

Panel on Monetary Policy in an Uneven Economy: An Uneven Global Rebound Threatens Sustainable Recovery Everywhere

Maurice Obstfeld

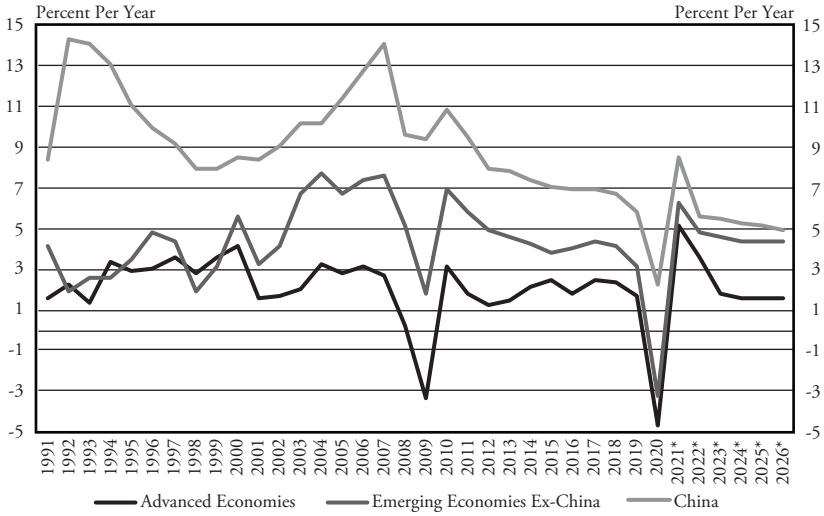
Faced with the outbreaks of the global financial crisis of 2008-09 and the more recent COVID-19 crisis, emerging and developing economies (EMDEs) showed unexpected resilience. True, growth in these countries slowed sharply—and in most turned negative in 2020, as Chart 1 shows—but the full-scale financial meltdowns of previous crises were largely avoided, contrary to initial fears.

Buttressing EMDEs' comparative resilience to the COVID-19 shock was a suite of policy measures that mirrored many pursued in the advanced economies. These measures included not only interest rate cuts, but quantitative easing, macroprudential easing and direct credit support.¹

EMDEs got an external assist, however, from the aggressive fiscal support measures that advanced economies deployed, as well as from the exceptionally aggressive easing measures of advanced economy central banks, notably the Federal Reserve. Chart 2 shows that as the gravity of the pandemic and its global nature sunk in across the world in March 2020, there was an unprecedented flight of portfolio capital from EMDEs.²

Widespread debt crises seemed inevitable. However, the “cardiac arrest” in capital flows abruptly turned around and became an unprec-

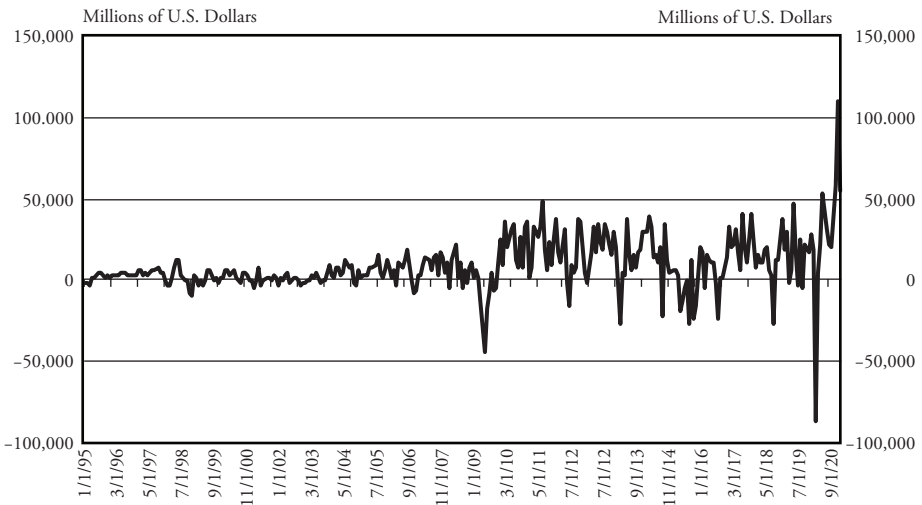
Chart 1
Global Growth Patterns Since 1991



*Projections starting in 2021.

