

## Primary Causes of the Ongoing Recession and Economic and Jobs Crises

(Updated June 02, 2010)

This document outlines the primary causes of the ongoing economic, jobs, banking, stock market, financial crises and the primary reasons the current actions by the government are not helping.

### A. PRIMARY CAUSES OF THE ONGOING ECONOMIC CRISIS

The primary causes of the ongoing economic crisis includes:

1. **Wide spread trading of mortgage backed securities and other derivatives**, that contributes nothing to the real economy instead of finding funds for the production and services economies,. Selling a single mortgage or bundling them into securities and then selling and reselling them takes funds from the true economy, is illogical and immoral and was and still should be illegal. Mortgages change in value continually as interest and taxes accrue, jobs are lost, children are born and payments are made or not made.

The Bank of International Settlements in Switzerland reports that the current notional (vague or general) value of derivatives<sup>1</sup> held by the world's financial institutions is \$1,140 trillion which is over 16 times the annual gross domestic product of the entire world. According to the Comptroller of the Currency, the books of U.S. banks now carry over \$180 trillion of derivatives. Obviously, these derivatives are not worth nearly their book value and they in general become worth less each day.

Derivatives are often called "toxic or troubled assets" if they are not worth as much as financial institution show that they are worth on their books. Since assets minus liabilities equals net worth, the actual value of the derivatives determines if the financial institution is solvent or not and whether or not the financial institution should be restructured or remain in business.

It is estimated that the actual value of derivatives in U. S. financial institutions are worth several hundred trillion dollars less than their value as listed on the financial institutions' books. Obviously many of the largest banks are bankrupt and have been, and are concealing this bankruptcy by listing these assets on their books at prices that are far above their market value. Current laws and regulations require that books show actual value of assets and liabilities and that insolvent financial institutions be seized and restructured. This was not done.

Trading derivatives which does nothing for the real economy, were rightfully outlawed by New Deal legislation. On December 14, 2000, Senator Phil Gramm, supported by then Fed Chairman Alan Greenspan, then Treasury Secretary Larry Summers and others, attached a 262 page amendment, that deregulated trading of derivatives and credit default swaps, to an omnibus appropriations bill. The amendment was never debated by the House or Senate and by-passed the substantive policy committees in

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<sup>1</sup> Derivative are so named because they derive their value from something else. For example the value of a mortgage backed security value is derived from the value of the mortgages that were packaged together to create it. Five articles by Steve Brandt provide excellent layman's descriptions of mortgages, mortgage base securities, derivatives, deregulation, lobbying, campaign contributions, earmarks, and pork barrel spending. <http://www.sanjuanislander.com/columns/brandt/part-1.shtml>

both the House and the Senate so that there were neither hearings nor opportunities for recorded committee votes.

This and other laws passed by Congress unleashed the now worldwide derivatives market and opened the door to an explosion of new, unregulated securities. Banks and Wall Street, instead of investing in companies engaged in manufacturing, began investing in mortgages backed securities and other derivatives.

Gramm's amendment also contained a provision lobbied for by Enron, a generous contributor to Gramm that exempted energy trading from regulatory oversight, allowing Enron to run rampant, wreck the California electricity market, and cost consumers billions before it collapsed.

Our legislators, government executives and regulators blamed it on a "few bad apples" and did nothing, and are not planning to do anything constructive.

## **2. Widespread fraudulent practices in the origination of mortgages and in the trading of derivatives.**

a. John R. Talbott, best selling author of 2003's "The Coming Crash in the Housing Market" said on FOX News in July, 2008 that:

i. "The current housing, mortgage and banking crisis was a vast criminal enterprise.

ii. Realtors were pushing homes on people they couldn't afford solely to garner the commission.

iii. Appraisers were inflating appraisals beyond reasonableness just to win business.

iv. Mortgage brokers were altering applications to change stated incomes to justify too much lending to home buyers.

v. More importantly, banks and investment banks were packaging and selling mortgages as high quality investments that they knew faced severe risk of default in a market downturn.

vi. The investment banks were paying supposedly independent rating agencies to provide AAA ratings to the packaged mortgages. And finally:

vii. The banks and investment banks were spending over \$400 million annually in lobbying expenses and much more in campaign contributions to "bribe" our congressmen and president so that their illegal activities would continue unregulated and unenforced.

