Watching out for the third pandemic: a massive debt-crisis...

COVID-19 is having a profound affect on the global economy. Deepanshu Mohan considers the consequences of increasing debt on countries such as India

In a recent column noted American economist Robert Shiller argued that the global economy is currently witnessing two pandemics advancing across nations at the same time. The first is a healthcare pandemic from COVID-19 virus spreading across continents, and the second, is the anxiety pandemic that is causing financial markets, commodity markets, economic activity to fall-off from a cliff in an I-shaped vertical curve.

This is unprecedented in modern economic crises history, as one often uses a reference of a U or V shaped curves in explaining the decline of economic activity within crisis scenarios, and then a rise after appropriate economic policy responses take effect. Right now, economic activity has just frozen across the nation(s).

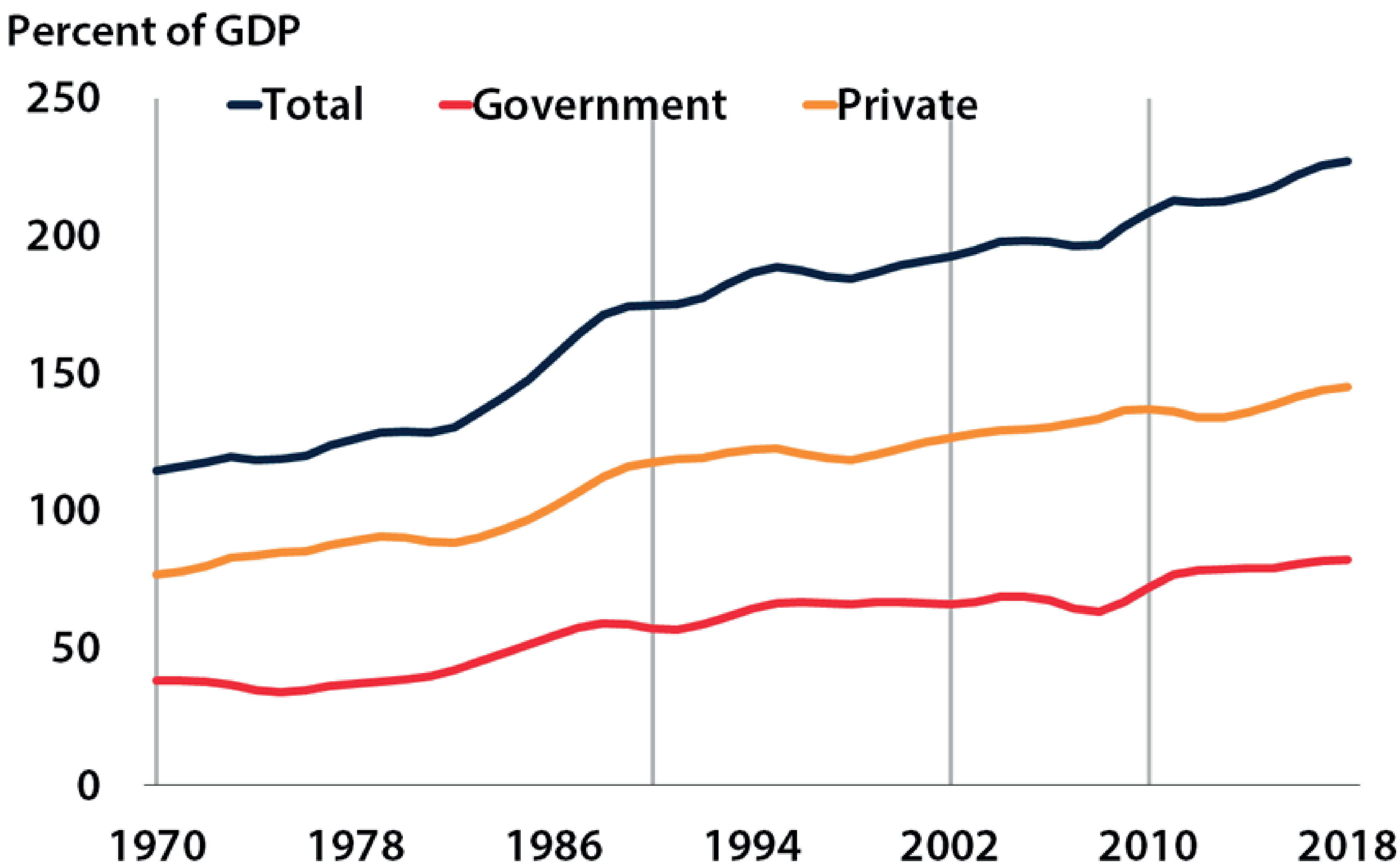
The pandemic of anxiety is particularly troubling for longer-term psychological changes in societies. *"When people are emotionally upset because of a tragic event, they tend to react with fear even in circumstances where there is no reason to fear."*

