

**ALOK SHEEL** lists various ways in which the Great Moderation called out for changes in macroeconomic policy. But, central banks were too focused on inflation to see the red flags go up

# Lessons and red herrings



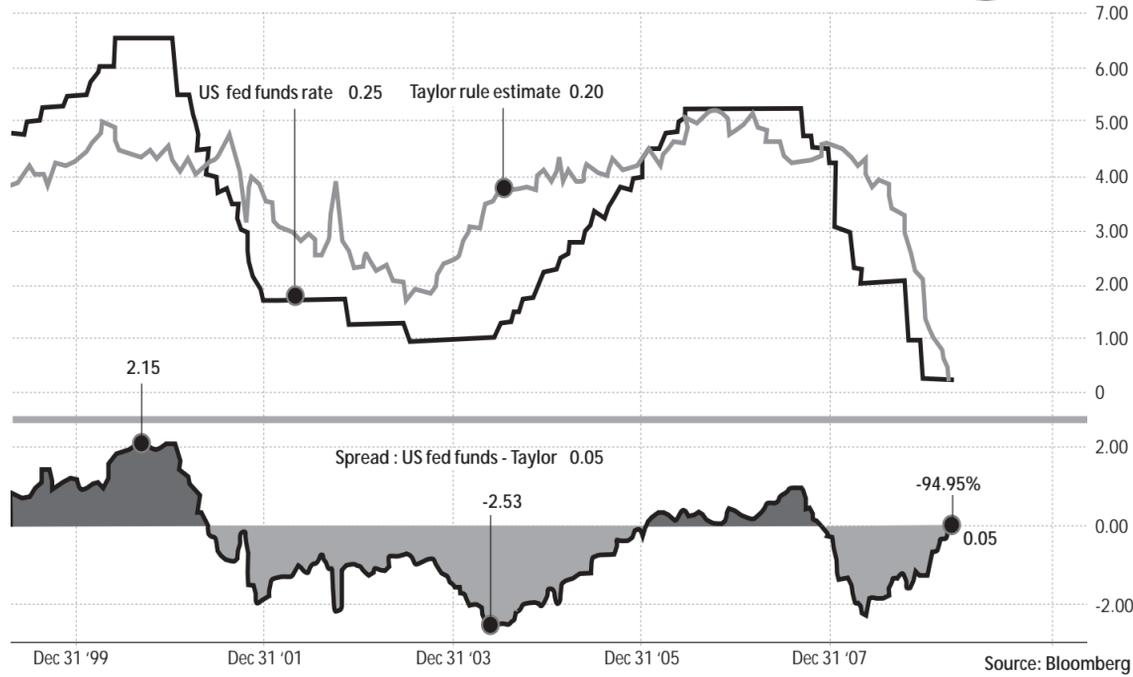
The 'Great Moderation' preceding the current crisis turned out to be simply the proverbial calm before the storm. It seems odd, even appalling, that economists, policy makers and multilateral surveillance bodies like the IMF should not have seen the storm coming, especially since the calm was associated with several macro-economic anomalies.

The dotcom boom and burst had shown, even prior to the housing boom, that asset prices were widely out of sync with consumer prices that remained remarkably stable. The latter were not responding as expected to rising liquidity, and even to rising input prices. The link between growth and employment was weakening. Mounting trade and budget deficits were not translating into inflation, higher interest rates and currency depreciation as expected. The need for bailout of hedge funds such as Long Term Capital Management was a pointer to the build up of systemically critical risk and leverage outside the regulated financial system.

The Great Moderation was therefore an indication that rapid, multi-layered global integration was redefining acknowledged relationships and challenging established economic paradigms. Since macroeconomic policy did not adjust to changing winds, is it surprising that it found itself trapped in the approaching 'perfect storm' that is now widely believed to be the greatest threat to the international economy since the Great Depression of the 1930s?

The US sub-prime housing crisis was by consensus the proximate trigger of this perfect storm, whose ultimate genesis is attributed to a complex interplay of several factors such as global imbalances, monetary policy, regulatory failure, financial innovation and globalisation. It is perhaps time to separate grain from chaff, or causes from distractive red herrings, if we are to put in place new structures to prevent similar crises in future.

