GLOBAL FINANCIAL CRISIS

2007 - 2008

CAUSES & EFFECTS

WHAT WERE THE KEY FACTORS THAT LEAD TO THE GLOBAL FINANCIAL CRISIS

WHAT HAS BEEN DONE SO IT DOES NOT HAPPEN AGAIN

A QUICK REVIEW BY:
WORLD INVESTMENT MARKET

WHAT HAPPENED DURING THE GFC AND WHY

The global financial crisis was a widespread financial meltdown that occurred between 2007 and 2009. It was characterized by the collapse of several large financial institutions, a rapid drop in stock markets around the world, and a banking crisis that spread from the United States to Europe and beyond.

THE CRISIS WAS CAUSED BY A COMBINATION OF FACTORS, INCLUDING:

The housing market bubble: In the mid-2000s, the U.S. housing market experienced a boom, with the price of homes rising rapidly. This led to a surge in subprime mortgage lending, where borrowers with poor credit histories were given loans to purchase homes.

Complex financial instruments: The rise of the housing market created a demand for financial instruments, such as mortgage-backed securities, which allowed banks to package and sell these loans to investors. However, these securities were often poorly understood and risky, and their value was tied to the performance of the underlying mortgages.

Loose lending standards: Banks and other financial institutions relaxed their lending standards in order to profit from the housing boom. This led to a surge in risky lending practices and an increase in the number of homeowners with high levels of debt.

Insufficient regulation: The lack of oversight and regulation in the financial sector allowed the above factors to develop unchecked, leading to a buildup of risk in the system.

When the housing market began to collapse in 2007, the value of these complex financial instruments plummeted, causing banks and other financial institutions to suffer massive losses. This led to a chain reaction, with banks becoming reluctant to lend to each other and many investors becoming wary of investing in the stock market.

The crisis had far-reaching consequences, leading to the largest recession since the Great Depression of the 1930s and affecting millions of people around the world. The global economy took several years to recover, and many countries implemented reforms to try and prevent a similar crisis from happening in the future.

US FED RESPONSE

The Federal Reserve (the Fed) played a key role in managing the global financial crisis and supporting the US economy in the aftermath of the crisis. During the financial crisis, the Fed implemented a series of monetary policy measures aimed at stabilizing the financial system and boosting economic activity. These measures included cutting interest rates to near zero, launching several large-scale asset purchase programs (also known as quantitative easing), and providing lending to banks and other financial institutions.

These measures helped to restore confidence in the financial system, ease borrowing costs for households and businesses, and support the flow of credit to the economy. The Fed's actions also helped to prevent a more severe economic downturn and laid the foundation for a robust recovery in the years that followed.

Since the financial crisis, the US economy has performed well overall. The economy has experienced a prolonged period of growth, with low unemployment, rising wages, and robust consumer spending. However, this growth has been accompanied by some challenges, including income inequality, slow wage growth for many workers, and a decline in the labor force participation rate.

In conclusion, the Fed played a crucial role in managing the global financial crisis and supporting the US economy in the aftermath of the crisis. The US economy has performed well overall since the crisis, but there have been some challenges along the way. The Fed is likely to continue to play a key role in supporting the US economy in the future.

WHAT IS QUANTITATIVE EASING AND HOW DID THE FED USE IT TO FIX GFC

Quantitative easing is a monetary policy tool used by central banks to increase the money supply and stimulate economic activity. It works by the central bank buying financial assets, such as government bonds, from banks and other financial institutions. This increases the reserves that these institutions hold with the central bank, which in turn allows them to make more loans to households and businesses. The increased lending activity can lead to higher spending and investment, which can boost economic growth.

The Federal Reserve (the Fed) used quantitative easing as a key tool to manage the global financial crisis that began in 2008. As the crisis unfolded, the Fed rapidly cut interest rates to near zero to provide support to the financial system and the broader economy. However, with interest rates already so low, the Fed had limited room to further stimulate the economy through traditional monetary policy tools.

TIn response, the Fed launched a series of large-scale asset purchase programs (also known as quantitative easing) in which it bought government bonds and other securities from financial institutions. This increased the reserves that these institutions held with the Fed, which in turn allowed them to make more loans to households and businesses. Additionally, the Fed's asset purchases helped to lower longer-term interest rates, making borrowing cheaper and encouraging spending and investment.

Overall, the Fed's use of quantitative easing helped to stabilize the financial system, ease borrowing costs for households and businesses, and support the flow of credit to the economy. This, in turn, helped to prevent a more severe economic downturn and lay the foundation for a robust recovery in the years that followed.

HAS THE PROBLEM BEEN FIXED?

WHAT HAS BEEN DONE TO ENSURE THAT SUCH A CRISIS DOES NOT HAPPEN AGAIN

In response to the global financial crisis, several measures have been taken to prevent a similar crisis from happening again. These measures include:

Regulatory reforms: The Dodd-Frank Wall Street Reform and Consumer Protection Act was passed in the United States in 2010, introducing new regulations on the financial industry and creating new agencies to oversee the markets. In Europe, the EU introduced the European Market Infrastructure Regulation (EMIR) and the European Banking Authority (EBA) was established to regulate the banking sector.

Increased capital requirements: Banks and other financial institutions are now required to hold higher levels of capital, which acts as a buffer against losses. This makes them better able to withstand financial shocks and reduces the risk of a widespread financial meltdown.

Stress testing: Banks and other financial institutions are now subjected to regular stress tests, which are designed to assess their ability to withstand economic shocks and to identify any potential risks in the system.

Improved transparency: The use of complex financial instruments and opaque financial structures was a key factor in the crisis. New regulations have been introduced to improve transparency in the financial markets and to reduce the use of such instruments.

