

IT'S A LONG ROAD FROM KEYNES TO CANNES

The process of recovery from the recession originating in the financial sector has been long and painful, and G20 leaders may have to coordinate another rescue at their upcoming Cannes Summit

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The co-ordinated macro-economic policy response of the G20 is widely credited with having saved the global economy from a second Great Depression. Considering that this was no ordinary cyclical recession, the almost V-shaped recovery was certainly impressive, even if tepid, especially if we keep in mind what Rogoff and Reinhart, and also the IMF, had to say about the long and painful trajectory of recovery from recessions originating in the financial and real estate sectors in the past.

In its recent World Economic Outlook of September 2011, appropriately entitled, *Slowing Growth, Growing Risks*, the IMF has however painted a grim picture of the current state of the global economy and financial system. These have once again entered a dangerous phase, recalling the pre-Lehman Brothers scenario. Not only is global growth weakening significantly, but financial markets, that had never quite recovered since the crisis of 2008-09, have become even more risk-averse, widely anticipating a default of Greek sovereign debt and contagion spreading to sovereigns, and banks that hold their debt, that are too big to bail out. At the upcoming Summit at Cannes, therefore, G20 leaders are expected to co-ordinate another global rescue, perhaps even another round of short-term stimulus, while ensuring that long-term consolidation remains on track.

The current situation therefore raises the overwhelming question as to whether the G20 declared victory too early, and indeed whether the widely acclaimed co-ordinated policy response, with its focus on aggressive short-term fiscal and monetary stimulus, was appropriate.

We need to address the question as to why this V-shaped recovery was tepid in advanced countries, and why the output loss has still not been made good fully. The recovery has all along been based on extraordinary macro-economic life support, and haunted by fears of a second dip recession.

The fact of the matter is that even as the attention of the G20 turned from short-term macroeconomic management to long-term external demand rebalancing and fiscal consolidation, the rebalancing of internal demand from the public sector to the private, which alone can make recovery sustainable, never took place. This is continuing to strain the balance sheets of both sovereigns and central banks in advanced countries. The current situation, therefore, is not entirely attributable to the euro zone crisis.

The western recovery stands in sharp contrast to the relatively robust recovery, at least till very recently, in emerging market economies (EMEs), which used the same macroeconomic policy tools to stimulate their economies. The differential output response to the same set of policies is remarkable and needs to be explained, especially since policy transmission channels in EMEs are believed to be weaker.

The likely explanation underlying this differential response is that the two recessions were structurally different — a balance sheet recession in the west, with its growth model based on leveraged consumption riding asset booms broken, leading to a permanent decline in disposable incomes; and a cyclical downturn in EMEs on ac-



Masked activists in Paris protest against tax havens, which they blame for countries' current financial difficulties

count of a temporary crash in external demand. In hindsight at least, it appears that the co-ordinated policy response should have been calibrated to accommodate this basic difference: short-term macroeconomic stimulus in EMEs, and adjustment in advanced economies. This adjustment to repair growth drivers could well have entailed some fiscal expansion — but to repair household balance sheets to rebuild consumer confidence rather than simply trying to substitute for the decline in private demand by shifting leverage from the private to the public sector.

Short-term macroeconomic policies can stimulate the economy back to growth only when the decline in private demand is cyclical. It cannot do so where there has been a permanent loss in income. Tepid growth can of course be ensured through public expenditure, but fiscal multipliers are notoriously weak, and tend to decline over time. If stimulus is sustained over an extended period, the resultant rise in public debt would need to be brought down subsequently by the robust growth that usually follows deep recessions.

One would have thought that policy makers had learnt the right lessons from the oil price shock of the seventies, which administered a lasting negative shock to final disposable income in oil importing countries. However, besotted with the new-found macroeconomic policy flexibility, enabled by the emergence of fiat money (as the world had recently gone off the gold standard) and inspired by the Keynesian revolution in economic thought, western economies tried to stimulate their way out of the prob-

lem. The result was stagflation, until Paul Volcker came along and forced painful adjustment on America by raising — rather than lowering — interest rates.

Extended macroeconomic stimulus has now damaged sovereign balance sheets to the point that they are being forced to adjust by markets losing confidence in the ability of policy makers to repair them through prudent (non-inflationary) means. This has made internal rebalancing even more challenging according to the “rational expectations” school of thought. The underlying fear is that the medium- to long-term growth prospects of advanced economies, particularly those in Europe, are nowhere near as good as they were in the post-war period, when they were not only young, but growing even younger, riding on the post-war baby boom.

Be that as it may, there is widespread scepticism about the ability of these economies to grow their way out of high levels of debt as they had done in the post-war period. Consumers and investors may therefore be pricing in future tax increases or inflation in their calculus and therefore becoming even more risk-averse through “Ricardian Equivalence”.

The intellectual battle lines at Cannes would therefore be drawn between those subscribing to Keynes, and those subscribing to rational market expectations, or Hayek in short. Where the market has already started imposing penalties, there may be little choice. However, countries with reserve currencies that attract safe haven flows still have a choice. The Nobel Committee, at least, has made it clear on which side it stands by awarding this year's Nobel Prize in economics to Thomas Sargent, a doyen of the rational expectations school.

The writer is a civil servant. The views are personal

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