Themes from FIM

Interest Rates and Devals – **15 February 2024**

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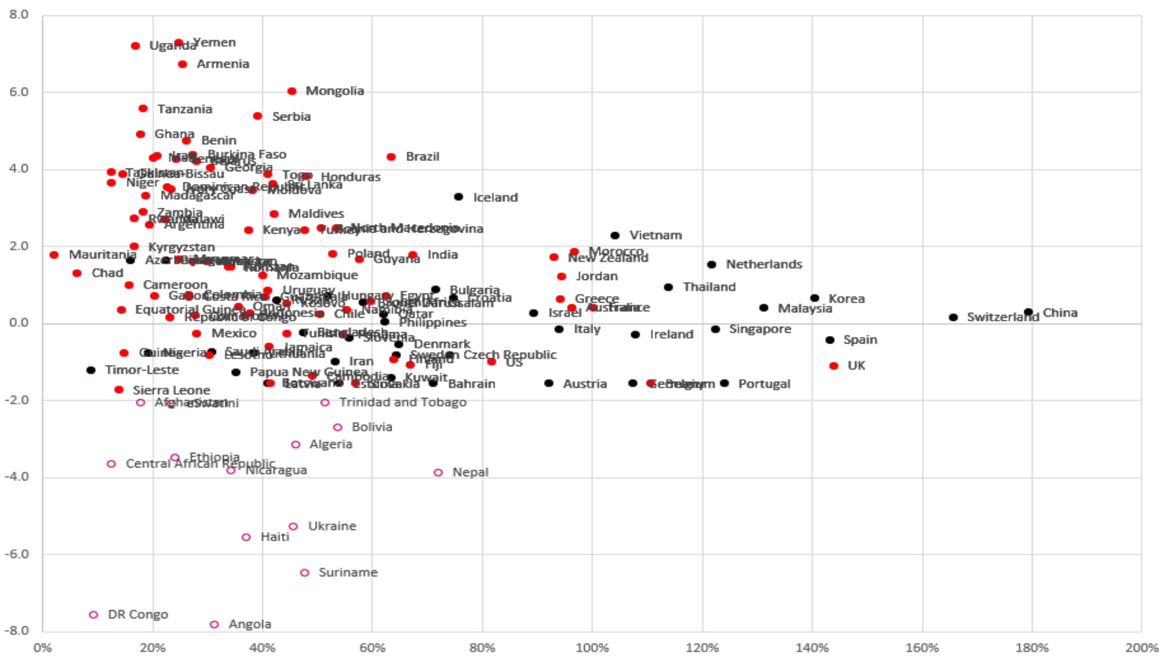
Why do the poorest pay the most to borrow? To many people, this is a moral, and not just an economic question. To provide cheaper funding to those that need it most, is why IMF shareholders boosted the IMF's lending ability so dramatically via the SDR increase in 2021 and the quota increase announced in 2023. We use a graph, as usual. We connect long-term demographic trends with big FX moves in Nigeria and (likely) Egypt that we're seeing right now, and tie in January's contentious debate about whether credit rating agencies mis-rate poor countries.

5yr subsequent average real interest rates (lhs) vs Deposits to GDP in 2013 (horizontal axis)



Source: Bloomberg

The truth is that interest rates are the price that matches the demand for money with the supply of money. Assuming roughly equal demand for money by all people globally, it is the supply of money which drives the price. When bank deposits to GDP are low and the supply of money is therefore limited, interest rates are usually high. I first looked at this in 2013 and the situation has not changed since. To get all the data onto one chart despite widely different inflation and interest rates, we used real interest rates as the best measure for the cost of borrowing.

Key Observations from Global Markets

Countries with lots of money, which are all low fertility countries (because low fertility countries find it easier to save), have real interest rates that cluster around 0%, from (not so rich) China to Korea and Ireland. The countries with the most savings, have the lowest borrowing costs.

Most countries where deposits are less than 40% of GDP pay much higher real borrowing costs.

