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Volatility dangers

A few months ago, the long-standing problems of "global imbalances" appeared to be abating, with a soft landing involving a dropping dollar and slow US GDP growth. Now, fears about global macro-economic worries are back on the front pages. Three major things have changed in recent weeks. The trouble in US housing has turned out to be much worse than was earlier felt to be the case. Many financial firms have failed—in the US and elsewhere. Credit spreads have risen sharply and risk perceptions have been revised upwards.

Stock prices fared very well in the last year, with the Nifty gaining 35 per cent and the S&P 500 gaining 12 per cent. Now fears about the world economy have led to lower stock prices. Home construction is the worst-performing industry in the US; shares of companies in the field have lost 60 per cent over the last two years. In addition, the projections embedded in option prices show an upsurge of volatility. The S&P 500's implied volatility has surged to 25 per cent, the highest in three years. In India, so far, the implied volatility is at 27 per cent, which is modest for India's markets. The relative numbers suggest that India's markets have some ground to lose before they stabilise.

An opinion poll conducted by the *Wall Street Journal* shows that as many as 66 per cent of the respondents believe the US will now have a recession. This conveys the gloom in the US. Will the US Federal Reserve mount a rescue by swiftly cutting interest rates? It is unlikely. The Fed is a de facto inflation-targeting central bank. The expected inflation embedded in the prices of inflation-indexed bonds in the US is at 2.3 per cent, which is above the 2 per cent target. Until future inflation softens perceptibly, the US Fed is unlikely to cut rates. At present, the derivatives markets are showing a 20 per cent probability of a rate cut by the Fed by September and a 40 per cent probability of a rate cut by October. In India, all these financial markets are missing, and the central bank's objectives are not clearly specified, hence it is not possible to anticipate what the RBI will do.

How would India be affected in an unhappy scenario? A recession in the US would lead to soft prices of tradeable goods worldwide, particularly given the massive investment boom in China focused on producing these tradeables. Hence, profits rates of Indian firms producing tradeables would be adversely affected. This would apply not just for companies exporting goods, but also for a company producing goods for the domestic market which are priced by import-parity pricing. The net profits of Indian companies have grown remarkably from 2002. The unhappy scenario would dent this profit growth. It would also diminish optimism, and thus investment demand.

A feature of recent weeks has been the robustness of global financial capitalism. A few hedge funds have gone bust, with losses of billions of dollars. A few very rich customers of the hedge funds have suffered big losses. Barring that, nobody seems to have got hurt. Hedge funds are, thus, shaping up as an important new shock absorber in global capitalism. In India, this shock absorber is lacking, through longstanding efforts by policymakers at preventing a hedge fund industry from coming about. The key tool for confronting future events, then, remains price flexibility. If there is bad news, the government should not prevent stock prices and the rupee from losing ground. These are the essential equilibriating responses of the system of financial markets.

Avoidable loss

Unlike earthquakes and other such natural disasters which cannot be predicted with any degree of accuracy, floods are easily predictable as it usually takes a river many hours, even days, to breach its embankments after heavy downpours in its catchment area. That level of advance warning is not enough to prevent vast areas from being inundated by flood waters, so on a short-term basis the extensive loss of property and vital infrastructure would seem unavoidable. The issue is very real just now, as large parts of

casting and warning system is supposed to be in place. On top of that, the home ministry, which is responsible for natural disaster management, has a special national disaster management programme exclusively for the flood-prone states. On paper, such an elaborate flood management-cum-preparedness system seems formidable. But when the rains come down, the system invariably fails. A happy exception to this is the experience this year in parts of Assam, where a change in the course of the Brahmaputra was pre-empted and the population moved

