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What Causes an Economic Recession

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For millennia, the people of Britain had been using bronze to make tools and jewelry, and as currency for trade. But around 800 BCE, that began to change: the value of bronze declined, causing social upheaval and an economic crisis — what we would call a recession today.

What causes recessions? This question has long been the subject of heated debate among economists, and for good reason. A recession can be a mild decline in economic activity in a single country that lasts months, a long-lasting downturn with global ramifications that last years, or anything in between. Complicating matters further, there are countless variables that contribute to an economy's health, making it difficult to pinpoint specific causes. So it helps to start with the big picture: recessions occur when there is a negative disruption to the balance between supply and demand. There's a mismatch between how many goods people want to buy, how many products and services producers can offer, and the price of the goods and services sold, which prompts an

economic decline. An economy's relationship between supply and demand is reflected in its inflation rates and interest rates. Inflation happens when goods and services get more expensive. Put another way, the value of money decreases. Still, inflation isn't necessarily a bad thing. In fact, a low inflation rate is thought to encourage economic activity. But high inflation that isn't accompanied with high demand can both cause problems for an economy and eventually lead to a recession. Interest rates, meanwhile, reflect the cost of taking on debt for individuals and companies. The rate is typically an annual percentage of a loan that borrowers pay to their creditors until the loan is repaid. Low interest rates mean that companies can afford to borrow more money, which they can use to invest in more projects. High interest rates, meanwhile, increase costs for producers and consumers, slowing economic activity.

Fluctuations in inflation and interest rates can give us insight into the health of the economy, but what causes these fluctuations in the first place? The most obvious causes are shocks like natural disaster, war, and geopolitical factors. An earthquake, for example, can destroy the infrastructure needed to produce important commodities such as oil. That forces the supply side of the economy to charge more for products that use oil, discouraging demand and potentially prompting a recession. But some recessions occur in times of economic prosperity — possibly even because of economic prosperity. Some economists believe that business activity from a market's expansion can occasionally reach an unsustainable level. For example, corporations and consumers may borrow more money with the assumption that economic growth will help them handle the added burden. But if the economy doesn't grow as quickly as expected, they may end up with more debt than they can manage. To pay it off, they'll have to redirect funds from other activities, reducing business activity.

Psychology can also contribute to a recession. Fear of a recession can become a self-fulfilling prophecy if it causes people to pull back investing and spending. In response, producers might cut

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operating costs to help weather the expected decline in demand. That can lead to a vicious cycle as cost cuts eventually lower wages, leading to even lower demand. Even policy designed to help prevent recessions can contribute. When times are tough, governments and central banks may print money, increase spending, and lower central bank interest rates. Smaller lenders can in turn lower their interest rates, effectively making debt “cheaper” to boost spending. But these policies are not sustainable and eventually need to be reversed to prevent excessive inflation. That can cause a recession if people have become too reliant on cheap debt and government stimulus.

The Bronze recession in Britain eventually ended when the adoption of iron helped revolutionize farming and food production. Modern markets are more complex, making today’s recessions far more difficult to navigate. But each recession provides new data to help anticipate and respond to future recessions more effectively.