Letter n°83

Emerging countries facing the wall of debt.

"We like to be called the continent of hope... This hope is really something like a promise of heaven, an IOU whose payment is always being put off." Pablo Neruda.

Disappointed hopes, this is the meaning of Neruda's words. What has been the evolution of emerging countries and what might the future hold for them? How can we reconcile and finance the vital need to alleviate poverty and achieve the necessary climate transition in emerging countries that are sometimes close to default? These are the questions that every potential investor in these markets ponders, and we will try to provide answers in this Letter 83 after four preliminary remarks:

- ***One of the successes of globalization*** in the past 30 years has been the reduction in the number of people living on less than $1.90/day, from 2 billion to 700 million. However, there is a caveat: while the convergence between developed and emerging countries was progressing until 2012, it has been interrupted since then.

- ***Two negative impacts of Covid*** and the consequences of the war in Ukraine have been the disruption of this trend of poverty reduction. The "whatever it costs" approach in vogue in the major Western countries could not be implemented in emerging countries due to lack of resources.

  As a result, since 2020, the number of poor has stopped decreasing and the goal of containing this figure to less than 3% of the world's population by 2030 now seems challenging to achieve.

  Thus, also, hunger in the world affects an additional 150 million people, i.e., according to the UN, 735 million, 9.2% of the world's population, and above all 20% of Africans.

- ***A new debt crisis?*** Debt crises in emerging countries have unfortunately been recurring. We remember the 80s after the oil shock and the Asian crisis of the late 90s, we are worried today about the consequences of the rising interest rates in the world and the tightening of credit conditions.

- ***Emerging countries eager to change international governance***: since the creation of major multilateral institutions like the IMF and the World Bank in 1945, the world has changed significantly. The number of countries has doubled to 200, and the population has tripled to 8 billion. The demographic and economic weight of developed countries has diminished, and emerging countries demand an evolution of multilateral organizations to have more influence in decision-making. The aim is to mitigate the Western-centric approach of these organizations and the underlying ideology of their policies.

After painting a picture of the vulnerability of emerging countries (Part 1), we will highlight the inability of these countries to finance the energy transition (Part 2), point out the increasing risks of default (Part 3) and conclude with the resentment of emerging countries (Part 4).

I. The 4 indices or factors of vulnerability in emerging countries:

The decline of the Human Development Index:

Over the past 30 years, the Human Development Index defined by the UN had never declined. However, this was the case in 2020 and 2021 due to a decrease in the standard of living and a decline in life expectancy.

Countries burdened by the weight of debt continually witness an increase in the percentage of their population living in extreme poverty. A topical example is Argentina, as the country is now rated C by the Fitch agency, just above the default level, and 43% of its population cannot afford the minimum required food or services, despite the country's historical wealth.

Inflation is more problematic than in developed countries:

The increase in food prices is politically, economically, and socially more severely felt in emerging countries because the share of food expenses in household budgets is often significant.

As a consequence of rising food and energy prices, and the depreciation of currencies, inflation rates in emerging countries are often higher than those in developed countries.

The risks posed by the Russian decision not to renew the grain agreement:

In 2020, 15 out of 54 African countries bought more than half of their wheat from Ukraine and Russia.

The non-renewal of the grain agreement by Russia, a surprising decision just a few days before an Africa-Russia summit that Putin wanted to succeed, penalizes Egypt and many countries in East Africa such as Kenya, Somalia, and Ethiopia.

The immediate impact is an increase in the price of cereal.

Increases in rates:

Since the beginning of 2022, the borrowing costs for countries rated as C by rating agencies, the most heavily indebted countries, have increased by 14 points, eliminating any possibility of growth.

According to UNCTAD, the debt burden for the poorest countries could increase by more than $800 billion by 2025.

The rise in interest rates is a consequence of inflation and currency depreciation. The most vulnerable countries are Zimbabwe, Argentina, Iran, and Egypt.

In Argentina and Egypt, interest rates are at 97% and 19%, respectively, with inflation officially at 110% for Argentina and 37% for Egypt. In Turkey, interest rates have recently been raised to 15%, but it is deemed insufficient.

II. The inability to finance the energy transition:

Achievements:

Since 2015 and the adoption of the Paris Agreement, international investments in renewable energies have tripled, according to the UN, but the majority of these investments have been made in developed countries.

On a global scale, it is gratifying to see that investments in clean energies have surpassed investments in fossil fuels, with $1.7 trillion against $1.1 trillion (figures from the IEA).

In emerging countries, not only are the amounts to be invested very high, but access to capital markets is at a much higher rate compared to developed countries. Even worse, according to the UN, around 30 emerging countries have not yet succeeded in attracting international investors.

