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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

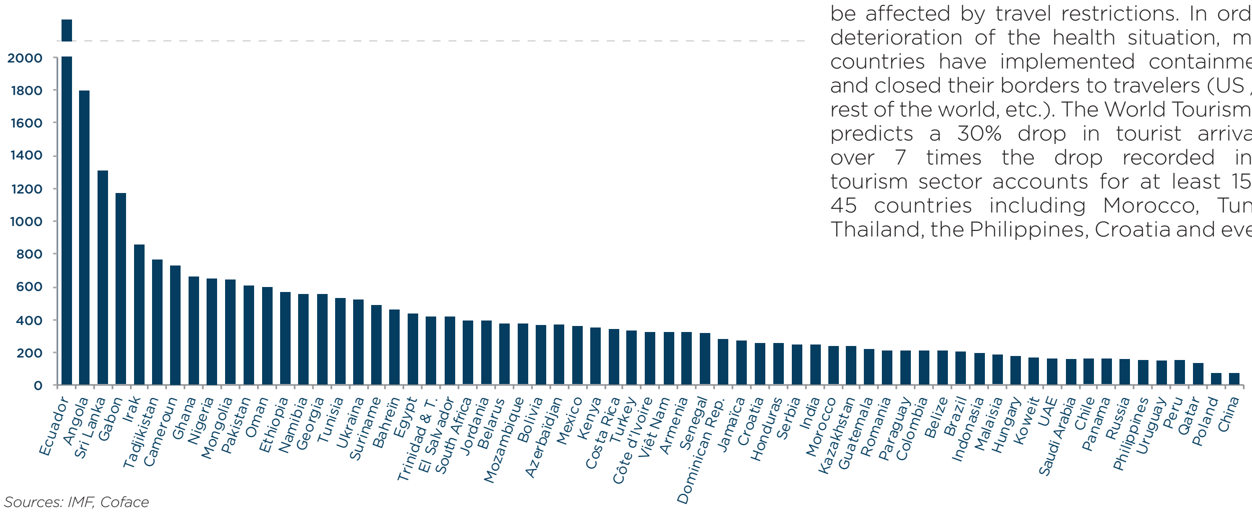
The immediate effect of rising global uncertainties on emerging markets can be observed through capital outflows of a magnitude never witnessed before. In times of crisis, capital outflows are common, as investors favor so-called risk-free assets. However, during the month of March, the sales of bonds 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.

On the bright side, capital outflows were less significant in the first half of April, with some net inflows observed during the third week.
These capital outflows lead to a rise in sovereign rates in local currency. Therefore, they entail a hardening of financing conditions for countries, whereas central banks try to soften them for households and companies by reducing their key rates. The emerging countries in which bond markets in local currency are the most open to foreign investors (like South Africa) are those where interest rates on sovereign bonds have increased the most. In other words, issuances in local currency certainly cover the exchange risk, but generate an additional increase in interest rates[2]. Ultimately, economies that thought themselves free from the "original sin" by favoring issuances in local currency are not immune today. In fact, almost 20 years ago, B. Eichengreen, R. Haussmann and U. Panizza[3] explained that the ability to borrow in local currency distinguishes mature economies from emerging ones. The possibility to obtain funding through foreign currencies represents the "original sin" for these countries, in reference to the doctrine of Christian theology, as they yield to the temptation of the forbidden fruit: the financing in foreign currencies made them vulnerable to the depreciation of their currency and explained many emerging crises in the 1990s. During the 2000s, the authorities of emerging countries gradually began to borrow in local currency, in which 80% of their debt is now denominated. This created the illusion that the "original sin" was gone.

Many other smaller emerging or developing economies have not been able to issue debt in local currency. In recent years, they certainly have taken advantage of abundant global liquidity to issue bonds, albeit in foreign currencies. However, the latter are also penalized by a rise in sovereign interest rates **(see Chart 1** in the case of USD denominated securities). Among them, the increase is particularly strong in Ecuador, Angola and even Sri Lanka. Nevertheless, beyond these extreme cases, the widening of the rate differential with the American equivalent is very large for the vast majority of countries (between 4 and 6 percentage points in a month and a half).