Consumer protection: The global financial crisis exposed the need for better consumer protection. In response, regulators have introduced measures to protect consumers from predatory lending practices and to improve financial literacy and education.

While these measures are designed to prevent a repeat of the global financial crisis, it is important to note that the financial system is complex and constantly evolving. Regulators and policymakers must remain vigilant and be prepared to adapt and respond to new risks as they emerge.

HOW HAS BASEL III HELPED

Basel III is a set of international banking regulations introduced by the Bank for International Settlements (BIS) in response to the global financial crisis of 2008. The aim of Basel III is to improve the resilience and stability of the global banking system by requiring banks to hold higher levels of capital and liquidity. The regulations are named after the city of Basel in Switzerland, where the BIS is headquartered.

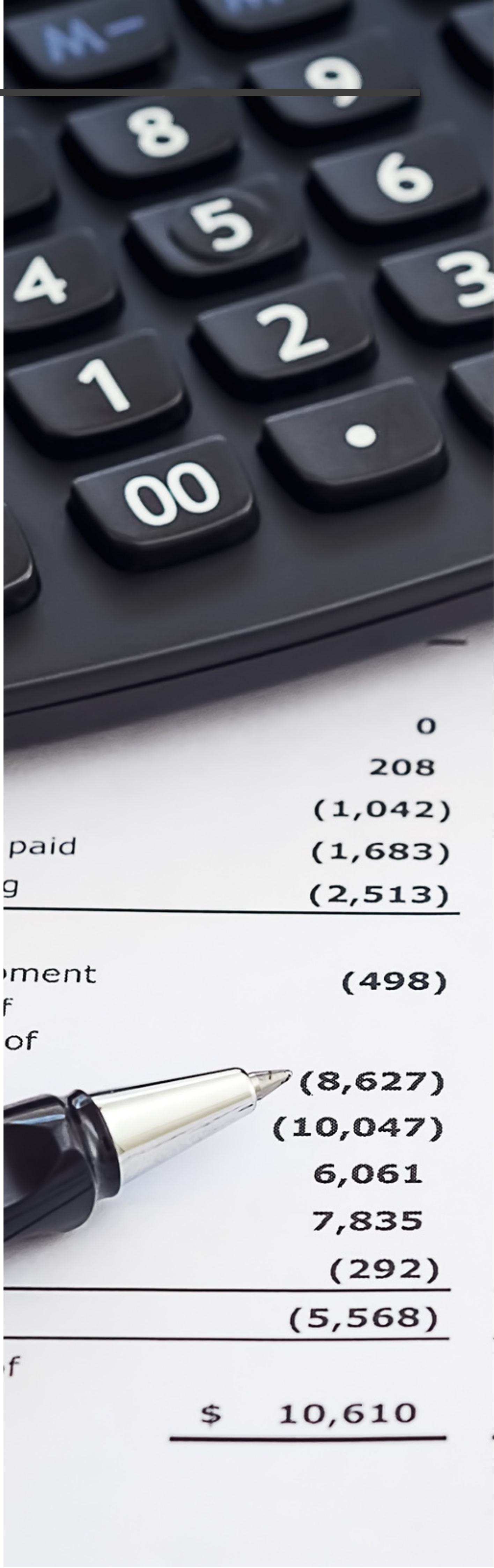
The key elements of Basel III include:

Increased capital requirements: Basel III requires banks to hold higher levels of Tier 1 capital, which is the highest quality capital that a bank can hold. This includes common equity and retained earnings. The aim of the higher capital requirements is to ensure that banks have sufficient buffers in place to absorb losses in the event of a crisis.

Improved risk-weighted assets: Basel III also introduces a more sophisticated system for risk-weighting assets, which determines the amount of capital that a bank must hold against a particular asset. The new system is intended to be more reflective of the actual risks associated with different types of assets.

Liquidity standards: Basel III introduces two new liquidity standards, the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), which are designed to ensure that banks have sufficient liquid assets to withstand short-term stress. The LCR requires banks to hold enough high-quality liquid assets to cover their net cash outflows over a 30-day period. The NSFR requires banks to maintain a stable funding profile over a one-year time horizon.

In conclusion, Basel III is a set of international banking regulations introduced by the BIS in response to the global financial crisis of 2008. The regulations aim to improve the resilience and stability of the global banking system by requiring banks to hold higher levels of capital and liquidity and by introducing a more sophisticated system for risk-weighting assets. The implementation of Basel III has been ongoing and is expected to be completed by the end of 2021.



MORTGAGE BACKED SECURITIES

WHAT WAS THE ROLE OF MORTGAGE BACKED SECURITIES IN THE GLOBAL FINANCIAL CRISIS

Mortgage-backed securities (MBS) played a significant role in the global financial crisis of 2008. MBS are financial instruments that bundle together a large number of individual home mortgages, which are then sold to investors as a single security.

During the housing bubble leading up to the financial crisis, many mortgage lenders made risky loans to borrowers who were unable to repay them. These subprime mortgages were then bundled together into MBS and sold to investors. The demand for MBS was fueled by their high returns and the belief that housing prices would continue to rise indefinitely.

As the number of subprime mortgages increased, so did the number of delinquent and defaulted loans. This caused the value of MBS to decline sharply, leading to large losses for investors who had purchased them. Many banks and financial institutions held large amounts of MBS on their balance sheets and suffered significant losses as a result.

The decline in MBS values also had a ripple effect on the wider financial system, as many financial institutions had used MBS as collateral for short-term loans. As the value of MBS declined, these institutions faced a liquidity crisis and were unable to repay their loans, leading to a freeze in credit markets and a wider financial crisis.

In summary, the role of MBS in the global financial crisis was to amplify and spread the risks associated with subprime mortgages, ultimately leading to a widespread loss of confidence in the financial system and a severe economic downturn.