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# The Great Financial Recession: Causes, Consequences and Policy Responses

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**ABSTRACT**

**Starting in mid-2007, the world monetary crisis quickly metamorphosed from the explosive of the housing bubble in the U.S.A. to the worst recession the world has witnessed for over six decades. Through associate degree in-depth review of the crisis in terms of the causes, consequences and policy responses, this paper identifies four key messages. Firstly, contrary to widely-held perceptions throughout the boom years before the crisis, the paper underscores that the world economy was by no means that as stable as prompt, whereas at an equivalent time the bulk of the world's poor had benefited insufficiently from stronger economic process. Secondly, there have been advanced and interlinked factors behind the emergence of the crisis in 2007, specifically loose financial policy, world imbalances, misperception of risk and lax monetary regulation. Thirdly, on the far side the combination image of economic collapse and rising state, this paper stresses that the impact of the crisis is rather numerous, reflective variations in initial conditions, transmission channels and vulnerabilities of economies, on with the role of presidency policy in mitigating the worsening. Fourthly, whereas the recovery section has commenced, a range of risks stay that might derail enhancements in economies and hinder efforts to make sure that the recovery is in the middle of job creation. These risks pertain specifically to the challenges of addressing debt and continued world imbalances.**

**Keywords: Global Crisis, History of crisis, Food & energy crisis,**

## I. INTRODUCTION

The global monetary crisis of 2007 has solid its long shadow on the economic fortunes of the many countries, ensuing in what has usually been referred to as the 'Great Recession'.1 What started as ostensibly isolated turbulence in the sub-prime section of the North American country housing market mutated into a full blown recession by the tip of 2007. The recent proverbial truth that the remainder of the globe sneezes once the North American country catches a cold appeared to be exonerated as systemically necessary economies in the European Union and Japan went put together into recession by mid-2008. Overall, 2009 was the initial year since World War II that the world was in recession, a black circle on the boom years of 2002-2007.

The crisis came for the most part as a surprise to several policymakers, multipartite agencies, lecturers and investors. On the eve of the happening of the money crisis, Jean-Philippe Cotis of the OECD (2007) declared: 'Second Great Contraction' for the OECD space as a full growth is about to exceed its potential rate for the remainder of 2007 and 2008, supported by buoyancy in rising market economies and favorable money conditions'. Within the wake of the world recession of 2008- 2009, the political economy profession has come back below a nice deal of criticism from leading students. Krugman (2009a) chides fellow economists for their '…blindness to the terribly chance of ruinous failures in a market economy'. Galbraith (2009) offers a sturdy critique of the political economy profession and argues that each express and implicit intellectual collusion created it tough for the leading members of the profession to encourage a real discourse based mostly on various views. The result was that a rather restricted intellectual speech communication took place between primarily similar students.

## II. A HISTORY OF CRISIS

Contemporary studies of the historical evidence such as IMF (2009a) and Reinhart and Rogoff (2009) have shown that such financial crises typically induce a sharp recession, which last approximately two years. Consumption, private investment and credit flows are also slow to improve, which is driven by deleveraging of debts and risk perceptions. As a consequence, recovery is slow with unemployment levels continuing to rise for a number of years after the economy has started to grow again. Economic crises are not just a peculiarity of advanced economies. Indeed, developing countries have been highly vulnerable to a plethora of banking, external debt, currency, and inflation crises during recent decades. The debt crisis of the 1980s, the Asian financial crisis of the late 1990s and the more recent debt crisis in Latin America in the 1990s and 2000s have all resulted in deep recessions. Many developing countries have repeatedly suffered crises due to poor macroeconomic management and policymaking. For example, Argentina has experienced four banking crises since 1945. In developing countries, how households cope with economic downturns and external shocks impose social costs that are not always easy to reverse. For example, in the case of the Asian financial crisis, there was an increase in the incidence of poverty, ranging between 3.1 per cent (Thailand) and 7.6 per cent (Indonesia) and a decline in real wages ranging between -8.9 per cent (Korea) to about -40 per cent (Indonesia).

Overall, it is clear that, despite the 'Great Moderation', the costs associated with low- frequency, high-impact events are high. This means that risk management strategies aimed at containing these costs should be a core part of economic policymaking.

## III. JOBLESS GROWTH SLUGGISH REAL WAGES AND THE FOOD AND ENERGY CRISIS

One legacy of the global boom of 2002 and 2007 was that insufficient attention was being given to the stresses and strains that afflicted labor markets across the world even during the high-growth era. Quantitative expansions in employment in many parts of the world, particularly in developing countries, were juxtaposed with sluggish real wage growth, persistence of the informal economy, 'casualization' of the work-force, declining wage shares in national output and rising inequality.

