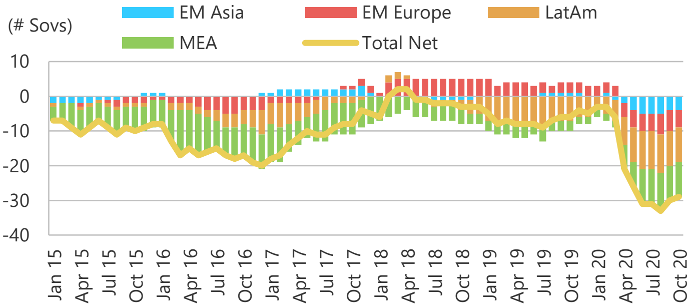
What Investors Want to Know: Emerging-Market Sovereigns – 4Q20

Coronavirus Crisis Evolves from Acute Shock to Prolonged Stress

EM Outlooks Are Highly Negative

Positive Outlooks less Negative Outlooks



Source: Fitch Ratings

Ratings Remain Under Downward Pressure

Fitch Ratings has made a record 35 emerging-market (EM) sovereign downgrades in 2020, across 24 different sovereigns. There are 30 EM sovereigns on a Negative Outlook, up from 13 at end-2019, signalling that further downgrades are likely over 2020 and 2021.

Negative Outlook Conversion to Downgrade Rate Likely to be Below Normal

Fitch believes the conversion rate of Negative Outlooks to downgrades will be below the long-term average of 63% (for EM and developed markets), as it was after the global financial crisis.

Risks remain heavily on the downside, but the range of those downside risk has eased somewhat since the height of the coronavirus crisis in March–May, when many of the Negative Outlooks were assigned. Rating changes need to account for sovereigns' relative changes as well as absolute deteriorations in credit metrics.

Questions from Global Investors

The report covers responses to topical questions from investors at our recent Global Sovereign Conferences and meetings.

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What Investors Want to Know: Emerging-Market Sovereigns– 2Q20 (April 2020)

What Investors Want to Know: Emerging-Market Sovereigns - 3Q20 (July 2020)

Sovereign Data Comparator - September 2020 (Excel) - Amended (September 2020)

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Does the High Number of Negative Outlooks Signal a Second Wave of EM Downgrades?

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There are 30 EM sovereigns on a Negative Outlook, up from 13 at end-2019, signalling that further downgrades are likely over 2020 and 2021. Fitch has already made a record 35 EM sovereign downgrades in 2020, across 23 different sovereigns.

Fitch rates Suriname at 'CC' and Angola, Argentina, Gabon, Laos, Mozambique and the Republic of Congo at 'CCC' (to which we do not assign Outlooks) – highlighting the exceptional downside risks in the current credit environment. There have also been a record four sovereign defaults in 2020. We expect Zambia to become the fifth following its 'consent solicitation' on deferring interest payments on Eurobonds until after March 2021, which led us to downgrade the rating to 'C' from 'CC'.

The long-term average (2000–2019) conversion rate for Negative Outlooks to downgrades is 63% (for all sovereigns – EM and developed markets), and downgrades take place an average of 9.5 months after the Negative Outlook is assigned.

However, Fitch believes the conversion rate for coronavirus-related Negative Outlooks is likely to be lower. This would be consistent with the experience after the global financial crisis, when it declined to 54% over 2008–2011.

Risks to creditworthiness remain heavily on the downside, not least from the path of the virus, the impact of weaker GDP and the extent of fiscal deteriorations underway. Even so, Fitch considers the range of these risks has eased somewhat since the height of the crisis in March–May, when many of the Negative Outlooks were assigned. Oil prices are off lows, capital has flowed back to EMs, sovereign funding conditions have improved and foreign exchange (FX) reserves have been reasonably stable in most cases. For many EMs the acute shock of the coronavirus crisis appears to have evolved to a more settled, albeit highly stressed, credit environment.

Rating changes also need to account for sovereigns' relative changes as well as absolute deteriorations in credit metrics. Peer comparisons are an integral part of rating assessments. All else equal, the more widespread a deterioration in credit profiles, especially if driven by common global factors, the lower the downgrade conversion rate.

Rating decisions centred on the fiscal outlook will be guided in part by the credibility of post-crisis fiscal consolidation plans and sovereigns' prior records in more favourable economic conditions.

