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The 2007–2010 U.S. financial crisis: Its origins, progressions, and solutions ☆

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ABSTRACT

The 2007–2010 financial crisis was originated from excessive liquidity afforded by low interest rates and active securitization of mortgages and their derivatives. The excess liquidity flowed into the subprime mortgage market until interest rates increased in 2005 and an economic recession followed soon thereafter. The start of a large-scale mortgage market meltdown in 2007 coupled with the 2007–2009 Great Recession caused a severe liquidity freeze. Many financial institutions had to fail and their failures created more uncertainty about the prospect for mortgage market and economic recovery. In an attempt to provide liquidity to the credit market and thus stabilize the economy, various policies were implemented. After revisiting the origins and progressions of the crisis, this paper examines closely three major controversial policy actions: the bankruptcy of Lehman Brothers; the policy reversal from debt purchase to capital purchase under TARP; and the bailout of AIG. After a detailed review of these cases, the paper highlights a few noteworthy solutions to prevent future crises as embedded in the Dodd–Frank Act and then, introduces a few possible solutions for quicker economic recovery that the Dodd–Frank Act overlooked.

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1. An inquiry into the origin of the crisis

The St. Louis Federal Reserve Bank starts its financial crisis timeline[2] with the February 27, 2007 announcement made by the Federal Home Loan Mortgage Corporation (Freddie Mac) that it would no longer buy the subprime mortgages and mortgage-related securities. It then lists sequentially the April 2, 2007 filing of Chapter 11 bankruptcy protection by a then-leading subprime mortgage lender, New Century Financial Corporation, and the June 1, 2007 downgrading of many second-lien subprime mortgage bonds by the Standard and Poor's and Moody's Investor Services. Given the series of events listed by the St. Louis Fed and others, the majority opinion seems to identify the subprime mortgage market of the U.S. as the epicenter of the 2007–2010 U.S. financial crisis.[3] Coupled with the recession that began in December 2007, unexpected

☆ This paper was originally presented at the international conference sponsored by the Athenian Policy Forum, the Deutsche Bundesbank, and the Goethe School of Business, Frankfurt, Germany, on July 29–31, 2010. Since then, many studies on the 2007–2010 financial crisis were published. However, this paper recalibrates, for the benefit of the general public, what caused the crisis, how it progressed and what remedies were implemented for the U.S. economic recovery.

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[1] Associate Professor of Economics. I would like to thank anonymous referees for their comments. All remaining errors are, however, mine.

[2] See http://timeline.stlouisfed.org/index.cfm?p=timeline. Also, French et al. (2010, p. 3) states that the first symptoms of the world financial crisis appeared in the summer of 2007.

[3] There is no uniformly agreed name for the recent financial crisis that occurred since 2007. It is often identified with the Great Recession, the subprime mortgage melt-down, the 2008–2009 financial crisis, etc. However, I wished to call it the 2007–2010 financial crisis because the Great Recession began in 2007, coinciding with the start of housing meltdown, and its impact was still too strong to be ignored in 2010 when the Dodd–Frank Act was passed.

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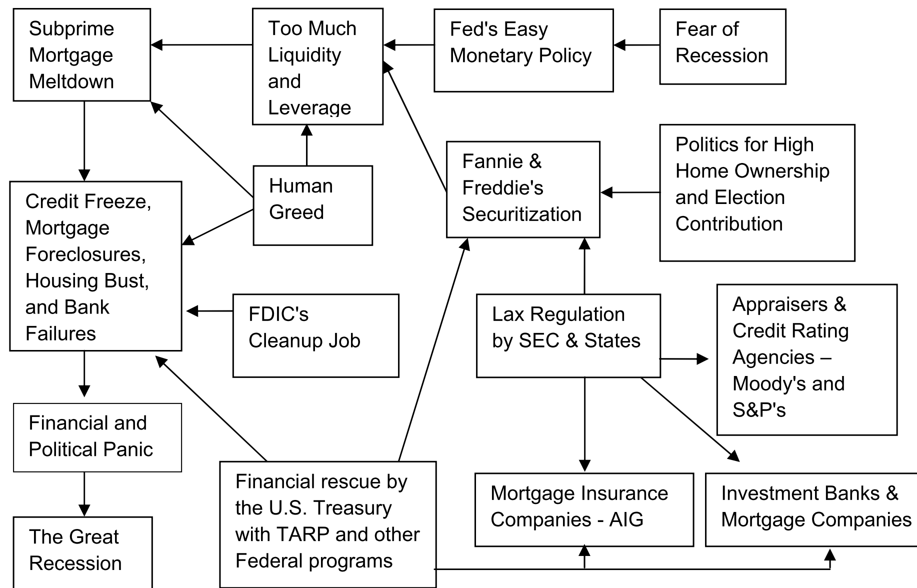

