Economic Views – Frontier Markets in Distress

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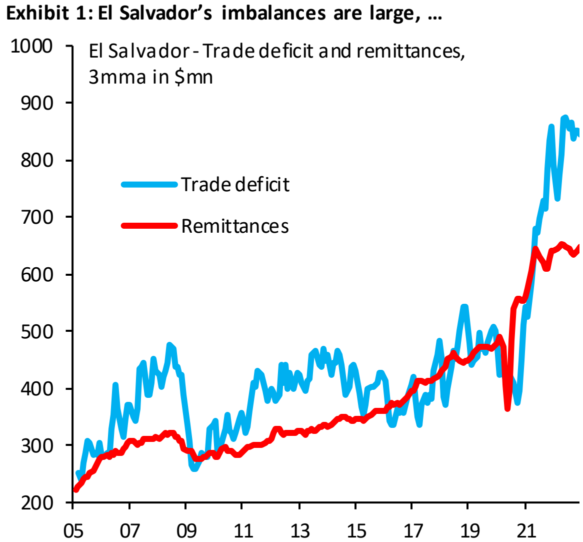
- High-yield EM credit has done very well in recent months, ...
- but we remain concerned about quite a few frontier markets.
- El Salvador's outlook will remain bleak if policies don't change.
- Reserves may run out before 2025, despite regional IFI support.
- Pakistan needs rollover above 75% to make it to end-March, ...
- unless there is even more import compression via recession.

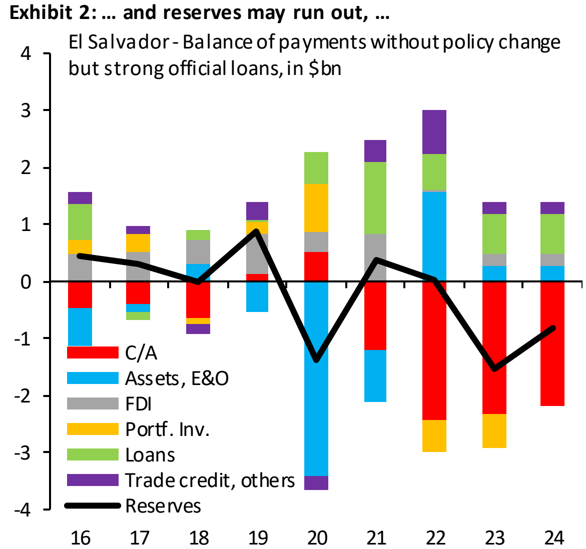
Despite a market rally in high-yield EM credit since early November we remain concerned about quite a few frontier markets. For example, last week we analyzed recovery scenarios for Ghana, concluding that upside to currently depressed market prices is likely limited. This week, we give an update on El Salvador and Pakistan. They both paid external bonds out of scarce reserves in the last two months and face a tenuous outlook. El Salvador has shown surprising resilience despite gaping current account deficits and no policy adjustment. However, if policies remain unchanged, support from regional IFIs will not be enough to make it to the January 2025 bond amortization. Pakistan is in a critical situation in the near term. Devaluation and domestic demand compression have erased current account deficits but there are absolutely no capital inflows. Assuming the IMF review is not completed until late March, survival depends on acceptable rollover rates and additional import compression. The former is not under Pakistan's control and the latter could be socially and economically disastrous given the depth of the ongoing crisis. We present rollover and import compression combinations that could avoid default. Whether Pakistan will be successful is a very close call. Fast agreement with the IMF and arrears on some bilateral may do the trick but ours is not a high-conviction call. Beyond the very near term, Pakistan will need large amounts of fresh official financing in addition to the ongoing IMF program.

Exhibit 1: El Salvador's imbalances are large, ...