CHART 1
Sovereign spreads (Change in basis points between Feb 19 and Apr 9, EMBI)



Sources: IMF, Coface

Emerging economies, already indebted before the crisis, will suffer from the effects of 3 shocks: lockdown, fall in oil prices and of tourism revenue

In the context of this crisis, emerging economies with a high initial level of vulnerability should be monitored. In the very short term, considering capital outflows, the degree of vulnerability depends on the balance of the external accounts and the exchange rate risk. The countries at risk in these areas can be observed in the upper part of **Chart 2**. Coface takes into account external debt, the current account balance, external financing needs, foreign exchange reserves and the variation of the exchange rate (among others) by calculating this index that fluctuates from 0 to 100% (very high risk). In the medium term, the initial situation of their public finances is the key issue: it determines their response capacity to the various potential economic consequences of this crisis. The abscissa axis is the measure of the risk associated to public finances, which is taken into account in the Coface model of Country Risk Assessment. It notably includes the public account balance, public debt as well as budgetary revenue. Briefly, economies that are the most at risk in this area appear on the right of this same visual[4].
In addition to the initial sovereign and exchange risk levels, three other factors must be taken into account when assessing a country's exposure to the economic consequences of the pandemic:
1) The reliance on revenue from non-agricultural commodities exports. Despite an expected rebound of oil prices in the second half of the year, the anticipated level (Coface forecasts USD 45 on average for a barrel of Brent in 2020) is insufficient for most of the main oil-exporting countries to balance their budgetary and current accounts. Moreover, a volume effect is added to the price effect for countries (including Saudi Arabia) that have agreed to drastically reduce their production in order to limit the depth of the fall in prices caused by the demand shock (see Coface Country and Sector Risk Barometer of April 2020[5]). Net exporters of other non-agricultural commodities[6] have also experienced a deterioration in their terms of trade since the beginning of 2020. The budget balances of commodity-exporting countries are expected to deteriorate the most this year (-15% and -16% of GDP respectively for Algeria and Oman, as forecasted by the IMF).
2) Countries that depend on tourism revenues will also be affected by travel restrictions. In order to avoid a deterioration of the health situation, many of these countries have implemented containment measures and closed their borders to travelers (US /Canada, EU/ rest of the world, etc.). The World Tourism Organization predicts a 30% drop in tourist arrivals for 2020, over 7 times the drop recorded in 2009. The tourism sector accounts for at least 15% of GDP in 45 countries including Morocco, Tunisia, Mexico, Thailand, the Philippines, Croatia and even Cambodia.

2 - https://www.bis.org/publ/bisbull05.htm
3 - Eichengreen, B., Hausmann, R., and Panizza, U., (2002). *«Original Sin: The Pain, the Mystery and the Road to Redemption».*
4 - The two axes represent the global averages for each indicator..

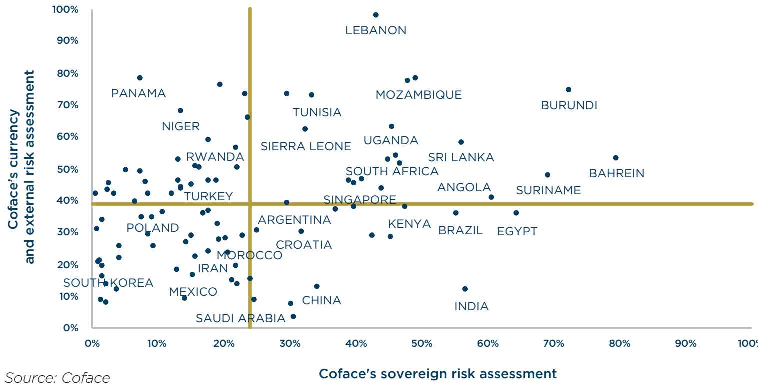
HOW TO STOP CAPITAL OUTFLOWS FROM EMERGING COUNTRIES?

