

Financial Crisis



François Dupuis

The mortgage loan crisis that has affected financial markets since late summer 2007 took a near-apocalyptic turn in early fall when the U.S. financial system—and, by extension, also those of the rest of the planet—seemed poised on the edge of disaster.

A CASCADE OF EVENTS

While serious, and requiring a strict response from the Federal Reserve, the effects of the crisis at first appeared to be controllable and concentrated in only a few sectors, particularly the construction and financing sectors. However, financial institutions in trouble were not in a position to raise the private capital necessary to rebalance their books, which led to growing fears about their ability to survive. The Bear Stearns investment bank was the first major victim in March, but quick action by U.S. authorities to prevent the entire system from becoming contaminated succeeded in temporarily calming fears on the markets.

Concerns about the survival of the major U.S. financial institutions became even more intense over the summer. Loss of confidence in the two American mortgage refinancing giants, Freddie Mac and Fannie Mae, forced the U.S. Treasury to place them under conservatorship at the beginning of September. Rather than reassuring investors, this action confirmed their worst fears. A few days later, Lehman Brothers, a major U.S. investment bank, declared bankruptcy, followed by the largest U.S. insurer, American International Group (AIG), which had to be rescued by the Federal Reserve.

The financial crisis reached its peak as confidence among the major market stakeholders crumbled. Fearing other bankruptcies, financial institutions refused to lend money to each other, and the money market nearly stopped functioning altogether.

SEVERAL SOLUTIONS SUGGESTED

Fortunately, the central banks took over by making hundreds of billions of dollars available to financial institutions in need of cash. But the wave of panic did not spare the stock exchanges, leading to a spectacular freefall on markets around the globe.

Realizing that interventions to provide liquidities and rescue certain companies would not succeed in re-establishing trust on financial markets, U.S. authorities decided to implement more heavyweight solutions. Treasury Secretary Henry Paulson proposed a plan to use up to \$700 billion to recapitalize the financial institutions and buy back the toxic securities they owned, thereby helping shore up their balance sheets. After a fair amount of back-and-forth, the plan was finally approved in early October. Even though the initial market reaction was somewhat subdued, the amount invested was high enough to make a difference and help improve the situation for U.S. banks.

Recent weeks have seen some of the most turbulent and difficult events in financial history. But how did the global financial system end up in this situation? The origin of the crisis is well known. Several mortgage lenders were carelessly granting mortgage loans to households that did not have the ability to purchase a home, and those loans were then used to guarantee a large quantity of financial products.

When the real estate bubble burst, it put an end to these poorly conceived practices and, towards the end of 2007, investors turned their backs on all securities even remotely related to mortgage loans. This caused a liquidity crunch, as well as credit rationing, and negatively affected the profitability of several financial institutions. Very high risk tolerance—a common feature in recent years—rapidly gave way to greater prudence, thereby in turn promoting the growth of so-called “safe” investments, such as government bonds, over more risky assets such as shares.

Update

Of course, the U.S. Treasury will have to wait awhile before it can start buying back the toxic securities that contaminated the financial institutions' books in the first place. Furthermore, the plan does not directly attack two underlying sources of the asset depreciation, i.e. the loss in value of homes and the increase in home mortgage seizures. Additional measures to correct these problems will have to be adopted sooner or later. The most urgent thing for the time being is to re-establish confidence in banks and ensure that the credit engine continues to run.

TIME FOR CONCERTED ACTION

Seeing that the financial crisis was taking on a global scale, with several European financial institutions also needing to be saved from bankruptcy, the major central banks decided to take action. In an unprecedented gesture, six central banks — including the Federal Reserve and the Bank of Canada — jointly dropped their key interest rates on October 8. This gesture demonstrated beyond a doubt the determination of monetary authorities to act forcefully to regain calm on the financial markets. Elsewhere around the world, governments spared no efforts to reassure investors and prevent bankruptcies among financial institutions.

Although the situation remains tense, we believe that conditions are increasingly gearing up to prevent this financial crisis from turning into a catastrophe. If we are to take a lesson from major crises in the past, it would be that the worst is generally avoided when strong, targeted

measures are rapidly put in place (see box). It would therefore not be appropriate to compare today's situation to the Great Depression of the 1930s or even to the Japanese crisis of the 1990s since, in both cases, authorities were very slow to react.

IS CANADA IMMUNE?

Although a major catastrophe seems to have been avoided, the financial crisis will have a serious negative impact on an already weakened global economy. A noticeable slowdown, if not a recession, seems inevitable in the United States. Additional tightening of credit terms and conditions will affect consumers who have already been hit by losses in their real estate and financial assets, as well as by a noticeable deterioration on the job market. As a result, it is wise to remain cautious.

While Canadian financial institutions are in a better position to deal with this financial crisis, Canada is still not completely sheltered from the storm. The situation is of course less worrisome here, since our domestic economy seems to be much more solid. However, the weakening of the trade balance will continue to slow growth of our gross domestic product and could even lead to a mild slowdown in economic activity. Even so, Canadian consumers, like our financial institutions and governments, are better positioned to deal with the repercussions of the current financial crisis. **D**

Most Recent Economic Crises

THE SAVINGS AND LOAN CRISIS (1986-1992):

A weak economy and real estate sector correction led to the bankruptcy of hundreds of financial institutions in the United States. The U.S. government had to set up a US\$115 billion plan to close the insolvent institutions and pay back depositors.

THE BANKING CRISIS IN SWEDEN (1990-1992):

A real estate crisis, strong depreciation of the Swedish krona and a rapid rise in interest rates pushed the country's financial system to the edge of bankruptcy. The Swedish government nationalized the banks and took the bad assets off their books. The gross cost of the bailout was around 4% of the Swedish GDP, but a large portion of this money was recovered when the assets were resold.

JAPANESE CRISIS (1990-2000):

The bursting of the stock market and real estate bubbles in Japan quickly led to repercussions on credit and on economic growth. In the absence of a swift and sustained intervention by the State, economic and financial difficulties were drawn out over an entire decade.

Only in 1998 did the government finally decide to implement serious measures. The measures adopted cost Japanese taxpayers approximately US\$500 billion.

ASIAN CRISIS (1997-1998):

At the end of 1996, rising inflation due to overinvestment and an overheated economy, as well as a slowdown in exports, pushed down Asian currencies. A wave of decreased currency value unfurled, following an increase in the risk premium on loans to emerging economies. Amid this financial riot, Russia imposed a 90-day moratorium on the payment of its debt in the summer of 1998. This situation brought the U.S. speculative hedge fund, Long-Term Capital Management (LTCM), to the edge of bankruptcy, jeopardizing both the U.S. and international financial systems. The Federal Reserve prevented a systemic world crisis by reducing its key interest rates and arranging a bailout for LTCM.