

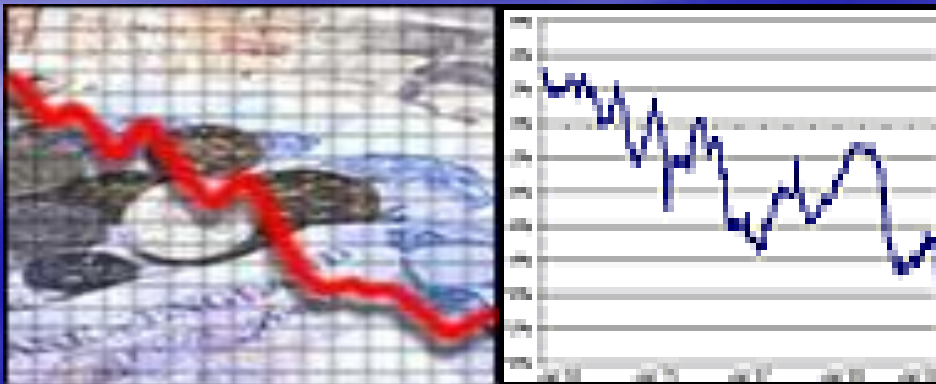


INSTITUTO POLITECNICO NACIONAL

Escuela Superior De Economía

Sección de Estudios de postgrado e investigación

# Causes of World Financial Crisis 2007-2009 Evidence From United States



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*“Yet it is also true that small events at times have large consequences, that there are such things as chain reactions and cumulative forces. It happens that a liquidity crisis in a unit fractional reserve banking system is precisely the kind of event that can trigger — and often has triggered — a chain reaction. And economic collapse often has the character of a cumulative process. Let it go beyond a certain point, and it will tend for a time to gain strength from its own development as its effects spread and return to intensify the process of collapse. Because no great strength would be required to hold back the rock that starts a landslide, it does not follow that the landslide will not be of major proportions.”*

*Milton Friedman and Anna Schwartz (1960)  
A Monetary History of the United States, 1867-1960*

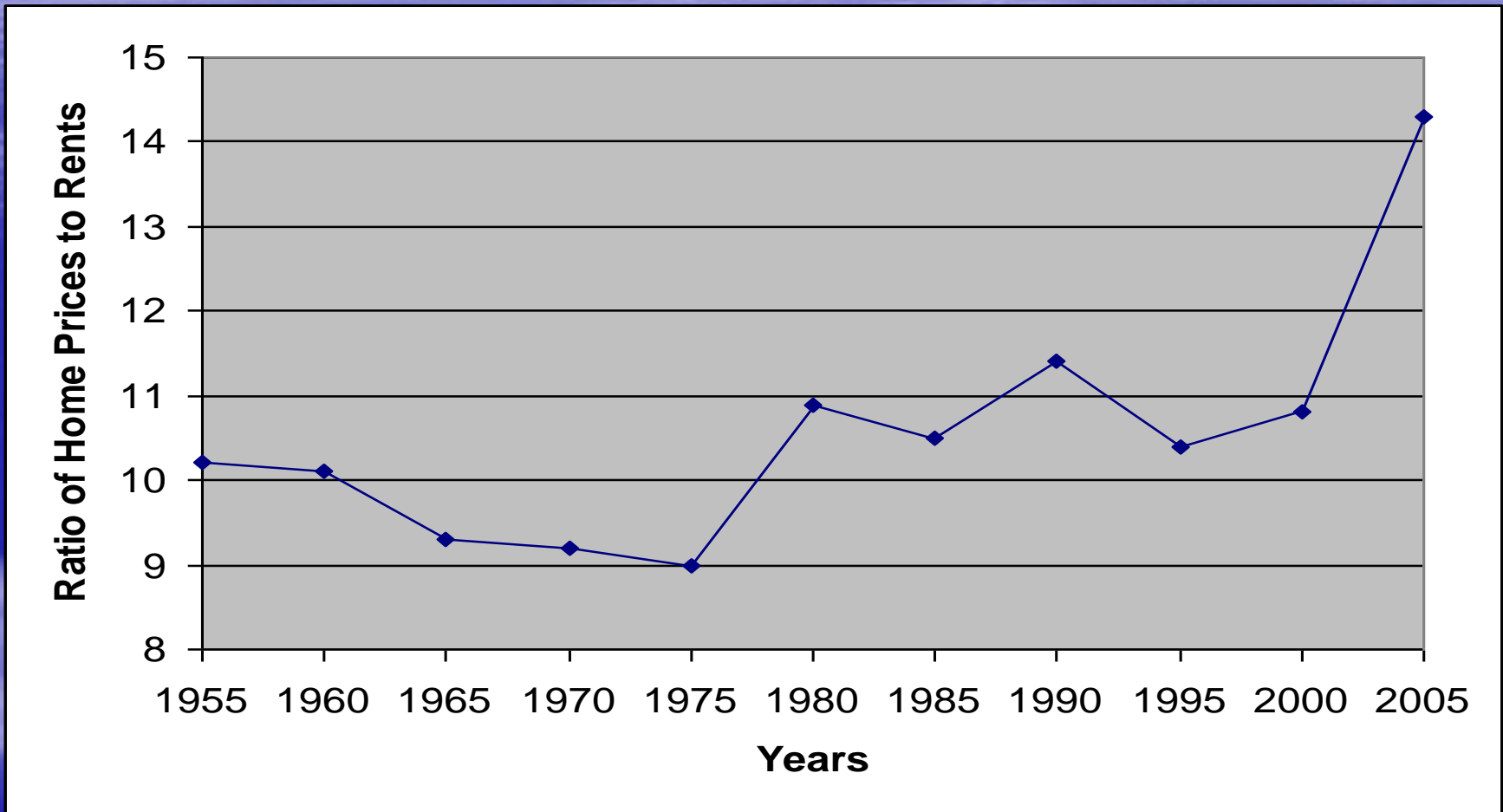
“The classic explanation of financial crises, going back hundreds of years, is that they are caused by excesses—frequently monetary excesses—which lead to a boom and an inevitable bust. In the recent crisis we had a housing boom and bust which in turn led to financial turmoil in the United States and other countries”.

(Taylor, 2008)