Source: Haver, IIF

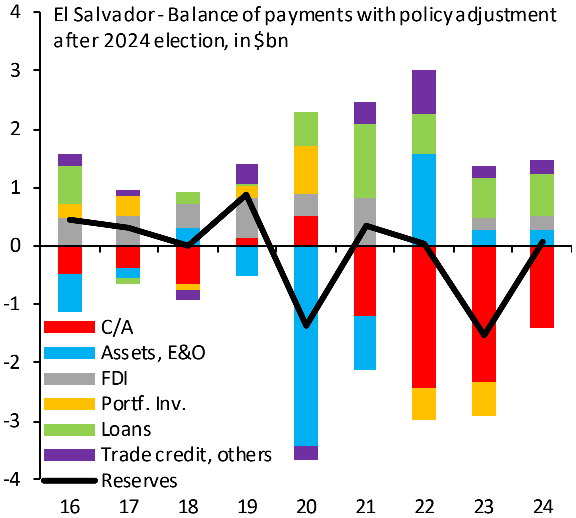
Exhibit 2: ... and reserves may run out, ...



Source: Haver, IIF

Last August we argued El Salvador's funding gap until the January 2023 bond matured could reach $1.5bn in a mild scenario. We projected end Jan-2023 reserves of $1.5 to $1.9bn. In an adverse scenario, we argued reserves could fall to $1.2bn by end Jan-2023. We correctly anticipated the bond would get paid. We now estimate reserves were $1.8bn last month, making some of our scenarios too pessimistic. Asset repatriation was extraordinarily high last year and regional IFIs lent at a fast clip. The next critical milestone is the January 2025 bond amortization, which is down to $350mn after buybacks. Core imbalances remain unaddressed. Remittances surged but so did the trade deficit (Exhibit 1). Lack of policy adjustment makes it unlikely that the trade deficit will shrink soon. We work with two scenarios. One without policy change and wide current account deficits, and one with adjustment after the March 2024 election. In both cases we assume regional IFIs continue to disburse a net $700mn per year—certainly an ambitious assumption. We set multilateral debt rollover to 100% (about $2bn is due in 2023-24). We assume recent asset repatriation is unsustainable and pencil in much more moderate amounts. Other than some FDI, we assume no non-official capital inflows. We are essentially testing whether strong official support can validate a no policy change scenario or a '24H2 policy change scenario'. Exhibits 2-4 summarize the scenarios. Without policy change reserves would be exhausted by end-2024 despite ample official support. Policy adjustment after the election would improve matters but may not be enough to pay the Jan-2025 bond if there is not an IMF program. Excessive exposure of IFIs to El Salvador could complicate things further. In a nutshell, we see significant downside risk to this bond's valuation.

Exhibit 3: … before the Jan-25 bond is due, …



Source: Haver, IIF

Exhibit 4: … even if policies improve in 2024.

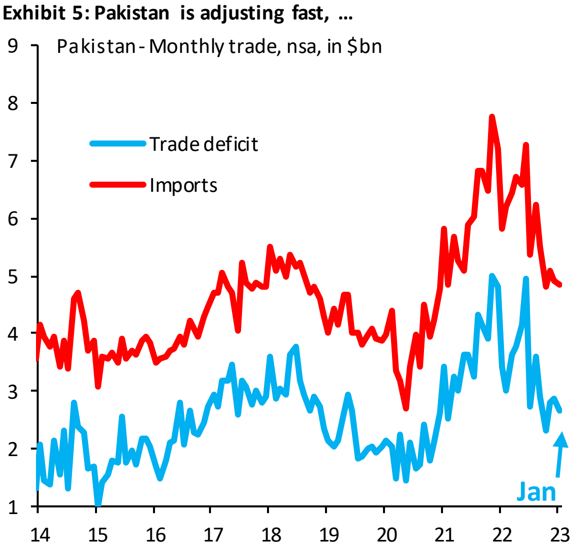
El Salvador - Summary BoP variables in both policy scenarios, in $ bn

			No adjustment		Adjust post election	
	2021	2022	2023	2024	2023	2024
Current account	-1.2	-2.4	-2.3	-2.2	-2.3	-1.4
Portfolio investment	0.0	-0.5	-0.6	0	-0.6	0
Loans liabilities	1.3	0.7	0.7	0.7	0.7	0.7
Asset repatriation	-0.6	0.6	0.3	0.3	0.3	0.3
Reserve change	0.4	0.0	-1.5	-0.8	-1.5	0.1
End of pd FX reserves	2.7	2.4	0.9	0.0	0.9	0.9

