



FINANCE AND DEVELOPMENT

JUNE 2021

**A COVID-19
tantrum?** P.24

**Rohini Pande
profiled** P.34

**Citizenship
for sale** P.50



What Next For Emerging Markets?

Contents



Emerging markets must reclaim their hard-won economic strength as they recover from the pandemic.

WHAT NEXT FOR EMERGING MARKETS?

- 4 Miles to Go**
Emerging markets must balance overcoming the pandemic, returning to more normal policies, and rebuilding their economies
Rupa Duttagupta and Ceyla Pazarbasioglu
- 10 Is the Emerging World Still Emerging?**
Two decades on, the BRICs promise lingers
Jim O'Neill
- 12 End of the Line**
A looming oil price super cycle will likely be the last
Rabah Arezki and Per Magnus Nysveen
- 16 Global Clout, Domestic Fragility**
China's long-term success will depend primarily on addressing its internal challenges
David Dollar, Yiping Huang, and Yang Yao
- 20 Inequality in the Time of COVID-19**
All metrics are not equal when it comes to assessing the pandemic's unequal effect
Francisco H. G. Ferreira
- 24 A COVID-19 Tantrum?**
The Federal Reserve's post-pandemic stance will expose vulnerabilities in emerging markets with high private external debt
Şebnem Kalemli-Özcan
- 28 Emerging Markets in Flux**
Mahmood Pradhan chats with Richard House and David Lubin on the outlook for this group of countries
- 31 From Stream to Flood**
Streaming video offers emerging markets an avenue for content at home and around the world
Adam Behsudi



ALSO IN THIS ISSUE

40 Monetary Meld

A currency union encompassing all of West Africa promises benefits but faces a multitude of obstacles
Eswar Prasad and Vera Songwe

44 Inequality Interest

Central banks should better communicate monetary policy's distributional effects
Nina Budina, Chiara Fratto, Deniz Igan, and H  l  ne Poirson

50 Citizenship for Sale

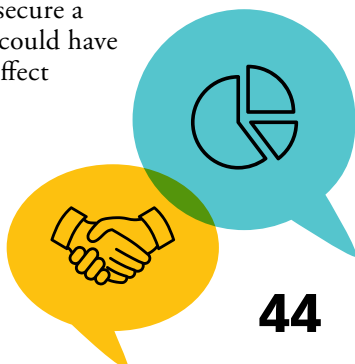
Programs that offer passports in return for investment have financial integrity risks that must be managed
Francisca Fernando, Jonathan Pampolina, and Robin Sykes

53 What We Owe Each Other

We need a new social contract fit for the 21st century
Minouche Shafik

58 Military Spending in the Post-Pandemic Era

Countries' efforts to secure a more peaceful world could have a positive economic effect
Benedict Clements, Sanjeev Gupta, and Saida Khamidova



DEPARTMENTS

34 *People in Economics*

Inclusive Innovator

Peter J. Walker profiles Yale's **Rohini Pande**, whose work focuses on how better institutions can make life fairer

38 *In the Trenches*

Putting People First

South Africa's longest-serving finance minister, **Trevor Manuel**, reflects on the country's lost decade

48 *Back to Basics*

Risk and Return: The Search for Yield

Low rates of return tempt investors to take risks, which can cause economic and financial instability
Jay Surti

56 *Picture This*

Jobs Dilemma

Creating sufficient employment in emerging market economies will require a big boost to economic growth

63 *Book Reviews*

The Spirit of Green: The Economics of Collisions and Contagions in a Crowded World, William D. Nordhaus

Rebellion, Rascals, and Revenue: Tax Follies and Wisdom through the Ages, Michael Keen and Joel Slemrod

The Profit Paradox: How Thriving Firms Threaten the Future of Work, Jan Eeckhout





The Next Move

WE FOCUS THIS ISSUE on the road ahead for emerging markets, a label frequently applied to economies in the middle—neither advanced nor low-income. Because of their growing systemic relevance, this group of countries helps anchor global stability. Yet, as we drill down and define their characteristics, we find a widely diverse set of economies of varying sizes and growth rates that face different prospects, priorities, and challenges.

Some, like China, have managed to emerge quickly from the present crisis. Others may struggle for years to deal with the pandemic's aftereffects.

Amid a multispeed economic recovery—including within countries and across sectors, age groups, genders, and skill levels—this issue explores several cross-cutting themes for emerging markets. The IMF's Rupa Duttagupta and Ceyla Pazarbasioglu take stock, with a focus on debt, economic policy trade-offs, and priorities for stronger growth. Two leading investors, Richard House and David Lubin, discuss how emerging market assets have fared during the pandemic and why they are unlikely to suffer systemic crises as in the 1980s and 1990s. Şebnem Kalemli-Özcan, in contrast, sees the potential for greater turbulence as US interest rates rise. Francisco Ferreira shows that the pandemic's effect on inequality is manifested in counterintuitive ways, depending on how you measure it. And 20 years after coining the acronym "BRICs," Jim O'Neill reconsiders the diverging fortunes of Brazil, Russia, India, and China.

While this crisis will leave scars, it would be inaccurate to see only adversity ahead. Emerging markets can not only reclaim their hard-won economic gains, they can do even better than before the pandemic. This will require well-calibrated economic policies and strategies that improve access to health care and education, support and retrain displaced workers, and strengthen public investment in green projects and digital infrastructure. The goal is to build more inclusive economies that benefit everyone, while ensuring macroeconomic stability.

As in a chess game, every move by leaders and policymakers has consequences. Let them be the right ones. **FD**

GITA BHATT, editor-in-chief



ON THE COVER

Our June cover by Daniel Garcia Art depicts emerging markets' struggle with COVID-19, market turbulence, and the specter of mounting debt as a chess game. Just as pawns can be "promoted" with the right moves, these countries can overcome challenges with the right policies.

EDITOR-IN-CHIEF:

Gita Bhatt

MANAGING EDITOR:

Maureen Burke

SENIOR EDITORS:

Andreas Adriano
Analisa Bala
Adam Behsudi
Peter Walker

DIGITAL EDITOR:

Rahim Kanani

ONLINE EDITOR:

Lijun Li

PRODUCTION MANAGER:

Melinda Weir

COPY EDITOR:

Lucy Morales

ADVISORS TO THE EDITOR:

Bernardin Akitoby	Mame Astou Diouf
Celine Allard	Rupa Duttagupta
Steven Barnett	Deniz Igan
Nicoletta Batini	Christian Mumssen
Helge Berger	İnci Ötker
Paul Cashin	Catriona Purfield
Martin Čihák	Mahvash Qureshi
Alfredo Cuevas	Uma Ramakrishnan
Era Dabla-Norris	

© 2021 by the International Monetary Fund. All rights reserved. For permission to reproduce any F&D content, submit a request via online form (www.imf.org/external/terms.htm) or by e-mail to copyright@imf.org. Permission for commercial purposes also available from the Copyright Clearance Center (www.copyright.com) for a nominal fee.

Opinions expressed in articles and other materials are those of the authors; they do not necessarily reflect IMF policy.

Subscriber services, changes of address, and advertising inquiries:

IMF Publication Services
Finance & Development
PO Box 92780
Washington, DC 20090, USA
Telephone: (202) 623-7430
Fax: (202) 623-7201
E-mail: publications@imf.org

Postmaster: send changes of address to *Finance & Development*, International Monetary Fund, PO Box 92780, Washington, DC 20090, USA.

The English edition is printed at Dartmouth Printing Company, Hanover, NH.

Finance & Development is published quarterly by the International Monetary Fund, 700 19th Street NW, Washington, DC 20431, in English, Arabic, Chinese, French, Russian, and Spanish. English edition ISSN 0145-1707



FSC FPO

IMF ECONOMIC REVIEW

The official research journal of the IMF

High-quality, peer-reviewed research
on open-economy macroeconomics
and related fields



- Featuring articles by leading scholars, such as Paul Krugman, Olivier Blanchard, Viral Acharya, Hyun-Song Shin, Stanley Fischer, and more
- Influencing academics and policymakers worldwide
- Covering some of the most important economic issues of our time

For free sample content, subscription information, and author submission guidelines
visit www.palgrave.com/journal/41308

ISSN: 2041-4161; EISSN: 2041-417X

Five-year Impact Factor: 2.658

MILES *to go*

Emerging markets must balance overcoming the pandemic, returning to more normal policies, and rebuilding their economies
Rupa Duttagupta and Ceyla Pazarbasioglu



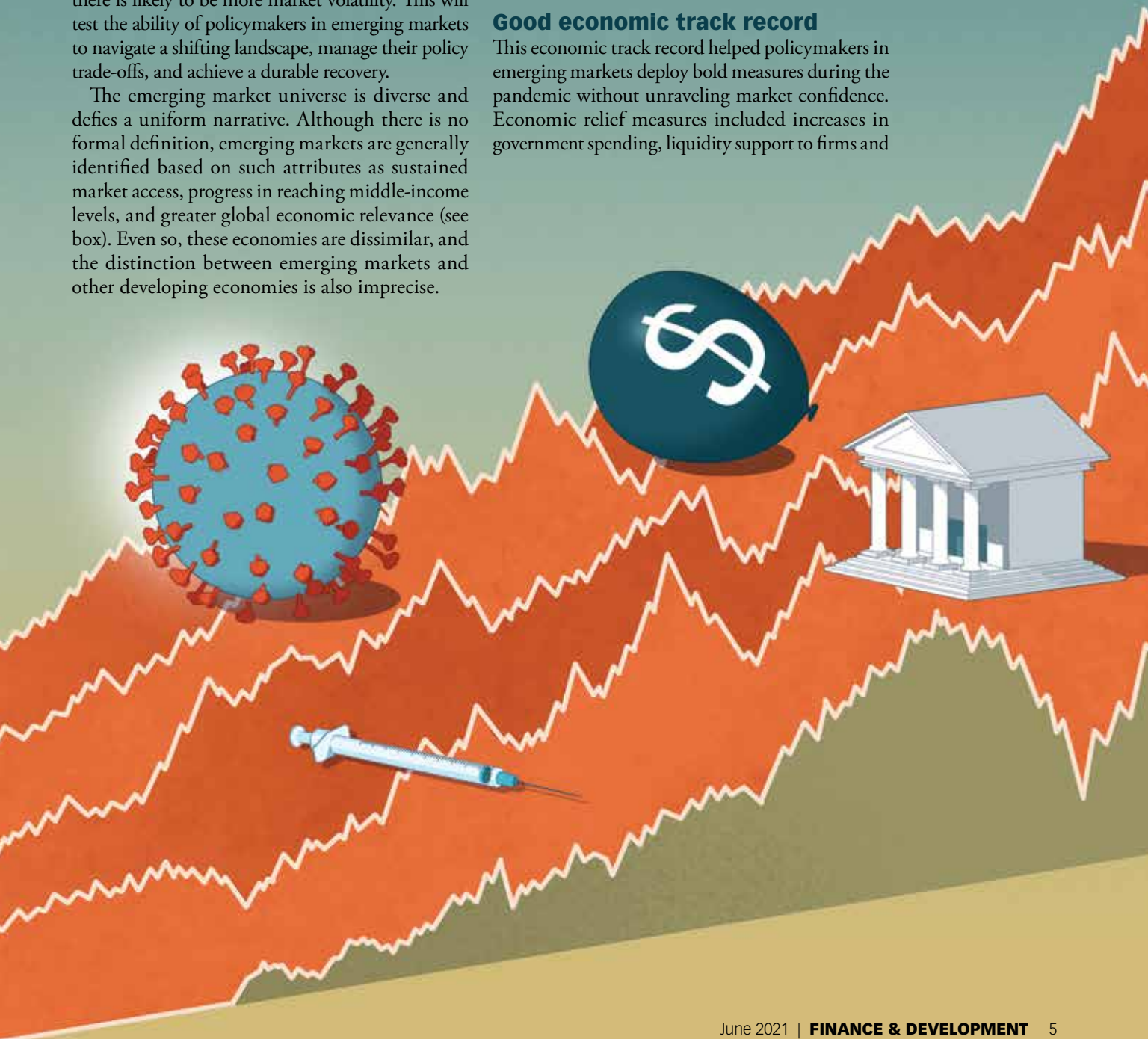
As the COVID-19 pandemic enters a second year, concerns are rising about how well emerging markets will fare. So far, they have been agile in responding to the economic fallout from the pandemic with unprecedented rescue packages for their hard-hit sectors and households. After a short-lived period of financial stress in March 2020, most emerging markets were able to return to global financial markets and issue new debt to meet their financing needs. However, in a global recovery in which some countries are rebounding faster than others and uncertainty is high regarding the pandemic, there is likely to be more market volatility. This will test the ability of policymakers in emerging markets to navigate a shifting landscape, manage their policy trade-offs, and achieve a durable recovery.

The emerging market universe is diverse and defies a uniform narrative. Although there is no formal definition, emerging markets are generally identified based on such attributes as sustained market access, progress in reaching middle-income levels, and greater global economic relevance (see box). Even so, these economies are dissimilar, and the distinction between emerging markets and other developing economies is also imprecise.

