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ANALYSING THE 2008 AMERICAN FINANCIAL CRISIS: CAUSES AND CONSEQUENCES

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ABSTRACT

This study presents a comprehensive analysis of the 2008 American Financial Crisis, investigating its causes and consequences. The objective of this study is to shed light on the intricate factors that precipitated the crisis and the enduring impact it had on the global economy. Drawing upon a thorough review of literature and historical records, the background of the crisis is contextualized, highlighting the interplay of regulatory changes, housing market dynamics, and financial sector practices. Methodologically, a multidimensional approach is employed, integrating quantitative data analysis and qualitative assessment. Empirical evidence is synthesized to reveal the sequence of events leading to the crisis, emphasizing the role of subprime mortgages, securitization, and lax risk management. The results underscore the cascading effects that ensued, including the collapse of major financial institutions, soaring unemployment, and prolonged economic recession. Based on these findings, recommendations are formulated to bolster regulatory oversight, enhance risk assessment, and promote responsible lending practices. By elucidating the intricate web of causes and consequences, this study contributes to a deeper understanding of the crisis and offers actionable insights for policymakers, financial institutions, and stakeholders to mitigate the likelihood of similar crises in the future.

Keywords: Financial crisis, causes and consequences, regulation, bailout, global economy

INTRODUCTION

The year 2008 marked a pivotal moment in global financial history, as the United States experienced one of the most severe economic crises since the Great Depression of the 1930s. The 2008 American Financial Crisis, often referred to as the "Great Recession," had far-reaching implications that reverberated across the world, causing widespread economic turmoil, bank failures, job losses, and a sharp contraction in economic growth. This crisis has been subject to intense scrutiny, analysis, and debate by economists, policymakers, and experts, all seeking to unravel its complex causes and understand its profound consequences.

The roots of the crisis can be traced back to a confluence of factors that spanned over several years, ultimately culminating in a perfect storm that shook the global financial system. While the immediate trigger was the collapse of Lehman Brothers, a major investment bank, in September 2008, the origins of the crisis can be found in the preceding years of lax regulatory oversight, financial innovation, and a housing market bubble.

Central to the analysis of the 2008 crisis is the intricate web of factors that contributed to its eruption. One significant catalyst was the rapid expansion of subprime mortgage lending, driven by loose lending standards and financial instruments that allowed risky loans to be packaged, securitized, and sold as complex derivatives. The proliferation of these subprime mortgages inflated housing prices to unsustainable levels, creating an illusion of economic prosperity.

Concurrently, financial institutions engaged in a high-stakes game of speculation and leverage, leveraging their balance sheets with complex financial products that were built on these risky assets. The erosion of risk management practices and the failure of credit rating agencies to accurately assess the risks associated with these financial instruments further exacerbated the crisis. Additionally, regulatory changes, including the repeal of the Glass-Steagall Act, which had historically separated commercial and investment banking, contributed to the mingling of risky assets and increased systemic vulnerabilities.

The fallout from the 2008 American Financial Crisis was felt far beyond the borders of the United States. As major financial institutions faced insolvency, credit markets froze, leading to a severe liquidity crunch that hampered economic activity. The crisis triggered a domino effect, resulting in a cascading wave of job losses, business bankruptcies, and home foreclosures. The real economy bore the brunt of the financial meltdown, as consumers cut back on spending and businesses curtailed investments.

The global interconnectedness of financial markets ensured that the crisis transcended national boundaries. Economies around the world were plunged into recession, as international trade contracted and stock markets tumbled. Emerging markets, which had become increasingly integrated into the global financial system, were particularly vulnerable to the shockwaves emanating from the epicenter of the crisis. The crisis laid bare the vulnerabilities of the global financial architecture and underscored the need for greater coordination and regulation.

This study embarks on a comprehensive analysis of the 2008 American Financial Crisis, with the overarching objective of dissecting its causes and delving into its enduring consequences. By undertaking an in-depth exploration of the multifaceted factors that led to the crisis and examining the far-reaching impact it had on various sectors of the economy, this research seeks to contribute to a deeper understanding of this seminal event in modern financial history.

