

Intermediate Macroeconomics

The Great Recession: A First Look

from before $Y \neq \bar{Y}$

$\tilde{Y} \rightarrow$ gap, fluctuations

ECON 3311 – Spring 2025 Driven by shocks
UT Dallas

Now: Effects of these shocks

(and policies in the 2007–08 GFCrisis)

Great Recession or "Great Financial Crisis"

Introduction

2007–2009

Crisis started in the US but became Global

In this lecture we will go over:

- The **Great Recession**, which was the biggest economic downturn in the US since the **Great Depression** → 1930's
- The causes of the financial crisis, which began in the summer of 2007 and pushed the U.S. and world economies into the deepest recession in many decades
- How this recession compares to previous recessions and previous financial crises in the United States and around the world

Different from other crises:

- Financial
- Longer Lasting
- had quick and strong Policy Interventions
- Policies were "unconventional"

Overview

The crisis began in the summer of 2007

- Real GDP starting declining in the fourth quarter of 2007
- Unemployment rate was 5% in December 2007 and then increased to 9.5% by June 2009
- **Home prices fell** by about 30%
- **S&P (stock) index fell by 57%** from October 2007 to March 2009
- Net worth of households and nonprofit organizations fell by \$14 trillion

→ Catalyst of GFC *

Downturn 'ended' in June 2009, but it **took several years** for certain markets
to recover

→ Particularly long (slow) Post-crisis recovery

* housing is a very special asset: Used as Collateral

→ Impacts financial Sector → affects aggregate wealth (Net worth)

Shocks as 'Drivers' of economic fluctuations

Shocks to the Macroeconomy

Previously we talked about macroeconomic 'shocks' that can move the economy from its long-run potential output

There were **several shocks that played a role** in the 2007 crisis

→ Shocks that weaken aggregate Demand

1) Housing prices declined sharply

2) Global savings glut

3) Subprime lending and rise in interest rates

4) Firms in financial risk

5) Oil prices (Increase)

→ Negative Supply Shock

Negative Feedback between ① & ③

↳ Between weak housing prices & financial conditions.

- high flow of Savings from other countries into the US

(External factor feeding the pre-crisis bubble)

Housing Prices

Pre-crisis: Housing bubble (\uparrow Prices)

Due to low cost of lending/mortgages

From 1996 to 2006, housing prices tripled

- A “housing bubble” was created

What caused the increase in housing prices?

- “New economy” (dot.com boom)
- Low interest rates in the early 2000s
- Increasingly lenient lending standards

From mid-2006 to the beginning of 2012:

2006: The bubble bursts

- Housing prices plummeted by 36%: The bubble burst

Since the 1950s, the next largest decline was ‘only’ 14% in the early 1990s

Why is decreasing housing prices a big deal? Don’t we want housing to cost less?

This led to adverse financial conditions

Housing Prices

- Suppose someone buys a home for \$200,000 and has a down payment of 20%, so they pay \$40,000 and take a \$160,000 loan
- If home prices increase by 20% to \$240,000, the individual can sell the house and be left with \$80,000 ($\$240,000 - \$160,000 = \$80,000$)
- If home prices decrease by 20% to \$160,000, the individual selling the home is left with \$0 ($\$160,000 - \$160,000 = \0)
- But what if you only have a down payment of 10% (\$20,000) and home prices decrease by 20% (\$40,000)?
 - Now you owe the bank \$20,000
 - What if you cannot make payments on your house?
- First, you may lose your investment (house) and wealth
- Moreover, if many people do not have the money to pay back the bank, then now the bank is in trouble
- If many banks are in trouble, then the entire economy is in trouble

If generalized: Banks get in trouble (they own the mortgages) \Rightarrow the whole economy falls apart.

Why? ... because banking funding is key for investment and the latter for growth

Housing Prices

Rising prices: homes are seen as a great investment

Note the anomaly that the 1996 to 2006 period is in terms of the 'real' value of homes

Naturally, people buy more houses, using loans, that are sustainable only if the prices remain high

