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Emerging Market Sovereign Pressures to Persist in 2019

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The key sources of pressure on emerging markets (EMs) over the summer – chiefly tighter US monetary policy and a strengthening dollar, and risks to global trade and growth – remain in place even if market pressure on EMs has eased. The impact of both EM-wide and sovereign-specific factors on EM exchange rates and portfolio flows can already be seen in sovereign credit metrics, and will continue to be felt in 2019.

EM vulnerabilities are reflected in Fitch Ratings' sovereign rating Outlooks and recent rating actions. Overall, Positive and Negative Outlooks are broadly balanced in our sovereign ratings portfolio, but the mix in EMs is mildly negative. And of the 15 sovereign ratings currently on Negative Outlook, only three are in developed markets. The remainder are mostly in Latin America and the Middle East and Africa (MEA) – the two regions where external and fiscal balance sheet pressures are most evident. In Emerging Europe, where external vulnerabilities are generally lower, six EM sovereigns are on Positive Outlook, and only Turkey is on Negative Outlook.

Notable negative EM sovereign rating actions in 2018 have included two Outlook revisions for Argentina (B/Negative) and a downgrade of Turkey (BB/Negative). We identified both countries in our May report *From QE to QT: Emerging Market Cross-Sector Risks* as among the EMs most vulnerable to rising global interest rates and quantitative tightening (QT), due to their persistently large external financing requirements. Our ratings reflect not only a sovereign's degree of vulnerability to tighter global financing conditions and shifting capital flows, but also its ability to navigate resulting economic and balance sheet pressures.

QT, Trade Tensions Weigh on EM Economic Growth

Global economic growth remains supportive of sovereign credit quality generally, and the sustained recovery in hard commodity prices since 2016 has given a boost to EM exporters. Nevertheless, we lowered our aggregate EM growth forecasts to 4.8% in 2019 and 5.0% in 2020 in our September *Global Economic Outlook* (GEO), from 5.1% in both years.

The reductions to our aggregate forecasts were partly due to one-off events and idiosyncratic risks in some countries, such as the Brazilian truckers' strike, the pending increase in VAT rates in Russia, uncertainty during NAFTA renegotiation and around new government policies in Mexico, and South Africa's technical recession. But they also reflect US rate rises, tighter financial conditions, and trade protectionism, which have ramifications for many EMs.

US labour market and inflation indicators continue to point to further monetary tightening. The Federal Reserve raised the federal funds rate by 25bp to 2.00%-2.25% in September, and we expect another hike in December. The Fed's more hawkish messaging since mid-2018 (its September statement removed the reference to "accommodative" monetary policy) has cemented our forecast for three more hikes next year.

With the ECB moving to phase out its bond buying, we expect the combined Quantitative Easing (QE) asset holdings of the major central banks to decline in 2019, signalling a global shift from QE to QT.

Related Commentary

Global Economic Outlook – September 2018

20/20 Vision – September 2018

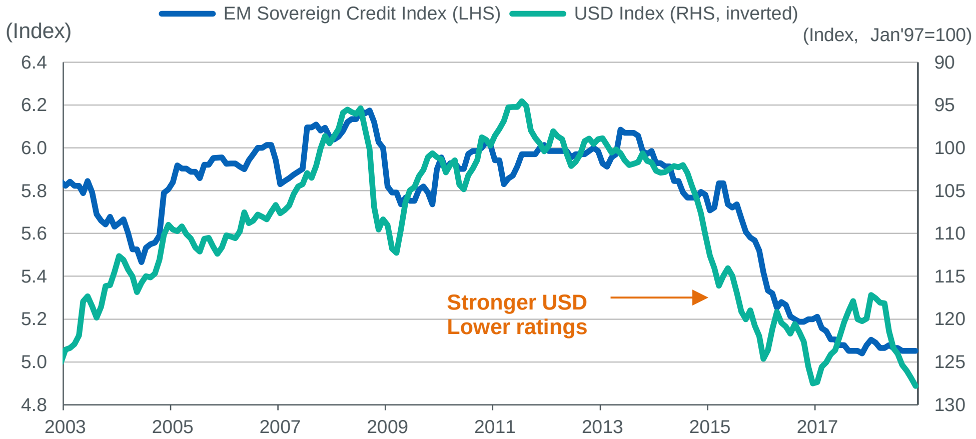
Latin American Sovereign Credit Overview – 4Q18

Meanwhile, we expect the US to increase the rate on the latest tariffs it imposed on USD200 billion of Chinese imports to 25% from 10% next year. Recent data suggest that Chinese exports have been boosted by some front-loading, and higher tariffs are likely to drag on Chinese export growth and only be partially offset by additional fiscal easing and a weaker exchange rate. Combined with the impact of earlier credit tightening, this will see Chinese growth slow to 6.1% in 2019 from 6.6% this year.

