COVID-19's liquidity and solvency shock for emerging economies: What to do about it?

Alicia Garcia Herrero - Chief Economist, Asia Pacific
alicia.garciaherrero@natixis.com
+852 3900 8680

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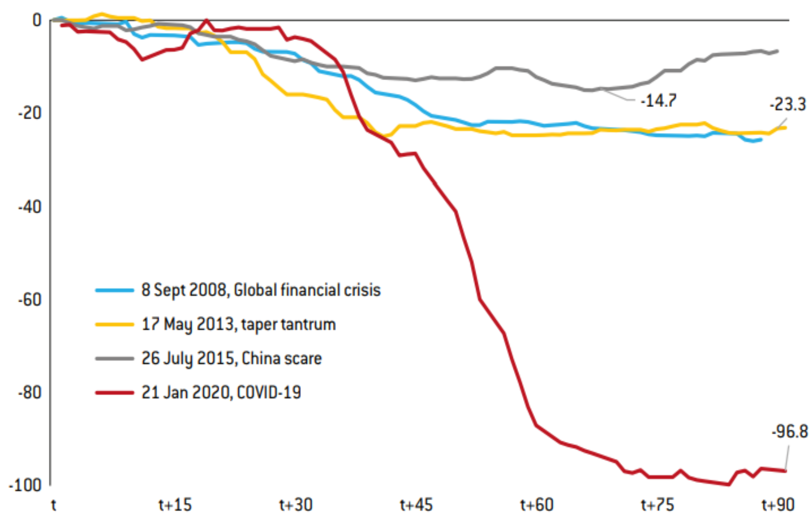
No bigger shock than Covid19 although no full awareness yet

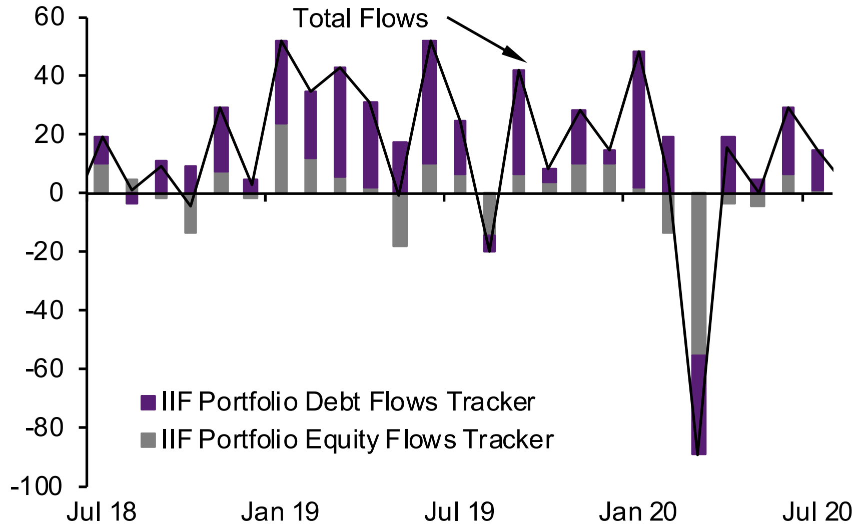
Reality: Foreign investors left EM markets in March at an unprecedented speed, rushing safe assets, resulting in a sudden global dollar shortage.
While investors are back, the same risk-off environment could happen any time.

Accumulated non-resident portfolio flows to emerging markets since indicated data, $ billions



Source: Bruegel based on IIF, Natixis.

