

## The American Fall

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# The American Fall

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ERDI ANIL KARACA, APR 22 2012

The latest Global Financial Crisis that occurred in August 2007 in the United States (US) is seen as one of the most devastating financial crises since the implementation of the Neo-liberal economic policies. Starting in the summer of 2007, the American Economy and the global market has witnessed the collapse of several financial institutions, bail outs of once wealthy countries, and sharp government responses in order to deal with the global financial crisis. The financial crisis had a Mexican wave effect, starting in the American continent, the financial crisis spread to the European continent and the other parts of the world causing severe economic and political problems. This vast spread was seen as a reason of global financial system which is based on the neo-liberal policies such as freer regulation, and freer capital flow as well as minimum government interventionism. Some believe that the neo-liberal policy is the only option while others declare the end of neo-liberal pro-market policies (Stutchbury, 2009). But was the only reason for this financial crisis the “liquidity problem” that occurred in the American banking system (Simovic, 2009)? Or were there other reasons? Were there any ways to get out of this financial crisis? And how effective were the policy responses? The short term and long term macro-economic policies that the US have applied proved the fact that the policy responses to the financial crisis were not satisfactory in terms of stopping the spread and that stronger policies were needed in order to deal with the current financial crisis. This paper will discuss the late global financial crisis in the US in three parts; the causes of the economic crisis in the US, the short-term policy responses and the macro-economic policy responses. Furthermore, I will argue that the policy responses were not only insufficient to deal with the economic recession but also poor in terms of stopping the spread of the crisis to other economies.

The first issue to discuss is that of the reasons for the occurrence of the late financial crisis. The most notable causes of the global financial crisis were the housing bubble that peaked in early 2006 in the US (Lahart, 2007), subprime lending (Simkovic, 2011) and wrong monetary strategy that the Federal Reserve used starting in early 2001. Hence, the current crisis is not only a production of the housing bubble in the real estate business in the US, but also the loans given to the borrowers with no proper income and the monetary strategy of the US Federal Reserve. Therefore, all of these causes are inter-related and have had significant effect on the continuing global financial crisis.

The first housing bubble effect arose in 1997 and continued up until 2008. As Dean Baker stated, the housing bubble in the US “grew up” along with the stock rise in the 1990s. People started to get wealthy as a result of this rise in the stock market and their “spending was based on this increased wealth” which eventually led to the “consumption boom” (Baker, 2008). Individuals were highly motivated in buying, selling since the essential neo-liberal idea was that the economic growth is accomplished through individuals pursuing their self-interest within freely functioning markets (Stutchbury, 2009). Ultimately individuals started spending their money on houses for investment as it was a profitable alternative to the stock market. Due to this high demand in the real estate market, the housing price went up significantly (Baker, 2008). According to S&P and Case-Shiller, the price of a typical American house rose up to 124% in 2007 (The Economist, 2007). In order to meet the demand in the real estate business, the investors started borrowing money from financial institutions to take part in the real estate business and turn their capitals into profitable investments. The expectation was that the rise in the housing prices would continue and that it would lead “homebuyers to pay far more for homes than they would have otherwise, making the expectations self-fulfilling” (Baker, 2008). However, the bubble was soon burst in late 2008 and the price of an American house declined more than 20% (The Economist, 2008). Since the consumption boom in housing resulted in over-supply, high prices could not be supported any longer. On one hand, the vacancy rates moved from renting to ownership and on the other

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hand, the vacancy rates on house ownership were 50% above its prior peak in 2006. In mid-2007, the prices plummeted and caused a shock drop in the housing market (Baker, 2008). This decline hit house owners, renters and the financial institutions in the real estate business.

Despite this rapid drop in the housing market, the individuals and the financial institutions still expected the housing bubble to continue. Due to the high demand in the housing market, big and medium sized financial institutions started competing with one another in order to gain a bigger share in the real estate market. This brought about the increase in the number of the borrowers with poor credit reports (The Economist, 2007). Therefore, the banks started to put loans into assets that they could sell in order to securitize their loans and reduce the number of more risky loans (Shah, 2010). Moreover, banks borrowed more money from the Federal Reserve to be able to compete. Besides, they borrowed money from other banks in addition to selling their risky loans to them. The banks which bought the risky loans were in more debt which eventually caused bigger problems such as bankruptcy. Collateralised Debt Obligations (CDOs) were also responsible for the spread of the subprime lending crisis for the reason that they hid bad loans (Shah, 2010). For all these mentioned reasons, the banks with high capital accumulation turned to a different direction, for example, buying, selling and trading, while investment banks turned their directions into home loans and mortgages lacking the ability and the capacity to manage them (Shah, 2010). All in all, the median house price rose to a point in which it was higher than the average household salary. For the reason that the borrowers were not able to finance their debt, the financial institutions started collapsing or they were simply bought out by other institutions (Bally and Elliot, 2009).