We made large growth forecast revisions for Turkey, which felt the force of investor concerns about more expensive dollar funding and the efficacy of its policy response during its currency crisis in July and August, But we also reduced growth forecasts for South Africa and Indonesia, partly in response to tighter financial conditions and the weaker outlook for China, alongside country-specific factors. In Argentina, we see the economy contracting due to a collapse in confidence and erosion of real incomes as inflation has shot upward.

US monetary and trade policies also mean we increased our USDEUR and USDCNY exchange rate forecast in September's GEO. The direction of the dollar is critical for EMs and is inversely correlated with EM sovereign ratings.

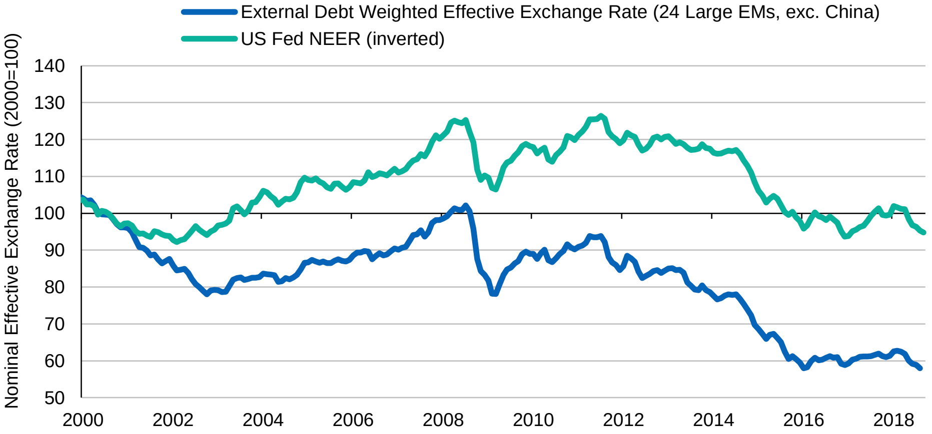
Emerging Market Sovereign Ratings and Nominal Dollar Index



Source: Fitch Ratings, Datastream

Further dollar appreciation and tighter global financial conditions more broadly will likely discourage capital flows to EMs, while the rise in foreign-currency (FC; mostly US dollar) EM debt in recent years has exacerbated the impact on the availability and cost of financing for EMs. This can be illustrated by constructing an alternative nominal effective US dollar exchange rate for larger EMs based on shares of gross external debt rather than trade flows.

External Debt Weighted Dollar/EM Effective Exchange Rate



Source: Fitch Ratings, Datastream

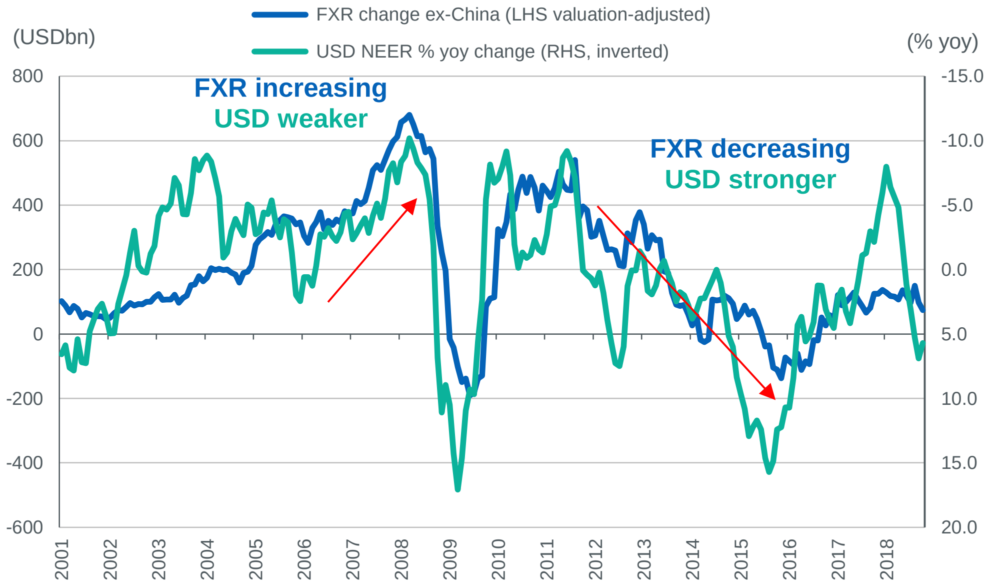
The impact of a strong dollar on EM GDP growth is not wholly negative, as currency depreciation can increase competitiveness. But the likely negative impact on EM investment spending and financial stability can outweigh the positive impact on net trade. A stronger dollar is also generally associated with weaker commodity prices, although this relationship varies.

