GEMs Viewpoint

Dispatch from Morocco

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GEM Fixed Income Strategy & Economics
Global

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Ugly sentiment in beautiful Marrakesh

We hosted our Small Talks conference along the IMF meetings in Morocco last week. Higher for longer is eroding HY market access and raises doubts about priced-in terminal rates. Fiscal is bad around the world. Finally, this is sinking in, and investors are increasingly wondering whether higher for "longer" becomes "forever". Sentiment at these meetings was similarly poor as one year ago where fiscal has taken over from inflation as the main worry – back then, a major rally wasn't far off. We don't think we are quite there yet but we see a cyclical buying opportunity for EM approaching in 1H24.

Asia: doing relatively better than other regions

There are three broad trends on growth: 1) Asia opened up relatively later than elsewhere, giving rise to a late rebound, e.g. in China. 2) External demand has been a drag, especially when the US rebalances towards a more balanced trade position in goods and services. 3) China grapples with property market correction. The rest of the region mostly have modest tightening in monetary policy and fiscal retrenchment.

EEMEA: lots of alpha opportunities

Türkiye sentiment much improved on policy steps and communication with investors. Egypt IMF review to pass in Q1, with more IMF funding. Ukraine macro improving, but financing risks rising. In CEE, revise NBH cut for Oct to 75bp from 100bp. Keep CNB cut for November. Very constructive meetings on Serbia, Montenegro, N Macedonia. Still expect another SARB hike.

LatAm: elections remain center stage

Most of the region have embarked on an easing cycle. However, fiscal and inflation concerns are preventing rate cuts in Mexico and Colombia. Argentina is under high stress ahead of its presidential election, given wide imbalances, high inflation, negative international reserves, and lack of policy anchors. In Ecuador, the macroeconomic policies can look very different in the coming years depending on who wins the election.

Debt restructurings: incremental progress

There has been better than expected progress on the technical work related to the architecture of sovereign debt restructurings, along with some progress on countries already in default. But comparability of treatment remains a major sticking point. Despite incremental progress, investors remain frustrated by the long time frame of debt restructurings.

Refer to important disclosures on page 14 to 16.
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Global View

Reforms and development in a high dollar rate environment

The global economy is recovering from many shocks, especially supply shocks that pushed up inflationary pressure. Meanwhile, growth is both slow by historical standards and uneven across regions and countries. The divergence of economies is becoming more evident, which makes it more difficult to generalize the trend. In a world where financial conditions are tighter and funding costs are higher, EM resilience is nothing but surprising. Such risks could be on the rise if the dollar remains strong and rates are higher for longer. The challenge is there is smaller space left for fiscal expansion and monetary policy becomes more difficult for domestic purposes. For structural reforms, pollical economy makes them rather difficult.

Global financial stability

Against a gloomy growth outlook, high core inflation, continued rate hikes, fiscal concerns and geo tension all raise questions on financial stability. But US and European equity markets held up quite well, which leads to more uneasiness about the consensus on soft landing. Cracks in the financial system may turn into worrisome fault lines should a soft landing of the global economy hoped for by market participants not materialize. In China, weakening economic momentum, a deepening property sector downturn, and growing strains on local government financing weigh heavily on market sentiment.

Asia

APAC outlook: doing relatively better than other regions

The general picture is gloomy, but Asia is doing relatively better than other regions. There are three broad trends on growth: 1) Asia opened up relatively later than elsewhere, giving rise to a late rebound, e.g. in China. 2) External demand has been a drag, especially when the US rebalances towards a more balanced trade position in goods and services. 3) China grapples with property market correction. Inflation-wise, Asia is at a comfortable spot, with outliers in China and Japan. The rest of the region mostly have modest tightening in monetary policy and fiscal retrenchment.

ASEAN outlook

ASEAN policy makers and observers have a more optimistic take on ASEAN growth relative to external peers with regional growth in ASEAN +3 expected to be 4.3% this year with the possibility that China could deliver 5% growth. This is more positive relative to consensus. The weakness seen in China is focused in the property developer sector, though it is recognized that China's manufacturing PMI is weak and export demand is disappointing, though there are some signs of stabilization and potential improvement. Additionally, there are some signs of stabilization in China's property market that should help stabilize regional growth prospects.

