Overview of Recession

1 Introduction

The following paper traces the origins of the current recession from the sup-prime mortgage crisis in the US to the global freezing of money markets. The latter part of the paper looks at current global conditions and forecasts, as well as looking specifically at the current conditions in the Northern Ireland and the UK as a whole.

Further useful information is contained in the Annexes to the document, namely: Annex 1, which provides a timeline of events leading up to the UK's announcement of recession; and Annexes 2-4 which present certain economic variables geographically for Northern Ireland.

2 Origins

Contemporary economic conditions, it is argued, have their foundation in the financial concept *"originate and distribute"*. Over the past two years global finance has witnessed a domino effect, which began with the sub-prime mortgage crisis and which led, ultimately, to a rapid drying up of money markets and recessionary conditions.[1] As the Economist pointed out in January 2009:

> *"Over the past 22 months the shock has spread from American housing, sector by sector, economy by economy. Some markets have seized up; others are being pounded by volatility".*[2]

The US sup-prime mortgage crisis broke in August 2007[3], although some commentators argue the warnings signs were visible as early as December 2006.[4] Sub-prime mortgages were typically sold to customers with poor credit histories and low incomes. The products sold were predominately adjustable rate mortgages (ARMs), linked to the federal interest rate.[5] The sub-prime market grew substantially from 1997 to 2006, by which stage the total market was worth approximately $700 billion.[6] ARMs were often sold at a two year fixed rate, which when it expired led to higher payments at a time when federal interest rates were also rising. The consequence was a spate of repossessions spreading through the US, exceeding 1.3m in 2008.[7]

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[1] IPPR Tomorrow's Capitalism Series *The Madness of Mortgage Lenders – Housing finance and the financial crisis* May 2009 p6

[2] The Economist Special Reports *Greed – and Fear* Jan 2009 http://www.economist.com/specialreports/displayStory.cfm?story_id=12957709 (accessed 10/06/09)

[3] International Monetary Fund *World Economic Outlook April 2009 – Crisis and Recovery* p2

[4] IPPR Tomorrow's Capitalism Series *The Madness of Mortgage Lenders – Housing finance and the financial crisis* May 2009 p6

[5] BBC News The Downturn Facts and Figures *Sub-prime mortgages* (November 2007) http://news.bbc.co.uk/1/hi/business/7073131.stm (accessed 10/06/09)

[6] IPPR Tomorrow's Capitalism Series *The Madness of Mortgage Lenders – Housing finance and the financial crisis* May 2009 p6

[7] BBC News The Downturn Facts and Figures *Sub-prime mortgages* (November 2007) http://news.bbc.co.uk/1/hi/business/7073131.stm (accessed 10/06/09)

Whilst bad in itself, had the sub-prime mortgage crisis occurred under traditional the model of mortgage lending it would have at least been localised. The reason the crisis had such a widespread impact on global economics lies in the "originate and distribute" model of mortgage lending.[8] In the traditional mortgage model banks were required to finance their mortgage lending through customer deposits, this limited the amount they could lend.[9] It also increased risk, as an IPPR example illustrates:

> *"In the old days, a bank might hold lots of mortgages from people living in a particular town. That would be quite risky, because if, for example, the local industry failed, the bank would be under pressure."*[10]

The adoption of the "originate and distribute" model was designed to spread this risk.[11]Within this model mortgages were sold initially as mortgage bonds, then repackaged as Collateralised Mortgage backed Obligations (CMOs) and Collateralised Debt Obligations (CDOs) and sold to investors. The idea was that everyone would be taking small bets, as numerous investors would own small parts of thousands of mortgages, and therefore the overall risk would be reduced.[12]

When the rate of defaults on sub-prime mortgages began to soar, investors in CMOs and CDOs realised they would not get the money back on their investments and would find it difficult to resell (despite the products been rated investment grade and therefore unlikely to default), this caused the CDO and CMO markets to implode. Investors in CMOs and CDOs had insured their investments against default, through Credit Default Swaps. As defaults increased, however, the amount of money owed in default insurance became so great that insurers worried about the ability to pay out.[13] This had a further knock on as:

> *"At this stage, international wholesale money markets began to dry up rapidly as lenders became fearful of lending to one another as the scale of their exposure to toxic debt was unclear."*[14]

