

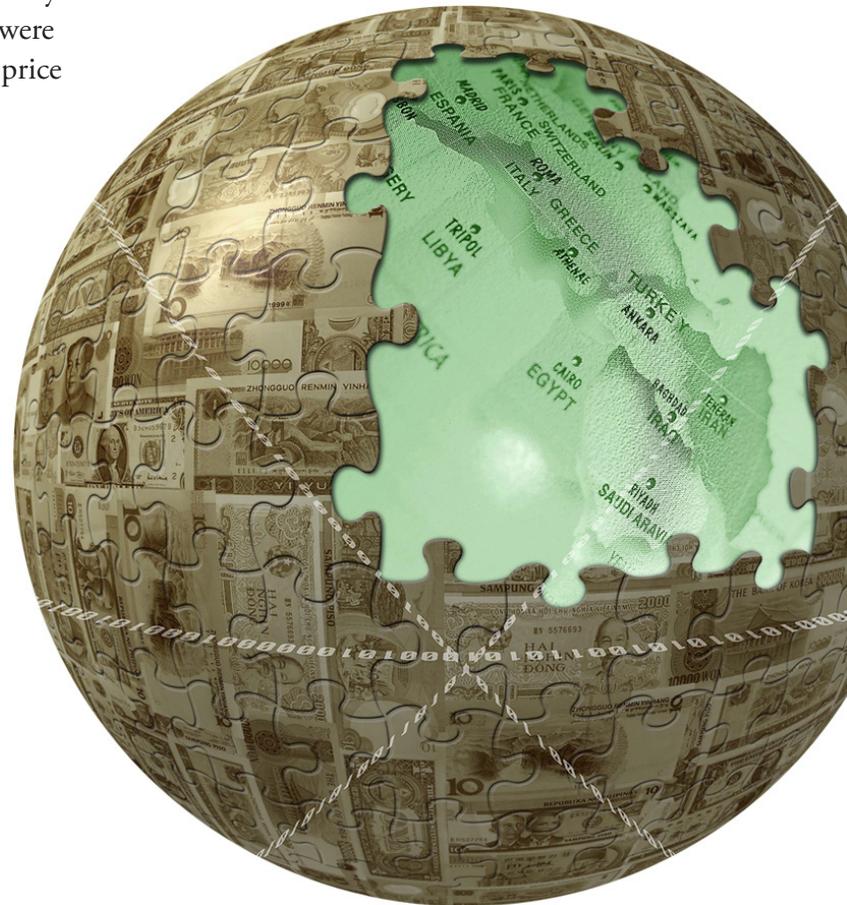
Understanding the Financial Crisis: Origin and Impact



The financial crisis of 2008 is only the latest in a string of financial crises that have hit the world economy. While each crisis is unique, each shares certain common features: too much money in the economy, changes to the framework within which decisions are made, and over-estimation of the value of assets (stocks and housing being two of the most common types of assets). This discussion provides a brief introduction to a very complex subject with the hope of shedding some light on the current crisis.

