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Great Recession of 2008 and Its Relevance Today: Lessons Learned From Policy Responses

Ankit Kumar and Rahul Borse
[MIT WPU]
B.A. Economics Hons
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Abstract
Purpose- The purpose of this paper is to analyze in regards to the most severe recession that occurred in the last 2 decades namely Great Recession of 2008. This event shook the global world financially. Furthermore, the paper also presents an understanding of the Indian context during the Great Recession. A proper relevance had been tried to find out in relation to the current recessionary situation and the 2008 recession.
Approach- The paper is approached in a very clear and a definitive way. The peer-reviewed journal articles and top quality books are used in this particular research paper. Causes and Consequences of the Great Recession event has been researched thoroughly and is provided in a defined manner. The study finds out the relevance of the recession of 2008 and the current recession through broad range of secondary research.
Findings- The study finds out that the causes of 2008 recession are widely different to that of the current recession. India did not get hugely affected due to the 2008 recession because of their proactive policy responses.
Value- To the knowledge of the author, the paper is the first study which implement a clear and a concise set of information regarding the 2008 recession.
Keywords- *Great Recession, Financial instability, inflation, unemployment, relevance*

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I. Introduction

Global financial crisis in the year 2007 had an influence on economic fortunes of various countries resulting in "Great Recession". The event started as an isolated turbulence in sub-prime segment of housing market of the US, and mutated into the full blown recession by end of 2007. The proverbial truth that 'world economy sneezes whenever the U.S. catches the cold' once again came true. The reason was that the significant economies of the Japan and European Union, collectively went into the recession by the middle of 2008. The year 2009 was the first in which the world was in the recession since World War 2. It was shocking that the particular crisis came as surprise to various investors and policy makers[1]

The purpose of the paper is to provide a detailed analysis of the Great recession of 2008. Furthermore, the causes and the consequences of the event have been provided in a clear manner. Moreover, the policy responses incorporated by the governments to tackle the recession globally have been provided. A description of the housing market crash has been provided to see whether or not it led to the recession. The objective of the research paper is to find the root cause of great recession and the scars left behind in the U.S. economy.

II. Literature Review

2007 and 2008 saw an unprecedented increase in the prices of food which forced global community to give more attention to the agricultural sector. The financial crisis occurred during the same period, and the US government launched huge bail out of its financial institutions to check the influence on the economic activities. In his journal article, Chand, Raju & Pandey (2010) indicated that the slowdown in the economic activity spread around the world. As the global meltdown was followed by the food crisis worldwide, nations affected by rise in the food prices had to deal with the twin crisis. Rise in the food prices during the same period of Great recession

[1] Islam, I., & Verick, S. (2011). The great recession of 2008–09: Causes, consequences and policy responses. In *from the great recession to labor market recovery* (pp. 19-52). Palgrave Macmillan, London. https://www.econstor.eu/bitstream/10419/36905/1/625861256.pdf

had more impact on developing countries as compared to the developed countries[2] In the opinion of Rajesh (2018) the global trade connections act as the channel for crisis spread from a nation to another. An analysis was done on the transmission of the worldwide monetary crisis to the business cycles in India with the usage of the data of GDP from 1993-2008. The result was that the trade intensity among OECD countries and India had crucial consequence on the correlation of its GDP cycles to the frequencies of business cycle. Indian economy was affected by the worldwide financial crisis by various channels namely trade, confidence channels and finance. However, there was no exposure to sub-prime assets[3]

Argyroudis & Siokis (2019) said in his paper that the financial crisis in the U.S. led to unprecedented global turmoil. Furthermore, the substantial growth in both housing prices and mortgage credit caused increase in the mortgage delinquencies as there was sharp increase in interest rates. According to the opinion of the author, the housing bubble burst and meltdown of associated prices triggered chain reaction to the other financial markets internationally and domestically. Researcher found out that financial crisis modified degree of randomness and complexity of housing indices of Hong-Kong[4] Great Recession was marked by the massive contractions in the output, consumption and investment. The rate of labor force participation and the per capital employment fell enormously and showed less sign of improvement. There are four shocks that account for main features of great recession. First shock was motivated by rise in the credit spreads which was observed in post-2008 period. Second shock was motivated by a notion that there were liquid assets[5]

