GEMs Viewpoint

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GEM Fixed Income Strategy & Economics
Global

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The elusive Washington consensus

In contrast to last October where bearishness pointed to a contrarian rally, consensus at these IMF meetings was too mixed to suggest much conviction. Net/net we sensed optimism due to the nearing end of the DM hiking cycles and high level of yield in many markets, but this is offset by concerns about DM risk assets and the absence of compelling stories in hard currency debt in EM. Top-down, clients seem most bullish on EM rates and most bearish on hard currency spreads, with FX being mixed.

Debt restructuring: Several client concerns

The focus was the countries with defaulted debt, including Sri Lanka, Zambia, and Ghana, as well as on the future of the sovereign debt architecture. Investor concerns are slow progress of the Common Framework restructuring programs, the inability of IFI's and bilateral creditors to complete the restructurings and the stark differences in the IMF's debt sustainability frameworks for low-income vs to market-access countries.

Asia: China hesitancy, ASEAN stability, frontier concerns

Our investor meetings reflected UW positioning on Asia, but for good reasons, not bad. Investors believe in a China recovery but want more hard evidence to offset downside risks stemming from strained US-China relations. Fed peaking will open the door to move yield-differential to growth-differential investment strategies, which should benefit China, Indonesia, and India. Indonesia is about the timing of a credit upgrade. ASEAN is seen as safe, but lacking yield and FX upside. Strong focus on Pakistan and Sri Lanka. Pakistan is expected muddle through for 6-9 months. Sri Lanka is all about domestic debt restructuring and moving forward with China on debt negotiations.

EEMEA: Better opportunities in local markets

There was a big focus on Türkiye but diverging views whether credit is still cheap; we've turned neutral from bullish, awaiting FX adjustment. Still hawkish SARB underpins ZAR, front-end flattener and back-end receiver. CEE central banks push back in early cuts; still like front-end flattener/payer in Czech vs receiving back-end and short PLN/HUF. Moderately good news on Ghana and Zambia programs, in contrast to Egypt and Tunisia. Ukraine focus still on creative restructuring solutions.

LatAm: A somewhat more constructive mood

Investors are turning more constructive on the region as Brazil's fiscal framework opens the door for the start of the easing cycle, while Mexico remains the darling of the region. Signs of moderation are observed in Colombia and Chile, but still political uncertainty dominates the outlook in Argentina, Peru, and Colombia. Sticky inflation brings uncertainty about the ability of inflation targeters to cut rates aggressively.

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China: GDP rebound

Near-term macro outlook

Investors generally share the consensus view of a post-reopening growth rebound in China this year, with little push-back against the IMF official GDP growth forecast of 5.2% for 2023 (higher than government target).

People seem to agree this cycle will be different from those in the past in the sense that growth will be less driven by infrastructure and property investment, and more by private consumption.

The property space continues to attract much attention, where the IMF expects the sector to remain as a drag on growth (smaller than in 2022).

Not many are concerned about inflation. This is because the output gap is still negative for this year and next year; no labor market tightness anywhere; housing prices are not propelling inflation; import good inflation is low; energy is a small part of their basket and administered; the pork cycle has turned.

There is limited expectation on policy stimulus in the near term, esp. in the form of interest rate cuts or cash handouts to consumers.

Medium-long term outlook

Much of the discussion focused on medium to long term potential growth, where the Fund's research report shows a cautious view.

With potential growth falling from 10% in the early 2000s to sub 5% in recent years, China suffered from an unsustainable investment driven growth model, falling marginal product of capital, demographic deficits, and slowing TFP growth.

The Fund predicts potential growth to slow considerably over the medium to long term – to 4.5% in 2022 – 2027, 3.6% in 2027 – 2032, and 2.4% in 2032 – 2037.

Downside risks include decoupling in energy and high-tech sectors, higher non-tariff barriers. In aggregate GDP terms, this implies a decline of 3ppts over the medium term, and China at around 4 ppts.

The reform scenario incorporates assumptions on retirement reform, education reform, and reallocation towards services, which will lead to significantly higher potential growth in this scenario than the baseline. It could lift the level of GDP by around 2.5% by 2027 and 18% by 2037.

Sanctions and trade controls on China

There was broad interest from market participants on sanctions and controls on trade and investment on China.

There are six independent policy tools that have been loosely referred to as "sanctions": economic sanctions, export controls, tariffs, import controls, FDI controls, and reverse CFIUS. Many noticed the expansion in sanction coverage and reinforcement on China in recent years.

More restrictions could be introduced, including potential restrictions on portfolio flows on certain entitites or funds with exposure to such entities.

India: macro outperformer

India represents the fastest growing major Asian economy this year, with inflation that is expected to remain under control. Additionally, its external position over the past year is seen as being in line with fundamentals. The bottom line is that that India has been in far better position to handle the aggressive US Fed tightening cycle. The Reserve Bank of India has engaged its own more modest tightening cycle, but this policy normalization is consistent with India's growth returning to potential. Potential growth estimates vary from 6-7%. The rising interest rate cycle is unlikely to result in credit distress as bank capitalization is at 16%.

On the inflation front, there are signs of deceleration, despite a lot of volatility in the CPI inflation components. A strong decline and helpful base effect in commodity prices will help bring inflation lower. The future trajectory of Reserve Bank of India monetary policy remains a close call, but based on current inflation trends it seems that we are close or at peak policy interest rates.

The current account has improved significantly compared to last year, while the fiscal position is also looking very robust. Admittedly, they are likely to spend more on targeted subsidies, but the better-than-expected tax buoyancy is providing a windfall in tax revenues to fund this. Nonetheless, there is still a concern that India is not taking the initiative to peruse more proactive fiscal reforms and consolidation. Privatization efforts are also lagging.

