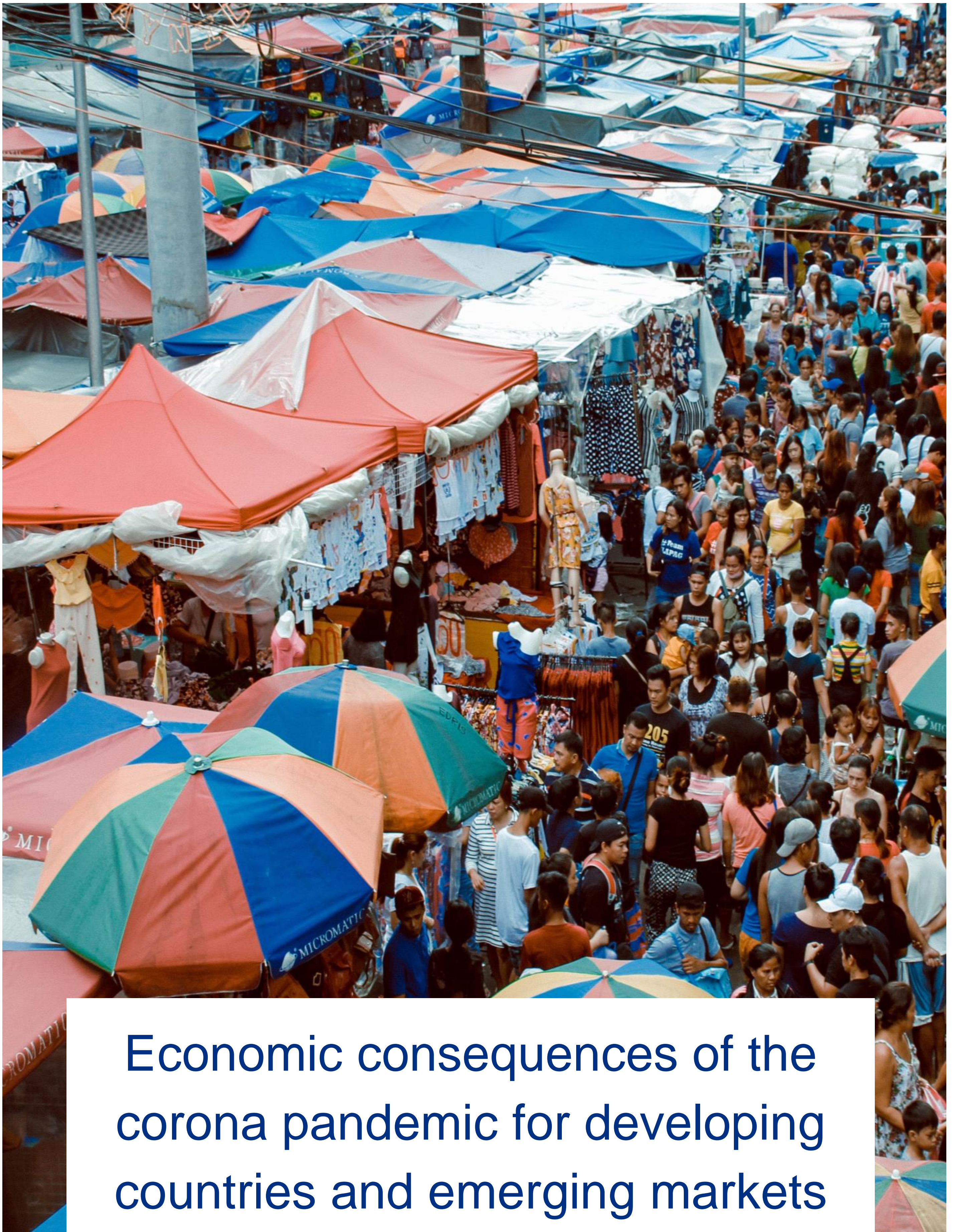

Economic consequences of the corona pandemic for developing countries and emerging markets

