THE ORIGINS OF THE CRISIS

A. LISTENING

BURNING DOWN THE HOUSE

1. Watch the video and complete the missing information on page 2.
2. What process is Steven Liesman explaining?
3. What is the purpose of the sentences marked in bold in the text?
4. Rewrite the explanation, summarising the information in one paragraph, using neutral language.

B. VOCABULARY

1. In pairs invent definitions for the terms given.

a.	b.	c.
to set the bar high	to urge	to reel
market jitters	to take down a notch	tender offer
to fall from grace	junk status	dismal

d.	e.
to track developments	to be caught out
shake-out	(to come to) a sticky end
to unwind	the final throes

2. Match each term with its real definition.

C. SENTENCE SWAPS

From each of the articles that follow on pages 4 and 5, 2 sentences have been swapped with sentences from 2 other articles. The group's first task will be to recreate the original articles by replacing the alien sentences with those that belong.

1. Read your article to identify the 2 sentences that do not belong.
2. Reread your article and take notes on the content of the article. Ignore the alien sentences.
3. Explain your article to the other students in your group so that they can try to identify if yours is the text from which their alien sentences were taken.
4. As you listen to your group members' explanations, try to identify the texts from which your alien sentences were taken.
5. As a group, reassign the alien sentences to their original texts.
6. As a group, synthesise the information from the 4 articles into a graphic form, e.g. a diagram, flowchart or table. To do this you will need to decide on a conceptual analysis that classifies the information from the 4 texts.
7. Present your results to the class.

A. BURNING DOWN THE HOUSE

TV presenter:

How do you create a subprime derivative and how do you blow it up? Senior economist Steven Liesman knows and he's going to explain with the help of the ... here. Steven

Steven Liesman:

We call this Burning down the house because that's sort of what's been happening. This looks like the books of some hedge funds or investment banks we know right now, now that we have these subprimes blow up.

But what we have to do first, we have to create it first. And then we'll show you how it went bad.

Now work with me on this Bill, if you don't understand anything here, you let me know.

Now you start off very simply here. You take a bunch of mortgages here, ok, Joe, Fred, Jane, ok. They're a hundred thousand, two, or three hundred thousand dollar mortgage. You put it into one big thing. …………………………………………………………………………………..

That's step 1. We have more to go. Bear with me on this. That's the easy part.

Now, you take a bunch of these mortgage backed securities, and you put it into one very big thing. You see, that's a 50 million dollar piece, that's a 50 million dollar piece. ……………………………………………………………………………………………………
……………………………………………………………………………………………………

Now watch what we're going to do here. …………………………………………………
………………………………………………………………………….. Bill, you just watch. We're gonna make some good paper.

So now we have this thing here, a one billion dollar vehicle, right? Now is the tricky part because what we're going to do is we're going to slice it up into 5 different pieces, ok, 5 different pieces, call them tranches, call them levels, call them what you will.

……………………………………………………………………………………………………
……………………………… Why?

Because what we're doing here, your triple B minus tranche here, they're gonna take the first losses from whoever is in the pool. ………………………….., ok, all the way up to about 8 % of the losses, these guys are assuming it. So what you're saying is: You got it, you got losses in your thing, I will absorb those losses and pay you for them. …………………………………
……………………………………………………… . All the way up to triple A where 24% of the losses are below that, ok? So the whole 24% of it has to go bad before they see any losses, and they get, you will see, a relatively low interest rate. **So what is triple A paper?** Here's what we've done. Here's the magic of this as far as Wall Street is concerned. …………………….
……………………………………………….., ok, we have a triple A tranche here, ok?

Now, we're going to show how it's blown up here. Here's a little nuclear bomb action there, ok? Here's the issue when it was issued. ………………………………………… now it's 7.7, ……………………………………………………………………………………………………
……………… Tremendous losses in there and gains for the guys that come in now and hold this paper.

What's interesting about this is that this thing suggests that there will be 80 or 90% losses and all they've been is in the 12% range. Well some guys are seeing a lot of value here.

Let's look at some of the keys to the blowup here now, ok?

……………………………………………………………………………………………………
…………………………………………….. and really caught up into the minus triple B.

If housing worsens, if things get worse from here, the big question here are ratings downgrades. If that triple A paper suddenly becomes seen as B paper or even just single A paper, …….
…………………………………………………………………………………………………….

So that's what you do, you take a whole bunch of mortgages, you put them in a pot, you slice them up and you sell them out there and the blowup has come because of a lack of belief, not in actuality, but in belief in the credit worthiness of these subprime loans.

