COVID-19 Upends Emerging Markets, But The Right Policy Mix Can Mitigate Symptoms

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Highlights

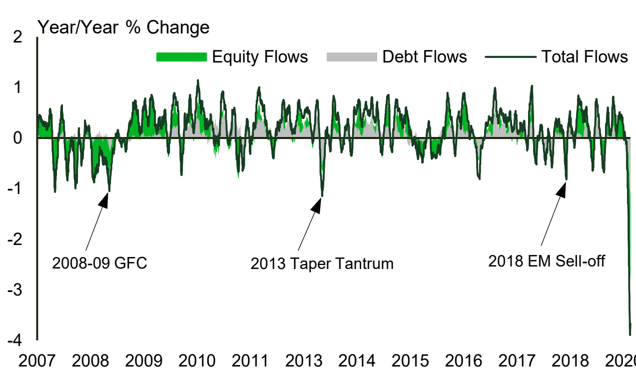
- COVID-19 disruptions have led to an unprecedented stop of capital flows in emerging markets (EMs). This has led to significant downward pressure on EM currencies, tighter financial conditions, and severe dollar shortages.
- EM policymakers are faced with limited options both on the fiscal and monetary front. They are also faced with past fears of unanchored foreign exchange weakness triggered by monetary easing.
- Bold and timely policy moves by EMs, cooperation of advanced economies, and a more proactive response by multilateral institutions, such as the IMF, could help mitigate symptoms.

The COVID-19 pandemic has not spared any region of the world, but attention has largely been focused on advanced economies (AEs). The disease is fast spreading in emerging markets (EMs), prompting authorities to initiate travel restrictions and lockdowns, with severe economic consequences. However, EMs are more vulnerable to such crises than AEs. Weak healthcare systems and high population densities constrain EMs' ability to stymie the virus spread. If dealing with COVID-19 disruptions was not enough, EMs also face an unprecedented stop in capital flows.

Rapid capital outflows are familiar territory to EMs, as are a drying up of inflows. For many EM policymakers, the dark memories of the 1997 Asian crisis are still fresh. While most EMs today have larger buffers than during the Asian crisis, the current crisis is broader and more all encompassing. The COVID-19 related drop in net capital inflows are not only bigger than the those seen during the global financial crisis (GFC), but also the 2013 taper tantrum and 2018 EM sell-off (Chart 1).

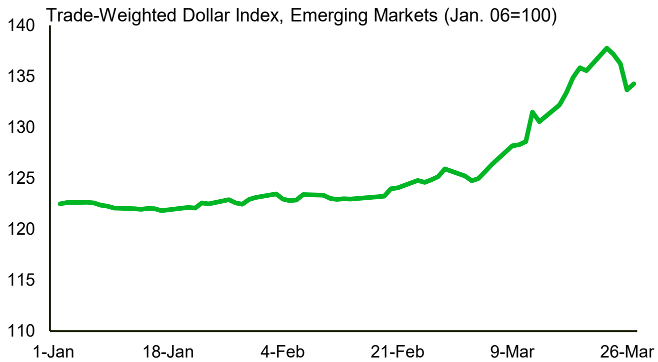
The end result is significant downward pressure on EM currencies (vis-à-vis the U.S. dollar), tighter financial conditions, subdued asset prices, and depleted foreign reserves. Since the beginning of this year, the U.S. dollar has strengthened by 11% against EM currencies (Chart 2). In better times, weaker EM currencies would have had helped their exports, but not this time, as the worldwide spread of COVID-19 means unprecedented weak global demand. All this makes government financing more difficult, especially for those with large deficits or where reserves are not enough to meet financing needs. This crunch also hurts the highly-leveraged EM non-financial corporate sector, which saw its borrowing go up from 65% of GDP at the advent of the GFC to 94% in 2019.

Chart 1: EM Portfolio Flows Are in Freefall



Source: IIF, TD Economics
Note: Total Net non- resident purchases (EM stocks and bonds) presented as a 28-day moving average

Chart 2: The US Dollar Has Strengthened Sharply Against EM Currencies



Source: Federal Reserve Board, TD Economics . Last data point March 27, 2020

EMs face a difficult policy dilemma in mitigating the economic damage caused by these types of crises. Easier monetary policy threatens to exacerbate capital outflows, worsen dollar shortages, and counteract the positive impact on the real economy. While monetary easing by major AE central banks mitigates some of this risk, more may be needed, including bold moves by EM central banks, an extension of the Federal Reserve's U.S. dollar swap line and a proactive IMF (International Monetary Fund).

