Interview with Udith Sikand, Senior Emerging Markets Analyst, Gavekal Research Ltd.

Global Investment Analyst Provides Views on the Prospects for a New Economic Society with Covid-19

By *Japan SPOTLIGHT*

Gavekal is one of the world's leading independent providers of global investment research, advising on a select range of funds and offering software solutions to the financial community. Their analyses are aimed at the business community and are thus practical rather than academic. We would do well to listen to business-oriented views as well as academic views at this crucial moment for the global economy.

Udith Sikand is senior emerging markets analyst at Gavekal and he provided us with an interesting perspective on emerging markets and developing economies (EMDEs) under the pandemic in the following interview conducted by email.

(Interviewed on Sept. 2, 2020 by email in answer to our questionnaire)

Udith Sikand

Perception of the Current Global Recession

JS: The short-term implication of the Covid-19 pandemic is that there will be the deepest and most synchronized global recession since World War II. Do you agree?

Sikand: Without a doubt, the global recession caused by the coronavirus pandemic is likely to be the severest since 1945-46. There is arguably no precedent for the speed at which economic activity has collapsed as a result of the quarantines and lockdowns imposed to deal with the public health crisis. The World Bank's Global Economic Prospects report pithily summed it up: "Covid-19 is the most adverse peacetime shock to the global economy in a century."

The good news is that global economic growth is likely to bounce back strongly as restrictions are steadily lifted and the unprecedented monetary and fiscal stimulus measures kick in. However, it is important to recognize that the rebound in global growth rates in the near term will largely occur for mechanical reasons (i.e. a low base effect). Moreover, there are considerable uncertainties including (but not limited to) the epidemiology of the virus, the effectiveness of vaccines currently under development and the efficacy of containment or suppression strategies that could continue to weigh on any recovery in the short term.

Economic Prospects for Advanced Nations & Emerging Markets

JS: What are your estimates for GDP growth rates in advanced nations, EMDEs, and the world in 2020 and 2021?

Sikand: At Gavekal, we generally resist the temptation to undertake forecasts – after all, if anyone could forecast anything, communism would work! The IMF's projections (https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020) are a useful starting point to map out the likely trajectory of global growth over the next two years. And even if the actual growth rates prove to be significantly off the mark, I would generally agree with the broad point about the swing in growth rates in advanced economies (AEs) being stronger than in EMDEs for three reasons. Firstly, policymakers in AEs have generally adopted far more aggressive and direct easing measures than their EMDE counterparts. Secondly, the latter's resource constraints along with the presence of large informal sectors means that stimulus in EMDEs will have a hard time reaching where it is most needed. Lastly, EMDEs are generally far more dependent on external demand as an engine of growth and although EM export volumes may recover quickly on the back of large stimulus packages in AEs, demand is unlikely to be strong enough to generate higher export prices for EMDEs.

JS: What about the long-term prospects for EMDEs, the OECD nations and the world economy? With large losses, do you think in any region there will be no return to pre-Covid trends?

Sikand: Even before the pandemic hit, the long-term prospects for the global economy were looking increasingly grim. On the one hand, the most pressing policy issue for AEs was how to overcome secular stagnation. On the other hand, EMDEs which have accounted for more than two-thirds of global growth in recent years were also grappling with the inevitable slowing of its biggest engine – China.

The pandemic and the extraordinary policy responses it has generated means a lot of the headwinds to global growth have either been upended (e.g. Europe has seemingly shed its penchant for fiscal austerity and embraced debt mutualization) or exacerbated (e.g. the disruption to global supply chains centered around China in the early stages of the pandemic will likely intensify efforts to decouple the world's two largest economies). How the balance of these competing forces stack up and the consequent implications that has for growth in various parts of the global economy may not be clear for quite some time.

However, for the developing world, particularly the world's poorest economies, there is a significant risk that the economic and financial shock has caused permanent damage to their economies. For AEs and even some of the larger EMDEs, raising financial resources to deal with the economic fallout of the pandemic has not proven to be a challenge as central banks have stepped in forcefully to help markets clear. But this is not an option available to the poorer countries that have underdeveloped financial markets and in many cases large amounts of debt already owed to foreign creditors.

A number of multilateral debt relief programs (by the G20 and the Paris Club among others) have been announced and emergency funding is being made available by the IMF and other multilateral agencies at breakneck speed. But without the participation of private sector creditors in debt relief programs and each emergency funding program being dealt with on a case-by-case basis, it is unlikely that these current efforts will be sufficient in terms of speed or size to meet the funding needs of EMDEs to get through the pandemic, estimated by the IMF at nearly US$2.5 trillion.

JS: Will the long-term implications for Covid-19 be weaker potential output, investment and productivity?

Sikand: Recency bias makes it hard to see just how the seemingly inexorable trend towards weaker investment and lower productivity that has characterized the global economy for the better part of the last decade could be altered. Indeed, the fallout from the Covid-19 pandemic seems to suggest that a lot of the underlying trends are likely to get even more firmly entrenched.

