

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

While the focus so far has been mainly on China, Europe and the United States, the consequences of the Covid-19 pandemic are likely to be even more severe for emerging economies.



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Even though their degree of vulnerability to this shock depends on many factors, the starting point of their public finances is a key issue, as it determines their capacity to respond to the crisis' many economic consequences. However, their public debt was already at an all-time high in 2019.

Capital outflows and increased sovereign risk go hand in hand

Capital outflows on a never-before-seen scale are the most immediate effect of rising global uncertainty in emerging markets. During March, sales by foreign investors of bonds and equities from 24 emerging markets exceeded \$80bn, a four-fold increase over the last quarter of previous crisis of 2008.

During the first quarter, currencies of countries with strong fundamentals depreciated. More generally, emerging country currencies with liquid financial markets were the most penalised. During this period, the strongest currency depreciations against the US dollar were recorded in Brazil, South Africa, Russia and Mexico (more than 25%), followed by Colombia and Indonesia.

It is important to note that capital outflows were less significant in the first half of April. These led to a rise in sovereign rates in local currency, whose issues certainly hedge the issuer against exchange rate risk but generate an additional rise in interest rates. Countries that thought they had freed themselves from the "original sin" – namely the inability to issue bonds in local currency – are ultimately not immune today.

Many smaller emerging or developing economies have not been able to issue in their countries' local currency. They have taken advantage of the very abundant global liquidity in recent years to issue bonds, but in foreign currency. Today, however, these obligations are also penalised by rising sovereign interest rates, which are particularly strong in Ecuador, Angola, and Sri Lanka.

In order to limit the scale of these capital outflows, the central banks of emerging countries have decided to intervene on the foreign exchange market. Other organisations, such as the European Central Bank and the US Federal Reserve, have launched asset purchase programs involving some country's sovereign bonds (Philippines, Colombia, South Africa and Poland).

Three shocks

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

In addition to the risk to public finances and currency depreciation, the exposure of emerging countries to the risks associated with Covid-19 when assessing country risk. First of all, countries affected by the pandemic and whose governments have decided on mandatory containment measures will have to face an increase in indebtedness, resulting from the decrease in revenue linked to the coronavirus crisis, as well as an increase in healthcare spending and spending to mitigate the economic consequences on the population. As of April 10, 2020, 87 countries were in this situation.

Countries dependent on tourism revenue (with a threshold of 15% of GDP) will also be affected by international 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. The tourism sector accounts for at least 15% of GDP in 45 countries, including Morocco, Tunisia, Mexico, Thailand, the Philippines, Croatia, and Cambodia.

Oil impact

Emerging countries dependent on revenues from the export of non-agricultural raw materials will also be affected. Despite a rebound in prices anticipated in the second half of the year, the forecast (average Brent barrel cost in 2020 expected at \$45) is insufficient for the main exporting countries to balance their budgetary and current balances.

All the more so as, in addition to this "price" effect, there is also a "volume" effect for the countries (including Saudi Arabia), who have agreed to drastically reduce their production in order to limit the extent of the fall in prices caused by the fall in demand. Commodity exporting countries are those whose budget balance is expected to deteriorate the most this year (respectively -15% and -16% of GDP for Algeria and Oman according to IMF figures).

Today, nine countries are affected by three of these four sources of vulnerability: South Africa, Algeria, Angola, Ecuador, Lebanon, Mauritania, Oman, Tunisia and Venezuela. 31 are affected by two of them and 71 by one.

The additional financing planned by international organizations (notably the IMF) and the debt adjustments announced by creditor countries will help many low-income countries but will likely be of little help to the major emerging countries.

Source: Coface

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