Perspectives
Emerging Markets

Second quarter 2020

Key messages

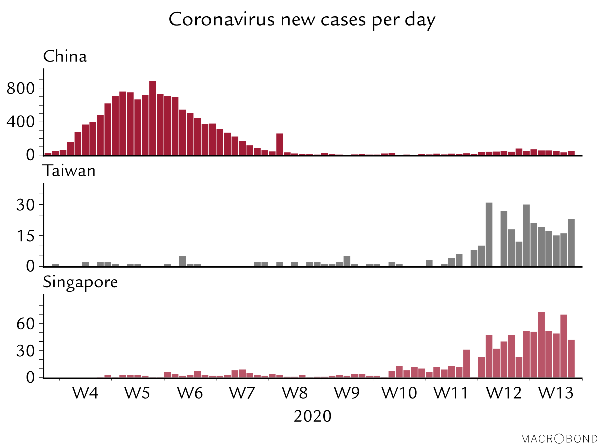
- China's economy to contract in the first quarter, while recovery will be gradual due to weak external demand
- Emerging markets hit by own lockdown measures and weak external demand as coronavirus cases soar
- Oil price shock is an additional drag on economies as exporters see their revenues squeezed

Number in focus

1/3

One third of the world population is under lockdown. On March 24, India's Prime Minister Narendra Modi ordered the country's 1.3 billion people to stay at home, initiating the world's largest coronavirus lockdown. Containment measures vary by country from full quarantine restrictions, non-mandatory recommendations, travel bans, to business closures. While lockdown measures imply severe economic repercussions via a supply shock, they are essential to dampen the speed of the virus transmission and deal with the global health crisis.

Chart in focus



Countries that had been able to swiftly tackle the spreading of the coronavirus, such as Taiwan and Singapore, face a new surge in coronavirus cases, as travellers are bringing the virus back to Asia. Also, in China most of the new cases that started to increase as of late are imported cases and pose a risk of a second wave. In order to control a new surge in infections, countries might need to reimpose lockdown measures, denting economic activity for an extended period and falling into deeper recession.

Coronavirus threatening the emerging world

The coronavirus is spreading rapidly across the globe and has reached more than 170 countries. Europe as well as the United States are already reeling from the outbreak and the emerging world is not being spared. From a health as well as from an economic point of view the threat of the virus for emerging economies is even more severe. Weak healthcare systems as well as the lack of proper sanitation to prevent infections create a risk of a humanitarian crisis. This institutional weakness means that strict lockdown measures are needed and might have to be implemented over an extended period of time. A wide range of emerging economies have already implemented different forms of containment measures in order to tackle the rising number of new coronavirus cases. India entered the world's largest complete lockdown, shutting down virtually all economic activity, except for essential services such as supermarkets and pharmacies. South Africa entered a nationwide lockdown as well. On the other hand, populist governments in Brazil and Mexico dismiss the dangers and resist the implementation of countrywide containment measures, creating the risk of a rapid surge in infections that can easily overwhelm their unprepared healthcare systems. Moreover, working from home during the lockdown period is often not an option, due to the lack of infrastructure, such as laptops etc. At present, the depth of the economic fallout is highly uncertain as it depends on the duration of the lockdown. However, since the spread of the virus can only be contained via sudden stops of economic activity due to the need of social distancing, dramatic economic repercussions are to be expected, with many major emerging markets falling into recession.

Weak external demand weighing on EM growth

As the pandemic hits the global economy, demand and supply chains are hurt and emerging markets are uniquely vulnerable to a global economic collapse. For many emerging countries exports make up a significant part of their economic output and since the world is in recession, demand for these goods will remain lackluster over the course of the year. Moreover, a number of emerging markets are highly exposed to tourism from abroad. Recent travel restrictions across a large part of the world are already being felt, contributing to sharp reductions in leisure activities. Since these shortfalls are likely to be lost for good, tourism dependent economies such as Thailand, Hongkong, Malaysia, Vietnam, etc. will only see partial compensation of lost output, once the situation is normalizing. Since both, the negative external backdrop as well as own lockdown measures pose an unprecedented threat for emerging economies, they are stepping up unprecedented fiscal and monetary support measures. A wide range of emerging market central banks delivered large rate cuts this month, such as Brazil and Mexico that cut their rates by 50 basis points (bps). India delivered a 75bps rate cut, while South Africa and Turkey reduced their policy rates by a total of 100bps. At the same time, also fiscal support is being ramped up. India announced a 1.7trillion rupee (1% of GDP) fiscal package in order to provide welfare assistance to over 800 million people. South Korea increased its emergency funds to 83 billion USD (6% of GDP) in order to support businesses hit by the coronavirus. Malaysia announced 58bn USD (15% of GDP) support for the economy and Brazil's government agreed to an income support scheme for 38 million of informal workers. As

