

EMERGING MARKETS: HOW TO FIGHT COVID19 WITHOUT 'WHATEVER IT TAKES'

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Emerging markets have registered record capital outflows over the past few weeks, triggering very strong currency depreciations and liquidity constraints for the weakest. Outflows have markedly accelerated over the past days and currencies have reacted accordingly, especially in commodity-exporting countries and those who implemented generalized lockdowns to fight the Covid-19 pandemic. Markets have started to price in such sudden-stop crisis risks: spreads, corporate or sovereign ones, investment grade or high yield, are currently close to or above the level of emerging spreads reached during the subprime crisis. The financial shock could intensify going forward as at 35% of GDP, the EM outflows exceed the level seen during 2008-09 crisis (see Figure 1). This comes mainly from strong sell-offs in equity in Asia (Taiwan, Thailand and South Korea) but also Brazil, and from bonds in South Africa (see Figure 2). More recently, EM hard currency bonds have not benefitted from the relief rally in risky assets. Market-making remains impaired: Many EM segments of the EM hard currency market seem to have dried up as contrary to IG corporates in USD and EUR, they don't benefit from central banks as the buyer of last resort. As funding needs rise in view of the economic impact of the crisis, EM issuer access to international markets looks very weak.

Emerging markets have unequal capabilities to fight a pandemic. The lower their capabilities, the longer confinement could last: We find Nigeria, Ukraine, Argentina, Romania and India as the most vulnerable. Given the spread of the Covid-19 crisis, most EMs have implemented national or partial lockdowns because of their very weak health systems. However, EMs have unequal capabilities to fight a pandemic. We look at two main indicators: (1) We compute an average of relevant WHO health indicators, ranging from human resources adequacy and emergency preparedness to surveillance systems and the quality of health response, and (2) we use the Rand Corporation's Infectious Vulnerability Index (see Figure 3). We find that countries such as Nigeria, Ukraine, Argentina, Romania and India are the more vulnerable.

The longer the confinement, the sharper the recession. We forecast Czechia, Slovakia, Mexico, Brazil, Argentina, Thailand, India, Nigeria and South Africa to register strong recessions in the emerging world. Some EMs already exhibited sources of vulnerability before the Covid-19 crisis (overvalued currencies, oil/tourism revenue/export dependency, little room to manoeuvre). Now, the pandemic presents a triple economic shock – trade, financial and consumption – on top of the health policy challenge. In particular, the sharp correction of equity prices

and the significant appreciation of the Dollar, as well as a generalized trend of widening in corporate and sovereign spreads, have contributed to a marked tightening of monetary and financial conditions. The lockdowns represent a significant shock on domestic demand and we estimate them to cost between 1.5pp and 3.0pp of annual GDP growth depending on their length (see Figure 4). We expect countries such as Czechia, Slovakia, Mexico, Brazil, Argentina, Thailand, India, Nigeria and South Africa to register strong recessions in the emerging world.

In **Emerging Asia**, we do not forecast a full-year recession overall, but the hit to growth should be the largest since the Asian Financial Crisis, exceeding that of the Global Financial Crisis. Due to a combination of low growth in key trading partners, capital outflows, low commodity prices and confinement measures pressuring domestic demand, we expect GDP growth for emerging economies in Asia overall at +3.1% in 2020, after +5.2% in 2019. The shock being mostly concentrated in H1, we expect a partial recovery overall in the second half of the year, and GDP growth in Emerging Asia to reach +5.2% in 2021 (i.e. returning to the 2019 level). In 2020, the countries hit most severely will include India, Malaysia, Thailand, Hong Kong and Singapore (with the latter three seeing negative growth for the full year). India could struggle to muddle through the crisis, given the limited policy easing leeway and financial and social issues that were already weighing on domestic demand.