This is the *"affect heuristic"* - a concept developed by psychologist Paul Slovic, and discussed by Shiller in explaining how the (financial) anxiety pandemic isn't gripping the economy and stock markets of United States alone but in nations world over. Also, both these pandemics, the survival anxiety surfacing from the health pandemic, and the financial/livelihood anxiety emerging from the former may look different but are actually inseparable.

But, for many developing and developed countries (especially those in Europe), there is a third pandemic that may hit affected nations, once the other two begin to subside. This is likely to be shape itself in form of a massive-debt crisis that can potentially grip highly-levered countries for years to come.

Earlier this year, the World Bank released a detailed study warning against a massive debt wave that has been emerging across the world (as seen in Figure 1) for some time now. When debt accumulation is high, any external

Figure 1. Global Debt Accumulation



Source: International Monetary Fund Database

(or exogenous) or endogenous (internal) shock may trigger a debt-crisis. While, it was difficult to speculate what exact shock might trigger such a debt-crisis, the COVID-19 pandemic, might be just that trigger element (as it seems now).

In the last fifty years the global economy has suffered from four waves of massive debt accumulation. The first three waves ended up in a subsequent series of financial crises surfacing in the 1980s (Latin America), and 1990s (South America, East Asia). The fourth wave, surfacing from 2010 (ie. after the subprime crisis in the US) has appeared to be the largest, fastest and most broad-based increase in debt across most economies.

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The total debt has risen by 54 percentage points of GDP to a historic peak of almost 170 percent of GDP in 2018. Emerging economies alone have amassed a record debt-to-GDP ratio of 170%, and are most vulnerable to a debt-crisis now (see Figure 2 (a) (b) for the debt composition of emerging market economies).

In emerging countries like India, Mexico, Colombia, Brazil, Argentina the freezing of economic activity from COVID-19 pandemic-induced shutdowns has almost destroyed their large organized and unorganized, informal segments of the economy, rendering millions of workers jobless with little fiscal support available on offer from the state.

