

Central Bank of Nigeria

Ensure Monetary and Price Stability
Issue Legal Tender Currency in Nigeria
Maintain External Reserves to safeguard the international
value of the Legal Tender Currency
Promote a Sound Financial System in Nigeria
Act as Banker and Provide Economic and Financial
Advice to the Federal Government

ision

“To be a people-focused Central Bank promoting
confidence in the economy and enabling an
improved standard of living”

Mission Statement

“To **ENSURE** Monetary, Price and Financial System
Stability as a Catalyst for Inclusive Growth and
Sustainable Economic Development.”

Core values

Integrity
Partnership
Accountability
Courage
Tenacity

MONETARY POLICY DEPARTMENT

Mandate

To Facilitate the Conceptualization and Design of
Monetary Policy of the Central Bank of Nigeria

Vision

To be Efficient and Effective in Promoting the
Attainment and Sustenance of Monetary and
Price Stability Objective of the
Central Bank of Nigeria

Mission

To Provide a Dynamic Evidence-based
Analytical Framework for the Formulation and
Implementation of Monetary Policy for
Optimal Economic Growth

FOREWORD

The Understanding Monetary Policy Series is designed to support the communication of monetary policy by the Central Bank of Nigeria (CBN). The series therefore, explain the basic concepts/operations, required to effectively understand the monetary policy framework of the Bank.

Monetary policy remains a very vague subject area to the vast majority of people in spite of the abundance of literature on the subject, most of which tend to adopt a formal and rigorous professional approach, typical of macroeconomic analysis.

In this series, public policy makers, policy analysts, businessmen, politicians, public sector administrators and other professionals, who are keen to learn the basic concepts of monetary policy and some technical aspects of central banking, would be treated to a menu of key monetary policy subject areas that will enrich their knowledge base of the key issues.

In order to achieve the primary objective of the series therefore, our target audience include people with little or no knowledge of macroeconomics and the science of central banking and yet are keen to follow the debate on monetary policy issues, and have a vision to extract beneficial information from the process. Others include those whose discussions of the central bank makes them crucial stakeholders. The series will therefore, be useful not only to policy makers, businessmen, academicians and investors, but to a wide range of people from all walks of life.

As a central bank, we hope that this series will help improve the level of literacy on monetary policy and demystify the general idea surrounding monetary policy formulation. We welcome insights from the public as we look forward to delivering contents that directly address the requirements of our readers and to ensure that the series are constantly updated, widely read and readily available to stakeholders.

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UNDERSTANDING ECONOMIC RECESSION¹

Danladi Osude²

Abstract

This series explains the concepts of economic recession to enhance the understanding of its basic elements such as the technical definition, types, historical evolution, and effects on the economy. There are variants to the definition of economic recession but the most adopted is- a negative growth in Gross Domestic Products for two consecutive quarters.

The main causes of a recession could be classified into two broad categories namely endogenous (internal) and exogenous (external) factors. The endogenous factors include inconsistency in policies, regulatory negligence, overheating of the private sector, and excessive investment in the housing sector while the exogenous factors are mainly natural disaster, climate change, revolution, and war.

It is somewhat difficult to accurately predict recession, but certain indicators could guide policymakers about impending recessionary conditions and these factors include an inverted yield curve, decline in consumer index, sudden drop in stock market value, and rising unemployment. Effective management of a recession would involve a combination of monetary, fiscal, and structural policies such as tax cut, increase in government spending, reduction in interest rate, and downward adjustment in currency

Key Words: Recession, Gross Domestic Output, Business Cycle, Shocks.

¹This material is designed specifically as an educational material for enlightenment on the monetary policy of the Bank. Consequently, the Central Bank of Nigeria (CBN) does not take responsibility for the accuracy of the contents of this publication as it does not represent the official views or position of the Bank on the subject matter.

² This publication was originally authored by **Daniladi Osude** in 2013 (Assistant Economist in the Monetary Policy Department, Central Bank of Nigeria) and revised/reviewed in 2021 by **Samson O. Odeniran** (Assistant Director, Monetary Policy Department, Central Bank of Nigeria)

SECTION ONE

1.0: Introduction

The term recession falls within the division of macroeconomics that lacks perfect consensus on the technical definition, but the most adopted definition is a negative growth in Gross Domestic Output (GDP) for two consecutive quarters. This definition hinges on the notion that a healthy economy should grow over time, hence a negative growth in output for two straight consecutive quarters is an indication of an underlying problem. Another prominent definition is by the National Bureau of Economic Research (NBER), US, which defines a recession as a significant fall in the level of economic activity that cut across the economy and persisted for several months. The decline is normally discernible in real GDP, real income, employment, industrial production, and wholesales as well as retail sales. This definition appears to be more flexible because it recognizes a “W-shaped” behavior in economic activities as a recession.

Regardless of the definition adopted, a glaring feature is that recession represents a slump in the level of economic activities. Recessions are regarded as an integral part of the business cycle because every economy is affected by fluctuations in production, trade, and general economic activities over medium-to-long-term, particularly in a free market system. A free market economy is one where there is minimum or absence of government intervention in economic activities, as such, the interaction of demand and supply corrects disequilibrium (anomalies) in the market. The business cycle is the upward and downward movements of levels of gross domestic product (GDP), and refers to the period of expansions and contractions in the level of economic activities (business fluctuations) around its long-term growth trend. These fluctuations involve shifts over time between periods of relatively rapid economic growth (boom), and periods of relative stagnation or decline (a contraction or recession).

