2016

Examining the Great Recession: What Caused the Financial Crisis and How to Prevent the Next One

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Economics 101

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Abstract:

Economics in an important part of our lives that affects everything we do. With this essay, I try to define economics and its effects on everyday life by looking at the big example in hand, the Great Recession of late 2000s. I will identify the reasons behind the financial crisis and how did it affect the world; ultimately, I hope to explain what should we do to prevent another one from taking place.

Some recall December 2007 as the gloomiest month of the decades; some recall it as the worst possible nightmare. As David B. Grunsky, Christopher Wimer, and Bruce Western have written on their best-selling book *The Great Recession*, it was a "Dramatic Fallout" that recast the economic landscape and affected the very foundations of society; "marriage and divorce rates, social and political attitudes, lifestyle and consumption practices and much more."[1] An article written by Cherlin et al. suggests that the recession even dropped the fertility rates of US by 9 to 11%.[2]

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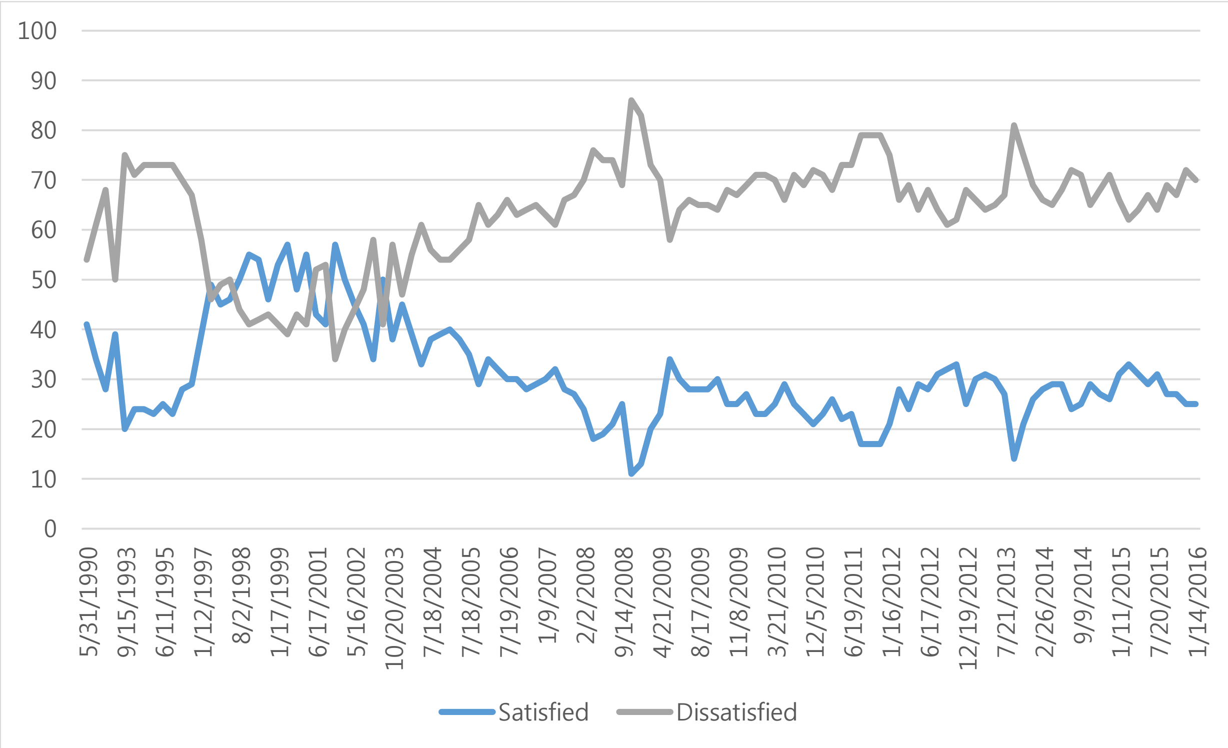
1 Grusky, D. B., Western, B., & Wimer, C. (2011). The great recession. New York: Russell Sage Foundation.

