How pandemic and war are transforming global finance

New report explores macroeconomic stability and policy, the international monetary landscape and the sustainability of sovereign debt post-2020.

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The COVID-19 pandemic and Ukraine war, which are bringing about a new and unpredictable geopolitical order, are also transforming global finance and economics, with far-reaching implications for policymakers.

A new report led by IESE Prof. Xavier Vives centers on three major elements of this transformation: macroeconomic stability and policy; the international monetary landscape, and in particular the U.S. dollar; and the sustainability of sovereign debt, especially in Europe.

The report, titled *The International Economic and Financial Order After the Pandemic and War*, is the fifth in a series by IESE's Banking Initiative and is published by the U.K.-based Centre for Economic Policy Research (CEPR). In addition to Vives, the report's co-authors are Giancarlo Corsetti of the European University Institute, Barry Eichengreen of the University of California, Berkeley, and Jeromin Zettelmeyer of the think tank Bruegel.

At present, there are more questions than answers as to how economics and finance will be altered by the events starting in 2020. The duration and outcome of the war in Ukraine will determine its ultimate impact. But there are important questions to pose now, in order to prepare for what may be in store. Some of those questions considered in the report are:

- Should the inherited policy model and institutional framework be changed to control inflation without endangering financial stability?
- Is policy coordination and cooperation among jurisdictions easier or more difficult?
- Will the U.S. sanctions on Russia penalize the international dimension of the U.S. dollar?
- Is the renminbi a feasible alternative to the U.S. dollar, U.S. banks and SWIFT as a cross-border financial vehicle?
- Will sovereign debt be sustainable after the large shocks that the international economy has endured?
- Should the European Union reform its fiscal rules?
- Are the credit restructuring mechanisms in place adequate?

While spiking inflation, rising interest rates and wobbly economic growth are new developments since 2020, the pandemic and war also have accelerated existing trends. Those include the rise of protectionism, the regionalization of finance, the decoupling of the West and China, and public debt accumulation.

These trends reveal potential conflicts between the objectives of managing inflation, maintaining debt sustainability and ensuring financial sector stability, all the while safeguarding the welfare of people.

Some of the general findings from the three areas are as follows:

Macroeconomic outlook and stabilization policies

A first broad message from the report is that policymakers may need to adjust the policy paradigm that posits the relative independence of fiscal, monetary and regulatory policies, finding new ways for the three to interact to effectively pursue stability.

A drastic break in the paradigm is neither necessary nor wise. "On balance, there are strong arguments for amending and fixing the policy model, rather than scrapping it altogether and venturing into unknown territory," the report concludes.

But overcoming the current inflation crisis and complex macroeconomic environment presents a challenge to the current policy model. Relative prices and wages must be realigned according to the supply and demand shocks suffered because of the pandemic and war — without feeding persistent inflation.

Both a stable fiscal outlook and a credible monetary policy are essential for a smooth resolution of the inflation spike. But achieving this may prove challenging without addressing financial vulnerabilities.

In a high debt environment, the aim should be to reduce vulnerabilities to a crisis of confidence and foster deleveraging at low economic and social costs. A key strategy will be to have central banks backstopping government debt, with the treasury, in turn, ensuring that potential losses in the balance sheet of central banks do not undermine the credibility of monetary policy objectives and mandates.

A new international monetary landscape

A second broad message of the report centers on the U.S. dollar's long-time dominance in international finance. U.S. financial sanctions against Russia and the threat of future penalties — what is being called the weaponization of the dollar — have opened a window for the international use of alternative reserve currencies.

Since other Western currencies, gold, barter and cryptocurrencies are, at best, limited alternatives, China is stepping into this gap. It has made efforts to be the first mover in the global race to develop a cross-border central bank digital currency, the e-CNY, and has established its own Cross-Border Interbank Payment System (CIPS). Through these and other actions, China is consolidating the renminbi as an alternative to the U.S. dollar, to U.S. banks and to SWIFT.

Nonetheless, the use of currencies in international monetary and financial transactions tends to evolve gradually, and the weaponization of the dollar and the rise of China will at most make it evolve a little less gradually. The dollar will likely retain its dominance for a long while, though it may face weakness by “a thousand cuts,” translating into a lengthy, if gradual, decline.

That could change, however, if relations between the U.S. and China abruptly collapse, and the two superpowers sanction countries for ties to the other. That would risk dividing the international monetary system into two main currency blocs: the U.S. dollar and the renminbi. “In such a case, countries would have to choose between doing business with the dollar or the renminbi, polarizing the international monetary system. This would have large costs for international trading and the stability of the international financial system,” the report concludes.

The sustainability of sovereign debt

A third broad message is that, although sovereign debt remains sustainable in most countries, a handful of European Union countries will need to undertake significantly more debt adjustment than is currently planned, over the medium term.

EU fiscal rules need reform to reconcile the sustainability of debt and stabilization policy, while preserving incentives for investment. Reforms initiated by the EC, which would give country-by-country debt sustainability analysis a central role, could be a step forward, provided that they reduce countries’ discretion and prevent potential abuse of rules.

“The bottom line is that EU debts will likely remain sustainable, but stabilizing and reducing debt ratios in the European Union will require more fiscal adjustment than currently planned by governments and expected under the IMF’s baseline projection,” according to the report.

For developing economies, the rise of China and other non-Paris Club creditors, and the increase in the share of external debt owed to multilaterals, are making crisis resolution much harder. Thus, debt sustainability requires expanding non-debt-creating financial support, bond contracts linked to climate risks and climate actions, and better coordination among official creditors, including China.