viii. Trillions of dollars of losses have resulted and the housing market is still only about halfway through its inevitable decline. Talbott sees home prices declining as much as 25% nationwide and more than 50% on the coasts and in Las Vegas and Phoenix. [Please note that These remarks were made in July 2008]"

b. FBI Deputy Director John Pistole and Acting Assistant Atty. Gen. Rita Glavin are quoted in a news article as saying in testimony before the Senate Judiciary Committee that:

i. *Mortgage fraud and other types of **corporate criminal behavior** has contributed to the economic tailspin.*

ii. *They already have more than 2,300 open investigations into suspected illegal financial activity -- including 38 probes specifically linked to the crisis.*

iii. *Investigations are already straining the resources of the FBI and the*

iv. They expected the number of major investigations to rise into the many hundreds, focusing on big-name companies that "everybody knows about," and to be similar in scope and complexity to the massive probe of energy company Enron Corp. after its collapse in 2001.

3. The majority of the people of the world are not purchasing because they are not earning enough to live on, have essentially no savings and are mostly deep in debt. Reasons for this include:

a. Lack of employment opportunities at living wages due to:

i. Failure of many businessmen to share revenues realized from increases in productivity, automation and technology with their workers.

ii. **Outsourcing of jobs**

iii. Mergers that have eliminated many businesses and small retail banks and resulted in the layoffs of millions of people.

b. Predatory lending, compound usury interest rates and late fees.

c. Regressive taxes that take funds out of the hands of the poor and middle economic classes and lessen the tax burden on the wealthy.

4. Corporation and individuals' offshore tax havens that shelter hundreds of billions of dollars. (<http://www.afterdowningstreet.org/node/41091>)

5. Funds wasted on wars, occupations, pork barrel, earmarks, unnecessary offensive weapon systems, a huge standing army deployed around the world, overseas bases and foreign military aid and campaign contributions

6. Many senior executives<sup>2</sup> of the financial communities and government officials have lost sight of the **true purposes of capitalism**:

a. **to provide a source of capital for worthwhile businesses**

b. **to provide investment opportunities**

7. These executives have also helped to create and taken advantages of **Key Structural Flaws in the Financial System**. James Crotty and Gerald Epstein, in their article **Proposals for Effectively Regulating the U.S. Financial System**<sup>3</sup>, outline key structural flaws of the "*New Financial Architecture*" – or *NFA* - *to represent the basic institutions and practices of today's lightly regulated financial system*.

a. *First, support for light regulation of commercial banks, even lighter regulation of investment banks, and little if any regulation of the "shadow banking system"- hedge and private equity funds and the bank-created Special Investment Vehicles (SIVs) that contributed significantly to the creation of the crisis.*

b. *Second, the current financial system is riddled with perverse incentives*

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<sup>2</sup> It is important to distinguish between business executives and their firms. Firms do not make decisions or commit good deeds or crimes, their leaders do. Also corporation executives are responsible for and to the employees of their firm.

<sup>3</sup> Proposals for **Effectively Regulating the U.S. Financial System** to Avoid Yet Another Meltdown by James Crotty and Gerald Epstein, Department of Economics and Political Economy Research Institute (PERI), University of Massachusetts, Amherst, October 7, 2008. [http://www.peri.umass.edu/fileadmin/pdf/working\\_papers/working\\_papers\\_151-200/WP181.pdf](http://www.peri.umass.edu/fileadmin/pdf/working_papers/working_papers_151-200/WP181.pdf)

c. *Third, the commonly accepted view was that banks were no longer risky because they sold loans to capital markets (the new 'originate and distribute' model of banking) and hedged whatever risk remained through credit default swaps. Both these propositions turned out to be myths.*

d. *Fourth, financial innovation has proceeded to the point where important structured financial instruments such as mortgage backed securities and collateralized debt obligations (CDOs) are so complex and so opaque that they are inherently non-transparent.*

e. *Fifth, the NFA created and widely distributed extraordinary levels of risk, while structured financial instruments re-concentrated risk segments in astoundingly complex ways. And securitization and funding via global capital markets created channels of contagion in which problems originating in one location (the US subprime mortgage market) spread throughout the world, triggering a systemic crisis.*

f. *Sixth, in the NFA banks were allowed to hold risky securities off their balance sheets, with no capital required to support them.*

g. *Seventh, giant financial conglomerates were allowed to become so large and complex that neither insiders nor outsiders could accurately evaluate their risk. i) Eighth, the structural flaws in the NFA created dangerous leverage throughout the financial system.*

h. Have exerted undue and sometime unlawful influence over members of Congress, the Administration and the Courts with bribes under the guise of campaign contributions and promises of jobs to eliminate and relax regulatory laws and regulations

