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IMF 2021 SPRING MEETINGS

# The glass is all full - Key takeaways from IMF's 2021 Spring meetings

*We are more positive on the outlook for emerging markets (EM) debt, especially local-currency debt, following the conference, which lagged positive growth news and over-reacted to the interest rate selloff.*

• Global growth forecasts were upgraded, and these could be durable. The US combination of excess savings, pent-up demand, and a vaccine amount to an economic boom, although the view is not commonly shared.

• Inflation and the Fed are the topic du jour – while inflation is widely expected, the Fed's ambiguous response is contributing to uncertainty over inflation and interest rates. We think the Fed is unlikely to blink soon.

• China loomed benevolently over meetings. While the China/US strategic competition is on the back-burner, this is spreading to other policy areas.

• Europe came off as the next zombie, potentially anchoring US yields. Italy, under Prime Minister Mario Draghi, might be a bright spot.

• Market participants are too bearish. Most are negative about the recent rate rise, even while acknowledging that EM is the key answer to the the low-yield environment.

• Nominal yields, while rising, are still low by historical standards and are not yet problematic for most EM borrowers. Moreover, real yields may not be rising and may actually decline as inflation and inflation expectations rise.

• Several risks to EM were highlighted. These were mostly related to debt and vulnerability to higher financing costs – fear of higher rates is already stark.

• It was clear that the Biden administration has one policy, political strategy, and goal – growth. The absence of deficit hawks is our most pronounced observation of the US fiscal discussion.

• Key EMs are getting out of the pandemic era at varying speeds, but overall they are pursuing good policies, will grow with a lag to the global trend, and are seeing virtually no strains on external accounts. Turkey and Brazil are important exceptions.

## Global growth upgrades

The IMF upgraded its 2021 global growth forecast to 6%, up from 5.2%. Its 2020 GDP was also revised upwards to -3.3%, which was 1.1% higher than its previous forecast only 6 months ago. While the Fund says growth is asynchronous, we think it looks staggered. China's economy rebounded last year, the US is now recovering, and Europe and the rest of the world should follow subsequently as vaccines are rolled out. US growth appears durable, giving plenty of time for laggards.

The US's combination of excess savings, pent-up demand, and a vaccine amount to an economic boom. The main difference between now and the GFC is that consumer and corporate balance sheets are in a good shape. Although the coronavirus, and policy responses may impede growth, the risks are fading with vaccine rollouts as well as governments' reluctance to employ lockdowns. Growth was ultimately viewed as the only solution to rising debt, while concern over inflation was temporarily set aside.

We think market participants under-appreciate the magnitude and durability of the coming US economic boom, particularly the Biden administration's singular focus on growth at any cost. Deficits, the coronavirus, higher interest rates, or the absence of an infrastructure bill were all presented as risks to continued growth momentum. The possibility of the Fed hiking interest rates early was another risk, but we see no evidence for that.

## Inflation and the Fed

While inflation is widely expected to rise, the Fed's vague response is contributing to uncertainty over inflation and interest rates. Whatever is driving up consumer prices, the focus will be one of labor market tightness, supply constraints, combined with a surge in demand. That said, a lot of this is already priced into markets and the Fed has repeatedly communicated that it will see through any near-term inflation.

This requires the Fed to stay on hold for a prolonged period to close the inflation gap. The Fed is not under pressure to do anything, as rates between 2 and 5 years are subdued compared to longer-term rates. The real problem will come if the US closes its output gap, anecdotal inflation rise, and the Fed faces internal dissent. Rising inflation expectations could be a driver here, too. But, overall, we find it very hard to think that the Fed is going to tighten prematurely.

## China loomed over meetings as a benevolent force

Just a few months ago, US/China tensions were investors' top concern. Now, though, the Biden administration's approach to China seems to be characterised by less noise and drama, which the market has welcomed. That US policy will be coordinated, better communicated, and more multi-lateral within the administration has also buoyed investor sentiment. Markets like predictability. And just like the Biden administration, China is more focused on domestic issues than seeking confrontation. But strategic competition is here to stay, though the tone has changed, with new policy spheres being re-framed as meeting China's challenge. These extend beyond the traditional defence spending, and issues around technology transfer and ownership.