This is a familiar theme in recent ILO reports,11 but other organizations, such as the OECD and the World Bank, have also highlighted the problems of growing economic insecurity and inequality in regional and global labor markets.12 Decent work remains an elusive goal in many low and middle-income countries.

One key shortcoming of the boom period was the failure for increases in economic growth to translate into improvements in household incomes. For example, in three major developing and emerging economies – Indonesia, South Africa and Turkey - real wages in the 2000s hardly showed any sustained improvement.13 Even in consumption-led economies like the US, incomes remained relatively stagnant over this period (Figure 1). However, in contrast to developing countries where this situation translates to stubborn levels of poverty, American households were able to increase consumption by tapping into their wealth, namely the increase in household equity that accompanied rising prices (Baily et al. 2008). This increase in consumption was reflected in the worsening US current account deficit, which rose from US$398.3 billion (3.9% of GDP) in 2001 to $803.6 billion (6.0% of GDP) in 2006.

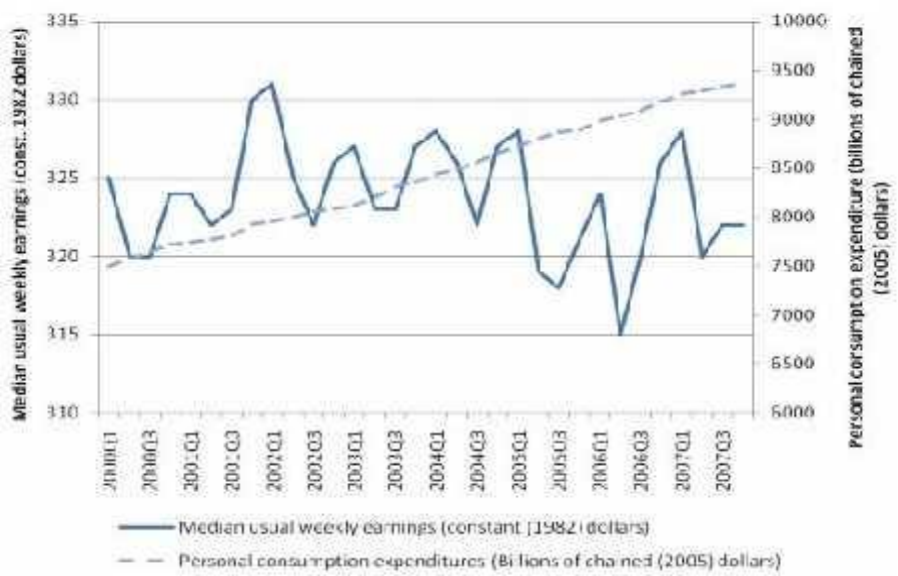


**Figure 1: Growing consumption in the US during the boom years despite stagnant real wages, 2000-2007**

## IV. FACTORS BEHIND THE GLOBAL CRISIS

Leading up to the crisis there were many telltale signs that should have set off alarm bells. The vast majority of academics, officials and investors ignored the signals and rather made profuse claims about a new era. There was a general euphoria about the conditions in the global economy and with many commentators claiming that 'this time is different'.

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As argued by this study, there are, however, many similarities between the US sub-prime crisis and previous banking crises such as the massive surge in housing and equity prices, the growing current account deficit and rising level of (private) debt. At the same time, the exposure of lenders and investors was complicated by the unprecedented level of securitization of mortgages (through collateral debt obligations), which created considerable uncertainty in financial markets as the crisis unfolded. This, in turn, resulted in a sudden reversal of risk perceptions. The causes of the crisis have become, understandably, a major topic of discourse among both academics and policymakers. The debate surrounding this issue has generally focused on the role of market failure in precipitating the crisis, namely the catastrophic performance of the financial market that was in stark contrast to the theoretical proposition that it is efficient. This puts one of the core tenets of capitalism into question. At the same time, most contributions to the ongoing post-mortem analysis of the crisis recognizes that government failure has played a major role in allowing banks and other financial institutions to capitalize on loop-holes in the regulatory system to increase leverage and returns.

Overall, drawing from a comprehensive review of crisis-related studies, four core, but interrelated, factors can be identified: interest rates, global imbalances, perceptions of risks and regulation of the financial system. These factors are captured in Figure 2 (though this diagrammatic representation of the crisis excludes the complex interactions between the different elements to ensure readability).

