CRITICAL ANALYSIS OF POLITICAL RESPONSE BEFORE AND DURING THE CRISIS: USA AND SPAIN

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Abstract
In 2008, world had one of the severe financial crisis and it became even worse just in a year. Causes of this financial crisis and what prolonged it unfortunately have not the only answer. Regulation of banking system, the problem of asymmetric information, government actions and interventions are some of the answers.
In this paper, while we investigate some of the reasons of the recent financial crisis such as housing bubble, easy credit conditions, subprime lending and excessive risk taking, we will emphasise that the main cause of it is governments' actions. Particularly, we will provide overview of specific governments' actions before and during the crisis. We will continue with the actions in the US and Spain and conclude our paper while providing some examples about their responds to it, such as monetary excesses and interventions in the private economy.

Key Words: 2008, Financial Crisis, government actions, US, Spain

KRİZ ÖNCESİNDE VE KRİZ ANINDAKİ POLİTİK CEVAPLARIN KRİTİK ANALİZİ: ABD VE İSPANYA

Öz
2008'de dünya en şiddetli finansal krizlerden birini yaşadı ve bu kriz bir yıl sonra, başlangıcındaki seviyeden daha da kötü duruma gelmiştir. Bu krizin nedenlerinin neler olduğu ve krizi nelerin uzattığı sorusunu maalesef ki tek cevapla açıklamak mümkün değildir. Bankacılık sistemi düzenlemeleri, bilgi asimetrisi problemi, hükümet politika ve müdahaleleri bu sorulara verilecek cevaplardan sadece bazılarıdır.
Biz bu makalede, konut balonu, kolay kredi olanakları, subprime krediler, banka ve hükümet kurumlarının aşırı risk alışları gibi krize neden olan olaylar üzerinde dururken; krizin asıl nedeninin hükümet Politikaları olduğunu vurgulayacak ve bu politikalara yoğunlaşacağız. Spesifik olarak ABD ve İspanya'daki kriz öncesi ve sırasındaki hükümet politikaları inceleyerek makalemizi sonlandıracağız.

Anahtar Kelimeler: 2008, Finansal Kriz, Hükümet eylemleri, ABD, İspanya

Introduction

Financial world had one of the severe and stormy periods in 2008. With this crisis, nearly all financial systems in the world are ruined. Banks, not even believed to be failed, collapsed, people would not pay their debts and governments' rescue plans weaken the GDP's. Governments queued to release the failed banks, burdened extra taxes on their citizens (Esen, 2011).

Mortgage system-based real sector and the system interconnected complicated structures of derivative instruments, are key factors for the crises. Lack of necessary regulations and control on the financial system in 1970s, financial institutions' activities in risky fields during 1990s and bad economic governance in the developed countries throughout 2000s have not only played vital roles, but also deepened the crisis and caused its spread to the whole world (Adanur, 2012).

Critical Analysis of Political Responses before and during the Financial Crisis

In the recent financial crisis, housing boom was first observed in the US then pervaded to the rest of the world due to monetary excess (Taylor 2008). Therefore it can be assumed that monetary excess was another main reason for one of the biggest severe crisis in the history. Some researches made by OECD (the Organization for Economic Co-operation and Development) also provides some evidence from countries like Iceland (2005) and Sweden (2001) that the greater the monetary excess degree, the more expanding was the housing boom.

It is thought that worthy economic policies ought to be predicated on historical experience. If the Federal Reserve of the US had followed its traditional method, which was working well during the last two decades, the boom and subprime crisis could have been prevented; Taylor (2008**).**

The chart below, which is cited from the Economist (October 2007), demonstrates how the interest rates decision should have been before and during the crisis. The light blue line in this graph shows that Federal Reserve decreased the interest rates until 2003, it remained

constant in 2004, and then began rising significantly until 2006. The other line in the graph-called "Taylor rule" denotes how the interest rates would have been if the Fed had persisted the policy, the traditional method of putting the interest rate always back to track. This was also the rule, which Federal Reserve used during the great depression.

