Bubbles, Bank Runs, and Bailouts
World Leaders Respond to the Financial Crisis of 2008–2009

To the Teacher

Home foreclosures. Bank bailouts. Plummeting stock prices. We are living through extremely tumultuous economic times. However, the U.S. economy has been through many bubbles and busts before and survived. How does the “Panic of 2008” compare with past financial crises? Are we headed for another Great Depression? Can we—should we—prevent such large-scale market failures?

Use today’s headlines to help students understand some of the causes of “free market” highs and lows and how leaders, institutions, and others respond.

Options for Using Student Activities and Worksheets

Provide a brief overview on how banks work (see Web resources). Emphasize that most banks are required to keep only a portion of depositor money on hand—in reserve. The bulk is loaned and invested to make a profit. For fun, show students the bank-run scene from Capra’s 1946 movie It’s a Wonderful Life.

Worksheet 1: Use the Financial Crisis Glossary handout to introduce students to key financial terms. Students may encounter complex financial information and additional terms during their research. Encourage them to focus on the main “story” of the crisis and how people responded. Ask them to keep an eye out for other new or unclear terms. Define them as a group and add them to the Financial Crisis Glossary.

Worksheet 2: Watch the 60 Minutes: Wall Street Shadow Market video clip (12 minutes) as a group. Then ask students to complete Worksheet 2 for homework in preparation for group discussion.

Worksheet 3: Allow students to work as individuals, pairs, or small teams to research an economic crisis of the past—either selected from the list or identified by students, with your approval. Remind students that they will present their examples to the class. If you prefer, you can limit the scope of this activity by offering only 1–2 research choices (e.g., students can pick the Great Depression or the dot-com crisis).
National Standards Addressed

National Standards for History

• The student understands the causes of the crash of 1929 and the Great Depression.
• The student understands economic patterns since 1968.
• The student is able to evaluate the impact of recurring recessions and the growing national debt on the domestic agendas of recent presidential administrations.
• The student understands how a democratic polity debates social issues and mediates between individual or group rights and the common good.

National Content Standards in Economics

Standard 10: Role of Economic Institutions
• Institutions evolve in market economies to help individuals and groups accomplish their goals. Banks, labor unions, corporations, legal systems, and not-for-profit organizations are examples of important institutions. A different kind of institution—clearly defined and enforced property rights—is essential to a market economy.

Standard 16: Role of Government
• There is an economic role for government in a market economy whenever the benefits of a government policy outweigh its costs. Governments often provide for national defense, address environmental concerns, define and protect property rights, and attempt to make markets more competitive. Most government policies also redistribute income.

Web Sites and Online References

Financial Crisis of 2008–2009

How Stuff Works: How Banks Work
http://money.howstuffworks.com/personal-finance/banking/bank.htm

Google Video: It’s a Wonderful Life—Bank Run Scene (starts at 51:00)
http://video.google.com/videoplay?docid=-4867975537967299162

60 Minutes: Wall Street’s Shadow Market (Video)
http://www.cbsnews.com/video/watch/?id=4502673n

How Stuff Works: How Can Mortgage-Backed Securities Bring Down the U.S. Economy?
http://money.howstuffworks.com/mortgage-backed-security.htm

Kiplinger.com: 15 Things You Need to Know about the Panic of 2008

Glossary: Translating the Financial Crisis

Other Financial Crises in History

U.S. News & World Report: The 10 Biggest U.S. Bank Failures

Ten Biggest Stock Market Crashes of All Time

Wikipedia: List of Recessions in the United States
http://en.wikipedia.org/wiki/List_of_recessions_in_the_United_States
Web Sites and Online References (continued)

Leadership in Times of Crisis

American Heritage Magazine: The Great Crash of 1792

FDR: First Fireside Chat—on Banking (transcript and audio)

Financial Crises: Lessons from History
http://news.bbc.co.uk/2/hi/business/6958091.stm

Stopping a Financial Crisis, the Swedish Way

Teacher Background Information

See Student Worksheet 1 for background information on the 2008–2009 financial crisis. To prepare yourself for activities, review the following three Web resources. They provide an excellent overview of issues and key terms.

- How Stuff Works: How Banks Work (Web article)
- 60 Minutes: Wall Street’s Shadow Market (video)
- How Stuff Works: How Can Mortgage-Backed Securities Bring Down the U.S. Economy?

You should also review the Financial Crisis Glossary handout (Worksheet 1)
Worksheet 1: Understanding Financial Lingo

In order to understand the current economic situation, you need to understand some key terms. Many are terms few people understood until recently!

1. Brainstorm a list of financial terms. Think of words that you know or have heard that are related to money or the economy. Can you define them?