On FX policy, this is still seen as being geared to preventing and smoothing disorderly movements, though some felt that India continues to have a policy preference of higher FX reserves to act as a buffer for volatile outflows and this would sustain more USD buying. With respect to the neutral real rate of interest the consensus seems to be around 1%.

Indonesia: playing safe

Policy makers in Indonesia remain focused on maintaining price stability and are unlikely to cut rates prematurely. There is also a sense that the reopening of the China economy will lessen the urgency to cut rates, despite the risks of a US recession. Aggregate demand in Indonesia is seen as improving and that the output gap is approaching zero. The recent weakness in Indonesia inflation data is not seen as a sign of softer demand, but rather the supply side starting to respond to higher prices. In addition, IDR appreciation is also helping to bring down inflation pressures.

The overall monetary stance looks well balanced as credit growth is consistent with 5% growth. However, there is still a case for more credit to be extended to SME sectors that are scarred by the COVID episode, such as textile, furniture and agriculture sectors. These sectors can still be helped with the use of macro prudential policies that are providing Bank Indonesia with scope to manage multiple policy objections. As a result, lending incentives are still likely to be in place until H2 next year.

Indonesia's policy makers remain constructive on the current account and forecast a range of +/- 0.4% and this is also supporting their positive view on IDR. They also hold an expectation that the Fed is only one more hike away from reaching a peak in policy rates. This peak in the Fed cycle is expected to bring in more inflows. Some investors expressed more concern over the ability of the bond market to absorb supply as Bank Indonesia is no longer obligated to help finance government spending through outright purchases in the primary market. Policy makers still felt they have diverse sources of funding and the Ministry of Finance is still holding high cash balances. Finally, despite central bank rate hikes, liquidity is still ample in the system, providing support for the bond markets.

On the technical and markets side, Indonesia will continue to push for central counterparty netting, which should result in a more liquid and larger repo market as well as the possibility of an active interest rates swaps market. On FX measures, policy makers are reluctant to be heavy handed on export proceeds to be remitted and are watching the development of the USD Fixed Term deposit facility to attract offshore

USD to the onshore more closely. This onshore USD facility was started in March and is off to a modest start.

Philippines: monetary cycle approaching peak

The outlook for the Philippines is positive with tentative signs that that inflation may be peaking. Thus far there has been little sign of credit stress as consequence of the tightening cycle as banks are strongly capitalized. This means that there is no urgency for the central bank to ease and that it will likely wait for three or four more well behaved inflation prints before it will consider easing interest rates. Additionally, the stabilization of PHP means that the central bank is less beholden to Fed policy than it has been. Indeed, over the past year the central bank of the Philippines has been maintaining a 100bps policy interest rate premium to the US to defend the PHP against the USD.

The return of remittance inflows, business process outsourcing proceeds and net direct investments should also help to support the Philippines external balances and stabilize the PHP. This will be important in sustaining the Philippines' ambitious growth targets of 6-7% in 2023 and 6.5%-8% in 2024. Nonetheless, FX intervention will remain part of the central banks toolkit, but will also be used together money market operations to make sure that the liquidity effects are sterilized. There is also a bias to replenish FX reserves, though this will be opportunistic. Policy makers are of the views that the recession risks in the US will be offset by China's re-opening.

Sri Lanka: IMF focus on macroeconomic stability

A Sri Lanka policy maker described that the economic crisis was due to policy missteps and economic shocks, but he believes that the IMF is particularly concerned about the poor and vulnerable who have no buffers against the shock. IMF is focusing first on macroeconomic stability and arresting the crisis with structural reforms later. An important part is anti-corruption and governance reforms, improving public financial management, and strengthening the anticorruption legal framework. The policy maker noted that the government has to implement some challenging reforms to address the unsustainable public debt which has reached 128% of GDP, with domestic debt being a significant amount. Sri Lanka is not eligible for the common framework.

IMF board approval for assistance to Sri Lanka required assurances from official bilateral creditors that they will provide debt relief to restore debt sustainability consistent with the program. Sri Lanka fulfilled the requirements of the board to allow the program to move forward. Some fiscal consolidations have already been made, including corporate and personal income tax and VAT.

Now the authorities and creditors need to coordinate to make progress on the debt treatment that will restore debt sustainability under the EFF . The policy maker believes that authorities have committed to transparency and comparability of treatment for all external creditors. He said that the IMF has four debt targets, not just one: debt stock, gross financing needs from 2027-2032, foreign currency debt service in the same period and how much debt relief needs to be achieved during the program. The IMF goal with the DSA is to show how much debt is sustainable, but the IMF does not get involve in how the burden is distributed among creditors.

The Paris club has established mechanisms for providing financing assurances in line with the IMF program, but now you have new creditors who are not used to that, and they don't know what it means to provide those assurances. China has not been as forthcoming in this regard as have other bilaterals.

Much local debt is held by the banks, so there may need bank recapitalization, but evaluation of bank exposures will not be completed until the late summer at the earliest.

Asia credit outlook: ASEAN oasis of stability amid Frontier stress

The overall rating prognosis is constructive for ASEAN. Clients continue to have an interest in the upgrade prospects for Indonesia. Ratings agencies agree that Indonesia's macro and external balances have improved a lot and Indonesia has weathered the COVID pandemic well. However, more signs of progress on structural fiscal reforms aimed at raising the revenue base are required. This is also affecting key ratios such as interest payments as a share of revenue, which is above the 15% threshold. There is also a desire to see the commodity cycle through to see how much of the export improvement is structural vs. cyclical.

