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The 2008 Worldwide Banking Crisis

The 2008 banking crisis had a long-lasting effect on most of the countries in the world that are integrated into the global economy. While there were several factors that led the crisis to happen, the rapid increase in the number of mortgages was the primary reason for the crisis to explode fully. The 2008 crisis was a combination of the immediate failure of the mortgage debt system combined with the consequences of the in-depth issues in the modern financial system; the crisis led to devastating financial losses and encouraged the conversation about the need to reform the financial system.

Though the banking crisis affected the entire world, it originated in the United States. In the 2000s, some of the underlying mechanisms of mortgages were changed. As a rule, mortgages were not given to everyone, and bad credit and the lack of a steady job were the reasons for mortgages not to be offered, as lenders were not interested in having such a high risk. Investors were looking for low-risk, high-return investments, which resulted in the increased financing of the housing market in the United States and several countries abroad.

At this point, the barriers for people to receive mortgages started to lower because the investors believed they would get bigger returns on the interest rates paid through mortgages. The investors did not deal with the individual mortgages, preferring to buy the mortgage-related

securities instead. Mortgage-related securities were compelled by the individual mortgages bought by the large financial institutions, such as banks (Financial Crisis Inquiry Commission xvi). The stakeholders failed to correctly predict the risks associated with this situation, as the housing market appeared to be striving and the housing prices were constantly going up. Another stakeholder participating in facilitating the mortgage crisis was the credit-rating agencies that stated that mortgage-backed securities were a safe source of investment. The safety status of the investments was downgraded only shortly before the collapse (Financial Crisis Inquiry Commission xviii). There was truth to their statements because mortgage-backed investments were truly considered to be solid investments at the time when the mortgages were only offered to individuals with good credit histories.

The demand for mortgages from investors was incredibly high, which resulted in lenders wanting to create a more efficient supply. The supply could not have been increased based only on the existing pool of individuals with a good credit history. Therefore, the stakeholders chose to change their standards and offer mortgages to individuals whose income and credit history was insufficient to sustain the loan. The loans granted to the individuals with low-income became known as "subprime" loans (Huwart and Verdier 129). In an attempt to sustain the demands, lenders went even further in their risks. They started to engage in predatory and fraudulent practices, as well as irresponsible lending (Financial Crisis Inquiry Commission xxiii). One of such practices was to offer mortgages that people could afford at first only to increase the payment beyond the point of it being affordable.

Though these practices were clearly risky, they were not considered as such due to being relatively new. The credit agencies responsible for risky labeling procedures did not find the

practices of the lenders to be of high risk and instead pointed towards previously known safety of mortgage payments. The investors did not double-check the information, preferring to trust the high ratings of the loans instead. The perception of the safety of mortgage payments was so high that the lenders began to sell collateralized debt obligations—the riskiest portion of the securities combined almost entirely of mortgages that involved a high-risk population that was unable to pay back the funds (Financial Crisis Inquiry Commission). The 2000s saw an unsustainable rise of housing prices, which led to assuming that the investments in mortgages were even more desirable.

The financial crisis fully came to fruition in 2007 when unreliable mortgage payers and the ones that were tricked by insufficient loan practices could no longer afford to pay their debts. The situation led to the default of many house payments, leading the houses to return to the market to be sold. However, though supply was high, the demand was no longer high, which resulted in the dramatic decrease in housing prices. On February 27, 2007, The Federal Home Loan Mortgage Corporation announced that it would no longer buy the risky subprime mortgages and mortgage-related securities ("Financial Crisis Timeline"). The decision was followed by the bankruptcy of the lenders. In April, New Century Financial Corporation, the primary mortgage lender, filed for bankruptcy ("Financial Crisis Timeline"). This was the official beginning of the 2007-2008 financial crisis, though the seeds for it were planted much earlier.

The 2000s housing situation with mortgages was, however, not the only reason behind the 2008 World Economic Crisis. The structural changes in the world economy that occurred since the 1970s serve in explaining the scale of the global financial crisis (Crotty 563). After that

era, the markets underwent the process of financial deregulation accompanied by fast-paced financial innovation. The responses of governments to the previous crises offered financial assistance, which led markets to rapid expansion (Crotty 563). With the growth of financial markets, the potential economic crises became even more dangerous to society. The process of market expansion culminated with the 2008 economic crisis. The economic interventions of the governments around the world were not as effective as they previously were due to the deeply rooted nature of the crisis in the world's economy.

Structural flaws of the modern economy were instrumental in creating opportunities for the 2008 financial crisis to occur. The issues with the new financial architecture include its weak theoretical foundation and incentives that increase the potential for high-risk situations (Crotty 564-565). Moreover, the modern financial architecture results in the completion of financial products so complex that establishing correct pricing for them was merely impossible, which led to the loss of liquidity after the end of the boom.

Banks are a primary asset in allowing a financial crisis to occur. Despite the common stereotype, banks do not distribute all the risky assets to capital markets and become risk-free. One of the primary dangers associated with banks is that they hold assets off balance without having the capital to support these assets (Crotty 570). Such an equation is made possible by financial regulators, who allow the banks to behave in such a manner. Moreover, the regulators made another risky choice of allowing banks to measure their risks and set requirements for capital (Crotty 570). This inevitably resulted in excessive risk-taking due to the inability of the banks to predict risks correctly. In addition, the risks were made even more apparent by the heavy reliance of the system on complex financial products (Crotty 572). In particular, a

dangerously high system-wide leverage was the most dangerous risk raised by the new financial system.

The devastating impact of the financial crisis was immediate, with the freezing of credit and trading markets around the world. What is more, the stock market immediately crashed, and the economies all over the world started to experience a massive recession. On October 3, 2008, the U.S. Congress passed a $700 billion Troubled Asset Relief Program to bail out the banks ("Financial Crisis Timeline"). Furthermore, the amount of money spent on the program increased significantly over the years. On February 25, 2009, The Federal Reserve Board announced the "stress tests" of eligible U.S. banks. Finally, in July 2010, U.S. President Barack Obama signed the Dodd-Frank law ("Financial Crisis Timeline"). The law sets up protections against predatory lending and established the norms for the increased transparency of the banks which prevents them from taking unjustified risks.

The law was worth enacting, as the worldwide cost of the financial crisis was so large and often manifested in subtle ways that it was almost impossible to predict. For the American government, the crisis likely cost a loss of over USD 2 trillion (Mukunda). The burden of the financial losses as a result of a 2008 financial crisis affects every individual. Though some of the attempts to manage the crisis were mostly successful, the global nature of the issues requires more efficient, global interventions. For instance, there is a need to create an international coordination framework to manage banking and financial transactions and reform the international financial system for imbalances (Huwart and Verdier 138-139). The lessons from the crisis should not be ignored to ensure it will not reoccur.

To conclude, the 2008 crisis created a conversation about the legitimacy of financial

globalization and the risks associated with it. Once again, the crisis demonstrated the presence of substantial risks linked to banking activities and financial markets. The imbalances between the leading economic powers became apparent in the wake of the crisis. The risk of the potential repetition of the crisis leads society to question the mechanisms of the modern market. Without an appropriate system of checks and balances implemented for a worldwide financial system, crises of this scale are bound to repeat.

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