UNIDAD EDUCATIVA JAVIER

THIRD BACHELOR D

2008 crisis in the United States

Autor

Franco Leandro Zalazar Vivar

Tutor

Guillermo Loor

Año lectivo

2016- 2017

Gratitude

First, I thank God who gave me the gift of learning, my parents who gave me life and I became a responsible, capable and independent person . My dear students , past and present , who have encouraged me to give my best every day, beat me personally and professionally and to be a good example for them .

Summary

In September and October 2008, the US suffered a severe financial dislocation that saw a number of large financial institutions collapse. Although this shock was of particular note, it is best understood as the culmination of a credit crunch that had begun in 2007

The US housing market is seen by many as the root cause of the financial crisis. Since the late 1990s, house prices grew rapidly in response to a number of contributing factors including persistently low interest rates. The bursting of the housing bubble, in addition to simultaneous crashes in other asset bubbles, triggered the credit crisis. However, it was the complex web of financial innovations that had purportedly been employed to reduce risk which ensured that the crisis spread across the financial markets and into the real economy. In particular, all manners of profit-seeking financial institutions used a complex financial process characterized by highly leveraged borrowing, inadequate risk analysis and limited regulation to bet on one outcome; a bet which proved to be misguided when asset prices collapsed.

Index

Introduction

I´m going to write about the crisis that suffered the USA in 2008 and I'am also going to explain how the crisis affected the economy and all the companies that broke or the prices went down when it started and the USA did to get out of the financial crisis and which other countries were affected.

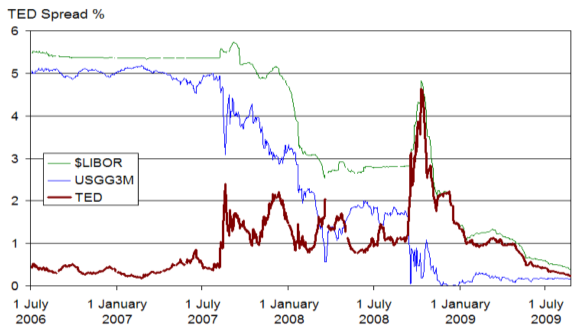
The financial turmoil that engulfed the US during 2007-08 began in the mortgage lending markets. Indicators of the emerging problems came in early 2007 when, first, the Federal Home Loan Mortgage Corporation announced it would no longer purchase high-risk mortgages and, second, New Century Financial Corporation, a leading mortgage lender to riskier customers, filed for bankruptcy.

The crisis set in as house prices started to fall. This in turn caused credit rating agencies to downgrade their risk assessments of asset-backed financial instruments in mid-2007. The increased risk restricted the ability of the issuers of these financial products to pay interest, and reflected the realization that the bursting of the US housing and credit bubbles would entail unforeseen losses for asset-backed financial instruments.

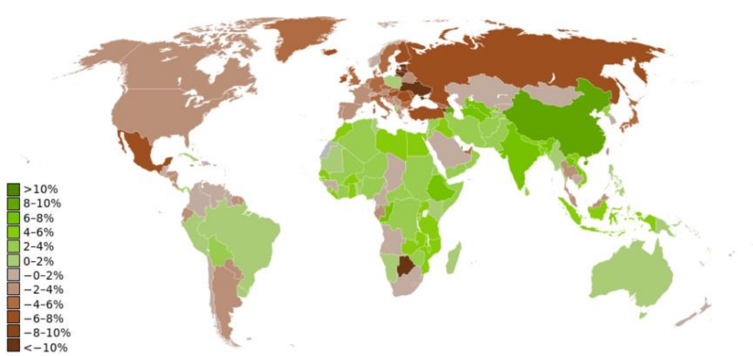
On that time the crisis was considered by many economists and people one of the worst financial crisis after 1930s. This crisis affected most of the exchanges all around the world and not only that, it also affected many of the companies in the USA.

And it is also important that by October 25 of 2008 , the stock market crash was global, and the announcement of a global economic downturn, to the point that some experts suggest the closure of bags to avoid continuous falls.

The TED spread (in red) increased significantly during the financial crisis, reflecting an increase in perceived credit risk.



World map showing real GDP growth rates for 2009. (Countries in brown were in recession.)



Chapter 1

The international crisis that broke out five years ago with the collapse of Lehman Brothers had started about a year before as a solvency problem mortgage loans in certain cities in the United States. Actually the problem was not large, at least compared to the size of international financial markets, but had devastating effects because it multiplied and expanded globally.

When American debtors were unable to pay their home loans, they were inflicting losses to certain financial institutions. In the 2008 crisis, the problem was that Americans mortgage loans had become "structured notes" and had been negotiated in financial markets around the world.

