

# POST COVID-19 EXIT STRATEGIES AND EMERGING MARKETS ECONOMIC CHALLENGES

**NBER WP 27966**



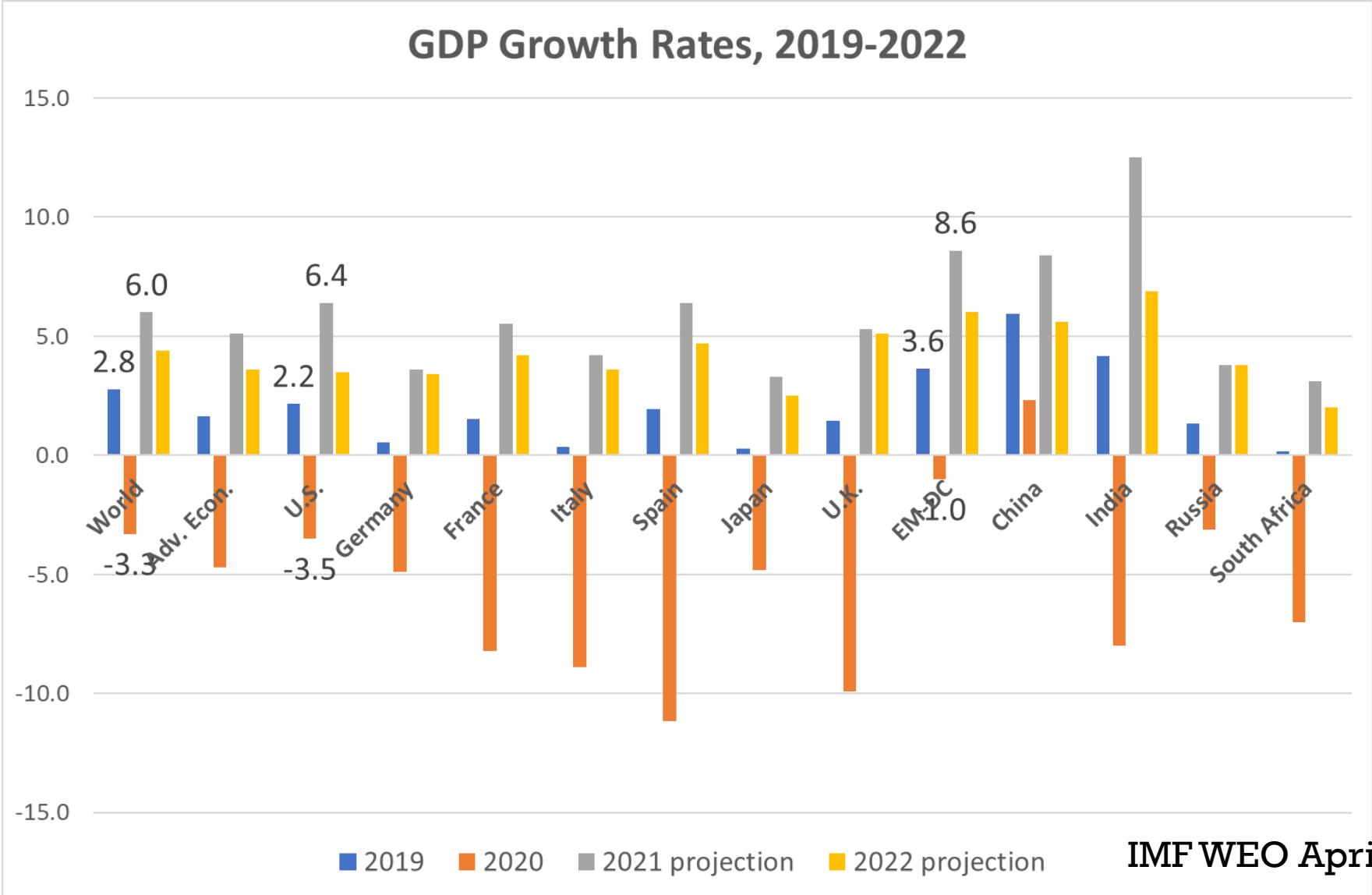
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**ABFER**  
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# THE PANDEMIC WREAKED HAVOC OF THE GLOBAL ECONOMY IN 2020



