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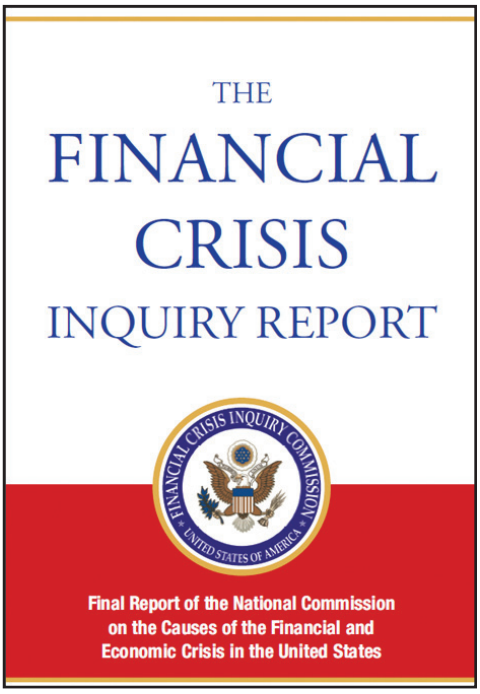
The Causes and Implications of the 2008 Financial Crisis

Lieutenant Colonel Bob Bradford

The financial crisis of 2008 shocked markets and led to a global recession. Failure of the financial markets caused economies to shrink resulting in hardship and loss around the world. In our modern connected world, few nations escaped the consequences of the crisis. This huge financial crisis diminished the economic strength of our nation, with significant implications for our national defense. This paper will address competing views of the causes of the crisis, and will discuss some of its potential impacts, including its impact on U.S. national security.

Post mortems of the 2008 financial crisis have pointed to many causes for it. The Financial Crisis Inquiry Commission issued three separate reports split along partisan ideological lines detailing the causes of the financial crisis. The majority report identifies the housing bubble fueled by low interest rates, easy credit, and lax government regulation as the proximate cause of the crisis.[1] The report maintains that the crisis could have been avoided with better government regulation, improved corporate risk management, and more transparency to provide better measures of risk. A better government response to the growing asset bubble, and better ethical enforcement would have minimized or prevented the crisis. According to the report, irresponsible lending practices, questionable mortgage securitization and an unregulated over-the-counter derivatives market contributed significantly to the crisis.[2]



The two minority reports assess different causes for the crisis. The first, by three republican commissioners, does not believe that the lack of regulation or over-the-counter derivatives directly caused the crisis.[3] This dissent points to the credit bubble, founded on the large capital surpluses existent in China and oil-producing nations as an important cause of this crisis. The excess capital enabled the housing bubble. Non-traditional, and in some cases deceptive, mortgages facilitated the scorching housing market. Inaccurate ratings by the credit rating agencies and poor securitization of these mortgages exacerbated problem by misidentifying inherent risk. Highly correlated risks were bundled into securities without a proper metric for the risk and an unrealistically low estimate of the risk correlation. Financial institutions did not maintain enough capital relative to the risk on their

1. The Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, (Government Printing Office: Washington, January 2011), xvi, http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf (accessed 18 April 2011). The majority report consists of the views of Chairman Phil Angelides and five of the other nine commissioners. Mr. Angelides served as California State Treasurer and a democratic candidate for Governor of California.
2. Ibid, xvii-xxvii
3. Ibid, 414. This is the Dissenting statement by Keith Hennessey, Douglas Holtz-Eakin, and Bill Thomas. Mr. Hennessey was President Bush's Economic Advisor during 2008. Mr. Holtz-Eakin served on President Bush's Council of Economic Advisors and was Senator McCain's economic advisor during the 2008 election. Mr. Thomas was the Vice Chairman of the Commission and is the former Republican Chairman of the House Ways and Means Committee.

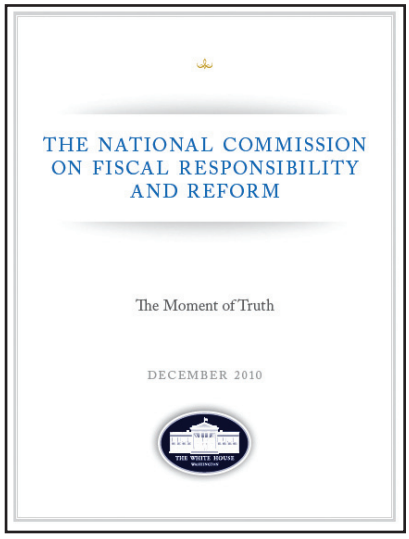
Lieutenant Colonel Bradford is an Army Operations Research Analyst whose next assignment after graduation from the Army War College is on the Army Staff in the Program Analysis and Evaluation Directorate.

balance sheets so they faced liquidity crises when asset prices fell. The risk of contagion made some in government feel that large financial institutions were "too big to fail," causing those institutions to believe they could avoid the downside risk of their securities, causing prices to rise unnaturally. When a price shock came to the housing market, many firms had similar positions with respect to housing prices, and they failed in quick succession. This caused the financial markets to panic. Confidence failed and liquidity tightened. The response of the financial markets created a serious contraction to the real economy, as capital flows became non-existent.[4]

