

Global Financial Crisis: Cause and Impact

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Abstract. The financial crisis of 2007–2008 is the worst financial catastrophe since the 1929–1933 Great Depression. The so-called "sub-prime mortgage crisis" caused the American financial sector to tragically collapse, wiping out the five major banks, the key economic data to continue to deteriorate, and inflationary pressures. The recovery will likely take a very long time, as is expected. This huge economic crisis even affected the world economic structure in the following ten years. The financial crisis is so influential that many economists are still committed to studying its causes and consequences. This paper analyzes the most important causes of this financial crisis as well as its effects in an effort to identify the best ways to reconstruct the whole financial system. Based on this, this paper comprehensively analyzes the causes of the 2008 Financial Crisis in the United States through relevant literature and data, and puts forward relevant suggestions.

Keywords: Financial crisis; international finance; international order.

1. Introduction

The financial crisis of 2008 is more of a financial crisis in the world. Only within a few months, the impact of the crisis spread rapidly from the United States to each region of the world, then became the global crisis. The world was faced with the capital chain rupture in succession, high unemployment, which caused huge social unrest and economic loss. People had been unable to recover and make up for the crisis, but the problems exposed by the crisis are what people need to think deeply. People need to learn lessons from this crisis in order to prevent the next economic crisis produced again. In this paper, Background Information, Causes and Effects are used to analyze the crisis. By summarizing a series of lessons and enlistments brought by this crisis, people can guard against the occurrence of the next crisis.

It is known that the American real estate market had abnormal success from 2003 to 2006. The subprime mortgage crisis erupted in the United States in 2007, and the international debt rose sharply. The implementation of neoliberal economic policies made the capitalist countries adopt the international monetary system dominated by the US dollar. Thus, under the background of excessive expansion of capital society, the contradiction between private ownership of capital materials and socialization of production deepened.

The 2007–2008 financial crisis is the worst financial catastrophe since the 1929–1933 Great Depression. The so-called sub-prime mortgage crisis caused the American financial sector to tragically collapse, the five major banks to fail, the important economic data to continue to worsen, the outlook for the economy to become negative, and inflationary pressures.

The subprime crisis of 2007 was the immediate trigger for the financial crisis. In fact, the riskiness of mortgages has increased ever since 2007. Mortgage risk in the United States started to emerge in February 2007. In April, the country's second-largest provider of subprime mortgages filed for bankruptcy protection. In August, the country's largest home mortgage lender announced it was drawing on bank credit lines for \$11.5 billion due to a liquidity crisis. In America's money markets, excessive liquidity turned into illiquidity. After the subprime mortgage crisis, which had its roots in the real estate market, became public, the US money market as a whole experienced a liquidity crunch.

2. Literature Review

Stamatios Dritsas (2019) believes that the most significant contributing reason to the onset of the global financial crisis is the subprime mortgage crisis. [1]. According to Keynes' theory of supply and demand, the problem with subprime mortgages was brought on by an imbalance in the supply and demand for real estate. Jannes Rauch (2019) explained in detail how bankers and investors purposefully sparked a "false boom" to continue luring investors from all over the world in order to address the supply and demand issue [2].

Radoslaw Mieszala (2019) points out that this view is shared, adding that numerous unseen crises have been accumulating and are simply waiting to blow up [3]. Istemi Berk (2016) believes that even while the hidden risks in the financial industry are significant, they can still be managed by changing national policy if there is no subprime crisis [4]. Agricultural Economics (2015) firmly believed that, the financial catastrophe could not have been prevented even if there had not been a subprime crisis; the long-hidden threats would eventually find another opening to manifest themselves [5].

Hidayat (2014) believed that the primary driver of the financial catastrophe was greed [6]. Ariel M (2014) thinks that the mortgage crisis can only be used as a spark, and the flawed financial system and regulatory framework are what are really to blame for the financial disaster [7]. Ariel H (2013) agreed that gluttony was one of the reasons of the financial crisis, but he also made the case that a more significant contributing component may have been a lack of monitoring [8]. This is because human reason will find ways to tame the nature of greed, and the primary cause of this financial catastrophe is the absence of close enough control to do so. Khawla Bourkhis (2013) pointed out that the enormous catastrophe that was concealed by the bubble economy might be found and controlled quickly under the stringent and ideal oversight system [9]. Global economic losses may be fully prevented if the hidden issues could be resolved at the beginning of the crisis.

Richard Holtzman (2011) believes that although the financial crisis was brought on by the subprime mortgage crisis, but the underlying reason was still a weak financial system, and there were problems in both financial supervision and innovation of financial products [10]. Thierry Warin (2010) believes that the American economic system may be the root of the crisis in addition to the absence of regulation [11]. The essay provides a thorough explanation that American economy at that time has been seriously biased toward the financial market. Moreover, because it served as the foundation for the financial market, the real economy was severely harmed, as was the industries. The financial market ultimately experienced a storm when the real economy's ability to support financial goods was compromised.