Source: International Monetary Fund, *World Economic Outlook* database, April 2021.

Chart 2
Portfolio Capital Inflows to 18 EMDEs



Source: Koepke and Paetzold (2020) data, updated to March 15, 2021, and available at <https://www.imf.org/en/Publications/WP/Issues/2020/08/21/Capital-Flow-Data-A-Guide-for-Empirical-Analysis-and-Real-time-Tracking-49646>

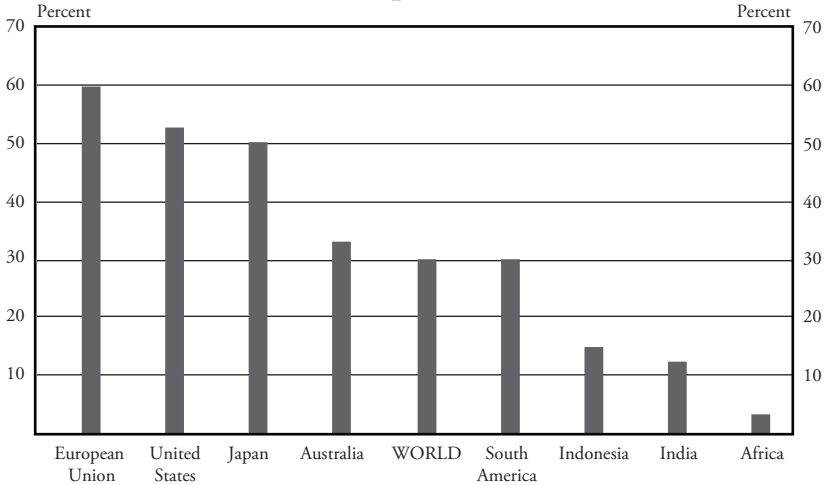
edented inflow surge as Fed action stabilized financial markets and pumped massive liquidity support into the U.S., and global, economies.

The sharp elasticity of capital inflows staved off disaster in the spring of 2020, but also warns of how exposed EMDEs remain to the vicissitudes of global risk sentiment. Right now, with growth having accelerated in the United States and Europe and with their central banks both increasingly worried about inflation and inching ever closer to less accommodative policies, the prospect of an uneven global rebound poses a threat to EMDEs and thus, to the sustainability of global recovery. We should not assume that EMDEs are out of the woods—or, as some have argued in light of their strong policy response to the pandemic so far, that the woods have been cleared away.

One major cause of uneven global recovery is the slow pace of vaccine rollout in much of the developing world. Chart 3 illustrates the disparities as of this writing (early September 2021). Relatively higher vaccine coverage in the United States and the European Union has supported their faster economic recoveries, and brought monetary policy tightening closer. In addition, prolonged disease in less prosperous countries is likely to have greater scarring effects, harming future growth rates that were in any case declining secularly in the decade after recovery from the global financial crisis, even apart from China (see Chart 1). Finally, vaccine coverage statistics alone do not tell the whole story. Widespread use of vaccines that appear less effective against the Delta variant of SARS-CoV-2, such as Sinovac, as well as ineffective and inconsistent non-pharmaceutical interventions, have been problematic. Malaysia, where 51.4% of people were fully vaccinated as of this writing, illustrates both problems. Alongside pandemic concerns, the certainty of bigger and more frequent climate-related shocks is especially worrisome for lower- and middle-income countries.

