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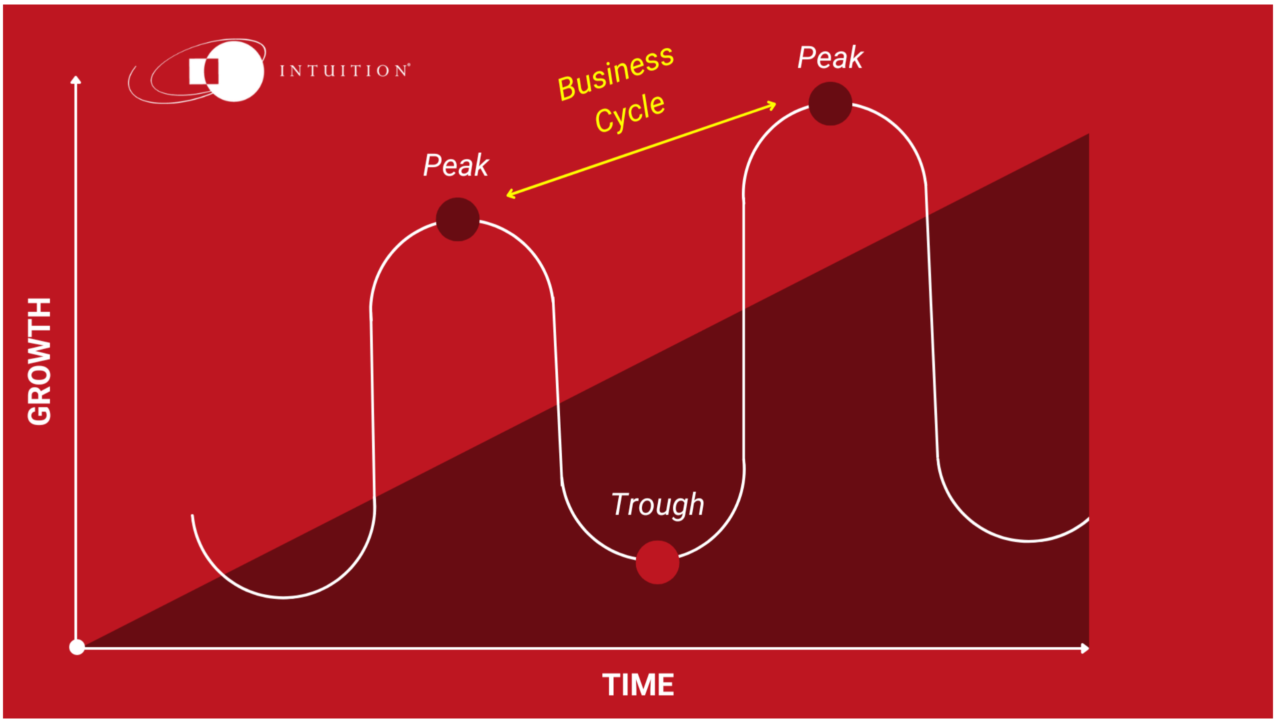
Understanding the Dynamics of Recession

Around the world, many economies are either in recession or heading toward one as a result of the inflation crisis and the associated policy response from monetary authorities. But what exactly is a "recession," what happens during it, how long does it last, and how does it end?

The trajectory of global economic growth is inevitably positive over the long term – driven by population growth and productivity improvements. But this is not a continuous phenomenon. The economy performs in cycles with periods of expansion and contraction. Where the contraction is sufficiently severe and prolonged, we have what is termed a recession.



Business Cycle

There is no universal definition of a recession but typically an economy is said to be in recession where it has seen two consecutive quarters of negative growth in real GDP.

Right now the word 'recession' is trending heavily in the financial media as the global economy struggles with the impact of central bank policies to curb inflation, principally through the raising of interest rates.

