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Covid-19 and the Fiscal Space of Developing Countries

By Hinh T. Dinh

Abstract

Between January 2020 and June 2021, the world spent about US $16.5 trillion (18% of world GDP) to fight COVID-19, and this amount does not even include the most important losses such as deaths, mental health effects, restrictions on human freedom, and other nonmonetary suffering. Nearly 90% of this amount was spent by developed economies; the rest by emerging market and developing economies. Low-income countries spent just US $12.5 billion, or less than 0.0001% of the total. Moreover, fiscal spending by developing countries so far did not concentrate on COVID-19 vaccination and treatment. This is because the vaccines have only been discovered and available in a few countries since 2021 and as of now there is no official, universally accepted, treatment available.

Until COVID-19 is controlled, near-term prospects for the recovery of developing countries are clouded with risks and uncertainties. To manage COVID-19, the top priority for policymakers is to control its spread by acquiring and deploying vaccines and treatment medications. This spending appears non-negotiable. The second area of urgency is to resume domestic production, especially for global supply chains requiring exports. Developing countries should take advantage of the International Monetary Fund's new Special Drawing Rights allocation for COVID-19, which countries do not have to repay, supplemented by loans from international organizations that offer longer maturities and lower borrowing costs.

INTRODUCTION

COVID-19 has hit the world economy hard, with global GDP falling more than 3.5% in 2020 (World Bank 2021a). The pandemic has inflicted widespread human misery and economic damages since it emerged from Wuhan, China, in late 2019. By November 2021, more than 250 million people had been infected worldwide and over 5 million had died, according to Johns Hopkins University[1]. Though the number of new infections has declined in recent months, the rapid spread of variants of the virus

1. https://coronavirus.jhu.edu/map.html

has rekindled fears about the reimposition of lockdowns and other measures to contain it.

Unlike previous global crises, COVID-19 spared no country. Both the developed and developing worlds suffered severe harm, creating a self-reinforcing contraction in global demand for goods and services. The more open a country's trade system was, the greater was the impact on its balance of payments and the deeper was the transmission to the national economy. Yet COVID-19's effects on developing countries have been more severe, deepening inequality between the two worlds (IMF 2021).

The countries hit hardest by the pandemic are those that have relied on tourism, services, or commodities for income. Unemployment, already high before COVID-19, worsened—particularly among women and young people—lowering per capita incomes and raising poverty and inequality. Both supply and demand factors have caused the sharp contraction in GDP. On the supply side, the contraction was mainly driven by a sharp decline in the services sector due to the collapse of tourism, reflecting strains on transportation due to closed roads, railroads, airports, ports, and border crossings. On the demand side, consumption and investment have fallen.

COVID-19 caught the world off guard. Emergency measures to save lives included closing borders and introducing lockdowns, quarantines, and stay-at-home orders. To maintain livelihoods, conventional and unconventional policies were developed to support businesses and workers during lockdowns and help them prepare for recovery when lockdowns were lifted. These included fiscal and monetary measures to support healthcare systems, income relief for businesses and households, and liquidity injections to stimulate economies.

All developing countries face a more daunting paradox of choices than before. On the one hand, they need to borrow continuously to manage the lingering pandemic and support their nascent economic recoveries. On the other hand, they face rising debt service costs while their exports slump and their weak economic growth has diminished creditors' confidence. Given the constrained space for budgetary maneuvering, the resulting fiscal deficits are increasingly being financed by central banks through direct advances and holding of more short-term treasury bills and long-term bonds. The fiscal burden on these banks is aggravated by the easing of monetary policies and injections of liquidity.

Until COVID-19 is controlled, near-term prospects for the recovery of developing countries are clouded with risks and uncertainties. Among the greatest likely challenges are the spread of new variants, limited access to or delays in the distribution of vaccines, restoration of supply (especially through global supply chains), and weaknesses in the recovery of consumer and business confidence causing protracted depression of domestic and external demand.

