# The impact of financial crisis on global development

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**Abstract:**
The following summary illustrates our views on the causes, consequences and outlook of the international financial crisis that emerged in June 2007 with the US sub-prime crisis. Three major points are emphasized. First, although the upward trend in commodity prices, including oil and food, respond to structural factors, the recent acceleration of these prices are closely related to the financial crisis. Second, the resolution of the financial crisis will imply a deterioration of macro fundamentals in the US, especially the fiscal deficit; this will exert upward pressures on the long-term interest rates and further depreciation of the US dollar relative to Asian currencies. Third, prices of oil and food will remain above trend as long as the financial crisis is not resolved. This will hurt growth prospects of many developing countries.

**Key words:** financial crisis, sub-prime crisis, commodity prices, fiscal deficit, growth prospects.

**JEL Classification:** F32

**The gripping problems of the American economy today are similar to the ones in the roaring twenties: i**n 1929, the roaring twenties came to a screeching halt with the crash of the stock market and a run on the banks. The depression affected the vast majority of Americans and had lasting economic consequences through World War II.

The twenties were fueled by an unprecedented number of Americans gambling on Wall Street -- not bankers and traders, but ordinary Americans.

The lubricant of this financial machine was something called "margin." Basically you could buy stock on credit, purchasing a thousand dollars worth of shares with just a hundred dollars down. Once the stock went up -- and it always did in the years leading up to 1929 -- you could sell it at a huge profit and pay off the loan and keep the rest.

But then stocks started going down. There was a mass "margin call" -- time to pay up for the stock you bought for 10% down. Not enough had the money, and the margin call accelerated the collapse of the market and the banks that funded all that buying. As the banks started to buckle under the weight of all that unpaid debt, depositors ran to get their money out. That hastened the fall of the banks and left millions of Americans broke.

The borrowers started treating their houses as investments rather than places to live -- and were bought on margin. i.e. they could buy a house (or two, or three) for 10% down or less. People started making fortunes virtually overnight as they bought condos pre-construction and "flipped" them for a profit before they were even built. With the profit, people started buying yet more properties, or larger ones.

Home prices shot up. And that was a good thing for just about everybody, or so it seemed. So long as the market kept going up, banks and sellers reaped huge profits. The buyer of the house will eventually pay off the loan when will sell it!

The banks started offering "exotic" loans with little or no money down. You could buy a property with an "interest only" loan and live in a mansion for less than you were paying in rent. Even at a time of historically-low interest rates of less than 5% for a 30 year fixed rate

mortgage, people were opting for ARMs (Adjustable Rate Mortgages) that would lock in an even lower rate for five years before eventually rising.

All Americans wanted to get in on this bonanza, so the banks relaxed rules for loan approval. The "sub prime" market was seen as very profitable because of those higher interest rates.

Wall Street took notice. All these average Americans were making fortunes in real estate. The bankers started cutting up mortgages and repackaging them as so called "derivatives." Investors could suddenly invest in a sure thing -- the American home -- which historically always goes up and is secured.

Then home prices stalled. They didn't drop, they just stopped ballooning. The home owners feared they would lose their profit (not their house, just the money they'd "earned" over the last five to ten years). Suddenly, thousands of home owners, then hundreds of thousands, put their homes on the market to get out while they still could. The market was flooded with supply and demand dried up while frightened buyers took a breather.

Home prices plummeted. A panic broke out first on Main Street. Simultaneously, millions of adjustable rate mortgages were getting to that five year point when the interest rates would jump. Many people couldn't afford the new rates and they couldn't sell.

Then came the margin call. Banks requested the pay up or else the foreclosure time arrives. Millions of people faced the prospect of losing their only home, albeit one they couldn't afford in the first place. A new term was coined: "jingle mail." Many home owners just dropped the keys in the mailbox and walked away. The bust quickly spread to Wall Street where those derivatives that looked like such a good idea were suddenly worthless. The banks (including Fannie Mae and Freddie Mac on the secondary mortgage market) couldn't sell foreclosed properties for enough money to cover the original inflated loan and the huge home equity lines. Three of the five top investment banks, plus Fannie and Freddie, either failed or were taken over.

