Recession in USA-Slowing Down of World Trade

Introduction

Different economists define the term "recession" in different ways. But, in general they all call recession as general slowdown in overall economic activity, lasting long enough and universal in its character. In case of a recession, economical decline spreads across the entire country, distinguishing it from structural crisis in separate industries. More over true economic recession can only be confirmed if it lasts for a period of two or more consecutive quarters in order to nullify seasonal effects. Due to globalization of modern business, recession easily crosses national borders and strikes whole regions or World economy partially or at times entirely.

A normal business cycle consists of four successive phases: expansion, boom, recession and crisis. Each phase is important for transition of a cycle. Not only different social and economic contradictions gain momentum during a recession and crisis but also a basis for future growth is built. Over long-term period, the highs and lows of business cycle form the trend, or average, economic growth rate. A recession becomes visible through decline of all major macro economic indicators: GDP (Gross Domestic Product) growth slows down or goes negative; production, investment spending, household incomes and spending decline while bankruptcies and unemployment rate rise. Being a part of natural business cycle a recession inevitably follows any economic boom.

Factors Causing Recession

There are various factors that may cause a recession to be divided in two large groups – internal (endogenous) and external (exogenous). The last one is represented by various forces; major obstacles of catastrophic nature: wars, revolutions, natural disasters. Economy of agricultural countries may be influenced by climatic changes, crop failure etc. Economists working in the neoclassical tradition also consider State regulations, labor unions acts, business monopolies and technological shocks as exogenous factors of a recession. In most cases external factors explain all crises prior to The Great Depression in 1930s. The longest and deepest depression of the 20th century happened during period of political stability and was caused by structural crisis in USA.

Internal causes of a recession could be resolved to accumulation of fundamental contradictions in an economical system. For example, Asian financial crisis in 1997-1998, which lead to global recession, was caused by overheating of private sector. Excessive investments in real-estate and production did not earn acceptable return. Large scale corporations used political leverage to create so called “cronyism” where resource allocation is based on personal relationship between managers rather than risk/return assessment. As a result foreign investors made risk valuation adjustment; overloaded private debt coupled with capital outflow sparked currency crisis.

World financial crises in 2008 and current recession are also caused by internal factors. It was triggered by The United States housing bubble – extensive lending of American banks into high-risk “subprime” and adjustable rate mortgages resulted in default rates overgrowth and downfall of banking sector financial indicators. Defaults and losses on other loan types also increased significantly as the crisis expanded from the housing market to other parts of the economy. Bankruptcy of several high rated investment banks started panic on the inter-bank loan and stock markets. Rapid growth of interbank interest rates and international liquidity crisis made serious impact on emerging markets, especially Russia and Ukraine. Soon recession became global leading to GDP fall, heightened unemployment and economic hardship in many countries.

Adequate government regulation may significantly reduce negative outcome of a recession. Experience of several last years is carefully examined by international organizations and institutes. As a result new approaches to elimination of existing global imbalances are formed. The OECD recommends to its member states to proceed with essential structure reforms in order to improve transparency and stability of financial system. Countries will also need to deal with too-big-to-fail problems associated with systemically important financial institutions, whose failures have exposed significant vulnerabilities in many countries during the crisis. Other tasks are to achieve better capital adequacy and liquidity standards; strengthen the quality of financial infrastructures; refining legal frameworks and to orient the investment inflows toward the longer term.

Global trade plunged by nearly 30 percent relative to GDP during the Great Recession of 2008-2009. The average of imports and exports relative to GDP for the four largest economies in the world: the United States, Japan, China, and Germany. Trade/GDP fell

sharply in each of these countries since 2008. This large drop in international trade has generated significant attention and concern. Given traded goods sectors such as durable manufactures are procyclical, one explanation is that trade fell relative to GDP due to the changing composition of global output in the recession. Another is that increasing trade frictions at the international border, broadly defined, might be the culprit. The bulk of the decline in international trade is attributable to the decline in the share of demand for tradables. The decline in trade for some countries (and between some country pairs) did exceed what one would expect simply from the changing composition of demand. Hence, increasing trade frictions independently contributed to the troubles facing the global economy and played an important role in some countries, particularly China and Japan.

Effect of recession on developing countries

The recession has affected developing countries in many different ways including the following:

1. Declines in foreign direct investment especially reductions in access to loans from banks – some developing countries have set up their own sovereign wealth funds to offset this

2. Falls in export revenues due to lower demand (and falling prices) for commodities and a sharp reduction in demand for manufactured goods from many emerging market countries. There is volatility in export prices and export revenues for developing countries. Much of the strong GDP growth enjoyed by these nations was due to rising demand for and prices of primary commodities which improved the terms of trade of developing exporters. This reversed from the middle of 2008 onwards although there were signs of a rebound in export revenue since the spring of 2009.

