U.S. Post-COVID Economic Policies, Emerging Markets, and the Future Global Role of the US $

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Post-Corona, Rapid Change of World Economic Leadership

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Based on Aizenman and Ito (2020)

https://voxeu.org/article/post-covid-19-exit-strategies-and-economic-challenges-emerging-markets

https://www.nber.org/papers/w27966

‘America First’ policy put question marks on the future role of the US $ So far, no credible competitor to the US $ has emerged.

Two divergent U.S. post COVID economic strategies:

1. **‘Kicking the can down the road,’** delaying needed adjustments, gambling for resurrection.
   Possible short-term benefits will come with a growing future exposure of the U.S. and the Global economy to crises worse than the 2008-2011 GFC.
2. **A two-pronged fiscal strategy**

I. Fiscal re-allocation of funds from dealing with COVID’s challenges, towards neglected activities with high social payoff.

II. With a lag, following the resumption of growth, increasing taxes, reaching overtime primary surpluses.

Post-WWII economic U.S. choices illustrate the feasibility and global gains from a two-pronged fiscal strategy. It means:

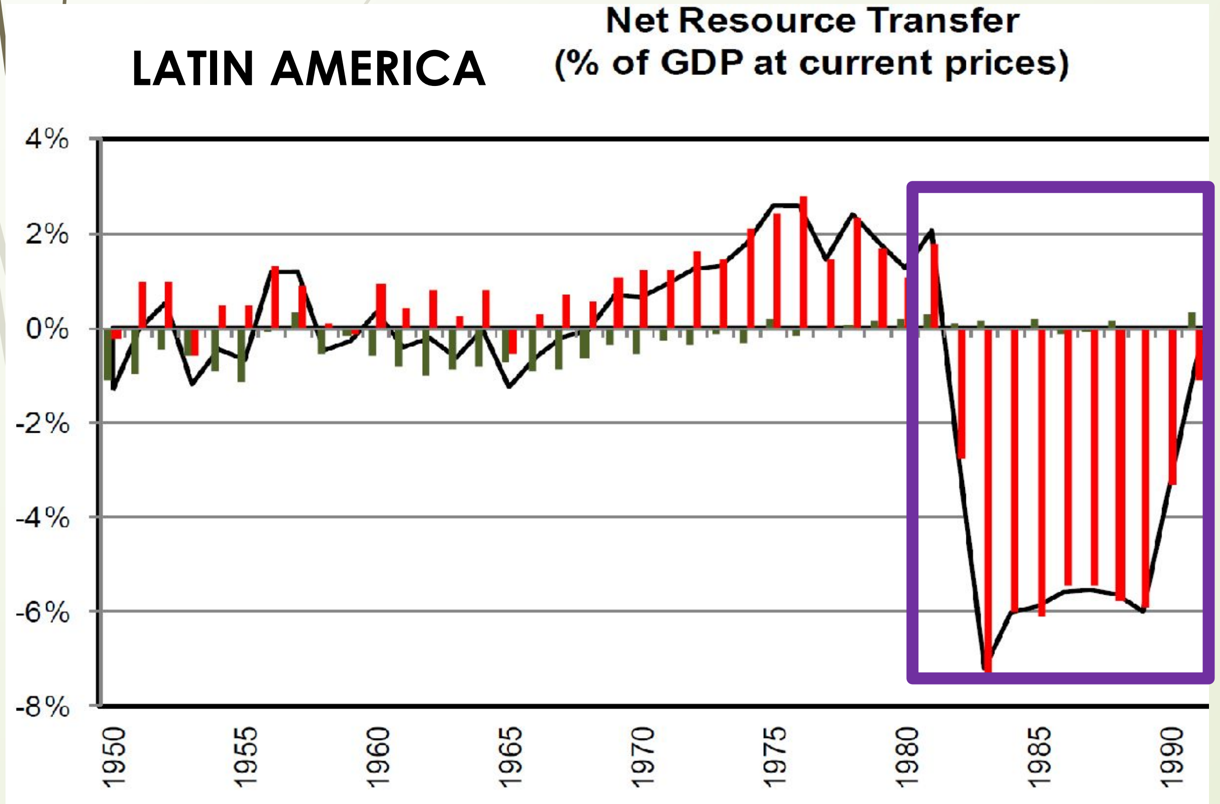
1. Reallocation of US fiscal spending towards physical, medical, and social infrastructures will boost future growth.
2. Following the resumption of robust growth, increasing taxes aiming at reaching a primary surplus will stabilize the US and the global economy.
3. The two-pronged approach is akin to an upfront investment in greater long-term global stability.
4. Such a trajectory will solidify the viability and credibility of the US dollar as a global anchor, thereby stabilizing Emerging Markets economies and global growth.
5. **The risk of *'Kicking the can down the road*'** is greater global instability, increasing the odds of a messy transition to a tri-polar global order: U.S., Euro Zone and China competing with each other for greater dominance of their corresponding currency and financial system within their geographic and geo-political periphery.

