# The Bail-Out and the Causes Of the Financial Crisis

Monica Gambrill*

Lucas Jackson/Reuters

The new Barack Obama administration's plans to deal with today's economic crisis must be evaluated in the light of its short-, medium- and long-term causes. From that vantage point, it is possible to judge how feasible their success is.

The long-term causes go back to Ronald Reagan's administration when he broke with the Republican Party's conservative policy of not spending more than what the government took in as tax revenues. Reagan lowered taxes without a corresponding reduction in spending, and as a result accumulated a large fiscal deficit. Since that time, the Republicans have spend more than they took in and have tried to compensate for the deficits with supply-side economic measures, not only tax cuts, but also deregulating markets and other measures to stimulate consumption.

While this fiscal deficit was corrected with tax hikes during William Clinton's Democratic administration, the policy of deregulating financial markets continued. For example, the laws banning the combination of commercial banks, investment banks and insurance companies were struck from the books. The Commodity Futures Trading Commission was also forbidden from regulating the derivatives market, among other things. That was how Clinton and his economic team (Robert Rubin, Lawrence Summers and Federal Reserve System [Fed] Chairman Alan Greenspan) consolidated the financial deregulation associated with the current crisis.

The following administration, that of George W. Bush, not only continued this deregulation, but also went back to deficit spending. This way, with the two policies implemented at the same time, the total national debt accumulated to cover surplus government spending rose to US$10,638,331,208,924.31 (10.63 trillion) by January 19,

* Researcher at CISAN.

2009, the last day of George W. Bush's presidency.[1] This debt is said to have begun with Reaganomics because, measured in real terms, it had been kept at a constant low until 1983, when it began to skyrocket, and it was the Republican administrations that made it grow.

The U.S. population emulated that same consumption pattern, spending more than it earned, particularly starting with the George W. Bush administration. Family debt rose from US$680 billion in 1974 to US$14 trillion in 2008, doubling over just the last seven years, from 2001 to 2008. This was possible because, on the average, 13 credit cards had been distributed to every home. This private debt was backed up by the rise in home prices and stock market investments, which were supposedly going to guarantee payment.

On the other hand, state and municipal governments began to follow suit, spending on infrastructure and urban development without corresponding increases in taxes, financing themselves through the sale of local government bonds guaranteed only by the expectation of future earnings.

The inherent imbalance in an international system in which some consume while others produce is the basic cause of the current crisis.

Many of the goods consumed were imported, which also made the U.S. trade deficit shoot up. The goods account accumulated a total deficit of US$8.07 trillion between 1980 and 2008 according to the Customs Census. While 1980 was not the first year there was a deficit, the sum of all the previous deficits had only reached US$43.84 billion. The difference between imported and exported goods was compensated by the surpluses generated in the capital account through the sale of federal bonds abroad. The purchasers of this federal debt were in large part Asian countries like Japan, in for US$580 billion, and China, in for US$390 billion, by November 2007. In this way, the constant demand for dollar-denominated instruments kept the dollar over-valued and Asian currencies, except the yen, undervalued.

It can be said that this international monetary arrangement constituted, *de facto,* a new Bretton Woods in which the United States' excessive consumption was financed by excessive savings by the Asian countries. The function of the United States in this system was to keep the demand for consumer goods high in the rest of the world, supported by an overvalued currency and easy access to credit for the population. The paradox is that consumption in the "rich" country was financed by the poor countries of Asia, which took advantage of their access to the developed market to displace the United States as the producer of manufactured goods. The inherent imbalance in an international system in which some consume while others produce is the basic cause of the current crisis.

The medium-term causes of today's crisis are circumscribed to the way in which the previous 2001 crisis was resolved, when the technology dot-com bubble burst. At first glance, it seemed like the Fed had been successful in its attempt to rapidly jumpstart economic growth by slashing the interbank rate. However, two more years had to go by before the employment situation began to improve. Finally, when employment recovered, it was because the technological bubble had been replaced by the housing bubble, and everything possible was being done to ensure that U.S. consumption would keep on expanding.