Source: IIF

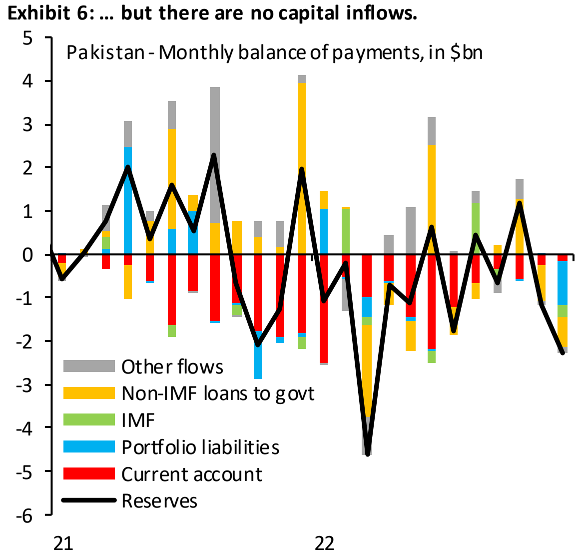
Pakistan's outlook worsened drastically in recent months. Last summer's floods were severe and reluctance to float the exchange rate and do fiscal consolidation precluded an IMF disbursement for $1.2bn in November. Despite large import compression since late 2021, the external funding situation became critical recently (Exhibit 5). Recession erased the current account deficit but capital outflows in all categories in November and December made the situation untenable in the context of very low reserves (Exhibit 6). Negotiations with the IMF are ongoing, but a disbursement may take some time. In Exhibit 7 we show what combinations of external rollover on the $5bn due in Feb-Mar and import compression relative to December levels could avoid depletion of reserves, which were down to $3.1bn in late January. The scenarios assume a 10% drop in exports due to lack of imported inputs, stable remittances, and moderate resident capital flight ($200mn per month). Further import compression could happen via a deeper economic crisis but Pakistan's import contraction since late 2021 already matches past major EM crises, where we typically observe a 25-30% drop in imports. In January, imports fell 5% m/m and exports held up. Rollover is hard to predict and is beyond Pakistan's control. As a reference point, rollover on non-IMF loans to the government last year was 85% (Exhibit 8). The situation is unpredictable, but we think there is chance Pakistan averts immediate default, perhaps running sizable arrears on non-bonded external debt if rollover falls sharply or the trade deficit stays at January levels.

Exhibit 5: Pakistan is adjusting fast, …



Source: Haver, IIF

Exhibit 6: … but there are no capital inflows.



Source: Haver, IIF

Exhibit 7: Even lower imports or some rollover, …

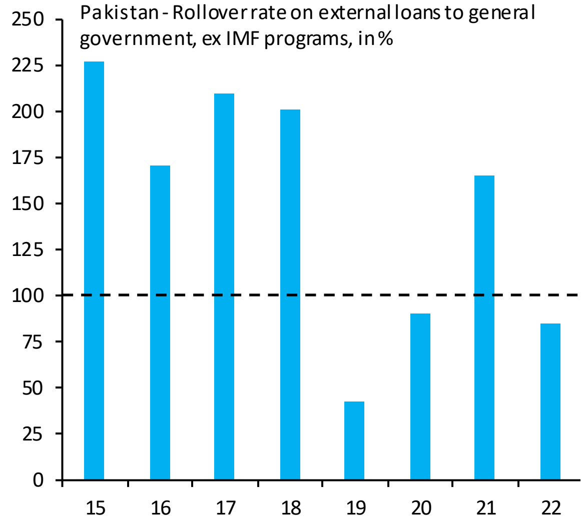
Pakistan - Reserve change in adverse scenarios, Feb-Mar, in $bn

External rollover rate, in % \ Import compression, in %	0	10	20	30	40
40	-6.2	-5.2	-4.2	-3.3	-2.3
50	-5.6	-4.6	-3.6	-2.7	-1.7
60	-5.0	-4.0	-3.1	-2.1	-1.1
70	-4.4	-3.4	-2.5	-1.5	-0.5
80	-3.8	-2.8	-1.9	-0.9	0.1
90	-3.2	-2.2	-1.3	-0.3	0.7
100	-2.6	-1.6	-0.7	0.3	1.3
110	-2.0	-1.0	-0.1	0.9	1.9

No reserves left
Zero to $1bn
More than $1bn

Source: IIF

Exhibit 8: … are needed to make it to end-Mar.



Source: Haver, IIF