

Political Economy of Debt Accumulation and Fiscal Adjustment in a Financial Crisis

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1. Introduction

The recent 2008-09 global financial crisis that turned into an economic crisis, affected mainly advanced economies that witnessed significant jumps in their respective public debts. The link between financial crises and build-up of public debt has been studied exhaustively, most recently, among others, by Reinhart and Rogoff (2010a, 2010b) using a historical cross-country time series of emerging and advanced economies. They establish “a strong link between banking crises and sovereign default” (page 1, 2010b).

A sequential and interacting process appears to be triggered, most times, by a catalyst of excessive domestic bank credit and external borrowing that lead to private debt surges and, with governments also borrowing heavily during these periods, precipitate domestic banking crises. They also found that banking crises in financial centres have led to banking crises elsewhere.

A banking crisis, in combination with rapidly rising public borrowing, leads to a sovereign debt crisis. Just as attention is focused on reining in public debt, hidden public debt at subnational levels or elsewhere in the public sector gets identified and added to the already known and quantified public debt. With sudden scaling up of public debt, the share of short term public debt tends to rise expectedly to bridge pending payments and meet other immediate needs. Further, this tendency, fueled by such excessive demand, leads towards hyper-inflation.²

Reinhart and Rogoff rightly caution that a domestic debt crisis appears when overall economic conditions are far worse than when there is an external default. Since external creditors are not largely involved, the domestic debt crisis tends to go unnoticed. Instead, it gets embedded in the evolving banking crisis.

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² They define an 'inflation crisis' as above 20 percent for the US; internationally, in the post Second World War period, 40 percent as a 'freely falling episode'; and hyper-inflation as above 500 percent.

The authors assert that countries suffer from a severe opacity syndrome of “this time is different”...“The old rules of valuation no longer apply. The current boom, unlike previous booms that preceded catastrophic collapses...is built on sound fundamentals, structural reforms, technological innovation, and good policy” (pp. 9-10). This is the most difficult part of their postulate to accept. If, as they say, over 200 years, a debt crisis and financial crisis have moved *pari passu* with each other, then it is difficult to comprehend their short sightedness premise.

The fundamentals begin to crack well ahead of a collapse with indicators on consumer credit and public debt adequately revealing impending danger. More likely, therefore, it is the fear or unwillingness to take corrective measures even when a debt crisis has already appeared on the horizon and just before it has turned into a financial crisis. Indeed, even when the financial crisis is in full view and on the verge of turning into an economic crisis, advanced economy governments suffer a helplessness in continuing to cajole financial sector mandarins to provision the sector, pay tax, or demonstrate willingness to give them time to pay taxes, rather than taking decisive action.³

Two elements are at play. First, the government financial heads are often from the private financial sector on secondment to the public sector, for example in the US and, second, during the short lived span of financial sector excesses, it also contributes a high portion of corporate income tax revenue, for example, 40 percent in the UK immediately before the recent 2008-09 crisis. It therefore becomes challenging to take corrective action on oneself so to speak, in the presence of an embedded self-interest. Hence it is not an opacity; rather, it is a mixture of deep unwillingness, and even strategic position taking perhaps, that vitiate possibilities of charting the right course needed for economic revival. At the other extreme, in emerging economies such as India, caution takes the form of excessive regulation if not control, a system that opts for financial sector stability over benefitting from the potential salutary effects of financial sector liberalization on long term economic growth.

As in previous such experiences, the recent global experience has made apparent that the buildup of unsustainable public and private debt was the outcome of excessive public and private consumption mainly in advanced economies, that comprised unsustainable government subsidies to the household sector and ‘ninja’—no income, no job, no asset—housing loans made by the multi-layered financial sector to unqualified borrowers under the rubric, ‘financial innovation’. The same economies that routinely prescribed austerity for profligate emerging economies in the IMF’s Executive Board (for Latin America in the 1980’s and East Asia in the 1990’s) as is amply evident from the Board’s proceedings, prescribed for themselves heterodox

³ Soon, of course, the sector pays little tax once it begins to show losses, a situation that may continue for many years before outcomes turn to taxable profits.

policies, renamed 'fiscal stimulus' packages, for recovering from the 2008-09 crisis. Emerging economies made a severe error in going along with such policies. For example, there is no proof that India needed a fiscal stimulus during this period that basically undid the conservative fiscal stance that had been successful between 2004-08, generating, by global standards, record high real tax revenue growth and containment of public debt. Reversals from expansionary policies internationally have appeared only since 2010 after further macroeconomic deterioration in advanced economies and the realization that heterodox policies cannot lead an economy out of deep breaches in economic fundamentals. Thus, the reversal was inevitable since it failed finally to escape the judgment of global rating agencies.

The solution to the present economic crisis led by sovereign European debt is austerity through strong IMF surveillance and programs and a reversal of further pumping in of consumption in these economies. No amount of quantitative easing is likely at this stage to ramp up the low level money multiplier, and no extent of fiscal relaxation will convince productive sectors to pick up on economic growth. In this light, in what follows, essentially using secondary information, the paper charts the course of public debt growth in advanced economies, attempts to demonstrate the spillover of the debt crisis into financial markets, and examines the nature of measures taken by the concerned central banks.⁴

2. Public debt in advanced economies

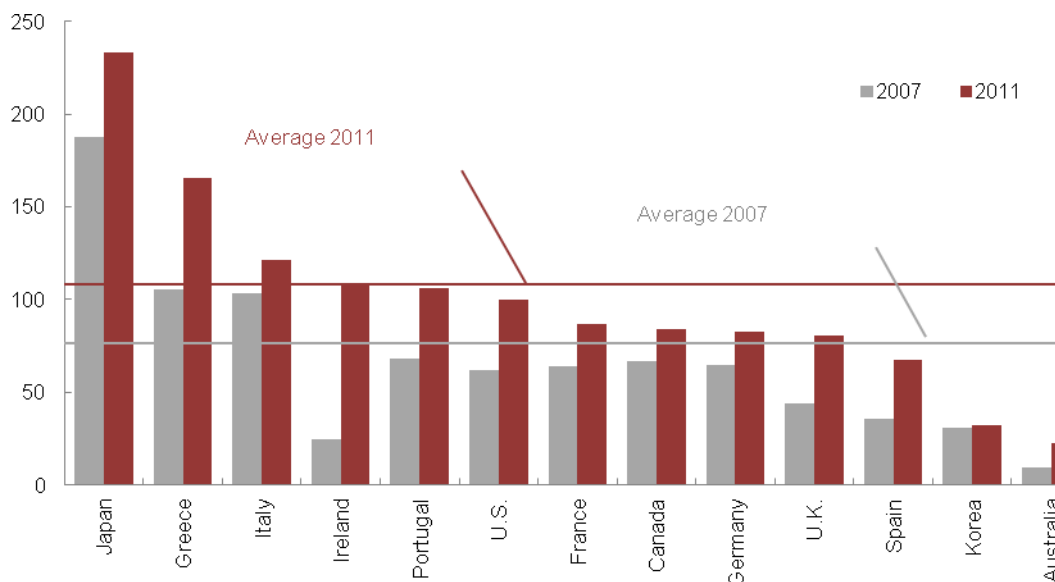
The global financial crisis of 2007-08 resulted in sharp deterioration in the public finances of advanced economies. Significant decline in government revenues, recapitalization of banks, purchase of debt and equity in distressed financial institutions and large stimulus packages to revive the economies led to substantial increases in public debt in Europe and the US⁵. In the US, government revenue as a percent of GDP declined from 33.9 percent in 2007 to 31.2 percent in 2009, while government expenditure as a percent of GDP increased from 36.7 percent to 44.05 percent in the same period (WEO 2011). Fragile recovery and increasing expenditure on healthcare and pensions in advanced economies compounded the debt problem. Diagram 1 shows that public debt as a percent of GDP in advanced economies increased from 76 percent in 2007 to 108 percent in 2011. In the US and Japan, public debt as a percent GDP increased by 38 percent and 45 percent respectively. European economies abandoned their Maastricht criteria, which required members not to exceed a budget deficit ceiling of 3% of GDP and a debt ceiling of 60 percent of GDP. In the Euro area, the debt/GDP

⁴ This author has attempted to take a similar overall view in recent writings, emphasizing the need for adhering to a cautious approach for achieving a chastened level of economic growth, while pointing towards lingering inconsistencies in the ongoing dialogue and debate. The Annexure is for reference.

⁵ Cecchetti et al. (2010)

ratio increased from 68 percent to 87 percent between 2006 and 2011 (WEO 2011). The debt explosion not only occurred in peripheral economies of Europe but also in fiscal conservatives, Germany and France.

Diagram 1: Selected Advanced Economies: General Government Gross Debt



Source: *Fiscal Monitor (2011)*

Note: Weighted averages based on 2009 purchasing power parity GDP.

It would not be too exaggerated to take the view that this debt build-up proved disastrous for European economies. Using historical data of advanced economies, Reinhart and Rogoff (2010a) show that “(countries) observations with debt to GDP over 90 percent have median growth roughly 1 percent lower than the lower debt burden groups and mean levels of growth almost 4 percent lower”⁶. Thus, many European economies are not only struggling with low or negative growth, but also a debt crisis, as distressed sovereign bonds have spilled out to overload and stress out the financial sector. It is fallacious to insist that further expansion, hence further debt accumulation, is needed to recover these economies.⁷

⁶ The above 90 percent debt/GDP observations come mainly from Belgium, Greece, Italy and Japan, among twenty advanced countries between 1946-2009.