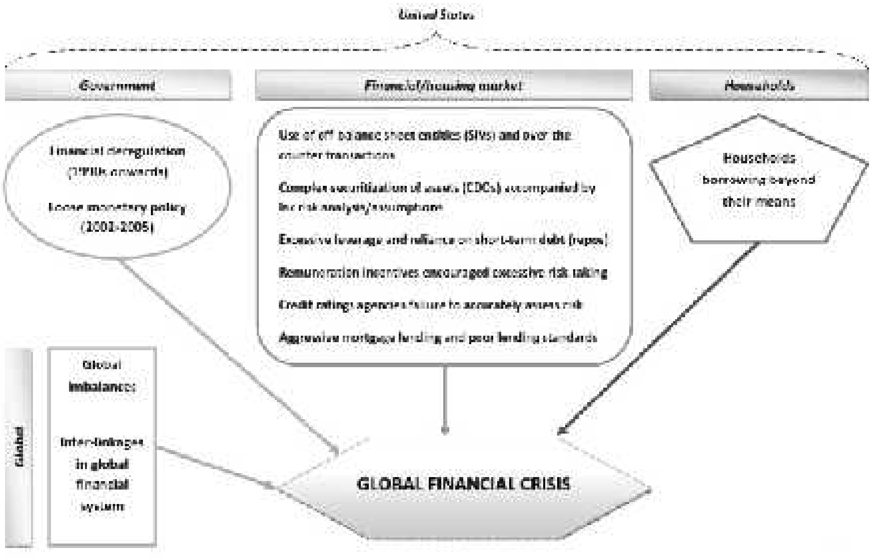


**Figure 2: Explaining the key factors behind the global financial crisis**

## V. GREATER DIVERSITY IN THE IMPACT OF THE CRISIS ON THE LABOR MARKET

Moving from the variation in the contraction of output to the impact on the labour market reveals that there is even more diversity in outcomes across countries. In OECD countries, the unemployment rate has increased from 5.7 per cent in the third quarter of 2007 to 8.6 per cent in the third quarter of 2009, representing a rise of 10.1 million individuals without jobs. According to the ILO's Global Employment Trends (January 2010), the number of unemployed persons is estimated at 212 million in 2009, an increase of almost 34 million on the number in 2007 (ILO 2010b). The five hardest hit OECD countries in terms of a surge in the unemployment rate from 2007Q3 to 2009Q3 are Estonia (+10.9 percentage points), Spain (+10.3 ppts), Ireland (+8.1 ppts), United States (+4.9 ppts) and Turkey (+4.6 ppts). The average increase in the OECD is 2.9 percentage points. At the same time, a number of countries have experienced a mild impact on the labour market in terms of rising unemployment. In Poland and Germany, the unemployment rate has, in fact, decreased over this period (by 1.2 and 0.7 percentage points, respectively). In others such as Austria, the Slovak Republic, Republic of Korea and the Netherlands, the change in unemployment rate has been marginal. Analyzing output and unemployment adjustment jointly provides a mapping of OECD countries that reflects both the diversity and complexity of the crisis (Table 1 and Figure 3). For example, Norway and Malta have experienced only a mild economic contraction and labor market impact, while others including Austria, Germany and the Netherlands have avoided a major deterioration in the labor market despite a greater fall in output. In comparison, unemployment in the United States has risen far more than other countries with a comparable economic contraction, which reflects the flexibility of the US labor market. A similar story is evident for Denmark, Spain, Slovakia and Turkey. The worst hit countries are Estonia, Ireland, Lithuania, and Latvia, which have all suffered both a severe fall in output and deterioration in the labor market. Australia is an outlier in this matrix as it is the only country to have avoided negative growth in 2009. As illustrated by Figure 3, this data suggests that for every 1 percentage point decrease in the GDP growth rate, the unemployment rate increases by a further 0.47 percentage points.

Table 2: Relationship between GDP growth (2009) and change in unemployment rate (from 2008 to 2009) - Australia, Canada, Turkey, United States and the EU

| | Mild labor market | Mild labor market | Mild labor market |
|---|---|---|---|
| Mild economic contraction | Norway (1.0, -1.9)<br>Malta (0.6, -1.5) | Australia (1.3, 1.3)<br>Canada (2.2, -2.6)<br>Cyprus (1.7, -1.7)<br>France (1.7, -2.2)<br>Greece (1.8, 2.0) | United States (3.5, 2.4) |
| Severe economic contraction | Austria (1.0, -3.6)<br>Belgium (0.9, -3.0)<br>Germany (0.2, -5.0)<br>Italy (1.1, -5.0)<br>Japan (1.1, 5.2)<br>Luxembourg (0.5, -4.2)<br>Netherlands (0.6, -4.0) | Bulgaria (1.2, -5.0)<br>Czech Republic (2.3, -4.3)<br>Sweden (2.1, -4.4)<br>United Kingdom (2.0, -4.9) | Denmark (2.7, -5.1)<br>Spain (6.7, -3.6)<br>Slovakia (2.5, -4.7)<br>Turkey (2.8, -4.7) |

