

Are recessions inevitable? essay sample

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Over the past year or so, there has been much debate about recessions, not only concerning the UK economy, but globally as well. As there are ongoing discussions and constant media speculation, I thought it would be interesting and worthwhile to base my coursework around this topic. My objective is to eventually understand whether a recession is avoidable, in particular for the UK economy; I believe that recessions are bound to happen, because sooner or later there will be a period in any economy when consumer confidence declines. As part of my investigation, I will be judging the UK economy against other international economies, in addition to analysing a few historical comparisons. In order to reach my conclusion, I will be will required to answer several essential questions:

1. What is the meaning of a recession and how can it be measured?
2. What are the causes of a recession?
3. Is a recession good or bad?
4. How can the government deal with a recession?

1. What is the meaning of a recession and how can it be measured?

The technical definition is met when a country experiences negative economic growth for at least two successive quarters. This means there must be a shrink in productive capacity, measured by a fall in real GDP, for a minimum period of six months.

Even deeper than a recession, a dramatic fall in real GDP or a prolonged fall in output can lead to a Depression. In the Great Depression of 1929-33, which started after the Wall Street crash, output fell by a massive 18%.

However, not all economists are happy with the description of a recession for various reasons:

- * Statistics may not be precise. Often GDP statistics are inexact and need to be rounded down. Conversely, figures can be revised up as well as down.

- * Fluctuations in Economic Growth. E. g. If economy A grew by 3% in the first quarter and then fell by 0.5% in the next two, it would be considered in a recession. Yet if economy B grew by 1% in the first quarter, then fell by 3% in the next, and finally rose by 1%, it would avoid being categorised under a recession. This is in spite of the fact that economy A would appear to have done relatively better than economy B.

- * Population Growth. If the population was increasing at a greater proportion to Real GDP, it would mean Real GDP per Capita was falling. This is an important factor for countries such as India which have growing populations.

- * Unemployment. Arguably, one of the most distinctive features of a recession is increasing unemployment. If unemployment rises considerably, even when there is economic growth, then this could signify that the economy is in or approaching recession.

- * Growth below Trend Rate. If capacity grows at a higher percentage than economic growth, it would mean a rise in spare capacity. Therefore unemployment is likely to go up as part of an output gap. As a result, some

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economists feel we should recognise a recession if spare capacity is rising. But the problem with this is that it means even low positive economic growth could become classed as a recession, which creates confusion. Some economists refer to a 'growth recession', when low growth is accustomed with features of a recession. 1

* Survey. You could ask a survey of economists and people, whether they think the economy is in recession, although this is very subjective.

The chart below illustrates different ways to judge the severity of the economic slowdown since the start of the credit crunch in August 2007.

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It shows that America has fared better in terms of a robust GDP growth rate, whereas it has lagged far more behind in its unemployment rate.

2. What are the causes of a recession?

According to Keynesian theory, a downturn in the economic cycle arises because of the multiplied effects of the changes in spending and investment. A fall in real GDP, due to a fall in aggregate demand, would be dependant on how close the economy is to maximum capacity, hence the steepness of the AS curve. When an economy is near full capacity, a decrease in AD would have a smaller effect on real GDP. Then again, if the economy were to be further away from full capacity, the decrease in AD would have a bigger impact on real GDP.

Any reduction in AD can be negatively magnified by both the multiplier effect and accelerator effect. The multiplier refers to when an initial change in aggregate demand leads to a much greater final impact on the level of national income. The higher the propensity to consume domestically-produced goods and services, the greater the multiplier effect will be. 5 In relation to the accelerator, a slowdown in consumer demand can create excess capacity and may cause a reduction in planned investment demand.

This can be exacerbated, since changes which may engender a recession can be self-reinforcing. For example, if a fall in production prompts workers to become unemployed, they will have less money to spend and thus cause further cutbacks in AD. Consumer and business confidence is crucial in influencing the rate of economic growth and their expectations play a significant role. An expectancy of ‘hard times’ ahead may cause a higher proportion of savings, cascading to a larger shrink in AD and more anxiety. This sequence is known as the ‘Paradox of Thrift’⁶.

