# Social Studies 30-1: Unit 2

## Causes of the Global Recession

- In the fall of 2008, a credit squeeze ballooned into Wall Street's biggest crisis since the Great Depression.
- As hundreds of billions in **mortgage-related investments** went bad, mighty investment banks that once ruled high finance crumbled or reinvented themselves as commercial banks.
- The nation's largest insurance company and largest savings and loan were seized by the government.
- Only the passage by Congress of a $700 billion bailout plan in October 2008 and actions by the Federal Reserve to pump money into the system headed off a full-scale meltdown.
- But while financial Armageddon was avoided, the crisis spread around the globe, toppling banks across Europe and driving countries from Iceland to Pakistan to seek emergency aid from the International Monetary Fund (IMF).
- A vicious circle of **tightening credit**, **reduced demand** and **rapid job cuts** took hold, and **the world fell into recession**.
- In 2009, a number of countries moved to stimulate their economies.
- In the United States, Democrats in Congress passed a **$787 billion economic stimulus** measure requested by President Obama.
- China undertook a stimulus plan described as roughly $500 billion.
- Central banks across the globe followed the Fed's lead in cutting interest rates to close to nothing; and the Fed took other extraordinary measures, including buying up over a trillion dollars in mortgage-backed securities.
- The Obama administration forced **General Motors** and **Chrysler** into **bankruptcy** to save them, **investing more than $60 billion and cutting thousands of jobs**.
- By the summer of 2009, it appeared that a financial meltdown had been avoided, and by the year's end, many big banks were reporting large profits and all but one had repaid or were in the process of returning their bailout money to the federal government.
- But many businesses, especially small ones, reported that credit was still tight and only a fraction of those homeowners the Obama administration had hoped to help with a **$75 billion foreclosure prevention program** had reached agreements with their banks.
- **Unemployment rose steadily all year** (2009) to the highest levels seen in a generation, and anger over the crisis, the banks, the bailout and new rounds of large bonuses became a potent force in politics.
- The crisis gained a second wind in 2010 as revelations about the size of Greece's debts rippled slowly across Europe and shook markets in the rest of the world.
- A new government in Greece discovered that its deficits were three times the amount that had been acknowledged, leading investors to demand higher and higher interest rates, which in turn raised the likelihood that **Greece would not be able to pay its debts**.
- The crisis also revealed sharp divisions within **the euro zone** (countries in the EU that used the euro as their currency), as rich northern countries, Germany in particular, balked at a bailout of what was called "Club Med" - **Greece, Italy, Spain and Portugal**, countries all suffering from the bursting of the credit bubble but unable to devalue their currencies in response.
- As markets became increasingly nervous, a string of aid packages were announced, none of which calmed investors.

- Desperate to get ahead of the crisis, in May 2010 the European Union (EU) and the I.M.F. pledged to make **750 billion euros**, or nearly **$1 trillion**, available to euro states in need.
- In the United States, President Obama and Congressional Democratic leaders pushed for **another round of stimulus spending**.
- But even a whittled down bill, focused on **extending unemployment benefits** and helping states plug their yawning budget gaps, was unable get past the opposition of Senate Republicans.
- And a growing number of Democrats found themselves feeling caught between a stubbornly **high unemployment rate** and concerns over the **mounting federal debt**.
- In December 2010, **Treasury Secretary**, **Timothy F. Geithner**, said the $700 billion financial bailout would end up costing taxpayers less than Congressional analysts had estimated.
- The Congressional Budget Office had estimated that taxpayers would lose $25 billion on the rescue of banks, other financial institutions and automakers.
- But Mr. Geithner said it would cost less than that, though he did not provide another estimate.

