The Political Economy of the 2008 U.S. Financial Crisis

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In 2008, Americans woke up one morning to find their banking system failing, their government in a full-fledged panic, and their savings virtually wiped out. In the course of the next few weeks, the United States government had to take very drastic and extremely unpopular steps in order to prevent another great depression. Overnight, an entire industry was nationalized, an industry which was the cornerstone of capitalism. A lot of people had no idea what happened, and most of them still don't. The crisis which began in late 2007 was officially declared over in June of 2009, when employment increased by 1.5%. But the crisis was far from over and even now eight years later not everyone has recovered.

Real Estate Market

The entire crisis was caused by the greatest fall in housing prices in U.S. history. What actually happened was a "bubble" was created which meant that prices of houses were artificially rising. In other words, the price paid was not the actual price or as Marx would call it the "Exchange Value"; but rather, it was the price the market pretended was real even though it was not. Bubbles have been created in the past, but nothing of this size. Federal Reserve Chairman Alan Greenspan was aware of this bubble continuously growing in size, but failed to act as he was a "free-market" believer, saying that when the bubble burst, the markets would be able to contain the damage and this was the natural business cycle. But prices kept rising and rising, reaching a record high in late 2006 and early 2007. Now the question is why was this bubble created? When Greenspan lowered interest rates, banks were more likely to give out money because more people were willing to borrow at a low interest rate.

CDOs

In the past a mortgage usually worked like this: a bank made a loan to a person who would pay back the loan usually over a period of thirty years. If the borrower made good on his loan, the bank made a nice profit. However, over time investment bankers invented something called a CDO. Commercial banks could sell their mortgages at a premium price to an investment bank. Investment banks would buy a lot of mortgages and bundle them together and then slice those mortgages up into different parts. Imagine taking pieces of paper that represent mortgages and putting them all together in a file and then cutting those files into sections with each section representing certain mortgages. This entire sliced up file

is called a collaterized debt obligation (CDO). Investment banks could sell these CDOs to investors.

With the creation of the CDO, the number of mortgages issued began to rise. When the banks ran out of people with good credit history to loan money to, they began to give out loans to people with bad credit history who did not have the means to pay them back. But this was of no concern to the banks since they would only sell the loan to an investment bank that created CDOs using those mortgages. With the government relaxing regulations, banks began to go wild. Mortgage lending companies such as Countrywide Financial made record profits, issuing loans to people who they knew would not pay them back.

Banks and other companies also began to advertise and developed new ways to virtually give out loans to anyone who would sign the paper. They started using “teaser rates.” Teaser rates were unusually low interest rates of about 1 or 2%. However, these rates would only last for a year or two. Then the bank would jack up the rate to 10% and the person would default on the loan resulting in foreclosure. Home ownership hit a high in late 2006. In 2007, people began to default in large numbers. This led to large numbers of foreclosures and vacant homes causing a massive decrease in housing prices.

Bear Sterns

The first spark of the fire was lit in July of 2007 when French bank BNP Paribas would not let owners of CDOs cash out, since it claimed it was unable to accurately value the CDOs. Then in January of 2008, Countrywide Financial, the largest mortgage company was sold to Bank of America (BofA) for $5.50 a share. When people defaulted in large numbers, they were unable to pay back the companies and as a result Countrywide Financial reported a drop in profits. This caused the stock price to fall drastically and there was a run on the company, with investors attempting to short-sell the stock. Finally, in January, it was bought by BofA. But the real challenge came in March with Bear Stearns, the fifth largest investment bank in the country. Bear Stearns had a lot of CDOs and when the rating agencies lowered the rating, they needed to raise new capital to pacify creditors. Unable to do so, the bank quickly fell to the mercy of the market.

In March, U.S. Secretary of Treasury, Henry Paulson got personally involved and behind closed doors, negotiated the sale of Bear Stearns to JP Morgan Chase at a price of $2 a share. He also had the Federal Reserve buy $30 billion of the most toxic assets owned by Bear Stearns, in order to provide liquidity. JP Morgan Chase later reneged on the deals, renegotiating the price to $10 a share out of fear that the Bear Stearns shareholders would not approve. But, this was still pennies compared to the stock price which had been $133.20 just a year ago.