Emerging markets have made remarkable progress in strengthening their macroeconomic policies since the turn of the century, which helped them more than double per capita incomes on average. Monetary policies in 65 percent of the countries we have identified as emerging markets follow forward-looking inflation-targeting regimes, and inflation has fallen and stabilized in most. Public finances in several are guided by fiscal rules. Many embraced major banking sector reforms after the financial crises of the 1990s. Progress was tempered by the global financial crisis in 2008–09, but not derailed.

Good economic track record

This economic track record helped policymakers in emerging markets deploy bold measures during the pandemic without unraveling market confidence. Economic relief measures included increases in government spending, liquidity support to firms and



banks, release of bank capital buffers with the intent to support lending, and asset purchase programs by central banks to stabilize domestic markets. Low domestic inflation and monetary easing by advanced economies also gave central banks in emerging markets room to cut domestic policy rates substantially. Household savings increased in most emerging markets following the onset of the pandemic. Much of the domestic savings went to finance the government, reducing the need for foreign borrowing, which, together with lower private investment, kept current account deficits in check.

However, some measures—such as direct monetary financing of budget deficits or temporary freezes on loan repayments—raise new risks. Policymakers defended them as temporary tools to alleviate enormous economy-wide strains. Higher fiscal deficits have also added to already elevated sovereign debt in some countries. In others, high corporate sector debt, including of state-owned enterprises, and unhedged foreign exchange exposures in corporate debt pose contingent fiscal risks in the event of corporate distress. Increased government debt held by domestic banks also intensifies the link between the health of the government and that of the banking system.

The pandemic is far from over, so it is too early to determine which measures have worked. Economic activity contracted sharply in most emerging markets in 2020. However, the IMF's April 2021 *World Economic Outlook* estimates suggest that without the policy measures implemented across the world—including in advanced economies and emerging markets—the contraction in global GDP would have been three times worse.

Divergent responses

Divergent recoveries in emerging markets reflect differences in economic positions and policy responses. Those that were able to contain the virus or inoculate their populations (such as China and the United Arab Emirates) are recovering earlier. Those with ample fiscal buffers, market access, or both were able to deploy greater fiscal support (such as the Philippines and Poland). Central bank credibility allowed some to cut policy rates to record lows and engage in unconventional monetary policy without severe exchange rate pressure (Fratto and others 2021). Emerging markets with macroeconomic imbalances or elevated debt burdens continue to face sharp trade-offs between supporting recovery and reducing imbalances (among them Argentina, Egypt, and Turkey).

The road ahead could be somewhat bumpier. Because of threats from new COVID-19 strains, countries will have to weigh the many trade-offs between continued efforts to mitigate spread of the virus—which will likely require maintaining economic support to households and firms—and normalizing policies and rebuilding economic resilience. Securing adequate vaccines is only a first step. Financial market volatility against a backdrop of rising US long-term rates must be deftly managed, particularly for countries with large external financing needs. And political and social support will be central to implementing structural reforms. There are a number of areas requiring policy action, although the priorities will vary from country to country.

Targeting corporate sector support: As the health crisis comes under control, countries must begin to transition from wholesale crisis emergency support measures to those that target support to viable firms and eventually allow a handover to private-led growth. How fast this can be done will depend on the link between growth and employment in the corporate sector and whether a country can afford to support viable firms long enough to allow them to shake off pandemic-induced distress. How efficiently that happens will depend on the strength of labor market institutions, safety nets, banking system oversight, and insolvency procedures for a smooth reallocation of resources. As shown in the IMF's April 2021 *Global Financial Stability Report*, distinguishing between corporate liquidity and solvency will not be easy. Some companies in emerging markets entered the crisis with already elevated debt, and the economy-wide implications of corporate distress need to be better assessed.

While advanced economies face similar challenges, the ensuing trade-offs are likely to be more acute for emerging markets because they typically face more imposing budget constraints. Emerging markets also tend to have weaker frameworks to deal with corporate bankruptcies. Policy interventions must therefore be designed to reduce both risks from excessive liquidations that lead to a wave of bankruptcies and risks of creating zombie firms that can operate on excessive credit support but cannot invest in new activity (Pazarbasioglu and Garcia Mora 2020). Past experience (such as Poland in 1992, Mexico in 1994, many southeast Asian countries in 1997–98, and Turkey in 2001) suggests that successful strategies include timely asset quality reviews



What is an emerging market?

There is no official definition of an emerging market. The IMF *World Economic Outlook* classifies 39 economies as “advanced,” based on such factors as high per capita income, exports of diversified goods and services, and greater integration into the global financial system. The remaining countries are classified as “emerging market and developing” economies. Among these, 40 are considered “emerging market and middle-income” economies by the IMF *Fiscal Monitor*, based on their higher incomes.

Income isn’t the only characteristic of an emerging market. Most are economies with sustained strong growth and stability that can produce higher-value-added goods and are more like advanced economies not only when it comes to income, but also in participation in global trade and financial market integration. To identify an emerging market, we looked at

- Systemic presence: The size of the country’s economy (nominal GDP), its population, and its share of exports in global trade
- Market access: The share of a country’s external debt in global external debt, as well as whether it is included in global indices used by large international institutional investors and the frequency and amount of international bonds issued
- Income level: A country’s GDP per capita in nominal US dollars

We derive a score for each economy not considered advanced, using five weighted variables:

- $0.40 \times \text{nominal GDP} +$
- $0.15 \times \text{population} +$
- $0.15 \times \text{GDP per capita} +$
- $0.15 \times \text{share of world trade} +$
- $0.15 \times \text{share of world external debt}$

If a country is ranked in the top 20 for 2010–20, it receives a score of 1 for that variable. Otherwise, it is assigned zero. The final score is calculated as the weighted sum of the individual scores. This approach identifies the following countries in the emerging market group, in alphabetical order: Argentina, Brazil, Chile, China, Colombia, Egypt, Hungary, India, Indonesia, Iran, Malaysia, Mexico, the Philippines, Poland, Russia, Saudi Arabia, South Africa, Thailand, Turkey, and the United Arab Emirates. Two countries were excluded: Nigeria because of its classification as a low-income country (eligible for IMF Poverty Reduction and Growth Trust financing) during the sample period considered (2010–20) and Qatar because of its population of less than 5 million.

These 20 emerging market countries account for 34 percent of the world’s nominal GDP in US dollars and 46 percent in purchasing-power-parity terms. These countries are also featured in commonly used indices for emerging markets, such as those of J.P. Morgan, Morgan Stanley Capital International, and Bloomberg.

FRANCISCO ARIZALA is an economist and **DI YANG** is a research analyst in the IMF’s Strategy, Policy, and Review Department.

as well as a combination of out-of-court workouts, debt relief, and disposal of nonperforming assets (Araujo and others, forthcoming).

Because bank-based financing is more prevalent than market financing in emerging markets, corporate distress could affect financial stability if banks have to recognize increased loan losses after the pandemic. To provide greater transparency, bank asset quality reviews may be necessary in some cases—especially because regulatory measures were eased during the crisis. The rise of shadow, or nonbank, financing of the corporate and household sectors in some emerging markets also raises risks because the nonbank sector is largely unregulated. Hence, a longer-term priority is designing stronger debt resolution and insolvency regimes and developing so-called macro-financial tools to monitor risks to the overall economy from the nonbank financial sector.

Generating job-rich, balanced, and sustainable growth:

Beyond the immediate recovery, a vital step toward long-term economic health is raising productivity and lessening the scarring effects of the crisis on investment, employment, human capital (because of setbacks to learning), and financial system strength. The long-term growth payoffs from structural reforms can be significant if they are well designed and properly sequenced (Duval and Furceri 2019). Some priorities include

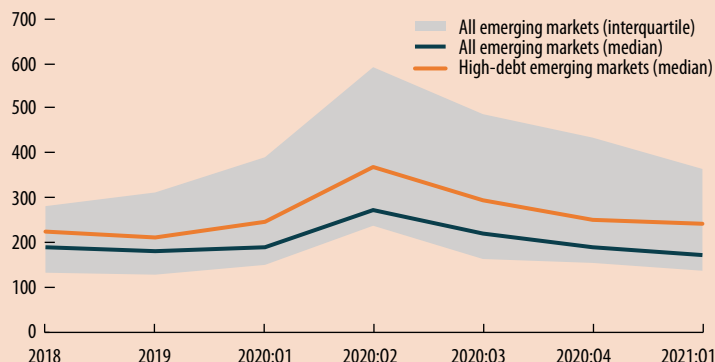
- introducing market-oriented reforms, including for state-owned enterprises (such as in China, India, and Mexico)
- strengthening social safety nets (for example, in Chile and China)
- closing infrastructure gaps (for example, in Indonesia and the Philippines)
- implementing pension, product market, labor market, and governance reforms in many countries

Chart 1

Emerging Market Global Bond Index spreads

Investors typically differentiate across emerging market debt.

(basis points)



Source: Bloomberg Finance L.P.

Note: The sample excludes Iran and Thailand due to data availability. Emerging Market Global Bond Index data are missing for the United Arab Emirates and Saudi Arabia in 2018. High-debt emerging markets are defined as economies where government gross debt is higher than the median.

service-oriented sectors and among unskilled, young, and female workers. To ensure a sustained recovery that does not leave anyone behind, the rise in inequality and poverty must be contained. Reducing informality, which accounts for one-fourth to one-third of the economy for most emerging markets (Medina and Schneider 2019), will allow more people to benefit from better wages and redistributive measures.

Some countries are seizing opportunities: in Asia, digitalization is transforming the efficiency of production, communication, and the inclusiveness of government operations (Gaspar and Rhee 2018). Indonesia is addressing the threat from deforestation through a program on sustainable land use. Some emerging markets, such as Malaysia, are strengthening the financial regulatory framework to better monitor and manage transition risks as they move to reduce the economy's carbon footprint.

Restoring macroeconomic resilience: The crisis was a sore reminder of the importance of building economic health during peaceful times. Emerging markets will soon need to start rebuilding fiscal, external, and macro-financial buffers to prepare for the next crisis. That means reestablishing fiscal rules and restoring financial regulatory standards, which were set aside during the pandemic, and rebuilding external reserves if they are running low. Priorities will vary and will need to be addressed without hurting growth prospects—raising tax capacity for spending on public services where safety nets are weak, taking steps to reduce debt and debt accumulation (fiscal consolidation) where the sovereign debt burden is high, and tightening macroprudential policies on financial institutions where financial stability risks are elevated.

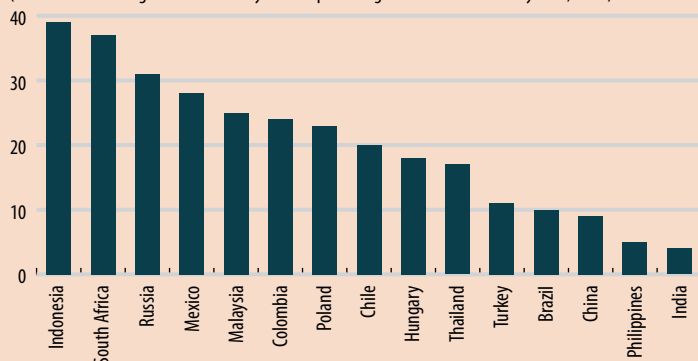
Governments in many emerging markets will need to balance different goals, such as raising spending on public investment and social safety while resuming fiscal consolidation to keep public debt on a firm downward path. Public and external debt have risen significantly for the median emerging market economy, reaching 59 and 44 percent of GDP, respectively, in 2020, and gross financing needs are projected to stay above 10 percent of GDP in 2020–21. While low global interest rates have kept debt servicing costs manageable, external borrowing costs should not be expected to stay low indefinitely. Investors typically differentiate across emerging market debt (see Chart 1). Even when debt is incurred in

Chart 2

Who owns the debt?

The large share of domestic debt held by foreigners makes the domestic financial market a key transmitter of external financial shocks.

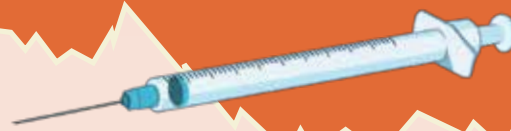
(nonresident holdings of local currency debt as percentage of total local currency debt, 2019)



Source: Arslanalp, S., and T. Tsuda. 2014. "Tracking Global Demand for Emerging Market Sovereign Debt." IMF Working Paper 14/29.

Clear communication on policy intentions, with measures to protect the vulnerable, is essential as well to building social support for difficult reforms.

It is also the time to build stronger economies than emerging markets had before the pandemic—by taking steps to create better and more equal access to health care and education, strengthening public infrastructure, and retraining workers displaced by the pandemic. Building resilience to climate change and steering digitalization for inclusive growth are also necessary. COVID-19 has caused more loss of human life in countries with weak health systems and social safety nets. It has triggered greater economic losses in



domestic currency, the sizable share of domestic debt held by foreigners makes the domestic financial market an important transmitter of external financial shocks (see Chart 2). Sustained high debt and gross financing needs will likely aggravate policy trade-offs and expose emerging markets to abrupt changes in the risk appetite of investors.

As the IMF's April 2021 *Fiscal Monitor* argues, stronger tax revenue generation would allow policymakers to provide better public services without adding to debt burdens. Tax revenues in emerging markets indeed stand below 20 percent of GDP on average compared with over 25 percent of GDP in advanced economies. Emerging market governments also tend to spend a higher share of their revenues to meet interest payments.

