

Effects on Market Volatility and Monetary Systems at an International Financial Market

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ABSTRACT

In January 2009, the Obama administration announced a stimulus plan to revive the economy with the intention to create or save more than 3.6 million jobs in two years. The cost of this initial recovery plan was estimated at 825 billion dollars (5.8% of GDP). The plan included 365.5 billion dollars to be spent on major policy and reform of the health system, 275 billion (through tax rebates) to be redistributed to households and firms, notably those investing in renewable energy, 94 billion to be dedicated to social assistance for the unemployed and families, 87 billion of direct assistance to states to help them finance health expenditures of Medicaid, and finally 13 billion spent to improve access to digital technologies. The administration also attributed of 13.4 billion dollars aid to automobile manufacturers General Motors and Chrysler, but this plan is not included in the stimulus plan. In an effort to increase available funds for commercial banks and lower the fed funds rate, on September 29 the U.S. Federal Reserve announced plans to double its Term Auction Facility to \$300 billion. Because there appeared to be a shortage of U.S. dollars in Europe at that time, the Federal Reserve also announced it would increase its swap facilities with foreign central banks from \$290 billion to \$620 billion. As of December 24, 2008, the Federal Reserve had used its independent authority to spend \$1.2 trillion on purchasing various financial assets and making emergency loans to address the financial crisis, above and beyond the \$700 billion authorized by Congress from the federal budget. This includes emergency loans to banks, credit card companies, and general businesses, temporary swaps of treasury bills for mortgage-backed securities, the sale of Bear Stearns, and the bailouts of American International Group (AIG), Fannie Mae and Freddie Mac, and Citigroup. China's export driven economy is starting to feel the impact of the economic slowdown in the United States and Europe, and the government has already cut key interest rates three times in less than two months in a bid to spur economic expansion. On November 28, 2008, the Ministry of Finance of the People's Republic of China and the State Administration of Taxation jointly announced a rise in export tax rebate rates on some labor-intensive goods. These additional tax rebates will take place on December 1, 2008. Until September 2008, European policy measures were limited to a small number of countries (Spain and Italy). In both countries, the measures were dedicated to households (tax rebates) reform of the taxation system to support specific sectors such as housing. From September, as the financial crisis began to seriously affect the economy, many countries announced specific measures: Germany, Spain, Italy, Netherlands, United Kingdom, and Sweden. The European Commission proposed a €200 billion stimulus plan to be implemented at the European level by the countries. At the

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beginning of 2009, the UK and Spain completed their initial plans, while Germany announced a new plan. The European Central Bank injected \$99.8 billion in a one-day money-market auction. The Bank of England pumped in \$36 billion

Key Words: *Obama- plan- stimulus- finance-commercial banks- AIG- unemployed*

Introduction

In our discussion of foreign trade in International Trade, we left out one crucial element: How do buyers and sellers in different countries do business when they all use different currencies? When a giant blue fin tuna is packed in ice and flown from Cape Cod to Tokyo, the fishing boat captain wants to be paid in dollars. But the Japanese fishmonger has nothing but yen. That doesn't help the Cape Cod captain, who has to pay his crew and his bills in dollars. So the Japanese fishmonger must somehow pay for the tuna in dollars. How are these problems resolved? What determines how many yen a dollar is worth? In other words, how does the foreign exchange system work? This section answers these questions and explains the foreign exchange markets, balance of payments, International Monetary Fund, and what is meant by a strong and "weak" dollar. International finance is the branch of economics that studies the dynamics of exchange rates, foreign investment, and how these affect international trade. It also studies international projects, international investments and capital flows, and trade deficits. It includes the study of futures, options and currency swaps. Together with international trade theory, international finance is also a branch of international economics. Some of the theories which are important in international finance include the Mundell-Fleming model, the optimum currency area (OCA) theory, as well as the purchasing power parity (PPP) theory. Moreover, whereas international trade theory makes use of mostly microeconomic

methods and theories, international finance theory makes use of predominantly intermediate and advanced macroeconomic methods and concepts. Absolute purchasing power parity (APPP) states that the random exchange rate is equal to the ratio of the domestic price level to the international price level. APPP: Random Exchange Rate = Price Level Domestic/Price Level Foreign. The price levels can be determined by the Laspeyres Indices, which are the summations of the price vector times the quantity vector. There are five factors which cause APPP to fail: taxes, homogeneity, and demand for characteristics, politics, and uncertainty. Relative purchasing power parity(RPPP) states that the estimated exchange rate is equal to the inflation rate differential, which is also equal to the interest rate differential, which is also equal to the ratio of the (forward rate - spot rate)/(spot rate).

Types of Financial Markets

The financial markets can be divided into different subtypes:

1. and enable the subsequent trading there of Bond markets, which provide financing through the issuance of bonds, and enable the subsequent trading thereof.
2. Commodity markets, which facilitate the trading of commodities.
3. Money markets, which provide short term debt financing and investment.