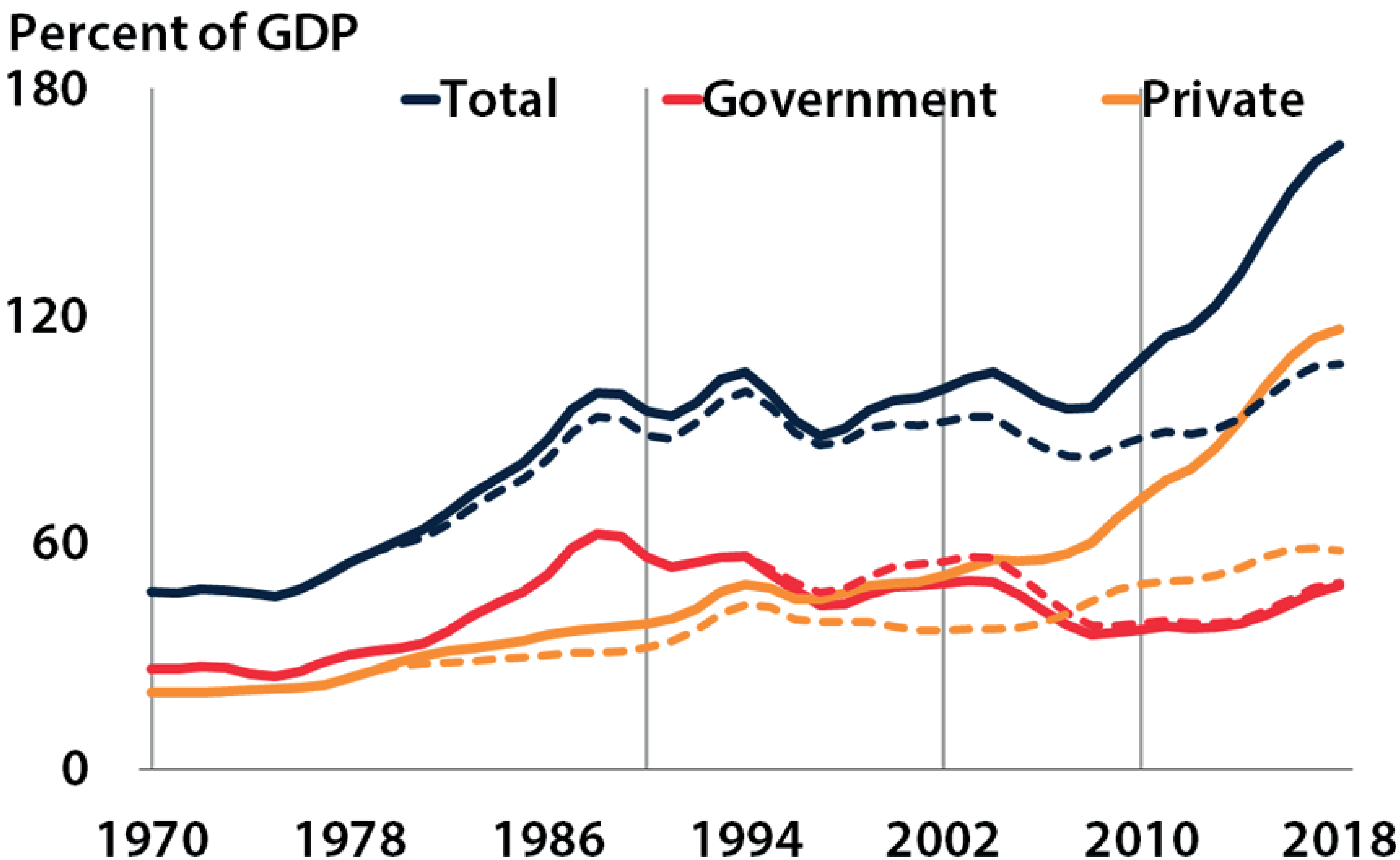
The economic situation has already forced many of these nations to expand their fiscal borrowing capacity in contingency (via internal and external means), that is critical for providing immediate relief to workers, firms and then to help restore confidence in the economy to aid a path to recovery. States are likely to do much more in addressing both the health pandemic and the anxiety pandemic to restore consumer and investor confidence to aid recovery.

Similarly, other high debt ridden developed nations like Italy, Spain, Portugal etc., even since the eurozone sovereign debt crisis had high leverage accumulating across their private, public and household segments of the economy (as seen in Figure 3 below).

How did this accumulation of debt happen at such a large scale?

