INTRODUCTION

Financial crises and accompanying economic recessions have occurred throughout history. Periodic crises appear to be part of financial systems of dominant or global powers. The United States is the epicenter of the current financial crisis. Enjoying a unipolar moment following the collapse of the Soviet Union and the failure of Communism, the United States was confident that economic liberalization and the proliferation of computer and communications technologies would contribute to ever-increasing global economic growth and prosperity.

As we discussed in Chapter 1, finance is usually the leading force in the growth of globalization. The rise of great powers is inextricably linked to access to investments and their ability to function as leading financial centers, as we saw in Chapter 2. Their decline is also closely linked to financial problems. Finance enables entrepreneurs to start various enterprises and to become competitors of established companies. It is also essential to innovation and scientific discoveries. Finance also facilitates risk sharing and provides insurance for risk-takers. Countries that have large financial sectors tend to grow faster, their inhabitants are generally richer, and there are more opportunities. Financial globalization contributed to the unprecedented growth and prosperity around the world. China and India became significant economic powers and the industrialized countries grew even richer.1 Closely integrated into the financial system are banks and investment firms. When the financial system is in crisis, banks reduce lending, companies often face bankruptcy, and unemployment rises. Ultimately, as we saw in the financial crisis of 2008–2009, many banks fail.

The financial crisis triggered a global economic recession that resulted in more than $4.1 trillion in losses, unemployment rates that climbed to more than 10 percent in the United States and higher elsewhere, and increased poverty. Stock markets around the world crashed in 2008. American investors lost roughly 40 percent of the value of their savings. Housing prices plummeted from their record highs in 2006. Consumers reduced
their spending, manufacturing declined, global trade diminished, and countries adopted protectionist measures, many turning their attention inward to focus on problems caused by the financial crisis. Given the central importance of finance to virtually all aspects of globalization, issues such as trade, the environment, crime, disease, inequality, migration, ethnic conflicts, human rights, and promoting democracy are affected. Furthermore, the financial crisis weakened some countries more than others, thereby engendering significant shifts of power among countries, especially between the United States and China. This chapter examines the causes of the financial crisis, its impact, and responses to it.

CAUSES OF THE GLOBAL FINANCIAL CRISIS

The causes of financial crises are as complex as many of the crises themselves and the human beings responsible for them. There have been at least sixty recorded crises since the early seventeenth century. Human beings seem to have always been obsessed with money, and greed drives them to obtain increasing amounts of it. And humans generally spend more than they have, thereby creating huge debts that undermine the stability of the financial system. As early as 33 A.D., Emperor Tiberius of Rome had to inject public funds into the financial system to prevent it from collapsing. Euphoria and excessive optimism, which often accompany financial bubbles, are usually followed by fear and panic when crisis arrives. Generally, people claim to not know how the crisis happened or that they could not see it coming. The Asian Financial Crisis in 1997 was a precursor to the financial crisis of 2008–2009. It started in Indonesia and spread to Malaysia, South Korea, other parts of Asia, and the rest of the world. Once prosperous economies were now in deep recession, with stock markets crashing and capital flowing out of the various countries at unprecedented rates. The Asian crisis was largely caused by “hasty and imprudent financial liberalization, almost always under foreign pressure, allowing free international flows of short-term capital without adequate attention to the potentially potent downside of such globalization.”

But the Asian crisis was part of larger global developments, many of which were driven by the United States. The end of the Cold War left America standing as the world’s sole superpower with unprecedented power and unlimited options, or so it seemed. Affected by hubris, and made overly confident by the exponential growth of computer and telecommunications technologies, the United States believed, in the words of Thomas Paine, that it could build a brand-new world characterized by unlimited success. However, terrorist attacks on September 11, 2001, fundamentally altered America’s sense of security and plunged the country into a recession.

An integral component of the struggle against terrorism was the restoration of domestic and global confidence in America’s economic system in general and its financial system in particular. President George W. Bush launched a perpetual war against terrorism. To accomplish this, the U.S. defense budget was rapidly increased, a department of Homeland Security was created, and two wars, one in Afghanistan and the other in Iraq, were launched. Furthermore, part of the new security strategy was a comprehensive globalization agenda, in which American
companies operating in foreign countries would be free from restraints imposed by those countries. This meant increasing government debt and encouraging consumers to spend even more to strengthen both the economy and national security. With easy access to capital created by economic globalization, consumers and the U.S. government relied on other people’s money. In addition to concentrating on fighting a perpetual war against nonstate actors, an atmosphere was created in which questioning was discouraged and taking excessive financial risks and getting rich quickly were lauded. From John C. Bogle’s perspective, at the root of the problem was a societal change. America valued form over substance, prestige over virtue, money over achievement, charisma over character, and the ephemeral over the enduring. While it is almost impossible to disentangle the causes of the global financial crisis, we will concentrate on those that are most often discussed. They include (1) deregulation of financial markets; (2) sophisticated financial innovations linked to rapid changes in computer technologies; (3) excessive executive compensation; (4) low interest rates; (5) subprime loans, especially for mortgages; and (6) speculation in general, with an emphasis on speculation in housing.

