

# Cause and impact of 2008 recession economics essay



September 2008 marked the first recession of the 21st century which resulted in stock markets all over the world in red for almost a year. The reason behind the recent recession was due to the lax monetary policy adopted by the privatised banks (Carmassi et al. 2009, p. 977). The mortgage and banking crisis had begun around the early 2007, then the equity market reaction occurred in July/August 2007 and then the collapse started in September 2008 with the bankruptcy of Lehman Brothers and the bailout of AIG (Bartram and Bodnar 2009, p. 1247). The phenomenon of financial crisis has been common, such as Great Depression of the 1930s. The difference between earlier and present financial crisis is the severity and global impact of the crisis (Allen and Gale, 2007 and Reinhart and Rogoff, 2009, cited in Bartram and Bodnar 2009, p. 1247). The recession revealed centrality of finance to United States and it also exposed the problems with arcane securities traded by financial institutions which went out of control and lead to the global financial crisis (Davis 2009, p. 27). United Kingdom economy was hardest hit among the other European Economies. The financial crisis that began in 2007 had adverse effect on the British banks since 1866, which neared the meltdown 12 months after the financial crisis (Hodson and Mabbett 2009, p. 1041). The financial crisis lead to unemployment in United States of America as well as in United Kingdom within the six months, which affected the circular flow of income i. e., from households to firms and vice-a-versa. The firms not only reduced the employees but also the output and investment made by the firm. This had a negative impact on economies around the world and leading to longevity of the financial crisis. The concentration should not only be on the causes of

financial crisis but also on the reducing the impact and avoiding the crisis in the future.

In 1973 it was observed that, in United States, majority of the population were working in service – based industry rather than in agriculture or manufacturing and it comprised about 60% of the labour force (Bell 1973, p. 15 cited in Davis 2009, p. 28). Same is the case with United Kingdom where majority of the labour force work in the retail and financial service sector. In United States, as majority employees work in retail sector they are provided with lower wages, benefits and tenures than that of manufacturing sector and it was proved when Walmart, United States largest retail chain, employed more employees than 20 largest United States manufacturing firms combined in year 2009 (Davis 2009, p. 30). The change in type of employment opportunities from manufacturing to retail can be referred to industrial upgrading i. e. from manufacturing to retail and many developed countries have passed this phase. The retail sector did not provide the employees with lifetime employment guarantee but it did provide employees with life – time employability by training, adaptability and making them mobile to explore other opportunities (Lagace, 2001, p. 1 cited in Davis 2009, p. 31). The shift from manufacturing to service base in developed countries such as United States and United Kingdom led to employment tenures and workplaces to get shorter, whereas in traditional rationale, the long term employment would encourage the firms to invest in firm – specific skills and employee mobility goes hand – in – hand with lower firm – specific investment (Davis 2009, p. 31). In United States large – scale employers use to provide employees with job securities, provided mobility through career

ladder and health and retirement benefits and these were main factors that were used to tie employees with the employers. The employers such as General Motors notified its retirees, in July 2008, that they would be no longer be covered by their private health insurance and were compensated by \$300 increase in their monthly pension checks (Bunkley, 2008 cited in Davis 2009, p. 31).

The problem with financial institutions was the room created by reducing the capital requirement by choosing counterparties or tailoring operations in legal constraints in order to economise capital and once Basel requirements were met, the management felt that they are exempted from any further scrutiny of actual risks (Carmassi et al. 2009, p. 993). The Basel rules and Securities Exchange Commissions (SEC) allowed the international banks (IBs) with low cost of capital. Due to this their leverage ratio was high and they attracted only 20% capital weight under the Basel requirements for any banks lending them. Therefore these businesses grew at high rate than they would have done with high cost of capital and better regulation (Blundell - Wignall and Atkinson, p. 542). Until early 1980s employers used to pay pension through "defined - benefit" plans that paid retirees according to tenure spend in the organization. In early 1980s employers began shifting towards the portable pension in which both employees and employers contribute to individually owned pension funds and these could be transferred if employee changes the organization, this is known as "defined - contribution". This transferred the risk from employer to employees, who were solely responsible for investment choices were offered by the employer (Cobb 2008, Hacker 2006 cited in Davis 2008, p. 31). The "defined -

contribution" pension funds were invested in the mutual funds and it led to enormous growth during 1980s and 1990s as it offered better returns than any other saving schemes. Nearly after three decades of individual participation in mutual funds led to the concentration of ownership into the hands of financial institutions (Davis 2008, p. 31-33). Therefore share prices were used to measure the corporate performance (Useem 1996 cited in Davis 2008, p. 31). Due to this firms make their decision regarding strategies and structure according to the expected market reaction. In traditional banking the asset were turned into securities that were traded on market this known as securitization. The best - known form of securitization is mortgage - backed bonds, which are pooled together and divided into bonds and this was regarded as more predictable and safer returns (Davis 2008, p. 33-35). When the house - prices were increasing, these financial institutions encourage the people to borrow money for their houses without concern whether they would able to service their debt (Carmassi et al. 2009, p. 980-981). The present scenario favours the short - term employment and their job stability will depend upon the level of personal touch involved such as personal fitness trainer (Davis 2008, p. 39-40).