Chart 1. The story of the great recession.

rapid defaults by mortgage borrowers had accelerated the deterioration of mortgage market and consequently, the balance sheet of many financial institutions which lent heavily to the real estate sector. Faced with a large-scale credit crunch and many bank failures thereof, the U.S. government had to step in to rescue financial institutions as well as recession-impacted businesses.

The main reason why the mortgage market became the epicenter of the crisis is due to the excessive liquidity that was available in the real estate market.[4] As shown in Chart 1, the first of the two reasons for the excessive liquidity owes much to the easy monetary policy the Federal Reserve Banking System accommodated between September 2001 and May 2005 when the federal funds rates were kept below 3%. The second reason can be attributed to the securitization afforded by Fannie Mae and Freddie Mac as advocated by Eyzaguirre and Bayoumi (2009).[5] Their eagerness to securitize mortgages no doubt reflected their profit-seeking motivation. More importantly, however, they were eager to meet the implicit demand of politicians who were in favor of affordable housing programs. Rajan (2010, p. 7), for example, lists the U.S. domestic political stresses as one of the many fault lines that created the financial crisis.[6] A modern version of crony capitalism was also present in the form of election fund contributions for an implicit government guarantee for their existence (Choi & Kim, 2009, pp. 103–111). The fuel that sustained and encouraged the growth of securitization was the lax regulation exercised by the Securities and Exchange Commission (SEC). The role played by “animal spirits,” as mentioned by Kaletsky (2010, p. 27), in creating or accelerating a crisis could not be ignored. Coupled with this idea, Kolb (2010) presents the case of a distorted incentive system that propagated the originate-to-distribute model excessively. Wessel (2009, p. 54), however, lists all of these plus many more as sources of blame for bringing about a financial crisis in the U.S.

The inadequate supervision of the credit rating agencies such as Moody’s and Standard and Poor’s gave a wrong stamp of approval to badly packaged securities. Many home appraisers who inflated home values were not properly supervised by state governments., either. The greed-driven no-doc mortgages issued by various mortgage companies such as the Countrywide Financial Corporation and Wachovia were not questioned by the Securities and Exchange Commission (SEC) and various state governments. Mortgage insurance companies such as AIG, MBIA and Ambac Financial Group had issued too many credit default swaps which escaped the regulatory supervision of the SEC and state governments. If the SEC had a better control of the mortgage brokerage and financing companies, mortgage-derivatives insurance companies, investment banks, etc., the severity of the crisis might not have been that widespread and deep.

[4] French et al. (2010, pp. 26–29) lists many contributing factors to the 2007–2010 financial crisis. However, no attempt was made to identify the linkage between excessive liquidity and real estate market melt-down, for example. Also, Walker (2009) makes a strong case that huge U.S. fiscal deficits will burden future generations. However, he does not suggest a direct connection between deficits and the 2007–2010 crisis. One of the best overviews of the crisis origin and progress is found in an Academy Award winning movie, “Inside Job,” directed by Charles H. Ferguson in 2010.

[5] Sorkin (2009, pp. 89–90) mentions the difficulty of understanding a collateralized debt obligation (CDO) by prominent people including Alan Greenspan, the then Chairman of the Federal Reserve Board.

[6] Rajan (2010) further identifies the trade imbalances and a financial system that backs the trade imbalances. He also details additional causes of the financial crisis: Among them, the indebtedness of American consumers to the world as the most fundamental one.

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