UPDATE ON THE FINANCIAL CRISIS OF 2008–2009

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In an earlier paper in this journal (Murphy, 2009), I explained the nature of the financial crisis of 2008 and how the effects of it would be very costly long-term because of the failure of government policies to deal with it effectively. Here I provide an important update and perspective for the future.

As I indicated in a brief report published in October 2008 in the Oakland Press (Murphy, 2008a) and in a working paper (downloaded over 10,000 times as one of the most read financial working papers of all time at www.ssrn.com), the financial crisis was caused by the deregulation of credit default swaps (CDSs) and by the use of purely statistical models of credit lacking in any financial common sense. The solution provided in those articles still apply, although the government’s counterproductive attempts to address the problem have already greatly magnified the costs that could have so easily been avoided. The world’s largest banks should have been allowed to fail, with the government regulators taking control of their branches and basic deposit/lending activities as they are supposed to do in the case of all bank failures. These government banks could have been privatized later once the banks had been sanitized of their non-core activities (including credit default swaps) that caused their demise. Doing so would have caused huge losses to investors (especially hedge funds), but 99% of the people wouldn’t have been seriously affected.
Government spending on needed infrastructure, education, and pollution control might have even prevented the crisis from causing a serious recession. However, to minimize the mortgage defaults relating to the busting of the credit bubble that has led to the subsequent collapse in housing prices, homeowners should have been provided with the opportunity to greatly reduce their mandatory payment obligations by allowing them to offer the lenders a share of the future appreciation on the homes. The result of the latter policy not only would have avoided most of the foreclosures but would have also greatly reduced the losses to the mortgage lenders. The chance of future financial crises could have been minimized by regulating CDSs and enforcing regulatory requirements on the quality of bank credit-granting activities.

The total costs of the catastrophic 2008–2009 government bailouts of the banks won’t be known for some time. The exact costs may actually never be completely recognized publicly, because they are well disguised through various government actions, which guaranteed payments to investors on over $10 trillion in mortgages, including on a proportionally large number of the ones with the greatest chance of default.\(^1\) Investors in

\(^1\) Representatives of some banks such as Goldman Sachs and JPMorgan Chase have claimed they could have survived without the government bailouts. While those two banks definitely didn’t need the TARP funds forced upon them, it is somewhat uncertain as to whether they would have been able to survive without Fed providing them with emergency liquidity. More importantly, if the government hadn’t bailed Citibank, AIG, FNMA, FHLMC, and other large financial institutions, both Goldman and JPMorgan Chase would have suffered catastrophic losses on the massive amount of mortgages and mortgage-backed securities they owned, as most of these were guaranteed against default by those institutions that definitely were bankrupt in 2008. In addition, while both Goldman and JPMorgan Chase were not as exposed to the mortgages with the poorest credit quality as others in 2008, that situation didn’t arise because they wisely avoided the most questionable lending practices but only because they decided to exit that sector early in 2006–2007. That withdrawal from that end of the market that took place about the same time as their incredible nature was becoming widely known publicly, including by many referring to them as NINJA mortgages (referring the borrowers having no income, no job or assets) and “liar’s loans,” helped
those mortgages like hedge funds were thus bailed out from taking any foreclosure related losses even while the homeowners were evicted. While the resulting costs to the taxpayers of the catastrophic bailout can probably be already counted in the trillions of dollars, further losses could be minimized by adopting the plan I proposed in 2008. Nevertheless, despite the large increase in the government budget deficits since the crisis, there still is an opportunity to spur economic growth by taxing corporations for the full expected costs of the global warming and other pollution. The expected value of those costs in present value terms amounts to tens of trillions of dollars, and so such a tax would provide an enormous amount of government revenue, with most of the tax being levied on the sale of the oil and coal that are inducing a potentially catastrophic global warming. This policy would thus enable large

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those banks avoid the worst drops in the market values of mortgages in 2008. In JPMorgan’s case, the bank’s CEO, the extraordinarily well compensated Jamie Dimon, is said to have had the great foresight to do so because he noticed a reversal in the incredible mortgage pricing bubble in a rising cost to guarantee those debts via CDSs (Tully, 2008). However, given that the entire credit boom was tantamount to a $60 trillion pyramid scheme to benefit financial institutions at the cost of the government (Murphy, 2011), Dimon’s brilliant exit from the highest risk mortgages before the market collapsed is analogous to those who ignorantly entered into Bernie Madoff’s far smaller $60 billion dollar Ponzi scam and then, because of a market indicator somewhat unrelated to the fraudulent scheme, withdrew the money prior to the pyramid imploding. JPMorgan still has potentially massive liabilities caused by its early participation in the mortgage bubble relating to inadequate legal documentation for the securitization of loans made and fraudulent robo-signings of documents to foreclose on defaulted mortgages, as well as due to questionable lending practices, just as virtually all banks do.

