Causes And Cost Consequences Of Financial Crisis In The USA 2007-2009

Saad Mofareh Alshahrani

Abstract: Both American government and citizens suffered from the last financial crisis during 2007-2009, and, according to the Department of the Treasury, 8.8 million jobs were lost and $19.20 trillion was lost household wealth. Although American government has attempted to develop the financial system, it has been impacting and costing them lots of money.

1 Introduction

THe USA government and residents have faced many severe problems; one of these issues is financial crisis, which has impacted on economic in America and numerous countries. In fact, the financial crisis had happened numerous times and the last one began on August 2007 and it has negatively influenced the financial system on several sectors, both governmental and private business, such as banks and companies. The reason is that I have heard and read lots of information about financial crisis, and it has influenced government organizations and companies that have downsized employees so that they do not have sufficient money to pay their salaries. According to businessdictionary, financial crisis is defined as “a situation in which the supply of money is outpaced by the demand for money.” Both American government and citizens suffered from the last financial crisis during 2007-2009, and, according to the Department of the Treasury, 8.8 million jobs were lost and $19.20 trillion was lost household wealth. Although American government has attempted to develop the financial system, it has been impacting and costing them lots of money. At first I will discuss how and when the financial crisis started. Second, housing bubble and shadow banking are the causes of this crisis. Finally, there are negative results and costs: the cost of lost output, the cost of reduced wealth, the cost of the crisis hampers an economic comeback, and job losing.

2 Facts

2.1 How Did It Start?

According to the Council on Foreign Relations (2009), the United States is where the global financial and global economic crisis started. It happened when housing prices declined, which caused the USA to have a serious problem at U.S subprime lending organizations. Dwyer and Tkac define a subprime mortgage as “a mortgage to an owner-occupier of a house with more credit risk than a prime mortgage” (Dwyer and Tkac, 2009, p. 2). Successively, this pushed problem at severe a wide credit squeeze and U.S financial association, which impacted the global economy.

- *Saad Alshahrani is currently pursuing MBA master’s degree program in accounting and finance at the University of Scranton, The United States of America, Pennsylvania. E-mail: Saad.mg2014@gmail.com*

Discreet American buyers spending and large-scale spending plans by the government led to have deficits in both current balance and large budget, which raised fears of the financial crisis. Although America’s central role in the financial crisis, the second part of 2008 noticed an increase of the U.S dollar close to other currencies, as investors avoid to not take a risk from dollar investment, which they considered a kind of secure investment. In addition, the investors were worried about a long-period investment due to decreasing in the U.S. influence and power. The president Obama and Washington have worked as one of the prime representatives for the international response to the financial crisis.

3 Causes of financial crisis

3.1 The Housing Bubble

Dean Baker points out (2008) that the housing bubble was the primary factor in the current financial crisis in America. In America, the housing bubble grew beside along with the stock market bubble, which caused people who had developed their wealth with the increase of the stock prices to spend more money. Thus, this rise in assets led people to purchase better or bigger houses. In the short-term, the supply of housing was almost fixed, which caused the increase in demand to trigger the increasing real estate prices. Consequently, the inflated property and housing prices created a large bubble. The increase in house values had an impact on several areas, especially when financial institutions speculate on the counting trend. The housing bubble started in 2007 because the houses were in over-supply, and the record available rate changed from the ownership side to the rental side. The available rate on ownership units was nearly 50 % above its prior peak by the fourth quarter of 2006. In addition, by the middle of 2007, prices nationwide had peaked and started to collapse. By the end of 2007, the real estate prices declined to 15 percent from the peak. At the beginning of 2008, the rate price acceleratory fell to 30 percent. As a result, this led to a loss of more than $7 trillion in housing bubble wealth. This huge number and it badly affected the economy because the loss of wealth was almost equal to 50 percent of Gross Domestic Product (GDP).

