

**Financial Markets 1, Europe 0**

By the time this article is published, the European winner of the soccer World Cup would be known. In the framing of macroeconomic policies, however, Europe seems to have lost to the financial markets. It is obvious that the fiscal contraction now afoot in most major European economies, involving both tax raises and expenditure cuts, is a surrender to rating companies and bond investors. Policy-makers are still traumatised by what happened in Greece, and are willing to make their people suffer to placate financial markets. It is amazing that this stance is being adopted even when unemployment in the EU as a whole is 10%; when core inflation and hence bond yields (Greece and a few others apart) are as low one would wish them to be.

It is equally amazing that finance capital should have regained its supremacy so soon after its excesses had brought the global economy to the edge of depression less than two years back. People like your columnist, who believe that finance should be a servant of the real economy, not its master, are clearly disappointed. The objective of the fiscal contraction is to make sure that the fiscal deficit, and hence the ratio of public debt to nominal GDP, remain low enough. On the issue of fiscal conservatism, we are witnessing a strange combination on the same side: *laissez faire* economists, Republicans in the U.S., Conservatives in U.K. – and “social market capitalists” in Europe.

It is also a moot factor whether the measures taken would achieve their purpose. For, the tax raises and expenditure cuts would surely lead to a further slowdown, if not recession, in the European Union; higher unemployment; perhaps deflation. Will this combination keep the fiscal deficit, and the public debt, within the budgeted levels – or are the European countries entering into a vicious deflationary spiral? One cannot help recall President Hoover’s fiscal policies in the U.S. (1928-32), and his successor’s in 1937-38, and the adverse impact they had on the US economy.

But Germany remains an exception to the general gloom in Europe. Unemployment keeps coming down, export orders are rocketing, thanks to the cheaper euro, and retail sales are up. Is Germany the real misfit in the Eurozone?

But to come back, the choice before too many western governments is unenviable -- because the opposite course of action can also lead to a slowdown. Consider the cycle -- continued fiscal deficits, higher public debt and inflation, bond markets taking yields higher, and a consequent slowdown in economic activity. Optimists would argue that this may not be inevitable given the very low inflation and unemployment; that bond investors have no option but to buy government paper; that stimulative fiscal policy will lead to faster growth, and lower unemployment; positive but still low inflation; and hence an acceptable debt to GDP ratio. Pessimists point to Japan to come to the conclusion that fiscal stimulation is no guarantee of growth: Japan has had extremely loose monetary and fiscal policies for two decades, without finding a sustainable growth path. (Nor has inflation flared up.)

To me, two things seem reasonably clear:

- ⇒ Growth hides a lot of sins; we ourselves are a good example.
- ⇒ Those with large deficits on current account need to be particularly prudent about fiscal deficits -- directly or indirectly, the savings shortfall needs to be financed by foreign capital; drawdown of reserves has its own limitations, particularly when they are composed of surplus susceptible-to-reversal capital inflows, and not current account surpluses. It was heartening therefore to see the Indian government sticking to its reduction of subsidies on some petro-products. (But more on Indian inflation and subsidies in a later article.)

To come back to G20, one was hoping that the unity of purpose, parallel monetary and fiscal actions, displayed during the height of the crisis, should have continued for some more time. Perhaps one more recession is needed to bring G20 back on track in Seoul.

Meanwhile, the mood in the global equity markets has turned bearish in recent weeks. Most of the indices are down, with little sign of confidence: obviously, money is flowing back to the safe haven of sovereign bonds.

### **Diary of a senior politician**

“One was shocked at the Indian Air Force’s suing former Prime Minister Deve Gowda for money he, it is claimed, owes to the I.A.F. The poor man, it seems, had

used the IAF aircraft for non-official travel, and some rule requires that he needs to pay the costs. This seems absurd. After all, those in public service are surely entitled to, shall we say, a few perquisites – some choice pieces of property; the use of cars and travel and hotel accommodation for his family and friends paid for by a PSU; the use of free aircraft; lifetime security and cars with red lights; etc. If even such petty amenities are to be denied, why should any reasonably able man enter public service? Our sibling Pakistan is so much more liberal and broad-minded – the man known as “Mr. ten present” when his wife was the country’s Prime Minister is now its President!”

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