



World Trade Organization

Global Financial Crisis

By Courtney Skinner and Alison Schumer

Introduction

On September 15, 2008, **Lehman Brothers**, one of the most renowned investment banking firms, filed for bankruptcy. Many view the fall of Lehman as the symbolic beginning of the current global downturn. Since then, the attention of the media has been focusing increasingly on the state of the world economy. With most major economies now in full recession, the global financial crisis has taken center stage and is of deep political importance.

Firms involved in the crisis have lost hundreds of billions of dollars since its start in 2007, as well as many billions of dollars in depressed market value in the US alone. Across the globe, the total losses have been staggering, registering well into the trillions of dollars. The financial crisis extends across different businesses, asset classes and national borders, touching virtually everyone in some capacity. As members of the WTO, we require a good understanding of what triggered the crisis in order to be able to stop it.

We will first explore the events that triggered the current crisis in depth. Understanding these nuanced issues is required before a systematic solution to these problems can be identified. The starting point was in a series of risky real estate loans made in the United States.

Explanation of the Problem

Subprime Lending

At the root of the current crisis lies mortgage lending. **Mortgage lending** historically was a local business – a family living in a small town in need of a home loan would request a mortgage from their local bank. The banker processing their loan request, often a resident of the same town could even know the family's income situation personally and certainly have a pretty good understanding of their ability to pay. Further, the local bank would hold on to the mortgages they issue until maturity. In other words, local banks would keep the mortgages until they were fully paid off. This meant that the banker's income would be directly impacted in the event that the family would be unable or unwilling to make its mortgage payments.

But during the late 1980's and through the 1990's, a number of financial innovations changed the mortgage business. Mortgages started increasingly being issued by mortgage brokers, who, unlike banks, did

Lehman Brothers—A bank founded in 1844. Over the years it grew and diversified to become of the most powerful financial institutions in the world until the economic crisis of 2008

mortgage lending—the process of taking out a loan to buy a property such as a house, apartment or commercial space

not hold on to the mortgages but passed them on to other institutions located outside of their town, such as investment banks. Since the mortgages were passed off to other institutions, the mortgage brokers did not participate in the downside risk of these deals, some engaged in unscrupulous, misleading and even illegal lending practices. Some of these practices included “teaser” rates, small initial interest rates that later exploded. Another detrimental practice was the use of “liar” loans, in which the borrower was given a mortgage, but no due diligence was done on his financial statements and whether he could actually make the mortgage payments.

Securitization

Upon receiving these mortgages, the investment banks would group large amounts of mortgages together and consolidate them off-balance-sheet in **Structured Investment Vehicles (SIVs)**. This stage in the process is more complicated and technical – but it is a critical step in how the crisis was formed and one which could potentially be addressed by regulatory oversight. By a financial engineering procedure called securitization, large pools of mortgages were consolidated into Mortgage Backed Securities (MBS), also known as Collateralized Mortgage Obligations, CMOs). These **securities** were then divided into tranches, according to seniority, and claims to the incomes of tranches were then separately sold off to investors. As mortgages are paid off by homeowners, income flows first to the best “senior” tranche and only after it has been fully paid off does income start accumulating to the payment of the second-best tranche and so on. This way, unless a large number of people fail to make their payments, the most senior tranche will pay off in full, with the lower tranches bearing all the risk.

Financial institutions were eager to securitize because the senior tranches that were created could be sold off to many more buyers than the mortgages themselves due to their superior credit rating, which means they could fetch a higher price for them. Additionally, some institutions such as pension funds are prevented from holding securities which are considered risky.

A central role in the widespread demand for these products was the fact that Moody’s, Standard & Poor’s, and other credit rating agencies rated the top tranches as AAA investment grade, which translates into a close-to-zero percent chance of payment default. They assigned this rating because they believed that while individual subprime mortgages are risky, collective groups of subprime loans are safe since events of default or non-payment are independent of each other and thus the total percentage of default is easily predictable from past experience.