The continual and increasing reductions in the Fed's interest rate lowered the price of money so much that it led to sustained expansion of credit that was used above all in the sub-prime mortgage market, that is, mortgages offered to low-income borrowers. Traditionally, this kind of mortgage was handled by government-regulated companies, but Wall Street financial firms began to get into this business. Since they were not subject to any government regulation, these firms failed to take the most elementary precautions, like asking for proof of earnings or demanding down payments. The more the demand for houses increased, the more their prices shot up, together with the price of these firms' stock on Wall Street; and, as we have already seen, their high price served as collateral for other kinds of loans.

After this second bubble —the housing bubble— burst, it has not been as easy as the last time for the Fed to reactivate the economy because it could not reduce the interbank rate more than the 0.5 percent it was already at, and because consumers were already over-indebted. This last factor is particularly grave since consumption made up 72 percent of the U.S economy. Retail sales have dropped dramatically because consumers have finally had to start saving. It is estimated that the tiny 0.2 percent savings rate may rise to 4.5 percent in 2009. This alone could produce a recession. Without another consumer bubble on the horizon, it has not been possible to put off the recession any longer.

The short-term causes of the current crisis are linked to the George W. Bush's inefficient implementation of his anti-crisis strategy. While mortgage companies had already begun to go belly up since the beginning of 2007, the only thing the government did at the beginning of the year was to send a tax rebate out in spring, and from there to the end of the year, just barely begin to investigate what Wall Street was doing about mortgages. In 2008, it finally acted, but in a different way with each financial institution: investing millions in preferential stocks in the first ones, nationalizing Fannie Mae and Freddie Mac; letting Merrill Lynch be sold at rock-bottom prices; letting Lehman Brothers declare bankruptcy; practically taking over operations of AIG; and committing itself to ensuring that Citigroup and Bank of America would not go under if there were a catastrophic loss.

Despite having a US$700-billion bail-out plan available,[2] the Bush administration showed its confusion about what it wanted to do with the money. It said that it was to purchase toxic debt from the banks in a Mexican-Fobaproa-like bail-out, but what it actually did was to force the nine largest banks to accept government purchase of its preferential shares for US$250 billion. The aim was to increase the banks' liquidity so they could help their debtors restructure payments and keep on loaning them money, but the bail-out was not conditioned to compliance with these goals. Thus, the mortgage crisis became a liquidity crisis and even a crisis of confidence, which has an impact on the healthy sectors of the economy and spread it to the rest of the world.

The short-term causes of the crisis have been attacked by a hail of measures launched during the first month of the Obama administration, with the whole world watching: 1) a bail-out plan for the financial system made up of a public/private fund that could reach US$2 trillion; 2) an economic stimulus package that would commit a total of US$787 billion in federal funds;[3] 3) a US$275-billion fund to stave off foreclosures;[4] and 4) a budget presented to Congress for US$3.6 trillion for fiscal year 2010.[5] The sum total of these expenditures (US$6.66 trillion) is too large for the markets to ignore.

Obama's financial bail-out plan is different from Bush's strategies because it does not invest in the banks, in the hopes of increasing their liquidity and reactivating their loaning activities. It is also not a guarantee against future catastrophic losses. And, as a first option, it shies away from taking over operational control or nationalization. Rather, it is a plan to purchase the banks' risky investments, wiping the red numbers off their books that prevent them from loaning money again. The government and private investment funds, like the hedge funds and the private-equity funds, will contribute the capital, but the decisions about what should be purchased and at what price would be made by the latter, and these private funds will be obligated to repay the government what it invested before realizing their profits (or losses).

The economic stimulus package is divided among infrastructure, social programs and tax cuts. Spending on infrastructure means building highways, bridges, transportation services and construction; networks to distribute energy, broadband access and drinking water; energy savings and alternative sources, etc. The big difference between reactivating the economy through this kind of investment and doing it by lowering interest rates, a measure oriented to consumption, should be underlined. At the same time that this plan stimulates the economy, it is a step toward a new model of economic development. Also, spending on social programs and tax cuts includes aspects that promote investment; for example, tax cuts for companies that invest in capital goods, financing for new technology development and scholarships for higher education.

The mortgage crisis became a liquidity crisis and even a crisis of confidence, which has an impact on the healthy sectors of the economy, spreading it to the rest of the world.