To limit the magnitude of these capital outflows, three types of response were quickly implemented:

1) Central banks used their foreign exchange (FX) reserves to contain downward pressures on their currencies: in Turkey, Egypt, Ukraine, Indonesia, Poland, Brazil, Nigeria and South Africa, FX reserves fell by more than 5% between the beginning of March and mid-April.
2) In the same way as the ECB or the Fed, some central banks of emerging countries have assumed the role of lender in last resort, by launching asset purchase programmes aimed at buying sovereign bonds of their country: Philippines, Colombia, South Africa and Poland.
3) The US Federal Reserve has opened swap lines designed to provide USD 60 billion in liquidity to its counterparts (notably in Brazil and Mexico), for at least 6 months. On April 6th, it also launched a program (FIMA repo facility) dedicated to foreign central banks, which can obtain USD liquidity in exchange of US treasury bills and thus limit dollar shortages in their countries, by then redistributing this liquidity to local economic agents in need (banks, companies).

3) Countries affected by the pandemic and whose governments have implemented compulsory containment measures (at national or local level) will have to face an increase in indebtedness, which results from the decrease in revenue directly caused by the pandemic, the increase in health expenditure and the cost of the support packages aimed at mitigating the economic consequences on the population. 87 countries were in this situation as of April 10.
Taking into account these 4 risk factors *(1- initial level of sovereign and exchange risk, 2- lockdown, 3- reliance on commodity exports and 4- dependence on the tourism sector)* the IMF anticipates that the budget deficit of emerging and developing countries will exceed 9% of GDP this year, twice as much as in 2019. It was still in surplus in 2008. Public debt, already at an all-time high in 2019, would reach 62% of GDP, up 25 points since 2012[7]. In addition to the initial level of vulnerability of public finances and of exchange risks (the average Coface risk assessment scores of public finances, external vulnerability and exchange rate are above 45%, 100% being maximal risk), the exposure of emerging countries to the other three shocks linked to the COVID-19 pandemic is to be factored in to assess the degree of exposure to the current crisis. In the end, 9 countries are affected by three out of the four sources of vulnerability: South Africa, Algeria, Angola, Ecuador, Lebanon, Mauritania, Oman, Tunisia and Venezuela, 31 others by two of them **(see Table 1)** and 71 by at least one of the four.

CHART 2
Coface's sovereign and currency/external risks (100% = very high risk, lines = global averages)



Source: Coface

TABLE 1
Heatmap: Exposure to pandemic related shocks

Source: Coface

The initiatives of international organizations and creditor countries to relieve low-income or emerging countries should particularly benefit the former.

As sovereign risk increases in the emerging world, the need for additional financing is urgent for many countries, which appealed to the International Monetary Fund (IMF). On April 16, 102 countries made an official loan request. The IMF theoretically has a total lending capacity of USD 1.3 trillion, but if the sums already lent and prudential rules are taken into account, the actual amount is more likely around USD 800 billion. First, the IMF recovers its own resources, devoted to the financing of its usual programs and based on the quotas of the member countries' capital contribution (approximately USD 300 billion, sum of loans deducted). Then, and above all, there are resources already available or usable in an emergency as loans, either from other financial institutions (USD 200 billion) or from member countries (around USD 300 billion). Acknowledging the COVID-19 pandemic as an emergency, the IMF has activated bilateral agreements with G20 members to increase available funds.
The emergency funds available (USD 100 billion) are in the Catastrophe Containment and Relief Trust (CCRT).

5 - https://www.coface.com/News-Publications/Publications/Country-Sector-Risk-Barometer-Q1-2020-Quarterly-Update
6 - Excluding precious metals.
7 - IMF, Fiscal Monitor Report, April 2020.

CREDITOR COUNTRIES ACT COLLECTIVELY AND RARELY INDIVIDUALLY TO HELP COUNTRIES FIGHT THE PANDEMIC

On 15 April 2020, the G20 countries agreed upon a moratorium on the service of bilateral public debt of low-income countries that are eligible for concessional financing from the World Bank (77 countries) between May 1 and December 31, 2020. This means that the payment of USD 12 billion will be deferred to the years 2022-24, counting a year of grace. At the same time, private creditors should agree to suspend the payment of USD 8 billion on the same conditions. The Paris Club, which brings together the main advanced creditor countries as well as Brazil and Russia, will use the year 2020 to determine - depending on the situation of each country - whether the debt should be canceled or restructured.
China, which is not a member of the Paris Club, should favor the bilateral approach – barring surprises. It could grant debt relief, as it has done in the past (Sudan in 2017, Congo, Ethiopia and Cameroon in 2019) with countries of which it is a major creditor (Angola, Congo, Djibouti, Mozambique, Niger, Ethiopia, Zambia, Ecuador, Venezuela, Cambodia, Kyrgyzstan, Laos, Mongolia, Tajikistan etc.). Johns Hopkins University estimates that China holds 17% of Africa's external public debt, 20% according to the Jubilee Debt Campaign. The fact that China has economic interests (especially raw materials) or that these countries are part of its Belt and Road Initiative (transport infrastructure) encourages this course of action.

