RBC Global Asset Management

Fiscal discipline and stability: a new era for EM sovereigns

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The last year in emerging markets can be defined as one of change, with a record number of elections, shifting economic and monetary policies, and geopolitical tensions influencing markets. Looking ahead, the geopolitical backdrop could pose new questions for some EM issuers and opportunities for others. Shifts in trade dynamics, fiscal priorities and geopolitical strategies could introduce volatility to global risk assets, including EMD. EM sovereign credits generally have lower debt and gross financing needs compared to developed markets countries, and credit rating trends are likely to remain positive in the year ahead.

Key Points

- Many EM countries have shown a remarkable commitment to fiscal discipline, with improved budget management, lower deficits and enhanced debt sustainability.
- Fiscal performance will be a key risk for many countries and continues to be a key driver of performance differentials between countries in the EM universe.
- Coupled with the adoption of prudent and effective monetary policy, many economies find themselves in a stronger fundamental position compared to the past.

> "In reality, many EM countries have shown a remarkable commitment to fiscal discipline, with improved budget management and lower deficits."

EMs exhibit improving fundamentals overall; we have a benign outlook for sovereign defaults

EM countries have often been portrayed as high-risk borrowers, especially when compared to DM. In reality, many EM countries have shown a remarkable commitment to fiscal discipline, with improved budget management, lower deficits and enhanced debt sustainability. Coupled with the adoption of prudent and effective monetary policy, these economies now find themselves in a stronger fundamental position than before, reflected in the trend of positive credit ratings witnessed in 2024 and expected to continue in 2025. EM nations have generally reduced their gross financing needs, making them much less reliant on external borrowing and better able to withstand economic pressures going forward.

With the majority of the sovereign restructuring events concluding in 2024, leaving only the long-standing sovereign defaults outstanding in Lebanon and Venezuela, the outlook heading into 2025 turns to life beyond restructuring (Chart 1). Having survived the shocks of the past few years, many sovereigns have grown reserve buffers and reduced near-term liquidity stress, aided by restored market access and bilateral and multilateral support. However, for these higher yielding issuers debt stocks and interest costs remain elevated, so attention now needs to focus on delivering debt sustainable fiscal policy to reduce vulnerabilities. Whilst a return to the Eurobond markets helps mitigate liquidity risk, the international financial institutions (IFI) will continue to be a key external lender to many EM high yield issuers.

Our base case is for no sovereign defaults in 2025, although Bolivia and the Maldives remain in a precarious financial position where policy correction and/or additional external support are required to prevent a sovereign debt default and restructuring. The benign outlook for sovereign defaults following the prior year's restructuring events leaves us positive on the outlook for EM sovereign credit in the year to come, coupled with overall improving fundamentals on the whole, mainly driven by high-yielding sovereigns.

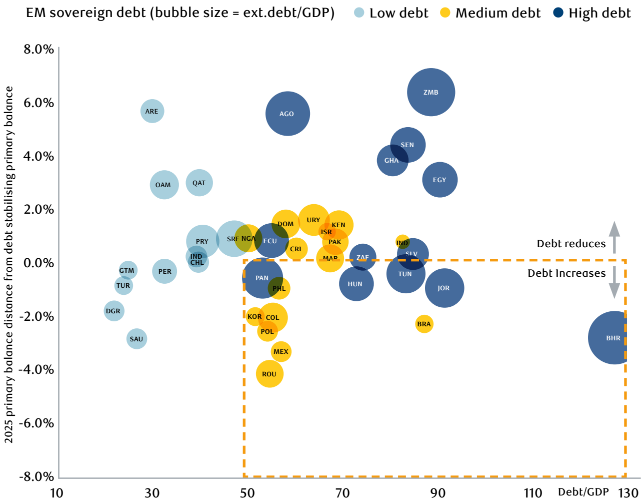
We envisage the fiscal outlook into 2025 will improve on aggregate from 2024 levels

Fiscal performance will be a key risk for many countries and continues to be a key driver of performance differentials between countries in the EM universe. Many countries have been left with higher debt levels and increased funding costs post the macro shocks of the last few years, and the room for adjustment and time to correct course is running out, with the market quick to punish unsustainable fiscal policies in vulnerable countries looking to force authorities into action. In 2024 we witnessed fiscal stress and market focus on a few countries, in particular, Brazil, Colombia, Panama, Poland, and Romania.

In LatAm, countries with challenged fiscal outlooks for 2025 include Brazil, Panama, and Colombia

Brazil is an anomaly because it has the highest public debt-to-Gross Domestic Product (GDP) ratio and largest nominal deficit, at around 85% and 9% respectively, but relies predominantly on domestic capital markets for its funding and so the local currency yields bear the brunt of doubts over the government's commitment to fiscal discipline[1]. We expect the Lula administration to deliver a balanced primary budget as targeted, but this will be a couple of points short of the level needed to stabilise the debt dynamics.

