IOSR Journal Of Humanities And Social Science (IOSR-JHSS)
Volume 30, Issue 2, Series 6 (February, 2025) 12-17
e-ISSN: 2279-0837, p-ISSN: 2279-0845.
www.iosrjournals.org

Unraveling The Financial Crisis Of 2008

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Abstract
A number of financial crises have struck many countless economies in the years following the Great Depression. Almost all are nearly similar and have been preceded by greater availability of credit and an unusual increase in asset prices (Carmassi, Gros, & Micossi, 2009) Most, however, have not been global in nature. Instead, like epidemics, they spread throughout their respective countries. It was, therefore, not until 2008 that events reminiscent of 1930 struck the world's principal financial centres. A number of papers have claimed to propose solutions and policy recipes. Many have, however, become incoherent and unstructured, with each coming up with different lists of what went wrong and what must be fixed. Although this approach is correct; the crises' causes must be identified before solutions can be implemented. A plethora of literature has emerged, claiming to do the same. This paper strives to examine and understand all the proposed contributors to the financial crisis; lax monetary policy, global imbalances, industry-specific problems, and financial innovation. Lastly, this paper ties them together, showing how their interplay created a toxic environment prior to 2008, facilitating a "bubble" in the housing market which, later burst, creating havoc.
Keywords: *Deregulation, Financial Crisis, Financial Innovation*

Date of Submission: 14-02-2025 Date of Acceptance: 24-02-2025

I. Introduction

The global financial crisis that began in early 2008 was of the more severe financial downturns that affected economies worldwide. Marked by the collapse of major institutions, market disruptions, and global economic stability, this crisis was primarily fueled by risky lending practices in the mortgage industry and exacerbated by unnecessary financial innovations (Demyanyk & Van Hemert, 2011) In addition to this, a wave of deregulation marked by the passage of laws like the Gramm-Leach-Bliley act allowed banks to engage in increasingly speculative activities. Combined with an influx of global savings from Asian and oil-producing countries, an abundance of credit and liquidity took over the American financial markets. (Bernanke, 2005) Lastly, the bursting of the dot-com stock bubble compelled the Federal Reserve, the central bank of America, to keep interest rates at a historic and sustained low; by 2005, they had decreased by to around 2%. *(EveryCRSReport, 2007)* Thus emerged a speculative housing bubble [***sharp increase in asset prices often accompanied by abnormal investor confidence***] (International Monetary Fund, 2014) When this bubble burst, it did so revealing underlying fragilities in the modern financial world system. (Carmassi, Gros, & Micossi, 2009)

II. The Financial Crisis Of 2008

Origins and Immediate Triggers

The election of Ronald Reagan as the 40th President of the United States in 1980 ushered in a thirty-year period of financial deregulation. Before this, investment banks were small partnerships with investors contributing their own money and, as a result, only taking small risks. With the passage of the Garn-St. Germain Act (U.S. Congress House, 1982), banks began to issue adjustable-rate mortgages, greatly impacting the industry (Krugman, 2009). This newfound freedom encouraged investments and greater risk-taking. Savings and Loan companies were first in line to reap the benefits of this policy, and could engage in progressively speculative ventures funded by their investors' capital. By the end of the 1980s, thousands of savings and loan companies had failed, and a $124 billion federal bailout stabilised the economy. (Ferguson, 2010) After the Dot-Com bubble burst in 2001, the Fed tried to revitalise the economy. Following the fall of the NASDAQ, the country faced a sudden deviation from the growth path that had occurred during this period of extreme deregulation. Starting in May 2000, the Fed implemented an expansionary monetary policy, gradually reducing interest rates from 6.5% in May 2000 to 1.75% in late 2001. As a result, banks could afford to borrow more and subsequently flooded the markets with increased credit, which has been claimed to be the primary catalyst behind the financial crisis.