## Europe's still a morass, but Italy is a potential hope

Europe came off as the next zombie, potentially anchoring US yields. The persistently low productivity, sluggish growth, a lagging pandemic response, despite the significant monetary and fiscal stimulus support our case. Italy, under the leadership of Prime Minister Mario Draghi, is a potential bright spot, which could be euro positive. Draghi is implementing structural reforms, and has implicit cooperation from the European Commission. Moreover, as vaccinations pick up, the worst could be behind us.

## Markets are too bearish on the recent rate rise

Notably, EM on the whole is deemed vulnerable because of weakness in EM debt for the year to date. While this may be apply to certain countries such as Brazil, Russia, and Turkey, this does not apply to other fundamentally stronger economies.

## Mixed views on global growth

Higher growth in the US and global economy was viewed as a positive for credit quality at country-specific meetings. But all this good growth couldn't be turned into a positive verdict on the EM debt asset class at the top-down level; we are skeptical of that, and think the market view is changing.

## Greater role for EM debt in mainstream portfolios

Insurance companies, in particular, are seen as likely to adjust their bond holdings in favour of emerging markets, particularly hard-currency EM debt. This is due to the strong performance of EM debt over the past three decades, combined with the absence of yield in Treasuries and US investment-grade debt. EM debt is quietly becoming the main answer to the new low-yield environment.

### Risks to EM growth

Several risks were highlighted, in particular rising global debt levels, higher corporate debt in China, EM banks' limited capacity to absorb further government borrowing, and the vulnerability to higher global interest rates/financing pressures.

### Biden administration's growth focus

We think the Biden administration's singular pursuit of growth has widespread impact. US fiscal stimulus is not ending with the stimulus bill, as a US$2 trillion infrastructure programme is now working its way through the US Congress.

### Key EMs exiting the pandemic era at varying speeds

Emerging markets on the whole are pursuing good policies, will grow with a lag to the global trend, and are seeing virtually no strains on external accounts; Turkey and Brazil are the exceptions.

Elsewhere, Chile is recovering. Two-thirds of firms that closed in 2020 have reopened. The vaccine roll-out is speedy, with roughly 80% of the population expected to be vaccinated by mid-year. Add in a global recovery, easy domestic financial conditions, and the outlook looks positive enough.

Colombia has a good starting point. Colombia's countercyclical policies helped to ease the COVID's pain, and low inflation allows the central bank to keep its accommodative stance for longer. The central bank also managed to boost its international reserves, while Colombia's access for the IMF's Flexible Credit Line provided a much-needed safety net. However, the country's fiscal issues remain, and political developments will keep the market on edge next year. The outlook for the tax reform – a necessary precondition for medium-term fiscal adjustment – is uncertain at best. The current proposal is likely to be watered down due to the proximity of the presidential elections. Colombia's generational change can improve the chances of left-wing politicians, and can mean a totally different game for the country and investors.

Ecuador gets a serious fresh start. Guillermo Lasso's victory against Andres Arauz for the presidency comes as a surprise to everyone and is a positive development that could mark the end of Correismo (a market unfriendly movement named after a former president currently in exile). The IMF stands ready to support the country with a new programme and the US Treasury will lend a hand as well. With oil prices above US$60 per barrel (the price assumed in the budget is US$48), along with a non-oil trade surplus, Ecuador has not had such a strong macro position in years. We think there is room for meaningful spread compression in the front end of the curve.

Peru's economy is strong, although that can't be said about the politics. Peru is running the largest trade surplus in its history: US$14.5bn this year, with US$15.7bn forecast for 2022. In addition to the positive terms of trade coming from commodities, the economy is getting a boost from extra loose monetary policy, with the policy rate just at the lower bound. This is in addition to a large fiscal stimulus in 2020. However, all this may not be enough to avoid an extreme outcome in the upcoming Presidential election, with the far left candidate Castillo making it to the second round. If he were to win, he would inherit nearly US$80bn worth of central bank reserves and the lowest debt levels in the region, giving him ample room to help the nation's poor, but potentially at the expense of foreign investors.