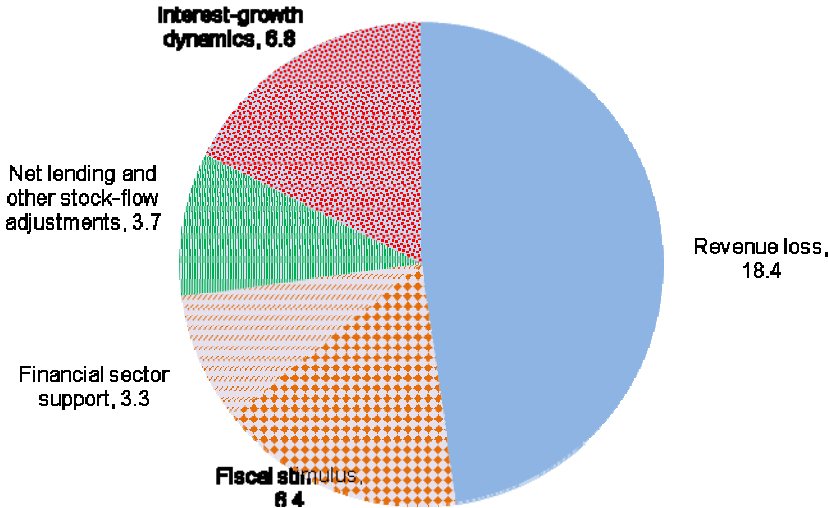
⁷ The argument that, unless this happens, even emerging markets such as India would suffer because of loss of export markets, lacks lustre. First, domestic demand has prevailed in many emerging economies; second, such economies should aggressively seek new markets within emerging economies; and, third, their own excessive demands may need to be contained in light of global economic and environmental challenges. Seen in such a long-run perspective, the argument of export dependence lacks conviction. After all, the G20 has included a ‘green’ recovery among its focus areas.

IMF projections for increase in government debt in advanced economies show that the primary reason for accumulation of public debt is revenue loss. According to the Fiscal Monitor (2011), ‘two-thirds of the projected debt surge is explained by revenue weaknesses associated with the recession and the direct effect on the debt ratio of the fall in GDP’ (Diagram 2). However, what is not clear is how much of this revenue loss is due to the failures and losses of the financial sector and, despite future expansionary policies, whether and when the financial sector will start making revenue contributions again. In other words, the relationship between GDP pick-up through expansionary stance of governments, and revenue growth, may suffer from a ‘ratchet effect’ and be only distantly linked at this point.

Slowdown in GDP is shown to have led to an unfavourable interest-growth dynamics during the period, in spite of falling interest rates. “Higher interest rates imply higher interest payments to service government debt, so adversely influencing debt dynamics, whereas higher nominal GDP growth will tend to lower the debt-to-GDP ratio by increasing the denominator” (Turner and Spinelli, 2011). Diagram 2 shows that in advanced G20 economies, a projected 6.8 percentage points are attributed to the interest-growth dynamics within the overall 38.6 percent debt/GDP increase. But the contention remains that the numerator can also be reduced more rapidly in order to get the ratio down.

Diagram 2: G-20 Advanced Economies: Increase in General Government Debt, 2008–15
(Percentage points of GDP) September 2011

(Total increase: 38.6 percentage points of GDP)



Source: Fiscal Monitor (2011)

Note: Weighted average based on 2009 purchasing power parity-GDP.

Diagram 2 also shows that financial support and fiscal stimulus are set to account for 3.3 percent and 6.4 percent respectively in the projected debt accumulation. First, as a countercyclical measure, the US, for example, enacted its Economic Recovery and Reinvestment Act in 2009. The \$787 billion stimulus package included tax relief for individuals and businesses, supporting individuals in need of purchasing goods and services, and providing funds to states and localities for Medicaid, education, and transportation projects (CBO 2011). Second, to stabilize the financial system, crisis countries provided support to banks and insurance companies. Cumulative financial support in advanced economies as percent of GDP since the beginning of the crisis accumulated to \$1722 billion on a gross basis, the latest data ending between December 2010 and July 2011 (Table 1). As a percent of GDP, direct financial support constituted 6.8 percent of GDP.

In absolute terms, the financial support provided in the US has been largest (though, in percentage terms, it is 5.1 percent of GDP). The Troubled Asset Relief Program (TARP) comprised a significant part of this. TARP was introduced in 2008. Originally, it was set at \$700 billion though, in the Dodd–Frank Wall Street Reform and Consumer Protection Act, it was reduced to \$475 billion. The transactions covered under TARP fell into four categories: capital purchases and other support for financial institutions, financial assistance to the automotive industry, investment partnerships designed to increase liquidity in securitization markets, and mortgage programs (CBO, March 2011). Government disbursed \$414 billion⁸ of TARP, of which more than 50 percent has already been repaid.⁹

Table 1: Selected Advanced Economies: Financial Sector Support
(Percentage of 2011 GDP unless otherwise indicated)¹

	Direct support	Recovery	Net direct support
Belgium	5.7	0.3	5.4
Ireland	40.6	2.6	38.0
Germany	13.2	0.8	12.4
Greece	5.8	0.4	5.4
Netherlands	14.0	8.8	5.1
Spain	3.0	0.9	2.1
United Kingdom	6.7	1.1	5.7
United States	5.1	2.0	3.1
Average	6.8	1.8	4.9
In \$US billions	1,722	452	1,270

⁸ Report on the Troubled Asset Relief Program (December 2011)

⁹ The figure for the US in Table 1 refers to a wider financial sector support than TARP.

Source: *Fiscal Monitor (2011)*

Note: Fiscal outlays of the central government, except for Germany and Belgium, for which financial sector support by subnational governments is also included.

¹ Cumulative since the beginning of the crisis—last data range between end-December-2010 and end-July 2011.

3. Spillover of debt crisis into financial markets

Risk and volatility in global financial markets increased considerably. According to the European Central Bank's (ECB) Financial Stability Review (December 2011), 'the transmission of tensions among sovereigns, across banks, and between the two, intensified to take on systemic crisis proportions not witnessed since the collapse of Lehman Brothers three years ago'. However, the trouble this time is originating from fiscal sustainability concerns in Europe and the US. The sovereign debt crisis which, in turn, was brought on by the global financial crisis, is threatening the stability of the financial system. High debt/GDP ratios and highly leveraged banking financial institutions (Table 2) reveal the vulnerability of advanced economies.

**Table 2: Indebtedness and Leverage in Selected Advanced Economies
(Percent of 2011 GDP, unless noted otherwise)**

	US	Japan	UK	Euro area	France	Germany	Greece	Ireland	Italy	Portugal	Spain
Government Gross Debt, 2007	62	188	44	66	64	65	105	25	104	68	36
Government Gross Debt, 2011 ^a	100	233	81	89	87	83	166	109	121	106	67
Government Net Debt, 2007 ^b	43	81	38	52	60	50	105	11	87	64	27
Government Net Debt, 2011 ^{ab}	73	131	73	69	81	57	n.a.	99	100	102	56
Primary Balance, 2011 ^a	-8	-8.9	-5.6	-1.5	-3.4	0.4	-1.3	-6.8	0.5	-1.9	-4.4
Households Gross Debt ^c	92	77	101	70	61	60	71	123	50	106	87
Households Net Debt ^{cd}	-232	-236	-184	-126	-137	-132	-57	-67	-178	-123	-78
Bank Leverage ^e	12	24	24	26	26	32	17	18	20	17	19
Bank Claims on Public Sector	8	80	9	n.a.	17	23	28	25	32	24	24
Total Economy Gross External Liabilities	151	67	607	169	264	200	202	1,680	140	284	212
Total Economy Net External Liabilities ^f	16	-54	11	13	10	-41	104	98	26	106	88
Government Debt Held Abroad	30	15	19	25	50	41	91	61	51	53	28

^a World Economic Outlook projections for 2011.

^b Net general government debt is calculated as gross debt minus financial assets corresponding to debt instruments.

^c Most recent data divided by annual GDP (projected for 2011).

^d Household net debt is calculated using financial assets and liabilities from a country's flow of funds data.

^e Leverage is defined as the ratio of tangible assets to tangible common equity for domestic banks.

^f Calculated from assets and liabilities reported in a country's international investment position.

Source: IMF Financial Stability Report (September 2011) and World Economic Outlook Database (for 2007)

It is salutary that, despite protests domestically (as may be expected in a life-cycle or inter-generational context), European economies are attempting to follow contractionary fiscal policy i.e. increased taxes and reduced government subsidies in order to reduce the fiscal gap, even though such expenditure measures imply GDP contraction in the immediate run. For example, Ireland and Greece imposed harsh austerity measures that were pre-conditions for receiving emergency loans¹⁰, and the UK's new 2010 government imposed austerity measures on itself. Hence, reducing sovereign debt while rethinking the course of eventual economic recovery has become the new challenge.

It is as if in final realization and acceptance that the present experience is not an ordinary recession that can be resolved with stimuli, but one that has to be conquered and then sustained only with belt-tightening, or that traditional contractionary policies that the IMF has prescribed since its inception may work after all, that is leading these economies to shift course in the right direction. Fiscal deficit and public debt have to be curtailed faster than contracting GDP. The error that was committed was the IMF's movement away from this traditional path since the 2008-09 period towards underscoring heterodox demand policies.

4. Bond yield and credit default swaps (CDS) on sovereign bonds

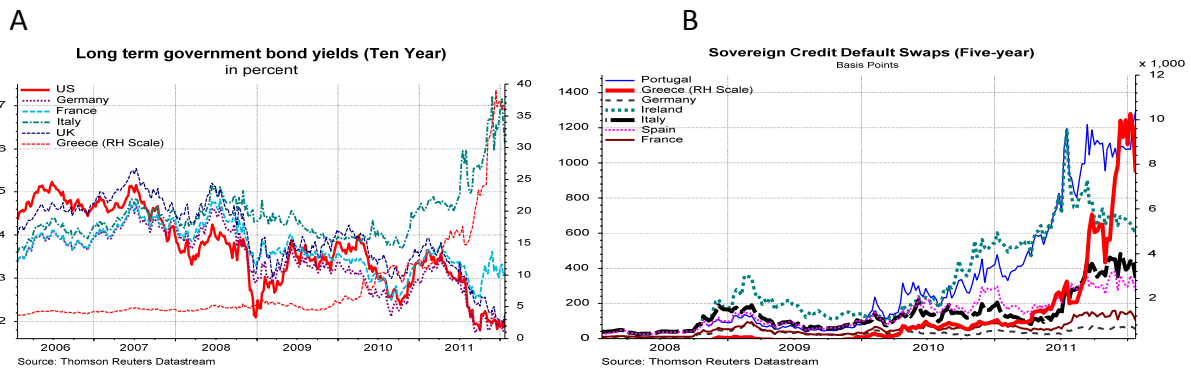
Debt sustainability issues due to increasing yield on government borrowing in several European economies has become a concern for the financial markets. Bond yield of several European economies has increased significantly (Diagram 3A). With increase in risk, investors rushed into safe havens such as gold, US Treasury and German government bonds, pushing their prices to record high levels. Investors poured money into US Treasuries despite its high fiscal deficit/GDP and debt/GDP ratios and economic slowdown. Disagreements between Republicans and Democrats over the method of debt reduction also did not deter investors. Dominance of the dollar as a reserve currency played, and plays, an important role. On German bonds, investors seem to be making each-way bets: if the Euro Zone breaks up, an appreciated Deutschmark will replace the Euro. However, if Germany decides to bail out the Euro Zone, the Euro will rise (Peston, 2011).

