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Primary Dealer Ltd

5 Nov 2012

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"It is the Politics Stupid!"

Bill Clinton won the 1992 elections based on his famous election campaign line "It is the economics stupid". He based his election campaign on the basis of adopting sound economics principles like lower budget deficit and inflation leading to higher growth and employment. This has been widely used as a case study by economists to suggest that ultimately it is economics that matters. "Good economics means good politics" has become a common phrase for most analysts and policymakers.

This note looks at the recent economic developments around the world to argue how this phrase has mostly turned on its head. The decline in economic activity is mostly a result of political decisions taken either recently or in the past. It is basically a case of supremacy of politics over economics and has always been the case.

Good politics helps bring gains not just in economic but in all walks of life. In this spirit, it is this recent decline in political environment which has emerged as a bigger concern for the whole world.

I. United States

The US political system was so far seen as a matured framework where opposition party did not work as per its literal meaning opposing and blocking everything. It was far more constructive where the opposition would coordinate over key matters with the ruling party. This is no more the case.

One crucial development seen in last few years is rising polarization between the two political parties. In a paper presented at Brookings conference, Jacob Jensen et al estimated polarization between Republicans and Democrats from 19th century onwards. Their findings show that today's level of polarization in public political discourse is historically high in last 30 years. However, polarization was higher throughout most of the last century and a half – with it being particularly high during the New Deal, the tax-debates of the early 20th century, and the political violence of the late 19th century.

The political quibbles over US debt ceiling in 2011 and upcoming fiscal cliff is alarming to say the least. This inability to fix debt ceiling at right time led S&P to lower US's credit rating. This was an unthinkable moment by all means and will be recorded in economic history as a high-shock event. The fiscal cliff debate has got mixed with US Presidential election but is a clear threat. It is bewildering that what is actually a known-known risk has become a known-unknown risk with the two political parties not acting to clear uncertainty over the issue. It looks like it happened in case of debt ceiling where the decision was taken at the last hour; same is going to happen over fiscal deficit issue. The ongoing Presidential debate only points to the trend of widening rift between the two political parties.

Even more interesting is economists claim that US politics was responsible for the crisis. In his widely acclaimed book Fault Lines, Raghuram Rajan explains this linkage. The widening inequality in 1970s forces politicians to think of ways to ease inequality conditions. The ideal

approach would have been to promote more inclusive policies like better education, opportunities for people whose incomes were not rising despite economic growth. However, they instead chose to let people increase home ownership via highly easy credit policies. The banks gave easy home loans, the Government sponsored enterprises securitized most of these housing loans and investment banks invested in the securities created in the process. The foundation of this whole financial process was weak as large part of loans were given without proper income assessment of the borrower. As the business cycle slowed, the whole system crashed because of the massive interlinkages in the system.

Others like Daron Acemoglu of MIT disprove this linkage. He claims that politicians did not respond to the middle class but to the top income class. The financial system was not just deregulated but allowed to indulge in highly risky activities. The crony capitalism arrangement between Wall Street and US Government ultimately led to the huge crisis and Occupy Wall Street movement.

The economists are still debating which side has more weight and finer points are emerging. However, the broad theme of role of politics in creating crisis has come to the centre. Some economists say it is prevalence of government following free market ideology which has led to minimal regulation and hence the crisis. The others say the crisis is not a result of lack of government regulation but because of too much government interference albeit for wrong reasons. These are very different points but political involvement is clearly the key.

II. Europe

The European crisis is even an amazing tale of politics and economics. There are two broad themes here much like the US case. The first is how politics has actually led to the crisis itself. The second is how the politicians have delayed or prolonged the crisis.

The summary of the European crisis is how political ambitions led to inefficient design of economic institutions and thereby policies in Eurozone. The oft-cited criticism is that Eurozone was always an unviable project. The ambition to create single currency Euro was a political project which was given an economic rationale. Moreover, Eurozone was a culmination of many decades of work to integrate European economies.

Post-World War-II, European leaders wanted to avoid any wars in the region in future. They also wanted to challenge the US economic and political hegemony which emerged much stronger post World War-II. Hence apart from polity, the leaders also retorted to economic measures and tried to integrate member economies. The process started from European Coal and Steel Community (ECSC) in 1952 which had six members. The aim of ECSC was to develop a common market in these two commodities amidst its six member economies. The idea was later expanded to European Economic Union covering most goods and services. This process culminated into Eurozone in 1999 with members agreeing to share their currencies and monetary policy as well. The eleven original member list of Eurozone expanded to seventeen members by 2010.

However, the creation of Eurozone was not that straight-forward and was a result of huge political impetus. Post-German reunification, European leaders were wary of rising German power in the continent. There was a need to make Germany a part of a more integrated union

which will then tie the hands of Germans and make them unable to exert their influence on Europe.

