The Unfolding Global Crisis*

C. P. Chandrasekhar

The IMF's most recent World Economic Outlook, released in time for the annual meetings of the IMF and the World Bank in Washington, presents a confusing picture of what shapes the present global conjuncture. This at a time when most economies are either contracting or recording lower than expected growth, even while global inflation in 2022 is forecast at 8.8 and is running at levels that are their highest in decades.

The confusion stems partly from the conservative lens through which the IMF views the world. It is also an outcome of material circumstances, characterised by the simultaneous operation of multiple drivers, often with conflicting effects on output growth or inflation. The IMF does identify many of these drivers. There is, to start with, the legacy of the COVID pandemic. While the pandemic is waning, its effects in terms of clogged supply chains, for example, persist, because the return to 'normalcy' is uneven and unpredictable across geographies. The lockdowns resulting from China's zero-tolerance Covid policy is an extreme example of this unevenness.

On the other hand, a waning pandemic means that restrictions on economic activity have been substantially relaxed, raising production and employment and releasing the pent-up demand stifled by the pandemic. But the revival of demand in the advanced economies such as the US, where the fiscal stimulus prompted by the pandemic was stronger than in the less developed countries, has been faster than the easing of supply. Moreover, unevenness in the pace of exit from the pandemic means that supply chains crucial to a globalised world economy do not fully clear and demand from some sources, such as China, remain subdued. If the responsiveness of supply to rising demand falls short, excess demand in the market spurs inflation. Unexpectedly, that seems to be the dominant tendency.

Meanwhile, the world has had to suffer the effects of the war in Ukraine. Energy price increases have accelerated the pace of inflation in the advanced nations, that are resorting to interest rate increases as a response. This adds to the flow of financial capital back to 'safe' dollar denominated assets, strengthening the dollar. And in the developing world, rising import bills on account of costlier oil and food imports and the outflow of capital induced by the rising interest rates and a strong dollar, is resulting in balance of payments difficulties and a depreciation of domestic currencies. The fall-out of that too has been varied and extremely adverse, especially in terms of imported inflation. Overall, the direction of movement is towards stagflation.

The operation of multiple drivers makes the outcome of polices adopted to address the effects of any one driver uncertain. Moreover, the extent of the slowdown or the intensity of inflation varies across countries and the determinants of stagflation are not the same. While this calls for different policies across countries, globalisation in an unequal world has created a situation where the effects of policies in the dominant economies spills over into the rest of the world.

The problem is that even in the developed economies, where there should be more clarity on drivers and outcomes, conservatism rules policy, facilitated in part by the

complexity of the situation. A striking case is the US, where the effects on growth of the waning of the pandemic are most visible. Demand there has revived both because of the unexpectedly strong fiscal response to the pandemic, to finance transfers aimed at protecting incomes and consumption and to facilitate the return to normalcy by vaccinating the population against the virus multiple times. So as supply restrictions have eased growth has revived and is projected at a reasonable 3.2 per cent in 2022.

But expectations that as output revives prices would remain relatively stable. Have been belied. This is puzzling. The US is relatively insulated from the energy crisis precipitated by the war in Ukraine. Yet inflation has risen sharply and persisted. The rate has touched one of its highest levels in 40 years and stood at 8.3 per cent in August. This is also puzzling because the factors the IMF identifies as having driven inflation during the pandemic—restrictions affecting domestic supply, clogged global supply chains and the strong fiscal stimulus—have all weakened. Domestic restrictions have been substantially relaxed and the fiscal transfers and subsidies that the pandemic warranted have been withdrawn.

The IMF falls back on three obvious (but not all too convincing) factors to explain the divergence from expectations of US inflation rates. First, evidence that the disruption in global supply chains has not ended fully. Second, the rise in global energy prices following the war in Ukraine that is seen as affecting prices in the US as well. Third, some indications that labour markets have tightened following the revival of growth.