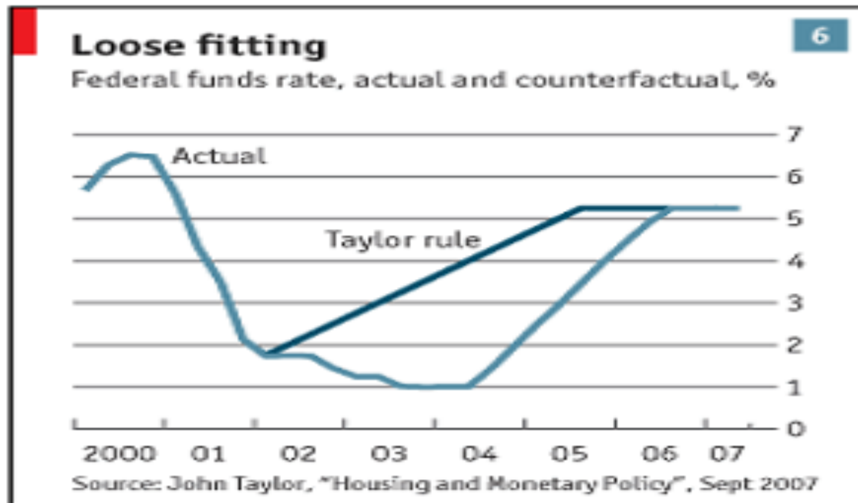


Chart 1

Easy Credit Conditions

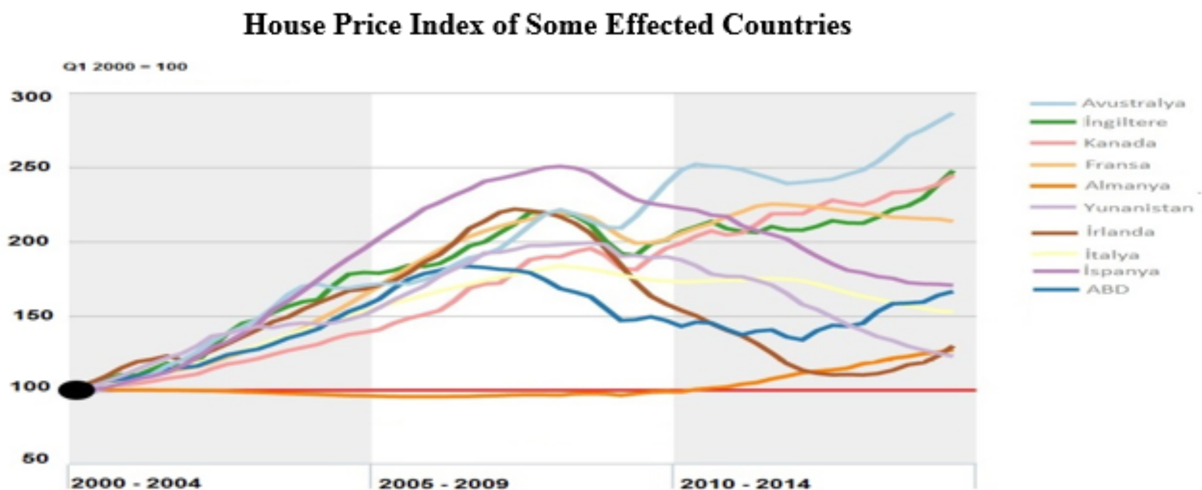
However, Fed took the low interest rate decision with careful consideration from 2002 to 2004. The purpose of this decision was to encourage people to purchase house. Yet, due to privileged access to two large government supported housing agencies, Fannie Mae and Freddie Mac, even people with bad credit records were exhilarated to increase their purchase of mortgage backed securities including the mortgage loans. Furthermore, there was moral hazard problem and no careful consideration while mortgage loans were given to people (Lawrence 2004).

In Spain, people were also encouraged to buy house for similar reasons. However, unsustainable growths in housing price misled especially middle-aged people that they would be 'rich' in an easy way. Occasional papers by some staff of the Bank of Spain, by regular reports as well as by some economists had identified this unhealthy process for years (Suarez, 2010). Therefore, it can be said that authorities were already aware of the problem; however the counteractive actions they took was doubtful.

By attractiveness of adjustable mortgage loan rates, the housing bubble was expanded. However, due to the great complexity of mortgage backed securities, adjustable and subprime mortgage rates were not well approximated (Taylor 2008). Rating agencies underestimated the risk of these securities either because of the difficulty in measuring risk and complexity or because of poor accountability. Therefore, the risk taking significantly amplified.

