
THE ECONOMIC CRISIS UPDATED – JULY, 2009

We have all heard President Obama state that we are facing the greatest economic crisis since the Great Depression. But how did we get in this fix? How bad is it really? And how can we get out?

While most economists agree that the crisis began with the explosion of sub-prime mortgages and the inability of millions of Americans to meet their suddenly higher monthly house payments, we must look further back to get to the root cause.

After the Great Depression, President Roosevelt and the U.S. Congress instituted a fairly comprehensive regimen of financial rules, regulations and oversight that required banks and other financial institutions to be transparent in their actions and investments. Perhaps most important was the *Glass-Steagall Act*, which stopped any financial institution from being both a commercial and an investment bank, and from also offering insurance services. The walls that *Glass-Steagall* erected remained in place for almost 50 years.

But beginning in the 1980s, the Reagan “revolution” began to systematically dismantle the rules and regulations that controlled the financial system. A fundamental contradiction also emerged under Reagan – the wages and benefits of workers were deliberately restrained (as attacks on unions increased), while at the same time consumers were urged to spend freely to keep the economy growing. Meanwhile, aided by administration policies, the manufacturing base (which had previously driven the economy) moved

overseas to take advantage of cheap labor. A service economy rapidly replaced the manufacturing base in America, and the decline of the middle class accelerated.

One of America’s economic strengths used to be the high savings rate of our citizens. But that strength vanished when the US Tax Code was changed to allow 100% tax deductibility of all mortgage interest payments in 1987. Americans soon took out second and third mortgages in order to buy cars and other consumer goods. Interest rates on car purchases are not deductible, but second mortgages are. This tax deduction helped change America from a nation of savers to one of debtors. We are now one of the most indebted nations in the world.

1987 was also the year that Alan Greenspan, a true believer in the “invisible hand” free market theory (which states that the free market itself is its own best regulator), became the Chair of the Federal Reserve, where he served until 2006. He initially stimulated the economy with deep interest rate cuts. That success gave him great credibility.

Twelve years later Phil Gramm, a Republican U.S. Senator from Texas, authored and shepherded the *Gramm-Leach-Bliley Financial Services Modernization Act* through Congress. The bill effectively voided most of the prohibitions provided by *Glass-Steagall*, and tore down the walls separating banks, investment houses and insurance companies.

When George W. Bush came to power, the influence of anti-regulation free market ideologues reached unprecedented heights. With the right wing firmly in control of all three branches of government (Executive, Legislative and Judiciary) all restraints were removed. We entered the financial services age. Wall Street no longer reflected the economy – it dominated it.

During this period Greenspan encouraged subprime lending by advocating Adjustable Rate Mortgages (ARMs). The sustainability of these ARMs came into question as early as 2004, when the term “housing bubble” first came into use. While Greenspan did call for increased regulation of Fannie Mae and Freddie Mac in 2005, and even warned of dire consequences to the financial system if either company faced difficulties, he remained a true believer in the free market.

Until it all blew up last year, unrestrained greed ruled the market throughout the Bush II era and led not only to the sub-prime crisis, but also to the credit freeze, the collapse of consumer confidence, rising unemployment and what is now recognized as a global recession.

What follows is a brief explanation of the timeline which led to the crisis, along with some definitions of terms.

SUBPRIME MORTGAGES

Subprime loans are usually classified as those where the borrower has a credit score below a particular level, e.g. a FICO score below 660. Subprime lending encompasses a variety of credit types, including mortgages, auto loans, and credit cards.

Although most home loans do not fall into this category, subprime mortgages have proliferated since 2001. About 21 percent of all mortgage originations from 2004 through 2006 were subprime, up from 9 percent from 1996 through 2004. Subprime mortgages totaled \$600 billion in 2006, accounting for about one-fifth of the U.S. home loan market.

As with other types of mortgages, various special loan features are available with subprime mortgages. “Hybrid” mortgages, with initial fixed rates that sooner or later convert to adjustable rates, became the loan of choice for most subprime lenders since the 1990s. When those rates began to rise, many homeowners had difficulty meeting their payments and faced foreclosure.

THE CREDIT CRUNCH

Free from oversight and regulation, the leading investment banks and insurance companies sought to increase profits and improve their stock values by figuring out how to securitize (i.e., sell) the large amount of debt they held in mortgages and other debt. They hired theoretical physicists and mathematicians who created extremely complex formulas that enabled the banks to slice and dice the mortgages and other debts and repackage them into financial “instruments” (aka mortgage-backed securities) that could be sold to banks, hedge funds, private equity firms and others.

The financial crisis of 2007–2008 began in July 2007 when a loss of confidence by investors in the value of mortgage-backed securities in the United States resulted in a liquidity crisis (i.e., unavailability of cash) that prompted a substantial injection of capital into financial markets by the U.S. Federal Reserve and the European Central Bank.

In other words, the credit risk of these instruments vastly outweighed their value. In fact, their complexity made it impossible to even measure their worth. The perceived credit risk of the entire economy soared in July 2007, remained volatile and then spiked even higher in September 2008. The crisis deepened as world-wide stock markets crashed. A considerable number of banking, mortgage and insurance companies failed in the following weeks.

The market crashes and institutional failures utterly froze the credit market. Since every capitalist economy runs on credit (all businesses need lines of credit to buy equipment, maintain commerce, meet payrolls, etc.), this led to the frightening scenario of a crash of the entire global economic system. It was this fear that led to the bailout bill.

THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008

Commonly referred to as a bailout of the U.S. financial system, it was a law authorizing the Treasury Secretary to spend up to \$700 billion to purchase distressed assets, especially mortgage-backed securities. Although this wasn't reported in the media or known to many congressmen, it also allowed Treasury to make capital injections into banks. The bailed-out banks could be U.S or foreign banks. In fact, they didn't even have to be banks, if the Fed arbitrarily decided there were exigent circumstances such as in the case of American Express.

Also called the Troubled Assets Relief Plan (TARP), it was intended to purchase bad assets, reduce uncertainty regarding the worth of the remaining assets, and restore confidence in the credit markets.

While Secretary Paulson insisted TARP worked and that it was premature to call it a failure, the fact is that despite the massive infusion of cash, banks did not significantly loosen up credit. In fact, many of the goals that were sought by Congress and promised by Paulson – controls on executive compensation, relief from foreclosures for homeowners, loosening of the credit squeeze – did not occur. In fact, the Treasury Department refused to tell Congress exactly how and where the first \$350 billion was spent.

While certain aspects have worked – the interest banks charge each other has significantly lessened, and the tripwire failure of more and more banks and financial institutions has not occurred – the ultimate goal (to restore confidence in the financial system and prevent a deep recession) has clearly not been met. Also, when Paulson told Congress that he would no longer purchase troubled mortgage based assets from financial institutions, he did serious damage to his credibility.

WHERE WE ARE NOW

The stock markets remain volatile world-wide. November's G-20 summit produced nothing more than a statement in support of joint action by the world's top 20 economies, but they were clearly treading water until President Obama took office.

The potential collapse of America's Big Three auto companies (GM, Ford and Chrysler) led to another call for a rescue package. But Congress, burned by the voters' reaction to the TARP bailout, refused to go along. At President-elect Obama's urging, President Bush released money from TARP to keep the auto companies afloat. Mr. Obama has insisted that any further aid must not be a blank check.

Since his inauguration President Obama has been extremely active. As of this writing, the SCHIP II bill which provides health care to 4 million children and was vetoed by Bush, was passed by the new Congress and signed into law by the President. He also signed the Lily Ledbetter Fair Pay Act, which relaxes the statute of limitations to allow women and others to sue over wage discrimination. He has also issued a number of executive orders, most of them reversing environmental, labor and other orders issued by Bush.

On February 10, Treasury Secretary Geithner revealed the Obama Administration's plan to save the banking system. The sweeping proposal will seek to marshal as much as \$2 Trillion from the Treasury, private industry and the Federal Reserve. The initial reaction was mixed, as the stock market lost almost 400 points (led by crashing bank stocks), while Treasuries rallied and the dollar and gold rose.

There are many unanswered questions about the new version of the bank bailout, including the extent of federal control of the banks, the specifics of new regulations and oversight, and the specifics as to how the government will deal with all the toxic assets which have clogged the banking system and which have led to the ongoing crisis in credit and lending.

ECONOMIC STIMULUS

It is widely accepted that the American economy needs a massive economic stimulus program. President Obama laid out an aggressive stimulus package that included:

Extend unemployment insurance

Aid to state and local governments to bridge budget deficits and save badly needed social service programs.

A large investment in infrastructure that would create jobs and modernize our crumbling bridges, roads, water and sewage systems

An aggressive shift toward green renewable energy production

School construction, weatherization of federal buildings and other education aid.

The House of Representatives took up a massive Economic Stimulus bill in January, which included much of what the President asked for, along with middle class tax relief designed to attract Republican votes. The \$820 billion bill was passed on January 24, but failed to win a single Republican vote.

The challenge in the Senate was more difficult. In order to avoid a Republican filibuster, the Senate bill needed 60 votes to pass. A group of moderate Republicans and Democrats revamped the bill, adding more tax relief and cutting significant spending, including half of the money designed to stabilize state and local government budgets. On Tuesday the Senate passed the modified \$838 billion bill with 3 Republicans joining the majority. The two bills then went to Conference to be reconciled.

As of this writing (Wednesday, February 11) rapid negotiations have apparently resulted in a compromise bill amounting to \$789.5 billion. Here are some highlights:

35% of the total is in the form of tax cuts, including fulfilling President Obama's goal of tax cuts for 95% of Americans.

\$150 billion is for infrastructure spending.

Expanded unemployment benefits, food stamps and health coverage.

State fiscal stabilization is \$44 billion, more than the Senate version but significantly less than the House version.

One-time \$250 payment to millions of social security beneficiaries, SSI recipients, veterans and disabled Americans.

Health care information technology improvements

A “green jobs” package to make buildings more energy-efficient and make the country less dependent on foreign oil.

The bill passed the House and Senate on February 13 and was signed into law by President Obama on Presidents Day.

WHY THIS IS NOT A REPEAT OF THE GREAT DEPRESSION

When the stock market crashed in October, 1929 Herbert Hoover had been in office since March, 1929. He spent his entire term urging the American people to buck up and understand that the markets would correct themselves. By the time FDR defeated Hoover in 1932, the crash-caused recession had become a full-bore Depression.

Our stock market crash occurred in September 2008. Barack Obama was elected in November of 2008 and took office on January 20, 2009. Since his first day President Obama has governed like FDR; the opposite of Hoover. The economy seems to be recovering. Obama is an activist President whose philosophy is to use the power of the Federal government to stimulate the economy and avoid a global depression.

So far it seems to be working.