The Financial Crisis and the Unraveling of the U.S. Economy
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The national economic crisis has begun to hit home for millions of Americans. Many homes are now worth less than what the owners paid for them. Construction workers suddenly can't find work. The value of 401(k)s have drastically fallen, and more employers threaten elimination of defined benefit pensions because of stock market losses. People face a very different retirement than they'd planned - if they're able to retire at all. How many layoffs are coming? How did we get in this mess? Who is responsible? And what will happen now?

This global economic crisis is the worst since the Great Depression. Many causes are interwoven, including thirty years of deregulation, the decline of manufacturing and the growth of financial services as the dominant segment of the U.S. economy. But many of the seeds of the crisis were planted early in the Bush administration.

ORIGINS OF THE CRISIS

After the collapse of the dot-com stock bubble in 2001, Wall Street looked for the next speculative market where quick and easy profits could be made. Investors sought to make up for a few years of brutal losses with a new high-return bonanza. The Federal Reserve under Alan Greenspan, whom many blame for the crisis, cut interest rates from 6.5 percent to 1 percent, keeping them at this historically low level for over a year. In addition, countries with whom he U.S. had large trade deficits, such as China, Japan, and oil-producing countries, had huge dollar surpluses they needed to pump back into the U.S. economy to maintain demand for foreign-made goods.

All these factors came together to make mortgages far cheaper, beginning in 2001, than they had been historically. Rates on 30-year mortgages fell from 8 percent to 5.5 percent, and the one-year rate on adjustable-rate mortgages fell from 7 percent to 4 percent. As the interest on mortgages dropped, it appeared people could loans with larger principal. Since buyers could afford more expensive houses, many did so, causing rapid increases in housing prices in many parts of the counrny. This was the start of the housing bubble.

The boom seemed initially to be a time of good fortune. Construction of new homes at the peak, 2005, was over double what it was in the early 1990s. This led to tremendous growth of construction employment. Workers facing stagnant wages refinanced their mortgages or took out home equity loans to get cash. At the peak of this practice in 2005, homeowners withdrew $750 billion worth of cash from the value of their homes, using the money for consumer spending, home improvements, credit card bills and for medical expenses and college tuition. Many workers previously unable to purchase a home were able to get mortgages.

But the devil was in the details. Twenty percent of these loans, over twice as many as in 1999, were "subprime," high-risk loans. Many, but not all subprime borrowers had bad credit history. Some loans were "interest only," at least for the first five to ten years. Others had adjustable interest rates, with an initial "teaser rate" (similar to many credit card introductory offers) which, would later skyrocket. Others were called stated income loans, popularly known as " liar's loans." These only required the applicant to write down their income on a piece of paper, without producing a W-2s or other documents. Unscrupulous lenders and mortgage brokers encouraged buyers to take loans they might not be able to afford, and failed to disclose the risks involved. Instead, they assured buyers that, with housing values all headed upward, they'd easily be able to refinance or sell the house before the adjustable rate ratcheted up. We'll examine below why the banks allowed these types of loans to proliferate.

In the short term these options didn't look bad - particularly if you believed that housing prices would continue to rise indefinitely. Rather than trying to regulate or stop these dangerous practices, Alan Greenspan gave the subprime market his seal of approval. Investors, even middle class individuals, bought houses to flip and sell for a profit. Some of the bubbliest markets, such as Miami and Las Vegas, saw an increase in real estate values of 80 percent or more. Condos were flipped dozens of times before ground was even broken for their construction!

THE BUBBLE BURSTS

Like all speculative bubbles, the housing bubble eventually burst. In many cities, overbuilding created too many homes for the available pool of buyers. Prices began to fall, and they still have not reached bottom. Adjustable rate mortgages and interest-only mortgages began to reset, and many new homeowners found themselves unable to meet their monthly payments.

