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Who's to Blame for the Economic Recession

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Abstract

This paper seeks to determine what caused the economic recession beginning in 2007 and continuing into at least 2010. A review of existing literature regarding the deregulation of banks, Federal monetary policy, financial engineering by large financial institutions and the decisions made by consumers is examined for evidence of causality. After reviewing the decisions and actions of consumers, institutions, and government agencies it is determined that no one group could have caused the economic crisis alone. Through the actions and miss-actions of all three groups market conditions were created which reviewing historical patterns or conducting single source simulations could not have foreseen.

Introduction

How did the economic crisis of 2007 – 2010 start and grow to such a level that it stopped the entire global economy? According to the broadcast news, everyone is to blame from the president to the new homebuyer. Who then really caused this problem? How did they manage to do it, and what can we learn from this? These questions lie at the heart of what financial, political, and everyday people must know in order to rebuild a stronger and more capable economy.

Through the research there are three possible culprits: consumers, financial institutions, and government agencies. We will review the role each played in the causing the crisis and what each should take away from this economic disaster in order to avoid another similar situation in the future.

Literature Review

Attitudes towards over-spending and over-lending were surveyed in Australia with over 70% of respondents concluding "It is too easy for banks to lend money to people who can't afford the repayments" (Fear & O'Brien, 2009). Additionally the survey points out multiple view points on spending, saving, and lifestyle management. In the end, most respondents agree that while the institutions offered easy access to money and the government agencies did not stop them from making the offer, it was ultimately the decision of the individual consumer to take and use the credit wisely.

Beryl Chang (Chang, 2010) conducted research on the effects of the easy access to consumer credit. Findings indicate that increased availability of consumer credit encouraged binge spending, excessive investment risk-taking, and decreased overall savings by all but the most wealthy. According to the Permanent Income Hypothesis and the Live Cycle Hypothesis this increased access to credit should not impact spending except to possible lower financing cost. This however is not supported the research data. Decreased regulations and the loosing of qualifications for consumer credit impact spending for four out of five income levels and decreased savings and ultimately the standard of living for all but the top 20% income bracket.

Duygan and Grans (Duygan-Bump & Grant, 2009) conducted research to determine the nature of consumer credit default. It was found that in most cases consumers chose to default on credit debt due to a genuine inability to repay. However, evidence showed that the reason for default may be more subtle for many consumers who strategically plan default in order to maximize welfare rather than a simple in ability to make payments. This questions the role that institutions and even governmental laws and regulations play in determining the level of consumer defaults.

The impact of institutions in the current financial crisis can not be denied. A great deal of literature has been created regarding these entities and the role they have played in the years leading up to the crisis. Schmudde (Schmudde, 2009) consolidates and recounts the events leading to the credit crisis and offers practical solutions including the correlation of decision making and risk accountability, the importance of survival for the primary and secondary mortgage markets, and transparency of information regarding a security be made available for appropriate rating by rating agencies.

Many call for the return of the Glass-Steagall act (Grumet, 2009), but most agree that while this type of recession did not occur during the tenure of the Glass-Steagall, its removal did little to create the current situation. Other countries that have never experienced the separation of commercial and investment banking were still susceptible to the mortgage crisis. The Graham-Leach-Bliley Act of 1999 allowed commercial banks to engage in more market activities such as investing, trading, sub-prime lending, insurance and currency trading. Although now free to do so, much of underlying principles remained in the form of Fed mandated capital reserves and profitability and capital adequacy before providing revenue to parent companies (Jaffee, 2009).

Merricka and Suanders (Merrick & Saunder, 1985) discussed the possible problems with deregulation in the banking industry with many of the prediction coming true via the credit crisis of 2007 – 2010. Namely they discussed the, at that time, potential costs of deregulation as a decrease in the safety and soundness of the banking system with an increase in deposit runs and financial crisis. Additionally they expounded on the inherent risk-taking incentives provided by deposit insurance by the FDIC. This separation of responsibility and risk decision making would possibly exacerbate the instability of the banking system as the government and ultimately taxpayers are forced to cover expenditures from poor decisions. To quote "It does not appear possible to design FDIC schemes that have the attractive properties of allowing deregulation to proceed without creating incentive for excessive risk taking and eventual crises."

