The Determinants of Financial Crisis

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Keywords: Financial crisis, Causes, Solutions

Abstract: The coming of financial crises is inevitable, the only issue worth doing is thoroughly understanding and positively preventing. This paper summarized and analyzed the main economic and political factors of the financial crises, the specific causes of main financial crises over the past thirty years and the solutions to resolve each financial crisis.

1. Introduction

The financial crisis appears periodically, but it is improbable to exactly predict when and why it will happen. Although it has been almost thirteen years since the catastrophic financial crisis in 2008, the suspension of enterprises and interruption of transnational cooperation attributed to the menacing COVID-19 affected the production and life of various countries. Therefore, the panic over the comeback of the financial crisis has pervaded among markets. The financial crisis could not be eliminated, but a profound understanding of financial crises and comprehensive prevention and resolving approaches could assist to steadily survive from the financial crisis. To discover the causes and solutions of financial crises, this paper will discuss the determinants of financial crises, retrospectively explain the main cause of the financial crisis over the past thirty years and illustrate various countries' measures to resolve each crisis.

2. Causes of the Financial Crisis

2.1 Economic Factors

1) Growth of the housing bubble

If a housing bubble exists, the house prices will increase initially, promoted by speculative activities. However, later the prices will drop dramatically. The credit- fueled housing bubbles have the most significant impact on the real economy (Brunnermeier and Oehmke, 2012), for countless families consist of the major participants of the real estate. Moreover, houses bring more remarkable wealth effects than other types of financial assets (Benjamin, et al., 2004). Therefore, when the apparent housing bubbles burst and gradually expand to a certain extent, enterprises will be trapped in a shortage of funds. As a consequence, credit crisis, large-scale enterprises bankruptcy, severe deduction of demand and the soared unemployment rate will occur successively, gradually forming an intensifying vicious circle.

2) Easy Credit Conditions

Banks might use the subprime mortgage to issue bonds at high returns in the rising subprime mortgage market. Banks could repossess the property when borrowers were unable to repay the debt, and then sell the house at a price far higher than the original loan amount, if the housing price was constantly increasing. As a result, banks aggressively marketed subprime loans to customers with poor credit or few assets, even undocumented migrants, to obtain a very considerable profit (Simkovic, 2013). Moreover, lenders gradually loosen mortgage eligibility rules to generate more collateral and securities, even they knew the loans may probably not be repaid by those borrowers. For instance, in the United States in 2006, the "Fixed Income, Verified Assets" loan replaced proof of income with its "statement". The "No income, Proven Assets" loan eliminated the proof of employment requirement, the borrower only needed to show proof of funds in his bank account.

"No income, no assets" eliminated the need to prove or even state any owned assets. The only need for a mortgage was a credit score (Gullapalli, 2008).

3) The Impact of Central Banks

Central banks take charge of monetary policy and rate of inflation. However, when making monetary policies, they are regardless of avoiding asset price bubbles; for instance, the housing bubble. Furthermore, to minimize collateral damage to the economy, banks usually react and remedy after bubbles burst, instead of priorly preventing the bubble itself (Labaton, 2008).

2.2 Political factors

1) Decreased regulation of financial institutions

Preceded the crisis, the global economy had been stable and prosperously developed for a long period. Having been deceived by the stable but fake appearance, many banking executives, government officials, and economists were convinced that economic turmoil would never come (Duignan, 2020). The confident attitude, emphasis of deregulation and capability of self-policing in financial gave rise to easing the regulation to banking institutions ahead of the crisis (Labaton, 2008).

2) Policies to promote affordable housing

In the U.S. before the financial crisis 2007-2008, regulated by the Department of Housing and Urban Development (HUD), an affordable housing loan purchase mandate was established. In the later period of the Clinton Administration, HUD announced new regulations to offer $2.4 trillion in mortgages for affordable housing for 28.1 million households, which enhanced the necessary percentage of mortgage loans for families with low-and moderate-income (Fried, 2012).