*The finance industry has effectively captured our government. ... recovery will fail unless we break the financial oligarchy that is blocking essential reform. And if we are to prevent a true depression, we're running out of time. Simon Johnson*

## **8. In return for campaign contributions and high-paying jobs Congress has eliminated and relaxed regulatory laws and regulations<sup>4</sup> including:**

a. **Truth in Lending Act “Reform”** (Sept. 30, 1995) Eased regulations on creditors. This bill was powered through by Rep. Bill McCollum (R-FL), a key recipient of finance, insurance, and real estate (FIRE) donations (\$136,000 in 1993-94).”

b. **Gramm-Leach-Bliley Act** (1999) A bank deregulation bill that undermined the Glass-Steagall Act by allowing commercial and retail banks to engage in investment activities, speculative trading and mergers opening up competition among banks, securities companies and insurance companies. It passed the Senate 90-8 and was signed by President Clinton. It led to a wave of megamergers “too big to fail.’ The driving force was Sen. Phil Gramm (R-TX) who had received \$4.6 million from the FIRE sector over the previous decade.

c. **Commodity Futures Modernization Act (Dec. 14, 2000).** Sen. Gramm attached a 262 page amendment that deregulated derivatives and credit default swaps trading to an omnibus appropriations bill just prior to the Christmas holiday in December of 2000. Gramm's amendment was supported by then Fed Chairman Alan Greenspan and then Treasury Secretary Larry Summers. The amendment was never debated by the House or Senate and by-passed the substantive policy committees in both the House and the Senate so that there were neither hearings nor opportunities for

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<sup>4</sup> Many of the items listed here are paraphrased from the document: [The Economic Crisis: Supplement to Undoing the Bush/Cheney Legacy: A Tool Kit for Congress](#)

recorded committee votes. This law unleashed the derivatives market, paved the way for banks to become more aggressive about investing in mortgages, and opened the door to an explosion in new, unregulated securities. The amendment also contained a provision lobbied for by Enron, a generous contributor to Gramm that exempted energy trading from regulatory oversight, allowing Enron to run rampant, wreck the California electricity market, and cost consumers billions before it collapsed.

d. **American Home Ownership and Economic Opportunity Act** (Dec. 27, 2000). This act makes it harder for consumers to get out of lender-required insurance.

e. **Bankruptcy Abuse Prevention and Consumer Protection Act** (April 20, 2005) The act makes it harder for consumers (but not businesses) to discharge debts. The strict means test that would force more debtors to file under Chapter 13 (under which a percentage of debts must be paid over a period of 3-5 years) as opposed to Chapter 7 (under which debts are paid only out of existing assets), the additional penalties and responsibilities the bill placed on debtors, and the bill's many provisions favorable to credit card companies.

f. **Suspension of the uptick rule** that required that short sale transactions be entered at prices that are higher than the price of the previous trade. This rule prevents short sellers from adding to the downward momentum when the price of an asset is already experiencing sharp declines.

g. Regulation that allowed **reduced margin and position limits** for speculators.

h. Laws and regulations regarding **lobbying, campaign contributions, earmarks, pork, revolving doors, government contracting, trusts/monopolies and the ethics of members and their staffs.**

9. Unsatisfactory oversight and supervision by regulatory authorities, federal and state attorneys, the Justice Department, Congress and the administration.

10. **The abject failure of the Federal Reserve System** to come even close to meeting its goals of **maximum employment, stable prices, and moderate long-term interest rates** as required by the **Federal Reserve Act**. About the time Mr. Ben Bernanke became its chairman, the Fed, raised the prime rate a total of 4.75%. This caused mortgages, government small business loans, other loans and credit cards tied to the prime rate to increase by the same amount and contributed to the home mortgage crisis and the economic crisis. Too many of the managers in the Federal Reserve are acting in the interest of investment bankers and Wall Street, not in the interest of the people of the United States.

11. **The Unconstitutional Federal Reserve Act of 1913 which unlawfully turned key Powers of Congress over to the Federal Reserve System, a private concern.** The Constitution states: "*The Congress shall have the Power..... To coin money, regulate the Value thereof ...*" and "*No money shall be drawn from the treasury, but in consequence of appropriations made by law.*" The Constitution does not give Congress the authority to delegate the printing of money or to appropriate funds to the Federal Reserve.

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