

The Global Financial Crisis and the Role of Monetary Policy

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Abstract. This paper investigates the significant influence of monetary policy on the global financial crisis, examining its effects on various economic downturns. Focusing on pivotal events such as the Great Depression of 1929, the stagflation of the 1970s, the financial crisis of 2008, and the COVID-19 pandemic, it analyzes the aftermath of each crisis and the corresponding monetary policies adopted. Through this examination, this paper underscores the intricate relationship between monetary policy and economic stability, shedding light on how policy decisions can either alleviate or worsen financial crises. By emphasizing the complexity and importance of monetary policy in navigating through economic turbulence, it underscores the necessity for prudent and well-considered policy measures to safeguard against future crises. This exploration underscores the critical role of monetary policy in shaping the trajectory of economies during periods of crisis and underscores the imperative for policymakers to adopt measures that promote stability and resilience in the face of uncertainty.

Keywords: Monetary Policy, Financial Crisis, Regulatory Response.

1. Introduction

In modern economic history, monetary policy has had a profound impact. Almost every crisis requires monetary policy and interest rate adjustments to restore the economy. However, different periods of economic crisis have their own complexity, which leads to the government and central bank cannot make the right judgment in time. In the grim context of the Great Depression, there was a huge break in the structure of the economic order, and people's livelihoods and livelihoods were destroyed. In 1929, the world was reeling from the aftershocks of a devastating stock market crash. As banks closed and factories closed, countries sank into the depths of economic despair. Central banks play a key role in exacerbating the severity of the recession and charting a road map to recovery. From the tightening of the gold standard to bold expansionary policies, these policies slowly put people's lives back on track. The turbulent scenes of the 1970s were confronted with a new pattern of economic malaise: stagflation. In the ashes of the postwar boom, countries grappled with the contradiction between stagnant growth and soaring inflation. As policymakers confront the limits of traditional policy tools, conventional economic wisdom falters in the face of this twin threat. Central banks and governments have again restored confidence in the economy through bold interest-rate moves and lax regulation, slowly raising interest rates and then boosting employment. Then came the upheaval of the 2008 financial crisis, a catastrophic event that reverberated around the globe with astonishing speed and ferocity. From the collapse of Lehman Brothers to the spread of toxic assets, the crisis has exposed systemic vulnerabilities lurking beneath the veneer of financial stability. Central bank interventions range from quantitative easing to subtle interest-rate manipulation. Through the perspective of policy analysis and historical investigation, the effectiveness of policy responses and the lasting impact of the crisis on the global economic landscape are analyzed. Finally, in the ongoing fallout from the COVID-19 pandemic, the economic impacts of uncertainty, volatility and resilience are different from those of the past. As countries grapple with the economic fallout from the global health crisis, monetary policy is once again in focus, with central banks taking a range of measures to support liquidity, stimulate demand and safeguard financial stability. The control of the quarantine and its subsequent easing were valuable lessons learned from previous experience to cope with the crisis.

In essence, the article is a testament to the enduring power of monetary policy. Under the challenges of various financial crises, policy makers have made many bold but reasonable policies by summarizing experience and analyzing the current situation, and it is this courage that has brought confidence to the masses and further accelerated the recovery and strengthening of the economic system. Through historical investigation and policy analysis of recent financial crises, this article attempts to uncover the complexities of monetary policy and point the way forward for policymakers, practitioners, and scholars.

2. 1929 Great Depression

The Great Depression of 1929 was a watershed in economic history, marking one of the deepest and most prolonged recessions of the 20th century. In the 1920s, countries slowly recovered from the chaos caused by the First World War, which led to a large amount of foreign travel and trade in imported goods. While such transactions have created a lot of wealth, they have left little effort for individual countries to control the economy, and the failure of countries to control the economy together means that even small changes can cause the economy to collapse [1]. The crisis was exacerbated by the stock market crash of October 1929, which saw a catastrophic stock market plunge that wiped out billions of dollars of wealth and threw the global economy into turmoil. By 1932 American public companies had lost 89% of their value. The collapse of the economy caused unemployment to soar to unprecedented levels: by 1933, the unemployment rate in the United States reached 25.6%, industrial production plummeted, businesses closed, and incomes plummeted [2]. The collapse in global trade made matters worse, exacerbating the downturn and prolonging the recovery.

In response to the crisis, governments and central banks implemented various monetary policies to stem the tide of economic disruption. The Federal Reserve initially tightened monetary policy in the years leading up to the crisis, raising interest rates and restricting credit. However, this exacerbated the severity of the recession because it led to unchecked behavior in the formation of the stock market bubble. Subsequently, the Federal Reserve took timely expansionary measures, including lowering interest rates and increasing the money supply, to stimulate economic activity and restore confidence in the financial system [3]. The gold standard, which pegged the value of currencies to gold reserves, limited central banks' ability to implement aggressive monetary measures, further exacerbating deflationary pressures and hampering recovery efforts. Moreover, the lack of coordinated global action among central banks exacerbated the spread of the crisis, prolonging its impact and deepening its severity.