A Decline in House Prices

Historically, the credit rating agencies have been trustworthy and

Structured Investment Vehicles (SIVs)—*the practice utilized by financial institutions before the economic crisis to yield a profit. The banks would buy securities at a low interest rate and sell them at a higher one.*

securities—*an investment instrument used by financial institutions to show equity or debt.*

a good indication of the riskiness of a specific financial issue, so what went wrong with the credit agencies' assessment of risk? Many of the subprime borrowers had been banking on a continued increase in the price of their homes, which would allow them to later refinance their mortgages, using the home as collateral and cashing in on the difference in home prices between the initial and the new mortgage. When home prices stopped increasing in 2006, it led to a large group of subprime borrowers simultaneously unable to meet their mortgage payments. This systemic risk was not appropriately factored into either the credit rating agencies' models or the expectations of the holders of the mortgage pools.

This, along with other systemic issues relating to a slowing economy in general and to the increasing poor judgment and occasionally downright fraud in mortgage brokerage practices, meant that large groups of subprime borrowers began to simultaneously default on their loans.

Perhaps the largest effect of the irresponsible subprime lending and borrowing spree, and one which is directly impacting the nation's economics, is increased foreclosure rates in certain parts of the US. This not only hurts the economy by creating large inventories of unsold homes, but foreclosure depreciates residential values in its proximity, which further exacerbates the crisis. Some homeowners are left with "negative equity," where the market value of their home is less than the amount outstanding on their mortgage, in which case they may be tempted to simply take a hit to their personal credit rating and just walk away from the home entirely.

The global financial sector has been badly hit by the crisis. Because the securitized subprime market had grown to such large proportions, many investment banks, hedge funds and other financial institutions had amassed subprime CMOs to a large portion of their holding portfolios. One of the initial signs of the depth of the crisis came in the summer of 2007 when two Bear Stearns hedge funds collapsed. Bear Stearns folded shortly after and was bought out by JPMorgan Chase in a bailout assisted by the **Federal Reserve**. Lehman Brothers crashed in September 2008, and Merrill Lynch was acquired by Bank of America that same month. Other banks, such as Citi, Morgan Stanley and Wachovia have written down billions of dollars in asset losses. In Europe, Fortis Bank (Holland) was nationalized, Hypo Real Estate (Germany) was bailed out by the German government and HBOS (UK) needed to be rescued by the British government.

Federal Reserve—*created in 1913, the Fed is the central banking system in the United States. Among many things the Fed regulates financial institutions and sets national interest rates.*

Recent Developments

Financial Support Programs

Since the economic crisis that was created from the U.S. sub-prime loans, different governments have taken different approaches in dealing with the recession. Some governments have allowed large banks to clean their “bad assets” from their balance. Essentially, these governments have given financial institutions a clean slate. Governments that have used this **TARP** method include the U.S., Canada, and Switzerland. Countries such as Brazil and Germany have helped facilitate the takeover of weaker banks by stronger and better-capitalized banks. In January 2009, the German government loaned Commerzbank ten billion euros to take over the fledgling Dresdner Bank. Another tactic the international community has used in the wake of the economic crisis is the nationalization of financial institutions.

The stance of the WTO has been cautious since the implementation of these new initiatives by governments. In a speech given on December 9, 2009, Pascal Lamy, the Director General of the WTO warned that the domestic strategy of each country may hurt international trade. In particular, Lamy spoke of protectionist policies and told the audience, “we have a collective responsibility to ensure that the poorest countries do not lose access to capital and product markets.”