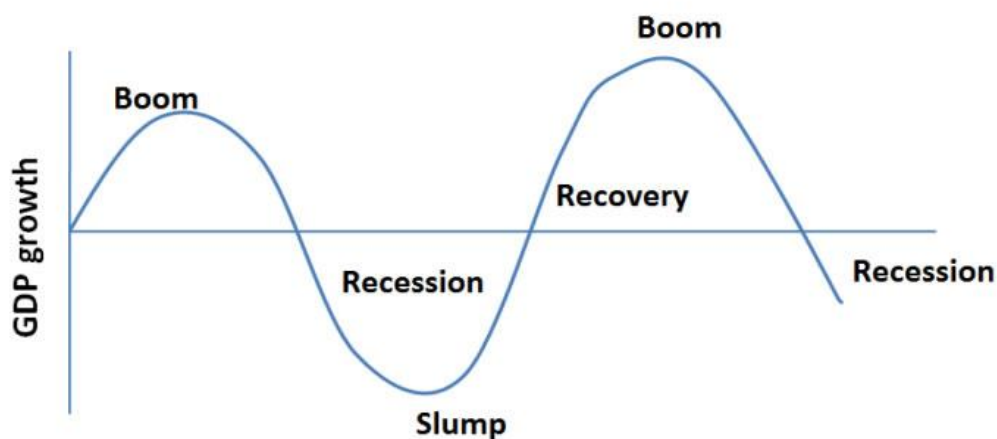
During a recession, there is usually a decline in certain macroeconomic indicators such as GDP, employment, investment spending, capacity utilization, household income, business income, and inflation, with the attendant increase in the rate of unemployment.

A typical business cycle, as demonstrated in Figure 1 has a period of booms (prosperity), followed by a period of burst, slump and recovery. During the boom period, there is minimal unemployment; high production and consumption; high standard of living; high inflation; and so on. It is a period when most

macroeconomic indicators are positive. In a recession period, economic activities slow considerably.

When economic activities reach the lower part of the chart (Figure 1), it is said to be in a slump (depression); a prolonged recession. Most macroeconomic indicators remain negative for a long time, usually more than two years. Subsequently, the cycle enters a recovery period. This is a result of the impact of fiscal policy (the use of taxes and government expenditure) and monetary policy (the cost and availability of money) to stimulate economic activities. Demand and other macroeconomic indicators begin to pick up, leading to increased investment and production of goods and services in the economy. Gradually, the boom would be restored, and the cycle continues.

Figure 1: Graphical Example of Business cycle



Against the background of controversies surrounding the definition of economic recession coupled with the dearth of educational series to fill the gap, this series discusses economic recession; concepts, causes and implications for the wider economy. Following the introduction, section II discusses the types and history of economic recession. Section III presents the causes and indicators of recession, while section IV contains the effects of a recession. The cases and management of recession are presented in section V and Section VI concludes the paper.

SECTION TWO

TYPES OF ECONOMIC RECESSION AND HISTORICAL PERSPECTIVE

2.1: TYPES OF ECONOMIC RECESSION

Based on the mode of occurrence, recession can be broadly classified into three categories as presented below.

Boom and Bust Cycles Recession: A stable macroeconomic condition is one in which the key variables are in equilibrium, in other words, they are around the long-term trend. Relatedly, an equilibrium condition is when there is both internal and external balance. When there is an excessive expansion in economic activities such that the variables perform above the long-term trend, it is normally regarded as a boom that is not sustainable. Such a boom would naturally be accompanied by a correction process, usually referred to as a burst. The burst phase of the business cycle is a recession.

Balance Sheet Recession: This occurs due to a sharp fall in business incomes, which is usually followed by a fall in the firm's assets. The decline in business income could result from exogenous factors such as natural disasters, a fall in consumers' income, and a shift in consumers' preferences. The drop in business income would increase corporate borrowings, which could make the firms vulnerable to interest rate risk

Depression: This occurs due to prolonged stagnancy in economic activities, which defies all forms of corrective policy measures. A notable one was the 1930s depression in the US.

2.2: HISTORICAL PERSPECTIVE OF RECESSION

The history of economic recession is as old as the history of humanity itself, dating back to the 3rd Century. This was the period of a Military Anarchy also known as an imperial crisis (AD 235-284), during which the Roman Empire came close to collapse as a result of economic depression, civil crisis, invasion and diseases. The crisis culminated in the assassination of Emperor Alexander Severus by his troops, resulting in competition for his succession. Consequently, the Empire split into three competing states by AD 258-260.

The resultant effect of the foregoing was hyperinflation in the Empire, necessitating years of coinage devaluation. During the period, fiat money was created to pay the salaries/bonuses of the Military, without accretion in real economic activities. Also, there was a serious disruption of Rome's extensive internal trade channels due to the crisis. The widespread civil unrest made it no longer safe for merchants to travel and the financial crisis that struck compounded the exchange with the