Focus Paper

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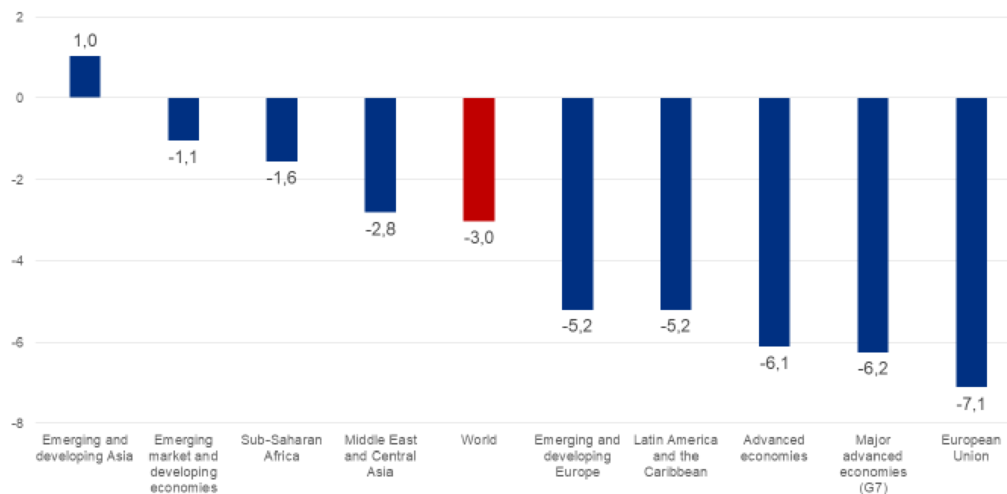
Economic consequences of the corona pandemic for developing countries and emerging markets

The spread of the corona virus (COVID-19) causes not only a high number of illnesses and deaths but also enormous economic damage. For many developing countries and emerging markets, whose economic development is fragile irrespective of this pandemic, the economic consequences may be even more serious than for most industrialized nations.

Expected economic consequences in developing countries and emerging markets

The economic downturn caused by the coronavirus pandemic is affecting the entire world. In April 2020, the International Monetary Fund (IMF) published forecasts for economic development in various regions of the world for the year 2020. For the global economy, a decline in real, i.e. inflation-adjusted gross domestic product (GDP), of three percent is expected. In the developed economies, the expected decline in GDP will even reach six to seven percent. For most developing countries and emerging markets, the decline in real economic output will be smaller. For emerging markets in Asia, modest economic growth is even on the cards. In Latin America, on the other hand, a deeper recession is expected with a decrease of 5.2 percent.

Figure 1: Change in real GDP in 2020 compared to 2019 (Figures in percent)



Source: International Monetary Fund, World Economic Outlook Database, April 2020.

When considering these numbers, it should be borne in mind that growth rates - especially in African and Asian economies - were higher in 2019 than in the developed economies (see Figure 2). Nevertheless, developing economies and emerging markets still perform relatively well in comparison with the rest of the world. While the difference between the growth rates in 2019 and 2020 is 5.9 percentage points worldwide, it is only 4.6 for sub-Saharan Africa, for example, and even less in Asia.

Figure 2: Change in real GDP for the years 2019 to 2021 (Figures in percent or percetage points)

	2019	2020	2021		Difference 2019 – 2020
European Union	1,7 %	-7,1 %	4,8 %		-8,8
Major advanced economies (G7)	1,6 %	-6,2 %	4,5 %		-7,9
Emerging and developing Europe	2,1 %	-5,2 %	4,2 %		-7,3
World	**2,9 %**	**-3,0 %**	**5,8 %**		**-5,9**
Latin America and the Caribbean	0,1 %	-5,2 %	3,4 %		-5,3
Sub-Saharan Africa	3,1 %	-1,6 %	4,1 %		-4,6
Emerging and developing Asia	5,5 %	1,0 %	8,5 %		-4,4
Middle East and Central Asia	1,2 %	-2,8 %	4,0 %		-4,0

Source: International Monetary Fund, World Economic Outlook Database, April 2020.