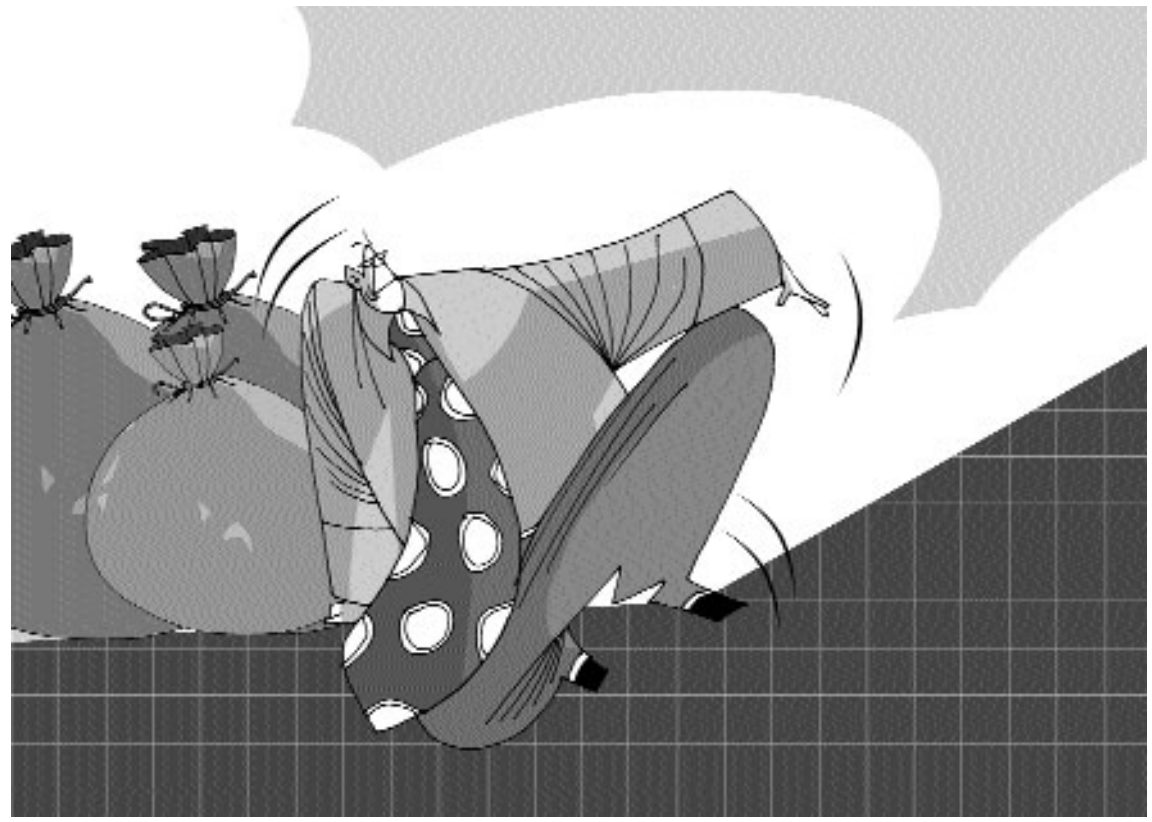

Illustration: BINAY SINHA

Happiness, growth and capitalism

The social ills adduced to capitalism have less to do with capitalism than individualism, says DEEPAK LAL

In the late 1980s I received an impressive missive from the Crown Prince of Bhutan inviting me to a conference which would seek to provide measures of a country's level of happiness to replace the traditional measures of GDP as the sign of a country's progress. Thinking this as something of a joke I politely declined. But, in the 1990s, many economists and politicians embraced this "happiness economics". In the UK, Tony Blair's Policy Unit took it up, and David Cameron, the Tory leader, has proclaimed that "gross national well being" (GWB) should replace GDP as the policy goal. And the Labour peer Richard Layard has written an influential book *Happiness: Lessons from a New Science*. What are we to make of all this?

The first point to note is that this "new" economics is another attack on capitalism. It echoes a refrain of the romantic critique of capitalism: capitalism breeds unhappiness. Many, from Marx to Etzioni, have seen this leading to immanent trends for capitalism's self-destruction. But with the spread of globalising capitalism it is the theories of immanence and not capitalism that seem to destroy themselves.