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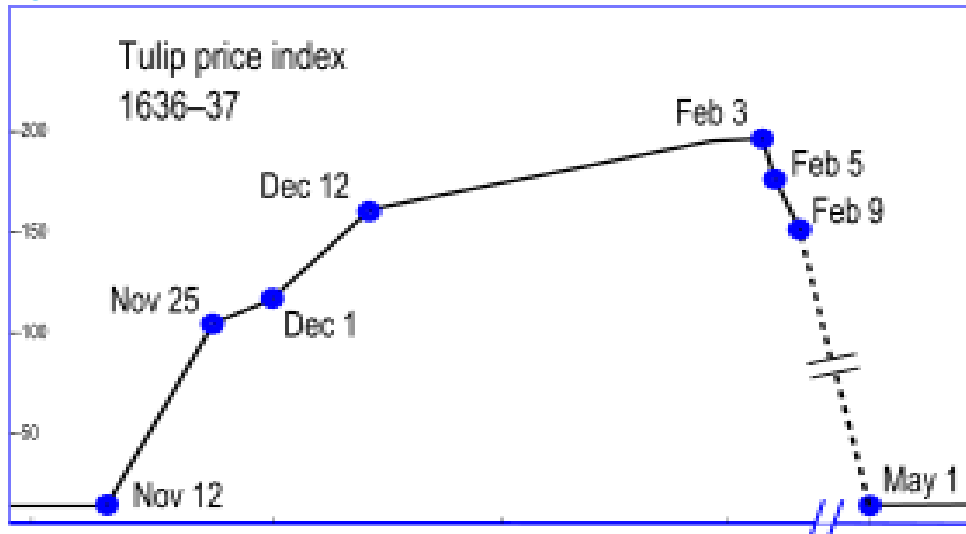
debased currency. This produced profound changes that, in many ways, would foreshadow the much decentralized economic character of the coming Middle Ages.

The 14th Century economic crisis stemmed more or less from the banking crisis, when the Bardi family and Peruzzi family lent Edward III of England a total of 1,500,000 gold florins which he failed to repay. The situation led to the collapse of the two family banks. During the 15th Century, the Bardi family continued to operate in various European Centres, playing a notable role in financing some of the early voyages of discovery to America, including those by Christopher Columbus and John Cabot (Guidi-Bruscoli, 2012). Besides Edward III of England, other notable rulers were indebted to the Bardi family and most of them defaulted.

The economic recession of the 17th century was a result of a Dutch prosperous era, during which the price for the supply of bulbs (from Tulip mania or Tulipomania) rose to a very high level and then suddenly collapsed. History stated that at the height of tulip mania around March 1637, one tulip bulb sold for over ten times the annual income of a trained artisan. The period was generally regarded as the first recorded speculative bubble, although, others argued that the Kipper-und Wipperzeit era of 1619 – 1622, when the whole of Europe experienced a series of reductions in metal content of coins to finance the war, was the first speculative bubble. Large economic bubbles are metaphorically referred to as Tulip mania in some quarters.

Tulip was different from other flowers due to its attractive petal colour, hence, its popularity began to spread to other parts of Europe. The emergence of the non-peril tulip as a status symbol during the period coincides with the rise of the newly independent Holland's trade fortunes, resulting in the rise of its golden age. Merchants made huge profits of up to 400 per cent exporting tulips to East Indies. As a result, the tulip became attractive luxury good and other varieties of tulip were introduced through mosaic virus (tulip breaking virus). The virus added to the beauty of the tulip, and at the same time weakened its reproduction as it took a long time to produce. This led to the scarcity of tulips, resulting in a significant increase in the price of the product. This resulted in speculative trading over time.

Figure 2: Tulip Price Index, 1636-37



Source: Wikipedia.org

The recession in the 18th century started with the stock price bubble of the South Sea Company. The South Sea Company was a British Joint Stock Company, established in 1711 as a public-private partnership (PPP) with the sole responsibility of reducing the cost of national debt. The company was established during Britain's war against Spanish secession, hence there was no way it was going to make a profit. This was because the company was given monopoly over South America, where Spain had greater influence. The value of the stock of the company rose principally on account of increased operations in dealing in government debt, peaking in 1720 before collapsing to a little above its original floating price; this became known as the South Sea Bubble. The share price crash affected many people at the time and reduced the value of the national economy. This was caused by several cases of abuse including insiders trading, parliamentary lobby, and margin trading.

Also, there was the peacetime Credit Crisis of 1772 in London, which then spread to other places like the Netherlands and Scotland. On June 8, 1772, Alexander Fordyce, a partner in the banking house Neal, James, Fordyce, and Down in London, fled to France to avoid debt repayment, and the resulting collapse of the firm stirred up panic in London. Economic growth was dependent on the availability of credit, which mirrors peoples' confidence in the banking industry. The default resulted in a run on banks which led to the collapse of the industry.

In the 19th century, there was the post-Napoleonic depression known as the post-war economic depression in Europe. In England, an agricultural depression led to

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the passage of the Corn Laws and placed great strain on the system of poor relief inherited from Elizabethan times. A major peacetime crisis was the Panic of 1819 that resulted in a financial crisis in the US and the general collapse of the US economy over three years. The main characteristic of the panic was the transition of the US from its colonial commercial status with Europe toward a dynamic economy, characterized by the financial and industrial imperatives of laissez-faire capitalism. The crisis was compounded by high speculation in public lands, fueled by non-regulation of the issue of paper money by banks. The development led to general banking apathy and the belief that government economic policies were flawed. This raised greater involvement in politics by the Americans to defend their local interest. The development led to the signing of the treaty between the US and Britain to end the war and other anti-trade regulations in 1812.

Following the situation in the US, was the Panic of 1825 that started in the Bank of England (BoE), which resulted in a stock market crash arising from speculative investment in Latin America. The crisis led to the closure of six London banks and sixty country banks in England. The crisis also extended to Latin America, Europe, and the US. It took the intervention from the Banque de France infusing gold reserves to save the BoE from total collapse. Economists term the crisis as the first modern economic crisis that was not exogenously induced by war. Thus, the particular crisis has been designated as the beginning of economic cycles.