Related Research

Coronavirus Sovereign Rating Shock Subsides, Prolonged Stress Ahead (August 2020)

Sovereign Defaults Set to Hit Record in 2020 (May 2020)

What Are Your Expectations for US-China Tensions after the US Elections?

Analyst

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With the US presidential elections just weeks away, there is a lot of speculation over how US-China relations might evolve over the next four years. Fitch believes tensions will persist regardless of the US election outcome, but there are reasons to believe the main candidates' policies towards China will differ in some key aspects.

A recent poll by Pew Research Center points to notable differences between Republican- and Democratic-leaning voters' attitudes towards China, even while American attitudes towards China have become increasingly unfavourable (73%) in recent years.

According to the poll, two-thirds of Republican-leaning voters believe it's more important to get tougher with China on economic issues than to build a stronger relationship. They are more likely (73%) to blame the Chinese government for the global spread of coronavirus, for which 71% believe the US should hold China responsible.

In contrast, one-third of Democratic-leaning voters believe it is more important to get tougher with China on economic issues than to build a stronger relationship. They are also less likely (38%) to blame the Chinese government's handling of the coronavirus outbreak, and less likely (37%) to want to hold China responsible.

Given Republican-leaning voter attitudes, it appears likely that US-China relations under a second term of a Trump presidency would look similar to his first term. This suggests continued fraught trade relations, additional restrictions on Chinese tech firms on US national security grounds, and a desire to further rectify perceived asymmetries in US-China economic and political relations.

A smaller share of Democratic-leaning voters are inclined to be tougher with China on economic issues, and the former vice president Joe Biden's public comments on the US-China trade war have been critical, while emphasising the negative spillovers that tariffs and other measures have imposed on American workers.

A Biden presidency may therefore seek to avoid further escalations in US-China trade tensions or pursue a path to reducing tariff levels. More broadly, it seems likely that US-China economic disputes would become less of a policy priority under a Biden presidency, given domestic priorities. To the extent that they do arise, they are also more likely to be resolved through a multilateral approach.

Almost three-quarters of Americans believe human rights are a higher priority for the US-China relationship than economic relations, an area with a clear bipartisan consensus. This points to a chance of further geopolitical flareups on issues such as Hong Kong, Taiwan, or Xinjiang, regardless of which party wins the elections.

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How Does Indonesia Resorting to Monetary Financing of the Budget Deficit Affect its Credit Profile?

Analyst

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The Indonesian authorities have adopted unconventional measures over the past few months to help finance a widening of the fiscal deficit in response to the coronavirus, including a form of government debt monetisation by Bank Indonesia (BI). We see little macroeconomic risk in the near-term given the absence of inflation. However, if resorting to such financing were to continue, it could undermine the credibility of the monetary policy framework, a loss of fiscal and monetary discipline over the medium term, a deterioration in the credit profile and negative rating action.

Fitch expects Indonesia's fiscal deficit to rise to around 6% of GDP in 2020 from 2.2% in 2019 due to relief-related spending and a revenue shortfall from a GDP contraction of around 2%. Indonesia entered the crisis with a low public debt ratio of 30.6% of GDP in 2019, but the challenge of financing the larger deficit is exacerbated by Indonesia's low revenue intake (which Fitch estimates at just 11.9% of GDP in 2020) as well as its fairly high dependence on foreign portfolio investors. Non-resident holdings of Indonesian government bonds fell to 30% in July from 39% in December 2019, as around USD9.5 billion was repatriated in February and March.

To facilitate financing, the authorities have implemented a "burden-sharing" scheme with BI involving a private debt placement, purchases of government bonds in the primary market, and the sharing of interest costs of additional debt issuance. The arrangements will reduce the government's direct interest costs, and in our view it is unlikely to generate inflationary pressure in the current environment of demand compression. Inflation dropped to 1.3% in August, below BI's target range of 3% +/- 1pp.

However, the scheme raises questions about Indonesia's policy approach over the medium term, particularly if central bank financing were to be sought repeatedly, beyond 2020.

