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THE CAUSES OF THE 2008 ECONOMIC CRISIS

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Abstract

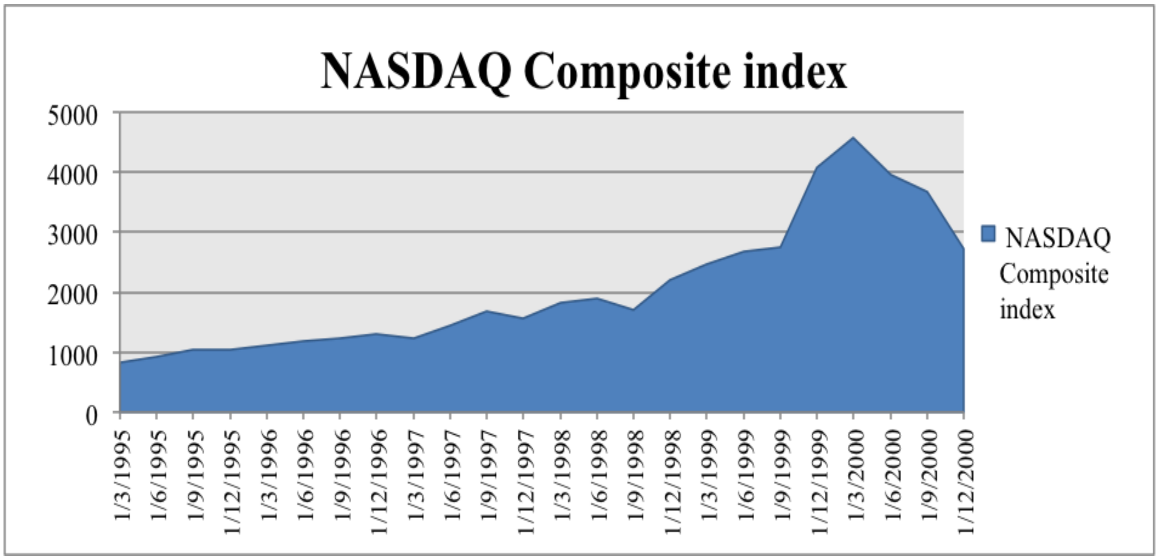
In this paper, the causes that led to the credit crunch, which played a key role in conveying the crisis to sovereign debt crisis are to be examined and reported. With simple and illustrative way, it will be made an attempt to analyze and understand the reasons, which brought the financial system to the brink of destruction. By the fall of 2008 everyone thought that the crisis started from the Wall Street and affected all financial markets globally would be limited to the financial sector. After the collapse of Lehman Brothers in September 2008 the credit crunch took dimensions of global phenomenon. The role of the savior played several countries. The price of the rescue was several countries to have increased their debts. But the crisis itself has highlighted cases and countries facing debt problems prior to this, which were inflated during this period. The factors that compose the multiple forms of crisis are divided into two phases: The credit crisis, the sovereign debt crisis.

Keywords: Financial Crisis, Housing Bubble, Mortgage Crisis, Debt Crisis, Credit Crisis

INTRODUCTION

The story begins in 2001, when the bubble of the Internet burst (Internet bubble or dot-com bubble). At this time the NASDAQ index recorded massive decline threatening with downturn the financial and consequently the real economy. From 1995 to 2000 there has been an increase of the NASDAQ index due to the development of companies related with the Internet. More specifically during this period companies saw their shares' value soar if they would simply add the letter "e-" at the beginning or ". com" in the end of their name. This marked the beginning of the phenomenon called "virtual value" having as a result the existence of disproportionate sizes compared with the stock market and the real value of many companies. The final outcome was the degradation of the model and major companies in this field saw their shares be affected by the bubble on the Internet. Figure 1 shows the course of the NASDAQ index during the bubble.

