

What is a Credit Default Swap Anyway?

The Financial Crisis for Capitol Hill Staffers

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WHAT YOU DON'T KNOW CAN HURT YOU.

- Describe the economic crisis of 2008
- Identify the four major factors contributing to the crisis: *The Fed, Government Policy, Financial Sector, Household Sector*
- **Answer:** What role did credit default swaps play? "Could the crisis have been avoided if regulators had done more? Less?"
- **Answer:** "Is this a crisis of capitalism or a crisis created by the unintended consequences of well-intended monetary and fiscal officials?"
- Questions

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- After this webinar we’ll post an update on our blog and you’ll be able to post your questions for us.



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Welcome to Econ4U.org. Our goal is to teach economics and personal finance using interesting, informative, and real examples. Our economic education program presents facts on personal finance, business economics, entrepreneurship, and government spending in unusual venues such as movie theaters, restaurants, and bowling centers. Take [our quizzes](#) to see how much you know, or explore our resources to find out more about consumer loans like [mortgages](#), [student loans](#), [short-term payday loans](#), [credit reports](#), and [car loans](#).

Latest from the Blog

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14

Wrapping Your Head Around 12 Zeroes

Suffice to say, a trillion of anything is a lot. Since most people we've talked to aren't entirely clear on how big it really is, for visual learners (like myself) we put together these graphics to illustrate the enormity of a trillion dollars.

AUG
13

7 Expensive Mistakes College Students Make

College is a time for students to learn to be on their own for the first time in their lives, and a majority have a lot to

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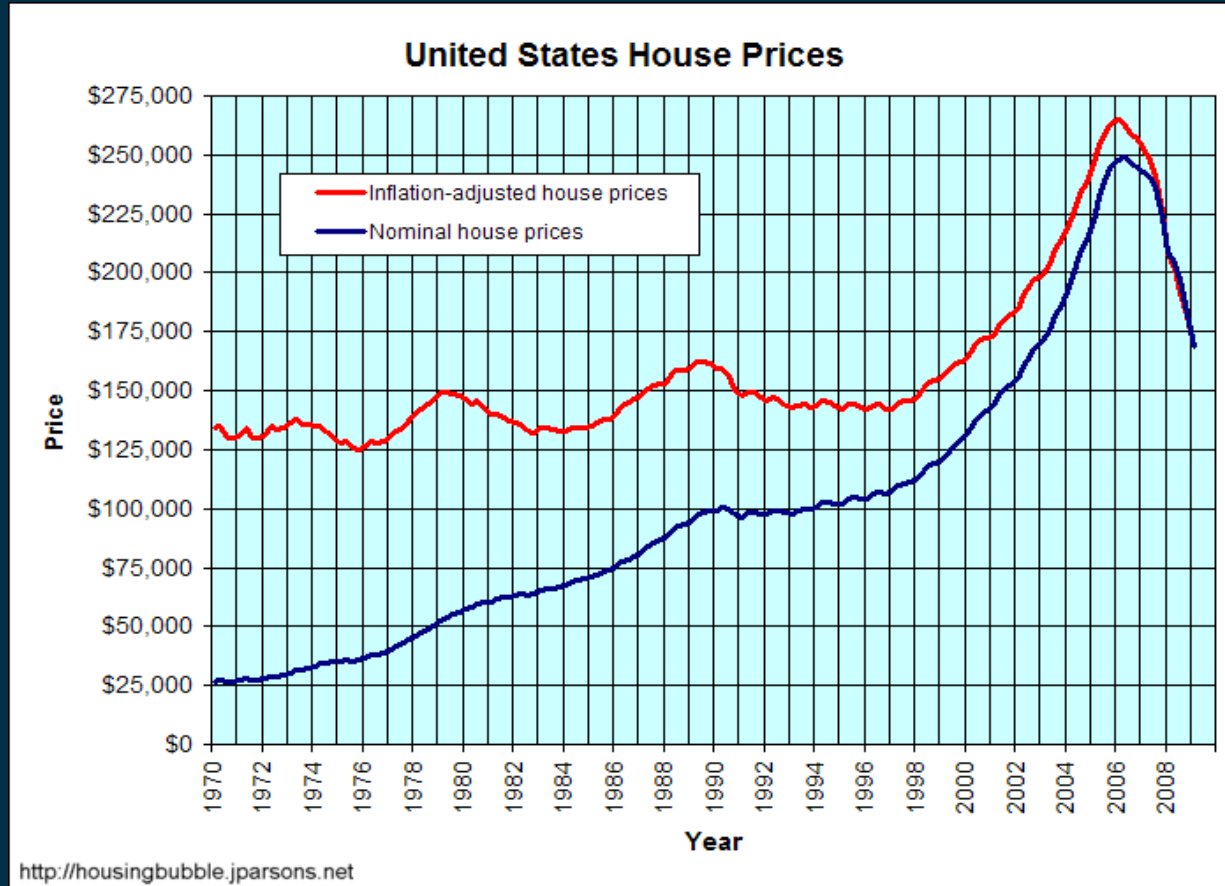
How much do **you** know?
Take our **economic quiz** to find out.

How much is

What is the U.S. Economic Crisis to the Average Citizen?

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Economic Crisis: *Housing Prices Fall*



- Housing price increase during 2000-2005, followed by a levelling off and price decline.