The Euro Area Member States (EAMS) created the European Financial Stability Facility (EFSF) in June 2010. Its mandate was to raise funds in capital markets in order to finance loans for those EAMS members that experience difficulty in obtaining financing at sustainable rates. The EFSF is able to issue bonds guaranteed by the EAMS¹¹. Credit rating downgrades of several economies including France have complicated the EFSF rescue plan, as its ability to raise money rapidly at low interest rates is directly linked to credit ratings of member states.

¹⁰ <http://www.nytimes.com/2011/12/30/opinion/keynes-was-right.html>

¹¹ EFSF Newsletter (2011)

Diagram 3



The costs of insurance on several European government bonds have touched a record high (Diagram 3B). In an effort to reduce speculation on sovereign default, the European Parliament voted on November 15, 2011 to ban "naked" credit default swaps (CDS)¹². In order to avoid a credit event, EU leaders insisted on a voluntary "haircut" on Greek bonds in the rescue plan. Insurance firms that sold credit protection on Greece will not be required to pay buyers of the swaps if restructuring of debt involves any voluntary "haircut"¹³. These experiences reveal the scale of difficulties that has to be overcome for past excesses in consumption and credit growth, rather than to be used as an explanation for abandoning suitable containment policies.

5. Banking sector signals continued easing

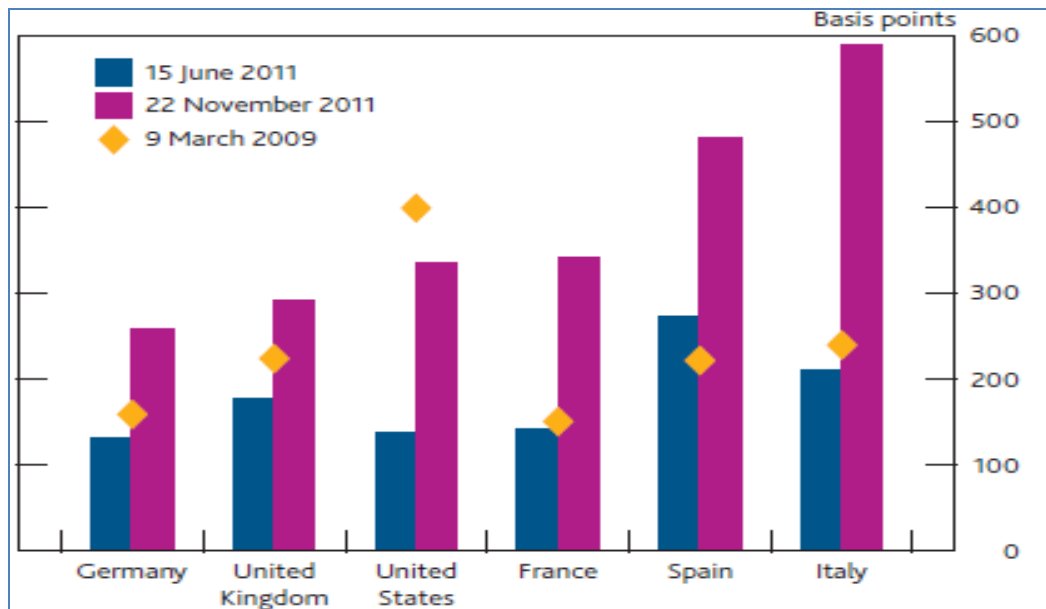
The European banking system is under heightened stress due to large holdings of distressed sovereign bonds. Prospect of large writedowns of sovereign debt to deal with the crisis is keeping the banking sector on tenterhooks. 'In addition to these direct exposures, banks have taken on sovereign risk indirectly by lending to banks that hold risky sovereigns. Banks are also affected by sovereign risks on the liabilities side of their balance sheets: ... implicit government guarantees have eroded (as) the value of government bonds used as collateral has fallen' (GFSR 2011). The cost of default protection on many banks' unsecured bonds has risen sharply. 'In the case of some European banking sectors, CDS premia rose to levels above those reached in late 2008/early 2009 (Diagram 4). CDS premia for several Euro-area banking sectors moved closely with the premia of their respective sovereigns, reflecting in part the importance of banks' domestic sovereign risk exposures' (Bank of England, 2011). The poor financial health of

¹² <http://www.eubusiness.com/news-eu/finance-economy-cds.dij>

¹³ <http://www.forbes.com/sites/steveschaefer/2011/10/27/why-voluntary-haircuts-on-greek-bonds-is-a-pyrrhic-victory/>

European banks has adversely affected their bond sales and, with large redemption of maturing debt expected in 2012, the banking sector is facing a huge funding gap.¹⁴

Diagram 4: CDS premia for selected banking systems



Source: Bank of England (Financial Stability Report, December 2011)

For recapitalization needs, the European Banking Authority (EBA) recommended on December 8, 2011, that banks raise 114.7 billion Euros by June 2012 (EBA 2011). This has narrowed the problem to a region, as most of the capital requirement falls on lenders in Spain, Greece, Italy and Portugal. The banking sector may resort to asset sales or reduce lending to meet their capital requirements; such austerity measures and shrunk capacities to lend are the price that some European economies have to pay to emerge from their present respective crises.

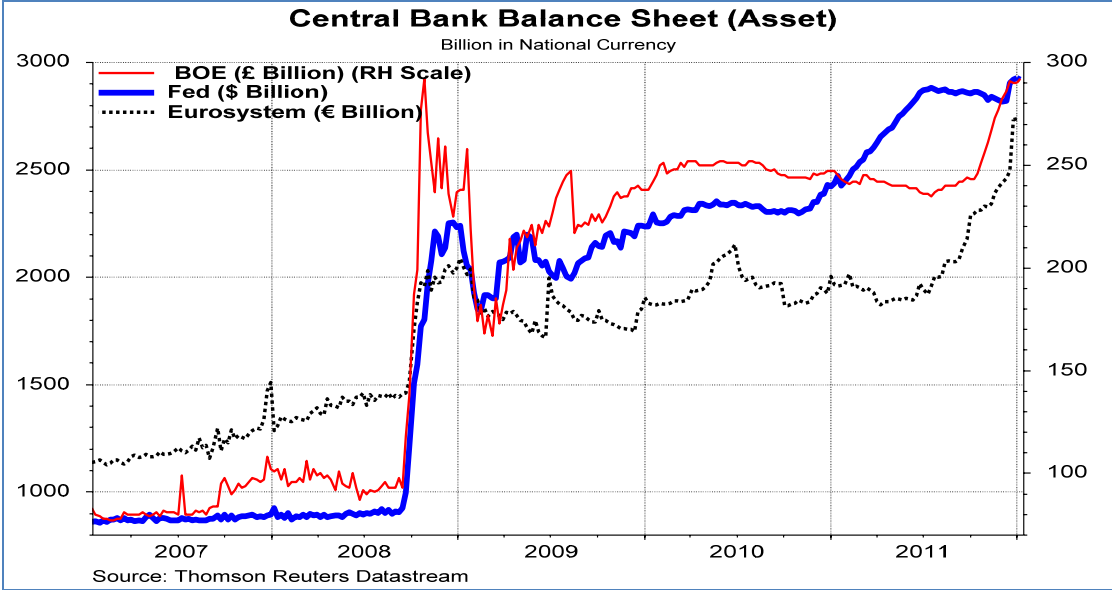
The timing of EBA's recommendation for bank recapitalization has been criticized even though ECB asked national supervisors to ensure that it does not lead to 'unwelcome pro-cyclical deleveraging involving significant constraints on the flow of credit to the real economy'.¹⁵ The challenge before the authorities is reducing financial sector vulnerability without hurting the flow of funds to the real economy too adversely. There is little other course to take except to buttress such action where feasible.

¹⁴ European banks sold bonds worth \$413 billion in 2011, while \$654 billion were due to be returned to investors as debts mature. In 2012, debt worth \$720 is due to mature (Financial Times, 2011).

¹⁵ ECB (2011)

The European Central Bank (ECB) has taken a series of measures to counter such a squeeze in lending. Apart from cuts in policy rates, ECB also offered banks unlimited cash for three years and loosened the collateral criteria by making credit claims such as bank loans (specifically residential mortgages and loans to small and medium businesses) eligible and reducing the rating threshold on asset-backed securities¹⁶. The ensuing rush for ECB's three-year long-term refinancing operation (LTRO) betrays the underlying vulnerability of European banks, while the earlier stigma associated with resort to central bank support seems no longer valid.

Diagram 5



Expansionary monetary policy to deal with the debt crisis has stretched the balance sheets of advanced economy central banks (Diagram 5). Major central banks have expanded their balance sheets to drive down the rate of interest on long-term government bonds (Blommestein & Turner 2011). The US Federal Reserve balance sheet expanded by \$ 505 billion in 2011 because of a significant increase in its holding of U.S. Treasury securities.¹⁷ However, the holding of mortgage-backed securities declined.¹⁸ Eurosystem balance sheet also expanded by € 809 billion, primarily because lending to Euro area credit institutions related to monetary policy operations increased in the same period.¹⁹ The impact of the quantitative easing is also

¹⁶ <http://uk.reuters.com/article/2011/12/08/ecb-liquidity-idUKL5E7N83LQ20111208>

¹⁷ Holding of U.S. Treasury securities increased by \$656 billion between December 29, 2010 and December 28, 2011.