Assuming that these are indeed the factors explaining unexpected inflation, what would be the best policy response on the part of the US government? Clearly there is little that domestic policy can do to either restore supply chains outside the US or to manage the impact on global energy and food prices of the Ukraine war. What the government can do is attempt to alleviate the impact on domestic consumers of the external drivers of inflation—by providing subsidies, by controlling prices or by preventing domestic suppliers (such as energy distributors) with monopolistic positions who are exploiting the situation and raising mark-ups to lift their profits. The IMF does not recommend the first two, and denies the relevance of the third possibility, though there is considerable evidence that mark-ups have indeed been rising. Rather the IMF focuses on the need to dampen excess demand. It calls for a conservative fiscal stance with limited public spending. It also supports tightening of monetary conditions and raising interest rates. The first would only dampen growth. As the fiscal stimulus adopted in response to the pandemic is being withdrawn, opting for further fiscal contraction would slow growth considerably. Advocating fiscal caution implies that use of the fiscal lever to push for higher growth is being discouraged. To this must be added the contractionary effects of the principal policy response to inflation being recommended by the IMF and adopted by the Fed, which is a hike in interest rates.

One way in which a rise in interest rates can rein in inflation is by dampening demand by curtailing debt financed consumption and investment spending. If excess demand is the result of supply bottlenecks as much as increases in consumption and investment demand, as appears to be the case, then this route to holding down inflation is one of engineering recession. Since the responsiveness of demand to a rise in interest rates or the cost of borrowing to finance expenditures is normally weak, a sharp shift to a high interest rate regime may be the solution adopted, as happened under then Fed chair Paul Volcker, in response to the inflation induced by the oil

price shocks of the late 1970s. That policy precipitated a steep recession in the advanced economies and a debt crisis and lost decades of growth in the less developed ones.

The IMF would not like to be seen as advocating such an outcome. So, it presents the case for monetary tightening and interest rate escalation not as means to squeeze demand but as measures that would dampen “inflationary expectations”. If high inflation is expected at a time when the economy is reviving, argues the IMF, it could give rise to demands for compensating increases in wages, which, if met, would trigger price increases, setting off a wage-price spiral. The World Economic Outlook includes a whole technical chapter that claims to investigate, using historical evidence, whether high inflation leads to inflation expectations that trigger wage increases and sets off a wage-price spiral. The situation in recent times has been one in which inflation has been on the rise and wages too have risen, but the unemployment rate has been flat and the relative movement of prices and wages has been such that real (or inflation adjusted) wages too were falling or flat. The historical evidence suggests that, on average, similar situations in the past did not deliver wage-price inflation but led to a decline in inflation, a rise in money wages and in some cases a recovery in real wages. That would suggest that there is no real cause for worry. But the IMF suggests that there is cause for worry, because there has been at least one instance when the outcome was different. Specifically, inflation in the United States kept rising and real wages fell after 1979, when the economy was hit by successive rounds of oil price hikes. This is seen as being the result of inflation expectations generated by persiting inflation. Only when the Federal Reserve raised interest rates sharply were those expectations dampened and inflation brought under control.

Given that experience, the IMF sees a strong case for an increase in interest rates in the current conjuncture, with the hike resorted to early to prevent inflationary expectations that lead to a wage-price spiral. So, the interest rate hike is not being recommended as a measure to directly curb investment and consumption spending and contract output. Rather it is being presented as a means to achieve the less damaging objective of holding back inflationary expectations, which in turn will help rein in inflation.

Unfortunately, the IMF cannot deny that sharp increases in interest rates and tight monetary conditions can indeed precipitate a recession. So, since it argues that adopting such measures is “unavoidable”, It has to recognise the dangers. The recovery in the US and elsewhere may give way to a recession in its view for three reasons: the monetary policy stance that must be adopted in response to elevated inflation, the impact of the war in Ukraine, and the still operative impact of pandemic-related lockdowns and supply chain disruptions. Clearly, precipitating a recession to combat inflation Volcker-style is not being ruled out. Globally, this policy response to inflation in the US and the advanced nations of Europe, being justified by the IMF, would worsen the balance of payments situation, precipitate a debt crisis, trigger capital flight and depress currency values in the less developed countries. In sum, It would generate a crisis in the South that would be far more damaging than in the North.

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