In other words, the global economy entered the credit crunch. There were further knock-on effects from the evaporation of credit. Concern over tightening credit conditions and losses from bad assets led to a questioning of the stability of major financial institutions. This ultimately led to the financial crisis of September 2008, the default of Lehman Brothers and numerous government interventions and bailouts in banks throughout the US and Europe. [15]

According to the International Monetary Fund (IMF):

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[8] IPPR Tomorrow's Capitalism Series *The Madness of Mortgage Lenders – Housing finance and the financial crisis* May 2009 p6

[9] BBC News The Downturn Facts and Figures *Sub-prime mortgages* (November 2007) http://news.bbc.co.uk/1/hi/business/7073131.stm (accessed 10/06/09)

[10] IPPR Tomorrow's Capitalism Series *Towards an Accountable Capitalism* (March 2009) p4

[11] *Ibid*

[12] *Ibid*

[13] IPPR Tomorrow's Capitalism Series *The Madness of Mortgage Lenders – Housing finance and the financial crisis* May 2009 p6

[14] *Ibid*

[15] International Monetary Fund *World Economic Outlook April 2009 – Crisis and Recovery* p2

> *"Although a global meltdown was averted by determined fire-fighting efforts, this sharp escalation of financial stress battered the global economy through a range of channels".*[16]

The fallout from the banking crisis has been felt across the board. The credit crunch and the *"breakdown of securitisation technology"* hit borrowers and investors. The protracted deflation of the housing bubble and the decline of equity markets, whilst to an extent *"inevitable"* corrections, led to greatly reduced personal wealth. The scale of the crisis was so large that its impacts passed quickly to all sectors and all economies. Moreover, the crisis hit business and consumer confidence hard, with the latter's reservations significantly evident in the decline of industrial production and consumer spending. Confidence, according to commentators, is returning to an extent, but job losses continue apace. [17]

It is generally accepted that turmoil in housing and financial markets triggered the economic recession, through a series of inter-related crises. Some commentators, most notably those from the OECD and the Economist, are of the opinion that these declines were symptomatic of a much broader set of trends. In a paper presented to the G20, the OECD state for example:

> *"… the rapid process of globalisation over the past two decades can explain some of these features and has played a main role in both the run-up to and the propagation of the current crisis".*[18]

Globalisation or more specifically the globalisation of de-regulated free market capitalism, it is argued, created the context within which *"freewheeling areas of modern finance"* could prosper. The logical consequence of such an argument is that the financial markets must, to a greater or lesser degree, be re-regulated.[19]

A counter argument maintains that is was not de-regulation but mis-regulation (particularly of sub-prime mortgages in the US) which facilitated the crises.[20] Economist Robin Blackburn further maintains that *"financialization was born in a quite heavily regulated world"* and asks whether *"more and better regulation",* whilst necessary will be enough to counter the current problems. It should be added that Blackburn's account of events still places emphasis upon the unregulated world of shadow finance.[21]

Irrespective of one's position on the heavily political deregulation/regulation debate it is still possible to see the hand of globalisation in propagating the crisis. This is particularly evident in the manner in which the decline in world trade acted as a line of transmission

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[16] *Ibid*
[17] *Ibid*
[18] OECD *The General Background to the crisis*
[19] The Economist *When fortune frowned* (October 2008)
http://www.guardian.co.uk/football/2009/jun/11/football-transfer-rumours-robinho-barcelona (accessed 10/06/09)
[20] The Wall Street Journal *Deregulation and the Financial Panic* (February 2009)
http://online.wsj.com/article/SB123509667125829243.html (accessed 11/06/09)
[21] Robin Blackburn The New Left Review *The Sub prime crisis* (March-April 2008)
http://www.newleftreview.org/?view=2715 (accessed 11/06/09)

"from countries directly affected by the financial crisis towards others, including emerging economies".[22]

3 Current Picture

3.1 Global Conditions & Forecasts

The Ulster Bank's *Northern Ireland Economic Review* (May 2009), which surveys a number of economic forecasts, predicts a -2.1% global contraction for 2009, with major regional contractions predicted to be as follows – US -2.7%, UK -3.3% and the EU 12 -3.4%.

The report also notes that Economic surveys show tentative signs of recovery. Manufacturing output in the US and China, for example, is considered to have "bottomed out" in December 2008, with both economies experiencing output growth in the sector since then.