## 2.1: CAUSE 1

# HOUSING BOOM, BUBBLE & BUST

# FIGURE 1: RATIO OF HOME PRICES TO RENTS





## FIGURE 2: EVOLUTION OF EQUITY AND BORROWING IN RESIDENTIAL REAL ESTATE

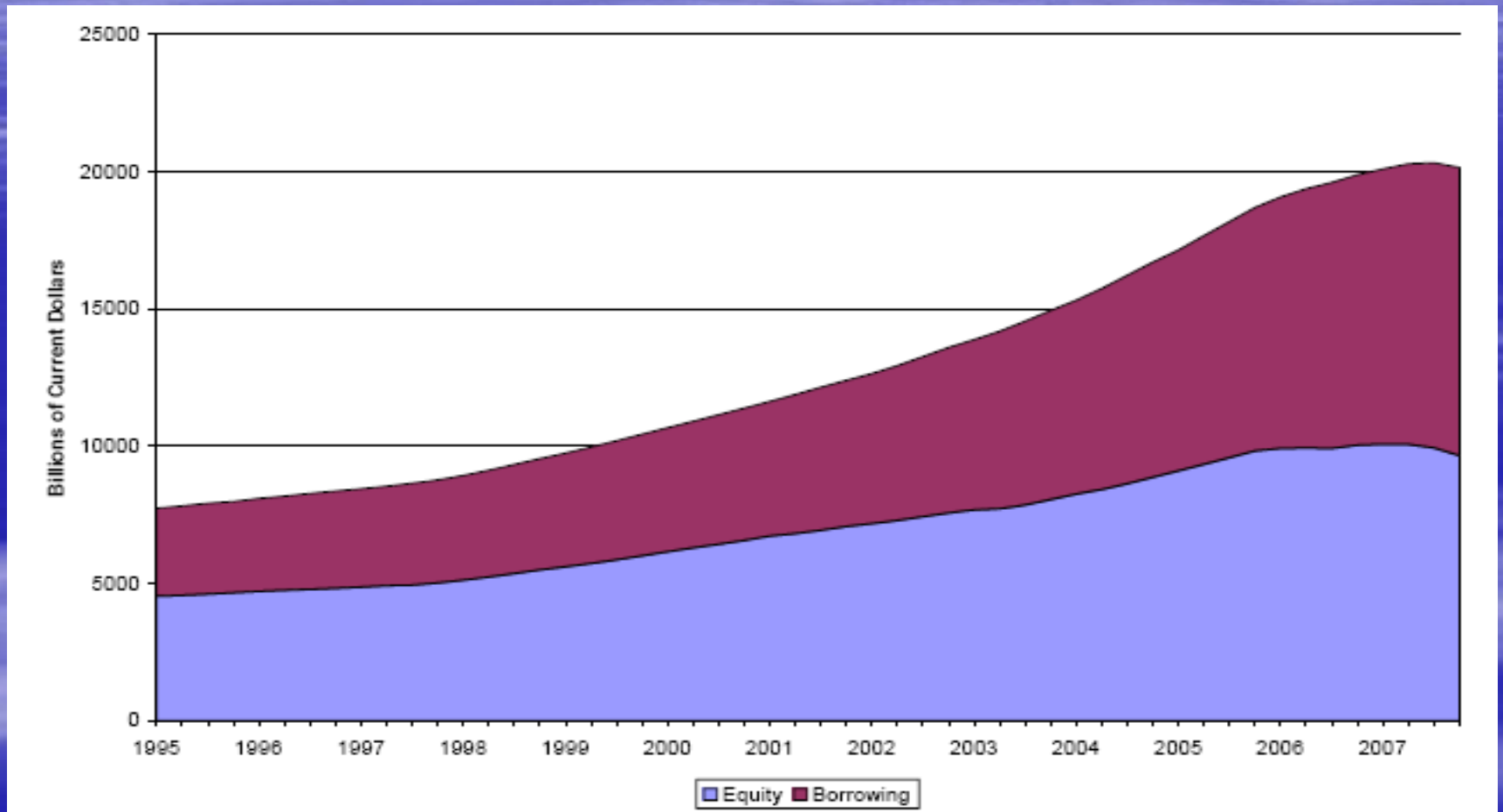
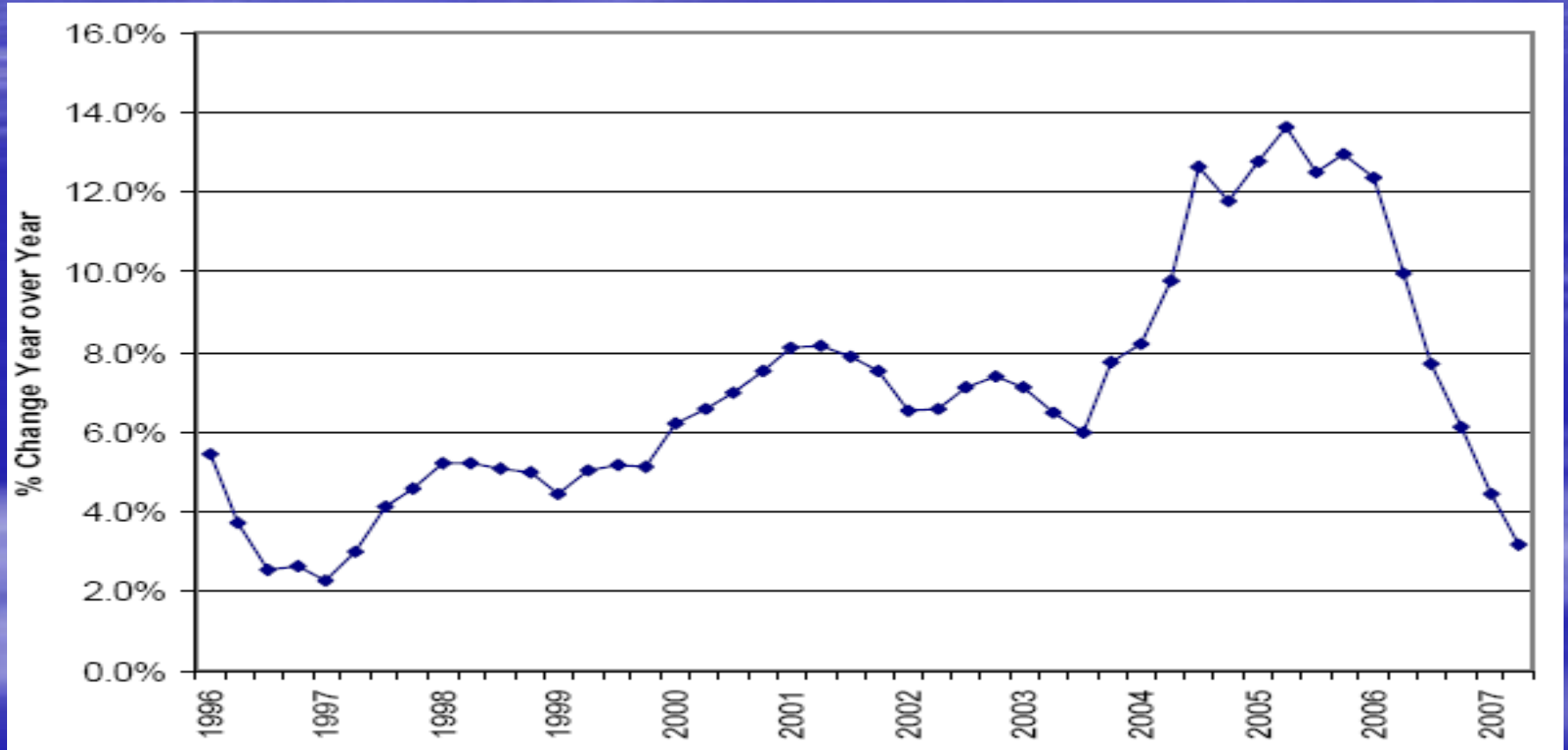
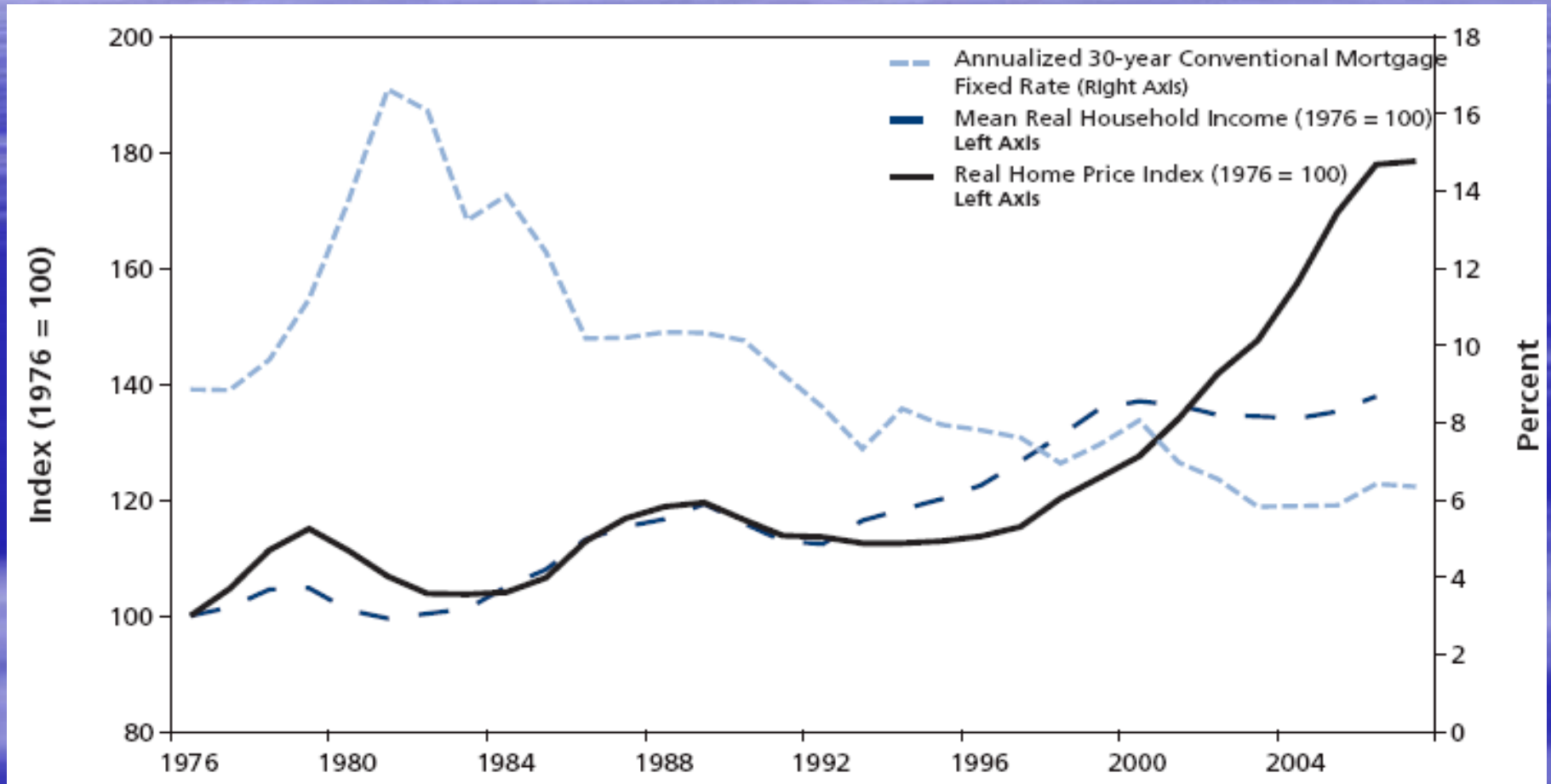