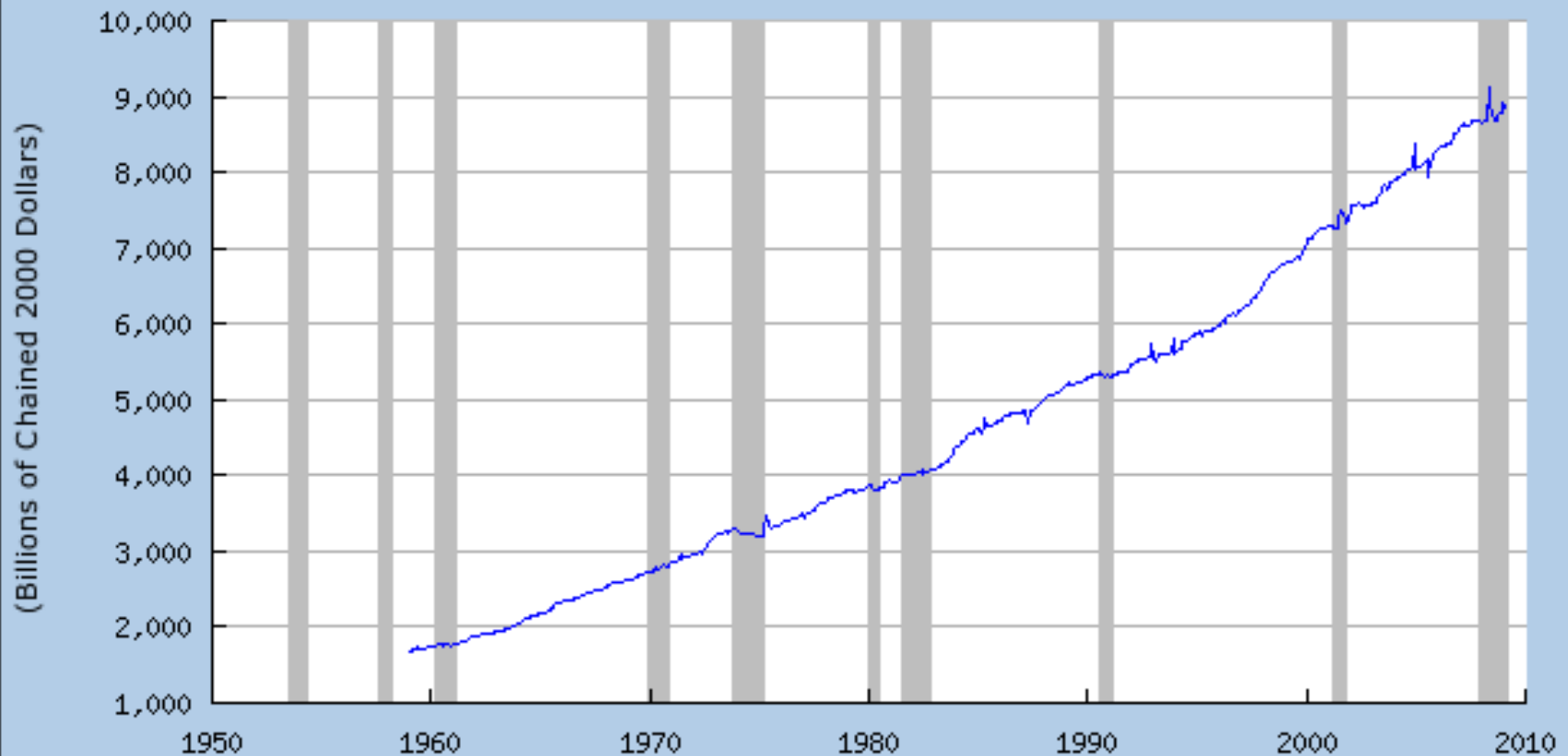
DJIA, S&P and Nasdaq Trends: *Stock Wealth Evaporates*



However, historically, average real disposable income is still on the rise.

Real Disposable Personal Income (DSPIC96)

Source: U.S. Department of Commerce: Bureau of Economic Analysis



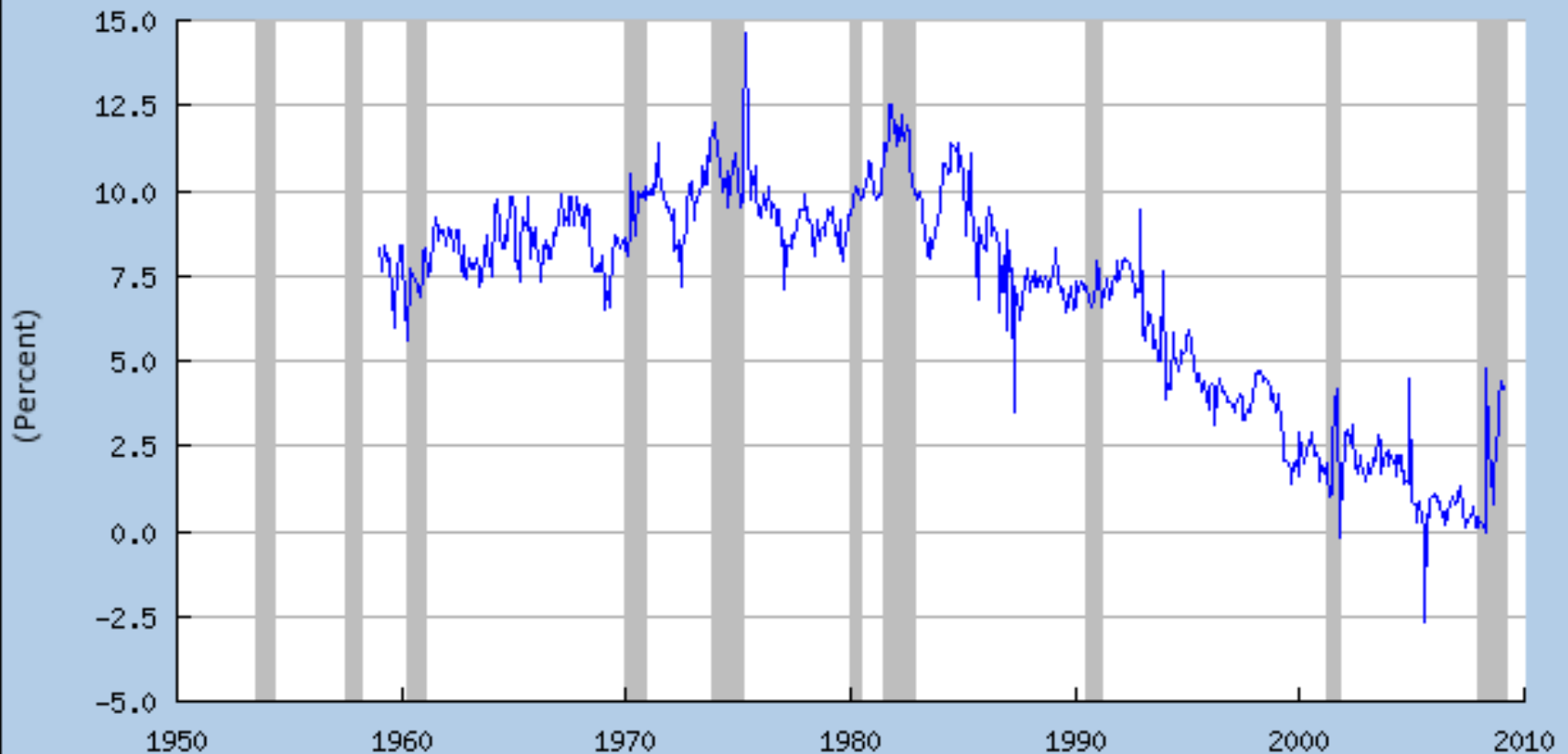
Shaded areas indicate US recessions.

2009 research.stlouisfed.org

Savings rates fell but have started to rise.

