The fiscal costs of COVID-19

Emerging Markets Outlook Fourth Quarter 2020

September 2020

As time goes by and we continue to wrestle with the pandemic, we are learning more about the immediate impact of COVID-19 and the effects on the global economy. It is now slowly becoming clearer how the lifting of lockdowns and fiscal stimulus are the most important elements in the economic landscape that determine how economies recover from the corona crisis. Almost all emerging and developing economies are seeing a uniform deterioration of budget balances and rising debt-to-GDP ratios. Although there are good reasons for this, there is a price to pay. Investors value fiscal discipline. Weaker fiscal positions make emerging markets more vulnerable to spikes in risk premia, increasing their borrowing costs. In this quarterly outlook we answer a few questions that focus on COVID-19 and its fiscal impact, on whether stimulus has been enough and on what this means for fiscal imbalances and investor's risk perception, as well as for the quality of long-term growth.

Triodos IM is entering a new, more forward-looking phase, in which we can direct more attention towards investigating options on how to start up or extend businesses in countries where this is possible. Microfinance, food & agriculture and (renewable) energy remain the strong foundations to rebuild countries coming out of this crisis. At the same time, we are looking closely at how macroeconomic variables develop, including the size of fiscal deficits and debt piles. Both can affect a region or a country in terms of higher risk premium and debt payment capacity. There is a silver lining though: as countries enter a new stage of the recovery, governments are now playing a more predominant role, which could mean more room for impact investment directed at increasing economic resilience and improving well-being. Triodos IM, with its experience, will continue steering support in this direction.

Has fiscal support led to a V-shaped recovery?

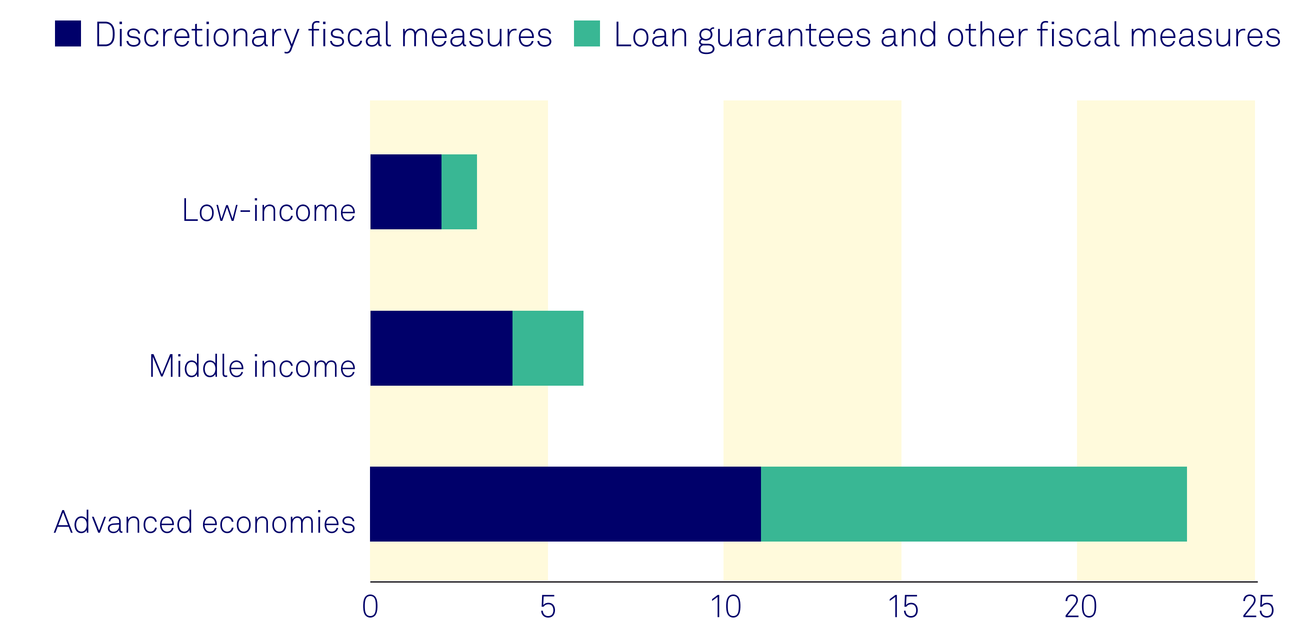
Synchronised fiscal support has done quite a lot, but the V-shaped recovery is not for all countries, particularly countries that had severe lockdowns and where the virus is not yet under control, including Brazil, India and South Africa. There is widespread consensus that if the aggressive fiscal response does not result in a V-shaped recovery, this will come at the cost of debt sustainability, exacerbating long-term growth, as well as inequality.