Fannie Mae and Freddie Mac were created to supply liquidity to the market. Banks make mortgage loans to a person, but then they have to wait up to 30 years to get that money back, so they sell your debt to Fannie or Freddie. That infuses them with fresh capital, allowing the same bank to make more loans (keeping the market "liquid").

The credit crunch became a true crisis last week when there was zero liquidity in the market. Fannie and Freddie weren't buying mortgages and banks weren't making loans to each other or anyone else. Those transactions are the engine of the entire economy.

**Explanation of the Financial Crisis:** The financial fiasco started in 1977 with Pres. Carters' Community Reinvestment Act .

It said that the banks had to fix it so minorities and people with very little credit could get loans for homes.

Each bank had a quota to fill to get enough loans so they would be allowed to open new branches.

When the people defaulted on their loans, Fanny and Freddy came to aid of the banks that were going down.

In the '90's , Pres. Clinton reinforced these plans.

The sub prime mortgage-crisis was born in a decade-long housing boom fueled by low interest rates and excess liquidity.

During these ‘boom’ years, mortgage brokers enticed by the lure of big commissions, talked to buyers with poor credit into accepting housing mortgages with little or no down

payment and without proper tax documentation and credit checks. In this way the groundwork was established for the coming mortgage meltdown.

These loans, usually ARMs were known as sub-prime mortgages. They typically cost two or three points above those with less-risky credit reports and carry interest rate structures with low 'teaser rates' for the first couple of years, followed by a reset to much higher rates. This reset or jump, frequently resulted in raising the borrower's monthly payment by as much as 100% and thereby making it financially impossible for him to handle.

The new homeowners saw a rising value of their previously foreclosed homes during the initial year or so of their mortgages, and frequently took out home equity loans for extra cash.

In addition, banks and financial institutions often repackaged these debts with other high-risk debts and sold them to worldwide investors creating financial instruments called CDOs or collateralized debt obligations.

The serious sub prime mortgage crisis began in June of 2007 when two Bear Stearns hedge funds collapsed. This had a rapid effect on other parts of the financial markets worldwide which reached the crisis level in August-September of 2007 and temporarily froze the money market sector that is critically important to banking and financial operations.

When this took place, the Federal Reserve Bank and European Central Bank dumped $100-billion in liquidity into the system that calmed the market down for a short period.

The sub prime mortgage market continued to be solid as long as the housing market continued to escalate and interest rates didn't go up. Meanwhile, the homeowners continued to incur more debt until it reached a level of $700 billion or 5% of the US GDP in 2004. By 2006, housing prices started to taper off after rising nearly 40% between 2004 and 2006. They continued their decline through 2007 and most of 2008.

As sub prime mortgages began to reset in droves and result in foreclosure, housing prices also declined. Because of the way these loans and CDOs were globally distributed, it knocked the whole system out of whack. As the defaults continued, the worldwide CDOs took a major hit and the entire thing went down like a house of cards. The fallout from the sub-prime mortgages have affected the housing market, financial markets and the entire US economy.

**Major indexes suffered their biggest percentage declines since the 1987 crash as the government's bailout plan was defeated Monday, September 29, 2008:** Wall Street was pinning its hopes on the government's $700 billion financial system rescue plan. The bailout was rejected Monday by the House of Representatives and investors reacted with a vengeance. Major U.S. stock indexes plummeted Monday in one of their worst sessions ever. When this took place, the Federal Reserve Bank and European Central Bank dumped $100-billion in liquidity into the system that calmed the market down for a short period.

The Dow Jones Industrial average tumbled almost 7%, the S&P 500 sank 8.8%, and the Nasdaq plunged a jaw-dropping 9.1%. The Dow suffered its largest point drop in history.

| Date | Close | Point Drop | Percent Decline |
|---|---|---|---|
| Sept. 29, 2008 | 10,365.45 | 777.68 | -6.98% |
| Sept. 17, 2001 | 8,920.70 | 684.81 | -7.13% |
| Apr. 14, 2000 | 10,305.77 | 617.78 | -5.66% |
| Oct. 27, 1997 | 7,161.15 | 554.26 | -7.19% |
| Aug. 31, 1998 | 7,539.07 | 512.61 | -6.37% |
| Oct. 19, 1987 | 1,738.74 | 508.00 | -22.61% |

On Monday, the blue-chip Dow Jones industrial average fell 777.68 points, or 6.98%, to 10,365.45. The broader S&P 500 index dropped 106.62 points, or 8.79%, to 1,106.39. The tech-heavy Nasdaq composite index tumbled 199.61 points, or 9.14%, to 1,983.73. According to Bloomberg News, $1.2 trillion was knocked off the value of American securities.