Figure-3: Appreciation of House Prices, 1996-2007



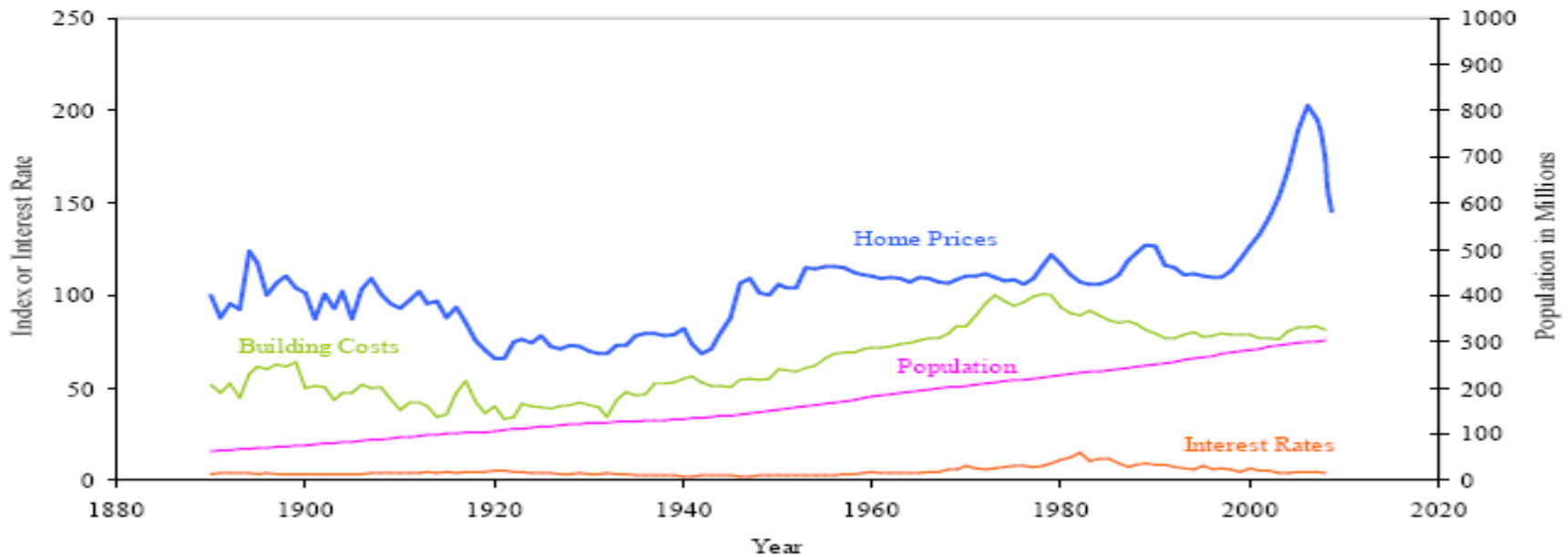
**Figure-4: Real home Prices and Real household income (1976=100);  
30-year conventional Mortgage Rate**