Lastly, we come to the review of the government's role in the financial crisis. This has by far the largest literature base. Key research is provided here indicating the prevailing thought of government's role in the crisis. White (White, 2009) discusses two main points regarding the Federal Reserve's expansionary monetary policy and the creation of unstable housing prices and financing, and the self-initiated lending role that produced a shadow bail-out. White concluded that while the Fed provided large sums of capital to markets it is uncertain if the impact will significantly change the outcome of the economy or act to delay the ultimate recovery. Through an analysis of the Fed's policy and the action of it chairman Alan Greenspan, White discuss the miscues that were made and the resultant failure of the markets. Ultimately the paper concludes that the Fed both created the housing bubble through poor monetary policy and provided its rescue through emergency funding all of which required no congressional oversight.

Raines, Richardson, and Leathers (Raines, Richardson, & Leathers, 2009) discuss the issue of liquidity in the market and the role of the Federal Reserve as a market maker when it runs low. They conclude with an appropriate question regarding how best to avoid liquidity shortfalls in the future and curb "credit-inflations". Possible solutions include the creation of Resolution Trust Corporations such as the ones used for the S&L failures in the late 1980's.

However, without appropriate legislation and regulation more RTC's will need to be created to deal with future financial failures.

Ferguson and Johnson (Ferguson & Johnson, 2009) focus on the "Paulson Put" as a means of pushing off bailouts until after the 2008 presidential election. Additionally Ferguson and Johnson discuss the implications of the 2000 – 2001 recession and its impact on the current financial crisis, with emphasis on the failure of regulators to curb the risk-taking attitude of Wall Street's ability to pass securities onto an unsuspecting Main Street.

Lastly Gaffney (Gaffney, 2009) gives a framework for the allocation of capital as a means of securing long-term stable economic growth. Gaffney discusses the importance of finding balance between capital, labor, and resources. Specifically he brings to light the need to balance capital and labor as a means of economic stability through full employment. By balancing labor and capital the economy, and the market forces that drive it, will be able to regulate itself more efficiently. This means that in some cases choosing investments that include less capital and more labor. This is not to say the creation of jobs for the sake of having jobs, but allowing capital to augment labor, not replace it completely.

Who's to Blame for the Economic Recession

To adequately discuss and define the financial crisis we are currently consumed with, it is necessary to view the problem from multiple angles, as there is rarely a single cause for events of this magnitude. In the case of the financial crisis of 2008 - 2010 we can see from the review of literature that there are multiple culprits each having played a part in the down turn. However, anyone of these events in isolation would, although inflicting harm on the economy, not result in such a global catastrophe. This paper will illustrate and explain the how each part (consumer, financial institutions, and government policy) contributed to the crisis and what they did specifically that should be avoided in the future.

Consumer

Consumers played a very significant role in creating the boom bust cycles that seem to be plaguing our economies for the past 20+ years and this cycle seems to be intensifying as time progresses. Although consumers do not control much of the inner-workings of the economy, they are the fuel that drives it forward. As such consumers alone have the power to begin, shorten, lengthen, or stop completely any economy by making the decision to buy or to save. In this seemingly simple decision lays the heart of all economies.

In the years preceding the crash of 2007 - 2008 consumers spending was trending upward at record-breaking rates. Gains by the major stock markets were breaking new records, and corporate profits were being handed to CEO's by the truckload. This all began to change as home prices, which had been rising at alarming rates, began to level off and then decline. This change began to create a ripple effect in the financial world, beginning with mortgage brokers and those who had invested in CDO's or MBS's. As the home prices fell, the problem escalated and suddenly institutions began to fine their portfolios over leveraged and undercapitalized. The shortage of liquidity ultimately brought down some of the largest players in every financial market including Bear Sterns, Wachovia, and Washington Mutual. But what caused this sudden down turn in home prices? The simplest answer is a lack of continued sales. As the price of homes climbed, they began to outpace the increase in real income, which had been flat for several years, and buyers could no longer afford them. It is natural at this point to ask why the price of homes climbed so sharply. The reasons are varied and will be discussed in the following sections, but to put it simply, there was for whatever reason a larger demand than supply and consumer were willing to buy, and apparently buy at any price.