Separately, a draft bill recently presented in parliament contains suggested changes to the monetary framework, including a broader mandate for BI debt monetisation. The bill is based on the controversial recommendations of a "panel of experts". It does not have the support of either the Ministry of Finance or Bank Indonesia, and is unlikely, in our view, to be passed in its current form. For the time being, therefore, our baseline assumption is that debt monetisation will be one-off, driven by the exceptional circumstances of the pandemic, and that Indonesia's disciplined approach to fiscal and monetary policy will continue.

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Fitch Affirms Indonesia at 'BBB'; Outlook Stable (August 2020)

How Is the Spread of Coronavirus Affecting the Philippines' Growth and Fiscal Outlook?

Analyst

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The Philippines experienced a resurgence in coronavirus cases in August, necessitating a re-imposition of lockdown measures in the metro Manila region. The pace of new daily cases has since been slowing over the past month and lockdown measures are being gradually lifted. Nevertheless, the spread of the virus places the Philippines' infection rate at among the highest number of recorded cases in the APAC region.

Economic growth momentum has been affected through domestic and external channels. The initial lockdown measures imposed in 2Q20 severely affected activity, with growth contracting by 16.5% yoy in the quarter. A decline in tourism and remittances inflows has exacerbated the downturn. The former is particularly significant as the Philippines has the largest dependency on remittances in APAC, equivalent to 8.4% of GDP.

The continued spread of the virus poses a risk to the Philippines' recovery. We expect a full-year economic contraction of 8% in 2020, against the authorities' forecast range of -4.5% to -6.6%. GDP in 1H20 alone contracted by about 8.5% yoy, driven by a plunge in investment (-54% yoy) and private consumption (-16% yoy). We expect growth to recover in 2021 and 2022, by 9.0% and 5.5%, respectively, on base effects and a lifting of lockdown measures.

We project the general government deficit to widen to 7.5% of GDP in 2020 from 1.2% in 2019 as spending on COVID-19 related measures increase and revenues decline with the GDP contraction. This incorporates spending measures for vulnerable groups and businesses hit by the pandemic, amounting to about 4% of 2020 GDP, and are included in the authorities' four-pillar socio economic programme against the pandemic. We expect a gradual decline in the deficit in 2021 and 2022 to 6.9% and 5.8% of GDP, respectively.

We forecast the general government debt to GDP ratio to increase to around 48% of GDP in 2020 and about 50% by 2022, from around 34% in 2019. Under these projections the Philippines' debt will remain below the forecast 'BBB' median. Importantly, the Philippines entered the crisis with fiscal space due to its relatively low debt ratio in 2019. In addition, the authorities' record of macroeconomic management lends credibility to their medium-term consolidation plans. We affirmed the Philippines' rating at 'BBB' in May 2020, but revised the Outlook to Stable from Positive to reflect the interruption to the improving trends prior to the outbreak.

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New Lockdowns May Further Erode the Philippines' Rating Buffers (August 2020)

Fitch Revises Outlook on Philippines to Stable; Affirms at BBB (May 2020)

Turkey: What Does Recent Tightening Mean for Monetary Policy Credibility?

Analyst

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Our revision in August of the Outlook on Turkey's 'BB-' rating to Negative from Stable reflected weak monetary policy credibility, negative real interest rates, a fall in FX reserves, and a sizeable current account deficit partly fuelled by a strong credit stimulus, which exacerbated external financing risks. Although the policy tightening that was underway then has continued, we still consider monetary policy credibility as a rating weakness.

The average weighted cost of the central bank (CBRT) funding increased from a low of 7.3% in mid-July to 11.5% in early October. More of this has been delivered through the main policy rate than we had forecast; September's 200bp increase to 10.25% compares with our year-end forecast at the last review of 9.25%. We view this positively, given the greater transparency and predictability relative to tightening through the interest rate corridor, and given we consider the political pressures on monetary policy are more strongly focused on the main policy rate.

In line with our expectations, there has also been less FX-intervention by the CBRT to defend the lira, and credit growth has moderated to 15% at end-September (on a 13-week annualised basis) from 45% in early July (due to a slowdown in state bank lending and use of the Credit Guarantee Fund).

However, inflation remains high, partly due to lira depreciation since end-July (of 12% against USD), and FX reserves continue to decrease. Gross reserves fell to USD83.6 billion in the last week of September, from USD90.3 billion at end-July, and net reserves to USD16.8 billion from USD27.7 billion, despite an increase in FX swaps in reserves to USD64.0 billion.