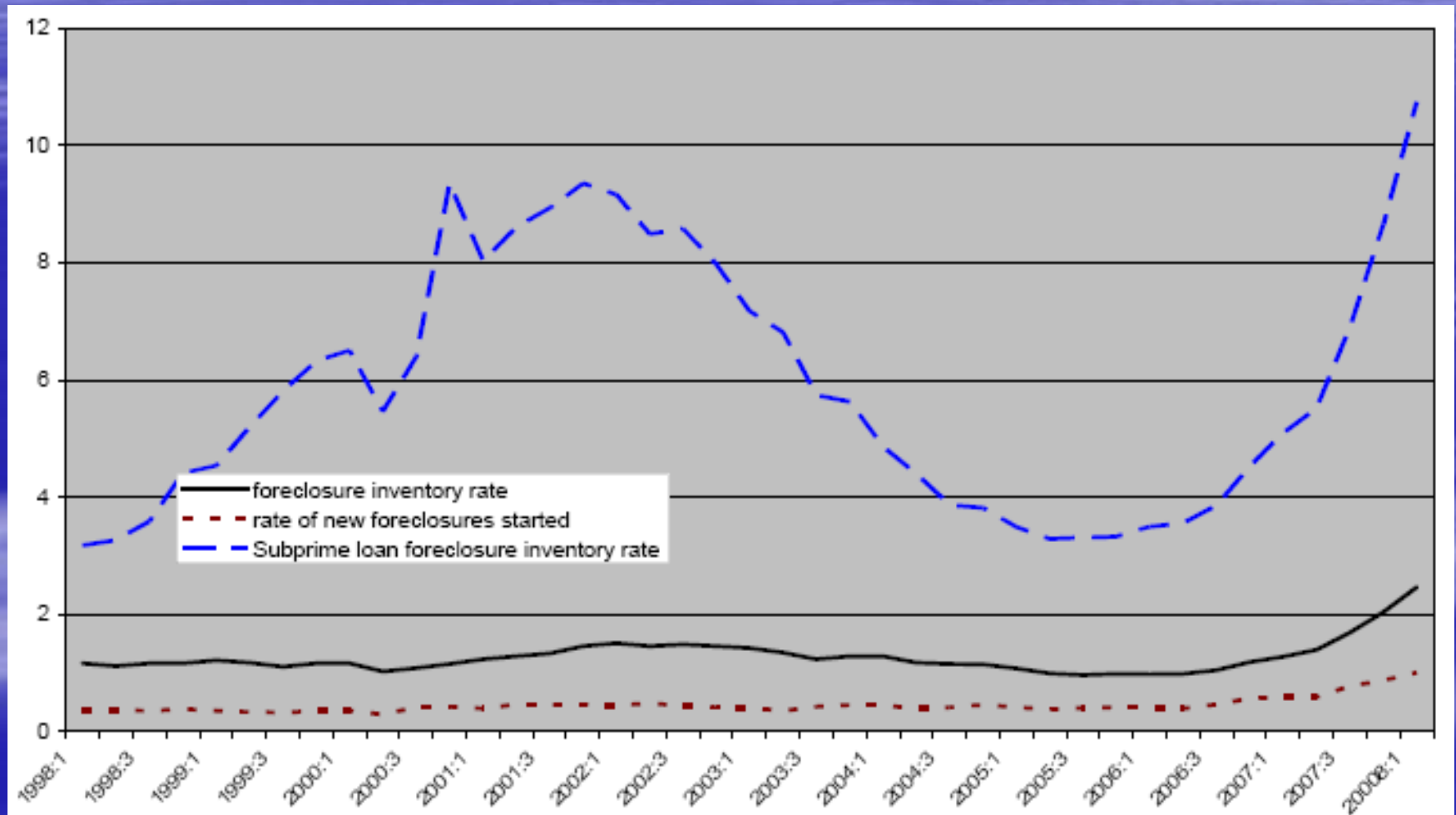


# FIGURE 5

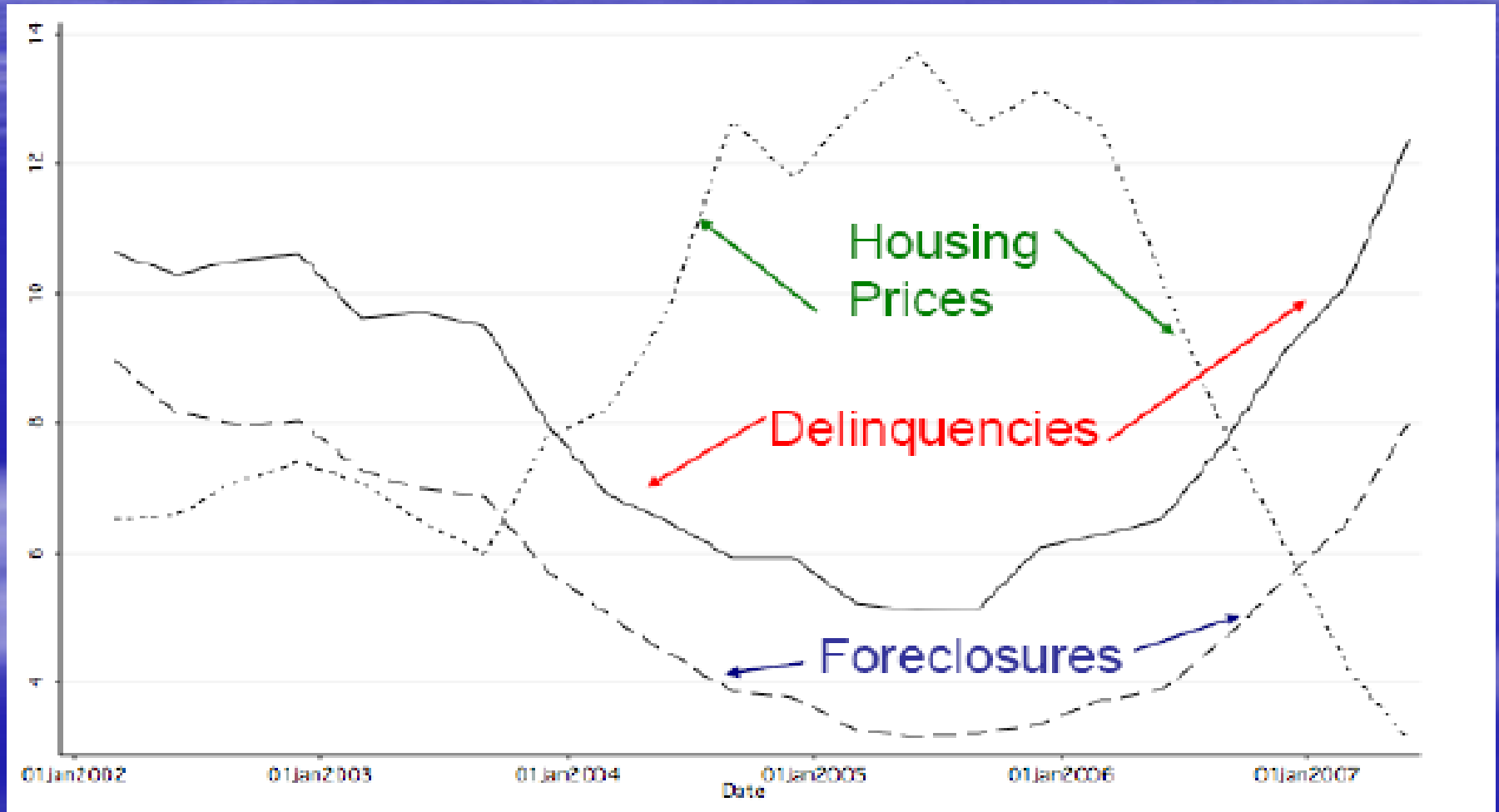
## US Home Prices 1890 to 2008 Q3 With Annual Building Costs, Population, Ten-Year Treasury Yield



# Figure-7: SUB-PRIME LOANS FORECLOSURE RATE



# Figure-8: Housing Price Inflation and Subprime ARM Delinquencies & Foreclosures



- A survey held by (Case and Shiller, 2003) report that the overwhelming majority of persons surveyed in 2003 agreed with or strongly agreed with the statement that real estate is the best investment for long-term holders
- The decline in mortgage interest rates was a key factor in triggering the run up of housing prices
- Many borrowers might have been motivated by the prospect for short-term financial gains and investors turned to riskier types of MBS and these investments create a housing bubble which ultimately becomes the main reason of Subprime Default.