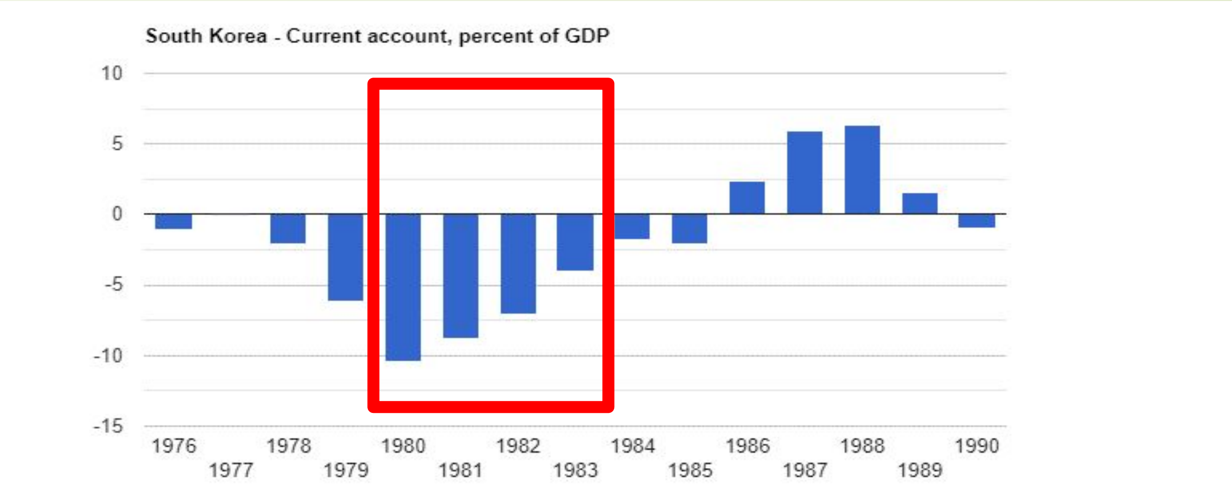
Policy Option I: *'Kicking the can down the road'*

1. Reducing COVID-19 transfers and credit lines, no new taxes, accommodating monetary policy, this time with public debt/GDP above 100%, and a much lager FED balance sheet Fiscal dominance…
2. Short-term benefits: faster growth as long as ***r*** [public debt interest rate] is below ***g*** [GDP growth], ***r*** – ***g*** < 0.
   The term ***r*** – ***g*** is also known as debt's snowball effect: the exponential growth rate of public debt/GDP if the primary fiscal deficit is zero.
3. Growing risk of hitting a fiscal wall, as will happen once **r >> g**, ending with a free fall crisis. This crisis will be amplified into a deeper global crisis impacting Emerging Markets (EMs).
4. **Free Fall Crises:** US 1979-1982 triggering the 1980s EMs lost growth decade;   GFC, EZ 2010-2012, and the EZ fragile 5.

