Policy Responses to the Great Recession

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01 Background

Economic Hardship

- 2007 – 2009 (18 months)
- International markets and banking, real estate industries
- Second-worst financial crisis in US history
- GDP decline of over 4%
    - Largest in the postwar era
- Estimated $19 trillion in net worth loss (US)
- Peak unemployment of 10%
- 3M home foreclosures in 2009 and 2010
- Bank and other institutional failures

BEAR STEARNS

Merrill Lynch

LEHMAN BROTHERS

WaMu®

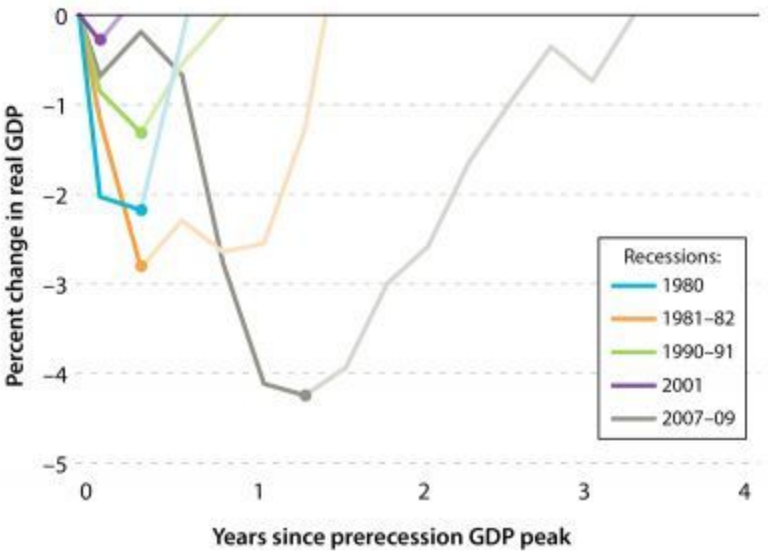
FIGURE 1A.

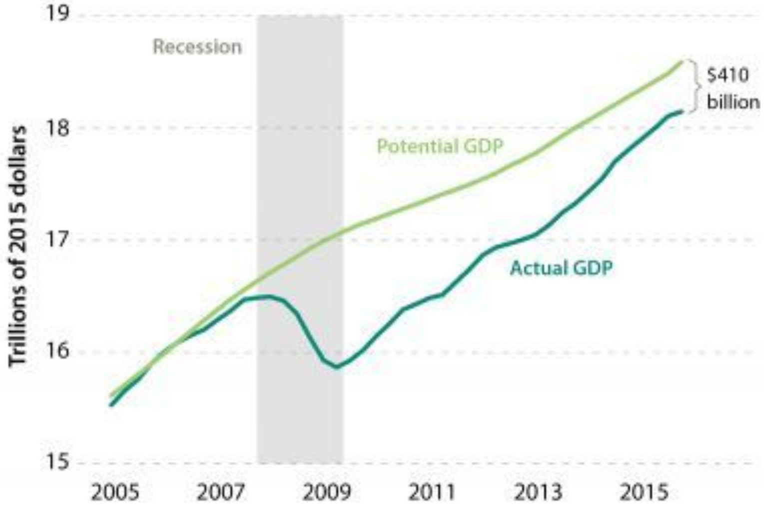
Depth and Duration of the Five Most-Recent Recessions

FIGURE 1B.

Potential GDP vs. Actual GDP, 2005–15

More than six years after the Great Recession ended, GDP remains about $400 billion below its potential.





Sources: Bureau of Economic Analysis 2016; CBO 2016b; National Bureau of Economic Research n.d.

Note: All values are seasonally adjusted. Actual GDP in figure 1b is smoothed using a three-quarter moving average. Gap between actual and potential GDP ($410 billion) is in constant 2015 dollars.