Fannie Mae and Freddie Mac

The nightmare was only beginning. Fannie Mae and Freddie Mac, were government sponsored enterprises (GSEs). They were companies who bought mortgages and converted them into mortgage-backed securities. Again it was the CDOs that almost killed these two companies. After months of uncertainty in the

markets with the danger of these two companies failing, the U.S. Treasury seized control of the two GSEs and replaced their CEOs. The Federal reserved bought about $55 billion of mortgage backed securities to provide liquidity and the U.S. Treasury bought $14 billion of stock in them, with the promise to provide up to $120 billion in capital if necessary.

Lehman Brothers

Next on the hit list was Lehman Brothers, the fourth largest investment bank in the country. Lehman Brothers also had significant exposure to CDOs given the amount of commercial real estate it owned. The price drastically fell for Lehman Brothers also. Unable to raise sufficient capital and unable to sell any assets because there was no market for real estate at the time, the entire firm was put up for sale. Given Lehman's exposure, no one wanted to buy it except for Barclays, the British investment bank. But they would only do so on the condition that the U.S. government agree to fund the deal the same way it did with Bear Stearns. U.S. Secretary of Treasury Henry Paulson, fearful of public backlash for bailing out another bank, refused to have the U.S. government fund the deal, but promised Barclays help if it would continue to negotiate with the intention of buying Lehman Brothers.

On Sunday September 14, 2008 a deal was reached: Lehman would be split into two banks, a good bank with valuable assets and a bad bank with toxic assets. Barclays would buy the good bank while the bad bank would be bought by a conglomerate of Wall Street banks including JP Morgan, Citibank, Goldman Sachs, Morgan Stanley, and Merrill Lynch. The problem would be resolved without using any taxpayer money. This deal never happened as the British government refused to approve it. Chancellor of the Exchequer Alistair Darling refused to do so, worried that Lehman's toxic assets would poison the other banks. On Monday September 15, 2008, Lehman Brothers filed for bankruptcy making it the largest bankruptcy in history with $639 billion in assets and $613 billion in debt with $155 billion in bond debt.

AIG

On September 16, 2008, two days after letting Lehman Brothers fail, citing moral hazard, the New York Federal Reserve loaned $85 billion to AIG, a company that was only minutes away from bankruptcy. AIG faced a liquidity crisis. It had sold too many Credit Default Swaps on CDOs filled with sub-prime mortgages to too many investors. When all CDOs were downgraded, creditors demanded AIG put up additional collateral, while others demanded their money outright. Unable to pay up and unable to sell many of their assets, AIG became insolvent. In return, Treasury took 79.9% stake in the company and replaced the CEO. Later on using TARP funds, Treasury injected an additional $100 billion to simply keep the company from failing.

TARP

On October 3, 2008 President Bush signed into law TARP (Toxic Asset Relief Program), a bailout package totaling about $750 billion. According to TARP, Treasury would buy the toxic assets from banks, freeing up their balance sheets. The toxic assets would mostly be mortgage-backed securities. However, ten days after its passing, Treasury Secretary Henry Paulson announced that instead of buying toxic assets, Treasury would inject capital directly into the banks. Later on TARP funds were also used to bailout out auto companies such as GM and Chrysler.

Reaction to Tarp by Markets

On October 3, 2008, the day TARP was passed by the U.S. Congress, the markets failed to recover. Instead, they fell further. The day TARP passed the Dow Jones Industrial Complex, a measure of the health of the U.S. economy, dropped 157 points.

Conclusion/Overall Effect on the Economy

This crisis was unlike any other crisis experienced in the past. This was a crisis of *liquidity* not capital. A shortage of capital can be solved by loaning out more money. A shortage of liquidity, which in this case had been taken for granted in the boom prior to the recession, is more difficult to solve. The root cause of the 2008 financial crisis was not simply a bubble in the real estate market, nor a simple conflict of interest of rating agencies, nor an error in marking the price of capital assets to the market, nor due to lack of regulation, despite their contributing factors. *As long as the motive for profit exists and its risk can be shifted (Swaps) there will be a greater financial crisis in the making.* With the financial sector bleeding, the economic system itself began to falter. Corporations were forced to lay off thousands of workers just to survive. As a result, unemployment increased leading to less money for people to spend. With less spending, companies were forced to cut back even more creating a vicious cycle. Only at the cost of trillions of dollars did the path to recovery even begin. The rate of GDP fell significantly and unemployment increased to 10%. Personal Consumption Expenditure, which is the amount of money spent by the American consumer, also fell significantly. The road to recovery was long and not easy, but the crisis did eventually pass.

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