Systemic Capital Outflows Have Exacerbated The EM Dollar Shortage

The strengthening of the U.S. dollar due to COVID-19 related flight-to-safety has made it more expensive for EM entities to borrow in the currency. This is problematic because dollars are needed for trade, debt repayment, regulatory requirements, and reserves. EMs are also more vulnerable to having weaker currencies as they have become more exposed to the dollar since the GFC, especially through the credit channel (Chart 3).

In non-crisis times, non-U.S. banks finance their dollar assets (for example: loans, bonds, derivative positions) in U.S. dollar repo markets or FX swap markets. But during crises, the willingness to provide dollar funding shrinks in private markets, raising funding costs. EMs are most vulnerable to such declines in cross-border dollar lending because they have limited access to other sources of funding and cannot typically replace dollars with other currencies.

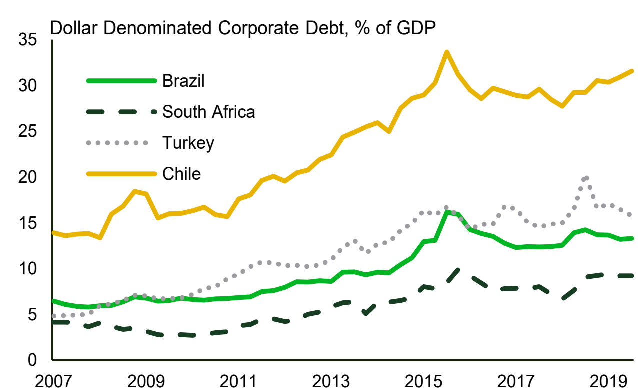
A Poor Start To The Year Means Several EMs Have A Weak Starting Point

For EMs such as Mexico, South Africa, and India, starting conditions were already weak. Mexico has seen negative quarterly growth in five of the last eight quarters and is forecasted to contract by 3.2% this year. South Africa ended 2019 with a technical recession and a persistent current account deficit (3% of GDP in 2019), which may prompt it to look towards the IMF for help. India is almost assured its slowest growth in eleven years as its economy continues to disappoint, decelerating into the start of 2020. COVID-related return-to-home measures recently put in place could result in some unprecedented economic declines yet. Even those EMs, such as Turkey, who had momentum coming into 2020 have heavily relied on credit to fuel growth, which keeps their economy fragile. These idiosyncratic weaknesses make EMs more susceptible to COVID-19 related disruptions.

Oil Exporting EMs Are Collateral Damage To The Russian-Saudi Price War

Oil prices were declining due to weakening demand caused by COVID-19, further exacerbated by the Russian-Saudi price war. From about $50 a barrel at the end of February, the WTI benchmark price has plummeted, hitting as low as $14 by end-March. Countries most severely hit include several oil-exporting EMs in Latin America, the Middle East and Northern Africa. Many oil exporting EMs have their currencies pegged to the U.S. dollar and would have to deplete their already fragile reserves to defend their fixed currencies. Oil importing EMs would usually benefit from

Chart 3: Dollar Denominated Corporate Debt in Emerging Market (% of GDP)



Source: IIF. TD Economics

such a price decline, but their ability to benefit from this price drop depends on how severely COVID-19 affects their domestic demand.

EM Policymakers Are Faced With A Catch-22 Situation

EM monetary policymakers are yet again faced with a dilemma. If they cut interest rates to ease financial conditions, they risk further capital outflows, thereby strengthening the sudden stop. If they tighten to stem the capital outflow, they risk further tightening financial conditions against an already-weak domestic demand backdrop. Traditionally, during crises periods EMs have been reluctant to cut. This has been due to the belief that monetary policy easing would lead to un-anchored currency weakness. However, this time we are seeing some EM central banks (Turkey, Chile, Thailand) cut rates, while others (Colombia, Philippines, South Africa) have started quantitative easing. Though unlikely for now, room to ease further may be limited if their fears come true.

There Is Fiscal Space Available, But Not For Major EMs

On the fiscal side, there is policy space in EMs to respond to the situation. However, given institutional limitations and capacity constraints, coming up with a timely fiscal response may be challenging for most EMs. Europe (Russia, Czech Republic) and Asia (Indonesia, Saudi Arabia) have room for fiscal easing, but the debt burden in a few major countries is a constraint on others.

