The Great Recession

An Explanation of The Timeline

MVE220 - Financial Risk
Project Group 3
Märta Ekvall
Zackarias Gillberg
Victor Kvillerud

Summary

Introduction:	Zackarias Gillberg
The Build Up:	Märta Ekvall
The Rundown of the Economy:	Zackarias Gillberg
The Aftermath:	Victor Kvillerud
Result/Conclusion:	Everyone
Reading Guide:	Victor Kvillerud & Märta Ekvall

Märta Ekvall

Zackarias Gillberg

Victor Kvillerud

Table of Contents

Introduction

Since the beginning of barter, when humanity began to exchange necessities with each other, we have seen many different types of financial and economic crises. The rundown of forex exchange markets, stock market, dot-com bubble and several housing market crashes are just some of the most known crises. The two biggest rundowns of financial crises we have seen are The Wall Street Crash of 1929 and the Great Recession of 2009, as the latter will be the topic of this report. The optimistic economies in the US that led to the severe aftermath of debt, unemployment and a global rundown resulted in the greatest crisis in modern times. Throughout this report, the reader will get a clearer picture of the whole timeline during the Great Recession and hopefully become a more educated person about financial risk.

The Timeline

The history of The Great Recession will be presented in the following section. The section covers the period of the build-up to the financial crisis, what effect the crisis had during the period 2007-2009 and the aftermath, the well-being of the global economy.

The Build Up

The Great Recession was the most significant economic recession in the United States since the Great Depression during the 1930s. It is a financial crisis caused by human action and inaction, holding the awful truth that it could have been avoided. It all began with the 2001 recession and the September 11 terrorist attacks. To keep economic stability, the Federal Reserve lowered the federal funds from 6.5 per cent in May 2001 to 1 per cent in June 2003. This was the lowest level observed so far during the post-Bretton Woods era. In combination with a federal policy encouraging homeownership, the interest rates were critical contributing factors to the surge in real estate prices and the boom in the financial markets. The total mortgage debt expanded dramatically due to subprime borrowers, i.e. people with lower credit scores than normally required, being able to buy houses. (The Investopedia Team, 2020a)

In response, the financial institutions sold the loans to massive aggregators to secure assets and free capital. Federal National Mortgage Association and Federal Home Loan Mortgage played essential roles as aggregators, popularly known as Fannie Mae and Freddie Mac. The institutes created many bundled subprime loans, so-called Mortgage-backed securities (MBS). The MBS were distributed to security dealers, such as Wall Street brokers, initiating a secondary mortgage market. (Singh, 2020)

The security dealers then formed collateralized debt obligations (CDO) by repacking the MBS. A CDO can be thought of as a box where multiple mortgages make monthly payments. They are normally divided into three tranches based on their level of risk. Even if these risky investments were far from the only financial instruments being used, they could be said to be one of the leading causes of the Great Recession. The CDOs increased rapidly through the shadow banking community, consisting of bank-like intermediations not being subject to regulatory oversight. (The Investopedia Team, 2020b)

By 2004 the U.S. homeownership peaked at as much as 69.2 per cent. But the home loans were built on expectations of the interest rates remaining low and home prices rising endlessly, which was not to be the case. To control the economic inflation, the government was forced to increase the interest rate from 2004 through 2006. As a reaction, the flow of new credit into real estate moderated, and the rates of adjustable mortgages and more exotic loans began to rise towards levels borrowers could never have imagined. Consequently, people had liabilities that exceeded the value of their properties, putting the homeowners in an exposed position. (Singh, 2020)

The first sign of the actual housing crash was the increase in early payment default, referring to borrowers who are 60 or more days delinquent within the first year. Looking at these numbers, it becomes clear that the areas of the country that had the most significant increase in house prices also experienced the greatest declines during the Great Recession. Therefore, the serious delinquency was highest in the so-called Sand States, consisting of California, Arizona, Nevada, and Florida (see Figure 1). Delinquency also varied by type of loan, starting way earlier and thus being significantly higher for subprime adjustable-rate loans (see Figure 2). At last, the housing bubble burst, bringing with it the credit market that had fueled it. The value of the CDO's underlying commodities dropped, leading to a financial catastrophe. The CDOs were as mentioned merely bets on the performance of real mortgage-related securities and for that reason the losses from the breakdown amplified. In addition, the effects became widely spread throughout the financial system as CDOs allowed multiple bets on the same securities. (The Financial Crisis Inquiry Commission, 2011)

