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Emerging markets: From risky to resilient?

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Introduction

Over the past decade, sound policies, structural reform and strong growth have led to stark improvement among emerging markets (EM). When compared with the developed markets (DM), it is evident that the gap in credit quality has narrowed. While DMs have seen a deterioration in their metrics since the COVID-19 pandemic, EMs have in most cases experienced superior growth rates, improving debt sustainability and strengthening fundamentals.

In this paper, we argue that the perceptions many investors have of EMs are typically neither accurate nor fair, especially for those investors less familiar with the asset class. In our analysis, EM fundamentals, in many cases, are superior to those of the DM world. Common preconceptions, which include riskiness, poor governance, high levels of corruption and unsustainable debt profiles, are inaccurate for most EMs.

EMs appeared vulnerable during the pandemic, but most bounced back strongly by taking measures to rebuild buffers and enacting reforms to further enhance resiliency and sustainability. Unlike DMs, EMs generally did not have the same fiscal space to support their economies, and so did not see the same magnitude of fiscal deterioration. While fiscal orthodoxy is returning to most DM countries, some, such as the United States, are still maintaining loose fiscal policy.

When comparing EMs to DMs, we think one needs to factor in how DMs such as the United States, Japan and the European Union (EU) benefit from their reserve currency status. DMs experience consistent demand for their government bonds (or, in the EU's case, government bonds of member countries), which are more typically

seen as "safe-haven" assets and risk-free. Additionally, DMs are typically less susceptible to the level of political volatility seen in EMs. These two factors help explain the higher risk premium of EM assets.

However, through a quantitative lens, EMs compare well in metrics such as debt-to-gross domestic product (GDP), GDP growth, currency reserves, and interest as a percentage of revenue, among others. In the analysis below, we outline how emerging markets as an asset class is improving by analysing fiscal consolidation, economic growth and the external reserves position versus DMs.

Fiscal: Is consolidation the path forward?

The fiscal outlook for EMs appears more promising to us than that of DMs. This divergence is highlighted by key fiscal indicators such as interest payments relative to revenue, primary balances[1] and debt to GDP, painting two deviating paths for these two asset classes.

DMs, especially the United States, have continued to accumulate high fiscal deficits, leading to increasing debt burdens. In contrast, EMs (excluding China) have managed to stabilise their debt levels after the pandemic and are expected to start to see a gradual reduction in debt-to-GDP in the short term (see Exhibit 1). Overall, EMs also have a much healthier debt-to-GDP starting point, which is in part due to their previous inability to sustain higher debt loads. This further adds to the resilience of these countries today. While DMs generally can sustain larger debt burdens thanks to more efficient revenue collection and lower borrowing costs, the gap between DMs and EMs in terms of debt stock and fiscal deterioration has been widening as EMs adopt more prudent policies, while the United States and China continue to grow their debt through loose fiscal policy.

The United States faced significant fiscal challenges in 2023, with its deficit soaring to 8.8% of GDP. The International Monetary Fund (IMF) expects the fiscal deficit to remain above 6% of GDP in the medium term. Similarly, China saw its deficit grow beyond 7% of GDP in 2023, and it is set to grow to around 8% of GDP by 2029. As a result, debt-to-GDP is expected to continue to rise in China, despite the favourable interest and growth dynamics.[2]

