

CHAPTER II

THE UNITED STATES' FINANCIAL CRISIS

A. The United States' financial crisis in 2008

The global financial crisis has been described as the most difficult economic conditions in the lifetime by many executives. Business leaders have had to changing from expectations of sharply rising inflation early in 2008 to an economic contraction in major economies with the threat of deflation over the rates. Global trade is set to decline for the first time since 1982.¹² It's probably that no sizeable industry, economy or region has gone unaffected. Historically, global economic crisis did not only happen in 2008, it also occurred in 1923, 1930, 1940, 1970, 1980, 1990, 1998 – 2001 and 2008.¹³ Economic recession in 2008 is come from United States and its well-known as "*United States' financial crisis*". Those crises had attacked all countries in the world such as Europe, Latin America, Asia, and the United State. The crisis had attacked in the states which implemented economic capitalist system. It has already inflicted considerable attacked social and political stability as well as the commercial prospects and eroding what was a remarkably widespread consensus in favour of market capitalism. In 2008 the crisis shows up again. The trigger of the crisis this time is financial crisis which happened in United States of America.

This crisis happened because of credit stagnancy in property sector which involved two big Investment Banking companies namely Lehman Brothers and

¹² www.DahlanIskan.wordpress.com (Accesed on: August, 08 2009/12:21 PM)

¹³ Ibid.,

Merrill Lynch which caused the decreased of stock value in the Wall Street Stock Exchange. This financial crisis referred to the loss of confidence by investors in the value of security mortgages in the United States resulted in liquidity crisis that prompted a substantial injection of capital into financial markets by some big Bank in United State. Actually, America has two types of bank. First, commercial bank such as bank of America and Wells Fargo. Those banks have the working as same as like Indonesia's bank working system. They accept some investment from the consumers or clients then, the bank creates the fund in the form of credits. Those credits were like cooperation credits, housing credits, car credits and student loan. Secondly, investment banking, those bank are such as Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley. There were any three majority working of those banks, such as investment banking, trading and research. Those banks became the first foundation of the advance of funding market in the United States. All of firms need a fund like investment and job fund. The United State, there was any two ways to got fund. First, they borrow money to the commercial bank. Secondly, they get the money from securitization method (investment banking). In the investment banking process, there also two ways to get fund. First, they sold products firm to the public. And second, they borrowed the money from public by bond.

The advance of financial engineering process in the United State made the financial managers more creative to seek money. Then they had an idea to put the housing credits in the securitization process. Analogically, previously the payment

become securitized by investment banking division with sales and trading process. Annually, the process of securitization has been done by Lehman Brothers and Merrill Lynch with “security mortgage”. Those letters have sold to the world including, Europe and Asia.

Why that security letters became the ones alternative investments for the world financial institutions? It like what happen in Assurance Corporation, it corporate submitted fund from society in the form of prime assurance. And then that corporate invest their money by bought some firms, bond, commodities and real estate. Unfortunately, most of that money has bought in the form of security mortgage which were based on the housing credit in United State. So, the crisis happened when the value of security mortgage have lost or valueless. When the owner of the house in the United State paid their housing credit then the mechanism of credits would be handling. But, why the credit crunch still happened. The answer is because most the rate of value in United State was too low. So, it made the people in the United State want to build house easily. They built house from credit with the aims their house could be sold again. There were many American people used housing credits with paid attention from the housing credit to the bank and in order they could build house. When the price of house increased, they hope could sold their house to paid loans and took a profit from that mechanism. Event, they had not housing credits, they could got facilitate of subprime mortgage (the rates higher then normal). So, with this situation many American built the house, so stock house in United State became oversupply. The

That case make the bank became collapsed, because the assets of bank were decreased and the assets value were lost then they have lost their resources input. The value of security mortgage became zero because there were no funds from the credits. So, it implicated the crisis in the United State occurred.