From one day to the other, almost all financial institutions in the world were suspected of having problems and internationally no one could trust anyone. Why did banks stop lending to each other and stop lending to the public. Thus, a crisis that had started with mortgage loans in the US spread to other sectors of the economy and the other countries of the world. In late 2008, there was a violent reduction of credits worldwide that caused the contraction of many economies.

“The greatest tragedy would be accepting that no one saw this coming and therefore they could not do anything”. (Agelides, 2011)

A first aspect to be taken into account checking this crisis is that it is largely a result of the monetary policy that has implemented the US government in recent years.

Thus, it is convenient to consider, first, that during the economic recession at the end of 2000, the Federal Reserve decided to lower the interest rate of federal funds from 6.5% to 1%. Also, the fixed-rate mortgage 30 years fell by 2.5%, from 8% to 5.5%; and adjustable-interest rates one year increased from 7% to 4% .

These low rates resulted in banks that could offer very cheap mortgages, by which many people took the opportunity to buy houses to live ; causing an unprecedented demand for real estate, which soon led to a dramatic increase in the price of such goods.

It became so attractive to borrow and buy real estate that many investors sold their shares from technology companies. We have to remember that the prices of these companies collapsed in 2001 and went to the property market.

For financial institutions this market became the perfect business, while credit options were created even for those customers who were not creditworthy on called; "Sub-Prime Customers" and those who provided them represented a very high risk. This action was legally supported by the "Community Reinvestment Act" which is a US law that requires banks to lend to people who have a good credit history.

The principal causes of the crisis in the USA were:

At first the financial crisis had resulted from the inability to pay mortgages of thousands of people who had Sub-Prime loans. Many of them contracted with interest-only payments or options of negative amortization, that changing to fully repaid loans led to the increase of payments to be made leaving no possibility of paying to debtors, when they had a poor credit history and no ability to pay, which was already known.

The inability to pay got them in trouble with the financial institutions that had granted mortgages, aggravating the situation of lenders with bad loans that piled up, looked down the price of property that had been collateral for mortgages. Between December 2006 and December 2007, the price of houses fell by 25% and initiated the "housing crisis", setting the stage for the financial crisis of 2008.

But also, since 2004 the Federal Reserve decided to raise rates to control inflation and a rate of 1% that was passed in 2004 to more than 5% in 2006 rate.

This led to the increase in the default rate, and the level of foreclosure for nonpayment. According to US Senator Dodd, Christopher, “one to three million people could lose their homes by increasing their monthly mortgage loans, which came from $ 400 to over $ 1,500 between 2004 and 2006. Only in July 2007, foreclosure proceedings against people who could not pay their mortgages reached the amount of 180,000; twice more than the previous year.”

In addition, since investors had taken so much risk, seeing that the market slowed down, they decided to get rid of their riskier assets, giving more impetus to the crisis.

That the crisis had spread worldwide is largely due to the existence of circulated that they bought by a lot of companies around the world.

In 2006, the financial turmoil began the housing crisis that caused the building stock index to fall 40% that year. By 2007, the market began to realize that major banks and large investment funds had compromised their assets in such subprime mortgages.

In February 2007, more than 25 companies dedicated to give mortgage loans went bankrupt, and in August Ameriquest, Inc., which was the company's largest Sub-Prime US loaner, sold part of its assets to Citigroup and then definitely closed.

In April 2007 the company New Century Financial, the second largest American company dedicated to Sub-Prime mortgage loans, filed for bankruptcy when already being under the bankruptcy.

By August 2007 as the situation of crisis triggered, the European Central Bank entered to 120,000 million dollars, representing its biggest intervention in the money market since September 2001.

On December 19 the investment bank Morgan Stanley, the second most important investment bank in the US, revealed losses of 9.000 billion dollars associated with the real estate market.

On October 3, 2008 the US President George W. Bush enacted the law on Emergency Economic Stabilization through which 700.000 billion dollars would be channeled to the financial market.

These are all the things that happened in the crisis of the USA, a fact that also repercuted in the global economy of the world, all of this caused by the financial problems of the most popular or biggest business in the US.

"I hope the possible consequences (of the crisis) for us (...) are limited." (Steinbrück, 2008)

Chapter 2

Consequences of the crisis in the USA:

In the first half of August 2007 the global economy has been shaken by what has been called the "crisis US mortgage ".

The central banks of the major countries of the European Union, the United States, Japan, Canada, Switzerland and Australia must attend financial markets with more than US $ 300 billion in order to avoid a massive leak investment and reassure markets before a possible global collapse. The effects led to the resignation of the director of the Industrial German Bank, an institution that nearly collapsed and was saved by the Deutsche Bank, Commerzbank and Dresdner Bank, among others. The IKB is one of the German banks that have lost large sums of money in the U.S.