Along with a longer period of slower and more variable growth possibly looming, EMDE debt-GDP ratios have moved sharply higher. In the pandemic slowdown, revenues fell (often even as a share of GDP), while governments had to spend more on fiscal support and on health. Chart 4 shows the evolution of general government debt relative to GDP in less prosperous (left axis) and richer (right axis)

Chart 3
Percent of Population Fully Vaccinated
(As of Sept. 9, 2021)



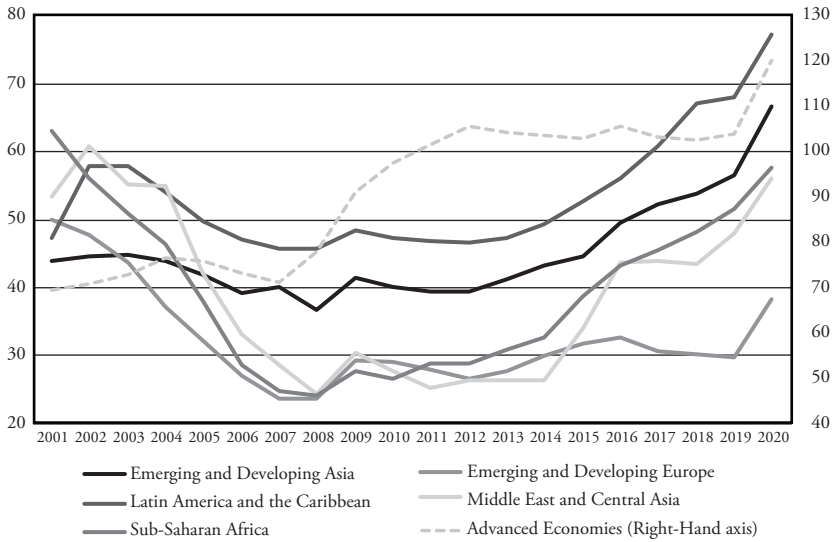
Source: Our World in Data.

economies. Sustainable debt ratios are expected to be lower in the former group, given lower fiscal capacity (e.g., owing to informality or inefficient revenue mobilization), but even so, debt rose in most regions in the years leading up to the pandemic, prior to taking a discrete upward jump in 2020. While debt burdens remain far lower than in the advanced economies, EMDE *percentage* increases in debt-GDP ratios for 2020 are comparable to those that took place in advanced economies (see Chart 5).

These higher debt levels make EMDEs much more vulnerable to advanced-economy interest rate hikes – especially if these occur, as now seems likely, when EMDE growth rates remain subdued. Even though most of these debts are for many countries denominated in domestic currency, a related challenge, most closely related to tightening by the Fed, will come from a strengthening of the U.S. dollar, insofar as this will be associated with a downturn in the global financial cycle.

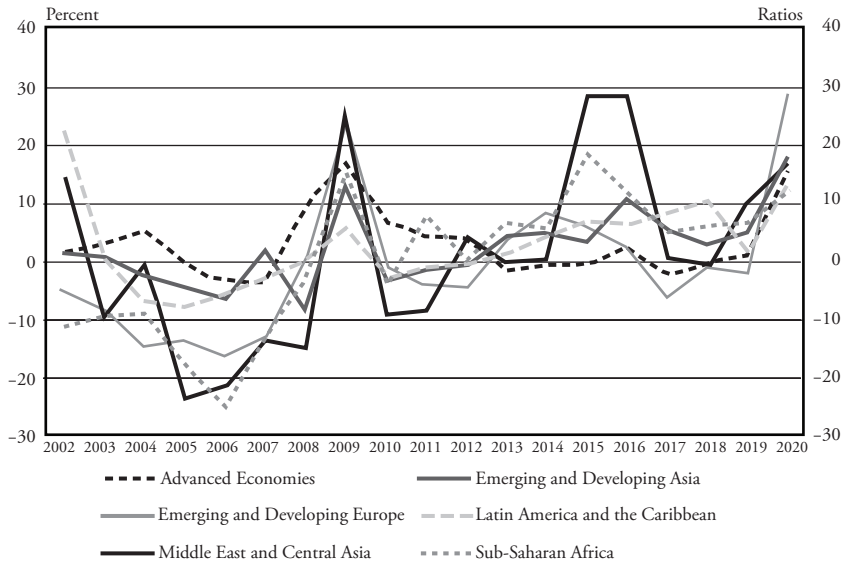
As explained by Rey (2013) some years ago at this conference, the global financial cycle refers to the synchronized movements in asset prices, commodity prices, capital flows and leverage that have

Chart 4
General Government Debt-GDP Ratios



Source: International Monetary Fund, *Fiscal Monitor*, April 2021.