Personal Saving Rate (PSAVERT)

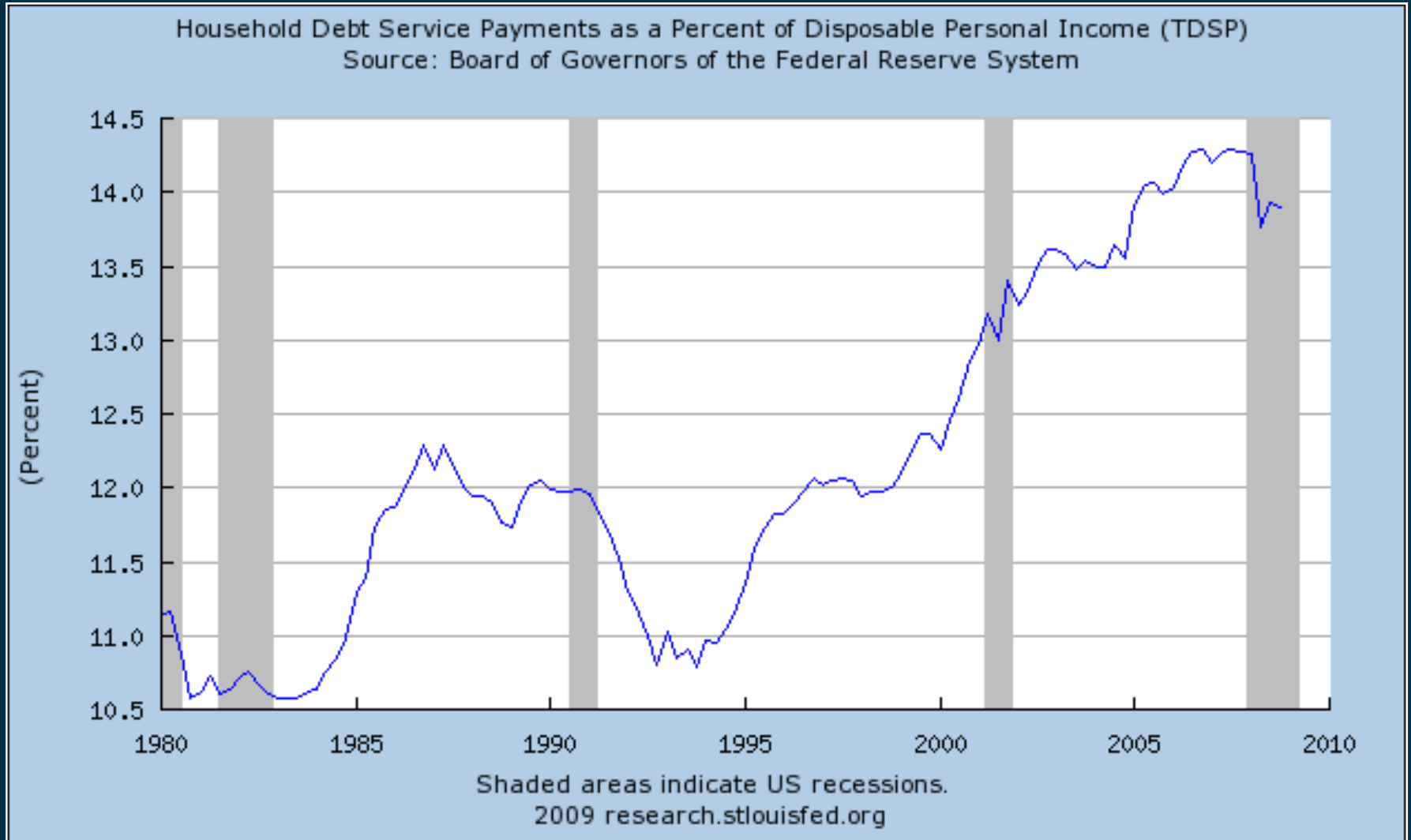
Source: U.S. Department of Commerce: Bureau of Economic Analysis



Shaded areas indicate US recessions.

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Household debt service payments as a percentage of Personal Disposable Income increased over time. But, it has started to decrease.

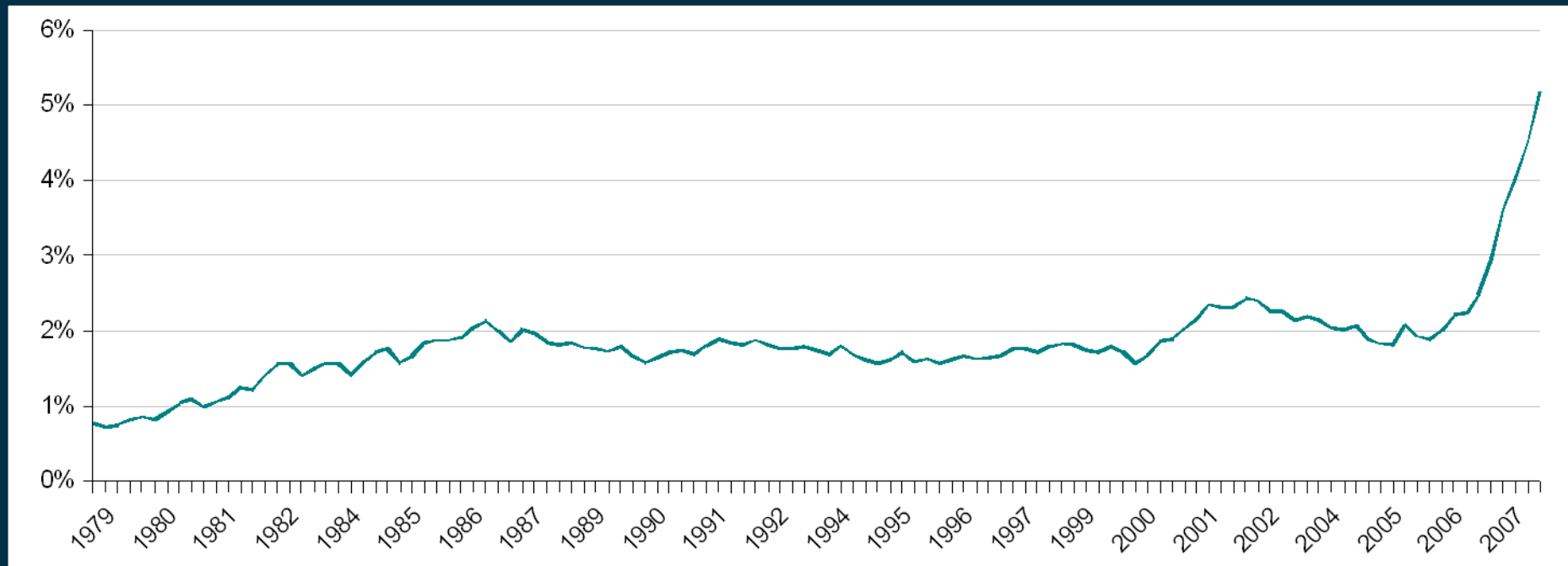


Consequence of These Private Decisions?