In the US, a serious economic depression started in 1893, caused by excessive construction and faulty financing of rail construction. The effect of the crisis was the failure of so many banks and a run on gold supply. As a result of the Panic, stock prices declined. Five hundred (500) banks collapsed, 15,000 businesses failed, and many farms ceased operation. Timberlake et al, (1997) noted that the unemployment rate rose significantly during this period; Pennsylvania (25 per cent), New York (35 per cent), and Michigan (43 per cent).

In the 20th century, there was the Panic of 1907 (1907 Bankers' Panic or Knickerbocker Crisis) in the US, where the New York Stock Exchange (NYSE) fell by over 50 per cent from the peak it attained in the previous year. The panic occurred during the economic recession, and resulted in several runs on banks and trust companies. The panic spread to other states and local governments, and resulted in their bankruptcy. The panic was a result of a failed attempt in October 1907 to corner the market on stock of the United Copper Company. The failed attempt to corner the market resulted in a crisis of confidence as there was a massive run on the companies associated with cornering schemes and their affiliates.

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Preceding the great depression of 1930, was the most devastating stock crash in the US in 1929. It is the Wall Street Crash of 1929 (Black Tuesday or Stock Market Crash of 1929). The crash marked the advent of 10 years of the great depression, which did not spare any of the industrialized Western countries.

The great depression affected both the rich and the poor countries alike, as unemployment rose across the globe, world trade declined (due mainly to protectionist policies adopted by countries of the world), and demand for goods and services fell.

Other crises in the century include the black Monday (October 19, 1987) where the stock market around the world crashed within a short space of time, the Mexican economic crisis (1994) caused by the sudden devaluation of the peso, and the Russian financial crisis (August 17, 1998) similar to that of Mexico.

In the 21st century, there was the global financial crisis (GFC), which started in 2007, caused principally by the housing bubble in the US that peaked in 2006. The complex interplay of policies that encouraged homeownership, providing easier access to loans for (lending) borrowers, overvaluation of bundled sub-prime mortgages based on the expectation that housing prices would continue to escalate triggered the crisis. Also, questionable trading practices on behalf of both buyers and sellers, compensation structures that prioritized short-term deal flow over long-term value creation and a lack of adequate capital holdings from banks and insurance companies to back the financial commitments, were other reasons for the crisis. The crisis has been adjudged the most severe since the great depression of the 1930s. The crisis resulted in the collapse of many big businesses, distressed banks, mergers and acquisitions in some cases, and bailouts in some countries.

SECTION THREE

INDICATORS AND CAUSES OF RECESSION

3.1 INDICATORS OF RECESSION.

There are certain shocks like war or natural disasters that could lead to a sudden plunge in economic activities, but these types of incidents do not occur frequently. This, in essence, implies that recessions do not occur suddenly as there are always some events or signs that precede recessionary conditions such that careful monitoring of these activities by policymakers could give a reasonable guide about the direction of the economy. Some of these indicators are presented below.

- i. **An Inverted Yield Curve:** The yield curve is a plot of the yield on government bonds of different maturities. Under a normal condition in which the economy is functioning normally, the yield curve should be upward sloping, suggesting that bonds of longer maturities have a higher yield than short-term bonds. When long-term bonds, however, have lower yields than short-term bonds, it suggests that investors are wary of future economic conditions, pointing towards recession.
- ii. **Declines in Consumer Confidence:** Consumption is the key driver of economic activities in most countries, notably advanced economies such as the US. If results from surveys reveal a sustained drop in consumer confidence, it could be a sign of likely future loom in economic activities. A persistent decline in consumer confidence is an indication that economic agents are not willing to spend money, which would inevitably slow down the economy
- iii. **Drop in the Leading Economic Index (LEI):** The LEI uses a combination of variables to predict future economic trends. The variables are carefully selected, most often based on rigorous empirical analysis that confirms that the direction of their movements is ahead of the direction of GDP. The selection of the variables varies from one country to another and even within the same country, the movements of the variables in relation to GDP is time-dependent. Nevertheless, some variables that have shown consistency as leading variables in both cross-sectional and time dimensions are applications for unemployment insurance, new orders for manufacturing, and stock market performance. A decline in the LEI is an indication that recession may be in sight.
- iv. **Sudden Decline in Stock Market:** A massive and sudden decline in stock markets could be a sign of an impending recession, since investors usually

sell off parts and sometimes all of their holdings when they anticipate an economic slowdown.

- v. **Rising Unemployment:** When people begin to lose their jobs in rapid succession, it portends a dangerous sign for the economy. More often, than not, it reflects a difficult operating environment, hence, likely fall in output.

3.2 The Causes Of Recession

Recession can be caused by two broad factors: internal (endogenous) and external (exogenous). The former is usually because of conflict of ideas, misapplication of economic theory and regulatory negligence or policy inconsistency. The Asian financial crisis of 1997-1998 was caused partly by internal factors; banks were lending abroad in pursuit of high profit margin, due largely to slow downs at home, desire to pursue development without due consideration of economic fundamentals, corruption, and structural and policy distortions (Wong, 1999; Corsetti et al, 1999). Other factors were the overheating of private sector and excessive investments in real-estate with non-commensurate returns. In the same vein, the global financial crisis of 2007 and the ongoing recession was triggered by the United States housing bubble; excessive lending of banks into high-risk subprime and adjustable-rate mortgages resulted in high default rates as well as the downfall of the banking sector. Defaults and losses on other categories of loans also rose considerably as the crisis expanded from the housing market to other sectors of the economy. The bankruptcy of several highly rated investment banks started to panic on the inter-bank loan and stock markets and eventually, the bubble busted. This resulted in the fall of global GDP, rising unemployment and economic difficulties in many parts of the world (Kamar, 2012).

