Global Macro Research - Insight

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#EM / #Monetary Policy / #Inflation

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Emerging markets outlook: prices, policies and polling

Emerging markets remain well positioned to begin easing cycles, despite recent caution. However, political uncertainty and the potential for fiscal slippage could mean the path to a pan-EM easing cycle in Q2 2024 will be bumpy.

Key Takeaways

- Emerging market (EM) central banks continue to inch towards monetary easing and, while individual circumstances will increasingly dictate the starting point and pace of cuts, a pan-EM easing cycle is likely to emerge only slowly, around Q2 2024, rather than early in the year as we had thought.
- Uncertainty about food and energy price pressures, and risks associated with several countries heading to the polls seem set to add to central bank caution.
- Indeed, a busy election year raises the possibility that governments turn to fiscal stimulus, potentially reducing the scope or need for monetary easing. And while external pressure from the market's assessment of the likely path for US rates – which swung dramatically towards easing from November – has fallen, the risk of a Trump presidency will likely drive further volatility in EM asset prices.
- That said, we expect further falls in headline and core inflation to make it very hard for EMs to continue to justify a restrictive stance. Indeed, high frequency measures of underlying inflation are already running close to target-consistent rates among the major EMs. Absent a reacceleration, year-over-year core inflation will converge with targets.
- As growth concerns usurp inflation risks and DM central banks start easing, we expect a pan-EM easing cycle to begin around Q2 2024.

Central banks cautiously shift towards monetary easing

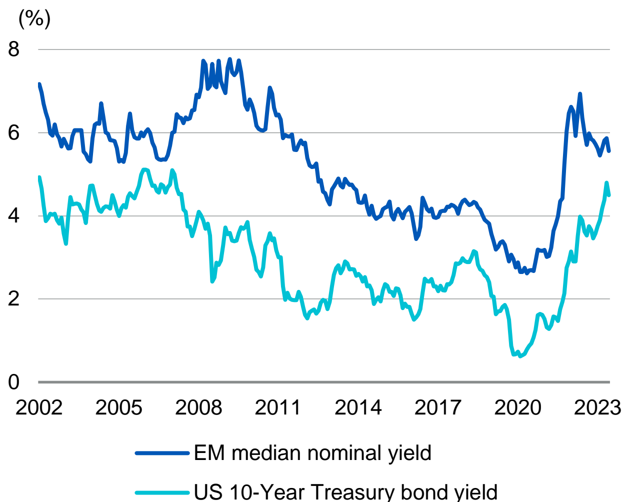
Emerging market central banks have adopted a cautious approach to monetary policy but we expect an eventual shift towards a broader easing cycle by Q2 2024.

More EM central banks begun easing cycles in the second half of 2023, but there have also been several hawkish surprises across regions reflecting caution.

In Latin America (LatAm), Chile cut less than expected in October; in Asia, Bank Indonesia delivered a surprise hike, and there was an off-cycle hike in the Philippines in October. In Europe, the National Bank of Poland paused its easing cycle unexpectedly.

These hawkish surprises can in part be attributed to the rise in US Treasury yields between August and October – 10-year US Treasury yields rose from 4% to almost 5% (see Figure 1) – putting pressure on EM currencies and bonds. Policymakers in Chile and Indonesia explicitly cited these pressures as key factors behind their decisions.

Figure 1: US Treasury yield pressure triggered hawkish reactions from EMs



Source: Haver, abrdn, December 2023

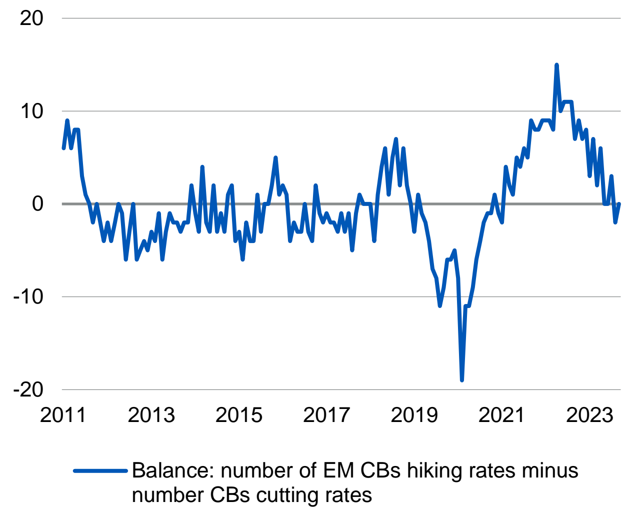
However, idiosyncratic factors – a rise in core inflation and inflation expectations in the Philippines and political uncertainty in Poland – were behind the other moves.

Positively, pressure from US Treasury yields and dollar strength has dramatically unwound since early November, as markets have become increasingly confident that the Fed's battle with inflation is largely over and 'insurance cuts' to generate a soft-landing are increasingly priced in.

