

In Search of the Reasons of “The Great Recession”: Time for a Change in Policies?

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The most recent global recession of 2007 - 2009, termed as the “Great Recession”, has left many economists, financial analysts and researchers thinking about its causes and the search for a good theoretical explanation of this phenomenon has started. Most mainstream researchers have given explanations which are quite similar to that given by the Austrian Business Cycle Theory, and many argue that this theory gives the most convincing explanation of this recession. Using monthly data of ten years, this paper is a first attempt at statistically finding out whether this theory provides the most accurate theoretical explanation of the “Great Recession”, and finding out the answer to the question most economists, policymakers, financial analysts and researchers are asking – is it time for a change? The results point to the fact that the Austrian Business Cycle Theory does indeed have a legitimate claim of being the most authoritative explanation of the causes of the recession. This actually shows that too much use of the same monetary policies in all situations may have adverse effects on the economy, and so it is indeed time for a change in the way government policies and regulation is conducted.

Field of Research: Economics (also includes concepts of Finance and Banking)

1. Introduction

The recent global recession, which started in USA and spread throughout the world during the period of 2007 – 2009, and which has been termed as ‘The Great Recession’ by many, has now slowly come to an end. But the questions still remain as to why all this happened. Researchers are now trying to find out what triggered this crisis in USA, and why any of the economists or researchers could not predict that a crisis was about to come. This actually leads to the most vital research question of all – is there any theoretical explanation of the facts in USA which led to this recession?

In economics, ‘business cycle theories’ try to explain the movements of economies from economic booms to economic recessions in the light of different viewpoints. There are many such theories, but after the events which led to the ‘Great Recession’, there has been renewed interest in a very old business cycle theory known as the Austrian Business Cycle Theory (ABCT). This happened for two reasons: firstly, when other economists could not predict precisely that a recession was inevitable, Austrian or Austrian-inspired economists have been precise in predicting that a crisis would be triggered by a collapse of an asset bubble, specifically the real estate bubble. Since the followers of the Austrian School of Thought based their predictions about this recession on the Austrian Business Cycle Theory, the natural question which arises is whether the Austrian Business Cycle

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Theory is the most precise explanation of the recession or not. Secondly, many of the main explanations of the reasons of the 'Great Recession' given by mainstream economists are similar to the explanation of recessions given by ABCT.

Therefore, the question which now arises is whether the Austrian Business Cycle Theory provides the key explanation of the events which led to this big global recession, and what we can learn from it. Hence, the main research question or objective of this paper is finding out whether the Austrian Business Cycle Theory is the closest explanation of the reasons of The Great Recession, and if it is, then what implications does it have for policy. For that, a general analysis, along with a statistical analysis of the events is necessary. But before that a look at the relevant literature is essential. Section 2 outlines the relevant literature concerning the causes of recession, Section 3 describes the methodology and dataset of the study, Section 4 contains the results of the analysis, and the final section concludes.

2. Literature Review

Many scholars and researchers have tried to find out the causes of this recession, but none of them have been successful in pointing out a *sufficient* condition—a single factor that would have caused the crisis in the absence of any others. They have been, however, successful in indicating a number of plausible *necessary* conditions—factors without which the crisis would not have occurred. Most analysts, such as Stanford Economist and former Reagan adviser John Taylor (2007), point out the flawed policy of former Chairman of the Federal Reserve System, Alan Greenspan, of keeping interest rates too low between 2003 and 2005 as a reason for this recession. He argues that the Fed's easy monetary policies spurred a frenzy of irresponsible borrowing on the part of banks and consumers alike. Taylor (2007) argues that from 2002 through 2005, U.S. monetary policy was far more accommodative than a rule-based approach would have called for based on an interpretation of inflation and output data. Correlating historical housing starts and interest rates, he finds that housing starts during 2003–06 were meaningfully higher than they would have been if the Fed had followed the more restrictive rule-based monetary policy after the 2001 recession.

