Recession And Fraud: The History Of The Modern American Economy

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ABSTRACT

In this paper, I will delve into the root causes of both large-scale economic recessions and details of prolific fraud cases in history. Based on this information, I will also explore the consequences of these events, specifically how large groups of people were harmed by fraudulent actions and reckless economic trends. In prolific fraud scandals such as the Bernard L. Madoff Investment Securities LLC, the largest Ponzi scheme in history, and the fraudulent actions of Enron and FTX, illegal behavior was used to manipulate systems to make money and subsequently harm thousands of people. Additionally, in large-scale recessions such as the ones seen in 1929 and 2008, reckless behavior over several decades resulted in major crashes that left millions desolate. Across all events, reckless and fraudulent actions in different ways resulted in prolific collapses that harmed large groups of people, and this paper will draw similarities between the causes and consequences of each.

Keywords: fraud, economy, recession, mortgage-backed securities, public holding companies, market-to-market accounting, economic bubble

1. INTRODUCTION

The modern American economy has been on a general increase in the last century, but in that time, it has been riddled with crashes, recessions, and numerous exploitations. Reckless behavior has continuously manipulated the modern stock market, leading to catastrophic events that harmed countless people. This is exemplified in the historic crash of 1929 that caused the Great Depression of the 1930s and 40s, the 2008 Great Recession, and prolific fraud cases such as the Bernard L. Madoff Investment Securities LLC, the largest Ponzi scheme in history, and the fraudulent actions of Enron and FTX in the last 25 years. All of these events are characterized by reckless actions and exploitation of the economy, directly leading to macroeconomic impacts as well as harm done to the livelihood of countless Americans. These prolific collapses and fraud cases are all inadvertently connected, and the common theme between them all can be applied to the current state of the American economy. This paper will explore the similarities and differences in the causes and consequences of these modern economic events.

2. DISCUSSION

2.1 1929 Crash

The years leading up to the 1929 crash were defined by staggering economic growth, hiding the true instability and chaotic nature of the market. Between August 1921 and September 1929, the Dow Jones Industrial Average (DJIA) increased from 63.9 to 381. This growth defined the Roaring 20s, but it was also an illusion of stability within the American economy. This rapid growth in the 1920s was a result of many things, but a prominent factor was the expanding trend of margin buying, investment trusts, and public holding companies (Williams, 2024). These companies would be loaned money from the public to invest, and they were investing in companies with money that did not belong to them, thus inflating stocks beyond their actual

value. Additionally, the money was often being invested very recklessly and speculatively, thereby creating debt among the public. An economic bubble was created as a result, and the federal government had to combat it. The Federal Reserve tightened credit to counter the amounts of debt that investment trusts often created, and the discount rate was raised from 5 to 6 percent (Pells et al., n.d.). On October 24th, 1929, the DJIA dropped to 299, leading to even more panic selling by the public. On the 29th, the market closed at 198 (Pells et al., n.d.). What followed was a historic collapse that threw the world into the widespread Great Depression. By the 1930s, stocks had lost 90 percent of their value, and unemployment across both the United States and the world skyrocketed (Williams, 2024).

The crash of October 1929 resulted in the famous Great Depression. Unemployment skyrocketed, and the American economy was at an all-time low. The downturn began as a recession in 1929, but continued for several years, thus creating a depression. Industrial production in the United States declined by 47 percent and the gross domestic product (GDP) fell by 30 percent (Pells et al., n.d.). The unemployment rate in the United States surpassed 20 percent, and the economic downturn was not limited to just the American economy. The Great Depression caused economic decline across Europe and is widely cited as a cause for the rise of totalitarian governments in the time period. After the October 1929 crash, faith in the economic system was destroyed, and the unemployment rates did not help. Additionally, the worst drought in modern American history occurred in 1934, making life even harder for Americans (Pells et al., n.d.). As a result of unemployment and lack of production, consumer spending fell from almost $80 billion in the 1920s to just $45 billion by 1933 (Lefebvre et al., 2020). The DJIA did not fully recover from the historic collapse until 1954 (Williams, 2024). The extent of this crash would not be experienced again until the Great Recession in the late 2000s, when the housing market crumbled and left the American economy in disarray.