ASEAN is also expected to be better with Vietnam, Singapore, Malaysia and Thailand well-positioned to benefit on external demand recovering as China opens up. Another positive aspect is that ASEAN still has fiscal space, however, this needs to be put in the context that the Fed interest rates could be higher for longer. This could put upside risks to financing costs and add to risks of global financial instability. But there is still an opening for ASEAN countries to ease ahead of the Fed as their inflation performance is better. Much will depend on the US achieving a soft landing. There is also a sense that if the Fed does hike interest rates again that ASEAN policy makers should not follow through with additional rate hikes, especially Indonesia, Malaysia and Thailand, where the output gaps are still potentially negative.

The policy dilemma is FX depreciation pressure is still present and policy makers do not want this to overshoot and destabilize portfolio flows. For this reason, there is still a robust effort to smooth volatility. Another regional development is that it is looking more inward. Global trade volumes fell post GFC, but intraregional trade volumes picked up. As long as there is global de-risking from China rather than decoupling, ASEAN is likely to be a beneficiary.

On ASEAN fiscal policy the advice is to improve the fiscal space further as growth dynamics are improving and requires less fiscal support. On Indonesia, as long as the economy is doing well, they will be unlikely to cut, according to policy observers. But even more unlikely to cut is the Philippines, as there remains a risk of inflation getting entrenched. On Thailand, they have hiked aggressively, but this is also motivated by financial stability issues and high household debt, though this is not seen as a systemic risk.

Asia Sovereign Rating Outlook

In general terms, ratings agencies have a stable rating outlook for the region. However, it is noted that APAC has not made much of a progress on fiscal consolidation following the pandemic. Relative to the pre-pandemic forecasts, sovereign debt loads have risen substantively and understandably. For example, Thailand's debt to GDP went up 20%. For Fitch, only Vietnam is on a positive outlook and is at double BB, as they are a little below their peers. However, their challenge is the debt issues in the property developer sector.

With respect to negative outlooks, Fitch has Bangladesh and Maldives on negative due to their poor external positions. On the positive side, credit agencies are getting questions on whether Indonesia and India and whether they deserve an upgrade. However, one pushback credit agencies have on Indonesia is that they have yet to see the positive spillover from the investment into upstream commodity production spillover into better fiscal numbers. On India, the issue is that debt interest payments are still quite high.

For Moody's, there appears to be a lot of headwinds for APAC going into 2024 due to the mix of commodity price performance and a disappointing tech cycle. One issue is ASEAN's exposure to China and the downside for them, especially if global rates are higher for longer. More domestic demand stories in India and Indonesia may do better. Other countries in the rest of the region in greater problem if we get recession in global economy. Indeed, the medium-term issue is if China growth is lower due to a structurally lower growth and weaker development sector.

For S&P, their key negative outlook is on Bangladesh. With respect to rising commodity prices, they believe that Indonesia is least likely to suffer, but the Philippines is at risk as they are not allowing their exchange rate to adjust sufficiently amid higher oil prices – this could ultimately result in balance of payments issues. The other alternative is that the Philippines could see weaker infrastructure spending, which could help the BoP. Nonetheless, the issue is how do they pay for their ambitious infrastructure plans. They are aware of the risks, but the financing costs are manageable for the time being and they are looking at creative solutions such as a Sovereign Wealth Fund to support their ambitious infrastructure investment plans.

Indonesia: focus on prices and FX stability

The macro construct for Indonesia remains reasonable for policy makers, who expect China to deliver 5% growth this year and for the US to avoid a recession, though this may mean the Fed could only cut in October 2024. With this backdrop in mind, policy makers are focused on maintaining price and FX stability. On this point, they remain concerned that IDR depreciation could result in inflation pass-through. In order, to maintain FX stability they have introduced Bank Indonesia Rupiah Securities (SRBI bills) to attract inflows and ensure that domestic liquidity is neutral. Thus far, the take-up by foreign investors is low (estimated at 7% of IDR10trn of issuance), but the ambition is to have foreign ownership in line with the foreign ownership of Indonesia's government bonds. There is very much a focus to build up the market infrastructure and dealer participation for this instrument.

There are also ambitious aims for infrastructure investment that need to be financed. For this reason, macro prudential policy is being targeted to help encourage investment in key industries by lowering the Reverse Repo Rate (RRR) for banks lending to these sectors. On the issue of FX export proceeds repatriation, an estimated USD1.5bn has come in so far and another USD1bn is expected by year end. The other operational tool that they have is the Domestic Non Deliverable Forward (DNDF) book, but usage has been limited as the banks appear less eager to participate.