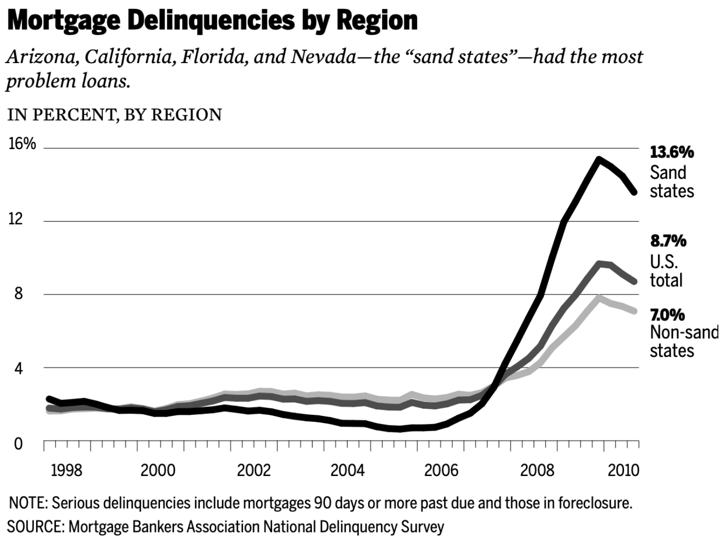

Figure 1. Mortgage Delinquencies by Region 1998-2010. From The Financial Crisis Inquiry Commission, 2011.

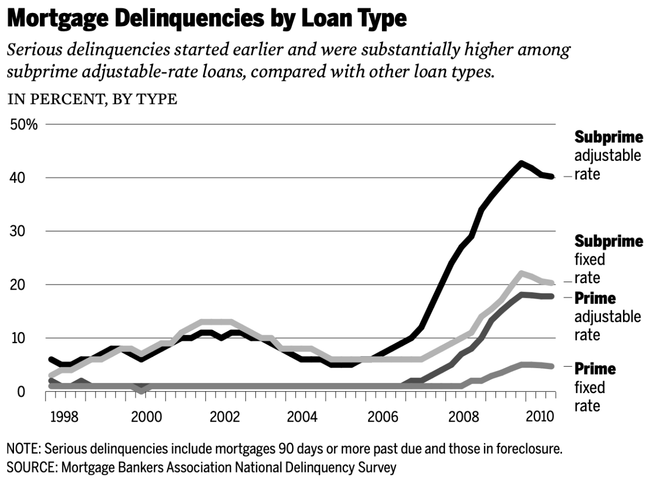

Figure 2. Mortgage Delinquencies by Loan Type 1998-2010. From The Financial Crisis Inquiry Commission, 2011.

Understandably, the trade with mortgages stopped, causing the credit market's liquidity level to a sudden decrease. As 2007 unfolded, the solvency of financial institutions and over-leveraged banks came to a breaking point, causing one subprime lender after another to file for bankruptcy. It then became clear that the U.S. economy could not handle the credit crisis, and the devastation would spread far beyond the country's borders. The U.S. had officially entered a great recession, which rundown of the economy and its consequences will be accounted for in the following sections.

The Rundown of the Economy

The following section covers the rundown of the economy; what consequences there were on the overall economy.

The fall of Lehman Brothers

Not only did small institutes file for bankruptcy, many of the U.S. most prominent institutes took a fall. Most would argue that the official start of the rundown is the fall of the notorious investment bank, Lehman Brothers. As of the collapse, Lehman Brothers was the fourth largest investment bank in the U.S. Many investments went through this bank, putting many companies and civilians at risk when bankruptcy lurks around the corner. Lehman Brothers employed over 25 000 people worldwide with assets worth $639 billion and liabilities worth $613 billion. (Lioudis, 2021). Mathematically, only accounting for these two numbers, the bank would be able to sell all its assets and pay off its debts, but financially nearly all of its assets were bound up in investments no one wanted to touch. According to the educational video there was only around $8000 available in cash, and the rest were practically untouchable. (Company Man, 2021).

