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The Relations Among Loose Monetary Policy and the Housing Bubble and the Financial Crisis of 2008

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Abstract: This paper examines whether the loose monetary policy was a key factor in the 2006 housing bubble and then led to the financial crisis of 2008. It analyses the situation of the US economy during the early 2000s. It presents how the role of the Federal Reserve's Monetary strategies such as the Expansionary Monetary Policy created an easy credit environment and investors' overconfidence in the US. Furthermore, this paper delves into the Taylor rule and explores the principle for adjusting nominal interest rates based on economic fluctuation and inflation. This framework is crucial in understanding the policy decisions of that time. In addition, this paper outlines the different perspectives on the Monetary Policy from the John B. Taylor and Bernanke who was defend for the Federal Reserve that fears of deflation and the restrictions brought about by the liquidity trap during that time. The paper also reveals labour market, including unemployment and output gaps, indicated economic strength but also inflationary pressure. In conclusion, this paper emphasizes the importance of a multifaced approach to monetary policy analysis in understanding the intricate factors that led to this pivotal event in economic history.

Keywords: Monetary Policy, Financial Crisis 2008, Housing Bubble 2006, Taylor rule, Inflation and Ecocnomic Growth

1. Introduction

In the initial phase of the 2000s, the US was experiencing a sequence of economic events, leading to a notable increase in the cost of homes. This development, peaking around the middle of the decade, has been a central topic in economic discussions, analyzed deeply from the perspective of the Federal Reserve's monetary strategies. The central issue stemming from these dialogues is whether the lenient monetary policies implemented had a hand in magnifying the housing bubble, consequently setting the stage for the financial crisis in 2008 [1]

To unpack the intricacies of this topic, it is vital to immerse in the functional intricacies of the Federal Reserve, which was instituted in 1913 with the main two goals, encouraging utmost employment and maintaining price steadiness [2]. This inquiry demands a thorough inspection of the economic determinants and scenarios that were dominant, steering the fiscal trajectory of the nation in an era characterized by both innate and unexpected external developments. Central to this analytical process is the Taylor rule, which sketches the path of nominal interest rates reacting to alterations in economic dynamics and inflationary pressures. This standard, formulated by John

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Taylor, promotes a supple modification of the nominal interest rate in accordance with inflation shifts, a notion set to be extensively dissected in the subsequent segments of this essay.

To develop a holistic comprehension, this essay navigates through the complex interactions of aggregate demand and supply frameworks, spotlighting the dynamics of economic components such as transient output levels and inflation indicators. These frameworks, firmly fixed in macroeconomic theoretical foundations, offer an indispensable viewpoint for examining the studied timeframe's economic waves and policy reactions.

2. The Housing Bubble

This situation is marked by a disparity between the housing valuations and the foundational economic indicators, such as income brackets and GDP growth rate [3]. There are various elements leading to the bubble such as easy credit environments, and the overconfidence of investors who were misleading the economy. To explore the U.S. housing bubble, we need to review the timeline from 2000 to 2006, which witnessed a significant rise in housing prices. From the macroeconomic data and business cycle theories in Lecture 2, the business cycle fluctuations could discern the contours of this bubble, which delineate the deviations from the long-run trend [4]. The examination of this span reveals the housing sector detached from the customary economic markers, initiating an ascending cycle.

In this context, it is important to know the major variables that exhibited a correlation with the GDP during the period. Detailed research shows that consumption and investment maintained a strong relationship with GDP, progressing harmoniously. The expenditure components, comprising consumption, investment, government spending, and net export, exhibited a co-movement with GDP, painting a picture of an economy where the different sectors were moving in harmony but on a path leading to an economic bubble. The labor market behaviors during this time further shed light on the evolving economic backdrop. Furthermore, it necessitates a more detailed examination of the unemployment rate, which is a vital gauge of economic vitality. Utilizing the concepts of the unemployment gap and output gap, one can unravel the economic conditions prevalent during this period. The unemployment gap, representing the difference between the actual and the natural unemployment rate, serves as an indicator of the economic slack. Likewise, the output gap, which outlines the differences between the real and the potential productivity of the economy, can be seen in the underlying economic currents [4]. In this span, the labor sector displayed characteristics of strength, with the unemployment figures remaining under the natural rate, which is compatible with the steady inflation rate signaling a vibrant market. Yet, this situation also cultivated a setting ripe for inflationary tendencies, showcased by the tight relationship between the unemployment divergence and the output gap.

The economic narrative was then characterized by a period of strong and positive economic activity, with the labor market signaling strength and the growth of GDP showing a positive trajectory. However, this era also heralded the beginning of the coming turmoil, as the housing sector began to show indications of reaching a boiling point, with valuations escalating to untenable heights. The speculative investments in the housing sector, fuelled by easy credit conditions and a buoyant economy, created a bubble characterized by inflated prices and an eventual sharp correction. As the housing bubble festered, it fostered an illusion of economic prosperity with entities and individuals surfing the surge of escalating home valuations [5]. However, beneath this mask of prosperity, there was an economic irregularity: the housing bubble was going away more and more from the fundamental economic indicators.

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3. Different Perspectives on Monetary Policy's Role

The timeframe preceding the 2008 financial crisis offers a rich field for economic discussion; there was a range of scholars and economists who held and published different views on the impact of monetary policy in encouraging the growth of the housing bubble. An important point in this discussion is the Taylor rule, detailed in Lecture 4, which acts as a standard for assessing the decisions in monetary policy. This rule, crafted by the economist John Taylor, proposes that the nominal interest rate ought to react more than proportionately to changes in inflation from its goal and variations in output from its potential. This guideline assists in deciphering how the Federal Reserve might modify the nominal interest rate considering economic changes.

