

How Effective Were the Economic Policies Introduced during the 2007-09 Global Economic Recession?

Hongyi Chen

Dulwich College Singapore, Singapore, 609776, Singapore

Abstract. The outbreak of economic crises is cyclical and unpredictable. The causes of each financial crisis are different. Studying the causes of the financial crisis can effectively mitigate the impact of the financial crisis on the national economy. So, what are the causes of the 2007-2009 world financial crisis? This paper examines the economic policies that existed during the global recession of 2007-09 and shows that controlling the domestic economy was ineffective in limiting the recession.

Keywords: Economic Policies; Global Economic Recession; The Causes of the Financial Crisis.

1. Introduction

To begin with, the 2007-09 economic recession must be explained, including the causes and the consequences. The Great Recession of 2007 - 2009 and the fiscal measures taken in response to it pushed already fragile federal budget deficits to dangerous levels. Economists agree that these costs are likely to be slowly absorbed over the next child years. If we hope to avoid another crisis of this magnitude, it is important to think about the ultimate factors that led to this economic catastrophe.

The immediate cause of the Great Recession was the collapse of the housing and credit bubble that began at the end of the 20th century and rapidly inflated in 2002-2006, when the first decline in home prices after the spring of 2006 acted as a catalyst, quickly igniting a firestorm in the housing market that crushed countless homeowners, financial institutions, and thousands of businesses, including those in the United States. Tens of thousands of businesses, including such icons as Merrill Lynch and General Motors.

2. Causes of Economic Recession

Before the economic crisis, the mortgage industry was a profit-making industry. At that period there were increasing demands for houses and thus increasing demands for mortgages. However as there is a significant number of mortgages being applied, the private investors are unable to lend out these mortgages as it is extremely expensive. Thus, the banks introduced a way in which the investors can give out several mortgages at once by combining individual mortgages into a pack called "mortgage-backed securities." These mortgage-backed securities were then lent out to the investors and given to those who were demanding houses. In the beginning, the mortgaged-backed securities were working perfectly as the banks were paid interests by the investors and the investors were rewarded with a high quantity of interest paid by homeowners who took out mortgages.

However, a possible threat was approaching as a moral hazard started to influence the banks. To explain, the banks had a significant market share and influence on the economy, which means that if they ended up in bankruptcy, there will be severe consequences including job losses, stock market crash etc. Therefore, these banks were "too big to fail." This resulted in a moral hazard, where the government can be forced to "bail them out" – meaning to provide funds and support for the banks threatened by bankruptcy – and this resulted in the banks taking more risks as they are sure that they will be bailed out by the government. This meant that banks and investors are now providing mortgages to those that are possibly unable to pay back the mortgages which will result in a "default". Defaulting means that when one is unable to pay back their mortgage, the real estate will be owned by whoever provided them with funds to buy the property in the first place, in this case, the investors instead of the banks. This is called a subprime mortgage and is extremely risky. What is the highest

possible threat, is that when defaulting, the real estate then belongs to the investors instead of the banks. This meant that once one defaults, they will lose an incredible amount of money.

Between 2001-2007, the six years before the crisis, mortgage debt for U.S. households soared 63% and entered the dangerous fast lane. And it was still an accelerating fast track - before the 2007 crisis, large U.S. financial institutions were still leveraging up, sometimes to a staggering 30 times, or \$30 of leveraged capital for every \$1 of principal.



Fig 1. Stages of the Financial Crisis

In the chart, the variable labeled "subprime" comes from the Subprime Mortgage Market Valuation Index, which shows investor concern about the housing market and mortgage-related assets. During the first phase of the crisis, as home prices fell and mortgage defaults began to rise in early 2007. These concerns began to grow as home prices fell and mortgage defaults rose from early 2007.