Lehman Brothers had survived several financial crises through its 158 years of operation; the railroad bankruptcies of the 19th century, the Great Depression, a couple of World Wars and several crises in modern times. But as the housing market collapsed, when Lehman Brothers had taken a massive leap of faith into the subprime mortgage market, they failed to survive. That was the beginning of the end for Lehman Brothers and many of its customers. (Lioudis, 2021)

Effects on the Economy

As Lehman began to fail, they laid off 1,200 employees within the department handling mortgages. (Lioudis, 2021). But this was just the beginning and just related to one large bank. During the rundown, the US alone experienced a massive increase in unemployment as 8.7 million Americans lost their steady income. This doubled the unemployment in the US from 5 per cent to 10. As a result, many people experienced trouble paying for insurance and lived more at risk than before, risking health and roofs over their heads. (The Investopedia Team, 2020a)

As the American stock market started to plunge, creating a ripple effect on the global stock market, American households lost $19 trillion as their investments mainly consisted of stocks and real estate. But it was not only the civilians in the US taking a beating; the national economy of the US experienced a rough time as well. Seeing the worst numbers since World War II, the US gross domestic product plunged by 4.3 per cent. As the national economy of the USA recessed, The Federal Open Market Committee (FOMC) lowered the federal funds' target rate progressively to its effective floor at a range of 0 to 0.25 per cent. This was a desperate attempt to turn the recession and rebuild the economy (Weinberg, 2013). Globally, not only did the stock market drop, but the global economy did see a loss of $2 trillion in economic growth. (Merle, 2018)

The official date when the crisis could be considered over was June of 2009, as the unemployment levels lowered and the economy slowly began speeding up again. (The Investopedia Team, 2020a)

The Aftermath

This section covers the Aftermath of the Great Recession, explaining the responses from governments and politicians trying to establish regulations ensuring a low risk of similar recessions in the future.

Consequences on regulations

The Dodd-Frank Wall Street reform was created due to the financial crisis. The reform aimed to target the actors responsible for the financial crisis, including banks, credit rating institutions and mortgage lenders. The regulation permitted the government to obtain control over the banks with unhealthy finances. It also stated an increased capital requirement for banks, which should act as protection in a possible future recession. The Volcker Rule, a vital component of the reform, was introduced to limit the problem of speculative trading and proprietary trading. After this, private equity firms and Hedge funds were no longer allowed to have business with banks. In 2018, President Trump signed a new law that limited critical parts of The Dodd-Frank Wall Street reform. (Hayes, 2022)

Consequences on the economy

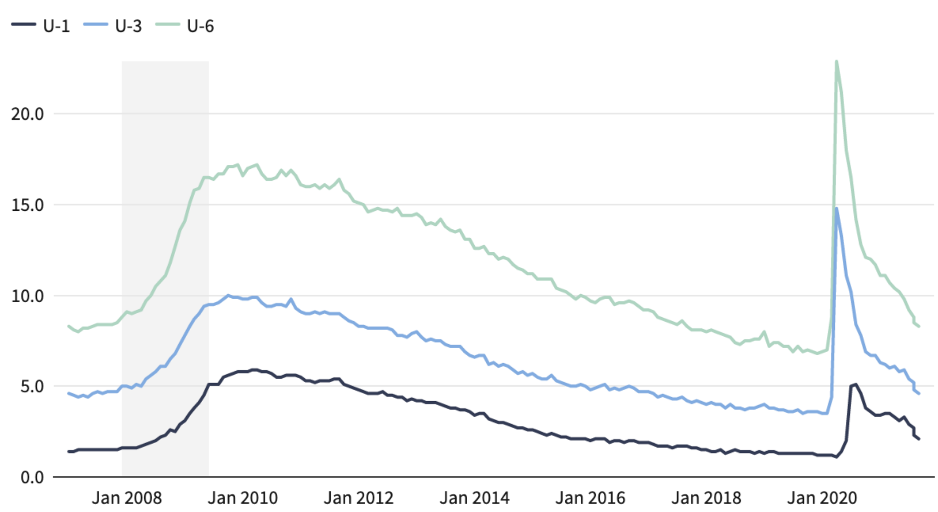

Figure 3. Structural unemployment, Jan 2008-Jan 2020. All figures in per cent. From The Investopedia Team, 2021b.

