After the Lock-down: Emergence of a New Global Economic Order?
by Sundar Sankaran[1]

Kristalina Georgieva, Managing Director of the International Monetary Fund expects the world to see its worst recession since 1930. This article outlines seven hypotheses, and discusses the dynamics leading to a new global economic order.

In the US, recessions are called by the National Bureau for Economic Research (NBER), a private, non-profit, non-partisan organization. NBER is dedicated to conducting economic research and to disseminating research findings among academics, public policy makers, and business professionals. NBER defines a recession as a significant decline in economic activity spread across the economy, lasting more than a few months (unofficially, it used to be two quarters). The decline in economic activity is normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales. A committee of Ph.D scholars in NBER decide if a recession has arrived – rather like Islamic scholars confirming sighting of the moon crescent!

Viewed through this lens, Kristalina's comment is a no-brainer. Almost the entire world is going to see several months of decline in economic activity. But policy makers, firms and individuals need a more nuanced perspective to support their decision-making.

The problem of the 1930s was not that the Great Recession happened – the bigger problem was that it persisted nearly a decade. The imperative for now is to ensure a soft landing, and aim for a quick U-shaped - if not a V-shaped - recovery.

Nine decades after the event, research continues on what caused the Great Recession in the 1930s. Popular belief is that the October 1929 equity market collapse caused the Great Recession. This is just one of several explanations that academicians have offered. Explaining the past is such a challenge - hypothesizing the future can only be more challenging! But the subject is important enough to take up the challenge. So, here we go.

Many factors compounded the recession problem in the 1930s. Countries were following the gold standard, which meant that currency had to be backed by gold reserves. This meant that pump-priming the economy with greater government expenditure was difficult. Further, the concept of debt itself was less developed.

In the absence of these limitations, we are better equipped today. I expect deficit and debt to power the fight against Recession 2020. Governments will make every effort to ensure that the wheels of consumption do not stall. This is evident from the following measures taken by a few large countries:

- The US Senate has approved $2 trillion (~10% of GDP) in aid to businesses, workers, state and local governments and the healthcare system. This is the largest economic stimulus package in US history.
- Japanese Prime Minister, Shinzo Abe has announced a $1 trillion (~20% of GDP) package.
- European Union finance ministers have agreed on a $0.5 trillion (~2.5% of GDP) stimulus package.
- The Indian Government too has announced a Rs 1.7 lakh crore (~0.8% of GDP) relief package aimed at providing a safety net for those hit the hardest by the Covid-19 lockdown, along with insurance cover for frontline medical personnel.

Some of these numbers need to be taken with a pinch of salt, because they include money committed under old programs, and are strictly not a Covid-specific stimulus. All the same, the measures are similar to what was done to avoid a full-blown recession during the financial crisis of 2008 viz. Governments spending money, and monetary authorities flooding the market with liquidity.

Measures like direct transfer of money to beneficiaries, and free or concessional distribution of grains / food will support the bottom of pyramid population. If efficiently

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managed, this can even become a solution for the livelihood problem. The pandemic will spawn several new last mile delivery and collaboration models, and improve social benefit transfer systems. Helicopter money policy is unlikely because it will lead to social crowding where the money is dropped. (This is unfortunate because I live next to a helipad 😊).

Governments will have to find the money to finance large scale subsistence support. India has started with a salary cut by parliamentarians and people holding constitutional posts. There is talk of a cut in salary of government servants across levels, and even pension of retirees. Government is also directing the private sector to avoid cut backs in jobs and salaries. The difference in economic impact of the same decision by the two types of employers is to be noted:

- Even the most prudent of companies might not have planned for zero revenue for an indefinite time period. So, cutting back on jobs and salaries becomes a survival tactic. If the business does not survive, it will take down all its employees. Such a scenario across the economy might cause a deep and long-term recession. Hence the need for the government to devise a mechanism to keep businesses afloat, rather than hasten their demise.
- When the Government cuts down salaries and pensions, it has a deeper impact. On paper, it generates resources to minimize the fiscal deficit. But it will lead to current and former government servants cutting back their expenditure. Further, such a decision by the government will be a license for non-government employers to cut salaries even if they can afford to pay. The resulting large scale cut back in consumption in the economy will lead to the same recession that the government is trying to avoid! Thus, we get caught in a vicious spiral of salary-cuts leading to more social benefit transfers which need to be financed with another round of salary-cuts. Once an economy is caught in this vicious spiral, it will find it difficult to come out. Ask Japan, which has been caught in a different economic spiral for two decades.

