

# IMF Fall 2020 meetings: Now comes the hard part

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We recently attended (virtually) the 2020 Annual IMF Meetings, where we met with officials from finance ministries, central banks, international financial institutions such as the IMF, as well as independent economists and experts on topics such as politics and public health. Below are our top global and emerging markets (EM) takeaways.

## Global takeaways

Now comes the hard part—debt is higher, growth is lower. The synchronised downturn and upturn have happened. Most asset prices are already around their pre-COVID-19 levels. Monetary and fiscal policy have provided market stability, but the growth impact is still uncertain. If growth does not persist, we believe the record levels of debt that have been incurred due to lockdowns may face repayment risk.

- In our view, the medium-term global growth outlook is fragile. The IMF has actually slightly upgraded its global growth outlook to -4.4% in 2020, from its April outlook. But it has penciled in lower -5.2% growth for 2021. Most important, the medium-term outlook looks to 3.5% growth, much lower than historical trends and the previous medium-term outlook.
- Downward projections for growth imply a smaller tax base, raising concerns about debt service. The projections imply wide output gaps and persistently high unemployment in developed and emerging economies. The projections also anticipate scarring from the recession, but also ongoing adjustment costs to governments and corporates.
- A key problem will be the large numbers of countries that may do even worse than these global projections. Large parts of Europe, Latin America and Africa have some of the least hopeful growth outlooks. China is the only major economy to grow in 2020 and because it was first into the crisis and skillfully managed the pandemic, we think its growth trajectory has been over-applied to growth expectations of other EM countries.
- The IMF encouraged all policymakers to maintain stimulus given scarring and uncertainty around second and third waves. We expect this to happen, especially in the advanced economies that have no funding issues. Money appears “free” (for now) in advanced economies, so no issues there. The IMF message was clear—“Don’t falter on stimulus now.”
- The questions for the rest, though, are: a) financing; and, b) the higher-debt/lower-growth future. A number of countries don’t have the fiscal space and will not be able to maintain the fiscal impulse. This may mean a negative impact—fiscal drag—for many EM growth outlooks in 2021.
- Recall that following the global financial crisis (GFC) aftershocks included Gulf and Eurozone crises.

## COVID-19 is a multi-year issue

There were a number of panels featuring healthcare experts and the main conclusion participants were left with is that a vaccine may not represent the “silver bullet” for EM that many thought it would be.

- Transportation and storage of a vaccine could be a serious obstacle in EM. Vaccines may need to be stored at -70° Celsius. India, for example, is estimated to need 100,000 specialised trucks and the current number of such trucks is approximately zero.
- There are other risks, such as low numbers of people who want to be the first to take the vaccine. Two doses may be required and the history of such vaccines is characterised by low take-up of the second dose.
- COVID-19 will be with us longer than participants expected. This is important given two key contextual points. First, a second wave is happening in many countries. Second, the market was already concerned about how the extraordinary debt accumulated as a result of COVID-19 was going to be repaid without recovery.
- Many, though, thought that lockdowns were going to be a less likely policy response going forward and could be subject to mass non-compliance (for example, Manchester’s mayor is rejecting British Prime Minister Boris Johnson’s lockdown order). This probably means that any second and third waves will not have as much economic devastation as the first.
- Also, a vaccine, however remote in practical terms, is light at the end of the tunnel and reduces fear and economic retrenchment. This can eventually be a positive for countries with weaker public health systems, such as Brazil or Indonesia.

## A blue wave?

A Democrat sweep of US elections was a widely and strongly held view on the part of investors and panelists. A contested election did not get much discussion, as most thought that outcome was unlikely. But, many came away with new worries about what a Biden victory might mean.

- The EM market implications of either a blue wave or

an unlikely-to-most Trump victory were not dramatically different, in the short term. Both outcomes were seen as leading to fiscal stimulus. We tend to agree. The market went smoothly from “Trump good, Biden bad” to “Biden good, Trump good” due to stimulus expectations.