2. Next, look over the Financial Crisis Glossary handout with your teacher. Which terms do you already know? Which are new?

3. Find a partner. Take turns explaining three of the new terms to each other. Use your own words in your explanations. Discuss all six words.

4. As you continue with this lesson, keep an eye out for other important terms you learn. Add them to the Glossary.
Credit  Trust in a person’s ability to pay; estimate of their ability to repay

Mortgage  A loan that uses property—such as a house—as collateral. Not paying on the loan leads to losing the collateral.

Subprime mortgage  Mortgages used by people with poor credit ratings; also, mortgages issued without the “usual” supporting information and documentation, such as proof of income. Interest rates on these usually go up after a certain amount of time.

Mortgage-backed security  A bond or security backed by a pool or bundle of mortgages. The investor earns money when people make their house payments.

Collateralized Debt Obligation (CDO)  A type of asset-backed securities and credits, including mortgage-backed securities

Reserve requirement/required reserve ratio  The amount of depositor money a bank is required to keep as “vault cash” or as a deposit with a Federal Reserve Bank

Speculation  An investment that takes a large risk but offers the chance of big gains; risky business deal designed for quick or huge profit

Bubble or financial bubble  Substantial, long-term trading activity at prices very much above the “intrinsic” or “real” value; inflated speculation

Stock market crash  Sudden, dramatic drop in price of many different types of stocks. Usually means a double-digit percentage loss in a stock market index, such as the Dow or NASDAQ, over a period of several days.

Foreclosure  When a bank or lender legally takes back property because the person who took out a loan secured by that property cannot make payments

Bank run  When customers rush to a bank to take out their money as quickly as possible for fear of losing it

Market-to-market  An accounting rule established in November 2007 requiring financial institutions (and others) to attempt to establish “fair value” on illiquid assets such as CDOs

Liquidity  The ease with which belongings can be changed into cash (sold); available cash or the ability to get cash when it’s needed

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Credit Default Swap (CDS)  A form of insurance for mortgage securities and other bonds. The buyer makes a premium payment or series of payments. The seller pays the buyer if the security or bond defaults. Neither the buyer nor the seller needs to own the actual bond to buy the credit default swap. Traders buy and sell CDSs in order to speculate on borrowers’ ability to pay. Think of CDS as Credit Default Insurance—the word swap is used in order to avoid having to obey rules that apply to the insurance industry.

Federal Reserve or “The Fed”  Central banking system of the United States—created to govern banking institutions, protect consumers, manage the U.S. money supply, keep the financial system stable, and provide financial services to banks and the U.S. government. The Fed is the “lender of last resort.”

Additional Terms You Encounter

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Financial Crisis Glossary (continued)
**Worksheet 2: Understanding the Crisis of 2008–2009**

**Background**

“No credit? No problem.” Did you ever catch those TV or radio ads? Millions of would-be home buyers did.

In 2002, the real estate market was booming. Homeowners watched their houses rise in value. Some people took out another loan or line of credit to make home improvements or to pay for a new car. If people didn’t own homes, they wanted to. Why rent when buying a home was such an outstanding investment?

Banks and mortgage companies loved the real estate boom. The more money they sold to people, in the form of home loans, the more money they made. Even better, they could put the loans they sold together into bundles. They would sell the bundles—called “mortgage-backed securities”—to investors. Investors earned money as people paid their mortgages.

However, the number of people qualified to borrow money began to shrink. In order to attract new customers, lenders took risks. They offered “subprime” loans to persons with low credit ratings. They also gave “no document” loans that didn’t require proof of income. They used “ARMs” (adjustable rate mortgages) that had low interest rates, but only for the first few years of the loan. They approved thousands of people with poor credit and lower incomes for surprisingly big loans. Large financial companies kept buying their loan bundles. They re-packaged them into new complex financial products such as “CDOs” (collateralized debt obligations), which they hoped would distribute the risk of the risky loans.

At the same time, these large financial companies also began to participate more actively in the “credit default swap” (CDS) market. CDS was a growing unregulated market. Companies made money trading the insurance contracts sold to investors to protect them should their mortgage-backed security investments fail. It all seemed so good—easy loans, great returns on mortgage-related investments, and insurance protection on those investments just in case.

Then the housing bubble burst. The United States economy began the downward slide from a subprime mortgage crisis into the worldwide financial meltdown of 2008–2009. Financial institutions that had survived the Great Depression of 1929 faced collapse.

As it turns out, credit matters. No credit? Big problem.

Assignment
Use your Web resources to learn more about the current financial crisis. Answer the following questions.

