Journal of Business Research 67 (2014) 2667–2670

Contents lists available at ScienceDirect

Journal of Business Research

Timeline of a financial crisis: Introduction to the special issue

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ARTICLE INFO

Article history:
Received 1 April 2012
Received in revised form 1 September 2012
Accepted 1 November 2012
Available online 25 April 2013

Keywords:
Economic recession
Marketing innovation
Metrics
Education

ABSTRACT

The economic crisis fueled by risky mortgages and the exotic financial instruments developed from bundling these mortgages caused the largest one-day losses on the US stock market in history (BBC News, 2009a). The resulting financial collapse quickly spread throughout the world, causing economic recessions in much of the EU, Turkey, and many other countries. Since 2008, economists, government agencies, and academics pondered the causes of the financial crisis with an eye toward avoiding such catastrophic collapse in the future. This special issue contributes to the discussion by bringing together academics from marketing, finance, and economics to put the financial crisis into theoretical perspective and propose theoretically viable alternatives to avoid similar economic downturns in the future.

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1. Introduction

1.1. Anatomy of the financial crisis

The financial crisis led to the worst economic collapse since the Great Depression. Most people blame the financial crisis on a complex series of events beginning in 2007 when the housing bubble burst. The housing collapse generated widespread liquidity problems that fueled a precipitous decline in the stock market (NPR, 2009). The Levin and Coburn (2011) report by the US Senate concluded, "the financial crisis was not a natural disaster, but the result of high risk, complex financial products; undisclosed conflicts of interest; and the failure of regulators, the credit rating agencies, and the market itself to rein in the excesses of Wall Street". Weakness in the US economy quickly spread to much of the world, causing financial collapse, unemployment, and business failure in its wake.

By early 2012, the US Economy recovered somewhat, but was still fragile. Problems in Greece, Italy, and other European nations threatened to plunge the world economies into recession again. Papers accepted in this special issue investigate the financial crisis more deeply, propose solutions to ameliorate the effects of the crisis, and suggest alternatives to improve the financial situation.

2. Factors contributing to the financial crisis

2.1. Housing

The housing bubble peaked in 2005–2006, fueled by questionable loans to individuals lacking credit worthiness — so called subprime loans (Lahart, 2007). In the decade before this, housing prices increased 124% (Economist, 2008). By September, 2008, housing prices declined 20% (Economist, 2008). Government-sponsored lenders, Fannie Mae and Freddie Mac, bore much of the blame in the popular press, while the report by the Federal Financial Crisis Commission contains evidence that private banks wrote twice as many subprime loans as governmental entities (Simkovic, 2011).

Predatory lending further exacerbated other housing-related factors contributing to the financial crisis. Banks falsified loan documents, enticed borrowers into interest-only loans, and misrepresented loan terms resulting in negative amortization (BBC News, 2009a). Combining declining housing prices with predatory lending practices resulted in a massive foreclosure rate, as consumers could neither pay their mortgage nor sell their homes.

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0148-2963/$ – see front matter © 2013 Elsevier Inc. All rights reserved.
http://dx.doi.org/10.1016/j.jbusres.2013.03.014

2.2. Other consumer debts

Consumers similarly over-leveraged themselves. The average debt ratio for consumers rose to 127% by 2007, up from 77% in 1990 (Economist, 2008). Over-leverage contributed to housing foreclosures, as consumers could no longer afford debt-service on their mortgage and other installment credit, especially when funded through home equity loans.

2.3. Commodity markets

Concomitant with increasing housing prices, prices for commodities, most notably oil, rose precipitously in the years leading up to the financial collapse. The price of oil rose nearly 300% between 2007 and 2008 (Conway, 2008). Prices for other commodities also increased, although none as dramatic as the price for oil. Among commodities with dramatic price increases were nickel and copper (BBC News, 2009b). Collapse of these commodities preceded the general economic collapse by nearly a year (BBC News, 2009a).

2.4. Financial innovations

Credit default swaps, derivatives, and off-balance sheet lending grew in the period immediately preceding the financial collapse. Banks over-leveraged assets with increasingly risky investment instruments (Simkovic, 2009). Some blame the vulnerability of financial institutions on systematically decreasing regulations begun under President Jimmy Carter, which allows such complex and risky investments (Labaton, 2008).

Mortgage-backed securities and collateralized debt obligations, which bundled sub-prime mortgages, represented other innovations sold to investors. Instead of spreading the risk among a large number of investors, exotic investments spread the contagion caused as mortgages when unpaid. (The Financial Crisis Inquiry Commission, 2011). Financial models, built on incorrect assessments of risk, encouraged firms such as AIG and JPMorgan to buy large amounts of these exotic financial instruments.

