The Global Economic Meltdown

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The Global Economic Meltdown

Perspectives from India and EU

Editor

JAYSHREE SENGUPTA

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Foreword

The global financial crisis (GFC) of 2008, which marked the most severe economic downturn since the Great Depression, shook the very foundations of the global financial system. The events, beginning with the mortgage crisis in the US, snowballed into a recession so deep that even four years later, any musings on recovery spawn equal speculation about a double or a triple dip recession. A combination of high risk lending by banks, regulatory failure, poor surveillance mechanisms, inflated credit ratings and investment bank abuse set off a chain reaction leading to a prolonged global economic slowdown that has now brought the Eurozone to the precipice.

The ripples of the GFC were not limited to the global economic system. The crisis brutally exposed fundamental shortcomings in the governance and regulatory structures of some of the most powerful governments in the world. And this was when, for the first time perhaps, in the aftermath of 2008, powerful state actors confabulated and coordinated with each other to bring in some of the most aggressive financial interventions ever seen in the history of the world. Governments across the world struggling to stabilise economies wracked by deep systemic uncertainty, seemed prepared to throw everything they had at the problem. Despite all these interventions however, the year 2009 saw the first decline in the global GDP since 1946, i.e., the end of World War II. Even today, as we listen to the news flow coming out of Europe as well as other parts of the world, the worst may be far from over.

In the immediate aftermath of the crisis, national governments rushed in with stimulus measures to relieve the pressure on their economies and compensate for a reduction in aggregate demand. The United States (US) intervened to rescue faltering financial institutions whose collapse would have had catastrophic consequences for the world economy. Developing countries like India stepped in with packages that targetted systemic social inequity and structural imbalances, correctives that would eventually feed consumption led growth.

Even as the first waves of the global tsunami reached Indian shores, the fortuitous effects of programmes like the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA), Jawaharlal Nehru National Urban Renewal Mission (JNNURM) and National Rural Health Mission (NRHM) were beginning to kick in. These together with loan waiver packages served in many ways to counter the immediate fallout from the global crisis. Enhanced social spending and investments in infrastructure growth were glibly seen as solutions that would help steer the country back to the nine per cent growth that by now seemed a birthright.

Global growth trends in the immediate aftermath of the crisis seemed to substantiate this outlook. The decline in the global GDP in 2009 was far from universal. Within the doom and gloom, in spite of the much vaunted interconnectedness of the global economic system, there seemed to stand out islands of unencumbered prosperity—economic powerhouses like India and China that continued to sustain very high levels of growth. It should come as no surprise then, that the mood in this part of the emerging world begun to turn self-congratulatory.

Four years on, the same economies are no longer so sure. Self-congratulation has given way to self-doubt. The crisis that hit in 2008, not only continues to retard growth throughout the world, but developing economies that previously thought themselves to be crisis-averse are now experiencing the tsunami. Clearly, global recovery is going to be a far longer haul than had been imagined in 2009. Iceland, Greece, Spain, Portugal, and other countries that are teetering on the precipice, are only symptoms of a deeper malaise.

Threatened by financial turmoil and facing serious political dysfunction, leaders across the world in general, and Europe in particular, are feverishly scrambling for a political and economic resolution. However, the fixes remain the same as they continue to bail out banks first, then member states to shore up their economies in the hope of avoiding a sovereign debt crisis. The US, where the problems began in the first place, seems better off for the time being. But that may be true, however, only in relative terms. In spite of having unearthed huge quantities of shale resources, bringing the country the advantage of the cheapest energy anywhere in the world, it still remains vulnerable to shocks in the prices of volatile commodities such as oil, and troubled by the continued weakness of the European markets. Countries that have so far managed to avoid the worst of the recession are now suffering as prolonged sluggish growth in Western economies—one of their most lucrative markets—takes a toll on their growth rates.

The Organization for Economic Cooperation and Development (OECD) has cut the forecast for growth in developed countries for 2012. The International Monetary Fund (IMF) predicts that the global economy will grow slower than the 3.9 per cent it clocked in 2011. Developing countries like India and China are now experiencing post-stimulus withdrawal symptoms, inevitable after the unprecedented amount of financial support—akin to a steroid overdose—injected into their systems. The Indian economy grew a mere 6.5 per cent in the last fiscal year, down from 8.4 per cent the year before. In fact, the last quarter saw growth slow down to just 5.3 per cent. Even China, whose annual growth rates had consistently been the envy of the world, is now experiencing a slowdown. In March, a far more sober government lowered its growth target to 7.5 per cent, from a long-term average of 9.8 per cent.

There were commentators who had actually begun complementing India for its traditionally conservative policies buttressed by painfully slow decision making, as if those had in some mysterious way permanently inured Indian institutions from the boom and bust models and bubbles that plague its Western counterparts. To some extent, financial institutions that were not fully integrated into the global financial markets did serve to shield domestic markets from the worst of the immediate fallout. However, as is increasingly apparent now, India is so deeply dependent on foreign direct investment (FDI) inflows to finance its structural trade deficit, that it could scarcely have been expected to outrun a crisis of this magnitude. Consequently, the hope that China, along with India, and others, would finally strut the world stage as global saviours in the wake of the resilience displayed by their economies immediately after the crisis proved to be short-lived.

Today, with much of that optimism gone, there are questions about the sustainability of transfer schemes that do not result in self-sustaining economic ecosystems that can be independent of continuing handouts from national and provincial budgets. The time has come to evaluate the durability of an 'inclusive growth' model that seeks to address inequity—a long-term commitment—with measures that last only as long as the government is able to provide short-term stimulus funds. The fundamental question which needs to be addressed eventually is: Are these programmes financially sustainable or are they simply transfer schemes? Do they create a viable self-sustaining mechanism or will it simply be another temporary entitlement programme that provides short-lived relief? Are such schemes simply vestiges of self-serving feudal impulses that exploit the skewed power dynamics between the giver and the taker, the donor and the recipient under the banner of a nominal democracy? Simply stated, inclusiveness in the long run is not about giving the man a fish, but in teaching him how to fish.

On the other side of the divide there are legitimate questions being raised about the rationale for bailing out institutions, banks and even countries. Why should millions living in poverty see global funds diverted to resuscitate failed systems and nations and ensure that they are able to continue to maintain the unsustainable practices and privileged lives that led to the global collapse in the first instance? Why should funds be committed in the absence of any real political will to bring in regulation, oversight and surveillance?

Finally, there is the other overarching debate that seeks to call for a new economic model, indeed a new basis for the financial order. Is it not time to relook at the fundamental economic design that emerged from the Washington consensus? Is it not time to finally question models of growth that depend on insatiable consumption on the one hand, and unsustainable saving regimes on the other, representing as it were the two poles that become the axle upon which the global economy moves?

This publication seeks to capture some of these key debates and more. It is unique as it approaches the crisis from a global perspective, with pieces focussing on India, Europe and the US. The writers in this compendium address the many complexities of the GFC and present a holistic overview of its background, how it unfolded and how many sought to respond to it. The book provides a thorough overview of the economic, political, environmental and social implications of the crisis and offers glimpses of the road ahead, replete with policy recommendations for a more stable and prosperous future. I want to congratulate the institutions and individuals who have produced this vital scholarly contribution that would be of much interest to students, academics and policy makers around the world.

Sunjoy Joshi

Director,
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Introduction

The papers in this volume based on the global financial crisis that began in 2008, were originally presented in two seminars, one held in Berlin in June 2009 and one in New Delhi in November 2010. Many international issues were taken up but the impact of the crisis on India and Germany were the main focus.

India was spared the worst effects of the crisis because its banks were not linked too closely with foreign banks and derivative trading was in its infancy. The real economy is sufficiently decoupled from the financial economy. However, the problems posed by the crisis have turned out to be of a different structural nature than in developed countries. Growth has picked up since the crisis, but so has inflation.

In India, the government failed to curb the strong inflows and outflows of hot money which led to the hardening of the rupee and exacerbated the troubles of the export sector. Liquidity tightening measures have been applied since April 2010. Social sector spending was also raised in Budget 2010 and the National Rural Employment Guarantee Scheme for giving 100 days of employment to the poor, helped in rural areas in providing a veritable fiscal stimulus. In her paper "The Global Financial Crisis and India", Jayshree Sengupta points out that a huge stimulus package was given to boost demand and it did provide some measure of relief to the export industries and the corporate sector.

Many explanations have been offered for India's relative resilience to the after-effects of the crisis. M.K. Venu in his paper "India after the Global Economic Crisis," suggests that India's strength lies in having robust rural demand. India's exports also turned around after a few months of the global crisis and forex reserves expanded although capital flows continued to be erratic. On the whole, the banking sector remained insulated as India, according to him, does not have the kind of structural weakness (or strength depending upon the interpretation) characterised in the Western economies. The global crisis has merely shifted the excessive debt from household and bank balance sheets to government account logs.

Exploring reasons for the genesis of the crisis, Mario Candeias has suggested that the crisis was the result of a slow over accumulation—a molecular change developing over the years. The crisis which started with subprime mortgage lending led to direct payment defaults that accumulated in this area at the outbreak of the crisis in 2007 and added up to $45 billion but which, through speculation, turned to a huge amount of $62 trillion. Euro area also has debt of over 80 per cent of GDP and there is no prospect of overcoming the crisis without reregulating financial markets and rethinking the current taxation policies.

Fabio de Masi, in his paper "Europe: To Be or Not To Be", suggests that the basic lesson from the Euro crisis is that liberalisation of capital flows work only in conjunction with institutional and symmetrical economic cooperation otherwise monetary autonomy is not collectively improved but undermined via 'beggar thy neighbour' policies.

In his paper "Currency War *versus* Monetary Cooperation", Fabio de Masi argues that monetary cooperation is superior to unilateral solutions through monetary policy. According to him economic policy has to restrict the movement of capital since monetary policy can only (temporarily) affect the output of an economy under flexible exchange rates or if the free movement of capital is restricted.

In his paper "From Financial Crisis to Depression and Deflation", Hansjorg Herr points out the dangers of deflationary process following a financial crisis. This happens when the nominal wage anchor cracks and nominal wages begin to sink. Historical experience with financial crisis indicates that a massive shrinking of aggregate demand is to be expected while a sharp recession and high job losses may also be likely. A dramatic reduction in demand tends to be accompanied by additional heavy losses in income and production. The spiral of income and job losses continues its downward spin and the market mechanism leads to a deeper and deeper crisis. He proposes an increase in state expenditure which he considers to be better than lowering taxes.

In her paper "Current Crisis, European Union", Judith Delheim suggests that systemic change is needed to overcome the economic crisis and to incorporate environmental restrictions and social responsibility into the overall economic process. She suggests the concept of 'sustainable consumption' which should be redefined to include achieving and maintaining a dignified life in times of scarcity.

Redefining is a social process and so is realising sustainable consumption. Building upon similar arguments in his paper "From Exportism and Growth Fetish", Mario Candeias proposes a participatory need for a centred, solidarity based, 'care economy'; where people care for each other and have access to social infrastructure like public health care, education, research, social services, food, sovereignty and protection of the environment.

In their paper "Deconstructing India's Inclusive Development Agenda", Samir Saran and Vivan Sharan discuss three national flagship schemes for inclusive growth in India. The schemes have been examined from the point of view of an organically defined inclusive growth framework. They found none of the Indian flagship programmes are wholly inclusive. The National Rural Employment Guarantee Scheme scored relatively well on their metrics. According to them, the lack of political will to lay a stake in the country's long term growth is worrying. Huge fiscal transfers to the real economy occurred due to the big rise in government expenditure on these programmes. Government spending on infrastructure however has helped India whether the Indian Government has a long term exit strategy that ensures that the flagship schemes have enough momentum to become self-sustaining and productive—the two essentials of inclusive growth.

Whatever frameworks the new global order moves towards, sustainable economic development will have to be at the forefront of the global growth agenda. There is broad based consensus on this premise for growth and development, throughout the papers published here. Policy reforms through peer learning and mapping experiences are certain to play a big role in achieving this objective.

1 The Global Financial Crisis and India

JAYSHREE SENGUPTA

The impact of the global financial crisis (GFC) was first felt in India in September 2008. This paper takes the economic and social point of view and examines the impact of the crisis on the various sectors of the economy, namely:

a) exports;

b) industry and services;

c) agriculture and

d) infrastructure.

It also offers an analysis of the Indian government's response to the financial crisis. Such will be analysed with reference to the following:

a) the 'stimulus package';

b) monetary policy;

c) trade policy, and

d) social sector policy.

The paper concludes with specific recommendations, including about the need for regulation and reforms in the post-crisis scenario.

Background

The GFC, which originated in August 2007 in the US took a more severe form with the collapse of the global financial services firm, Lehman Brothers, in September 2008. The world financial system was shaken. India, however, was spared any dramatic impact. Analysts say that this was because despite India's own forays into globalisation, the extent of its openness and dependence on exports was relatively small. Indian banking institutions have had limited exposure to either the US mortgage market directly, or through derivatives or 'toxic' assets to the failed and stressed international financial institutions. India has also maintained relatively strict regulatory policies on its domestic banking sector and the foreign banks operating from India. It has also not fully opened up the capital account.

Of course, the crisis did have some amount of negative impact, especially at its onset. The recovery process has been quicker, however, than in most other countries which were severely affected. India's exports and financial sector were on track to rebound by the end of 2009.

The two large emerging economies, India and China, did not experience a beating as severe as the developed countries because the former had less exposure to derivative trading and loosely regulated financial markets. India's credit derivatives market is still in its embryonic state, and the banking system, is sound: well capitalised and prudently regulated. Restrictions are in place on investments by residents in derivative products issued abroad, and regulatory guidelines on securitisation do not permit immediate profit recognition. The challenges are varied and can be seen as coming from increased capital flows with ramifications on monetary growth, inflation, and also in the exchange rate uncertainty along with its policy implications for the capital account.

From the end of 2009, India's economic recovery has been broad-based, with various industries registering impressive growth: for example, mining, quarrying, manufacturing, electricity, gas and water supply. The government was able to successfully generate demand by various means, such as the release of 60 per cent of arrears of the Sixth Pay Commission in September 2009. This led to a significant pick up in the growth of community, social and personal services as well as to an increase in demand for consumer durable goods.

There were, of course, shock waves when the crisis first hit India. The government soon came out with an assessment on whether it would cause any damage to the banking system. The government stated that most banks were safe and sound, and exposure to 'toxic assets' was confined to only one or two banks. Thousands of jobs, however, were lost in the export sector in the months following the crisis and the financial sector served to transmit the crisis to the real estate sector.

The country's stock market also fell immediately after the global crisis. The 30 share BSE Sensex dropped by 1982 points in October 2008. It had also tanked sharply in January 21, 2008 when the global crisis was in its initial stages by 16 per cent and had shed 1,430 points. Such shock was relatively lower in scale as India's stock markets are not fully globalised and the volume of trading is smaller compared to those of other emerging market countries. A large majority of Indians do not participate in equity and asset markets, thus the negative impact of the wealth loss effect that plagued the advanced economies was quite muted.

The overall impact of the crisis on the Indian economy was first evident in the shrinkage of GDP growth, falling from 7.8 per cent in the first half of 2008-09 to 5.8 per cent during the second half of the year. Growth improved to 6.1 per cent in the first quarter of 2009-10 and to 7.9 per cent in the second quarter. By the beginning of 2010, the country's industrial health seemed to have improved considerably and industrial growth began to rise to double digits.

Yet problems have remained. Consumers feel the pinch of food price inflation, triggered partly by the monsoon deficit in 2009 as well as by the the government's stimulus package and liquidity injection into the financial system.

According to a recent report from the UN Department of Economic and Social Affairs (UNDESA), the 2.1 per cent decline in India's GDP growth has effectively translated into a 2.8 per cent increase in the incidence of poverty. According to UNDESA's *World Economic Situation and Prospects 2010*, around 19 to 40 million people became poor that year in South Asia alone. In India, the report estimated that an additional 13.5 million slipped into poverty.

In India, most job losses occurred in 2008; there was a net addition of jobs towards the end of 2009. This is based on the information collected from 2,873 units covering 21 centres spread across 11 states and union territories, in which eight sectors were covered. There has been a net addition of 1.15 lakh workers to the eight industries studied from October 2008 to September 2009 (*Economic Survey 2009*).

Many economists share the view that since India did not contribute to the global financial imbalances, it was not responsible for the crisis that emanated from the US. The extent of the fall in consumption demand in India has also been much less after the crisis than in western countries where huge income losses resulted in the shrinkage of demand in the post-crisis period.

While there is evidence of a rise in income inequalities in India since the crisis struck the country, there has not been any evidence of a strong deficiency in aggregate demand in the domestic economy. Most of the domestic trade has been financed by domestic savings, although trade and financial linkages between India and the global economy have increased significantly in the past few years.

The economic slowdown was caused no doubt by the impact of the crisis. But the Indian economy began to slow down in early 2007, much before the global crisis started. After growing at around nine per cent around 2002-2007, it began to slow down in late 2007 and 2008. The crisis came at a time when the slowdown had already begun.

The main problem in August 2008 seemed to be 17.8 per cent inflation due to the sharp rise in the price of crude in July 2008 to $149 per barrel, and a steep rise in the prices of minerals and metals. Food inflation started at that time and was pegged at 11.4 per cent.

The government responded to the crisis phase with a tight monetary policy pronouncement from Reserve Bank of India (RBI).

Openness of the Indian Economy

The GFC's impact has been felt in India mainly because of the greater degree of integration of the Indian economy with the rest of the world since the 1990s, when it began to open up and launched its era of economic reforms. While the degree of openness is lower than in many other emerging market economies, India's exports and financial flows still felt the negative ripples.

India's integration with the world economy is evident in the following:

- Ratio of current receipts and gross capital outflows to the GDP: on average, around 49 per cent during 1997 to 2001-02, and rising to 80 per cent from 2003-04 to 2007-08 (Y.V. Reddy).

- Ratio of gross inflows and outflows on current and capital account to GDP: at 120 per cent in 2007-08, as compared to 50 per cent in 2002-03 and 60 per cent in 2003-04.

With such a greater degree of openness, India became more vulnerable to capital flight. Indeed in the immediate aftermath of the GFC, there was a mass exodus of foreign institutional investors (FIIs) from the country's financial markets.

Since the 1990s, there has been a significant increase in capital flows to India and FIIs have rapidly expanded their operations in recent years. FII inflows were relatively stable between 1992 and 2003, then increased sharply in more recent years with the push from favourable government policies. The limits for FII investments were progressively raised through the 1990s and by 2001, the aggregate FII investment limit was hiked to match the cap for foreign direct investments (FDIs) in the respective sectors. FII investments were exempted from long-term capital gains tax in the Union Budget for 2003-04. The cumulative net inflow of FIIs between 1990-91 and 2002-03 was $24,263 million, increasing in the next three years to $33,184 million. Portfolio investments in the country exceeded 60 per cent of total foreign investments (the sum of FIIs and FDIs) between 2003-04 and 2005-06.

Other important components of capital flows to India are external commercial borrowings (ECBs) and bank deposits by non-resident Indians (NRIs), which are also highly short term in nature.

From September 2007 to January 2008, FII inflows were at $22.5 billion, as against $11.8 billion from April till July 2007. The outflow of FIIs started in February 2008. They fled due to the unwinding of stock positions and to replenish cash balances abroad. There was a net outflow of portfolio investments amounting to $16 billion between February and June 2008.[1]

With the outflow of FIIs, there was a depreciation in the rupee's value and the stock markets also witnessed a collapse. The rupee's value fell from Rs 39-40 to the dollar in January-April 2008 to more than Rs 50 per dollar (Mathew Joseph).

1. *Economic Survey 2008.*

India's forex reserves also went down because with the outflow of the FIIs and the depreciation of the rupee, the RBI tried to defend the rupee by selling $63 billion from its reserves.

The Indian Financial System

Indeed the Indian financial system has not been directly exposed to the 'toxic' or distressed assets of the developed world. This is not surprising (Rangarajan, 2009) because Indian banks have very few branches abroad. There has been an indirect impact, however, and what followed was a crisis in confidence in the financial markets after the crisis hit the Lehman Brothers in mid-September 2008, leading to its bankruptcy. India's financial markets comprise equity markets, money markets, forex markets, and credit markets. According to D. Subbarao, Governor RBI, all came under pressure. First, as a consequence of the global liquidity squeeze, Indian banks and corporate firms found their overseas financing drying up, forcing corporate firms to shift their credit demand to the domestic banking sector. Moreover, in their frantic search for substitute financing, corporate firms withdrew their investments from domestic money market mutual funds, putting redemption pressure on the mutual funds and down the line on non-banking financial companies (NBFC) where the mutual funds had invested a significant portion of their funds. This substitution of overseas financing by domestic financing brought both money markets and credit markets under pressure.

Second, the forex market came under pressure because of reversal of capital flows as part of the global deleveraging process. Simultaneously, corporate firms were converting the funds raised locally into foreign currency to meet their external obligations. Both these factors put downward pressure on the rupee. Further, the RBI's intervention in the forex market to manage the volatility in the rupee, added to liquidity tightening.

Also, the tight global liquidity situation in the period immediately following the crisis, coming as it did on top of a turn in the credit cycle in India, increased the risk aversion of financial systems and made banks cautious about lending.

The government's response to the situation shall be discussed shortly. The RBI's response, meanwhile, led to the easing of the tight liquidity situation with interest rate cuts, which ultimately led to the excess liquidity of Rs 185,000 crore in the subsequent months that resulted in generating inflationary pressure. The FDI inflows also got affected to a lesser degree, even though the countries from which FDI originated felt the severe impact of the financial crisis.

FDI remained strong throughout 2008-09 and in spite of the global meltdown, in 2008-09, total FDI inflow was at $27.3 billion as compared to $24.5 billion in 2007-08. It showed a growth of 25 per cent in rupee terms and 11 per cent in dollar terms.

A number of measures were taken in order to encourage the infusion of FDI into India. A paradigm shift was evident in the FDI policy issued by the Department of Industrial Policy and Promotion on 17th February, 2009.

The government modified the guidelines for the calculation of foreign investment and the transfer of ownership or control of Indian companies to non-resident entities. It aimed at creating investor-friendly, credible and reliable regulations that facilitate greater foreign capital inflows which would send a positive signal amidst the global crisis. The amendment in the regulation focusses on the more sensitive sectors such as retail, telecommunications, banking, media, aviation, defence and insurance, which previously had high barriers to FDI.

The modified regulations include the following (Geethanjali Nataraj):

- The FDI cap for the telecom sector was increased from 74 to 98 per cent.
- FDI upto 100 per cent has been allowed automatically in all activities and sectors, except for a few like gambling, betting, lotteries, atomic energy, multi-brand retail, real estate trading and agriculture.
- No environmental clearances are required for projects with an investment of less than Rs 1 billion.
- A new concept of controls and ownership in the sector is also introduced: An Indian company that is backed by foreign

investment but is ultimately controlled and owned by Indians, can invest without being subject to the FDI cap.

- The government has yet to offer any details on the new FDI caps in other sectors like mass media and banking.

Exports

The export sector was one of the first to feel the impact of the financial crisis. There was a sharp increase in unemployment in labour-intensive sectors like textiles, gems and jewellery, leather manufactures, as well as in the service sector, software and outsourcing. The slump in exports that lasted for more than a year also affected related domestic activities that dampened overall economic activity. A turnaround began recently, and all the sectors have registered an increase in employment.

Around 5 lakh workers were given fresh employment in the export industries by the end of 2009; the job crisis seemed short-lived.

Exports in goods and services now contribute about one-fourth of GDP, and its share has risen from 10 per cent in 1993 to 24 per cent in 2008. India's two-way trade in goods and services (exports plus imports) as a proportion of GDP, increased from 20 per cent in 1993 to 56 per cent in 2008. Merchandise exports plus imports as a percentage of GDP, have also increased significantly over a decade, from 21 per cent in 1998 to 35 per cent in 2008.

The pattern of trade has also changed, which has proved to be a boon in disguise: Focus has shifted from the West to the Middle East and Far East. The share of exports going to developed countries declined from 53 per cent in 2000 to 39 per cent in 2007. US was the biggest partner in the 1990s but the share of exports going to US declined from 22 per cent in 1999 to 14 per cent in 2007.

In recent years, the United Arab Emirates (UAE) has emerged as a major trading partner for India. There has also been a rise in the trade with East Asia, Africa and Latin America. The ground lost by India in the West has been gained by China in recent years. Perhaps, that is why the shrinkage in exports was not too severe. But even with China, India's trade changed from a position of surplus to that of having $17 billion in deficit by January 2010.

Imports also fell, indicating that less capital goods were being imported as production was sluggish. The trade gap shrank because of falling exports and imports. In April 2010, however, alarm bells rang because of the widening current account deficit caused by an increase in imports due to the hardening of the rupee against the dollar.

Overall, from September 2008, the trade sector declined quite visibly. In the second half of 2008-09, merchandise exports declined by 18 per cent against a growth of 35 per cent in the first half, and imports fell by 11 per cent against a growth of 45 per cent in second half. Exports started picking up from November 2009, registering a 9 per cent growth in December 2009. Since 2010, exports have begun to grow at double-digit rates.

Service Sector Growth

The growth in software exports dropped by less than 4 per cent in the second half of 2008-09 as compared to the first half and was at 26 per cent. Financial services grew at 45.7 per cent but business services grew only by 3.9 per cent. Overall, the negative impact of global recession was relatively less on India's service export growth which still managed to grow at the rate of 9.8 per cent in 2008-09 (*Economic Survey 2009*).

There is no doubt that India's service exports faced some problems especially with US President Barack Obama announcing his government's policy of withdrawing tax benefits for companies that outsource their services. Many BPOs closed down and the hospitality sector was also affected. Yet many software giants continued to make profits. In January 2008, Satyam, an important software exporter, collapsed. Ramalinga Raju, its chairman, confessed to a Rs 7,136 crore fraud. The company has since been restructured and a new board constituted.

There has been a slowdown in the growth of the service sector due to the slow growth in its sub-sectors in 2009. There was a slowdown in construction, transport and communication, trade, hotels and restaurants, media and cinema. It grew at 8.7 per cent in 2009-10.

Investments in the service sector grew at 20.2 per cent in 2006-07, declining to 16 per cent in 2007-08 due to a dip in the performance of hotels, trade, restaurants and sub-sectors. But in 2008-09, the same sub-sector grew at 19.4 per cent and pulled up the overall growth rate of the service sector.

The crisis had a negative effect on remittances, as well as the forex reserves. Remittances declined in absolute terms by about 20 per cent in the second half of 2008-09 (from a growth of 41% in the first half of the year). Remittances further declined at the tail-end of 2009, following the crisis that hit Dubai in November.

Industry

Industrial output also fell in the first few months of the crisis. It showed signs of improvement only after one year, with the revival of manufacturing output. The manufacturing sector also suffered due to a decline in the performance of the real estate sector, consequently affecting the demand for non-metallic minerals, wood and wood products, and basic metals.

The housing and real estate sector was also affected: Housing shares fell steeply and the real estate giants came under severe pressure. It has recently picked up although investment in housing remains quite low. A lot of capacity built in new cities like Gurgaon, Faridabad, lie idle and commercial property values and rents have shrunk. Real estate development was going full throttle before the global crisis. It slowed down after the crisis, especially in the relatively low-cost housing segment where there seemed to be a glut. The office-space developers have since been waiting for the multinational corporations to return. Thus, there was a double squeeze—one from the decline in exports, and second, from the decline in domestic demand.

The growth of investments in the industrial sector was more than the total investment growth till 2007-08. In 2008-09, the trend was reversed when investments in the industrial sector declined by 17.6 per cent as compared to a decline in total investments of 2.4 per cent. Within the industrial sector, the decline was more prominent in manufacturing and construction.

The corporate sector experienced not only a decline in profits but actual losses as well. Investments, too, declined, but corporate investments have registered an increase in January 2010 and many corporate houses have also shown profits. Investments slowed down and the growth in fixed investment declined from 10.9 per cent in the first half of 2008-09 to 5.7 per cent in the second half. In 2007-08, the average rate of investment was 12.9 per cent.

The credit offtake also slowed soon after the crisis as industry refrained from making big investments. Recent industry data, though showing that investments are picking up, do not match the credit offtake which has not risen proportionately. It seems the corporate sector has been using other sources of finance. The primary market has also been tapped by the corporate companies to raise resources. Another source of finance has been foreign borrowing—the ECB norms that had been eased to facilitate this. Running down inventories was another way the corporate sector managed to deal with the crisis.

The small- and medium-scale industrial units also faced severe problems, given that many of them have already been experiencing problems of high cost and poor access to loans prior to the crisis. At that time, many units succumbed to various financial and infrastructural pressures, eventually shutting down altogether.

Small and medium enterprises (SMEs) began to show signs of a rebound in growth in December 2009. Overall, SMEs have been badly hit by the crisis. Besides struggling with spiralling costs of raw materials as well as lack of access to funds, they also faced the new situation of massive cancellation of orders.

