

For professional and institutional investors only – not to be further circulated. In Switzerland for qualified investors only.

Emerging market central banks are in the waiting room

Emerging market (EM) central banks will have to wait longer to loosen policy as developed markets (DMs) prioritise tackling inflation with further hikes. This will put pressure on central banks that pivoted too early, especially as the pace of disinflation in core measures slowed across major EMs.

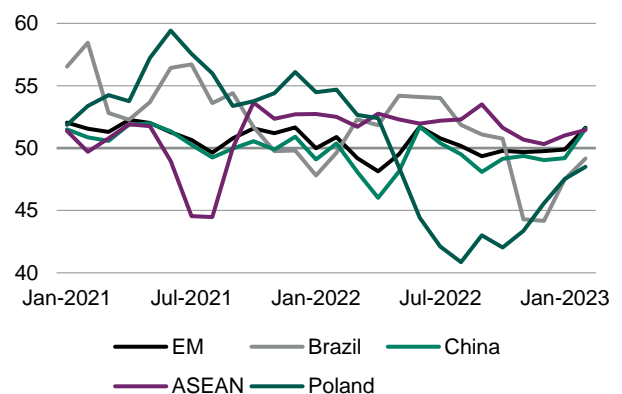
Key Takeaways

- Emerging market central banks are in a precarious position. The global economy and underlying inflation have proved more resilient, motivating developed market central banks to continue to hike.
- However, financial markets remain on edge following the collapse of Silicon Valley Bank (SVB), which is tightening EM financial conditions and limiting the room for manoeuvre.
- This means some EM central banks will have to tighten further, while others will have to wait longer before easing. Those whose pivots already had low credibility are likely to face increased pressure to reverse course.
- In a tougher financial market backdrop, EM core inflation has proved sticky. Headline inflation has broadly peaked and will fall further due to energy base effects, but underlying inflation will remain uncomfortably high in many countries, especially those in central and eastern Europe (CEE).
- The onset of the DM recession will eventually usher in a pan-EM easing cycle, but a marked worsening of risk sentiment at the onset of the US recession will limit the ability of most EMs to ease conclusively. Those with large current account deficits will face the greatest pressure, but should still avoid balance of payments crises.
- Once the Fed has eased monetary conditions and market pressures abate, we expect the pan-EM cutting cycle to commence in early 2024.

Global economic resilience has been overshadowed by strains in DM banks and ongoing inflation concerns

At face value, a better-than-expected global growth backdrop – as the euro zone avoids a winter gas crunch, the US consumer remains resilient and China reopens at pace – should be positive for EMs. Indeed, February PMI readings showed a rebound in activity across EMs, particularly in China, ASEAN and Brazil (see Figure 1).

Figure 1: Manufacturing PMIs bounce back in February



Source: Haver, abrdrn, March 2023

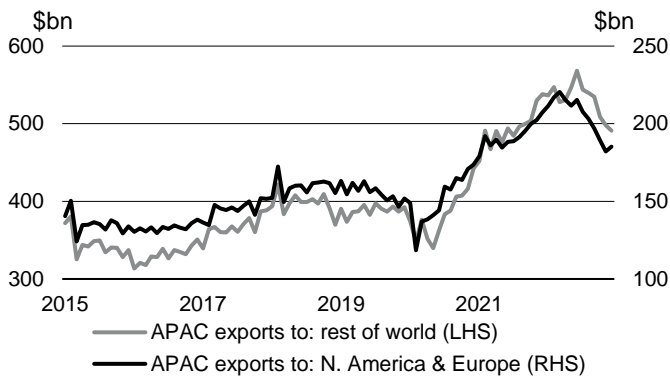
However, the services-led rebound in China implies a low import intensity, muting the typical link from Chinese growth to its trading partners. Indeed, the boost to commodity exporters such as Brazil, Chile and South Africa is expected to be modest.



Instead, those EMs which can benefit from a rebound in Chinese tourism, such as Malaysia and Thailand, are more likely to benefit from a China spillover.