2.2 Great Recession

The financial collapse of 2008 was the culmination of recklessness, lack of regulation, and a major economic bubble that ultimately resulted in a major recession and harmed countless people across the world. The recession was caused by the collapse of the American housing market in the late 2000s. The crash resulted from banks and insurance companies unknowingly investing in a fraudulent and unstable market. For decades, the housing market was seen as a low-risk low-return way to invest because of the general reliability of housing payments. Mortgage-backed securities (MBSs) are bonds based on the reliability of mortgage payments and sold to investors. MBSs were a trustworthy way for banks to make money in addition to insurance companies selling credit default swaps (CDSs). The housing market that all of this was based on, however, became increasingly more unstable in the 2000s with the rise of subprime mortgages. These mortgages were extremely easy to obtain, and they were often offered to people with low credit scores who were not able to make payments. The mortgages involved minimal down payments and began with small monthly payments to entice the borrower, who did not understand the complexity of their agreement (Duggan, 2023). Said complexity was a result of the mortgage agreements being adjustable-rate mortgages (ARMs), meaning they could change based on economic climate and the federal interest rate (Duggan, 2023). In the late 2000s, the federal funds rate was raised from 1 to 5.25 percent and coincided with subprime mortgage lenders such as IndyMac collapsing, resulting in a wave of foreclosures on mortgages (Williams, 2024). With the lack of payments going into subprime mortgages,

MBSs lost all of their value. Banks and other investors were losing money quickly, and insurance companies that were selling CDSs had to pay out billions of dollars (Dugga,n 2023). On September 15th, 2008, Lehman Brothers went bankrupt after owing $613 billion from its investments in subprime mortgages, and the US government bailed out the insurance company AIG the next day (Williams, 2024). On September 29th, 2008, congress was unable to pass a bailout bill, causing the market to fall 777.68 points. By March 2009, the DJIA closed at 6926 points, less than half of the value of its pre-recession high (Williams, 2024).

What resulted after the crash of the housing market was an 18-month recession, where financial institutions had to be restored by the Federal Reserve, and an economic downturn spread across the world. American unemployment rates, particularly long-term unemployment, skyrocketed following the housing market crash. During the recession's peak, unemployment had risen to 10 percent, over double the pre-recession rate of below 5 percent (Weinberg, 2023). In 2008 alone, the collapse of the subprime mortgages caused 3.1 million people to file for foreclosure. As a result of the unemployment and wave of foreclosures, around 10 million Americans were displaced from their homes (Boyle et al., 2021). The recession expanded past American borders, heavily impacting Western Europe as well as other countries across the globe. Countries like Spain, Greece, and others underwent significant debt crises that required intervention from the European Union. The recession saw specific social groups being hit the hardest. For example, job prospects for the young population were diminished for several years, and levels of student debt increased drastically. The wealth deficit became greater among socioeconomic classes, as the richest households in the U.S. recovered sooner and saw their share of the total wealth increase by 7 percent (Duignan, n.d.).

2.3 Bernie Madoff

Bernard L. Madoff Investment Securities LLC and the man who created it became one of the most infamous fraud cases in American history. Bernie Madoff and his investment advisory company defrauded thousands of people of an estimated $65 billion over a course of 17 years (Hayes, 2024). Madoff's operation was a classic Ponzi scheme. Under the guise of an investment advisory company, Madoff really just paid existing customers with capital from new clients. He upheld this for at least 17 years in the 1990s and 2000s until it came crumbling down along with the American economy in 2008. During the housing crash, many clients wanted to withdraw money, but he was unable to meet the redemption payments because it wasn't a legitimate company (Hayes, 2024). Madoff confessed the fraud to his sons in December 2008 and was reported to authorities on December 11th, bringing an end to a fund that possessed an estimated $65 billion of essentially stolen money. Bernie Madoff pleaded guilty to securities fraud, money laundering, and much more, ultimately leading to a 150-year prison sentence and a forfeit of $170 billion. He died in 2021, and the victims of his scheme are still being paid back to this day.

The consequences of Madoff's crimes are straightforward. He profited billions of dollars off of lying and exploitation while countless people were harmed. Thousands of his investors lost their life savings, and the reparations remain incomplete (Hayes, 2024). As of December 2023, $4.2 billion has been distributed to 40,843 victims (Department of Justice, 2023). The Madoff victim fund has recovered an estimated 91 percent of investor losses over the past decade, but thousands of lives remain devastated by Bernard L. Madoff Investment Securities. Even people

who did not know him had their retirement funds and life savings completely drained. Steve Heimoff, for example, had a $2 million retirement nest egg with Stanley Chais, a fund manager in California. Unbeknownst to Heimoff, the fund he had entrusted his life savings with had financial ties to Madoff Investment securities, and when the scheme collapsed, so did Stanley Chais and Heimoff's savings (Zarroli, 2018). Heimoff is just one of the tens of thousands of people like him who had their lives devastated by the crimes of Bernie Madoff.

