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Subir Gokarn: Confluence of negatives

Subir Gokarn | New Delhi December 29, 2008 Last Updated at 00:00 IST

Globally, this quarter's performance is a predictable response to monetary and financial forces.

The collapse of Lehman Brothers is viewed by many observers as a point of inflection in the evolving global economic scenario. Until it happened in mid-September, things looked bad but not out of control. After the collapse, it was almost as though any hope of the global economy being able to pull out of the crisis evaporated. Virtually every indicator after that — quarterly GDP growth rates, monthly industrial production, exports and unemployment rates, financial flows and, of course, the daily gyrations of stock markets around the world — reinforced the perception that the world economy was on a slippery slope. Of course, we will have to wait for a couple of months to see how bad things actually were during the October-December quarter, but the early indications clearly are that it will turn out to be amongst the worst quarters ever.

The range and magnitude of the negative news during the quarter is an indisputable fact. However, the fact does lend itself to alternative interpretations, which in turn influence one's outlook for the next few months. One interpretation, which essentially sees macroeconomic and financial developments as a mutually reinforcing vicious circle, suggests that not only is the slope steep, the drop is indefinitely long. In technical terms, this means that in making economic forecasts over the next year, high weights are given to the most recent data points, ie, post the Lehman collapse. Obviously, the more weight that is given to negative news, the more pessimistic the forecast will turn out to be.

Let me offer an alternative interpretation of the negative news during the past three months or so, which views these outcomes against the backdrop of developments over the past year. The fact that the global financial system was in trouble was widely accepted by late 2007, the collapse of Bear Stearns removing all remaining doubts about its severity and damage potential. The response to the collapse by the US Federal Reserve combined a traditional monetary response, a significant reduction of the federal funds rate in January 2008, and the unconventional support for JP Morgan Chase's takeover of Bear Stearns. At this point, although the financial system was clearly shaken by the collapse, the speed and nature of the policy response provided assurance that things would not be allowed to deteriorate any further.

In hindsight, had central banks around the world followed the Fed's lead in at least cutting interest rates, we would in all probability not have seen the Lehman Brothers collapse in September. As it turned out, though, by February 2008, the attention of global central banks was completely focussed on the massive supply shock that hit the global economy, resulting in an enormous surge in inflation rates. Oil prices had already begun to increase sharply in the second half of 2007 but now, other commodity prices, already quite buoyant, accelerated sharply and, most significantly, food prices went on the rampage.

The combined impact of these developments was simply too hot to handle. Around the world, central banks, instead of following the Fed's lead, began to increase interest rates and curb liquidity. The complaint that this was not an appropriate response to supply shocks was countered with the argument that the failure to act would result in spiralling inflationary expectations, which would make it increasingly difficult to bring inflation under control. Even the Fed accepted the dangers of inflation and made no further interest rate changes after January. At that point, while the fragility of the financial sector was recognized, the likelihood that it would suffer further damage as a result of the anti-inflationary policy response was not enough of a deterrent.

It is well known that monetary policy works with a lag. It would take at least two quarters for the impact to be felt in the form of slowing demand. Other things being equal, we should have expected that the concerted increases in interest rates early in the year would manifest as decelerating growth rates by about the fourth quarter. This has indeed happened. The simple point is that it did not take a Lehman Brothers collapse to explain why indicators of economic activity worsened so sharply over the past couple of months. This development can reasonably be seen as the lagged outcome of the global monetary stance in the early part of the year.

Of course, monetary policy, besides having an impact on consumption and investment, also affects asset prices. Their predictable downward response to monetary actions increased the pressure on the balance sheets of financial intermediaries around the world. Under “normal” circumstances, this pressure would have been absorbed by the various buffers that have been created by provisioning requirements. However, in early 2008, the financial system was not in normal circumstances. Its shock absorption capacity had already been seriously eroded by the developments of the previous year. It was simply unable to cope with the decline in asset prices during 2008. This explains the collapse or near-collapse of several financial institutions around September 2008.

If the dismal news of recent months is attributable to global monetary actions early in the year, then equally, the massive turnaround in the monetary stance beginning around August should presage a similar turnaround in macroeconomic performance a couple of quarters down the road. Whatever might have caused the inflationary pressures to virtually disappear, it has given central banks a lot of room, and very quickly, to completely reverse their stance of early 2008. From a forecasting perspective, this interpretation, by giving weight to the monetary dynamics of early 2008, uses the reversal of those dynamics to project a turnaround in macroeconomic performance during 2009.

In other words, the past few months have been so bad because they have seen a confluence of the negative impact of developments in the financial sector and the monetary policy responses to the high inflation in the first half of 2008. More recent developments, specifically on the monetary policy front, have created conditions that will break up that confluence.

However, there are a couple of threats lurking in this generally positive interpretation. First, monetary policy tends to be more effective as a brake than an accelerator. Second, any recovery is going to depend on the ability of the financial system to function normally again. The former is a given, while the latter is surely the top item on every forecaster’s wish list for 2009!

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