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Theme 206

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SIB STUDENTS' ECONOMIC FORUM

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Theme No. 206 : ECONOMIC SLOWDOWN / RECESSION AND STIMULUS PACKAGES - PART I

"The world is likely headed for a deep recession" says Paul Krugman, the Nobel Prize Laureate for Economics in 2008. The economic downturn started with the sub-prime crisis in the US. Lending against homes to borrowers of doubtful quality resulted in debt defaults. The defaults led to a fall in property prices as home loans were foreclosed and the property was put on sale. This has set off a chain reaction. Securities that were based on repackaged loans and held by a wide range of financial institutions lost value, triggering massive losses and finally bankruptcies. All these resulted in job losses and its subsequent impact on consumer spending in the US. A vicious cycle of fall in sales, fall in profits and decline in economic growth, ultimately results in unemployment and lower consumer spending, the key reflector of recession. As the global economies today are interdependent, the phenomenon of recession has percolated to all the countries.

What are the expectations of the global economic growth?

A recent IMF report presents a grim picture of the global economy in 2009. The economic growth will fall to 0.50 per cent, the lowest level in 60 years. This is stated in IMF's World Economic Outlook (WEO) 2008. Thus the world economy will come to a virtual halt. The growth rates are being revised downward in all countries. The advanced economies - the United States, Europe and Japan - have gone into recession, and the contagion of the crisis has spread from the financial sector to the real sector. The IMF estimates that in 2009 the advanced countries will witness the sharpest contraction since the Second World War. The US economy will decline by 1.50 per cent, the Euro area by 2 per cent, and Japan by 2.50 per cent. It is expected that China will grow by 6.75 per cent and India by just 5 per cent in 2009. The official forecasts in India have placed economic growth for the current fiscal around 7 percent.

The economic scenario around the world appears to indicate the occurrence of a second Great Depression after the one in 1929. The recent evidences suggest that recessionary forces are strong: demand has slumped, production is plunging, job losses are rising and credit markets remain in trouble. Also, world trade – the main channel through which the downturn gets transmitted – is projected to contract by 2.8 per cent in 2009.

Is India too vulnerable to a recession?

As of now, evidence points only to a slowdown in growth and not to recession. Though India is not an export-reliant economy, the impact of inflation and global recession is being felt here too. According to business cycles theory, every economy is sure to go through repetitive cycles of boom, slowdown and recession as a long term trend. In an economic cycle, a downturn can be considered as consequence of an expansion reaching an unsustainable state, and a bubble boom is subsequently corrected by a decline in business activity.

Although the origins of the crisis are common around the world, the crisis has impacted various economies differently. Importantly, in advanced economies where it originated, the crisis spread from the financial sector to the real sector. In emerging economies, the transmission of external shocks to domestic economy has been from the real sector to the financial sector. Countries have accordingly responded to the crisis depending on their specific circumstances. The policy responses in advanced economies were concerned with financial crisis and deepening recession; in India, the stimulus packages are aimed to arrest moderation in economic growth.

What exactly do the terms Slowdown, Recession, Depression denote?

The term ‘recession’ generally describes the reduction of a country’s gross domestic product (GDP) for at least two quarters. The usual dictionary definition is “a period of reduced economic activity”, a business cycle contraction. The U.S.-based National Bureau of Economic Research (NBER) defines economic recession as: “a significant decline in the economic activity spread across the economy, lasting more than a few months, normally visible in real GDP growth, real personal income, employment, industrial production, and wholesale-retail sales.” According to widely accepted definition, recession is defined as decline in a country’s gross domestic product (GDP), or negative real economic growth, for two or more successive quarters of a year. A recession is denoted by declines in measures of activity such as employment, investment, and corporate profits. The stock markets and the real-estate market also usually decline before recession.

Economic slowdown is regarded as a mild variant of recession. Slowdown is just a slower growth in economic activities. While a slowdown is most likely industry specific, a recession results in a wide ranging impact on the economy. A severe or prolonged recession is referred to as economic depression. In anticipation of recession, the producers will cut back production and consumers will spend less, thus accelerating the phase of recession. This results in the so-called phenomenon of 'race to the bottom'. The pessimistic expectations of producers and consumers reinforce the course of recession.

The great depression of 1929 persisted for nearly a decade. During the 1930s, countries pursued unilateralism as an antidote to growing unemployment, and resorted to protectionist policies for safeguarding domestic industries and sectors. This is otherwise called 'beggar-thy-neighbour' policies and as a result, world trade and incomes contracted during that period.

What are the policy responses to recession / slowdown?

John Maynard Keynes, the famous economist, advocated for huge public spending programme to overcome the economic depression of the 1929. Thus, according to Keynesian economists, government expenditure which pumps in incomes and generates expectations of sustained demand is the only solution. Monetary economists argue for sufficient money and credit expansion to boost the sagging economy. The supply-side economists suggest tax cuts to promote business investment. It is also suggested that benefits for consumers, in the form of subsidies or tax reductions are more effective for relieving the suffering caused by a recession. The vulnerable sections of the population are to be taken care of in recession times by way of massive social development programmes.

