Trip Notes

IMF Annual Meetings Spring 2023

Aktia

View from Lincoln Memorial to Washington Monument

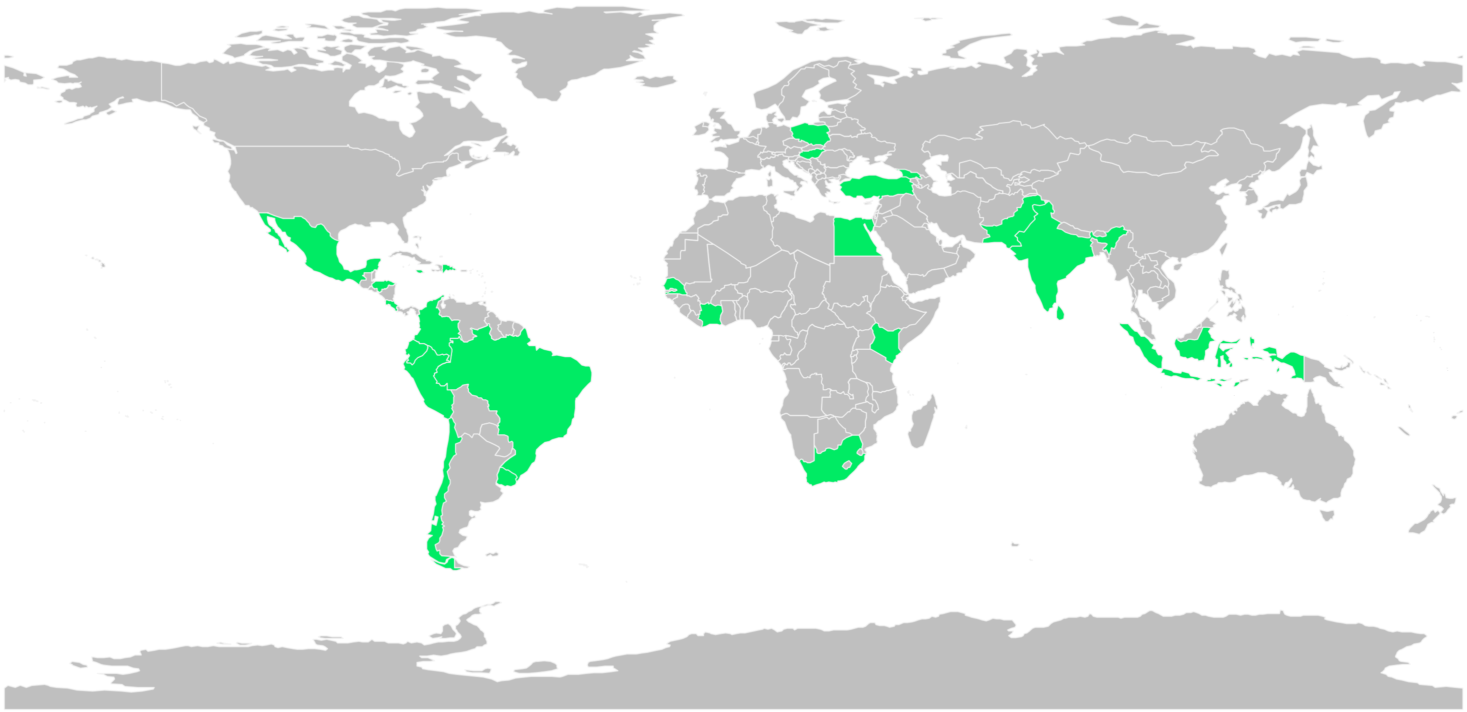
IMF Meetings

- Aktia's Emerging Market Debt Team travelled to Washington D.C. to participate in the side events organised in connection to the IMF's Spring Meetings.

- All in all, we had over 30 meetings with central bankers, finance ministers, treasurers and IMF representatives covering a total of 23 emerging and frontier countries.

- In this report, we go through some of the key themes that came up in the meetings and go into more detail on selected countries.

Aktia EMD Team's country meetings alongside the semi-annual IMF meetings



Africa: Ivory Coast, South Africa, Kenya, Senegal

Asia: India, Pakistan, Sri Lanka, Indonesia

Central America and the Caribbean: Mexico, Honduras, Costa Rica, Dominican Republic

Europe: Czech Republic, Hungary, Turkey, Georgia

Middle East and North Africa: Egypt

South America: Brazil, Chile, Colombia, Peru, Ecuador, Uruguay

Overview

- Sticky inflation was one of the core themes alongside topics related to financing costs and refinancing risks. Additionally, the recent banking sector turmoil was discussed. The war in Ukraine and other political risks were less in focus. However, nearshoring, the transfer of production to a nearby country, was occasionally mentioned in meetings.

