

Macroeconomics

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Recession in the US Economy in 2007 The Events that Led to the Recession

The US economy recession of 2007 was manifested in the form of liquidity crisis caused by a plummet in the real estate pricing and consequently the collapse of the US subprime mortgage industry. This crisis was mainly caused by financial instruments such as securitization where financial institutions particularly investment banks would borrow money from huge investors and convert the loans into sellable assets, thus divesting risky loans onto others. Prior to this, the central bank had reduced the borrowing interest rates to 1% following the 9/11 tragedy. While this was unfavourable for many investors who had invested in treasury bills, it provided an opportunity for investment banks to borrow money at this low interest rate and invest in real estate industry where they would get good returns. In this case, the bank would turn the borrowed money into securities which it would sell to home owners and get regular payments from all those mortgages. Initially, this turned out to be a highly profitable venture for both the lenders and the banks with up to 10% return on investment.

However, with time most people who could afford a mortgage had taken one and this caused a reduction in the number of new mortgage applicants. This compelled the banks to open up the mortgages to other potential home owners by removing all restrictions on securities. This encouraged many home owners to take up mortgages. Unfortunately, many could not afford to repay the mortgages. This led to a high number of defaulters and higher-than-expected home foreclosure rates. Suddenly, there were too many homes up for sale in the market which exceeded the demand thereby resulting in a decline in the home value.

Role Played by the Financial Market

The financial market had a major role to play in the 2007 great recession. First, the low interest rates offered by the central bank in response to the 9/11 tragedy fuelled the already rising housing bubble by the sub-prime mortgages and the related derivatives. In addition, the absence of regulation of the financial institutions involved in the sub-prime mortgage lending led to unprecedented growth of the real estate market and so did fraud. The bursting of the housing bubble led to meltdown of the three principal derivative securities that had guarded the industry, namely Collateralized Debt Obligation (CDO), Mortgage Backed Securities (MBS) and Credit Default Swap (CDS) which eventually paralyzed the very supple and resilient financial market with its spill over into the entire economy.

Work Cited

Jarvis, Jonathan. The Crisis of Credit Visualized. https://www.youtube.com/watch?v=bx_LWm6_6tA