Market volatility certainly has the potential to recreate a tough environment, but for now markets have cleared the runway for further EM central bank cuts heading into 2024. An example is the National Bank of Hungary, which delivered a well-telegraphed cut of 75bps in late November.

And moving forward we think that individual country circumstances will become more important than pressure from the US. We see the outlook for growth and inflation proving more favourable to monetary easing across an increasing number of EMs in 2024. This should allow more central banks to join the rate cutting cycle and several of those that are already easing to push ahead with lowering their policy rates further.

Figure 2: Balance to shift towards cutters by Q2 2024



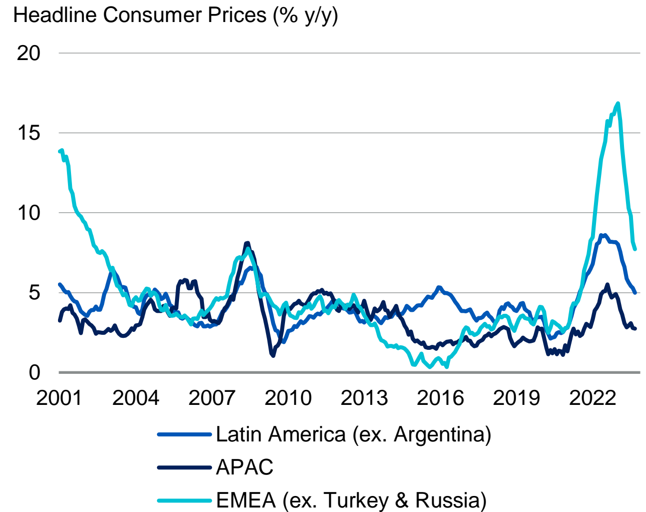
Source: Haver, abrdn, December 2023

Inflation risks receding

Importantly, inflation rates have fallen and will continue to cool next year. The decline in the headline measure has been substantial, particularly in LatAm and Central and Emerging Europe (CEE), where double-digit inflation is now limited to Colombia and an extreme outlier like Turkey (Figure 3).

Figure 3: Inflation continues to fall

Headline Consumer Prices (% y/y)



Source: Haver, abrdn, December 2023

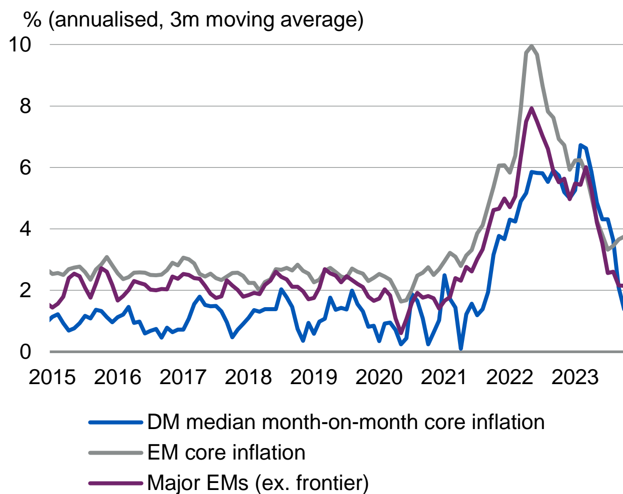
A combination of lower energy and food prices, reduced supply-chain pressures and weaker global goods demand has contributed to this sharp decline. Indeed, we expect these disinflationary effects to persist into 2024.

While there remains a risk of upside pressures on food and energy prices from El Niño or the Israel-Hamas conflict, oil prices are now around $20 per barrel lower than they were at the start of October, implying commodities will push inflation lower over the coming months.

This is more significant for EMs than it is for developed markets (DMs) given the higher weightings of food and energy in consumer price baskets and less well anchored inflation expectations.

Significantly, major EMs have matched their DM counterparts in reducing core inflation risks, with the median annualised month-over-month rates now at target-consistent levels (see Figure 4).

Figure 4: The 'last mile' of disinflation is increasingly looking like a sprint finish



Source: Haver, abrdn, December 2023

Some of the core disinflation reflects the unclogging of global supply chains, which has helped to lower core goods inflation. With producer prices in deflation and consumption rotating towards services, this implies limited upside risk to the inflation outlook from goods.

The unwinding of pandemic-era imbalances also reflects the success EM central banks have had in reducing domestic demand pressures. That said, while services inflation has softened and is heading in the right direction, it often remains too high for comfort – another reason why central banks will remain cautious.

Growth to become the primary concern

The slowdown in EM growth through 2023 has helped to bring inflation lower, but we expect the combination of weaker growth in 2024 with further progress on core inflation to be the catalyst for more EM monetary easing.

Several EM economies have already experienced quarter-over-quarter contractions in growth, with a few entering technical recessions (e.g. Czechia, Hungary, Chile, Peru and Taiwan). However, there has also been some surprising resilience in economies such as India, Mexico and South Korea. Again, central banks have held off easing in these economies, but we expect growth to fade in 2024.

External conditions will likely become less favourable over the coming months as demand slows in the US, remains lacklustre in Europe, and China's import demand fails to provide an offset.

