INTRODUCTION

In the last ten years, perhaps no phenomenon has shaken the foundations of the global economy as much as the 2007/08 financial crisis. From severe economic contractions in industrialized and developing countries to sovereign debt crises in Europe and the adoption of austerity programs throughout much of the world, the crisis has left a significant imprint, reverberating up to the present day. Originating in the United States, the crisis highlighted the interconnectedness of global financial markets. While the crisis’ implications are quite clear, debate remains over the ultimate causes of an event of this magnitude. Pinning down the exact causes of the collapse remains extremely difficult (Rose and Spiegel 2012). One guide prepared by the US Congressional Research Service lists 26 potential causes (Jickling 2009). Financial markets are inherently complex. As such, they provide ample space for competing narratives to explain how a global financial meltdown could have happened at the time it did.

Against this background, this essay will analyze three different explanatory narratives to account for the emergence of the financial crisis. First, a conventional explanatory model based in essence on incentive structures, domestic financial regulation and inept oversight is presented. This model focuses on major players within the US financial market, in addition to behavior at the individual employee level. It highlights the micro-level at which the crisis manifested itself. Secondly, a further explanation employs an international political economy framework to account for global financial imbalances between developing countries and emerging markets, principally China, on the one hand, and the industrialized world, most importantly the US, on the other. This second model makes use of a more structural approach, focusing on developments inherent within the globalization of finance and business. Lastly, in order to assess the explanatory validity of the first two models, a third framework is based on global ideological shifts. Such a framework seeks to account for the environment under which developments at both micro and macro level were enabled and legitimized.

THE FINANCIAL CRISIS: WHAT HAPPENED, EXACTLY?

There appears to be some consensus that the proximate cause of the 07/08 financial crisis was to be found in the US housing market. Over a period extending approximately from 2001/2002 to 2006/2007, the housing market experienced a bubble characterized by sharply rising prices and significant profits for investors. In this period, the ratio of debt to national income increased from 3.75 to 1 to 4.75 to 1, while year-on-year house prices grew at a staggering eleven percent per year (Acharya and Richardson 2009). Given the financialization of mortgages through investment structures such as mortgage-backed securities (MBS) and collateralized debt obligations (CDOs), both the US and European financial markets were highly vulnerable to movements on the US housing market. A large enough drop in the housing market would implicate major financial players, including both commercial and investment banks, hedge funds, insurance companies and public financial entities. When borrowers did start to go under in 2006...
and 2007, MBSs and CDOs began to lose their underlying value, which led to increasing problems on the balance sheets of those financial players which had tied up significant investments in these products. As more and more actors exhibited an inability to pay back outstanding loans, inter-bank lending came to a freeze. This feedback process reached its high point when Lehman Brothers, one of the biggest US investment banks and a so-called system-relevant actor, was forced to announce default in September of 2008. The US government decided not to bail out Lehman Brothers, setting in motion the final collapse of the financial system and facilitating adverse financial and economic consequences not only in the United States but on a global level.

INCENTIVES, REGULATION AND OVERSIGHT: A MICRO-ANALYSIS

The official enquiry commissioned by the US government concludes that “the crisis was the result of human action and inaction” (Financial Crisis Enquiry Commission 2011, XVII). Incentive structures are often taken as a significant reason why risk-taking and short-termism were encouraged within financial institutions. The move towards compensation systems based on yearly performance bonuses led to a focus on immediate profit-making opportunities (Blinder 2009). Such incentive structures may also contribute to our understanding of lending practices. Berndt and Gupta (2009) highlight that loan quality deteriorated throughout the housing boom. Lindsay (2007) points out that, at the height of the boom in 2006, first time home owners were required on average to contribute only two percent towards the total cost of a home. De Michelis (2009) attributes much of the housing crash to the practice of such so-called sub-prime lending. Moreover, Feldkircher (2014) identifies credit growth as one of the main determinants of financial vulnerability once the crisis broke. Reinhart and Rogoff (2008) demonstrate that equity price appreciation was taking place in addition to the housing boom. The asset price boom in part was enabled by the loose monetary policy employed by the Federal Reserve (FED). Financial actors thus had an incentive to take excessive risks, given the cheap money available to them and the plethora of investment opportunities. In fact, as Crotty points out, “it is rational for top financial firm operatives to take excessive risk in the bubble even if they understand that their decisions are likely to cause a crash in the intermediate future” (2009, 565).

Blundell-Wignall and Atkinson (2009) identify four causes within the micro-analysis outlined in this section. First, capital rules and tax wedges provided arbitrage opportunities to financial actors. Secondly, regulatory change permitted such actors to significantly increase leverage levels, enabling risk to accumulate. Third, regulators failed to limit the emergence of systemically important actors that were “too big to fail”, creating an environment imbued with moral hazard. Lastly, the regulatory infrastructure itself was incapable of dealing with new financial products that were poorly understood by both financial actors themselves as well as public officials. Hence, implicit in this understanding of the crisis is the mismatch between financial innovation and financial regulative capacity. Public oversight was insufficient in keeping tabs on the activities and behavior of certain actors in the financial world, who were able to exploit the gaps to their short-term benefit. Through the securitization of assets and the emergence of the originate-to-distribute model (Rötheli 2010), which allowed banks and other institutions to conceal risks, transparency within the financial system was eroded. The development of a highly opaque financial sector populated by rationally risk-assuming actors thus created the conditions under which the crash occurred. What was rational for the individual actor was not congruent with what would have been rational for the system.

