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# CONTENTS

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Title

# A COMPREHENSIVE STUDY ABOUT THE REPERCUSSION OF RECESSION

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**ABSTRACT:**

The fear of a 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. An economy which grows over a period of time tends to slow down as a part of the normal economic cycle. A 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 a decrease in production, lay-offs and a sharp rise in unemployment. Investors spend less as they fear stocks values will fall and thus stock markets fall on negative sentiment. The Indian stock markets also crashed due to a slowdown in the US economy. The realty sector boomed but could not sustain the momentum for long, and it collapsed under the gargantuan weight of crippling loan defaults. Foreclosures spread like wildfire putting the US economy on shaky ground. This, coupled with rising oil prices at $147 a barrel, slowed down the growth of the economy. How to fight recession? Tax cuts are the first step that government usually takes in fighting recessionary trends. Government also hikes its spending to create more jobs and boost the manufacturing and services sectors and to prop up the economy. The government also takes steps to help the private sector come out of the crisis.

**Key Words:** Recession, layoffs, Depression, GDP, Economy

**INTRODUCTION:**

**What is Recession? And how is it different from Depression**

The standard definition of a recession is a decline in the Gross Domestic Product (GDP) for two or more consecutive quarters. This definition is unpopular with most economists for two main reasons. First, this definition does not take into consideration changes in other variables. For example this definition ignores any changes in the unemployment rate or consumer confidence. Second, by using quarterly data this definition makes it difficult to pinpoint when a recession begins or ends. This means that a recession that lasts ten months or less may go undetected.

However, The Business Cycle Dating Committee (BCDC) at the National Bureau of Economic Research (NBER) provides a better way to find out if there is a recession is taking place. This committee determines the amount of business activity in the economy by looking at things like employment, industrial production, real income and wholesale-retail sales. They define a recession as the time when business activity has reached its peak and starts to fall until the time when business activity bottoms out. When the business activity starts to rise again it is called an expansionary period. By this definition, the average recession lasts about a year.

Further it is very important to understand how Recession is different from Depression.

There is an old joke among economists that states: **A recession is when your neighbor loses his job & a depression is when you lose your job.** An attempt has been made to clearly highlight the difference between Recession & Depression.

Before the Great Depression of the 1930s any downturn in economic activity was referred to as a depression. The term recession was developed in this period to differentiate periods like the 1930s from smaller economic declines that occurred in 1910 and 1913. This leads to the simple definition of a depression as a recession that lasts longer and has a larger decline in business activity. **So how can we identify what is the real difference between a Recession and a Depression?** A golden thumb rule for determining the difference between a recession and a depression is to look at the changes in GDP. A depression is any economic downturn where real GDP declines by more than 10 percent. A recession is an economic downturn that is less severe.

## OBJECTIVES:

The objective of the study is to understand what exactly Recession is and how it is different from Depression. Further, the study tries to reflect the impact of Recession in Global & Indian Economy. Thereafter the study reflects what all measures has been taken by Global economists & countries at large to overcome and fight from the consequences of Recession.

## METHODOLOGY:

The broad methodology adopted for this study is conceptual views of available literature. The study of said literature is done to integrate it with changing economic paradigms. Specifically cases are highlighted where impact of recession is shown on US & Indian Economies and further measures taken by Global economies to come out of it has also be reflected in the study.

**2008, is it a Year under RECESSION?**

It took 7 economists and 11 months to decide what should seem obvious given all the Foreclosures, Bank Failures and Layoffs to declare officially on 1st December 2008 by NBER (National Bureau of Economic Research) that United States is officially mired in a recession.

This declaration by NBER sent WALL STREET into Bearish fit that knocked off the S&P 500 Index by more than 9%. S&P 500 Index is prices of 500 large capital common stocks actively traded in the United States. These stocks are those large publicly held companies that trade on either of the two largest American stock markets, the New York Stock Exchange (NYSE) and NASDAQ.

**Reaction of White House on December 1, 2008 announcement by NBER**

"What's important is what is being done about it," said White House spokesman Tony Fratto without using the word Recession in his addressing.

During Bush administration of 8 years it is the second time when NBER has declared about US economy is in Recession. Previously it was declared during the period from March to November 2001 in a decline brought on by a stock market crash that struck Silicon Valley exceptionally hard.