**Deregulation of Financial Markets**

Just as the current financial crisis has engendered demands for reforms, the Great Depression of the 1930s led to the implementation of financial regulations to stabilize the economy and to give American savers confidence in banks. Banks were widely perceived as boring but safe. Although interest rates were low, inflation was also low. Furthermore, deposits were protected by the Federal Deposit Insurance Corporation (FDIC). An outgrowth of the Great Depression, rising inflation, that also occurred following rapid and dramatic increases in oil prices in 1973–1974, contributed to the erosion of confidence in regulations designed during the Great Depression. Rising inflation in the United States prompted foreigners to lose confidence in the U.S. dollar as the leading currency and to seek security by purchasing gold. In response, President Richard Nixon unlinked the dollar from gold and adopted a regimen of floating interest rates. This created greater volatility in the financial system as well as increased opportunities to earn higher interest rates.

Significant societal changes and developments in technology combined to serve as a catalyst to propel deregulation. Although large banks and financial institutions initiated efforts to eliminate or modify regulations that restrained them, individuals were also more assertive in gaining control over their savings pension funds and investments in the stock market. Between 1974 and 1980, many regulations were removed. For example, in 1980, commercial banks and savings and loans institutions were permitted to determine their own interest rates on deposits and loans, thereby spurring greater competition. Many smaller banks were acquired by larger, more distant banks. The local bank was fast becoming an outdated institution.

Just as financial globalization drives economic globalization, the rapid growth of trade was now facilitating global financial liberalization. Globalization in general enabled American banks to argue that they were disadvantaged in competition with British, German, Japanese, and other foreign banks that were free of
restrictions faced by American banks. Moreover, American banks adopted a global outlook that freed them from limiting their operations to the United States. Many were moving their activities offshore to places such as the Cayman Islands, Bermuda, and the Bahamas. President Ronald Reagan, elected on a platform of limiting the role of government, pressured other countries to open their financial systems to American firms. Financial deregulation in the United States was now inseparable from the globalization of trade and financial services. However, impeding global competition in banking was the Glass-Steagall Act of 1933, which prohibited commercial banks from underwriting or marketing securities.8 The rapid growth of capital flows across national borders and the increasing power of investment bankers eventually led to the demise of the Glass-Steagall Act in 1999. The phenomenal proliferation of sophisticated computer technologies and an almost unquestioning faith in the wisdom of markets contributed to escalating demands for and acceptance of less regulation. In essence, federal agencies designed to regulate banking became less effective. There was a general loss of control at all levels, which led to exponential risk taking at many companies, largely hidden from public scrutiny. Violations of financial regulations went largely unpunished.9 Simon Johnson argues that from the confluence of campaign finance, personal connections, and ideology flowed a river of deregulatory policies. These included:

1. Insistence on free movement of capital across borders.
2. The repeal of Depression-era regulations separating commercial and investment banking.
3. Decreased regulatory enforcement by the Securities and Exchange Commission.
4. Allowing banks to measure their own riskiness.
5. Failure to update regulations to keep up with the tremendous pace of financial innovations.10

Financial Innovations

As the global financial crisis unfolded, it was obvious that many of those in the banking and investment communities did not fully comprehend how the financial system they created functioned, or the scope and severity of the crisis. The financial wizards, the best and the brightest from leading business schools, could not really explain what was happening on Wall Street and in global financial markets. Ironically, financial innovations, designed by brilliant computer experts to manage risk and make capital less expensive and more available, ultimately led to the global financial crisis. Financial innovations, with instantaneous global impacts due to technologies that made electronic transactions faster and less expensive, raced ahead of regulations. Complex financial products created in one financial center involved assets in another and were sold to investors in a third financial market. As we saw in Chapter 1, governments are increasingly challenged to operate effectively in a globalized world. Whereas governments are restrained by issues of sovereignty, global financial firms enjoy relatively greater flexibility. Furthermore, many different agencies in the United States have regulatory authority, a situation that
The Global Financial Crisis creates confusion and ineffectiveness. Among the numerous financial innovations that led to the global financial crisis were securitization and hedge funds.

Prior to the widespread use of securitization, banks, many of them local, provided loans to customers they often knew and the banks were responsible for the risks involved in making loans. This meant that bankers gave loans only to individuals and companies they believed could repay the loans. With securitization, risks inherent in granting loans were passed from the bank giving the loans to others who had no direct interest in the customers’ ability to repay the loans. Subprime mortgages, student loans, car loans, and credit card debts were securitized. **Securitization** is a sophisticated process of financial engineering that allows global investment to be spread out and separated into multiple income streams to reduce risk. It involves bundling loans into securities and selling them to investors. In 2009, an estimated $8.7 trillion of assets globally were funded by securitization. This innovation made vast sums of money available to borrowers. For example, securitization increased the amount of money available to individuals purchasing homes. This led to unprecedented growth in house prices. It also resulted in high default rates and the housing crisis. As we will discuss, applicants for mortgages were not carefully examined and were encouraged to obtain subprime loans.