Out of the $770 billion invested in emerging countries, over two-thirds are in China.

Needs:

If a powerhouse like India, ranking 5th in the world, despite substantial investments in solar energy, still relies on fossil fuels for 90% of its energy balance, one can understand the difficulty for smaller emerging countries to ensure their energy transition.

COP27 estimates that $2.4 trillion per year in investments are required for the energy transition of emerging countries, equivalent to 6.5% of their GDP, a percentage much higher than that of developed countries, as emerging countries, often located around the Tropics, are frequently vulnerable to cyclones, floods, or droughts.

According to COP27, emerging countries will hardly be able to finance more than one-fifth, perhaps even one-tenth, of the estimated needs.

A recent report from UNCTAD is more alarming as it takes into account the Sustainable Development Goals set for 2030 and estimates the required investments at $4 trillion per year. However, this goal is far from being achieved, as in 2022, emerging countries only attracted $545 billion in foreign investments in clean energies.

Grievances:

Certainly, today, emerging countries contribute significantly to pollution. However, if we consider only greenhouse gas emissions, those of Africa account for less than 5% of global emissions, while developed countries have been responsible for 70% of greenhouse gas emissions since the beginning of the industrial revolution.

Therefore, many emerging countries accuse developed countries of obliging them to finance the fight against climate change to which they have contributed little due to their low level of development.

The second cause of resentment is the implementation, by the EU in late 2023, of the carbon border tax. Calculated based on the carbon content of imported products, it discourages the relocation of polluting companies to less regulated countries, which are often emerging countries, and is perceived as a hindrance to development.

The third cause of resentment is the subsidies allocated by major states for the development of renewable energies, which are seen as unfair competition.

III. The increasing risks of default:

The most vulnerable countries:

Among the most vulnerable countries, Sri Lanka has a debt service equivalent to 75% of its budgetary revenues, Angola at 60% of its budgetary revenues, Zambia and Sudan at 40%, Chad and Tunisia at 30%.

On average, according to UNCTAD, debt service represents 16% of revenues, and on average, according to the UN, African countries face interest rates that are 8 times higher than those of European countries.

Without assistance, the coming years of growth for the African continent will be jeopardized as expenditures on education, training, and healthcare will be sacrificed.

Zambia defaulted on its payments in late 2020, Ghana today, and around 20 other African countries possibly in the coming months, these are the risks, these are two of the reasons for our caution before investing in the stock markets of these countries.

Among the countries exposed to default risk, we think of Tunisia, facing a public debt equivalent to 80% of GDP, and Egypt, weakened by a debt equal to 93% of GDP.

The need for debt relief for the poorest:

Is it utopian to dream of an agreement, an arrangement, a relief of this debt? Public debt of emerging countries accounts for 30% of global public debt, a percentage that is growing as interest rates are higher, especially for the increasingly significant portion allocated by international private investors.

The list of countries in precarious situations is long. Net interest on public debt, according to the UN, exceeds 10% of GDP in 50 emerging countries. Such an interest burden can lead to insolvency for these countries. And we are talking about countries representing a population of 3.3 billion.

On their own, these countries are unable to cope, but with the help of the rest of the international community, the worst could be avoided, as the overall amount of interest is not much different from the cost of rescuing just one American regional bank, Silicon Valley, last spring.

China under scrutiny:

China has consistently presented itself as a non-colonialist power and, in support of its Belt and Road Initiative, initially appeared generous, willing to grant significant loans, nearly $130 billion between 2000 and 2019, to African countries alone.

In the past, Western countries, members of the Paris Club, have often undertaken debt relief measures.

Today, this solution requires involving China as it is the largest creditor. However, once again, in recent days, during the meeting of G20 finance ministers, China has maintained its opposition to a multilateral agreement to assist the most indebted countries. China expects the IMF and the World Bank to give up their status as privileged creditors. The World Bank refuses, arguing a risk of a credit downgrade and thus not being able to lend at low rates.

As seen in Sri Lanka, a country in default, China, as a creditor on the Hambantota port, preferred to seize the port and even plans to establish a military base there.

IV. The dual resentment of emerging countries and the reforms to consider:

The limited representation in multilateral organizations:

Since the creation of multilateral organizations after World War II, the weight attributed to each state's votes has not evolved and remains equivalent to a property-based suffrage. The United States has pre-eminence, Western states have a majority, and sub-Saharan Africa has less than 5% of the votes at the IMF, 10% of the votes at the World Bank, and no permanent member in the UN Security Council.

