**What is capitalism? What are its benefits and problems?**

**Guiding Question: What caused the Great Recession?**

**Introduction**

One of the most profound economic crises in modern US history occurred during your lifetime. Just before the national elections of 2008—the election that saw Senator Barak Obama elected president—the entire banking system of the United States, and, then, most of the banking systems across the rest of the globe, went into what might be called cardiac arrest. The bursting of a speculative bubble in the US housing market in 2007 resulted not only in a sharp increase in foreclosures and sharp declines in the price of real estate all across the US, but sharp declines in the prices of stocks and bonds and the failure of multiple banks and insurance companies. This crisis began in the spring of 2008 with the failure of the large investment bank, Bear Stearns. By mid-September, the problem spread to other large investment firms like Lehman Brothers and Merrill Lynch, as well as the insurance giant American International Group, Inc. (AIG). This cascading series of failures crated a desperate situation, one that could have resulted—if not for federal intervention in the form of tax-payer loans or “bail outs”—in total, or near total, collapse of the US banking system and larger US economy. By the time voters went to the polls to vote in November, the US was facing its worst economic crisis since the Great Depression. For this reason, the crisis, and the prolonged economic troubles that followed, have been dubbed the Great Recession. But why did the collapse of the housing market lead to the collapse of the banking and financial services sectors? What caused the Great Recession?

**Source 1**

**NBC Nightly News report on Stock Market Crash and Failure of Lehman Brothers, Merrill Lynch, and AIG**

**September 15, 2008**

**Twitter Video, 4:02**

<https://twitter.com/CNBC/status/776473202717515776>

**Questions**

**1.** What does the report identify as the main cause of the collapse of the financial services sector?

**2.** How would you characterize the tone of this report?

**3.** Is NBC simply reporting the cratering of the financial services sector, or is it trying to reassure Americans that the economy is safe?

**Source 2**

**“Partying Like It’s 1929”**

***New York Times* op-ed, March 21, 2008**

By Paul Krugman

If Ben Bernanke manages to save the financial system from collapse, he will — rightly — be praised for his heroic efforts.

But what we should be asking is: How did we get here?

Why does the financial system need salvation?

Why do mild-mannered economists have to become superheroes?

The answer, at a fundamental level, is that we’re paying the price for willful amnesia. We chose to forget what happened in the 1930s — and having refused to learn from history, we’re repeating it.

Contrary to popular belief, the stock market crash of 1929 wasn’t the defining moment of the Great Depression. What turned an ordinary recession into a civilization-threatening slump was the wave of bank runs that swept across America in 1930 and 1931.

This banking crisis of the 1930s showed that unregulated, unsupervised financial markets can all too easily suffer catastrophic failure.

As the decades passed, however, that lesson was forgotten — and now we’re relearning it, the hard way.

To grasp the problem, you need to understand what banks do.

Banks exist because they help reconcile the conflicting desires of savers and borrowers. Savers want freedom — access to their money on short notice. Borrowers want commitment: they don’t want to risk facing sudden demands for repayment.

Normally, banks satisfy both desires: depositors have access to their funds whenever they want, yet most of the money placed in a bank’s care is used to make long-term loans. The reason this works is that withdrawals are usually more or less matched by new deposits, so that a bank only needs a modest cash reserve to make good on its promises.

But sometimes — often based on nothing more than a rumor — banks face runs, in which many people try to withdraw their money at the same time. And a bank that faces a run by depositors, lacking the cash to meet their demands, may go bust even if the rumor was false.

Worse yet, bank runs can be contagious. If depositors at one bank lose their money, depositors at other banks are likely to get nervous, too, setting off a chain reaction. And there can be wider economic effects: as the surviving banks try to raise cash by calling in loans, there can be a vicious circle in which bank runs cause a credit crunch, which leads to more business failures, which leads to more financial troubles at banks, and so on.

That, in brief, is what happened in 1930-1931, making the Great Depression the disaster it was. So Congress tried to make sure it would never happen again by creating a system of regulations and guarantees that provided a safety net for the financial system.

And we all lived happily for a while — but not for ever after.

Wall Street chafed at regulations that limited risk, but also limited potential profits. And little by little it wriggled free — partly by persuading politicians to relax the rules, but mainly by creating a “shadow banking system” that relied on complex financial arrangements to bypass regulations designed to ensure that banking was safe.

For example, in the old system, savers had federally insured deposits in tightly regulated savings banks, and banks used that money to make home loans. Over time, however, this was partly replaced by a system in which savers put their money in funds that bought asset-backed commercial paper from special investment vehicles that bought collateralized debt obligations created from securitized mortgages — with nary a regulator in sight.