The above analysis suggests an interplay between incentive-structures at the individual level, changing behavior at the firm level, and insufficient capacity or willingness of regulators to deal with a changing financial environment. However, such a micro-analysis fails to account for the structural enabling conditions which allowed the boom to assume the heights it ascended to. We thus turn to a political economy approach to examine some of these conditions in the next section.

IPE TO THE RESCUE: GLOBAL FINANCIAL IMBALANCES AND THE CRISIS

One aspect that seems evident about the 07/08 crisis is its global dimension. While the US housing market provided the canvas on which the financial crash materialized, the crisis
highlighted the extent of financial and economic globalization. The following analysis will therefore turn to a global perspective to highlight the structural determinants leading up to the collapse.

Jagannathan et al. (2013) argue that, far from an idiosyncratic event, the financial crisis should be looked at as an extreme manifestation of the globalization of markets. According to the authors’ analysis, a “huge and rapid increase in the developed world’s effective labor supply” (2013, 5) is at the heart of the processes which paved the way for crisis to emerge. Emerging markets are unable to channel savings into their domestic economies, necessitating currency movements which flood mature markets. The rise of China in particular has led to significant global imbalances, as huge money inflows from China had to be absorbed in the United States. Such a global savings glut in part enabled the United States to pursue both its economic as well as monetary policy, as it was able to run up a significant current account deficit without being subject to higher interest rates, helped along by the US dollar’s status as the main global reserve currency (Obstfeld and Rogoff 2009). Cheap money thus available was subsequently put to use within the US financial sector, often being channeled into speculative investments and highly securitized assets. This is the enabling environment under which the activities outlined in the first section took place.

A second global structural factor is the global financial architecture. There are a number of suggestions indicating that the rules developed under the Basel I and II financial framework regimes where wholly inadequate in dealing with financial imbalances. On the contrary, several regulatory arrangements made it possible for banks and other actors to circumvent the rules and encourage off-balance sheet activities. The Basel I rules required banks to hold only little capital, while Basel II further eroded financial stability by enabling banks to further lower their capital ratio, provided they could demonstrate AAA-rated securities (Crotty 2009). Credit ratings agencies, whose business model was subject to moral hazard, readily offered the desired ratings, thus greasing the chain of regulatory arbitrage. Financial actors, under the global financial architecture, were thus incentivized to devise opaque financial instruments in order to maximize the opportunities afforded to them by the ever increasing inflow of money coming from emerging markets. What is thus referred to as financial innovation is an attempt by certain actors to respond to gaps in the global regulatory environment. As observed at the domestic level, the regulatory framework was at odds with the new realities characterizing the global economy.

IDEOLOGY IN CRISIS

It is perhaps a trivial assertion that ideology matters in global affairs. However, the extent to which the financial crisis was partly determined by philosophical currents and political choices should be highlighted. To a significant degree, both the bubble and the eventual collapse were underpinned by the adoption of particular ideological positions and their respective policy implications.

Financial liberalization was an eminent feature of US policy in particular. A number of initiatives taken during the 1990s and 2000s highlight how, against the background of certain ideological convictions, banking and finance came to assume an ever more important role within the larger economy, while also achieving more and more detachment from the reaches of public regulation. Most important among these events may have been the repeal of the Glass-Steagall Act in 1999, which had previously separated commercial from investment banks. By allowing for the emergence of systemically important financial actors, such policy choices contributed to moral hazard. Countries such as the US and UK in particular have increasingly relied on the financialization of the economy in order to drive productivity in the post-industrial era. The growing importance of finance has thus entered into a dialectical relationship with deregulation, with greater financialization contributing towards further deregulation, and vice-versa. In this context, Crotty has referred to the new financial architecture (NFA), whose “celebratory narrative […] states that relatively free financial markets minimize the possibility of financial crises and the need for government bailouts” (2009, 564). Yet, as Demirgüç-Kunt and Detragiache point out, “if liberalization is not accompanied by sufficient prudential regulation and supporting institutions to ensure effective supervision, it is likely to result in excessive risk-taking and
Growing levels of economic inequality within the US further necessitated a policy of both easy money and easy credit. Since incomes derived from wages remained stagnant, improved living standards needed to be realized via the housing market, based on credit-financed consumption. Such a model seems to fit both the definition of a bubble as well as of a Ponzi scheme, as its persistence required a continuous inflow of new borrowers. This may explain why lending standards were lowered year after year. The dominant economic paradigm was reliant on asset-price appreciation in order to generate improving living standards.

Beyond the national level, the globalization of financial markets was not matched by a globalization of governance. As Moshirian (Moshirian 2011) points out, we are currently far away from effective global governance structures that would be able to prevent significant cross-border arbitrage from taking place. While institutions such as the Financial Stability Board and the G20 are in place, they largely work on the basis of the NFA. The question is whether technical fixes to facilitate “smart regulation” will be enough to deal with the next global crisis.

CONCLUSION

In summary, it appears that a good way of thinking about the 07/08 financial crisis is to relate the significant shifts within the global political economy to the concurrent reconceptualization of ideological frameworks. On the one hand, the rapidly globalizing financial system meant a higher degree of complexity. On the other, conditioned significantly by neoliberal rationality, the regulatory environment was unable to respond to the new demands being placed on oversight and control. One could even go so far as to say it failed to even recognize these new demands, blinded by assumptions which failed to square with a highly financialized economy. Hence, incentives, individual greed and hubris did play a significant role. However, these crisis ingredients need to be embedded within a larger framework accounting for developments at the macro-level. It remains important to reflect on the emergence of an environment in which the observed behavior seemed legitimate, and was moreover encouraged and engendered by policy in many instances.

REFERENCES


