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The Covid Crisis Will End. The Recovery May Take a Lot Longer.

By Leslie P. Norton   Updated January 10, 2021 / Original January 8, 2021

Carmen Reinhart, chief economist of the World Bank, says there are limits to what central banks can do help the economy.
Photograph by Zack Wittman

Could a financial crisis follow the Covid-19 pandemic? It's a frightening scenario, but one that's entirely plausible, says Carmen Reinhart, chief economist of the World Bank. This week, the World Bank forecasted that world gross domestic product would grow by 4% this year, leaving economic activity below its level before the pandemic. And mounting debt and risky behavior related to the pandemic stimulus could threaten a fragile global recovery. Reinhart is a student of boom-bust cycles, sovereign debt defaults, and other financial debacles, as well as co-author, with Ken Rogoff, of the bestselling book, *This Time Is Different: Eight Centuries of Financial Folly*. In an interview with *Barron's,* Reinhart described how all of the easy money in the world can't lead us to prosperity, notwithstanding the stock market's belief to the contrary. Edited excerpts follow.

***Barron's*: You've said in the past that debt from the global financial crisis would slow us down. But now, government debt is exploding.**

Carmen Reinhart: This is a truly global [crisis]. You have to go back to the 1930s to see [a crisis in which] no one is unscathed, whether you're low income, middle income, high income, irrespective of region. The accumulation of debt is also at a global scale. It's advanced, middle income, low income.

Covid-19 has been akin to a war. You first fight the war. You win the war. And then you worry, how are you going to pay for the war? Because nothing less than human lives have been at stake here. Do I take a benign view of the debt accumulation? Absolutely not. It's important to recognize that even before Covid-19, almost half of low-income countries were facing debt difficulties, or were in an outright debt crisis. So, the time horizon and severity of the consequences are very uneven. We're already seeing it unfold in low-income countries, in rapidly rising incidents of sovereign debt problems. We've had emerging market crises: Ecuador, Argentina, Lebanon.

The advanced economies with the greatest resources have the greatest ability to withstand the debt buildup. But debt problems that this crisis is creating go over and beyond the sovereign. They're at the household level, at the business level. This crisis didn't begin as a financial crisis, but is morphing into one.

Could we, perhaps, print our way to prosperity?

Central banks—the Fed, the European Central Bank—have all been incredibly supportive to avoid an even worse outcome than what we've seen during the pandemic. But there's a difference between being illiquid and being insolvent. Printing and liquidity provision can't really tackle a fundamental solvency issue, namely, you just have no resources to repay.

Certainly, the low-for-long interest-rate environment makes debt servicing—public and private—much more manageable, much more affordable. But for those who have lost their jobs, the firms that have had to shut down, or countries that are being hit by a tsunami of a collapse in revenues—you don't deal with insolvency with the provision of liquidity. There are orders of magnitude here that are beyond the reach of what a central bank can do.

> **"Don't confuse rebound with recovery."**
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> — Carmen Reinhart

What kind of recovery do you expect?

How many countries have gotten back to their pre-crisis level of per capita income? We're not there yet. Let's take a standard, well-known global forecast, like the World Economic Outlook from the International Monetary Fund, or the Global Economic Prospects from the World Bank. Both projections, even with a V-shape rebound, still don't get you to your pre-crisis per capita income level. That takes longer. If you look at past serious crises, that full recovery, getting back to, at a minimum, where you were before the crisis hit, is a multiyear process.

Don't confuse rebound with recovery. We're going to see this snapback, because we had output and employment collapses the likes of which are four standard deviations and more away from any normal downturn. The temptation is to say, aha, we've recovered. Not the same thing. And once you get into other dimensions, into things like poverty levels, it's a very, very unequal crisis, hitting the most vulnerable most. That takes time to overcome.

How long is multiyear?

In 2008-09, it took the U.S. about five years to get back to the pre-crisis level of per capita income. In Europe, it has taken longer: Italy and Greece are still waiting to recover the level of per capita income of 2007. In developing countries, whether you're talking about Zambia, Angola, Ecuador, or Lebanon, these are very serious crises. Look back to the 1980s: It's not called the Lost Decade for nothing. In 1990, about 60% of the emerging markets and developing countries had per capita income levels below what they were in 1980.