The external causes of recession have to do with factors that are exogenous to the economy over which policymakers have little or no control. Factors like natural disasters, climate change, revolution, and wars. An agricultural economy could face crop failure resulting in a general economic slowdown. Also, a mono-economy could suffer recession from international price shock for its product. The neoclassical economists are of the view that state interference in the market, labour union, monopolies and technological shocks are external causes of the recession.

To another group, negative demand and supply shocks as well as deflationary macroeconomic policies are the main causes of recession. The negative demand-side shocks that affect the aggregate demand work through a global economic slowdown that impacts major trading partners of a country. In the case of Nigeria, when there is an economic slowdown in the U.S., China, India, and the EU, it could have a negative impact on the demand for Nigerian crude oil from these

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countries. As a result, the government's revenue and spending would drop, taxes will rise, disposable income will fall and aggregate demand will fall, adversely impacting the production of goods and services. These developments would culminate in an economic recession. Also, a crash in asset prices as was the case during the GFC, credit crunch, where financial institutions reduced the amount of credit to support production could occur. Another source of negative demand shocks could be a sharp appreciation of the domestic currency, which encourages import and discourages export of goods and services, and causes disequilibrium in the balance of trade and deterioration in the balance of payments position.

Supply-side shocks cause of recession result mainly from general increases in commodity prices such as crude oil, metals and other non-fuel inputs, foodstuff prices, etc. These factors are inflationary. Inflation, which is the persistent rise in prices of goods and services, results because of the high cost of inputs, which are usually transferred to the final consumers who can only afford less quantity because of higher prices. This lowers demand for goods and services, reduces the standard of living, and ultimately depresses the production of goods and services by firms. The macroeconomic policies work more or less like the internal factors discussed above. Here, when monetary and fiscal policies are not well coordinated it results in recession. During contracting growth or economic slowdown, taxes ought to be lowered, and the government also ought to spend more to stimulate the economy. On the other hand, monetary authorities ought to encourage borrowing by households and businesses by lowering the interest rate. However, when the above policy mixes are not properly synchronized, it could further stifle the economy. Macroeconomic policies need to be complementary to achieve the desired result.

SECTION FOUR

EFFECTS OF RECESSION

A slowdown in economic activities affects all aspects of national life. A lot of elections are won and lost as a result of bad economic conditions. For example, the current American President (Obama) rode to electoral victory, because of the promised change to bring America out of the global economic crisis (GFC) prevailing at the time. Bank of America, Lehman Brothers, and other major companies in the U.S. and other parts of the world went down as a result of the GFC. There were also a lot of mergers and acquisitions (M&As) during the period. Many jobs are usually lost families usually adjust budget during the recession and in the process, social activities are also affected. This section discusses the impact of the recession on politics, business, employment and social life.

4.1 BUSINESS

When household incomes are cut as a result of economic slowdown, they reduce their demand for goods and services. As a result of low demand from households, firms reduce their production of such goods and services to cut costs and profit will decline. As a consequence of production fall, workers would be laid off, there will be no buying of new equipment, no funding for research and development, no new product rollouts and general business activities would also fall. The experience of the recent GFC showed that many businesses such as Bank of America, Lehman brothers in America to some local banks in Nigeria were affected. Recession affects both small and large business. Specifically, recession results in one or more of the following consequences on businesses:

4.1.1 FALLING STOCKS AND DWINDLING DIVIDENDS

Stocks prices mirror the performance of a business because they move proportionately to the returns earned. As revenues decline on the statutory reports of businesses, lower dividends are declared. This will depress the price of stocks in the market. The incidence that happened when share prices crashed across the world during the GFC may not be blamed entirely on this factor; however, this is partly responsible for the event. So many businesses lost their viabilities because of the risks they were carrying at the moment. When dividends fall or vanish, it creates other problems such as the sacking of the board of directors and senior management of the company. The advertising/marketing unit may be affected, creating unemployment problems for the economy. When the manufacturer's stock falls and the dividends decline or stop, institutional investors, holding the stock may sell and reinvest the proceeds into better-performing stocks. This will further

depress the company's stock price and affect the entire equities market and the cycle continues. For instance, the All-Share Index of the Nigerian Stock Exchange lost 65.4 per cent of its value from 57,814.92 on July 02, 2008, to 19,814.92 on April 15, 2009.

4.1.2 CREDIT DEFAULT AND BANKRUPTCY

The recession can also affect the ability of customers to pay their debt to the creditors, leading to growing non-performing loans (NPL). In the heat of the GFC, so many subprime debts went bad, thereby impairing the ability of debtors to service their debts. As a result, so many banks went bankrupt. Also, when debtors are not able to repay their debts, companies' ability to repay their creditors is hampered as a result of falling revenues. This leads to default in paying interest and the principal. The resulting consequence is debt downgrade and rescheduling. In the process, investors will lose confidence in the company and the company may not be able to raise money from the capital market again. When the source of funding ceases, the business will fold up resulting in employee lay-off, and increasing unemployment in the economy.