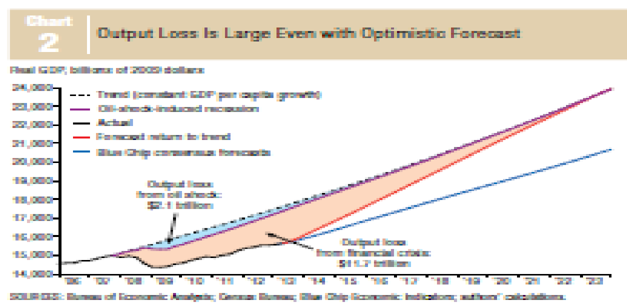
3.2 Shadow Banking

Kodres argues (2013) “many financial institutions that act like banks are not supervised like banks.” They are called Shadow Banking. The USA accused the shadow banks of being non-bank financial organizations, which were involved in the maturity transformations. Maturity transformation means when commercial banks use short-term deposits to fund longer term loans to buy assets with longer-term maturities. Shadow banks cannot borrow money in an emergency situation from the United States central bank (Federal Reserve) because they do not have traditional depositors whose money is covered by insurance. Furthermore, they are not subordinate to traditional bank regulations. In fact, as long as investors identify all the events in market systems, and if the events do not pose any threat to the financial system, then it remains very clear the mode of getting funds for investors who desire to have a quick return on their money is by obtaining property which has a long-term maturity span. Trouble always arises when a big number of investors with the long-term investment assets decide to pull out of the market at once. These moves always create a worldwide economic disaster. In order to pay all the investors' shadow banks, they have to sell their properties to generate the required income. During the sales process, the shadow bank raises prices on properties forcing other banking institutions with similar properties to reduce their prices in order to compete favorably in the market. At the head of the crisis were many investors who did not reinvest due to the fear of market instability, as a result financial institutions (both banks and nonbanks) ran into serious problems. If these events had occurred outside the banking system, it would have been possible to identify the source of the problem and the affected entities. The problem was that real banks were also cash strapped in the shadows. Some of the shadow banks had links to the commercial banks and were, in fact, controlled by the same banks. In other scenarios, the connections were not as direct, but the effect was seen when the shadow banks had to withdraw from other markets. They also had to withdraw from markets where the banks sold commercial paper and also in short-term debt markets. This move disrupted a significant source of funding for the banks. The shadow banking institutions were typically identified by their lack of disclosure about their assets, there values and the location of the assets. The unclear governance and ownership structures that surround the relationship between shadow banks and banks, minimum regulatory or administrative lapse as compared to the conventional banks, with an unclear loss absorbing capital or cash for redemption and non-existing access to a reliable and official form of liquidity support to aid in the aversion of fire sales (Kodres, 2013).

4 THE COST AND CONSEQUENCES OF FINANCIAL CRISIS

4.1 The Cost of Lost Output

The massive $6 trillion to $14 trillion estimates the lost output following the disaster relies on the hypothesis about the economy's rate of growth and as to whether the shock in oil prices in the year 2008 might have caused the mild recession. This is the estimation of the total cost of the crisis is from 2008 up to 2023, when the trend of output is assumed to return to normal. At the end of the day there is no any reliable method to determine as to whether output would have followed a different path or whether the financial crisis led to a drop in the output. A typical assumption is that trend growth would have proceeded with similar steps as the previous period (from 1984-2007). This period is known as the Great Moderation owing to price stability and a relative economy. The average growth rate of the gross domestic product (GDP) was 2.1 percent per year. Undoubtedly, the high crude oil prices were partially responsible for the contraction that occurred and the effect on the growth trend. The reasons for the oil shock may not be separable from the financial crisis. A global-imbalance account insists an increase in the demand for U.S financial assets by people overseas led to an unsustainable establishment of structured credit products such as mortgage backed securities. This led the worsening of the real (inflation adjusted) interest rates. Undoubtedly the relationship between the financial movements and the prices of different hard-assets commodity- not forgetting the sudden increase of the crude oil price- were the onset the economic instability experienced in the year 2007-2008. The estimated difference between the GDP and the realized GDP with the absence of the financial crisis is shown in chart 2. The graph also shows that an oil shock recession would happen despite of the crisis. The estimate (represented by the red line in chart 2) gives a sensible middle ground between the exceptionally unlikely, instant return to trend and the uncertain continuous output loss. This is seen by a continued reserved rate of economic growth (this is shown by the blue line in chart 2. In addition to affecting the amount of goods and services produced in the U.S, the 2007-2009 burst is associated with worldwide downturn. The same output-loss seen in the world GDP is estimated to be $8.1 trillion dollars through the end of 2012. This figure excludes the U.S. (David Luttrell, Tyler Atkinson and Harvey Rosenblum, 2013)



