



HOUSE OF REPRESENTATIVES I

Credit Crisis

By Marc Steinberg

Introduction

The United States has a large and easily accessible capitalist economy. Although the US and other nations have seen unprecedented economic prosperity under free market systems, America's economy can only function when **credit** flows through the economy freely. Beginning in 2007, a recession has crippled many aspects of the U.S. economy to an extent which has not been seen in years. During the past two years, the US lending channels—which include domestic and international banks that issue loans to groups or individuals—have dried up, as the most accessible means of acquiring credit have quickly frozen. As the economy has floundered, the inability of Americans to acquire the credit necessary for everyday activities threatens to send the country spiraling toward depression.

Capitalist economies function efficiently when money to purchase desired goods and services flows freely between businesses and individuals. Thus, it is necessary for people to be able to acquire the requisite funds for such transactions. The public obtains these funds—often in the form of loans or credit cards—from banks and other financial intermediaries in order to supplement their income. Beginning in the latter half of 2007, however, banks quickly began to stop lending funds to those seeking credit. This dramatic change in banks' lending policies was a result of a number of economic setbacks related to housing prices and the **equity** market, each of which only served to intensify the negative ramifications of later events.

In an emergency effort to stimulate lending, the government has taken several steps to make credit more readily available. In February 2008, the Economic Stimulus Act of 2008 was passed, in order to help stimulate the economy, by providing tax rebates to consumers and businesses, as well as by assisting those who have been forced to default on their mortgages. Later that year, Congress passed the Emergency Economic Stabilization Act of 2008, which greatly intensified the government's role in boosting the economy. Through this act, Congress and the Federal Reserve greatly increased their lending to banks and failing corporations. The Treasury resolved to purchase many of the foreclosed loans, distressed mortgages, and failing assets. The goal of such measures was to rekindle the confidence of American consumers in hopes of resuscitating the floundering stock market and reviving the vital **lending channels**.

The strength of these lending channels must be restored so that

credit—when one party gives a sum of money to another party with an understanding that the receiving party will repay the money at a later date

equity—total value of an asset minus what is owed on that asset

Assets—everything of value that one possesses
lending channels — parties through which individuals may obtain credit. These include foreign banks, American banks, or certain companies that have enough resources to issue these “loans”

American consumers can gain the credit they need to jumpstart the failing economy. Although the composition of American financial institutions will certainly differ from the one before the recession, the underlying principles of free market capitalism must be reestablished. Therefore, it is your responsibility as members of the United States House of Representatives to propose legislation which will make loans once again available in order to save the US from plunging further into economic despair.

Explanation of the Problem

The Rise of Collateralized Debt Obligations and the Ensuing Housing Bubble

The rise of the Internet and the development of other forms of modern technology brought about a period of unprecedented growth to the American economy in the 1990s. However, despite this, the US found itself with a stagnating economy in the first years of the new millennium. After the collapse of the dot-com bubble and the tragedy of 9/11, the interest rate established by the **Federal Reserve** was lowered to 1%. Moreover, the great inflows of money from abroad, which created an excess of readily available capital in the US, helped to drive down interest rates. This extremely low interest rate had two influential effects. First, it became relatively cheap to take out loans because the low interest rates made the burden of payment seem negligible—it seemed that one would need to pay little more than he or she borrowed. As a result, more people were compelled to take out substantial loans. Such large-scale loans made it easy for all Americans to purchase real estate, which led to a boom in the housing market.

Low interest rates also led banks to borrow more funds from the Federal Reserve. Cheap borrowing caused banks to quickly become highly leveraged, which means that they took out money in order to supplement their investments in hopes of higher returns. Banks borrowed **prodigious** sums from the Federal Reserve, and then reinvested these borrowed funds to make larger profits. Successfully leveraged transactions are extremely profitable, because they allow banks to reap a profit on their investments which is significantly larger than the initial sum of money they had in the first place. But, when leveraged transactions take a turn for the worse, the investors stand to lose far more than they originally invested, making it easy for a leveraged investor to rapidly plummet into debt during difficult economic times.

Federal Reserve—*The central bank of the United States. It is responsible for setting monetary policy and ensuring the stability of the US financial system.*

prodigious—*extraordinarily large in size or amount*

Relaxed Lending Standards

In addition to lower interest rates, relaxed lending standards allowed more Americans than ever before to purchase homes and to take

out mortgages. If homeowners defaulted on their mortgages, banks and investors would foreclose their homes and take possession of them. Although banks hoped borrowers would not default on loans, the rising housing prices provided a means of offsetting the costs of lending money with the profits gained from other, responsible borrowers. As such, the practice remained lucrative in spite of the rise in foreclosures.