2 Cherlin, A., Cumberworth, E., Morgan, S. P., & Wimer, C. (2013). The Effects of the Great Recession on Family Structure and Fertility. The ANNALS of the American Academy of Political and Social Science, 650, 214-231. doi:10.1177/0002716213500643

Figure 1 is compromised by the data collected from Pew Research Center, a non-partisan fact tank. According to the Data, the satisfaction rate of America has taken a notable hit by the financial crisis in 2007 and the aftermath still continues.[3]

Figure 1: National Satisfaction Rate, provided by Pew Research Center



We have taken the backward approach, and just briefly examined how the recession did affect us, in every possible ways from government satisfaction and fertility. And at this stage one might wonder, what happened? What did it happened to mess up the life of, basically, everyone? So many factors affected the results and there is no single ultimate answer. However given the courses of economics and how it sparked my interest in the field in general, one can only make

[3] National Satisfaction. (2016, January 14). Retrieved April 20, 2016, from http://www.pewresearch.org/data-trend/national-conditions/national-satisfaction-2/#

educated guesses. And one of the guesses will be MBS, Mortgage Backed Securities, as the financial crisis is often referred as "subprime mortgage crisis."

It all begin with a low interest rate. As interest rates lowers, people are more likely to take out loans to buy the things that they could not afford otherwise. If I were to buy a car, if the interest rate as high as 30%, I probably will take minimum amount of loans to buy the car. I will probably buy a cheap one, maybe. However if it happens that the rate suddenly drop down to 5%, it will feel like that I will have no interest at all. I can buy the car now, without feeling guilty to tomorrow's me. So maybe I will take out bigger loan and buy a bigger car. Or maybe two. Large financial institutions saw this situation as an opportunity. They lend more at lower rates. People, now with disposable cash on hand, spend the cash on something big and expensive – homes.

Figure 2 shows changes of interest rate, effective federal funds rate over decades.[4] As seen on the graph, from 2000 to 2004 the rates decreases, and this in turn leads to what is shown on Figure 3. Average sales prices of houses sold for US[5] crossed over with previous graph, the interest rates graph.

Figure 2. Effective Federal Funds Rate

[4] Board of Governors of the Federal Reserve System (US), Effective Federal Funds Rate [DFF], retrieved from FRED, Federal Reserve Bank of St. Louis https://research.stlouisfed.org/fred2/series/DFF, May 1, 2016.

[5] US. Bureau of the Census, Average Sales Price of Houses Sold for the United States [ASPUS], retrieved from FRED, Federal Reserve Bank of St. Louis https://research.stlouisfed.org/fred2/series/ASPUS, May 1, 2016.