With industrial production picking up and the index of industrial production (IIP) reaching 17.5 per cent in December 2009 (and 16.5% in January 2010), the demand from ancillary SMEs has also risen. Manufacturing growth has also shown an impressive growth of 17.9 per cent. Thus, there has been a related growth in the output of SMEs. They posted 25-fold increases in net profits on the back of a 730 basis points increase in operating margins (*Business Standard*, Feburary 1, 2010). Sales, however, increased only marginally. In the quarter ending of December 2008, SMEs posted a 0.61 per cent rise in net sales and 97 per cent decline in net profit. The improvement has been quite impressive in the third quarter and net profit of Rs 2,773 crore has been registered. But it is 18.3 per cent lower compared to Rs 3,394 crore before the GFC hit India in October-December 2008. Operating margins have also been lower by 14 basis points despite a 118 basis point saving in raw material cost.

Government consumption growth, meanwhile, rose steeply from 0.9 per cent in the first half of 2008-09 to 35.9 per cent in the second half of the same year. (It was 7.4 per cent in 2007-08.) The sharp increase in government consumption growth helped to cushion the sharp drop in aggregate demand and prevented what could have been an acutely sharp fall in GDP in the second half of 2008-09.

On the whole, private sector consumption is climbing up, from 1.5 per cent growth in the first quarter to 5.6 per cent in the second quarter of FY 2010 and should average 6.5 to 7 per cent in the second half. Automobile sales, for example, have increased by 68 per cent in December 2010, which shows that auto parts industry should be doing well, too. In the non-durable consumer goods sector, there seems to be a persistent problem of low demand and this could be related to the high food prices which leaves families very little to spend on such fast-moving consumer goods (FMCG). The average low-income family spends as high as 58 per cent of their income on food.

Agriculture and Food Prices

Even before the financial global crisis, food prices were rising all over the world. India, too, experienced such inflation from end-2007 well into 2008. In 2009, it took a higher pitch, due to a monsoon deficit of 23 per cent that year which was the highest ever recorded since 1972. What followed was a supply deficit in essential commodities like rice, wheat, sugar and pulses. To take advantage of rising food prices, essential food items with high protein content like *dals* were sown less and farmers switched to food grain production instead, where they were guaranteed a higher minimum support price every season. Every year the government's policy has been that of hiking the support and procurement prices under political pressure. The government was forced to raise the support prices of both rice and wheat which helped fuel inflation because procurement prices and selling prices were simultaneously raised. Sugarcane production, which is cyclical, alternating between surpluses and shortfalls, was affected by anomalies in government policy. This led to a shortfall in sugar production in 2009-10. Authorities decided to start exporting sugar even as the domestic demand was not being fully met. To fill the shortfall, sugar was then imported, and at a huge cost. The result was a rise in sugar prices.

Agriculture suffered on account of a combination of events: A monsoon deficit, leading to drought, in many areas, as well as unprecedented floodings in others. The monsoon deficit led to a shortfall in rice production of 13 million tonnes in 2010. Official projections for 2010 pegged the decline in agricultural output by at least 1 to 2 per cent. According to the *Economic Survey 2010,* agriculture will decline only by 0.2 per cent in 2010-11. Wheat production from the 2009 winter crop, however, has been good. It resulted in the relative easing of the food price situation from January 2010.

By January 2010, food inflation touched a steep 20 per cent. The global crisis added more problems for the poor, as many lost their jobs and faced high food prices. Instances of suicide were not unheard of in both urban and rural areas, invariably led by depression over job loss and lack of income to support the family.

Fertiliser and food subsidies have been hiked after the crisis, and there is a pressing need for increasing agricultural investment to raise productivity and supplement irrigation facilities in rural areas.

Further increasing demand for food was the expenditure on various relief programmes following the GFC, like the extension of the National Rural Employment Guarantee Act (NREGA) to more districts. It added to the existing demand-supply deficit as families who ate less before their employment were demanding more cereals as a result of cash in hand.

The real incomes of workers and cash-crop cultivators have also failed to keep pace with the rise in food prices. Poor or inadequate nutrition is already a big problem and the situation is expected to deteriorate if food inflation continues unabated.

The public distribution system (PDS) has been used to reach food grains at cheaper rates to the low-income groups. Unfortunately, however, the system has remained inefficient. There is also a need for specific interventions to ensure the viability of cultivators, especially those who have been hit by falling prices of crops meant for export even as their costs have escalated.

Excess liquidity in the system has also been blamed for a general inflationary trend and hoarding by suppliers who are often private traders. Indirectly, the government's policy response to the crisis has led to an increase in the liquidity of the system and has been blamed for the increase in the price of food items. It has been alleged that some traders have been borrowing money and engaging in speculative activities.

The government has sought to increasingly privatise the PDS in an effort to reduce costs of distribution. Private traders have been asked to procure food grains for the PDS. Many have blamed them for hoarding the supplies in the hope of later gains.

Government's Stimulus Package

On the socio-economic front, the government tried to alleviate the impact of the crisis by introducing three stimulus packages, all amounting to some five per cent of the GDP. The package, which is considered huge, was meant to stimulate demand. The government tried to resuscitate demand because of the loss of confidence and income amongst a large section of the population. For one, tax rebates were given to exporters in packages, in order to ameliorate the adverse impact of the cancellation of orders.

The government also gave tax rebates to manufacturers to pull down their costs. Many exporters and corporations benefitted from such initiatives and began showing profits. The fiscal package was given in three parts: one in early December 2008; the second in early 2009; and the last in early March 2009.

Following are some of the other features of the stimulus package:

- An across-the-board central excise duty reduction by four percentage points was given to industry.
- An additional government spending of Rs 200 billion was announced.
- An additional borrowing by state governments of Rs 300 billion for Plan expenditure was granted.

- Assistance in the form of an interest subsidy on export finance was given to some export industries.
- A refund of excise duties/central sales tax was offered to export houses.
- A reduction of two per cent in central excise and service tax was granted to exporters.
- Government employees received a salary hike.
- Cash rewards were given through the Pay Commission recommendations, benefitting thousands of government employees.
- A very popular debt-waiver scheme for farmers was offered: The government waived 75 per cent of the farmers' debts, requiring them to pay only 25 per cent.
- The government also undertook an additional expenditure for its flagship rural employment scheme.
- For oil and petroleum products, there was duty reduction and oil and fertiliser bonds were offered as subsidy.

In the Budget 2010, instead of government bonds, cash subsidy was offered. The combined fiscal deficit rose to 11 per cent in 2008-09 for centre and state finances.

Infrastructure

As the economy experienced a general slowdown, infrastructure industries suffered too; after all, demand for such products and services is a derived demand. As the economy took a nosedive consequent to commodity prices and oil price shocks and then the global crisis, most infrastructure sectors witnessed subdued growth in the production of such services and products in 2008-09. Most infrastructure sectors underwent a drastic slowdown in the second half of 2008-09. Port and air cargo growth slowed down considerably, reflecting sluggishness in the import and export growth in the second half of 2008-09. Rail freight growth slowed down, though to a lesser degree, because of the rise in coal transportation which accounts for a substantial chunk of rail freight. Coal registered robust production. Along with coal, the growth in teleconnectivity also stood as an exception amidst the general slowdown.

Overall, the core industries managed to recover in 2009. Electricity generation, however, posted lacklustre growth in 2007-08 and recovered only at the end of 2009. Growth in electricity generation by power utilities during 2008-09 was at a low of 2.7 per cent which was well short of the target of 9.1 per cent. Such poor performance was due to constraints imposed by the inadequate supply of coal. Still, despite the dismal hydel generation owing to the failure of monsoons in 2009, power generation picked up largely due to the improved availability of gas during that year.

The Union Budget 2009-10, made higher allocations for many infrastructure sectors, especially the National Highway Development programme, the Jawaharlal Nehru National Urban Renewal Mission (JNNURM), and the Accelerated Power Development and Reform Programme (APDRP).

The Planning Commission estimates that in order to sustain a GDP growth of 8.9 per cent, investments in infrastructure will have to be hiked to around $1,000 billion during the Twelfth Plan period (FY 2013-2017). Infrastructure allocation was increased to Rs 173,552 crore in 2010, representing a rise of 20 per cent from the previous years, and 46 per cent of the government's planned expenditure for 2010-11.

Policy Responses

Monetary Policy

Upon the onset of the financial crisis, the government's monetary policy was geared at closing the liquidity gap that appeared in the financial markets following the flight of the FIIs in early 2009. The bank rate and the repo rates were lowered, as well as the cash reserve ratios (CRRs). As a result, there was a rise of liquidity in the system. Yet there was no increase in the quantum of bank credit. Banks chose to park their extra funds with the RBI and earn interest; in general, they remained cautious in their approach to lending. The non-performing assets (NPAs) rose too. Around 39 listed banks saw their gross NPAs rise by Rs 15,000 crore from February 2009 to February 2010. They also did not bring down their lending rates appreciably to encourage loans.

Bank balance sheets showed an increase in profits in 2009. But industry failed to avail itself of the cheaper and expanded amount of credit as it also assumed a highly conservative approach to expansion and innovation due to uncertainty in demand. After the financial crisis there was a distinct slowdown and many companies took a hit on their revenue and profitability. Moreover, the flow of new projects slowed down and revenue earnings for companies deteriorated. In fact, certain segments felt significant negative impact due to the slowdown in capital expenditure and delays in the award of new projects.

The growth of bank financing to the industrial sector decelerated significantly from April to November 2009. But mobilisation of financial resources from domestic non-bank sector, including the capital market, was significantly higher during this period compared to the corresponding period in 2008. The flow of investible resources from external sources was also comparable with higher infusions from American depository receipts (ADRs)/global depository receipts (GDRs) and FDI.

Growth of credit to industry declined steeply from 37 per cent in November 2008 to 14.2 per cent in November 2009.

But in 2010, there was a revival in credit offtake. The order book-to-sales ratio of construction companies—which had dropped to about 2.5—improved to about 3.2 to 3.4 in 2010. In projects on road, power, urban infrastructure segments, there was a visible improvement in offtake.

It was the infrastructure sector that pulled up the growth in industrial credit at the level of 14.2 per cent during November 2009. Net of infrastructure, the growth in industrial credit was pegged at only 4.6 per cent in November 2009, compared to the 36.5 per cent posted in the corresponding period of the previous year.

The implications of the slowdown in credit offtake have been especially adverse for SMEs, including the service sector. Credit offtake grew at 19.3 per cent in November 2009 as compared to the low credit to the overall industrial sector.

In March 2010, the RBI raised the repo and reverse repo rates by 200 basis points in order to control inflation. In April 2010, the RBI hiked the repo and reverse repo rates by 25 basis points and increased the CRR to six per cent. The main problem in 2010, according to the RBI, was too much liquidity in the system. The rise in repo rates was followed by a rise in the bank rate to suck out the liquidity in the system. Coupled with the prospect of a good *rabi* crop entering the market, inflationary pressure was calmed further.

However, the hardening of the rupee has made problems of effective monetary control even more complicated. In the latter half of 2009, the return of FIIs has led to the hardening of the rupee against the dollar. It further aggravated exporters' woes because for 13 straight months they saw a decline in exports. There was a positive growth in exports in November 2008 but the rupee's appreciation *vis-à-vi*s the dollar resulted in the weakening of the competitiveness of Indian exports compared to that of China.

Heavy FII inflows came in the latter half of 2009 to take advantage of higher interest rates and investment returns in India as compared to the near-zero rate in the US and relatively flat stock markets in Western Europe. It led to excessive liquidity in the system which fuelled inflation. A further rise in interest rates complicated the scene further.

On the growth front, India seems to be coming out of recession because GDP grew at the high rate of 7.9 per cent in April-September, and then at 6 per cent in the fourth quarter. The IIP also grew at a double-digit rate: 17.5 per cent in January 2010 and 16.5 per cent in February. Thus, industrial growth is clearly picking up and many companies have started hiring labour again. There has already been a significant expansion in some export sectors already.

India's monetary policy response has been aimed at price stability, which the government has yet to achieve. There has been, however, a timely response to the crisis from the RBI. It acted fast by reducing the bank rate, the repo rate and the reverse repo, and aimed at increasing liquidity in the market.

The RBI slashed the CRR and statutory liquidity ratio (SLR) of banks so that they could access huge amounts of funds. The banks were thus flush with funds, but then a confidence crisis emerged. As pointed out earlier, the banks did not want to make fresh loans and instead parked their funds with the RBI, earning interest.

Banks posted higher profits within only a year of the crisis, accompanied by a decline in non-farm lending. Obviously, the corporate sector found its own means of financing their own production at lower interest rates and more importantly, without conditionality nor too much fuss.

As bank credit continued to decelerate in 2009-10, there was a turnaround in the finances from non-banking domestic sources.

The subsequent hiking of interest rates from April 2010, which was meant to contain inflation, can have adverse effects on investment decisions.

Trade Policy Response

As pointed above, exports were most affected by the global crisis and the industries that were hit hard saw a large number of unemployed who had no recourse but to go back to their native villages. The government tried to cushion the impact on the export industries that faced decline with some measures that helped them access credit on easier terms. These include:

1) A foreign exchange swap facility of three months' duration was given to the Indian public, in general, and private sector banks with overseas operations, in particular. This was meant to provide them flexibility in managing their short-term funding requirements at their overseas offices. This facility has since been discontinued.

2) Foreign exchange was sold through agent banks to augment supply in the domestic foreign exchange market or intervene directly to meet any demand and supply gaps.

3) The period of entitlement for pre- and post-shipment (rupee) export credit was extended by 90 days from November 2008.

4) Interest rate subvention for export credit was extended up to March 2010 for pre- and post-shipment export credit (in rupees) for certain employment-oriented export sectors like textiles, ready-made garments and handlooms, handicrafts, carpets, leather, gems and jewellery, marine products and SMEs.

5) A refinance facility of Rs 50 billion was established for Exim Bank of India and extended till March 2010. The limit of export credit refinance facility was also increased from 15 to 50 per cent of eligible outstanding export credit to provide liquidity support to banks. It was later pulled back down to 15 per cent in 2010.

6) Interest rate ceiling was reduced by 250 basis points below the benchmark prime lending rate for pre-shipment rupee export credit up to 270 days; post-shipment credit to 180 days was extended till end of April 2010.

Social Sector Spending

The Indian government raised its social sector spending after the GFC hit the country. It was meant to serve as a cushion against the ill effects of the crisis on poorer sections of the population. After all, one of the most painful effects of the crisis was inflation in food prices, which hit the poor even more severely: They had far less disposable income to spend on non-food essential items like health and education.

Government expenditure on social services (both Plan and non-Plan) has steadily increased from 10.46 per cent in 2003-04 to 19.46 per cent in 2009-10, and a record 37 per cent of the total Plan outlay in 2010-11. Moreover, the finance minister earmarked another 25 per cent of the Plan allocation to the development of rural infrastructure.

The government has also taken various measures for the expansion in scope and coverage of the social security scheme for unorganised workers. Beginning in 2009 the Aam Admi Bima Yojana, which assures the grant of minimum level of social (health) protection, began issuing smart cards to unorganised workers. By January 2010, 97 lakh were covered. In the 2010 Budget, the Finance Minister announced the setting up of a National Social Security Fund (NSSF) with an initial allocation of Rs 1,000 crore. The fund would support schemes for unorganised labour, including for example, weavers, toddy tappers, rickshaw pullers, and *bidi* workers. More than one crore smart cards have been issued so far under the scheme.

For the urban poor, a massive 700 per cent boost has been given to the allocation of funds in order to encourage the states ‘to create a slum free India at the earliest’.

The allocation to the Ministry of Social Justice and Empowerment has also been stepped up by 80 per cent over the previous year's and was pegged at Rs 4,500 crore, in order to focus more on the welfare of scheduled castes, scheduled tribes and other backward castes, as well as the physically challenged.

In general, India's response has been twofold: One path was the release of a huge stimulus package; the second, the cutting of excise duties on main inputs like petro products, cement and steel. Both strategies were intended to stimulate aggregate demand. It is fairly clear that the additional expenditures that the government has undertaken actually worked in pushing up the GDP growth. The government injected a huge amount of money into the system by giving pay hikes and providing employment in rural areas.

Both in urban centres and rural India, the demand thrust has been maintained as a result. Some industries have done particularly well in the post-crisis years, especially automobiles, pharmaceuticals, and other consumer durables.

As in other countries, the hike in public expenditure has led to an increase in the size of the fiscal deficit. The budget estimate of total public expenditure for 2009-10 was 37 per cent higher than the budget estimates of 2008-09. As a result, the fiscal deficit increased to 6.3 per cent. The Fiscal Responsibility Bill Management (FRBM) target is 3.2 per cent of the GDP. In the 2010 Budget, the fiscal deficit is projected at 5.5 per cent of the GDP for the year. The government has allocated a huge additional allocation of funds on infrastructure development and improvement that would, in turn, also generate employment.

The government's policy of incentives for the export sector has also resulted in higher export growth. Industrial growth has also picked up significantly.

Though the social sector spending has also increased, there is no certainty about its success in reducing school dropout rates, nor the number of malnourished children. There are also dark clouds hovering over general health and educational levels.

Regulation and Reforms

What types of regulations are needed in order to ameliorate the problems triggered or accentuated by the crisis? India's banking system, for one, on the whole remains sound, healthy, well capitalised and adequately regulated. Second is the comfortable foreign exchange reserve position of around $300 billion that provides confidence to overseas investors. Third, job losses were not as big as in the western countries. Consequently, consumption demand has held up fairly well. Fourth, because of India's mandated priority sector lending, which goes to the farm sector, institutional credit for agriculture was somewhat unaffected by the credit squeeze even though many banks have not fulfilled the requirement for such lending.

The farm loan waiver package implemented by the government has further insulated a part of the agriculture sector from the crisis. Sadly, however, it is the big farmers who have become the main beneficiaries of such mechanism, precisely because they are the ones who manage to take out loans from the big banks. Small farmers, on the other hand, resort to borrowing from moneylenders who impose high interest rates and take their produce as collateral. Lastly, the social safety net programmes—including the flagship NREGA programme—have been successful in many states. It has enabled job seekers to have 100 days of paid work in a year. It has been able to protect the poor and the returning migrant workers from the extreme impact of the global crisis as it was extended to many more districts and improved to include more than one family member for eligibility.

To be sure, though, some of the problems endemic to the system remain. The regulatory framework remains old and is in need of reform in order to facilitate domestic and foreign investment. Bureaucratic red tape still plagues business ventures and corruption remains rampant in many areas. As a result, India continues to lag in most comparative studies of state's regulatory frameworks. For example, in the category, 'ease of doing business', India is 133rd in the world; Singapore is first and China, 89th. In the question, 'number of days it takes to enforce a contract', India has 1,420 days; Singapore is 150 days, US is 300, and China is 406. Closing down a business that has gone bankrupt takes 9 months in Singapore, 18 months in the US, 20 months in China, and 7 years in India.

The Need for Reforms

India is posting a relatively high GDP growth of 6 to 8 per cent as well as double-digit industrial growth rates. Yet some 800 million people continue to live in poverty. The GFC has made millions of Indians even poorer, as unemployment rates went up especially in the export industries. Although many have since got their jobs back, they have been hit by food price inflation. It cannot be over emphasised that the GFC brought hardships on the populations that are already poor. The government, in response, put emphasis on the Employment Guarantee Programme and several other schemes in order to help them.

NREGA—since renamed Mahatma Gandhi National Rural Employment Guarantee Scheme—guarantees 100 days of employment at the state's minimum wage. In 2008-09, it provided opportunities for more than 44.7 million households. The following fiscal year, the government increased its allocation for NREGA by 144 per cent to reach Rs 39,100 crore.

Funds should also be made available for the programme's implementation, which has been characterised by uneven success across states. In Jharkhand, for example, huge amounts of money is being wasted in 'ghost' or non-existent workers. Also, a new breed of brokers has sprung up, charging the beneficiaries money on the pretext of arranging their jobs. Meanwhile, states like Rajasthan and Andhra Pradesh have had higher success rates due to transparency and the use of support functions like information technology (IT).

Access to credit remains a problem especially for SMEs. Many women-led microcredit institutions (MCIs) have been successful in some states, allowing poor (often women) entrepreneurs to gain access to funds. Self-help groups (SHGs) have been successful in Gujarat, though not in other states. In December 2009, 36.78 lakh SHGs were formed across the country. Some 132,81 lakh SHGs have been assisted so far, with a total investment of Rs 30,896.08 crore.

The government has allocated more funds for primary education and health in the last two Union Budgets. It also increased public expenditure on infrastructural development by 46 per cent in Budget 2010. Yet with so many programmes in place for poverty alleviation, there has been slow progress in the uplift of the poor. Obviously, proper distribution of food and jobs to the poor especially in rural areas, housing, education and health for the urban poor, have remained problem areas.

Land rights and compensation for land acquisition has been an important issue in the government's quest to start special economic zones (SEZs) across the country to boost exports and create jobs. By failing to take into account the appropriate compensation for the landless daily wage labour on a three-crop farmland near Kolkata, the Singur fiasco erupted in 2008. The Government of West Bengal acquired 1,000 acres of prime agricultural land at Singur in Hooghly district, West Bengal, for establishing a car factory by Tata, one of the biggest car manufacturers in India. The project was opposed by activists, displaced landowners and opposition parties in Bengal. The agitation regarding proper rehabilitation and settlement cost the government heavily and the factory had to be closed down in October 2009.

Unlike China, land acquisition for development of manufacturing enterprises and for building highways is not without serious problems in India. Similarly mining projects in tribal areas are facing issues of compensation and land rights, with the tribal population turning against the government's policies. The Naxalite movement (now called the Maoists), one of the most serious insurgencies in India's post-independence era, is recruiting many of the tribal men and women displaced by increasing mining activities. The movement has become the biggest security threat for the country.

The Indian mining industry has been growing fast in the last two years. In the context of eternally rising food prices and joblessness, the poor have become more restless, and increasingly vulnerable to recruitment by insurgents. Illegal mining is also on the rise, and the lack of proper rehabilitation for the communities traditionally living in those areas has led to a surge in violence.

With the economy recovering well in the beginning of 2010, the financial crisis was unable to upset the macroeconomic variables of the economy too much or for too long. However, the problems of inflation and lack of infrastructure, remain. Other problems relate to the exchange rate fluctuations caused by uneven and uncertain inflow of FIIs into the Indian financial markets and the hardening of the rupee against the dollar, which is affecting the competitiveness of Indian exports.

Prospects for a New Public Distribution System

Since the old PDS has proved to be faulty and has not benefitted the poor living in distant villages, the government is considering the idea of giving people below the poverty line, coupons which can be traded for food grains in village ration shops.

Earlier, the government sold food grains to the ration shops at subsidised prices, which would then be sold to the poor. Invariably, these food items either got diverted to the open market or were adulterated by the ration shop owners in search of big profits.

The new strategy is to allow ration shops to charge regular market prices for the food grains. Theoretically, the shop owner will have no incentive to adulterate the food grains as he would be charging the same price from the poorer buyers as from ordinary clients. Instead of money, he would receive coupons, which he could then cash in banks. Conceptually, this system may seem likely to work, although it has not been tried out yet.

In the old system, around 40 per cent of food grains meant for the poor got diverted to the open market. The acutely poor were left with very little. India has been spending a huge amount of money on food and petroleum product subsidies. Unfortunately, the heavily subsidised scheme has tended to miss out on those who are really poor. Those who benefit can well afford market prices. The real poor are suffering from severe malnutrition and more than 43 per cent of Indian children under five are malnourished, representing one-third of the world's total.

The government will have to continue with the PDS as long as the population living in poverty remains huge; at present, it is at 37 per cent of the population. These families will have to be given subsidised access to basic commodities like rice, wheat, sugar and kerosene.

As things are, subsidised kerosene is also diverted to the open market, where it is mixed with petrol and diesel before being sold. The adulterated fuel causes more pollution.

Another scheme for housing of the poor has also been getting more allocation of funds from government's total expenditure. Similarly, allocations are being made for the improvement of rural roads, which in the monsoons get heavily flooded, thus causing villages to be cut off from the cities.

Yet while rural development has been receiving a quantum jump in allocation of funds, what gets translated into creation of actual assets for the poor is another matter altogether.

Providing gainful employment to the rural poor remains an acute challenge for the state. For as long as it remains unresolved, huge swathes of the rural population will continue to seek greener pastures in the cities, putting even more pressure on the resources of those areas and adding to the problem of urban blight. The new immigrants end up living in slums, where civic amenities are absent and conditions are inhuman. The gargantuan task is to integrate these slums with the rest of the urban population through decent housing and provision of infrastructure like sanitation, drainage, water and power. More than half (58%) of India's urban slums lack proper toilets and there is water scarcity as well. Unless jobs are generated in the rural areas, more ghettos will easily mushroom in the cities, choking the very little available urban spaces.

Even though the government has indeed attempted to respond to the financial crisis by combating inflation with prudent policies, for the common person, what remains most important are food prices, housing, jobs, education and health facilities.

The government has been giving various incentives for the corporate sector, including excise duty rebates. Big corporations do not have a problem finding resources, especially external finance, as ECB rules have been eased in order to enable them to go for cheaper foreign borrowing. It is the small enterprises who do not have easy access to funds for investment. Amidst the global crisis, it is the SMEs which seemed to have suffered most. They come under the category of 'informal sector' which absorbs 92 per cent of the labour force.

Compouding the problem is the fact that people working in the unorganised or informal sector are without any protection against job losses, accidents and illnesses. It is quite ironic, given that it is the only sector in which jobs have actually been growing. For these workers' protection, a national insurance fund has been established and a social safety net was announced in the Budget 2010 in the area of health.

Conclusions

After the global crisis the Indian government began taking on a more important and visible role, keeping in mind that in other countries too, government stimulus packages helped those economies ride out of the recession. A huge stimulus package in India was similarly doled out. It has clearly boosted demand and provided some measure of relief to the export industries and corporate sector.

After the crisis, the ease of doing business in India becomes important for foreign as well as domestic investors. Keeping in mind their requirements, the government has tried to be a facilitator of business. It has assumed such a role quite well and in its macroeconomic policies has remained market-friendly. India has been spared the worst effects of the world crisis because its banks were not linked too closely with foreign banks and derivative trading in India hasn't really taken off.

To be sure, India also felt the ripple effects of the crisis that affected the global economy. In many ways, the problems were different from those met by the developed world. While the growth rate has since picked up, so has inflation and to that extent, the problems posed for emerging economies like India have turned out to be of a different nature.

In the matter of food price inflation, for example, the government has not shown much promptness in its response; it failed to execute timely imports. Moreover, the government was unable to curb speculative accumulation of food grains by private traders. It also failed to curb the strong inflows and outflows of 'hot money' or FIIs, which led to the hardening of the rupee and, in turn, hurt India's exports.

While jobs are being created, there remain a lot of industries which are still struggling to get back to normal. In view of the crisis in Europe due to the size of sovereign debt and continuation of high rates of unemployment, it is doubtful whether India's exports will be able to recover fully from the slump. China has the advantage of an undervalued yuan; its cheap credit and power also add to the cost advantage against exports of manufactures from India.

On the home front, many of India's domestic industries are losing out to competition from China and instead of manufacturing goods themselves, businesses have chosen to import goods from China and sell them in the home market. Trading has replaced manufacturing in many consumer items as the industries did not survive the cut-throat competition.

Yet consumer durables, automobiles and general manufacturing growth seem to have experienced a turnaround. The only anomaly seems to be slow credit growth, though according to recent reports, that too is picking up.

It remains to be seen how much new investment takes place in the Indian industry. The Reserve Bank has been applying liquidity tightening measures since April 2010.

Agricultural growth remains the laggard but wheat production in the winter season of 2009 yielded a bumper crop. Food management through proper stock maintenance remains a major challenge as most of the produce is in the godowns of the Food Corporation of India (FCI). There have been reports about huge wastage and rotting food stocks due to lack of adequate storage space. Recently, the government has announced that private stocking of food grains will be allowed.

Similarly, more investments in food processing and cold storage facilities would lead to less wastage of India's huge crop of fruits and vegetables, aside from providing rural employment. Cold storage chains are important for transporting perishable food from farm gate to consumers, and even for exports. India's flower exports—which are slowly gaining in importance—would also benefit from more public investment in cold storage trucks and vehicles.

India's service sector, meanwhile, is recovering impressively. In the aftermath of the crisis, IT, aviation, tourism, suffered a big blow because of their linkage with the foreign markets. Gradually the sector started to recover, and the hotel and hospitality industry as well as airlines are coming out of the recessionary phase. A large number of measures have been taken to enable the service sector to come out of recession, and they have paid off.

On the social sector front, the government has pushed through a law that seeks to guarantee free compulsory education to all children between the ages of 6 and 14. This should lead to the implementation of the universally accepted right to education. Over 35 per cent of Indians are illiterate; female illiteracy is more pronounced. More than 20 million children are out of school and though the Supreme Court has decreed that school children have to be provided with a hot meal every day—over 120 million children are, on paper, officially the beneficiaries—scandals are rampant regarding the pilfering of food. Complaints about the low quality of food being served have also surfaced. The situation is highly unfortunate, given that the school meal is often the only proper meal these children will have during the day.