Argentina is set to achieve its goal of muddling through. Argentina's goal of muddling through without any major policy adjustment before the mid-term elections this October appears feasible. The IMF's new SDR allocation of about US$4bn covers the country's external financing needs. The lack of a clear long-term economic strategy from the Peronist governing coalition, combined with its plummeting popularity, could be enough to bring about political change in upcoming polls.

Brazilian policymakers are behind the ball. The central bank's rate hike appears to have gone too far, given that it didn't achieve the macro environment targeted. While the economy is still suffering fromthe pandemic, the central bank tightened policy because it is looking through to future when the economy is expected to pick upin the latter half of the year. For this reason, and because it views the recent pickup in inflation as temporary, it is guiding the market to a partial normalisation of policy rates. However, given the weak fiscal dynamics and unsustainable debt levels, most investors are skeptical of the policy stance.

Indonesia continues to enjoy low inflation, despite the massive fiscal stimulus largely financed by the central bank. Bank Indonesia appears able to execute the same "costless" QE as in developed markets, with 5.1% of GDP in government debt already on its balance sheet. This is in addition to the extra financing provided for the government via primary bond auctions that will continue through 2022. However, EM investors are skeptical and purchases by offshore investors are running behind the central bank's forecast for the year to date. The big test will likely come if, and when, the US dollar regains its strength.

Russia is monitoring inflation. The central bank sees meaningful non-food inflation pressures and a very tight labour market as key risks to meeting its inflation target. As a result, it is pursuing a moderately tight policy stance similar to the one taken in 2018. As regards the impact of sanctions, the central bank made it clear that it would only address the shock via macro prudential measures, unless the sanctions lead to a change in Russia's r* (neutral rate of interest). The central bank also did not see any change in Russia's potential growth rate as a result of the pandemic.

Czech Republic faces problems that are akin to those of developed markets. The economy is quite industrially-oriented, which helped to mitigate COVID's impact on services and trade. But the main issue is when the central bank will be able to start normalising its policy rate. The discussions seem to suggest that the true policy rate path might be below the one implied by the central bank's model, and that it can start raising rates in the second quarter, at the pace of 25bps per quarter.

Turkey might end up being among the fastest-growing economies in 2021, but the structure of growth – especially the return of cheap government-sponsored credit and its impact on external balances - is a big concern. Discussions on Turkey took place after a major shake-up at the central bank, and it looks like the new governor's ability to cut rates will be limited – in part due to high and rising inflation. And while the central bank's international reserves do provide some buffers, they do not offer much cushion. Local markets are likely to face a bumpy ride in months ahead, given that the central bank is no longer seen as independent.

Egypt's policymakers have managed to boost revenues and reallocate spending despite the pandemic taking a toll on the tourism industry – a laudable achievement under the circumstances. What's at stake is sticking to its primary balance target by using administrative resources, digitalization and bringing in the informal sector to rapidly reduce the country's debt/GDP ratio, and create fiscal space for future development. That most of Egypt's debt is very short-term underscores the urgency of the problem.

Nigeria's pandemic-related contraction was smaller than expected, its debt level still compares favourably to regional peers, and the 2021 funding costs appear to be manageable. However, the medium-term growth path is well below the pre-pandemic level, and there are sustainability risks due to fiscal vulnerabilities. Nigeria had managed to transition to a lower oil price regime, but non-oil revenues are low. Policymakers' piecemeal approach to the exchange rate liberalisation is another major concern, as it reinforces the existing macroeconomic imbalances.

Under the IMF programme, Angola is getting an oil revenue windfall, and its legislative agenda is impressive. However, the country's discussions were firmly focused on debt sustainability. The participation in the G20 debt agreement temporarily eased Angola's debt burden and improved its cash flow, but there are multiple uncertainties as to what happens when the debt moratorium expires at the end of 2021, especially if oil prices go south.

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