However, to fully understand the context, we need to revisit the 1990s when Citicorp and Travelers Group merged to form Citigroup. This merger had significant implications for the banking system. Until then, such mergers were illegal because firms couldn't engage in both commercial and investment banking, as mandated by the Glass-Steagall Act of 1933. The American government, after initially granting Citigroup a year's

exemption, ultimately facilitated the passage of the Gramm-Leach-Bliley Act, often referred to as the Citigroup Relief Act, which permitted these activities (Ferguson, 2010) This action, more importantly, transferred the risks undertaken by investment banks from the financial sector to retail banks, permitting more complex transactions such as was observed in the broker-dealer model of Lehman Brothers. (Yueh, L 2010) Although the Gramm-Leach-Bliley act aimed to increase the international competitiveness of the American economy, it introduced into the system a plethora of risks by allowing institutions to engage in a greater array of financial activities (NSUCORP) This system also allowed for the emergence of "conglomerates", excessively large firms with seemingly unlimited capital, which prioritised profits over long-term stability. With reference to such organisations, the amalgamation of investment and retail banking practices implied that losses in one area could jeopardise the entire entity, making clear the dangers behind this interconnectedness (Better Markets, 2021) This regulatory shift is crucial for analysing the financial innovations that preceded the 2008 crisis. However, other factors also contributed to creating an environment that bred the monstrosity of financial instability and unsustainable growth. (Ferguson, 2010)

Global Imbalances

In the 1990s, Asian countries, notably China and Japan, experienced asset bubbles of unprecedented proportions. The bursting of these bubbles later left banks throughout Japan in financial ruin with massive amounts of debt. The delayed response by the Japanese government and loose monetary policy further worsened the situation. With the administration of public funds politically unpopular, the use of taxpayer money was delayed (as seen in Japan). Although the crisis originated in Japan, it spread to other economies. With Japan accounting for over approximately 60% of goods and services produced in Asia, its unresolved problems had a profound effect on neighbouring economies. As part of their response to tackling these problems, countries increased their savings to build reserve cushions against future financial crises and purchased increasing amounts of foreign currency, investing heavily in the USA. They invested in low-interest and low-risk Treasury bonds. A number of other countries having recently benefited from the almost-worldwide economic liberalisation found themselves being too volatile: instead, their capital was often recycled into the American financial markets (Rodrik, D., 2006).With increased complacency at the Federal Reserve, a current account deficit in the US grew while countries like China built up their budget surpluses (Carmassi, Gros, & Micossi, 2009) This cycle of surplus countries' reinvestment into the global markets facilitated the conditions necessary for a housing bubble to emerge (Obstfeld and Rogoff, 2009)

Furthermore, the Reserve Currency effect of the US dollar coupled with the deepening of global imbalances led to excess liquidity in both the primary and secondary financial markets At the same time, substantial amounts of dollar denominated assets were kept by various countries, exacerbating the situation as the United States continued to run into deficits, importing more goods and services than it exported, without consequence, worsening global imbalances(Yueh, L. 2010) A number of these surplus nations further established international sovereign wealth funds (SFWs), which invested heavily into American equity and debt(Yueh, L. 2010)

This Financial capital, along with that coupled from emerging market savers flowed into the US, fuelling large appreciations in stock prices and the value of the dollar, implying wealth and international competitiveness consistent with a larger US deficit (Obstfeld, M. and Rogoff, K., 2009). Arguments for global imbalances being a contributor to the crisis circle around the impacts of extra savings by BOP surplus into BOP deficit countries. In this case, China and other emerging economies have pursued a similar policy, investing their surpluses into financially deficit countries like the USA, which led to the fall of long term interest rates and inflated asset prices. (Liang, Y, 2012)

The influx of foreign money allowed Americans to consume more than they produced, import more than they exported, and spend more than they earned. This made the US current account deficit worse which, in 2006, accounted for around 59.8% of global deficits. (Altuzarra 2010) Coupled with the artificially low interest rates set by the Federal Reserve after 2000, borrowing became very cheap, encouraging consumers to borrow more. The combined effects created an abundance of credit and liquidity, which fuelled a rapid expansion of the housing market with people buying homes with adjustable-rate mortgages with low initial rates set by the Fed (Acharya, S. and Bengui, J., 2018). Therefore, we conclude that excess savings from countries like China led to a surplus of funds in the financial markets of the United States, which, combined with the low interest rates set by the Fed, contributed to the buildup of the bubble (Bernanke, B.S., 2005)