Another financial innovation was credit **derivatives**, which were bets on the creditworthiness of a particular company, like insurance on a loan. There were two types of credit derivatives: credit default swaps and collateralized debt obligations. **Credit default swaps** were widely used, especially by insurance companies such as the American International Group (AIG). Life insurance companies invested in credit default swaps as assets. Parties involved in a credit default swap agreed that one would pay the other if a particular borrower, a third party, could not repay its loans. Credit default swaps were used to transfer credit risks away from banks. A major problem with credit default swaps was the lack of transparency. They were also unregulated. Ultimately, credit default swaps created confusion and encouraged excessive risk taking. It was difficult to determine where the risk ended up. Designed to pass on risks, loans were packaged as securities. **Collateralized debt obligations** were linked to mortgage companies, which passed on the risk. Mortgages, instead of being held by banks and mortgage companies, were sold to investors shortly after the loans closed, and investors packaged them as securities.

Similar to securitization, hedge funds grew rapidly, accounting for more than $1.3 trillion in assets globally before the financial crisis of 2008–2009. The name **hedge funds** implies investment funds with a particular sort of hedging strategy. Created by the Investment Company Act of 1940, hedge funds allowed wealthy investors to avoid many financial regulations, and hedge funds were early participants in financial globalization. Essentially, hedge fund managers created portfolios reflecting an assessment of the performance of diverse global markets. As long as the number of participants was relatively small, hedge funds avoided great systemic risks. This changed with revolutions in computer technology that allowed split-second timing on huge volumes of trades. An integral component of the hedge fund strategy is a technique known as **arbitrage**. This involves simultaneously buying at a lower price in one market and selling at a higher price in another market to make a profit on the spread between the two prices.
Executive Compensation

Excessive executive compensation is widely perceived as playing a pivotal role in creating the global financial crisis. Wall Street became a magnet for the brightest Americans who wanted to make a large amount of money very quickly. Most companies rewarded short-term performance without much regard for market fundamentals and long-term earnings. Executives were given stock options, which they could manipulate to earn more money. The more an executive could drive up his or her company’s stock price or its earnings per share, the more money he or she would get. Frank Partnoy argues that a mercenary culture developed among corporate executives. They merged with or acquired higher-growth companies and, in many cases, committed accounting fraud.17 This fraud led to the bankruptcy of companies such as Enron, Global Crossing, and WorldCom. Many executives received long prison sentences. Table 7.1 shows the highest-earning American executives.

Low Interest Rates

A fundamental cause of the global financial crisis was the easy availability of too much money globally. An oversupply of money created unprecedented levels of liquidity and historically low interest rates. As we mentioned earlier, the terrorist attacks on the United States on September 11, 2001, triggered a national embrace of increased government spending as well as consumer spending. To accomplish this, the U.S. Federal Reserve, led by Alan Greenspan, lowered interest rates to around 1 percent in late 2001. The European Central Bank and the Bank of Japan also reduced interest rates to record lows. The U.S. government encouraged Americans to purchase homes and to refinance or borrow against the value of homes they owned. As consumers and the government lived beyond their means, they were able to borrow from developing countries that were accumulating huge reserves from

![Table 7.1](image)

**TABLE 7.1**

<table>
<thead>
<tr>
<th>Name</th>
<th>Company</th>
<th>Compensation ($ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sanjay K. Jha</td>
<td>Motorola</td>
<td>104.4</td>
</tr>
<tr>
<td>Lawrence J. Ellison</td>
<td>Oracle</td>
<td>84.6</td>
</tr>
<tr>
<td>Robert A. Iger</td>
<td>Walt Disney</td>
<td>51.1</td>
</tr>
<tr>
<td>Kenneth I. Chenault</td>
<td>American Express</td>
<td>42.8</td>
</tr>
<tr>
<td>Vikram S. Pandit</td>
<td>Citigroup</td>
<td>38.2</td>
</tr>
<tr>
<td>Mark V. Hurd</td>
<td>Hewlett-Packard</td>
<td>34.0</td>
</tr>
<tr>
<td>Jack A. Fusco</td>
<td>Calpine</td>
<td>32.7</td>
</tr>
<tr>
<td>Rupert Murdoch</td>
<td>News Corp</td>
<td>30.1</td>
</tr>
<tr>
<td>David M. Cote</td>
<td>Honeywell</td>
<td>28.7</td>
</tr>
<tr>
<td>Alan G. Lafley</td>
<td>Procter and Gamble</td>
<td>25.6</td>
</tr>
</tbody>
</table>