- Many leave IMF meetings seeing new risks to EM from a Biden victory. In particular, there’s a bipartisan consensus that the China relationship has taken on a huge national security dimension. Sanctions policy won’t go away.
- There was also concern about the implications for the US relationships with China, Saudi Arabia, Israel and others, if the progressive wing of the party succeeds in elevating human rights as an issue. This may be non-negotiable for some countries, though our sense is that in the US progressives will focus on domestic economic objectives over foreign policy. On domestic policy, there was a popular view that it would be sectoral (i.e., picking winners/losers), not macro (i.e., all regulations and taxes go up).
- Republicans holding the Senate in a Biden victory, moreover, might be more risky to fiscal stimulus in the near term than market participants think, in our view. Any budget would need to go through the budget reconciliation process which requires a simple 51-vote majority. Any package could be substantially lower, which represents un-priced risk.

## China “graduates” IMF meetings, yet again

In general, the past decade-plus of IMF meetings we’ve attended has seen China “graduate” in investor perceptions. This meeting was no exception. China was widely praised for its economic recovery (the only economy to grow in 2020) and its willingness to control leverage whenever possible—the pedal is not always to the metal. Its domestic bond market was viewed as one of the most attractive global fixed income opportunities and we agree. The rationale is straightforward—rates are now high in real terms compared to the rest of the world, the currency is stable and inflows into the bond market look set to increase. One adverse (but not new) conclusion from meetings is that the US and China were viewed as heading inevitably to a “selective de-coupling”.

- Growth in China has been manufacturing-led, with services lagging. Much of that growth, though, was driven by inventories, which puts downward pressure on core inflation. We wouldn't be surprised with rate cuts resuming later in 2021.
- China's resilience helps EM. Developed markets (DM) had been the single biggest independent driver of import demand until the past 10 years. China has now emerged again as another independent driver. This allows EM lower growth volatility, and gives EM investors the ability to invest with diversification, not just growth.

### Europe came off as more vulnerable

A second COVID-19 wave seems more acute in Europe than elsewhere in the developed world. Non performing loans were an issue before the lockdowns and are more so now. Growth looks lackluster yet again, after hopes that the European Union's stimulus package was going to make Europe a growth outperformer.

### Emerging markets takeaways

Burden-sharing for private creditors is coming down the pike, with big implications for a number of poorer countries, particularly in Sub-Saharan Africa. From the April, 2020 Semi-Annual IMF meeting, we were encouraged by a new policy development established by the G-20—the Debt Service Suspension initiative (DSSI). We saw incredible opportunities for many of the bonds we look at as a result of this. In a nutshell, the DSSI allowed the poorest countries to suspend debt service to rich countries (bilateral debt) and multilaterals, without requiring the country to default to private sector creditors such as bondholders.

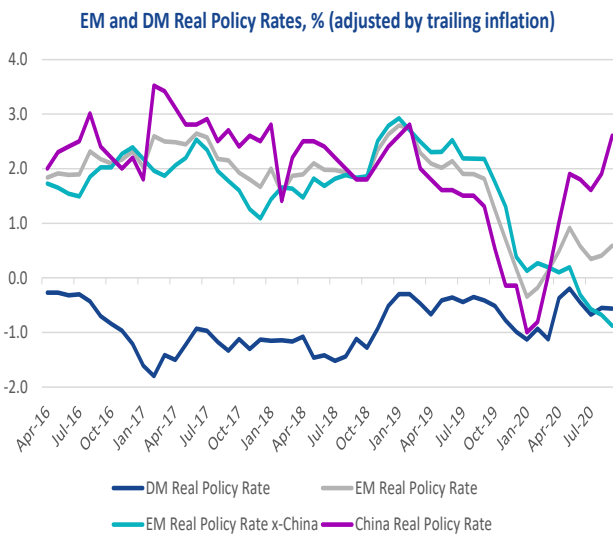
- Officials, especially from the richer G-7, repeatedly expressed disappointment that there was not more cooperation from private creditors. They expected them to voluntarily reschedule payments, which seemingly overlooks that private creditors have fiduciary responsibilities that prevent this.
- The recipient countries themselves don't want to ask private creditors to reschedule their debt, because this would lead to ratings downgrades and risk a loss of market access.