All major economies in **Emerging Europe** have now put in place confinement measures for at least four weeks, which is expected to lower domestic demand (notably consumer spending but also investment) by around one third over that period. This will reduce regional growth by -1.7pp to +0.9% in 2020 as a whole, assuming that confinement will gradually be lifted in the two months after the end of the announced duration, so that the economies would recover in H2. The demand shock will be lower in Russia (growth down -1.1pp to +0.8%) as stronger volume growth in the oil sector along with stepped-up public spending will support demand. In contrast, Turkey and Central European Economies (CEE) belonging to the EU will suffer growth reductions of more than -2pp in 2020 as private consumption and investment have been key growth drivers in recent years and the absence of tourism will also play a role in many countries. In the alternative scenario, where confinement is extended to two months across the region (with gradual relief in the two months thereafter and recovery in H2), the demand shock would be much harder, cutting full-year 2020 GDP growth by a further -1.2pp in Russia, -2pp on average in CEE and -2.5pp in Turkey.

Confinement measures have also been imposed in the **Middle East**. A one-month lockdown will cut annual regional growth by an average -2pp, pushing the region into a full-year recession (-0.2% forecast for 2020). In the Gulf Cooperation Council, the lockdown comes on top of the oil price shock. Yet, Saudi Arabia, which has stepped up volume growth in the oil sector, as well as government spending, will be hit less hard (-0.6pp). In the event of a two-month lockdown, annual regional growth should be cut by another -1.5pp to -2.5pp.

As Covid-19 is now also spreading across **Africa**, some countries have already imposed confinement measures and others are expected to follow suit. A one-month lockdown is forecast to reduce regional growth by -1.3pp

to +0.5% in 2020. A two-month lockdown should cut annual growth by another -2pp or so.

In **Latin America**, a recession is unavoidable due to a triple shock: the China trade and commodity price shock (Brazil, Chile and Peru), then the oil price shock (Colombia, Mexico, Ecuador) and lastly the even stronger shock of confinement measures in virtually all economies. We believe such measures are the only way forward in a region where healthcare spending lags behind OECD countries, and where the growth momentum was already weak in the largest economies. Overall, we expect a contraction of -1.5%, excluding Venezuela, in 2020, after a low +0.7% growth in 2019. Almost all the largest countries will contract this year. We expect a recovery in H2 and hence a positive +1.7% growth in Latin America in 2021.

The rest of the world is doing “Whatever it takes” but can the EMs afford to do this too? Several EMs had better initial conditions compared to 2008, but still more limited room to manoeuvre to stimulate the economy much further without secondary negative effects. Unconventional policies are less available in EMs, especially lending facilities and partial unemployment to safeguard the private sector. Impacts on jobs and bankruptcies will be high. Also, keep in mind that the increase in indebtedness and the use of Quantitative Easing in EMs (e.g. South Africa) will create defiance, solvency risks and credibility stress on central banks’ signatures in more acute ways than in the Northern Hemisphere. Stagflation risks in H2 2020 will need scrutiny.

Compared to 2008, **Emerging Asia** overall is facing the current crisis in less solid initial conditions. For most economies, public debt and deficits are larger than they were in 2008 (though still at decent levels for most), and growth momentum was already slowing in 2019. On the positive side, the picture for external financing needs is more encouraging, with a more favorable current account balance for several economies. Regardless of initial conditions, the policy mix across Emerging Asia has been eased aggressively. The aim is to help economies muddle through the crisis, but this is unlikely to result in avoiding a technical recession in most cases. In most economies, real policy rates are already close (or even below) zero. This has not deterred all major central banks in Emerging Asia from cutting policy rates, thanks to policy space provided by the Federal Reserve in the U.S. and to likely deflationary forces as the global economy goes into recession. Generally speaking, there is still fiscal leeway in Emerging Asia (except in China, India and Malaysia, comparatively speaking), and most have used it to announce significant fiscal stimulus packages. We estimate the deterioration in fiscal balances in major emerging economies in Asia to range from -1pp to -11pp in 2020. It could increase in particular for Taiwan, Indonesia and the Philippines.