- Inflation figures are still above many central banks' targets, and de-anchored inflation expectations were a worry for many central bank board members we met with. The credit channel of monetary policy transmission is operating weakly in many emerging and frontier countries. The importance of central banks continuing with policy action consistent with policy guidance was stressed as an essential factor for expectations management.

- Tightening dollar liquidity and higher interest rates are forcing countries which have refinancing needs to seek alternative funding sources. Countries are looking towards the Gulf Cooperation Council, Asia, and concessional financing to avoid bond market financing. Also, in countries where there is a well-functioning local bond market, future issuance is targeted towards local bonds.

- US banking sector worries were mentioned but most countries did not see any immediate impact on them or the banking sector. However, it was seen as an issue that needs to be monitored closely.

- Nearshoring was an especially positive factor for many Central and South American countries. Mexico was seen as one of the biggest beneficiaries, but also smaller countries like Costa Rica see potential in attracting Foreign Direct Investment.

- In the latest edition of the World Economic Outlook, the IMF sees that the world economy could achieve a soft landing and avoid recession despite banking sector worries and globally tight monetary policy. The baseline forecast, which assumes that the recent financial sector stresses are contained, is for growth to fall from 3.4% in 2022 to 2.8% in 2023, before rising slowly and settling at 3.0% five years out. Debt levels are still high after the pandemic which limits the possibility of fiscal stimulus.

"Inflation figures are still above many central banks' targets, and de-anchored inflation expectations were a worry for many central bank board members we met with.

Mexico

- Mexico has been one of the best performing emerging markets. Economic growth has been around 3% but the pace is slowing due to weaker external demand. Consumption is the key driver of growth in coming quarters.

- Mexico has widespread and persistent inflation. Inflation has surprised to the upside, and the central bank has revised its inflation forecast upwards. The tight labour market is keeping service sector inflation elevated. Inflation is still above the central bank's target.

- The central bank has signalled a continuation of hawkish monetary policy. It sees that the monetary policy transmission mechanism is operating weakly, and that strong communication is needed to pull inflation expectations lower. The central bank hiked by 25bps in March and has not ruled out additional hikes if needed. Monetary policy will be kept tight "throughout the planning period" as inflation is seen to show stronger convergence towards the target in late 2024.

- Regarding issuance, Mexico intends to slightly increase duration in the local curve (with the intention to reduce short term indebtedness). An average maturity extension for bonds can be expected in the 1-2Y mark, as maturities up to the 2025 mark are likely to be reduced. Should financing conditions allow for it, Mexico may also issue a fixed rate ESG bond towards the end of this year.

- Mexico is one of the nearshoring beneficiaries, its traditional strong connections to the US economy and especially the US car industry has supported the external balance.

- **View:** Mexico is our biggest holding in our local currency strategy, and among the top three largest positions in our hard currency strategy. Mexico offers one of the highest real rates in EM, and the currency has been stable. The peso looks slightly overvalued, so the biggest short-term risk is a weaker peso if market sentiment deteriorates. Also, a weakening US growth outlook would affect Mexico's economy, but if domestic demand takes a lead as a growth driver, the downside risks due to softer exports could be mitigated.

Brazil

- Growth has been slowing down as tighter monetary policy continues to be a drag on activity. Service sector growth is already close to zero. The main growth contributor is the agricultural sector that has been supported by a good harvest.

- Despite headline inflation coming down from peak levels, price pressures are sticky and inflation expectations are elevated. One reason behind de-anchored inflation expectations is President Lula's verbal attacks towards the central bank, and especially the ongoing discussion whether the inflation target level should be lifted.

- Due to high inflation expectations, the central bank must keep monetary policy tight. The central bank does not have any explicit rate target or terminal rate. Instead, the overall monetary policy stance is influenced by macrofundamentals and projections.

- Brazil has recently published its new fiscal rule. The lower house will discuss and vote for it in coming weeks. The final version after congressional approval may differ from the proposed one.