EM Debt and Interest Metrics Have Begun to Stabilise Following the Pandemic

Exhibit 1: EM Debt/GDP is Expected to Stabilise Going Forward

2001–2029 estimated

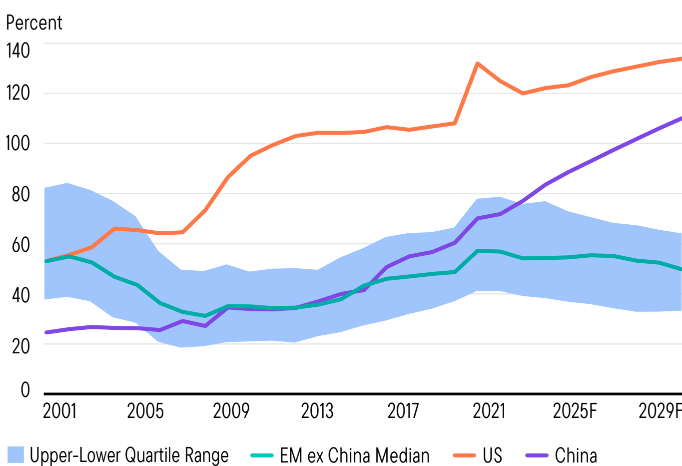
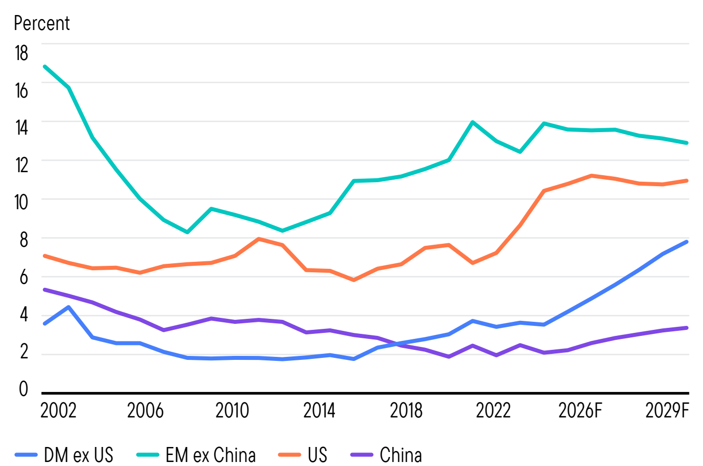


Exhibit 2: EM Interest as a Percentage of Revenue is Set to Decline

2002–2029 estimated



Sources: IMF World Economic Outlook, FTI Fixed Income Research. There is no assurance that any estimate, forecast or projection will be realised.

Interest as a percentage of revenue is a useful measure to assess debt sustainability. One would expect DM countries to do particularly well in this metric given the higher revenues (as a percent of GDP) and lower cost of debt relative to EMs. For the most part, DMs are superior (see Exhibit 2). However, the United States has seen a significant deterioration in its interest-to-revenue measure since 2020, leaving it only marginally superior to EM. China is expected to experience a similar-size deterioration over the coming years. The picture would greatly improve if one were to exclude EM outliers that distort the average, such as Egypt, Nigeria and Pakistan. These countries have interest payments consuming 40%, 34% and 59% of revenue, respectively, in 2023, when the EM median was 7.4%.[3] The downward trend for EM ex-China highlights that EMs have made policy adjustments to mitigate the additional cost of operating in a high-rate environment.

Primary balances, i.e., fiscal balances excluding debt service payments, offer a clearer view of fiscal health. In 2023, primary deficits in advanced economies (excluding the United States) deteriorated by 0.6 percentage points to an average deficit of 2.1% of GDP as a result of ongoing subsidies along with transfers and extensions of pandemic-related support measures. In 2023, primary deficits in EMs (excluding China) weakened to an average of 1.3% of GDP, still well below that of DMs (see Exhibit 3). The increase in EM primary balances was due mainly to falling revenues in commodity-exporting countries and higher spending driven by inflation. EM primary deficits are expected to fall to 0.3% by 2029, driven by cuts in primary spending.[4] The United States and China are large (negative) outliers compared to the rest of the world. In summary, while DMs grapple with higher debt levels and rising interest costs, EMs are navigating ahead with relative resilience and prudent fiscal management that is continuing to improve the quality of the EMD asset class. Moving forward, targeted reforms and careful fiscal policies will be crucial for further enhancing EM economic sustainability.