Malaysia continues to be rated as BBB with a stable outlook by Fitch (a notch higher by S&P), despite ongoing concerns that the desire for fiscal reforms remains constrained by the political realities of a coalition government. There is also a focus on improving governance issues, however one thing in Malaysia's favor continues to be its macro growth performance and its diversified export base. This macro growth performance factor is playing a larger role in the Philippines debt sustainability assessment, though concerns remain over the risk of permanent scarring on human capital because of the COVID lockdowns. There was also a sense that the fiscal tax reforms have not resulted in the big boost to revenues. As such, the relative tax revenues compared with the levels of debt stock remain a concern. Because of these issues Fitch hold a negative outlook on the Philippines.

Frontiers are of obvious interest with Pakistan and Sri Lanka in focus. Overall, Pakistan is being evaluated as having a possibility of default or credit event, though the next debt maturity payment is not until next year. Pakistan's situation remains highly complex with an election cycle, FX reserves below one month import needs and the prospect of disbursements from friendly or supportive bilateral lenders. In the case of Sri Lanka the external bonds are rated as default, while local currency bonds are rated with the expectation that they are also in a real risk of default. Much will continue to depend on how and whether their local bonds are restructured.

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Czechia: strong Koruna helps with inflation

Inflation has peaked and the Czech National Bank (CNB) currently expects it to reach single digit by summer and hit target in 1H24. They believe that tight monetary policy has helped decrease the inflation. Negative real wage growth has also curbed household's purchasing power. The CNB sees a shallow recession, almost no growth this year. The man risk to their outlook is a wage-price spiral, with a potential increase in real wage growth in 2024. On the other hand, the stronger than expected CZK helps fight inflation, which is one of the reasons the central bank does not want to hike rates further from here.

Egypt: all eyes on asset sales and EGP

The near-term outlook hinges on the finalization of asset sales this quarter. This would alleviate external liquidity constraints, reduce debt build-up, ease pressure on EGP, improve investor sentiment, help meet FX reserves accumulation targets, and allow for completion the International Monetary Fund (IMF) Extended Fund Facility (EFF) program first review, in our view. Authorities project confidence that inaugural asset sales could take place by June. Still, the interlinkages between asset sales and EGP dynamics could complicate timely completion of transactions, in our view.

We expect the first review of the IMF EFF to pass, with a delay. The first review, originally scheduled for 15 March, could take place in May-June, in our view. An IMF board approval of the first review should broadly take place by end-June to interpret the program as on-track, in our view. While end-December quantitative performance criteria have been met, more questions for the review will center around the renewed lack of EGP flexibility and the delay to the finalization of asset sales. We suspect the latter two elements are interlinked. We think authorities are unlikely to allow a weaker EGP for now (particularly during Ramadan), especially as it could set an inflationary spiral while FX inflows could come in soon instead to ease external liquidity. The launch of high-yielding Certificate of Deposit (CDs) by domestic banks also seem to indicate time-bound moves to support EGP. This could nevertheless decrease banks' Net Foreign Assets (NFAs) position, and trigger further discussions further discussions with the IMF if a third consecutive month of NFA decline is witnessed.

Authorities indicate the IMF may be open to upsize the program but that there are no such discussions at this time. We do not expect an upsizing of the IMF program to take place for now. Indeed, we think it would be unusual for such a step to take place during the first program review.

Authorities appear confident that US$2bn in asset sales (transactions mainly in tourism, wind farm and two other sectors) will be finalized by June, as per the IMF program framework. Request for Proposals (RFPs) have been issued for advisory roles back in March, and a privatization unit has been set up at the Prime Minister's (PM) Office. Overall, the number of assets slated for privatization has increased from 32 to 40. We suspect the RFP issuance by the Central Bank of Egypt (CBE) for the United Bank privatization likely means a potential sale away from a strategic Saudi investor, in our view. While privatization proceeds of assets held by the Ministry of Finance (MoF) will flow to the budget, authorities are targeting a minimum of 50% of privatization proceeds of assets held by other entities to be transferred to the budget.

Fiscal consolidation remains broadly on track. The FY24 draft budget targets a primary surplus of 2.5% of GDP, up from the original target of 2.1% of GDP previously projected under the IMF program. The budget includes 0.4-0.5% of GDP in privatization proceeds. The broader fiscal stance across the public sector is difficult to track, and its impact on demand conditions unknown. Authorities guide that mega projects with completion rate below 50% are being slowed down, while those above 50% are proceeding.

Forthcoming guaranteed issuance could support FX reserves and external liquidity. Authorities are at advanced stages in preparations for the issuance of a loan guaranteed by a AAA entity and for a Panda guaranteed bond. Authorities expect one of these transactions to close by June. Some thought is being given for an external debt buy-back liability management exercise.

Authorities are committed to publishing the annual report on tax exemptions and loopholes across the public sector by end-April, as per the IMF program. This inaugural report is likely to be relatively concise in its first iteration. Nevertheless, it could provide a useful starting point for future conditionality linked to structural reforms, in our view.

Israel: solid fundamentals

The economy has strong fundamentals and very tight labor market. Inflation has peaked but was stickier than the BOI expected. They see fiscal policy as moderate and not expansionary. Public wage increase is front loaded but moderate as well. They don't see pressure from these channels on the inflation outlook. Housing market and rental prices are important, and they expect easing in prices to start soon. FX is an important factor and they believe the recent depreciation has part in inflation being higher than their previous forecasts. They see FX pass-through at 0.1 to 0.2 for 1% depreciation.

Consumption is still strong but it is slowly decelerating. They see GDP growth at 2.5% this year. Tech sector is an important part of the economy and FDI into this sector slowed down significantly in part due to global conditions and shrinking venture capital flows in the US.