*Unexpected shocks are more difficult to
absorb during troublesome times*

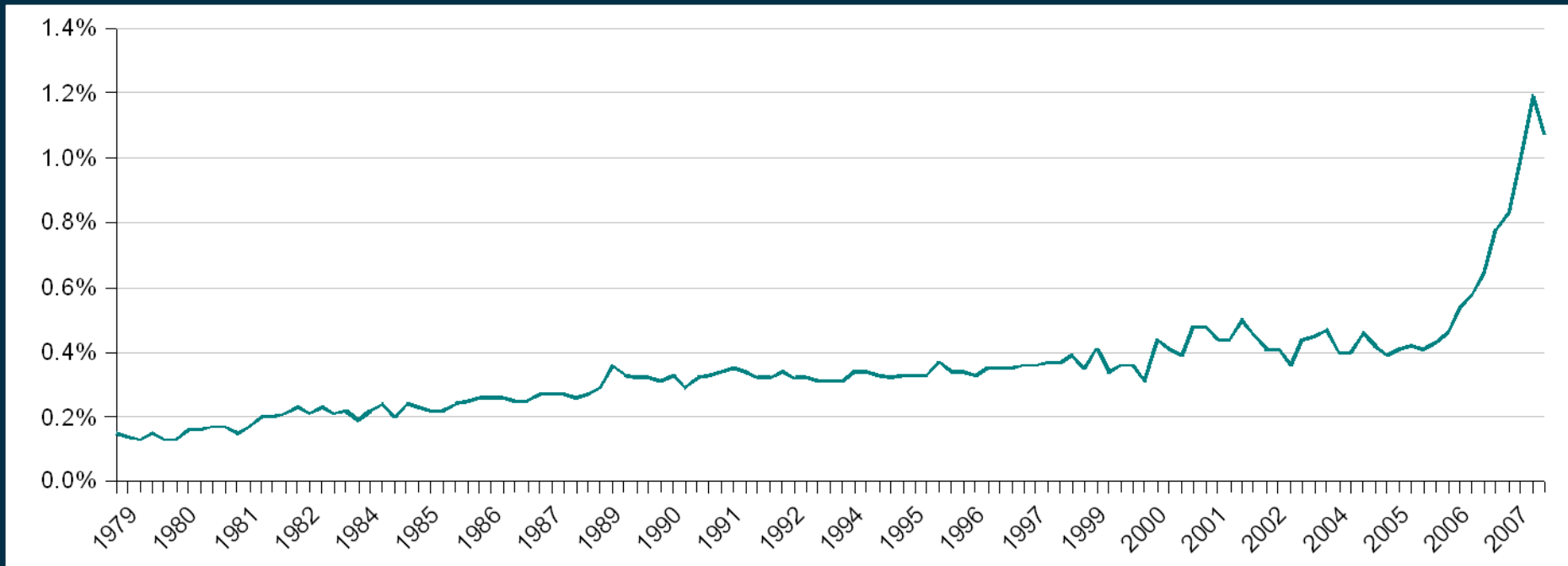
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Consequently, default rates rise.



and, foreclosure rates increase.

Foreclosure Rates



Large Financial Institutions Are Shaken In 2008...

- Activity in the market for credit defaults swaps had accelerated between 2003 and 2008.
- Firms like JPMorgan sold credit default swaps to allow pension companies and others to hedge against the inherit risks associated with lending to corporations, governments and emerging markets. Other firms like AIG emerge in the CDS market.
- These markets are shaken and overleveraged firms can not make it through uncertain times.

Emergency Economic Stabilization Act of 2008

- **Emergency Economic Stabilization Act of 2008**
 - Tightening of credit
 - Reduced home values
 - Severe uncertainty in the stock markets
- **Initially authorized the United States Secretary of the Treasury to**
 - Spend up to \$700 billion to purchase distressed assets, especially mortgage-backed securities
 - Make capital injections into banks

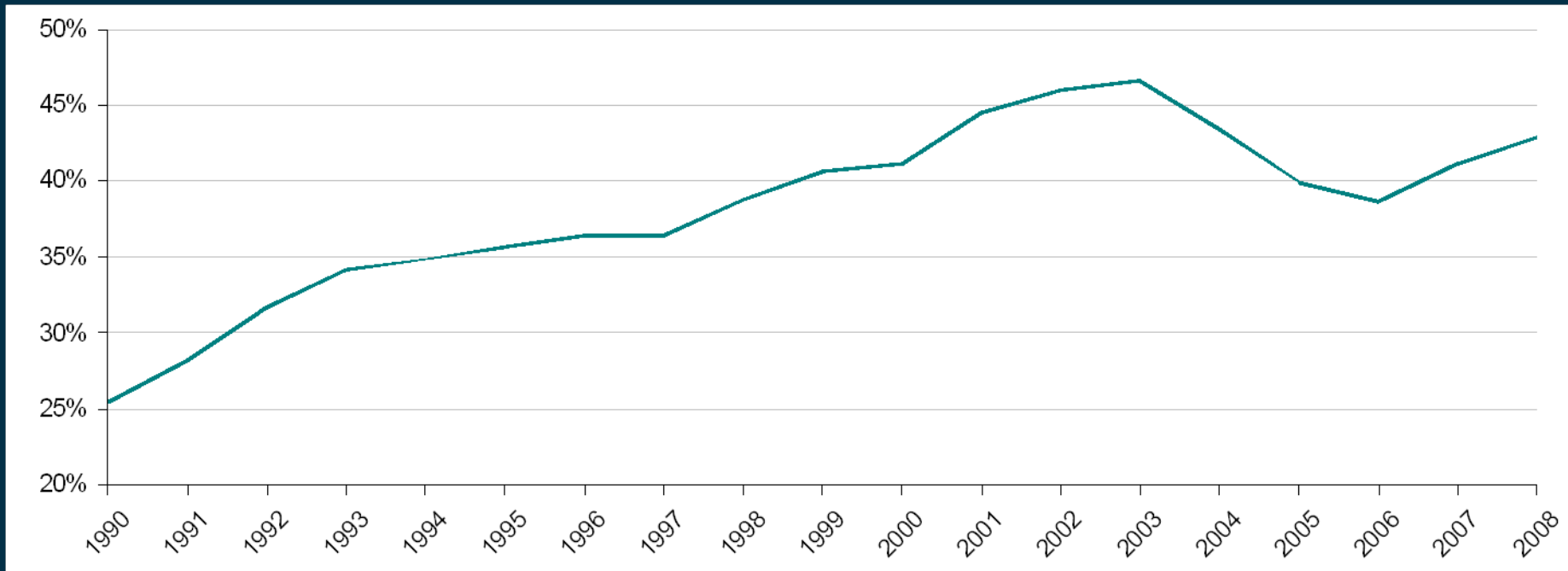
The Current Crisis: *Four Main Factors*

1. Erosion of conventional lending standards.
2. Low interest rate policies of the Federal Reserve System during 2002-2006.
3. Increased leverage lending of Government Sponsored Enterprises (GSEs) and investment banks.
4. Increased household debt to income ratio.

- **FACTOR 1:** Beginning in the mid-1990s, government regulations change the conventional lending standards.