Chart 1: Fiscal/debt overview looking into 2025



Source: Haver Analytics, IMF, Morgan Stanley Research.
Note: Forecasts by Morgan Stanley Economics where country is covered, otherwise the IMF. Note that for Senegal this does not include the recent restatement of fiscal and debt numbers.

Panama and Colombia, on the other hand, face less challenging debt dynamics because their debt ratios still hover below 60%[2], but both governments still lack political will to implement a significant fiscal adjustment.

The Petro administration in Colombia has little ideological inclination but will be forced by robust institutions to respect the fiscal rule and therefore restrict the budget deficit to around 5.1% of GDP.

> **"The 2025 deficit is likely to be above 5% of GDP, and only a return to Panama's historic pace of economic growth will prevent the debt ratio rising above 60%"**

The Mulino administration in Panama is more ideologically inclined to implement a fiscal adjustment but lacks support in the National Assembly and has already had to row back on budget plans and proposals for a parametric reform of the social security system, as well as shy away from proposals to re-open the controversial Minera Panama copper mine. The 2025 deficit is likely to be above 5% of GDP, and only a return to Panama's historic pace of economic growth will prevent the debt ratio rising above 60% and likely triggering the loss of investment grade.

[1,2] Bloomberg.

In Central and Eastern Europe, focus on fiscal risks has mainly centred on Poland and Romania

Poland's fiscal position has deteriorated in recent years with a ramp-up in defence spending post the outbreak and lasting effects of the war between Russia and Ukraine. The country's strong sovereign balance sheet and deep domestic markets, as well as readily available access to concessional grants and funding from the EU and external markets for the moment, has seen the increase in the fiscal deficit and spillover effects remain relatively well contained. However, this will continue to be a key focus for investors in the coming years if it continues but with no plan to reign in the overall deficit.

In **Romania**, continuous fiscal underperformance and unchecked spending, as well as a pick-up in defence spending due to the Russia-Ukraine war in recent years, have seen a large rise in the Eurobond debt stock that has continued to weigh on markets from ever-increasing appetite to tap markets to plug the fiscal gap at ever-wider spread levels.

Ongoing turmoil in domestic politics post a cancelled presidential election, that has been rearranged for May 2025, has raised concerns on the ability of the incoming parliament and coalition government to reign in the fiscal deficit and stick to the relatively lax seven-year plan that the Ministry of Finance has agreed to undertake with the EU under the Excessive Deficit Procedure that aims to reduce the fiscal deficit by 1% per year over the programme.

Alongside the political developments in the run-up to the presidential vote re-run in May, the market will be keenly watching the initial fiscal policy steps of the new government coalition post parliamentary elections in December, for signs of course correction and its willingness and ability to push through painful adjustment measures for the Romanian population, if Romania aims to hold onto its Investment Grade credit rating currently held by Fitch, Moody's,and S&P. This rating risk was driven home in recent weeks, with Fitch's negative outlook move in mid-December during the height of the political fall-out post the now-cancelled presidential first-round election.

African sovereigns in focus in 2025 include Senegal, Gabon, Egypt, and Nigeria

In **Senegal** and **Gabon**, increased debt and spending have meant a halt in their IMF programmes. The ability to pivot toward policy adjustment & regain programs will be key to the debt trajectory and performance of bonds in both. Whilst Senegal has recently completed it election cycle, offering it a window to enact difficult policy, Gabon is presently scheduled to hold elections in August 2025, which may delay a shift in policy.

Egypt, having secured large FDI and resumed its IMF program in 2024, has weathered the external liquidity storm, however, its adherence to structural policies to increase the private sector contribution to growth, and FX flexibility, are still in early stages and we will remain focused on the evolution of these in tandem with an ambitious fiscal adjustment to bring debt lower over the next few years.

It should be helped by lower inflation and borrowing costs in 2025. While reserves have grown, external funding needs remain high and a reliance on capital flows remains, should lower domestic gas production and Suez Canal receipts remain depressed.

Nigeria has been on an improving path in 2024, with reforms to FX markets and energy subsidy, and growth in reserves providing optimism on policymakers' decision making. Even so, Nigeria remains heavily reliant on oil receipts and needs to raise non-oil revenues from a very low base to reduce its vulnerability to oil prices. Low external debt service and a growth in reserves, combined with attractive yields, make Nigeria a favoured pick at the start of the year, with attention on the oil outlook as the year progresses.

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