Questions That Matter

Emerging Markets | Will Next Year Be Better?

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Governments and corporations in emerging markets (EMs) have little room to maneuver if the economic recovery doesn't accelerate in 2021.

How this will shape 2021

EM economies will likely continue to face challenges. Overall, the efforts of governments, corporations, and banks to deal with the shock of the COVID-19 pandemic has taken a toll on their balance sheets and fundamentals. Economic recovery is underway, but seems slower than initially expected. Over the last quarter of 2020, the pandemic and resurgence of new cases in many EMs, along with a rise in infections in Europe and the U.S., will probably subdue activity through the first quarter of 2021.

Positive developments supporting economic growth in EMs could make the difference in the second half of 2021. First, China's economic recovery is benefiting EM commodity exporters like Brazil, Chile, South Africa, and Indonesia, which have strong trade ties with China. Second, progress toward developing a COVID-19 vaccine could boost overall economic activity in 2021.

Economic recovery is underway, but seems slower than initially expected. A sluggish recovery could result in more downgrades for EM governments, and corporations

What we think and why

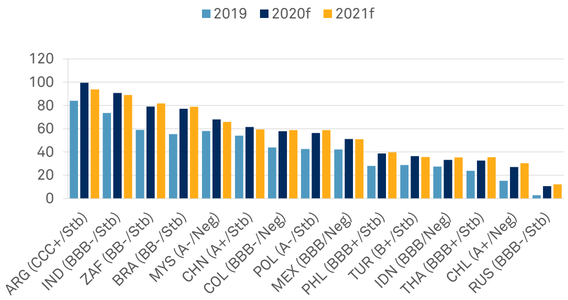
Most EM sovereigns will need to boost growth to stabilize debt and reduce fiscal pressures. Net debt in key EMs will increase by 12% on average by year-end 2020 (see chart 24), and in some cases--including Brazil, Chile, Colombia, Indonesia, Poland, Russia, and South Africa--will continue increasing in 2021. Key EMs' primary deficit increased to an average of 6% (versus a 1% deficit for the past five years), with countries like Brazil, Chile, and Saudi Arabia posting a double-digit primary deficit in 2020. Increasing debt, fiscal pressures, and slower growth have resulted in eight of the 16 key EMs being downgraded or having outlooks revised to negative; currently five EM sovereign ratings still carry negative outlooks. The main challenge for EM governments is to resume economic growth, therefore policy response will be critical over the next few quarters. Most EMs have limited flexibility to provide additional fiscal or monetary support without hurting their credit quality. Consequently, EMs will need reforms to stimulate growth, improve productivity, expand tax-collection capabilities, or reduce expenses.

EM corporate debt has increased but is manageable, while the pandemic has squeezed earnings. The decline in corporate earnings ranges from 10%-60%, with leisure, airlines, and airports being the hardest hit. Rated corporations' average debt to EBITDA has climbed to 3.7x this year from 3.0x in 2019, with notable outliers, such as China 6.5x, Brazil 6.3x, and Chile 5.0x. The corporate recovery will mostly depend on the sector. In 2021, we expect the consumer products (agricultural), retail essential, health care (services and pharmaceuticals), telecom, consumer staples, and tech (software) sectors to return to pre-pandemic earnings levels. For most sectors, this will happen by 2022; for others, including leisure (lodging, hospitality, and cruise lines), airlines, and nonessential retail, stronger EBITDA will come only by 2023 or later. EM corporations have already slashed expenses to deal with the pandemic's impact. Consequently, a second wave leading to extended lockdowns and slower-than-expected economic recovery, or a delay in finding an effective treatment or vaccine, could derail earnings. In some cases, additional pressure might result in bankruptcy, especially for corporates rated in the 'B' category or lower.

Authorities' quick actions have spared banks in key EMs so far. The measures include regulatory relaxation to support banks' capitalization and liquidity, and accommodate payment-holiday schemes. As is the case for corporations, the success of these measures depends on how long the pandemic's impact will last and whether an effective treatment or vaccine becomes available. A deeper and longer economic shock will put additional strain on banks' asset quality, fueled by mounting SME bankruptcies and unemployment. In other words, key EM banks have been able to delay the effect of the pandemic on their portfolios mainly by extending payment holidays and adopting more lenient accounting for these loans, as allowed by the authorities. This means it would take time for banks' balance sheets to show the real magnitude of the impact. At this point, given estimates of the percentage of loan portfolios benefitting from a payment holiday, the number of SMEs that went bankrupt, and the unemployment rate, we anticipate that nonperforming loans will increase rapidly once the payment holiday ends.

Chart 24

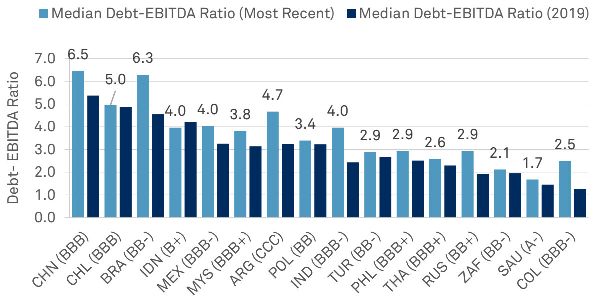
Net Debt To GDP Of Key EM Sovereigns (%)



Source: S&P Global Ratings. Foreign Currency Ratings in Parenthesis

Chart 25

Median Debt To EBITDA Of Rated EM Corporations



Data as of Sept 22, 2020. Source: S&P Global Ratings and S&P Global Market Intelligence. Median Corporate Ratings In Parenthesis.

What could go wrong

A longer and slower economic recovery would further pressure EM governments and corporations. EM governments and corporations have used most of their flexibility to face the pandemic, so many of them have little leeway to manage additional hardships, like a second wave of COVID-19 cases. Another hit to corporate earnings could lead to more downgrades and defaults. In the case of EM sovereigns, higher debt and increased fiscal pressure could lead to downgrades.

High income inequality, limited access to health services, and lockdown fatigue spurring social unrest and political instability. The pandemic has exposed the poor living conditions of a large portion of the population in most key EMs. Moreover, the economic slump has led many families into poverty. These conditions will probably result in heightened social demands that, if not addressed, could result in violent protests and political instability.

This report is an extract from the S&P Global Ratings report, "Global Credit Outlook 2021: Back On Track?"

This report does not constitute a rating action

S&P Global Ratings believes there remains a high degree of uncertainty about the evolution of the coronavirus pandemic. Reports that at least one experimental vaccine is highly effective and might gain initial approval by the end of the year are promising, but this is merely the first step toward a return to social and economic normality; equally critical is the widespread availability of effective immunization, which could come by the middle of next year. We use this assumption in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

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