
US Recession and the World Catches a Cold

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Abstract :

As slow down in US economy is expected to turn into recession soon, impulse of export led growth through spill over of consumption splurge through housing sector boom as a result of sub prime lending, has been receding. Indian Economy once achieved 9% economic growth in the recent past, is now facing threat of contraction of rate of growth of output and employment as an immediate effect of US recession. Indian economy may attract high inflows of FDI causing high inflation, slow down of exports oriented sectors such as IT, IT-enabled services BPO, financial services, healthcare, textiles, jewellery, handicrafts and leather goods. In the long term Indian economy can experience stable growth provided India implements effective monetary policy to control and make use of large influx of FDI, and Indian exports diverted to European, African and other Asian markets. Since this recession is predicted to last for about 2-3 years, companies may prepare themselves to reap early benefits of recovery of the world economy. Meanwhile they could invest in up gradation of technology, market development and supply chain links in the period of recession, as the strategy of preparedness for ensuring recovery.

Introduction

The fear of recession looms over the United States, and as the cliché goes, whenever the US sneezes, the world catches a cold. This is evident from the way the Indian markets crashed taking a cue from a probable recession in the US and a global economic slowdown.

Over the past couple of months, fears of a slowdown in the United States of America have increased. The impact of the sub prime crises along with a slowdown in mortgage has led to a significant lowering of growth estimates. Since the US dominates the global economy, any slowdown there would have an impact on most of the global economic variables.

It would be naïve to imagine that a recession in the US would have no impact on India. The US

accounts for one-fourth of the world GDP and any significant slowdown is bound to have reverberations elsewhere. On the other hand, interdependencies between the US economy and emerging economies like India and China has reduced considerably over the last two decades. Thus the effect may not be as drastic as would have been the case in the 1980s. The overall impact of a US slowdown on India would, however, be minimal as the factors driving growth here are more local in nature. Unlike the rest of Asia, India is a strong domestic demand story, so any slowing in the US is likely to have a more muted impact on India. Strong growth in domestic consumption and significant

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spending on infrastructure are the two pillars of India's growth story.

Recessions: In Brief

A **recession** is a contraction phase of the business cycle, or "a period of reduced economic activity. The U.S. based National Bureau of Economic Research (NBER) defines a recession more specifically as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP growth, real personal income, employment (non-farm payrolls), industrial production, and wholesale-retail sales." A sustained recession may become a depression.

The term **business cycle** or **economic cycle** refers to the fluctuations of economic activity (**business fluctuations**) around its long-term growth trend. The cycle involves shifts over time between periods of relatively rapid growth of output (recovery and prosperity), and periods of relative stagnation or decline (contraction or recession). These fluctuations are often measured using the real gross domestic product. Despite being termed cycles, these fluctuations in economic growth and decline do not follow a purely mechanical or predictable periodic pattern.

Attributes of recessions

A recession has many attributes that can occur simultaneously and can include declines in coincident measures of overall economic activity such as employment, investment, and corporate profits. Recessions are the result of falling demand and may be associated with falling prices (deflation), or rising prices (inflation) or a combination of rising prices and stagnant economic growth (stagflation). A severe or prolonged recession is referred to as an economic depression. Although the distinction between a recession and a depression is not clearly defined, it is often said that a decline in GDP of more than 10% constitutes a depression.

Responding to a recession

Strategies for moving an economy out of a recession vary depending on which economic school the policymakers follow. While Keynesian economists

may advocate deficit spending by the government to spark economic growth, supply-side economists may suggest tax cuts to promote business capital investment. Laissez-faire economists may simply recommend that the government not interfere with natural market forces. Populist economists may suggest that benefits for consumers, in the form of subsidies or lower-bracket tax reductions are more effective and serve a double purpose including relieving the suffering caused by a recession.

Both government and business have responses to recessions. In the Philadelphia Business Journal, Strategic Business adviser Carter Schelling has discussed precautions businesses take to prepare for looming recession, likening it to fire drill. First, he suggests that business owners gauge customers' ability to resist recession and redesign customer offerings accordingly. He goes on to suggest they use lean principles, replace unhappy workers with those more motivated, eager and highly competitive. Also over-communicate. "Companies," he says, "get better at what they do during bad times." He calls his program the "Recession Drill."

