Economic Views –EM External Adjustment under COVID-19

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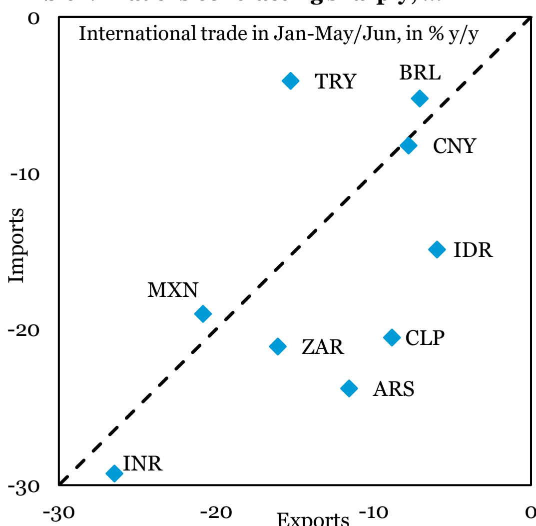
- The EM external outlook is shifting under the COVID-19 shock.
- We study import and export trends in the first half of 2020.
- Imports are contracting as much as in past major EM crises, ...
- more than offsetting falling exports in almost all countries.
- This is a signal that EM current account deficits will vanish.

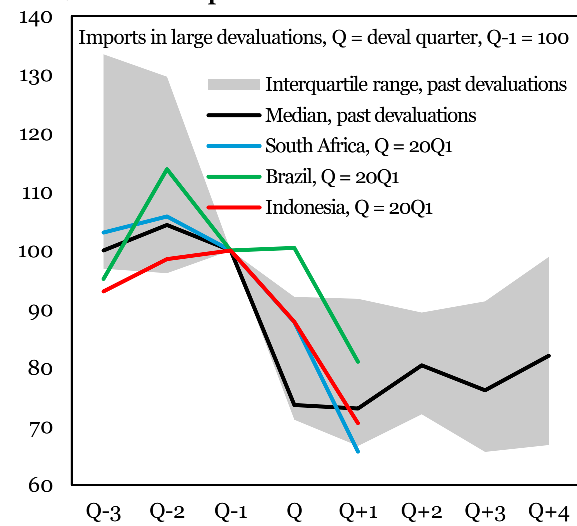
The EM outlook has shifted radically under COVID-19. Global growth is the major casualty and in the early stages of the pandemic there was a nearly unprecedented reversal in capital flows to EM. As the effects of the growth and flows shocks play out, we are going to see big changes in the EM external outlook. In recent weeks, we looked into the currency valuation implications of this evolving landscape. The rand has swung from overvalued to fair and the Turkish lira shifted back to overvaluation. A central input into currency valuation and external risk assessment more generally is the current account. In recessions, we usually see shrinking current account deficits via import compression. This time around, synchronized lockdowns have the potential to disrupt exports too. We use data on trade in goods, which are available earlier than current accounts, to map out trends in EM external adjustment. Trade is contracting across the board. With few exceptions, trade balances are improving as imports fall more than exports. We thus expect most EM current account deficits to vanish. This is by no means a reflection of healthy import substitution or export competitiveness. It is the temporary result of collapsing growth and tightening financing conditions. Turkey is a notable exception, as it looks to be returning to a sizable current account deficit in the context of a large credit expansion.

Exhibit 1. Trade is contracting sharply, ...



Source: Haver, IIF

Exhibit 2. ... as in past EM crises.



Source: Haver, IIF

The trade balance is a main component of the current account that we can nowcast ahead of the full balance of payments release using customs data, which are available through May or June. We focus on y/y changes in cumulative imports and exports through May/June to avoid issues with seasonality. The effects of the COVID-19 shock on international trade are drastic (Exhibit 1). Both imports and exports contracted sharply with few exceptions. Brazil and Turkey show the least import compression in the sample (June data are available for both). Brazil's moderate drop may reflect a strong start of the year and lagged COVID-19 impact relative to other EMs, as imports in April-June were down 15% y/y. In Turkey, policies to support growth via credit expansion prevent imports from falling as fast as in other countries, but risk wide imbalances in the context of low reserves. India is an outlier at the other end of the spectrum. Collapsing international trade and the weakest services PMI in the world suggest economic activity fell off the cliff. The import contraction in many countries is on par with past large devaluations in EM (Exhibit 2). The sample of past devaluations includes cases like Mexico 1994 and Russia 1998, underscoring how severe the ongoing import drop is. Low oil and agricultural commodity prices explain part of the drop but the severe contraction in non-commodity imports across countries confirms that depressed domestic demand is also a major driver of external adjustment (Exhibit 3).

