International Commentary — May 16, 2022

Emerging Market Sovereign Debt Dynamics Are Concerning

Economist(s)

Brendan McKenna
International Economist | Wells Fargo Economics
Brendan.Mckenna@wellsfargo.com | 212-214-5637

Summary

Throughout our publications, we have highlighted our bearish outlook on emerging market currencies. Most of our concerns draw from tighter Fed monetary policy, economic challenges in China as well as rising geopolitical and political risks globally as well as locally. Our most recent exchange rate forecasts in our *April International Economic Outlook* indicate that we expect currency depreciation across all of the major emerging market regions, and in select cases, we expect declines to take some currencies to all-time lows against the U.S. dollar. We would also not be surprised if currencies associated with weak underlying fundamentals and political instability experienced currency crisis conditions over the next 18 months. Typically, we express our concerns through our currency forecasts; however, we believe current conditions could be ripe for a sovereign debt crisis across the emerging markets.

With that in mind, in this report, we examine how government debt has evolved since the Global Financial Crisis, and lay the foundation for more comprehensive and frequent reports focused on emerging market sovereign debt. Despite a sharp rise in commodity prices and a global recovery from the COVID pandemic, the EM sovereign debt burden continues to rise and debt service costs have become significantly more expensive over the years. The combination of rising debt and more expensive servicing costs concerns us, and with yields spiking over the course of this year, debt dynamics and sovereign creditworthiness, in our view, could worsen over the next few years.

Going forward, we plan on publishing more reports focused on emerging market sovereign debt. We plan on refreshing existing frameworks and will introduce new tools to analyze government debt and sovereign creditworthiness. These tools will focus on thematic developments, but also seek to highlight individual countries that could be at risk from a fundamental credit perspective. For multi-national corporations, our tools and frameworks can inform decision-makers on evolving business conditions in certain countries. Our analysis could also be helpful in considering longer-term investment decisions in emerging market countries as well as where cross-border currency restrictions could be imposed.

Emerging Market Sovereign Debt May Be on the Brink

We are concerned about the emerging markets. Our concerns stem from tighter Fed monetary policy, uninspiring global growth prospects, rising "hard landing" risks in China, military conflict involving Russia, heightened geopolitical and political risk...and those developments are just the worst of the worst. The list can, and does, go on. Regardless of how many issues we name, we believe the dynamics permeating around the global economy as well as regionally and locally spell trouble for emerging market currencies. We have been bearish on emerging market currency prospects for years, and given these concerns, that view is unlikely to change in the near future. And while we do not explicitly forecast any as of now, we believe some of the fundamentally weaker and politically unstable countries could very well experience currency crisis conditions going forward. For those who follow our monthly *International Economic Outlook* publication as well as our ad hoc reports, this pessimistic outlook on the emerging markets should not be a surprise. Our forecasts reflect widespread currency depreciation across Asia, EMEA and Latin America, and we believe multiple currencies could reach all-time lows against the U.S. dollar in the next 18 months.

Typically, we express these concerns in the context of currency markets and our exchange rate forecasts. Once in a while we will comment on developments in sovereign debt markets, most likely in extreme circumstances. In the past, we opined on default risk in Argentina, even branching out to explicitly forecast an Argentine default after Macri lost his re-election bid in a landslide. We have also written about the possibility of an external debt crisis in the emerging markets and which countries could be most at risk, given the economic stresses induced by COVID. When markets began whispering that the Fed should start tapering asset purchases in 2021, we touched on which sovereigns could experience a funding crisis and sudden stop of capital flows in the event of a Taper Tantrum 2.0. And more recently, we have published views on the possibility of a Russian default amid the wave of sanctions and restrictions affecting Russia's ability to pay debt obligations. However, these reports are more one-offs and meant to provide insight into thematic global developments or an event risk that can affect our currency forecasts. But COVID left economic scars across the developing world. Scars that are likely to have a long-lasting effect across asset classes, including sovereign debt. Depressed government revenues, precarious public finance positions and higher debt service costs have hurt government debt affordability and sustainability as well as sovereign creditworthiness.