  A serious implication in terms of the country's economic system too needs to be considered. If the number of people who are dependent on (and obligated to) the Government for their subsistence goes beyond a level, the economic system will start looking like that of the erstwhile Soviet-bloc, with its implicit economic and political consequences.

This discussion will be incomplete without mentioning another explanation given by academicians for the Great Depression. According to them, inflexibility in wage (i.e. no cut back in wages) in a deflationary environment caused the Great Depression to continue for the long period it did. There is merit in this argument. Therefore, wide-ranging cuts in salaries will be essential **if we enter a deflationary (i.e. negative inflation) situation.** So long as this economic curse does not fall on us, the Government will have to find means other than salary cuts to manage its finances. Else, through salary-cuts, the Government will end up creating a deflation.

Governments will need to recognize that the real battle-ground for the war on Recession 2020 will be the world of business. The conflict between lives and livelihood was never so stark. As of now, the pendulum is almost completely on the side of lives. The sooner the discourse shifts to ensuring a balance between lives and livelihood, the greater the probability of avoiding a scenario similar to the Great Recession. This shift of pendulum is not so easy. Inherently, there is tension between democratic Heads of State not wanting to take the political risk of veering away from lives as the driver of decisions; and the reality that lives without livelihood can be hollow - and livelihood of people is linked to survival of businesses. Not every leader has the luxury that President Xi Jinping of China enjoyed, to quickly and confidently lift the lockdown at the source of the Covid pandemic.

Against this backdrop, I outline seven hypotheses for the way forward.

Hypothesis 1: There may not be an extended global recession of the 1930s type

Purists can justifiably question the philosophy of high fiscal deficit and extended periods of easy money policy. But they do not have a credible alternate narrative on how to handle the situation that we find ourselves in. Economic profligacy will support consumption, keep factories running, keep sweat-shops sweating & minimize unemployment issues. This should help avoid the 1930s type of extended global recession. Individual countries could still face deep recessions, depending on their choices between lives and livelihood, their fiscal strategy and some other factors outlined below.

Hypothesis 2: Macro-economic fundamentals will determine countries' pain points and opportunities

Profligacy has its inevitable consequences. Warren Buffet and Bill Gates can blow a billion dollars and remain unfazed and untouched. They have past wealth to support the profligacy. Through a complex set of checks and balances, past wealth of countries is captured in the reserves of their monetary authorities. The reserves are a protection against adversity. Whenever the need arises, these reserves can be used to subscribe to bonds issued by the Government to fund the bump in fiscal expenditure. The alternate format for government financing viz. printing notes can cause inflationary spirals.

In India, a committee of wise men (there were no women) made a comparison of the reserves of Reserve Bank of India (RBI) with the reserves of several countries including:

- US (which does not face an exchange-rate risk on account of the dominant position of the USD in international flows);
- A few countries whose currency can be viewed as *reserve currency* (i.e. mature enough to be held by central banks of other countries as part of their foreign currency reserves); and
- Some Latin American countries (the region has a history of economic turmoil).

The committee concluded that RBI had too much reserves, and these could be better utilized by the Government. Accordingly, some of these reserves were transferred to the Government on August 26, 2019. The amount – Rs1.7lakh crore! Eerily similar to the size of the first stimulus package mentioned above?

Normally, when fiscal deficit shoots up, inflation also raises its head. Fortunately, fuel prices are low for now. Commodity prices too may be low until global activity picks up. This will provide some relief for India, but will give a huge impetus for other countries that are import-dependent for energy and commodities, but do not share the same fiscal problem. These countries are in the best position to benefit from the flux in global business environment.

Hypothesis 3: Exchange Rates will re-align globally

If a country's inflation is much higher than that of its peers, then its goods and services lose their competitiveness vis a vis those peers. Exchange Rates are a rather blunt tool to correct for such lack of competitiveness. When a country's currency weakens, competitiveness that is lost to inflation is recouped. The process of weakening of the currency can be driven by either conscious government policy, or international investors fleeing the country. The problem with the latter is that exchange rates might correct sharply, and potentially create a foreign exchange problem for the country.

