BOX 3.2 Impact of COVID-19 on investment: Deep, persistent, and broad based

Investment in emerging market and developing economies (EMDEs) collapsed in 2020, following a decade of persistent weakness. It is expected to expand again in 2021, but not sufficiently to reverse the decline in 2020. Based on the experience of past epidemics, investment is likely to remain weak for several years following the COVID-19 pandemic, but it is possible that renewed investment in digital technologies will spur productivity gains in some sectors. A supportive policy environment will be key to laying the groundwork for an investment rebound in EMDEs.

Introduction

The plunge in global economic activity during the COVID-19 pandemic has been accompanied by an even larger collapse in investment. The investment contraction in 2020 was deeper in advanced economies than in emerging market and developing economies (EMDEs) but the investment downturn in EMDEs was considerably sharper than during the global financial crisis.

Against this backdrop, this box addresses three questions about investment in EMDEs:

- How has the pandemic impacted investment?
- What are the prospects for it?
- What will be the long-term effects of the pandemic?

Investment before and during the pandemic

Pre-pandemic trends. As the pandemic began, the world had already experienced a decade-long slowdown in investment growth (figure B3.2.1). From a peak of 10.8 percent in 2010, investment growth in EMDEs had fallen to 2.5 percent in 2019, complicating progress toward the Sustainable Development Goals (SDGs) related to infrastructure (Vorisek and Yu 2020).[a] Periods of weakness in global commodity prices and associated adverse terms-of-trade developments, policy uncertainty, and rising corporate leverage had all curtailed investment over this period (Kose et al. 2017; World Bank 2017a, 2019a). The sluggishness of investment growth was broad-based, with more than half of EMDEs experiencing investment growth below their 2000-19 average in every year since 2012.

Deep investment collapse during the pandemic. Investment plunged particularly sharply in EMDEs excluding China as the pandemic took hold. In the full year 2020, investment in EMDEs shrank by an estimated 4.5 percent, and by a much deeper 10.6 percent if excluding China. This contraction for EMDEs excluding China was more than 4 percentage points deeper than during the 2009 global recession, despite financial conditions being substantially easier in 2020. The contraction in 2020 was sharpest in Latin America and the Caribbean and South Asia, where GDP also declined the most. The decline in investment in 2020 was smallest in East Asia, where activity was supported by large fiscal stimulus programs in China and Vietnam and also resilient foreign direct investment (FDI) inflows to Vietnam.

Investment prospects

Subdued investment rebound, by historic standards. Even with the pandemic expected to recede in 2021, the short-term rebound in EMDE investment is projected to be much weaker in 2021, at 5.7 percent, than the rebound in 2010 (10.8 percent) following the global financial crisis. For most EMDEs, investment growth during the forecast period will remain at or below average rates during the 2010s (figure B3.2.2). These growth rates will be insufficient to reverse the investment losses during 2020. After the substantial fiscal stimulus of 2020, the transition to tighter fiscal policy in EMDEs in order to retain creditworthiness and contain debt service costs will constrain public investment projects. Private investment will be limited by uncertainty about the post-pandemic economic landscape and the viability of existing production structures. Overall investment growth in EMDEs is projected to soften to 4.3 percent in 2022. China is expected to contribute half or more of aggregate EMDE investment growth in 2021 and 2022. Without China, investment in EMDEs is projected to be still below the pre-pandemic level by 2022.

Long-term effects of the pandemic

Lasting investment losses. History suggests that the adverse effects on investment of the pandemic will linger. After epidemics in the past, losses to investment have been deeper and longer lasting than GDP losses, perhaps because of lasting effects of uncertainty and risk aversion on investment (figure B3.2.3). These same mechanisms, along with sharply lower corporate profits, can be expected