The unemployment rate became a big issue at the end of the recession. As stated earlier, it reached 10.0 per cent at the end of the crisis, doubling the rate against the 5 per cent level before the crash. Although the group today has returned to the pre-crisis level, some factors suggest that the labor market structure has changed. The crisis increased respect for risk associated with derivatives, loans and real estate. In addition, since the financial crisis, there has been a development where automation is becoming more common and outsourcing of production has made simple factory jobs disappear. (The Investopedia Team, 2021b)

High unemployment rates and low inflation became a problem following the crisis. The long term unemployment rate was exceptionally high, and inflation averaging around 2 per cent became an issue for the American economy. The FED worked out the different types of monetary programs to get the economy started, where Quantitative easing (QE) became the most popular. With QE, the central bank buys bonds to stimulate the economy. As a consequence of the bank's purchase, bank and mortgage lenders have more money to lend or make other investments. During the recession, these transactions were critical to awakening the economy. But this type of monetary programme also comes with a couple of flaws. As a result of the purchases, the interest rates decline as the transactions drive up the prices of the securities. Investors often tend to reallocate to stocks and other securities when rates are falling, which increases the risk of asset bubbles driven by investors speculating in the stock market. (Curry, 2022)

Result/Conclusion

In this section, the authors discuss their conclusion of the report. It covers long term effects on the world economy, means of measures to prevent future crises and the question of whether the world is headed into a new financial crisis or not.

What's remaining from the Great Recession and how has it affected the world?

The effects of the Great Recession have hit individual U.S. households and whole businesses, both big and small. The crisis was not a result of Mother Nature or computer models going wild. It was a consequence of human action and inaction. People in the financial system ignored the early warning signs and failed to understand and manage the emerging risks in the system. As Shakespeare so nicely put it, the fault lies not in the stars but us. Although it was officially over in the U.S. in 2009, Americans and people in other countries worldwide felt its effects for many years to come. The U.S. economy has rebounded in several ways but is less vibrant, more unequal and less productive than it would have been. The increased level of long-lasting unemployment caused by fundamental changes in the economy has worsened income inequality. Moreover, the recession has had extreme effects on the U.S. and many other countries' economic productive capacity. In 2015 the total loss of potential output relative to the pre-crisis path was 8.4 per cent. This means that the damage of the Great Recession corresponds to more than the loss if Germany's entire economy disappeared. The most significant long-term effects are experienced by the countries having the deepest recessions. The economies in the euro area's periphery had dire banking and debt crises, while Australia, thanks to fiscal stimulus and exports to Asia, was almost unharmed.

What can be done to prevent a similar crisis in the future?

Since the financial crisis of 2009 depended on bad investments and weak demands on loan takers, the consequently established regulations from the crisis will undoubtedly lower the risk of a similar crisis in the future. Before, when these regulations didn't exist, institutes were more like animals, blinded by their goal of being as profitable as possible, not thinking of all risk factors. Over time, many different crises have been dealt with using financial politics and monetary adjustments as this affects the money flow and hopefully ensures a low level of unemployment and a healthy level of money spending. If economic politics are handled correctly, we can lower the risk of loan takers defaulting and handle credit rate fluctuations without devastating consequences.

Are we headed into another crisis?

Some critics argue that we are repeating the mistakes of the great recession and that we are heading into a new crisis. Since then, a monetary policy pursued by central banks has been a great example of this. Quantitative easing was invented due to the great recession, but it has become central banks' primary weapon in bad times. Q.E. is an excellent method of stimulating the economy when the economy is stagnating. But, the process is at risk of becoming a poison pill, where the economy requires continuous injections to grow and reach inflation targets. Q.E. is also imposing the risk of a new asset bubble, where the constant purchases made by the central banks are risking asset bubbles on the stock market when investors are reallocating their portfolios in favour of higher returns.

What have we learned from this project?