Oxford Economics' (OE) latest World Economic Prospects publication carries the headline *"recovery still some way off, despite 'green shoots'"*. The report states that world GDP for 2008 was 1.8% growth and predicts a -2.5% reduction in 2009, with growth retuning in 2010 with a 1.7% increase. In 2011 a return to growth levels in the region of those pre-recession (2006) is expected, with upward trends to continue the years to follow.[23]

In qualitative reading of the future prospect, the OE report notes that:

- although manufacturing performance has improved this is largely due to a cycle of de-stocking, in which output growth was cut to bellow the growth of demand;

- consumer spending will remain low, on account of unemployment and falls in houses price, depressing demand into 2010; and

- although government stimulus efforts will provide some support, there remains a risk that a continued *"retrenchment in the private sector will drag growth down again"* resulting in a *"W-shaped growth scenario".*[24]

The National Institute Economic Review (NIER) concurs with the general view that modest growth of 2.1% will return in 2010. However, they add that they expect *GDP growth to remain below recent trend rates in most of the major economies in 2011 and in some cases in 2012".* According to NIER *"from 2013, growth should rise above trend rates towards a new, lower, equilibrium",* although the recession will leave permanent scars on the major economies, with lenders likely to continue to act cautiously and maintain a perception of higher risk. Despite this, the same report notes that lending to the private sector, which slowed considerably in 2008, is showing signs of relaxation if

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[22] International Monetary Fund *World Economic Outlook April 2009 – Crisis and Recovery* p7

[23] Oxford Economics *World Economic Prospects* (May 2009) http://www.oxfordeconomics.com/free/pdfs/wepmov(may09).pdf (accessed 10/06/09)

[24] *Ibid*

not recovery. They note that while there was a continued tightening of loan conditions in the first half of 2009 the rate of this tightening has eased.[25]

The IMFs outlook deems short-term prospects to be *"precarious".* They estimate a global contraction of -1.3% in 2009, noting that output is projected to decline in countries representing three-quarters of the global economy and that growth in all countries will decelerate sharply from "normal" trends. Like other forecasts the IMF also predict modest growth in 2010, although, at 1.9% their estimates are more conservative. For the IMF, the key factor in returning to pre-recession growth patterns is the speed with which the financial sector can be stabilised. They argue, however, that this process will take longer than they and others had previously predicted given the *"complexities involved in dealing with bad assets and restoring confidence in bank balance sheets, especially against the backdrop of a deepening downturn in activity that continues to expand losses on a wide range of banking assets".*[26]

3.2 Current UK Conditions [27]

- The Budget 2009 predicted a 1% contraction in the UK economy, followed by growth of 1.75% in 2010. The current consensus is less favourable – a 3.3% contraction in 2009 followed by a modest growth of 0.3% in 2010.
- Q1 2009 saw a 1.9% contraction in UK GDP, Q4 2008 had shown a 1.6% contraction.
- 2007/08 Public Sector Net Borrowing stood at 2.5% of GDP; estimates predict this will increase to 6.3% in 2008/09 and 12.4% in 2009/10.
- Public Sector Net Debt is expected to rise to 76% (80% when financial interventions in the banking industry are included). Higher taxes and lower public sector expenditure are expected as a consequence.
- UK public finance problems are expected to spill over to the Northern Ireland economy. NI will shoulder some of the £9bn/yr of efficiencies savings from 2011. Calculated using the Barnett formula this translates to approximately £200m – £250m per year from 2011.
- Purchasing Managers Indexes (PMI) show some sign of improvement, the pace of contraction, for example, was seen to slow in April's composite PMI for the UK. Mortgage approvals in March 2009 where 44% higher than their November 2008 low.
- In September 2008 annual CPI inflation hit 5.2%. In March 2009 the corresponding figure was 2.9%, a lesser decrease than expected on account of sterling prices inflating imports.

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[25] National Institute Economic review *The global financial crisis and collapse in world trade* (May 2009) pp11-13
[26] International Monetary Fund *World Economic Outlook April 2009 – Crisis and Recovery* p2
[27] Ulster Bank *Northern Ireland Quarterly Economic Review* (May 2009) p4

- In March 2009 interest rates were decreased to a record low of 0.5%;

- An increase in secured credit availability is anticipated in Q2. While, in the corporate sector, credit availability improved during Q1, with further improvements expected in Q2 results.

3.3 Current Conditions - Northern Ireland[28]

The latest Ulster Bank *Northern Ireland Quarterly Economic Review* (May 2009), makes the following observations on the Northern Ireland Economy:

- In Q4 2008 private sector output decreased by 3.9% compared to the same quarter the previous year. In 2009, a total contraction of 5% is anticipated.