Figure 1: course of the NASDAQ index during the bubble



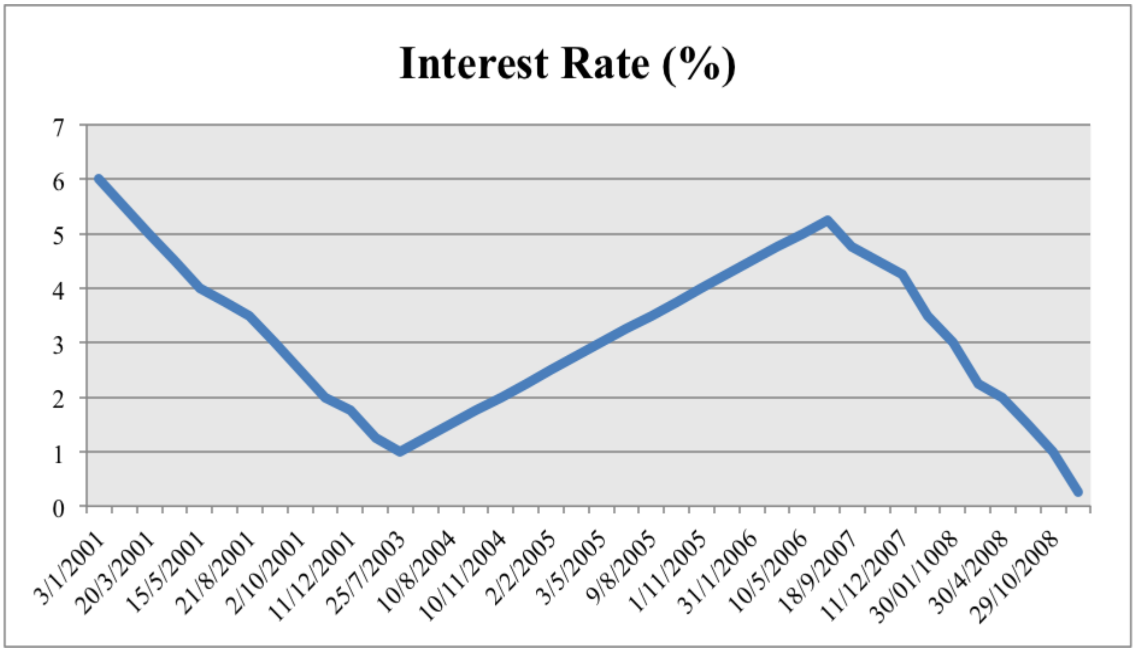
Source: Colombo (2012)

CREDIT CRISIS

The Reduction of Interest Rates by the Federal Reserve (Fed)

After the fall of the NASDAQ the economy was threatened with a deviation from the path of growth that has been. The risk of recession began to emerge strongly. Therefore there was a need for drastic measures in order to stimulate the economy. Amidst a climate of panic in order to limit the risk the Fed acted immediately. From May 2000, Fed implemented a policy of gradual reduction of interest rates in order to boost the economy. In 2001, Fed reduced the interest rate from 6.5% that was in May 2000 to 1.75% in December 2001. This move has triggered to facilitate borrowing by banks and as a natural consequence the consumers' ability to borrow easily. At that period the U.S. government implemented a program to help middle and low incomes to acquire their own houses with some conditions (income, deposits, etc.). During the process of speculative lending, criteria began to disappear. Consumers were able to borrow at low interest rates and the market for mortgage loans, which previously held a small share of the U.S. economy, has experienced a tremendous boom. Mortgages from $ 468,000,000,000 that were in 2000, reached their peak concentrating the amount of 2.8 trillion in 2003 (The Financial Crisis Inquiry Report 2011). People who had low incomes could now get easier a mortgage with extremely low rates. This has meant an increase in the price of real estate and the creation of the housing bubble. In Figure 2 is shown the downward trend in Fed's lending rates.

Figure 2: Trend in Fed's lending rates



Source: Board of Governors of the Federal Reserve System

From the 25/07/2001, which the lending rate was at 1%, it began a gradual increase. The increase continued throughout the duration of the housing bubble. On 29/6/2006 the rate reached at 5.25%. Thereafter, the Fed began reducing the interest rates as the first signs of the crisis emerged. During the crisis, the Fed continues to lower interest rates, sometimes apart from strategic planning by making unexpected movements due to the emergency of that period. On December 16, 2008 interest rates reached a record low of 0.25%. The former head of Fed, Alan Greenspan had admitted that the policy of reducing interest rates created the housing bubble.