In the post-pandemic environment, policy space has shrunk. With higher fiscal deficits and debt, larger financing needs, and less room to cut domestic interest rates, policies must therefore be better integrated to achieve the best outcomes for growth and stability, while maintaining the autonomy of fiscal, monetary, and regulatory authorities. For example, where inflation pressure is subdued, monetary policy can continue to support domestic demand, even as fiscal support is withdrawn.

Other policy trade-offs must also be managed as multispeed recoveries give rise to market pressure. While a flexible exchange rate generally acts as an external shock absorber, under some conditions, the effects can be the opposite. For instance, depreciation in the domestic currency can increase the stock of foreign-exchange-denominated liabilities, further intensifying market pressure. Pass-through from depreciation can generate inflation pressure when monetary policy credibility is not fully established. Concerns about navigating financial volatility are foremost in the minds of many policymakers in emerging markets and are a major plank of the IMF's work on the Integrated Policy Framework.

Rebuilding resilience

Past crises demonstrate that emerging market policymakers can overcome adverse shocks and rebuild economic resilience. Moreover, medium-term growth in most emerging markets is projected to remain strong. However, a collective global effort is crucial for emerging markets to realize their growth potential and generate much-needed dynamism in global activity, trade, investment, and finances.

First, *emerging markets must reclaim their hard-won macroeconomic strength*, as they did after the financial crises in the 1990s and early 2000s and the global financial crisis that began in 2008. With recovery from the pandemic proceeding at divergent speeds, emerging markets must also learn from one another how best to navigate risks and maintain resilience. This affects more than just emerging markets. With their growing systemic relevance in the global economy, a strong emerging market universe will also drive global stability.

Second, *major advanced economies must do their part*: Multilateral cooperation on free trade, vaccine supply, and taxes; commitment to providing dollar liquidity under resurgent financial stress; and joint action toward climate change are all essential. Some emerging markets will need financing support to invest in building back stronger without further aggravating climate change.

Third, *global development and financial institutions must be complementary in their efforts*: For the IMF, this will mean working through its key responsibilities—policy dialogue and advice, financial support, including through precautionary lines, and capacity building—serving as a convening platform for cross-country learning and leveraging relevant expertise from other international institutions to help its most dynamic member countries regain their footing in the post-pandemic landscape. **FD**

RUPA DUTTAGUPTA is a division chief in the IMF's Strategy, Policy, and Review Department, where **CEYLA PAZARBASIOGLU** is director.

References:

Araujo, J., J. Garrido, E. Kopp, R. Varghese, and Y. Weijia. Forthcoming. "Corporate Debt Resolution in the Time of COVID-19." IMF Departmental Paper, International Monetary Fund, Washington, DC.

Duval, R., and D. Furceri. 2019. "How to Reignite Growth in Emerging Market and Developing Economies." IMF Blog, October 9.

Fratto, C., B. Harnois Vannier, B. Mircheva, D. de Padua, and H. Poirson. 2021. "Unconventional Monetary Policies in Emerging Markets and Frontier Countries." IMF Working Paper 21/14, International Monetary Fund, Washington, DC.

Gaspar, V., and C. Y. Rhee. 2018. "The Digital Accelerator: Revving Up Government in Asia." IMF Blog, September 26.

Medina, L., and F. Schneider. 2019. "Shedding Light on the Shadow Economy: A Global Database and the Interaction with the Official One." CEPR Working Paper 7981, Munich Society for the Promotion of Economic Research.

Pazarbasioğlu C., and A. Garcia Mora. 2020. "Strengthen Insolvency Frameworks to Save Firms and Boost Economic Recovery." World Bank Blog, May 18.

Is the Emerging World Still Emerging?

Two decades on, the BRICs promise lingers

Jim O'Neill



PHOTO: COURTESY OF JIM O'NEILL

BRICs revisited

My primary goal in my first paper, “The World Needs Better Economic BRICs,” was to make a case for changing the framework for global economic governance, not necessarily the inevitable future growth of these countries.

In subsequent papers I laid out what the world *could* look like, in the highly unlikely event that the countries we studied reached their potential. We defined this potential using the standard methodology for macroeconomics, in which real economic growth is determined by two variables: the size of a nation’s workforce and the economy’s productivity. Because of their population size, the associated size of their workforce, and the scope for productivity catch-up, it was quite easy to show that the potential growth rates of BRICs were higher than those of most advanced economies. What our analysis was *not* meant to show was that all these countries would persistently grow at their potential. That frankly is not realistic, and not what we intended as our message.

In this context, the second decade of this century has been quite a contrast to the first decade, which for all four countries turned out even better than in the scenarios I outlined in 2001. While India has notably disappointed in recent years, it is broadly developing along the path we envisioned. For both Brazil and Russia, however, 2010–20 economic performance was very disappointing, which has occasionally led me to joke that perhaps I should have called the “BRICs” the “ICs.” Brazil and Russia have both suffered from the well-known commodity curse and, as evidence suggests, are far too dependent on the world commodity cycle for their own sustainable development. Each of these countries has considerable differences, but they both need to diversify their economies away from commodities and grow the role of the private sector.

In contrast, the ongoing strength of the Chinese economy suggests that it is fully achieving its potential. China’s GDP, in excess of \$14 trillion (as of 2019), is more than twice that of the other BRICs

WITHOUT COVID-19, GDP growth in the past decade would have been about 3.6 percent—just below the 3.7 percent experienced in 2000–09. Not bad given all the challenges, and contrary to the mood of pre-pandemic times. Indeed, each decade has witnessed stronger economic growth than the 1980s and 1990s, each about 3.3 percent. Hundreds of millions of people have been taken out of absolute poverty as a result, in part because of the growth miracle led by the so-called emerging markets, of which my beloved BRICs were front and center.

The year 2021 marks the 20th anniversary of my coining the acronym “BRICs” to summarize the likely rising economic relevance of Brazil, Russia, India, and China and the implications of their rise for global governance. As the world looks to the remainder of 2021 and beyond, what can we expect from emerging markets?

in aggregate. The sheer scale of China means that the BRIC economies combined are now larger than that of the European Union and are approaching the size of the United States.

Back to the future

Although China's real GDP growth rate will slow beginning in 2021, given its increasing demographic challenge, that will not stop it from overtaking the United States as the world's biggest economy. For the world to grow faster in aggregate, countries with favorable demographics must boost their productivity.

It will be very hard for the world to get to a real GDP growth rate of 4 percent; even the 3.7 percent of the past two decades could be challenging. Four factors will determine whether we get the growth we need: productivity in developed economies; how quickly China's growth trend slows; the success of India; and, crucially, whether the other highly populated emerging market economies emerge. Can the likes of Indonesia, Mexico, Nigeria, Vietnam, and others get close to their long-term potential? If they do, then real GDP growth for the world could have a better chance of emulating that of the past decade.

Obviously, an immediate strong post-COVID-19 recovery almost exclusively depends on developing and distributing vaccines and treatments to eradicate this pandemic. In my judgment, the multiplier benefits of the required \$20–\$30 billion from donors are such that it would represent the biggest no-brainer economic stimulus any generation has had the chance to agree to, dwarfing the potential benefits of 2008–09.

The IMF must play an active role in encouraging this stimulus and—in addition to its newfound focus on climate change—must enter the arena of health systems and integrate analysis of health spending in its surveillance work. Aligning with finance ministers to support the Access to COVID-19 Tools (ACT) Accelerator—a collaboration between leading global health organizations—is a small beginning, but it needs to be bigger.

Having led the UK government's independent Review on Antimicrobial Resistance (AMR), I know there are other health threats out there equal to COVID-19. AMR could cause as many as 10 million deaths annually by 2050 and, as a result, a cumulative \$100 trillion in lost economic opportunity. Some observers find such numbers hard to believe, but as a result of the pandemic, we now know such things are unfortunately a reality. Trying to strengthen the


links between economics, finance, and health should be at the center of our emerging ideas.

Bolder and smarter

In the aftermath of COVID-19, emerging market economies, especially the larger ones, must adopt smart fiscal policies—policies that prioritize public investment. We need a different basis for assessing the real economic framework and circumstances of fiscal policy. To be specific, the time has come to truly distinguish between government investment spending and consumption spending; the former is likely to have a positive multiplier effect and should not be treated from an accounting perspective the same as government expenditures on consumption. Tackling climate change and future health threats requires such investments. Emerging market economies' achievement of their growth potential depends on such investment, which is arguably more important for economic growth than financial conditions.

A framework for smarter fiscal policy will almost definitely require stronger domestic financial systems. Continued dependence on a monetary system based on the US dollar makes this difficult. Despite the relatively smooth but ongoing slow relative decline of the share of the US economy in the world, the dollar-based monetary system remains as dominant, broadly speaking, as it was when I started my financial career in 1982. This means that the world must ride the cyclical roller-coaster of the Federal Reserve's monetary policy, its consequence for the United States, and the global financial conditions that follow. As the Fed tightens, by and large, financial conditions for emerging markets tighten—often chaotically. As the Fed eases, the reverse happens.

There is a way out, and one day, this change will take place. The monetary system needs to evolve to be more reflective of the changing dynamics of the world, and until it does, emerging market nations' ability to reach their growth potential will remain challenging, albeit perhaps not quite as challenging as other domestic initiatives such as health and education systems.

Many emerging market nations need to be bolder and smarter about these issues, and the IMF of course will be there to help them. 

JIM O'NEILL is chairman of Chatham House and former chairman of Goldman Sachs Assets Management.





End of the Line

A looming oil price super cycle will likely be the last

Rabah Arezki and Per Magnus Nysveen

After a pandemic and a price war sent petroleum prices tumbling in 2020, they are again on the rise. A new oil price super cycle—an extended period during which prices exceed their long-term trend—seems to be in the making, driven by *pervasive supply shortages* from the lack of investment that has continued since the 2014 collapse in oil prices and, more recently, reduced investment in shale oil production; and *demand growth* triggered by a strong recovery in countries such as China, a big stimulus package in United States, and global optimism about vaccines.

Some of these factors have persistent components and will likely more than offset any downward pressure on consumption that becomes part of a new normal post-COVID-19 environment.

Nevertheless, this could be the last super cycle for oil because major economies appear committed to replacing fossil fuels, and mass car manufacturers have responded by committing to replacing internal combustion engine vehicles with electric vehicles over the medium term. This shift will transform the oil market into one consistent with climate goals, but poses a risk of disorderly adjustment for economies dependent on oil, with far-reaching effects that in some cases could spill over their borders.

Oil investment crunch

Even with relatively lower oil prices, extraction and exploration companies have been highly profitable. At the same time, perhaps in recognition of a less buoyant future, they have reduced their investment. Production in oil fields and the number of wells are declining, and reserve depletion is rapid. The drop in both capital expenditure and replacement of oil reserves has persisted since 2014.

COVID-19 has exacerbated the investment decline. For example, shale oil output—which has a shorter production cycle and therefore is more sensitive to changes in investment—is now increasing by half a million barrels a year, compared with 2 million barrels a year before the onset of the pandemic. While the Biden administration’s announced ban on drilling on federal land in the United States will have little direct impact on shale production, it signals a shift in federal government sentiment against the oil industry.

Shale producers have adopted a noticeably more cautious investment posture. As a result, they will be operating with positive cash flows—cash flow was previously directed toward investment

spending. This reduced investment will lessen the role of shale as swing production and plants the seeds of a price super cycle. On the other hand, the Organization of the Petroleum Exporting Countries will likely increase production to counter that upward pressure on price.

The debate over peak demand

Several commentators and major oil market players, including BP and Shell, argue that global demand for oil peaked in 2019 at about 100 million barrels a day and that it will never again reach that level because of pandemic-related structural changes. That view seems supported by the sharp reduction in oil consumption for transportation, including jet fuel. After travelers started cancelling flying plans in March 2020, jet fuel consumption collapsed and only began to creep up as travel restrictions started to ease.

Those who believe consumption has peaked still anticipate that gasoline consumption will rise in mid-2021, despite higher prices as a result of the inevitable lag between any demand-induced increase in crude oil production and the increase in refined products to meet demand. With vaccine developments and optimism from a proximate reopening of the global economy, it is expected that oil consumption will continue to recover, but to a level lower than what prevailed before the pandemic—effectively the peak of oil consumption.

Yet proponents of the view that oil demand has peaked overlook the structural increase in consumption that will eventually offset any downward shift from COVID-19. Rising living standards and a growing middle class in China and India will lead to increased demand for individual cars and air travel. So even if economic growth slows, the large numbers of people crossing the income threshold that enables them to afford a car will support demand for travel. In emerging markets such as China and India, any shift toward electric vehicles will likely be slower than in advanced economies given concerns over the availability of charging stations. The rate of adoption of electric vehicles will, by and large, be the major driver of future oil demand because road fuel accounts for half of global oil demand.

The structural increase in oil demand, together with a persistent reduction in production from insufficient investment, will likely precipitate—and keep alive for some time—an oil price super cycle.