The decision to buy or not buy on the part of the consumer is the fuel that drives economies. If buying and saving are balanced then it is reasonable to expect the economy to grow at a stable and predictable amount. When these levels are out of balance as we have seen over the past several years, boom economies are created. These booms will see the rise in consumer and real asset prices. This boom however is not sustainable and will eventually come to an end. Recessions often mirror their boom counterpart in size and duration. The bigger the boom, the bigger the bust. All of this fueled by consumer's decision to buy or save.

In the case of the 2000's consumers made two determining decision regard what to buy and how to buy it. Consumers bought homes and accumulated credit card or consumer debt. The homes that American's bought were also highly leveraged with little or no money down at the time of purchase. This left homeowners with little or no equity in the properties they owned and thus little to no room to sell the home if they needed to do so without suffering a loss. This seemed to be a small problem as home prices in America rarely trend down over time (seasonality not withstanding). Additionally consumers in American began to spend on goods that were financed with credit cards (an industry that had exploded over the preceding 10 years). These two facts led to consumers increasing their personal debt exponentially again eliminating any means of avoiding financial disaster if income levels fell. The upward trending of home prices with the ability to refinance easily allowed consumers, for a while, to take equity out of their home and pay for previous spending on their credit cards. This cycle continued very successfully so long as the increase in home prices continued to rise and mortgage rates continued to stay low. Any change in either of these two conditions would stop the upward spiral. This is exactly what happened in 2007. Interest rates began to rise and home price accumulation began to decrease. Consumer now found themselves in the precarious predicament of homes with no equity, adjustable mortgage rates that are climbing, falling home prices, over supply of homes on the market due to foreclosures, high credit card debt and interest payments, and rising unemployment. The boom is over.

The natural response from consumers is to stop spending and begin to save, but it is too late for most. They have lost their home to foreclosures, defaulted on credit card debt, and lost their jobs. At best income increases will not happen and many consumers must take pay-cuts or unpaid time off to avoid joblessness all together. So what really happen? In short, consumers spent more money than they earned during this time period. As we can see, consumers bought houses not with 20% down and fixed 15 or 30-year mortgages, but with no money down and with adjustable rate mortgages that increased over time. In extreme cases consumers took on mortgages in which no principle was paid at all, only the interest.

These problems could have been avoided by simply spending what is appropriate for the individual income level. This would have resulted in mortgage payments that were affordable to most with the ability to make payments even income levels declined. This simple result would have greatly decreased the severity of the economic crisis by allowing homeowners to stay in their homes, make monthly payments, and provided cash flows to mortgage investors who expected returns on loans made. It is difficult for economist and financial experts to locate errors in this theory, as it remains a foundational principle for market economies.

If there is one fault of the consumer in the financial crisis for the late 2000's it is they spent more than they earned. The balance between spending and saving became unbalanced and the booming economy and subsequent bust became the only outcome. It should be the goal of consumes to spend and save appropriately, never spending more than they earn and never financing more than can be reasonably repaid. Historical research and trending indicates that consumer financing beyond 20% to 30% of their gross annual income becomes unstable and sacrifices savings for immediate purchases. When consumers are able to save this creates reserves capable of sustaining welfare through times of job-loss, economic down turns, or personal turmoil that arises from time to time such as the birth of a child or death of a parent or spouse. As the nation looks for answers and solutions to our economic problems it should start by reviewing the activities of our own pocketbooks and looking for ways to spend appropriately in accordance with our income levels. This will do more to curb the excesses of an out of control economy than any legislation, monetary policy, or regulatory agency.