Su & Qian (2018) has explained the impact of high housing prices on the market of China. 2010 witnessed high housing prices in both secondary and primary markets of China. It was seen that housing prices dropped enormously from 2011 after housing bubble burst[6]. Sullivan & Power (2012) indicated that municipalities face continuing financial predicament after four years of the start of Great Recession. There has been a need for affordable housing and municipal budget cuts are carving the funding for the critical areas namely public safety programs and education. Despite 30% fall of housing prices since 2006, value adjustment has done little to provide stability to the financial burden of the rental housing[7]

Maclennan & Sullivan (2011) indicate that recession was mediated in various ways by the national housing sector trajectories. The credit crunch impacted the availability of the credit for financing construction activity directly. Furthermore, the U.S. had less pronounced house price boom in post-millennium as compared to the UK[8]. 2008 recession in Canada was connected to events in the U.S. in relation to the poor mortgage financing. Experience of the house owners of the U.S. in relation to the housing markets was heterogeneous. Furthermore, equity losses and huge wealth concentrated among low-income and African American home owners[9]

III. Methodology

The research paper has been prepared by incorporating qualitative research method. It is the method which deals with a more descriptive analysis. Furthermore, secondary research has been done in this research paper. Several peer-reviewed articles have been taken along with authentic online articles for successful completion of this research paper.

Research Objective

In this research paper, a descriptive research has been undertaken which attempts to provide a description regarding a situation or a phenomenon. Information has been provided regarding the Great Recession of 2008.

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[4] Argyroudis, G. S., & Siokis, F. M. (2019). Spillover effects of Great Recession on Hong-Kong's Real Estate Market: An analysis based on Causality Plane and Tsallis Curves of Complexity–Entropy. *Physica A: Statistical Mechanics and its Applications*, *524*, 576-586. https://doi.org/10.1016/j.physa.2019.04.052

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[9] McIntyre, L., Wu, X., Kwok, C., & Emery, J. H. (2017). A natural experimental study of the protective effect of home ownership on household food insecurity in Canada before and after a recession (2008–2009). *Canadian Journal of Public Health*, *108*(2), e135-e144. https://doi.org/10.17269/CJPH.108.5568

Research Inquiry Mode

An unstructured approach has been used in this research and this is also classified as the qualitative research. It is an appropriate method to use in this research as explores the problem nature and do not quantify it.

Qualitative Research Methodology

A qualitative research method is applied in this particular paper. This type of research is providing an explanation of a particular situation. Secondary sources are taken to complete the research paper. Authentic journal, online articles and also books are used in this research. These resources are collected from the Internet[10]

Timeline: Great Recession

The below interactive timeline of the occurrence of Great Recession highlights the main dates in financial collapse and helps to find out how the credit crunch in 2007 turned into the financial meltdown by mid-2008.

8th February 2007: HSBC revealed colossal losses at their US mortgage Household finance due to the subprime losses. It was the first sign of the US housing market turning sour, which had a knock-on effect on world-wide financial sector.

2nd April 2007: A top subprime lender namely New Century Financial filed for the bankruptcy. It was the first signal which indicated that something was seriously amiss at the US mortgage lenders[11]

17th March 2008: US investment bank was rescued by the rival bank JP Morgan Chase after the government of the US provided $30bn guarantee against the mounting losses. The financial crisis was getting worse but the investors were relieved of the government's act.

7th September 2008: Government of the US rescued the giant mortgage lenders namely Freddie Mac and Fannie Mae, taking them to the short-term communal possession after revelation of huge losses on US mortgage market.

15th September 2008: Lehmann Brothers was ruined after the US government refused to bail out. Bank of America bought Merrill Lynch after revelation that it also faced huge losses.

16th December 2008: The central bank of the US lessened the interest rate to around 0-0.25% in order to stem deepening recession. They began to consider a program of the quantitative easing. It means to throw the money in the economy in order to make borrowing easier. The rate of interest was the lowest in the FED history[12]

The above timeline is a brief summary of the happenings of the Great Recession of 2008.