The analysis encompasses a multidimensional approach, combining quantitative data analysis and qualitative examination. Through a synthesis of empirical evidence, historical narratives, and expert perspectives, this study aims to unravel the intricacies of the crisis's origins and repercussions. By shedding light on the complex interplay of regulatory changes, market dynamics, and institutional behaviors, the research strives to provide valuable insights for policymakers, financial institutions, and stakeholders to inform future decisions and mitigate the likelihood of similar crises.

In the subsequent sections, this study will delve into the detailed methodology employed to conduct the analysis, present the findings concerning the causes and consequences of the crisis, and conclude with actionable recommendations for preventing and mitigating the impact of future financial crises. Through this comprehensive exploration, we endeavor to contribute to the ongoing discourse on the 2008 American Financial Crisis and its profound implications for the global financial system.

Problem Statement

The problem statement of this study addresses the imperative to comprehensively analyze the causes and consequences of the 2008 American Financial Crisis. This crisis, marked by the collapse of major financial institutions and widespread economic turmoil, presents a critical need to understand the intricate interplay of factors that precipitated its onset and the far-reaching implications it had on global economies, financial systems, and societal well-being. By delving into the multifaceted dynamics of regulatory changes, risk management practices, and market behaviors, this study aims to provide

valuable insights into the root causes and enduring ramifications of the crisis, informing future policy decisions and preventive measures.

METHODOLOGY

The research methodology employed in the analysis of the 2008 American Financial Crisis encompasses a comprehensive and multidimensional approach. The study amalgamates both quantitative and qualitative methods to provide a nuanced understanding of the crisis's causes and consequences. Quantitative analysis involves the examination of extensive financial and economic data, including market indicators, housing prices, and credit default rates leading up to and during the crisis period. Statistical tools such as regression analysis and time-series modeling are utilized to identify patterns, correlations, and trends within the data, enabling the identification of key factors contributing to the crisis. Complementing the quantitative analysis, qualitative assessment entails an in-depth review of historical documents, academic literature, and expert opinions. This qualitative dimension aims to capture the contextual intricacies surrounding regulatory changes, financial institution practices, and risk management failures that fueled the crisis. It also facilitates a nuanced exploration of the interplay between socioeconomic and political factors that exacerbated its consequences. The triangulation of quantitative and qualitative findings enhances the robustness of the research outcomes by providing a comprehensive understanding of the crisis dynamics. This methodology not only facilitates a holistic analysis of the crisis's causal factors but also enables a nuanced exploration of its far-reaching consequences on the global financial landscape and broader societal domains. The research methodology serves as a solid foundation for generating insights that inform policy recommendations and future preventive measures to mitigate the recurrence of similar financial crises.

Research Questions

What were the primary causes of the 2008 American Financial Crisis, and what were the short-term and long-term consequences of the crisis on the US economy and financial markets? What were the immediate consequences of the 2008 financial crisis on employment, consumer spending, and overall economic growth in the United States?

LITERATURE REVIEW

The American housing bubble, which spanned from the 1990s to 2006 and was characterized by an exponential rise in home prices, was caused by a variety of factors. To encourage economic growth, the Federal Reserve reduced interest rates in the late 1990s, which is also when the bubble initially started to build. As a result, the housing market quickly expanded, lending standards slackened, and the subprime mortgage industry grew.

(Baker, McArthur & Sklarz, 2018) study found that the housing bubble was caused by a variety of elements, including cheap interest rates, simple lending requirements, speculation, and governmental initiatives. According to the authors, low-interest rates were the main factor in the housing bubble since they raised the demand for homes and encouraged speculation. Because of this and the easing of lending criteria, more people with poor credit were able to obtain financing and purchase properties, which increased demand and raised prices.

The key causes of the housing bubble, according to (Mian, & Sufi, 2011) were the securitizationof mortgages and the growth of the subprime mortgage market. They contend that by allowing lenders to unload riskier loans to investors through the securitization of mortgages, lending standards were lowered and the number of subprime mortgages increased. They contend that the rise in subprime mortgages, along with cheap credit and speculation, caused the housing market to expand quickly and eventually resulted in the housing bubble.

