In 12). if these figures are compared

In Economics, recession refers to decline in a country’s gross domestic product for two consecutive quarters.

There are several factors which caused recession but inflation is a key element. It is believed that global financial crisis was activated by liquidity decline in the banking sector following problems related to valuation of property. The resultant is a collapse in banking institutions and its subsequent bailout. Being a sub-sector in the financial market, the stock market suffered adverse effects. Furthermore, other key businesses and wealth of consumers or rather consumer confidence declined to its minimum level. Other factors which caused the 2007 recession include: ‘‘ the credit crunch, decreasing prices of houses, inflation resulting from the costs and loss of confidentiality of the financial institutions’’ Turner (9).

Collapse in the prices of houses

Statistics indicate a crash in the prices of home from the year 2005 to the end of the year 2006 consequently sending a message that recession was finding its way to the economy (Turner, 14). This was motivated by a 14% fall in construction of houses.

Arizona, Florida and 40 other estates registered a decline in sale of homes. A further investigation proved an increase by approximately 34% in the number of vacant homes in the year 2006. Cumulatively, low sales level demonstrates that profits are less and the economy will automatically face shrinkage.

Furthermore the housing bubble decelerates consumer spending while sending more dedicated labor force into unemployment. Statistics illustrate

an estimate of 6 trillion US dollars mortgage debt in 1999 which translated to 12 trillion US dollars in 2007 and a further higher level in later years (Turner, 12). If these figures are compared with annual value of gross domestic product of approximately 11. 5 trillion US dollars with a debt of 9 trillion US dollars then it was not possible to pay the losses. This acted as the beginning of the present predicament of never ending financial crisis.

Although expansionary fiscal policy has been used to counter the effects of financial crisis, there were minimum positive results.

Inflation

As mentioned earlier in the text, inflation is the progressive increase in the prices of commodities. Between the years 2007 – 2008 the price of oil was three times its original price (Read 8). More funds were used to buy fuel thus registering an outward flow of wealth from importing nation to exporting nation.

Prices of other commodities like copper and nickel also fluctuated hence affecting the stability of an economy through a hampered purchasing power.

The credit crunch

This refers to absence of finance or putting in place strict rules and procedures necessary in order to obtaining loans. In such a situation, the interest rates and availability of credit are two independent variables. Collapse of prices due to inflation brings about credit crunch.

If investors cannot access loans from banks, it means that investment level declines. Subsequently, national income will reduce as the prices of common

goods goes up. A simple Keynesian rule states the correlation between savings, investment, imports and exports and consumption. A decline in liquidity can lead to unemployment because companies seek to save other than spend the little amount of money they have.

Easy credit setting

Straightforward economics shades light on the effects of easy conditions when lending.

If interest is lowered, people will go for more borrowings from banking and other lending institutions. At the beginning of the year 2002, Federal Reserve Bank reduced its lending rates by approximately 5. 5% (Turner, 11). This action was initially triggered by security alert and the risk of deflation. In 2006, the United States of America faced unfavorable trade deficit with rising current account. This forced the US treasury to borrow funds from Asia and some Middle East nations in order to supplement on its budget.

Purchase of bonds was the form of borrowing used. The net effect was a rising prices of bonds while the interest rates face an acute fall. With reference to balance of payment, existence of current account deficit means running a concurrent surplus capital account. Influx in the amount of capital after an external borrowing created demand for monetary assets while lowering interest rates. Individuals spent the money borrowed for consumption while financial institution diverted the funds to securities which were mortgage-backed.

Subprime mortgage lending

This type of lending simply refers to giving credit to persons who does not qualify for loans at the prime rates (Cooper, 13).

Use of credit cards and mortgages covers this category of lending. The nature of sub-prime borrowers has a characteristic that they do not pay for the loans given to them. Consequently, they are riskier when given loans as compared to the prime borrowers. In the United States of America, sub-prime lending has increased over the years beginning 90s. This saw a rise in loans to an estimate of $1.

3 trillion in relation to subprime mortgages. The increase in the amount of loan followed an action by financial institution to package mortgages in form of securities and subsequently selling them to investors. In the year 2006, decline in prices of homes resulted to losses as owners discovered that the amount they owed on mortgage was more than the value of their homes. The effect of this discovery was a loan default and a later reduction in the price of homes. This destroyed the mortgage backed securities making companies to write off their assets since they did not have any value.

Declining prices of homes with increasing interest rates made borrowers to default paying their loans causing the mortgage industry to cave in. The lenders in the subprime industry were adversely affected as investor confidence declined steadily. Furthermore, Instability in the financial market was caused by depression of collateralized debt obligation. The credit crisis and mortgage industry has elicited varied views on how it caused the recent recession experience in the world. It is important to note that Banks are

vulnerable to risks emanating from financial crisis. Some of these risks are related to overdrafts and the risks to credit where those who borrowed fail to pay their financial obligation.

During the financial crisis many banks collapsed or merged to ensure their continuity in the market. Banking industry had to borrow excessive amount of money as compare to their equity capital an event which made them highly leveraged and susceptible to unpredictable market conditions. Banks like the Lehman Brothers went bankrupt while others merged.

In the same context, governments pumped in funds in form of bailout plan. Institutions which benefited from the bailout plan include: AIG and Freddie Mac

Burden of debt

Too much external borrowing increased individual and financial institution's indebtedness thus putting housing bubble to collapse while deteriorating the economic situation. Economic statistics of 2007 indicate a 27% rise in home mortgage debt as compared to GDP (Read, 42). On the other hand, household debt expanded by 127%. By mid 2008, US private debt had increased by more than 100%. These are unfavorable economic conditions which gave way to recession but can be reduced by borrowing internally and reshaping micro financial institutions.

Deregulations

The DIDMCA Act of 1980 widened bank's lending powers and their insurance deposits.

This motivated them to lend for speculative purposes. In the year 2004, the United States Securities and Exchange Commission relaxed the net capital rule enabling banks to increase the level of their debts. This action fueled development of mortgage- backed securities and subprime mortgages. Banking sectors in the shadow banking system do not operate as depository banks. These banks are allowed to take up additional debts comparative to their capital base.

Another important point to note with regard to deregulation is the course taken by accounting regulators in allowing some banks i. e. Citigroup and Enron to make use of structured investment vehicles (Cooper, 33).

This off balance sheet events hid the weakness of the financial institution.

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