THE FINANCIAL CRISIS AND GREAT RECESSION OF 2008-2009

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Business cycles have been a longstanding feature of macro-economies—including the United States.

Downturns have had various causes.

But the most severe and long lasting have resulted from financial crises—historically, banking panics.

Prior to the recent Great Recession, many thought cycles had been tamed—the “Great Moderation”
The Great Depression

• The most severe downturn in U.S history was the Great Depression of the 1930s

• Output fell 25 percent and the unemployment rate soared to 25 percent

• Caused by a financial—banking—crisis in which a third of all commercial banks failed

• There were waves of bank runs that forced banks to sell assets at “fire sale” prices, adding to failures
The recent crisis developed in 2007 and reached a crescendo after the Lehman Brothers bankruptcy in September 2008.

- It had comparable dimensions to the 1930s and could have caused comparable damage.
- The worst of the problems were concentrated in major financial institutions—commercial banks, investment banks, and a global insurer.
- Enlightened policies avoided a repeat of the 1930s.
As noted, the preceding two and one-half decades had been a time of macroeconomic stability—dulling concerns in markets about “tail” risks.

Interest rates had been at historically low levels, inducing many investors to “reach for yield”.

Financial engineers were creating new—synthetic—financial instruments with presumed low risk features.

Ratings companies were assigning such new products good ratings and insurers were insuring some of them.
At the heart of the crisis was a bursting of a bubble in real estate prices.

Real estate prices more than doubled in just a few years—and rose to at least 30 percent above fundamentals.
Unlike earlier depositor runs, major banks and investment banks had created exposures largely through “shadow banking” operations funded by wholesale creditors.

These commonly took the form of off-balance-sheet vehicles.

Typically based upon subprime mortgages that were transformed into new synthetic instruments through financial engineering.
UNDERLYING RISKS

• Through off-balance-sheet vehicles and the underwriting process, exposures had various embedded risks:

  - Credit risk, which was much greater than perceived
  - Maturity risk from funding longer-term assets with short-term liabilities
  - Reputational risk from having a sponsored vehicle fail
Losses on real estate loans began to mount

- Owed to defaults on poorly underwritten subprime mortgages and to declines in home prices
• This reverberated throughout the financial system

• Wholesale creditors pulled back and funding costs soared, as shown by TED spread below

• Synthetic assets—once highly sought by investors—became toxic, and markets for them dried up
The Fed responded through various programs to replace lost funding—and its balance sheet ballooned.

Other federal programs—notably TARP—were launched to contain the systemic crisis.
A SEVERE CREDIT CRUNCH STILL ENSUED

- Commercial and investment banks cut back drastically on providing funding to the economy

- Loan underwriting standards tightened dramatically

Net Percentage of Domestic Respondents Tightening Standards for Commercial and Industrial Loans Large and Medium Firms (DRTSCILM)
Source: Board of Governors of the Federal Reserve System
LENDING DROPPED SHARPLY

- Business loans leveled off and then plunged

Other types of loans also registered exceptional drops
Financing in other markets also curbed

- Corporate bond yields jumped as credit risk premiums soared and borrowing plummeted

- More generally, investor appetites for risk swung from being nearly insatiable to being extremely resistant
Caused an adverse feedback loop in which credit losses were causing lenders to cutback

The cutback was causing a reduction in spending

The reduction in spending was causing losses of household and business income, defaults, and further credit losses

And the process continued
Real GDP fell nearly 5 percent
The unemployment rate rose to 10 percent and has only edged lower.
• Real estate prices fell around 30 percent, creating a special set of difficulties arising from lost home wealth

• The devastation was much greater than a comparable bursting of the stock market bubble of the 1990s
More on the Policy Response

• The Fed lowered its policy rate to zero and supplemented this with a massive asset purchase program—continuing now at $85 billion per month.

• The $700 billion TARP program was enacted to put major financial institutions back on their feet—largely through capital injections.

• Also, a $900 fiscal stimulus program was enacted to complement the Fed’s stimulus in turning the U.S. economy around.
Still, the recovery has been weak. This has been the weakest and most protracted recovery of the postwar period—in contrast to other sharp downturns. Has left considerable slack, as shown by the output gap.
Financial crisis has held back recovery

- Problems stemming from the financial crisis continue to hold down the U.S. economy
- But other factors are also contributing, such as uncertainty about public policy (chart below) and fiscal restraint
Businesses have been reluctant to undertake investment spending, despite vast piles of cash, strong profits, and very low interest rates.

Households, too, have been highly cautious.
SLACK IS KEEPING INFLATION LOW

• Core inflation has fallen to about 1 percent—well below the Fed’s 2 percent target
LEGACY

• Has left massive amounts of federal debt, owing to both the fiscal stimulus and the weak economy—now constrains further fiscal stimulus

• Has left concerns about how the Fed will exit its unprecedented stimulus program and avoid serious inflation

• Has resulted in a major banking bill—Dodd-Frank—that has greatly extended the reach of government into the financial system, and is focused on reducing systemic risk— and a repeat of this horrible episode