The causes and effects of a recession economics essay

Introduction

In 2008 there are some troubles with the U. S. economy. Different people had different views on whether the US economy was in a recession. Some people believed that the U. S. economy had already in recession, but official data released showed the U. S. economy is not in recession. The U. S. Federal Reserve Bank would take monetary policy to cope with economic difficulties, such as lowering interest rates, but inflationary pressure will be brought.

1. 0 What does it mean to say an economy is ‘ in recession’?

A recession is formally defined as occurring when the growth rate of an economy’s real GDP is negative for two successive quarters. GDP is the value of all goods and services newly produced in a country during some period of time, adjusted for inflation. Reducing the overall value of goods and services means reduced demand in most markets. If this happens, the company is likely to dismiss employees, resulting in an increase in unemployment. Meanwhile, the stock market’s performance will be poor. Generally speaking, GDP is a measure of the overall situation of an economy. It is a very good economic indicator. But economists do not rely solely on GDP to formal a conclusion if the economy is into a recession. Some economists and newspaper writer define a recession as the gross domestic product, income, and unemployment continue to reduce for six months.

When recession occurs, income of people will decrease and employment rate will get rise in many departments in an economy. A recession means a change of the economy development trend in the long-term. Recessions are normally fairly short-lived. A longer recession, always over twelve month period or longer, it is defined as depression. Keynes argued that the reduction in aggregate demand for goods is the main reason for the recession (Ireland, Peter N, 2011).

Economic recession could lead to declines of a number of economic indicators at the same time, such as employment, investment and corporate profits, and other associated phenomena including changes in price levels. If the economy is in the state of stagflation, prices may rise rapidly. The activity of economic will decrease generally as result of massive unemployment. Severe economic recession is defined as depression. Devastating recession is called economic collapse. Economic recessions relates with excess merchandise inventory, the fall in consumption (possibly due to loss of confidence in the future), technology innovation, the lack of new capital accumulation, and the randomness of stock market. Recession will make a country’s investment activities reduced economic growth will become even more difficult. In the market-oriented economic model, due to the collapse of capital markets, private sector investment will be greatly reduced. Economic growth prospects are deteriorating so the consumer confidence will in a high degree of panic. From the figure 1. 0, if a economy has a recession, AS curve will has a leftward trend. Then the total supply of the economy will decrease from Q0 toQ1. If consumer confidence has been influenced by the recession, the AD curve will have a leftward trend. It also makes the total supply decrease.

Figure1. 0

AS1

2. 0 Whether the US economy is in recession or not

Many people and economists thought the U. S. economy was already in recession. They thought more and more signs reflected that the economy was sliding into recession position. The decline in spending power was the biggest problem. The purchasing power of U. S. consumers was facing four aspects of combat: the housing market collapse, credit crisis, soaring oil prices and food prices. It coupled with the recent weakness in the labor market, in March 2008, the U. S. unemployment rate rose to 5. 1% (Wisman and Baker, 2011). The downsizing of the private sector has already continued to four consecutive months. People feel more and more cash-strapped and credit has become increasingly difficult. The consumer market went into the doldrums which was performed by the plummeted of car sales. Specifically:

(1) The weakness in consumer spending became the biggest worry. Consumption used to account for more than 70% of U. S. GDP so its importance is evident. For downturn in investment, to maintain strong spending is critical to the U. S. economy. During the first three quarters of 2007, consumption had always been the main driving force of economic growth, but after entering the second quarter, consumption growth reduced to 1. 4% from the 3. 7% of the previous quarter while the contribution rate to the GDP growth rate fell to 1. 00% from 2. 56% in the third quarter as consumers have picked up momentum the Contrary to most people expected, according to the date released U. S. Department of Commerce, U. S. retail sales fell 0. 4% in December 2007, the worst since 2002. From Figure 2. 0, it can be seen that the reducing consumption will make the AE

turndown, as shown from AE1 to AE2. The national output will reduce from Y1 to Y0. Retail sales reflect the personal consumption expenditure, which also shows that the wealth effect of housing market slump and the impact of high oil prices were taking effect gradually(Jonathan; Samuel; Neiman, Brent; Romalis, John, 2011).