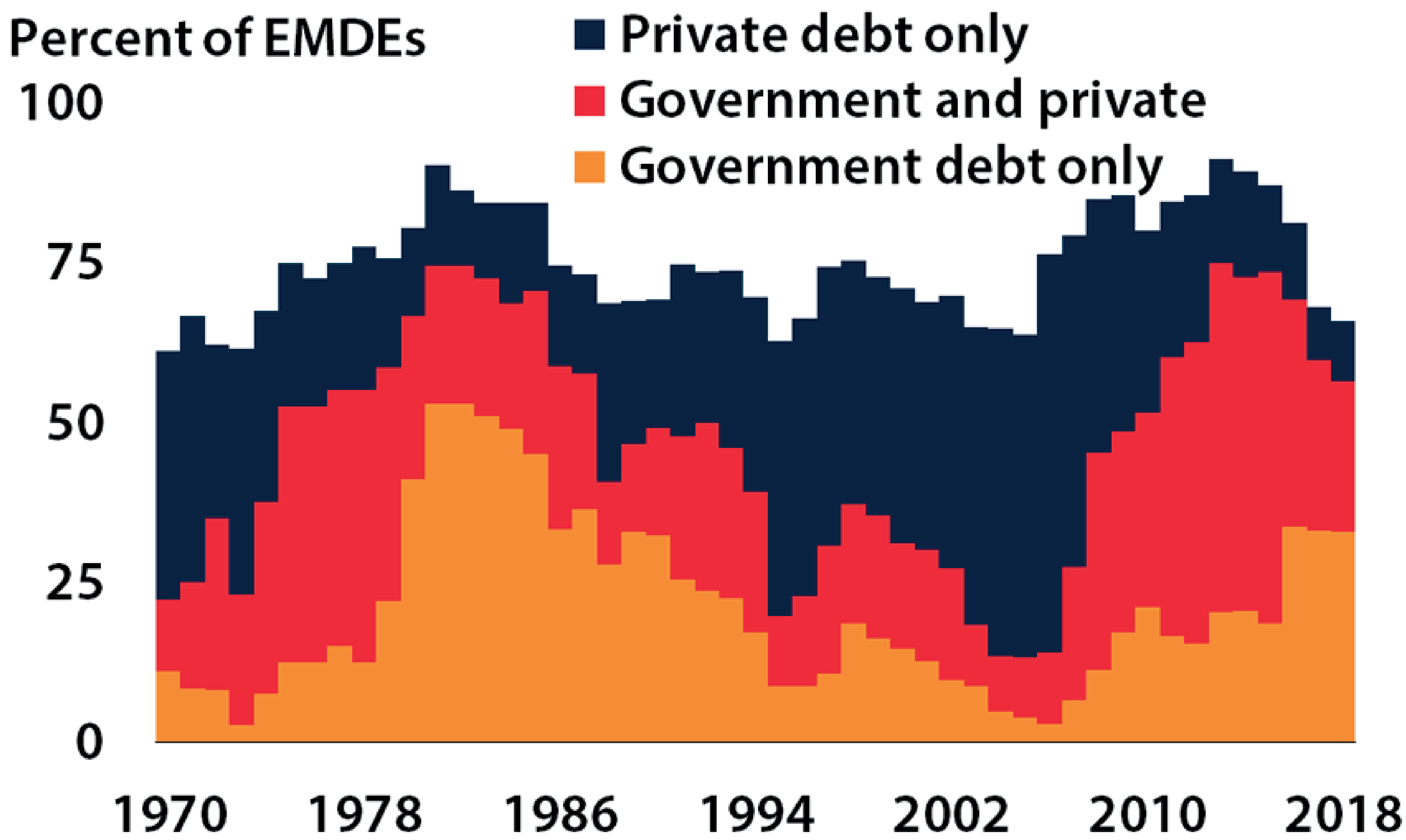
Economists with expertise in crises diagnosis - from Kenneth Rogoff, Maurice Obstfeld, Raghuram Rajan to Gita Gopinath - have been cautioning against a gradual formation of a massive debt-bubble that has been fuelled by cycles of slow growth and low long term interest rates (reducing the cost for borrowing) in many nations (see Figure 4 (a) (b) below).

Figure 2 (a). Emerging Market Developing Economies



Source: International Monetary Fund Database

Figure 2 (b). Share of Debt of Emerging Market Developing Economies in Debt Accumulation Waves



Source: International Monetary Fund Database

Figure 3. Region-Wise Distribution of Government Debt to GDP (%)

