

Macroeconomic Management in Times of Crisis

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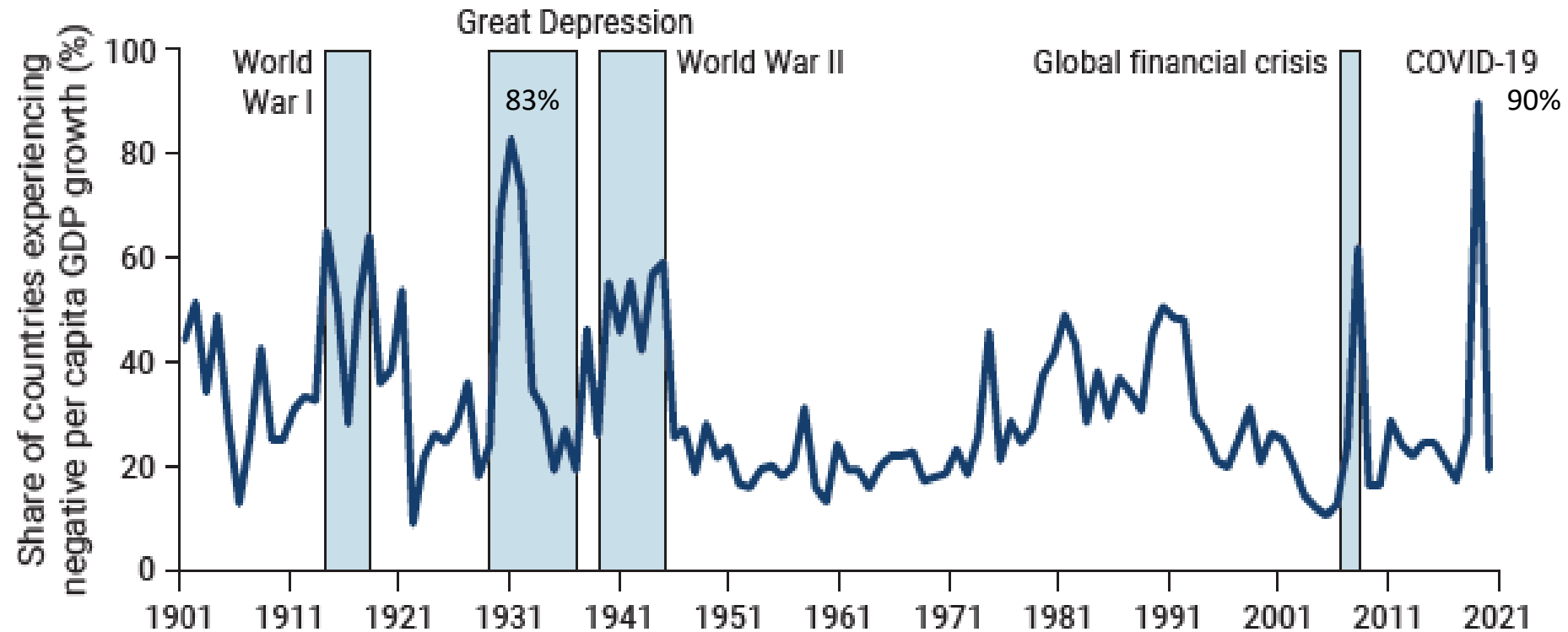
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Outline

- The global setting in an unsettling environment: From disease to war
 - An uneven recovery
 - The return of global inflation
- The risks of tighter and more volatile global financial conditions--with a focus on emerging markets and developing countries (EMDEs)
 - Capital flows and risk aversion
 - High and rising public and private debt; Focus on debt management
- A challenging time for governments and central banks
 - Inflation stabilization/recovery tradeoffs and the exit from negative real interest rates
 - Pressures on central banks and domestic banks from rising domestic debt (*sovereign-banks doom loop*)
 - “Hidden” nonperforming loans and financial fragility
- Concluding thoughts

The COVID-19 shock: Share of countries with annual declines in real per capita GDP, 1901-2021



Source: Holston and Reinhart (2022) and sources cited therein.

Notes: The number of countries ranges from 34 in 1901 to 192 in 2020; *World Economic Outlook*, October 2021 estimates for 2021.

Rebound or Recovery?

Real per capita GDP: 1980-2021, 194 countries

Rebound or recovery from the COVID-19 shock?

	Advanced economies		Middle-income		Low-income	
	Number of countries	Share in percent	Number of countries	Share in percent	Number of countries	Share in percent
2021 ≥ 2019	15	40.5	36	27.5	6	23.1
2021 < 2019	22	59.5	95	72.5	20	76.9
Total	37	100	131	100	26	100

but for many countries the income slowdown preceded COVID-19...