A vicious cycle started. More foreclosures meant more vacant houses on the market. More unsold homes further depressed the selling price of homes. As home prices tumbled, for some homeowners the best option was simply to walk away from a house on which they owed more its current market value. By March 2008, one out of ten homeowners owed more on their house than it was worth.
The collapse of the subprime mortgage market also had real effects on the nation's economy. The homebuilding industry contracted dramatically. The subprime mortgage origination industry, which employed hundreds of thousands, essentially folded in March 2007, with 25 different companies either going bankrupt or sold at fire sale prices to larger financial institutions. But as bad as the bursting of the housing bubble was, it was not the immediate cause of the economic crisis which is engulfing the world. For that, we have to look up even farther - to the now fallen financial titans which recently loomed over the world economy.

THE CRISIS TRICKLES UPWARD

Historically, when you took out a mortgage, your bank held it and collected the payments from you. If you defaulted, this was a loss to the same bank that had loaned you the money, which is why banks were stringent in judging the credit-worthiness of potential home buyers. Your bank would then use your mortgage, along with the mortgages of others in your community, as capital to make loans to other homeowners and small businesses.

Starting in the 1970s, the financial industry introduced a concept called "securitization" of mortgages. Instead of merely holding the loan, the originating company could chop the mortgage up into small pieces, blend those pieces with chunks of other mortgages of similar risk, and offer shares as an investment to third parties such as hedge funds, pensions, and other banks. The risk was thus spread widely among many investors - spread so widely that, in many cases, it became impossible to determine who had the right to foreclose on a particular house if the owner went into default.

Securitization became widespread during the 1990s, especially with subprime mortgages, which were turned into investments with higher rates of return to compensate for their greater risk. Despite the risky nature of these securities (especially those whose ingredients were high-risk subprime mortgages), the credit rating agencies usually gave them AAA ratings - in other words, they considered them as safe rather than risky investments.

The perverse incentives under this system meant that at the height of the bubble, many in the industry had an interest in pushing as many people as possible into subprime mortgages. Many home buyers who qualified for regular ("prime") mortgages were deceived into talking subprime loans. Mortgage originators made their money not by collecting monthly payments, but by selling new mortgages to investors. Investors made more money on subprime securities than regular ones. While there was a dramatic growth in demand for home ownership, this was outweighed by corporate demand to expand this new, high-return type of mortgage debt.

But when large numbers of homeowners began to default on their mortgages, trouble started arose for the nation's leading financial institutions. In 2006, there was $6.1 trillion tied to mortgage-backed securities – a substantial proportion of it subprime. The subprime assets now had an unknown value. The assets clearly were totally worthless, as not every homeowner with a subprime will default, but do one wanted to buy them for even fraction of their price tags. This forced the financial companies to "write down" billions of dollars in assets, as essentially worthies! Companies which formerly had enough assets to cover their debts now found themselves owing tens, even hundreds billions of dollars more than they could cover. They became increasingly dependent upon financing to survive, but financing was harder to come by, both due to the dramatic fall in the credit ratings of these formerly gilded financial titans, and bank becoming terrified to loan to each other. Suddenly, no banks trusted any other bank.

There have been a cavalcade of failures of large financial companies over the past year: Bear Stems, IndyMac, Countrywide Financial, Merrill Lynch, AIG, Lehman Brothers, Washington Mutual, Wachovia, Sovereign Bank, and National City, to name only some of the biggest. Only a handful of these companies have been allowed to go bankrupt, but without help, all of them would have. The federal government intervened to arrange "fire sales" at pennies on the dollar, compared to these companies worth just a short time earlier. But case-by-case rescues turned out to be not enough.

THE FEDS TO THE RESCUE?

By September, it became clear that if nothing was done, the financial crisis could drag the already-slowing U.S. economy into full-scale depression. There were several nightmare scenarios. One was a market panic, where investors lose faith in stocks or depositors lose faith in banks, causing a selling frenzy which destroys healthy companies. Most frightening, however, were signs the credit crunch was becoming so severe that businesses were unable to get needed commercial credit to make payroll. For many businesses, this would mean layoff or even closing up shop, even if they had good credit ratings and were profitable. This would trigger a massive spike in unemployment, along with a wave of bankruptcies of non-financial companies.

