

# Causes and effects of the current economic crisis economics essay



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Overall economy is bullish; it is not only the stock exchanges that tell riches to rags stories but even small businesses. It all adds to the national exchequer. An economist is likely to give a detailed, comprehensive definition of recession. But for the layman who has been affected knows it only one way-when he loses his job and has no money to pay his credit and loans. Recession is when the consumer faces foreclosure and the banker comes knocking for his pound (or dollar) of flesh. Many companies and whole countries go bankrupt for want of liquid funds and cash flow for even daily requirements.

If you look at it from the point of view of a businessman, recession is a transitory phase. The Business Cycle Dating Committee of the National Bureau of Economic Research has another definition. It profiles the businesses that have peaked with their activity in one season and it falls naturally in the next season. It regains its original position with new products or sales and continues to expand. This revival makes the recession a mild phase that large companies tolerate. As the fiscal position rises, there is no reason to worry. Recession can last up to a year. When it happens year after year then it is serious.

Are we facing a recession or not? Yes, for the simple reason that not only our neighbors but our friends are unemployed. There is less of business talk and more billing worries.

Transitory recessions are good for the economy, as it tends to stabilize the prices. It allows run away bullish companies to slow down and take stock.

There is a saying, ' when it's tough the tough get going'. The weaker

companies will not survive the brief recession also. Stronger companies will pull through its resources. So when is it time to worry? When you are facing a foreclosure, when the chips are down and out and creditors file cases for recovery.

Firms face closures when they go through recession and are not able to recover from losses. If, at this time, they are not able to sustain their prices and stocks then there is more trouble. Even when the recession period gets over, they will not be able to do well. If a business survives a recession period they should be able to survive a depression. But how many recession proof businesses are there? Who will eventually survive the recession?

1. Those that have been able to save their funds.
2. Those who have not invested in fly-by-night companies.
3. Those who remain clam till the storm passes.
4. Those that take stock immediately and decide to reinvest in a recession proof business.

## **GLOBAL FINANCIAL CRISIS**

The world is seemingly inching towards recession . Companies are going bankrupt, stock market are nose diving and more employees are being laid off while companies struggle to cut cost. Looking theng back, it seems not so long ago when economies across the globe, especially india , were going

through a boom . What went wrong , then? Here, s a quick round up of the major events that bought the current economic downturn.

## **2001-2005:**

### **Housing prices shoot up in the US.**

### **Bank start lending aggressively, leading to the creation of sub primary Industry.**

Subprime lending refers to lending at slightly higher interest rates to borrowers, who under normal circumstances would not have been eligible for the loan . Such borrowers are consider to have a less -than-ideal credit as they may have defaulted in the past or are employed or without any regular income. Banks usually, refrained from lending to such people owing to the higher default risk. However, with the rise in property prices, banks started lending to such borrowers as these loans were mortgaged against property . In case of default, the banks could recover the money by selling off the mortgaged property.

**2005:**

**The prospering housing market comes to a standstill in many parts of the US.**

**2006: As the prices even out, homes sales drop.**

**February 2007:**

**Sub -prime bubble in the US burst-more than 25 sub prime lenders either go bankrupt, incur heavy losses or are up for the sale**

Banks files to take into account the possibly of a fall in property prices while undertaking sub prime lending . With the hike in interest rates by the Federal bank , the sub-prime borrowers began defaulting . This prompting banks to sell off the mortgaged properties. As more banks joined this trend of selling mortgaged properties , prices of property dropped down in the U. S.

**August 2007 :**

**A no of leading mortgage lenders in the us go bankrupt :**

**March 2008 :**

**bear Sterns crumbles**

**September 2008 :**

**Lehman Brothers file for bankruptcy while Merrill Lynch is sold off to Bank of America**

Financial markets in the us developed a new product between 2001 nd

2006 . This product was in form of a bond securitized against mortgages .

Financial institutions like bear sterns, Lehman brothers and Merrill lynch lent money to mortgage banks against the mortgages, on condition that these

mortgage banks would repay the money as soon as they recovered their mortgages . These lenders , in turn sold the retail bonds to individual investors .

However, as mortgages could not be honoured , banks were unable to pay the back this money to financial institutions, who in turn could not pay repay individual investors. In the entire process, Institutions like Bear Sterns, Lehman Brothers Merrill lynch and AIG got a serve blow.

