

America's Financial Crisis: The End of an Era

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Fundamental determinants of America's financial crisis

- The enormous growth of the subprime mortgage market
- The lack of regulation and prudent lending procedures
- The complexity of mortgage-backed securities led to failure of both regulators and purchasers to adequately assess the risks associated with these assets
- Low level of interests led to an environment conducive to the housing markets bubbles.

The financial panic of 2008

- The housing price bubble burst in mid-2006 and both housing prices and housing starts began a long period of contraction.
- With declining home prices, borrowers were unable to refinance their loans and default rates soared.
- Problems in mortgages and mortgage-backed securities festered for over two years before exploding into a full-blown financial panic in September 2008.

Three major events

- The government takeover of Fannie Mae and Freddie Mac on 8 September
- The Lehman brothers bankruptcy on 15 September
- The Federal Reserve's bailout of AIG on 16 September
- Firms were unable to refinance their debt because of increasing investor uncertainty.

The Policy Responses

- Monetary policy
- The Fed began easing interest rates in September 2007
- By the end of 2008. the federal funds rate had been effectively reduced to zero.

Unconventional monetary policy

- The Fed began to expand its operations into non-traditional areas to directly supply credit to financial markets
- The balance sheet of the Fed swell from \$900 billion in August 2008 to more than \$2trillion by March 2009.
- The government also guaranteed the new debt of commercial banks.

Fiscal policy

- Congress passed an economic stimulus program in February 2009, calling for a combination of tax cuts and expenditure increases to \$767 billion.
- The measures were spread over several years, with 40 percent spent in 2009.
- These measures were temporary and had modest effects on the long-term budget situation.

Expansionary fiscal policy

- Stimulus effects of temporary tax measures are small.
- Spending of low- income and credit-constrained households responded strongly to tax rebate.
- The Obama administration proposed to push the long-term deficit to \$1trillion per year (6 percent of GDP).
- Expenditures are projected to rise up to 24 percent of GDP and revenues decline to 18 percent of GDP (due to tax cut extension).

Financial reconstruction

- An accurate assessment of the losses in individual financial institutions, followed by
- A process of writing off the losses against equity capital and

Financial reconstruction

- Moving the non-performing assets to a separate asset management corporation, which would subsequently sell off these assets over a sustained time-period.
- The affected financial institutions must be either closed or recapitalized so that there is no continuing uncertainty about the financial conditions.

A more competitive system is needed

- The declines in asset values have overshoot as the result of the panic and the passage of time will resolve many of the solvency problems.
- Increased regulations as a solution to the problems can restrict competition and increase Wall street firms' rents that can influence the government policy.
- Attention should be given to revising the concentration of economic power in the hands of large financial institutions.

Future monetary policy

- The earlier emphasis on narrow policy rules, such as inflation targeting, appears to blind policymakers to a wider range of concerns such as asset market bubbles and excessive risk taking.
- The broadening agenda of monetary policy implies a more powerful and discretionary role of monetary authorities which will heighten concerns about accountability.