COFACE ECONOMIC PUBLICATIONS

29 APRIL 2020

FOCUS

By: Julien Marcilly - Chief Economist, Dominique Fruchter - Economist for Africa and Mohamed Akallal - Junior Economist, based in Paris, France.

COVID-19 swings the spotlight back onto emerging countries'debt

While the focus, so far, has mainly been on China, Europe and the United States, the consequences of the COVID-19 pandemic are likely to be even more severe in emerging economies. Even though their degree of vulnerability to this shock depends on many factors, the initial situation of their public finances is a key issue, as it determines their response capacity to the multitude of economic consequences of this crisis. However, their public debt was already at an all-time high in 2019. The massive capital outflows generated by this health crisis also remind us that many emerging economies continue to suffer from the "original sin", i.e. the inability to issue bonds in local currency. In addition to this initial risk on public finances and the depreciation of currencies, the exposure of emerging countries to three other risks linked to the COVID-19 pandemic should be emphasised: 1) the implementation of strict containment measures, 2) the reliance on tourism revenues and 3) the dependence on non-agricultural commodities. Nine countries are affected by three out of these four sources of vulnerability, 31 by two of them, and 71 by one of the four. The additional financing provided by international organizations (notably the IMF) and the debt arrangements announced by creditor countries will help many low-income countries, but should be of little use to the larger emerging economies.

Capital outflows and increased sovereign risk go hand in hand, even for local currency indebted economies

The immediate effect of rising global uncertainties on emerging markets can be observed through capital outflows of a magnitude never witnessed before. In times of crisis, capital outflows are common, as investors favor so-called risk-free assets. However, during the month of March, the sales of bonds and shares of 24 emerging countries by foreign investors exceeded USD 80 billion, four times more than in the last quarter of 2008. During this period, not all decisions were rational. For instance, currencies of countries with solid fundamentals depreciated. This was the case of the won, even though Korean public debt is low, that the budget and current accounts show surpluses and that foreign exchange reserves remain at a very comfortable level. Moreover, South Korea's management of the pandemic is considered top-tier. Overall, the currencies of emerging countries with liquid financial markets were the most penalized: during the first quarter, the strongest currency depreciations against the dollar were in Brazil, South Africa, Russia and Mexico (more than 25%), followed by Colombia and Indonesia[1].

1 - In countries with fixed exchange rate regimes (like some in the Gulf or in Asia), pressures subsequent to capital outflows are more visible through the intervention of central banks. However, data on foreign exchange reserves fluctuations are usually published late.