# COUNTRIES MOBILIZED FISCAL RESOURCES TO STIMULATE THE ECONOMIES

- The U.S. has implemented a series of stimulus packages
  1. \$2 trillion in March 2020; \$900 billion in Dec 2020
  2. \$1.9 trillion in Mar. 2021; Another \$2 trillion for infrastructure(?)

Figure 2: U.S. budget deficit

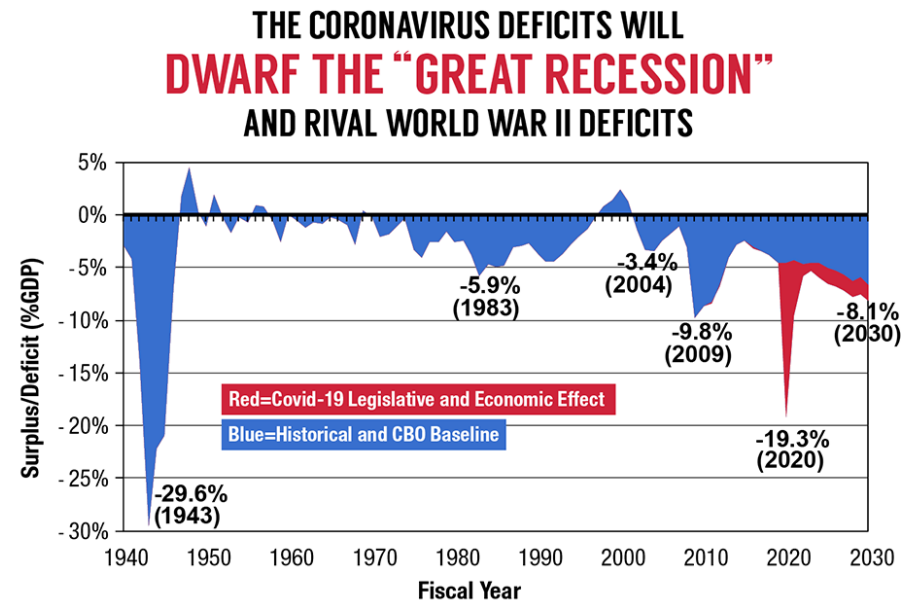


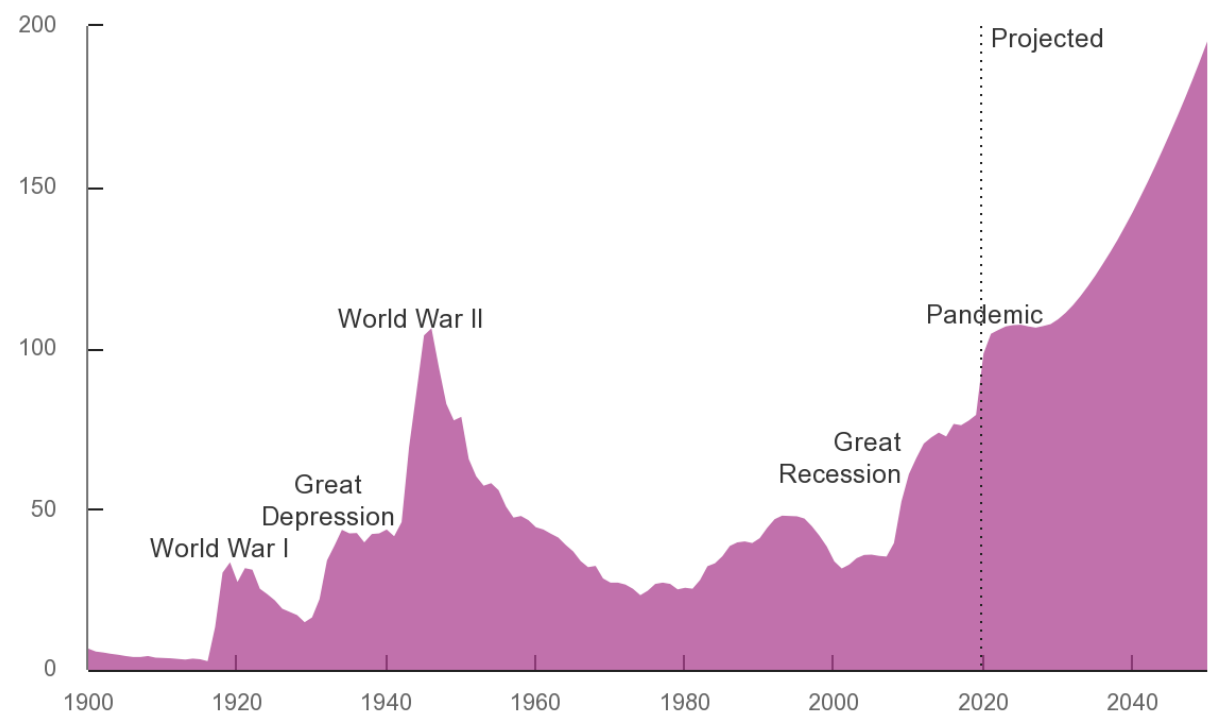
Chart: Manhattan Institute / Estimated using Jan. 2020 CBO baseline and historical data, CBO bill scores, and author estimates of economic costs as of April 2020. By Brian Riedl, Manhattan Institute (@Brian\_Riedl)

Source: Manhattan Institute

Figure 3b: U.S. national debt projection, September 2020.