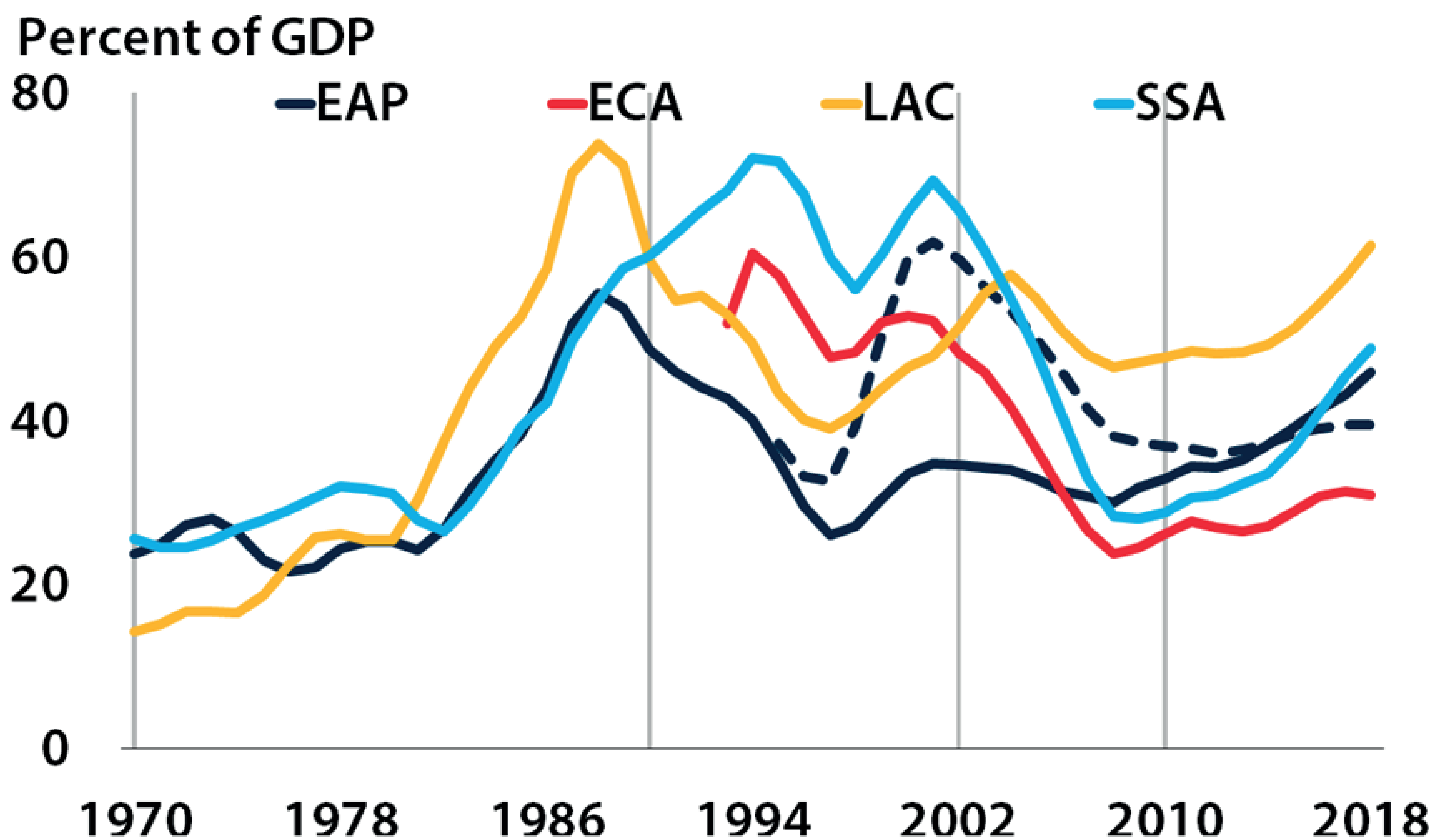
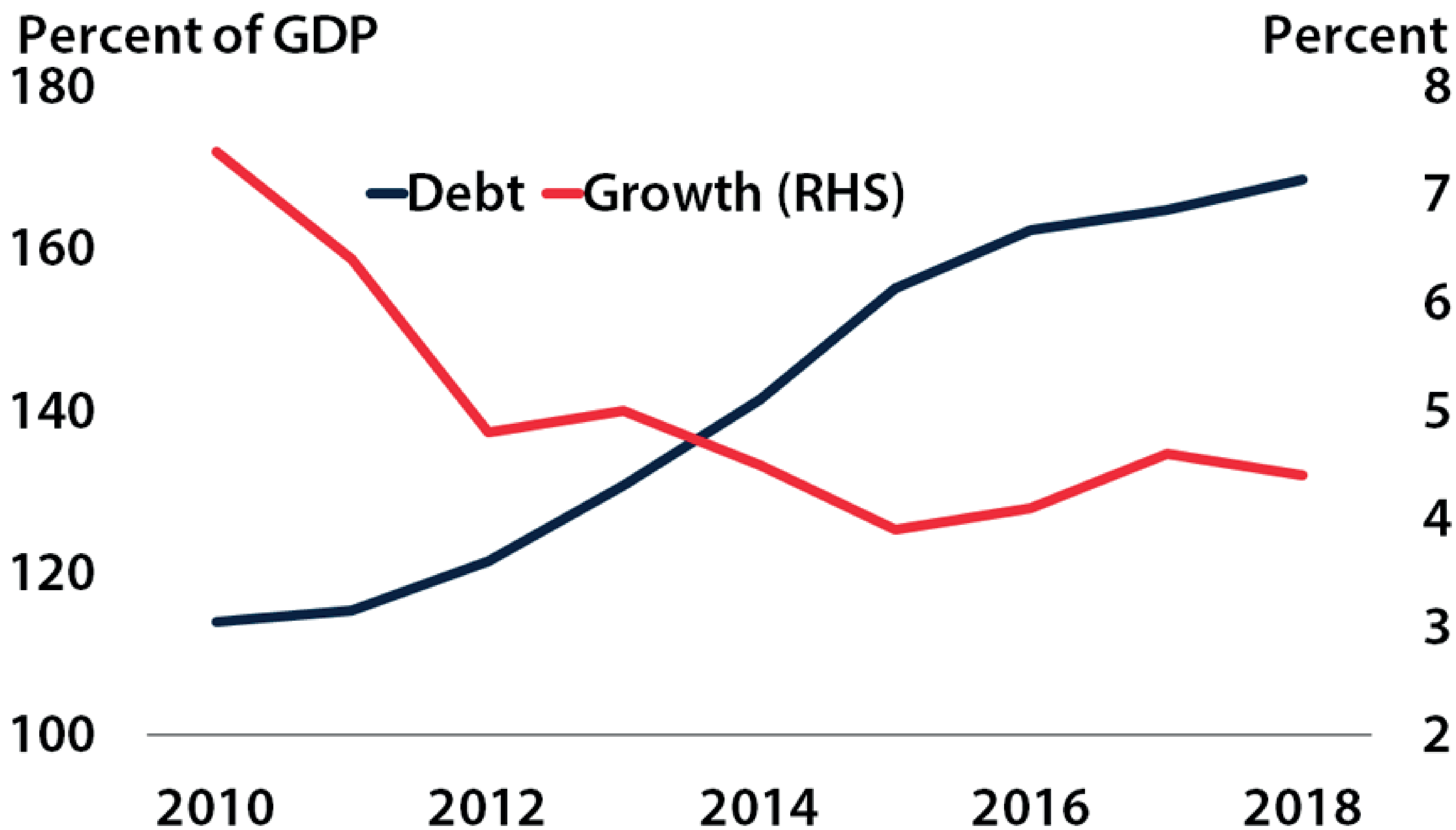