4. Derivatives markets, which provide instruments for the management of financial risk.
5. Futures Capital markets which consist of:
6. Stock markets, which provide financing through the issuance of shares or common stockmarkets, which provide standardized forward contracts for trading products at some future date; see also forward market.
7. Insurance markets, which facilitate the redistribution of various risks.
8. Foreign exchange markets, which facilitate the trading of foreign exchange.
9. The capital markets consist of primary markets and secondary markets. Newly formed (issued) securities are bought or sold in primary markets. Secondary markets allow investors to sell securities that they hold or buy existing securities

1. International Finance Market

- a. About foreign exchange
- b. Effect on Imports, Exports, and GDP
- c. Trade Deficits: Bad or Good?
- d. The International Monetary System
- e. The Dollar and the U.S. Economy

2. About Foreign Exchange

1. As you know, money is anything that is accepted as a medium of exchange. In most of the world, people accept pieces of paper

imprinted with pictures of national heroes or local wonders of nature as money. But in each nation, they accept different pieces of paper. This means that if someone in the United States wants to buy something from someone in, say, Mexico, she must first exchange her local currency—dollars—for the currency accepted in Mexico—pesos. This currency conversion occurs at an exchange rate. The exchange rate—the price of one nation's currency in terms of another nation's—is a central concept in international finance. Virtually any nation's currency can be converted into the currency of any other nation, thanks to exchange rates and the foreign exchange market. For instance, let's say the current exchange rate between the U.S. dollar and the Mexican peso is \$1 to 10 pesos. This means that \$1 will buy 10 pesos and that 10 pesos will buy \$1. (I am ignoring transaction costs, such as the commission charged by the bank or foreign exchange broker who does the currency conversion.)

2. The foreign exchange market includes the importers, exporters, banks, brokers, traders, and organizations involved in currency conversion. The FX or FOREX market, as it is called, is not a physical place—though many participants work in offices and on trading floors—but rather the entire network of participants in the market. Importers and exporters need foreign currency in order to complete transactions. Banks and brokers maintain inventories of foreign exchange, that is, various

currencies, and convert currencies as a service to customers. Traders and speculators make (or lose) money on the movement of foreign exchange rates (which I'll describe later). As you will see, central banks also play a role in the foreign exchange market.

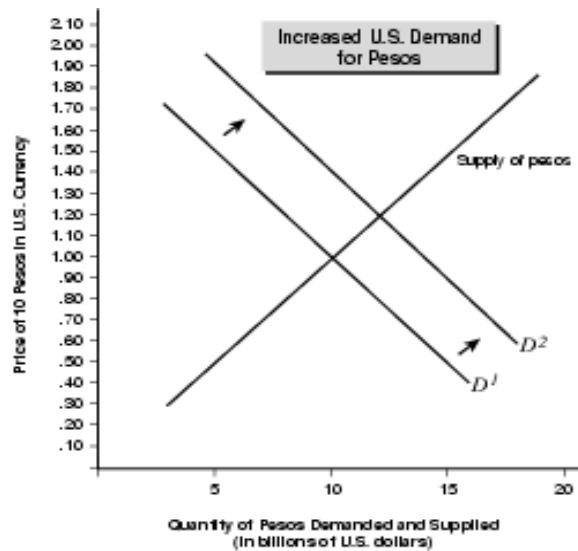
3. Types of Exchange Rates

4. Foreign currency exchange rates have historically been determined in three different ways:
 - a. Fixed rates
 - b. Floating (or flexible) rates
 - c. Managed rates

With a fixed exchange rate, the value of the currency is determined by the nation's central bank and held in place by central bank actions, mainly the purchase and sale of the currency. Another way to fix exchange rates, which has been used by the United States and other nations in the past, is to tie currencies to the gold standard. If all the currencies in the exchange rate system have a value pegged to gold, it is a simple matter to convert the currencies to one another according to their value in gold. Floating exchange rates are determined by the market forces of supply and demand. We will examine these forces in this section. Essentially, if demand for a currency increases, the value of that currency in terms of other currencies increases. If demand for the currency decreases, then the value of the currency decreases. Managed exchange rates are influenced by nations' central banks, but are not targeted to a fixed rate. In practice, the system of managed rates that we have today operates through the forces of supply and demand *and* are influenced by central banks. So we now have a mix of floating and managed rates, which is called managed

float. The economic forces that determine foreign exchange rates are rooted in supply and demand, both of which are determined mainly by foreign trade activity. For instance, if Americans increase their demand for products from Mexico, Americans will need to buy more pesos in order to buy those Mexican products. Thus an increase in U.S. demand for Mexican imports will increase the demand for pesos. An increase in the demand for any item, including currency, will increase its price. As we see in Figure 18.1 that is the case when Americans demand more pesos. The increase in the demand for pesos from \$10 billion worth to \$12 billion worth increased the price of pesos. Where \$1.00 used to buy 10 pesos, after the increase in U.S. demand for Mexican imports—from \$10 billion worth to \$12 billion of Mexican goods—it takes \$1.20 to buy 10 pesos. Put another way, a peso that used to cost 10¢ costs 12¢ after the increase in demand. In this situation, the dollar is said to have depreciated against the peso. Other ways of stating this are to say that the dollar lost value, lost ground, or weakened against the peso. This sounds worse than it is. All it means is that the United States demanded more imports from Mexico. But this kind of language is used for a simple reason: The dollar buys less than it used to in Mexico. After the increase in the peso to dollar exchange rate, it takes \$1.20 to buy what \$1.00 used to buy in Mexico. Given the law of supply and demand, this only makes sense. When Americans demand more Mexican products, they bid up the price of those products. When that occurs, the exchange rate mechanism adjusts itself to reflect that price increase. Therefore, the price of the peso, and thus of Mexican goods, rises. Let's look at this from Mexico's point of view. If the dollar has depreciated—lost value, lost ground, and weakened—against the peso, then the peso has appreciated—

