

SEEING THROUGH THE GLOOM



RECESSIONS OF THE TWENTIETH CENTURY SENTIMENT CAN GO UP AS WELL AS DOWN

STARING INTO THE ABYSS

Discussion about recession is rarely out of the news these days. Following a period of almost unprecedented growth – from 1992 right through to this year – the business and personal finance pages are covered with nothing but bad news and negative predications. Analysts differ on how long and severe this downturn might be but they all agree on one thing – the UK is headed for recession.

WHAT IS A 'RECESSION'?

A recession is generally recognised as two consecutive quarters of negative growth in the Gross Domestic Product (GDP) of a country. If negative growth continues for much longer than this, or the GDP figures show very significant falls, this becomes a harsh recession - which will more than likely be redefined as a depression.

THE UK ECONOMY FACES A TOUGH TIME

What does appear to be true is that economic growth in the UK has stagnated. After showing zero growth in the second quarter of the year, the economy fell 0.5% in the third quarter. Despite a recent surge in inflation to over 5%, Mervyn King has cautioned that this slowdown could push it back down significantly, perhaps even below the BoE's rolling target of 2%.

In the meantime, however, the inflation surge means businesses face the unenviable choice of either passing on high prices to consumers, and losing business, or absorbing them, and losing profit. Many firms are therefore cutting costs by reducing their workforces and unemployment figures are already on the rise.

Finally, on top of all this, we have the fallout from the global credit crisis. This contraction in the availability of credit, combined with high levels of existing consumer debt, is already having an adverse effect on domestic demand. Consequently, many now expect that end of year GDP figures will simply confirm what we already fear – that the UK is in recession.

"THIS TOO SHALL PASS"

Recession, however, is nothing new. The UK has experienced four major recessions during the last 80 years. All have had a negative impact on individual's wealth and the profits made by companies and were generally the result of existing vulnerabilities in the economy being hit by a catalyst. The combination of events brought economic activity to a sudden standstill as the full impact was absorbed.

However, just as there was a catalyst for the slump, there was also, eventually, a catalyst for recovery – something which started to turn sentiment and allowed companies and individuals to start to build their wealth again.

PAST RECESSIONS IN THE UK

1929-1932

The recession of 1929-1932 was perhaps the most severe economic downturn in living memory, and has gone down in history as the Great Depression.

After the First World War ended, the UK returned to the Gold Standard, i.e. the value of the pound was fixed against the dollar and backed by British gold reserves. However, the value at which it was fixed made UK exports relatively expensive and demand was therefore low. This problem was then compounded by fallout from the Wall Street Crash of 1929, which led to a slump in demand for British products, a run on Britain's gold reserves (as investors sold their pounds) and finally to industrial stagnation and mass unemployment.

Eventually, in 1931, the UK withdrew from the gold standard, allowing the pound to devalue, and interest rates were cut. This led to a decrease in the cost of exports and a consequent increase in demand, providing the backdrop for a gradual uplift in economic growth and employment.

1973-75

Following the end of the Great Depression, World War II was succeeded by a period of overall growth that lasted until the 1970s. The early 1970s saw a speculative boom across every asset class that drove share prices higher. However, major stock markets around the world subsequently crashed following a series of external shocks that included the devaluation of the US dollar and the 1973 oil crisis.

Oil prices rose sharply as OPEC cut production and increased prices against a backdrop of war and geopolitical unrest, leading to a sharp rise in inflation. Consumer demand fell as prices soared, unemployment rocketed and economic growth ground to a halt. The UK government sought to dampen inflationary pressures by intervening in pay deals for workers, a move that ultimately led to the infamous "winter of discontent".

1979-82

When the Conservatives took over government of the UK, in 1979, inflation was running at over 20%, and the British public had just experienced the "winter of discontent". The incoming government worked to reduce inflation by raising interest rates and tightening fiscal policy. As a result, the value of sterling increased, exporters and the manufacturing sector struggled and unemployment rose, leading to a recession.

In response, the Conservatives introduced what is now known as the Thatcherite approach – they reduced state intervention, encouraged entrepreneurialism and privatised a number of government-owned companies. This subsequently helped to boost growth in the economy and the stock market.

1989-93

Following these changes of the early 1980s, the following period was characterised by a period of extreme optimism, but UK inflation was once again spiralling out of control. The UK joined the European Exchange Rate Mechanism (ERM) with the aim of shoring up the value of sterling, but this move prevented the British government from setting interest rates at levels appropriate for the UK economy.

High interest rates led many British businesses to collapse, unemployment to rise and the housing market to crash, and ultimately contributed to a period of recession in the UK. It was only when the government was forced to pull the pound out of the ERM in September 1992, that they could once again reduce interest rates, allowing the UK economy to begin its recovery.

IN SUMMARY

When looking back at past recessions, it is important to remember that, each time, the UK later returned to economic prosperity – and stock markets have usually emerged in reasonably good shape, as far-sighted investors take advantage of inexpensive share prices.

Meanwhile, companies often take the opportunity to cut costs which, whilst it may not be good news for workers in the short-term, shores up their balance sheets and allows them to emerge from the fray leaner and meaner, potentially improving their prospects long term.

Even a weak pound, another common characteristic of recessionary periods, is not necessarily all bad news. This can prove positive for exporters and UK-based companies that generate profits overseas as their services become cheaper on the world stage.

Ultimately, it is important to remember that, whilst recession is a difficult experience to have to go through, like so many other unpleasant experiences, "This too shall pass".