Using Economic Fluctuations to Understand the Recent Recession

What Caused the 2007 Recession?

1) Collapse of the housing bubble

The sharp drop in housing sales and prices led to rising foreclosures, lower consumer spending and large-scale layoffs in construction and housing-related jobs.

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What Caused the 2007 Recession?

2) Financial Crisis

The sharp fall in the value of mortgage loans had a negative impact on the health of banks, investment banks and mortgage lenders, leading to the collapse of several leading financial institutions.

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What Caused the 2007 Recession?

3) Credit Crunch

Banks and other financial institutions cut lending substantially, leading to a decline in economic activity.

4) Commodity Price Inflation

Commodity prices, especially gasoline, experienced substantial increases in 2007 and early 2008, resulting in a decline in consumer spending.

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5) Stock Market Collapse

Sharp decreases in 2008 in stock markets in the United States and worldwide eroded wealth and retirement portfolios.

6) Greater Uncertainty

Firms and households decrease spending as a result of higher uncertainty due to lack of job security, lack of access to credit, deteriorating sales conditions, etc.

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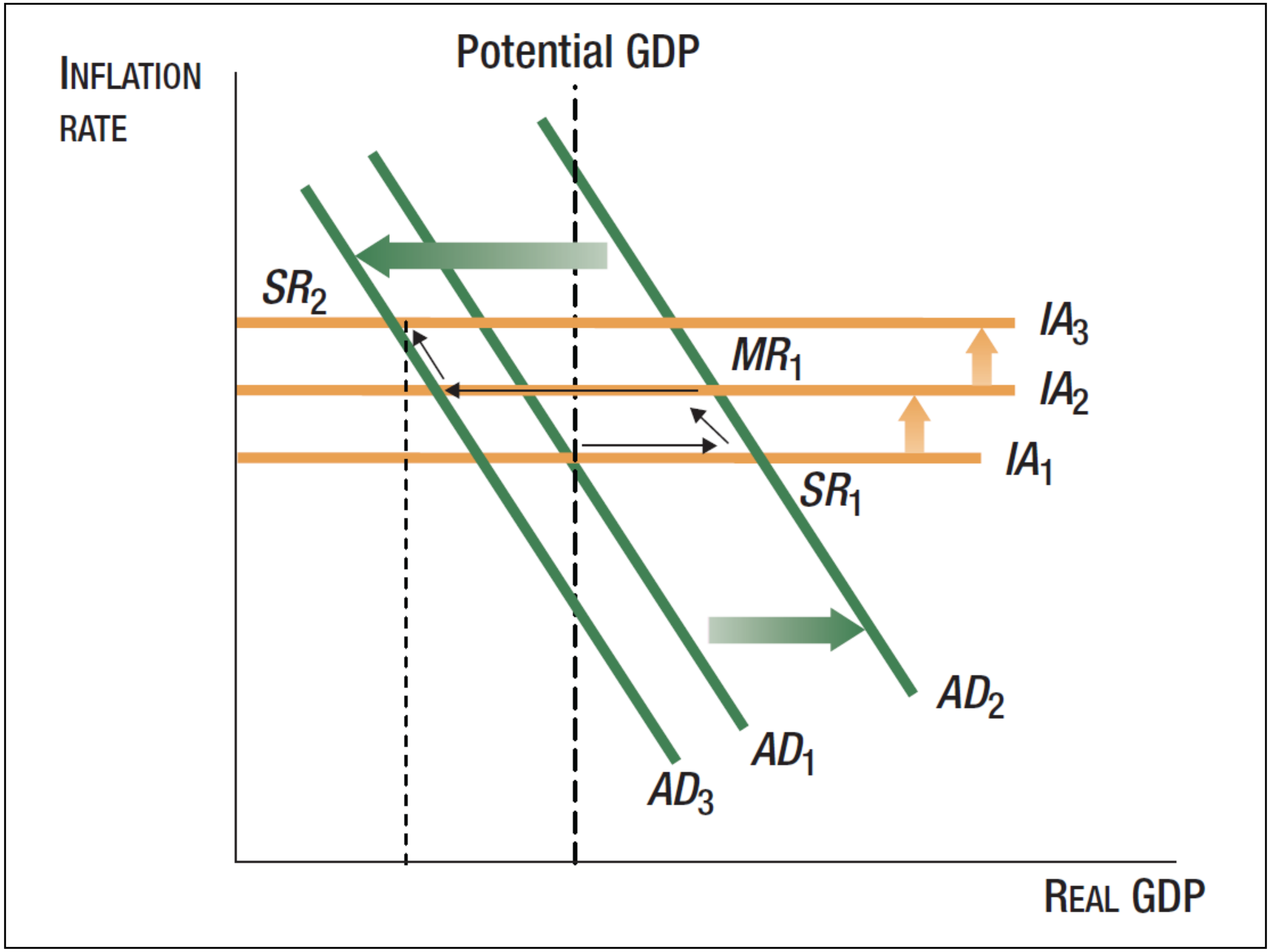
Figure 13-7 provides a graphical analysis of how these factors can be represented in an economic fluctuations model.

Explaining the Onset of the Recession

Figure 13-7



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In **Figure 13-7**, the higher inflation target and the increased spending from the housing boom shifts the *AD* from AD_1 to AD_2.

In the short run, real GDP is above potential, causing the *IA* line to adjust upwards in the medium run.