gained value, gained ground, and strengthened—against the dollar. While this makes Mexico's products more expensive for Americans, it also makes U.S. products cheaper for Mexicans. The effects of these changes in two currencies mirror one another.



Source: Compiled from internet wikipedia-2009
Graph-1 Foreign Currency Supply and Demand

1. Effect on Imports, Exports, and GDP

Recall the formula for gross domestic product, $C + I + G + (Ex - Im)$. The expression $(Ex - Im)$ equals net exports, which may be either positive or negative. If net exports are positive, the nation's GDP increases. If they are negative, GDP decreases. All nations want their GDP to be higher rather than lower, so all nations want their net exports to be positive. (Of course it is not possible for all nations to have positive net exports because one or more nations must import more than they export if the others export more than they import.)

Returning to our example of the United States and Mexico, here is the sequence of events I just described and the impact on trade and GDP:

1. U.S. demand for Mexican imports increased.
2. This increased U.S. demand for pesos.
3. The increased U.S. demand for pesos raised the price of the peso in dollars.
4. When Americans purchase more imports from Mexico—holding all else equal—U.S. net exports (and GDP and employment) will decrease.
5. However, the change in the exchange rate will automatically correct this situation, because a) as the price, in dollars, of Mexican imports rises, U.S. demand for Mexican imports will fall, and b) as the price, in pesos, of U.S. exports to

Mexico falls, Mexican demand for U.S. products will rise.

6. When U.S. exports to Mexico rise (because they are cheaper), it will reverse the trend that began when U.S. demand for Mexican products increased. It will also reverse the effect on U.S. net exports, which will increase when exports to Mexico increase.
7. The price of the peso in dollars—the dollar-peso exchange rate—is determined by U.S. demand for Mexican goods and Mexican demand for U.S. goods. However, when the exchange rate changes that affects the price of each country's goods. That price change affects each country's demand for the other's goods in ways that tend to reverse the initial trend. This mechanism depends on floating exchange rates. If exchange rates are not permitted to respond to the forces of supply and demand, these automatic adjustments cannot occur. Given the high levels of international trade in the world today, and the “managed float” nature of exchange rates, the economies of most nations are intertwined in various ways. Let's examine some of those ways.

The Balance of Payments

The balance of international payments, commonly known as the balance of payments, is the overall accounting of a nation's international economic activity. It is a statement summarizing the transactions that took place between a nation and the rest of the world, usually over a calendar quarter or year. It shows the sum of all the transactions between the individuals, businesses, and government agencies of the nation and those of the rest of the world.

Transactions are recorded as debits and credits in the balance of payments. Transactions that cause money to flow into the country (inflows) are credits, and those that cause money to leave the country (outflows) are debits. For example, if the U.S. exports a cement mixer to Brazil, the transaction is a credit to the U.S. balance of payments and a debit to Brazil's balance of payments. If Malaysia borrows \$1.5 billion from the U.S. government, the transaction is a debit to the U.S. balance of payments and a credit to Malaysia's. However, when Malaysia makes its first payment on the principal and interest on the loan, it is a credit to the U.S. balance of payments and a debit to Malaysia's. The balance of payments statement divides international transactions into three accounts: the current account, capital account, and financial account, as follows:

The current account includes trade in goods and services; income receipts, such as dividends and interest; and unilateral transfers of assets, such as foreign aid.

The capital account includes forgiveness of international debt, migrant transfers (goods or financial assets accompanying migrants into or out of the country), transfers of funds arising from gift and inheritance taxes, and uninsured damage to fixed assets.

The financial account records trade in fixed assets such as companies and real estate; in financial assets such as stocks and bonds; in government-owned assets and foreign-owned assets in the United States; and in rights and intangible assets, such as mineral rights, copyrights, patents, trademarks, franchises, and leases.

Each of these three accounts—the current account, the capital account, and the financial account—is summed separately. The sum of the current account should

balance with the sum of the capital account plus the financial account. Thus, the current account should balance out to zero against the capital and financial accounts. In practice, the balance is close to zero relative to the sums involved, but is rarely exactly

zero. This is due to statistical discrepancies, accounting conventions, and exchange rate movements that change the recorded value of transactions. Why should the current account balance out to zero against the capital and financial accounts?