4.2 The Cost of Reduced Wealth

A considerable amount of financial wealth was wiped out by the crisis. The net worth of households in the U.S. dropped by $16 trillion, which is equivalent to 24 percent, from the third quarter of the year 2007 to the first quarter of the 2009. This sharp reduction in accrued savings shook the confidence in households. On the other hand, a more suitable assessment as to the level of harm done to the households lies in the loss of total wealth, which contains human capital. The permanent income theory projected by Friedman (1957) states that the decision of how much to consume in a given period is not based on income in that period but on the average present value of anticipated income over one's remaining lifetime. Hall (1978) shows that consumption ought to follow a "random walk with drift" Any changes in the consumption rate of the households that are either above or below its regular growth rate, which shows an adjustment to expected permanent income of the households. Durable goods, that are continuously consumed past their initial period of purchase can be characterized as investments, thus they are expelled from consumption in order to try and obtain the change in permanent income. Through 1974 to 2007 it is estimated that the rate of consumption in nondurables goods and services for each working age adult increased by 1.7 percent annually. From the end of 2007 to the end of 2009, it dropped by 3.4 percent. The rate of consumption has only increased by 1.2 percent rate per year. This is 8.4 percent below the expected rate that it should have been if it kept growing as like the past periods. With regards to the permanent income theory, this is a $5,000 reduction rate for each working age adult. It is also adjusted account for consumption of durable goods. Durable goods also show a large downward amendment of households' outlook to their lifetime income. They can also be to gauge the cost of the crisis. In this case it does not rely on estimates of trend to show output growth (Atkinson, Luttrell, and Rosenblum, 2013).

4.3 Costs of the Crisis Hamper an Economic Comeback

The 2007-2009 financial crisis is estimated to have cost the United States economy a minimum of 40 to 90 percent total goods and services produced in one year. The approximation depends on the perception of growth what growth is and what it will be in the future. More complete assessment of some factors gives the suggestion that the effect of the crisis is greater than it seemed. With regard to this the 40 to 90 percent of one year's production is the minimum estimate of the total crisis cost. The loss in output in other states owing to the financial crisis could equal the U.S. output loss. It is assumed that output will go back to its prerecession trail, but there is concrete evidence that financial crisis has reduced the potential of output, thus furthering the extent of losses. The drop in the consumption owing to the financial crisis only reflects the downward drop to the household income. This implies the loss of two years output within the households. This may exaggerate the loss if consumption was push to very high rates and the fall was attributed to the temporary change in the credit markets. However, all these heavy measures pay no attention to the intangible costs past the lost income. A common feature that is characterized by the recession is the loss employment, a market that is full of mentally and physically unfit individuals due to the high level of stress and the deterioration of health between the employed and the unemployed as a result of financial constraints. Importantly the crisis started a nationwide movement by the government aimed at preventing future occurrences. In addition, it also showed the abilities of government institutions such as the Federal Reserve in curbing such episodes. Owing to this crisis the estimated economic recovery is and other effects resulting from this contraction have an equivalent cost of one year GDP. Thus proper policies should be formulated in order to protect the economy against future huge losses. (Atkinson, Luttrell, Rosenblum, 2013).