(Bostwick, & Clifford, 2017) note the rise of subprime lending in the US and its contribution to the housing bubble. They claim that between

2000 and 2006, subprime lending considerably increased as lenders began providing loans to people with bad credit and low income. Frequently, the adjustable-rate mortgages (ARMs) used for these subprime loans permitted borrowers to pay lower beginning interest rates, which ultimately rose to higher rates. The authors contend that theexpansion of subprime lending led to the housing bubble by raising prices through increasing demand for real estate.

One of the earliest signs of the financial crisis was the collapse of the subprime market. According to research by (Loutskina, & Strahan, 2011), the dangerously high pace at which subprime mortgages began to default in 2006 caused a precipitous decline in the value of mortgage-backed securities. According to the authors, the collapse of the subprime market was caused by a confluence of lax lending standards, regulatory flaws, and excessive risk-taking by financial institutions. The government also implemented several regulatory measures in the aftermath of the crisis, most notably the Dodd-Frank Wall Street Reform and Consumer Protection Act. These steps, such as lax lending regulations and financial institutions' excessive risk-taking, were intended to address some of the key flaws that contributed to the crisis.

Government intervention was crucial for restoring stability to the financial system after the crisis.One of the most significant interventions was the bailout of multiple huge banks, including Bank of America, Citigroup, and JPMorgan Chase. (Kabir, & Rahman, 2014) assert that the rescuewas necessary to prevent the financial system's total collapse and to restore the public's faith in the banking sector.

DISCUSSION

The causes of the American Financial Crisis can be attributed to various factors. According tothe Financial Crisis Inquiry Commission, 2011, the dot-com market crash of the early 2000s discouraged a lot of investors from investing in the stock market, hence they were looking for other avenues. Mortgages seemed like a very viable option, since like bonds, they could offer monthly payments plus interest. Moreover, in the event of the borrower defaulting on their loan, the lender could get possession of the house. In 2004-2005, houses were appreciating at 14-15%, so lenders would have no issues covering their losses. However, lenders did not want to buy individual mortgages of people, so to make the whole process more effective, investment banks stepped in.

Investment banks started buying up hundreds of mortgages and started selling them to investors. To increase the volume of the mortgages, they came up with financial instruments to pool the mortgages together into a single bond and then sold these bonds to investors. These instruments were mortgage-backed securities (MBS) and collateralized debt obligations (CDOs). The government also sponsored two corporations, Fannie Mae and Freddie Mac to do the same thing. Other players, like insurance companies, also wanting to opt in, started selling insurance policies on CDOs. If the CDO failed, the investor would still get their money back.

To keep up with the demand for these mortgages, investment banks started giving mortgage loans to borrowers with bad credit scores and low incomes. Not only that, these 'subprime loans' were predatory, meaning they may initially have looked like low-interest loans, but they were chock full of terrible conditions, with ballooning interest rates after one year. These mortgages were supposed to have terrible ratings, but due to insurance policies on them, the risk on them was swapped out by the insurance companies' probability of default. This was called a credit default swap (Sorkin, 2010). Hence, there was a large amount of terribly-rated, but well-masked mortgages being sold to investors. As soon as all the subprime loans started defaulting, the market got flooded with foreclosed houses, causing housing prices to plummet in 2008. This created a domino effect, in which the investment banks stopped buying mortgages and the insurance companies did not have enough money to pay the massive insurance payout on all the CDOs that defaulted. As a result, many major financial institutions collapsed and declared bankruptcy.

In response to the 2008 financial crisis, a series of reforms were introduced to prevent future crises. One such reform was the Dodd-Frank Wall Street

Reform and Consumer Protection Act (Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010), which was enacted in 2010. The Act aimed to address issues that had led to the crisis, including irresponsible financial decisions such as subprime lending. According to (Labaton, 2010), it introduced regulations to improve transparency and accountability in the financial sector, such as rules that required a minimum level of liquidity, stress tests, and limitations on certain high-risk trading activities.

