EDITORIAL

CAUTIOUSLY OPTIMISTIC

As the new year gets underway, emerging countries are benefiting from a combination of favourable factors for a recovery (catching-up movements in foreign trade, a weak dollar, rising commodity prices, and domestic financing costs that are lower than pre-crisis levels). Yet lots of uncertainty and threats remain: the rollout of vaccination campaigns, the risk of a surge in insolvency cases among the poorest countries, despite financial support from international institutions and official creditors, and a rise in non-performing loans in banking systems as of 2021. The main risk in the medium term is the combination of a probable loss of growth potential due to the pandemic and the private sector's record-high debt burden.

After a Q3 rebound, emerging countries seem to have avoided another downturn in economic growth. A widespread improvement in economic and financial indicators can be seen in Q4 2020.

THE SKY HAS BECOME CLEARER...

Purchasing manager indexes (PMIs) for the manufacturing sector have continued to improve. In a few countries (China, Brazil and Hungary), manufacturing PMIs deteriorated in December albeit from high levels (above the 50 threshold). Mexico is the only country whose PMI suggests an ongoing industrial recession. For the majority of countries, year-on-year export trends swung into positive territory again over the summer or early fall. In Asia, where foreign trade has been more robust thanks to China's contribution, the export catching-up movement has already run its course. This movement is intensifying in central Europe. In contrast, the recovery in exports still seems to be very fragile in Latin America (including for manufactured goods) and in Africa and the Middle East. Yet the later regions should benefit from the ongoing rebound in commodity prices, which is resulting from both the consolidation of metal prices and a more clear-cut upturn in oil prices, which should consolidate with Saudi Arabia's recent cutback in oil production.

The improvement in financial indicators is more spectacular, notably portfolio investment flows, exchange rates and risk premiums. According to the IIF, portfolio investment was still hesitant over the summer months, but soared in the fourth quarter to a record high of nearly USD 60 bn a month on average (USD 42 bn excluding China), easily erasing the outflows reported earlier in the year. Since the shock last spring, net investment flows have reached a cumulative total of USD 250 bn. In comparison, for the same interval following the shocks of the 2008-2009 financial shock and the mini-crash of the Chinese stock market in 2015, net investment flows simply returned to their point of departure. Bond issues hit an air pocket only once, in March, and by the second half, the pace of issues had surpassed the 2019 level.

With a few rare exceptions, exchange rates appreciated against the US dollar between end-September and end-December (with a median of 4%, vs 2% in Q3). At a time when external accounts were improving, emerging currencies also benefited from the weak US dollar. With few exceptions, sovereign bond yields in the local currency and risk premiums (CDS spreads) have fallen, even though there were fewer key rate cuts than in Q3. Pressures have eased, even in the countries that have proven to be the most vulnerable to the shock (South Africa, Brazil and Turkey, although for the later, at the expense of a reversal and tightening of monetary policy).

... BUT THERE ARE STILL CLOUDS ON THE HORIZON

On the whole, emerging countries are benefiting from a combination of factors that should support their recovery in the short term (weak US dollar, rising commodity prices, lower financing costs than pre-crisis levels). But a lot of uncertainty and pitfalls remain.

In the short term, logistical constraints and population size raise fears of an unequal race against time between the rollout of vaccination campaigns and the spread of the virus (notably in Brazil and Russia), even though its propagation does not necessarily result in higher mortality rates. The second threat, potentially only in the very short term, is the surge in the number of insolvency cases among the poorest countries despite support from the international financial institutions (IFI) and official creditors, via emergency funds and the debt servicing suspension initiative (DSSI). Even after DSSI was extended into 2021, the initiative provides relief for only 20% of the financing needs of eligible countries. Lastly, the banks will have to absorb the rise in non-performing loans. In all three cases, let's hope the key players (governments, IFIs, bilateral official creditors and private creditors and banks) have the capacity to mobilise and/or show proof of resilience to manage these risks.

Looking beyond 2021, one of the big uncertainties is the erosion of growth potential due to the pandemic. The health crisis could be seen as a transitory shock, unlike shocks generated by a structural decline in the terms of trade (for commodity producing countries) or by a financial and/or banking crisis. Yet the pandemic was global, and not just regional as in previous cases. Even under a scenario in which vaccination campaigns bring the pandemic under control, the World Bank evaluates the loss of growth potential at 0.6 points of GDP a year for all of the emerging and developing countries (including China) in the period 2020-2029. Let's keep in mind that growth potential has already contracted by 1 point over the past decade. The extra loss of growth potential is mainly due to the smaller contribution of investment. According to the World Bank, the main reasons are uncertainty, risk aversion and the decline in corporate earnings. We would like to add the record-high level of private sector debt (even excluding China), knowing that the causal relation between growth potential and debt is a two-way street.

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