However, the consideration of mere growth rates should not obscure the fact that the economic damages caused by COVID-19 - and the social distortions related to them - are nevertheless likely to be much more serious for developing countries than for the developed industrialized nations.

This is mainly due to the fact that the pure average growth rates per region mask two decisive factors. On the one hand, even a rate of economic growth of around four percent, which is regarded as high in the OECD region, is far from sufficient to ensure solid economic development in view of demographic pressures and high investment requirements in most developing countries.

On the other hand, as the table above already indicates, there are considerable regional disparities (Hartmann 2020a). In the past decade, for example, the inherent instability of resource-driven growth, which is subject to the volatility of world market prices and demand, has become apparent in numerous Latin American economies. When world market prices for energy, metals and agricultural products fell rapidly from the end of 2014 onwards, such an economic model turned brittle and, without productivity gains, diversification and a substantial reduction in the informal sector, quickly reached the limits of its development, including that of the welfare state. In the Bertelsmann Stiftung's Transformation Index (BTI), the economic performance of Latin America and the Caribbean fell by an average of 1.43 points on a scale of ten within a decade, a significant drop.

This negative balance is even undercut by the plummeting average economic performance in Middle Eastern and North African countries, which has fallen by 1.79 points since the BTI 2010. Regional economic and social development is not only halted by civil wars and the massive marginalization of broad sections of the populace, but also by the economic policies of arbitrarily ruling potentates primarily geared to retaining power.

In the South African region, the unfavorable macroeconomic indicators cannot be attributed solely to global economic difficulties and the sharp fall in commodity prices in the second half of this decade. They are also due to the destabilization of weak market-economy structures in favor of clientelism in many of those African countries that are still undisputedly governed by parties whose legitimacy derives largely from their fight against colonialism and apartheid. In this region, too, average economic performance dropped by a dramatic 1.78 points.

In contrast to most African, Arab and Latin American countries, the majority of Asian economies have experienced solid to dynamic economic development. Most Asian economies benefited from the fact that the traditional engines of regional economic growth (China, India and also South Korea) still proved to be relatively powerful and, thanks to their demand and investments along with international supply chains, exercised a positive impact on growth in most neighboring countries. In the BTI 2020, two-thirds of all Asian economies are certified a good to excellent economic performance (7 to 9 points). The economic and social impact of the corona crisis therefore hits economies that are very unevenly prepared for it, depending on the region and country-specific characteristics. Macroeconomic indicators deteriorated in 61 of the 128 countries studied since the BTI 2010, including in Argentina, Brazil, Russia, South Africa and Turkey, and stagnated in a further 35 countries.