¹⁸ Holding of mortgage securities fell by \$155 billion between December 29, 2010 and December 28, 2011.

¹⁹ Lending to Euro area credit institutions related to monetary policy operations increased by € 350 billion between December 24 2010 and December 30, 2011.

visible on the balance sheet of the Bank of England, which increased by £43 billion reflecting an increase in 'other asset holding'.²⁰

These expansionary monetary policies may be better than further fiscal stimuli. If systemically they remain unabsorbed, the signal for correction should reveal itself with continuing low money multipliers. In contrast, fiscal expansion could drive up interest rates and exacerbate inflation. Ultimately it will be fiscal prudence and economic realism that belt tightening is imperative that will convince rating agencies, and will have to be depended upon for successful recovery, albeit at a lowered, sustainable growth path.

6. Conclusion

Historical evidence is ample that global financial crises have their genesis in excessive spending by households and governments. The build-up in private debt reflects not only high demand but also easy availability of loans for consumer spending spearheaded by the financial sector. Investors are led to believe that returns from banking and financial stocks are high and invest heavily in financial stocks. High returns to the financial sector often result in disproportionate remuneration and returns to financial sector managers and employees. At this stage, this sector also contributes a good portion of corporate sector tax revenue in a global environment where garnering revenue from the corporate sector has become increasingly difficult for tax administrations reflecting uncontrolled company practices. The revenue contribution by the financial sector thus develops into a cozy relationship between government and the financial sector in which the financial sector excesses are overlooked as long as it shares part of its returns with the exchequer.

This phase of increased private spending is usually accompanied by a rapid rise in public expenditure. They combine to cause a build-up in private sector debt as well as public debt. Even as public debt build-up gets scrutinized, new public debt components become visible which were not accounted for earlier, and inflationary pressures appear. Governments are reluctant to take action on the financial sector because of the revenue connection and, perhaps equally importantly, of the synergy that evolves from participation of the private financial sector directly in government with high likelihood of an eventual return to origin.

Even when a financial crisis is clearly converting to a global economic crisis, government action remains painfully slow. To add to the complexity, reflecting the globalization of financial markets, governments are obliged to take action co-operatively. This becomes almost impossible as has been evidenced in the slowness of the G20 process in coming to grips with the need for financial regulation. In the absence of clarity, once uncertainty in financial markets takes hold, volatility increases. It spreads not just in financial markets, but to commodity

²⁰ Holding of other assets increased by £50 billion between December 29, 2010 and December 28, 2011.

markets as well. This is because commodity markets, which were traditionally less risk prone since they reflected underlying demand-supply factors more closely, have become increasingly financialised, following similar rapid rise and fall patterns as financial markets. The increasing volatility in commodity markets impacts economic growth adversely, turning a financial crisis into an economic crisis among other links and causes.

The emergence of a Euro area debt crisis has led the re-emergence of an economic crisis in 2011. If one ponders the sequence of events between 2009 and 2011, the unmistakable conclusion is the prevalence and growth of erroneous over-exposure of European banks in excessive demand economies with a high build-up of debt, within their own economic area. If analysts are to accept that, despite the 2008 global crisis, such banks continued to suffer from Reienhart and Rogoff's "this time is different" postulate, that expectation would be too fantastic. The conclusion has to be that demand needs to be scaled back to the full extent needed to restore the confidence of rating agencies and demonstrating a roadmap that brings debt quickly to sustainable levels. Further, the problem needs to be solved primarily from resources from the affected region.

For resources from elsewhere, there is an important anchor from where problem solving should be launched in a meaningful way. It is the IMF. It is perhaps not entirely surprising that the IMF has opted for supporting expansionary policies in a diversion from its well established demand management approach to economic recovery and for which it had developed a reputation of an essentially unbiased monitor. It should revert to its traditional framework lest its reputation should be further diminished. Rules of the game should be perceived to adhere irrespective of the times or of who the protagonists are. If that happens, replenishing the Fund adequate should be feasible and rebalancing could occur exclusively with IMF resources and through its strong adjustment programmes. What is not being realized immediately is that, once that reputation is lost, it would be far more difficult to reinstate it than to resist heterodox shifts in its policy framework reflecting large shareholder interests.

Annexure

GLOBALISATION AND G20

G20 should strive for ushering in less global consumption, says PARTHASARATHI SHOME

In the context of G20, let us scrutinise selected aspects at its epicentre, revealed by changing international trade patterns. First, using merchandise exports statistics, we define globalisation and its evolution and course. Second, we note a striking change in the composition and direction of trade among selected countries. Third, we point to a commensurate shift in regional trade balances. Accordingly, fourth, we can assess the role of G20 despite dampened expectations.

Over 50 years, we witnessed an exponential rise in merchandise exports (Diagram 1, right axis). Yet, the global crisis resulted in a 20-25 per cent fall in world exports in 2008-09 alone, a manifestation of a finally unsustainable heterodox consumption-driven economic stance in many advanced economies, reflected in stubbornly negative household savings.

Looking to the antecedents of the crisis, Diagram 1 (left axis) breaks down growth in the global trade index. The bottom portion shows how much trade would have grown with GDP at constant prices or, if fixed at the 1960 share of GDP. The middle portion adds in the effect of prices. The top portion then shows the additional growth in trade over this period, reflecting trade's increasing share in world GDP. Without this, trade would have been 45 per cent lower than that actually experienced in 2008. It is this portion that reflects globalisation. Many have blamed it not only for its inability to control depletion of global non-renewable resources but also for failing to provide appropriate signals for the self-regulation of the international marketplace.

So, how did trade grow over real economic growth and inflation? First is an economic rationale — cost advantages of large-scale specialisation in particular countries resulting in greater supply than domestic demand. Second were complementary technological improvements in communication and transport (air shipment, containerisation), increasing use of billing and tracing through the Internet, to name a few. Third were reductions in trade barriers through the WTO that reduced tariffs and quotas, and customs unions such as Asean, the EU and Nafta. Fourth, globalisation accelerated with escalating consumer demand and a growing taste for high turnover and product differentiation. This consumption-linked aspect became simply unsustainable. Just as an individual household cannot dissave in the long run, so must economies at the macro level eventually be constrained by dissaving.

Diagram 2 breaks down net trade (ex-

Diagram 1: WORLDWIDE MERCHANDISE EXPORTS

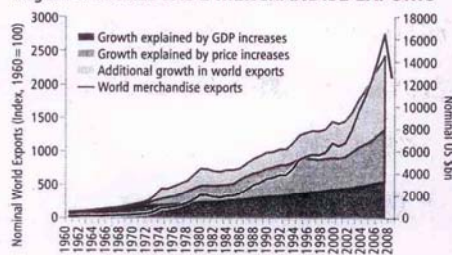
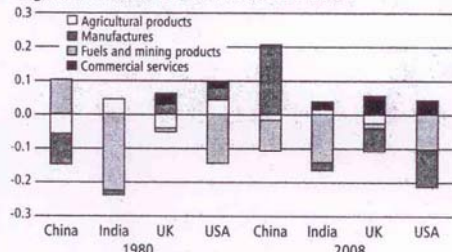


Diagram 2: TRADE BY COMMODITY TYPE



Source: WTO

ports minus imports as a percentage of total trade) for selected countries. The space above zero shows net export sectors, while below zero are net import sectors. Indicators for 1980 reveal China and India exporting low value-added raw materials and agriculture, with the UK and the US having the advantage in services and manufacturing. The change in comparative advantage by 2008 is equally clear: China developed a strong advantage in manufacturing and is now a net importer of raw materials, while India gained advantage in commercial services. Indeed, between goods and services, services grew steadily in relative terms, from 15 per cent to 21 per cent between 1980 and 2009. Though still small in global share, India nevertheless contributed to this changing pattern, with information technology comprising a major component.

Changes in regional trade balances in Diagram 3 reveal how North America — primarily the US — moved into deficit over recent decades, while Asia moved towards trade surpluses. The changed trade balances are symptomatic of the much-maligned "global imbalances", cited as one of the key indicators of the need for global economic rebalancing.



Diagram 3: REGIONAL TRADE BALANCES: NET TRADE AS A % OF TOTAL TRADE

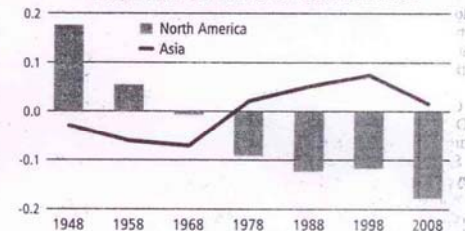


ILLUSTRATION BY AJAY MOHANTY

The IMF has historically argued against over-consumption. In the early annals of the IMF, its executive board did not desist from reining in post-War Europe from excessive consumption. In the 1970-80s, Latin American countries faced opprobrium that, in the 1990s, East Asian economies did not escape either. In the 2000s, the US and Europe, the historical rule-setters, themselves fell into unsustainable consumption, suffering its deleterious impact on economic growth. Reflecting the changed world economic order, G8 expanded into G20 for future global economic and financial dialogue, and revisions of IMF quotas could not be stalled any longer.

A huge socio-economic change is needed to get back to the basic habit of household savings in advanced economies where untargeted subsidies in various sectors and in multiple forms have curbed incentives to work or save, and have resulted in heavy expenditure burdens on government. This is where the need for rebalancing is most apt. Households, government and private businesses comprise an economy. They cannot all be in deficit, filling it perennially from abroad. That is unsustainable in the long run. It also leaves an unjust debt burden on pos-

terity. Recognising this, more advanced countries are of late embracing tough, unpopular belt-tightening measures.