B. The Domino impacts of the United States' financial crisis

The United State countires is the centre of the world economy. America as the one of major export oriented with the highest purchasing power level in the world. Logically, the decreased of purchasing power of American people, so the demand level toward products will also diminishing. Because of that, the countries which have the huge export volume in United States would automatically have affected to the decreased of their export values. It caused the emerge of slow economic growth in many countries. Hence, the crisis from United State give the domino effect for the world. Include the states which have strong in economic sector. That has affected to the weakness of market fund in each state, so there were many countries inject for capital market.

The global financial crises bring a huge damaged and started to show its effects in the middle of 2007 and into 2008. Many economic observers commented that the turmoil in world financial markets has lead to a severe and still unfolding economic downturn in most of the Western economies, and as a result, the world has come on the brink of the 'worst economic downturn' since the Second World War.¹⁴ In November 2008 the IMF (International Monetary

¹⁴ Gokay, Bulent. *"The 2008 World Economic Crisis: Global Shifts and Faultlines"*. International Relations

Fund) released an update to its October 2008 World Economic Outlook in which it highlighted the fast deteriorating economic environment and downgraded global real Gross Domestic Product growth forecasts for 2008-2009. Many developed countries are now expected to face a deeper recession than had been anticipated. IMF downgraded its predictions for economic growth in 2008 and 2009, with world GDP growth expected to be 2.2% in 2009 instead of 3.0% predicted in October, and 3.7% in 2008 instead of 3.9% predicted in October.¹⁵ The US economy is predicted to shrink by -0.7% in 2009 while the United Kingdom is set to be the worst affected of Western European countries with a contraction of -1.3% in 2008.¹⁶ Thus, it is expected that emerging economies will account for 100 percent of global growth next year. The IMF reported indicates that the economic performance of the emerging economies will be critical in order to attain the hoped-for revival of global growth after 2010. However, the effects of financial crisis also made the world stock markets have fallen, large financial institutions have collapsed or been bought out, and governments in even the wealthiest nations have had to come up with rescue packages to bail out their financial systems. On one hand many people are concerned that those responsible for the financial problems are the ones being bailed out, while on the other hand, a global financial meltdown will affect the livelihoods of almost everyone in an increasingly inter-connected world. The problem could have been avoided, if ideologues supporting the current economics models weren't so vocal, influential

¹⁵<http://www.imf.org/external/pubs/ft/weo/2008/update/03/index.htm> 'World Economic Outlook Update.

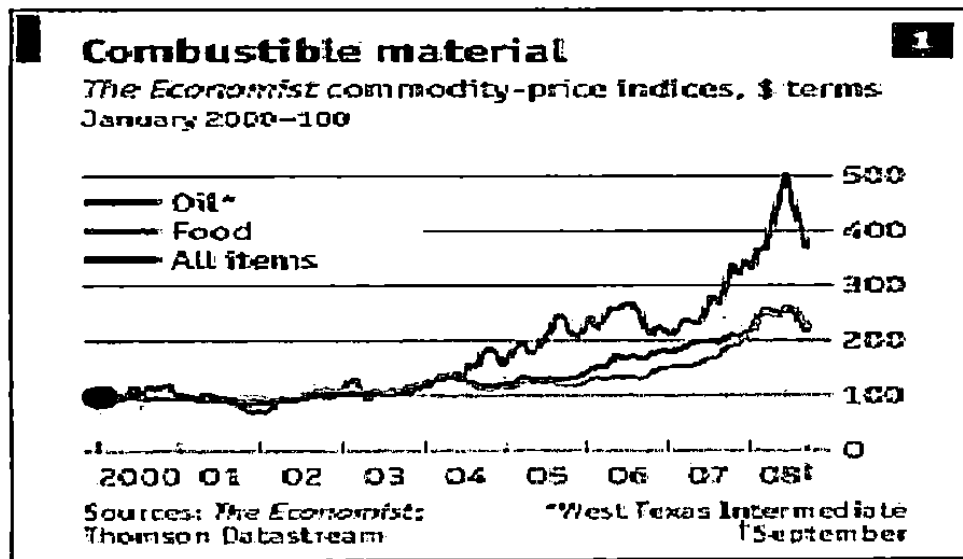
and inconsiderate of others' viewpoints and concerns. Every party has involved the economic condition in United State. It means that when the economic condition of one power state have disturbed or destroyed, it could be trust brought the large consequences for the economic worlds. Mass-media has been declared about the crisis which happened in United State and it started in 2008. It crisis influenced for the management of financial system in all countries such as America, Europe, Asia Pacific, South Asia, and Middle East. In the beginning of Subprime Mortgage since 1925, United State of America have constitution about mortgage it self. That constitution was involved to the property sector like the owner of housing credit. All of American have the certain requirement to get credit easily. That credits as like housing credit. When the loan of credit to be the property right in the United State rising, so the growth of property market were also made speculators in the housing sector increased.

