Committees: Economic and Financial Committee (GA2)

Issue: Preventing Global Financial Crises

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TOPIC INTRODUCTION

In 2008 the global financial system suffered from a great crash which pushed the world's banking system towards the edge of collapse. During the Global Financial Crisis (GFC), a triggering downturn in the US housing market caused a financial crisis that spread from the United States to the rest of the world. Many banks around the world incurred large losses and started to rely on government support in order to avoid bankruptcy. Millions of people lost their jobs as the world's largest economies experienced their deepest recessions since the Great Depression in the 1930s.

The recovery from the crisis was particularly slow and destructive because of the way domestic problems devolved into a global pitfall. In a globalized world connected not only by trade but by financial capital, there will certainly be further recessions that expand to a global community. The main cause of these recessions are banks, and more importantly, those that are multinational. As a result, a global framework for banking regulations has never been so important in the face of issues like the massive amount of productivity loss, unemployment, and personal hardships caused by financial issues.

Solutions are wide-ranging to such a problem. A common response of governments is to fight off recession with austerity and monetary easing and other untested measures so as to ensure money and credit markets did not seize up. For instance, liquidity requirements, the separation between commercial and investment banking, or stronger loan policies are possible, global solutions to the topic. It is important that besides the monetary sector, (certain operations that are usually attributed to the central bank), other alternatives to such economic departments be introduced so as to avoid future recessions.

DEFINITION OF KEY TERMS

Financial Crisis

A situation in which the supply of money is outpaced by the demand for money. This means that liquidity is quickly evaporated because available money is

withdrawn from banks, forcing banks either to sell other investments to make up for the shortfall or to collapse.[1]

Gross Domestic Product (GDP)

Gross Domestic Product (GDP) is a broad measurement of a nation's overall economic activity. GDP is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.[2]

Commercial Bank

A commercial bank is a type of financial institution that accepts deposits, offers checking account services, makes various loans, and offers basic financial products like certificates of deposit (CDs) and savings accounts to individuals and small businesses[3].

Investment Bank

Investment banking is a special segment of banking operation that helps individuals or organisations raise capital and provide financial consultancy services to them. They act as intermediaries between security issuers and investors and help new firms to go public.[4]

BACKGROUND INFORMATION

Causes of Financial Crises

Considering the 2008 GFC as the main example of a financial crisis outburst, its causes are similar to any recent or upcoming financial crisis.

Excessive risk-taking in a favorable macroeconomic environment

The pre-GFC environment was particularly favorable in the United States. The rates of unemployment and inflation were low, while the economic growth was strong and stable. Therefore, under such circumstances, house prices grew significantly. However, this brought

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[1] "What Is Financial Crisis? Definition and Meaning." BusinessDictionary.com, www.businessdictionary.com/definition/financial-crisis.html.

[2] Chappelow, Jim. "Gross Domestic Product (GDP) Definition." Investopedia, Investopedia, 16 May 2019, www.investopedia.com/terms/g/gdp.asp.