Jarociński and Smets (2008), using a Bayesian vector autoregression estimate for the U.S. economy that includes a housing sector, conclude that there is “evidence that monetary policy has significant effects on housing investment and house prices and that easy monetary policy designed to stave off perceived risks of deflation in 2002–04 has contributed to the boom in the housing market in 2004 and 2005.” Smithers(2009) blames the financial crisis on “the actions of incompetent central bankers, who provided excessive liquidity on which the asset price bubbles and their associated absurdities were built” (p. 3). This is because “interest rates affect asset prices and, as asset prices affect the economy, this is a major transmission mechanism whereby central banks influence demand in the real economy” (p. 5). Vogel (2010) finds that “interest-rate policy levers such as Fed funds rates appear to have some effect on the creation and sustainability of bubble conditions.”

Other economists, including Nobel Laureate Paul Krugman and Greenspan's successor Ben Bernanke, attribute this crisis to regulatory failure. In this view, the emergence of an unsupervised market in more and more exotic derivatives—credit-

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default swaps (CDSs), collateralized debt obligations (CDOs), CDSs *on* CDOs, allowed heedless financial institutions to put the whole financial system at risk. "Financial innovation + inadequate regulation = recipe for disaster" is also the favored explanation of Ben Bernanke. However, Mr. Bernanke does not completely disagree with the argument provided by Taylor (2007).

Many other analysts outlined causes, which didn't fundamentally cause the crisis but either enabled it or made it worse. These include: global savings imbalances; conflicts of interest and massive misjudgments on the part of credit rating agencies; the lack of transparency about the risks borne by banks, which used off-balance-sheet entities known as SIVs to hide what they were doing; excessive reliance on mathematical models like the VAR and the dreaded Gaussian copula function, which led to the underpricing of unpredictable forms of risk; a flawed model of executive compensation and implicit too-big-to-fail guarantees that encouraged traders and executives at financial firms to take on excessive risk, etc. Bartlett (2008) said that crisis was started with the downfall of US sub-prime mortgage industry and the intensity of this collapse was significant; "Market-to-market losses on mortgage-backed securities, collateralized debt obligations, and related assets through March 2008 were approximate \$945 billion." He further stated that it is "The largest financial loss in history", as compared to Japan's banking crisis in 1990 about \$780 billion, losses stemming from the Asian crisis of 1997-98 approx \$420 billion and the \$380 billion savings and loan crisis of U.S itself in 1986-95. Yilmaz (2008) charged U.S subprime mortgage industry to be the major reason of current global financial crisis. However, they failed to point out the exact reasons of the downfall of the US sub-prime mortgage crisis.

While enlightening the facts concerning why this US sub-prime mortgage crisis turned into global banking crisis, Khatiwada and McGirr (2008) stated "Many of these sub-prime mortgages actually never made it on the balance sheets of the lending institutions that originated them"; and they were made attractive to foreign banks by high investment grading, "when sub-prime borrowers failed to repay their mortgages, the originating institution needed to finance the foreclosure with their own money, bringing the asset back on its balance sheet. This left many banks in a financially unviable situation, in a rather short, unmanageable timeframe". However Hyun-Soo (2008) argues that it was the "Trust Crisis" which caused this global predicament. DeBoer (2008) believes that it was series of events which caused the crisis; it begins with the collapse of currencies in East Asia in 1997; next, in USA was the "dot-com" stock collapse in 2001, and the final stroke was again in USA, when after a swift decline in housing prices and "rapid contraction in credit, it fell into recession. Rasmus (2008) also has the same thoughts. These explanations do point out that the collapse of the housing bubble triggered the crisis, but did not point out what caused the housing bubble and why it collapsed.