The most recent data suggest that the global recession has bottomed out in the second quarter. Investor sentiment has been improving in the first place towards advanced economies, and now also across emerging countries, particularly China, South Korea and Taiwan. Yet uncertainty remains, as COVID-19 continues to spread and several countries that seemed to be over their contagion peaks see the number of new cases rise, requiring them to maintain or even install new, localised lockdowns.

Fiscal support in emerging and developing economies easily surpassed the stimulus provided during the global financial crisis. The IMF estimates suggest that on average emerging markets and developing countries have spent around 5% of GDP in government support in tackling the pandemic. This is sizeable but less than advanced economies did. Estimates from the IMF suggest that government support from advanced economies reached approximately 23% of GDP. This includes discretionary measures and loan guarantees and other fiscal measures.

Government stimulus COVID-9

% GDP



Source: IMF, July 2020

There is also a large variability between countries in the size and composition of fiscal packages. A few countries had room to expand their fiscal spending (China and Indonesia), while others needed to fund themselves abroad. Mexico raised USD 6 billion in April and Egypt USD 5 billion in May with market access bolstered by strong support from multilateral creditors. Other countries are in the queue, including Cote d'Ivoire, Turkey, and South Africa. Meanwhile, Argentina and Ecuador concluded their debt restructurings, which means that the larger restructurings in emerging markets are off the table.

In the case of countries with limited market access, the IMF and the World Bank have continued extending COVID-related emergency financing. The largest chunk was approved already in March and April, and now around 80 countries have access to IMF funding. In addition to emergency financing, debt relief granted to low-income countries has also given some fiscal space. The IMF alone approved debt relief for 25 countries. China, as part of the G-20 debt relief initiative, has recently granted 10 countries debt relief. For countries like Angola and Mozambique, large recipients of China's loans, this solution will certainly help.