4.1.3 PRODUCT QUALITY COMPROMISE

Recession affects the revenue of firms, and by extension, profitability. To cut costs and improve its bottom line, the company could compromise product quality, and in the process lose its market share. A baker could offer the same loaf of bread at the same price but reduce major ingredients such as milk, butter, etc. to cut costs and improve the bottom line during the recession. Recession could force airlines to lower their maintenance standards to cut costs and break even. They may cut flights to routes that are not profitable and frequently cancel flights when there are insufficient passengers for a particular flight. This could cause some inconveniences to passengers, leading to economic loss.

4.2 FINANCIAL MARKETS

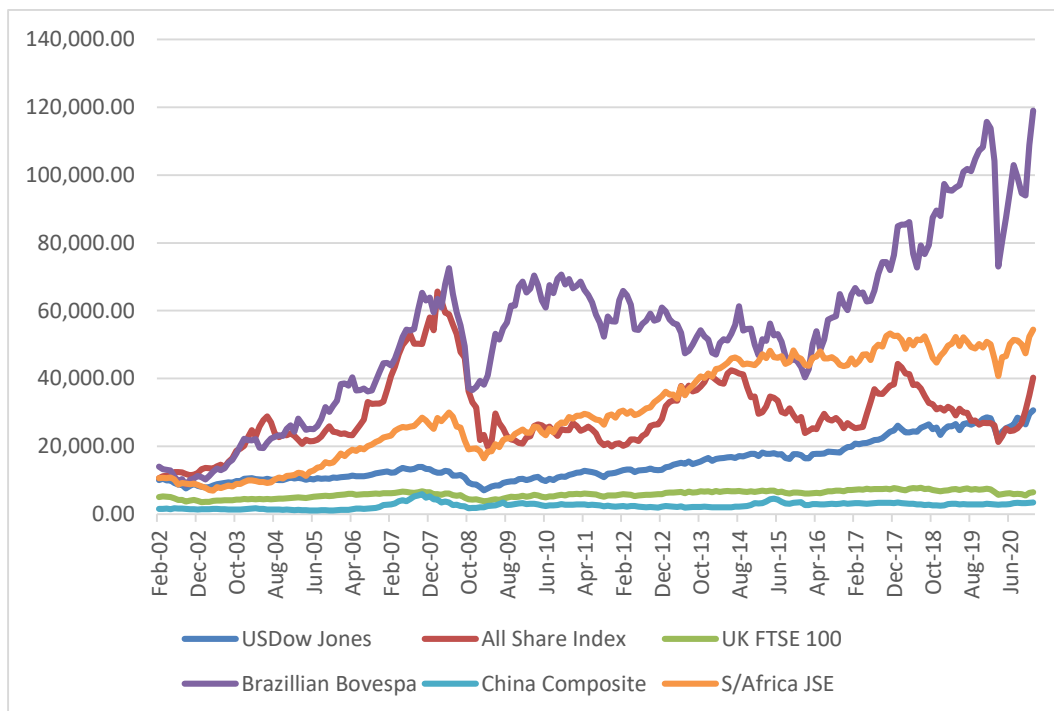
Another sector that usually takes the heat during a recession is the financial markets. Recession leads to general fall in interest rate, the crash of stock prices and rise in prices of some commodities (precious metal). Regulators usually lower interest rates to stimulate borrowing for investment that would lead to economic activities and growth. Most of the advanced economies of the world brought their interest rate to near zero during the GFC to stimulate economic activities through borrowing.

One noticeable event during the GFC was the crash of global equities markets. Equities prices mirror the performance of listed companies on the exchange. Any

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time investors notice a dwindling fortune with such listed companies, they usually offload their shares. There was a massive share sell-off in 2008, resulting in the crash of stock markets across the globe. As of October 2008, stocks in North America, Europe, and the Asia-Pacific region fell by about 30 per cent relative to the level in the early part the year while the Dow Jones Industrial Average dropped by 37 per cent during the same period.

Figure 3: Stock Market indices for some selected countries



Source: Bloomberg 2021

A common feature of the chart (figure 3) is that prior to the GFC, all the stock indices peaked; U.S., U.K. and China markets peaked in September 2009, while Nigeria, Brazil and South African indices peaked between the first and second quarters of 2008. Between the last quarter of 2008 and the first quarter of 2009 however, all the markets were brought to their knees and crashed because of the GFC. The same trend was equally observed from mid-2019 to early 2020 as most of the stocks peaked before the recession that resulted from the 2019/20 Coronavirus global pandemic. The phenomenon could be explained by the fact that recession triggers loss of confidence in the financial markets and as such, investors turned to assets that they perceived as tangible or sustainable. A sector that normally

benefits from the lull in the financial market is the commodity market. For example, the price of gold gained 30 per cent from the middle of 2007 to the end of 2008.

4.3 SOCIAL

Recession affects social life in some respects, from tourism to certain consumption of the household. According to Zagat's (2009), U.S. Hotels, Resorts & Spas survey, business travel has decreased in the past year as a result of the recession. Thirty per cent (30%) of travelers surveyed stated they travelled less for business today while only 21 per cent stated that they travelled more. Reasons for the decline in business travel include company travel policy changes, dwindled personal economic fortune, uncertainties and high airline prices. Hotels were responding to the downturn by dropping rates, ramping up promotions and negotiating deals for both business travelers and tourists.