Although Exxon-Mobil has spent tens of millions of dollars to convince about half of the American public that manmade pollution isn’t a serious risk (Begley, 2007), the conviction of these skeptics is at odds with the opinions of the majority of scientific experts in the field (Brahic, 2009). Insurance companies are already realistically pricing the costs of increasing environmental catastrophes into their policies to protect against the damage expected to be caused by them. Even if there were only a slight chance of continued use of oil and coal causing incredibly large environmental catastrophes, the statistical expected present value of those costs would still be enormous. For example, one research study indicated that virtually the
increases in government spending on infrastructure and education, as well as on social spending to offset the impact of the policy on energy costs, at the same time the budget deficit is reduced or eliminated. It would also create enormous incentives for the private sector to engage in unsubsidized development of clean energy, thus spurring the creation of a very large number of good-paying jobs, and economies of scale in these industries might easily lead to the impact on energy costs being negligible if the tax on dirty energy were phased in over time.

However, as long as governments are controlled by corporate lobbyists and donors that are led by banks and oil companies, this proposed solution to some of the most important economic problems of our time will not happen. Much more likely is the continuation of banks’ reckless activities and further increases in the risks of future environmental catastrophes. The government, whether controlled by the Democrats or Republicans that all are heavily financed with corporate “donations” (Murphy, 2000), especially from banks and oil companies, will likely continue to place the financial burden for the problems on 99% of the people.

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entire USA will very likely be transformed into a desert by the end of this century, causing it to be useful only for solar panels that would provide power to those who migrate to Canada, and that the earth will be able to support five billion less people then (Vince, 2009). Taking precautions against even a remote possibility of such a scenario would seem to be every bit as important as spending large amounts of money on defense as a protection against possible invasions that might never happen.

3 Note that individuals’ efforts to minimize their own carbon footprint are insufficient to offset the effects of continued use of oil and coal that can only be feasibly stopped if there is a change in government taxation and regulation. Expectations that only individuals should make all the sacrifices necessary to avert environmental catastrophes may actually magnify the problem, as it can provide public justification for the USA government’s continued refusal to even eliminate the subsidies that oil producers receive.
through government spending reductions, with the lowest income groups being the most savagely impacted.\(^4\)

The latter trend is apparent not only in the USA but also in Europe. In particular, most European banks, which also invested heavily in the mortgages that defaulted as a result of the financial crisis and the subsequent failure of governments to adopt viable solutions to it, were bailed out just as the USA banks were. The result has been huge increases in their governments’ budget deficits that were proportionately large in the case of Ireland and Greece. The European Union has already imposed a draconian solution on Ireland to prevent that country’s default by requiring massive reductions in government spending, and it is in the process of forcing similar and probably worse consequences on Greece. Portugal, Italy, and Spain (that round out the PIIGS, the name by which European bankers so “affectionately” refer to them) are also being pressured into doing the same. Such policies are known to lead to a large contraction in their real economy that partially offsets the deficit-reducing spending cuts with a decline in tax revenue. Barring a revolution by the people of these countries (that may not be farfetched, at least in the case of Greece), a default on debts owed by any government in the European Union is remote because most have a reasonable balance between their imports and exports and because Greece will very likely continue to be bailed out of the problems associated with

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\(^4\) The government budget deficit that is spurring the current attempts to reduce federal spending is partially caused by the Middle Eastern wars initiated by a Republican administration, as well as magnified and spread by the Democratic President Obama. Those wars are projected to cost around $4 trillion, or about 3 times the stated figures that don’t cover the entire long-term expenses of the wars (Cornwell, 2011). Since the rather questionable justification for these conflicts was at least partially based on false information, and since the government’s true motivation for engaging in them may be related to attempts to take control of the very large dirty energy resources there (that may only coincidently benefit the big oil company donors to the two ruling parties in the USA), this clean energy plan might also reduce the incentive for such wars, whose ending could help erase the budget deficit without requiring any decreases in social spending and services.
its own international current account deficit as long as the Greek government persists in further spending cuts.5

The outlook is therefore rather dismal both short-term and long-term for both the USA and Europe. A recession is very likely near term, and long-term the reductions in spending on infrastructure, education, and pollution control will probably be catastrophic. Stocks might suffer the most short-term, but bonds might be the biggest losers long-term, as the latter disasters might very well contribute to a collapse in the value of the dollar that already is at very serious risk due to the USA’s enormous trade deficit, which isn’t sustainable, especially in the face of a slowing economy that is exacerbated by

