COVID and the Outlook for Emerging Markets[1]

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1. Introduction

COVID-19, it is said, changes everything. In this paper I ask how the pandemic changes the outlook for emerging markets.

For context, it may be useful to ask how our colleagues at the IMF think COVID changes the outlook. In their last pre-COVID *World Economic Outlook*, in the autumn of 2019, they forecast GDP in emerging markets and developing countries to grow by 4.8 percent in both 2022 and 2023. More recently, in the spring of 2021, they downgraded these figures to 5.1 and 4.6 percent, respectively. (See Table 1.) These relatively small changes reflect either the firmly held belief that the pandemic will have only a very slight, passing effect on emerging markets or else the intrinsic inability of large bureaucratic organizations to significantly modify inherited views.

My own conclusion is that the impacts will be both larger and more persistent. Let me count the ways.

2. More Public Debt

To start, emerging markets (like advanced economies) will emerge from the pandemic more heavily indebted. Public-debt-to-GDP ratios had already been rising before COVID-19 (as they had been since 2013). But those ratios have now risen further from 55 to 65 percent (IMF 2021). No one questions the wisdom of borrowing to help meet a national health crisis and economic emergency. But these heavier debts create management challenges. The good news is that much of this debt is denominated in domestic currency, which makes management somewhat easier. In addition, there has been little if any increase in interest costs as a percent of GDP.[2] Interest rates on public debt have fallen by less and remain higher than in the advanced countries, but they have fallen, from about 6 ½ in 2018 to 5 ½ percent in 2020 for Kose et al.'s (2021) sample of 84 emerging markets and developing countries.

Unfortunately, the bad news outnumbers the good. First, domestic-currency-denominated debt is no panacea for economies that depend on external finance. Hofman, Shim and Shin (2021) emphasize that local-currency denomination doesn't eliminate the currency-mismatch problem; it only shifts it from the government to foreign investors. A negative shock to the exchange rate imposes losses on foreign investors with liabilities denominated in, say, dollars but assets in the emerging market currency, leading to fire sales as those investors seek to restore their liquidity. The result of this "double whammy" (lower local-currency bond valuations and a lower exchange rate) can be very considerable volatility in local-currency bond markets as foreign investors retrench. And despite the considerable progress made in issuing domestic-currency debt, emerging markets continue to sell a third to half of their new issuance to foreign investors. This pattern is also evident in the pandemic period: portfolio capital flows, though declining by 13 percent year-on-year in 2020 (due mainly to events at the start of the

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[2] Kose et al. (2020) show a modest rise in interest payments as a percent of GDP between 2019 and 2020 in their sample of "up to 150 EMDEs," while IMF (2021) no increase in emerging market economies.

pandemic), remained strongly positive, as foreign investors continued to absorb a significant share of emerging markets' new issuance. This dependence on capital inflows and the double-whammy risk to which foreign investors are exposed means that emerging markets remain at risk of a sudden stop. In principle, domestic-currency denomination means that the central bank can intervene to backstop the market, but only at the cost of inflation and depreciation risk.

This reference to inflation brings us to a second consideration, namely that interest rates can go up. They *will* go up if the forecasts of the Institute of International Finance (2021) are believed. The global savings glut that has put downward pressure on interest rates worldwide may dissipate as appetite for the petroleum of oil exporting economies dries up and China builds out its safety net, causing precautionary savings to decline (China and the oil exporters having been heavily responsible for the savings glut). Similarly, the trend toward growing inequality, which has skewed incomes in advanced economies toward better-off, high saving households (Mian, Straub and Sufi 2021) may be reversed by public policy. Interest rates may be pushed up by a "red-hot capex cycle," as firms invest in machinery, factories and intangibles in an effort to position themselves for the post-pandemic economy (Economist 2021). The Fed has already begun tapering, and sooner or later (probably sooner) it will begin raising its policy rate. Investors appear to be of the view that emerging markets will be able to avoid a taper tantrum this time around (Chowdhury 2021). Current account deficits are smaller than in 2013, they say, while anti-inflationary credibility is stronger. I'm not so sanguine. Be that as it may, there is no doubt that, at some point, higher interest rates will make for heavier debt-servicing costs.

Third, public debt is only one part of the debt burden. In the year following the onset of the pandemic, the debt of households and nonfinancial corporations in emerging markets grew only slightly more slowly than the debt of governments.[3] It is likely that some of these debts may end up being socialized; they may end up on the balance sheet of the government.

My reading of the literature is that there is no stable relationship, with predictive power, between debt and growth (see Eichengreen et al. 2021). That said, there is no questioning the intuition that emerging markets, coming out of the pandemic more heavily indebted, will have less capacity to borrow if faced with another shock and will face hard choices when interest rates rise.

