Great Recession

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# Introduction

The Great Recession is the term used to describe the economic downturn during the late 2000s. It is considered to be the most severe downturn after the Great Depression and this term is used most commonly for the US recession which lasted from December 2007 to June 2009. The impacts of the Great Recession were in the form of the Global Recession of 2009. It initiated with the economic slump of the US housing market and it produced the worst economic outcome after the Great Depression. Great Recession is said to be caused by the collapse of 8 trillion-dollar housing bubble which ultimately led to the closure of the bigger insurance firms and banks such as Wall Street Journal and millions of Americans lost their homes. Many causes and reasons are attributed to this Great Recession. This paper seeks to answer what are the major drivers of Great Recession and what impact did they produced on the economy, lives of labors and households and how American government managed to overcome the aftermath of it. This paper will first highlight the major causes of the Great Recession, then it will cover the major consequences and the way American government dealt with recession. The paper will end with the concluding remarks.

# Cause 1: Deregulation

The financial crises were mainly a result of heavy deregulation in the industry which allowed banks a free hand to become involved in hedge fund trading. The banks traded in derivatives and then wanted higher mortgages to create profitable margins while trading in derivatives. For this purpose, they created loans that were interest-only and which were more affordable to the average borrower. The process of deregulation involves eliminating or reducing state or federal regulations on certain industries for the purpose of enhancing businesses. In this case, a regulation was removed which interfered with the businesses potential to compete with the overseas firm ("What Really Caused the Great Recession?" n.d.). Thus, the Glass-Steagall Act of 1933 was repealed by the Gramm-Leach-Bliley Act of 1999, which later came to be known as the ‘Financial Services Modernization Act’. The Act repealed earlier regulation allowing the banks to invest in derivatives by making use of deposits. It was ardently demanded by bank lobbyists who wanted to compete with foreign banks, promising only to invest in securities considered low risk in order to protect customers.

In the next year, another deregulation measure was introduced which exempted derivatives such as credit default swaps from regulation (Bentley, 2015). The Commodity Futures Modernization Act overrode previous state laws which had restricted the trade as a form of gambling. In particular, it exempted energy derivatives from being traded. The bill was advocated by the Chairman of the Senate Committee on Banking who became convinced by lobbyists from energy firms and agreed to endorse it. Moreover, his wife was a board member of Enron, a major lobbyist for the deregulatory measure. Furthermore, Senator’s election campaigns were funded by Enron earlier, who wanted to use their online futures exchanges program to trade in energy derivatives. Enron’s reasoning was that overseas firms were allowed to engage in foreign derivatives exchanges which gave them an unfair advantage over American firms.

# Cause 2: Growth of Subprime Mortgages

In 1989, the Community Reinvestment Act became increasingly enforced after the Financial Institutions Recovery, Reform and Enforcement Act were passed in 1989. The purpose of the Act was to restrict ‘redlining' of low-income neighborhoods by banks which had a negative impact on housing and led to the expansion of ghettos. After regulation, banks were graded and ranked according to their success in ‘greenlining' neighborhoods.

Moreover, the federal government had raised interest rates on subprime borrowers. Derivative products were welcomed by banks who were hit by the recession in 2001, leading the then Federal Reserve Chairman to lower the federal rates to 1.75%, and subsequently to 1.24% in 2002. Furthermore, interest rates were lowered on adjustable-rate mortgages, basing the rates on short-term bill yields from the treasury, that was in turn dependent on the fund's rate set by the federal government. This subsequently led to the overall payments becoming cheaper, however, this resulted in bank incomes falling which were mainly based on interest rates set on loans (Jagannathan, Kapoor, & Schaumburg, 2013). Consequently, those homeowners who found it difficult to afford conventional mortgages saw it as a relief as now interest-only loans could be approved. Resultantly, subprime mortgages saw a sharp increase between 2001 and 2006 from 10 to 20% of all mortgages and developed into a $1.3 trillion industry by 2007. The 2001 recession was ended by creating a secondary market and mortgage-based securities, yet it also led to the creation of an asset bubble within a few years. As the demand for mortgages increased, homebuilders struggled to keep up with the rising demand for housing which had sharply risen due to the availability of cheap loans or to invest in housing.

