EDITORIAL

FROM ONE SHOCK TO ANOTHER

Emerging countries have recently faced a series of unexpected and severe shocks that will significantly dampen their economic performance in 2022. Global inflation has increased due to rising commodity prices and world supply disruptions resulting from the conflict in Ukraine. The lockdowns in China's industrial regions during the spring have aggravated supply problems and further worsened the global economic outlook. Moreover, monetary policies have tightened in most countries, while external financing conditions have also deteriorated due to the weakening in global investor sentiment and US monetary policy tightening. Emerging markets have already faced a bout of large capital outflows since the beginning of the year. In this context, the emerging borrowers most exposed to potential payment difficulties include speculative-grade sovereign entities in countries currently posting both weak public finances and widening current account imbalances. They are not so many facing this situation.

MULTIPLE HEADWINDS ON ECONOMIC GROWTH

Over the past four months, Emerging Markets (EMs) have faced a new series of severe shocks, which were not predicted at the start of the year. First, global demand and world supply chains have been hit by two major and very different blows, including the war in Ukraine since late February and stringent lockdowns that disrupted activity in industrial regions in China from March to May. Moreover, global inflation pressures have increased rapidly, driven by supply disruptions and soaring prices of energy and agricultural commodities, which were already high and increasing before the war. In turn, most central banks have started to tighten monetary policies in spite of the deterioration of the economic growth outlook. Finally, fast tightening in US monetary policy and weaker market sentiment have led to the deterioration of external financial conditions for EM borrowers and to significant foreign portfolio investment outflows.

As a result, economic growth in EMs will be slower than expected in 2022. One of the main downward real GDP growth revisions recently has affected our forecast of China's economic growth. As a matter of fact, China's economic activity slowed in Q1 2022, probably contracted in Q2 2022, and should recover only gradually in the short term. Moreover, downside risks remain high. In particular, the health situation remains uncertain and the authorities maintain a tough COVID strategy; private consumption will struggle to recover because of the slack in the labour market; and the contraction continues in the real estate sector. China's economic policy mix is increasingly expansionary, with the authorities implementing gradual and targeted support measures rather than a vast stimulus plan. Monetary policy and credit conditions have been eased gradually since Q4 2021, but the effectiveness of monetary policy easing on economic activity has been impaired by weak credit demand.

TIGHTENING IN EXTERNAL FINANCIAL CONDITIONS

The impact of recent foreign portfolio investment outflows on EMs' external liquidity is not yet a matter of concern, even if central banks' forex reserves have weakened in most EMs (notably Turkey), including in many commodity exporters. The impact on exchange rates and borrowing costs is significant as well, but less negative than expected, given the magnitude of the reversal in portfolio inflows in light of past experiences.

Regarding the impact on external borrowing costs, the shock has reinforced the dichotomy between investment-grade and speculative-grade sovereign borrowers. As for domestic borrowing costs, the picture is much less binary and more reassuring to some extent as, except for a few countries, real government bond yields are unchanged or even lower now than at end-2019.

For investment-grade sovereign borrowers, the real interest rate on debt will remain below the real GDP growth expected in 2022. The debt burden may therefore ease despite the rise in the debt-to-GDP ratio. By contrast, for countries whose public finances were already structurally fragile before the COVID-19 crisis and for which the current account deficit will worsen as a result of the rise in commodity prices, the cost of external financing has reached a dissuasive, or even prohibitive, level. The refinancing of external debt will necessarily require the support of international financial institutions or official bilateral creditors in order to avoid a sovereign default. Among the main emerging and developing countries, Tunisia and Pakistan are currently in this dire situation. Countries that will only have to bear a heavier debt burden include South Africa and Brazil. Egypt is between these two categories.

The COVID-19 crisis has not entailed a major surge in debt of the non-financial private sector, contrary to public debt. The strongest rise in corporate and/or household debt has been registered in countries posting a high level of development and/or good macroeconomic fundamentals. Regarding foreign-currency indebtedness, corporates' external debt has actually decreased, or increased marginally for a large number of EMs since end-2019. However, tensions on exchange rates and interest rates may weaken corporates' capacity to support higher indebtedness.

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