Determining Factors of Persistent Recession in Developed Economies

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Abstract
Despite the apparent recovery, the economies of developed countries seem to enter again in recession. The most important signs of this possibility are the precarious state of the labor market, consumer skepticism and lack of confidence and a global debt crisis by which the national governments seem overcome. An additional worsening of the situation in any of these problem areas and in other, strongly connected areas, would be enough to trigger a new global economic crunch.

Key words: Recession, consumption, unemployment, debts, taxation, crisis, consumer.

JEL Classification: G01

Introduction
The economic recession can be described in general terms as a period of time in which the economy of a country or region slows down its growth or enters a phase of decrease. It is generally characterized by a drop in the people’s consumption, a drop in industrial production, increasing unemployment, drop in the people’s individual income and an unhealthy stock exchange market. These factors are interconnected in a cycle that must last at least for 6 months in order for the period of economic slowdown to be considered recession.

The economic recession, when it occurs, can be monitored by analyzing the respective factors and analyzing their interconnection. The economic and financial crisis that currently affects the Western developed economies is apparently drawing to a situation in which after an initial period of recession, the economy enters a stage of temporary recovery and then falls back into recession (Investopedia, 2012).

Generally speaking, the probability reentering and mentaining in a recession is indicated by the drop in the consumption of goods and services as a result of the growing unemployment and spending cuts from the first stage of the recession. These general factors are doubled by others that are less conspicuous yet equally important due to the cause-effect interconnections among them.

Practically, the fact that the current crisis facing the developed economies today seems to evolve on such a path is indicated by the situation and specific development of unemployment, the consumption levels for physical and legal bodies, taxation, certain sectors of the economy and/or of the markets for certain categories of goods, etc. Their development can vary from one country to the next, but in whole, we can use them to
assess somewhat precisely the tendency in which the crisis-stricken developed economies as a whole may evolve.

1. Situation and development of the main economic factors

Despite the fact that some specialists in the field believe that the likelihood of the developed economies to fall back into recession is not necessarily very high, if such a prospect becomes real, it will have grievous consequences for them. These economies, if they cannot cope, risk crumbling rapidly, while their prospects for recovery are very difficult to anticipate. For investors, a comeback of the recession would be tantamount to a comeback to the situation in 2008, which was characterized by plummeting profitability of the shares. And the exchange market indicators showed such a possibility as early as end 2010 (Roos, 2012).

In July 2011, the economic figures showed that the US economy was entering a new recession. If we factor in the situation of the European countries (where Greece is practically bankrupt), we can consider that the current crises of the developed economies is very close to acquiring the characteristics of a W-type economic cycle. This development seems to be confirmed by the way in which properties values and real estate values evolve, but mostly by unemployment, which remains persistent and with reserved prospects of alleviation, even if its drop in real terms these last 5 months has exceeded expectations. The imminence of a new recession becomes evident if we analyze the situation and development of several economic indicators such as inflation, unemployment, taxation and consumption levels.

1.1 Inflation

Inflation, especially through the rapid growth of prices on consumer goods, is one of the factors with the highest impact on consumer confidence. In general, the consumers in crisis-stricken economies have already experienced a relatively significant decrease of their purchase power for both non-food and food staple goods (McIntyre, Ten Signs the Double-Dip Recession Has Begun, 2011). The price on cotton has increased by 20%, the price on coffee by 17%, on clothes by up to 20%, and in general, the consumers in developed countries pay more for sugar, meat, flour, etc. (McIntyre, Ten Signs the Double-Dip Recession Has Begun, 2011). In time, this phenomenon can affect the purchase of goods and services that are meant to meet higher needs.

1.2 Unemployment

Unemployment is one of the most serious problems caused by the global crisis which started in 2007 and is one of the main hurdles to sustainable growth for the concerned economies. Despite the fact that jobs have been created these last few years and the effect of temporary jobs is relatively less important, as a whole, the process of creating new jobs is too slow to allow durable and sustainable economic growth (Baden & Silverblatt, 2010).

