

## A Brief Analysis of the Financial Crisis of 2008

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**Abstract:** The end of the first decade of the new century was a disaster for many people around the globe financially. The fall in the housing market in the summer of 2007 caused a series of chain reactions that would eventually cause a financial breakdown that led to the Great Recession in 2008. The causes of the Great Recession in 2008 was very complicated and hard to understand. But the basis of those causes was human greed that made people unaware of the real situation and over-optimistic about their capacity of handling the situation.

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### 1 Introduction

Many economists would consider the financial crisis in 2008 was the most devastating economic disaster since the Great Depression of 1929. The impacts would eventually lead to the Great Recession. The financial crisis began with a crisis in the US subprime mortgages market in 2007. The belief that the US housing market would never fail also played an important role in terms of the causes of this financial crisis. The struggles within many financial institutions like Lehman Brothers, who took enormous risks in the subprime mortgages market, greatly affected Wall Street, then the main street, and would eventually affect the world's economy as a whole. The US government was interfering with the market excessively during the crisis. People also have different opinions about the massive bail-out of financial institutions, whether the government had the power to act constitutionally, and whether that was

beneficial to the whole economy.

### 2 The causes of the financial crisis

The financial institutions were making money by lending money to people who were trying to achieve their "American dream." Most of them benefited by fees of each transaction. They wanted to make more money and enlarge the mortgage market! They did that by taking risks in the subprime market. To make their business seem less risky, they transferred the risks to other businesses who were also trying to benefit from fees by ensuring the subprime mortgages. They were even lending money to those who did not have the ability to afford a house. Wall Street became extremely interconnected, everyone seemed to be greatly benefited by that business. However, all the derivatives and tools of making money were based on the belief that the US housing market would never fall. Those who did not have the ability to pay their bills started to default on their contracts with their mortgage companies and had to give away their house in order to pay their bills. As the foreclosure rate increases, the housing market started to fall. This damaged the assets of the shadow banking system, a type of financial institution that made up a huge portion of the market and was not under the regulation of the federal government. That also made the shadow banks to sell their assets at a very low price. As a result of the interconnections and the risks within the system, the whole banking industry's ability to intermediate house purchases and investments were being deeply affected. That period time of history was a time when investing in house-related assets and mortgage-backed securities were extremely profitable to financial institutions. Like former Citi group CEO Charles Prince said, "as long as the music is playing, you've got to get up and dance," all financial firms had to step into this field even if they know there would be

unlimited risks because it is profitable. The government didn't see it coming and act during its very early stages because of the enormous size of the shadow banking industry. The shadow banks took up about 230 percent of the GDP in 2007, while depository institutions that were supervised and regulated by the government only took up about less than 100 percent of the GDP. Most shadow banks existed outside of the regulatory framework, which made the federal government difficult to foresee the upcoming disaster.

### **3 Why should the recession be considered “great”?**

The recession after the 2008 financial crisis was being considered as great because of its huge and long-lasting destructions to the economy. Output, consumption, investment, employment, total hours worked dropped more than other recessions after 1945, GDP fell 4.3 percent during this period. The US economy also took a longer period of time compared to other recessions to recover. However, this is not being considered as a severe depression because the conditions were better than those during the Great Depression in the 1920s and 1930s. Many American households were being severely damaged financially, and therefore unwilling to increase their spendings. They were more inclined to save their money instead of investing it during this time of crisis. This is a perfect real-life scenario for the paradox of thrift. The economy during a recession is being dragged by personal savings. People were not able to adjust to the current conditions of the economy, which is contrary to the typical expectations of a classic macroeconomy.

### **4 Government regulations and interventions during the crisis**

The US government released the fiscal stimulus programs, a combination of government spendings and taxes, in order to prevent a recession by increasing the employment rate and spendings. The Economic Stimulus Act of 2008 and the American Recovery and Reinvestment Act of 2009 were part of the fiscal stimulus programs during this financial crisis and recession. During the early stages of the financial crisis, the government took several “traditional steps” in an effort to fight against the signs of crisis. The Federal Reserve reduced the federal funds rate as an immediate response to the situation. However, actions that were taken by the Federal Reserve bring uncertainties to the market and decreased confidences by showing that

there was a sign of a negative look on the economy. The FOMC provided guidance for the federal fund rates and made it at near zero levels. There were also “nontraditional” and controversial policies that fought the crisis in a unique way. The credit easing programs were being introduced and helped to facilitate credit flows and reduce the cost of credit. The LSAP, large scale asset purchase, was also an untraditional way of fighting the crisis. It helped to reduce the public and private borrowing rates in the long term and gave the government opportunities of purchasing MBA, Fannie Mae, Freddie Mac, and Federal Home Loan Banks. Troubled Asset Relief Program, or TARP, helped the economy by strengthening the financial sectors who were struggling during the crisis. The government would purchase toxic assets and equity from those firms. Many people viewed the TARP as a “cash for trash” plan that would not benefit the tax-payers. The oppositions of those untraditional ways of solving the problem came from both the public and within the government itself. Many people argued the LSAP and TARP are programs that allowed the government to inject capitals into private businesses which made them unconstitutional. The public and a significant amount of government officials would favor little to no government interventions. They wanted to draw a line between the democratic way of solving a problem and the communist way of solving a problem. They didn't want to see the government interfering with the free market. From the perspectives of Ben Bernanke, Hank Paulson, and Tim Geithner, preventing another Great Depression was their top priority. They definitely tried to accomplish both tasks but they seemed to run out of options. They also had difficulties maintaining a consistent policy. Hank Paulson and his colleagues bailed out Bear Sterns but did not do the same thing for Lehman Brothers. They bailed out other companies and introduced TARP right after announcing that the government would not bail out another company. Again, this is another example of how contradictory the policymakers can get between their top priority and pressures from others. Government interventions during this time of crisis should be considered successful and helpful because it prevented the whole economy from falling apart.

### **5 Impact and aftermath**

There are no doubts that the financial crisis, followed by a Great Recession was devastating to the

world's economy. Countless jobs were being lost. According to the U.S. Bureau of Labor Statistics, the unemployment rate in the US reached a record high of 10 percent in October 2009. The foreclosure rate also kept going up after the crisis. It reached 2.23 percent in the year of 2010 while it was only 0.58 in the year of 2006. The government also have different ways to supervise banks. A more comprehensive stress test is put into place. An article written by the Cleveland Fed states that "our stress tests consider hypothetical, severe, economic downturn conditions." Consumer Financial Protection Bureau was also being created to serve as an organization that "protect consumers from unfair, deceptive, or abusive practices and to take action against companies that break the law."

## **6 Conclusion**

Twelve years after the financial crisis in 2007, it is amazing to re-interpret the causes of the financial crisis and the decision making processes made by government officials. The excessive risk takings by the finance industry were the cause of this financial crisis in general. The lack of regulations and supervisions by the government prior to the fall of the housing market also contributed to the further breakdown of the economy. Part of the federal government's responses to the crisis was very controversial at the time, and it is still debatable today. However, we cannot neglect the fact that the government officials did whatever they can, and successfully prevented a depression waiting ahead of this subprime mortgage crisis.