However, it is worth recalling that in 1982, at the peak of a worldwide inflation crisis and a global depression caused by 20% interest rates, it was unimaginable that inflation was about to be permanently defeated and that interest rates would fall even to single digits, never mind to the zero and negative levels taken for granted today. Thus, it would be silly to dismiss the possibility that the new global macroeconomic environment characterized by enormous fiscal stimulus that is supported by unlimited monetary expansion could work just as predicted in most mainstream economics textbooks. In other words, Keynesian policies that embrace expansionary demand management could work to boost private sector consumption and investment without generating runaway inflation, echoing the period after World War II until the late 1960s that could be described as the "Keynesian golden age".

Of course, this is not to suggest that Keynesian policies are a sufficient condition to generate rapid growth, for higher investment does not always generate productivity improvements. Still, it is worth contemplating three reasons to be optimistic about the structural and technological drivers of growth in the years ahead. Firstly, a global transformation of energy and transport systems is almost certain as fossil fuels and internal combustion engines are sought to be replaced by renewable energy. Secondly, there is almost certainly going to be an upsurge of investment in technology, science and higher education in China as it seeks to overcome the squeeze being put on its technology firms by the US. Lastly, a revival of economic growth in Europe is now a distinct possibility as a result of the transformation of European Union fiscal politics caused by the Covid crisis.

Concern About Financial Systems in EMDEs

JS: How do you assess the prospect of a financial crisis in EMDEs, as a significant increase in government debt for an expansionary fiscal policy to deal with the recession due to the pandemic could destabilize the financial system in those countries?

Sikand: Historically, bouts of "capital flight" have almost always forced policymakers in EMDEs into a pro-cyclical tightening of monetary and fiscal policy in order to stabilize currencies and avoid a spiral of higher inflation and a rising cost of capital with a long lag before these tightening policy moves are unwound. This time, rather than hiking interest rates to stem currency falls and thwart inflation, EMDEs have slashed rates and prepared the way for quantitative easing policies that can "monetize" debt issued to fund fiscal expansions. As a child of the Washington Consensus, I must admit that I was caught flat-footed by this development as past experience suggested that EMDEs would have to deploy capital controls if they wanted such policy flexibility.

One explanation for the equanimity of markets to these developments is that EMDE policymakers have justified their actions on the basis that they are market-smoothing operations rather than stimulus measures. The fact that EMDEs are conducting asset purchases when they still have scope to ease rates – and have done so in small quantities – certainly supports this notion.

Ben Bernanke has argued that Quantitative Easing (QE) works by (i) cutting the supply of long duration assets to reduce their yields ("portfolio balance effect"), and (ii) showing policymakers' intent to keep interest rates low for a long period (the "signaling effect"). As such, the efficacy of QE can be judged by a yield curve that both shifts downwards and flattens. Yet most EMDEs doing QE today have seen their yield curves steepen, probably because investors want higher term premiums to compensate for institutional deficiencies and higher expected inflation.

To be fair, it is early days and QE-toting EMDEs may eventually see flatter yield curves, as intended. But if this does not happen it is possible – and indeed likely – that formerly cautious EMDE central banks will shed their inhibitions and ramp up purchases, lest their credibility with investors be doubted. It is true that larger EMDE economies today borrow much more in their own currencies than in the 1980s and 1990s – periods characterized by waves of defaults among EMDEs. But the significant presence of foreign institutions in local currency bond markets means they remain vulnerable to capital flight should external liquidity conditions change, or confidence in EMDEs to execute such policies suddenly reverse.

JS: To avoid a financial crisis and enhance productivity in the long run, will structural reforms to reignite growth and improve debt and investment transparency be important for EMDEs in particular?

Sikand: The standard policy prescription given to EMDEs is to undertake structural reforms that would allow them to emulate the so-called East Asian development model that has been used successfully in Japan, South Korea, Taiwan and most recently in China. However, that model has not proven to be universally adaptable even within Asia itself – Thailand and Malaysia are two prominent examples of economies where the early gains from pursuing an export-oriented economic development strategy could not be sustained. Moreover, the East Asian development model, at least in its initial stages, has historically required substantial government interventions such as financial repression, capital controls and the mollycoddling of "national champions". These interventions were coupled with considerable opacity in the operations of the broader financial system in order to allow the socialization of the high initial costs of setting up large-scale manufacturing units capable of producing export-quality goods and the enabling infrastructure.

Striking a balance between the generalized demand for greater political and economic freedoms *vis-à-vis* the desire to maintain political and economic control in order to achieve the long-term development goals is a function of each individual country's unique circumstances – the manufacturing exporters of Central and Eastern Europe face a very different set of challenges as compared to the commodity exporters of Latin America. In this context, it is also important to recognize that policymakers in EMDEs today are faced with Hobson's choice – either they risk the wrath of the market and seek to jumpstart growth using risky policy tools like deeply negative real rates and QE, or they risk the ire of electorates whose economic suffering is exacerbated by the inadequacy of offsetting stimulus measures. The path chosen by various EMDEs, both in the near term as well as the long run, will be just as much a function of their economic circumstances as it is of their political pressures.