Causes of Great Recession of 2008

Great Recession which is sometimes referred as 2008 recession was connected to the "subprime mortgage crisis". These subprime mortgages refer to the home loans that are approved to the debtors with the poor history of credit. Mortgage lenders were seeking to capitalize on the increasing home prices during housing boom in the U.S. in early 2000's. As a result, they were not restrictive in approving loans to the borrowers. Furthermore, various financial institutions acquired several risky mortgages as an investment due to the continuous rise in the housing prices in the Western Europe and North America. However, the decisions soon proved to be catastrophic.

Subprime Crisis

The crisis had to occur when the lender namely New Century Financial acknowledged the liquidation in 2007. Freddie Mac announced a couple of months earlier that no purchase of the risky subprime mortgages would be done. As a result, there was no market for its owned mortgages which meant there was no way to sell the mortgages in order to recoup initial investment. Therefore, New Century Financial collapsed. Furthermore, the housing prices across the U.S. started to fall as subprime crisis continued. As a result, several homeowners and the mortgage lenders were in a bad position. The value of their houses were less as compared to the total loan amount[13]

It was found that median inflation fell by higher than XFE inflation during the period 2007-2010. Furthermore, a flatter Phillips curve lessened the predicted fall in inflation during the period 2008-10[14]. There is little doubt that entire system leverage of financial sector surged markedly from 2003, which played significant role in boosting the crisis severity. Research found that regulatory response to financial crisis hassled negative

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[12] BBC. (2020). *Global recession timeline*. https://www.bbc.com/news/business-10775625#rock

[13] A&E Television Networks. (2019). *Great Recession*. https://www.history.com/topics/21st-century/recession#section_2

[14] Ball, L. M., & Mazumder, S. (2011). *Inflation dynamics and the great recession* (No. w17044). National Bureau of Economic Research. https://www.nber.org/papers/w17044.pdf

externalities of the large and complex institutions[15]. Monetary policy of the U.S. remained in high discretionary mode after panic of 2008. Research found that reserve balances extended during the panic of 2008. It was basically classic lender of the resort policy which involved exchanges with the foreign central banks along with loan to the US financial institutes[16]

Flawed U.S. Growth Model

Economic crisis must be understood as a combination of the ultimate and proximate factors. Furthermore, the proximate factors refer to the triggering events, whereas, the ultimate factors indicate the deep causes. It was seen that the meltdown of the market of subprime mortgage on 2007 triggered the great recession and financial crisis. A crisis of this huge magnitude requires facilitating macroeconomic environment.

Post-1980 Neo-Liberal Model of Growth: The economic policy of the U.S. was structured to achieve a full employment before 1980 and one of the features was growth of wages with the productivity. However, commitment to full employment was abandoned with the advent of new growth model after 1980[17]. The new model substituted borrowing and the asset price inflation in place of wage growth as an engine of demand growth. Furthermore, this model was formed on the basis of cheap import and financial booms. In the earlier economic model, policymakers viewed trade gaps as the cause of concern as they signified leak of the aggregate demand. However, post 1980 model of growth viewed trade deficits as semi-virtuous as they helped to control the inflation and also reflect the consumer's choices in marketplace. Therefore, trade deficits were allowed to grow at a steady rate which hit new peaks as GDP's share, in every business cycle after the year 1980[18]. Overall, the above growth model of the U.S. had a role to play in the occurrence of the Great recession of 2008.

Proliferation of the subprime mortgages and quick dispersal of 'credit-default swaps' developed a housing bubble- difference between real and the actual values of the houses. In 2008, this housing bubble burst inevitably leading to the deterioration of both US economy and market for subprime mortgages. As the prices of house fell, individuals who were unable to meet loan repayments did not have the option to sell their properties in order to avoid bankruptcy. As less information was information was available on which financial institutions were holding toxic assets, so banks completely stopped lending among each other. Therefore, companies could no longer borrow the money. Indebted customers reduced their spending, and there was a collapse of the housing market. Certain banks disappeared overnight, and the stock market crashed. These failures emanated shock waves in the economic system, leading to great recession globally[19]

