

The 2008 Crisis

THE ESSENTIALS

The 2008 crisis marked the world economy by its magnitude and rapid spread. It took place in **three consecutive stages: an American mortgage crisis** (summer 2007), which became a **financial crisis** (2007-2008) and then a **global economic crisis**.

The crisis erupted during a **period of market euphoria**, characterised by strong economic growth, the deregulation of the financial system and the strengthening of international trade, as well as a low interest rate policy pursued by the United States central bank (the Fed) between 2001 and 2004; this was to counter the 2001 recession caused by the bursting of the dotcom bubble. In this context, **American banks (and weakly regulated American non-bank financial companies) granted many real estate loans**, often at variable rates, to low-income households. These loans were called **subprime loans** because they presented a high risk of non-repayment. In practice, these real estate loans were secured by the property purchased. This is called a mortgage loan. Households were encouraged to bet on a long-term resale of their real estate assets to repay the loans taken out. Once the loans were granted, banks (as well as non-bank financial companies) easily parted with these loans by transforming them into securities, which were sold to investors on the financial markets - also called **securitisation**.

However, the Fed, faced with the pressures linked to strong growth (rising prices and risk of speculative bubbles), decided to **increase its key interest rate**, which rose from 1% to 5% between 2004 and 2006. This increase was automatically reflected in the variable interest rates on subprime loans. Monthly loan payments rose sharply, to the point that households were unable to meet them. Several million American households found themselves in default and having to give up their real estate, which was often their homes.

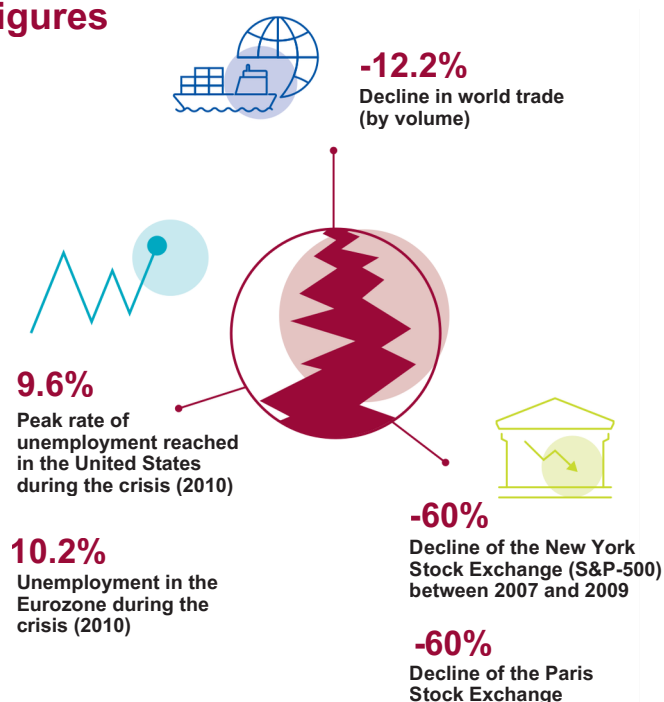
Given the scale with which homes, having been seized by banks and financial companies, were being sold, this contributed to the fall in real estate prices. Financial investors holding the securities associated with the subprime loans experienced significant losses. The real estate crisis was becoming a financial crisis.

Rating agencies downgraded the ratings they gave to financial players and bonds backed by subprime mortgages. Some institutions, notably Lehman Brothers, went bankrupt. Systemic risk materialised due to the interdependencies between financial actors, sectors and economies; therefore, a contagion effect (domino effect) threatened the stability of the global financial system.

This created **mistrust** between the banks, paralysing the interbank market. Due to uncertainty, they refused to lend money to each other and the slightest rumour led to significant flows of withdrawals by investors. Weakened, they also granted less credit to households and companies - this was the **credit crunch**. The financial crisis spread to the economy. Consumption and investment declined, causing a **fall in GDP**, an explosion in **unemployment** and a **fall in prices**, thus a risk of deflation. In addition, the state of public finances deteriorated, and public debt rose sharply.