Initially, Germans were skeptical of such a union as Bundesbank had built an unimpeachable track record over anchoring inflationary expectations. Hence, there was hesitation to give up Bundesbank responsibility to another central bank. The assurances were given by European policymakers and ECB was modeled much like Bundesbank. Just like Bundesbank, ECB adopted monetary pillar as one of the critical ingredient for its monetary policy. Most developed country central banks had stopped looking at money supply as a parameter for inflation except Bundesbank. ECB was also given a single mandate of focusing on price stability to satisfy Germans of the seriousness of the project.

Germans also understood that by joining the Union they will gain as Euro is likely to be more devalued compared to D-Mark, helping German exports. Infact, this is what happened leading to build up of large imbalances on current account side in Eurozone. Germans exported their goods to the periphery economies and invested the proceeds back into the economies (via capital account flows). This led to large current account surpluses in Germany and large current account deficits in periphery economies.

Economists typically those from US always criticized the formation of Eurozone. It is fine to create a common market and a custom union, but altogether a different thing to share monetary policy and currencies. Economists classify research & discussion on common currency/monetary areas under the name Optimal Currency Area (OCA). Countries have tried creating these unions in the past as well but the discussions became more nuanced post landmark work by Robert Mundell in 1961. In his paper, Robert Mundell specified four conditions for an OCA:

- **Labor mobility across the region:** This includes physical ability to travel to any member region and lack of cultural barriers to free movement.
- **Capital mobility and price and wage flexibility across the region:** This is so that the market forces of supply and demand automatically distribute money and goods to where they are needed.
- **Similar business cycles:** It is easier to implement monetary policy in case regions/members face similar business cycles. Hence, when regions grow together leading to higher inflation, the common central bank can raise rates and vice-versa when the cycle reverses. In case of different business cycles or heterogeneous regions, this becomes a difficult task for the common central bank. If some regions are booming and others declining, central bank will be unsure of its action.
- **A fiscal agency to provide transfer mechanism**: This is a very critical and important ingredient for a monetary union to be effective. It redistributes money to areas/sectors which have been adversely affected either by first three characteristics or an economic shock. Even if the first three conditions are not met and members are gradually moving towards optimality, a fiscal transfer agency can iron the differences. For instance, it is difficult to find regions which will share similar business cycles. However, transfers from a fiscal agency can help in case there are asymmetric shocks.

  Though this characteristic is loosely labeled as central fiscal transfer agency, in reality it is nothing but having a proper government structure. It is much like any state economy

which could be either a federal or unitary structure. Under both there is a central government which collects larger share of revenues and distributes the proceeds to lower levels of government.

So most nation economies typically have this structure where you have one central bank which forms monetary policy for the whole region. And there is a central/union government which provides resources to the other states.

However, in case of Eurozone there was no such fiscal transfer agency. Infact most above conditions were absent barring capital and trade mobility. European institutions were established via several treaties and sovereign governments continued to maintain their respective budgets.

The idea of making a monetary union functional without any kind of fiscal union relied on discipline. There were efforts to increase mobility in other areas like labour etc but remained limited as cultural gaps between member economies were wide. On fiscal front, it was understood that single monetary policy could only be effective if members maintained fiscal discipline. Hence, members agreed to limit deficits under the Stability and Growth Pact (SGP). Under this members were expected to keep their debt levels at 60% of GDP and deficit at 3% of GDP.

However, again political discretion ruled over rules. The principles of SGP were first violated by the leaders of the union viz. Germany and France in 2003. SGP framework was weakened to allow Germans and French to violate SGP without getting penalized. This led to surge in moral hazard in the zone and led Greece and Italy to remain in the zone despite having public debt more than 60% of GDP. Apart from deficits, current account deficits also widened significantly in periphery economies which were financed via flows from core economies. This led to some economies having large twin deficits in the Eurozone.

As the crisis struck in the Eurozone the deficiency in the currency union arrangement came to the fore. First, there was no fiscal agency which could transfer the resources to the troubled members. Second, the burden came on to European Central Bank for which it was neither prepared nor designed. ECB's mandate as per the treaty is to focus on price stability and prohibits deficit financing. Hence, ECB was highly reluctant to buy government bonds. The criticism was on both counts, for expanding ECB balance sheet and buying bonds of selective governments. There was huge dissent particularly from German policymakers and public over ECB policies. This even led to resignation of Axel Weber from Bundesbank and Jurgen Stark from ECB protesting against bond buys by ECB. Even the recent chief of Bundesbank Jens Wiedmann has expressed his dissent over ECB bond buys and threatened to resign from Bundesbank board.

As the crisis intensified, we have seen both delayed and inefficient responses to address the crisis. There have been more than twenty European summits since the crisis where leading policymakers from the Union have tried to work around a solution to ease the impact of the crisis. Most summits have proposed certain solutions (fiscal compact, fiscal and growth compact, Eurobonds etc.). The markets react to the news favorably for some days and then correct later on realizing the difficulty in implementing the proposals. Prof. Henry Farrell a political scientist at George Washington University terms European solutions as fudges. These

fudges are incomprehensible to the outside world but get some minimum consensus among member states. So initially markets react favorably and then decline once they understand the fudge.

