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Proactively Facing Financial Crisis: A Case Study

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Abstract: It has been 21 years since the 21st century has started. Over this period of 21 years the world has faced 2 severely affecting financial crisis. This case study discusses 2 such examples where a major damage was experienced by most of the countries specifically talking about the financial and the economic condition. In addition, the reasons caused this crisis are discussed in detail. However, to all of these causes there is a remedy stated which states how a country be ready to face such a situation where a country falls completely, financially and economically.
Keywords: Financial crisis 2007-08, COVID-19, Declaration of pandemic, Lockdowns, Russia-Saudi Arabia oil price war, Easy credit conditions, Increase debt burden or overleverage, case study.

I. BACKGROUND INFORMATION

A financial crisis is any of a broad variety of situations in which some financial assets suddenly lose a large part of their nominal value[1]. In simpler words it can be said that whenever something loses its monetary value exponentially compared to its minimal base value a financial crisis occurs. Well, most common reasons for a financial crisis to occur are, banking panics, crashing of stock market, bursting of financial bubble and currency crisis. However, other reason include, strategic complementarities in financial markets, leverage, asset-liability mismatch, uncertainty and herd behavior, regulatory failures and contagion[1]. In the past there have been many cases where countries or the while world has faced a financial crunch, but in this case study we will specifically be talking about the once seen and experienced in the 21st century round the globe.

A. Financial Crisis 2007-08

The financial crisis that occurred in 2007-08 was also given the name of, "global financial crisis" (GFC), and was accounted to be a very severe economic crisis which had hit across the globe. Before the crisis encountered during the COVID-19 pandemic, GFC was considered to be the most serious financial crisis according to some economists. Financial institutions around the world were severely damaged[2] which concluded with the bankruptcy of Lehman Brothers and subsequent international banking crisis[3]. The seeds for this financial crisis to occur were buried in the soil by the government approximately 2 decades before the crisis had hit. The U.S. Congress had passed laws which encouraged lending money for affordable housing[4]. The, "Glass-Steagall legislation" which stated that investment banks, a commercial bank, and an insurance company should not be intervening in one another's work, was rewritten and was declared that all the three type of banks could cross-pollinate their operations[5]. This undoubtedly became a helping hand for the development of the roots to the financial crisis faced in 2007-08.

B. Financial Crisis COVID-19

This was a global economic recession caused because of the outbreak of a deadly virus, which forced government bodies to declare a pandemic worldwide. The recession began in February 2020, and this financial crisis was accounted to be the worst ever hit on the globe. Following an extended period of worldwide financial slowdown that saw stagnation of stock markets and customer action, the COVID-19 lockdowns and other precautions taken in mid-2020 tossed the worldwide economy into emergency[6]–[8]. According to the strategies and algorithms followed by the world bank, it states that many countries will not be able to fully recover at least by the year 2025[9]–[12]. The first evidence of this recession was the crashing of the stock market in 2020, where major indices dropped 20 to 30% in February. However, recovery was seen later in the month of April and by the end of the year 2020 there were new records set by many organizations[13]–[15].

II. CAUSES OF THIS FINANCIAL CRUNCH TO OCCUR IN THE YEAR 2007-08

A. *Subprime Lending*

The standards set by the investment banks and the commercial banks were relaxed resulting in a significant increase in the number of people receiving credits under subprime lending. Subprime lending is a term used to where the loan is provided to people who have problems in maintaining the repayment schedule. However, over this period of time subprime lending never became less risky, but the financial institutions were ready to take more risk[16].

B. *Growth of the Housing Bubble*

The growth percentage in the cost of a typical American house was a huge 124% which was observed between the years 1998 and 2006[17]. During the 1980s and 1990s, the national median home price ranged from 2.9 to 3.1 times median household income. By contrast, this ratio increased to 4.0 in 2004, and 4.6 in 2006[18]. This housing bubble resulted in many homeowners refinancing their homes at lower interest rates, or financing consumer spending by taking out second mortgages secured by the price appreciation.