Between 2007 and 2010, in the United States, unemployment rose from 4.6% to 9.6% of the working population and public debt from **86.4% to 125.8% of GDP**. In the UK, unemployment rose from 5.2% to 8.4% and public debt from **36.3% to 70.3%**.

Figures



Sources : OMC, Bloomberg, OCDE, G20

Understanding

Measures taken by public authorities

To respond to the exceptional nature of this crisis, a wide range of measures were deployed.

Central banks used conventional monetary policy tools, such as lowering key interest rates in an effort to stimulate growth and consumption. They also put in place unconventional monetary policy tools, such as the provision of **unlimited liquidity to banks**, **quantitative easing** (a large increase in the quantity of money in circulation, through the purchase of securities on the financial markets) and **forward guidance** (central banks communicating their likely future monetary policy: this includes for example the future path of their key rates and the pace and amount of their future asset purchases).

Governments, for their part, pursued a policy of **fiscal stimulus**. On the expenditure side, they rescued financial institutions by bailing them out and provided guarantees on loans, helped companies in difficulty and launched public investment programmes - as social benefits increased due to the rise in unemployment. Governments also saw their tax revenues fall (taxes on household income or corporate profits, for example) due to the decline in economic activity.

There were also **structural reforms** - for example, the strengthening of the regulation of the financial system and the reform of accounting standards. In many countries, as well as at a European Union and global level, groups were established to bring together the various authorities responsible for supervising banks, insurance, financial markets, payment systems and accounting standards, etc. The aim has been to reduce supervisory blind spots, to develop a common understanding of financial stability risks and to implement a macroprudential supervisory policy. In France, the High Council for Financial Stability is the authority responsible for overseeing the financial system as a whole. The Financial Policy Committee of the Bank of England is the equivalent body in the UK.

Finally, the crisis has given rise to a **strengthening of international cooperation in economic matters**. The role of the G20, created in 1999, has been affirmed, with the heads of state and government present at the start of each meeting. This development corresponds to a recognition of the increased role of emerging economies and of the interdependence reinforced by globalisation. The resources of the IMF and the World Bank have also been increased.



Timeline of events

- **July 2007** The rating agency Moody's downgrades the rating of securities linked to subprime loans granted by major American banks (Citigroup, Merrill Lynch, Bear Stearns).
- **26-27 July 2007** Record low on Wall Street.
- **9 August 2007** The French bank BNP Paribas decides to suspend the listing of three of its investment funds with a high exposure to subprime loans.
- **9-10 August 2007** The ECB, the Fed and the Bank of Japan inject \$330 billion into the global monetary system.
- **February 2008** Nationalisation of Northern Rock Bank, the fifth largest British property financing company, following a panic among depositors.
- **March 2008** With the help of public financing, the American bank JP Morgan takes over the investment bank Bear Stearns, which is highly exposed to securities associated with subprime loans and is on the verge of bankruptcy.
- **11 July 2008** Indymac, one of the largest U.S. mortgage lenders, goes bankrupt.
- **7 September 2008** Fannie Mae and Freddie Mac, two financing organisations in the real estate sector in the United States, are placed under public trusteeship.
- **15 September 2008** Lehman Brothers Bank goes bankrupt.
- **16 September 2008** The Fed lends \$85 billion to save the American insurer AIG from bankruptcy and then, in North America and Europe in particular, governments must help banks that are near-bankrupt.
- **6 October 2008** Black Monday for the world's stock markets.
- **10-12 October 2008** The member countries of the G7 and the Euro zone decide on a vast rescue plan for the global financial system in order to avoid the bankruptcy of systemically important financial institutions.
- **15 November 2008** First meeting of the G20, gathering Heads of State and Government.