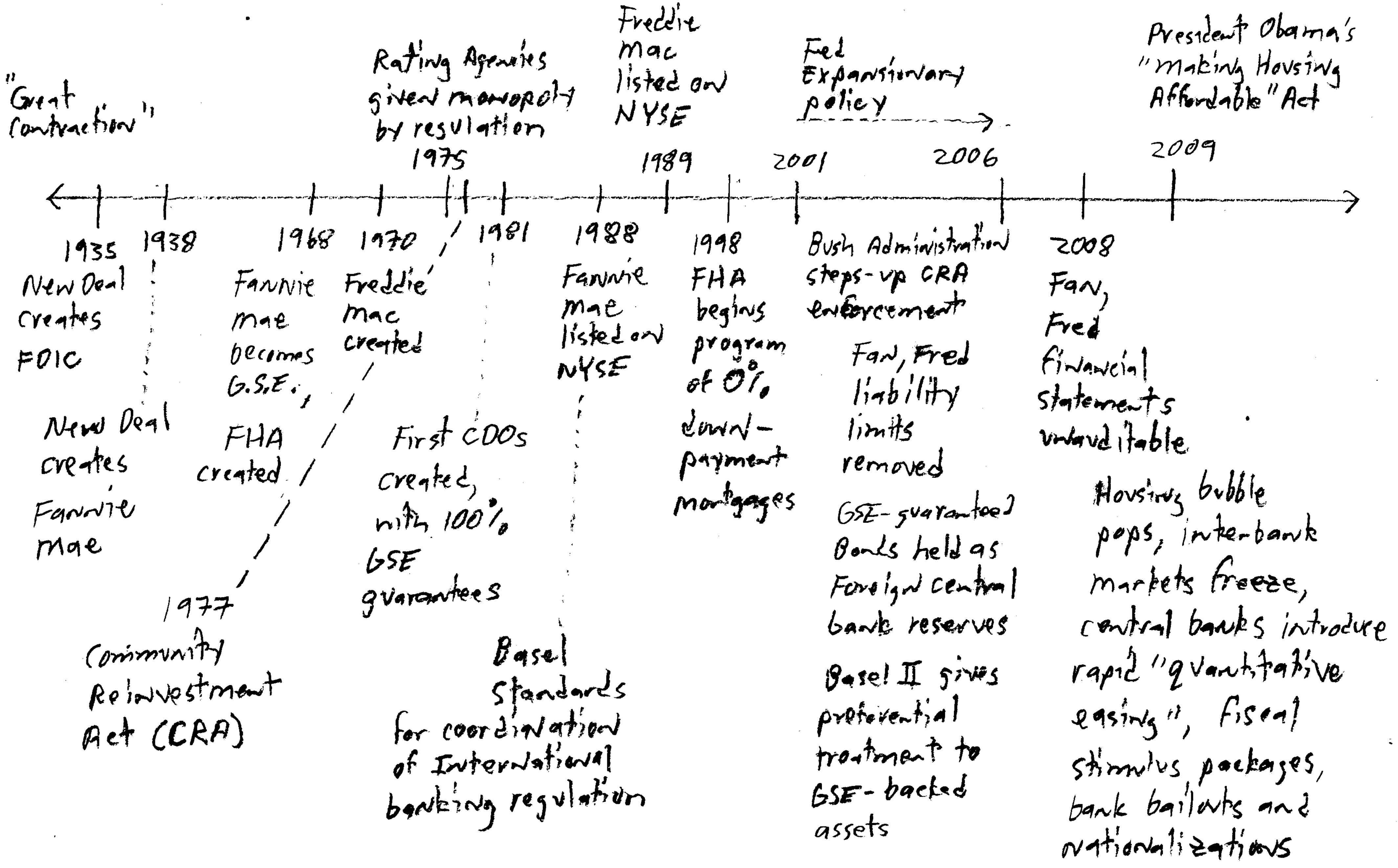
Timeline for Financial Crisis of 2008



Financial Crisis of 2008

In order to understand the financial crisis we will first present
two theoritical concepts from economics and show, perhaps,
there relevance towards the crisis.