TV presenter: There has to be a lot of faith in some of these investments that they make.

S.L.: As they said in the song, "We're in for nasty weather."

TV presenter: Thank you, that was very clear. Well done.

B. Vocabulary

2. Match each term with its definition.

1.	to set the bar high	a.	to encourage
2.	to be caught out	b.	to follow or pay attention to progress or changes
3.	to fall from grace	c.	to create a standard that will be hard for others to follow
4.	to urge	d.	to lose your high status
5.	to track developments	e.	to find yourself unexpectedly in a difficult or unexpected position because you were not prepared
6.	to come to a sticky end	f.	to find yourself in an unpleasant or very difficult position from which it is unlikely that you will recover
7.	to reel	g.	to reduce the status of something/someone
8.	to take down a notch	h.	to react unfavourably to a shock
9.	to unwind	i.	to return to a normal state
10.	market jitters	i.	miserable
11.	the final throes	j.	a US practice of offering securities to the public to buy by auction
12.	junk status	k.	a low rating indicating that the bond or … is worth very little
13.	shake-out	l.	uncertainty in the market, fear that the market will fall
14.	tender offer (NG)	m.	reaction to change where assets return to realistic values
15	dismal	n.	the final stages

D. Martin Wolf

1. Complete the vocabulary exercise on page 8.
2. The editorial by Martin Wolf has been divided into two parts. In his analysis of the financial crisis Martin Wolf essentially describes situations, evaluates situations, describes reactions to situations and describes the ensuing consequences. In doing so he creates chains of cause and effect.

Read your part and take notes on it so that you can share the information with your partner. Together, summarise Martin Wolf's analysis of the financial crisis. To what extent do you agree with him?

E. A Marxist explanation of the crisis.

Watch and listen to David Harvey's explanation of the current financial crisis. As you listen complete the charts below, then answer the questions on page 8.

http://www.youtube.com/watch?v=qOP2V_np2c0

Cause		Features	Solutions
1.	Human frailty		
2.	Institutional failure		
3.	False theory		
4.	Cultural values		
5.	Failure of policy		
6.	Internal contradictions of capital accumulation		

Case for a closer look at hedge funds

The move by Standard & Poor's to downgrade $453bn (£240bn) of General Motors and Ford debt to junk status was always going to become an event in the market no matter how well flagged. It is not every day that two of the credit market's biggest borrowers are taken down a notch. The carmakers' debt has been used in so many different structured products that some investors were bound to feel a difference.

Markets have been reeling this week with rumours that some hedge funds were wrong-footed by the development. Some which had apparently been shorting GM shares and buying the bonds were caught out when the shares rose last week following a tender offer by Kirk Kerkorian, the billionaire, and the bonds fell after the downgrade.

While there is no evidence that any hedge fund faces a big liquidity crisis, market jitters over their potential exposure highlight the sensitivities surrounding these sophisticated investment vehicles. Hedge funds have not had a good year, with dismal returns from some of the most popular strategies such as convertible arbitrage. Iceland's banks expanded rapidly by increasing overseas lending to more than 10 times the size of the country's economy. It is difficult to track hedge fund developments closely since they are highly secretive and many of their strategies rely upon exploiting little-known niches. But hedge funds have become such large and integral players in the global financial system in recent years that their exposure and investment strategies need to be better understood by regulators. Hedge funds regularly account for a quarter to a third of equity trading volume in New York and London. They have become some of the biggest and most profitable customers for investment banks.

Regulators typically rely on the banks to ensure that funds are not taking on too much debt or exposure. But in a speech to the Bond Market Association last month, Timothy Geithner, president of the New York Federal Reserve, highlighted the concentration and growth of hedge funds in financial markets as a challenge of risk management: "Although hedge funds help improve the efficiency of our system and may also contribute to greater stability over time by absorbing risks that other institutions will not absorb, they may also introduce some uncertainty into market dynamics in conditions of stress." Add to that the fact that many of the instruments in the credit derivatives market in which many hedge funds are dealing have not been tested in a difficult environment.

The credit cycle must turn at some point, even if not now. When it does, there could be a shake-out as some hedge funds unwind their positions. As the housing market turned toxic, so the loans that Bear Stearns, Lehman Brothers, Fannie Mae et al, had cheerfully advanced, bought up, repackaged and insured, lost value. While there appears little danger to the financial system as a whole from hedge funds, regulators need to know a lot more about their activities.

The Financial Times, 12 May 2005

Lehman reports record profits

By David Wells in New York

Lehman Brothers yesterday reported record profits that surpassed analysts' expectations, which set the bar high for rival investment banks about to report third-quarter earnings this week and next.