Developing Countries Have Limited Fiscal Space to Respond

Because the pandemic hits both the supply and demand sides of economies, its effects are far more serious than a typical economic shock. On the supply side, lockdowns and quarantines reduce labor supply and firm capacity utilization, while disruptions to global supply chains undermine the provision of inputs—causing shortages and rising costs. On the demand side, the loss of income causes consumption and investment to drop. Workers in services such as tourism and hospitality are hit hardest, and informal workers suffer the most due to the need for close contact with customers. Low-income households fare worst due to limited access to healthcare and financial resources. Commodity exporters and tourism-dependent economies are also vulnerable.

Two types of fiscal measures have been used to support households and businesses during COVID-19. The first are above-the-line policies that directly raise budget deficits, such as cash transfers to low-income households, temporary enhancements of unemployment benefits, and wage subsidies or paid sick and family leave for workers who stay home to care for their children during school closures. These policies also include temporary government cashflow assistance or tax relief for people and firms affected by COVID-19. The second type are liquidity measures that do not directly affect budget deficits. For example, to help firms with liquidity, governments provide cashflow support in the form of loans, umbrella guarantees, and other support. These measures do not show up in budgets immediately but involve contingent liabilities outside budget revenue and spending.

Between January 2020 and June 2021, the world spent about US $16.5 trillion (18% of world GDP) to fight COVID-19, and this amount does not even include the most important losses such as deaths, mental health effects, restrictions on human freedom, and other nonmonetary suffering. Nearly 90% of this amount (US $14.5 trillion) was spent by developed economies; the rest by emerging market and developing economies (Table 1). Low-income countries spent just US $12.5 billion, or less than 0.0001% of the total. COVID-19 has had especially devastating impacts on vulnerable groups including women, young people, poor people, and informal sector workers.

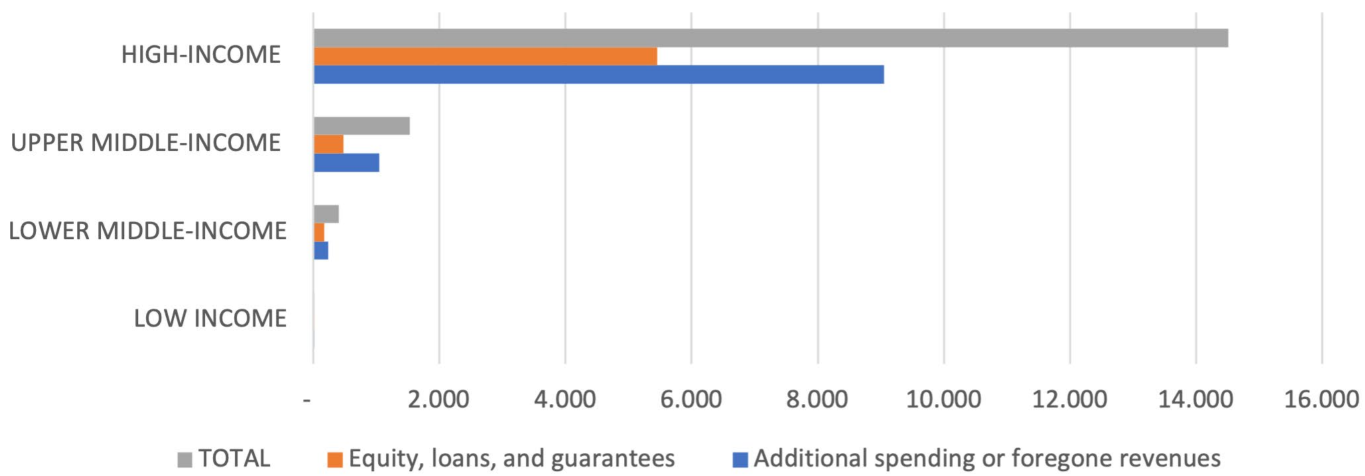
Table 1. Total Fiscal Spending By Income Group, January 2020-June 2021 (US$ Billion)

	Additional spending/ foregone revenues	Equity, loans, and guarantees	TOTAL
Low-Income Countries	11	1	12
Lower Middle-Income Countries	239	169	408
Upper Middle-Income Countries	1,051	482	1,533
High-Income Countries	9,048	5,458	14,506
TOTAL	10,350	6,110	16,460

Source: IMF, https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19
Country groups are classified by author according to World Bank 2021 classification.