These funds can be released quickly, without the beneficiary having to present an action programme beforehand. Countries can claim up to 50% of their quota (100% temporarily). The funds are divided between the Rapid Credit Facility (RCF) reserved for poor countries and the Rapid Financing Instrument (RFI) open to all[8]. The need has to come from an urgent problem with the balance of payments that results from health spending or economic consequences linked to the COVID-19 pandemic. 130 countries meet the criteria to access these funds. As such, the IMF has already granted loans to Nigeria (USD 3.4 billion, 0.9% of GDP), Pakistan (0.5%), Ghana (1.5%), Tunisia (1.9%), Senegal (1.8%), Mozambique (2.1%), Albania (1.3%), Madagascar (1.2%), Gabon (0.9%), Niger (1.6%), Rwanda (1.1%). While these emergency loans have the merit of being able to change the situation for low-income countries of relatively small size and can potentially represent 6 to 10% of GDP (for certain African countries in particular), they are too small for large emerging economies. If Turkey, South Africa or Brazil decided to use them, the amount granted would probably not exceed 1% of their GDP.

Additionally, the Catastrophe Containment and Relief Trust (CCRT) allows the IMF to provide grants to the poorest and most vulnerable countries, to help reduce their debt and assist them in case of with disasters, including those related to public health. These countries include the ones eligible for concessional loans and with a per capita income of less than USD 1,175, or those with a population of less than 1.5 million and a per capita income of less than USD 2,350. The issue is that this source of funding is undercapitalized, with only USD 500 million, but the IMF has appealed to G20 countries to increase it to USD 1.4 billion. In the light of this, the IMF decided on April 13 that 25 countries would benefit from a 6-month cancellation of debt service[9].
The IMF can also help through the usual instruments such as: 1) faster availability and increase of resources contained in programs that already link the IMF to beneficiary countries and the implementation of additional programs, 2) changing the priorities of technical assistance and emergency training actions within the framework of existing programs, 3) the use of precautionary lines by beneficiary countries (thus, Morocco has decided to use the three billion dollars available). , 4) the newly established renewable short-term liquidity line. Finally, with the agreement of a majority of its members, the IMF could allocate additional SDR, opening the possibility for more loans from its own resources. However, this requires the consent of 85% of voting rights. The United States, which own 16.5% of these rights, is not favorable.
In addition to the IMF, the World Bank (envelope of USD 160 billion in grants and loans planned for the next fifteen months), the African Development Bank (USD 10 billion), the Islamic Development Bank (USD 2.3 billion) and the European Union have also announced similar initiatives. Nevertheless, while international organizations have planned to increase their aid to developing countries, mainly in the form of concessional loans, they are not (for now) suspending the service of their debt, estimated at USD 12 billion for 2020. Furthermore, higher income emerging countries are also facing challenges. Given the limited scope of the abovementioned emergency aid, the latter should appeal to the usual and more substantial assistance programs. However, a conditionality would then be introduced, which some would not necessarily be willing to accept (like Turkey, Mexico or South Africa), while others are excluded (Venezuela, Iran) because of international sanctions and opposition from the United States.

8 - In the first case, these are interest-free loans, repayable over 10 years with a grace period of 5 and half years. In the second, the loans are similar to those granted in the Stand-By Arrangement: 1.5% of interest and reimbursement over 3 to 5 years. Aid can be variegated.
9 - Afghanistan, Benin, Burkina Faso, Central African Republic, Chad, Comoros, Congo, DRC, Gambia, Guinea, Guinea-Bissau, Haiti, Liberia, Madagascar, Malawi, Mali, Mozambique, Nepal, Niger, Rwanda, São Tomé and Príncipe, Sierra Leone, Solomon Islands, Tajikistan, Togo and Yemen. This represents aid worth USD 213 million. Four additional countries should be added and the suspension could be extended to two years, if the IMF's matching contribution is made.

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