2.4 Enron

The Enron scandal was an infamous case of a once-renowned company crumbling as a result of its fraudulent practices and leaving thousands of lives ruined in the process. From the late 1980s to the 2000s, Enron had become one of the world's leading energy companies. The industry had been deregulated at the time, and they were ready to take advantage. In the 1990s, Jeff Skilling was appointed as head of Enron finance, and he transitioned the company to market-to-market (MTM) accounting. This method is generally a widely accepted and reliable practice where a company's value is based on assets and potential worth as opposed to physical dollars, but it can be easily manipulated. During the late 1990s, the Dotcom bubble was in full swing, and Enron did not want to miss its opportunity. The company had so many investments and new subsidiaries such as EnronOnline, so it could capitalize on the new economic trend. By the middle of 2000, EOL was conducting $350 billion in trades (Segal, 2024). When the bubble burst in the early 2000s, Enron was involved in the most volatile parts of the market as a result of its investments. However, the company was able to hide losses by manipulating the MTM accounting. Because MTM assesses a company based on market value as opposed to physical book value, Enron reported potential profits for a new asset immediately, even before it made money. If the asset failed to reach the reported profits, it would be transferred to a hidden subsidiary company. In this way, Enron could report profits without having any known losses. The company also utilized Special Purpose Vehicles to legally but quietly hide money away (Segal, 2024). In 2001, both Jeff Skilling and former CEO Kenneth Lay left the company. Enron reported its first quarterly loss and disclosed the use of Special Purpose Vehicles. As a result of pressure from the SEC, Enron restated its financial records and revealed that the company lost $591 million and had almost $700 million in debt in 2000 (Segal, 2024). The company declared bankruptcy in December of 2001 when its share prices reached 26 cents, as opposed to the $90 it was at during the company's peak.

Several members of the Enron board were convicted of fraud and conspiracy and forced to make payments to victims. Former CEO Kenneth Lay was found guilty of fraud and conspiracy, but he died before sentencing. CFO Anthony Fastow was found guilty of wire and securities fraud, and he served 5 years in prison after making a deal with the prosecution. Jeff Skilling was sentenced to 14 years in prison for fraud, conspiracy, and insider trading in addition to a $42 million payout for victims (Segal, 2024). During the collapse, Enron froze the retirement funds for thousands of employees, restricting them from selling stock to save themselves. An estimated $890 million was lost from employee retirement plans during the company's collapse (L.A Times, 2001). The employees were essentially forced to go down with the company as their 401ks were primarily Enron stock. This completely changed the fraud case. During the late 1990s, the company was making false reports to hide losses, but the fraud was then made public, and Enron forced its employees to suffer for the crimes of the company. Despite this,

both Jeff Skilling and Kenneth Lay profited $60 million and $145 million respectively in 2000 off of stock options as their company and employee's retirement funds collapsed (L.A Times, 2001).

2.5 FTX

This extent of high-profile fraud was seen again in 2022 during the widespread use of cryptocurrency. As crypto trading became increasingly popular in the late 2010s and early 2020s, exchanges were founded such as FTX and its competitor Binance. Among the founders of FTX was Sam Bankman-Fried, a young entrepreneur who sought to capitalize on the growing industry when he created his cryptocurrency exchange in 2019. For the several years that he was CEO, however, Bankman-Fried misappropriated billions of investor dollars for personal and business use, such as paying off debts for his sister company, Alameda Research (Department of Justice, 2024). This company was discovered in 2022 to have most of its assets be FTT, a token created and controlled by FTX. As a result, many investors wanted to withdraw their money from FTX. Binance announced that it was going to sell all $530 million worth of FTT tokens in its possession and FTX was soon looking at $6 billion of withdrawals. Amidst the liquidity crisis, FTX sought a bailout in November 2022 but ultimately filed for bankruptcy protection on November 11th (Reiff, 2024).