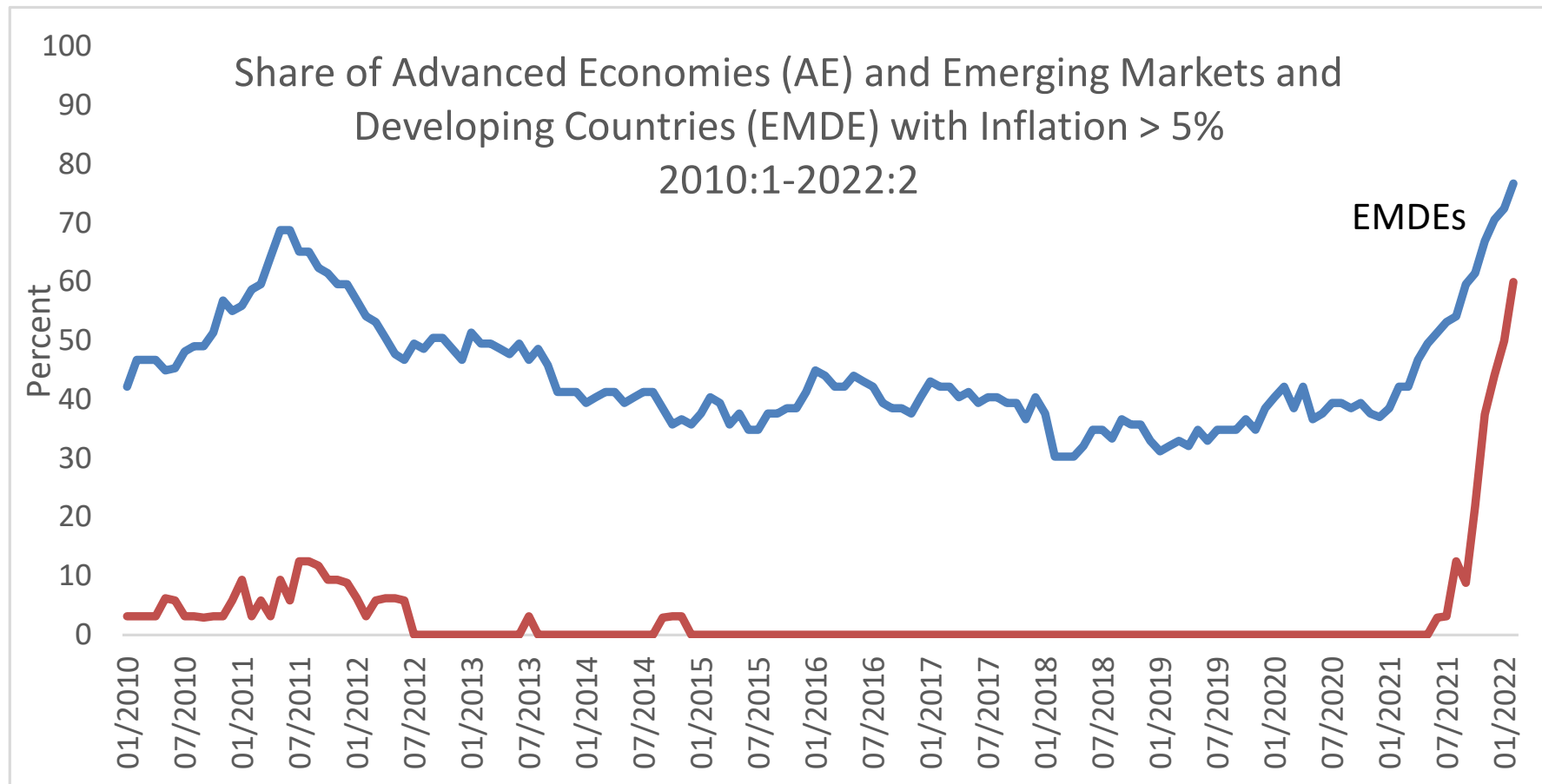
2021 = peak	13	35.1	27	20.6	3	11.5
2021 < peak	24	64.9	104	79.4	23	88.5
Total	37	100	131	100	26	100

The COVID-19 crisis is markedly regressive

Sources: IMF, World Economic Outlook and author's calculations.

The return of inflation is global

(or nearly so, as Asia has been more immune thus far)



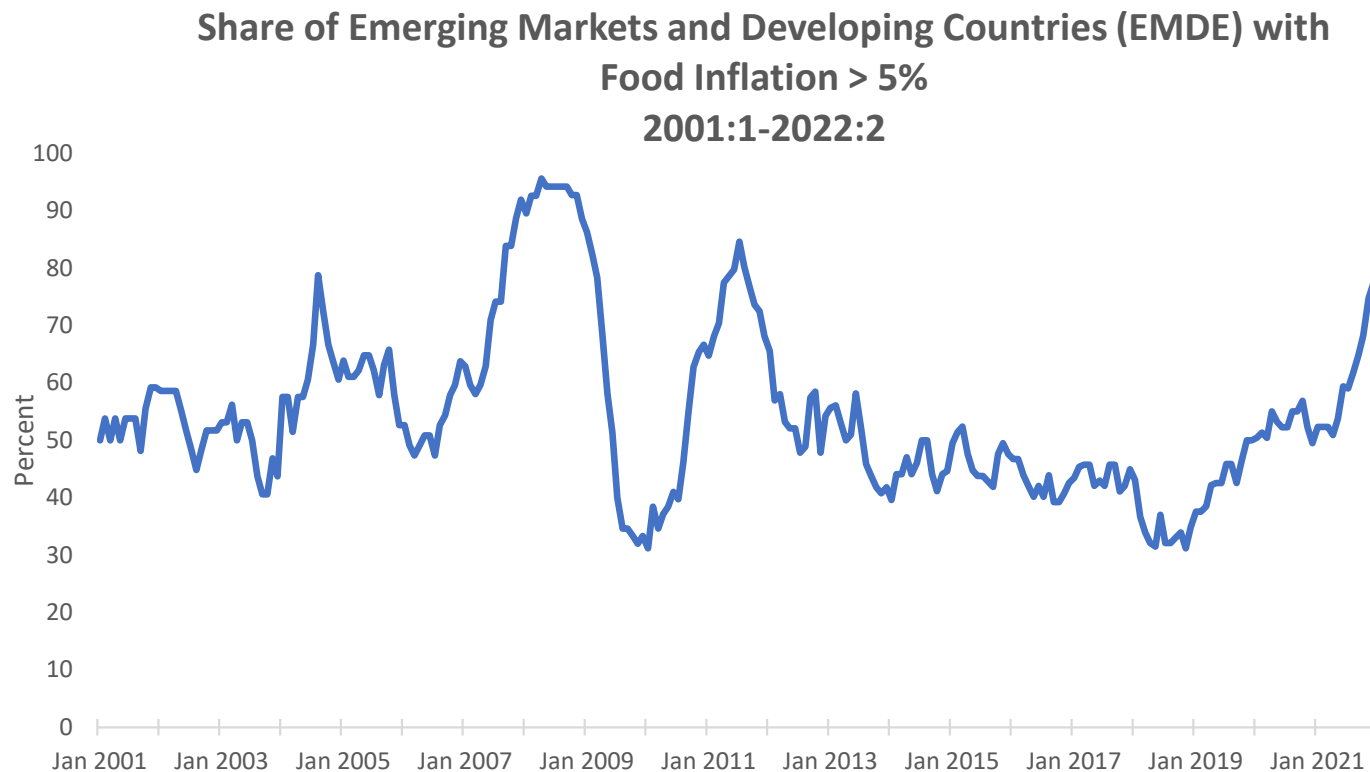
Sources: Graf von Luckner and Reinhart (2022), International Financial Statistics, IMF, and Trading Economics.

Drivers of the inflation surge

- **Overheated economies** following record fiscal and monetary stimulus during the COVID-19 crisis (this is more an **AE** story). More to follow.
- **Global supply chains** have been and continue to be severely impacted, and transport costs have skyrocketed since the outbreak of the pandemic. Unlike the supply shock of the 1970s, which was easy to pin on oil, the COVID-19 supply shocks are diverse and opaque and their potential persistence remains uncertain. The Russia-Ukraine war has also brought in the 1970s-style oil shock dimension and created other dislocations with lasting effects.
- **Commodity prices** have risen as global demand increased from 2020 levels and the war impacted the supply of key commodities, with **oil** prices up 138 percent between December 2020 and March 2022.
- **Currency depreciation** in EMDEs, as foreign capital inflows retrench and sovereign credit ratings are downgraded, have contributed to inflation of imported goods. With inflation expectations less anchored than in AEs, the passthrough from exchange rates to prices is usually faster and higher and especially for commodities denominated in dollars.

