Chapter 36:

1. Look at Table 36.1 reproduced below and answer the questions.

TABLE 36.1

Quarterly Economic Growth in G7 Countries, 2006–2009.

Country	Q4: 2006	Q1: 2007	Q2 2007	Q3: 2007	Q4: 2007	Q1: 2008	Q2: 2008	Q3: 2008	Q4: 2008	Q1: 2009	Q2: 2009
Canada	0.5	0.9	1.0	0.5	0.3	−0.2	0.1	0.1	−0.9	−1.6	−0.9
France	0.7	0.7	0.4	0.7	0.3	0.5	−0.5	−0.2	−1.4	−1.3	0.3
Germany	1.0	0.3	0.3	0.8	0.1	1.6	−0.6	−0.3	−2.4	−3.5	0.3
Italy	0.9	0.3	0.1	0.2	−0.4	0.5	−0.6	−0.8	−2.1	−2.7	−0.5
Japan	0.8	1.4	−0.2	−0.1	0.8	1.0	−1.1	−1.0	−3.5	−3.1	0.9
UK	0.8	0.7	0.6	0.5	0.5	0.8	−0.1	−0.7	−1.8	−2.4	−0.7
US	0.7	0.3	0.8	0.9	0.5	−0.2	0.4	−0.7	−1.4	−1.6	−0.3

Source: OECD (http://stats.oecd.org/index.aspx) accessed September 14, 2009

a) Which country was the first to enter recession and when?

Answer:
Japan – in quarter 3 2007. The technical definition of recession is two successive quarters of negative economic growth. Japan might be said to have had a double dip recession!

b) From the data, which country suffered the most severe recession and why?

Answer:
From the data we can see that the UK suffered five successive quarters of negative growth which might be argued to be severe. The fall in output in Germany was significant especially in Q4 2008 and Q1 2009. Given that Japan suffered decline in 2007 and then again from Q2 2008 and that the size of the decline in Q4 2008 and Q1 2009 was considerable it might be argued that Japan suffered most.

2. Is it inevitable that a period of rising house prices will suffer a correction?

Answer:
Whether house price increases suffer some sort of correction would depend on the state of the market and the demand and supply of houses as well as what was driving the market upwards. It would also depend on how we interpret the word 'correction'. For homeowners the key is the difference between the price they buy a property at and the price they get when they sell it. Any talk of house price values when active trades are not being considered is largely irrelevant for those not involved. If an individual buys a house for €300 000 in year *x* and then sells it for €450 000 in year *x* +*y* does this represent a correction if a year before the sale the value of the property was rated at €500 000? There might be periods when house prices are falling but to get a better picture we might want to look at the trend in house prices over a period of time and history tends to show that the trend is essentially positive. This might suggest that it is far from inevitable that house prices will suffer a correction.

3. Why did the market for credit default swaps seem to be associated with lower risk?

Answer:
CDS are relatively new instruments which were developed during a period of relatively strong economic activity. The data on which default risks were based tended to be skewed, therefore, as it did not include periods where asset holders faced significant financial pressures.

5. Briefly describe the main stages to show how an increase in defaults on sub-prime mortgages led to the financial crisis.

Answer:
Owners of mortgages deemed sub-prime begin to default on payments (possibly because of job loss, death or illness in the family etc.). Bonds were sold on the basis of the stream of income coming from mortgage payers are used to pay investors. When this income stream slows, some investors do not get their payments. Bond holders may have insured the risk of default via a CDS and so the tprotection seller has to pay out the protection buyer. CDS were not only traded between those directly involved in the bond but to other interested parties and so the amount the protection seller has to find to pay holders of the CDS increases. To fund these liabilities, protection sellers look to borrow money from the interbank market. However, protection sellers, holders of bonds and sub-prime loans may also be banks who are themselves facing increased exposure. As these institutions look to protect their assets or build up their capital they cut back lending on the interbank market unless the interest rate is higher. For borrowers the higher cost of borrowing may mean it is not worth taking out the loan even if they could find a willing lender and so credit dries up. Banks with excess exposure least able to finance the extent of their obligations become insolvent and those that go under default on their obligations and so the process spirals.