## 2.3: CAUSE 3

Lack of Transparency  
&  
Accountability



Figure-14: Quality of New Debt Issuance, 1993–2007

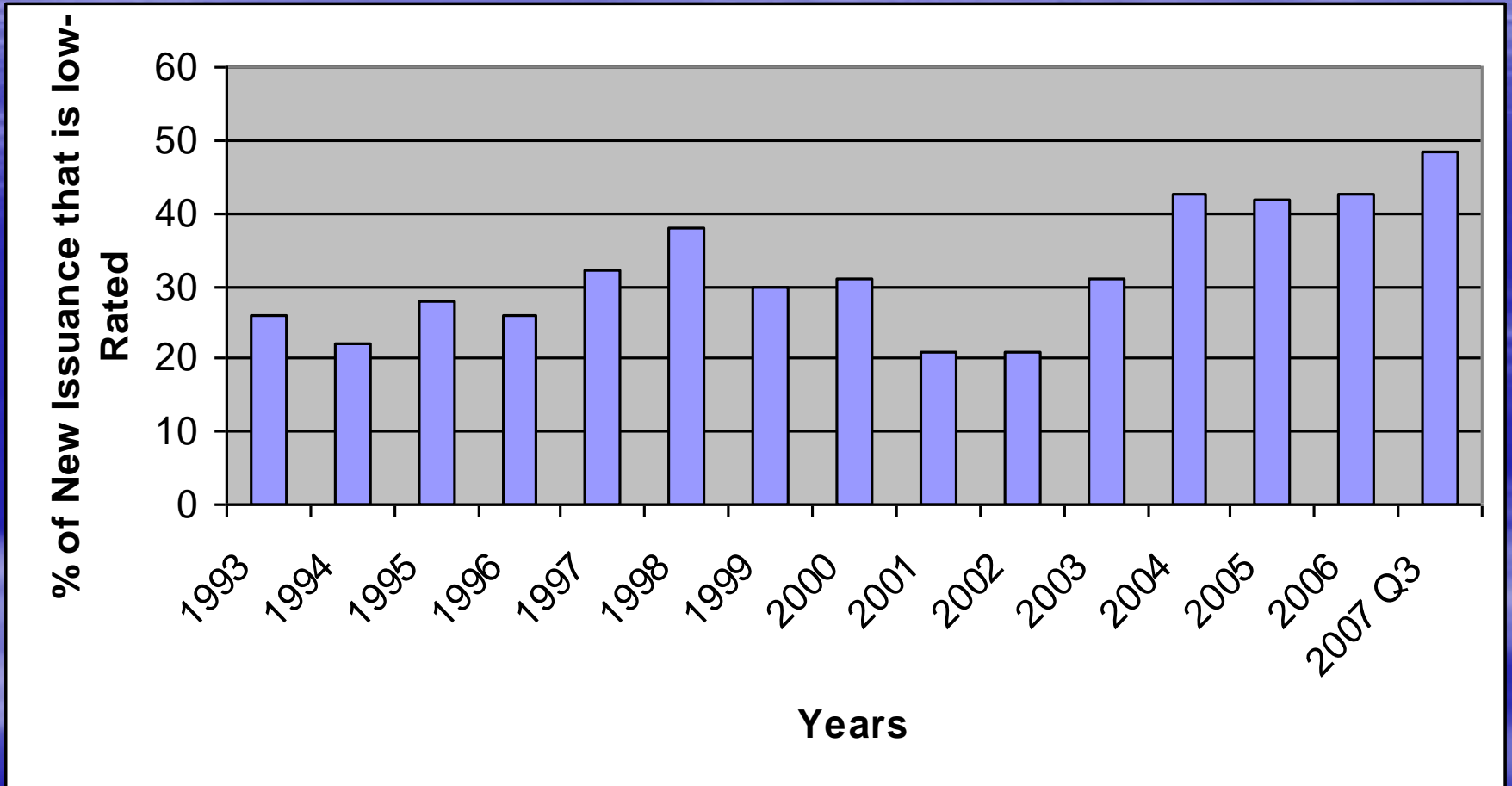
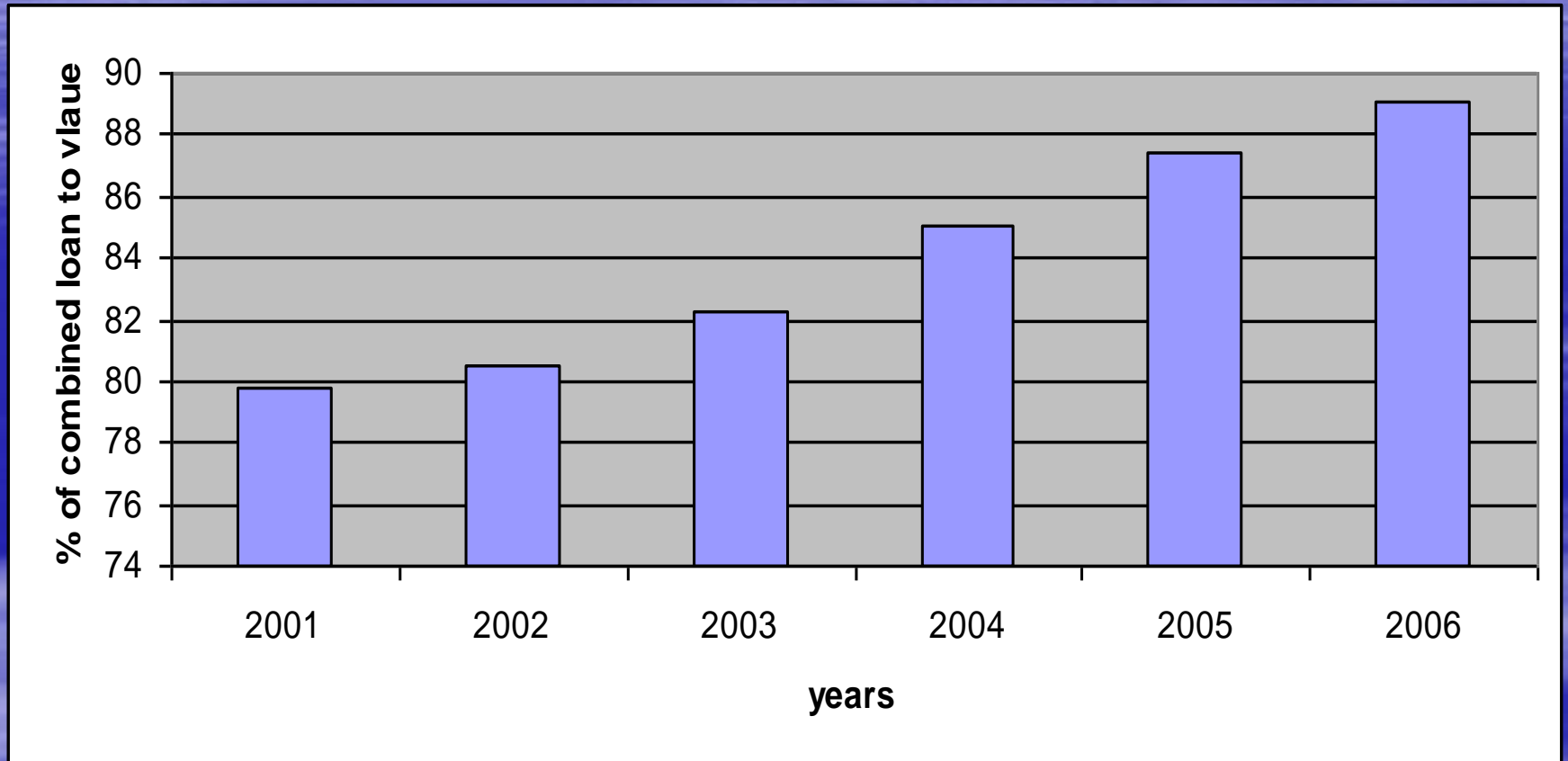
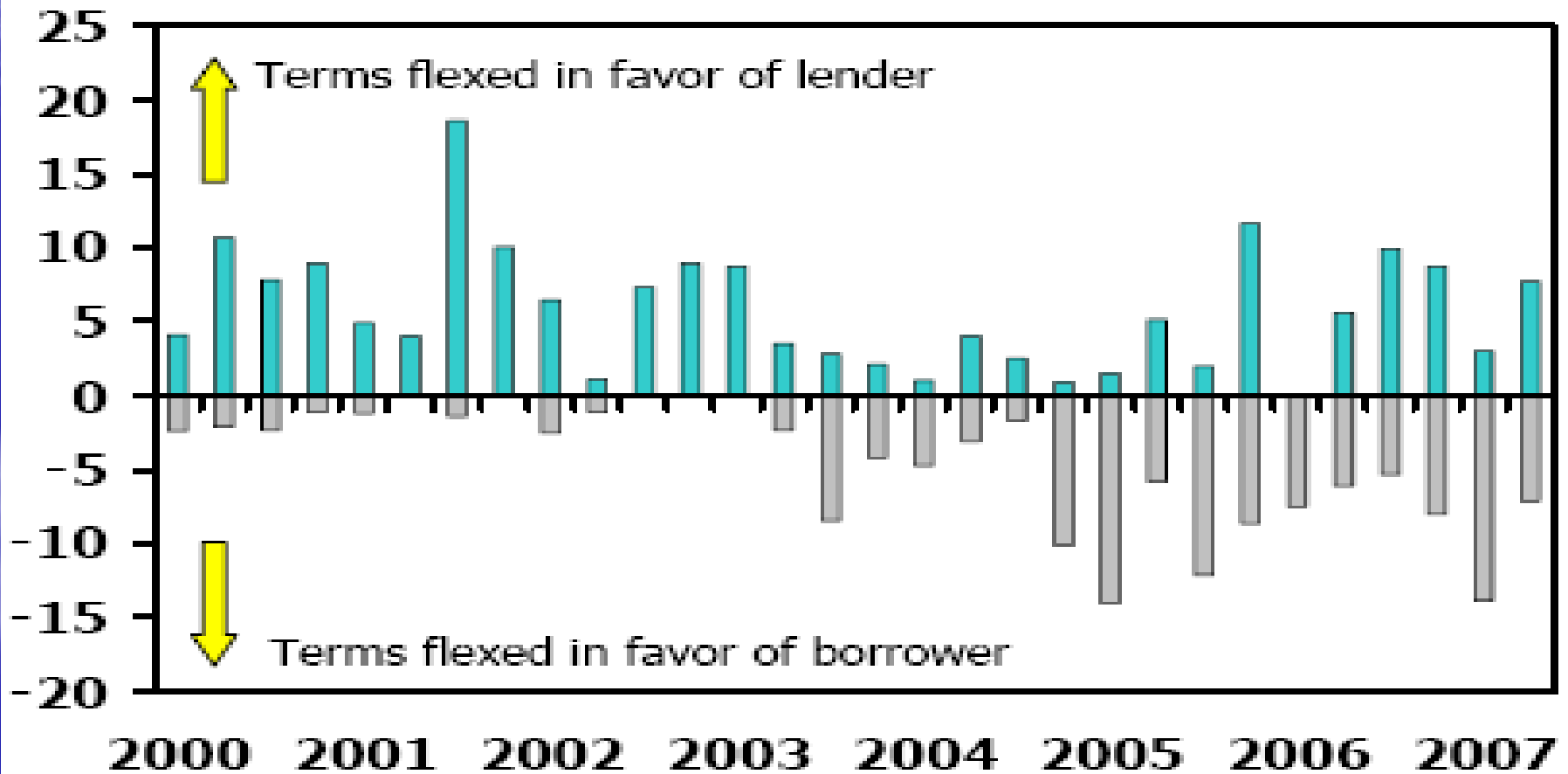