3. Cause

Bear Stearns, the fifth-largest investment bank in the United States, announced in March 2008, was acquired for a fire-sale price by J.P. Morgan Chase. The two largest mortgage financiers, Fannie Mae and Freddie MAC, were announced to be bailed out by the Federal Reserve and the Treasury in July. In September, Lehman Brothers sought bankruptcy protection. The approval of America's largest \$700 billion financial rescue package in October. That month, two of the world's largest central banks slashed interest rates, and the finance ministers of the Group of Seven largest western nations vowed to employ "all available tools" to combat the financial emergency. In December, central banks all over the world again slashed interest rates in tandem, injecting liquidity. The outbreak of closely paced risk events caused huge fluctuations in the US stock market, the Nasdaq index experienced the worst daily collapse in history and the Dow Jones Industrial Average experienced the biggest point loss in a single day on September 30. The financial market was swiftly affected by the subprime mortgage catastrophe, which also negatively impacted corporate and consumer credit and seriously harmed US economic growth. Due to the US financial market's close ties to the global economy and the false prosperity's attraction of numerous international bankers and investors to inject capital, this financial storm had an impact everywhere.

At that time, the US government adopted a consistent low interest rate policy. Long-term low interest rates led to a cyclical bubble boom in the US economy. This economic bubble burst with the high housing prices and people's inability to repay loans, and then the crisis spread to the whole world. The implementation of the neoliberal policy was mainly to deregulate financial institutions, the scale of speculative business grew rapidly, at the same time, the excessive expansion of financial derivatives under the innovation system, the accelerated weakness of the real economy and the rapid growth of the virtual economy led to the imbalance of the original economic system.

3.1 Excessive Financial Innovation: Subprime Loan Securitization

After the corporate stock market, the home mortgage market in the US is the most significant market on the national capital market. Three factors help real estate finance companies in the US identify high-quality clients: the client's credit history and score, the borrower's debt to income ratio, and the mortgage amount relative to the property's value. There are three main categories of loan quality: prime, intermediate and subprime loans. A group of debtors with an extremely high default risk is the subprime market. They are referred to as "three nobodies," which are people who lack a source of income, a job, and property. The low interest rate policy of the Federal Reserve is the primary factor behind housing loan financial institutions' provision of loans to subprime borrowers. Even though the price of collateral housing has been rising, the bank may still be able to sell the collateral at auction (residential). Securitization enables banks to transmit risk to outside parties, which is even more significant. The subprime mortgage crisis began to develop during the process of securitizing subprime loans. Lenders initially gave third-party financial intermediaries, typically investment banks, ownership of house loans before they gathered the subprime loans into asset pools. Investment banks disassemble and repackage various assets in the asset pool in accordance with the various types and characteristics of loans. These derivative bonds, which frequently take the form of Mortgage-backed securities (MBS) and CDOs issued by subprime lenders, use subprime mortgages as collateral (CDO). Securitization can then be carried out in this manner to create CDOs that are squared and cubic. The subprime mortgage crisis began to develop during the process of securitizing subprime loans. Lenders initially gave third-party financial intermediaries, typically investment banks, ownership of house loans before they gathered the subprime loans into asset pools. Investment banks disassemble and repackage various assets in the asset pool in accordance with the various types and characteristics of loans. These derivative bonds, which frequently take the form of subprime mortgage bonds (MBS) and collateralized debt obligations, use subprime mortgages as collateral (CDO). Securitization can then be carried out in this manner to create CDOs that are squared and cubic.

3.2 Easy Monetary Policy: Real Estate Bubble

Debt can fuel an ongoing cycle of overinvestment, as well as the rise and fall of asset prices, as the eminent economist Friedrich Hayek noted. The US economy experienced a recession in 2001 as a result of the September 11 terrorist events and the busted dot-com boom. The Federal Reserve established a low interest rate policy, decreasing rates 13 times in a row, to encourage economic growth. This significantly boosted the expansion of the US real estate market and made it the nation's primary engine for economic growth. Low interest rates encouraged excessive consumption and mortgage lending, which also fueled the housing bubble in the United States. The crisis was ultimately brought on by asset price bubbles and their burst.

3.3 Regulatory Inaction: Loopholes in Separate Regulation

Investment banks are not subject to Federal Reserve oversight or the Federal Deposit Insurance Act in the United States. Additionally, they are exempt from the Basel Agreement's 8% capital adequacy requirement for commercial banks. Warren Buffett has even attacked the Fed's "inaction" in the face of excessive financial innovation and the complexity of financial derivatives, referring to them as "financial weapons of mass devastation." Financial risk-taking was made possible by the over-the-counter trading of financial derivatives, which even got beyond regulation. A large number

of loans were allowed to flood the financial system due to insufficient risk regulation in the banking industry, which brought down the whole banking system.