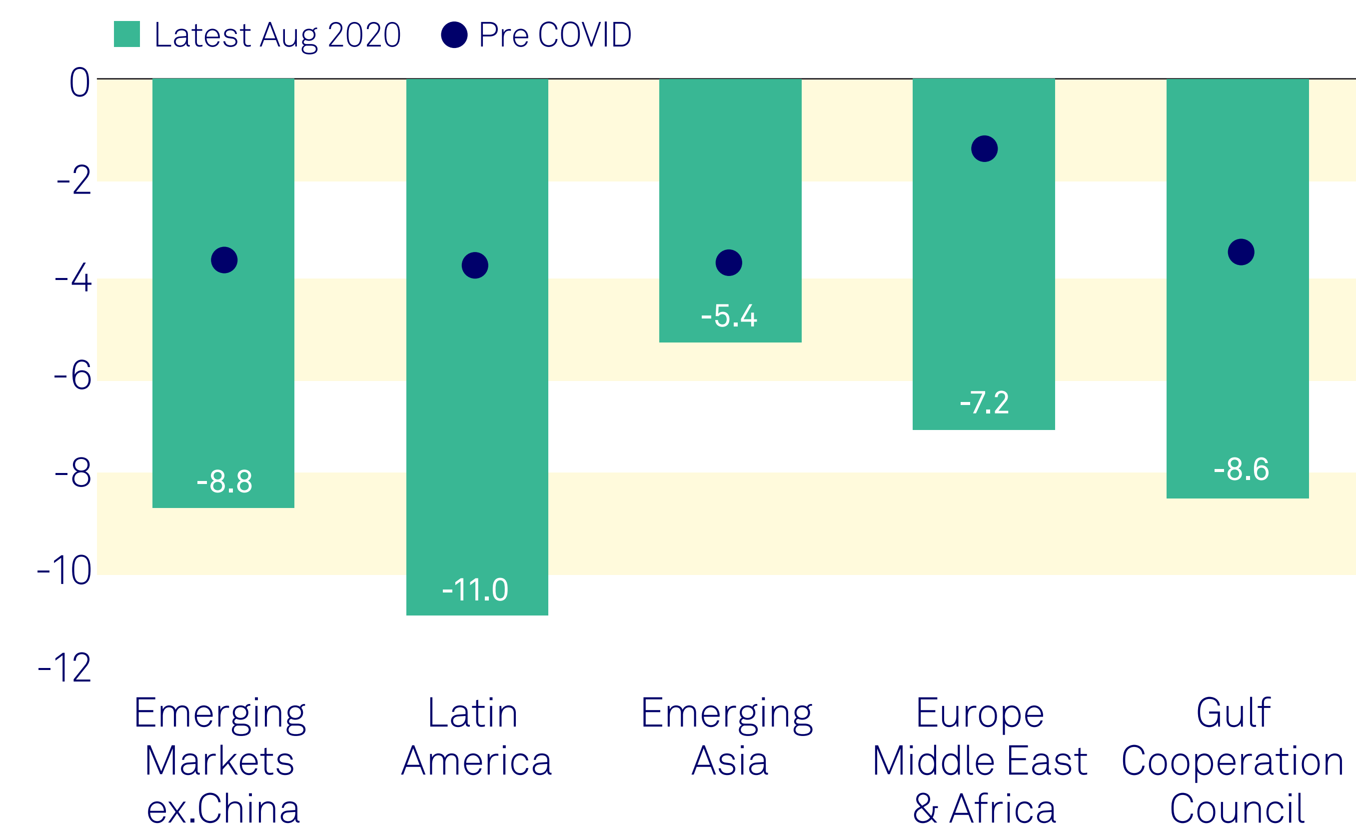
And still support from central banks continues. Policy rates are at their lowest levels, which should help ease financial conditions for banks in many countries. Rates are close to bottoming out though. Several emerging countries report some inflation pressures, mainly resulting from disruptions in food supplies and the impact of large

currency depreciations immediately after COVID-19. We see these as temporary pressures though and expect that policy rates will remain at low levels for a longer period of time.

Fiscal support has prevented a deeper crisis and at the same time resulted in a sharp widening in fiscal deficits. Those countries that entered the crisis in a weaker economic condition are still facing many risks, given that extraordinary financing and debt relief measures will not be enough to fill the large financing gaps that were already there prior to the pandemic and are only increasing as the pandemic carries on.

Widening in fiscal deficits

% of GDP



Source: IHS

How has stimulus been implemented?

Governments and central banks have chosen different paths in providing stimulus, either through financials, nonfinancial firms or households, and if there was enough room, by providing stimulus to all sectors. This has been in the form of liquidity support for firms, expenditures to support employment and income, as well as in-kind support for the most vulnerable segments of the population. The type of stimulus, its timing and size are setting the pace of the recovery. Going forward, the temporary nature of the stimulus will be critical in avoiding distortions, including crowding out of the private sector and moral hazard for the firms and households receiving government support.

China's strategy appears effective. The government chose the path of targeted fiscal support to firms by providing tax cuts and employment subsidies and broke temporarily with the consumption support strategy implemented in the past years. Given that support in China was complemented with the fast reopening of manufacturing firms, while other sectors remained in lockdown, the strategy quickly translated into improvement in manufacturing activity. Thanks to this targeted strategy, and support from the central bank the fiscal deficit remains moderate at around 6.7% of GDP this year.