- **View:** Brazil real rate is currently the highest in EM local currency universe due to tight monetary policy. The biggest risks are around fiscal policy, although the proposed fiscal rule has taken off some of the tail risks. Our current holdings are around 8% and we do not have plans to add before we have better clarity about Lula's policies. We have also a moderately sized position in our hard currency strategy.

Paulista Avenue, Sao Paolo

Indonesia

- The macroeconomic state and narrative behind Indonesia's macro developments path forwards is solid.

- Inflation for this year is expected to be in the range of 3% +/-1% and reach the central bank's inflation target of 2.5% +/-1% next year (authorities' projections). The Ramadan inflation spike for this year seems to be significantly lower relative to previous years, which can be explained in part by price control policies and dampened aggregate demand.

- Exports are on a robust growth trajectory. The downstreaming project in itself has boosted Indonesia's nickel exports from USD 2.5 billion to USD 30 billion with new nickel smelting infrastructure being under construction. Bauxite exports, while relatively smaller in terms of output potential, are also expected to increase under the downstreaming project. The banking sector remains well capitalised, which is much higher that that of Basel regulatory standards. The banking sector's non-performing loans rate stands at 2-3%.

- The labour market is not particularly tight (despite loose macro policy and moderate inflation). Interest rates have nonetheless been relatively tighter as with the case of many EM countries. In part, this is due to Indonesia's desires to attract international financial flows at competitive rates. Furthermore, this has not hampered Indonesia's banking sector to extend loans to the domestic economy as credit growth has been solid.

- Indonesia continues to intervene in its bond and FX markets, and the central bank is the largest holder of government bonds. "Operation twist" (local yield curve control typically targeting the 8Y pivot) has not been as heavy this year as it was last year, however.

- On the external financing side, FDI flows have mainly been coming from China and are primarily related to the downstreaming project. Reserves account for 120% of the Assessing Reserve Adequacy (ARA) metric and bilateral commitments remain in place with other Asian central banks as a further supplementary liquidity supporting mechanism. Currently, reserves are at the highest record in Indonesian history.

- **View:** In our EM Local Currency Strategy, Indonesia is one of the core investments in Asia, as we see country's medium- and long-term growth outlook as positive on the back of reforms and ample reserves of key commodities that are needed for the global green transition. We also see that positioning is light as foreign ownership in local currency bonds is still low compared to pre-pandemic levels. Indonesia is also among the top 5 largest investments in our hard currency strategy.

Dominican Republic

- The Dominican Republic has been the fastest growing economy in Latin America. It is known as a tourism destination, but the share of tourism is only 9% of GDP. The growth forecast for 2023 is 4.3% which is well below potential (authorities' projections).
- One reason for slower growth is tight monetary policy. The central bank raised rates aggressively, but it has been on hold for five months with its policy rate at 8.50%. Inflation is cooling down and the latest print was 5.9% y/y (March), which is close to the 4% target within a 1%-point range. The IMF projects 4.9% inflation by year end.
- The fiscal deficit is expected to be around 4% of GDP in 2023, and the current account deficit is projected to be around similar levels. The Dominican Republic runs twin deficits, but these are financed by FDI, tourism, and remittances. A medium-term fiscal framework is expected to be published later this year.
- The Dominican Republic has attracted investors due to its robust and sustained growth outlook with market friendly and stable policies. Foreign participation in local currency bonds is still below levels seen pre-pandemic.
- On the FX side, the currency is relatively fairly-valued when looked at from purchasing power valuations and taking into considerations dollar flows which have supported the currency's strength. The currency may even have some further strengthening potential, which would have the potential added benefit of further aiding in controlling inflation.
- The Dominican Republic is working on making local bonds clearable through Euroclear towards the end of this year. This would in effect increase foreign interest and add liquidity to local markets.
- **View:** We have Dominican Republic exposure in all our three EMD strategies. The Dominican Republic has a stable political environment which has positively contributed to solid economic performance. Growth prospects look robust also going forward. Domestic bonds' low liquidity and the economy's small size limit us from having a higher allocation in our frontier strategy.

"Tightening dollar liquidity and higher interest rates are forcing countries which have refinancing needs to seek alternative funding sources.