CHAPTER 7
The Global Financial Crisis

YOU DECIDE

Limiting Executive Compensation

Contrary to general assumptions about equality in the United States, executives of leading companies often make more than three hundred times the wages earned by the average worker in those companies. Although some shareholders had voiced concerns about executive pay prior to the financial crisis, most Americans believed that executives should be rewarded for their responsibilities. As the financial crisis deepened, the global economy weakened, unemployment rose, and household wealth declined; as individuals became more financially insecure, they began to focus more on income inequality, especially on the gap between the super rich and the middle class. When General Motors, AIG, and several Wall Street banks were deemed too big to fail because of their impact on the global economy in general and the U.S. economy in particular, the U.S. government created a stimulus package to prevent them from failing. Ultimately, the American taxpayers owned roughly 80 percent of AIG and 70 percent of General Motors. As the global recession deepened, popular demands for limiting executive pay in companies supported by taxpayers became more vociferous and widespread. Senator Charles Grassley, a senior Republican, said that senior AIG executives should apologize Japanese-style and then perhaps commit suicide. Government officials demanded that bonuses be returned or taxed at 100 percent. There were demonstrations outside executives’ homes. The U.S. government and governments around the world struggled with the idea of imposing limits on executive compensation.

2. What are some implications of public ownership of private companies?

Sovereign Wealth Funds

Created by countries to save and recycle surplus revenues

Subprime Loans

High-risk credit given to individuals who fail to meet rigorous standards

Subprime Loans

Another major cause of the financial crisis was the availability of subprime loans, which were directly an outgrowth of easy credit. Subprime loans generally refer to credit given to individuals who fail to meet rigorous standards usually expected by

the phenomenal growth of global trade. Much of the surplus of money in the global system also came from declining investment in the Asian economies following the 1997 financial crisis. Rising oil prices in the Middle East, Russia, and elsewhere enabled many countries to earn more money than they could spend rationally. By the end of 2008, central banks in emerging economies held $5 trillion in reserves.18

The money supply increased rapidly in China, India, Russia, and the Persian Gulf states. Whereas it was generally assumed that global monetary policies were set by central banks in the United States, Europe, and Japan, the reality was that three-fifths of the world’s money supply growth flowed from emerging economies.19 Based on their experiences with financial problems, many developing countries decided to save for a rainy day, as it were. They believed that high oil prices or trade surpluses would not last forever. As Table 7.2 indicates, many of these countries created sovereign wealth funds to recycle their financial surpluses. It is estimated that by 2012 these funds will be worth roughly $10 trillion, or 3 percent of global traded securities. Several Wall Street firms, such as Merrill Lynch and Citigroup, had to borrow from sovereign wealth funds in 2008.20
Causes of the Global Financial Crisis

These individuals could not really afford their loans because of inadequate income and poor credit histories. In most cases, borrowers were not required to have a down payment. With excess liquidity globally, interest rates remained low. People with weak financial histories are generally more vulnerable to being charged higher interest rates. For example, poor people pay exorbitant rates for payday loans. A basic reality of finance is that yields on loans are inversely proportional to credit quality: the stronger the borrower, the lower the yield, and vice versa.21 Driving the demand for subprime loans was the development of a culture of entitlement and a false egalitarianism that appealed to people’s egos. Home ownership was pushed by the U.S. government as an inalienable right, despite borrowers’ inability to repay loans. Fannie Mae and Freddie Mac, both U.S. government corporations, made more money available to lenders and borrowers by purchasing loans from the lenders and selling them to investors in the secondary markets. Huge amounts of money gravitated to subprime mortgages in the United States and Europe and, ultimately, to weak borrowers globally. Given the complex interdependence that characterizes financial globalization, problems emanating from subprime loans in the United States rapidly spread around the world. Governments were largely unaware of the risks associated with new forms of financing and were unable to prevent the global financial crisis.22

As the unprecedented sums of money flowed into commercial and residential real estate, housing prices escalated. For thirty years before the housing boom, the average American house appreciated at an average of 1.4 percent a year. This low