C. *Easy Credit Conditions*

Lower interest rates encouraged borrowing. From 2000 to 2003, the Federal Reserve lowered the federal funds rate target from 6.5% to 1.0%[19], [20]. This was done to soften the effects of the collapse of the dot-com bubble and the September 11 attacks, as well as to combat a perceived risk of deflation[21]. As early as 2002, it was apparent that credit was fueling housing instead of business investment as some economists went so far as to advocate that the Fed "needs to create a housing bubble to replace the Nasdaq bubble"[22]. Moreover, empirical studies using data from advanced countries show that excessive credit growth contributed greatly to the severity of the crisis[23].

D. *Increase Debt Burden or Overleverage*

Prior to the crisis, financial institutions became highly leveraged, increasing their appetite for risky investments and reducing their resilience in case of losses. Much of this leverage was achieved using complex financial instruments such as off-balance sheet securitization and derivatives, which made it difficult for creditors and regulators to monitor and try to reduce financial institution risk levels[24]

III. CAUSES OF THIS FINANCIAL CRUNCH TO OCCUR DUE TO COVID-19 PANDEMIC 2020

A. *Declaration of Pandemic*

Starting from the month of December in 2019 when the outbreak of corona virus was first detected in Wuhan to the month of march in 2020 when world health organization declared a pandemic[25], [26]. The pandemic has led to severe global economic disruption[27], the postponement or cancellation of sporting, religious, political and cultural events[28], and widespread shortages of supplies exacerbated by panic buying[29], [30]. Schools, universities and colleges have closed either on a nationwide or local basis in 63 countries, affecting approximately 47 percent of the world's student population.

B. *Lockdowns*

While stay-at-home orders clearly affect many types of business, especially those that provide in-person services (including retail stores, restaurants and hotels, entertainment venues and museums, medical offices, and beauty salons and spas), government orders are not the sole pressure on those businesses. In the United States, people began to change their economic behavior 10–20 days before their local governments declared stay-at-home orders[31], and by May, changes in individuals' rates of movement (according to smartphone data) did not always correlate with local laws[32]–[34]. According to a 2021 study, only 7% of the decline in economic activity was due to government-imposed restrictions on activity; the vast majority of the decline was due to individuals voluntarily disengaging from commerce[35].

C. *Russia-Saudi Arabia oil Price War*

The reduction in the demand for travel and the lack of factory activity due to the COVID-19 pandemic significantly impacted demand for oil, causing its price to fall [36]. The Russian-Saudi Arabia oil price war further worsened the recession, due to it crashing the price of oil. In mid-February, the International Energy Agency forecasted that oil demand growth in 2020 would be the smallest since 2011 [37].

A slump in Chinese demand resulted in a meeting of the Organization of the Petroleum Exporting Countries (OPEC) to discuss a potential cut in production to balance the loss in demand [38]. The cartel initially made a tentative agreement to cut oil production by 1.5 million barrels per day following a meeting in Vienna on 5 March 2020, which would bring the production levels to the lowest it has been since the Iraq War [39].

IV. HOW SHOULD A COUNTRY BE READY TO FACE ONE IN THE FUTURE?

Liquidity means how quickly you can get your hands on your cash. In simpler terms, liquidity is to get your money whenever you need it[40]. Common liquid assets include cash, precious metals, stocks, bonds, certificate of deposit etc. let us strait move onto the direct benefits an individual or even on a broader prospective, "a country" holds if the amount of liquid assets is high. Firstly it provides great flexibility especially in conditions where there is a total disruption in the sources of income, to support this pointer let me highlight a point here! When the pandemic was declared US government having enough liquid assets was in a state where it provides funds to all the tax payers and the homeless people, where the amount was enough for an individual to survive for a month. Having this luxury of adequate liquid assets people could get funds which not only helped them survive with basic ammonites but also to pay off their bills. In additions on the other part of the globe in the European countries government had provided funds to big companies. This was done in order to avoid large scale bankruptcies. [41].

Holding Safe Haven Currencies. A safe haven is a type of investment that is expected to retain or increase in value during the times of market turbulences. Investors seek out to safe haven currencies in order to limit their exposure or losses in the event of market downturns [42]. Swiss Franc, Japanese Yen & US Dollar (for short term) are some of the best, "safe haven" currencies. During the financial crisis of 2007-08 which disrupted so many economies worldwide, Swiss Franc showed an appreciation which increased the cost of exports dramatically, which is a good example for showing the inverse relationship among the safe haven currencies and economic recession[43].