Industry shift		
Traditional car manufacturers are increasingly replacing vehicles powered by internal combustion engines with electric vehicles.		
Car manufacturer	Production targets	Target year
VW Group	30 percent of total global sales of electric vehicles	2030
Nissan	Electric vehicles 100 percent of sales in key markets	2030
Renault	30 percent of total vehicle sales battery electric, 35 percent hybrid vehicles	2025
Toyota	5.5 million global electric vehicle sales, at least 1 million of them battery electric and the rest some version of electric, including hybrids	2030
GM	100 percent of global sales to be zero-emission vehicles	2035
Hyundai-Kia Group	Cumulative battery electric vehicle sales to reach 1 million units	2025
Kia	Electric vehicles to account for 40 percent of global sales	2030
Ford	100 percent of European vehicle sales to be battery electric	2030
Honda	Two-thirds of global vehicle sales to be electric	2030
Daimler Group	At least 50 percent of total car sales to be electric	2030
BMW	Electric vehicles to account for 30 percent of year-over-year sales growth	2020–30
Volvo	100 percent of new vehicle sales to be fully electric	2030
Mazda	5 percent of total sales to be fully electric and all new vehicles to have an electric component	2030
PSA Group	100 percent of vehicles to be electric	2025

Source: Rystad Energy.

But will an increase in oil prices prompt more investment and lead to another price bust as has happened in the past?

Technology and its consequences

Technological innovation may make things different this time. Large investments will likely be discouraged by the new technology at the heart of carmaker plans to replace internal combustion engine vehicles with those that run on electricity. The stock market capitalization of electric carmaker Tesla points to the imminence of the transformation of the automobile market. Tesla's capitalization dwarfs that of traditional carmakers—even though those manufacturers produce vastly more cars than Tesla. That disparity has prompted traditional car manufacturers to commit to replacing vehicles powered by internal combustion engines with those powered by electricity, which in turn has triggered massive research and development on electric vehicles by manufacturers seeking to grab shares of the new market (see table).

A frenetic ramping up of production of electric vehicles is not without risk, however. It could cause supply to exceed demand—which would lead to negative cash flows, illiquidity, and bankruptcies of car manufacturers. The automakers' bet is driven both by the commitment of governments to achieving zero net carbon emissions and by the belief that consumers will want to adopt cleaner modes of consumption—transportation accounts for about a quarter of global energy-related carbon dioxide emissions. But it is unclear whether consumers will merely pay lip service to cleaner consumption or actually change their behavior. Will higher carbon prices become less important to consumers than concern about an inadequate charging infrastructure for automobile batteries?

That said, mass manufacturing will eventually make the price of electric cars attractive, and a spike in oil prices would hasten the conversion to electric vehicles. This last oil price super cycle will be consistent with climate goals and associated with commitments by large economies to net zero carbon emissions in the medium term. However, felicitous a development that will be for the global climate, however, it poses a risk that the oil reserves so many oil-dependent economies count on will be less valuable—especially for reserves where extraction costs are high. The reserves and the investment surrounding them become, in effect,

stranded assets. That could lead to severe economic woes, including bankruptcies and crises, in turn leading to mass migrations, especially from populous oil-dependent economies, many of them in Africa. Other larger oil-dependent economies in the Middle East, central Asia, and Latin America are also an important source of remittances, employment, and external demand for goods and services that benefit many neighboring countries. The end of oil, then, could not only devastate oil-dependent economies but could also overwhelm their neighbors. It is not all bad news for countries with mineral deposits important to the energy transition. Cobalt, essential for car batteries, will be in much higher demand. Uranium could be valuable as well as electricity generation moves away from fossil fuels and nuclear power becomes more attractive.

The end of oil thus makes economic transformation imperative. Oil-rich countries must diversify to become resilient to the changes in energy markets. An appropriate governance framework to manage proceeds from oil in good and bad times has always been important to fostering economic diversification. But with stranded assets a new risk, radical shifts in governance in oil-dependent economies are urgent. Dubai, for example, facing the depletion of its oil reserves, transformed itself into a global trade hub. Countries and businesses reliant on these markets must formulate policies to address this transformation, including the development of renewable energy. To jettison their hidebound economies, which have led to low productivity and waste, oil-rich economies should commit to reforms that lessen obstacles to innovation and entrepreneurship. Reforming corporate governance and legal systems, promoting markets that have no barriers to entry and exit, and ending favoritism for both state-owned enterprises and politically connected private firms will help attract investment and change attitudes toward innovation (Arezki 2020). **FD**

RABAH AREZKI is chief economist at the African Development Bank and a senior fellow at Harvard University's Kennedy School of Government. **PER MAGNUS NYSVEEN** is senior partner and head of analysis at Rystad Energy.

Reference:

Arezki, Rabah. 2020. "The Economics of Sustainability: Causes and Consequences of Energy Market Transformation." *Economics of Energy & Environmental Policy* 9 (2).



GLOBAL CLOUT, DOMESTIC FRAGILITY

China's long-term success will depend primarily on addressing its internal challenges

David Dollar, Yiping Huang, and Yang Yao

In 2012 the Chinese government set a long-term goal: build China into a fully developed and prosperous country by 2049, 100 years after the founding of the People's Republic. Given its success since the beginning of economic reform in 1978, this kind of transformation is certainly possible. But it is difficult and not guaranteed.

China faces serious domestic challenges such as an aging population, a rural-urban divide, an underdeveloped financial system, insufficient innovation, and reliance on carbon-based energy sources. Furthermore, China's external economic relations have become contentious with a number of major partners, resulting in growing trade and investment barriers in both directions. Our book, *China 2049*, examines the policies that can help the country achieve this ambitious goal.

An older population

The COVID-19 pandemic has been a reminder that there will be many unpredictable events between now and 2049. But one thing is certain: China will have a rapidly aging population. Total fertility has dropped to 1.7 births per woman, far below the replacement rate of 2.1. This





decline may have been helped along by the one-child policy, but relaxing it did not produce more babies. China is like many other densely populated Asian countries, with high housing and education costs, where many couples choose to have one child, or none. Even some increase in fertility would not affect the labor force for 20 years.

China's population may have already peaked. More important, the working-age population has already started to decline. The elderly population is expected to increase dramatically in the next few decades (see Chart 1). The over-65 cohort will more than double to 400 million people by 2049. Especially striking is that the "old-old," 85 and over, will more than triple to about 150 million people, surpassing their peers in the United States and Europe combined. The only working-age bracket that will increase is the 55- to 64-year-olds.

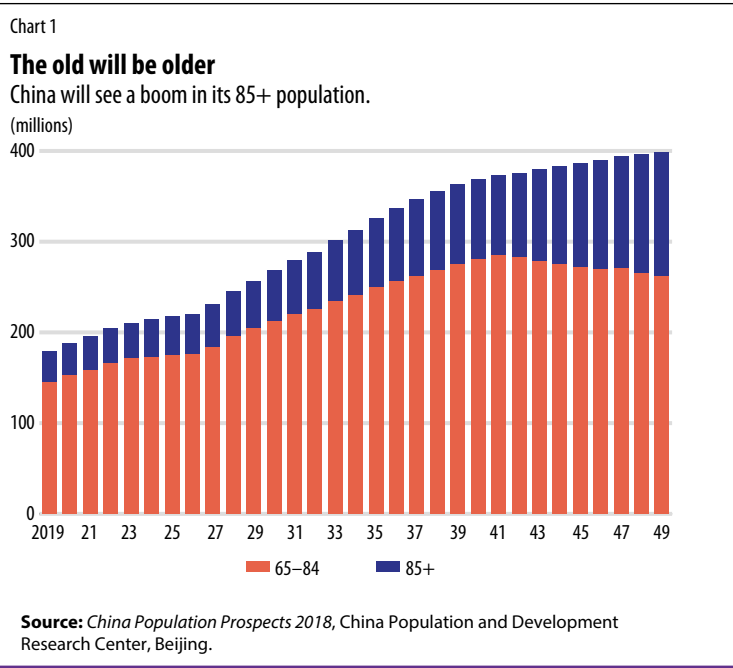
This population aging is both a social and an economic issue. Taking care of the elderly will require devoting more resources to health care, long-term care, and assisted living. Traditionally, the elderly are cared for by their children. But, with smaller families, many elders could end up with no one to rely on. It makes humane and economic sense to socialize costs that previously were privately borne.

The COVID-19 pandemic has revealed both the strengths and weaknesses of China's health care system. The pandemic was brought under control with a huge ad hoc mobilization that shifted scarce resources to where they were needed most. But many Chinese now feel the need to strengthen the health care system and resource it adequately. This is especially true in rural areas, where many of the elderly live.

Although challenging, the working-age population decline need not presage a dramatic drop in the labor force, depending on what happens with participation. Retirement age, in particular, needs to be reformed and gradually increased: male civil servants can retire at 60, female civil servants at 55. Many people over 65 choose to continue to work if they are healthy. Family-friendly policies can sustain and enhance female labor force participation.

Urban-rural gap

China's 40 years of reform and growth have coincided with steady urbanization. The urban population has been increasing by 1 percentage point a



year, from 20 percent at the beginning of the reform to 60 percent today. That includes more than 200 million urban migrant workers still registered as rural residents under the *hukou* household registration system. This migration has been an important source of dynamism and productivity growth in the economy. But migrants face various constraints. If laid off in a downturn, they are expected to return to their rural village. It is difficult to bring children or parents along when migrants move to cities where they do not have full access to social benefits (education, health care, pensions). The result is divided families with parents working in cities while grandparents maintain the family farm and raise the children left behind.

The restrictions on urban registration are gradually being dismantled, especially in smaller cities. Jiangxi province recently scrapped these restrictions. But controls are still strong in the largest centers with the highest productivity, such as Guangzhou and Shanghai. Despite this migration, the ratio of urban to rural income rose steadily. By 2007, urban workers were making 3.14 times as much as those in rural areas—one of the highest levels of rural-urban inequality in the world (see Chart 2). China has about one-fifth of the world's population but only 7 percent of its arable land, making it difficult for 500 million people to live well off the rural economy. Even including rural migrants, China's



urbanization rate is low relative to the country's per capita income and population density. Fast-growing Asian economies such as South Korea had urbanization closer to 80 percent at this stage of development. It is encouraging that the disparity has come down over the past decade, but it is still high, with urban workers making 2.71 times more.

China would benefit from fully scrapping the internal migration restrictions. On the social side, the rural population is disproportionately composed of children and elderly people. Schools are much better in cities, allowing the workforce of the future access to better education. While some elders will prefer to remain in rural areas, others perhaps would like to move to cities closer to their adult children and to high-quality medical care. Economically, there is still an excess supply of workers in rural areas, and easier migration policies would help maintain the urban workforce.

More bits, fewer bricks

An interesting paradox of China's success is its rapid growth despite an underdeveloped financial system. An index of "financial repression"—based on ownership of banks, regulation of interest rates, intervention in credit allocation, and control of cross-border capital flows—shows China to be

one of the most repressed among major economies, similar to India. It ranks as moderately more financially repressed than Russia and South Africa and considerably less liberalized than advanced economies. Almost completely controlled until the 1980s, the Chinese financial system made good progress toward liberalization until about 2000, but has stalled ever since.

Our interpretation is that the initial steps in liberalization were sufficient to carry out the straightforward task of channeling the country's high savings into export-oriented manufacturing and housing. A moderate amount of financial repression can be helpful at this stage of development to ensure that the cost of capital remains relatively low. In both these sectors, lending depends on physical collateral (property, buildings, machinery), so allocation is not that difficult. China's exports come largely from private firms, not state enterprises. Real estate development and housing ownership are also private. So a policy that encouraged exports and real estate was indirectly a policy that channeled resources to the private sector.

The period between accession to the World Trade Organization, in 2001, and the global financial crisis, in 2008, was the golden age of China's growth. There was rapid credit growth, but sufficient GDP growth to keep metrics such as the ratio of nonfinancial corporate debt to GDP stable. This all changed in 2008. To maintain demand in the wake of the global shock, China invested massively in infrastructure by lending to local governments and upstream sectors such as steel that tend to be state-dominated.

At the same time, the central government decided to channel more resources into key state enterprises, hoping to help them become global champions. The surge in lending to local governments and state enterprises caused overall indebtedness in the economy to grow at an alarming rate, showing that the financial system was not performing well in the new environment. If the financed investments had produced strong growth effects, the debt-to-GDP ratio would have remained stable or risen more slowly. A rapidly rising leverage ratio is a sign that poor investments are being financed.

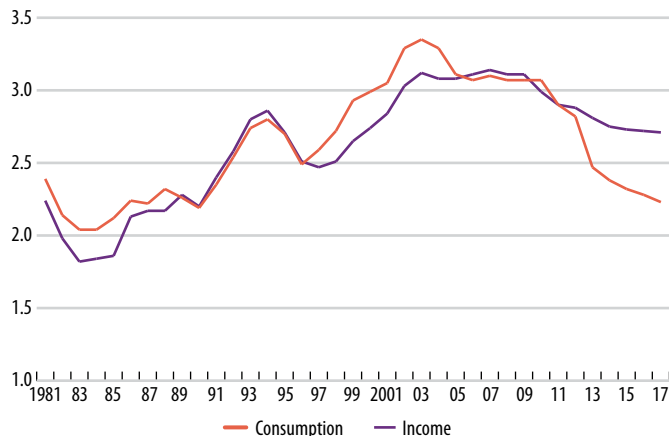
In recent years, the weakness in capital allocation is also underscored by the stalling of total factor productivity, which measures productivity growth not explained by labor or capital increases. In the early 2000s, following significant direct investment

Chart 2

Income gap

Urban workers make almost three times as much as rural workers.