EMs Are Normalising Primary Balances Quicker Than DMs Following the Pandemic and Energy Shock

Exhibit 3: EMs Ex-China Have Been More Restrained Than DMs

2000–2029 estimated

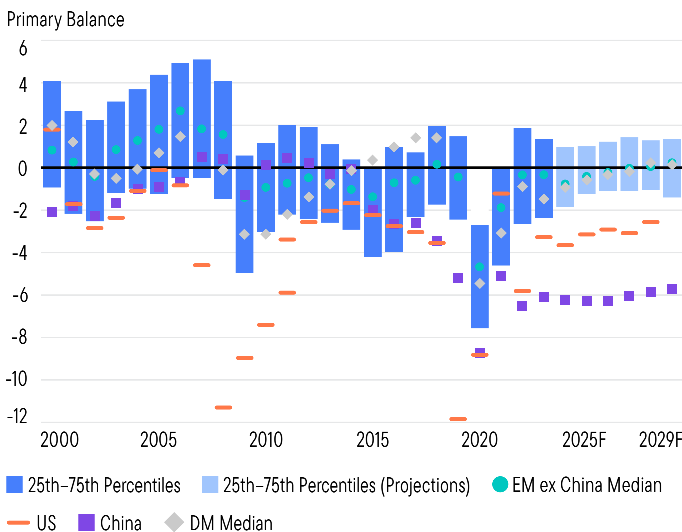
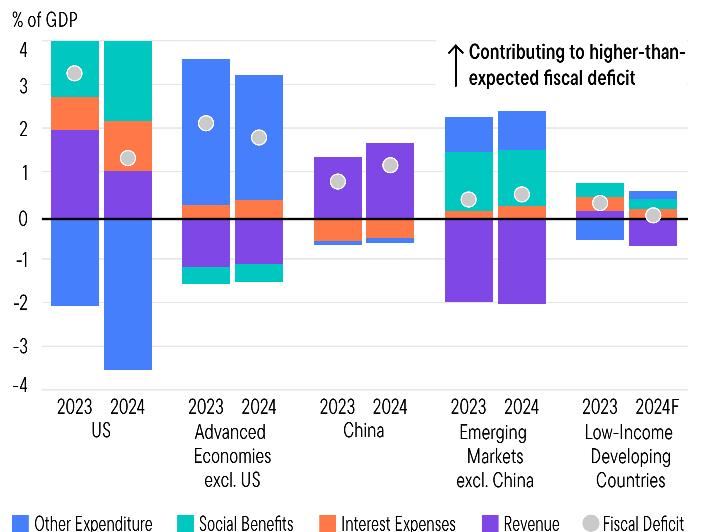


Exhibit 4: Latest vs. Pre-pandemic Projections for Fiscal Deficits

2023–2024 estimated



Sources: IMF World Economic Outlook, IMF Fiscal Monitor, FTI Fixed Income Research.

Growth: The ever-important differential

A key strength of EMs has been the growth differential relative to DMs (see Exhibit 5). Growth rates matter in the context of debt sustainability, as the higher the growth rate, the more expansionary fiscal policy can be without impacting debt levels. This means a country can run higher primary deficits without seeing debt-to-GDP grow. In other words, assuming zero primary deficits, a higher growth rate allows a country to outgrow its debt. The growth differential between DMs and EMs has become increasingly important in a high interest-rate environment. A country's future debt stock is determined by the interest cost, the growth rate, the existing debt stock and the primary balance. Higher interest rates mean that higher growth rates are needed to stabilise debt compared to what had been the case in the previous decade.

There are several reasons why EM countries experience higher growth. For example, EMs start from a lower GDP-per-capita base, and they can benefit from *catch-up growth* driven by technology transfers and capital accumulation, among other factors, that result in a convergence with DMs. Another reason EM countries have, and are likely to continue to see, higher growth rates is the demographic dividend, which is the benefit an economy gets from a young and growing population with declining mortality and fertility rates, leading to a reduced dependency ratio and increased productivity. Many EMs benefit or are likely set to benefit from this demographic dividend. On the other hand, developed markets are experiencing the opposite—aging and shrinking populations that reduce the labour force and further erode growth. This means that we can expect to see continued growth differentials that further support EM resilience.

