CHAPTER 7

The Global Financial Crisis

The global financial crisis had widespread effects. Out of work like many, marketing executive Chuck Bridges wears a variation of the "will work for food" sign.

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. Globalization contributed to the extraordinary accumulation of wealth by a relatively few individuals and created greater inequality. In an effort to reduce inequality in the United States, the government implemented policies that engendered the financial crisis.

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.

finance ■ The major catalyst in the growth of globalization and national power

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. 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. The European Union struggled over how much to shore up or bail out banks and nations using the euro currency. The financial, economic, social, and political fallout continue. Citizens took to the streets in a protest movement against financial inequality that began in New York City as "Occupy Wall Street" and spread around the world. This chapter examines the causes of the financial crisis, its impact, and responses to it. It concludes with a case study of the decline of the Celtic Tiger (Ireland).

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.[2] 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."[3]

Asian Financial Crisis ■ Started in Indonesia, caused stock markets to crash, and reversed economic growth

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 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.[4] 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.[5] 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, which 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.[6]

FDIC ■ Insures individual bank deposits for up to $250,000

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.[7]

deregulation ■ Removed many government restrictions on financial institutions in the United States and other countries

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

global financial liberalization ■ Opening banks around the world to competition 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.

Glass-Steagall Act of 1933 ■ Prohibited commercial banks from underwriting or marketing securities

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 creates confusion and ineffectiveness.[11] Among the numerous financial innovations that led to the global financial crisis were securitization and hedge funds.

financial innovations ■ Sophisticated financial engineering, an outgrowth of revolutions in computer and telecommunications technologies

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.[12] 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.[13] 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.

securitization ■ Financial engineering designed to reduce risk

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.[14] **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.

derivatives ■ Bets on the creditworthiness of a particular company, like insurance on a loan

credit default swaps ■ Financial innovation used to transfer credit risks away from banks

collateralized debt obligations ■ Linked to mortgage companies

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.[15] 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.[16]

hedge funds ■ Enabled wealthy investors to avoid some financial regulations in global financial markets

arbitrage ■ Simultaneously buying at a lower price in one market and selling at a higher price in another market to make a profit

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.

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 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]

Alan Greenspan ■ Chairman of the U.S. Federal Reserve who kept interest rates low

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. Many of these countries created **sovereign wealth funds** to recycle their financial surpluses.

sovereign wealth funds ■ Created by countries to save and recycle surplus revenues

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 lending institutions. 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

subprime loans ■ High-risk credit given to individuals who fail to meet rigorous standards 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.[20] 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 (Federal National Mortgage Association) and Freddie Mac** (Federal Home Loan Mortgage Corporation), 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.[21]

Fannie Mae and Freddie Mac ■ U.S. government corporations involved in real estate

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 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.[22] 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.

adjustable-rate mortgage ■ A long-term loan that has varying interest rates

Speculation

A combination of low interest rates, unprecedented liquidity, and a belief that the Internet and various computer technologies virtually guaranteed unending and

speculation ■ Involves excessive risk taking, excessive optimism, and the development of a herd mentality

Taxpayer Relief Act of 1997 ■ Exempted profits from taxes gained from selling one's home

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.[23]

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 homeowners to exclude up to $500,000 for couples and $250,000 for singles from capital 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, especially in the automotive industry; students were faced with higher costs as colleges 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 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.

Housing was at the epicenter of the financial crisis. Falling house prices directly affect government revenues, including spending for education.

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 products generally experienced declining sales. Because houses became primary sources of wealth or perceptions of wealth, falling real estate prices made homeowners 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. Rising levels of unemployment also pushed homeowners with strong credit into foreclosure. One in forty-five U.S. households, or 3 million, received a foreclosure filing, and banks repossessed 1 million homes in 2010. Housing prices continued to fall in 2011, the construction of new houses declined the most in twenty-seven years, and building permits dropped to their lowest level on record.[24]

The mortgage crisis inevitably spread to financial institutions, causing reputable 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. Iceland, which had a very successful banking system, saw its economy and currency collapse along with the banking system. Ireland, widely regarded as the Celtic Tiger for its rapid economic growth, experienced a deep recession. American 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.[25] Both economies rebounded, with China surpassing Japan to become the world's second-largest economy and Germany experiencing the highest economic growth rate in Europe.

