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Statement of integrity: By typing the names of all group members in the text box below, you confirm that the assignment submitted is original work produced by the group (*excluding any non-contributing members identified with an "X" above*).

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2008 Global Financial Crisis Explained

A Crisis Synopsis

Although there are many factors underlying the 2008 Economic Crisis that started in the USA, leading economists agree that the most decisive factor was that the low interest rate policy implemented in the USA in the 1990s pushed the households into excessive borrowing and the FED was late in raising interest rates. The banks' attempt to reduce the credit risks they undertake by means of exotic securities with extreme risk, and the entry of these extremely risky securities into the portfolios of investors and financial institutions all over the world through global financial markets has made the global financial system vulnerable to these risks. While the FED's interest rate hike in 2004 to control inflation caused the bad loan rates in subprime housing loans to grow rapidly, banks and financial institutions in the USA were suddenly left with risks that they could not handle. (Doviz.com, 2019)

Market conditions that caused the crisis

The beginning of the 2000s in the prices of all commodities and agricultural products, especially oil accompanied by large increases. In 2008, together with food prices, the prices of gold, oil and many other commodities had reached historical highs. (Arici, 2010)

In the statements made by the FED in 2006, in the subprime mortgage market, deterioration in the quality of the loans was observed, but this was not said to be problematic, in conjunction with the fact that additional regulations should have been be made and the surveillance methodology should have been reviewed. It was hoped that balance would have been achieved automatically. In this process, the FED, unless it is necessary, the regulatory authorities argued that market interventions should be the last stage. However, as necessary inspections and regulations were not made in the credit market, in order to avoid shrinkage, the process resulted in the mortgage crisis as the market could not balance itself. (Demir, 2008)

In the USA, the country wherever the crisis emerged within the pre-crisis amount, and once the worldwide crisis, it's seen that there's a heavy accounting deficit in countries that additionally expertise crises or money issues. though there was a heavy improvement during this quantitative relation within the years once the primary effects of the crisis emerged, there has been a rise within the accounting deficit / GDP quantitative relation of the USA in recent years. The re-deterioration of self-moving rates and therefore the re-growth of this account deficit with the result of the crisis will be thought-about as a sign that serious solutions to the structural issues within the North American country economy couldn't be found. (Halisçelik, 2021)

In the US economy; the gap between growth in outstanding debt and the underlying economic growth was substantial. While the unpaid debts of the country were about 1.5 times the GDP in the 1970s, this rate was twice the GDP in 1985, and the debt was almost 3.5 times the GDP in 2005, and the total debt amount was equal to the whole world GDP. It was very close to the $44 trillion level. In this way, it became inevitable that the borrowing, which constantly increased both in quantity and proportionally, at some point incurred tremendous costs to the society. This borrowing trend in the US economy had progressed to include many segments of the society.

Problems with subprime loans had antecedently emerged simply before the 2001 recession. However, these issues were quickly resolved throughout the economic boom within the 2002-2005 amount. the rise in mortgage interest rates, that started within the last half of 2005, was the primary indicant of the deterioration within the housing market. (Öztürk, S. Body, 2010)

Most important causes of the crisis between 2001 and 2006 is securitization of the subprime mortgage loans used. As of 2006, the securitization rate in subprime mortgage loans has increased to 78.3%, and in this way, it has become possible to transfer a significant part of the risks to others. Both the rate of subprime mortgage loans increased and the securitization rate of subprime mortgage loans increased. This situation caused the risk level to increase through two different channels.

Global Effects of these primary causes

The rise of commodity, agriculture and food prices in the beginning of 2000s, US interest rate policy, account deficits of in US economy, increase in US household spending trends, the bubble emerging in the US real estate market and extreme usage of exotic financial instruments depending on subprime loans were prime causes of this crisis. Each of these affected in a global sense; however the imitation of mortgage loaning and financial instrument pratices by other countries without necessary domestic regulations had an ultimate knock-on effect on these economies. The 2008 economic crisis in the USA soon spread to Europe. It showed its very effects in Euro zone like Iceland, Greece, Portugal and Spain to name a few. These economies were also deeply affected by the aftershocks (increasing inflation and unemployment rate) of the 2008 economic crisis. (StratejikAnaliz, 2018)

The response of policymakers and regulators

The responses were swift going by the larger scale impact it had and all major fabrics of the economy and the United States being the epic center of the global financial crisis had to respond spontaneously in two ways:

1. Macro Policies: Actions designed to stimulate economic activities and spending

2. Systemic Policies: Actions designed to maintain the functioning of financial institutions.

Interest rate cuts and the setting up several agencies to respond to the crisis like Emergency Economic Stabilization Act (EESA), Troubled Assets Relief Program (TARP) and American Recovery and Reinvestment Act (ARRA) were promulgated. Others are Term Auction Facility (TAF), FX swap, Term Securities Lending Facility (TSLF) and Primary Dealer Credit Facility (PDCF). Fannie Mae and Freddie Mac were placed under conservatorship.