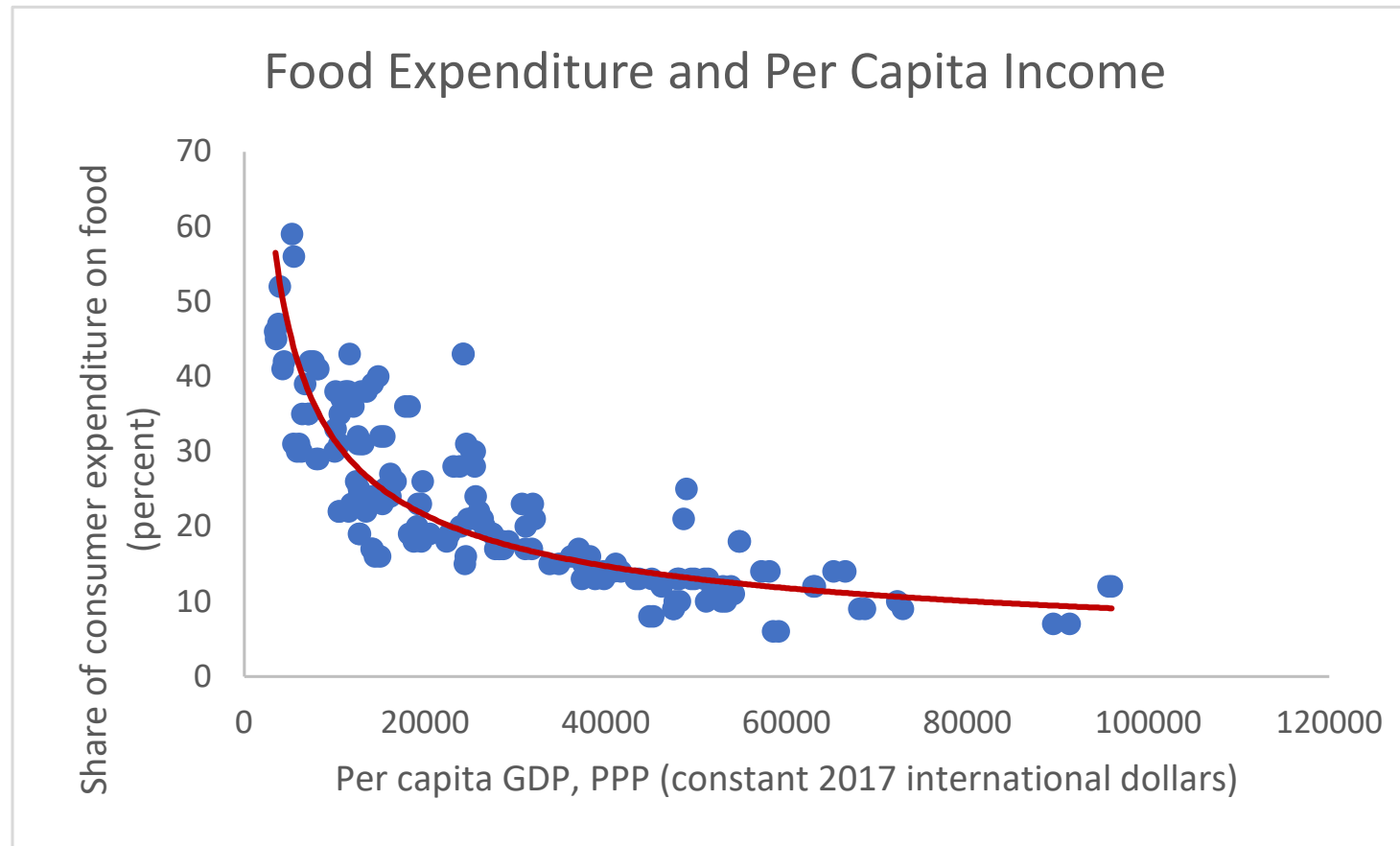
Spotlight on food price inflation

Food price inflation. Food accounts for a much larger share of the household consumption basket in EMDEs. As such, lower income countries (and lower income households) are hit particularly hard.



Source: *International Financial Statistics*, IMF, Trading Economics, and author's calculations.

Food inflation is a particularly regressive tax both across countries (below) and within countries. Inflation, in general, is a regressive tax which is levied without legislation or votes.



Sources: USDA and World Bank.

Notes: Based on 2017 data for 168 countries.

The largest share of countries are in Quadrant I-- stagflation risk (shown in yellow)

Quadrant I:

Higher (or high) inflation; lower incomes than prior peak

Stagflation risks

Quadrant II:

Higher (or high) inflation; incomes at peak in 2021

Overheating risks

Quadrant III:

