



# World Economy & Development *in brief*

European Briefings on Globalisation, North-South Relations and International Ecology

## The Most Recent Global Financial Crisis From market turmoil to credit crunch

Almost exactly ten years after the Asian crisis, the world is again confronted with a veritable financial crisis. This time the harbingers arise on the other side – the USA rather than East Asia. Whereas ten years ago a real estate bubble in Thailand burst, triggering the flight of international speculative capital, today it is the fallout of the real estate crisis in the USA which threatens the financial markets. By **Rainer Falk**

Every financial crisis has its peculiarities and its similarities with predecessors. The current crisis differs from the Asian crisis also because the search for its origins is not leading to some form of *crony capitalism* in emerging economies but to the centres of the world financial system with all its modern financial innovations. Some analysts say that this is the first crisis in the modern financial markets where new “products”, created by debt and asset securitisation, are traded globally. However, already the 1994/95 Mexican crisis was labelled “the first major crisis in our new world of globalised financial markets,” by former managing director of the IMF, Michel Camdessus.

### \* From speculation to excess

The current credit crunch shares certain qualities with prior financial crises, such as the pattern of rising asset prices, expanding lending activity, increasing speculation to excess and then declining prices, insolvency and, finally panic in which the “investors” try to save their gains as rapidly as possible. As always in such situations, the analysts ask whether this is due to a mere adjustment correcting the overheating of

certain markets under fundamentally healthy conditions or the beginning of a longer period of turbulence with potentially systemic consequences. However the popular chimes of healthy fundamentals seem rather queer in this context since developments in the financial markets have long been relatively disconnected — that is to say relatively unaffected — from the real economy.

That does not mean that the two spheres are irrelevant to each other. The more interesting question is rather if and when the crisis in the financial system will take its toll in the real world of production and employment. Thus, the noticeable increased volatility of certain markets visible since the end of July could be seen as the beginning of the end of the current world economic boom phase, in which above all developing countries have reached growth rates unattained since the early 1970s (see table).

### \* Impact on the real economy, but how much?

Until now it has only been apparent that the financial turbulence will have an im-

pact on the global economic situation. Thus, following the OECD and IMF, also the European Union has performed a cautious downward correction of its forecasts.

Yet it is still unclear how serious this fall-out actually will be. Of course it is becoming undeniable that any underestimation of the loan crisis impact is frivolous.

### World Economic Growth, 1991-2007 (in %)

	1991-2000	2003	2004	2005	2006	2007*)
<b>World</b>	<b>2.9</b>	<b>2.6</b>	<b>4.1</b>	<b>3.4</b>	<b>4.0</b>	<b>3.4</b>
<b>Developed countries</b>	<b>2.5</b>	<b>1.8</b>	<b>3.1</b>	<b>2.4</b>	<b>3.0</b>	<b>2.4</b>
Japan	1.1	1.4	2.7	1.9	2.2	2.3
USA	3.5	2.5	3.9	3.2	3.3	2.0
EU	2.2	1.2	2.3	1.7	3.0	2.8
<b>Eastern Europe and CIS</b>	<b>-4.2</b>	<b>7.1</b>	<b>7.7</b>	<b>6.4</b>	<b>7.5</b>	<b>7.0</b>
<b>Developing countries</b>	<b>5.0</b>	<b>5.1</b>	<b>7.1</b>	<b>6.5</b>	<b>6.9</b>	<b>6.4</b>
Africa	2.7	4.9	5.3	5.3	5.6	6.0
Latin America/Caribbean	3.2	2.1	6.2	4.8	5.7	4.7
Asia	6.5	6.5	7.8	7.4	7.6	7.2
China	12.4	10.0	10.1	10.2	10.7	10.5
India	6.0	7.1	8.5	9.2	9.2	8.5

\*) Forecast

Source: UNCTAD

As is well known, it all began with the crash in the US real estate sector in the last week of July — something that had been predicted for some time. (Actually no financial crisis has been prophesied more often than this one!) The financial sector was affected immediately because banks had packaged their claims from mortgage lending together with other debt instruments into new products — and sold them on in the form of so-called ABSs (Asset Backed Securities) or CDOs (Collateralized Debt Obligations), traded globally and therefore internationalising creditor risk.

That is the cause of the potentially high “contagion” of recent turbulence. Thus it should be no surprise that banks like the

German IKB or the Sächsische Landesbank, and most recently the British Northern Rock which invested heavily in ABSs, have to be aided by expensive bailout actions although they otherwise have nothing to do with US American homeowners.

It would also be a big mistake to think that the new securities and trading with them are limited to the real estate sector. Included in the alphabet of this new crisis are also the so-called LBOs (Leveraged Buy-Outs) — the wave of recent mergers and acquisitions (M&A), financed by loans to an extent well exceeding the value of the acquired companies. All these debt instruments were and are being securitised for international trading and, therefore, have

met with extreme market scepticism for the last six weeks. The general uncertainty results to a great extent from the fact that among the banks no one knows who holds how many of these doubtful assets in his portfolio and who — in the case of a massive run — will ultimately bear the risk.

#### \* **Worse than LTCM**

There are good reasons to fear that the current financial crisis will be worse than the burst of the New Technology bubble at the beginning of this decade or the collapse of the LTCM hedge fund in 1998 in the USA. There is a much higher risk, e.g. of a chain reaction of collapse and insolvency, whose mechanism was described by US economist Paul Krugman, recently writing in the *New York Times*: “Financial institution A (e.g. a hedge fund; R.F.) can’t sell its mortgage-backed securities, so it can’t raise enough cash to make the payment it owes to institution B, which then doesn’t have the cash to pay institution C – and those who do have cash sit on it, because they don’t trust anyone else to repay a loan, which makes things even worse.”

This is the situation that led the central banks — above all the European Central Bank (ECB) to pump more liquidity into the inter-bank market than in any previous crisis. However, it has long been clear that this is much more than a liquidity crisis that can be bridged with temporary injections of money. Today we not only have a liquidity crisis like in 1998, we also have an insolvency crisis and a debt crisis with a number of debtors who became excessively over-indebted in the boom phase, says US economist Nouriel Roubini in his blog. “We have a hundred thousand households that can no longer pay their mortgage. That is not only a problem of the market for sub-prime debt. In some cases these dubious practices (securitisation) are par for the course... They have a batch of insolvent mortgage banks... We have in-

solvent hedge funds and other funds... Some are already bankrupt or close to it...”

#### \* **Hard landing?**

Therefore Nourini is pretty certain that the US economy is in for a hard landing that could be followed by a serious recession with all conceivable consequences for the rest of the world economy. However it is also possible that the summer turmoil in the financial markets is just the writing on the wall for a downturn of the global economy that could take much longer than the abrupt crash scenario would suggest. And it is already clear that the crisis shifts attention to urgently needed regulatory intervention:

\* What is the economic value of loans extended to finance corporate takeovers where the firms are then cannibalised according to the dictates of modern predatory capitalism?

\* Is it possible to dispense with practices whose only purpose is to shift the lending risks of over-liquid banks to others and internationalise them?

\* And what about the rating agencies that issue the best ratings to dubious securities and funds — never having to accept responsibility for the consequences of their failures?

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