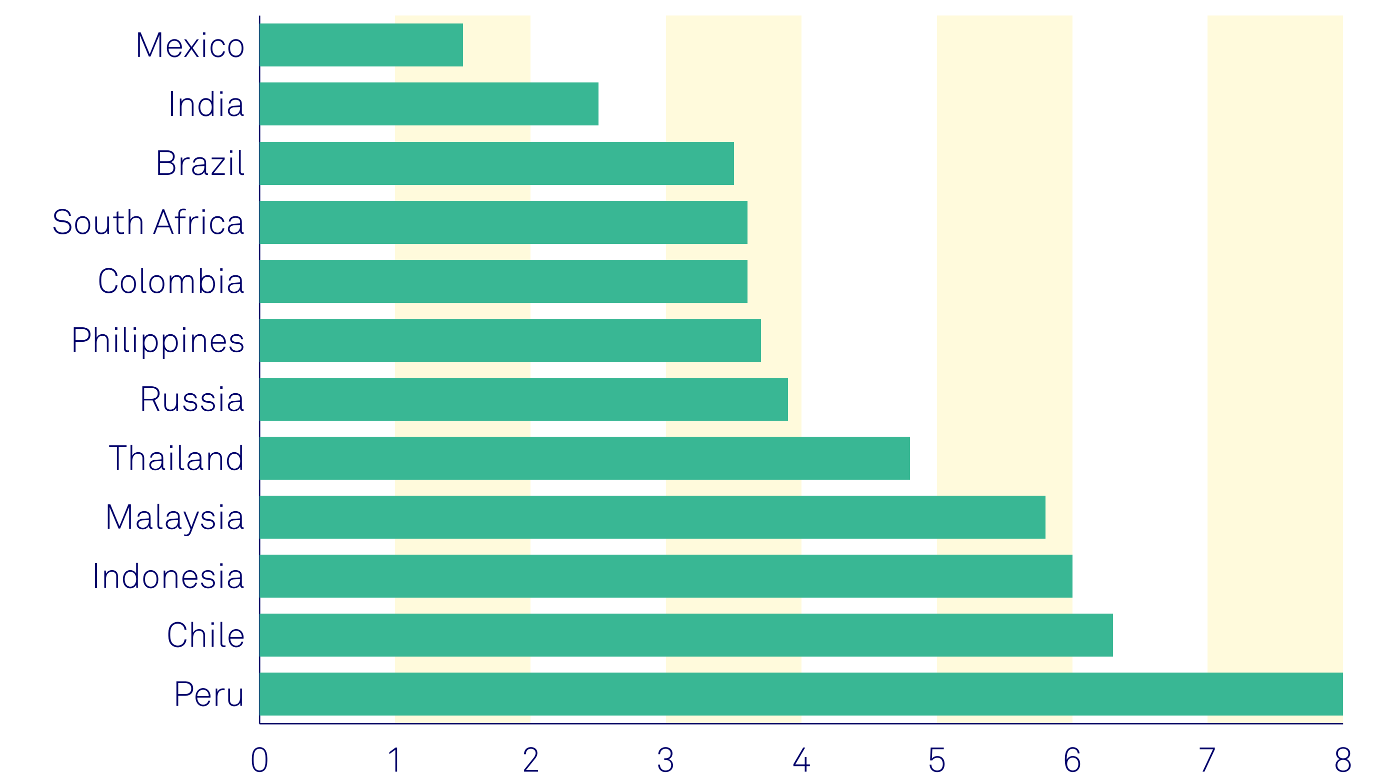
In Brazil a large chunk of fiscal support has been targeted at households, mainly the informal sector. This has been done through emergency aid paid through state banks and credit sales in order to mitigate the impact on disposable income. This approach has had an immediate effect as consumption (retail sales) returned to pre-pandemic levels in June. It is likely that this support will be extended until December. Brazil's fiscal deficit was already one of the largest and given the size of the stimulus it is now estimated at 13% of GDP this year.