The size of financial support has varied by country depending on income level, political willingness, and the extent of the pandemic. For developed countries the increase in fiscal deficits comes from both higher spending and declining revenue. For developing countries, the increase mainly reflects a collapse in fiscal revenue.

Figure 1. Fiscal Spending By Income Group, January 2020-June 2021 (US$Billion)



Source: IMF, https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19
Country groups are classified by author according to World Bank 2021 classification.

About 88% of this fiscal spending was incurred by the 57 high-income economies. For them, half the above-the-line support was devoted to protecting jobs and supporting household incomes. High-income countries spent 14% of GDP on average on COVID-19. Italy led in spending as a share of GDP (more than 46%), though the United States spent the most—nearly $6 trillion (Table 2).

Table 2. Top Ten Developed Countries Ranked by Total COVID-19 Spending (% Of GDP)

	Add. Spend. or Forg. Rev.	Liquidity Support	Add. Spend. or Forg. Rev.	Liquidity support	TOTAL
	USD Billion		as % of GDP		
Italy	205.4	664.5	10.9	35.3	**46.2**
Japan	830.7	1429.2	16.5	28.3	**44.8**
Germany	519.3	1058	13.6	27.8	**41.4**
United Kingdom	440.1	452.9	16.2	16.7	**33.0**
Greece	38.9	12.9	21.1	7	**28.1**
United States	5328.3	510	25.4	2.4	**27.9**
Macao SAR	6.7		27.4	0	**27.4**
Czech Republic	23.4	37.8	9.6	15.5	**25.1**
France	251.9	399.8	9.6	15.2	**24.8**
Singapore	62.5	15.9	18.4	4.7	**23.1**

Source: See Table 1

Among the emerging market and developing economies, Mauritius, Micronesia, and Peru are the top spenders. Mauritius spent a high proportion of GDP on liquidity support (Table 3).

Table 3. Top Ten Developing Countries Ranked by Total Covid-19 Spending (% Of GDP)

	Add. Spend. or Forg. Rev.	Liquidity Support	Add. Spend. or Forg. Rev.	Liquidity support	TOTAL
	USD Billion		as % of GDP		
Mauritius	1	4.2	9.2	37.3	**46.5**
Micronesia, Fed. St.	0.1		19.6	0	**19.6**
Peru	16	23.9	7.8	11.8	**19.6**
Bolivia	2	4.1	5.5	11.2	**16.7**
Chile	35.6	6.3	14.1	2.5	**16.6**
Timor-Leste, Dem. Rep.	0.3		15.8	0	**15.8**
Thailand	57.2	21.3	11.4	4.2	**15.6**
Brazil	132.5	88.2	9.2	6.2	**15.4**
Kosovo	0.8	0.4	10	5.3	**15.2**
Hungary	16.3	6.5	10.5	4.2	**14.7**

Source: See Table 1

Developing countries face difficult choices between increasing spending to fight the disease and protecting people during a time of fiscal constraints due to lower domestic revenue and external inflows. As a result, in addition to more accommodative monetary policy, countries have had to borrow more—domestically and externally. Among developing countries, low-income countries face a particularly difficult situation. Faced with contractions in output, drops in commodity prices, and rising debt burdens, these countries could not afford the needed fiscal support, resulting in higher poverty and malnutrition. Many resorted to cutting capital spending, which will make it harder to grow after the pandemic.

Thus, the fiscal outlook for developing countries is not promising. Risks are intertwined and reinforcing. The main sources include:

- Protracted economic downturns, such as further lockdowns, delays in vaccine access and availability, and new waves of infections caused by new variants.
- Tighter financing conditions, including rising international interest rates.
- Realization of contingent liabilities, as a significant part of global financial support has been through loans or guarantees, equity injections, and other quasi-fiscal operations.

Other risks include volatile commodity prices and rising social discontent caused partly by mental stress due to lockdowns.

Covid Vaccinations and Treatments are Urgently Needed

But the problem is deeper than the above assessment indicates. Budgetary needs by developing countries will need to expand in the next 18-24 months to acquire and deploy vaccines and treatment medications if these economies are to survive. In addition to vaccine and treatment budgets, governments are expected to continue to provide social protection—especially cash transfers to vulnerable populations. These needs will pose massive challenges to countries under tight financial constraints, especially those at risk of debt distress.

