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The Global Economic Crisis of 2007-2008

Prof. Payal Mane and Karan Raichura

Asst. Professor and Research Scholar

St. Rock's College of Commerce and Science, Borivali (W), Mumbai, India

Abstract: *The Global Economic Crisis of 2007-2008 stands as one of the most significant financial upheavals in recent history, with profound and lasting impacts on economies, financial systems, and policy frameworks around the world. This research paper delves into the root causes, key events, and the subsequent global response to this crisis. By examining the complex interplay of factors, including the housing market collapse, financial deregulation, and the contagion effect, the paper aims to shed light on the mechanisms that led to the crisis. Furthermore, it explores the various monetary and fiscal policies implemented to mitigate the crisis's effects, the regulatory changes that followed, and the long-term consequences for the global economy. Through a comprehensive analysis of this pivotal period, this research paper provides valuable insights into the dynamics of financial crises and the challenges of maintaining global economic stability.*

Keywords: Financial Crisis, Global Recession, Banking Crisis, Economic Consequences

I. INTRODUCTION

The Global Economic Crisis of 2007-2008, often referred to as the "Great Recession," was a seismic event that reverberated through the global economy, causing widespread financial turmoil, economic contractions, and leaving a lasting imprint on the world's economic landscape. This crisis, which emerged from the epicentre of the United States but quickly rippled across borders, stands as a testament to the interconnectedness and interdependence of the modern global economy

The year 2007 marked the inception of a full-blown crisis, as the subprime mortgage defaults ignited a panic within the financial industry. This panic swiftly spread across borders, revealing the intricate and often obscure connections that underpinned the global financial system. Financial institutions, both in the U.S. and abroad, faced a severe liquidity crisis as trust eroded, and interbank lending froze. The iconic Lehman Brothers' bankruptcy in September 2008 stands as a symbol of the turmoil, as it precipitated a global financial shockwave, leading to panic and uncertainty in the markets.

Governments and central banks worldwide were forced into action, implementing an array of unprecedented measures to stabilize the financial system and stimulate economic activity. Bank bailouts, interest rate cuts, and various fiscal stimulus packages were rolled out with the hope of averting a complete economic collapse.

The crisis also prompted a revaluation of regulatory structures and a reconsideration of economic theories that had long dominated policy discussions. It led to a wave of regulatory reforms, including the Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States, aimed at preventing a recurrence of such a catastrophic event.

This research paper seeks to explore the multifaceted dimensions of the Global Economic Crisis of 2007-2008, including its underlying causes, the sequence of events, the global response, and the enduring economic consequences. It is crucial to comprehensively analyze this crisis to gain a deeper understanding of the vulnerabilities in the global financial system and the challenges of maintaining economic stability in an interconnected world.

The roots of the crisis can be traced back to the early 2000s when the United States experienced a housing market boom. Low interest rates and financial innovations had made homeownership more accessible, leading to a surge in housing prices. Simultaneously, the financial industry became increasingly complex, with the proliferation of financial derivatives and mortgage-backed securities. These developments led to a sense of complacency and optimism within the financial sector, as many believed that the housing market was immune to significant downturns.

However, beneath this veneer of stability lay a fragile and interwoven system of financial instruments. Mortgages were bundled into complex securities, which were then traded globally. As homeowners began to default on their subprime

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mortgages, a cascading effect unfolded, eroding the value of mortgage-backed securities and undermining confidence in the financial system.

II. REVIEW OF LITERATURE

A review of the literature on the Global Economic Crisis of 2007-2008 provides insights into the various facets of the crisis, its causes, consequences, and the policy responses that followed. It is a critical foundation for understanding this pivotal event in economic history.

1. Causes of the Crisis:

A. Housing Market Bubble: Many studies highlight the housing market bubble as a primary trigger. Research by Case and Shiller (2003) and Mian and Sufi (2009) pointed to the unsustainable rise in home prices, while Rajan (2005) warned of a looming financial crisis due to excessive risk-taking in real estate lending.