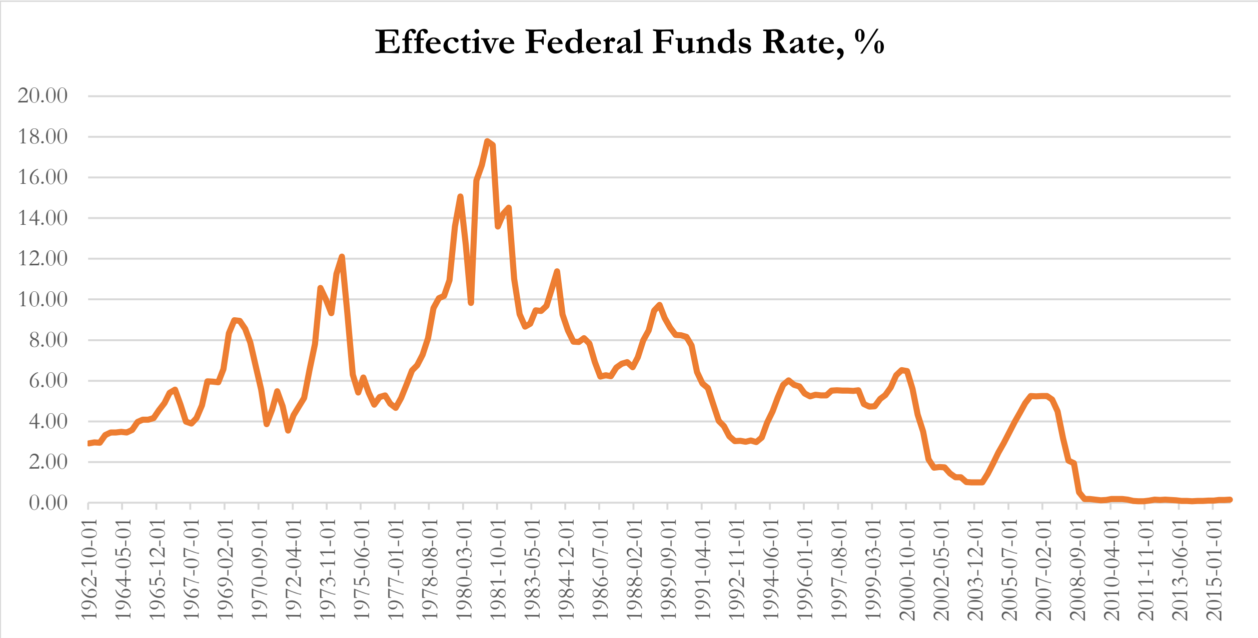
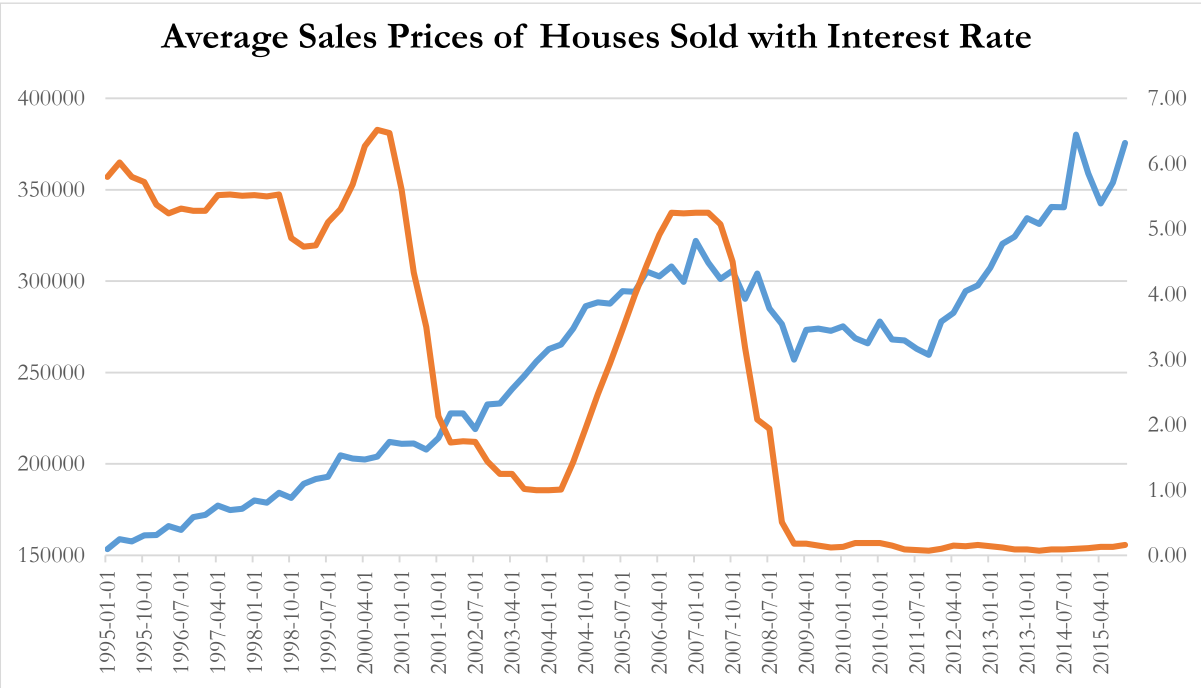


