

Large public deficits and inflation: recovery challenges ahead

The global economy is expected to grow, boosted by government spending and expansionary monetary policy. The formidable challenge in the coming years will be to rein in the public deficit.



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The IMF now expects the global economy to grow 5.5% in 2021. Fiscal stimulus measures are expected to help the United States grow 5.1%, while Europe is forecast to grow 4.2%. Within the Eurozone, Spain is expected to have the highest growth rate, up nearly 6% -- although this forecast is lower than earlier expectations announced back in October 2020.

With these numbers, [Juan José Toribio](#) opened an online session with IESE alumni, together

with his colleagues [Antonio Argandoña](#) and [Pedro Videla](#), focused on the post-COVID world economy. The three IESE professors analyzed the current economic situation as well as expectations for the coming years. They agreed that any recovery depends upon the evolution of the pandemic. That said, some countries seem to have the situation under control: in Canada, for example, they have four vaccines per person. Within Latin America, only Chile has more than two vaccines per person.

Toribio noted that increased public spending to mitigate the effects of the COVID-19 crisis has turned governments into capital allocators and turned central banks into market makers in both public and private debt markets. In a sense, they have become financiers of the public sector. As such, they may lose some of their political relevance, since they are increasingly restricted to what the public sector can do.

At the same time, Toribio pointed out that the pandemic has lowered the demand for and use of cash, bringing us closer to becoming a cashless society. Several central banks are already considering adopting digital currencies, he said, which would mark a fundamental change in the financial economy.

We may also see the structure of employment transformed by this crisis, due to internationalization as well as fluctuations in the weight of some sectors (such as tourism and logistics) in the labor market as a whole. Coping with these changes will require greater flexibility in the labor market and more training for workers.

Another cultural trend that COVID-19 has prompted is that of anti-globalization, with the interruption of supply chains and countries' defense of their national champions.

Latin America and the role of China

Argentina's economy plunged 19% in the second quarter of 2020, joined by many other countries in the region, such as Brazil (-10.9%), Chile (-14.5%) and Peru (-29.8%). Forecasts for the year ahead are optimistic, even more so now than in October 2020, and Latin America is expected to grow 4.1% in 2021. A full recovery for the region should occur sometime later in 2022.

Despite experiencing a great recession, capital flows have not reversed back to the United States, which is good news for the region in the eyes of Pedro Videla. Capital inflows have allowed Latin American countries to apply expansive monetary and fiscal policies locally. It is Chinese demand that has done the most to help the region's raw materials maintain their

value and keep investor interest.

As a consequence, South America is increasingly tied to China and not the United States, added Toribio. In fact, China -- which did not experience economic decline in 2020 and is expected to grow 8.1% in 2021 -- has become the pole for the global economy.

Going back a few decades, Toribio recalled when the year 2000 was in the future and everyone assumed that Japan would be the main economy for the new millennium. However, Japan's motor of growth was industry, which now accounts for only 30% of the world economy. The other 70% corresponds to the service sector, an area in which Japan had not made great progress. Something similar could happen with China, whose current growth is driven by housing, which is surprising when you consider that China has already built so much.

Public spending: when will it dry up?

According to BBVA's calculations, European funds could add 1.5% to Spanish economic growth in 2021, which it estimates at 6%, and the same in 2022, when GDP is expected to grow 4.4%. The country's budgets already take these funds into account and the Spanish government has announced its willingness to spend to boost growth. More broadly, Europe is following the same trend, said Antonio Argandoña.

The question on Argandoña's mind is whether or not this level of public debt is sustainable. The large increase in the fiscal deficit (which now stands at -12.7% worldwide) and the amount of liquidity generated raises the specter of inflation. For Toribio, the current crisis differs from those of the past, so it's not easy to predict what happens next.

In any case, all three speakers agreed that reducing public debt will be a great challenge in the coming years, since it has reached almost 100% of GDP on a global scale. As Toribio asked: how many years of suffering at the hands of austerity measures might be ahead of us?



The online session "Economía en el mundo post-COVID. Lo que nos espera" (in Spanish) was held on January 28, 2021, as part of the series of online learning sessions for IESE Alumni Association members.

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