4.4 Losing Jobs

The big loss of American jobs sped up at a high pace at the end of the year 2008, thus bringing total job losses to 2.6 million in that year. This is the highest level seen in more than six decades. The Department of Labor showed the economy lost a record of 524,000 jobs in December. The number jumped to 1.9 million from September as the economic crisis begun. The high number of jobs lost is the highest I the country since the year 1945 after world war two. The growing numbers of people looking for employment sky rocketed, with a majority of them not able to find full time employment. The number was 715,000 people to 8 million people. This was the highest record ever since the records were kept in 1955. The record of under employment, which consists of both part time workers and those who look for jobs but could not get rose to 13.5 percent from 12.5 percent. Great number of people lost their jobs or moved to other manual jobs as a result of the crisis. To further show the effects of the crisis the average hourly work week dropped from 33.5 hours to 33.3 hours. This is the highest ever recorded level in the history of the U.S. the average weekly paycheck dropped by $2 to $611.39. The loss of jobs was massive all through the industries in the country, manufacturing industries lost 149,000 jobs, followed by the leisure and hospitality sector with 22,000 jobs. The mining industry lost 1000 jobs. Even though it was the holiday shopping season, retailers dropped 66000 people from their pay roll as a result of the massive crisis. The professional job category was not spared and they lost 113,000 jobs. The same financial sector lost 14,000 jobs. The government, health and education industries resumed to hire with the last two offering 45,000 jobs. The general president of the Laborers International Union of North America urged the congress to move and create jobs with the same urgency that they showed while bailing out the financial institutions. (Goldman, 2007)

5 Conclusion

Taking everything into consideration, in this paper, I discussed the financial crisis of 2007-2009 in the USA. It was mostly caused by housing bubble and shadow banking. It started in the United States in 2007 when the housing price declined and nonbanks used short-term deposits to fund longer term loans to buy assets with longer-term maturities. The financial crisis cost around $19 trillion in household and many people lost their jobs because companies and government organizations could not pay salary for them. From 2007 to 2011, 8.8 million jobs were lost. In addition, housing bubble lost around $7 trillion and $14 trillion was lost in output. President Obama and U.S government have worked as one of the main representatives for the international response to the financial crisis. Even though the crisis started in the USA, it affected other countries. The US government has tried to avoid the negative consequences by recapitalizing some US banks and establishing more banking regulations.

Acknowledgment

I would like to thank Mr. Alex V. Bochkov, who supported me to have my paper done. I wish him all the best.

References

[1] Barry, F. (2013). Federal Reserve Bank of Dallas Staff Papers: How Bad Was It. Retrieved from http://www.jdsupra.com/legalnews/federal-reserve-bank-of-dallas-staff-pa-78558/

[2] David, G. (2009). Worst year for jobs since'45. Retrieved from http://money.cnn.com/2009/01/09/news/economy/jobs_december/

[3] David, L, Tyler. A & Harvey R. (2013). Assessing the Costs and Consequences of the 2007–09 Retrieved from http://www.dallasfed.org/research/eclett/2013/el1307.cfm

[4] Dean, B. (2008) The housing bubble and the financial crisis. (2009). Retrieved from http://www.paecon.net/PAEReview/issue46/Baker46.pdf

[5] Dwyer and Tkac. (2009). DIANE Publishing, Financial Crisis of 2008 in Fixed Income Markets Issue Guide: The United States and the Global Financial (2009). Retrieved from http://www.cfr.org/world/issue-guide-united-states-global-financial-crisis/p19524

[6] Laura, E. K. (2013). What Is Shadow Banking. Retrieved from

http://www.imf.org/external/pubs/ft/fandd/2013/06/basics.htm

[7] The Financial Crisis Response In Charts - U.S. Department of (2012). Retrieved from http://www.treasury.gov/resource-center/data-chart-center/Documents/20120413_FinancialCrisisResponse.pdf

[8] What is financial crisis? definition and meaning. (n.d.). Retrieved from http://www.businessdictionary.com/definition/financial-crisis.html