This crisis originated with the difficulty of much of the American society to pay mortgages incurred, which are considered high risk and expressed a rise in interest rate. It is estimated that 80% of debt US consumers is more than US $ 12 billion. It corresponds to mortgage loans. These soft loans financed up to 100% of properties with low interest rates and

in many cases they were granted to applicants without serious guarantees. It is estimated that 46% of those loans that were granted during 2006 did not have conventional collateral, the which was warned by the International Monetary Fund 2 in a report issued in July 2007 which also warns that between 2007 and 2009 may occur significant "shocks" of payments. The situation results from a loss of balance that remained among prime loans-those that are granted to applicants with back of it and subprime. According to the report, hiring mortgages "junk" has increased twelve between 1999 and 2006.

The "housing bubble" was warned previously by several analysts in recent years, including Paul Krugman, who had announced that the collapse was imminent. Already several companies property loans have closed and others have stopped granting them seriously impacting other sectors of the American economy. In 2006 there were 1.2 million foreclosure Mortgages representing an increase of 42% compared to 2005.

The effects of this crisis hit financial markets Latin American -São Paulo, Mexico and Chile that fell strongly on Tuesday, August 14, 2007, up from 2% 3.

It was not only a mortgage crisis in the USA:

Leaving aside the costs that the United States must face because of their military interventions in Afghanistan and Iraq, there are other indicators that highlight the crisis not only responds to the "housing bubble" and that in any case, this is also a result of an economic downturn and greater underestimation of reality.

External debt:

In 2004 the IMF had warned of the danger of deficit States for the global economy in a report entitled US program for the economy and guidelines to establish long-term stability, which indicated that the tax cuts implemented by President George W. Bush, and budget deficits posed "significant risks "not only for the United Kingdom but also for everyone.

The report added that in a few years the US financial obligations might represent 40% of its total economy, "an unprecedented level of external debt for industrialized countries "that could wreak havoc on the dollar and parity of other currencies.

“It is a major mistake to theorize before one has data. One begins to alter the facts to fit them and theories, instead of theories to fit the facts.” (Sherlock, 1892)

The document, which Washington downplayed, warned the danger posed by the need for external borrowing of that country, which could push interest rates upwards there by holding back investment and overall economic growth.

"This is the biggest financial crisis, not only that I have lived, but it seems to me that is of greater magnitude, the most complicated or complex and more global than there has been in previous years." (Slim, 2008)

In March 2006, the Group of 24, which represents developing countries in the IMF and the World Bank warned of a next global financial crisis caused by a sharp drop in American dollar.

Moreover external debt should be considered American who, at June 30, 2006, had climbed to US $10.04 billion.

Effects of the crisis in Latin American:

The global economic crisis interrupted the growth cycle 2003-2008. Not surprisingly, the international crisis began swatting Latin America from September 2008 causing an almost instantaneous reaction of financial variables, although the effect was, after all, short-range, in most cases, these variables quickly recovered from the second quarter of 2009 and almost any country had to cope with a prolonged restriction of external financing. Thus, between September 2008 and March 2009, a general increase in risk of sovereign debt followed, since March 2009, a recovery of the situation due to the decline in risk aversion was recorded and abundant global liquidity. This prompted the return of capital flows to the region and easier access to international credit markets for most Latin American countries access. Moreover, the currencies of the countries in the region accused a noticeable depreciation in late 2008 and early 2009 followed, from March to April 2009 of a general reassessment. In parallel, after the deep depression of the local stock exchanges in late 2008, from March 2009, a rapid reactivation of the dynamism of most Latin American financial centers was found.

The negative effects of the international crisis were also felt, especially in the commercial field. Thus, in Latin America the crisis resulted in a sharp deterioration of trade both in terms of volume and value. In volume, the ECLAC evaluates the reduction of regional exports by 9% in 2009. The result mainly from the collapse of international demand especially from industrialized countries, there was a sharp fall in export volumes, especially in countries exporters of manufactured goods that had the United States as main client. As for the commodity-exporting countries, the fall in export volume was lower due mainly to the maintenance of Chinese demand. Regarding trade in value between late 2008 and early 2009, the billed amounts were undermined by a brutal downward correction of commodity prices, directly affecting the net commodity exporting countries. Instead, for net importing countries, lower prices helped reduce tensions in the current balance in a context of international credit crunch. Nevertheless, the price of certain key raw materials for some Latin American economies like oil, copper and some agricultural products, recorded a remarkable rise from the beginning of 2009. The increase in these prices was a relief for countries exporting raw materials who have limited access to international capital markets access and whose public finances depend heavily on these products. Therefore, even though the terms of trade deteriorated throughout 2009, the decline was less severe than initially expected. Moreover, the decline in exports in value recorded during the year did not cause a significant deterioration of the balance of trade balances of the major economies in the region since imports fell because of the recession.

