The 'Great Recession' of 2008: a three stage theory of economic collapse

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Abstract

This paper examines the causes of the great economic recession which began in the UK 2008 and which has continued into 2012 albeit as a 'double dip recession'. Although the effects of the recession are similar, the causes of recessions are complex, with different causal factors applying to different countries at different times. This paper attempts to identify the key factors which contributed to the impact of the 'Great Recession' in the UK 2008-12. The research methodology will encompass secondary research into the literature behind recessive and depressive economic periods from post 1945 to the present and the economic and fiscal strategies employed by successive governments to manage them. Some sources suggest that the 'Great Recession' of 2008 onwards was and could have been avoided whilst others suggest it was inevitable. This paper will analyse the decision making processes of government and institutions which led to this recession, compared to recessions and depressions of recent history and construct a conclusion to whether in theory, recessions can be managed and controlled to achieve sustainable growth.

Keywords: Recession, interdependence, globalism, natural economic cycle; discontinuity

Introduction

A recession is defined by Abberger and Nierhaus (2008) as, 'a decline in the seasonally and calendar adjusted real gross domestic product (GDP) in at least two successive quarters'. Recessions have reoccurred periodically in the UK since 1945 and are typically regarded as a by-product of natural economic cycles represented by the 'boom' and 'bust' patterns of a nation's production levels. Recessions vary in their specific causes and duration in terms of flat / rising GDP production levels.

The five major macro-economic indicators of economic health are unemployment, bank interest rates, inflation, investment and balance of payments e.g. imports and export levels. There are three economic growth drivers including consumer demand, business to business demand and exports. In recessions unemployment rises due to lower production, interest rates are consistent with diminishing economic activity in that less demand for borrowing usually lowers the price of that borrowing. Inflation is more complicated in the fact that some inflation is actually good for an economy as it indicates an increase in living standards and wages, but rapid rises in the prices of goods and services to an unaffordable level permits less demand to consume, slowing production and real money flowing around an economy. In some ways, it is economic growth indicators operating in reverse, for example a fall in gainful employment when increasing employment populations are healthy as less people are being left unproductive within an economic system.

There have been numerous recessions in the global economy since 1945, some worse than others in the UK, US and Europe – all major economic contributors and subsequent victims of under-regulated market activity in the latest "Great Recession". The USA has endured ten recessions from 1945 up to the time of the "Great Recession whilst the UK has experienced eight recessions (Buckley 2009). According to Buckley, the early ones in the late 1950s and early 1960s were both short-lived and relatively shallow. The Eurozone crisis is different in nature because it has only been established since 1999, therefore, data on historic recessions in this region are categorized differently. Some Eurozone nations may be in recession while others are in robust growth, but it's statistically clear that many previously 'healthy' Eurozone nations have been in a state of recession since 2008.

Under traditional statistical measurements of GDP, a recession is simply a return to slightly more supply than demand of a nation's goods and services, requiring less new jobs created, less employment and less required new skills acquired by employees who consume. A recession can potentially be triggered by any fluctuation in demand and supply levels within an economy. For example, if a there is a significant increase in inflation levels for an economy, then prices for consumer goods also rise for the employees of the economy purchasing them. A higher price may cause less demand and subsequent excess production. Excess production levels lead to redundancy and company downsizing to maintain overheads while in business downturns. Redundancy means less people employed and able to spend on consumer products, a rise in unemployment insurance and less production further. This encapsulates the dynamics of contraction cycles within economies. According to Pettinger, (2009) recessions end when a combination of factors impact to stimulate economic activity by releasing demand i.e. interest rates fall, Government spending has increases, banks restore liquidity, house prices stop falling. Rostenko (2002) suggests that, ‘The ‘job’ of a recession is to clean the ‘fat’ out of the system, mop up excess, and pave the way for the next expansion. Until that process is complete, there isn't much from which a legitimate expansion can arise.’