(ratio)



Source: National Bureau of Statistics of China.

Note: The ratio shows how much higher income and consumption are for urban workers than for rural workers.

that helped build up the domestic private manufacturing sector, total factor productivity grew 2.6 percent a year, accelerating to an impressive 3.9 percent in the later part of the past decade. Since the global financial crisis disruption, it has never recovered, growing only 0.2 percent a year between 2015 and 2019.

Stagnant productivity is a signal that China needs more innovation, and a diversified financial system to support it. China has many of the ingredients that contribute to innovation—a large domestic market; high spending (2.4 percent of GDP) on research and development; millions of scientists, engineers, and software developers graduating every year; and gradually improving intellectual property protection. Still, innovation output is inconsistent. There are some impressive areas of technical advancement, such as fintech and artificial intelligence, but productivity growth for the economy as a whole is weak. The state still channels a lot of resources to its own enterprises, whereas most patents are generated by private firms.

The financial system does a better job of funding firms with traditional assets (buildings, machinery) rather than dynamic start-ups built on intellectual property. As China fine-tunes its next five-year plan, it should focus on strengthening the innovation ecosystem, including its financing, rather than supporting particular industries and technologies. Innovation will be the key to meeting the country's environmental goals, especially the target of zero net carbon emissions by 2060.

More trade and investment

China's ability to catch up with advanced economies in GDP per capita depends on continued integration into global trade and investment. It went from virtual self-sufficiency to being the world's largest trading nation and, last year, the largest recipient of foreign direct investment. The current international environment is challenging, however. A bad dynamic has emerged in which China's plan to develop leadership in specific technologies worries its partners, which in turn place trade and investment restrictions on Chinese tech firms. There is a danger that China will turn inward, following its "dual circulation" program, which emphasizes domestic demand and national innovation. Technological


decoupling would hurt not only China but also global productivity growth more generally.

A countervailing trend is China's recent membership in major economic agreements, such as the Regional Comprehensive Economic Partnership with countries in the Asia-Pacific region and the Comprehensive Agreement on Investment with the European Union. China has also opened a dialogue with members of the Trans-Pacific Partnership about future membership, which would require significant reforms, such as limits on state enterprises and subsidies and opening up new sectors to foreign investment. China has also made overtures to the Biden administration concerning reduction of trade and investment barriers between the two economies.

Success or failure will depend primarily on China addressing its domestic challenges.

In conclusion, China is at an inflection point in its external economic relations. It makes sense for the country to continue opening up its own economy and negotiating trade and investment agreements in all directions. But success or failure will depend primarily on addressing its domestic challenges. The aging population and the rural-urban divide are interrelated: more integration can help meet the needs of the growing elderly population and prevent an unnecessarily sharp decline in the urban labor force. Financial reform and innovation policy are interrelated as well. Moving away from targeted industrial policy toward more general support of innovation calls for a diversified, competitive financial system that no longer favors state enterprises. Innovation will be the key to eliminating carbon emissions without compromising productivity or living standards. [FD](#)

DAVID DOLLAR is a senior fellow in the John L. Thornton China Center at the Brookings Institution, **YIPING HUANG** is Jinguang Chair Professor of Economics and Finance at the National School of Development and director of the Institute of Digital Finance at Peking University, and **YANG YAO** is a Cheung-Kong Scholar and Liberal Arts Chair professor at the China Center for Economic Research and the National School of Development, Peking University.



A boy is home schooled in Guerrero state, Mexico, amid the COVID-19 pandemic.

INEQUALITY

in the time of COVID-19

All metrics are not equal when it comes to assessing the pandemic's unequal effect

Francisco H. G. Ferreira

The severe impact of the COVID-19 pandemic is clearly seen in the numbers: more than 3.1 million deaths and rising, 120 million people pushed into extreme poverty, and a massive global recession. As suffering and poverty have risen, some data show an increase in another extreme: the wealth of billionaires.

With both extreme poverty and billionaire wealth on the rise, the pandemic's effect on inequality may appear obvious. The reality is not as simple as you may think.

Inequality is a notoriously challenging concept on which to make definitive statements. Inequality of what? Of household income or of GDP per

capita? Or even of mortality rates themselves, across different groups? Inequality among whom: should it be viewed at the level of individuals? Households? Countries? Even once a distribution is precisely specified—so that we are clear about what is distributed among whom—firm conclusions about the direction of inequality change will generally depend on what part of the distribution you care about most. Different measures of inequality—such as the Gini coefficient, the Theil index, and the income share of the wealthiest in society—are sensitive to different parts of the distribution and can in principle rank inequality before and after the pandemic differently. Clarity about which

inequality is being measured matters a great deal for assessing the unequal impact of the pandemic.

Consider first the global distribution of COVID-19 mortality itself. Using the concept of life years lost to the disease—estimated using ages at death and the residual life expectancies at those ages—we find that the mortality burden of the pandemic is *positively* correlated with national income per capita, despite the superior health and public prevention systems in rich countries (Ferreira and others 2021). The chart plots the number of years of life lost to the pandemic per 100,000 inhabitants against GDP per capita for 145 countries, using log scales on both axes (see chart, next page).

Although there is enormous variation at each income level—with Brazil’s mortality burden (adjusted by population) 1,000 times greater than Thailand’s, for example—there is nonetheless a very clear positive association. Richer countries suffer greater losses of life years per capita than poorer countries. Measurement error is likely substantial, with a number of poor countries, such as Burundi and Tanzania, clearly underreporting deaths, but the association is so strong that it is unlikely to be spurious. Among other things, it reflects the older age structure of the population in richer countries and an illness whose lethality is highly age-selective. Higher life expectancies, greater urbanization, and the pandemic’s spread along major trade routes also likely have played a role.

Examining income inequality

But what about the distribution of *income*, instead of mortality? How did global income inequality change during the pandemic? Well, global inequality in incomes can be understood in at least three ways: first is the question of what happened during COVID-19 to the distribution of GDP per capita among countries—labeled “Concept 1” global inequality by Branko Milanovic. In a recent paper, Nobel laureate Angus Deaton shows that, on average, richer countries also experienced *larger* economic contractions than poorer countries in 2020 (Deaton 2021). And although by itself this result does not necessarily imply a decline in inequality between countries, it turns out that the actual pattern of income declines did indeed lead to a *reduction* in (unweighted) inequality between countries during 2020, whether it is measured by the Gini coefficient, the Theil index, or the

coefficient of variation. This represents a continuation of the trend since the turn of the millennium, when Concept 1 global inequality began to fall, owing in large part to the rise of China and India. But Deaton argues that, if anything, the pandemic *accelerated* the decline.

This calculation takes countries as the unit of measurement and thus attaches the same weight to Luxembourg as to China. One might ask, alternatively, what happened during COVID-19 to the distribution of GDP per capita among countries *when these are weighted by population*. That approach is the same as measuring inequality in an imaginary distribution of all individuals in the world, where all people are assigned their country’s GDP per capita—Milanovic’s “Concept 2” global inequality.

Inequality is a notoriously challenging concept on which to make definitive statements.

When differences in GDP per capita are weighted by population, inequality between countries *increased* during 2020—which Deaton argues can be attributed to the pandemic. More specifically, it can be attributed to the sharp economic contraction in India, which suffered a great deal both in terms of mortality and economic performance—even before the massive second wave in 2021. Although China’s positive growth (and far fewer deaths) helps offset India’s decline, China is now too close to the global average income to completely compensate for India’s economic losses. When India is omitted from the calculation, Concept 2 inequality continues to decline, as it had been doing since the 1990s. Through India, the pandemic *did* contribute to a reversal in the previous pattern of falling weighted inequality between countries.

Of course, people are very far from earning the same income within any given country. Concept 3 global inequality refers to the inequality among all the world’s individuals when they are assigned their *own* incomes. This is arguably the most interesting of Milanovic’s three concepts of global inequality, and it is the only one that takes inequality *within* countries into account. For many “good” inequality measures, this Concept 3 inequality is just the sum of

(appropriately weighted) inequality within countries and Concept 2 inequality between countries.

Since Concept 2 inequality appears to have risen in 2020, it would be enough for “average” inequality within countries also to have risen for us to conclude that global inequality among individuals has grown during the pandemic, in conformance with what most people suspect. Unfortunately, it is too early to tell whether or not that is the case: data on individual incomes come from household surveys and administrative sources that are simply not yet available for 2020. For most countries, it will be at least a year, and typically more, before data on income inequality within countries become available.

For the moment, though, it certainly seems plausible that inequality within many countries is on the increase, given evidence of rising poverty and rising billionaire incomes. There are good reasons to expect that the pandemic both created new inequalities and exacerbated

preexisting income gaps within countries. There is long-standing evidence from many countries that people entering the labor market during a severe recession earn less than the cohorts just before and after them—and that those differences linger for many years. By inducing a massive global recession, COVID-19 has certainly created new inequalities among cohorts of young people.

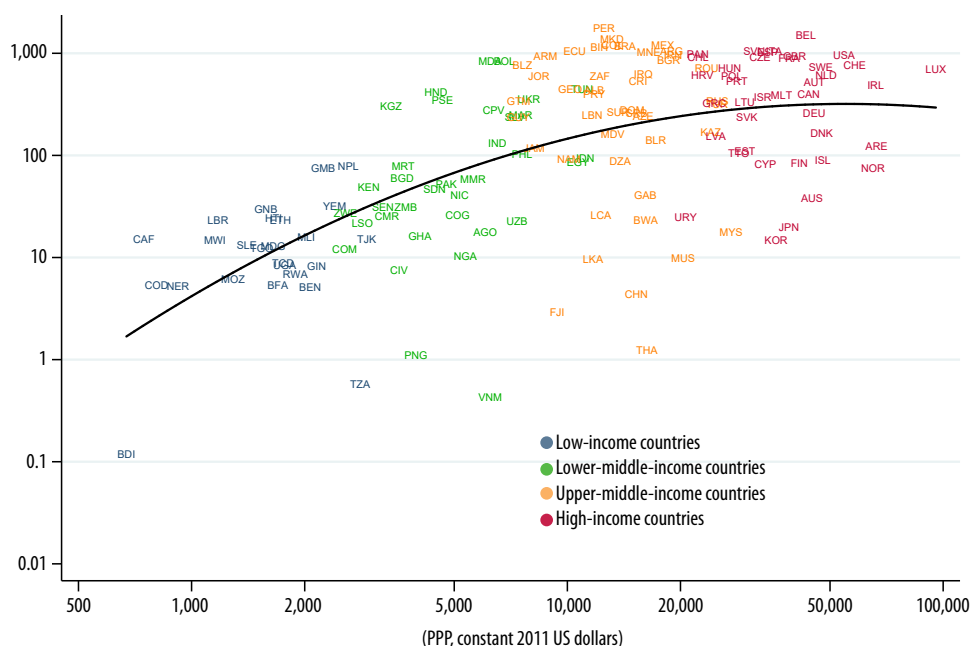
Preexisting conditions

The pandemic has also exacerbated preexisting inequalities in the labor market, largely because the ability to work remotely is highly correlated with education, and hence with pre-pandemic earnings. Despite all the talk of “essential workers” and everyone being “in this together,” the stark reality is that job and income losses are likely to have hit lower-skilled and uneducated workers the hardest. Early evidence from both public and private big data sources in the United States seems to confirm

Wealth and health

Despite their advantages, richer countries have shown a larger loss in life years due to the pandemic than many poorer countries.

(life years per 100,000 people)



Source: Ferreira and others (2021).

Note: Country abbreviations are International Organization for Standardization (ISO) country codes. PPP = purchasing power parity.

this—although there are interesting nuances that we don't have space for here. In developing economies, the same labor market forces are, if anything, turbocharged by informality: when lower-skilled labor is predominantly informal, those workers have no access to furlough programs or unemployment insurance. This year, hundreds of millions of such workers faced very stark trade-offs, on a daily basis, between staying safely at home or facing the threat of infection to provide food for their families.

Given preexisting racial and gender occupational differences, the exacerbation of these inequalities in the labor market is also likely to have translated into even greater racial and gender disparities in many countries. In addition, with the burden of additional time required for childcare and housework falling disproportionately on women, gender inequality in earnings is particularly likely to have grown even wider.

Capital markets are also likely to have played a nontrivial role in generating inequality during the pandemic, particularly at the top. In response to the widespread economic collapse in March and April 2020, the world's key central banks further loosened monetary policy, injecting enormous amounts of liquidity into financial markets. While that additional liquidity has not so far translated into goods price inflation, it has certainly helped keep asset prices high. It is the main reason stock markets boomed while the economies that underpin them were in the doldrums. These monetary policy interventions were well-intentioned, and they are likely to have helped prevent bankruptcies and preserve jobs. Nonetheless, they did inflate the value of assets held primarily by rich people and have a lot to do with the generalized growth of billionaire incomes. Owning shares in Amazon or Zoom wasn't the only way to gain wealth during this period.