The Great Depression of 1929 left an indelible mark on the global economy, reshaping economic policy and financial regulation for decades to come. It is a stark reminder of the inherent fragility of the financial system and the need for aggressive government intervention to mitigate economic downturns. All the factors combined to create this financial storm, and it was not until after World War II that the economic system was restored to normal under the guidance of the victorious countries. These wrong behaviors and the impact of the consequences deeply alarmed people, and gradually formed the current rigorous financial system.

3. 1970-1980 Stagflation

The stagflation period of the 1970s presented a unique economic system: it was characterized by stagnant economic growth accompanied by high inflation. Yet this phenomenon flies in the face of conventional economic wisdom and poses major policy dilemmas for policymakers around the world.

As mentioned above, after the Second World War, the financial crisis was self-defeating, and the economies of countries achieved explosive growth. In the United States, for example, GNP increased from \$200 billion in 1940 to \$500 billion in 1960 to nearly \$1 trillion in 1970. However, contrary to the data, the unemployment rate in the United States increased by 33% between 1960 and 1970, and

the consumer index increased by 11%. With this combination of inflation and stagnation, stagflation sets in. The consequences of stagflation have affected both advanced and developing economies: stagnant growth has led to rising unemployment and falling living standards for many, while high inflation has eroded purchasing power and destabilized financial markets [4]. Businesses face uncertainty that makes it difficult to plan, impeding investment and innovation.

Yet monetary policy to tackle stagflation has had limited success, as traditional policy tools have proved ineffective in tackling both inflation and unemployment. Central banks face a dilemma: raising interest rates to curb inflation risks exacerbating unemployment, while lowering them to stimulate growth risks exacerbating inflation further. The result has been a period of experimentation with unconventional policy measures, including wage and price controls, with mixed results [5]. For example, the price freeze imposed by President Nixon in 1971 solved some problems in the short term by devaluing the currency and boosting exports, but it did not solve the root cause of the problem.

Over time, greater control over reserve and monetary growth, while imperfect, has produced the expected slowdown in inflation. The Currency Control Act, introduced in early 1980, strengthened strict reserve management. In between, interest rates soared, fell briefly, and then soared again. Lending activity fell and unemployment rose. Although the economy recovered in the second half of 1980 and inflation declined somewhat, it remained high. Yet they still want to fight high inflation by raising interest rates and slowing the growth of reserves. In July 1981, the economy fell back into recession, but the recession was more severe and prolonged, lasting until November 1982. Unemployment reached nearly 11 percent, but inflation continued to fall, and by the end of the recession, year-over-year inflation was back below 5 percent. Yet as the Fed's commitment to low inflation gained credibility, unemployment fell, and the economy entered a period of sustained growth and stability [6]. The Great Inflation is finally over.

To sum up, the stagflation of the 1970s once again demonstrated the complexity of economic phenomena and the limitations of traditional macroeconomic theory. This period prompted policymakers to rethink their approach to economic management and inspired a wave of innovation in economic thinking. While the stagflation experience was undoubtedly painful, it ultimately served as a catalyst for intellectual and policy reform, paving the way for new insights and new approaches to economic policy making.

4. 2008 Financial Crisis

The 2008 financial crisis was one of the most significant economic upheavals of modern times, inflicting damage on the global financial system and triggering a prolonged period of economic turmoil. Starting with the bursting of the housing bubble in the United States, the crisis quickly spread to global financial markets, once again exposing systemic vulnerabilities and triggering a series of devastating consequences.

The U.S. housing expansion that began in 2007 reached its peak, but mortgage and other financial losses began to weigh on the market. A long period of house price appreciation led people to borrow recklessly to buy and build houses, and when this phenomenon reached its peak, the backlash came. When house prices reached the threshold and began to fall, banks and investors suffered huge losses on their overinvestment, leaving them increasingly dependent on lenders for new loans, and inflation further aggravated the impact. The pressure reached its peak after the collapse of Lehman Brothers in September 2008: people did not know what would fail next, so there was a lot of withdrawal and selling. Investors and acquirers don't have enough money to buy because of loan problems. As a result, financial markets got out of control, public confidence collapsed, investment willingness decreased, and public spending began to decline [7].

In response to the widening crisis, policy enacted a series of unprecedented currency interventions. Central banks, particularly the Federal Reserve in the United States and the European Central Bank in the euro zone, have implemented expansionary monetary policies, including quantitative easing and near-zero interest rates, to pump liquidity into the financial system and lower borrowing costs

[8]. While monetary intervention succeeded in preventing a complete collapse of the financial system and mitigating the severity of the recession, the recovery proved slow and uneven. Many countries have experienced a long period of economic stagnation, high unemployment and stagnant wages, exacerbating social inequality and fueling discontent. While currency intervention succeeded in averting a total collapse of the economy, the scars of the crisis remain, pointing out that the financial system still needs a strong regulatory framework, prudent risk management, and effective crisis response mechanisms to guard against future financial turmoil.