Recessions are now closely associated with the effects of globalisation and interdependency between trading nations. Globalisation is demonstrated by the lowering of geographical, socio-economic, cultural and political barriers between nations leading to a growing exchange of products and services. Al-Rodhan and Stoudmann, (2006) define globalisation as, ‘...a process that encompasses the causes, course, and consequences of transnational and transcultural integration of human and non-human activities.’ There is a clearly documented ‘domino effect’ of modern recessions due to the interdependency of the modern global economy. However, Turner (2008: 14) identifies a change in the nature of recessions in the last 15 years compared with previous recessions:

> But there is a distinction that needs to be drawn between these numerous crises. The first two were remnants of the battle against inflation and were characterised by overconsumption. In the classic monetarist phase, there was too much demand chasing not enough supply. However, from 1997 onwards, the financial panics were disinflationary or deflation shocks, driven by the increasing dominance of big business and its ultimate manifestation – over-production and investment.

The relative impact of these different recessions is illustrated by Figure 1 below:

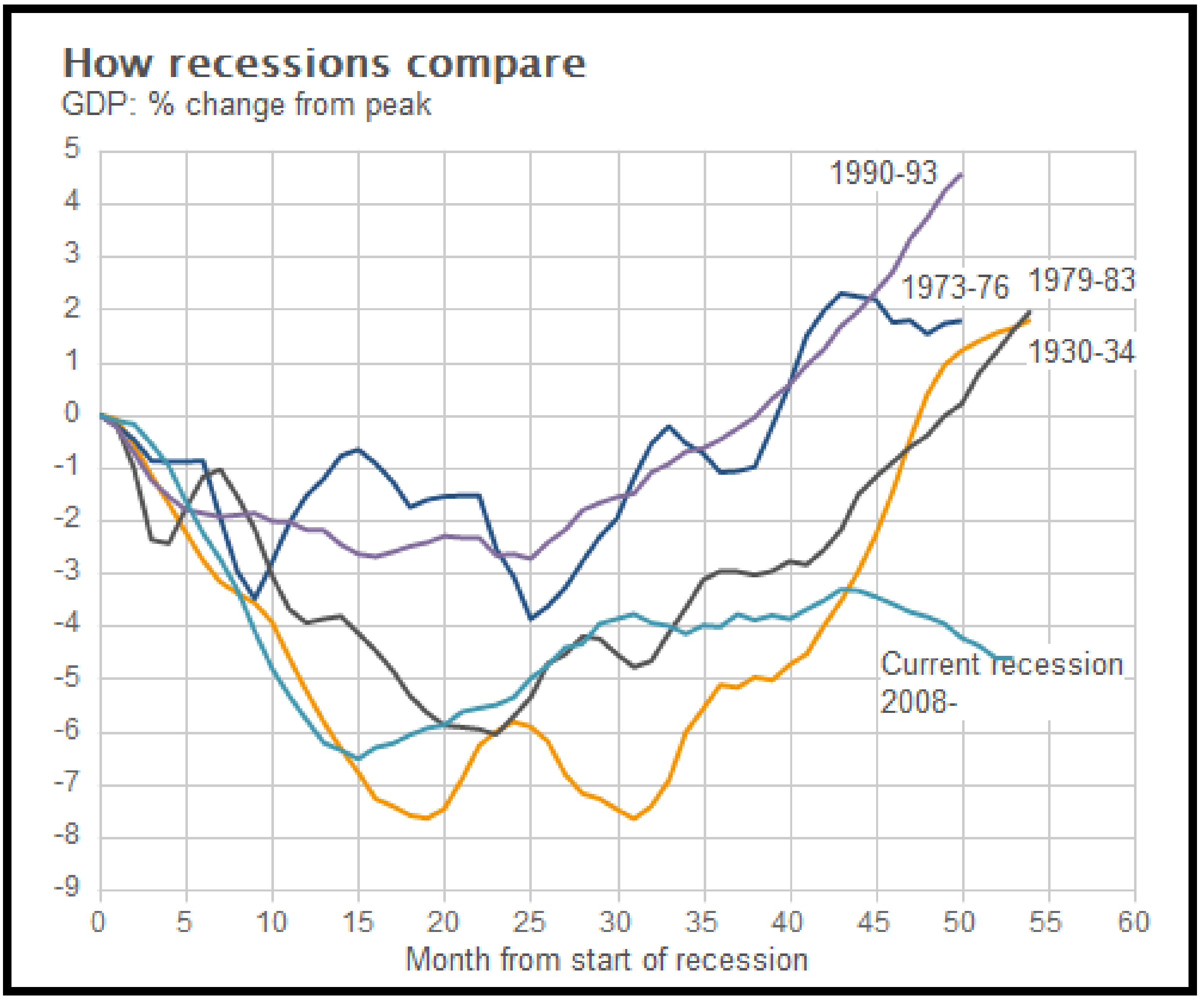

Figure 1 How Recessions Compare. (British Broadcasting Corporation, 2012)

The following section examines the specific causes which are attributed to the 'great recession 2008-12, which Turner (2008) would claim represents a discontinuity in post 1945 economic history.

Stage 1: Ingredients that led up to the "Great Recession"

Deregulation of the US financial system and stock exchange is one of the commonly agreed main causes of the "Great Recession". According to Stiglitz (2010:1):

> What was different about this crisis from the multitude that had preceded it during the past quarter century was that this crisis bore a "Made in the USA" label. And while previous crises had been contained, this "Made in the USA" crisis spread quickly around the world. We liked to think of our country as one of the engines of global economic growth, an exporter of sound economic policies – not recessions. The last time the United States had exported a major crisis was during the Great Depression of the 1930's.