Inflation was unchanged in September at 11.7%, and 12-month inflation expectations are sticky, at 10.2%. While the real interest rate (ex-post, policy rate) has risen to -1.5% from a low of -4.4% in June it is still below the 0.2% average of the other "Fitch 10 Emerging Markets". Turkey's real rate using the average funding cost and 12-month market inflation expectations has increased to +1.2% from -1.3% in June.

We forecast inflation will stay high, at 11.5% at end-2020 and close to 11% at end-2021 and end-2022, and 175bp of policy interest rate increases to 12% at end-2022. The limited independence of the CBRT from political pressures and record of high inflation (averaging 11.7% in 2015–2020, compared to the 'BB' median of 3.4%) and of being slow to respond to events, add to the risk that policy tightening is insufficient to stabilise the external position – a key factor in the Negative Outlook on Turkey's 'BB-' rating.

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Fitch Revises Outlook on Turkey to Negative; Affirms at 'BB-' (August 2020)

Could a Large Increase in Pensions Trigger a Downgrade in Romania's Ratings to Sub-Investment Grade?

Analyst

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Implementation of a legislated 40% increase in pensions without offsetting measures would likely lead to a downgrade of Romania's 'BBB-' rating. A smaller increase appears more likely and the 14% introduced by emergency ordinance for September could be absorbed more easily given the headroom provided by a low level of government debt relative to peers (46% of GDP; 'BBB' median: 53%). However, it would add to expenditure rigidities that have built up in recent years. Even if sufficient offsetting measures are implemented, uncertainty over fiscal policies and performance will remain a downside risk for the rating.

The actual level of pension hikes remains uncertain. In August the Partidul Național Liberal (PNL)-led minority government approved an emergency ordinance that increased pensions by 14% starting in September, as opposed to an originally-legislated 40% hike and consistent with our baseline assumption of 10%–15%. However, in late September the main opposition party, the Partidul Social Democrat (PSD; the largest party in parliament and the architect of the pension hike), secured a parliamentary majority to reinstate the 40% increase. We estimate a 40% increase would raise annual spending by 4pp of GDP from 2021, compared with 1–1.2pp for a 14% increase.

The final outcome will depend on the president and the Constitutional Court. We believe President Klaus Iohannis, a former leader of the PNL, is likely to delay the abrogation of the emergency ordinance for several weeks. Moreover, the PNL has said it would challenge any abrogation in the Constitutional Court, particularly as the legislation requires fiscal measures to offset the cost of the original pension increase. Although the previous PSD government had failed to identify such measures, there is no certainty how the Court will rule.

Offsetting the costs of the pension hike will fall on the next government. Elections are scheduled for early December and have to be held by March 2021. Having performed well in regional elections in late September, the PNL is in a strong position to form a stable coalition government. Nevertheless, it will have limited options to consolidate the budget deficit if pensions rise by 40% as the starting position will be weak (we forecast the budget deficit will rise to close to 10% of GDP in 2020), and consolidation measures risk damaging growth and worsening the debt trajectory.

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Romanian Pensions and Politics are Key to Fiscal Prospects (August 2020)

Fitch Revises Romania's Outlook to Negative; Affirms at 'BBB-' (April 2020)

What Are the Rating Implications of Belarus' Political Crisis?

Analyst

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The political crisis in Belarus creates near-term risks to macroeconomic and financial stability and exacerbates key downside risks to the sovereign rating (B/Stable) including weak growth prospects, low external liquidity and dependence on Russia.

Public protests have continued following the declared victory of President Alexander Lukashenko at the 9 August presidential election, which the opposition claim was marred by widespread irregularities. Heightened uncertainty led to a sharp depreciation of the exchange rate in August, bank deposit withdrawals and a drop in reserves of USD1.45 billion over August and September.

The absence of a visible path towards de-escalation of tensions will probably keep the Belarussian rouble under pressure, adversely affect the highly dollarised financial sector's asset quality and liquidity, and erode international reserves. The longer it persists, the greater the threat to macroeconomic and financial stability, which had improved in prior years.