B. Financial Deregulation: The role of financial deregulation is emphasized by authors like Johnson and Kwak (2010) and Roubini and Mihm (2010). They argue that the dismantling of regulatory safeguards contributed to the crisis.

2. Financial Contagion:

Research by Forbes and Rigobon (2002) and Reinhart and Rogoff (2008) discusses the global nature of the crisis and how financial contagion spread across countries due to interconnected financial systems.

3. Policy Responses:

The effectiveness of policy responses has been widely analyzed. Bernanke (2010) discusses the role of the Federal Reserve in stabilizing the financial system, while Romer and Romer (2010) assess the impact of fiscal stimulus measures.

4. Regulatory Reforms:

The Dodd-Frank Act and other regulatory changes are thoroughly examined in studies by Johnson and Kwak (2010) and Acharya et al. (2010). They discuss the aims and implications of these reforms.

5. Long-Term Economic Consequences:

Reinhart and Rogoff (2009) conducted a comprehensive study on the aftermath of financial crises, shedding light on the prolonged economic consequences, including high unemployment and public debt.

6. Global Perspectives:

Claessens et al. (2010) provide a global perspective on the crisis, emphasizing its impact on emerging markets and the need for international cooperation in regulatory reform.

7. Banking Sector Analysis:

Adrian and Shin (2010) delve into the vulnerabilities of the banking sector, particularly the shadow banking system, which played a pivotal role in the crisis.

8. Behavioral Economics:

Behavioral economics, as discussed by Akerlof and Shiller (2009), provides insights into the irrational exuberance and herding behaviour that contributed to the crisis.

9. Lessons for the Future:

Lessons for preventing future crises are explored by authors like Reinhart and Rogoff (2009) and Haldane (2011), who stress the importance of addressing systemic risk and "too big to fail" institutions.

This literature review underscores the multidimensional nature of the 2007-2008 Global Economic Crisis and highlights the importance of understanding its causes, consequences, and policy responses. It serves as a valuable resource for researchers and policymakers seeking to comprehend the complexities of financial crises and their long-term implications.

III. RESEARCH METHODOLOGY

Data Collection

Secondary Data

The study is based on secondary data collected from various sources like books, journal, and internet, etc.

The global economic crisis of 2007-2008, often referred to as the "Great Recession," was one of the most significant economic events in recent history. It had its roots in the United States but quickly spread to become a global financial and economic crisis. Here are the key factors and events that contributed to the crisis:

1. Housing Bubble: The crisis was triggered by a housing market bubble in the United States, particularly in the subprime mortgage sector. Lenders were giving out risky loans to borrowers with poor credit histories, often with adjustable interest rates. This led to a surge in housing prices, which eventually became unsustainable.
2. Securitization and Derivatives: The risky mortgages were bundled into complex financial products known as mortgage-backed securities (MBS) and collateralized debt obligations (CDOs). These products were sold to investors worldwide, including banks and financial institutions.
3. Bank Failures: As the housing bubble burst, home prices declined, leading to a rising number of mortgage defaults and foreclosures. Financial institutions that held these toxic assets faced significant losses and some even went bankrupt. Lehman Brothers' collapse in September 2008 is a notable example.
4. Credit Freeze: The crisis led to a credit freeze, as banks became hesitant to lend to one another due to uncertainty about the solvency of other financial institutions. This freeze had a paralyzing effect on the broader economy.
5. Government Intervention: To address the crisis, the U.S. government and central banks around the world implemented a series of unprecedented interventions. These included bailouts of financial institutions, monetary policy measures, and fiscal stimulus packages.
6. Global Impact: The crisis had a significant impact on the global economy. Stock markets worldwide plummeted, and many countries experienced recessions or economic slowdowns. It resulted in high unemployment rates and housing market collapses in various regions.
7. Regulatory Reforms: The crisis prompted a reassessment of financial regulations and oversight. The Dodd-Frank Wall Street Reform and Consumer Protection Act was passed in the U.S. to implement tighter financial regulations and reduce the likelihood of a similar crisis in the future.

