The US Economy: Why the future may differ from the past?

*By A V Vedpuriswar**
*Senthil Ganesan***

During the major part of 2001, the US economy witnessed a significant slowdown. Sharp cut backs in capital spending, accompanied by liquidation of inventory were seen. Now, it looks as though the worst is over. The recovery seems to have got under way in the last quarter of 2001. The US Conference Board's composite index of leading indicators, rose 0.6% in January, following jumps of 1.3% in December and 0.8% in November, (Business Week, March 11, 2002). People are waiting with crossed fingers to see if the growth picks up momentum. For Indian software companies, of course, it is a period of great suspense, as their fortunes are closely tied to the US economy.

In the past, recessions in the US have tended to be short. Which is why, many businessmen did not panic this time around. Now that the US economy looks like recovering, it is important to appreciate some of the important structural changes which have taken place in the US economy beginning with the early 1990s.

Investments in Information Technology (IT) have enabled manufacturers to anticipate demand more accurately. This has helped them to avoid piling up unnecessary inventory. By smoothening the inventory build up process, prolonged contraction of productive activities in the economy has been obviated. As Alan Greenspan, the Federal Reserve Chairman remarked in a speech made in June 2000, "Information technologies, by improving our real time understanding of production processes and of the vagaries of consumer demand, are reducing the degree of uncertainty and hence risk." Another reason for the dampening of cyclical fluctuations is the growth of the service sector. Unlike goods, services cannot be stored.

This does not mean that inventory accumulation has been completely avoided. Cisco for example found itself saddled with huge unsold stocks towards the end of 2000 and had to write off $2.5 billion. But wherever inventory has piled up, the adjustments have taken place quite fast. This is what economists mean by a V shaped recovery. In 2001, reduction of inventory accounted for virtually all the contraction in real gross domestic product. In the fourth quarter of 2001, an estimated $121 billion worth of inventory was liquidated. Even if inventory build up does not take place in the near future, but inventory liquidation stops, growth will be restored.

The availability of real time information has also enabled the US Federal Reserve to react very fast. The Fed cut interest rates aggressively, a total of 11 times during 2001. Rate cuts and tax rebates have boosted home sales and maintained the tempo of consumer spending. Another unique phenomenon is that reduction in capital spending has not been across the board. While people are hesitant about expanding capacity, they are continuing to buy computers and electronic products. New orders for such products grew at an annualised 20% from the third quarter of 2001 to the fourth quarter. The thinking seems to be that such investments can further boost productivity and cut costs.

As Business Week (February 25, 2002) recently reported, "Like increased productivity and greater labour flexibility, quick reflexes became a key characteristic of the US economy during the 1990s. These New Economy phenomena will affect this year's upturn too… Whether the Fed chief mentions it or not (in the forthcoming congressional testimony), one key aspect of the recovery will be quicker responses made by businesses, consumers and policy makers to shifts in the economy."

One other point needs to be mentioned. It is true the US economy's recovery has been quite fast. But there is no guarantee that there will not be one more sudden contraction in the near future. In the real time economy, adjustments to downturns are going to be fast. So, we may well see a few quarters of expansion, followed by a quarter or two of contraction. This will be unlike the past where a boom period would continue for years followed by a recession typically extending over a period of 1.5 – 2 years. Indeed, for the real time economy, a new definition of recession (The current one is two consecutive quarters of negative growth) may have to be coined! The real time economy will continue to spring surprises. Business and policy makers need to be fast and nimble to survive in the changed economic scenario.

* Dean, ICFAI Business Schools, Hyderabad.
** Faculty, ICFAI Business Schools, Hyderabad.