According to the IMF, there are limitations on both monetary and fiscal fronts. Lower interest rates and more credit availability may not help in the near term to prop up business investments. Fiscal action is constrained due to the widening fiscal defict.

Will the emerging / developing economies be affected by recession?

The emerging economies are also hit by the crisis. According to 'decoupling theory', even if advanced economies went into a downturn, emerging economies will not be affected because of their substantial foreign exchange reserves, conservative policy framework, robust corporate balance sheets and relatively healthy banking sector. But given the evidence of the last few months – capital flow reversals, sharp widening of spreads on sovereign and corporate debt and abrupt currency depreciations - the 'decoupling theory' stands totally invalidated. The growth prospects of emerging economies have been undermined by the cascading financial crisis with considerable variation across countries. India too has been impacted considerably by the crisis.

Why is India affected by the crisis?

The Indian banking system did not have much exposure to the sub-prime mortgage assets or to the failed institutions. It has very limited off-balance sheet activities or securitized assets. So, the question arises how India can be caught up in the present crisis. Also, India's recent growth has been driven predominantly by domestic consumption and domestic investment.

The answer to the above questions lies in globalization. First, India's integration into the world economy over the last decade has been remarkably rapid. Going by the common measure of globalization, India's two-way trade (merchandize exports plus imports), as a proportion of GDP, grew from 21.2 per cent in 1997-98, the year of the Asian crisis, to 34.7 per cent in 2007-08. Second, India's financial integration with the world has become deeper over the years. The ratio of total external transactions (gross current account flows plus gross capital flows) to GDP has more than doubled from 46.8 per cent in 1997-98 to 117.4 per cent in 2007-08. The Indian corporate sector's access to external funding has increased significantly in the last five years. In 2007-08, India received capital inflows amounting to over 9 per cent of GDP as against a current account deficit of just 1.5 per cent of GDP. These capital flows, in excess of the current account deficit, indicate the importance of external financing and the depth of India's financial integration with the global economy.

(To be contd........)

Latest IMF projections

(year over year percent change)

			Projections		Difference from 2008 WEO projections	
	2007	2008	2009	2010	2009	2010
World output[1]	5.2	3.4	0.5	3.0	-1.7	-0.8
Advanced economies	2.7	1.0	-2.0	1.1	-1.7	-0.5
United States	2.0	1.1	-1.6	1.6	-0.9	0.1
Euro area	2.6	1.0	-2.0	0.2	-1.5	-0.7
Germany	2.5	1.3	-2.5	0.1	-1.7	-0.4
France	2.2	0.8	-1.9	0.7	-1.4	-0.8
Italy	1.5	-0.6	-2.1	-0.1	-1.5	-0.1
Spain	3.7	1.2	-1.7	-0.1	-1.0	-0.9
Japan	2.4	-0.3	-2.6	0.6	-2.4	-0.5
United Kingdom	3.0	0.7	-2.8	0.2	-1.5	-0.9
Canada	2.7	0.6	-1.2	1.6	-1.5	-1.4
Other advanced economies	4.6	1.9	-2.4	2.2	-3.9	-1.0
Newly industrialized Asian economies	5.6	2.1	-3.9	3.1	-6.0	-1.1
Emerging market and developing economies[2]	8.3	6.3	3.3	5.0	-1.8	-1.2
Africa	6.2	5.2	3.4	4.9	-1.4	-0.5
Sub-Saharan Africa	6.9	5.4	3.5	5.0	-1.6	-0.7
Central and eastern Europe	5.4	3.2	-0.4	2.5	-2.6	-1.3
Commonwealth of Independent States	8.6	6.0	-0.4	2.2	-3.6	-2.3
Russia	8.1	6.2	-0.7	1.3	-4.2	-3.2
Excluding Russia	9.7	5.4	0.3	4.4	-1.3	-0.3
Developing Asia	10.6	7.8	5.5	6.9	-1.6	-1.1
China	13.0	9.0	6.7	8.0	-1.8	-1.5
India	9.3	7.3	5.1	6.5	-1.2	-0.3
ASEAN-5	6.3	5.4	2.7	4.1	-1.5	-1.3
Middle East	6.4	6.1	3.9	4.7	-1.5	-0.6
Western Hemisphere	5.7	4.6	1.1	3.0	-1.4	-1.0
Brazil	5.7	5.8	1.8	3.5	-1.2	-1.0
Mexico	3.2	1.8	-0.3	2.1	-1.2	-1.4

Source: IMF, *World Economic Outlook*, January 2009.

[1]The quarterly estimates and projections account for 90 percent of the world purchasing-power-parity weights.

[2]The quarterly estimates and projections account for approximately 76 percent of the emerging and developing economies.

Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur, Kerala 680 001 or by E.mail: ho2099@sib.co.in

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