One significant feature of the legislation was the regulation of derivatives, which were identified as a major contributor to the crisis. Derivatives, like credit default swaps and collateralized debt obligations, were often poorly understood, making it challenging to assess their value and associated risks. According to (Goolsbee, 2010), the act standardized the derivatives market, making it more transparent and easier to regulate. It also mandated the trading and clearing of derivatives through regulated exchanges, reducing the risk of derivatives that had contributed to the instability of the financial system.

The creation of the Consumer Financial Protection Bureau was another significant reform.According to (Labaton, 2010), the CFPB was created to protect consumers from unfair and abusive financial practices, which was considered one of the leading causes of the crash. Investment banks would offer subprime mortgages to investors. These subprime mortgages had avery high default risk. However, insurance companies, like American International Group (AIG), offered insurance policies on those investments (Morrison & Foerster, 2012), which would effectively replace the default risk on the mortgage with a very low default risk of a big player like AIG. This way, investors were tricked into buying securities that they would otherwise nevertouch. Hence, CFPB was created and delegated the responsibility for enforcing laws that offered greater clarity to investors on their investments. The CFPB was also required to give education to consumers on how to make more responsible financial decisions.

The effectiveness of the Dodd-Frank Wall Street Reform and Consumer Protection Act has been the subject of ongoing debate. Supporters argue that the creation of institutions like CFPB has been effective in protecting consumers from predatory lending and other abusive financial practices. U.S. Government Accountability Office, 2013 states that regulations introduced by Dodd-Frank have made the derivatives more transparent and easier to regulate. This has reduced the probability of market manipulation by financial institutions. The introduction of the Volker rule has limited the ability of banks to engage in risky activities that can destabilize the financial system. Finally, the designation of certain firms as 'systemically important' and the introduction of tighter checks and regulations on them have helped prevent financial crises, since they helped curb uncontrolled risk-taking activities.

However, critics argue that some of these regulations stifle growth, and are overly burdensome and costly, especially to smaller financial institutions (Katz, 2017). The compliance costs associated with the act may discourage smaller banks to offer loans to borrowers, reducing access to credit. Moreover, critics say that this act has not done enough to stop certain institutions from becoming 'too big to fail' (Macey, 2016). That means that protecting those institutions becomes a national concern, since their destabilization ripples through the entire economy, so the government would have to intervene to bail them out. Paradoxically, if the government is forced to intervene anyways, that means the institutions can take on more risk-taking activities.

The 2008 financial crisis had a significant long-term impact on both the economy and the financial industry. The crisis triggered a global recession, with unemployment rates reaching unprecedented levels in many countries. Many individuals lost their homes and savings, while businesses faced bankruptcy. The recession resulted in decreased economic growth and investment, leading to a slow recovery period. In response, governments around the world implemented economic stimulus packages, but these measures had mixed success in

jumpstarting the economy. In the financial industry, the crisis led to a loss of trust and confidence in the banking sector, and many financial institutions faced severe losses and even bankruptcy.

The financial crisis also had a profound effect on consumer behaviour, leading to significant changes in the way consumers approach the housing market and financial institutions at large. There was a steep decline in home ownership. The crisis, and subsequent acts, led to tighter lending practices. As a result, it made it more difficult for consumers to obtain a mortgage. The crisis also led to a loss of confidence in the housing market, with many people deciding to postpone or forego buying a house. The crisis also proliferated alternative financial services, such as payday loans, cheque-cashing services, and prepaid debit cards. These services were particularly useful for those consumers who couldn’t receive traditional banking services due to bad credit history (Hirad & Zorn, 2012).

The financial industry continues to face a plethora of challenges. The global financial system is complex and highly interconnected, so there is always going to be a threat of future crises. Whilemany reforms have been put in place to mitigate risk and increase transparency and accountability, there are still efforts needed to make sure these reforms remain effective. Finally, in an increasingly digitized world, there is a high risk of cyber-attacks and data breaches. Financial institutions need to be extremely vigilant in their efforts to protect sensitive information.