Activity in the broader market was overwhelmingly negative. On the New York Stock Exchange, 31 stocks fell in price for every one that gained. The ratio on the Nasdaq was 25-4 negative.

The House defeated the bailout measure, which had been crafted by the White House and legislative leaders over the weekend, by a vote of 226-207. The news, which took many investors by surprise, drove the Dow down over 700 points during the session as disappointed investors fled to the safety of Treasury bonds and gold. Other major indexes followed suit and posted outsized losses.

The rescue plan, as agreed to by lawmakers and the White House over the weekend, would use taxpayer money -- $350 billion initially, and up to $700 billion with Congressional approval -- to buy mostly soured mortgage-backed securities from Wall Street firms and banks. By taking these securities off the banks' hands, the bailout plan seeks to restore confidence in the financial system and ensure that banks can still carry on their fundamental role of handling payments and offering credit to the masses.

House members were expected to head back to the negotiating table, though it appeared unlikely that there would be a second vote Monday. Regardless of the outcome, the world appears headed for a recession with the global banking system in convulsions, says S&P MarketScope

Investment Banking & Brokerage fell 14.82% amid big drops in Goldman Sachs (GS) and Morgan Stanley (MS) Asset Management was down 17.12%.

Diversified Banks was down 13.50%, paced by Wachovia Corp. (WB) which fell nearly 80% after it announced plans to sell its retail bank, corporate and investment bank and wealth management businesses to Citigroup (C) .

Regional Banks was down 13.14% amid investor jitters likely due to the assumption that this group faces a similar situation as Washington Mutual. The shares of industry member National City Corp. (NCC) were down significantly.

Consumer Finance was down 12.78% as shares of American Express (AXP) were weak after Credit Suisse cut its estimates and target on the stock. Credit Suisse said it expects AmEx's credit quality deterioration to continue over next several quarters.

In technology, Computer Hardware was down 9.23%, dragged lower by Apple (AAPL) after Morgan Stanley downgraded its rating on the stock to equal weight from overweight. RBC Capital lowered its rating on the stock to sector perform from outperform, citing a worsening consumer spending environment.

In commodities, Diversified Metals & Mining fell 16.60%, while other commodity groups such as Coal (-17.63%), Steel (-18.50%) and Aluminum (-9.96%) came under pressure as a defeated financial rescue plan heightened fears the world is headed into a severe recession that will reduce demand for commodities.

Oil & Gas Exploration & Production sank 13.83% along with November crude oil futures amid concerns that slowing global economic growth would likely lessen demand for oil.

Markets around the world were also disturbed by more turmoil among financial institutions as the credit crisis goes global, with indexes in London and Paris dropping over 5% Monday. Among the developments: news that Wachovia's (WB) banking assets were to be acquired by Citigroup (WB) and that the Justice Dept. and Securities and Exchange Commission

subpoenaed mortgage giant Freddie Mac's (FRE) records. News that two European banks were being nationalized suggested that the industry's problems were global in nature.

Monday brought word of another shotgun marriage for a troubled financial firm. Wachovia plans to sell its retail bank, corporate and investment bank and wealth management businesses to Citigroup (C). Wachovia will remain a public company with two main operating subsidiaries: Wachovia Securities, the nation's third largest brokerage firm, and Evergreen Asset Management, a leading provider of asset management services. Citi will pay $2.1 billion to Wachovia and assume the company's senior and subordinated debt. The FDIC would backstop any losses beyond $42 billion on Wachovia's $312 billion pool of loans. In economic news Monday, U.S. personal income rose 0.5% in August, and above the 0.2% markets had expected. However, spending was flat and below the 0.2% increase. Moreover, July and June spending readings were also revised down. Disposable income fell 0.9%, a third consecutive monthly decline. The savings rate slowed to 1.0%. The core PCE deflator accelerated to a 2.6% rate compared to 2.5% in July (revised from 2.4%).