The Great Recession was associated with financial collapse of the late 2007. Most of the countries experienced fall in the output, starting early in 2008. Demand for the labor fell and there was increase in unemployment. Researcher found that the youth unemployment surged as compared to an overall unemployment as recession deepened[20]. It was found that latter half of the year 2009 saw a rise in the unemployment more than what was implied by Beveridge curve. Researcher found that the job loss has played main role in encouraging unemployment in recession[21]

"Too Big to Fail" Banks

The other main side of Great Recession was "too big to fail" modus operandi of the banking system. A top investment banking player namely Bear Stearns resigned after losing huge on the investments in the subprime mortgages. Bankruptcy of the Lehmann brothers took place a few months later. Fed made a decision to lend the investment and insurance company namely AIG with $85 billion in order to prevent them from shutting. However, the conundrum was whether the above companies were too big to have failed. In addition,

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Federal Deposit Insurance Corporation had taken control of Washington Mutual which was the largest savings at that time[22]

Housing Market Crash: Was It Responsible for the Great Recession of 2008?

Federal Government has supported the lending of mortgage for over 80 years by various institutions, programs and policies. This particular support has provided help to the millions of middle class people to purchase houses. Some of the conservatives still question the effectiveness and relevance of the government housing policies. They also argued that certain aspects of the federal housing policy led to the financial crisis of 2008.

Background

Homeownership has been a huge source of wealth for most of the U.S. households. It allows the households with greater financial stability and predictability. The hurtful set of the policies of discriminatory lending started to be reverse in 1960's and 70's. Federal policy started to promote the historically discriminated access to housing by insurance and securitization on the mortgage loans[23]

Roots of the Cause

The export led development of emerging markets overlapped with the rise in current account shortfall of the US that swollen from $124 billion in the year 1996 to $413Bn in 2000 and $738Bn in 2007. In order to balance this shortfall on current account, there was enormous capital inflows. In order to recognize this design in capital movements, one must gather information that the Dollar is the real reserve currency in the world. Furthermore, most commodities are generally traded in Dollars. In fact, the foreign reserve holdings of the US dollars grew at a quick rate after 2002. It became double over five-year period from 2002-07. Amidst the Great Recession, the total government debt was $9.5 trillion. The falling government financing requirements and the little capital yields made alternate government backed funds, such as the GSE (Government Sponsored Institutions) loan pools, more striking due to the ranges these investments originally offered. The money flow into the securitized mortgage areas led to fall in the borrowing cost and aided creation of record profits for Freddie Mac and Fannie Mae. The mortgage volumes increased as a result. The investment banks developed their individual pools of ''private label'' loans, providing the investors with preferred greater yields at superficially trivial extra risk. Therefore, the capital flow was eventually channeled into housing market of the US resulting to a housing bubble[24] A housing bubble burst due to excessive lending led to the Great Recession.

Consequence of Great Recession

Global recession began in the year 2007. It was seen that initial effect of the Great recession in India was muted. The growth in the GDP fell from 9% in 2007-08 to around 7.8% in April 2008. However, in the next 3 quarters, growth rate of India fell to 5.8%, 5.8% and 6.1%[25]. This was due to the collapse of the Wall Street in September 2008. Although, the rate of growth fell, but it exceeded the forecast of 4% growth by the World Bank in 2009. As compared to the Asian financial crisis, India's performance in Great recession was much better. In the Asian financial crisis, India's GDP fell to 4.5% as compared to the 6% in Great recession. Corporates of India were not so much over loaned out, and banks were capitalized. India's performance during the recession was so resilient that foreign investors who withdrew in 2008 came back to invest in the India's stock market at $1bn per week in 2009. The reason behind India's less sufferings due to the recession are as follows:

- Firstly, India's financial institutions and banks had entirely avoided the purchase of mortgage backed securities. This security turned toxic and led to the fall of western financial institutions.
- Secondly, merchandise exports of India were hit by the Great recession which declined by 30%. However, service exports did not fell which provided a significant boost to the exports of India.