Sovereign spreads are determined by markets' expectations, susceptible to 'flight to quality,' exposing affected countries to self fulfilling prophecy dynamics, inducing financial, banking, and currency crises.

Examples: LATAM LOST 1980s: the rapid rise of ***r – g*** during 1979-1982 was amplified into capital outflows from LATAM, financial & banking crises, sovereign defaults and political unrest. Similar though milder dynamics took place in S. Korea.





By 1980 the S. Korean economy had entered a period of temporary decline: negative growth was recorded for the first time since 1962, inflation had soared, and the balance-of-payments position had deteriorated significantly.

Ocampo, J.A., 2014. The Latin American debt crisis in historical perspective. In *Life After Debt* (pp. 87-115). Palgrave.

https://www.theglobaleconomy.com/South-Korea/current_account/

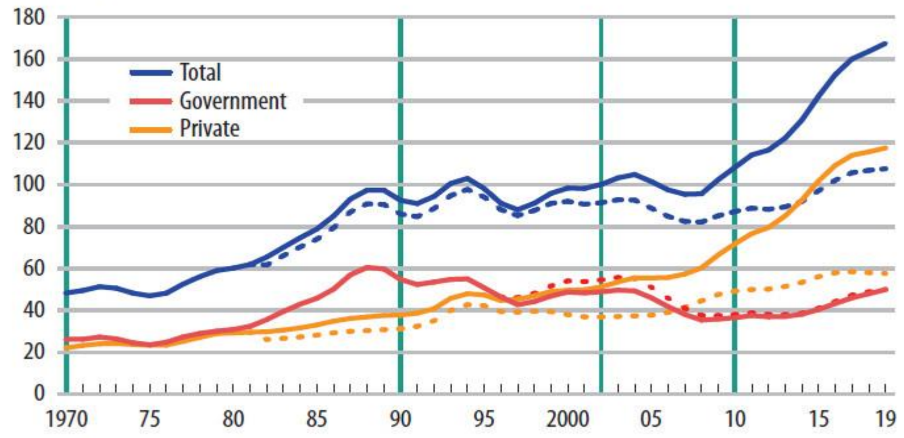
EMs entered the COVID-19 crisis with massive debt overhang propagated by the decline in risk free interest rates and sovereign spreads associated with a 'search for yields,' the outcome of QEs and other factors.

Chart 1

Ballooning debt (1970–2019)

During the past decade, total debt in emerging market and developing economies rose to a historic peak.

(percent of GDP)