The company's collapse resulted in a full investigation by the Department of Justice, the Securities Exchange Commission, and the Commodity Futures Trading Commission. The aftermath of all of it consisted of multiple arrests, a stint of house arrest, and an ultimate 25-year prison sentence and $11 billion forfeit for Sam Bankman-Fried. He allegedly protected investor money on real estate ventures, political contributions, personal spending, and payments for Alameda Research. Financial reports were then falsified to erase evidence of wrongdoing (Department of Justice, 2024). Bankman-Fried was found guilty of wire fraud, commodities fraud, money laundering, and more on March 28th, 2024. In total, it's estimated that around 1 to 2 million FTX customers lost a collective $8 billion and investors lost another $1.7 billion as a result of the fraud (Helmore, 2024).

2.6 Significance

The 2 macroeconomic collapses were similar in that recklessness and irresponsible spending across the United States resulted in large economic bubbles, thereby causing massive recessions and downturns for people across the world. In 1929, the reckless behavior observed by investment trusts and similar companies massively inflated stocks beyond their true value, and when this backfired, millions of people were harmed. The nation's GDP plummeted, and unemployment inversely skyrocketed. Similarly, in 2008, the irresponsible investments made by banks and other institutions into the unstable housing market created a bubble that doubled the American unemployment rate and had massive impacts on the country as a whole. Both collapses saw their devastation expand into other countries, with 1929 spreading its influence so much, it caused a rise in totalitarian regimes in the interwar years. As for the late 2000s, countries in Europe saw their debt reach historic levels.

A consistent observation among many recessions and moments of downturn in modern economic events is the impact on income inequality in the United States. Interestingly, the recessions of 1929 and 2008 had completely different effects on this. During the 1910s, income inequality became a massive problem in the United States, resulting in the creation of federal

income tax in 1913. The Depression brought incomes down across all social classes, but it actually decreased the wealth disparities during the 1930s and 40s. Just before the crash, the top 1 percent in 1928 possessed 21 percent of the total wealth in the country, an outlandish amount (Johnston, 2023). In 1944, as the country recovered from the downturn, the top 1 percent saw their share decrease to only 11 percent (Johnston, 2023). This was largely due to policies such as the New Deal and other reforms aimed at stabilizing the American economy and supporting lower economic classes. In 2008, the opposite happened. The recession saw the upper classes recover faster and eventually start to prosper while the lower classes continued to suffer from the high unemployment rates and economic downturn. From 2009 to 2011, as the country was recovering from the collapse of the housing market, the top 7 percent in America saw their net worth rise 28 percent while the bottom 93 declined by 4 percent (Duignan, n.d.).

This idea of income inequality and large groups of people being harmed while others became rich is exaggerated in the prolific cases of fraud across the modern American economy. Even just a few years ago, millions of people’s excitement for a new commodity was stunted by executives who embezzled their money and ultimately harmed others' lives. For decades, Bernie Madoff made billions of dollars doing that exact thing. He capitalized on thousands of people’s trust and ultimately ruined their lives so that he could make more money. The executives of Enron profited tens to hundreds of millions of dollars from their lies at the tail end of the company’s lifespan. They capitalized on options derived from the false profits of assets while thousands of employees were forced to watch as their savings and retirement funds depleted. This idea of exploitation and harm being caused to countless people while the rich get richer is a repeated theme over the last hundred years and almost defines the American economy. Few events exemplify this more than the Bernie Madoff fraud scheme and the collapses of FTX and Enron in the 21st century.

3. CONCLUSION

Over the last hundred years, the economy has been defined by its booms, crashes, and scandals. While all events heavily differ from each other in their own ways, one common theme stands out. Some people are harmed, often having their lives ruined, and there are people who profit off of that. Even in a situation such as the 1929 Crash and the resulting Great Depression, where everyone lost, it was derived from a multitude of things, including large investment trusts losing other people’s money because of their own reckless behavior and greed. The aftermath of the Great Depression is unique in that income equality actually decreased because of the complete collapse of the economy. In almost every other instance, however, people were harmed while others profited from it. In 2008, people with lower income were exploited with subprime mortgages, resulting in a domino effect that led to a recession across the entire world. During this recession however, income inequality increased by a wide margin because higher economic classes were able to capitalize on the low prices of stock and real estate. This theme of winners and losers is exaggerated in modern scandals. The Bernie Madoff scheme, the falsified reports of Enron, and the recent collapse of FTX are all rooted in the same thing: people were exploited while the rich became richer. It sounds repetitive because that is the true nature of American economics. Situations like this happen time and time again and will continue to occur for the rest of time. While the United States and the concept of the “American Dream” are

defined by the idea where anyone can prosper, it is truly defined by the repeated themes of profiting off exploitation, and winners and losers.

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