Institutions

Institutions are also responsible in part for the financial collapse. Through the research conducted it is apparent that institutions contributed to the run-away economy in three key areas. The first area is the issuance of credit to unqualified consumers. The second failure is the subsequent securitization and marketing of poor debt obligations to the capital markets. Lastly financial institutions and their sister rating companies failed to conduct full due-diligence in the rating of the securities to determine the exact risk level of each security so that investors are protected from exposure they did not intend to acquire. In each case we see that individuals within the institutions knew what was happening and either failed to inform regulators, or their warnings went unanswered.

Institutions Issue Credit to Unqualified Consumers

Institutions beginning as early as the 1990's began expanding credit markets with the issuance of credit cards to consumers, college students, and those who traditionally had not dealt with banks and other financial institutions. This methodology continued into the 2000's with the issuance of mortgages for homes that consumers could not historically qualify for. These actions greatly expanded the primary and secondary mortgages markets. The greatest expansion came from those who were new to the credit markets (young adults, college students, etc) and those with low incomes who traditionally would not qualify for home mortgages. In these cases institutions took full advantage of the opportunity by extending introductory and adjustable rates to encourage the purchase of a new home or a home loan larger than appropriate for the level of income. This was accomplished due to historically low interest rates and the loosening of lending requirements by those purchasing mortgages on the secondary market, primarily large investment banks and GSE's (government sponsored enterprise).

The intention of expanding credit to these new demographics was to make it possible for a larger percentage of the population to participate in the dream of owning a home. The hope was this would help more people become investing in their communities and expand the economy through spending on homes and consumer goods that are tied to the housing market. President Bush was one of many who championed this idea of an Ownership Society (Wikipedia Foundation Inc., 2010). The end result however is that you are now lending massive amounts of money to those who are not capable of repaying the balances. Lending practices for centuries within the banking and financial industries had been to lend money only to those who were able to repay the loan with interest. By contrast the new methodology seemingly only required a mailing address and phone number. The end result of this change was the increase in default rates on consumer debt. This rise in defaults under historical lending practices (2% - 5% annually) would not have created a global financial crisis. However, these loans do not correlate with historical actuarial tables for the type loan created. By shifting the requirements of the loan, the industry nullified the historical ratio's that had proved so reliable.

The mechanics of the new loans work just as they had balancing the capital loaned, the cash flow of payments, and the security of the underlying asset. In the past the capital loan was minimized by requiring large down payments thus reducing the amount of capital at risk, increasing the equity or lowering the leverage against the asset being collateralized, and minimizing the required cash flow from the consumer. By lowering the month payment the consumer is more likely to pay the monthly payment as it represents a smaller amount of their discretionary spending. By expanding the market of qualified consumers, a greater number of people took on debt that required a greater percentage of their monthly income and possessed a smaller or in some cases a negative equity balance with the asset. This problem was offset as long as home prices continued to rise because they could refinance and pay in past due payments from the newly acquired equity. However once this property appreciated stopped the crash ensued.

The solution to this problem is to return to historical qualification requirements for consumers. This seems like a simple solution, but it means that financial institutions must be able to say no to consumers who wish to borrow money. This solution is especially sensitive given the political desire for all citizens to own homes and have access to credit. While this is a noble gesture, it is impractical and opens the economic welfare of the entire nation to unnecessary risk. Political goals and financial goals need to be aligned with the emphasis on financial sustainability and long term economic growth not full housing.

Institution's Securitization of Poor Collateralized Debt

Developing a market of bad debt is destructive enough for banks, credit card, and mortgage companies, but finding a way to pass these onto investors is worse. Had banks, credit card companies, and mortgage companies issued bad debt and then held onto the debt, receiving what profits it would have brought, the damage to the economy would have been bad. However the damage would have been isolated to those companies with some, but limited, spillage onto other areas of the economy. This however is not what occurred. With the help of securitization techniques these toxic assets are converted to marketable securities and bonds and then sold to institutional investors. With the sale of the debt, the mortgage originators are made whole and able to then go back to consumers with new capital to issue new loans. Investors who purchased the loans are left with the challenge of realizing profits from the securities, not those who originated the loans. Although this methodology is not new and has been the standard practice for the industry for decades, it requires the ability to accurately predict the financial returns for investors and exposure to default risk.