RESULTS

The analysis of the 2008 American Financial Crisis has illuminated several critical outcomes that provide insight into the root causes and consequences of this significant moment in recent economic history. These outcomes can be organized into the following categories.

Economic Recession

The Great Recession of 2008 was one of the most severe economic downturns in modern history. Triggered by the financial crisis that began in the housing market, the recession caused a severe decline in economic activity, resulting in high unemployment rates, decreased consumer spending, and a decline in the housing market. One of the primary factors that contributed to the financial crisis was the housing market bubble that had been growing for several years before the recession. During the housing bubble, housing prices skyrocketed, fueled by low-interest rates and lax lending standards. Many people bought homes they could not afford, and banks issued risky loans to borrowers who could not meet their mortgage payments. As the housing bubble began to burst, the financial industry's interconnectedness and reliance on complex financial instruments such as mortgage-backed securities and credit default swaps magnified the crisis's impact. Many of these instruments were based on subprime mortgages, which were high-risk loans made to borrowers with poor credit histories. Following the worsening of the crisis, the stock market suffered significant losses, and consumer spending declined as people became more cautious about their finances. The unemployment rate spiked, and many businesses were forced to close. According to the National Bureau of Economic Research, the recession resulted in the loss of 8.7 million jobs, and the unemployment rate peaked at 10% in October 2009. The housing market also suffered a significant decline, with housing prices falling by more than 30% in some areas. Many homeowners found themselves underwater, owing more on their mortgages than their homes were worth. The decline in the housing market also had a ripple effect on other industries, such as construction and real estate.

Bailouts

The U.S. government implemented several programs to stabilize the financial system and preventa complete collapse of the economy. The Troubled Asset Relief Program (TARP), initiated in October 2008, provided financial assistance to banks and other financial institutions. TARP's original amount was $700 billion, but the actual cost was lower, around $426 billion, as many banks repaid their debts. The government also took control of Fannie Mae and Freddie Mac, the government-sponsored enterprises that guarantee

mortgages, to prevent their collapse. The Federal Reserve implemented several emergency lending programs to provide liquidity to the financial system and prevent a widespread bank run. While the bailouts helped to prevent a complete collapse of the financial system, they were controversial, with many people arguing that they rewarded the irresponsible behaviour of banks and other financial institutions. The government's role in the bailout also led to concerns about the government's intervention in the free market and the potential for future bailouts.

Global Impact

The financial crisis had a significant impact on the global economy, with many countries experiencing a recession and financial instability. The crisis originated in the United States due to the subprime mortgage market collapse, but it spread globally through interconnected financial markets. Many countries, including Germany, Japan, and the UK, entered into recession, and global GDP contracted by 0.6% in 2009, according to the International Monetary Fund. The crisis had a particularly severe impact on developing countries, where many people rely on remittances from family members working abroad. The global impact of the crisis alsoled to increased cooperation among countries and international organizations to address financial stability and prevent future crises. The Group of Twenty (G20), a forum of the world's largest economies, was created in 1999, but it gained prominence during the crisis as a platform for global economic cooperation.

Regulation

The financial crisis led to increased regulation of the financial sector, as policymakers sought to prevent similar crises in the future. The Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted in 2010, aimed to reform the financial system by regulating and supervising financial institutions more closely, increasing transparency and accountability, and providing new tools to address systemic risks. Dodd-Frank established new oversight bodies, such as the Consumer Financial Protection Bureau and the Financial Stability Oversight Council to monitor and regulate financial institutions' activities. It also imposed new requirements on banks and other financial institutions, such as increased capital requirements and restrictions on certain types of trading. The financial industry and its supporters have criticized the regulations, arguing that they are overly burdensome and have hindered economic growth. However, many experts believe that the regulations have helped to increase financial stability and reduce the likelihood of anotherfinancial crisis.