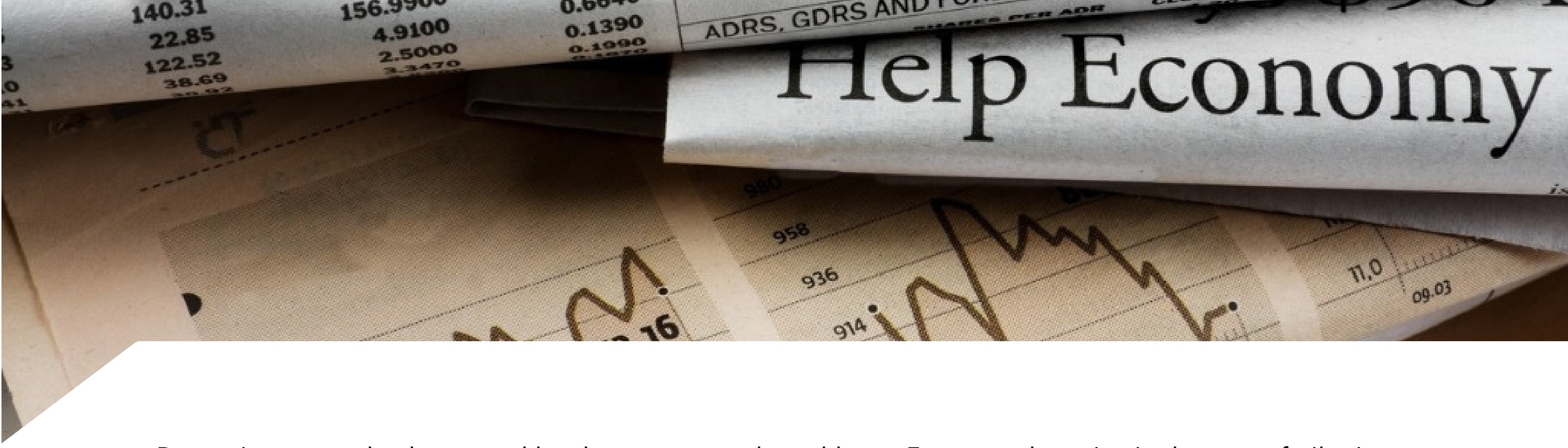
Features of a Recession

Definitions of recessions vary but every recession has its own individual features. So, while recessions (and subsequent recoveries) are often marked by certain typical dynamics, they are by no means uniform. Back in 1990, the recession that began that year was marked by high unemployment and the post-recession period was notable for weak demand for labor – the so-called jobless recovery. The 2001 recession saw severe stock market declines, most spectacularly in the case of the bursting of the dotcom bubble. Recovery in the case of the 2008 global financial crisis (GFC) was long and slow and badly affected a depressed housing market. The pandemic recession of 2020 was a singular event that was particularly sharp and severe although recovery proved relatively swift.

Causes of Recession

And the causes of recessions are similarly diverse, although they can be divided roughly into demand-side and supply-related factors.

Demand-side economists believe that short-term changes in demand can affect the supply of goods and services. Negative economic sentiment may cause people to save rather than spend. A decline in home prices may cause people to feel less wealthy, leading to a reduction in spending which causes demand to fall. This has a knock-on effect on companies who will sell less, causing them to lower production and cut jobs. This reduces household income, which further lowers demand, resulting in a recession.



Recessions may also be caused by short-term supply problems. For example, a rise in the cost of oil raises companies' costs and discourages production as margins suffer. This again means job cuts and less money for suppliers. In turn, income in the economy is reduced which reduces overall demand, leading to a recession.

Recessions and Asset Prices

The prospect and reality of a recession also has major implications for asset prices, notably equities. In general, slowdowns and recessions depress asset prices but the effect is not spread equally. Some sectors are more sensitive to economic conditions than others. Those that respond to the different phases of the economic cycle are known as cyclical stocks, sectors such as consumer discretionary, while the stocks that are less affected by the cycle are known as defensive stocks, sectors such as consumer staples and utilities. The performance of defensive stocks will respond less to changes in the cycle and therefore are preferred in a recessionary phase.

Recession and Central Bank Policy

The current momentum toward recession has several causes but the great accelerator has been central bank policies to combat a surge in inflation worldwide. Put simply, central banks are looking to reduce overall demand and hence they have increased interest rates rapidly from what were historically low levels – so-called interest rate normalization. This causes credit to contract and puts pressure on company margins, leading to increased business failures and an even greater slowdown in the economy.

The effects of this policy have been compounded by the ending of the era of quantitative easing (QE) where central banks worldwide in the aftermath of the GFC engaged in massive purchases of securities to increase the money supply, keep interest rates low, and stave off recession.