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- Thirdly, payments from the foreign Indians was persistent which hit $46.4 billion in the year 2008-09. It was a rise from $43.5 billion in 2007.
- Fourth, the foreign direct investment continued to increase and was $27.3 billion in the year 2008-09, despite worldwide financial crisis. It was seen that the financers reversed the FDI movements into India. However, the long-term financiers in the factories and plant finished their enduring projects.
- Fifth, monetary policy was quite accommodating in the year 1998 as compared to a restrictive monetary policy in 1998. In 2008, RBI did not restricted money flow to safeguard rupee and was tolerable to reduce from Rs 40 to around Rs 52 to dollar. The RBI expanded credit and dropped the interest rates. Government lessened the excise duties in order to strengthen the demand. The above mixture of monetary and fiscal policies mitigated the shockwave to the economy[26]

Great Recession was most dangerous recession since Great Depression of 1930's. It was seen that both job availability and gross domestic product fell by around 6%. Furthermore, the median family incomes fell by 8%. In 2013, national unemployment rate was around 7.4%, below 2009 peak rate of around 10%. It was seen that 16% of the workers experienced job loss at certain time during 3-year period from 2007-09. In addition to the above, several home owners who were long-term unemployed lost their houses[27]

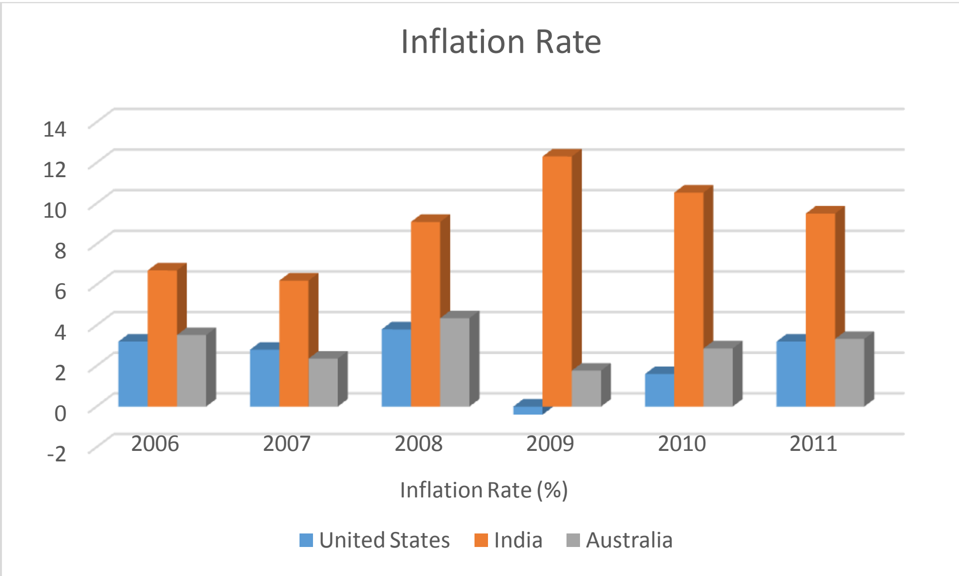

Fig 1: Inflation Rate Before and After Great Recession of 2008 (Source: Statista, 2020)

[26] Aiyar, S.S.A. (2008). *India weathers 12 months of financial crisis*. Bennett, Coleman and Company Limited. https://economictimes.indiatimes.com/swaminathan-s-a-aiyar/market-boom-not-led-by-modis-supposed-cronies-mid-small-caps-rise-the-most/articleshow/36365294.cms