Those countries with deeply negative real interest rates (from -2% to -8%) were either commodity exporters, often with unsustainable currency pegs at the time (e.g. Angola), or countries with no market mechanism to set rates (e.g. Central African Republic, Afghanistan). Because very negative real rates are unsustainable over time, we excluded these 14 countries in the next calculation.

We coloured the remaining 126 countries by whether they ran a current account surplus (in black) or a current account deficit (in red).

What we found is that in countries with plenty of savings, it did not matter if a country ran a current account surplus (such as Spain) or a deficit (such as the UK). Domestic savings were so high that running deficits of a few per cent of GDP was immaterial.

Where the current account really matters is in countries with few savings. On average those who ran a surplus, even if bank deposits were under 40% of GDP, had real interest rates around 0%, the same as savings-rich China.

The Asian Model of Development

This is of course the Asian model of development. You use a current account surplus to ensure a plentiful supply of foreign currency, which helps keep your overall interest rates low, so you can invest your way to growth (which boosts exports, suppresses imports and helps the cycle continue). The vast majority of China's GDP growth has come from investment, not net exports, even though exports have helped enable that investment story.

The Gulf countries today follow the same model, thanks to high demand for their commodity exports. Low real interest rates, fuelled by current account surpluses, are sustainable and support the investment into GDP diversification that we invest in, across the GCC.

By contrast, countries whose bank deposits were under 40% of GDP and a current account deficit, pay the highest real interest rates in the world, at an average 2%. This deters investment. It encourages countries to borrow "cheaply" from abroad, risking eventual debt default. Both Ghana and Zambia were paying 3-5% real interest rates in the 5 years after 2013, so they borrowed heavily from abroad, and then defaulted in the early 2020s.

The Implications

The chart suggests countries like Brazil, Morocco and Vietnam were paying excessively high real interest rates in the 2010s, relative to their bank deposits, and that the 2020s would deliver lower real rates. We see it today in Vietnam and Morocco. It is harder to see in Brazil after the inflation and interest rate shock of 2022-3, but this does support our bullish view on Brazilian rates.

The broader story is that high fertility countries should be aiming for current account surpluses if they want to lower their borrowing costs.

Yet if we go back just a few years, economies like Egypt, Pakistan, Nigeria and Kenya as well as Ethiopia, Ghana, Zambia and Sri Lanka were all running current account deficits. Many of them had currencies that were 20-50% overvalued vs their Real Effective Exchange Rate history.

Today, the latter group have all defaulted while the former group have devalued their currencies so much that each of them now have undervalued currencies. Current account deficits in Pakistan and Nigeria have become surpluses. Egypt is close to achieving that too. The implication is that if these countries maintain these cheap currencies, their real interest rates should trend towards zero in coming years, helping them manage their debt. Defaulting Ethiopia is the only country left with an extremely overvalued currency.

From a Different Perspective

For those interested in the moral aspect of the question then, the most encouraging conclusion is that countries have it in their control to avoid default, and to cut their own borrowing costs to the same level as savings-rich countries. They don't have to become colonies of the IMF. Indeed, Nigeria is making its adjustments with no IMF support at all, although the support would be helpful in our view.

Lastly, we can touch on whether the credit rating agencies have been unfair to Africa, as some suggest, or indeed have been too generous in their ratings. The data are pretty clear. High fertility countries with low savings are inherently more likely to default, if they run a current account deficit, because they are paying the highest real interest rate on their debt. That unfortunately sums up the policy stance of many African credits before 2022 but it was concealed by cheap global borrowing rates. Only when global rates soared did the unsustainability of the model become obvious.

Today though, as our CIO Francesc Balcells mentioned in January, we now have Frontier Healing. Governments are correcting their policy course. Cheaper currencies should help FX reserves swell and interest rates fall. The result should be that investing in a better future will get easier, growth can pick up and that brings both moral and economic benefits to all.

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