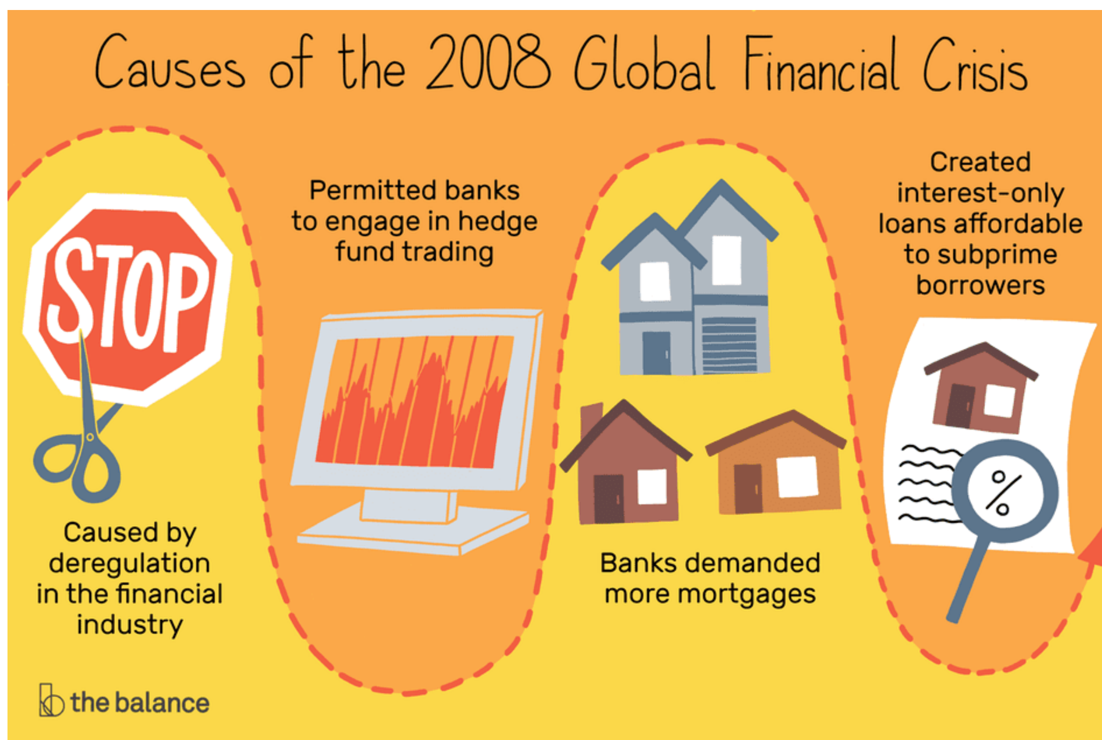
[3] https://www.investopedia.com/terms/c/commercialbank.asp

[4] https://economictimes.indiatimes.com/definition/investment-banking?from=mdr

expectations that house prices would continue to rise and therefore households started to borrow imprudently to purchase and build houses.

A large share of such risky borrowing was done by investors seeking to make short-term profits. Alongside with that, banks and other lenders were willing to make increasingly large volumes of risky loans. The reasons vary with one of them being constant competition between individual lenders. Private individual lenders are a financing alternative especially in times of crisis and the competition between them increased to extend ever-larger amounts of housing loans that, because of the favorable economic environment, seemed to be very profitable at the time.

Secondly, many lenders providing housing loans did not closely estimate borrowers' abilities to make loan repayments and expected to bear no losses. Instead, they provided investors with large amounts of loans, usually in the form of loan packages called 'mortgage-backed securities' (MBS). MBS consisted of numerous of individual mortgage loans (in which property or real estate is used as collateral) of varying quality. Subsequently, MBS products became increasingly complex, but were still considered as if they were very safe, a fault made by the investors purchasing MBS products.



Banks and investors increase their borrowing

In the lead up to the GFC, banks and other investors, especially in the United States borrowed large amounts to expand their lending and purchase

MBS products. However, such acts always magnify potential losses. As a result, when house prices began to decrease, banks and investors incurred large losses because of the huge amount of loans they had already taken out.

In addition, banks and some investors increasingly borrowed money for very short periods of time, to purchase assets which, in such case, could not be sold quickly. Therefore, they became increasingly reliant on lenders (which included other banks) extending new loans as existing short-term loans were repaid.

Regulation and policy errors

Regulation of subprime lending (loans made to people who may have difficulty maintaining the repayment schedule) and MBS products was loose and vague. In particular, there was insufficient regulation of the institutions that created and sold the composite MBS to investors. Many individual borrowers were provided with large loans that were unlikely to be repaid. Subsequently, crimes like fraud were already common. Borrowers started to overstate their income and overpromise investors on the safety of the MBS products they were being sold.

In addition, as the crisis unfolded, many central banks and governments neglected the extent to which bad loans had been extended and the many ways in which MBS failures were spreading through the financial system.

MAJOR COUNTRIES AND ORGANISATIONS INVOLVED

United States

The United States of America is the country in which the 2008 Global Financial Crisis began. In particular, after many years of deregulation, US banks saw profit in making increasingly risky housing loans to people who were not necessarily able to repay their loans. Investors often bought these loans, thinking that even if the lender defaulted on his loan, they would get to keep the valuable house, which they could then resell. However, in early 2007, housing prices began to plummet. Soon after, in February and March 2007, many of the firms that made such loans bankruptcy.