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**TABLE 7.2**

**SOVEREIGN WEALTH FUNDS (2008)**

<table>
<thead>
<tr>
<th>Country: Name</th>
<th>Assets ($ Billions)</th>
<th>Inception Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>UAE: Abu Dhabi Investment Authority</td>
<td>875.0</td>
<td>1976</td>
</tr>
<tr>
<td>Norway: Government Pension Fund—Global</td>
<td>380.0</td>
<td>1996</td>
</tr>
<tr>
<td>Singapore: GIC</td>
<td>330.0</td>
<td>1981</td>
</tr>
<tr>
<td>Saudi Arabia: various</td>
<td>300.0</td>
<td>Na</td>
</tr>
<tr>
<td>Kuwait: Reserve Fund for Future Generations</td>
<td>250.0</td>
<td>1953</td>
</tr>
<tr>
<td>China: China Investment Corporation</td>
<td>200.0</td>
<td>2007</td>
</tr>
<tr>
<td>Singapore: Temasek Holdings</td>
<td>159.2</td>
<td>1974</td>
</tr>
<tr>
<td>Libya: Oil Reserve Fund</td>
<td>50.0</td>
<td>2005</td>
</tr>
<tr>
<td>Qatar: Qatar Inv. Auth.</td>
<td>50.0</td>
<td>2005</td>
</tr>
<tr>
<td>Algeria: Fond de Régulation des Recettes</td>
<td>42.6</td>
<td>2000</td>
</tr>
<tr>
<td>U.S.: Alaska Permanent Fund Corporation</td>
<td>38.0</td>
<td>1976</td>
</tr>
<tr>
<td>Brunei: Brunei Inv. Auth.</td>
<td>30.0</td>
<td>1983</td>
</tr>
<tr>
<td>Other</td>
<td>171.4</td>
<td>–</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2876.2</strong></td>
<td>–</td>
</tr>
</tbody>
</table>

return of prime loans discouraged homeowners from viewing their houses as cash machines. Home-equity lines of credit were not available until recently. Things changed dramatically after 2000. Appreciation rates climbed to 7.6 percent between 2000 and 2006, reaching 11 percent before the market crashed between 2006 and 2007. Real estate prices in California, Arizona, Nevada, Florida, and other areas grew even faster.

There was a wide variety of subprime mortgages. These included adjustable-rate mortgages, balloon mortgages, piggyback loans, and interest-only loans. An **adjustable-rate mortgage** is a long-term loan that does not have a fixed interest rate. The interest can be changed, with low rates at the beginning and high rates at the end. It is also possible, but highly unlikely, that rates could decline. Adjustable-rate mortgages were attractive to homebuyers who moved frequently. They were less expensive, or so it seemed, than fixed-rate mortgages, which offered more protection. A variation of the adjustable-rate mortgage is a balloon mortgage. Under this arrangement, lower payments are made on a loan for five to ten years, with a final installment, or balloon payment, that is significantly larger than earlier payments. Most borrowers could not afford to pay the balloon payment. The piggyback loan allows the homeowner to take out a second mortgage that is piggybacked onto the first mortgage. This is a high-risk loan because it clearly indicates that the borrower cannot afford the down payment to purchase real estate. In an environment that encourages consumption over savings, easy credit fueled the housing crisis. Interest-only loans required borrowers to pay the interest on a loan without reducing the principal balance. This enabled weak borrowers to obtain larger loans.

**Speculation**

A combination of low interest rates, unprecedented liquidity, and a belief that the Internet and various computer technologies virtually guaranteed unending and ever-increasing prosperity facilitated the growth of speculative financial forces. Excessive risk taking replaced caution, which was often equated with a lack of optimism. **Speculation**, a deeply ingrained human characteristic, fosters the development of a herd mentality. As prices continued to rise, even the most cautious individuals get caught up in speculation. Ultimately, a speculative bubble is created. **Speculative bubbles generally go through four stages:**

1. A new technology or invention changes people’s expectations and those who are well informed try to profit from it.
2. Prices or profits continue to rise, which draws more people into the market.
3. The boom passes into euphoria and rational decision-making is suspended.
4. The bust is almost inevitable. Prices and profits fall, companies and individuals go bankrupt, and the economy plunges into a recession.

Many homeowners became speculators. In addition to low-interest loans and financial innovations in the housing market, political pressures to reduce taxes, including real estate taxes, contributed to the housing boom. Congress passed the **Taxpayer Relief Act of 1997**, which, among other things, exempted profits realized from the sale of a home if the home was owned and used as a principal residence.
for two of the last five years before it was sold. This new provision enabled home-
owners to exclude up to $500,000 for couples and $250,000 for singles from capi-
tal gains tax. In many cases, removal of the capital gains tax encouraged home
buyers to engage in a form of speculation known as flipping. The buyer would own
the house for a short period with the sole intention of selling it very quickly for a
higher price, thereby gaining a significant profit without much effort and by using
very little of his or her own money as an investment. When the stock market

crashed in 2000, real estate became more attractive to investors. Furthermore, the
shock of the terrorist attacks on September 11, 2001, influenced more Americans
to seek security in their homes. Consequently, they concentrated their investments
in real estate. Because of the huge amounts of money that went into real estate
globally and the preponderance of subprime loans and excessive risk taken in home
mortgages, the housing crisis was at the epicenter of the global financial crisis.