Another explanation is the monetarist view that fluctuations in economic activity arise because of changes in the money supply. Alternatively, political cycles based around elections can have an impact. But beyond the Keynesian reason, real shocks are vitally influential as well. Unanticipated fluctuations in aggregate demand and aggregate supply can influence an economic cycle. They are independent of changes in government policy and may be internal or external. In recent years, the role of shocks has been given more prominence in the explanation of economic cycles, and it is thought that a number of recent fluctuations in economic activity have been caused by unexpected changes.

Nowadays, globalisation has rapidly changed the way countries produce. Hence, another vital aspect is international trade. Accordingly, the UK has been affected by the global recession, especially as the EU accounts for 60% of its trade. Furthermore, recessions in other countries like the US could dent confidence at home, although if domestic demand stays high, a recession will not take place.

The article states that, despite the US being one of the largest economies in the world and contributing to approximately one fifth of global GDP, its downturn has had a lesser impact on other countries than was initially and perhaps conventionally expected.

The main reason for a recession is a fall in Aggregate Demand. Since $AD = C+I+G+(X-M)$, a fall in any of these components and injections, or an increase in imports and other leakages, could cause a recession. In the UK recession of 2008, the main causes of falling aggregate demand have been (similar to the US):

- * Financial Sector Crisis. The prospects of well-known banks such as Northern Rock and Royal Bank of Scotland going insolvent have made people less convinced about spending and investing, even in the real economy.

- * Falling House Prices. This reduces consumer wealth and prevents equity withdrawal through remortgaging. 8 When house prices fall, people lose confidence in spending as their key asset is declining in value.

- * Mortgage Defaults. Many homeowners were given mortgages, in spite of their incomes being relatively low. As the banks raised their interest rates

after the introductory period ended, the mortgages were too expensive to be paid back. This lowered homeowners' disposable incomes and caused many to default on their mortgage payments.

* Credit Crunch i. e. shortage of finance. Due to the high mortgage defaults, mainly in the US, many banks lost a lot of money. Consequently, financial institutions have become very unwilling to lend money, causing a lack of funds in the money markets. This has made borrowing more difficult and expensive, leading to lower investment and consumer spending.

* Cost-push Inflation. Mounting oil, energy and food prices have led to an increase in the costs of production. This shifts the aggregate supply curve to the left and leaves the typical consumer with less to spend.

What are the differences between the UK recessions and how long does a recession last?

Classical economists argue that any decrease in real GDP will only last for the short term. This is because they believe that markets will adjust so the problem will only remain temporary. However, this was criticised by John Maynard Keynes, as he said that the depression in the 1930s shows that markets do not amend automatically.

The early 1980s recession was primarily caused by an excessive contractionary monetary policy to control high inflation. At the time, there was high demand and an inflation rate of 27%. This led the government to utilise deflationary strategies for both monetary and fiscal policies. There were higher interest rates and taxation which drastically reduced aggregate

demand. Government spending was decreased, partly persuaded by Monetarists, who felt that lower government borrowing was needed. Owing to the high value of the pound, imports were relatively cheap whereas exports were expensive, so it had a severe effect for British manufacturing. The recession lasted about 6-7 quarters, although unemployment was around 3 million for another 5 years. 9

The early 1990s recession was a classic scenario of boom and bust. Due to the Lawson Boom, rapid and unsustainable economic growth had caused the economy to overheat. This created high inflation, which was tacked by the government's deflationary measures. The government wanted to maintain a strong currency so they chose to join the Exchange Rate Mechanism. This engendered high interest rates of 15%, causing a big drop in AD. The recession lasted just over a year (5 quarters), prolonged by the government's persistence to stay in the ERM, only to it leave later.

In 2008-2009 much of the industrialised world entered into a deep recession, sparked by a financial crisis that had its origins in reckless lending practices involving the origination and distribution of mortgage debt in the USA. 10 Nonetheless, we still find ourselves questioning how long this current recession will last. There is no obvious answer and recessions can vary in time. It depends on how they were brought about, what actions the government and consumers take, and how they respond.