Lower inflation; Income at peak in 2021

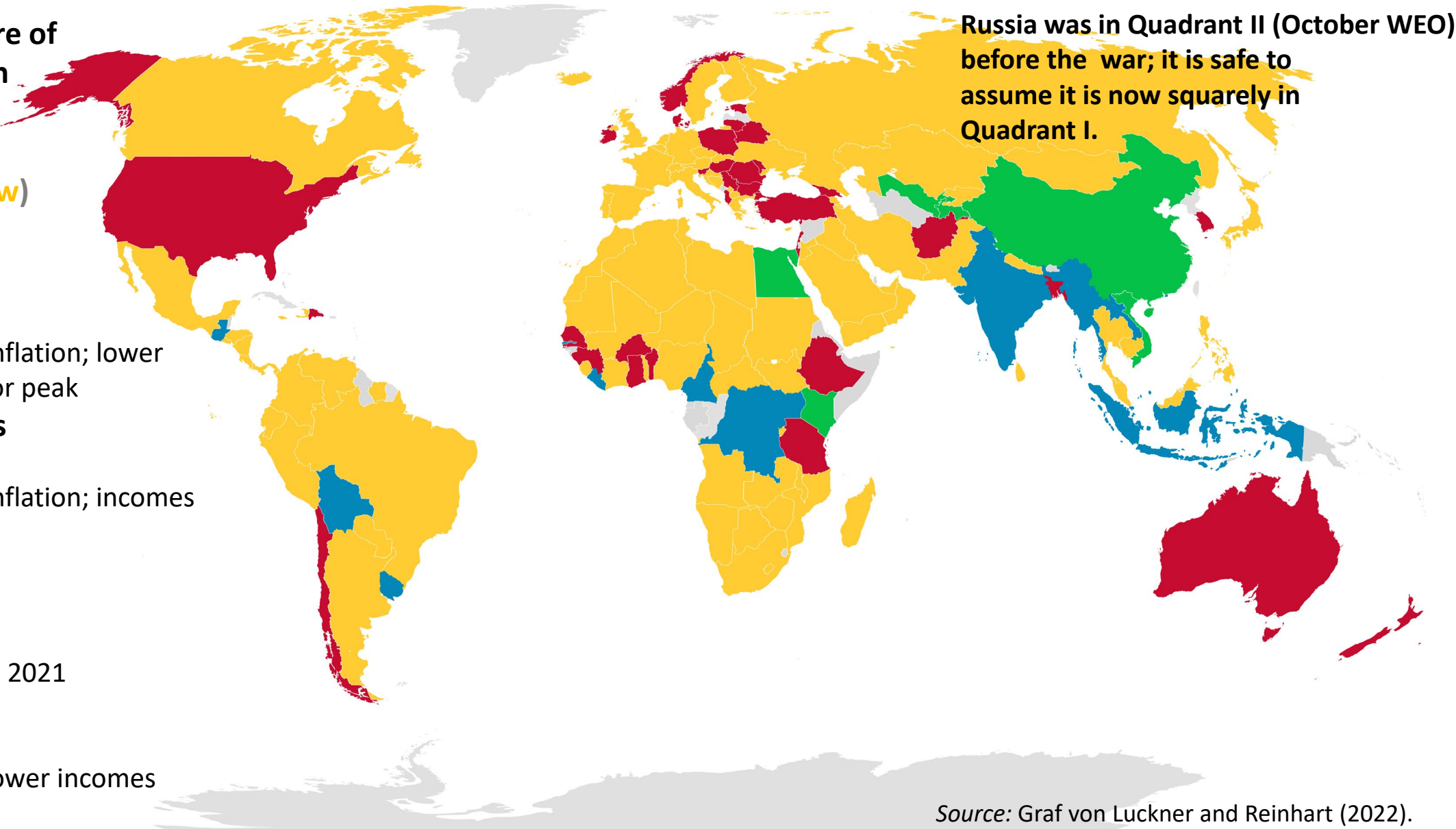
“Low” risk bucket

Quadrant IV:

Lower inflation; lower incomes than prior peak

Recession/ depression risks

Russia was in Quadrant II (October WEO) before the war; it is safe to assume it is now squarely in Quadrant I.



Source: Graf von Luckner and Reinhart (2022).

■ Quadrant 1: HL ■ Quadrant 2: HH ■ Quadrant 3: LH ■ Quadrant 4: LL ■

Implications of tighter and more volatile global financial conditions—Fed tightening, the Russia-Ukraine war, and other factors

- Economic slowdown, recession risks, as in past tightening cycles.
- Equity markets in the US have lofty valuations.
- China was an engine of growth for the global economy following the Global Financial Crisis and the **largest** (by far) official lender to EMDEs (including Russia post-2014). They now have their own financial/balance sheet fragilities to cope with. **Their overseas lending has stalled.**
- A more timely and robust policy response from the major central banks is not good news for EMDEs in the short run.
 - Most of these countries will see their debt servicing costs rise
 - For the already vulnerable (especially low-income countries), it may increase the odds of a debt crisis.
- Contagion risks may also increase in EMDEs, as in the 1990s (the last major episode involved the Russian default of 1998 and Long-Term Capital Management, LTCM).

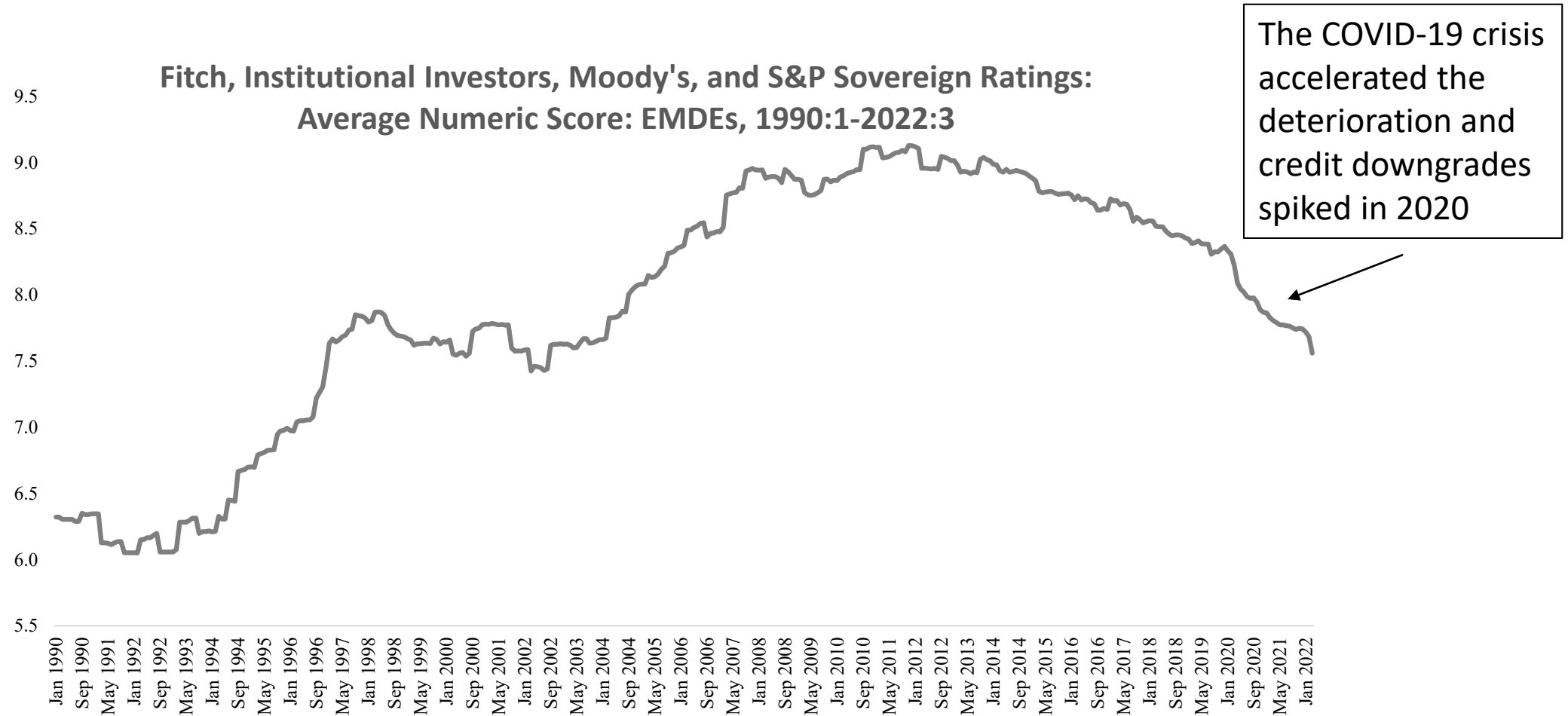
Historical negative short-term real interest rate spells in global financial centers: UK, 1870-1918 and US, 1919-2021 (Real ex-post rates are at historical lows on a sustained basis)

Negative real rate spell	Average annual US inflation	Major shocks
1916-1920	14.7	WWI
1941-1948	7.1	WWII
1974-1980	9.3	OPEC oil shock
2008-2021	1.9	GFC and COVID-19

Sources: Bank of England, Board of Governors of the Federal Reserve, FRED, and Nickols, Reinhart, Reinhart, and Trebesch (2016 and 2022).