Chart 5
Percent Increases in Government Debt-GDP



Source: International Monetary Fund, *Fiscal Monitor*, April 2021.

buffeted EMDEs and are often driven by shifts in U.S. monetary policy and financial conditions. As of this writing, the world economy looks to be in an expansive phase of the cycle. But this is likely to change as the Fed and European Central Bank tighten.

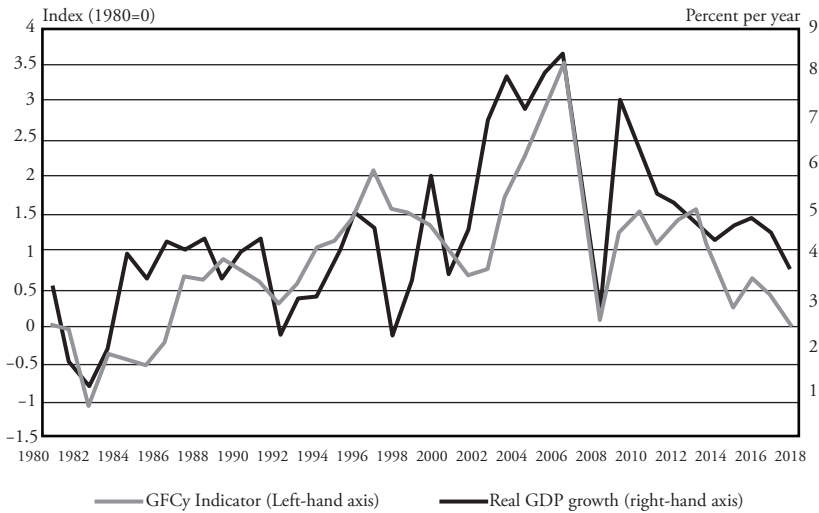
Chart 6 shows the close relationship between EMDE growth and an indicator of the global financial cycle proposed by Miranda-Agrippino and Rey (2020). The indicator, denoted *GFCy*, is estimated as a single global factor that explains more than 20% of the common variation in a large global sample of equity, corporate bond, and commodity prices.³ Evidently, movements in *GFCy* closely track movements in EMDE output, raising the question of the causal links between the two variables.

One central regularity, highlighted in Bruno and Shin (2015) and subsequent papers, is the close link between the nominal dollar exchange rate and global financial conditions, with a stronger dollar dampening international banking activity, leverage, asset-price arbitrage and capital flows globally. Unsurprisingly, the dollar's nominal effective exchange rate is highly negatively correlated with the *GFCy* index of Miranda-Agrippino and Rey, such that dollar strength coincides with a more contractionary level of the cycle. Chart 7 illustrates this negative correlation in monthly data. A stronger dollar can reflect tighter monetary conditions in the United States, but it also tends to reflect higher global risk aversion that raises the demand for dollar assets (with risk aversion, in turn, possibly reflecting shifts in anticipated or actual Fed policy). Dollar strength thus is a powerful common factor driving both the global financial cycle and the EMDE business cycle.

The channels through which the dollar impacts EMDE activity are several, but two key channels are the dollar's negative association with global trade volume growth (Chart 8) and dollar commodity prices (Chart 9), where the latter correlation also reflects movement in real commodity prices, raising the real profits of commodity exporters in poorer countries.