The second dissent to the FCIC report states that:

> *...the sine qua non of the financial crisis was U.S. government housing policy, which led to the creation of 27 million subprime and other risky loans—half of all mortgages in the United States—which were ready to default as soon as the massive 1997-2007 housing bubble began to deflate government policy.*[5]

In assessing the blame for the crisis squarely on government policy, this dissent is distinct from the other two reports. All of the commissioners on the Financial Crisis Inquiry Commission viewed the financial crisis through the lens of their political ideology. Those who believe in a larger role for government in the economy saw lax regulation and oversight as a main cause of the crisis, while those who believe in a lesser role for government saw the crisis stemming from systemic imbalances, or even excessive government intervention into markets.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The Moment of Truth

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The search for the cause of the crisis has become politicized as people from all sides tried to assign or deflect blame for the crisis. Determining the true cause has become politicized as explanations for the crisis show more about a person's political views of the economy than what the true cause of the crisis may be. This has caused some difficulties as the government has worked to enact policies to avoid future crises. While this politicization of the search for causes makes solution-finding difficult, it has less impact on identifying the impact of the crisis. The remainder of this paper will address some of these impacts of the financial crisis.

Impacts of the Financial Crisis

The financial crisis exacerbated an already challenging fiscal imbalance in the United States caused by reduced revenues from the Bush tax cuts and increased spending to support fighting wars in Iraq and Afghanistan. In this environment, the Troubled Asset Relief Program (TARP) injected liquidity into the financial markets in order to reduce panic and stabilize the financial system. The direct costs of this $700 billion added to already increasing fiscal deficits and worsened the current accounts balance of the U.S. government.[6] While some of these costs were paid back fairly quickly, estimates of the total cost of TARP are as high as $73 billion.[7] Additionally, the collapse of financial institutions and tightening of the financial system directly resulted in a shrinking of the national economy, with losses in wages, incomes, jobs and wealth. Estimates of the cost to the nation of the financial crisis include $648 Billion in unrealized GDP due to slower growth, a $3.4 trillion reduction in United States real estate wealth with 500,000 additional foreclosures due to the collapse of the housing bubble, a reduction of $7.4 trillion of stock wealth as a result of the crisis, and the loss of an additional 5.5 million American jobs.[8] In addition to causing real pain and human suffering, these losses in the economy reduced government revenues, further exacerbating the fiscal situation.

In addition to impacts on the U.S. economy, the financial crisis has impacted the world economy. The liquidity crisis caused by the financial panic spread the problem around the world. Smaller economies could not absorb the cost of the failure of financial institutions. The failure of banks in Iceland effectively bankrupted the entire country,

4. Ibid, 417-418.
5. Ibid, 444. This is the dissent of Peter J. Wallison of the American Enterprise Institute. He served in the Treasury Department under President Reagan and worked to de-regulate the financial services industry.
6. Phillip Swagel, *The Cost of the Financial Crisis: The Impact of the September 2008 Collapse*, (Washington DC: Pew Economic Policy Group, April 28, 2010) 5, http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Economic_Mobility/Cost-of-the-Crisis-final.pdf?n=6727 (accessed 18 April 2011).
7. Ibid.
8. Ibid, 10-19.

resulting in a change of government and the requirement for a bailout by the International Monetary Fund.[9] Similar financial difficulties occurred in Ireland,[10] and other European countries are also suffering through crises of debt.[11]

While impacts in the developed world are severe, the impact on the developing world may be even worse. In November 2008, the Director of the World Health Organization warned of potentially catastrophic impacts on global health caused by cuts in developmental assistance and social spending necessitated by the financial crisis.[12] Additionally, the crisis has slowed world efforts to reduce poverty. Economists at the World Bank estimate that the financial crisis kept an additional 64 million people world-wide from rising above the $2 per day income level in 2009.[13]

While the crisis may cause much individual anguish in the developing world, it may paradoxically increase the relative power of these countries within the world economic system. In November 2010, Robert Zoellick, the Director of the World Bank, stated:

> *The developing world is becoming the driver of the global economy. Led by emerging markets, developing countries now account for half of global growth and are leading the recovery in world trade.*[14]

Because it is less connected to the U.S. financial system, the developing world did not suffer the same kind of losses that more developed and connected countries did. The change in relative economic power, and the growth of trade and other connections among the developing countries suggests a need to rebalance the global economic system. The world is rejecting the Washington Consensus and is searching for other models to support global economic growth.[15] China, already a rising producer on the global economy, has seen a rise in its relative economic position.[16] More importantly perhaps, the financial crisis has moved perceptions of these power shifts faster than the actual shifts in real economic power. China's position in the world economy is growing.[17] As China and other emerging countries rise in relative economic power, the United States will have to determine how to react to a world where they are not the sole economic superpower. Policies and decisions in other countries will soon have a larger impact on outcomes in the U.S. economy than they once had, and the United States will have to negotiate from a less powerful position.