According to commentators like Stiglitz, during the 1980s and 1990s the deregulation of markets has meant that they have been operating in a risky fashion in the years prior to the "Great Recession" of 2008. Since the 1980's there has been less and less regulation within the US financial services industry, which led to an explosion in size and prosperity, especially with investment banks going public. Deregulation of the US financial industry started in the era of the Reagan administration from 1981–1989, which systematically deregulated savings and loans companies. The Clinton administration from 1993-2001, continued this deregulation under the economic consultation of then corporate director / economist Alan Greenspan. By the 1990's the financial industry was dominated by a select few monopolies. It has also been suggested by some that banks actually have bailout guarantees from accommodating government administrations in times of crisis such as the 'Great Recession' of 2008.

The economic 'big bang' of 1986 was a pivotal moment of deregulation within the financial market in the UK. It was a package of deregulatory measurements announced by the Thatcher administration of 1979-1990 specifically designed to encourage investment from overseas companies into London and considered an opening to a new era of banking. A particularly significant development was the spectacular growth in financial derivatives.
A financial derivative is defined by Fincad (2012) as, 'A contract between two or more parties where the price of the contract is dependent upon or derived from the price(s) of one or more underlying assets, rates or relationships. Its value is determined by price fluctuations in the underlying asset. The most common types of derivatives are options, futures, forwards and swaps.'

According to Allen (1999: 165-166) there was a general lack of knowledge by investors of the workings of the derivatives market:

> The general public remains ignorant of derivatives, yet the US Federal Reserve estimated as early as 1993 that its member banks held $7 trillion of privately invested derivatives. The Bank for International Settlements estimates that over-the-counter trading in derivatives, worldwide, was $1 trillion in 1995, based upon outstanding contracts worth $40.7 trillion.

This combination of deregulation and subsequent easy credit for investors and mortgage customers lef to the housing bubbles in the USA and other western economies and are regarded by some commentators as the origins of the 'Great Recession' and the 'credit crunch that accompanied it.. The housing bubble that coincided with the relaxation of the financial industry is described by Gjerstad and Smith (2009) in the following terms:

> Both the Clinton and Bush administrations aggressively pursued the goal of expanding homeownership, so credit standards eroded. Lenders and the investment banks that securitized mortgages used rising home prices to justify loans to buyers with limited assets and income. Rating agencies accepted the hypothesis of ever rising home values, gave large portions of each security issue an investment-grade rating, and investors gobbled them up.