First, Veblen in "Absentee Ownership" (1923) wrote of impending
trend in American business where a managerial class was
evolving which removed the management of a company from
the direct oversight of the (entrepreneurial) ownership of the
company. This trend of course meant that the managers
of a company would tend to emphasize their own
interests over that of the owners (stockholders) of a company.
This trend was made certain by the tax code of the United
States. The tax code prioritizes debt financing over equity
financing because a corporation can write-off on taxes the
interest payments on debt, whereas, equity is penalized under
the tax code. First, because dividend payments to stock are
tax as income to the owners of the debt, and secondly, because
owner's equity (the value of stock ownership) is only
accumulated after taxes are paid. Thusly, corporations (including
financial institutions) become capitalized by debt to a much
greater degree than equity. This in turn means that
the actual owners of a company have a decreased incentive
to monitor the performance of a company relative to
actual capitalization (debt plus equity) of the corporation.

Financial Crisis, "Absentee Ownership" (cont.)

In addition, the income structure, again due to the tax code incentives for debt-creation, of a financial firm create more incentives for debt creation. When a financial firm helps a company raise debt, or when financial firms sell debt to each other, it creates fee income for each debt-creation transaction. The more debt that is created the more fee income a financial firm earns. This is especially true during the lead-up to the financial crisis, which many believe was due to the creation of debt instrument derivatives based on the mortgages issued for U.S. housing. There was again incentives for US citizens to take on mortgages, because, again, the mortgage interest payments are written-off against personal income taxes. Finally the Basel standard which were created, and agreed-upon internationally, in 1988, allowed banks to set-aside less reserves for debt which was guaranteed by the government, and, in fact it was government guarantees of mortgage-backed bonds in the first place which may have created the trend in finance to continual repackage and resell the debt obligations for more fees, to each other, with derivatives becoming increasingly complicated.

Financial Crisis of 2008 (cont.)

The second theoretical framework we will use to approach our analysis of the crisis is what Marx called "fictitious capital", which has become known by later Marxists as "financialization". The idea is that the circulation of capital can be increased in volume and become increasingly removed from any underlying value. For Marx the underlying value, of course, was the product of labor; as capital accumulates and circulates amongst capitalists without being applied to production of 'commodities' using labor-power, the economy becomes more and more financialized with less and less underlying value.

We can apply this notion of financialization of the economy in two ways to help explain the crisis. In the first instance, the crisis was based upon an over-investment, or, financialization, of mortgage-backed securities. The underlying value of the securities was the value of the homes which were funded through mortgages. The U.S. government, since the 1930s, has made it policy to encourage Americans to buy homes.

Financial Crisis of 2008, "Financialization" (cont.)

The Federal National Mortgage Association (Fannie Mae) was created in 1938 to repurchase mortgages from mortgage banks, freeing-up more capital to make more mortgage loans. Then in 1968 Freddie Mac was created, while Fannie Mae was turned into a GSE instead of a directly-Government-owned corporation. Both of these GSE were given the authority to directly make mortgage loans, and to guarantee 100% that bonds created by mortgages packaged together into bonds and then sold to another financial institution would be free from risk. The market understood that the failure of people to pay-back the underlying mortgages would be guaranteed repayment for the value of the bonds by the government. This created "socialized risk and private gain" for financial institutions trading the 100% guaranteed bonds. This, coupled with the tax incentives and fee income incentives to create debt, meant that by some estimates the volume of mortgage-backed bonds were 500% the value of the underlying homes as banks, insurance companies and other financial businesses kept repackaging the bonds into different derivates and selling them to one another for fees.

Financial Crisis of 2008, "Financialization" (cont.)

