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CAUSES OF GLOBAL RECESSION

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ABSTRACT

A Legion of both policymakers and scholars are at word analyzing the causes of global crisis to reach findings for both immediate and longer- term solutions (for example the de Larosiere Report (2009), the Geneva Report (2009), the group of Thirty Report (2008) and the IMF Lessons paper (2009). What one can attempt to do is to provide one's own interpretation of the unfolding of the global financial crisis? How it is affecting us? Why the Indian financial sectors has been able to whether the crisis relatively well? The economic crisis during 2007-09 started in American housing market because of the sub- prime lending by some of the financial institutions has now spread around the world .At a fundaments level, crisis could be ascribed to the persistence of loose monetary policy, light interest rates credit created policy. Many factors directly and indirectly caused the global recession. Major causes of the initial subprime mortgage crisis and following recession include International trade imbalances and lax lending standards contributing to high levels of developed country household debt and real –estate bubbles. In present research paper I highlight the causes of Global recession during 2007-09.

KEYWORDS:-Global, financial crisis, recession, economic crisis

INTRODUCTION

Recession is a business cycle contraction when there is a general decline in economic activity. Recession cycle are thought to be a normal part of living in a world of inexact balances between supply and demand. Scholars have not agreed on the exact causes and their relative importance. The search for causes is closely connected to the question of how to avoid a future depression. The even larger question is whether it was largely a failure on the part of free markets or on the part of government efforts to regulate interest rates, curtail widespread bank failures and control the money supply. The intensification of the global financial crisis, following the bankruptcy of Lehman brothers in September 2008, has made the current economic and financial environment a very difficult time for the world economy, the global financial system and for central banks. The fall out of the current global financial crisis could be an epoch changing one for central banks and financial regulatory systems. It is therefore very important that we identify the causes of the current crisis accurately so that we can then find first appropriate immediate crisis resolution measures and mechanism; second understand the differences among countries on how they are being impacted and finally think of the longer term implications for monetary policy and financial regulatory mechanism.

The proximate cause of the current financial turbulence is attributed to the sub- prime mortgage sector in the U.S.A. At a fundamental level however the crisis could be ascribed to the persistence of large global imbalances, which in turn were the outcome of long periods of excessively loose monetary policy in the major advanced economies during the early part of this decade.

Global imbalances have been manifested through a substantial increase in the current account deficit of the US mirrored by the substantial surplus in Asia particularly in china and in oil exporting countries in the Middle East and Russia. The global imbalances interacted with the flows in financial markets and instruments to generate the specific features of the crisis. The role of monetary policy in the major advances economies particularly that is the United States, over the same time period need to be analyzed for a more balanced analysis.

Apart from creating large global imbalances, accommodative monetary policy and the existence of very low interest rates for an extended period encouraged the search for yield, and relaxation of leading standards. Even as financial imbalance ware building up, macroeconomic stability was maintained. The stable microeconomic environment encouraged under pricing of ricks. Financial innovations regulatory arbitrage, lending malpractices, excessive use of the originate and distribute model and securitization of sub-prime loans were to result in the observed excessive leverage of financial market entities.

A global recession has resulted in a sharp drop in international trade, rising unemployment and slumping commodity prices. In December 2008, the National Bureau of Economic Research (NBER) declared that the United States had been in recession since dec, 2007. Several economists have predicted that recovery may not appear until 2011 and that the recession will be the worst since the great depression of the 1930s. The conditions leading upto the crisis, characterized by an exorbitant rise in asset prices and associated boom in economic demand are considered a result of the extended period of easily available credit, inadequate regulation and oversight or increasing inequality.

Fiscal and monetary policies have been significantly eared to stem the recession and financial risks. While this has renewed internet in Keynesian Economic ideas, the recent policy consensus is for the stimulus to be withdrawn as soon as the economies recover to “chart a path to sustainable growth”.

OBJECTIVE OF STUDY

The objective of the proposed research work is to find out the causes of global recession in developed industrialised countries and to make comparison of such causes with Indian conditions that is whether such causes may occur in India as well as outside India may face recessionary situation due to different causes.

RESEARCH METHODOLOGY

The present study is descriptive nature based on secondary data collected from the various websites, books and journals. The study attempts to the causes of global recession during the period 2007-09.

SUBPRIME LENDING AS A CAUSE

The term sub-prime refers to loan that are given to borrowers with unsatisfactory credit history and low repaying capacity, based on the assumption that sub-prime lending precipitated the crises some have argued that the Clinton Administration may be partially to blame, while others has pointed to the passage of Gramm- Leach-

Bliley act by the 106^{th} congress and over leveraging by banks and investors eager to achieve high returns on capital. Some believe the roots of the crisis can be traced directly to sub-prime lending by Fannie Mae and Freddie Mac , which are government sponsored entities. The Clinton administration pushed for sub-prime lending. Fannie Mae, the nation's biggest underwriter of home mortgages, has been under increasing pressure from the Clinton administration to expand mortgages loans among low and moderate income people.

