

## The U.S. Subprime Mortgage Crisis: Credit Crunch and Global Financial Meltdown

Shalendra D Sharma

What began in mid-2008 as a downturn in the U.S. housing market soon plunged the world economy in the worst financial crisis since the Great Depression. In response, governments and central banks have been forced to bailout failing and failed financial institutions -- directly through capital infusions and indirectly by providing a wide array of liquidity facilities and guarantees. Why did a seemingly localized problem set off a global financial meltdown? Financial institutions around the world by purchasing over a trillion dollars of complex mortgage-backed securities, especially the so-called subprime loans based on inflated real-estate values made themselves extremely vulnerable to market sentiments. When house prices fell and subprime mortgage defaults increased, a credit crunch ensued and quickly spread. These developments in turn led to bank failures and sharp increases in the spreads on funds in interbank markets, and into a global crisis. While over the short-term providing liquidity to the markets is essential, over the long-term recovery of the housing market is critical.

The months of August and September 2008 will forever be known for the economic tsunami on Wall Street. September 7 witnessed the collapse of the venerable "models" of mortgage finance -- the government-sponsored enterprises Fannie Mae and Freddie Mac -- which were placed into conservatorship in the hopes of stabilizing the housing and mortgage finance markets. September 15 saw the collapse of the 154 year-old Lehman Brothers and the fire-sale of the investment-bank and stock-market "Bull" Merrill Lynch to Bank of America.<sup>1</sup> On 16 September the insurance giant, American International Group (AIG, the nation's largest insurer) received a large bailout totalling \$85 billion in the form of an emergency credit line from the Federal Reserve to facilitate an orderly downsizing of the company. By the second week of September, funding markets had come to a virtual standstill in the United States (and many other countries), with bank funding markets essentially ceasing to function at terms longer than overnight. Moreover, corporate bond spreads widened to all-time highs, equity markets experienced sharp declines, and foreign exchange volatility increased sharply. Finally on September 19, the "hands-off" U.S. Treasury Secretary Hank Paulson and the Bush administration finally woke-up to the spiralling financial

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Shalendra D. Sharma, Professor, Department of Politics, University of San Francisco, St. Ignatius Institute, 2130 Fulton Street, San Francisco, CA 94117-1080, USA, Email: sharmas@usfca.edu

<sup>1</sup> Lehman Brothers had survived the American Civil War, two World Wars, and the Great Depression. Its collapse was the largest corporate bankruptcy in world history. Merrill Lynch was acquired by Bank of America for \$50 billion. In 2007, it was valued at \$100 billion.