The 'new mercantilism', where hard currency acquisition through exports is targeted as the conscious objective of national policy just as



gold was a few centuries ago, no doubt has harmful consequences, including to other emerging market economies for which they create enormous competitive disadvantages. However, there have been global imbalances in the past, as the marginal propensity of countries to save and consume varies according to cultural preferences and their phase of development. The proximate problem was consequently the failure to manage the fallout of the imbalances. The failure was both monetary and regulatory.

Global imbalances led to excessive liquidity that drove down long-term interest rates, particularly in the US. This encouraged excessive risk taking to increase returns. This should have raised regulatory red flags but did not. Why?

Most central banks have over the years moved away from targeting monetary aggregates to targeting inflation. The red flag did go up, in the form of asset price inflation, but central banks were not looking in that direction.

This was because the conventional measure of inflation is consumer prices, which were remarkably stable on account of rapid globalisation. Excess liquidity was re-directed towards non-tradable assets, particularly the housing sector, which witnessed an unprecedented boom. Alan Greenspan, once the doyen amongst central bankers, was of the view that central banks could not detect asset price bubbles and therefore were ill advised to prick them. They could only clean up the mess afterwards. It so turned out that the mess was too big

for the Fed to clean up. There was, consequently, a failure of inflation targeting on the part of central banks.

As Adam Smith observed long ago, a house generates no income of its own, and has to be ultimately paid out of current income earned in the real economy. When a huge gap opens up between income growth in the real economy and the financial sector, central banks need to take note. The problem is not that inflation targeting is ineffectual but that the measurement of inflation needs to change. The Taylor equation needs to be tweaked to accommodate asset price inflation.

Practically every financial crisis has been preceded by runaway credit creation. Recognising this, circuit breakers and liquidity buffers have

evolved over the years, but these proved both too pro-cyclical (as risks typically decline during booms) and too micro-regulatory (addressing only risks relating to individual lending institutions). We need to get back to basics by treating the financial system as a handmaiden of the real economy and should not allow it to run amuck through excessive leveraging.

Subprime lending was risky, but lenders were able to take the associated risks off their balance sheets through the securitisation route. The moral hazard inherent in this 'originate and distribute' model is that lending standards can become lax since associated risks could be passed on. Securitisation, however, has long been an article of belief in the financial sector, with a trade-off between return and risk. And the solution does not lie in banning complex innovative products, but in ensuring that risky investments are conservatively leveraged with adequate equity buffers to cover losses, and in optimising trading mechanisms to make such products liquid through standardisation and centralised, mandatory market clearing mechanisms.

Since globalisation amplified the crisis through monetary and regulatory arbitrage and through cross border trade and investment linkages, it too has come in for blame and flak. But it is globalisation that lies behind surges in productivity and unparalleled igrowth.

One of the lessons of the current crisis is that growing trade and investment linkages are fast blunting time-tested macro-economic policy tools as fiscal, monetary and financial policies now need to be co-ordinated across countries to be effective. Yet the institutional framework for such global governance lags far behind economic reality. It would however be impossible to design such institutions without an inclusive global financial architecture of all systemically important economies through a radical reform of the Bretton Woods institutions. Only then can the subject of a global regulator, necessary to prevent monetary and regulatory arbitrage, and a mechanism for dealing with failed cross-border institutions, be conceivable, as this involves ceding sovereign space. Until this happens, we can at best think in terms of national monitoring and implementation of globally agreed regulatory principles that is currently engaging the attention of the G 20.

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## OVERVIEW

- ▶ The IMF forecast that the world economy would shrink by 1.3% in 2009, the first global fall in 60 years. In January the fund predicted growth of 0.5%.
- ▶ Japan's customs-based exports fell by 45.6% in the year to March. The rate of decline slowed, raising hopes that the export slump may be bottoming out. Imports fell by only 36.7% on a year earlier, which caused Japan's monthly trade surplus to shrink to 10.9 billion yen (\$112m) last month from 1.1 trillion yen in March last year.
- ▶ Producer prices in Germany fell by 0.5% in the year to March, the first fall since February 2004. However, the ZEW index of German investor and analyst expectations, a widely used measure of investor confidence, rose to 13 in April from -3.5 a month earlier.
- ▶ Britain's annual consumer-price inflation rate fell to 2.9% in March from 3.2% in February.
- ▶ Sweden's central bank cut its benchmark interest rate by half a percentage point, to 0.5%. India's Reserve Bank reduced the repurchase rate to 4.75%, and shaved a quarter of a percentage point off the reverse repurchase rate, to 3.25%. It was the sixth cut in as many months.