The United States has been in a unique position in the world, with the dollar as the *de facto* currency of world trade and the preferred store for international reserves. The financial crisis and some of its underlying causes may reduce international faith in the dollar. Declining faith in the dollar will limit U.S. ability to finance debt, and will slow economic growth.[18] While some argue that the magnitude of this trend is exaggerated,[19] the direction of this trend is not in question. This change will put constraints on the U.S. economy, and consequently on the United States' ability to fund global security. The United States has been able to maintain current account deficits because demand for U.S. debt has been high. As countries and other investors look to maintain capital reserves in other currencies, U.S. deficits will become more expensive to finance. Demand for dollars and faith in the U.S. government has kept the cost of debt

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9. See Stefan Karlsson, "Iceland is No Role Model," *Christian Science Monitor*, January 21, 2011, http://www.csmonitor.com/Business/Stefan-Karlsson-s-Blog/2011/0121/Iceland-is-no-role-model (accessed 18 April 2011) and Stefan Karlsson, "The Forgotten Icelandic Meltdown," *Christian Science Monitor,* May 4, 2010, http://www.csmonitor.com/Business/Stefan-Karlsson-s-Blog/2010/0504/The-forgotten-Icelandic-meltdown (accessed 18 April 2011).
10. Paul Krugman, "Eating the Irish," *New York Times,* November 25, 2010, http://www.nytimes.com/2010/11/26/opinion/26krugman.html?_r=1 (accessed 18 April 2011).
11. Nouriel Roubini, "Roubini: Greece Debt Crisis is only the Tip of the Iceberg," *Christian Science Monitor*, April 29, 2010, http://www.csmonitor.com/Commentary/Global-Viewpoint/2010/0429/Roubini-Greece-debt-crisis-is-only-the-tip-of-the-iceberg (accessed 18 April 2011).
12. Dr. Margaret Chan, "Impact of the Global Financial and Economic Crisis on Health, " *World Health Organization*, 12 November 2008, http://www.who.int/mediacentre/ news/statements/2008/s12/en/index.html, (accessed 19 April 2011).
13. Shaohua Chen, Martin Ravallion, "The impact of the global financial crisis on the world's poorest," *Vox*, Research-based policy analysis from leading economists, 30 April 2009, http://www.voxeu.org/index.php?q=node/3520 (accessed 19 April 2011).
14. Matthew O. Berger, "Zoellick Embraces Multi-Polar World Economy," *Inter Press Service*, September 29, 2010, http://www.ipsnews.net/news.asp?idnews=53008 (accessed 19 April 2011).
15. Harold James, "The Making of a Mess: Who Broke Global Finance, and Who Should Pay for It?" *Foreign Affairs,* Volume 88, Number 1, January/February 2009, 168.
16. Daniel W. Drezner, "The Global Financial Crisis and its Effects," *Great Decisions,* 2010, 60.
17. Ibid, 61.
18. James G. Lacey and David L. Asher, "Finance and Power," *Joint Force Quarterly*, Issue 53, 2nd Quarter 2009, 15-18
19. Barry Eichengreen, "The Dollar Dilemma," *Foreign Affairs*, Vol. 88, no. 5 (September/October 2010), 53, in ProQuest (accessed March 25, 2011)

low, enabling our deficit spending. This cost should grow in the future, putting more pressure on the United States to deal with its thorny fiscal issues.

The financial crisis has accelerated this rebalancing of international power, and increased U.S. motivation to balance government budgets. Reasonable approaches to balancing the federal budget include both increases in revenue and decreases in spending.[20] These decreases in spending will undoubtedly be felt by all parts of government, including defense. Decreases to defense spending may put limits on the U.S. ability to pursue an expeditionary military strategy and may limit the ability of the United States to protect the global commons. Recent growth in international trade and economies is predicated on safe and secure access to the sea, air, space, and cyber domains. Without the United States underwriting the cost of securing these common domains, the world may see increased competition for access and less security within these domains. The world will have to work through how it wants to protect and ensure access in a more multi-polar environment.

The 2008 financial crisis demonstrated the truth of economic experience. Excess credit leads to the over-appreciation of assets. When everyone seems to be winning, oversight relaxes, and business practices become more risky. When asset bubbles inevitably collapse, money gets much tighter, and economies contract. In today's connected global economy, crises like this quickly spread beyond national borders with implications for the global economy and for global security. These are lessons that the United States must remember.

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20. See *The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform*, (Washington, DC: The White House, December 2010), http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf (accessed 1 April 2011); and The Debt Reduction Task Force, *Restoring the Future: Reviving the Economy, Cutting Spending and Debt, and Creating a Simple, Pro-Growth Tax System*, (Washington, DC: The Bipartisan Policy Center, November 2010), http://www.bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf (accessed 19 April 2011).