International Commentary — June 2, 2023

Sovereign Default Risks Exist Outside The U.S. Too

Summary

The United States has managed to avoid default by coming to a debt ceiling resolution; however, in the event the U.S. did default on its sovereign debt obligations the repercussions would have been severe. Sovereigns around the world likely would have followed the U.S. into default, with emerging market countries arguably most vulnerable. Despite the worst case scenario being avoided, sovereign default risks in the emerging markets still exist. We highlighted elevated default risks in a recent report citing rising debt service costs, and in this report, we note that financial markets are also pricing relatively high default risk for sovereign borrowers across most emerging market regions. While we remain constructive on emerging market currencies, sovereign default risks represent a tail-risk to our outlook, and should defaults materialize and gather momentum, our outlook could change over time.

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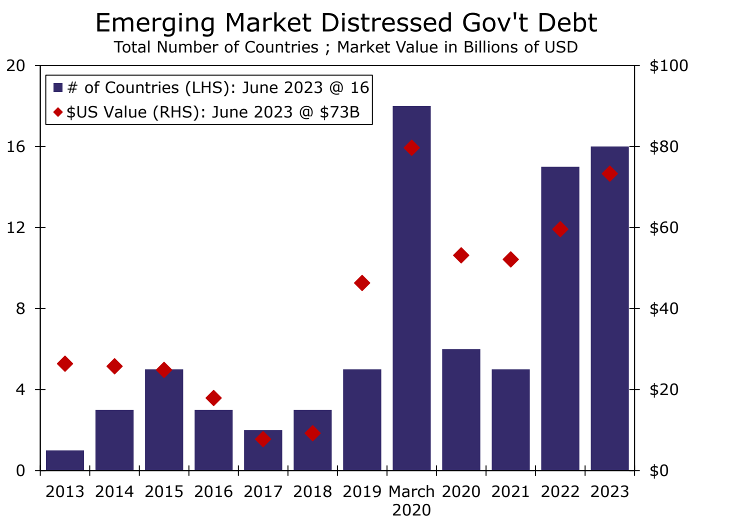
Emerging Market Sovereign Default Risks Still Present

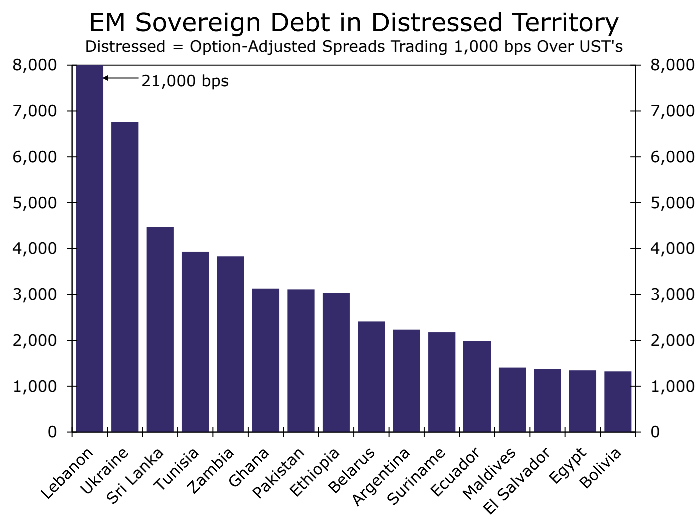
The U.S. debt ceiling standoff has finally come to a resolution, and while the worst case scenario has been avoided, a U.S. sovereign debt default could have had significant implications for the global economy and financial markets. Ripple effects of an American default would have likely reverberated in such a way that a wave of sovereign debt defaults around the world would have followed soon after. Spillover effects of a U.S. default would have been felt most acutely in the emerging markets where economic conditions are more fragile and public finance profiles more worrisome. But even though the United States has avoided default, multiple sovereign debt defaults across the emerging and developing economies could still materialize in the near future. We pointed out default risks in a recent report where we highlighted how debt service costs in the emerging markets are on a worsening trajectory and at the highest they have been in the last fifteen years. Rising debt service costs, along with additional external challenges such as a strong U.S. dollar, have placed pressure on sovereign repayment capacity over the last few years. With interest rates set to remain elevated for the time being, the U.S. dollar resilient, and growth prospects subdued, multiple borrowers are likely facing an elevated probability of default.

