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MARKET COMMENTARY

Ashmore

Dispatch from DC

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The Autumn IMF meetings present an opportunity for investors to engage with IMF authorities, central bankers, finance ministers, technocrats, political consultants, economist and peers. The state of the global economy and the main risks and opportunities across global markets is the primary focus.

But it is also a chance for investors to update their views on the evolution of the economic reform processes (or lack of) across individual countries, particularly emerging and frontier economies. This year, the meetings were characterised by the contrast of global macro challenges (low growth, sticky services inflation, and elevated debt) with the solid implementation of promising structural reforms by EM countries.

This report summarises the main findings of four and a half days and 35-meetings organised by seven different partners in nine different venues. with IMF Chief representatives, Central Bank Governors and Directors, Ministers of Finance, and political consultants.

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1. Global Macro: Global Growth, Inflation, Deficits and Debt

The IMF foresees a challenging macro environment ahead, with growth plateauing at pedestrian levels, 3.2% in both 2024 and 2025. Public debt is set to surpass USD 100tn this year, 93% of global GDP, an all-time high, and is expected to approach 100% of GDP by 2030. Developed Markets (DM) growth is seen at 1.8% in 2024 and 2025 while EM growth is forecast at 4.2% over the same period.[1] Within DM, Europe is expected to underperform. China and India are expected to slowdown in Emerging Markets (EM). Overall, as per previous years, the IMF seems to have adjusted for the last 3-months' changes in economic forecasts from sell-side economists. There is a consensus that the level of uncertainty about both growth and inflation paths has increased significantly, as the disconnect between tight monetary policy and loose fiscal policy leads to an 'imbalanced landing'.

Headline inflation has converged towards 2.0% across DM in September, although core inflation is still close to 3.0%, as 60% of the largest countries have 3-month moving average core inflation above their central bank targets. Concerningly, the pace of service sector disinflation has stalled between 4% and 5% across large DM economies ex-Japan.

Globally, monetary policy is far from coordinated. The Brazilian Central Bank hiked interest rates in the same week that the Fed started its easing cycle with a 50bps cut. The ECB cut 25bps in September and another 25bps in October, while the Bank of Canada accelerated the pace of easing to 50bps in October, after three consecutive 25bps cuts.

"While the direction of policy is now clearer in most countries, the appropriate size and pace of easing remain quite uncertain.[2]"

Augustin Carstens, 22 October 2024

The inflation uncertainty seems to be at least partially related to large fiscal deficits that have worked against central banks' efforts to lower inflation. The United States, Italy, and France are good examples of fiscal expansion leading to sticky service inflation. Problematically, larger interest payments put further pressure on fiscal accounts, creating a negative feedback loop.

This dynamic is also reflected in financial stability risks. According to the IMF, near-term financial stability risks have been contained, but there is a disconnect between growing economic uncertainty – particularly related to geopolitical risks – and financial market volatility, which is the highest in 12-years since. This suggests that economic uncertainty will decline sharply following the US elections on 5th November, financial volatility will rise, or a bit of both.[3]

Upside Risks

While this is a grim growth picture, the IMF doesn't have perfect foresight. In October 2017, the IMF was cheering on the synchronised global growth which proved to be the peak of the cycle. The IMF now expects China's GDP growth to slow down faster over the next two years, just as authorities are moving away from austerity towards supporting the equity market, local government debt and real estate developers. The expected slowdown in India contrasts with the ongoing infrastructure investments and economic digitalisation that have been supporting faster growth. GDP growth has remained resilient in Brazil despite the IMF fears of a slowdown.

Draghi's report on 'the future of European competitiveness' is a blueprint for investments of EUR 750-800bn to support innovation, decarbonisation, and economic security. It offers rays of hope for European growth. In the past, such intra-European capex has boosted European and EM GDP growth as well as supported the common currency.[4]

[1] See – https://www.imf.org/en/Publications/WEO/Issues/2024/10/22/world-economic-outlook-october-2024
[2] See – See https://www.bis.org/speeches/sp241022.htm
[3] See https://www.imf.org/en/Publications/GFSR/Issues/2024/10/22/global-financial-stability-report-october-2024?cid=bl-com-AM2024-GFSREA2024002
[4] See https://commission.europa.eu/topics/strengthening-european-competitiveness/eu-competitiveness-looking-ahead_en

US election: Protectionism, fiscal, and immigration

The risk of trade protectionism was also repeated across meetings. While the threat is real, Scott Bessent, a key economic advisor of Donald Trump, said that tariffs would be phased in on an incremental basis, until countries decide to negotiate a 'Mar-a-Lago accord' which could encompass 'trade, defence, and currency levels'. This is even more ambitious than our 'Trump Tower Accord' view, published in July.[5] These policies could be much more supportive for EM in the medium term, as a lower dollar is always supportive of financial conditions and growth in EM.