“Consumption spending shows a significantly weaker trend after this morning's personal income report," wrote Morgan Stanley economist David Greenlaw in a note Monday.

"The income data are a little better than expected, while the deflator numbers were a little worse. However, markets today will likely focus on the credit markets and the Congressional vote on the rescue package," wrote S&P senior economist Beth Ann Bovino Monday.

Fed funds futures were mixed in early trading Monday as traders bet on the merits of the Treasury bailout package, and weigh the likelihood of its success in rescuing the financial markets and salvaging economic growth, according to an Action Economics report. The market is fully priced for a 25 basis point rate cut at next month's Fed policy meeting, says Action, with some modest risk for a 50 basis point easing, even though the Fed has indicated over the past several months it prefers to hold the line on the target Fed funds rate at 2%.

There were also some worrisome new credit-crisis developments out of Europe on Monday.

The deepening of the financial turmoil has led to sharp rise in inter-bank rates and the ECB allotted €120 billion in a special 38 day tender, that will be extended into next year. Meanwhile European central banks have announced that they will double their USD swap facilities in another coordinated move to deal with the troubles in the financial sector.

Belgian, Dutch, and Luxembourg governments agreed to inject €11.2 billion (US$16.4 billion) into Fortis, and U.K. mortgage lender Bradford & Bingley became the second British bank to be taken under the government's wing since the crisis began last year. Fortis is the first major euro zone bank to buckle under the financial turmoil triggered in August last year by U.S. mortgage defaults.

Meanwhile, Germany's Hypo Real Estate secured credit guarantees of €35 billion, the bulk of which will be provided by the German government.

European stock markets plunged Monday. In London, the FTSE 100 index fell 5.3% to 4,818.77. In Paris, the CAC 40 index declined 5.04% to 3,953.48. Germany's DAX index shed 4.23% to 5,807.08.

Asian markets also felt the heat Monday. Japan's Nikkei 225 index fell 1.26% to 11,743.61. In Hong Kong, the Hang Seng index dropped 3.26% to 17,880.68.

The dollar index was higher at 77.59.

December gold futures were up $25.60 to $914.10 per ounce in volatile trading Monday afternoon. Investors were seeking the haven of gold in a flight to safety from worries the current financial crisis in the U.S. and Europe will result in a global recession. While a recession would

reduce demand for commodities, some view gold as an alternative and safer investment. Regardless, the liquidity and negative sentiment in the banking sector will not go away soon and will have to be dealt with by the next administration.

November West Texas Intermediate crude oil futures tumbled $10.48 to $96.41 per barrel Monday afternoon after the House defeated the financial rescue plan.

**Chronology of the financial crisis:**

- **Jun 2007** Two hedge funds belonging to New York investment bank Bear Stearns collapse as a result of the sub-prime mortgage crisis. The failure of the funds cause investor losses of some $1.8 billion.
- **Jul-Aug 2007** German banks -- including IKB, Sachsen LB, WestLB and BayernLB -- are caught in the crisis. Multi-billion euro bailouts are needed to stabilize the banks' balance sheets.
- **Sept. 2007** Worried customers line up outside branches of the British bank Northern Rock to pull out their savings.
- **Oct. 2007** US financial services company Citigroup's profits collapse. From then on, one financial group after another announce billions of dollars of writedowns and high losses.
- **Jan 2008** Swiss bank UBS announces writedowns of more than $18 billion for 2007 due to turbulence in US property markets. In April, the bank announces a further $19 billion in writedowns.
- **Feb. 2008** US Congress approves an economic stimulus package of about $150 billion.
- **Mar 2008** Bear Stearns stands on the brink of collapse, leading to JP Morgan Chase acquiring the investment bank under pressure from the US Federal Reserve. The Federal Reserve assumes the risk on $30 billion in Bear Stearns investments.
- **Apr. 2008** Deutsche Bank announces a loss of €141 billion ($203 billion) for the first quarter -- the bank's first quarterly loss in five years.
- **Jul. 2008** Californian mortgage bank IndyMac collapses. US mortgage giants Fannie Mae and Freddie Mac fall into increasing difficulties. In Spain, real-estate and construction group Martinsa-Fadesa is forced to declare bankruptcy.
- **Sep. 2008** The US government takes over Fannie Mae and Freddie Mac. The crisis at Lehman Brothers, a US investment bank, becomes acute. Other financial institutions such as investment bank Merrill Lynch, insurance corporation AIG, and Washington Mutual -- the biggest US savings bank -- are all affected.
- **Sep.15 2008** "Black Monday." Lehman Brothers declares bankruptcy, Merrill Lynch is purchased by Bank of America, and AIG announces it needs billions in stop-gap loans. Bank writedowns from around the world total nearly $500 billion.
- **Sep.16 2008** News that AIG, the world's largest insurer, is threatened with insolvency creates massive instability in international financial markets. Efforts by the insurance industry to save the company founder. Finally, the Federal Reserve announces it will provide AIG with an $85 billion loan in exchange for a nearly 80 percent stake in the troubled giant.
- **Sep.17 2008** Scottish mortgage bank Halifax Bank of Scotland (HBOS) captures worldwide attention with more bad news. The stricken bank desperately seeks investors. Bank of Scotland enters talks with Lloyd's, according to the BBC.