The second instance of financialization which will allow us to help understand the financial crisis is regulation of the financial sector itself. money, and related financial institutions, is seen as some type of "public good" which requires government management to provide the maximum social welfare.

It is for this reason that the Federal Deposit Insurance Corporation (FDIC) was created in 1935, and indeed the rationale for central banking itself. These policies are subsidies to the banking sector because it means that banking activities both have access to "cheaper" money than non-bank industries, and, this regulation prevents competition, and promotes monopolization, of banks. This, in turn with a tax code which encourages debt-creation, and, indeed, a Federal government itself which borrows huge sums of money, encourages financialization of the economy.

Financial Crisis of 2008 (cont.)

A Brief Explanation for the Crisis

Because the US Government prioritized financialization and investment in housing, a housing bubble occurred and 'popped'. The bubble was encouraged by an expansionary Fed policy between 2000-2006 (much as the stockmarket bubble and crash of 1929 was partially the result of an expansionary and then contractionary monetary policy, first catalyzing unsustainable asset price increases, then 'popping' the asset price bubble by contractionary policy). In addition there was cumulative causation (see timeline) leading to more and more unsustainable investment in housing (not least when HUD declared in 2000 that Fan and Fred must make 50% of their housing loans to low income - e.g. those that might not be able to yet afford homes - households, and, when the FHA issued approx. one million no-down-payment mortgages 1998-2001).

Brief Explanation for the Crisis (cont.)

As more high-risk mortgages were being made, and more and more financialization of mortgage-backed bond derivatives were being sold by banks to each other, the ability to price the risk of the derivatives became less-and-less. However, the bond-rating agencies, who were given a monopoly by government regulation in 1975, did not have the incentive to re-rate the bonds to reflect the increased risk because they were paid by the banks who issued the bonds, and, were free from competition which might have required more accuracy. In addition, as long as housing prices, continued to increase, the underlying asset values backing the bonds increased as well. However, it is not possible for prices to increase without bound.

Brief Explanation for the Crisis (cont.)

Several events triggered the collapse of the bubble. In 2003-2004 the Financial Statements of both Fan and Fred had to be restated and in 2008 these GSE financial statements were deemed to unauditable. By 2007 The Fed had begun to raise interest rates, sending a signal that funds (and thus mortgages) had become more expensive. By September 2008 the bubble had popped and Fannie Mae had to be taken over by the government. And as is well known other bailouts ensued, especially that of Goldman Sachs after Lehman Brothers had been allowed to fail.

The "popping" of the bubble must be tied to the ensuing financial crisis and "jobless recovery". In the first instance there was a freeze in the Inter bank markets after popping of the bubble because the banks did not want trade the agreed-upon mortgage-backed derivatives with each other because they did not want to suffer the loss on their Balance Sheets and Income Statements.

