Inflation and Recovery in an Era of High Public and Private Debt

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Effective Public Debt Management and Fiscal Sustainability in the Post-COVID-19 Era

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Outline

• The global setting: An uneven recovery
• The return of global inflation and its drivers
• High and rising leverage:
  • Public debt
  • Private debt
• Implications for the global economy of tighter monetary policy--with a focus on emerging markets and developing countries (EMDEs)
  • Maturity, short-term debt, and variable rate debt
  • Pressures on domestic central banks from rising domestic debt
  • “Hidden” nonperforming loans
• 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.
Do not confuse rebound with recovery

A minimalist definition of recovery: Real per capita GDP reaches the pre-crisis level. In the case of COVID-19, it implies that:

2021 real per capita GDP ≥ 2019 real per capita GDP


2021 real per capita GDP ≥ previous peak in real per capita GDP
Rebound or Recovery?
Real per capita GDP: 1980-2021, 194 countries

Rebound or recovery from the COVID-19 shock?

<table>
<thead>
<tr>
<th></th>
<th>Advanced economies</th>
<th>Middle-income</th>
<th>Low-income</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of countries</td>
<td>Number of countries</td>
<td>Number of countries</td>
</tr>
<tr>
<td></td>
<td>Share in percent</td>
<td>Share in percent</td>
<td>Share in percent</td>
</tr>
<tr>
<td>2021 ≥ 2019</td>
<td>15</td>
<td>36</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>40.5</td>
<td>27.5</td>
<td>23.1</td>
</tr>
<tr>
<td>2021 &lt; 2019</td>
<td>22</td>
<td>95</td>
<td>20</td>
</tr>
<tr>
<td></td>
<td>59.5</td>
<td>72.5</td>
<td>76.9</td>
</tr>
<tr>
<td>Total</td>
<td>37</td>
<td>131</td>
<td>26</td>
</tr>
<tr>
<td></td>
<td>100</td>
<td>100</td>
<td>100</td>
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</tbody>
</table>

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

<table>
<thead>
<tr>
<th></th>
<th>Number of countries</th>
<th>Share in percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>2021 = peak</td>
<td>13</td>
<td>35.1</td>
</tr>
<tr>
<td>2021 &lt; peak</td>
<td>24</td>
<td>64.9</td>
</tr>
<tr>
<td>Total</td>
<td>37</td>
<td>100</td>
</tr>
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Sources: IMF, World Economic Outlook and author’s calculations.

The COVID-19 crisis is markedly regressive
The return of inflation is global
(or nearly so, as Asia has been more immune thus far)

Share of Advanced Economies (AE) and Emerging Markets and Developing Countries (EMDE) with Inflation > 5%
2010:1-2022:1

Note: The sample consists of 34 advanced economies and 109 emerging markets and developing countries.

Sources: Graf von Luckner and Reinhart (2022), International Monetary Fund, 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).

• **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 (global-AEs and EMDEs factor).

• **Commodity prices** have risen as global demand increased from 2020 levels, with oil prices up 77 percent between December 2020 and January 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.
Drivers of the inflation surge (concluded)

• **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.

Number and share of countries with 12-month food price increase > 5% sometime during 2021

<table>
<thead>
<tr>
<th>Country group</th>
<th>Total number</th>
<th>Number &gt; 5%</th>
<th>Share &gt;5% (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advanced</td>
<td>34</td>
<td>9</td>
<td>26.5</td>
</tr>
<tr>
<td>EMDEs</td>
<td>109</td>
<td>86</td>
<td>78.9</td>
</tr>
</tbody>
</table>

*Source: World Bank, 2022.*
Recovery and inflation pairings and risk varieties: 2019 to 2021 compared

we also compare separately 2021 to peak GDP

<table>
<thead>
<tr>
<th>12-month inflation rate</th>
<th>Real per capita GDP</th>
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<tbody>
<tr>
<td>end-2021 &gt; end-2019 or inflation ≥ 10%</td>
<td><strong>Quadrant I:</strong> Higher (or high) inflation; lower incomes Stagflation risks</td>
</tr>
<tr>
<td>end-2021 ≤ end-2019</td>
<td><strong>Quadrant IV:</strong> Lower inflation; lower incomes Recession/depression risks</td>
</tr>
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*Source: Graf von Luckner and Reinhart (2022).*
What short-term risks does Fed (and other major central banks) tightening pose for the global economy?