In the aftermath of the GFC, many families that are already poor, have had to withdraw their children from school after losing their jobs and sources of livelihood. For example, there was a big spike in the dropout rates in Surat, which is India's diamond-cutting export hub. Moreover, the poor who were employed on the fringes of industrial and service activities like construction workers, security guards, maintenance personnel and domestic helpers, have been affected. Many of them are still jobless. Now that there is light at the end of the tunnel and the economy seems poised for a rebound, social sector spending in the 2010 Budget has been increased. Thus, it would be more important to monitor the proper delivery of programmes like the mid-day meal scheme and NREGA.

The public sector delivery system has failed miserably in the area of health. Public health remains in such a sorry state that a huge 80 per cent of all health care spending in India is in the private sector. The village primary health care units are inadequately equipped, whether in medicines and other supplies, or in doctors and personnel. The poor are forced to seek health care from private practitioners who are based in the towns. Public hospitals in big cities are incredibly congested and filthy with overstretched infrastructure. It is remarkable that this pattern has remained, despite hefty increases in the annual budgets of public hospitals since the onset of the financial crisis.

Private health care remains highly expensive and prohibitive. When a family member falls ill, they are reduced to even more acute penury as they try to respond to their medical needs by borrowing from moneylenders who charge usurious interest rates. India's public health care remains hard pressed and can hardly cope both in villages and cities.

The allocation for the National Rural Health Mission (NRHM), which was started in 2005, was raised to Rs 12,050 crore in 2009 but it has not solved the problem of inadequate health facilities. The problem also lies with the shared responsibility between states and the Central government. The Central government contributes 85 per cent of the total fund requirement while the states contribute about 15 per cent to the NRHM. But the Central government has not been successful in holding the states accountable. The health sector is riddled with huge corruption scandals and private health care is often substandard with many programmes being purely commercial ventures.

On all the different facets of Indian government's rights-based approach to development—the right to food, education, health, housing—it has yet to fulfill and deliver the promises it has made to the people. It has not delivered either on its promise of guaranteeing jobs under NREGA in times of recession. The GDP though, seems to be following an upward path of eight per cent growth. After China, India's recovery seems to have been the fastest.

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Note: 1 lakh =100,000; 10 lakh=1million and 1 crore=10 million.

2 India after the Global Economic Crisis

M.K. VENU

With the benefit of hindsight, it is now widely accepted that the 2008 global financial crises (GFC) had relatively little adverse effect on the Indian economy, which managed a GDP growth of over seven per cent in 2009-10. In fact, the country's economy appears to have bounced back rather quickly, and projections peg the growth rate at 8.5 per cent for the 2010-11 financial year. If achieved, such rate approximates the average GDP growth during the boom years of 2003-2008.

Indeed, as global finance froze temporarily due to the Wall Street meltdown in September 2008, there was a massive scare that the entire world will experience the worst recession since the Great Depression. As it turned out, the scare was highly exaggerated, especially for emerging economies like India. India's economy continues to grow largely because there is ample rural demand. During the worst period after the 2008 financial crises, rural India's consumption generated enough demand to insulate India from global trade shocks caused by the recession faced by Western nations. Though Organisation for Economic Cooperation and Development (OECD) economies witnessed negative GDP growth in 2009, India's consumption story remained alive. No wonder then that in 2009-10, India's consumer durable companies were clocking double-digit growth in their sales. Again in 2010-11, a large number of Indian companies are back to robust sales growth rates of over 20 per cent. An analysis of India's top 500 companies shows that most of them are doubling their sales every five years, riding largely on the back of domestic demand. Such a trend is only expected to continue.

The domestic demand growth helped India counter the big slump in its export growth in 2009. Even that, however, eventually recovered beginning in 2010. India's external sector witnessed further improvement with the recovery seen in the global economy as reflected in the turnaround in exports, buoyancy in capital inflows, and further accretion of the country's foreign exchange reserves. Exports recovered from 12 months of consecutive decline and posted an average growth of 20.5 per cent in the period from November 2009 to February 2010. Imports also turned around and exhibited an average growth of about 43.0 per cent during December 2009 to February 2010, thus reflecting a pickup in industrial activity. India's foreign exchange reserves in 2009-10 increased by US $27.1 billion, reaching US $279.1 billion by end of March 2010.

The other big impact on India was a near total drying up of capital flows in 2008-09. Net inward capital flows dropped from $100 billion in 2007-08 to about $10 billion in 2008-09. This recovered substantially to over $50 billion in 2009-10.

As for the Indian banking sector, it was largely insulated from the toxic elements of global finance partly because Indian banks were not integrated enough with the western financial system, which became a chief victim of adventurism in the financial product market. Helped by a strong regulatory framework and good performance, Indian bank stocks have risen the most in the stock markets through 2009 and 2010. This was in contrast with many leading banks in the western world, who struggled to survive. Fundamentally, India does not have the kind of structural weaknesses that characterise the western economies. The aggregate outstanding debt of the government, corporates and households in India, is under 150 per cent of GDP, compared with over 330 per cent in the US and many European economies. The looming sovereign debt crises being faced by Europe is a reflection of some of those structural problems. They get exacerbated in the western economies as government after government becomes more profligate in a bid to revive growth and employment. Some economists are now saying that the unemployment problem in the US and Europe may have already become structural, as any incremental growth revival could be, by nature, unable to generate the needed numbers of jobs.

The big picture, therefore, seems to be clear. The inherently robust and strong emerging economies like India and China, increasingly driven by domestic factors, will continue to grow at over 8 per cent. Meanwhile, the OECD nations might experience a modest growth of 1-2 per cent in the decade ahead. Thus, it will not be surprising to see emerging economies dominating world GDP in another 10 years.

In effect, the GFC has pushed India to look at a more domestically-driven growth strategy. Such a strategy will get reinforced because of the European debt crises. Sometimes emerging nations take time to discover their unique strengths. The GFC was a catalyst that enabled India to understand its strength and resilience.

Indeed, this resilience can be viewed in both its medium-term framework and long-term historical context. This paper will seek to study both the medium-term resilience seen in the strong domestic factors that are leading an economic recovery, as well as the belief held by many that India is on the right side of history, which can be seen in a 150-year timeframe. Indeed, both the medium-term and long-term resilience of Asian societies will be the basis of a shift in the balance of economic power towards Asia in the 21st century. It will help India chart its own independent, domestically-driven growth story and, to that extent, enable it to decouple from the growing structural weaknesses in the OECD economies.

India Decoupling

This takes me to my first proposition that the domestically-driven growth story of India will indeed enable it to progressively decouple from the indifferent performance of the OECD economies. The idea that growth in domestically-driven emerging markets like India could decouple from those in the West had got somewhat discredited when the global economy, in general, went for a tailspin after the Wall Street crisis in 2008-end. It was argued that the decoupling theory did not hold much water because fast-growing, emerging economies were inextricably linked to the developed ones through trade and capital flows. While there is an element of truth in such an assertion, an equally strong case can be made for the strong and sustainable domestic factors that will help India decouple from a continued slowdown in the OECD bloc. It may be instructive to look closely at some of the domestic dynamics at play which may largely neutralise the impact of lower export growth caused by the non-recovery of GDP growth in the US and the EU to the average rates achieved in the boom years. What are these local factors that can relatively insulate India's growth rate in the next five years or so? The real surprises could come from some of the domestic drivers of the economy that are not linked to international trade—what we describe as non-tradables. A simple example will illustrate this point.

A recent study published in *Economic and Political Weekly* (Vol.46(16), April 22, 2011) shows that Bihar registered an average GDP growth of 11 per cent for five years starting 2003-04, largely on the back of massive road construction projects. Similarly, many other relatively backward states showed average GDP growth rates of nine per cent and above in these years, possibly because they have just begun to implement projects relating to roads and other infrastructure sectors where there is massive pent-up demand. Now Bihar's road construction-driven GDP growth has no real link with international trade or the recovery of the OECD economies. Similarly, there is an ongoing, massive scaling up of power generation in order to meet the target of 70,000 MW of power during the Eleventh Plan ending in 2012. Even if we achieve 60,000 MW, it will mean massive investments in the medium term. Again, this has to do with pent-up demand caused by past GDP growth, and has no link whatsoever with how the US or EU economies behave in the next few years.

What is interesting to note is that India's investment in infrastructure had substantially lagged the overall industrial investment during the boom years of 2003 to 2008. According to one estimate, private corporate investment grew by nearly 10 per cent of GDP during this period, whereas investment in critical infrastructure to support such growth grew barely by 2 per cent of GDP. So the India growth story going forward will be supported by the pent-up demand for such infrastructure, which is a non-tradable, and therefore, might counter some of the negatives caused by a continued slowdown in international trade. The other interesting facet of this infrastructure-driven growth story is that it is happening on a relatively low base. Therefore, one tends to get a fairly high growth rate, especially in some of the backward states. A few 100 kms of road, for instance, or two or three 1,000 MW projects in these states, tend to create a big spike in the GDP growth rate. This is purely a growth opportunity created by the massive historical deficit. It is this historical deficit that has the potential to keep India's GDP growth racing at nine per cent for at least the next 10 years. However, one need not become ecstatic about such high growth rates; keep in mind that it is happening from such a low base! It is this large and continuing deficit in infrastructure that is responsible for the currently high growth rates in the capital goods production: 39 per cent in December and 50 per cent in January. The growth in capital goods production is quite high even on a seasonally adjusted basis. Data produced by the Centre for Monitoring Indian Economy (CMIE), a reputed data collation agency, bears out India's robust investment growth story based on infrastructure growth.

Between November and January of 2009-10, the production of broad gauge rail wagons recorded a remarkable growth rate of over 500 per cent. Again, this could be a case of production lagging way behind demand caused in the boom phase. Moreover, an estimated 21,300 MW of power is coming on-stream in 2010-11. The Power Finance Corporation (PFC) is in the process of releasing massive funds to drive such power projects. CMIE data also show that projects worth Rs 4 lakh crore would have got commissioned by the end of 2009-10, and this is 36 per cent higher than what was seen in the previous year. It is also becoming clear that India's investment-led growth has not suffered in the aftermath of the current global economic down cycle. Note that when the business cycle was down in the late 1990s, Indian industry withdrew into a shell for a long time following the Asian financial crises. This time, the critical difference is that businesses have retained their confidence in India's domestic consumption story. The Keynesian 'animal spirits' are really alive this time round and that seems to be the key motivator.

What would appear to turn conventional wisdom on its head is the unusually high contribution made by the services sector to the high growth rates in backward states like Bihar, Jharkhand, Madhya Pradesh and Orissa during 2004-2009. In classical theory, economic development happens in a certain sequence. Historically, societies have progressed from the agricultural mode of production, to industrial, and then on to a predominantly service economy. The contribution of the service sector is thus very high in developed economies like the US and the EU, compared with those in the developing world. It surprises analysts that states like Bihar, Jharkhand, Orissa and Madhya Pradesh—which all grew at annual rates in the range of 8.5 to 11 per cent in the previous five years—should be heavily driven by service sector components such as communications, construction, hotels and restaurants. All these states have been marked by low levels of industrialisation in the past 16 years or so, after industry was delicensed in 1991.

The accepted wisdom is that industrialisation leads to the development of a service economy, and not the other way round. I would contend that in some of the backward states like Bihar, Orissa and Madhya Pradesh, the sequence may get reversed. It is possible that a pick up in the services sector could lead to better agriculture and small manufacturing in these backward states. This may sound absurd to a trained economist but anecdotal evidence suggests that an improved services sector will enhance productivity and incomes in agriculture and industry. The key driver is communications. Data shows that communications, which is a big part of the service sector, grew by 17.4 per cent in Bihar, 24 per cent in Jharkhand, 18 per cent in Madhya Pradesh, and 19.5 per cent in Orissa, all between 2004 and 2009.

Evidently, this has been made possible largely by the telecommunications revolution in India, as the mobile subscription base has crossed 500 million in the country. With anecdotal evidence, I will attempt to illustrate how the mobile phone revolution is enhancing productivity growth in rural areas.

In the Pune-Nashik belt of rural Maharashtra, small villages with populations of less than 2,000, we can see a total transformation in the way the small grocery shops are run today. Traditionally, the grocery shop would stock up the usual daily consumer items like food grains, soap, or toothpaste. Today, virtually every grocery shop along the belt is earning nearly half of its total revenue from mobile prepaid cards. These small businesses have managed to double their sales after the advent of mobile talktime as a new consumer item. A wholesaler claimed that even in value terms, the average household had a faster turnover of mobile talk time than washing powder. Clearly, prepaid cards have become a faster-moving consumer good (FMCG). The advent of mobile technology is improving the productivity of the millions of the self-employed people in rural and semi-urban India. It must be kept in mind that anywhere from 45 to 50 per cent of the employed in India are self-employed. The massive mobile penetration would certainly have enhanced the productivity of this humongous population. In turn, it has created an upside at the macro level. There is also a veritable construction boom in rural India, which similarly escaped the direst consequences of the global economic crisis. No wonder, steel and cement offtake had been normal in India throughout 2009 and 2010. Thus, the backward states seem to be witnessing a veritable revolution in communications and construction. The two 'Cs' are driving overall growth in these states.

Economists argue that there is something seriously amiss about India's service sector: how, they ask, can it expand so rapidly as a proportion of its GDP—now 56 per cent—when manufacturing has not even realised its full potential? To be sure, there is some validity to this assertion. A lot more research needs to be done, however, in order to understand whether the ongoing communication revolution could in fact reverse the sequence. It is possible that the advent of 3G mobile communications technology could end up giving a huge leg-up to the productivity and incomes of some 200 million self-employed, which in the future would create demand for more manufactured goods. The bulk of rural India is still unbanked, after all. If appropriate policy changes allow the 3G revolution to be accompanied by low-cost mobile banking, India will not only greatly enhance its savings rate by collecting rural deposits, but also enable a large population to access cheaper bank funds. More efficient agriculture and manufacturing could follow eventually. Clearly, India appears to be defying conventional economics. India was also greatly helped by its unofficial, cash economy during the global economic recession. This economy—which can be described as a 'shadow economy' —operates largely outside the formal banking and stock market systems.

In this respect, the well-known Peruvian economist, Hernando de Soto said something quite thought provoking when he visited India recently. He argued that the biggest 'shadow economy' did not exist in India, but rather certainly in the West as nobody there knows where the majority of the housing market derivatives are hiding! Hernando was speaking plain economics. He emphasised the need to unravel the shadow economy so that it could be officially recorded for the purposes of defining property rights, which is the basis of capitalism. India has been grappling with its own shadow economy for decades. Varying estimates put the black economy at over 50 per cent of the official one. One fascinating aspect of India's shadow economy is the amount of gold privately held by its citizens. The World Gold Council estimates that gold privately held by Indians could be as much as 15,000 tonnes. At today's value of a little over $1,000 per ounce, the dollar value of gold privately held in India amounts to $600 billion. This represents a high 60 per cent of India's official GDP.

Now, a large part of the privately held gold in India is unrecorded in terms of ownership. It just loosely resides under the custody of large families, especially in rural India, and is used from time to time for the purposes of raising money from the informal money market for either business or social purposes. Unlike the massive, unrecorded derivative assets of the West, India's shadow economy proved to be a great virtue during the financial crisis. Global investors are convinced that India's shadow economy has great value and actually acts as a bulwark in times of crises. Samir Arora, a prominent hedge fund manager in Singapore, unabashedly argues that India's privately held gold reserves are a permanent source of confidence for investors. It is also true that India's rural-based shadow economy helped maintain the country's seven-plus per cent growth rate in the worst period after the global financial meltdown. According to the National Council of Applied Economic Research (NCAER), the bottom 80 per cent of India's population accounts for 65 per cent of total consumption. The majority of these people reside in rural India.

India and G-20 in the Context of Global Financial Crisis

As the global economy recovers—and much more robustly in the non-OECD bloc—the big question before the G-20 group of nations is: How do you reconcile imperatives of national politics with those of multilateral governance objectives? This question clearly remained unresolved at the G-20 leaders meeting at Toronto, convened to take stock of the global economic recovery and related issues of governance in the context of the financial crisis that shook the world in 2008. The problem the G-20 faces today is very simple: As the world economy is on a recovery path, particularly in the East, differences are beginning to appear among these nations with regard to the future agenda of the grouping. G-20 unity was more easily forged in 2008 end, when the GFC seemed to take all nations into its fold. However, domestic political pressures are today pulling some G-20 nations in different directions.

India will have to be cautious in the way it deals with new tensions emerging in this expanded club of the developed and fast emerging economies which came together in the backdrop of the GFC. The two most contentious issues are already on the table. One relates to the EU's growing anxiety over how to address the severe sovereign debt problem across many smaller EU economies, which is threatening the very idea of nations surrendering a part of their sovereignty into a sort of political-economic union. The other is the role of the Chinese currency in addressing global economic imbalances. For now, EU has somehow managed to stave off the larger crises in the region but most analysts believe the worst may not be over yet.

Leading EU nations like Germany and France, on whom the burden of bailing out the smaller economies has fallen, say the Union's top priority should be addressing the problem of high budget deficits which have caused the sovereign debt problem. US President Barack Obama has a different take on the matter. He had warned the EU that it should not be excessively obsessed with the problem of high government debt. Instead, EU should remain focussed on sustaining the global recovery as its highest priority. Budget deficits can be addressed once the world output growth returns to its long-term median growth path. India is closer to the Obama position on this issue.

Indian Finance Minister Pranab Mukherjee had articulated a similar stance at a meeting of G-20 finance ministers in South Korea in early 2010. India, like the US, fears that Germany could usher in a double-dip recession if it takes any drastic step resulting in the contraction of the EU economy.

However, India has serious differences with both the US and the EU on some other critical matters relating to the governance of global financial institutions. There is a growing political consensus in the EU and the US that the financial sector, which received massive bailouts from taxpayers' money, must now start paying back the government in the form of a tax on all transactions executed by it. This proposal, which had gained significant political support in Germany, France, and the UK, and also seemed to have Osama's blessings, did not get any support from emerging economies like India and China at the G-20 meeting of heads of state at Toronto. Seeing the opposition from almost all emerging economies and some developed ones, the G-20 decided not to pursue the issue which could have divided the grouping down the middle.

Politically, Obama too is believed to be under severe political pressure to demonstrate that he has the courage to make Wall Street pay for its sins, especially after bailing them out heavily with taxpayers' money in 2008-09. He has already come up with a tough plan to regulate the financial players on Wall Street. There appears to be a sustained middle class backlash in the West against what is seen as excessive sympathy among the ruling political elite towards finance capitalists whose irresponsible behaviour was seen as primary reason for the GFC. Clearly this sentiment cannot be wished away at the political level, and both America and EU will be dogged by this problem in the years to come. The support for a financial transaction tax flows from this very politics. However, there is an element of duality in this politics because the western finance capital elite is also well entrenched in running the politics of America and the EU. Wall Street's unsaid and unwritten influence over America's politics is well known. So there are always hidden (and not-so-hidden) compromises that Washington makes with Wall Street.

On the financial transaction tax, India justifiably argued that its own financial sector was well regulated even prior to the GFC, and thereafter. Since the government did not bail out the financial sector with taxpayers' money, a case cannot be made out for the financial sector paying back the government in the form of a special tax. It was the logic used by the EU to impose a tax on bank transactions. In fact, if anything, India could argue that Indian banks were part of the solution to help revive the domestic economy. Public sector banks have delivered bailouts in the form of Rs 60,000 crore of rescheduled loans to leading Indian companies that got into trouble after global credit froze in 2008 end. Similarly, China could also argue that the banking system there actually helped revive the economy through an extraordinary state-directed credit boom.

The emerging economies within the G-20, thus, have a different take on the issue of imposing a tax on the financial sector. The point is that emerging economies have a different set of problems, and therefore need a different set of solutions. G-20 will have to recognise this if there must be a way forward.

It is clear that the OECD economies will witness a somewhat muted subpar GDP growth in the years ahead. The emerging economies will continue to have robust growth and will therefore lead global growth in an incremental sense. It is logical that the developed economies will pursue macroeconomic policies that are designed to deal with an economy which is generally in a deflationary mode, like Japan was for two decades following the 1990s.

The emerging economies will then follow their own set of policies which are designed to maintain stability associated with rapid growth. If the OECD, in general, witnesses subpar growth and the emerging economies in Asia, Latin America and Africa, show much higher growth, as is likely, there will be further tension within G-20.

These tensions would emerge from a lack of consensus on the conditions under which the economic power must shift towards the emerging economies. After all, the West still controls the institutions that govern global finance and trade. It is logical that the West will come up with new agendas to somewhat soft-land the rapid shift in economic power towards emerging economies in Asia and Latin America. The new climate change protocols being evolved post-Copenhagen, for instance, is but one sophisticated framework under which the OECD is seeking to calibrate the pace of economic development in the emerging economies.

There are other sophisticated arguments being made in the name of the so-called 'smooth rebalancing of global growth'. Because of productivity rising much faster in the emerging economies, their currencies will naturally rise against the dollar, euro and yen, in the years ahead. This is a hypothesis most analysts on Wall Street also endorse. The need to 'smoothly rebalance world growth' finds expression in America's penchant to blame all its problems on a 'highly undervalued yuan'. The Chinese are very sensitive about this and have already warned G-20 nations not to make the yuan a bone of contention. However, the Chinese are also very pragmatic, and therefore, have made a general declaration that they will make the yuan more flexible in the future. Western economists reckon it is about 40 per cent undervalued and is therefore the cause of the current imbalance in trade between the US and China. The Chinese, of course, retort by saying Americans need not indulge in overconsumption of Chinese goods just because they end up very cheap on account of an undervalued yuan. Besides, they argue, the Americans should not complain as they are consuming with money borrowed from China year after year.

This, in simple terms, is the crux of the ongoing global imbalance that the G-20 wants to address. However, too much consumption in the West and too much savings in the East must have deeper cultural/behavioural roots which some 20 heads of state will certainly not be able to fathom and resolve easily. India's position on the issue of the West putting pressure on China to revalue its currency, will have to be examined more closely. Tomorrow the same pressure can come on India as the productivity of its economy grows much faster relative to the West and the rupee is suddenly perceived as highly undervalued. After all, the rupee moves on the basis of a 'manage float'. Overall, it is anticipated that the East-West divide within the G-20 is likely to heighten in the future.

The most critical thing to watch is how the next phase of global growth is sustained over the next decade and more in a cooperative framework between the West and East. Most economists agree that the GFC of 2008 has its roots in the larger real economy imbalance that is growing between the developed and developing world. This imbalance is manifested in the form of excessive consumption in the Western societies on borrowed money which makes basic economics unsustainable. The global crisis and its aftermath has merely shifted the excessive debt-from household and bank balance sheets, to government accounts. Excessive and mounting debt in government balance sheets, in turn, can create another financial markets collapse. This appears to have become a vicious cycle and is waiting to happen in the EU zone.

While the developed West is grappling with the ills of unsustainable consumption and debt burden, the developing economies still have about two billion people living on less than \$2 to \$3 a day. The most logical thing for global governance institutions to do is to create a framework whereby the incomes and consumption of these two billion people gradually increases. That is the surest way of addressing the global economic imbalance which is at the root of the financial crisis of 2008. Global capital and credit must be directed where it is actually needed, not among segments of population which already has achieved a certain minimum level of income and consumption.

The Long View: India on the Right Side of History

In certain phases of history, the sheer resilience shown by some economies cannot be seen purely through an economist's prism. The science of economics then becomes totally inadequate in helping us understand big changes in societies as a result of the energies unleashed by their economic agents. The Western world is still trying to understand what is it with the 2.3 billion people in India and China that makes them so resilient that they can quickly shrug off the greatest recession since the Great Depression. Suddenly, the Westerner is trying to intuit as to what makes India and China relatively immune from global economic shocks. I deliberately use the word 'intuit' because this phenomenon cannot be understood through any of the current frameworks of analysis about India and China. India was always viewed as too much of a chaotic, misgoverned democracy to be on a sustainable growth path. Most economists agreed that India had no stomach for further reforms as there were too many competing interest groups: The self-seeking middle class; farmers; the rural poor; caste, religious and gender groups. Besides, the instruments of the state do not adequately work in nearly a third of India's districts, where Naxalite/Maoist insurgency adds one more layer to the complexity of the problems.

Similarly, the view on China is that it cannot sustain its current rise as an economic power, and it is only a matter of time before its successful economic globalisation programme gets halted by domestic political turmoil or civil society unrest. These same observers note that it is not possible to run capitalism within a communist institutional framework. Therefore, many Western academics view China as a pressure cooker waiting to implode in the not-too-distant future. Sometime before the 2008 Wall Street crisis, a renowned expert on global democracies being hosted by the US Embassy in New Delhi told an audience that America was actually preventing China from imploding by encouraging its deeper participation in the global free trade regime. In general, most analyses on India and China has often been marked by sheer skepticism about the way the two societies function, followed by incredulity over how they manage to keep afloat amidst global shocks such as the Great Recession of 2008-09. To better understand this phenomenon, one only has to look at some longer-term economic patterns in history. According to a statistical study by well-known British economist Angus Maddison (2001), India and China had a nearly 48 per cent share of global output until 1830. Subsequently, as the industrial revolution bypassed these two societies, their share of world output dramatically fell to around 10 per cent over the next 70 years. Their combined share of output stagnated at the same level for much of the 20th century and was about 8 per cent until 1980. The impressive rise in the share of these two countries' output happened only over the past 30 years. On a purchase power parity (PPP) basis, India and China have reached about 23 per cent of world output. Using Maddison's data, some economists have projected the share of India and China to reach 38 per cent by 2020.

Thus, an examination of the historical growth pattern for India and China over 200 years—from 1830—will show that they are steadily and surely coming back to their peak share of world output. During this 200-year period, the two societies have suffered the worst forms of internal strife as well as colonisation by the West, which completely emasculated their economic potential. How did these societies manage to bounce back to recover a good part of their share of world output, which they lost in the mid- to late 19th century? It becomes even more puzzling considering that the industrial revolution followed by massive economic growth in the West, fed partly by erstwhile colonies, gave such an unbeatable advantage to Europe and later America through leadership in military and other technologies.

In spite of these crippling historical disadvantages, if India and China are relentlessly coming back to reclaim their share of world output, there are clearly forces at work which are yet difficult to understand. This can only be explained by the existence of a different kind of resilience. One can perhaps speculate whether this resilience stems from a certain deeper civilisational consciousness, which goes beyond existing social structures and institutional frameworks—the nation state, democracy, linear capitalist progress, and so on. Of course, proponents of scientific temper and determinism might dismiss the very idea of a 'civilisational consciousness' as something totally without any empirical basis. Eminent Marxist historian, Eric Hobsbawm (1997), too has tentatively speculated about the possibility that the 'Protestant Ethic' which drove Western capitalism in the previous centuries could be replaced by the 'Confucian Ethic', which might power Asian capitalism. Hobsbawm also suggests that Asian capitalism might follow its own unique trajectory in the way it harnesses resources, both human and material. The entire debate on how India and China, with their unique growth strategies, could be the real game changers in charting a different path of development in the context of the challenges posed by climate change and the optimal use of scarce resources such as water and energy has a deep connection with the brand of Asian capitalism that Hobsbawm talks about. Of course, Asian capitalism should not be seen as some new animal altogether. It could draw a lot from the Western framework but at the same time get imbued with a deeper cultural experience that is uniquely Asian. Marxist scholars might balk at the idea but this is precisely where the cultural consciousness comes to play a critical role. After all, India and China must eventually evolve their own version of modernity which emerges organically from their deeply scripted cultural memory.

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3 Organic Crisis and Capitalist Transformation

MARIO CANDEIAS[1]

Transformation as Passive Revolution

Nothing will remain as it is. Transformation for the last 150 years has meant: A passive revolution of the modes of production and the respective modes of living. Following Antonio Gramsci, passive revolutions are one way to restore fragile power by revolutionising all social relations—not only restoring order, but developing a bourgeois, capitalist rule, by actively pushing forward society (Gramsci *Gef.* 1: 102). The passive element is to integrate the interests of the subaltern but to keep these groups in a subaltern, powerless position, and to absorb their intellectuals and leaders into the power bloc, while depriving the subaltern of their leadership (*Trasformismo*). The neoliberal management pushed on with the globalisation and internationalisation of production, culture and consumption, as well as the information technology thrust, the scientification of production by including the knowledge of the immediate producers and it enforced personal responsibility and economic emancipation of women.

The first transnational wave of the neoliberal transformations weakened the power of workers, trade unions, social movements and social democracy; the second wave integrated their representatives into a social democratic-neoliberal power bloc (Candeias, 1999; 2004/2009). The result was a rapid development of productive forces, of accumulation and profits at the expense of accelerated redistribution and inequality. However, neoliberalism has lost its propulsive social function. The third wave was an authoritarian turn, both with regard to international and to internal relations. There is a lack of adequate investment opportunities, profit rates

1. Translated by Andrea Lenz and Anne Steckner.

in general are falling, more and more social needs are not being fulfilled, the people have lost their faith in individual and social progress. The consensus faded away, but there has been no visible alternative.