Causes of recession

Recession is defined as when businesses cease to expand, the GDP diminishes for two consecutive quarters, the rate of unemployment rises and housing prices decline.

Recession normally takes place when consumers lose confidence in the growth of the economy and spend less. This leads to a decreased demand for goods and services, which in turn leads to decline in production, lay-offs and a sharp rise in unemployment. Investors spend less as they fear stock values will fall and thus stock markets fall on negative sentiments. Many other factors contribute to an economy's fall into a recession, but the major cause is inflation. Inflation refers to a general rise in the prices of goods and services over a period of time. The higher the rate of inflation, the smaller the percentage of goods and services that can be purchased with the same amount of money. Inflation can happen for reasons as varied as increased production costs, higher energy costs and national debt.

In an inflationary environment, people tend to cut out leisure spending, reduce overall spending and begin to save more. But as individuals and businesses curtail expenditures in an effort to trim costs, this causes GDP to decline. Unemployment rates rise because companies lay off workers to cut costs. It is these combined factors that cause the economy to fall into a recession.

How to fight Recession

The government can adopt many fiscal and monetary measures to fight the recessionary conditions in its economy. Tax cuts are the first step that a government fighting recessionary trends or a full-fledged recession proposes to do. Tax cuts can increase the purchasing power in the hands of customers, which will influence them to consume more giving a rise to increasing demand in the market which can act as a solution to fight with inflation. The government can also hike its spending to create more jobs and boost the manufacturing and services sector and to prop up the economy.

Current Crisis in the United States

The defaults on sub-prime mortgages (home loan defaults) have led to a major crisis in the US. Sub-prime is a high risk debt offered to people with poor credit worthiness or unstable incomes. Major Banks have landed in trouble after people could not pay back loans.

The housing market soared on the back of easy availability of loans. The real estate sector boomed but could not sustain the momentum for long and it collapsed under the gargantuan weight of crippling loan defaults. This revealed the ugly fact that many lenders have made huge property loans to people who could not or would not repay. Banks and other mortgage lenders suddenly found themselves hundreds of billions in bad debt. The consequent financial crunch hit the whole US economy. Foreclosures spread like wildfire putting the US economy on shaky grounds. This coupled with the rising oil prices at \$100 a barrel, slowed down the growth of the economy. This now threatens a recession, which will lower consumption spending.

Impact of United States Recession on India

After four years of 9% GDP growth, and boasts of overtaking China, Indians are reluctant to believe that the economy is headed for a serious fall. But the stock market has crashed, as an indication of pain ahead.

Western observers have lavished praise on India as rising economic superpower; so many Indians believe we have achieved 9% growth simply because we are so clever and resourceful. This is a delusion of grandeur. In fact, a global tide has lifted the whole world economy – India along with all others. Now that global tide is ebbing, India will fall with all others. Given our strengths, we will not suffer as badly as some others, but we will suffer.

India's 9% growth in the last four years is hardly exceptional as other countries also grown at the same or even at a higher pace. The core cause of India's boom was huge overspending by Americans in the last decade, based on a long housing boom. Americans borrowed even more billions against their rising property values, and went on a spending spree that greatly exceeded their disposable incomes. Over spending led to a record U.S. trade deficit of \$700 billion per year.

The mirror image of this was raising trade surpluses – and hence, foreign exchange reserves – in other countries. These foreign exchange surpluses were in turn used to buy U.S. securities, depressing U.S. interest rates and making borrowings even more attractive. Americans borrowed still more, spent still more, and imported still more.

This created a huge consumption – based growth cycle across the globe. The U.S. consumer splurge was especially helpful to China, the most competitive exporter of manufacturer, which grew rapidly through an export boom. India which exported competitive services also benefited from the same.

But as the phrase goes "No boom based on over – consumption can last forever". The U.S. housing bubble burst, and prices started falling, resulting in a financial crises and lower consumer spending. Lower U.S. spending will mean a negative effect on the exporting countries.