While inflation is the notable factor in the current recessionary phase, it has less in common with other high-inflation recessions such as those post-World War II and the Korean War recession in 1953. It has more in common with the stagflation recession of 1981 – stagflation being the phenomenon of economic contraction combined with high inflation.

This poses particular problems for policymakers as they struggle to contain inflation while understanding that measures in that regard may well deepen the recessionary trend.

The worst of all possible scenarios arises when monetary and interest rate policy comes into conflict with fiscal policy. This is the scenario that played out in October 2022 when the UK government announced a raft of unfunded tax cuts – a measure that directly contradicted the Bank of England's anti-inflation program of quantitative tightening (QT) and interest rate hikes. The effect was to undermine market confidence in the UK Exchequer, which placed immediate pressure on sterling.

This fall in the value of sterling would normally exacerbate inflationary pressures by making imported goods more expensive, and so the BoE was forced to accelerate its rate-hiking, in turn increasing recessionary fears.

Now that economies around the world begin to tip into the recessionary phase, the question is how long this phase can be expected to last? Every recession is different but, according to the US National Bureau of Economic Research (NBER), the average U.S. recession lasted about 17 months in the period from 1854 to 2020. Post-World War II, from 1945 to 2020, the average recession lasted about 10 months.

At that point all eyes will be on indicators of recovery, when a return to positive growth, looser monetary policies, increased production and company profits will announce the end of the recession.

Intuition Know-How has a number of tutorials relevant to this article:

- Economic Indicators – An Introduction
- GDP – An Introduction
- GDP Indicators
- Business Cycles – An Introduction
- Business Cycle Indicators
- Inflation – An Introduction
- Inflation Indicators
- Employment & Unemployment – An Introduction
- Labor Market Indicators
- Monetary Policy Analysis
- Fiscal Policy Analysis
- Global Financial Crisis – Causes, Impact, & Legacy

How to Identify and Manage Problem Loans

With many economies bracing for downturn and a higher interest rate environment, a sharp spike in default rates is a likely prospect. What steps should banks and other lenders take to manage this?

All lenders provide credit facilities in the belief that their customers will meet repayment obligations in full and on time. The reality, however, is that a certain proportion will default and ultimately trigger credit losses. Credit losses are therefore seen by banks as a cost of doing business, just like other costs. And while these costs are less predictable, adverse market conditions will inevitably force these upward.

Stages in the Business Cycle

And so the rate of credit default is very much influenced by the business cycle, which alternates around four phases.

The initial or expansionary phase is the phase following a recession. Economic growth switches to positive and accelerates. Central banks ensure looser monetary policies that create better conditions for banks to issue credit. Industrial production increases, inventories are low, and company turnover, margins, and profits grow.