From 2000 to 2003, mortgage loans quadrupled. Sub-prime loans were preferred by lenders as they operated with higher interest rates, therefore resulting in more profit for companies. The housing bubble of 2001 to 2007 in the USA, UK and Europe was the biggest in history. Under this new mortgage system, home buyers were now indirectly paying their mortgage payments to investors worldwide through *collateralized debt obligations* (CDOs). Investment banks then paid rating agencies to evaluate *collateralized debt obligations*, often being graded AAA which is the highest credit rating available. Contrary to traditional mortgage lending, lenders now cared less whether borrowers were financially able for these CDO's. Investment firms were also careless, as the more CDO's sold, the more business and the more profit. Rating agencies were careless in their evaluation of CDO's as they hold no liability should their assessment emerge inaccurate. Deregulation of the housing / mortgage lending market ultimately led to low income families obtaining homes and mortgages that were financially unsustainable, and a financial system ‘co-operating’ with a flawed housing market was bound to lead to collapse. Soon after this, the market started to falter, people fail to make payments to lenders and the origins and destination of financial instruments or products (for example CDO’s and there subsequent debts) were unidentifiable within the over complicated financial market. This led to the credit crunch which then deprived business and consumers of investment funds and hastened the ‘Great Recession’.

Stage 2: Collapse of global markets post 2008

GDP began to fall in the USA in Q3 2008 and by 2009 was falling at an unprecedented rate not seen since before the 1950’s. Capital investment also began to deteriorate at this time, especially within the residential market of the USA hit by the bursting of the housing bubble. The significance of this is that traditionally, falling house prices and diminished construction are two of the first indicators of downward economic trends and a slowing on consumer expenditure in cycle and relation to company production / expenditure – therefore a recessionary period in the economy. As Pittman and Ivry, (2009) point out:

> The worst financial crisis in two generations has erased $14.5 trillion, or 33 per cent of the value of the world’s companies since Sept. 15; brought down Bear Stearns Cos. and Lehman Brothers Holdings Inc.; and led to the takeover of Merrill Lynch & Co. by Bank of America Corp.

Before the crisis, relaxation on the regulations of mortgage lending in the UK was also prevalent, though not as much as the US with slightly more controls over private practises. *Northern Rock*, a bank that was more suited to risky lending business procedure fell first in the wake of the subprime crisis collapse with no more availability for reselling of these risky products through the wider capital marketplace. This resulted in imminent collapse of the bank without bailout finance from the Bank of England. What initially resulted from this credit crunch and mortgage squeeze was greater scrutiny of borrowers. More specifications made secured mortgages harder to obtain and maintain for customers equalling less lending for houses in general. Less business equates as with any product or service, to a decline in house prices. The declining of house prices now produced negative equity for many customers, and this further exacerbated the overall economic state as mortgage defaults are more damaging for private companies as they are unable to reclaim the preliminary loan for the house.

What resulted from this dramatic drop in the value of the housing and financial markets is a widespread loss of consumer confidence, furthering the cycle of declining demand. Consumer spending had struggled against a backdrop of price increases in oil and energy since the start of the “Great Recession” of 2008 and decreases in manufacturing have declined at the fastest rates in over a decade. The construction industry has been extremely badly affected as a result of the “Great Recession” and is also held in importance for analysing the current weak revival of the economy. Many suggest that in terms of damage to economic growth, the duration of the downturn, unemployment, GDP, and most importantly the living costs and inflation upon flat wage increases to squeeze ordinary workers, this “Great Recession” is the worst financial meltdown since the “Great Depression” of the 1930’s. Others have suggested that the recession in the UK is currently reminiscent of the “double dip recession” of 1975.