## Federal Debt Held by the Public, 1900 to 2050

Percentage of Gross Domestic Product

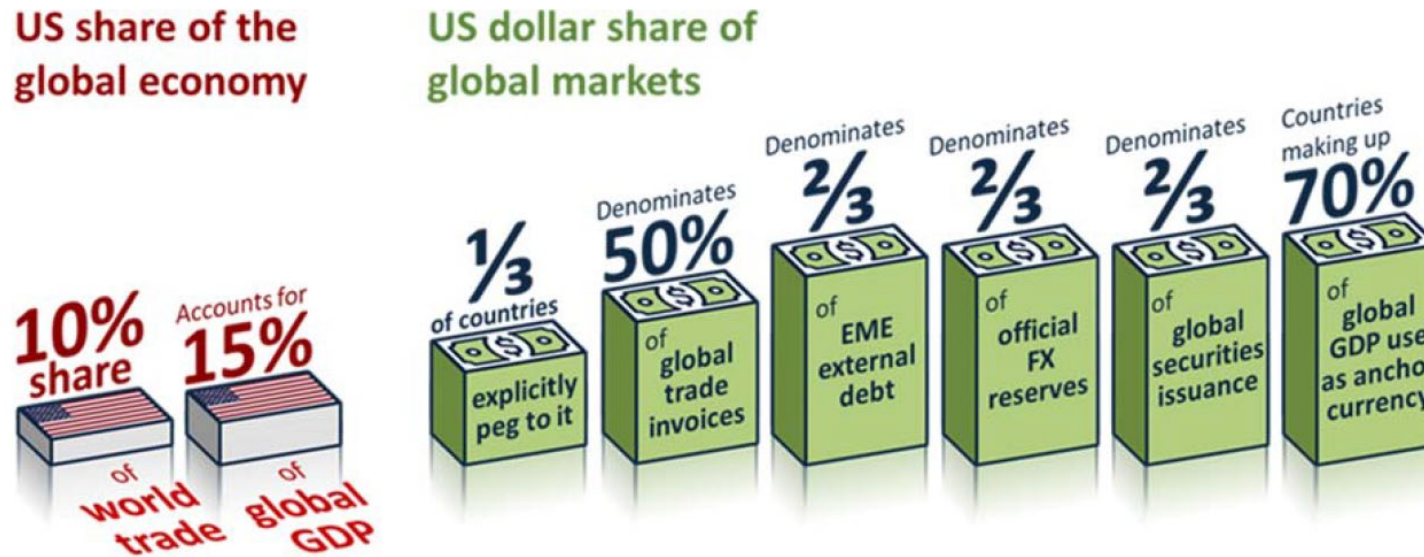


Source: Congressional Budget Office report, September 2020

# IS THE US DEBT SUSTAINABLE?

USD remains the anchor of the global financial system – so far no credible competitor to the USD has emerged

Figure 1: The US dollar continues to be as important today as it was during the Bretton Woods era



## **We contrast two divergent exit strategies of the U.S. from post COVID-19 debt-overhang, and analyze their implications on Emerging Markets and global stability.**

- **I.** the U.S. aiming at returning to the 2019, pre-COVID mode of loose fiscal policy and accommodating monetary policy.
- The benefits of this strategy include faster economic growth as long as the snowball effect – the difference between  $r - g$ , the interest rate on public debt and the growth rate – is negative. However, this strategy entail a growing tail risk of a deeper crisis triggered by a future reversal of  $r - g$ , inducing a deeper future sudden stop crises and instability of Emerging Markets.
- **We illustrate this scenario by evaluating Emerging Markets' lost growth during the 1980s, triggered by the large reversal of the U.S. snowball effect during 1974-1984.**