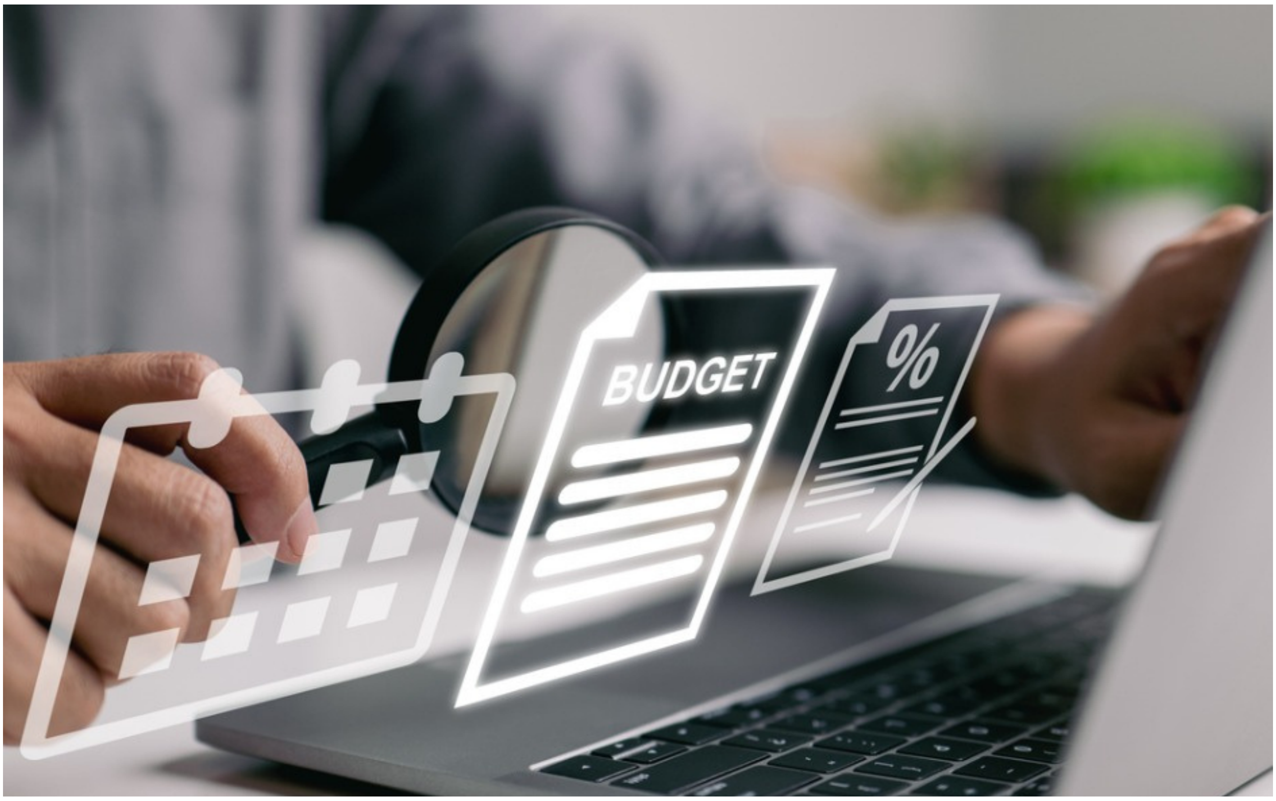
In the intermediate phase, growth slows down but remains healthy. This is generally the longest phase of the cycle. Economic activity is strong with good credit availability as a result of previous expansionary monetary policy, which now moves to neutral.

We now move to the advanced phase of the cycle, which is currently being played out in many economies. Activity has slowed, but what is remarkable about the current cycle is rampant inflation. This has led to highly restrictive monetary policy and major interest rate hikes. The final phase in the business cycle – recession – seems imminent.

Determining Credit Risk Appetite

For lenders, current conditions are fraught. Indications of distress among borrowers will already be apparent. For the lender, these indicators and prospects need to be set against its credit risk appetite at a customer, product, and industry-specific level.

A lender's credit risk appetite is implemented daily through credit decisions made at customer and transaction level having regard to the particular stage in the business cycle.



Once credit facilities are approved, customer performance and risks must be monitored regularly to determine whether credit risk appetite measures are breached or may be at risk of being breached. This becomes decidedly more common in a recessionary phase.

Credit risk deterioration is normally signaled through falling sales and profitability that increase the risk of default. In this case, the bank's internal credit rating for that counterparty needs to be adjusted downward with potential knock-on effects on credit limits. Recessions put pressure on cash flows: delayed payments by creditors to a borrower can lead to cash flow difficulties, which in turn may result in missed repayments or credit limit excesses. Meanwhile, a fall in property prices may lead to maximum loan-to-value (LTV) limits being exceeded.

Quantifying Credit Losses

In these conditions, credit losses can be expected to increase. In quantifying expected loss (EL), three inputs are vital:

1. **Probability of default (PD)** relates to the possibility that a borrower will enter into a default state.
2. **Exposure at default (EAD)** measures how much money is at risk in the event of default.
3. **Loss given default (LGD)** is the expected loss on default net of any recoverable amounts.

The objective of problem credit management is to minimize potential losses as far as possible and the tactics used to achieve this depend on the categorization of the loan or facility.

Customers with outstanding credit facilities can be classified as either "performing" (customers that are meeting expectations and showing no early warning signs) or "non-performing" (customers that are showing some early warning signs or experiencing difficulties). A bank's portfolio of performing customers is often referred to as the "Good Book," while that of non-performing customers is often referred to as the "Bad Book."

