



House I

Credit Crisis

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Introduction

Credit can be thought of as the grease on the gears of a modern economy. Without easy access to money, consumers cannot buy the goods that they need, causing the gears to halt and damaging the allocation of goods in the economy. It was this very situation that helped to launch America into a recession. Banks and other lenders lent excessive amounts of money to people who were unlikely to pay that money back. In the case of housing, banks received mortgages (essentially the rights to repayment with interest on a home loan), in return for their loans. They then leveraged these mortgages in the stock market in the form of CDOs. As long as housing prices continued to rise, this remained a lucrative system, but when they stagnated, banks, investors, and consumers all ran into trouble. When the housing bubble burst and borrowers began to default on their debt, creditors lost substantial amounts of money, and their stocks rapidly depreciated in value. As banks began to realize that their assets were losing so much value, they became desperate to hold on to what money they had and began denying loans, or credit, to consumers and other banks who wanted to borrow from them. The channels through which people were previously able to acquire credit to buy certain necessities, most importantly homes, began to dry up, leaving people without easy access to money and sending the economy into a series of downward spirals.

Since the major bank failures of 2008, the government has taken a number of measures to rescue the economy from these dangerous spirals, including the stimulus packages of 2008 and 2009. Taxpayers have spent billions of dollars to bail out failing firms across the country, raising the question as to whether the government has a responsibility to prop up mismanaged and failing companies. As we enter a new year, policymakers are still in the midst of a heated debate surrounding how, or indeed if at all, the government should take steps to ensure that such an economic disaster does not happen again.

Summary of the Problem

A wide range of issues stand in the way of a solution to the credit crisis. Insurance firms like AIG and large banks like Goldman Sachs are essential to the workings of the financial market, but policymakers disagree about whether the government should pledge emergency funds to firms that have failed due to their own incompetence or irresponsibility. In addition, spending too much money on a stimulus package could drive up the national debt and create more long-term problems. As we enter the new year, news of corruption affecting the use of bailout money has further shaken the willingness of some to commit funds to private firms and awakened others to the need for more stringent oversight. Policymakers acknowledge that dire mistakes were made in both the public and private sectors, but they disagree about how much regulation is needed to prevent the risky lending practices that sparked this credit crisis in the first place.

Unemployment Rate Hits 10 Percent

In November of 2009, the unemployment rate in the United States hit a high of 10.2 percent and stayed there through December. A leading cause of hunger in the US, especially during the recession, unemployment is one of the direst issues facing policymakers as they struggle to get the economy back on track. The simple fact is that if people can't find jobs, they can't pay for enough food to keep their families well-nourished. While unemployment is expected to fall in 2010, many starving families can't wait for the economy to come around on its own, even with the help of last year's stimulus package. If policymakers are to confront hunger as both an international and domestic issue, they must ensure, whether through more liberal unemployment aid or the creation of new jobs, that America's unemployment problem is addressed, and soon.

Recent Developments

Wall Street Reform and Consumer Protection Act of 2009 (HR 4173)

In December of 2009, the House passed a financial regulatory bill that many have hailed as the most sweeping set of financial reforms since the New Deal. Awaiting debate in the Senate, the bill's central provision involves the establishment of a Financial Services Oversight Council chaired by the Treasury Secretary and including the heads of several federal financial agencies, including the Federal Reserve. The council would be responsible for monitoring banks and other financial institutions to prevent them from engaging in overly risky financial practices. The council would retain a number of powers, including the ability to enact regulatory measures such as debt-equity caps and, in extreme cases, the power to order firms to restructure or restrict executive pay. It could also back the debts of failing firms in times of crisis. In addition, the Consumer Financial Protection Agency (CFPA) would be created to regulate mortgages, credit cards, and other financial products, ensuring that banks and other lenders remain responsible in their dealings with consumers. Finally, private stock market firms such as hedge funds would be held more responsible to the Securities and Exchange Commission, the federal agency charged with overseeing the stock market.