Emerging Europe, which was at the core of the 2008-09 crisis due to large macroeconomic imbalances across the region, has much better initial conditions today, except for Turkey. However, conventional monetary policy leeway is limited in the region as policy interest rates are already well below inflation rates. But the larger economies in the region have fiscal policy leeway and have announced fiscal stimulus measures, though only Romania (1.2% of GDP), Poland (9%) and Czechia (18%) have unveiled amounts. The package sizes of the latter two should be enough to cope with the combined Covid-19 shocks on trade and financing, and

two months of confinement. However, financing those measures on international markets could prove difficult for many countries as investors have been fleeing to safe havens, as reflected in large capital outflows and rising spreads. As a consequence, the central banks of Poland, Romania and Croatia have started to purchase sovereign bonds (QE), and we expect Czechia and possibly Hungary to follow. But this in turn poses substantial risks of negative second-round effects. Inflation could surge in 2021 once the crisis is over and central banks want to exit from QE.

In **Latin America**, monetary policies will help cushion the blow although they won't prevent a recession from happening: Central banks in Brazil, Mexico, Chile, Peru and Colombia already cut rates to support activity. Inflation should remain in check due to strongly depressed demand and lower commodity prices. Second, fiscal leeway is unequally distributed in Latin America and public debt-to-GDP ratios will climb almost everywhere. Argentina and Brazil have very low fiscal space. In Colombia, Chile and Peru, and even in Mexico, governments can act in a more sizable way. Yet everywhere, lower fiscal revenues due to lower oil prices, depressed activity and fiscal stimulus will contribute to increase the public debt burden. Lastly, while external vulnerabilities have been reduced in Latin America in the past decade, there remains weak links in the region. Argentina is already in restructuring talks due to its inability to meet its financing needs this year and should be put in an even harsher position amid a risk-off sentiment on markets (the economy should contract -4%). Ecuador will be hit by the oil shock and is the next weakest link, likely to announce a debt moratorium. Brazil and Mexico remain on our watch-list due to their belated policy responses, which call for harsh confinement measures with the potential to severely depress the economy.

The international policy response: external support (G20) would be key to suspend some of the debt repayments and allow for more fiscal spending to support health needs. EMs have not been on the radar of policymakers yet as they were still debating on how large fiscal and monetary bazookas would be, especially in China, Europe and the U.S. However, financial markets have reminded observers of the risks ahead and several actions have been taken in the past week, using the G20 locus, the Breton Woods institutions, as well as central banks' networks to mitigate the severity of the shock on EMs. First, G20 finance ministers and central bankers pledged to address the debt burden of low-income countries and deliver aid to EMs as part of a plan to combat the Covid-19 pandemic. Emerging economies would need at least USD2.5tn. Ministers and bankers from major industrialized and emerging economies welcomed a USD160bn World Bank relief package to be deployed over the next 15 months to support its member countries.

Of the 189 members of the IMF, 85 have now asked the IMF for financial assistance since the start of the corona virus outbreak – this number of requests for financial assistance is unprecedented in the 75 year history of the fund. The International Monetary Fund and the World Bank could ease a lack of liquidity in EMs, which have seen an outflow of USD83bn in capital. Secondly, the Federal Reserve is acting as central banker to the world by seeking to provide the global financial system with the dollar liquidity it needs to avoid seizing up. The Fed established a temporary repurchase agreement facility to allow foreign central banks to swap any Treasury securities they hold for cash. The New York Fed says it has over

200 account-holders, with foreign central banks and monetary authorities making up the vast majority. However, the new facility does lack something the currency swaps provide: While it allows foreign central banks to liquefy their holdings of Treasuries and obtain dollars, it does not add to their reserves. Observers close to the matter mention a potential USD5tn facility.

The question is whether this is enough. A moratorium on bilateral sovereign debt payments in the Paris Club framework, as well as swap lines to provide foreign currency needs, and a new IMF allocation of \$500bn worth of special drawing rights for developing nations may be needed in addition to already-announced initiatives. We believe that in some cases the IMF will insist on bond holders sharing the burden as a condition of additional lending to countries in need. This will be in the form of haircuts on sovereign Eurobonds for some Frontier countries. This crisis also asks some important questions to financiers of emerging markets growth: What role could China play in alleviating part of the debt to these economies? Should we already put in place a restructuring committee in the Paris Club? Are existing institutions enough?