THE TROUBLE WITH RECOVERY

Deep economic shocks

take a long time to heal, particularly for developing nations.

60%
The percentage of emerging market nations whose per capita income levels in 1990 were below what they had been in 1980.

There's a huge level of uncertainty about whether either monetary or fiscal policy can sustain even a fraction of the stimulus we saw earlier this year. In the U.S., some of the risks to recovery are declaring victory prematurely and withdrawing stimulus prematurely. To get recovery on a sustained footing, we still need to see more fiscal stimulus. Good news on the vaccine notwithstanding, we are still seeing record infection rates.

Let me highlight another headwind to growth. By almost any realistic assessment, the issue we are looking at is more nonperforming loans. You don't get this kind of economic contraction and not affect household and business balance sheets. What do financial institutions do when they're facing compromised balance sheets? They curtail lending. This was a classic case in Europe after the 2008-09 crisis. In varying degrees, you're going to see tighter lending standards, less new lending in an environment with so much uncertainty.

At what point do current central-bank policies create serious consequences?

If, in the global financial centers, you have had either negative or zero rates, for the past 200 years, it only fostered the search for yield. It takes you to riskier investments. It takes you down the path of skewing toward riskier projects. One variant of increased risk taking is skewing activity away from better regulated institutions—the banks—to more maverick, less well-regulated shadow banking.

Do you foresee another global financial crisis?

In a classic financial crisis, you have a period of a boom, fueled by credit creation, leverage, the asset price bubble. The bubble bursts. And you still have the leverage. Boom, you have a balance sheet problem on your hands.

This time, we may have the bust without the boom. In lieu of a big dramatic Lehman moment, what you're likely to get is a sustained deterioration in asset quality. How long can small and medium-size businesses that are still dealing with the closures, with a very uncertain environment, maintain debt servicing? There are financial fragilities. There are financial crises that come about with less drama, [because of] a significant cumulative deterioration in asset quality. We are not out of the woods. This really applies globally.

The World Bank is concerned about income inequality. Do loose policies make it worse?

They already have. This is a very unequal crisis, hitting lower-income, most-vulnerable groups of the population, and across countries, as well. The ability to do what we're doing and work from home has not been evenly distributed across income groups. The poorest countries have the least capacity to do the kind of stimulus that ensures people have even the minimum minimorum of a safety net.

The recent World Bank report on poverty and shared prosperity for 2020 showed the first spike in global poverty rates in more than 20 years. The inequality dimension is already very significant. Prosperity takes a long time to build, but it takes a much shorter period to destroy.

How does the developing world emerge from this crisis?

Let's talk about China: It's very important to understand its recovery in the developing world. Coming out of the 2008-09 crisis, China was the engine of growth for developing and emerging economies. In the decade that ended in 2013, China's growth rate averaged double digits, a little over 10% or so. That's not where China is today.

The first thing that jumps out is how successfully China was able to contain the pandemic, because everything follows from that—comparatively strong performance relative to everyone else. Is China going to be the kind of growth engine for the developing and emerging world that it was at the end of the 2008-09 crisis? I don't think so.

Over the past decade, Chinese corporates took on record levels of debt. The capacity to be a vibrant exporter is very much still there, but the rest of the world is in a different shape. Much of China's spectacular growth after the global financial crisis was from infrastructure investment. The idea that you can go into another mega-fixed-investment-boom is not feasible. And the China commodity boom, which lasted longer than any commodity boom in the past 200 years—we're not likely to get there. Another engine was that China became the largest lender to low-income countries and some middle-income ones. Many of the countries now facing serious debt-repayment difficulties have taken on quite a bit of debt from China. That source of new financing is not there now.

Which countries will be in the worst shape?

If you're a commodity producer, your export revenues have been shot. Your government revenues have been shot. Economic activity is less capable of rebounding if the sovereign government is in the midst of a debt crisis. The most immediately, heavily impacted are many low-income countries, but there are a lot of middle-income countries, especially in Latin America, that are hit especially hard. When you look back over the past 20 years, one of the great achievements of globalization was the narrowing gap between rich and poor countries. That [gap] is widening markedly again.

Thank you, Carmen.

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