

The Evolution of Financial Crisis in 2008

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Philosophically, it is important to examine how the current financial crisis evolved and what the root circumstances are before addressing issues of how to address the problem and what effect various actions on the part of the government might or might not generate. It is indeed ironic that some of the same mechanisms that fuel an economy's growth at one point in time turn out to be the very same mechanisms that contribute to its decline at a different point in time, which is essentially where we are today. Over the last decade we saw a few things happen, which when considered in isolation, would be considered innocuous and even hugely beneficial to the economy. Much like an individual medications, that are so beneficial in fighting diseases, in combination may interact to quietly create the perfect storm—the financial catastrophe that we are experiencing is the result of an interaction of circumstances in the financial sector.

At the end of the previous century and beginning of the current, certain policy shifts occurred at the federal level that are important contributors to today's events. The Gramm-Bliley Leach Act and the Commodities and Modernization Act were passed in 1999 and 2001, respectively. What these legislations accomplished was essentially the rescinding of the same banking regulations that were put in place by the Glass Steagall Act. Glass Steagall established the Federal Deposit Insurance Corporation and also placed barrier between commercial banks and investment banks. This legislation came in the wake of the 1929 stock market crash and it was instituted in 1933. The Gramm-Bliley Leach Act of 1999 essentially removed the barrier and allowed commercial banks to operate as investment banks. The justification for this was to place U.S. banks in a stronger position to compete internationally with banks from other countries that were not so constrained.

Two important banking activities can be traced to the joint operations in the commercial and investment arenas. The banks that evolved under deregulation in the early part of the century were able to securitize their commercial lending activities and use the securities as leverage to raise funds. With the new administration in 2000, the Federal National Mortgage Association (also known as Fannie May) and the Federal Home Loan Mortgage Corporation (also known as Freddie Mac) were given the mission to increase home ownership in the U.S. At some point, this mandate to increase home ownership was interpreted to mean that the goal should be reached regardless of whether home buyers could afford to sustain home ownership. Such unwise lending required a mechanism to insure against default and the so-called Credit Default Swap (CDS) was born. Initially, the CDS were meant to apply to municipal bonds, corporate debt, mortgage securities and were sold by banks, hedge funds, and other institutions. However, in the last decade these CDS contracts expanded into structured finance contracts containing pools of mortgage and, more importantly, these pools contained subprime borrowers that were increasingly getting loans through the Freddie Mac and Fannie May programs. In isolation, CDS is an insurance contract taken out by banks to protect their loans against default, much like an individual or family would secure a homeowner's insurance

policy to protect their investment in a home. However, by referring to them as swaps (and not insurance) they became classified as investment products rather than insurance products. This allowed the CDS industry to avoid the regulation and scrutiny that applies to the insurance industry and rendered CDS totally outside the purview of any regulatory mechanisms.

The pieces for an explosion of classic proportions were all in place by early 2005. All that remained was a match to set off the explosives. That match came in the form of a downturn of the housing market and the resulting waves of default among subprime borrowers that caused the holders (which comprised all major banks) of trillions of dollars in CDS contracts to exercise their option to trigger the insurance policies. Unfortunately, there was no one on the other side of the relationship to honor them because, thanks to deregulation, the CDS had been sold, resold again many times over by banks to investors across the globe who had no interest in the original contracts and had simply bet on them much like a gambler might bet on the outcome of a sports competition. To these speculators, the CDS was purely a speculative position of high risk. Defaults in the CDS market led very quickly to the great uncertainty concerning the financial positions of major banks that held these mortgage backed securities. It is now difficult for the banks themselves to determine the exact value of their CDS portfolio not to mention the difficulty faced by potential creditors in evaluating the ability of these banks to repay loans.

Thus, the great risk to the economy is that this uncertainty has reduced and threatened to halt the willingness of banks to lend to one another creating a liquidity crisis in financial markets. In such a situation, there is great potential that businesses find it impossible to secure operating capital and are forced to shut down. We are already seeing the first signs of borrowing limits, and if this kind of a crisis were to truly take hold, the result would be an economy that would come to a screeching halt and create a panic in the banking sector. The economy would unquestionably be careening toward a very severe recession or even depression. Recent Congressional action was targeted toward loosening the lending between banks and providing liquidity to capital markets. What has not happened to date is a re-evaluation of regulations such as the Glass Steagall Act and the Gramm-Bliley Leach Act to close loopholes in regulation of banking and investment activities.

The Japanese experience of the nineties provides one final note of caution. Namely, when Japan went through its economic crisis in the early 1990's, the central bank of Japan employed a similar approach to that which the Federal Reserve and the Treasury are now undertaking. The Japanese were not successful in stemming an economy wide recession that lasted over a decade. This highlights the important distinction between a credit crisis and a recession in the context of current events (see the paper by Abbott and Foster in this series of publications for more detail). What is not known at this point is how severe the U.S. recession will be and how long will it last. Granted the American economy is more resilient than the Japanese economy ever was. The ability of our economy to stand a macro shock such as this and still be the dominant force is exponentially better than any other country. That is precisely what gives us hope at the end of the day that we may yet come out of the current crisis with minimal long term damage to the U.S. economy.