Fannie Mae/Freddie Mac Market Share Increases

Freddie Mac/Fannie Mae Share of Outstanding Mortgages

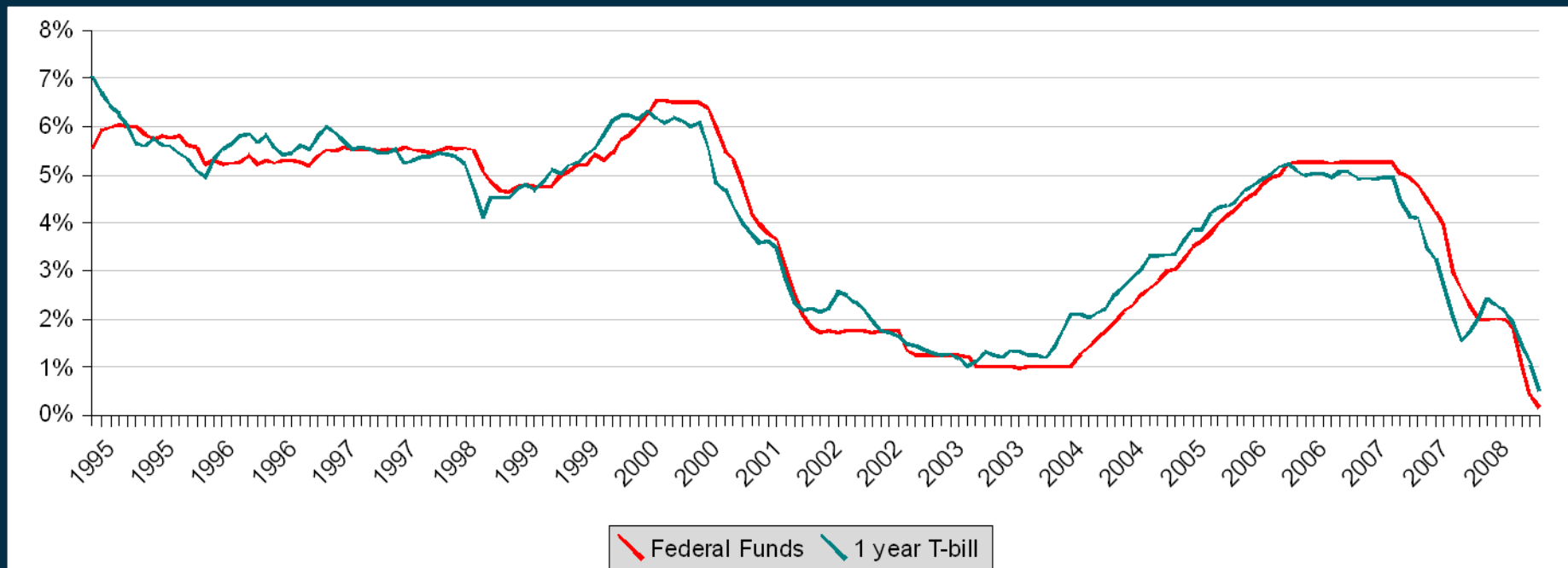


Source: Office federal Housing Enterprise Oversight, www.ofheo.gov.

- **FACTOR 2:** The Fed under Greenspan's chairmanship follows a low interest rate policy during 2002-2006.

Short-Term Interest Rates

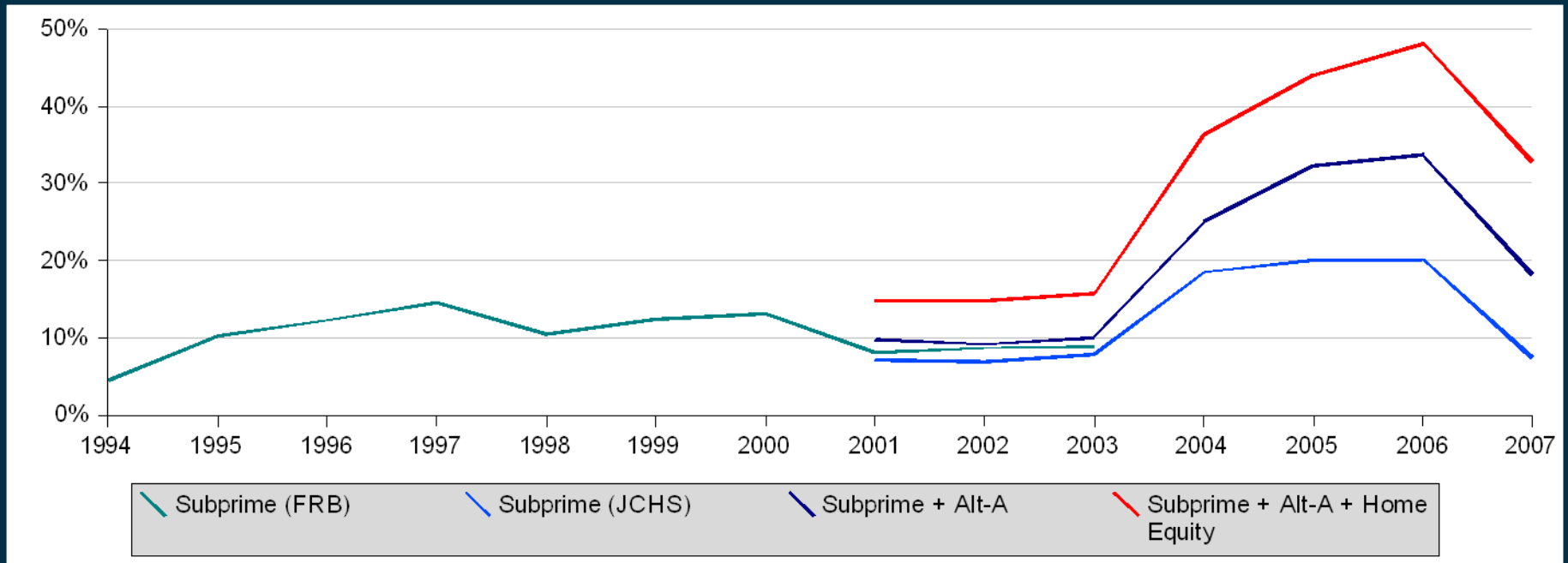
Federal Funds Rate and 1-Year T-Bill Rate