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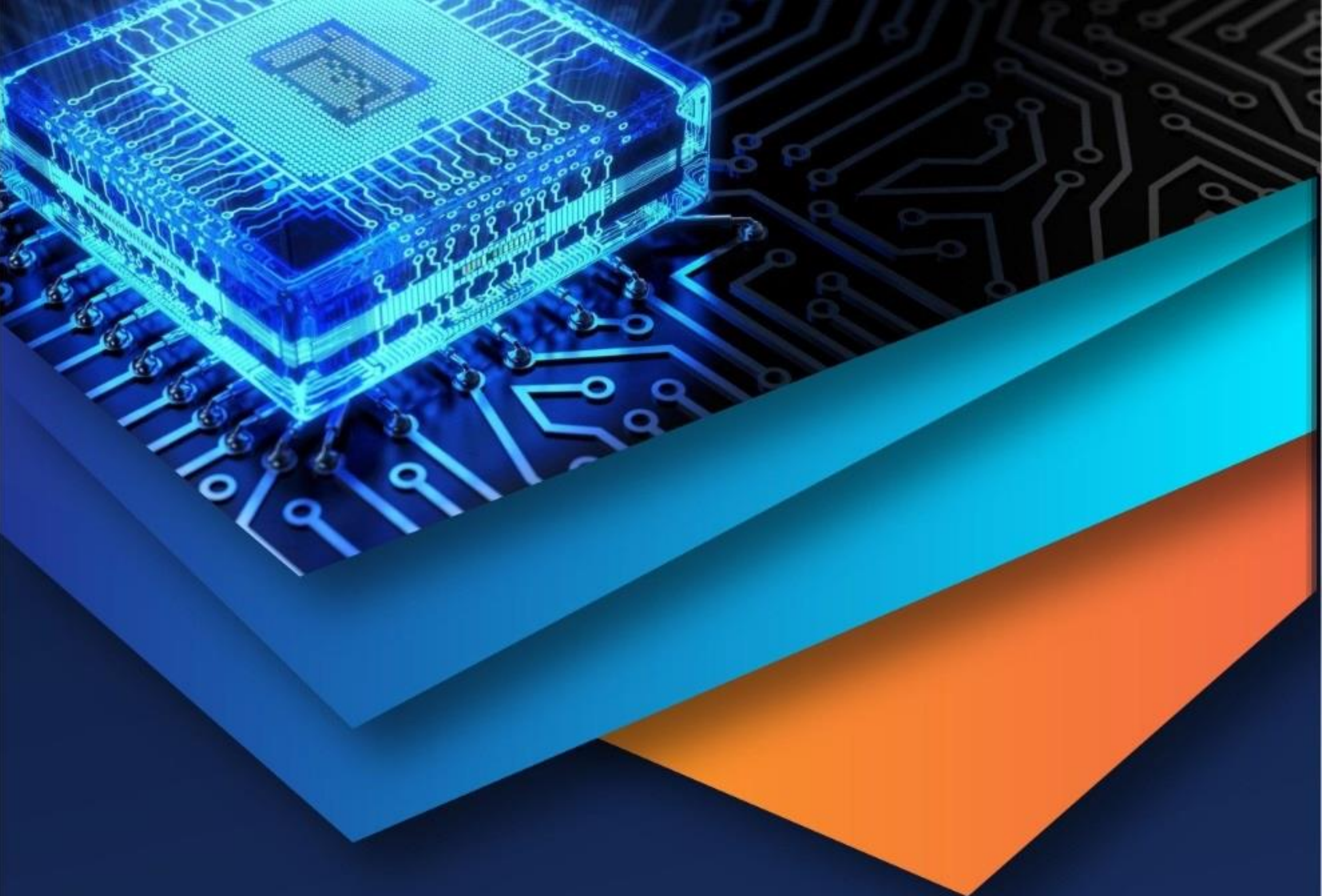

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