Thus, it is pertinent to ask what G20 can achieve to usher in less, yet better, global consumption that could form the anchor for a new exports road map from developing countries, rather than exclusively emphasising relative exchange rates or pushing artificial trade barriers. Perspicacity and reform in demand from advanced economies would naturally result in a realistic exports trajectory from developing nations, that could: (i) slow the rush; (ii) allow space for more intelligent use of depletable resources; (iii) minimise environmental degradation; (iv) enhance internationally comparable labour standards; and (v) minimise the use of child or indentured labour. G20 has included development issues in its Seoul Summit. To end on a cautionary note, it is necessary on the part of the Sherpas to ensure that crucial objectives are not lost in a creeping incrementalism of agenda items, as was evidenced in revisions in the IMF's agenda after earlier global crises.

All views expressed are exclusively those of the author.

2010 FOR UK

YEAR OF FISCAL CONSOLIDATION

India's forthcoming Budget should use fiscal policy to curb inflation. The components would be quite similar, says PARTHASARATHI SHOME

The 2008-09 global financial crisis led to severe economic contraction — actual decline in GDP — in several advanced economies. In the UK, for example, the medium-term GDP trend shifted downwards for some years to come. This shift was accompanied by a decline in revenue/GDP and a rise in expenditure/GDP ratios reflecting unemployment benefits. The revival of economic activity was anchored on quantitative easing which did not work fast enough since the injected finance froze as the money multiplier collapsed. Focus turned to fiscal support through tax reductions and further current expenditure enhancements. The already rising fiscal deficit/GDP was further exacerbated. Public debt/GDP in some countries doubled. Stock market and rating agencies did not appreciate what the country indicators were showing and strategies had to be reformulated.

Strategies were refocused on fiscal consolidation and debates ensued on its pace and content. Elections were won and lost on this issue. Indeed, at Brookings, Alesina, Perotti and Tavares in 1998 had found fiscal rectitude to be rewarded by voters. The UK proved a case in point: Labour departed and a Conservative-Liberal coalition entered in May 2010. The latter's more austere fiscal positioning won the voters' confidence.

Later at NBER Harvard, Alesina and Ardagna in 2009 also found that fiscal adjustments mostly on the spending side have a better chance of not creating large recessions on impact. Mid-year, post-election UK opted for this route. The pre-election Labour Budget (March) and post-election Conservative-Liberal Budget (June) viewed corrective policies quite differently. Figure 1 illustrates the additional tightening. The final calibration expressed in the coalition's Spending Review (October) that anchored a five-year austerity programme further recomposed expenditure in favour of investment over consumption. It cut back untargeted direct consumption subsidies and reduced the length and pattern of unemployment coverage.

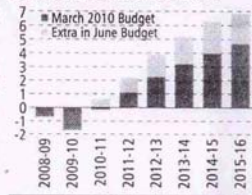
Table 1 presents published figures on how the tightening — tax increase and expenditure reduction — was broken down in March,

Table 1: UK COMPOSITION OF TIGHTENING: PROJECTIONS FOR 2014-15

£ billion	Mar '10 Budget	Jun '10 Budget	Oct '10 Spending Review
Tax	21.5	29.8	29.8
Spending	50.9	82.8	80.5
Investment Spending	17.2	19.3	17.0
Current Spending	33.7	63.5	63.5
of which:			
Debt Interest	7.0	10.0	10.0
Benefits	-0.3	10.7	17.7
Public Services	27.0	42.8	35.7
Total Tightening	72.4	112.6	110.3
% Spending	70.0	74.0	73.0
% Tax	30.0	26.0	27.0
Forecast Net Public Debt as % GDP in 2013/14	74.5	70.3	69.7

Source: Institute of Fiscal Studies (2010)

Figure 1: UK FISCAL CONSOLIDATION PLANS



June and October. Only 2014-15, the last projection year, is selected for illustrative purposes, revealing a significantly tighter stance of the new government in nominal terms (Row 8). The coalition, in two (June and October) steps: (1) increased taxes more; (2) maintained investment spending; (3) scaled back current spending considerably; and (4) within current spending, cut back benefits (direct subsidies) much more than public services (mainly National Health Service (NHS), the universal health coverage for which the UK is well known).

Thus, tax increase shot up between March and June Budgets (Row 1) while expenditure reduction was more severe than tax increase (Row 2). Cut in investment spending was a bit deeper in June than March but the cut was pulled back and investment spending was restored in October (Row 3).

The severe cutback instead came from current spending. The cutback almost doubled between the two governments (Row 4). Interestingly, direct benefits (targeted and untargeted consumption subsidies and work incentives) had been protected in the March Budget; but they were reduced considerably in June by the incoming government — even

more than their tax increase — and the benefits cutback was further increased in October (Row 6). The reduction in expenditure on public services, the other major head of current spending — the significant component being the NHS — was also deeper between March and June. But in a reversal, the cutback was partially reduced between June and October. In sum, the new government reallocated the cuts within current spending between June and October, making them deeper for direct subsidies and less so for the NHS. Thus the right combination of cutbacks emerged between: (1) tax and expenditure, (2) between investment and current spending, and (3) between pure consumption and service-oriented current spending. The new mix relied more on spending cuts than tax increase (Rows 9 and 10). Also, the deeper fiscal correction implied that public debt/GDP improved faster by almost 5 percentage points (Row 11). Most importantly, the much deeper nominal fiscal correction will be achieved with a lower economic growth — and, therefore, income path — that is more realistic than the pre-election projections.

Table 2 explains some basic macroeconomic projections between March, June and October. First is the considerable reduction in the trajectory of GDP growth between March and June Budgets, bringing the series closer to the average of independent projectors. The October Review made small dif-

ferences to those projections. Second, projections of public sector net borrowing/GDP also declined from March to June through October. Third, a comparable change occurred in the cyclically adjusted current fiscal account surplus. The March figures had projected a deficit even for 2014. The subsequent tightening produced a small surplus in June figures for 2014, and a higher one in October. Fourth, translated into net public debt, the increase in the series in terms of GDP became less pronounced between March and June Budgets, and further so in October.

Thus, the incoming UK government undertook difficult fiscal measures in 2010 on both the revenue and expenditure fronts. These corrections were higher in nominal terms compared to the pre-election measures. And, since GDP projections were scaled down post-election, the measures represented tighter belt-tightening. This fiscal stance moved with academic empirical findings and won the regard of multilateral institutions. A challenge appeared much later when the inheritors of an almost doubled public debt/GDP were also informed that they would face an almost threefold increase in their university tuition fees. Clearly, the UK opted for a consolidated fiscal stance. India's forthcoming Budget should use fiscal policy to curb inflation. The components would be quite similar.

The views expressed are exclusively the author's

Table 2: UK MACRO INDICATORS

	2010	2012	2014
Real GDP Growth*			
March Budget 2010	1.25	3.5	3.25
June Budget 2010	1.2	2.8	2.7
October 2010 Spending Review1	1.8	2.6	2.8
Public Sector Net Borrowing (as % GDP)*			
March Budget 2010	11.1	6.8	4
June Budget 2010	10.1	5.5	2.1
October 2010 Spending Review1	10	5.6	1.9
Cyclically Adjusted Surplus on Current Borrowing (as % GDP)*			
March Budget 2010	-4.6	-2.5	-1.3
June Budget 2010	-4.8	-1.9	0.3
October 2010 Spending Review1	-4.7	-1.8	0.5
Net Public Debt (as % GDP)*			
March Budget 2010	63.6	73	74.9
June Budget 2010	61.9	69.8	69.4
October 2010 Spending Review1	60.8	69.1	68.8

* Figure given for tax years (i.e. 2009=2009/10)
1. Economic data taken from OBR's Autumn 'Economic and Fiscal Outlook'

THE EVOLVING FISCAL STANCE

Fiscal consolidation based on curbing expenditure is a sensible move, but direct tax collection efforts also need to be strengthened, says PARTHASARATHI SHOME

The 2010-11 Economic Survey and 2011-12 Union Budget have come and gone. The immediate reactions sought by media have dissipated. Now is the moment to deconstruct and thus view the overall fiscal stance that is emerging over the last few years through, and post, global financial crisis.

First, India's fiscal developments reveal a relaxation in tax and expenditure efforts during the crisis followed by relative tightening after the crisis from 2010-11. Thus, consolidation is taking place during the current up-cycle. Overall, therefore, the stance has been counter-cyclical as it should be. And any overall fiscal strategy behind this has to be commended.

However, the total consolidation picture appears to be dependent somewhat on serendipity as non-tax revenue growth flipped due to temporary gains from spectrum sales (Table 1, Row 2) and disinvestment receipts. On the expenditure side too, though efforts towards counter-cyclical policy in non-Plan current expenditure have been successful, (Row 5), Plan expenditure maintenance has been unstable over recent years. Of course, the finance minister expressed satisfaction in his Budget Speech that last year Plan expenditure was met.

The second good aspect is that post-crisis, in 2010-11 and 2011-12, fiscal consolidation is coming mainly from the expenditure side rather than from revenue (excluding the spectrum windfall) (Table 1, Rows 4 and 7). Academic research has shown that consolidation based on expenditure tightening is less recessionary than that based on tax revenue increases.

However, further scrutiny of the effort to reduce the fiscal deficit (Row 8) as well as the primary deficit (Row 9) indicates that, while fiscal deficit tightening, or reduction, turned out to be 1.3 per cent of GDP in 2010-11, it is budgeted to be only 0.5 per cent of GDP for 2011-12. One explanation for this tepid course of action is that there were no underlying discretionary tax effort or net revenue yielding tax measures in the Union Budget. Going deeper, since no net tax measures were taken, post-crisis, the tax revenue buoyancy is coming from economic growth rather than from tax effort. During the up-cycle, the lack of tax effort appears to be somewhat pro-cyclical and remains a challenge to be corrected in the 2012-13 Budget. A positive, and higher tax effort would enable a faster reduction in the deficit, and getting back on, and recharting the course of, FRBM quickly.

