

Downturn Exacerbates Risks

Dec. 1, 2022

This report does not constitute a rating action

Key Takeaways

- Credit conditions in emerging markets (EMs) will remain pressured during 2023, while economic stress will be taking a toll mostly on sovereigns and households.
- The balance of risks for EMs is firmly on the downside, given that rapid monetary tightening is potentially pushing major economies into recession and strengthening the U.S. dollar.
- Financing conditions will probably remain restrictive during 2023, because we expect policy rates and overall financing costs to stay elevated next year.

Editor's Note: S&P Global Ratings' Credit Conditions Committees meet quarterly to review macroeconomic conditions in each of four regions (Asia-Pacific, Emerging Markets, North America, and Europe). Discussions center on identifying credit risks and their potential rating impact in various asset classes, as well as borrowing and lending trends for businesses and consumers. This commentary reflects views discussed in the Emerging Market committee on Nov. 17, 2022.

Credit conditions in EMs will remain pressured during 2023, while we expect sovereigns and households to be particularly hit by the likely economic downturn. The corporate sector continues to present a mixed picture; some sectors will be able to protect profits by passing costs through prices in goods and services, taking advantage of high commodity prices (commodity exporters), while others will suffer from subdued demand (consumer products, chemicals or building materials). Banks are well positioned to face the downturn, and higher interest rates could help bolster their net interest margins. Alternatively, asset-quality and credit losses will depend on the economic downturn's severity. Our downside-case scenario assumes that some banking systems could suffer as asset quality weakens and blunts the benefit of higher interest rates.

EM sovereigns will be challenged as the revenue windfall from the nominal effect of high inflation and recovering economic growth dissipates, and expenses climb amid higher interest rates, wage pressures, and social demands to curb energy prices. At the same time, EM households will continue struggling as lingering high prices erode their purchasing power and unemployment rises.

The balance of risks for EMs is firmly on the downside due to rapid monetary tightening potentially pushing major economies into recession and strengthening the U.S. dollar; persistently high prices lifting costs and eroding households' purchasing power; tight financing conditions, given investors' demand for higher returns and limited access to funding for speculative-grade issuers; and China grappling with structural factors that are undermining its economic growth.

Financing conditions will probably remain restrictive during 2023. While slower economic activity and easing inflation might relieve pressure on central banks, we expect reference interest rates and overall financing costs to remain high next year. Easing inflation, on the other hand, might bring back investor appetite for EMs and lower-rated issuers, which currently have very limited access to capital markets.

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Top Emerging Market Risks

High inflation squeezes the finances of corporations, households, and banks

Risk level Moderate Elevated **High** Very high **Risk trend** Improving **Unchanged** Worsening

Risks remain that pressures over core inflation will continue, owing to second-round effects, as higher energy and food prices are passed through to core prices, especially those in the services sectors. Lagging inflationary effects could materialize in 2023, including increasing financing costs, as refinancing with higher interest rates takes place (and variable-rate loans reset) and demands for wage increases persist. Corporations' capacity to pass on higher costs to customers is ebbing, due to households' decreasing purchasing power. The pressure may also intensify on some EM sovereigns, given that lingering high energy prices could prompt subsidies to rise, diminishing fiscal leeway. If this continues, corporate margins could shrink, households' credit quality weaken, and banks' asset quality indicators deteriorate.

Further monetary tightening in the U.S. and the dollar's strength weaken financing conditions

Risk level Moderate Elevated **High** Very high **Risk trend** Improving Unchanged **Worsening**

There's still a risk that the U.S. Federal Reserve needs to tighten its policy rates further than expected, and for rates to remain higher for a longer period. This could not only heighten market volatility but lead to overly restrictive financing conditions for issuers across EMs. In this scenario, the U.S. dollar could further strengthen as investors rebalance their portfolios considering higher rates on lower-risk debt instruments from U.S. issuers (as the higher yields offered by EM instruments will be less attractive to investors), or away from the most vulnerable EM issuers to higher-quality ones offering better returns. The U.S. dollar's strength heightens refinancing risk, prolongs inflationary pressures, and complicates fiscal and monetary policy, exacerbating an already uncertain economic outlook.

A sharper slowdown in the largest economies leads to a global recession

Risk level Moderate Elevated **High** Very high **Risk trend** Improving **Unchanged** Worsening

Sharply rising interest rates, a pullback by consumers, and Europe's energy crisis could push the U.S. and Europe's largest economies into a deeper-than-expected recession and cause a steep rise in unemployment. In China, losses in the corporate sectors and households in 2022 and restrictive COVID policies could undermine a rebound of activity in 2023. Slower global demand could weigh significantly on key EM exporters by reducing trade, portfolio flows, and foreign direct investment. Slower economic activity in these EMs could imperil the corporate sector's fundamentals and banks' asset quality. Unemployment could rise, which could further hit EM households that have been battered by inflation.

Increasing geopolitical tensions and difficult domestic socio-political conditions erode credit fundamentals

Risk level Moderate Elevated **High** Very high **Risk trend** Improving **Unchanged** Worsening

The Russia-Ukraine military conflict has reached a stalemate, with no visible short-term resolution. Disruption of gas supplies from Russia is weighing on Europe's economic outlook for 2023 and increasing risks for EMs with strong links with Europe, such as through trade, tourism, and remittances. Additional escalation and a continued rise of energy and food prices could sap confidence and growth. It could also fuel tensions and trigger social unrest, particularly among EMs with limited fiscal space or high debt, such as those in the Middle East and Africa.

Prolonged restrictive COVID policies and real-estate sector stress to curtail recovery of China's economy and business and household confidence

Risk level Moderate Elevated **High** Very high **Risk trend** Improving **Unchanged** Worsening

China's COVID lockdowns and crackdown on the real-estate sector have stalled its economic growth momentum, denting business activity, household confidence, and employment. Concurrently, the government's mobility restrictions to curb the rise in COVID cases have hit consumption, intensifying credit pressures for the services sector and SMEs. Even if the policy is lifted (possibly in 2023), China will be emerging into a much less conducive global environment (both economically and geopolitically). Losses sustained by the corporate sector and households in 2022 could undermine a rebound of activity in 2023.

Structural risk

Climate change and rising adaptation costs

Risk level Moderate **Elevated** High Very high **Risk trend** Improving Unchanged **Worsening**

Larger, more frequent natural disasters increase physical risks for public- and private-sector entities and threaten to disrupt supply chains such as for agriculture and food in some EMs. EMs located near the equator are particularly exposed to heatwaves and droughts as global warming increases, while island states are set to face more frequent storms and exposure to higher sea levels. At the same time, stepping up adaptation to climate change may represent an additional fiscal burden for the most vulnerable countries and higher costs for private-sector entities.

Source: S&P Global Ratings.

Risk levels may be classified as moderate, elevated, high, or very high. They are evaluated by considering both the likelihood and systemic impact of such an event occurring over the next one to two years. Typically, these risks are not factored into our base case rating assumptions unless the risk level is very high.

Risk trend reflects our current view about whether the risk level could increase or decrease over the next 12 months.

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