

Research on the Response to Crisis, Inflation, and Economic Development

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Abstract. Around 2008, due to the subprime mortgage crisis and the real estate market crisis, a large number of banks in the United States and even the world went bankrupt. This has led to a sharp rise in the unemployment rate and a sharp decline in the per capita GDP of the United States. As a result, the United States and the global economy fell into a severe recession, which became known as the 2008 financial crisis. Faced with the financial crisis, the US government has adopted different measures and policies. Although these measures did restore economic conditions to some extent, they also had a negative impact on the economic system. This paper will discuss the US financial crisis by analyzing different papers and data (such as US GDP and unemployment rate), and analyze the most suitable policy for the current economic situation by analyzing and comparing the advantages and disadvantages of different policies. By studying fiscal policy and monetary policy, this paper finds that the combination of fiscal policy and monetary policy can achieve better results, and this way of combining the two policies may be better able to deal with the possible financial crisis in the future.

Keywords: Fiscal, Monetary Policy, Financial Crisis.

1. Introduction

Due to excessive demand for subprime mortgages and soaring housing prices, interest rates in the U.S. economy began to rise sharply in 2005, which led to the 2008 U.S [1]. financial crisis. During the financial crisis, the economy of the United States fell into recession, a large number of workers lost their jobs, and a large number of banks collapsed.

In response to the 2008 financial crisis, the U.S. government used different policies. Among them, the most typical is monetary policy. However, the gang, dominated by John Maynard Keynes, argues that monetary policy cannot make a significant difference to GDP and interest rates in the long run [2].

Nevertheless, Milton Friedman also showed in his research that monetary policy can indeed prevent the economy from being seriously disturbed by other factors in the short run. Therefore, although monetary policy has obvious limitation, it can still play a role in stabilizing the economy in the short term [3].

In addition to monetary policy, there are many other policies used to fight financial crises. However, these policies are as obviously flawed as monetary policy. To this day, many economists continue to debate the appropriate economic policies to combat the financial crisis.

This article will discuss the impact of the 2008 US financial crisis by analyzing different data, such as US GDP data and US house price data. Then the paper will discuss the different measures taken by the US government to deal with the financial crisis, and analyze the advantages and disadvantages of different policies.

By studying different government actions or policies, economists can analyze what works best for the current economic situation. This is very important for a country because as experience grows, the economist or the government can better predict the future situation and thus prevent economic measures.

The rest of this paper is arranged as follows: the second part is an analysis of the basic facts of the US financial crisis, the third part is the measures taken by the US government to deal with the financial crisis, the fourth part is the prospect of the future, and the final part is the conclusion of the full text

2. Analysis of basic facts

The course of the financial crisis in the United States, the factors leading to the financial crisis, and the impact of the financial crisis on the American economy and financial system will be discussed. It is important to understand the basic facts of the financial crisis, because the government needs to judge different situations and then take appropriate measures.

2.1. The course of the American financial crisis

The US government deliberately promoted the mortgage market and decrease the interest rate (Figure 1). In particular, between 2001 and 2004, in an effort to boost economic growth, the U.S. government cut U.S. interest rates to 1 percent [1].