The second is that, ever since Bentham sought a happiness meter to measure the pleasures and pain which would allow his Utilitarian calculus to be put to use for public policy, many economists of a *dirigiste* disposition have sought to create a quantitatively informed Brave New World. But lacking a happiness meter they had to fall back on basing "happiness" on the satisfaction of individual desires, as revealed in actual choices in the market place. Hating the recent victory of the market over the plan and the great material prosperity it has engendered, the new *dirigisme* is seeking to replace the quantitative measures of this prosperity provided by GDP, by purportedly "hard" measures of subjective well-being, provided by the cross-country and cross-cultural data from the *World Values Survey*.

There are serious methodological problems with the data and the inferences that some happiness researchers have drawn, which Helen Johns and Paul Omerod (*Happiness, Economics and Public Policy*, Institute of Economic Affairs, London) show, are far from robust. Many variables like longevity, crime and unemployment, which would commonly be expected to increase a country's well-being, do not seem to affect the happiness indices. What the happiness research finds is that, on its measures of *reported* subjective happiness there is a moderate positive correlation with per capita income (in PPP $), which is strongest with countries with a per capita GNP up to $10,000 (in 1995). "There are no rich countries where people's happiness, on average is low. But, for the rich countries, it does not seem that higher per capita income has any marked effect on happiness" (B Frey and A Stuzer: *Happiness and Economics*, Princeton). This is hardly surprising, because real income is likely to be only one element in a person's happiness, and as economic theory postulates diminishing marginal utility from increased income (consumption) we would expect rich countries to have reached what Frank Ramsey postulated as the "Bliss" level of utility. But, as the data refer to "reported" rather than "actual" happiness, even this inference is insecure. Happiness economics has also tried to econometrically estimate the determinants of "happiness", and to argue that the standard microeconomics of utility theory needs to be revised. These byways need not detain us.

More serious are the implications various dirigistes have drawn from this line of research. Some have argued that the estimated "happiness functions" provide an approximation to the social welfare function—which hitherto had been a merely theoretical construct of modern welfare economics—yielding the optimal values of its determinants which public policy is then expected to implement. But this raises Arrow's famous Impossibility Theorem, which showed that under a set of "reasonable assumptions" it was not possible to aggregate individual preferences into a social welfare function which consistently ranked outcomes: something which a dictator would obviously be able to do, and a role these social planners hope to fill!

The other implications are more disturbing. The rat race for social status is deemed to increase unhappiness requiring heavy taxation of the winners. As working too hard is a source of unhappiness, work should be taxed more heavily. So that people substitute leisure for work at the margin—something the French government has imposed by fiat with its statutory reduction of the working week with no apparent improvement in happiness to offset the obvious losses in economic output.

These complaints about the psychologically dysfunctional effects of capitalism confuse questions about how best to make a living (material beliefs), with those concerning, in Plato's words, "how one should live" (cosmological beliefs). Capitalism provides a new and highly productive way of making a living. Whilst the social ills adduced to capitalism, like the decline in family values and companionship, have less to do with capitalism than individualism. It is the demoralisation of their societies rather than the instrument of their prosperity—capitalism—which is to be blamed for the social ills cited by the "happiness researchers".

This would not have come as a surprise to the sages of the Scottish Enlightenment. Discussing happiness in his *Theory of Moral Sentiments*, Adam Smith wrote: "Happiness consists in tranquility and enjoyment. Without tranquility, there can be no enjoyment; and where there is perfect tranquility there is scarce any thing that is not capable of amusing. But in every permanent situation, where there is no expectation of change, the mind of every man, in a longer or shorter time, returns to its natural and usual state of tranquility. ...The great source of both the misery and disorders of human life, seems to arise from overrating the difference between one permanent situation and another. Consider the ... conduct of almost all the greatly unfortunate, either in private or public life, ... and you will find that the misfortunes of by far the greater part of them have arisen from their not knowing when they were well, when it was proper for them to sit still and be contented. The inscription upon the tombstone of the man who had endeavored to mend a tolerable constitution by taking physic; 'I was well, I wished to be better; here I am'; may generally be applied with great justness to the distress of disappointed avarice and ambition."