Free research paper on recession and depression

Economics

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Research paper

Introduction

The economy is a complicated apparatus that subordinates all of the major aspects of our present life, and as every system, might be experiencing different states, its ups and downs. This research paper will uncover such unpleasant states of the economy as recession, and depression. In such conditions the economy will slow abruptly, with trade and financial flows shrinking, while the overall output and employment losses will mount. When the recession or a depression hits the credit markets remain frozen for some time, which postpones the improvement of the financial health.

Economic cycles

Prior to the explanation of these two economic conditions (recession and depression), first, we must go to the very bottom, and actually prove that depressions are absolutely normal states of economy that should occur every now and then. In order to explain this regularity an attention must be

turned to the concept of economic cycles. This concept refers to the constantly changing levels of economic activity over a long period of time (a cycle) that has two main phases: a recession phase, distinguished by a contraction in economic activity, and an expansion phase. The major index that is considered for determining the business cycle is the GDP growth index, which fluctuations present contraction and expansion periods.

Among all of the theories regarding the economic cycle, the most comprehensive on so far was proposed by Joseph Schumpeter. Schumpeter, explaining the concept, put forward an idea of boom and busts being an unavoidable part of every market economy, a part that was driving progress. Contraction period after the expansion was the price needed to be paid for capitalist economic development.

Another French economist from the second half of the XIX century, Clement Juglar, after studying economic fluctuations came to a conclusion that an economic cycle was a natural phenomenon that occurs every ten years. Juglar refers to the contraction period as to the main phase of the cycle, which is a considered to be a sanitary factor leading to an overall decrease in prices and liquidation of enterprises that is called to meet the artificially overgrown demand.

The concept of economic cycles applies to every single country, but its effects do vary in each one of them. For example, well developed economies have already experienced six complete cycles of recession and expansion since 1960, but the actual number of recessions and depressions varies significantly from country to country; while some countries (Canada, Ireland, Japan, Norway, Sweden) have experienced only three recessions, others

(Italy, New Zealand, Switzerland) have had nine or even more contraction periods.

Recessions

Talking about the changing period in cycle, one thing can be said for sure and that is recessions are always appear to be shallower, briefer, and less frequent than expansions. During a typical recession the GDP can fall by about 2 percent, while during some recessions the declines in output exceeded 10 percent, that presents a more severe kind of a recession that is often called depression. Since 1960, the worldwide economy has experienced six depression episodes, with the latest being observed in Finland during the early 1990s. A typical recession phase lasts for about a year, and as a result, advanced economies are in a recession state of the economy only 10 percent of the cycle time.

Depending on factors contributing to the recession three types of recession can be distinguished. The first type of a recession usually occurs under the influence of unplanned and very profound shifts in market conditions. Such changes include war or sudden changes in world prices of natural resources and account for 20. 74 percent of recessions in advanced economies. An economic recession caused by these factors is especially dangerous, as it is impossible to predict and anticipate; as result they have painful impacts on the economy.

Second type recessions are more political or even psychological. Joseph Schumpeter provides a wonderful explanation of this phenomenon telling that the uncertainty inherent with human nature results in things seldom going according to the plan. Not only do people make mistakes and change

their minds, most of us suffer from cognitive biases when we engage in economic activity. The knowledge of the economic data that we possess is incomplete and fragmentary, and the undefined future is no reason for that. When people work on financial markets a remarkable capacity of moving from bouts of unwarranted optimism (greed) to unwarranted pessimism (fear), and back again are shown. That intangible but critical influence on investment decisions in market economies, the ‘ state of confidence’, is equally volatile. And when they intervene collectively in markets, our policymakers and regulators turn out to be neither omniscient nor infallible. Recession of a third kind occurs when the economy loses its balance, and is characterized by rapid growth of debt and the fall in the capital markets and equity markets. Thus, a conclusion must be made that most of recessions are associated with a financial crisis, if the contraction episode starts either at the same time or after the beginning of the financial crisis. 14 In fact 18. 3 percent of all the recessions are associated with financial crises. 15This recession tend to be less harmful for the economy, with the situation being quite simple to fix by lowering interest rates or artificially creating some buzz in the economy.