Along with the housing bubble and subprime lending crisis, the late global financial crisis is also highly affected by the wrong neo-liberal monetary strategy such as lowering interest rates that the Federal Reserve applied before the global financial crisis. According to some researchers, this mistake has contributed to the build-up of the financial crisis (Merrouche and Nier, 2010). Researchers also argue that the neo-liberal monetary policy reduced the cost of the whole sale funding (Adrian and Shin, 2008), caused banks to take more risks including high liquidity risks (Borio and Zhu, 2008) and increased the demand for mortgages which eventually caused house prices to rise (Taylor, 2007). On one hand, many believe that the US Federal Reserve kept the low rate monetary policy for rather long time which was first applied after 2001 in order to deal with the dot-com crisis (Merrouche and Nier, 2010). Others, on the other hand, argue that the rates were particularly low before the financial crisis world-wide (Merrouche and Nier, 2010). However, according to Baker, the reason for the Federal Reserve to continue to cut interest rates was the weakness of the recovery. This weakness of the recovery led the Federal Reserve to cut the federal funds rate to 1% in 2003 which was the lowest rate of a 50 year period in the US economy. This not only caused the low federal funds rate but also the mortgages rate fall to 5.25% in 2003 which was also low for a 50 year period (Baker, 2008). The federal funds rate still kept as low as 2% although many believe this is wrong yet this was again the influence of the neo-liberal policy. These unusually low interest rates both in the federal funds and the mortgages speeded up the housing price and turned into one of the main causes of the late financial crisis.

Seeing the negative effects of the housing bubble, subprime lending and the neo-liberal strategy that the US Federal Reserve followed, the government responded by two short-term policy responses; term auction facility (TAF) and the temporary cash infusion (TCI) in order to deal with the late global financial crisis (Taylor, 2009). The government were involved in these two short term policy responses in the economy and they are believed in prolonging the crisis since they failed to address the main causes of the crisis (Taylor, 2009). The TAF was introduced in order to make it easier for banks to borrow from the Federal Reserve in December 2007. With this short-term response, the US government aimed to accelerate the crediting process for the banks. With this facility banks could avoid going to the discount window and they could ask for funds from the Federal Reserve Board. The main aim of this policy was to stop the spread by increasing the money flow through credit and lower interest borrowing (Taylor, 2009). Banks were reluctant to get credit from the Federal Reserve as they did not want their name in the list of credit seeking institutions. Soon after the TAF agreement, the confidence issue in the economy rose as people realised that the economy was weak (Federal Reserve, 2012). Following the introduction of the TAF, the spread of the economic crisis slowed down for a short amount of time, yet the spread was inevitable and therefore continued to increase. For that reason, economists believe that the TAF was not satisfactory in dealing with the spread of the economic crisis (Taylor, 2009).

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Similar to the TAF, the TCI was also an early policy response to the spread of the crisis, signed under the title of the Economic Stimulus Act of 2008. With this rescue package, the US government sent cash totalling over \$100 Billion to individuals and families in the US in order to lead people to spend more and consequently give a jumpstart to the consumption and the economy (Taylor, 2009). The expectation of the US government was to make people more involved in the economy and create a feeling that the economy was not deteriorating. The package was delivered in the summer of 2008 yet the contribution of it was rather insignificant in the economy. However, the main problem with this policy response was that the rebate of this package was financed thorough borrowing rather than money creating. Therefore, it shared common commodities with the TAF and did not address the underlying causes of the crisis (Taylor, 2009).

Realising that the short term policy responses were not adequate to stop the spread of the crisis, the US government changed their direction from short term policy responses to macro-economic policy responses such as increasing borrowing, reducing interest rates, reducing taxes and government investment on public infrastructure (Shah, 2010). These macroeconomic policies make the core of neo-liberal policies, yet their validity is still questionable.