Actually, the growth integration of the world economy has been changing at the same time with the developing of free market capitalism by America as the cheerleaders. The advance of the freedom on trade circulation, assets, deregulation on domestic industry and financial system have caused the developed of global integration in the big amount. The domino effects have continued with the collapse of *Washington Mutual*. Washington Mutual has closed after many investors attracted their fund since the collapsed of Lehman Brothers. Its fund reached about US\$ 16,7 million.¹⁷ The collapsed of Washington Mutual has affected to the firms market foundation in Europe, Asia and also United States.

Financial crisis has creates sentiment trust to the financial institution. The other effects were the collapsed of commodities price index for the latest prior to the oil price. In early month until July, the price of oil mostly increased till twice. The price index of foods also increased about 55 % showing it as follows;¹⁸

Graphic. 1

Commodities Index in 2000-2008



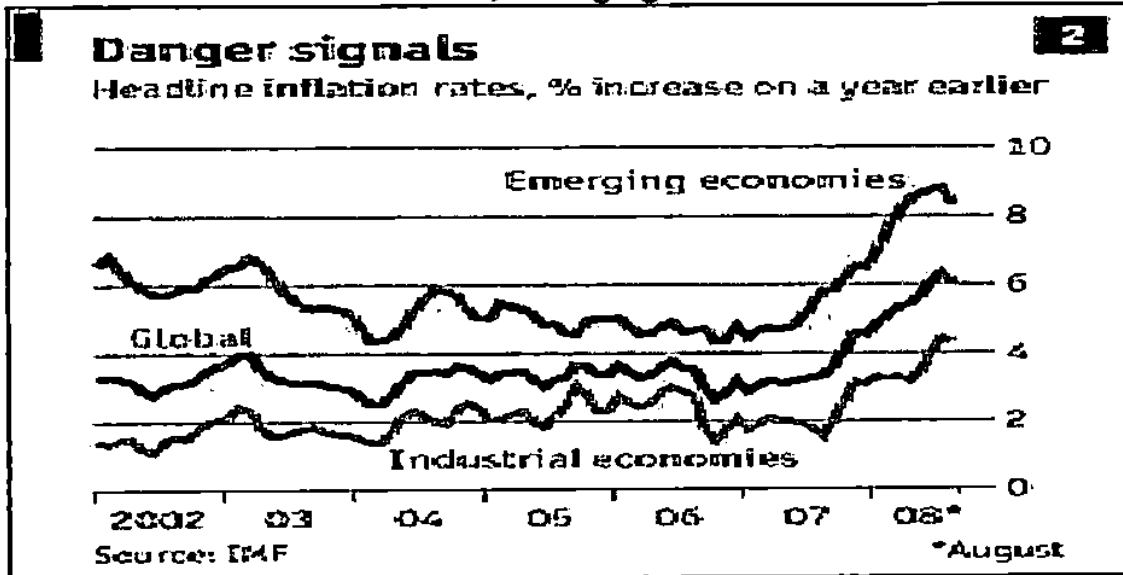
Resource: Didik Kurniawan Hadi, "*Dampak Krisis Keuangan Global Bagi Indonesia*". Research report: Indonesian Banking (2008). Chief of economic Assistant PT Recapital Advisor, January 7th, 2009.