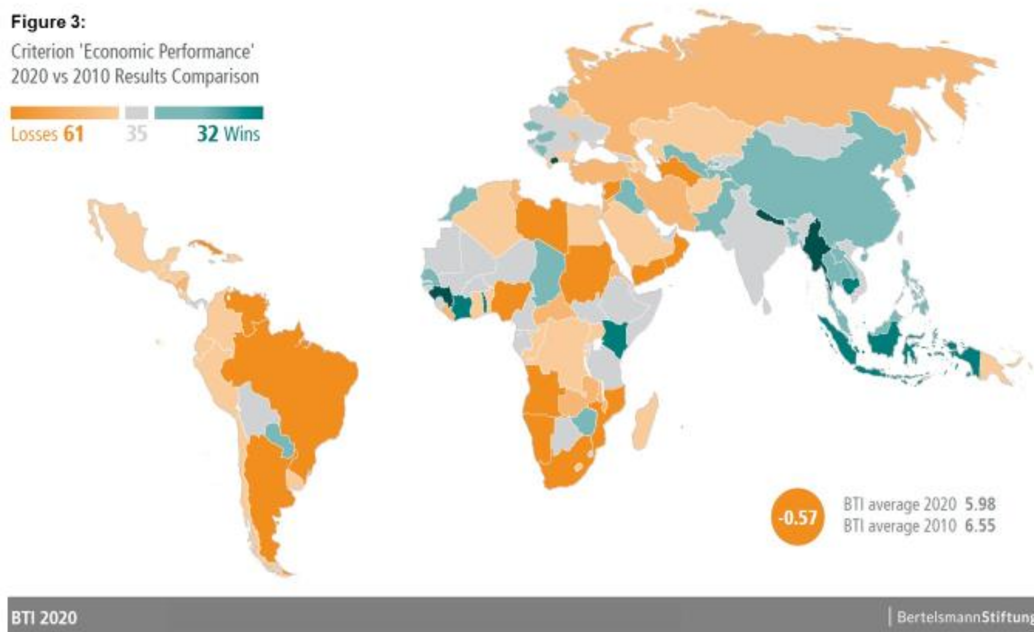


Figure 3: Criterion 'Economic Performance' 2020 vs 2010 Results Comparison

Vicious circle of current account deficit, devaluation and foreign debt

Accordingly, even before the outbreak of the corona pandemic, many developing countries and emerging markets were already trapped in a vicious circle of permanent current account deficits, devaluation of

their currency and rising foreign debt - the latter often held in the external creditor's currency. While the BTI 2010 still rated 38 percent of all the countries examined as stable in terms of fiscal policy, this proportion fell to 20 percent in the BTI 2020. Many developing countries and emerging markets are more heavily indebted than at any time since the 1980s and in some cases spend well over 20% of their income on interest payments alone (see Hartmann 2020a).

In data published in April 2020, the IMF shows the current account balances for 154 emerging markets and developing economies. In 2019, only 40 of them had a current account surplus. These countries included oil-exporting countries (Venezuela, Kuwait, Saudi Arabia, the United Arab Emirates, Russia and Qatar) and Asian emerging markets (China, Thailand, Vietnam, Malaysia). In contrast, the remaining 144 countries had current account deficits (see IMF 2020a).

A current account deficit means that a country spends more money than it earns in its economic transactions with the rest of the world. This has repercussions on the exchange rate, i.e. the value of the domestic currency in foreign exchange markets. These show up particularly in payments for exports and imports:

- Normally, expenditure must be met in the currency of the country from which the imports originate. For example, if Egypt imports trucks from Germany, the German company will charge Euros for them because it has to pay its wages, taxes, rents, interest, etc. in Euros.
- If Egypt is to have the required Euros at its disposal, it must buy them with its own currency on foreign exchange markets.
- Conversely, German companies offer Euros to obtain Egyptian Pounds with which they then pay for natural gas and oil from Egypt.
- If Egypt has a current account deficit, the supply of Egyptian currency on foreign exchange markets exceeds demand. The value of the Pound falls, leading to a devaluation.