IIF Tracker: Total Portfolio Flows into Emerging Markets

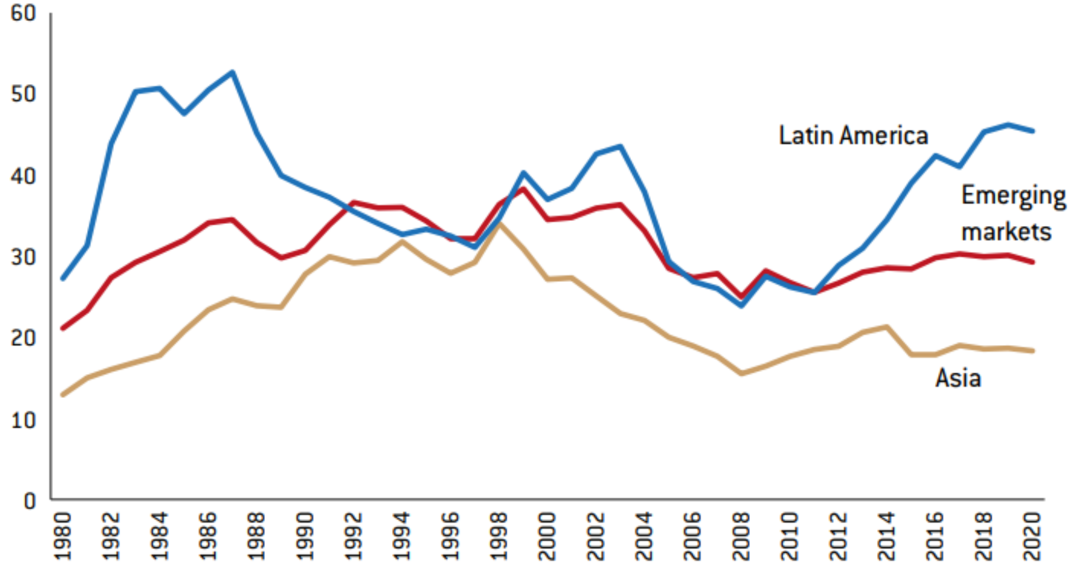


Source: National Sources, Bloomberg, IIF, Natixis

Dollar inflows plummeting

- Beyond capital inflows, also FDI stalling as well as tourism receipts, and even remittances.
- Hard to see how external debt is going to be serviced

External debt, %GDP



Source: Bruegel based on IIF, Natixis

Response more aggressive than ever but still not enough

- For central banks, at least as 12 EM central banks have introduced QE but the size and the scope very different from that of developed countries and probably hard to do more without consequences of the exchange rate.

- Additional fiscal expansion hard to be financed, especially externally

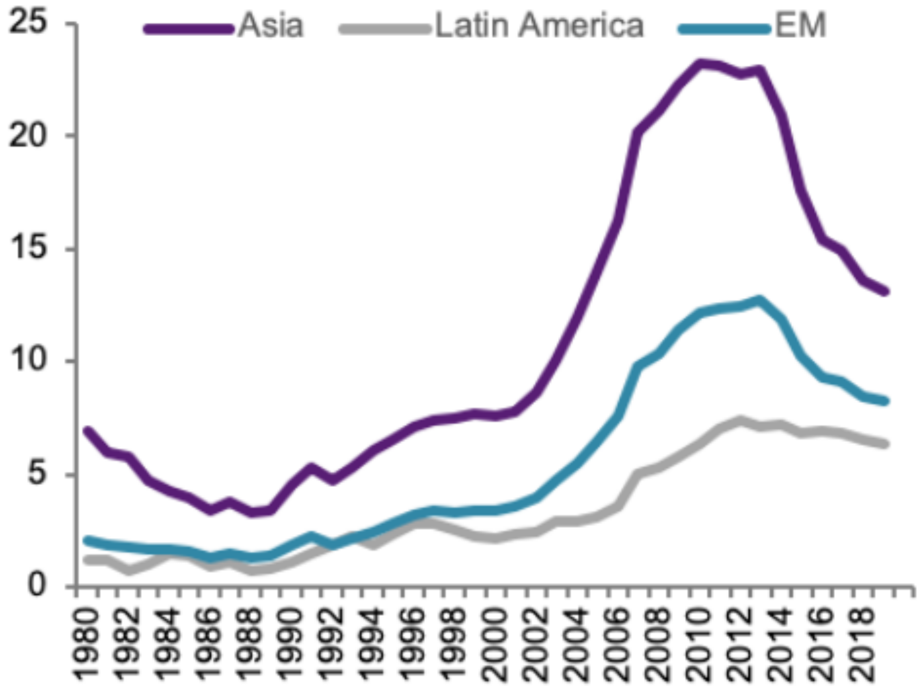
- Public debt sustainability key issue for an increasing number of EM economies

What can EM countries do?