**Major Financial Events of Recession (2008):**

Though no one likes or wants a recession, almost everyone appears to be feeling the heat of Recession. Some highlights on major events which were observed after NBER declared Recession on 1st December 2008:

- ***Collapse of Bear Stearns***: The Bear Stearns Companies, Inc. was once known for its top risk management talent and was one of the largest global investment banks and securities trading and brokerage firms. On 14th March 2008 JP Morgan in conjunction with Federal Reserve Bank of New York, provided a 28-day emergency loan to Bear Stearns in order to prevent the potential market crash that would result from Bear Stearns becoming insolvent. Bear's inability to repay its obligation even after issuance of Emergency Loan from JP Morgan, Federal Chief Ben Bernanke & Treasury Secretary Henry Paulson told Alan Schwartz (CEO Bear Stearns) that it would be advisable for firm to sell Bear Stearns before opening of Asian Market so as to avoid chaotic unwinding of investment across US Market. Two days later, on March 16th, Bear Stearns signed a merger agreement with JP Morgan's at $2 per share. Amazing fact is that Bear Stearns stock had once traded at $172 per share as late as January 2007. A action Lawsuit was filed by existing shareholders of Bear Stearns challenging the terms of JPMorgan's acquisition of Bear Stearns. Later, on May 29, Bear Stearns shareholders approved the sale to JPMorgan Chase at the $10-per-share price.

- ***Bankruptcy of Lehman Brothers:*** In the history of United States of America, Lehman Brothers Bankruptcy is the largest bankruptcy, filing with Lehman holding over $600 Billion in assets. It all started in August 2007 for Lehman Brothers when they closed some of their operations eliminating 1,200 positions in 23 different locations. In 2008, due to bad health in ***Subprime Mortgage operations*** Lehman reported unprecedented loss of $2.8 billion and was forced to sell $6 Billion in assets. Lehman's stock lost 73% of its value in the first half of 2008 alone. In August, Lehman's reported that it intended to release 6% of its work force (1,500 in numbers). During end of August Lehman stock jumped to soaring 16% (for a week) on reports that the state-controlled Korea Development Bank was considering buying Lehman. On 9th September the Lehman's shares plunged 45% to $7.79, after it was reported that the state-run South Korean firm had put talks on hold because Korea Development Bank faced difficulties pleasing regulators and attracting partners for the deal. Investor confidence continued to erode on Lehman's stock & on September 10, 2008, Lehman announced a loss of $3.9 billion and their intent to sell off a majority stake in their investment-management business. On September 13, 2008, Timothy, then president of the Federal Reserve Bank of New York called a meeting on the future of Lehman, which included the possibility of an emergency liquidation of its assets. Lehman reported that it had been in talks with ***Bank of America and Barclays*** for the company's possible sale. On September 14, 2008, it was officially declared that Barclays had ended its bid to purchase all or part of Lehman and a deal to rescue the bank from liquidation collapsed.

- ***Collapse of Merrill Lynch:*** It all started in November 2007 for Merrill Lynch when it announced that it would write down $8.4 billion in losses due ***National Housing Crises***, and to remove the then CEO E' Stanley O'Neal. In December 2007, the firm announced it would sell its commercial finance business to General Electric in an effort to raise capital and this deal raised $6 billion for Merrill Lynch. In July of 2008, the new CEO of Merrill Lynch, John Thain, announced $4.9 billion fourth quarter losses for the company ***from defaults and bad investments in the ongoing mortgage crisis***. In one year between July 2007 and July 2008, Merrill Lynch lost $19.2 billion, or $52 million daily. On September 5, 2008 Goldman Sachs downgraded Merrill Lynch's stock to "conviction sell" and warned of further losses from the company. Bloomberg reported in September 2008 that Merrill Lynch had lost $51.8 billion in mortgage-backed securities as part of the ***subprime mortgage crisis.*** Trading partner's loss of confidence in Merrill Lynch's solvency and ability to refinance short-term debt ultimately led to its sale. On September 14, 2008 The Wall Street Journal reported that Merrill Lynch was sold to Bank of America (BOA)

- ***Icelandic Economic Failure:*** Recession did not had it boundaries stretched to US but its different colors were seen in various part of Globe. A model example for historians and economists for years to come was the economy of Iceland which fell into economic depression as a result of financial sector failure. The impact was that the local currency, the KRONA, collapsed by almost 40 percent as traders sold the currency against the euro over the span of a few days. *The instability led UK Prime Minister Gordon Brown in threatening legal action against the country's banks as their actions were deemed "totally unacceptable and illegal"*. ***How it all happened? A question for which everyone was looking for an answer.*** It was only two years ago that the world thought Iceland was a wealthy country with the highest standard of living of any nation. Thanks to deregulation of Iceland's banks and a mad rush to invest in derivative financial instruments, Iceland experienced a runaway expansion of money that virtually everyone misinterpreted as an economic boom. In reality, however, it was just the false promise of fictitious money running amok. No real wealth had ever been created, and once the money bubble popped, reality came crashing down quite rapidly. Many of its residents were now face total financial wipeout, and for a while they were unable to import food due to the collapsing value of their national currency. The frustration led to riots, and the riots eventually led to the Prime Minister effectively ending his administration's rule.