THE IMPACT OF THE GLOBAL FINANCIAL CRISIS
As we mentioned earlier, the global financial crisis affected virtually all areas,
including the process of globalization. Housing prices crashed; foreclosures
became commonplace; unemployment reached 10 percent in the United States
and higher levels in Europe and elsewhere; manufacturing declined sharply, espe-
cially in the automotive industry; students were faced with higher costs as col-
leges suffered financial losses; finding jobs after college became more
challenging; and a global recession created widespread hardships. On the other
hand, many developing countries that took a prudent approach to finance and

Paul Nawrocki, a
former opera-
tions manager
for a toy manu-
facturer, com-
mutes to
mid-town Man-
hattan wearing a
sign saying
“almost home-
less” and hand-
ing out his
resume in search
of a decent job
with health care
benefits for his
wife.
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Reserved.
saved money were not as badly damaged. In fact, countries that did not fully
embrace financial liberalization were less affected than those that gave in to
American pressure to fully engage in financial globalization. We also saw a
global power shift, with the United States losing ground to China, India, Brazil,
and other developing countries.

**Foreclosures**
Plunging real estate prices affected virtually all areas of the economy. People
could no longer afford to purchase homes, which meant that homebuilders were
forced to abandon construction projects. Think of all the products that are used
in building and furnishing a home; all of the industries that produced these prod-
ucts generally experienced declining sales. Because houses became primary
sources of wealth or perceptions of wealth, falling real estate prices made home-
owners feel less economically secure. In a vicious circle, the economic recession,
fueled by declining real estate markets, further eroded demand for real estate.
But, mortgages must be repaid or the consequences can be severe. Despite
decreasing home values, homeowners must continue to pay real estate taxes and
spend money on maintenance. Many homes were bought at prices much higher
than their actual worth just two or three years later. For example, a house pur-
chased in Phoenix in 2006 for $225,000 sold for $110,000 in 2008. Housing
prices in parts of California, Arizona, Nevada, and Florida declined by 60 percent
or more. Banks also suffer financial losses when homeowners can no longer
afford to repay loans. It is estimated that each foreclosure costs lenders $50,000.25
Rising levels of unemployment also pushed homeowners with strong credit into
foreclosure.

The mortgage crisis inevitably spread to financial institutions, causing rep-
utable Wall Street firms such as Lehman Brothers to collapse overnight. Because
of Lehman’s pivotal role in finance, its demise in September 2008 is generally
perceived as the most tangible evidence of the financial crisis on Wall Street. Ice-
land, which had a very successful banking system, saw its economy and cur-
rency collapse along with the banking system. Ireland, widely regarded as the
Celtic tiger for its rapid economic growth, experienced a deep recession. Ameri-
can consumers, the backbone of the United States and, to some extent, the
global economy, had exhausted their resources and had a savings rate that was
close to zero.

**Decline in Manufacturing and Trade**
Manufacturing, already in decline, fell dramatically. This especially was the
case in the automotive industry, with General Motors and Chrysler declaring
bankruptcy after closing many factories and dealerships, despite unprecedented
financial support from the U.S. government. Industrial production was down
by 12 percent in Europe, 11 percent in the United States, and 43 percent in
Taiwan. Tightening credit and consumer fear ultimately created a downward
spiral that significantly diminished global trade. Germany saw its exports drop
by 20 percent. China’s exports fell by more than 25 percent and U.S. exports fell by almost 24 percent in 2008.  

**Global Power Shift**

Another major impact of the global financial crisis is a global power shift. Although most countries were negatively affected by the financial crisis and global recession, some emerged stronger than others. Brazil, Russia, India, and China, also known as the **BRIC countries**, enhanced their power vis-à-vis the United States, Western Europe, and Japan. In sharp contrast to the policies adopted by the U.S. Federal Reserve under Chairman Alan Greenspan, the Reserve Bank of India, led by **Yaga Venugobal Reddy**, rejected many financial innovations and limited the participation of foreign investors in India’s financial system. Instead of believing that markets are self-regulating, as many Americans do, the Indian government favored regulations and was quick to recognize financial bubbles. Reddy restricted bank lending to real estate developers, increased the amount of money banks had to set aside as reserves, and blocked the use of some derivatives. This conservative approach enabled India to largely avoid the global financial crisis. Given America’s role in pressuring the world to adopt a financial system that failed, BRIC countries perceive the financial crisis as a serious economic and political setback for the United States and free-market capitalism. All of these countries, sensing America’s vulnerabilities, are becoming more politically and financially assertive. From their perspective, America is declining. It has escalating budget deficits, it is extremely dependent on foreign creditors such as China, and the dollar’s status as the main global reserve currency has eroded.