Bank of Israel believes they are very close to complete their hiking cycle although the path is data dependent. The research department forecast for the policy rate is 4.75%. They believe the front-loaded hikes helped ease inflation.

Kazakhstan: inflation is not over

Inflation is the main challenge in the economy. The Central Bank sees inflation going down to single digit by end of the year after peaking in February. They see current stance as tight enough and expect to hold the rate at this level for one or two quarters. Reforms to tariffs can cause some upside risk to their forecast however they would prefer to keep rates high for longer rather than hike further in response to price pressures.

They believe that the fiscal stance is important in bringing inflation down. They expect transfers from the fund to decrease over time. The budget rule would be useful when fully implemented.

High oil prices pushed the current account into a big surplus. It will be lower this year but remain positive. Tenge has been volatile lately and appreciated sharply but they believe it will be less volatile this year.

They see CPC remaining as main pipeline for oil exports. There is potential to diversify using Baku-Tiflis-Ceyhan or through China but the volumes will likely be small.

Hungary: EU funds disbursement delayed

The meeting confirms our view that the disbursement of EU funds under the Recovery and Resilience Plan (RRP) and the new cohesion funding will be delayed, with payments likely in the fall at the earliest. Implementing the 27 'super milestones' under the RRP is key, and there are some hurdles in place. The OECD is involved in evaluating some parts of the measures and likely to provide an assessment end of 2Q. Meanwhile, the rule of law issues and pension reforms are still work in progress.

The authorities note that performance has been strong in 2021 and 2022, reaching 7 and 5% respectively supported by industrial growth. This year growth is expected to slow below 2% estimate. Efforts towards diversifying energy sources beyond gas are increasing with a push towards renewable projects. Inflation is still high above 20%. However, it's starting to decelerate and expected to be lower in 2H 2023.

Fiscal deficit is high in recent years close to 6% of GDP in 2022, partly due to one-off items related to gas costs. 2023 target is towards below 4% of GDP. Near term pressures relate to pension payments and one off repurchase of telecoms assets by government.

Poland: no rate cuts soon

Following meetings in our conference, we remain comfortable that the National Bank of Poland (NBP) will not cut rates any time soon. However, while the market expectations of cuts may not be reasonable, the likelihood of further hikes is low. If the central bank sees risks to the inflation target, they will likely hold rates high for longer rather than hike.

The central bank continues to be confident that inflation will reach single digit by November or December, and are not particularly concerned about elevated core CPI. Negative output gap and unit labor costs should help bring down core inflation, though later than the deceleration in the headline rate. Fiscal policy is not seen as a risk to inflation, as so far fiscal policy has been rather on the prudent side.

Romania: fiscal consolidation is key

IMF forecasts Romania GDP growth to slow from 4.8% last year to 2.4% in 2023. Inflation has peaked in December and expected to be 7.5% by year-end. Main drivers of declining inflation were slowdown in economy and strong base effects. However, output gap is still positive. Market rates are below the policy rate. Main reason for allowing for this was that currency was stronger than expected and the current account deficit was large. The discussions confirm general views in the market that the currency is overvalued. Capital inflows and EU funds have been the main drivers of RON appreciation. But a weaker currency would not solve the current account problem as the twin deficits are a structural problem. As long as the fiscal deficit is large, the current account deficit will also remain high.

Last year Romania reached the budget deficit target but this year the target of 3.5% may be very ambitious. That said, there are many fiscal reforms in the pipeline. If these are indeed implemented, fiscal outlook in the medium term would improve.

Tunisia: muddling through

The political backdrop remains a hindrance to reaching International Monetary Fund (IMF) Executive Board (EB) approval of the Extended Fund Facility (EFF) program, in our view. President Kais Saied's rejection of 'foreign diktats' in his latest official pronouncements complicate IMF talks and the completion of prior actions, in our view. We suspect that this reflects a fear of the social implications of IMF reforms and of protests in a backdrop of already high inflation. Presidential elections appear likely to take place around October 2024, and President Kais Saied's pronouncements suggest he will run again. The increase in Tunisian outward migration to Europe puts pressure on donor countries, in our view.

An IMF agreement does not appear imminent. We suspect that the Tunisia delegation to IMF annual meetings had a mandate to renegotiate some program conditionality, but not the ability to close a deal in the absence of President Kais Saied's approval. The Cabinet-approved State-Owned Enterprise (SoE) law is likely to be examined in the new sitting parliament as a priority, perhaps in the coming month. Any approval would deflect responsibility and reform ownership away from President Kais Saied, in our view. We suspect that authorities are examining implementing a hike of domestic fuel prices as a goodwill gesture signal to the IMF and to facilitate Executive Board program approval. Such a hike would still fall short of catching up with the missed monthly hikes since late last year. However, after Executive Board program approval, authorities could still be prepared to subsequently commit to bringing domestic fuel prices to international levels by year-end, as per the original timetable agreed within the October 2022 Staff-Level Agreement (SLA).

Credit risks persist. Authorities hope to be able to close an IMF deal in May, if not in September or the year-end. The longer it takes to conclude IMF talks, the more likely the program could need to be redrafted and potentially include restructuring. However, we understand that there is no appetite now for restructuring external debt. Under these dynamics and without IMF involvement, a restructuring could end up being a disorderly event with arrears accumulation, rather than a proactive, orderly, process, in our view.

