A season of wishful thinking

IMF Spring 2023 Meetings Takeaways

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Summary

There was a lot of wishful thinking among policy makers and market participants at the recent IMF Spring meetings. *The IMF's April World Economic Outlook paints a picture of still high global inflation in 2023 of 7% that will only converge to inflation targets in most countries by 2025. The disinflation process is driven by tight monetary policy and a high unemployment rate but also by lower oil prices. These 3 assumptions are all wishful thinking. Monetary policy in developed markets is hardly tight with ex-post real rates negative and ex-ante real rates barely positive. Additionally, developed market monetary policy is being effectively neutered by the extraordinary actions of central banks to shield both markets and the real economy from any pain. Labor markets remain extremely tight not only due to strong demand but also by a shortage of labor supply. Oil prices are buoyed by strong global demand aided by robust tourism from China and an OPEC that is assertive in its desire to keep oil markets tight.*

- **Wishful thinking from the IMF. The IMF expects slowing global growth and slowing global inflation to eventually return developed market interest rates down to levels that make sovereign debt sustainable. Any other scenario is unthinkable.**
- **Wishful thinking from markets. Banking problems in the US and Europe result in slower credit growth but are otherwise contained, markets can be saved by validating the interest rate cuts currently priced. Unfortunately, growth and inflation data do not corroborate this scenario.**
- **Wishful thinking on US power relative to China. China does not want to play along with the IMF's debt restructuring agenda despite the invention of new forums (the Common Framework and the Global Sovereign Debt Roundtable) to coerce it to do so. China has a strong hand both economically and geopolitically and the US does not have a good strategic response.**
- **Hope in EM. There are good reasons for EM debt investors to be optimistic: countries with high real interest rates, declining inflation and strong growth outlooks buoyed by China's reopening and commodity prices. The US may default on its ballooning debt stock but this isn't an issue for most emerging markets that have low debt and modest fiscal deficits.**

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Additionally, developed market monetary policy is being effectively neutered by the extraordinary actions of central banks to shield both markets and the real economy from any pain. Labor markets remain extremely tight not only due to strong demand but also by a shortage of labor supply. Oil prices are buoyed by strong global demand aided by robust tourism from China and an OPEC that is assertive in its desire to keep oil markets tight.

Policy makers have good reason to wish for inflation to return quickly to target and for interest rates to decline back to pre-COVID levels due to one key initial condition: excessive debt burdens. The IMF dedicates Chapter 2 of the World Economic Outlook to the natural real rate of interest (the interest rate that neither stimulates nor contracts the economy, and the real rate assumption underpinning the IMF's debt sustainability analyses).

Debt burdens in advanced economies are unsustainable at higher real interest rates and there is no political will to make the necessary fiscal and structural adjustments. Since the IMF cannot say that its major shareholders are not solvent, the baseline assumption is for interest rates to decline to levels that solve the problem. Any other conclusion would be sacrilege. In fact, the need for global capital to finance investment in the green transition, combined with ageing populations (which tend to consume more than to save) will likely raise the global cost of capital for a generation.

There was a lot of hope that a contained banking crisis would solve investors' inflation and Federal Reserve concerns. The failure of Silicon Valley Bank exposed to the US consumer major inconsistencies in central bank policy and regulation that have led depositors to slowly exit zero interest bank deposits in exchange for treasury bills yielding over 4%. The "hope" is that the decline in funding to the banking sector will lead to a decline in lending and a gradual contraction in economic growth. Any bank failures along the way to this desirable soft landing will be contained by extraordinary policy measures by the central bank. The modest growth slowdown will help inflation moderate and the Fed will not need to hike more. In this twisted logic, banking failures lead to goldilocks moments for markets. But by removing any pain from the economy and market, monetary policy loses effectiveness, while the labor market remains tight and inflation sticky. The Fed will need to hike more to compensate and the market is not pricing these additional rate hikes.

