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The Lessons Learned from the Great Recession

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Keywords:
Global economic crisis;
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Abstract: *The lessons learned from the crisis management of the 2008 Great Recession stem from significant structural differences between the two centers of the world, the United States and the eurozone. In the case of the United States, a monetary, fiscal and political union is realized, with a single economic policy, operates as a coherent unit, uniting the three areas. In the case of the eurozone, we can talk about a monetary union. The crisis has highlighted the structural flaws of the eurozone because without a unified fiscal policy no effective economic policy can be achieved. The symptoms of the euro area crisis weren't the consequences of the global economic downturn; rather the stalling of the integration process, the lack of real convergence, and the weaknesses of monetary and fiscal policy were the problems that have been brought to the fore and exacerbated by the crisis.*

1. INTRODUCTION

The lessons learned from the crisis management of the 2008 Great Recession stem from structural differences between the two centers of the world the United States and the eurozone. This topic now is extremely relevant, as it was one of the worst global economic downturns since the Great Depression. More than ten years have passed since the crisis began, growth has started in some centers, but it can be seen that the crisis has long-lasting consequences, such as over-indebtedness in developed countries which redraws the relations of world economic centers. Each center took a different path, which is also due to their structural differences. The United States was already a monetary, fiscal, and political union and saw the recovery in a different way than the eurozone. The United States risked a larger deficit to stimulate the economy and executed expansionary monetary policy in a form of serious "quantitative easing", which has led to the current unsustainable level of public debt. However, quantitative easing started again in 2020 because of COVID-19 and FED's balance sheet is bigger than ever. The euro area, on the other hand, is just a monetary union and the fiscal and political union is not realised. During the 2008 crisis, the European approach focused on tight fiscal policy and operated with a primary aim to prevent the over-indebtedness of the eurozone countries. The eurozone compared the United States introduced a smaller amount of quantitative easing during the 2008 crisis. After 2018 the years to come will still be about the crisis, but only in different ways: challenges such as debt reduction versus growth and withdrawal of incentives will come to the fore. Due to the different structures of the two centers, they will follow different trajectories.

2. METHODOLOGY

Different methods for data collection were used, in some chapters from books, periodicals, journals and central bank publications, which were mainly the theoretical background chapters and some data-linked chapters. In other chapters, macroeconomic and economic policy processes were illustrated. Therefore, they were accessed from databases such as Trading Economics, which also compiles data from the CIA, World Bank, and IMF.

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3. RESULTS

3.1 United States crisis management

The financial crisis emerged from the United States which has caused serious problems for the whole world. All countries have faced major challenges and significant measures have been put in place to bring economic stability. Crisis management was partly implemented through coordinated cooperation and partly within the framework under national competence. Some countries got help from international financial organizations. Bankruptcies caused by the financial crisis have spread to the whole economy. It caused reduced production, job losses, factory closures, rising public debt which are just a few examples of the global problems that required economic policy intervention.

The United States is the world's largest economy, a monetary, fiscal, and political union: its GDP was $ 18,569 billion in 2016, nearly 25% of world GDP, and its population was 324 million. The country's public debt was 106.1% of GDP in 2016. The United States economy is largely determined by its internal market, which generates huge demand, and its competitive advantage is based on high value-added products. The first figure shows that, as a result of the crisis, U.S. GDP growth slowed from the first quarter of 2008 and then began to decline in the fourth quarter. The decline was at its lowest point in the second quarter of 2009, when it stood at -4.6%. This was followed by a reversal of the trend and the economic stimulus was taking effect: the economy started to expand from the first quarter of 2010, with a growth of 1.9%. Between 2011 and 2017, GDP fluctuated between 1-3.8% and has not been able to exceed the 3.8% growth rate which the economy reached in the first quarter of 2015. It was clear that the crisis unfolded – GDP first slowed and then fell. A recession is a state of decline for two consecutive quarters for the U.S. economy, which was six quarters at the time of the 2008 crisis.