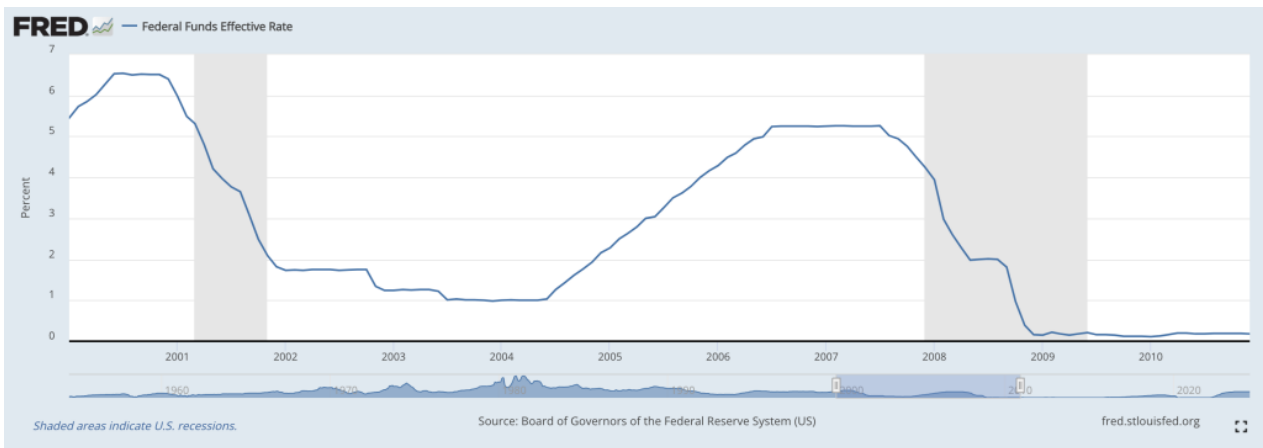


Fig 1. US federal funds rate from 2001 to 2010.

However, this led to more and more people wanting mortgages. As figure 2 shows, house prices began to rise sharply. As a result, interest rates also began to rise sharply in 2005 [4].