Global Power Shift

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

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

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. Within the EU, Germany emerged with the strongest financial and economic system and greater political and economic power. 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.[26] 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. As we saw in Chapter 2, America's economic power following World War II enabled it to shape global financial institutions such as the International Monetary Fund (IMF) and the World Bank. However, the BRIC countries are now challenging America's leadership.[27] Economic power has shifted from the G-7 to the G-20, the group composed of countries with the largest economies, many of

TABLE 7.1

Growth of Foreign Banks in the United States

Leading Banks (1999)	Share of Market (%)	Leading Banks (2009)	Share of Market (%)
1. Citi (U.S.)	13.9	J.P. Morgan (U.S.)	14.8
2. Merrill Lynch (U.S.)	13.7	Citi (U.S.)	14.7
3. Goldman Sachs (U.S.)	10.4	Bank of America Merrill Lynch (U.S.)	12.9
4. Morgan Stanley (U.S.)	10.4	Morgan Stanley (U.S.)	10.4
5. Lehman Brothers (U.S.)	8.2	Goldman Sachs (U.S.)	8.8
6. Chase Manhattan (U.S.)	7.3	Barclays Capital (British)	7.1
7. Credit Suisse First Boston (Swiss)	6.0	HSBC (British)	4.5
8. J.P. Morgan (U.S.)	6.2	Deutsche Bank (German)	4.2
9. Donaldson Lufkin Jenrette (U.S.)	4.9	Credit Suisse (Swiss)	4.1
10. Bear Stearns (U.S.)	4.6	RBS (Scotland)	3.7

Source: Graham Bowley, "Stalking a Weaker Wall Street," *New York Times*, 17 June 2009, B1.

them in the developing world. In 2011, when a new leader was being chosen for the IMF, countries with emerging economies called for the end of the tradition of European leadership of the IMF. Another indication of a power shift is the growing role of foreign banks in America's financial system, as indicated in Table 7.1.

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 also 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

Henry Paulson ■ U.S. Secretary of the Treasury who initiated the stimulus package to rescue banks on Wall Street

stimulus package ■ Money allocated by governments to financial institutions and selected industries to prevent their collapse and reinvigorate economic growth 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 with average weekly outflows of roughly $5 billion. The huge amount of money poured into credit markets and banks was designed to restore confidence in financial institutions and to expand credit. Concerned about high unemployment rates and stagnant economic growth, the U.S. Federal Reserve enacted a type of monetary stimulus known as **quantitative easing** (QE). It bought $600 billion in long-term Treasury bonds to push down long-term interest rates.[28] That depreciated the value of the dollar, thereby making American exports less expensive and raising the cost of imports. That, in turn, fueled debates about currency wars. America also responded by electing Republicans in 2010 to replace Democrats who controlled the House of Representatives. A greater emphasis was placed on reducing budget deficits at both the national and state levels. Many public service employees lost their jobs, and public sector unions were severely weakened.

quantitative easing ■ A type of monetary stimulus used by the U.S. Federal Reserve. Long-term Treasury bonds are purchased to decrease interest rates.

European Responses

Although other countries also implemented stimulus packages, their concerns differed to a significant degree from those of the United States. Germany, for

Fallout from the financial crisis and economic recession is seen in Portugal, at a workers' protest against the government's new budget policies for trimming the country's budget deficit. Portugal asked the European Union for financial assistance to help solve its crisis.

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. 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. However, faced with mounting debts and a worsening financial crisis, many governments implemented austerity programs that cut government budget deficits and raised the minimum retirement age. These changes caused protests in France, Greece, Portugal, Britain, and elsewhere. Leaders of the "euro zone" countries, in which the single European currency is used, struggled to create an overall policy to deal with the region's growing debt crisis. Students in Britain protested the government's decision to increase college tuition and fees. Similar to the United States, the government that was in power in Britain during the financial crisis (Labor), lost its majority to a coalition of Conservatives and Liberal Democrats.

safety nets ■ The health insurance, pensions, and other programs that European governments provide citizens and that lessen losses in economic hard times

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. 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

Ben S. Bernanke ■ Chairman of the U.S. Federal Reserve

Bank for International Settlements ■ Based in Basel, Switzerland; created to regulate banking and harmonize banking standards

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.[29] Since 1999, there has been a greater effort to develop a stronger regulatory framework, known as Basel 2. The accord gave credit-rating agencies an explicit role in determining how much capital is enough to cover certain risks. In 2010, an agreement known as *Basel 3* created new international rules for banks. They raised the amount capital lenders are required to have as a cushion against unexpected financial losses to 7 percent of their capital.[30] 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.

