

# Economic political science

Finance



Name: Tutor: Course: Date: Economic Political Science The recent financial crisis was the worst economic recession ever witnessed since the Great Depression. Most of the blame for this economic predicament centers on three main groups.

For instance, some sections of people hold the government responsible for the crisis. They assert that the inability or reluctance to regulate the financial market caused the incidence. Other individuals lay their blame on Wall Street investors. These individuals believe that the inability of the investors to adopt self-regulation and give in to greed created the problem.

Additionally, other persons also blame American homeowners. According to them, their ignorance, financial incompetence and lack of information concerning the types of mortgages they accessed led to the problem.

Nonetheless, the blame for the economic crisis centers directly on the inability of the government to regulate the financial market. Government's Role in the Economic Crisis Indeed, the economic crisis arose from the government's unwillingness and inability to control the financial market. The economic predicament arose from the lack of oversight from the government especially on banks and government agencies. One of the main problems arising from insufficient oversight comprises the issue of housing. In the 2000s, the housing boom arose from the creation of new financial instruments originating from the 1990s.

Some of these instruments comprise default swaps, sub-prime mortgage lending and structured finance. According to Johnson and Kwak (121), government agencies such as Securities and Exchange Commission (SEC)

failed to see structured financial commodities such as hedge funds. This is because the persons purchasing these products constituted sophisticated investors and university endowments.

Additionally, the government also failed to regulate default swaps, which increased leverage, while the Federal Reserve largely supported sub-prime lending. The government was answerable to the economic crisis because of its policies on housing. At one point, the government initiated policies based on amplifying home ownership. This instigated the housing bubble, which comprised one of the major factors for the economic predicament the nation was facing. At the start of the 2000s, the government necessitated Fannie Mae and Freddie Mac to obtain escalating figures of ‘reasonable’ housing loans. This was a social policy aimed at increasing home ownership especially among persons deemed by the government as unable to qualify normally. Accordingly, McCoy and Peddle state that, “the neoliberal system may give limited, residual benefits to the poor, but it refuses to address what makes these people poor in the first place” (McCoy & Peddle 76). This neo-liberalist approach, centered mainly on social welfare, focused on providing housing benefits to the low and middle class.

However, this was another initiative by the government to avoid addressing the structure of inequality within the society. The government further enhanced the situation especially because of the oversight of credit rating agencies. Credit rating agencies rated Mortgage-Backed Securities (MBS) and Collateralized Debt Obligations (CDOs) the same way as government bonds. These financial products were similar since most required assets as collateral if the borrower or investor failed to reimburse. Nonetheless, the <https://assignbuster.com/economic-political-science/>

high rating of these securities by the agencies persuaded numerous investors to purchase these securities without considering the contents of these commodities (Johnson & Kwak 124). Even though the ratings were similar to government bonds, products such as the MBS were less risky but offered advanced interest rates to investors. Furthermore, the CDOs, which were built out of the MBS, also offered low risk and massive returns for investors.

Nonetheless, the impact of credit rating agencies on the sudden investment in MBS and CDOs was a factor crucial towards the rise of the economic crisis. Comparison of Government's Role with Other Groups in the Economic Crisis Even though economists attach other factors because of the economic crisis, it is still apparent that the government influenced these factors further amplifying the economic predicament. As mentioned, the government's reluctance and lack of oversight propelled the nation into an economic crisis. The oversight is evident based on the policies it instituted to encourage home ownership. These policies, which led to the incorporation of Freddie Mac and Fannie Mae attracted Wall Street investors and American citizens to invest in real estate. For Wall Street investors, the introduction of MBS and CDOs meant exponential profit maximization for them.

According to Johnson & Kwak (124), Wall Street investors structured models that depicted that the asset-backed securities lacked risk based on the exponential increase in housing prices. Furthermore, borrowers were able to refund their mortgages because of the consistent increase in pricing even in the case of a default. American homeowners could not be answerable for their indulgence in acquiring mortgages. This is because the financial

<https://assignbuster.com/economic-political-science/>

products allowed them to buy homes at a lower risk and still gain higher profits. For Americans earning low incomes, the opportunity to own homes was indeed a prospect they could not afford.

The government agencies, Fannie Mae and Freddie Mac purchased the high rated mortgage securities. The purchase of these securities by the government focused on amplifying lending especially to these specific Americans. Furthermore, this motive further increased demand for such profits, which translated into larger profits for Wall Street investors. Furthermore, the government further deregulated credit default swaps leading to an increase in leverage and delusions of insurance especially among financial institutions owned by Wall Street investors (Epstein 21).