This separation of risk and return is a fundamental violation of the market principle that normally holds the two together. Under this condition risk of mortgage default does not impact those who originate the loans, as they will not be required to hold the loans and thus experience any ill effects of poor decision making. With the ability to sell securities to the open market, originators now have an unlimited source of capital. This creates an imbalance in the supply and demand principle as the supply of capital is virtually unlimited making the demand for loans finite in comparison. This imbalance lowers interest rates and make homes affordable to those who otherwise could not afford them. While this seems like the answer to the political housing problem the sudden increase in available funds creates a frenzy of lending that erodes lending principles significantly. While many who were on the fringe of affording homes can now do so, the magnitude of the influx of capital is such that loans were given to anyone. The NINA loan is a perfect example of this, requiring No Income and No Assets to qualify for the loan. Under normal conditions this is a laughable notion of loaning money to someone with no means of paying the loan, and no assets with which to collateralize the loan. However, this is exactly what happened during the boom. As such, over time as quality of loan origination decreased, the quantity of defaults increased dramatically. This exposed significant portions of the world economy to financial risk. Here again we see that so long as home prices continue to rise and consumers can restructure their debts, monthly payments can be made and the securities they belong to will continue to perform. Once monthly payments can no longer be made, the entire system will crash in on itself as we have experienced starting in late 2007.

Here we see that the quality of the mortgages created caused performance to decline as interest rates rose, but this is not all that happened to the financial system. An additional complication was created with the addition of credit swaps and other derivatives that speculate on future credit and interest rates. This extra level of complexity in many cases created a situation where even if good assets supported the security the entire security could still be compromised by a change in the interest rate of unrelated securities. This level of complexity created for many consumers an impenetrable vale of intertwined securities and risk possibilities that could not be understood or accurately forecasted. Although the financial institutions that created these securities and swaps claimed to have full understanding of what was created, following the crash it became increasingly evident that they, along with their investors, did not fully understand the impact of their own creations.

The solution to this problem is to require extreme transparency to the underlying assets and options such securities are built upon. Without this transparency, investors are unable to determine which securities best match their portfolio needs. With true transparency, investors will invest in what they need. The market as a result will consume what investors are willing to invest in. In the end the number of high risk, sub-prime loans created will fall as high-risk investors are relatively small percentage of the market. Here again we see the solution is fairly straightforward and backed by historical precedents.

<u>Institution's Failure to Rate Securities Correctly</u>

As we have alluded to earlier in this paper the ability of the financial industry to sell asset backed securities required something to help investors determine what the risk of default is likely to be. This help has come in the form of ratings from the major rating agencies Moodys, Standard & Poors, Fitch, and regulated by Securities Exchange Commission. These rating agencies and the SEC together failed to investigate the securities being formed by the financial institutions to determine the underlying risk. This is partly because of lack of funding for the SEC by Congress and partly due to reliance on historical performance tables by the rating agencies. As we have seen though, with the change in qualifications for credit, these historical tables had become obsolete. This problem plus the reduced funding from Congress meant there were few available resources to actually investigate the industry. The reduction in funds from Congress is the result of years of lobbying from the industry and the Federal Reserve Chairman Alan Greenspan to reduce the government interference in the markets. We will discuss this in more detail later in the paper.

The end result of this failure is that many of the securities received credit ratings much higher than they actually were. Many of the investors that bought these securities were institutions looking for low-risk investments with which to invest large sums of money. These investors who traditionally bought US Treasury notes entered the market due to exceptionally low rates of return on US Treasuries, which will be discussed later in this paper. As a result the billions of dollars that were now available to originators to invest required a stamp of approval indicating what was purchased was safe. This was provided by the rating agencies that applied triple A rating to many securities that later turned out to be backed by worthless assets. This additionally meant that investors would not know about the risk until it was too late to divest themselves into cash or more secure investments. This resulted in many investors losing the majority of their investment. The effect of which created a chain reaction in the market as liquidity limitations began to hit in all areas of the market.

