Commentary

2024 Sovereign Outlook: Higher Rates and Slowing Economies, but Stable Credit Ratings

DBRS Morningstar
December 8, 2023

Key Highlights

- A weak macroeconomic environment poses potential challenges.
- Interest costs are rising with higher real rates but remain manageable for most major economies.
- Political risks and election uncertainty could complicate the outlook.

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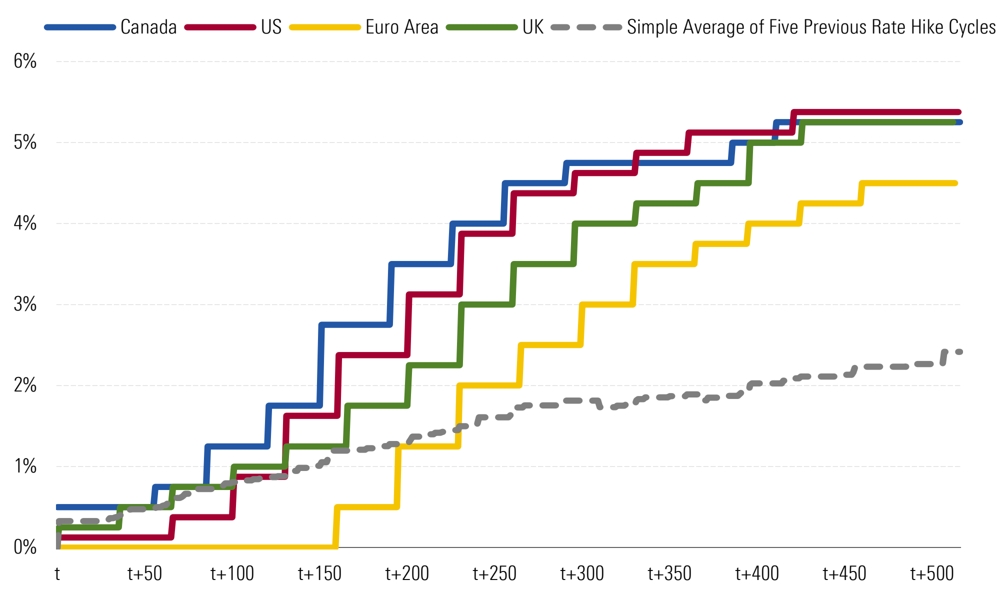
A Weak Macroeconomic Environment Poses Potential Challenges

2023 is coming to a close with inflation gradually coming down and interest rates stabilizing. Over the past two years, central banks have carried out the most aggressive tightening cycle in over four decades (see Exhibit 1) yet 2023 growth generally exceeded expectations (see our latest baseline macroeconomic scenarios, https://www.dbrsmorningstar.com/research/421227). European growth has weakened due to a combination of factors, including energy shocks following Russia's invasion of Ukraine and some structural challenges, particularly in Germany. Most other advanced economies have enjoyed robust growth thanks to earlier government support measures, healthy household balance sheets, high cash balances, a strong labour market, and pent up pandemic demand. Emerging market economies (EMEs) continue to face headwinds, but some central banks have initiated easing cycles as inflationary pressures recede.

Exhibit 1 Central Bank Policy Rates (%)



Source: Bank of Canada, Federal Reserve Bank of New York, Bank for International Settlements, Bundesbank, DBRS Morningstar.
Note: For current cycle, t = 15-Dec-2021 (first BOE rate hike). Date count ends at t+516 and excludes weekends. Previous rate hike cycles for Bank of Canada: 1999, 2002, 2004, 2010, 2017; Federal Reserve: 1988, 1994, 1999, 2004, 2015; Bundesbank/ECB: 1979, 1988, 1999, 2005, 2011; Bank of England: 1994, 1996, 1999, 2003, 2006. Data as of 7-Dec-2023 for Canada; as of 6-Dec-2023 for US; as of 4-Dec-2023 for Euro Area; as of 1-Dec-2023 for UK.