In terms of their monetary policy tools and financial assets, there is still a concern that Treasury bonds are not liquidi enough to support monetary policy tools and efficient pricing as they also reflect government credit risk and pricing. For this reason, they are focusing on creating new monetary policy instruments and assets that will help capture market inflation expectations. For now, policy makers are very focused on their business survey of inflation expectations, which is at 3.1% currently. There is a desire to see this drop further within the inflation target band of 2-4% for a sustained period of six months or more. This would be one pre-condition for a potential rate cut. The reality for now is that relatively high rates are required to stabilize the FX market and portfolio flows, even though the output gap is still negative.

Pakistan. Fiscal reforms to continue

Pakistan is closely monitoring and implementing the IMF's standby agreement, which entails maintaining a primary surplus. Pakistan continues to look closely at its expenditure tightening efforts, which includes recurrent and development expenditures. The issue with the recurrent side of expenditure are the debt service liabilities and elevated financing costs. On revenues, Pakistan is achieving higher revenues than expected for the first three months. The Federal Board of Revenue agency is being reviewed for reforms to enhance its tax collection efforts. One proposal is to separate tax policy and tax collection and administration, so that there can be greater focus on efficiency and reduce tax distortions.

On the collection agency, new documentation is being introduced for tax information collection to expand the tax net. Pakistan has already widened its tax collection population by two million people and could increase this number if its digitalization efforts bear fruit. There is also an ambition to broaden the tax base as the import slowdown has seen that this tax revenue source that accounted for 50% of revenues underperform. As a result, the IMF targets are on track.

The existing IMF program will run until February (which had an initial release of USD1.3bn), the second review is due in early November, which will be followed by a third review. The election commission has said election would occur as early as January. Nonetheless, Pakistan has a strong commitment to the program and has every intention to request a continuation of the IMF program after the election. The reality is that the next government will still likely be a coalition government and will need to form a consensus and commitment to reform.

The next Eurobond maturity for Pakistan is in June, which is the focus of many investors and is trading around 80. Some market participants propose that the central bank could buy back this debt on behalf of the government to improve its financing costs. The central bank's reserve position has improved and is at about USD7.6bn, including deposits it is closer to USD13bn or 1.5months of imports. The priority is to strengthen the FX reserve position of the central bank. Officials are aware of the discount on the bonds and will examine its FX reserve performance. The issue is the volatility of commodity and oil prices that could increase import costs, so FX reserves buffers are critical on a forward-looking basis.

The priority of the caretaker government is to maintain fiscal and financial discipline in the country, and they don't want to derail the economy. They recognize that the incidence of poverty has risen and there is a need for an improved social safety net policy and program. Ideally, progress on a debt relief program by the G20 would be helpful; the prior suspension of debt servicing under COVID was helpful, but this has ended. Nonetheless, Pakistan has to go on the assumption that it has to remain committed to its reform program.

Philippines: constructive outlook

The overall policy outlook for the Philippines is constructive, though there is still a focus on maintaining FX stability and a further rate hike cannot be ruled out if inflation surprises further to the upside.

Policymakers are still encouraged that inflation expectations are still anchored, according to their survey data. However, rising oil prices and El Niño still pose a risk with 70% of their inflation subcomponents still above target.

Nonetheless, policy efforts are underway to secure food imports to lessen the supply side shocks. There was an attempt to guarantee rice prices, but this is being reversed as better policy responses are being adopted.

There remains a policy recognition that FX smoothing is necessary to reduce FX inflation pass-through risks and it was observed by market participants that USDPHP 57 was holding. That said, policymakers understand that there needs to be some FX adjustment in the context of broad USD strength.

The current account deficit continues to be wide, but from a policy standpoint, this is viewed as financeable and desirable to achieve growth objectives. Moreover, the Philippines still has fiscal capacity to borrow and their services sector and exports continue to grow and provide a viable growth strategy.

EEMEA

CEE: hawkish CNB, NBH; fiscal concern but no major risks

NBH to slow pace of cuts, CNB November cut a close call

Our discussions in Marrakech suggest a more hawkish bias at the Czech National Bank (CNB) and the National Bank of Hungary (NBH) than we thought. We thus revise our call for the NBH to cut by 75bp on 24 October (from 100bp previously), but opt to keep our forecasts for the CNB to cut by 25bp on 2 November by 25bp despite it being a very close call. We maintain our call for YE2023 base rate in Hungary at 11%, and Czechia at 6.50%, YE2024 at 6.50% and 4.0%, respectively.