- Q1 2009, Northern Ireland wholesale and retail distribution output fell by 1.9% on the previous quarter (corresponding UK figure was 2.4%) bringing the year on year decrease to 7% (4.9% in the UK).

- Between September 2007 and December 2008 the Business Service and Finance sector incurred 3,300 job losses (from a 2007 peak of 96,500 employees), further losses are expected in 2009.

- Northern Ireland Tourist Board note that the hotel industry experienced a 10% fall in sales in Q4 2008, compared to the previous year.

- In Q4 2008 manufacturing output fell by 4.8% (UK=4.5%) compared to the previous quarter and 5.2% (UK=7.5%), the steepest decline since 2001.

- The Food & Drink sector has been the exception to the above - Q4 figures show an 8.9% year on year increase.

- 3,100 jobs were lost in the manufacturing sector in 2008. A decline of 10% is expected in 2009.

- Q4 2008 saw a 0.9% quarterly increase in construction output, although year on year this represents a decrease of 4.3%. Housing output (new houses) declined by 19% in 2008. Infrastructure construction increased 24% in 2008.

- 5,090 jobs were lost in the construction sector in 2008, equivalent to -4.2% (UK = +0.5%).

In addition the Ulster Bank report, commenting on the Northern Ireland housing market, notes:

- NI average house prices were estimated in the DCLG survey to be £182k in February 2009, a 19% decrease on the previous year (UK = -12%). An alternative Nationwide survey found Q1 prices to be 38% below their Q3 2007

[28] *Ibid pp8-14*

peak. Prices are expected to fall to £135k during 2009 (45% below Q3 2007), stabilizing at £125k in 2010 (50% lower than Q3 2007).

Figures from the Department of Social Development[29] illustrating annual average house prices between 2007 and 2008 are presented Annex 2. The figure shows that the largest contractions have been in Ballymoney, Omagh, Lisburn and Newtownabbey district council areas.

DETI's *Economic Overview,* which draws from the latest Labour Market Survey and Claimant Count data, identifies the following traits:

- In the first quarter of 2009 the employment level was 756,000, representing a fall of 18,000 on the previous quarter and 29,000 on the same point the previous year.[30]

- Unemployment in the same period was estimated at 6.1%, up 1% on the previous quarter and 1.5% on the previous year. The number of unemployed persons was estimated at 49,000, up 7,000 over the quarter and 11,000 over the year.[31] Unemployment rate, the number of claimants expressed as a percentage of the working age population is presented in Annex 3. The three Parliamentary Constituencies with the highest unemployment by this measure were East Londonderry, Foyle and West Tyrone.

- April 2009's claimant count saw an increase of 2,000 on the previous month, resulting in a total claimant count of 46,100 (5.3% of the workforce, compared to 4.7% in the rest of the UK). The annual increase in Northern Ireland was 90.5% (21,900) compared to 88.6% in the UK. Two thirds of this annual increase (14,600) occurred in the six months leading up to March 2009.[32]

- At a district council level, the highest claimant count levels (April 2009) were found in Derry (6.2%), Limavady (6.1%) and Strabane (6%). The highest percentage increases, however, were found in Magherafelt (219%), Dungannon (206.1%) and Cookstown (162.3%).[33] The percentage increase in claimant count is illustrated geographically in Annex 4. As evident from the figure the largest percentage increases dissect the region. The Parliamentary Constituency areas with the largest percentage increase were Foyle, East Londonderry, Mid Ulster, Upper Bann, South Down and Newry and Mourne.

- In April 2009 there were 523 confirmed redundancies bringing the twelve month total to 4,249, an increase of 159% on the previous year. The highest number of confirmed redundancies occurred in the Belfast District Council area (18.9% or 805 the yearly total).[34]

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[29] Department for Social Development *New House Prices and Sales – full year data table 2007-2008* http://www.dsdni.gov.uk/2007-2008_with_links.xls
[30] DETI *Economic Overview* http://www.detini.gov.uk/cgi-bin/get_builder_page?page=4660&site=4&parent=48 (accessed 03/06/09)
[31] *Ibid*
[32] *Ibid*
[33] *Ibid*
[34] *Ibid*

- 458 insolvencies were recorded in Q1 2009. A further 1,766 were recorded in 2008.[35]