Taylor put forward a vital argument associating the relaxed monetary policy leading to the development of the housing bubble. He argued that the Federal Reserve kept the interest rates too low for a prolonged time, notably straying from what the Taylor rule would recommend. Taylor [6] believed this departure created a setting where credit was easily accessible, thereby encouraging the housing boom. The later increase in interest rates resulted in a Default rate rise particularly among borrowers with lower credit quality, paving the way for the financial crisis. Taylor's examination portrays a monetary policy that drifted away from the Taylor rule's foundational guidelines, entering a phase of undue leniency that significantly impacted the housing market [7].

Contrastingly, Bernanke [5] defended the actions of the Federal Reserve during that time frame. The speech from Bernanke indicates the changing of monetary policy made by the Federal Reserve System with the target federal funds rate lowered quickly in response to the 2001 recession from 6.5 percent in late 2000 to 1.75 percent in December 2001 and 1 percent in June 2003[5]. Referencing materials from Lecture 4, Bernanke underscored the influence of the delayed response of the unemployment rate and the liquidity trap in determining monetary policy choices. He maintained that the Federal Reserve was maneuvering through a complicated economic environment marked by fears of deflation and the restrictions brought about by the liquidity trap. Bernanke stressed that the policy choices were based on the real-time data and projected rates available then, which did not indicate an imminent crisis.

He describes a scenario in which the Fed wisely guides the economy, considering the various economic indicators involved [5]. To enhance this discussion, it is necessary to explore the perspectives shared in the supplementary readings. Taylor [6] provides a detailed investigation of policy responses to financial instability, critically assessing the mistakes that exacerbated the crisis. His analysis of the policy environment offers a powerful case for the consequences of deviations from traditional monetary policy standards.

Conversely, the detailed examination of Bernanke's address by Dokko et al. [3] provides an in-depth exploration of the worldwide aspects of the housing bubble.

This review highlights the complexity of the economic environment at the time, highlights the international factors involved, and paints a detailed view of the impact of monetary policy on the housing bubble. It reveals just how interconnected the global economy is. It presents a perspective beyond the United States, painting a global picture of the housing bubble and the following financial chaos. It helps us understand how everything in the economy is connected, from one end of the globe to another, placing the housing crisis on a larger global scale. It gives us a context much larger than one country and helps illustrate the ripple effects that events in one place can have elsewhere.

4. The Taylor Rule and Monetary Policy Analysis

In analyzing money rules, the Taylor rule is a super important tool. It gives a straightforward way to change the introductory interest rate when the economy goes up or down. It's like a roadmap for figuring out interest rates during different economic times, helping to guide decisions steadily using

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a tried-and-true method [6][7]. This rule explained in depth in Lecture 4, is at the heart of understanding how to react when the economy changes, giving a structured plan to follow, which can be helpful.

Taylor [6][7] explained how central banks should alter interest rates in response to changes in economic conditions. It is grounded on the principle that the nominal interest rate should be adjusted more than proportionately in response to deviations of inflation from its target and output from its potential. This rule has been super helpful in directing decisions about money policies, giving forecasts that use central economy stuff like inflation and the output gap. It works using a formula that looks at the goal for inflation, the actual inflation rate, and the output gap, which means it helps organize policies. It's like having a recipe that considers the key ingredients of economic health, guiding how to mix them just right to get the best outcome, and giving a reliable method to figure out the best moves. This way, it becomes a handy tool, grounding the policy talks in solid numbers and facts.

However, applying the Taylor rule has not been without gaps in its forecast. A notable historical event that elucidated this was the 1970s oil crisis. During this period, a loose monetary policy coupled with external shocks led to a surge in inflation, a scenario not adequately captured by the Taylor rule. This event underscores the rule's limitations in navigating complex economic landscapes characterized by multifaceted shocks. Similarly, in the 1980s, adopting a tight monetary policy spearheaded a period of high-interest rates and disinflation, a trajectory that diverged from the predictions of the Taylor rule. These cases show the holes in Taylor's predictions, signaling the need for a more detailed way to deal with money policy considering a wider range of economic signs. While Taylor originally proposed specific weights for these variables, subsequent analyses have suggested that these weights might vary depending on the economic context and monetary policy objectives.

5. Conclusion

In the discussion about the 2008 financial mess, the Federal Reserve's money guidelines were a central thing to check out. This paper started a detailed journey into the detailed actions of the US main bank's change over time, what made the housing bubble what it was, and different takes on how money rules played into the disaster, shining a light, particularly on what the Taylor rule has to say. Using the total demand and supply ideas explained in lectures, this essay shows that the relaxed money rules may have made a good place for the housing bubble to grow big. That time saw a bunch of economic things coming together like changes in inflation and output gaps, a lot affected by the way the money policy stood. Still, it's key to know there were also other things adding to this, like world economy paths and new finance stuff, having a big part in forming the money scene then.

Overall, while the relaxed money rules might have helped it along, saying the housing bubble was just because of it is too simple. The crisis showed how much we need a detailed grasp of money policy details to get the full picture of economic crashes, considered a many-sided way to look at the economy to make steady and smart policy plans.

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