International Commentary — March 22, 2024

Is Peak Emerging Market Debt Distress in the Past?

Summary

In mid-2022, we published a series of reports focused on sovereign default risks in the emerging and frontier markets. Takeaways included how tighter monetary policy, a strong dollar and global economic malaise were weighing on developing nation's ability to service sovereign debt obligations. During the middle of 2022, we believed credit rating downgrades and a wave of sovereign defaults were likely to materialize. While sovereign stresses indeed mounted over the course of 2022 and 2023, we now believe the most challenging period for emerging and frontier market sovereigns is over as sovereign debt profiles and asset positions have improved. Going forward, should our outlook for central bank policy rate cuts and a weaker dollar come to fruition, sovereign default risks could ease more substantially over time.

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Emerging Market Sovereign Default Risks Are Receding

Not long ago, the global economic backdrop offered serious challenges for emerging market countries. Dynamics surrounding monetary policy, financial markets, global economic growth and politics were less than ideal for stability in the developing world. Which is likely why—combined with economic mismanagement at the local level—so many emerging and frontier governments experienced sovereign debt repayment issues over the course of 2022 and into 2023. In fact, during the summer months of 2022, we published a series of reports focusing on sovereign debt dynamics in emerging markets. We pointed out how debt servicing costs had risen considerably despite overall debt burdens being lower relative to advanced economies. We also highlighted that an elevated number of governments across the emerging markets had debt trading at distressed levels, and probabilities of sovereign default and credit rating downgrades were elevated. We even went so far as to identify which countries were at risk of default in the near future as a difficult global landscape was likely to persist for the time being. Fast-forward to 2024 and the problems that once weighed on emerging sovereign repayment capacity have not completely disappeared but, in our view, have subsided. Central banks around the world, in particular the Federal Reserve, have ended tightening cycles and are approaching interest rate cuts. The U.S. dollar, while still strong relative to historical levels, has broadly slowed its pace of appreciation and is off recent highs. Global growth has been resilient, and the political and social volatility that spawned from cost of living pressures has also cooled. While the global economy is not without challenges and uncertainties, we believe the global landscape has evolved in a way where emerging market sovereign default risks have come down and the most challenging post-COVID period for widespread sovereign stress in the developing world is in the past.

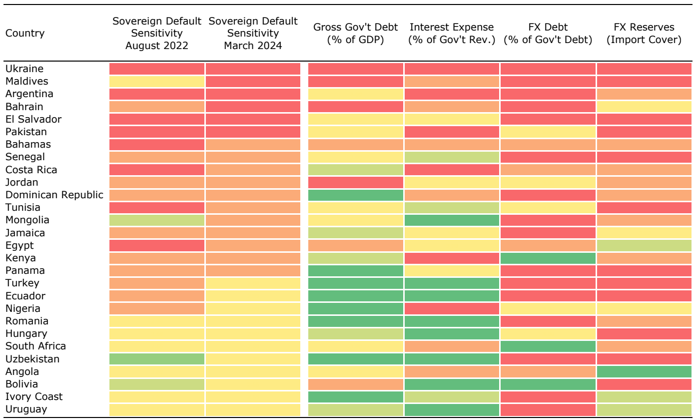
In August 2022, when the global backdrop was arguably most concerning for emerging markets, we developed a framework to identify sovereigns potentially at risk of default. In 2022, our analysis was useful to highlight at-risk sovereigns, some of which did ultimately miss debt payments, but also nations likely to experience crisis conditions in the near future. We recently updated this framework not only to get a sense for country-specific default risks, but also to discern the overall direction of sovereign stress. As mentioned, we believe the direction of sovereign credit risk is on an improving trajectory, a view supported by our analysis of the global economy but also revealed by our sovereign default framework. Our framework is built around four indicators that we believe appropriately capture debt repayment capacity. These indicators are centered around the sovereign debt profile as well as components of the sovereign's asset position, and include:

- Gross Government Debt (% of GDP)
- Interest Expense (% of government revenue)
- Foreign Currency Denominated Debt (% of total outstanding sovereign debt)
- Foreign Exchange Reserves (months of import coverage)

We selected these metrics to assess the size and cost of sovereign debt burdens, the currency composition—local currency vs. foreign currency—of government debt to ascertain sensitivity to dollar strength, as well as liquid reserve assets that can be used to service coupon payments or make maturity payments. As far as the methodology for our framework, we use a scorecard approach to aggregate these variables and determine an overall level of sovereign default sensitivity. Our framework incorporates IMF forecasts for each indicator. We then use IMF projections to create a rolling 12-month forecast to ensure a forward-looking view of the evolution of sovereign debt profiles and asset positions, rather than where these metrics stand today. We also selected a very specific universe of countries to analyze. Our framework is designed to capture the more systemically important emerging market nations—such as China—as well as some of the largest and most liquid frontier nations, such as Nigeria. While frontier economies may not be systemically important the same way countries like China are, should one or more frontier sovereigns in our universe default, financial markets could be briefly rattled. And finally, we excluded sovereigns that are currently in default, such as Zambia and Sri Lanka. While these sovereigns would flash as highly at risk, we left these countries out of our universe in an effort to identify only new sovereign default candidates.