	Inflows	Outflows	Net
Current Account			
Merchandise Account (Exports/Imports)			
Goods	\$719	-\$1,146	
Services	279	-210	
Total Merchandise Account	\$998	-\$1,356	-\$358
Income Account	284	-269	15
Transfers			-50
Balance on Current Account			-\$393
Capital Account			1
Financial Account			
Foreign Investment in the United States	753		
U.S. Investment Abroad		-371	
Balance on Financial Account			\$382
Statistical Discrepancy			10
Balance on Capital and Financial Accounts			\$393

Source: Bureau of Economic Analysis, *International Accounts Data*
Table.1.U.S. Balance of Payments, December 31, 2001(billions of dollars)

(If this reminds you of the discussion about federal budget deficits and the national debt, that's no accident. The mechanisms at work are similar.) Labor unions oppose trade deficits because they believe that when imports exceed exports, jobs are being lost to overseas workers, or soon will be. On the surface, it seems a reasonable argument, but

the data on trade deficits and unemployment don't support it. In the late 1990s, when the trade deficit reached record highs, unemployment dropped to its lowest level in three decades.

Some economists who oppose trade deficits see them as a symptom, rather than a cause, of trouble, specifically bad central

bank policy. They believe that trade deficits arise from loose monetary policy. A rapidly growing money supply boosts demand, including demand for imports. This has two effects: First, it generates inflationary pressure, some of which is “exported” to other nations, in the form of higher prices over there. Second, it directs too much investment in other nations into export industries. These nations' economies then suffer when America hits a recession and imports less.

Economists who consider trade deficits good associate them with positive economic developments, specifically, higher levels of income, consumer confidence, and investment. They argue that trade deficits enable the United States to import capital to finance investment in productive capacity. Far from hurting employment, they believe that trade deficits financed by foreign investment in the United States help to boost U.S. employment.

Some economists see trade deficits as mere expressions of consumer preferences and as immaterial. These economists typically equate economic well being with rising consumption. If consumers want imported food, clothing, and cars, why shouldn't they buy them? That range of choices is part of a successful economy. Perhaps the best view of trade deficits is the balanced view. If a trade deficit represents borrowing to finance current consumption rather than long-term investment, or results from inflationary pressure, or erodes U.S. employment, then it's bad. If a trade deficit fosters borrowing to finance long-term investment or reflects rising incomes, confidence, and investment—and doesn't hurt employment—then it's good. If a trade deficit merely expresses consumer preferences rather than these phenomena, it is immaterial.

But what about the effect on GDP? Shouldn't Americans worry when net exports are negative and GDP is smaller than it otherwise would be? Most mainstream economists believe that because the current account deficit is offset by foreign investment in the United States, the effect on GDP is negligible. The security of the U.S. economy and the U.S. dollar make investments in U.S. productive capacity and in U.S. corporate and government securities quite attractive. So as long as the trade deficits are financed by foreign investment and the dollar is not overly weakened by them, then GDP will be fine.

So, given the size of the U.S. economy and the benefits of foreign investment in the United States, the effect of trade deficits on GDP is minimal. This is particularly true when compared with the effect of other, more easily influenced factors, such as U.S. monetary policy. It's best to view trade deficits in the context of growth, unemployment, inflation, and other measures of economic performance. The size of the trade deficit itself, and even its trend, reveals very little about the condition of the U.S. economy.

1. The International Monetary System

The rules and procedures for exchanging national currencies are collectively known as the international monetary system. This system doesn't have a physical presence, like the Federal Reserve System, nor is it as codified as the Social Security system. Instead, it consists of interlocking rules and procedures and is subject to the foreign exchange market, and therefore to the judgments of currency traders about a currency.

Yet there are rules and procedures—exchange rate policies—which public finance officials of various nations have

developed and from time to time modify. There are also physical institutions that oversee the international monetary system, the most important of these being the International Monetary Fund.

Exchange Rate Policies

In July 1944, representatives from 45 nations met in Bretton Woods, New Hampshire to discuss the recovery of Europe from World War II and to resolve international trade and monetary issues. The resulting Bretton Woods Agreement established the International Bank for Reconstruction and Development (the World Bank) to provide long-term loans to assist Europe's recovery. It also established the International Monetary Fund (IMF) to manage the international monetary system of fixed exchange rates, which was also developed at the conference.

The new monetary system established more stable exchange rates than those of the 1930s, a decade characterized by restrictive trade policies. Under the Bretton Woods Agreement, IMF member nations agreed to a system of exchange rates that pegged the value of the dollar to the price of gold and pegged other currencies to the dollar. This system remained in place until 1972. In 1972, the Bretton Woods system of pegged exchange rates broke down forever and was replaced by the system of managed floating exchange rates that we have today.

The Bretton Woods system broke down because the dynamics of supply, demand, and prices in a nation affect the true value of its currency, regardless of fixed rate schemes or pegging policies. When those dynamics are not reflected in the foreign exchange value of the currency, the currency becomes overvalued or undervalued in terms of other currencies. Its price—fixed or otherwise—becomes too high or too low, given the

economic fundamentals of the nation and the dynamics of supply, demand, and prices. When this occurs, the flows of international trade and payments are distorted.