- **II.** The second strategy entails a two-pronged approach. **First**, turning U.S. fiscal priorities from fighting COVID's medical and economic challenges, towards investment in social, medical and physical infrastructures. **Second**, with a lag, promoting a gradual fiscal adjustment aiming at reaching overtime primary-surpluses and debt resilience.
- **We illustrate this by reviewing the exit strategy of the U.S. post-WWII, and its repercussions on the 'Phoenix Emergence' of W. Europe an from WWII destruction.**
- **The contrast between the two exit strategies suggests that the two-pronged approach is akin to an upfront investment in greater long-term global stability. We also empirically show how lowering the cost of serving public debt has been associated with higher real output growth.**



# We look at how the debt sustainability of the U.S. (which essentially determines that of EMEs) depends upon the “snowball effect”

□ “Snowball effect” =  $r - g$


$r$  = the interest rate paid to service government debt

$g$  = the potential growth rate of the economy

□ Look at how different countries experienced different ( $r - g$ )

□ What is the impact of the cost of servicing debt on the economic growth

$$\underbrace{B_{t+1} - B_t}_{\text{Growth in national debt}} = \underbrace{(r_t - g_t) B_t}_{\text{Snow ball effect}} + \underbrace{D_t}_{\text{Budget deficit}}$$



Change in debt  
b/w this and next  
years

“Net” interest  
rate

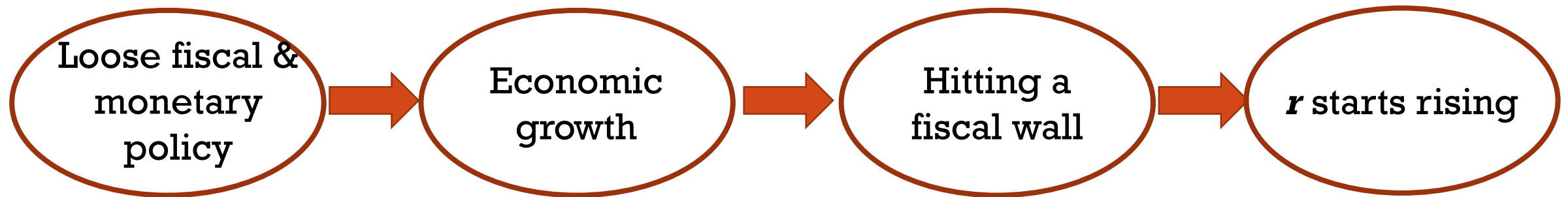
Debt bill (this year)