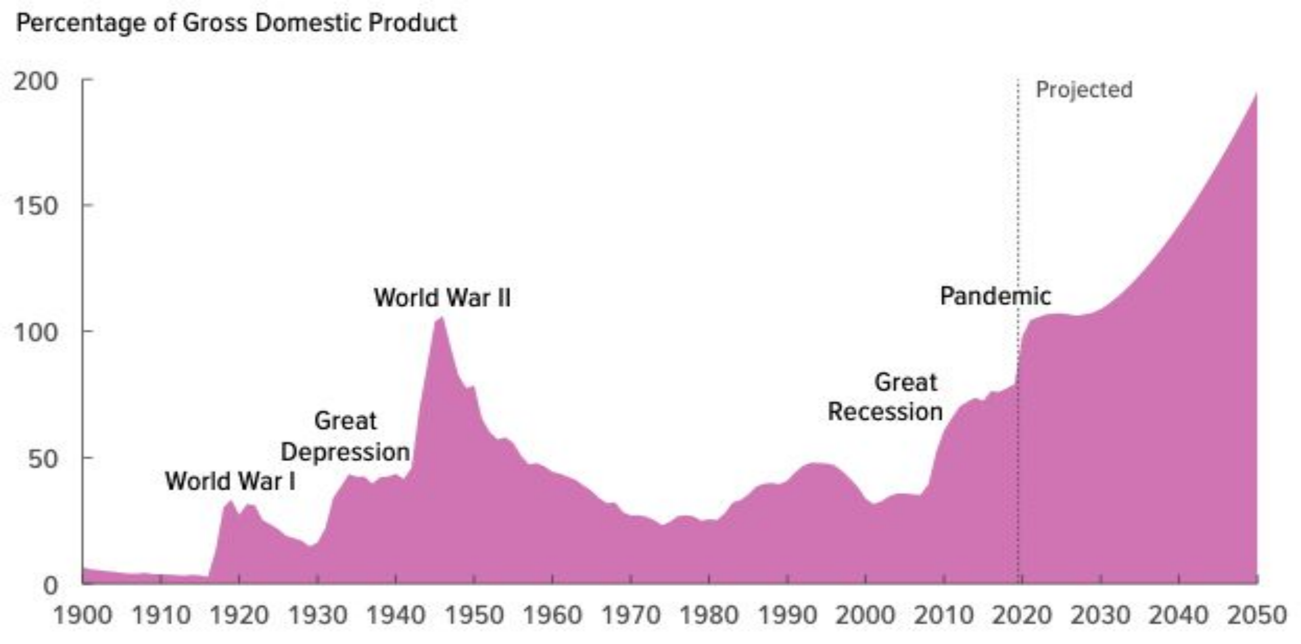


Sources: International Monetary Fund; Kose and others (2020); and World Bank.
Note: Aggregates are calculated using current US dollar GDP weight and are shown as a three-year moving average. Dashed lines show debt, excluding China. The vertical lines represent the beginning of debt waves in 1970, 1990, 2002, and 2010.

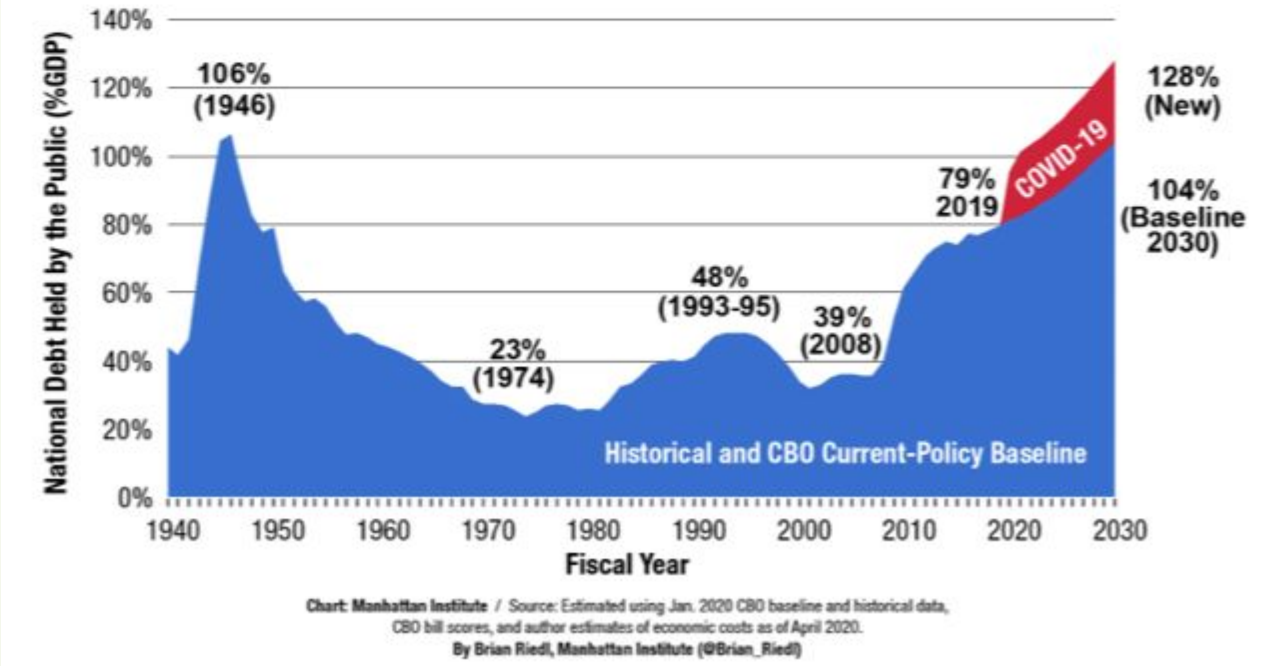
1. While some expect U.S. *r* – *g* to be negative for the coming decades, the record of predicting changes of snowball effects is mixed.
2. Summers (2013) secular stagnation interpretation occurred five years after the GFC, a backward-looking explanation of the 'great moderation' and the on-set of demographic transitions, at times when concerns regarding the future of the dollar system were muted.
3. Presuming that the new normal is a negative snowball effect may increase the risk of a deeper future crisis over time, as was the case in the late 1990s and early 2000s when the presumption of an enduring 'Great Moderation' dominated policymaking.