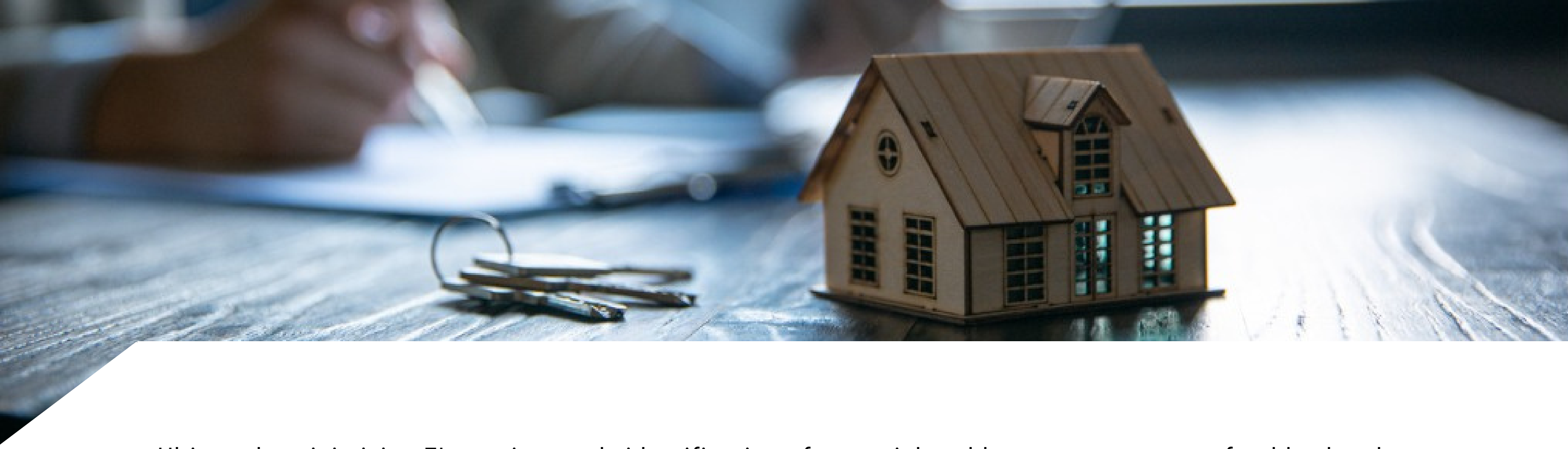
Categorizing Problem Credits

When it comes to problem credit management, however, these two categories are too broad. Instead, the loan portfolio can be viewed on a more graduated basis according to probability of default. While the terminology can vary from bank to bank, the characteristics of each stage will be broadly similar, as will the approaches to managing and accounting for customers that fall into each category.

For regulatory reporting purposes, terms/classifications such as the following are used – performing, special mention, substandard, doubtful, and loss. Internally, typical classifications might be: performing, potential problem, problem (early stage), problem (late stage), non-performing, and write-off.

Guidance from the European Banking Authority (EBA) on loan origination and monitoring identifies five data clusters that can provide early indicators of default:

- *Financial Data* related to the borrower's financial position, including any deterioration.
- *Behavioral Data* related to the expected payment behavior of the borrower.
- *Covenant Data* capturing the borrower's compliance to covenants, including expected covenant breaches.
- *Macro-Economic Data* likely to affect the borrower's repayment capacity.
- *News Data* that may affect the borrower's financial position.



Ultimately, minimizing EL requires early identification of potential problem customers – preferably ahead of other lenders – and proactive account management where the customer is contacted at an early stage and revised account strategies and remediation plans are agreed (and subsequently monitored). Input from staff independent of the relationship manager (RM), or management by an independent recovery team, is generally needed to ensure that appropriate action is taken sooner rather than later, thus helping to minimize EL.

Intuition Know-How has a number of tutorials relevant to this article:

- Credit Risk – An Introduction
- Credit Risk – Types
- Credit Risk Management – An Introduction
- Credit Risk Management – Framework
- Credit Risk Management – Stakeholders
- Credit Risk Management – Strategic & Business Unit Management
- Credit Risk Management – Credit Culture
- Credit Risk Management – Risk/Reward
- Credit Risk Appetite – An Introduction
- Credit Risk Appetite – Customer & Industry Risk
- Credit Risk Appetite – Product & Country Risk
- Credit Risk Measurement – An Introduction
- Credit Risk Measurement – PD & Risk Rating
- Credit Risk Measurement – EAD & LGD
- Credit Risk Customer Management – An Introduction
- Problem Credit Management – An Introduction
- Problem Credit Management – Early Stage Problem Credits
- Problem Credit Management – Late Stage Problem Credits
- Problem Credit Management – Accounting for Problem Credits