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How Politics and Perceptions Trump Economics

By [Martin Gilman]

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If you were to measure the recent economic performance of the world's major countries — say, those that comprise the Group of 20 — you might be surprised to find Russia among the top performers by most common metrics. This outcome is a fact. For example, based on data compiled by The Economist, Russia's real growth in gross domestic product in the first half of 2012 at 4.4 percent exceeded all other countries except China, India and Indonesia. This unexpected outcome, which may or may not persist into next year, certainly seems at odds with the skepticism and negative perceptions of the country as seen from abroad and even often at home.

What accounts for this discrepancy between actual economic performance and conventional views about the economy? Why are so many investors and the media so optimistic about Brazil and India despite a serious deterioration in their economic performance? The most likely explanation is politics and political perceptions that seem to dictate the direction and strength of economies earlier driven predominately by market factors.

It is not just in Russia where economic performance is dominated by politics. If fact, rarely since the Great Depression of the 1930s has so much of the global economy been at the mercy of politicians. The dominance is real and direct in advanced economies, perhaps more so than in Russia.

In Russia, foreign investors may be spooked by perceptions of a more repressive political regime since the return of President Vladimir Putin to the Kremlin in May. It may be too soon to discern whether investor caution is the result of a real objective threat to the country's reform path or whether it is linked more to media hype during a summer of slow news. Perhaps it stems from heightened risk perceptions in general about globalization, which has a direct impact on Russia. The far more significant issue is the country's economy is beholden to the policies of the government and the Central Bank — even more than usual.

Of course, in post-Soviet Russia as elsewhere, governments have always played a key role in the economy. It seems almost axiomatic that once a country's per capita income starts to rise beyond subsistence, governments undertake functions that extend well beyond British political philosopher John Locke's 17th-century dictum that the fundamental role of the state is to protect person and property.

With the onset of the global financial crisis — which marks its anniversary this week with the collapse of Lehman Brothers in September 2008 — a long period of laissez-faire economics has ceded its place to a new era of politically led economics. In fact, one of the first actions to avert a complete meltdown of the global financial system after Lehman Brothers was an orchestrated and massive G20 fiscal and monetary stimulus agreed at a summit in Washington in November 2008.

There have been numerous examples of this since then, and it seems that the advanced economies, and especially their equity markets that reached four-year highs last week, are in thrall to the expectations of political action. Witness the reactions of bond and stock markets to the decision of the European Central Bank last week to support unlimited sovereign bond purchases of periphery euro-zone countries under certain conditions, or the nail-biting anxiety over whether the U.S. Federal Reserve will announce more quantitative easing at its meeting this week. In Europe, as in the United States, the rancor over who should bear the economic costs of debt deleveraging is a high-stake political battle between creditors such as Germany, which advocate austerity, and over-extended borrowers like Spain and Italy, which argue for a fiscal stimulus to growth financed by more debt. In the United States, the debate between Wall Street and Main Street seems to be reflected to some extent in a cleavage between the Republicans and Democrats in which the spending role of government is a key issue.

We now live in a world where politics play a magnified role in the economic outcome, whether the question is growth, inflation, interest rates or unemployment. Some would ask what exactly is new about this. The answer is that business is not usually as beholden to government in advanced economies as in the past four years. People in all walks of life anxiously await political decisions. In the United States, for instance, Friday's lower-than-expected employment figure spooked the markets, but who wants to hire or invest when the country faces a "fiscal cliff" in just over three months when legislated spending sequestration and tax hikes are scheduled to bite. In Europe, there is a veritable run on the banks in some countries as the future of the euro remains under a shadow. It's a political show, and the economy is the backdrop.

In some ways, the dominance of politics over economics is no different in Russia. Here, one does not even need to get into the longstanding issues that affect the economy, such as tolerance of corruption and inadequacies in the rule of law. Immediate policy questions concern mixed signals about whether ambitious public spending, especially for the military, will proceed as planned, or whether the state should instead set aside resources in anticipation of another global financial crash, or whether the Central Bank will continue to favor the banks with liquidity support or pursue disinflation to contain the real appreciation of the ruble.

Where does this all lead? In 2009, PIMCO head Mohamed El-Erian and his colleagues developed the concept of the "new normal." They envisaged that the world was entering a period in which economies would reduce their high debt levels, policymakers would re-regulate, and there would be increasing political and economic pressure to de-globalize. In short, in a meaner economic climate following the unsustainable debt bubble, politics dominate over markets.

We are living in this "new normal," and we might as well get used to it, no matter what the politicians promise. The hope must be that they will at least maintain peace and avoid rampant xenophobia in a world of stagnation. No one wants to see a repeat of the 1930s.

As strange as it may seem, Russia might actually be well-placed for the "new normal" with a low-debt, growing economy and a relatively stable political regime to play a pivotal role to prevent such an outcome when it assumes the presidency of the G20 next year.

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