Source: www.federalreserve.gov and www.economagic.com

Subprime, Alt-A, and Home Equity Loans

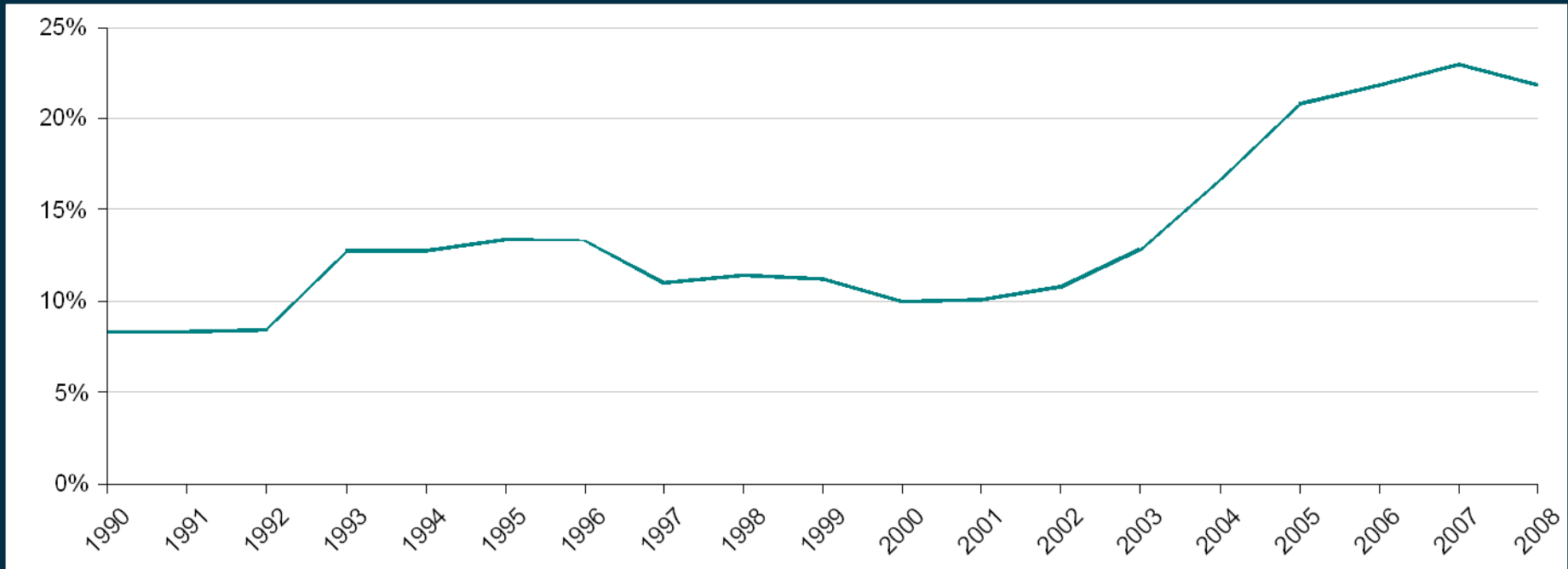
Subprime, Alt-A, and Home Equity as a Share of Total



Source: Data from 1994-2003 is from the Federal Reserve Board while 2001-2007 is from the Joint Center for Housing Studies at Harvard University

ARM Loans Outstanding

ARM Loans Outstanding



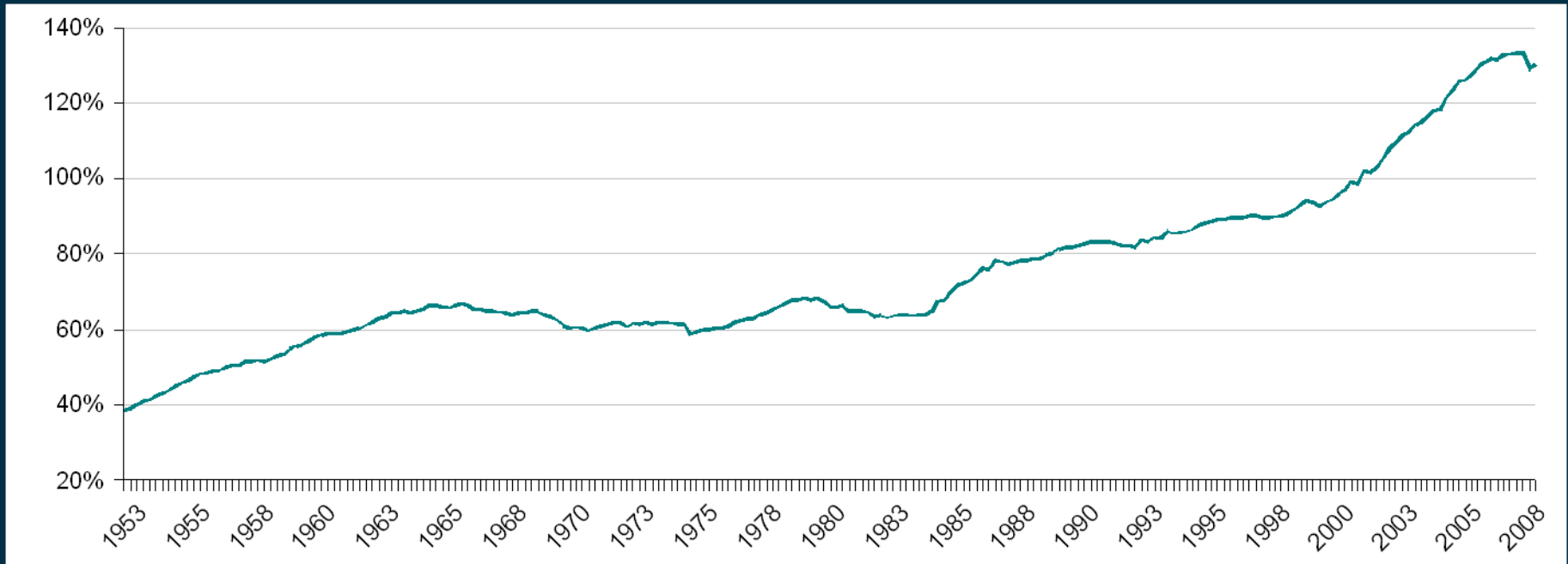
Source: Office of Federal Housing Enterprise Oversight, www.oftheo.gov.

- **FACTOR 3:** A Securities and Exchange Commission (SEC) Rule change adopted in April 2004 led to highly leverage lending practices by investment banks and their quick demise when default rates increased as housing prices fell.

- **FACTOR 4:** The Debt/Income Ratio of Households since the mid-1980s doubles. America falls in love with debt!