Social transfers

Yet, despite these multiple reasons the pandemic can be expected to have raised income inequality within countries, we cannot yet be sure of just how general those increases are. For one thing, evidence is emerging from some (apparently) unlikely places that social protection policy responses—such as income transfers targeted to poor and vulnerable workers—have worked rather well. Early work out of Brazil's well-respected IPEA think tank suggests that generous “emergency support” transfers helped *reduce* both poverty and inequality in Brazil between May and September 2020, despite the country's

disastrous response to the health emergency. Similar claims have been made about five European countries: France, Germany, Italy, Spain, and Sweden (Clark, D'Ambrosio, and Lepinteur 2020).

The upshot is that we will not know the effects of the pandemic on income inequality within countries for sure until reliable administrative and household survey data become available. In the meantime, the tentative good news that income transfers can provide an effective response, at least in the short term, should spur other countries into action. But more action is needed: perhaps the most insidious new inequality spawned by the pandemic is between children who have been able to continue their schooling over the past year—whether in person or online—and those who have not, because of poor connectivity or weaker, poorer schools. Students in the latter category are often at great risk of falling substantially behind in their learning, or even of dropping out altogether. The learning and schooling inequalities arising from these differences are as stark as they are widespread, and as these children join the labor force the consequences are likely to be with us for decades to come.

The overall picture that emerges from these considerations is, for the moment, one of falling income gaps between countries (when not weighted by population) and—speculatively and preliminarily—rising gaps within countries, on average. Given the educational and labor market dynamics I have outlined, the latter gaps may well persist for more than a generation. What is more, it now appears plausible that even unweighted inequality between countries may well rise in 2021, if the unequal spread of vaccination allows countries such as the United States, the United Kingdom, and parts of developed Asia to recover much more rapidly than India, Latin America, and much of Africa. **FD**

FRANCISCO H. G. FERREIRA is the Amartya Sen Professor of Inequality Studies and director of the International Inequalities Institute at the London School of Economics.

References:

- Clark, Andrew, Conchita D'Ambrosio, and Anthony Lepinteur. 2020. “The Fall in Income Inequality during COVID-19 in Five European Countries.” ECINEQ Working Paper 2020-565, Society for the Study of Economic Inequality, Palma de Mallorca, Spain.
- Deaton, Angus. 2021. “COVID-19 and Global Income Inequality.” NBER Working Paper 28392, National Bureau of Economic Research, Cambridge, MA.
- Ferreira, Francisco, Olivier Sterck, Daniel Mahler, and Benoit Decerf. 2021. “Death and Destitution: The Global Distribution of Welfare Losses from the COVID-19 Pandemic.” *LSE Public Policy Review* 1(4), 2.



A COVID-19 TANTRUM?

The Federal Reserve's post-pandemic stance will expose vulnerabilities in emerging markets with high private external debt

Şebnem Kalemlı-Özcan

The pandemic has not yet led to a full-blown debt crisis for emerging markets, but substantial risks remain.

The current situation might be an “illusion” of stability that largely results from the mitigating role of US monetary policy on emerging markets' external financing conditions. By weakening the dollar, providing swap lines, and reducing external dollar financing costs for emerging markets, US monetary policy kept capital flowing to these economies. US monetary policy, because of its influence on global investors' perception of risk, has always been the single most important determinant of emerging markets' capital inflows and outflows. Will there be an emerging market crisis when US interest

rates eventually start to rise? That will depend on three key issues:

- The effect of US monetary policy on emerging market capital flows, which will vary across emerging markets depending on country-specific risk;
- The currency and sector composition of these economies' external debt—largely in US dollars and borrowed by the private sector—at the outset of the pandemic; and
- Limited fiscal space in emerging market economies to fight the pandemic, requiring continuous domestic and external government borrowing.

US monetary policy

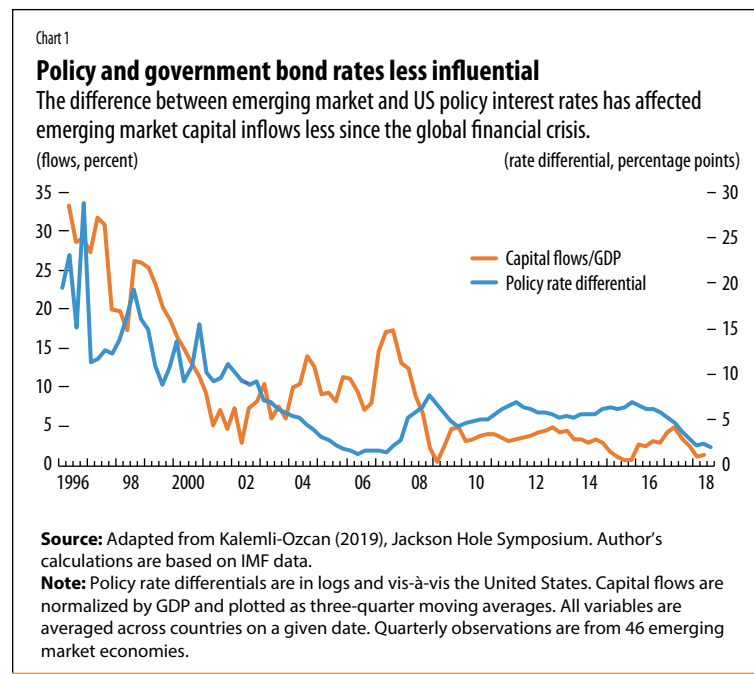
Historically, sovereign borrowing has played a major role in emerging market economies. Literature going

back to the 1980s has argued that the difference in interest rates between US Treasury securities and emerging market government bonds affects demand for emerging market debt. More recently, this tight link has begun to weaken.

Chart 1 shows a much lower correlation since the global financial crisis between capital flows and policy interest rate differentials, which directly affect short-term government bond rates. This is because private capital flows, such as cross-border bank flows and corporate loans and bonds, have become a much more significant component of emerging markets' total external borrowing since the early 2000s. Private capital flows are more likely to be affected by private investors' perceptions of risk for a particular emerging market economy than by government bond interest rate differentials. Of course, public flows can also be sensitive to global risk perception, especially if they are in local currency. Thus, US policy affects both private and public capital flows in and out of emerging markets. Note that these flows can also go in opposite directions: public flows could come into emerging markets and private flows could go out, if US policy rates go down and global risk sentiment goes up.

Unprecedented action by the Federal Reserve led to a comeback of the initial \$100 billion in outflows of public and private portfolio holdings (securities such as stocks and bonds) that had left emerging markets between January and May 2020. The Fed's action not only lowered borrowing costs for emerging markets, but it also helped to ease global risk aversion, which in turn encouraged private sector capital flows into emerging markets during the second half of 2020, with a lower risk premium on such investments. There was also heterogeneity in capital flows across emerging markets depending on how they handled the pandemic (Çakmaklı and others 2020; IMF April 2020). This heterogeneity was not surprising, as we knew from the previous episodes of US monetary policy changes (Kalemli-Özcan 2019). The responses of emerging markets to the Federal Reserve's policy stance vary according to country-specific risk, which is directly affected by their handling of the pandemic.

This is all good news, but since we lack real-time balance of payments data to track *total* capital flows, we might get an incomplete picture about potential capital flow responses to COVID-19 and to US monetary policy from figures that cover only portfolio



flows out of emerging markets—\$70 billion in portfolio equity and \$30 billion in portfolio debt (IMF April 2020). Knowing what types of capital flows were most drained during previous emerging market crises and the composition of the stock of external debt in emerging market economies at the outset of the pandemic will deliver a fuller understanding of emerging markets' remaining vulnerabilities to possible future capital outflows under changing global conditions.

Currencies and sectors

So what was the currency and sector composition of emerging market debt at the end of 2019, just before the pandemic? While portfolio debt, composed of emerging market government and corporate borrowing in bonds, constitutes a significant portion of their external debt, cross-border bank loans are equally important. Yet these loans are not included under portfolio flows. In emerging markets, a disproportionate share of external liabilities (65 percent) is in portfolio debt (bonds) and other investment debt (loans), in about equal amounts. Portfolio equity and foreign direct investment constitute the remaining 35 percent. Sovereigns account for over 60 percent of the portfolio debt, whereas banks and corporate loans together account for 80 percent of other investment debt (Avdjiev and others 2020). Although sovereigns can borrow externally

via local currency bonds, most cross-border bank and corporate bonds and loans are in US dollars.

It is important to know which borrowing sector and what type of asset class lost the most foreign capital during previous emerging market crises, such as the 2008 global financial crisis and the 2013 “taper tantrum,” when US Treasury yields surged on speculation that the Federal Reserve would slow, or “taper,” its purchases of financial assets to boost the economy. During those episodes, the largest capital outflows from emerging markets were cross-border bank loans, followed by cross-border corporate loans and corporate bonds, as shown in Chart 2.

The 2008 and 2013 episodes show that what we witnessed in terms of capital outflows from emerging markets at the beginning of the pandemic in March–May 2020 actually could have been worse. During the financial crisis and taper tantrum episodes, outflows focusing on total debt of the private sector—as opposed to portfolio debt alone—were understandably much larger than the \$30 billion in portfolio debt outflows early on in the pandemic. As for the \$70 billion that left portfolio equity, this was not surprising since this is the riskiest emerging market asset class and COVID-19 was the biggest shock since the global financial crisis in terms of investor flight from risk.

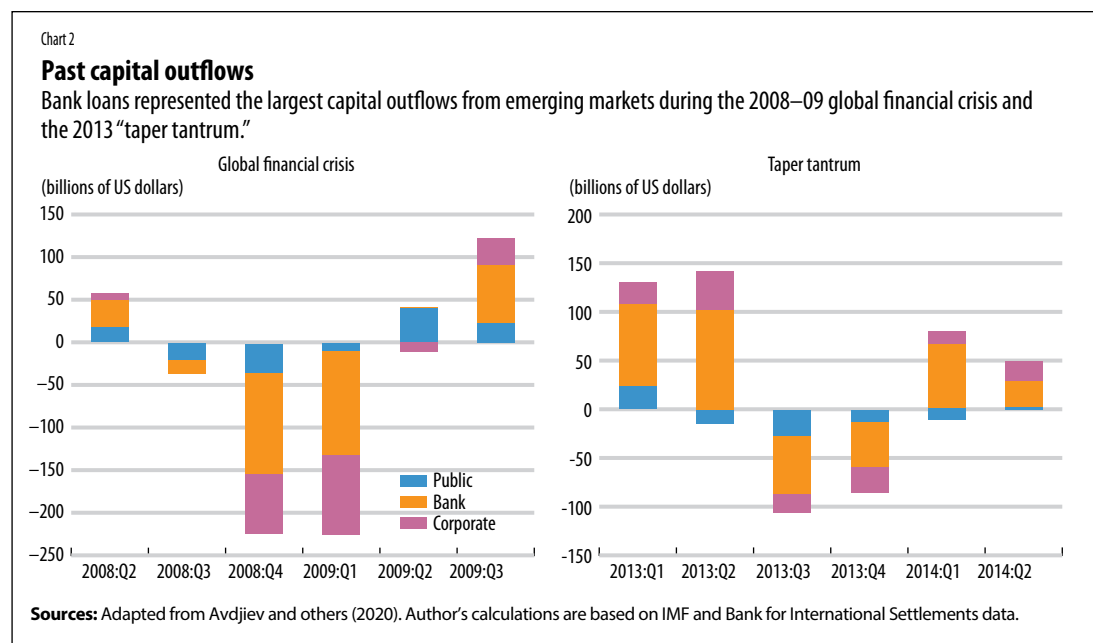
Banking and corporate debt flows for emerging markets stayed intact in 2020, unlike during the

global financial crisis and the taper tantrum, thanks to fast, clear, and unprecedented action by the Federal Reserve. US monetary policy is the key determinant of emerging market private sector flows, which are in dollars and borrowed from private creditors, and sensitive to the risk appetite of global investors.

Fiscal policy

Will we witness another taper tantrum event, with capital fleeing emerging markets once US policy rates rise as the US economy strengthens? The answer depends on country-specific risk, which is not only a function of classic vulnerabilities, such as high external debt, high domestic private sector foreign currency debt, and inflation, but also emerging markets’ policy response to COVID-19. So far, emerging markets, like advanced economies, have adopted a fiscal/monetary policy mix. As we know from emerging markets’ own histories, fiscal policy has a specific role in the nexus of external debt, domestic debt, and inflation.

Emerging market governments must fight the pandemic domestically, and their private sectors must roll over their external foreign currency debt. This means that these governments need to raise financing both domestically and externally, not only to fund the fight against the pandemic but also to prepare for possible private sector defaults leading to government-financed bailouts. However, these countries’ governments have limited fiscal space.



At a time when emerging market economies need all the support they can get, they need to raise both domestic and external financing.

There were large differences between advanced and emerging market economies in the scale of their fiscal packages early in the pandemic. As of early 2021, these differences had grown larger; emerging market economies put together fiscal support worth only 6 percent of their GDP on average, compared with average support of about 20 percent of GDP in advanced economies (IMF 2021).