Figure 3. Average Sales Prices of Houses Sold with Federal Funds Rate



As the housing prices on steady rise, people bought the houses with expectation that tomorrow it will worth more. And it did. For a while. Look at the blue line (housing prices) over

2001-2004. While interest rates fell, the housing prices nearly skyrocketed. So tomorrow's houses actually worth more than today's. Banks had no problem lending out huge loans. After all, they were mortgage-backed. Housing prices were continuously increasing and if the unfortunate events ever happens, they will get the expensive houses anyway. So they gave out loans to people who were really unable to pay back, with their new houses as mortgages. This were only possible because the housing values were increasing. As long as they have the ever-increasing asset in hand, the borrowers did not have to go through rigorous credit checks as they do nowadays. These unable-to-pay people were classified as subprime borrowers.

Those were the good days, where everything was based on the rising housing prices. Then what will happen if this ever-rising housing prices stopped? After all, they cannot rise infinitely; they have to stop somewhere. And when it happened, the vicious cycle begun.

People were taking heavy loans they could not afford to pay back. As housing prices dropped, they did have more money owed to the mortgages than the value of the house itself. Some simply walked away. This, hurt the banks. They were selling the people's debts as Mortgage Based Securities. They wrapped up those debts nicely, even the subprime ones, and sold that among themselves. They had many of those MBSs classified as asset in their balance sheet. When people just walked away from those loans, the loans just evaporated into the thin air. They had to be written down, and suddenly banks found that they have less money on hand than before. They restricted giving out money, so people were unable to buy new homes, thus dropping the housing prices more. That's what happened in 2007 to 2012 in Figure 3. The price continuously dropped. Suddenly a new group of people found their homes value less than mortgages and walked away, and the cycle started all over again.

This cycles squeezed all the excess money out of the financial system and tightened the job market. That's why we suffered in 2007. And that is why our economy is still in slight recession, even after 9 years. Surely the government learnt a lesson and made revisions and amended the rules. The Dodd-Frank Act, passed in 2010, supervises those firms that are considered "too big to fail." They make sure that they are not too big to fail, trying to minimize the impact of possible bankruptcy.

Those were the brief overviews of what happened in 2007 and why did it happened, with example of MBSs. MBSs were one of the big factors, but they were more to the crisis than the brief stories. And the moral of the story is that that can happen again. It is possible. Seeing that how many times the history repeats itself, such unfortunate crisis can happen again in the future. Maybe near future, perhaps. And how can we prevent such events from re-occurring? The answer lies in the very subject of where everything stem from – economics.

The online version of Merriam-Webster defines the economy as "relating to an economy: relating to the process or system by which goods and services are produced, sold, and bought."[6] It is the act of relocation driven and fueled by scarcity. It is the choice between A and B, a cake and a cookie, and everything that affects the final decision. It is the study of the decision itself and the ways of reaching the decision. In a sense, it is the life itself because we make decisions every living day. Not the big decision of buying a car or house. Even the small ones as which roads to take to school and should I have a snack before or after my economics class. Our life is based on those decisions interwoven and therefore study of economics can benefit us make smarter decisions.

Economy teaches us to be awake every decision-making moment. We should be awake and aware of consequences before taking loans. When we sign for the things, we must carefully weight possible pros and cons. The same standard applies to bigger things. We should be aware when the big banks change their policies and notify the public with a letter full of jargons that no ordinary people understands. We should be aware of consequences in making political decisions such as casting votes, as they will be the people who will shield the public from others. (Including, but not limiting to, the big financial institutions)

[6] Economic. (n.d.). Retrieved April 25, 2016, from http://www.merriam-webster.com/dictionary/economic

Therefore, prevention of future financial crisis from happening lies in smart decision making skill and the ability to carefully weight pros and cons before making a decision. This ultimately leads to economically-educated public, thus they are less likely to create a crisis like the great recession and they will have sharper decision making skills. This time, economy is making a cycle of prosperous.