ESG in Emerging Markets:
Can Emerging Markets Create Fiscal Space?

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Can Emerging Markets Create Fiscal Space for ESG?

There is a need to prepare for climate change, improve income distribution and governance. But how to pay for it? Fiscal policy is the main crisis tool. 3 steps are needed.

Fight the pandemic

- Phase 1 – Lower the infection rate
- Phase 2 – Keep the infection rate low
- Investment in testing, treatment, monitoring

Stabilize the economy

- Governments provide funds to relieve liquidity-constrained households, firms, possibly financial institutions
- Multilateral institutions provide liquidity support, debt relief

Stimulate aggregate demand

- As lockdowns ease, pent-up demand drives recovery
- Possible room for investment, reallocation of spending, external funding for ESG
- Role for IMF to include green projects in conditionality for concessional loans

Fighting the Pandemic

For all countries, controlling the virus will determine the downturn and recovery

Phase 1: Lockdown (lowering infection rates)

- In developed markets, flattening the curve is predictable. However testing has been slow and partial, it is unclear who has the virus, and controlling it is inefficient.
- But treatment improving. Vaccine research promising.
- Most EM health care systems do not have the capacity to manage the pandemic. Testing is slow or non-existent. Social distancing is difficult if not impossible in poor, crowded cities.

Phase 2: Partial Lockdown (keeping infection rates low)

- In EM, strong possibility of herd immunity – widespread infection rates, high death rates, but a lower effect on growth.
- However, many unknowns: how deadly the virus is; whether hot, humid weather slows the infection rate; what level of antibodies convey safety (no evidence that people who have recovered form Covid-19 are protected from a second infection).

Stabilizing the Economy

For EM, the starting point was unfavorable

- Low growth, stagnation
- Fiscal imbalances
- High debt in foreign currency, weak exchange rates
- Unidentified and poorly managed public assets and liabilities

The crisis sharply worsened the outlook

- Collapse in growth and tax revenues
- Deficits will rise sharply from automatic stabilizers, spending, tax relief, loans, equity injections, guarantees
- Large capital outflows and currency depreciation as investors repatriated capital
- Declines in tourism, remittances, oil and commodity prices as global demand collapses

As a result, fiscal space is extremely limited, leading to reliance on multilaterals

- Borrowing costs may continue to rise; additional borrowing may not be accessible
- Outstanding public debt may become unsustainable

Macro Stabilization: Debt Sustainability

Developed economies

- Average deficit to rise to -10.7% GDP. General government debt to rise by 17% GDP to 122% in 2020. (Japan 252%, Italy 156%, US 131% GDP.)
- Interest rates likely to remain low. Effect of higher public debt on interest rates is unclear.
- When growth returns, interest rates are likely to remain below nominal GDP. If the virus is contained, and central banks maintain interest rates at zero, debt looks sustainable.

Emerging markets

- Average deficit to rise to -9.1% GDP. General government debt to rise by 9% GDP to 62% in 2020. (Brazil 98%, South Africa 77%, India 74% GDP.) Bond spreads have widened (Argentina, Turkey, South Africa; also Mexico, Brazil, Russia)
- In short term, central banks and multilateral institutions will provide liquidity; Central Bank swap lines, World Bank IDA, IMF concessionary loans, grants, DM country gifts to help EM countries fight the virus. Possible capital controls on outflows.
- If recession lasts into 2021, debt standstill may be necessary.

Stimulating Aggregate Demand

Restarting demand

- As lockdowns ease, pent-up demand to drive recovery.
- Governments must maintain flexibility to intervene.
- Possible room for investment or a reallocation of spending to ESG; more likely funding to come from abroad.
- Role for IMF conditionality to jump-start green projects.
- Disclose fiscal risks (government guarantees, contingent liabilities) to assess balance sheet weakness, restore confidence, foster international coordination.

Virus presents a warning and an opportunity to address climate change

- EM even less prepared for much larger threat of more frequent, severe climate shocks.
- Risk is crisis will delay structural changes needed to meet Paris Agreement's long-term temperature goal.
- Once the infection rate is brought under control, the recovery presents an opportunity to introduce climate-friendly policies. Building green infrastructure as part of the demand stimulus is a perfect opportunity to revive growth, create jobs and confront climate change.