Costa Rica

- Costa Rica seems to be an outlier, as inflation is under control and the central bank has been able to cut interest rates this year by 150 bps (YTD April). The latest inflation was 4.4% y/y in March, just marginally above the central bank's target range of 2–4% (authorities' projections).
- The economy is estimated to grow around 2.7% in 2023 with upside potential. However, growth is still below potential (3.9%). Costa Rica has been a target country for nearshoring. Also, recovery in tourism has been strong following the pandemic.
- On the external side, the Costa Rican colon has strengthened 18% y/y due to strong exports and capital inflows. The current account deficit is expected to narrow from 4% in 2022 to 3% 2023. FDIs are currently higher than current account deficit so basic balance is positive in Costa Rica.
- Foreign exchange reserves have accumulated with strong external performance and are at high levels based on historical standards. This spring, Costa Rica will set an internal, not to be published, target level for FX reserves.
- The fiscal situation has also improved, the fiscal rule limits budget deficits until the debt-to-GDP is below 60%. The current figure is around 64% and it will take a couple of years before the fiscal rule is achieved.
- Although the latest economic performance has been strong, Costa Rica is a small open economy, which makes it vulnerable to external shocks. However, if it manages to keep the economy on track, it might attract even more portfolio inflows in the future.
- **View**: We have allocations to Costa Rica in both our frontier local currency and in our hard currency strategies. Our hard currency strategy participated in Costa Rica's recently issued USD 1.5 billion eurobond in March which was oversubscribed. Costa Rica enjoys strong positive investor sentiment and the IMF program from 2021 has reined in government spending. The limited liquidity of the local government bonds somewhat limits further increasing our frontier strategy's weight in these.

Sri Lanka

- Sri Lanka is currently in its early phases of post-shock recovery, as the economy was hit hard from the unwinding of prolonged fiscal policy mismanagement and materialisation of external vulnerabilities. The hardship facing the Sri Lankan population has been further exacerbated by global credit liquidity tightening and the rebounding of imported commodity prices, such as oil.

- The key take aways from meetings with both country officials and IMF representatives were that the lessons on past policy mismanagement have been understood, and that government authorities are seriously engaging with the IMF to take the necessary steps to remedy the situation. The recent Extended Fund Facility arrangement agreed by Sri Lanka and the IMF consists of around USD 3 billion worth of funds to support Sri Lanka's economic policies and reforms.

- In a nutshell, the IMF recovery programme consists of policy reforms and provides a line of liquidity to address short-run financing needs. The reforms broadly intend to increase tax revenues, make public debt more sustainable, re-establish price stability along with FX reserve accumulation and greater FX flexibility, safeguard financial sector sustainability, and engage in structural changes related to governance reforms, anti-corruption reforms and so on.

- An asset quality review on the banking sector will be published in Q3 this year, the Fiscal Management Act is to be enshrined into law, and the Central Bank Act is almost finalised.

- With 17 IMF programmes agreed so far in Sri Lanka's history, the question remains: is this time different? The programme currently has bi-partisan support which to a degree protects the programme from short-term political risks. In addition, the magnitude of this economic turmoil is something that Sri Lanka has never felt before, so there seems to be a consensus by the electorate that the reforms are necessary (at least for the time being).

- However, the programme and recovery are not without risks. The actual debt restructuring execution plan is still open and has yet to be set in stone. Furthermore, while the short-term issues facing public sector financing have been arguably remedied, domestic interest payments remain high. Furthermore, whether bi-partisan and electoral support will be sustained throughout the policy implementation period is another downside risk factor.

- **View:** None of our strategies have exposure to Sri Lanka currently. We will continue monitoring the ongoing debt restructuring negotiations and reform progress.

Honduras

- Honduras is expected to grow by 3.7% this year with a slight slowdown in activity from thereafter (IMF projections). The inflation picture has been largely impacted by the commodity price shock stemming from oil prices, as inflation is expected to be in the 11% mark for this year. Nonetheless, some gradual slowdown is expected and inflation should reach the 3-5% inflation objective next year.

- Remittances are expected to expand this year, but so is the current account deficit. A 4.5% government deficit is expected by government officials for this year, but the IMF sees the figure being in the 2-3% mark.

- Some policy prescriptions include a suggestion to tap into and develop the local currency market (a policy the IMF seems to be broadly supporting for a number of EM countries). Should this policy be executed, we could see a possible smoothing of maturity profiles of domestic debt.

- However, monetary financing of government spending is an issue that weighs down on the credibility of the country's macrofundamentals. A step forward would be to tone down on the extent to which the central bank intervenes in fiscal financing.

- Out of the recent USD 1 billion funding package announced by US Vice President Harris aimed towards Central American EM countries, around a third of the funds have been allocated. Most of the allocations so far have been allocated to dams and hospitals, which is something that the IMF supports; investments intended to support civil society and investments that bolster Honduras's climate resilience.

