Social Studies 30-1
Unit Five: Economic Classical Liberalism
Key Question: How has economic liberalism evolved over time?
Assignment 5.9: Who is Responsible for the Great Recession of 2008?

The Great Recession of 2008 was the worst economic downturn since the Great Depression, spreading a contagion around the world. While the vulnerabilities that created the potential for crisis were years in the making, it was the collapse of the housing bubble—fueled by low interest rates, easy and available credit, scant regulation, and toxic mortgages—that was the spark that ignited a string of events, which led to a full-blown crisis in the fall of 2008.

Trillions of dollars in **risky subprime mortgages** had become embedded throughout the financial system, as **mortgage-related securities** were packaged, repackaged, and sold to investors around the world. When the bubble burst, hundreds of billions of dollars in losses in mortgages and mortgage-related securities shook markets as well as financial institutions that had significant exposures to those mortgages and had borrowed heavily against them. This happened not just in the United States but around the world.

The crisis began to unravel in early 2008, with **Bear Stearns**, a major Wall Street investment bank, being the first high-profile casualty. Bear Stearns had been heavily exposed to subprime mortgage-backed securities, and when confidence in its financial health crumbled, the bank faced a liquidity crisis. The **Federal Reserve** intervened to facilitate a forced sale to **JPMorgan**, signaling the fragility of the financial system and setting the stage for the more significant collapse that was to follow.

The crisis reached seismic proportions in September 2008 with the failure of **Lehman Brothers** and the impending collapse of the insurance giant **American International Group (AIG)**. Panic, fanned by a lack of transparency regarding the balance sheets of major financial institutions, coupled with a tangle of interconnections among institutions perceived to be "too big to fail," caused the credit markets to seize up. Trading ground to a halt. The stock market plummeted. The economy plunged into a deep recession.

The Emergency Economic Stabilization Act of 2008, commonly referred to as a bailout of the U.S. financial system, was enacted in response to the subprime mortgage crisis, authorizing the United States Secretary of the Treasury to spend up to $700 billion to purchase distressed assets, especially mortgage-backed securities, and supply cash directly to banks. In short, Main Street would bailout Wall Street.

NOTES ON THE DOCUMENTARY

So, who was to blame? Highlight those you blame in yellow and annotate why you are placing the blame here.

a. **the government**, for a lack of oversight and regulation.

b. **consumers**, for reckless borrowing and recklessly taking on debt and defaulted at historically high rates. U.S. consumers overspent and under saved, while simultaneously accumulating large personal debts. They purchased homes they couldn't pay for with mortgages they couldn't afford.

c. **financial institutions**, for **predatory lending** and unscrupulous bundling and selling of mortgage-backed securities, creating trillions of dollars in risky mortgages and they packaged, repackaged, and sold those loans to investors around the world.

d. **The Federal Reserve** because it created the conditions for a housing bubble that led to the economic downturn and because it was instrumental in perpetuating the crisis by not doing enough to stop it.

e. **Alan Greenspan**, the Federal Reserve chairman — an economist and a disciple of **libertarian icon Ayn Rand** —presided over a long economic and financial-market boom and attained the status of Washington's resident wizard, but the super-low interest rates he brought in the early 2000s and his long-standing disdain for regulation are now held up as leading causes of the mortgage crisis. The maestro admitted in an October congressional hearing that he had "made a mistake in presuming" that financial firms could regulate themselves.

f. **Bill Clinton**, his presidential tenure was characterized by economic prosperity and financial deregulation, which in many ways set the stage for the excesses of recent years. Among his biggest strokes of free-wheeling capitalism was the Gramm-Leach-Bliley Act, which **repealed the Glass-Steagall Act**, a cornerstone of Depression-era regulation. The Glass-Steagall Act separated the powers of commercial and investment banking, which ensured that banks would not take too much risk with depositors' money. After the repeal of Glass-Steagall, greed won out over prudence and banks took too much risk with their depositors' money. He also signed the Commodity Futures Modernization Act, which exempted credit-default swaps from regulation. In 1995 Clinton loosened housing rules by rewriting the Community Reinvestment Act, which put added pressure on banks to lend in low-income neighborhoods.

g. **George W. Bush**, embraced a governing philosophy of deregulation, which trickled down to federal oversight agencies, which in turn eased off on banks and mortgage brokers. Bush did push early on for tighter controls over Fannie Mae and Freddie Mac, but he failed to move Congress. Also saw unsustainable budget deficits and massive trade deficits, all requiring huge funding. Bush lowered taxes and waged wars without cutting spending or raising revenues.

h. **Greedy bankers**, for taking huge, reckless risks in pursuit of quick profits and massive bonuses. Wall Street banks did not practice financial ethics. Instead of practicing prudence with depositors' money, the large banks bet against its customers using **risky credit default swaps** during the subprime housing mortgage crisis in order to chase short-term profitability. Short-term profitability should not be the goal of any firm in a capitalist society.

Canada and the Great Recession

Although Canada was hit by the worldwide recession, the Canadian financial system weathered the global financial crisis comparatively well. Canadian financial institutions were not unscathed by the crisis, but none were excessively affected by toxic assets, no public funds were injected into financial institutions, Canadian banks remained profitable and they continued to lend.

The sharp contrast between the Canadian experience and how negatively the financial crisis affected the United States, and much of Europe, reflects different regulatory regimes, as well as different corporate governance systems, financial institution lending practices and different structures. Interestingly, in the halcyon years before the financial crisis, Canadian practices were often criticized in New York and London as being too conservative, too **prudent** and too unwelcoming of the new financial innovations that were sweeping global balance sheets.

A key asset class that fuelled the global financial crisis was subprime mortgages. The vast majority of Canadians mortgages are originated by banks to be held, thereby providing a "front-line" incentive <u>not to lend where there is a high risk of default</u>; unlike the U.S., where the majority originated to be sold. In Canada, this is further buttressed by government regulations that require insurance for high-ratio mortgages and higher credit standards on the eligibility for mortgage insurance.

The financial crisis provides the impetus to learn from what went wrong, and to introduce reforms that will make such crises less likely and less traumatic in the future. It will be important to learn these lessons well.

Excerpts from *Prudent, perhaps, but the Canadian model pays off*
by KEVIN LYNCH Special to The Globe and Mail
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My List of How to Avoid Another Great Recession