There was a lot of concern about the looming US debt ceiling deadline and a firm belief in last-minute resolutions. The market expects politicians to do the right thing for the economy at the last minute, just like in 2011. The problem is that House Speaker McCarthy made extraordinary concessions to secure his position last year including a provision that allows for any one member to ask for a vote of no confidence. Several congressmen from the far-right wing of the GOP will only vote to increase the debt ceiling if the budget is balanced. If McCarthy were to bring any compromise legislation to increase the debt ceiling up for a vote, the publicity that comes with forcing a default could be more valuable for some of his key supporters than "doing the right thing" for the economy. The Treasury will soon provide an update of when it expects to not have enough cash to meet all obligations and if that date is not moved past mid-June due to favorable tax receipts, the market will start to worry. Many speakers viewed the risk of default as greater than 10%. Before defaulting, the Treasury would cut other expenditures and the immediate fiscal contraction would push the economy into a deep recession. The market implications of an actual default would be even more severe as many institutional investors can not own defaulted debt and there would be panicked selling.

There was a palpable frustration with China's unwillingness to restructure bilateral sovereign debt. There was talk of a lost decade for debtors stuck in limbo because of China. IMF programs cannot move forward without an agreement from China and private sector investment needs to know how capital will be treated before moving forward. The Paris Club framework took time to develop and there is hope that as the West better understands China's needs, debt relief agreements that are acceptable to all creditors can be achieved. China is averse to principal haircuts but comparable treatment in net present value terms using maturity extensions is a potential solution. However, China did a lot of its lending to emerging markets for geopolitical influence, specifically to secure access to critical commodities or trade routes, and restructuring its debt gives China's influence away. The Zambia debt restructuring, if and when it arrives, will show the path forward. Zambia has been the perfect student for the IMF, putting the onus to forgive debt squarely on China.

There was a lot of discussion of the US decoupling its trade from China but little evidence of it. For national security purposes it makes sense for the US to build supply chains that rely on domestic production or production from close allies. If China were to invade Taiwan, supplies of critical imports such as pharmaceuticals and even some inputs into military aircraft would be at risk. However, China's economy is too large to avoid and it is profoundly expensive to divest from existing production facilities. Even when building new facilities in neighboring countries, a Chinese firm often has some value-added role. The most recent trade data showed the China trade surplus with the US reaching a new record high.

From China's perspective, there are also national security considerations to make regarding its investments in the US. This other side of the coin was surprisingly not discussed at IMF. China's record US dollar trade surplus needs to be invested somewhere and the one place it is most clearly not being invested is US treasuries. China watched as the US froze Russia's access to its own holdings of US dollar debt. If China is heading toward conflict with the US, it is simple risk management to decrease its exposure to assets the US could seize first.

There was hope that Japan would finally exit yield curve control and that it would be positive for markets. Japanese growth is forecast at 1.3% for 2023 which is above potential growth of 0.5% and the output gap should close this year. The labor market is tight and with inflation above 3%, the Bank of Japan's extremely accommodative stance risks pushing inflation even higher. The market expects the BoJ to drop yield curve control this year. The Yen is cheap, and when interest rates on JGBs rise without the BoJ's intervention, the Yen could appreciate substantially. However, the Yen's gain is the US dollar credit market's loss as Japanese investors' appetite for US credit should decline substantially. China and Japan are the two largest foreign holders of US treasuries; without their purchases, more US treasuries will need to be purchased domestically and this should raise the cost of capital for the US private sector.

The Ukraine-Russia war and ESG were out of the limelight. Frozen conflict was the collective wisdom of how the war would end. There was some skepticism about starting reconstruction while bombing was still taking place. Ukraine sessions were less well attended than in the past as investor focus has shifted.

ESG was also less discussed and where it was, the conversation was more balanced. There were complaints from the rest of the world that the US Inflation Reduction Act was making green investment less competitive in their own country and that the legislation is not consistent with WTO rules.

There was a lot of investor pessimism due to specific bad credit investments and underperformance. Egypt stood out as having been a consensus favorite overweight by investors that had performed poorly and was now a source of angst. Egypt borrowed an unsustainable amount of external debt while under an IMF program and yet it has been unable to reduce its external financing needs meaningfully. The currency is under large devaluation pressure but it has no policy anchor as real rates remain extremely negative and there is no one willing to bring new capital onshore. There are major maturities coming due towards the end of the year that could catalyze a default.

Aside from Egypt, many Sub-Saharan Africa sovereigns along with Ecuador, Tunisia, and Pakistan have also disappointed. But the impact on the indices is not material. The performance of the broader EM asset class has been stellar with the GBI-EM up over 5.2% and the EMBIG up 1.9%. Given the strong performance, one would expect investors to be more upbeat. However, the majority are underperforming their benchmarks as they are overallocated to HY which has underperformed and under allocated to EM local debt which has outperformed. The outlook for EM local debt is very positive as EM investors view it as being the most likely top performing EM asset class this year and they are underinvested.