The increasing of commodities price would stimulate to the increasing of consumer price index in the world. Mostly, the headline inflation rates in July have over 4 percent in developed counties. And emerging economies has reached about 9 percent that far from the target of central bank.¹⁹

¹⁸ <http://www.bps.go.id/indonesia> ¹⁹ <http://www.bps.go.id/indonesia> (Accessed on 10/09/2009)

Graphic. 2

Inflation in Industrial Countries, Emerging Economies and Global on 2002-2008



That picture has shown the increasing of inflation by the same time with weakness of financial. It caused central bank have confused and face with danger trade-off. Definitely, they could keep monetary policies to avoid the rate inflation. They also could cut interest rate to save financial circulation. But should be happened because the decreased of commodities price and consumer price index sharply. If the price of oil stable may it would decreased about percent of consumer price index in United States. Then decision maker would worry about the rising of deflation. But, the problem is come from the high deficit scales in United States that was very depending on the foreign capital.

The collapse of the US sub-prime mortgage market and the reversal of housing boom in other industrialized economies have had a ripple effect around the world. Furthermore, other weaknesses in the global financial system

and the growing complexity of financial instruments have become so complex

2008, a series of bank and insurance company failures triggered a financial crisis that effectively halted global credit markets and required unprecedented government intervention. Fannie Mae (FNM) and Freddie Mac (FRE) were both taken over by the government. Lehman Brothers declared bankruptcy on September 14th after failing to find a buyer. Bank of America agreed to purchase Merrill Lynch (MER), and American International Group (AIG) was saved by an \$85 billion capital injection by the federal government.²¹ Shortly after, on September 25th, J P Morgan Chase (JPM) agreed to purchase the assets of Washington Mutual (WM) in what was the biggest bank failure in history.²² In fact, by September 17, 2008, more public corporations had filed for bankruptcy in the U.S. than in all of 2007.²³ These failures caused a crisis of confidence that made banks reluctant to lend money amongst themselves, or for that matter, to anyone. Lehman Brothers is the one of huge Bank in the United State, the collapse of Lehman Brother has also affected for the decrease of world stock exchange. It also affected to the ruin the stock exchange rate in the part of the world such as in Asia, Japan, Hongkong, China, Asutralia, Singapore, India, Taiwan and South Korea, and Europe, which falls about 7 to 10 % level.²⁴

The housing bubbles in the United State became noticeable almost immediately after the subprime crisis began in the US in August of 2008.²⁵ The large mortgage lender, Northern Rock, ran into funding difficulties in September

²¹<http://www.globalissues.org/print/article/768>, page 4 of 32 (Accessed on: 12/12/2008 12:36 PM)

²² Ibid.,

²³ Ibid.,

²⁴ Adiningsih, Sri. Mensiasati Keuangan dan Ekonomi Global. Research Report, Seminars on Global Crisis 2008, Gajah Mada University, (December, 18 2008/08.00-11.30.)

²⁵ Ibid.,

2007 and requested help from the Bank of England. Northern Rock had aggressively expanded its share of the United State's mortgage lending from 3.6% in 1999 to 9.7% in 2007 (Bank of England 2008) and had financed this expansion through securitization of its assets.²⁶ In a situation of deteriorating credit and money market conditions, Northern Rock faced difficulties in meeting its debt obligations amid doubts about the value of its assets. Quickly the spread between its borrowing and loan rates plunged and Northern Rock approached the monetary authority for help. Liquidity support provided by the Bank of England could not save Northern Rock from bankruptcy, and in early 2008 the United Kingdom Government had to place Northern Rock under public ownership. The US subprime crisis spread across the Atlantic was related to the perception that many investors there had exposure to the toxic assets derived from the US mortgage mess. This perception has proven to be accurate. For example, the Dexia Group (a French-Belgian lender incorporated in Luxembourg) had exposure to the subprime residential mortgage backed securities through its affiliate Financial Security Assurance, Inc., which had to write down losses of over US\$750 million in the first half of 2008. Thereafter the governments of Belgium, France, and Luxembourg had to jointly inject US\$9 billion into Dexia after its shares plunged by 30%.²⁷ Fears of losses from exposure to the subprime-backed derivatives through the investments by big European banks in failed US investment banks such as Bear Stearns and Lehman Brothers are palpable.