The Bush administration began hatching a plan to rescue the financial industry. Bush himself was notably absent from these proceedings, other than giving a few speeches whose only effect was to drive the stock market lower. Instead Treasury Secretary Henry Paulson took the public lead. Paulson's initial proposal was typically Bushian - a $700 billion bailout of the financial industry using taxpayer money. For these billions, the US government would purchase from the big financial institutions their now toxic mortgage-based securities. The government might someday get back some of the money if the assets regained value, but in the short term the bankers were getting money for nothing. The hope was that this would thaw the freeze in the credit markets. Paulson's initial plan had no mechanism
for to review his decisions, no oversight by Congress or anyone else, and no transparency.

Democrats in Congress were not opposed to a bailout but were not about to give the lame duck Bush administration $700 billion blank check. Democratic leaders in the House and the Senate wanted greater oversight, limits on executive pay, and government equity in the rescued companies. In effect this would be partial nationalization of the banks, in the hopes that once they return to profitability they could be sold and taxpayers might at least break even. Sweden used a similar nationalization of its banks in 1992 to successfully recover from its own financial crisis.

Paulson compromised with the Democrats on virtually every issue - perhaps the Bush administration’s first meaningful compromise with congressional Democrats in eight years. The "bailout" which eventually passed Congress was closer to the proposal by Sen. Chris Dodd (D-CT) than to the original Paulson Plan. Oversight, transparency, and judicial review were added to the bill. Only the first $250 billion was immediately disbursed to the Secretary, with the last $350 billion only available if Congress allows it. No company from which the Treasury purchases assets can offer its executives golden parachutes. FDIC insurance on bank deposits was increased from $100,000 to $250,000. Most importantly, the plan allowed for a bailout option – and Paulson has since indicated he intends to use the first $250 billion to purchase shares in the rescued banks and companies.

WHAT NOW?

The plan passed by Congress and signed by President Bush was far from perfect. It lacked a mechanism to change the terms of a subprime mortgage without the consent of all companies holding part of that mortgage, and the stock received by the federal government in exchange for had assets is non-voting stock. Credit markets seem to have loosened slightly, but the damage has been done to consumer and investor confidence. Consumer spending fell 3.1 percent in the third quarter, with overall GDP down 0.3 percent. If the economy contracts in the final three months of this year, which now looks all but certain, the economy will officially be in recession by the start of the new year.

It is hard to predict how exactly this recession will unfold. In July, oil was at its highest price ever, $147 per barrel, and many predicted that some overseas manufacturing would return to the U.S. because of high shipping costs. Oil is now less than half of that price, $65.50 a barrel, because of decreased global demand and less speculation on oil prices. Inflation, which had increased by 6.2 percent from July 2007 to July 2008, fell in August and September. While a couple of months ago some were predicting 1970s style stagflation in the U.S. (stagnation plus inflation), it seems likely now we could have a deflationary spiral (falling prices) like what Japan experienced in the '90s.

The crisis is global. When the first U.S. banks failed, many in Europe and elsewhere saw the beginning of the end of American financial dominance. But in a world of interlinked global finance, European banks were heavily invested in U.S. mortgage markets, and some countries such as the UK had their own real estate bubbles. This crisis forced Iceland to nationalize all of its banks, and it now has a higher inflation rate than any country but Zimbabwe and may face depression. The European Union adopted a common policy towards the banking crisis, including partial nationalization of banks, after piecemeal responses by individual countries risked the flight of capital to whichever nation provided the highest deposit guarantee. Pakistan is close to default and may need a $100 billion loan from the International Monetary Fund. Even China and India may see slowdowns due to the drop in world demand.