In order to prevent this from occurring again, there are two possibilities that when taken together create a significant incentive for agencies to investigate securities stringently before issuing a rating. The first is to remove the government-sanctioned oligarchy with which these agencies operate today. This will allow others to enter the market and create competition to improve industry quality. This improvement will see asset disclosure and stress test simulation to help reveal the true risk investors will encounter as they hold the security. The second is to hold the rating agencies liable in part for the rating they give to a security. If an agency must share in part for the securities performance, then the agency is motivated to make sure what they claim the risk of the security to be is what the risk of the security actually is. Investors in the rating agencies as well as insurers of the rating agencies will also be motivated to improve the quality and accuracy of the agencies as a protection of their investment. Any time risk and reward are separated it seem reasonable to assume that deviations will occur between the decisions being made and the desires of stock holders for risk appropriate decisions. Here again we see that by reuniting risk and return we can improve the quality of the service provided.

Government

We have seen how consumer spending when let run out of control will create boom bust cycles as well as the ability for financial institutions to magnify the effects. Governments however may by the most guilty in that it is the government that sets the rules and regulations for how the economy will work. In the US this is done between the Fed Banking system, the US Treasury, and the US Congress. These three government entities determine the monetary supply, the issuance of currency, and the regulatory agencies that will oversee operations as well as the level of funding available to monitor the various aspects of the economy. As we will see the government failed in two very critical ways leading up to the current recession. The first is the poor monetary policy created by the Fed and the second is the ineffective funding to regulate the financial markets.

<u>Government's Poor Monetary Policy</u>

The primary tool used by the US government to monitor the speed of the economy is the interbank transfer rate and the increase or decrease of the monetary supply via the open market counter, which buys and sells US Treasury notes. These two activities regulate the economy by modifying the cost of borrowing money and the amount of money available to the economy. Lowering the amount of money available creates scarcity and slows the economy as cash is conserved. This activity will also raise interest rates offered by banks as a reactionary means to the decreased cash supply. The Fed may also modify the interbank transfer rate, which is used by banks for borrowing money for overnight transactions to cover liquidity issues. This rate is also an indicator of lending rates, as banks will generally use this plus an additional spread for extending loans to customers. In either case these two are the prime methods the US government uses to monitor and adjust the health of the economy.

Starting in 2003 in response to the recession starting in 2000 the Fed Chairman Alan Greenspan lowered the interbank interest rate to 1% where is stayed until 2005. This rate represented a record low for the Fed. The rate was so low that it could not keep up with inflation, meaning that an investor would be better off holding any asset that would appreciate at the same rate as inflation than holding US Treasuries. This action was intended to spur the economy to growth and hold down unemployment through the creation of new jobs. This may or may not have occurred, but what certainly did occur is the movement of capital away from US Treasuries to the open markets.

As we have alluded to earlier, Wall Street and the open markets experienced a tremendous influx of cash from investors seeking greater returns than that of US Treasuries. This influx needed to find assets to invest in and what was found was US mortgages and other consumer debt obligations. Although the intent of the low interest rate and expanded monetary supply was to preserve jobs, the unintentional effect was an excess of capital flowing into the open market. This sudden increase in supply needed a sudden increase in demand, which did not yet exist. Although the Fed had lowered interest rates before, never had they lowered rates this far for this long. Had the duration of the 1% interest rate been shorter or the rate not fallen so far the magnitude of the shift may not have been so great. However this was not the case.

The result of this movement shifted capital, labor, and resources away from industrial markets and focused them on construction and an epic home building cycle that grossly out stripped real and sustainable demand. Once the boom ended America found itself with homes and communities that could no longer sustain themselves. Today there are thousands of newly built homes that stand vacant and the construction market decimated. The situation is so bad that there is debate in Washington if it would not be better to raze the newly built homes to help restore equilibrium to the market. It might however be better to foreclose and then auction off the homes to the highest bidder, although this would represent a tremendous loss on the part of the one who hold the mortgages currently.

Through this boom, it was largely reported that real asset pricing was increasing at alarming rates, even if consumer pricing was not. This aspect of the economy had never before been seen as an indicator of boom economies and went largely ignored by the Fed as an indicator that the economy was running away with itself. Given the effects that asset price increases have had it is recommended that they be considered along with consumer price indexes as a determining factor for economic health.