Those who had taken adjustable-rate loans did not realize that the rates would be revised within 3 to 5 years. The federal funds saw an increase of 2.25% by 2004 which rose to 5.2% by June 2006. As a result, a large number of homeowners had to make payments that they could not afford, especially because the rates increased quicker than they had previously. Moreover, housing prices started to fall rapidly during this time which prevented mortgage-holders from selling but who still had to make large amounts of payments. The bubble creating by the housing market started to bus and led to the recession.

# Cause 3: Market Instability

A number of factors were responsible for creating instability in the market. A primary factor was the creation of a new credit line which restricted money from flowing freely and subsequently slowed economic growth. In turn, the selling and buying of assets were reduced which hurt businesses, individuals and financial institutions ("What Caused the Financial Crisis & Recession?" n.d.). Many institutions ended up holding assets that were mortgage-backed but which dropped rapidly in value, and thus not generating enough revenue to pay back loans. In turn, this restricted their ability to credit and dried up their reserve cash. Another factor was the availability of cheaper loans that led many people to make investments based on speculation alone. There was more money flowing within the system which fuelled buying. However, investing in a single asset increased demand and let to inflation. Private equity firms had taken cheap loans to buy companies and generated billions of dollars by merely shuffling paperwork, yet not creating tangible assets. Further disrupting the market was increased speculation on oil prices which further contributed to inflation (Christiano, Eichenbaum, & Trabandt, 2015).

In addition, the high dependence of the American economy on credit leads it to be vulnerable to simple greed. Greed can lead to unchecked credit and make it out of control. In this case, mortgage brokers determined loans as middlemen and transferred the responsibility of those loans to others. It became common to engage in risky and exotic mortgages wherein the brokers absolved themselves of any risks when they sold assets backed by other mortgages as investments. Consequently, the loans that people had procured were higher than what they could hope to afford in the expectation that they could sell the house later to make a profit or refinance the house a at a lower rate later on, which would then be used as a leverage to buy another mortgaged based asset. In all this, the brokers made their cut and absolved themselves of any responsibility, however, the assets they had sold to others were financial time bombs.

# Economic Impacts

The global financial crises had hit the U.S. the hardest owing to a number of aforementioned factors. It was directly hit by the sub-prime mortgage market busting, however, the ensuing credit crunch and indirect repercussions of the financial crises also hit it badly (Federal Reserve Bank of San Francisco, 1970). By December 2007, the US economy had fallen deeply into recession and had shrunk by nearly 2.7% within a year. The contraction was generally smaller than other advanced G20 economies, nevertheless, the recession was the worst since the Second World War. The Recession had hit a lot of countries by the end of 2007 that mostly got exposed through trade and financial channels. Yet, countries such as India and China had managed to avoid a major fall despite their deep integration with the world’s economy. Some low-income countries such as Uganda and Ethiopia had managed to grow within the same time, thus the impact could not be termed as universal. It was middle-income countries, especially in Eastern and Central Europe that were impacted severely, which was a result of a culmination of different domestic and international factors. Those countries that suffered more significant shocks were countries like Latvia, Estonia, Lithuania, Ukraine, and Armenia which saw a decline as sharp as 14% in their GDP. The contractions were depression-like and observers could see many striking similarities between the 1930s Great Depression and the 2008-2009 financial Crises (“The Great Recession | Federal Reserve History,” n.d.). Latin America, in particular, had fallen into a deep contraction owing to its deeper association with the US economy. Mexico’s economy had undergone a contraction of nearly 7.1% in 2009, yet countries like Brazil still managed to sustain a 0.1% growth during the time (World Bank 2010). However, the slowing down of growth had dramatic implications for lower income countries in terms of poverty and government spending.

# Impacts on households

The effects of the Great Recession were worse globally, but the United States felt the effects of the downturn for so many years. American household lives were highly impacted in terms of affect and mood, home equity, spending, the housing market and expectations about the stock market. The survey conducted by a study reported that American households reduced their spending due to the financial crisis (Hurd & Rohwedder, 2010). The survey also aimed to obtain information about the impact of economic shocks and the reactions of households. It reported that one of the American households went through financial distress if one of the spouse was unemployed. Those having lower incomes also suffered from financial distress. Majority of the American households had negative home equity and it was the major impact of the Great Recession.