- **Sep.18 2008** News breaks that the state-owned German development bank KfW transferred €300 million ($426 million) to Lehman Brothers in New York just prior the investment bank's collapsed. More than half of the sum is lost.
- **Sep.21 2008** US Treasury Secretary Henry Paulson announces the planned creation of a $700 billion rescue package to buy bad credit from failing banks. After a full weekend of negotiations in Washington, the fate of the bill is to be decided within a week.
- **Sep.22 2008** News of the possible $700 billion bailout calms the financial markets only temporarily. Before long the price of oil rises more than $25 in just a few hours -- the highest absolute hike in one day since oil prices began to be monitored. Experts see this as a reason to be skeptical of the bailout. The dollar also loses considerable value.
- **Sep.23 2008** The price of crude oil eases during trading on the Asian markets. Traders attribute the price decrease to investors cashing in on profits.
- **Sep.24 2008** Powerful US investor Warren Buffett makes headlines with a hefty investment in Goldman Sachs. Analysts hail the legendary financial strategist as a savior.
- **Sep.25 2008** A summit in the White House to discuss the rescue package falters. A few hours later, bank supervisors announce that US savings bank Washington Mutual is broke
- **Sep.28 2008** It looks as though both Democrats and Republicans in the US Congress would support the $700 billion bailout plan for needy banks.
- **Sep.29 2008** The financial crisis reached new heights in Europe. German mortgage bank Hypo Real Estate is bailed out with €35 billion ($50 billion). British mortgage lender Bradford & Bingley and Belgian-Dutch Hypo Real Estate Holding AG are both bailed out with sums in the billions of euros. US representatives reject the $700 billion bailout package, and stock markets collapse around the world.

Discussions were ongoing in Europe regarding possible remedies for financial instability in Europe leading up to a conference. UniCredit of Italy was reported to be the latest bank to come under pressure.

- **Oct.2 2008** Greece followed Ireland's lead and guaranteed all bank deposits.
- **Oct.3 2008** Wachovia had rejected the previous offer from Citigroup in favor of acquisition by Wells Fargo, resulting in a legal dispute with Citigroup.
- **Nov. 2008** Dow Jones Industrial Average (DJIA) touches recent low point of 7,507 points
- **Dec. 2008** The Australian Government injects 'economic stimulus package' to avoid the country going into recession, December, 2008
- **Dec. 2008** Madoff Ponzi scheme scandal erupts
- **Dec.2008** Belgium government resigns as a result of Fortis nationalization
- **Jan. 2009** U.S. President Barack Obama proposes federal spending bill approaching $1 trillion in value in an attempt to remedy financial crisis; the lawmakers propose massive bailout of failing U.S. banks , the U.S. House of Representatives passes the aforementioned spending bill
- **Jan. 2009** Government of Iceland collapses.
- **Feb. 2009** Canada's Parliament passes an early budget with a $40 billion stimulus package.
- **Feb. 2009** JP Morgan Chase and Citigroup formally announce a temporary moratorium on residential foreclosures. The moratoriums will remain in effect until March 6 for JPMorgan and March 12 for Citigroup.
- **Feb. 2009** U.S. President Barack Obama signs the $787 billion American Recovery and Reinvestment Act of 2009 into law.

