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Shock overtook the world with the announcement of downgrading of the US by the rating agency, Standard & Poors, from the highest rating of AAA to AA+, leading to blood bath in the financial markets around the world. S&P said, it stripped the US off this rating, downgrading it a notch lower to 'AA+', terming the efforts being taken to tackle the country's soaring debt levels as inadequate.

Stung by the first-ever downgrade to its top-notch sovereign credit rating, the US Administration hit back at S&P, saying that the rating agency's flawed analysis has put its own credibility and integrity at risk. The US administration has also got support from legendary investor Warren Buffett, who said that the rating downgrade from 'Triple-A' did not make any sense and he would rather give the US a 'Quadraple-A' rating, if there was one. Reacting to the unprecedented downgrade, the US Treasury Department issued a detailed statement on its website, questioning the credibility and integrity of S&P and terming as misleading and flawed the agency's analysis for the action. S&P, however, defended its action through media interactions and said that the US administration's angry response was on expected lines from any country or company being downgraded.

The US Treasury officials have been saying that S&P had erroneously inflated the US deficit figure by over USD 2 trillion, which they rectified after being pointed out of the error but still decided to go ahead with the downgrade. "S&P acknowledged this error - in private conversations with Treasury and then publicly. In the interim, they chose to issue a downgrade of the US credit rating," Treasury statement said. The head of the White House Council of Economic Advisers, Gene Sperling, also joined in assault on Standard and Poor's, saying that S&P first arrived at a conclusion to downgrade the rating and they decided on the required arguments. "The magnitude of their (S&P's) error combined with their willingness to simply change on the spot their lead rationale in their press release once the error was pointed out was breathtaking. It smacked of an institution starting with a conclusion and shaping any arguments to fit it," he said.

Standard and Poor's has, however, added that there will be no immediate impact of its action on the Asia-Pacific region. But it has, nevertheless, issued a cautionary note. For one, India is the 14th largest creditor to the US, with an exposure of $40 billion in the US securities.

However, two other equally renowned and professional credit rating agencies-Moody's and Fitch - have refused to downgrade the US rating, for now.

Growing US Domestic Fears

There have been growing fears among Americans that this downgrade would lead to recession, particularly in view of the fact that the US economy is not in the pink of its health. The fact remains that the US has not been able to make good the damage that the 2008 recession had caused and now, if another recession turns up, as many economists are now warning, the bloodletting could be a lot more painful than the last time around. Given the tumult of the Great Recession, this may be hard to believe. But the economy is much weaker than it was at the outset of the last recession in December 2007, with most major measures of economic health-including jobs, incomes, output and industrial production-worse today than they were back then. And growth has been so weak that almost no ground has been recouped, even though a recovery technically started in June 2009.

"It would be disastrous if we entered into a recession at this stage, given that we haven't yet made up for the last recession," said Conrad DeQuadros, senior economist at RDQ Economics. When the last downturn hit, the credit bubble left Americans with lots of fat to cut, but a new one would force families to cut from the bone. Making things worse, policy makers used most of the economic tools at their disposal to combat the last recession, and have few options available now.

Anxiety and uncertainty have increased in the last few days after the decision by Standard & Poor's to downgrade the country's credit rating and as Europe continues its desperate attempt to stem its debt crisis.

President Obama acknowledged the challenge in his address, saying the country's "urgent mission" now was to expand the economy and create jobs. And Treasury Secretary Timothy F. Geithner said in an interview on CNBC that the United States had "a lot of work to do" because of its "long-term and unsustainable fiscal position." But he added, "I have enormous confidence in the basic regenerative capacity of the American economy and the American people."

Still, the numbers are daunting. In the four years since the recession began, the civilian working-age population has grown by about 3 percent. If the economy were healthy, the number of jobs would have grown at least the same amount. Instead, the number of jobs has shrunk. Today the economy has 5 percent fewer jobs-or 6.8 million-than it had before the last recession began. The unemployment rate was 5 percent then, compared with 9.1 percent today.

Even those Americans, who are working, are generally working less now; the typical private sector worker has a shorter workweek today than four years ago. Employers have shed all the extra work shifts and weak or extraneous employees that they could during the last recession. As shown by unusually strong productivity gains, companies are now squeezing as much work as they can from their newly "lean and mean" work forces. Should a recession return, it is not clear how many additional workers businesses could lay off and still manage to function?

We need to know how the world, at large, has reacted, for, the sovereign credit rating of US is too important a matter to be taken lightly. In so far as India is concerned, not only we are the 14th largest holder of US treasury bills worth USD 40 billion, but the US continues to be one of very important destination for Indian goods, including and particularly apparel.