![BRIC Countries](BRIC_Countries.png)

**BRIC Countries**  ■  Brazil, Russia, India, and China; emerging global powers

![Yaga Venugobal Reddy](Yaga_Venugobal_Reddy.png)

**Yaga Venugobal Reddy**  ■  Governor of the Reserve Bank of India; credited with helping India avoid the financial crisis

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**TABLE 7.3**

<table>
<thead>
<tr>
<th>Country</th>
<th>Existing Share (%)</th>
<th>Proposed Share (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>16.77</td>
<td>16.73</td>
</tr>
<tr>
<td>Japan</td>
<td>6.02</td>
<td>6.23</td>
</tr>
<tr>
<td>Britain</td>
<td>4.86</td>
<td>4.29</td>
</tr>
<tr>
<td>France</td>
<td>4.86</td>
<td>4.29</td>
</tr>
<tr>
<td>China</td>
<td>3.66</td>
<td>3.81</td>
</tr>
<tr>
<td>Russia</td>
<td>2.69</td>
<td>2.39</td>
</tr>
<tr>
<td>Belgium</td>
<td>2.09</td>
<td>1.86</td>
</tr>
<tr>
<td>India</td>
<td>1.89</td>
<td>2.34</td>
</tr>
<tr>
<td>South Korea</td>
<td>1.38</td>
<td>1.36</td>
</tr>
<tr>
<td>Brazil</td>
<td>1.38</td>
<td>1.72</td>
</tr>
</tbody>
</table>

*Source: Economist, 11 April 2009, 72.*
Another indication of a power shift is the growing role of foreign banks in America’s financial system, as indicated in Table 7.4.

### TABLE 7.4

**GROWTH OF FOREIGN BANKS IN THE UNITED STATES**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Citi (U.S.)</td>
<td>13.9</td>
<td>J.P. Morgan (U.S.)</td>
<td>14.8</td>
</tr>
<tr>
<td>2. Merrill Lynch (U.S.)</td>
<td>13.7</td>
<td>Citi (U.S.)</td>
<td>14.7</td>
</tr>
<tr>
<td>3. Goldman Sachs (U.S.)</td>
<td>10.4</td>
<td>Bank of America Merrill Lynch (U.S.)</td>
<td>12.9</td>
</tr>
<tr>
<td>4. Morgan Stanley (U.S.)</td>
<td>10.4</td>
<td>Morgan Stanley (U.S.)</td>
<td>10.4</td>
</tr>
<tr>
<td>5. Lehman Brothers (U.S.)</td>
<td>8.2</td>
<td>Goldman Sachs (U.S.)</td>
<td>8.8</td>
</tr>
<tr>
<td>6. Chase Manhattan (U.S.)</td>
<td>7.3</td>
<td>Barclays Capital (British)</td>
<td>7.1</td>
</tr>
<tr>
<td>7. Credit Suisse First Boston (Swiss)</td>
<td>6.0</td>
<td>HSBC (British)</td>
<td>4.5</td>
</tr>
<tr>
<td>8. J.P. Morgan (U.S.)</td>
<td>6.2</td>
<td>Deutsche Bank (German)</td>
<td>4.2</td>
</tr>
<tr>
<td>9. Donaldson Lufkin Jenrette (U.S.)</td>
<td>4.9</td>
<td>Credit Suisse (Swiss)</td>
<td>4.1</td>
</tr>
<tr>
<td>10. Bear Stearns (U.S.)</td>
<td>4.6</td>
<td>RBS (Scotland)</td>
<td>3.7</td>
</tr>
</tbody>
</table>


The BRIC countries are now challenging America’s leadership. Another indication of a power shift is the growing role of foreign banks in America’s financial system, as indicated in Table 7.4.

### GLOBAL RESPONSES TO THE FINANCIAL CRISIS

**America’s Response**

Responses to the global financial crisis varied from country to country, with the strongest actions occurring in the United States. Being largely responsible for the crisis, the United States was not only the most severely affected, but also the most shell shocked and anxious to find solutions. In a sharp reversal of its strong commitment to economic and financial liberalization and free-market capitalism, the United States has led efforts to nationalize its financial and some aspects of its manufacturing sectors to an unprecedented degree. There was general consensus among Republicans and Democrats that a massive financial and economic stimulus package, engineered primarily by Secretary of the Treasury **Henry Paulson**, was essential not just to rescue America’s financial institutions but to reassure Americans that their savings and investments were secure. A $787 billion **stimulus package** was passed by Congress. Because the financial crisis was reminiscent of the Great Depression, with its high levels of unemployment and massive withdrawals from banks, the U.S. government responded to avoid repeating the mistakes of the 1930s. Despite various protections implemented to insure the safety of deposits, such as the FDIC, Americans withdrew $150 billion from money market funds over a two-day period in September 2008, compared to average weekly outflows of roughly $5 billion. The huge amount of money...
Global Responses to the Financial Crisis

Poured into credit markets and banks was designed to restore confidence in financial institutions and to expand credit.