What could go wrong? Some EMs are highly dependent on international capital markets to finance growth (large current account deficits, large share of external debt) and may not have institutions with sufficient ammunition (low fiscal space) or credibility to experiment further (QE, debt monetization). If the crisis is commensurate with what we see in China, Europe, and the U.S., experimentation may be either constrained (and the recession and belt tightening more severe) or carried through anyhow, leading to serious concerns during the exit phase. Could we see a structural wave of defaults in the emerging world? Could we see hyperinflation in some economies? Untamed currencies?

Should the liquidity crisis turn into a debt crisis, the large EMs most at risk of rating downgrades and subsequent sovereign or corporate defaults are: Argentina, Turkey, South Africa, Mexico, Chile, Pakistan, Indonesia, Mayasia, Romania and Poland. Indeed, debt rollover has become more challenging for those most indebted: around USD250bn of corporate and sovereign bond principals are due in 2020, a record high. More than 20% of the EM bonds is trading at distressed levels (>1000bp), similar to the situation in 2009. A wave of (sovereign and corporate) defaults cannot be excluded at the trough of the crisis, or the months thereafter, and some countries are more at risk than others of being pushed into IMF financial support, notably South Africa. Moreover, we expect a number of frontier markets (FMs) and developing markets to be at the forefront of the crisis in the coming weeks: These include oil producers (Oman, Bahrain, Kazakhstan, Algeria, Nigeria, Ecuador) and countries already in distress (Sudan, Zimbabwe, Venezuela, all three), and more generally FMs with the highest gross external financing needs: Mozambique, Belarus, Tunisia, Sri Lanka, Bahrain, Ukraine and Zambia. These countries may also need IMF support or eventually default.

Looming political crisis, on top of the health, financial and economic ones. The health, financial and economic crisis could also become a political crisis in several countries where political fragilities have been identified. The countries that had already been veering towards authoritarianism will use the crisis to abolish whatever checks and balances were left. The election calendar in 2020-21 is packed in key EMs and recent election

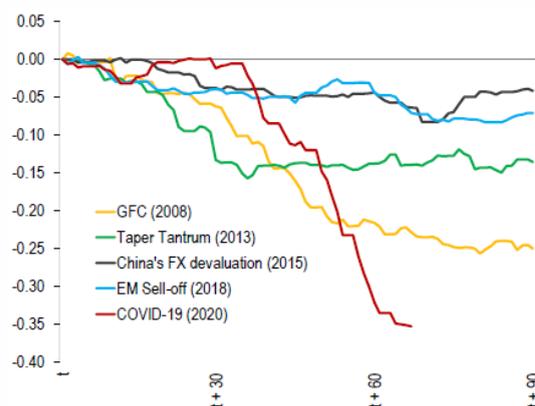
results have showed the rise of illiberal leaders. This crisis could further intensify political turmoil in fragile EMs.

In **Latin America**, social tensions could reignite should the handling of the crisis falter and should too many vulnerable people be left behind. The strongest protests could rise in countries with low growth momentum, high inequality and weak social mobility, but where new governments managed to leverage political disaffection to their advantage. Yet in that case, the high confidence granted to such leaders and their teams would be eroded, in Brazil and Mexico mostly. Such a scenario would mean the return of political instability in the two largest economies in the region, which would not only damage the economies but also institutions, and could mean a spike in political risk for companies. This could result in power struggles between central governments and local authorities, and potentially exacerbate nationalist policies in Mexico and increase the risk of presidential impeachment in Brazil. Complete and prolonged lockdowns in key commodity exporters such as Chile, Peru or even Brazil, which are leading exporters in some commodities, could put pressure on prices and even disrupt the world supply in copper, iron ore or some agrifood commodities.

The exit of the crisis could prove slow and inflationary, given higher dependency on trade, tourism flows and the lower credibility of central banks.