As frightening as the global economic crisis is, it is, it is also a moment of opportunity for a new direction in U.S. economic policy. Paul Krugman, recent winner of the Nobel Prize for economics, wrote, "There are no atheists in foxholes, and there are libertarians in an economic crisis." The neoliberal agenda – to privatize, deregulate, and let the market look after itself – has been thoroughly discredited. The former financial titans, who held great sway over U.S. economic policy only months ago, have been reduced to begging for government handouts. The economic disruption of the Great Depression, as awful as it was, paved the way for a new paradigm in U.S. government (policy) – that government should play an active role in helping working people not only stay afloat, but to achieve some measure of economic justice. It is time again to call on the government to take bold steps to undo the damage of the disastrous Bush years and decades of deregulation. We may be surprised at just how much change is now possible.

REBUILD THE ECONOMY, PUTTING PEOPLE FIRST

The economic crisis and the overwhelming mandate for change on November 4 present both the necessity and the opportunity for an economic reconstruction program that will put the needs of the people first. Here are some steps the government could take to begin to turn things around:

A massive works program to put people to work and rebuild our country's infrastructure. The collapse of New Orleans' levees in 2005 and the 1-35 bridge in Minneapolis in 2007 showed that much of our basic infrastructure is in terrible condition due to long-term neglect. Much of it was built in the 1930s through the New Deal's Work Progress Administration - as part of President Franklin Roosevelt's program to end the Great Depression. Seven decades later, we desperately need a similar federal commitment to
rebuild our water systems, sewers, roads, bridges, and levees.

Federal commitment to green energy for energy independence. Alternate energy sources and energy conservation must be part of an infrastructure reconstruction program. This includes wind, solar and hydro power, rebuilding the railroads – including passenger rail service – and mass transit. A major commitment to these technologies will mean jobs as well as reduction of global warming.

Put the financial system to work for the people. The Bush administration has done something no one would ever expect from an ultraconservative Republican administration - they've partly nationalized the financial industry. Their motive was simply to use the public money to rescue financiers - from the consequences of their own grossly irresponsible behavior. But instead of bailing out reckless bankers, why not adopt the goal of placing the resources of the banks and financial corporations at the service of the people? With democratic control, the government could redirect these vast financial resources into investments in rebuilding our communities, industries, education and healthcare.

Stop foreclosures. Throwing people out of their homes leaves more abandoned homes on the market and further drives down all house values in the community. Home values will not begin to rebound until the glut of vacant houses starts to decline. If people are unable to pay their current mortgages, the terms need to be renegotiated, or they can be allowed to pay rent, and perhaps buy the house later when things improve.

Reverse the decline of wages and unions. Workers’ real wages have fallen for decades. The decline of wages and of unions weakens our economy and has forced more people into debt. The new administration and Congress should raise the minimum wage to $12 and index it to inflation. We need passage of the Employee Free Choice Act, to make it easier for workers to organize unions. The new president needs to appoint people to the National Labor Relations Board who will follow its mandate to promote unionization, instead of inventing reasons to prevent workers from organizing. And both the federal government and some of the states need to lift their restrictions that ban some public employees from bargaining.

Create a national healthcare plan. Half of all foreclosures were caused at least in part by unaffordable medical bills. A single-payer national healthcare system would be a huge boost to the economy by removing a major cost to both families and employers-the cost of supporting the bloated for-profit health insurance industry.

Create a national retirement system. The Wall Street crash has not only wrecked people's 401 (k) accounts. It's added more reasons for employers to try to dump the remaining defined benefit pension plans. Unless we want to see millions of people forced to work far into their old age, the government needs to establish a true national pension system, either by expanding or supplementing Social Security.

Overhaul trade policies to protect jobs. "Free trade" has proven to be a national disaster. It's really been about encouraging the mobility of capital, which means the export of jobs. We need trade, investment and tax policies that bring back jobs, keep the industries we have, and strengthen workers' rights everywhere.

End the war and change our foreign policy. We need the new administration to not only get us out of Iraq, but to turn our foreign policy away from militaristic efforts to dominate other countries. This would enable major reordering of budget priorities toward domestic needs, such as education and infrastructure.