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Pandemic: What about the 'Third World'?

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The Covid-19 pandemic became a preferred theme within economics but most of the focus has been placed on advanced economies. This policy brief aims at shedding some light on how lower-income economies are being affected and on their alternatives to cope with and overcome the current crisis.

INTRODUCTION

For months now, the Covid-19 pandemic has been omnipresent in the news and in daily chatter around the world. Likewise, scholars have been researching and writing extensively on the subject, including in economics. However, much of the recent papers and blog publications concerned with the effects of the outbreak on the economy and on how to overcome the crisis triggered by the virus are focused on advanced economies. In this Policy Brief, I will try to draw attention to the fact that 'Developing and Emerging Countries' (DECs) are much more vulnerable to the social and economic consequences of the pandemic and are unlikely to benefit from policy recommendations designed for advanced economies.

THE PANDEMIC AND THE 'FIRST WORLD'

After the tragic Italian scenes of overwhelmed hospitals, it became clear to most that 'curbing' the contagion curve was a must. Otherwise, health care systems would not be able to cope. Strict lockdowns and widespread social distancing measures were implemented around the world, despite negationist attempts e.g. in the USA and Brazil. In advanced economies, as soon as lockdowns were announced governments stepped in to try and protect the most vulnerable households from stringent financial distress. Cash transfers, loans, bills' payments freeze, and other measures were enforced. At the same time, policies were implemented to prevent businesses from going bankrupt, reducing permanent job losses.

Such initiatives are positive and desirable as far as they reduce the crisis' economic and social impacts in the short and long term. However, they imply significant fiscal costs and, hence, demand funding which in advanced economies is to be obtained, to a large extent, through monetary financing, QE being the most notorious example.

The post-2008 experience has shown that unbelievably sizable monetary financing is indeed a possibility in advanced economies and that it does not lead inexorably to dysfunctional macroeconomic outcomes. Is it also a possibility in DECs?

WHY IS THE 'THIRD WORLD' DIFFERENT?

At DECs, perspectives are much grimmer. To begin with, social distancing measures are much harder to implement and potentially less effective at poorer countries whose share of the population living in deprivation is higher. The share of the population living under the US$1.90 per day poverty headcount ratio is 0.7% in high-income countries, 11.9% in low and middle-income, and 45.2% in low-income groups[1]. The share of urban population living in slums—where overcrowded and inappropriate dwellings are widespread—in 2014 (latest data) was 30% in low and middle-income countries, 68% when only low-income regions are considered, and up to 96% in South Sudan[2]. In advanced economies such as the UK, the US, or Japan, close to 100% of the population has access to drinking water and sanitation facilities. In 'developing' regions, these figures were respectively 87% and 67% in 2015[3].

DECs are also typically characterised by a high share of the working force employed in the informal sector, numerous 'hand-to-mouth' workers, and a smaller share of workers able to work from home (Hevia and Neumeyer, 2020; Ray et al., 2020). This is another challenge to pursue social distancing, which becomes thus embedded with higher risks of leading to stringent social and economic distress. Yet another aggravating factor is that many DECs, especially those further down the income/development ladder, tend to lack a welfare system able to reach the vulnerable population in its totality (Ray et al., 2020).

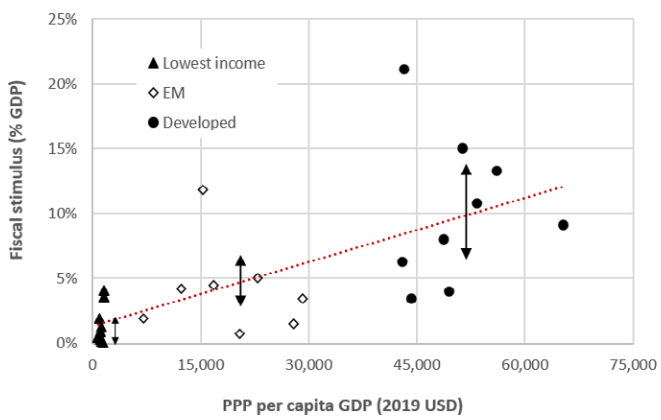
Social distancing in overcrowded dwellings and hygiene recommendations where drinking water and sewage are lacking tend to be more difficult to enforce and less effective to contain the spread of the virus. Likewise, the technical and financial ability of poorer countries to reach the most vulnerable share of the population through social policies and transfers in not to be taken for granted. Hence, the more one moves away from advanced economies, the less self-evident is the technical, social, and economic feasibility and effectiveness of the main policies proposed to tackle the current crisis.

On top of that, several scholars have argued that DECs will likely struggle more than their richer peers from the economic crisis triggered by the Covid-19 outbreak due to the effects of the pandemic in international trade and financial flows dynamics (more on this below).

