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2008 Global economic crisis: A commentary

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Abstract. The most common narrative about the causes of the 2008 crisis is centered on the housing market in the United States and the inability of many lenders to repay their loans. The so-called "deregulation" of the financial system that began in the 1980s in Great Britain and continued in the 1990s (Mankiw & Taylor, 2010) could be, however, considered as the starting point. By "deregulation" we mean a change in the institutional framework so that the rules and regulations concerning the operation of banks and other financial institutions are either abolished or become more flexible. In the era of the Thatcher government in the Great Britain, the banking system changed radically, as a series of restrictions on bank financing were abolished. Throughout the decade of 1990s, the restrictions became more flexible, allowing financial institutions to operate more freely, while the law Gramm-Leach-Blilay of 1999 (also known as "The Financial Services Modernization Act of 1999") abolished the differences between commercial and estate banks, insurance and stock exchange companies.

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1. Introduction

The filing for Chapter 11 bankruptcy protection by financial services firm Lehman Brothers on September 15, 2008, remains the largest bankruptcy filing in U.S. history, with Lehman holding over US$600,000,000,000 in assets. What followed was a financial "tsunami" that swept away banks, securities, businesses and millions of ordinary investors around the world.

Ten years after the outbreak of the financial crisis, the world economy has not yet fully recovered, as demonstrated by the Zero Interest-Rates Policy run by the most prominent central banks worldwide[i]. The collapse of Lehman Brothers is the symbolic culmination of the bust of the toxic bond bubble. These were securities that were created on allegedly highly subprime mortgage loans. These debts were initially released in the US without (at least the first years) to "pollute" the economy. When the "bubble" of real estate exploded and the debt of non-performing loans started to accumulate, the domino effect began: from the lending banks, to those converting them into bond-bonds, to those who bought and resold them (along with investment funds and hedge funds) to millions of unsuspecting investors. What is more, the situation deteriorated when Washington made it clear that it would not bail out Lehman Brothers with the largest exposure. As a result, the Wall Street began to "sink". Faced with the upcoming disaster, governments were forced to put their hand in the taxpayer's pocket.

2. The globalization of the economy

The globalization of the economy as we know it today began gradually after the Second World War, but it was fully dominated by the rise of neoliberalism in the early 1980s; a movement characterised by the full liberalization of capital

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movements. The volume of transactions has widened considerably and the movement of capital, especially speculative, from country to country has dramatically increased. This has increased the possibility of generalizing a crisis that would manifest itself in some area of the globalized financial space. The risk of this occurring at any given time is even greater if one considers the impossibility of effective controls and the absence of a supranational regulatory framework for capital and financial transactions. Another significant side effect of neo-liberal globalization was the significant growth of the so-called shadow banking. A shadow banking system refers to the financial intermediaries involved in facilitating the creation of credit across the global financial system. These intermediaries operation the brink of the formal financial system, outside any control or supervision by market supervisors. The term “shadow banking” is used to describe “unregulated” financial activities carried out by formal non-bank institutions outside the scope of regulators. These include underground over-the-counter trading, speculative investments by insurance companies and private investment funds, money laundering from criminal activities (e.g. drug trafficking, illicit arms trade, trafficking),tax evasion, frightening capital through tangled routes and offshore seals-companies established in tax havens (a popular activity among reputable financial institutions operating in the City of London).Overall, it is estimated that the shadow banking system is trading $ 71 trillion in funds; an amount close to global GDP.

3. A critical review

Concerning the economic crisis, we know the following: First of all, it is due to a bubble which was finally blown out in the summer of 2007 in the American bank system and was due to housing loans whose owners could not afford to pay. At this point it must be mentioned that the last economic crisis has as an officially date of starting among the economic circles the September 15th, 2008. It was the year of Lehman Brothers’ collapse, one of the largest buyers “toxic debt”; a term used to describe the money that has been borrowed but is unlikely to be repaid. Secondly, the most common financial recipe derives from Keynes’ theory, which suggests the solution of an increase in expenditure and/or a decrease in taxes during an economic recession. This theory however provokes skepticism since it causes a financial derailment in countries which, even in periods of an economic boom, did not implement a counter cyclical policy so as to reduce their national debt and commercial deficit towards third countries. This causes an economic distortion. Thirdly, because the change of the capitalist system, which focuses on banks and the stock markets, is not the solution to get away from the crisis, we have to be patient so that the market is fully clear of the investment products which stemmed from non-guaranteed housing loans. Furthermore, the abolition of the Glass-Steagall Act and the Paul Volcker’s proposal, known and as “Volcker Rule”, that struck into the bankers of Wall Street as a last-ever effort of the former president Obama in 2009, to set up a relevant committee in order to restrict the United States banks from making certain kinds of speculative investments that do not benefit their customers. Lastly, the serious lack of business ethics by several, particularly prominent executives had a significant impact on the outbreak ofthe worst economic shocks in the world after WW II. More wounded came Europe where they have found application the theories of small open economies and non- optimal economic regions, i.e. the Euro zone, with dramatic economic performances, mainly, of the southern countries[ii]. Finally, what is left today could be presented in two points; one negative and one positive. Firstly, it seems to be the feeling of uncertainty for the operation of the markets, the credit rating agencies, the banking system and the traditional political parties. Trust recovery requires time and powerful institutions plus business ethics and professional integrity need to characterize the new political and economic leaders around the world. On the other hand, a good sign came from the OECD’s Employment Outlook 2017. According to this report, the average employment rate of OECD countries is expected to reach