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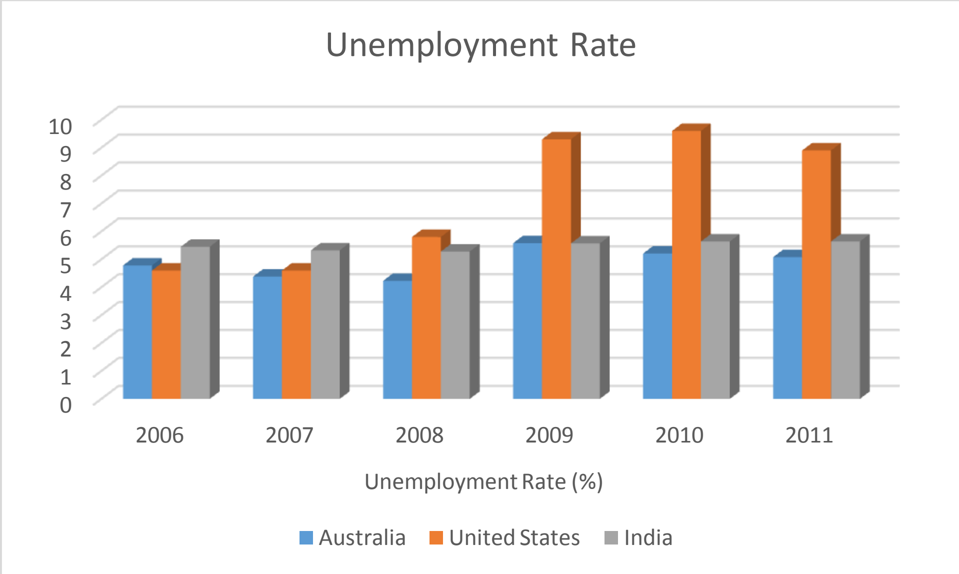

Fig 2: Comparison of Unemployment Rate Before and After Great Recession (Source: Macrotrends, 2020; Statista, 2020).

The above two figures show a comparison of the unemployment and inflation rate before and after the Great Recession in 3 countries namely U.S., India and Australia. Inflation rate in the U.S. became negative in 2009, which was the time of peak of the recession. India's inflation rate remained stable, and increased during the Great Recession. Conversely, India's unemployment rate did not get affected due to the Great recession in comparison to the rising unemployment rates of the U.S. and Australia.

In addition to the effect of crisis on the macroeconomic indicators, there are also negative externalities in the form of population welfare. Empirical evidences indicate that the 2008 recession resulted in the rise in suicides. It appears to be linked with the government spending and age as well as gender specific. However, evidences from the Europe indicate that the recession had an overall positive effect on the health with an exception for suicides. Research found out that unemployment increases problems of mental health. This particular evidence is unsupportive of pro-cycle impact of business cycle for the Greece- country which was hard hit by the Great recession. Furthermore, research from the US focused on how did the 2008 recession influenced the population sub-groups. Hispanic boys consumed more alcohol, marijuana and became obese. Girls likely smoked more and the black girls drink more. It was seen that the financial distress had negative outcome on the use of healthcare resource, life-expectancy and mental health across the OECD nations[28]

13 years after the economy gone into deep contraction of the post- World War 2 era, scars of the Great Recession remained which can be seen in the government figures. In spite of the U.S. rebounding in various ways, the country became more unequal, less productive and poorer. The country would have been different, if the crisis had been less severe. The share of the Americans of ages 25-54 who were working or looking for the job had fell by a percentage point since the year 2007. In simpler words, the recession squeezed the workers out of labor market. It also dampened the earning, with a high rise in jobless rate of certain areas. Broadly speaking, the economic downturn of 2008 skewed the job market in ways which hurt the middle class. Rural areas and "distressed communities" of the U.S. was hit hardest and was left behind, with the Great Recession amplifying the long standing trends[29]

It is recognized that state governments of the U.S. faced huge budget gaps in the last three fiscal years as an outcome of "Great Recession". Most of the states relied mainly on the spending cuts in order to balance their budgets. The central cities of the U.S. have felt the influence of recession and disruptions to housing market much later than that of state governments. In each year after 2008, respondents to the annual survey of

[28] Jofre-Bonet, M., Serra-Sastre, V., & Vandoros, S. (2018). The impact of the Great Recession on health-related risk factors, behaviour and outcomes in England. *Social Science & Medicine, 197*, 213-225. https://openaccess.city.ac.uk/id/eprint/18735/15/

[29] Lowrey, A. (2017). *The Great Recession Is Still with Us*. Atlantic Monthly Group. https://www.theatlantic.com/business/archive/2017/12/great-recession-still-with-us/547268/

the city chief expect that the cities would be not able to meet the fiscal needs as compared to previous years. Spending of the real general fund lessened by 4.5% in the year 2010 and 1.9% in 2011[30]