Problems in the US Mortgage Industry

Alternative views are also provided on the crisis. Rather than macroeconomic instability, some view problems in the US mortgage industry itself as causes of the crisis. By 2006, subprime lending formed 23.8% of all mortgage originations, and therefore, given as a result of overlooked bad credit (Financial Crisis Inquiry Commission, 2011) Now, why did banks lend to those they knew wouldn't pay them back? Firstly, the nature of

the vast majority of mortgages that made them “rate adjustable” proved to be particularly damaging. The “teaser structure” of these loans attracted investors who would otherwise have stayed away, amplifying the growth of a bubble(Acharya & Richardson, 2009)

Secondly, the rapid increase in the originate-to-distribute model led to the further distribution of lower quality loans. 'Instead of banks originating mortgages and holding on to them, brokers and also some banks started originating them and selling them to be securitised.' (Demyanyk, Y. and Van Hemert, O., 2011). Securitisation is the process through which multiple loans are bunched together and later sold in the markets as complex financial instruments. Under the originate-to-distribute model, loans were quickly resold to other investors and monitoring of underlying credit quality was overlooked in general. Because banks knew the loans would be resold to other investors, they tried to issue as many as possible. In the long run, the originators wouldn’t care if the borrowers defaulted because the loans would be transferred. With bankers being paid on the basis of the number of mortgages they approved in an attempt to stimulate economic growth, those that borrowed credit weren’t properly screened to ascertain whether they may or may not default on those loans. The risks were, for lack of a better word, hedged. (Carmassi, Gros, & Micossi, 2009) With an increase in the sale of these securities, the number of houses bought with bad credit increased. One can, therefore, say that a bubble was created. 'A stock market bubble occurs when investors drive stock prices above their intrinsic value.' (Investopedia)

However, other than the originate-to-distribute model, other problems also plagued the mortgage industry. With complex financial instruments called Mortgage-Backed Securities being created by bundling a number of these loans together and then trenching them, investors viewed them as safe to invest in. The securities were divided into tranches; junior, mezzanine, and senior. Juniors promised more returns but were risky because their returns would decrease if mortgage defaults increased. However, in case of widespread defaults, even the highest tranches would be affected (Ökte, 2012)

Unhelpful Role of Ratings Agencies

It wasn’t only the tranching structure that created the illusion of these securities being safe to invest in. Because buyers of tranches used information from ratings agencies when making decisions, they were wholly dependent on what they said.'For these agencies, income was derived from undertaking ratings of securitised products. With banks being able to reject their ratings, ratings agencies were incentivised to offer AAA ratings. In hindsight, this is absolutely ludicrous because only US Treasury Bonds receive ratings this high. (Ferguson, 2010)

Furthermore, many agencies failed to adequately factor in the possibility of widespread defaults. This inability to account for systemic risk is further made evident when they, despite the increasing number of defaults, failed to change their ratings. Their actions inadvertently caused investors to think their investments were secure, causing them to hold onto these “safe” assets, despite their great exposure to risk(Krause, 2008; Bernstein, 2011) Many were illiquid in nature, making it difficult for investors to dispose of them when the crisis began to unfold; thus, these agencies contributed significantly to the severity of the crisis (Fitch, 2011)

US Monetary Policy

As has been mentioned, the deregulation that preceded the time under consideration can be said to have begun during the 1980s and led to the creation of an environment that allowed for the expansion of mortgage lending and increased speculation (Chen 2020, Orhangazi 2014**).** Some hold the view that the crisis originated from a loose monetary policy Post-2000 the government failed to address the emergence of the policy-induced housing bubble in a timely fashion, as was observed in Japan half a decade prior. With a floating exchange rate system, the value of the U.S. dollar fluctuates in response to events in the foreign market. The Federal Reserve conducted a contractionary monetary policy throughout the 1980s and 1990s, characterised by a tight control over the money supply and exchange rates. However, as has been mentioned, when the economy swayed from its standard path and deviated with less economic growth, the government adopted an expansionary monetary policy. In the years preceding the crisis, interest rates were accordingly kept at an all-time low; this low-rate environment encouraged over-the-top borrowing as consumers and secondary financial institutions found it easier to do so. (Taylor, 2007; Mian & Sufi, 2009)