Organic Crises and Disruptions

Structural or organic crises precede transformation. There are indications of 'incurable contradictions' (Gramsci *Gef.* 7: 1557) in the structure of society. Crises are natural in societies in which the capitalist mode of production prevails. It is quite typical for neoliberalism as a hegemonic project to absorb crises by getting them organised (Demirovic, 1987: 121). Economic-cyclical or 'generic' crises (Poulantzas, cit. in Ibid.), which became more frequent in shorter intervals during neoliberalism, are causing instability, lead whole countries and regions to the brink of collapse; they produce unemployment, poverty, hunger and challenge the legitimacy of the rulers. While causing much individual and social unrest, 'productive destruction' has a 'cleaning effect' that produces or accelerates technical, economic and social innovations, as well as triggering dynamic impulses and helping to energise bourgeois hegemony. As hard as these crises hit the living conditions of many people, the destruction and devaluation of capital reduces the tendency of over-accumulation and creates conditions for the redistribution of surplus value benefitting profits. It also improves the conditions for valorisation and enforces adjustments of social regulation. This comes with changing political conjunctures during a certain period of capitalist development, e.g., the change from orthodox-conservative to social democratic, and finally to authoritarian neoliberalism (Candeias, 2004/2009: 404). It's not the resolution of contradictions that is crucial for the power bloc, but rather the management of them in such a way that they do not endanger power. Thus, such a concept of hegemony does not ask for the stability of a certain order but rather for determining ways of dealing with the contradictions.

Organic crises are characterised by a condensation and entanglement of various crises, which cause conflicts and blockages within the bloc in power. This includes molecular changes as well as a series of fractions during the development. Such series of fractions occurred, for example, in 1929, 1933 and 1945 at the origins of Fordism and its crisis during the transformation to neoliberalism in 1968, 1973/1975 and 1980. This series shows that there are not only economic crises but also political ones, like the New Deal, Fascism, World War II (WW-II), and the protests of 1968, or like Pinochet's neoliberal *coup d'état*, Thatcherism, and the 'intellectual and moral turn' in Germany. Because one can exclude the idea that the immediate economic crises produce fundamental events by themselves; they can only provide a fertile ground to reflect, ask and solve the key questions for the whole further development of the modes of production and the respective modes of living (Gramsci *Gef.* 7: 1563).

However, it is also clear that it would be unhistorical to assume that after a 'great' crisis like 2007/08, all will continue as before, albeit with slight modifications (Candeias, 2009a). The same goes for the assumption that everything can change overnight. The transformation from imperialistic globalisation and competition to Fordism in the US took at least 13 years, in Europe even until after WW-II—by that time spatial asymmetry and varieties of the development had begun to show. The next transformation from organic crisis in the late 1960s until the actual enforcement of neoliberalism lasted until 1980. It unfolded in stages, and was dominated first by Keynesian economics, but already with a switch to monetarism and floating exchange rates. Indeed, that does not happen automatically and the history of enforcement of Fordism shows how violent such a transformation can be, and in how different ways Fordism—as later neoliberalism—is realised in different contexts.

Organic Crises and Molecular Changes

Now, before economic or political disruption occurs, but also independently of it, there are developing molecular changes in social relations, which are an everyday form of movement within contradictions that are barely visible at first. We have to distinguish between 'cyclical or occasional' and 'organic' or structural molecular changes (Gramsci *Gef.* 7: 1557). The first type requires modifications of the mode of regulation without entailing structural changes. The second type cannot be managed sufficiently within the provided mode of regulation, although modifications may delay its critical condensation. According to the course of the social conflicts, the first can turn into the second type. Thus, it depends on the concrete analysis of the situation.

Such molecular changes as generic crisis elements are manageable as isolated phenomena, even if they lead to shifts in the structure. Accordingly they organically belong to the capitalist mode of reproduction.

Since they are permanently effective, it is not useful to see themselves as a crisis or to see them still as a teleological principle, which leads almost automatically to the 'real' crisis (Demirovic, 1987: 118). But this form of molecular changes always contains the possibility of a shift of contradictions and power relations and thus can lead to a condensation in 'large' structural crises, which touch questions of hegemony and legitimacy. Molecular changes as cyclical crises do not ultimately threaten the existence of the mode of production, but generate social conflicts. Owing to the complexity of social relations, crises and conflicts are unpredictable.

Over-Accumulation of Fictitious Capital

The financial crash in 2007-08 and the global economic crisis are the result of a slowly growing over-accumulation—a molecular change developing over the years. As is known, the volume of financial transactions of US $3,300 billion a year has potentiated in comparison to a global trade volume of only $16 billion and cross-border direct investment of nearly $2 billion in 2008. The Bank for International Settlements (BIS) estimated only the volume of derivates trading for 2008 to US $1,600 trillion, the stock was estimated at about $345 billion (*www.bis.org*). If an average interest rate is assumed, say from a modest three per cent, then interest claims would arise from more than US $10 trillion, roughly the entire GDP of Germany, Japan and Great Britain, combined. These are claims that ultimately display nothing other than the levy surplus value, which had been produced elsewhere.[2]

This tendency to over-accumulation[3] has been addressed by different strategies, such as the constant refinement of financial instruments and

2. This comparison is intended to illustrate only the volume of trading in derivative financial instruments; of course, direct interest demands are derived only partly from derivative supplies, rather it is mostly a zero-sum game of mutual demands within the transnational bank sector. In contrast to ordinary stock transactions, the derivatives trading takes place 'in the future', and therefore, do not have to be funded in the present. Accordingly, a merchant is able to build up huge positions with Future Options for instance, at the lowest cost with minimal security deposits.
3. The height of the real over-accumulation is not determined, because rates cannot simply be set in relation to actual profits, but always reflect expectations of future profits to be realised as well as they reflect price developments. Also productive investments financed by loans, bonds or issue of shares are still speculative investments in the future. On the debate about the relative decoupling of the financial markets from production and trade see Altvater and Mahnkopf (1996: 250) and Candeias (2004/2009: 144).

the search for new investment opportunities by incorporating new areas (such as East Asia), and opening up to previously non-valorised areas (e.g., genetic resources, general knowledge and intellectual property, pollution rights and privatisation of public services). Another way was, and still is, to develop new products and means of production (e.g., information technologies). One decisive strategy is to increasingly and directly integrate the reproduction of the working class into valorisation of capital, and to create more and more new consumer needs, for example from flat screen to private real estate property. For this purpose it was important to push the working class into credit relations by financial innovations, such as installment payments, consumer loans, mortgages and building society loans with state funding, credit cards, the privatisation of pensions or the so-called subprime loans. All these strategies have not prevented a growing 'plethora of capital' (Marx, *MEW* 25: 261), of over-accumulated capital, which lacks adequate investment possibilities and is therefore 'pushed on the path of the adventurer: speculation, credit fraud, stock fraud, crises.'

The speculative bubbles, which led to the crises in Asia, Latin America and Russia in 1997-98, had for a real basis the extension of accumulation into new spaces. The dot-com bubble that burst in 2001 funded the spreading of internet technologies, before the 'exaggerations' were corrected. The housing and credit bubble that is now discharged, however, had hardly opened any new accumulation viable fields, but it had almost exclusively driven forward the financial or 'fictitious' accumulation. Thus, the mortgage crisis started from the so-called subprime loans; however, the direct payment defaults that accumulated in this area at the outbreak of the crisis in 2007 only added up to an estimated $45 billion (IMF, 2008). The volume of the speculation results from the complex combination of credits and their hedging with credit default swaps (CDS) contracts. CDS are credit derivatives, which were originally used to hedge against default risks of loans and other securities. They are themselves tradable and represent objects of speculation, with a market of about US $62 trillion (*Financial Times Deutschland,* June 3, 2008).

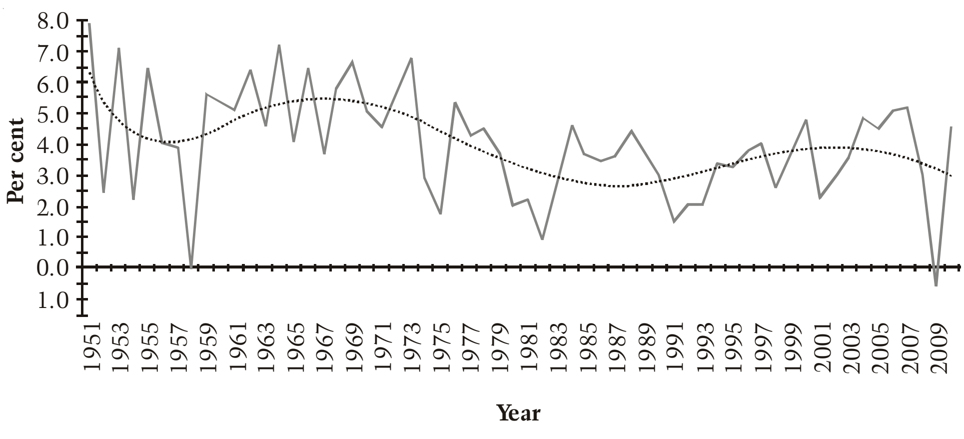
The sum of the accumulated assets leads to claims on surplus value, which exceeds by far the actual surplus value production (Husson, 2010). During cyclical crises, modified accumulation strategies could deal with the consolidation of this molecular change for long periods and delay but not prevent it. The mortgage crisis was, so to speak, the cyclical expression of this molecular change (see Candeias, 2009a).

The Myth of Economic Recovery

Structurally—and this is probably economically the most problematic for the power bloc—this change has led to the fact that the accumulation on an expanded scale has not been guaranteed for some years now. The BIS speaks of 'the myth of economic recovery': 'When economic performance declines, after recovery it tends to remain far below the previous levels' (Cerra and Saxena, 2007: 16). Especially in countries with a strong liberalisation of financial markets, economic recovery is slower. After every financial crisis long periods of recovery are to be expected, and they are often too long to return to the old level before the next crisis breaks once again. The crisis cycles become shorter and shorter, shifting increasingly from the peripheries into the capitalist centres—the progressive transnationalisation leads to the synchronisation of the cycles, and the crises tend not only to deepen but to last longer as well. If the recovery period of the affected economies typically lasts for four years, but crisis comes repeatedly every four to five years, there can no longer be any talk of genuine recovery in the sense of advanced reproduction (Ibid.; see also Krüger, 2010: 408). The global growth trend has been pointing downward since the late 1990s (see Figure 3.1).

Figure 3.1

Growth of the Global Gross Domestic Product



Source: Mariña Flores and Izquierdo Cámara (2010: 12).

This myth of economic recovery brings with it the belief that rising yields are only achievable through continuous redistribution at the expense of workers, the state and nationally or regionally limited capital factions, while more and more areas of socially necessary labour, of public infrastructure and social services are running dry. While over-accumulation cannot be reduced substantially, a reproductive crisis of society is aggravating, putting the basics of accumulation itself at risk (lack of infrastructure, lack of qualifications, lack of cohesion, lack of profit expectations etc.).

In Germany, the investment required for infrastructure by 2020 is estimated at over €700 billion, equivalent to annual investments of about €47 billion (Reidenbach *et al.*, 2008). In fact, however, especially local investments have been declining for years. Even in 2005, the underinvestment was approximately 20 per cent. In the wake of the crisis, after the economic stimulus packages ran out, the investments keep declining because of the statutory debt brake and austerity programmes. The Federation of German Industries (BDI) had already complained in 2008 of the threat to international competitiveness according to the lack of investment and called for 'ten per cent more public investment in infrastructure' (*Frankfurter Rundschau,* May 27, 2008). The investment gap of the United States looks even more dramatic. The Organisation for Economic Cooperation and Development (OECD) estimates that worldwide demand for infrastructure investments will be at least $41 trillion by the year 2030. This corresponds to an annual amount of about $2 trillion. In contrast, there is only about $1 trillion invested—predominantly by the public sector. These calculations insufficiently include investments in social infrastructure such as nursing, health, education and training.

However, the macroeconomic investment rates of Germany continue to decrease, between 2001 and 2008 from 22 per cent to 17 per cent of GDP, i.e., the contribution of gross capital investments to economic growth is (negative) 0.1 per cent during the same period. The actual net investment (i.e., gross investment minus capital depreciation) even fell from 8 per cent to 2.7 per cent, in the US from 9 per cent to 2.8 per cent. In both countries there is real disinvestment in industry. Despite the investment boom in Brazil, India, China, and other emerging economies, there is, according to data from the World Bank, a falling tendency of the world investment rate in relation to the declining growth rate since 1979: After a rugged crash in the 1980s, it managed to stabilise shortly after the crisis in 1990, then remained flat until a small investment boom in the wake of the New Economy. Thereafter, investments had continued to fall, in 2008 down to 20 per cent of global GDP, 4 per cent below the historic low point of 1979. According to Husson (2010), 'Investments abroad do not compensate for the weak domestic investment dynamics'. Investment and growth remained behind, despite a rising rate of surplus value. An approximation to the rate of surplus value in the bourgeois economy corresponds to the proportion of the macroeconomic gross income, which in Germany increased by 12 per cent from 1982 until 2010.[4] With regard to the historically low investment also in other OECD countries, Artus and Virard (2007) had already spoken of 'capitalism without a project,' even before the recent crisis had started. Low growth and low investment are, if nothing else, the result of the lack of profit opportunities and once again declining rates of profit (while capital costs increase).[5]

In the US, after the crisis of Fordism, from 1982 to 1997 the rate of profit started from a low level and elevated significantly. Despite the New Economy boom, it then dropped to rise again only after the crisis. From mid-2004—even before the great crisis—it had already been falling down again, and more so in the ongoing crisis since 2007 (see Figure 3.2).

In Germany, the tendency of the profit rate continues to be flatter than in the US after a sharp drop in 1982 (see Krüger, 2010: 464). Along with lowering the wage rate and improving productivity since 1982, net profits have stabilised, from 5.9 per cent in 1982 to 11.6 per cent in 1986. 'However, this is not sufficient, not even for a compensation of the increasing weight of the advanced fixed capital with its extended turnover; the total turnover of the advanced capital, considered the average turnover

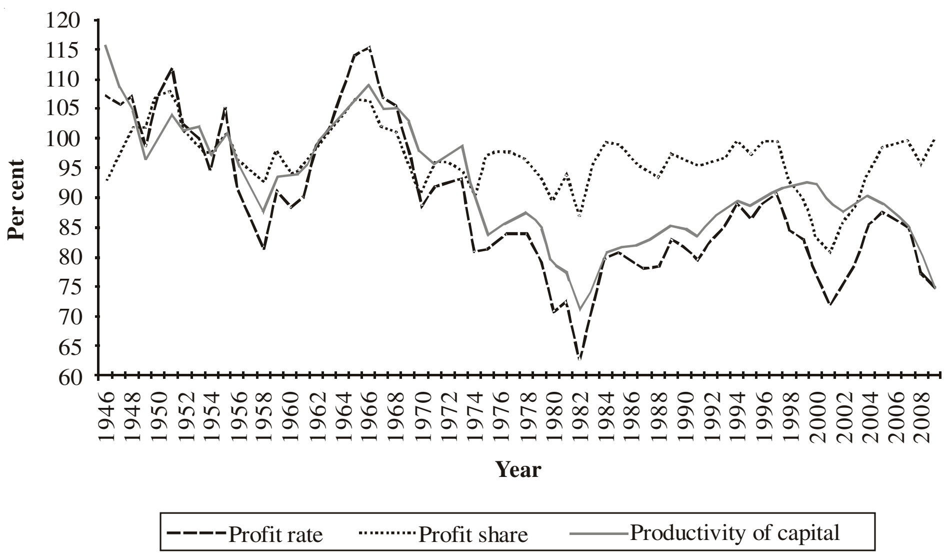
4. In the US, the gross share of profits remained relatively stable (around 10% below the German rate). The dramatic rise in executive pays—statistically counted as wages—compensate for the declining real wages, so that the relation of wage and profit rate remains virtually unchanged.

5. Despite the price reduction of capital goods due to the microelectronic revolution, declining capital productivity (see below) and rising commodity prices, especially the growing levy of value by financial activities (despite low interest rates, but high real interest rates) lead to rising capital costs.

of all its components, has been decreasing over the whole period' (Ibid.:467) since the beginning of the 1980s. At the same time, the proportion of variable capital has been falling due to the accelerated transformation of 'living labour' into 'dead labour' (Marx) as well as the decline in real wages, especially since 2001. After the crises of 1998 onward, the rate of profit could again be increased from 8 per cent to 11 per cent. The increase in the rate of profit, which had been 12 per cent throughout the period since 1982, strikingly corresponded to the reduction of the wage rate by 12 per cent. The crisis of 2008, as Krüger suspects (2010: 466), marked the turning point for another decline in the rate of profit.

Figure 3.2

Profit Rate, Profit Share and Capital Productivity in the US



Source: Cámara Izquierdo (2009: 5).

Molecular Aggregation of Elements

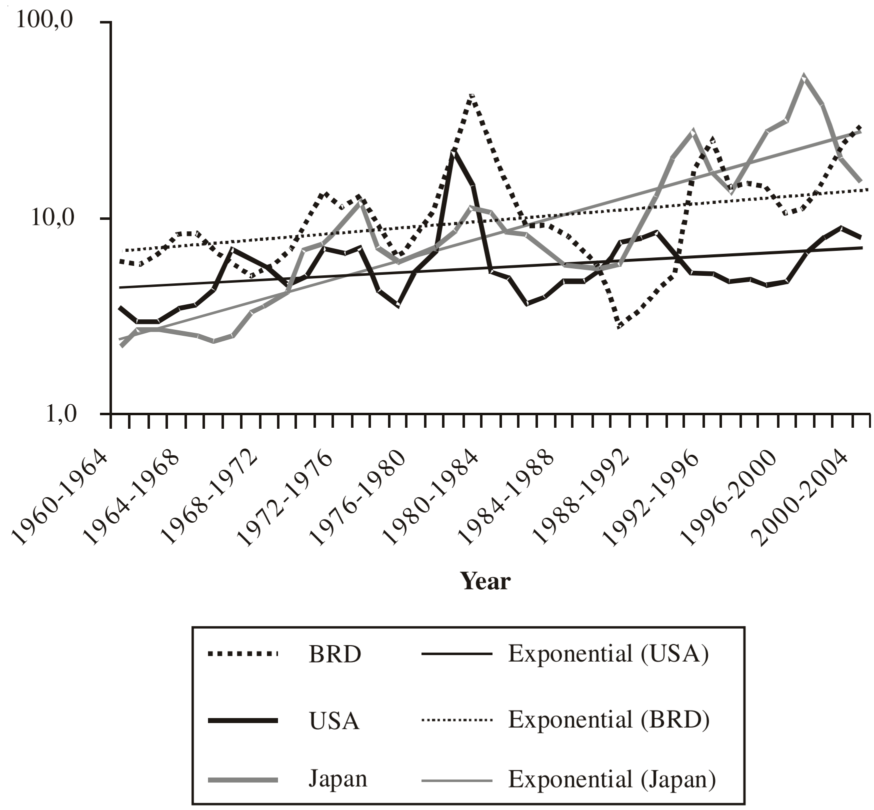
According to Krüger (2010: 411), 'the inherent limits of cyclical booms emerge more rapidly,' decreasing investment, resulting from lack of profit prospects, diminishes the possibilities for an intra-cyclical adjustment of economic disproportions—accordingly, there will be more violent adjustments of the proportions through crises. Against this background, other molecular changes, which themselves may not be a threat to the neoliberal hegemony, can be looked at in a different light, meaning that they can be seen as a crisis-exacerbating factor, such as the exhaustion of the new productive forces: In the last few years, new forms of work organisation have been repelled. Capital dismantles workers' autonomy, tightens control, and intensifies insecurity and overexploitation of the labour force. From the perspective of workers, this leads to demotivation and blocked creativity, both through 'self-exploitation' in flexible, less hierarchical labour relations and narrow limits of management requirements and despotism (especially in the low-wage labour market) or lack of promising perspectives. In many cases this leads to fatigue, uncertainty, burnout or lack of requalification. As a result, labour productivity in Germany has for the last 10 years been under 2 per cent, despite the New Economy boom. It usually fluctuates around 1 per cent. In the US, the growth of labour productivity had gone down from 2000 to 2007 by an average of 0.5 per cent. It could only be (statistically) improved to an average of 2 per cent by mass layoffs during the crisis (Bureau of Labour Statistics, 2010).

Capital productivity is stagnating: From 1980 to 1992 it had increased significantly, but with the recession of the early 1990s, it again fell back and could only be increased once more for a short term within the New Economy boom. Following the crisis of 2000-01, it dropped significantly (below the level of 1979). The Bundesbank confirmed: 'The declining capital productivity corresponds to…the long-term trend that is reflected by the disproportionately growing use of capital (substitution of capital for labour)'. In the 2008 crisis the capital productivity significantly decreased by further 6.6 per cent (-4.9 per cent labour productivity) (*BuBa Wirtschaft & Statistik*, 1/2010: 16).

In the US, capital productivity has been decreasing since the year 2000 (see Figure 3.2). Despite the drop in investments and the decreasing share of wages, the capital intensity increases; while labour and capital productivity decline and the capital output ratio (capital stock by domestic product) increases. That is a strong indicator of the rapidly growing organic composition of capital. As per Husson (2010), '"The rate of profit rises if the growth of real wages is less than…the weighted average of labour and capital productivity"—but "it is this double decline in labour productivity in relation to capital expenditure per head, but also in relation to the wages, that initiates the fall of the rate of profit"'. At the latest from 1999, increasing profit rates can neither be related to increasing growth rates nor to growing productivity. The respective stabilisation and increase of profits after a slump are the result of redistribution of surplus value. The potential of new productive forces can no longer be realised under the neoliberal relations of production.

Figure 3.3

Capital Coefficient (EU Commission)



Further molecular changes, which by themselves haven't led automatically to the crisis of hegemony, but could have been processed within neoliberal regulation, occurred—the following only cursorily: In everyday life the ecological crisis is already manifest which not only threatens the lives of millions of people (disasters with storms, floods and droughts), but also leads to massive destruction of capital. For instance, according to the Stern Review (2006), the expected costs of insufficient climate protection would reach at least 5 per cent of global GDP, and therefore, cause an actual shrinkage of the world economy (in the worst case upto 20%). Furthermore, fossil energy reserves are running out. Their combustion not only promotes the ecological crisis, but also, given the expected rise in prices, threatens many industries and growth. However, a consistent climate protection programme will lead to severe adjustment crises, capital destruction or the demise of certain industries. One must generally expect rising costs because of the growing hunger for natural resources. In view of uncertain profit prospects, the rising costs inhibit the willingness to invest.

The further tightening of precarious working and living conditions, which pushes large parts of society into growing uncertainties, the thinning of public services, the intensification of work, along with neglecting necessary education and care work, deepen the already mentioned crisis of the reproduction. Partly the related dissatisfaction, leads to revolts among those who are most affected in the outer and inner peripheries, especially the younger population. Protest and resistance are arising at all levels, rather fragmented and without clear direction, but periodically increasing. The Central Intelligence Agency (CIA) doesn't warn for any reasons that global terrorism is no longer the biggest threat to 'national security', but that it is rather the expected consequences of financial and economic crises.

Especially in the peripheries, particularly in South America, large segments of population and many governments have seceded from neoliberalism and are now searching for new ways of an autonomous development. The so-called Washington Consensus and its institutions, but also the approaches for good governance, are openly rejected by more and more states in the Global South. Those who can afford it just pay their debts in advance and bid farewell to International Monetary Fund (IMF), like Brazil. Connected to this crisis of international institutions and Western hegemony, we are facing global-political and economic shifts in the social relations of power. The so-called BRIC or the Gulf states have become new capitalist centres (in detail see Schmalz and Ebenau, 2011).

In the old centres, a growing part of the population turns away from parties and governments; some even from formal democracy as such. This has led to an ongoing crisis of representation, which has remained unresolved (Heitmeyer, 2010). Internationally, coercive and violent securitisation of neoliberal globalisation and the overstretch of the United States as a global monopolist of legitimate violence have reached their limits. Even within the different societies the enforcement of security measures, policing and prison fare (Wacquant, 2010) prove inadequate (and expensive) to ensure social order, let alone organising the consent of the subaltern.

These are long-term trends, which cannot be eliminated by a few small efforts of crisis management. The changes will take place at different levels, and in fragmented ways, including: economic inconsistencies, exhaustion of the productive forces, changes in subjectivities, the shifting of the social relations of power, political legitimacy losses and ecological and social reproduction. Their condensation is proceeding slowly, but then it often suddenly runs quickly, from a certain condition of aggregation on—which has to be instigated politically—when 'quantity becomes quality, in other words: organic crisis, no longer cyclical crisis' (Gramsci *Gef*. 5: 1070).

Conjunctures of the Crisis

The different elements of the crisis also show effects on other levels. Long-smoldering generic crisis tendencies are being intensified. Thus, the hotspot of the crisis is shifting. Crisis management is to prevent the condensation of the crisis. This partly succeeds. The way in which the crisis is being managed is already preparing its next conjuncture, the next chapter of the drama.

Financial and World Economic Crisis

The biggest financial crisis since 1929 was initially handled with huge bailouts and unlimited provision of liquidity by the Central banks, in order to avoid a collapse of the financial system—this was the first chapter. The second chapter was intertwined with the first one, and followed immediately: The credit and financial crisis uncovered a world economic crisis, which had been processed in the old and new capitalist centres. The United States is using more than $2 trillion to contain the impact of the crisis. The 'rescue parachutes' of the EU and its member states are coming to a total of €2 trillion, and another €600 billion are being spent for stimulus packages. The Federal Reserve is trying to stimulate the US economy by all means, and to secure liquidity by purchasing mortgage securities and government bonds at the amount of over $800 billion. Since March 2010, it has invested $100 billion a month in such titles (*Financial*

Times Deutschland, October 18, 2010). The European Central Bank (ECB) and other Central banks have followed this example, but in a highly cautious and inconsistent manner.

These crises and the reactions to them led to an enormous increase in state expenditure, without having reduced the financial over-accumulation significantly. According to the Financial Stability Board, only about $2 billion of fictitious capital were depreciated in real terms, and thus destroyed—whereas there is an estimated stock of $200 trillion of privately held financial assets. The extreme current account imbalances have not been deleveraged either (data according to the IMF and UNCTAD). Despite Basel III agreements and the financial market reforms in the US constituting the largest re-regulation in the last 40 years, different governmental interests as well as strong opposition from the financial institutions are blocking coordinated actions. A serious regulation, or even a reduction of the financial assets (by controlled destruction, depreciation and socialisation), as in the 1930s, is not taking place (see Wahl, 2010).

Debt Crisis

After that the third chapter followed: a debt crisis. The budget deficit in the US rose to a record high and US debt increased to over $13 trillion (about 85% of GDP, *Handelsblatt,* April 7, 2010). Furthermore, there has to be added another $900 billion for health care reform and some billions more for infrastructure projects. The Congressional Budget Office estimates the cumulative deficit from 2011 to 2020 at almost $10 trillion and expects an increase in the national debt of 90 per cent of GDP. Not even the proposed austerity programme of $250 billion throughout the following 10 years could change much. The US growth model has become a thing of the past and can no longer be restored: high consumption rates, financed on credit by massive capital inflows from all over the world, which made possible low interest rates—this is not going to work again. Households in the United States will never again be able to consume that much, and the 'global consumer' is failing in the long term. This has an enormous adverse impact on the global economy. Now the US companies, consumers, government and financial services are indebted with about 355 per cent of GDP. Inflation reached the zero per cent mark. At that point, a depression can only be prevented by the state pumping huge amounts of money supplies into the economy. That's because the economic outlook is uncertain, at least at a closer look. After the drastic declines in consumption since 2007, households have since increased their spending again, *albeit* slightly. However, this increased spending does not correspond to increases in income. In fact, income is decreasing, that is to say, the private debt is rising again—the savings rate is now at a point of -1.3 per cent (*Financial Times Deutschland,* October 15, 2010). The market-based income just amounts to 68 per cent of the total income—the lowest level since 1947, meaning that the state more and more guarantees the incomes. And yet, despite the huge stimulus packages, aggregate demand just rises by 2 per cent. As earlier stated, private investments have reached a new negative record. Without government expenditure, the official unemployment rate would not be at 10 per cent, but significantly higher. There will be no growth without government intervention. In the situation of high public and private debts, 'a stable recovery is as likely to occur as the repayment of all outstanding Greek loans'—the US being 'on their direct path into the next chapter of the crisis' (*Financial Times Deutschland,* May 4, 2010).

Let's take a look at Europe, because the debt crisis also hits the Euro area. Greece is forming just the tip of the iceberg. The Euro area with a debt of over 80 per cent and new indebtedness rates of more than 6 per cent for 2010 and for 2011 (both in relation to GDP) is by far exceeding the Maastricht criteria (total debt not above 60%, annual new indebtedness not more than 3% of GDP). The worst affected are not the free spending countries, but those who in the past vied especially with low tax rates for the timid deer called capital, and who had rather low public spending. Again there will be hundreds of billions of euros mobilised to avoid the worst scenario: Needless to say, the national bankruptcy of a member of the Euro zone, which would lead to worse consequences than the Lehman shock. Germany, as the most responsible economy of imbalances within the monetary union, is at the same time the main profiteer of the crisis. The devaluation of the euro, which is directly connected with the debt crisis, allowed anew an export boom for German industry. Now German cars become more and more attractive for the growing rich upper class in China, triggering a boom in the automotive industry (over 130% of increase in car demand in China in 2010). Now the governments are competing with austerity programmes: pension cuts, wage cuts, cuts in child benefit and family assistance, reduction of unemployment benefits and an investment freeze, which does not even spare necessary expenses in infrastructure, child care, or education. For that reason, the reproduction crisis is further deepening. Although the idea of austerity is still rooted in common sense, the solution is not convincing, given the one-sidedness of the burden on the population without making those responsible for the crisis to pay up for it. In surveys, over 80 per cent of respondents think that it is actually the ordinary citizen who has to bear the negative consequences of the crisis (Heitmeyer, 2010: 23). Almost half of the respondents feel threatened in their personal life planning. About 90 per cent expect an increase in poverty as well as a social decline, but more than half of them hope that the crisis would pass them by personally (Ibid.: 25). Nine out of 10 respondents argue, in consequence of the economic and debt crisis, for a new economic order with more consideration of social equality and environmental protection (*www.zeit.de/2010/34/Emnid-Umfrage*).