THE HAMILTON PROJECT
BROOKINGS

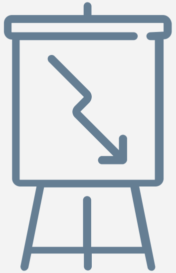
How it Happened

Housing
prices rise

Underqualified
get home loans

Fed increases interest
and home prices fall

Subprime borrowers cannot
afford loan payments or
sell/borrow against value of
home at a profit



More foreclosures and
lower prices: **Mortgage
and housing markets
collapse**

Banks holding MBS and
firms insuring them take
tremendous losses → job
losses

Fannie Mae & Freddie Mac

- Government-sponsored private enterprises
- Provide liquidity, stability, and affordability to mortgage markets
- Does this by buying mortgages from lenders and either:
    - Holding them in their portfolio
    - Repackaging them into Mortgage-backed securities to be sold to investors
- Fannie Mae and Freddie Mac take on a majority of default risk
- Enables banks to make more loans
- Failed during the crisis and bailed out by the government

02 Fiscal and Treasury Responses

Department of Treasury and Congress

- Sect. of Treasury Henry Paulson
- Treasury had little legal authority until new legislation
    - Troubled Asset Relief Program (TARP) 2008
        - Received $700B to use to fight the crisis
        - Committed money to restabilize banking, restarting credit markets, auto industry, AIG, avoiding foreclosures
- The Economic Stimulus Act of 2008
    - $152 billion stimulus with $600 tax rebates for middle and low-income Americans
- American Recovery and Reinvestment Act of 2009
    - $787 billion bill which covered relief and expenditures in many different areas
        - Education, infrastructure, healthcare, business investment, tax rebates, and more

TARP bailed out and saved:

citi

BANK OF AMERICA

Goldman Sachs

AMERICAN EXPRESS

BNY MELLON

AIG

Morgan Stanley

STATE STREET

us bank

JPMorgan Chase & Co.

WELLS FARGO

PNC

Capital One

DISCOVER

Automotive Industry Financing Program (AIFP)

- Made to prevent collapse of American auto industry
- "Big 3" – General Motors, Ford and Daimler Chrysler
    - Collapse would mean massive job losses and lost revenue
- AIFP provided loans to automakers if they restructured operations for long-term viability
- GM: $51B
- Chrysler: $12.5B
- Ally Financial: $17.2B
    - Former financial subsidiary of GM, now separated

Housing and Economic Recovery Act (HERA)

- Created Federal Housing Finance Agency (FHFA) which pur Fannie Mae and Freddie Mac under a conservatorship
- Housing Assistance Tax Act of 2008
  - Refundable tax credit for certain first-time homebuyers with income under $75,000 (tax amount was 10% of price up to $7,500)
- FHA Modernization Act of 2008
  - Increased FHA loan limit and mandated 3.5% down payment for FHA loans
  - Prohibited seller-funded down payments
- Secure and Fair Enforcement for Mortgage Licensing Act of 2008
  - Required states to start a mortgage loan originator (MLO) licensing and registration system

03 Monetary Response

Traditional Policy Response

- Federal Reserve Chair Ben Bernanke
- Frequent interest rate (Federal Fund) cuts
    - Banks borrow money from each other over night for lower costs
    - Meant to spur business investment and purchases, increasing employment
- Before the crisis, these cuts created inflation so the Fed temporarily paused them