A close look at the US numbers can put things in perspective when it comes to the size of this shock relative to the global financial crisis. So far in the pandemic, US active and promised future support amounts to \$7.25 trillion, which is 34 percent of 2019 US GDP. In comparison, US support of \$830 billion in the wake of the 2007–09 financial crisis amounted to just 6 percent of 2007 GDP. The fiscal support needed for a shock like COVID-19 was dramatically larger.

Many emerging market economies, lacking the resources to mount fiscal packages on this scale, added monetary policy to the mix. Like advanced economies, they turned to asset purchases, so-called quantitative easing (QE) programs. Academics and policymakers immediately warned of debt monetization—printing money to buy government debt. The fear is that this will lead to inflation in emerging markets, reversing the hard-won gains of the past two decades, as a result of the adoption of inflation-targeting regimes.

The link between inflation and fiscal policy has always bedeviled emerging market economies. Many of them learned the hard way that fiscal discipline is the key to successful inflation targeting. Any emerging market central banker will tell you that controlling inflation calls for fiscal discipline. The consensus that fiscal backing and central bank independence are the key to taming inflation arose in advanced economies first, after the high-inflation episodes of the 1970s. For emerging markets, as in advanced economies, central bank independence and fiscal discipline can prevent QE programs from being inflationary. The backbone of a successful QE program is policy credibility.

Fifteen emerging market economies undertook these programs with the rationale that, without

them, the increase in the budget deficit would flood the market with government bonds, forcing interest rates higher. By purchasing these bonds, emerging market central banks hoped to prevent this (BIS 2020; IMF 2020). So far, most of these programs, though small, have been successful, with a few exceptions where central banks did not have the credibility to assure markets that they would not fund the government indefinitely. The cost of credit default swaps (CDSs)—essentially insurance against default, a good barometer of external financing costs—reflects in part this lack of confidence. The CDS spreads have increased on certain emerging markets but not on others, reflecting the heterogeneity in the credibility of the monetary/fiscal policy mixes.

At a time when emerging market economies need all the support they can get, they need to raise both domestic and external financing. Higher costs for external financing can lead to disastrous outcomes at such a juncture, especially if the Federal Reserve starts raising rates, reversing the accommodating tide it has provided to emerging markets so far. So emerging market economies should balance the monetary and fiscal policy mix carefully, communicating these policies in a transparent way and watching closely their effects on their external borrowing costs. **FD**

ŞEBNEM KALEMLİ-ÖZCAN is a professor of economics at the University of Maryland, College Park.

References:

- Avdjiev, Stefan, Bryan Hardy, Şebnem Kalemli-Özcan, and Luis Servén. 2020. "Gross Capital Flows by Banks, Corporates and Sovereigns." NBER Working Paper 23116, National Bureau of Economic Research, Cambridge, MA.
- Bank for International Settlements (BIS). 2020. *BIS Bulletin*, June.
- Çakmaklı, Cem, Selva Demiralp, Şebnem Kalemli-Özcan, Sevcin Yesiltas, and Muhammed A. Yildirim. 2020. "COVID-19 and Emerging Markets: A SIR Model, Demand Shocks and Capital Flows." NBER Working Paper 27191, National Bureau of Economic Research, Cambridge, MA.
- International Monetary Fund (IMF). 2020. *Global Financial Stability Report*, Washington, DC, April and October.
- . 2021. *World Economic Outlook*. Washington, DC, April.
- Kalemli-Özcan, Şebnem. 2019. "The U.S. Monetary Policy and International Risk Spillovers." Jackson Hole Symposium Proceedings, September.



EMERGING MARKETS IN FLUX

Mahmood Pradhan chats with Richard House and David Lubin on the outlook for this group of countries

Emerging market assets have proved remarkably resilient over the past year, confounding more dire expectations at the outbreak of the COVID-19 pandemic. The very large liquidity injections from central banks in advanced economies have undoubtedly helped. But some emerging market economies have also found more policy space, including turning to unconventional monetary policies that many would have thought available only to advanced economies. This crisis will, however, leave scars. Debt burdens of emerging markets and low-income countries are rising to unprecedented levels. Will more countries need financial assistance when the tide of global liquidity turns? And will private investors be willing to share the burden?

Two veteran market players—Richard House, chief investment officer for emerging market debt at Allianz Global Investors, and David Lubin, head of emerging market economics at Citibank—explain why the maturity of this asset class helped limit the fallout and bodes well for its resilience and return to a more normal global liquidity environment. But they do see a need for the private sector to share the burden of adjustment in some countries. They also call for the public sector, including the IMF, to help countries take advantage of the growing demand for debt issuance that complies with environmental, social, and governance standards.

F&D: Are you surprised by how well the emerging market asset class has fared during the pandemic?

RH: No, for two reasons. First, emerging markets have become a much more diversified asset class. Second, ownership now is mostly domestic. When I started out, 25 years ago, there were just a handful of countries to choose from, and foreign investors like ourselves dominated the asset class. Today, there are more than 80 countries to choose from, and average ownership of foreigners is about 20 percent, including corporate debt. Large domestic ownership limits contagion and has made the whole asset class more resilient.

DL: The scale of the health crisis was so devastating that there could have been any number of outcomes. But the collapse of US real interest rates starting in late March was critical—40 years of history teaches us that when that happens, capital is pushed toward emerging economies. For the whole of 2020, Eurobond issuance by emerging economy borrowers was some \$800 billion, more than a 10 percent increase over 2019. This was particularly surprising because many emerging economies saw their external financing needs go down due to the recession-induced reduction in their current account deficits.

F&D: What will happen when long-term yields begin to normalize in advanced economies and central banks start to unwind asset purchases?



Richard House



David Lubin

DL: Rises in US interest rates have been a threat to emerging markets' capital flows since the 1970s. A recent small increase in 10-year US Treasuries caused some turbulence. But by any historical standards, a 10-year US Treasury yield that remains negative in real terms is absurdly low. As long as that remains the case, the threat of significant capital outflows should be contained.

F&D: You both think emerging markets are more resilient for being less dependent on foreign investors. But are foreign investors also better at differentiating between countries? Or has the large-scale policy response from advanced economies muddied the waters?

RH: Almost all asset classes collapsed early last year, then bounced back strongly. Liquidity injections have masked some problems, but not everywhere. While a rising liquidity tide has certainly lifted many boats, macro and political drivers ultimately drive asset prices. There has been reasonable differentiation, certainly in sovereign credit and foreign exchange.

DL: The biggest surprise last year was how almost all emerging economies were able to ease monetary policy. This was significantly facilitated by the Fed, which basically said, in March of 2020, "Leave it with us; we've got this covered." That was a very powerful signal that monetary policy could come to emerging markets' rescue as well. Fiscal policy turned out to be more difficult because many countries did not have the firepower of advanced economies.

F&D: If long-term rates are moving up because of stronger US growth, could that offset the impact of higher borrowing costs?

DL: Under normal circumstances, I would say no. When US monetary conditions tighten, I think

emerging economies lose more through capital outflows than they gain from more exports. The reason is that in recent years, the main driver of global investment trade and commodity prices has not been the United States, but China. Emerging markets' capital accounts are impacted by decisions taken in Washington; their current accounts are more influenced by Beijing.

The ideal combination would be a weaker US, with low interest rates pushing capital toward emerging markets, and a stronger China boosting trade and investment. Should the United States be more able to shape global investment growth with President Biden's infrastructure plan, that would help emerging countries, particularly if China refocuses toward consumption.

F&D: Emerging markets used unconventional policies more actively. Does this suggest some countries have more tools in their arsenal than previously envisaged?

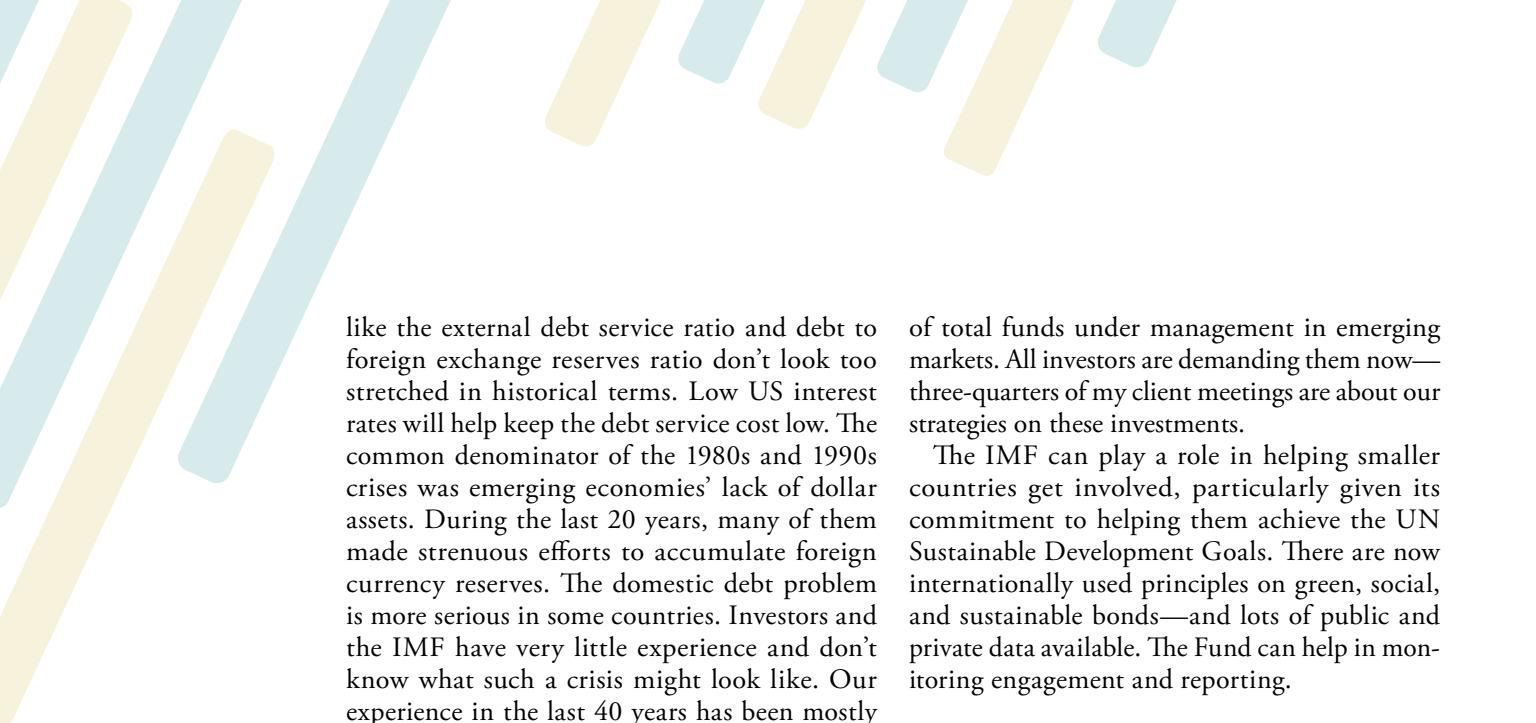
RH: It's very hard to generalize: there have been several different forms of quantitative easing. But compared to only a few years ago, every central bank has been unconventional. The narrative that emerging countries cannot do quantitative easing or all hell breaks loose is long past.

DL: There is a lot of diversity. India, for example, has successfully announced expansionary fiscal policy together with caps on bond yields. If others tried that, there would be massive capital outflows. The difference is often in markets' confidence about each country's growth potential, but also how open their capital account is.

F&D: How concerned are you about mounting debt burdens? Can emerging markets, and especially low-income countries, grow their way out of debt?

RH: Coping with COVID-19's financial impact is a global concern. An immediate concern for me is the disparity in growth rates across countries. Sadly, vaccine distribution in emerging economies will be much slower than in advanced ones. Markets are not paying attention to that disparity. Although emerging economies will bounce back, I don't see debt-to-GDP levels coming down to pre-COVID-19 levels for many years.

DL: I would agree. Accumulating large debt in foreign currency is much more dangerous. However, we're still far away from that. Indicators



like the external debt service ratio and debt to foreign exchange reserves ratio don't look too stretched in historical terms. Low US interest rates will help keep the debt service cost low. The common denominator of the 1980s and 1990s crises was emerging economies' lack of dollar assets. During the last 20 years, many of them made strenuous efforts to accumulate foreign currency reserves. The domestic debt problem is more serious in some countries. Investors and the IMF have very little experience and don't know what such a crisis might look like. Our experience in the last 40 years has been mostly with foreign debt.

RH: The biggest difference is that pegged exchange rates have been thankfully consigned to history. So I don't think there's ever going to be another big systemic emerging markets crisis again. Maybe in some countries at the corporate level, but certainly not at the sovereign level.

F&D: Do you expect many countries will need financial assistance from the IMF or other multilateral institutions? And can the private sector share the burden of adjustment?

RH: We have seen record issuances from emerging markets, sovereign and corporate, in the first quarter of 2021, despite a pretty sizable repricing of US Treasuries. Some countries facing liquidity or solvency issues will need more assistance from the Fund and potential private sector participation in restructurings. They are well known to anyone with a basic grasp of sovereign balance sheet analysis. I do not think there will be contagion. There was no contagion from the most recent defaults or restructurings in Argentina, Ecuador, and Lebanon. Why would it be different now? The private sector should definitely participate when debt is clearly unsustainable.