Response to HR 4173

Though the bill passed 223 to 202, no Republican voted for the bill, and 27 Democrats diverged from their party to vote against it. Opponents of the bill cite the expectedly high costs of implementing its provisions, predicting that the new programs and agencies will lead to higher taxes that will, in turn, hurt the economy. More fundamentally, conservatives are reluctant to establish so many new regulatory agencies with so much power over private financial institutions. Since conservatives are fundamentally weary of government intervention, the regulatory measures of this bill run against their most basic principles. They worry that so much additional regulation will not only prevent the free market from functioning efficiently, but will do undue harm to the profits of banks and other institutions. Finally, conservatives contend that too much regulation in the financial market could constrict access to credit for both banks and everyday consumers in a time when it is most needed. Predictably, banks are vehemently against the measures contained within the bill.

Scandal and the Federal Bailout

A major concern with awarding federal tax dollars to failing firms has been the chal-

lenge of monitoring whether that money is being used honestly and efficiently by its recipients. Although firms that receive federal bailout money under the TARP program are ideally held to high levels of scrutiny, there have been several incidents which have shaken confidence in both corporate and government leadership. One of the most prominent scandals involves the insurance firm AIG (American International Group Inc.) and U.S. Treasury Secretary Timothy Geithner. AIG is a firm that provides insurance to banks in case the people who borrow from those banks default on their debts (a process known as a “credit-default swap”).

After engaging in a series highly of risky financial moves, AIG took a dive in 2008, making the insurance that it provided to banks virtually worthless and totally devastating the financial sector. The US government subsequently provided \$182 billion in bailout money to the firm, promising to repay the insured banks dollar for dollar. Currently under investigation, AIG is accused of providing exorbitant bonuses to its top executives with that money, also hiding essential information from the public about overpayments that put billions into the coffers of major Wall Street firms. U.S. Treasury Secretary Timothy Geithner is accused of telling the firm to withhold details about the latter misstep, causing some to question their confidence in Geithner as Secretary and raising public skepticism toward private firms receiving bailouts. The incident is under ongoing investigation by the Office of the Special Inspector General for the Troubled Asset Relief Program, and both policymaker and taxpayers continue to wonder how much companies can be trusted to use government bailout money responsibly.

Focus of the Debate

Conservative View

Conservatives believe that the government should abstain as much as possible from involvement in the economy, having faith in the “invisible hand” and the ability of market forces and private firms to recover on their own. Consequently, they oppose large bailouts for failing firms and are especially against excessive regulation of the financial market, believing that too many restrictions on banks and other lending institutions could constrict the flow of credit in the economy. They are staunchly opposed to the massive bailout packages passed through Congress during the recovery, believing that such policies only reward the malpractices of CEOs, who should be left to learn from their own mistakes, and do not do enough to help average Americans who cannot get access to credit.

Liberal View

Since Democrats generally trust the government’s ability to solve problems with the market, they favor the distribution of federal financial aid to businesses that need it. Skeptical of the ability of the private market to regulate itself, liberals point to a lack of regulation as a major cause of the credit crisis, advocating for tighter oversight of large financial institutions and banks and stricter rules around borrowing, lending, and holding reserves in case of credit default. They are willing to immediately spend as much as is needed to effect a quick recovery and are far less reluctant than conservatives to raise taxes to do so.

Presidential View

President Obama’s first priority is to aid individuals who are struggling to attain credit for the purchase of homes. He has pushed both stimulus packages through Congress and sup-

ports government bailouts for financial firms. Obama has made continued attempts to establish a bipartisan compromise on economic policy, but intransigence on both sides as well as potential quandaries within his own administration have made moving forward increasingly difficult.

Questions to Consider

Should Congress pass regulations to protect against future financial crises even if they risk lowering the long-term profits of private firms and banks? To what extent can we trust private firms to use only as much tax money as they need to prevent essential banks and institutions from failing? More broadly, is it the responsibility of a government to ensure the success of the financial market, or are we better off leaving the market to its own devices? What can be done to recover as quickly as possible from the current crisis, and how can future crises best be prevented?

Conclusion

The credit crisis facing today's American economy is one that pits some of the fundamental principles of American politics against each other. Debates that have been raging for more than two centuries are at the heart of the credit debate, yet it is a problem which, despite its polarizing nature, may require policymakers to come to an immediate agreement if it is to be solved. It is your responsibility to decide whether the principles of free market economics are compromised by government intervention in the market for credit, and if they are, whether it may be necessary to safeguard the future of Americans' way of life.

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