INVESTOR'S GUIDE

A guide to the financial markets, investments and the economy

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NICO Asset Managers

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Topic 247: Effects of Recession

Last week we continued the topic on business cycles. We discussed recession and its causes. We stated that there are four major causes of recession: high inflation, high interest rates, reduced consumer/business confidence and a crash of the stock market. This week we will discuss the effects of recession. There is a general economic decline during recession. The purchasing power of individuals goes down as a result of insufficient income, leading to a slump in the market for goods and services. As a result, production also goes down and this leads to losses and job cuts. Eventually, government faces high fiscal deficits and national debt, hence a decline in GDP. The effects of recession are explained as follows:

1. Decline in Consumer Spending

During recession, consumers reduce their spending which leads to a decline in the market for goods and services. The purchasing power of individuals goes down which influences them to refrain from spending, and this makes it difficult to sell goods and services. This results in a decrease in the sale of goods and services especially luxury items.

2. Increase in Unemployment

The decrease in the sale of goods and services often leads to lower production. As sales go down, businesses begin making losses and some can even go bankrupt. In order to reduce costs, businesses stop hiring new workers and may even resort to laying off workers, resulting in a rise in unemployment. As the unemployment rate rises, consumer spending declines even more, and many businesses close down.

3. High Budget Deficit

As businesses continue to suffer losses and lay off workers, this results in lower tax revenues.

- Firms make less profits, such that government receives lower corporate tax.
- Fewer workers employed hence lower income tax.
- Lower expenditure leads to lower VAT payments.

These falling tax revenues add pressure to government due to rising welfare payments. Governments increase expenditure in order to help bail out companies and also address economic challenges of citizens. These increased expenditure often leads to high budget deficits.

4. High National Debt

During recession, governments often resort to borrowing as they are inclined to spend in order to bail out the economy. The increase in national debt means less money can be spent on development. This also leads to crowding out effects, as the rise in the government borrowing drives down the private sector. Since governments have the power to borrow large sums of money, this leads to an increase in interest rates as banks take advantage of the massive borrowing. The increased borrowing leads to higher interest rates and national debt.

5. Depression

If a recession persists for a long time, this can eventually lead to a depression. Depressions are usually characterized by large increases in unemployment, falls in the availability of credit often due to a financial crisis, reduced output, bankruptcies and significantly reduced trade. A depression is very severe and can quickly spread to other economies as well.

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