In the short run, unemployment causes two major problems (McIntyre, Ten Signs the Double-Dip Recession Has Begun, 2011). The first refers to (a) the consumption spendings of the people affected by unemployment, while the second (b) refers to the level of the necessary expenditures for helping the unemployed. The drop in the unemployed people’s consumption spendings (a) seriously impacts the activity of consumer goods producers and suppliers and implicitly causes a drop in the GDP. The unemployment benefits (b) trigger an increase in the budget deficit; therefore, governments have to cut other expenditures, which in a kind of spinning effect additional impact the consumption of the employed and the activity of the companies. Thus, implicitly, this contributes to an even further increase in unemployment.
Unemployment causes medium and long-term problems as well (Baden & Silverblatt, 2010). They include notably (1) a fall in the younger generation’s consumption power, and (2) an increase in the financial and economic difficulties of larger families and local communities. The fall in the young people’s consumption power (1) is the indirect result of aggravating unemployment and is also caused by an ageing population correlated to the economic situation of physical bodies. People over-60 years of age have to work a longer period of time following the drop in the value of their real estate, which was the basis of their income after retirement. Therefore, these people occupy relatively well-paid jobs that younger people could have had. In their turn, the young people have to accept lower wages if they want to enter the labor market, which affects their consumption power that reaches a normal maximum much later, long after they turn 30. This will have a negative impact on the GDP in developed countries for the next decade.

The increase of financial difficulties for families and community (4) is an even more serious problem triggered by unemployment. It is caused by the fact that once the period for receiving unemployment benefits ends, the respective people practically start living on the expenses of their family members, their friends and the community they belong to, and sometime of NGOs. A family that must support an unemployed member cannot afford other expenditures but those for their basic needs (the prices of which is rising). Moreover, there can also be an increase in the state expenditures for the programs meant to help these people. In the current situation, the number of unemployed people who have reached their unemployment benefits time limit is high both on the US and EU markets.

The first reports of early 2012 about the US market show an increase in the labor occupancy and a drop in unemployment from 8.5% to 8.3%; this development has exceeded expectations. Nevertheless, the US market would need the labor occupancy to increase by 6 mil jobs in order for the labor market to return to the 2008 situation.

1.3 Taxation
Growing taxation on the US market was imminent (Baden & Silverblatt, 2010) considering that some tax reduction programs have expired in end 2011. Estimates show that if taxes rise by 1% of the GDP it would lead to a 3% drop of the GDP, while taxes are expected to actually rise by 2%. This would mean a drop in the US GDP by 6% than its expected value, which will be an important trigger for the country to fall back into recession. In the EU Member States that are already affected by the sovereign debt situation and forced to take tough austerity measures, increasing taxation is already in full swing, even if in some cases it has meant only an increase of the VAT.

1.4 Consumption
The consumption level is directly influenced by the consumers’ confidence in the development of the market in general and of the labor one in particular. The current tendency on the crisis-stricken markets is an increasing propensity for saving rather than spending. Yet, the comeback to a favorable development in this area does not appear probable considering the way the labor market is developing and the fact that general pessimism remains dominant. Moreover, there is a feeling of mistrusts among employers as well, who are not tempted by major development investments either (Baden & Silverblatt, 2010).

2. Situation and development of other economic factors
The four factors that we have analyzed so far are closely connected to the state and evolution of (1) consumer confidence, and (2) budget deficits of the countries experiencing
the crisis. Moreover, (3) the access to credits for physical and legal bodies as well as (4) spending cuts of governments and companies are also important.

2.1 Consumer Confidence

According to recent studies (Baden & Silverblatt, 2010), consumer confidence is dropping. This phenomenon is connected to the consumers’ worsening perception about the prospects for their personal and professional life (especially for a job). Both phenomena can be factors that could negatively impact the recovery of crisis-stricken economies, yet this would not necessarily mean a fall back into recession. It can rather mean a “wait and see” attitude of the consumers towards the way the labor market may evolve. Moreover, consumer confidence is not easily assessed. O series of research studies (Consumer Confidence Survey®, 2012) shows that consumer confidence is actually high, higher than in January 2008.

2.2 Budget Deficits

The fact that budget deficits are high and very high both in the EU and the US makes it impossible for stimulus financial packages to be granted or investments to be made, which are essential solutions for a complete recovery of the economies that are currently in recession. Moreover, the deficit triggered tough austerity measures both in the US and the EU Member States, especially in the Euro-zone. The effects of these measures were felt in the level of consumption, the decrease of which has additionally impacted the crisis-stricken economies, as well as the unemployment level, which subsequently rose (McIntyre, Ten Signs the Double-Dip Recession Has Begun, 2011). Furthermore, the general distrust with the way in which the Euro-zone economies evolve can be one of the most important triggers of a new recession and a W-type economic cycle.