Scott Bessent also said Trump would cut the fiscal deficit towards 3.0% of GDP by 2028, a significant consolidation far from the consensus for ongoing fiscal expansion. Indeed, the next Congress will find it difficult not to deal with the large deficits, in our view. Further expansion will be constrained by inflation, and 'bond vigilantes' who have been driving US Treasury yields and gold prices higher despite the highest level of real interest rates since 2007.

In contrast, Kamala Harris' policy priorities would be to increase the corporate tax rate from 21% to 28% and to increase the top income tax rate from 37% to 39.6%, while de-emphasizing the use of tariffs on trade policies, a combination that would be positive for EM straight out of the gates. On immigration, there seems to be consensus about the need to slow down net immigration to the US, although Trump would be more aggressive.

2. Emerging Markets and Frontier update highlights

In contrast with the challenging global macro backdrop, most EM and frontier countries we met presented profound economic reforms. Their impressive achievements and further reform plans were the standout of the trip.

Moving out of distress

Despite the political challenges, both Angola and Argentina pledged to maintain an overall surplus.

Angola's reforms started some 6-7 years ago, while Argentina's are more recent, but both countries remain on the right track. The IMF was surprised by the underperformance of Angolan Eurobonds and re-iterated they would be ready to support the country, should they request the fund's assistance.

In Argentina, there is a consensus that the economy is at important cross-roads. One path sees inflation continuing to decline and economic activity recovering enough for the population to reward President Javier Milei's party in next year's mid-term elections, and reforms persisting. On the second path, inflation remains elevated and/or the economy recovery is too shallow, leading to a poor election result and then significant political challenges for reforms. We think Milei's reforms are already paying dividends in terms of a better investment environment and lower inflation and believe the first path to now be more likely.

Ghana and Zambia have concluded their debt restructuring processes with bondholders and are on track to implement the structural reforms requested by the IMF. Both countries always had excellent growth potential, but were saddled with excessive debt and poor budget planning.

Zambia was hit by a severe drought in 2024, which forced the country to re-distribute expenses to avoid food shortages. They also had to start importing energy, as most of the country's energy matrix is hydroelectric. GDP growth is likely to be 1.0% this year, significantly below the 3% expected in the budget. Despite this challenging scenario, the country is delivering on all IMF macro adjustment targets in the program. The medium-term growth outlook in Zambia is anchored by an ambitious target for copper production growth, a metal that is both scarce and critical for energy transition.

In Ghana, the IMF Mission Chief delivered one of the most cogent presentations of the week, highlighting the country's structural reform achievements and a positive outlook. Ghana has a diversified external economy, with exports of gold, oil, and cocoa dominating its dollar revenues.

The Nigerian Finance Minister highlighted the country is now saving 5% of GDP, thanks to ending fuel and foreign exchange subsidies. This move led to a spike in inflation, which is normal, but the Central Bank was fast to hike interest rates and tighten liquidity. Such policies allowed the authorities to replenish reserves, which recently hit USD 40bn thanks to the return of foreign investors and an increase in oil production to 1.5m barrels per day (mbpd) from 1.2 mbpd in 2023. There is still much to do. Challenges include increasing transparency about NNPC, the large state-owned oil

[5] See – *"The US Election's impact on Emerging Markets"*, The Emerging View, 31 July 2024.

company which still runs backlogs worth USD 4bn – down from USD 6bn – and completing a cash transfer programme to 15 million poorer households (affecting 75 million people), of which only 1/3 has been implemented. But following eight years of inaction under former President Buhari, the direction of travel is very encouraging.

Pakistan and Egypt also remain on an IMF agreed structural reform path. Pakistan has a more challenging adjustment to make from an external account perspective but has been successful in accumulating reserves. Egypt has received a large investment package from the UAE which allowed the country to navigate the decline in dollar revenues. After lifting subsidies, the Egyptian authorities expressed their desire so slow down the pace of adjustments, something the IMF said they would be open to consider. Pakistan is the more fragile of the two, but both are moving forward to avoid a destabilising default.

On the negative side, Senegal reported two weeks ago that the previous government had understated both debt and deficit levels, with the IMF freezing a USD 1.8bn support program. An updated support package will likely be negotiated soon.