Stock Market Boom

The vast increases in mortgage and other housing investments led to an unprecedented stock market boom. Indeed, the tremendous increase in housing prices contributed to a significant rise in the **stock market**. As stock prices rose, more Americans chose to invest larger portions of their capital in the stock market in hopes of quickly amassing wealth. But, while this increased the amount of investment in America, it also helped create an artificially high level of stock market values.

stock market—a public market where small pieces of publicly traded companies can be bought and sold

Recent Developments

Collapse of the Housing Market

The rise in home values classically sustained the American economy until the system recently shifted towards a heavy dependency on mortgage-backed **securities**, which are securities that generate interest based on payments on mortgages. As long as housing values continued to increase, both homeowners and lending banks benefited greatly. Homeowners profited, since their net worth increased along with the price of their home. Similarly, as the value of homes rose, homeowners were able to borrow more against the equity of their homes, thereby increasing the amount of credit circulating in the market. Banks also profited insofar as much as homeowners were able to repay their mortgages—and for those who were forced to default on their loans, the banks were able to repossess homes, which continued to rise in value.

securities—an investment instrument—such as a stock or a bank-note—that represents financial value

However, in 2005 and 2006, experts became wary, regarding the rise in housing prices. As more people postulated that home values had been grossly overpriced and that there was a bubble for the past few years, consumer confidence fell, and home prices immediately began to fall. Although there had been regional declines in housing prices for years, this sudden drop marked the first national decline in housing prices. Once housing prices began to fall, a disastrous chain of events was set in motion. Home equity had long served as one of the major lending channels through which homeowners had been procuring credit; homeowners borrowed against the value of their homes and remortgaged their houses frequently to generate credit. However, they were only able to do so as long as their house's value continued to rise.

Therefore, when housing prices dropped and homeowners were no longer able to borrow against their homes, credit began to grow tight.

The Rise of Subprime Defaults

During the rise of mortgage-backed securities and collateralized debt obligations (CDOs), loans were awarded to a range of homeowners, including many who were clearly under-qualified for the type of loan they received. These loans were sliced and packaged according to their safety rating. ‘AAA’ was awarded to the most secure loans, and a ‘sub-prime’ rating was given to the riskier loans—loans that would be given to individuals with bad credit, shaky payment history, or a less secure source of income. Such CDOs were set up so that even if many of the lower end borrowers defaulted, investors would still profit as much as the highly rated loans would compensate. It soon became clear, however, that all borrowers had been overrated. As a result, defaults extended beyond the loans labeled sub-prime—other borrowers who had been thought to have a negligible chance of default were actually much more at risk of defaulting. Thus, the entire foundation of mortgage-backed securities began to crumble. With foreclosures and defaults increasing daily, homeowners soon found themselves in dire economic straits, and were forced to declare bankruptcy and default on the loans they had taken out. As a result, investors who had poured tremendous funds in CDOs were now seeing their assets depreciate astronomically.

Stock Market Collapse

Since such a large number of investors had poured money into mortgage-backed securities, the entire financial system was shaken when many CDOs began to fail due to foreclosures and defaults on loans. Banks lost many of their assets. Furthermore, since most of these banks were highly **leveraged** to begin with, these decreases in the value of their assets irreparably damaged many banks. As Americans witnessed the financial plight of their trusted banks, they began to rapidly withdraw large amounts of money from banks, creating what is known as bank runs.

leverage—*borrowing money to increase investments in the hopes of creating greater profit*

Bank runs and the prodigious decline in the value of their assets crippled the highly leveraged banks. In fact, the stock market experienced one of the worst drops in history, losing an astonishing \$8 trillion during the one-year period between October 2007 and October 2008. This crash meant that millions of Americans lost a great deal of their investments, further intensifying the financial crisis. This drop in asset prices shrunk the financial capital of banks, and thus caused devastating liquidity spirals. As banks sought desperately for liquid assets—assets that are immediately available—they began to sell off whatever equity

they had in order to raise funds. This rapid liquidation of assets drove the prices of stocks and other financial assets even lower. All the while, banks also hoarded whatever funds they still had, which left little room for Americans to receive the loans they needed. Furthermore, the amount of available credit from other sources was decreasing drastically, and fewer Americans were able to procure the loans necessary for any large-scale purchase or investments.

Congressional Action

The Economic Stimulus Act of 2008

On February 13, 2008, President Bush signed a bipartisan stimulus bill that aimed to inject \$152 billion into the American economy through a number of **divergent** means. This bill provided for a number of tax incentives to both businesses and individuals in an attempt to encourage these parties to invest their funds.