Now, a question arises. Why, when a bubble had clearly emerged by 2004, did the Fed not use monetary policy to tighten the money supply and control the housing market? Albans Akhtar Hossain alleges that it did so because of its concern that the action needed would have created a recession. With increased interest rates, borrowing would decrease. So would innovation, enterprise and expansion (Hossain, A.A., 2019). A similar opinion is put forward by Ben Bernanke, the then chairman of the Federal Reserve. He underscored the influence of the delayed response of the unemployment rate in determining monetary policy choices. With the Federal Reserve manoeuvring through a complicated economic environment with fears of deflation, a choice like this was, as Bernanke asserts, deliberate and calculated. (Bernanke, B. (2010). “Monetary Policy and the Housing Bubble,” Speech at the AEA Meeting, Atlanta, Georgia).

Regardless, it is evident that the decrease in interest rates created a setting where credit was easily available. What can be viewed as indecision and unnecessary accommodation from the Fed led to a delay in the tightening of interest rates until June 2004. By then, people had already borrowed more than they could pay back. When interest rates tightened later on, the defaults began as the "bubble" burst. (Origins of the Financial Market Crisis of 2008 Anna J. Schwartz)

The prolonged policy of low interest rates deviated from traditional guidelines that warned against credit booms and misallocate resources, feeding into what we call the "bubble" (The Relations Among Loose Monetary Policy and the Housing Bubble and the Financial Crisis of 2008) (Xinlin, 2021*)*

Financial Innovation

Financial innovation; mentioned throughout the paper, is defined as the process of creating new financial products, services, or strategies. (Investopedia). Since the 1980s, banks and other financial institutions have been competing to innovate in an attempt to cope with a changing world and increasing competition. (Abdel Aziz, 2009) They create new products to circumvent government regulation and maximize profits (Carmassi, Gros, & Micossi, 2009) As has been mentioned, the credit crisis preceding 2008 was caused by a number of reasons, one of them being the adoption of innovations in investment instruments such as mortgage-backed securities and derivatives, providing large firms with the opportunity to increase income by *bunching* instruments into tranches. (Anna J Schwartz) (Park, Y.S., 2009) The aforementioned originate-to-distribute model caused banks to, more often than not, issue loans while overlooking bad underlying credit quality. Banks had, at the time, simply become loan originators, which shovelled loans out to other packagers and securities underwriters. The root cause of the crisis, in essence, is the abuse of various innovative financial methods and the development of these financial instruments. (Park, Y.S., 2009) Finally, the explosion of derivative contracts, equally used to hedge and take open positions to synthetic instruments, further destabilised the economy (Carmassi, Gros, & Micossi, 2009) Here, the *innovators* forgot the universal truth that governs the financial world, to not put all their eggs in one basket; they bundled subprime mortgages (bad loans) together and then, to gain a competitive advantage, came up with the innovative breakthrough of converting those packages into "high yield mortgage-backed securities". (Abdel Aziz, 2009)

The aforementioned practice of securitisation soon spread from home loans to other assets such as loans for vehicles, credit card receivables, manufacturing and even student loans. The objective of the same was to provide liquidity and allow for banks to offload risks. This transfer of risk, without full understanding by investors, contributed to the widespread exposure to bad debt that consequently paved the way for the housing market's collapse. The situation went from bad to worse as credit ratings agencies unseemingly accommodated these CDO's false ratings, exacerbating investor confidence in perhaps even faulty instruments. The regulatory oversight was a problem too; financial innovations outpaced the same, leading to a great deal of unchecked systemic risks. It can also be asserted that some innovations may be designed to circumvent this *regulation*; being created not only to meet market needs but also to bypass existing regulations, contributing to the instability of the financial system. (Manuel Sanchez).

