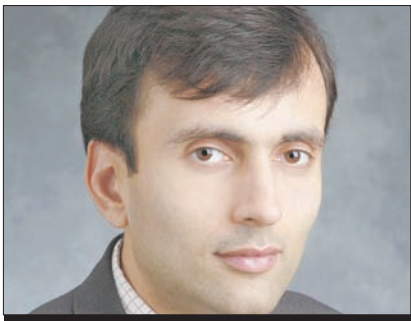


The downside of stimulus

The realisation that all the money injected into the system has not found the right home is spreading from Beijing to Washington



Ruchir Sharma

WITH the market fireworks of early this year now fizzling like bottle rockets on a damp day, many investors are wondering how the environment changed so suddenly. After all, the widespread expectation at the start of the year was that rallies in most asset classes from stocks to commodities would continue for a while longer on the back of a recovering global economy. Policymakers were hailed for saving the world from a Great Depression redux through their stimulus efforts. However, the realisation that all the money injected into the system has not necessarily found the right home is now spreading from Beijing to Washington.

In emerging markets such as China and India, economic growth has indeed rapidly returned to trend but inflation is resurfacing much too early in the economic cycle. Meanwhile, in developed countries such as the US, frustration is growing over the rather mediocre recovery that is only benefiting a privileged few despite the explosion in government spending.

Cracks in the Keynesian script of stimulating your way back to prosperity have been widening over the past months. An extraordinary jump in prices of commodities from oil to copper in the face of rising inventories was a major troubling sign. The sharp appreciation in commodity prices began well before the global recession ended in the second quarter of 2009 due to a surge in paper rather than physical demand. Financial investors poured more than \$50 billion into commodity funds in 2009 — more than three times the average annual pace in the 2003-07 boom years — spurred on by excess liquidity in the system and due to a loss of confidence in paper money, preferring 'hard assets' instead.

The rise in commodity prices is self-limiting beyond a point, as it damages global economic growth. Oil and food prices typically do not increase meaningfully at the early stages of an economic upturn because enough excess capacity from the previous cycle satisfies incipient changes in demand. This allows inflation to remain low and central banks to maintain an accommodative monetary policy stance. In the current cycle, commodity price-led inflation is forcing many emerging market central banks to tighten monetary policy prematurely. It is no coincidence that the selloff in financial markets began following China's decision to raise the reserve requirements on its banks in mid-January.

Market bulls argue that it took a similar action in early 2004 and after a few months of volatility, the Chinese and the global economy were again firing on all cylinders. They forget, however, that the global economy was on a much stronger footing then. In fact, a surge in exports boosted China's growth later in 2004 even as domestic demand took a while to recover from the monetary tightening. This time around, the world is looking for China's import demand to be the saviour.

Furthermore, inflation was not an issue in 2004 in many other emerging markets as commodity prices had not risen so violently. Oil was trading below \$50 a barrel and food prices outside China were stable for much of that year. Many economic observers overlook the fact that at \$75 a barrel, oil is back to where it was at the peak of global industrial activity in October 2007; the price of oil has made its way back up

more due to liquidity-driven speculative fervour rather than genuine demand.

Apart from being inflationary, higher oil prices are a tax on growth. Estimates show that every \$10 increase in the price of oil shaves off 0.3% from US GDP growth. As most models put the fair price of oil closer to \$50 a barrel — given the prevailing trend in consumption and inventories — the current \$25 'liquidity' premium is cutting a percentage point from US growth. While higher oil prices are not on their own a burning issue in the US today, they add to the angst of the average consumer who is anyway worked up by the shallow recovery that all the stimulus has achieved, with overall unemployment still close to 10% and wages unchanged.

As a result, a near-revolt is underway against the stimulus policies in the US. One of the main reasons why George W Bush lost the support of a part of his Republican base as well as some in-

no government intervention.

However, the faith in the purging power of the market went too far in the 1930s, when the policy mix of tight money and high taxes remained in place well after the excesses had been wrung out of the system. The result was the Great Depression. Parallels drawn to the 1930s following the 2008 meltdown brought on the impulsive reaction by policymakers to do everything possible to bail out the economy. In doing so, they may have swung to the other extreme by not allowing a cleaning of the rot and legitimising a part of the preceding debt binge. Research from the firm Ned Davis shows that it has taken over \$5 of debt to produce one dollar of US GDP over the past decade compared with \$3 in the 1980s and 1990s and an even smaller \$1.50 on average in the 1950-80 period.

Japan too tried to prop up its economy through massive fiscal spending and various bailout pack-



SALAM

DIMINISHING RETURNS

Research by Ned Davis shows that it has taken over \$5 of debt to produce one dollar of US GDP over the past decade compared to \$3 in the 1980s and 1990s and an even smaller \$1.5 on average in the 1950-80 period

Date Range	Decade Change In		
	Debt (\$ B)	GDP (\$ B)	Debt/GDP
1949-1959	337.6	248.0	1.36
1959-1969	752.1	491.4	1.53
1969-1979	2,785.2	1,655.9	1.68
1979-1989	8,563.7	2,923.8	2.93
1989-1999	12,565.7	3,935.2	3.19
1999-2008	26,390.5	4,893.3	5.39

Source: Ned Davis Research

dependent voters in his second term was due to his failure to rein in government spending. At 40% of GDP by 2008, total US government spending as a share of the economy was at its highest level in post-war history. The anger against the rise in government spending has spread further under the Obama administration, with his \$800-billion stimulus package only adding to the mounting debt load without yielding any real widespread benefits.

One of the less-understood aspects of the fiscal and monetary stimulus is that it ends up protecting the inefficient and well-connected players instead of ushering in renewed vigour in the economy. Some sort of a Darwinian flush is necessary after a long boom to clear the ground for a fresh crop to emerge. Capitalism draws its dynamism from a natural clearing mechanism. Allowing boom-bust cycles to play out served the US economy well during the downturns in the 19th century; it emerged stronger each time with

ages over the past two decades following the end of the 1980s debt-financed boom. That led to an increased share of the government in the economy and an associated decline in productivity. The US was headed for the same fate but the one key difference could be that the US is by nature less of a socialist society than Japan or Europe and does not like too big a role for the government.

The message the US electorate has started sending to the incumbents in Washington is that it has had enough with all the wasteful government spending and will lean toward candidates more focused on fiscal rectitude and smaller government. This was evident in last month's surprise election victory of Republican candidate Scott Brown as the senator from the traditional Democrat preserve of Massachusetts.

Two-thirds of US voters think the stimulus spending is ineffective, according to opinion polls. Small businesses, which employ nearly 60% of the US workforce, say they are not hiring new workers amid concerns over a hike in taxes in the future to finance the mounting debt load. The declining popularity of the Obama administration is mainly because he is coming across as an old-fashioned, big government liberal.

When the global economy was in crisis, policymakers could easily justify all the proactive government action as necessary measures to stave off a complete collapse. Now that it has stabilised, attention has turned to the effectiveness of the stimulus. Unfortunately, the negative aspects are surfacing: ranging from commodity price inflation in emerging markets to the lack of a big bang for the enormous bucks spent in the developed world. A withdrawal of the stimulus may lead to some fresh pain in the short term, with the latest global market selloff reflecting that risk. But it could well clear the deck for a more sustainable, inclusive and organic upturn to materialise in the medium-to-long term.

(The author is head of emerging markets at Morgan Stanley Investment Management)

On the bright side, the withdrawal of stimulus could clear the deck for a more sustainable, inclusive and organic upturn to materialise in the medium-to-long term