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2008 Recession: What the Great Recession Was and What Caused It

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What Was the Great Recession?

The Great Recession was the sharp decline in economic activity during the late 2000s. It is considered the most significant downturn since the Great Depression. The term "Great Recession" applies to both

the U.S. recession, officially lasting from December 2007 to June 2009, and the ensuing global recession in 2009.

The economic slump began when the U.S. housing market went from boom to bust, and large amounts of mortgage-backed securities (MBS) and derivatives lost significant value.

KEY TAKEAWAYS

- The Great Recession refers to the economic downturn from 2007 to 2009 after the bursting of the U.S. housing bubble and the global financial crisis.
- The Great Recession was the most severe economic recession in the United States since the Great Depression of the 1930s.
- In response to the Great Recession, unprecedented fiscal, monetary, and regulatory policy was unleashed by federal authorities, which some, but not all, credit with the subsequent recovery.

Understanding the Great Recession

The term "Great Recession" is a play on the term "Great Depression". An official depression occurred during the 1930s and featured a gross domestic product(GDP) decline of more than 10% and an unemployment rate that at one point reached 25%.

While no explicit criteria exist to differentiate a depression from a severe recession, there is a near consensus among economists that the downturn of the late-2000s, was not a depression. During the Great Recession, U.S. GDP declined by 0.3% in 2008 and 2.8% in 2009, while unemployment briefly reached 10%.1 However, the event is unquestionably the worst economic downturn in the intervening years.

Causes of the Great Recession

According to a 2011 report by the Financial Crisis Inquiry Commission, the Great Recession was avoidable. The appointees, which included six Democrats and four Republicans, cited several key contributing factors that they claimed led to the downturn.2

First, the report identified failure on the part of the government to regulate the financial industry. This failure to regulate included the Fed’s inability to curb toxic mortgage lending.

Next, there were too many financial firms taking on too much risk. The shadow banking system, which included investment firms, grew to rival the depository banking system but was not under the same scrutiny or regulation. When the shadow banking system failed, the outcome affected the flow of credit to consumers and businesses.3

Other causes identified in the report included excessive borrowing by consumers and corporations and lawmakers who were not able to fully understand the collapsing financial system. This created asset bubbles, especially in the housing market as mortgages were extended at low interest rates to unqualified borrowers who could not repay them. This caused housing prices to fall and left many other homeowners underwater. This, in turn, severely impacted the market for mortgage-backed securities (MBS) held by banks and other institutional investors.

Origins and Consequences

In the wake of the 2001 Dotcom bubble and subsequent recession, along with the World Trade Center attacks of 9/11/2001, the U.S. Federal Reserve pushed interest rates to the lowest levels seen up to that time in the post-Bretton Woods era in an attempt to maintain economic stability. The Fed held low interest rates through mid-2004.4

Combined with federal policy to encourage homeownership, these low interest rates helped spark a steep boom in real estate and financial markets and a dramatic expansion of the volume of total mortgage debt. Financial innovations such as new types of subprime and adjustable mortgages allowed borrowers, who otherwise might not have qualified otherwise, to obtain generous home loans based on expectations that interest rates would remain low and home prices would continue to rise indefinitely.

However, from 2004 through 2006, the Federal Reserve steadily increased interest rates in an attempt to maintain stable rates of inflation in the economy. As market interest rates rose in response, the flow of new credit through traditional banking channels into real estate moderated. Perhaps more seriously, the rates on existing adjustable mortgages and even more exoticloans began to reset at much higher rates than many borrowers expected or were led to expect. The result was the bursting of what was later widely recognized to be a housing bubble.

During the American housing boom of the mid-2000s, financial institutions had begun marketing mortgage-backed securities and sophisticated derivative products at unprecedented levels. When the real estate market collapsed in 2007, these securities declined precipitously in value. The credit markets that had financed the housing bubble, quickly followed housing prices into a downturn as a credit crisis began unfolding in 2007. The solvency of over-leveraged banks and financial institutions came to a breaking point beginning with the collapse of Bear Stearns in March 2008.

Things came to a head later that year with the bankruptcy of Lehman Brothers, the country's fourth-largest investment bank, in September 2008. The contagion quickly spread to other economies around the world, most notably in Europe. As a result of the Great Recession, the United States alone shed more than 8.7 million jobs, according to the U.S. Bureau of Labor Statistics, causing the unemployment rate to double. Further, American households lost roughly $19 trillion of net worth as a result of the stock market plunge, according to the U.S Department of the Treasury. The Great Recession's official end date was June 2009.

The Dodd-Frank Act enacted in 2010 by President Barack Obama gave the government control of failing financial institutions and the ability to establish consumer protections against predatory lending.5

Response to the Great Recession

The aggressive monetary policies of the Federal Reserve and other central banks in reaction to the Great Recession, although widely credited with preventing even greater damage to the global economy, have also been criticized for extending the time it took the overall economy to recover and laying the groundwork for later recessions.

Monetary and Fiscal Policy

For example, the Fed lowered a key interest rate to nearly zero to promote liquidity and, in an unprecedented move, provided banks with a staggering $7.7 trillion of emergency loans in a policy known as quantitative easing (QE). This massive monetary policy response in some ways represented a

doubling down on the early 2000's monetary expansion that fueled the housing bubble in the first place.[6]

Along with the inundation of liquidity by the Fed, the U.S. Federal government embarked on a massive program of fiscal policy to try to stimulate the economy in the form of the $787 billion in deficit spending under the American Recovery and Reinvestment Act, according to the Congressional Budget Office. These monetary and fiscal policies had the effect of reducing the immediate losses to major financial institutions and large corporations, but by preventing their liquidation they also keep the economy locked in too much of the same economic and organizational structure that contributed to the crisis.