The mortgage fund will offer assistance to between seven and nine million homeowners to ensure that they do not fall behind in their payments and lose their homes. Freddie Mac and Fannie Mae's rules for refinancing mortgages will be changed so homeowners can enjoy the lower interest rates available today. Government financing of mortgage companies will increase US$200 billion to stabilize the market. In addition, another US$75 billion will be used to reduce the absolute amount of mortgage payments under certain conditions: wherever the excessive sub-prime mortgage rates have shot up to up to 40 percent or 50 percent of owners' monthly incomes, whether because they have lost their jobs or their wages have been reduced.

While it will not be clear what changes Congress will make to the budget proposal until summer, the fact that the

original version does reflect what the president promised during his campaign will galvanize the Democrats. Energy independence, universal medical coverage and scholarships for higher education and vocational re-training will be funded by higher taxes on the oil and gas industries, multinational corporations, investment fund managing companies, and the three million people with the highest incomes in the country (plus cutbacks on some existing programs). The consistency of the promises and the proposed budget, plus its swift presentation —practically at the same time as the three plans— creates a favorable impression that might mark the end, not of the economic crisis, but of the crisis of confidence that was the short-term cause of the financial maelstrom.

The medium-term causes of the financial crisis are corrected in President Obama's bail-out and recovery plans since they are not aimed at creating new growth bubbles, but at balancing stimuli to consumption with investment and job creation. Also, it should be noted that these plans include precise guidelines for how federal agencies and the private sector should intervene in the markets. Thus, it is to be expected that in the near future the financial market will be re-regulated. The fact that some members of the new economic team are the same people who during the Clinton administration transferred governance to the financial markets might imply that they have sufficient knowledge to recover effective control of the financial market without inhibiting its ability to fulfill its primary functions.

Overcoming the long-term causes of the crisis implies generating a new driving force for the economy, one different from the old model based on importing consumer goods from Asia.

Overcoming the long-term causes of the crisis implies generating a new driving force for the economy, one different from the old model based on importing consumer goods from Asia. Both the stimulus package and the new budget presented to Congress are oriented to stimulating productive investment in the United States to create alternative sources of energy and new green technologies. The success of this economic aim will depend on the private sector's willingness to adapt to the new kind of stimuli diametrically opposed to the ones they had been accustomed to under Reaganomics. If it is possible to produce these new goods, they will not be fully commercially successful until they can be exported to the rest of the world.

Exporting more presupposes reducing the dollar's overvaluation, which could be achieved in two ways. One is to reduce the government's fiscal deficit so that, by issuing fewer debt instruments, the demand for the dollar *vis-à-vis* other currencies would drop. President Obama has promised to reduce this deficit by at least a third by the year 2013. The other way is to devalue the dollar, which could happen too rapidly, above all if this is caused by the sale of dollar-denominated debt instruments by other countries. Perhaps Secretary of State Hillary Clinton's first trip abroad was to Asia precisely to prevent this kind of scenario.

Changing the trade and financial relationship that has existed between the United States and Asia since World War II implies a historic change of the first magnitude. Correcting Asia's structural surplus, which has allowed it to develop industrially, not only implies a new economic development model in the United States, but in Asia as well. This will be the long-term way out of the current crisis because it involves its ultimate cause. However, the plan to restructure the international economy does not yet exist. Its implementation will require Timothy Geithner's relaxing the position of his predecessors at the Treasury Department about the US dollar/Chinese yuan exchange rate. Its success will depend on the way he situates himself in a broader negotiation that would take into account the real ability of the different countries to contribute to a new economic world order. VM

## NOTES

[1] www.brillig.com/debt_clock.

[2] See the Emergency Economic Stabilization Act on line at http://www.ustreas.gov/

[3] See the American Recovery and Reinvestment Act of 2009, which became law on February 17, 2009, on line at http://thomas.loc.gov/.

[4] Michael A. Fletcher and Renae Merle, "75B Program Aims to Lower Mortgages, Foreclosures," *The Washington Post*, February 18, 2009, and Josh Gerstein and Craig Gordon, "Obama aiming high with housing plan," *Politico*, February 18, 2009.

[5] The 2010 budget proposal is available on line at http://www.whitehouse.gov/omb/budget/.