On the other side, it also considers how the markets of oil-exporting countries have been affected by the United States downturn and global financial turmoil and how this might change the outlook for many countries. What happens to the United States dollar will have a strong effect on the markets in these countries. Foreign investors have been selling shares and withdrawing from planned investments as confidence has crumbled surprisingly fast. The sharp drop in oil prices that is accompanying the global slowdown threaten to countries strong external balance and is revealing some cracks in its financial system.

The issue of United State's financial crisis in 2008 rooted in the US subprime crisis also has affected the financial stability of Asian countries. The subprime crisis has already spread across the Atlantic to many European countries. The general perception is that so far Asian financial institutions and financial systems as a whole have been largely unscathed by the global credit crisis. The underlying reason behind Asia's relative immunity is that the region's financial institutions, unlike their counterparts in Europe, have only limited exposure to subprime and related products, the so-called toxic assets. Nevertheless, the global financial turmoil is far from over, as the dramatic events in the fall of 2008 made abundantly clear. It remains to be seen whether Asian financial systems will remain healthy as the global crisis unfolds. Although the impact of the global financial instability on Asia's financial stability has been limited up to 2009, we should remember that the region suffered a devastating financial meltdown of its own a decade ago. Underdeveloped financial systems

devastating Asian crisis of 1997–1998.²⁸ Post crisis reform and restructuring efforts have improved the soundness and efficiency of the region's financial institutions but they still lag far behind their counterparts in industrialized countries. In a fundamental sense the relative backwardness of Asian financial systems has turned out to be a blessing in disguise. Their backwardness prevented Asian lenders from moving into complex and sophisticated financial products that lie at the heart of the current financial turmoil.

However, notwithstanding its accidental benefits for Asia at the present, financial underdevelopment is more generally a cause of financial instability and fragility. In particular, the health of Asia's commercial banks, which continue to play a dominant role in Asian financial systems despite the rapid development of capital markets, has improved substantially. This improvement is reflected in the incidence of nonperforming loans, capital adequacy ratios, rates of return on assets, and other key indicators. The key changes in Asian banking sectors include consolidation and rationalization, greater transparency and disclosure, increase in foreign ownership, and decline in state ownership. Furthermore, in most countries the prudential supervision and regulatory structures have been strengthened, and have become more forward-looking and risk based. As a result of all those changes, Asian banks have become better at managing risks, which contributed to their avoidance of subprime products. There are various channels through which the global financial chaos could be transmitted to Asia. The most direct and core transmission channels are through banks and short term credit markets. Banks

²⁸[http://www.International Monetary Fund, Direction of Trade Statistics 2008](http://www.International%20Monetary%20Fund,%20Direction%20of%20Trade%20Statistics%202008) refers to January–May. (Accessed on November 18, 2008/10:19 PM)