Until recently, fiscal spending by developing countries focused on issues unrelated to resolving the two main problems of COVID-19: vaccination and treatment. The reason for this phenomenon is well known: the vaccines have only been discovered and available in a few countries since 2021 and as of now there is no official, universally accepted, treatment available even though some promising ones (such as the oral antiviral medicine by Merck/Ridgeback Biotherapeutics and by Pfizer) are being evaluated by the U.S. Food and Drug Administration (FDA). According to the World Health Organization (WHO), effective management and control of COVID-19 requires four components: vaccinations, diagnostics, therapeutics, and health system links. The last component is to effectively deliver the other components.

Unfortunately, developing countries will have no choice in this matter. Economic activities cannot resume unless COVID-19 is under control, and therefore, until governments acquire and deliver these four components. Moreover, no country will be safe until and unless all countries are. For the world to return to normalcy, all countries need to continue with vaccination efforts until at least 70% of the population is fully vaccinated. In addition, treatment of infected people needs to continue apace. As of October 2021, just 35% of the global population had been vaccinated—and in the developing world far less. Less than 5% of Africans have been vaccinated. Though COVID-19 does not seem to have ravaged Africa as much as it has other continents, its full effects are not yet known. The WHO has found that six of seven COVID-19 infections go undetected in Africa. Underreporting and lack of testing reflect limited healthcare resources, which make COVID tests and diagnoses hard to come by.

How to finance this additional and absolutely necessary fiscal spending in the next 18-24 months will be a challenge for the developing countries, especially given their limited market access and restricted ability to increase revenues in the short term. Moreover, developing countries had already faced external debt issues before the pandemic arrived (World Bank 2021b). Over the past decade a growing number of low-income countries had fallen into debt distress. The structure of international debt has also changed as more private creditors are making loans to poor countries, while the role of official creditors—especially bilateral ones—has shrunk. Both creditors and debtors had created this situation. For creditors, high returns and the relatively low debt burdens in low-income countries following the Heavily Indebted Poor Countries (HIPC) initiative created incentives for international lending. For debtors, funding from commercial creditors has become increasingly popular because such loans often come without the conditions usually attached to multilateral and bilateral loans. In addition, syndicated loans and public-private partnership project finance have grown.

Higher borrowing from non–Paris Club and commercial creditors has meant shorter maturities and higher refinancing risks. Since 2013–14 a surge in issuances of 10-year Eurobonds by many African countries as well as non–Paris Club loans (which have shorter maturities than typical multilateral concessional long-term loans) has caused bunching and created sovereign debt liabilities coming due in 2024–25—just as countries are expected to be recovering from the COVID-induced recession. This bunching in maturities elevates risks of debt distress. Developing countries need to begin debt resolution and restructuring negotiations before these risks materialize.

The past decade has also seen an increase in the share of private debt in developing countries' total debt, including private nonguaranteed as well as public and publicly guaranteed private debt. The presence of private creditors has implications for the incentives and ability to provide debt relief. This trend has occurred in both low- and middle-income countries, though more prominently in the latter. Among private creditors, bondholders are diverse and difficult to organize in case debt restructuring is needed.

Prior to the pandemic, the debt problems of developing countries reflected slow growth, unproductive use of debt, and borrowing on commercial terms at high costs and short maturities by some countries. Debt levels in these countries are projected to peak in 2021 and continue to climb in some. In 2020 actions were taken under the Group of 20 (G20) Debt and Debt Service Suspension Initiative (DSSI)—the first international effort after the emergence of COVID to help the poorest countries through grants, concessional loans, and debt relief to address the steep rise in their public debt. But these temporary relief actions do not address the root cause of debt problems.