- On the FX side, more could be done regarding FX flexibility as well as transparency and communication. The current peg could be ameliorated by a crawling peg with FX bands. The currency is currently somewhat overvalued (in the 0-5% mark), which is consistent with our in-house FX valuation metrics.

- **View:** We have exposure to Honduras in our Hard Currency strategy.

Georgia

- GDP growth was remarkable in 2022 at 10.1% and recovery is expected to continue in 2023 at a 5% pace. The main drivers behind the strong growth have been tourism and trade and capital flows from Russia. Spending by Russian migrants explain approximately 1.5%-points of last year's growth and increased trade with Russia is of similar importance.

- The current account deficit is the narrowest in over ten years 4.1% (2022). It has been supported by service flow and transfers mainly from Russia, but other countries have contributed too. Tourism revenue is still below pre-pandemic levels.

- Most Russian immigrants are expected to return to Russia when the war in Ukraine is over and the situation stabilises, but around 80 000 Russians are expected to remain in Georgia permanently. Currently, it is estimated that a Russian family spends around USD 1 500 weekly in Georgia.

- Also, money outflow from Russia is seen in the financial account. At the end of the year, the monthly pace was around USD 500 million. Money transfers are expected to continue and 2/3 of money are expected to stay in Georgian bank accounts, at least for some time.

- The Central Bank of Georgia cooperates with the US and EU to monitor sanctions against Russia. Georgia has not imposed its own sanctions – the exports to Russia are only foods, wine, and mineral water.

- The lari has strengthened against the US dollar by 18% y/y, but the central bank did not see it as expensive on the longer term, although the short-term REER indicates a 15% overvaluation. The central bank has intervened in the market and increased FX reserves by USD 5 billion.

- Inflation is back on target and is expected to stay there. The central bank communication was already softer in the last meeting and the monetary policy rates is expected to be cut early 2024 at the latest.

- **View:** Our Frontier strategy has exposure in Georgia in the form of Development Finance Institution bonds and NDFs. We did not anticipate Georgia to benefit this much from Russian flows, when Russia's war in Ukraine began in February 2022. Since then, the currency has appreciated and we have not seen attractive enough levels to add to our exposure.

This presentation is produced by Aktia Bank plc (“Aktia”) for investors. The information has been collected from available public sources, considered by Aktia to be trustworthy. However, Aktia cannot guarantee that the information is correct or all-inclusive. The presentation is meant as a tool, among others, to help the investor to make decisions. The investor’s investment decision is his own, and it should always be founded on information and analyses that the investor himself deems to be sufficient. The investor should observe that there may be swift changes on the market, affecting this presentation. Aktia, its subsidiaries and associated companies, co-operation partners, or employees of said companies are not responsible for direct or indirect losses or damage caused by the use of this presentation, or parts of it, in investment operations. The presentation is meant to be shown in conjunction to a spoken presentation given by Aktia, and it should not be used without the presentation. The contents of this presentation is aimed for the target group it was presented to, and it shall not be made available to any other recipients. Copying or quoting the presentation, or parts of it, is not allowed without the permission of Aktia.

Investments always involve financial risks. The customer bears the responsibility for the financial impact of his investment decisions. The investment may fail to yield a profit, or the invested capital may even be lost. The customer may be debited the costs for financial services irrespective of the investment results. It is always advisable to study the investment market and alternative investments in detail before making the decision to invest. Aktia cannot give assurance to the materialisation of the expected yield presented. The information is based on assumptions based on the historic yield from different financial instruments, but it is no guarantee for future development of yield or value. This presentation is part of Aktia’s marketing material, and therefore not necessary put together in accordance with the rules for independent investment analysis. Trade restrictions concerning investment analysis is not applied on the financial instruments presented. This presentation is not based on the customer’s individual data, and it is not intended to be investment advice. The aim is to present the financial instruments, and their characteristics, included in the quotation. We would be happy to set a date for preparation of an individual investor profile and to give you individual investment advice. The customer may be obliged also to pay taxes and official charges other than those debited by Aktia. The customer should be aware that investments and investment property are subject to taxation, the impact of which was not necessarily taken into consideration in this presentation. Future performance is subject to taxation which depends on the personal situation of each investor, and which may change in the future. The customer is responsible for the gathering of necessary information regarding taxation of his investments and his decisions concerning these.

Aktia