EDITORIAL

EMERGING COUNTRIES WILL BEND BUT NOT BREAK

Emerging countries are now facing another major shock whereas the post-pandemic recovery has remained fragile. The war in Ukraine will impact emerging countries through its negative effects on foreign trade, capital flows and, above all, inflation. The indirect effect of soaring global commodity prices on inflation households' purchasing power may be particularly severe, and affect mostly low-income countries in Africa, Central Europe and the Balkan region. In spite of these gloomier prospects, we do not expect a broad-based worsening in sovereign and external solvency in emerging countries in the short term. However, a few governments, especially in Africa and the Middle East, may rapidly experience payment difficulties.

Before the military confrontation in Ukraine, we were cautiously optimistic for Emerging Markets (EMs). Activity had recovered its Q4 2019 level in a majority of countries. In January-February, global economic activity was on a recovery path from the Omicron-led temporary drag and supply-chain constraints in the manufacturing industry were abating. However, caution was justified by the general acceleration in inflation and the new deterioration in the Covid epidemic curve in Europe, Asia and, most worryingly, in some industrial regions in China.

After the Covid shock in 2020-2021, EMs are now facing a second major shock whereas the post-pandemic recovery has remained fragile, especially for low-income countries (LICs). The military confrontation is basically a supply shock that will impact EM and LIC economies through various channels (trade, inflation, financial).

For EMs as a whole, the financial impact has been moderate so far. Exchange rates have either stayed stable or appreciated for commodity exporters. Spreads on foreign currency-denominated debt have widened only for non-investment grade borrowers. Equity markets have been resilient, not only in Asia (excluding China) and Latin America, but also in EMEA markets (excluding Russia), a region deemed to be the most impacted. Lastly, EM banks' exposure to Russia is very limited, even for Central European countries and Turkey that are the most exposed.

The direct demand impact of the huge contraction of imports from Russia and Ukraine should not be very significant, except for CIS countries and, to a lesser extent, Central European and Balkan countries (CEBCs) and Turkey.

INFLATION RISK

The indirect impact of the surge in commodity prices on inflation should be more harmful as it will severely dent the population's purchasing power in all regions. The commodity price shock is comparable to previous shocks and is observed across-the-board (energy, metal and food prices). The commodity price shock will hit first and foremost LICs in Africa (whether commodity exporters or not) as 50% of them have an import dependency on cereals of close to 50% or more. As for commodity exporters, especially in Latin America, the negative inflationary impact on private consumption should be offset by the windfall gain in terms of trade. But this requires that governments implement a pro-active redistribution policy. Regarding commodity importers, CEBCs and Turkey are expected to be more severely impacted than Asian countries as they are characterized by a much larger share of imports of energy, metals and soft commodities from Russia and Ukraine. As a consequence, producers will face both supply constraints and the rise in energy prices. Households will also be comparatively more impacted as the weight of energy in CPI is larger than in Asian countries. As a consequence, monetary policies in CEBCs will be tightened further.

SOVEREIGN RISK : ONLY A FEW COUNTRIES ON THE SPOTLIGHT

Despite these gloomier perspectives, we maintain our cautious and selective approach when assessing sovereign risk in emerging countries. Firstly, most EMs will face the new shock with a generally sound external liquidity and even an unscathed external solvency compared with the situation at end-2019 – with the exception of Argentina, Egypt and Turkey.

For commodity importers, the impact of the surge in commodity prices on external accounts will be obviously negative. But given the expected deceleration in import volumes, we do not expect a deterioration in the current account deficit to above 5% of GDP, except for Egypt, Morocco, Romania, Tunisia and Senegal. In Egypt, the deterioration in current account imbalances, the strong dependency on grain imports and the memory of the bread riot in 1977 and social tensions in 2008 have triggered a sell-off from foreign investors on the sovereign domestic debt market. Monetary authorities have been forced to devalue the pound and the government has asked for IMF support.

Secondly, beyond the across-the-board increase in public indebtedness between 2019 and 2021 (+10pp of GDP on average or on median), major indicators used to assess sovereign solvency have remained satisfactory or have deteriorated less than feared. Interest-to-revenue ratios have moderately increased (by about 1% on median), and the share of foreign currency-denominated debt and the share of domestic debt owned by non-residents have decreased. Countries for which both solvency and liquidity indicators are the weakest and/or have deteriorated the most since 2019 are almost exclusively in the Middle East & Africa region. Argentina remains very fragile with a public debt ratio unchanged and mostly in foreign currency, but it has obtained the rescheduling of its debt to the IMF and the current account surplus should consolidate.

Thirdly, despite the rise in domestic government bond yields and/or spreads on external borrowing, the gap between the cost of borrowing and GDP growth (the so-called "snowball effect") will remain negative, i.e. favourable, for debt dynamics – except for Egypt, Russia, South Africa and, to a lesser extent, Brazil. Turkey is an outlier but in a positive way as, despite the surge in domestic rates and the depreciation of the currency, the snowball effect will be even more negative provided that the country avoids recession.

In the short term, the key indicator to assess sovereign solvency remains repayments of international bonds and loans of sovereigns & quasi sovereigns compared with either official foreign reserves or net foreign assets of the sovereign (if they are larger than reserves). On the basis of this ratio, countries that need to be closely monitored are Bahrain, Angola, Croatia, Egypt, Oman and Turkey. For these countries, repayments represent at least 50% of official foreign-currency liquidity/assets. There is a second group of countries that deserve attention since the ratio ranges between 20% and 30% (Argentina, Indonesia, Ghana, Romania, Tunisia and Ukraine).

Angola, Argentina, Bahrain, Ghana, Indonesia and Oman should manage to fulfill their obligations thanks to the commodity price bonanza. Croatia, Indonesia and Romania still benefit from an affordable cost of external borrowing. Turkey and Egypt have managed to secure financing from Gulf States so far (credit lines for Egypt, international bond purchases for Turkey) but market financing is very costly now. Tunisia is in the weakest position as support from international financial institutions has been suspended pending an agreement with the IMF.

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