Besides time, we can also contrast the depth of the prior recession with the current one.

These graphs show that, in spite of most gloomy unemployment reports, the starting level is below what it was last time. As of yet, we are still to reach those heights, and the same line gradients indicate that people are losing jobs at roughly the same speed as last time.

3. Is a recession good or bad?

Like most things, there are both positive and negative results. A recession can be beneficial to an economy in the long run. As consumer spending tightens up, inefficient businesses will struggle to continue to operate and good businesses will perform better. It also reminds us of the risks in investing in the stock market. But, in my opinion, the most central benefit of such a period is that it forces us to look at some main problems we which we often ignore. E. g. not sufficient regulation in the financial sector.

An economic decline is likely to reduce the income of businesses, so firms will experience a decline in profitability. The lower demand for products means that there is less demand for labour, which is a derived demand. Some firms will be affected more by the downturn. Firms producing luxury goods (Income elasticity of demand > 1) will experience the biggest % fall in demand. 16 Firms producing basic necessities or lower priced products, known as inferior goods, will be more insulated from the effects of a recession and may even face higher demand. E. g. Aldi supermarket - low-priced goods.

The article below illustrates a major negative feature of the 2008-present recession.

But it must be hastily added that there are approximately 3 million more people of working age this time than last, and 4.5 million more than in the early 1980s recession. And regardless of all the media headlines portraying a pessimistic economy, it is worth bearing in mind that many people do actually keep their jobs. But whilst unemployment statistics may be relatively favourable, the financial sector has been hit hard.

People are more likely to be directly affected by rising costs of living. The rise in food and energy prices is hard to ignore; it is estimated that many consumers could be worse off this year because prices are rising faster than wages. This is what people will notice. However, in light of recent data, deflation occurred in May 2009 for the first time in nearly five decades, as prices measured by the retail price index (RPI) were lower than the same time a year ago. Nevertheless, the road to recovery has overruled fears over inflation.

Weighing up both the plusses and minuses of a recession, it seems to cause more harm than good, and it is unnecessary to enhance economic efficiency. Instead, the long term future of an economy should be aided through stable growth, which evades the extreme fluctuations of boom and bust economic cycles.

4. How can the government deal with a recession?

Fiscal policy - changes in government spending and taxation

By cutting tax rates and/or increasing government spending, the government can increase AD. Lower income taxes give consumers more

disposable income, therefore consumption increases, which will then stimulate economic growth.

But an expansionary fiscal policy for the UK involves a growing budget deficit.

Source: HM Treasury - may prove to be overly optimistic²¹

Having such a high national debt means several problems occur. Interest payments on these debts are massive and may lead to higher taxes in the future. It will also have a negative impact on the exchange rate. The government's ability to kick-start the recession-hit economy with further large-scale fiscal stimulus is limited by the sharp deterioration in the public finances. ²²

The pie chart below demonstrates where tax money was spent last year. In future years, cuts will have to be made, alongside tax increases, so that the accumulation of deficits can be paid back.

In order for the government to have a huge impact in its fiscal stimulus packages, it should exploit generating higher revenue through income tax because it accounts for the largest proportion of government revenue. However, this could make the situation worse if it causes AD to decrease further. One of the aims of the Tax Budget 2009 was to raise the tax on the highest income earners through progressive taxation.

This pie chart, supplemented with actual up-to-date data, can allow the government to manipulate taxes in specific areas where possible.

The extent to which taxes should be adjusted can be based around the theory of the Laffer curve. Reductions in tax can lead to higher government revenue. This is because too much tax can be a disincentive to work and earn money, whereas too little tax will simply raise less government revenue.

It also takes time to filter through the economy.

Monetary policy - government changes in interest rates, the money supply and the exchange rate

By lowering interest rates, it will make borrowing cheaper. This will encourage consumption and investment, thus the Bank of England can increase AD. But an expansionary monetary policy may conflict with targets for inflation, although this is unlikely as inflation tends to be low in such times of scarce demand.