Further, whatever tax effort has been made in increasing indirect tax revenue has

Table 1: INDIA FISCAL CONSOLIDATION

(Δ % to GDP)	2008-09	2009-10	2010-11	2011-12*
1) Tax Revenue (net to centre)	-0.87	-0.97	0.19	0.24
2) Non-Tax Revenue	-0.32	0.04	1.02	-1.40
3) Capital Receipts**	-0.76	0.39	-0.10	0.21
4) Total Consolidation of Revenue Side	-1.95	-0.55	1.10	-0.94
(Δ % to GDP) × -1				
5) Non-Plan Expenditure	-0.72	-0.10	0.58	1.34
6) Plan Expenditure	-0.82	0.30	-0.38	0.10
7) Total Consolidation of Expenditure Side	-1.54	0.19	0.20	1.44
8) Fiscal Deficit (7+4)	-3.5	-0.4	1.3	0.5
9). Primary Deficit	-3.5	2.9	1.1	0.4

Table 3: INDIA TIGHTENING OF SUBSIDIES

(% to GDP) × -1	2008-09	2009-10	2010-11	2011-12*
Δ in Fertiliser Subsidy	-0.76	0.44	0.24	0.14
Δ in Food Subsidy	-0.15	-0.11	0.12	0.09
Δ in Petroleum Subsidy	0.01	-0.18	-0.26	0.22
Δ in Interest Subsidies	-0.01	0.02	-0.03	-0.01
Δ in Other Subsidies	-0.01	-0.01	0.00	0.04
Δ in Total - Subsidies	-0.92	0.17	0.07	0.49

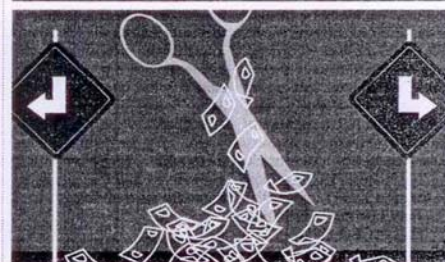
Note: + Tighten / - Loosen; * Budget; ** Does not include receipts in respect of Market Stabilisation Scheme and excludes Borrowings and other Liabilities

been given away through decreases in direct tax revenue. This is especially curious in an economy that should have been continuing to reduce its dependence on narrow production taxes while expanding the direct tax base even while reducing the headline income tax rates. And this would not have been a new direction since revenue reform had already made a solid start in this direction from 2005, tilting the revenue balance in favour of direct over indirect tax.

Indeed, the components of tax effort or buoyancy are widely different year by year (Table 2). Whatever the underlying explanations, overall it appears that varying tax policies have been employed through time, for example corporate income tax (Row 1) in 2011-12 and customs duty (Row 3) in 2010-11. The overall stance in the mix and sources of tax revenue change should ideally reflect a well-rounded strategy rather than a mere bottom-line. This should occur even if the DTC or GST is awaited since neither of them would represent an immediate solution to the right revenue

Table 2: INDIA TAX EFFORT

(% to GDP)	2008-09	2009-10	2010-11	2011-12*
Δ in Tax Revenue	-0.87	-0.97	0.19	0.24
Composition of the Δ in Gross Tax Revenue				
1) Corporation Tax	-4.4	-6.6	5.7	62.52
2) Taxes on Income other than Corporation Tax	-15.1	-2.4	-15.7	8.9
3) Customs	-28.4	-39.5	88.3	4.1
4) Union Excise Duties	-50.7	-28.5	37.4	20.0
5) Service Tax	6.0	-15.3	-2.4	8.1
6) Wealth Tax	0.0	0.1	-0.1	0.0
7) Other Taxes and Duties	-7.4	-7.5	-13.3	-3.0
8) Taxes of Union Territories	0.0	-0.2	-0.1	-0.6
Total	-100	-100	100	100



balance between direct and indirect taxes. Indeed, no such calculation is known to have been conducted. Thus, the revenue mix and balance between direct and indirect taxes should be independently addressed and treated as another challenge for the 2012-13 Budget.

The third nice aspect in the 2011-12 Budget was the tightening of subsidies. This has been the case in all major subsidies and has taken place over recent years as revealed in the numbers (Table 3) for subsidies on fertiliser, food, and petroleum. This too is commendable.

However, the Budget might have been cautious on its allocation of petroleum subsidy in the prevailing global environment of escalating oil prices that might not abate for some time. Instead, it has shown a tightening of 0.22 per cent of GDP in petroleum subsidy even after experiencing a loosening of 0.26 per cent of GDP in 2010-11 (Row 3). It is this hue of optimism rather than judicious caution that is a bit worrisome in the Budget. It does detract from successfully

garnering the confidence of analysts.

To sum up, India has been following counter-cyclical fiscal policy outcomes through, and post, crisis. This is a welcome overall policy stance. However, analysis reveals that some of it is chance. Also, discretionary tax effort is nil. It should be revived, and in such a way that direct tax revenue effort overcompensates indirect tax loss rather than the opposite way around as in the just introduced Budget. Subsidy policy is on the right track though realistic projections for petroleum subsidy are lacking in light of last year's experience and in anticipation of the international petroleum environment that is emerging. It would help if the derivation of important Budget numbers are presented to Parliament as in mature and many emerging economies. This indeed remains another challenge for the 2012-13 Budget.

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FINANCIAL MARKET BEHAVIOUR

Models are still restricted in their capability to predict market behaviour, says PARTHASARATHI SHOME

A FAMILIAR issue is how to gain an edge over volatile international financial markets to obviate or minimise future global financial doldrums. Should capital controls be imposed by countries or under multilateral understandings or agreements? Should there be an international financial regulatory agency to initiate action under stipulated conditions? Should financial transactions be taxed? Some countries are making forward-looking suggestions; some are resisting; others are being Humpty Dumpties.

To address price volatility, price determination needs to be understood first. Traditional financial economics literature says the outcome of the market is a "random walk" in prices, or, all available information is already reflected in the current price, so that any future price movements would only result from random exogenous shocks. However, information has always been scarce. Thus, even quite early, such premises were already challenged. Ratti and Shome (1977) demonstrated that, in the presence of uncertainty, the usual solution for an auctioneer, to search and find a set of relative prices through a tatonnement process, at which there is no excess demand in any market, is no longer achievable. Thus, exchanges are not perfect Walrasian auctions. More recent evidence by Lo and Mackinlay (1999) showed that stock market prices do not follow a random walk; there is volatility that cannot be explained as an outcome of exogenous or uncontrollable factors alone.

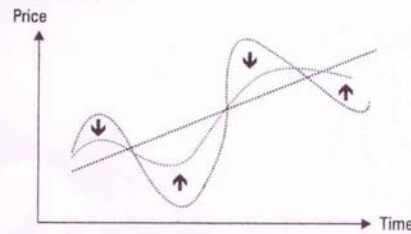
Related questions arise on whether traders are rational; whether it matters that the marketplace does not determine a price through an equilibrating tatonnement process; and whether volatility is a market failure that needs to be addressed.

Therefore, to develop a coherent policy in an international framework, we need to first understand the behaviour of players in financial markets.

Consider diagrams I and II. The dotted straight lines indicate the line of "fundamental values" or the true underlying long-term trend values of a stock or share. The lines in blue indicate price movements in the share market with speculators, while the lines in red indicate the price trajectory with no speculators.

The question is: will speculation bring prices towards, or take them away

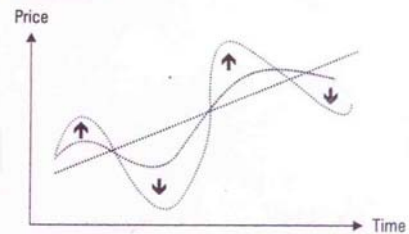
DIAGRAM I



Are short-term speculators rational, 'fundamental' traders who identify price discrepancies and push the market towards equilibrium?

— Price with no speculators

DIAGRAM II



Or, are short-term speculators irrational 'noise' traders who push the market away from fundamental values for private gain?

— Price with speculators

— Fundamental value

from, the fundamental values? The old algorithm was that "stabilisation is stabilising". Thus, in diagram I, when prices are high, speculators consider it a good opportunity to sell, and do that. Consequently, the prices decrease, which results in speculation bringing prices towards fundamentals. So, speculation becomes stabilising.

Diagram II shows the opposite. When prices rise, operators buy in the hope that prices will rise even further. This type of "noise" trader is said to trade often, usually in a herd, who ignores market fundamentals. This is compounded by "technical or automated trading" that is software-driven and takes place on the basis of recent price and trade volume information rather than on any analysis of underlying economic data. The outcome is destabilising speculation — prices being pushed further away from fundamentals. The relative strengths of the two behaviours — stabilising and destabilising — determine the outcome of whether market activity leads prices towards or away from fundamental values.

Technical trading mimics destabilising speculation. This is because technical traders buy until a certain ceiling is reached when prices are rising, and sell when prices fall below a certain minimum level. Beinhocker (2007) has given an interesting example from Farmer et al (2004), on the impact of a bid-ask spread. They studied one trade in AstraZeneca, a pharmaceutical company. AstraZeneca's "limit sell order" — offers to buy and sell that are conditional on a price — was set at £31.84. The next limit order

was set at £32.30. When a small "buy order" of £16,000 came in, the asking price jumped from £31.84 to £32.30. This was an increase of 46 pence, which now represented the bid-ask spread; the share price moved up by 23 pence. This added £374 million to AstraZeneca's market value, though there was no policy or performance change of AstraZeneca on that day. Thus, a £16,000 buy order had generated a £374 million valuation jump for the company, reflecting solely the way market price recording and clearing take place in technical trading.

To curb volatility, those who recommend controlling financial transactions through capital controls or by taxing capital flows claim that such instruments would curtail technical intra-day trading or short-term transactions; and, in turn, the market would move more towards fundamentals or the underlying long-term trend. The opposite argument is that the reduction in transactions could mean that, when people do trade, they trade in larger amounts in a "thinner market" with fewer participants. This leads to bigger gaps between the limit orders in the market makers' order books. These gaps increase price volatility whenever a market order — an order to buy and sell with immediate fulfilment regardless of price — is placed.