Growth of the Housing Bubble

It can be seen from the graph of housing price index that American house prices increased by 65% between 2000 and 2006. In the same period, the prices of house in Britain went up around 120%, those in Australia about 90% and those in France around 110%. It can be seen in the chart 3 that the situation in Italy was similar, which rose by nearly 70% from 2000 to 2006. The biggest rise in the graph belongs to Spain with 220%, which was more than most of the European countries. Therefore, it can be said that Spain was affected more severely than most of the European countries due to having a developed mortgage market.



Source: Australian Boreau of Statistics; Banco de Espana; Bank of Greece; Deutsche Bank; Eurostat; INSEE; OECD; ONS; Standard&Poor's; Teranet – National Bank; national statistic

House Price Index Chart 2[1]

What was abnormal to the US was the capability of large volume of subprime borrowers (particularly those with bad credit records) to take out mortgages and purchase houses, tempted by cheap credit and relying on that the price of house could only increase. Yet, since mortgages were guaranteed by the two government institutions, junk loan was enlarged in

[1] This table is taken from the journal of "A Worldwide Overview of Real Estate Prices in Recent Years" Pp: 10

America (Bader 2008). Increased adverse selection and the insufficient consideration of moral hazard problem during housing boom has exacerbated the mortgage crisis with high default mortgage rate.

Moreover, considering the government allowances to Freddie Mac and Fannie Mae on offering the mortgage loans, some of the investment banks such as Lehman Brothers and JP Morgan embarked on a tight competition against these government supported institutions by taking risk excessively. Additionally, because investment banks have been allowed to raise their debt level in accordance with the rule which The Securities and Exchange Commission (SEC)[1] have published in 2004, the investment banks took massive risk with a huge amount of leverage. So, government allowances on mortgages as well as tight competition in private markets have detonated the housing bubble.

The explosion of the housing bubble was not only affected in the US, but in whole world due to the economic integration and globalisation. As it can be clearly seen in the chart 3, house prices decreased dramatically in the world, after the crisis arose in the US.

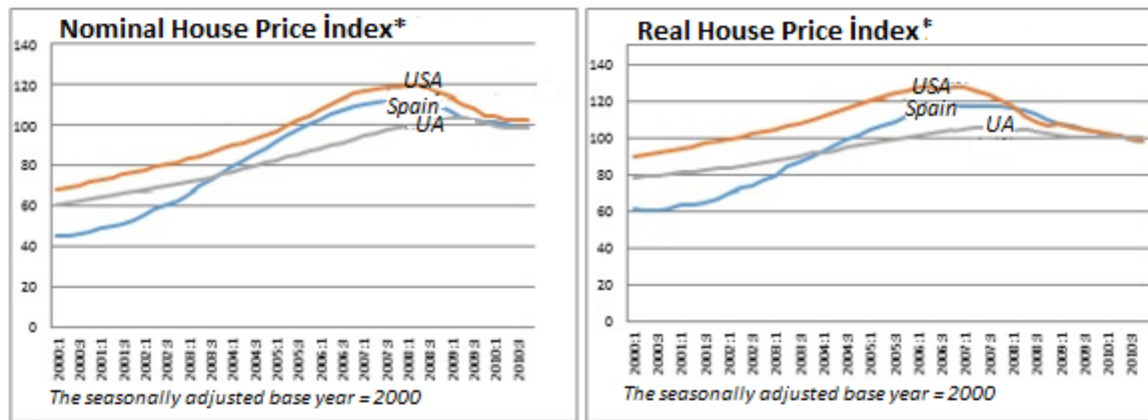
Source: www.imf.org/housing

Chart 3

The chart 4 compares the house prices in EU, US and Spain. The price in Spain was more similar to that in US. This can be an indication of why the crisis was more severe than most of the European countries.