In the 1960s, rising costs in the United States made U.S. exports uncompetitive. At the same time, Western Europe and Japan emerged from the wreckage of World War II to become productive economies that could compete with the United States. As a result, the U.S. dollar became overvalued under the fixed exchange rate system. This caused a drain on the U.S. gold supply, because foreigners preferred to hold gold rather than overvalued dollars. By 1970, U.S. gold reserves decreased to about \$10 billion, a drop of more than 50 percent from the peak of \$24 billion in 1949. In 1971, the U.S. decided to let the dollar float against other currencies so it could find its proper value and imbalances in trade and international funds flows could be corrected. This indeed occurred and evolved into the managed float system of today. A nation manages the value of its currency by buying or selling it on the foreign exchange market. If a nation's central bank buys its currency, the supply of that currency decreases and the supply of other currencies increases relative to it. This increases the value of its currency. On the other hand, if a nation's central bank sells its currency, the supply of that currency on the market increases, and the supply of other currencies decrease relative to it. This decreases the value of its currency. The International Monetary Fund plays a key role in operations that help a nation manage the value of its currency.

The International Monetary Fund

The International Monetary Fund is like a central bank for the world's central banks. It is headquartered in Washington, D.C., has 184 member nations, and cooperates closely

with the World Bank, which we discuss in *The Global Market and Developing Nations*. The IMF has a board of governors consisting of one representative from each member nation. The board of governors elects a 20-member executive board to conduct regular operations. The goals of the IMF are to promote world trade, stable exchange rates, and orderly correction of balance of payments problems. One important part of this is preventing situations in which a nation devalues its currency purely to promote its exports. That kind of devaluation is often considered unfairly competitive if underlying issues, such as poor fiscal and monetary policies, are not addressed by the nation. Member nations maintain funds in the form of currency reserve units called Special Drawing Rights (SDRs) on deposit with the IMF. (This is a bit like the federal funds that U.S. commercial banks keep on deposit with the Federal Reserve.) From 1974 to 1980, the value of SDRs was based on the currencies of 16 leading trading nations. Since 1980, it has been based on the currencies of the five largest exporting nations. From 1990 to 2000, these were the United States, Japan, Great Britain, Germany, and France. The value of SDRs is reassigned every five years.

SDRs are held in the accounts of IMF nations in proportion to their contribution to the fund. (The United States is the largest contributor, accounting for about 25 percent of the fund.) Participating nations agree to accept SDRs in exchange for reserve currencies—that is, foreign exchange currencies—in settling international accounts. All IMF accounting is done in SDRs, and commercial banks accept SDR-denominated deposits. By using SDRs as the unit of value, the IMF simplifies its own and its member nations' payment and accounting procedures.

In addition to maintaining the system of SDRs and promoting international liquidity, the IMF monitors worldwide economic developments, and provides policy advice, loans, and technical assistance in situations like the following:

1. After the collapse of the Soviet Union, the IMF helped Russia, the Baltic states, and other former Soviet countries set up treasury systems to assist them in moving from planned to market-based economies.
2. During the Asian financial crisis of 1997 and 1998, the IMF helped Korea to bolster its reserves. The IMF pledged \$21 billion to help Korea reform its economy, restructure its financial and corporate sectors, and recover from recession.
3. In 2000, the IMF Executive Board urged the Japanese government to stimulate growth by keeping interest rates low, encouraging bank restructuring, and promoting deregulation.
4. In October 2000, the IMF approved a \$52 million loan for Kenya to help it deal with severe drought. This was part of a three-year \$193 million loan under an IMF lending program for low-income nations.

Most economists judge the current international monetary system a success. It permits market forces and national economic performance to determine the value of foreign currencies, yet enables nations to maintain orderly foreign exchange markets by cooperating through the IMF.

The EU and the Euro

The biggest news on the foreign currency front over the past few years is the adoption of the euro by the European Union (EU). Twelve member states of the EU use the euro instead of their old local currencies: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain. Nations that adopt the euro participate in a single EU monetary policy and are subject to fiscal guidelines requiring them to keep deficits to a certain level and to balance their federal budgets by 2006. Although it will reconsider the matter again, Britain has refused to adopt the euro and has stuck with the pound sterling. This reflects England's traditional sense of "apartness" from continental Europe and its reluctance to give up sovereignty over its economic policies.

1. The Dollar and the U.S. Economy

A strong dollar—one that can purchase more foreign currency relative to a weak dollar—means that U.S. consumers pay less for imports. It also means that foreign consumers must pay more for U.S. exports. A weak dollar—one that can purchase less foreign currency relative to a strong dollar—means that U.S. consumers must pay more for imports from foreign nations. However, foreign consumers will pay less for U.S. goods and services, which will help increase production and employment in America. So the strong dollar and the weak dollar each have positive and negative effects. Think about it: A strong dollar helps U.S. consumers because it makes foreign goods, which American consumers clearly enjoy buying, cheaper. Yet it hurts U.S. exports and therefore U.S. production and employment. It also makes the United States a less affordable travel destination for foreign visitors. Meanwhile, a weak dollar makes U.S. exports and travel in the United States more affordable for foreigners. That

helps U.S. production and employment. However, it also raises the price of imports for Americans. This, in a sense, limits U.S. consumers' choices (and can contribute to inflation), but it shifts buying behavior in favor of U.S. products, which also helps U.S. employment.

