

Misplaced Market Fear (2022), Beyond The Fed and Dollar (2023)

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This report does not constitute a rating action

For the final edition of our Essential Economics newsletter this year, we asked each of our chief economists to share their insights about following questions:

- What was the biggest surprise in 2022 and what are the takeaways?
- What will you be watching most closely in 2023, and why?

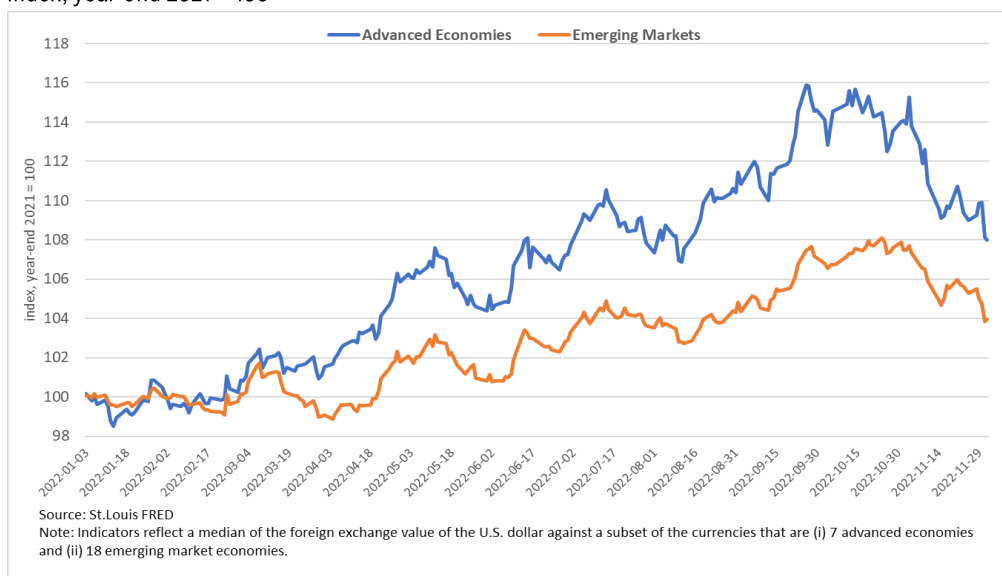
Here are the answers to those questions from our Emerging Markets Chief Economist.

2022: Risks of External Shocks Mitigated

The recurring market fear in 2022 -- that a combination of tightening by the Fed and a strong US dollar would precipitate a wave of debt crises in emerging markets (EM)-- was misplaced. We were skeptical of this thesis to begin with since current account deficits and dollar debt burdens in the core emerging world were generally much lower than in the past. Throughout the year, aggregate EM exchange rates held up far better than the advanced economy (AE) currencies against the US dollar. Pro-active monetary tightening and strategic use of FX reserves helped mitigate risks to domestic macro stability in the face of external shocks.

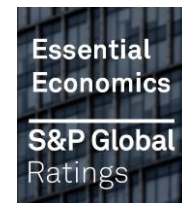
Chart

Emerging market currencies held up better than advanced economy currencies (vs. US \$)
Index, year-end 2021 = 100



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The takeaway is that most EMs have learnt the lessons of the 1980s and 1990s crises. There is a subset of frontier EMs that still suffer from the so-called “original sin” of borrowing in foreign currencies and are now in distress (driven by currency and maturity mismatches on their balance sheets), but the fact of the matter is that most EM borrowing is now done in local currencies, and increasingly, by households and businesses. Borrowing has also increasingly moved away from bank credit to market-based financing. The channels through which external influences have made themselves felt on domestic financial conditions have changed over time.

2023: Beyond the Fed And Dollar

By focusing simply on the dollar strength and the Fed, we risk missing the big picture. There is a need of a new framework for assessing debt risks in emerging economies.

What to watch: In 2023, beyond the Fed and the dollar, we will be keeping an eye on EM vulnerabilities more through the lenses of rising domestic real interest rates, private sector debt burdens, and strategically motivated geo-political financing flows that have kept balance of payments afloat for some.

Outlook: We’re not expecting explosive debt crises in the major EMs like those seen in past decades. Yet, higher interest rates and debt burdens should result in weaker GDP growth. Most economies are poised to expand below their longer-run trend rates. Even as inflation is forecasted to ease in most EMs next year, primarily due to falling food and fuel inflation, it's poised to remain above many EM central banks' respective targets. The outlook remains subject to geopolitics-related risks, and we don't expect terms-of-trade to improve significantly over the course of 2023, weighing on EMs' balance of payments and exchange rates (see [“Economic Outlook Emerging Markets Q1 2023: Hanging In There, But Growth Prospects Remain Tough”](#) published Nov. 28, 2022).

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