



EconoMag

The Show that demystifies Economics

2008 Financial Crisis – part 4

Following the tipping point: how did the aftermath of the crisis in the financial system? ©

by Pierre Vercueil

Welcome back to another edition of Economag on EnglishWaves. As you'll recall we were last talking about the Financial Crisis of 2008, and we left off at the point when the crisis erupted. We worked through the mechanics of how this happened – remember our fictional character William who took out his subprime housing loan, which the big investment banks then turned into a CDO, or a collateral debt obligation, and was ultimately marketed as a safe investment. This was then sold to unsuspecting investors. Now what happened when it became clear that there was a very, very big crack in the financial system?

Investors who held CDO products, and who were no longer being paid, were in big trouble. This was on an international scale but for simplicity's sake, let's stick to the example of the United States where the crisis had severe, long-lasting consequences. The country entered a deep recession with nearly 9 million jobs lost during 2008 and 2009 – this was nearly 6% of the workforce; meaning 15 million people were unemployed. U.S. housing prices fell nearly 30% on average and the U.S. stock market fell approximately 50% by early 2009.

The picture is most dramatic when we look at what happened to US Gross Domestic Product, or GDP. This refers to the total monetary value of all the goods and services produced in the United States in one calendar year. It's estimated that in 2007 roughly 40% of US GDP was lost. Another way of looking at this is considering GDP as a country's ability to create wealth, so in 2007 alone the US lost 40% of its wealth-creating ability. Indeed between 2007 and 2008 Americans lost more than a quarter of their net worth.

Let's bring all this back to our example of William, and consider how this would have affected him and his local community. Remember William took out a sub-prime loan, and he didn't have the means to service his debt. After the crisis, the bank would have repossessed his home, but since housing prices fell dramatically, the bank would probably not have been able to recover the loan amount from the sale of the house. Before the crisis, William had trouble finding stable, long-term employment. Now that the economy was in crisis, it was even more difficult. Banks were no longer lending money to anyone – individuals or businesses – so businesses were no longer hiring. After the crisis, William was with neither a home nor a job.

What about William's community? Let's assume William's neighbor, Sally, is a 80-year-old pensioner. She doesn't work, so she relies on her pension income, which was managed by a pension fund. Who was a big buyer of the CDO products? That's right, pension funds, and now

Sally's pension fund has lost her pension, so Sally is without any income at 80 years old. Total retirement assets, Americans' second-largest household asset, dropped by 22%, from \$10.3 trillion in 2006 to \$8 trillion in mid-2008.

In our next programme we'll consider how the crisis spread beyond the US, and what it has meant for the Eurozone up until now.