**Origins**

- The roots of the credit crisis stretch back to another notable boom-and-bust: **<u>the tech bubble of the late 1990s</u>**. When the **stock market began a steep decline in 2000** and the United States slipped into recession the next year, the Federal Reserve **sharply lowered interest rates to limit the economic damage**.
- **Lower interest rates make mortgage payments cheaper**, and **demand for homes began to rise, sending prices up**. In addition, **millions of homeowners took advantage of the rate drop to refinance their existing mortgages**. As the industry ramped up, **<u>the quality of the mortgages went down</u>**.
- And turn sour they did, when homebuyers had to leverage themselves to the hilt to make a purchase. Default and delinquency rates began to rise in 2006, but the pace of lending did not slow. Banks and other investors had devised a plethora of **complex financial instruments to slice up and resell the mortgage-backed securities** and to hedge against any risks - or so they thought.

**The Crisis Takes Hold**

- The first shoe to drop was the collapse in June 2007 of two hedge funds owned by **Bear Stearns** that had **<u>invested heavily in the subprime mortgage market</u>**. As the year went on, more banks found that securities they thought were safe were tainted with what came to be called **<u>toxic mortgages</u>**. At the same time, the **<u>rising number of foreclosures</u>** helped speed **the fall of housing prices**, and the number of prime mortgages in default began to increase.
- The Federal Reserve took unprecedented steps to bolster Wall Street. But still the losses mounted, and in **March 2008 the Fed staved off a Bear Stearns bankruptcy by assuming $30 billion in liabilities and engineering a sale to JPMorgan Chase** for a price that was less than the worth of Bear's Manhattan skyscraper.

**Sales, Failures and Seizures**

- In August 2008, government officials began to become concerned as the stock prices of **Fannie Mae** and **Freddie Mac**, **government-sponsored entities** that were linchpins of the housing market, slid sharply. On September 7, 2008 the Treasury Department announced it was taking them over.
- Events began to move even faster. On Sept. 12, top government and finance officials gathered for talks to fend off bankruptcy for **Lehman Brothers**. The talks broke down, and the government refused to step in and salvage Lehman as it had done for **Bear Stearns**. Lehman's failure sent shock waves through the global banking system, as became increasingly clear in the following weeks. **Merrill Lynch**, which had not been previously thought to be in danger, sold itself to the **Bank of America** to avoid a similar fate.
- On Sept. 16, **American International Group** (AIG), an **insurance giant** on the verge of failure because of its exposure to exotic securities known as **credit default swaps**, was **bailed out by the Fed in an $85 billion deal**. Stocks dropped anyway, falling nearly 500 points.

**The Government's Bailout Plan**

- The bleeding in the stock market stopped only after rumors trickled out about a huge **bailout plan** being readied by the federal government.
- **$700 billion proposal** that would allow the government to buy **toxic assets from the nation's biggest banks**
- Congress eventually amended the plan to add new structures for oversight, limits on executive pay and the option of the government taking a stake in the companies it bails out.
- **Many Americans were angered by the idea of a proposal that provided billions of dollars in taxpayer money to Wall Street banks**, <u>which many believed had caused the crisis in the first place</u>.
- Lawmakers with strong beliefs in free markets also opposed the bill, which they said amounted to socialism.
- **President Bush** pleaded with lawmakers to pass the bill, but it was rejected.
- Negotiations for a new proposal began.
- A series of **tax breaks** were added to the legislation, among other compromises and **earmarks**, and the Senate passed a revised version Oct. 1 by a large margin, 74 to 25. On Oct. 3, the House followed suit, by a vote of 263 to 171.
- Overseas, the crisis continued to take hold. **Banks in England and Europe had invested heavily in mortgage-backed securities offered by Wall Street**, and England had gone through a housing boom and bust of its own.
- Losses from those investments and the effect of the same tightening credit spiral being felt on Wall Street began to put a growing number of European institutions in danger.
- The weekend after the bailout's passage, the German government moved to guarantee all private savings accounts in the country, and bailouts were arranged for a large German lender and a major European financial company.

**Continued Volatility**

- When **stock markets in the United States, Europe and Asia continued to plunge**, the world's leading central banks on Oct. 8 took the drastic step of a coordinated cut in interest rates, with the Federal Reserve cutting its two main rates by half a point.