DL: Portfolio managers are paid to do risk assessment. The IMF first introduced its lending into arrears policy in the 1980s. If private creditors still think the IMF will bail them out, they're not doing their job properly.

F&D: Can emerging markets and low-income countries benefit from the growing demand for environmental, social, and governance-compliant borrowing (ESG)?

RH: It's a nascent asset class, but with huge potential. At an estimated \$16 billion, it's still only 4 percent

of total funds under management in emerging markets. All investors are demanding them now—three-quarters of my client meetings are about our strategies on these investments.

The IMF can play a role in helping smaller countries get involved, particularly given its commitment to helping them achieve the UN Sustainable Development Goals. There are now internationally used principles on green, social, and sustainable bonds—and lots of public and private data available. The Fund can help in monitoring engagement and reporting.

F&D: Should the IMF focus on helping countries develop capacity to issue green bonds, or on monitoring and enforcement?

RH: Investment banks are eager to help countries issue these bonds. The Fund could help more on monitoring and engagement, and especially on social and governance aspects. It has been encouraging that IMF reports have covered these issues. Engagement with countries is critical. It's the question investors always raise.

DL: It is a complicated area because money is fungible. A country says it is raising money to invest in this green project or to build schools in rural communities. How can we know for sure?

A second problem is that ESG ratings are highly correlated to per capita GDP. I worry that, as green and socially responsible bonds become more entrenched in global markets, there could be perverse consequences. Capital flows to lower-income countries could be at risk.

F&D: But isn't that exactly the point, to exert economic pressure on governments to abandon bad practices?

DL: Investors are used to making risk-based assessments of ESG. Social and governance aspects have always been part of the analysis, because they are part of credit risk. But values-based investing is increasingly the case. "This country treats its journalists terribly; I couldn't possibly invest there until they sort this out," for example. If that kind of thinking seeps into the investment process, I'm not sure who benefits. The leverage investors might have could end up perpetuating a situation. **FD**

MAHMOOD PRADHAN is deputy director of the IMF's European Department.



From Stream to Flood

Streaming video offers emerging markets an avenue for content at home and around the world

Adam Behsudi

She is a beautiful Nigerian attorney. He is a dashing Indian investment banker. Just as their romance spans the international divide, the movie that immortalizes it is equally cross-cultural: filmed and produced in Nigeria, edited in India, and released by Netflix to a global audience.

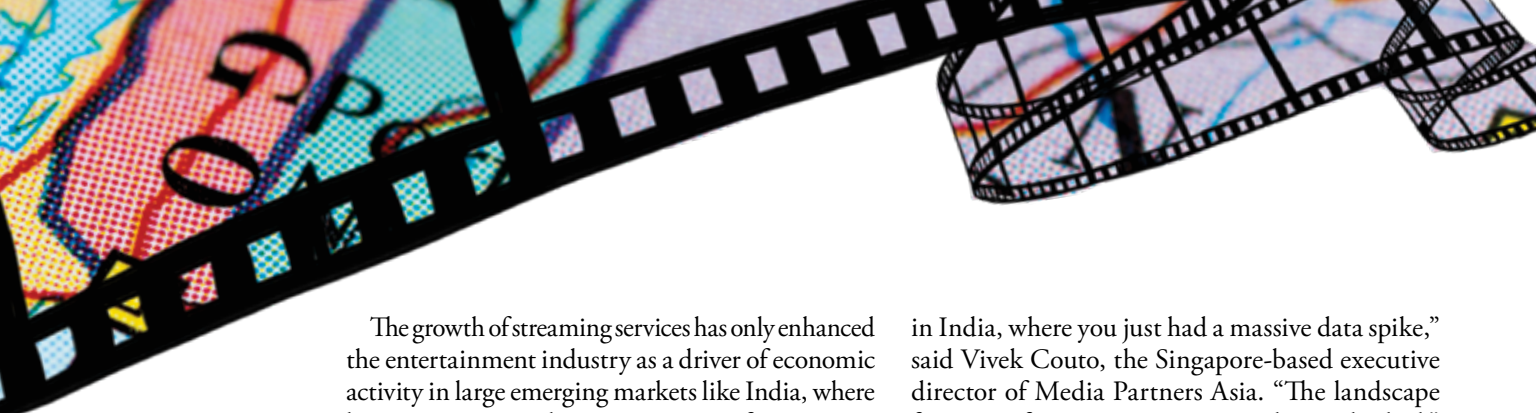
Beyond a plotline of disapproving parents and saccharine-sweet dance numbers, the merging of Nigeria's Nollywood and India's Bollywood with the release of *Namaste Wahala* ("Hello trouble" in Hindi and Nigerian pidgin) represents how small the world of entertainment has become in a new age of streaming video.

Streaming giants like Netflix, Disney+, and Amazon are growing new audiences and overlapping markets in ways never seen before. In doing

so, they've opened burgeoning film and television industries in some of the most vibrant emerging markets to new possibilities, changing the economic calculation for producing films and redefining what can be a hit.

"What's beautiful about it is we're sitting on the same platform. That's what's exciting—being a Nollywood movie—where it's going, what we're sitting next to in terms of Hollywood production and it being received in that way," said Hamisha Daryani Ahuja, a third-generation Nigerian with Indian roots who created, directed, produced, and acted in the movie that Netflix released on Valentine's Day.

Ahuja's romantic comedy broke into Netflix's top 10 list in the United States for a short period, generating buzz for the streaming company's recent expansion into African content.



The growth of streaming services has only enhanced the entertainment industry as a driver of economic activity in large emerging markets like India, where by some estimates the sector accounts for 1 percent of GDP; Nigeria, where more than a million people work directly or indirectly for Nollywood—the second-highest employer after agriculture; and China, which overtook the United States in box office sales last year. Even though the pandemic has had an unavoidable impact, people’s desire to be entertained remains a constant, and the digitization of content is changing the rules of the game.

“I think right now we are at the beginning of a huge wave of international content and more investment in international content than we’ve ever seen,” said Stefan Hall, project lead for media, entertainment, and culture at the World Economic Forum.

Infrastructure is king

In Asia’s largest emerging markets, the growth of streaming services has exploded (see Chart 1). Subscriptions to video streaming services in India grew from 4.5 million in 2017 to 59.6 million in 2020. Indonesia saw growth increase from 200,000 subscribers in 2017 to 8 million in 2020. Thailand and the Philippines saw growth in the same period of 130 percent and 71 percent, respectively, according to Media Partners Asia, an independent research and consulting firm.

“In the last three to four years, there has been a mobile revolution in those markets, particularly

in India, where you just had a massive data spike,” said Vivek Couto, the Singapore-based executive director of Media Partners Asia. “The landscape from an infrastructure perspective has multiplied.”

In India, rapid expansion in internet access has fueled fierce competition between the country’s largest telecommunications providers, which has driven down data prices to some of the lowest in the world. Most people access streaming video services on their smartphones, and India has some of the highest data usage per smartphone in the world.

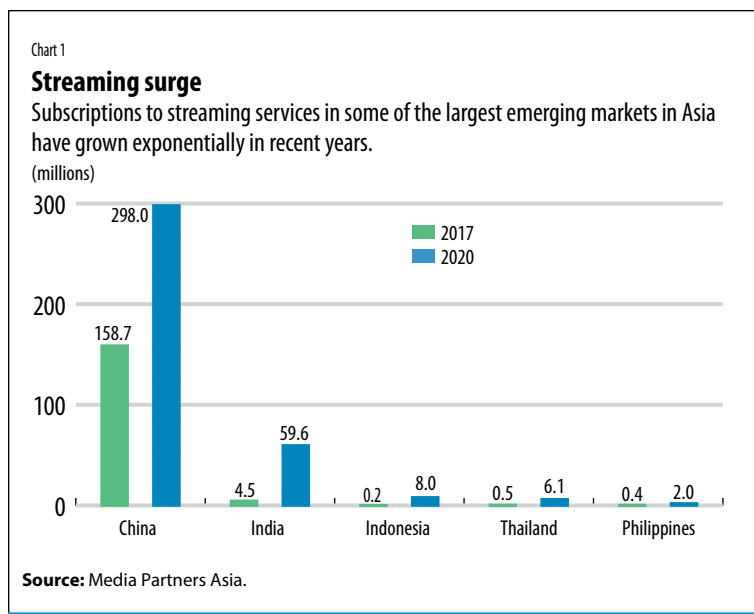
In 2019, Netflix in India launched a mobile-only plan that would allow users to stream content to their smartphones or tablets for less than \$3 a month. Netflix rolled out a similar plan in Malaysia. On the other side of the world, Spain-based Telefónica, one of the largest providers of telecommunications services in Latin America, announced in 2018 a multiyear partnership that would allow subscribers to seamlessly sign up for Netflix on its platforms across the region. In Africa, where internet service poses more of a challenge, the streaming service is working with telecommunications operators to make it easier for potential subscribers to make payments.

The trend has only accelerated with the COVID-19 pandemic. An annual survey of thousands of viewers from 10 advanced and emerging market economies found that nearly half of those surveyed subscribed to streaming services in the first half of 2020, with spending more time at home as the main reason.

This new level of connectivity in many countries has eased the entry of major streaming players, which has in turn redefined the possibilities and increased competition in the area of content creation.

While streaming services have made it easier for content to travel beyond a country’s borders to a regional market or a global audience, enticing and retaining subscribers who seek more options from their own countries remain a key focus.

In 2019, Disney+ acquired Hotstar, India’s leading streaming service, which now comprises 30 percent of the streaming service’s subscriber base. Netflix is steadily ramping up investment in the creation of local content in new parts of the world, including a new push into Africa last year with more original content. The streaming titan that started as a mail-order DVD rental service gained 36.6 million customers in 2020, its largest annual gain, and now boasts more than 200 million subscribers worldwide. After making a



rare public apology in India in 2019 for a TV series deemed offensive to Hindus, Amazon gave no sign of retreating from the market after announcing in March that it would move beyond television shows and co-produce its first big Bollywood feature.

While US-based companies face some competition from domestic streaming services, they have come to dominate through a willingness to use their deep pockets to finance local content.

“The local content ecosystem is important,” said Couto. “As the big internet giants (Netflix and Amazon) and Disney grow within these big local geographies, their commitment to invest locally and grow the creative economy is critical because otherwise there will be a greater degree of hostility against them.”

A two-way street

Trade in cultural goods such as movies and music has always been fraught with cultural and political sensitivities. It still is.

European countries have long mandated that a certain portion of content broadcast, and now streamed, be locally produced. China has fashioned a landscape where foreign content is carefully monitored, giving rise to robust streaming dominated by Chinese players Tencent and iQiyi. Cultural sensitivities in India have forced large US companies to make course corrections to keep business growing.

But in markets where US-based giants like Netflix and Amazon operate, they’ve acted more as facilitators of free trade than cultural hegemons, said Joel Waldfogel, a professor of economics at the University of Minnesota.

“The happy surprise here is that this trade is a two-way street. So now it’s a horse race,” said Waldfogel, who studies how digitization of content has affected creative economies. “What we’ve seen in even the slightly longer run is the costs of producing things have fallen so much that there has been an explosion in creation in music and movies.”

Waldfogel argues in his 2018 book *Digital Renaissance* that digitization of content is ushering in a golden age of popular culture.

New technologies have put filmmaking capabilities into more hands. The internet, meanwhile, has expanded distribution channels. For movies that means bypassing traditional theaters and box office releases. Amid the pandemic, this

trend has accelerated even in markets like India, where straight to streaming has lagged behind the United States.

Streaming services have elevated lower-budget productions and glossy high-dollar films to the same platform.

“Cultural products are extreme examples of products where it’s very hard to predict what will be good, meaning appealing to consumers at the time the investment decision gets made,” said Waldfogel. “There’s an expression in Hollywood, ‘nobody knows anything.’”

However, the rise of streaming services has taken some of the guesswork out of film production. In economic terms, the internet has created economies of scale and scope, meaning there is more supply and demand for greater quantity and variety of creative content. By matching viewers more easily with what they want to see, it has created a more efficient business model that can be adapted almost anywhere in the world.

That’s been good news for emerging markets with large captive audiences and the capacity to produce content. Streaming services from Netflix and Amazon have played a key role in providing another avenue for TV and film industries in these markets and increasing competition with domestic broadcasters.

“For a producer, there’s nothing more than to be seen beyond your natural geographic reach,” said Couto, of Media Partners Asia. “For the cultural entities of a country, whether they are governments or institutions, to have a story that showcases your country, that has those values and gives a global name to your content—that’s huge as well, because it all comes back in economic contribution.”

For Ahuja, the creator of *Namaste Wahala*, the opportunity came with an invite to a launch event with Netflix executives in Lagos in February 2020. Pre-release promotion of her movie had garnered attention. The movie was set to release in Nigerian cinemas in April 2020, but then the pandemic hit. The streaming giant provided an opportunity.

“I feel like this is a content market right now,” she says. “I don’t think there’s a limit on how much content can be put out there.” **FD**

ADAM BEHSUDI is on the staff of *Finance & Development*.