An Uneven Recovery

US recovering faster than emerging economies presents a policy challenge for latter

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WITH THE PASSAGE of Joe Biden's $1.9 trillion coronavirus relief package receiving final backing from the US House of Representatives, the cumulative fiscal stimulus to heal the pandemic-scarred US economy amounts to a staggering 25 per cent of GDP. This reliance on fiscal stimulus to boost US growth is in sharp contrast to the policy response in the aftermath of the 2008 global financial crisis (GFC) when monetary policy was the main tool to ramp up the economy. The over reliance on fiscal measures this time around is understandable given the "liquidity trap" — interest rates are already treading close to zero. Also, in hindsight, fiscal policy post GFC was criticised for being conservative. So, what does this mean for the US and emerging economies?

From the US perspective, this is good news. There is a general consensus that the economic recovery in the US has indeed been V-shaped. The Brookings Institute estimates that the package would boost US real GDP growth by about 4 per cent at the end of 2021 and 2 per cent at the end of 2022, relative to a projection that assumes no additional fiscal support. In fact, the economy is expected to converge to the pre-pandemic GDP projection after the third quarter of 2021, exceeding it by 1 per cent in the fourth quarter.

The impact on emerging economies is less certain. A booming US economy generally bodes well for global growth as higher demand "spills over" to the rest of the world. However, the sectoral contribution to US growth presents a different picture this time.

With the fiscal stimulus in emerging economies being much smaller, the vaccine roll out remaining slower relative to the richer counterparts and the US recovery largely being led by the non-tradable sector, we should expect a divergence in growth between the US and emerging countries. The OECD's latest economic outlook forecasts that by the end of 2021, the US economy will converge back to the pre-pandemic trend growth but other emerging economies would still be far below the pre-pandemic projections.

Recently-released US GDP estimates suggest that the higher than anticipated growth in the latest quarter was largely led by a recovery in the services (non-tradable) sector. Private consumption of goods (tradable) is already back to pre-pandemic levels, while consumption of services remains significantly below pre-pandemic levels. As the vaccination drive gathers pace in the US and the economy slowly opens up, it should be fair to assume that the non-tradable sector would be driving growth. This is not to say that emerging economies will not benefit from a booming US economy, but given the expected nature of the underlying growth, the positive impact on emerging economies will perhaps be softer.

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This unequal nature of growth presents a policy challenge for emerging economies that is very different from what they had to face post-GFC. Post-GFC, a combination of zero interest rates and quantitative easing in advanced economies led to a significant surge in capital inflows to emerging countries in search of higher yield leading to an appreciation of their currencies. Now, the situation is exactly the opposite. The differential rate of recoveries has already led to capital outflow from emerging economies. The hardening of the US yield curve may further fuel capital outflows in coming days leading to tighter monetary conditions in emerging markets.

So what is the likely policy response from emerging economies? Depending on the country-specific macro-economic fundamentals, emerging economies may either respond by letting their currency depreciate or by increasing domestic rates to contain outflows. As far as India is concerned, the macroeconomic fundamentals are much stronger than during the taper-tantrum days which provides a much-needed cushion to deal with currency outflows. The foreign exchange reserves remain at historically high levels, the current account situation is comfortable and the inflation rate remains within the target band of the RBI. In the event of capital outflows, the RBI should let the currency depreciate as the first line of defence to preserve India's external competitiveness and intervene only to smoothen out extreme volatility. It should avoid the temptation to increase interest rates at the risk of hurting the pace of economic recovery.

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