Divergent—*differing.*

The Emergency Economic Stabilization Act of 2008

Passed in October 2008, this bill authorized the Treasury to buy roughly \$700 billion of distressed assets—such as mortgage-backed securities which had been defaulted upon—and then allowed for that capital to be injected directly into banks. The Temporary Assets Relief Program (TARP) was also established as part of this legislation; this program made it possible for consumers to purchase assets and equity from financial institutions. This legislation was passed in hopes of rekindling consumer faith in the American financial system, which would prompt Americans to invest in domestic equity. It was hoped that, by temporarily relieving the economic distress of financial intermediaries, banks would become economically stable enough to issue loans to the general public, thereby reopening lending channels.

American Recovery and Reinvestment Act of 2009

Signed into law on February 17, 2009, the American Recovery and Reinvestment Act of 2009 was designed as a means of stimulating the floundering U.S. economy. The stimulus package, as it is more commonly known, called for the government to increase spending on many fronts, including increasing tax breaks and unemployment benefits, as well as increasing spending on education, infrastructure, and energy. Unlike the Economic Stimulus Act of 2008, this bill called for direct government involvement that extended beyond mere tax rebates or investment incentives, to spending directly on American goods and services. The projected cost of this stimulus package is \$787 billion.

Focus of Debate

Conservative View

With very few exceptions, most Conservatives vehemently opposed the stimulus spending plans and government intervention. Conservatives believe in pure free-market capitalism and support the **invisible-hand doctrine**. Conservative disapproval of these plans is bolstered in light of how the economy collapsed in the first place. Indeed, most of the current financial problems stem from early instances of avarice; greedy investors knowingly extended loans to under-qualified individuals and used dubious accounting tactics to make higher profits at the taxpayers' expense. Consequently, many Republicans view government bailouts as rewarding business misconduct. Instead of saving these institutions, conservatives believe that the government should abstain from intervention and allow for the perpetrators of these poor decisions to carry the consequences.

Nevertheless, some Conservatives do support government intervention in certain circumstances. For instance, several Republicans supported the bailout of **Bear Stearns** because it was aimed at reducing aggregate risk and ensuring the survival of the entire financial institution, rather than covering up the organization's bad business practices. Conservatives are not as concerned with the success of mismanaged financial institutions. They instead focus their efforts on honest and law-abiding homeowners who have suffered as a result of these bad business practices. Furthermore, the states which are dominated by Republican party members, such as those in the South and the Midwest, despite being considerably hurt by the housing crisis, have not been damaged as badly as the predominately Democratic states in the Northeast and the West.

Liberal View

The Democratic Party is most concerned with providing the greatest amount of help to both individuals and businesses. Historically, liberals support greater government involvement in the marketplace, and they especially favor government intervention in tough economic times. Consequently, liberals aim to take whatever steps are necessary to pull all Americans out of this economic crisis. They staunchly support government intervention and the federal stimulus plan proposed by President Obama. Liberals strongly support government spending and other public works programs that would improve the general economic climate, as well as provide jobs for millions of Americans.

Liberals favor continuing the short-term stream of money to homeowners in order to help them remedy their mortgage problems.

Invisible Hand—first proposed by economist Adam Smith, the idea that free markets will naturally achieve the most efficient economic solution, as though guided by an invisible hand. A corollary is that the government should not be involved in direct market intervention or action

Bear Stearns—an American Investment Bank. It went bankrupt in 2008 but was kept afloat by the US Government via emergency loans and a special deal that allowed the Bear Stearns to be sold to another prominent investment firm.

Additionally, many liberals support providing more funds to banks and mortgage companies in order to help remedy mortgage problems and to reinvigorate the housing market. Moreover, many Democrats support the idea of using tax money to immediately inject money into the hands of struggling homeowners.

Presidential View

Barak Obama has proclaimed that he wants to help all Americans, even those who have recently fallen victim to the mortgage crisis and suffer from bad credit. His first and foremost goal is to lend immediate help to homeowners who are trying to procure housing and are struggling due to the credit crunch. Obama wants to set up federal initiatives for long-term loans as well as government-funded counseling services for those seeking to purchase a new home. Similarly, Obama recently proposed the development of the Consumer Financial Protection Agency, which would attempt to increase consumer protection, promote transparency on the practices of banks and other lending institutions, and would establish a series of regulations regarding loan-giving agencies.

However, Obama's task is a difficult one. Not only is he faced with the challenge of effectively countering the financial crisis, but he must also balance the heavily divided interests of the public, all while trying to promote other issues on his agenda, such as the healthcare reform. Furthermore, he is also forced to balance policies that would improve the credit market in the short-term with policies that would create a long-term change in the foundation of American financial systems, so that a crisis of this nature does not occur again.

Interest Group Perspectives

The Heritage Foundation

The Heritage Foundation is a conservative **think-tank** with strong ties to the Republican Party. With respect to the recent economic downturn, the Heritage Foundation is vehemently against bailing out those individuals and corporations which acted irresponsibly during the years preceding the recession. Heritage has frequently criticized Fannie Mae and Freddie Mac and, in particular, the government's financial backing of these corporations, as these institutions engaged in the risky purchases of mortgage-backed securities. While the Heritage Foundation is not unopposed to providing incentives and relief to homeowners and to those seeking to procure credit, they are strongly opposed to any efforts which attempt to put more money into the hands of those corporations whose bad practices precipitated the financial recession.