But the record low interest rates impede the Bank of England from cutting interest rates any more. Furthermore, it has been estimated that they take 18 months to come into effect, although it is perhaps one of the quickest methods. So over time, people will start responding and so increase their spending and investment. The rate may also affect other elements of the British economy such as the exchange rate. E. g. low UK interest rates would cause devaluation in the sterling. In this case however, this would help reduce the balance of payments deficit.

Quantitative easing - a method of boosting the money supply (therefore part of monetary policy)

Quantitative easing is the modern way to print money. Its aim is to get money flowing around an economy when the normal process of cutting interest rates isn't working – most obviously when interest rates are so low that it's impossible to cut them further. In such a situation, it may still be possible to increase the “ quantity” of money. The way to do this is for the central bank to buy assets/securities from banks, in exchange for money.

Moreover, there may be unintended side-effects such as depreciation in currency and inflation. Since it is risky, it needs to be practiced carefully.

Supply-side policy – increase aggregate supply by raising the efficiency in markets

The main advantages of this are that it can improve the government's macroeconomic objectives without necessarily conflicting one another. They include:

- * Lower unemployment
- * Lower inflation
- * Higher economic growth
- * Improved balance of payments

Most supply side policies aim to enable the free market to work more efficiently by reducing government interference. Education and training are generally excellent ways to combat labour shortages. However, in practice it is not always so easy to increase productivity. They are costly and take a

long time to come into effect. Also, there is a limit to how much benefit they can give, and it is often more appropriate to use demand side policies. 29

All of these combined measures can mitigate the consequences of a recession and, in some cases, prevent it from occurring in the first place. Nevertheless, there is no guarantee it will work. And with increasing internationalism, a lot depends on things beyond the control of a single government. International factors are very important, like how much demand there is from other countries. Other issues include the housing markets, bank lending, and time.

How long will it take to recover?

Seeing as most countries are already in recession, many people are wondering when we will leave the recession stage.

Conclusion

1. There are various ways to measure a recession. In general, it is acknowledged by its standard textbook definition. In my opinion, I feel that a recession should be identified through several main characteristics rather than simply by negative GDP growth. For instance, one indicator could be when unemployment reaches a certain percentage. This can be coupled together with any fall in real GDP per capita, so it can be argued that the standard of living has actually decreased per person, a contrast to what occurs during economic growth.

2. The massive rise in globalisation means that causes are not enclosed within a country, but can permeate other dependant countries as well.

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Despite there being several factors which can provoke a recession, the current situation was brought because of the toxic assets dilemma in the financial sector. Seeing as the banks had lost vast sums of money, their lending froze so that they could protect themselves from further losses.

3. The advantages and disadvantages of a recession have been widely debated. Although there are many benefits, I feel that they are constrained by the harmful effects. Even though some economists argue that a recession can improve the efficiency of markets, it would probably be wiser to uphold a stable economy so that greater assurances can enable people to plan ahead.

4. Ultimately, the solutions are disputed between the free market systems vs. government regulations. In favour of capitalists, the argument is that the markets will adjust in the long run. But this recession has been tagged as the deepest since the Great Depression and the harsh outcomes for most people clearly exemplify the need for government assistance. To overcome the concerns, governments should try and mitigate the ramifications. This has been the case as governments around the world have had to come together to combat the crisis; the G20 meetings and the collective policies are visible indications of tackling the problems. These are to be achieved through expansionary policies, but they must be cautious and prevent market failure turning into government failure, if their strategies exacerbate the conditions of the markets. As various economists have said, a government's role is to "take away the punch bowl just as the party gets going".

So finally, are recessions inevitable? After much scrutiny I believe that, theoretically speaking, it is possible. However, in practice it will be unlikely.

Even if governments do their best to utilise their economic instruments and political rhetoric, we now live in a smaller world where countries are increasingly integrated economically. As we have witnessed, the sub-prime bubble in America burst onto the international scene, toppling the dominoes of confidence via the cumulative causation effect. That is not to say that the government should not try. In fact, they should learn from any past mistakes and realise that more regulation is required in areas such as finance, where the circumstances of an economy can hinge. Additionally, the volatility of the business cycle should be dampened to sustain a long period of unwavering economic growth. In this way, many nations will prosper for a long time to come.

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