## **LEHMAN BROTHERS**

Lehman Brothers was founded in 1850 by two cotton brokers in Montgomery, Ala. The firm moved to New York City after the Civil War and grew into one of Wall Street's investment giants. On Sept. 14, 2008, the investment bank announced that it would file for liquidation after huge losses in the mortgage market and a loss of investor confidence crippled it and it was unable to find a buyer.

Lehman's slow collapse began as the mortgage market crisis unfolded in the summer of 2007, when its stock began a steady fall from a peak of \$82 a share. The fears were based on the fact that the firm was a major player in the market for subprime and prime mortgages, and that as the smallest of the major Wall Street firms, it faced a larger risk that large losses could be fatal.

As the crisis deepened in 2007 and early 2008, the storied investment bank defied expectations more than once, just it had many times before, as in 1998, when it seemed to teeter after a worldwide currency crisis, only to rebound strongly.

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Lehman managed to avoid the fate of Bear Stearns, the other of Wall Street's small fry, which was bought by JP Morgan Chase at a bargain basement price under the threat of bankruptcy in March 2008. But by summer of 2008 the rollercoaster ride started to have more downs than ups. A series of write-offs was accompanied by new offerings to seek capital to bolster its finances.

Lehman also fought a running battle with short sellers. The company accused them of spreading rumors to drive down the stock's price; Lehman's critics responded by questioning whether the firm had come clean about the true size of its losses. As time passed and losses mounted, an increasing number of investors sided with the critics.

On June 9, 2008, Lehman announced a second-quarter loss of \$2.8 billion, far higher than analysts had expected. The company said it would seek to raise \$6 billion in fresh capital from investors. But those efforts faltered, and the situation grew more dire after the government on Sept. 8 announced a takeover of Fannie Mae and Freddie Mac. Lehman's stock plunged as the markets wondered whether the move to save those mortgage giants made it less likely that Lehman might be bailed out.

On Sept. 10, the investment bank said that it would spin off a majority of its remaining commercial real estate holdings into a new public company. And it confirmed plans to sell a majority of its investment management division in a move expected to generate \$3 billion. It also announced an expected loss of \$3.9 billion, or \$5.92 a share, in the third quarter after \$5.6 billion in write-downs.

By the weekend of Sept. 13-14, it was clear that it was do or die for Lehman. The Treasury had made clear that no bailout would be forthcoming. Federal officials encouraged other institutions to buy Lehman, but by the end of the weekend the two main suitors, Barclays and Bank of America, had both said no.

Lehman filed for bankruptcy Sept. 15. One day later, Barclays said it would buy Lehman's United States capital markets division for \$1.75 billion, a bargain price. Nomura Holdings of Japan agreed to buy many of Lehman's assets in Europe, the Middle East and Asia. Lehman also said it would sell much of its money management business, including its prized Neuberger Berman asset management unit, to Bain Capital and Hellman & Friedman for \$2.15 billion.

Lehman's demise set off tremors throughout the financial system. The uncertainty surrounding its transactions with banks and hedge funds exacerbated a crisis of confidence. That contributed to credit markets freezing, forcing governments around the globe to take steps to try to calm panicked markets.

On Oct. 5, Richard S. Fuld Jr., Lehman's chief executive, testified before a Congressional panel that while he took full responsibility for the debacle, he believed all his decisions "were both prudent and appropriate" given the information at the time.

## **EFFECT ON THE INDIAN ECONOMY**

Impact of global recession on India



America is the most effected country due to global recession, which comes as a bad news for India. India have most outsourcing deals from the US. Even our exports to US have increased over the years. Exports for January declined by 22 per cent.

RECESSIONS ARE the result of reduction in the demand of products in the global market. Recession can also be associated with falling prices known as deflation due to lack of demand of products. Again, it could be the result of inflation or a combination of increasing prices and stagnant economic growth in the west.

Recession in the West, specially the United States, is a very bad news for our country. Our companies in India have most outsourcing deals from the US. Even our exports to US have increased over the years. Exports for January have declined by 22 per cent. There is a decline in the employment market due to the recession in the West. There has been a significant drop in the new hiring which is a cause of great concern for us. Some companies have laid off their employees and there have been cut in promotions, compensation and perks of the employees. Companies in the private sector and government sector are hesitant to take up new projects. And they are working on existing projects only. Projections indicate that up to one crore persons could lose their jobs in the correct fiscal ending March. The one crore figure has been compiled by Federation of Indian Export Organisations (FIEO), which says that it has carried out an intensive survey. The textile, garment and handicraft industry are worse effected. Together, they are going to lose four million jobs by April 2009, according to the FIEO survey.