Deregulation of the Financial Sector (laissez faire)

Perhaps one of the main causes of the crisis was the so-called deregulation of the financial sector based on the doctrine of laissez faire. The following philosophy establishes the non-intervention in the economy and especially in the financial system, which can adjust itself in such way that is beneficial to the economy. The governments of the United States faithfully followed this doctrine. During the 90s two laws were passed that gave greater flexibility to the banking system. These laws allowed the commercial banks to be able to enter into new activities, such as investment and insurance products. Also, the regulatory authorities should do a survey on financial regulations every decade and indicate which ones were outdated. At this point it is worth mentioning that the derivatives market (investment products) operated throughout the course of the housing bubble without being governed by regulations. The inaction of regulators combined with the "pressure groups" working in order the financial sector to stay self-regulating, made impossible any preparation of the state for the upcoming crisis.

In the period of low interest rates apart from the real economy, the housing sector experienced a rapid rise also in the financial sector. The more the mortgage loans were granted by the banks, the greater was the participation of major financial institutions and private investors. However, in order the mortgage market to become more attractive it was considered necessary to eliminate some regulations, in order to be achieved a corresponding growth in the financial sector. According to the annual report of one of the regulatory authorities the Federal Deposit Insurance Corporation (FDIC) in 2003, the top executives of the banking sector and the head of that agency expressed some concerns about a series of measures, which were binding the elasticity, and flexibility of the mortgage loans. Under legislation that defined the investigation for regulations that do not fit in the current era, ten major regulatory issues emerged and seemed to be the biggest concerns of bankers and regulators:

1). Bank Secrecy Act, including Suspicious Activity Reports (SARs) and Currency Transaction Reports (CTRs)

2). USA Patriot Act and Know Your Costumers Requirements

3). Withdrawal Limits on Money Market Deposit Accounts (Regulation D)

4). Home Mortgage Disclosure Act (HMDA)

5). Community Reinvestment Act

6). Truth-in-Lending Act (Regulation Z) and the Real Estate Settlement Procedures Act (RESPA)

7). Three-Day Right of Rescission

8). Extensions of Credit to Insiders (Regulation O)

9). Flood Insurance

10). Privacy Notices

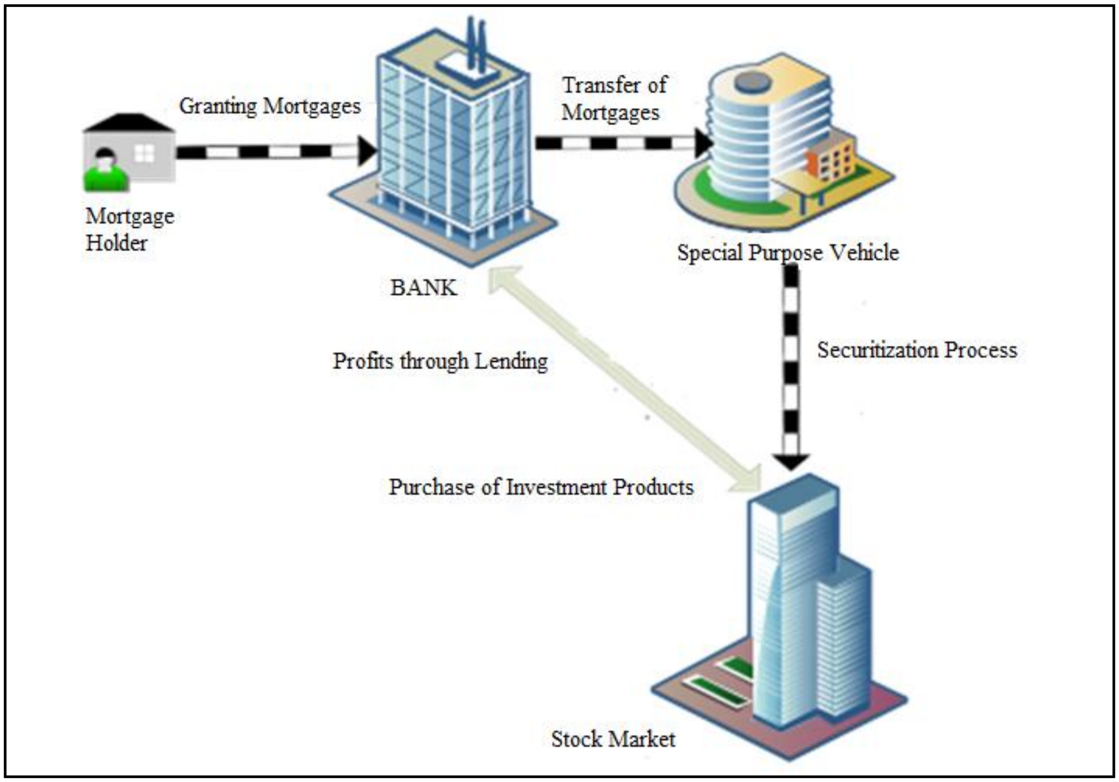
With the removal of these regulations and with the ideal conditions created by Fed’s low interest rates, there has been the expected boom in the mortgage market.