CREDIT CREATION AS A CAUSE

Credit rating agencies play a crucial role in defining inverter confidence in financial market by providing information on the future credit worthiness of issuer security or obligation as of a given date. Monetary policy of central banks create excessive quantities of cheap credit by setting interest rates below where they would be set by a free market. This easy availability of credit inspires a bundle of mal investments, particularly on long term projects such as housing and capital assets and also spurs a consumption boom as incentives to save are diminished. Thus, an unsustainable boom arises, characterized by mal investment and overconsumption.

But the created credit is not backed by any real saving nor is in response to any change in the real economy, hence, there are physically not enough resources to finance either the mal investments or the consumption rate indefinitely. The bust occurs when investors collectively realise their mistake. This happens usually some time after interest rates rise again. The liquidation of the mal investments and the consequent reduction in consumption throw the economy into a recession, whose severity mirrors the scale of the boom's excess. The Austrian school of economies proposes that the crisis is an excellent example of Austrian Business Cycle theory, in which credit created through the policies of central Banking gives rise to an artificial boom.

The Austrian school argues that the conditions previous to the crisis of the late 2000s correspond exactly to the scenario described above. The central Bank of the United States, led by Federal Reserve chairman Alan green span, kept interest rates very low for a long period of time to blunt the recession of the early 2000s. Austrian economists argue further that while they probably affected the nature and severity of the crisis factors such as lack of regulation, the community Reinvestment act, and entities such as Fannie Mae and Fraddie Mac are insufficient by themselves to explain it.

GOVERNMENT ACTIVITIES AS A CAUSE

In 1992, the 102^{nd} congress under the George H.W. Bush Administration weakened regulation of Fannie Mae and Freddie Mac with the goal of making available more money for the issuance of home loans. The Washington post wrote:- congress also wanted to free up money for the Fannie Mae and Freddie Mac to buy mortgages loans and specified that the pair would be required to keep a much smaller share of their funds on hand than other financial institutions. Whereas banks that held $100 could spend $90 buying mortgage loans, Fannie Mae and Freddie Mac could spend $97.50 buying loans. Finally, congress ordered that the companies be required to keep more capital as a cushion against losses if they invested in riskier securities. But the rule was never set during the Clinton administration, which came to office that winter, and was only put in place nine years later."

OIL PRICES AS A CAUSE

Economists James D. Hamilton has argued that the increase in oil prices in the period of 2007 through 2009 was a significant cause of the recession. He evaluated several different approaches to estimating the impact of oil price shocks. On the economy some methods that had previously shown a decline in the relationship between oil price shocks on the overall economy. All of these methods, support a common conclusion, had there been no increase in oil price between 2007:Q3 and 2008: Q2, the US economy would not have been in a recession over the period 2007: Q4 through 2008:Q3." Hamilton's own model a time series econometric forecast based on data upto 2003, showed that the decline in GDP could have been successfully predicated to almost its full extent given knowledge of the price of oil. The result imply that oil prices were entirely responsible for the recession, however Hamilton himself acknowledged that this was probably not the case but maintained that it showed that oil prices increases made a significant contribution to the downturn in economic growth.

An empirical study by John B. Taylor concluded that the crisis was:

1. Caused by excess monetary expansion
2. Prolonged by an inability to evaluated counter- party risk due to opaque financial statements and
3. Worsened by the unpredictable nature of government's response to the crisis.

THE ROLE OF ASSET SECURITISATION AS CAUSE

The traditional mortgage model involved a bank originating a loan to the borrower and retaining credit risk. With advent of asset securitisation, the traditional model gave way to the 'originate to distribute' model in which the credit risk is transferred to investors through various financial products. In the original set up the lender and borrower know each others risks clearly. If the borrower defaults on the payment, the lender is directly affected and therefore would take all possible steps to recover the loan from the borrowers including selling the mortgaged assets.

CONCLUSION

Global financial crisis that originated in the US has during the period 2007-09 spread to the entire world some economists claim that the ultimate point of origin of the great financial crisis of 2007-09 can be traced back to an extremely indebted US economy. The collapse of the real estate market in 2006 was the close point of origin of the crisis. The failure rates of sub- prime mortgages were the first symptom of credit boom tuned to bust and of a real estate shock. But large default rates on sub-prime mortgages cannot account for the severing of the crisis. Rather low – qualities mortgages acted as an accelerant to the fire that spread through the entire financial system. The latter had become fragile as a result of several factors that are unique to this crisis, the transfer of assets from the balance sheets of banks to the markets, the creation of complex and opaque assets, the failure of rating agencies to property assets the risk of such assets and the application of fair value accounting. To these novel factors, one must add the now standard failure of regulators supervisors in spotting and correcting the emerging weaknesses. Let us hope that the policies work and the world would see the light at the end of tunnel.

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