The Dodd-Frank Act

Not only did the government introduce stimulus packages into the financial system, but new financial regulation was also put into place. According to some economists, the repeal of the Glass-Steagall Act—the depression-era regulation—in the 1990s helped cause the recession. The repeal of the regulation allowed some of the United States' larger banks to merge and form larger institutions. In 2010, President Barack Obama signed the Dodd-Frank Act to give the government expanded regulatory power over the financial sector.[5]

The act allowed the government some control over financial institutions that were deemed on the cusp of failing and to help put in place consumer protections against predatory lending.

However, critics of Dodd-Frank note that the financial sector players and institutions that actively drove and profited from predatory lending and related practices during the housing and financial bubbles were also deeply involved in both the drafting of the new law and the Obama administration agencies charged with its implementation.

The U.S. Federal government spent $787 billion in deficit spending in an effort to stimulate the economy during the Great Recession under the American Recovery and Reinvestment Act, according to the Congressional Budget Office.[7]

Recovery From the Great Recession

Following these policies (some would argue, in spite of them) the economy gradually recovered. Real GDP bottomed out in the second quarter of 2009 and regained its pre-recession peak in the second quarter of 2011, three and a half years after the initial onset of the official recession. Financial markets recovered as the flood of liquidity washed over Wall Street first and foremost.

The Dow Jones Industrial Average (DJIA), which had lost over half its value from its August 2007 peak, began to recover in March 2009 and, four years later, in March 2013, broke its 2007 high.[8] For workers and households, the picture was less rosy. Unemployment was at 5% at the end of 2007, reached a high of 10% in October 2009, and did not recover to 5% until 2015, nearly eight years after the beginning of the recession. Real median household income did not surpass its pre-recession level until 2016.

Critics of the policy response and how it shaped the recovery argue that the tidal wave of liquidity and deficit spending did much to prop up politically connected financial institutions and big business at the expense of ordinary people and may have actually delayed the recovery by tying up real economic resources in industries and activities that deserved to fail and see their assets and resources put in the hands of new owners who could use them to create new businesses and jobs.

How Long Did the Great Recession Last?

According to official Federal Reserve data, the Great Recession lasted eighteen months, from December 2007 through June 2009.[9]

Have There Been Recessions Since the Great Recession?

Not officially. While the economy did suffer and markets fell following the onset of the global COVID-19 pandemic in early 2020, stimulus efforts were effective in preventing a full-blown recession in the U.S. Some economists, however, fear that a recession may still be on the horizon as of mid-2022.[10]

How Much Did the Stock Market Crash During the Great Recession?

On October 9, 2007, the Dow Jones Industrial Average hit its pre-recession high and closed at 14,164.53. By March 5, 2009, the index had fallen by more than 50% to 6,594.44.

On September 29, 2008. The Dow Jones fell by nearly 778 points intraday. Until the market crash of March 2020 at the start of the COVID-19 pandemic, it was the largest point drop in history.[8]

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- **Recession: Meaning in Economics With Causes**
  1 of 36
- **What Causes a Recession?**
  2 of 36
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  3 of 36
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4 of 36

- How Do Asset Bubbles Cause Recessions?
  5 of 36
- Why Does Unemployment Rise During a Recession?
  6 of 36
- How the Federal Reserve Fights Recessions
  7 of 36
- What Happens to Interest Rates During a Recession?
  8 of 36
- Why Is Deflation Bad for the Economy?
  9 of 36
- Are Economic Recessions Inevitable?
  10 of 36
- Do Recessions Have a Silver Lining?
  11 of 36
- The Impact of Recessions on Businesses
  12 of 36
- 9 Businesses That Thrive in Recession
  13 of 36
- Industries That Have Thrived During Recessions
  14 of 36
- What's the Best Investing Strategy to Have During a Recession?
  15 of 36
- 5 Characteristics of Recession-Resistant Companies
  16 of 36

- 3 Ways to Take Advantage of a Recession
17 of 36
- 4 Ways to Hedge the Next Recession
18 of 36
- A Review of Past Recessions
19 of 36
- 2008 Recession: What the Great Recession Was and What Caused It
20 of 36
- American Recovery and Reinvestment Act (ARRA)
21 of 36
- 5 Top Investors Who Profited From the Global Financial Crisis
22 of 36
- Double-Dip Recession Definition
23 of 36
- Economic Cycle: What It Means and 4 Phases of Business Cycles
24 of 36
- Economic Recovery Definition
25 of 36
- Economic Stimulus
26 of 36
- What Is Fiscal Policy?
27 of 36
- Growth Recession Definition
28 of 36
- Inverted Yield Curve: Definition, What It Can Tell Investors, and Examples

29 of 36

- **Recession Proof Definition**
  30 of 36
- **What Does “Recession Resistant” Mean?**
  31 of 36
- **K-Shaped Recovery Definition**
  32 of 36
- **L-Shaped Recovery**
  33 of 36
- **U-Shaped Recovery**
  34 of 36
- **V-Shaped Recovery**
  35 of 36
- **W-Shaped Recovery**
  36 of 36

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