Templeman (2010) argues that Austrian business cycle theory has a legitimate claim to being the most authoritative explanation of the recent global financial and economic crisis, and many mainstream economists have begun to analyze the crisis in terms that sound as if they were derived directly from the theory. Woodall, in his article in *The Economist* in 2002, was explicit in acknowledging Austrian Business Cycle Theory as an explanation of the recession by saying that "The recent business cycles in both America and Japan displayed many 'Austrian' features." Four years

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later, *The Economist* even cited Ludwig von Mises, an Austrian economist of the early 20th century, in pointing out that Fed's overly stimulative monetary policy was not without consequences. Since the Austrian Business Cycle Theory shows how overly accommodative monetary policies can lead to recessions, the explanations of Taylor(2007), Jarociński and Smets (2008), Smithers(2009) and Vogel (2010) discussed earlier are similar to the explanations of this theory. Hence, the relevant empirical literature indicates that the Austrian Business Cycle Theory is the closest explanation of the events which led to The Great Recession.

3. Methodology

The main objective of the study presented in this paper was to find out the closest theoretical explanation of the causes of The Great Recession, and since empirical literature points towards ABCT as the closest explanation of this recession, the objective of the analysis of this paper is to find out whether ABCT actually provides the most precise explanation or not. The study or analysis of this paper has been done in two steps: one is a general analysis and another one is a statistical analysis. For both the analyses, the hypothesis is that the Austrian Business Cycle Theory (ABCT) is the closest explanation of the causes of The Great Recession. This means that for both the analyses, the hypothesis is that the lowering of the federal funds rate caused increases in consumer loans, which caused the housing price bubble, and once this bubble collapsed, the US economy fell into a recession.

3.1 Procedure of the General Analysis

The general analysis involves finding out the main implications of the Austrian Business Cycle Theory and comparing it with the actual events which led to the Great Recession. This would lead to a preliminary conclusion about whether ABCT is the main theoretical explanation of the causes of the Great Recession or not. The statistical analysis involves employing complex statistical techniques on time series variables to find out the main causal relationships, and from this it has been concluded whether ABCT is actually the closest theoretical explanation of the Great Recession or not.

3.2 Procedure of the Statistical Analysis

Researchers who argue that the Austrian Business Cycle Theory is the closest explanation of the causes of the Great Recession try to point out that the lowering of the federal funds rate (ffr) caused increases in total consumer credit (tcc), which, in turn, caused the housing price bubble (or increases in housing price), and once this bubble collapsed, this led to the Great Recession. Hence, if the hypothesis of this analysis (which is that the Austrian Business Cycle Theory is the closest explanation of the causes of the recession) is true, then federal funds rate (ffr), housing price index(hpi), total consumer credit (tcc) and real GDP (rgdp) would be closely and causally related to each other in terms of cointegration and causality, and the relationships would prove to be statistically significant. The variable real GDP is considered as an indicator of recession, since the NBER (National Bureau of Economic Research) defines an economic recession as: "a significant decline in [the] economic activity spread across the country, lasting more than a few months, normally visible in real GDP growth, ...".

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For statistically proving cause and effect using time series variables, there are two popular and well-established methods – one of them is testing for cointegration and another one is testing for Causality. This paper uses the Johansen cointegration tests and Granger Causality Tests on the variables to find out the cause and effect relationship between the variables. The main reason of using these types of tests is that these are the only two well-known methods of examining causality and relationships among the time series variables, and examining the relationship and causality among the variables is the objective of this analysis. Many tests of Granger-type causality have been derived and implemented, including Granger (1969), Sims (1972), and Geweke et al. (1983), to test the direction of causality. The tests are all based upon the estimation of autoregressive or vector autoregressive (VAR), models involving (say), the variables X and Y , together with significance tests for subsets of the variables. Guilkey and Salemi (1982) have examined the finite sample properties of these common tests and suggest that the Granger-type tests should be used in preference to the others.