Other widespread **measures** are those related to the financial systems, including liquidity injections, lower reserve requirements, loan moratoria, and exceptional lending guaranteed by the government to small and medium-sized enterprises. In many countries these measures are being prolonged, and it is yet to be seen what the consequences will be when they are withdrawn. In India, in addition to a deluge in liquidity from the central bank, borrowers could restructure their debts and treat exposures as 'standard' and not as non-performing loans. Banks are also required to keep additional provisions. However, there is still risk aversion in the banking sector in India given that the magnitude of restructuring remains unclear. As a result, credit provision is reluctant despite the measures, suggesting that a more structural approach to improving banks' balance sheets may be needed.

According to the World Bank, almost all low-income countries had to expand their funding for health care systems and provide vulnerable groups access to critical public services. Reprioritising expenditures was not enough, and fiscal deficits have surged, partly financed by multilateral lenders. An effective fiscal response, with a long-lasting impact was absent.

Fiscal stimulus

% of GDP



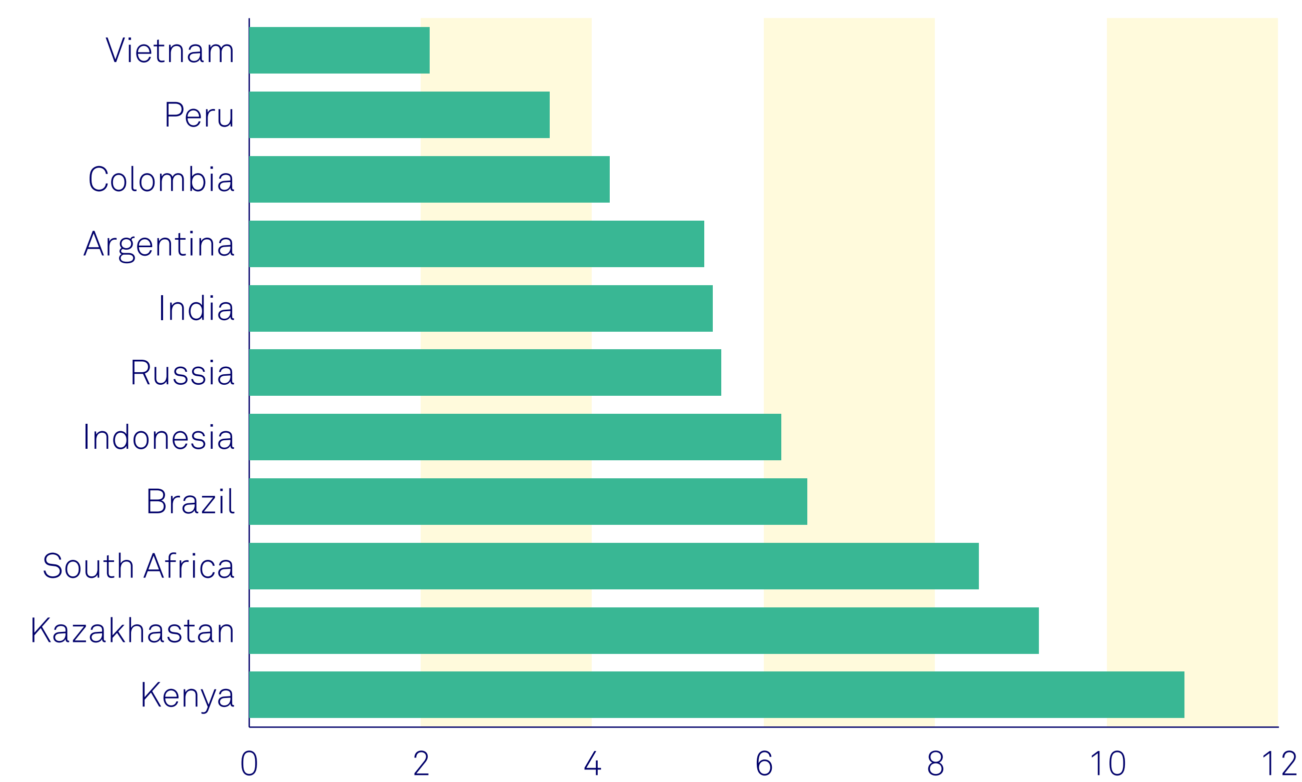
Source: Bloomberg, July 2020

How do investors perceive higher fiscal deficits and debt?

Every single emerging market is seeing a rise in the ratio public-debt-to-GDP. This reflects outright recessions (lower GDP) and widening budget deficits (higher debt) partly due to stimulus programs to fight the pandemic, as well as the loss of tax revenues from lower economic activity. International investors are sensitive to emerging market fiscal fundamentals and are less tolerant to higher debt levels. This has consequences for governments' debt risk premia and investment returns over the longer term. Additionally, local currencies are highly sensitive to fiscal deficits and high debt. Many emerging countries despite the weaker US dollar in the recent past continue to show weak currencies, including Brazil, Russia, South Africa, and India.

The IMF, in its recent **country assessments** to approve emergency financing, has looked closely at the debt sustainability. However, the focus has been the ability of countries to repay the IMF. The assessment concludes that approximately one third of all emerging market economies entered the crisis with high-debt levels and are assessed as having no space for undertaking additional discretionary fiscal policy, or as having that space significantly at risk. For countries where debts prove to be unsustainable, timely and durable resolution of these problems will be needed.