Intended effects of responses

Reflating the economy was primus. The macro policy geared to increase economic activity and minimize output and employment gap, with fiscal and a monetary policy that includes increase governmental spending, tax cut, and reduced cost of credit.

The systemic policies centred on the functioning of the financial system, ability to provide credit, payment and risk transfer to the real economy.

Roles and effects within the housing market

1. *Homebuilders:* The desire to capture more market share, immense speculation, and excessive risk taking with expectation of higher returns, housebuilder created excess housing units resulting in continued expansion and taking up roles of land developers and home builders.
2. *Mortgage Lenders:* Pursued loose lending practices fuelled by predatory marketing, adoption of innovative adjustable-rate mortgages. Unabated manipulation of credit scores, deceptive practices by agents, riskier lending climaxed by poor due diligence and outright fraud.
3. *Mortgage Back Securities (MBS) Structurers:* MBS is a form of Securitization backed by mortgages and in this case, subprime mortgages mostly. This fuelled excessive risk taking by most of the financial Institutions until the prices of houses start to decline the borrowers start to default.
4. *Realtors (real estate brokers):* They created a market of homeowners that took facility over and above their capacity thereby contributing to the default rates. They aided and abetted unscrupulous lenders and mortgage brokers.
5. *Real Estate Appraisers:* They knowingly breached their fiduciary responsibilities by lying about values adopting only market data methods and ignoring the other two methods of assessment.
6. *Townships that collect local real estate taxes:* Property tax constitute the major source of income for them, and in a high property valuation market more income, to that they disregarded all the anomalies.
7. *Homeowners using a mortgage:* Some were naïve, while some are fraud and speculative, this led to mismatch of loan grants that eventually resulted in vast default rate and foreclosures.

Who benefited from rising housing costs?

In an environment where housing costs are on the rise there are surprisingly many players that benefit from this. We see the following, seemingly benefit more than most with the market:

- Homeowners
- Banks and Financiers

Homeowners benefit because a rise in housing cost, signified by increased demand outweighing the supply, influences their gains in two ways:

- Capital appreciation,
- Increased rental costs.

Because the houses were bought at fixed valuations, any capital accumulation on the properties goes directly to the homeowners. This is beneficial to homeowners as they can utilize this for any future leveraging in the form of an equity release, but also provides an opportunity for profit when the property is sold off. This facilitates the opportunity for more valuable property investments or even better yet, refinancing their existing mortgages, reducing their monthly premiums and in return the cost of the property itself.

An increase in the rental prices of their property doesn't do very much to hurt the benefits either. Bank and other forms of lenders also benefit from rising housing prices, as the rentals on these properties go up, more renters are inclined to desire to be homeowners themselves. The property climate has changed in such a way that the rise in housing prices has probably gone up, faster than the intertest rates have decreased, meaning more expensive monthly installments and in turn more revenue for the banks.

The Risk of it all

With borrowers defaulting, the banking sector is most at risk, this has a knock-on effect on the economic system, with diminished returns in banks, thus there will be less and less money available for lending. This will increase the cost of borrowing, and as such bring economic activity to a lull. The government, as well, will see diminished tax revenue to reduced property taxes with defaulting properties.

Systemic risks in the housing market

Systemic risk refers to the total failure of an entire system/market, as opposed to a single unit within that market. In the housing sector Banks are the most heavily exposed to systemic risk as they generally have large positions in the real estate sector, meaning the exposure to the downside is much higher. Defaults in the sector caused by continued inflationary erosion on the disposable income of households could lead to a collapse of the system. Not only does this expose banks to their direct exposures, but their performance as well could be significantly affected due to diminished returns.

Final: The Basel Accord

The Basel Accord regulations have tried to minimize this risk as they have continuously evolved from Basel I, II and now recently III. Basel III introduces new capital and liquidity requirements and standards to encourage and improve supervision, risk management and regulation of the whole finance sectors. These require banks to have more stringent internal processes and controls as well as enhanced capital buffers and increased transparency within the banking sector.

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