Relevance of 2008 Crisis in Present Scenario

The financial markets and the U.S. economy are facing unexpected crisis for the 2nd time in 12 years. The financial crisis of 2008 and present COVID-19 pandemic differ in character, but both produced massive volatility in the financial markets. Furthermore, the downturn presented several challenges for the financial consultants as they keep the anxious customers from forsaking their monetary plans. The two situation compare in the following way:

- Bank's role (2008 vs 2020): In 2008 crisis, banks were the main source of problem for the monetary markets. Explosive growth of the mortgage lending fueled by securitization process produced huge bubble in housing market. However, banks were not culprit in this 2020 pandemic. A contraction by 30% was expected in the 2nd quarter due to community lockdown across country along with closing of business in the effort to prevent Covid-19 virus.
- Active Federal Reserve: The 2nd distinction among the two crisis is the emphatic support of the government. In Great Recession, federal government led the Lehmann brothers to collapse in September 2008. Fiscal stimulus of around $941 billion was provided in term of tax cuts. In this present crisis, federal government acted quickly in the form of slashing interest rates to around zero. A program also started to purchase corporate bonds and exchange of traded finds[31]

Policy Responses

Fiscal Situation of the State during Great Recession

In looking at the policy responses to the event, a story of similarity and convergence is revealed. From this viewpoint, fiscal policies of every nation were categorized by modest counter-cyclical reaction which is limited in scope and time. Governments of the 12 countries of advanced economies raised their budget deficit as well as public expenditure during crisis peak in 2008-2010. After that, these advanced economies lessened the budget discrepancies and also moderated increase in the public expenditure.

Furthermore, expansionary monetary policies were adopted by these advanced economies and involved "unconventional" plan instruments. Along with the above, there were extensive reductions in overnight rate of interest rate. Central banks of all countries reduced its interest rate in late 2008 and kept below pre-crisis levels[32]. The response of government of the U.S. against financial crisis was multifaceted and ensured that Great Recession involve aggressive monetary policies. It involved the Congress, Federal Reserve and the two administrations. A variety of the initiatives was incorporated by the Federal Reserve and the policy response as a whole was effective. Firstly, Federal Reserve created new facilities for credit which were planned to give liquidity to the markets and financial institutes. Furthermore, fed also adopted policy of zero-interest rate by the end of 2008.

It was seen that the Congress created Troubled Asset Relief Program in October 2008, which was used partly to inject capital in the nation's bank. Efforts to end recession and to begin the recovery was built around various fiscal stimulus measures. Tax rebate checks were informed to the middle income households in 2018 and American Recovery and Reinvestment was passed in 2009[33]. The Mexican and the Chilean governments responded to international crisis very distinctly as "policy space" to incorporate countercyclical policies differed substantially. In Chile, as the inflationary pressures slowed down in Jan 2009, the Central bank made a decision to lessen the policy rate by around 750 basis points in order to boost the economic activity. On fiscal side, Government of Chile incorporated stimulus package of around US$4 billion that equalled 2.8-3% of the GDP. Mexico's stimulus package was small in comparison to other Latin American countries due to less fiscal space[34]

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IV. Conclusion

Great recession indicated the problems within Euro Zone that experienced high unemployment and double-dip recession. Subprime crisis, the flawed U.S. growth model, and the housing market crash are some of the reasons for the occurrence of Great Recession. Furthermore, policy planners must consider significant points of actions regarding the event of Great Recession. The consequences of the Great recession should be studied in detail in order to prepare for upcoming storm in relation to the present pandemic situation. A significant lesson must be learnt from the Great Recession in order to provide effective responses for the current pandemic. In 2008 crisis, banks were the main source of problem for the monetary markets. Banks were not culprit in this 2020 pandemic. In this present crisis, federal government acted quickly in the form of slashing interest rates to around zero. Americans aged 25-54, lost their interest to look for a job during the Great Recession. Workers faced income loss and they reduced their spending on goods and services.

The economic policies needed to be well thought out in advance in order to evade any financial crisis. Interest rates should be kept at a lower rate during the pre-financial crisis stage. Countries needs to attract more foreign investment through various policies to evade any crisis in the future.

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