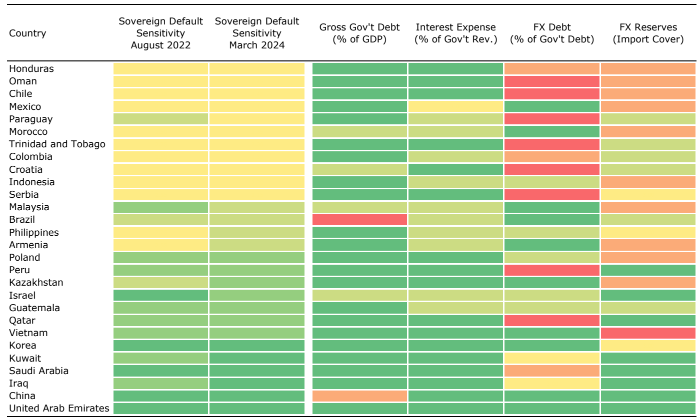
The results of our updated framework are in the following tables, and more specifically, in the "Sovereign Default Sensitivity March 2024" column. As far as how to interpret the analysis, sovereigns at the top of the table and highlighted in red and orange (Figure 1) are most at risk of default or experiencing a form of sovereign stress based on the indicators included in our framework. According to our framework, Ukraine is most at risk—which makes intuitive sense, given the ongoing military conflict with Russia—followed by The Maldives, Argentina, Bahrain, El Salvador, Pakistan and so on. We also include the forward-looking assessment for each of the indicators built into our framework and how countries fare on each variable. Using Pakistan as an example, debt levels are only moderately elevated and sovereign debt is more or less balanced between FX and local currency denominated debt; however, debt servicing costs are high and central bank FX reserves are dangerously low. When we aggregate these variables, we determine Pakistan has an elevated default or sovereign stress risk based on a weak debt profile and limited external asset buffers. Indeed, Pakistan has been on the brink of default for years and has turned to the IMF on multiple occasions for emergency funding to avoid missing debt payments. Pakistan showing up toward the top of our list is comforting in the sense that our framework and methodology is still practical and has a degree of being able to predict sovereign crises to it. On the other hand, there are plenty of sovereigns our framework identifies as having little default risk (Figure 2). These countries are highlighted in green with the United Arab Emirates exhibiting the least amount of default risk of the countries in our universe. The UAE has an ideal sovereign debt profile—low debt that is mostly denominated in local currency—while central bank FX reserves and sovereign wealth fund assets are more than adequate to act as buffers. Other sovereigns, such as China, Saudi Arabia, Kuwait and Qatar, also have limited sovereign stress risks.

Figure 1 - High to Moderate Default Risk



Source: International Monetary Fund, Institute of International Finance and Wells Fargo Economics

Figure 2 - Moderate to Low Default Risk



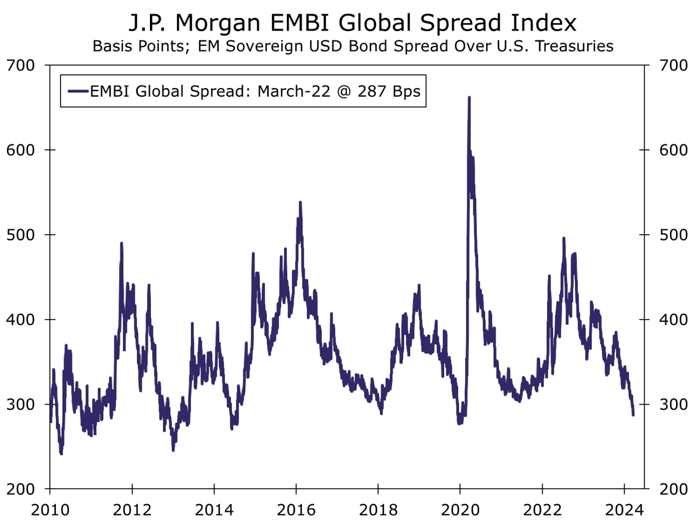
Source: International Monetary Fund, Institute of International Finance and Wells Fargo Economics

