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# FINANCIAL CRISIS

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In the recent years we have known a new term of economic history- financial crisis. The financialcrisis is considered by many economists to be the worst financial crisis since the Great Depression of the 1930s. It was triggered by a liquidity shortfall in the United States banking system, and has resulted in the collapse of large financial institutions, the bailout of banks by national governments, and downturns in stock markets around the world. In many areas, the housing market has also suffered, resulting in numerous evictions, foreclosures and prolonged vacancies. It contributed to the failure of key businesses, declines in consumer wealth estimated in the trillions of U.S. dollars, substantial financial commitments incurred by governments, and a significant decline in economic activity.

It began in the 1980s with historic bull market in shares and bonds, propelled by falling interest rates, new information technology and corporate restructuring. Thanks to cheap money, they could take on more debt—which makes investments more profitable and more risky. Thanks to the information technology, they could design myriad complex derivatives, some of them linked to mortgages. By combining debt and derivatives, the banks created a new machine that could originate and distribute prodigious quantities of risk to a baffling array of counterparties.

This system worked; indeed, at its simplest, it still does, spreading risk, promoting economic efficiency and providing cheap capital. By 2007 financial services were making 40% of America's corporate profits—while employing only 5% of its private-sector workers. Meanwhile, financial-sector debt, only a tenth of the size of non-financial-sector debt in 1980, is now half as big. The financial system, or a big part of it, began to lose touch with its purpose: to write, manage and trade claims on future cashflows for the rest of the economy. It increasingly became a game for fees and speculation, and a favourite move was to beat the regulator.

Such situation makes us to look at all financial system with great attention.

When examining the causes for the financial crisis most people start directly with the real estate market (the place where the crisis really began) focusing on the subprime mortgages and unscrupulous lenders and casting the blame on the unsustainable real estate bubble which began to collapse in 2006. Whereas this is true, it is not the whole story. The whole real estate bubble originated mainly as a response to the huge demand of financial assets. And since not many places can actually provide such assets, naturally in such situations speculative bubbles come on the stage and become part of the supply response of financial assets to the demand of such assets.

Many financial institutions that are saddled with risky mortgage backed securities can no longer afford to extend new credit. Unfortunately, making loans is how banks stay in business. If their current loans are not bringing in a positive cash flow and they cannot loan new money to individuals and businesses, that financial institution is not long for this world.

It is often observed that successful investment requires each investor in a financial market to guess what other investors will do.

Furthermore, in many cases investors have incentives to coordinate their choices. For example, someone who thinks other investors want to buy lots of Japanese yen may expect the yen to rise in value, and therefore he has an incentive to buy yen too. Likewise, a depositor who expects other depositors to withdraw their funds may expect the bank to fail, and therefore he has an incentive to withdraw too. Economists call an incentive to mimic the strategies of others strategic complementarity.

It has been argued that if people or firms have a sufficiently strong incentive to do the same thing they expect others to do, then self-fulfilling prophecies may occur. For example, if investors expect the value of the yen to rise, this may cause its value to rise; if depositors expect a bank to fail this may cause it to fail. Therefore, financial crises are sometimes viewed as a vicious circle in which investors shun some institution or asset because they expect others to do so.

So, financial markets play a very important role in our life. It is hard to have a well-performing modern economy without a good financial system. However, financial markets are not an end in themselves but means: they are supposed to perform certain vital functions which enable the real economy to be more productive, including mobilizing savings, allocating capital, and managing risks, transferring it from those less able to bear it to those more able. In America, and some other countries, financial markets have not performed these functions well: they encouraged spendthrift patterns, which led to near-zero savings; they misallocated capital; and instead of managing risk, they created it.

These problems have occurred repeatedly and spread everywhere. They are the evidence that the problems are systemic. Failures in financial markets have effects that spread out to the entire economy.

In recent years some of the “innovations” in the market, e.g. securitization and derivatives, have made these problems worse. Securitization has created new asymmetries of information. In the old days, those originating mortgages held on to them; banks knew the families to whom they had lent money. When there was a problem in repayment, they could understand its nature and work with the family on a payment plan.

Our financial markets have not only exploited these information asymmetries, but they have often also exploited the uninformed and the poorly educated people. This is part of the reason for the need for strong consumer and investor protection. It is not a surprise that the problems first occurred in the sub-prime market, among less educated and with individual lower income. There was extensive predatory lending, and financial markets resisted laws restricting these abusive practices.

There is an important element of well-function markets—competition. But information imperfections often limit the extent of competition. In many markets, small and medium size businesses have access to only one or two lenders. That is the part of the reason that bank failures are of such concern: as the bank fails, information about credit worthiness held within these institutions is destroyed, and it will take time to recreate. In the meanwhile, access to credit may be limited.

If world community wants to improve a financial sector, governments of countries should take some measures.

Derivatives and similar financial products should neither be purchased nor produced by highly regulated financial entities, unless they have been approved for specific uses by a financial products safety commission. Regulators should encourage the move to standardized products.

So, we should make our financial system work better. That will require more than just the reforms of financial market regulations and regulatory structures.

It would be the best way if we could get an agreement on a global regulatory structure.

Good financial institutions are essential to a well-performing economy. Our financial institutions have failed us, with the predictable and predicted consequences. Part of the reason is inadequate regulations and regulatory structures. We can, we must do better, much better than we did in the past.