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Subir Gokarn: 2010: An economic odyssey

What happens after the war has been won is an equally important story

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What happens after the war has been won is an equally important story, says *Subir Gokarn*

As we look back over the crisis of 2007-2009, a striking feature is that it played itself out in three very distinct tempos. From the beginnings of mid-2007 until September 2008, there was a steady deterioration in the health of the financial system — alarming, but not catastrophic. Had this happened in a course of a normal business cycle, the managers of the global economy would have had both the instruments and the capacity to bring about a soft landing. But that was hardly the case. Instead, they were busy fighting inflationary fires caused by the surge in energy and commodity prices. Given the inherent contradiction between the deteriorating state of financial systems and the contractionary stance of macroeconomic policies, something would have to give.

The collapse of Lehman Brothers was clearly a point of inflection, in which the rate of decline of the financial system accelerated sharply and its impact on the global economy intensified. In retrospect, it could have been any one or more of the global financial institutions to precipitate the collapse. What is important, though, is that when it happened, the contradiction referred to above was no longer in force. Shrinking liquidity and growing pessimism about the global economy had brought energy and commodity prices down just as abruptly as they had risen a mere few months before. At this point, policy responses were no longer bound by the problem of unintended consequences — the solution to one problem being the cause of another, equally serious one.

The rapid meltdown phase lasted for about five months from September 2008 until February 2009. Given the severity of the crisis and the room that governments and central banks now had to manoeuvre, every conceivable instrument was brought into action — interest rates, conventional and unconventional measures for boosting liquidity and shoring up asset prices, spending, tax cuts and a whole lot more. More so, the re-activation of the somewhat moribund G-20 process underscored the global dimensions of the crisis and the need for all the major economies to act in concert to deal with it.

The third phase, which began around March 2009, with a simultaneous and rapid recovery in global equity markers, is of a mixed tempo. Asset prices have run far ahead of indicators of real economic activity — way too far, some would say — driven again by two sets of factors, one unambiguously positive, the other less so. The positive force is the revival of confidence in the global economy and, importantly, the capabilities of its managers. The more ambiguous factor is the impact of the huge increases in global liquidity on asset prices, increases which are consequently disproportionate to the turnaround in the productivity of the underlying real assets.

As 2009 fades and 2010 approaches, this mix of tempos represents the most significant challenge to the global policy-making establishment. Can markets be trusted to make relatively accurate assessments about macroeconomic prospects, particularly against the backdrop of the events of 2007-08, during which, many people now concede, the premise of market efficiency has been critically, if not fatally, damaged? If, in fact, the exuberance currently visible in global equity markets is largely irrational, would it be appropriate to consider policy actions to dampen it?

But then, the capacity of global policy-makers to assess the state of the economy and make reasonable predictions about its performance in the near term has also been seriously questioned as this episode has unfolded. Even if markets are not getting it right, can policy-makers claim that they know better what the real situation is and that they can effectively use the tools that they have to bring about an alignment between the financial and real sectors?

This leads to the larger question of understanding the true nature of the transmission from policy actions to economic outcomes over the past few months. Even with all their limitations, large-scale models have given economists the ability to identify the direction and magnitude, and time lags of linkages between specific policy actions and outcomes. But, these models work only with data from long periods of time, which allow the impact of various other factors to be isolated and controlled.

This reflects the essence of what policy-makers are grappling with. The law of unintended consequences looms very large in their thinking. It may well become an iron law of macroeconomics that the solution to every crisis contains the seeds of the next one. The huge build-up in government commitments that took place over the past few months, both in terms of direct fiscal actions and through rescue operations for endangered financial institutions, could very well trigger the next upheaval as government borrowing requirements crowd out the private sector from access to finance. “Exit” from these commitments is now unanimously seen as the next priority for global macroeconomic policy.

But exit when and how? From an analytical perspective, answering the question “what worked, what didn’t” in the resolution of the recent crisis will be a nightmare, if not a complete impossibility, given that there is only a few months of data available and a very large number of both policy responses and extraneous factors to consider. The question will certainly not be resolved even to the point of a reasonable consensus in time to give policy-makers clear guidance on what to do next.

Since the title of this article is inspired by literature and cinema (with due acknowledgement to Homer, Arthur C Clarke and Stanley Kubrick), a cinematic metaphor is apt. A typical scene has the bomb disposal expert having to choose between two wires to cut. It is a 50-50 choice between safety and oblivion. Policy-makers now face the choice between cutting several; worse, many of these are interlinked. In short, neither do they have a clear identification or understanding of “what worked, what didn’t” in resolving the crisis, nor are they immune from the law of unintended consequences; even a seemingly reasonable sequencing of exit may derail the global economy because of unknown inter-linkages.

Even as we heave a collective sigh of relief at the abatement of the crisis, we must remember that its story is not yet finished. Just as the Odyssey began after the Trojan War was won, the events of 2010 may well be the most important and interesting phase of the crisis.

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