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Are EM Countries Able (and Willing) to Pay Their Debt?

Capitalising on opportunities in EM debt will not only require traditional fundamental analysis to determine countries' ability to satisfy their debt obligations, but also—and perhaps just as importantly—an understanding of their willingness to pay.

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COVID-19 has been devastating for emerging market economies. Just as in developed markets, economic growth came to a halt as many countries went into lockdown. The services sector was hit hardest, perhaps unsurprisingly—tourism essentially stopped, impacting emerging markets as diverse as Thailand and the Dominican Republic. Industrials, too, struggled from the initial shock as many factories were forced to temporarily close or operate at very limited capacity.

At the onset of COVID, there was a perception that commodity prices would collapse, disproportionately affecting commodity exporters. But in hindsight, this has largely proven to be a service-based crisis rather than a production crisis. While commodities did decline early on in the pandemic, prices have since rebounded. Copper and iron ore, for instance, have gained roughly 45% and 60%, respectively, since they bottomed in March and April[1]—providing support for exporters like Brazil, Peru and Bolivia. Oil has been somewhat of an exception given its closer ties to macro events, and as a result, oil exporting countries have faced greater challenges.

From a market perspective, EM debt experienced a swift and broad-based decline as the pandemic took hold in March. Even investment grade-rated countries like Russia, Indonesia and Mexico—which have large domestic markets to borrow from and fairly robust international reserves—sold off significantly. While the market has rebounded over the last several months, there remains a disconnect with the real economies of emerging markets, which may take years to get back to full capacity.

Given the breadth of the EM universe, it's almost impossible to make sweeping conclusions about the attractiveness of the asset class. There are—and will continue to be—a plethora of risks to navigate economically, politically and from a market perspective. But there are also opportunities, and these can be particularly compelling during times of stress. The key is understanding countries' ability and willingness to satisfy their obligations.

Can They Pay?

Determining whether a country can pay its debt requires a close look at its fundamentals. Interest rates certainly play a role—and on the positive side, lower interest rates in developed countries should translate to less expensive debt, suggesting more EM countries will be able to borrow.

International reserves and remittances are also critical to understanding whether a country has enough savings to satisfy its debt obligations—as is assessing a government's ability to generate tax revenues. Environmental, social and governance (ESG) factors—from the structure of a country's government to its social and environmental policies—also play a critical role. And countries that have deep local markets to borrow from may be better able to fund themselves going forward—versus those that borrow primarily in the hard currency markets.

Looking across the EM debt landscape today, there are a number of countries that we believe have the ability to pay their debt. Mexico, for example, looks quite strong from a financial perspective given its robust foreign reserves. Russia, Thailand and Peru also appear able to pay—as do some emerging European countries like Hungary, the Czech Republic and Poland. At the far end of the spectrum are countries like South Africa, where economic growth has been stagnant for the last few years and, without significant private sector intervention, may remain challenged going forward.

Will They Pay?

Assessing whether a country is willing to pay its debt is more complicated, due in part to the involvement and influence of international financial institutions like the World Bank and International Monetary Fund. As the pandemic has progressed, there have been indications that these institutions may encourage EM countries with high debt-to-GDP ratios—or those whose ratios may rise going forward—to restructure their debt, or default.

This presents a number of challenges, in our view. For one, analysing a country's solvency based on its GDP ratio can be misleading—some countries, for instance, can borrow at very low rates and therefore accommodate much higher debt-to-GDP ratios than others. Further, as many countries entered into lockdowns, the flow of goods and services all but stopped—which could cause debt-to-GDP to rise sharply, even if a country hasn't borrowed significantly.

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Compounding this, many EM countries will likely need further financial assistance from these institutions in the years ahead. Somewhat problematically, we believe this could result in EM countries experiencing pressure to restructure as a condition of receiving financing. Herein lies one of the more complex and challenging aspects of investing in this space—distinguishing between a country that, when under pressure, prioritises repaying its debt versus one that may opt to default (even if it has the ability to meet its obligations).

Indeed, a country's willingness to pay is not the same as its ability. Ghana is an example—a country with significant growth potential, well-managed finances and a debt load that appears manageable. However, the country's finance minister recently suggested that it may be in the best interest of Ghana and other EMs to suspend debt payments—creating much uncertainty in the minds of investors. On the other hand, countries like El Salvador, Bolivia, and Angola are working hard at upholding their obligations via fiscal adjustments and appear committed to paying their debt—and in our view, would have to come under tremendous pressure to default.

It's worth noting that pressure from international financial institutions does not necessarily mean that a country will have to default—and there have been plenty of countries in history that have resisted that pressure, particularly given the implications for accessing the capital markets in the future.

Looking Ahead

EM debt can be an attractive option for investors searching for yield—and can offer a potentially significant spread premium versus developed market debt. On balance, we think that countries that are investment grade rated—or close to investment grade rated—look particularly attractive. Brazil is an example. Although the country has garnered negative press lately, its governance structure appears to be strong, and we believe the country may be positioned for significant growth as the pandemic recedes. There are also potential opportunities in lower rated, higher yielding countries like Angola and Guatemala, although selectivity is critical.

While we have seen signs recently that fear may be creeping back into the market—from COVID to trade tensions to the upcoming U.S. election—we think there is plenty of opportunity on offer in EM debt. But taking a country-by-country approach, and selecting the right credits, is paramount.

This article was adapted from a recent episode of Barings' Streaming Income podcast. Listen to the full interview here: https://www.barings.com/viewpoints/can-em-issuers-pay-their-debt-and-will-they

FOOTNOTES

1 Source: Bloomberg. As of September 11, 2020.