3. Recession has cut export prices – but another key effect has been increased volatility of prices – this increases revenue uncertainty for commodity-dependent countries and acts as a barrier against much-needed capital investment

4. A decline in remittances from overseas migrants working in developed countries – the World Bank had predicted that remittance flows to developing countries will decline by 7-10 percent in 2009. The World Bank estimates show over 250 million people living overseas

who send some of their earned income back - remittances to all countries topped $305bn in 2008.

5. A recession in global tourism – often a significant share of GDP for many poorer nations

6. Rising food prices has created a huge problem of food poverty – the World Bank termed this as a silent tsunami

7. Increased unemployment, under-employment and loss of income. Many laid-off formal sector workers are forced into low-income jobs in the informal and rural sectors (China is a good example)

8. Weaker growth and rising unemployment puts huge pressure on government finances and in many countries there is not a widespread social welfare system as a safety net

9. Some countries have been hit by multiple macroeconomic shocks. A good example is Nigeria – whose export revenues have declined following a 70% fall in crude oil prices, a sharp fall in domestic share prices (which has made funding investment tougher) – both of which contributed to a depreciation of the naira by 20% which has worsened their terms of trade, increased the cost of servicing foreign debts and increased the prices of imported foods.

10. Overall the recession has worsened prospects for developing countries meeting the Millennium Development Goals. The World Bank estimated that up to 90 million extra people world-wide (62 million in Asia) will live in extreme income poverty (less than US$1.25 per day) in 2009 as a result of the global economic slowdown

The effects of the recession vary widely across the developing world – some countries have avoided recession and have started to recover more quickly than expected – the obvious example here is China, largely as a result of a gigantic fiscal stimulus programme.

Concept Of Coupling – Decoupling

In August 2007 the world economic crisis started because of (low standard) sub-prime mortgage market in America. This has affected other security markets. Because this started in America and some other countries, in a few months the deterioration in financial field gathered momentum. The result has been that because of bankruptcy in all the industrial countries economic depression is clearly felt, after about more than a year of this crisis, it was

felt that the emerging countries of Asia, especially the Chinese and the Indian economy are comparatively far from this crisis. Not only this, these countries can play an important role in controlling this world depression. At the world level also these countries can open the path for reconstruction. But from September 2008 the decline in advanced and rising markets in economic systems the decoupling hypothesis has been shattered and there is no sign of improvement of declining economies. In the background of decoupling hypothesis it is necessary to measure on experimental basis as to whether the dependence of countries on each other, affect macro economic variables. The available statistics shows that industrial production index of America and also the industrial production index of European Union affects macro economic variables of India. It seems that, in the present circumstances it would be desirable to reject/deny the decoupling hypothesis related to the group experiments of external factors. The incentive response result also shows that other countries affect India's macro economic variables.

US exports are disproportionately sold to the EU and Canada; US imports are disproportionately sourced from China, Japan, and the rest of Asia. Imports from China dominated the US (real) import decline, while exports to Canada figured disproportionately in US export declines. US imports peaked in October 2007, with a secondary peak in October 2008, and a trough in February 2009. US exports, by contrast, continued to rise until much later in June 2008. The timing of US import peaks by sector is markedly different from that of US export peaks by sector. The export peaks cluster around the general peak in mid-2008. The import peaks, by contrast, both came much earlier (end of 2007) and show a great deal of sectoral dispersion. US imports related to housing construction – especially wood and construction equipment – showed relatively early downturns. The downturn in US imports of motor vehicles and parts has been particularly deep; it began in March 2007 when oil prices were still rising sharply. These facts suggest that the transmission of the recession to the US (via declines in US exports) is mediated by a very different set of goods than the transmission from the US to other nations (via US imports).

The timing of US real import peaks by sector is markedly different from that of US real export peaks by sector. US export peaks tend to cluster around the general peak, reflecting the synchronisation of the global peak in GDP in mid-2008. US import peaks, by contrast, show a great deal of sectoral dispersion, with some sectors turning down much earlier than others. This suggests that the decline in US import demand, as well as its depth, was

significantly influenced by particular sectoral weaknesses in the US economy, in particular the timing of the housing and oil bubbles.

Geographically, US exports go disproportionately to the EU and Canada, while US imports come disproportionately from China, Japan, and the rest of Asia. More precisely, from 2006-2008, the EU and Canada accounted for 42.9% of US exports and 34.0% of US imports on a nominal basis, while Asia accounted for 35.5% of US imports and only 25.9% of US exports. China alone accounted for 16.1% of US imports and only 5.9% of US exports.

