Subir Gokarn: Beyond the crisis

The after-effects of actions taken to deal with the crisis might themselves hinder recovery

Subir Gokarn | New Delhi August 24, 2009 Last Updated at 00:12 IST

While policy responses were instrumental in arresting the decline, they now have to be re-oriented to nurture the recovery, says *Subir Gokarn*

I have spent the past few days meeting with people from the financial sectors and business media across a number of cities in Asia, talking about prospects for recovery in the region. The last time I did this was in November 2008, when the likely severity of the problem was just sinking in and the predominant concern everywhere was how bad it would be and how long it would last. Nine months later, those two concerns have made way for others.

Signs of the bottom having been reached and things beginning to stabilise, even recover, are increasing by the day and that the worst is over is now accepted by virtually everyone. But, even as this is happening, there is an acute consciousness of the drastic actions taken by central banks and governments across the region to deal with the crisis and the apprehension that the after-effects of these might themselves hinder or even de-rail the recovery. Against this backdrop, the first concern is whether the early signs of recovery are, in fact, a false dawn. As governments begin to retract, will the recovery have enough steam to continue unaided?

The fact that the US economy showed a sharp turnaround in the second quarter (still declining but at a far slower rate) was taken by many as a vindication of the monetary-fiscal one-two punch that was delivered there. The Chinese and Indian recoveries, similarly, are being broadly interpreted as a consequence of strong policy responses. The Chinese fiscal stimulus package announced in November, in particular, is seen as playing a stellar role in that economy's sustained positive growth and recent acceleration. Based on these instances, the role of fiscal expansion appears critical and, quite naturally, leads to the question: What happens when governments run out of room to do what they have done until now?

This is a legitimate concern. Quite clearly, the sustainability of the recovery depends on the ability of the private sector to revive quickly and significantly enough to take on the load as the government withdraws. However, during the past week, an interesting twist was provided to this issue by the release of second-quarter GDP data from Germany and France.

Both these governments decided not to go down the fiscal stimulus road, focussing instead on shoring up their debilitated financial sectors. Both showed a second quarter turnaround comparable to the US. This obviously raises the question: Did the fiscal stimulus matter at all? Or, was the key factor in the stabilisation a restoration in confidence in the financial system and its capacity to continue to channel funds into real economic activity?

The debate will go on, but the contrast between the two situations has important policy implications. If, in fact, restoration of confidence as well as financial sector capacity is the key factor, governments that have gone out on a limb with their stimulus packages can begin withdrawing them without the fear that the recovery will collapse. In fact, the sharp rise in interest rates across the Asian economies in response to enhanced government borrowing requirements may itself hinder a revival in private borrowing and, consequently, spending. The positive message from the European evidence is that if confidence and willingness to spend and invest have returned to the private sector, a gradual scaling down of public spending may do more good than harm.

A related, but broader, question is about the possibility of a double-dip or W-shaped recovery. One cause of this could be the excessive dependence of the recovery on fiscal stimulus, but that is not the only one. Another shock to the global financial system could trigger off a downward spiral similar to the one we saw in late 2008. Significantly, if this were to happen, it is quite obvious that the capacity of governments and central banks to respond to it is now severely limited, in contrast to 2008.

Initial conditions clearly matter and the fact is that both central banks and governments were in a position to respond strongly to the conditions of late 2008. They have now largely exhausted their ammunition. Even if a new shock does not actually strike, this lack of capacity to respond could, in and of itself, undermine that all-important confidence factor and, consequently, constrain a revival in private spending. Admittedly, this is a threat for which there is no automatic mitigation. Governments have to walk a fine line between restoring the capacity to respond to another shock by consolidating their fiscal positions, while being careful not to trigger off a second dip merely by doing this.

A third issue that has repeatedly come up, also in the general context of "exit" strategies is the ability of central banks to maintain their current stance. Inflation is hardly a concern at the moment, but the apparent speed of the turnaround in Asia is raising questions about stresses on capacity and the potential inflationary consequences. This is a relatively easy concern to assuage. Given the build-up of global capacity in most sectors during the pre-recession boom, the recovery is hardly expected to stretch it. With the GDP of most of the world's major economies set to decline in 2009, a modest turnaround in 2010, which is the likely outcome, will not take GDP levels back to the benchmarks of 2007 and 2008. Therefore, capacity constraints are not likely to exert inflationary pressures.

However, recent tendencies in commodity prices are a different story. Elevated levels of global liquidity are apparently contributing to this and this puts central banks in a position similar to governments as far as exit or unwinding is concerned. If inflationary pressures driven by commodity prices consolidate, monetary policy stances may have to change even though private spending has not adequately recovered. Further, if fiscal withdrawal and the reining in of liquidity are not synchronised, interest rates could surge, possibly disrupting private spending even more.

Overall, though, as significant as these issues are, the fact that they are in the spotlight is itself a welcome sign. These are, essentially, questions of consolidating, reinforcing and sustaining what is now being almost unanimously seen as a recovery. They underscore the fact that, just as governments and central banks played a critical role in stemming the decline, they now have an equally important role in managing the recovery.

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