- Oil-producing countries were hit by a sudden reversal of fortune, as the record oil prices reached over the summer were cut in half by October because of the world economic outlook. Even an agreement on a production cut by OPEC on Oct. 24 failed to stem the price decline.
- Stock markets remained in upheaval. On Oct. 29, the Fed cut its key lending rate again, to a mere **1 percent**.
- In early November 2008, the European Central Bank and the Bank of England followed with sharp reductions of their own.
- Federal officials also moved to put together a plan to aid homeowners at risk of foreclosure by shouldering some losses for banks that agree to lower monthly payments. Detroit's automakers, meanwhile, hard hit by the credit crisis, the growing economic slump and their belated transition away from big vehicles, turned to the government for aid of their own.

**The Crisis and the Campaign**

- The credit crisis emerged as the dominant issue of the presidential campaign in the last two months before the election.
- On Sept. 24, 2008 as polls showed Senator John McCain's (Republican candidate for President) support dropping, he announced that he would suspend his campaign to try to help forge a deal on the bailout plan.
- The next day, both he and Senator Barack Obama met with Congressional leaders and President Bush at the White House, but their efforts failed to assure passage of the legislation, which went down to defeat in an initial vote on Sept. 29, a week before it **ultimately passed**.
- The **weakening stock market** and **growing credit crisis** appeared to benefit Mr. Obama, who tied Mr. McCain to what he called the **failed economic policies of President Bush** and a **Republican culture of deregulation of the financial markets**.
- Polls showed that Mr. Obama's election on Nov. 4 was partly the fruit of the economic crisis and the belief among many voters that he was more capable of handling the economy than Mr. McCain.

**Deeper Problems, Drastic Measures**

- With credit markets still locked up and investors getting worried about the big banks, Wall Street marked a grim milestone **in late November 2008** when **stock markets tumbled to their lowest levels in a decade**. In all, the slide from the height of the stock markets had wiped out more than $8 trillion in wealth.
- In December, an obscure group of economists confirmed what millions of Americans had suspected for months: **the United States was in a recession**. The economy had actually slipped into recession a year earlier, a committee of economists said, putting the current downturn on track to be the longest in a generation.
- **Unemployment rose to its highest point in more than 15 years**. Trade shrank. Home prices fell farther. Retailers suffered one of the worst holiday seasons in 30 years as worried consumers cut back, and stores like Sharper Image, Circuit City and Linens 'n Things filed for bankruptcy.
- On Dec. 16, 2008 the Federal Reserve entered uncharted waters of monetary policy by cutting its benchmark **interest rate to nearly zero percent** and declaring that it would

deploy its balance sheet and essentially print money to fight the deepening recession and locked credit markets. Other countries followed the Fed with rate cuts of their own.
- The fourth-quarter corporate earnings season was marked by billion-dollar losses and uncertain outlooks for 2009. The economy showed no sign of turning around.
- Some bailout recipients, including Citigroup and Bank of America, were forced to step forward for additional lifelines, raising one of the most uncomfortable questions a new president has ever had to address: **Would the government nationalize the American banking system?**

**A New Administration**

- As president-elect, Mr. Obama made confronting the economic crisis the top priority of his transition. In January 2009, before taking office, he laid out a **stimulus proposal** for Congress, which developed into the **<u>$787 billion package passed in February 2009</u>** - with only three Republican votes in the Senate, and none in the House.
- To the dismay of some of his liberal supporters, Mr. Obama appointed Timothy F. Geithner as treasury secretary; Mr. Geither had been president of the New York Fed, and had been deeply involved in the crisis as it unfolded. In internal discussions about how to deal with the nation's reeling banks, Mr. Geithner prevailed, swinging the debate away from drastic actions like nationalization of the worst cases.
- Mr. Geithner laid out a plan for a **public-private rescue fund** that would **buy up to $1 trillion in assets so-called toxic assets** - a plan banks resisted and that was made moot by their recovery. Mr. Geithner and Mr. Bernanke also put the nation's biggest banks through a "stress test" that suggested that all could survive, though some were ordered to raise more capital.
- Mr. Obama also unfurled a **$75 billion plan** to help as many as **nine million families refinance their mortgages or avoid foreclosure - <u>a plan that proved to be the least successful of the administration's many initiatives</u>**.