Figure-15: Combined loan to value



# FIGURE 16

## Flex and Reverse Flex Deals (in percentage of deals)



# Figure-17: volume of Covenant-Lite Loans

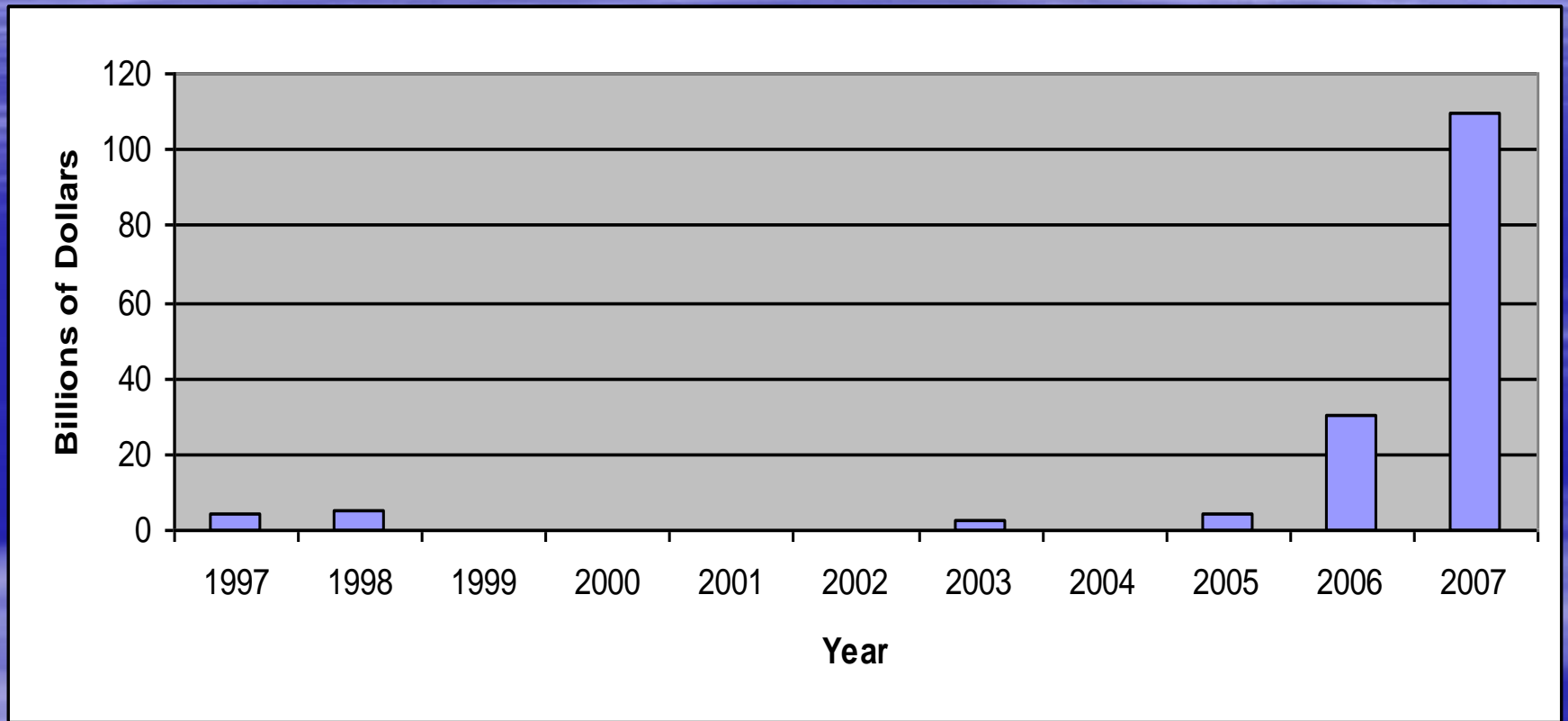
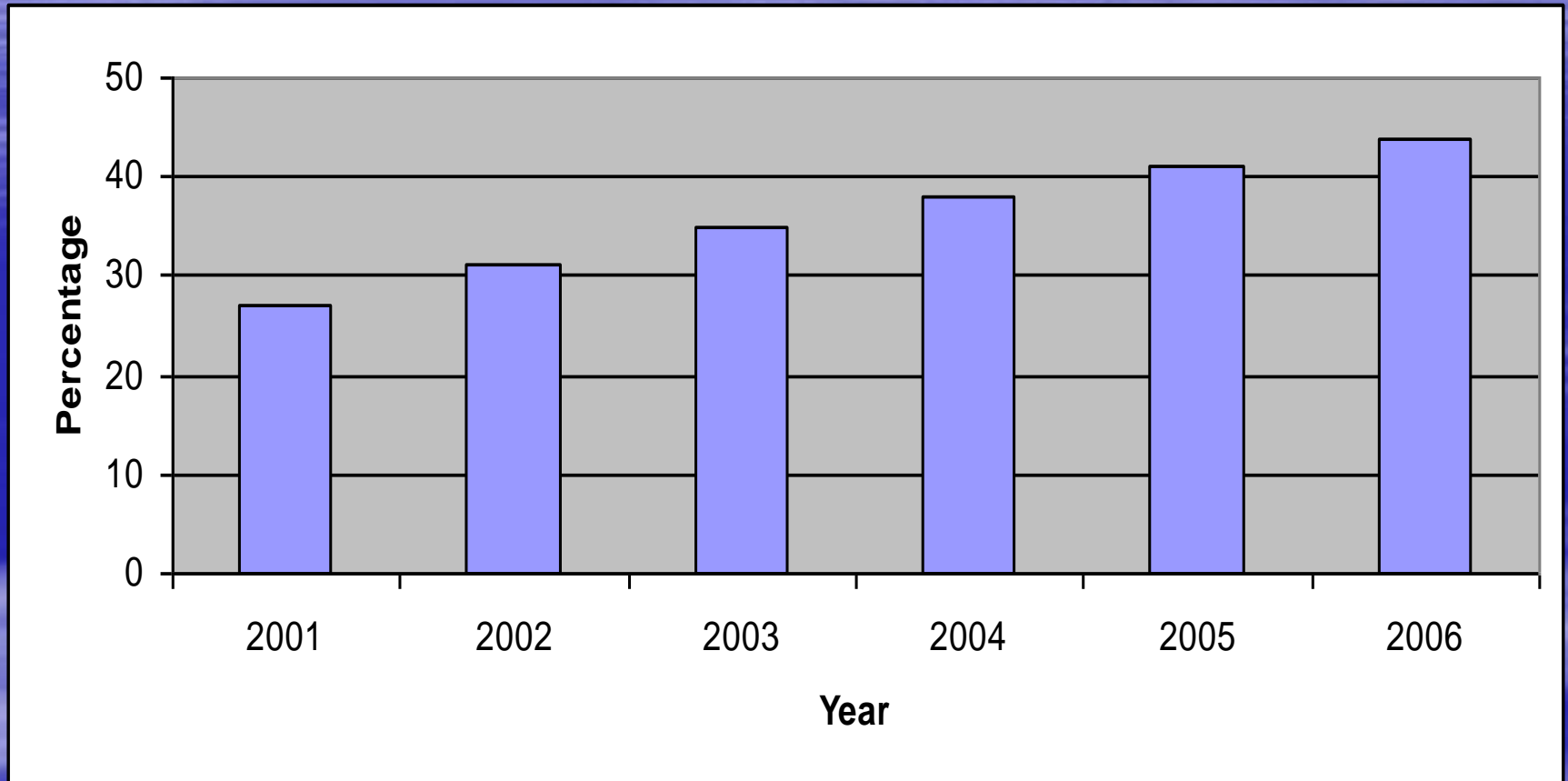
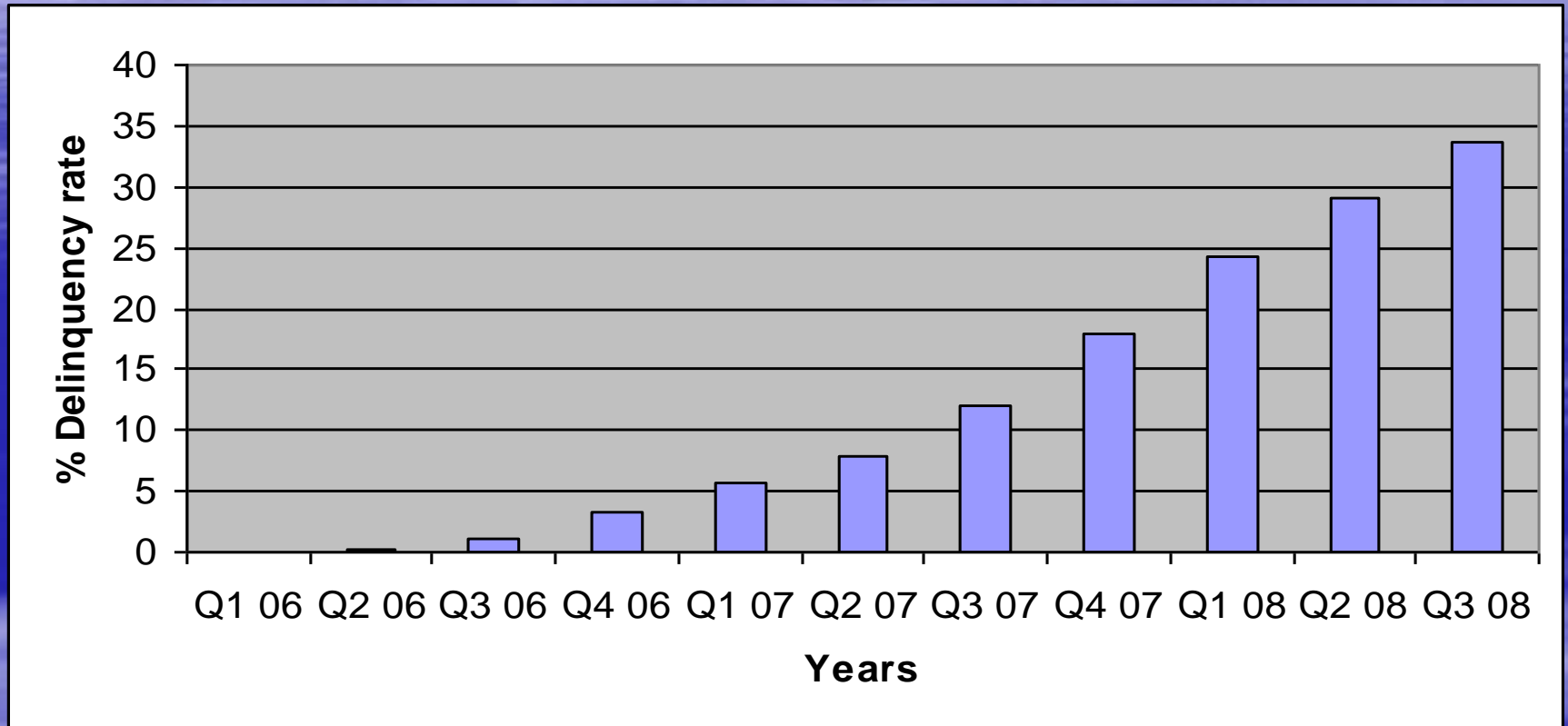