- Self insurance but not big enough for everybody (Asia better, followed by Gulf)
- Regional insurance schemes virtually only available in Asia
- FED Swap lines: only for very few
- IMF: tools and overall funds not enough for liquidity shortage
- Debt restructuring should become a central discussion in policy circles, especially G20: coordination desperately needed

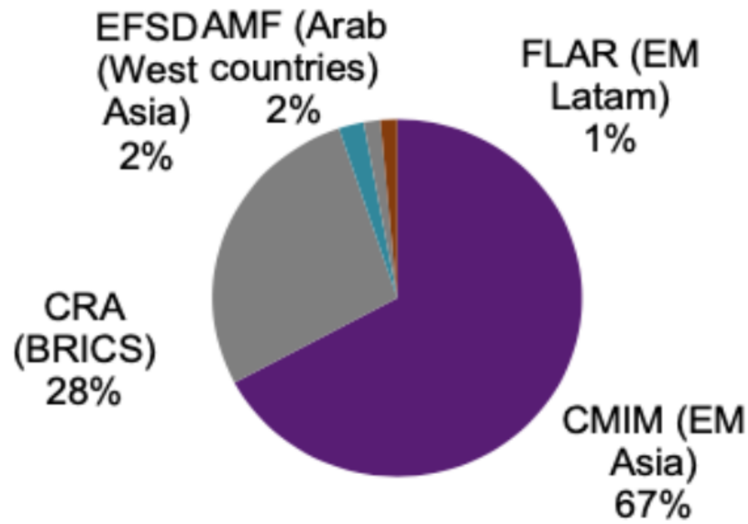
Self insurance less of an option than in the aftermath of 2008

Forex reserves concentrate in Asia and the Middle East, with more than half of $22 trillion held be central banks and sovereign wealth funds globally.



Sources: IMF, Natixis

Regional insurance is an Asian story



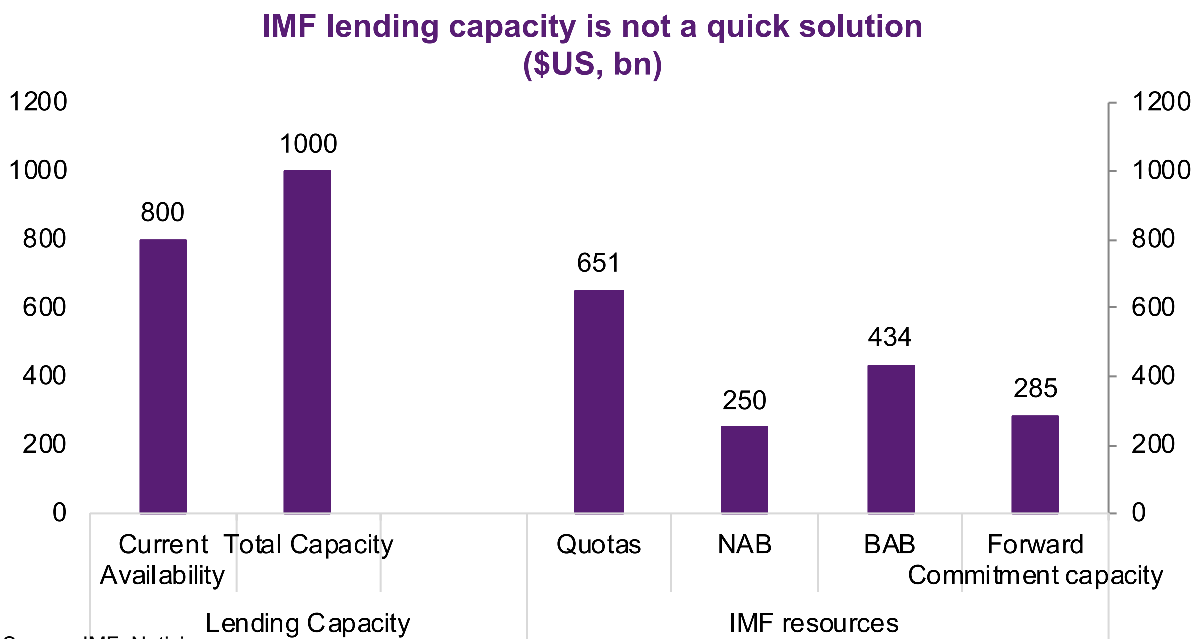
FED liquidity to EM not as ample

- Swap lines only available for 4 EM central banks: Singapore, Korea, Brazil and Mexico
- Repo line less appealing:
    - General pool with potential rationing in bad times.
    - Need for collateral (US treasuries) so dependent on amount of foreign reserves

Central Bank	Approved USD swap line size with FED (USD bn)
Reserve Bank of Australia	60
Banco Central do Brasil	60
Bank of Korea	60
Banco de Mexico	60
Reserve Bank of New Zealand	30
Monetary Authority of Singapore	6

Source: Federal reserve

IMF lending capacity very limited and no signs it will increase any time soon



Source: IMF, Natixis

IMF’s additional problem will be to disentangle the liquidity and solvency problems