Reviving the Doha Development Round

Organized in 2001, the Doha Development Round was a trade negotiation organized by the WTO. The aims and goals of the negotiations were to increase global trade through lowering of trade barriers. After seven years of progress the negotiations collapsed in 2008 due to a disagreement about agricultural trade and many countries walked away from the negotiating table. But with the current economic situation, there have been repeated calls to restart the negotiations. To many, the reopening of negotiations might be the antidote to domestic protectionist policies caused by the global recession. Director General Lamy said, “These realities leave us with no room for complacency as far as trade is concerned. And this is part of the much bigger systemic context for why rising to the challenge of completing the Doha Round is so vital. This is not only about reaping its underlying economic gains. Success also sends a powerful signal in terms of business and consumer confidence, and governments resolve to match words with action. Just as importantly, a successful Round will strengthen the hand of governments as they confront protectionist pressures.”

TARP (Troubled Asset Relief Program)— a program that allows the United States government to buy assest and other equity from banks and other financial institutions. This program is intended to restore confidence in the nation’s financial sector and to encourage banks to being lending again. So far, \$700 billion have been committed to this program, and the money has been used to infuse cash in troubled institutions in exchange for equity stakes

Focus of the Debate

Credit is another word for debt, and many companies in the so-called “real” economy need credit to survive. Let’s consider the example of a typical construction company and how it interacts with the credit markets. If a construction company is looking to raise cash to pay for a new building project, it should be able to ask its bank for a loan. Once it uses the loan to complete its project and then sells or rents the resulting building off to a buyer, it generates income. Part of the income goes back to the bank, in the form of the original amount of the loan plus interest, and the remaining income stays with the construction company as profits. This allows the company to pay its employees and engage in new projects again in the future. If the construction company had to pay a larger amount of interest for its loan, it would generate smaller profits or perhaps operate at a loss, in which case it would stop pursuing new projects. So for the construction company, less interest is good.

There are two factors that determine the level of interest that the bank charges the construction company. The factors are the bank’s own reserves of cash and how risky it considers the construction company’s projects to be.

Because of the massive losses related to the risky mortgage-backed assets discussed in the “Explanation of the Problem” section, banks have become much more cautious both about the adequacy of their own cash reserves as well as their willingness to lend to others. When very large institutions with an extensive global presence such as Bear Stearns and Lehman Brothers failed, every other financial institution simultaneously began to worry about two things. First, these institutions re-evaluated the risks in their own **mortgage-backed portfolios**. They found that they had largely underestimated the potential losses they faced in an environment of depressed real estate prices, so this caused them to become more conservative with their cash base. Second, it caused them to be very skeptical about each other – if you can’t completely figure out what’s in your own back yard it is so much more difficult to realize what’s in your neighbor’s.

When all lending institutions behave this way at the same time, it means that the typical construction company we mentioned earlier will find it much more difficult to get the essential loans it needs to perform its business activities. Since it may have fewer business opportunities, it could respond by firing a number of its staff. The staff, now unemployed, will be more likely to not make its mortgage payments. This will further depress real estate values which hurts the mortgage-backed portfolios of the banks even more. In turn, this would cause the banks to continue restricting their lending standards. This process is a fatal spiral for the economy, and does not seem likely to stop on its own without

**mortgage-backed-
portfolios**—
*investments that are
based on underlying
mortgages.*

intervention.

NGO Perspectives

Greenpeace

Greenpeace is a non-governmental organization that promotes protection of the environment. As part of this agenda, they are concerned with all trade and investment activity that might hamper conservation of resources and increase carbon emissions. They are therefore strong proponents of a proposal set forth by the New Economics Foundation, which is called “Green New Deal” and sets forth an environmental “bail out package.” The steps outlined in their plan would help protect the environment while stimulating the economy at the same time. Specifically, investment in renewable energies and sustainable development projects would yield high returns in the medium- and long run, all while initiating steps to conserve the environment in the short run.