The shortcomings of Western aid:

Official Development Assistance, theoretically set at 0.7% of GDP each year since the 1970s, barely exceeds half of the intended amount.

African countries south of the Sahara, among the neediest on the planet, received less than $30 billion in bilateral aid in 2022, a figure that the OECD states has declined by 8%.

Since the signing of the Paris Agreement eight years ago, which envisaged an annual aid of $100 billion to facilitate climate transition in emerging countries, the amount has yet to be reached. During a recent G20 meeting led by India, members failed to agree on mobilizing this amount, even though the estimated needs are at least $1 trillion per year.

The only advancements from the Paris summit at the end of June this year were $2.5 billion to help Senegal in energy transition and an agreement to restructure Zambia's debt.

Three reforms to consider:

- In response to high interest rates: access to lower-cost financing must be organized. Two to three years ago, the IMF decided to allocate an additional amount of Special Drawing Rights (SDRs) of $100 billion to emerging countries, but the availability of this fund has only been announced recently. The World Bank must also increase its credit capacity by a few $50 billion and offer greater access to low-interest loans for low-income countries.

- In response to the lack of financial aid: a tax on maritime transport could be partially redistributed to emerging countries to contribute to financing the energy transition.

- Given the financial constraints of developed countries, the already high level of their public debt, and the scale of the investments needed for the energy transition, it is unclear why China, Gulf countries, and a few others would not be more generously involved in aiding the poorest countries.

  Private financing should also be substantially increased through public-private partnerships, but this often requires implementing a more favourable legal environment for investor protection.

Conclusion: ***"There is no fatality in history. The future will be what we want it to be," Bergson*** in Mélanges, page 1538.

In line with Bergson's thoughts, let us avoid excessive pessimism about the future of emerging countries and recognize some investment opportunities. From the numerous points discussed in this Letter 83, we highlight seven:

- ***The accusation of protectionism is not unfounded***: many emerging countries accuse Western countries of disguised protectionism through subsidies for renewable energies or reindustrialization. This was recently expressed by India's Prime Minister, Narendra Modi. An example is the use of the Buy American Act. Another recent example is Germany's subsidy of €9.9 billion to attract Intel.

- ***The recurring theme of insufficient aid denounced by emerging countries***: as seen in this Letter, the inadequacy is supported by evidence, but developed countries defend themselves by citing their debt constraints. In fact, except for Germany, all G7 countries have public debt exceeding 1x GDP.

- ***Insufficient job creation***: key to poverty reduction, job creation is challenging in many emerging countries facing an informal economy. In Africa, the population will double to 2.5 billion by 2050, with 10 million young people entering the job market each year, but the number of jobs created does not exceed 4 million. In India, the problem is similar, with the need to create 200 million jobs in the next decade, but out of the 900 million working-age individuals, only half are part of the labour force, and only around 60 million have formal employment. In China, the youth unemployment rate is 21.3%.

- ***The energy transition*** is a global issue. If OECD countries invest alone, climate change will not be controlled. Currently, emerging countries are responsible for nearly two-thirds of emissions but, due to a lack of private investments and sufficient budgetary revenues, they are unable to finance the transition.

- ***The need for differentiation***: the emerging world comprises over 150 countries, with an average growth of 4%, three to four times higher than that of developed countries, but the economic situation varies significantly from one country to another. Some countries, such as Vietnam and India, benefit sustainably from Western companies' investments aiming to reduce dependence on China. Others, mainly in Latin America, profit from commodity exports. Meanwhile, many others, often in Africa, face significant challenges.

  Overall, the 25 largest emerging economies, including Mexico, Brazil, and India, show satisfactory growth and prospects and, excluding China, they represent half of the GDP of emerging countries.

  To date, the five recorded payment defaults concern small economies like Zambia and do not constitute the beginning of a systemic crisis risk.

- ***The contrasting evolution of currencies***: over the past two years, while there has been depreciation of emerging currencies against the $, there is more frequent appreciation against the € because emerging countries, such as Brazil, rely on higher interest rates. Since the beginning of the year, currencies in Latin America, supported by high interest rates, have appreciated significantly against the $. The Colombian peso and the Mexican peso have increased by more than 20% against the $, the Brazilian real by about 15%, and the Chilean peso is close to 15%. This explains capital inflows into these countries.

- ***The expected decline in interest rates:*** average inflation in emerging countries has returned to 5-6%, surprisingly close to that recorded in developed countries. Interest rates had been raised earlier and more significantly than in developed countries. Hence, there is significant potential for relaxation, offering investment opportunities for investors. Brazil, with rates at 13.7%, is a notable example.

Geneva, 26th July 2023

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