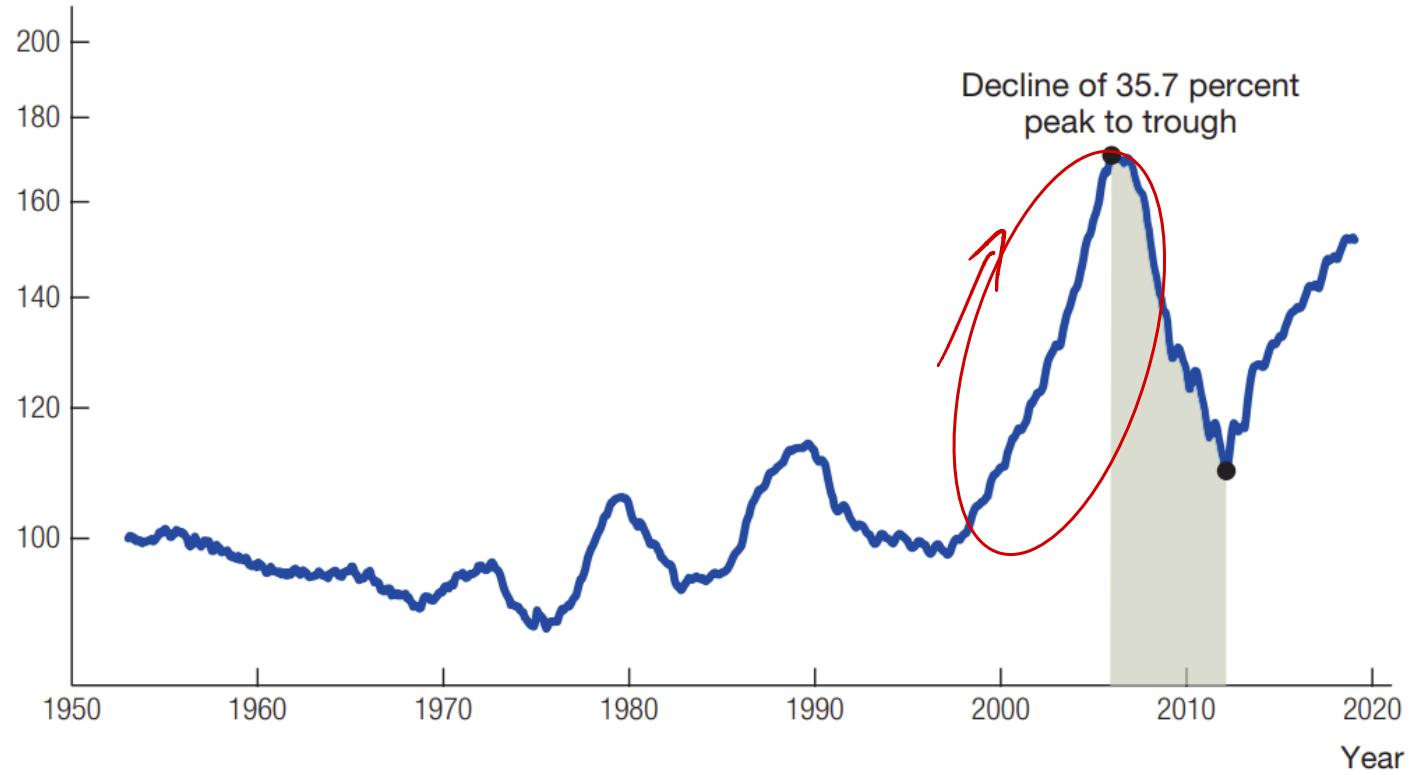
Otherwise, you'd rather not pay your mortgage and lose your house

house purchase viable only if

Bubble build up (abnormal price surges) ↗
↑ willingness to buy ← Self enhancing

A Bursting Bubble in U.S. Housing Prices?

Real home price index
(1953=100, ratio scale)



Source: Robert Shiller, www.econ.yale.edu/~shiller/data/Fig3-1.xls

- Lending conditions are good
- Prices remain high

↳ dependent conditions

Excess Savings from Emerging Countries

Global Savings Glut went to the US

Developing and Emerging countries borrowed much less from other countries and started saving more in the years prior to the crisis: **Savings 'glut' (excessive supply)**

- Looking for places to put these savings, they looked to the US in both the housing market and the stock market, inflating them even further

These resources entered the US and bought all sorts of assets: Safe, Risky, **Riskier**

External Savings = Current Account Surpluses and Deficits

Date	Industrial Region	Developing Region
1996	31.1	-82.8
2000	-304.7	124.7
2004	-296.5	296.5
2005	-502.5	507.9
2006	-607.3	643.2

Source: Ben S. Bernanke speech September 11, 2007

Excess Savings was massive
& inflated the financial
& housing market

Even the market of "less safe"/low quality assets

On top of this, there was an underestimation the risk of these investments — many backed on the prices of housing themselves ("securitization" & "mortgage-backed securities").

→ Emerging Economies

Also:

Financial Innovations
(Securitization) made
more difficult to
gauge actual risk
build-up.

Lending in housing market

Firms behind "repackaging" assets with
Prices derived from housing were quasi-
public (from government)

They had little oversight

There were many different factors leading to the housing market crash

- Key example: Fannie Mae (Federal National Mortgage Association)
- Company created during the Great Depression in 1938 to increase access to housing – this was done by buying mortgages from banks
- It became public in 1968, which led it to concentrate much more on making sure it was profitable
- In 1970, Freddie Mac (Federal Home Loan Mortgage Corporation) was created to provide some competition in this market
- One of the problems with the two firms was that even though they were private companies, they were still 'seen' as public and backed by the government
- They sold **mortgage-backed securities** because everyone believed the investments were safe – but many loans (in the 2000s) were subprime loans
- If the companies were scrutinized more closely, from the outside or inside, perhaps their downfall would not have been as sharp

The assets sold were actually very risky.

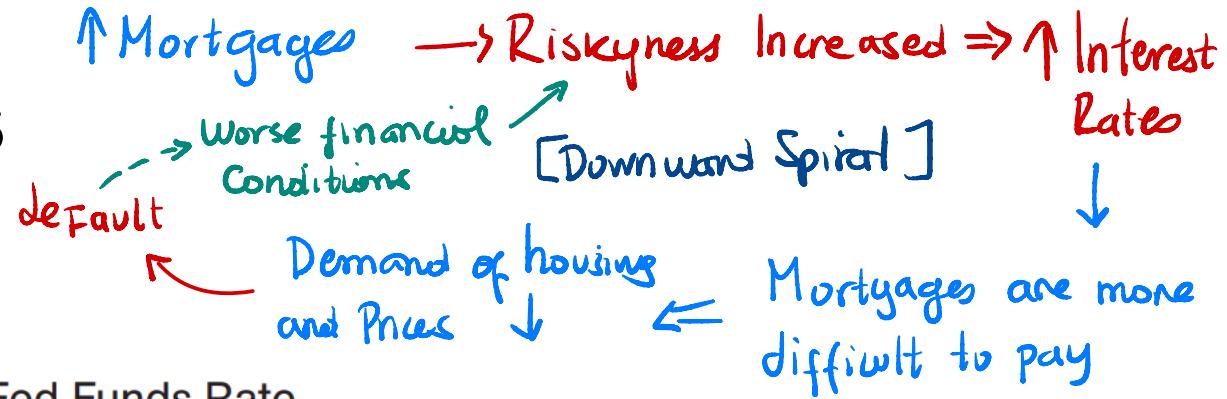
Rising interest rates

Low initial rates and optimism about house prices led to an increase in mortgages