- **Feb. 2009** The Australian Government seeks to enact another "economic stimulus package".
- **Feb. 2009** 2009 Eastern European financial crisis arises.
- **Feb. 2009** The Bank of Antigua is taken over by the Eastern Caribbean Central Bank after Sir Allen Stanford is accused by US financial authorities of involvement in an $8bn (£5.6bn) investment fraud. Peru, Venezuela, and Ecuador, had earlier suspended operations at banks owned by the group.
- **Feb. 23 2009** The Dow Jones Industrial Average and the S&P 500 indexes stumbled to lows not seen since 1997.
- **Feb. 27 2009** The S&P index closes at a level not seen since December 1996, and also closes the two month period beginning January 1 with the worst two month opening to a year in its history with a loss in value of 18.62%
- **Mar. 2 2009** The S&P index finishes the first trading day of March with a drop of 4.7%, the worst opening to a March in NYSE history.
- **Mar. 6 2009** The UK Government takes a controlling interest in Lloyds Banking Group by insuring their debt.
- **Mar. 18 2009** The Federal Reserve announced that it will purchase $1.15 trillion in US Assets ($750 billion in mortgage backed securities, $300 billion in Treasuries, $100 billion in Agencies) in a bid to prop up liquidity and lending to spur economic growth. The markets initially rallied on the news, however concerns began to grow regarding long term devaluation of the US dollar and subsequent inflation.
- **Mar. 23 2009** In the United States, the FDIC, the Federal Reserve, and the Treasury Department jointly announce the Public-Private Investment Program to leverage $75–$100 billion of TARP funds with private capital to purchase $500 billion of Legacy Assets (a.k.a. toxic assets)….

The conclusion based on the presented facts above, leads to the conclusion that this severe crisis is affecting mainly the United States, which is already in a weakened position, and it could accelerate the country's relative demise as a superpower which already began a long time ago. American industry, represented mainly by the Detroit's Big Three carmakers, General Motors, Ford and Chrysler, have lost a combined $110 billion (€83 billion).

The history of the US auto industry is the history of America as an economic superpower. The GM model, characterized by massive marketing, little substance and an excessive policy of debt financing, has also become the country's model. America currently needs more than half of worldwide savings merely to avoid falling below the levels of previous years. The government and private households borrow roughly $1 billion (€760 million) on each business day. Three years ago, the country was only borrowing two-thirds of this amount.

Even when adjusted for the size of today's economy, the US's current debts significantly exceed debt levels during the Great Depression. The superpower has become an empire of debt.

If only the problem were limited to the United States. But the situation that has been brewing on the periphery of the crisis is far more dramatic than it was in 1929. This is mainly attributable to the fact that modern globalization had only begun at the time. Many of today's industrialized nations were agricultural economies, and were not linked to the global economic system.

Countries like Romania, Hungary, Russia, Latvia and Ukraine did not play a significant role at the time of the Great Depression. Today, they are either on the brink of bankruptcy or, like Russia, they are in serious trouble because the price of oil has declined dramatically and Western investors are pulling out their money.

The Institute of International Finance expects the flow of capital into the emerging economies of Eastern Europe, Latin America and Asia to fall to only $165 billion (€125 billion) this year, or one-sixth of the level of foreign investment in these countries only two years ago.

Unlike 1929, the governments of the major industrialized nations today are generally in agreement and are combating the crisis together, a commitment they agreed upon at the London G-20 summit in early April.

Unlike 1929, the world's major countries are flooding the economy with money to prevent deflation and, with it, a downward spiral of declining prices and income.

But no one knows whether this will suffice, the debts are being fought with debts, meaning that not only banks but entire countries could end up bankrupt. Perhaps the efforts to combat the current crisis are merely laying the foundations for the next crisis, which will be bigger still.

**Conclusion:** The markets can and do recover if given enough time.

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