3. The Main Factors of Different Crisis Over the Past Thirty Years

Although many economists have offered various theories of prevention of financial crises, the crises continue to appear from time to time. Over the past thirty years, overall three major financial crises have happened in the world: the Mexican peso crisis in 1994, the Asian financial crisis in 1997 and the Global financial crisis in 2007-2008. The main cause of each crisis will be explained in the ensuing paragraphs.

The Mexican financial crisis was caused by the Mexican government's sudden peso depreciation against the U.S. dollar in 1994. Under the presidential election pressure, Mexican central bank bought more dollar-denominated public debt to facilitating the money supply and synchronously repaid such debt by depleting the bank’s reserves. Mexican government unexpectedly devalued the peso and the fear of foreign investors resulted in a higher risk premium (Eun and Resnick, 2011).

The main causes of the Asian financial crisis were the breakdown of the currency exchange rate and hot money bubbles. Because of the shortage of foreign currency in the Thai government, the Thai baht was forced to float, contributing to the serious financial collapse and immediate capital flight (Yamazawa, 1998).

The main factor of the global financial crisis in 2007-2008 was the housing bubble in the United States. Although the American housing price enhanced by 124% from 1998 to 2006 (AMADEO, 2021), the average price of U.S. housing had decreased by over 20% in 2008 (Steverman and Bogoslaw, 2008). Facing the problem of decreasing prices, borrowers with adjustable-rate mortgages could not address higher payments related to growing interest rates with refinancing and forced to default.

4. Measures to Recover Financial Crises

Administered by the IMF, the United States appropriated $50 billion to resume the financial crisis in Mexico. Targeted to moderating developmental risk premium, the funds provided loan guarantees for Mexican public debt, which boosted the confidence of investors to the economy (Hufbauer and Schott, 2005).

As the collapses of the Asian financial crisis was large-sale and severe, the outside intervention was imminently required. As the support of IMF was founded on economic reform, namely "structural adjustment package" (SAP), IMF appealed to countries stricken by the crisis to decrease government expenditure and deficits, permit insolvent banks and financial organizations to bankrupt and substantially increase interest rates. Moreover, the monetary authorities employed traditional high-interest-rate wisdom to achieve the objectives of shrinking money supply, restrain currency speculation, steadied exchange rate, contained currency devaluation and eventually curbed inflation (Fischer, 1998).

Collaborating with central banks all over the world, the Federal Reserve, as the central bank of the US, took various measures to cope with the crisis in 2007-2008 (Appelbaum, 2014). The approaches were based on two main fundamental conceptions: supporting and operating the liquidity of the market and accomplishing the macroeconomic objectives by adopting monetary policy (Bernanke, 2008). Initially, the Federal Reserve Bank declined the rate of the Federal funds from 5.25% to 2% as well as the discount rate from 5.75% to 2.25%. Later in December 2008, the target for the federal funds rate was further decreased to 0-0.25% (25 basis points). Meanwhile, the Federal Reserve addressed open market operations with other central banks to assure the liquidity of banks in member countries. Member banks were provided with effective short-term loans, which were collateralized by government securities. The interest rates of short- term loans charged to member banks were additionally decreased by the Central banks (Bernanke, 2009).

5. Conclusion

Financial crises will occur now and then. This paper summarized that financial crises may be contributed to two perspectives of factors: economic factor (growing housing bubble, ease credit conditions and impacts of central banks) and political factor (decreased regulation of financial institutions and policies to promote affordable housing). In the past thirty years, each financial crisis had its particular causes. The Mexico Crisis in 1994 was in virtue of the sudden devaluation of the peso. The lack of shortage of foreign currency shed lights on the Asian financial crisis in 1997. Moreover, the housing bubble gave rise to the global financial crisis in 2007-2008. To solve these crises, local governments provided loans, supported the liquidity of open market and decreased expenditure and deficits. In the future, these examples and approaches could assist countries to prevent or resolve new-coming financial crises.

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