In a scenario with a strong rebound of GDP growth, this would by itself reduce public debt to GDP, mostly because of the denominator effect. However, it should be noted that fiscal deficit projections exclude contingent liabilities and state guarantees. This is now particularly relevant since this has been a preferred choice for government support given the temporary nature of the shock and the assumption that these guarantees would be not used and were only necessary to restore confidence in an environment of uncertainty. These guarantees varied from 4% in South Africa to around 16% in the Czech Republic. This is a high contingent risk not only for emerging markets, but also for advanced economies.

Emerging markets government bonds over US treasuries
% pts



Source: Refinitive, 18 September 2020

Can fiscal spending reshape long-term growth for better?

Given the large stimulus packages being provided, governments have the choice to play a more prominent role in shaping a sustainable recovery. We are aware that the trajectory of the virus is the most important determinant of economic conditions and therefore making the vaccine available for everyone remains a priority. At the same time, governments in cooperation with the private sector will do well in enforcing some positive trends that have accelerated since the crisis. In this process upon which government policy rests and business investment decisions are made, people, planet and prosperity remain the essential values.

Ensuring a fair distribution of the vaccine in emerging markets

After trying to solve the immediate problems caused by the pandemic, including a health crisis and reducing the impact of lockdowns on the real economy, most countries are already deliberating on a critical topic: access to the vaccines. Our assumption is that an effective vaccine will become available in the first half of 2021, but that it will take longer for all countries and particularly some emerging markets to get hold of it. Global cooperation in fighting the pandemic has been weak so far. However, there is a sense of urgency for governments to work together and guarantee a more equitable access to the vaccine. Nobody will win this race until everyone has. Although the US and Europe have been backing the development of several vaccines, emerging market's participation has been quite limited.

There are global initiatives, though, to protect the most vulnerable groups in poor countries: **COVAX**, for instance, is a purchasing pool for late stage vaccines that has the ambition to ensure rapid, fair and equitable access to COVID-19 vaccines. The World Health Organisation has also drawn guidelines for equitable distribution of the vaccine across countries, signalling which segments of the population should go first in accessing the vaccine.