Crisis of Representation

This is where the fourth chapter of the crisis is to be found: a rampant crisis of representation. In order to fix the state budget, the socialist government of Hungary has already sacrificed itself. Now governing lies in the hands of Right-wing parties together with national fascists whereas in Spain, ministers of the Zapatero government fear to have already lost the next election. The Irish government hits its historical rock bottom with an approval rating of 13 per cent. Even in Germany, the inconsistency of government policy maneuvered politics into a crisis and survey lows. This leads to the decoupling of the representatives from the represented; decisions are now represented as imperative necessities. A clear majority of the population, especially in the vulnerable middle class, believe they no longer have any influence in policy decisions (Heitmeyer, 2010: 27). This doesn't lead necessarily to a re-politicisation, but on the contrary to a private retreat. Crouch (2008) calls this a 'post-democratic' tendency where democratic procedures remain as formally intact, but are substantially emptied. Trust in politicians drops dramatically and anger about the consequences of the crisis has massively increased (see Klein and

Heitmeyer, 2010: 174; *Eurobarometer,* August 26, 2010). What is even more threatening to the government, however, is the alarming fact that at least 92 per cent of entrepreneurs consider the government incompetent. The June 14, 2010 headline of *Der Spiegel* says: 'Stop!'. Bourgeois media and the economy beyond withdrew confidence from their own leaders, and initiated various campaigns against government policies.

The crisis of the 1930s has already been a lesson: Keynesian policies do prevent a depression. At the same time, the power bloc remains loyal to neoliberal principles, such as liberalised financial markets, and to the religion of austerity. A return to the *status quo ante* is intended. But without tackling the causes of the crisis nor re-regulating financial markets and reversing tax policy, there is no perspective to overcome the crisis. 'The political crisis has knocked at the doors of the government apparatus of the ruling neo-liberal bloc… After the panic of 2007/08 and the satisfaction in 2009, now disorientation and striking strategic uncertainties have become obvious' (Rilling, 2010: 4; Candeias, 2009b). At the same time, the stabilisation of old structures (e.g., 'cash for clunkers'), the retreat from emission limits, the end of the support for solar power as well as the lack of green investments, are exacerbating the ecological crisis.

The impacts of the crisis and austerity policies remain diffused in Germany. The currently active exclusion of the unemployed and migrants is of secondary importance in comparison to broadened personal fears about job losses and social decline. Nevertheless, this exclusion is receiving strong support. More than half (60%) of respondents in Germany think that in times of crisis, too many weak groups have to be fed by society. At the same time, disrespect of the long-term unemployed has declined because of the personal experiences of crisis (Heitmeyer, 2010: 33).

Structural crises lead to the disintegration of the relation between the represented and the representatives. However, they are not directly translated into personal problems, least of all into the motivation of individual or collective action. However, the hotchpotch of protests, crashing polls, growing doubts about democracy—in particular the abandonment of bourgeois representatives by their supporters in the electorate—have all put pressure on the rulers who are unable to bind the conflicting interests into a common political project.

The Tightening Monetary Competition

A lack of international agreement, and especially the failure of the G-20 because of very different economic conditions and ideological orientations, promotes individual national strategies and an accelerated currency competition. While Europe is implementing a turn to implacable austerity and gets busy with educating the budgetary 'scruffy' Greek, the US is trying to impose inflation on the world, in order to prevent its economy from slipping into depression.

Wherever you look in the US, the state has its finger in the pie. The state has to create jobs and pay the unemployed, as well as provide investment and pay hospital bills. And since it does not have the money for this, it has to acquire it, and where else but in the capital market. US government bonds are considered safe, particularly in times of crisis. However, the US needs to find purchasers in the short term, within the next few months, for borrowing loans of \$1.6 trillion—which means an estimated total sum of \$2.55 trillion in 2010. This triggers a flood of government bonds that not even China can absorb. China has been buying about \$1 billion a day. But the People's Republic recently sold US bonds on a large scale: more than \$34 billion were sold off. Moreover, the dollars are being spent on the purchase of raw materials, land (land grabbing), on acquisitions of foreign companies, as well as on foreign infrastructure. With an amount of \$755 billion, China is now the second largest owner of US treasury bonds after Japan, Moody's—which is itself deeply involved in the causes of the financial crisis—is already threatening with a devaluation of the rating for US government bonds. The pessimists among financial analysts are warning of a state bankruptcy of a much larger dimension than the one in Greece.

Against such a background, the Fed always announces a 'quantitative easing'. It buys US government securities (monthly for about \$100 billion) and tries to push the real interest rate, which is now -1 per cent, even further down. Thus, the Fed is trying to ensure the liquidity of the domestic economy and to reduce the debt burden of companies, homeowners and consumers alike. This also weakens the exchange rate of the US dollar, which is supposed to stimulate exports.

The policy has had a particular impact on Japan. The yen was revalued in no time, causing a drastic slump in exports and thereby threatening the minimal recovery of the Japanese economy. At the same time, the Japanese Central bank has little to contribute against this. The prime rates have been aground for decades and cannot be reduced any further. Even the new capitalist centres like Brazil are suffering from the rising cost of their exports as well as from the flooding of their markets with capital looking for high interests, which, without counter measures, would lead to an overheating of the economy. This is already threatening China, too.

Thus while the US goes on inflating, China sticks to its course with minimal adjustments. Since the renminbi is connected to the dollar, there are no changes to the unfavourable exchange rates between the two largest economies. For Europe, Latin America and Japan, this monetary competition means a tendency towards revaluation of their currencies. The euro revaluated from June to October 2010 by 17 per cent (*Financial Times Deutschland,* October 19, 2010)—bad news for German exports. The reforms of the monetary system and the underlying economic imbalances have so far played no role to the G-20. As there are different conditions and interests pursued, high currency volatility is to be expected in the future. This leads to erratic capital flows in search of high interest rates and 'safe havens'. This is alternating with overheating, bubbles and rapid withdrawal of capital. Let us recall the series of crises in the years 1980-1990 (also known as 'the lost decade') or 1998-2001: among them, the Asian crisis, the Russian crisis and the Latin American crisis. Owing to that, companies need to prepare for the fluctuations with hedging on the basis of derivatives.

Recession Again

This inconsistency in government policies and lack of financial and monetary reforms, are laying the groundwork for the sixth chapter of the crisis. In Europe, particularly, the procyclical austerity will likely lead to a deep recession.

Under much pressure from the EU and the German government, the socialist government of Greece made radical cutbacks, even more radical than those demanded by international creditors. As a result, the budget deficit was cut in half within a short time; by 2014 it ought to be reduced from 14 per cent of GDP to 3 per cent. As a reward, Moody's (the rating agency) downgraded the bonds of Hellenic banks. Their explanation: the poor economic prospects, caused by the austerity measures, increase the default risk of asset-backed securities and jeopardise the consolidation of the banks. Indeed, due to the drastic cost-cutting programmes and declining investments, Greek GDP sank by 4.5 per cent in 2010 (at 6.5% in the last quarter). For 2011 it is expected to fall by 3 per cent. Consumption-which accounts for at least 70 per cent of the country's total economic output—is collapsing. According to the Greek Trade Association, a fifth of the small shops in Central Athens have had to close down. A huge majority (90%) of Greek companies are facing severe liquidity problems. The banks are aware of conceding credits given the poor economic prospects. In Greece, the unemployment rate is exploded up to an official rate of 12.5 per cent in 2010, while the estimated real rate is about 20 per cent. The proportion of precarious and temporary jobs was extremely high, even before the crisis. Many people are not even able to benefit from a social security system, which is comparatively poorly developed. The consolidation will once again fall in the hands of the mass population, whereas finance capital, banks and wealthy individuals, are rarely considered to pay for the crisis. In the end, the consolidation will be threatened, ironically enough, by the official measures themselves. The tax losses from recession overcompensate what has been saved from implementing austerity. Finally, the state is financially worse off than before.

All EU member states are pursuing tough austerity measures: the United Kingdom, Spain and Italy, even France have had to bend to the pressure in the end. The EU Commission is working on a tightening of the stability pact. As a consequence, the growth of industrial production in Europe once again arrived close to the zero per cent mark in summer 2010 (Eurostat, 13.09.10). 'The peak of industrial recovery in the Euro Zone could now be exceeded for good,' says Chris Williamson in the *Financial Times Deutschland*. He adds: 'Especially in the service sector, the prospects have weakened significantly' (22.10.10). According to Daniel Leigh from the IMF, the consolidation of a national budget of about 1 per cent causes a decline in growth of about 0.5 per cent, as well as a rise in unemployment of 0.3 per cent (*Financial Times Deutschland*, October 18, 2010). The consolidation rates aspired for—around 10 per cent in a number of European countries—imply an inevitable deep recession. If countries like Ireland, Greece and Spain—and also the United Kingdom which is not a member of the Euro zone—do not manage to escape the recession, then the debt crisis will quickly become virulent once again and the European 'rescue parachute' budget would be exhausted.

The Right-Wing Populist Solution

In the face of the diffuse threat by crises, bankers, social decline and the loss of confidence in politics, a seventh chapter of the crisis is imminent: namely, the Right-wing populist solution. The signs are mushrooming: the increasing clout of the party of Geert Wilders in the Netherlands; the Flemish separatists in Belgium; neofascists in the Hungarian government and other countries in Eastern Europe; a general shift to the right in Denmark; the expulsion policies of the French government against Sinti and Roma (nomadic communities); and the overwhelming approval of two-thirds of the population to the chauvinist and racist resentment of German social democrat Thilo Sarrazin against the unemployed, migrants and Islam.

Interregnum: Decomposition of the Historical Bloc

The ruling power bloc has no constructive solutions to offer in the face of arising manifestations of the crisis. The solutions that are called for must induce a boost of accumulation while at the same time incorporating the interests of the subaltern, and thereby would be able to once again create an active consensus in favour of the neoliberal project. Neoliberalism is exhausted. Yet its institutions will continue to show severe impacts for a long time (similar to the end of Fordism), their position still being dominant but not hegemonic in the sense of organising active consent (Gramsci *Gef.* 2: 354). The "'molecular aggregation of elements" may "cause an explosion"' (Gramsci *Gef.* 9: 2063), or can lead to the disintegration of the hegemonic bloc and ultimately to the transformation of the mode of production and the mode of living. This would be a long and highly competitive process. The old is fading, while the new cannot yet be born.

The neoliberal forces are still strong enough to block further reforms and transformations. The blocking on the inside and at the global fringes of the transnational power bloc, as well as the different, competing and contested societal projects, will probably result in a constellation of transition (see Candeias, 2009b). During this interregnum the crisis can persist for a long period, perhaps even a decade, before a hegemonic direction develops out of the competition between the different projects to dissolve the crisis. This new hegemony will encompass a certain bandwidth of different paths but the terrain and the direction of development will be largely determined. Therefore, 'post-neoliberalism' does not characterise a new period of capitalist development (see Brand *et al.,* 2009). Instead, it is a transition period or interregnum in which numerous search processes occur and the future organisation of society is in debate. A new term must be coined as soon as a hegemonic project becomes apparent. In my opinion, at the moment there is only one potentially hegemonic project which can provide the required resources, accumulation dynamics and potential for consensus: the Green New Deal, a period of green capitalism (Candeias and Kuhn, 2008; Kaufmann and Müller, 2009). Such a project would try to manage the multiple crises, open up new field of accumulation, create more jobs—a strong fundament for a broad consensus (with a strong authoritarian character in face of lacking social movements and political pressure). But this scenario is far from being definite; after all, the reactionary and neoliberal forces are too strong so far. Furthermore, the project of the Green New Deal is in itself too contradictory. It is still a relatively open historical situation in which no hegemonic direction has been pursued up to now.

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4 Currency War *versus* Monetary Cooperation

FABIO DE MASI

Introduction

A currency war is looming: the US economy is in a very worrisome condition. The electoral Republican victory in the US congress has made new fiscal stimulus packages in the US unattainable. Hence, the Federal Reserve Bank (FED) pumps liquidity into markets to devalue the dollar and lower external deficits. China will only revalue the renminbi currency in a slow and controlled manner. The European Central Bank (ECB) does not intervene into markets but Germany follows a sustained strategy of real devaluation by wage dumping which poses a great threat to the stability of the euro. The current German upswing of the economy has been nearly exclusively financed by demand from the US, other Euro zone members, and the emerging economies.

Moreover, the low interest rate policies of the core encourage carry trade respectively an inflow of hot capital into emerging economies. The Brazilian Minister of Finance, Guido Mantega has expressed concerns over a currency war. War knows many losers, but rarely winners.

This setting may explain why the US Minister of Finance, Timothy Geithner, has made, for the first time after World War II, a peace offer. He proposed to stabilise exchange rates and decrease external imbalances by fixing upper limits of surplus and deficits in the current account. Germany has refused the peace deal. However, 'beggar thy neighbour' may soon translate into 'beggar thy self'.

Constant deficits in the current account lead to a net indebtedness of the total economy (state, private households and firms). If surplus countries do not share the burden of adjustment, the sectors in the deficit countries have to adjust by cutting expenditures. If all countries cut expenditure at the same time, a new recession looms.

Borrowing money in low-interest countries and transferring it to high-interest countries—the problem with carry trade is, it pushes interest rates away from 'equilibrium'. The currencies of high-interest rate countries will further appreciate.

The paper argues that monetary cooperation is superior to unilateral solutions to monetary policy. Money matters for economic development. Financial power or the ability to stimulate the economy by credit expansion is unevenly distributed across economies. Hence, developing countries or countries with little financial power have only two options: seeking global or regional monetary cooperation or exercising unilateral capital controls. The paper reviews these strategies and argues that unilateral solutions are only available to few countries and regional cooperation has no strong tradition in regions such as East Asia. Hence, a new global monetary framework would greatly support economic development.

Theory of Credit or Does Money Matter?

Economic theory has identified investments as the primary source of technological progress, and thus, of growth. The major division in economic theory is the role of money for investment.

The classical or political economists witnessed the emergence of European capitalism and modelled the economy as a barter system. The available pool of capital for investment restricts the growth of a barter economy. The role of money is limited to being a store of value and facilitating the exchange of goods and services. As the level of productivity in agriculture is low, the population consumes most of the output and few resources are left for investment. Workers' salaries have to be kept at the subsistence level in order to reserve any surplus for additional investment (capital restriction) (Lowe, 1975: 415-25). Therefore, the appropriation of surplus labour from workers (exploitation) is a precondition to economic development (Reismann, 1985: 4). In other words, saving is non-volitional and determines investment.

The term 'investment' refers to both productivity- and capacity-enhancing investment. More recent versions of (neoclassical) economic growth theory have introduced concepts such as 'human capital' to explain (exogeneous) technological progress (Wurm, 2006). However, in that instance, investment (e.g., investment in education) continues to explain growth.

A notable exception among classical economists is Karl Marx, who acknowledged the role of money advances when referring to the realisation problem and the circuit of capital. Money allowed investment and additional production to exceed consumption, assuming that capitalists undertake investment in order to generate profit or accumulate wealth. Unfortunately, the discourse on Marxian economics has mainly centred on the labour theory of value and the tendency towards a diminishing rate of profit that involves conceptual problems (Hein, 2006: 113-140).

In neoclassical economics, the available pool of capital likewise restricts growth. However, as workers' or private households' incomes are not necessarily kept at the subsistence level, they may save income. Therefore, the available pool of capital depends upon the 'volitional decisions of economic units to save their money and abstain from consuming' (Moore, 2006: 2). If more (less) investment is desired than savings available, interest rates will rise (fall) and induce more (less) savings and less (more) investment. The money market transfers savings smoothly to investors, and interest rates are endogenously determined by supply and demand of money (Fisher, 1930). The interest rate is flexibly determined on money markets and secures an identity of savings and investment. Hence, in neoclassical economics, money is a store of value and a means of transaction with no implication for growth. The growth rate is exogenously given by the combination of factors of production and exogeneous technological progress (Solow, 1956: 65-94).

In the monetarist version of neoclassical economics, any additional supply of money (credit) beyond the growth rate of the economy will simply cause prices to rise (inflation). The demand for money is a function of income. Free movements of capital and freely floating exchange rates will compensate inflation and interest rate differentials (Krugman and Obstfeldt, 2003: 341-50). Thus, the domestic monetary institutions are the culprits of inflation. Consequently, the growth of money supply should be firmly controlled by central banks according to a fixed rule (Friedman, 1969).

Post-Keynesian and Schumpeterian economics differentiates between the (historical) development of barter economies, where growth is restricted by capital and modern monetary economies. A modern monetary economy is primarily restricted by the effective demand for goods and services and insecure expectations (Moore, 1988; Messori, 2002).

The interest rate is influenced by the central bank, and planned investments may not correspond with planned savings. Investment does not depend on savings but, instead, savings are the accounting record of investment (Moore, 2006a: 2-3). To illustrate the argument: In a stationary economy, where all the available output is consumed (zero savings), additional savings can only occur if investment raises income. Money or credit pre-finances these investments without utilising prior savings (Bertocco, 2007: 101-22).

In modern credit economies, half of the finance for investment spending is provided by corporate retained earnings, while the other half is primarily raised by bank borrowing (Moore, 2006a: 2). Loans or bank borrowing results in newly created deposits (money). In practice, the central bank supplies any reserves demanded by banks to support this level of deposits at a given interest rate. The (short-term) interest rate is exogenously determined by the central bank (Moore, 2006b: 208-14). As a consequence in Keynesian theory, savings or the available pool of capital are not a restraint on investment (growth) and 'most saving is no longer volitional' (Moore, 2006a: 2).

Money is not neutral and constitutes a decisive source of investment and, hence, income which in turn impacts on consumer spending. Further, central banks have no direct influence over the money supply as economic agents' demand for money is determined endogenously (with respect to their expectations of future income). Hence, additional creation of money must not result in inflation if an economy is operating below its capacity level.

The concept of insecure expectations must be separated from the neoclassical concept of probability and risk. The latter allows the prediction of certain market outcomes with statistical tools (Knight, 1921: 233).

The current US Central bank concerns over deflation despite huge measures to provide additional liquidity to the banking sector very clearly illustrate that case: Additional liquidity does not necessarily translate into additional money since the commercial banks create money, and not the central bank.

Certainly, 'too much money chasing to few goods' might cause inflation if the economy has reached its temporary capacity level. However, additional money could also create additional productive capacity. Therefore, in economies operating below their capacity level inflation is explained with the development of unit labour costs. External factors for inflation are changes in the relative values of money (exchange rates) and the prices of important input factors (i.e., oil) (Moore ,1988).

Lately, a new consensus has emerged, which can be called 'neoclassical-Keynesian synthesis'. This view stipulates that money is relevant in the short run, at least, as prices are sticky. However, in the long run, the neoclassical proposition on money prevails as an expansionist central bank loses credibility with rational economic agents and the production capacity is fixed. Wages and prices will adjust and neutralise the expansionary effects of monetary policy (money illusion). Thus, monetary policy is at best an option to restore full employment within the given production capacity (Moore, 2006b: 247-252).

The Role of Credit in the Real World

The dispute about the role of money for economic development is a chicken-and-egg problem. Empirical studies validate both assumptions: a correlation between inflation and unit labour costs (economic indicator) as well as increasing money supply during periods of accelerating inflation (monetary indicator) (Moore, 1988). The huge swings and upward trend in the prime lending rate set by institutions such as the US FED during its monetarist period indicate an endogeneous money demand, and has led to a public reversal of money supply targetting among most central banks (Moore, 2006b: 233-34). Therefore, increasing money supply seems rather the byproduct of inflation than vice versa.

The Deutsche Bundesbank was one of the few central banks that (officially) adhered to pure monetary targetting. It had a great influence on the monetary strategy of the ECB, which, however, is based on two pillars: the analyses of economic and monetary indicators (European Central Bank, 2008). The two pillars were primarily a political compromise and a signal to the financial markets that the euro would become a safe heaven of value for financial investors. In practice, the Bundesbank also followed a rather pragmatic stance when such was deemed necessary (e.g., to keep the exchange rate within a certain parity to other currencies) (Issing, 1997: 67-79). The pragmatic monetary strategy of the FED was much more successful in terms of growth (and employment) than the monetarist policies of the Bundesbank.

Price hikes of crude materials and energy accelerated inflation prior to the recent economic crisis. However, they can be clearly attributed to speculative patterns. Neither patterns of supply and demand nor lending activity by central banks explain these price movements since core inflation remained low (Schulmeister, 2008). A tighter monetary policy would have been likely to induce more financial speculation due to higher interest rates and would have made the crisis more severe.

The Monetary Policy Tools of Central Banks

Central banks regulate monetary policy with open market operations (OMOs) through purchase and sale of government bonds. If a central bank sells government bonds to the public, it receives money and, hence, takes liquidity out of the market (Gilpin, 2001: 371). A different tool is the discount or repo rate that regulates the rate at which financial institutions can borrow money from the central bank. Further, central banks can adjust reserve requirements for commercial banks (Gilpin, 2001: 372). The reserve requirement is critical to central banks' monopoly of money emission. It ensures collateral influence on money substitutes such as credit cards issued by commercial banks.

These three monetary tools are the main transmission channels by which central banks can influence the short-term interest rate relatively precisely. The central bank sets an upper or lower ceiling for short-term interest rates in a competitive banking sector. The long-term interest rates relate to fixed-interest bearing assets and shares, and are not as closely controlled by central banks. However, they usually lie above the short-term rates. Long-term assets are less liquid than short-term substitutes. If economic agents face fundamental insecurity about the future and favour flexibility or liquid assets, they will usually demand a higher premium for long-term assets. Further, expectations about monetary policy and asset valuations influence long-term rates. In most instances there is an inverse relationship between interest rates and asset values. If short-term interest rates rise, fixed-interest bearing assets and shares become less attractive as an investment or store of value (Keynes, 1936). However, if investors anticipate economic decline, long-term rates can fall below short-term rates since financing in the present appears more risky.

A Theoretical Concept of Money

The present paper supports a post-Keynesian perspective on monetary policy. That perspective is fully in line with Susan Strange's argument that financial power or the ability to lend has a pronounced impact on economic development (Strange, 1988: 90). The distinction between the short-run effect of money on economic activity and the long-run neutrality of money is not convincing, since economic agents face fundamental insecurity about the future (Moore, 2006b: 112- 119). Even in neoclassical economics the capital stock affects long run growth potential (Solow, 1956: 65-94).

Hence, it is quite a shady assertion that money has an influence on the capital stock in the short run, but no impact in the long run.

In post-Keynesian economics, the domestic wage bargaining system or social contract is of crucial importance to financial power as unit labour costs mostly explain inflation. Economies with centralised wage bargaining systems (corporatist model) usually experienced moderate inflation since wages followed average growth in productivity (Cukierman and Lippi, 1999: 1395-434). Monetary policies can be less restrictive if effectively coordinated with wage policy. Anyhow, not all central banks are willing to loosen or coordinate monetary policy in response to corporatist trade unions (e.g., Deutsche Bundesbank).

However, euro members have concentrated on adjusting monetary policies and increasing financial power rather than strengthening the domestic social contract to deflate their economies. Restrictive monetary policies or unemployment are more readily available tools for keeping inflation at bay.

The adjustment of the domestic social contract is a far more complicated and time consuming process for governments. It may provoke political opposition from domestic interest groups. Independent central banks are democratically less accountable and, hence, less permissive towards political opposition. Further, the external sources of inflation (exchange rates, prices of imported goods) are often of greater relevance to small vulnerable economies with a pronounced openness to trade than domestic sources. On the contrary, most European countries have sufficiently weakened their social contracts (Herr and Kazandziska, 2007: 131-62).

This, thus, corroborates the argument of the great polish economist, Michael Kalecki (1943), that the capitalist class has no interest in full employment (mirrored in the neoclassical concept of a 'nonaccelerating inflation rate of unemployment'). Monetary policy is a very comfortable tool to create unemployment by monetary restraint (high interest rates) and, hence, weaken workers' bargaining position.

The next section will illustrate that the ability to pursue favourable monetary policy (lowering interest rates, thus making a greater variety of alternative investments profitable) without inflationary pressures is heavily conditioned by the international monetary system and its distribution of financial power.

Financial Power: The Role of the International Monetary System

The adequate design of the exchange rate regime has split generations of economists. Free market economists usually favoured flexible exchange rates, whereas Keynesian economists argued for fixed, but adjustable or no exchange rates. However, the division has even cut across economic paradigms (Sardoni and Wray, 2007: 53-77).

Lately, the economic mainstream tends to emphasise the corner solutions of the exchange rate regime; irrevocably fixed or freely floating exchange rates (Summers, 2000: 1-17). The core of the debate is the so-called unholy trinity, which states that economic policy can never reconcile more than two goals at the same time: monetary policy independence, openness to capital flows, and stable or fixed exchange rates (Gilpin, 2001: 248).

The section will illustrate the controversy, and develop a theoretical perspective on how the monetary or exchange rate regime affects financial power. Based on that analysis, a critique will be made of the dominant fashion of corner solutions and the claim of an unholy trinity.

The Case for Flexible Exchange Rates

The case for flexible exchange rates is fundamental to the controversy on monetary sovereignty and will be illustrated in detail.

Flexible exchange rates are usually seen as a necessary buffer against real shocks to the economy or wage and price rigidity (De Grauwe, 1997: 5-11). Further, only flexible exchange rates would allow monetary policy autonomy while fixed exchange rates support fiscal policy (Mundell, 1962; Fleming 1962).

The argument for exchange rates being a buffer against real shocks (positive and negative supply/demand shocks) is central to the theory of optimum currency areas (OCAs). OCA theories tried to establish criteria that may answer the question of whether exchange rates between regions or countries are necessary or superfluous. An exogeneous shock may occur due to a sudden shift in economic policy or even natural disasters such as an earthquake. Following is an illustration of the latter:

An earthquake that destroys most of the productive capacity of a region or industry would be labelled a negative supply shock (negatively affecting the supply side of the economy). Since a reduction in productive capacity *ceteris paribus* causes inflation (demand for goods and services remains the same), the industry or region loses competitiveness (inflation) and jobs (less output). Monetary policy is complicated in such a situation, because a lowering of interest rates might accelerate inflation while a tightening of monetary policy will make new investment dear. Consequently, there remain four options to counteract the negative effects of a negative supply shock:

1) The domestic currency might be devalued to restore competitiveness.

2) Producer might lower prices and sacrifice profits to stabilise market shares.
3) Workers could abstain from wage increases as a response to inflation.
4) Workers could migrate into the competitive region that wins market shares, or conversely, capital could flow into the affected region realising higher returns on investment.

Consequently, OCA theories assume that in the absence of flexible wages and prices or factor mobility (labour and capital) exchange rate adjustments are required (and vice versa) (Mundell, 1962). Hence, OCA theory is open to both outcomes: the need for exchange rate adjustments with sticky prices and immobile factors of production, and the abolition of exchange rates (monetary union) if prices or factors of production are sufficiently flexible.

The purchasing power parity (PPP) and the uncovered interest parity (UIP) are the very basis of the case for flexible exchange rates. They can be summarised in the relationship:

$e^* = i^* = p^*$ (Flassbeck, 2001: 13)

The relationship suggests that in the long run, and with exchange rate expectations being rational, exchange rate expectations (e^*) will always equal the interest rate differential (i^*) and price level differential (p^*) across economies. For example, if the price level or the interest rate in a domestic economy rises more than in a foreign economy (the former amounts to an appreciation of the real exchange rate, since domestic goods buy more foreign goods), the expected nominal exchange rate will also rise from the perspective of the domestic economy (its currency will depreciate). (see Appendix I for detailed illustration of the mechanism.)

In consequence, exchange rates will always equalise the purchasing power across economies, eliminating sustained trade imbalances. Further, expected returns on currencies reflect the nominal interest rate differential and expected changes in the nominal exchange rate. Hence, according to UIP, financial arbitrage will restore equilibrium on the asset markets (Krugman and Obstfeld, 2003: 394-96, see Appendix II). These assumptions have a pronounced impact on the effectiveness of monetary policy.

If the neoclassical proposition on money and UIP holds, a (temporary or permanent) monetary stimulus can at best restore full employment within given capacities. In the long run, the currency will re-appreciate after the money supply has been increased and prices will rise (neutralising any further effects on output). Permanent fiscal policy is assumed to be ineffective under flexible exchange rates since it 'crowds out' private investment and the exchange rate will negatively affect the trade balance (Krugman and Obstfeld, 2003: 450-60).