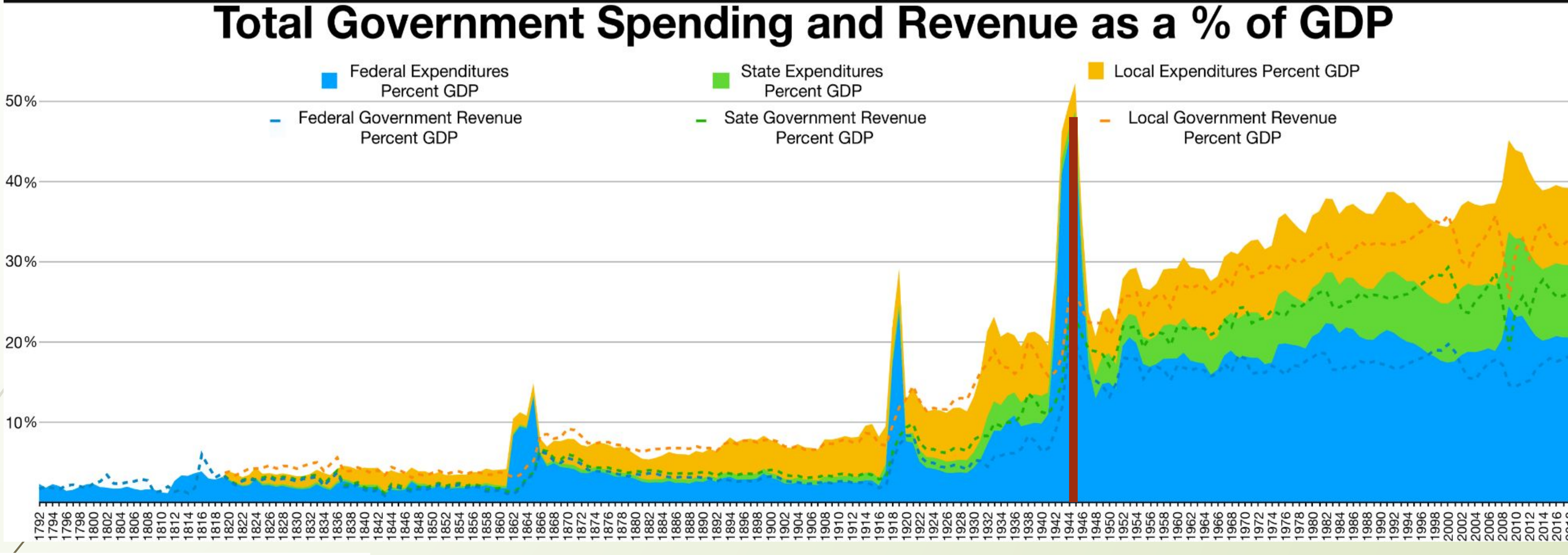
Policy option II: A two-pronged strategy, akin to the US exit from WWII, 1946-1960

