THE FINANCIAL CRISIS IN THE US AND ITS INTERNATIONAL IMPACT

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Draft outline for Global Labour University Conference, Mumbai 22-24 February 2009
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US financial crisis

Deregulation of US financial system, 1980-1999
- Expansion of the financial sector ('finance led capitalism')
- Dependence of economic growth on credit expansion and asset bubbles
- 1980s: leveraged buyouts, rationalisation, decline in real wages
- 1990s: 'new economy' boom, stock market bubble

Federal Reserve Response to stock market crash
- reduction of interest rates
- credit expansion
- mortgage boom
  - house-price bubble
  - credit financed consumption

Financial market innovation & developments
- Sub-prime mortgages
- Securitisation
- 'Shadow banking system'
  - investment banks
  - hedge funds
  - structured investment vehicles
- Leverage

The crisis
- House-price bubble bursts 2006; mortgage backed securities lose value
- 9 August 2007: Breakdown in trust between commercial banks; inter-bank market dries up
- December 2007: publication of bank losses intensifies crisis in inter-bank market; big banks turn to Asia and Middle East for additional capital
- March 2008: investment banks 'mark to market'; failure of Bear Stearns
- September – October: Collapse of Lehman Brothers (15 Sep) sets off
  - Chain of financial failures (AIG, Washington Mutual, Warchovia etc)
  - Acute tightening of money market; banks drastically reduce credit to industrial and commercial companies
  - Crisis of Money Market Funds as depositors withdraw funds
  - Share-prices collapse second week of October

State response
- Massive increase in Fed provision of reserves; new instruments (Term Auction Facility)

- Troubled Asset Relief Programme ($700bn)
- Capital injections into major banks
- Fed lending directly to firms and households ($800bn)

The international impact

Four main channels:

Banks (principally in Europe)

- Losses due to investments in US mortgage backed bonds & CDOs (HSBC, RBS, Paribas, UBS, German Landesbanken, Icelandic banking system, etc.)
- Drying up of European inter-bank market; contraction in availability of credit brakes growth

Access to international capital markets

- Countries with current account deficits unable to secure funding; forced to turn to IMF (Baltic states, Hungary, Turkey etc.)
- Middle income countries also vulnerable (Argentina, Venezuela)

Collapse in demand for manufactured goods in US (and Europe)

- China
- Other Asian exporters and suppliers of China

Impact of downturn in US, Europe and Asia on primary commodity prices

- Oil producers (Russia, Venezuela)
- Mineral & agricultural producers (Latin America, Africa)