Developing economies hardest hit by pandemic downturn

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Don’t expect developed countries to come to the rescue of struggling developing economies when the pandemic ends. While it may be in their self-interest over the medium- and long-term, policymakers are constrained by what is politically feasible. Credit: Western News

Along with a global health pandemic, many countries are also facing an economic recession unlike any seen in decades.

While the economies of developed countries are struggling, most experts are confident they will recover over time. Those of developing countries, however, were in economic peril prior to COVID-19—and now face a frightening and uncertain future.

In fact, the fate of those countries may ripple across every economy and influence the global recovery—no matter if it is politically popular or not, according to Economics professor Juan Carlos Hatchondo.

Governments in developing countries will not be able to intervene as aggressively as necessary to keep their economies from freefall. They simply don't have the financial fire power of advanced economies. That will lead to a more pronounced downturns—ones that could suck others down with them.

Advanced economies like the United States, Germany, France, and Canada have two instruments available to finance the large-scale government interventions required by the current crisis: They can issue debt and they can issue 'money' by decreasing nominal interest rates through central banks.

Because of them, in part, investors believe these governments are going to employ sound, long-term fiscal and monetary policies going forward. They are not concerned about the future governments ability or willingness to pay back debt or tolerate high inflation rates.

Those are a huge advantage, Hatchondo said.

The picture is different for developing countries. Even though many have made progress on the fiscal and monetary fronts, they are still more constrained than advanced economies.

"The market for newly issued debt has almost frozen for developing countries. The fall in the value of developing countries' currencies can be a sign that the market has concerns about their ability to conduct sound monetary policies in the long run," he said. "This implies their central banks need to be more cautious if they want to conduct expansionary monetary policies now."

This uncertainty has pushed many developing countries to seek financial assistance from institutions like the International Monetary Fund (IMF), World Bank and others. In fact, the IMF has created new credit lines available for countries that require them.

Given the magnitude of the global shock, official credit may not be sufficient. Actions governments in developing countries may need to take could lead to higher inflation rates and GDP collapse in those countries.

And don't expect developed countries to come to the rescue either, Hatchondo added. While it may be in their self-interest over the medium- and long-term, policymakers are constrained by what is politically feasible.

"An increase in local unemployment and closed businesses would make it politically toxic to overtly divert resources to assist foreign countries instead of helping local communities," Hatchondo said.

"Instead, we will see a more direct involvement from advanced countries through international financial institutions like the IMF or World Bank, which are funded mostly by advanced countries. We might even see an increase in the funding from advanced economies to those institutions. But that may not match the higher demand for loans from governments in developing countries."

With the effects of the economic downturn, there may be an unprecedented acceleration in stark structural changes in the economy. Some businesses will grow rapidly; others will disappear completely.

"Think about the shift from shopping in retail stores to online. Or a shift from commercial real estate to residential real estate as more people will work from home more than in an office or store," Hatchondo said.

"Structural changes can be beneficial, but they also create tensions. New jobs may be in different locations and demand different skills than the jobs that are lost."

Provided by University of Western Ontario

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