Authorities intend to repay the 2023 Eurobonds (Yen-denominated Eurobonds in August and EUR-denominated Eurobonds in October). They do not anticipate legal impediments to do so, as payments are included in the 2023 Budget Law approved by President Kais Saied. Authorities are confident in their ability to mobilize half of the external financing targeted in the 2023 budget. We understand that discussions with Qatar for financial support are ongoing, but we do not expect significant disbursements given political economy orientations. Authorities expect to mobilize financial support of US$0.3bn from Algeria, and US$1bn from other sources (including at least US$0.5bn from the African Export-Import Bank (Afreximbank)) in the coming period. This would allow Central Bank of Tunisia (BCT) FX reserves to service Eurobonds and decline to only 90 days of import cover by year-end, from 93 days currently, even in the absence of an IMF program. We understand external financing avenues for 2024 repayments are not yet being explored for now.

We understand that the World Bank Executive Board is likely to meet to consider the Strategic Framework for Tunisia in June. Authorities indicate approval is not required as part of the IMF program.

South Africa: investing in energy generation

Near term economic outlook is weak dragged by electricity supply constraints. Investment is increasing into electricity generation which is positive for medium term growth outlook. In the near term, investment increase could lead to higher imports and a widening current account, likely closer to 2% of GDP relative to current account surpluses experienced since 2020. Beyond energy sector, reforms are slow.

Inflation is decelerating but risks remain on the upside. Inflation risks are related to food prices, currency weakness and additional load-shedding costs. Hiking cycle appears not done yet until the central bank is convinced inflation is back into target. Officially moving to a lower inflation target such as 4.5% mid point or 3% point target remain on the table but is not yet firm.

Fiscal risks are both on expenditure and revenue sides. On expenditure side they relate to higher wage settlements, temporary social grants likely to remain beyond 2024, and supporting weak state-owned enterprises beyond current baseline. Weak economic performance adds to likely under performance in associated tax revenues.

Zambia: more flexibility needed

Zambia has met all targets required in the IMF first review. A strong fiscal adjustment and improved economic performance are commendable in 2022. Fuel subsidies were removed while agriculture subsidies reduced. A weaker currency has posed upside inflation risks and tightening from central bank. Inflation likely to stay outside of target for some time.

However first disbursement under the program is held up by debt talks delays. That is, until financing assurances have been provided by official creditors. Discussions are ongoing with increased lobbying at high levels of global leadership. More flexibility may be needed to unlock progress in reaching an agreement with official creditors in coming weeks and months. A new macro framework that improves Zambia's debt carrying capacity could help ease the burden sharing and unlock further steps. Non-residents holding local currency debt have declined and remain out of debt restructuring scope.

Ghana: getting closer to IMF board approval

There is consensus that Ghana is likely to receive financing assurances from official creditors in coming weeks, which will allow next step for IMF Board consideration. Chinese exposure to Ghana is smaller than Zambia. The challenge for Ghana will be IMF's estimates on the size of external debt relief required and subsequent creditor haircuts. The haircuts could range between a third to two thirds. Faster progress with debt relief will depend on the size of haircuts that may be required post program approval by the IMF board.

Nigeria: time to deliver?

There is consensus that the incoming government campaigned on a platform to remove fuel subsidies and currency adjustments and that it is time to deliver. Fuel subsidies are budgeted until June 30. The President is likely to be sworn in on May 29, while National Assembly will start June 10. Consultations with labor unions are key for successful subsidy removal. A softer landing on removing fuel subsidies is being prepared- world bank funding to support the vulnerable with cash transfers. Ultimately it will be political will to deliver that will carry the day. Securitization of government debt owed to CBN is still to receive parliamentary approval. Adding this debt, will push overall debt stock to GDP close to 40%.

Kenya: dollar inflows likely in 2Q

Economic and fiscal adjustments are progressing well in Kenya. Financing risks remain biggest concerns as currency and FX buffers decline. 2Q is promising with a likely World Bank disbursement of $1 billion and a tranche of $200 million syndication loan in coming weeks. Financing solutions for $2 billion Eurobond due in 2024, are still not clear. Will require a combination of increased official assistance and market access in 2024.

SSA ratings outlook

Ghana and Zambia are going through debt restructuring negotiations. Strong push on official creditors to make progress on negotiations. There are concerns on potential downward direction of travel for Kenya and Nigeria. External financing risks for Kenya. For Nigeria, action on pending policy reforms could avoid further downside, fx reserves have a buffer and limited concerns on a default scenario. Angola has some upside-dependent on oil price, and further deleveraging in debt to GDP ratio. However moderate external debt repayments over the medium term remain a source of risk. For South Africa, despite blackouts weakening economic performance, downside rating risks appear limited and can withstand current pressures in BB category.

Ukraine: looking for creative solutions

For the bonds, 2023 is a year to find solutions ahead of the 2024 timeline for restructuring. The authorities continue to emphasize the need to entice private investment in the reconstruction effort and consider a range of possible structures. Progress on using the frozen assets continues to be slow but eventually the political rationale should be in favour.

Albania: accession talks

GDP growth is seen at 2.6% this year. Construction and tourism have been strong last year. Inflation peaked in October and they expect to hit the inflation target by 2024. Fiscal consolidation continues. According to budget rule they target a lower debt to GDP ratio every year. They expect to reach a positive primary surplus by 2024 and onwards.

Government plan to issue more eurobonds but they have no urgency. They have enough cash FX buffers and timing will depend on market conditions. On the domestic side, there is demand for longer maturity as yields are going down.

They believe that their credit rating is too low. It has remained the same for almost 10 years, but they have made many reforms and structural improvements. More reforms are in the pipeline.

EU accession talks are progressing without major issues. They are expecting to start opening the fundamental chapters soon. They have been working on the capital amnesty bill but it is still a draft, there have been many changes and may change further. They want to make sure it would not be an element for controversary with their partners or international institutions.

Georgia: flows are temporary

Economic growth has been strong in 2021 and 2022 averaging 10% helped in part by tourism recovery and Russian migration. This year economic performance is estimated to moderate to 4%. Current account deficit remains modest around 4% of GDP. Inflation is moderating helped by currency appreciation and lower commodity prices.