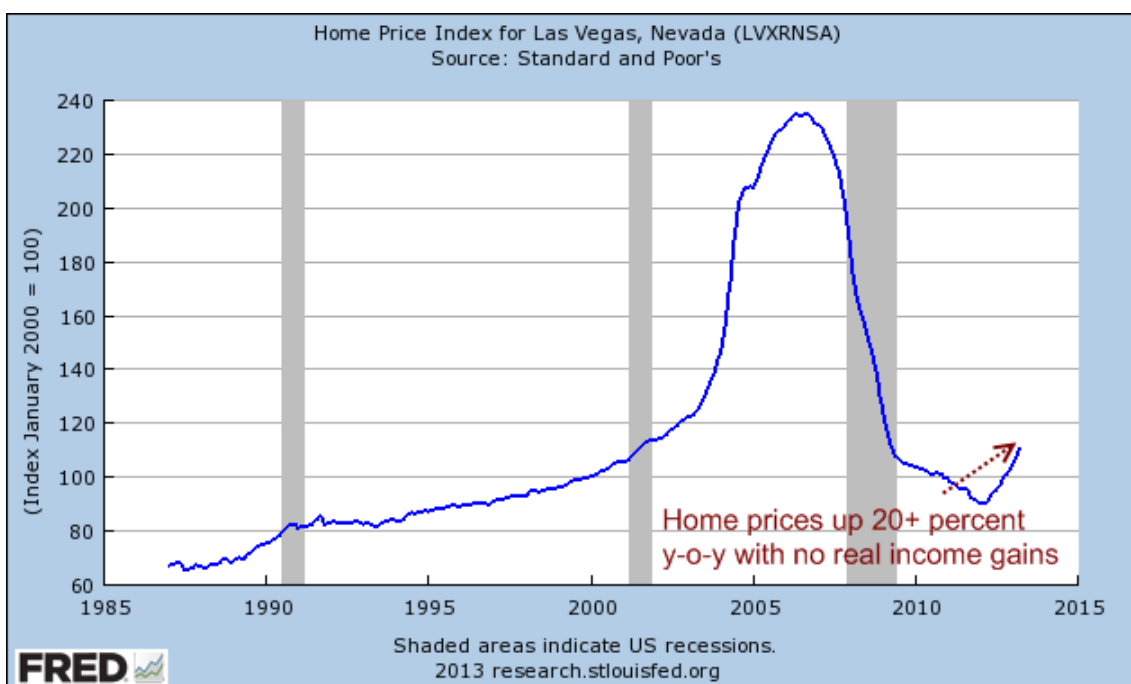


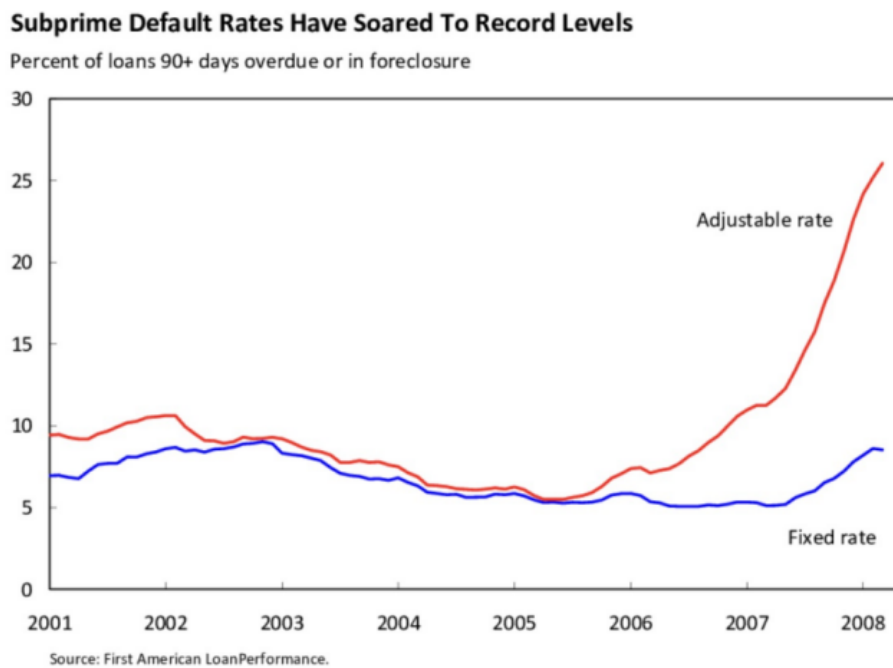
Fig 2. US home prices from 1985 to 2015.

The financial crisis resulted in the collapse of two mortgage companies, Fannie Mae and Freddie Mac. Then came the most famous bankruptcy of all: the bankruptcy of Lehmann Brothers. As banks went bust, banks became less creditworthy and stopped making loans. Then, stock markets began to fall sharply, and global trade markets were severely affected. The unemployment rate in the United States has soared from 4.4 percent to 7.2 percent in a year and continues to rise. The United States and the global economy are continuing to experience a deep recession [1].

2.2. Factors that led to the financial crisis

After 1945, the U.S. government introduced the mortgage system from Europe to promote economic growth. At first this did not cause any problems, because only the upper classes had access to mortgages. However, after 1992, more and more citizens had access to the mortgage system, which led to the growing liquidity of subprime mortgages.

The increasing demand of subprime mortgages has led many middle-class people to borrow to buy more expensive properties that cost far more than their normal income. These middle-class people bought their homes and then sold them at a higher price for a profit, which caused house prices to start soaring (Figure 3). Eventually, supply outpaced demand in the housing market, and prices stopped soaring but stayed high. Fearful that house prices would start to fall, homeowners began to sell in large quantities, and as a result, houses began to fall again. As housing prices began to decline, many borrowers found themselves unable to repay their loans. As figure 3 shows, this leads to a surge in mortgage defaults and foreclosures [1].



3: Default Rates on Subprime Mortgages

Fig 3. US subprime default rates from 2001 to 2008.

2.3. The impact of the financial crisis on the US economy

Because of the collapse of the mortgage market, people could not repay the high loans, so they had no choice but to sell their real estates. More than five million homes were sold, but with supply far outstripping demand, the housing market began to stall. The credit markets were also severely affected by the collapse of the housing market, which caused huge losses for many people who had invested in CDOs [4-6].