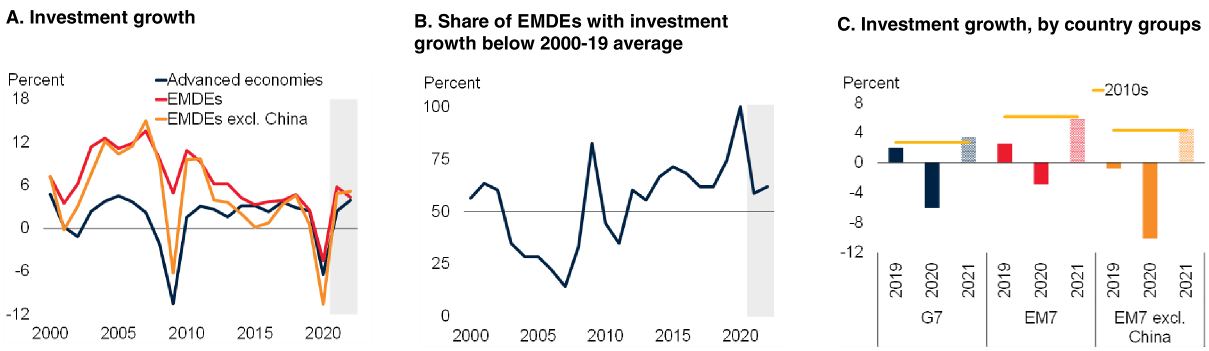
Note: This box was prepared by Naotaka Sugawara and Dana Vorisek.

[a] Investment is defined as gross fixed capital formation.

BOX 3.2 Impact of COVID-19 on investment: Deep, persistent, and broad based *(continued)*

FIGURE B3.2.1 Investment trends

Following a decade-long, broad-based declining trend in investment growth in EMDEs prior to the COVID-19 pandemic, investment contracted sharply in 2020. The collapse in investment was much sharper in large EMDEs (excluding China) than in large advanced economies.



Sources: Haver Analytics; World Bank.

Note: EMDEs = emerging market and developing economies. Data for 2020 are estimates and for 2021-22 are forecasts (shaded bars and areas). Investment refers to gross fixed capital formation. Aggregate growth is calculated with investment at 2010 prices and market exchange rates as weights.

A.B. Sample includes 97 countries, consisting of 34 advanced economies and 63 EMDEs.

B. Figure shows share of EMDEs with investment growth below their own average during 2000-19.

C. "G7" includes Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. "EM7" refers to the seven largest EMDEs and includes Brazil, China, India, Indonesia, Mexico, the Russian Federation, and Turkey.

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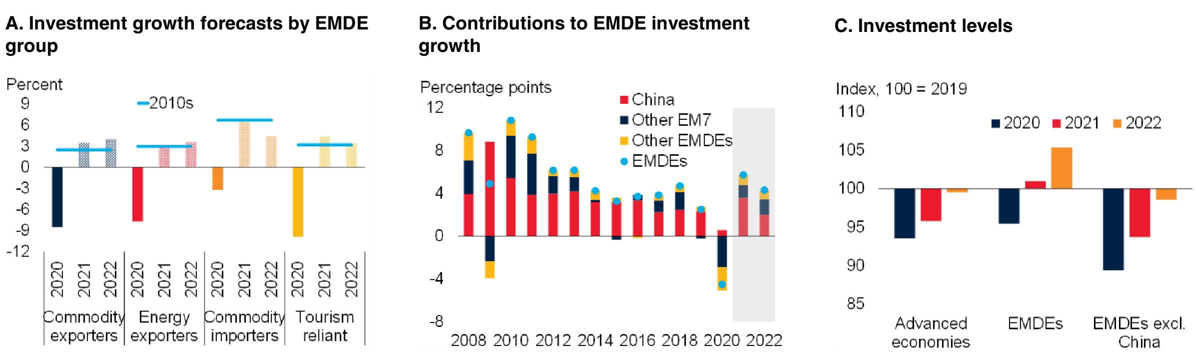
FIGURE B3.2.2 Investment prospects

The speed of recovery in investment will vary by EMDE group, but is expected to be weak overall. Excluding China, investment in EMDEs is projected to remain below pre-pandemic levels through 2022.



Sources: Haver Analytics; World Bank.

Note: EMDEs = emerging market and developing economies. Data for 2020 are estimates and for 2021-22 are forecasts (shaded bars or areas). Investment refers to gross fixed capital formation. Aggregate growth is calculated with investment at 2010 prices and market exchange rates as weights.

A. Sample includes 40 EMDE commodity exporters,15 EMDE energy exporters, 23 EMDE commodity importers, and 19 tourism-reliant EMDEs. Tourism-reliant EMDEs are defined as those with above-average international tourism expenditures as a share of GDP.

B. "EM7" refers to the seven largest EMDEs and includes Brazil, China, India, Indonesia, Mexico, the Russian Federation, and Turkey. "Other EMDEs" includes 56 economies.

