Cause and consequences of the great recession

1. 0 Introduction

There was a recession in the United States (US) at the end of 2007 (Verick and Islam 2010). McKean (2010) noted that a healthy economy will proceed into a period of high growth, slow growth or no growth. Power (1996) commented that the economy is needed to be contracting and expanding in order for the economy to be healthy. When the contracting period has last for a long period of time (such as at least two consecutive quarters of a year or 6 months in a row), the economy is considered as a recession (Arnold 2008; Brainard and Perry 2001). According to National Bureau of Economic Research (NBER) (2010), recession was defined as ' a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real gross domestic product (GDP), real income, employment, industrial production and wholesale-retail sales'.

According to Wang (2009), the US recession has leaded to a global financial crisis shattering businesses and consumers' confidence in many countries such as in European Union, China, Japan and Asia countries. As a result, it has been named as the " Great Recession" which has caused financial meltdown in the US and was spread out quickly affecting almost every corner of the world (Kurki et al 2009). The great recession was seen as the worst economic downturn since the great depression that the world was in recession after World War II (Wang 2009; Verick and Islam 2010).

According to economists, this episode of great recession was resulted from a sudden busting of house bubble in US, where the house bubble was caused by rapid growth of improper regulation on sub-prime mortgages (Merriam

2009; Wang 2009; Whitney 2007). This episode of great recession have proven and shown the accuracy of Greenspan' prediction who was the former Federal Reserve Chairman predicting that US has one-third probability getting into recession at the end of 2007 (Torres 2007). In order to have a better understanding on the great recession, causes and consequences of this recession will be analysed at the following chapters.

2. 0 Causes of the Great Recession

Apparently, US was faced many severe problems including banks on the verge of bankruptcy, high record levels of public debt, a falling stock market, a plummeting dollar, frozen money markets and imminent threat of a recession (Lyons 2009; Stiglitz 2010; Taylor 2009). According to Verick and Islam (2010), the global financial crisis was greatly affected by global imbalances, perceptions of risks, interest rates, and regulation of the financial system (Figure 1). With references to the Figure 1, causes of the great recession was summarised as below:

2. 1 Housing Crash

US housing market are a major determinant of consumers spending and rate of economic growth (Congressional Budget Office 2007). There are various factors affecting house price to rise much faster than consumer incomes, and thus it was created overvalued assets (Eklavya 2008). Taylor (2008) noted that US house prices were raised rapidly until 2006 and experienced a fall of house prices after the boom. Figure 2 shows the trend for house price for 1991 to 2007. When house prices fall to correct the imbalance, it had a significant impact on consumers spending where people cannot remortgage to obtain extra capital for spending (Taylor 2008).

2. 1. 1 Subprime Mortgages Burst

According to Eklavya (2008), there was no regulation of subprime mortgages where the mortgage industry was able to sell mortgages without considering whether the buyers could pay back. Global research (2009) was estimated the value of US subprime mortgages at $1. 3 trillion on March 2007, but there was over 7. 5 million first-lien subprime mortgages outstanding. It was because the subprime mortgage was spiked to nearly 20% of all mortgage originations during the peak of US housing bubble (Smith 2007). In figure 3, it shows that subprime mortgage was expanded significantly during the period of 2004 to 2006. The huge majority of the subprime mortgages were caused massive foreclosures, and thus it was greatly affected the institutions and independent mortgage brokers which were not covered by the Community Reinvestment Act (Pressman 2008). Thus, it was indirectly affected a slow growth or even started to fall on consumer spending and investment (Taylor 2009).

2. 1. 2 Low Interest Rate

Economists commented that US monetary authorities had adjusted the interest rates at unprecedented levels which created a debt-finance consumption boom leading the way in boosting housing bubble (Taylor 2009; Eklavya 2008; Kurki et al 2009). Similarly, some economists argued that interest rates in the US were stayed too low for too long and even stood at just 1 per cent in 2003 and 2004 which activated the great recession (Figure 4) (Elmendorf 2007; Taylor 2009; Verick and Islam 2010). Verick and Islam (2010) criticized that the monetary policy in US was failed to tackle the

overvalued asset bubble, and at the same time contributed to the rapid growth in subprime mortgages.

2. 2 Credit Crunch

McHugh (2007) commented that high subprime mortgage defaults in US had caused credit crunch which referred to a sudden shortage of funds resulting a decline in loans available. According to Bloom (2008), many investment banks and commercial banks were faced huge losses due to the risky mortgage loans. Therefore, banks were reluctant to lend money to anyone and even to other banks leading a shortage of funds in the money markets (Smith 2007; Verick and Islam 2010). Whalen (2007) commented that the shortage of liquidity in the finance sector had caused borrowing to be more difficult and more expensive which had leaded to a lower consumer spending and investment.

2. 3 Budget Deficit and National Debt

According to GAO (2009), the US national debt was stood at 65% of GDP for 2007 and it was even worst when pension liabilities were included. With such a large deficit, US government had less room for expansionary fiscal policy because demographics worked against fiscal stability and the stage of economic cycle worsened the deficit (Auerbach 2009). Kurki et al (2009) noted that the deficit has caused difficulties in attracting capital flow because Asian investors who were aware of the US deficit had slowed down the capital flow to US and contributed to devaluing dollar. Thus, it indicated that there is a fundamental imbalance between domestic production and consumption which had become a constraint for future economic growth (Auerbach 2009).

