A SELECTIVE APPETITE FOR EM DEBT

Monetary and exchange rate conditions in emerging economies are more favourable in this early part of the year than they were at the end of 2022 and beginning of 2023. The relaxation of monetary policies made possible by lower inflation and upward revisions of economic growth forecasts has attracted portfolio investment. Despite the increase in geopolitical risk, sovereign risk is likely to reduce except for the most fragile countries, which were already under pressure in 2023. For low-income countries, 2024 will be a high-risk year as governments' external debt repayments will remain very heavy, just as they were in 2023.

A RELAXATION OF FINANCIAL CONDITIONS IN MOST EMERGING ECONOMIES...

Monetary and exchange rate conditions in most emerging economies (EMs) eased significantly in the final quarter of 2023, for both external and internal reasons: expectations of an easing of US monetary policy, an across-the-board appreciation of currencies against the dollar, and the continued slowing of inflation, helped by falling commodity prices. Most central banks in Latin America and Central Europe continued to cut policy rates. Bond yields followed this trend, but without amplifying it. Yields also fell in countries where policy rates were held steady (mainly in Asia), and even in Turkey where monetary tightening was still ongoing.

Appetite of fund managers for EM debt has returned. Excluding China, non-resident portfolio investments in bond markets were particularly strong in November and December, contrasting with the picture seen in late 2022 (see chart). According to IMF economists, bond yields in emerging economies over the last monetary cycle have been less sensitive than in the past to changes in US bond yields. Relative to the 'taper tantrum' of 2013, the sensitivity coefficient has fallen by two-thirds for Latin American countries and by 40% for those in Asia.

BOND FUNDS DEDICATED TO EMERGING COUNTRIES

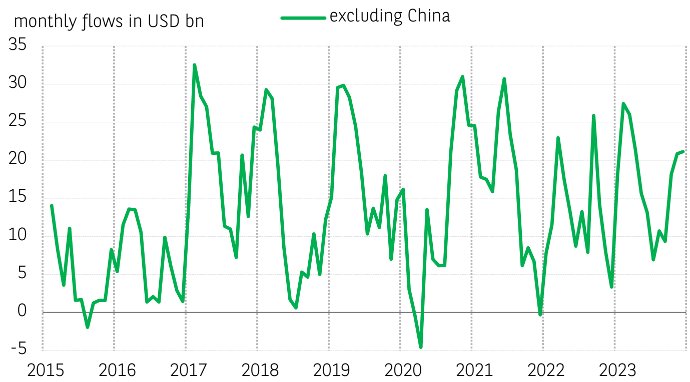

CHART 1 SOURCE: IIF, BNP PARIBAS

...BUT SOVEREIGN RISK IS RISING FOR THE MOST FRAGILE EMERGING ECONOMIES AND FOR LOW-INCOME COUNTRIES

In general terms, the solvency of EM governments should improve in 2024, thanks to the combined effects of lower interest rates and upgraded economic growth prospects. The IMF has increased its forecast for global growth by 0.2 percentage points since October 2023, with a notable increase in its forecast for the US, where it expects the landing to be much softer than previously thought (2.1% growth in 2024, from 2.5% in 2023). The Fund has also uprated forecasts for several of the major emerging economies (Brazil, India, Mexico, Russia). It continues to expect growth in China to slow (from 5.2% to 4.6%), but by less than it predicted last autumn.

Be this as it may, amongst the emerging economies the risk of a sovereign default has increased for three countries which were already under pressure in 2023, namely Argentina, Egypt and Tunisia (see below). Tunisia's financing requirement has more than doubled, rising to 17% from 8% of GDP before the pandemic. In Egypt, the debt interest burden will account for 70% of government revenue, which looks unsustainable.

In Argentina, the 2020 debt restructuring lightened the government's interest burden but that of the central bank has ballooned to sterilize the monetary financing of the budget deficit; the cost for the central bank has reached 8% of GDP. In addition, the governments in these three countries have a large part of the debt in foreign currency whereas official foreign exchange reserves are low. Argentina is on financial life-support from the IMF, but support to Egypt was interrupted in 2023 and Tunisia has still not reached an agreement.

2024 will be a high-risk year for low-income countries (LICs) as well. Geopolitical risk remains very high, with the continuing war in Ukraine and tensions in the Middle East with Israel's military intervention in Gaza. And the LICs clearly suffer the most from the economic consequences of these conflicts. The IIF notes that more than half of the 73 countries that have had access to the debt service suspension mechanism have a high level of sovereign risk or are in a position of debt distress (15 are in default). As in 2023, repayments of long-term external debt by these countries will be very high in 2024, at USD78 billion, after USD75 billion in 2023 – twice as much as in 2020.

François Faure
francois.faure@bnpparibas.com