Just a day after the Lehman Brothers (the fourth largest investment bank in the United States) was allowed to collapse, the US Federal Reserve stepped in to rescue American International Group (AIG), the largest insurer in the United States, with an $85 billion loan. This was the first of many moves made by the United States to not only rescue financial institutions, but also mitigate the effects of the crisis and prevent future crises. On July 21, 2010 President Barack Obama signed into law the Dodd-Frank Financial Overhaul, aimed at preventing future financial crises by giving

the federal government new powers to regulate Wall Street. More recently, in 2018, after Republicans in the U.S. House of Representatives tried to repeal the Dodd-Frank Financial Overhaul, President Donald Trump signed a new Act, which retained much of the Dodd-Frank framework, with exemptions for smaller banks that should stimulate growth.

Analysts estimate that these measures are still not sufficient and that the USA will need to further reform its financial sector, if it wants to avoid such damaging crises in the future.

European Union

The Global Financial Crisis of 2008 resulted in the European economy suffering its deepest recession since the 1930s. While the crisis first hit European Banks, it quickly became clear that the budget surpluses of governments in Ireland and Spain came from unsustainable revenues, most notably from the property market. These member states were therefore unable to deal with their debt. In this way, the Financial Crisis evolved into the European Sovereign Debt Crisis, with most severe consequences for the people of Europe. National Governments all over Europe had to increase taxes, reduce welfare spending and put in place significant reforms, while Greece, Spain, Portugal, Ireland and Cyprus all had to be bailed out by the International Monetary Fund (IMF) and the European Central Bank (ECB).

The European Union initiated many policy responses to the Sovereign Debt crisis. Firstly, a new fiscal treaty was signed to limit government deficits at the national level and monitor the public debt of each member state. Furthermore, European financial supervision was and is being stepped up, to make sure that banks behave responsibly and are able to lend money to businesses and households. Also, the European Stability Mechanism (ESM) was set up in October 2012 to provide financial assistance to countries unable to repay their debt. As of August 2019, Greece is the only EU member state still under a program of the ESM.

China

The People's Republic of China has in the last two decades emerged as a major player in the world economy. However, contrary to much popular discussion, China was hit fairly hard by the global financial crisis. It suffered a huge drop in exports. Like in other countries, China had enjoyed a stock market boom, increasing fivefold between 2005 and 2007. In October 2007, the Chinese stock market crashed and a crash in the housing market ensued. While its economic growth remained well above international averages (around 10% in 2010) its drop was of the same order of magnitude as for the United States.

China, much like other Asian countries, learned a lot from the Asian crisis of 1997-98 and was ready to enact a major economic stimulus program as soon as the crisis hit. However, the Chinese economy still faces a number of major challenges.

Firstly, its export oriented economy is not a viable long-term strategy. Likewise, the efficiency of China's high levels of investment has been put into question. Also, analysts estimate that there is an ongoing bubble in the real estate sector in China that could pop in case of a new financial crisis.

TIMELINE OF EVENTS

Date	Description of event
1637-Tulip Mania	The Dutch tulip bulb market bubble occurred in Holland during the early and mid 16th century when the value of tulip bulbs skyrocketed. There was a period of time, where the rarest bulbs were traded for as much as six times the average person's annual salary.
Credit Crisis of 1772	Even though it originated in London, it spread in the rest of Europe such as Scotland and Netherlands. A partner in a large bank, Alexander Fordyce, lost £300.000 worth of East India Company shorting shares and in order to avoid repayment fled to France. Credit use was largely based upon people's confidence in the banks, so when this confidence started to die down the credit system paralyzed. The outcome of this paralysis was the bankruptcy of twenty important banking houses.
Stock Crash of 1929	Started on October.24 and resulted in the Great Depression, a worldwide phenomenon. Its social impact lasted for a very long time.
1973-OPEC Oil Crisis	The OPEC oil embargo was a decision to stop exporting oil to the United States. On October 19, 1973, the 12 OPEC members agreed to the embargo. Over the next six months, oil prices quadrupled. Prices remained at higher levels even after the embargo ended in March 1974.