While identifying countries with elevated or little default risk is certainly a worthwhile exercise, examining sovereign default risk for the entire developing world is arguably more imperative at the moment. And according to our framework, generally speaking, default risks across the emerging and frontier markets are receding. To make that assessment, we compared our framework's current assessment to the output from our original analysis in August 2022, which we show in the "Sovereign Default Sensitivity August 2022" column above. Our framework identifies 12 sovereigns where default risks have retreated. At the same time, default risks have risen in only eight sovereigns, suggesting debt profiles and asset positions have broadly turned a corner, and at a high level, overall sovereign stress risks are lower relative to mid-2022, when stresses were arguably at a peak. In addition, the composition of the countries where default risks have changed is interesting, and we can draw a similar takeaway. Costa Rica, Egypt, Turkey, Ecuador, Nigeria and Kuwait are examples of countries where sovereign stress risks have fallen. In aggregate, the economies our framework identifies as less likely to default have a nominal GDP worth ~3.5% of global GDP. On the other hand, The Maldives, Bahrain, Mongolia, Bolivia, Malaysia and Israel represent select sovereigns our framework identifies as where default risks are rising. While certain sovereigns from this group—particularly Malaysia and Israel—are sizable and could disrupt markets should they miss payments, the majority of this set of economies are relatively small. In aggregate, sovereigns that have seen default risk rise—including Malaysia and Israel—have a nominal GDP worth a little over 1% of global GDP. Point being, a greater number of countries, as well as larger and more systemically important sovereigns, have seen risks of a credit event ease since the middle of 2022, giving us more confidence that overall EM and frontier default risks are moderating.

Financial markets seem to agree with our framework's results. Year to date, the J.P. Morgan EMBI Spread—an index designed to measure the basis point spread of emerging market sovereign dollar bond yields over U.S. Treasuries—has fallen noticeably. To that point, the EMBI Global Spread is down

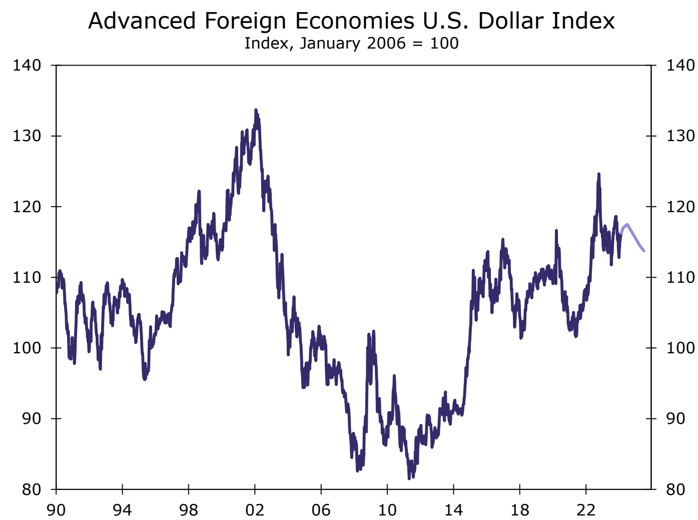
32 bps this year on top of 200+ bps of narrowing since the index's high point in mid-2022 (Figure 3). In fact, emerging market sovereign spreads are currently the narrowest they have been in the post-COVID era and are approaching pre-COVID levels. Of course, this is not to say that no government could default on their sovereign bond obligations in the near future. Our framework does suggest that vulnerabilities exist as many emerging and frontier nations are exposed to dollar strength through a sizable portion of foreign currency denominated debt, while FX reserve positions are not quite sufficient, broadly speaking. While these vulnerabilities are unlikely to disappear, we do believe these vulnerabilities will not trigger broad repayment capacity issues nor another wave of sovereign defaults at this time. To that point, we believe the U.S. dollar is set to cyclically weaken over the second half of 2024 and into 2025 (Figure 4). In our view, dollar weakness will be a function of Federal Reserve interest rate cuts and an easing of global financial conditions that creates a risk-on sentiment among market participants. Should dollar depreciation indeed materialize, dollar-denominated coupon and maturity payments will become more serviceable and exposure to FX debt may actually become a positive characteristic of many sovereign debt profiles. Dollar depreciation may also lead to central banks replenishing FX reserve stockpiles. Should local currencies experience appreciation pressure, central banks would have little rationale to intervene in FX markets to further support their respective currencies. In this scenario, FX reserve accumulation could occur and asset positions would improve. As mentioned, the EMBI spread index is approaching pre-COVID levels, and if our longer-term U.S. dollar outlook plays out, spreads could fall below January 2020 levels.

Figure 3



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

Figure 4



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

We developed this framework as a starting point to identify sovereign default risks. Of course, our framework does not include all metrics of debt and fiscal sustainability nor does it pick up risks related to the political will to repay debt. Our framework also does not fully capture governments that receive donor support from friendly nations or any future financial assistance from programs agreed to with multilateral institutions such as the IMF. If we include friendly nation support, Bahrain may have inherently less default risk. Bahrain is toward the risky end of our framework's assessment; however, the government receives significant financial support from Saudi Arabia that reduces sovereign default risk substantially. If we were to include official sector support, countries such as Pakistan and Egypt may move toward having less sovereign default risk, as both the governments are working with the IMF and currently receiving funding disbursements. We purposely exclude multilateral lender programs as there is always a risk governments cannot meet economic targets and disbursements end suddenly. There is also a risk that financial support from other countries dwindles or tensions build in a way that alters the nature of relations between countries. Separately from our analysis, we would not be shocked if smaller non-systemically important countries not in our sample universe (such as Laos) defaulted on its obligations in the near future. While any sovereign default is significant in some sense, a Laos default may not carry the same amount of weight as the countries in our framework and would likely have only very limited impact on broader global financial markets.

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