Unfortunately, models of noise trading (De Long et al, 1990) are generally unable to adequately explain behaviours. They fall short of establishing one-to-one relationships between a trader and a behaviour or, for that matter, an "attitude to speculate". This is probably because of the mul-

tiples personalities of traders and investors. As a result, Grundfest et al (1991) have even claimed that a tax on financial transactions would affect both (short-term) traders and (long-term) investors.

Thus, instead of modelling speculators' behaviour, would it not be more revealing to model financial markets themselves? One possibility is to model the chaos and complexity endemic in financial markets. The theory of chaos and complexity is best explained through an example of throwing a pebble in a pond. The ripples have no pattern and are, therefore, chaotic, as are financial markets. At the edge of chaos, where the ripples are dying out, however, complex patterns may be discerned. This is the Mandelbrot set, named after the scientist who programmed it.

The complexity theory is being used to explain biological cell growth and galactic formation, so why not financial markets? Global financial equilibrium has successfully escaped traditional analyses and prescriptions. We need new methodologies to take corrective action. If complex behaviour patterns are discerned in otherwise chaotic financial markets, we can observe those patterns and introduce policy to manipulate them. A new generation of economists could surely pioneer such methodologies and bring them to the policy table?

The writer is director and chief executive, Icrier

All opinions are exclusively those of the author

VOLATILE TIMES

Better regulation of global commodity markets is crucial for price stability, says PARTHASARATHI SHOME

REGULATORS and experts recently met in Brussels to analyse market volatility in food and agricultural commodities, fossil fuels and energy, and industrial raw materials, and to debate what regulators can and should do, and how multilateral institutions might respond coherently. French President Nicolas Sarkozy delivered an impassioned speech on why markets should be regulated. A handful of players are controlling large chunks of most markets, driving and determining prices. Further, huge gains are being made from orchestrated price movements rather than availability based on production and weather conditions, or changes in demand for products owing to economic growth or natural disasters. He implied that an intolerable situation was developing and that regulation had become imperative. He indicated that he was giving the speech in anticipation of the following week's Paris meeting.

That G20 agriculture ministers' meeting took place in Paris to discuss measures against volatility in global agricultural markets. The members could not conclude concretely. They, however, agreed to collect comparable information with the Food and Agriculture Organisation's involvement, committing to an Agricultural Market Information System. It is an onerous task since the US, which is the only member that publishes reliable data, remains unwilling to regulate the markets effectively. But data are not enough. It is important to ask how the data would be used for indicators, and if the indicators are meaningful.

Only after the first stage is completed could agreements be meaningfully drawn up on regulation to contain prices and volatility. But volatility is not the only concern. The world is also worried about extreme price rises and, based on evidence, the increased volatility as prices rise. Two explanations follow. First, the rapid change in the nature of market operations, with price determination in commodity markets moving closely with financial markets. And second, the real demand-supply gap in global markets.

On the first, price rise and volatility have been closely linked to the increasing financialisation of commodity markets that Mr Sarkozy denounced, unless regulated. Commodities have become an asset class. They now comprise investor havens for hedging against higher-risk sources, low interest rates and a depreciating dollar. Hedgers take speculative positions on commodities, and exploit arbitrage opportunities in markets through index funds, pension funds, mutual funds

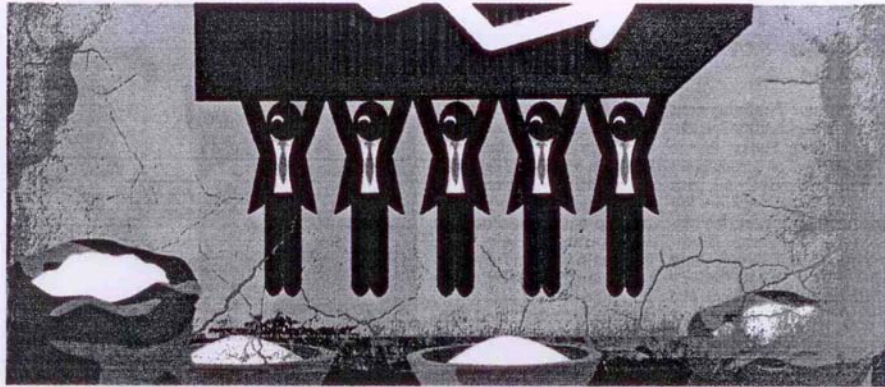


ILLUSTRATION BY BINAY SINHA

and the like. These activities would not have been questioned but for the emergence of instruments that do not necessarily reflect market fundamentals such as hedge funds, swap deals, exchange-traded funds and exchange-traded notes, where passive traders track commodity values and act on them. Thus, commodity index futures are operating much like financial market indexes, creating bubbles intermittently. Their regulation must, therefore, be along the same lines.

The regulatory indicators should, therefore, target such trend spotters who have little or no intent of taking futures to delivery. They ride the wave, accelerating and enlarging both price upswings and downswings. Speculative position limits have to be stipulated to prevent excessive speculation and assist in monitoring potential violations in the market. It can be implemented through surveillance of individual and institutional traders' activities to contain, if not obviate, an oligopoly in market power.

In the absence of full agreement on the course of action, monitoring based on traditional macroeconomic indicators remains in vogue. It cannot be sufficient since links between an economy's macro performance and financial/commodity market-driven global dolldrums are tenuous. Unfortunately, there is a stubborn continuation in, and overemphasis on, using macroeconomic indicators such as savings rate, fiscal deficit/GDP, or current account balance as indicators linked to all ills. But fiscal deficits have different impacts – multipliers – reflecting country characteristics. Similarly, the current account indicates net financial flows, while we need gross flows from trade in goods and services to obtain trade in financial assets that comprise the bulk of cross-border

financial activity. In fact, gross financial flows make current account positions look small. Claudio Borio of BIS, Piti Disyatat of the Bank of Thailand, this author and others are pointing to the need for indicators that are more directly linked to global market movements.

The problem is that many of them are financial indicators that the US seems reluctant to touch despite the experience of the 2008-09 financial crisis and its continuing fallout. Fortunately, the large trader reporting system has been endorsed by the Dodd-Frank Act, which has accepted the importance of collecting data to implement aggregate position limits for certain physical commodity derivatives. The G20 process must push forward on this issue. While the French chairmanship appears to be a silver lining, the outcome of the Paris meeting is not sufficiently reassuring.

What are the better indicators? These have to be found from observed associations between volume and value in the line-up of global commodity markets measured by indices such as S&P GSCI Commodity Spot, CRB Spot Index Fats & Oils, and others that can be related to prices of corn, wheat, crude and minerals on the one hand, and movements in major asset classes such as the Dow Jones Industrial Share Price Index and FTSE Global Bond Index, and global liquidity such as global money stock (M1) as a percentage of real GDP, on the other. Further, the correlation between the financial asset classes and off-index commodities (commodities not included in commodity indices) will shed more light on the impact of portfolio rebalancing on indexed commodities.

Price stability can be achieved by putting together a framework of triggers based on observed strong associations.

Otherwise we are heading for another vortex of price escalation and volatility that would fuel the next global recession. Further, there is a continuing lack of resolve to tighten belts or control runaway financial innovation.

Now to the demand-supply gap—the second explanation on global price movements. Take China. At an overarching level, China is criticised for excessive savings and current account surplus. Yet at the Brussels conference, China was singled out for over-consumption of global resources. China consumes over 50 per cent of the global supply of cement and iron ore, and just under 50 per cent of steel, copper, nickel and zinc. Its per capita consumption of these metals is higher than developed countries'. Hence China is over-consuming. Finally, this author found himself in the awkward position of having to speak on the argument's internal inconsistency. At the macro level, China has too much current account surplus and excessive savings; at the micro commodity market level, it is over-consuming. So, should China stop producing and only import finished products when global demand reflects otherwise? Additionally, that China consumes only 10 per cent of global oil supply was ignored until pointed out. And since oil prices and their volatility are central to the prevailing inflation, price volatility and potential resurgence of global recession, should the solution not lie in rapid fiscal and monetary tightening elsewhere?

I felt a strong desire to escape from the real world and found refuge in Brussels's museums showcasing Bruegel's unreal miniatures and Magritte's surreal vision of the world.

The author is director and chief executive, Icrier, New Delhi. Opinions are exclusively of the author

COUNTDOWN TO CANNES

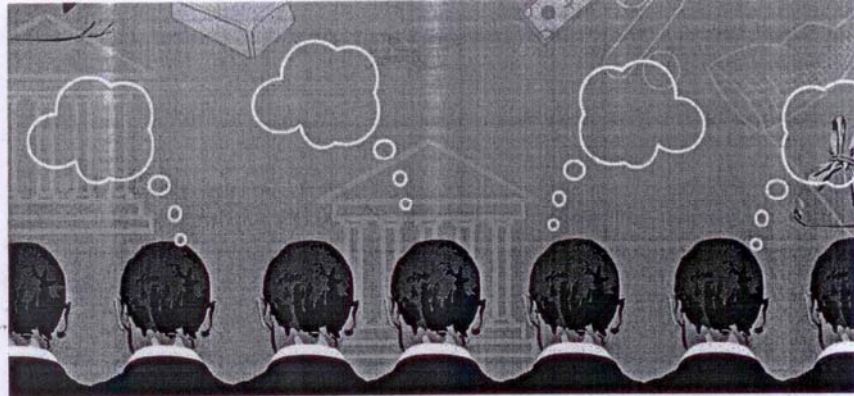
PARTHASARATHI SHOME outlines what to expect at the upcoming G20 summit

ILLUSTRATION BY BINAY SINHA

As the G20 leaders' summit of November 3-4 approaches, different streams of thought have taken hold. First, there is a divergence over the utility of the process that has turned out to be relatively slow in achieving consensus on mutual assessments among countries. Second, there is continuing disagreement over the relative importance of artificial exchange rates, loose fiscal stance, and reluctance to provide support in, broadly speaking, Asia, America and Europe. Be that as it may, G20 is still the vehicle that a group of economically diverse, advanced, large and emerging nations have put together which, at present, is the only vehicle that offers the potential of leading the way out of a deep and continuing global economic and re-emerging financial crisis. And, within G20, Brics - Brazil, Russia, India, China, South Africa - have appeared as a formidable bloc from which greater contribution is anticipated.