There has also been a decline in the tourist inflow lately. The real estate has <https://assignbuster.com/causes-and-effects-of-the-current-economic-crisis-economics-essay/>

also a problem of tight liquidity situations, where the developers are finding it hard to raise finances.

IT industries, financial sectors, real estate owners, car industry, investment banking and other industries as well are confronting heavy loss due to the fall down of global economy. Federation of Indian chambers of Commerce and Industry (FICCI) found that faced with the global recession, inventories industries like garment, gems, textiles, chemicals and jewellery had cut production by 10 per cent to 50 per cent

## **IMPACT ON DIFFERENT SECTORS**

### **1. Impact on stock market**

The immediate impact of the US financial crisis has been felt when India's stock market started falling. On 10 October, Rs. 250, 000 crores was wiped out on a single day bourses of the India's share market. The Sensex lost 1000 points on that day before regaining 200 points, an intraday loss of 200 points. This huge withdrawal from the India's stock market was mainly by Foreign Institutional Investors (FIIs), and participatory-notes.

### **2. Impact on India's trade**

The trade deficit is reaching at alarming proportions. Because of worker's remittances, NRI deposits, FII investment and so on, the current deficit is at around \$10 billion. But if the remittances dry up and FII takes flight, then we may head for another 1991 crisis like situation, if our foreign exchange reserves depletes and trade deficit keeps increasing at the present rate. Further, the foreign exchange reserves of the country has depleted by

around \$57 billion to \$253 billion for the week ended October 31.(Sivaraman, 2008)

### **3. Impact on India's export**

With the US and several European countries slipping under the full blown recession, Indian exports have run into difficult times, since October.

Manufacturing sectors like leather, textile, gems and jewellery have been hit hard because of the slump in the demand in the US and Europe. Further India enjoys trade surplus with USA and about 15 per cent of its total export in 2006-07 was directed toward USA. Indian exports fell by 9.9 per cent in November 2008, when the impact of declining consumer demand in the US and other major global market, with negative growth for the second month, running and widening monthly trade deficit over \$10 billions.

Official statistics released on the first day of the New Year, showed that exports had dropped to \$1.5 billion in November this fiscal year, (Sivaraman, 2008) from \$12.7 billion a year ago, while imports grew by \$6.1 billion to \$21.5 billion.

### **4. Impact on India's handloom sector, jewelry export and tourism**

Again reduction in demand in the OECD countries affected the Indian gems and jewellery industry, handloom and tourism sectors. Around 50,000 artisans employed in jewellery industry have lost their jobs as a result of the global economic meltdown. Further, the crisis had affected the Rs. 3000 crores handloom industry and volume of handloom exports dropped by 4.6 per cent in 2007-08, creating widespread unemployment in this sector

(Chandran, 2008). With the global economy still experiencing the meltdown, Indian tourism sector is badly affected as the number of tourist flowing from Europe and USA has decreased sharply.

## **5. Exchange rate depreciation**

With the outflow of FIIs, India's rupee depreciated approximately by 20 per cent against US dollar and stood at Rs. 49 per dollar at some point, creating panic among the importers.

## **6. IT-BPO sector**

The overall Indian IT-BPO revenue aggregate is expected to grow by over 33 per cent and reach \$64 billion by the end of current fiscal year (FY200). Over the same period, direct employment to reach nearly 2 million, an increase of about 375000 professionals over the previous year. IT sectors derives about 75 per cent of their revenues from US and IT-ITES (Information Technology Enabled Services) contributes about 5. 5 per cent towards India's total export. So the meltdown in the US will definitely impact IT sector. Further, if Fortune 500 hundred companies slash their IT budgets, Indian firms could adversely be affected.

## **7. FII and FDI**

The contagious financial meltdown eroded a large chunk of money from the Indian stock market, which will definitely impact the Indian corporate sector. However, the money eroded will hardly influence the performance real sector in India. Due to global recession, FIIs made withdrawal of \$5. 5 billion, whereas the inflow of foreign direct investment (FDI) doubled from \$7. 5 billion in 2007-08 to \$19. 3 billion in 2008 (April-September).

## **Conclusion**

From the above argument it can be noted down that the ' Financial or Subprime Crisis' was the shear consequences of ' greed' and to make ' too much profit' on the part of Wall Street Firms and Investment Banks. This crisis also shows the failure of capitalist market economy. Though the Indian economy would be able to withstand the crisis without any major difficulty, but the crisis is still causing mayhem all over the world.