# THE FUTURE OF THE SUSTAINABILITY CAN DEPEND UPON THE POLICY THE US TAKES IN THE POST-COVID ERA

## 1. *'kick the can down the road'*

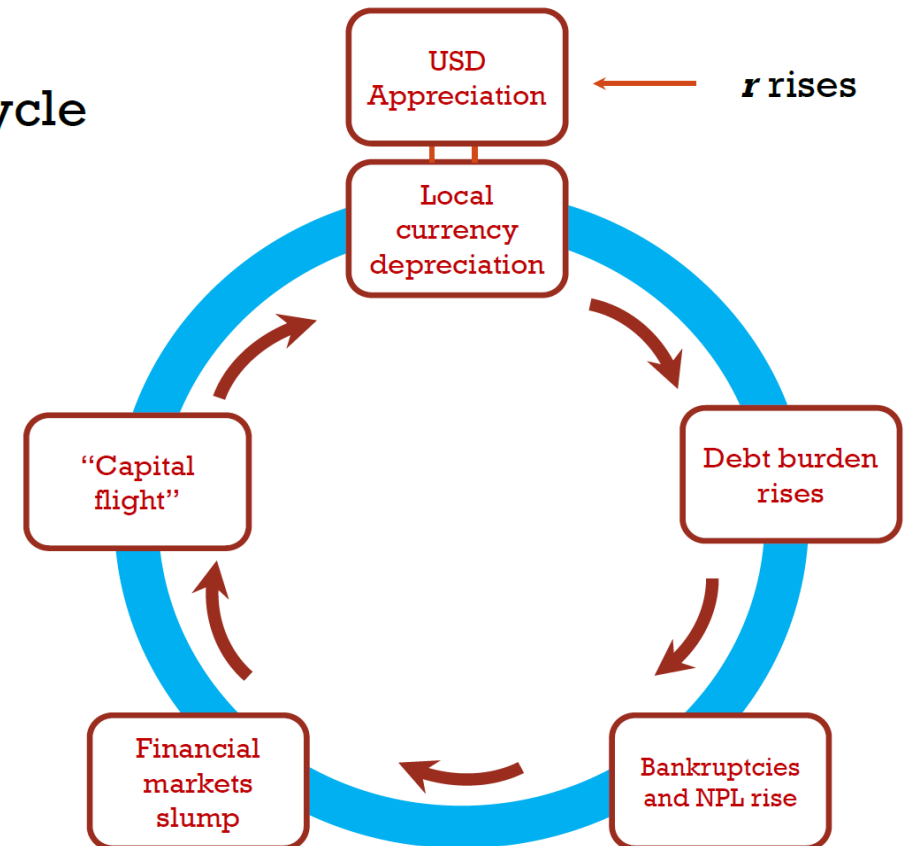
- Return to 2017-19 policies: reducing COVID-19-related expenses; imposing no new taxes, accommodating monetary policy; and a much larger FED's balance sheet



# A POSSIBILITY OF FREEFALL CRISIS: FRAGILITY LEADS TO MULTIPLE EQUILIBRIA WITH SELF-FULFILLING DEBT CRISES

- ❑ Latin American debt crisis in the 1980s; Euro debt crisis in the 2010s
- ❑ **Even if the U.S. will avoid a full-blown crisis, it can impact other countries, esp. EMEs, as EMEs remains heavily indebted in USD**
- ❑ USD appreciation →
  - local currency depreciation
  - debt burden rises in local currency