- The DSSI recently extended to last through mid-2021, could be extended further, and may be applied to a bigger number of countries.
- We expect this to unfold on a country-by-country basis, with some countries given more of a break than they would normally get, but this is not endless. Moreover, some countries are near the end of the line already. If a second COVID-19 wave hits global economic and risk sentiment, these concerns could be brought forward.
- China is not yet on board with these policies, complicating the situation, as it is the largest bilateral creditor for a large portion of EM.
- There was little appetite for a bigger IMF balance sheet. There wasn't strong opposition to it, either. The issue is more technocratic. A bigger balance sheet and borrowing quotas doesn't do a lot for the poorest countries who would need more support. Such support is also not targeted—it's a hammer not a scalpel. Finally, a bigger balance sheet is permanent while the crisis is not.
- Greater US involvement in a multilateral approach under a Biden administration might be negative. Instead of the country-by-country bilateral approach under the current administration, which has worked well for the market, a multinational approach is more likely to come up with "blanket solutions" for entire swathes of countries. Be careful what you wish for.

### EM monetary policy tapped out? Maybe not

There's been unprecedented monetary easing in EM, to the point that EM countries have lower real rates than DM. The chart below shows this (it also shows how China looks like it has space). Recent signs of inflation in EM have caused central banks to pause and markets to get concerned. Financial sector risks are also heightened by the thin cushion. It could turn out to be inflationary. We don't think it will, we think the recent upticks in inflation are temporary. In fact, in China and Central Europe, we've already seen the rise in inflation begin to fade. Disinflationary forces remain strong, in our view (other than in, say, Brazil or Turkey). Easing could resume in a number of countries, with China the most obvious, with disinflation forces possibly turning to deflation.

Exhibit 1 – Real interest rates in EM, China and DM



- Some of the stronger EM local currency bond markets could see lower interest rates as a result of ongoing economic weakness, as has happened since the COVID-19 lockdowns. A number of these countries' currencies were stable, in part because weak growth led to substantial import declines, improving their balance of payments. We sometimes call these countries the "EM graduates". A fourth quarter slowdown will be good for many of these bond markets. We'd put China, Mexico and Russia in this category, along with the Czech Republic and Thailand.
- The more risky local currencies, though, might not enjoy that scenario.
- As a gross generalisation, we should reiterate the big-picture fact that EM has some high yields in local currency, high yields in hard currency, and is not over owned. In a low rate environment, that context is still key. Of course, our view is that one needs to be selective and not "like or not like EM" as a whole.

**Mexico's commitment to fiscal orthodoxy**

Mexico's government maintained its commitment to fiscal orthodoxy, but the COVID-19 crisis has exacerbated the country's structural deficiencies which were already undermining the growth trajectory. Mexico's recent pension reform showed that the government can work with the private sector to deal with pressures before they

become a crisis. However, President Andrés Manuel Lopez Obrador's (AMLO) policies and mixed signals continue to weigh on sentiment and this includes the recently unveiled "reinvigorated" infrastructure plan. These are important concerns because Mexico may be hit from the growth side in this crisis due to a lack of fiscal stimulus and slow progress on structural reform which can mean continued sub-par growth in any recovery. There remains a big question of whether President Lopez Obrador will address tax reform before the mid-term elections (probably not). This means that there might be less policy space going forward, as the non-oil revenue base is low, local governments remain under pressure and the stabilisation fund's money may be gone soon.

- Despite these issues, though, Mexico remains one of the few EM countries with high real policy rates and a government that still remains within the mainstream of the type of economic thinking that markets like. Our review above highlights some of the topics that the market will use to guide its ongoing debate over "AMLO good" or "AMLO bad".
- Mexico's challenge is generating growth, given stimulus was below Latin American averages.

**Brazilian officials know their problems**

They have promised to address them; the problem is how they will get policy through the legislature and the limited cushion being provided by the country's low real interest rates. Brazilian authorities came across as fully aware of the severity of their fiscal situation (much worse than the EM average), the market's reaction to it (including the recent sell-off and steepening of the local yield curve) and what needs to be done in the future. The post-COVID-19 fiscal adjustment plans are very ambitious, in our view, (to the tune of 6% of GDP in 2021). The reform agenda includes administrative and tax reforms, the federative pact, spending cap rules, privatisations, deregulation and other measures to improve productivity and growth outlook. Low interest rates are a major boon and Brazilian officials acknowledged that policy credibility is key for keeping rates low going forward. We came back from the IMF meetings with a feeling that there is appetite for reforms within the congress and administration. At the same time, the window of opportunity for advancing reforms is limited and domestic

politics can be a complicating factor. Further, Brazil's weak starting fiscal point reduces future fiscal space in the event of a second COVID-19 wave. Still, Brazil's external position and super-credible monetary policy remain the country's major strengths, potentially offsetting the impact of growth and fiscal dynamics.