<u>Government's Regulatory Funding</u>

Lastly we come to the government's ability to effectively regulate the various aspects of the financial markets. When we look at the purpose of government it is no far stretch to see that a primary reason for its existence is to protect the population from which it was elected. Certainly this is a key theme in almost every political campaign. As such, it is a wonder why the government, after spending so much time and money determining what needs to be regulated, would underfund so many of its regulatory agencies that it becomes virtually impossible for them do complete the task to which the agencies have been given. While certainly you can impose regulation that is so extensive that it becomes a burden to the citizenry and the companies that work within its boards, those agencies with which have been charged a duty should have the resources necessary to, at a minimum, identify and prevent the largest of regulatory violations. This of course is not what we see happening starting as early as the 1990's. With scandals such as Enron, WorldCom, Arthur Anderson, and Bernie Madofft one could easily wonder if there is regulation in the US at all.

It is clear, that the funding levels and regulatory guidelines given the SECC were insufficient to regulate the size of the market. In addition to funding, it is clear that the Fed and financial markets supported an unregulated market and fought to keep many securities and derivatives completely open with no regulatory oversight at all. While markets should be free to operate with as little regulatory burden as possible (in order to maximize efficiencies), it is clear that there must be someone reviewing the actions taken by those that would seek to profit from the creation and sale of a financial instrument. In short, government officials and regulatory agencies completely failed to fulfill their obligations to the citizenry of the US. Regardless of the course chosen to ineffectiveness, the result is the same, the economy and the consumers were severely harmed due to poor regulatory policy and oversight.

The solution to this problem must be a fundamental change in the members of the elected bodies and a change in which we regard government regulation. While central planning has proved an equally poor form of governmental control as seen through the former Soviet Union, it is apparent that government must provide a set of laws that creates a market place where risk and reward are tied unbreakably together and provide government oversight at a level sufficient enough to prevent gross misconduct in the financial markets. This is not what currently exists. With government insurance and bailouts it is apparent that it is not the financial institutions that bare the ultimate risk of poor decisions, but the taxpayer who must come to the rescue of those institutions that destroyed the investments of the very consumer who must now pay the bill.

Final Comments

There is a need for further research into this topic at both the macro and micro level. Consumer spending habits have profound impacts on the market and should be understood as well as possible in order to better predict and avoid economic problems in the future. Regarding consumers there is a need to better understand what causes consumers to spend in one manner verse another, specifically what causes consumers to spend using savings (monies available), spend using debt (future earnings), and probably most important what causes consumers to save money. There appears to be a great deal of research on consumer spending and how to stimulate it via interest rate changes and monetary policy, but there does not appear to any research into what would cause consumers to save. It is here that institutions and government agencies should look to help cool overheated economic activity. Lastly there is reason to believe that by working towards a more steady balance between savings and consumer spending the economy will grow more steadily over a longer period of time thus eliminating or at least greatly minimizing the boom bust cycle we are currently experiencing.

Conclusion

It is the conclusion of the author that consumers, financial institutions, and government agencies are liable for the events leading up to the crash of 2007. Consumers spend too much money and engaged in risky decision regarding home mortgages either by design or due to a lack of understanding of all the ramifications of possible outcomes. Financial institutions failed to produce goods that were capable of producing the returns promised. The inability to accurately model and rate the products they produced created extreme harm in society and greatly decreased the wealth of individuals, investors, and society in general. In the future, any “manufacture” of financial products should fully understand it performance characteristics and be held liable for failures to perform as predicted. Lastly and most importantly the U.S. government agencies charged with protecting those not capable of protecting themselves represents the greatest failure of the entire crisis. The people of a nation pay taxes to support and pay for elected officials to act in the best interest of the citizenry. Their blatant failure to respond to allegations of wrongdoing and intentional underfund of regulatory agencies is almost criminal in intention. Although at any time consumers or institutions could have pulled back and slowed the development of the crash, it is the U.S. government that was created and funded by taxes to carry out this charge. It is, therefore, with the U.S. government that primary blame should rest.

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