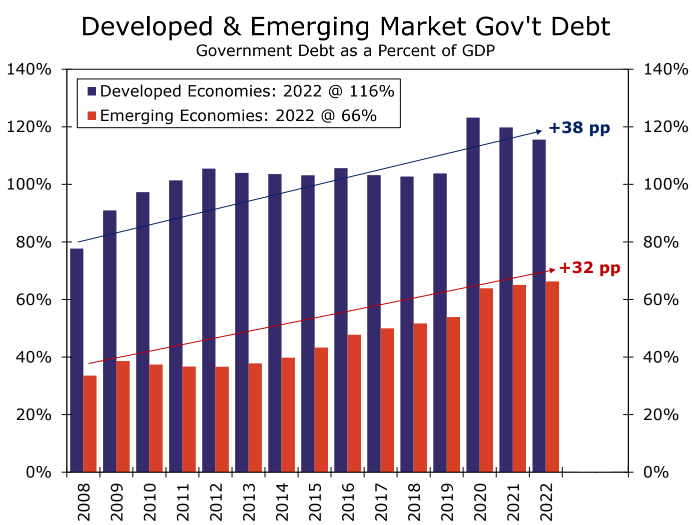
Over the past two years, countries defined as low-income and frontier market nations have been affected the most. Right now, multiple countries are on the brink of default. In each country, government officials are negotiating bailout programs and economic reform plans with multilateral lenders, such as the IMF, World Bank and Paris Club. Countries, such as Sri Lanka and Pakistan, have signaled a high likelihood of default in the near future unless they can receive official sector or concessional financial support. Frontier governments, such as Lebanon, Zambia and Suriname, defaulted in 2020 and are currently in uncured default without access to international capital markets. Last year, Belize missed multiple foreign currency payments and experienced numerous bouts of default. Larger emerging market countries have experienced similar issues. Egypt is currently showing tentative signs of a balance of payments crisis, while sanctions have Russia teetering on the edge of its first foreign currency default since the Bolshevik Revolution in the early 1900s. Not to mention, Argentina defaulted on $108B of foreign and local currency debt in early 2020, the largest sovereign default since the Greek debt crisis in March 2012. COVID may have exacerbated the deterioration in creditworthiness, but going forward, the list of issues we laid out above are likely to keep pressure on emerging market sovereign debt and could result in additional government defaults. In our view, deteriorating creditworthiness and the possibility of a widespread debt crisis across the emerging markets is a risk not only worth highlighting, but worthy of more frequent updates and analysis.

Going forward, we plan on publishing reports focused on emerging market sovereign debt in addition to sharing our views on emerging market currencies. These publications may not be as frequent as our International Economic Outlook; however, they will touch on thematic and country-specific developments in emerging market debt. We plan on refreshing some of our existing frameworks more often to gauge countries that could be vulnerable to sovereign funding stress. We will also update our external debt crisis framework to identify countries at risk or countries where fundamentals suggest a low probability of an external debt default. Evaluating sovereign creditworthiness will also become part of our future publications. We plan on building new tools to analyze creditworthiness and the possible path ahead for sovereign credit ratings. These frameworks can provide guidance on countries that may be deteriorating from a fundamental credit perspective and could be close to imposing capital controls or other types of cross-border currency restrictions. These tools can inform multi-national corporations on the evolving business environment and act as a resource for corporates considering longer-term investment decisions in select emerging market countries.

EM Government Debt Dynamics Look Dangerous

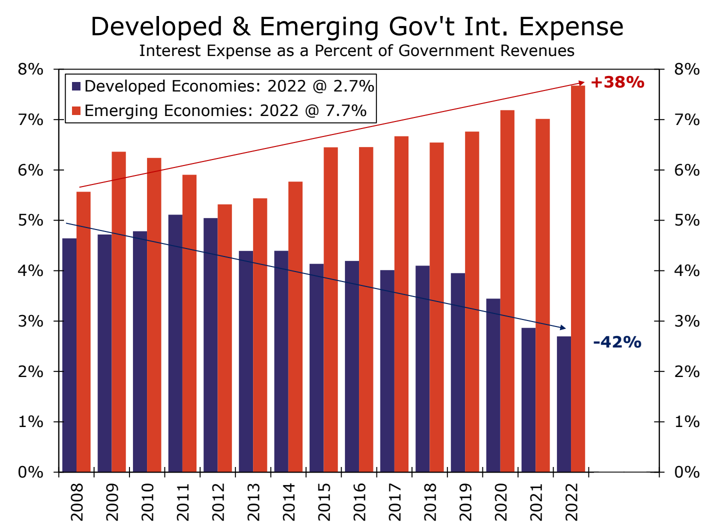
In this first report, we will focus on how debt dynamics across the emerging as well as developed markets have evolved since the Global Financial Crisis and over the course of COVID. The IMF defines "emerging markets" as inclusive of all developing nations whether they are considered emerging, frontier or low-income. By grouping all these countries together, we can see how debt as a percent of GDP has changed in the emerging markets, and for comparison purposes, how debt has evolved in the advanced economies. Since 2008, emerging and advanced governments have increased the size of their debt burdens substantially. In 2008, advanced economy governments in aggregate held debt worth a little under 80% of output. Fast-forward through the Global Financial Crisis, the Eurozone Debt Crisis as well as the need for aggressive fiscal stimulus to offset the economic impact of COVID, and advanced sovereigns have seen debt rise 38 percentage points to 116% of GDP (Figure 1). In the emerging markets, sovereign debt is worth only 66% of GDP and has risen a slightly more modest 32 percentage points. Relative to the advanced economies, the stock of EM sovereign debt and the rise in debt levels may not seem worrisome; however, there are underlying nuances to these statistics that concern us.