In addition, while the uptick in manufacturing PMIs is consistent with near-term resilience, the broader external environment remains tough: the composition of global demand continues to move away from goods, while new export orders remain close to levels associated with manufacturing recessions, even if they have improved. As such, it is possible that global trade continues to fall in the near-term (see Figure 2).

Figure 2: External demand has weakened



Source: Haver, abrdrn, March 2023

Most importantly, stronger growth delays the resolution of imbalances across the major economies, making it difficult for the Fed and European Central Bank (ECB) to alter their policy paths despite cracks emerging in the global financial system following the failure of SVB.

Indeed, the ECB pressed ahead with its previously telegraphed 50bp hike, attempting to separate the inflation fight from financial stability concerns.

Market expectations remain in flux, but we expect the Fed will deliver another 75bp of tightening over the course of the next few months.

Heightened uncertainty around the global financial industry will deter EM central banks from easing in the near term and add pressure on those who may have been relying on a weaker growth backdrop to unwind their imbalances.

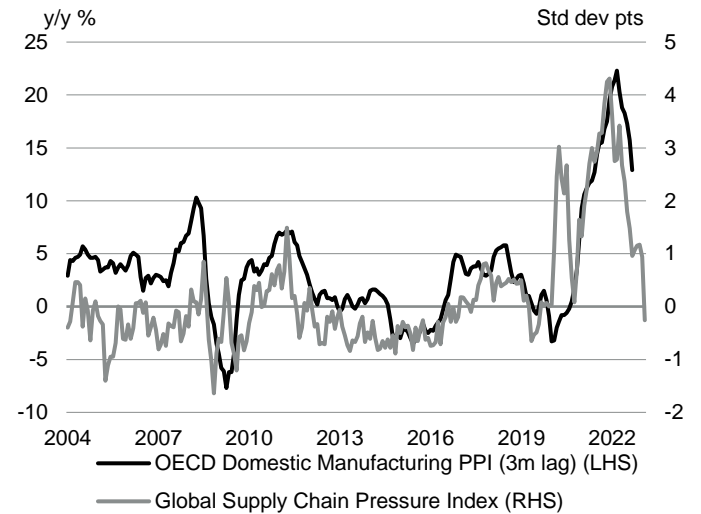
Headline inflation has peaked and is set to ease further

The good news for EM central banks is that base effects from energy should help to bring down headline inflation. In LatAm and Asia it had already been easing since mid-2022, while in CEE it will moderate from early-2023 as the base effects from price spikes due to the Russian invasion of Ukraine begin to feed through.

Supply chains also continue to normalise (see Figure 3). Disruptions from the pandemic and Russia-Ukraine war have faded. And the reopening of China has proved faster than we expected, with the swift move to endemic living

removing a potential supply-chain bottleneck that could have come alongside a more cautious reopening.