Georgia foreign exchange inflows into banking sector and tourism have increased due to border re-openings with neighbors, inflows largely from Russia/Ukraine through remittances and money transfers. The inflows are perceived to be temporary. FX deposits into the banking system are perceived as temporary and not directly used for lending. Legal steps, a new law effective from June, aims to bring monetary transfers and crypto operations to be consistent with US and EU rules.

NBG will gradually exit the current tight monetary policy stance. Fiscal consolidation has been strong since 2020 with deficit expected below 3% of GDP this year. Financing likely to rely on domestic market and less of external commercial financing.

LatAm

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BofAS

Brazil: sentiment improving

Two key discussions dominated the debates on Brazil during the IMF meetings: the fiscal framework and the proximity of interest rate cuts. The overall tone from investors towards the country appears to be improving, consistent with the recent performance of Brazilian asset prices (equities, FX, and local rates). Brazil still looks under owned and we continue to see a disconnect between foreign and local sentiment. While foreign investors have been slightly more constructive, locals' bearishness is still in place but appears to be declining at the margin given better news flow, in particular lower than expected inflation and better guidance on the new fiscal framework.

On the new fiscal framework, the key doubt is how feasible it will be for the administration to meet the primary surplus fiscal targets. Consensus is that revenues would have to increase but the government is getting ready to present fiscal measures to increase tax collection in the short-term. The market remains skeptical about the potential stabilization of the debt to GDP ratio in the near-term. Key focus ahead is the approval of the new fiscal framework in Congress (expected to happen in the next month), presentation of revenue generating measures and the VAT tax reform. Recent guidance in the new fiscal rule has also been more positive with the clarification that the new fiscal rule will be based only on recurrent revenues and on the potential limitations for investments.

Regarding monetary policy, although the recent tone from the Brazilian Central Bank remains hawkish, recent data is giving confidence for the ongoing compression in local yields. Inflation has surprised on the downside at the margin, underlying inflation is also declining, activity data is a surprising on the downside and the credit squeeze is ongoing. All these combined with the more positive news on the fiscal framework support the call for earlier interest rate cuts.

Mexico: the markets' darling

Sentiment continues to be very constructive towards Mexico and the MXN. In our meetings Mexico was always portrayed as an EM with sound fiscal, monetary and external policies/balances and on top of that with a good narrative: nearshoring or the diversification of productive resources away from Asia into North America. Even growth, Mexico's traditional Achilles heel, has surprised to the upside lately.

On growth, domestic sectors remain strong. Consumption continues to be supported by high wage growth, very low unemployment and high remittances. Investment has some sub-sectors such as machinery and equipment growing, probably as a result of nearshoring. The government has been spending on the administration's big infrastructure projects. But the external sector is decelerating at a relative fast pace, with exports contracting in part due to weak US manufacturing. In all our meetings the baseline was a soft-landing in the US and hence in Mexico. We are less constructive and expect a deeper downturn in the US that eventually spreads into Mexico, dragging even the domestic economy. From a more structural perspective, nearshoring is an important upside risk for growth.

On the fiscal front Mexico remains with a debt to GDP slightly below 50% and a stable IG rating. However, at the margin there has been a slight fiscal deterioration as the broadest measure of fiscal deficit, including Pemex, increased to 4.4% of GDP in 2022 from below 4% in 2021. But the administration is targeting only a small primary deficit for this year and a 0.7% of GDP primary surplus for 2024, which if achieved would reduce the total deficit and would keep debt to GDP around 50%. The government is likely to delay infrastructure projects if needed to achieve its fiscal targets, for instance if there is a recession. We believe risks are to the downside especially as Pemex has large amortizations this year and next (around 8.5 and 9.5bn dollars, respectively) and requires support from the government. The latest support has come in the form of delayed royalty payments (that is, 0% short-term financing from the federal government to Pemex).

On the monetary policy front, it seems clear that Banxico is close to the end of its hiking cycle (we expect only one more 25bp hike, with downside risks). What is less clear is when will Banxico start its cutting cycle. Inflation is falling but core inflation remains high (above 8%), and services inflation is still trending up. The labor market seems to be very tight. Banxico will have to keep a restrictive monetary policy for a long time (most likely for the rest of the year and at least the beginning of next year). But the real ex-ante rate is so high (above 6%) that Banxico may have some room to cut the policy rate while still keeping a restrictive posture as long as inflation expectations move down towards the 3% target. Because the business cycles in the US and in Mexico are highly correlated, we believe there is a good chance that Banxico will cut the policy rate with the Fed (we see little chance that Banxico cuts ahead of the Fed).

Argentina: all eyes on the election

Experts seem to agree that the economy will likely get worse ahead of the elections given the drought impact (more than $20bn of exports lost this year). Inflation is expected to continue trending up while tighter import controls may be needed to support reserves. The government looks for financing from multilateral organizations.

The weak state of the economy is taking a toll on government popularity, while anti-system candidate, Javier Milei, may be capturing votes.

It is unclear who will run for president in FDT; the economic performance is affecting the chances of some candidates running. JXC public tensions increase the risks of votes fleeing to Milei after the primaries according to analysts we met.

If a policy transition takes place after the election the program will include a large fiscal adjustment to achieve primary balance, likely a frontloaded currency correction and gradual lifting of capital controls. The adjustment is hard to implement amid high poverty.

Positive outlook for export sector (energy and mining) may improve capacity to pay in a couple of years, Argentina not necessarily has to restructure its external debt (if fiscal/FX adjustment is done)

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Chile: policy moderation

Domestic uncertainty has declined substantially, due to policy moderation and other positive shocks.