Figure2. 0

(2) The employment situation tended to be pessimistic. Employment situation is an important factor affecting consumer spending and in consumer confidence. In the year of 2007, the U. S. unemployment rate of each month fluctuated between 4. 4% and 4. 7%. In the September employment situation has deteriorated since, in September -11 months were 4. 7% unemployment rate each month. And 12th month, the employment situation was more worrying, the unemployment rate reached to 5%, which was the highest point since November 2005. The new jobs were only 18, 000, which was the lowest level since August 2003. Professional and technical, health care, and catering and other services to increase employment did not offset the decline construction and manufacturing employment. Such pessimism thought the U. S. was in a recession was largely due to the employment report released, showed at that time, employment fell in February by 63, 000 people, for the twice consecutive monthly decline. Stephen Stanley of RBS Greenwich Capital determined a recession from the employment data, the figure in his view was a sign of recession(Atif, Sufi, Amir; Trebbi, Francesco , 2011).

(3) Consumer confidence. Consumer confidence usually plays a important role in the recession. If consumers have no confidence about their job

security or investment value then they will not buy too many things. In American economic downturn, a large number of unemployed people had cut expenses as much as possible¼›many people worried about unemployment also chose to save money. It is estimated that U. S. consumption growth in recent years, more than 70 formed by relying on real estate value driven wealth effect, while the consumption rate of the U. S. contribution to GDP growth of about 70%. However, in case of crisis, this wealth effect reversed, which seriously affect the consumer. As of the end of 2007, U. S. household net worth, that is, the difference between assets and liabilities, was estimated as 57. 7 trillion and has decreased by 5, 000 million compared to the previous quarter. The U. S. stock market fell more than 30% and the average price of real estate prices also fell sharply. The U. S. CaseShiller house price index showed property prices in major U. S. cities in the second quarter of 2007 went down by 15. 4 % to second quarter of 2008. Therefore, it was conservatively estimated that the net assets of U. S. households fell in the range of 10% or more, which means that household net worth devalued 6 trillion Chris (Isidore, 2008). As the recession deepened, the prices the family-owned real estate and stock market would fall further, while the value of the debt would rise, so it would be a drastic shrinkage of household net worth and would force the family to further reduce consumer spending, resulting of the internal power attenuation in economic recovery(Mishkin, Frederic S, 2011). These factors would lead to decreased consumer confidence.

Although some people feared that the U. S. was in the recession but figures released by the United States showed that the U. S. does not fall into recession in the first quarter. These figures can give an indication to know how the US economy operates. The first quarter figures of the national accounts are about the output of American economic in the early part of the year. It showed that the US economy had grown by 6% contrary to people's expectation. This was the same as the final three months' figure recorded for the last year. U. S. economic data was weak, but some people thought it was only a correction. The third-quarter annualized real GDP growth rate was 4. 9%, while November retail sales rose 1. 1%. Decline in retail sales in a single month was not unusual things. Over the past 5 years, the monthly retail sales data appeared at least 3 times negative growth of a year. Some data decreased can be said that they are the result of normal fluctuations of economic. Its causes included volatile oil prices, seasonally adjusted, or the weather and so on Michael (Rowland, 2008). Based on these reasons, many people believed that the U. S. economy did not fall into recession.