For the CNB, a part of the central bank, particularly Governor Michl, is concerned about the difficulty of communication to the public when October CPI is set to accelerate, and the release date is a few days after the November decision. The other part is not comfortable that if the start of the easing cycle is delayed till 2024, a big rate cut would be needed. But we see increasing efforts by the central bank in warning the public about this technical inflation spike. The CNB blog post on 11 October is a likely sign that Michl and Board member Prochazka are keeping the option open for a November cut.

For the NBH, we sense a strong signal to the market that the commitment to FX stability is intact, and with that the NBH want to keep real rates high. There is also a wish to benchmark Hungary real rates against Czechia. This likely means a slower pace of rate cut from the 100bp monthly steps in the first phase of the easing cycle. We think 75bp may be a good compromise for the NBH to deliver on its guidance to the market and support the HUF, while still progressing in the easing cycle in a meaningful way in view of the visible disinflation trends and the weak economic growth.

Fiscal uneasiness offset by some financing comfort; no risks to credit ratings
Budget gaps have been revised up across the region, but investors are not particularly concerned about financing. In Hungary, there is some optimism that EU funds will be unblocked before year-end. The government is still fully committed to a deficit target of 2.9% of GDP in 2024, as Fidesz will try to steer clear of the EU's Excessive Deficit Procedure (EDP).

In Romania, investors are critical of the slow fiscal consolidation progress and lack of adjustments in the current account. The government is trying to get the EU's approval for the deficit target to be revised up to 5.5-6% of GDP in 2023 and c.4-4.5% in 2024. However, fiscal financing provides a lot of comfort. The borrowing need for this year is largely covered with no plan for more Eurobond issuance, while the cash buffer is c.EUR3bn above the desired level. For 2024, depending on the final deficit target, external issuance may be in the range of EUR6-7.5bn, from EUR9.6bn in 2023. There remains good demand from local and foreign investors for Romanian bonds.

Despite some concerns from rating agencies about weaker fiscal paths and increasing downside risks to growth in CEE, we do not see major risks to credit ratings. EU funds and the Recovery and Resilience Program remain an important anchor for Hungary and Romania, with the latter also benefiting from a better growth backdrop.

South Africa: closer to a hike than cuts

Key focus of discussions were largely on monetary policy outlook. Inflation moderation has been short-lived with near term upside risks stemming from oil, food and ZAR weakness. Near term inflation forecasts likely to get closer to the upper end of the 6% target than the 4.5% mid-point. Given the near term weakening of inflation outlook, SARB could hike policy rate in November. Policy rate cuts are not yet on the agenda.

Over the course of 2024, inflation likely to be around 5%.

Broader fiscal concerns remain going into the mid-term budget policy statement on November 1. Potential use of funds from the Gold and Foreign Exchange Account kept at SARB on behalf of the National Treasury is a possibility rather than an impossibility. Timing is less certain. Discussions are ongoing and require buy in from the central bank and ensure any partial drawdowns do not harm the central bank's capital position.

South Africa ratings remain comfortable in BB category despite weak economic performance and fiscal deterioration. More room to absorb current risks before worrying about downgrades.

Ukraine: improving macro, worsening risks

The macro data has surprised on the upside in terms of GDP, inflation and reserves. Demand for FX has eased lately after a spike during the move to a managed float. Russian assets likely to be eventually used. However, at the same time, the risks have increased due to the recent delays in US funding.

Georgia: cautious central bank

The central bank (NBG) is running monetary policy in a very cautious way. The recent resignation of several members of the staff and the management team has probably added to this caution, with the new Governor likely not keen to deliver more than 50bp rate cut before year-end. There are no major concerns about capital outflows. The current account improvement together with inflows so far has brought appreciation pressures on the GEL, which is starting to raise some concerns about competitiveness. Meanwhile, we perceive a high desire for EU candidacy status, as well as a resumption of the IMF program.

Serbia, Montenegro, N Macedonia: rising investor interest

The Western Balkans countries continue to attract strong investor interest as relatively uncorrelated and fundamentally constructive stories. EU accession is becoming a more credible prospect due to the Ukraine conflict. EU financial support for the region is increasing. The development of the domestic debt markets remains a key focus for policymakers and foreign investors. Geopolitical risks in Kosovo remain the main concern, though investors generally believe tail risk will be avoided. We maintain our constructive view on these three countries.