Asian Crisis ,1997-1998	The crisis broke out with the collapse of the Thai baht. The government was forced to float the baht due to lack of foreign currency to support its U.S. dollar peg. The crisis to spread to other countries of East Asia, such as Indonesia and South Kore, but led to improvements in financial regulation and supervision.

POSSIBLE SOLUTIONS

A stable economy is the key to prevent any financial crisis. In order to find a way to achieve that, one should have a better understanding of the business cycle, which is a cyclical pattern that economies typically tend to go through.

Even though real GDP in most countries around the world grows over long periods of time, GDP growth is uneven and irregular everywhere in the world. Real GDP may grow rapidly or slowly in different periods of time, but may also fall, indicating negative growth. These are the so-called fluctuations of real GDP, which alternate between periods of expansion and contraction.

The business cycle consists of the following 4 phases:

Expansion: Occurs when there is positive growth in real GDP. Unemployment decreases and the general price of the economy grows rapidly

Peak: The point where the cycle's GDP reaches its maximum and the phase of the expansion its end. In some cases, unemployment has fallen substantially and the general price level is so high that the economy is likely to be experiencing inflation.

Contraction: Following the cycle's peak, the economy experiences a fall in real GDP. Unemployment increases and the general price level falls. If a period of contraction lasts for longer than 6 months then it is characterised as recession.

Trough: the point of the cycle where GDP reaches its minimum. A trough marks the beginning of a new phase of expansion.

By observing an economy's alternating phases of GDP, we can predict an upcoming financial crisis, but most importantly take measures in order to reduce the intensity of the economic fluctuations, thus achieving price stability and full employment.

Preventing global crises essentially means trying to keep individual national economies at least stable and ideally on the rise. There are two primary courses of action a nation can take in order to control fluctuations in its economy, namely fiscal and monetary policy, each one having its own advantages and drawbacks.

Fiscal policy: Fiscal policy includes all actions taken by a government concerning its spending and taxation. Governments can raise taxes and cut back on spending, during periods of inflation, or cut tax rates while increasing its own spending to assist the economy. An example of how, in this case, an expansionary fiscal policy, during a period of recession would be applied is the following. In order to increase its spending, a government can invest in infrastructure development through projects such as highways or bridges. This would lead to an increase of employment, boosting aggregate demand and growth. Rather than increasing spending, a decrease in tax rates can lead to an increase in investment spending and firms would hire more in order to compete in labor. Reduced unemployment wages are raised and consumers have the ability to spend and invest more.

Monetary policy: Monetary policies are also applied by a nation's central bank to either boost a falling economy or cool down an overheating one. Its aim is to trigger economic activity by encouraging businesses and citizens to borrow and spend. During a period of inflation, a central bank may take the following restrictive actions. By reducing the money supply, money circulation is reduced and injection of new money in the economy is smaller. Central banks, such as the Federal Reserve Bank in the United States, are able to reduce the demand for cash and loans by raising interests rates, which makes the value of money more expensive, and by increasing borrowing costs.

Comparing fiscal with monetary policy: One of the biggest advantages of fiscal policies is that their effects can be seen much quick than those of monetary policies, which tend to have a time lag. So, in a situation where immediate actions need to be taken, a fiscal policy is more preferable.

On the other side, central banks are independent, therefore a monetary policy can be undertaken unaffected by a nation's political stance. For example, a government may be reluctant to apply a restrictive fiscal policy, such as raising taxes, in order to maintain its popularity.

In a case of a fiscal policy being applied for a very long period of time, the risk of a budget deficit being created is very high. A budget deficit occurs when a nation's annual expenditures are bigger than its revenue, thus increasing national debt.

In monetary policies, there is also the risk of hyperinflation. This could happen if for example over-borrowing meets very cheap interest rates. Big injections

of money in economies can lead to such an outcome, since the value of money would drop with a consistently high level of demand.

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