In the case of cointegrated data Granger causality tests may use the $I(1)$ (integrated of order 1) data because of the superconsistency properties of estimation. With two variables X and Y :

$$X_t = \alpha + \sum_{i=1}^m \beta_i X_{t-i} + \sum_{j=1}^n \gamma_j Y_{t-j} + u_t \quad (1)$$

$$Y_t = a + \sum_{i=1}^m b_i Y_{t-i} + \sum_{j=1}^n c_j X_{t-j} + v_t \quad (2)$$

where u_t and v_t are zero-mean, serially uncorrelated, random disturbances. On the other hand, Granger causality tests with cointegrated variables may utilize the $I(0)$ (integrated of order zero) data, including an error-correction mechanism, i.e.,

$$\Delta X_t = \alpha + \sum_{i=1}^m \beta_i \Delta X_{t-i} + \sum_{j=1}^n \gamma_j \Delta Y_{t-j} + \sum_{j=1}^n \delta ECM_{t-j} + u_t \quad (1')$$

$$\Delta Y_t = a + \sum_{i=1}^m b_i \Delta Y_{t-i} + \sum_{j=1}^n c_j \Delta X_{t-j} + \sum_{j=1}^n d ECM_{t-j} + v_t \quad (2')$$

where the error-correction mechanism term is denoted ECM .

If ffr is cointegrated with $ltcc$, $ltcc$ is cointegrated with hpi , hpi is cointegrated with $rgdp$, and if ffr is a Granger Cause of $ltcc$, $ltcc$ is a Granger Cause of hpi , hpi is a Granger Cause of $rgdp$, then it would be statistically proved that the lowering of the Federal Funds Rate caused increases in loans, which caused a “price bubble”, and once this bubble “burst”, the economy fell into a recession. Hence, following from the theoretical explanation of section 2, it would be proved that ABCT is actually the most precise explanation of the events which led to the recession.

3.2 Dataset

The dataset consists of monthly data for 10 years, ranging from 2000 and 2009. Hence, the number of datapoints, $N = 120$. Following H. Y. Toda (1994), Toda, Hiro Y. & Yamamoto, Taku (1995) and Johansen and Katarina (1990), this sample size is good enough for cointegration and Granger Causality analysis. Now, the lowering of the Federal funds rate started in the 2000s, while the recession spanned from 2007 to 2009. Hence, analyzing the reasons of the recession and finding out whether ABCT is actually the precise explanation of the events would require studying data of the period 2000 to 2009, since according to ABCT, the lowering of the federal funds rate was actually the most vital cause of this recession. Since the objective of this paper is finding out whether this is true or not, monthly data of the period 2000 to 2009 has been chosen. The data has been collected from the NBER database and the Bureau of Labor Statistics database of USA.

4. Analysis of the Data and Results

The first step of the analysis of this paper, as mentioned in the methodology section, is the comparison of the Austrian Business Cycle Theory with the events which led to the recession. The following section describes the theory along with the events which led to the recession in USA, while the subsequent section provides the results of the statistical analysis.