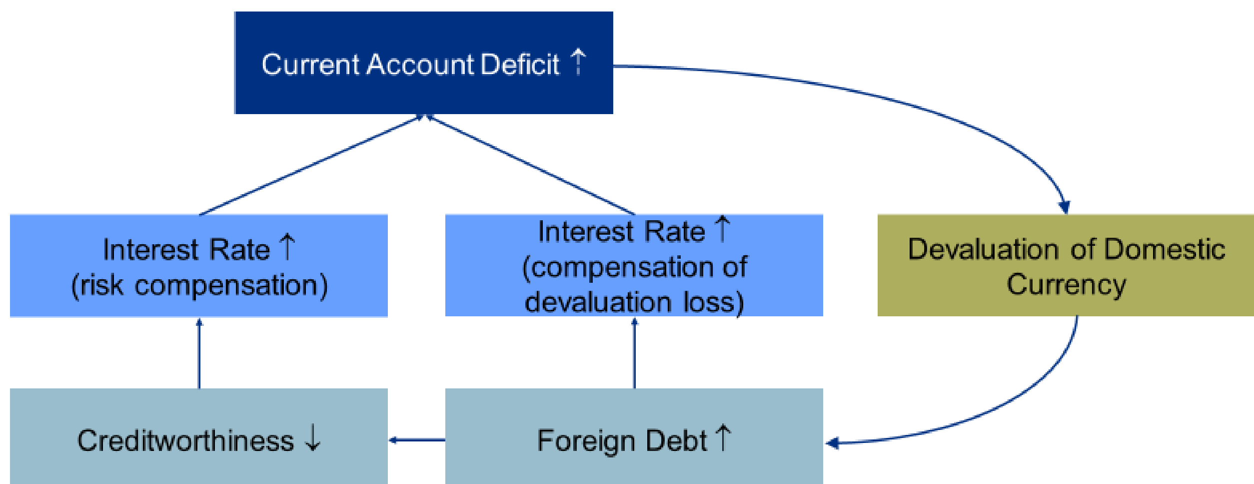
A permanent current account deficit also results in a permanent **devaluation**. This has consequences for the country's ability to borrow money abroad. Let's assume that the interest rate on borrowing is four percent per annum. Now, if an annual devaluation of the Egyptian Pound by five percent against the Euro is expected because of Egypt's permanent current account deficit, this raises the interest rate Egypt has to pay for overseas borrowing. A European lender who grants the Egyptian government a loan of ten million Egyptian Pounds for a period of one year does not just want the usual four per cent interest rate. He is also demanding compensation for the five percent loss in value resulting from the expected devaluation of the Pound. The interest rate to be paid is therefore nine percent.

This **interest rate premium** can only be avoided if the loan is granted in Euro, because the exchange rate risk no longer exists for the lender in that case. For this reason, many loans taken out by developing countries and emerging markets are granted in hard currencies - above all the US Dollar. However, this

also has negative consequences for the country taking out such a loan: If its own currency depreciates by five percent, a loan of one million Euros taken out in January 2020 will have to be repaid in January 2021 with an amount in domestic currency that is five percent higher. For the borrower, this means that the effective cost of the loan remains at nine percent. Since loans usually have a longer term - and are often repaid only by taking out a new loan - the borrower's foreign debt (expressed in local currency) increases year by year.

Rising expenditure on interest has a retroactive effect on the country's current account: The country increases its foreign expenditure, which in itself widens an existing deficit. The devaluation tendencies continue and the foreign debt - expressed in domestic currency - continues to grow. As a result, the country's **creditworthiness declines**. In addition to the interest premium for devaluation-related losses, lenders demand a **further interest premium** to compensate for the rising risk of a loan default (**risk premium**). The vicious circle continues (see Fig. 4).

Figure 4: Vicious circle of current account deficit, devaluation and external debt



Source: Own representation.

The interaction outlined above between a country's current account deficit, the devaluation of its currency and growing foreign debt is further accelerated by the corona pandemic.

Economic impact of the corona pandemic on developing countries and emerging markets

The global economic downturn has led to a decline in demand for raw materials, especially oil and gas. Developing countries and emerging markets, whose exports consist mainly of raw materials, are coming under additional pressure because they can only sell a **lesser amount** on world markets.

In addition, when **global demand for raw materials declines**, prices fall. For example, the price of a barrel of crude oil (159 liters) of around 65 US Dollars at the beginning of 2020 fell sharply with the outbreak of the corona crisis. In mid-March, it reached less than 25 US Dollars, the lowest level for more than 15 years. The **price decline** within this short period of time was thus 40 US Dollars or 65 percent (IMF 2020b, p. 2). In April 2020, there was even **briefly** a **negative price** for crude oil for the first time - anyone who wanted to get rid of their oil had to pay around 40 US Dollars per barrel. The reason for this development was a combination of speculation in the form of so-called commodity futures, the global decline in demand for oil and the technological problem that oil production can hardly be throttled back in many oil fields (Schultz 2020). Thus, an oversupply of oil for which there was hardly any storage capacity left encountered collapsing demand.

