What Was the Original Cause of the 2007-2009 Financial Crisis?

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Abstract

The year 2007 bears significance since it marks a time at which the financial world was brought to its knees. Despite being most notable for a fall in house prices and massive unemployment, the Great Recession originated from a much deeper, intricate web of occurrences. This paper aims to explain how government policies were the root cause of the crisis in three ways. First, the government implemented an inefficient expansionary monetary policy. Second, certain policies relaxed lending standards and encouraged “subprime lending.” Third, deregulatory policies permitted financial institutions to operate with higher risk. I also consider and refute alternative claims that government policies were not a cause of the crisis, banks are to blame, and that mortgage lending was the only source of the crisis. I conclude the paper by recommending that understanding the original cause of the Great Recession is important to avoid similar dire events in the future.

Keywords: Great Recession, Taylor rule, government deregulation, subprime loans, securitization

What Was the Original Cause of the 2007-2009 Financial Crisis?

In the 1980s, the U.S government adopted certain policies with the expectation that they would boost economic growth, but the result was a setback that impacted the whole world (Palley, 2010). With the aim of promoting liberty in financial markets, the government mitigated the regulations on banks and financial institutions and allowed them to operate with more freedom in risky transactions. For instance, government policies urged banks to approve mortgages for low-income applicants. However, this was an extremely risky approach because it is less likely that these borrowers would be capable of repaying the loans. As a result, a chain of events ensued that eventually led to severe decline in economic growth, and therefore this critical period is named as the Great Recession. Accordingly, in this paper, I argue that government policies were the main cause of the 2007-2009 financial crisis.

I support my position with the following three arguments. First, I argue that the expansionary monetary policy was not properly implemented. The policy became ineffective since it exceeded certain benchmarks, and in turn, the policy resulted in adverse impacts on the economy (Rötheli, 2010; Taylor, 2009). Second, I argue that government policies significantly contributed to the crisis by encouraging mortgage lending. Banks were enticed to provide mortgages to individuals who were less likely to repay the loans (Tarr, 2010). Finally, I contend that the deregulatory policies no longer limited banks from increasing level of risk in investment. For example, the Commodity Futures Modernization Act prompted banks and financial entities to engage in riskier transactions (Hera, 2010). Thus, the increased level of risk led to a severe downturn in the financial market.

I also consider alternative positions against government policies being the main cause of the Great Recession. Among the arguments is the belief that government policies were meant to increase liberty in the financial markets, and thus boost economic growth. While this position has merit, I show that the expansionary monetary policy that was carried out had a certain fault, which eventually contributed to the crisis (Palley, 2010). Some critics have also claimed that banks' greed is the most important reason behind the crisis. These claims are based on the fact that banks relied on unconventional methods to generate profit (Acharya et al., 2009). While this claim may have some truth, I show that deregulatory policies fed the banks' greed in the first place and were the original reason that gave rise to the crisis. Finally, there are critics who insist that mortgage lending is the primary reason for the crisis. For instance, mortgage lending caused the house prices to fall, and this "housing market crash" ultimately led to substantial losses in the global markets (Tarr, 2010). Nevertheless, Adelson (2013) explains that mortgage lending is not the sole cause of the crisis. Indeed, while mortgage lending did cause significant losses on the financial markets, it was only a partial cause of the crisis.

This paper is important because in a world filled with uncertainty, especially in financial markets, it is crucial to take into consideration that various scenarios, whether favorable or adverse, may occur. While it is practically impossible to predict every possible situation, it is worth taking into account that sometimes, certain actions may lead to entirely different results. For instance, even though certain government policies were implemented to spur economic and financial prosperity, massive unemployment struck many parts of the world. Therefore, to avoid events like the Great Recession, it is imperative for governments as well as banks and citizens to take precautionary measures and assess the risk that may arise from financial activities.

How Government Policies Paved the Way for the Global Recession

The main cause of the crisis can be a subject that involves an abundance of opposing views. Although it may be controversial, there are certain policies by the U.S government that can be linked to the series of events during 2007-2009. Among these policies was an unduly expansionary monetary policy. Another way in which the government played a role in inducing the Great Recession was inordinate loosening of mortgage lending requirements. Government policy was also responsible for turbulence in the financial market as it deregulated financial institutions, especially those that were "too big to fail."