The G20 Mutual Assessment Process (MAP) is designed as a reasonable, multilateral process to develop a set of indicators for noting internal and external imbalances and indicative guidelines for assessing those imbalances. Will an Action Plan be adopted at the Cannes summit that would draw up triggers for corrective action? A September 22 communique of finance ministers and central bank governors released at the G20 meeting in Washington promised to "commit to take all necessary actions to preserve the stability of banking systems and financial markets as required. We will ensure that banks are adequately capitalised and have sufficient access to funding to deal with current risks and that they fully implement Basel III along the agreed timelines. Central banks will continue to stand ready to provide liquidity to banks as required. Monetary policies will maintain price stability and continue to support economic recovery". Interestingly, the emphasis is on domestic policy rather than on international agreed triggers that would compel domestic policy. Thus, whether there is scope for sharp changes in policy direction is to be awaited at Cannes but opinions are stacked in favour of slow progress. Even if it is "slow but steady", advanced economies would be charting the right course and emerging economies would be delighted.

A second feature at Cannes should be the role and prevalent use of capital



controls. Some countries have been, and some are contemplating, imposing them to contain surges in capital inflows caused by untamed quantitative easing elsewhere. However, such controls should only be a measure of last resort rather than a substitute for sound macroeconomic policy. Cannes should take a position on this. After all, there is broad agreement in research findings that capital controls cannot compensate for fundamental macroeconomic imbalances. Governments, however, could temporarily improve the quality of capital flows by curbing shorter-term, and encouraging longer, maturity flows. There is also built-in futility in using capital controls, for, unless quantitative easing or loose fiscal policy in advanced economies is directly addressed, capital is bound to flow, find locales offshore, and suffer increased volatility. Only progressive international co-operation in monetary affairs through MAP can counter this, not unilateral imposition of capital controls.

A third feature at Cannes has to be G20's long-term agenda based on the Seoul summit's Development Consensus for Shared Growth and the recent Washington communique of the G20 Ministerial Meeting on Development. In policy circles, however, there is the expressed preoccupation that G20 has overreached itself in defining nine pillars of development that will be addressed: infrastructure; human resource development; international trade; private investment and job creation; food security; growth with resilience; finan-

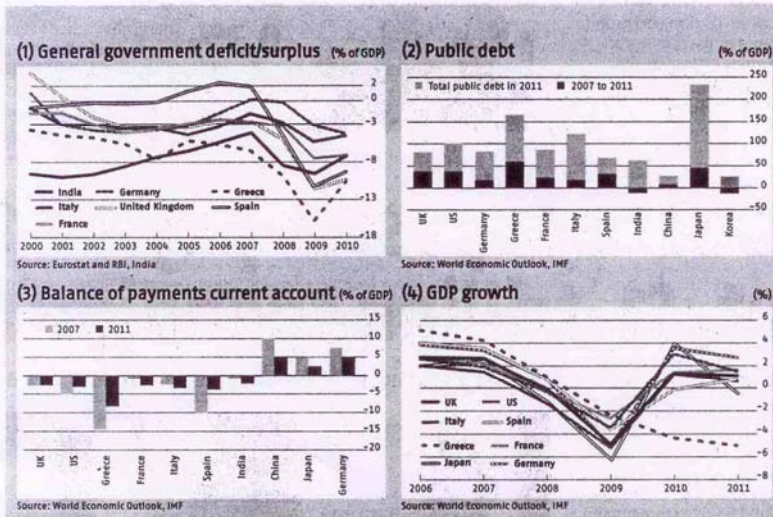
cial inclusion; domestic resource mobilisation; and knowledge sharing. These appear to challenge the singular focus that is needed to address the most crucial systemic faultlines that should be closed for restoring stability in financial flows. The broadening of objectives assuages the developing countries that claim recognition of their long-term structural concerns as a group. However, it carries the danger, and perhaps the reality, of diluting the immediacy of instituting strong and meaningful global indicators that should quickly enable automatic triggers for tightening, or loosening, macroeconomic - financial and fiscal - policies that most advanced economies should be implementing now or in future. Perhaps the development agenda is a way for the G20 to maintain its relevance beyond the present global crisis and to reach out to countries beyond its own membership. In turn, the question that arises is, how should G20 relate to G24, of which India has just taken over the chairmanship for a year?

Finally to Brics. Advanced economies are interested in what they can do proactively as a group. Some within the group are keen to make a contribution in terms of financial resources. Thinking out of the box, however, would it not be more helpful if Brics took a combined position in advancing their agendas over remaining aspects of liberalisation of their economies, an issue that advanced economies harp on during ordinary circumstances? In the case of India in particular, financial sector liberalisation including banking and insurance would

help buttress supply opportunities for mature economies, improve the allocative efficiency of investment, and reduce expenditure in mature economies through a scaling back of global demand for their government securities.

Liberalising the retail sector would help advanced country firms find a new source of unmet demand and improve their global supply chain. This would, in turn, rationalise the cost of production and enhance net exports of these economies. That would act as a catalyst in reviving global demand. In the process, Brics, and India in particular, would reap the benefit of organised retailing, investment in local supply-chain management and storage capacity, areas in which improvement is required immediately. An efficient service sector would make a better enabling environment for more foreign investment, thus engendering a second round of correction in global imbalances. Making a contribution towards redressing global imbalances through domestic policy reform by Brics, rather than through making a token contribution of financial resources that can at best represent a drop in the bucket, would be a more proactive, albeit deeper and more challenging, route for them to adopt. Let us await Cannes.

All opinions are exclusively those of the author. His book, Modernising Tax Administration: Championing Analysis and Specialisms is forthcoming this winter



Has the euro matter now been solved?

The euro zone should consider allowing countries to leave and rejoin, argues Parthasarathi Shome

For the first time, it appears that the European Union (EU) has taken an appropriate structural measure in their recent meeting in Brussels that could allay market fears for a time. They have decided to create, with haste, a €500-billion European Stability Mechanism as early as July 2012. It will be permanent, and perhaps would be able to borrow directly, as needed, from the European Central Bank. In a complementary, confidence-seeking short-term gesture, they also agreed to ask their respective central banks to give the International Monetary Fund (IMF) €200 billion to buttress the €440-billion European Financial Stability Facility. These do represent moves in the right direction, and should enable these institutions to quickly come to the rescue of their ailing members.

What self-imposed belt tightening would the 17-member EU undertake? They have agreed to more centralised oversight and control of the fiscal budgets of individual countries, and possible sanctions for countries that break public debt understandings. Diagram 1 reveals the continuation of higher than trend fiscal deficits in selected EU economies, and the need for correction. However, only time will tell if they would, or could, adhere to agreements this time. Recall that, after all, the Big Two broke the Maastricht Treaty guideline of a three per cent fiscal deficit with

respect to GDP. Regarding a public debt ceiling, Diagram 2 indicates the scale of the problem in 2011 compared to 2007, and the need for rules.

But these rules cannot be designed with a cookie-cutter. A lacuna for imposing a single fiscal rule for all of the EU is that, in practice, economists know well that the same fiscal deficit-to-GDP ratio leads to different multiplier effects in different economies — depending on their particular characteristics, such as trade openness, exchange rate regime, stage of development and others. Despite empirical evidence to the contrary, if the EU decides to re-deploy the generic flawed criterion/indicator that they have already broken in the past, and then expect that Moody's or other rating agencies would suddenly retreat from downgrading some of their economies, it would be fallacy. Instead, the rules would have to be designed for each country through IMF-type programmes. The Fund should revert to traditional financial programming and apply a modified and improved version across the board, rather than being perceived as selective. Clearer signals are needed that the EU too is willing to consider the acceptance of such individually-guided, corrective programmes for its member countries.

The consideration should, therefore, remain on the table that euro zone members that have no realistic

long-run alternative but to severely curtail domestic consumption and lurch into an export-driven recovery might move off the euro and devalue — in the process countering somewhat the undervaluation of selected Eastern currencies. In effect they would be like the UK, being a part of the EU but not of the euro zone. Diagram 3 illustrates selected figures for cross-country balance of payments; it should make obvious where the need for continuing correction lies, even though between 2007 and 2011, adjustments among surplus and deficit countries have indeed occurred.

Once solidly on the path to recovery, the exited EU members should be able to rejoin the currency union equally smoothly. Arguments that such a course — comprising altering membership of the euro zone, and presumably more fluctuations in the currency itself — might cause disruptions in the global trade and payments system is *post facto*. The rapid fluctuations in relative exchange rates with respect to the euro are already challenging lines of credit arrangements and causing discomfort for future, trade-dependent business plans.

The fact that the UK is basically staying out of the newly-reached understandings is a good sign. It should follow its conservative fiscal policies. There should be no surprise that it has been a slow process for it to pick up on the growth rate. The severe belt-tightening that it has opted for is akin to that of Korea, which voluntarily did the same after the 1997-98 East Asia crisis. It served Korea well. If the UK clings to its current fiscal path, it will emerge stronger in the longer term, and with less of a burden on posterity.

In the same vein, any speculative debate over how to resurrect GDP growth quickly is not based on realism since this is not an achievable short-term scenario. Diagram 4 shows recent GDP trends. These economies should be guided to accept that not only has there been a dive in their GDPs, but the future trend GDP growth rates will be lower than past trends for some time to come. How long it will take to get back on the pre-2007 rate path will depend on how much they are willing to tighten their belts and leave more of their product for export. They can achieve this at realistic exchange rates, rather than be seen as continuing to need bailouts. Markets have perceived the short-sightedness of continuing with the previous century's East-West divide in economic ratings, with lopsided prescriptions for correction primarily on one side. Commensurately, rating agencies have become less and less oblivious and forgiving.

A final word. There remains little option for the EU but to infuse confidence among its counterparts in the G20. Their mettle will be proved with the strength of correction that they actually undertake, rather than with their mere agreement to take action. The world can wait until the summer of 2012 — but not too much longer.

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