WELLS FARGO

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Emerging Market Sovereign Debt Dynamics Are Worsening

Summary

While emerging currencies have performed well overall so far this year, in our view underlying vulnerabilities across the emerging world are building, particularly in the sovereign debt space. Following a few years of somewhat stable debt-to-GDP ratios, the IMF now forecasts sovereign debt burdens across the emerging markets to start rising at a quicker pace, with the debt burden for emerging markets in particular moving in a more worrisome direction. In addition, the cost of servicing this debt burden has risen substantially for emerging economies since the global financial crisis, and is expected to get significantly more expensive this year. For now, we highlight worsening debt dynamics as a vulnerability, and a potential risk to our constructive emerging currency outlook.

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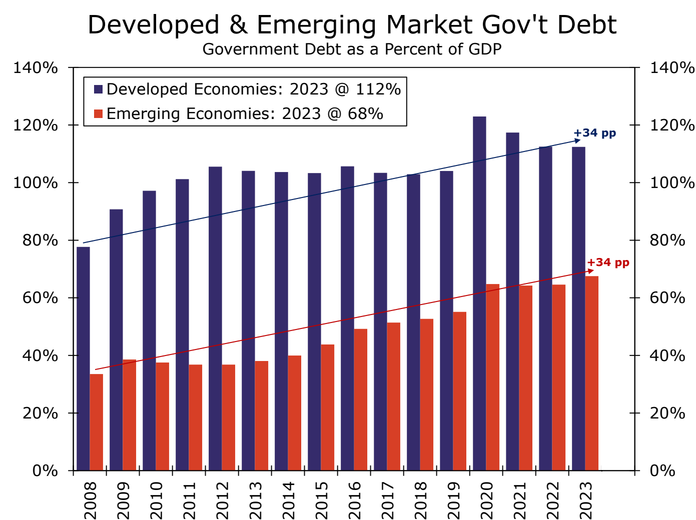
Debt Levels Are Rising As Interest Costs Spike

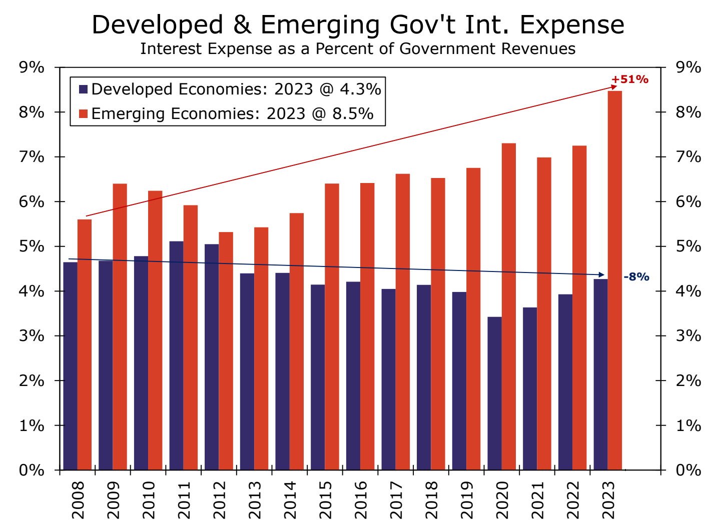
Throughout our monthly International Economic Outlook publications this year, we have highlighted emerging market currency strength and outperformance as one of our high conviction views. To date, this currency outlook has broadly materialized; however, underlying vulnerabilities across the emerging world are building, particularly in the sovereign debt space. Following a few years of somewhat stable government debt-to-GDP ratios, the IMF now forecasts sovereign debt burdens across the emerging markets to start rising at a quicker pace. As a sidebar, 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 each increased the size of their debt burdens by 34 percentage points (Figure 1). More recently, advanced economy debt burdens have trended lower, with the IMF expecting the aggregate debt-to-GDP ratio to fall to 112% of GDP by the end of this year, down from 123% in 2020 and flat relative to 2022. On the other hand, in the emerging markets, while the aggregate debt burden is lower relative to advanced economies, the trajectory is moving in the opposite and a more worrisome direction. By the end of this year, the Fund forecasts debt in emerging markets to climb to 68% of GDP, higher than the 2020 ratio and greater than the 65% debt-to-GDP ratio at the end of last year. This debt trajectory was top of mind at the World Bank and IMF Spring 2023 Meetings, although there are additional nuances that concern us.

Figure 1



Source: IMF and Wells Fargo Economics

Figure 2



Source: IMF and Wells Fargo Economics

Perhaps most worrisome is that the cost of servicing this rising debt burden is expected to get significantly more expensive for emerging market sovereign borrowers this year. 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. By 2022, this ratio jumped to 7.3%, and the IMF expects debt service costs to rise to 8.5% of revenue this year. Since 2008, EM sovereign debt service costs are expected to rise 51% (Figure 2). We can attribute the sharp rise in debt service costs this year to aggressive central bank interest rate hikes, especially from the Federal Reserve, but also from central banks in the emerging markets. While advanced economies are not immune to higher interest rates as governments in the developed world are also expected to see a rise in debt service costs this year, debt affordability in the developed economies is significantly better. In 2023, the IMF expects the interest-to-revenue ratio for developed sovereigns to rise to 4.3%, about half the cost borne by emerging market governments. In addition, since 2008, advanced economies have seen overall debt service costs decline 8%, a significantly different trajectory than interest expenses in the emerging markets.

Better 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

during times of crisis. 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 to keep yields at subdued levels. Regardless, debt service costs in the emerging markets are the highest they have been in the period since the Global Financial Crisis. Higher levels of indebtedness or elevated debt service costs in isolation may not result in sovereign default pressures; however, the combination of both is more likely to yield a further deterioration in sovereign creditworthiness and debt repayment capacity, and is a notable vulnerability for emerging market governments. Over the last few years, multiple sovereigns in the emerging markets have defaulted on sovereign debt obligations. With debt levels rising and debt service costs more expensive, additional emerging market sovereign defaults could still be yet to materialize. Further defaults could complicate the outlook for emerging markets not only from an economic perspective, but may also have the ability to damage overall sentiment toward local financial markets and could be enough for us to adjust our outlook on emerging market currencies.

For now, we highlight worsening debt dynamics as a vulnerability and not necessarily a forecast for additional sovereign defaults, as these are not the only metrics worth considering when thinking about sovereign default risk. Economic trends, political and institutional willingness to address economic issues, as well as the health of a country's banking sector are all important variables. In addition, not every emerging country is experiencing the same worsening in debt metrics. The statistics in this report are at a high level, and show how emerging market sovereign debt dynamics in aggregate are trending. In the coming weeks, we will update our sovereign debt toolkit in order to highlight countries most at risk of a debt crisis. We will also update our sovereign credit rating framework and highlight where overall creditworthiness is evolving and where sovereign credit rating adjustments could be warranted.

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