Figure 3: Supply-chain improvement to help disinflation



Source: Haver, abrdrn, March 2023

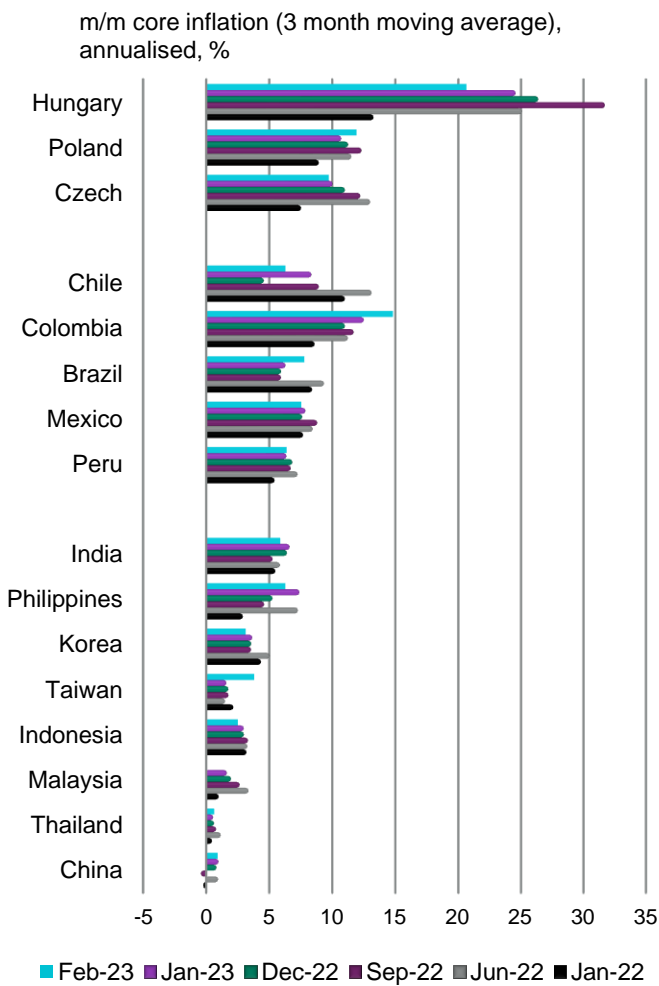
This should further prove disinflationary for core prices, which have already eased since the summer for most EMs (see Figure 4).

Questions however remain over how inflationary China's reopening will prove. Concerns over the global growth outlook have dragged commodity prices lower but China could provide some support for prices. Pent-up demand for travel could push up oil prices, muting some of the expected disinflationary effects from base effects. Moreover, the sudden return of China's tourists could put strain on services inflation, especially in countries still struggling with high core prices.

On the other hand, the composition of Chinese growth should mean that the impact on imports (see Figure 5) and industrial commodities is more limited than in previous growth surges. Ultimately the US recession will push down commodity prices, but the path to get there will add complications for central banks' policy setting.



Figure 4: Core inflation proving sticky for some



Source: Haver, abrdrn, March 2023

Figure 5: China's rebound is less import intensive



Source: Haver, abrdrn, March 2023

Credible versus non-credible pivots

The combination of lower headline and core inflation, and a darkening economic outlook, led many EM central banks to signal that the rate hiking cycle was at — or was close to — an end.

However, while the pivots of certain central banks are credible, others are not.

Several eastern European central banks, in particular Poland and Hungary, can no longer rely on a euro zone recession to help unwind their imbalances, and with core inflation running at around 15% and 16% annualised respectively, their pivots look increasingly misguided. Labour markets have yet to show signs of significant cooling, with wage growth remaining strong. In Poland, upcoming parliamentary elections could also spur some fiscal stimulus, ultimately worsening the inflation problem.

Mexico, the Philippines and India risk pausing too early. Indeed, all three could face currency pressures if they were to pause in upcoming meetings, given the persistence of underlying inflation and tighter external financing conditions. While all three have slowed their pace of hikes, core inflation remains above target-consistent levels, and more will need to be done to tighten domestic financial conditions to reduce imbalances.

The most credible central banks - such as Brazil and Chile - will still face a longer wait before beginning to meaningfully cut their policy rates, but they are the most likely to follow the Fed in cutting before the end of the year. Having hiked early and relatively aggressively, activity has moderated, which should feed into a further cooling of underlying inflation in time.

As the global backdrop worsens, these economies should see output gaps quickly widen, giving them scope to cut rates. Moreover, it is possible that core inflation dips back to target-consistent rates – at least in Brazil and Chile – before the US recession unfolds.