3.4 Investment Banks and Rating Agencies: Greed and Fraud

Consumer demand is outpacing income, but Wall Street's investment banks are packaging poor Americans to cause a phony housing bubble. When people who couldn't afford to spend money were wrongly pushed to enter the misaligned residential mortgage market, the loans were securitized and sold to institutional and individual investors at a high rate of return, ultimately causing the collapse of American credit. Mortgage derivative instruments now have a significantly higher level of complexity as a result of the loans' decomposition and repackaging. It is crucial to guarantee the bonds' accurate credit rating. To increase their earnings, rating agencies, as commercial institutions, are typically inclined to offer these securities higher ratings if they are backed by insurance companies. However, credit-dependent investors. However, the original intent of derivative instruments cannot be easily comprehended by investors who rely on credit ratings. Investor losses will unavoidably result from the loss of rating agencies' impartiality, which is unquestionably dishonest for investors.

4. Effect

The subprime mortgage crisis accelerated the depreciation of the US dollar and led to the appreciation of the RMB, affecting the import and export business of many countries including China. The scale of global financial assets shrank significantly, the people's economic pressure increased, the government's economic decision-making ability was not trusted, and the standard of living declined.

The US financial crisis' cascading effects not only caused an unparalleled damage to the US economy but also significantly altered the global economic landscape and course of growth. First, there was a blow to the world financial system. Many commercial banks failed during the crisis and were taken over by governments. The majority of the total global write-downs, or nearly 60%, were taken by American banks. In the European region, banks collected more than 30%. Second, the financial crisis had varied degrees of influence on a vast number of financial institutions, among them are banks, hedge funds, insurance firms, pension funds, and government-backed financial institutions, and so on. This significantly worsened the crisis' effects. Thirdly, the market panic has grown more severe, and the market panic brought on by the financial crisis has had an impact on how the real economy is developing. Finally, China is not immune to the crisis. Chinese commercial banks have suffered more than \$20 billion in losses on their holdings of U.S. financial assets, such as Lehman Brothers bonds and Fannie Mae and Freddie MAC bonds. China's foreign exchange reserves held in US dollar assets and its overseas financial investment have been impacted to varied degrees, creating significant difficulties for China's real economy.

5. Response

As the U.S. economy recovers, the dust seems to have settled on the financial crisis of 2008. But the goal of deleveraging the capital market remains difficult in the face of negative pressure on the domestic economy. The consequences and lessons of the financial crisis are even more important. People will pursue and adopt prudent and balanced macro-economic policies to ensure that monetary and fiscal policies are balanced, coordinated and sustainable, and prevent macro-economic policies from being out of whack. In terms of financial entities, the virtual economy should support the real economy's needs for development, with the real economy serving as the essential foundation for economic system development. It should prevent asset bubbles from emerging, the hollowing out of actual sectors, and the financial sector from "idling" away from the real economy.

In addition, both established and developing financial markets require strict oversight. Innovation in the financial sector must adhere to the prudent operation principle. Effective risk management

involves monitoring the deleveraging of financial institutions and limiting excessive speculation. The financial industry will undergo advance, cautious change. Mixed company risk management and control should be carried out with the appropriate regulatory systems and controls. In any other case, it will quickly result in systemic concerns and have a significant impact on how the real economy develops. The diversified operations of financial institutions must be integrated with their in-house capacity for risk management and the department's capacity for supervision.

On the other hand, to increase the infrastructure construction, infrastructure construction increases, the increase of fiscal expenditure will lead to the increase of jobs, the increase of workers' income, the dead economy began to flourish. In other words, investment in job creation will stimulate economic recovery. In terms of the use of monetary policy, interest rates can be appropriately lowered. Low interest rates are conducive to investment, which in turn increases people's income and drives economic development. As a result, lending increased dramatically, and many borrowers took out expensive loans but were unable to pay them back. This system is exactly like the time bomb that started the crisis. Setting up commercial paper with assets to provide loans to banks, guide a large amount of funds to be injected into the foreign exchange market, and make capital flow through the transmission of the foreign exchange market, so as to make policy formulation and transmission smoother.

6. Conclusion

The subprime mortgage crisis was a direct cause of the 2008 financial crisis, but there were four additional issues with the financial system as a whole: excessive financial product innovation, a weak system of market oversight, loose monetary policy, and greed and fraud on the part of financial institutions. The financial environment of the world changed as a direct result of this catastrophe. Despite the significant harm this crisis has caused, people have also learned the value of financial regulation, the need for a healthy macroeconomic balance, and the significance of finance serving the entity. It is thought that by learning these important lessons, governments will be better able to handle the upcoming, unknowable financial problem.

According to the argument above, the American government's monetary policy is the cause of the financial crisis. It is also fueled by financial institutions' moral hazard and the misuse of derivatives. Despite the fact that the financial crisis plunged the US economy into chaos, the financial reform, which was the key step the US government took to address the crisis, had no lasting effects on the financial sector. Due to the interests that Wall Street and the US government hold, the financial crisis will be lessened but not completely eradicated. Financial derivatives also contributed to this catastrophe. These financial products served as a way to manage risk in the past and still do today. The regulation of derivatives was outlawed in 2001 by the Commodity Futures Modernization Act, which was drafted with the assistance of banking lobbyists. The use of derivatives and financial advances skyrocketed after 2000 once the legislation was completed. Derivatives allowed bankers to bet on almost anything.

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