Net income rose 74 per cent from a year earlier to $879m (€716m) and Lehman shares rose $1.66 to $113.94 in midday trading in New York. These accounts are at the centre of the crisis.

Investors placed bets that rivals also performed well in the quarter, which is traditionally a slow period for Wall Street. Shares in Bear Stearns, which reports earnings today, and Goldman Sachs and Morgan Stanley, which report next week, posted gains.

Lehman has invested heavily in talent and businesses in recent years, expanding its ability to serve clients. Once known primarily as a bond house, it has stolen market share from rivals, including in mergers and acquisitions, and has built an investment management business and an equities franchise. It has also expanded its international operations.

Some investors may also discover they have underestimated the risks to which they are exposed.

Investment banking revenues increased 55 per cent from a year earlier to $815m, driven by debt and equity underwriting as well as success in arranging mergers and acquisitions. Lehman advised on three of the largest completed acquisitions for the quarter.

One area where Lehman Brothers has excelled is in its mortgage business. Lehman has created a business that both underwrites, securitises and trades mortgages. It originated mortgages in the US, the UK and the Netherlands and is thinking of expanding to South Korea and Japan, Mr Goldfarb [the chief administrative officer] said.

The Financial Times, 15 September 2005

Wall Street's bloody Sunday

The crisis gripping the US financial markets shows no signs of ending after an unprecedented weekend of drama

Richard Adams

Has Wall Street ever seen a weekend like the one it has just been through? Perhaps, in the depths of the great depression - but nothing in recent memory, not even the collapse of the hedge fund LTCM 10 years ago, comes close to the drama and crisis that the US financial system is going through.

In case you haven't been paying attention, here's what's happening. Richard Fuld, chairman and chief executive, yesterday said the record results this quarter proved that the company's investment over the years had increased its ability to generate earnings. Merrill Lynch, for years one of the titans of Wall Street, hocked itself in a firesale to a rival, Bank of America. And AIG, one of the world's largest insurance firms, is begging for a $40bn emergency loan from the US government to stave off its own destruction. In the words of the Wall Street Journal: "The American financial system was shaken to its core".

And that was just on Sunday. It doesn't pay to take the weekend off on Wall Street these days – it was just last Sunday that the US Treasury confirmed it was taking control of Fannie Mae and Freddie Mac – the vast American mortgage agencies – at a cost to the taxpayer estimated to eventually range between zero dollars and a few hundred billion.

And as the minutes ticked over from Sunday to Monday on the US east coast, Lehman Brothers finally threw in its towel and filed for bankruptcy. In one way or another it will be the end for a bank that started in Alabama back in 1844 – a sticky end considering that last year it had sales of $57bn and only a few months ago was named by Business Week magazine in its 50 top performing companies for 2008. (Business Week's citation, in hindsight, looks wise: "Still, the firm is highly leveraged. The final throes of the global credit contraction will test just how good it really is." Now we know.)

What links all these once-buoyant institutions? All of them – from Fannie Mae to AIG – have been caught up in the bonfire of the vanities that was the US housing market, the same underlying cause that six months ago saw the combined forces of Wall Street and Washington rush to prop up and then dismember another former investment banking stalwart, Bear Stearns.

With conventional strategies producing low returns, some hedge funds are seeking out new and more exotic products. The Federal Reserve, abetted by the US Treasury, pumped cash into the financial markets to prevent them seizing up. But their efforts were hampered by the very financial instruments that the masters of Wall Street had invented. The blizzard of options and derivatives the banks have used in recent years are Byzantine in their complexity, making it very difficult to value the potential losses on the books.

The Guardian, 15 September 2008

Bank governor says he warned of lending risks

By David Ibison in Reykjavik

The governor of Iceland's central bank has defended his controversial role in the collapse of the country's banking system, saying he repeatedly warned the heads of the banks that they were in danger but was ignored.

David Oddsson, prime minister between 1991 and 1999 and father of the liberal politics that revolutionised the economy, has fallen from grace in the aftermath of the crisis. There have been demonstrations calling for his resignation, where protesters chanted "David out!" and sang the socialist anthem "The Internationale" outside his office in Reykjavik.

Mr Oddsson said he urged the banks to deleverage.

Lehman shares have gained 30 per cent so far this year and are trading at an all-time high. When it became difficult to raise funds on wholesale markets, they turned to deposit funding by offering high interest rates to savers across Europe. Lehman Brothers, one of the largest and oldest US investment banks, is going bust, barring an unlikely last-minute government bailout.