CASE STUDY | Ireland: The Decline of the Celtic Tiger

Ireland, the second-richest country in Europe before the global financial and economic crisis, now has one of Europe's weakest economies. What makes the Irish case different and of special interest is that after such a long history of hardship and poverty, Ireland was radically transformed into a highly successful country, becoming the Celtic Tiger in the 1990s, only to see prosperity decline precipitously by 2007. Massive public debt, due largely to the banking crisis, forced Ireland to turn to the European Union and the IMF for financial assistance. Unemployment rose to 14 percent and consumer spending and incomes fell. Ghost estates proliferated, homelessness increased, and younger Irish emigrated to the United States, Canada, Australia, and elsewhere to find employment.[31]

Ireland endured severe economic problems in the 1980s. Emigration, an integral part of the Irish experience for more than 150 years, rose sharply, draining the country of many talented individuals. High tax rates discouraged foreign investment, and high inflation and high interest rates made it difficult for the economy to recover. Ireland's entry into the EU and its adoption of the euro marked a major step toward Ireland's integration in the global economy. Ireland gained access to low interest rates, and the Anglo Irish Bank and other financial institutions borrowed heavily in the euro interbank market to finance property loans. Ireland's rapid economic growth was aided by policies implemented by the government led by Charles Haughey. Those included cuts in public spending to reduce the budget deficit, a three-year freeze on wages, and lowering inflation and interest rates. Ireland attracted many companies, especially high-tech industries like Intel,

(*continued*)

that wanted to gain entry in the EU before the removal of trade barriers among member countries in 1992. Ireland in many ways resembled South Korea, Taiwan, and other Asian Tigers. It offered a relatively low-wage workforce, highly educated individuals, low tax rates, and concessions to companies that invested. It also had the advantage of being an English-speaking country with a global diaspora. Ireland's economic prosperity was closely linked to America's. Many in the Irish diaspora, especially in the United States, returned to Ireland during the boom in the 1990s, bringing with them skills and capital. Ireland also became a magnet for immigrants from Eastern Europe and elsewhere, many of whom worked in the booming construction industry and in the service sector. Between 1993 and 2000, average GDP growth rates were around 10 percent, similar to rates in China and other Asian countries. Ireland became a Celtic Tiger during this period. But a financial bubble was also developing. Wages and prices rose faster than those in Ireland's trading partners, which diminished Ireland's competitiveness. Imports became less expensive and government deficits grew, as was the case in the United States. At the same time, the cost of living escalated. Ireland had become Europe's second-richest country overnight.

Ireland, like the United States, turned to investing in real estate following the dot-com bust. The general belief among many Irish was that real estate was a safe investment that would continue to appreciate. Low interest rates, the lack of stringent government regulations, and government corruption fueled a construction boom. Small down payments enabled financially vulnerable individuals to purchase homes. Buyers routinely secured loans worth more than 90 percent of the home's value, which pushed them into negative equity when property values declined. Speculation was common. People wanting to make money quickly invested in second homes and commercial property. The number of people employed in construction reached 272,000 in 2007, accounting for one eighth of the workforce. When employment in areas related to housing is considered, such as real estate agencies, mortgage brokers, and banks, the housing sector employed a fifth of Ireland's population. Housing problems were the main cause of the decline of the Celtic Tiger. Ireland experienced a precipitous drop in housing prices.[32]

In an effort to solve its economic problems, Ireland borrowed money, primarily to bail out banks. Germany, the leading EU economy and the biggest creditor, opposed lowering interest rates on Ireland's debt, favoring instead fiscal discipline. But austerity programs and high unemployment rates lessen the likelihood that consumers will be able to reinvigorate the economy. Ireland faces many difficult choices. The financial and budgetary crises will take time to be resolved. By keeping corporate taxes low, Ireland is likely to attract foreign investment as the global economy improves. Ireland's young and talented workforce will continue to be a major asset that will assist in the country's economic recovery.

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 argued 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 139
Asian Financial Crisis 140
Federal Deposit Insurance Corporation (FDIC) 141
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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 and their broader social and economic implications.
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. Give examples.

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