

FINANCIAL CRISIS IN PLAIN ENGLISH

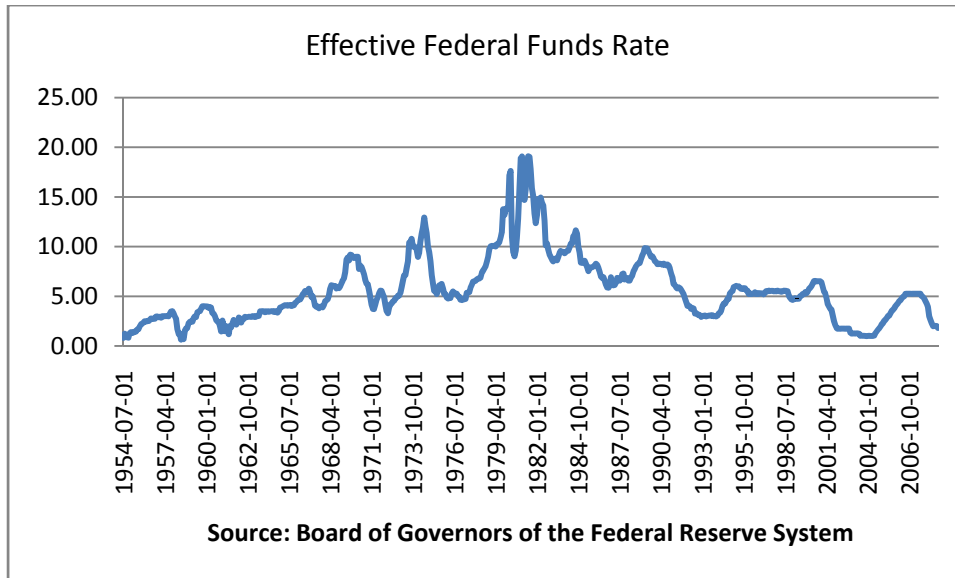
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How did it start?

The current financial crisis has been discussed by people from all walks of life. While academics and experts debate heavily both consequences and origins of the crisis, people who are not educated in Economics may have hard time in disentangling the whole puzzle. In this essay, we intend to do just that: explain the current financial crisis in layman terms.

While economists and practitioners are dealing with the consequences of the current financial crisis, its origins are also a point of contention. We would like to start discussing the issue by digging deep to understand the root causes of the problem.

First of all, there are probably accounting, financial and economic explanations of the issue. We, however, prefer to stay close to home—Economics, maybe with tangential references to finance. We believe the whole thing may be dated back to the era when securitization got into full swing in 1970s. But the biggest spark for the current crisis was lit in the aftermath of the most recent economic recession of early 2000s in the US, which was exacerbated by the 9/11 attacks. Noticing the decline in economic growth in the downturn of the economy, the monetary authorities in the US flooded the markets with cheap money. In the meantime, stock market plummeted as a result of the socio-economic events around the aforementioned time frame. One of the major motives behind the interest rate cuts was the desire to revive the stock market. Unfortunately stock markets are not in any way significant in terms of external funding for companies' projects*, but inexplicably they attract enormous attention in media, and by extension in the main street**.



Thus, people found themselves with loads of cash, provided by the central bank at the lowest interest rates for the last 40-45 years (see the interest rate graph). Since stock market was not an option to choose to invest, especially after the disastrous slump in it following the burst of the 1990s' bubble, the only viable option was seen as the real estate—a familiar territory and safe haven in the eyes of many. One should not forget that banks too were lush with cheap money. That was a perfect match (*or was it?!):* banks with money to lend out to customers with interest to get into the real estate bonanza. Instead of renting, people figured it would be even more affordable and sensible to purchase. That allowed many people with very low credit ratings, or put it differently very high risk characteristics, to get into the mortgage market...

Even small community banks lent huge sums of money in the mortgage industry. They of course did not wait for the mortgage customer to pay his/her debt for the next 15-30 years. The small bank wrapped these loans into packages to be sold to larger banks such as Freddy and Fanny at present discounted values of loans, and extended further loans in the process. As a result, the value of mortgages held in mortgage pools (mortgage-backed

securities, MBS) reached close to \$5 trillion by the end of 2003 from very humble beginnings in earlier decades***. The speed of growth of the pool accelerated throughout 2000s. This is the gift of securitization!

Speculators got into the game, as well, and a house in Los Angeles was bought and sold in Chicago or New York by people who had no real interest in the house but only its speculative return. Low interest rates also made it possible for homeowners to refinance their existing loans and/or obtain credit by putting up their houses as collateral. Little attention was paid to the details of the lending and borrowing operations, to the extent of attaining the textbook definition of moral hazard, or aka greed. In short, a large amount of interest based lending took place in America.

Where are we now?

As time progressed, the economy slowly but surely recovered, and interest rates started to edge upward again. Unfortunately, this put many mortgage customers in a precarious situation. Rising interest rates gradually made it more and more difficult for the mortgage customers to make good on their payments, and we witnessed a gradual exit from the market. Remembering that the historical wedge between commercial and investment banks still persists in the minds of many banks in America, the commercial banks too found themselves in an unenviable situation. The houses evacuated by the mortgage customers due to foreclosures were left with the banks, which are not experts in real estate, at all, other than lending in the mortgage market. On one hand, former owners of houses are in a state of disbelief as they lost their houses; on the other hand, banks are left with property they do not know what to do with. Houses lost their value in the market as demand fell sharply, but also

wear and tear led to further damage and loss in the value of a residential unit. Eventually, we all confronted with the housing/credit crisis at record levels in history.

The rest is pretty much current news!.. What is more worrisome in our modern age of information is the quick spread of news. The decline in one market is immediately replicated in other markets. Unfortunately again, people pay way too much attention to what happens in the stock markets as a barometer of the economic activity. Therefore, we now have a global phenomenon. So much for the globalization of our world!

What is next?

Many governments *cum.* central bankers responded with injecting more money into the system as if it was not the cheap money the root cause of the problem in the first place. As before, the tax payers are supposed to foot the bill. The cost of the less than scrupulous behavior of certain members of the financial world has to be borne by the rest of the society.

It has never been easy to forecast the future. But it is not absurd to say that the impact of this crisis will be on us for the foreseeable future, especially in the economic sector. The cries for help, even if not directly related to the financial crisis at hand, would be louder than ever. In the meantime, it is also conceivable to imagine that some companies and/or governments will use the opportunity (*sic*) to weed out the bad apple from the system to have a healthier economy. The companies thereafter will hopefully be more competitive. In the meantime, we will hear more calls for more regulation. We are no stranger to this kind of request, though. Just check back the aftermath of S&L crisis of 1980s.

References

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