Sanctions announced by the EU, UK and Canada, amongst others, currently only target Belarusian officials. Although a deepening of the political crisis could create additional risks, we do not anticipate sanctions similar to those targeting Russia's key economic sectors or financing. However, worsening relations with the West will likely constrain access to external financing, including from multilaterals.

Belarus's July Eurobond issuance, cash buffers of around USD4 billion and the announced USD1.5 billion loan from Russia reduce financing risks for 2020 and 2021 and provide some space for the sovereign to identify additional financing. External amortisations are USD1.9 billion in 2021 and USD2 billion in 2022 – around 70% of which are directly to Russia or Russia-related entities.

Russia is Belarus's largest trading partner (49% of trade turnover), creditor (38% of external public debt), source of FDI (26%), and now its main source of external financing. Bilateral relations have not been smooth in recent years, with issues over energy prices and broader economic integration highlighting the risks surrounding timely access to external financing.

High near-term uncertainty and the authorities' policy response, including tightening local-currency liquidity to rein in depreciation pressures, will hit already weak growth (five-year average of 0.1% in 2019). The political backdrop will probably reduce the incentive for state-owned enterprise (SOE) reforms and could further erode investor interest and undermine the previously booming IT sector.

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Belarus Crisis Creates Risks to Macro, Financing Improvements (August 2020)

Fitch Affirms Belarus at 'B'; Outlook Stable (May 2020)

Can Mexico Maintain its Tight Fiscal Stance?

Analyst

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Mexico stands out in having avoided a large-scale fiscal response to the economic shock triggered by COVID19 – with specific measures estimated at less than 1% of GDP. We recently lowered our estimate for the 2020 fiscal deficit, despite having lowered our forecast for real GDP growth to -10.8% in 2020 (from -9.1% previously). We believe the government can narrow the deficit in 2021, although potentially not by as much as the budget assumes.

September's draft budget revised the government's forecast for the 2020 nonfinancial public sector primary budget deficit to just 0.2% of GDP from the 0.6% forecast in July, largely due to relatively firm tax revenues. The government projects a zero primary balance in 2021 before primary surpluses of 0.8%–1.1% of GDP in the following five years.

Policies that prioritise public finance sustainability support Mexico's 'BBB-'/Stable sovereign rating, as does the stable and predictable macroeconomic policy framework. Economic contraction and peso depreciation will push public sector debt-to-GDP to a multi-decade high of 54.7% in 2020, up by around 10pp of GDP according to the draft budget.

Oil revenue has been the main source of weakness. Government estimates put oil revenues at the federal level at just 1.1% of GDP, down 0.7 pp from 2019. Our forecasts assume oil production undershoots the government's latest target of 1.857mbbl/d and oil-related revenues remain around 1% of GDP in 2021.

However, tax revenue has proved resilient and the government plans to draw down 1% of GDP from the revenue stabilisation fund (FEIP) in 2020 as well as other deposits. This will help limit the fall in overall government revenues to 0.6% of GDP this year, according to draft budget estimates.

Tax revenues are low at around 13% of GDP. Mexico's narrow revenue base implies room to grow additional revenue sources. The draft budget rules out new taxes or higher tax rates, supporting Fitch's view that no tax reform will be introduced until 2022.

We still forecast the 2021 general government deficit forecast to narrow to below 4% of GDP, from 4.8% in 2020. It could be lower when central bank profits – potentially exceeding 1% of GDP – are included. Under budget laws, these are used to reduce Mexico's financing requirement and grow the FEIP. However, this cushion to revenue shocks is being eroded.

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Fitch Downgrades Mexico to 'BBB-'; Outlook Stable (April 2020)

What Investors Want to Know: Mexico's Downgrade (June 2020)

Mexico Maintains Tight Fiscal Stance, Erodes Oil Fund Buffer (September 2020)

What is Fitch's View on Colombia's 2021 Budget and Medium-Term Fiscal Plan and How Will it Guide the Resolution of the Negative Outlook?

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Colombia's 2021 budget, approved in Congress's in first debate in late September, calls for a spending increase to 21.3% of GDP, up by0.6% of GDP from the level in 2020, leading to a projected central government deficit of 5.4% of GDP, slightly above the deficit outlined in the Medium Term Fiscal Framework (MTFF), published in June, and down from the 8.2% of GDP projected in 2020.