Figure 1



Source: IMF and Wells Fargo Economics

Figure 2



Source: IMF and Wells Fargo Economics

First, while the advanced economy debt burden has risen more rapidly since 2008, recent dynamics are encouraging. According to the IMF, developed economy debt peaked in 2020 and has been on a downward trajectory over the past two years. Fund forecasts suggest advanced economy debt topped out at 123% of GDP and should fall to 116% by the end of this year. While still elevated, the path for major economy debt is trending in a positive direction. However, in the emerging markets, we have yet to see debt levels trend lower, and as of its most recent forecasts, the IMF expects the EM debt burden to rise further this year. While debt levels are not expected to skyrocket, the fact higher commodity prices and a global recovery from the COVID pandemic have not helped place debt on a similar downward trajectory is concerning. But what worries us the most is that the cost of servicing this rising debt burden has gotten significantly more expensive over the years. One of the most important metrics for analyzing sovereign debt service cost is the interest-to-government revenue ratio. In 2008, emerging market governments had an interest-to-revenue ratio of 5.6%, meaning governments spent 5.6% of their total revenue on bond interest payments. Over the past decade plus, the IMF forecasts this ratio jumped to 7.7%, an increase and worsening in EM sovereign debt service cost of 38% (Figure 2). On the other hand, debt service costs decreased and improved in the advanced economies by over 40%.

Improved affordability and lower debt servicing costs in the advanced economies is primarily a result of central bank bond buying programs and impressive balance sheet capacity to absorb new issuance.

Most emerging market central banks either cannot legally engage in asset purchase programs or do not have balance sheet capacity to purchase large amounts of debt. Regardless, debt service costs in the emerging markets are the highest they have been since the immediate aftermath of the Global Financial Crisis in 2009. With the Federal Reserve raising policy rates and global interest rates rising sharply this year, debt service costs could get more expensive going forward. Higher levels of indebtedness and elevated debt service costs in isolation may not result in sovereign default; however, the combination of both is more likely to yield a further deterioration in sovereign creditworthiness and debt repayment capacity. This combination may also set the foundation for a widespread debt crisis in the emerging markets. Of course, these are not the only metrics worth considering. Economic stagnation, political and institutional strength as well as the underlying health of a country's banking sector are all important as well, and going forward, our frameworks and tools will examine and incorporate these other components. In addition, not every country is experiencing the same worsening debt metrics. The statistics in this report are at a high level, and show how emerging market sovereign debt in aggregate has trended. Our new tools will also highlight countries most at risk of a debt crisis, worsening creditworthiness as well as where the general business environment could be deteriorating.

Subscription Information

To subscribe please visit: www.wellsfargo.com/economicsemail

Via The Bloomberg Professional Services at WFRE

Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Mark Vitner	Senior Economist	704-410-3277	Mark.Vitner@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Charlie Dougherty	Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Shannon Seery	Economist	332-204-0693	Shannon.Seery@wellsfargo.com
Nicole Cervi	Economic Analyst	704-410-3059	Nicole.Cervi@wellsfargo.com
Sara Cotsakis	Economic Analyst	704-410-1437	Sara.Cotsakis@wellsfargo.com
Jessica Guo	Economic Analyst	704-410-4405	Jessica.Guo@wellsfargo.com
Karl Vesely	Economic Analyst	704-410-2911	Karl.Vesely@wellsfargo.com
Patrick Barley	Economic Analyst	704-410-1232	Patrick.Barley@wellsfargo.com
Coren Burton	Administrative Assistant	704-410-6010	Coren.Burton@wellsfargo.com

Required Disclosures