The Recession 2020 EconoView
by *Sundar Sankaran*[1]

How quickly inflationary worries have given way to recession woes? UK, Japan, Singapore, Taiwan – all have reported two successive quarters of economic decline (technically, treated as a recessionary situation). The United States is hanging on. Growth rate in the two biggie economies, China and India, is already down.

How has this turnaround happened? In a previous column, Inflation EconoView (July 15, 2008), I mentioned the fears of a global recession. I reasoned how, among other things, the US Asset Bubble and Inflated US Dollar had pushed up consumption in the global economy. The article also spoke about the oil bubble, created by a spurt in oil prices.

The bubbles have burst. First to burst was the asset bubble. Defaults in sub-prime mortgages (finberry Quickie, May 15, 2008) were followed by a decline in other security markets. Balance sheets were bleeding. Investors wanted their money back from funds. But funds could not find buyers for the securities they held. Funds, desperate to sell securities – and margin financiers, selling clients' securities to settle margin calls from stock exchanges – exacerbated the fall in asset values.

Bankers' Trust and Lehman Brothers were considered too big to fail. But the US allowed them to go down, under the impact of their poor asset portfolios. Not knowing who would go down next, a fear psychosis got created. No one wanted to have an exposure to anyone else. Liquidity in the market dried up.

Businesses operate as "going concerns". They presume that inventory will get converted to sale, which would yield cash. Creditors for raw materials would give credit, while credit would need to be given to debtors who buy the finished goods. Gaps in the financing are met by bankers and other financiers. When this normal business liquidity dries up, then businesses are stuck. They can no longer buy raw materials, nor pay their workers, nor run their business. It is easier to sack a worker, than sack a fixed asset. Thus, jobs were lost.

Job loss affects future income. A job loss by itself is bad enough. Wealth loss is worse. It can destroy everything that people have built over the years. Combine job loss with wealth loss - the impact can be deadly.

Today, people neither have the means, nor the will, to buy what can be postponed or avoided. The global decline in consumption has increased the need to cut business activities – and jobs. A bad problem thus became worse. A financial market problem has spread to the real economy. In a globalised world, the US trouble has spread to other countries, through different kinds of linkages:

1. US investors required money, and had to beef up their capital. They sold their investments in the so-far-lucrative emerging markets of Asia. Thus, the decline in US asset prices led to declines in markets across the world. People who felt wealthy when asset prices boomed, suddenly were poor. The ones who took huge loans against inflated asset prices, became paupers. Wealth erosion and defaults are hardly an environment where economies do well.

2. Resource rich countries like Russia, Middle East, Africa and Brazil found that in a recessionary environment, their minerals and oil were less sought. The resulting crash in prices has hit these economies.

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3. China finds that its economy, which is so dependent on exports to the developed world, now does not have buyers. Large factories are idle – more job losses.

Where does India stand in all this?

Let us start with a rather prescient view which was expressed in Inflation EconoView (May 15, 2008):

"Unfortunately, the policy response to inflation, in many countries, is not based on ground reality, but the philosophy the policy-maker subscribes to. A widely prevalent economic philosophy is to control money supply / raise interest rates to control inflation. There are two concerns to this approach:

- An aspect that is often ignored is that money supply controls, and increases in interest rates, might stifle supply and thus exacerbate the inflationary pressures, instead of controlling them.

- Monetary policy takes time to take effect. Political realities of coalitions, and looming elections, mean that the Indian Government might be in a hurry to control inflation. A monetary policy overdrive might lead to the parallel of a sick person taking one aspirin after another to get quick relief from head ache – only to see the cumulative effect of all the aspirins hit her later."

Many people praise the Indian monetary authorities for having limited the problem for India. Reality may well be otherwise…

Indian economy is less dependent on exports. The contrast with China in this aspect is stark. As such, decline in global consumption ought to have less impact on India. But the impact is a lot more than what should have happened. Why?

- Local investors have suffered wealth erosion, because of the decline in stock prices and real estate. Can't blame the RBI for this.

- The Mumbai terror made things worse for some industries. Can't blame the RBI for this.

- The RBI may however like to ponder over the aspirin example mentioned earlier. Did the continuous tightening of liquidity through tight monetary policy over several months (which did not make sense when inflation was caused by global factors) cumulatively squeeze Indian industry? Now the RBI is busy undoing everything it did earlier this year and last year. Money is being made cheaper. But then, remember, monetary policy, like aspirin, takes time to yield results.

If one aspect of local economic policy contributed to inflation in India, it was the fiscal policy viz. the government's unproductive spending through populist give-aways. The coalition government did not have the political will to be prudent in its finances. This has left the government finances in a mess. This fiscal mess was being compensated by RBI through monetary tightening.

While monetary policy takes time to take effect, fiscal policy shows quicker results. In the current recessionary situation, a quicker way for the economy to escape would have been a fiscal measure to increase government expenditure. Alas, the already weak government finances leave us with fewer sensible options on the fiscal front.

It will take a few months for the easing of monetary policy to deliver results in the economy. In the meanwhile - money or no money – the government will spend. Don't all governments do that before elections?! This will help boost domestic consumption and the Indian economic recovery.

In April-May 2009, India will have another round of general election. Hopefully, a hotch-potch coalition of minor parties will not come to power. Indian economy will be comfortable with either of the two major parties leading a coalition. Political stability in May-June 2009 might help stabilise the equity market, enhance the feel-good, and improve the Indian economic scenario.

The Concerns

- One shudders to think what will happen in India, if the elections throw up political instability. Let me join the majority in wishing this away as a nightmare we may not have to face.
- India may not go to war with its neighbor. But it is useful to keep in mind the economics of wars:
    - The first Gulf war, led by George Bush Sr. was financed by countries in the Middle East. The US economy grew.
    - The second Gulf war, led by George Bush Jr., was financed by the US tax payers. We know how they feel about it.
    - Any post-war recovery helps economies expand. Imagine a giant like India in a recovery mode. Let us hope other countries do not look forward to India getting embroiled in a war, so that the global economy recovers faster.
- It is always difficult for policy-makers to take a call to temper a booming economy. Even Alan Greenspan, who served as Federal Reserve Chairman for nearly two decades, could not bring himself to reverse the cheap money policy. The asset and consumption bubble that this created, sowed the seeds of the current global economic turmoil.

  The same cheap-money and expansionary economic policies of the US, are now being implemented across the world – to avoid a global recession. How many of these governments will have the nerve to reverse these policies when the economy has to be tempered in future? Will the world create a more spectacular bubble than the US created?

  The world will survive the current turmoil. Let us not worry about global recession in the next two years. Start worrying about the next global economic turmoil, 12 years down the line. **Recession 2020**.