The ability of each country to undertake the needed fiscal spending to fight COVID-19 can only be assessed through a detailed analysis of debt sustainability at the country level. In a forthcoming study[2], we analyze the debt sustainability of some selected low- and lower-middle-income countries and find that most these countries will be under debt stress, with the ratio of debt to GDP exceeding 65%. Some of these countries will experience liquidity problems, and most will face solvency problems that require addressing their debt stock burdens. The developing countries therefore are facing a stark choice between avoiding a collapse through vaccination at any cost and risking further debt distress. The debt situation will be made much worse if global economic growth slows while borrowing costs rise as a result of tighter monetary policy in developed economies. The rising global inflationary pressures due to supply chain disruptions and fuel prices will further limit any possibility to print money as an alternative policy.

Conclusion

Spending on COVID vaccines and treatments will be a priority in 2022–23 for the developing countries. In addition, priority has to be placed on protecting workers, especially informal ones. COVID-19 has increased external vulnerabilities and markedly reduced external buffers for these countries. The shift in debt structure from official bilateral to private creditors—mainly Eurobond and commercial sources—to finance budget and current account deficits has raised the costs of debt service and made it more sensitive to movements in interest and exchange rates. Some economies will have insufficient liquidity to meet financial obligations as the pandemic continues beyond 2021.

Many policies in place or designed before COVID-19 are no longer valid. Developing countries should focus on priority policy actions covering the short term (2021–23), to survive the pandemic, and the medium term (2023–25), to ensure full economic recovery.

To manage COVID-19, the top priority for policymakers is to control its spread by acquiring the vaccines and vaccinating at least 70% of their populations, and acquiring and distributing medications to treat it. Along with adequate testing and decent health system links, these policy actions are not negotiable. In

2. See H. Dinh.2021, forthcoming. COVID-19 and the Developing Countries- the Road to Recovery. Policy Center for the New South. Rabat: Morocco.

the medium term, efforts should focus on reforming healthcare systems, particularly decision making and implementation and delivery mechanisms. Developing countries should take advantage of the International Monetary Fund's new Special Drawing Rights allocation for COVID-19, which countries do not have to repay, supplemented by loans from international organizations that offer longer maturities and lower borrowing costs.

The second area of urgency is to resume domestic production, especially for global supply chains requiring exports. In Asia, lockdowns have decimated the labor force in many countries, leading many migrant workers to return to rural areas. The first step is to bring workers back to factories by providing incentives such as relocation bonuses, housing subsidies, and transport grants. Such efforts obviously need to be combined with policies that reduce administrative restrictions on or impediments to workers' movement. Governments should work with private firms to ease any constraints they are facing to get back to output levels prior to COVID-19.

In the medium term, governments in developing countries should encourage the development of personal protective equipment and medical industries, improve worker skills through training and technical assistance programs, provide incentives for domestic companies to link with foreign ones, and review laws on foreign direct investment to foster higher-value activities. Some countries might also need to implement stimulus packages for non-tradable goods and services, since most unskilled workers are informal—especially in services and domestic trade. Such packages could provide grants to all households and reduce or delay charges and taxes for small and medium-size enterprises.

The DSSI is insufficient to deal with the magnitude and urgency of the debt problems facing developing countries because it provides only temporary relief while the problems are long-lasting. The initiative also fails to distinguish appropriately between countries with liquidity problems and those with solvency problems. Furthermore, serious debt service problems also will likely also occur in middle-income countries. Finally, the DSSI does not address the liquidity problems of the public sector or of private businesses in developing countries—essential to resuming growth as soon as possible.

The international community needs to fully recognize the desperate situation of low income countries and take prompt, decisive actions to help restore growth. Another round of the Heavily Indebted Poor Countries (HIPC) initiative may be needed. Debt relief could be linked directly to acquisition and deployment of COVID-19 vaccines and treatment medications. The international organizations would need to be more flexible and understanding when using traditional debt burden and debt service criteria for lending.

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The PCNS advocates the concept of an open, responsible and proactive « new South »; a South that defines its own narratives, as well as the mental maps around the Mediterranean and South Atlantic basins, within the framework of an open relationship with the rest of the world. Through its work, the think tank aims to support the development of public policies in Africa and to give experts from the South a voice in the geopolitical developments that concern them. This positioning, based on dialogue and partnerships, consists in cultivating African expertise and excellence, capable of contributing to the diagnosis and solutions to African challenges.

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