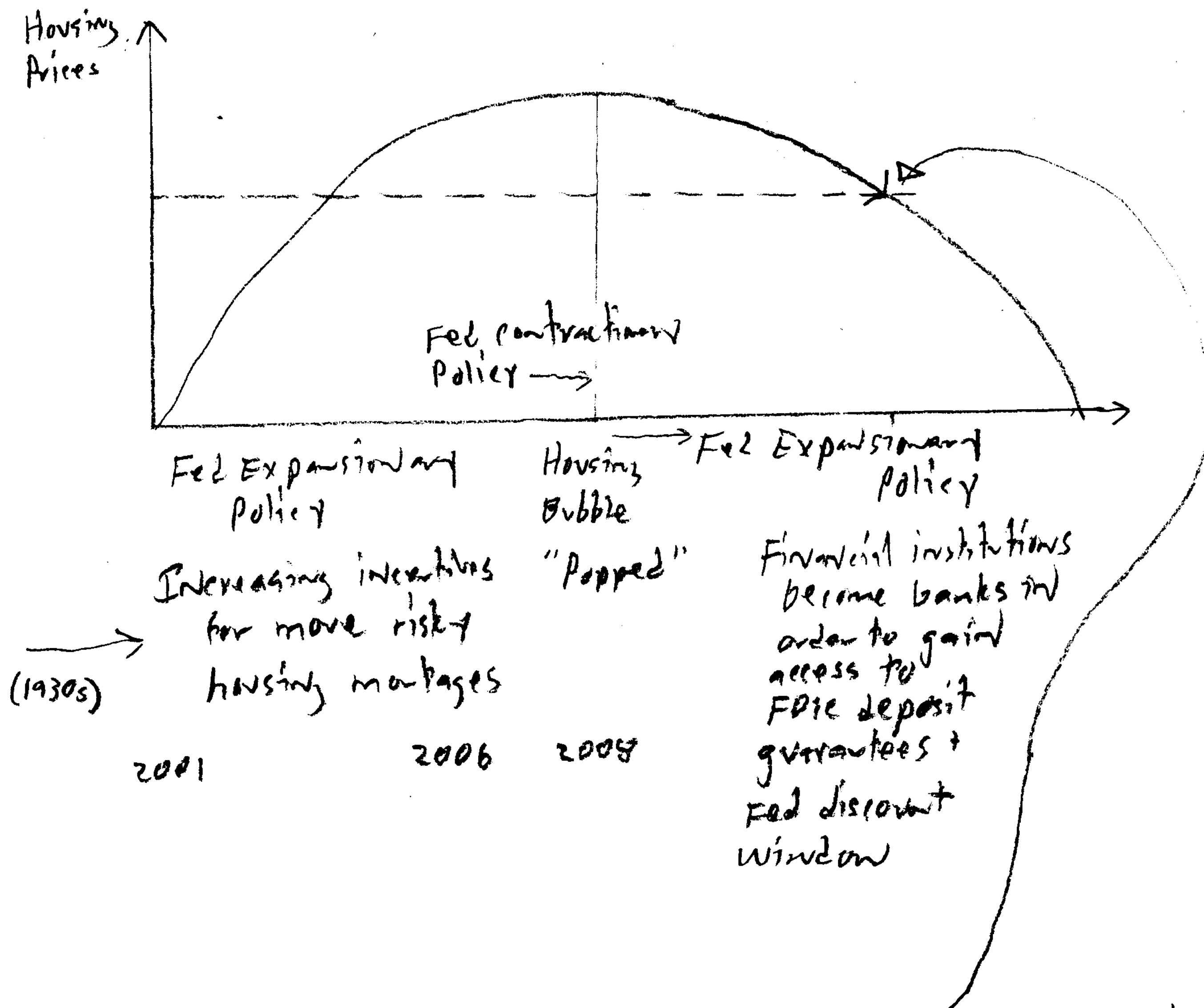
The "crises" (cont.)

Thus, the financial markets froze because of the interbank non-trading. However, because of the "too big to fail" doctrine of central banks, the banks knew that despite a self-imposed liquidity crisis, they would get emergency (subsidized) financing by the Central Bank, and later, Treasury, authorities. Instead of allowing the bad assets to be cleansed from the Balance Sheets of the banks, insurance companies and financial institutions, the bailouts meant that "good money" was thrown at "bad assets".

When the rule of law is usurped by discretionary (bailout) policy, uncertainty is created in the market as institutions try to figure out the next steps to ensure government support. Instead of needed bankruptcy and the freeing-up of assets, a "wait and see" uncertain investment climate was created, prolonging crisis and paving the way for uncertain long-term recovery.

Lecture Notes for Economic History

The Financial Crisis of 2008 (cont.)



The Basel II standards require that banks "mark to market" assets + proscribe risk ratio reserves. Thus all bank values move together instead of local private risk management due to absentee ownership and financialization. So when bubble "pops" all mortgage-backed bond derivatives decrease in value world-wide, freezing markets and triggering bailouts and "quantitative easing".