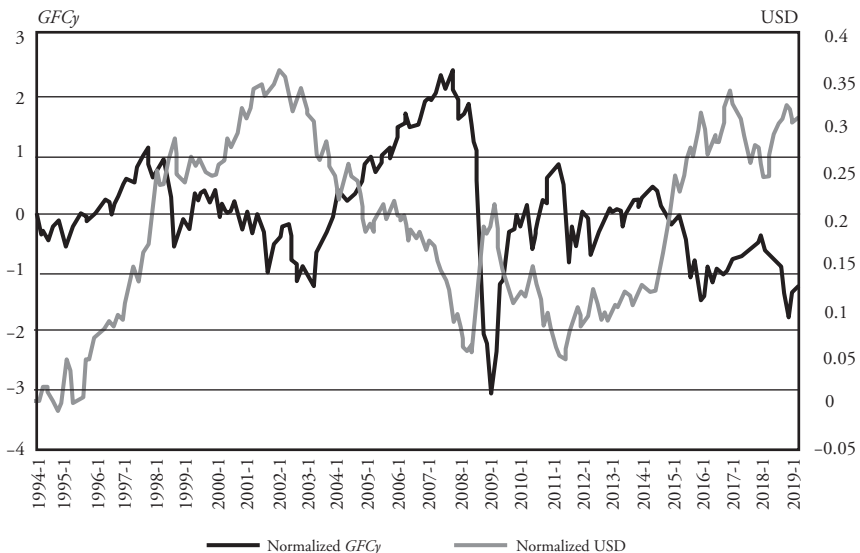
The implication of these patterns is that increases in U.S. interest rates and the dollar's value, coming in an environment where EM-

Chart 6
Growth in EMDEs and the Global Financial Cycle



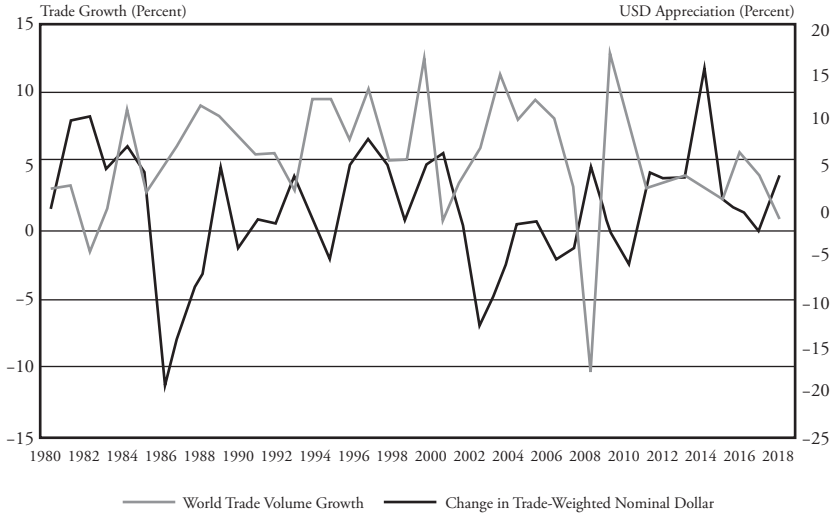
Source: *GFCy* variable with data updated through 2019 is available at <http://silivaminandaagrippino.com/codedata>. The raw monthly data are averaged to derive annual observations. Real GDP growth is from International Monetary Fund, *World Economic Outlook* Database, April 2020