1. A housing “bubble” preceded the current crisis. What factors created the housing bubble?

2. In 2006, housing sales began to slow. By 2007, the housing bubble had burst. Prices were down around the country. What impact did the “bursting bubble” have? How did it affect people, financial institutions, businesses, and the U.S. and world economies as a whole? Give four examples.

3. How have leaders responded? What have they proposed or done along the way to try to limit the effects of the crisis? Give three examples. Overall, how well do you think they have responded?

4. Do you think we could have anticipated this crisis? If so, how? If not, why?

5. What if banks and investors are bailed out? Do you think they will be more careful “the next time,” or does a financial rescue have the reverse effect?
Walsh Education

Worksheet 3: Panics of the Past

Stock market crashes, bank failures, and financial panics have long been part of our economic lives.

• In the 1630s, the popularity of flower bulbs caused “Tulip Mania.” This caused one of the world’s first recorded financial crises.

• In 1792, Alexander Hamilton, the first Treasury Secretary of the United States, weathered the first Wall Street crash. He completed a financial revolution that helped transform the United States from a debtor nation into a country that could finance the Louisiana Purchase.

• During the 1907 Bankers’ Panic, the stock market lost nearly 50 percent of its value. Wealthy financier J.P. Morgan pledged huge sums of his own money to stop the panic and rescue the U.S. banking system and economy.

• In 1929, on Black Tuesday, stock markets crashed around the world. This signaled the end of the Roaring ’20s and the start of the Great Depression.

• In 1933, newly elected President Franklin Delano Roosevelt tried to stop a new wave of bank runs by declaring a national bank holiday. He used the first of his famous Fireside Chats to urge the nation to “unite in banishing fear.”

• The late 1980s was the peak of the Savings & Loan Crisis. At least one U.S. bank failed every day—2,377 banks in all.

• In March 2000, the dot-com bubble burst. There was a $5 trillion loss in company stock value. Within two years, nearly 50 percent of Internet companies folded.

In all, the United States has experienced more than a dozen major stock market crashes and periods of financial panic. In fact, between 1934 and 2007, we had only two years with no bank failures.

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Worksheet 3: Panics of the Past *(continued)*

Select one of the financial crises listed on the previous page or select one of your own, with approval from your teacher, and complete the questions below.

Past Panic: _____________________________________________________

1. What preceded the crisis? Was there a boom period or bubble? If so, what factors caused or contributed to it?

2. How did leaders respond? Did their actions work?

3. Did the crisis lead to any significant changes in our financial system or other area?
Worksheet 4: Comparing and Contrasting Crises

Share your financial crisis example with your class. After you hear from one another, compare and contrast the various situations. Answer the following questions.

1. What do these crises have in common? How are they different? Are there common features to bubbles and crashes?

2. How much of a role did “irrational” fear play in these crises?

3. Many of the situations involve speculation—bets that land, companies, or other assets or investments will rise or fall in value. Is speculation bad?
4. In a “free market” economy, the central government constantly wrestles with its role, during boom times and during and after crashes. Should the government intervene to deflate a bubble slowly? Should it regulate markets more or less? Should it bail out collapsing financial institutions?

5. Can you draw any insights about the role of government from the examples you researched and discussed?

6. Compare panics of the past to the current financial crisis. What similarities do you see? Is there anything about the crisis of 2008–2009 that seems different or unique to our time?
Answer Key

Worksheet 1: Understanding Financial Lingo
Answers will vary.

Worksheet 2: Understanding the Current Crisis
Student answers will vary but should include some of the answers listed below. Additional examples are included which teachers can introduce during the discussion, as appropriate.

1. Bubble Causes or Contributing Factors
   - Historically low interest rates. People could borrow money at low rates in order to buy property.
   - The burst of the dot-com bubble made real estate an attractive investment.
   - Lenders relaxed their standards. Risky borrowers could get loans, often with terms/interest rates they didn’t fully understand (predatory lending practices).
   - Strong consumer spending. People could refinance for lower mortgage payments. They took out equity loans or lines of credit because of high home values.
   - Lots of new home construction.

2. Effects
   - Adjustable rate mortgages began to revert from low introductory rates to normal, higher rates. People could no longer pay their mortgages. Many defaulted on their loans. Banks foreclosed on properties.
   - Large subprime mortgage companies declared bankruptcy.
   - Mortgage rates began to increase for everyone.
   - Banks tightened lending requirements (crackdown on subprime lending, tighter loan qualification standards).
   - Mortgage cash flow declined (no money coming in from bad mortgage debts).
   - Large investment banks trading in mortgage-backed securities experienced major losses related to bad mortgages and subprime lender bankruptcies.
   - Even before losses were incurred, new “market-to-market” regulations caused damaging “on paper” losses.
   - Investors lost confidence in mortgage-backed securities.
   - Large investment companies started to fail. They didn’t have funds to loan (less cash flow) or tightened lending. Banks couldn’t borrow money to pay off their own debts. This had a domino effect and created a bank liquidity problem or “credit crunch.”
   - Businesses couldn’t get loans or needed to pay higher rates. They began to lay off employees and close plants.
   - State governments cut budgets and began to lay off employees.
   - Multinational banks and financial services companies based in other countries experienced the same issues as U.S. banks (investment losses, credit crunch, and possible failure).