Inefficient Expansionary Monetary Policy

The expansionary monetary policy was not properly implemented. More specifically, according to Taylor (2009), this policy exceeded the benchmark at which it should be implemented. To provide a certain interest rate that would be used in a monetary policy to effectively control inflation and growth, Taylor developed a mathematical formula called the Taylor rule. In addition, the author provides a graph demonstrating the actual federal funds rate, which is the interest rate charged between banks. Furthermore, the graph reveals that this interest rate significantly dropped from the level that it was supposed to be at according to the Taylor rule. Specifically, the drop in interest rate was especially evident between 2002 and 2004 (Rötheli, 2010; Taylor, 2009). The two tools that a central bank uses to execute a monetary policy are interest rate and money supply. For instance, an "expansionary" or "loose" monetary policy involves either increasing money supply to increase consumption, or decreasing the interest rate to make it easier and more rewarding for people to borrow. That is, an expansionary monetary policy reinvigorates the economy in times of low growth or recession. Thus, these findings indicate that lowering the interest rate beyond a certain benchmark meant that the economy would suddenly grow more than intended, and high inflation would arise.

This improperly implemented policy paved the way for the crisis by impacting the housing market. Taylor (2009) argues that this extreme loosening in the monetary policy was causing house prices to increase at a rapid rate. Usually, people would want to invest in an asset if they believe that it is valuable. In the early 2000s, when interest rates were falling, demand for home ownership was increasing (Rötheli, 2010; Taylor, 2009). In other words, since interest rate is the cost of borrowing, people found it cheaper to borrow because they would be required to pay lower interest amounts to the lender. When people observed that home ownership started to become more prevalent, they expected it to be a worthwhile investment. Consequently, demand for house ownership further increased, which in turn pushed the prices upward. The price of a house continued to abruptly rise by more than its true worth, so inflation began to prevail. As a result, people simultaneously realized that house ownership is no longer profitable, so demand dropped as well as prices. Indeed, studies by Palley (2010) and Wallison (2009) show that this scenario is evident when house prices continuously rose from 1995 until they reached an apogee, and then started to plummet in 2007, just like a bubble that rises and suddenly bursts.

Policies Encouraged Subprime Lending

Government policies contributed to the crisis by encouraging mortgage lending. This activity was implemented through the Community Reinvestment Act (CRA). The act was originally enacted in 1997 with the purpose of facilitating home ownership to members in the community, including the citizens who earned relatively lower income (Community Reinvestment Act, n.d.). According to Tarr (2010), the government modified the act in the 1990s to ensure that banks were lending mortgages to low-income earners, even if banks were to resort to unconventional and new methods to do so. Furthermore, the author goes on to explain that banks substantially reduced requirements for home ownership to levels that were lower than the usual standards that were previously set by banks. Since low-income borrowers did not have sufficient amounts of funds to afford house ownership in the first place, they were less likely to repay the mortgage, or more likely to “default.” Consequently, banks across the financial sector suffered colossal losses, which Adelson (2013) estimates to be between $750 billion and $2 trillion. Therefore, even though the government intended to provide chances of home ownership to those who cannot afford it, this approach was risky from the outset.

Another way in which policies caused the crisis was by incentivizing mortgage lending via the mortgage companies Fannie Mae and Freddie Mac. Tarr (2010) highlights that these entities were government sponsored enterprises (GSEs), which means that the government employed them to provide mortgages. Since they were also pressured by the government to increase mortgages, Fannie Mae and Freddie Mac opted for unorthodox methods that deviated from normal procedures by financial institutions. More specifically, they would purchase prime mortgages (which are offered to individuals who are more likely to repay their loan), along with subprime mortgages (which are intended to those who would be most likely to default). The mixtures of mortgages were bought as packages that were categorized based on the expected level of risk. For instance, if individuals would invest in an asset that was deemed riskier, they may potentially receive higher returns but may also experience losses. Acharya et al. (2009) describe this complex and risky process as "securitization." As a result, the mortgage giants failed, and the authors assert that the consequences "paralyzed capital markets and thus caused the worldwide recession" (para. 38). Therefore, the researchers demonstrate that policies caused the crisis through mortgage lending.

Government Deregulation

Government policies paved the way for the crisis by deregulating financial markets. Adelson (2013) explains that if the excess deregulation was not implemented, then all the events that unfolded in the financial market would not have existed between 1970 and 2007. Likewise, Palley (2010) agrees by contending that deregulation led to gradual accumulation of events that led to the breaking point in the financial markets. Although loosening regulations in financial markets was initially intended to increase economic productivity by promoting more freedom in financial operations, deregulation did not result in economic prosperity. For instance, since the bank serves as an important pillar in the financial market, there should be certain strict regulations to keep it rigid. Thus, when policies permitted banks and the prominent institutions that were deemed "too big to fail" to operate in riskier transactions, the pillar that was once rigid crumbled on all the market.