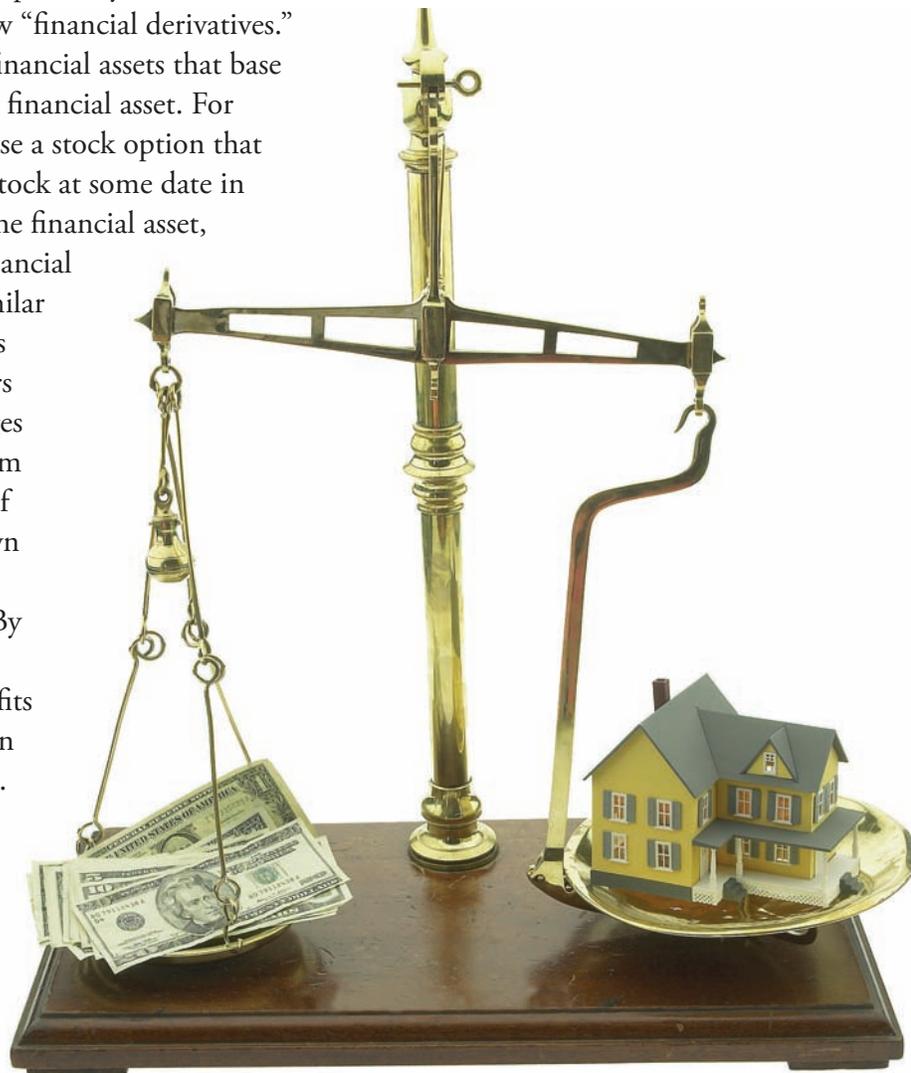
Starting in the 1980s, several Asian economies, most notably China, began to grow very rapidly. This rapid growth increased the incomes of citizens of these countries and increased their ability to save. People everywhere like to have a safe place to save money. For many, this safe place is the United States. So, as those economies grew, a large amount of foreign savings flowed into the U.S. economy. In many ways this was good for our economy; it allowed us to borrow money inexpensively. What did we use the money for? Businesses used the borrowed money to fund the building of new factories and the expansion of existing businesses. Government used the borrowed money to cover budget shortfalls. Households used the borrowed money to pay for new or bigger houses. Looking back, it is clear that we did too many of those things. Most important, people were buying so many houses that the price of housing increased by almost 200 percent between 1994 and 2006. That pace of increase is far too high.

With housing becoming very expensive, shouldn't someone have stopped the borrowing? Thirty years ago that might have happened. But in the past 30 years, the rules of banking changed. If you look back at banking



50 years ago, bankers typically knew their customers and what the customers would do with borrowed money. Further, 50 years ago if a bank issued a loan, the bank would hold on to that loan. Therefore, a bank would only make money if the loan were paid back. “Financial deregulation” – or a reduction in the rules governing what a bank is allowed to do – changed those constraints. First, “branch banking” was widely introduced. With branch banking, where you bank is only one small part of a larger company. This makes banking far more convenient for the customer (I can travel to California and still access money that I “banked” in Colorado). But, it reduces the personal connection between the bank and the customer (the branch in California does not know me). This reduction in personal knowledge forces banks to rely more on rules to determine who gets loans. But what happens if those rules turn out to be wrong? If this happens, banks will give loans to some who cannot afford the payments.

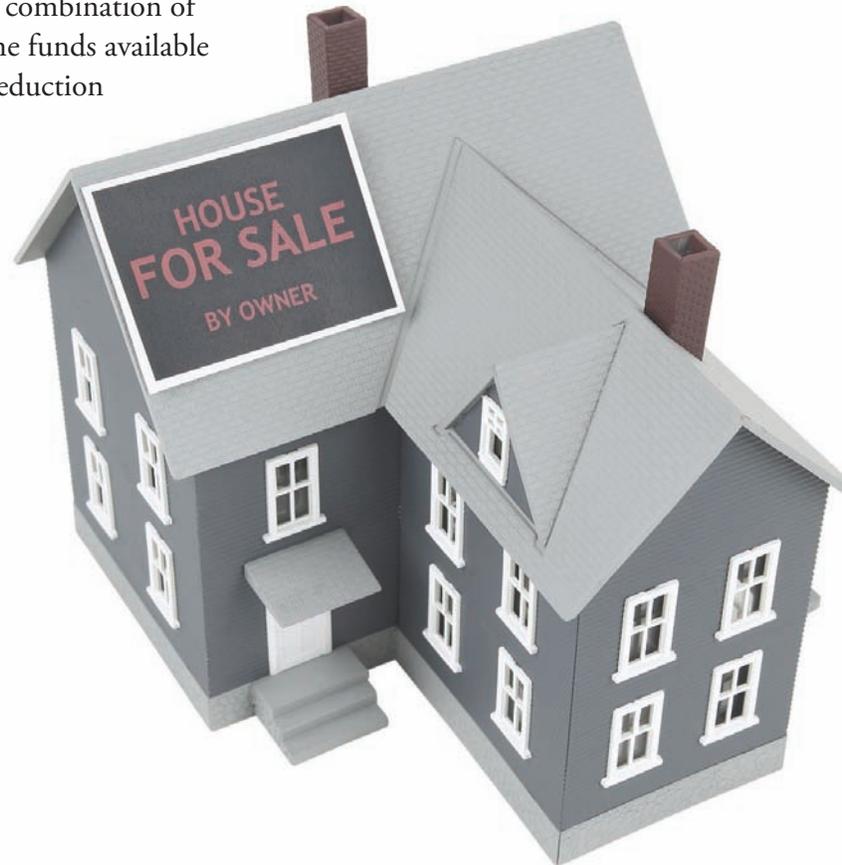
Even more important, the past 30 years saw the development of many new “financial derivatives.” Financial derivatives are financial assets that base their value on some other financial asset. For instance, you may purchase a stock option that is just the right to buy a stock at some date in the future – the stock is the financial asset, the stock option is the financial derivative. Something similar developed with mortgages (loans on houses). Bankers began packaging mortgages together and reselling them (these are among a class of financial derivatives known as Collateralized Debt Obligations, or CDOs). By selling these derivatives, bankers made greater profits and were able to offer even more loans to households. Unfortunately, once a