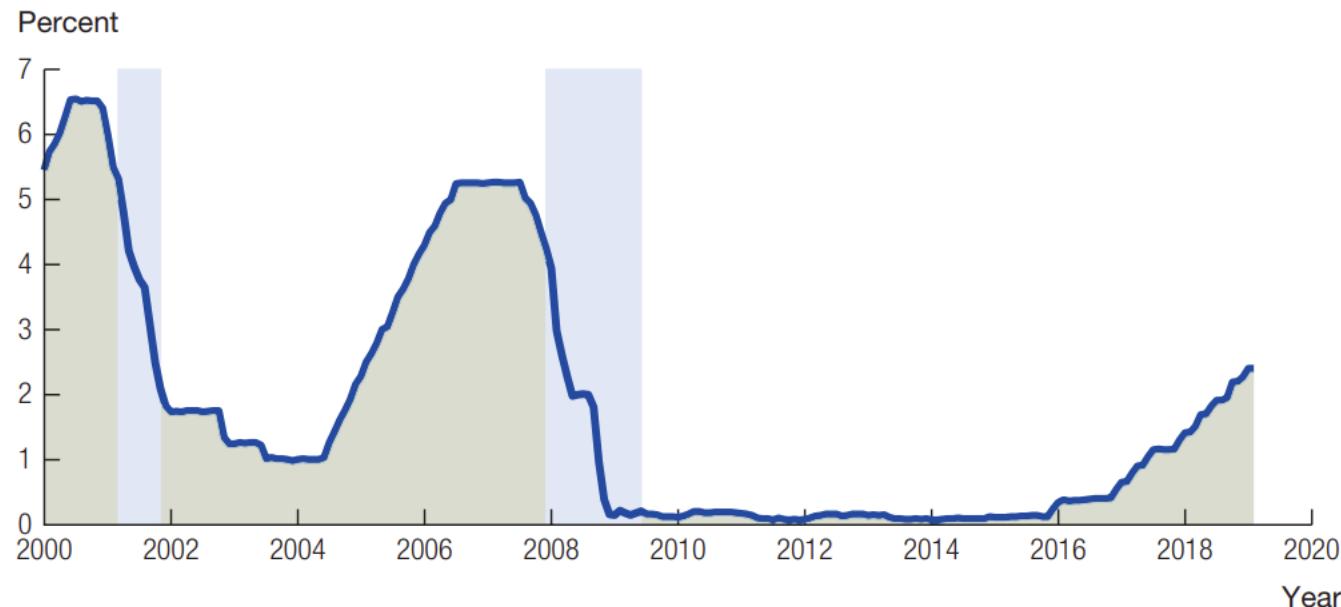
This included low quality lending (subprime loans) —lending standards deteriorated

Accordingly, interest rates increased beginning in 2004

This made mortgages harder to pay — by Aug. 2007, 16% of subprime adjustable rate mortgages were in default.



The Fed Funds Rate



Source: Board of Governors of the Federal Reserve System (US), Effective Federal Funds Rate [FEDFUNDS], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/FEDFUNDS>, September 22, 2019.

These problems created a downward spiral situation between the housing prices, the default on mortgages and cost of debt (higher rates).

Liquidity and Risk Shocks from Interest Rate Spreads

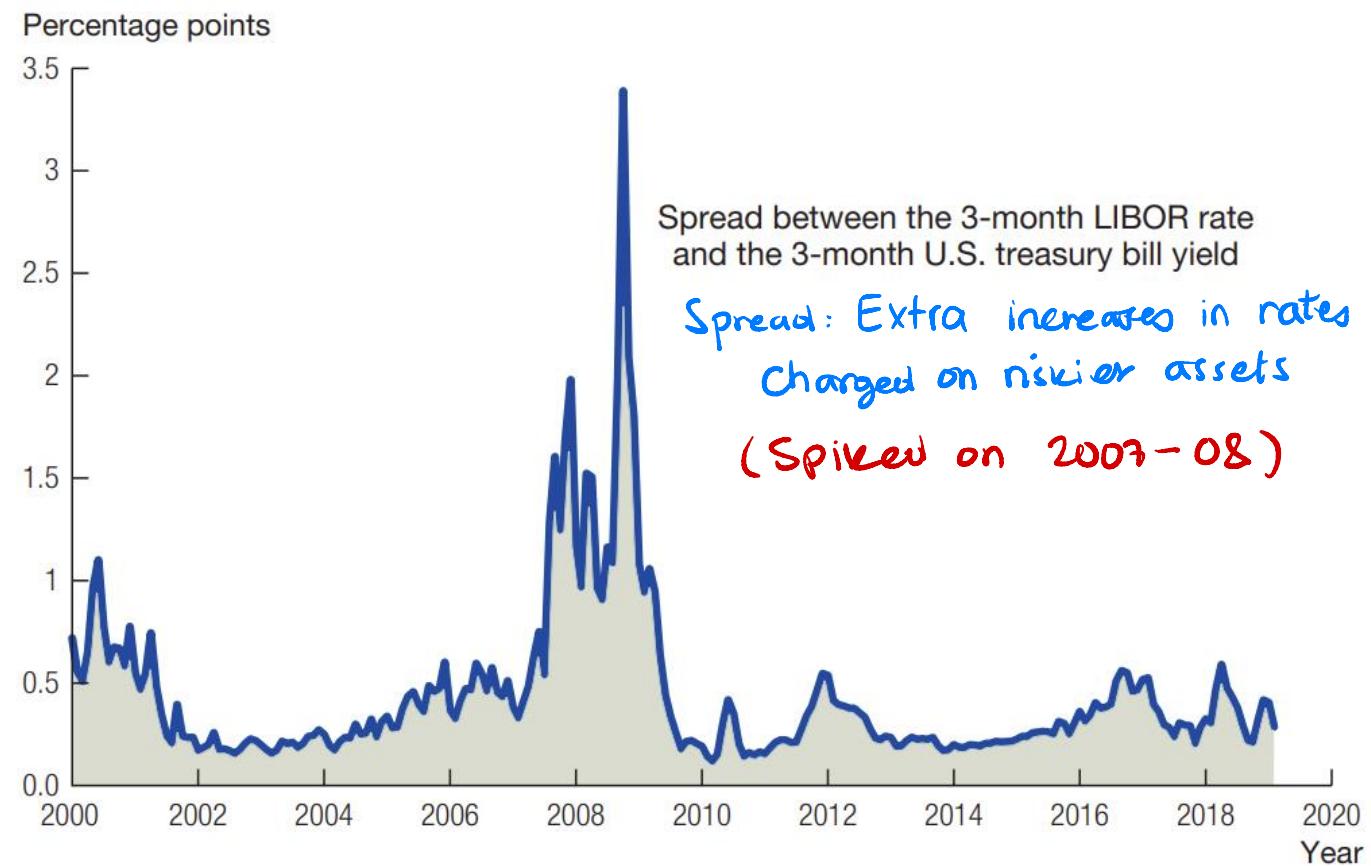
Financial innovations made it difficult to know exposure of banks to risk.