Most of the increase is in capital spending as the government seeks to reactivate the economy after the sharp contraction in 2020. The government suspended its fiscal rule in 2020 for two years. The lower deficit is therefore coming mostly from improved revenues in 2021. We project a deficit of 5.9% of GDP, given expectations for lower revenues as a result of our lower growth forecast.

Returning to the fiscal rule in 2022 would mean a budget deficit target of 2.5% of GDP, according to the government. In its MTFF framework, it outlined the need to raise structural revenues by 2% of GDP. The feasibility of such a tax reform is uncertain, especially as Colombia heads for presidential and congressional elections in early 2022, although the government has a long track record of passing tax reforms to increase revenues. Additionally, in Fitch's view, some of the underlying assumptions for the medium-term growth trajectory are optimistic.

The government projects GDP growth of 6.6% in 2021, above 5% from 2022–2023 and above 4% in 2025, citing the large output gap that has emerged after the pandemic. However, Fitch believes there is uncertainty on both the new potential and the pace at which the output gap closes, which could undermine MT revenue assumptions.

Fitch forecasts a more gradual deficit reduction over the medium term, reaching 4.3% of GDP in 2022. This is insufficient to stabilise the debt burden. We forecast general government debt to climb from 45% of GDP at end-2019 to 59% at end-2020 and 61% in 2022.

The government has previously had difficulty lowering current spending sustainably and has often relied on capital expenditure cuts instead. However, given the large capital spending increases in 2020 and 2021, such a reduction may be feasible starting in 2022.

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Fitch Downgrades Colombia's Rating to 'BBB-'; Outlook Remains Negative (April 2020)

What Investors Want to Know: Colombia's Negative Outlook (July 2020)

How Will the New Dominican Republic Government's Institutional Reforms Affect the 'BB-' Rating?

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Institutional reforms initiated by the new Dominican Republic president Luis Abinader (inaugurated on August 16 and the first non-Partido de la Liberación Dominicana (PLD) president since 2004) to strengthen public administration and improve efficiency of the electricity system are likely to lift, or at least sustain, the country's World Bank governance indicators. The Dominican Republic's weak control of corruption and government effectiveness have constrained its governance indicators (43rd percentile composite average, 2019).

President Abinader's Partido Revolucionario Moderno (PRM)-led administration put anti-corruption at the center of his campaign. Cross-party congressional support will be important for the progress of his reform agenda. Appointing an independent attorney general, strengthening judicial system independence and police labour conditions are also on the new president's agenda.

Measures to stem the persistent financial losses of public electrical utilities are a positive rating sensitivity. The plans, if implemented, would slow growth of the government debt (61.2% of GDP, 2020F) and interest (25.6% of revenues, 2020F) ratios.

The Abinader administration liquidated the central CDEEE authority, transferred oversight of the electricity system to the Ministry of Energy and Mines, and plans to tender private management of the Punta Catalina coal-fired power plant. In 2019, the Dominican government paid a budgeted electricity subsidy of 0.5% of GDP, absorbed CDEEE and distributed arrears to electricity generators, increasing government debt by 0.3% of GDP, and paid 1.4% of GDP to suppliers for contracted arrears. The generator contracts levy 30% interest on their US dollar liabilities. Cutting the arrears would slow pressure on Dominican Republic's already high interest bill and 74% foreign currency share of debt.

Non-resident visitors were down 48% yoy in August. Plunging tourism and domestic lockdowns have led to the economy contracting 8.5% yoy in 1H20. Fitch expects the small current account deficit and the government's closure of its 2020 financing needs with a USD3.8 billion bond issue in September to limit pressure on external liquidity. The administration is accelerating gold mine investment, introducing a new mining code, inviting greater private participation in electricity management and using a new PPP framework for infrastructure investments to boost FDI and FC inflows to the economy.

Related Research

Fitch Revises Dominican Republic's Outlook to Negative; Affirms at 'BB-' (8 May 2020)

Do Low Oil Prices Threaten the Currency Pegs of Gulf Cooperation Council Countries?