4.1 A General Analysis of the Similarities between ABCT and the Events which caused The Great Recession:

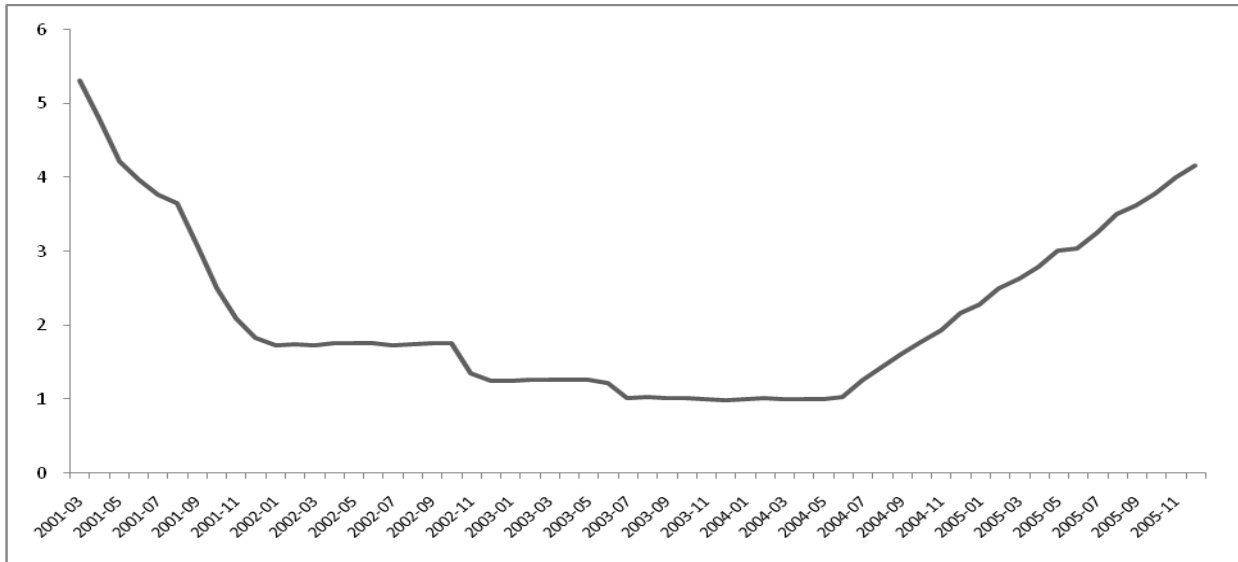
According to Templeman (2010), the Austrian business cycle theory roughly states that when credit creation by monetary authorities (usually done by lowering interest rates) exceeds a society's structural savings rate, financial intermediaries end up lending money at interest rates that are below the rate where supply and demand clear in the market for loanable funds. As a result, the information embedded in market prices (including interest rates) is distorted, affecting entrepreneurial decisions and causing a misallocation of capital across the economy. Specifically, too many capital goods and not enough consumer goods end up being produced relative to ultimate consumer preferences. Eventually, as the lack of underlying demand for these capital goods becomes apparent, production capacity is idled, and the boom that was fed by the credit expansion turns to bust. Thus, credit expansion during an economic downturn will not help bring about a sustainable boom but will merely postpone it, as it causes a delay in the structural adjustments, such as business closures and other eliminations of unproductive uses of capital, that need to be made to bring about a sustainable economic expansion.

Hence, the main argument of ABCT is that the lowering of the interest rates by central banks causes increases in loans, which causes "price bubbles", and once this bubble "bursts", the economy falls into a recession.

Many researchers argue that this is exactly what happened in USA, which led to the recession. In USA, the Federal Reserve System (The Fed) did actually lower the federal funds rate to historical levels in the 2000s, which led to an influx of credit flow. This has been shown in the following figure:

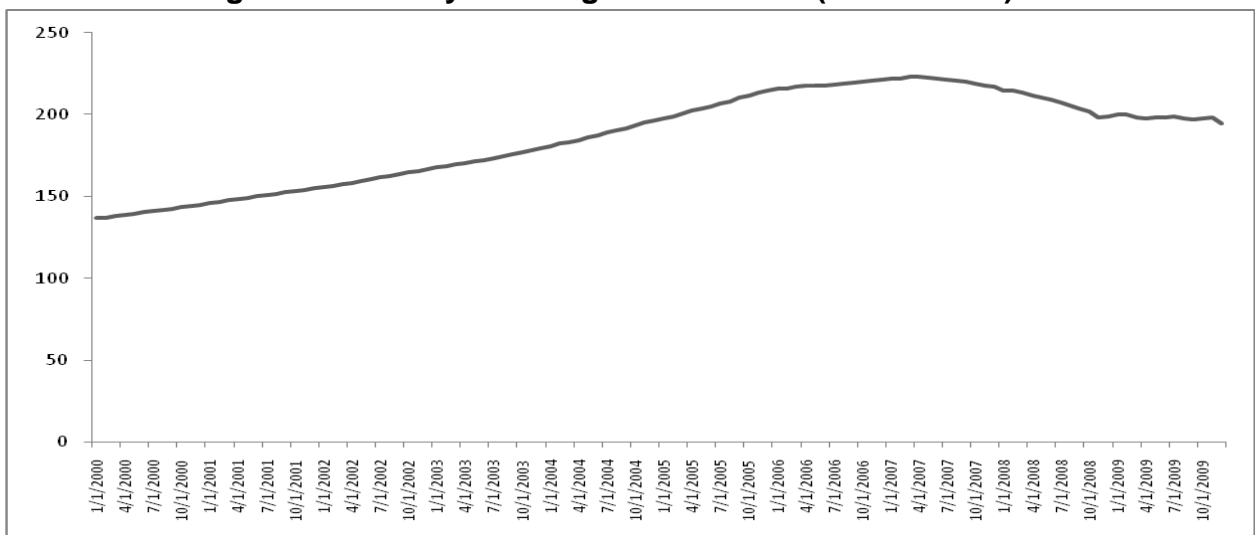
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Figure 1: The Federal Funds Rate (in %)



Consumers started taking loans and investing in real estate, because firstly, after the dot com bubble, equity markets were down and real estate was the asset with the most attractive return; and secondly, because financial innovations such as CDOs (Collateralized Debt Obligations), CDSs (Credit Default Swaps), CDSs on CDOs, mortgage-backed securities etc. made investment in real estate even more attractive. The demand for housing rose, raising the price of houses and creating the 'housing bubble'. This has been shown in the following figure:

Figure 2: Monthly Housing Price Indices (2000 – 2009)



Expecting future rises in housing prices, people started taking loans they could not afford on the basis of Adjustable Rate Mortgages (ARMs), hoping that the terms of these loans would become easier once the prices of their houses rise. But to combat inflation, the Fed raised the interest rates in 2005. Since loans became more expensive, people could no longer afford loans to buy houses, and so housing demand fell, and the housing bubble collapsed. For this reason, people who took loans based on ARMs could not repay them, mortgage cash flow of banks declined,

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and there was the Subprime Mortgage Crisis. This caused the Credit Crunch, and the economy slowly moved to a recession.

Hence, summing up, the lowering of the federal funds rate caused increased consumer loans, which created the housing price bubble, and once this bubble collapsed, the economy fell into a recession. On the other hand, Austrian Business Cycle Theory (ABCT) states that the lowering of the interest rates by central banks causes increases in loans, which causes “price bubbles”, and once this bubble “bursts”, the economy falls into a recession. Therefore, from the general analysis, it is clear that the chain of events through which the The Great Recession unfolded are the same as ABCT had predicted. This means that the general analysis supports the hypothesis that the ABCT is the closest explanation of the causes of The Great Recession.

4.2 Statistical Analysis

The first part of the statistical analysis is the cointegration analysis. The target here is to find out whether pairwise cointegration holds between *ffr* and *tcc*, *tcc* and *hpi* and *hpi* and *gdp*. The results of the Johansen cointegration tests (as reported by the popular statistical package STATA) have been shown in the following tables:

Table 1: Johansen Cointegration Test Results (*ffr* and *ltcc*)

Maximum Rank	Parameters	Log-likelihood	Trace Statistic	Critical Value
0	14	589.3196	21.1509	15.41
1	17	598.5715	2.6472	3.76

Table 2: Johansen Cointegration Test Results (*ltcc* and *hpi*)

Maximum Rank	Parameters	Log-likelihood	Trace Statistic	Critical Value
0	6	488.1737	47.806	15.41
1	9	511.8559	0.4416	3.76

Table 3: Johansen Cointegration Test Results (*hpi* and *lgdp*)

Maximum Rank	Parameters	Log-likelihood	Trace Statistic	Critical Value
0	6	401.0488	35.6162	15.41
1	9	417.7983	2.1172	3.76