Securitization

The main reason for the spread of the crisis is the process known as securitization, in which banks had direct profit by granting mortgage loans. The procedure was the following: Consider a bank named “X”, which has assets in a number of mortgages. The bank transfers this mortgages to a company, which has the characterization of Special Purpose Vehicle (SPV), for example an offshore company. The SPV in turn issue debt securities based on loans (Mortgage

Backed Securities, MBSs), mixed with other theoretically secure investment products and thus created an investment package. The debt security, which is consisted by the components of the investment package, is evaluated by rating agencies (Credit Rating Agencies, CRA). From there, the investment package (having the highest ratings) "breaks" into pieces to be sold to potential investors, generating profits for banks and investors on the condition that the borrowers will be consistent with their obligations. This method is called securitization. This technique allowed the banks to convert loans into securities investment packages CDO (Collateralized Debt Obligations), limiting credit risk. Banks looking at the easy profits they decided to expand their commercial mortgage lending activity in families where their credit quality was questioned. These types of loans are called sub-prime loans. Figure 3 describes the process of securitization and also how through this process the credit crisis affected the financial sector as a whole. Also is becoming evident the interrelationship between consumer-bank-money and how these entities affect each other.

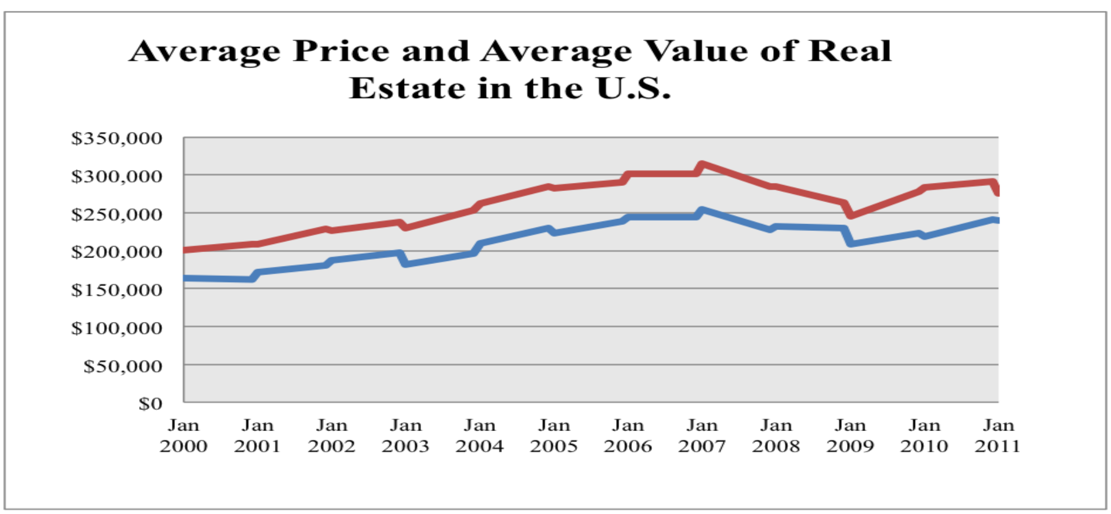
Figure 3: Process of securitization



The Easing of Lending Criteria

Through securitization banks had direct profit with each loan. The behavior of lenders changed dramatically in the years before the crisis by giving mortgages to more and more families who were not creditworthy. In this way they had increased their profits but also the market for mortgage loans flooded with sub-prime mortgages. The guidelines for the approval of mortgage loans began to relax.Criteria such as the declaration of income and assets verification (Stated Income, Verified Assets (SIVA)) were removed. Potential borrowers had only simply to declare their income without being made any further control by the lenders and to show that they have deposits (No Income, Verified Assets (NIVA)). Furthermore the applicant for loan was not necessary to submit documents certifying that works. The only prerequisite for lending was to demonstrate that has deposits. These terms were simplified even more resulting in the creation of what is called as NINA (No Income, No Verified Assets) loan or otherwise Ninja loan. NINA loans are official loan