In addition, economic preparation for their retirement also got affected. People approaching retirement suffered from substantial losses and most of them lost their retirement and savings prior to the recovery in the stock market. Some of them had to face early retirement due to unemployment and young people would not reach their estimated level of lifetime earnings and they will also suffer from lack of resources in retirement. Household spending also reduced and reach its minimum in November 2009 (Hurd & Rohwedder, 2010). However, the study indicated that people have pessimistic with regard to their long-term expectations as compared to short-term expectations. Due to unemployment and the increasing loss of jobs, American household also faced some serious mental health issues. Continuous stress owing to financial crisis resulted in sleeplessness. Those who were employed in showed a better record of health as compared to those unemployed. Those who became unemployed also lost their health insurance which worsened the situation for them (Hurd & Rohwedder, 2010).

# Impacts on US labour market

The Great Recession marked with the severe Impacts on US labour market. Almost one in the five employees lost their jobs and they were not able to recover (Radio, Podcasts, Research, & America, n.d.). The generation of young people who were on the verge of entering the job market faced disruption at the beginning of their careers. This group of people continued to postpone getting houses, starting families. Great Recession was a very traumatic event and in order to survive people entered contract based jobs, temporary jobs because they were unsure of their future. The unemployment rate increased to about 7.4 % in December 2008. Unemployment is also observed to be one of the greater shocks among others. This downturn is considered a genuine deterioration in terms of labour market outcomes (Elsby, Hobijn, & Sahin, 2010).

The employment situation at the time of the Great Recession was most of the workers unemployed or looking for jobs, working for pay, or laid off temporarily. The substantial loss of income resulted in the people undertaking activities, such as getting support from extended family members. People took money out of their savings and strived to obtain unemployment benefits. Workers also suffered from the situation of failure to keep up the benefits, and lack of qualifications (Hurd & Rohwedder, 2010). Those who were able to keep their jobs and or were successful in getting a new job retired with a very small nest to rely on. Workers were able to build up less wealth and most of them retired in debt. According to the study by Elsby, the extension of Emergency Unemployment Compensation initiating in June 2008 will probably result in the long-term employment in recession (Elsby et al., 2010).

# How the American government dealt with the economic crisis

The United States government reacted to the Great Recession by implementing the most aggressive monetary and fiscal policies. A fabulous range of initiatives was taken by the Bush and Obama administrations and the Congress. The government set out to achieve two objectives, the first one to make the financial system calm and to mitigate the growing recession, finally moving towards economic growth. The Federal Reserve established new credit facilities to provide liquidity to the financial institutions. The rates of interest were decreased, adopting the policy of zero-interest rate. The FDIC also worked towards increasing the limits of deposit insurance. The Troubled Asset Relief Program was started in October 2008 to determine if the banks and financial institutions have enough amount of capital (Blinder & Zandi, 2010).

The American Recovery and Reinvestment Act was made in 2009, in addition, the nation's auto and housing industry were also rescued. TARP funds were used to help companies like GM, to recover from the crisis. The government steps were also accused of criticism, however, they were very helpful in recovering the economy. Such as the Capital Purchase Program gave a lifeline to various financial institutions. TARP also helped and protected the system to keep the financial institutions functioning. It also restructured the auto industry at the time when the closure of its activities could be a major economic blow. The financial and fiscal policies resulted in a great response and saved the economy from another depression. Another initiative taken by the government of OCED countries in addition to the United States was to increase social transfers. These social transfers are the way to expand government consumption, and the fiscal policy of the US government also seems to have the large increase in social transfers, which eventually resulted in a boost in the output and employment. (Oh & Reis, 2012).

# Conclusion

To sum up, the Great Recession most severe downturn after the Great Depression and this term are used most commonly for the US recession which lasted from December 2007 to June 2009. Market instability, deregulations of government policies and growth of subprime mortgages were the major causes of the great recession. The Great Recession produced negative impacts not only on the economy and life of households of the US but its impacts have been noticed globally. The US government made various changes in the policy to reduce the impacts of Great Recession and made policies that put the economy at the verge of growth, however, the impacts of that downturn are still felt on the US economy.

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