Economic And Financial Crisis

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Introduction

The financial crisis of 2007–2009 developed from a network of vulnerabilities rather than from one irresponsible borrower, institution, or financial product. Years of rising house prices encouraged lenders, investors, and policymakers to underestimate the possibility of a nationwide decline, while mortgage underwriting weakened and highly leveraged institutions accumulated complex securities whose risks were difficult to evaluate. Securitization distributed mortgage cash flows across the financial system, but it also separated loan origination from long-term ownership and created incentives to earn fees before borrowers' ability to repay was fully tested. Investment banks financed long-lived and uncertain assets with short-term wholesale funding, rating agencies assigned high grades to structured products that proved more correlated than their models assumed, and derivatives connected institutions through obligations that were opaque in normal markets. When mortgage losses rose, creditors demanded collateral or withdrew funding, forcing asset sales and accelerating price declines. The crisis therefore demonstrates how leverage, liquidity risk, poor incentives, information failures, and interconnectedness can turn losses in one sector into a system-wide economic emergency.

Housing, Securitization, and the Accumulation of Hidden Risk

Mortgage credit expanded rapidly before the crisis, including loans with low documentation, adjustable rates, high loan-to-value ratios, and structures that depended on refinancing or continued house-price appreciation. Higher-risk lending was not inherently destabilizing, but weak underwriting became dangerous when brokers and lenders were rewarded primarily for loan volume rather than durable repayment. Mortgages were then pooled into mortgage-backed securities, while portions of those securities were repackaged into collateralized debt obligations. This structure could diversify risk under ordinary conditions, yet it relied on assumptions that defaults across regions would remain sufficiently independent. When housing prices declined broadly, that assumption failed. Credit-rating agencies compounded the problem by assigning high ratings to senior tranches of complex securities, encouraging investors and regulated institutions to treat them as safer than the underlying mortgage quality justified. Once defaults rose, investors could not easily determine who owned the losses or what structured products were worth. Markets became illiquid precisely when institutions needed

reliable valuations, transforming credit deterioration into uncertainty about counterparties and solvency. (Financial Crisis Inquiry Commission, 2011)

Leverage, Short-Term Funding, and the Collapse of Lehman Brothers

Lehman Brothers illustrates why an apparently positive accounting net worth does not guarantee survival. The investment bank held substantial real-estate and structured-finance exposures, operated with high leverage, and depended heavily on repurchase agreements and other short-term funding that had to be renewed continuously. Reported assets exceeded reported liabilities before bankruptcy, but those totals depended on valuations that became increasingly uncertain as markets deteriorated. Creditors cared not only about book equity but also about whether collateral could be sold and whether Lehman could meet immediate cash demands. As counterparties demanded more protection and clients withdrew, the firm faced a classic liquidity spiral: it needed to sell assets into falling markets, which reduced prices and weakened confidence further. The bankruptcy examiner later documented Repo 105 transactions that temporarily reduced reported leverage around reporting dates, intensifying concerns about transparency. Lehman filed for bankruptcy on September 15, 2008, and the disorderly failure rapidly disrupted money markets, derivatives, commercial paper, and global funding, showing how one institution’s collapse could propagate through interconnected financial networks.

AIG, Emergency Intervention, and the Problem of Moral Hazard

American International Group failed for a different reason. Its traditional insurance businesses were linked to a financial-products operation that had sold credit-default-swap protection on large amounts of structured securities and to securities-lending activities that created substantial liquidity demands. As the insured securities were downgraded and AIG’s own credit rating weakened, counterparties required collateral that the company could not provide quickly enough. Federal authorities supported AIG one day after Lehman’s bankruptcy because they judged that a disorderly collapse would threaten insurers, banks, municipalities, and counterparties throughout the financial system. The contrasting treatment remains controversial. Officials argued that AIG had sufficient collateral to support emergency lending whereas Lehman did not and that the legal tools available were limited. Critics argue that the sequence exposed improvisation and protected sophisticated counterparties after private gains had already been realized. Both views point to the same institutional weakness: policymakers lacked a credible framework for resolving a large nonbank financial company without choosing between chaotic bankruptcy and extraordinary public support, creating difficult trade-offs between immediate stability and future moral hazard.

Why a Financial Panic Became the Great Recession

The crisis spread beyond Wall Street because modern economies depend on credit, confidence, and short-term funding for ordinary business activity. After Lehman failed, the Reserve Primary Fund "broke the buck," triggering withdrawals from money-market funds that had been important purchasers of commercial paper. Businesses suddenly faced difficulty financing payroll, inventory, and other short-term needs, while banks and investors conserved cash because they distrusted one another's balance sheets. Households reduced spending as home values and employment fell, and companies postponed investment as demand weakened. International institutions holding U.S. securities or relying on dollar funding experienced similar stress, transmitting the crisis through trade and capital markets. The recession consequently produced unemployment, foreclosure, lost household wealth, weaker public budgets, and widening inequality. Communities exposed to predatory lending experienced especially severe housing losses. Government responses included emergency Federal Reserve facilities, capital injections, guarantees, fiscal stimulus, conservatorship of Fannie Mae and Freddie Mac, and later regulatory reforms intended to strengthen capital, liquidity, consumer protection, and resolution planning.

Conclusion

The 2007–2009 financial crisis was the product of interacting failures in mortgage underwriting, securitization, credit ratings, leverage, short-term funding, derivatives, governance, and regulation. Housing losses became systemic because financial institutions had created structures in which uncertain assets were financed with runnable liabilities and connected through contracts that became difficult to value under stress. Lehman Brothers demonstrated how liquidity can disappear even when accounting statements still show positive equity, while AIG demonstrated how collateral calls on derivative positions can threaten an institution whose traditional businesses appear sound. The different government responses remain debated, but both cases revealed the absence of an orderly mechanism for resolving large interconnected nonbanks. Subsequent reforms strengthened parts of the system, yet the deeper lesson is broader than mortgages. Future crises can emerge wherever leverage, correlated exposures, opaque valuation, and fragile funding combine. Financial stability therefore requires continuous attention to incentives, liquidity, consumer protection, market infrastructure, and emerging sources of concentrated risk rather than assuming that the next crisis will repeat the precise form of 2008.

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