutions.com

The following diagram shows this.



Source:<http://news.bbc.co.uk/1/hi/business/7654647.stm#europe>