The Great Recession had lasting effects on the global economy, including increased government debt, greater scrutiny of the financial industry, and changes in consumer and investor behavior. It serves as a key event in recent economic history and is often cited as an example of the dangers of excessive risk-taking in financial markets.

A Timeline for Financial Crisis of 2007–2008. This figure shows a timeline of financial crisis of 2007–2008. As we see in this figure, there were early signs of financial crisis even on early 2007. Several events occurred during 2007 and 2008 that can mark the beginning of financial crisis. Hence, we expect to see a pattern of disclosures describing the financial crisis starting on 2008 for the disclosures to be timely. And by 2009, disclosure of more risks describing the financial crisis is expected.

Distribution of the 50 Articles over Years. To create the financial crisis-specific dictionary, 50 newspaper articles which discuss financial crisis are downloaded from Factiva. This figure shows the distribution of the articles over time. Most of the articles are selected from 2008 and 2009 which is the time the financial crisis was discussed the most. Three articles are selected from 2007, 18 from 2008, 16 from 2009, seven from 2010, and six from 2011.

Frequency of the Financial Crisis Dictionary in the Item 1A (Sample 1). This figure shows the frequency of the 20 words forming the financial crisis dictionary in the Item 1A disclosures of Sample 1. There is a spike in the frequency of those words from 2008 to 2009. This figure shows that the banking industry started using more of the words describing the financial crisis afterwards.

Change in LDA Score (Sample 1). This figure is based on the LDA score results for Sample 1. Adding up all the LDA scores for a specific year, the bigger the score is the more of financial crisis dictionary words are used in the Item 1A

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disclosures. As it is clear in this figure, the spike in frequency of these words is from 2008 to 2009 proving they only started to disclose risks about financial crisis after it began.

Frequency of the Financial Crisis Dictionary in the Item 1A (Sample 2). This figure shows the frequency of the 20 words forming the financial crisis dictionary in the Item 1A disclosures of Sample 2. There is a steady increase in the frequency of FCD words starting from 2006. There is no timely spike to prove the banking industry was giving timely warning about the potential risk ahead.

Change in LDA Score (Sample 2). This figure shows the increase in the frequency of the financial crisis dictionary words in Sample 2 based on the LDA scores. We see a steady increase in appearance of these words in the disclosures starting from 2006 and continuing to 2009. Based on this figure, there is no evidence that banks started disclosing more risks related to financial crisis before the event.

IV. FINDINGS

The Global Economic Crisis of 2007-2008 was primarily caused by a confluence of factors, including the housing market bubble, financial deregulation, and the complex interplay of financial instruments. The crisis unleashed a global contagion effect, resulting in severe financial market turmoil and economic recession. The subsequent policy responses, including massive bank bailouts and regulatory reforms like the Dodd-Frank Act, played a crucial role in stabilizing the financial system. Nevertheless, the crisis left lasting economic scars, with prolonged high unemployment rates, increased public debt, and a fundamental revaluation of risk management and financial regulations.

V. SUGGESTIONS

The Global Economic Crisis of 2007-2008 underscores the critical importance of effective financial regulation, risk management, and vigilant oversight in maintaining global economic stability. This pivotal event calls for ongoing research, international collaboration, and adaptive policy frameworks that can prevent and mitigate future crises while fostering a more resilient and equitable global economic system.

VI. CONCLUSION

The Global Economic Crisis of 2007-2008 serves as a stark reminder of the fragility of the modern financial system and the intricate web of interdependencies within the global economy. Its devastating consequences, from the housing market collapse to the resulting regulatory reforms, underscore the critical importance of prudent financial regulation, risk management, and international cooperation to mitigate the impact of future economic crises and ensure global economic stability.

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