

What Caused the Panic of 2008?

While the financial crisis had been going on for more than a year, it suddenly worsened into a full-fledged sell-off in the fall of 2008. The S&P 500 Index fell from 1,255 on September 19 to 899 on October 10, a decline of 28 percent in three weeks, a staggering loss for many people. Some call it the Panic of 2008.

What caused the panic? Many argued it was the decision by the U.S. government not to intervene to prevent the bankruptcy of a financial institution, Lehman Brothers, which then led to expectations of more failures and instability. However an examination of the timing of stock price movements shows that the answer is more complicated. The figure in this box focuses on a few key dates and events, including the panic itself, which is marked with the brackets.

Monday, September 15, is the day that Lehman declared bankruptcy after learning over the previous weekend that the government would not provide funds to pay its creditors and keep it open. You can see that the stock market moved down a bit, but it then bounced back up on September 16. By the end of the week the S&P 500 was virtually the same as it was one week earlier, so the decision to let Lehman Brothers go bankrupt was not apparently what caused the panic. But if not, then what was the cause?

On Friday of that same week, the U.S. Treasury announced that it was going to propose a large rescue package for the entire U.S. banking system, though the size and details were not determined. During the weekend the package was put together, and on Tuesday, September 23, Federal Reserve Board Chairman Ben Bernanke and Treasury Secretary Henry Paulson testified in the Senate about the package, which they called the Troubled Assets Relief Program (TARP). They said it would be enormous, \$700 billion, yet provided very few details and made no mention of oversight or restrictions on the use. They were questioned intensely and the reaction was quite negative. A large volume of critical mail was received by members of Congress.

As shown in the figure, it was following this poorly received testimony that the crisis seriously deepened, as measured by the sharp fall in the stock market for the next three weeks. It is plausible that events around September 23 increased risks and drove the markets down, including the realization by the public that the intervention plan had not been fully thought through and that conditions were much worse than many had been led to believe. A great deal of uncertainty about what the government would do to aid financial institutions, and under what circumstances, was revealed. Such uncertainty would have driven up risk and thereby driven the market down. Clarity about the TARP improved on October 13 when the government announced it would buy shares in banks with the TARP money. The panic ended at that time.