The best "dollar policy" is, therefore, one that balances the pros and cons of a strong and weak dollar, and that takes the economies of our trading partners into account. That last point can be important: A dollar that is strong against the euro, for example, will weaken the euro. EU products will become more affordable to Americans, and Americans will be encouraged to travel to Europe. That can help EU nations struggling with recession and unemployment. Indeed, much of Europe and Asia correctly view the United States as the engine of growth for the global economy. The U.S. market is so large, strong, driven by consumption and partial to imports that it can boost production in European and Asian nations. That's a large responsibility and one that Americans, by virtue of their free spending ways, unwittingly but willingly take on. Likewise, when the U.S. business cycle turns down and demand decreases, no one in Europe or Asia is happy about it. Of course, economic policies and behavior in Europe and Asia are larger determinants of their economic fate. So it would be going too far to say, "When the U.S. sneezes, Europe catches cold," but there is a grain of truth in it.

Current Scenario of International Finance

Beginning in the late 2000s (December 2007 in the United States according to the National Bureau of Economic Research) — and with much greater intensity since September 2008—the industrialized world has been undergoing a recession, a

pronounced deceleration of economic activity. This global recession has been taking place in an economic environment characterized by various imbalances and was sparked by the outbreak of the financial crisis of 2007–2009. Although the late-2000s recession has at times been referred to as "the Great Recession," this same phrase has been used to refer to every recession of the several preceding decades. The financial crisis has been linked to reckless and unsustainable lending practices resulting from the deregulation and securitization of real estate mortgages in the United States. The US mortgage-backed securities, which had risks that were hard to assess, were marketed around the world. A more broad based credit boom fed a global speculative bubble in real estate and equities, which served to reinforce the risky lending practices. The precarious financial situation was made more difficult by a sharp increase in oil and food prices. The emergence of Sub-prime loan losses in 2007 began the crisis and exposed other risky loans and over-inflated asset prices. With loan losses mounting and the fall of Lehman Brothers on September 15, 2008, a major panic broke out on the inter-bank loan market. As share and housing prices declined many large and well established investment and commercial banks in the United States and Europe suffered huge losses and even faced bankruptcy, resulting in massive public financial assistance. A global recession has resulted in a sharp drop in international trade, rising unemployment and slumping commodity prices. In December 2008, the National Bureau of Economic Research (NBER) declared that the United States had been in recession since December 2007. Several economists have predicted that recovery may not appear until 2011 and that the recession will be the worst since the Great Depression of the 1930s. The

conditions leading up to the crisis, characterized by an exorbitant rise in asset prices and associated boom in economic demand, are considered a result of the extended period of easily available credit, inadequate regulation and oversight or increasing inequality. Fiscal and monetary policies have been significantly eased to stem the recession and financial risks. While this has renewed interest in Keynesian economic ideas, the recent policy consensus is for the stimulus to be withdrawn as soon as the economies recover to "chart a path to sustainable growth".

Commodity boom

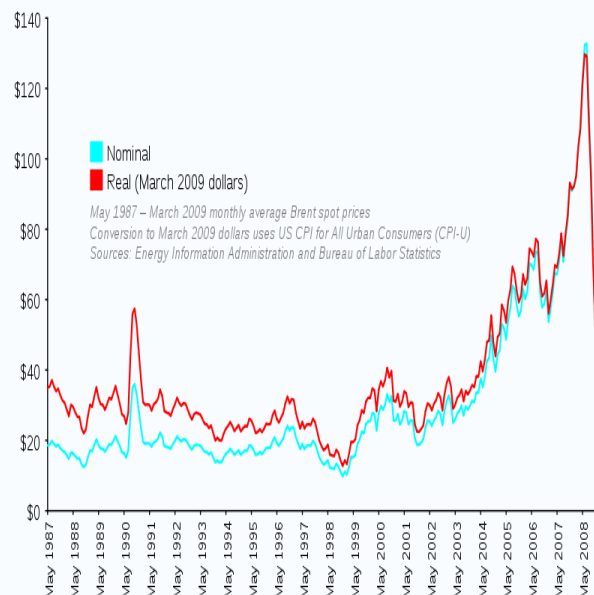
The decade of the 2000s saw a global explosion in prices, focused especially in commodities and housing, marking an end to the commodities recession of 1980-2000. In 2008, the prices of many commodities, notably oil and food, rose so high as to cause genuine economic damage, threatening stagflation and a reversal of globalization. In January 2008, oil prices surpassed \$100 a barrel for the first time, the first of many price milestones to be passed in the course of the year. In July 2008, oil peaked at \$147.30 a barrel and a gallon of gasoline was more than \$4 across most of the U.S.A. These high prices caused a dramatic drop in demand and prices fell below \$35 a barrel at the end of 2008.^[17] Some believe that this oil price spike was the product of Peak Oil. There is concern that if the economy was to improve, oil prices might return to pre-recession levels. Sulfuric acid (an important chemical commodity used in processes such as steel processing, copper production and bio ethanol production) increased in price 3.5-fold in less than 1 year while producers of sodium hydroxide have declared force majeure due to flooding, precipitating similarly steep price increases. In the second half of 2008, the prices of most commodities

