Revision: Causes of Recession

“What’s the difference between a recession and a depression? A recession is when your neighbour loses their job; a depression is when you lose yours.”

In Western economies, recessions are unusual. Take the world’s largest economy the United States - it has suffered only two official downturns, in 1990-91 and 2001. When they happen, they tend to be short-lived lasting perhaps no more than two or three years. If a country fails to emerge from a downturn then it is likely to be in a deeper depression.

The NBER in the United States defines a recession thus:

“A recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales.”

Full-blown recessions are relatively uncommon for the UK too as our chart indicates. The recessions since 1970 occurred in 1974-76, 1980-82 and between 1990-92.

Since then there has been a path of sustained growth. 2005 was the weakest year with real GDP rising by 1.9% (well below trend) and 2008-09 are also likely to be years when real national output grows less than 2%. Years of slowdown yes – but will they include a full-blown recession?

Many factors can create a slowdown – the issue becomes whether this turns into a downturn – and this depends crucially on the size of multiplier and accelerator effects, the impact on confidence. And also whether monetary and fiscal policy is able to manage demand to stabilise the economy.

Possible causes of a recession

1. Major “negative” demand-side shocks hitting the components of AD
   a. A global economic slump or a deep recession in the country of a major trading partner such as the countries of the EU (60% of UK trade) and the United States (15% of UK trade)
   b. A sharp fall / collapse in asset prices e.g. share prices, property prices
   c. A credit crunch where financial institutions cut back the amount of credit they are prepared to lend to households and businesses and raise the interest rate on these loans
   d. A large appreciation of the exchange rate which hits demand for exports, raises import demand and causes the trade balance to worsen
2. Major inflationary **supply-side shocks** which affect SRAS, cost-push inflation, business profits and investment

   a. Higher crude oil and gas prices – leading to increased **input costs**, driving inflation higher and causing a fall in **real incomes** for households (less consumption) and a fall in profits for businesses (less investment and possible employment cut-backs) – this is known as **stagflation**

   b. Higher prices for metals and other non-fuel inputs

   c. Surge in foodstuff prices which increase costs and lower profits for food manufacturers

   d. Other inflationary effects globally such as a sharp rise in inflation in the USA or China, leading to a burst of imported inflation

   e. If wages remain sticky there is a danger of a wage-price spiral emerging.

3. Risks of recession arising from **deflationary macroeconomic policies** such as higher interest rates or increased direct and indirect taxation

   a. If interest rates are raised to counter higher inflation from the domestic economy or from overseas – this can cause a **fall in confidence**, less spending and a downturn in output and jobs

   b. Taxes may have risen to counter a budget deficit – squeezing real **disposable incomes** and demand or perhaps damaging business investment

A severe slowdown can quite easily become a recession because of

1. **Negative multiplier effects** arising from less consumption on goods and services

2. **The accelerator effect** – less consumption ► less incentive to invest in new capital

3. **A drop in consumer and business confidence / worsening expectations** can lead to more saving and cost-cutting by firms ► rising unemployment

But full-blown recessions in the UK are **unlikely** for several reasons

1. **Proactive use of monetary policy**: The Bank of England is prepared to cut interest rates in a pre-emptive manner to boost confidence and demand if the risk of recession is high – always providing that inflationary pressures are under control. It did this in the wake of the 9-11 terrorist attacks and has started to do it in 2007-08 as the impact of the credit crunch has become more apparent – but is it doing enough in time?

2. The government can use **fiscal policy** to actively manage aggregate demand – e.g. the **Golden Rule** that Brown/Darling have used, which allows the government to borrow more during slowdowns – because government borrowing is measured over the course of the economic cycle – in technical terms, this means that government fiscal policy is allowing the **automatic stabilisers** to work

3. The **exchange rate** might also depreciate if interest rates are falling and the economy is weakening – this will again provide a boost to competitiveness and AD. A good example of this is the fall in the sterling exchange rate against the Euro over the last year

4. If the **supply-side of the economy** is strong and flexible, then businesses should be able to adapt to a worsening of economic conditions e.g. by innovating, cutting costs, looking for new export markets etc. The true test of the much vaunted UK supply-side would be a real recession!

5. Although one part of the global economy might be in recession, it is unlikely that the whole world would be experiencing a downturn – e.g. fast growth in **emerging market countries**.

6. Although the UK, like all countries, is vulnerable to external shocks, often these **shocks do not persist** for a long time, e.g. the recent rise in oil and gas prices, giving businesses and consumers a chance to adjust.
Components of aggregate demand

The Components of Aggregate Demand
£bn per year at constant 2003 prices

Source: Reuters EcoWin

There are time lags between rate changes and their effects on AD, output and prices.

The 1+1 rule is worth remembering – i.e. Rate change takes up to 1 year to feed through to AD and output and then a year to work through to prices

The lightest shading represents a 10% probability forecast – i.e. the Bank continues to believe that a recession in the UK will be avoided!

Economic Growth and Inflation
UK Real GDP Growth and Consumer Price Inflation. annual percentage change

Source: Reuters EcoWin

Exam hints
• For essays on cycles and shocks, remember to use AD-AS analysis
• The key is whether economic policy works in stabilising demand and output when confidence is falling
• At times when business and consumer confidence is weak, cuts in interest rates might be ineffective – this is known as the liquidity trap
• The United States is in recession! What matters is the fall-out from this and whether policy can work to lower the impact.