Significant differences in economic policy and inflation between countries could lead to high volatility in exchange rates, until a new equilibrium is established. If the equilibrium is not restored soon, then globally co-ordinated action cannot be ruled out. Global co-ordination is inevitable if exchange rate movements hurt any "powerful" country.

On balance, it looks like the Indian rupee might need to depreciate. However, the healthy foreign currency reserves of about USD475bn should protect the country against any foreign exchange problem, so long as economic policy is sensible.

Hypothesis 4: Companies will re-align their global value chains

The world has learnt the benefits of geographical diversification of their value chain. Supply chains will see a shift away from China. The quick rebound of China is a boon for companies. But soon, companies will start strategic shifts of their sourcing to other countries, even if the cost goes up. Covid-19 will therefore be a great leveler for China. The country will perhaps be the biggest loser from the pandemic.

Can Japan, which ceded space to China decades ago, win back its position? Seems unlikely. The beneficiaries of this re-alignment might well be some of the erstwhile Asian tigers (Hong Kong, Singapore, South Korea and Taiwan). Hong Kong, for political reasons will find it difficult. The dark horses could be countries like Bangladesh and Philippines. In any case, the dominance that China shares with the US in a bi-polar trade world, might get re-distributed among a few other countries. US might well be an unintended beneficiary of this re-alignment.

For India to benefit, the Government will have to play its cards really well, and provide protection to companies from not only Covid-19 but also policy flux. This, together with depreciation of the rupee, can help India partly benefit from the re-alignment of global value chains. But the dice is loaded against India, especially on account of geo-political risks.

Hypothesis 5: Business structure of countries will shift towards "large"

Larger companies have their strengths in access to capital for weathering the storm, ability to influence policy, and, let us not forget, they may be "too big to fail". It is also easier for Governments to quickly influence the overall economic landscape by working with a few large companies, as compared to tens of thousands of smaller companies. This is good news for the large companies, as well as companies that are closely integrated to their value chain.

In India, the words of Niti Ayog Vice Chairman, Rajiv Kumar are an indication of where we are headed. He is quoted in the Economic Times (April 11, 2020): "We have too large an informal sector in our economy where our workers have no social safety net, where it is difficult for us to bring about any semblance of proper working conditions," Kumar said. "This informality of our workforce — 90% of them are in the informal sectors — has to be brought to a close." A discussion on appropriateness of this line of thinking is beyond the scope of this article.

Survival of companies that are not aligned with large companies would depend on:

- The extent of fixed operating costs in their business (operating leverage of the sector to which they belong);
- Their borrowings (financial leverage of the company);
- The cushion they have built in the form of reserves.

Sectors like airlines and hospitality suffer a double whammy in terms of adverse change in consumer behavior as well as high operating leverage. Companies in these sectors that also have high financial leverage will suffer a triple whammy which will make it difficult for them to survive.

Hypothesis 6: Role of financial investors in business will increase

In the impending shake-out, several businesses across the world will fold up or change hands. Non-financial operating companies will need to use their moneys sparingly. They may or may not wish to acquire the companies that are changing hands, especially if they are sitting on excess capacity. On the other hand, vulture funds and other distressed asset funds may see an opportunity in this space. Thus, business ownership structure might shift towards such funds. Is this a good thing to happen? Again, beyond the scope of this article.

Hypothesis 7: Blood-bath in the financial sector
Someone has to bear the brunt of such a chaotic environment. Banks and shadow-banks (Non-banking finance companies) that have lent money to businesses which fail will have to take the hit in their balance-sheet. This might well be the last straw for the sector in India, which was in any case struggling to survive. So, we can expect more contributions from the government to re-capitalize the institutions that are "too big to fail" (adding to fiscal deficit); and more merger of struggling institutions with those that are capitalized. Thus, it will be business as usual – not banking business, but re-structuring business! More on the subject can wait for another article.

In conclusion, the world may see a recession that matches (or even surpasses) the intensity of the 1930s Great Recession, but its duration might be shorter. Extended and deep recession in some countries cannot be ruled out. A new global economic order could emerge, depending on the inherent strengths of the countries, and their economic policy. China will be the only clear loser, caught as it is, in a "heads you win, tails I lose" quagmire – a rare case of swift free-market economic retribution for initial secrecy about the virus.