Kenya: muddling through 2024 financing

External financing ahead of $2 billion June 2024 Eurobond payment remains the key issue. Still no market access and alternatives being explored. There are options on the table but yet to crystallize. The official lenders could step up support – IMF increasing financing through exceptional access in upcoming review, while the World Bank could increase the budget support loans. Other regional banks could provide near term financing and help stabilize FX reserves – $7 billion is seen as low mark to June 2024. Partial buyback remains on the table. However, likely into early 2024 for amounts up to $500 million. Kenya likely to muddle through and pay 2024s rather than default.

Growth outlook remains strong with authorities' official estimates of 5.5% in 2023 and 6% in 2024. Current account deficit has narrowed closer to 4% of GDP in 2023 on strong tourism receipts, remittances, lower oil prices and weaker currency constraining imports. Headline fiscal deficit in 2023/24 likely to weaken to 5.4% of GDP from initial projection of 4.4% largely due to higher debt service costs from a weakening Kenyan shilling. Primary balance target remains a surplus of 0.3% at the end of the fiscal year.

Middle East – North Africa (MENA): of oil and moral hazards

Tunisia – uncertainty prevails beyond 2023-24s

Tunisia's commitment to repay the 2023 and 2024 eurobonds is matched by the reliance on regional and international financial support to fill the external financing gap. International Monetary Fund (IMF) program talks have not resumed, economic tailwinds this year (remittances, tourism, European and regional support) may have reduced the urgency of reform and the outlook from 2025 remains uncertain. The renewal of the mandate (or not) of the Banque Centrale de Tunisie (BCT) governor is likely to be a key signal to markets.

Authorities reaffirmed their commitment to service the EUR0.5bn eurobond (maturing on 31 October 2023) and the EUR0.85bn Eurobond (maturing on 17 February 2024). Banque Centrale de Tunisie (BCT) Fx reserves remain comfortable enough to service these two upcoming eurobonds. Authorities suggest a US$0.5-0.7bn loan from Afremexim Bank is in the offing by year-end. We estimate this is unlikely to increase net BCT reserves by more than US$0.2bn.

A key risk for the February 2024 eurobond maturity is that it matures a day after the expiration of the mandate of the pro-reform BCT governor, at a time where there has been renewed headlines about proposing legislation to reduce BCT independence. Authorities suggest institutional continuity within the BCT could nevertheless ensure full repayment.

A parliamentary bloc submitted a draft law to amend the statutes of the Banque Centrale de Tunisie (BCT). The amendments being sought are broadly in line with the new Constitution and reduce BCT independence by a) allowing direct purchases of government debt instruments; and b) by allowing monetary financing of the budget upon Cabinet demand and parliamentary approval, although within some limits. The financing cannot exceed 5% of GDP of 20% of budget revenues of the last three years. The financing should be for a three month renewable period, as long as it is reimbursed within 12 months of it being extended. The cost of the financing is defined through a Ministry of Finance and BCT agreement, and on the basis of market interest rates capped at 4%.

Potential amendment of BCT statutes does not bode well for IMF talks and raise medium-term credit risks for eurobonds. Recall that BCT allowed direct monetary financing in 2020 on an exceptional basis only. It is thus unclear if BCT governor Abassi will have his mandate renewed. While BCT Governor Abassi and the rest of the administration are likely to oppose the measures by principle, we think they could eventually relent in practice due to political pressure. Forthcoming BCT engagement with Members of Parliament on 1 November could nevertheless yield some amendments.

Servicing the 2025 eurobond maturities (US$1bn Eurobond maturing on 30 January 2025) will require sustained reform momentum within an IMF program or continued financial support by international or regional partners. Authorities are looking to raise US$2-2.5bn in external financing in 2024, independent of an IMF deal.

An IMF mission is due to visit Tunis for article IV consultations over 5-19 December. IMF program talks have not resumed, authorities have not yet submitted a revised program, and the new Prime Minister (PM) has not yet engaged the IMF.

President Kais Saied remains, seemingly ideologically, opposed to IMF reforms, and this opposition is likely to extend beyond the October 2024 presidential elections. The union's wage bill has helped contain the fiscal deficit but could lead to social pressures given the high inflation backdrop. Despite the importance of Tunisia within the border refugee crisis, continued financing by multilateral and bilateral lenders in the absence of reform appears sustainable. This is because it effectively is likely to only increase their exposure to an unsustainable macro backdrop and potential losses while reducing exposure of commercial lenders and keeping them whole.

