



EconoMag

The Show that demystifies Economics

2008 Financial Crisis – part 1

Introduction ©

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Welcome to another edition of Economag. It seems that a lot of what is going on in the news nowadays, economically speaking at least, has ties to the financial crisis of 2008 – a bit like the economic ‘big bang’ of the last 50 years. It’s certainly a very large topic, so as always, we’ll be breaking it down into 5 bite size pieces, hopefully leaving you with a good understanding of the mechanics behind the story.

Today it would be helpful to start with a simple analogy about the volatility of asset values in the market place. In other words, something can be worth a lot today, but be worth nothing tomorrow all because the market sentiment – or the way in which different people in the economy view a certain asset – changes suddenly due to a particular event or piece of information.

Let’s imagine that you would really like to buy a box of oranges worth 100€, and I say okay, I’ll let you borrow 100€ from me. Let’s also say you’re really happy to find someone who is willing to lend you the money because you don’t currently have a job, meaning you have no stable income. You agree to pay me back in full, but with an extra 10€ as a way of thanking me for my generosity. In other words, you pay an interest rate of 10%. To make sure you pay me back, I ask for collateral on the loan, or in the words, an object or asset that you own which is worth at least 100€. That way, if you don’t pay me back, I can sell that object or asset to make back my money.

Now let’s suppose you have a big box of apples, and it just so happens that the box of apples is worth around 100€. I think to myself, right, everyone likes apples, so I’ll have no trouble selling a box of apples if you don’t pay me back. I even reckon that people like apples so much, that the price of apples will continue to increase in the future given that demand for them is so strong. Sounds risk-free, right? We both agree your box of apples can be the collateral for the loan, so I come round to your house, take the box of apples, and give you a 100€ bank note.

But now imagine one day people realize that pears are healthier than apples, and that they taste better too; instead of 1€ per apple, people are now only willing to pay 50 cents. That’s right, everyone changed his or her mind about apples on the same day! The box of apples, which is currently in my possession, is no longer worth 100€; if either you or I wanted to sell it, the most we could fetch would be 50€, or in other words, half its original value.

At the same time, you're having trouble paying back the 110€ you owe me. Remember, you have no job! So what would you rather do: try and pay me back the €110 or just default – in other words, tell me you won't be able to pay me – and give me your box of apples now worth only 50€? You'd give me the box of apples! Who wouldn't? That way you score 60€. I expected to make 10€, but I have ended up losing 50€. What's the lesson here? There are two: first, you can't expect the value of something to increase forever, and second, you should not lend money to people without an income!

Now instead of a 100€ loan, imagine that it's hundreds of thousands of US dollars, and instead of a box of apples, it's your house. For a very long time economic prosperity in the US was built on the idea that house prices would never go down. Multiply this wishful thinking by thousands of people, and it becomes clear how this could lead to a countrywide, and eventually international, financial crisis. Indeed this is exactly what happened.

We'll take a closer look at why a little story about a box of apples can go a long way in explaining the pretty big story of the international financial crisis of 2008.