How bad will the impact on India be? It all depends on the pace at which the U.S. reduces its

over – spending to manageable proportions. Indian companies have major outsourcing deals from the U.S. India's export to the U.S. have also grown substantially over the years. The Indian economy is likely to loose between 1 to 2 percentage points in GDP growth in the next financial year. Indian companies with big tickets deals in the U.S. would see their profit margins shrinking.

The worries for exporters will grow as rupee strengthens further against dollar. But experts note that the long term prospects for India are stable. A weak dollar could bring more foreign money to Indian markets.

The whole of Asia would be hit by a recession as it depends on the U.S. economy. Even though domestic demand and diversification of trade in the Asian region will partly counter any drop in the U.S. demand, one simply can't escape a downturn in the world's largest economy. The U.S. economy accounts for 3% of the world's GDP.

According to Sudip Bandyopadhyay, director & CEO, Reliance Money: "In the globalized world, complete decoupling is impossible. But India may remain relatively less affected by the adverse global events."

The only silver lining is that the recession will happen slowly, probably in six months or so. As of now, IT and IT-enabled services, textiles, jewellery, handicrafts and leather segments will suffer losses because of their trade link. Certain sections of commodities could face sharp impact due to the volatile nature of these sectors. C.J. George, managing director, Geojit Financial Services, says profits of lots of re-export firms may be affected. Countries like China import commodities from India, do some value-addition and then export them to the US.

The IT sector will be the worst hit as 75 per cent of its revenues come from the US. Low demand for services may force most Indian Fortune 500 companies to slash their IT budgets. Zinnov Consulting, a research and offshore advisory, says that besides companies from ITes and BPO, automotive components will be affected.

During a full recession, U.S. companies in

health care, financial services and all consumers demand driven firms are likely to cut down on their spending. Among other sectors, manufacturing and financial institutions are moderately vulnerable. If the service sector takes a serious hit, India may have to revise its GDP to about 8 to 8.5 per cent or even less.

The US recession is likely to have a dual impact on the outsourcing industry. Appreciating rupee along with poor performance of US companies (law firms, investment banks and media houses) will affect the bottom line of the outsourcing industry. Small BPOs, which are operating at a net margin of 7-8 per cent, will find it difficult to survive.

A severe recession will seriously affect the portfolio and fixed investment flows. Corporates will also suffer from volatility in foreign exchange rates. The export sector will have to devise new strategies to enhance productivity.

Counter Strategy

It has been observed that there is already a shift in business strategies of corporate India. Large IT and BPO firms have started looking at other markets like Europe, and even the domestic market, to spread their risks and reduce the impact of the rising rupee. This can be best seen with Infosys setting up an India centric team.

It is felt that Indian companies will have to adopt a multi-pronged strategy, which includes diversification of the export markets, improving internal efficiencies to maintain cost competitiveness in a tight export market situation and moving the product portfolio up in the value chain to impart resilience.

The IT sector too is keen to defend its position. In case of a full-blown US recession, the onsite staffing business will see a decline in sales and profit. "At the same time, it can increase the offshore work. Recessions at this juncture may not last for more than two to three years. Smart companies will continue to make investments so that they can be ahead of the competition when the US economy comes out of recession.

This means corporate India will have to spend

a lot more to develop market and supply chain links in alternate markets like Asia and Europe. Experts say the export dependent sectors of the economy need to re-focus on local demand and income from non-dollar economies.

The European, West Asian and the African countries may offer viable short-term alternatives to our export-dependent sectors. BPOs, for example, will have to re-negotiate with their clients and fix appropriate price for their services.

Can India be a market option? The appropriate answer to this question could be that IT firms can definitely find a market in India, but the deal sizes are likely to be small. India has a huge, small and medium enterprise base and it is the right time to tap this segment. As for automotive components, consumer electronics and mobile devices, they have already found a market in India and have also started looking at tie-ups in China and other BRIC countries.

Global Recession: It's also an opportunity for India

Though no one likes or wants a recession, almost everyone appears reconciled to one in the United States. Meanwhile, politicians continue to downplay any fears of global repercussions, citing decoupling of the United States and other economies as a buffering factor. But what is the reality for countries like India? Since interdependencies between the US economy and emerging economies like India and China has reduced considerably over the last two decades. Even so, fears of a US recession led to panic in the Indian stock market. Much has happened between then and now. The Indian economy has shown a robust and consistent growth trajectory and the projection for 2008 is 9%. Indian exports to the United States account for just over 3% of GDP. India has a healthy trade surplus with the United States. Thus, the effect may not be as drastic as would have been the case in the 1980s.