5. COVID-19 Crisis

The financial crisis triggered by the COVID-19 pandemic, caused by the novel coronavirus, is a more recent event, and its legacy is still being felt. It disrupted supply chains in many industries, led to the collapse of numerous companies and sent shockwaves through financial markets. As governments-imposed lockdowns and social distancing measures to contain the spread of the virus, economies around the world ground to a halt, leading to a sudden and severe contraction in economic activity.

An important thing triggered by the COVID-19 economic crisis is that central banks have implemented quantitative easing (QE) measures to support financial markets and stimulate economic growth. While these measures were effective in preventing a complete collapse of the financial system, they also raised fears of inflation and a loss of purchasing power. As central banks inject liquidity into the economy through quantitative easing, there is a risk that excess money supply could lead to inflationary pressures, which could erode the value of money and push up the consumer price index (CPI).

In response to the impact of the epidemic on the economy, central banks, including the US Federal Reserve, implemented a series of monetary policies to support the economic recovery. One notable policy response from the Fed has been to adjust interest rates, cutting them to near zero early in the crisis to encourage borrowing and investment. However, as the economy showed signs of recovery and inflationary pressures mounted, the Fed began gradually raising interest rates from 0.25% to 5.5% to tame inflation and prevent the economy from overheating [9]. However, the practice of pushing down and then pushing up has seriously affected people's judgment and confidence in purchasing power.

The impact of the COVID-19 economic crisis has been mixed. On the positive side, the unprecedented fiscal and monetary stimulus implemented by governments and central banks has mitigated the impact of the crisis and provided support to vulnerable individuals and businesses. In addition, the rapid development and deployment of vaccines offers hope for a return to normalcy, bolstering consumer confidence and bolstering optimism about an economic recovery. Industries such as face masks have also seen unprecedented revenues because of the impact.

However, the economic impact of the pandemic has also led to a host of negative consequences, including widespread job losses, business closures, and financial instability. Many industries, such as tourism, hospitality and retail, have been particularly hard hit by the crisis, facing prolonged disruption and uncertainty. In addition, the sharp rise in inflationary pressures has raised concerns about the sustainability of economic growth and the possibility of prolonged stagflation, characterized by stagnant growth and high inflation, leading to negative investment and nervous purchases.

While monetary policies such as quantitative easing and interest rate adjustments have played an important role in mitigating the effects of the crisis, the path to recovery remains uncertain: there are lingering risks of inflation, financial instability, and economic hardship. After the collapse of the closed economy, countries recognized the problem and began to loosen policy gradually to save their own economies. The suddenness of the epidemic is also one of the reasons why governments and central banks did not respond in time this time, which led to the instability of economic markets [10]. However, after realizing the importance of the matter, they quickly formulated policies and issued clauses to limit the loss to the greatest extent.

6. Conclusion

In conclusion, analysis of the impact of monetary policy on various global financial crises, including the Great Depression of 1929, stagflation of the 1970s, the financial crisis of 2008, and the COVID-19 crisis, shows that monetary policy has played a key role in shaping economic outcomes. Each crisis presents unique challenges that require targeted policy responses to mitigate their impact and support economic recovery. The Great Depression was a stark reminder of the devastating consequences of uncontrolled financial speculation and the importance of active government intervention to stabilize the economy. The stagflation of the 1970s challenged the traditional economic system and prompted a reassessment of macroeconomic theory, leading to the emergence of new policy paradigms. The 2008 financial crisis exposed systemic vulnerabilities in the global financial system and highlighted the need for strong regulatory frameworks and crisis response mechanisms, as well as controls on imports and exports between countries. The unprecedented scale and impact of the COVID-19 epidemic has tested the resilience of the global economic and financial system, highlighting the importance of coordinated policy measures and international cooperation.

Throughout history, monetary policy has played a central role in shaping economic outcomes and responding to financial crises. However, the effectiveness of monetary policy measures depends on several factors, including the nature of the crisis, the policy tools available to policymakers, and the broader economic backdrop. While traditional monetary interventions such as quantitative easing and interest rate adjustments have helped mitigate the impact of the crisis, they also carry risks, including inflationary pressures and financial instability. Prudent policy measures and careful consideration of longer-term implications are therefore essential to ensure a sustainable economic recovery and financial stability. Lessons learned from past crises can inform future policy decisions and help policymakers navigate the complexities of the global economy. By adopting proactive, forward-looking monetary policies, policymakers can better anticipate and respond to emerging challenges, guard against future economic turbulence, and promote inclusive and sustainable growth.

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