Egypt – buying time

We expect the International Monetary Fund (IMF) program to be upsized from US$3bn to between US$5-6bn in 1Q24. Alongside likely greater EGP flexibility post-presidential elections, this should lead to the IMF Executive Board approval of the delayed first and second reviews in 1Q24 (unblocking US$0.7bn in tranche disbursements). We expect an IMF mission visit to Cairo at end-October, which is likely to result in a Staff-Level Agreement on the delayed first and second reviews. Talks on a US$1.3bn Resilience Trust Fund could resume next year. We understand no additional Gulf financial support is forthcoming in the coming period. An upsized IMF program could likely delay credit concerns to 2025, but a sustained reform momentum is necessary given the peak in external debt amortizations in 2024 and 2025.

Authorities aim to improve external liquidity receipts in the coming period. Authorities suggest that US$2bn in asset sales agreed to in late June and another US$0.6bn asset sale proceeds could be received by November. Authorities intend to raise by year-end US$0.5bn in guaranteed Panda bonds, US$0.5bn in guaranteed Samurai bonds, and US$0.5bn in a syndicated loan guaranteed by Kuwaiti-based Dhaman.

The Israel-Gaza conflict could lead to economic pressures on Egypt due to lower gas imports (and, in turn, re-exports) and potential refugee flows. However, we think this could result in greater economic support to Egypt from the international community.

LatAm

Brazil: cutting rates but focusing on fiscal

Brazil (together with a few countries) has been leading in terms of interest rate cuts. So far, the Brazilian Central Bank (BCB) has delivered two cuts of 50bp and the bar for a change in the easing pace in the short-term remains high. Cuts of 50bp ahead remain the most likely scenario. The likelihood of an acceleration in the easing pace, which have been discussed by market participants for a while, declined following the pick-up in US yields. While the likelihood of a deceleration in the monetary easing pace ahead increased, our baseline remains that rate cuts won't accelerate.

Key focus remains on the fiscal front with discussions about which revenue measures are going to be approved in Congress ahead and about the potential deviations to the primary fiscal target next year. The administration remains committed to improving Brazil's fiscal situation ahead. One discussion that is gathering investors' attention is the potential solution for the outstanding of court ordered debts (Precatórios).

Overall, investors believe that following the recent sell-off in local rates, there is room for yield compression but the potential move remains conditional to the behavior of US Treasuries. On the BRL front, investors are discussing if the increase in the flow of dollars due to strong crops could be structural.

Mexico: BANXICO closer to hike than to cut

The main topics regarding Mexico were BANXICO's next steps and the 2024 fiscal deficit.

BANXICO said inflation is falling but risks remain to the upside, and therefore the plan is to keep the policy rate at 11.25% for an extended period of time even as inflation keeps falling. BANXICO is looking at local pressures to inflation from strong growth and now also from the increase in the fiscal deficit announced for 2024. BANXICO mentioned that the increase in cost of production services has not all passed through consumer prices yet. Core inflation may be more persistent than previously thought. Another source of pressure to inflation arises from the likely reversion of non-core inflation to its mean, rspecially given that energy and food prices are under pressure globally. Our baseline is that BANXICO will remain on hold for many months and only cut after the June 2024 election. Given strong growth and upside risks to inflation, we believe that the risk in the short term to the policy rate is to the upside, and the central bank agreed that the next move could be up and not down if risks to inflation materialize.

On the fiscal posture, the discussion centered around the persistence of the deficit. Most investors see the increase in the deficit as a one-off in a country that has fiscal space. But the IMF, some investors and we believe that the increase in the deficit was unnecessary given the economic boom and that a fiscal consolidation is needed in order to take away pressure on inflation and hence on interest rates. The current policy mix with tight monetary policy and lose fiscal policy, in a context of tighter global financial conditions and higher term premia in core rates, could lead to unnecessary interest rate costs down the road which could deteriorate the fiscal position more.

Chile: fiscal and monetary easing, but CLP weakness a risk

The government is expected to present the details of the fiscal pact shortly (though we expect the tax reform not to be discussed in congress before March. The government continues negotiating common ground for the pension reform with concessions. Investors perceive slow progress on reforms due to fragmented progress. New constitution is being rejected in the polls. If not approved in December, there is unlikely to be another pension draft process.

The government expect a recovery of GDP next year of 2.5% percent. Fiscal policy is moderately expansionary and BCCh is easing. The macro adjustment (reduction in consumption and inflation around 5%, from peak 14%) is happening more or less as BCCh planned, but with new risks emerging.