According to the World Tourism Organization (2008), international travel suffered a strong slowdown beginning in June 2008, and this declining trend intensified during 2009. This resulted in a reduction from 922 million international tourist arrivals in 2008 to 880 million visitors in 2009, representing a worldwide decline of 4 per cent, and an estimated 6 per cent decline in international tourism receipts.

4.4 POLITICS

The recession led to electoral misfortune, though democratic institutions continue to exist. In the U.S. for instance, the Republicans lost the 2008 elections partly as a result of the GFC that started in 2007. The GFC was an offshoot of some of the policies of the Republican government under President George W. Bush. Business Week in March 2009 stated that global political instability was rising fast due to the global financial crisis, creating new challenges that needed managing. The Associated Press reported in March 2009 that "the United States Director of National Intelligence Dennis Blair has said the economic weakness could lead to political instability in many developing nations." Even some developed countries experienced political instability.

There were several civil unrests in Greece as a result of some conditions set by the trio of the International Monetary Fund (IMF), the European Commission (EC), and European Central Bank (ECB) to bail out the country from sovereign default. Greece found itself in the condition as a result of debt overhang that resulted in its sovereign default in 2012. The GFC and recession worsen the debt crisis of Greece, resulting in many failed elections.

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In January 2009, the government of Iceland was forced to call early elections two years ahead, after the people of Iceland staged mass protests and clashed with the police due to the government's handling of the economy. Hundreds of thousands protested in France against President Sarkozy's economic policies, and he eventually lost in his re-election bid in 2012 to the socialist candidate, François Hollande, who won with 51 per cent of total votes cast.

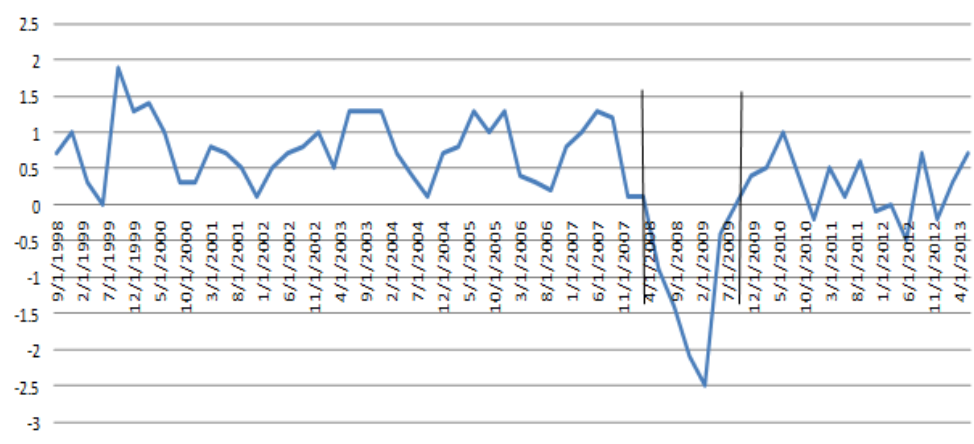
SECTION FIVE

TYPICAL CASE AND MANAGEMENT OF RECESSION.

5.1 TYPICAL CASE OF RECESSION

In this section, effort is made to present the GDP of some countries to show how a recession affects general economic activities of a country, and to portray the technical definition of recession, which is a 2-quarter of consecutive negative declines in GDP of a country.

Figure 6: Quarterly GDP growth rate in the UK: Q3:1998 - Q2:2013 (Update)



Source: Bloomberg 2013

The GFC affected the U.K. economy negatively as can be seen from figure 6. From the peak in the GDP growth of 1.3 per cent in the second quarter of 2007, the economic growth rate plummeted to -0.9 per cent in the second quarter of 2008 and remained in recession for five consecutive quarters till the second quarter of 2009.

5.2 MANAGEMENT OF RECESSION

A recessionary condition always requires multidimensional and coordinated responses from policymakers, involving both fiscal and monetary policy measures. Since the key issue borders on the need to stimulate output growth, the direction of macroeconomic policy should always tilt towards an expansionary. Some of the policy measures normally employed to address recession are presented below.

- i. **Tax cuts:** This is one of the fiscal measures that could support the recovery process during the recession. The underpinning thesis is to enhance the disposable income of households and firms, which in turn would increase their

spending capacity and overall aggregate demand. Considering the axiom that demand always creates its supply, the increase in aggregate demand would encourage firms to produce more goods and services, hire more labor, and ultimately lead to an increase in output. The major drawback of this approach, however, is that if economic agents were highly leveraged before the tax cut, the extra disposable income from tax cut may be channeled towards repayment of their debts rather than on consumption.