- In 2008, 3,628 mortgage arrears actions were recorded, an annual increase of 1,415 (64%). Of these actions 1,200 led to repossessions, compared to 700 the previous year.[36]

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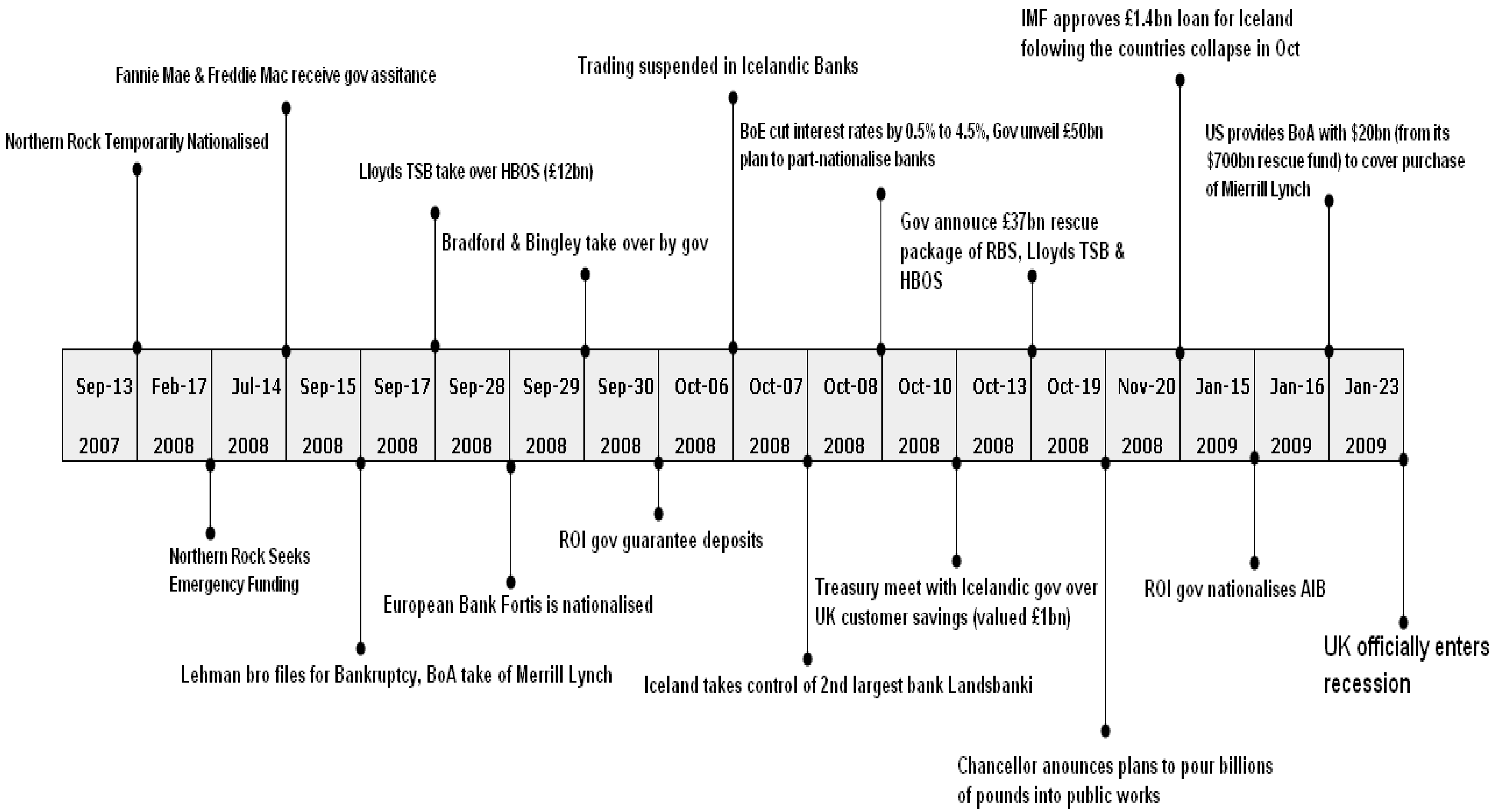
15/06/09

[35] Ulster Bank *Northern Ireland Quarterly Economic Review* (May 2009) p16
[36] *Ibid*