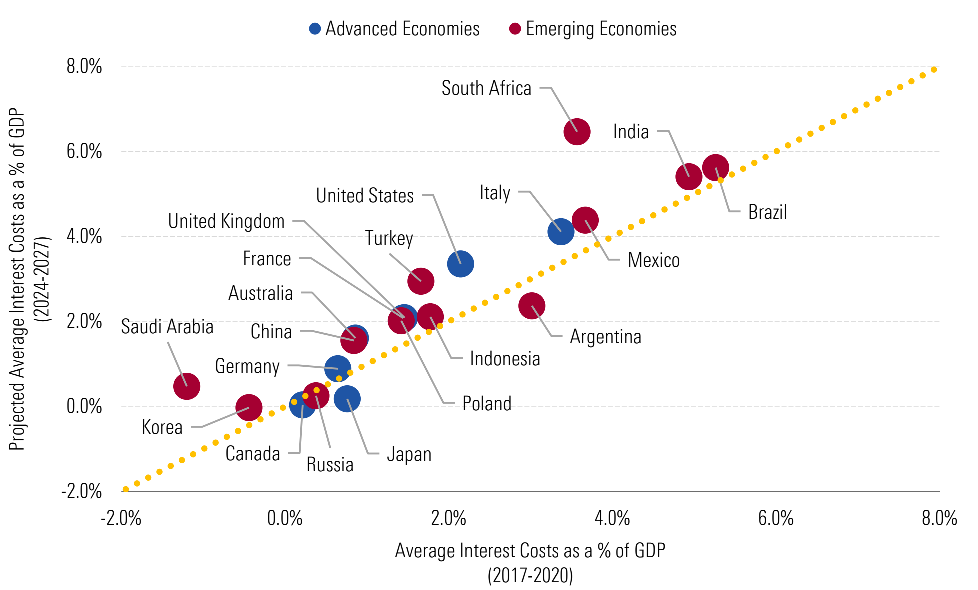
We remain cautious regarding the 2024 outlook because the full impact of monetary policy tightening has not yet been felt in Europe and North America. Growth is expected to be below 1% in all the major advanced economies, though markets seem to be growing more optimistic regarding prospects for a soft landing in North America. China's property market challenges are also weighing on global sentiment. The possibility of (likely mild) recessions in some major economies is not sufficient to undermine sovereign credit ratings, but may add to challenges for those governments needing to undertake significant fiscal adjustments.

Among sovereigns publicly rated by DBRS Morningstar, upgrades have outnumbered downgrades during 2023. The upgrades primarily reflect continued gradual recoveries in countries that were in much weaker positions a decade ago (e.g., Euro area periphery countries). Economic reforms, strong fiscal performance, and support from European institutions have contributed to the gradual improvements in their credit ratings. In contrast, policy shortcomings and a challenging international environment have led to a few downgrades over the past year.

Looking ahead to 2024, we presently have no Positive or Negative trends on our public sovereign ratings, and in most cases expect stability and resilience in the face of economic headwinds. Some weaker emerging markets face significant vulnerabilities already reflected in the ratings (such as Argentina, rated CCC, Stable; see our recent commentary on the challenges facing the new president-elect, https://www.dbrsmorningstar.com/research/423647/).

Interest Costs Have Risen But Remain Manageable For Most Major Economies

Exhibit 2 Average Net Interest Costs Relative to Pre-Pandemic Levels



Source: IMF World Economic Outlook, DBRS Morningstar.

Higher nominal interest rates have contributed to a material increase in interest costs across some countries. The burst of high inflation following the pandemic lowered the real cost of debt, but central bank tightening combined with slowing inflation will gradually increase debt servicing costs over the next year or more. As shown in Exhibit 2, most G-20 sovereigns are expected to see higher average debt servicing costs in the next several years than they did prior to the pandemic (implied by the red and blue dots above the yellow diagonal line). This may put additional pressure on countries with large structural primary deficits, where debt dynamics are likely to be unfavourable.

Among the large advanced economies (excluding Canada and Japan), the IMF projects that net interest costs as a percent of GDP will increase relative to pre-pandemic levels, driven both by higher debt levels for most governments and by higher nominal rates. This increase will put some pressure on budgets but remains manageable, particularly when viewed on a historical basis; for most countries, interest burdens remain lower than long-term historical averages dating back more than 20 years, even though debt levels are broadly higher for most as well.

Many emerging markets were less aggressive in supporting their economies during the pandemic, and some also started with lower levels of debt. This helps explain the relatively limited impact of higher interest rates thus far. South Africa has seen the largest increase, while India, Brazil and Mexico stand out among the G-20 countries with relatively high (and gradually rising) interest burdens. Argentina is also far more vulnerable than this projection of interest costs suggests, given the high percentage of foreign currency debt, strong inflationary pressures and very limited FX reserves.

Political Risks and Election Uncertainty Could Complicate the Outlook

Geopolitical tensions and wars can lead to physical output and trade disruptions; shortages of commodities, raw materials, and industrial inputs; slower economic growth; and even recession and stagflation. So far, the worst anticipated economic outcomes from Russia's invasion of Ukraine and the Israel-Hamas war have been avoided. However, both situations are emblematic of the complex geopolitical risks that could affect commodity prices or lead to other confidence shocks. In the current high interest rate environment, governments face tough spending decisions and fiscal prioritisation will be as important as ever, if not more so. Governments are starting to tackle post-crisis fiscal deficits and are attempting to lower public sector debt burdens, while at the same time trying to meet public investment and security needs. In this context, additional political shocks with adverse economic implications could shift governments off track and present grave challenges for weaker sovereigns.

Elections in some key countries, including the United States and Taiwan, could also generate uncertainty or negative surprises. Policies of important trading blocs such as the US, EU and China could change at short notice, leaving trade partners ill-prepared. European parliamentary elections will bring focus to long-standing issues such as EU reforms, enlargement and immigration policies. Bloc cohesion is key to many of our sovereign ratings in Europe, and the pandemic response along with rising EU-supported investment have been positive signs. Any firm evidence of this increased cohesion weakening could have negative credit implications.

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