Investment is another source of growth. It can be a productive use of debt because it has the potential to boost growth sufficiently to offset the higher primary balance and debt associated with the investment and thereby lead to debt stabilisation or even decline. EMs, especially China, have higher investment rates, with approximately 24% and 42% of GDP in 2023, respectively. In comparison, DMs excluding the United States have an investment rate of 24% of GDP, while the US rate is 22% of GDP, as of 2023. The higher investment rate of China may somewhat justify their higher primary balance, but this assumes that any investment is productive and has a positive growth multiplier, which may not be the case.[5]

Supportive Growth Differentials Will Make Debt Stabilisation Easier for EMs Than for DMs

Exhibit 5: EM Growth is Set to Outpace DM

2015–2029 estimated

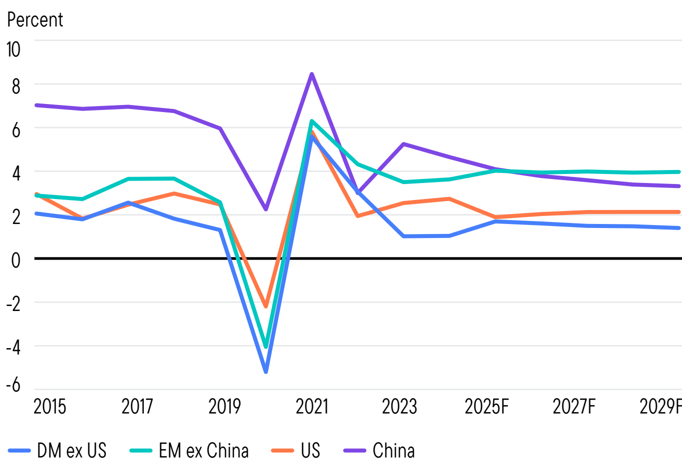
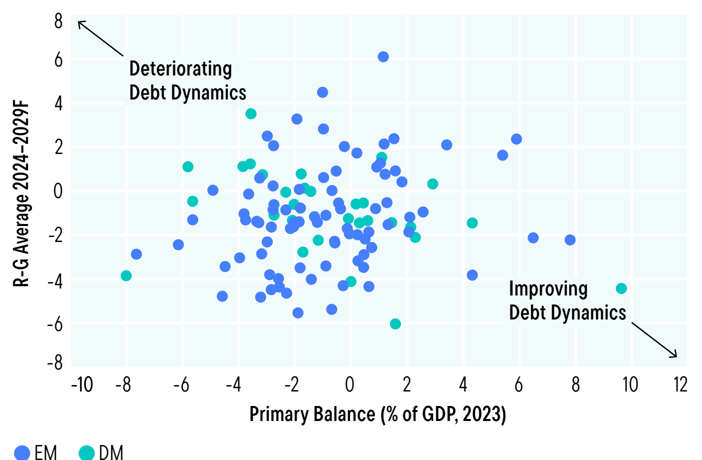


Exhibit 6: Interest Rates and Debt Sustainability

2023–2029 estimated



Sources: IMF WEO, FTI Fixed Income Research.

External: For those less privileged

An important factor to consider when comparing EMs to DMs is the external resilience of EM countries. This is less relevant for DM countries given they have reserve currency status, which leads them to hold minimal reserves at their central banks. For EMs, external risks are particularly important, especially because most have a significant portion of their debt stock denominated in foreign currencies (e.g., the US dollar). Foreign currency debt is often referred to as "the original sin," as it was a cause of previous EM debt crises. As a result, many EMs have, and are in the process of further developing, a deeper domestic bond market to reduce the risks associated with foreign-currency-denominated debt. However, countries with mature domestic debt markets are not isolated from external vulnerabilities. Foreign investors still can be significant holders of domestic market debt, which can make a country vulnerable to portfolio flows putting pressure on the country's external accounts and currency. Many countries have in the past benefitted from hot money inflows that came to an acute stop. Such an event can cause a balance of payments crisis and leave a country in a precarious position.