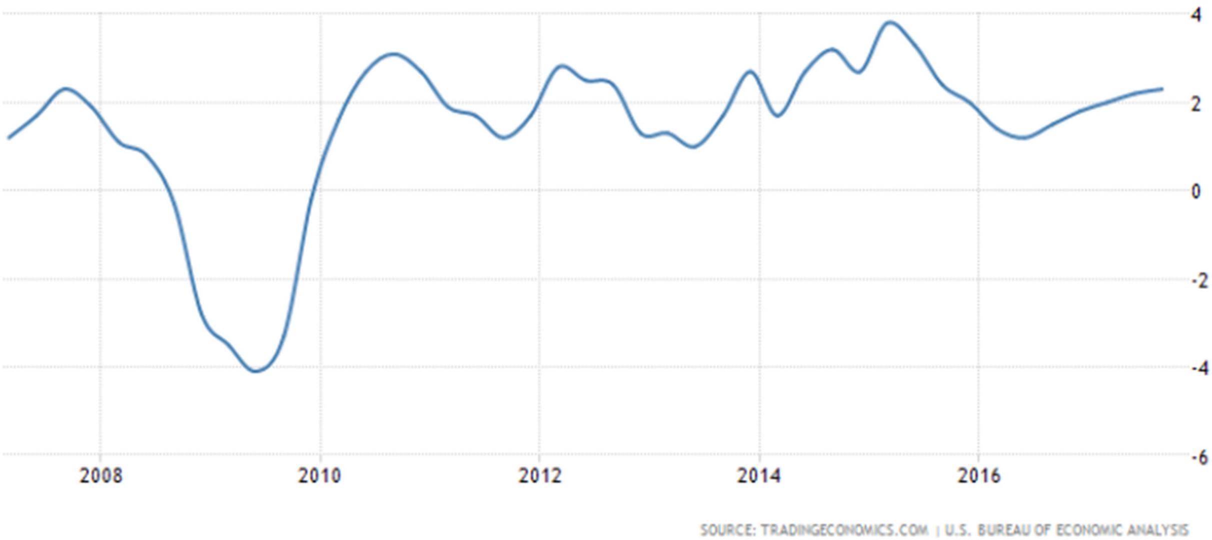

Figure 1. United States GDP annual growth rate (YoY), 01.2007.- 12.2017.

Source: Trading Economics (2019a)

The first figure also shows how growth reversed the downturn with the start of the stimulus and how GDP reached 2.3% in the third quarter of 2017. The U.S. has successfully emerged from the crisis on the basis of GDP indicators and has been growing steadily since 2010 on the observed timeline (Figure 1).

Figure 2. United States unemployment rate, 01.2007.- 12.2017.

Source: Trading Economics (2017b)

As a result of the crisis, the unemployment rate rose above 5% in June 2008. After a year in June 2009, it was already above 9% and in November it exceeded 10%, but as the economy recovered the trend changed and the unemployment rate declined and stood at 4.1% in November 2017. Correlation can be detected in declining GDP and rising unemployment: a 4.6% year-on-year decline in GDP accompanied by a nearly 4% increase in unemployment between June 2008 and June 2009. However, the decline in unemployment responds more slowly to GDP growth. Between September 2009 and September 2010, GDP grew by 2.8% year on year quarterly, while unemployment fell by 0.5%. Thus, the decline in unemployment, the job creation, is slower. In the trend over the period under review, GDP fluctuated between 1% and 3.8%, and the trend in unemployment continued to decline. As the first step in crisis management, the bankrupt banks were consolidated, and the United States assisted the banking system through the Federal Reserve (FED) and the U.S. National Deposit Insurance Fund. The overall goal was for weaker banks to be bought by stronger competitors. The capital injection also flowed into the automotive sector: since so many people were employed in the automotive industry, their help was also important in the development of further unemployment. These steps were vital to restoring confidence and stability.

The United States saw the recovery differently than the eurozone, as higher deficits were also risked stimulating the economy. FED started an expansionary monetary policy and executed a serious amount of quantitative easing (QE) to stimulate demand. After the banks were consolidated the main problem was the rising unemployment which was resulting in declining demand. So the FED introduced QE, which was designed to stimulate economic growth and create jobs. The central bank can stimulate the economy with low-interest rates, which increases investment and consumption, but if interest rates cannot be further reduced or interest rates could be reduced but the transmission mechanism does not work, unconventional central bank instruments are used. The purpose of unconventional instruments is to keep inflation close to the target, to avoid deflation, to prevent the collapse of financial intermediation and to reduce the economic downturn to stimulate the economy. Basically, we can distinguish two situations: one of them is when we cannot apply further interest rate cut because the base rate is close to zero, but further monetary easing is needed. This was the case in the United States in 2009 when further interest rate cuts couldn't be made. The other one is when even above-zero base rate intervention is justified – if the transmission mechanism is breached – this was the case in the EU in 2009. According to the QE method, three types can be distinguished: liquidity-providing instruments for commercial banks, direct credit market interventions, and government security purchases. According to another taxonomy, three types can be distinguished as well: credit easing, which aims to improve lending conditions in the private and banking sectors, quantitative easing, which aims to increase the volume of the central bank balance sheet, and qualitative easing, which aims to change the qualitative composition of the balance sheet. Central bank intervention is a welfare gain, as the state is able to raise funds indefinitely by issuing risk-free government securities. Before the recession, the FED already had $ 700-800 billion worth of treasury bills on its balance sheet. In November 2008, the FED began buying (QE) mortgage-backed securities (MBS) worth $ 600 billion. In March 2009, it reached $ 1,750 billion worth of treasury bills, MBS and debt, culminating in June 2010, when it had already reached $ 2,100 billion (Federal Reserve, 2010).