Chart 7
***GFCy* versus BIS Broad Nominal U.S. Dollar Index**



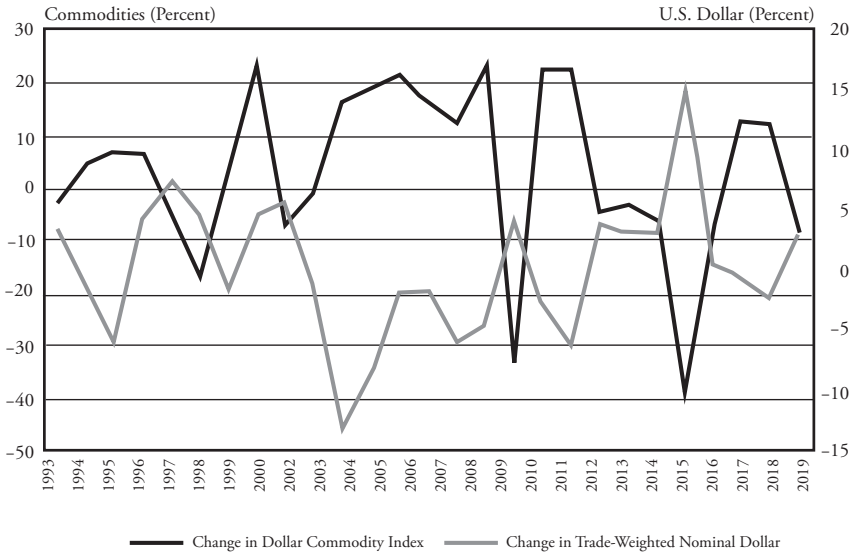
Sources: Exchange rate data from Bank for International Settlements (BIS), <https://www.bis.org/statistics/eer.htm>. *GFCy* data based on Miranda-Agrippino and Rey (2020).

Chart 8
World Trade Volume Growth and
Nominal U.S. Dollar Appreciation



Sources: International Monetary Fund, *World Economic Outlook* database, April 2021; FRED, dollar exchange rate series TWEXMANL, trade-weighted based on goods trade with major-currency trading partners.

Chart 9
U.S. Dollar Appreciation and Commodity Prices



Source: See Chart 8 source note.

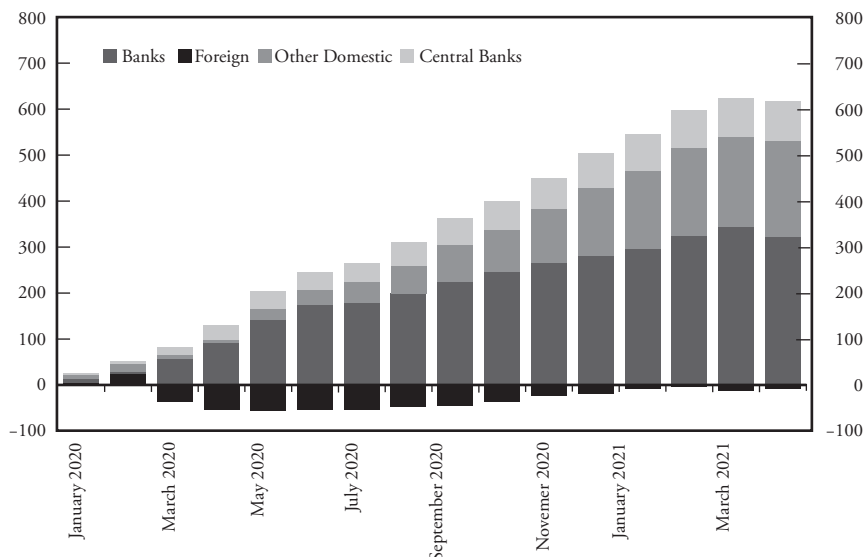
DEs continue to struggle with the pandemic amid historically high levels of public (not to mention private) debt, are likely to create challenging economic conditions.⁴ A sharp reversal of capital outflows, associated with crises in some countries, could result. This adverse scenario is most likely if the Fed were to shift gears abruptly, perhaps as a result of finding itself behind the curve on inflation.

One specific vulnerability, pointed out by Sachdeva and Harvey (2020) and International Monetary Fund (2021), is that much of the debt recently issued by EMDE governments, resides on the balance sheets of private domestic banks rather than central banks – contrasting with the extensive take-up of government debt by the Fed and the ECB. In a capital-flow sudden stop, the result could be a “doom loop” of bank-sovereign distress. Chart 10, updated from International Monetary Fund (2021), shows the ownership distribution of total sovereign debt issuances from January 2020 through April 2021 for a sample of 12 emerging market economies.⁵ For this group of countries, about half of new sovereign debt issuance has ended up on domestic bank balance sheets.