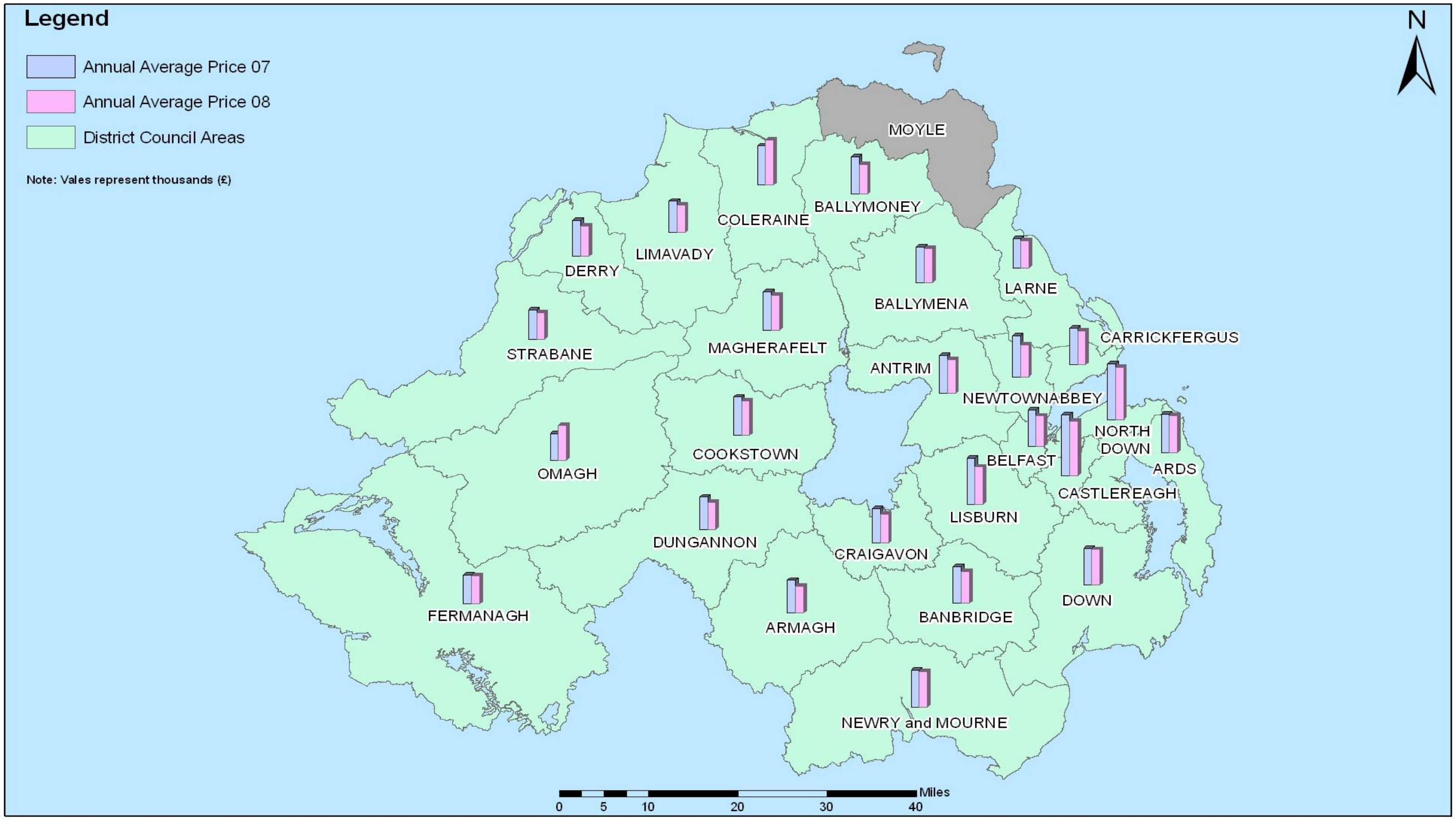
Annex 1 – Recession Timeline[37]