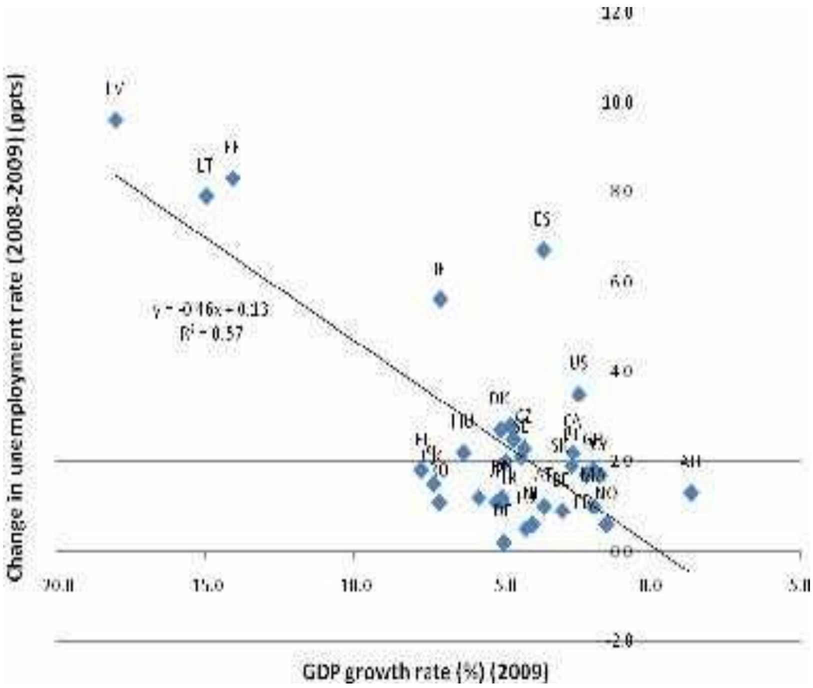


**Figure 3: The relationship between economic contraction and deterioration in the labor market - Australia, Canada, Turkey, United States and the EU**

## VI. LABOR MARKET AND SOCIAL POLICIES AS PART OF THE RESPONSE TO THE CRISIS

The labor market policy response to the crisis has centered around four main areas: maintaining and increasing labor demand; improving the match between demand and supply; providing income support; and targeting of vulnerable groups. Drawing on the findings of a range of recent surveys on the policy response to the global financial crisis of 2008-2009, a large number of high-income countries have utilized policy measures that address these different goals (Figure 4).

The most commonly used intervention in high-income countries is training for both those threatened by layoffs and the unemployed (including work experience and apprenticeship initiatives) (27 countries), followed by work sharing (24 countries), increased resources for public employment services, including job search assistance measures (20 countries), and job/wage subsidies (20 countries). The least implemented intervention in this group of countries is public works programs (6 countries), which is not very surprising given the limited effectiveness of this intervention in such labor markets.