bank sells a mortgage that has been repackaged, the bank no longer has an interest in the mortgage. With that loss of interest, comes a reduced need to be certain that a loan will eventually be able to be paid back. It is clear that bankers during the early part of this decade did not lend as cautiously as previously – the loss of financial interest in the loans led bankers to grant loans to some who would not be able to pay them back.

The above changes – inexpensive loans and lax banker oversight – would likely not have been enough to drive the economy into crisis. Households also changed how they treated housing. Homes became more of a “speculative asset” – an asset purchased in the hope that it will increase rapidly in value. Because home prices were increasing rapidly, many people entered the market. This increased the demand for homes and drove an upward spiral in prices. Because banking changes made bankers more willing to give loans, borrowed money became readily available to fund the surge in prices. Unfortunately, the upward spiral cannot last forever.

In 2006, foreign savings dollars flowing into the United States began to slow. Additionally, the federal government and central bank – the Fed – were acting to slow down the U.S. economy because of fears of inflation. The combination of these actions removed some of the funds available for loans from the market. The reduction in available loans slowed the pace of housing price increases. This led to an erosion of the speculative demand; houses were not going up in value as rapidly, thus they were less attractive to purchase. The combination of these forces eventually narrowed the market for housing sufficiently so that prices of homes began to fall. As this occurred, some borrowers found that they could not



afford the payments on their mortgages. Unfortunately, with fewer people in the market for homes, existing homeowners couldn't sell the properties. This left some in the difficult situation of owing more on a mortgage than their house was worth. Some responded by walking away from the house and the mortgage, which drives down the value of the mortgage-backed derivative – CDOs.

The situation rapidly became worse for a very simple reason. Any bank (or other financial institution) must have assets backing its operations. The assets may be cash, gold, stock in other companies, government-issued debt or financial derivatives. During this decade, banks purchased many CDOs (mortgage-backed financial derivatives) to use as assets backing their operations. As the value of these fell, they found themselves unable to issue as many loans – they did not have the assets to back their previous level of operations. As they issue fewer loans, fewer people can afford to buy homes. With fewer people buying homes, the prices of homes falls further. Quickly a downward cycle forms. It is this downward spiral we currently are trapped in.

The government is trying to reverse the spiral by providing assets to banks. The government may do this by directly buying a portion of banks or by purchasing mortgage-backed financial derivatives from banks. The first act directly gives banks more cash. The second action protects banks by putting their balance sheets on a more stable footing. Either action offers some promise of slowing the decline in bank lending and putting the economy on a more stable path. However, any action the government takes comes with risks. First, it may not work. The problem may so



large that government efforts (already heading towards \$1 trillion) will be too small to stop the decline. Second, the government will eventually have to cover the cost of its actions. Because the government currently faces a national debt of over \$10 trillion, the additional burden of this “bailout” may generate significant inflation in the coming years. Third, by taking a direct role in bank operations, the government increases its role in the economy. For this to be beneficial, the government must be able to better manage banking risks than bankers. If it fails to do so, it just sets up the next round of economic crisis. Unfortunately, evidence from around the globe suggests that governments do not make good bankers. Finally, by stepping in, the government protects borrowers who borrowed too much and bankers who lent too much. If both borrowers and lenders know the government will protect them from their own mistakes, might both be more likely to make more such mistakes in the future? If so, the seeds of the next crisis are now being planted.