products that allow consumers to borrow only with the commitment to comply with the terms related to the repayment of the loan. Furthermore to make it more tempting for the consumers to take a loan, it was introduced by the banks the measure called Adjustable Rate Mortgages (ARM). This measure allowed the borrower to choose to pay only the interest during an initial period, and to pay an amount of his choice as a resulting the transfer of the remaining amount to the rest, but with the new rate. According to statistics one in ten chose to get a loan with the ARM option, which meant that he could give an amount of his choice having as a consequence the increase of the loan balance each month with a different rate Financial Crisis Inquiry Position, (2011).Banks urged people where instead of getting another kind of loan to choose the ARM loan. Moreover, several brokers have taken appropriate incentives from lenders to grant such loans regardless of whether the persons concerned complied with the conditions for a non-subprime ARM loan. The continuous lending with the ARM term resulted from 41% that these loans held in the mortgage market in 2000, to be skyrocketed at 61% in 2006 (Brooks and Simon 2007).These tactics of relaxation to lending criteria in conjunction with the promotion of the ARM loans had as a result the skyrocketing of the objective values of real estate. Figure 4 shows the trend in the value of real estate throughout the housing bubble.

Figure 4: Trend in the value of real estate throughout the housing bubble

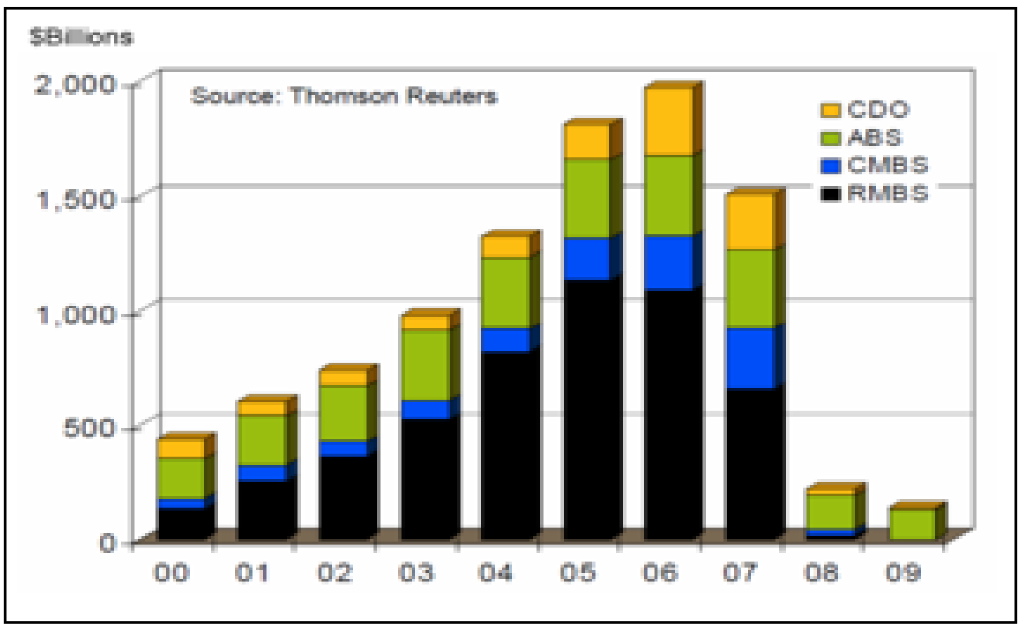


Source: U.S. Census Bureau (2012)

The Role of the Shadow Banking System

The term shadow banking system refers to the activities of institutions associated with the financial markets (capital management, mutual funds, and hedge funds). During this period, in which the housing bubble was growing increasingly there have been a number of factors that made the financial system more vulnerable. This system had the ability to keep hidden the levels of leverage from investors through complex instruments such as derivatives (off-balance sheet) and securitizations. These tools provided banks and mutual funds the ability to guarantee high profits and shield against any potential financial risk. Derivatives of various kinds (such as Credit Default Swap CDS, Asset Backed Securities ABS, Mortgage Backed Securities MBS, Collateralized Debt Obligations CDO), which were channeled to the stock market were not controlled by any regulatory authority making it impossible to calculate the risk. With the derivatives market stay uncontrolled, many financial institutions acted with naivety in their effort for increased short-term gain. Figure 5 shows a figure presenting the path of the derivatives market from 2000-2009.