*With an emphasis on EMDEs*

- Economic slowdown, recession risks, as in past tightening cycles.
- Equity markets have lofty valuations.
- The PRC was an engine of growth for the global economy following the Global Financial Crisis—they have their own financial fragilities to cope with.
- 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 and
  - 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
- It will probably also add to global poverty, which increased for the first time in 2020 since 1998.
### Historical negative short-term real interest rate spells in global financial centers: UK, 1870-1918 and US, 1919-2021

<table>
<thead>
<tr>
<th>Negative real rate spell</th>
<th>Average annual US inflation</th>
<th>Major shocks</th>
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<tbody>
<tr>
<td>1916-1920</td>
<td>14.7</td>
<td>WWI</td>
</tr>
<tr>
<td>1941-1948</td>
<td>7.1</td>
<td>WWII</td>
</tr>
<tr>
<td>1974-1980</td>
<td>9.3</td>
<td>OPEC oil shock</td>
</tr>
<tr>
<td>2008-2021</td>
<td>1.9</td>
<td>GFC and COVID-19</td>
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Exit from the previous negative interest rate spell called for a draconian policy from the Federal Reserve.
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

Beware of private debt: What is private before a crisis often becomes public after the crisis (see *World Development Report*, 2022)

As is the case with public sector debt, the levels are low by AE metrics—but at record highs for EMDEs. Nonperforming loans may not be a reliable indicator of current contingent liabilities risks...
Average total external debt service, EMDEs: 1970-2020
(% of exports of goods, services and primary income)

Notes: Default shares based on all countries (193 as of 2020).
Debt servicing is an average for 123 EMDEs.
For the low-income countries, the situation (even at the current historically low international Interest rates) is already complicated. Almost 60% of DDSI-eligible countries are either in debt distress or high risk of debt distress (IMF-WB, debt Sustainability analysis).

Sources: World Economic Outlook, IMF and Horn, Reinhart and Trebesch (2022).
Notes: General government debt and revenues. Defaults and restructurings include private, Paris Club, and the PRC. Domestic defaults and restructurings are not included.
Features of external debt: 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.

One of the challenges posed by rising **domestic** public debt: Most emerging markets and EMDE central banks that hold higher levels of government debt also tended to have higher inflation rates.

![Graph showing average annual inflation for 2000-2020.

**Average annual inflation for this group over 2000-2020 is 10.2%**]

*Sources: Arslanalp and Tsuda (2014b) and Reinhart (2022).*
Are reported non-performing loan (NPL) data misleading? COVID-19 Business Pulse Survey Dashboard conveys a very different picture. Forbearance policies in reporting NPLs are among the reasons for a potential *Hidden NPL* problem (WDR, 2022)

The 20 countries with the largest gaps:
Share of establishments in arrears or expect to fall in arrears in the next 6 months (Pulse Survey) minus share of non-performing loans

Cross-country data on business failures in a sample of emerging and advanced economies that adopted credit forbearance policies for banks (or small businesses and corporates) presents a similar discrepancy. NPL rates remained essentially flat between 2019 and 2020, while failure rates, as calculated by a global payment provider, more than doubled.

Final thoughts

• 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 tackling 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.

• From an EMDE perspective, conservative debt management—avoiding heavy reliance on short-term debt (and bunching) can reduce roll-over risks at a time of great (global and domestic) uncertainty.

• For those countries where recovery has yet to materialize and large repayments are coming due, pre-emptive reprofiling (or restructuring) has performed better than the delay option, which runs a higher risk of evolving into a disorderly default (WDR 2022).

• Evaluating risks arising from contingent liabilities should be an integral part, especially in the current conjuncture, of conservative, pre-emptive debt management.

Reinhart