[1] Using computerized models, the SEC, under its new Consolidated Supervised Entities program, allowed the broker dealers to raise their debt-to-net-capital ratios. It also eliminated the method for applying haircuts, relying instead on another math-based model for computing risk that led to a much smaller discount. For more detail: www.sec.gov

House Price İndex (USA, Spain EU)



Source: www.oecd.org/eco/outlook

Chart4

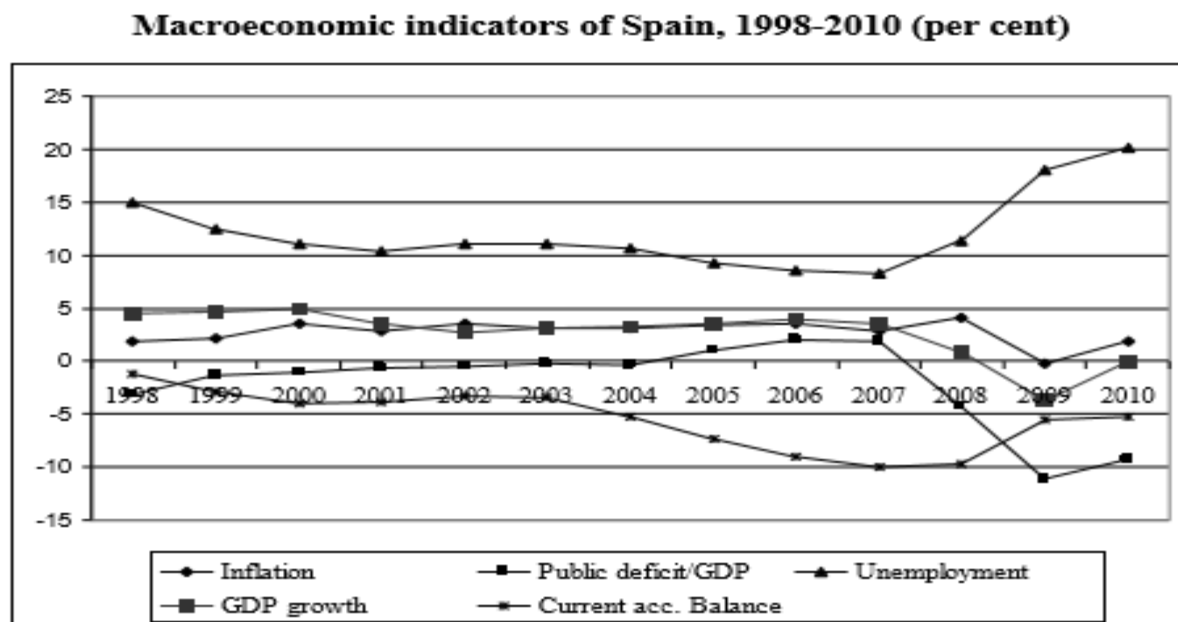
When Euro came to the circulation in 2002, the currency risk of Peseta was eradicated and economic stability for Spain became easier, and also switching its currency to Euro decreased the interest rates. Demand for mortgage raised between 2000 and 2008 when population reached to 45 million from 40 million (Gutierrez, 2009).

Additionally, banks in Spain are mostly under the control of local authorities and not publicly owned. The customers of these banks are generally from less creditworthy environments such as SMEs, NGOs (Non-governmental organization) as well as families (Akçadağ, 2012). Moreover, the banks were not obliged to inform about their housing debt to equity ratios, collateral to debt ratios as well as repayment schedules, due to the lack of infrastructures which therefore caused the government to be unaware about the situation of the banks (Harrington, 2011).

These banks, which hold 56 % of mortgage, ended up with massive deficit when housing market ruined and firms started to collapse one after another in 2009. People used their assets to pay their debts. So, they were not able to invest in another sector. The Central Bank of Spain (Banco de Espana) announced that non-performing loans were almost € 180, 8 billion during that time.

New house selling shrank 28 %, completed house price dropped 8 % and employee firing started in the housing sector in one year after the subprime mortgage crisis began. Banks failure would start before end of the year as they could not withstand the rapid increase in

debt burden (Santos, 2014). In March of 2009 the first caja[1], Caja Castilla La Mancha or CCM, was taken over by the Bank of Spain and immediately sold to another caja (Cajastur). In line with the economic contraction, the expenditure of the public and private sector decreased between 2006 and 2009 and consumers' debt reached to \$1, 4 trillion (Oğuz ve Pehlivan, 2012).



Source: ÉLTETŐ, Andrea,2011

Chart 5

As it can be seen in the chart 5 unemployment raised to 20 % from 8, 3 % between 2007 and 2011, macroeconomic indicators became upside down, economic downturn became apparent and the economy started to shrink. Even though Spain had the biggest percentage of the growth rate before the crisis by around 4 % yearly, the growth rate turned to negatives - demonstrated the record drop (decreased to -3,7 %) - in 2009 (Oğuz and Pehlivan, 2012).