As the years went by, the shadow banking system took over more and more of the banking business, because the unregulated players in this system seemed to offer better deals than conventional banks. Meanwhile, those who worried about the fact that this brave new world of finance lacked a safety net were dismissed as hopelessly old-fashioned.

In fact, however, we were partying like it was 1929 — and now it’s 1930.

The financial crisis currently under way is basically an updated version of the wave of bank runs that swept the nation three generations ago. People aren’t pulling cash out of banks to put it in their mattresses — but they’re doing the modern equivalent, pulling their money out of the shadow banking system and putting it into Treasury bills. And the result, now as then, is a vicious circle of financial contraction.

Mr. Bernanke and his colleagues at the Fed are doing all they can to end that vicious circle. We can only hope that they succeed. Otherwise, the next few years will be very unpleasant — not another Great Depression, hopefully, but surely the worst slump we’ve seen in decades.

Even if Mr. Bernanke pulls it off, however, this is no way to run an economy. It’s time to relearn the lessons of the 1930s, and get the financial system back under control.

Source: *The New York Times*, <http://www.nytimes.com/2008/03/21/opinion/21krugman.html>

**Questions**

**1.** Krugman wrote this piece not during the collapse of the financial sector in September 2008, but during the failure of the investment bank Bear Stearns the previous spring due to slide in home prices that began in 2007. In what ways does he say conditions in 2008 were similar to those in 1930-31?

**2.** Who does Krugman blame for the 2008 banking crisis? The government or the banks?

**3.** What, according to Krugman, did investment banks like Bear Stearns do to bring on the 2008 crisis?

**Source 3**

**The Great Recession and Hollywood**

**“Jenga” Scene from *The Big Short* (2015)**

**Video clip, 3:44**

<https://www.youtube.com/watch?v=3hG4X5iTK8M>

**Questions**

**1.** Who, in this clip from *The Big Short*, are identified as the creators of the financial crisis of 2008?

**2.** What does the Jenga tower represent in this clip? And what do each individual puzzle piece represent in this clip?

**Source 4**

**“What Caused the Crash? Let the Bickering Begin”**

***Newsweek* Magazine, January 8, 2010**

By Jacob Weisberg

As the [financial crisis of 2008–09 draws to a close](http://www.slate.com/id/2240282/), narratives of the meltdown are flooding bookstores, think tanks are cranking out white papers, and four different congressional committees are investigating what went wrong. Now that the debate over how to prevent the next collapse has begun, it might not be a bad idea to figure out how the last one happened. The only near-consensus is on the question of what triggered the not-quite-a-depression. In 2007 the housing bubble burst, leading to a high rate of defaults on subprime mortgages. Exposure to bad mortgages doomed Bear Stearns in March 2008 and then led to a banking crisis that fall. A global recession became inevitable once the government decided not to rescue Lehman Brothers. But right about here, agreement ends.

There are no strong candidates for what logicians call sufficient conditions—a single factor that would have caused the crisis in the absence of any others. There are, however, a number of plausible necessary conditions—factors without which the crisis would not have occurred. Most analysts find former Fed chairman Alan Greenspan at fault, for varying reasons. Conservatives tend to blame Greenspan for keeping interest rates too low between 2003 and 2005 as the real-estate bubble inflated, spurring a frenzy of irresponsible borrowing.

Liberal analysts are more likely to focus on the way that Greenspan's aversion to regulation turned innovative financial products into lethal weapons. In this view, the emergence of an unsupervised market for more and more exotic derivatives—credit default swaps (CDSs), collateralized debt obligations (CDOs), CDSs on CDOs—allowed heedless financial institutions to put the entire financial system at risk. Fed chairman Ben Bernanke also echoes this view, attributing the crisis to [regulatory failure](http://www.nytimes.com/2010/01/04/business/economy/04fed.html).…

Other analysts look to…[the] psychological argument…that investors fell prey to recurring delusions about risk and bubbles, which the economists Carmen Reinhart and Kenneth Rogoff describe in their book, [This Time Is Different](http://www.amazon.com/exec/obidos/ASIN/0691142165/?tag=nwswk-20). In another new book, [How Markets Fail](http://www.amazon.com/exec/obidos/ASIN/0374173206/?tag=nwswk-20), John Cassidy of The New Yorker focuses on the fallacies of free-market fundamentalism (Greenspan again). Still other writers, like Nobel Prize winner Joseph Stiglitz, in his new book, [Freefall](http://www.amazon.com/exec/obidos/ASIN/0393075966/?tag=nwswk-20), point to the way globalization spread the toxicity from the U.S. mortgage market to the rest of the world. Not all such explanations fall according to ideological expectations. The conservative jurist Richard Posner argues in his book [A Failure of Capitalism](http://www.amazon.com/exec/obidos/ASIN/0674035143/?tag=nwswk-20) that the free market itself is to blame for the recent troubles. Unfortunately, what these "root causes" explanations have in common is that they don't lend themselves to practical solutions.