Countries whose budgets depend largely on **income from oil exports** are thus suffering from a dramatic fall in prices with falling sales volumes. Export revenues collapse, existing **current account deficits** widen, or current account surpluses turn into deficits. As described above, the result is a devaluation of the domestic currency and an increase in the value of existing **foreign debts**. In many countries, government budgets will then also have to be cut, as these are heavily dependent on exports of raw materials. These cuts then also mean fewer resources for education, infrastructure, etc. In the long term, the prospects for economic and social development will deteriorate.

The same effect occurs for countries that are particularly dependent on **tourism**. Due to the travel restrictions in force, revenues are lost here, and in many cases these losses will not be recovered after the pandemic. This also has an impact on the current account and exchange rate. These two developments have consequences for government revenues. They decline because the **tax base shrinks**. The effects on the state budget are even more serious if the state itself is an exporter or tourism provider.

The value of the currencies of many developing economies and emerging markets is coming under additional pressure as investors from industrialized countries **withdraw** their **capital** from them. One reason for this is that companies in the industrialized countries already affected by the pandemic need liquidity: The economic crisis is leading to reduced local demand for their goods and services. As a result, companies' sales are declining. In extreme cases, production may even come to a complete halt because they lack the necessary workforce; urgently required factors of production are no longer supplied; or the government orders their closure. Many costs, however, continue to run. For example, rents, leases, interest on loans and wages for employees who are not laid off despite the halt in production must continue to be paid. In order to prevent insolvency, investors and companies therefore take back their money.

In addition, many investors **anticipate** the connection outlined above between a pandemic and currency devaluation in emerging markets and developing countries. In order not to suffer **devaluation-related asset losses**, capital is withdrawn from emerging markets and developing countries even if there is no liquidity requirement.

According to the Institute of International Finance (IIF), emerging markets have been suffering **record outflows of capital** since the beginning of 2020. The combination of the corona pandemic and the fall in oil prices in emerging markets led "to a record-breaking outflow episode of around $83 bn in March alone" (IIF 2020, p. 3).

The decline in commodity prices and **capital withdrawal** is leading to a considerable loss in value of among domestic currencies, especially in the emerging markets, i.e. to a devaluation of domestic currencies. In its calculations, the IMF shows that the currencies of Mexico, Brazil and South Africa, for example, lost around 20 to 25 percent in value against the US Dollar between December 31, 2019 and the beginning of April 2020 (IMF 2020b, p. 4).

This loss in value is also evident when looking at the Euro (see Figure 5). Looking at its value in the currency units of selected emerging markets, it can be seen that the Euro gained around 36 percent against the Brazilian Real between January 2, 2020 and April 28, 2020. Against the South African Rand, the Euro's appreciation is almost 20 percent, against the Mexican Peso 25.5 percent and against the Turkish Lira at least 14 percent. The mirror image of this Euro appreciation is a corresponding devaluation of foreign currencies.

Figure. 5: Euro reference rate of the European Central Bank for selected countries (1 Euro = … units of foreign currency)

	Brazil	Mexico	South Africa	Turkey
01.11.2019	4.444	21.316	16.828	6.376
15.11.2019	4.630	21.219	16.249	6.343
02.12.2019	4.665	21.567	16.177	6.344
16.12.2019	4.549	21.202	16.131	6.519
02.01.2020	**4.487**	**21.138**	**15.750**	**6.670**
15.01.2020	4.635	20.954	16.022	6.558
03.02.2020	4.717	20.818	16.481	6.622
17.02.2020	4.674	20.124	16.210	6.554
02.03.2020	4.994	21.996	17.420	6.925
16.03.2020	5.538	25.448	18.560	7.157
01.04.2020	5.735	26.410	19.662	7.293
15.04.2020	5.712	26.080	20.414	7.509
28.04.2020	6.100	26.527	20.291	7.612
Change between 02.01.2020 and 28.04.2020 (Reference value 02.01.2020 = 100)				
	136.0	125.5	128.8	114.1

Source: Deutsche Bundesbank 2020.