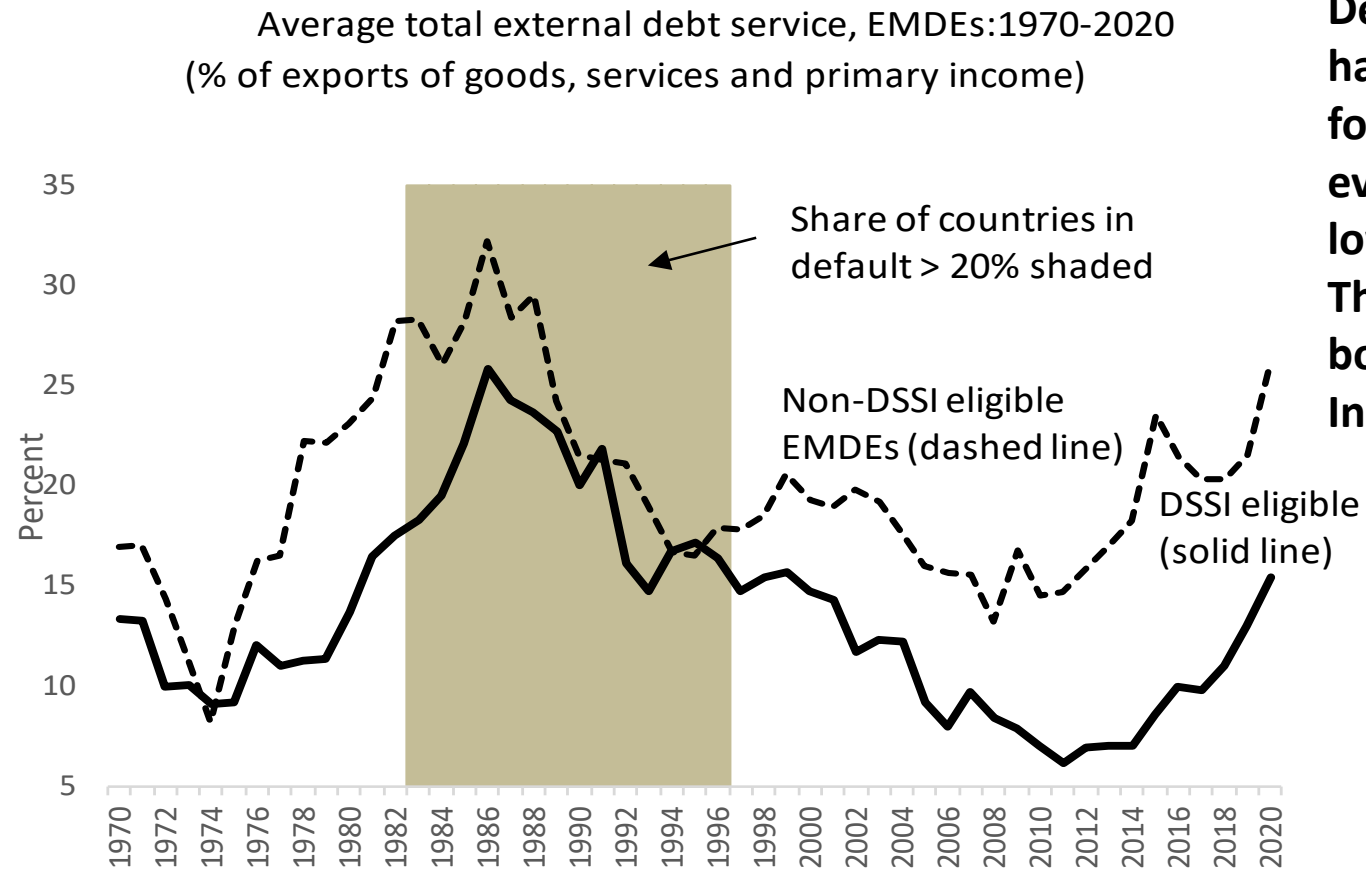
**Exit from the previous negative interest rate spell called for a draconian policy from the Federal Reserve.
What will this exit look like?**

While global financial conditions have remained favorable for EMDEs, the crash in commodity prices and slowdown in China since 2015 took a toll on EMDE's capital flows and domestic "pull" factors, as captured in sovereign credit ratings.



Sources: Fitch, Institutional Investors, Moody's, Standard and Poor's, and Nickols, Reinhart, Reinhart, and Trebesch (2022).

Average total external debt service, EMDEs:1970-2020 (% of exports of goods, services and primary income)



Debt servicing burdens have been rising markedly for about a decade now—even with exceptionally low global interest rates. This trend is evident in both low- and middle-income countries.