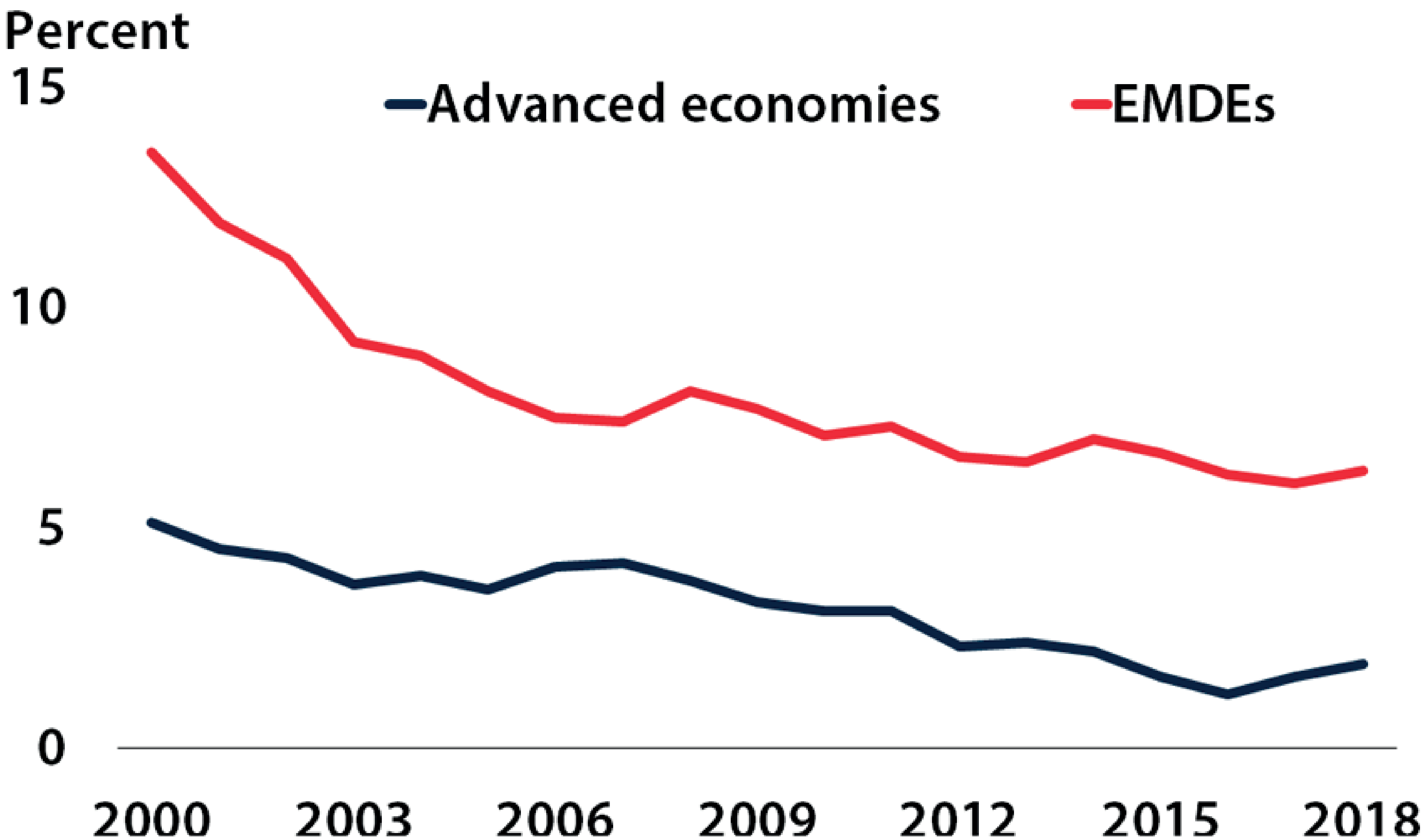