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We foresee no change in the pegged exchange-rate regimes in GCC countries in the medium term, despite double-digit fiscal and current account deficits that have opened up as a result of the crash in oil prices and the coronavirus pandemic. GCC countries prefer fiscal consolidation as a means of fiscal and external rebalancing, which is consistent with their structural economic constraints.

They are also able to defend the pegs, either alone as in Kuwait (AA/Stable), UAE, Qatar (AA-/Stable) and Saudi Arabia (A/Stable), or with likely external support as in Bahrain (B+/Stable), where it has been amply demonstrated, and Oman (BB-/Negative), where it has so far been limited. The foreign assets of the UAE, Kuwait, Saudi Arabia and Qatar are more than sufficient to cover their entire stock of broad money liabilities and years, if not decades, of current account deficits and foreign maturities, allowing them to withstand even a complete loss of domestic and market confidence.

Foreign assets are much lower in Bahrain and Oman. However, Bahrain's peg has survived periods of exceptionally low reserve coverage, helped by the expectation and reality of support from allies in the GCC. To some extent, expectation of GCC support may also be a factor supporting confidence in the Omani rial, although Oman also benefits from having significant gross foreign assets and reserves (despite net assets being negative).

Devaluation would result in few competitiveness benefits to GCC countries given the undiversified nature of their economies, instead delivering fiscal and external adjustment through erosion in the real value of government spending and residents' incomes and wealth (leaving the real value of oil revenue unchanged).

In oil exporters outside of the GCC, devaluations have led to import compression but often inflated foreign-currency debt burdens, exacerbated financial sector vulnerabilities and undermined macroeconomic stability. Successful currency adjustments have been accompanied by broader fiscal and economic reforms.

In our view, fear of social unrest is another factor discouraging governments in the GCC and elsewhere in the region from currency devaluations. The soaring cost of living has been a factor in political unrest across the region, including in the Arab Spring protests in Tunisia, Jordan and Oman in 2011. Potential social backlash is a risk both of devaluation and fiscal consolidation, although fiscal policy may lend itself better to a more gradual adjustment.

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Currency Pegs in the MENA Region (July 2020)
Oil, Coronavirus Impact on GCC Sovereigns (May 2020)
MENA Sovereign Credit Overview (October 2020)

What Do the Abraham Accords Mean for Ratings of Abu Dhabi, Bahrain and Israel?

Analyst

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The signing of the Abraham Accords on 15 September 2020 marks a historic turn in Middle-Eastern politics as the UAE and Bahrain moved past the Arab Peace Initiative, which conditioned the recognition of Israel on the creation of a Palestinian state. However, it is unlikely to materially reduce geopolitical risks in the region or affect sovereign ratings.

The accords will open up trade and investment between Israel and its two Arab counterparts but economic benefits are likely to be too limited to impact credit ratings. Bilateral trade could ramp up rapidly, but all three countries are relatively small and already have very open economies. Even if Saudi Arabia enters a similar agreement, the impact for Israel would be only moderate.

The Accords do not significantly reduce Israel's geopolitical risks. Israel's 'A+' LT FC rating is weighed down by a negative notch adjustment reflecting geopolitical risks. It is linked to the risk of an escalation of the simmering conflicts with forces in Gaza and the West Bank and Hezbollah in Lebanon. While the Abraham Accords demonstrates an improvement of the relationship between Israel and parts of the Arab world, a reduction of tensions with Palestinians remains a distant prospect and the deal also does not address the tensions between Israel and Iran-linked Hezbollah.

The effect of the strengthening security relationship between Israel and the GCC on regional tensions with Iran, which denounced the deal, is unclear. Israel considers Iran and Hezbollah a key threat and regularly targets their positions in Syria. The UAE and, more acutely, Bahrain, with its Sunni leadership and Shi'a majority population, also view Iran as a threat. A UAE-flagged tanker carrying petrochemical products was sunk in the Gulf of Oman in 2019 in an attack attributed to Iran by the US. An attack on Saudi Arabia's oil infrastructure in 2019 widely attributed to Iran was the main contributor for Fitch's downgrade of Saudi Arabia's ratings.

The UAE and Bahrain would both be very exposed to Iranian hostilities. The UAE in particular would seek to avoid jeopardising its reputation for stability by avoiding any actions that heighten conflict risk. The bilateral relationship with Iran has appeared to be more constructive following the UAE's military withdrawal from Yemen. The US presidential election could mark a turn in the US-Iran relationship, which will remain a key determinant of geopolitical risk for the region.