### The Economist commodity-price index

	2000=100		% change on	
	Apr 14th	Apr 21st*	one month	one year
<b>Dollar index</b>				
All items	170.0	166.9	+3.3	-36.8
Food	191.5	189.6	+0.4	-28.1
<b>Industrials</b>				
All	142.1	137.7	+8.8	-48.0
Nfat*	121.9	118.2	+6.7	-38.3
Metals	153.2	148.3	+9.8	-51.3
<b>Sterling index</b>				
All items	173.0	173.1	+4.0	-13.8
<b>Euro index</b>				
All items	118.6	119.1	+7.8	-22.1
<b>Gold</b>				
\$ per oz	888.65	882.15	-4.5	-4.0
<b>West Texas Intermediate</b>				
\$ per barrel	49.47	46.95	-12.3	-60.6

\*Provisional \*Non-food agricultural

### Output, prices and jobs

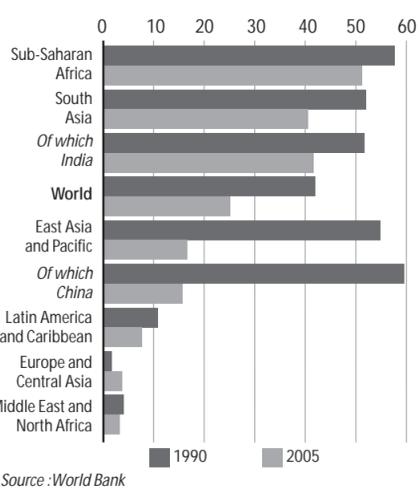
% change on year ago

Country	Gross domestic product				Industrial production latest	Consumer prices			Unemployment rate <sup>2</sup> , %
	latest	qtr*	2009 <sup>†</sup>	2010 <sup>†</sup>		latest	year ago	2009 <sup>†</sup>	
United States	-0.8 Q4	-6.3	-2.7	+1.4	-12.8 Mar	-0.4 Mar	+4.0	-0.8	8.5 Mar
Japan	-4.3 Q4	-12.1	-6.5	+0.4	-38.4 Feb	-0.1 Feb	+1.0	-1.0	4.4 Feb
China	+6.1 Q1	na	+6.0	+7.0	+8.3 Mar	-1.2 Mar	+8.3	-0.8	9.0 2008
Britain	-2.0 Q4	-5.9	-3.5	+0.3	-12.5 Feb	+2.9 Mar <sup>§</sup>	+2.5	+1.2	6.7 Feb <sup>††</sup>
Canada	-0.7 Q4	-3.4	-1.9	+1.6	-7.8 Jan	+1.2 Mar	+1.4	+0.6	8.0 Mar
Euro area	-1.5 Q4	-6.2	-3.4	+0.2	-18.4 Feb	+0.6 Mar	+3.6	+0.4	8.5 Feb
Austria	+0.5 Q4	-0.8	-2.0	+0.3	-6.5 Jan	+0.8 Mar	+3.5	+0.6	4.5 Feb
Belgium	-0.8 Q4	-6.5	-2.7	+0.3	-17.9 Jan	+0.6 Mar	+4.4	+0.7	11.2 Feb <sup>†††</sup>
France	-1.1 Q4	-4.4	-2.7	+0.3	-15.5 Feb	+0.3 Mar	+3.2	+0.3	8.6 Feb
Germany	-1.7 Q4	-8.2	-4.3	+0.3	-20.3 Feb	+0.5 Mar	+3.1	+0.3	8.1 Mar
Greece	+2.4 Q4	+1.2	-3.4	-0.4	-4.6 Feb	+1.3 Mar	+4.4	+0.9	9.4 Jan
Italy	-2.9 Q4	-7.5	-3.7	+0.1	-20.7 Feb	+1.2 Mar	+3.3	+0.8	6.9 Q4
Netherlands	-0.6 Q4	-3.8	-2.7	+0.5	-12.7 Feb	+2.0 Mar	+2.2	+0.9	4.1 Mar <sup>††</sup>
Spain	-0.7 Q4	-3.8	-3.1	-0.5	-23.9 Feb	-0.1 Mar	+4.5	+0.3	15.5 Feb
Czech Republic	+0.7 Q4	-3.7	-3.0	+1.2	-23.4 Feb	+2.3 Mar	+7.1	+1.8	7.7 Mar
Denmark	-3.7 Q4	-7.3	-3.1	+0.5	-11.3 Feb <sup>††††</sup>	+1.8 Mar	+3.1	+1.1	2.5 Feb