Rate at which banks borrow and lend to one another rose sharply.

Liquidity crisis that subsided only until banks over-invested in mortgages collapsed.

Bankers could not secure funds as needed (borrow from other banks)

Liquidity and Risk Shocks from Interest Rate Spreads



Note: The LIBOR rate is the London Interbank Offer Rate and is a measure of the interest rate charged on loans between banks.

Source: Federal Reserve Economic Data (FRED).

Banks failures: Lehman Brothers bankrupted, Merrill Lynch was sold to BoA. The government took over Fannie Mae and Freddie Mac, and implemented bailout programs (TARP)

Simultaneous negative (Supply) Shock:
↑ Oil Prices

Other shocks: Oil prices

At the same time (2007-08) the oil prices increased to unprecedented levels: A surge in oil prices can be seen as a —negative— supply shock for most countries

For the US: If oil prices increase, the cost of inputs (and production) rises

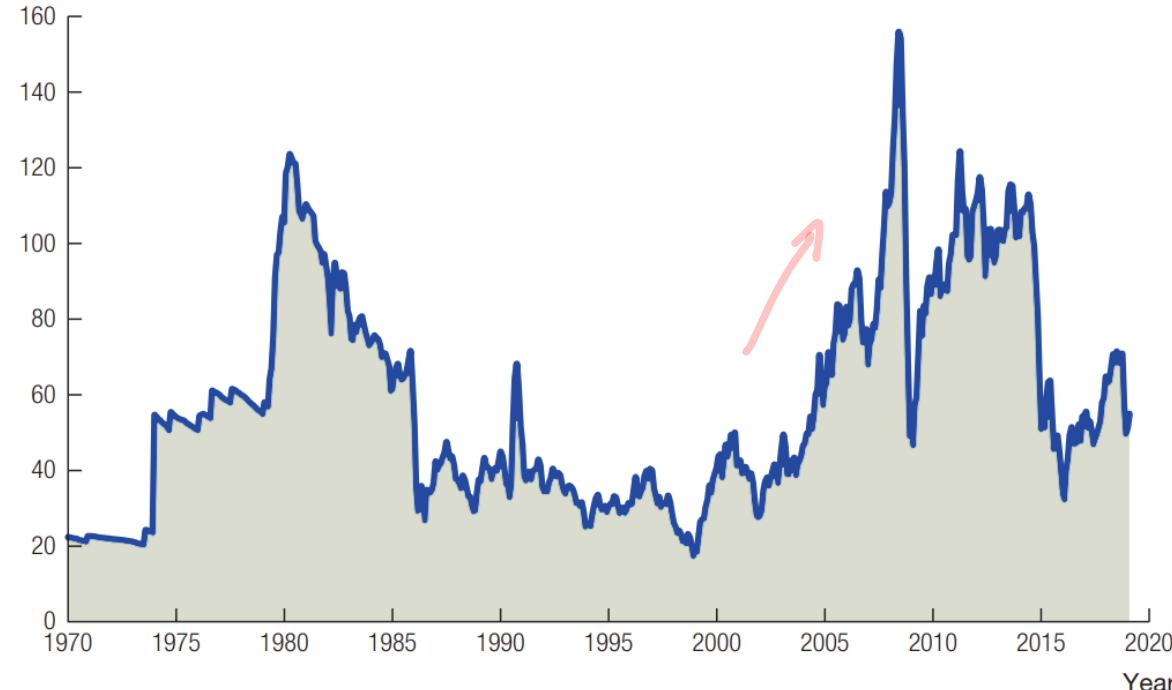
Volatility in oil prices:

- Price increase caused by increased demand coming from Emerging countries:
China, India, and the Middle East
- The subsequent economic slowdown helped to alleviate oil demand pressures

The resulting volatility is marked: prices went from \$160 to \$40 in a few months

The Price of Oil

Price of oil, per barrel
(2019 dollars)



Source: The FRED database.