Crisis is prolonged

Local authorities, which generate the federal structure of the country and autonomous regions positioned their and the government's budget in a difficult condition. Additionally, late decision making mechanism of the Euro area not only made the Spain banking weak, but also made the crises worse.

[1] "Cajas" are the terms, which is used for saving banks in Spain.

After seeing the shocking effect of the crisis in Greece, the banks in Spain used the European Rescue Funds to fill their balance sheet with the government bonds rather than using it for foreign lending. This created government bonds up to 40 years (Chan, 2011). Spain gained some time by domestic borrowing, however, loose monetary policies of the local authorities and the autonomous region changed the government debt into a banking crisis (Akçadağ, 2012). Finally, financial market collapsed, unemployment rate reached to 19, 3 % in December 2009, which was the highest in Europe with 8 % before the crisis started and GDP depreciated 10 % during the 2008 summer (Chan, 2011).

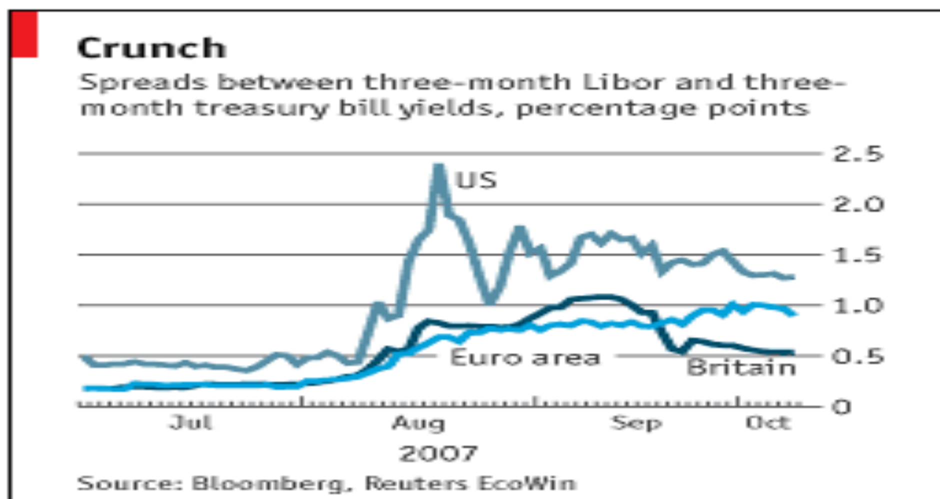


Chart 4

According to The Economist magazine, when the market interest rates increased sharply, the financial crisis became acute on 9th and 10th August 2007, (October 2007). The gap between Libor and Overnight Index Swaps (OIS) rose. Therefore, the differences between overnight interbank and three-month loans became excessively high. Libor-OIS spread increased by 1% from 0.1% in July 2007 to 1.1% in January 2008.

Identifying the reason of this rapid rise in interest rates was essential to define appropriate policy responses. Taylor (2008) interviewed some of the interbank market dealers and hoped to measure the counterparty risk. During this interview, he found out that monetary officials and many traders thought it was mostly a liquidity problem.

Additionally, it can be seen from the chart 4, cited from the Economist, that the banks were abandoned each other in August. They increased their three-month interbank rates, expressing their willingness to lend to each other for only very short periods. The spread

between the government bills' rates and three-month Libor rates, a measure of riskiness of lending to another bank, increased significantly in America and also in Europe. "Banks did not want to lend each other as they did not know which counterparties may prove bad credit risks" (The Economist).

Actions of Government:

1. **USA**

Although, central bank is the lender of last resort, banks were not keen on borrowing from the discount window due to an embarrassment connected with such borrowing since the public and the Fed may misinterpret frequent bank borrowings, even for legitimate purposes, as a signal of financial weakness. However, central banks encouraged the banks to borrow as this is their usual part of business (Cecchetti 2008). Thus, the Federal Reserve introduced Term Auction Facility (TAF) to make borrowing from the central bank simpler. Then, banks might find a way of circumventing to drive to the discount window with this new facility and they would be able to ask funds directly from Fed. But, providing more liquidity as a policy action did not work.

