Monetary policy in the US during the Great Recession

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The intervention

The Great Recession started in 2007 in the US, when the housing bubble burst, leading to a financial and economic crisis (Weinberg, 2013). To combat the effects of the recession, the U.S. Federal Reserve lowered the interest rate from 5% to almost 0% (see Figure 1).

Expectations

The financial crisis shifts the IS curve left because of the reduction in consumer confidence and business confidence: before the intervention, the IS-LM model predicts a decrease in output, consumption and investment. The intervention then shifts the LM curve down by lowering the interest rate.

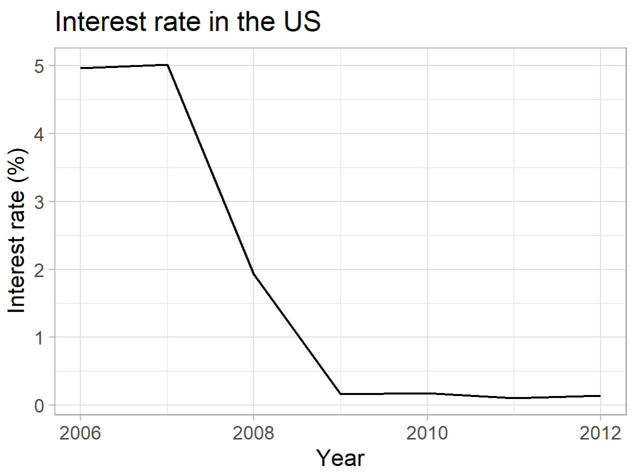

Figure 1

The shift of the LM curve leads to a movement along the IS curve to higher output. So the IS-LM model predicts that after the intervention consumption, investment and output increase.

Empirical evidence

Figure 2 shows how consumption, government spending and investment changed around the time of the policy intervention. Investment spending showed negative growth for three years in a row between 2007-2009, but rebounded quickly from 2010 onwards. Consumption did not grow in 2008 and slightly decreased in 2009; afterwards its growth rate was similar to pre-crisis growth rates. The policy intervention took place between 2007-2009, as a reaction to the decrease in output. Once the interest rate was lower, consumption and especially investment were increasing again. These patterns are in line with the expectations based on the IS-LM model.

Figure 3 explicitly shows the relationship between output growth and the interest rate. Before the crisis both output growth and interest rates were high. As output growth went down, the Federal Reserve lowered the interest rate to nearly 0%. These low interest rates supported the economy's return to pre-crisis growth rates after the crisis, just like in the IS-LM model.
The empirical evidence suggests that the monetary policy intervention in the US during the Great Recession was successful in increasing consumption, investment and output.

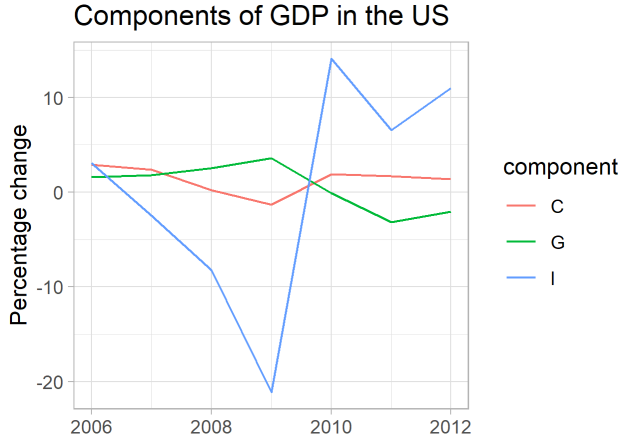

Figure 2

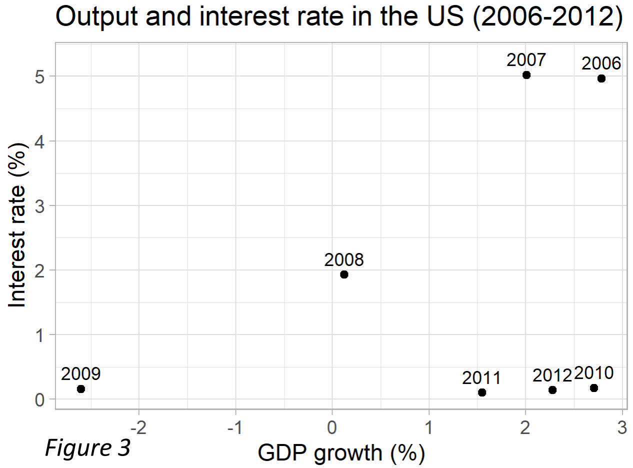

Figure 3

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