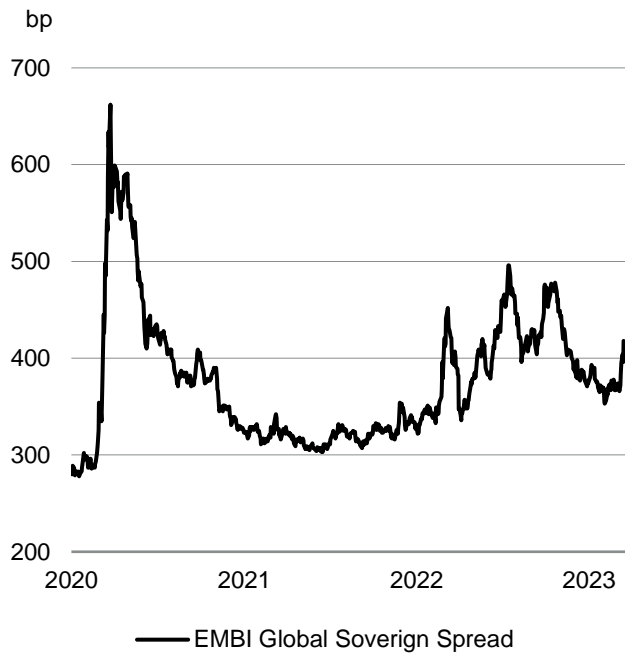
There is also another group of central banks, mainly in Asia – such as Malaysia, Indonesia and Taiwan – where pivots are largely credible given headline inflation peaked at relatively lower levels and core inflation has cooled since summer. However, given shorter and less aggressive hiking cycles, these central banks may have less scope to ease in 2023.

DM recession will make credibility moot

The onset of the DM recession will eventually usher in a pan-EM easing cycle, but it will also exacerbate crisis risks and put many EMs under considerable market pressure in the early phases. Recent market volatility has led to a retightening of financial conditions, but this could be intensified by the unfolding of a US recession (see Figure 6).



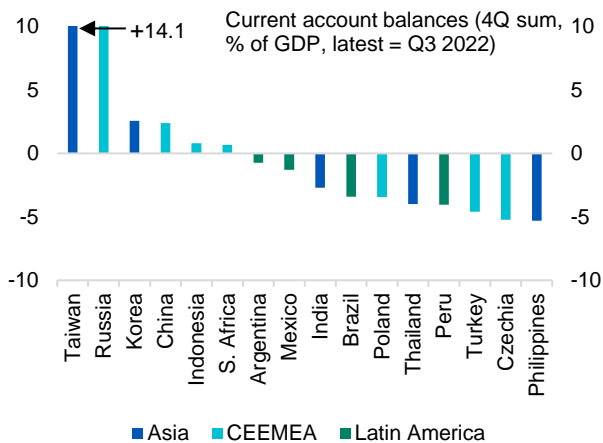
Figure 6: Market pressures are rising again



Source: Haver, abrdrn, March 2023

Many frontier markets are already either in the midst of crises or teetering on the brink, including Sri Lanka, Zambia, Pakistan, El Salvador, Ghana, Egypt, Tunisia and Lebanon. The drop in global risk appetite and capital flows will only further complicate debt restructuring.

Figure 7: External imbalances still large



Source: Haver, abrdrn, March 2023

Authors

Robert Gilhooly, Michael Langham

Those major EMs with large current account deficits may face currency pressures as the Fed waits for core inflation to abate during the initial stages of recession.

But the “original sin” vulnerabilities present in frontier markets – low FX reserves, large short-term FX debts and fiscal indiscipline – are generally absent (or less acute) in more mainstream EMs, suggesting pressures will fade.

Indeed, in recent months, import coverage ratios have improved as reserves have been built up and imports have softened, creating some buffer against portfolio outflows. As pressures subside, we expect policy easing to begin in early 2024 for most EMs.

India is more insulated than most but isn’t a safe haven

Even EMs with relatively low exposure to external financing and trade will see growth slow during the US recession. India’s low exposure to external demand and financing, makes it more insulated than most EMs. Both exports and external debts are around 20% of GDP, as the country is more reliant on domestic demand to drive growth.

However, India’s basic balance has deteriorated (-3.0% of GDP as of Q3 2022) and reserves fell in 2022, leaving it somewhat more vulnerable to a squeeze in external financing conditions. Efforts to pivot towards more export-led growth would also stall during a US recession, with foreign direct investment inflows falling and general business sentiment waning. Therefore, while India may be less exposed than most, it is an example that even the more insulated EMs will not be safe havens during a US recession.