Marxist economists, including Samir Amin, argue such financial crises result from fundamental flaws in the capitalistic system. While this argument is unpalatable to most western economies, parts of the argument appear valid. The assertion that over-investment in financial markets creates financial bubbles when investors seek greater yield than possible through traditional financial transactions appears viable, for instance (Amin, 2008). Managerial decisions based on increasing managers own returns rather than those of stakeholders, places overemphasis on share price rather than value, and massive failures of gatekeepers, such as auditors, politicians, and Wall Street analysts lead firms toward financial collapse (Bogle, 2005).

2.5. Declining wealth

Individual wealth declined as the stock market plummeted to less than half its 2007 high, home equity loans dried up, retirement accounts shrank, and home prices fell, causing consumers to stop spending. A downward spiral erupted when the effects of the financial crisis hit businesses and they laid-off workers. At its height in 2009, the unemployment rate hit 10.1% (Herbst, 2009). These workers could no longer pay their mortgage or buy products, which further decreased business profits, causing more layoffs.

The downward spiral continued as foreclosures weakened banks, which led to increased regulations and tightened credit. These actions further squeezed private firms already reeling from declining sales and stifled growth of new businesses. Consumers became disillusioned and feared layoffs, causing a crisis of consumer confidence that kept consumer spending low. The housing and construction industries, commonly leading indicators of a financial rebirth, remained stagnant through a combination of poor access to credit, reduced financial assets, over-supply of foreclosed homes, and reluctance of current homeowners to trade or remodel their home. Declines and failures in these industries created pressure on supplier industries. These pressures travelled quickly through the economy; affecting other businesses and service providers who relied on the construction and construction-related industries for income.

Governments in the US and Eurozone implemented aggressive spending programs to counteract declining consumer spending. These spending programs reduced unemployment; however, the price tag for these bailouts and stimulus programs forced deficit spending that exacerbated credit markets and did little to convince consumers to spend more. The effect of government spending programs on employment was insufficient to dramatically improve the economic condition, leaving millions chronically unemployed or under-employed.

3. History of the financial crisis (BBC News, 2009a; Credit Writedowns, 2010)

To better understand the financial crisis, a timeline of major events draws attention to important conditions and factors leading to the financial collapse.

2004–2006	Interest rates rise, causing a number of homeowners with adjustable rate mortgages to default on their loans.
Feb. 2007	HSBC announces loan loss provisions signaling problems with sub-prime loans.
April, 2007	New Century Financial, specializing in subprime loans, files Chapter 11 bankruptcy.
July, 2007	Bear Stearns warns investors of the impending collapse of its hedge funds invested in subprime mortgages. Bernanke warns subprime failures might cost $100 billion.
August, 2007	American Home files for bankruptcy. Lehman Brothers and HSBC begin closing offices. US and European banks inject money and drop reserve rates to forestall building crisis. A rival bank rescues Sachsen Landesbank from failure.
Oct. 2007	Merrill Lynch announces $8+ billion write-down on bad debt.
Nov. 2007	Morgan Stanley loses nearly $4 billion.
Dec. 2007	Standard and Poor's downgrades investment ratings for businesses with sub-prime exposure.
Jan. 2007	Stock markets worldwide suffer massive 1-day losses. A run on a Scottish bank forces delays for depositors.
Feb. 2007	G7 announces losses of over $400 billion from sub-prime mortgages.
Q1, 2008	Losses increase at financial institutions already in trouble and spread to Norway, France, and other countries. Losses spread to other institutions, such as UBS, which looses over $18 billion.
March, 2008	Bear Stearns collapses. Acquired by JPMorgan.
Q2, 2008	Hemorrhage of money continues and spreads to Deutsche Bank, Washington Mutual, Wachovia, National City Bank, and RBS.
April, 2008	Housing prices drop for the first time in over a decade.
May, 2008	Fannie Mae needs $6 billion infusion. Town of Vallejo declares bankruptcy.
June, 2008	Countrywide Mortgage sued by several states over lending practices.
July, 2008	IndyMac seized by federal regulators.
Aug., 2008	BNP Paribus tells investors they cannot withdraw from two funds. Nationwide announces decline in UK home prices of 10%.
Sept. 2008	Fannie Mae and Freddie Mac fall to government take-over. Lehman Brothers collapses. Merrill Lynch acquired by Bank of America. Several banks in Euro-zone nationalized to remain solvent. Russia closes its stock market after major downturn in other world markets. HBOS acquired and Morgan Stanley merges with Wachovia to stay solvent. Morgan Stanley and Goldman Sachs lose status as investment banks. Ireland declares it's in recession. Washington Mutual seized by federal regulators.

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