Another way in which deregulatory policies caused the crisis was through the Commodity Futures Modernization Act of 2000. This act enabled banks and financial institutions to engage more frequently in transactions involving over the counter ("OTC") derivatives. Usually, banks and other financial entities present a balance sheet to report what they own (assets), and what they owe (liabilities) as a result of all their financial transactions.

Nonetheless, there are certain items called derivatives that are not included in the balance sheet, so they are considered as "off-balance sheet items" (Beers, 2021). One reason for this term is that derivatives are exchanged in over-the-counter markets, which are not subject to extreme regulations. Furthermore, Hera (2010) suggests that when derivatives are not mentioned in the balance sheet, there may be a lack of information that may cause confusion regarding the true worth of derivatives. If these OTC transactions occurred more frequently and on a larger scale, mass confusion would spread across the whole market. The author presents statistical data that depicts how instability substantially rose in the early 2000s. These results reflect the degree of the impact that deregulatory policies inflicted on the financial markets.

Arguments Against the Stance That Policies Caused the Crisis

Critics contend that government policies did not cause the Great Recession. For example, some believe that policies are implemented to propel economic growth rather than drive the economy into a downturn like the Great Recession. Others insist that banks are mainly responsible for the financial crisis. Additionally, some also argue that mortgage lending was the only driver of the crisis.

The Policies Were Meant to Improve the Economy

Some people argue that government policies are not the main cause of the Great Recession. For instance, critics may argue that an expansionary monetary policy is supposed to promote economic growth; thus, it would never lead to a crisis like the Great Recession. This argument is formed on the basis that expansionary monetary policy involves increasing money supply or reducing interest rate. A reduction in interest rate would allow consumers to acquire loans much more easily since they do not have to repay substantial amounts of interest when they need to repay the loan (Jahan & Papageorgiu, 2014). Although the main purpose of an expansion monetary policy is to boost economic performance, when it is carried out excessively, it can be detrimental to the economy. Taylor (2009) demonstrates that because the interest rate was set below the required target rate, inflation started to rise above what is deemed acceptable. Thus, the extremely low interest rate, especially in the early 2000s, exemplifies that an excessive monetary policy led to the crisis.

Others may argue that the deregulatory government policies were not responsible for the crisis. This claim arises because some people believe that deregulation has aided in stabilizing the economy. For instance, one such deregulatory policy, the 1999 Gramm-Leach-Bliley Act, permitted commercial banks to merge with other types of financial institutions called investment banks (Taylor, 2009). According to critics, this act ensured that financial services such as lending and investment opportunities were provided to citizens. Nevertheless, Chouliara (2020) explains that this act allowed risky practices that were common in investment banks to become prevalent and spread to regular banks. The author also provides an example as to how one of the main investment banks in the early 2000s, Citigroup, lost $258 billion of its value. This appalling loss was a result of banks losing control over the excessively risky transactions. Therefore, this finding shows that deregulation was ultimately detrimental to the economy.

Banks and Financial Institutions Are Mainly to Blame

Another common argument is that banks are mainly responsible for the Great Recession. Kagan (2021) explains that banks opted for unconventional methods to increase profits such as “securitization,” which involved grouping together various mortgages into a single new investment called mortgage-backed security (MBS). In addition, banks were criticized for altering their original roles as financial intermediaries by involving a third party in this intricate process. Acharya et al. (2009) explain that the conventional role of a bank was to directly provide a customer with financial services, such as lending. However, the banks started to sell mortgage-backed securities to a third party, such as a financial institution, which would then offer mortgage loans to potential borrowers. The authors use statistical data to demonstrate that the value of these securitization investments skyrocketed to $2.7 trillion before ultimately crashing in 2008.

Although banks certainly played a major part in precipitating the Great Recession, they are not the ultimate reason. Instead, the original cause can be found by understanding what lies behind the unreasonable behavior of banks. Adelson (2013) provides an explanation to this argument by discussing deregulation. The author goes on to explain that banks would be willing to operate with more risk if they were given the ability as well as the motivation to do so. Since deregulatory policies prompted banks to increase mortgage lending, regardless of the methods used, banks in turn did not hesitate in delving into risky tactics. Moreover, banks also took this decision because they knew that they would neither be punished nor subject to penalties by the government. Therefore, had the government taken additional caution by assessing the level of risk that may arise from deregulated bank actions, the crisis would not have occurred.

