Economic Views – EM Funding Needs in the COVID-19 Shock

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- EM funding needs are still high despite current account adjustment.
- Risk is elevated where debt amortization is high relative to reserves.
- South Africa is at risk of a significant external financing gap this year.
- Others such as Turkey and Ukraine also face a tough funding picture.
- Unconditional IMF emergency loans are too small given EM needs.

A sudden stop in capital flows has hit emerging markets. Our real-time trackers show cumulative outflows from EM in the vicinity of a hundred billion dollars since the COVID-19 crisis began. This is an extraordinary shock even by the standards of the global financial crisis. The sudden stop, coupled with low commodity prices and global recession, will make external funding hard to come by. This is a particularly relevant issue in countries where amortizing debt is large and reserve buffers to plug funding shortfalls low. On this front, countries like Turkey and South Africa stand out. The latter is especially concerning as poor growth and an explosive public debt path compound external vulnerability. We see a high risk of significant reserve drains in South Africa, as part of the large inflow of hot money in the last ten years reverses under a tenuous macroeconomic outlook. In this turbulent global situation, the IMF will likely be called into action. A small part of its resources can be mobilized quickly in the form of emergency assistance, but the substantial amounts EMs in distress might need likely require full programs with conditionality.

Exhibit 1. Sizable external funding needs, ...

Exhibit 2. ... despite lower current account deficits.

We forecast deep recessions across EM that will reinforce last year’s trend toward smaller current account deficits via import compression (Exhibit 1). Exports will obviously suffer as DMs sink into recession, but imports will fall even more under tight funding conditions and collapsing domestic demand. This translates into lower external financing needs, albeit at the cost of income and jobs domestically. Unlike trade, external debt does not automatically shrink as growth falls and remains significant in a few countries. The risk posed by debt depends on two factors. First, how resilient rollover rates are. For example, rollover in Colombia was high through the commodity price and China shocks in 2014-16 but fell sharply in Turkey in 2018-19. Second, low reserve buffers raise higher risk for a given level of amortization (Exhibit 2). Buffers are the most limited in Turkey, Ukraine, and South Africa—countries facing challenging situations in other respects too. We are less concerned about Chile, as amortization to related enterprises, which are more likely to roll over, accounts for a high share of the total. South Africa’s outlook is especially complicated, as growth was poor last year, fiscal risk is elevated, and some FX overvaluation persists. Low FDI and the heaviest nonresident investor position in EM are also a sources of vulnerability. We see sizable reserve losses in adverse scenarios where debt rollover rates range from 60 to 80% (Exhibits 3 and 4). Our estimated reserve drains are significant relative to GDP and especially so in proportion to the stock of reserves. As in past shocks, we expect the private sector to repatriate some assets, but we do not think this mechanism can fully offset growing nonresident outflows. While the risk of large reserve drains is generally lower elsewhere in EM, funding shortfalls are still a possibility in a complicated global environment.
IMF resources will be in high demand in such a complicated global situation. The institution has $270bn readily available and can access an additional $508bn if member countries agree the ongoing global shock calls for the activation of extraordinary resources. As a reference point, total IMF resources roughly amount to the gross financing needs we project for the 16 EMs ex China we cover in this note. Outstanding IMF loans and credit lines as of 2019 amounted to 0.2% of global GDP, a figure that would rise to more than 1% if all resources were deployed. We suspect many of the 80-odd assistance requests the IMF says it received concern unconditional emergency loans to deal with natural disasters (RFIs and RCFs in IMF jargon). This type of loan can be large relative to the size of the economy in Africa but would be modest for EMs (Exhibit 5). In the case of South Africa for example, emergency loans would cover just a small fraction of our estimated reserve drain in adverse scenarios. Similar scale arguments apply to SDR allocations, which give all countries SDRs they can then swap for hard currencies in a market of central banks managed by the IMF. Unless allocations were very large, they would not be a game changer for EM (Exhibit 6).