3. Leaders’ Responses to the Crisis
   - In the early stages, the Federal Reserve made money available to help prevent a credit crunch. The Fed also lowered the rate at which banks borrow money.
   - Congressional leaders held hearings on the mortgage industry crisis.
   - Major financial institutions fired CEOs.
   - President Bush called for a “teaser-freeze”—a voluntary 5-year freeze that would allow borrowers with adjustable rate mortgages (ARMs) to keep their introductory rates (December 2007).
   - Various government and political leaders proposed various bailout plans along the way, starting first for subprime lenders and borrowers (March-January 2007) then larger banks and financial institutions (August-October 2008).
   - The Fed took over Fannie Mae and Freddie Mac and provided an emergency loan to insurance giant AIG (Sept 2008).
   - Congress passed the Emergency Economic Stabilization Act of 2008 (October 2008), a “bailout” plan which authorized the government to spend up to $700 billion to buy troubled assets and mortgage-backed securities from banks. $250 billion was made immediately available.

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4. Answers will vary. Students may mention preventive measures (better lending practices) or better financial market regulation. Many people would love to know how to anticipate or predict bubbles and bursts. In general, “timing the market” is incredibly difficult—perhaps even impossible—and financial advisors warn against it. This doesn’t stop people from trying. Some people did spot trouble ahead for housing (and all bubbles eventually burst), but no one predicted how widespread the impact would be.

5. Answers will vary. Financial bailouts are an example of the “moral hazard” problem: the idea that someone insulated from risk (or who can expect rescue) may behave differently than if fully exposed to that risk. Some people argue that the current crisis is an example of a moral hazard chain, in which every link could pass the risk along to someone else (borrowers > brokers > banks > investment banks and investors > bailouts paid by taxpayers). See if students can identify other moral hazard situations, e.g., car insurance (with deductibles), having dental insurance or not having it, skiing down an expert trail with health insurance or without.

Worksheet 3: Panics of the Past
Answers will vary depending on the crisis researched.

Worksheet 4: Comparing and Contrasting Crises
Answers will vary but should include some of the following:

1. Commonalities
   - Speculation or risky investments
   - Rapid rises in demand for and value of a product or company
   - New technology or new opportunity (land, resources)
   - Several involve a lead person or speculator who is well-connected and draws others into the venture.

Differences
   - The amount of “contagion”—how far the crisis spreads across financial institutions and countries
   - Whether or not a recession or depression follows the crisis
   - The amount of financial protection available (The FDIC, which insures deposits, was created in 1933.)
   - Amount of government regulation or intervention; the power of central authorities and/or the central bank (The United States has sometimes had a central bank and sometimes not. The Fed was only created in 1913.)

2. It can sometimes be difficult to know whether fear or real economic issues are driving the situation.
   - Fear played a big role in earlier crises, especially when the crisis involved bank stability and people stood to lose everything (no deposit insurance).
   - People should have been more afraid—less eager to sign on for loans they couldn’t afford, less eager to extend their credit.

3. Speculation is always happening and generally plays a valuable role. It allows people with new ideas or innovative products or services to raise the money they need to build their business. Anything new or bold is risky.

4. Answers will vary. This debate is at the heart of many economic and political philosophies.

5. Answers will vary. In the United States, many units of government can influence financial markets, e.g., The Fed (interest rates), Congress and the Executive Branch (economic stimulus packages, financial regulations). Rarely do they intervene as directly as they have during the current crisis. Often, during and after a crisis, important financial policies are established, such as the creation of the Federal Reserve System, deposit insurance (FDIC), and industry regulation.

6. Similarities
   - Leaders play an important role.
   - Rising prices, cheap credit, increasing debt
   - Even if there are signs that a bubble is about to deflate or pop, it is very difficult to recognize the full extent of the problem or predict how bad things will get.
   - A lot of mistrust and fear; faith lost in financial institutions, the market, government, and other leaders

Differences
   - Financial investments and systems are more complex and interconnected.
   - People are much more involved in the stock market today (retirement funds, stock trading sites, etc.).
   - We have immediate access to a variety of local, national, and global media sources. This might help calm us or spread panic.