The interdependence of Eurozone and UK production can be witnessed by dampened imports required from the UK since the ‘Great Recession’ of 2008, which has further damaged the prospects for internal manufacturing, production and job creation in the UK. This again relates back to the interdependence of nations on exports and imports in the modern global economy, and also how recessions are now globally contagious as opposed to recessionary periods of the past that insulated certain vicinities from others due to a lack of trade with neighbouring regions in difficult economic times in addition to healthy times.It is to this dimension of the ‘Great Recession’ that I now turn.

Stage 3: The impact of the Eurozone financial crisis

The Eurozone has recently negotiated a new fiscal compact strategy for boosting GDP, growth and sustainable lending by limiting all borrowing within individual member states at 3% of national output. Although this was originally passed in 1997 on introduction of the Eurozone, these lending regulatory rules were broken by member states. Italy, Germany, France, Spain and Greece were all major manipulators of this rule in their financial reporting regularly breaking this 3% instruction. Greece, Spain and Italy have fared the worst from this, with Germany being regarded as a safe investment haven due to excess cash resulting from exceptionally improving exports since Eurozone establishment, France not far behind in terms of business performance despite worse borrowing tendencies than Spain. Spain and Italy have long established private debts to coincide government loans that have multiplied the severity of the ‘Great Recession’ on their nations’ GDP and overall economic outlook for the near future. Greece's governmental debt crisis has now led the country to the verge of total financial collapse / exit from the single currency in the Eurozone. This impacts the Eurozone because ultimately it will be funds from the European Central Bank which decides monetary policy for all Eurozone states, or more indirectly - better faring nations like Germany. Germany has managed to escape any substantial losses in GDP due to its quality and demand of exports, which has to supply the funding for bailout packages for governments such as Greece, Spain and Italy. This is because certain legal requirements and regulations exist within the Eurozone under a single currency.

When Eurozone currencies were merged in 1999, they each gave up the privilege of printing their own currency for the purposes of quantitative easing – this places further pressure on the strategies suggested for the Eurozone. Various austerity packages have been supplied from the International Monetary Fund and the European Central Bank since the start of the financial crisis to alleviate these debts incurred. EU member states including Italy, Spain and France to a lesser extent have experienced extreme negative GDP growth, slowing production and stark unemployment increases. The key point here is that these southern economies are currently unable to pay interest on their loans. These austerity packages are for the purpose of reducing individual government / private financial deficits to restore the balance sheets of nations and attempt to resume economic recovery by encouraging new business and lending. Like the UK and US, house prices in the Eurozone have dramatically fallen and inflation has had to be actively controlled to avoid further squeezes on the living costs and poverty of much of these respective populations.

It's very possible that a cycle or domino effect of countries falling into bankruptcy could occur, especially in Europe. When government backed bailouts are the only systematic relief for failing banks, with so much influence on key attributes of recessionary periods and economic downturns, its plausible to predict that one nation could easily fall into national bankruptcy as a direct consequence of financial collapse elsewhere. This relates back to the significance of interdependency within the modern global economy. As one nation's imports reduce due to decreased demand, a neighbouring country in partnership for shipping those imports have lost export figures and therefore revenue of their own and the domino effect continues. This is a relatively new phenomenon that has arisen in correlation with the supposedly ever increasing prosperity of the increasingly globalised economy and loss of independence, swapped for interdependence with co-operating trade between partner nations. The switch to globalised trade has arisen in an immediate attempt to minimise overheads and provide the specific products demanded by nations that lack the materials and skills to produce and export their own of such. Traditionally, recessions have been contained from nation to nation because trade rarely crossed borders and therefore finances and economic states were relative to their specific constituency or nation in this case.