- ***Bernard Madoff: It is considered as Tip Of The Iceberg***

  One of the biggest stories to hit 2008, former fund manager and financial market icon Bernard Madoff was arrested on orchestrating the largest Ponzi Scheme (a fraud in which belief in success of nonexistent enterprise is fostered by payment of quick return to the first investors from money invested by later investor) ever, potentially scoring $50 billion. The incident not only crippled Wall Street's credibility but also showed potential leaks and inefficiencies in US regulation. Even more disturbing has been continued news of more hedge fund managers being arrested under the same claims as Madoff as clients continue to clamor for their money back.

- ***Crude Oil reached its all time high touching $147 per barrel***: On July 11, 2008 Crude Oil prices touched all time record high of on New York Mercantile Exchange (NYMEX). Impact on India was too high of this rise as India imports nearly 80% of its crude oil requirements. All major Oil companies had a fear that this uptrend may cast a major impact on their profits, which may even see complete erosion during the complete financial year.

**After getting feel of recession on Global cues, surly it generates interest about how it is impacting INDIA in a Global Map. We will try to understand that what is the reality for countries like India due to Recession**

It would be naive to imagine that a recession in the United States would have no impact on India. Alone, United States accounts for one-fourth of the world GDP and any significant slowdown is bound to have reverberations across globe and India is not left untouched. As the cliché goes, whenever the US sneezes, the world catches a cold. A lethal cocktail of the falling sales, rising inflation, increasing input costs and drying cash flow topped with US economy slowdown is hurting India industry hard. Here are some of the highlights which had a *huge impact* on India due to recession 2008.

- ***Impact on Indian Exports:*** India's exports fell most on record in March with achieving $168.7 billion in fiscal year ended March 2009 as against the target of $200 billion set by the government before the September collapse of Lehman Brothers Holdings Inc. As per India's Trade Secretary Gopal K. Pillai on 13th April 2009, the export is likely to decline until September 2009. Falling overseas sales may cost India about 10 million jobs, according to estimates from the Federation of Indian Export Organizations, a lobby group.

- ***Impact on Information Technology Enabled Service Sector:*** 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. As per Manish Sonthalia, head, equity, Motilal Oswal Securities, if the US economy contracts much more than anticipated, the whole world's GDP growth-which is estimated at 3.7 per cent by the IMF-will contract and India, would be no exception. Jasjit Sawhney, CEO, NET4 India Ltd says "The major impact of recession or economic slowdown is with the small exporters and importers in the country as most of them are facing the problem of heavy duties. The US slowdown will immensely hit the mid-sized IT companies and also the big players to some extent. There would be scenarios where customers are cutting back on contracts and reducing the fees per manpower in their contracts". He further added that "The service sector in the IT industry has been the victim of global downswing as the profitability in most of the segments has reduced a lot. Software multinationals in India have begun freezing wage increases, slashing salaries and postponing merit-based hikes. Though Bangalore stands highest in its average salary for multinational R&D firms, followed by Pune and Chennai, the economic slump is causing undue pressure on them to retain compensation levels. "Of the 30 representative multinationals surveyed in these three cities (Bangalore, Pune and Chennai), 27 per cent of them said they have frozen salary increases this year. According to recent data published on "Compensation and Benefit Study 2009", 12 per cent of the MNCs have announced 5-10 per cent salary cuts either for senior management or across levels.

- ***Impact on Auto Sector:*** With India Inc in the grips of a slowdown, the auto sector is also feeling the pinch. Companies are both deferring their hiring plans and holding their capacity expansion plans. Mahindra & Mahindra, which added 1,000 white-collar employees and 2,000 workers in its assembly line over the last two years, is now slowing down its recruitment plans. “Hiring is a function of demand and supply. While in the last two years we hired around 3,000 employees, this year so far we have hired only 200,” said Dr Pawan Goenka, President (Automotive Sector), Mahindra & Mahindra. General Motors too, which commenced operations of its second plant in September this year, is likely to defer its plans on starting a second production shift. “We were looking to start a second shift at our Talegaon plant in the next calendar year. But considering the market scenario, we will see the demand and accordingly take a decision,” said P. Balendran, Vice-President, General Motors India. Last week, Tata Motors also admitted that it had laid-off a section of its temporary workers at its Jamshedpur plant owing to a slowing demand in commercial vehicles. Ashok Leyland too has been adjusting production to avoid a build-up of stocks on the retail front.