C. Sample includes 34 advanced economies and 63 EMDEs.

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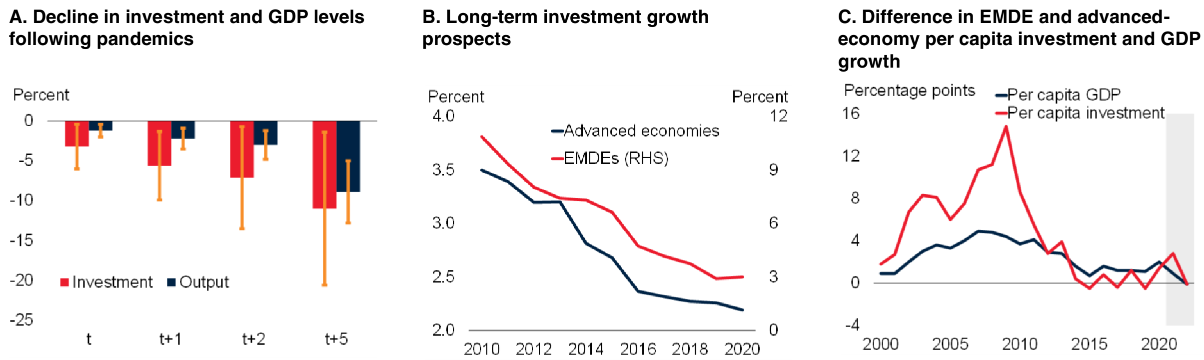
BOX 3.2 Impact of COVID-19 on investment: Deep, persistent, and broad based *(continued)*

FIGURE B3.2.3 Long-term impact of the pandemic on investment

The decline in investment after pandemics tends to be deep and long lasting. The pandemic could lead to a further decline in long-term investment growth, which has already been on a downward trajectory, and will also likely hinder EMDEs' per capita income convergence with advanced economies.



Sources: Consensus Economics; Haver Analytics; World Bank (2020a); World Bank.

Note: EMDEs = emerging market and developing economies. Investment refers to gross fixed capital formation.

A. Bars show the cumulative estimated impacts of the four most severe biological epidemics on investment and output levels relative to non-affected EMDEs. Orange lines display the range of the estimates with 90th percentile significance. The four epidemics considered are SARS (2002-03), MERS (2012), Ebola (2014-15), and Zika (2015-16). Swine flu (2009), which coincided with the 2008-09 global financial crisis, is excluded to limit possible confounding effects. Sample includes 116 economies, including 30 advanced economies and 86 EMDEs.

B. Long-term prospects refer to ten-year-ahead forecasts. The horizontal axis shows the year when long-term forecasts are surveyed. Sample includes 24 advanced economies and 20 EMDEs.

C. Data for 2020 are estimates and for 2021-22 are forecasts. Sample for per capita investment includes 97 countries, consisting of 34 advanced economies and 63 EMDEs.

Click here to download data and charts.

to constrain investment during and after the COVID-19 pandemic (Caballero and Simsek 2020; Stiglitz 2020).

Weak investment, a source of slowing potential growth. The prospect of weak investment in EMDEs during the medium to long term, after the severe contraction in 2020, raises concerns about the effects on EMDEs' potential growth—the growth rate EMDEs can sustain at full employment and capacity. The sustained weakening of investment growth during the 2010s, together with declining total factor productivity growth, has already contributed to a slowdown in labor productivity growth in EMDEs and, as a result, limited EMDEs' convergence toward per capita income levels in advanced economies (Dieppe 2020).

Upside risk in some sectors. On the other hand, a productivity-enhancing investment surge triggered by the pandemic remains a possibility. This boost could materialize through renewed investment in digital technologies in sectors such as manufacturing, finance, and education, or through the onshoring of production of some essential products (Dieppe 2020). The pandemic also creates opportunities to shift infrastructure investment toward more resilient and environmentally sustainable options, in turn raising productivity and supporting progress toward the SDGs in the long term (Hallegatte and Hammer 2020).

Conclusion

The adverse effect of the COVID-19 pandemic on investment in EMDEs, already large, could extend for a prolonged period. Given the importance of investment in supporting productivity and per capita income gains, it is important that impediments to productive investment, including those related to financing, be reduced. For EMDEs, boosting public investment can have particularly large benefits due to high multipliers (Izquierdo et al. 2020). At the same time, improving business climates and reducing policy uncertainty is key in supporting private investment.