Economic Divergence Gone Awry*

C.P. Chandrasekhar

It is the second year running in which the IMF and the World Bank have been forced by the Covid pandemic to hold their annual Spring Meetings online. But this time there was slight cause for optimism. Signs of a strong reversal of the economic downturn in the US and other advanced economies and progress, however unsatisfactory, in the drive to vaccinate populations hold out promise of a recovery. However, a troubling feature, as the April 2021 edition of the IMF's World Economic Outlook notes, is the sharp divergence in the economic impact of the crisis and in the pace of recovery across and within countries. The divergence meant that the economic fallout of the pandemic has crippled low- and middle-income countries and devastated vulnerable populations subject to multiple forms of deprivation with little social protection. Unfortunately, outcomes from the spring meetings point to a lack of the ambition needed to bridge this performance gap.

While the varying intensity of the pandemic across space and time played a small role in differentiating the pandemic's impact, that cannot be the main explanation for this divergence. The US, UK and Europe were also overwhelmed by the virus, which hit them even harder than it affected at least a few emerging markets and poor countries. They too have experienced more than one wave and have had to repeatedly shutdown activity in different cities and regions. But it is becoming clear that, as economies, they were hurt less than most emerging markets and developing countries, though segments of their populations were disproportionately scarred by the pandemic's fallout. The net result is an aggravation of the underlying pre-pandemic inequalities across and within countries. From the point of view of the international community, those inequalities need addressing not merely because they are per se unacceptable, but because they prolong the pandemic by hindering the vaccine roll-out, worsen the looming emerging market debt crisis and militate against building back better through a process of Green Resilient and Inclusive Development (GRID).

What emerges from the analyses embedded in the different documents released as background for discussions at the spring meetings is that, going beyond the bounce back of economies following the relaxation of containment measures and lockdowns, the strength of the recovery depends crucially on government response in the form of a fiscal stimulus. What is striking is the sharp variation in the size of the stimulus across countries. The April 2021 edition of the IMF's Fiscal Monitor (titled A Fair Shot) provides estimates by country of the value of additional spending, revenues foregone and liquidity support provided through measures adopted between January 2020 and mid-March 2021. Of these, what matters most are the additional spending and revenues foregone, because they directly and indirectly increase effective purchasing power, which would drive output growth as restrictions on economic activity are lifted or relaxed.

The IMF's figures suggest that additional spending and revenues forgone by all countries put together between January 2020 and March 2021 amounted to $9.93 trillion, of which $7.98 trillion or 80 per cent was contributed by the 10 advanced economies in the G20. The United State alone accounted for $5.33 trillion or a huge 54 per cent of the total. Even among the G20 advanced economies the divergence was sharp, with Japan, the second highest spender, accounting for just $801 billion. Japan was followed not by an advanced economy but China with $711 billion. The rest of the world excluding the G20 advanced economies and China accounted for just $1.24 trillion of the additional spending and foregone revenues or 12.5 per cent. As a per cent of GDP, 'above the line' fiscal measures varied between 0.7 per cent (Mexico) and 8.8 per cent (Brazil) in G20 emerging markets. As compared with this the figure stood at 25.5 per cent in the US, 16.2 per cent in the UK, 15.9 per cent in Japan and 11 per cent in Germany. The fiscal stimulus that can boost recovery is concentrated in the US and a few advanced economies.

There is another striking difference between the US and the rest of the world. Globally, as compared with $9.9 trillion in additional spending and revenues foregone, the value of 'below the line' measures such as equity injections, loans, asset purchases, debt assumptions and guarantees (which are useful but not powerful as stimuli) totaled $6.1 trillion or 38 per cent of the total value of fiscal measures. In the case of the US on the other hand, these monetary and contingent liability support measures amounted, at $510 billion, to just 8.7 per cent of the total. The 38 per cent figure was true of the group of 10 G20 advanced economies as well.

Because of this divergence in the magnitude of the pure fiscal stimulus, the fiscal deficit in the US has risen significantly more than elsewhere. In the US the deficit rose by more than 10 percentage points from 5.7 per cent in 2019 to 15.8 per cent in 2020, and is projected to stay at 15 per cent in 2021. As compared to that the deficit in the Euro Area rose from 0.6 per cent to 7.6 per cent and is expected to fall to 6.7 per cent in 2021. On the surface, it appears that the emerging markets have also primed their economies in response to the Covid-induced economic crisis, with the average deficit for emerging market and middle income economies rising from 4.7 per cent in 2019 to 9.8 per cent in 2020, and a projected 7.7 per cent in 2021. But as the IMF notes: "In advanced economies, higher deficits have resulted from roughly equal increases in spending and declines in revenues, whereas in emerging market and developing economies, on average, the rise in deficits has stemmed primarily from the collapse in revenues caused by lower economic activity. For commodity exporters, depressed prices and supply cuts have added to the challenge." Not surprisingly, "Cumulative per capita income losses over 2020–22, compared to pre-pandemic projections, are equivalent to 20 per cent of 2019 per capita GDP in emerging markets and developing economies (excluding China), while in advanced economies the losses are expected to be relatively smaller, at 11 percent." Meanwhile, as a consequence of the fall in revenues, public debt of developing countries rose 8.3 per centage points to 62.3 per cent in 2020. Financing needs have risen despite the limited resort to a stimulus, and there are constraints to increasing borrowing any further.