On monetary policy, BCCh is sounding more cautious/less dovish, in particular due to risks associated with CLP that has depreciated overt 10% in three months, (and higher global interest rates). Still, BCCH has kept the forward guidance of 7.75%-8% policy rate by December (from 9.5% now). Recall BCCH cut rates 100bp in July and 75bp in September.

Current account deficit also declining to ~4% from 9% of GDP.

Argentina: Unavoidable adjustment after the elections

Argentina is under high stress ahead of its presidential election, given wide imbalances, high inflation, negative international reserves, and lack of policy anchors. Fiscal stimulus has amplified these stresses. Given policy deviations that could jeopardize future IMF disbursements (in the absence of correction policies), Argentina may need to obtain bridge loans to remain current on its obligations to the IMF later this year. Among investor concerns were a potential post-election political vacuum amid an accelerating crisis, risk of arrears to the IMF, Eurobond coupon payments in 2024 and governability challenges during the next administration. In our view, significant fiscal and FX adjustments will be needed, regardless of the winner of the elections, but could lead to dangerously high levels of inflation in the first months and a recession. Given the social difficulty of such adjustments, governability conditions will be critical to the success and longevity of the economic program.

Colombia: Keeping macroeconomic policies tight

The government is committed to respecting the fiscal rule. It is unlikely to submit a bill to Congress to propose new targets. The discussion to make changes to the fiscal rule framework is incipient, "philosophical", and related to climate change aspects. Any change would need to take place under the democratic process, in Congress. For the short-term, the government continues targeting a small net structural primary deficit of 0.2% for 2024. On the monetary policy side, the majority group of board members – who voted to keep rates unchanged at the last meeting – is particularly monitoring inflation, inflation expectations, and labor market data. They agree with the minority group that Colombia must do an easing cycle, but they are waiting for the appropriate conditions.

Peru: Monetary easing cycle will have pauses

2023 is a year of very disappointing economic growth. Incoming data is not showing convincing signals of recovery. Mining potential is huge, with a US$ 50bn project portfolio, but no projects are expected for the next few years. Inflation is trending down in a clear way, driven by lower core inflation. The Central Bank has space to cut rates. They had the lowest policy rate in LatAm during the pandemic, and less aversion to a narrowing interest rate differential compared to other LatAm inflation-targeting central banks. The Central Bank has an easing bias. It intends to continue cutting rates. But they are unlikely to do it in every meeting. There will be some pauses. El Niño is a meaningful risk for Peru, but there is no conclusive evidence that it will be strong.

Ecuador: At political crossroads

Macroeconomic policy can look very different in the coming years depending on who wins the elections. At the time of writing, no polls can be published because of the blackout period before election day. But the last data points showed Luisa Gonzalez was catching up to Daniel Noboa. Gonzalez is in favor of vindicating Rafael Correa's policies, mainly through state-led growth which would entail more expansionary fiscal policy. Noboa, in contrast, is viewed as the market-friendly candidate. But he shook the confidence of markets when he said his (hypothetical) future administration would draw money from the international reserves to fund El Niño expenditures. Noboa's economic advisers – who are orthodox economists – are likely to dissuade him from this idea.

Uruguay: resilient to Argentina crisis

The economy has been resilient due to strong credit and FDI, despite the very large impact of the drought this year. Exports more diversified now, economy more resilient to Argentina collapse, but tourism is suffering.

Fiscal discipline (especially due to the pandemic) and structural reforms (including labor reform and fiscal rule) led to rating upgrades. Fiscal target of 3.2% deficit this year likely doable as extraordinary public works disappear.

Inflation is below center of target (4.5%) from first time in over a decade. It may bounce from very low levels due to base effects.

Elections next year will be a test for fiscal policy. Lacalle Pou cannot run for second term in a row. Polls show a competitive election between center left and center right.

Central American and Caribbean

El Salvador: Investor sentiment is improving

Market prices are a testament to the substantial improvement of investor sentiment towards El Salvador. Salvadoran bonds have rallied significantly in 2023. There is acknowledgment from the investor community about the progress on fiscal consolidation. The primary surplus was 2% of GDP in 2022, and the government continues taking action to deliver further consolidation. The actions are on the expenditure side; namely, the phasing out of fuel subsidies, reduction in the number of municipalities, freezing of government wages, voluntary retirement, among other measures. Meanwhile, a path for a deal with the IMF seems to be opening up.