3. Accelerated Automation

There has been much commentary – and some evidence – to the effect that COVID-19 has accelerated automation (see e.g. McKinsey Global Institute 2021). As working shoulder to shoulder in a meatpacking plant became riskier, meatpackers and their suppliers intensified efforts to automating tasks where the need for close hand-eye coordination previously frustrated mechanization efforts (Motlteni 2020). Experience with a workforce prone to fall ill led employers to contemplate shifting to machines not subject to medical problems. In addition, the COVID-19 recession, like all recessions, provided downtime during which firms had the opportunity to reorganize, including by replacing labor with robots; previous studies have documented that automation accelerates in recessions (Muro, Maxim and Whiton 2020). These

[3] Again according to Institute of International Finance (2021), Table 1. Financial-sector, in contrast, grew noticeably more slowly.

studies also suggest that changes in the extent of automation coincident with recessions tend to stick subsequently.

The traditional route to higher incomes for developing countries is through the export of labor-intensive manufactures (textiles, apparel, footwear, toys and furniture). These industries do not require heavy investments or highly trained and educated workers. But they help to instill factory discipline, enable learning by doing, accustom firms to competing on global markets, and generate the foreign exchange needed to import more advanced equipment.[4] The fear now is that such manufactures will be produced using robots in the same high-wage countries that constitute their final markets. This prospect feeds directly into Dasgupta and Singh(2006) and Rodrik's (2016) concern about "premature deindustrialization."

One can exaggerate the extent of the danger (as many observers do). But there is no question, to the extent that COVID has given an additional fillip to automation, that it will make life more difficult for emerging markets that rely on labor-intensive light industry for manufacturing experience, exports and employment.

4. Reorganization of Supply Chains

Many emerging markets – Mexico, in Eastern Europe, in East Asia – have thrived by linking into global supply chains, specializing in parts, components and assembly operations. This model experienced a major shock with COVID-related port shutdowns and congestion, higher shipping costs and greater uncertainty around delivery, and inability of suppliers to adapt quickly and reliably to shifts in demand (as evidenced, for example, by the semiconductor shortages that followed the shift from consumption of services to consumption of goods).

These problems have led to some reshoring – actual, on the part of firms, and prospective, as a result of efforts by governments to build additional local capacity (again, as in the case of semiconductors). Firms have sought to shorten supply chains, outsourcing the production of parts or assembly operations to foreign countries relatively nearby, where shipping problems and the like are apt to be less.

The negative effects are not unlike those of accelerated automation. Points of entry into manufacturing for emerging markets and developing countries are not just textiles and apparel but also assembly and the production of components for assembly operations. Such opportunities will be fewer insofar as companies in advanced economies, having witnessed supply-chain disruptions, do more operations at home. But not all emerging markets will be affected equally. One imagines that Mexico will benefit from efforts of U.S. firms to shorten their supply chains and that emerging Eastern Europe will benefit from an analogous desire on the part of EU firms. There is some evidence that supplies of inputs from South Korea and Taiwan to Japan were positively affected in the crisis (Zhang 2021), although Korea and Taiwan don't exactly qualify as emerging markets. At the same time, one worries about other emerging markets, in South Asia, Africa and Latin America, that may be left on the outside.

[4] Rodrik (2016) emphasizes also favorable political consequences of growing employment in labor-intensive manufacturing, namely that the mass political parties that are part of the infrastructure of stable democratization tend to be byproducts of industrialization.

5. Human Capital

The impact of COVID on educational attainment and human capital formation, though negative everywhere, is more negative in emerging markets than advanced economies. The availability of high-speed broadband needed for effective distance learning is less. A slower pace of vaccination will make for more extended school closures and absenteeism.[5] Azevedo et al. (2020) estimate that COVID will increase the share of children in emerging markets and developing countries unable to read and understand a simple text by the age of 10 from 53 to 63 percent.

Some lost schooling can be made up subsequently, but some cannot; these same authors estimate that COVID-19 will result in a loss of 0.6 years of quality-adjusted schooling and a reduction, for today's cohort in primary and secondary school, and of $872 in yearly earnings, or a total $10 trillion of lifecycle earnings in present value. These are global estimates, and not just for emerging markets. They are speculative and subject to considerable uncertainty. But, uncertainty notwithstanding, this may turn out to be the most significant cost of all for emerging markets.

