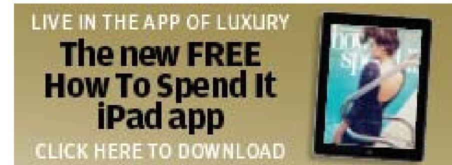

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2012 elections portend even greater volatility

The end of 2012 will mark a once in 20-year overlap of a presidential election in the US with a leadership transition in China. France also chooses its president in the spring of next year, Germany its chancellor later in 2013. Unfortunately, election year pressures threaten to complicate an already very difficult and unpredictable policy dynamic, particularly as the European crisis goes from bad to worse.

Ordinarily, a prospective clumping of elections might portend a classic political budget cycle. Anxious to please their constituencies, governments would be cutting taxes, raising transfers, and boosting spending on particularly visible projects. Their largesse would be financed not only by higher deficits, but also by deferring expenditures with less immediate visibility, and by levering the government balance sheet through off-budget loan guarantees and other non-transparent mechanisms. In earlier times, particularly before the advent of central bank independence, election year interest rate cuts might also be expected. The central bank would be timing stimulus so as to maximally impact pre-election output and employment, while hoping that the main effect on inflation would come later.

The late US president Richard Nixon is perhaps the all-time hero of political budget cycle researchers. In his 1972 re-election campaign, famous for the Watergate scandal, Mr Nixon left no stone unturned when it came to turbo-charging transfers, spending and growth. He doubled social security benefit increases, and browbeat Federal Reserve chairman Arthur Burns into significantly increasing the money supply. Indeed many monetary scholars

regard Mr Burn's 20 per cent plus pre-election increase in the money supply as the real culprit for the inflation of the 1970s, not the Opec oil price increases as is commonly assumed.

It is a different story today. The world is still very much gripped by the aftermath of the financial crisis. The orgy of post-financial crisis spending and deficits has left both the public and investors wary of further red ink. More importantly, the prolonged period of slow growth has dramatically weakened incumbent governments. Few are commanding the kind of majority needed to engage in a Nixonian political budget cycle, even if it were desirable. Indeed, as highlighted both by this summer's debilitating debt debate in the US, as well as by Europe's continuing struggle with periphery insolvencies, macroeconomic policy is much closer to being paralysed, than to being manipulated.

In normal times, any dynamic that shut down the political business cycle might well be interpreted as a plus for longer-term stability and growth. But the risk of partisan political paralysis in the face of a potential euro crash is another matter. Imagine, for example, that US growth collapses so severely that once again a major financial company finds itself on the brink of bankruptcy. Will the Fed and the Treasury be able to prevent a full-scale panic and systemic collapse in a timely fashion? Perhaps, but pre-election paralysis might make the task even harder than it was in 2008, particularly thanks to Dodd-Frank legislation aimed at preventing bailouts.

There is a presumption that China has both the will and the means to react forcefully to any global growth crisis, as it did in 2008. Having raised reserve requirements to over 21 per cent for the largest financial institutions, its central bank has ample scope for monetary easing. But even in China, the scope and timing could be complicated by the delicate dance between an outgoing government interested in ending on a strong note, and an incoming administration that may want to front-load badly needed rebalancing of demand.

In theory, central banks ought to be relatively immune to electioneering. In practice, however, central bank independence has its limits. The Fed has already come under severe political pressure from Republicans wary of further easing measures. It can resist such pressures, but it can hardly dismiss them. Congress ultimately controls over the Fed's mandate and the president controls the appointment of governors. Given the highly skewed risks now facing the economy, it is absurd to be worrying excessively about a 1970s-style stagflation, though some continue to do so. The risks of a Japanese-style lost decade or even a second Great Depression are far more

immediate. The Fed has very limited tools at its disposal, yet pre-election political pressures are constraining even these.

Similarly, the fact the European Central Bank has not already cut interest rates to zero reflects far more the need to preserve a semblance of independence than a sober calculation of the balance of risks. If the eurozone ultimately becomes unglued, will anyone care that during euro's brief life, inflation expectations remained firmly anchored about 2 per cent?

The US, Europe and China all have big decisions to take over how their economies and societies are to be shaped in the future. If existing or new leaders emerge from the upcoming elections with a clear mandate, perhaps we will see the kind of structural reform that will help growth and stability over the longer term. But if the overhang of elections exacerbates paralysis around difficult policy decisions, it will create huge potential for amplification at the worst possible time. Even under the best scenario, 2012 promises to be a year of even greater politically-induced volatility than 2011.

The writer is professor of economics at Harvard University and co-author with Carmen M Reinhart of 'This time is different'

Back to top