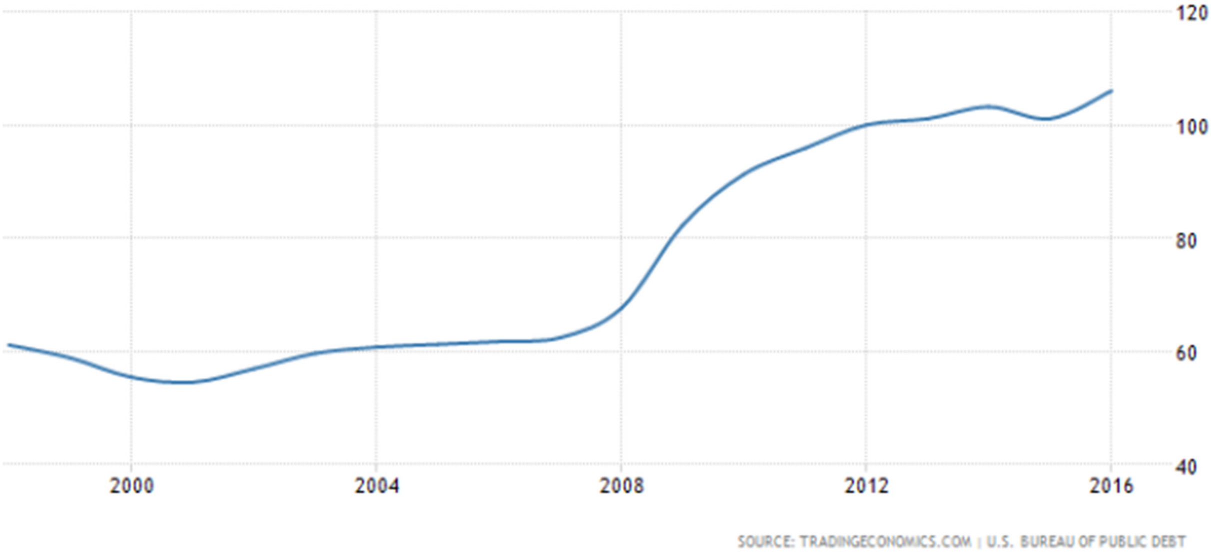

Figure 3. United States Government debt to GDP, 01.1998.- 01.2017.

Source: Trading Economics (2017a)

However, the first amount of incentives proved to be weak: strong economic growth was lagging behind, allowing FED to execute QE 2 from November 2010. This meant another $ 600 billion of stimulus (The Balance, 2011). QE 3 was announced in September 2012, under an indefinite-term, $ 40 billion-a-month MBS asset purchase program, while keeping interest rates low until mid-2015 (Money CNN, 2012). The Federal Open Market Committee (FOMC) announced in December 2012 that it would increase the volume of open-ended purchases to $ 85 billion a month and stipulated that these purchases would be maintained until unemployment fell below 6.5% and inflation expectations do not exceed two percent by half a percentage point over two years, which was the committee's long-term goal. On February 1, 2014, Janet Yellen became the new president of the central bank and in October the FED terminated its bond-buying program (New York Times, 2014).

From 2011, however, an interesting trend unfolded in the structure of U.S. debt: certain trends and conditions seemed to be reversed, as China was no longer the number one creditor of the United States. According to the data, the Asian country has been replaced by the US Federal Reserve. The FED's government securities portfolio rose to $ 1,108 billion in January, pushing China in second (The Balance, 2018).

3.2 Eurozone crisis management

The euro area is an economic and monetary union that is a group of countries within the European Union where the euro is the official currency. The monetary union is not considered to be a fiscal and political union. Eurozone countries are economically heterogeneous, but Germany, for example, has a competitive advantage and its economy is characterized by high value-added products such as machinery and vehicles.

Figure 4. Eurozone GDP (YoY), 01.2007.- 12.2017.

Source: Trading Economics (2019b)

