Mid-Term Examination #3
GEOG 2064

Alexandre Vann
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Dr. Joel Shelton

"Figuring out what happened is like 'peeling and onion': each explanation raises new questions" (Stiglitz, pg. 11). Joseph Stiglitz makes no understatement when analogizing the deciphering of the financial and economic crisis to the removal of layers of an onion. The financial crisis is full of complex and seemingly contradictory instances where actions seem irrational and incredibly irresponsible. Fortunately, Stiglitz attempts, and does a rather succinct job at explaining the various variables that led to the collapse of the housing crisis, credit crisis, and ultimately, the economic crisis.

First, Stiglitz explains what went wrong with respect to the financial crisis, the instigator being the bursting of the housing bubble, "When the bubble broke and housing prices fell from their stratospheric levels, more and more homeowners found themselves 'underwater,'" owing more on their mortgages than on the actual value of their homes (pg. 1). Part of the situation begins with the lowering of interest rates (to 1%) by the Federal Reserve Chairman Alan Greenspan in the years following the Dot Com bust and September 11 attacks in order to keep the economy strong. As a result, investors were no longer buying treasury bonds (which would provide measly returns of 1%) and instead borrowing money at low rates (again 1%) to invest elsewhere. A side factor important to note is the use of leveraging, or borrowing considerably more than a down payment in order to maximize profits. Commercial banks then stepped in and created a new area for investment: mortgages. Homebuyers were now purchasing mortgages from lenders, which in turn were sold to investment banks for a commissioned fee (off-loading any risk of default) (Jarvis).

A new financial instrument became incredibly popular during this process: a CDO, or collateralized debt obligation, the first issue. A CDO is simply a packaging of several mortgages into various AAA, BBB, and unrated investment opportunities. These opportunities were often rated by agencies that may not have fully investigated the actual risk involved, leading to a second main issue. As these CDOs were sold to various groups (such as hedge and pension funds), it became clear that a lucrative business had blossomed. At this point, greed became the critical fulcrum. In order to create more CDOs, mortgage lenders were "asked" to issue more mortgages, which meant lending to potential individuals who were not fully qualified to take on such a financial burden. The individuals became known as sub-prime mortgages and the practice as predatory lending, the final issue. Eventually, these individuals began defaulting and greater and greater rates, directly meaning that the supply of houses (which at this point were continuously increasing in price) was exceeding the demand (causing house prices to fall), meaning the once lucrative CDOs were now becoming time-bombs and essentially worthless, and the investment banks that had leveraged a great deal of money to buy these financial tools were facing default on their payments (Jarvis).

Predictably, blame was attributed to varying groups, some more outrageous than others. At the heart of the crisis was the availability of credit and the deregulation of the sectors concerned. Stiglitz writes, that "those in the financial sector blame the Fed for allowing interest rates to remain too low for too long," an irrational argument that the inputs for profits were too cheap (Stiglitz, pg. 9). Alan Greenspan, on the other hand pointed the blame to excessive liquidity in Asian markets while bankers argued that the government did nothing to stop them (pg. 9).

In this turmoil, the area of the economy most immediately affected was employment. As Equation A in the appendix shows, each area of the national economy can be directly affected by a lack of spending. Less spending means less consumption, less investment, and in order to counter this occurrence, government spending increases to maintain a wanted gross domestic product, though this may sometimes not be possible. As the Bush administration passed a $168 billion tax cut, those who would most likely spend the benefits (typically the poorer) were not targeted and as a result, most of the rebate was actually saved (pg. 29). As a result of the intertwined global economy (United States debt owned by China, European banks owning "toxic assets"), the once financial crisis became an economic crisis.

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To deal with the financial and growing economic crisis, the government instituted two separate instruments to help "fix" the temporary issues at hand and prevent a depression from occurring. First was the TARP, or Toxic Asset Relief Program, signed into law by President George W. Bush and backed by then-Treasury Secretary Henry Paulson, which aimed to get money back into the banks literally by injecting liquidity and cleaning up banks' balance sheets at the same time (pg. 123). Initially defeated by the House of Representatives, the Bush administration held an auction to win necessary votes through promises of aid to constituents, and the bill was eventually passed in October 2008 (pg. 123). Unfortunately, as the bill was written with no congressional oversight or judicial review, most of the taxpayer money destined to fix the issues at hand ended up being paid to bank executive and colleagues (pg. 123). The second instrument was the American Recovery and Reinvestment Act of 2009, or known colloquially as the stimulus. As will be discussed in further detail in the next paragraphs, the stimulus's stated primary objective was to save and create new jobs immediately (111-5, pg. 1).