Vicious cycle





# THE FUTURE OF THE SUSTAINABILITY CAN DEPEND UPON THE POLICY THE US TAKES IN THE POST-COVID ERA

## 2. Fiscal restructuring

➤ Retrench from expenditures oriented towards COVID-related challenges, and move towards expenses with a high social payoff (e.g., **upgrading K-12 education, investing in medical infrastructures, general infrastructure**, etc.) → Raises potential output growth

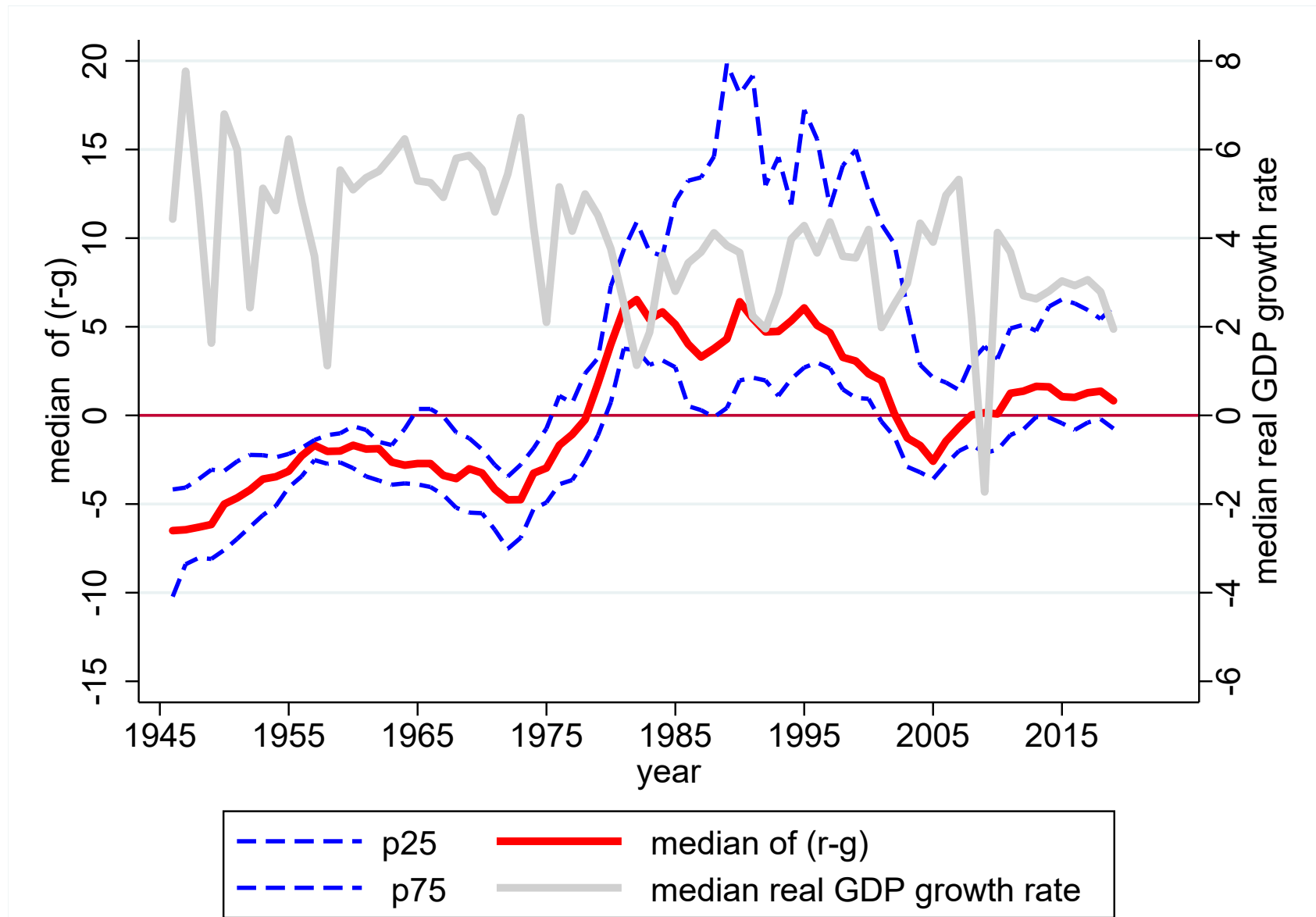
➤ Increase taxes

– This may lead to primary surplus. The cost of servicing debt falls

–  $r \downarrow - g \uparrow < 0$



# *Interest rate (r) – Potential economic growth (g)*



# DOES A RISE IN THE COST OF SERVICING DEBT HAVE A NEGATIVE IMPACT ON OUTPUT GROWTH?

Regression model