While the innovations were originally designed to increase liquidity and make more credit available in the market, they were ultimately misused by banks and financial institutions, leading to subsequent collapse. The model of distribution, combined with a lack of federal oversight and inflated credit ratings, allowed for risky loans to be packaged and sold without proper assessment of credit quality. The unchecked growth of derivatives, estimated at 767 trillion $ at the time, further highlights the scale of the issue. Ultimately, the abuse of financial innovation, coupled with regulatory failures, laid the foundation for the global economic downturn.

The widespread adoption of derivatives, including credit default swaps (CDS), introduced additional layers of complexity and risk to financial systems. These instruments were initially designed as tools for managing risk, but they became mechanisms for speculative trading and leverage amplification. Financial institutions heavily relied on these derivatives, often exceeding their capital reserves, which magnified losses when the housing market collapsed. The interconnectedness of firms using CDS to hedge or speculate further contributed to systemic risk, as defaults in one area cascaded throughout the global financial network (Acharya & Bengui, 2018; Ökte, 2012). The lack of transparency in over-the-counter (OTC) derivatives markets and the failure to regulate leverage ratios compounded the crisis, underscoring the dangers of unchecked financial innovation.

The Complex Nature of the Crisis

The financial crisis that followed wasn't in isolation; rather, it was the culmination of all the aforementioned factors that, together, created a region so volatile and the situation so complex. Many factors, such as global imbalances and lax monetary policy reinforced each other. The dismantling of regulatory safeguards led to greater proliferation of sub-par loans; almost like a building with a shaky foundation, the system that had been birthed was bound to collapse. Simultaneously, this complex web of factors fed greater borrowing and risk-taking. Deregulation allowed for people to engage in all of the dangerous practices that contributed to the

crisis. Stricter regulations could have spilled the crisis spreading from one part of the economy to another; greater oversight with regards to the mortgage industry *may* have led to the curbing of predatory lending. Clear separation between investment and retail banking activities would have isolated risk-taking activities, mitigating the severity of the crisis.

Deregulation didn't only lead to the mushrooming of multiple financial innovations, but also made financial institutions think they were **"too big to fail"**, instilling in them a perilous sense of confidence (Bernanke, 2023) These financial innovations, if used differently, may have led to greater economic prosperity; in this regard, it was their ***misuse*** that proved to be so disastrous. The convergence of all the aforementioned factors made the crisis inevitable when cracks appeared in the economy. (Xinlin, 2023)

Lastly, the almost damaging role played by credit rating agencies instigated by their underestimation of risk and conflicts of interest emphasises that such situations require an across-the-board reconsideration of prevalent practices and the introduction of investments that provide for transparency and greater accountability. The lessons drawn from this chain of events make clear the need for an all-encompassing framework that protects all facets of the economy and prevent such catastrophic convergences of failures in the future (Bernstein, 2011; Fitch, 2011).

III. Conclusion

Following the financial crisis, a number of regulatory reforms have been proposed, and some implemented. The following are a few:

Stricter Industry-specific Regulations: Given that the crisis originated in the mortgage industry, stricter rules regarding the origination of loans must be implemented. Banks must determine credit scores, reliability and assurance against defaults prior to the same. (Orifjonov, 2023).

Credit Agency Reform: Considering the near debilitating role these organisations played prior to the crisis, they must be subject to stricter evaluation and regulation by the respective central banks. Proposals with regards to this include greater rigorous oversight by the SEC, given "their large contributions to the financial crisis" (Warren, 2019). Furthermore, the "issuer-pays model" raises a glaringly obvious conflict of interest due to the fact that agencies are paid by the respective organisations whose credibility they rate. (Beker, 2021)

Mortgage Industry Reform: It is also worth keeping in mind the fact that it was the ***originate-to-distribute model*** that played the most direct role in the issuing of bad loans. This "merit based" system focuses on rewarding management for the creation of short-term profits (Ferguson, 2010) In this case, many advocate for a system that rewards on the basis of profit creation, *post* risk adjustment. (Financial Stability Board, 2021)

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