6. State of the Global Economy

The most powerful counterargument to the preceding is that emerging markets could benefit from a supercharged global economy in coming years. Productivity growth in the advanced economies was very strong during the pandemic. In the United States, output per worker-hour in the business sector increased by 4 percent in 2020-21; fully half of that was due to total factor productivity growth. Firms reorganized to capitalize on the opportunities afforded by remote work. Restaurants figured out how to serve more diners with fewer workers.

The advanced countries could thus serve as a powerful locomotive pulling along emerging markets. Productivity and economic growth had been trending downward for decades in the advanced-country world. Technological and organizational change prompted by the pandemic may now reverse this trend, creating additional demand for the exports of emerging markets and more broadly a more supportive external environment.

At this point, however, the argument is purely hypothetical or at least highly premature. Fernald, Li and Ochse (2021) show that most of the acceleration in labor productivity during the pandemic was due to cyclical increases in capital/labor ratios (as workers were laid off) and in labor quality (as the service sector, which employs younger and less educated workers, contracted).[6] They attribute most observed TFP growth to business cycle factors – to firms using their resources more intensively as the economy bounced back from its early 2020 lows. On balance, the behavior of TFP growth looks much like it did in earlier cyclical recoveries. Meaning that, as yet, there is little evidence of a durable acceleration.

We should not be surprised. Even if there has been an acceleration in technological and organizational change, history suggests it will be years before these changes show up in the

[5] See Gutierrez and Bilefsky (2021) on the case of the Philippines, which is illustrative.

[6] De Vries, Erumban and van Ark (2021) also find evidence of measured productivity gains due to the reallocation of hours from low- to high-productivity industries and sectors, and report similar evidence for other advanced economies such as France and the UK. They too conclude that there is no clear evidence to date of a break in the longer-term productivity trend.

productivity statistics. Economy-wide reorganization was required to capitalize on earlier general purpose technologies such as electricity, the internal combustion engine and the digital computer (Gaggl, Gray, Marinescu and Morin 2019), and that process of reorganization took time. There is no reason to expect Artificial Intelligence to be different (see e.g. Brynjolfsson, Rock and Syverson 2019).

In addition, the advanced countries will face many of the same challenges as emerging markets. They too have heavier debts. Their young people have similarly lost education and training, not all of which will be made up. They too may suffer efficiency losses from increased shipping costs and shorter supply chains.

The external environment for emerging markets is also heavily shaped by China, which is both an important source of demand for their commodity exports and a leading provider of foreign direct investment. Both China's commodity imports and outward FDI will slow as economic growth decelerates to rates more typical for a middle-income country and as the economy rotates away from commodity- and energy-intensive growth. Although it is important to reiterate earlier cautions about official forecasts, it is indicative that the IMF sees growth in China slowing to 5.6 percent in 2022, 5.3 percent in 2024 and 4.9 percent in 2026, largely as a function of mounting demographic headwinds. And now we have the addition of problems in China's property, construction and banking markets. All of which is to say that the country will be the source of less external support for growth in other emerging markets.

7. Conclusion

All is not doom and gloom. The fact that central banks in emerging markets were able to reduce policy interest rates and governments boosted fiscal spending following the onset of the crisis, quite unlike the policy response in earlier crises, is evidence of strengthened policy credibility. This ability to respond to shocks in countercyclical ways will serve emerging markets well when, in the future, they seek to keep economic growth on a stable upward path. The fact that emerging markets have continued to receive capital inflows through the first two years of the COVID-19 crisis is yet additional evidence of improved policy credibility. The relative dearth of bank failures and financial accidents speaks to stronger macro- and micro-prudential policies that will similarly serve emerging markets well going forward.

That said, the direct impacts of the pandemic and associated disruptions are likely to be strongly negative. There is the inheritance of negative debts. There is the interruption to schooling and human capital formation. Changes in global supply chains and a faster pace of automation will make the traditional pathway to higher incomes more difficult for many middle-income countries. I remain of the view that downgrading growth rates by two-tenths of a percent in 2023 is too modest a revision given what we know about COVID-19.

Table 1

IMF Growth Forecasts Before and After the Pandemic

	2022		2023	
	Before	After	Before	After
Emerging Market and Developing Economies	4.8	5.1	4.8	4.6
Emerging and Developing Asia	6.0	6.3	6.0	5.7
Emerging and Developing Europe	3.6	3.6	2.5	2.9
Latin America and the Caribbean	2.8	3.0	2.7	2.5
Middle East and Central Asia	3.3	4.1	3.3	3.8
Subsaharan Africa	4.1	3.8	4.2	4.1

Sources: "Before" figures drawn from October 2019 World Economic Outlook Database. "After" figures drawn from October 2021 World Economic Outlook Database.

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