Prior to the crisis, the macroeconomic models used by central banks and forecasters - including the Fed's working models - provided little guidance on how to consider the economic impact of credit market disruptions. As a result, Fed staff and policymakers underestimated the depth and duration of the recession. For example, in October 2008, at the height of the financial panic, Fed staff predicted that the unemployment rate would peak at just over 7 percent; in fact, by fall 2009, the figure reached 10 percent. Other forecasters land underestimated the impact of the crisis. As I discuss in my paper, the crisis has dramatically changed economists' views on the importance of credit factors in the economy. Over the past decade, many interesting new studies have demonstrated the importance of these factors and shown how they can be incorporated into macroeconomic forecasting and analysis. But much work remains to be done.

This also created a bubble, which is the phenomenon that can be explained by game theory as when people start to heavily invest, others will quickly follow due to the rising trend. At that time, the investors and banks were desperately borrowing and providing loans and mortgages for the subprime owners which can be highly rewarding. Moreover, if one investor is making high profits, it is an incentive for other investors to join because they can be outcompeted by firms that did invest in the subprime mortgage. And when the subprime bubble eventually burst when there was a huge number of defaulting within the economy, the investors then got a huge amount of real estate. However, as demand and supply define when most people managed to pay back the mortgage and received the real estate property, the market is saturated and fewer people are willing and able to own real estate. Therefore, the supply ended up higher than the demand which caused a decreasing real

estate value. This meant that not only did the investor lose money, but those who bought the real estate earlier also lost money as houses were worth less than when they bought them.

Thus, the economic recession began. As the people's real estate properties are less valuable, they were then unable to take out higher loans for other expenditures which meant that there is falling aggregate demand and lower real GDP. This indicates a recession. Moreover, the investment companies are also failing and Lehman Brothers was one of the symbols of failed investors during the economic recession. The stock market hit the lowest point since the terrorist attack on September 11, 2001.

3. Economic Policies Introduced during the Global Recession

To correct the aggregate supply and demand, and the economy in general, the government had to implement economic policies that can quickly resolve the crisis. The federal reserve provided emergency loans to banks to stop them from bankruptcy, and the government enacted the Troubled Asset Relief Program (TARP) and spent \$250 billion to bail out the banks. This was highly effective as it created relief for the panics and uncertainty among the investors. In January 2009, the government enacted a series of expansionary fiscal policies, including lower taxation and increasing government spending which provided 800 billion dollars which significantly reduced the rate at which businesses were failing and rising unemployment rates. In 2010, the government introduced the Dodd-Frank Law, with the purpose to reduce predatory lending (lending money to individuals and businesses that are unable to pay back their debt) and stimulating transparency in the economy. This series of support provided by the government proved its belief in the Keynesian economic model, where the government is expected to assist and correct the economy during recessions whereas the neo-classical model that the government believed in during the great depression claims that an economy can be self-corrected.

4. Conclusion

To conclude, the United States government provided sufficient and direct assistance to the economy. If the government adopted the Neo-Classical model and waited for the economy to self-correct, many more banks and investment firms would've gone bankrupt considering the panic and uncontrollable nature that lay within the investors. Moreover, the government stopped the rising rates of unemployment caused by failing firms. The tax cuts provided for the economy were essential as they relieved tax burdens on the citizens who were facing rising fuel prices, cost of living, and failing investments. Lastly, the Dodd-Frank Law improved transparency within the economy and to a high extent prevented investors from making risky and unreasonable investments for those who might cause another subprime crisis in the future. However, these measures do not prevent a future economic crisis as they can be formed for different reasons. The recent fuel price rises caused by the Russian-Ukraine war are a perfect example of where controlling the domestic economy is ineffective in limiting an economic recession.

References

- [1] NIU Wenxin. Coping with the global economic recession - will the "epidemic crisis" surpass the 2008 financial crisis? [J]. 2020.
- [2] Li, Li-Hui. From Financial Crisis to Recession: Global Challenges: A Review of the Global Economy and International Finance in 2008 [J]. International Financial Studies, 2009.
- [3] Cao Yuna. Behind the World Economic Crisis 2007-2009[C]// 2009 National Doctoral Conference: Global Financial Crisis, China's Economic Growth and Macro Stability. 2009.