Fiscal policy may vary from country to country in the eurozone, but there are guidelines to follow. The Stability and Growth Pact was established to reach budgetary discipline. It stipulated that the budget deficit should not exceed 3% of GDP and public debt 60% of GDP. The European Central Bank (ECB) is responsible for the monetary policy of the countries in the euro area. The European Monetary Authority pursues a different policy from the FED, as its main task is to ensure price stability and in addition, to play an active role in rescuing the European financial system. The recovery of the eurozone differed from the United States recovery between 2007 and 2017. In the case of the euro area, after a downturn in 2008, in 2012 the economy fell into a recession again (Figure 4.). The stimulus-induced recovery was also smaller, as it did not exceed 2.4% for the euro area, in contrast to the US level. The development of GDP shows that although the economy grew in 2010, it did not last long, as in 2012 there was a decline again. GDP growth in the euro area suggests that crisis management has not been as successful as in the United States. The ECB didn't formally conduct quantitative easing at first, but provided virtually unlimited liquidity to the euro area banking system and played a major role in managing the euro area sovereign debt crisis. Since May 2010, it has been buying the riskiest government bonds of the monetary union on the market, for which it has initially spent around € 70 billion. The euro area interest rate wasn't reduced as the interest rate in the United States. The ECB's communication is rather controversial, as the ECB is guarding over price stability in their official announcements. Accordingly, the European Monetary Authority wants to avoid suspicions of money printing. Due to the ailing economy in the eurozone and a successful QE in the US, the ECB launched a € 60 billion monthly asset purchase program in May 2015, which was raised to € 80 billion from March 2016 (ECB, 2016). The amount of debt grew between eurozone countries and some member States had huge public debt. The debt crisis started to become a serious problem for the euro area (Figure 5.). Greece, Ireland, Portugal and Spain are the countries with excessively high debts. These countries needed to find a solution so that fiscal austerity does not contract their economies.

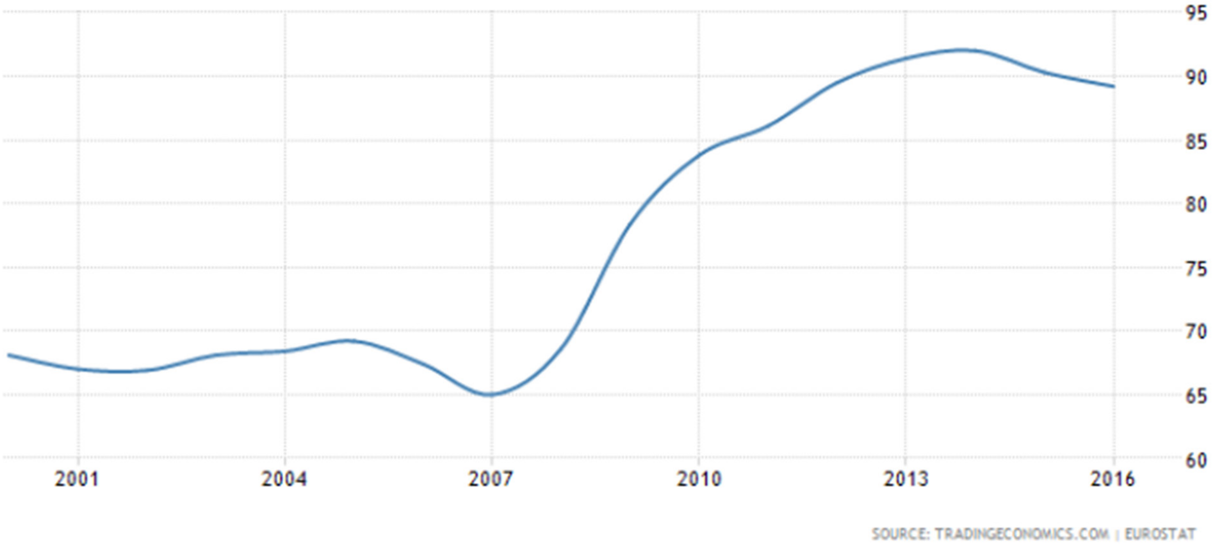

Figure 5. Eurozone Government debt to GDP, 01.2000.- 01.2017.

Source: Trading Economics (2017c)

If we compared the eurozone and the U.S. we can see that unemployment rate was 4.1% in the U.S. in October 2017, while the unemployment rate for the eurozone was 8.8% . In addition, however, the euro area debt was 89.2%, compared with 106.1% in the United States, reflecting the cost of economic growth and low unemployment.

4. FUTURE RESEARCH DIRECTIONS

After the 2008 Great Recession in 2020, a virus called COVID-19 caused another global economic downturn. For future research directions, it would be interesting to compare the two different kinds of crises and how the United States and the eurozone reacted differently to the COVID-19 crisis.

5. CONCLUSION

The 2008 Great Recession has highlighted the structural differences between the two centers of the world, the United States and the Eurozone. In the case of the United States, a monetary, fiscal and political union is realized, which with a single economic policy, operates as a coherent unit. In the case of the eurozone, we can talk about only a monetary union. The 2008 crisis has highlighted the structural flaws of the eurozone because without a unified fiscal policy no effective economic policy can be achieved. The symptoms of the euro area crisis weren't the consequences of the global economic crisis; rather the stalling of the integration process, the lack of real convergence, and the weaknesses of monetary and fiscal policy were the problems that have been brought to the fore and exacerbated by the crisis (Magas, 2011). The crisis management of the United States is considered to be more successful, in which the single economic policy has played an important role – as long as the eurozone doesn't deepen integration, it will not be able to address vulnerabilities between its countries.

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