Figure 4 (a). Debt vs. Growth



Source: International Monetary Fund Database

Figure 4 (b). Long-Term Interest Rate



Source: International Monetary Fund Database

This has been down to incentivize higher borrowing capacity for firms and households in low-growth countries, which have further a greater degree of risk to macro-financial stability with more leverage and debt accumulation.

Now, with a shock like COVID-19, massive fiscal stimulus plans; high government borrowings; central banks using helicopter money to inject more cash into the system to both commercial and non-banking financial institutions, with banks and government likely to engaging in massive bond-selling spree (externally and internally), a cascading effect triggering crises in form of debt, currency crashes are likely to surface.

A currency crash for a given set of emerging markets will hyper-inflate the value of short-term external debt in hours. In crises terminology, these culminate as twin-crisis, and if banks have high debt-accumulated as well and consumer confidence in banks drop, then the twin crisis may result in a triple (currency + debt + banking).

India's context is particularly important here. It's economy -even before COVID-19, was performing at its worst level in the last 30 years or so, with low private investment, high unemployment, close to zero export growth, declining consumption, and a crippling financial sector banked with high proportion of Non-Performing Assets (NPAs). Not to mention, the deeply polarized political environment that has aided in quarters of weak investor confidence across sectors.

The actual level of limited growth - for whatever it was - remained strongly dependent on the volume of government spending and consumption (and there are limits to that now). In a pandemic-induced lockdown, when most businesses (in manufacturing and services) have shut-shop due to a lockdown, and unemployment has tripled up to 23% and may only rise in weeks ahead, the Union government's ability to use an expansionary fiscal capacity to assist in a short to medium term economic recovery plan will come at a huge debt-explosion risk.

It is also important to note that States in India are already cash strapped and their revenue-generating capacity is extremely weak in a post-GST fiscal landscape.

It is imperative that, at this stage itself, the Government of India considers creating a parallel National Economic-Recovery Task-Force (as a peer-task force to COVID-19) that develops a collaborative strategy between both private and public sectors with support of State governments, and streamline a set of fiscal incentives (provided in form of tax reliefs and waivers to labour intensive firms) with periodic monetary incentives (similar to what RBI has tried to ensure to maintain enough liquidity in the financial system), and help firms and workers without borrowing excessively.

Any comprehensive economic recovery plan must be planned in conjunction with an economic support plan that aims to provide temporal relief to workers and firms. But this has to be done in a manner that doesn't cause India's gross debt-situation and external borrowing situation to worsen drastically (some changes and compromises are inevitable given the magnitude of our crisis).

One idea, as suggested earlier, is to introduce a retrospective wealth tax of 2-3% on the top 5% income/wealth class. All unproductive government expenditure must be postponed and direct transfers to boost aggregate demand of labour-intensive sectors (and products) need greater prioritisation. That's critical for employment and also for increasing consumption.

Sectors like infrastructure, travel and tourism, hotel and accommodation, textiles, big manufacturing, and other services, will particularly require major support in the months to come after witnessing a vertical I fall in business and economy activity. But these support measures must feature more creative, cooperative solutions between the private and public sector as against a solution that relies solely on the government.

The 'I' curve in economic performance can bend into a 'U' or a 'V' form if pre-emptive measures are taken to tackle all three pandemics in tandem - as against one after the other. ■

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