Response of the Fed and Treasury

Emergency Economic Stabilization Act of 2008

- Created \$700 billion Troubled **Asset Relief Program (TARP)**
- Allowed banks to get rid of distressed assets

American Recovery and Reinvestment Act of 2009

- Extend unemployment benefits
- Food stamps
- Cash payments to individuals
- Highway repair and bridge construction
- Repair federal buildings
- Money to states to help with Medicaid
- Money to states to prevent cuts in education due to decrease in tax revenue
- Tax credits to individuals

Good & Prompt Policy Response
(TARP)

- Extended Resources to Banks
"bail outs" (Lending)

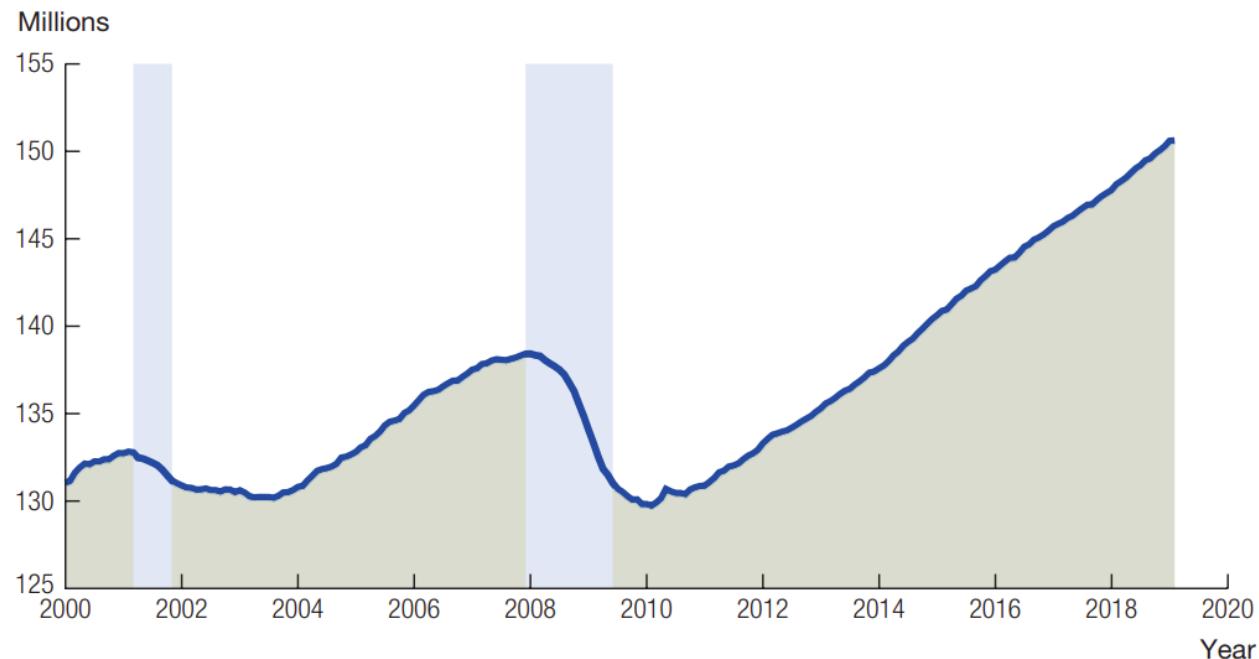
These policies are
always subject to debate

- Should the Gov. do this?
- To what extent before
Creating too much
Inflation?

Macroeconomic outcomes of the recession

- Decrease in employment began in December 2007
- By 2009, output was 7% below potential, and unemployment was more than 10%
- By February 2010, 8.5 million jobs were lost

Nonfarm Employment in the U.S. Economy



Source: U.S. Bureau of Labor Statistics, All Employees: Total Nonfarm Payrolls [PAYEMS], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/PAYEMS>, September 23, 2019.

Decrease in:

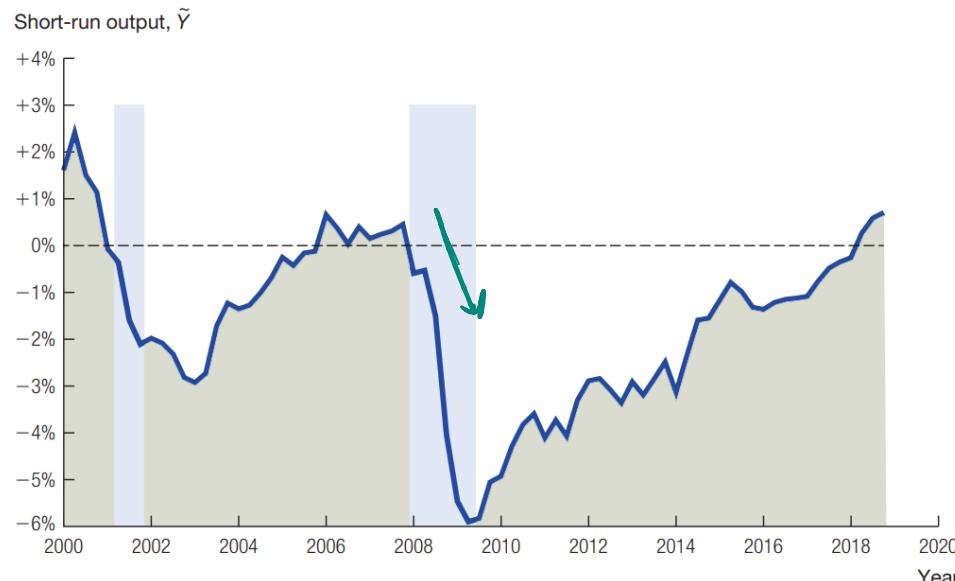
Employment $\rightarrow \uparrow u$

Output $\rightarrow \downarrow \tilde{Y} (-7\%) = (y - \bar{y})/\bar{y}$

Reminder: Okun's Law

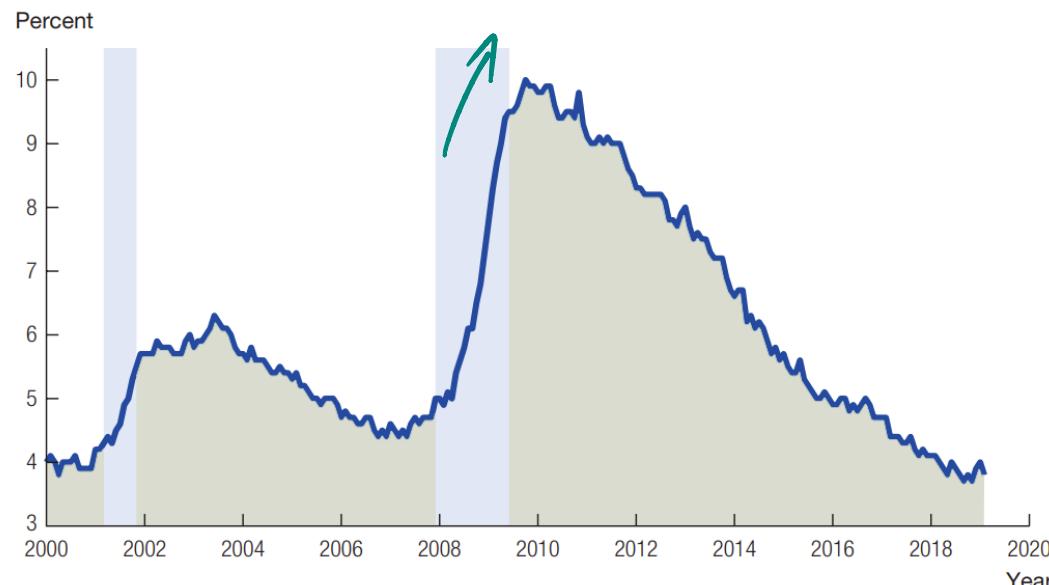
Macroeconomic outcomes of the recession

U.S. Short-Run Output, \tilde{Y}



Source: The FRED database and author's calculations.

The U.S. Unemployment Rate



Source: The FRED database.

Short-run output fell sharply: To 6% below the potential output.

The fall was of such magnitude that has prompted economist to ask two questions:

- How stronger was this recession previously to past ones?
- Did such severe downturn affect potential output too?

(the second one goes beyond this course but know that this concern has led to a large number of studies recently)

GFC Recession {
- big magnitude
- long & Recovery
was very long too

Severity of recession

This recession was unusually strong

However, there are two stronger recessions:

The 1929 Great Depression

The 2022 COVID lockdown

However, the 2022 one was much more short-lived.

Changes in Key Macroeconomic Variables:
Previous Recessions and the Great Recession

	Average of previous recessions since 1950	The Great Recession
GDP	-1.7%	-4.7%
Nonfarm employment	-2.5%	-6.3%
Unemployment rate	2.5	4.5
<i>Components of GDP</i>		
Consumption	0.4%	-3.4%
Investment	-14.4%	-34.0%
Government purchases	1.2%	5.5%
Exports	-1.5%	-10.3%
Imports	-4.2%	-18.7%

Source: The FRED database.

Strong impact on Investment \Rightarrow longer lasting impact on growth.

Then, the 2007 Great Recession was **atypically bad** (but not the only atypical one)

Moreover, what makes the Great Recession special is its **Financial Nature** which led to its after-effects to be much longer lasting than other recessions.

Food for thought: The severity of the recessions is not independent of the policy response. Policy actions can make the recession considerably milder/worse.