fell dramatically on expectations of diminished demand in a world recession. The late-2000s recession is shaping up to be the worst post-war contraction on record: Real gross domestic product (GDP) began contracting in the third quarter of 2008, and by early 2009 was falling at an annualized pace not seen since the 1950s. Capital investment, which was in decline year-on-year since the final quarter of 2006, matched the 1957-58 post war record in the first quarter of 2009. The pace of collapse in residential investment picked up speed in the first quarter of 2009, dropping 23.2% year-on-year, nearly four percentage points faster than in the previous quarter. Domestic demand, in decline for five straight quarters, is still three months shy of the 1974-75 record, but the pace – down 2.6% per quarter vs. 1.9% in the earlier period – is a record-breaker already

Trade and Industrial Production

In middle-October 2008, the Baltic Dry Index, a measure of shipping volume, fell by

50% in one week, as the credit crunch made it difficult for exporters to obtain letters of credit. In February 2009, *The Economist* claimed that the financial crisis had produced a "manufacturing crisis", with the strongest declines in industrial production occurring in export-based economies. In March 2009, Britain's *Daily Telegraph* reported the following declines in industrial output, from January 2008 to January 2009: Japan -31%, Korea -26%, Russia -16%, Brazil -15%, Italy -14%, Germany -12%. Some analysts even say the world is going through a period of de-globalization and protectionism after years of increasing economic integration. Sovereign funds and private buyers from the Middle East and Asia, including China, are increasingly buying in on stakes of European and U.S. businesses, including industrial enterprises. Due to the global recession they are available at a low price. The Chinese government has concentrated on natural-resource deals across the world, securing supplies of oil and minerals.



Source: Compiled from internet wikipedia-2009

*Graph-2***Pollution**

According to the International Energy Agency man-made greenhouse gas emissions will decrease by 3% in 2009, mainly as a result of the financial crisis. Previously emissions had been rising by around 3% per year. The drop in emissions is only the 4th to occur in 50 years

Unemployment

The International Labor Organization (ILO) predicted that at least 20 million jobs will have been lost by the end of 2009 due to the crisis — mostly in "construction, real estate, financial services, and the auto sector" — bringing world unemployment above 200 million for the first time. The number of unemployed people worldwide could increase by more than 50 million in 2009 as the global recession intensifies, the ILO has forecast. In December 2007, the U.S. unemployment rate was 4.9%. By October 2009, the unemployment rate had risen to 10.2%. A broader measure of unemployment (taking into account marginally attached workers, those employed part time for economic reasons, and discouraged workers) was 16.3%. Spain's unemployment rate reached 18.7% (37% for youths) in May 2009 — the highest in the euro zone. In July 2009, fewer jobs were lost than expected, dipping the unemployment rate from 9.5% to 9.4%. Even fewer jobs were lost in August, 216,000, recorded as the lowest number of jobs since September 2008, but the unemployment rate rose to 9.7%. In October 2009, news reports announced that some employers who cut jobs due to the recession are beginning to hire them back. The rise of advanced economies in Brazil, India, and

China increased the total global labor pool dramatically. Recent improvements in communication and education in these countries has allowed workers in these countries to compete more closely with workers in traditionally strong economies, such as the United States. This huge surge in labor supply has provided downward pressure on wages and contributed to unemployment

Recession Entrepreneurs

The term Recession Entrepreneurs was coined by JJ Ink in 2009, after they found that most of their marketing consulting clients were recession made entrepreneurs, those that had been laid off due to the economic downturn and had thus decided to use their savings and unemployment benefits to start their own business. The recession has allowed many Recession Entrepreneurs to completely change course in their careers and pursue their dream jobs. Recessions are historically ripe with opportunity for innovation, allowing a unique opportunity for entrepreneurs. "The recession has also injected life into a slew of small businesses that are thriving either in spite of or because of the economic downturn, giving new relevance to the old adage that one man's misfortune is another's opportunity.

Financial Markets

For a time, major economies of the 21st century were believed to have begun a period of decreased volatility, which was sometimes dubbed The Great Moderation, because many economic variables appeared to have achieved relative stability. The return of commodity, stock market, and currency value volatility are regarded as indications that the concepts behind the Great Moderation were guided by false beliefs. January 2008 was an especially volatile

month in world stock markets, with a surge in implied volatility measurements of the US-based S&P 500 index, and a sharp decrease in non-U.S. stock market prices on Monday, January 21, 2008 (continuing to a lesser extent in some markets on January 22). Some headline writers and a general news columnist called January 21 "Black Monday" and referred to a "global shares crash," though the effects were quite different in different markets. The effects of these events were also felt on the Shanghai Composite Index in China which lost 5.14 percent, most of this on financial stocks such as Ping An Insurance and China Life which lost 10 and 8.76 percent respectively. Investors worried about the effect of a recession in the US economy would have on the Chinese economy. Citigroup estimates due to the number of exports from China to America a one percent drop in US economic growth would lead to a 1.3 percent drop in China's growth rate. There were several large Monday declines in stock markets world wide during 2008, including one in January, one in August, one in September, and another in early October. As of October 2008, stocks in North America, Europe, and the Asia-Pacific region had all fallen by about 30% since the beginning of the year. The Dow Jones Industrial Average had fallen about 37% since January 2008. The simultaneous multiple crises affecting the US financial system in mid-September 2008 caused large falls in markets both in the US and elsewhere. Numerous indicators of risk and of investor fear (the TED spread, Treasury yields, and the dollar value of gold) set records. Russian markets, already falling due to declining oil prices and political tensions with the West, fell over 10% in one day, leading to a suspension of trading, while other emerging markets also exhibited losses.