Important Information

For professional and Institutional Investors only – not to be further circulated. In Switzerland for qualified investors only.

Any data contained herein which is attributed to a third party (“Third Party Data”) is the property of (a) third party supplier(s) (the “Owner”) and is licensed for use by abrdn**. Third Party Data may not be copied or distributed. Third Party Data is provided “as is” and is not warranted to be accurate, complete or timely. To the extent permitted by applicable law, none of the Owner, abrdn** or any other third party (including any third party involved in providing and/or compiling Third Party Data) shall have any liability for Third Party Data or for any use made of Third Party Data. Neither the Owner nor any other third party sponsors, endorses or promotes any fund or product to which Third Party Data relates. **abrdn means the relevant member of abrdn group, being abrdn plc together with its subsidiaries, subsidiary undertakings and associated companies (whether direct or indirect) from time to time.

The information contained herein is intended to be of general interest only and does not constitute legal or tax advice. abrdn does not warrant the accuracy, adequacy or completeness of the information and materials contained in this document and expressly disclaims liability for errors or omissions in such information and materials. abrdn reserves the right to make changes and corrections to its opinions expressed in this document at any time, without notice.

Some of the information in this document may contain projections or other forward-looking statements regarding future events or future financial performance of countries, markets or companies. These statements are only predictions and actual events or results may differ materially. The reader must make his/her own assessment of the relevance, accuracy and adequacy of the information contained in this document, and make such independent investigations as he/she may consider necessary or appropriate for the purpose of such assessment.

Any opinion or estimate contained in this document is made on a general basis and is not to be relied on by the reader as advice. Neither abrdn nor any of its agents have given any consideration to nor have they made any investigation of the investment objectives, financial situation or particular need of the reader, any specific person or group of persons. Accordingly, no warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the reader, any person or group of persons acting on any information, opinion or estimate contained in this document.

This communication constitutes marketing, and is available in the following countries/regions and issued by the respective abrdn group members detailed below. abrdn group comprises abrdn plc and its subsidiaries:

(entities as at 28 November 2022)

United Kingdom (UK)

abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated in the UK by the Financial Conduct Authority.

Europe¹, Middle East and Africa

¹ In EU/EEA for Professional Investors, in Switzerland for Qualified Investors - not authorised for distribution to retail investors in these regions

Belgium, Cyprus, Denmark, Finland, France, Gibraltar, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, and Sweden: Produced by abrdn Investment Management Limited which is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL and authorised and regulated by the Financial Conduct Authority in the UK. Unless otherwise indicated, this content refers only to the market views, analysis and investment capabilities of the foregoing entity as at the date of publication. Issued by abrdn Investments Ireland Limited. Registered in Republic of Ireland (Company No.621721) at 2-4 Merrion Row, Dublin D02 WP23. Regulated by the Central Bank of Ireland. **Austria, Germany:** abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated by the Financial Conduct Authority in the UK. **Switzerland:** abrdn Investments Switzerland AG. Registered in Switzerland (CHE-114.943.983) at Schweizergasse 14, 8001 Zürich. **Abu Dhabi Global Market (“ADGM”):** Aberdeen Asset Middle East Limited, 6th floor, Al Khatem Tower, Abu Dhabi Global Market Square, Al Maryah Island, P.O. Box 764605, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. For Professional Clients and Market Counterparties only. **South Africa:** abrdn Investments Limited (“abrdnIL”). Registered in Scotland (SC108419) at 10 Queen’s Terrace, Aberdeen AB10 1XL. abrdnIL is not a registered Financial Service Provider and is exempt from the Financial Advisory And Intermediary Services Act, 2002. abrdnIL operates in South Africa under an exemption granted by the Financial Sector Conduct Authority (FSCA FAIS Notice 3 of 2022) and can render financial services to the classes of clients specified therein.

GB-220323-189870-1