India is a prime example. India's fiscal deficit so far this year is 3.3% of GDP which is 129% of its revised budget target. India has now missed its fiscal deficit target three years in a row and is expected to do the same this year. At the same time, India's total debt-to-GDP ratio stands at 68%. Other large EMs, such as Brazil and South Africa also have large debt burdens standing at 88% and 61% of GDP, respectively. The current situation has also increased EM governments' borrowing costs, as reflected in the 3.4 percentage point increase in South Africa's 10-year sovereign bond yield since the start of this year. However, regardless of fiscal space, we do not suggest EMs hold back on fiscal spending in the current environment, as the unprecedented risks from COVID-19 are severe and immediate.

The Right Policy Prescription Includes EMs Getting Over Their Fear Of Floating

EMs are in a difficult position, but the right policy mix can soften the blow. Some of the policy options include:

- *Traditional monetary easing:* EMs should not have a "fear of floating". At least not this time. The aggressive easing by central banks in Europe and North America has increased EM monetary policy space. EMs can piggy-back on the moves by AE central banks and loosen monetary policy themselves. This would ease financial conditions without increasing the interest rate differential between EMs and AEs. In fact, interest rate differentials – as priced into currency forwards or non-deliverable currency forwards – between certain EMs (Russia, Philippines, Indonesia) and the U.S. have risen in recent days, despite EM monetary policy loosening. An easier policy stance with little to no exchange rate intervention would also discourage speculative capital outflows, as it would make investors face higher exchange rate risks. And lastly, loosening monetary policy along with AE central banks would ease financial conditions globally, helping global growth.
- *Limited use of capital controls:* While protecting the real economy through lower rates is important, lose monetary policy may exacerbate net capital outflows. Therefore, EMs could also implement temporary capital controls such as limits, taxes, differential exchange rates, and bans. But they need to proceed with caution. The permanent nature of capital controls means that it is difficult to remove them once they are implemented. Capital controls can also damage the country's reputation, preventing investors from returning, even when the situation improves. Alternatively, EMs could incentivize investors by easing rules on incoming capital.
- *Expanding U.S. Federal Reserve (Fed) swap lines to more EMs:* The Fed should consider including more EMs in its U.S. dollar swap arrangements. Given the global nature of the dollar, it is in the interest of the Fed to do so. The swap lines announced between 14 countries currently only include two EMs, Brazil and Mexico. Excluding other EMs from the agreement puts them under unnecessary scrutiny. This is reflected in the widening of their cross-currency basis – a measure of U.S. dollar shortage – for the excluded EMs, such as Turkey

and Colombia. The newly announced Fed's temporary repo facility would work in tandem with the swap lines and alleviate dollar shortages faced by EMs. But since EMs can only access dollars through this facility if they use U.S. treasuries as collateral, it is most likely to benefit those EMs with high levels of reserves (China, Thailand, Hong Kong), and not those with low levels (South Africa, Turkey, Indonesia).

- *Additional IMF support:* The IMF has an important role to play, as it did during the GFC. More than 80 countries – 40% of its membership – have already approached the IMF for emergency funding. The IMF – being the central bank of the world – can address EM's balance of payment needs. To meet countries' urgent needs, the IMF can inject additional SDR (Special Drawing Rights), as it did during the GFC, but at a much larger scale.[1] It could also lower conditionalities and expedite disbursement of programs. The good news is that, unlike during the GFC, the IMF has credit lines with several EMs. These lines could be extended to others. The IMF could also act as a "central bank swap clearing house" that manages existing and enhanced central bank swap agreements in one liquidity network.[2] The IMF has already said that it stands ready to mobilize its $1 trillion lending capacity. But more needs to be done. And urgently.

Bottom Line

EMs are in a difficult position. They are faced with a sudden stop worse than the GFC, which has led to significant downward pressure on their currencies, tighter financial conditions, and severe dollar shortages. Limited policy space and weak healthcare systems have compounded their issues. Given the growing importance of EM economies and the interconnected nature of today's global economy, shocks of this nature are a recipe for a major balance of payments crisis, that can boomerang to AEs. Deliberate yet bold policy moves by EMs, cooperation of AEs, and multilateral support by the IMF is needed to mitigate symptoms.

End Notes

1. SDRs are IMF issued international monetary assets. They are accepted by all of IMF's membership and are used by countries' as reserves and can be sold and used as payment to other central banks.

2. https://voxeu.org/article/global-safety-nets-imf-swap-clearing-house