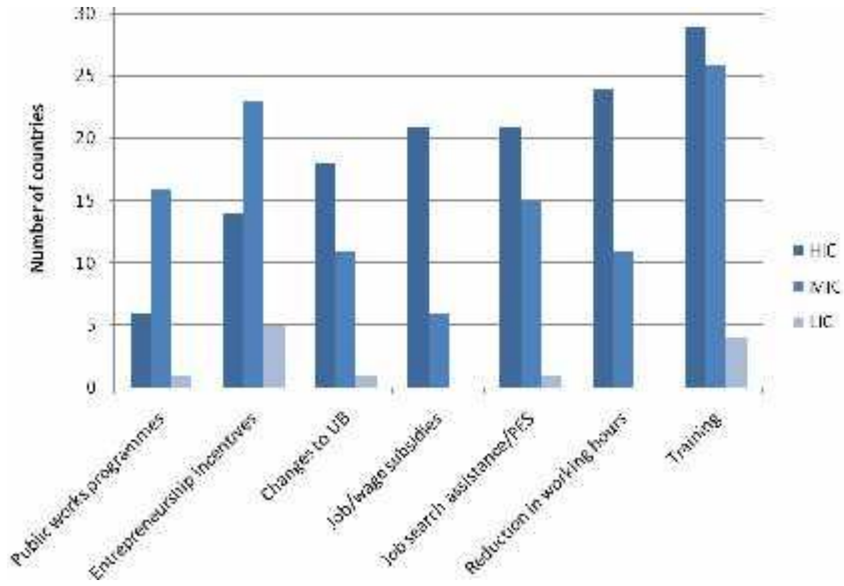


**Figure 4: National labor market policy responses to the global financial crisis of 2008-2009**

Overall, the use of labor market policies in terms of scope and diversity declines with the income-level of countries, which reflects the financial and technical constraints hindering the response of these governments. Nonetheless, a range of policies have been utilized in low and middle-income countries, in some cases in a similar fashion to more developed nations. As displayed in Figure 4, the most utilized policy response in the middle-income group is training (with 25 countries) followed by job search assistance, entrepreneurship incentives and public works programs. There are far fewer low-income countries implementing such policies in response to the crisis. In general, low and middle-income countries tend to rely on labor market policy measures that do not require complex institutional structures and social dialogue. Nonetheless, some governments are turning to more innovative policies that have not been widely used before such as providing subsidized training for threatened workers.

## VII. FROM RECESSION TO RECOVERY

Towards the end of 2009, a variety of indicators showed that the worst of the global financial crisis was over in most countries. Stock markets have recovered from their nadir that was evident in March 2008 and also exhibit far less volatility than at the height of the crisis (World Bank 2010). Third quarter figures for GDP did indicate that most OECD countries technically exited recession (besides Greece, Hungary, Iceland, Spain and the UK). At the same time, one is even witnessing an incipient asset price boom. Later in 2009, trade and industrial production statistics suggested that a recovery is underway. Figures on manufacturing activity in China, Europe, the US, and other badly-hit countries indicate that the global recovery was beginning to strengthen at the start of 2010. Most notably, US industrial activity reached its highest level since August 2004. However, growth figures for the last quarter of 2009 reveal that this exit from recession is not as robust as first thought. In particular, growth in the European Union has slowed down (from 0.3% in 2009Q3 to 0.1% in 2009Q4). Growth in Czech Republic and Italy fell back into negative territory, while Greece, Hungary, and Spain continued to contract. Expansion in the US and Japan appeared to gather pace, though some of this has been argued to be driven by the ‘inventory, which will not continue to be an engine of growth over coming quarters.

## CONCLUSION

The paper has navigated a wide and diverse terrain. It would be useful at this juncture to weave together the different strands in the discussion, highlight the key findings and the implications that follow from them. Firstly, the historical perspective outlined in this paper on the decades leading up to the global financial crisis provides an insight into different interpretations of recent economic trends. Over the years leading up to the global financial crisis of 2007 and the ensuing recession, commentators, including leading academics, postulated that the economy had entered a new era of low volatility. Apart from this OECD-centric view, there are other interpretations of the economic trends of the last few decades, namely the insufficient rates of growth in developing countries in the 1980s and 1990s to tackle poverty, and then more recently, the devastating impact of the surge in oil and food prices on the poor .In addition, there had been little improvement in employment outcomes in many countries, despite the surge in economic growth from 2002. Moreover, the financial crisis that hit the global economy in 2007 and 2008 was by no means the first. A review of previous crises reveals that these episodes have occurred frequently, a fact that was so easily forgotten during the boom years of the 2000s. Overall, this review shows that the global economy was by no means as stable as suggested by many observers, and thus given the warning signs, the crisis Shouldn’t have come as a surprise. Secondly, the paper stresses that there are a range of complex and interlinked factors behind the emergence of the global financial crisis in 2007, namely loose monetary policy, global imbalances, misperceptions of risk and lax financial regulation. The paper also summarizes how economies around the world have been affected, resulting in millions of job losses. Beyond this aggregate picture, the impact of the crisis is rather diverse, reflecting differences in initial conditions, transmission channels and vulnerabilities of economies, along with the role of government policy in mitigating the downturn. In terms of the policy response, this paper stresses that macroeconomic stimulus measures and labor market policies have been utilized in both advanced and developing economies. Nonetheless, these policies have only partially offset the crisis; in some cases they have been more successful in helping governments avoid either a severe economic contraction or at least a rapid deterioration in the labor market.

Finally, this paper underscores that while the recovery phase has commenced, a number of risks remain that could derail improvements in economies and hinder efforts to ensure that the recovery is accompanied by job creation. The main risks to the recovery relate to the premature withdrawal of the stimulus packages, the continuing and emerging imbalances and the challenge of setting an appropriate level of regulation for the financial sector to avoid some of the mistakes that were made leading up to the start of the crisis in 2007. The path to recovery will be protracted and uncertain, and ultimately, will hinge on whether China can continue to drive global growth.

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