Editorial

Triple whammy

Emerging countries have been severely affected by the COVID-19 pandemic even though the official number of confirmed cases and deaths (excluding China) is still low compared to the figures for the developed countries. A wave of slowdowns and recessions is only just beginning, and the economic fallout will probably spread beyond 2020, because the real shock (shutdown of business due to confinement measures) is compounded by a financial shock and commodity price shock. Capital outflows and the freeze on bond issues in international markets increases refinancing risk in US dollars. Preventative safety nets are being set up to reduce defaults, but the solution for the most vulnerable countries is probably a sovereign debt moratorium or a debt relief.

Multiple shocks hit the emerging countries

The entire planet has been hard hit by the COVID-19 pandemic. According to the OECD, for a selection of nearly 50 developed and emerging countries, the supply-side shock generated by confinement measures could result in a loss of activity of at least 15% (the median is -25%). This is an unprecedented shock, surpassing even that of the 2008-2009 Global Financial Crisis (GFC), when no country reported more than a 5% decline in GDP from peak to trough. Granted, the periods of confinement will be followed by a rebound, like the one in China in March. But unlike the 2008-2009 crisis, the recoveries will not be synchronised. Asia will be the first to recover, followed by the countries of central Europe and then Latin America. Growth in the main emerging countries will be about 1% this year (0% excluding China), vs 4% in 2019. Latin America will be hit hardest, with a contraction of at least 2.5%.

For the emerging countries, the supply-side shock is coupled with a financial shock. Portfolio investment funds specialising in the emerging countries have reported massive withdrawals, which are also unprecedented compared to previous periods of financial stress. According to IIF (Institute of International Finance) estimates, there has been a cumulative outflow from portfolio investments of USD 95 bn since the beginning of the pandemic, compared to outflows of USD 20 bn during the GFC and Taper Tantrum. In March, there were no sovereign bond issues in foreign currencies.

Commodity producing countries will be especially hard hit because the dollar's appreciation will not offset the decline in global commodity prices. OPEC and Russia stroke a deal to reduce production by 10% but global demand has already reduced by 20% and oil stocks reached a record high, which suggests prices will remain low in the short term. World trade growth will probably be structurally lower because of industries relocation and the shortening of global value chains. This may have a negative impact on commodity prices.

Like in the developed countries, the governments and monetary authorities have reacted rapidly and in multiple ways. The central banks immediately sent strong signals of support for domestic liquidity, including key rate cuts, lower required reserve ratios and easier refinancing terms for banks. These support measures are all the more important for the emerging countries since domestic interest rates could come under pressure simply due to the drying up of external liquidity.

At the same time, most governments have announced economic stimulus plans. Of course, the amounts are not comparable since they comprise a wide range of solutions, from fiscal measures and effective spending (which will add to fiscal deficits) to the set-up of credit lines and guarantees (which are potential expenditures or debt). These are not budgetary impulse but measures aimed at maintaining activity. Multiplier effects are thus expected to be limited.

Towards a sovereign debt moratorium?

The shutdown of the international bond market has raised fears of USD refinancing risk. In 2020, many countries will have to face up to debt servicing charges on international debt representing at least 20% of their foreign reserves: Bahrain (47%), Turkey (30%), Ghana (27%), Nigeria (23%), Chile (22%), South Africa (21%), and Ukraine (21%). A priori, the risk of default is low for these countries. With the exception of Chile and Turkey, however, these countries have fragile economic structures that make them susceptible to protracted recessions. Investors will be keeping a close eye on them. Of these countries, Ghana and Senegal have officially requested IMF assistance.

Preventative safety nets are being set up to reduce defaults. For the moment, only a few of the emerging countries are covered by the swap lines announced between the Fed and other countries (Brazil, South Korea and Mexico). But the IMF is providing USD 100 bn in accelerated emergency financing, including USD 10 bn in the form of zero interest loans for the most vulnerable countries.

Another more radical option would be a sovereign debt moratorium or debt relief. The IMF has already approved a temporary debt flow relief (i.e. up-front grants to cover debt repayments) for 25 countries. G20 countries are expected to offer a moratorium on bilateral loans to end-2021. It is a first step that should be amplified. A moratorium would allow priority to be given to channelling funding towards their healthcare needs, and it would prevent the rating agencies from downgrading their sovereign ratings, which would only pour oil on the fire.

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