The government continues to promote a tax reform and is willing to negotiate which taxes may be included, after the tax reform rejection in congress last month, focusing on income taxes, royalty taxes and green taxes.

The pension reform will likely focus on increase in future pensions, increase in current pensions and social insurance, but discussions in congress are going slowly.

Authorities could announce a national lithium policy in coming weeks, open to private-public partnerships in certain exploitations.

The central bank continues with a hawkish tone in line with its monetary policy report. Inflation remains very high and output gap is positive, which signals the adjustment is incomplete.

Consumption has been more resilient to interest rate hikes, perhaps due to deleverage in previous years

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Colombia: the reformers

Uncertainty associated to economic reforms is diminishing. Investors seem to be getting a bit more comfortable with Colombia. Recent news that Jose Antonio Ocampo will stay at the helm of the Ministry of Finance until mid-2024, longer than expected, is reassuring for investors.

Ministry of Finance is strongly committed to respecting the fiscal rule, which constrains the space for expensive economic reforms. The hike of regulated fuel prices continues every month, with the purpose of lowering fuel subsidies. The government is spending political capital by hiking gasoline prices.

Economic reforms are being watered down. The pension reform bill is friendlier for markets than the original idea proposed during the presidential campaign. Health reform, which has a large fiscal cost, has strong opposition in Congress. Labor reform might be delayed. The government is expected to make an announcement on oil reserves in May, which could open the doors for new oil exploration. Although this announcement is uncertain.

On monetary policy, policymakers see signals that inflation might start declining soon. The signals are: i) lower imported inflation, ii) stronger exchange rate, iii) declining producer price inflation, iv) and rebound of domestic agricultural production.

Nevertheless, we believe Colombia will be among the last central banks in LatAm to start cutting rates. We don't foresee cuts happening in 2023.

Peru: cautious on political instability

Investor sentiment on Peru seems cautious, seemingly wary of the political instability. Policymakers are concerned about the risks of economic slowdown. The Ministry of Finance is rolling out fiscal stimulus measures, and the bar for more Central Bank hikes seems high notwithstanding the weather shock affecting inflation.

Two weather shocks – the Yaku cyclone (March) and El Nino (Q2) – are preventing inflation from declining. Signals of El Nino are getting increasingly stronger. Weather shocks pose downside risks on GDP and upward pressure on inflation.

Amid inflationary risks, the Central Bank is unlikely to cut rates soon. The Central Bank acknowledges that inflation expectations have never been above the tolerance range for so long, since the beginning of inflation-targeting in the early 2000s. We expect the BCRP's first rate cut to happen in January 2023.

Social protests are gone, except for in the Southern highlands. The political equilibrium is very fragile. Political analysts say there is high uncertainty on whether President Boluarte will finish her term.

Ecuador: bearish politics

Investors seemed bearish on Ecuador, and the dominant view is that President Lasso could be impeached by mid-May.

If Lasso is impeached, the VP, Alfredo Borrero, would assume the presidency. But there is also the possibility that Lasso invokes the "Crossed Death" provision of the Constitution which would empower him to dissolve Congress and call for early elections.

Local experts believe that the "Crossed Death", which implies the dissolution of Congress, would be a catalyst for another wave of large social protests. If this scenario plays out, local experts think the President would be under heavy pressure to resign.

We have an out-of-consensus view on the impeachment, as our view is that the probability of President Lasso surviving the vote is being underestimated.

Meanwhile, policymakers are emphasizing that Ecuador's macroeconomic conditions are much stronger than in the pre-pandemic period. There is surplus both in the current account and the fiscal balance (measured at the Non-Financial Public Sector level). International reserves, which reached critically low levels, have recovered. Moreover, the IMF program was accompanied by key reforms, such as the prohibition of central bank financing to the government.

Central American and Caribbean

Costa Rica: positive surprise

Economic activity surprised to the upside in the first months of 2023 with the monthly economic activity indicator up 5.6% yoy in the January-February period. Economic activity will likely be supported by the relaxation of the monetary policy stance after the Central Bank (BCCR) began a cutting cycle back in March.

Economic growth continues to be driven by the FTZ and supported by FDI inflows. There is a duality in the Costa Rican economy, while the sectors related to the FTZ grow above 20%, the rest of the economy is growing around 1%. 4 new FTZ are being developed in the country currently and authorities see evidence of nearshoring. Electronics, medical equipment and food processing are the sectors that has benefited the most.

The CRC has strengthened considerably vs the USD after experiencing depreciation pressures in 1H22. The CRC appreciated about 30% since June ´22

In the first half of 2022 the increase in the oil imports bill, the pension funds related outflows and higher interest payments in foreign currency among other variables, led the CRC to depreciate substantially and diminished international reserves. But this dynamic has reverted and now some sectors are complaining due to the CRC strong level.

International reserves also recovered and gross reserves now represent about 13% of GDP after reaching a low level of 9% in 1H22. However, note that the increase in reserves was partially driven by a Latin American Reserve Fund (FLAR) loan and by the resources coming from the eurobond issuance.

On the fiscal front, the primary fiscal surplus will likely continue for the next three years due to the fiscal rule. Authorities expect the central government debt to decline to 60% by 2026.

Authorities think that fiscal rule can be improved and that the changes proposed by the government will not hurt the fiscal consolidation process. The fiscal rule was done in a hurry and it has a lot of misconception that need to be addressed.

Dominican Republic: slower growth

Despite of the significant economic slowdown observed in Q1, investors generally view DomRep as a positive story in LatAm.

Presidential elections, to be held in May 2024, are unlikely to affect markets in a negative way. DomRep and Panama are arguably the only countries in Latam where elections do not impact asset prices.

