IMF on Growth and Systemic Risks

The IMF's World Economic Report[i] is interesting reading not only because of the downward revisions to its forecasts but also because the special reports on contagion in crises and volatile capital flows give a good indication on the Fund's agenda in the wake of the global financial crisis. The IMF now expects global output growth to slow for a second year to a meager 2.9% in 2013. Much of the downward revision to the output is occurring in the emerging economies and reflecting the painfully slow and belated recovery in demand from high-income developed countries. Moreover, the Fund warns that a combination of slower potential growth and lingering debt and leverage overhangs are likely to weigh on growth prospects for many years to come. Their outlook calls for an uptick to 3.6% in 2014, principally on the hopes for a better showing by the US and Europe. The prospect of lower potential growth in particular raises the question of how ambitious should central banks be in creating monetary stimulus if the constraints on growth are not conducive to monetary stimulus. With few other options in the toolbox, it seems highly likely that central banks will be called upon to pull rabbits from hats for many years.

Crises tend to promulgate new measures to fix whatever caused the meltdown. We can find some hints of where the IMF is headed in the findings of the special report on the causes of the extraordinary co-movement in output across countries during the Global Financial Crisis (GFC). Nearly all economies collapsed in tandem which actually is not the norm. In the words of the IMF, the correlations across countries was 'off the charts' compared with previous economic contractions, in part because the trigger was a global bank (Lehmans) with far-reaching counter parties and in part the large US economy contracted the most. Still, there remained some unexplained cause that has been attributed to widespread 'panic' or loss of confidence as people were pummeled with scary media reports. Unmentioned in the report is the fact that the ultimate cause was a huge fraud in US housing finance that meant a lot of fixed income investors would lose their principal and many investment banks held an unknown amount of worthless assets in the form of unsold structured products.

Moreover, countries with strong financial linkages were more likely to have their economies dragged down into recession than those that are less dependent on global banks and capital markets for their financing. Not surprisingly, those who dodged the bullet tended to be creditor nations with sovereign wealth funds or strong national pension funds that filled the gap. Other than the direct financial link, which dominated as a source of contagion, the IMF found evidence that trade linkages between countries tended to spread the recession, which has become more obvious this year as commodity producers finally are falling prey to weak global demand. At the outset of the GFC, though, the trade link usually hits emerging countries hard because trade finance is the first thing to dry up. To mitigate this dearth of liquidity, the Fed immediately extended USD swap agreements to many of the larger emerging countries including Brazil, South Korea, Taiwan and others that would otherwise have faced a

massive shortage of dollars. Those countries with access to dollars including oil producing countries and China fared much better and many even continued to grow. An oversimplified version of these findings is that banking crises transform recessions into depressions that are much harder to escape. That adage has become more acute with the globalization of financial markets and investment banks. These findings then are "consistent with the idea that financial linkages, while facilitating efficient capital allocation during normal times, also transmit large financial shocks across borders during crisis times.

Apparently there is something in the nature of global banking that lays the groundwork for subsequent crises. Whether that flaw is rooted in incentives to take leverage off the balance sheet or hide it in structured products or simply facilitates excessive capital flows that end up as asset price bubbles, the IMF concludes that systemically important financial institutions will need more and better oversight and transparency, not to mention more capital. No specifics are given but nearly every major central bank is working on a scheme to deal with big bank failures through some expeditious resolution mechanism that would allow the bank to keep essential functions open while severing the bad parts and containing its counter party risks. If this sounds complicated, it is which is why no amount of bank regulation or oversight will preclude future crises. There also is a push to find ways to contain asset price bubbles so that systemic risk does build up during normal times. To deal with that dragon, Western central banks will need to rethink their slavish reliance on a single policy tool - interest rates. Asset price bubbles are not necessarily associated with general price inflation or output gaps in Western economies, so their central banks will need new policy tools and tighter regulatory controls that cast a wider net around off-balance sheet activity. In a strange twist of fate, the People's Bank of China had success in pricking its property bubble during the 2000s using targeted non market measures and now needs to add market-based interest rates and open capital markets to its toolbox to staunch the wasteful abuse of cheap credit in normal times, while the Western central banks are trying to come to grips with their dangerous side effects when things go bad. Ironically, one of the institutional policy adaptations in the wake of the GFC may be a convergence in central bank practices around some new norm less Western and more nuanced. Whatever policy changes come to pass, they are unlikely to end the cycle of financial booms and busts anytime soon, so investors should always carry a defensive position or hedge to protect against a future meltdown in security prices with the size of that position contingent on their assessment of how soon the next crisis might occur.

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[i] IMF World Economic Outlook (WEO) - Transitions and Tensions, October 2013 Global growth is in low gear, and the drivers of activity are changing. These dynamics raise new policy challenges. Advanced economies are growing again but must continue financial sector repair, pursue fiscal consolidation, and spur job growth. Emerging market economies face the dual challenges of slowing growth and tighter global financial conditions. This issue of the World Economic Outlook examines the potential spillovers from

these transitions and the appropriate policy responses. Chapter 3 explores how output comovements are influenced by policy and financial shocks, growth surprises, and other linkages. Chapter 4 assesses why certain emerging market economies were able to avoid the classical boom-and-bust cycle in the face of volatile capital flows during the global financial crisis.

http://www.imf.org/external/pubs/ft/weo/2013/02/index.htm

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