Could the 2008 Financial Crisis be avoided and what were the causes

Introduction

In his study, Taylor (2007) observed that the in the US economy, housing demand is highly responsive to the interest rates in the money market. For this reason, he makes a point against Federal Reserve's accommodative policy from 2001 as a key cause to the build-up in asset prices and housing demand. Equally, Del Negro and Otrok (2007) established that the accommodative monetary policy's impact on the prices of housing had been minimal compared to the general housing price in the US. On his part, White (2009) speculated that the collapse of the stock market boom in the late 1990s resulted in a sharp reduction in the rates. To him, this was the genesis of the housing market boom. Accordingly, Greenspan (2010) observed that house prices in the U.S. have a close relationship with long term rates. Noting that the relationship between long and short term rates was reportedly weak during this period had been weak over the period the most likely outcome was a crisis. Accordingly, some economists claim that as a matter of principle, intervention measures by the government through monetary policy has an insignificant impact on long-term rates. They claim that the major cause of low real and nominal rates during the 2007-08 periods was the increase in global imbalances. More so, a survey by the IMF (2009a) established that while in most economies, policy rates had been low for a long period, there was practically no link between monetary policy measures and house price increases in major economies of the world. Conversely, various sets of evidence blame it on the healthy relationship that existed between the increase in house price and capital inflows. For instance, Aizenman and Jinjarak (2009) identified that in a sample of forty-three states one standard deviation (4%) raise in the prevailing account deficit yields a 10% increase in prices in the real estate, consequently affecting various macro factors. Equally, Obstfeld and Rogoff (2009) identified a note worth negative association between the cumulative appreciation in real house prices and the change in the ratio of the current account to GDP between 2000 and 2006. Further, Reinhart and Reinhart (2008) noted that increases in the inflow of capital are related to a surge in both house and real equity prices in major economies. In this paper, the intention is to identify and discuss the key causes of the 2008 financial crisis and subsequently evaluate whether the crisis could have been averted.

Actual Cause of Crisis

Financial facts show that in 2007 the U.S GDP grew by two percent. However, they never noted the size of the mortgage market sector; this created heaven for subsequent adverse economic events. For instance, the banking sector did not project that borrowers could be unable to repay their credit. Similarly, mortgage brokers who are mainly unregulated lend/borrowed from unqualified entities/individuals (Bigio and La'O, 2011). On their part, a large portion of homeowners borrowed interest-only loans as a means of cushioning themselves from paying high monthly installments. Therefore, as mortgage rates settled at higher levels, the majority of these homeowners were unable to pay their mortgage. Consequently, when the prices of houses drastically decreased, they could not sell their homes and make a profit. A combination of these reasons ultimately forced them to default.

On their part, banks reformulated mortgages and came up with mortgage-backed securities (MBS). Under this arrangement, two packages were forms; high-risk and low-risk packages. Under the high-risk package, higher interest rates were paid although the risk of default was high. Conversely, under the low-risk package, low interest rates were paid. However, due to misinformation, the industry experienced a lot of confusion. Thus, after everything had settled, most people purchased the high-risk package for the reason that their returns were high {Halliday, & Carruthers, 2009). When the housing market declined, and the products lost value and given that no one had sufficient understanding of the concept, it became hard to determine accurate resale value. Lastly, since most buyers of the mortgage-backed securities were individuals, hedge funds as well as pension funds rather than other banks/ financial institutions, the risk was simultaneously passed to other sectors of the economy. For instance, under hedge funds, the derivatives were used as collaterals which in the bull market would yield higher returns in a bull market; however, a downturn would result to adverse consequences (Panzner, 2009). Accordingly, since SEC did not regulate hedge funds, there was no information about the amounts invested.

Wholesomely, the single largest factor that contributed to the financial crisis was the lack of strict regulations underwriting and lending principles as well as inadequate regulation in the financial market within the regulated loan sector. These factors accelerated the credit boom, which subsequently caused a housing bubble which inflated the impact of the crisis on the financial sector and the general economy.

How could the 2008 financial crisis have been avoided?

Tightening of monetary policy

The measure that would have seen the application of higher interest rates before the crisis would have yielded a stronger dollar which would have subsequently made expensive and imports cheaper. Precisely, a strong dollar would have played a big role since the loan asset would have attracted a few foreigners and as a result led to a decline in the availability of credit (Cable, 2009). Accordingly, such an action would have caused restraints in the credit markets of the liquidity supply and through that limitation eliminating the housing bubble and which ultimately contributed to the credit boom and the housing bubble (Zeckhauser, 2010). Additionally, through the higher interest rates borrowing would have been less attractive and most people and institutions would have been enticed to save due to high returns. The move would have decelerated the mortgage markets and most likely minimized the risks of the financial crisis being witnessed.

Fiscal Tightening

The government could have intervened by removing deductable interests on a homes loan payment. The policy had allowed many individuals to invest in property due to the fiscal incentives resulting to a major shift in property demand which subsequently resulted to the increase the price of the property, hence, the upsurge in the amount of mortgage that was allocated (Panzner, 2009). Also, the "The American Dream Down Payment Fund" policy ought to have been eradicated. The policy allowed low-income earners to as well invest housing, and at the same time, it diverted resources away from longer-term public investment.

Tighter financial regulation

Lastly, key policies that should have been applied for purposes of avoiding the financial crisis would have been policies targeting financial regulation. For instance, a lead area should have been the introduction of tighter control measures on underwriting loan. This could have been realized by restricting the amount that individuals could have been allowed to c borrow pegged on their net assets, annual income, or the value of the asset's security. Besides, control measures would have been used to criminalize practices by a primary lender or an underwriter to sell on the total risk linked with a loan. It is evident that having these lenders have a stake on the associated risk would have strongly motivated them to act morally or appropriately. Finally, Bigio and La'O (2011), advice that it would have been wise to change laws in states where home loans were effectively non-recourse. Such a move would have ensured that the interests of homeowners adequately matched to those of the lender.

Conclusion

The sudden increase in home ownership followed by a housing bubble that resulted from the availability of affordable credit from the unregulated loan market was a major cause of the financial crisis. Besides, a weak dollar, low interest rates from the government, and packages that influenced individuals and institutions to own houses fuelled an unprecedented growth in the housing market. Nonetheless, owing to the market structure at that time, this limited the ability of lenders to make practical lending decisions, or for the buyers to exercise precautionary measures before taking on a loan. Additionally, the failure to strictly regulate the banking sector denied banks a chance to prepare for the housing bubble turbulent adequately. This ultimately led to the failures in the securitized loan value. However, the paper has identified that combining tighter fiscal and monetary policies by applying mixed economic policy strategies, tough financial regulations, as well as tough regulations on credit facilities and the secondary banking systems, would have minimized or helped to avoid the financial crisis.

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