Global Financial Crisis

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What is a Financial Crisis? (1/2)

- A situation wherein values of financial assets fall rapidly in an economy.
  - ➢ Demand for money outstrips the supply of money
  - ➢ Liquidity quickly evaporates from the system due to disproportionate withdrawal of money
- The situation gets confounded when depositors withhold themselves from depositing due to
  - ➢ some kind of a fear that the banks might collapse
- Empirics : financial crisis associated with banking panics
  - ➢ because people lose faith in the banking system.

What is an Economic Crisis? (2/2)

- Financial crisis leads to an economic crisis, a situation in which an economy of a country experiences sudden downturn
- An economy facing such a crisis is most likely to
  - experience falling GDP,
  - liquidity crunch - scarcity of cash in the economy,
  - rising and falling prices due to inflation and deflation
- Economic crisis can further deteriorate and become recessionary in nature or could lead to depression.
- Plagued by contagion.

Global Financial Crisis 2007-08 (1/3)

- As most countries in the world affected by Financial Crisis of 2007-08, it was the global financial crisis
- Began in 2007 with the crisis of the subprime mortgage market in the US and
  - ➢ Developed into a full blown international banking crisis with
  - ➢ Investment bank Lehman Brothers collapsed on 15th September, 2008
- Excessive risk-taken by banks combined with the bursting of the US housing bubble
- Caused the values of securities tied to U.S. real estate to plummet, damaging financial institutions globally.

Global Financial Crisis (2/3)

- An international banking crisis erupted with the bankruptcy of Lehman Brothers on September 15, 2008,
- Massive bail outs of financial institutions and other palliative measures taken to prevent a possible collapse of the world financial system
- The crisis caused severe contraction of liquidity in global financial markets that originated in the US
  - ➢as a result of the collapse of the U.S. housing market
- The stock markets all over the world collapsed, financial bubbles busted
- Sovereign defaults and currency crisis occurred due to the crisis.

Global Financial Crisis (3/3)

- European debt crisis also an important example of the financial crisis
- The crisis in the banking system of the European countries using the Euros followed later
- Commercial banks across the globe suffered from a sudden rush of withdrawals by depositors
- The worst financial crisis after the Great Depression of 1929 (*August 1929 – March 1933*).

Causes of GFC (1/2)

- The Federal Reserve and the Central Bank of the United States, having anticipated a mild recession that began in 2001, reduced the federal funds rate (the interest rate that banks charge) 11 times between May 2000 and December 2001, from 6.5 percent to 1.75 percent
- This significant decrease enabled banks to extend consumer credit at a lower prime rate and encouraged them to lend even to “subprime,” or high-risk, customers, though at higher interest rates
- Consumers took advantage of the cheap credit to purchase durable goods such as appliances, automobiles, and especially houses

Causes of GFC (2/2)

- The creation of a "housing bubble" in the late 1990s
  - a rapid increase in home prices to levels well beyond their fundamental, or intrinsic value, driven by excessive speculation
- Relaxation in lending regulations without due diligence of objective and professional assessment of borrowers' credit worthiness and repaying capacity
- high interest cost led to rising EMI which tightened repaying capacity of borrowers to pay back loans.

Subprime Lending

- Subprime lending implies giving loans to borrowers who don't have the capacity to repay the loan
- Subprime lending characterized by
  - higher interest rates,
  - poor quality collateral and
  - less favorable terms to cover for higher credit risk
- Lending decisions by financial institutions and borrowing decisions by individuals led to housing bubble formation
- Housing bubble burst in the U.S. : a case of ‘subprime mortgage’ crisis.

Impact of the Subprime Crisis

- It led to
  - job losses,
  - higher incidence of poverty,
  - reduced consumer spending, and
  - low GDP growth.
- Major banks suffered huge losses.
- Lehman Brothers went out of business and collapsed
- Merrill Lynch had to sell itself to the Bank of America for a fraction of its value
- Countrywide Financial Corporation, the biggest U.S. mortgage lender, eventually taken over by the Bank of America

Was India Insulated from GFC?

- Though the World inter-connected, India was not well integrated into the financial markets with other countries,
  - yet, India was also impacted by the crisis
- As a result of the crisis, India's growth decelerated to nearly 6.7% in 2008-09
  - Down by 2.1% from average growth 8.8% in previous five years.

Checks and Balances in India

- India institutionalized financial discipline by enacting the 'Fiscal Responsibility and the Budget Management Act, 2003' (FRBM)
- This was a piece of legislation enacted by the Parliament in India with an objective to reduce India's fiscal deficit, improve macroeconomic management and the overall management of the public funds towards a balanced budget
- And it gave additional support to the exporters
- In essence, India went for a massive stimulus target.

Measures Taken by RBI

- To reduce the quantum of bank reserves and maintain a comfortable liquidity situation in the economy
- To augment foreign exchange liquidity
- To maintain a policy framework that would keep credit-delivery on track so as to arrest the deceleration in growth
- To reduce policy interest rates aggressively and rapidly
- To expand and liberalize the refinance facilities for export credit.

Effects of the Crisis (1/4)

- Failure of 168-year-old investment bank Lehman Brothers, with US$639 billion in assets
  - ➢ created lasting turmoil in financial markets worldwide
  - ➢ It severely weakened the portfolios of the banks,
  - ➢ fostered new distrust among banks,
  - ➢ led them to further reduce inter-bank lending
- During the financial crisis*
  - ➢ the net worth of American households declined by US$17 trillion in real terms, a loss of 26 %
  - ➢ 7.5 million jobs lost between 2007 and 2009,
  - ➢ Unemployment rate doubled.

**As estimated by St. Louis Federal Reserve Bank in 2012*

Effects of the Crisis (2/4)

- Millions of families
  - ➢ lost their jobs, homes, businesses
  - ➢ wiped their savings
  - ➢ fell into poverty
- Millions of workers faced long-term unemployment
- continued to struggle years after passing of the turmoil
- Although the recovery started in 2009 but…
  - ➢ many of the added jobs were lower paying and
  - ➢ less secure compared to jobs lost

Effects of the Crisis (3/4)

- In general, the key leaders of financial firms and other very wealthy Americans had not lost as much in proportional terms as members of the lower and middle classes
- The situation of common person remarkably in contrast with that of the bankers who had helped to create the crisis
  - ➢ No American CEO or other senior executive prosecuted on criminal charges—in stark contrast with earlier financial scandals, such as the savings and loan crisis of the 1980s and the bankruptcy of Enron in 2001

Effects of the Crisis (4/4)

- By 2010, leaders of financial firms largely recovered their losses, while many ordinary Americans never did
- That visible disparity naturally engendered a great deal of public resentment
- Political and economic system seemed to serve the interests of the very wealthy—
  - the **top "1 percent," as opposed to the bottom "99 percent**"
- This underscores the issue of economic inequality in the US too
- It demands an answer to the question,

'Whose priority Counts?'

Before we move to ‘Quiz’

Any Comment/Suggestion/Queries

Quiz (1/3)

Quiz Question-1 : In which year, did the Lehman Brothers Bank collapse?

a. 2007

b. 2008

c. 2009

d. 2010

Quiz (2/3)

Quiz Question-2 : Which of the following does not hold good in the situation of Financial crisis?

a) Values of financial assets fall rapidly in an economy.
b) Demand for money outstrips the supply of money
c) Liquidity quickly evaporates from the system
d) People save more and deposit more in the banking system to hedge against uncertainty

Quiz (3/3)

Quiz Question-3 : In 2008-09, India's growth decelerated to which level?

a) 2.1%

b) 4.8%

c) 5.9%

d) 6.7%

References

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Thank you