I've left out some farther-fetched interpretations of the cause of the crisis. Libertarians and The Wall Street Journal editorial page continue to insist that [government did it](http://online.wsj.com/article/SB10001424052748704869304574596092863514668.html). In I.O.U., the only truly entertaining book I've read on the subject, the British writer John Lanchester theorizes that after the Cold War, capitalism could go wild because Western governments no longer had to worry about competing with communism. This is a fascinating idea, with no evidence to support it.

Historians are still debating what caused the Great Depression, so it's not likely this argument will be settled any time soon. But if we haven't at least learned that our financial markets need stronger regulatory supervision to prevent bad bets by big firms from going viral, we'll be back in the same place faster than you can say “30 times leverage.”

Source: *Newsweek*,[*http://www.newsweek.com/what-caused-crash-let-bickering-begin-70921*](http://www.newsweek.com/what-caused-crash-let-bickering-begin-70921)

**Source 5**

**“Catharsis, Then Common Sense”**

***Washington Post* op-ed, September 26, 2008**

By Charles Krauthammer

Treasury Secretary Henry Paulson went to Capitol Hill seeking $700 billion. He got an earful.…

In fact, Paulson is a lame duck. In four months, he is gone. Paulson is asking for the money not for self-aggrandizement but for the same reason Fed Chairman Ben Bernanke and the markets are asking for it: to prevent the American economy from going over a cliff.

Some disdain that assessment as hypothetical. Paulson and Bernanke, who actually peered into the abyss on Black Thursday (Sept. 18), think otherwise.…

Hence the need to go below the institutional superstructure to the underlying toxic assets, which Paulson proposes to take off the private sector's books by having the government buy them for, yes, $700 billion.

Congress has every duty to be careful with taxpayers' money and to suggest improvements in the administration plan. But part of Congress's reaction has nothing to do with improving the proposal and everything to do with assuaging the rage of constituents -- even if it jeopardizes the package's chances of success, either by weakening it or by larding it up with useless complicating provisions designed solely to give the appearance of sticking it to the rich.…

The mob is agitated but hardly blameless. While the punch bowl -- Alan Greenspan's extremely low post-Sept. 11 interest rates -- was being held out, few complained about cheap loans and doubling home values. Now all of a sudden everything is the fault of Wall Street malfeasance.…

For decades, starting with Jimmy Carter's Community Reinvestment Act of 1977, there has been bipartisan agreement to use government power to expand homeownership to people who had been shut out for economic reasons or, sometimes, because of racial and ethnic discrimination. What could be a more worthy cause? But it led to tremendous pressure on Fannie Mae and Freddie Mac -- which in turn pressured banks and other lenders -- to extend mortgages to people who were borrowing over their heads. That's called subprime lending. It lies at the root of our current calamity.

Were there some predatory lenders? Of course. But only a fool or a demagogue -- i.e., a presidential candidate -- would suggest that this is a major part of the problem.

Source: *The Washington Post*, <http://www.washingtonpost.com/wp-dyn/content/article/2008/09/25/AR2008092503600.html>

**Questions**

**1.** What, according to Krauthammer, caused the 2008 financial crisis?

**2.** Who does Krauthammer ultimately blame for the crisis? The government or the bankers?

**3.** Where, according to the Weisberg article, does Krauthammer fall on the political spectrum? Is his op-ed a conservative or liberal assessment of the 2008 crisis?

**Source 6**

**Dan Wasserman, “Bailout Bulge”**

***The Boston Globe*, 2011**

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Source: *The Boston Globe* <http://archive.boston.com/bostonglobe/editorial_opinion/outofline/2011/03/bailout_bulge.html>

**Questions**

**1.** Is this cartoon sympathetic to bankers and their role in the financial collapse of 2008?

**2.** What is the basic argument of this cartoon?

**Source 7**

**“The Great Recession”**

**Marginal Revolution University**

**YouTube Clip, 12:52**

<https://www.youtube.com/watch?v=dI6HNi5I8d4>

**Questions**

**1.** What does it mean to be a homeowner “underwater?”

**2.** Who else, besides homeowners, were “underwater” during the lead up to the crash of 2008?

**3.** What are the four causes of the crash discussed in this video?

Home owner leverage/debt, Bank leverage/debt, securitization, shadow banking system

**4.** What are the five components of the “shadow banking system?” Why did the shadow banking system collapse in 2008?

**5.** What event triggered the 2008 financial crisis?