For the people in these countries such a strong devaluation has considerable consequences. Imported products that the country cannot do without must now be purchased from abroad at higher prices. For a Brazilian consumer, a 35 percent devaluation means that he suddenly has to pay 135 Reals for a product from Germany that originally cost the equivalent of 100 Reals. For Brazilian **consumers**, a devaluation therefore means **higher prices** and a **loss of purchasing power**. This is a real loss of prosperity for

ordinary people. If necessities, such as medicines and food, can no longer be paid for and imported **supply shortages** may arise.

If many products have to be imported, their prices will rise, as correspondingly will the overall inflation rate. The country loses **international competitiveness** because of **higher production costs**. As a result, its exports may decline, which accelerates the devaluation and thus causes prices to rise further. If this downward spiral goes unchecked, there is a risk of **hyperinflation** in extreme cases.

It should also be borne in mind that the interplay of capital withdrawal, devaluation tendencies, rising inflation and growing foreign debt further worsens **creditworthiness.** Potential lenders will therefore increase their risk premiums on the interest rate to be paid - in other words, the cost of borrowing will rise. This makes it more difficult for many emerging markets and developing countries to obtain further credit. This is particularly problematic if a country has an **increasing need for credit** due to falling export earnings and capital withdrawal by foreign investors during the pandemic phase. A need for credit arises already from the mere fact that these countries need fresh credit to be able to repay expiring loans. By mid-April more than 100 governments had already applied to the IMF for financial assistance (see IMF 2020).

Finally, the negative financial situation of emerging markets and developing countries is exacerbated by the fact that **remittances from migrants** who support their families with income earned abroad are declining: Migrants' remittances back home are reduced because jobs are lost in Europe, the USA or the Gulf States (Kappel 2020, p. 229). This aggravates the supply of financial resources for the local population. And it increases existing current account deficits, as these revenues from abroad also decline.

It is important to note at this point that all the negative economic impacts outlined so far affect **developing countries and emerging markets**, even if there is **not a single coronavirus infection there**. The economic effects only result from the fact that there is a corona pandemic in the rest of the world. If, on the other hand, the corona virus also spreads to the extent feared in developing countries and emerging markets, these are at risk of **additional economic damage**, which will further worsen their economic and social situation.

Economic effects of the coronavirus outbreak in developing countries and emerging markets

The outbreak of a contagious infectious disease will also lead to **production losses** in developing countries and emerging markets. If employees can no longer appear at work due to illness - or no longer want to turn up because they are afraid of infection - the company will have to shut down production. If state authorities close down factories to stem the spread of the disease, this will lead to even greater cuts in output. In highly developed economies with sufficient production of essential goods, this does not constitute an existential thread. If necessary, missing products can be imported from abroad. In countries in

which many people normally have just enough goods to ensure their survival, a reduced supply can become **life-threatening** - especially if food cannot be imported from abroad due to a lack of financial resources.

Unlike rich industrial nations, many developing countries and emerging markets suffer from a **lack of political capacity to act** due to a lack of financial resources on the part of the state. This affects its ability both to support people in need through transfer payments and provide companies with loans or finance **economic stimulus packages**.

The social policy component is also very important: Living at or below the poverty line is part of everyday life for most people in developing countries. In the BTI 2020, 76 of 137 countries show a very low level of socio-economic development, with rates of 4 points or less. Poverty and inequality are thus widespread in more than half of the countries studied by the BTI, indicating firmly established patterns of exclusion. Despite an overall decrease in extreme poverty rates, social inequality has increased over the past decade.