61.5% at the age group of 15-74 until the end of 2018 from 60.9%, which was the rate during the last three months of the year 2007. The policy (decision) makers should use this 10 years' experience from major economic players like the Public Democracy of China. Given the current market expansion, there will be no room for maneuver or the potential of imposing new austerity measures as no country yet seems to be able to burden its fiscal budget. The relentless question over these years if the economic crisis could have been avoided, indeed it is true that there were data showing negative signs of the subprime mortgage market since 2006, but everyone was trying to isolate the evidences as the volume and value of transactions in the secondary market was significant[iii]. Maybe if Ludwig Von Mises lived today to analyze us through "human action" and "praxeology" how complicated is the interpretation of economic problems. Yet, a very good approach on how we could prevent another financial crisis was stated by James Crotty and Gerald Epstein in their on-line article, entitled "Financial Regulation to Prevent and other Financial Meltdown[iv]".

4. Concluding remarks

"…Economists should be more humble. For too long we have tried to be like natural scientists. Like they we like to develop our theories with the method of deduction – start from a few axioms and describe the world in mathematical terms from there. This was a little presumptuous, to say the least. We need to realize that we are to a significant extent a social science. Social scientists, like historians, use the method of induction. They observe, and then develop tentative descriptions of the world from these observations. Because we did not pay enough attention to economic history and relied heavily on formal models of the economy we repeated a number of the mistakes that caused the Great Depression[v]."

Notes

[i]The use of a 0% nominal interest rate implies that the monetary policy has lost its effectiveness as a macroeconomic tool.

[ii]Ireland was the first Eurozone country to face economic recession in 2018. The Irish banking crisis was the reason why Irish financial institutions faced collapse due to insolvency. In response, the Irish government instigated a 67 billion euro bailout. Over the years, Ireland managed to recover being currently recognised as one of the friendliest countries to invest. Ireland's experiment was a success while Ireland is held up as an example for countries, especially Greece facing a sovereign debt crisis. Portugal instigated a 78 billion euro bailout in 2011, being unable to repay its governmental debt. The Portuguese Government was forced to adopt an austerity package with painful and unpopular economic reforms in order to enhance its competitiveness. The "bitter drug" had an effect. Portugal exited the bail-out programme in May 2014. The Cypriot crisis started when the financial sector collapsed due to the exposure of local banks to overleveraged local property companies, the Greek debt crisis and the downgrading of Cypriot government's bond credit rating. Cyprus received a 10 billion euro bailout, in return the government committed to implement austerity measures such as budget cuts, privatization and new taxes. Greece has not yet recovered from economic recession, as the country is still under an economic adjustment programme that seem to act as a barrier to economic development. National accounts and statistics can be compared with those of countries dissolved by a war.

[iii] Claims securitization took place for several years in the US while in the euro area it was adopted with delay. However, its growth was excessively rapid: the value of securitized mortgages of financial assets in euro rose from € 50 million in 1999 to € 400 million in 2007 (ECB Bulletin, "Securitization in the Euro area", 2/2008). This increase was certainly not equally distributed among Member States and continued to lag behind growth rates in the US and the UK. At the same time international credit risk transfer activity grew rapidly as the value of credit swap contracts (CDS) worldwide rose from zero in 2001 to $ 60 trillion at the end of 2007 (International Financial Crisis, Charilaos Mertzanis, 2008).

[iv] [Retrieved from].

[v]"I am an Austrian in economics", Thomas Mayer, Deutsche Bank Research, September 16,2011.

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