Conversely, the adverse impact of fiscal policy on the exchange rate may be neutralised under a fixed exchange rate regime. But monetary policy is difficult in the presence of free movement of capital. Financial investors will not be willing to hold currency assets with a lower return (interest rate) in the absence of an expected currency appreciation (fixed exchange rates). Economic policy has to restrict the movement of capital (Mundell, 1962; Fleming, 1962).

In sum, monetary policy can only (temporarily) affect the output of an economy under flexible exchange rates or if the free movement of capital is restricted. This constitutes the core of the unholy trinity.

The Case for Fixed but Adjustable Exchange Rates

A system of fixed but adjustable exchange rates requires a multilateral approach to the determination of currencies, whereas a monetary regime of flexible exchange rates has a unilateral character (self-help regime).

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Appendix I

Purchasing Power Parity (PPP)

Absolute PPP states that market forces equalise purchasing power of different currencies for a basket of homogenous and tradable goods (assuming perfect information, no transportation costs, perfect competition, similar baskets of commodities, absence of barriers to trade and unrestricted capital flows). Relative PPP states that nominal exchange rate movements will adjust for differences in the real exchange rate (the purchasing power of a basket of goods in terms of another region's basket of goods) (Krugman and Obstfeld 2003: 389-94).

Example[1]: A pair of identical and tradable shoes costs $20 in the US, but only €10 in an European Monetary Unit (EMU) country. Then one US dollar ($) must buy half a Euro (€) or one € buys two $ in order to equalise the price for a pair of shoes. If the exchange rate or the shoe price does not meet these criteria, arbitrage will occur. If one $ buys one € in that example, 'hungry arbitrageurs' will buy shoes in Europe. They will thus increase the price of shoes in Europe and/or the demand for € (appreciation of € *versus* $) until purchasing power has equalised (one € buys two $).

Absolute PPP can be expressed as:

$$E_{\$/€} = P_{US}/P_{E}$$

E denotes the exchange rate; P denotes the price level

Relative PPP can be expressed as:

$$(E_{\$/€,t} - E_{\$/€,t-1})/E_{\$/€,t-1} = \pi_{US,t}/\pi_{E,t}$$

t and t-1 denote a time frame in which a change occurs;

π denotes the rate of inflation

(Krugman and Obstfeld 2003: 390-91)

1. For simplification the example operates with a specific commodity instead a basket of goods.

Appendix II

Uncovered[2] Interest Parity (UIP)

UIP operates similarly (assuming perfect information, identical risk premium and openness to capital flows): It maintains that currency markets equilibrate when the expected returns on different currencies equalise (which eliminates incentives for arbitrage). The return on a currency is given by the nominal interest rate and the expected change in the exchange rate (Krugman and Obstfeld 2003: 341-46).

Example: \$1 buys €1, but the nominal interest rate level is higher in the US than in the EMU area. According to interest rate parity (IRP) this can only be justified, if the interest rate differential equals the expected change in the exchange rate (the US \$ is expected to depreciate). From a standpoint of intuition, one might expect that shifting funds into \$ might be more attractive. However, according to the model, rational investors expect a certain future exchange rate which will eliminate incentives for arbitrage. Hence, if investors were to shift their funds into \$, raising its value in relation to the € in the short term, the \$ is expected to depreciate even more in the future (E is expected to rise, see below).

The relationship can be expressed as

$$R_{\$} = R_{€} + (E^{e}_{\$/€} - E_{\$/€})/E_{\$/€}$$

R denotes the interest rate on a deposit; E^{e} denotes the expected change in the exchange rate

(Krugman and Obstfeld 2003: 342)

2. Covered interest rate parity involving forward exchange rates (defined via contract) instead of future expected exchange rates is neglected.

5 From the Great Recession to Deflation and Stagnation

HANSJORG HERR

Introduction

The subprime mortgage crisis that broke out in 2007 and escalated in 2008, and let to the Great Recession is by no means an isolated case. Although unique, the crisis nevertheless follows a pattern which has been well studied in theory and investigated historically (see for example Fisher, 1933; Minsky, 1975; Kindleberger, 1996). In this paper, the question under scrutiny is whether and how the present financial crisis will affect economic growth and the level of prices for goods. In the first section, the emphasis will be on state interventions after the escalation of the crisis in the fall of 2008. It is followed by a discussion of the danger of a 'Great Depression' and long term stagnation. Finally, policies that could be implemented to prevent such a depression will be identified.[1]

Stabilisation of the Financial System will Succeed

Overall, central banks and governments have introduced the right short-term policies to stabilise the world's stumbling financial systems. The world's most important central banks have taken over the role of lender of last resort and have been providing an unlimited amount of liquidity. In addition to banks, other financial institutions, like investment banks, have been placed under the wings of central banks.

Public households have offered guarantees and equity capital to financial institutions and are helping those institutions suffering from a lack of capital due to non-performing loans and sinking asset market prices. The intervention of public households is becoming very costly. In

1 For this contribution also see Herr (2009).

many cases, the state simply handed out money to bail out financial institutions. Instead, it would have been better to demand ownership with all the rights and obligations of owners. This would appear to be the most appropriate strategy to help and restructure insolvent institutions. Also, in regulative terms, state ownership is justified as the financial system itself is the cause of the deep economic crisis.

The financial crisis has given rise to the question of social justice. Before the outbreak of the crisis, exorbitant incomes were being earned in the financial sector, but the costs of the crisis are being borne by everyone. Managers in the financial system did not suffer much and after bailouts by government continued to earn very high salaries including bonus payments. Joseph Stiglitz (2010) proposes that the state takes over the power of decision for all institutions unable to survive without assistance. Governments could then fire managers, appropriate their incomes and bonuses, sell off some of the institutions and ban businesses that work through tax havens and offshore locations. Also to guarantee a minimum of social justice, a higher tax on higher incomes and wealth appears indispensable.

The Danger of a 'Great Depression'

The era of the Great Depression during the 1930s provides us with a good example of the development of an asset market bubble and the inevitable consequences of an asset price deflation. Japan during the 1990s is another exemplary case, after the end of its stock market and real estate bubble that had started in the second half of the 1980s. What these two periods exemplify is that asset market deflations lead to liquidity and solvency problems in the whole economy as a result of the drastic tightening of credits to the private sector and a fall in asset prices and destruction of equity. One of the reasons why Joseph Stiglitz was awarded the Nobel Prize was because he made it clear that a rationing of credit always takes place in financial markets. This is due to the fact that because creditors do not have complete information about debtors, they do not grant loans to every applicant. As shown by the example of Japan after the mid-1990s, even a zero interest rate policy can't force banks to expand credit. Due to sinking real estate and capital market prices which reduce the wealth of debtors, the situation is exacerbated by the fact that creditors have less to fall back on in the case of loan default. In the present situation, given the banks' negative forecast for the future, the shrunken equity capital of the financial system and the diminishing collateral of debtors, the danger of a sharp credit rationing towards the private sector appears to be compelling, and a long-term stagnation in many industrial countries likely. Although short-term injections of liquidity by central banks and of capital by governments can alleviate the financial institutions' problem of equity capital, this will not necessarily avert their rationing of credit. And even if governments take over the management of banks, this will not immediately affect the hesitation of banks to grant loans.

A reduction of the credit volume does not only come from the supply side. Debtors—whether corporate or private households—are becoming more wary about taking out loans, as they too are being forced to handle their affairs in an insecure financial environment. Due to falling capital market and real estate prices, both companies and households have had to cope with the burden of high asset losses. This drop in people's wealth has a negative effect on their willingness to borrow and suppresses consumption and investment demand (see the case study about Japan in Herr and Kazandziska, 2011).

In summary, one can say that theoretical arguments as well as historical experience with deep financial crises indicate that a massive shrinking of aggregate demand is to be expected, while a sharp recession and high job losses may also be likely. A dramatic reduction in demand tends to be accompanied by additional heavy losses in income and production. The spiral of income and job losses continues its downward spin; the market mechanism leads into a deeper and deeper crisis. And even if a shrinking of the economy can be stopped, the non-working financial system and the lack of trust in future development may lead to long-term stagnation.

In this scenario there is another very real danger: the possibility of a goods market deflation. A falling price level can be generated by two economic processes.

First, because of a lack in the demand for goods, companies are forced to reduce production and then to lower their prices. During a cyclical downturn, demand deflation is unavoidable and appears regularly. However, the situation becomes even more dangerous when demand deflation is reinforced by a deflation of costs, which reflects the second factor of falling prices. Cost deflations originate first of all in falling nominal unit labour costs. For this reason nominal pay rises to prevent a fall in unit labour costs are of key importance to prevent good market deflation. Nominal wages should increase according to the trend in the change of productivity plus the target inflation rate of the central bank. If we assume an increase in productivity of 2 per cent for the mid-term and accept a target inflation rate of 3 per cent, the level of nominal wages should increase 5.5 per cent (Herr, 2009a). If the increase in wages is lower than this norm or if they sink, costs decrease and results in deflation. The development in Japan after the mid-1990s shows that deflationary periods are not ghosts from the 1930s. In Japan, sinking wages reduced unit labour costs and brought on deflation. Although the deflationary process did not become cumulative, it was strong enough to force Japan into a stagnation that has not been completely overcome to this day. In Germany, to give another example, the increase in the macroeconomic wage level was also too low; the level of unit labour costs remained almost constant from the mid-1990s to 2007. In some years, Germany was on the verge of deflation.

Deflations in the goods market have devastating consequences for economic development because they increase the burden of debt for all debtors. In a deflation, the nominal revenues of debtors (turnover of firms, income of households) inevitably sink while nominal amortisation expenditures remain the same. As sure as death and taxes, a deflation at a high level of debt leads to massive financial breakdowns of companies and private households. Economic coherence falls apart because money flows break down in all corners of the economy. Irving Fisher (1933) was right in his analysis of the 1930s when he emphasised that in a deflation the economic boat not only rocks, it capsizes. It is obvious that a deflationary process drastically pushes down the demand for goods. Which companies would purchase a machine today when they believe their competitors will be able to buy it for less in the future? What household will be willing to buy a new car today when it will be cheaper in the future? Deflations are dangerous because they shatter the whole economic system of debtors and creditors, and bring about a cumulative shrinking of the demand for goods and production.

Deflationary processes appear when the nominal wage anchor cracks and nominal wages begin to sink. The nominal wage anchor against deflation is based on labour market institutions including wage bargaining systems that exclude wage reductions. The drama of the present economic situation is that not only have the financial systems been deregulated worldwide since the 1980s, so do have labour markets. This has meant that two of the most important columns of a stable economy have caved in.

Germany serves as an example: an ever-greater number of employees work in volatile and precarious work situations; a coordinated wage bargaining mechanism only functions well in part of the economy; in some branches (especially in service industries), some regions (e.g., Eastern Germany) and in certain types of businesses (i.e., small businesses) labour unions and employers' associations are so weak that the traditional system of wage bargaining is no longer functional. The sovereign debt crisis in Europe, which started in 2010 and the austerity policy followed in many European countries led to very high employment rates. Unions are no longer able to prevent nominal wage cuts. If the unsolved financial crisis, which started in 2007 leads to another sharp recession and even only medium-term stagnation in GDP growth, bringing about a wave of further unemployment and a cracking of the wage anchor, developments such as those experienced in the1930s are highly likely in Europe, and especially in the European Monetary Union (EMU). It is not only Europe that suffers from the danger of deflation. Japan will most likely fall back into deflation; serious fears have arisen of a deflation also in the United States if GDP growth does not recover.

The wave of deregulation in the financial and labour markets has been accompanied by neoliberal understanding and a neoclassical theoretical approach that took hold after the elections of Ronald Reagan and Margaret Thatcher in the 1980s, as US President and UK Prime Minister, respectively, and were copied by most western countries. These developments led the world economy into a constellation of instability, injustice and uncertainty and made a Great Depression possible again.

The Stabilisation of Demand and the Strengthening of the Wage Anchor

When private demand declines, governments take on the responsibility of stabilising macroeconomic demand. To begin with, the state needs to let automatic stabilisers take effect. This means accepting the reduction of tax revenues, for example, due to decreasing revenues from the value added and income taxes and the increase in public expenditures caused by increasing unemployment. However, in a deep crisis this passive anti-cyclical governmental policy is insufficient on its own. Additional measures to fight against an economic downturn or long-term stagnation are imperative, whereby in principle, an increase in state expenditure is better than the lowering of taxes. Such a policy should be supported by government expenditures that would be financed by taxing high incomes and wealth, as well as drying up tax havens.

After its stock market and real estate bubble burst in the 1990s, Japan was only able to prevent a 1930s style development by means of state support of its ailing financial institutions and an expansionary fiscal policy over a period of many years. Nevertheless, despite this fiscal policy and a policy of zero interest rates, the public households in Japan and the Bank of Japan were not able to enforce a recovery. Japan's national debt is far over 200 per cent of GDP (in the year 2012, see Ameco, 2012)—the price of the asset market bubble and a deflationary development.

But Japan made mistakes. From Japan we can learn that the insolvency problems of financial institutions require quick and decisive responses. The financial system has to be restructured in a way that it starts working again. Both monetary and fiscal policy must react promptly when confronted by asset market deflation, and, especially, a policy of wage reduction has very negative results.

In Europe and the USA (in 2012) this is not achieved. The financial system has been not fundamentally regulated and restructured. There is the danger that fiscal stimuli are stopped in a situation that the economy has not recovered. High incomes are not taxed to use the collected money stimulated the economy without increasing public debt.

For labour markets, policies are needed that can prevent the cracking of the nominal wage anchor in a period of expectant high and rising unemployment. In Germany, for example, this is the reason why the introduction of a minimum wage which does not exist so far is more important than ever before. Also, as was the custom previously, the government should be comprehensive in declaring labour agreements as binding for all companies in an industry and a region. Comprehensive extension mechanisms of wage bargaining outcomes are needed. The system of wage bargaining beyond the firm level should be strengthened; labour unions and employer's associations should receive sufficient political backing. Precarious jobs should be abolished systematically.

In the EMU, monetary policy is carried out by the European Central Bank. The areas of fiscal policy and the prevention of a cracking of the wage anchor should also be handled at the level of the EMU. European fiscal policy can only be effective when coordinated at the EMU level. In addition to the national programmes, investments for European infrastructure, for example, in the field of transport and ecology would be potential areas to spend money. In the medium-term, the European centre should have their own tax revenues and should be able to carry out their own fiscal policy. The EMU countries should band together to agree to a minimum wage and other labour market principles. Thoughts about a European economic 'government' at the EMU level are headed in the right direction. In the end, the EMU only makes sense when banking supervision, fiscal policy including taxation policies, minimum wages, wage bargaining systems, co-determination in businesses, industrial policy, etc., is coordinated at the EMU level. This allows for different paces within Europe. Countries that belong to EMU need to be the ones that drive efforts towards integration; other European Union countries, those that do not choose to take this step, can opt for a lower level of integration. However, presently Europe is moving very slowly in this direction and in many areas not at all. It becomes a destabilising factor for the world economy.

The globalisation project of recent decades needs to be reassessed. It has not only led to capital market and real estate bubbles, but also to an increase in the instability of many prices which are relevant for the global economy. Exchange rates, commodity prices or food prices have thrown the global economy into a state of shock. Since the 1980s, currency and financial crises have increased and intensified in countries on the economic periphery. In the light of such turbulence it is difficult to speak of an efficient worldwide allocation of resources, but rather at best of gigantic waste. At the same time, in almost all countries there has been an increase in the inequality of income and wealth distribution, and a rush of precarious working conditions. The level of insecurity has increased for all economic actors—for employees, small business owners, the wealthy, financial institutions and even multinational corporations. In order to bring about the creation of a framework for regulation that can direct the globalisation process along a more stable and just track, a rethinking is long overdue about new global parameters for the world's economy (for the proposal in this direction see Dullien *et al*., 2012).

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6 Current Crises, European Union

Alternatives and the Idea of Socioecological Reconstruction of a Society beyond Neoliberalism and Capitalism[1]

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I want to start with three remarks. I wonder why the poverty and climate issues are mostly regarded separately. It seems also that the climate issue is separated from the environmental problem as a whole. So the biodiversity issue is hardly mentioned. But the climate, the poverty and the economic issues are connected with the biodiversity issue very closely. I want to underline that the possibilities and effectiveness of dealing with global warming depend on biodiversity. If the destruction of biodiversity would continue as it is going on, the global ecosystems would also collapse if the critical 2° aim would be achieved.

The second remark concerns the main message of my contribution: that the different combined crises—the financial, economic, climate, ecological , food and energy crises—reflect that human living conditions are social and ecological at the same time. The social dimension has two interlinked aspects: the individual quality of life and the individual position in the society. Here, society is regarded as the sum of individuals and the relations between the individuals as members of the society.

The conditions of human life always involve the physical and mental wholeness of individuals, their individual freedom and possible influence on societal developments, their mutual relationships within and outside the territorial centre of their lives—especially as regards their place in

1. The paper includes contents of the PowerPoint presentation that was not shown during the discussion, as well as points which were prepared but not spoken.

society and in the social processes of labour and reproduction, their education, medical treatment and social security protection, and in the way that their natural conditions of life are constructed. People always live within gender relations and within structures of cohabitation.

I think that Left political alternatives must start from the social and ecological dimensions of living conditions of the socially weakest. Such alternatives must halt, structurally rollback and overcome social and ecological destruction.

Keywords for social and ecological destruction are: poverty, social exclusion, social and territorial divisions, discrimination; destruction of nature and culture; above all, global warming and the disappearance of species; de-democratisation, surveillance and repression, loss of democratic possibilities of political regulation, political extremisms, religious fundamentalism; militarisation and wars, armed conflicts and aggression; process of structural rolling-back, overcoming social and ecological destruction and socioecological reconstruction. It can be realised only by interested fighting actors.

The struggles of these actors especially involve four key questions deriving from the formulated understanding of human living conditions:

a) the implementation of human rights, of social, political and cultural basic rights;

b) the organisational and valorisation of social labour, especially of socially useful labour;

c) the preservation, extension and democratisation of the public sector—of public services, public enterprises, facilities and budgets; and

d) the confrontation with the protagonists of the prevailing financial and energy economy, of the chemical and agricultural industry, of the automobile industry as well as the military-industrial elites.

What is involved is the strengthening of individual freedoms and of the people's rights to social and political participation; the deployment of public resources for the mitigation and solution of social, ecological and global problems; a new social division of labour; the organisation of social labour based on social needs and on social and ecological requirements.

The third point concerns the structure of the rest of my contribution: After coming back to the different crises, I shall express some views about their interlinkages, explain the idea of socioecological reconstruction more concretely and what it means for actual EU alternative energy policy.

About the Crisis

We—that is, different social actors in the Global North West—have been plundering the world's natural, social, human and economic capital stocks. Now, it is not only necessary to stop this process, we have to replenish the stocks of socially unequal society and of the environment. In the Global North West, over-consuming energy has driven up prices, damaging business, hitting households, and changing the climate. Hunger for resources has fuelled price hikes and also global trade and resource conflicts, from the local level to the global one. Producing economies have been doing better than service economies, but peak oil, peak gas, peak metals and minerals are looming. The world economy must take a turn now and avoid falling off the cliff. We are slipping into an intertwined crisis of the natural, social and economic systems. It all makes for a crisis that is overwhelming and complex, and the race to find adequate and workable solutions is difficult.

As a result, the problems are larger than the solutions proposed so far. Some solutions, in fact, only reproduce the causes of the crises themselves. Debt accumulation is an inevitable collateral damage of growth turned into a faith. This applies to the economic as well as ecological and social debt we have been accumulating.

Climate change is no longer looming; it is here. Forest destruction not only contributes a fifth of all causes to the heating of the earth, it is also a main reason for biodiversity loss and undermines ecosystem services, another pillar of human survival that is at huge risk. Water scarcity is an emerging threat to some two billion people. With climate change, dry regions tend to lose their precious resource, the rains, while wet regions tend to suffer from additional oversupply and are more frequently flooded. The problem is aggravated by intensive agriculture through erosion and humus loss which both, in turn, contribute to climate change. Amidst all this is rapid population growth, which strains the world's resources even more.

Interlinks

Systemic change is needed to overcome the economic crisis, to incorporate environmental restrictions and social responsibility into the overall economic process. But this systemic change can be started and realised only as a social process because the actors who are concerned and involved have very different interests and social positions.

If the systemic change should amount to a new industrial revolution and so become also a change of the direction of the development, it presupposes a paradigm change of consumers and their suppliers. A paradigm change can only be a result of political change and, thus, of political struggles. The necessary industrial revolution must also become a cultural and a technological one. This time, the target is predefined: low carbon, biodiversity sensitive, socially just, poverty alleviating, participatory and gender-just.

This is also the condition for achieving a society of free individuals which are socially equal, living together in solidarity and in responsibility towards nature. But the formulation and realisation of the target is the question of political struggles and social changes. Today, most innovations are incremental ones focussing on production processes, rather than being systemic. These limits to improvements simultaneously diminish consumers' expectations, and thus, the demand pressure. The interaction of both factors results in a high level of inertia, in a lock-in of current unsustainable patterns of production, consumption and behaviour. This, in turn, keeps innovations within the limits of the existing system.

House and share prices are dropping, people see their wealth disappearing, and for many, even their pensions lost. Unemployment is rising. For a massive population of ordinary citizens, their day-to-day income base is threatened.

Poverty and social exclusion are rising on the local and global level. The time of cheap resources is over. The pressures to reduce salaries are rising, worsening the situation. And the energy markets prepare for the next hike.

Consequently, consumption opportunities are shrinking, consumer demand is faltering, and income polarisation is increasing. The whole political and economic philosophy of the last few decades has been exposed as nothing more than a fair-weather approach for upper and upper-middle classes, working on the illusion of permanent growth.

With growth prospects becoming increasingly bleak, it is high time to redefine the concept of 'sustainable consumption': achieving and maintaining a dignified life in times of scarcity. Redefining is a social process and also realising sustainable consumption.

Stopping and overcoming the destructive developments demands political and social struggles of actors having common interests. Combating poverty, social exclusion and social insecurity means social change, change of actors and the relations between (Spangenberg, 2008).

The Idea

While it may be costly to invest in new, eco-friendly technologies, change consumption patterns, and redefine progress; it fights poverty and social exclusion, and creates employment and income. They reduce environmental pressures and social hardships at a time when it is most needed. Inaction on social and environmental issues would ruin the best hopes of overcoming the crises, the economic as much as the social and environmental one.

Stagnating—or even only decreasing—public transfers and investments would make the economic situation worse. If social and global inequality is not tackled, social unrest increases conflicts. If the environmental problems are not solved, even bigger scales of migration will be the result. If poverty is not overcome, it may result in violent conflicts. Readjusting the international relations is a benefit for the rich as much as a necessity for the poor. The 'polluter pays principle' requires the North to bear the costs of its inaction—paying compensation to the victims would be an investment into a peaceful and habitable future.

We have to rethink what the purpose of the economy is: it should be catering for human needs, providing people with goods and services at affordable prices, and offering adequate income opportunities to all. The product efficiency increases with engineering and design improvements, focussing less on the products as such and more on the services they generate (service delivery machines). Even if a product is efficient in offering its services day and night, the supply/use efficiency may be extremely low. It is easy to detect the possibilities for improvement from this perspective; they are more sociocultural than technical. Service design is part of the optimisation task. But what we need most are innovations, especially those that are problem-solving ones. Many of these will have to be social innovations, regarding sustainable consumption patterns, but even more than that: new social identities with status symbols no longer characterised by ever increasing squandering of monetary and environmental resources, and new value systems underpinning this change (Spangenberg, 2008).

All this won't be realised without struggles against the principal protagonists of social and ecological destruction: the governments in the capitalist metropolises and the political parties in government, the institutions of global and European finance capital, multinational corporations, banks, funds and insurance companies, the military establishment with its leading strategists and its military-industrial complex.

They are also the largest producers of the causes of the global financial crisis—of growing social divisions, of privatisation of public services, of gigantic uneven weight in the international balances of trade and payment, of the liberalisation of nation-state and international financial markets. Being in a political defensive we have to formulate and realise few political objectives and principles. These include the following:

a) Mobilising against poverty and social exclusion: advocating poverty-proof minimal standards and a financial transaction tax that favours the world's poor and their capacities for dealing with climate change.

b) Organising resistance to the privatisation of public services and resources: mobilising for their preservation and extension while actively democratising them.

c) Opposing the prevailing security and military doctrine fighting for civil conflict solutions.

d) Opposing socially and ecologically devastating production: mobilising for the conversion of destructive production (especially of arms).

e) Opposing the breaches of human and civil rights: advocating the defence and reinforcement of basic rights.

The EU must be forced to take back its strategy of 'Global Europe' and to end its policy of 'unequal treaties' which reinforce and extend neo-colonial relations of dependency. All economic treaties with poor countries that do not serve to achieve the Millennium Development Goals (MDGs) should be subjected to a moratorium. Through moratoria it should be possible to initiate a broad public discussion on new paths to foreign policy, to foreign trade and development policy, to revise existing treaties and to open negotiations on new goals and new conditions.

All the named or stressed positions, proposals and demands go out from the idea of 'socioecological reconstruction of society beyond neoliberalism and capitalism' to a continuous reflexive process of searching and transformation, in which both the social-political relations of power and property as well as social structures are so changed that people's social conditions of life can be preserved and improved, in which people can so change their mode of life, especially their economic activity, that their natural conditions of life and the ecological environment (the biosphere) can be maintained, and can remain healthy.

This means a break in the symbiosis of economy and society, of society and nature, among individuals—also, and especially, in their plural gender relations—and the relations of individuals to their bodies and to nature. In this the struggling for change, their ways of thinking, their tools and their action, their political understanding and conceptions will undergo deep-going transformations. The social modes of production, reproduction and regulation will, when the reproduction requirements of the biosphere and of healthier human beings is recognised, be rebuilt in such a way that individual people can gradually live in self-determined dignity and in solidaristic cooperation (working theses elaborated by Dellhiem, Krause, Paust-Lassen, Spangenberg, Wolf).

Thus, what is involved is a reconstruction of society and with it, the system of social division of labour, a reconstruction that aims at the gaining and preservation of the capacity to reproduce society—the reproduction capacity of humanity as a whole, not of one at the cost of the other and of the natural bases of life. The organisation of the reproduction capacity and with it the democratic and solidaristic solution of social, ecological and global problems are considered to constitute 'progress' in this context. 'Progress' is especially the development of a solidaristic cooperation which minimises the poisoning of the biosphere, and minimises social and ecological costs. It can only rest on the prioritised decentralised development, production and use of renewable energies (Dellheim, 2009).

More Concrete Problems Facing the EU Today

In facing the realities and crises, one question is about the concrete EU programmes that will strive to achieve synergies, addressing the immediate demands raised by the financial crisis and its impact on the global economy, while also promoting measures that will prevent catastrophic turns of other critical processes, including climate change, the loss of biodiversity and the impending absolute scarcity of oil and other fossil fuels.

With regard to energy policy, this requires the following:

a) An ambitious policy—at the EU as well as at the member-state level—aimed at realising a leap forward in energy saving and energy efficiency (while minimising 'rebound effects'), and which requires a programme of loans and targetted subsidies, managed by the European Bank for Reconstruction and Development (EBRD) and based on euro bonds; a determined focus that cuts across all EU policy areas to promote the accelerated development and implementation of sustainable sources of renewable energy, and the phasing out of all support for non-sustainable energy sources.

b) A common programme for the improvement of energy grids, especially for facilitating the decentralised production and use of renewable energy.

c) A coordinated effort by member-states to enhance rapidly energy saving, energy efficiency, and the use of sustainable renewables.

d) A global energy security strategy for the EU which relies on long-term exchange relations based on the mutual interests of the EU and of provider countries.

The steps towards such an alternative European energy strategy bundle would involve:

- The introduction of a primary energy tax complemented by social transfers to ensure that poverty is not exacerbated.
- A reduction of value added tax (VAT) for renewable energy supply and for cogeneration.
- The creation of a European Energy Authority capable of protecting decentralised energy production and which can be used to counter the oligopolistic power of the major energy corporations.
- A targetted support programme for reducing energy needs in urban areas and in low-cost housing.
- Using the possibilities of leverage given by the implementation of the trans-European network (TEN) programme for energy and transport in order to improve the mix in transportation by giving clear priority to rail- and sea-bound modes.
- Concentrating present support programmes for renewable energies on sustainable options, by withdrawing support from non-sustainable options, such as biofuels of the first generation.
- Transferring funds from the European Atomic Energy Community (Euratom) budget to programmes supporting sustainable renewables, especially those produced in Europe.
- Activating the important potential of gendered energy-saving by creating a common and coordinated programme for the EU and its member-states addressing gender-specific energy needs.
- Starting a common European Habitat programme for the EU and its member-states focussing on urban improvement, combining social inclusion, cultural integration and ecological/energetic quality.
- Opening a new round of multilateral negotiations with oil and gas supplier countries for a long-term agreement on development perspectives and energy supply security.