Hungary	+2.0 Q4	-3.9	-3.0	+0.4	-25.4 Feb	+2.9 Mar	+6.7	+2.9	9.1 Feb <sup>††</sup>
Norway	+0.8 Q4	+5.6	-1.2	+0.5	-5.1 Feb	+2.5 Mar	+3.2	+1.7	3.1 Jan <sup>†††</sup>
Poland	+2.9 Q4	na	+0.7	+2.2	-14.3 Feb	+3.6 Mar	+4.1	+3.0	10.9 Feb <sup>†††</sup>
Russia	+1.2 Q4	na	-3.0	+2.0	-13.7 Mar	+14.0 Mar	+13.3	+13.5	11.9 Mar <sup>†††</sup>
Sweden	-4.9 Q4	-9.3	-3.6	+0.7	-22.9 Feb	+0.2 Mar	+3.4	-0.1	8.3 Mar <sup>†††</sup>
Switzerland	-0.1 Q4	-1.2	-2.3	+0.1	-6.0 Q4	-0.4 Mar	+2.6	-0.2	3.3 Mar
Turkey	-6.2 Q4	na	-2.0	+1.5	-23.7 Feb	+7.9 Mar	+9.2	+7.8	12.3 Q4 <sup>†††</sup>
Australia	+0.3 Q4	-2.1	-0.8	+1.6	-0.7 Q4	+2.5 Q1	+4.2	+2.1	5.7 Mar
Hong Kong	-2.5 Q4	-7.8	-5.9	-0.3	-10.3 Q4	+0.8 Feb	+6.3	+0.9	5.2 Mar <sup>†††</sup>
India	+5.3 Q4	na	+5.0	+6.4	-1.2 Feb	+9.6 Feb	+5.5	+5.9	6.8 2008
Indonesia	+5.2 Q4	na	+1.3	+0.6	-2.4 Feb	+7.9 Mar	+6.3	+3.9	8.4 Aug
Malaysia	+0.1 Q4	na	-0.3	+1.1	-14.6 Feb	+3.5 Mar	+2.8	-0.7	3.0 Q4
Pakistan	+5.8 2008 <sup>†††</sup>	na	+1.2	+3.2	-8.9 Jan	+19.1 Mar	+14.1	+10.1	5.6 2007
Singapore	-11.5 Q1	-19.7	-7.5	+1.9	-22.4 Feb	+1.6 Mar	+6.7	+0.9	2.6 Q4
South Korea	-3.4 Q4	-20.8	-5.9	+0.3	-10.3 Feb	+3.9 Mar	+3.9	+0.1	3.7 Mar
Taiwan	-8.4 Q4	na	-6.5	+0.1	-27.1 Feb	-0.1 Mar	+3.9	-1.0	5.7 Mar
Thailand	-4.3 Q4	-22.2	-4.4	+1.4	-19.8 Feb	-0.2 Mar	+5.3	-1.2	2.4 Jan
Argentina	+4.9 Q4	-1.2	-2.8	+1.5	-14.0 Feb	+6.3 Mar	+8.8	+6.4	7.3 Q4 <sup>†††</sup>
Brazil	+1.3 Q4	-13.6	-1.5	+2.7	-17.0 Feb	+5.6 Mar	+4.7	+4.4	8.5 Feb <sup>†††</sup>
Chile	+0.2 Q4	-8.3	-0.5	+2.4	-11.5 Feb	+5.0 Mar	+8.5	+3.0	8.5 Feb <sup>††††</sup>
Colombia	-0.7 Q4	-4.1	-1.0	+1.5	-12.8 Feb	+6.1 Mar	+5.9	+5.0	12.5 Feb <sup>†††</sup>
Mexico	-1.6 Q4	-10.3	-4.4	+1.2	-13.2 Feb	+6.0 Mar	+4.3	+5.0	5.3 Feb <sup>†††</sup>
Venezuela	+3.2 Q4	na	-5.0	-5.4	-25.4 Dec	+28.6 Mar	+29.1	+30.1	6.3 Q4 <sup>†††</sup>
Egypt	+5.9 Q3	na	+3.8	+3.9	+7.3 Q3	+12.1 Mar	+14.4	+8.1	8.8 Q4 <sup>†††</sup>
Israel	+1.2 Q4	-0.5	+0.4	+2.6	-4.1 Jan	+3.6 Mar	+3.7	+1.8	6.3 Q4
Saudi Arabia	+4.2 2008	na	+0.4	+3.3	na	+6.0 Mar	+8.3	+4.3	na
South Africa	+1.0 Q4	-1.8	-0.8	+3.1	+8.6 Feb	+8.6 Feb	+9.8	+6.0	21.9 Dec <sup>†††</sup>