2. 4 Devaluation of Dollar

According to basic economic theory, a decrease in exchange rates will eventually help to increase exports and stimulate growth in the export sector (Grant and Vidler 2003). However, the depreciating dollar had contributed to cost-push inflation and declining in living standards where consumer goods were more expensive leading to lower spending power of individuals (Bloomberg 2010). Bloomberg (2010) argued that decline in dollar was resulted US to become less competitive compared to its trading partners.

3. 0 Consequences of Great Recession

Since US went into recession at the end of 2007, it had caused a crisis on economies across the world (Verick and Islam 2010). According to Taylor (2008), middle-incomes countries (especially in Central and Eastern Europe, and the Commomwealth of Independent States) were severely affected (Figure 5), where as low-income countries such as Uganda and Ethiopia were able to grow strongly despite the downturn (Figure 6).

Verick and Islam (2010) noted that although most low-income countries have evaded from recession, these countries had experienced a slow growth in economy due to the negative implications for poverty. Lockstein (2010) argued that, in overall, the smaller and more open economies countries had been hit stronger, whereas the larger emerging economies countries could be survived by the supporting from domestic demand and government spending. It had been noted that China and India were able to recover faster from the great recession (Taylor 2009; Verick and Islam 2010). Llaudes, Salman and Chivakul (2010) commented that the great recession had caused various impacts to different countries. Thus, an analytical study on

the consequences of great recession towards US and India have stated as below:

3. 1 The United States

According to Gulzar (2010), the great recession had caused a great impact on US labour market. Laibson (2010) noted that although government had adjusted the inflation rate causing the economy grew 2. 2% in 2009 Q3, 5. 6% in 2009 Q4, and 2. 7% in 2010 Q1, the unemployment rate had stubbornly remained high. The unemployment rate had risen from 9. 5% in June 2009 to 10. 1% in October 2009, before it felt back to 9. 5% in June 2010 (Laibson 2010). Altig (2010) commented that the disconnection between the demand and supply of workers which was reflected in statistics such as the hiring rate, the layoff rate, and the unemployment rate can be expressed by the Beveridge curve (Figure 7). Altig (2010) argued that, with the given average number of job opening in April and May, the unemployed were expected about 10. 4 million instead of 15 million as stated in Figure 7.

Some analysts have commented that the unemployment benefits policies should responsible for abnormally high unemployment rates (Altig 2010; Gulzar 2010; Verick and Islam 2010). Valletta and Kuang (2010) estimated that extended unemployment benefits may have increased between 0. 4% and 1. 7% of unemployment rate. Krugman (2010) argued that there is a strong tendency of high unemployment to become permanent because those who have out of work for a long enough periods have become less productive and less competitive in the job market. Ball (cited in Krugman 2010) prompted a problem that high unemployment tend to increase the

level of structural unemployment, if there is a weak policy, thus inflation will increase much higher unemployment rates than before.

3. 2 India

During great recession, India economy was turning down because of Indian companies with big tickets dealing in the US were seeing their profits margin shrinking, and majority of Indian companies have major outsourcing deals with US (Malik and Pandit 2010). According to Alex and Kumar (2009), India’s merchandise has been exported to ASEAN (52%), followed by the EU27 (21%), and the US (13%). However, Malik and Pandit (2010) noted that the global crisis has caused the US’s share felt to 11% (March 2009), which was even lower than the United Arab Emirates (13%) (Figure 8). Figure 9 shows that all of the products (except gems and jewellery) were experienced a major contraction during the great recession: petroleum and crude products have the largest contraction (about 45%), whereas agriculture and allied products contracted by 28%, engineering goods exports by 22%, chemical and related products by 9%, and textiles by only 2% (Alex and Kumar 2009).

Besides, India’s financial market was hit badly from the great recession where share market was fall, rupee was weakening again dollars, and banks were faced severe cash crunch resulting in shortage of liquidity in the market (Eklavya 2008). Due to Foreign Institutional Investors (FIIs) were the main investors for India, the investors (majority based in US and Europe) had withdrawal their money from Indian Stock Markets to meet their liabilities at their home countries (Mohanty 2009). Alex and Kumar (2009) commented that rupee was lost its strength against dollar when FIIs converted their invested money into dollars. However, India was able to recover faster from

the great recession due to Indian Banks were escaped from the ill-effects of subprime mortgage crisis where major Public Sector Banks exercising extremely caution in giving loans to needy people or companies (Eklavya 2008).

4. 0 Conclusion

In the age of globalisation, every country is affected by the fluctuations of world economy where no country can remains isolated (Eklavya 2008). Thus, great recession has caused a vast impact to the world such as fall in demands, shortage of cash, decreasing growth rate, and high unemployment rate (Taylor 2008; Verick and Islam 2010). On the other hand, recession can help to transform country or business’s outlook for the future (Kurki et al 2009). Although the recession has turned down the growth process, it helps to generate ideas and strategies stimulating the economic growth and maintaining stability of the market in order to become more competitive in the world.