A World Economy in Disarray*

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When the world's financial leaders met mid-April at Washington for the annual spring meetings of the International Monetary Fund and the World Bank, the mood was one of gloom. The world economy is in disarray, with world leaders clueless as to where it is headed or what can be done to prevent a possible collapse. In the April 2022 edition of its World Economic Outlook, the IMF has slashed its 2022 GDP growth forecast of six months ago by 1.3 percentage points to 3.6 per cent, and projects growth to remain below that level for the next two years. Inflation that had emerged as a problem in 2021 has been accelerating over the past three months, and expectations that the price spike would be transitory seem wholly misplaced. And supply levels and price trends are signalling imminent crises in global energy and food markets, with frightful humanitarian implications for vulnerable nations and populations.

Four factors have combined to intensify global economic uncertainty. The first is that, by 2019 it was clear that strenuous efforts aimed at transiting from the Great Recession, triggered by the Global Financial Crisis of 2008, to robust growth had at best been half successful. There has not been a single year after 2010 and till 2019, when the growth of global GDP (at constant prices using market exchange rates) equalled the 3.9 and 3.8 per cent levels it touched in 2006 and 2007. The second was the onset of the COVID-19 pandemic in 2020, the rapid transmission and severity of which drew responses from governments that precipitated sudden stops in economic activity, with every sign of recovery soon being swamped by another wave of the pandemic. Third, when a modest and uneven recovery began in 2021 as the pandemic waned in intensity and restrictions on economic activity were relaxed, it appeared that the revival of demand for many goods and services went ahead of the restoration of supply through still-clogged global supply chains. The result was inflation in a context of supressed demand and slow growth. Finally, as leaders in all nations struggled to pull their economies out of the new normal of below-potential growth, the war broke out in Ukraine, with curtailed production and economic sanctions against Russia further squeezing supplies, including of oil, gas and food, resulting in an acceleration of inflation.

The ongoing economic disruption does not end there. Even before the Ukraine invasion, the return of inflation had put advanced country central banks in a dilemma. The two leading tenets of neoliberal macroeconomic policy are: (i) that fiscal policy should be tailored to ensure that government spending is kept in check to prevent excessive deficits in government budgets that are financed with borrowing; and (ii) that the prime concern of monetary policy should be the control of inflation, with monetary levers adjusted to keep inflation rates within a specified target range. In recent years, however, the Great Moderation, or a long period of low inflation, had attuned central banks to adopting a loose monetary policy regime, with large infusions of cheap liquidity into the system that were expected to counter the depressing effects of fiscal conservatism. With the global embrace of neoliberalism in the 1980s, this expansionary monetary policy regime became the defining element of a pro-active macroeconomic policy. Though less effective than fiscal expansionism, it provided a veneer of state command over the growth process.

More recently this has posed a dilemma. For the reasons mentioned earlier growth has slowed considerably, requiring governments to provide a fresh stimulus to drive growth. But inflation has been on the rise, necessitating a rethink of the "unconventional" monetary policies adopted by central banks that kept interest rates near zero and siphoned in large volumes of liquidity through "quantitative easing" or large-scale bond buying. As a result of the "fear of inflation", bond buying has stopped. And, though interest rates are still low, they are expected to rise sharply over this year, with the US federal funds rate expected to rise from less than 0.5 per cent to 2.5 per cent. That leaves advanced nations with no lever to drive growth as the system slides into another recession.

The retreat from unconventional monetary policies adversely affects financial markets as well. The availability of cheap liquidity had encouraged punters in search of quick and high returns to borrow cheap and invest the proceeds in financial markets, which rose to dizzy heights in the years when the real economy was sluggish at best. When shocks such as the COVID-19 pandemic struck, governments committed to relying on monetary stimuli pumped in larger volumes of cheap liquidity, fuelling the speculative boom in financial markets. While the financial boom led to a false sense of confidence among wealthholders, it also raised the vulnerability of the system. If for some reason central banks had to withdraw quantitative easing measures and/or raise interest rates, speculative investors deprived of their cheap capital would be forced to unwind their exposures. If that occurs, markets would lose momentum and even collapse, capital flight from some nations can cause currencies to depreciate, and firms with large foreign currency exposures built during the era of cheap money will find their interest costs rising and the domestic currency equivalent of their foreign debt servicing requirements spiking. Widespread debt default and bankruptcy are real dangers.

In a paradoxical turn, while the crisis triggered by these medium- and short-term factors has rattled the world's economic policy-making establishment, the Ukraine invasion, that has intensified the crisis, has come in handy. It is being used to divert attention from the inner weaknesses of neoliberal capitalism that had prevented full recovery from the Great Recession and increased vulnerability to shocks like that imparted by the COVID-19 pandemic. The IMF's World Economic Outlook reflects the tendency to lay much of the blame for the current predicament of the world economy on the Ukraine invasion. In its words: "The war in Ukraine has led to extensive loss of life, triggered the biggest refugee crisis in Europe since World War II, and severely set back the global recovery." However, the evidence suggests that, despite the recovery in 2021, the world economy had just about managed to regain the level it would been at if it continued to growth at rates recorded in 2018 over the next three years. And few among the world's economies have benefited from that return to 'normalcy'.

The economies that are the most vulnerable are developing countries and the so-called emerging markets like India. To start with, depressed global conditions have meant that export growth was for long restrained in these economies, with the balance of payments remaining manageable only because imports too fell as growth remained low. Second, both poor and not-so-poor developing countries were the targets for the flow of yield-seeking finance during the years of cheap money. The poorest countries found themselves able to access markets for sovereign bonds because of the high interest rates they offered to attract speculative investors. And the not-so-poor emerging market saw footloose capital in search of high returns flowing into their equity and bond markets. As changing circumstances in the developed countries limits the availability of cheap funding, financial investors are exiting, roiling equity and bond markets and triggering currency depreciation. Those trends have been accentuated by the economic consequences of the war in Ukraine, as a result of which energy and food prices have spiked and currency depreciation has accelerated. According to the IMF, around one among every four emerging market countries that had tapped international financial markets is already facing debt distress.

This financial vulnerability has another aspect to it, which is a possible sharp rise in domestic interest rates. Central banks in emerging market and poor countries, with little fiscal headroom because of conservatism or imposed austerity, are also left with only monetary levers to deal with the inflation that rising energy prices and falling domestic currency values (which raise the cost of imported inputs and finished goods) result in. That has led to the adoption of monetary tightening measures and higher interest rates in the midst of a recession. To make matters worse, the fear that foreign investors in bond markets may choose to flee given economic circumstances, raises the pressure to hike interest rates in order to please investors with attractive spreads. According to the IMF, distressed emerging market debt is trading in markets at rates reflecting spreads of 1,000 basis points (or 10 percentage points) relative to US Treasuries. Interest rates elevated to this extent only depress economic activity even further.

All this suggests that even the pessimistic growth projections of the IMF may turn out to be optimistic, as emerging markets drag down the global economy. It does not help that China has chosen to stick to its zero-tolerance policy and resort to brutal lockdowns following a recurrence in COVID infections in cities such as Shanghai and Beijing. That is expected to sharply curtail growth in a country that has helped shore up global growth rates in the past. Meanwhile, advanced country governments are at a loss on what is to be done. High inflation, fiscal conservatism and the opposition of finance prevents adoption of an expansionary fiscal policy. And when inflation rules high, easy money policies and engineered low interest rates are not an option. In the midst of an intensifying crisis, developed country governments are left with no options under the capitalist rule of the game.

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