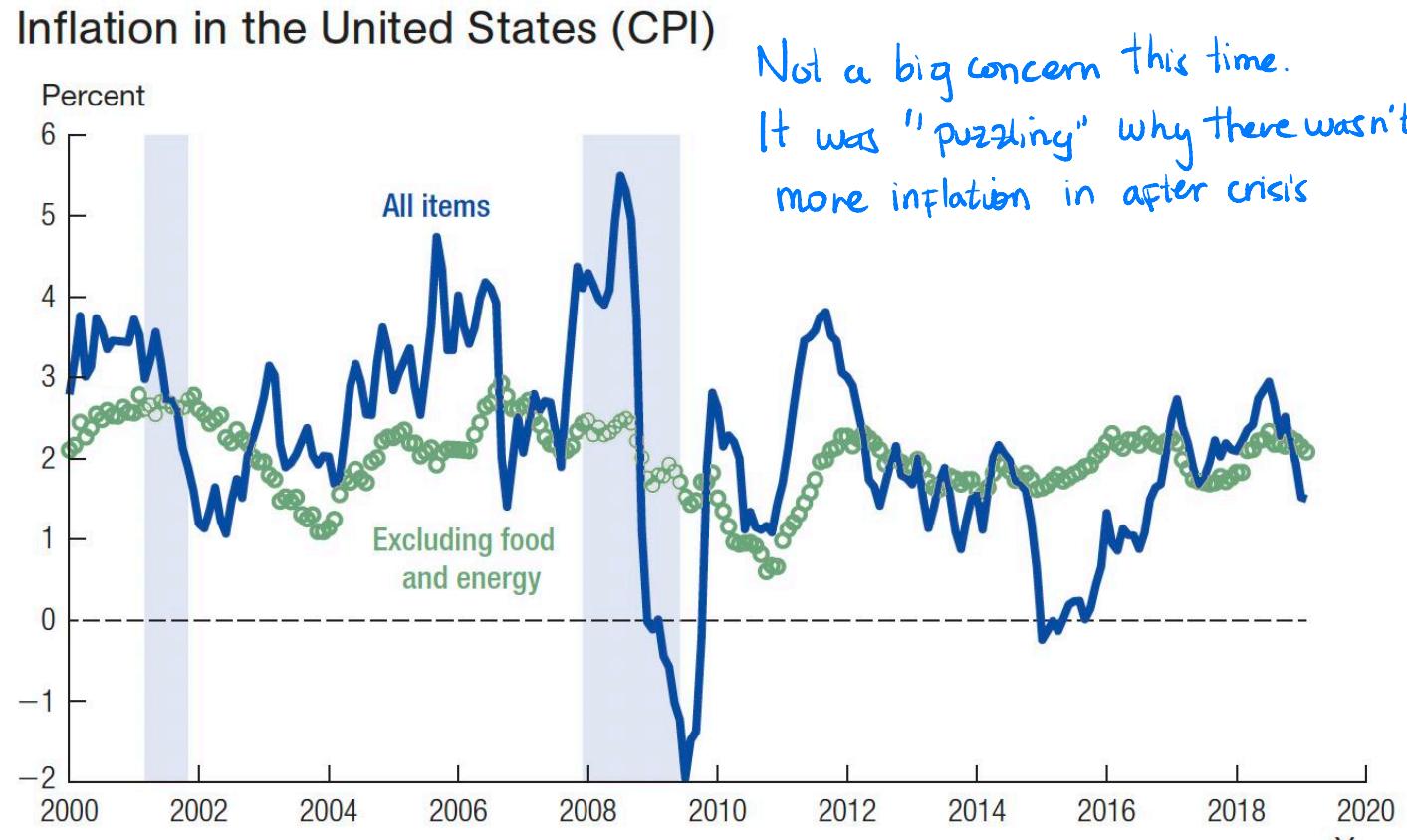
Inflation during the recession

- 'All items' inflation fluctuated vastly due to changing oil prices
- When excluding food and energy: Only slight decrease in inflation during the recession

All Items → Volatile (due to Oil Prices)

Core CPI: Slight decrease

Not a big concern this time.
It was "puzzling" why there wasn't more inflation in after crisis



Source: The FRED database.

We can say inflation was not as concerning as output dynamics. If something, it has been relatively puzzling how dormant the inflation was ("missing inflation puzzle")

Which was totally in contrast to the aftermath of the COVID recession.

Global GDP Changes

2009 financial crisis led to significant GDP declines in many developed countries.

Japan, the United Kingdom, and the Euro area were hit particularly hard, with GDP decreases of 6.3%, 4.9%, and 4.3%.

In contrast, China and India kept a good growth in 2009

This has led to the idea that although Global, this was mainly a crisis of the Developed world.

Percentage Change in Real GDP around the World

	2009	2012	2018*
Japan	-6.3	2.0	0.9
United Kingdom	-4.9	-0.2	1.4
Euro area	-4.3	-0.4	1.8
Italy	—	-2.1	1.0
Spain	—	-1.4	2.5
United States	-3.5	2.3	2.9
Brazil	-0.6	1.0	1.3
India	+6.8	4.5	7.3
China	+9.2	7.8	6.6

Source: IMF World Economic Outlook. *2018 is an estimate.

Crisis was even longer lasting in the EU

Unemployment in the Euro Area

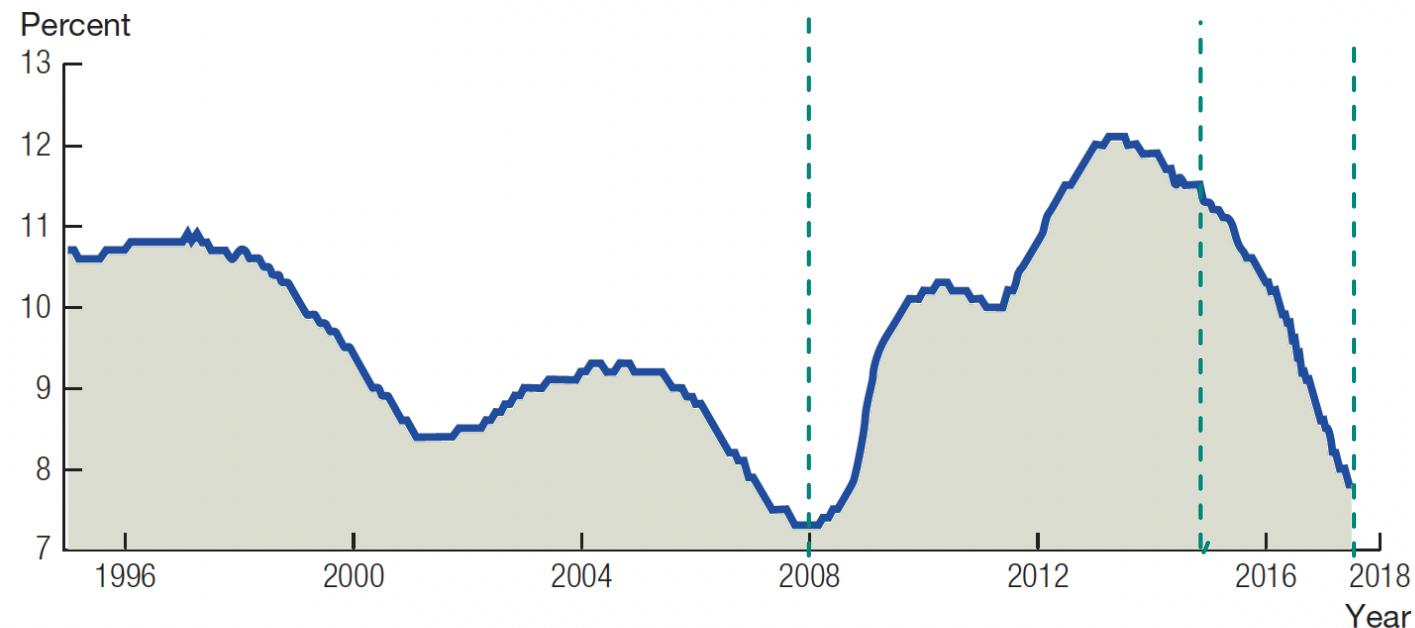
Major impact on the Euro area unemployment rate:
Peaked at over 12% in 2013.