The tables show that there is evidence that the variables *ffr* and *ltcc* (log of *tcc*), *ltcc* and *hpi*, and the variables *lgdp* and *hpi* are cointegrated. Now, if the chain of events of the Great Recession is interpreted in terms of the Austrian theory, the lowering of the federal funds rate (*ffr*) caused excessive loans (*tcc*), which caused the housing bubble (*hpi*) and eventually the recession which is evident in real GDP (*rgdp*). Hence, the cointegration tests partially prove this. To complete the analysis, pairwise Granger Causality Tests need to be done on the same variables to see whether these cointegrating relationships can be interpreted as cause and effect relationships. For variables which are $I(1)$, the testing procedures outlined in equations (1) and (2) of the methodology section has been used, and for the variables which are $I(0)$, the testing procedures outlined in equations (1') and (2') have been used. The test results (as reported by STATA) are shown in the following tables:

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Table 4: Granger Causality Test Results (*ltcc* and *ffr*)

Equation	Excluded	Chi ²	df	Prob>chi ²
<i>ltcc</i>	<i>ffr</i>	16.514	2	0
<i>ltcc</i>	All	16.514	2	0
<i>ffr</i>	<i>ltcc</i>	0.05669	2	0.972
<i>ffr</i>	All	0.05669	2	0.972

The table above shows that, the federal funds rate is a Granger cause of the log of Total Consumer Credit, but it is not true the other way round. Hence, this provides a statistically significant evidence of the fact that the low federal funds rate increased the total consumer credit in USA during the period 2000 – 2010. The proof that the total consumer credit and the federal funds rate have a negative relationship is shown in the following regression results of *ltcc* on *ffr*, where the coefficient of *ffr* has a negative sign:

Table 5: Regression Results

Dependent Variable: <i>ltcc</i> (log of total consumer credit)				
	Coefficient	Standard Error	Value of z	Probability > z
<i>ffr</i>	-0.02513	0.006738	-3.73	0
Constant	14.65095	0.018337	798.98	0
R-squared: 0.12		Number of Observations: 120		

The Granger Causality test results for *ltcc* and *hpi* has been shown as follows:

Table 6: Granger Causality Test Results (*ltcc* and *hpi*)

Equation	Excluded	chi ²	df	Prob > chi ²
<i>dltcc</i>	<i>dhpi</i>	13.157	2	0.001
<i>dltcc</i>	<i>r</i>	15.391	2	0.00
<i>dltcc</i>	All	18.483	4	0.001
<i>dhpi</i>	<i>dltcc</i>	5.8875	1	0.015
<i>dhpi</i>	<i>r</i>	1.7588	2	0.415
<i>dhpi</i>	All	6.1734	3	0.103
<i>r</i>	<i>dltcc</i>	9.50E+11	1	0.00
<i>r</i>	<i>dhpi</i>	2.50E+12	2	0.00
<i>r</i>	All	2.80E+12	3	0.00

In the table, *dhpi* and *dltcc* refer to the first differenced values of *hpi* and *ltcc*, and *r* refers to the one year lagged values of the residuals of the regression of *ltcc* on *hpi*. The test result shows that the total consumer credit is a Granger cause of housing prices, while housing prices are also a Granger cause of total consumer credit. This proves the fact that increases in loans increased demand for housing which increased housing prices. On the other hand, this also proves that increases in prices of houses caused increased consumer credit, since increasing housing prices caused people to expect that they would be able to refinance their mortgages.