With regard to climate policy this requires:

- Bolstering ambitious climate reduction objectives capable of ensuring that catastrophic 'tipping points' will not be reached quickly in a few years, by introducing support programmes for industrial and consumer demand in the member-states strengthening the transformation capabilities of their main industries.
- 'Embedding' the use of 'economic instruments' with regard to climate gas emissions into pertinent framework regulations capable of hindering 'effects of perversion', especially on employment and working conditions, and by clearly orienting the limits imposed on the reduction aims indicated by the Intergovernmental Panel on Climate Change (IPCC).
- Negotiating and implementing the EU emission permit trading scheme in a radically reoriented way in order to tie it to ambitious reduction targets; to make it a source of relevant funding for the transition towards the use of renewables; and to make it a dynamic factor of continuous progress in reaching the reduction targets proposed by the IPCC.
- Changing the ambiguous role of the EU in the post-Kyoto negotiations so as to take a clear position of giving absolute priority to avoiding catastrophic climate change.

Meanwhile, the first steps towards such an alternative European climate strategy bundle are:

- Focussing all programmes addressing the needs for demand stabilisation which will be created and implemented on energy saving, and the transition to sustainable energy sources.
- Radically changing the present direction of the negotiations on the EU climate gas emissions trading scheme in the direction of imposing more ambitious reduction aims and of making it a tool for a dynamic reduction process.
- Linking the proposed auctioning of emission rights for the electricity sector with targetted and differentiated transition programmes for the member-states concerned.

- Creating a EU investment programme for the prevention of climate gas emissions geared towards helping member-states with the highest needs for improvement.
- Introducing a framework programme for the improvement and stabilisation of working conditions in the new sectors of employment created in the change to a low and zero carbon economy.
- Aiding other regional groups of states, such as Mercosur or ASEAN, to create ecologically effective schemes of climate gas emissions trading.
- Strengthening the Johannesburg renewable energy initiative of the EU in order to become a relevant factor in combining and coordinating efforts between the EU and partner states among developing countries.
- The creation of an informal group of state governments interested in giving a higher priority to avoiding 'tipping points' in climate change.

In the context of such strategies it would be useful to maximise the synergies between energy and climate policy which can be realised at all levels. For example, strong priority should be given to energy saving programmes that facilitate the transition towards renewables (Euromemo, 2008: 39-41).

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7 Europe: To Be or Not to Be

FABIO DE MASI

Introduction

The causes of the global economic crisis have been abundantly discussed: (1) a lack of financial regulation and a high integration of economies with the US financial system; (2) excess liquidity seeking high returns on financial markets due to a steady decline of the wage share (redistribution from labour to capital), and hence, fragile investment opportunities in the real economy and (3) unstable global trade patterns, namely the US facing an enormous 'twin deficit', while countries such as China, Germany and Japan accumulated a large trade surplus. This paper highlights specific factors that enabled an economic crisis to develop into a political crisis of European integration: firstly, Germany's real devaluation via wage depression ('beggar thy neighbour' policy) has deepened unequal trade patterns within the EU and contributed to a high total indebtedness of Euro member-states. Furthermore, fierce tax competition has eroded the tax base of EU member-states. As opposed to conventional wisdom, the sovereign debt crisis is not a consequence of reckless public spending. Secondly, the lack of supranational economic governance and financial regulation has made European Monetary Union (EMU) vulnerable to speculative attacks, which further increased the cost of refinancing European governments. National governments were not protected but exposed by the common market. Thirdly, and quite ironically, market-based integration does not stand the 'test of the markets'. Europe is not prepared to provide leadership or to act as lender of last resort as US hegemony erodes.

European Integration Revisited

European integration has been security-driven. No region in the world has ever achieved a comparable level of interstate cooperation. Regional projects such as free trade agreements (FTAs), which are solely based on economic relationships, often pronounce economic imbalances, and hence, lead to a *cul de sac* of integration. A prominent example is the European free trade area (EFTA), initially sponsored by the United Kingdom and Scandinavian countries as an alternative to continental European integration.

Two unique historical conditions enabled the unparalleled level of European integration: Firstly, two World Wars taught the political elites of continental Europe that they needed an insurance against each other. The insurance was European integration and (Western) Germany's[1] participation in the North Atlantic Treaty Organisation (NATO). Secondly, European integration and Europe's economic recovery enjoyed hegemonial support by the US due to Cold War. The terms of handing back the Saar region to Germany illustrate the relationship of security imperatives and economic integration. The Saar region contained many of the basic crude materials, like steel, that were vital for Germany's economic recovery while being a potential source for arms production. Hence, France agreed only to hand back the Saar if Germany accepted equal-market access of the founding members of the Montan Union (European Coal and Steel Community) to the resources of the Saar and if integration of Germany into European security architecture was ensured. The Montan Union then became the nucleus for the current EU merging three pillars: The common market or the European Community (EC), the Montan Union and the European Atomic Energy Community (Euratom).

Additionally, there was the US-sponsored European economic development via the Marshall Plan to secure its zone of influence *versus* the erstwhile USSR. The US allowed the war-torn economies like Germany and Japan to develop economically by restricting trade and capital flows and providing financing facilities via the International Monetary Fund (IMF). While Germany's economic recovery after World War II depended on limiting the exposure to global markets, it soon pushed for greater economic liberty after economic consolidation.

1. When speaking of Germany in the context of European integration, the paper refers to Western Germany or the Federal Republic of Germany.

Germany Conditions European Integration

The approach of Germany to European integration has conditioned the European project and has been dominated by two objectives: Germany tried to compensate its limited national sovereignty after World War II by its integration into the supranational European architecture while using market access for its re-establishment as an economic power.

The Deutsche mark became a well-established reserve currency and the lead currency of Europe. Germany sponsored a corporatist labour market regime that assisted its integration into the world economy, respectively its export-oriented corporate sector. However, as opposed to the United States, which used their lead currency privilege to finance economic expansion, the German Central Bank exercised a very restrictive monetary policy to secure competitive advantage of its corporate sector on the global markets.

Hence, German governments had been traditionally very sceptical of monetary unification throughout European integration. Germany was certainly interested in a certain kind of exchange rate stability for the sake of its export sector. Exchange rate bands supported this objective. However, the liberalisation of capital flows made it too complicated for European countries to defend parities if their unit labour costs rose above German levels. Since Germany became a net exporter, there was constant pressure for appreciation of the Deutsche mark. While some European countries, such as France and the small open Benelux (Belgium, the Netherlands and Luxembourg) economies, opted for a common currency[2], Germany stressed the need for fiscal discipline. These contradictions were further intensified by the termination of the Bretton Woods exchange rate system.

2. Mainstream exchange rate theory postulates an unholy trinity of free movement of capital, autonomous monetary policy and stable exchange rates. The author disputes that conventional wisdom. There is no such thing as an autonomous monetary policy under flexible exchange rates. Exchange rates will tend to overshoot and monetary policy cannot ignore it. Hence, the unholy trinity is an unholy duality. Free flows of capital undermine monetary sovereignty. From the time that European countries liberalised their current accounts, and hence restrictions on capital loosened, a common currency was the means for countries with less 'financial power' than Germany to restore monetary sovereignty on a collective basis.

There were two basic preconditions for European monetary unification:

Firstly, the German elite had to be convinced that a common currency would not negatively affect its export sector, which had become a powerful political lobby. Hence, European monetary policy would have to follow the German example. This objective was achieved when then French Prime Minister François Mitterrand ended the 'Keynesian experiment' of its governing leftist alliance in the early 1980s.[3] The German government under Helmut Schmidt and the Bundesbank finally agreed to a timeframe for European monetary unification. The Single European Act (SEA) of the European Commission under Jacques Delors in the late 1980s further catalysed market-based integration.[4] European monetary integration became a German offspring and European integration a marked-based project.

Secondly, Germany needed France to accept German reunification. Mitterand agreed to German reunification if the country would be willing to accept closer political integration and monetary unification. On the back of greater political sovereignty, Germany felt prepared to push through with its monetary concepts while benefitting from the elimination of exchange rates.

European Economic Governance

Prior to European monetary unification, accession countries had to fulfill a certain set of criteria of convergence (Maastricht Criteria) with respect to price stability, public debt, exchange rate stability and long-term

3. The French government had embarked on a programme of heavy public spending and nationalisation. However, the German central bank (Bundesbank) organised capital flight through sharply raising interest rates amidst the monetarist recession of the Reagan and Thatcher era. The French trade balance turned sharply negative due to the deflationary policies in Germany. However, the economic performance in France was quite well and a future devaluation of the France would have probably boosted French exports. However, Mitterrand felt tremendous pressure of French capital and sacrificed the nation's development for a broader political goal. Mitterrand feared that France might exceed the borders of the European exchange-rate mechanism and hence lose the political grip on the neighbouring country, Germany. His strategy could be broken down to this: 'If you can't beat them, hug them.'
4. Till the SEA's complete liberalisation of capital flows had been envisioned after completion of monetary unification. Now it turned into a pre-condition for monetary union.

interest rates.[5] The public debt criteria remain mandatory regardless of participation in the euro (Stability and Growth Pact).

The German Deutsche mark served as an anchor of convergence. A convergence of exchange rates, price levels and interest rates, was certainly necessary for successful monetary integration. However, the ambitious target of below two per cent annual inflation mirrored the highly restrictive stance of German monetary policy. Accession countries met these requirements by cooling down growth in unit labour costs.[6]

Fiscal Architecture

The fiscal architecture of the EU is mandatory even for countries that did not introduce the euro. European treaties neither centralised European fiscal policy nor created a meaningful economic coordination beyond restrictive rules for public finance. The EU budget commands slightly more than one per cent of EU GDP and deficit financing is principally foreclosed to the EU. The EU, therefore, has no resources to offset regional disparities.

5. Inflation rates: no more than 1.5 percentage points higher than the average of the three best performing (lowest inflation) member-states of the EU. Government finance: the ratio of the annual government deficit to gross domestic product (GDP) must not exceed three per cent at the end of the preceding fiscal year. If not, it is at least required to reach a level close to three per cent. Only exceptional and temporary excesses would be granted for exceptional cases on a *ex-post* basis (no *ex-ante* anti-cyclical policies). The ratio of gross government debt to GDP must not exceed 60 per cent at the end of the preceding fiscal year. Even if the target cannot be achieved due to specific conditions, the ratio must have sufficiently diminished and must be approaching the reference value at a satisfactory pace. Exchange rate: applicant countries should have joined the exchange-rate mechanism (ERM II) under the European Monetary System (EMS) for two consecutive years and should not have devalued its currency during the period. Long-term interest rates: the nominal long-term interest rate must not be more than two percentage points higher than in the three lowest inflation member-states.

6. From a post-Keynesian perspective, unit labour costs are the main determinant of inflation (as opposed to the monetarist assumption that money supply determines inflation). Post-Keynesians argue that a central bank cannot meaningfully control the money supply since money demand is endogenously determined by economic agents in accordance with the level of interest rates and future expectations. If nominal wages increase with productivity, unit labour costs respectively the wage and profit shares remain constant. If wages exceed average productivity, corporations will raise prices. Hence, *ceteris paribus* according to a simple 'Bastard-Keynesian' rule, an inflation target of below 2 per cent implies that unit labour costs have to increase annually by roughly 1.9 per cent.

The 'no bailout clause' in Article 125 of the Treaty on the Functioning of the European Union (TFEU) provides that member-states of the EU are held liable for debts of other member-states.[7] Further, as opposed to the United States or Japan, Euro member-states have to refinance themselves through national bonds since central bank financing via the European Central Bank (ECB) is ruled out in Article 123 of TFEU. Hence, banks can borrow money from ECB, but states cannot.[8] Effectively, this means commercial banks earn interests on public debt, despite the bailout of banks having caused the recent rise in public deficits.

Monetary unification with national fiscal autonomy serves to let member-states feel the full force of the markets if they do not comply with the policies of the most 'competitive' country. Hence, the restrictive fiscal architecture of the EU has an asymmetrical bias. Member-states shall not benefit from the shield of a common currency and the common market while pursuing excessive fiscal policies.[9] However, while such an institutional design rules out a free ride on fiscal discipline of other EU member-states, a free ride on fiscal stimuli remains possible. Countries with a high export quota can deny meaningful fiscal stimuli expecting to benefit from the domestic stimuli of trading partners.

Economic Disparities

However, interest rates on government bonds initially converged despite great deviations in the development of unit labour costs. Apparently, prior to the economic crisis, investors ruled out specific

7. However, when it became clear that financial assistance for Euro members was inevitable, the legal interpretation of the no-bailout clause was stretched far to allow for voluntary bilateral assistance (the official German interpretation) and respective assistance under extraordinary conditions (a clause in European treaties usually reserved for occasions such as natural disasters or other exogeneous shocks).

8. However, the ECB is allowed to buy government bonds from commercial and public bonds on the secondary markets, and hence, indirectly stabilise bond markets. The ECB always resisted such interventions till recently, which indicates how grave they perceived the financial risks in Europe. An internal report of ECB defended these interventions by drawing parallels to the bankruptcy of Lehman Brothers, which led to a complete breakdown of the inter-banking market, and hence, the credit sector.

9. International comparisons have found no evidence that the Stability and Growth Pact (SGP) has helped contain public debts if compared to regions without such agreements. Basically, restricting budget deficits in times of economic downturns can lead to a worsening of economic contraction and even produce higher long term debt.

country risks under the umbrella of the common currency. The unit labour costs increased by 31 per cent since the year 2000 in the EU (without Germany) but by only 7 per cent in Germany. The (restrictive) inflation target of the ECB of slightly below 2 per cent annual inflation would have required a growth in unit labour costs of at least 2 per cent each year or roughly 20 per cent since 2000. Greece's growth in unit labour costs of 28 per cent was above that target, but Germany's 7 per cent has been even a larger deviation.

Hence, Germany accumulated a huge trade surplus with the rest of the EU. If one country constantly sells more goods and services to its trading partners than vice versa, the trading partners have to run external debt.

Since the ECB set a unitary interest rate while growth in unit labour costs and inflation differed across Euro member-states, domestic real interest rate levels (nominal interest rates minus inflation) differed markedly. Southern Mediterranean countries like Spain experienced, *inter alia*, rapid domestic growth, rising unit labour costs and price levels while countries like Germany were close to deflation. Low real interest rate levels in Spain and Ireland contributed to a real estate boom while high real interest rate levels in Germany dampened growth and wage dynamics.[10]

Financial Markets *versus* Euro

The situation further worsened when investors observed different reactions[11] (size of fiscal stimuli) to the financial crisis and EU member-

10. However, lower real interest rates in a higher inflation country will not offset competitive disadvantages. While interest rate differentials do cease to exist if inflation converges competitive disadvantages accumulate. Hence, if unit labour costs increase by 28 per cent since 2000 in Greece *versus* 7 per cent in Germany, Greek unit labour costs have to rise less than 21 per cent compared to Germany in the following years to restore competitive equilibrium.

11. Germany only reluctantly accepted coordination and provided a fiscal stimulus to its own economy. The belated German fiscal stimuli packages in the aftermath of the economic crisis were too small and ineffective. China spent 14 per cent of GDP, Japan, 6 per cent and the United States, 7 per cent. Accounting for 'automatic stabilisators' via Germany's leftovers of the welfare state, Germany's stimulus accounted for 2.5 to 3 per cent of GDP. Furthermore, Germany's fiscal stimulus had little emphasis on public investment. The public investment component of the second fiscal stimulus package accounted for 0.4 per cent of GDP. The average ratio of public investment to GDP stands at 1.7 per cent in Germany compared to 2.9 per cent in the average of the EU.

states 'nationalised' the risk premiums of their respective banking sector. Institutional investors (here labelled 'speculators') drove up interest rate spreads (commonly measured against the interest rate level of German government bonds) on government bonds of Greece, respectively the so-called PIIGS (Portugal, Ireland, Italy, Greece and Spain).

Financial strategies can heavily influence the risk perception of investors and rating agencies, and hence, drive up interest rates on government bonds.

Credit Default Swaps

A very prominent tool to 'manipulate' capital markets are credit default swaps (CDS): if CDS-risk premiums for Greek bonds rise, bond holders will either try to sell off Greek bonds[12] or demand higher interest rates for new bond emissions. Hence, CDS do not simply indicate a larger risk of sovereign default but can bring about the expected default themselves (self-fulfilling prophecy) by increasing the cost of public refinancing.

Naked CDS are not limited to bondholders. In other words, speculators can insure themselves against state bankruptcy even if they do not lend money to that state. That is comparable to a hitman selling a life insurance.

Buyers of CDS for Greek bonds benefit from state bankruptcy, CDS sellers bear the risk to insure the buyer against a Greek default but receive interest (rising risk or insurance premiums). The buyer himself may either speculate on a Greek default or intend to sell the paper again to a third party until the chain breaks down. The art of the game is to design contracts that terminate before a CDS insurer can be held liable.

However, CDS are no genuine insurance at all. Risks are commonly externalised to the public. Since the volume of CDS emissions is commonly much higher than the underlying fundamental volume of bonds, buyers of CDS contracts can never be paid off. The case of the insurer American International Group (AIG) in the US illustrates that in the end, the public has to pay for the contracts. Thus, most institutional speculators

12. Since nominal interests on government bonds are fixed, a lower value of bonds leads to higher effective interest rates.

like the Deutsche Bank optimised their portfolio by buying and selling CDS. Even Goldman Sachs has become prominent by dealing with collateral debt obligations. They sold real estate credits to their customers and insured themselves at the same time against the default of these credits.

Greece became the 'Beauty Queen' for Speculators

Speculators attacked Greece not merely because of high public deficits. The root cause were 'bad news' when the new social democratic government of Greece admitted statistical fraud and corrected public deficits. These manipulations were essentially well known to the EU elites. The statistical body of the EU Commission, Eurostat, issued several complaints since 2004 and major banks like Goldman Sachs and the Deutsche Bank were involved in huge cross-currency swaps that postponed Greek debts into future obligations. However, the EU tolerated these methods since Greece was holding the council presidency at that time and was vital to securing eastern enlargement (which has been important to Germany as it hugely benefits from penetrating the neighbouring eastern markets). The difference between public debt and bad news on public debt is important: speculators are not concerned about sustainability of public budgets. They try to make money. Speculation works according to the principles, which John Maynard Keynes described like a 'beauty contest' in a newspaper. Readers may win a price not by choosing whom they think is most beautiful among the portrayed people but if they correctly anticipate whom the average of the reader will find most attractive. Hence, every reader tries to make assumptions about the behaviour of the others who they think will do the same. Therefore, financial markets work like herds and tend to overshoot into one direction.

Sovereign Debt Crisis or Ponzi Finance?

The argument that Greece or other PIIGS have lived beyond their means is flawed. In fact, Greek government spending (public spending compared to GDP) has fallen sharply from 2000 till the economic crisis (to a level lower than in Germany). The EU accredited Sweden and Finland with the soundest public budgets. Both countries have two of the highest public expenditure quotas in the EU.

The Greek state was not too fat but rather too weak. The average effective tax rate on capital (measuring taxes effectively paid to the tax authorities compared to declared income from assets and profits) stands at 19.9 per cent in Greece compared to 27.2 per cent in the Euro zone.

The crisis in Europe is not primarily a sovereign debt crisis. Consider, for example, that Japan's debt-to-GDP ratio stands at 198 per cent, as compared to Greece's 115 per cent. But Japan experiences no similar problems so far since the creditors of the Japanese government are primarily its domestic banks and citizens (which can be taxed domestically). Furthermore, countries such as Spain and Ireland reduced their public debt ratio till the economic crisis in 2007 to 25 and 31 per cent, respectively. (Germany had a public debt ratio of 65% back then). However, private households in Spain and the financial sector in Ireland had accumulated high debts. Certainly, in times of crisis, these debts are externalised to the state. If private households and companies are highly indebted the state has less room for taxation, needs to bail out banks and to stimulate the economy by a larger extent. Moreover, credit finance and debt levels are much higher in the private and corporate sector than in the public domain

Credit finance is a major innovation of capitalist development. Neoliberal economists argue that investments require prior savings, and hence, a sacrifice of wage earners (income can be divided into consumption and savings, hence more volitional saving requires less consumption). Joseph Schumpeter, Keynes and even Karl Marx demonstrated convincingly that the opposite is true. Fiat money can pre-finance investment without sacrifice. Future returns on investment can serve credits. Rising income leads to higher savings, and not vice versa.

This is not to say, however, that high public debt levels are no source of concern. If states have to devote an increasing proportion of public resources to debt service, then less resources are employed in a productive manner.

'Bastard Keynesianism'

The post-Keynsian economist, Hyman Minsky and the neo-Marxist economist, Paul Marlor Sweezy, have both accurately described a shift to finance-led capitalism. Minsky coined the term ‘Ponzi Finance’ to describe how development of financial markets leads to unsustainable debt dynamics.

Credit financing is sound as long as the tax quota remains constant and growth rates (returns on investment) exceed interest rates. However, since the late 1970s the major capitalist economies have embarked on a kind of 'Bastard Keynesianism'. The tax base is eroding due to the reduction of taxation of mobile factors (corporations and high income earners). It had little or no effect on economic activity since higher income earners do spend a smaller proportion of their additional income. Wage growth and public delivery have been substituted by increased debt financing of private households. Further, restrictive monetary policies have set a lower ceiling for long-term interest rates. In sum, low growth, (relative) high interest rates and erosion of the tax base have led to increasing public debt ratios. Hence, ironically, neoliberal policies have led to rising debt levels in the industrialised countries, and not sound Keynesian macroeconomic policies.

The Euro Interior Design is very Cosy for Speculators

Financial speculators are fully aware that EU member-states can be singled out and attacked. Fiscal solidarity across member-states faces fierce political opposition at the national level. This is the basic difference between trade imbalances within a federal state like the United States and a federation of sovereign states with a unitary monetary policy, such as the EU. If California goes bankrupt, for instance, Washington and Texas can come in to rescue the ailing state. Whereas, if Greece or Portugal gets into trouble, Germany comes and strips them naked.

Thus, interest rate spreads on government bonds widened sharply prior to the regional elections in North Rhine Westphalia (Germany). Investors knew German chancellor Angela Merkel shielded their speculative business by opposing a quick and determined relief for Greece prior to the elections and demanding a substantial interest rate markup for bilateral loans to Greece.

For Merkel, that policy was a combination of the convenient with the practical. Her fierce resistance to assistance for Greece was convenient as it was well-received among the population who (legitimately) felt it had already paid enough for the so-called 'banksters'. At the same time, it was practical because it reflected Germany's interest in opposing European economic governance and forcing Euro member-states to take deflationary measures.[13] Further, Germany's export sector derived huge benefits from the temporary devaluation of the euro.

Political Alternatives

Die Linke (The Left Party) has criticised the flawed euro architecture and the respective and subsequent European treaties (Maastricht, Nice and Lisbon). However, much more relevant than such intellectual endeavour are strategic answers to the erosion of the European consensus among the people in the member-states. Election results in Eastern Europe and the Netherlands indicate that Right-wing populism capitalise on the crisis of European regionalism. Hence, a political communication, which does not adequately spell out that the flawed character of current European integration will not defend but endanger European cooperation. The duty of Die Linke is to channel public anger against the EU towards the beneficiaries of economic liberalism.

Hence, Die Linke has decided to emphasise domestic policy responses to the Euro besides medium-term political reforms of the euro architecture.

Domestic Responses

The basic domestic responses were the calls for the following:

- Opposition to the austerity packages which serve to present the bill of the economic crisis to the majority of the population instead of taxing the beneficiaries of financial capitalism.
- Coordinated fiscal stimulus packages in Europe of at least two per cent of GDP and a permanent expansion of public investment in Germany of 100 billion euro for future investments in education,

13. The latter seems contradictory at the first sight because deflationary policy in other EU member-states threatens the trade surplus of Germany. However, it only served as a political door opener for sustained austerity packages in Germany while keeping the cost of intermediate imports for German exporters low. It's like soccer; in the end Germany wins.

health, traffic, ecological restructuring, and the creation of two million jobs in the private and public domain.

- Introduction of a minimum wage of 10 euro per hour in Germany (Germany belongs to the minority of EU member-states with no general minimum wage legislation).
- Introduction of a financial transaction tax and the so-called 'millionaires tax' (Germany has one of the lowest quotas of wealth taxation to GDP among the OECD countries).
- Financing government deficits at low interest to a certain degree directly via the ECB to limit the power of capital markets over public budgets (necessitating an amendment of the Treaty of Lisbon or at least a public institution as intermediary allowed to buy up government bonds).

Structural Reforms

A decisive expansion of the EU budget is highly unrealistic since fiscal autonomy as well as military capacities are the very basis of sovereign nation states. Hence, economic coordination must be improved and freed from its institutionalised neoliberal bias. The core elements of better European economic governance as proposed by Die Linke require amendments of the European treaties, i.e.,:

- Substituting the Stability and Growth Pact with an External Stability Pact requiring symmetrical adjustments in case of huge trade imbalances (i.e., a country like Germany would be required to reduce its huge trade surplus by expansionary policies—designed at the discretion of the national government—if surpassing a certain threshold of trade surplus to GDP).
- Institutionalising euro bonds guaranteed by all Euro member-states as an alternative to national bonds issuance.
- Institutionalising policy dialogue between the ECB, national finance ministers, trade unions and business. ECB could abstain

from too restrictive monetary policy in exchange for productivity-orientated wage policies.[14]

- Reintroducing selective capital controls in the members-states currently ruled out by European treaties (or at least limited to exceptional circumstances which are highly contested).

Conclusion

European integration—as a product of two World Wars and a close fit of hegemonial interests and the interests of former war adversaries—remains unique. However, even Asian countries with their respective unilateral traditions, have developed institutionalised attempts for closer cooperation in the aftermath of the South East Asian financial crisis in 1998. A prominent example is the Chiang Mai Initiative (CMI). The initiative is a multilateral currency swap arrangement among the 10 members of the Association of Southeast Asian Nations (ASEAN).

The basic lessons from the euro crisis: Liberalisation of capital flows works only in conjunction with institutionalised and symmetrical economic cooperation. Otherwise, monetary autonomy is not collectively improved, but undermined via 'beggar thy neighbour' policies. The Asian integration path based on capital controls and selective cooperation seems much more promising than free market regionalism in Europe.

The financial markets, quite ironically, have demonstrated a distrust of market-based regionalism, as it undermines economic development and stability.

From the perspective of the European power brokers, the euro crisis could not have come at a worse time. The crisis of US hegemony principally opens doors for competing (and cooperating) political powers. However, the asymmetrical concept of European integration, which is an

14. ECB is fiercely opposed to any such institutional arrangement that could affect its institutional autonomy. However, while most international central banks enjoy instrumental autonomy, the ECB is one of the few central banks of the world, which enjoys freedom of accountability for their monetary strategy. The problem is the big veto power of ECB. If a government decides to tackle an economic recession by increasing public expenditure, ECB can neutralise the desired effects and increase the fiscal burden of debt service by raising interest rates.

expression of power gambling, exactly undermined the kind of coherence and stability needed to provide economic and political leadership.[15] Therefore, if Europe does not radically reinvent itself fuelled by broad-based political opposition to the neoliberal revolution, the sun in the global gamble will surely rise in the east and set in the west.

15. For example, the ECB as 'apolitical monetary institution' is simply unable to act as lender of last resort according to the principles of the Federal Reserve Bank of the United States.

8 From Exportism and Growth Fetish towards an Ecosocialist 'Economy of Reproduction'

MARIO CANDEIAS

The 'Acceleration of Growth Act' is the first measure taken by the new governing coalition of Christian Democrats (CDU/CSU) and Liberals (FDP). Exports shall again be the driver of economic growth. However, German exportism—based on growing exports and ailing domestic demand—can just as little be restored as it can be in China, for instance. Ecological and most important economic limitations and imbalances speak up against it. These include the following:

1. In spite of 30 years of environmental politics and increasingly efficient technologies, the emission of gases relevant to climate change and the consumption of natural resources has not only not been reduced, but has increased even. According to the Intergovernmental Panel on Climate Change (IPCC) this leads up to the worst-case scenario of an impending global warming of six degree celsius. As things are, the two-degree target of a so-called 'manageable climate change' has already been crossed. Every attempt to stimulate capitalist growth in the global north contravenes a solution to the ecological crisis.

2. Unrealistic hopes have been set on a Green New Deal (GND) to combine the interests of the capital with ecological necessities in a harmonic way. Given the current power relations, a 'Green Capitalism' will probably be established, favouring market instruments and technical solutions. This creates urgently needed investment areas for capital by commodifying nature and its protection, putting a price tag on it while neglecting non-profitable sectors. The electric car, for example, offers new perspectives to car manufacturers but does not change anything about the structure of

individual traffic, soil sealing, or the enormous consumption of resources that are in part highly toxic, such as lithium. GND aims at stimulation of growth and export, which does not limit the consumption of resources. It continues or even intensifies imbalances and competition in the global economy. Experiences with climate negotiations and emissions trading show: this takes too long. If 'ecological restructuring' is too slow, aggravated environmental and socioeconomical crises will be the result. If the restructuring was pursued thoroughly, for example through a significant cut in emission rights, it would inevitably bring about the decline of old industries and destruction capitals, and thus lead to respective resistance. It would be impossible to prevent economic crises and ruptures. There is no smooth transition.

3. Between 2001 and 2007 real annual growth of the German economy only amounted to an average of 1.1 per cent; it has been declining since the 1970s. Economic constraints to growth, not least due to the 'structural heterogeneity' of exportism and weak domestic demand. From an ecological perspective, material production must shrink in any case.