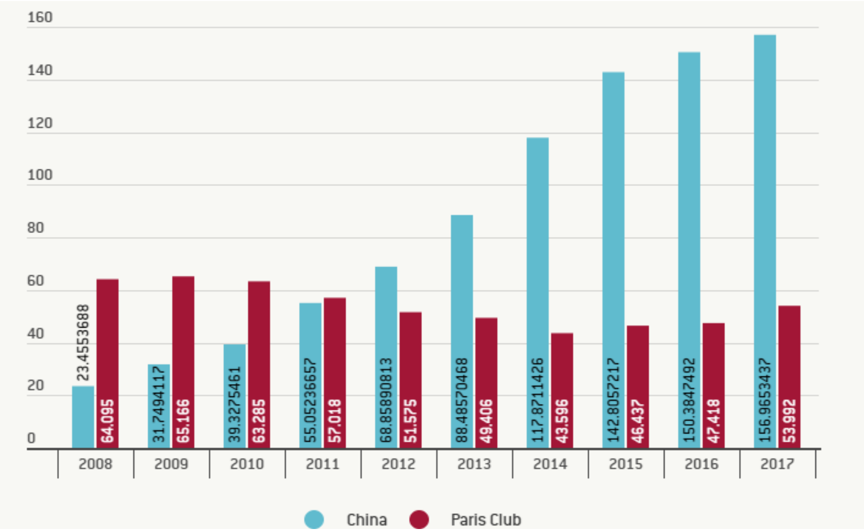
- Different programs to deal with liquidity problems but none very automatic or big enough, especially for countries losing market access

- Solutions for debt restructuring have not been developed while gaining time after the G20 agreement on TEMPORARY debt relief

- Coordination of creditors even bigger than in the past
  - China not fully into the Paris club but huge (China development bank out of the G20 deal so far)
  - Private creditors not yet following

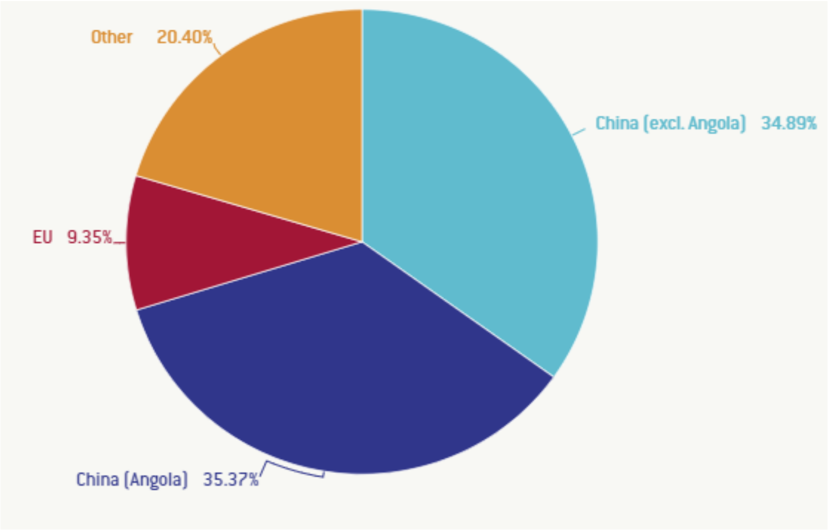
For the specific case of Africa, China already much bigger than Paris club members

Outstanding credit stock to SSA countries eligible for DSSI by China and the Paris Club, 2008-2017, USD bn



Source: Hom, Reinhart and Trebesch (2019) and Paris Club Website

Bilateral PPG debt service costs of SSA countries eligible for DSSI between May and December 2020 by creditor origin



Source: Bruegel based on World Bank International Debt Statistics

Way forward

- Covid19 is too big a crisis not to expect financial crises in EM
    - Some may be liquidity crises but others will be solvency ones

- Time is of the essence to find solutions to mitigate the damage
    - On the liquidity space, self and regional insurance schemes look abundant for Asia but not for the rest.
    - Still some Asian countries might not be fully protected by such insurance schemes
    - Fed liquidity may look ample today but it will quickly fall short if there a new episode of global dollar shortage as last March
    - The IMF needs to increase its available resources but also modernize its toolkit.
        - The former might need more international cooperation than we can dream of today
        - The latter might be easier to achieve and urgently needed.
        - IMF should start with easier to access liquidity tools to new forms of debt restructuring
        - Starting with better access to lending flows into EM so that debt sustainability analysis is more credible

Lots to do in very little time!

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