Household Debt to Disposable Personal Income Ratio

Household Debt to Disposable Personal Income Ratio



Source: www.economagic.com

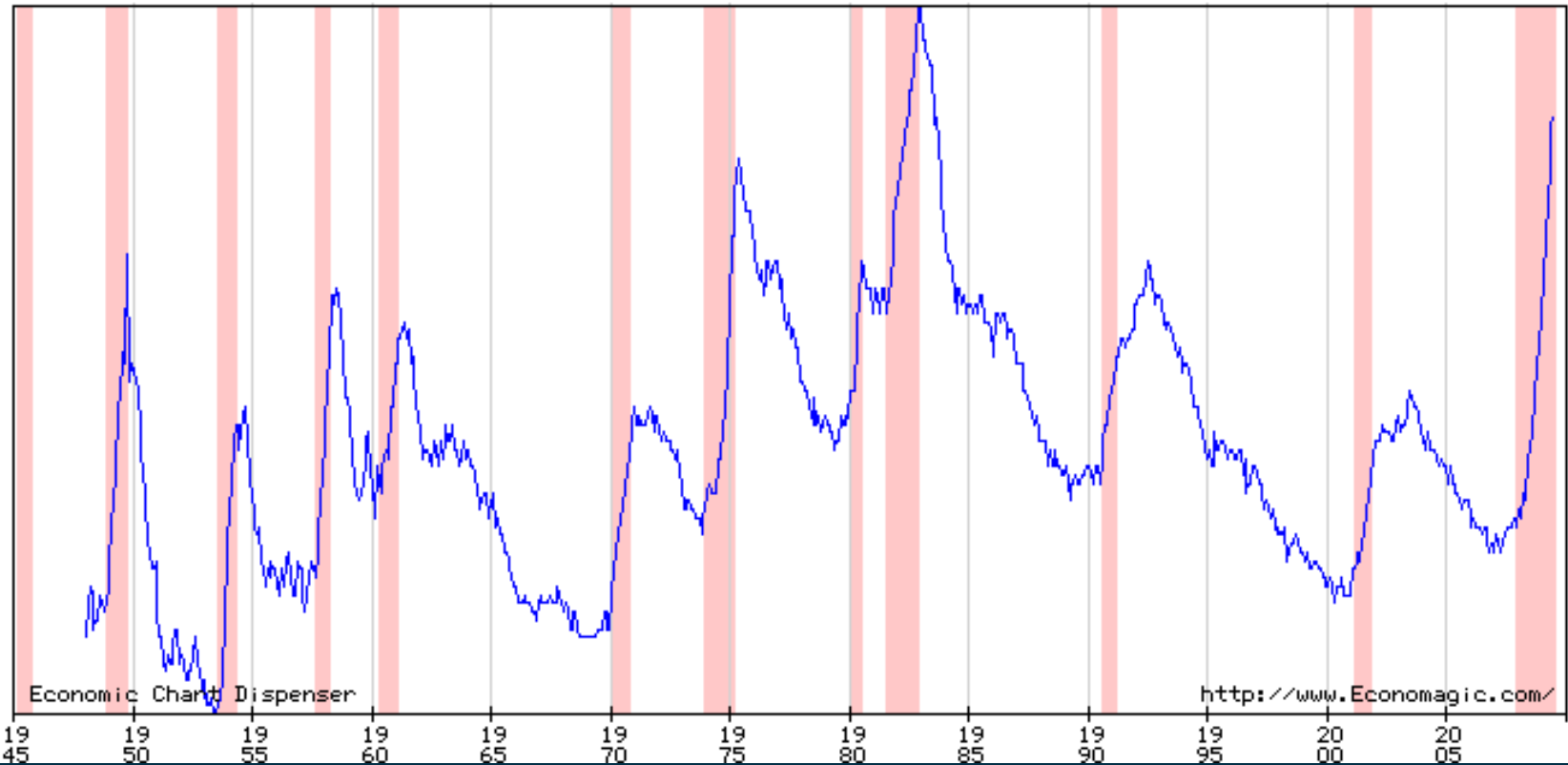
The Decisions of the Past

- Help us understand where we are in terms of output, employment and spending.
- The U.S. Bureau of Labor Statistics reports that the unemployment rate rose from 9.4% in May to 9.5% in June and dipped back down to 9.5% in July of 2009. Since the current recession officially started in December of 2007 over eight million people lost their jobs. All of us are affected by this, unemployed or not.
- Let's put all of this into historical perspective.

Unemployment in Recent Severe Recessions

Unemployment in the U.S.