Health systems under pressure could ask for long-lasting social distancing, resulting in lower tourist inflows beyond June due to border closures. This is a key point to stress for most of the emerging economies where tourism receipts account for more than 20% of GDP (Hong Kong, Mexico) and for more than 10% of GDP (Turkey, Argentina, India, South Africa). In addition to the possibly slower resumption of domestic demand and opening of borders, the recovery could be slower, given the inflationary pressures (double-digit inflation rates by year-end) triggered by strong currency depreciations. Hence, we think that growth will remain below potential in 2021 at +4%.

Figure 1 – Outflow episodes scaled by GDP (% of GDP, cumulative daily flows since 21 Jan, total non-resident portfolio)



Sources: IMF, Allianz Research

Figure 2 – Total portfolio flows by region, USDbn

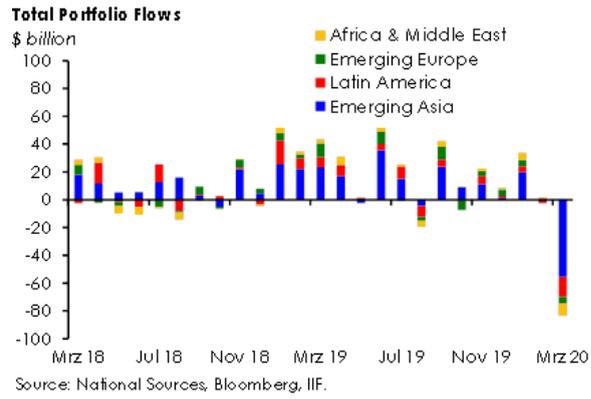
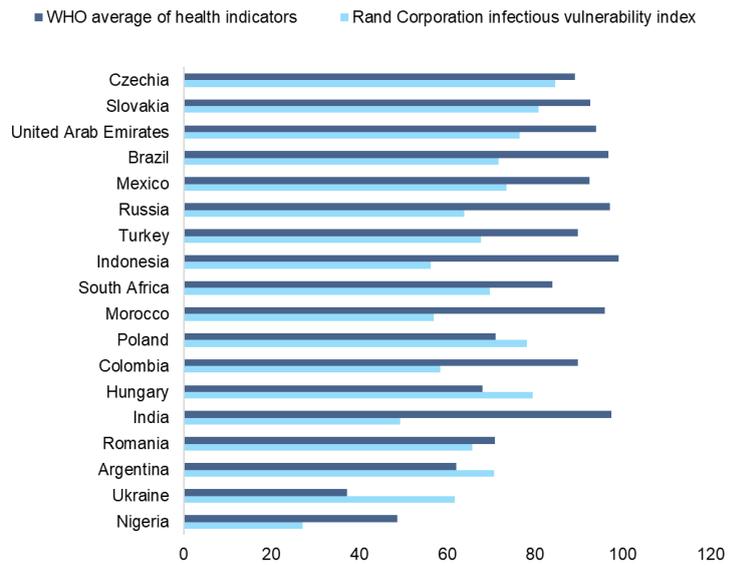