If UK government or any other national governments want to resolve the crisis without outside help then it would require adequate tax - collecting capacity, accurate policy advice and appropriately skilled labour (Kane 2002, p. 217). It has been argued through public and private financial crisis report that large complex organizations require a different layer of regulation in order to deal with systematic risks by considering their sheer size and particular functions (G-30 2009, IMF 2009 cited in Carmassi et al. 2009, p.

995). The difficulty in applying these layers is to define in their domain of application and without creating new incentives for regulatory arbitrage. As these financial institutions often act as main counterpart for derivate contracts and moreover legal structures and business functions often do not coincide (Hupkes 2008 cited in Carmassi et al. 2009, p. 996). The specific safeguards are needed in order to preserve the integrity of clearing and settlement for securities. It would be recommended to have concentrate institutions at European Union level in order to ensure greater co - ordination and interoperability between these bodies across main financial centres (Carmassi et al. 2009, p. 996). The creation of regulatory incentives to move a significant share of over the counter (OTC) transactions in order to organise clearing platforms with capital in order to encourage pooling of counterparty risks with well capitalized institutions and standardised financial products (Cecchetti 2007 cited in Carmassi et al. 2009, p. 996). Insurance providers should ensure that contracts resembling insurance should not be written off without adequate capital reserves and externally validated models in order to ensure business is risk free (Carmassi et al. 2009, p. 996). The policies that are required to reduce the risk of future recurrences of financial crisis are choosing less distorting emergency steps, undertaking fundamental reform relating to causes of crisis and unwinding the measures taken in order to avoid the crisis i. e., exit strategy (Blundell - Wignall and Atkinson 2009, p. 546).

The financial crisis of 2007/2008 has affected multi - national corporations such as General Motors (GM), Chrysler, etc., these corporations were under impression that economy would continue to grow. Whereas organizations

such as Ford Motor Company which were deteriorating earlier were much more stable during the crisis as Ford have sold lot of their asset in order to survive. The crisis would be profitable to the organizations that are well prepared as they can invest in capital, hire the employees, acquiring the other organizations etc. The reason behind the longevity of financial crisis was the growth of the retail sectors in United States and other developed countries. These retail stores employ fewer employees than the manufacturing companies and they import from China and other South Asian countries in order to obtain the lower price. The money was driven to these Asian countries and was struck due to tendency of Asian people to save the money for the future. Therefore, there is a requirement of the detail analysis of the current financial crisis in order to safeguard from the future threats (Davis 2009, p. 42).

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Multinational enterprises (MNE) are those firms which have production facilities and/or sales operations in more than one country excluding home country; usually they are large corporations in domestic markets such as General Motors in United States of America (USA). When MNEs expand their operations to foreign countries then they have to invest in the purchasing or building the production facility in that country (Bartlett et al. 2006, p. 2). MNEs can also acquire or merge with existing country in the foreign market that can provide them perfect foundation and competitive advantage in order to sustain in foreign market. Foreign Direct Investment (FDI) is said to be occurred, whenever company invests in the foreign market. There is a significant growth in FDI since 1990s, but there has been a decline in recent years and it can also be argued that FDI is large but not entirely global. If we split the recipients of FDI into developed and developing economies then, USA and Europe led in developed economies whereas in developing economies it is led by China. The main reasons why firms to turn multinationals can be related to the high production costs in domestic



markets and to increase the revenue of the firm (Begg and Ward 2007, p. 335-339). How firms invest in the foreign markets can be related to Dunning's eclectic paradigm and model of internationalization by Johanson and Vahlne.

The firms becoming multinationals can be linked with the motivation in order to increase the revenue, increasing the sales, reducing the input cost of manufacturing, etc., motivation can be divided into two types traditional motivations and emerging motivations. In traditional motivations, companies invest in foreign countries in order to secure the key supplies of the raw materials, such as oil companies open up the new oil fields in Canada, Middle East and Venezuela. Firms try to exploit their intrinsic advantage especially related to their technological or the brand recognition. The initial motivation is often opportunistic, but gradually they exploit the economies of scale and scope and that provides them competitive advantage over their domestic rivals (Bartlett et al. 2006, p. 4). It can also be argued that firm's growth is limited by the size and growth of domestic market (Begg and Ward 2007, p. 339). For example, Walmart entered United Kingdom (UK) through Asda chain and they also set - up their own supply chain in China. This not only provided them revenue growth in terms of sales but also competitive advantage over its domestic rivals such as Aldi, Target, etc. The developed countries such as US and Western European countries usually have high labour costs and they reckon that their products had competitive disadvantage over the imports. With decrease in tariff barriers by 1960, this triggered the firms to access the low cost factors of production in the developing countries such as China, India, etc. In - case of emerging

motivations, the forces such as increasing scale economies, increasing Research and Development investments and shortening product life cycles has motivated firms to turn multinational by not only by choice but also to survive in the market. Whenever the firm is drawn offshore in - order to secure the raw materials, the firm is likely to come across the alternative low - cost production facilities and it might also be exposed to new technology or market needs that would develop its product. It benefited the firms with competitive positioning, that they would not have achieved if they would have remained onshore (Bartlett et al. 2006, p. 4). The firms in the developing countries have the international cost advantage, by considering raw materials, labour, etc., and it would enable them to compete effectively in the foreign markets. This would be vice - versa for the firms in the developed countries, as it benefit the firms with cost advantage by expanding in foreign countries (Begg and Ward 2007, p. 339).

