Causes of the Financial Crisis

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Abstract
[Excerpt] The current financial crisis began in August 2007, when financial stability replaced inflation as the Federal Reserve’s chief concern. The roots of the crisis go back much further, and there are various views on the fundamental causes.

It is generally accepted that credit standards in U.S. mortgage lending were relaxed in the early 2000s, and that rising rates of delinquency and foreclosures delivered a sharp shock to a range of U.S. financial institutions. Beyond that point of agreement, however, there are many questions that will be debated by policymakers and academics for decades.

Why did the financial shock from the housing market downturn prove so difficult to contain? Why did the tools the Fed used successfully to limit damage to the financial system from previous shocks (the Asian crises of 1997-1998, the stock market crashes of 1987 and 2000-2001, the junk bond debacle in 1989, the savings and loan crisis, 9/11, and so on) fail to work this time? If we accept that the origins are in the United States, why were so many financial systems around the world swept up in the panic?

To what extent were long-term developments in financial markets to blame for the instability? Derivatives markets, for example, were long described as a way to spread financial risk more efficiently, so that market participants could bear only those risks they understood. Did derivatives, and other risk management techniques, actually increase risk and instability under crisis conditions? Was there too much reliance on computer models of market performance? Did those models reflect only the post-WWII period, which may now come to be viewed not as a typical 60-year period, suitable for use as a baseline for financial forecasts, but rather as an unusually favorable period that may not recur?

Did government actions inadvertently create the conditions for crisis? Did regulators fail to use their authority to prevent excessive risk-taking, or was their jurisdiction too limited and/or compartmentalized?

While some may insist that there is a single cause, and thus a simple remedy, the sheer number of causal factors that have been identified tends to suggest that the current financial situation is not yet fully understood in its full complexity. This report consists of a table that summarizes very briefly some of the arguments for particular causes, presents equally brief rejoinders, and includes a reference or two for further reading. It will be updated as required by market developments.

Comments

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financial crisis one by one: Causes. One) During the Greenspan era, recessions were not allowed to do their job of reducing bad debts. Recessions ended early, and expansions went on too long. The financial crisis of 2007–2008, also known as the global financial crisis and the 2008 financial crisis, is considered by many economists to have been the worst financial crisis since the Great Depression of the 1930s. It began in 2007 with a crisis in the subprime mortgage market in the United States, and developed into a full-blown international banking crisis with the collapse of the investment bank Lehman Brothers on September 15, 2008. Excessive risk-taking by banks such as Lehman Brothers.