Figure 5: Securitization Market Activity



Source: Mark Zandi, (2010)

The Rating Agencies

Rating agencies are financial institutions that have the role of the evaluator in the finance industry. They evaluate everything related to the financial markets and everyone takes their reports very seriously. Their ratings cover a wide range, from investment products to the economic progress of states and firms based on their creditworthiness. Investors calculate the risk of an investment based on these ratings. These institutions have a lot of responsibility for the credit crisis. Their role in the various stages of the housing bubble and the crisis was a catalyst for the spread of it. The rating agencies were rating the derivatives derived from risky loans with the best rating (AAA), considering them as a reliable investment and absolutely safe. From research done, it has found that there was pressure on rating agencies for good rankings from financial institutions, which they were paying to show that the derivatives are safe. In the years before the crisis, rating agencies evaluated on a daily basis a large number of derivatives from the field of mortgage loans. The excellent ratings made the most reluctant to invest by purchasing derivatives from the mortgage market. Big firms of the finance industry had in their portfolio a large number sub-prime mortgages in the form of derivatives. When the bubble burst, the majority of these products were downgraded from the agencies making impact more intense (Financial Crisis Inquiry Position 2011). These downgrades (which were the result of objective evaluations) spread the panic. The panic was translated into a lack of confidence among banks making interbank borrowing very difficult. Although it was not the only cause, the role of rating agencies is often considered crucial for the burgeoning of the housing bubble with the high ratings values for sub-prime derivatives. It was also vital the decision of degradation of the derivatives market, which exacerbated the credit crisis.

SOVEREIGN DEBT CRISIS

The Financial Support of Banks

With the outbreak of the credit crisis the banking system worldwide faced major liquidity problems. The interbank lending was weak as banks refused to borrow each other. The distrust has brought huge liquidity problems leading to a failure of the debt refinancing. Especially after the collapse of Lehman Brothers in September 2008, the uncertainty that prevailed made banks reluctant to loan. This hesitation reflects both the fear of an impending bankruptcy of the borrower (whether a bank or consumer) and preserving their own liquidity. The liquidity problems brought several financial institutions around the world close to suspend their operation. Within this climate of panic several countries assumed the role of guarantor and pumped their banking systems with money. The financing of the banking system from the sovereigns transformed the crisis from credit to debt crisis. The debt crisis was created by the involvement of several states in an effort to rescue and recovery the financial sector. Financial support came from the sovereigns' coffers containing taxpayers' money. With these movements the banking system was strengthened but public debt increased in several countries. In some cases the financial packages, which were given account for a large percentage of the Gross Domestic Product (GDP). Characteristics are the cases of the United States, Great Britain Iceland and Ireland. The first two saw their public debt rising at an alarmingly levels whilst the latter two were faced with the possibility of default. The attention of financial markets turned to the ability to maintain public debt of countries to sustainable levels in 2009. The reason was the Dubai where in September 2009, stated that it cannot serve the needs of public debt repayment.

CONCLUSIONS

The main conclusion that derives from the causes of the credit crisis is that it could have been avoided because there were warnings about an upcoming crisis, but the belief that this model could withstand any blow did the leaders to turn a blind eye. The atrophy of regulatory authorities combined with the deregulation based on the doctrine of free market economy led to a failure of the entire financial system. Major financial institutions have reached the brink of bankruptcy. From the events it is concluded the greed of bankers for more profits, granting brazenly mortgages even to homeless people. It is also concluded the power relations of the financial sector lobby with politicians in order to act undisturbed. The so-called "pressure groups" had a tremendous influence over the last thirty years in order to be voted laws and regulations that allowed the uncontrolled speculation. Several new evidences emerged for bribing important persons. Banks that specialize in buying mortgage bribed several members of Congress and those responsible for the regulatory bodies in the United States. Even the former governor of the Fed, Alan Greenspan pushed to keep the derivatives market deregulated. Also the CEOs of the government sponsored enterprises in mortgages, Fannie Mae and Freddie Mac used their acquaintances in the government to act autonomously without checking their moves. As a consequence of all was the degradation of the real economy. The citizens were those who were called to pay from their income the wrong moves of that were made from the political authorities and the financial industry. In countries such as Great Britain and Ireland in order to reduce the fiscal deficit created by the partial nationalization of the banking system, citizens are subject to austerity policies.

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