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Once the housing bubble bursts, the firms and consumers cut spending. This is illustrated in **Figure 13-7** as the shift in the *AD* curve from AD_2 to AD_3 .

The higher commodity prices in 2008 further shift the *IA* line upwards to IA_3.

How to Recover from the Recession

Earlier in this chapter, we found out that if the economy were in a recession, the economy will eventually recover as its own inflation rate falls gradually over time.

The government can also implement steps to get the economy out of the recession faster.

How to Recover from the Recession

Policies to faster recovery:

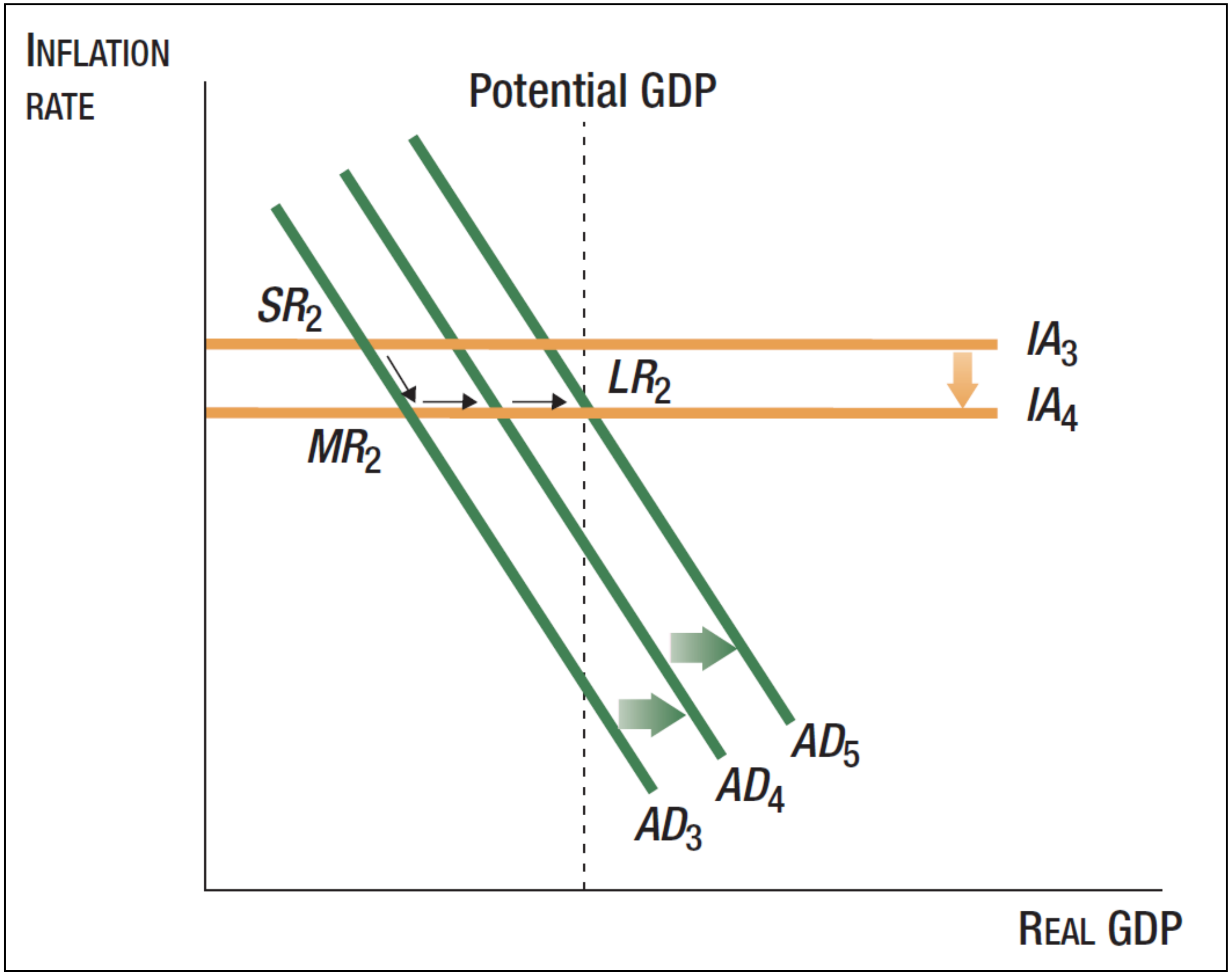
- The Fed lowers the real interest rate .
- The government implements a $789 billion economic stimulus package of spending increases and tax cuts.
- The Fed and the Treasury put together a policy to ease the woes of the banking/financial industry.
- *Note*: The drop in oil prices also contribute to the economy's recovery.

How to Recover from the Recession

Figure 13-8 provides a graphical analysis of how these government policies (along with the commodity price drop) can help the economy recover from the recession.

Recovering from the Recession

Figure 13-8



How to Recover from the Recession

In **Figure 13-8**, the 2 shifts in the *AD* curve represents the large stimulus package and the lower interest rates implemented by the Federal Reserve.

The lower commodity (specifically, oil) prices at the end of 2008 is represented by the shift in the *IA* line downwards.

How to Recover from the Recession

The recovery laid out in **Figure 13-8** does not match the actual experience of the U.S economy which is still well below potential output almost 18 months after the recession ended.