Most of Latin American hiked early and high enough to set inflation on a declining path while also benefiting from improving terms of trade due to high commodity prices. In Mexico, high real interest rate and the near shoring narrative has attracted a lot of hot money inflows. However, the Mexican Peso is expensive and FDI has not lived up to expectations, leaving the currency vulnerable to a downturn in the U.S. economy. The Chilean central bank was more hawkish than market expectations in terms of how long it would keep rates high and when it would undo its FX intervention program as domestic consumption remains uncomfortably strong.

Colombia's high growth and high deficits look to be a thing of the past as central bank policy and responsible government policy cool the economy. There is a good chance the Peruvian government survives until 2026 as the population has grown tired of changing its government every year which is welcome news as the country benefits from higher copper prices and a credible central bank. The Brazilian central bank knows real interest rates are too high but it is afraid to give in to the Lula administration's pressure for fear of upsetting inflation expectations. The Lula administration is trying to say just enough of the right thing to get the central bank to cut rates without upsetting growth too much. The two are still figuring out their relationship but the market has become accustomed to this dance.

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Emerging Europe was harder hit by the fuel price shock emanating from the Russia-Ukraine war and inflation there remains uncomfortably high. The lack of consistency between Hungary's fiscal, monetary, and regulatory policies could mean higher for longer inflation while the timing of EU fund disbursements remains uncertain. Poland's monetary tightening has started to impact growth, but it remains to be seen whether this is enough to tame inflation. The labor market is structurally tight, and the fiscal gap is likely to widen further in the run up to the elections. Romania contrasts favorably due to its great relations with the European Union, which paves the way for very large capital inflows. The key challenge is to address price pressures that go beyond base effect/energy, and stem from stronger GDP growth than in the rest of the region, pro-cyclical fiscal policy, and high real wages.

In contrast to Europe, the most Middle Eastern countries have modest inflation and strong external positions due to high commodity prices. UAE's fundamental outlook remains very solid, supported by high oil prices, and authorities are using this opportunity to implement structural reforms to diversify the economy in the medium term, implement green transition, and the rest of the ambitious reform agenda for the post-hydrocarbon future. UAE is playing the geopolitical fragmentation card well, including partnerships with China and India. Qatar managed to avoid the World Cup host country curse with continued strong growth along side large fiscal and current account surpluses and debt on a declining trajectory.

While Africa also benefits from strong commodity prices, excessive debt burdens and lack of affordable financing makes the outlook more challenging. The market is waiting for change to come in Nigeria where the incoming government has promised to raise the VAT from 5% to 8% and to eliminate fuel subsidies. Still, there are no easy answers to the overvalued exchange rate and a new central bank governor has not yet been appointed. Mozambique's authorities are working hard to keep the IMF program on track – and they've been successful so far – but security risks are non-trivial and hard to predict. The recent OPEC+ move to curb oil production is good news for Angola, albeit a longer-term outlook for the sector is not very optimistic. The government's liability management operations eased near term concerns for the country's debt. Cote d'Ivoire's relatively good performance in 2022 came at a cost of widening "twin" deficits (fiscal and current account), and the international reserves might have fallen more than desired. The significant upfront fiscal consolidation would be a huge improvement (both near-term and structurally), as authorities are scheduled to have their IMF Board review in May. Morocco remains a solid macro story with a good track record in reforms, and it might soon join other countries in getting the IMF's brand-new Resilience and Sustainability Trust (RST) facility.

Emerging Asia benefits from a China who is growing sharply due to a V-shaped consumption led post COVID recovery. Thailand benefits the most from surging Chinese tourism but other regional economies have seen their growth upgraded as well. Indonesia's balance of payments is extremely strong with coal exports to China and nickel exports booming combined with surging FDI and portfolio inflows. The central bank is enjoying the FX strength and the lack of inflation pressures, though there is risk of food inflation if El Nino impacts rice crops adversely. The Philippines is the one ASEAN economy that remains overheated and the central bank has not yet taken forceful enough action. 2022 growth of 7.6% exceeded expectations and 2023 growth is forecast to be near 6.5%. January inflation came in at 1% which would be a 12% annualized rate, though the central bank forecasts inflation to slow to 6% for the full year.