— Civilian Unemployment Rate: Percent SA



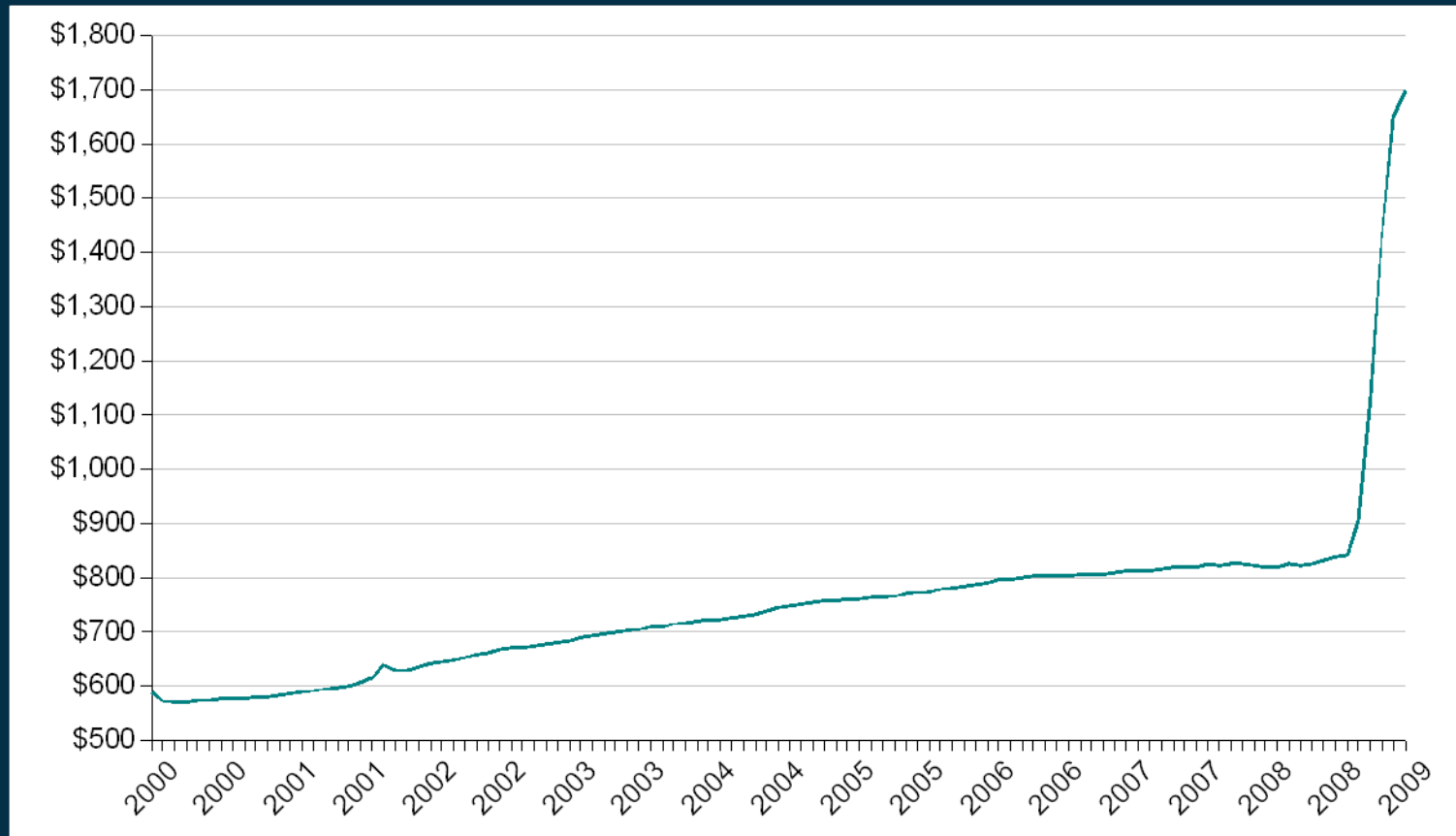
Economic Chart Dispenser

<http://www.Economagic.com/>

Source: www.bls.gov

U.S Monetary Base Expands to Grease the Wheels of Exchange

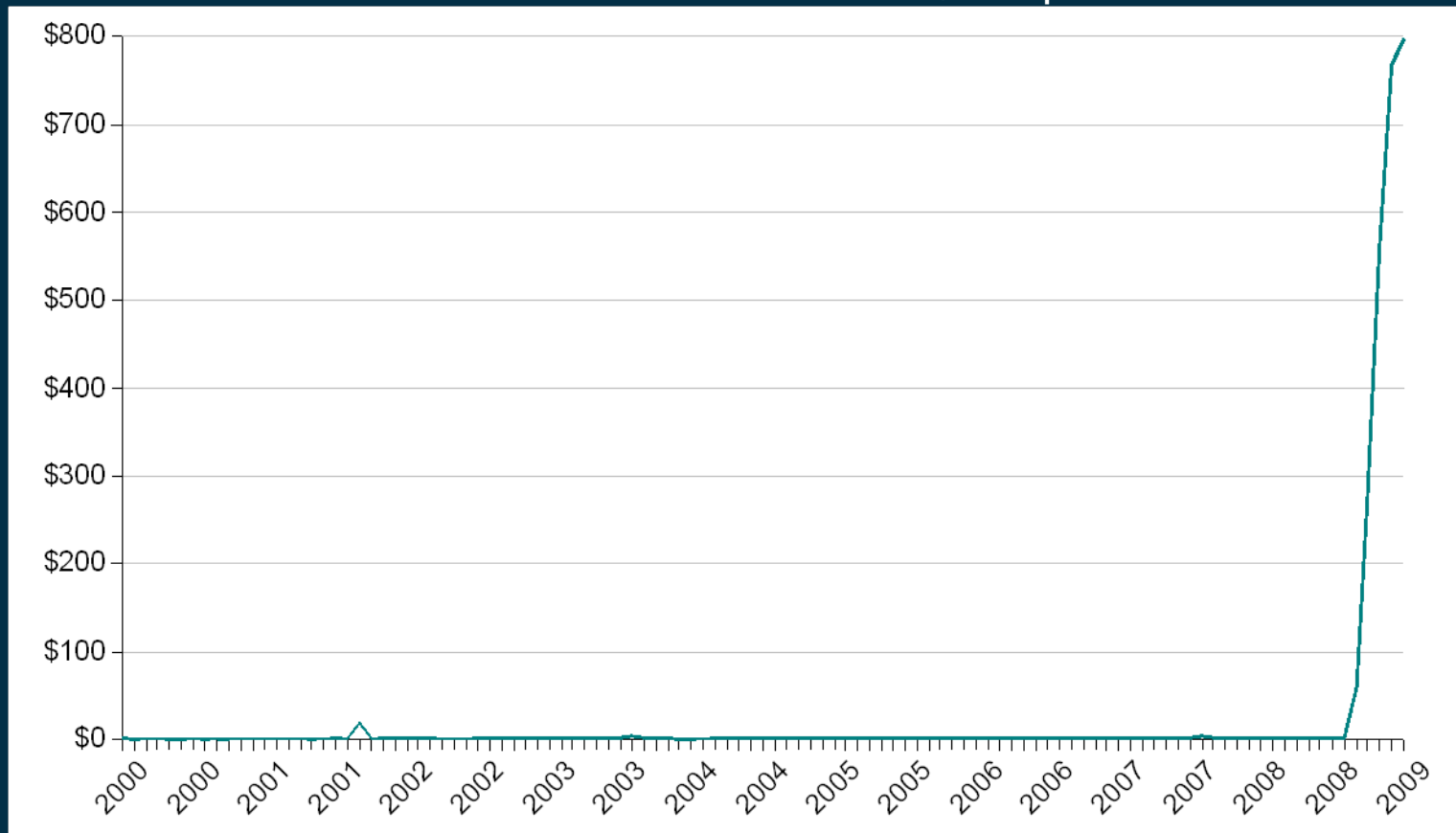
Monetary Base in Billions of Dollars, 2000-present



Source: The Federal Reserve Bank of St. Louis, www.stlouisfed.org

U.S. Excess Reserves Increase to Make Lending Possible

Excess Reserves in Billions of Dollars, 2000-present



Source: The Federal Reserve Bank of St. Louis, www.stlouisfed.org

We Have the Lessons Learned From the Great Depression

- Carefully consider those governmental policies which distort incentives and create unintended consequences with negative results:
 - Monetary contraction of the Great Depression Era
 - Trade restrictions (Smoot-Hawley Tariff Act of 1930)
 - Tax increases (Revenue Tax Act of 1932)
 - Constant changes in monetary and fiscal policy generates uncertainty and delays private sector recovery.

Conclusion

- Could the crisis have been avoided if regulators had done more? Less?
- Is this a crisis of capitalism or a crisis of businesses and households responding to distorted incentives created by government?
- Is this crisis a result of the unintended consequences of well-intended monetary and fiscal officials?

- [CommonSenseEconomics.com ~The Crash of 2008: Cause and Aftermath \[PDF\]](#). By James Gwartney, David Macpherson, Russell Sobel, and Richard Stroup provides a comprehensive analysis of the current economic crisis. This crisis is likely to be the most important macroeconomic event of our lifetime. [The Crash of 2008: Cause and Aftermath \[PDF\]](#) addresses the cause, analyzes the future, and considers the often ask question of whether we are headed for another Great Depression. [The Crash of 2008 PowerPoint slides \[PPT\]](#) will help teachers communicate valuable information to students.
- [Econ4u.org](#)
- [EconTalk](#)
- Gwartney, James D., and Joseph Connors. "The crash of 2008: causes and lessons to be learned.(Special Section)." [Social Education](#) 73.2 (March 2009): 63(5). [Educator's Reference Complete](#). Gale. Northern Michigan University. 24 Apr. 2009
<http://ezpolson.nmu.edu:5558/itx/start.do?prodId=PROF> .

- Before we go to questions, remember that <http://www.econ4u.org/> is a great resource for tips on personal finance and basic economics.
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- Check back this afternoon for our blog post on this topic to ask questions we don’t get to today.

Questions From The Audience?

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