The Economic Stimulus Act was introduced as another policy In February 2008. Supplying cash money to individuals and families was the vital part of this act. By this way, they would have money to spend, therefore consumption and the economy would restart. However, *due to the fact that people could not predict what will happen in the future, they saved the money instead of spending it*. (Forecast from Milton Friedman's permanent income hypothesis).

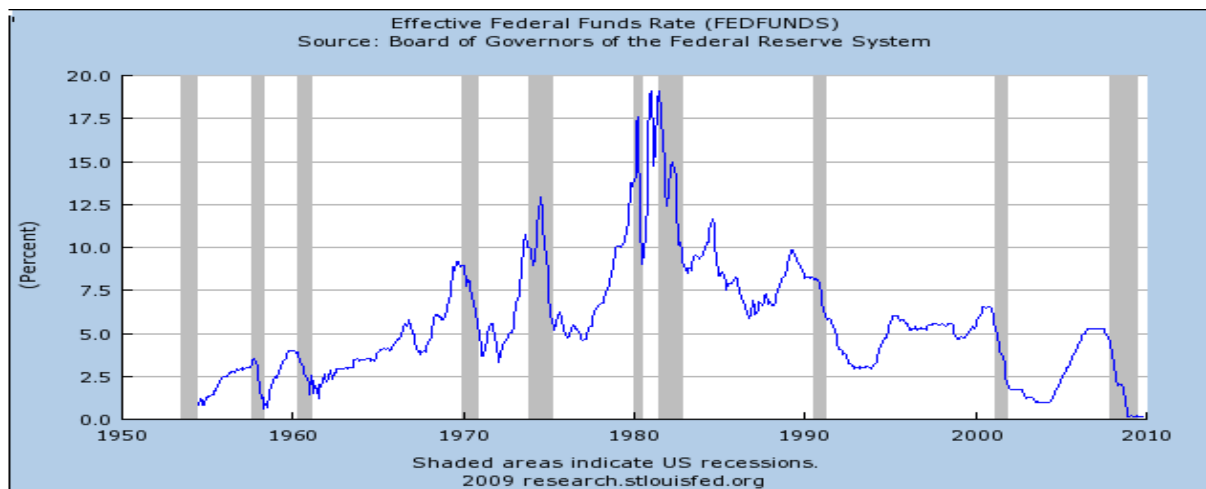


Chart 5

In August 2007 another policy response, which is the initial cut in interest rates, was introduced. Reducing federal-funds rate was the purpose of this action. Therefore, between August 2007 and August 2008 Federal Fund rate declined from 5.2 to 2.0. Dollar depreciated, with this sharp reduction. Oil price increased to over $140 in July 2008 (it was $70 in August 2007), which hit the economy severely and automobile sales plunged. This affected commodity prices to upsurge as well. Consequently, this action also did not succeed, but the financial crisis extended and worsened.

2. Spain

Economic model in Spain was based on construction and housing sectors and these sectors represented 13 % of employment and 10 % of GDP before the crisis. According to data from Eurostat, 150,000 new companies and 900,000 jobs are created in the construction sector from 2001 to 2007, most of them were small with maximum 10 employees, however, 100,000 of those businesses and 800,000 of the people lost their jobs between 2007 and 2008 and annual wages in the sector dropped by €12,000.

Practices put in place in Spain were not enough either to control the housing prices or to control the increase in the construction sector, compared to the development in these sectors. To be sure some of the admired exemplary regulatory and supervisory practices, more specifically, “Dynamic provision”, instituted in 2000 by the Bank of Spain was as an early answer to credit side of the housing boom. This provision forced banks to hold enough capital when economic conditions were good and not allowed them to use it during economic downturn, when it is more expensive; so that the probability of failure from capital deficiencies would be reduced. Moreover, a target of dynamic provisioning is applied to make certain that the balance sheet accurately mirrors the exact value of assets to banks. . If revenue is not decreased to provision for non-collectable assets, then managers might be forced to provide greater dividends to investors based on the reported income in the period (Balla, 2009). This practice was partly successful, however could not prevent housing boom (Saurina, 2009).

Another action was an economic aid package with € 1 billion. This package was announced on 28 November 2008. The reason behind it was to strength the economy by supporting families and businesses and increasing employment by 300.000 people. However, IMF has reported that this support caused GDP got down 1, 2 %. Additionally, the government announced to reduce public deficit, which made it compulsory not to have more than 3 %. Thus, € 35 billion were given to the local authorities and the autonomous governments to pay their debts. (Akçadağ, 2012). As a result, because of these government actions 2 % budget surpluses in 2007 turned into 11 % budget deficit in 2009, and public debt increased 54 % from 36 % during this period[1].