Market access countries

Within the market access countries, Hungary, Morocco, and Oman are making good progress. The Hungarians announced the intention of setting multi-year budget frameworks anchored by fiscal deficit targets of 4.5% of GDP in 2024, 3.7% in 2025, and below 3.0% in 2026. They will promote the integration of small and medium companies in the existing supply chain of multinational companies and rely mostly on local markets to refinance debt.

Oman had its significant reforms rewarded by the first upgrade to investment grade (IG) status. Net assets (liquid assets minus debt) are to turn positive this year, from -25% of GDP in 2021, as budget surpluses have allowed the country to retire debt without selling assets. Foreign investment is accelerating in tourism, green steel, plastic production, and pharmaceuticals. The IMF is assisting the country to move to a multi-year budget structure.

Morocco is another country reaping the rewards of sound macroeconomic policies. GDP growth is likely to be just under 3.0% in 2024, despite a severe drought leading to a 7% contraction in agriculture. In 2025 growth is likely to rise to around 4.5% as the agricultural sector recovers. Inflation remains anchored and the central bank is discussing introducing some flexibly in the currency, moving away from the current peg to USD and EUR. They see potential large inflows into the market if foreign investments from the Gulf materialise. There are many infrastructure projects to be financed, including hydrogen energy and desalination plants. Many projects, including high speed trains, have already started.

Mehmet Simsek, Türkiye's Finance Minister, put up with a marathon of investor meetings. He delivered a candid overview of the challenge of tackling inflation in a country which had inflationary monetary and quasi-fiscal policies for around a decade. The challenge is compounded by the increase in utility prices resulting from lower subsidies. Nevertheless, the minister is confident that the reforms are paying off and will continue to yield results. He also explained that despite political pressures, there is ample ownership of the tough monetary and fiscal restriction policies by the administration. Growth opportunities exist across industries, but the discovery of natural gas resources in the Mediterranean coast could be transformational, by eliminating a structural balance of payment gap from energy imports.

Latin America

Paraguay's sound macro policies were rewarded by large foreign direct investments both in commodities (pulp and paper) and industry, as the country is now fully interconnected with Brazilian industry. Higher GDP growth, sound budgets and low debt were rewarded by two rating agencies which granted the country investment grade (IG) status in 2024.

The outgoing Uruguayan government will be relieved by the fact that the pension fund referendum did not pass, which would have reversed the government's stellar work over the last four years.

The finance minister of the troubled IG-rated Panama delivered an impassioned speech on the importance of achieving social justice and dealing with the impasse with copper miner First Quantum. He also emphasised maintaining the market economy and deepening reforms to capitalise on the country's competitive advantages.

The Brazilian central bank acknowledged the risk premium on inflation expectations and the local bond markets were mostly related to fiscal uncertainties. However, they pointed out that the degree of fiscal deterioration was in line with the EM average, and that the government is starting to discuss a structural reform in the fiscal accounts.

3. Sovereign Debt Restructuring Architecture

Recent developments in the ever-evolving architecture of sovereign debt restructuring were also debated. The key milestones were the introduction of standard collective auction clauses (CACs) in 2014 (revised in 2015) following the decade-long impasse between Argentina and holdout investors. These CACs were improved following the Ecuador and Argentina restructuring during the pandemic.[6] A joint initiative (Debt Service Suspension Initiative – DSSI) between the G-20, the Paris Club, and selected creditors, also during the pandemic, agreed to suspend debt payments from low-income countries to bilateral and multilateral organisations such as the IMF from May 2020 until December 2021. But post-pandemic, several countries were forced to restructure their debts, including Ghana, Zambia, Suriname, Chad, and Sri Lanka.

Several of these countries also had bilateral debt with other sovereigns, such as China, India, and the Gulf nations, adding a layer of complexity to negotiations, as these sovereign lenders didn't necessarily recognise the Paris Club process. Initially, bilateral creditors were requesting to be treated like multilateral organisations, refusing any net present value (NPV) reduction in their claims post-restructuring despite having lent at commercial rates. The Common Framework tried to introduce "comparability of treatment" which mandated that bilateral creditors would have to concede similar NPV relief to that which private creditors (such as Eurobond holders) obtain, at comparable interest rates.

Common Framework, Global Sovereign Debt Roundtable, and VRIs

However, the Common Framework failed to provide a clear process, structure, and timing for negotiations, meaning that restructuring processes differed on a case-by-case basis depending on the creditor base, leading to severe delays to the conclusion of the restructurings with costs for bondholders, bilateral creditors, and the debtor nations. The process was somewhat improved once the Global Sovereign Debt Roundtable (GSDR) network was formed between the IMF, World Bank, G-20, and private creditors, allowing for better coordination between parties.