Mr Oddsson's comments reveal worrying limits on the ability of the central bank to ensure the financial system's stability. They also contribute to the growing belief that Iceland's banks had become so economically and politically powerful that they could disregard central bank guidance.

Oversight and regulation of the banking system is expected to form a central part of the conditions imposed on Iceland by the International Monetary Fund when an expected announcement is made, possible as early as today, of a $65bn (4.7bn, £3.7bn) bail-out for the country, backed by co-ordinated action from other central banks.

The Financial Times, 24 October 2008

D. An ABC of financial shocks and fiscal aftershocks – Part 1

By Martin Wolf *The Financial Times*, May 28 2010

"Is the crisis over, Daddy?"
"Not really, Bobby. Just look at the news of market turmoil."
"Why isn't it over, Daddy?"
"The crisis began in August 2007 and reached its worst in autumn of 2008. By historical standards, that is not so long for such a big crisis."
"Not so long, Daddy? Did you not say that the guarantees and capital injections, the money-printing by central banks – 'unconventional policy', you called it – and the borrowing by governments had fixed the crisis?"
"Bobby, you don't pay enough attention," replied his father, a bit impatiently. "What I said is that these actions would stop the crisis from becoming a depression. I was right, as usual."
Bobby smiled, affectionately.
"Stop smirking," said his father. "Take the rich western countries: their output shrank by 3.3 per cent last year – the worst performance since the second world war. You do know about the war, don't you?"
"Oh yes. We have studied it at least three times at school."
"Well, the Organisation for Economic Co-operation and Development – I know, that's a mouthful – said this week that the output of the rich countries might grow by 2.7 per cent this year. The world economy is forecast to grow 4.6 per cent after a 0.9 per cent decline in 2009. This is better than almost anybody expected even half a year ago."
"If that's true," replied the boy, "why do all these people talk about 'instability'? What's that about?"
"You know about aftershocks following earthquakes. Well, fiscal crises can be the aftershocks of financial crises. And then they can cause financial aftershocks, in their turn."
Bobby was beginning to find this lecture interesting, to his surprise. "So how does that work, Daddy?"
"Well, think about what happened before the financial earthquake of 2007-09: there were huge rises in property prices and booms in construction; there was an explosion of private debt; and there was a big increase in financial complexity. So, when property prices fell, we had the big panic. But two other things happened: governments received more revenue than they had expected, most of which they spent; and they borrowed easily, too.
"In the new eurozone, all governments found they could borrow as if they were Germany's. Households and businesses could also borrow on German terms. So they bought and built. In the good times, wages also soared."
Bobby yawned. His father drove on.

D. An ABC of financial shocks and fiscal aftershocks – Part 2

By Martin Wolf *The Financial Times*, May 28 2010

"So what happened after the crisis? Fiscal deficits exploded to levels never before seen in peacetime, particularly in countries affected by the bubbles – the US, UK, Ireland and Spain. So the threat of a fiscal crisis emerged.
"What triggered this aftershock was the revelation that Greece had lied about its fiscal position, followed by the inability of the eurozone to respond: Germans were outraged at the idea that they should rescue irresponsible profligates; others thought the Germans inflexible bullies. So the Europeans made the same mistake as the Americans had made when responding to financial worries: they let the crisis get ahead of them."
"But they bailed out Greece," said the boy. "So why all the turbulence?"
"The big point is that investors are not altogether stupid: they know these are temporary patches; they know Greek indebtedness is going to worsen; they know that other countries in peripheral Europe will find it hard to grow out of their plight; they know that solidarity among eurozone member countries is fraying; they know Germans are very angry; and they know that inadequately capitalised banks are vulnerable to sovereign risks. All this makes the euro seem a worse bet. So it has fallen in value."
"I understand that," replied Bobby. "But won't that help the eurozone?"
"Yes," agreed his father. "But it will worsen prospects elsewhere – in the UK and US, for example. And then there's the worry that these countries have huge fiscal difficulties, too. The markets don't seem to mind now. But they might change their view. Worse, they don't know what to fear: will it end up in deflation, default, inflation, financial shocks, or all of these? Markets are unpredictable, like children."
Bobby decided not to respond to this teasing. "So," he asked thoughtfully, "what's going to happen next?"
"If I knew that, I wouldn't be a mere economic journalist," his father said.
Bobby smiled: a familiar remark.
His father did not notice. "Maybe, the momentum gained by the US and the big emerging markets, especially China, will let the world ride through the shocks. The OECD calls the outlook 'moderately encouraging'.
"Alternatively, you could argue that the massive fiscal deficits are unsustainable and that attempts to rein them in, in the eurozone and UK, are going to cause renewed recession and political strife. We have also barely begun reducing private debts, which will take years. The banks are far too big and have too many doubtful assets on their books. Meanwhile, emerging countries are too small and weak to be locomotives for the world. Some people worry that China is overheating or suffering from huge asset price bubbles, too, though I disagree. And then there is geopolitical uncertainty over North Korea and Iran. In short, markets are volatile because of all the uncertainty out there."
Bobby was beginning to find this familiar: his father tended to see the gloomy side. But he could be wrong, as his mother enjoyed pointing out.
"Anyway," concluded his father, "these aftershocks are likely to go on for years, with fiscal worries undermining confidence in the financial sector and back again. It will affect you, too: western governments are going to be short of money for decades. It's going to be miserable. But you can learn Chinese and go east."
Bobby groaned. It sounded like hard work. But he went off quietly to bed. What nightmares disturbed him?