Nearly two decades ago, Reinhart, Rogoff and Savastano (2003) highlighted how “debt intolerant” EMDEs might experience market stress at far lower sovereign debt levels than those that advanced economies can easily support. In the half-decade after they wrote, debts fell relative to GDP in the buoyant macroeconomic conditions leading up to the global financial crisis, but have since returned near the levels of the early 2000s and in some regions (notably Latin America) have surged beyond (Chart 4). While it is true that real interest rates have fallen over this entire period while EMDE inflation performance and central bank expertise have improved markedly, social and political tensions remain salient in many countries and therefore complacency about public debt would be unwise.⁶ Moreover, the financial impact of global capital-market shocks differs between EMDEs and advanced economies, as Kalemli-Özcan (2019) documented at this conference two years ago.

One clear policy implication is that EMDEs have an especially big stake in the Fed engineering a smooth withdrawal from the current

Chart 10
Who Holds EMDEs' Sovereign Bond Issuance?
(billions of U.S. dollars)



Note: Local-currency values are converted at month-average exchange rates.
 Source: Updated from International Monetary Fund (2021, chapter 1).

exceptional stimulus, avoiding abrupt big surprises in messaging or actions.

A second is that enhancing the liquidity available to EMDEs will be useful. The recent \$650 billion allocation of special drawing rights (SDR) by the IMF is an important step in that direction, and it could be leveraged if richer countries are encouraged to lend SDR to a broader range of potential recipients through the proposed Resilience and Sustainability Trust. The IMF's board should also reconsider the pandemic support facility proposal of Fisher and Mazerai (2020).

Third, we should be ready for more solvency challenges for EMDEs, implying an increase in the frequency of restructuring needs. The G-20 Common Framework for Debt Treatments beyond the DSSI is an important step, especially because it includes China, but it needs strengthening.

Finally, the unevenness of the global rebound can be mitigated if rich countries sharply accelerate their efforts to supply poorer coun-

tries with vaccines and to invest in those countries' infrastructures for getting vaccines into arms. The budgetary cost of an all-out effort would be small compared with the fiscal support already disbursed since early 2020. Continuing disease in poorer regions is a direct threat even to highly vaccinated countries, as COVID-19 pockets are effectively labs for the creation of new variants of SARS-CoV-2. Indeed, the current pandemic shows that we need even more: a cooperative effort to build a permanent global public health infrastructure that will be robust against future pathogens. In an interdependent world, no one is safe until everyone is safe.

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Endnotes

¹Several chapters in English, Forbes and Ubide (2021) highlight EMDE responses to the COVID-19 shock, notably the overview chapter by De Gregorio and Céspedes (2021). In Obstfeld (2014), I contrasted Asian responses to the late 1990s regional crisis with those seen in the global financial crisis a decade later. Most elements I highlighted in the latter paper have generally continued to serve EMDEs well (although as I describe below, outside of emerging and developing Europe, public debt-GDP ratios began to deteriorate around 2012 even before the global pandemic).

²The illustrative data in Chart 2 are equity and debt inflows for 18 EMDE countries as so classified by Morgan Stanley Capital International (and thus, including Korea). Data come from Koepke and Paetzold (2020).

³The factor is estimated based on dollar asset prices, but according to Miranda-Agrippino and Rey (2020), its general behavior is robust to estimation based on assets' local-currency prices.

⁴De Gregorio and Céspedes (2021) highlight how EMDE governments were able to keep domestic credit growing during the early stages of the pandemic, in contrast to the experience of the global financial crisis. While this credit expansion was an essential support to economies in the lockdown phase of the crisis, it could leave financial vulnerabilities in its wake. The same point applies to the macroprudential easing measures undertaken early on. See also chapter 2 of International Monetary Fund (2021).

⁵The countries are Brazil, Colombia, Mexico, Indonesia, Malaysia, Ukraine, Turkey, Thailand, South Africa, Poland, Hungary and Romania.

⁶That is also the message of Blanchard, Felman and Subramanian (2021) and Mauro and Zhou (2021).

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