Discussion 4

Econ 100B, Summer 25 (Session 2)

1. **2008 Financial Crisis & The Government's Response**:

   Watch the following CrashCourse video on the 2008 Financial Crisis, and then **use the following to guide your summary of the events**:

   (a) Did you catch one crucial assumption made by these investors investing in mortgage-backed securities (MBSs)? It has to do with the trajectory of house prices.

   (b) The MBSs were rated really well (AAA), as typically mortgages were held by those with good credit who always paid on-time. As a result, these MBSs were a really popular investment product. How did mortgage lenders respond to this investor demand? What did this do to the overall quality of mortgage loans?

   (c) If the MBS ratings started out being AAA quality, since the average risk of the mortgages that made up the MBS was low – what do you expect would happen to the overall quality if you start adding in sub-prime mortgages? (hint: think of a high average changing as you add in zeroes)

   (d) If new, more relaxed, mortgage lending practices made it easier for people to buy homes, what do you think that would do to the demand and thus, the prices, for houses? Recall from the video that bubbles tend to form around fast-paced increases in prices that are driven by irrational decisions. Based on your answer to the previous question, did this create a housing bubble?

   (e) Recall also, that some of the predatory lending practices leveraged an *adjustable rate mortgage* (ARM) that ballooned monthly payments after a teaser-price period. If many of these ARMs ballooned on individuals that were previously only marginally able to afford their mortgage payments, what happens to them? What happens ordinarily when one cannot pay back their loan?

   (f) If many people suddenly start defaulting on their mortgages, what does that do to the demand for housing, prices for homes, and the quality of the MBSs? How does the affect the housing bubble?

   (g) All the while, financial institutions were still hunting for higher yields. They created unregulated instruments like collateralized debt obligations (CDOs) and credit default swaps (CDSs) that, simplistically, were bets on whether the value of MBSs would increase or decrease. Now, all of a sudden, bubble bursts and no one wants expensive mortgages, nor do institutions want MBSs that are clearly not AAA. All of these interconnected things, based principally on home prices and mortgages, meant that when things went bad, they went really bad for everyone. Home prices declined, mortgages defaulted, MBSs decrease in value, CDOs and CDSs are lost bets, and everyone is out of money (not everyone, but notably **banks**).

(h) **So what did the government do?** First, what did the Fed do with respect to loans to banks? Knowing what you know now about the IS-MP-PC framework, and knowing that the Great Recession lead to a massive negative short-run output, what do you think the Fed did with respect to interest rates?

(i) What did Congress do in January 2009?

(j) What is a perverse incentive? What about moral hazard?

After your summary, answer the following discussion questions:

(a) What can we learn from the 2008 financial crisis? What do you think about the widely accepted faith in the self-correcting nature of markets? What about the ability of financial institutions to effectively police themselves?

(b) Do you think that by bailing out the banks, the government created a moral hazard problem?

(c) Even if so, do you think it was necessary for the government to provide that support? What do you think could have happened if the government did not step in?

2. Please also respond to at least one other student's post.