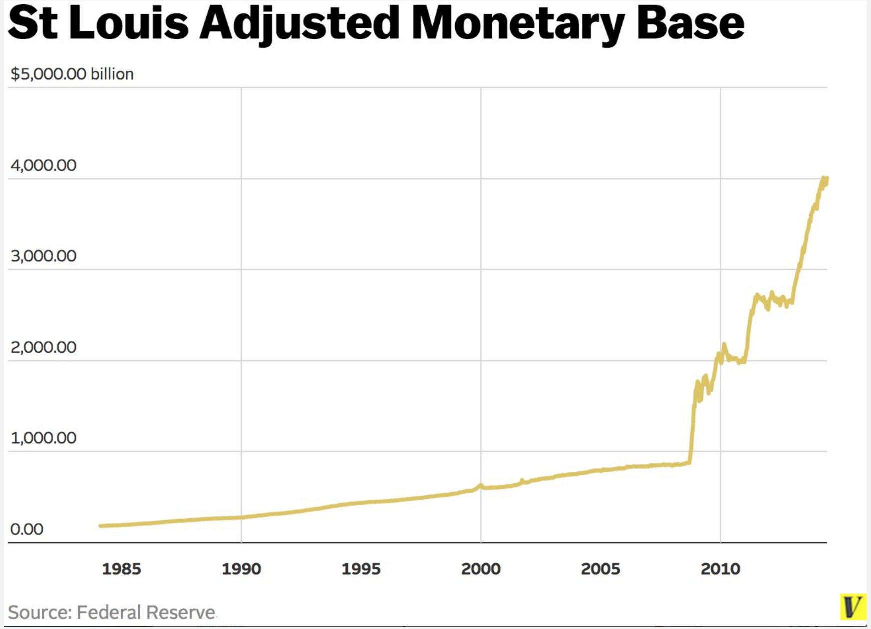

FRED
Federal Funds Effective Rate
20.0
17.5
15.0
12.5
10.0
7.5
5.0
2.5
0.0
Percent
1960
1970
1980
1990
2000
2010
2020
Source: Board of Governors of the Federal Reserve System (US)
fred.stlouisfed.org

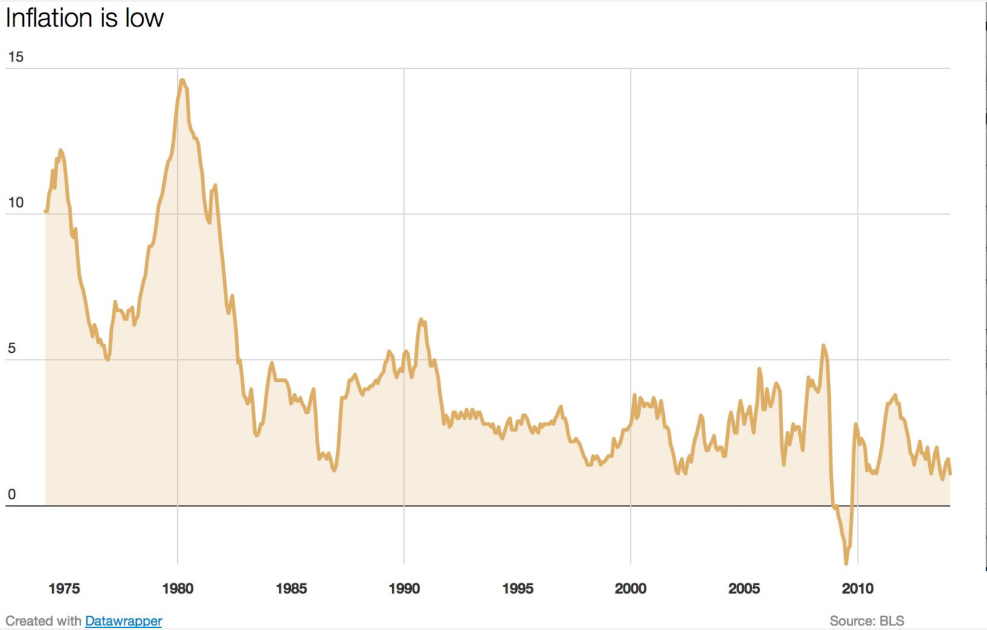
Forward Guidance

- Communicate future monetary policies to households
- Tells public the expected path of interest rates
  - Helps households, investors, and businesses make financial decisions
- Dec. 2008: weak economic conditions "likely to warrant exceptionally low levels of the federal funds rate for some time"
- Prevents surprises that disrupt markets

Quantitative Easing

- Implemented when interest rates were near zero and could not be lowered further
- Unconventional and controversial
- Government buying long-term debt issues and assets
- Form of “printing money”
- Injects new money into the economy
- Specific, predetermined dollar quantity of assets to be bought
- Nov. 25, 2008 was the first usage of QE by the US Federal Reserve
    - $175 billion in agency securities and $1.25 trillion in mortgage-backed securities


St Louis Adjusted Monetary Base
$5,000.00 billion
4,000.00
3,000.00
2,000.00
1,000.00
0.00
1985
1990
1995
2000
2005
2010
Source: Federal Reserve
V


Inflation is low
15
10
5
0
1975
1980
1985
1990
1995
2000
2005
2010
Created with Datawrapper
Source: BLS

Going Forward

- The Great Recession showed the negative impact of too much debt and bad loans
- Importance of personal debt management
- Consumer Financial Protection Bureau created to ensure fair treatment of consumers by Wall St. firms
- Bank stress tests
  - Evaluates resilience of banks over a period of time under different hypothetical crisis scenarios

cfpb Consumer Financial Protection Bureau