Figure 3 - WHO average of health indicators



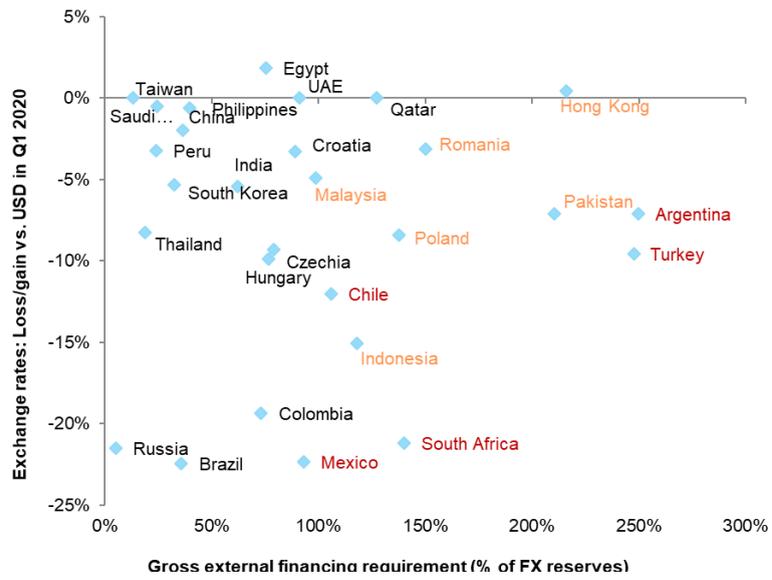
Sources: WHO, Allianz Research

Figure 4 – Real GDP growth expectations in emerging markets

Real GDP growth	2019	2020f pre-confinement	2020f with 1 month confinement	Change due to confinement
EMERGING MARKETS	3.8	3.9	2.0	-1.9
Latin America	0.7	1.0	-1.5	-2.5
Brazil	1.1	1.8	-1.5	-3.3
Mexico	-0.1	0.8	-2.5	-3.3
Argentina	-2.2	-3.0	-4.0	-1.0
Columbia	3.3	2.0	-0.4	-2.4
Chile	1.0	0.4	-2.0	-2.4
Peru	2.2	3.0	-0.3	-3.3
Emerging Europe	2.2	2.6	0.9	-1.7
Russia	1.3	1.9	0.8	-1.1
Turkey	0.9	4.1	2.0	-2.1
Poland	4.1	3.1	1.0	-2.1
Czechia	2.4	2.0	-0.5	-2.5
Romania	4.1	2.8	0.5	-2.3
Hungary	4.9	2.9	0.2	-2.7
Slovakia	2.3	2.0	-0.6	-2.6
Emerging Asia	5.2	4.9	3.1	-1.8
China	6.1	5.9	4.0	-1.9
India	5.3	5.5	3.8	-1.7
South Korea	2.0	1.5	0.5	-1.0
Indonesia	5.0	4.3	2.9	-1.4
Thailand	2.4	0.2	-2.6	-2.8
Hong Kong SAR	-1.2	-0.6	-2.4	-1.8
Singapore	0.7	0.4	-1.8	-2.2
Middle East	0.1	1.8	-0.2	-2.0
Saudi Arabia	0.2	1.8	1.2	-0.6
UAE	2.2	2.0	-0.1	-2.1
Africa	1.9	1.8	0.4	-1.4
Nigeria	2.0	0.9	-1.5	-2.4
South Africa	0.3	0.3	-1.0	-1.3

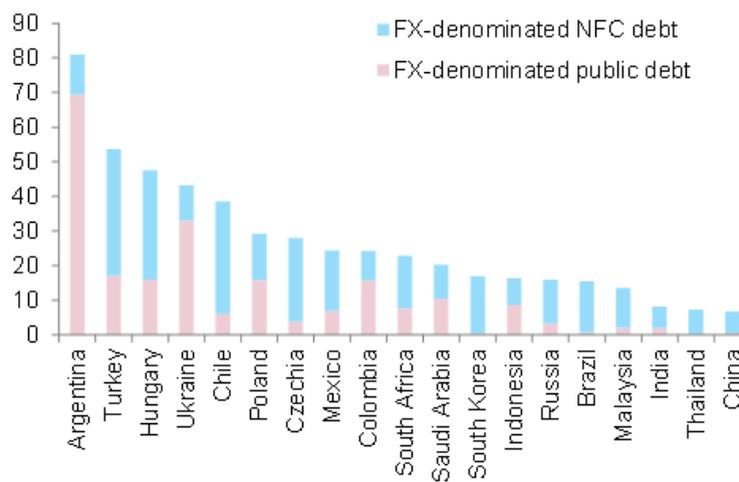
Sources: WHO, Allianz Research

Figure 5 – Gross external financing requirement (% of FX reserves and assets held in SWFs)



Sources: various sources, Allianz Research

Figure 6 – Foreign exchange-denominated sovereign and NFC debt (% of GDP)



Sources: IIF, various sources, Allianz Research

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