D. Martin Wolf

Match each verb on the left (1-8) with a meaning on the right (a-h).

1. to rein in	a. to rescue
2. to shrink	b. to open your mouth because you're tired
3. to bail out	c. to control and slow down
4. to undermine	d. to get smaller
5. to ride through the shocks	e. to not have enough of
6. to be short of	f. to come apart
7. to fray	g. to take away
8. to yawn	h. to endure and survive a difficult situation

Match each expression on the left (1-7) with a similar meaning on the right (a-g).

1. plight	a. difficult situation
2. bully	b. confusion, uncertainty
3. turmoil	c. aggressive, domineering person
4. gloomy	d. outlook
5. prospects	e. in their possession
6. strife	f. trouble
7. on their books	g. miserable, sad

E. A Marxist explanation of the crisis (cont.)

1. What is meant by 'systemic risk'?
2. David Harvey claims that crises can be triggered by excessive power. In what way is today's crisis different from that of the 70s?
3. How was the crisis in the 70s overcome?
4. What factors (a chain of problems and solutions), which were the result of the solution to the 70s crisis, led to the current one?
5. What are the 3 barrier points he refers to in the accumulation of capital? How are these overcome?
6. What was happening to profits in the financial sector and the manufacturing sector during the 90s?
7. What does he imply about the future?

G. Rich nations face increased debt burden

Complete each space with one word.

Alan Beattie in Washington *The Financial Times*: October 31 2010

The government debt burden shouldered by employees in the rich world will more than double between 2007 and 2015 as an ageing population (1) …. rising strain on welfare and health systems in advanced economies.
In new calculations (2)…. the Financial Times, Eswar Prasad, a former International Monetary Fund official (3) ….. at the Brookings Institution and Cornell University, finds that the rich economies (4) …. owe a rapidly rising share of public debt worldwide, while (5) ….. relatively less to global growth. Rich countries already experiencing heavy demographic pressures (6) ….. their public finances, such as Japan, will be joined by others, (7) ….. as the US, which is beginning to experience the full force of the postwar "baby boomer" (8) ….. retiring. Professor Prasad finds, rich countries will see the average government debt per person of working age (9) ….. from $31,700 in 2007 to $68,500 in 2015. Of the sample of (10)….. than 50 countries, the US, which has enjoyed a relatively benign demographic profile, (11) ….. from having the 11th heaviest debt burden per employee in 2007 to the third (12)….. by 2015. The increasing burden of servicing public debt falling on a relatively smaller workforce will imperil (13) ….. and stability, Prof Prasad says.
"Advanced economies had better get their fiscal act together (14)….. the recovery is better entrenched," he says. "It will take strong political will to tackle near-term deficits and (15)….. to control the growth in entitlement spending. In the absence of decisive action, ballooning (16)….. debt in the advanced economies could become a major threat to domestic and global financial (17)…..."
The ratio of government debt to gross domestic product around the world (18)….. risen as a result of the global financial crisis, as governments (19)….. supported their economies and financial systems with public spending. But while those burdens are likely (20)….. start shrinking again in emerging markets, they will rise in the rich world as the (21)….. of an ageing population continues to weigh. Globally, the rich countries will (22)….. markedly more to the overall worldwide debt burden than they will to (23)….. growth. Middle-income countries accounted (24)….. 10 per cent of the increase in global debt levels from 2007 to 2010 and are projected to account for 13 per cent of the increase from 2010 to 2015. But they contributed 70 per cent of the growth (25)….. global nominal GDP from 2007 to 2010 and will contribute 54 per cent from 2010 to 2015.