A major problem in this context is the modest size of the formal sector in most countries. According to the International Labour Organization, more than 60 percent of the global labor force is employed in the informal sector; in sub-Saharan Africa the level is as high as 85 per cent (ILO 2018). Even though the informal sector is a safety valve for job seekers, it is significantly less productive, less well paid, less accessible in socio-political terms and virtually unprotected by employment laws. The social vulnerability of the population working in the informal sector is therefore particularly high and, as in the case of India, with well over 80 percent of informal workers, is likely to increase dramatically because of the corona crisis (cf. Hartmann 2020b).

As a result, it is often not possible to maintain the social distancing necessary to contain the infectious disease. Even if people want to avoid such contact purely for self-protection, they cannot do so because they have to work to earn a living in the **absence of a social safety net**. This will accelerate the spread of the corona epidemic.

The state's inability to act is even more dramatically reflected in the quality of the health care system. This is illustrated by the number of **intensive care beds** available in a country. In Mali there are six intensive care beds for 18 million people, in Rwanda eight for twelve million and in Ethiopia 150 for 105 million people (see Monath 2020). By way of comparison: before the Corona crisis, there were a total of 28,000 intensive care beds in Germany, 20,000 of which have mechanical ventilation. During the corona pandemic, the number of intensive care beds was increased to 40,000 and the number of ventilators to 30,000 (DKG 2020). The district of Gütersloh with 360,000 inhabitants has 54 intensive care beds.

If the epidemic spreads rapidly in countries with low capacities in the health care system, because social distancing is impossible, a **humanitarian disaster** with high numbers of sick and dead people is looming.

As a result, all the economic problems that already result from a corona pandemic **outside** developing countries and emerging markets will be **exacerbated** by an epidemic outbreak in these countries themselves. This is leading to:

- a loss of production and employment also resulting in a loss of income,
- a deterioration in the real living conditions of the local populace, including shortages of essential goods,
- falling exports with a tendency to devalue the domestic currency,
- rising prices for imported products and thus possibly rising inflation with declining international competitiveness,
- withdrawal of capital from these countries, which exacerbates devaluation pressures,
- growing external debt, leading to lower creditworthiness and rising interest rates, thus further increasing debt,
- and a further decline in the already limited political capacity to act, which makes it more difficult to contain the epidemic.

Conclusion and outlook

According to current estimates, the economic effects of the corona pandemic described above are hitting the developing and newly industrializing countries somewhat less hard than the developed economies, if one simply looks at changes in GDP levels alone (see Figs. 1 and 2).

At the same time, however, it should be noted that many of these countries were already in a problematic economic situation **before the outbreak of the corona pandemic**. This was characterized by persistent current account deficits and foreign debt that was rising due to local currency devaluation.

The **corona pandemic aggravates this situation** through falling raw material prices; declining exports; growing foreign debt; a withdrawal of capital which fosters devaluation; as well as production and employment losses that can lead to supply bottlenecks.

This results in a **dilemma**: Particularly in the pandemic period, many developing countries and emerging markets are dependent on financial resources from the developed economies to be able to purchase urgently needed products from abroad. These include not only food but also medical supplies. At the same time, however, the industrialized countries are withdrawing their capital from these regions. In addition, their willingness to grant loans is diminishing due to the declining creditworthiness of developing countries and emerging markets.

Ultimately, however, the developing countries and emerging markets are manifestly dependent on **financial support from industrialized countries.** Without this aid, a humanitarian disaster is imminent. This

is particularly true for most African countries. If Africa is left alone with its medical and economic problems, this is likely to raise migration pressures significantly. This could in turn overburden Europe's economic, social and political capacities. Supporting developing countries and emerging markets in solving medical and economic challenges is therefore not only a humanitarian imperative and a multilateral desideratum, but also in the well-understood self-interest of European states - even if they are facing enormous problems in view of the pandemic themselves. Robert Kappel is therefore perfectly correct in saying that "without the necessary means to combat the crisis effectively, the human and economic price to be paid will be devastatingly high. It is therefore essential that the rich countries recognize how much a reeling Africa exacerbates their own economic and social crisis" (Kappel 2020, p. 229).

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