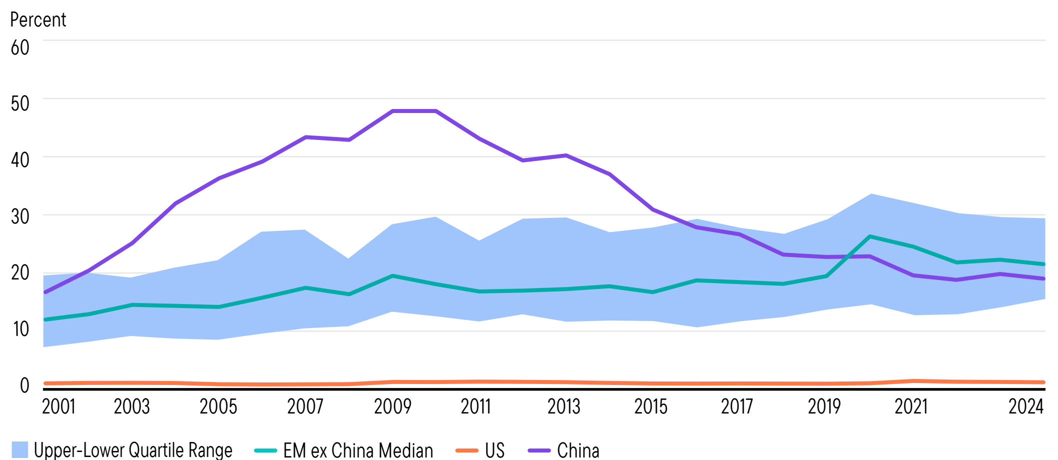
To mitigate the risk of sudden capital flows, the size of buffers is important. Throughout previous decades, EMs have seen a steady increase in their reserve levels. While there has been a small deterioration in this trend over the most recent few years (see Exhibit 7) due to the pandemic, the energy crisis and closed capital markets, it is important to note the strong starting point and stabilising trend of the reserve balances. Having sufficient central bank reserves mitigates the risk of a balance of payments crisis, as it provides a buffer that countries can draw on when in need of external liquidity. Also of note is the build-up of other forms of reserves through sovereign wealth funds, state-owned banks among other holders of sovereign reserves.

Finally, there seems to be a misconception around the volatility of EM foreign exchange compared to DM. We find that the median standard deviation of a basket of EM currencies (0.52%) against the US dollar over a 10-year period (2014–2024) was lower than that of the British pound (0.60%) and Japanese yen (0.55%), and in line with the euro (0.50%), but remains more volatile than a US dollar index (0.43%).[6] This data suggests that the external resilience we have already alluded to is beginning to show in EM currencies.

EMs Do Not Have the Luxury of Reserve Currency Status and Therefore Must Hold Sufficient Reserves

Exhibit 7: EM Reserves as a % of GDP

2001–1Q 2024



Sources: IMF WEO, FTI Fixed Income Research.

Conclusion

We highlight in this paper that EM countries are often misunderstood by investors who have outdated perceptions, and that many EMs are developing resilient macro fundamentals. While in recent years DMs have seen fundamentals deteriorate, EMs have been more prudent with fiscal policy by containing and normalising primary balances following recent shocks. EMs also continue to benefit from favourable growth differentials. However, DMs still benefit from reserve currency status, which means they do not have the same external concerns as EMs. That said, EM countries have taken steps to build reserves to improve their external resiliency.

While investors are still justified to differentiate between DM and EM assets, EMs are improving to an extent that some now more closely resemble DM countries. The EM asset class is not a homogenous group, and any quantitative analysis should be combined with country-by-country fundamental analysis to fully understand the risks.

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Endnotes

1. Source: Primary balance is the difference between government revenue and non-interest expenditure.
2. Source: IMF. Fiscal Monitor. April 2024. There is no assurance that any estimate, forecast or projection will be realised.
3. Source: IMF. World Economic Outlook. April 2024.
4. Source: IMF. Fiscal Monitor. April 2024. There is no assurance that any estimate, forecast or projection will be realised.
5. Source: IMF. World Economic Outlook. April 2024.
6. We use the Bloomberg DXY USD Index for this analysis. The DXY Dollar Index measures the value of the US dollar relative to the exchange rates of six major world currencies (the euro, Japanese yen, Canadian dollar, British pound, Swedish krona and Swiss franc) which represent a majority of its most significant trading partners. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

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