Subsequent **slow** decline in unemployment as the economy recovered.

Italy and Spain: Very slow recovery

- Secondary impact of the sovereign debt crisis.

The Unemployment Rate in the Euro Area



Source: www.tradingeconomics.com. Reprinted with permission.

Slower recovery: Partly due to fiscal issues

(longer time of deterioration & recovery (relative to the US))

Some Fundamentals of Financial Economics

As hinted, the Great Recession was financial and thus requires some financial economics background to understand it better.

Net Worth: Difference between its total assets and its total liabilities.

Leverage: Ratio of total liabilities to net worth

Prior to crisis: Highly leveraged banks.

Drop in the price of assets can hugely impact net worth leading to bankruptcy.

Some of the assets were tied to the value of Mortgages as that's how the housing prices drop let do a generalized balance sheets deterioration.

What's special in this case? The **after-crisis recovery is slow** because it requires an initial **“deleveraging”** that postpones the investment grow necessary to normalize the economy

A Hypothetical Bank's Balance Sheet (billions of dollars)

	Assets		Liabilities
Loans	1,000	Deposits	1,000
Investments	900	Short-term debt	400
Cash and reserves	100	Long-term debt	400
<i>Total assets</i>	2,000	<i>Total liabilities</i>	1,800
		<i>Equity (net worth)</i>	200

$$\text{Net Worth} = \text{Assets} - \text{Liabilities}$$

$$\text{Leverage} = \frac{\text{Liabilities}}{\text{Net Worth}}$$

↑ high prior & during
↓ GFC

Conclusion

The Great Recession stands out for its **magnitude and duration**

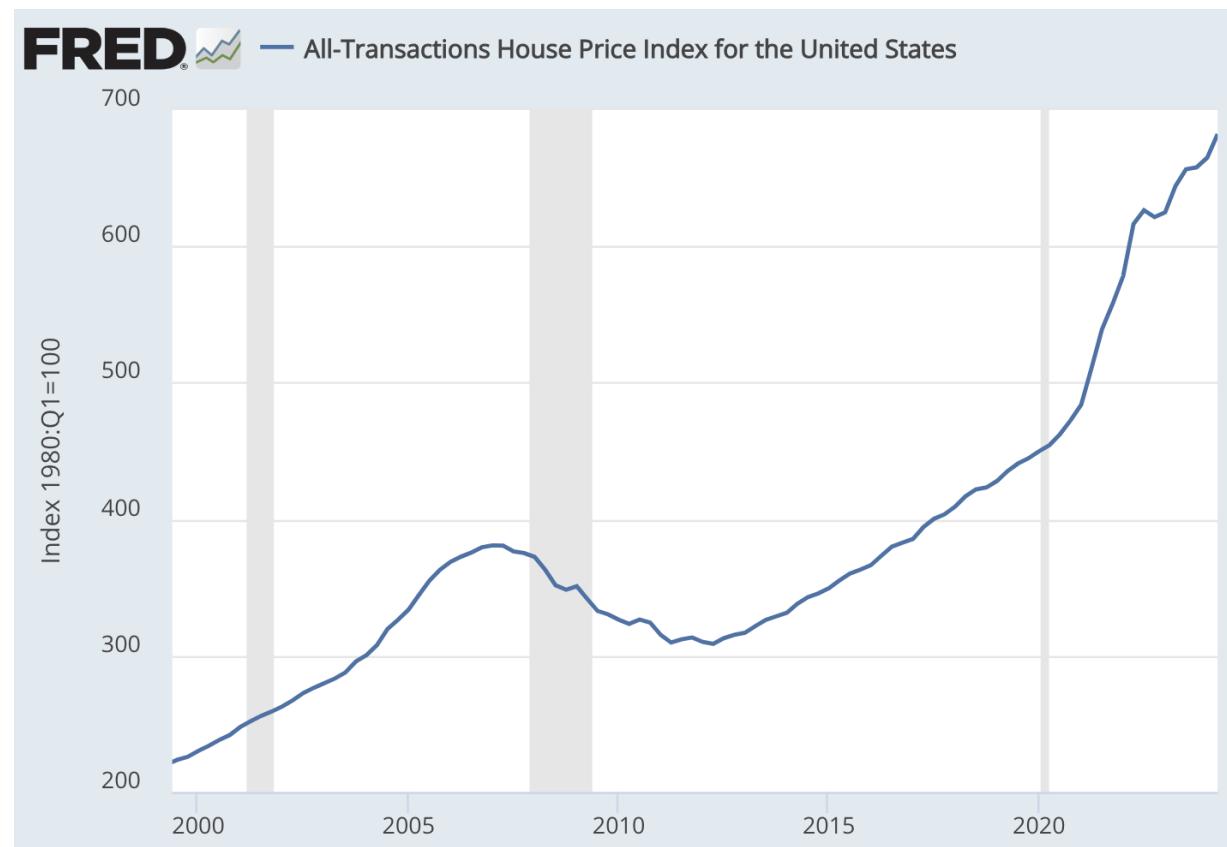
The main **cause was the bursting of the housing bubble** and then other factors contributed to its severity

Early policy actions were key:

FED and Treasury took unprecedented steps to stabilize the economy

GFC: Atypical Recession in many ways
(Financial in nature; special in magnitude & Duration)

Initial Cause: ↓ Prices of housing ⇒ Collapse of financial sector & of the whole economy



Source: U.S. Federal Housing Finance Agency

The crisis originated in the US but quickly became global