The transmission of the recession to and from the US is mediated by a very different set of goods. From July 2008 to the trough, there are 13 categories of goods for which US real imports fell by $1 billion or more, and 10 categories of goods for which US real exports fell by $500 million or more. They are largely non-overlapping categories. For example, US import declines are dominated by electronics, crude oil, and other consumer goods, while US export declines are concentrated in intermediate and capital goods. There are large two-way declines in US trade in passenger cars, motor vehicle parts, and organic chemicals. Goods imported from China dominated US import declines, while goods exported to Canada figured disproportionately in US export declines.

The collapse of US housing associated with the financial crisis shows up clearly in US construction imports, which began to decline much earlier than US imports in general and have fallen more deeply. US real imports of sawn or chipped wood, of the type used in construction, peaked in May 2005 and declined by 62.9% through May 2009. This peak is 29 months earlier than the general peak in US imports. The corresponding price series peaked earlier, in March 2005, and has declined by a cumulative 32.5% through May 2009. A simultaneous decline in prices and quantities is a clear indicator of a decline in import demand, induced by the declining demand for construction. Similarly, US real imports of equipment such as bulldozers, graders, and shovel loaders, which have multiple uses but are important for construction, peaked in May 2006, 19 months before the general peak, and declined by 81.5% in the subsequent three years.

Import prices and quantities for inputs related to housing turned down relatively early compared to more direct indicators of the state of the housing market and prices of new one-family homes under construction (March 2007). Construction firms anticipated the bubble, restricting their purchases of imported wood inputs at least as early as their construction

activity and well before the decline in housing prices. Since construction plays an important role in the business cycle (Leamer 2007), this suggests that import data on construction inputs may be an important tool in anticipating the business cycle. The impact of the decline in US construction on US trading partners was highly geographically concentrated. In a typical year, about 80% of US imports of sawn wood come from Canada, while about 50% of US imports of bulldozers and similar equipment come from Japan.

Real trade in motor vehicles and parts has decreased more sharply than trade as a whole. US real imports for the category have fallen by 55.1% since their peak in March 2007, while US real exports have fallen by 60.4% since June 2008. This fits in with the general pattern observed above – US imports were reduced by the increase in gasoline prices prior to the recession, while the decline in US exports corresponds to the general drop in global demand and the emerging crises of GM and Chrysler. US real imports of passenger cars have recovered slightly since February 2009. This is unlikely to be a seasonal effect, since prior to the recession the seasonal peak for US auto imports was usually in the fourth quarter and could possibly be related to anticipation of the "cash-for-clunkers" program under which US consumers received government financial incentives in the summer of 2009 to trade in low-mileage vehicles for more fuel-efficient ones.

The nature of present recovery is of different type in different countries, hence in international process, when gap between different countries is being reduced, it would be difficult to establish co-ordination between different nations. Because of the liberal monetary policy of nations like Europe and America and restrictive policies of developing countries (after recovery) the condition of non-equality would be created at the world level, Hence, serious effects would result at the world level and difficulties will have to be faced in establishing co-ordination. It is necessary to raise mechanism of regulation and control which would be acceptable to all the countries.

We analyse the mechanism of transmission of the global recession to and from the US using real monthly merchandise trade data. The channels of transmission arise both from historical patterns of comparative advantage and peculiar features of the US and global recessions. The US's import decline was a major vector for transmitting the recession to Asia, as this drop in demand came well before the official recessions began in Asia. Peaks in US imports show a higher degree of sectoral dispersal than peaks of US exports, reflecting the particular patterns

of weakness in the US, such as imports of inputs into construction and the relatively synchronous timing of the recession in US trading partners.

In particular, contractions of US imports of wood and construction equipment, used as inputs into housing, showed relatively early downturns. The downturn in US imports of motor vehicles and parts, which began when oil prices were still rising sharply, has been particularly deep but appears to have reversed in recent months. The downturn in US auto exports was related both to the global contraction and to the situation immediately preceding the bankruptcies of General Motors and Chrysler. By contrast, large nominal swings in exports of mineral fuels were largely price-induced, and mask relatively stable US demand for crude oil and foreign demand for US refined products.

Conclusion

Crisis has affected the entire economic system of the world and all economists are finding it necessary to overhaul the nature, objectives and structure of the world economy. In the era of globalization, no nation can decide and implement its own economic policy. Because of this the world recession has affected the developed and under-developed countries as well and all these countries have to face the problems of unemployment, poverty and increasing debts. The solution to the problem of world recession lies in changes in the rate of aggregate demand of the world. It is important to remember that any crisis is exposure of structural misfits and is intended to overcome them by the price of social and political shock. A recession shows "weak links" in economic system, destroys them and releases resources for new undertakings. Decline in business activity forces companies to follow strict financial discipline, abandon non-effective business practices, improve their productivity. It also opens a way for new ideas, technologies and business models

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