Because of not achieving effectual results with its policies, Spain started an austerity policy by placing European Union saving measures. As a result, the government spending reduced 3, 5 % of GDP, unemployment benefits and private sector salaries reduced by 7 % and department budgets dropped by 17 % (Roman, 2012).

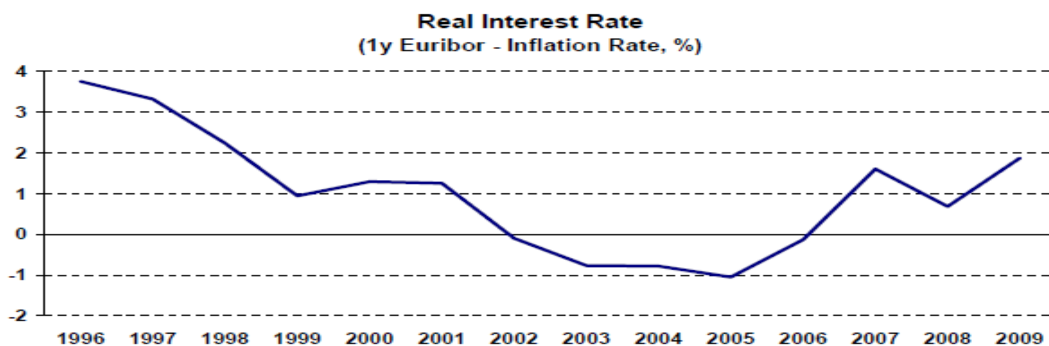


Chart 8

Monetary policy could have been a more effective tool to fight the housing bubble; however, it was not under the control of the Spanish authorities. As it can be seen from the chart 8, short term interest rates were negative from 2002 to 2005. The countries like Spain had a great benefit from it and had an opportunity for their economies, but from macroeconomic perspective it might be a reason for the subprime mortgage crises in Europe. Even though credits were at the highest levels in some countries like Spain and Ireland, reel interest rates, credits or high housing prices did not become reasons for the EU to have strict policies as these indicators were at more moderate levels in most of the European countries such as Germany and France (Suarez, 2010).

[1] IMF Country Report No. 13/331, November 2013 Spain: Financial Sector Reform—Fourth Progress Report

Conclusion

In this paper, by providing some empirical evidences, it is supported that the government policy responses and interventions leaded and extended the crisis. Building an economic growth model only on specific sectors such as real estate and construction generated very severe outcome. Wrong policy actions have prolonged financial and economic conditions. Governments hold interest rates lower than necessary levels in order to encourage people to buy houses as well as to keep their economies alive.

After the collapse of the housing and constructing, structural adjustment reforms also put in practise to repair the system's imperfect aspect and to boost its long term growth potential. However, the financial crisis was extended because of misinterpretation of the problems and inappropriate actions taken by the government against the crisis. Furthermore, excessive risk taking of investment banks, government sponsored agencies and tight competition played massive role in the housing boom and exacerbated the crisis.

It is clearly experienced that being an active player in the financial markets and extremely intervening financial system even during crisis generate adverse effects. Meanwhile, excessive debt burden, uncertainty for borrower to pay their debts back and believing that house prices can only raise leaded to wrong expectations. Two massive government supported institutions in the US, Fannie Mae and Fredie Mac, destroyed the credit mechanism by urging people to have house and making them believe that they would not be able to have otherwise; therefore, even people with low credit score had credits. The privileges, which were given the government institutions and local authorities also caused negative outcomes for financial system. In addition, given advantageous to "too big to fail" institutions by some set of rules damaged competition and exposed small entities with no advantageous and leave them vulnerable.

To sum up, massive policy responses to financial crisis without prior extensive investigation and deep research on the causes might make things worse in the economy. This is one of the main lessons from this crisis. In order to explain all the exact reasons behind the crisis, it would be better to do more analysis.

To prevent misguided actions in the future, it is crucial to maintain sound principles of monetary policy, for government interventions and actions based on clearly stated diagnoses

and predictable frameworks (See: Basel Committee on Banking Supervision Consultative Document).

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