Figure 1



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Figure 2



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Financial markets are also pricing elevated default risks across emerging market regions. To that point, emerging market bond and credit default swap prices have evolved in a way that is consistent with deteriorating creditworthiness and worsening repayment capacity. One of the indices we watch to gauge how market participants view sovereign creditworthiness and the perceived risk of default is the J.P. Morgan Emerging Market Bond Index (EMBI) Global Spread. The EMBI index is a weighted average of the largest emerging market countries and how their dollar-denominated bonds are trading relative to U.S. Treasuries. As the index rises, the yield spread over U.S. Treasury bonds is widening (i.e., EM sovereign debt is declining in value relative to the United States) and sovereign creditworthiness is worsening. Year-to-date, the EMBI is up 25 bps—which is in addition to a 53 bps rise in the index last year—suggesting even weaker repayment capacity and a rising probability of default among emerging market sovereign debt issuers. Also, and perhaps just as interesting, as of early June there are 16 sovereigns that have dollar-denominated bonds trading in "distressed" territory (i.e., yield spread over an equivalent U.S. Treasury bond of at least 1,000 bps). This number is greater than the number of countries with distressed bonds at the end of 2022, approaching the same number of countries that had debt trading at distressed levels during the depths of the COVID crisis in March 2020, and is higher than most periods over the past decade (Figure 1). The market value of this distressed debt is currently around US$73B, which is also close to the market value of distressed debt in March 2020, and greater than the market value of distressed bonds at the end of last year.

Countries with bonds in distressed territory represent some of the fundamentally weaker countries as well as countries that have been exposed to exogenous shock events (Figure 2). As far as the fundamentally weak countries, sovereigns with either uncured defaults or recent defaults such as

Lebanon, Sri Lanka, and Zambia (among others) continue to see yields well into distressed ranges. Pakistan also has sovereign debt trading in distressed territory, and while Pakistan has not defaulted, the country has been hit by multiple shocks that have the government on the brink of missing payments. The Russia-Ukraine conflict and the subsequent rise in commodity prices initiated crisis conditions in Pakistan; however, economic conditions have deteriorated further amid natural disasters, an overvalued currency, and domestic political instability. IMF financing has stalled as the Pakistan rupee has yet to freely float and fiscal slippage imbalances persist, and until an IMF program is solidly in place and authorities hit program targets, Pakistani sovereign debt will likely continue to trade at an elevated premium to risk-free U.S. Treasury bonds. Argentina, a repeat defaulter, has yet to regain investor confidence as the peso is heavily overvalued and large economic imbalances seem unlikely to correct in the near future, especially with elections set to take place around the end of this year. Also in Latin America, Ecuador, El Salvador and Bolivia have distressed debts, which particularly stem from idiosyncratic issues such as political instability in Ecuador, unorthodox policy implementation in El Salvador, and a lack of foreign exchange reserves due to protecting a currency peg in Bolivia. And in Egypt, commodity price shocks, a lack of commitment to freely floating the pound, and inadequate FX reserves have kept sovereign debt in distressed territory for some time now.

While we are not necessarily forecasting a wave of sovereign defaults in the emerging markets to materialize, we wanted to further highlight this potential tail-risk to not only the global economic outlook, but also to our constructive outlook for emerging market currencies. We highlighted this risk when we touched on rising debt service burdens, but another round of sovereign debt defaults was a concern shared by public and private sector analysts that we took away from our time at World Bank and IMF 2023 Spring Meetings. We should note that of the countries with debt currently trading in distressed territory, none of these countries in isolation are large enough to disrupt global financial markets nor investor sentiment towards emerging markets. However, should all of these countries default in aggregate, financial market disruption could be severe. Last year, we did a deep dive into individual countries that could be vulnerable to sovereign default based on underlying economic fundamentals. In the near future, we will update this framework and take a forward-looking view on where sovereign debt dynamics could be set to worsen materially and which countries could be at risk of default. Should we feel that more countries—both systemically important sovereigns and countries less influential over global financial markets—are at risk, we could look to incorporate default risk into our currency forecasts. However, to reiterate, we remain optimistic on the path ahead for emerging market currencies, and sovereign default risks only represent a vulnerability for the time being.

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