3. 0 The ' official benchmarks' might not tell the whole story about the state of the US economy

Official benchmarks refer to the health of a country's economy. These data are important to investors based on investment decisions. Business enterprises estimate future sales and determine the quantity of production based on these data. The Government also estimates whether the economic performance is good based on these dates and thus specify the policy. But there are many causes change these official benchmarks. And in some cases, the official benchmarks do not tell the whole story of the economy. Take the inflation for example. Countries always use inflation to describe the price level of an economy. It always means an upward trend of prices. It is made up by a large numbers of goods and services. If the good or service forms an important part of consumers budget, it is usually a good indicator to describe the trend of the prices. However, the supply and demand also influence the prices in a particular market. So in this case, the inflation is not a good indicator of the prices. Some official benchmarks may be a forgery, to stabilize the market and consumer confidence. The Government will choose to modify some of the data to cover up the fact that the economy deteriorated to stabilize market confidence, promote economic growth. Therefore, from this point of view, the official benchmarks can not reflect the healthy level of the economy. Besides, economic cycles are always taking effect. For economic cycles, high or low level of productivity, economic growth rate go ups and downs, which are inevitable and constitutes phenomenon of a normal economic growth. Economic cycle is also known as the business cycle and it means the economy occur economic expansion, economic contraction, alternating and change periodicity. It is fluctuation of the gross national output, total income and total employment. An economy always divided in four phases as prosperity, recession, depression and recovery. Business cycle changes the official benchmarks so they do not reflect the whole state of the economy. In addition, many causal factors can cause changes in the dates. Such speculation can cause sudden changes in the economy. It can also lead to the corresponding dates change. However, this does not mean long-term trend of economic development (James D and Michael T, 2011)

4. 0 The Central Bank is walking something of a tightrope

The central bank control the official cash rate to introduce its monetary polices. The official cash rate is the short-term interest rate charged in the money market and affects all interest rate of the particular types of loans. So the official cash rate plays a leading role in the financial market. Federal Reserve to adjust interest rates will bring a series of effects(Hess; Laforte, Reifschneider, Williams, 2011).

If Federal Reserve raises interest rates, other interest rates will also be impacted and the result is to improve these interest rates. Enterprises due to higher financing costs will face the lack of investment capital. The supply of products will reduce in society as a whole. It also increases unemployment. An economy's total expenditure will be reduced, inflation will fall. Lower interest rates will bring the opposite effect. Lower interest rates will stimulate enterprises to increase investment and production, so unemployment will be reduced. The total expenditure of an economy will increase and inflation may become serious. Therefore, under the pressure of economic recession, the Fed hopes to reduce unemployment by lowering interest rates to promote economic recovery. Cutting interest rates has the role of curbing the financial crisis on the real damage to the economy and releasing panic in the market psychology. But it will in turn bring about a negative impact on the economy. Among them, the greatest impact is inflation (Kormilitsina, Anna, 2011). If inflation exceeds the scope of the U. S. economy can bear, it will give the U. S. economy fatal blow. Interest rates will reduce borrowing costs and bank operating costs and stimulate the real estate market consumption. So it will play an active role in market confidence to the stability. But rate cuts alone are very difficult to stop the economic decline. Economic stability is the key to rapid recovery of the U. S. financial institutions to lending capacity, and enhancing market liquidity. Also, to prevent the emergence of inflation and tight, stable commodity prices are also very important. The improvement of business conditions is the key in order to increase employment and improve personal consumption expenditures. Released by the U. S. Department of Labor, the consumer price index (CPI) in January 2008 was increased by 0. 4%, increased by 4. 3% compared to the same period of last year. Because the risk of a recession continued to exist, the Fed was in a dilemma for the face of the risk of recession and inflation (Reade, J James, 2011). So the Central Bank is walking something of a ‘ tightrope’. If the inflation rises very high, the US is likely to fall into “ stagflation.” It is so dangerous to the Central Bank to introduce a monetary policy.

Conclusion

Economic recession is a disaster to any country. It will cause many companies face closure, rise the unemployment rate and slow economic growth. But whether an economy is in a recession, people have no unified views. The Central Bank must consider the consequences in the implementation of a monetary policy. It has to consider both the promotion of economic development and the control of inflation.