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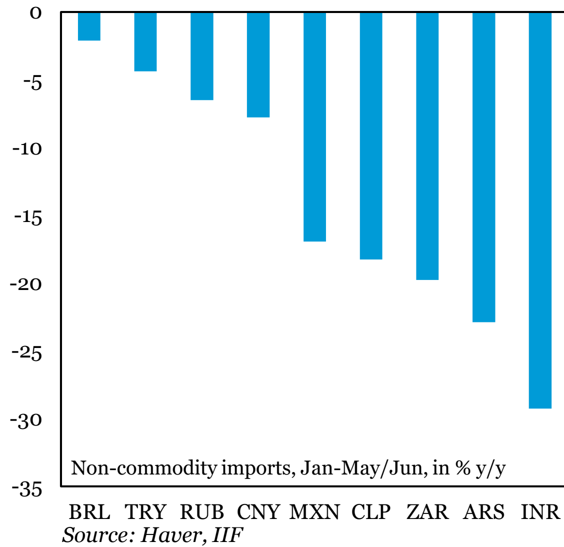
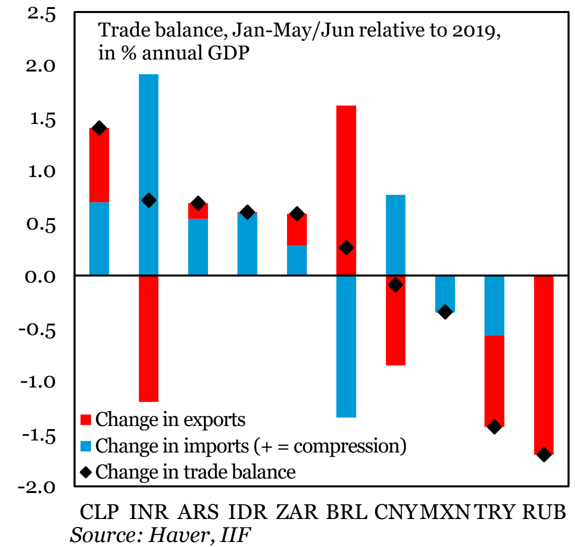
Exhibit 3. Imports fall with domestic demand.



Source: Haver, IIF

Exhibit 4. Improving trade balances.

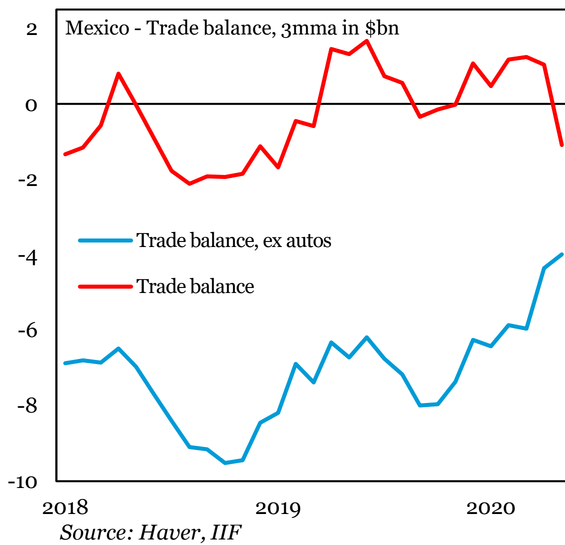


Source: Haver, IIF

Since imports are generally falling more than exports in dollar terms, trade balances in percent of GDP are improving in several countries (Exhibit 4). In cases like Brazil and Mexico, imports year to date are higher relative to annual GDP than in 2019 because dollar GDP is projected to fall sharply (a "denominator effect"). But it is still the case that imports have fallen, just less than GDP. Unlike many idiosyncratic EM recessions in the past, we have seen severe export disruption in some countries. Mexico is a case in point. The overall trade balance is worsening but the balance ex auto imports and exports is improving (Exhibit 5). We suspect that when the auto industry normalizes to some extent, we will see external adjustment driven by weak domestic demand.

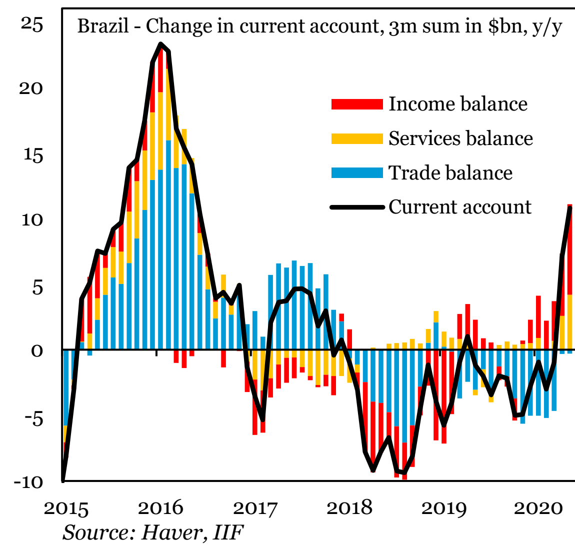
Next week we will analyze how shifting trade balances fit into the overall current account adjustment picture and external financing needs. Cases like Brazil, where we already have full balance of payments data through May, show meaningful current account adjustment (Exhibit 6). So far, the income balance (lower reinvested earnings) and services (falling travel imports) account for the lion's share of Brazil's external adjustment.

Exhibit 5. Export disruption in Mexico.



Source: Haver, IIF

Exhibit 6. Brazil's external adjustment.



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