

Growth now, need for austerity next

The latest G20 communiqué prescribes falling back on fiscal policy to hasten the global economic recovery

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It is not only India that has had a disastrous fourth quarter in calendar year 2012. All major advanced economies – the United States, the United Kingdom, Japan and the larger euro zone, including Germany, Italy, Spain and France – have registered negative growth. Moreover, the peripheral economies of the euro zone have been in steep recession for some time. And the strong recovery in emerging markets seems to be stalling. It is, therefore, a little surprising that the communiqué of G20 finance ministers and central bank governors issued from Moscow on February 16 should rather complacently talk about a reduction in near-term tail risks, and focus more on medium- to long-term challenges.

It is possible that the G20 finance ministers took a deliberate decision not to spook markets. However, the markets can also be spooked if they feel that policy makers are not on top of the situation. It is, therefore, likely that too much has been read into the increase in asset prices and the reduction in sovereign borrowing spreads in the euro zone periphery.

Indeed, if we consider the Dow Jones Industrial Average (DJIA) as a proxy for the financial markets, it has been improving almost continuously since it reached its nadir following the collapse of Lehman Brothers. The DJIA is now pushing 14,000 — the peak during the Great Moderation, prior to the global financial crisis. Trading volumes, however, are much lower compared to the Great Moderation, and the buoyancy is not account of the increase in the exposure of the financial markets to the real economy, but of policy actions by central banks.

These policy actions have repeatedly injected record levels of liquidity that has fed asset prices but with little impact on the real economy, since normal transmission channels of monetary policy remain dysfunctional on account of continued deleveraging by households and banks. US personal savings, which hovered between 1.5 and 2.5 per cent of the domestic personal income in 2005-2007, were still at a high 4.7 per cent in the fourth quarter of 2012. The abnormally large deposits that banks have parked with the US Federal Reserve since 2008 – a measure of risk aversion by banks on the one



Russian Finance Minister Anton Siluanov (centre) rises to leave after a family photo during a meeting of G20 finance ministers and central bank governors in Moscow on February 16 (RBI Governor D Subbarao can be seen top left). Russia's initiative to seek technical advice from international organisations on dealing with the public debt overhang is being seen as timely

hand and a lack of demand on the other – remain at their crisis highs. Central banks now seem to be fuelling the kind of asset price inflation that is attributed to shadow banks in the run-up to the global financial crisis. The most recent rally since November 2012 is not a response to current growth trends but on the expectation that central banks will continue to keep their taps open in response to the dismal fourth quarter growth numbers.

It may be recalled that the boom in asset prices during the lead up to the global financial crisis was accompanied

by an economic boom — not because rising wages were increasing demand but because financial innovation and weak regulation translated the asset boom into a consumption boom through the wealth effect and leverage. Central banks in advanced countries are now waiting for this wealth effect to kick in to lift economic growth. The G20 has given *carte blanche* to central banks although the fourth quarter figures indicate that this is still not happening, and despite cross-border policy spillovers (“currency wars”). So, what needs to be

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done if Godot does not turn up?

The G20 communiqué perhaps has the right prescription for growth: fall back on fiscal policy, despite the dramatic increase in fiscal deficits and public debt. The tension between the need for austerity over the medium term and the need for growth over the short term is reflected in the latest communiqué, as it indeed has been ever since the fourth G20 summit at Toronto in June 2010. The Russian presidency's initiative to seek technical advice from international organisations on dealing with the alarming overhang of public debt is timely. The case for Keynesian stimulus in a situation of weak private demand, low inflation, tight sovereign borrowing

spreads and dysfunctional monetary policy is also impeccable. The recovery has been the most robust, relatively speaking, in the US and China, the two countries that have had the most aggressive and sustained fiscal stimulus. The International Monetary Fund has also recently revised potential fiscal multipliers for advanced economies.

But fiscal multipliers do not seem to have attained their potential, since fiscal policy seems to be hamstrung by Ricardian equivalence (the US) and premature austerity (Europe). The recovery has been tepid and unsustainable since the rebalancing from public demand to private is not taking place. A Japan-like situation is developing, in which a dose of fiscal stimulus lifts the gross domestic product slightly for a while (the most recent spurt in Japanese growth was in the wake of the post-Tsunami stimulus), then falls back again, even as public debt continues to rise alarmingly. Japan at least has a huge domestic demand for government bonds, supplemented on the margin by the original quantitative easing factory — the Bank of Japan. US government bonds are dependent on both external demand and the US Fed.

The recent G20 focus on infrastructure investment – that the Indian prime minister has underscored in all recent G20 summits – as a mechanism for reviving growth and creating jobs appears to be spot on, although it is perhaps too sanguine about private investment taking the lead. A change in the fiscal mix in advanced countries from consumption to investment could create the kind of demand that crowds in private investment, and increase fiscal multipliers by countering Ricardian equivalence, as jobs are created directly, giving the sense of permanent increase in income and generating the confidence to spend.

The G20 has come a long way from viewing infrastructure investment as a developing country issue to be handled in their Development Working Group, to recognition of the role it can play in reviving growth and creating jobs in developed countries by shifting it to their flagship Framework Working Group. The nitty-gritty is still to be fleshed out, even as G20 commissions yet another study on the subject by international organisations.

The author is a civil servant. These views are personal