More than half of the recession episodes are caused by oil shocks, monetary and fiscal policy shocks. Oil shocks are currently the most affecting cause type that affects; there are fewer monetary and fiscal policy shocks, and the least common of all are the external demand shocks, which affects only a small and more open economies. 17 Although recessions are now occurring less frequently, the episodes that are associated with financial crises are actually becoming more common. Recessions caused by financial crises usually last longer and generally appear to be more costly than others.

The difference between recession and depression

There are two criterions by which the recession is identified: depth of contraction and duration. Depth of contraction is the most accurate methods of identifying the recession that can be calculated simply by measuring the percentage that the real GDP has change or the change of percentage in the unemployment rate from the peak to the trough. As for the duration of the Recession, most of them appear to be relatively short, with a minimal duration of six, and maximum of 18 months (an average duration of 10 months).

But what if a recession turns out to be longer than 18 months, after which it goes to another level, becoming a depression. Then a question of the difference between a recession and a depression appears - a question that confuses most people. Both of these serious economic crises are direct results of economic imbalances' interaction in the world economy and the financial decision makers' ruling ideology, who actually confronted these imbalances.

Recession is the state of the economy when the gross national product (GDP) steadily declines, which indicates the overall decline in production activity across the economy. It is a natural part of the economic cycle that usually lasts between six and eighteen months. As it can be traced in industrial production, wholesale-retail trade, employment, and real income the decline can actually be determined simply by measuring the amount of business. Scholars see a recession as the state during which the business activity reaches its peak and then starts to decrease until the moment the business activity hits the bottom. By applying this definition, the average recession period should last about a year. Another feature by which a recession can be

indicated is the presence of two consecutive quarters of negative economic growth that are measured by a country's gross domestic product (GDP); although the National Bureau of Economic Research (NBER) does not necessarily accepts it as a part of a recession.

But this particular definition is not popular among most economists for two main reasons. First reason is that this definition does is not considering the changes that occur in some other variables. For example this definition absolutely ignores any changes in the rate of consumer confidence. Second reason is problems in pinpointing the time frame of a recession due to the use of quarterly data, which the process difficult. This might result in a short recession (ten months or less) going undetected.

While depression is a phase that starts when the recession has a prolonged character, thus, it represents a sustained and severe contraction of economic activity. Where a recession is a normal part of the business cycle, lasting for a period of months, a depression is an extreme fall in economic activity lasting for a number of years. Economists have multiple opinions on the usual duration of depression; some economists think that a depression includes only the period of economic stagnation of contraction, while other say that it goes on up to the point of full recovery of the economy. A number of economic factors can help identify the depression: sharp decline in production, diminishing output, serious increase in unemployment rate, a drop in available credit, bankruptcies and sovereign debt defaults, reduced trade and commerce, and sustained volatility in currency values. During the whole period of depression the level of production remains stable but very low, unemployment rate remains high, fall in prices is suspended, with lending rate falling to stabilize inventories. At the microeconomic level

depression represents an uncertainty, erratic actions. Particularly affected resellers, and stock agents, which can be explained with low consumer confidence and decrease in investments that can cause the economy shut down.

This type of crisis usually begins from gradual reduction in business activity (reduces the amount of business transactions in cash and credit). The depression creates an imbalance between supply and demand on a product in a particular industry sector, so that it emerges as a general overproduction, followed by a rapid decline in prices, the collapse of banks, the growth of interest on loans, and unemployment rate.

Actually no officially accepted criterion of telling the difference between a recession and a depression has been established yet. The U. S. NBER agency defines a recession to be a significant drop in economic activity that spreads across the whole economy, lasts for more than just a couple months, and which can be detected in the industrial production, in changes of the GDP, unemployment rate, real income, and the wholesale retail sales. There is no need for the use of consecutive quarters of the negative real GDP growth to define the recession, despite the widespread use of the rule of thumb. Most economists agree on a more meaningful way to define a recession, and that is an extended period of below trend or below potential growth, which can be extremely hard to measure; nevertheless this particular method allows the GDP to be not negative in countries that have high rates of population and productivity growth. Another point that must be mentioned is that the recession is almost always the product of a tight monetary policy, while depression is caused by a noticeable shortage in credit or debt.

Conclusion

According to the conducted research, the concept of economic cycles indicates that basic economic principles are cyclic and happen with repetitiveness, with only difference in time and scope of results. This means that every country (especially those with weak economies) have a potential of running into a contraction that might evolve into a depression, which is long lasting and severe in consequences. Thus, the needed measures must be undertaken by governments in order not put their country in a threat.

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