**New Fears, New Lows, Then New Hopes**

- It was a hard winter for stock markets and the global economy. The United States reported that the economy shrank even faster than originally estimated in the last three months of 2008 - a punishing 6.2 annual rate of decline - and the government increased its stake in Citigroup to 38 percent, increasing fears that the **country's major banks** were hurtling downward so fast that they **could face the prospect of nationalization (become state-owned)**. Credit conditions began to slip again, and stock markets fell even further, skidding to their lowest levels in 12 years and slashing the share prices of blue-chip companies to something akin to penny stocks.
- Conditions across the globe didn't look much better. Countries in Eastern Europe that had embraced American-style capitalism began to teeter, raising concerns that the Baltic republics (Estonia, Latvia, Lithuania), Hungary and Romania could be the next victims of the credit crisis, and could drag Western European banks down with them. Trade levels skidded lower and lower as demand for goods fell worldwide, hurting big exporters like China, and countries began throwing up trade barriers as the downturn deepened.
- But just as investors seemed more hopeless than ever, an unfamiliar force took hold of the markets: hope. A flurry of economic reports released by the government and private research groups showed surprising signs of stability in areas like home sales, retail

spending, factory orders and consumer confidence. Leaders of JPMorgan Chase, Bank of America and Citigroup offered more optimistic projections about their profitability.
- Despite sharp divisions over how to respond to the economic crisis, leaders of the world's largest economies smoothed over some of their differences at the Group of 20 (G-20) meeting in London at the beginning of April. They **pledged $1.1 trillion** that could be used to shore up developing countries and avoided the discord of a similar meeting during the Great Depression, but critics said the gathering failed to address some of the root problems of the global financial crisis.

**A Crucial Moment for Banks and Automakers**

- For investors hunting for reasons to feel optimistic, signs of spring abounded. Although the International Monetary Fund said the global economy was the worst since 1945, many were eagerly hoping that the worst days of the recession were over. Stocks continued to race higher in April.
- Home sales in some battered markets were bouncing back.
- The banking system even offered signs of improvement. Major banks like **Citigroup**, **Wells Fargo** and **Bank of America** that had been deep in the red said they had returned to profitability in the first three months of 2009, although many of those earnings came from one-time gains and creative accounting. For the second quarter of 2009, **JPMorgan Chase** and **Goldman Sachs** posted stellar profits.
- But for the country's sagging automobile makers, problems only seemed to multiply. Sales dropped by double digits, and **General Motors** and **Chrysler**, which **<u>received billions in government bailouts</u>**, rushed to complete restructuring packages, but they were unable to avoid the path to bankruptcy court.
- After negotiations between Chrysler and a small group of bondholders failed, the government forced Chrysler into bankruptcy at the end of April and cobbled together an alliance with the Italian automaker Fiat. A month later, General Motors followed its rival into bankruptcy. But the automakers surprised experts by racing through restructuring and government-sponsored sales to create a new Chrysler and a new G.M. But an old question remained: Could the companies regain the status they had lost, become profitable and persuade the world to buy their cars and trucks?

**One Year Later, Signs of Recovery**

- A year after the credit crisis erupted, its impact was fading on Wall Street.
- In June 2009, after weeks spent jockeying with regulators and raising billions in stock offerings and debt sales, **10 big financial institutions were allowed to return their share of the government's $700 billion financial bailout**. Banks including **JPMorgan Chase**, **Goldman Sachs** and **American Express** paid back a total of **$68 billion**, a move that allowed them to stand without taxpayer dollars and operate without increased government scrutiny over matters like executive pay.
- But even as the banks wired the money back to the Treasury Department, some asked whether Washington and the banks were moving too fast. The financial system had stabilized and credit markets continued to improve, but none of the systemic problems that brought banks to their knees had been addressed. Mr. Obama **called for a broad**