JS: What are the major policy issues in East Asia and the Pacific in promoting structural reforms?

Sikand: East Asian economies have achieved considerable economic success by implementing policies that prioritize exports. This strategy is reflected in the substantial current account surpluses across most of Asia that have, in turn, facilitated the accumulation of large stockpiles of foreign assets which are used effectively to tide them over external shocks. However, one corollary to these "excess savings" is that domestic demand, specifically consumption, has been inhibited. Meanwhile, the desire to diversify risks and generate returns has meant that this large and growing pool of Asian savings has helped stoke asset price inflation both at home and abroad.

There is no universal template to solve Asia's problem of excess savings. South Korea and Taiwan could certainly afford to run larger budget deficits to invest in expanding social safety nets, thus reducing the need for high savings among their populace. But the same cannot be said for Japan which already has the highest public debt-to-GDP ratio in the world and a private sector that continues to generate substantial savings simply because there are few profitable investment opportunities in an economy where the population is shrinking.

Even China that has been running "augmented" fiscal deficits worth 8-10% of GDP for several years now has failed to achieve the necessary rebalancing away from an investment-led growth model towards consumption-led growth. Perhaps in recognition of this failure in past policy, President Xi Jinping's recently proposed "dual circulation" model seeks to continue to build out China's export prowess while also providing greater policy support for production facilities that cater to domestic consumption.

However, the crux of the issue is that reorienting China (and indeed the rest of Asia's export-focused economies) towards boosting the domestic consumption share of GDP requires a large shift in the distribution of income, and perhaps even wealth, towards those with a higher propensity to consume. That transition can be difficult to achieve as evidenced by the continued dominance of Japanese *zaibatsu* and Korean *chaebol* in their respective economies and is arguably going to be even trickier in China where the state itself exerts control over vast amounts of wealth.

Global Fiscal Policy Coordination to Reduce Risk of Disruption

JS: What do you think about global fiscal policy coordination, such as a Tobin tax on speculative exchange market transactions by all nations for reduction of fiscal deficits, to enhance fiscal stimulus in all nations to cope with the pandemic crisis?

Sikand: Given the long gestation periods involved in globally coordinated policy actions, it is unlikely that a global Tobin tax will be implemented anytime soon. One example of the difficulties in coordinating policy at a global level can be seen in the OECD's G20 Base Erosion and Profit Shifting Project that was set up to tackle tax avoidance by multinational corporations – an agreement that was expected this year, eight years after the project was announced, is now likely to be delayed further because of the pandemic and renewed disagreements among members. Of course, individual countries could go ahead and impose such a tax unilaterally but past experience of countries (notably Brazil) unilaterally imposing such taxes has shown that the direct and indirect costs associated with imposing a Tobin tax generally outweigh the benefits.

The "End of Shareholder Capitalism"?

JS: Do you think in the post-pandemic age, we will see an end to "shareholder capitalism", as businesses will need to take care of a wide range of stakeholders such as the employees, local communities, and so forth?

Sikand: In the aftermath of the Global Financial Crisis, one major obstacle to a constructive policy response had been the ideology of market fundamentalism. Since the early 1980s, politics has been dominated by the dogma that markets are always right and government economic intervention is almost always wrong. This doctrine took hold in response to the inflationary crisis of the 1970s.

Powerful political interests motivated the revolution in economic thinking of the 1970s. The supposedly scientific evidence that government economic intervention is almost always counter-productive legitimized an enormous shift in the distribution of wealth, from industrial workers to the owners and managers of financial capital, and of power, from organized labor to business interests.

The dominant ideology of government non-intervention naturally intensifies resistance to change among the winners from globalization and technology, and creates overwhelming problems in sequencing economic reforms. To be successful, monetary, fiscal and structural policies need to be implemented together, in a logical and mutually reinforcing sequence.

If market fundamentalism blocks expansionary macroeconomic policies and prevents redistributive taxation or public spending, populist resistance to trade, labor deregulation and pension reform is bound to intensify. Conversely, if populist opposition makes structural reforms impossible, this encourages conservative resistance to expansionary macroeconomics.

But suppose that the "progressive" economics of full employment and redistribution could be combined with the "conservative" economics of labor reform and trade liberalization. Both macroeconomic and structural policies would then be easier to justify politically – and much more likely to succeed. The Covid-19 crisis, and the policy responses it has engendered, looks like it may mark the start of precisely such a confluence of styles in macroeconomic management which is then likely to be combined with and reinforced by a boom in long-term investment driven by energy transformation, European integration and China's need for technological self-reliance. None of these things is certain but hopes of a structurally stronger world economy will become increasingly credible unless there is evidence to the contrary and provided expansionary macroeconomic policies persist.

(The interviewee would like to acknowledge the expertise of his colleagues at Gavekal which has informed some of his responses.)

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