Irrespective of such difficulties, DECs need to find their own path to curb infections and to aid vulnerable households and businesses. Therefore, they also need—and desperately so—to increase fiscal expenditures to diminish short and long term social and economic losses. However, their ability to do so is much more limited.

The discrepancies between announced fiscal stimuli depicted in the chart below is symptomatic of the extent to which DECs have less fiscal space than richer countries.

FIGURE 1 - FISCAL STIMULUS PACKAGES ACROSS DIFFERENT INCOME GROUPS



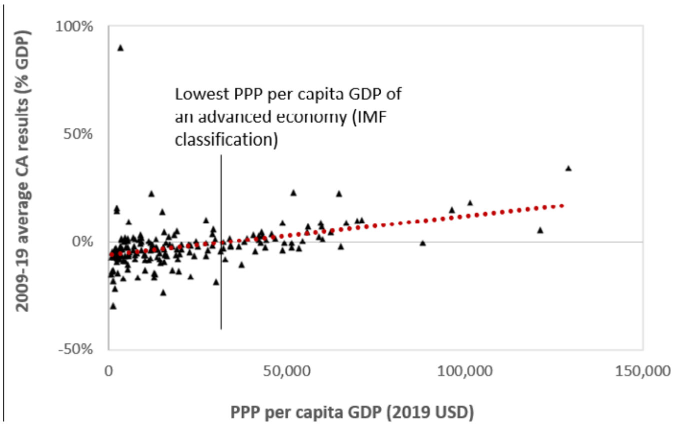
Source: Own elaboration. Data: IMF Policy Tracker, World Bank. Notes: Includes countries to which Covid-19-related above-the-line fiscal stimulus data could be found within G20 and the 10 lowest PPP per capita GDPs.

The chart above suggests a positive correlation between per capita income and the size of fiscal expenditures announced to diminish and overcome the health, social, and economic impacts of the pandemic[4]. The data also suggests that the higher up one moves in the income ladder, the larger is the difference between intra-group fiscal stimuli (vertical arrows representing intra-group standard deviations). This might be an indication that in richer countries the policy space is wider and the size of the stimulus mainly determined by political choices whereas in DECs the policy space itself is more restricted irrespective of political will.

A central reason behind such different fiscal spaces across income groups is that in DECs monetary financing is less of an alternative. Although one could claim that this is due to DECs' 'lack of credibility' and 'flawed institutions' (Drabowski, 2020), the roots of the issue are deeper and lay on structural dynamics of underdevelopment and dependency. The clearest way to address this from an economics stand is to look at the international monetary hierarchy and at DECs' external financing needs.

Starting from the latter. DECs are commonly characterised by significant external financing needs, i.e. they tend to have structurally negative current account balances which need to be funded through capital inflows. The plot below illustrates this.

FIGURE 2 – CURRENT ACCOUNT RESULTS ACROSS DIFFERENT INCOME GROUPS



Source: Own elaboration. Data: IMF, World Bank.

External funding in all its forms—loans, portfolio investments and foreign direct investments—bears inherent risks. Interest payments as well as dividend and profit remittances pressure the current account, potentially requiring further capital inflows to compensate it, increasing foreign liabilities and future outflows in a vicious cycle (Akyüz, 2018).

Even more important, after periods of large capital inflows, capital reversals and sudden stops can have drastic effects on DECs economies, easily leading to painful adjustments and, ultimately, defaults (Reinhart and Reinhart, 2008).

Hence, structural external financing needs tend to make DECs vulnerable to external shocks, which is reinforced if forex reserves are scarce and liabilities largely denominated in foreign currencies. Moreover, as international trade is expected to fall due to the pandemic (by 20% year-on-year according to UNCTAD's June forecast), improving current account results and reducing foreign financing needs through boosting exports will hardly be a possibility (Baldwin, 2020).

That is not the whole story though. The international monetary system is hierarchical. Not all moneys are used and accepted as store of value or means of exchange internationally. Indeed, international contracts are signed and settled in a small handful of currencies; those of first-tier advanced economies such as the UK, Japan, the European Union and, mainly, the US (Prates, 2017).

The poorer the country, the lower its position within the international monetary hierarchy. This makes DEC's moneys more volatile and vulnerable to changes in portfolio allocation decisions. As investors decide to sell off assets denominated in 'exotic' currencies and 'fly to quality' in times of high uncertainty and financial-economic turmoil—a phenomenon thoroughly analysed by the international liquidity cycles literature (e.g. Rey, 2015) —, risks of sharp currency depreciation with its macroeconomic consequences arise (see Kaltenbrunner and Painceira, 2015). Likewise, painful trade balance adjustments may be required in light of sudden stops (Calvo, 1998), which usually goes hand in hand with fiscal tightening, increasing interest rates, and rising unemployment. Moreover, being curtailed from international capital markets may bring about relevant challenges to refinance debt, increasing defaults risks.