The World Reacts

Asian economists are shrugging off for now the global market turmoil sparked by U.S. and European sovereign debt problems, saying that domestic demand in the region will hold up and help offset lower exports even if Western economies slip back into recession. Many economists had already trimmed their 2011 and 2012 growth forecasts for China, India and some other Asian economies in a Reuters poll in late July before the U.S. credit rating was downgraded, reckoning that policy tightening to tackle inflation made a slowdown in growth seem inevitable.

However, Asian states are likely to retain their US Treasury holdings for now and European governments expressed confidence in the world's largest economy after Standard & Poor's cut the US's sovereign credit rating to AA+. Russia said the one-step cut "can be ignored" and France joined the U.S. in questioning S&P's reasoning. South Korea affirmed its "faith" in Treasuries after an emergency meeting of officials near Seoul.

"They won't be happy about it, but Asian central banks will just have to hold on and stick it out," said Sean Callow, a senior currency strategist at Westpac Banking Corp. in Sydney. "There is pressure on them to hold on to liquid assets and there is nothing more liquid than the Treasury market. At least Treasuries have been doing well and they aren't holding on to distressed assets."

Asia accounts for about half of foreign-owned U.S. debt, Treasury data show. Speaking on Japan's NHK television, Igarashi said the government may intervene again if its sees speculative trading. Recently, the government may have sold a record 4.5 trillion yen ($57 billion), according to Totan Research Co., a Tokyo money-market brokerage. "Our faith in U.S. Treasuries has not changed," Yim Jong Yong, South Korea's Vice Finance Minister, told after meeting with counterparts from the central bank and financial regulators. The nation will step up monitoring of capital flows and currency movements because of the U.S. downgrade and Europe's debt crisis, he said. Japan, the second-largest international investor in American government debt, sees no problem with trust in the securities, a Japanese government official said on condition of anonymity.

China critical of U.S. debt downgrade

China's top newspaper has warned that Asian exporters could be among the biggest victims of mounting U.S. economic woes after Standard and Poor's downgraded the United States' sovereign credit rating. Although Beijing officials have so far been publicly mute about the blow to Washington, the People's Daily, the main newspaper of China's ruling Communist Party, gave a bleak assessment of the potential consequences for China and other emerging economies.

"The lowering of the United States' long-term sovereign credit rating has sounded a warning bell for the international currency system dominated by the U.S. dollar," said economist Sun Lijian, writing in the paper. "The biggest victims may not be the United States itself, but other countries that have depended on external demand to amass national wealth-be they Asian nations that depend on exporting goods or nations in Latin America and the Middle East, as well as Russia, that depend on exporting resources," economist Sun Lijian wrote. Such countries include China, the world's biggest foreign holder of U.S. Treasuries. "They all face the risk that the U.S. treasury debt that they hold will plunge in value, leading to deterioration in liquidity," wrote Sun.

The Foreign Ministry, Central bank and other government agencies, however, have made no comment on the downgrade, and are likely to remain more cautious about any remarks that could undermine the value of China's dollar-held assets.

Downside risks in India

Noting that India was not insulated from global developments like the downgrade of the US, the Reserve Bank of India (RBI) said it was closely monitoring the situation and would continuously assess the impact on the Indian economy. "Developments relating to the US economy have significantly increased uncertainty about its prevailing condition," the RBI said in a statement. "The Reserve Bank is closely monitoring all key indicators and will continuously assess the impact of global developments on rupee and forex liquidity and macroeconomic stability. We will respond quickly and appropriately to the evolving situation," it added.

"Two other rating agencies, Moody's and Fitch, had recently maintained their AAA rating, but suggested that this could change." the RBI said. "While downside risks to growth may have increased in the wake of global developments, they are likely to have limited impact," the RBI added. The RBI clarified its immediate priority was to ensure that adequate rupee and forex liquidity is maintained in domestic markets to prevent excessive volatility in interest rates and exchange rates.

"As regards forex liquidity, in anticipation of financial market turbulence related to the US debt ceiling impasse, the Reserve Bank made an assessment of the ability of the forex reserve portfolio to meet potential forex requirements in the event of significant capital outflows. "This exercise indicated that there were sufficient liquid reserves to meet the demand for forex even in a stress scenario," it added.