Amnesty International

Amnesty International is a non-governmental organization that is primarily concerned with work on human rights and equal access to basic material and immaterial goods for all. As a humanitarian NGO, Amnesty does not take a position for or against free trade or any specific trading agreements, whether they affect financial market policy or not. However, they do maintain the stance that in order to ensure that the consequences from the global financial crisis and resulting trade agreements don’t undermine human rights, many of the measures proposed should be tested by agencies such as Amnesty so that they don’t undermine basic human rights, especially in developing nations. Especially if nations are involved that already have a gravely negative human rights record such as Venezuela or China, while their part in **fiscal** and trade negotiations might be crucial, their negatives have to be evaluated and highlighted.

fiscal—relating to finance or financial policy

Possible Solutions

Federal Guarantee of Debt

This instrument tries to put a stop to the fatal spiral of the crisis. By guaranteeing some portion of the mortgage-backed portfolio in banks, for example, you would restore the mutual trust that the financial sector desperately needs. This would encourage banks to open up lending again and would permit the flow of credit which is so essential to the functioning of the global economy.

The problem with this approach is that an agreement must be

reached on how much each government should contribute to this guarantee. Since the benefits of this measure could be felt across the globe and not just in the country whose government guarantees the debt, then perhaps some cost splitting should be agreed upon. The US, British, Chinese, Japanese and several other major governments have already taken the lead on this by **unilaterally** infusing their own banking sectors with capital.

unilaterally—a issue that has only one side or solution that is enacted.

Global Accounting Standards

Part of what allowed this crisis to balloon to such an extent was the “mark-to-market” accounting prevalent in the US and other major economies. This accounting measure implies that a firm records its assets at the price they would currently sell for in the market. This can have the effect of not updating the asset price for long stretches of time. For example, if no similar assets have been sold in the market for 3 years, then the accounting record will still have the asset registered today at 3-year-old price.

However, if another institution holding the same kinds of assets defaults and is forced to sell those assets off at very depressed prices, then you would be forced to reduce the accounting value of your own asset to these depressed values, even though you could probably get more for your asset in the market.

Accounting is currently country-specific, although there are several global guidelines and standards that seek to unify the different regulations. Perhaps the imposition of a global accounting standard, which renders these subtleties much more transparent, would have the effect of preventing or mitigating similar crises in the future.

Coordinated Infrastructure Spending

An innovative agreement might entail some form of global infrastructure investments. Considering the truly global scope of this crisis and the potential synergies and cost-savings which could result from coordinated infrastructural efforts, this could be a politically feasible and practically effective option. A specific example of this could be a consolidated effort to upgrade transportation or to make manufacturing units more energy-efficient.

Conclusion

Though progress has been made, the international community is still reeling from the global crisis. In rebuilding trade and financial institutions it is imperative that the WTO weigh domestic needs with international ones. While the US and most other large Western nations are still very much in a recession, industry indicators point to slow but steady recovery in 2010.

Many of these positive signals, however, could be caused by an overreaction in the market and could potentially simply constitute a small kink in an otherwise prolonged recession. Issues such as the growing national debt of the US, increased spending on non-core assets and future inflation have been a growing concern for fiscal and monetary policy experts. To the current date, there are many potential outcomes from this crisis and subsequent recession, and it is partly up to the governing powers of the WTO to help determine the future course of the world economy.

Guide to Further Research

As a member of the WTO, you will have to analyze how your particular nation has handled the economic crisis. In addition, you must look at how that strategy conflicts or agrees with the international policies of the WTO. Look at the World Trade organization website at www.wto.org and keep up with the evolving financial situation in financial newspapers.

Bibliography

Brownell, Charles: "Subprime Meltdown: From U.S. Liquidity Crisis to Global Recession"

Magdoff, Fred: "The Great Financial Crisis: Causes and Consequences"

"Tackling the Climate Crisis will resolve the Financial Crisis:"
<http://www.greenpeace.org/international/press/reports/tackling-the-climate-crisis-wi>

"The Global Trading System and the World Economy" speech given by Pascal Lamy, December 7, 2009, http://www.wto.org/english/news_e/sppl_e/sppl144_e.htm

"Report to the TPRB from the Director-General On the Financial and Economic Crisis and Trade-Related Developments", March 26, 2009
www.wto.org

<http://www.federalreserve.gov/>

<http://www.ustreas.gov/>

<http://www.wto.org>