The direct consequence of this higher external vulnerability underpinned by structural financing needs and a subordinate place within the international monetary hierarchy is twofold. Firstly, it increases the pandemic's economic impact as capital reversals, resident capital flight and sudden stops are brought to centre stage, jeopardising DECs' ability to finance current account deficits and pressuring their currencies. Secondly, it makes it very challenging to increase fiscal expenditures backed by monetary financing.

Indeed, it has been argued (Bonizzi et Al, 2019) that MMT-like proposals to finance public debt through direct or indirect central bank bond purchases were never a real alternative to most DECs. The (lack of) willingness of residents and foreigners to hold domestic currency, structural current account deficits, and risks of enhanced exchange rate volatility make such proposals potentially irresponsible. In a world marked by free capital flows, DECs' monetary policy autonomy is not to be taken for granted as the level of interest rates set by advanced economies shape, to a large extent, monetary policy decisions in less developed regions (Rey, 2015). Resorting to large monetary financing measures could imply in relevant risks considering the fragility of DECs currencies, possibly curtailing their access to hard currencies and jeopardising their ability to import essential goods[5].

Hence, the picture is grim and policy alternatives limited. Where can we start to frame a positive policy agenda from?

WHAT CAN BE DONE?

Designing policy responses to the current crisis from a DECs' perspective is not an easy task. As a preliminary attempt, I will outline some proposals and considerations set forth by different authors.

As DECs start to face international liquidity issues, several eyes have turned to the IMF urging it to finally assume the role of international lender of last resort (Eduardo Levy, 2020).

Indeed, the demand for IMF emergency financing skyrocketed since the beginning of the pandemic, with calls made by 102 countries so far. A caveat should be stressed in capital letters here: for IMF loans to contribute to DECs' recovery and social wellbeing, **it is mandatory that they do not come with fiscal austerity requirements.** This has been highlighted in an open letter signed by several progressive scholars circulated by end-March[6].

1 World Bank data available here
2 Millennium Development Goals Indicators (MDGI) data available here
3 Ibid
4 A significant share of stimuli announced by low-income countries are to be funded by foreign aid, a sign of such countries' extremely limited domestic fiscal space.
5 DECs whose public debt is denominated in the domestic currency and mostly held by residents might have some room for monetary financing, though dysfunctional macroeconomic outcomes cannot be ruled out.
6 Available here

The moment also seems propitious to discuss the relevance of capital controls as they may contribute to reduce DECs exposure to extremely volatile capital flows and their potential deleterious effects, both when capital is flowing abundantly to DECs and when it is scarce (Reinhart and Reinhart, 2008).

Some measures may contribute to disincentivise further capital flights in the months to come. More importantly, a thorough consideration of capital controls that channel international investments to productive and productivity enhancing projects rather than to speculative and volatile portfolio allocations may contribute to DECs development strategies in the decades to come.

Yet another claim, and a bold one, raised by scholars and activists (e.g. Toussaint, 2020) advocates **the cancelation of public debt and/or the immediate suspension of its servicing**. Such an agenda is challenging from a political feasibility perspective ("totally unthinkable" according to ECB president Christine Lagarde[7]) albeit the efforts of activist groups such as Auditoria Cidadã da Dívida and CADTM and a successful historical precedent therein advanced in Ecuador in the late 2000s when around 85% of the country's commercial external debt was written off. However, one should note that such a proposal has significant potential to alleviate fiscal and solvency pressures at DECs. As stressed by UNCTAD :

> *"With sudden stops to external refinancing possibilities, suspending sovereign debt repayments due over this and the next year […] is key to averting immediate and wide-spread debt crises. Clearly, the amounts that would be involved in suspending sovereign debt repayments in poorer developing countries are small change compared to the economic rescue packages hurriedly put together across the developed world (UNCTAD, 2020, p.8)."*

FINAL REMARKS

As I tried to argue in this PB, the current crisis is set to hit DECs harder than their richer peers, which is further potentialized by DECs' smaller policy room for manoeuvre. The outlook is gloomy for the years to come. Policies to reduce financing constraints at DECs, from non-austerity-based IMF loans to the cancelation of public debt, are challenging but could help substantially. A thorough assessment to include capital controls in DECs policy toolkit could also contribute to curb further capital outflows and, mainly, to channel future inflows accordingly to national development strategies in the years to come.

There is no easy answer to tackle the crisis triggered by the pandemic in DECs as deep structural issues such as the dependency on external financing and DECs' subordinate position within the international monetary hierarchy inexorably enhance these countries' economic and social vulnerability. How to overcome such challenges is a question often posed to a goal difficult to achieve. More than difficult, it allows, at best, for only a handful of successful cases through history as under the current economic system there is just no room to overcome underdevelopment on a global level.

7 Interview at France Inter available here

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