As a result, the economy of the United States fell into a severe recession, and both large and small companies experienced huge losses during the financial crisis. In addition, the global trading market

has also been paralyzed by the economic recession, among which the United States import and export trade has been the most severely affected. At the same time, due to the downturn of the stock market, most of the banks had to go bankrupt, the unemployment rate in the United States continued to soar rapidly during the financial crisis, and even at the end of the financial crisis, the unemployment rate in the United States and most of the European countries reached more than 10 percent. This has led to a decline in U.S. GDP of about 4 percent in two years (figure 4) [1].

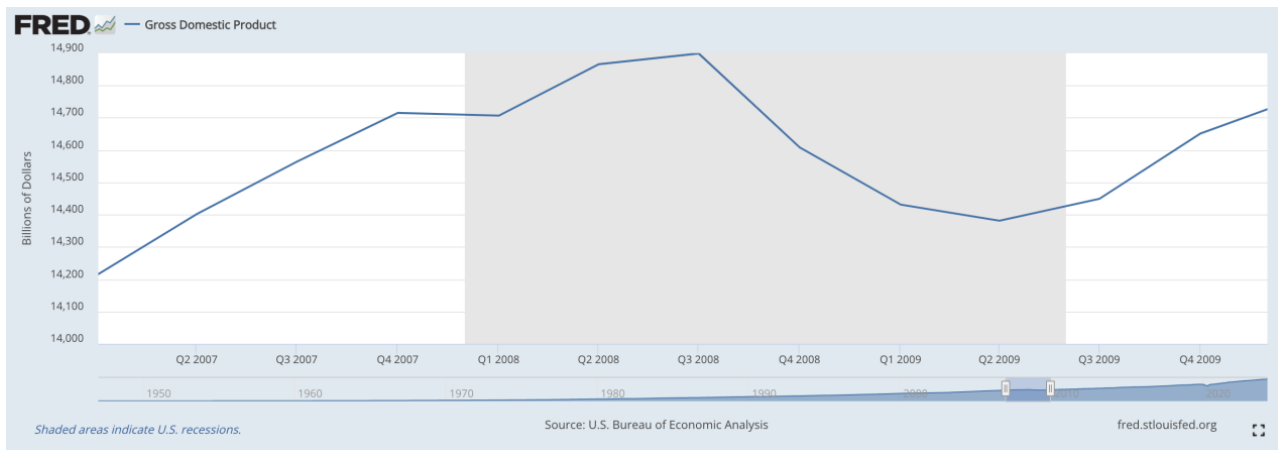


Fig 4 .US GDP from 2007 to 2009.

3. U.S. government policy in response to the financial crisis

In this section, the essay will talk about how U.S. government deal with financial crisis and the effect of this policy.

3.1. Summary of the policy

In 2008, the US government tried to ease the economic recession by lowering the interest rate. However, this kind of monetary policy could not alleviate the economic crisis well at that time, because the monetary policy had a certain lag. And the Fed predicted at the end of 2008 that interest rates would be low for a long time to come. As a result, the Fed decided to use unconventional monetary policies such as quantitative easing. The purpose of using quantitative easing (QE) is to stabilise the economy and reduce unemployment in the short term.

Quantitative easing is when the government increases the supply of money by buying government bonds, thereby lowering interest rates to encourage lending and investment. The Fed responded to the 2008 financial crisis with three different QE policies, which are known as QE1, QE2 and QE3 [5].

QE1: In 2008, the government mainly bought \$600 billion of Mortgage Backed Securities, which is known as MBS and government bonds to stimulate the economy. To deepen the policy's impact, the Fed ramped up its purchases of MBS and government bonds in 2009.

QE2 was the government's 2010 effort to boost economic growth by buying \$400 billion in Treasury bonds.

QE3, on the other hand, is an increase in the government's purchases of Treasury bonds and MBS in 2012, on top of the previous policy [5].

At the same time, the US government adopted fiscal policy. Because the U.S. economy was in recession and consumption was generally lower, more government spending would have been more effective than tax cuts. Government spending includes public spending on goods and services, and fiscal policy in this way can better stimulate consumption and investment [6].