This project has taught us more about the financial market and what disastrous consequences harmful regulations can have on the economy. It has been interesting to see that we may not be as bright as we think and do not learn from our mistakes. Admittedly, lax regulations have hardened as a result of the crisis, at the same time as we are inventing new methods that risk being very harmful to the economy. It would have been interesting to get a better overall picture of how this has affected the world globally, as the focus on the project has been more on the USA than the rest of the world. It would also have been interesting to dive into regular Americans' lives and understand how the crisis affected them. Unfortunately, our view has more or less been on a bigger picture.

Reading Guide

For the ones who want to learn more about the Great Recession we recommend checking out some of the following sites.

- “The Big Short”. A movie about the financial crisis which follows a group of individuals that bet against the American housing market after discovering the bubble. The movie is a really fun and easy way of learning more about the crisis.

- An interesting article of how the great recession affected the daily lives of American families, including both economic and non-economic effects. It is also discussing how the safety net in America worked during the crisis, and especially how this affected citizens in already difficult economic situations.
  https://irle.berkeley.edu/the-great-recession-families-and-the-safety-net/

- An article that discusses human psychology and why we may repeat our mistakes from the great recession all over again. The article discusses the problem with big banks and Wall-street's influences on the regulators.
  https://www.cnbc.com/2018/09/14/the-next-financial-crisis-why-it-looks-like-history-may-repeat-itself.html

- A book worth reading is “Broken Bargain: Bankers, Bailouts, and the Struggle to Tame Wall Street” published in 2019 by Kathleen Day, with as much as 4.9 out of 5 in rating at Amazon. After the Great Depression in the 1930s the U.S. financial sector struck an impressive bargain with the federal government, which played a major role for the stability of the financial markets. This engaging book goes through the country’s major financial crises and reveals how the two more recent crises arose from the neglect of this fundamental bargain.

References

BoyKin, Ryan. (2022, March 31).*The Great Recession's Impact on the Housing Market.* Investopedia https://www.investopedia.com/investing/great-recessions-impact-housing-market/

Company Man. (2021, January 13). *The Collapse of Lehman Brothers - A Simple Review*. [Video]. Youtube.
https://www.youtube.com/watch?v=BnDbdQa_r38

Curry, Benjamin & Jackson, Anna-Louise. (2022, January 19). *Quantitative easing explained*. Forbes. https://www.forbes.com/advisor/investing/quantitative-easing-qe/

Nick Lioudis. (2021, January 31). *The Collapse of Lehman Brothers: A Case Study*. Investopedia. https://www.investopedia.com/articles/economics/09/lehman-brothers-collapse.asp

Renae Merle. (2018, September 10). *A guide to the financial crisis - 10 years later*. Washington Post. https://www.washingtonpost.com/business/economy/a-guide-to-the-financial-crisis--10-years-later/2018/09/10/114b76ba-af10-11e8-a20b-5f4f84429666_story.html

Singh, Manoj. (2020, November 27). *The 2007–2008 Financial Crisis in Review.* Investopedia. https://www.investopedia.com/articles/economics/09/financial-crisis-review.asp#toc-the-aftermath

The Financial Crisis Inquiry Commission. (2011, February 25). *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*.
https://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf

The Investopedia Team, & Hayes, Adam. (2022, February 7). *Dodd-Frank Wall Street Reform and Consumer Protection Act*. Investopedia.
https://www.investopedia.com/terms/d/dodd-frank-financial-regulatory-reform-bill.asp

The Investopedia Team. (2021a, October 15). *Quantitative Easing (QE).* Investopedia. https://www.investopedia.com/terms/q/quantitative-easing.asp

The Investopedia Team. (2021b, October 31). *How Did the Great Recession Affect Structural Unemployment?*. Investopedia.
https://www.investopedia.com/ask/answers/050715/how-did-great-recession-affect-structural-unemployment.asp

The Investopedia Team. (2020a, October 23). *The Great Recession.* Investopedia. https://www.investopedia.com/terms/g/great-recession.asp

The Investopedia Team. (2020b, May 14). *Were Collateralized Debt Obligations Responsible for the Financial Crisis?*. Investopedia.
https://www.investopedia.com/ask/answers/032315/were-collateralized-debt-obligations-cdo-responsible-2008-financial-crisis.asp

Weinberg, John. (2013, November 22). *The Great Recession and Its Aftermath*. Federal Reserve History.
https://www.federalreservehistory.org/essays/great-recession-and-its-aftermath