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Class

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Analysis of the 2007-2008 Financial Crisis

The decade of the 90s was one of surprising prosperity. It saw the good years of the housing bubble, the dot com bubble, and the emergence of an increasingly strong technology sector. This era of plenty led many to believe that their good fortune would last forever. However, anyone who chose to pay closer attention would have caught the early warning signs that there was a bubble and that it would burst. Unlike other bubbles however, the bursting of the housing bubble would have far more serious consequences for the national (and global) economy. Millions lost their homes, their jobs, their life savings, their retirements, and more. They were plunged into crippling debt and then forced to pay for bailouts for those same banks who lost their money. It was a difficult time and one from which we still have not fully recovered. It was the worst recession in American history since the Great Depression. Unlike the Great Depression, however, we got no New Deal afterward. In fact, the government did surprisingly little in the way of policy change and regulation to help prevent this same kind of financial crisis from happening again. Despite sufficient evidence to suggest fraudulent activity (at least enough to warrant going trial), only one person would be put in jail for a crisis which destroyed millions of people's lives and cost the tax payers billions of dollars. Perhaps this is because the factors that caused the 2007-2008 financial crisis were not as clear or easily understood. In order to understand what kind of reform is needed, one must first understand what caused the crisis and what the consequences were. The films *The Big Short* and *Too Big to Fail* help us to better understand the causes and consequences of the 2007-2008 financial crisis.

The easiest aspect of the recent financial crisis to understand are the effects that it had on people and the economy. This is because these effects are clearly visible while the causes have been purposefully obscured. In the film *The Big Short*, some key statistics are provided to show the full gravity of the crisis. Unemployment rose above 10% after eight million people lost their jobs. On top of that, six million people were forced out of their homes which increased the rate of homelessness. At the financial level, approximately five trillion dollars total disappeared from people's pensions, 401ks, bonds, savings, and the value of their real estate (The Big Short 2015). In addition to the numbers, the film humanizes the crisis by showing examples of the real people and the real effects this had on their lives. The audience sees a family renting a home from a landlord who could not pay the mortgage get kicked out of their house. We see the many mid- to low level employees at Lehman Brothers emotionally distraught and angrily leaving the building after losing their jobs. Overall the film helps to show the reality of the crisis rather than reducing it to a bunch of numbers. However, the numbers alone are also staggering.

Understanding what exactly could cause such a massive crisis with such widespread impact is difficult. *The Big Short* does an excellent job of breaking down the complex and purposely confusing deals and tricks that were being used. In short, the banks found that mortgage bonds was a very lucrative business as real estate value increased in the 90s. They would sell mortgage bonds and get a 2% return on each mortgage sold. However, they soon began to run out of mortgages so they started to give out more subprime adjustable rate mortgages. These subprime loans were targeted at low-income families who were drawn in by the low initial payments and often did not know or did not understand that their payments could double or even triple once the adjustable rates kicked in. The majority of these adjustable rates would not kick in until 2007, however, so there was a honeymoon period in which millions of people were buying homes they could not afford using these subprime loans. The banks would bundle these subprime loans into mortgage bonds and sell them. In the film, we see how a few people begin to realize that these mortgage bonds are not nearly as secure as they seem so they approach the bank to buy credit default swaps which are essentially a way of betting against the mortgage bond so that one can profit immensely when people begin to default on their loans. At first, banks thought this was ridiculous since mortgage bonds were considered some of the safest investments. Soon, however, selling these swaps became bigger business than selling the mortgage bonds which were quickly becoming worthless. The banks sold their worthless mortgage bonds to unsuspecting buyers and began to buy up as many credit default swaps as they could. By 2007, millions of people began to default on their loans. Yet the credit ratings of the mortgage bonds were being artificially propped up by false ratings that the banks bought from the rating agencies. By 2008, most had sold their swaps to the banks and pocketed the cash. One by one, the biggest banks were going bankrupt. In response, the government decided to offer bailouts. *Too Big to Fail* focuses more on the aftermath and the government's response to the crisis, namely the bailouts. The bailouts were sold to the American people as a necessary measure to preserve the American economy. The film also highlights the key reason the bailouts were not very effective. During the long negotiations with the CEOs of the top banks, we see the treasure secretary struggling to impose regulations and restrictions as conditions for receiving the bailouts. By the end, he admits that he imposed far less restrictions than he would have liked because he was afraid if he established too many regulations, they would not take the bailout money. As a result, there were some regulations about how the money was spent and how the banks should do business but it was not nearly enough to cause lasting change.