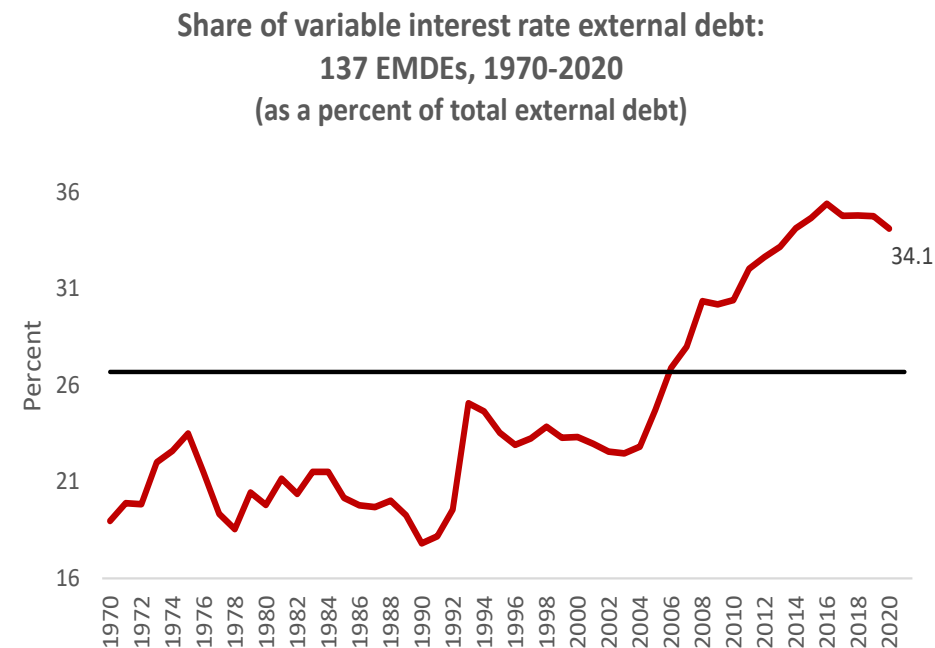
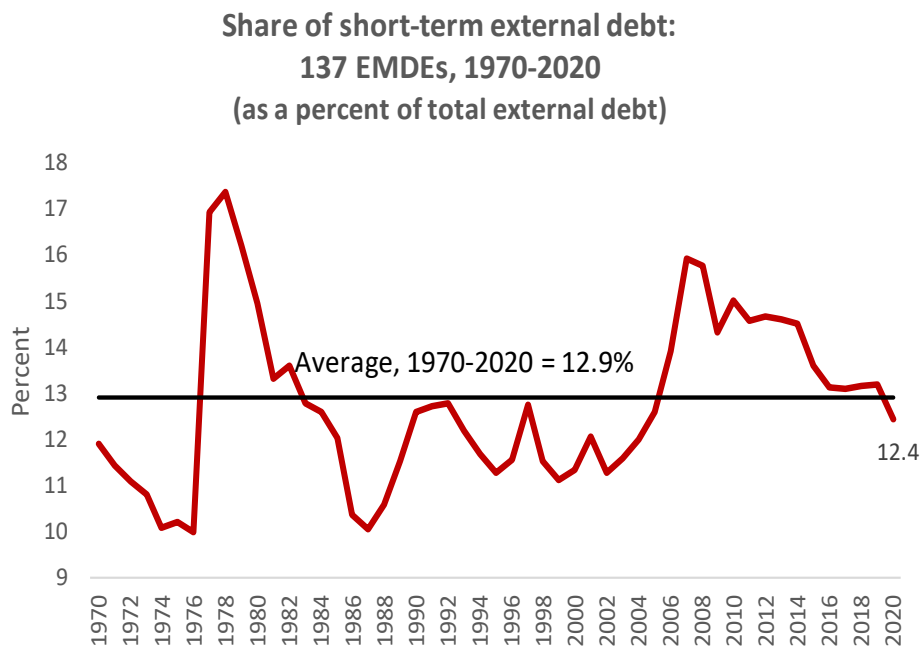
Sources: *International Debt Statistics*, World Bank and Farah, Graf Von Luckner, and Reinhart (2022).

Notes: Default shares based on all countries (193 as of 2020).

Debt servicing is an average for 123 EMDEs.

Features of external debt affect how quickly interest rate shocks are transmitted: Average maturity, share of short-term debt, and share of variable interest rate debt

The good news: Maturities are long and share of short-term debt is below the historical average.
 The not-so-good-news: The share of variable rate debt is close to all time peak—implying a faster passthrough.
Prudent debt management is critical.

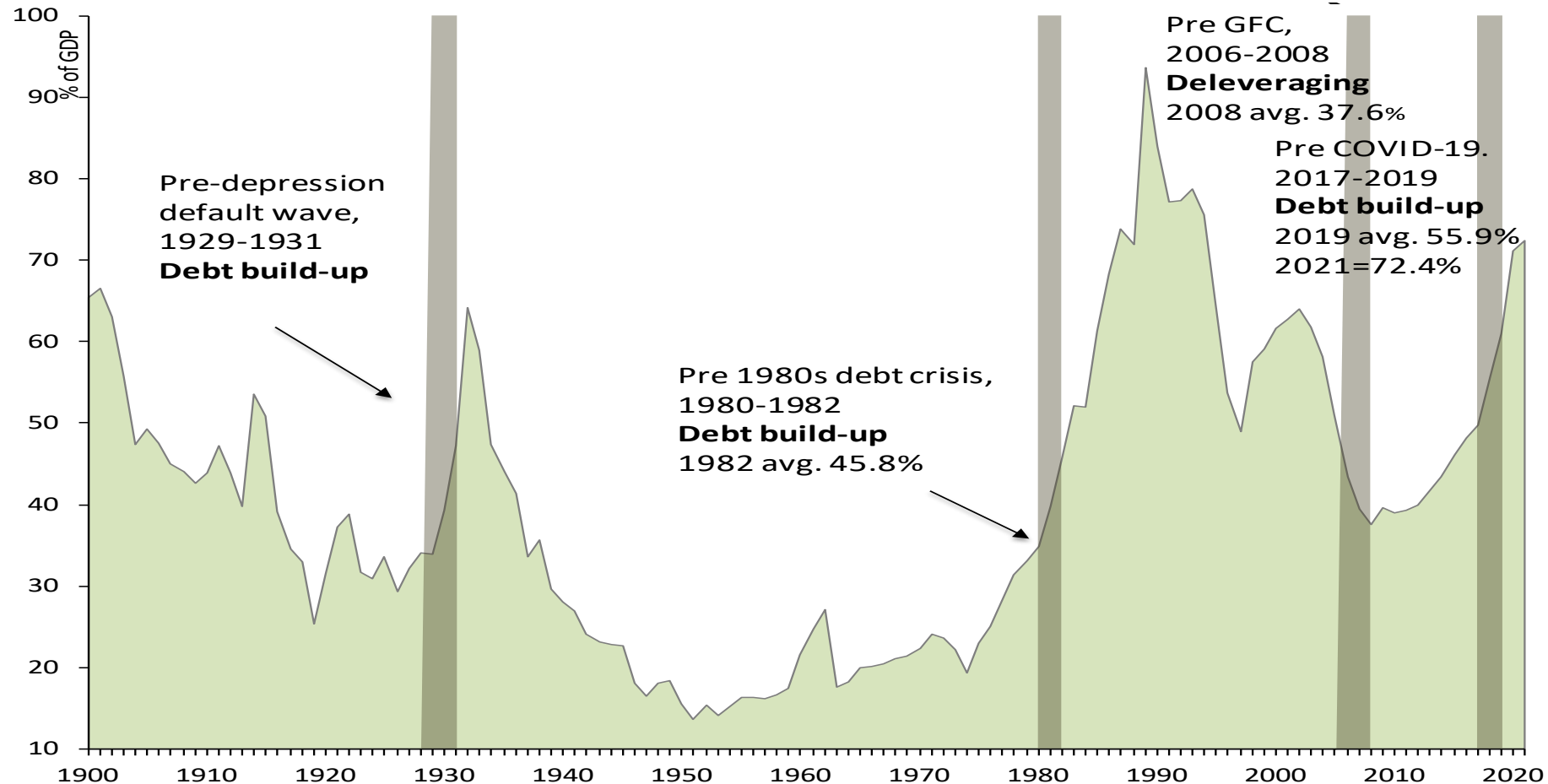


Source: *International Debt Statistics*, The World Bank and author's calculations.