Travel

According to Zagat's 2009 U.S. Hotels, Resorts & Spas survey, business travel has decreased in the past year as a result of the recession. 30% of travelers surveyed stated they travel less for business today while only 21% of travelers stated that they travel more. Reasons for the decline in business travel include company travel policy changes, personal economics, economic uncertainty and high airline prices. Hotels are responding to the downturn by dropping rates, ramping up promotions and negotiating deals for both business travelers and tourists.

Insurance

A February 2009 study on the main British insurers showed that most of them do not plan to raise their insurance premiums for the year 2009, in spite of the prediction of a 20% raise made by The Daily Telegraph and The Daily Mirror. However, it is expected that the capital liquidity will become an issue and determine increases, having their capital tied up in investments yielding smaller dividends, corroborated with the £644 million underwriting losses suffered in 2007.

Countries Most Affected

The crisis affected all countries in some ways, but certain countries were vastly affected more than others. By measuring currency devaluation, equity market decline, and the rise in sovereign bond spreads, a picture of financial devastation emerges. Since these three indicators show financial weakness, taken together, they capture the impact of the crisis. The Carnegie Endowment for International Peace reports in its International Economics Bulletin that two eastern European countries - Hungary, and Ukraine - as well as Argentina and Jamaica are the countries most deeply affected by the crisis. By contrast, China,

Japan, India, Peru and Australia are "among the least affected.

Policy responses on 2008-2009

The financial phase of the crisis led to emergency interventions in many national financial systems. As the crisis developed into genuine recession in many major economies, economic stimulus meant to revive economic growth became the most common policy tool. After having implemented rescue plans for the banking system, major developed and emerging countries announced plans to relieve their economies. In particular, economic stimulus plans were announced in China, the United States, and the European Union.^[115] Bailouts of failing or threatened businesses were carried out or discussed in the USA, the EU, and India. In the final quarter of 2008, the financial crisis saw the G-20 group of major economies assume a new significance as a focus of economic and financial crisis management.

United States Policy Responses

The Federal Reserve, Treasury, and Securities and Exchange Commission took several steps on September 19 to intervene in the crisis. To stop the potential run on money market mutual funds, the Treasury also announced on September 19 a new \$50 billion program to insure the investments, similar to the Federal Deposit Insurance Corporation (FDIC) program.^[117] Part of the announcements included temporary exceptions to section 23A and 23B (Regulation W), allowing financial groups to more easily share funds within their group. The exceptions would expire on January 30, 2009, unless extended by the Federal Reserve Board. The Securities and Exchange Commission announced termination of short-selling of 799 financial stocks, as well as

action against naked short selling, as part of its reaction to the mortgage crisis.

Market volatility within US 401(k) and retirement plans

The US Pension Protection Act of 2006 included a provision which changed the definition of Qualified Default Investments (QDI) for retirement plans from stable value investments, money market funds, and cash investments to investments which expose an individual to appropriate levels of stock and bond risk based on the years left to retirement. The Act required that Plan Sponsors move the assets of individuals who had never actively elected their investments and had their contributions in the default investment option. This meant that individuals who had defaulted in to cash fund with little fluctuation or growth would soon have their account balances moved to much more aggressive investments.

Conclusion

In the part of conclusion, the Starting in early 2008, most US employer-sponsored plans sent notices to their employees informing them that the plan default investment was changing from a cash/stable option to something new, such as a retirement date fund which had significant market exposure. Most participants ignored these notices until September and October, when the market crash was on every news station and media outlet. It was then that participants called their 401(k) and retirement plan providers and discovered losses in excess of 30% in some cases. Call centers for 401(k) providers experienced record call volume and wait times, as millions of inexperienced investors struggled to understand how their investments had been changed so fundamentally without their explicit consent, and reacted in a panic by liquidating everything with any stock or

bond exposure, locking in huge losses in their accounts. Due to the speculation and uncertainty in the market, discussion forums filled with questions about whether or not to liquidate assets and financial gurus were swamped with questions about the right steps to take to protect what remained of their retirement accounts. During the third quarter of 2008, over \$72 billion left mutual fund

investments that invested in stocks or bonds and rushed into Stable Value investments in the month of October. Against the advice of financial experts, and ignoring historical data illustrating that long-term balanced investing has produced positive returns in all types of markets, investors with decades to retirement instead sold their holdings during one of the largest drops in stock market history.

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