Where domestic demand has proved supportive, we expect the decline in real wages and still-tight domestic monetary conditions to weigh on consumption in early 2024. As such, for most EMs, growth will disappoint, spurring policymakers to consider easing.

Political calendar throws up uncertainties

However, the road to monetary easing may prove bumpier for some EMs, owing to uncertainties on the political front.

As the biggest year for democracy on record (in terms of the number of people voting in democratic elections), politics will have a greater influence on the decision-making process for several central banks.

Elections are to be held in Taiwan (January), Indonesia (February), India (April or May), Mexico (June) and South Africa (TBD), among others. Ahead of and following elections, fiscal policy may be eased to boost voter sentiment or as part of attempts to attract votes.

This could lead to fiscal stimulus targeted at households, offsetting some of the tightening of monetary conditions and reducing the need for monetary easing. The uncertainty around fiscal policy may prolong caution among central banks as they assess the potential impacts.

In 2023, there have been several examples of this. In Brazil, the central bank initially held off from policy cuts due to the uncertainty surrounding the Lula government's fiscal plans. In Poland, the policy rate cutting cycle was unexpectedly paused and the new government has indicated some fiscal loosening to support demand in 2024. Likewise, in Thailand, the government plans to deliver cash handouts and cut fuel prices to boost domestic demand – a key reason why the country's central bank decided to deliver an additional rate hike in September.

Fiscal loosening is likely in Mexico and Indonesia, while government spending is already boosting India's economy ahead of elections. In South Africa, the African National Congress (ANC) government has sought to boost social spending and public sector wages to offset the impact of higher inflation.

Argentina may be an extreme case, but it is a reminder that populism and poor fiscal management can lead to economic malaise and radical political and policy shifts. While newly elected President Javier Milei has proposed an aggressive fiscal adjustment, re-anchoring domestic inflation expectations and rebuilding trust in policymaking are exceptionally high hurdles to overcome.

Finally, many EMs will be wary of the potential spillovers from the US election cycle on investor and business confidence in 2024.

The increased likelihood of a Trump presidency raises the prospect of tariffs, limited US fiscal consolidation, and a more isolationist foreign policy. This could impact flows into EMs and spark bouts of FX volatility, complicating central bank positioning.

In particular, expectations around reshoring trends may become less certain under a Trump presidency. On the one hand, a broadening out of tariffs and trade tensions could dampen business investment and weigh on currencies highly driven by the global trade cycle in the near term, and on the other hand, any ramp-up in tensions with China could hasten the 'friendshoring' dynamics that have boosted investor sentiment towards the likes of Mexico and India.

Overall, politics may delay central bank easing but is unlikely to derail it. The busy electoral calendar therefore contributes to our updated assessment that a pan-EM easing cycle will begin slightly later in 2024 than we had thought previously. We have pushed back the timing from Q1 to Q2.

EM policy: restrictive to accommodative

To sum up, as the year progresses, we expect DM central banks to deliver policy cuts, global growth to slow and the broad global disinflation trend to persist. This should provide scope for easing for all the major EM central banks.

While most central banks in LatAm and CEE are already easing, we expect other regional central banks to begin cuts before mid-year. The Czech National Bank is particularly well placed to begin easing, and we expect core inflation to cool further in Colombia and Mexico.

Authors

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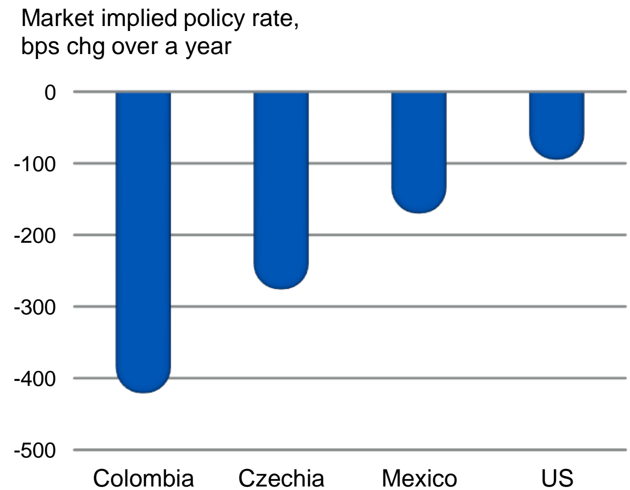
Market pricing also shows an expectation for more central banks to join the cutting cycle and deliver more than the Fed (see Figure 5).

Figure 5: Markets expecting policy cuts



Source: Haver, abrdn, December 2023

In Asia, we expect a loosening of monetary policy to begin as the Fed cutting cycle gets underway, particularly as it becomes evident that inflation risks are giving way to growth risks. Even in laggards, such as Thailand, we expect growth concerns and persistently soft underlying inflation to prompt modest rate cuts.

Ultimately, the period of tight monetary conditions is coming to an end for EMs and policy conditions are set to become more accommodative in 2024, providing the backdrop for a growth rebound in 2025.

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