FINANCIAL LITERACY
FOR YOUTHS

Days After 2008 Financial Crisis

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In 2008, a global economic crisis struck, with many countries experiencing the full brunt of it's effects. Fortunately for some countries, they were able to recover from the economic plague. For instance, U.S.'s and China's GDP grew by 12% and 65%, respectively, between late 2008 and late 2014. China was a better performer as it adopted massive expansionary fiscal policies (policies that involve increasing consumption to stimulate GDP) with a whopping RMB¥ 4 trillion (US$586 billion) to be invested in key areas such as housing, rural infrastructure, transportation, health and education, environment, industry, disaster rebuilding, income-building, tax cuts, and finance, and thus, it recovered the fastest.

Due to China's rapid and strong recovery, regions that exported in large volumes to China, like Southeast Asia, or that supplied raw materials to power China's industrial engine, such as Africa, Australia, and the Middle East, also recovered reasonably well from the crisis. However, when China started to experience a series of structural changes in 2011, its long-run growth rate declined from its long-run average of 10% in early 2011 to 7% in late 2015. Consequently, nations that relied on trade with China, particularly meeting its demand for raw materials and oil also experienced economic slowdowns.

However, a lot of this apparent growth has been fueled by government bailouts, loosened monetary policies and huge injections of capital in the form of quantitative easing. The problem is that expansion cannot continue forever, fueled only by cheap money and central bank support. Ultimately, an economy must catch up with the external support to create real growth or, in other words, the economy should be able to absorb the injection of capital effectively to create real growth. Because the real economy has lagged in many ways, could it be that we are on the verge of another global recession? And if so, what are the main contributors? Let's break it down.

The Chinese Bubble Is Starting To Pop and Its Aftermath

After 2008, with less demand for its exports in crisis-ridden developed countries (most notably the US), China attempted to rebalance its economy. It tried to compensate for reduced export revenue by inciting infrastructure investments and increasing domestic consumption. For a few years, this strategy seemed to work, but this is not the case anymore – it resulted in the creation of domestic bubbles (notably in the real estate), which are now bursting.

As a consequence, China is importing less material and commodities from other developing countries. This is why the price of these commodities is shrinking: there is too much supply and not enough demand to meet it. Parts of the developing world that specialized in exporting commodities to China are now experiencing a reduction of export revenue (which also affects their public finances). As a result many Latin American countries (including the biggest one, Brazil) are currently in outright recession or stagnating. The same applies for some African and Asian countries.

The European Situation

The European Central Bank (ECB) has also taken extraordinary measures to implement quantitative easing in the Eurozone to stimulate growth. The so-called PIIGS nations (Portugal, Ireland, Italy, Greece & Spain) have been bailed out repeatedly by the EU (European Union) and the IMF (International Monetary Fund), with mandatory austerity measures (contractionary fiscal policies that include spending cuts, tax increases, or a mixture of both) imposed onto their populations. Not only has austerity been unpopular, such measures may have also restricted growth by reducing aggregate demand and keeping the debt burdens in these nations high.

The worst of the PIIGS has been Greece, which defaulted on an IMF loan in 2015. The Greeks had elected an anti-austerity government which called a popular referendum, rejecting EU bailout terms and calling for an end to austerity. A collapse of the euro would have widespread negative consequences for the world economy, perhaps bringing on recessions.

As for the U.K., its economy contracted by 0.2% in the month following the Brexit vote giving Britain an ‘even’ chance of slipping into recession, according to the latest forecast from the National Institute of Economic and Social Research (NIESR). Simon Kirby of the NIESR, similarly, argued that the referendum vote had led to such financial and political uncertainty that this would bear directly on the spending and investment decisions of both businesses and households.

Central Banks Do Not Have Much To Work With

Central banks typically employ loose or expansionary monetary policy to stimulate an economy when it appears to be slowing down. They do this by lowering interest rates, engaging in open market operations (OMO) which refers to the buying and selling of government securities in the open market in order to expand or contract the amount of money in the banking system, facilitated by the Federal Reserve (Fed), or through quantitative easing (the introduction of new money into the money supply by a central bank). Since interest rates are already near-zero, with some European countries even deploying a negative interest rate policy (NIRP), that policy tool is no longer effective for banks to use to stave off the next downturn. Meanwhile, quantitative easing and the buying of government assets has already ballooned central bank balance sheets to unprecedented levels. Again, central banks will see their hands tied in trying to avert a recession.

Mounting Debt Due To Student Loans

The debt crisis that accompanied the Great Recession had a lot to do with the burden of home mortgages that were issued to people who simply could not pay them back and bundled into securities called collateralized debt obligations (CDO) and sold to investors with an illusory 'A'-credit rating. Today, something similar seems to be going on in the student loan market.

The U.S. government backs nearly all student loans, so ratings agencies gave a high credit rating to such debts, even though students may not have the ability to repay. Right now, the government is stuck with a staggering $1.3 trillion in outstanding student loans that need to be paid back, in comparison to the size of Canada’s accumulated student loan debts of roughly $15 billion.

Not only could a wave of defaults impede the U.S. treasury's ability to function properly, but student loan burdens prevent young people from engaging in other economic activity such as buying homes and cars.

Economic Data Shows Patterns Similar to Right Before the Last Recession

Aside from the "stories" unfolding in the global economy above, some finer economic data is beginning to show some eerily similar patterns that have predicted recessions in the past:

- Retail Sales have dropped the most since before the last recession. The same is true with wholesale sales.
- U.S. factory orders fell in December of 2015 by the most in a year, according to the Commerce Department.
- Real U.S. GDP growth is slowing.
- U.S. export growth has been weakening.
- Corporate profits are declining.

What Can We Take Away From This?

We may be on the verge of another global recession. Patterns in economic data are showing signs of weakness, and the troubles persisting in Europe or the bubble bursting in China may be the trigger that sends the economy over the edge. Unlike in 2008, when central banks were able to lower interest rates and expand their balance sheets, central banks now have much less elbow room to enact loose monetary policy to prevent a recession from happening. Although recessions are a normal part of the macroeconomic cycles that the world experiences, and happen from time to time and the last recession was already seven years ago, there are tell-tale signs that indicate that the next is right around the corner.

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