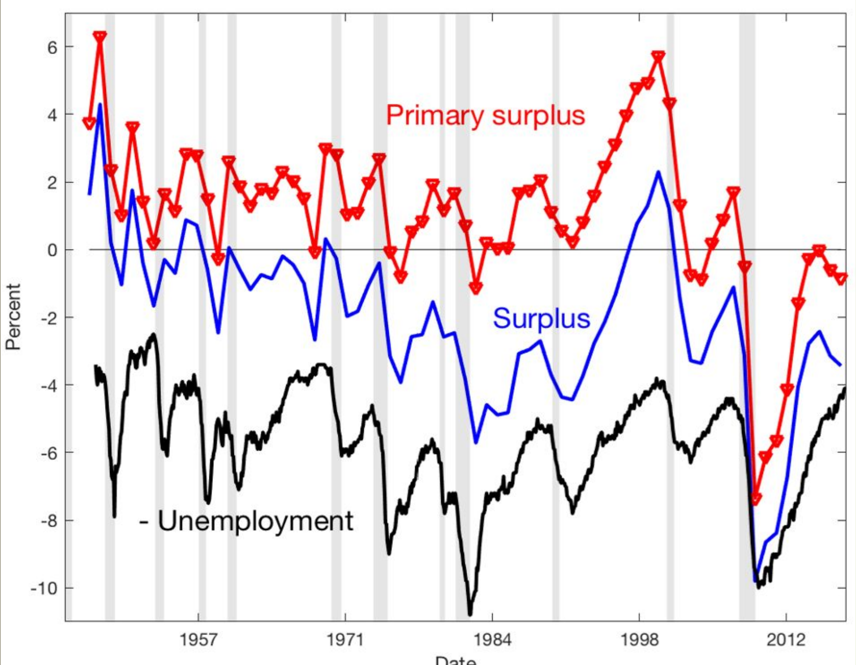
US national debt projection,
Congressional Budget Office report
Sept. 2020, Debt held by the public/GDP



Present public debt debt/GDP ~ the end of WW II







The dramatic decline in public debt/GDP during 1946-1955 was accommodated by financial repression (inducing lower r), mild inflation (~ 4.2%), higher taxes and robust GDP growth.

Aizenman J. & Marion N. (2011). Using inflation to erode the US public debt. *Journal of Macroeconomics*.

Cochrane J. (2020). The Grumpy Economist Perpetuities, debt crises, and inflation.

Reinhart C., and Sbrancia B. *The liquidation of government debt*. No. w16893. National Bureau of Economic Research, 2011.

A two-pronged strategy, akin to the US exit from WWII, 1946-1960:

1. **A fiscal re-allocation from fighting COVID's medical & economic challenges towards neglected margins: medical services & research, upgrading infrastructure, education, etc.**
2. **With a lag, increasing taxes once growth resumes, converging to primary surpluses [i.e., government revenue > government expenses <u>excluding</u> interest payments on outstanding debt].**

Done properly, the fiscal re-allocation increases employment overtime, while the higher tax and larger tax base trajectory reduce overtime the public debt/GDP.

Chances are that financial repression and mild inflation will supplement these policies [Reinhart and Sbrancia (2015)].

Financial repression: policies inducing transfer from creditors and savers, to borrowers. QEs effects are akin to financial repression.

Concluding Remarks

1. The past performance of the U.S. $ as the safe anchor of the global financial system does not guarantee maintaining the "exorbitant privilege" status into the future [Gourinchas et al. (2010), Eichengreen (2011) and Carney (2019)].
2. The two-pronged U.S. post COVID exit strategy may mitigate the growing discontent with the dominance of the U.S. dollar.
3. Greater U.S. attention to scaling down its public debt overhang will mitigate the present centrifugal forces working towards multipolar global currencies discussed by Carney (2019).
4. Presuming that the new normal is a negative snowball effect ($\boldsymbol{r} - \boldsymbol{g} < 0$) may increase overtime the risk of a deeper future crisis, as was the case in the late 1990s and early 2000s when the presumption of an enduring 'Great Moderation' dominated policy making.

More readings

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