3.2. The effect of quantitative easing

After the government purchased a large amount of MBS and government bonds, it did increase liquidity in the market at the time and lowered interest rates. These influences encouraged lending, which helped stabilize the precarious U.S. economy at the time.

QE (aka unconventional monetary policies) did help revive stocks and boost economic growth in the short term, though [7]. But QE also has obvious drawbacks. It will cause inflation and interest rate increases in the long run. That is because QE helps to pump money into markets, but if economic output does not increase at the same time, too much money will cause prices to soar. Moreover, an increase in the money supply can cause businesses and consumers to misjudge future prices, leading to higher long-term interest rates [8].

Overall, QE has helped ease the economic crisis, but its long-term risks cannot be ignored. Therefore, the government should use QE policy in conjunction with other economic policies, so that different policies can complement each other.

4. Future expectations

This section will talk about the lessons from 2008 US financial crisis, and how can the government use the policy to deal with future financial crisis.

4.1. How can financial crises be prevented

To prevent a financial crisis, governments should start at the root: they should create a stricter legal framework to supervise banks, that is, to limit large financial activities. But supervision and restrictions alone will not stop large financial activities, so governments should increase transparency in financial reporting and provide real-time assessments of financial conditions. It should be noted that the government should evaluate the current economic situation in a macro sense, not a few individual institutions [9].

In addition, the Fed should vary interest rates based on current economic conditions. When inflation is high, for example, the Fed should raise interest rates appropriately. Of course, the adjustment of the interest rate should come after the government has completed its macro-assessment of the current economic situation.

4.2. How to improve policy

As for the monetary policy mainly discussed in the above article, because of its obvious limitation, the government should carry out the implementation methods according to its limitations. In response to this situation, the government should pay attention to the inflation that monetary policy may bring. Moreover, governments can choose to combine fiscal policy (including increased government spending and tax cuts) with monetary policy, which can deliver better results.

But how can the government interconnect fiscal policy and monetary policy. First, expansionary monetary policy is to stimulate growth by lowering interest rates. However, there may be some destabilizing factors, such as the possibility of inflation. In that case, fiscal policy can help shore up the economy [10]. Second, an expansionary fiscal policy will lead to a government budget deficit. Thus, expansionary monetary policy can alleviate the government budget deficit by stimulating short-term revenue growth and reducing interest payments on public debt [11-12]. Generally, monetary and fiscal policy will be more efficient and stable when used together.

The reason why government should use fiscal policy alongside monetary policy is that it can help boost consumption and thus the economy. It should be noted that unlike monetary policy, fiscal policy has almost no lag time and can produce quick results. Therefore, fiscal policy is very suitable for rapidly mitigating the negative impact of financial crisis. However, fiscal policy also has its limitations: excessive reliance on the use of fiscal policy may lead to an increase in the deficit, which

will lead to an increase in the national debt. That is why governments need to balance the use of monetary and fiscal policy [11].

5. Conclusion

During the 2008 U.S. financial crisis, the collapse of the housing market and a spike in interest rates caused massive bank failures and job losses in the United States. The economy of the United States and the world suffered a severe recession around 2008, which severely hit the society at that time. The quantitative easing policy chosen by the US government at that time undoubtedly played a role in reviving the economy.

However, even if QE was useful at the time, the US government should continue to study the negative effects of unconventional monetary policies, especially the long-term inflation that monetary policies can bring. Faced with the shortcomings of monetary policy, the US government should pay close and strict attention to price changes. Moreover, the US government should use fiscal policy in concert to face possible future financial crises. Although the US government has not yet found a perfect way to deal with the financial crisis, the US government can still find the most suitable policy for the current situation by strengthening financial supervision and evaluation. At the same time, the government should also make relevant plans in advance to prevent a possible financial crisis in the future.

To sum up, government should draw lessons from the past financial crisis, sum up experience, and take active measures to prevent the occurrence of future financial crises. The most important thing for the government is not to find the perfect policy, but to find the most suitable policy.

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