**European Responses**

Although other countries also implemented stimulus packages, their concerns differed to a significant degree from those of the United States. Germany, for example, resisted American pressure to adopt a more comprehensive, coordinated global stimulus package, partly because many Germans believe that the crisis was primarily an outgrowth of American financial policies and would have to be solved domestically. Germans worry about the possibility of hyperinflation, which the country experienced in the 1920s. Germans are also more frugal than Americans and are reluctant to impose huge deficits on future generations, especially in light of Germany’s shrinking population. Europeans in general took a less-frantic approach to the financial crisis because in normal times their governments had created numerous **safety nets**. European governments provide national health insurance and generous pensions, and they have implemented programs to reduce unemployment and lost wages. Although Europeans are negatively affected by the financial crisis, their safety nets have diminished their fears. Because they save a greater percentage of their income, at reduced levels, they have avoided losing their homes on such a massive scale as is the case in the United States.30

**China’s Response**

China’s response involved taking measures to strengthen its power vis-à-vis the United States. Unlike the United States, China regulates its financial institutions, has more than $2 trillion in reserves, and continues to have economic growth rates in excess of 7 percent, and the Chinese save more than 40 percent of their income. Despite rising unemployment and declining exports, China emerged from the financial crisis in a strong position and is taking advantage of new opportunities created by the crisis. China is using its $600 billion economic stimulus package to improve its infrastructure, to help its companies to become more competitive domestically and globally, and to enhance research and development. It is also gaining greater access to resources and augmenting its relations in Latin America, Africa, the Middle East, and elsewhere, even as the United States is preoccupied with its financial and economic crises as well as with fighting wars in Iraq and Afghanistan. China is also acquiring European and American companies in the automotive, textile, food, energy, machinery, electronics, and environmental protection sectors.31 One of the most visible acquisitions is the Hummer from General Motors.

**Financial Regulations**

In light of the general consensus among experts that deregulation and the lax enforcement of regulations in the financial sector contributed significantly to the global financial crisis, an immediate response to the crash was to try to strengthen and update regulations. The chairman of the U.S. Federal Reserve, **Ben S. Bernanke**, was particularly aware of the need for new regulations. As a professor at Princeton
University, Bernanke focused his research on the Great Depression. The American government was now determined to avoid mistakes made during that financial and economic crisis. Efforts to enact international banking regulations began with the creation of the Bank for International Settlements, based in Basel, Switzerland. In 1988, the banking community signed the Basel Capital Accord, which attempted to harmonize banking standards, especially those requiring banks to set aside capital to cover the level of risk they faced. However, due to the dominant influence of bankers, the Bank for International Settlements was not very focused on regulations. Since 1999, there has been a greater effort to develop a stronger regulatory framework, known as Basel 2. The new accord gives credit-rating agencies an explicit role in determining how much capital is enough to cover certain risks. But, the failures of financial institutions in the United States, Europe, and elsewhere demonstrate that individual countries’ unwillingness or inability to supervise their financial sectors was at the heart of the problem. Consequently, domestic regulatory reforms are likely to be more effective than global regulations. Financial innovations such as derivatives and executive compensation are the primary targets for greater supervision. However, the complex nature of the global financial system and strong reservations in the United States about the government’s role in the economy will most likely diminish the effectiveness of regulations.

SUMMARY AND REVIEW
The global financial crisis of 2008–2009 ushered in the most severe global recession since the Great Depression of the 1930s. Given the central role played by finances in globalization, the crisis has serious implications for virtually all global issues and for globalization itself. Although this chapter argues that financial crises seem to be an integral component of capitalism, human beings are ultimately responsible for creating them. Revolutions in computer and telecommunications technologies fostered the development of complex financial engineering that radically altered the global financial system. An emphasis on government deregulation, the growth of a culture that encouraged quick profits and excessive executive compensation, and the availability of low interest rates played significant roles in creating the financial crisis. But a crisis presents both dangers and opportunities. While the United States has suffered severe setbacks, China has gained, thereby shifting global power. The financial crisis has significantly reduced global trade and caused unprecedented home foreclosures and high levels of unemployment. The global response has centered around regulating some of the financial innovations, paying greater attention to risk management, and monitoring executive compensation. Overall, the financial crisis has diminished support for financial liberalization and strengthened the role of governments around the world in economic affairs.

KEY TERMS
finance 149  global financial 151  financial innovations 151
Asian financial crisis 149  liberalization 150  securitization 152
Federal Deposit Insurance 150  Glass-Steagall Act of 1933 151  derivatives 152
Corporation (FDIC)
DISCUSSION QUESTIONS

1. Discuss how deregulation of financial markets and low interest rates contributed to creating the financial crisis.
2. Discuss the implications of the stimulus package for the United States. In light of the benefits derived from Europe’s safety net, discuss the pros and cons of America’s adoption of European policies, such as universal health care and job protection.
3. Discuss the role of subprime loans in real estate in the financial crisis.
4. In your view, has the financial crisis weakened the United States globally and strengthened China? Discuss.
5. Evaluate the global responses to the financial crisis.

SUGGESTED READINGS


END NOTES