\*% change on previous quarter, annual rate. †The Economist poll or Economist Intelligence Unit estimate/forecast. ‡National definitions. §RPI inflation -0.4 in March. \*\*Year ending June. ††Latest 3 months. ††† Not seasonally adjusted. †††† Centred 3-month average. ††††† New series Sources: National statistics offices and central banks; Thomson Datastream; Reuters; Centre for Monitoring Indian Economy; OECD; ECB

### Poverty

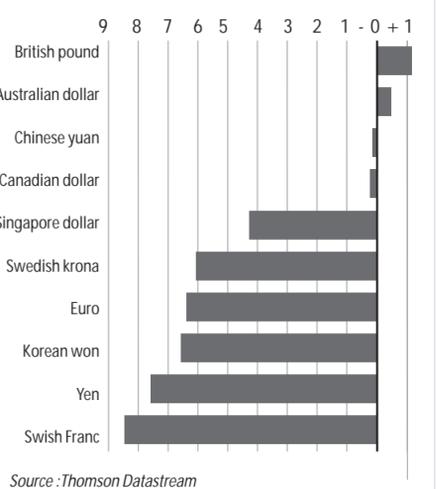
People living on less than \$1.25 a day, % of total



Just over a quarter of the world population, or 1.4 billion people, lived in extreme poverty in 2005, according to the World Bank. That compares with 42% in 1990, when the bank first published its global poverty estimates. Rapid economic growth has led to a dramatic decline in poverty in China, where the share of people below the threshold of \$1.25 a day fell from 60.2% to 15.9% between 1990 and 2005. But the poverty rate fell much more slowly in India, to 41.6% in 2005 from 51.3% in 1990. South Asia has the most very poor people of any region in the world. But the fraction of the population that lives in extreme poverty is highest, at 50.9%, in sub-Saharan Africa, though it has fallen there from 57.6% in 1990.

### Exchange rates against the dollar

% change, December 31st 2008-April 22nd 2009



Most major currencies have weakened against the dollar since the end of last year. Comparing currencies on April 22nd, the biggest loser has been the Swiss franc, which has fallen by 8.4% this year. This was in part because of the intervention of the Swiss central bank in currency markets on March 12th to push the franc's value down. But the euro, the Korean won and the Swedish krona have also weakened by more than 6% against the dollar, and the yen has fallen by 7.6%. The Australian dollar, the Canadian dollar and Chinese yuan were almost steady. This year has been kinder to the pound than to other major currencies: it has risen by 1.1% against the dollar—but only after collapsing in 2008.