Policymakers are hopeful that the economy will recover from the weak performance in Q1 and end up growing around 4% in full-year 2023. We are less optimistic. Our growth forecast is 3%.

Central Bank seems more comfortable with recent inflationary dynamics. Also, they take pride on the buildup of international reserves. We expect them to start cutting rates in mid-2023.

El Salvador: muddling through

Majority of investors seem to be more constructive on El Salvador compared to last year. They acknowledge the government has demonstrated willingness to pay. They slashed capex and made a major effort on tax enforcement to create the space for servicing external debt.

Policymakers emphasize they will continue conducting fiscal policy with discipline. There is a major improvement in the fiscal accounts. The government is running a primary fiscal surplus of 2% of GDP.

IMF program seems distant. The main sticking point seems to be Bitcoin, not the fiscal adjustment plan, nor governance issues either. The government is publicly saying they continue exploring the possibility of a program with the IMF.

Guatemala: ratings and elections

Arguably the best macro story in LatAm in 2023, together with Costa Rica. By "best stories" we refer to the trend (of improvement), not the position. Of course, investment-grade countries like Chile have a better position. Both Guatemala and Costa Rica have been upgraded by rating agencies in 2023.

Policymakers believe reaching investment grade status in 2023 is possible. Moody's has Guatemala only one notch below investment-grade. Fitch and S&P upgraded Guatemala to BB in February and April, respectively. If Moody's makes a move, Guatemala will have its first IG rating in history. It's worth pointing out that Moody's hasn't changed Guatemala's rating since 2010.

Policymakers expect GDP of around 3.5% for 2023, roughly tripling the Latam average. They also expect a current account surplus and a small fiscal deficit. The public debt ratio will likely remain among the lowest in the region, along with Chile, Peru and Paraguay.

General elections (presidential and legislative) will take place in June 2023. Unlike Panama and DomRep, there is at least one competitive leftist candidate that can bring volatility to the markets. This is one of the likely negative aspects of the story.

Panama: mixed feelings

Investor sentiment on Panama appears mixed. They acknowledge GDP growth has been surprising to the upside big time (double digit growth both in 2021 and 2022), but they are wary of fiscal transparency and plans to deal with the deficit in the pension system.

Presidential elections will be held in May 2024. Locals have high conviction that the outcome will be market-friendly, as it has always been the case since the fall of the military dictatorship in the late 80s.

It should be easy for the government to meet the fiscal target of 3% (deficit) in 2023, given the revenues coming from the renegotiation of the contract with Minera Panama (copper mine). The new contract establishes a minimum tax payment of US$ 375mn (0.5pp of GDP) per year. The government will get 1pp of GDP from mining revenues in 2023, including the minimum tax from 2022 (retroactively).

Restructuring and Alternate Financing Methods

Debt restructurings and debt distress were hot topics this year, given the increasing number of frontier countries in distress and the large number of unresolved defaults. We held meetings with policy makers, academics, and advisors who addressed various aspects of the restructuring process. The focus of discussions were on the countries with defaulted debt, including Sri Lanka, Zambia and Ghana, as well as on the future of the sovereign debt architecture.

Investors had strong views and were concerned by the slow progress of the Common Framework restructuring programs. Zambia was expected to be the first restructuring to be completed and it continues to linger with China not yet agreeing to participate in the way they expected.

Investors seem disappointed with the inability of the multilateral development banks and bilateral creditors to complete the restructurings. Without agreement on non-commercial debt, external bond restructurings have been on hold because it is unclear how IMF sustainability targets would be met. Some investors and analysts have proposed incorporating “most favored creditor” clauses into restructured bonds to overcome this impasse, though implementation could be complex.

Investors also noted the stark differences in the IMF’s debt sustainability frameworks for low income countries compared to market-access countries.

Some are discouraged by the large percentage of restructurings that still ended up being unsustainable several years later. The two countries that restructured in 2020, Argentina and Ecuador, have their bonds trading at distressed levels again.

Investors believe that a major impasse in the restructurings is due to the Chinese unwillingness to take the same haircut as the other bilateral lenders. Several reasons have been given, including that there are separate types of Chinese entities that have made the loans, with different priorities and different classifications (official debt vs commercial debt). For example, the EX-IM bank is different from the China Development Bank.

In addition, Chinese lenders seem unwilling to provide principal haircuts and would instead prefer to accept maturity extensions and lower interest rates (similar to the Paris Club approach in the 1980s).

Progress on the Common Framework seems to be in the eye of the beholder. Some senior officials argue that the Global Sovereign Debt Roundtable agreement that Multilateral Development Banks (MDBs) would provide grants and positive net flows rather than explicit debt relief was a major step forward, and that the G20 discussions generally became much more constructive in the last few months, opening the door to a major breakthrough on the stalled country cases this year. Others argued that the biggest bilateral creditor was still not showing any major change of view on debt relief.

Even with the potential breakthrough about the role of MDBs, many complex technical aspects remain unresolved, such as on the comparability of treatment (technical workshops will be convened).

Restructuring policy makers who are aware that it took many years for the Paris Club to come to an agreement on the structure of Paris Club debt relief and the coordination between countries, suggested that these international agreements take time to modify and to satisfy everyone.

In addition, in many countries the domestic debt is an even bigger problem than the external debt, but banks, who hold much sovereign local debt, may need to be recapitalized if domestic debt is restructured. Domestic debt restructurings can have significant negative externalities, and thus they need to be well designed and funded to avoid a collapse of the financial system.

Considerations are also being given to creative bond structures that could be used for an eventual restructuring of Ukraine's debt and to fund reconstruction. Many analysts and policy makers are looking back to the 1980s for inspiration on the way forward.

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