Rising public (domestic and external) debt levels:

While EMDE debt levels are well below AEs, many of these countries are *Debt Intolerant* and have encountered debt crises at lower levels than those in prevailing in 2021.

Unweighted average, 46 EMDEs 1900-2021

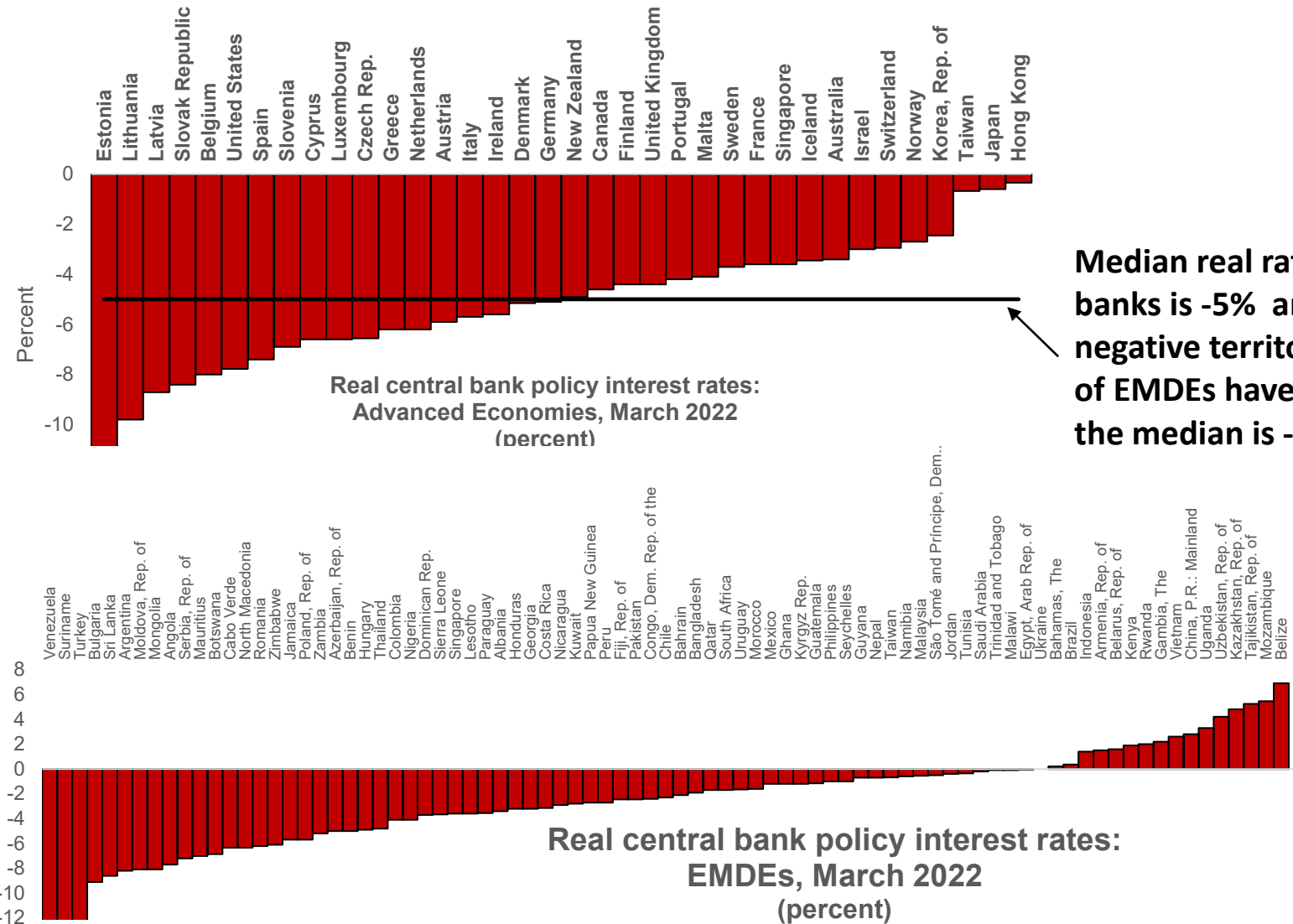


Sources: IMF, *World Economic Outlook* and Reinhart and Rogoff (2009, 2011) and sources cited therein.

Real ex-post (inflation-adjusted) central bank policy interest rates are in exceptionally negative territory across the world--and poised to rise

Higher rates tackle inflation, attract capital inflows/curb outflows, and limit currency depreciation (the last two are less pressing issues in most AEs.)

Higher rates may also delay recovery (feed a credit crunch), increase domestic debt servicing costs, and add to financial fragility.