- ***<u>Impact on Reality Sector:</u>*** Leading global financial services firm US-based Goldman Sachs has estimated that Indian realty prices may fall by up to 30 per cent from current levels, with a significant knock on the economy. In a report by Goldman Sachs said, in commercial real estate, supply outstrips demand in a big way so that construction activity, in particular, will slow down. Construction activity directly accounts for 7.3 per cent of India's gross domestic product (GDP) but has sector linkages which Goldman Sachs estimates to be 14 per cent of GDP. The realty sectoral index of the Bombay Stock Exchange has lost more than 83 per cent in the last one year dragged down by heavyweights like Unitech, DLF and India Bulls Real Estate. The index is currently trading at 1,631 points, as against 9,783 points a year ago.
- ***<u>Impact on Capital Goods Sector:</u>*** Diversified conglomerate Aditya Birla Group said its various businesses, including mutual fund, life insurance, garments and BPO operations, have been impacted by the global slowdown in the third quarter of current fiscal. According to Aditya Birla Group’s third quarter performance, some of the Group's businesses have been impacted by the global slowdown and it is taking various initiatives, including cost control measures, to face the challenges. The performance of the manufacturing sector is expected to deteriorate on the profit front. Though apparels sector was expected to slip into the red, sector like steel, copper, aluminium, alkalies,

edible oils, automobiles and auto components are all likely to witness fall in net profits. Due to the lower unit realisation, sectors like edible oils, steel, copper, aluminium are expected to report a slower growth in sales in coming quarters. The deterioration in global macro-economic conditions suggests a weakening demand environment for metals. Hit, in particular, would be steel, whose consumption is slowing in China, the world's largest producer and consumer of the industrial metal. Construction activity in China has turned sluggish and this is likely to hit the steel market. Because construction accounts for about half of steel end-use demand, a slowdown in construction activity (housing, infrastructure) is expected to exert negative pressure on steel demand and, in turn, steel prices. Weak stainless steel demand is seen hurting nickel market. Nickel stocks are at record levels. Currently, the metal is trading below $16,000 a tonne, which is considerably below the marginal cost.

- ***Decline in GDP:*** As the world economy slips into recession hitting the demand hard and the banking sector takes conservative approach towards lending to corporate sector, the CEOs Survey based GDP growth forecast done by Associated Chamber of Commerce and Industry (ASSOCHAM) Business Barometer (ABB) has downgraded it to 7.1 per cent for 2008-09 and predicted it to be 6.5 per cent for FY 2009-10. 83 per cent of the 250 CEOs surveyed by the ASSOCHAM projected the GDP growth for FY 2008-09 at 7.1 per cent with strong waves of negative economic sentiments flowing in the economy. As per D S Rawat, ASSOCHAM Secretary General the outlook for the fiscal 2009-10 is seen as even worse with the growth projections made at 6.5 per cent as the effect of job cut, negative production growth rate and stagnant US and EU economies would be felt on the Indian economy.

**Measures taken by Global Economies & India to fight back against recession:**

British Prime Minister Gordon Brown claimed that the end of the global recession is now achievable, as he unveiled an agreement from the G-20 summit that would pump an additional one trillion dollars ($1 Trillion) into the global economy. He said, "This is the day that the world came together to fight back against the global recession, not with words but with a plan for global recovery and reform and with a clear timetable," Brown said that the world had come together in a way that was unprecedented, and the G20 countries had already committed themselves to spending 5 trillion dollars by the end of next year on measures to promote growth.

The Reserve Bank of India (RBI) slashed its cash reserve requirement to free up $12 billion in funds and ease a cash squeeze that drove overnight rates to an 19-month high. The Reserve Bank of India cut the reserve ratio by 1.5 percentage points to 7.5 percent. Citing this liquidity condition (release of $12 billion) by Government of India called off an auction for $2 billion worth of government bonds. India's RBI assured the Government of India that it is keeping a close watch on the market situation and economic situation and would take appropriate steps as an when needed to be taken. The release of liquidity will ease the credit crunch and also have a full effect on money multiplier within 4-6 months. This has also helped the call rates to stabilize in the Repo and Reverse Repo rate window of RBI

## CONCLUSION:

RBI believe that in the wake of current financial crisis which now is trickling to real economy, RBI will continue to take various policy measures not necessarily at its scheduled meetings. RBI expect the CRR to come down to 4.0% from 5.0% in medium term with another 150 bps cut in Repo and 100 bps cut in Reverse Repo in the wake of the slowdown in the economy. We can expect unscheduled announcements from RBI on Monetary Policies so as to combat current financial crises.

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