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 245: Business Cycles

Last week we began a new topic on business cycles. A business cycle was defined as the fluctuation of economic activity over a period of time. It is basically a pattern of expansion and contraction in the economy. We stated that business cycles have five distinct stages: expansion, peak, recession, trough and recovery. This week we will discuss the causes of recession.

Two of the biggest economies in Sub-Saharan Africa, Nigeria and South Africa, have slid into recession, and this has negatively affected the region's output. The two countries have been struggling with political instability, corruption scandals and lower commodity prices which dented their business and consumer confidence. It has also been anticipated that the US will fall into recession in 2019, mainly contributed by higher interest rates which will weigh on consumption and investment. This will consequently deteriorate global economic growth. It is thereby important that we discuss recession and its causes.

Recession

A recession is a significant decline in economic activity that lasts for at least six months. The technical indicator of a recession is two consecutive quarters of negative economic growth, measured by the country's gross domestic product (GDP). There are several metrics that are used to determine whether a recession is imminent or already taking place. These indicators are divided into two categories: leading and lagging indicators. Leading indicators materialize before the recession is officially declared for example stock market underperformance. Lagging indicators materialize after recession is officially declared. Unemployment is a common lagging indicator of recession.

Causes of Recession

1. High Inflation

Many factors contribute to an economy's fall into recession but the major one is inflation. The higher the rate of inflation the smaller the amount of goods and services one can purchase. High inflation rates influence individuals and businesses to reduce overall spending which causes real GDP to decline. Subsequently, unemployment also rises in an effort by companies to reduce costs. These combined factors cause the economy to fall into recession.

2. High Interest Rates

Another significant cause of recession are high interest rates. High interest rates are caused by high inflation rates, as central banks are inclined to adjust interest rates that are aligned with the inflationary environment. High interest rates limit liquidity (the amount of money available to invest) and this deters people from borrowing, resulting in lower investment levels. This also causes real GDP to decline.

3. Reduced Consumer/Business Confidence

Another important factor that can cause recession is a loss in business or consumer confidence. As confidence recedes, so does demand. If investors and consumers believe that the economy is going bad, they are less likely to spend money or invest. Consumer/business confidence is psychological but can have real impact on an economy.

4. Stock Market Crash

The loss in business confidence can deteriorate investments, this can create a subsequent bearish stock market and drain capital out of businesses. The poor performance in businesses can lead to a decline in real GDP, resulting in recession.

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