Chart 1: Coronavirus cases have only started to surge in emerging economies

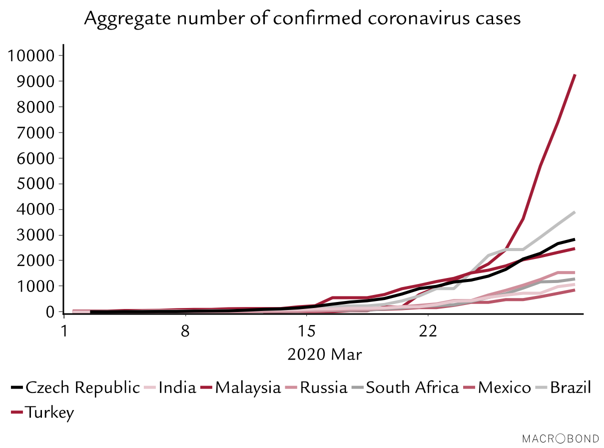
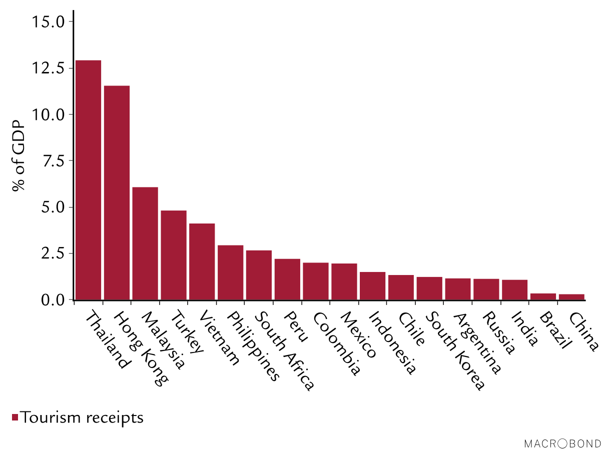


Chart 2: Tourism-dependent economies hit as coronavirus halts travel



these support measures contribute to fundamental vulnerabilities, capital outflows are likely to increase. South Africa already lost its investment grade credit rating due to worsening public finances and more rating downgrades of emerging economies could follow. Especially for those economies that rely on external financing to cover their current account deficits and foreign debt repayments, such as Turkey, South Africa and Colombia, capital outflows pose a major challenge.

China's economy to contract sharply in first quarter

China's economy suffered a large slump as the draconian lockdown measures to contain the spreading of the coronavirus paralysed economic activity. All economic indicators fell to levels never seen before, with fixed asset investments contracting by 24.5%, industrial production plunging by 13.5% and retail sales dropping by 20.5% in January and February from a year earlier. The readings indicate a massive fallout of economic activity in February which is to translate into a substantial contraction in the first quarter this year, leading us to sharply revise down our full year GDP growth forecast to 3.8% from 5.4% previously. As new domestic coronavirus cases approach zero, the government is lifting lockdown restrictions and started to move towards a pro-growth stance. High frequency indicators, such as coal consumption, which can be used as a proxy for industrial activity, are continuously improving. However, the recovery in consumption remains slow, as indicated by the weekly car sales that remain at weak levels. A potential further increase in unemployment could dent consumption over the course of the year. Moreover, the fast coronavirus spread causes a global recession, which dampens demand for Chinese goods. Therefore, we expect only a gradual recovery of the Chinese economy in the second quarter this year. Against this backdrop, Beijing will likely ramp up its monetary and fiscal support via further interest rate cuts and increased infrastructure investments in targeted projects, such as the 5G network and the healthcare system.

Oil price slump as an additional drag on growth

Oil prices crashed to a 17-year low, amid weak global demand due to the coronavirus crisis, coupled with an oil price war between Saudi Arabia and Russia who did not manage to agree on deeper oil production cuts in order to support crude oil prices. As demand is expected to remain subdued, oil prices will likely remain at low levels. Moreover, Saudi Arabia and Russia do not seem to feel pressured to find an agreement on production cuts. Saudi Arabia's oil production costs are lower than the current oil price, while Russia has built up ample reserves, including a national welfare fund, which can be tapped to offset lower oil revenues. Oil producers, such as Colombia, Mexico, Brazil as well as Middle Eastern countries, will take an immediate hit from the plunge in oil prices. First, a slump in oil revenues derails public spending. Second, a confidence shock leads to a depreciation of currencies which can translate into higher inflation and therefore lower real incomes. At the same time, any positive impact on oil importers, such as India, Thailand or South Korea, is likely to be muted as a big part of the consumers are locked down amid the coronavirus spread.

Chart 3: China's economic activity indicators slump to record low

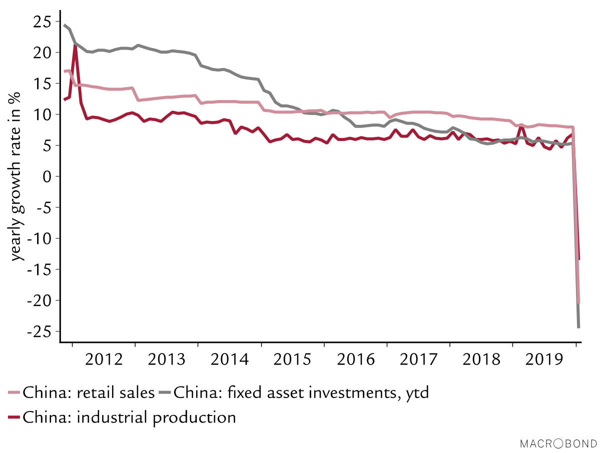
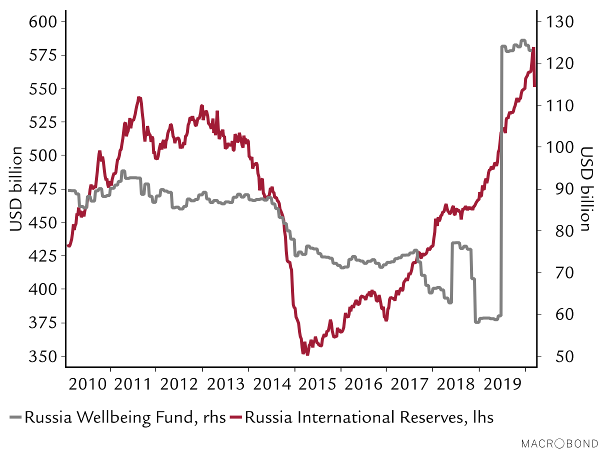


Chart 4: Russia has built up reserves to counter oil price volatility



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