ECO 106: Microeconomics

PBS Frontline: Inside the Meltdown

The PBS program, “Inside the Meltdown” provides us with a rather curious point of view of how the current financial crisis was originated. The program starts describing the generalized situation in Wall Street as the stocks of Bear Stearns Bank started to go down in a dramatic way. They will try to fix the situation without success until the government steps in and takes position in the matter. Finally, provided that the government could not let Bear Stearns go bankrupt, they tried to bail the bank out. But, as it turned out to be, given some Washington regulations, the Federal Government was in no position to lend the necessary money directly to Bear Stearns. So, given the complications of this way of action, they decided to lend the money via some other bank, which turned out to be JPMorgan. That done, they succeeded in saving Bear Stearns from going bankrupt, and for a moment there they thought that was the end of their problems. Actually, what they did not know is that that was just the tip of the iceberg.

The second major case was the one of Lehmann Brothers. As well as Bear Stearns, their stocks suddenly started plummeting down. No one knew which the cause of that problem was but of one thing they could be sure, something was really wrong. Lehmann’s CEO thought that the government would never let them go bankrupt. Actually, the fact that they had rescued Bear Stearns from a catastrophic end was proof that they would not risk the safety of the entire financial system by letting any big financial corporation go bankrupt. No one would have guessed what would happen then, for the government had no intention in rescuing Lehmann from inevitable demise. Paulson, Treasury Secretary, wanted to teach Lehmann a lesson. He asked its CEO to make some sort of deal with some other bank to avoid bankruptcy, but unfortunately, they would not listen. And, finally, when they became aware that the government would not intervene as it did in Bear Stearns’ case, it was already too late.

Lehmann was history, but for some reason, Paulson was confident of the fact that this event would have no major effect in the financial system. The truth is that he could not have been more wrong. The moment after he announced at a press conference of the bankruptcy of Lehmann the stock market suffered its greatest drops in a single day since the Great Depression. The feeling of confidence in the system was now lost, vanished and something had to be done. That same week, news of AIG’s problems reached the public. Now the situation was different, they could not let AIG go bankrupt, because that you mean global financial chaos. So, with this in mind, a request was made to the Congress in Washington to inject capital directly into the market and so prevent more major corporations from going down. Finally, after much argument the document was passed, enabling the Federal Reserve to create rescue packages to try to save the up to that moment moribund economy.