2.3 Physical and Legal Bodies’ Access to Credits

The very limited access to credits seriously impacts the economic activity of small and medium-sized companies and people consumption. The larger companies are less hit due to a higher volume of liquidities and better business balance. On the other hand, banks are more reluctant to give loans to companies with less than 100 employees because they have a narrower client pool and therefore lower profits and a lower cash flow (McIntyre, Ten Signs the Double-Dip Recession Has Begun, 2011), although they are the main drive of these economies. For the time being, there is no concrete policy to remedy this situation. Physical bodies find themselves in the same situation as the small and medium sized companies. The associated costs of credit cards exceed 20% even in the US, where the Federal Reserve gives loans to the big financial institutions with an almost 0% interest rate. The buyers on the real estate market are also asked interest rates of over 20%, which hinders the recovery of this sector. Moreover, the private owners of real estate they bought on credit cannot sell it and have to limit their consumption to the mere basic needs of goods and services.

2.4 Governments and Companies’ Spending Cuts

The spending cuts of both governments and companies were mainly meant to decrease the countries’ budget deficits. Although is a generally appropriate measure, it can prove unfortunate in the current state of the world economy. Many European countries, especially Spain and Greece, are in full process of implementing severe austerity programs that combine expenditure cuts with tax increase. In the US, on the other hand, the situation is unclear, dangling between austerity measures or maintaining a deficit that would allow the government to stimulate the economy. On the whole, the governments of the developed countries are caught between the option of cutting spending in order to reduce their huge budget deficits at the expense of the economic growth and the option of stimulating the economy in an effort to help it recover. The problem thereof is how long these governments
can afford to wait before taking action. The danger is that amid a very fragile economic recovery, the result of the waiting would be not only a falling deficit, but also a falling budget by at least 1% (Baden & Silverblatt, 2010), which is quite a high percentage given that the economic growth rate is even less than that.

Conclusions

The current situation of the developed economies represents a new state of recession, marching towards a “liquidity trap”: a recession in which the credit interest rates do drop at nearly 0%, yet this does not stimulate the economy. Theoretically speaking, such a decrease of the interest rate should encourage consumers and companies to ask for loans and consume. Nevertheless, if too many of them are concerned with saving money and paying back their outstanding loans, the low interest rates have little effect on the investment and consumption behavior.

One of the remedies for a “liquidity trap” is to provide cash by issuing money or by other means in order to increase quantitatively the acquisition of goods, which leads to an inflationist tendency that resumes consumption. Another solution is for the state to spend more in order to stimulate exports and reduce imports or to use other techniques of stimulating demand. Estimates say that in the current crisis which affects the developed economies that make for 70% of the global GDP, these countries are caught in a liquidity trap (Krugman 2010). This situation seems to be confirmed by the poor or at best stagnant state of these economies.

In September 2011, the IMF warned the European states and the US about the danger of a falling back into recession following the failure to solve the financial and structural problems. The resumption of the economic growth may be affected by the deepening sovereign debt crisis in the EU Member States and the precipitated actions taken to reduce the US budget deficit. The structural problems in the crisis-stricken developed economies are also more difficult to solve and the reforms harder to implement than it was previously held. In general, the perception of the economic – and not only economic – circles is that the European leaders have lost or are losing control over the development of the economic crisis, which makes the Euro-zone to be seen as a source of serious concern.

In this context, the economic outlook for the Euro-zone countries is rather pessimistic. Their governments are concerned with reducing the budget deficits, but the private sector seems unable for the time being to compensate the dropping demand on the markets. Furthermore, the global misbalances between the countries with large budget deficit, such as the US, and large budget surplus, such as China, seem to be growing continuously worse. The financial markets have grown distrustful of the governments’ ability to stabilize the budget situation of their countries, which increases the risk of a slowdown of the already fragile economic growth. This will make fiscal consolidation even more difficult, which, in its turn, can further lower the growth pace following the negative impact on banks.

References


