

The US Financial Crisis of the Late 2000s

On September 15, 2008, one of the biggest investment banks in the United States, Lehman Brothers, declared bankruptcy, Merrill Lynch was forced to sell itself, and the world's largest insurance company, AIG, collapsed. This triggered a global financial crisis and the single largest stock market point drop in history. The global recession that ensued cost the world trillions of dollars, forced 30 million people into unemployment, and doubled the US national debt. There exists a pattern demonstrated by historical events in the financial sector that led up to and directly caused the financial crisis.

After the great depression, the US experienced 40 years of economic growth without any financial crises at all. The financial sector was tightly and carefully regulated, and most normal banks were local businesses and weren't allowed to speculate with depositors' savings. Investment banks were small private partnerships which handled stock & bond trading; partners put up all of the money and watched it very carefully, engaging in almost no risk taking whatsoever.

In the 1980s, the financial industry expanded dramatically. Investment banks went public, receiving enormous sums of stockholder money, and people on Wall Street began to get extremely wealthy. In 1981 Ronald Reagan appointed the CEO of Merrill Lynch, Donald Regan, as secretary of treasury. What followed was a 30 year period of financial deregulation supported by economists & financial lobbyists. The Reagan administration began allowing savings and loan companies to make risky investments with depositors' money.

This was the start of a series of increasingly severe financial crises, each one causing more public damage and more private profits. By end of 80's, hundreds of savings & loan companies had failed, and it cost taxpayers \$124 billion. Thousands of executives in savings and loan firms were imprisoned for looting their companies

One of the most extreme cases was Charles Keating. Keating became the subject of an investigation by federal regulators in 1985 for investment activity with customers' money. He hired an economist named Alan Greenspan to help him out of the situation. In return for \$40,000, Greenspan denied to regulators that there was any risk involved in Keating's investment of customers' money. Keating ended up in prison anyway, and Reagan appointed Greenspan as chairman of the Federal Reserve; he was then reappointed by Clinton and George W. Bush, and he continued to deregulate. Meanwhile, former CEO of Goldman Sachs, Robert Rubin, was appointed as treasury secretary. These developments are indicative of how politics and corporate finance became increasingly intertwined, and how the financial sector gained control over politics as it grew in power and created lobbyists.

By the late 1990s, the financial sector had consolidated into a few gigantic firms, each so large that their failure could threaten the whole system. In 1998, two firms merged to form Citigroup, the largest financial services company in the world. The merger was illegal, however; it violated Glass-Steagall act of 1933 which prevented banks with consumer deposits from engaging in risky investment activities. Alan Greenspan did & said nothing. One year later, congress, urged by

Rubin, overturned Glass-Steagall & paved way for future mergers. Rubin later made \$126 million as Vice Chairman of Citigroup.

The next crisis happened in the late 1990s; investment banks fueled a massive bubble in internet stocks followed by crash in 2001 which cost \$5 trillion in investment loss. An investigation showed that banks had promoted internet companies they knew would fail in order to drive up stock prices & sell them at their peak price and make a profit. The SEC, whose purpose is to regulate investment banking, had done nothing. The banks involved were forced to settle the case for \$1.4 billion, and they promised to change their ways

Beginning in the 90s, complex financial products emerged called derivatives. Bankers claimed they made markets safer, but in reality they made markets unstable. Bankers could use them to gamble on virtually anything. By the late 1990s, derivatives had turned into a \$50 trillion unregulated market. Since banks relied so heavily on derivatives for earning, any attempts to regulate them were condemned and thwarted by Greenspan and Rubin. Regulation of derivatives was eventually banned in late 2000 and, their use, in turn, skyrocketed.

By the time George W Bush took office in 2001, the US financial sector was the largest, most powerful, and most concentrated it had ever been, and a new system emerged called the securitization food chain. In the previous system, people's monthly mortgage payments went to their local lender, and since they took so long to repay, lenders were very careful with these loans. In the new system, however, lenders sold loans to investment banks; investment banks then combined thousands of mortgages with other types of loans to create even more complex derivatives called CDOs; investment banks then sold the CDOs to investors around the world. It no longer mattered to anyone in the chain whether borrowers could repay because they were making a profit regardless, so lenders began making riskier and riskier loans. Investment banks could still sell CDOs based on bad loans to investors, because the banks paid rating agencies off to give the CDOs high ratings, even though the banks and rating agencies both knew they were bad deals. Rating agencies also had no liability if the ratings proved to be false. The system was a ticking time bomb, and no regulatory restraints at all were in place to prevent it.

By 2003, the number of mortgage loans made each year nearly quadrupled. The riskiest loans were actually the most profitable because they carried the highest interest rates, so lenders began intentionally giving out loans people could not repay. Soon, hundreds of billion dollars a year were flowing through the securitization food chain, anyone could get a mortgage, and home purchases and housing prices skyrocketed. This led to the biggest financial bubble in history.

Meanwhile, on Wall Street, annual cash bonuses spiked, and traders and CEOs became insanely wealthy. Still, Alan Greenspan refused to use his authority to regulate the mortgage industry, despite a magnitude of warnings from economists and financial experts all over the world that were backed up by sound evidence. No major investigations were conducted on investment banks during bubble.

By October 2007, one third of mortgages had defaulted. By 2008, home foreclosures were skyrocketing, and the securitization food chain imploded. Lenders could no longer sell their loans to investment banks, so dozens of lenders failed. The

market for CDOs in turn collapsed, leaving investment banks with hundreds of billions of dollars in loans, CDOs and real estate that they couldn't sell.

Just like that, the big investment banks went bankrupt and the stock market plummeted, triggering the global financial crisis from which we are still recovering. This situation was caused by a toxic combination of deregulation, corruption, and greed. Hopefully our nations political and financial leaders have learned from this experience and will not repeat their mistake.