Figure-18: Limited Documentation %

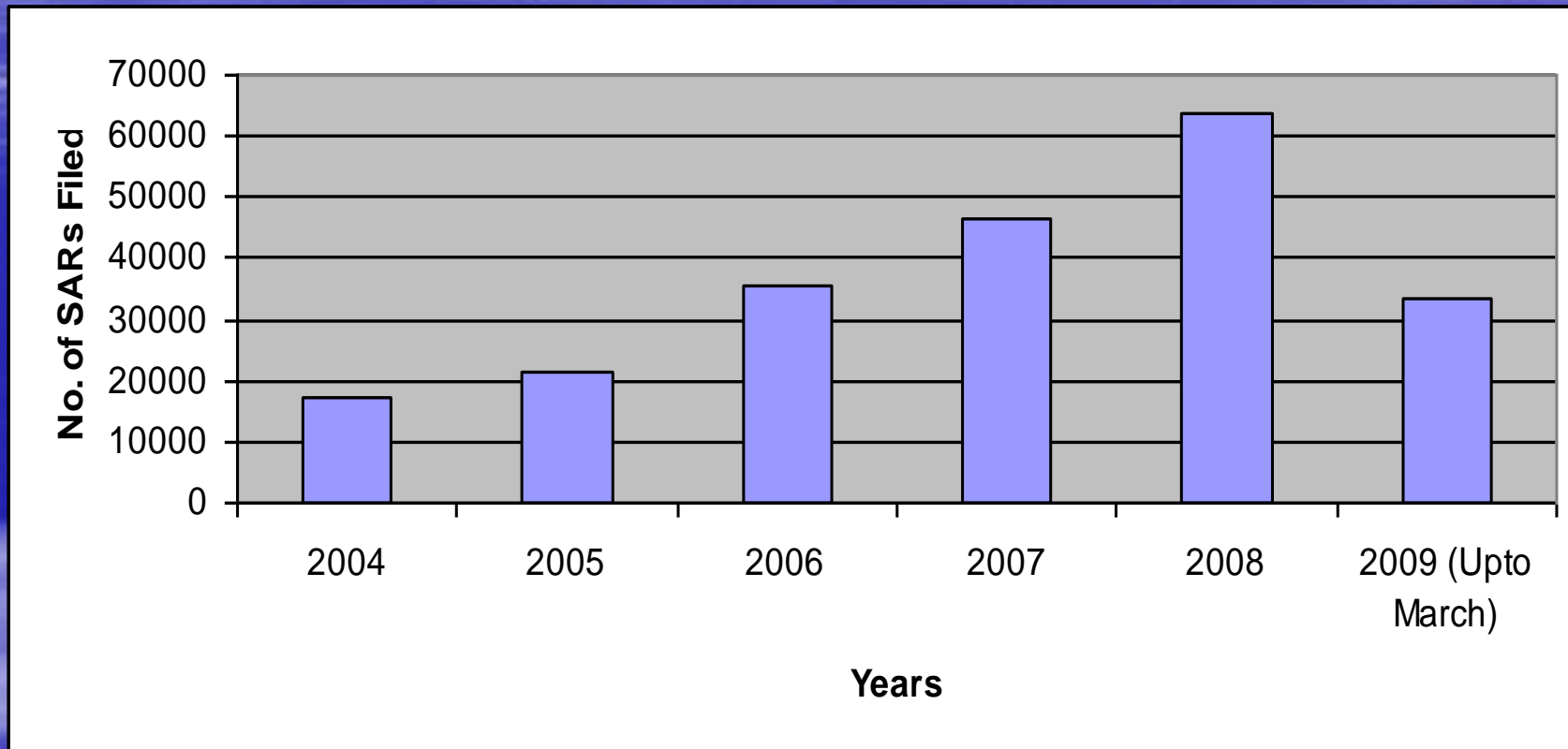




**Figure-20: Subprime 60 days Delinquency Rate**

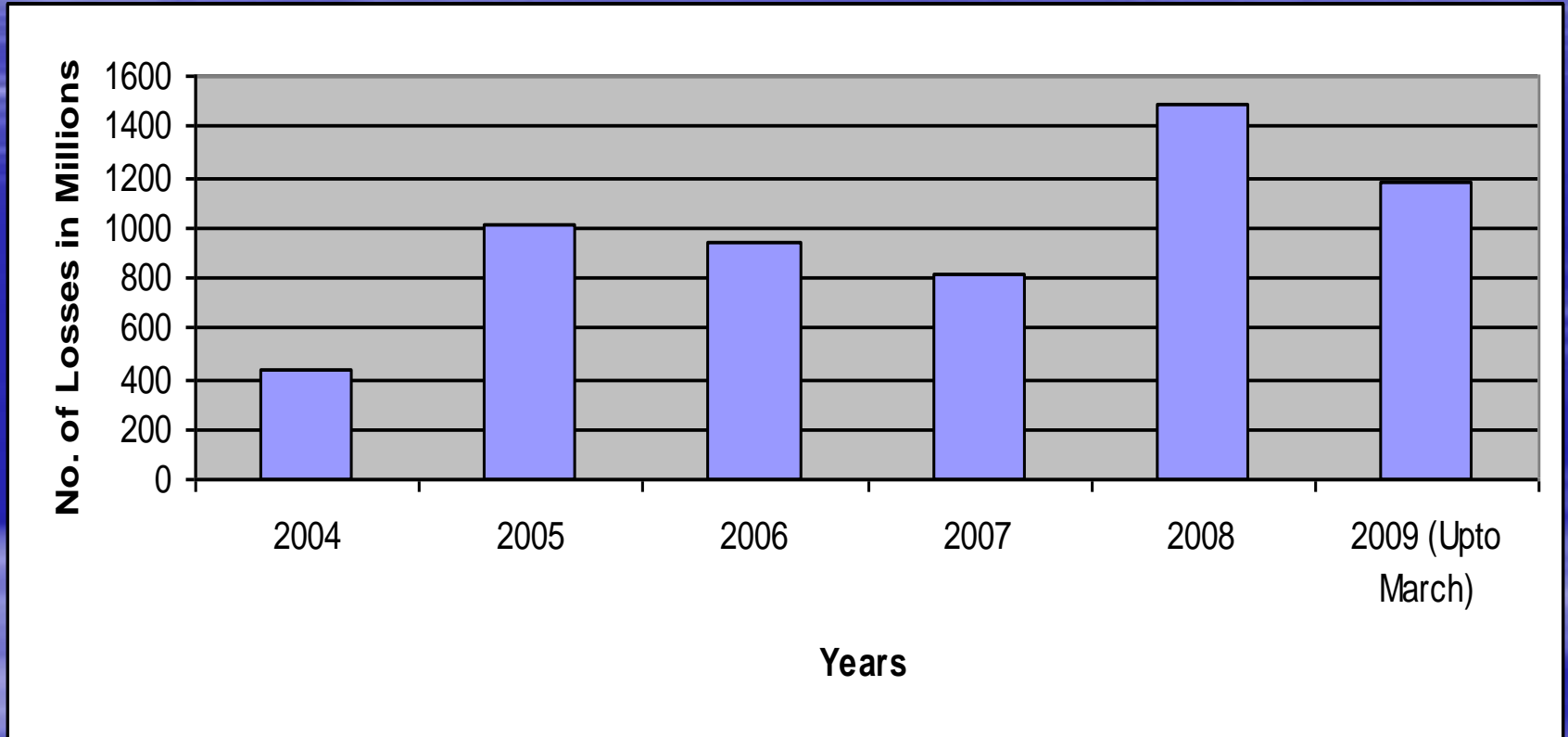


# Figure-21: Mortgage Fraud related SAR (SUSPECIOUS ACTIVITY REPORT) Financial Year 2004 TO MARCH 2009

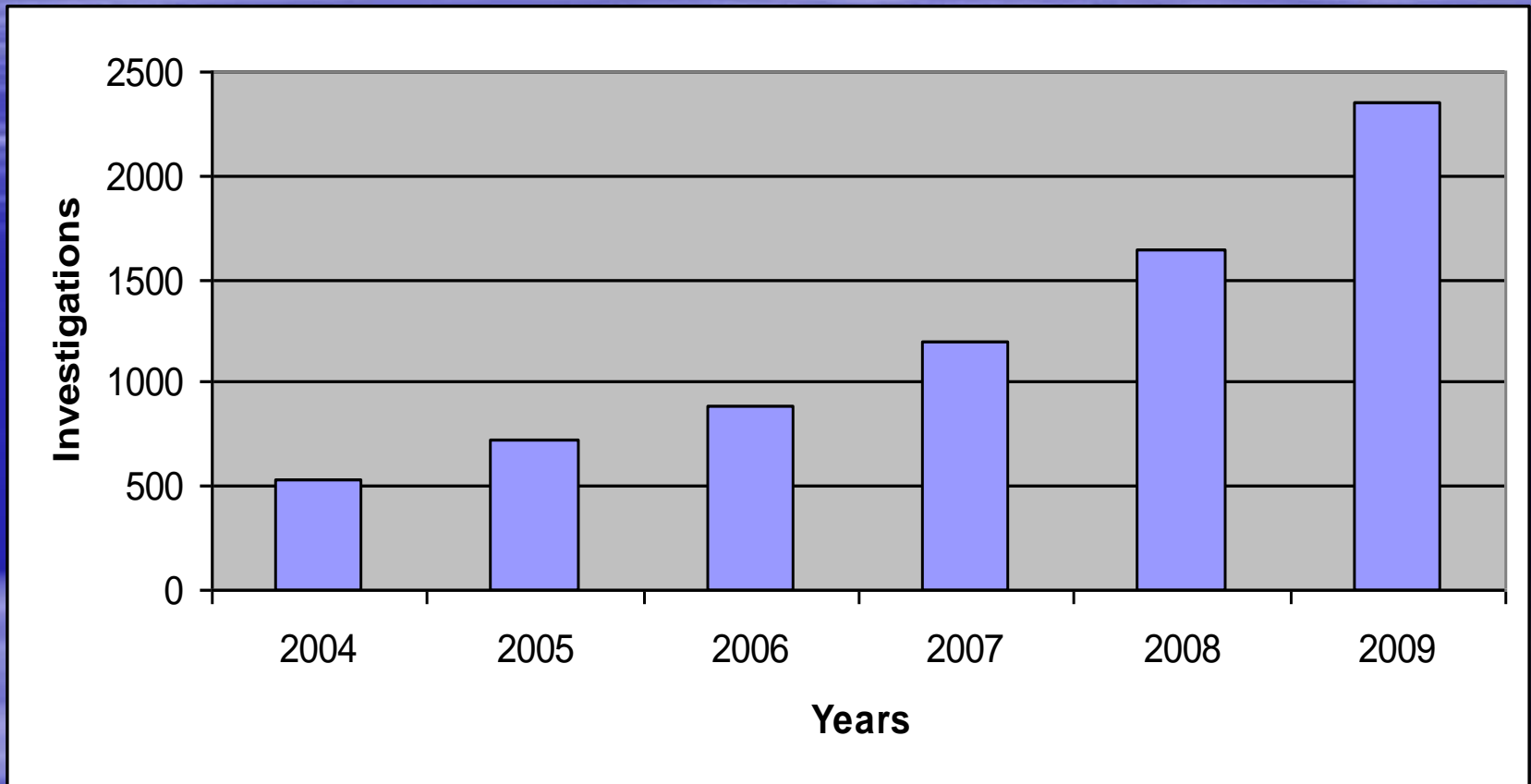


# Figure-22: Mortgage Fraud SAR losses (\$ Millions)

From 2004 TO MARCH 2009



**Figure-23: Increase in FBI Mortgage Fraud Pending Investigations from 2004 TO MARCH 2009**



- Lack of transparency and accountability in financial institutions motivated borrowers to borrow more and more even if they are not eligible
- Former Fed Chairman Paul Volcker has observed that problems of financial crisis began with a lack of accountability in mortgage lending and the trading of mortgage-backed securities. Financial executives spawned a proliferation of mortgage backed securities without integrity and traded them in non-transparent markets
- Apart from the low standard of credit and minimum documentation there have been cases of massive frauds in mortgage loans.
- According to Financial Times 18th January 2008, the five largest investment banks – Merrill, Goldman Sach, Morgan Stanley, Lehman Brothers and Bear Stearns paid out about \$66 billion in compensation in 2007, including an estimated \$40 billion in bonuses. Despite the decline in profit the bonus figure was higher than the \$36 billion last year



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**GRACIAS**