The economic crisis is pushing policymakers into taking some tough political decisions in Eurozone. The fears of economists which had warned against the Eurozone have indeed come true. To form a monetary union of highly heterogeneous economies without any safeguard mechanism was a clear recipe for disaster. However, political forces chose to ignore the basics. The Union worked well for a couple of years but met with a stiff test within 10 years of formation of the union.

Interestingly, European Union was recently awarded the Nobel Peace Prize for 2012. The Committee awarded the prize "for over six decades contributed to the advancement of peace and reconciliation, democracy and human rights in Europe". Needless to say this has invited huge criticism. The recent economic crisis has led to wide discontent and disharmony amidst the European citizens. It has become North Europe vs South Europe. North has large and stable economies in the zone like Germany, Netherlands etc and latter have troubled economies like Greece, Spain, Portugal etc. Citizens in North Europe feel they are being victimized and forced into saving their southern counterparts. Those in the latter are disappointed with their Northern neighbors for imposing steep austerity onto their people. The surveys have pointed that European people believe lesser in the idea of Europe and relate more to their national ideas. Some experts opine that perhaps the idea of the union has failed with the crisis.

This again emphasizes on importance of getting the political system right. The political integration process did not move along with economic integration leading to wide differences as crisis broke out.

III. Other Countries

In developing countries like China and India too, political concerns have fed into economic crisis. China provided large fiscal stimulus post the 2008-09 crisis via its banking system to the local provinces. The stimulus was successful initially but has created problems lately as economic growth has slowed down leading to large NPAs in banking system and troubled balance sheets of local provinces. The top down push by the government post-crisis has emerged as a serious risk for the Chinese economy. And all this is happening at a time when the leadership is going to be passed into new hands in China. All this is creating huge nervousness with respect to state of Chinese economy and its probable impact on world economy.

In India, the situation is turning to be a very interesting one. Coalition politics has been a way of life for Indian politics since 1967 when the hegemony of Congress Party was broken in several states. In a large country with such heterogeneous populations with different interests, coalition politics has emerged as the only solution. This leads to problems while pushing any economic reform as some or the other member partner threatens to quit. This has been the story of India's economic reforms for the past decade which has frustrated both investors and citizens. In last year, several corruption scams have broken out worsening the market

sentiment. In last few months, government has taken some stern measures to reverse the market sentiment which showed some immediate gains in form of FII inflows and rise in equity prices. It clearly highlighted the importance of taking proper political decisions.

There are some other interesting examples as well. Japan is a surprise choice in the list as its political crisis is rarely discussed with focus remaining on the economic crisis. Since the crisis broke out in 1989, there have been sixteen Prime Ministers till date. Even post 2008-09 crisis, there have been four prime ministers each lasting an year. In Japan, the term of service for Prime Minister is four years if he/she is a member of House of Representatives and 6 years if a member of House of Councilors. However, barring Junichiro Koizumi (2001-06) none of the Prime Ministers have served their full terms since the crisis. It will be interesting to extend the scope of lost decade in Japan from pure economic reasons to political ones as well.

IV. Final Thoughts

Economists try and stay away from political reasoning. The idea is that as economists we should not let political views color our analysis and influence economic policy. This is ideal but takes the entire discussion away from reality. In the early years, economics was indeed taught as Political economy where students debated and reasoned economic theories within a political framework. Studying political economy also helped students learn about history which shaped certain economic institutions and decisions taken by the same institutions. However in recent times politics has been distanced from economics and students learning is centered only around economics.

The recent crisis has certainly pushed discussions in this direction. Research on political economy has started to pick up and some university economic departments are even looking at reintroducing history and politics in their economics curriculum. This does not imply economic students should let political science take over economics. It simply means to understand the broad political contours under which economic policies are framed.

Daron Acemoglu (of MIT) and James Robinson (of Harvard) have recently released a book – Why Nations Fail. This book looks at multiple countries and time-periods to understand why some nations succeed and others fail. The central lesson which emerges from their work is that it is basically political institutions which shape the destiny of a country. The more inclusive the political institutions are higher are the chances of inclusive economic development. This book has received huge attention and invited discussion from economists and policymakerson both for and against the book findings. In the process, the attention has been brought to importance of understanding political system of a country/region.

Last twenty years or so have been seen as a victory of the economy over the polity. Hence, "It is the economics stupid" made up a smart advertisement line for Clinton's election campaign. The reality is it was the political administration which made certain economic policies which resulted in favorable macroeconomic environment. The economic policies in turn were made either on account of political vision or political compulsion (because of crisis in their respective nations). Perhaps politics worked in background and has emerged again at the forefront post crisis. Politics has always played a central role in determining fate of nations/economies and is expected to continue to play a role in future as well.

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