Think tank—an organization that engages in political or public policy research and advocacy

Center for American Progress

The Center for American Progress is liberal public policy research and advocacy group. As a liberal group, CAP is in favor of greater government intervention in the economy, especially during difficult economic times. Consequently, CAP supports government bailouts of failing institutions as well as President Obama's stimulus package. However, CAP's first priority is the interests of American workers and homeowners, so it also supports strong governmental oversight over any bailouts or stimuli to ensure that they actually help average Americans rather than just business and financial firms. Because of its focus on protecting consumers, CAP is also in favor of increased regulation of the financial sector, as well as strong **antitrust laws**.

Antitrust laws—laws that prohibit unfair business practices and anti-competitive behavior (such as monopolies)

Possible Solutions

Reform Financial Systems

It is evident that there are fundamental flaws to recent financial tools such as mortgage-backed securities and collateralized debt obligations. Consequently, one solution is to reform these financial systems. In addition, more stringent requirements could be imposed upon banks and other financial intermediaries. In the past, banks were certainly far too loose in extending lines of credit to individuals, and so one possible solution would be to enforce stricter rules in ensuring whether or not borrowers are qualified from the beginning to undertake such loans. Instituting a more thorough system of checks on a borrower might hold banks to a higher standard.

More Stimuli

Many contend that a federal stimulus is necessary to reinvigorate the economy. Government programs following the Great Depression effectively lowered unemployment while simultaneously performing important tasks, such as improving the country's infrastructure and working on a variety of other public works. Accordingly, one possible solution for the current situation would be to inject more money into the economy by hiring Americans for government projects, or by providing tax relief and stimulus checks. However, it is important to consider that the government is not drawing upon an endless supply of money for this stimulus. Although it may temporarily boost some facet of the economy, one must also be cognizant of how this spending by the government, which already runs an astonishingly high deficit, will affect the country in the long run.

Do Nothing

Many staunch advocates of Adam Smith's concept of the invis-

ble hand contend that the government should not inject money directly into the economy. Instead, it should allow the economy—and the American people—to rectify this situation without intervention. They argue that government interference would only distort the natural order of things, and that, in the long run, the market always works itself out if left alone. These proponents of non-intervention would be opposed to government bail-outs of banks and other large-scale companies who defaulted on their loans, and would not be likely to advocate the government's interference in determining lending policies.

Questions a Bill Should Address

There are a plethora of issues a bill should address with respect to the recent economic downturn, lending practices, and the role of government intervention. Should the government bail out banks and individuals that default on loans, and under what conditions? How much stimulus money should the government provide, and where is this money going to come from? Should there be a limit on how high or low interest rates can go? How should lending standards be reformed to eliminate inefficiency and corruption? Should tighter regulations be applied to the activities taking place on the domestic equity market? How can we prevent such a recession from occurring again in the future? Does the government need to create stricter loan regulations, or is it the government's role to be more hands-off and let the economy move at will?

Conclusions

In the past two years, the United States economy has suffered tremendous setbacks. As the housing **bubble** burst and the stock market collapsed, millions of Americans found themselves without a job or with decreased pay. In this time more than ever, it is essential that individuals are able to withdraw money—in the form of loans and other modes of credit—in order to pay for everyday essentials, as well as for larger projects, including housing, investments in new companies, and more. It is vital that we do not allow the lending channels to dry up, and so we must look for ways to stimulate the economy once again and to develop a strategy to avoid this situation in the future.

Bubble—high volume trade in products as prices that are far above the products' true value. Bubbles inevitably lead to a crash, where prices suddenly drop to true levels.

Guide to Further Research

It is impossible to fully explain the complexities of the US financial system in a single briefing. It is up to you to further research this topic and be prepared to draft thoughtful, constructive bills to strengthen

the American economy in both the short and long term. Here are a few sources to help you start your research:

<http://www.ustreas.gov/economic-plan/>

This is the website of the US Department of the Treasury, an agency responsible for setting America's economic policy. Here you can find information on proposed economic plans, as well as updates on the current state of the economy.

<http://financialservices.house.gov/>

This is the website for the House Financial Services Committee. The committee posts all of its hearings online. The hearings in the committee span a wide variety of topics and include testimony from numerous economic experts.

<http://www.nytimes.com/pages/business/economy/index.html>

This is the link to the New York Times' economics page, which deals with a variety of current economic issues and stories. It may be helpful to browse both current and past stories, as well as articles from other prominent US newspapers, such as *The Washington Post* and *The Wall Street Journal*.

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