5 The European threats to refuse to bail out Greece with more lending to that country to enable it to pay its debts, as well as the formation of contingency plans to deal with a Greek default, actually serve the purpose of helping the Greek government justify the harsh measures that are being imposed on the country. There are actually three entities involved in the bailout of Greece: the European Union, the European Central Bank, and the International Monetary Fund (IMF), which is always headed by a European, and this group of three has come to be called collectively “troika,” which is the Russian term for such an administrative threesome. The term troika is widely viewed in Europe as the word for the 1937–38 deadly purges in the Soviet Union when Stalin, having been deceived by Nazi German agents into believing there was a massive plot to overthrow the government, authorized a large number of committees of three to execute nearly 75,000 people without any trial, and these groups of overzealous communist party loyalists eventually requested authorization to sentence hundreds of thousands more to death, although it is unclear how many of these requests were actually granted or carried out (Murphy, 2000). Similarly, the Greek people feel they have been overzealously and unjustly sentenced without a trial for a crime they didn’t commit (i.e., their government budget deficit was caused by its bailout of their banks, not by social spending or government workers who, despite foreign allegations of them being overcompensated, are among the lowest paid employees in Europe). It should be mentioned that the treatment of Greece is not much different from the solution imposed on many other poor nations unable to pay their foreign debts, as such countries are typically subjected to similar economic sentencing by the IMF with callous disregard for the suffering imposed on the people, and debts are generally repaid (Murphy, 2000). In the case of Greece, however, bank investors in that country’s bonds are being asked to take a partial loss on them in return for the bailout by the troika, which thereby allows them to avoid the bigger losses that would occur with an actual default.
the existing contractionary fiscal policies, and which can’t be helped by a failure to modernize infrastructure and education or address environmental problems. The expansionary monetary policies that have been followed since the financial crisis started in 2008 could also eventually induce an initial decline in the dollar and inflation, which might very easily feed on each other and lead to double-digit interest rates, especially since a very large increase in real interest rates may eventually be required by investors to hold dollars in this situation. In addition, since the causes of the financial crisis still haven’t been addressed insofar as there is still no regulation of credit default swaps, and since financial institution regulators still allow credit analysis to be conducted strictly via computer without any human judgment, it is very plausible that further financial crises in the USA might precipitate a flight from USA investments and the dollar, or at least erode investor confidence in the currency enough to cause a drastic fall in its value. While such a crisis could actually lead to the risk of widespread bank failures that could precipitate a long-term depression with especially negative impacts on equity investments, another bailout of the financial institutions by the government politicians whom the banks finance, would seem to be almost assured, as do further government stimuli to avoid such a catastrophe. Much more likely would be a scenario that is nothing worse than the sort of economic stagnation experienced by Japan over the last few decades. In such an environment, stocks would still outperform bonds long-term because even the stagnate earnings yields at today’s Price/earnings ratios exceed the extremely low interest rates available on bonds today. Whereas PIIGS like Greece might be forced into large declines in economic output by contractionary macroeconomic policies over many years in order to stay within the European Union and keep the euro, it seems improbable that the world will voluntarily induce such a state of events.

On the other hand, it’s always possible that a movement like Occupy Wall Street will somehow result in the control of the USA government by big corporations being replaced with
rule by the people and thus change this financial outlook, since the huge problems caused by the control of the government by big banks and oil companies might then be finally addressed. However, such efforts face very sizable hurdles, especially since the corporate media may eventually succeed in its various attempts to ignore, belittle, or vilify peaceful demonstrators, and since the Obama Democrats and the Paul Republicans could redirect much of their energy into their own corporate sponsored election campaigns that provide no viable solutions to the continuing crisis.

In 2000, I submitted an article to the *Oakland Journal* indicating that the long-term outlook for stocks was very poor, and that bonds would likely outperform them. That article wasn’t published there because of a subjective opinion that a political analysis incorporated into the paper wasn’t acceptable in the journal at the time, although it did appear in a good academic finance journal a few years later with the realistic political evaluation unchanged (Murphy, 2002). Investment analysis requires an evaluation of cross-disciplinary subjects, and it would be especially ineffective if it were attempted without a realistic consideration of the economic and political outlook that is optimally conducted without being biased by the prevailing ideology, corporate propaganda, or “mainstream” opinion of the day. This paper, which provides an update on a previous set of articles I have written on the financial crisis whose effects continue, incorporates such a useful view.

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