$$\begin{aligned} y_{it}^{Local} = & \alpha + \beta_1 \Delta(r_{t-1} - g_{t-1}^{USD}) \times \left( \text{GrossDebt}/Y \right)_{t-1}^{USD} + \\ & + \beta_2 \Delta(r_{t-2} - g_{t-2}^{USD}) \times \left( \text{GrossDebt}/Y \right)_{t-2}^{USD} + \\ & + \beta_3 \Delta(r_{t-3} - g_{t-3}^{USD}) \times \left( \text{GrossDebt}/Y \right)_{t-3}^{USD} \\ & + X_t' \Gamma + \varepsilon_{it}. \end{aligned}$$

Is  $\beta_i$  negative? We apply this equation to 57 AEs and EMEs for the period 1961 – 2019.



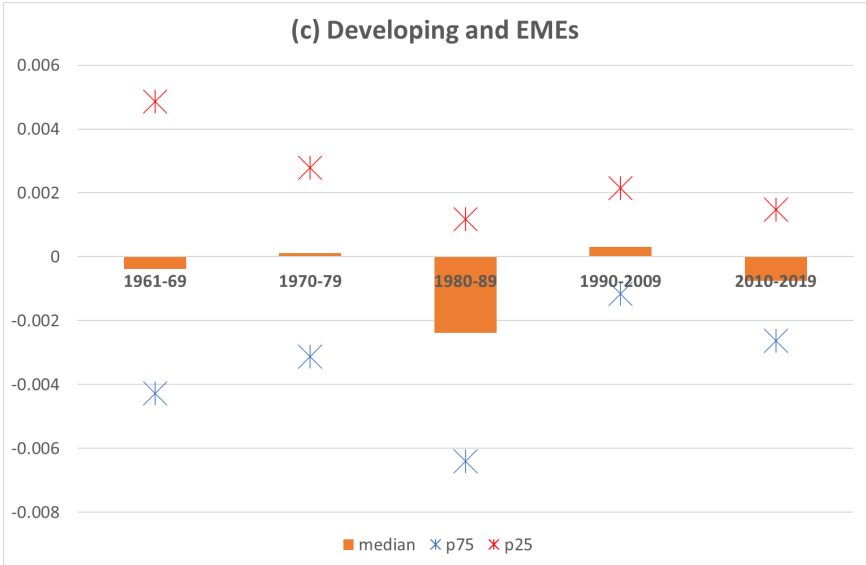
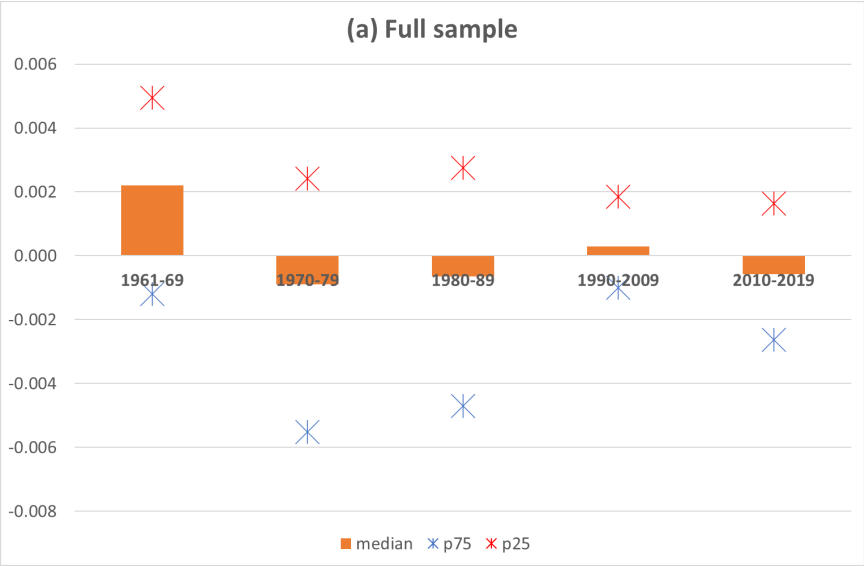
# FINDINGS