The crisis has also affected Latin America deteriorating balance of other items in the current account balance. This is the case of remittances from emigrants, representing a significant proportion of the GDP of some countries in the region. Although these transfers are less volatile than other financial flows, the effects of the crisis in developed countries and the impact on their labor markets brought down these shipments made by Latin American immigrants to their countries of origin. According to estimates by the Inter-American Development Bank, these flows fell by 15% in 2009.

Chapter 3

Proposals to solve the crisis:

In the fall of 2008, begins the "great crisis". At that time in the "epicenter of the earthquake" he flew over a certain sense of "repentance". Alan Greenspan -in his almighty day President of the Federal Reserve before the United States Congress, on 24 October 2008, acknowledged: "The free market is not the panacea of self-regulation that had worshiped all my life."

In this context, these 15 experts tried to identify the guiding principles of the new regulation, based on two principles:

a) Consider the impact of the reforms from a global perspective, regardless of the potential conditions on specific companies. That is, an overview of system over the particular approach that is required.

b) Under the new rules, the responsibility for the crisis must fall on financial companies, so that the restitution of damages should be supported by them rather than by taxpayers. It was required to discard the idea of "too big to let them fail" (too big to fail) and allow banks to fail; this would avoid excessive risk-take by those responsible for them. In its course, the financial crisis has exposed flaws in the financial system as:

1. Conflicts of interest:

The binomial "higher risk-higher remuneration" of executives is a very dangerous attraction. Managers act based on more particular interests (high returns in the shortterm) rather than being guided by a more strategic long-term vision, and defend an improvement in the position of companies and stakeholders.

2. Bankruptcy and resolution procedures:

When a bank gets into trouble, if an output of some customers for this reason occurs, you can panic. To the extent that the massive withdrawal becomes widespread, it could precipitate an otherwise avoidable situation.

3. Risk of banking Panic:

Distrust in the system caused many counterparts to disappear: increasing lenders demanded guarantees, hedge funds failed to ensure operations ... and finally the destructive bank runs that plunged many companies broke.

4. Inefficiency of the regulatory structure:

This time the financial regulation followed after financial innovation. The reality was monitored with systemic unable rules to manage the increasing complexity of the financial system; hence many operations and institutions remain "outside the regulation." To avoid this phenomenon they should sacrifice some financial innovation for stability.

The recommendations of that group of scholars generally focus on improvements in regulation. The idea that more regulation is needed to save the honesty of capitalism "we just need even more regulation to keep capitalism honest" underlies his approach.

What are the recommendations of the expert group?

The proposed measures are aimed at:

- Creating a systemic regulator to control the relationships between agents and changes in financial innovation.
- A new information structure, capable of unleashing alarms to changing indicators on emerging crisis.
- Regulation of provident funds, with high doses of transparency regarding its fees and risk profile of their investments.
- Reforms on ways to strengthen the capital. A larger or greater reliance on funding sources with short-term maturities or less settled assets, higher capital requirements.
- Regulation of executive remuneration in financial services, mitigating the incentives associated with high risk.
- Regulatory hybrid securities (convertible bonds) to avoid penalizing taxpayers.
- Improvements in solution, so that too large entities have to file a quarterly kind of living will stating how to liquidate in case of difficulty.
- Clearinghouses and markets. Clearinghouses would confront the positions between counterparties in the event of conflict.

Conclusion

In conclusion the current crisis is due to the rise of prices in a generalized form and this is called inflation. But inflation is also due to the spread of this disease when products from foreign markets are imported, especially from the United States, where a financial crisis is occurring due to the lack of financing of private banks. Through the market the crisis expands all over the world and also reaches our country. When there is inflation means that prices go up unnecessarily and the government has to act to control such inflation either by raising the price of the interest rate, but in any case if inflation persists there comes a time when production has to be affected And that is when you get to the recession.

References

Agelides, P. (2011). *La crisis financiera de 2008 en Estados Unidos "habría podido evitarse"*. Retrieved from BBC Mundo: http://www.bbc.com/mundo/noticias/2011/01/110127_economia_eeuu_crisis_evitable_jrg.shtml

Sherlock, H. (Febrero de 1892). *Las aventuras de Sherlock Holmes.* Edimburgo: George Newnes. Obtenido de SlideShare.

Slim, C. (9 de Diciembre de 2008). *Expansion*. Obtenido de Expansion: http://expansion.mx/economia/2008/12/09/las-18-frases-de-slim-sobre-la-crisis

Steinbrück, P. (16 de Septiembre de 2008). *iProfesional*. Obtenido de iProfesional: http://www.iprofesional.com/notas/87368-Cules-fueron-las-frases-ms-inslitas-sobre-la-quiebra-de-Lehman-Brothers