Mortgage Lending Is the Only Reason

Critics may also claim that the action of mortgage lending is the sole reason for the crisis. Mortgage lending also involves subprime lending, which means lending funds to individuals with low credit ratings. That is, more loans were easily offered to those who have a history of not having the capability of repaying debt. Since taking a loan essentially means being indebted, the fact that such a majority of individuals are taking on debt that they could not afford was an adverse sign in the financial market. Furthermore, people speculated that house ownership would be a profitable investment because house loans were being facilitated, and in turn, the rising demand for house ownership rapidly drove house prices upwards. Nevertheless, when borrowers could not repay the debt, the value of houses was virtually worthless, so prices plummeted (Coleman, 2008; Taylor, 2009). Thus, these events supply compelling evidence that mortgage lending originated the crisis.

Despite mortgage lending being a critical event that contributed to the crisis, it is not the only cause. Adelson (2013) contends that the story of mortgage loans being the main cause of the crisis is a misconception that eclipses the true picture. According to the author, the cost can be traced by observing the behavior of banks. Traditionally, when individuals decide to borrow from a bank, the bank usually conducts a lengthy process and imposes many requirements on the borrowers to ensure that they are capable of repaying the loan. However, this process was not strictly implemented in the case of subprime lending because the deregulatory policies had been pushing banks to act in this way in the first place. Furthermore, the author provides quantitative estimates demonstrating that even though losses resulting from mortgage loans were approximately between $750 billion and $2 trillion, he estimates that the total loss of the entire crisis varied between $5 trillion and $15 trillion. This information indicates that even though financial losses resulting from mortgages were indeed colossal, they only constituted a relatively small proportion of the total loss that was incurred from the crisis. Thus, the author shows that mortgage lending alone could not possibly have been the single and only reason for the Great Recession.

Conclusion

There is a plethora of conflicting opinions when it comes to the true trigger of the Great Recession. In this paper, I argued that government policies were the initial reason behind events associated with the financial crisis. For instance, I argued that when it became far too excessive, the expansionary monetary policy contributed to the housing bubble. Another way in which the government aggravated the housing market was through the Community Reinvestment Act (CRA) and the government-sponsored mortgage companies Fannie Mae and Freddie Mac. In addition, deregulatory policies eventually caused companies that were deemed “too big to fail” to lose control and suffer financial losses worth billions of dollars.

Critics argue that government policies did not lead to the 2007-2009 financial crisis. One such justification is that the expansionary monetary policy is supposed to stimulate economic activity and prevent unemployment. Although this claim describes the general purpose of such policy, research shows that when the policy exceeded the level that renders it efficient, it adversely impacted the economy. Some also argue that deregulation serves to promote liberty in financial markets and to remove strict barriers that may impede economic productivity. However, research demonstrates that deregulation eventually caused financial institutions to lose control in managing risky transactions, which in turn thrust the financial market into a state of turmoil. Meanwhile, others accuse banks of being the central cause of the Great Recession. Even though banks' actions contributed to the housing crash, researchers assert that government policies originally incentivized banks to act irrationally. Additionally, some critics insist that mortgage lending is the only occurrence that precipitated the crisis. Again however, quantitative evidence suggests that it would not have been possible for mortgage lending to be the sole determinant of the crisis.

This paper is important because it sheds light on what many people may be unaware of regarding the cause of the Great Recession. Despite being an economic setback, the crisis also left behind valuable lessons. That is, the recession serves as a reminder to consider the consequences that may arise from our actions. Additionally, preparing a plan for potential adverse situations is just as crucial, even if expectations of the future are entirely optimistic. For instance, when the government intends to implement a new policy, it must analyze how this policy could impact every member of the economy, ranging from regular citizens to corporate giants. Similarly, banks and financial institutions should be more scrupulous in assessing possible risk that may arise if they intend to experiment with new methods of incrementing profit and growth. Even though regular consumers may have less expertise regarding future conditions, it is essential to set aside an emergency fund. Another way in which individuals can protect their financial conditions is diversification, the process of increasing income by investing in various types of assets (rather than investing in house ownership alone). As such, these practices may help avoid events in the future akin to the Great Recession, when the government, prominent corporations, and citizens suffered excruciating losses.

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