- Debt/GDP went from 76% pre-crisis to 94% post-crisis, one of the largest increases in EM.
- The tax burden is already high, at 10% higher than the Latin American average.
- Brazil's challenge is addressing the rise in debt and spending which the Finance Ministry seems up to. The legislature is another thing, especially with municipal elections next month.
- Any good fiscal measures would have the effect of reducing longer-term interest rates. However, front-end rates are already low. One has fewer medium-risk ways of expressing a bullish Brazil view.

#### **South Africa had been considered a likely "de-rater"**

IMF meetings drew attention to some underappreciated positives which can improve recovery prospects in South Africa. First and foremost, South Africa's prime rate is at a 55-year low and it has started to feed through into the real economy, this is especially visible in household credit. Those who retained jobs and income can take advantage of low interest rates. Second, the central bank's credibility is stellar, which means that inflation is resistant to large FX depreciations. Third, a combination of weak demand and sub -4%/5% inflation creates more policy space. There are major challenges, of course. Unresolved electricity issues are weighing on corporate investments and longer-term growth and unfortunately the meetings did not bring any new information on this front. The fiscal position is weak and the prospects for the debt/GDP ratio are concerning. These items remain at the top of South Africa's post-IMF "to do" list.

- South Africa has one of the steeper EM local currency yield curves. If the front-end remains anchored, as we expect, and you see low interest rates, low inflation, bottoming of economic activity, nascent housing demand and potential for the mining sector, there's room for compression in long-end rates too.

- South Africa's external accounts are strong and the floating exchange rate means there is no need to use reserves to manage the exchange rate. Strong gold prices, weak oil prices and weak domestic demand all contributed. Only the latter looks like changing, which we believe would be viewed as positive in its first interpretation.
- The South African Reserve Bank (SARB) communicated its willingness to support bond market functioning and was not overly concerned about fiscal deterioration. The upcoming budget could be a positive market surprise (i.e., somewhat restrained), which would be positive, but even if it disappoints, we think the concerns are priced. The SARB also indicated that it would prefer a longer period of low rates to further cuts.

#### **Turkey still looks a mess, despite central bank tightening**

The Turkish government began to tighten policy in July, as loan growth was running at 40% year-on-year and real rates were negative. The over 30% devaluation of the lira year-to-date, even as other EM currencies recovered, is the most likely catalyst. However, the lira remains vulnerable due to the loss of credibility of policymakers that has led to a substantial dollarisation of domestic portfolios and the Erdogan government is courting of US sanctions under a future Biden government due to its testing of the Russian S400 defense system.

- The Ministry of Finance continues to highlight Turkey's low level of gross debt to foreign investors which, at 35% of GDP, is well below peers. However, investors' main concern is on the low level of gross and net foreign reserves, which have declined by US \$24 billion year-to-date, spent to defend the currency.
- Going forward, it will be key to monitor if the government's recent tightening bias continues long enough to bring real rates into positive territory, helping to support the currency and slow imports. The main risk from an ensuing contraction in economic growth would come from a rise in non-performing loans as the recent rapid credit growth would have looser credit standards.
- The borrowing strategy of the Turkish Treasury is also starting to shift. The Treasury just issued a US \$2.5 billion, five-year US dollar global bond at a spread

of roughly 600 bps over US government bonds. Additionally, the Treasury will begin issuing long-maturity bonds in local currency again in an attempt to increase the sovereign's weight in EM benchmark indices. Foreign ownership of Turkish fixed income is near record lows. This could be a risky strategy if foreign demand fails to materialise at these auctions.

- The Treasury also made clear to investors that Turkey had no need or interest in an IMF program and Moody's talk of a coming balance of payments crisis was both speculative and wrong.

### Uruguay is one of clear bright spots in global EM

The new government in Uruguay is implementing an ambitious reform agenda at the same time as it has skillfully managed the COVID-19 pandemic. COVID-19 cases and fatalities in Uruguay are not only the lowest in the region, but also one of the lowest in the world on a per capita basis. We believe the government's management will allow Uruguay to return to growth quicker and will help support government revenues. Its management also underlines what we view as strong institutions and effective policymaking.