may have either direct exposure to toxic assets or indirect exposure through investments in foreign financial institutions with large exposure to toxic assets, in Lehman Brothers. Furthermore, the seizing up of global cross-border interbank markets will raise the cost of funding for banks relying on those markets. Major events such as the collapse of Lehman Brothers can harm global financial stability and thus have negative spillover effects on Asian stocks. The loss of investor confidence in Asian equity markets closely mirrors that of the US, and the two markets have moved in tandem since August 2007. Indonesia, Pakistan, Philippines, and Vietnam and other countries have also suffered to a lesser degree. Not surprisingly, the widening of the credit spread has curtailed the issue of new bonds from the region. Such tightening of financing conditions has not yet spilled over into local currency bond markets, except for Indonesia. According to Adams (2008),²⁹ the limited spillover reflects limited switching of funding between the dollar and local currency bond markets. In addition, the dollar bond remains at best a minor source of funding for firms in the region. There has been no noticeable reduction in the growth of private domestic credit in most countries in the region. The exceptions are India and Korea, where the year-on-year growth rate of banking credit to the private sector turned negative in the second quarter of 2008.³⁰ The Indian banking sector has begun to suffer from high credit costs as can be seen in the spikes in the interbank rate. In India, credit spreads are widening for corporate sector borrowing as well as household loans. For example, the spread for rated companies increased to 257 basis points in August from 100—

130 bp in early January 2008.³¹ Similarly, banking sector spreads on household loans have increased significantly. The tight lending condition of the banks would most severely affect middle to low income consumers (for consumer durables and automobile purchases), small and medium size enterprises, and property companies. In Korea, the sharp decline in domestic credit may be partly a result of the banks' increasing difficulty in borrowing from abroad. As discussed earlier, the outstanding loans of Korean banks exceed their domestic deposit base and they have relied on foreign borrowing to fill the gap. The drying up of foreign credit lines may thus have encouraged banks to cut back their credit to firms and households. The reduction of domestic credit may also be partly due to weakening consumption expenditures. Entails that, the real impacts of United State financial crisis in 2008 could see from the sectors which have affected, that contain of the impacts on trade and financial instability.

Finally, that the immediate catalyst of the United States subprime crisis that precipitated the global financial crisis was the decline in United States housing prices. Furthermore, although there are substantial differences across countries, the European Union as a whole is also suffering from a housing market slump, which will further complicate the recovery of the financial system and the real economy. The overall trend of Asian housing market price indices suggests that housing prices have not experienced the sharp declines seen in the US or EU. The declines that have occurred have been moderate and are nowhere near as pronounced as those seen in the region's equity markets. Intuitively, property

prices are determined by local conditions and there is much less scope for contagious effects from industrialized country markets, in particular the US. Looking ahead, however, the ongoing slowdown in the region's real economy will have adverse effects on its housing markets. However, real economic impacts through the financial channel should not be ignored. A number of indicators such as bank liquidity indicate that prolonged turmoil in the global financial market could eventually deteriorate real Asian economies through this channel. Consumption and investment could weaken through shrinking liquidity, rising costs of capital, and a decline in household wealth. In particular, the availability of loan able funds is a key factor influencing investment behavior independently of the cost of capital. Available bank credit to the private sector may be quantitatively the most important variable in determining the amount of actual investment in developing countries. This is because equity markets are not well developed and excess demand for credit typically exists. Thus, firms are highly dependent on bank credit for both their working capital needs and longer term

CHAPTER III

THE FACTORS AND IMPACTS OF THE UNITED STATES' FINANCIAL CRISIS IN 2008

A. Indonesia's economic condition

The collapse of financial markets is now being matched up by the decline of the real economy. The world appears headed for a period of inevitable economic stagnation/recession (a period of negative economic growth). It crisis was effect to the Indonesian national economic condition. The impacts of the crisis was disturb several area such as the relation trade between Indonesia and United State, the trade among Indonesia, Asia and European, the increased of loan, appreciation of rupiah currency and the monetary policy of exchange rate from central bank in the United State. Although the crisis only caused by the housing credit and affected to the credit crunch but United States' financial crisis brought the big impacts toward several corporations and international financial market. Generally, financial crisis made Indonesian macro economic condition in the weaknesses situation. The bad condition could see from the still dominant investor domestic in using foreign product investment and foreign transaction. On the other side, the policy of inflation control through the increase of Indonesian banking rate has positive influence and it possibly did not destroyed national economic condition. However, the Indonesian financial market became the one of market alternative that did not secure from the damaged, but it also can potentially affected by the United States'