Both *Too Big to Fail* and *The Big Short* end with a hint of a potential crisis in the future. These hints about the danger of a repeat financial crisis in the future point to the serious need for meaningful economic policy reform in the United States. Without proper regulation, capitalism is unable to function properly. This is because, as a “profit and loss system”, it needs to experience both the profits and losses in order to correct itself (Friedman in Gambling with Other People’s Money 4). With things like bailouts, the losses are absorbed by the taxpayers, leaving the banks protected from the consequences of their risky behavior. As a result of this ineffective policy, the system becomes distorted in the sense that the amount of “reckless and imprudent risk taking” behavior increases to unsustainable levels (Gambling with Other People’s Money 4).

This is why effective policy is so important. Some possible reforms could be to put caps on executive pay to prevent their greed from weakening the financial foundations of their bank and the economy. Better loan regulations are also needed. For example, placing strict interest rate caps could help eliminate outlandish interest rates that make otherwise affordable payments completely unmanageable. Predatory loan tactics, such as targeting immigrant families as the mortgage brokers in *The Big Short* describe, should also be more effectively criminalized and punished. It could also be beneficial to establish transparent government programs to help increase home ownership rather than subsidizing private banks (Gambling with Other People’s Money 20). Furthermore, getting loans should be made more difficult. People with no verifiable income or who clearly do not have the means to pay should not get such large loans and those who do qualify should be given clear and easily understandable details about the terms of their loan agreement. With reforms like these, we could better prevent the possibility of a second disastrous financial crisis.

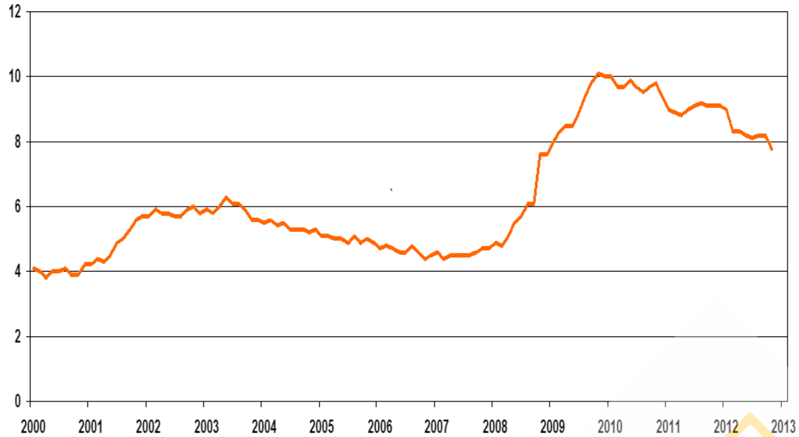
Works Cited

Gambling with Other People's Money. N.d.

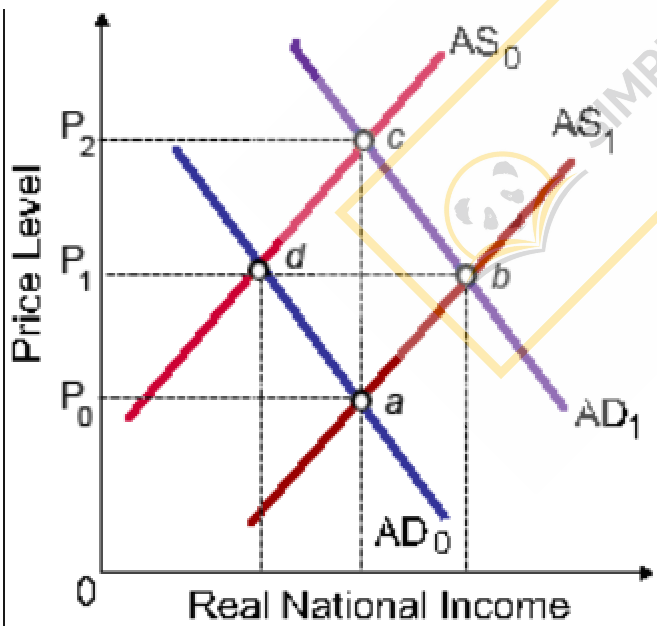
The Big Short. Dir. Adam McKay. 2015. DVD.

Too Big to Fail. Dir. Curtis Hanson. 2011. DVD.

Appendix- Graphs



United States Unemployment Rate (in %) from 2000 to 2013



AS/AD Graph of Recessionary Price Levels and Income