Some emerging markets, including Brazil, Indonesia, Peru and Mexico are also seeking to position themselves favourably for vaccine access by collaborating with international pharmaceutical companies on testing.

As governments prepare their budgets for 2021, fiscal expenditures to improve access to the vaccine worldwide are a first order priority. For some countries the investment to facilitate a vaccine for all will be a minor fraction of what has already been spent to fight the pandemic, for other low-income countries this will probably be another barrier to defeating the COVID-19 virus.

Governments now have more leverage to work towards a more resilient and inclusive economy. Not only through stimulus that is being handed out, but through better regulation and cooperation with the private sector. Some of the trends that will need continuous enforcement are:

- **Online education and internet banking for the unbanked.** The costs for society related to closing schools, particularly for Latin American countries, that are going into the seventh month of closure will be large. Students with no access to internet will have lost practically a year of school which will be difficult to compensate, resulting in even worse inequality. Digital banking has helped mitigate the impact of the pandemic. Pakistan, Namibia, Peru, Zambia, and Uganda are some examples of countries that have made good use of these services. Additionally, evidence from small and medium firms in emerging markets shows that virtual due diligence and loan monitoring by lenders, is also being supported by digital services. Governments can accelerate digital access by making it more affordable and safer.
- **Sustainable choices for emerging economies dependent on oil.** Covid-19 has increased public awareness and investor/lender pressure for more sustainable choices. Oil producing countries, including Russia, Ecuador and Nigeria still must make tough and fundamental choices for the long term and find alternatives to reduce the impact of large swings in oil prices in the transition process. That means that public and private investments should already be moving towards more green energy, which can be particularly effective in creating a relatively high amount of jobs, while also laying the foundations for sustainable long-term growth. Governments will have to develop a comprehensive strategy that avoids exacerbating poverty when materialising this transition.
- **Commitment to trade connectivity among governments**. Although the benefits of free trade have not been shared equally, for most emerging countries with small internal markets, trade remains a window of opportunity. Some countries have already underlined their commitment to maintaining global supply chains during COVID-19, including Chile, Myanmar, Canada, Singapore and New Zealand. Fiscal policy could target a better integration into global markets, with targeted and temporary incentives and infrastructure to facilitate this process.
- **Better health and well-being**. According to the World Bank, sanitation facilities in emerging and developing countries are available to only 34% of the population and clean drinking water is available to only 55%. Access to health care is also limited. In countries like Malawi and Kenya, thousands of people have access to one ICU bed. Government budget support is often channelled to top-of-the-class urban hospitals and not to distressed rural health posts. The course of the pandemic has exposed these vulnerabilities and inequality. Improving access to health care systems and healthy food is a first step that still needs to be taken in some countries.

There is no doubt that the economic impact of the COVID-19 pandemic will become more visible in the coming months when measures are withdrawn, but it will also make clearer how governments and investors are contributing to building a more sustainable future.