Some External Adjustments Are Under Way

Pressure on EM currencies has triggered the start of external rebalancing. In Turkey, for example, the current account swung into a USD1.86 billion surplus in August and posted a USD1.83 billion surplus in September as imports fell. The pace of imports growth has decelerated in South Africa and Russia, and a period of higher commodity prices has reduced exporters' external imbalances.

Forced adjustments will be accompanied by more active responses, sometimes in conjunction with IMF programmes, although engineering soft landings could be challenging and test the credibility of some EMs' policymaking frameworks. Where they are forthcoming, policy adjustments are not costless. For example, in September's GEO we revised our policy interest rate forecasts higher for five of the 10 EMs covered, and made no downward revisions. This may help contain pressure on EM currencies, but monetary tightening from a relatively loose starting point will be another headwind to growth. And while many EM central banks typically say that they only intervene in currency markets to smooth volatility, the evidence suggests that they may spend reserves to prevent even greater depreciation, depleting external buffers.

Changes in FXR (yoy) and Changes in NEER (% yoy)



Source: Fitch Ratings, Datastream

The impact on reserves will vary considerably from sovereign to sovereign depending on the foreign exchange regime in place and the authorities' commitment to exchange rate flexibility. But broad regional trends are discernible. For Asian EMs excluding China, FX reserves are nearly twice the level of FC debt, while in Emerging Europe reserves have grown since 2015 and also now exceed FC debt.

In contrast, in Latin America, FX reserves have been flat since 2013 while FC debt has grown to the point where it is nearly double the size of total reserves. The growth in FC debt in MEA since 2015 means it now exceeds reserves, although these have recovered somewhat in 2018 with higher commodity prices.

The future direction of individual sovereign ratings will reflect their relative vulnerability and the predictability and effectiveness of their policy responses, both of which vary substantially. For example, capital outflows and weaker currencies have not yet had a dramatic impact on most Asia-Pacific sovereign credit profiles. But tighter global financial conditions are exacerbating refinancing risks in countries such as Pakistan (B/Negative) and Sri Lanka (B+/Stable), which were already facing external pressures. And the summer EM sell-off has led to sizeable currency depreciations and some decline in FX reserves in both India and Indonesia.

In sub-Saharan Africa (SSA), the earlier rise in oil prices has reduced exporters' external imbalances and helped to support their economic growth prospects (a factor in the revision of the Outlook on Nigeria's 'B+' rating to Stable from Negative earlier this month). However, pressure to improve infrastructure, weaknesses in public financial management, and higher external commercial debt will be factors in SSA sovereigns' ability to respond to a more difficult global environment for EMs.

Emerging European sovereigns other than Turkey have been relatively insulated from market turbulence in 2018, reflecting their largely European investor base and euro funding requirements. Tighter ECB policy from 2019 may prove more testing, particularly for those with large non-resident participation in their local bond markets, given generally relatively loose policy settings and an expected cyclical growth slowdown.

In Latin America as elsewhere, idiosyncratic risks, such as those relating to politics and governability, can add to credit pressures created by tighter external financing conditions and sluggish regional growth. The scope for policy uncertainty and deterioration under the incoming administration was one driver of our revision of the Outlook on Mexico's 'BBB+' rating to Negative at the end of October. Even if IMF disbursements mitigate near-term sovereign financing risks, macroeconomic and fiscal uncertainty can weigh on ratings – as was seen in our revision of Argentina's Outlook to Negative on 7 November.

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