In so far as the downside risks are concerned, other analysts have been more forthcoming and have a different take on the subject. They feel India weathered the 2008 crisis well, but there are fears that this time round, the country is not even ready for a crisis of much lesser magnitude, let alone a full-blown debt default in Europe or a possible US recession. Weak finances, persistently high inflation and policy inertia have considerably weakened the Government's position today. "This time our basics are weak. A domestic meltdown is expected and our resilience won't be as much as last time," said Nisha Taneja, Professor of Economics at ICRIER. Growth estimates are down to 7.2% in the current year, not far from 6.8% the country managed in crisis-ridden 2008-09, and every other indicator is pointing downwards.

Contrast that with 9.3% growth on the eve of the crisis when India could do no wrong. "This time we may be on weaker foundations," admitted Chief Economic Advisor Kaushik Basu to Washington Post. Just before the crisis in 2008, the repo rate, the key rate in the economy, was 9%, which was cut quickly to stimulate demand and investments. This time round the best the Reserve Bank can do is to halt the rate increases because despite high borrowing costs consumption, demand remains strong and any policy reversal risks inflation going out of hand.

"The ability to respond (globally) is very limited this time around," said Samiran Chakraborty, Chief Economist, Standard Chartered. "The fiscal space in India is also comparatively more constrained." Although the foreign exchange reserves are in excess of $300 billion, the balance of payments situation is weaker and the country could find it difficult to weather an export slump similar to the one in 2008, when growth turned negative for 13 straight months. "The overall impact of the global uncertainty is difficult to predict as of now," said Pronab Sen, Principal Advisor to the Planning Commission.

Impact on Indian exports

Acknowledgedly, both the US and the EU have been most important export destinations for Indian exports, particularly the garment exports with both the destinations traditionally accounting for some 66% of our total exports. The state of their economies is indeed of paramount importance to us. Unfortunately, both of them have not been fairing well.

The US market

In so far as the US is concerned, they never got out of 2008 recession, some details of which have already been discussed above under "Growing domestic fears". I will add a few more facts to complete the US picture. Unlike during the first downturn, there would be few policy remedies available if the economy were to revert back into recession. Interest rates cannot be pushed down further-they are already at zero. The Fed has already flooded the financial markets with money by buying billions in mortgage securities and Treasury bonds, and economists do not even agree on whether those purchases substantially helped the economy. So the Fed may not see much upside to going through another politically controversial round of buying. "There are only so many times the Fed can pull this same rabbit out of its hat," said Torsten Slok, the Chief International Economist at Deutsche Bank.

The European market

The position of European Union is no better; and is perhaps even worse. While the consumer sentiment in the US is down to a three-year low, intensifying fears of a double-dip recession, few doubts linger about the severity of Eurozone's sovereign debt issues. World Bank Chief Robert Zoellick is more worried about the Eurozone crisis than the Standard and Poor's US downgrade.

In India, from the point of view of bilateral trade, Europe's problems are more significant than those of the US. Indo-Europe trade today stands at $ 67 billion, making it India largest trading partner globally. The industrial production in the 17-nation Euro area fell 0.7% in June this year. In France, the second largest economy in the EU after Germany, growth came to a standstill in the three months through June, according to official figures. Another recession is already well under way in Greece and Portugal, while growth in countries like Spain, Italy and Britain has been very slow since last year. But nor Germany, which has been remarkably strong, hauling the rest of the Continent along with it, seems to be decelerating. A big problem for Europe is that domestic demand is weak and growth has become primarily dependent on sales from abroad, where the signals are flashing disappointment. Analysts feel that with flat growth in the second quarter in France, whether France could also lose its triple A credit rating. This, of course, comes on the back of the crisis in Greece, Spain, Ireland, Portugal and, more recently, Italy, which has reached critical proportions.

As far as Japan is concerned, the earthquake, Tsunami and nuclear disaster had a greater impact on global trade than economists expected, while the demand from China and other emerging markets is slackening.

Where else to export our garments?

The discovery of "new markets" too has little potential. The fact that is often lost sight of is that even these markets draw their sustenance from important markets like the US and the EU, whose capacity to import will certainly be curtailed, given their domestic problems. One should not place too much of reliance on those markets, which are themselves somewhat shaky and facing serious financial problems at home. Further, even if these markets are depended upon, their capacity to import from India is extremely limited. Notwithstanding our thrust in new markets, in the likely event of the two most important markets i.e. the US and the EU falling in maintaining their demands, could lead to more risks and uncertainties than what we have met with and even probably battled more or less successfully, in our export efforts in the past. This is particularly true of garments.

Can one draw a conclusion that Indian exports would not be impacted adversely in view of the recent downgrading of US read along with the sovereign debt problems in the European continent, even if one wishes to do so?

The views presented here are that of the author