	GDP growth (% yoy)			Inflation (CPI, % yoy avg)			Government debt/GDP (%)			Government balance/GDP (%)		
	2018	2019	forecast 2020	2018	2019	forecast 2020	2018	2019	forecast 2020	2018	2019	forecast 2020
Argentina	-2.5	-2.1	-12.5	47.4	54.0	38.3	84.3	90.0	98.2	-5.0	-3.6	-8.6
Brazil	1.3	1.0	-5.2	4.1	3.5	2.7	76.5	76.0	94.2	-7.1	-6.0	-13.0
Chile	4.0	1.0	-5.6	2.4	2.5	2.2	25.5	27.8	35.0	-1.7	-2.9	-9.9
China	6.6	6.1	1.9	2.2	2.9	0.4	16.6	16.9	20.4	-4.1	-4.9	-6.7
Colombia	2.5	3.3	-7.7	3.3	4.0	2.6	46.6	54.0	66.3	-3.4	-3.3	-7.1
Czech Rep	2.8	2.5	-5.1	2.1	2.8	3.1	32.6	30.5	40.0	1.1	0.3	-5.8
Hungary	5.1	5.0	-5.7	3.2	3.5	3.6	70.2	68.0	75.0	-2.2	-2.0	-5.9
India	6.1	4.2	-6.9	2.6	3.7	6.4	39.3	41.6	50.2	-6.4	-7.7	-10.1
Indonesia	5.2	5.0	-3.0	3.4	2.8	1.9	29.6	29.5	38.9	-1.8	-2.5	-1.0
Malaysia	4.7	4.3	-7.7	0.3	0.7	-0.7	51.2	52.2	62.6	-3.7	-3.4	-5.1
Mexico	2.1	-0.5	-10.0	4.8	3.5	3.4	44.9	44.8	56.2	-2.0	-2.0	-6.0
Peru	4.0	2.2	-12.5	2.1	2.0	1.7	24.9	25.8	35.4	-2.2	-1.7	-11.0
Philippines	6.2	6.0	-8.3	5.9	2.5	2.5	39.9	39.6	52.7	-3.0	-3.3	-9.1
Poland	5.1	4.0	-3.4	1.4	2.5	2.9	48.9	47.4	53.4	-0.2	-0.7	-9.3
Russia	2.3	1.5	-6.0	4.0	4.5	3.8	13.0	12.3	16.2	2.8	2.0	-4.7
South Africa	0.7	0.2	-9.3	4.9	4.0	3.1	56.7	62.2	82.5	-1.7	-4.0	-14.4
South Korea	2.7	2.0	-1.5	1.8	0.5	0.6	34.4	36.7	41.8	1.6	-0.6	-4.2
Taiwan	2.7	2.7	0.6	0.5	0.6	-0.2	35.1	33.4	33.3	0.6	0.0	-0.7
Thailand	4.2	2.5	-7.8	0.8	0.7	-1.0	41.8	41.2	54.0	-1.6	-2.7	-3.3
Turkey	2.8	0.7	-6.4	22.4	15.2	11.4	30.2	32.5	37.0	-2.0	-2.9	-6.6

Source: IMF, IHS

Disclaimer

- This document has been carefully prepared and is presented by Triodos Investment Management.
- It does not carry any right of publication or disclosure, in whole or in part, to any other party.
- This document is for discussion purposes only.
- The information and opinions in this document constitute the judgment of Triodos Investment Management at the time specified and may be subject to change without notice, they are not to be relied upon as authoritative or taken in substitution for the exercise of judgment by any recipient. Under no circumstances is it to be used or considered as an offer to sell, or solicitation of any offer to buy, nor shall it form the basis of or be relied upon in connection with any contract or commitment whatsoever or be taken as investment advice.
- The content of this document is based upon sources of information believed to be reliable, but no warranty or declaration, either explicit or implicit, is given as to their accuracy or completeness.
- This document is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.
- All copyrights patents and other property in the information contained in this document is held by Triodos Investment Management and shall continue to belong to Triodos Investment Management. No rights whatsoever are licensed or assigned or shall otherwise pass.

About Triodos Investment Management
With over 25 years of experience as a globally active impact investor, and as a wholly-owned subsidiary of Triodos Bank, Triodos Investment Management has developed deep sector-specific insights across Energy & Climate, Inclusive Finance, Sustainable Food & Agriculture, and Impact Equities and Bonds. Offering impact solutions through private equity, debt, and listed equities and bonds, our assets under management amounted to EUR 4.9 billion as per 31 July 2020.

Investing in positive change
For more information about Triodos Investment Management, please contact our Investor Relations team at:

+31 (0)30 694 2400
TriodosIM@triodos.com
www.triodos-im.com

Published
September 2020

Text
Maritza Cabezas Ludena,
Triodos Investment Management

Design and layout
HelderGroen, Haarlem / Via Bertha, Utrecht

Cover photo
Kyle Glenn