According to Stiglitz, "[The government] had to breath life back into [the economy], and they had to stem the flood of mortgage foreclosures" (Stiglitz, pg. 58). Essentially, Stiglitz implies that the government's main goal with the stimulus was to return the economy to the way as it was pre-crisis, and in doing so, the government would need to reestablish trust in the real economy. Such growth can be achieved by increasing the multiplier, giving money to sectors that would continuously spend money. Stiglitz mentions however, that "the Bush and Obama administrations underestimated the severity of the recession," (pg. 74) by believing that credit flow could be reignited by providing money to banks, which would in turn restore health to the economy. This hypothesis, according to Stiglitz is incorrect. He mentions that an underlying issue of the economy, debt-focused consumption, had been broken and would be difficult to fix (pg. 74). Obviously, the government's response to the crisis aimed to reestablish a growing economy, however, regulations and restrictions were to be applied to prevent this crisis from happening again.

Stiglitz does not have a very high esteem for the stimulus and mentions several problem areas where the stimulus fell short. He notes that a proper stimulus should be fast, effective, address the country's long-term problems, focus on investment, be fair, deal with the short-run exigencies created by the crisis, and be targeted at areas of job loss (pg. 59-61). Relating specifically to the Obama administration's stimulus, Stiglitz claims that the stimulus package ($800 billion) was not nearly as large as it should have been and actually ended up offsetting the state cutbacks which essentially meant no stimulus (pg. 63). Another issue with the stimulus that was put forth was dealing with the fact that most retirement programs used defined contribution programs, which meant that an employer contributed a certain amount to a retirement fund, which was invested into the stock market (pg. 66). Of course, when the stock market crashed in September 2008, many of these retirement funds were lost leading older employees to forgo retirement in order to recuperate their losses, which meant fewer new jobs for the rising workforce, creating more unemployment. As convoluted as it may seem, the overall picture is quite clear. The stimulus was simply not big enough to address all the issues.

With this criticism, Stiglitz does write that the new health care law passed early in the Obama presidency was a correct move to provide health care to those who had lost their jobs. Previously, one could buy insurance (COBRA: Consolidated Omnibus Budget Reconciliation Act of 1985) if they could afford it, however more and more unemployed works simply could not (pg. 68). This insured unemployed workers who had lost their coverage would still be able to have some sort of health care insurance.

Lastly, and probably the most notable inefficient response to the crisis, was the fact that much of the stimulus went "into shovel-ready projects, followed by green investments that could be put in place relatively quickly" (pg. 69). Stiglitz says that tax cuts targeting investments should have been implemented more effectively "to accelerate the flow of funds into the economy—and yield long term benefits" (pg. 69). During a downturn, most firms are hesitant to invest in risky investments for fear of losing more resources, however (and according to Stiglitz), "a temporary investment tax credit can provide them with the appropriate incentive" (pg. 69) to do so and create potential long-term benefits.

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Compared to other sources, Stiglitz does a fair job of detailing the issues behind the financial crisis however, at times his politics are a more dominant voice used to express his ideas. Stiglitz, being a Keynesian economist and Democrat, has a firm stance that government should be at the forefront of economic stability and should be a regulating entity to protect the interest of its citizens. Though the point is valid and arguably agreeable, the point can be made that Stiglitz is light on the concrete facts to support this claim. His argument is typically broad, understandably given the uniqueness of this crisis, however, more data could have been used to support his theses.

To rectify the global crisis Stiglitz focuses on changing the role of government in the coming years, which shows the influence that Keynesian economics has had on his economic ideology. Stiglitz outlines four main points where the government will have to change its active role in a more efficient manner. First, the government will need to maintain full employment and a stable economy. He describes how markets are inefficient in handling recessions and depressions and how maintaining the economy at full employment will prevent catastrophic levels of unemployment during tough time (pg. 201). Secondly, he advocates the government's promotion of innovation stating that, "if knowledge is to be freely disseminated, government must assume responsibility for financing its production" and advocating an improved patent system (pg. 202). Next, the government must continue to provide social protection and insurance to help protect individuals against unemployment and disability, though these expenditures may not be "viewed as socially productive" (pg. 203).

Lastly, the government must prevent exploitation. Essentially, Stiglitz argues that though the government cannot prevent every form of exploitation, it can reduce the scope (pg. 204). He continues by stating that since governments already enforce laws to protect workers and labour, there should be regulations that prevent companies from preying on the ignorance of individuals, such as misleading credit card rates and predatory lending (pg. 204-5). Overall, Stiglitz promotes a more powerful government, though not one intent on power as much as protection of its citizens from the greed of others.

Stiglitz suggests that though greed is a principle factor in the financial crisis, the government can be reformed in such a way as to limit destructive behavior in the future. He writes, "the fact that the wealth of most ordinary individuals is managed by others… has heightened the need for better regulations on corporate governance" (pg. 205).

Appendix – Additional Information

A.) The Composition of Gross Domestic Product

$$Y = C + I + G + N \cdot X$$

Where…

Y: The gross domestic product of a nation

C: The goods and services purchased by consumers

I: The purchase of capital goods (investments)

G: The purchases of goods and services by the federal, state, and local governments

NX: The purchases of goods and services by foreign entities (net exports)

When a fiscal crisis occurs, firms cut back on their amount of purchases, tending to layoff workers as well. As unemployment rises, consumption in the economy lessens, leading to less investment. As a result, government expenditures increase in order to keep the gross domestic product as comparable levels.

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