

Gloom is better than panic

Political stalemate is a cause for long-term gloom, while incompetence is reason enough for short-term panic



HUGH SANDEMAN

“Political inflexibility and an apparent lack of will”: it is hard to argue with finance minister Mukherjee’s verdict at the IMF meeting on the rout in economic policymaking in the US and Europe. Even assuming the Eurozone restructures Greece and the single currency, panic will be replaced at best by prolonged stagnation. As Mukherjee said recently to his fellow BRIC finance ministers, “Both fiscal and monetary policy tools seem to be exhausted”.

Financial panic induced both of the market crashes of the past three years, but in each case panic obscured a cyclical adjustment that was already underway. The economic cycle in the US began to turn in late 2006 – 18 months before the destructive power of modern financial dealings was fully revealed. In August this year, when new data confirmed the failure of the US and then the European economies to respond to the post-crash stimulus, stock markets were immediately (and quite rationally) re-priced for lower growth.

That effect was compounded, though, by the fiscal implications of lower growth, which meant that the governments of industrial countries now had more debt than they could comfortably service at low or zero growth rates. And they all suffer a similar political stalemate, that prevents both necessary reductions in long-term spending commitments, and equally necessary postponement of immediate spending cuts, leaving no obvious way out. This is certainly a cause for long-term gloom. However, it has been the incompetence of Eurozone leaders in responding to the impact of these events on Greece, Spain and Italy, and on European banks too, that has provided reason enough for short-term panic.

The distinction between long-term gloom and short-term panic may seem a bit academic in Europe at the moment, but it matters for India. The stampede in the past two months for what investors conventionally think of as low risk assets has drained capital from the emerging world, and temporarily reversed the long-term tendency for currencies like the rupee to appreciate. Investors have piled back into the very government bonds whose safety has just been put in question by the collapse of growth prospects in the West.

As soon as the worst of the panic is over – there is a limit to how long even the Eurozone

can drag this drama out – investors will wake up to the illogicality of recent moves in the market. Faced with the long-term gloom of slow GDP and earnings growth in the US, Europe and Japan, and with historically low yields on government bonds, investors will once again start looking for faster growth and higher yields. In time, the contrast between the pessimistic outlook of industrial countries and relatively faster growth in Asia will revive capital flows into India.

It is because there is reasonable certainty of high growth in India for the medium term, that foreign investors can afford for the moment to overlook the fact that public spending in India, too, is not fully under control. The IMF’s *World Economic Outlook*, published for the Washington meeting in late September, grumbles that “among G20 economies, the structural deficit is large in India”, and estimates the deficit for 2011 at about 8 per cent of GDP, significantly higher than in any other BRIC economy. This is roughly twice the level that the UPA government hoped for in its last budget.

One consequence of the overshoot in public spending is that Indian fiscal policy has made no contribution to reducing demand and, hence, inflation over the period since March 2009, when the RBI decided it was time to end emergency support to the economy following the financial crash. Finance minister Mukherjee made this point at the IMF meeting, when he said that RBI tightening has addressed the huge fiscal expansion caused by the stimulus packages. It certainly has, but the excessive reliance on monetary policy, in the absence of counter-cyclical fiscal management, has been painful for Indian business, with rising interest rates and limited liquidity for the past 18 months.

There is an echo here of the policy dilemma in the US, where fiscal management is paralysed and the central bank is burdened with unrealistic expectations of what monetary policy and manipulating the Fed’s balance sheet can achieve. The fiscal problem in India will be easier to fix, because continued growth means the country can more easily afford political delays to reforms like reducing subsidies. And next year could bring huge improvements in tax efficiency with the overhaul of direct and indirect taxes. ♦

The author is
managing director,
Langham Capital.
He can be reached at
hugh.sandeman@
langhamcap.com