.Some nations have been affected much more than others and some countries have had various different stakes in their specific role towards the financial downturn, dependant on their individual banking regulations for example there has been more extensive use of subprime mortgage lending in the US than in the UK due to more regulatory influence within the UK financial system. Public spending has been a major factor of controversy in recent years due to the strain of the recession on government budget. Cuts have been made in virtually all government spending bodies, value added tax has been increased and Bank of England interest rates have deliberately been kept historically low at 0.5% to encourage banks to improve lending and start circulating money around the economy. This produces further problems for growth as government spending includes everything valuable to a developed nation including healthcare, education, training for new skills for new jobs created etc. *Quantitative easing* has also been utilised in an attempt to start circulating artificially created new money initially in the accounts of the Bank of England itself, then by purchasing government bonds from private financial institutions such as banks, insurance companies and pension funds. These financial institutions then use the proceeds of these sales to invest in companies and individual investors / enterprise, interest rates are in theory supposed to fall when more borrowing is resumed and more customers secure loan agreements. This results in more internal expenditure and flow of money, boosting economic activity. When more economic activity is created and economies improve in GDP data, the Bank of England eradicates these bonds by themselves selling them, therefore no real new cash has been created and economic performance has returned to 'normal'. Although quantitative easing is widely regarded as very useful in healing damaged economies, without consumer confidence secured and proof of healing markets, new business will simply not resume.

There has been much confusion, conflict and opposition to the US presidency in late 2011 on how to adjust economic policy to accommodate the demands of the recession with compromising measures taken by an agreement secured by the centre left politically positioned President Barrack Obama and the right wing dominated congress. Instead of merely lifting the national debt ceiling and raising taxes to justify increasingly high public spending, now deemed unaffordable by many, a phased progression in increasing the ceiling was confirmed in direct comparison to spending cuts and no tax increases in an attempt to increase productivity. There has been recent debate in the Daily Mail on similar system installation for the UK, as stated by Javid, (2011), "Why is there such backing for the idea? The figures speak for themselves. Over the past decade, our net public debt has rocketed from £312 billion to £920 billion (or from 31.5 per cent of GDP then to 60 per cent now). This happened because Labour chose the easy way out instead of trying to find solutions to the long-term challenges facing the public finances. It believed that the answer to every problem was to spend more money: so budgets and debt soared." This is an area of constant conflict between right and left wing political stances for the best policy performance suited to an economy.

Conclusion

In conclusion, it seems likely that the 'Great Recession' was both a natural progression stage of economic and market cycles within an interdependent economic system based on deep structural weaknesses. These structural weaknesses have emerged in the form of, for example, the housing bubble of the US, the false financial irregularities in Greek government and the private loans rule infringements regarding debt ceilings imposed in Italy and Spain. Once these problems are seriously addressed and austerity measures are beginning to benefit, then it's at this point, skilled, and valuable production may improve and grow with the economy lubricated by an honest financial system with integrity of its sales to suitable consumers. Financial regulation in future has to be found a balance by the economy that reflects an honest depiction of the state of the market. Private loan and government borrowing has to be kept to a minimum and based upon certain business production requirements, not speculation of future investments. The credit crunch, housing bubble and bailing of indebted governments are all branches of a universal problem which is essentially the same everywhere and that is loans need to be accounted for in all stages and levels of a nation's infrastructure therefore unreliable borrowings are toxic no matter what their credit rating. Overspending, whether individual or by large corporate structures is never good business procedure and doomed for failure eventually. Economic boom should be received as promising, but also suspicious.

The 'Great Recession' of 2008 is different to other post war recessions because it's a combination of spending and consumption factors and balance sheet imbalance / deficit. In balance sheet recession, banks, businesses, other corporate entities and governmental bodies become so indebted that austerity measures are forced to be taken. At these times, the values of assets diminish dramatically therefore decreasing their real wealth. Consumption also diminishes for the purposes of rebuilding wealth, banks become more cautious in their lending to ensure no losses of custom or defaulted payments and sustain capital as governmental bodies reduce public expenditure for national services for example healthcare, raise taxes to create revenue and attempt to provide whatever funds available for private banking institutions in debt. There does however remain the problem of the banks actually lending money rather than simply restoring their balance sheets. Until that problem is resolved we are unlikely to see a significant return to continuous economic growth.

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