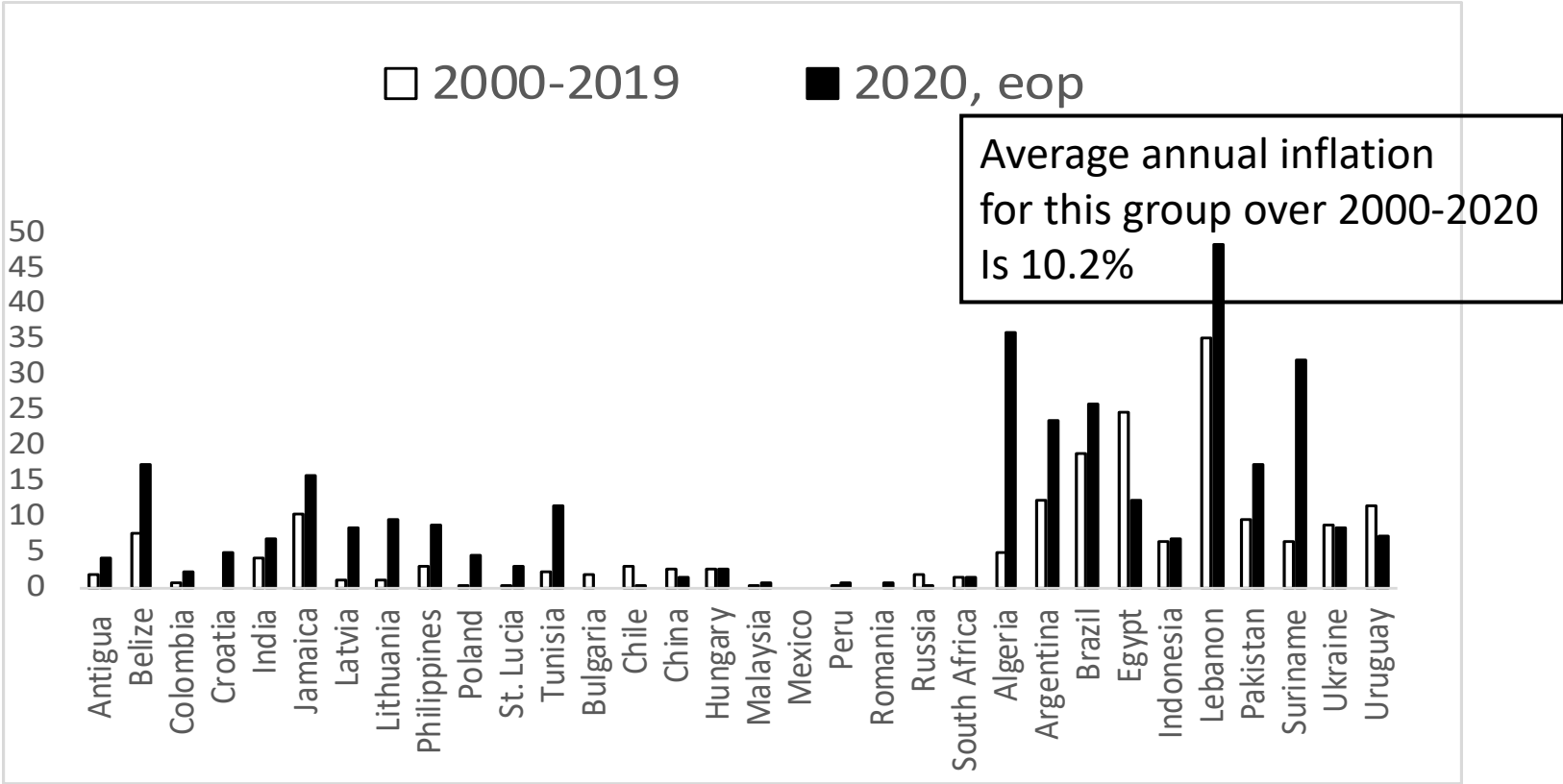
Median real rate for AE central banks is -5% and ALL AEs are in negative territory; about 80% of EMDEs have negative real rates—the median is -2.3%

Reinhart

Sources: Central Bank Rates, www.cbrates.com, central banks (various), International Financial Statistics, IMF, Trading Economics, Graf von Luckner and Reinhart (2022).

One of the challenges posed by rising **domestic** public debt is that governments may pressure the central banks to purchase the debt, especially if external financing is difficult or not feasible. Historically, EMDEs, where central banks held higher levels of government debt, also tended to have higher inflation rates. It remains to be seen whether it will be different in AEs.

Central bank holdings of government debt as a % of outstanding debt stock



Sources: Arslanalp and Tsuda (2014) and Reinhart (2022).

There is less **fear of floating** in EMDEs now than 20 years ago (when Guillermo Calvo and I wrote the paper)—but the issue has not gone away, especially in the current vulnerable environment for EMDEs

But beware of fear of floating...

- Reasons for “fear of floating”
 - i) Foreign currency debt: Large depreciations increase debt burdens **RAPIDLY**.
 - ii) Large depreciations are associated with **recessions (not textbook expansions)** in many EMDEs, particularly for commodity producers
 - iii) **Pass-through** from exchange rates to prices is higher and faster in EMDEs; can give rise to credibility problems for central banks.
 - iv) Fear of appreciation and the “Dutch disease” in *good times* (not a big issue at the moment for most EMDEs)

- Problems created by “fear of floating”

i) Defending the exchange rate can **quickly deplete** central bank foreign exchange reserves, leaving the country in a situation where it cannot finance imports or service external debt.

ii) Can stimulate **betting” against the central bank** and reduce its credibility

iii) Can precipitate the introduction of capital controls and exchange rate rationing—providing impetus to **parallel markets**.

iv) Defending via interest rate hikes also has limitations—especially in an environment of lower growth and high and rising **domestic** government debt.

Final thoughts—with a focus on central bank policies

To state that this is challenging time for governments and central banks is an understatement. This may be the first real test of inflation targeting frameworks. There is no one size fits all playbook, but a lesson that emerged from the 1970s was that monetary policy is ill-equipped to offset the negative economic impacts of supply shocks (which, at present, are NOT in short supply).

Central bank credibility is difficult to achieve but may be more easily lost. With inflation expectations in EMDEs less anchored than in AEs and more attune currency movements, the passthrough from exchange rates to prices is usually faster and higher—especially in countries with a history of high inflation.

The exit from negative real interest rates is poised to be difficult for countries that have not recovered (politically difficult also). But in the meantime, the resurgence of inflation (in its most regressive form, as food and fuel have had a relative price increase as well) is reinforcing inequality both within (and across) countries.

Rising inflation is already impacting fiscal policy (subsidies and price controls), and in some instances, trade policy (food export restrictions). Credit rating agencies have taken note. These measures have a poor track record in dealing with inflation and feed the rise of black markets. A better alternative is providing support through transfers and social safety nets.

Final thoughts concluded

In the context of their financial stability mandate, this is a moment for central banks to work closely with **banking/financial sector supervision** for the reasons discussed.

It is also a time for **risk-averse debt management** (for the treasury and central bank) with emphasis on reducing roll-over risks in a period of rising global and domestic uncertainty.

Finally, the impetus to tackle inflation may not come from US monetary policy. While a modest tightening (by historical standards) is poised to unfold in 2022, at least in the US, it is unlikely that it will be sufficient to roll back inflation. As Reinhart and Rogoff (2013) highlight, much of the inflation persistence of the 1970s owed to the Federal Reserve's tendency to do too little too late until Paul Volcker's arrival.

Delays in stabilizing inflation in the US during the 1970s ended up requiring draconian measures that ushered in one of the deepest postwar recessions in the US and the developing country debt crisis of the 1980s.