[37] Source Daily Telegraph 23/01/09 & The Guardian 23/01/2009

Annex 2

Average Annual House Prices 2007 versus 2008 by District Council Area



Note: No data supplied for sales in Moyle for 2008

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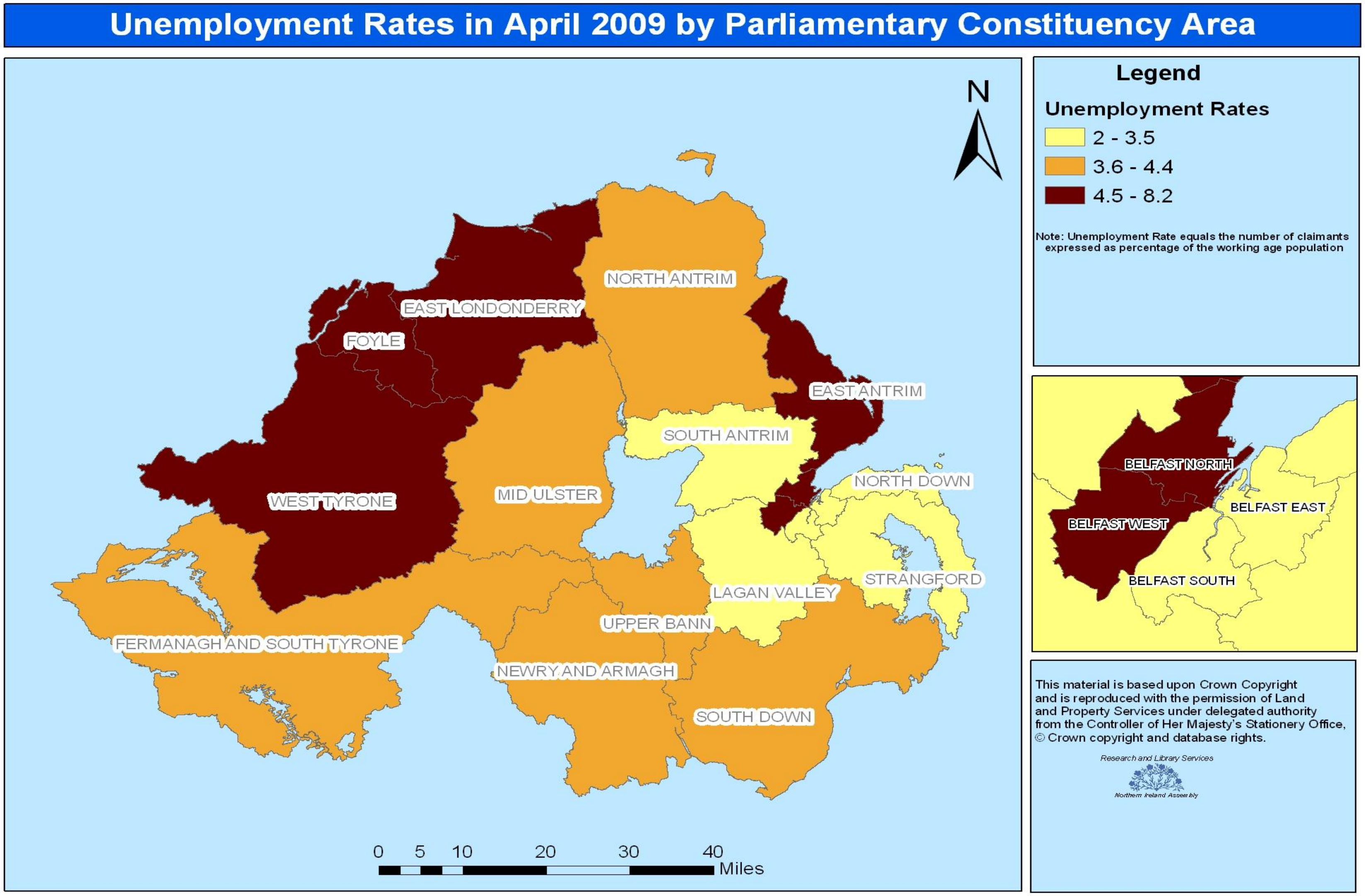
Annex 3


Unemployment Rates in April 2009 by Parliamentary Constituency Area
N
NORTH ANTRIM
EAST LONDONDERRY
FOYLE
EAST ANTRIM
SOUTH ANTRIM
WEST TYRONE
MID ULSTER
NORTH DOWN
STRANGFORD
LAGAN VALLEY
UPPER BANN
FERMANAGH AND SOUTH TYRONE
NEWRY AND ARMAGH
SOUTH DOWN
0 5 10 20 30 40 Miles
Legend
Unemployment Rates
2 - 3.5
3.6 - 4.4
4.5 - 8.2
Note: Unemployment Rate equals the number of claimants expressed as percentage of the working age population
BELFAST NORTH
BELFAST EAST
BELFAST WEST
BELFAST SOUTH
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Annex 4

Increase in Claimant Count between April 2008 and April 2009 by Parliamentary Constituency Area