For some time now, the IMF has at least in its rhetoric been rethinking its traditional fiscal conservatism, which emphasises reining in debt financed pubic spending, capping the level of public debt relative to GDP, and implementing austerity measures when faced with inflation or balance of payments difficulties. But global financial interests that now have a presence in poor countries as well still call for tight control on fiscal deficits. They fear that deficit spending would spur inflation and erode the real value of financial assets. They suspect that rising public debt would force the government to raise tax rates and impose new taxes to finance interest and amortisation payments—a view partly confirmed by the Biden administration's decision to raise corporate, income and wealth taxes. They also fear that support for deficit spending encourages governments to take on a proactive role at the expense of markets, which they don't approve of.

Clearly the developed countries have greater flexibility here. The US, which enjoys the privilege of the dollar and dollar-denominated assets serving as safe havens, need not fear that the world's wealth holders would desert its currency because its government is being fiscally flexible. But the same cannot be said of poor countries, which are in constant fear of capital flight, triggered often by what are considered "excessive" deficits. And though the IMF is willing to ignore or encourage US "profligacy", it is still far more circumspect about deficits in middle- and low-income countries. In fact, in practice the institution appears downright discriminatory. Thus, a study by OXFAM reports that in 16 programmes for developing countries approved starting September 2020, fiscal "consolidation" or retrenchment was a prerequisite. Since the Covid-induced contraction has reduced revenues, this fiscal conservatism implies reduced spending. Based on IMF projections, the Initiative for Policy Dialogue at Columbia University finds that more than 40 governments, many with significant development needs, would spend 12 per cent less on average in 2021-22 as compared with 2018-19.

One consequence of this combination of expansion at one pole and retrenchment at the other, is that recovery in most emerging and developing country markets depends on the enhanced spending and resulting recovery in the United States having positive spill over effects for them. That is unlikely. In fact there are fears that the opposite may be true. This is because with the huge fiscal stimulus, which is to be followed by an additional $2 trillion spending over 8 years on the Biden administration's infrastructure plan, inflation that has been trending low for decades in the US is expected to exceed the Federal Reserve's targets. This together with the impact that the demand surge and price rise may have on inflation expectations is likely to encourage the Fed to begin unwinding its accommodative monetary stance and prod interest rates up from the near zero levels at which they had been set in response to the Great Recession and the Global Financial Crisis. Higher rates in the advanced economies would trigger an outflow of capital invested in emerging market equity and bond markets to take advantage of the huge differentials between the cost of capital borrowed in advanced country markets and the financial returns to be earned in lucrative, albeit risky, developing country investment opportunities.

The IMF, which strives to paint a picture of an optimistic, near-term economic future, with some caveats, recognises this risk. Referring to the asynchronous and divergent recovery flagged in the World Economic Outlook, the IMF's Global Financial Stability Report released in time for the spring meetings notes: "There is a risk that financial conditions in emerging market economies may tighten markedly, especially if policymakers in advanced economies take steps toward policy normalization. A less favourable financial environment may result in large portfolio outflows and pose a significant challenge to some emerging and frontier market economies, given the large financing needs they face this year."

The evidence and the prognosis suggest that the developed nations and the Bretton Wood institutions they control, besides looking to boost their own economies, must provide support that increases fiscal flexibility and policy space in the developing world. That response has been slow in coming. The Debt Service Suspension

Initiative (now extended till December 2021) is far too limited in scope. According to Daniel Munevar of Eurodad, the Covid crisis resulted in a net negative transfer on the external public debt account of developing countries of US$ 194 billion in 2020. The debt is clearly unsustainable. Yet the terms of the debt restructuring mechanism to be introduced through the Common Framework for Debt Treatments, which promises to bring in multilateral and private actors, is unclear. In any case, it is no substitute for another round of debt write off for debt distressed poor countries that are unlikely to be able to meet their commitments.

The major step forward in terms of global liquidity access was the decision to issue an additional $650 billion worth of SDRs, though this being linked to existing quotas means disproportionately low access for developing countries. If the demand for a $3 trillion SDR issue had been accepted, even the small share would have meant reasonable access in absolute terms. Discussions on how advanced economies that do not need the additional liquidity can make it available to poor countries is yet to begin.

In sum, with ambition restricted to the core, there is little hope of an adequate recovery, let alone a Green, Resilient and Inclusive one in the periphery. Meanwhile the problem refuses to go away. Rather the grossly unequal vaccine access will perpetuate the pandemic's adverse effects for quite some time to come.

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