This further indicates the influence of the government on the behavior of Wall Street investors. The government also encouraged unwarranted risk-taking by failing to regulate the financial market. This move by the government saw Wall Street investors use risky asset-backed securities in order to gain higher returns. Additionally, the increase in derivative trading further warranted extreme risk-taking especially among investors (Denning 2). Based on this phenomenon, American homeowners saw the opportunity to apply for sub-prime mortgages dished out by financial institutions. Nonetheless, even though the Federal Reserve could control these institutions, it did not have the jurisdiction to control non-bank entities.

Accordingly, non-bank entities, which comprised institutions such as mortgage lenders, exploited the average American into purchasing risky mortgages without asserting the long-term risk associated with them. Thus,

the failure of the government to regulate derivative trading fuelled the nationwide economic crisis arising from the housing bubble. It is also prejudiced to assert further that homeowners and Wall Street investors played a hand in the economic crisis because most of the investments made at the time revolved around speculation financially. At this time, the government did not possess perfect information concerning its market. In economic terms, perfect information implies the accessibility of market information concerning market trends.

The government did not possess full market information based on the Efficient Market Hypothesis. Additionally, economists ignored the drastic rise of the bubble in the housing market. Economists such as Eugene Fama declared their trust in the housing market because of its restricted liquidity and cautious investments (Krugman, 8). This explains the reason why the government encouraged excessive liquidity at the time via the drastic reduction of money-market interest rates. Plan of Action Based on the intricacies of the government because of the crisis, it is important for the government to consider certain economic procedures. These procedures would focus on creating long-term economic growth and stability.

One of these procedures comprises: Government Regulation of Wall Street Lack of government regulation especially for Wall Street investors comprised one of the factors leading to the financial crisis. In the late 1990s, government organizations such as JP Morgan-Chase scouted for leveraging means in order to initiate profit maximization especially from the housing market. One of the ways in which JP Morgan sought leverage was through credit default swaps. According to Johnson & Kwak (125), credit default

<https://assignbuster.com/economic-political-science/>

swaps permitted the insurance of mortgage loans or MBS thus expunging the default risk. Consequently, the firm took advantage of these instruments in order to shift default risks arising from non-payment of loans from the balance sheet. The move allowed the banking organization to reduce the maintenance of its capital reserves meant for the loans by using them for further lending. As such, JP Morgan would reap considerable profits from using the capital reserves for lending purposes. JP Morgan was also able to design special CDOs for the housing market.

Thus, these securities could undergo creation without necessitating the purchase of MBS or mortgages because of the use of credit default swaps on existing securities. The lack of regulation of Wall Street investors in terms of leveraging saw them use the swaps in order to fill the gap arising from excess demand. Furthermore, these instruments allowed Wall Street to create another profit maximization model, free money. Because of the economy's stability and the increasing housing prices, default risks of less-risky MBS and CDOs seemed diminutive. As such, selling the swaps especially for such securities implied free money of which hedge funds also acquired.

Additionally, financial groups such as AIG started offering insurance for AAA-rated assets free (Johnson & Kwak 126). However, these organizations did not consider the re-materialization of risk during the start of the 2008 economic crisis. The crisis arising from these practices affected American taxpayers considerably. The losses that JP Morgan faced from their strategies trickled down to the public because the bank receives support from FDIC-

insured finances. Additionally, the organization also possesses considerable shareholders.

Therefore, the impact of the crisis on the organization meant that the taxpayers mitigate for the losses since they comprise the guarantors. Thus, in order to avoid such problems again, it is important for the government to regulate Wall Street investment. The regulation would focus on necessitating sturdy capital requirements, wide Volcker guidelines, lucidity as well as margin prerequisites within derivative trading.

The move will assure ethical and considerate efficient investment by Wall Street investors. In conclusion, it is certain that the government was entirely answerable for the economic crisis. This is because most factors that influenced the crisis stemmed from the lack of government to oversee and regulate the financial market. The insufficient regulation of factors such as Wall Street investment and the housing market plunged the American economy into a recession state that is still effectual up to today.

Nonetheless, the government can avoid a similar situation by regulating Wall Street investment and thus ensure long-term economic growth and stability.

Works Cited Denning, Steve. "Big Banks and Derivatives: Why another Financial Crisis is Inevitable." *Forbes*, 1 Aug. 2013. Web. 25 Jul.

2013. Epstein, A. Richard. "Krugman's Scapegoats." *National Review* (2009): 20-21.



Print. Johnson, Simon, and James Kwak. 13 Bankers: The Wall Street Takeover and the Next Financial Meltdown. New York: Pantheon Books, 2010. Print. Krugman, Paul. “ How Did Economics Get It So Wrong.

” New York Times, 6 Sept. 2009. Web.

25 Jul. 2013. McCoy, Ger, and Roisin Peddle.

“ Neoliberal Policy and Its Influence on Welfare Ideology: A Source of Social Injustice?” Socheolas Limerick Student Journal of Sociology 3. 2 (2012): 61-79. Print.