UNIVERSITY OF THE PEOPLE

BUS 2203-01 Principles of Finance 1 – AY2024-T2

Learning Journal Unit 5

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Chapter 12 discusses financial crises, their causes, and potential responses. “In a financial crisis, asset prices see a steep decline in value, businesses and consumers are unable to pay their debts, and financial institutions experience liquidity shortages” (Kenton, 2023). Financial crises occur when financial markets or institutions stop functioning properly, disrupting the flow of credit. Asset bubbles, fueled by low interest rates, leverage, technological changes, and shifting demand, often precede crises. When bubbles burst, financial panics can occur as investors rush to sell assets to meet demands for loan repayment. Highly leveraged investors suffer the most losses. Lenders of last resort, usually central banks, try to stop panics by providing liquidity, restoring confidence, and making loans. Bailouts may follow to mitigate economic damage, but they are controversial.

The 2007-2008 crisis was triggered by the bursting of the housing bubble in the United States. As home prices declined after years of unsustainable growth, the values of mortgage-backed securities plummeted, which led to major losses and liquidity issues at overleveraged banks and financial institutions. The crisis quickly spiraled out of control, threatening to bring down the entire global financial system. Several major investment and commercial banks, mortgage lenders, insurance firms, and other financial institutions failed or had to be bailed out. The drying up of credit and financial turmoil contributed to the Great Recession, the worst economic downturn since the Great Depression in the 1930s. Though governments around the world stepped in to provide liquidity and bail out key institutions, the damage to the financial sector and overall economy was severe (Duignan, 2019).

The financial crisis of 2007-2008 serves as an important reminder of the economic devastation that can ensue when asset bubbles burst. Though regulators have since implemented reforms aimed at preventing another crisis of this magnitude, bubbles continue to develop in various assets and markets. Key lessons include the dangers of widespread overleveraging, complexity of financial instruments, lax regulation and oversight, and systematic risk accumulation. Going forward, policymakers must remain vigilant through careful monitoring of the financial system and decisive interventions when stability is threatened. Implementing mechanisms to deflate bubbles in their early stages may also help mitigate future crises. Ultimately, the crisis highlighted just how interconnected modern financial systems have become globally, and the need for coordinated policy responses during periods of turmoil.

Reference:

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Word count: 384