Causes of the 2007/2008 global financial crisis

Exercise *(individual work, work in pairs, plenary session)*

1. Read, take notes on and analyse the arguments of the two positions presented below by working out the main differences.

2. Discuss which of the two positions seems more convincing to you.

Info text:

The causes of the financial and economic crisis, which began in 2007 and continues today, are diverse. Its consequences – low economic growth, high unemployment and national debt – can still be felt today. Politics and science continue to argue about what the main causes were and which possible solutions should be pursued.

Among other things, it is disputed whether the crisis can be attributed to an unavoidable and unpredictable market failure or to avoidable regulatory failure. It is important to clarify this question in order to find effective possible solutions.

Causes of the 2007/2008 global financial crisis: Position 1

Market-liberal politicians and economists generally regard the financial markets as a social sphere in which politics should not interfere. Financial markets enforced economic reason against uneconomic economies by demanding favourable interest rates for economically efficient customers and higher interest rates for less economically efficient customers.

From the liberals' point of view, US state was mainly responsible for the financial crisis because it had destroyed this mechanism. By adopting a misguided housing market policy with the aim of allowing everyone to own their own homes, the US government encouraged the excessive risky behaviour of banks and customers, putting the financial markets in difficulty. The supporters of this position, the government-related mortgage banks *Fannie Mae* and *Freddie Mac*, bought up, bundled and sold mortgages from regular banks and credit providers as *Government-Sponsored Enterprises* (GSEs) and sold them on as securities to investors worldwide in order to allow private banks to grant more loans. By doing so, the government had intervened massively in the financial market. The lending standards for *Fannie* and *Freddie* had been relaxed by market intervention in order to allow mortgages to be granted with a higher default risk. The so-called “subprime sector” was actually created by interventions in the market. The decision of the US Federal Reserve to lower the base rate was is also considered another cause of the financial crisis. By doing this, loans became so cheap that apparently even the less affluent could afford to borrow.

According to Stefan Hähnel from the University of Bayreuth, the real reasons for the financial crisis are therefore the lack of state intervention in market mechanisms: “It was not markets that got out of control or rampant greed of bank managers; it was predominantly political mismanagement that fuelled the crisis and caused it to escalate in many places” (quoted from Wißler 2016). For Hähnel, political goals destroyed the rationality when responsibly granting loans and responsibly dealing with mortgages. “Because the financial crisis is often understood as a result of market failure, the public expect the state to intervene more deeply in economic affairs. However, what is overlooked is that politically motivated interventions often pave the way for future market dysfunctions instead of preventing them, as intended. ‘It is therefore not without a certain irony that state intervention in market affairs often forms the basis for later crises, but that citizens demand stronger state intervention after the crisis without knowing the underlying problems’”, says the Bayreuth-based economist (Wißler 2016). For Hähnel, it is more market and less state that is needed.

Sources:

Wißler, Christian (2016). *Politische Fehlsteuerungen als Hauptursache der Finanzkrise 2007-2009* (Political mismanagements as the main cause of the 2007-2009 financial crisis) URL: https://idw-online.de/de/news?print=1&id=647986.

Causes of the 2007/2008 global financial crisis: Position 2

Other politicians and scientists accuse the US government, among others, of not having regulated the market mechanisms enough and in fact of having abolished existing regulations. A 576-page report by a US government investigative commission, which was supposed to go through the causes of the financial crisis, states, among other things, that the government's regulatory authorities had failed to monitor financial institutions and stipulate clear rules for them. For years, the US Federal Reserve had also been advocating deregulation of the financial system rather than regulation.

The consequences of the deregulation of the financial market were responsible for the crisis. "It began with U.S. President Ronald Reagan, who exempted regional savings banks from state regulations in 1982 and allowed banks to grant loans with variable interest rates for the first time" (Storbeck 2011). "President Clinton praised his new banking law in 1994, saying that he had removed 'unnecessary hurdles'. 'The new rules make us stronger economically, more efficient and are good for consumers', he said at the time. Because freer financial markets would create more growth, less inflation and unemployment" (Oberhuber 2017). The Clinton government then made a serious mistake in 2000 by relaxing the regulation of certain financial products, such as derivatives. Financial products that were ultimately worthless were allowed to be sold. "Under President George W. Bush, the U.S. Securities and Exchange Commission in 2004 also allowed investment banks to finance their operations" without equity with money borrowed from other banks (Storbeck 2017).

The five largest banks in the country made losses of USD 40 billion with small reserves of only USD 1 billion in equity. Only these serious errors in the deregulation of the markets would have encouraged mismanagement and reckless pursuit of profit on Wall Street and triggered the global financial crisis in the USA. Leading managers from companies such as Citigroup, Goldman-Sachs, AIG and Merrill Lynch could demonstrate that they knowingly let overvalued, virtually worthless and therefore high-risk financial products be sold to achieve a short-term increase in profits and share prices of their banks and therefore also the bonuses of bank employees. For the authors, on the other hand, the Federal Reserve's reaction to lower interest rates is no more a mistake than the government's policy of promoting home ownership on a large scale. The commission also pointed out that from 1998 to 2008, there was evidence that "donations of around USD 2.7 billion from financial sector lobby groups have been channelled to Washington". From the point of view of these experts, the financial crisis is the result of a market failure that politics did not prevent.

Sources:

Storbeck, O. (2011). *Folgen der Deregulierung. Die selbst gemachte Krise*. (Consequences of deregulation. The self-made crisis.) URL: www.handelsblatt.com/politik/konjunktur/oekonomie/nachrichten/folgen-der-deregulierung-die-selbst-gemachte-krise/3765676.html

Oberhuber, N. *Der Weg zur Finanzkrise: Das Pendel schwingt zurück*. (The path to the financial crisis: The pendulum swings back.) URL: www.evidero.de/deregulierung-triebfeder-fuer-die-finanzkrise.