- The government is embarking on a multi-year fiscal consolidation that includes a reform of the pension system, the implementation of a fiscal rule that caps real growth in primary expenditures in line with real economic growth and a modernisation of monetary policy that includes an inflation targeting framework with the policy rate as the main price-setting tool. Not only will this help anchor Uruguay's investment grade rating, but it will also finally set Uruguay on a credible disinflationary path and allow for both lower nominal interest rates domestically and a meaningful de-dollarisation process.
- Uruguay is also considering issuing a sovereign green bond. As a leader in sustainable energy with over 90% of energy consumption domestically being renewable, Uruguay's leadership in ESG may allow it to borrow at even lower yields.

### Argentina is doubling down on losing policies

In particular, Argentina is doubling down on its slow fiscal adjustment path, with a target primary deficit of 4.5% of

GDP, of which at least 60% will be financed by the central bank printing pesos (Argentine pesos, unfortunately for them). Minister of Finance, Martin Guzman, still riding high after his successful sovereign debt restructuring negotiation, claimed that this monetary financing would not have a meaningful inflationary impact. Additionally, there is not yet any credible reform agenda in Argentina that would anchor investor expectations of the government being able to reach an agreement with the IMF. The government likely knows that this is really the IMF's problem and not theirs, as Argentina had made it abundantly clear the government will not seek new financing from the IMF and does not have any ability right now to repay the US \$40 billion plus in loans that will come due over the next few years.

- The finance minister also expressed concern over the high parallel exchange rate that is pricing over a 220% devaluation of the official rate. The authorities may switch strategies from punishing that parallel market with ever tighter restrictions to one of embracing it in the hope that liquidity can return and help reduce the significant premium. However, it is doubling down on no devaluation of the official rate other than in line with official inflation and so as long as the government continues to finance the deficit by printing pesos, the impact of any supportive measures is likely to be short lived.

### El Salvador and Costa Rica look headed for more trouble

Both economies have debt burdens on unsustainable trajectories and were unable to articulate a credible consolidation approach to investors during IMF meetings.

- Costa Rica lacks the political will to pass a fiscal consolidation plan through the legislature without which the deficit may reach 15% of GDP in 2021. There is a meaningful risk that without urgent access the government will be unable to roll debt in the domestic market.
- El Salvador is in a similar position with a fiscal deficit this year of 13.5%, for which the government cannot find sufficient funding to execute. It is not clear how the Bukele government plans to reduce this deficit to 8.5% of GDP in 2021. Both of these countries are potential targets for future restructurings.

### **Jamaica and the Dominican Republic, on the other hand, saw re-confirmation of their effective policy stances.**

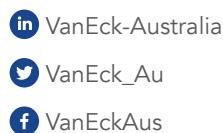
- Both of these economies were lauded by the IMF for their macroeconomic policy. In recent elections, Jamaica's government won a second term in government with the prime minister reaffirming his government's commitment to strong fiscal and monetary policy and the need to tackle governance issues. The primary surplus for 2020 is 3.1% in the recent supplementary budget, despite the need to finance an additional 0.8% of GDP in COVID-19 related expenditures. That's pretty incredible, in our view, relative to the rest of the world.
- On the other hand, the Dominican Republic is running a 2020 budget deficit of 9.3% of GDP. But, it plans to undertake a massive fiscal adjustment in 2021 by raising revenues by 22% and cutting expenditures by 18%, resulting in a target deficit of 3% of GDP. The government has substantial credibility with both the IMF and the investor community so that if it fails to meet such an ambitious target it won't have any issues with financing.

### **Romania**

The Romanian government challenged a 40% pension increase in the Constitutional Court, which is expected to overturn it. The government wants to stick with the more limited 14% increase in pensions that started on 1 August. Even though the European Union suspended the fiscal pact for 2021, Romania plans to show a significant budget consolidation for 2021 because it believes it is the right path to follow. Additionally, it plans to significantly improve the proportion of its spending that is paid for with EU funds to 70% of total in 2021. Importantly, Romania still has the goal of joining the Eurozone and adopting the Euro as its currency.

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