Will Angola Undertake Private Sector Debt Restructuring?

Analyst

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In September 2020, Fitch downgraded Angola's ratings to 'CCC', which indicates that default is a real possibility. Angola has had a difficult external adjustment that included a sharp FX depreciation increasing foreign-currency obligations in local-currency terms. This was exacerbated by the fall in oil receipts in 2020, leading to additional pressure on international reserves.

Fitch's central scenario is for Angola meeting its external debt servicing obligations in 2020 and 2021 due to a combination of re-scheduled payments to China and other bilateral creditors, support from multilateral lenders, and drawing down of external buffers. The good relationship between Angola and the IMF suggests the viability of a follow-on programme to the current Extended Fund Facility. In addition, Angola may regain market access and use issuance to cover remaining financing gaps.

The IMF noted serious challenges for debt sustainability, although it expects public debt to fall from 123% of GDP (including 7.6% of GDP SOE debt not included in Fitch government debt numbers) at end-2020 to 70% by 2025, but highlighted that debt dynamics remain highly vulnerable to further shocks, and "further debt relief may be needed if downside risks materialise".

Over 80% of Angola's government debt is foreign-currency denominated or linked. Angola's sizeable oil receipts provide some hedge to foreign-currency debt, but the sheer size of the debt stock presents a challenge to medium-term debt sustainability. By end-2020, Fitch forecasts general government debt to increase to 129% of GDP, or 850% of government revenue, which is more than twice the 'B' median forecast of 356% and is indicative of Angola's difficulties in increasing non-oil revenue.

While the authorities have built a strong recent track record of implementing fiscal and structure reforms, a failure to steadily reduce the debt burden could lead to a situation where the IMF makes private sector debt re-structuring a precondition of its financial support.

We believe the authorities will continue to service their Eurobond debt in 2020 and 2021, but as the amortisation dates draw nearer, the government will have to secure new financing sources. This may prove difficult given Angola's debt overhang and may depend on further economic rebalancing and a return to robust economic growth.

Related Research

Fitch Downgrades Angola to 'CCC' (September 2020)
Rising Debt Distress in Sub-Saharan Africa (June 2020)

How Do Water Risks Affect Sovereign Ratings and Which Countries Are Particularly Exposed?

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Water risks are likely to become a more important sovereign rating driver over the medium to long term. Intensifying water risks will have implications for ratings through three main channels:

1. ***Economic growth*** as water scarcity and incidence of droughts and floods will cause a drop in agricultural yields, with spillovers to the broader economy.
2. ***Social and geopolitical tensions*** due to higher food inflation and mounting domestic and regional competition over water being an increasingly scarce resource.
3. ***Public finances*** as water risks raise pressures for investment in infrastructure, which could also generate contingent liabilities for sovereigns.

Middle Eastern and North African countries such as Egypt, Israel, Jordan, Kuwait, Morocco and Tunisia are particularly exposed to drought and water stress risks, based on our composite water risk indicators, which incorporate measures of current country exposure to water risks as well as measures of projected climate change. Exposure to flood risks is high for several sovereigns in Asia, including Bangladesh, Sri Lanka, Thailand and Vietnam, and sub-Saharan Africa, including Benin, Mozambique and Rwanda. Countries with stronger institutions are more likely to bolster their resilience through adequate water-management policies.

Under our sovereign rating framework, we aim to capture water risks through their impact on structural features, macroeconomic performance and public and external finances. In recent years, water risks have featured as a subsidiary sovereign rating driver in the context of negative rating actions on several emerging countries across regions, mainly through their impact on economic growth, amplifying challenges from other sources. Such examples include Morocco (March 2020), Namibia (June 2020), Sri Lanka (December 2018), Thailand (March 2020) and Uruguay (October 2018).

Water Resources and Management is also one of the five environmental factors captured under our ESG relevance scores. An ESG relevance score of '3' for Water Resources and Management is assigned to Egypt, Laos and Namibia. This indicates that for these countries, Water Resources and Management is relevant for the rating, and has an impact in combination with other factors.

Related Research

Water Risks and Sovereign Ratings (September 2020)