Although borrowing during the financial crisis is risky, it aimed to be paid back after the recovery of the economy. Having borrowed money from banks or other financial institutions, people were expected to use this money in several ways to be active in the economy. Through this neo-liberal macro-economy policy, the US government aimed to raise the money accumulation and re-gain the confidence of the individuals and investors. However, this created more liquidity problems and was not effective especially as individuals and investors were not eager to borrow at any cost (Shah, 2010).

Another macro-economic policy response that the financial institutions pursued was to reduce interest rates. Reducing interest rates lessened the incentive for individuals and businesses to keep their savings in the banks especially as the banks needed to raise their capital reserves during the crisis (Shah, 2010). The expectation was to encourage individuals to take part in the economy so that the weak economy could gain strength to deal with the recession. The banks and financial institution in the US reduced their interest rates to 2%. However, I believe that this was not sufficient in terms of lessening the incentives for individuals to keep their savings as it motivated people to invest in housing again. Furthermore, countries such as China took an advantage from this macro-economic policies and attracted investors from the US. Wealthy investors realised that the savings they kept in the US banks and were not cost-effective. For this reason they moved their capitals into stronger economies with stronger currencies such as in China where the interest rates were up to 40%. As a result, the Chinese current account surplus reached \$60 billion (Bernanke, 2007).

Along with increasing borrowing and reducing interest rates, the US government also practised tax reduction which is another core policy of macro-economics. Even though individuals and investors favour tax reduction, it is seen as an unsatisfactory policy for the reason that it would cause reduced government revenues during the economic recession. Moreover, government investments on health, education and transportation as well as the investments on superstructure would be at risk. However, the government believes that the high taxes cause hardships for the individuals and the investors during the time of the crisis and therefore low tax would give opportunities to both parties in dealing with the recession. In addition to this, the increased borrowing is supposed to balance the reduction in tax (Shah, 2010).

Regardless of the criticism from several institutions, the US government decided to apply another neo-liberal policy: improving public infrastructure. The main idea underlying this intervention was to employ people in order to reduce the rate of unemployment as well as to help the economy recover. Although it is criticised as the intervention was more than it should have been, the crisis that started in the US economy and spread to other economies proved the fact that even stabilised markets are not always able to function without government interference (Shah, 2010). Therefore, I believe this neo-liberal tool was satisfactory. As Shah also states, this macro-economic policy response was pragmatic and a sensible adaptation of market system as the government could guide development and progress (Shah, 2010).

Although the macro-economic policies make the core of Neoliberal economies both in good and bad periods, the

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functionality of some of these policies are rather sceptical since their results had either little impact or none in dealing with the recession. In their work *Rethinking Macro-economic Policies*, Blanchard, Dell'Ariccia and Mauro (2010) question the ways that the macro-economic policies are conducted. They claim that the regulations such as negligible government intervention and low inflation were not stable in the free market economies. They believe that the late financial crisis would be stopped if there was a government intervention while the prices of assets were rising (Blanchard, Dell'Ariccia and Mauro, 2010). They also state that the policy makers ignored the problems although they knew that the macro-economic policies were failing. In addition to that, they argue "the high inflation and high nominal interests made it possible to cut interest rates", yet they "reduced the drop in the output and deteriorated the fiscal positions" meaning that the macro-economic policies were not functioning properly (Blanchard, Dell'Ariccia and Mauro, 2010). Furthermore, they suggest that depending on the monetary policy as the only tool for economic management was wrong and that regulation and taxation ought to be explored deeper (Blanchard, Dell'Ariccia and Mauro, 2010).

All in all, the late global financial crisis that started in 2007 in the US had devastating financial outcomes. Several financial institutions, banks and companies were bankrupt and millions of people all around the world suffered it, no matter where they are from. The global financial crisis proved that the main cause of the crisis was not only related to the liquidity problem in the American Banking system but it was also related to the short term monetary policies and existing regulations of the Neoliberal market. The global financial crisis also showed that the macro-economic policies and regulations conducted in the free market economy were not steady and that sharp government response was inevitable. As Stiglitz argues it was the neo-liberal economic policies that underlay the global financial system in "favour of free market economy, privatization, liberalization, and independent central banks focusing single-mindedly on inflation" (Stiglitz, 2007). From discussions on the main reasons for the economic crisis, short-term and macro-economic policies, it is clear that government interventions and strong evaluations of neo-liberal economic tools are needed in order to deal with the economic recession and create more stable global economy.

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Date written: 02/2012