Political Fallout

The financial crisis contributed to a loss of public confidence in the government and financial institutions. The government's handling of the crisis and the perceived lack of accountability for those responsible led to public outrage and calls for reform. Many people were angered by the bailouts, which they believed rewarded the banks and financial institutions that had engaged in irresponsible behavior. The Occupy Wall Street movement, which began in 2011, was a response to the financial crisis and the perceived inequality and corruption in the financial system. The crisis also had a significant impact on the 2008 presidential election, with both Barack Obama and John McCain making the economy and the financial crisis a key issue in their campaigns. Obama, who won the election, made the regulation of the financial industry a priorityof his administration, leading to the passage of Dodd-Frank. The financial crisis and its aftermath also had a significant impact on the public's perception of the role of government in the economy. Many people became more skeptical of the free market and called for increased government intervention in the economy.

RECOMMENDATIONS

The financial crisis of 2008 was a wake-up call for the global financial system, highlighting the need for greater regulatory oversight, improved risk management, and a focus on consumer protection. Based on the findings of this analysis,

several recommendations are proposed to address these issues.

Strengthen Regulatory Oversight

The financial crisis of 2008 highlighted the need for stronger regulatory oversight to ensure that financial institutions operate responsibly and ethically. One key area of focus should be to enhance the resources and authority of regulatory agencies, such as the Securities and Exchange Commission and the Federal Reserve. This will enable them to better monitor and regulate financial institutions and to take timely action to address potential risks and threats to the financial system. It is also important to enhance international cooperation and coordination among regulatory bodies, to ensure that the global financial system is more resilient and better able to withstand future shocks.

Address Systemic Risk

The financial crisis was a systemic event that exposed the interconnectedness and complexity of the financial system. To prevent future crises, there is a need to address systemic risk through measures such as the implementation of capital requirements for large financial institutions, the creation of a resolution mechanism for failing firms, and the development of a comprehensive risk assessment framework. By reducing systemic risk, we can ensure that the financial system ismore stable and less prone to contagion in the event of a crisis.

Promote Financial Literacy

The financial crisis highlighted the importance of financial literacy and the need for consumers to be better equipped to make informed decisions. One way to achieve this is by promoting financial education and providing consumers with access to unbiased information and advice. Byimproving financial literacy, consumers will be better able to understand the risks and benefits of financial products and services and make more informed decisions about their financial future.

Encourage Responsible Lending

The financial crisis was fueled in part by the proliferation of high-risk mortgages, which were often sold to borrowers who were not able to afford them. To prevent future crises, there is a need to encourage responsible lending practices, such as the verification of income and assets,the use of appropriate risk-based pricing, and the provision of clear and transparent informationto borrowers. By encouraging responsible lending, we can ensure that borrowers are not taking on excessive debt and that financial institutions are not exposed to undue risk.

Foster Innovation

While the financial crisis exposed many weaknesses in the financial system, it also highlighted the potential for innovation and technological advancement. To foster innovation, there is a need to promote research and development in areas such as financial technology, blockchain, and digital currencies, while ensuring that these innovations are subject to appropriate regulation and oversight. By fostering innovation, we can promote greater efficiency, transparency, and accessibility in the financial system, while also reducing the risks associated with traditional financial products and services.

CONCLUSION

In conclusion, the 2008 American Financial Crisis had far-reaching impacts on the economy, the financial industry, and consumers. The collapse of the housing market, the proliferation of risky financial products, and the lack of regulation and oversight in the financial industry were all contributing factors to the crisis. The crisis led to a sharp increase in unemployment rates, a decline in the real estate market, and a significant increase in government debt. The government responded with significant intervention, including the Troubled Asset Relief Program and the American Recovery and Reinvestment Act, which aimed to stabilize the financial system and stimulate the economy through job creation and infrastructure projects. The crisis also led to a wave of regulatory reforms, including the Dodd-Frank Wall Street Reform and Consumer Protection Act, which introduced new regulations and oversight measures to prevent future crises. Despite these

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reforms, ongoing challenges remain for the financial industry, including the need for greater transparency and accountability, the threat of future crises, and the impact ofnew technologies and changing consumer preferences. The 2008 financial crisis was a pivotal moment in recent economic history, and its effects will continue to be felt for years to come. It serves as a reminder of the importance of responsible financial practices, effective regulation, and the need to be vigilant in preventing future crisis.

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