How the firms become multinationals can be linked to Dunning's eclectic paradigm and model of internationalisation by Johanson and Vahlne. While understanding growth of FDI, several economic and business theories suggests that, it depends on investing firm to possess some kind of unique and sustainable advantage or advantages that would lead to competitive advantage over the foreign competitors. Ownership sub - paradigm of Dunning's eclectic theory states that competitive or ' O' specific advantages reflects the resources and capabilities of the host country of the firm and firm will invest in foreign countries only when benefits of exploiting competitive advantages from foreign location more than that doing in the host country. The Location sub - paradigm is the main aspect of the

Dunning's eclectic theory as it is a key determinant of the foreign production of MNEs. The firms invest in foreign countries only when if location offers cross - border value added activities. Firms will particularly look for exchange rate, political risks, regulations and policies of the supra - national entities, inter - country cultural differences and also value of other variables common both to domestic and international preferable countries. The firms are also interested if foreign country has good market or it has plenty of natural resources or created resources such as China developed a Special Economic Zones (SEZ) or the country has foreign policy advantage over the other countries. The third important sub - paradigm of eclectic theory is Internalization it states that transaction costs of investing in foreign country is positively correlated to the imperfections of the market (Dunning 2000, p. 168 - 183). Whenever firms become aware that it is better to add value to its ' O' advantages rather to sell them, or their right of use, to foreign firms, these advantages are called market internalization ' I' advantages (Dunning 1993, p. 79). The internationalisation model put forward by Johanson and Vahlne consists of four main components namely, Market Knowledge, Commitment Decisions, Current Activities and Market Commitment. Market Commitment can be divided into two parts degree of commitment and amount of resources committed, in first part; firm commits the resources for the particular market, but firm also should not disregard commitment that followed from employing parts of present capacity for a particular market. Whereas in second part relates to the size of investment firm makes for marketing, personnel, organization and other areas. Then it is Market Knowledge, whenever firm enters in new market it does not have experiential knowledge to begin with, but it acquires it over the time. Many

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commitment decisions are related to knowledge related opportunities or problems and the evaluation of alternatives about the market environment and the performance of various activities. The next phase is Current Business Activities, it can be argued that consequences may or in fact will not surface until activities are repeated continuously. Current activities can also be source for the experience. It is also possible to gain experience by hiring of personnel with experience or taking advice from person with experience. This can be divided into firm experience and market experience, these are essential for firms in order to internationalize. The Commitment Decisions depend on the decision alternatives are raised and how they are chosen by the firm (Johanson and Vahlne 1977, p. 26-31). When the firm tries to internationalize it has four main options exporting, licensing/franchising, joint ventures and FDI. The firm chooses the path depending upon degree of resource commitment needed, potential balance of risk to return, degree of control in maximising success and degree of learning it affords. In exporting the firm is involved only in selling goods and services from one country to another. It can be divided into two types indirect and direct, the former involves some intermediary concerned in selling to foreign markets, whereas later deals directly with sales channels overseas. Licensing is a process in which firm, i. e. licensor provides the permission to another firm, i. e. licensee, to utilise or sell its intellectual property in return of finance. Franchising is form of licensing, in this franchisee firm undertakes the business activity as per prescribed manner for a certain period of time and at a specific location in return for royalties or fees. The joint venture can be defined as commercial collaboration of two or more firms whereby they pool, exchange, or integrate their resources. FDI

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can be defined as establishment and acquisition of assets in foreign country that would provide income for investing firm and firm has full control over its operations. The contractual forms of international business that firm take into consideration are management contracts, turnkey operations, contract manufacturing, countertrade, etc. (Loughton 1995, p. 4-26).

Every firm in private sector tries making maximum profit and it provides the motivation for the firms to internationalize. Then the firm goes through series of processes as described in model of internationalization and eclectic theory. When the firm selects the foreign market it chooses the entry mode that provides the firm platform to carry on its operations smoothly. It can also be argued that even FDI is large, but it is not entirely global. Many firms are attracted towards small number of economies especially developed instead of developing (Begg and Ward 2007, p. 338). The recent MNEs activities have added to, rather than subtracted from, the robustness of the eclectic and model of internationalization and they continue to meet the most the criteria the firms follow in the process of internationalization (Foss 1996 cited in Dunning 2000, p. 184).