Costa Rica: Little to worry about

Almost everything is going well on the macroeconomic front. Growth is consistently surprising to the upside. This might lead to a upward revision of consensus estimates, soon. The incoming data is telling. The stellar performance of free trade zones (FTZs) – receiving investments from US nearshoring – are having spillovers on other economic sectors. The sectors of the definitive regime – which do not enjoy the tax benefits of the FTZs – are growing at the highest rates in over a decade. The fiscal rule continues working well, inducing the decline of the debt ratio, and monetary policy has degrees of freedom because of negative headline inflation.

Panama: Raising eyebrows on fiscal adjustment

Panama looks on track to have the highest GDP growth rate in LatAm in 2023. Nevertheless, the slow pace of fiscal consolidation is raising eyebrows. The government has relied on ad-hoc measures to meet the targets written in the fiscal responsibility law, such as a swap contract to defer interest expenditures, the extension of the fiscal year (to bring forward revenues), and – more recently – discounts to prepay property taxes. Moreover, the delay in Congress to approve the new mining contract – which entails a large increase in tax collection – is affecting investor sentiment. The consensus seems to be that without the extra mining revenues, Panama would breach the deficit ceiling for 2023, established in the fiscal rule.

Guatemala: Concerns about the social protests

The social protests that began on October 2nd are topical for investors. These protests are affecting economic activity by blocking highways and roads across the country, forcing retail commerce to shorten hours, stranding tourists, disrupting the supply of goods to urban areas, among other issues. There should be an economic impact in October, although policymakers believe that the population's purchases to hoard goods (increasing consumption) can offset the effect. Protesters demand the resignation of the Attorney General who is engaged in a confrontation with President-elect Bernardo Arevalo. A tail risk scenario discussed by investors is the possibility of Arevalo not being allowed to assume office, but this seems very unlikely according to locals.

Dominican Republic: Restrictions at Haitian border are easing

Policymakers argue that the restrictions for trade exchange of goods and services, and the mobility of people, at the Haitian border have begun to ease. This diminishes negative risks for the economy we analyzed in our Central America & Caribbean Trip Notes report. Haiti is DomRep's second top trading partner. President Abinader had shut down the border in mid-September, over a dispute about water resources. The shutdown of the border has implications for activity, inflation, fiscal, and the balance of payments. But these effects are less likely to materialize if the border conditions are gradually normalized. On the fiscal slide, it seems there will be some slippage in 2023. On the monetary side, the Central Bank has room to cut rates, but they are mindful about the interest rate differential with the US.

Restructuring and Alternate Financing Methods

Debt distress and restructurings

There was a strong awareness among policymakers that debt distress, while generally contained to lower-rated and lower-income countries, would be a lingering issue for several years. Many such countries have lost market access at reasonable rates, and need to find replacements for this private source of financing. As such, improving the architecture for sovereign debt restructurings was seen as important to not only resolving current defaults, but making future restructurings less traumatic for both debtors and creditors.

The perception among policymakers was that the Global Sovereign Debt Roundtable (GSDR), a forum convened to find common ground on debt restructurings, was making better-than-expected progress on technical work. It was hoped that such common understandings would make future debt restructurings faster. That said, the GSDR is not an executive body and its recommendations need endorsement by, for example, the G20.

The GSDR made the most progress on reaching consensus on cutoff dates, information sharing, and exclusion of short-term debt from the restructuring perimeter. This builds upon a major breakthrough during the IMF's Spring meetings, where there was an understanding that multilateral development banks (MDBs) would contribute to debt restructurings by providing net positive flows and concessional lending (instead of having their claims restructured).

The GSDR has also tackled domestic debt restructurings, where the consensus was that it may be unavoidable in some cases where debt sustainability cannot be restored solely with an external debt restructuring. Nevertheless, domestic debt restructurings must be sensitive to the risk that they could deepen the crisis, especially by impairing the local financial system.

Where consensus remains more elusive is on the definition of comparability of treatment (CoT). On this topic, there were disagreements on the appropriate formula for NPV calculations and the applicable discount rate (the latter a particularly sensitive issue for private creditors).

On the pending restructurings, there was optimism that progress on official renegotiations would soon pave the way for Eurobond negotiations. In particular, the signing of a MoU (memorandum of understanding) with Zambia's official creditors, expected to happen soon, was an important milestone. On the other hand, the announcement of a deal between Sri Lanka and China's Exim Bank caught investors by surprise, because the official creditor committee (which does not include China) has not yet reached an agreement.

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