Despite the evolution, several questions remain about the Framework. One is the role of variable revenue instruments (VRIs), which offer a higher payout to bondholders that accept restructuring in case the country's economy recovers faster than expected. VRI's are usually granted in the form of a separate bond that has an asymmetric payout, valued close to zero initially, but with significant upside. These instruments are not "fixed income" by nature and are not only not included in the debt indices, but also not allowed in some portfolio mandates. These instruments could be challenged by bilateral creditors as well. The debt restructuring of Zambia included a bond with an amortisation profile that would shorten significantly should the ability of the country to service its debt, as defined by an IMF composite indicator, improve significantly.

Liquidity vs. Solvency

Another discussion focuses on liquidity vs. solvency conditions. The former would merit a maturity extension without NPV losses to investors, while the latter would require an NPV 'haircut' depending on the criteria of from the IMF's debt sustainability analysis (DSA). The IMF DSA remains a controversial point. It was not designed as a tool to define the size of haircut that would be required from private creditors, but ended up becoming one due to the need of an arbiter between different parties.

A key insight on the liquidity vs. solvency question was shared by Indermit Singh Gill, Chief Economist and Vice President for Development Economics at the World Bank. The next two paragraphs are a loose paraphrase of his views expressed at a JP Morgan event:

Generally, there should be three groups of countries. The first is 26 low-income countries with a combined 1 billion population, but only a combined 1% of global GDP. This group is home to half of the poorest people in the world. In this first group, debt/GDP has doubled to 75% from c. 37%. This group includes places like Afghanistan, Syria, Sudan, and the Democratic Republic of Congo. As a rule of thumb, one could add c. 10% of GDP to their debt due to poor transparency. For these countries, the G-20, IMF, and private creditors starting assumption is that they have a solvency problem.

[6] See – *"Insights from recent EM sovereign debt restructurings"*, Market Commentary, 11 August 2020.

Then there are around 50 low-to-middle income countries, excluding places like India. It is not a bad idea to start with the thinking they have a liquidity problem. Maybe some countries like Ghana had a solvency issue (hence the IMF-mandated haircut). Maybe Kenya has a liquidity problem today, which may become a solvency problem two years down the road. However, the IMF should not be using the low-income DSA for this second group of countries. Instead, the IMF should apply the criteria of market access countries as these countries do borrow from abroad, through Eurobonds, loans, and sometimes local bonds bought by foreign investors.

Then we have another group of countries like India, Brazil, Vietnam, etc. These countries have discovered local debt markets and fund most of their liabilities locally. This means they don't have a balance of payments problem. But in many cases, the government's excessive borrowing is crowding out the private sector. They are just 'killing growth'. To them you have another calculus, which is not debt sustainability, but debt optimality. The IMF should want to see if a country with a 95% debt/GDP ratio doesn't have a debt stress risk, but a development risk.

Summary and conclusion

The IMF meetings in DC conveyed a challenging global macro backdrop, as the Fund expects global GDP growth to flatline at a low level while debt levels continue to increase. Loose fiscal policies not only put pressure on debt, but also risk de-anchoring inflation, as services inflation remains far above most large countries' targets. The Fund also highlighted an increase in financial stability risks not yet reflected in volatility or asset prices.

There is much debate about US election risks for EM economies. But there are few arguments over the upside risks to China, and the ongoing resilience of many EM economies. This sets a scene for upside surprises, in our view. A debate between the IMF, World Bank, the US Treasury, a legal expert, and a scholar highlighted the latest changes in the debt restructuring architecture, with some insights about future developments in solvency vs. liquidity conditions.

Last, but not least, several frontier and EM countries presented significant structural reforms that are allowing for a much-improved fiscal and balance of payments situation, key to boosting their GDP growth potential. This list includes countries that have restructured their debt, such as Argentina, Zambia, and Ghana, and countries that have avoided a default despite challenging conditions, such as Oman, Egypt, Pakistan, Nigeria and Angola. The impressive macro policy turnaround in Türkiye will remain in place, despite challenges. Countries with sound policies that continue to make improvements include Hungary, Morocco, Paraguay, and Uruguay. Elsewhere in Latin America, the hysteria about Brazilian fiscal slippage is not justified by the actual numbers, so far, and the government has indicated reforms are forthcoming. Panama is looking to undertake a course correction after the last administration's poor fiscal and mining concession policies led to a crisis that threatened its IG status.

Overall, the challenging global macro environment contrasts with the impressive progress in macroeconomic policies and reforms undertaken by various EM and frontier countries. This suggests the Emerging Markets growth outperformance over the last two years is likely to have more legs, regardless of the result of the forthcoming US election.

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