Logo

Subir Gokarn: Shock absorbers

Subir Gokarn | New Delhi July 14, 2008 Last Updated at 00:00 IST

Inflation is accelerating, industrial production is decelerating. The fiscal deficit is widening, as is the current account deficit. Interest rates are up, while stock prices are down. In short, we are in a macroeconomic Murphy's Law scenario: anything that can go wrong either already has or will. Is this, then, the meltdown or will the Indian economy emerge, from these dire conditions intact and, perhaps, a little bit wiser about how to handle such situations in the future?

Going back to the textbooks provides some guidance with respect to the mechanisms that help an economy absorb and recover from the kind of shocks that we have seen in recent months. The key word here is "recovery". There have, of course, been significant examples of macroeconomic shocks resulting in prolonged stagnation. "Latin America and Japan come to mind" but, for the most part, circumstances such as the ones we are currently experiencing can be handled by appropriate policy responses and do not necessarily pose a threat to long-term performance. The duration and intensity of the adjustment depend on certain institutional features of the economy, which can collectively be referred to as "shock absorbers".

Let's go through a simplified textbook model of adjustment to illustrate the point. An adverse supply shock, as reflected by the behaviour of oil and commodity prices, should result in slower growth and a higher inflation rate. Let's assume that there is no policy response. Can the economy recover from this shock? Yes, as a result of two factors. One, workers who are unemployed and producers who have excess capacity now have an incentive to lower their wage demands and prices. This begins to counteract the initial supply shock. Two, these processed cause inflationary expectations to moderate, which then speeds up the adjustment as more and more workers and producers tone down their wage and price demands in tune with these changing expectations.

One implication of this analysis is that the greater the initial impact of the shock "in terms of slowing growth and rising inflation" the greater will be the impact of the two shock absorbers described above and, hence, the faster will be the recovery. This, in turn, implies that the appropriate monetary response to an adverse supply shock is to address the inflation spike rather than the growth slump. If the shock absorbers are efficient, in the sense that prices across the board can be lowered easily and that lower inflationary expectations can be quickly translated into lower wage and price demands "for example, through short-duration and flexible contracts" monetary contraction will help to speed up the adjustment and recovery process.

In the meantime, the impact of the initial shock on the fiscal situation is ambiguous. On the revenue side, slower growth and a higher inflation rate may have no impact on tax collection, since nominal GDP growth, which is the tax base, may remain more or less constant. On the other hand, if public expenditure is sensitive to slower growth and higher unemployment "for example, through a broad-based unemployment insurance scheme" the deficit may widen. However, this is itself an important shock absorber because it helps to mitigate the impact of rising unemployment on, particularly, lower-income households.

The external implications of this process, in a situation in which the shock emanates from global prices, are mainly by way of a widening current account deficit, which in turn, causes the currency to depreciate, other things remaining the same. The depreciation itself is a shock absorber because it can help to narrow the deficit by reducing imports and increasing exports. However, the adjustment may well take a while; in the meantime, the deficit will widen and the currency will continue to depreciate. If capital flows are brought into the equation, the picture becomes rather complicated, but one plausible consequence is that, just as guaranteed currency appreciation makes a country more attractive to foreign investors, the likelihood of depreciation makes it less so.

This reinforces the already significant impact of slowing growth and rising inflation on capital movements, speeding up outflows.

There are two shock absorbers available to the economy to deal with the external consequences. One is foreign exchange reserves, large enough to tide things over until the recovery is visibly under way. The other is the exchange rate itself. The faster it adjusts to the current account deficit, the quicker will be the adjustment in the current account itself. In fact, by intensifying the upward pressure on imported commodities, which are the originators of the shock, depreciation will speed up the adjustments in domestic consumption that are necessarily a part of the adjustment process.

Finally, we need to consider the role of financial markets, which can also serve as shock absorbers in at least two ways. One, closely integrated and efficient markets amplify signals from the policymakers or elsewhere, facilitating the process of price adjustment, which, as described above, is critical to the recovery process. There isn't much point in the policymakers doing anything if consumers and investors receive confusing signals from the markets that they transact in. Two, they give people opportunities and instruments with which to hedge against the adverse consequences that they might have to deal with as the economy goes through the adjustment and recovery process.

How does the Indian situation stack up against this textbook model? One, the outcomes that are currently visible do conform to the pattern that the model implies and should not, in and of themselves come as a surprise. Two, the recovery of the Indian economy over the coming months will depend on the capacity and efficiency of the various shock absorbers. A quick assessment indicates that it does reasonably well on some, but raises concerns about others. The concerns are mainly on account of forced price rigidities, such as on fuels, which impede the entire adjustment process, first by muting the impact of the shock and then by aggravating both fiscal and current account pressures.

Finally, the problems the economy is having in absorbing the current shocks provide a clear indication of the priorities for macroeconomic policy reform. Strengthening non-existent, weak and distorted markets is the over-arching theme. Ultimately, flexible prices, whether of oil or the currency, with adequate opportunities to hedge against risks of wide movements, are the best shock absorbers. All adjustments to macroeconomic shocks are painful; however, some can be less painful than others.

The writer is Chief Economist, Standard & Poor's Asia-Pacific. The views are personal