- ii. **Increased Government Spending:** Another fiscal measure to address recessionary condition is an increase in government spending. This is often encouraged than tax cuts because tax cuts could reduce government revenue which would be difficult to restore even when recovery has been achieved. Increased government spending, particularly on capital investment leads to employment of more resources with the multiplier effect having a positive spillover on the entire macroeconomic space. The key challenge is that since government revenue is equally adversely affected during a recession, how would government fund the required higher expenditure? A normal approach to resolving this puzzle is for government to borrow particularly external borrowing.
- iii. **Reduction in Interest Rate:** This is another monetary policy tool, normally employed to stimulate economic activities during a recession. The central banks reduce their policy rate, which is expected to transmit to other rates in the economy. This action should lead to a reduction in interest payments by households on their loan commitment to a financial institution, thereby enhancing the level of disposable income and aggregate demand. Furthermore, it is also expected that businesses and firms would borrow at a lower interest rate, thereby reducing the cost of production and ultimately spur a higher level of production and profit. Another channel is that reduction in interest rate would reduce returns on fixed income instruments, shifting investors' sentiments to the equity market which would lead to appreciation in the value of equity. This, in turn, would improve the net worth of firms and ultimately enhance their capacity to source more funds for expansion.
- iv. **Currency Adjustment:** This is a monetary policy measure that could be used to stimulate the economy from the external sector side. A downward adjustment in the value of the domestic currency through depreciation or devaluation could enhance the competitive strength of the external sector and invariably, aid the recovery process. This is possible where both export demand and export supply are price elastic, a condition that exists mostly in the advanced economies. For most emerging and developing economies, that are mono-product and export unprocessed produce, currency devaluation may not be beneficial. It is equally argued that even in the advanced economies, currency devaluation could trigger a countervailing response from other countries, leading to a price war, that will inevitably hurt global trade.

- v. **Quantitative Easing:** This is always regarded as non-conventional monetary policy measures. It is usually applied by central banks to influence the level of money supply when interest rates are already at, or near, zero. Thus, it is a tool for overcoming zero-bound constraints of conventional monetary policy tools. Quantitative easing is normally deployed by monetary authorities when all other options seem to have been exhausted, or to complement other options. The approach involves the purchase of securities, which would increase banks' reserves such that the banks would be able to increase lending to support economic activities. In addition, the purchase of bonds by central banks helps to reduce the bond interest rates, which could equally increase investment spending. The drawbacks of quantitative easing, however, include difficulty in determining the exact level of injection required by the economy, likely financial losses by central banks, possible upside risk to inflation over the medium term and, the possibility of a loss of confidence in the economy by external investors.

SECTION SIX

6.0: CONCLUSION

A recession is a business cycle contraction, referred to as a general slowdown in economic activities. During a recession, there is usually a decline in certain macroeconomic indicators such as GDP, employment, investment spending, capacity utilization, household income, and business income. Recession, as a challenge to macroeconomic condition, has a long antecedent, pre-dating the 17th century. Recession could be caused by two broad factors: internal (endogenous) and external (exogenous), and its impact could be across the various sectors such as business, financial markets, stocks and dividends, product quality, credit conditions, and even socio-political structures.

Effective containment of recession would involve the deployment of both monetary and fiscal policies to stimulate investment and achieve enduring growth. Monetary authorities can pursue accommodating/easy monetary policy to stimulate economic activities. This is a situation where monetary authorities reduce the policy rate to lower the cost of credit. In addition, the monetary authority could lower eligibility conditions for banks to access the monetary authority's window. When monetary authority lowers the interest rate, it is to encourage individuals and businesses to borrow more funds to finance consumption or expand productive capacity. Individuals and businesses pay less interest on borrowing thereby making it possible for them to repay the interest and the principal amount borrowed. When consumption increases, companies produce more, hire more workers and buy more raw materials for production, and in the process stimulate economic activities that would end a recession.

At other times, the monetary authority can also embark on unconventional monetary policy or quantitative easing (use of things other than the interest rate and market forces to affect money supply) to stimulate the economy. This is done when monetary authorities inject money into the banking system to shore up banks' balance sheets or by buying government securities from the secondary market (a market where securities like bonds are traded), thereby injecting money into the economy to stimulate activities.

The actions of the monetary authority could be complemented by fiscal measures. The fiscal authority could equally pursue a loose stance to restore growth. Government can lower taxes on individuals and businesses thereby freeing additional resources to the household and businesses for consumption and investment. Another instrument at the disposal of the government is to increase

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their spending in real activities during a recession to bring about growth. When taxes are lowered for individuals and businesses, extra money is made available for consumption or investment. If consumption rises, businesses spend more to produce additional goods and services, which would result in more employment and results ultimately in increased economic growth. Finally, the government could embark on essential structural reforms to improve transparency and stability of both the financial system, and fiscal activities to restore confidence in the economy during a recession.

GLOSSARY

Acquisition: It is the expansion of a company through the purchase of others.

Balance of Payment (BOP): It is an overall statement of a country's economic transactions with the rest of the world over some time, usually one year.

Balance of trade: It is the difference in value of a country's visible exports over visible imports. It constitutes a major component of the current account in the balance of payments.

Credit crunch: This is a state in which there is a short supply of cash to lend to businesses and consumers and interest rates are high.

Equilibrium: It is a situation where nobody (economic agent) has any immediate reason to change their actions, to allow the status quo remains temporarily.

Economic bubbles: Occurs when asset prices deviate from their inherent values

Fiscal policy: This involves the use of taxation and government spending to influence the economy.

Inflation: This is the general and persistent increase in the prices of goods and services in an economy.

Mergers: It is the combination of two or more firms into a new one.

Monetary policy: This is the use of interest rates by monetary authorities to control the availability and cost of money.

Non-Performing Loan: This is a debt on which payment of interest and principal due is not made.

Recession: This is a situation when there is a slowdown in demand, real output is falling, and unemployment is increasing. Technically, it refers to a situation when the gross domestic product (GDP) falls for two consecutive quarters.

Sovereign default: A sovereign default is the failure or refusal of the government of a sovereign state to pay back its debt in full. It may be accompanied by a formal declaration of a government not to pay (repudiation) or only partially pay its debts (due receivables), or the de facto cessation of due payments.

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