$$\begin{aligned} y_{it}^{Local} = & \alpha + \beta_1 \Delta(r_{t-1} - g_{t-1}^{USD}) \times \left( \text{GrossDebt}/Y \right)_{t-1}^{USD} + \\ & + \beta_2 \Delta(r_{t-2} - g_{t-2}^{USD}) \times \left( \text{GrossDebt}/Y \right)_{t-2}^{USD} + \\ & + \beta_3 \Delta(r_{t-3} - g_{t-3}^{USD}) \times \left( \text{GrossDebt}/Y \right)_{t-3}^{USD} \\ & + X_t' \Gamma + \varepsilon_{it} \end{aligned}$$

- $\beta_1, \beta_2, \beta_3 < 0$ : Higher cost of servicing gross public debt dampens the per capita real output growth
- In 1961-69,  $\Delta(r_{t-1} - g_{t-1}^{USD}) < 0$  led to high economic growth, esp. **Europe** and **Japan**
- In the 1980s,  $\Delta(r_{t-1} - g_{t-1}^{USD}) > 0$  dampened economic growth among EMEs and caused the **“Lost Decade” in Latin America**



# FIGURE 9 (A) – (C): ACTUAL CONTRIBUTIONS OF THE COST OF SERVICING GROSS DEBT TO ANNUAL OUTPUT GROWTH RATES



**FIGURE 9 (D) – (E): ACTUAL CONTRIBUTIONS OF THE COST OF SERVICING GROSS DEBT TO ANNUAL OUTPUT GROWTH RATES FOR THE MEDIAN, 75 AND 25 PERCENTILE FOR LATAM AND ASIAN COUNTRIES**



# Conclusions

- ❑ Many countries experienced negative growth in 2020
- ❑ Countries, esp. Advanced economies, implemented large-scale stimulus packages to prevent their economies from free-falling
- ❑ Many countries have experienced large-sized budget deficit
- ❑ Among AEs, the size of national debt will soon approach that as of the end of WWII'
- ❑ EMEs had had their debt levels rising even before the COVID crisis



# Conclusions

- Two possible policies the U.S. could take in the post-COVID era
  1. Same kind of policies as in 2017-19 = lax monetary and expansionary fiscal policies. It may bring about short-term buoyancy to the U.S. economy, but entails the risk of a future global crisis.
    - e.g. Latin American debt crisis
  2. Fiscal restructuring = It can move towards expenses with a high social payoff (e.g., upgrading K-12 education, investing in medical infrastructures, etc.) and increase taxes e.g., resurgence of European and Japanese economies in the 1950s- 1960s





# Conclusions

- ❑ Many EMEs still cannot borrow in their own currencies. They borrow in USD, which makes their economies vulnerable to U.S. policies
- ❑ When the U.S. has low interest rate policy in place, that would let global money flow to EMEs with high yields, making EMEs highly indebted
- ❑ When the U.S. raises its interest rate, it would make EMEs' currencies depreciate, which will make debt burden larger and cause capital flight. Financial instability may arise
- ❑ The costs of servicing debt (gross, domestic, or external) dampens per capita real output growth



***THANK YOU!***

