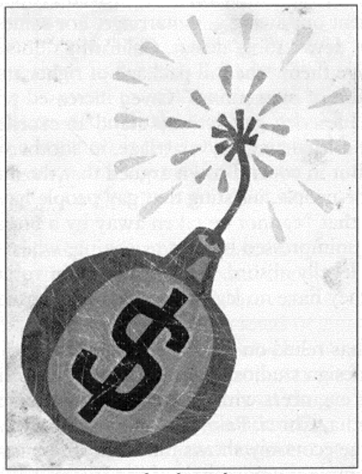
NAME____ Class Period _____

ECONOMICS
HOMEWORK ASSIGNMENTS
DUE FRIDAY, MAY 22, 2009

I. The Toxic Debt Tsunami

Trillions of dollars in bad debt have brought the financial system to its knees, choking off lending and leaving major banks on life-support. How can this toxic mess be cleaned up?

What is toxic debt?
It's a catchall term for the trillions of dollars of bad loans that are at the heart of the global economic meltdown. The term originally referred to bonds backed by mortgages granted to dubious, "subprime" borrowers. Now, though, it extends to bonds backed by a wide array of bad loans—auto loans, credit card debt, student loans, commercial mortgages, even aircraft leases. The buyers of those bonds—banks, insurance companies, hedge funds, pension funds, and other institutional investors—expected them to throw off large amounts of cash every month. But the bonds are generating much less cash than investors expected, causing massive losses and resulting in a crippling credit crunch affecting virtually everyone.


Mediabakery

Now in a bank vault near you

How much toxic debt is out there?
Amazingly, nobody really knows for sure. The vast majority of the toxic securities were bought and sold in private transactions beyond the reach of regulators. And the securities themselves were dizzyingly complex. They consisted of bonds backed by hundreds or thousands of mortgages, which were then often combined with *other* mortgage-backed bonds and other debt into super-sized securities called collateralized debt obligations. Financial institutions bought these toxin-laced CDOs for their own accounts or for clients, with the ultimate owners disappearing behind a web of bank-secrecy laws. "No one knows where the toxic debt is buried," says University of Oregon political scientist John Foster.

Why is that such a problem?
Since nobody knows exactly where the toxic bombs are lurking, the system has virtually ground to a halt. The world's financial institutions have stopped lending to other institutions, fearing those would-be borrowers are so tainted by toxic debt that they would be unable to pay their loans. The International Monetary Fund estimates that investors worldwide are sitting on \$2.2 trillion in toxic debt. But other estimates are far higher, including one that leaked from a recent meeting of European finance ministers. The estimate—\$16.3 trillion—left the assembled ministers "ashen-faced," according to one participant. That's because the figure is more than the annual economic output of the European Union or the U.S.—raising the fear that the debt could overwhelm not just banks but the governments trying to bail them out.

Are these securities worth *anything*?
Yes, but again, no one knows how much. In fact, disputes about pricing have paralyzed the federal TARP program, which was supposed to solve the problem of toxic debt by having the government buy it from banks. Some institutions, though, have attempted to place a value on toxic debt. JPMorgan Chase recently examined \$450 billion in mortgage-backed securities issued by various institutions between 2005 and 2007. It determined that *\$305 billion* of those mortgages were already in default. Worse, the amount that investors recovered from those defaulted loans ranged from only 5 cents to 32 cents on the dollar. A similar examination last year found that investors recovered 44 cents on the dollar. So not only is the debt toxic, "it's getting more toxic by the minute," says economist Nouriel Roubini, whose ultra-gloomy predictions about the financial crisis keep coming true.

Why is there so much of it?
Because for most of the past decade, too much money was chasing too few borrowers, leading to a decline in lending standards. In 2001, in response to the dot-com meltdown, the Federal Reserve flooded the financial system with money, cutting short-term interest rates to 1 percent and keeping them there for more than a year. Banks borrowed cheaply from the Fed and lent the money at a higher rate to millions of home buyers and other consumers. Then firms such as Lehman Brothers (now defunct), Bear Stearns (now defunct), and Merrill Lynch (now owned by Bank of America), bundled the loans into CDOs—more than \$550 billion in 2006 alone. The firms kept some of the bonds for themselves and sold the rest to investors, who snapped them up, drawn by the prospect of steady, above-average returns with minimal risk. Those investors believed there was no chance the bonds could go bad—a belief encouraged by Wall Street. Investors "wanted the high yield, so Wall Street sold it to them," said Chriss Street, who manages money for Orange County, Calif. "They put lipstick on a pig."

Why they didn't see it coming
Financial firms have spent billions of dollars on technology for managing risk. So why didn't they recognize the risk posed by subprime mortgages and other forms of toxic debt? The answer involves the mathematical models the firms used to predict the behavior of the housing market. Those models were based on recent historical data, which seemed to prove that house prices could go in only one direction—up—and that even subprime borrowers rarely defaulted. But recent history was a highly misleading guide. Never before had housing prices risen so far, so quickly as they did in the first years of this decade, and never before had so many unqualified borrowers obtained mortgages. Among the firms that fell into this death trap was the giant insurer AIG, which sold protection against mortgage defaults. Because AIG assumed that few mortgages would default even in the worst-case scenario, it didn't set aside money to pay claims on the \$500 billion in protection it sold. AIG is now nearly insolvent—and 80 percent owned by the federal government.

Can the toxic mess be cleaned up?
Not easily. Most experts believe the cleanup can't begin until banks and other investors disclose their holdings of toxic debt, a move they have resisted until now. The so-called bank stress test announced recently by the Treasury Department could force the banks to 'fess up. Federal examiners are now in the process of analyzing bank assets, including toxic debt, and trying to figure out what will happen to them if the economy continues to deteriorate. In theory, the government would then seize the most vulnerable banks. But a growing chorus says that it's too late for tests and that the U.S. should simply take over at-risk banks. Under temporary federal ownership, the government would segregate the toxic holdings, and without the burden and distraction of the bad debt, the banks could get back to collecting deposits and making loans. "Of course, the economy would still stink," Roubini says, "but the death spiral we are in could end."

THE WEEK March 20, 2009

II. Questions

Answer the following questions on a separate sheet of loose-leaf paper using the article on the first page.

1. Define dubious using a dictionary or an Internet resource.
2. What types of loans are turning bad on the institutional investors that bought them?
3. How much toxic debt is out there?
4. What is happening to the value of the toxic debt?
5. What did the Federal Reserve do to increase the supply of money after the dot-com meltdown?
6. What should the government to help the economy recover from this bad debt problem?
7. What was AIG's role in this mess?

III. Political Cartoon

IV. Questions

Answer the following questions on a separate sheet of loose-leaf paper using the cartoon above.

1. Who is the guy on that big creature, and what does he intend to do?
2. What is that big creature, and what does it represent?
3. What point is the cartoonist trying to make about the mortgage crisis? Make sure you explain the metaphors in the image.