Duvvuri Subbarao: US recession anxiety and the eurozone sovereign debt crisis

Intervention by Dr Duvvuri Subbarao, Governor of the Reserve Bank of India, at the International Monetary Fund Meeting, Washington DC, 23 September 2011.

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1. The messages that we heard are sharp, specific and candid. If I were asked to pick the headline message of the presentation, it is that we are rapidly running out of time, and may therefore be running out of solutions.

2. The two big flashpoints are: renewed anxiety in the US about recession, and the deepening of the sovereign debt crisis in the Euro area. Each is by itself a big risk, but the bigger risk is that both could materialize simultaneously, and interact with each other with adverse feedback loops manifested through trade, finance and confidence channels.

Political gridlock

3. The problems are well known, and the solutions are on the table. The main impediment to an effective resolution common to both flashpoints appears to be political.

- In the US, the central issue is managing the tension between fiscal stimulus in the immediate term, and credible fiscal consolidation over the medium to long term.
- In the Euro area, there is a shared monetary framework, but without a shared fiscal framework. What is standing in the way of a credible and confidence inspiring resolution of the fiscal-financial imbroglio are political compulsions.

Decoupling

4. Let me look at the global situation from the perspective of the EMEs. Before 2008, it was intellectually fashionable to talk of "decoupling" – that EMDCs will continue to be resilient even if there is a downturn in advanced economies, because of improved macroeconomic policies, robust foreign exchange reserves and resilient financial flows. In an age of globalization, the decoupling theory was never persuasive. The 2008 crisis dented its credibility and the 2011 crisis has completely demolished it.

Channel of contagion to EMEs

5. EMEs have been affected by both crises. Their macroeconomic stability, price stability and financial stability are jeopardized by the global crisis through several channels.

- First, there is the trade channel. With growth stalled in the advanced economies, external demand is slowing and affecting the exports of EMEs.
- The second channel of transmission is capital flows. The crisis is permeating to EMEs through risk aversion and deleveraging to produce volatility in capital flows and in financial markets. This is impacting financing conditions, with feedback to economic activity.
- The third channel through which shocks are being transmitted is commodity prices. Spikes of volatility in the already elevated levels of commodity prices are stoking inflationary pressures in some of the EMEs and complicating macroeconomic management in the face of slowing growth. Among the drivers of commodity prices is accommodative monetary policy in advanced economies. Abundant liquidity is

adding pressures to commodity prices. The negative outlook on growth should have driven down prices, but that has not been evident so far to any significant extent.

- Fourth, macro-financial loops could come into play as another channel of transmission of shocks. Rising credit risks due to deterioration in asset quality could impair the capital of banks or even render it insufficient. This could trigger a cascade of deleveraging with attendant real economy consequences.
- By far, the most important channel of transmission is the confidence channel which could hurt investment and growth prospects in EMEs – when confidence is hit, even strong fundamentals do not matter.

6. The probability that all these channels become active and feed on each other is quite high. The impact on an EME depends on its objective conditions and on which channels become most active in its case. Thus, the crisis could affect different EMEs differently. But what is common across EMEs is that their growth momentum will be interrupted if the current global problems are not resolved quickly.

Market signals

7. In trying to reach a solution, it is important to recognize what the markets are signaling, even though, admittedly the basis of some of these market engendered fears may not be objective. Let me illustrate with a metaphor from physics. It is well known that Einstein could not reconcile to the probabilistic nature of quantum mechanics all through his life. He famously said: “God does not play dice.” Less well known perhaps is the retort of his friend and mentor Niels Bohr who said: “Albert, stop telling God what he can or cannot do.” Similarly, it is possibly the case that all market signals are not objective. But as policy makers, we cannot presume to tell the market how to behave. We have to take market signals as given. The policy decisions that we take will be more effective if they are seen to be endorsed by markets.

2008 and 2011

8. To understand the situation today, let us throw back to the global crisis of 2008. Then too, we faced similar extreme siege conditions of the global financial system, and the challenge of responding immediately and decisively to the crisis within the boundaries of democratic processes. We managed that challenge. The G-20’s leadership and the all-out efforts mounted by the IMF and other multilateral institutions to do what it takes to pull back the global economy from the brink of collapse and set it on a path of recovery were applauded across the world.

9. There are important differences between the 2008 crisis and today’s situation.

i. In 2008, when the world got into a crisis, there was a lot of policy force. In the years before the crisis, the world enjoyed the so called “Great Moderation” with steady growth in advanced economies and accelerated growth in the emerging economies, and low inflation all around. So we could attack the crisis with the full fire power of monetary and fiscal stimulus. Sadly, the policy space for stimulus is much less today.

ii. In 2008, the world responded to the crisis in coordination. Sure there were differences, but these differences were resolved, and governments and central banks acted firmly, decisively and where required creatively. A similar perception of coordination is lacking today.

iii. In 2008, both advanced economies and EMDCs were at the same phase of the business cycle. Today, they are at different phases of the business cycle.

iv. In 2008, the crisis originated in the financial sector and transmitted to the real sector, but the rescue was by the public sector. In 2011, it is the other way round. The crisis is originating in the public sector and hitting the financial sector, and undermining the confidence of the private sector.

10. Let me now conclude. There is a great deal of anxiety around the world about the outcome of this weekend's Fund-Bank annual meetings and the G-20 meetings. There are strong expectations that we will converge on a plan of action that will reverse the crisis of confidence. We once again have to show the resolve that we did in 2008 to meet those expectations.