Table 7: Granger Causality Test Results (*hpi* and *lrgdp*)

Equation	Excluded	chi ²	df	Prob > chi ²
<i>lrgdp</i>	<i>hpi</i>	19.141	2	0.00
<i>lrgdp</i>	All	19.141	2	0.00
<i>hpi</i>	<i>lrgdp</i>	23.024	2	0.00
<i>hpi</i>	All	23.024	2	0.00

Table 7 shows that *hpi* is a Granger cause of *lrgdp*. This completes the process of proving the statements made earlier in section 3. More precisely, the results show that the low federal funds rate caused excessive credit expansion, which in turn caused the housing bubble and eventually the recession. Therefore, these results actually support the hypothesis that the Austrian Business Cycle Theory can be considered as the theory which has a legitimate claim to being the most authoritative explanation of the recent global financial and economic crisis. This is certainly a unique discovery, since previous literature has vaguely identified that this recession might have some Austrian origins, but have not proved it. It is this gap in the literature that this analysis fills in. Hence, these results contribute to the body of knowledge in the sense that these results show another perspective of looking at the events which led to the Great Recession, which is important for policy purposes.

5. Conclusion

The objective of the analysis of this paper was to look for a good theoretical explanation of the events which led to the Great Recession. The relevant literature, along with the statistical analysis point towards the Austrian Business Cycle Theory as the closest theoretical explanation of the causes of the Great Recession. However, this does not mean that unregulated financial markets and too much financial innovations (such as CDOs, CDSs on CDOs, Mortgage Backed Securities) did not play any role in causing the recession. This means that in the presence of these financial imperfections, a credit flow induced by the Federal Reserve System made matters even worse, since in this case slight movements in interest rates are channeled quickly towards investment movements. This is a unique and original discovery, since it provides a different perspective of looking at the causes of The Great Recession.

Analyzing the movements of each and every type of loan, especially loans based on adjustable rate mortgages, each type of investment, and the movements of weekly federal funds rate would have provided a much convincing picture of this analysis, since larger sample sizes tend to be more representative of the population. Data availability is the main problem in doing such analyses, and so this may be identified as one limitation of this analysis. However, this does not mean that the statistical analysis presented in this paper is not sufficient, since the techniques and sample size have been chosen based on established econometric theories and empirical literature; and this analysis shows that Austrian Business Cycle Theory does indeed deserve to be referred to as the most precise explanation of the events which led to the Great Recession. The Austrian Business Cycle Theory basically points out the disastrous effects credit expansion can have on the economy, and with highly developed financial markets with unregulated financial innovations, these effects can be huge.

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The analysis outlined in the previous sections not only shows that the Austrian Business Cycle theory is indeed a good explanation of the Great Recession, but this theory also has some implications for policy. In the modern times, increasingly mobile capital flows now quickly seek out investment projects that are perceived to provide the most attractive returns. In such an environment, herding behavior and bubbles could encourage malinvestment similar to that predicted by the Austrian theory. Hence, the policy implications are more important now than before.

The main policy implication of the whole analysis outlined in this paper is that the optimal policy response to any situation would depend on the underlying causes. In the presence of financial and structural imbalance, such as those which prevailed in USA during the recent financial downturn, traditional demand management policies may not prove to be optimal. This is becoming more true everyday with the development of the financial markets around the world.

Hence, it is indeed time for a change, and this change does not include increased government regulation. This change calls for a change in the way government regulation should be conducted. Government regulations should help the market forces to work properly, such that proper signals are conveyed to the economic agents. Government regulations should not try to distort the workings of the market forces. Policies such as fiscal policies and monetary policies tend to use the market forces to generate desired results for the economy. They should not be used to artificially depress prices or interest rates for too long, since this leads the consumers and entrepreneurs to expect that these depressed prices would perpetuate, leading to behavior which might not be considered as rational.

Similar implications hold for the financial markets. Regulation of financial markets should be in the form of helping out people in making sound financial decisions. There should have been some form of regulation in the United States of America which would have overseen the operation of credit rating agencies. These agencies rate the financial instruments available, which help people in taking investment decisions. These institutions 'overrated' many mortgage-backed securities, which led to widespread malinvestments in the financial market. Hence, these implications need to be kept in mind if economic crises of this sort are to be prevented in future.

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