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The Last Financial Crisis and the Fed Response

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Abstract- This paper discusses the causes and effects of the last financial crisis (2007-2009) and the Federal Reserve's response in order to help the economy to recover from the financial crisis. It also deliberates the Taylor rule, discusses the three factors of the formula, and to see if the reduction of federal interest rate from 5.25% to 0.25% has helped to recover the economy toward sustainable growth and full employment. At the end, I will briefly discuss the five goals of Fed, the ethical standards missed in this crisis, and some recommendations for the future.

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Causes and Effects of the Last Financial Crisis (2007-2009)

Subprime mortgage crisis caused a deep recession in the US economy. The effects included, but not limited to, a decrease in gross domestic product, a high unemployment rate, a decline in home prices and a fall in the stock market. The GDP decreased by 40% and the unemployment rate increased from 5% to 10% (9 million jobs lost) between 2008 and 2009 (Johnson, 2013). It has decreased to 7.6% in March 2013 (see Figure 1) but is still high compared to the target rate (Elwell, 2013). The housing prices decreased by 30% and the stock market fell by 50% in 2009. In 2006, the home prices declined drastically after the market bubble (2005-2006). As a result, borrowers had difficulties in refinancing their loans which later on led to a higher interest rate through adjustable rates for mortgages.

"The expansion of household debt was financed with mortgage-backed securities (MBS) and collateralized debt obligations (CDO), which initially offered attractive rates of return due to the higher interest rates on the mortgages; however, the lower credit quality ultimately caused massive defaults" (Lemke, Lins, and Picard, 2013). Financial institutions, regulators, credit agencies and government housing policies were among the responsible causes of the crisis. However, the main reason was the increase in subprime lending (Financial Inquiry Commission, 2013).

Fed Responses to the Crisis and Recession

To stimulate the economy and liquidate the financial system, the Federal Reserve (Fed) lowered the federal funds rate to near zero. In 2008, the Fed's balance sheet increased from $1 trillion to $2 trillion to induce confidence among lenders and offer lending to financial institutions. However, the demand for loans declined in 2009 which did not help the economy to recover from the crisis, so additional actions were needed to improve the economy. "On March 18, 2009, the Fed announced a commitment to purchase $300 billion of Treasury securities, $200 billion of Agency debt (later revised to $175 billion), and $1.25 trillion of Agency mortgage-backed securities" (Elwell, 2013).
Another policy used by the Fed to stimulate the economy is the quantitative easing (QE) in which they buy financial assets from banks and other institutions which raise the prices and lower their yield. "On November 3, 2010, the Fed announced that it would provide more monetary stimulus by means of the purchase an additional $600 billion of Treasury securities at a pace of about $75 billion per month, and continue the practice of replacing maturing securities with Treasury security purchases" (Elwell, 2013).

In June 2011, the balance sheet of the Fed reached more than $2.5 trillion (Elwell, 2013). In June 2012, the Fed purchased $400 billion of treasury securities (6yrs-30yrs maturities) and sold an equal amount of treasury securities matured in 3 years or less in order to keep the long-term interest rate low. Due to slow economic growth and no improvement of the unemployment rate, the third round of quantitative easing (QE3) started in September 2012 by purchasing $40 billion of mortgaged-backed securities every month. At the end of 2012, the Fed's holdings of long-term securities will increase by $85 billion per month and the Fed announced that QE3 will continue until a significant progress occurs in the labor market (Elwell, 2013).

The monetary stimulus by Fed to recover the economy through lowering the interest rate and quantitative easing did not make a big difference to sustain the US economy. Alternatively, The Taylor rule, invented by Economist John Taylor in 1992, is a forecasting model of the interest rate. It is based on three elements: "(1) Actual versus targeted inflation levels; (2) Actual employment versus full employment levels; and (3) The appropriate short-term interest rate consistent with full employment". Taylor's rule advises Fed to raise interest rates in times of high inflation, or when employment is above the full employment levels.

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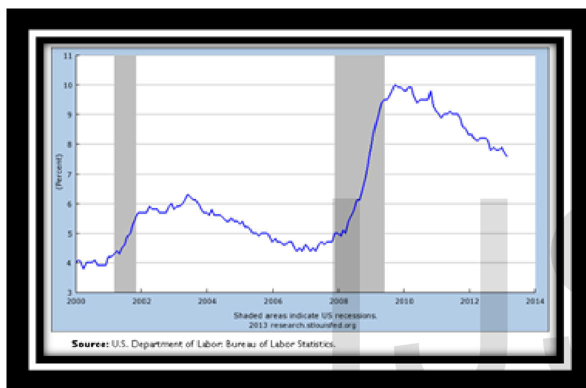
On the other hand, it suggests lowering the interest rates in the opposite conditions (Investopedia).

Five Goals of Fed

The Fed sets five goals to improve the US economy to recover from the financial crisis; these rules are:

- Reasonable price stability, inflation around ≈ 2%
- Maximum employment, $U^N \approx 4\%$
- Sustainable economic growth, (Q): Q = Y-T
- Balance in current account (CA ≈ 0)
- Moderate long-term interest rate (i_{L-T})

Figure 1. Unemployment Rate



The Lack of Ethical Standards

This crisis has proved the lack of many ethical standards such as honesty, fairness, human dignity and the principle of the common good. Lenders were looking at their benefits only and acted with greed to increase their rate of returns. They did not tell the truth for clients and were not transparent with them. Moreover, lenders acted unfairly because they encouraged their clients to invest in subprime -backed securities through risky operations while taking off these loans from their portfolios at a high profit.

Similarly, these acts are against human dignity because many people lost their jobs and homes which affected their life badly and could not satisfy the basic needs of living. Additionally, they failed to behave morally and look to the common good of the society instead of being selfish.

Conclusion

To summarize, I believe that the lenders are the main cause of the subprime home crisis because of the risky lending to low credit clients. Additionally, the US Federal Reserve should change its policies to help the economy to recover from the financial crisis and prevent other crisis from occurring in the future. The new policies should focus on the goals of achieving economic growth, reducing unemployment and lowering inflation rate.

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