**regulatory overhaul**, including **increased protection for consumers**, but faced resistance not only from the financial industry but within Congress, particularly for his suggestion to give the Fed more explicit authority to monitor the markets for system-wide problems.
- Stock markets, meanwhile, zoomed higher through the summer. Demand for risky investments like junk bonds surged back. Wall Street's financial wizards were busy creating new investment instruments to profit from life-insurance policies. Bonuses were back (if they had ever gone away), risk was being rewarded and big financial firms like Goldman Sachs were again reporting huge profits. Even Bank of America, recipient of some $45 billion in taxpayer aid, was talking about repaying the government.
- In September, Mr. Geithner told a Congressional panel that it was time to start winding down the government's bailout programs, and that the Treasury was expecting more banks to repay their bailout funds. A few days later, Mr. Bernanke said that the recession was "very likely over," even though he expected the recovery to be bumpy, and marked by high unemployment.

**Europe's Credit Crisis**

- In December 2009, the new prime minister of Greece, George A. Papandreou, announced that his predecessor had disguised the size of the country's ballooning deficit. That declaration set in motion a chain of events that threatened not only the finances of Greece, but of other southern-tier European states, like Spain, Portugal and Italy, shook markets worldwide and raised deep doubts about the future of the euro and European integration.
- The roots of the crisis go back to the strong euro and rock-bottom interest rates that prevailed for much of the past decade. Greece and other southern European countries took advantage of this easy money; in the process, some of them, like Athens, built up formidable levels of debt, others, like Spain, set off gigantic housing bubbles, and all of them became less competitive than their northern neighbors. When the global economy crumpled, those chickens came home to roost.
- The financial crisis has highlighted the constraints of euro membership for these struggling economies. Unable to devalue their currencies to regain competitiveness, and forced by E.U. fiscal agreements to control spending, they are facing austerity measures just when their economies need extra spending. Other countries, like Germany, the Netherlands and Austria, have kept deficits down while retaining an edge in global markets by restraining domestic wage increases. France lies somewhere between the two camps.
- The chief difficulty in working out a package to support Greece was the popular sentiment in Germany, deeply concerned about becoming the answer to the **debt problems of all of Europe's endangered economies** (sometimes referred to as the PIIGS—Portugal,Italy, Ireland, Greece, Spain) that Greece should pay a penalty for its former profligacy.
- After rounds of deep budget cuts and months of vague pledges of support from the rest of Europe failed to stop the steady rise of interest rates the market was demanding to finance Greece's debt, Mr. Papandreou in April 2010 formally requested a promised **$60 billion aid** package, calling his country's economy "a sinking ship."
- But global investors, who had seen Greece's bonds downgraded to junk status, were not reassured, forcing the I.M.F. and Greece's European partners to hastily prepare a far larger package. The new plan, announced May 2 and passed by Parliament on May 6, calls for 110 billion euros, or **$140 billion**, in loans over the next three years to avoid a debt default. In exchange, Greece had to accept deep cuts that will lead to years of sacrifice.

- Yet support for the euro continued to erode, markets began to sink worldwide and signs of a renewed credit crunch in Europe appeared. Against this anxious backdrop, European leaders on May 9 agreed to **provide nearly $1 trillion** as part of a huge rescue package. Only hours later, central banks began the direct buying of euro zone government bonds directly - an unprecedented move to inject cash into the financial system.
- Officials were hoping the size of the rescue package — a total of **$957 billion** — would signal a "shock and awe" commitment to such troubled countries as Greece, Portugal and Spain, in the same vein as the $700 billion package the United States government provided to help its own ailing financial institutions in 2008.
- After a brief respite following the announcement of the bailout plan, fear in the financial markets rebounded over worries that the continent's biggest banks face strains that will hobble European economies. Investors feared that the only solution for debt-strapped governments who are unable to devalue their currency would be a restructuring that would cost their bondholders billions. Since many of those are European financial institutions, the fallout could be felt on both sides of the Atlantic.