Why the Crisis Happened

After the Wall Street Crash in 1929, the US Congress passed a new law called the Glass-Steagall Act so that history could not repeat itself. Fifty years later, Congress repealed or scrapped this law and consequently, history did repeat itself.

There are two principal causes to the current global crisis. The first is overproduction and the second is the deregulation of the financial markets, which is, in fact, a direct result of the first cause, overproduction.

Since the Second World War, humans, in particular production engineers and economists, have become brilliant at manufacturing high quality goods that people want to buy on a large scale. Engineers and economists have used both robotics and the outsourcing of production to parts of the world where the cost of labour is low. Fantastic products are made very cheaply, sent all over the world in containers and sold at bargain prices. All this has happened in a highly competitive environment.

This intense activity caused two important things to happen. The governments of manufacturing countries like China became very rich and formed the now famous sovereign wealth funds with the objective of investing all this lovely capital. Investing in industry was unattractive as profit margins were very slim. Investors wanted bigger profits. Strict banking regulations also made life very difficult for investors. Secondly, all this liquidity caused a continued increase in the price of real estate, just like in the 1920s.

When the US Congress repealed the Glass-Steagall Act, investment banks and retail banks were able to work together again for the first time in 50 years. Next, not to be left behind, the European financial sector lobbied the European Union, mostly in secret, to liberate the European market. This deregulation put an end to transparency in the banking world. Hedge funds, whose investments are carried out under the cover of darkness, mushroomed.

Simplicity was replaced by complexity and uncertain risk. Credit default swaps gave investors large payouts for loans gone bad and futures, which are more like bets than investments, offered juicy returns.

Hungry investors then began speculating on the price of food commodities, especially rice and wheat and this was when we saw the first signs of trouble. The price of wheat flour increased more than 25% due to speculation and the Sphagetti Riots broke out in Italy. Petrol prices increased further and further still. Farmers complained that they could not afford to refuel their tractors and truck drivers went on strike in Spain.

The world now had a stagnant real economy and a very busy financial sector. In the USA, the financial sector accounted for 40% of the nation’s total profits but less than 5% of the GNP.

On January 24 2008, the French investment bank Société Générale announced that it had lost an astounding 7.2 billion dollars of its clients’ money from futures which went the wrong way.

Next, in the space of just 6 weeks, the price of a barrel of crude oil fell from $150 a barrel in July to less than fifty by October.

Then we found out about sub-prime loans. Investment banks and retail banks, working together, had lent vast quantities of their clients’ money to high risk borrowers. This means borrowers who are likely to default on their home loans or mortgages because of low incomes and job instability. And guess what? They defaulted, handed back the keys to the house and the banks are now left with properties that nobody wants and whose value continues to fall. What a disaster!

After that, it was the turn of the hedge funds. Many banks, such as Grupo Santander, passed on investors’ money to hedge funds who then passed the money on to... Bernard Madoff.

Governments have now spent billions of taxpayers’ money because of the mistakes made by greedy and irresponsible bankers and The White House has said that the US deficit will rise to $1.6 trillion in 2009. The Bank of England puts the cost of the global crisis at $2.8 trillion but nobody really knows and nobody really knows what all this means for the future.

677 words

Grammar: irregular verbs with a consonant change