In other words, the effects of this recession on India may be quite distinct from those of the past. Here are some areas worth following:

1. A credit crisis in the United States might

lead to a restructuring of asset allocation at pension funds. It has been suggested that CALPERS is likely to shift an additional US\$24 billion to its international portfolio. A large portion of this is likely to flow into India and China. If other funds follow suit, a cascading effect can be expected. Along with the already significant dollar funds available, the additional funds could be deployed to create infrastructure—roads, airports, and seaports—and be ready for a rapid takeoff when normalcy is restored.

2. In terms of specific sectors, the IT Enabled Services sector may be hit since a majority of Indian IT firms derive 75% or more of their revenues from the United States—a classic case of having put all eggs in one basket. If Fortune 500 companies slash their IT budgets, Indian firms could be adversely affected. Instead of looking at the scenario as a threat, the sector would do well to focus on product innovation (as opposed to merely providing services). If this is done, India can emerge as a major player in the IT products category as well.

3. The manufacturing sector has to ramp up scale of economies, and improve productivity and operational efficiency, thus lowering prices, if it wishes to offset the loss of revenue from a possible US recession. The demand for appliances, consumer electronics, apparel, and a host of products is huge and can be exploited to advantage by adopting appropriate pricing strategies. Although unlikely, a prolonged recession might see the emergence of new regional groupings—India, China, and Korea?

4. The tourism sector could be affected. Now is the time to aggressively promote health tourism. Given the availability of talented professionals, and with a distinct cost advantage, India can be the destination of choice for health tourism.

5. A recession in the United States may see the loss of some jobs in India. The concept of Social Security, that has been absent until now, may gain momentum.

6. The Indian Rupee has appreciated in relation to the US dollar. Exporters are pushing for government intervention and rate cuts. What is conveniently forgotten in this debate is that a stronger

Rupee would reduce the import bill, and narrow the overall trade deficit. The Indian central bank (Reserve Bank of India) can intervene anytime and cut interest rates, increasing liquidity in the economy, and catalyzing domestic demand. A strong domestic demand would also help in competing globally when the recession is over.

In summary, at the macro-level, a recession in the US may bring down GDP growth, but not by much. At the micro-level, specific sectors could be affected. Innovation now may prove to be the engine for growth when the next boom occurs.

For US firms, who have long looked at China as a better investment destination, this may be a good time to look at India as well. After all, 350 million people with purchasing power cannot be ignored. This is not a sales pitch for India, but only a gentle suggestion to US corporations.

Conclusion

Over the last couple of months, fears of a slowdown in the United States of America have increased. The impact of the sub – prime crises along with a slow – down in mortgages has led to a significant lowering of growth estimates. In the annual meeting of the World Economic Forum (WEF) the focus this year was also on the U.S. slowdown.

The near recession in U.S. will have an impact on all the developing economies as well as on the economies which are dependent on the U.S. for either imports or exports. As now the purchasing power of the people is getting lowered and so are the changes in their demand patterns. The recession in the U.S. and the global meltdown will, of course, have its impact on India's high-tech industry, as it is one of the greatest financial crises of our globalize times. But it also presents an opportunity for Indian services vendors to improve their market share, while forcing them to diversify and de-risk across the sectors and geography.

In the recent WEF Chidambaram addressed, "We have a large number of poor people who don't feel anything about growth. Their main concern is inflation. The US slowdown has inflationary concerns, which we need to cater for". India will do everything

possible to not only lift economic growth but also to keep the Inflation low. He also added that as long as Indian investment is buoyant and consumption rises steadily, we can moderate the impact of U.S. slowdown.

On the other side the recessionary conditions in the U.S. economy is not a long term phenomena as being the most active economy, and consisting of very innovative and inventive society in the world, it will bounce back. Its knowledge base and appropriate policy stimuli, it will quickly recover from the bad situation and take its momentum again very soon.

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