Smoothening the exit

Managing the recovery is likely to be a far more serious challenge than arresting the decline

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Managing the recovery is likely to be a far more serious challenge than arresting the decline, says *SUBIR GOKARN*

Globally, the policy focus has shifted from dealing with the crisis to finding ways to withdraw from the huge monetary and fiscal commitments made in the process. This is reassuring in some ways and worrisome in others. On the positive side, it reflects the widening perception that the worst of the crisis is behind us and that the many steps taken by governments and central banks did contribute significantly to arresting the decline and inducing stabilisation and recovery.

On the negative side, though it is generally accepted that the combined policy responses worked, the ability to distinguish between things that worked and things that didn't isn't quite at hand yet. Without this, disengagement by governments comes with the risk of doing the wrong thing at the wrong time, thereby nipping the still tentative recovery in the bud.

The emerging debate on exit strategies figured prominently in the recent G-20 Finance Ministers' meeting, which was a prelude to the Heads of Governments meeting to be held later this month. One aspect of it arose in the wake of recent GDP growth numbers from Germany and France. Both these economies, though still in negative year-on-year growth territory, showed a strong improvement during the April-June quarter. The US economy also showed similar tendencies, but the key difference between the two situations is that the US had implemented a rather large fiscal stimulus package earlier in the year, while Germany and France focused much more sharply on repairing their financial systems, with relatively modest fiscal programmes.

One could argue that the bulk of the US stimulus is yet to kick in and that its stabilisation is also the consequence of steps taken to stabilise and restore confidence in the financial system. By that logic, financial restoration will provide a firm foundation for the fiscal measures to boost growth sharply as they kick in. The European economies will benefit from the first part but not the second. That, of course, remains to be seen. The contrast may help to provide some confidence to governments that they can begin rolling back their fiscal commitments without jeopardising the recovery. But, how many would be willing to take that chance at least in the immediate future?

A second dimension of the exit issue is the expected turn in the monetary cycle. Central banks around the world responded very strongly to the crisis, using both conventional and unconventional means. The latter, by enlarging the range of securities that they were willing to buy through open market operations, allowed them to pump liquidity into the financial system while providing support to prices. It is logical that the sequence of exit will begin by rolling back these steps, but given the somewhat unexpected speed of the turnaround, there is a view emerging that the cycle needs to turn on conventional measures as well.

If the recovery does gain momentum, the overhang of liquidity will induce inflationary pressures at some point, by when it may be rather late in the day for a change in stance. Anticipating this and moving to a credible anti-inflationary stance ahead of it is a key challenge. In some countries, speculation on rate hikes by the end of 2009 has already begun, even as growth remains in negative territory.

The dilemma is intensified by the fact that government borrowing requirements are already putting pressure on interest rates. This is not so much of a problem in countries whose government securities have global currency but it can be a threat in economies where governments are predominantly domestic borrowers. Rising interest rates are, in effect, already posing risks to the sustainability of the recovery in these countries even as concerns about a liquidity-induced upturn in inflationary expectations arise. A premature shift to an anti-inflationary stance could exacerbate those risks.

A third aspect of the exit debate relates to global integration. The dynamics of the crisis have demonstrated that integration helps to transmit shocks very quickly across the world. Given this, a faulty exit strategy on the part of governments of the world's larger economies could easily spill over into smaller economies, swamping the efforts of their governments to deal with the slowdown. Every country, therefore, has a stake in the sequencing and magnitude of the strategies of the large economies.

In this context, the commitment by the G-20 to enhance the resources of the International Monetary Fund (IMF) is significant. The impact of global exit on smaller economies could manifest in a return of recessionary tendencies as well as balance of payments (BoP) problems, which have generally not been a significant feature of the crisis so far. IMF programmes have conventionally been oriented to dealing with BoP crises. In the current scenario, the larger resource base may have to be deployed with much more flexibility to help particularly the smaller economies to deal with the potentially recessionary impact of exit — a kind of global macroeconomic safety net. Some operating guidelines for such a programme need to be quickly developed.

Against this backdrop, minimising the risks that exit poses for the sustainability of the global recovery will involve four elements: sequencing, magnitude, co-ordination and monitoring. Sequencing and magnitude involve the consideration of impact lags. Measures that will impact actual spending with the longest lag should be first in the sequence, provided that they affect expectations in the desired way.

Co-ordination needs to take place at both domestic and global levels. Treasuries/finance ministries and central banks in individual countries need to act in concert to get the sequencing and magnitude of their particular exit strategies right. Global co-ordination of policy actions is too much to ask for but a forum like the G-20 should at least provide the means to talk about sequencing and magnitude proposals and their likely spillovers to other countries.

Monitoring is a key element of a successful exit. The sustainability of the recovery depends on various demand components — private consumption, investment and exports — rising to take the place of rolled-back government spending. Tracking the performance of these components and, to the extent possible, calibrating the magnitude of the rollback to this will improve the prospects of sustaining the momentum.

Of course, a lot of this is easier said than done. In hindsight, dealing with the crisis was easy. Everything and the kitchen sink could be thrown at it and something was bound to work. Managing the exit is going to be a lot more difficult.

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