4. Since the beginning of the 21st century, Germany is the world champion in exports again (if we take currency relations into account; and no doubt if you take per capita relation). In 2008, Germany sold commodities for a value of more than 1.2 trillion € in the world market. The trade surplus is nearly 200 billion €. The one-sided orientation towards export growth was attended by real wages that have been stagnating since 1990 (including the boom year 2007-08). In no other European country has the low-wage sector grown as rapidly. Consumption was no real factor for economic development: its contribution to growth has been at an average of 0.11 per cent per year between 2001 and 2007. Hardly any other country is so dependent on export: about 45 per cent of the gross domestic product (GDP) relies on it. Since 2001, Germany's trade surplus has come to a venturesome one trillion € and so redounds to the world's huge current account imbalances. Simultaneously this 'structural heterogeneity' renders the so-called world champion of exports extremely vulnerable to global crises

like the current one. The most important export industries are struggling with a severe decline in orders: machine construction about 50 per cent less, the car industry 34 per cent less, the chemical industry 27 per cent less. The economic contraction is about six per cent of GDP. Especially the core industrial regions in the South have to deal with a contraction around 7.5 per cent. The government's response includes stimulus programmes, longer short-time working benefits, cash for clunkers to support car sales and employment. And before—as everywhere in Europe—enormous amounts of money were used to support the banks and the financial sector.

4a. The costs of the crisis and the enormous (trade) imbalances inside the EU led to a new state of crisis: a European debt crisis. With an average debt of 80 per cent of the GDP and 6 per cent annual new debts, the Euro zone has so far failed the Maastricht criteria (allowed are debts at a maximum of 60% of the GDP, and annual new debt at a maximum of 3% of the GDP). Those countries which spend a lot were spared the hardest hit, but those with record-low tax rates, with a very low public expenditure quota, trying to court the timid deer called capital. Now every government in Europe is trying to implement ever tighter austerity programmes. One thing is for sure: if every country tries to save on expenditures, cut investments, raise consumer taxes, these measures will not accelerate growth but likely lead to recession. Thus, the prospects for German exports look bad, or end up in crowding-out competitors in the rest of Europe, while promoting deeper imbalances. The European Union is in need of deep social and economic reform.

5. The German model of export and growth is lacking a perspective. In light of an increasing orientation to reduce national debt that exploded as a consequence of the crisis, enormous over-capacities, and stagnating demand, strong deflationary tendencies are to be expected over the coming years. In the US, the household will never again consume as much as before; they simply will be not able to. Demand for imports will then decline, too. When the 'global consumer' that is the US, with a share of 16.5 per cent of

world imports, fails the expectations to support growth, then the dynamic of China, for instance, is also at stake. The assumption of decoupling global economic growth form the crisis in the US has disgraced itself. At the same time, the poor profit prospects are contributing to a financial over-accumulation that has hardly been reduced until now, to an asset price inflation, and new speculative bubbles, accompanied by rising prices of oil and other resources due to peak-oil and other scarcities. There is no end in sight to the crisis.

6. It is necessary to get away from exportist delusion and the fetish of growth. But how? There is no system-hopping. Therefore, transformative steps are needed: a revolutionary realpolitik, as Rosa Luxemburg called it. An initial project could be the socioecological conversion of the car industry. State capital assistance should be bound to concepts of alternative production and partial or full public ownership of the company. This would have to be connected to an extended participation of the workforce, trade unions and the region, for example in regional councils which decide on the concrete steps for a conversion of a car manufacturer into a service provider for public mobility with ecological focus.

7. This is impossible to be achieved in individual companies, but requires deep structural change. Embedded in a macroeconomic orientation, conversion would therefore imply to transform our growth-orientated capitalist economy into an 'economy of reproduction' that knows how to limit itself and how to create new wealth at the same time. Let us focus on a participatory, need-centred, solidarity 'care economy' where people care for each other: social infrastructure of public health care, education, research, social services, food, sovereignty, and protection of our natural environments. These are central needs, the deprivation of which has been universally deplored for years. A reproductive economy also means a qualitative development of needs and production, but not quantitative growth. This would contribute to truly ecological modes of living and producing and to developing a practice of *buen vivir* (good living) that many try to explore, not only in Latin America.

8. This goes together with an orientation towards domestic markets and production. The tendency to deglobalise and regionalise the economy also makes for a reduction of current account imbalances and export fetish. Through a non-mercantile expansion of the public, markets and privatisation are being pushed back. Given the necessity to shrink certain sectors, strategies of a socially sustainable just transition have to be developed. This also implies that other sectors have to grow in the meantime, relatively decoupled from material growth. Such qualitative growth is necessary for the time of transition also due to the deficiencies in many sectors of reproduction, especially in the Global South.

9. To place reproductive work in a broader sense of the term at the centre of a transformation project makes it possible to abandon the growth fetish—and by doing so questions the capitalist mode of production in the medium term. Ultimately it poses the question of who decides on the deployment of resources in society and which activities are socially necessary. This requires elements of participative planning processes, *consultas populares* and people's planning processes, democratic councils.

9 Deconstructing India's Inclusive Development Agenda

SAMIR SARAN AND VIVAN SHARAN

> Managing a complex economy is a difficult task, more so when it is a growing economy in a globalised world.
>
> —Pranab Mukerjee[1]

The United Progressive Alliance (UPA) government has realised that managing an economy which is integrated with the global financial system is a difficult task in this post-financial crisis world. The focus of the government has quickly shifted from a high growth rate strategy to an inclusive strategy—or has it? This paper debates if, how and why this policy shift has taken place. Is the repeated appearance (six times) of the word 'inclusive' in the 2010-11 Budget speech of the Finance Minster (as opposed to not even once in the 2004-05 Budget) merely symbolic or is there a political and economic traction in this direction? Is it because the government has rediscovered the socialist ethos enshrined in India's Constitution, or is it merely old rhetoric in new vocabulary? We test the flagship programmes of the UPA government to see if they pass the seven criteria for inclusiveness that are developed in this paper. The paper concludes that the inclusive growth focus is still in its infancy, though with certain well-intentioned schemes under way. The discourse on inclusiveness is loud, bordering on political rhetoric and has resulted in support for such schemes across the social and political spectrum. An unintended though welcome consequence of this has been the financial stimulation of the economy, which may well have contributed to India's sturdy response to the global financial crisis.

1. Budget Speech, 2010.

The Inclusive Agenda: An Introduction

> Inclusive Growth does not Mean Everybody has to be Protected.
>
> —Montek Singh Ahluwalia[2]

The economic transformations that India has undergone since the balance of payments crisis two decades ago have been rapid. In 1991, P.V. Narasimha Rao's government, with Manmohan Singh as the finance minister, was faced with managing foreign exchange reserves of $1.1 billion, just enough to finance about three months of imports. With India's credit rating dipping and left with no other alternative, the Congress led government decided to apply for an International Monetary Fund (IMF) loan, offering assurances of structural reforms. The structural adjustment package or the 'New Economic Policy', announced in the annual budget of 1991 led to a policy shift that moved India toward a more liberal market-driven growth path.

For some time now, a large part of India has been obsessed with the 'mantra' of double digit growth in GDP. However, data does not suggest that this growth has been trickling down—as vouched for—to the bottom of the socioeconomic pyramid at an acceptable rate. Between 1993 and 2004, national accounts data has confirmed that per capita income has increased at about four per cent per year, whereas household surveys showed dramatically less increase in consumption expenditure.[3] With poverty line drawn at an irrationally modest per capita income of $1.25 a day,[4] India still has around 410 million living below this line. At a slightly more functional estimate of $2 a day, the below poverty figure swells to over $800 million people.

These are stark numbers. The strong rhetoric of liberalisation, privatisation and globalisation in the early nineties has now been replaced by the inclusive growth agenda of the UPA government. This reformulation of ideology has not come about through introspection by the polity alone, but rather through a variety of external push and pull factors. They include: the massive increases in inequality (indicated by a marked rise in the 'gini

2. Published: November 01, 2007 in India Knowledge@Wharton.
3. World Bank (2008a).
4. As prescribed by the World Bank at 2005-06 prices.
5. See Topalova (2008).

coefficient',[5] especially for urban households), and the expansion of the base of the socioeconomic pyramid. This has led to populist rebuttals of a purely market-based growth. As a result, the government announced nine flagship schemes to promote inclusive growth in 2005. These schemes are at the core of the growth agenda, and the inclusiveness narrative has also been seen to positively influence the grassroots election politics (in favour of the ruling party). The agenda of inclusive growth is prone to *ex-ante* analysis in India. Given that the flagship programmes of the UPA government began in 2005 and are slated to end in 2012, it is not too early to discuss the outcomes within the framework of inclusivity.

Inclusive growth, being a loosely used term, especially in the political establishment, needs at the outset to be defined with greater precision. This will help put three of the UPA's grandest flagship schemes under the inclusiveness scanner and see how they perform.

Defining Inclusive Growth

'Inclusive growth' is common parlance in India today, but it is not a new concept. The ideal of growth with equity has been followed (at least in theory) since Independence, and is enshrined in our Constitution. While defining inclusive growth in the context of India, it would be important to start by stating that it refers to both the pace and pattern of growth.[6] If the pace of overall GDP growth is rapid, as has been the case in India over the last two decades, it is very important that the pattern of growth becomes sustainable.

There has been a steady rise in the population and income over the last two decades, as seen below:

	1990	*2009*
Population	0.85 billion	1.15 billion
Per capita income	USD 373.09	USD 1,032

Source: India Data Labs, Observer Research Foundation.

One of the frameworks for measuring the effectiveness of inclusive growth has been suggested by the eminent economist Subir Gokarn in a speech delivered at the Ahmedabad Management Association in 2007.[7] He

6. Commission on Growth and Development (2008).
7. At the 8th Dr. R.L. Sanghvi AMA Endowment Lecture, December 6, 2007.

has suggested that opportunity, capability, access and security—together are important in constructing the definition of inclusiveness. An economy where there are diverse, viable opportunities for income generation and skill enhancements, is one which can ensure a broad-based growth.

All the above parameters can be sensibly discussed only if we consider them over a certain time horizon. History is replete with examples of rapid economic expansion and income growth, followed by stagnancy or decline. What is also clear is that 'transfer schemes' cannot be sustainable in the long term if they do not assist in generating capacities and opportunities, and therefore any meaningful steps to promote income generation will have to be organic and productive. It is important to mention that income and employment generation are generally seen as the potential outcomes of an inclusive growth-based strategy.

Productivity forms the backbone of any inclusive growth strategy. According to a recent report from the World Bank,[8] 'the inclusive growth approach takes a longer-term perspective as the focus on productive employment rather than on direct income redistribution, as a means of increasing incomes [of] excluded groups.' The report also makes the relevant and valid point that, in a country like India, the problem is not only unemployment, but also underemployment.

Given below is the breakdown of class-wise consumption patterns (as an example of inequitable income distribution) in rural and urban areas:[9]

Table 9.1

Class-wise Consumption Patterns

Social Group	*2009 All-India (Rural + Urban)*		
	% Population	*Household Size*	*Average MPCE*
Scheduled tribe	8.8	4.56	854.47
Sscheduled caste	20.29	4.57	887.44
Other backward class	41.76	4.60	1064.50
Others	29.14	4.38	1578.70
Total	100	4.52	1159.80

Source: India Data Labs, Observer Research Foundation.

8. World Bank (2008b).
9. MPCE = monthly per capita consumption expenditure.

Breakdown of consumption patterns across religious groups (as an example of inequitable income distribution) in urban areas:[10]

Table 9.2

Consumption Patterns across Religious Groups

Religion	*Urban (2009-10)*		
	% Population	*Household Size*	*Average MPCE*
Hindu	78	4.00	1840.28
Muslim	15.85	5.00	1321.38
Christian	2.51	3.62	2162.70
Sikh	1.61	4.54	2319.56
Jain	0.82	4.85	3450.15
Buddhist	0.92	4.54	1472.57
Zoroastrian	0.05	2.70	4664.51
Others	0.22	4.68	2092.04
Total	100	4.14	1785.81

Source: India Data Labs, Observer Research Foundation.

There are of course a myriad other factors to be considered while talking about inclusiveness in a country like India. Deininger and Squire (1998) have shown that high asset inequality has significant deleterious effects on growth. They conducted this study using land distribution as a proxy for asset inequality, and in India, there is a significant amount of inequity in land distribution itself. In India, landlords—traditionally known as *zamindars*—form the farmer elite, who own huge tracts of land, while the majority of the agricultural populace, the common farmer, owns very little or no land at all to call his own.[11]

10. Ibid.

11. According to the *Report on Conditions of Work and Promotion of Livelihoods in the Unorganised Sector* by the National Commission for Enterprises in the Unorganised Sector, 2007; 7.5 per cent and 15.4 per cent of the agricultural and non-agricultural workers are totally landless.

Illustrated below are the huge variations in average landholdings in key agriculturally developed states:

Table 9.3

Average Land Owned (2009-10)

(Hectare)

State	Sector	
	Rural	*Urban*
Punjab	0.74	0.15
Uttar Pradesh	0.59	0.17
Madhya Pradesh	1.41	0.43
Andhra Pradesh	0.52	0.11
Bihar	0.40	0.23
Haryana	0.78	0.22
Maharashtra	0.98	0.16
West Bengal	0.18	0.03

Source: India Data Labs, Observer Research Foundation.

In 2009, the Planning Commission published a report by the Raghuram Rajan Committee on Financial Sector Reforms.[12] A part of this report primarily focusses on financial inclusion, which is another key step towards ensuring inclusiveness. The report states that the way to promote financial inclusion is through 'expanding access to financial services, such as payment services, savings products, insurance products, and inflation protected products.' The report also states that the aim of financial inclusion should not be to force credit on households by making banking services available, but rather, to enhance the poor households' creditworthiness. Additionally, the report makes a case for including urban areas apart from rural areas, to account for the heavy migration of the poor in India to towns and cities. If executed properly, greater financial inclusion can indeed lead to reduction of leakages in the system, besides ensuring greater accountability of and [financial] access to the rural and urban poor.

12. See Planning Commission (2009).

Table 9.4

Increasing Migration Rates across Urban and Rural Areas

	Rural			Urban		
	Male	Female	Overall	Male	Female	Overall
1999-2000	6.9	42.6	24.4	25.7	41.8	33.4
2007-08	5.4	47.7	26.1	25.9	45.6	35.4

Source: India Data Labs, Observer Research Foundation.

In order to objectively judge the success or otherwise of the inclusive growth policy, we have to sieve it through all of the above definitions. This means that a good policy has to be broad-based one, impacting all sectors for long-term sustainability. It has to benefit those at the bottom of the pyramid by making the poor vertically mobile by effectively enhancing their skill sets and knowledge base. This process will ensure growth in productive employment and not just in employment alone. Inclusiveness must focus on a large part of India's labour force in order to narrow down the base of the pyramid. And finally, the poor need to have access to properly regulated financial institutions. The following seven parameters must form the broad base of the criterion for inclusive growth, and any policy/programme must respond to these parameters:[13]

1. *Opportunity*: Is the scheme generating diverse opportunities and avenues of income generation to its people?
2. *Capability*: Is the scheme generating new ways and options for people to enhance their skill sets and knowledge base, in order to avail the opportunities with the system?
3. *Access*: Is the scheme building a bridge between capabilities and opportunities?
4. *Security*: Is long-term job security being created by the scheme or are there chances of temporary or permanent loss of livelihood?
5. *Equity*: Is the scheme creating equal opportunity across gender, regions, religions and classes?

13. The first four criterion are taken from Gokarn (2007). The fifth criteria is common to many interpretations of inclusiveness, and the sixth and seventh criterion are inspired by parts of Planning Commission (2009).

6. *Financial inclusion*: Is the scheme providing better access and integration to the financial system in the country?
7. *Financial sustainability*: Is the scheme sustainable in the long term, does it create a viable self-sustaining mechanism or is it a 'transfer scheme'?

This paper will test three of the largest flagship schemes of the government through the above parameters for inclusive growth.

The Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA)

The NREGA was enacted by the UPA government in August 2005, as part of the flagship programmes to promote inclusive growth in the country. The Act ensures a 100 days of paid labour to any rural household wishing to perform mainly unskilled manual labour for a minimum wage. In order to objectively assess the inclusiveness of this act, we have to consider specific pivotal factors.

The Act during its formulation provisioned for Rs 100 as the minimum wage for a day's work. This was later revised to an inflation indexed wage, whereby the wage rate was linked to the consumer price index for agricultural labourers. This has ensured that the wage rate is uniform across the country. As pointed out by a recent study,[14] this in turn has meant that in several states, NREGA wages will be lower than the wages stipulated by the Minimum Wages Act, 1948 (MWA). Under the MWA, each state assigns its independent wage rates depending on the skill of labour involved and keeping in consideration basic human necessities of food, clothes, housing, educational costs and social security. However, because of the non obstante clause in section 6(1), NREGA is not constrained by the provisions of the MWA, and the wage rates can be lower than those prescribed by it.

While it has proved beneficial in many areas, NREGA is forcing people to accept below-minimum wage in many states, which is fundamentally unconstitutional and can be interpreted as forced labour by the International Labour Organisation (ILO's) Declaration on Fundamental Principles and

14. Sankaran (2011).

Rights at Work, 1998. Inclusive policy certainly should not claim to be pro-poor and be exploitative at the same time. This contradiction shows that NREGA is not an inclusive policy at the very outset. Further, NREGA support level is now becoming a benchmark for unskilled workers with detrimental effects either way.

There are some inclusive measures within the Act. The Act mandates that a third of the workers should be women. There is also no restriction on how each household's quota of 100 days will be shared within the household (although in an ideal setting, the government would be able to guarantee 100 days of employment to the individual rather than the household).[15] This promotes equity between men and women, which is essential as equal opportunity is one of the tenets of inclusiveness.

In 2008, the government shifted from a policy of cash transfers to NREGA workers to bank payments. This was lauded as the world's largest ever financial inclusion scheme. By making payments through financial institutions like banks and post offices, the government has separated the agencies that implement the scheme and make payments. This has certainly reduced the scope for embezzlement provided that the system works according to plan. However, according to a survey conducted in 2010,[16] the possibility of embezzlement through collusion still remains a concern due to pervasive ignorance among the workers.

However, looking at NREGA from a security perspective, it contributes positively in ensuring job security. The Arjun Sengupta Report (2007) on *Conditions of Work and Promotion of Livelihoods in the Unorganised Sector* also lauds the Act for this achievement, stating that it 'makes a historic step towards reorganising and ensuring work as a right of the people.'

An area of concern is that the Act does not focus on productive employment. Non-skilled labour remains the focus of the NREGA, and this does not ensure the self-sustainability and vertical upwards movement of the worker. The added dimension of a 100 days of job security further incentivises the worker not to add to his/her skill set. According to Article 43 of the Directive Principles of State Policy, to 'promote cottage industries

15. Khera and Nayak (2009).

16. Adhikari and Bhatia (2010).

on an individual or cooperative basis' is a way to ensure decent quality of life for those working in the unorganised sector. However, with the guarantee of 100 days of paid work, we feel that NREGA undermines the productivity of the informal sector. This is because workers are increasingly tempted to gather the wages for 100 days of labour and take time off from their informal sector work. Hence, from a long-term perspective, the Act does not contribute to inclusive growth in that it promotes wage inefficiencies, skill stagnation and underemployment.

Jawaharlal Nehru National Urban Renewal Mission (JNNURM)

The Government of India estimates that urban population will increase to about 40 per cent of the total population by 2021.[17] In order to counteract the effects of this vast increase in the urban centres' population, the JNNURM was launched as another one of the flagship programmes in 2005. The total allocated expenditure on the programme by the Centre is Rs 50,000 crore, with additional funding requests to the government and the World Bank totalling up to Rs 100,000 crore. The programme has two submissions in order to fulfil the mandate of inclusiveness; urban infrastructure and governance (UIG) and basic services to the urban poor (BSUP).

The 74th Constitutional Amendment Act ushered in a new era of local urban governance with its enactment in 1992. The Act decentralised the powers of urban governance to democratically elected local governments. The JNNURM has stipulated that this Act be fully implemented under its mandate, since most state governments have remained reluctant to implement it.[18] At the outset JNNURM as an idea is hard to argue against, given the fast pace of urbanisation and therefore the need for big cities and towns to keep up with this rapid expansion both in terms of infrastructure and services.

The implementation of this scheme has not been quite as equitable as it should be. Of immediate concern is the marginalisation and dislocation of the poor in the cities covered under the JNNURM.[19] Recent studies have

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17. According to the overview document (2005) of the Jawaharlal Nehru National Urban Renewal Mission; Released by the Ministry of Urban Development and the Ministry of Urban Employment.
18. Mehta and Mehta (2010).
19. Mahadevia (2006).

estimated that out of the 35 million slum dwellers living in the 63 'mission cities', only about 10 million will stand a chance at getting a formal housing unit.[20] The question also remains unanswered as to which urban poor should receive immediate benefits, and this is not clarified by the mission statement of the JNNURM. The ongoing beautification drives in cities along with the development of infrastructure such as mass rapid transit systems and bridges has led to the dislocation of countless number of poor. They suffer from inadequacy of supply in terms of housing and basic facilities. The eligibility criteria for the relocation of those dislocated as a result of the aforementioned development projects has not been clarified by the Indian government.[21]

Delivery of urban services such as water supply, sanitation and sewerage and solid waste management are admissible under the UIG. However, there is an abysmal chasm between the stated targets and the service delivery. The Joint Monitoring Programme for Water Supply and Sanitation[22] (2010) has estimated that access to basic sanitation has stagnated at 54 per cent and that about 18 per cent of the urban population resorts to open defecation. A recent UN report even pointed out that more people have mobile phone subscriptions in India, than access to proper sanitation, with an estimate of only 336 million people out of more than a billion.[23] In the absence of documents such as title deeds and property tax bills, the urban poor living in slums are not eligible for the benefits of municipal services. The answers to question on inclusiveness remains elusive when confronted by figures which point to a lack of basic necessities which, no doubt, would have contributed towards poverty reduction under the BSUP.

According to a recent study, there are regional inequities inherent in the implementation of the JNNURM.[24] The study states 'the coverage has been better in the developed states ranging from 50 per cent to 80 per cent, except Haryana and Punjab.' It goes on to state that 'the less developed

20. Joshi (2009).
21. Kundu and Samanta (2011).
22. See WHO and UNICEF (2010).
23. *The Telegraph*, April 15, 2011.
24. Kundu and Samanta (2011).

states like Bihar, Chhattisgarh, Madhya Pradesh, Orissa, Rajasthan and Uttar Pradesh have reported that about 60 per cent to 65 per cent of their population is yet to be covered under the scheme.' Surely the objective of an inclusive agenda should be complimentary to a pro-poor and hence pro-underdeveloped states strategy and not the other way around.

Fiscal sustainability is deeply intertwined with the mandate of inclusive growth. Hence, it is also worth the while to question the fiscal sustainability of programmes such as JNNURM, which are more or less solely dependent on discretionary government expenditure. Developed countries the world over rely on the issuance of municipal bonds for financing urban infrastructure projects. In India, the municipal bond market is still in a relatively nascent stage and rarely tapped. Although the mandate of the JNNURM encourages urban local bodies to exploit the bond market and use public private partnerships for financing projects, the actual implementation of such schemes has been fairly limited, with the last major bond issuance taking place in 2005.[25] There seems to have been a crowding out of commercial financing because of the large doses of discretionary expenditure, as stipulated by the JNNURM.[26] What is essential is that the expenditure takes place with a self-sustaining model in mind—with particular emphasis on infrastructure that pays for itself.

National Rural Health Mission (NRHM)

The NRHM was instituted to 'provide effective health care to rural population throughout the country with special focus on 18 states which have weak public health indicators and/or weak infrastructure.'[27] It aimed to increase focus on public health in the country, which had an allocation of only 0.9 per cent GDP in 1999. The main objectives of NRHM are to reduce infant mortality and maternal mortality rates following the Millennium Development Goals of the United Nations.

25. The Ahmedabad Municipal Corporation has been leading the way in this regard. It issued the first municipal bond in Asia without a sovereign or state guarantee and with a credit rating. The last major issuance (Rs 1,000 million) of municipal bonds in India was also carried out by it in the year that the JNNURM was started (2005) for roads and water supply projects.

26. Mehta and Mehta (2010).

27. NRHM Mission Document, Government of India.

Table 9.5

Percentage of Population between Ages 0-5

	2004-05			2009-10		
Age Group	*Rural*	*Urban*	*Total*	*Rural*	*Urban*	*Total*
0-5	15.04	11.9	14.29	12.67	10.79	12.19

Source: India Data Labs, Observer Research Foundation.

The recent Parliamentary Public Accounts Committee (PAC) report has termed the NRHM a 'fiasco'.[28] One of the main concerns has been the shortage in the supply of health equipment and medicines. The PAC report has stated that health centres have been supplied with sub-standard and expired medicines. A recent survey has also indicated that there is an absence of toilets and medical waste disposal systems in many of the health care centres across the country.[29] It says that 'a large number of sub-centres, primary health centres and community health centres are located in sub-standard environment such as garbage dumps, cattle sheds and stagnant water bodies and functioning in unhygienic conditions.'

India's health care system's malaise is that its foundation itself has been weak right from the begining. The Bhore Committee in 1943 had suggested that the Indian health care system should be based on a top-down, western approach, whereby an elaborate network of hospitals and health care centres should be made in order to provide free health care for all.[30] This model has been unsuccessful in India due to lack of funds and lack of will to provide the required funds. Besides, in terms of inclusiveness, it does not stand on a widely-based pyramidal system.

The NRHM envisions a structure of 'integrated comprehensive primary health care', and there have been various failed community participation objectives in order to try to execute this goal. The Accredited Social Health Activists (ASHA) scheme is one such strategy under the aegis of NRHM, which mandates that accredited, trained local health care activists should up the ante as far as community awareness and

28. Public Accounts Committee Report, Government of India, March 2011.
29. Gill (2009).
30. Ashtekar (2008).

participation in public health is concerned. Predictably, the PAC report has trashed the scheme, maintaining that there is a severe lack of trained ASHAs equipped with drug kits. Furthermore, the ASHAs are not trained to carry out the complex social roles that they are supposed to fulfill.

As far as funding the health care system is concerned, once again it is evident that the NRHM is not representative of a self-sustaining model. Although, under the NRHM, the government has upped its public health expenditure to 2-3 per cent of the GDP, this is nowhere near enough to ensure an inclusive strategy. The private sector's share in health care stands at about 70 per cent, but it is largely bypassed in NRHM. The lack of public-private collaboration in the health care sector is indicative of a lack of integration between sectors. This is certainly not good for the inclusiveness agenda. The fact that health care centres are being used as 'godowns for storage of food grains and cow dung' according to the PAC, is a reminder to the government that pumping in funds into a system without any external checks and balances is not the way to allocate money. The PAC has called for a reappraisal and restructuring of the NRHM and, given that the programme is supposed to reach its outlined objectives by 2012, this would prove to be too little, too late.

Conclusion

The examination of the three schemes from the inclusive growth framework described above, demonstrates that each of the schemes suffer from structural flaws. The individual appraisals of the three schemes are highligted in Table 9.6.

Table 9.6

Individual Appraisals of the Three Schemes

Parameters/Programmes	*NREGA*	*JNNURM*	*NRHM*
Opportunity	✓	✓	X
Capability	X	✓	✓
Access	X	X	X
Security	✓	X	X
Equity	✓	X	✓
Financial inclusion	✓	X	X
Financial sustainability	X	X	X

Going by the definition for inclusiveness suggested in this paper, none of the flagship programmes are inclusive. But then, it is impossible for individual schemes to adhere to all parameters, and if this fact is taken into consideration, the NREGA scores well. The fact that none of the programmes are financially sustainable is not surprising, and neither is the fact that none of them increase access by bridging the gap between capability and opportunity. The 'demographic dividend' that is often talked about in India's context—is in danger of being jeopardised by the lack of infrastructure and services, absence of skills, lack of access and financial exclusion. The lack of political will to lay a stake in the country's long-term growth is worrying.

As more and more people shift from villages to cities, India's urban landscape is evolving rapidly. It is no longer the case that the political establishment can afford to overlook the aspirations of the marginalised urban poor. Given that there are a wide variety of problems that need to be addressed—ranging from inequity to basic infrastructure, the JNNURM can certainly not be considered a silver bullet. Furthermore, with malnutrition rates worse than Sub-Saharan Africa and the attempt to improve the country's health profile having proved to be a 'fiasco', (along with poor performance on our inclusiveness matrix) no victories can be claimed by the NRHM either.

There is little doubt that the government expenditures on these programmes have resulted in huge fiscal transfers to the real economy. The government spending on infrastructure such as roads, transport, wages etc.,—certainly have helped India weather the recent global financial crisis by acting as a temporary fiscal stimulus. However, it is important to emphasise that the assumption *vis-à-vis* temporary stimulus is that it can be reversed when it is no more needed. It is uncertain whether the government has a long-term exit strategy that ensures that the flagship schemes have enough momentum to become self-sustaining and productive—the two essentials of inclusive growth.

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