Research Institute - Insight

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What to expect from the emerging market cutting cycle

We retain the view that a pan-EM easing cycle is unlikely to occur in 2023, but more emerging markets will begin cautious monetary easing as economic weakness and receding inflation create scope for such moves.

Key Takeaways

- Emerging markets (EMs) face a challenging growth environment as they contend with squeezed real incomes, tighter monetary conditions and still subdued global trade backdrop.
- However, inflation continues to broadly recede across EMs and the core measure in particular has cooled over recent months and is likely to ease further before the end of the year.
- All this means more EM central banks can begin easing cycles before the end of the year, with Latin America (LatAm)'s central banks best placed to entrench easing cycles.
- That said, challenges remain for EMs given the potential upside risks to inflation, currency pressures and tight external financing conditions.
- As such, we think a pan-EM easing cycle will be delayed until 2024, with central banks in Asia being the laggards.
- We expect most EMs to have begun lowering policy rates before the Fed, and cuts to exceed market expectations as the easing cycle gets underway in the US.

Divergences in EM growth

Growth in emerging markets slowed through the first half of 2023. Headwinds included: the growing impact from last year's inflation shocks; domestic and external monetary tightening; and the downturn in the global trade, among other factors.

Regionally, Central and Eastern Europe (CEE) has increasingly struggled due to the shock to real incomes brought about from 2022's surge in inflation, as well as weak external demand. Czechia, Hungary and Poland have all experienced quarter-on-quarter contractions in GDP. In LatAm, aggressive monetary tightening has hit the likes of Chile, Colombia, and Peru. Similarly, in the Philippines growth disappointed in Q2 as demand buckled under tighter borrowing conditions.

However, the trend is not universal and there are several EMs where growth is holding up better. The EM Services PMI outperformed developed markets (DMs) in 2022 and has continued to outperform through 2023. This could in part reflect the slower reopening of China and the tourism recovery. Also, the domestic consumer rebound in some EMs has lagged, given weaker household balance sheets during the pandemic relative to DMs. That said, this trend points to the better-than-expected, but still moderating, economic performance of EMs through the first half of 2023.

On a country basis, Brazil has benefited from strong agricultural output and domestic demand; Mexico is booming thanks to spillovers from a resilient US economy; while domestic activity is supporting growth in India, Indonesia, and Malaysia.

Figure 1: EM service sector strength is fading

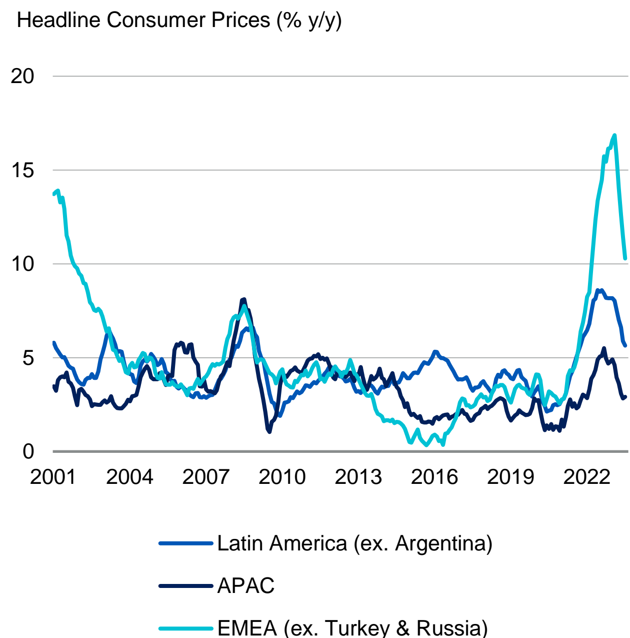
Source: Haver, abrdn, September 2023

The domestic strength in Asia could be attributed to less aggressive bouts of inflation, which in turn required less policy tightening and milder slowdowns in economic activity to bring inflation back to target. Indeed, policy rates in India and Indonesia are just 135bps and 75bps higher relative to the end of 2019, while Malaysian rate are at the same level.

Convergence on the inflation front

Convergence across EMs is more evident on the inflation front, with the headline measure continuing to fall from its late 2022 highs (see Figure 2). By the end of the year, most EM inflation rates will be in single digits and an increasing number will have inflation running within central bank target ranges.

Figure 2: Headline inflation is falling rapidly



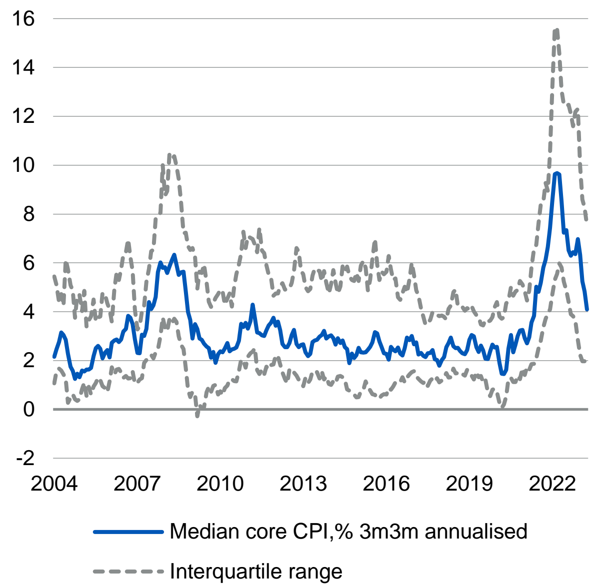
Source: Haver, abrdn, September 2023

Energy and food price base effects have played a major role in the sharp reversal in price trends, while improved supply-chain performance has also eased pressures on goods prices.

Core inflation has continued to cool in recent months following a period of stickiness in Q2. Both core goods and services measures show underlying inflation proving less persistent through Q3.

Reflecting lower energy prices and reduced supply-chain disruptions, imports prices have been receding, while producer prices are in deflation in several EMs. All this should feed through to further core goods disinflation.

Figure 3: Core inflation cooling back to its pre-pandemic range



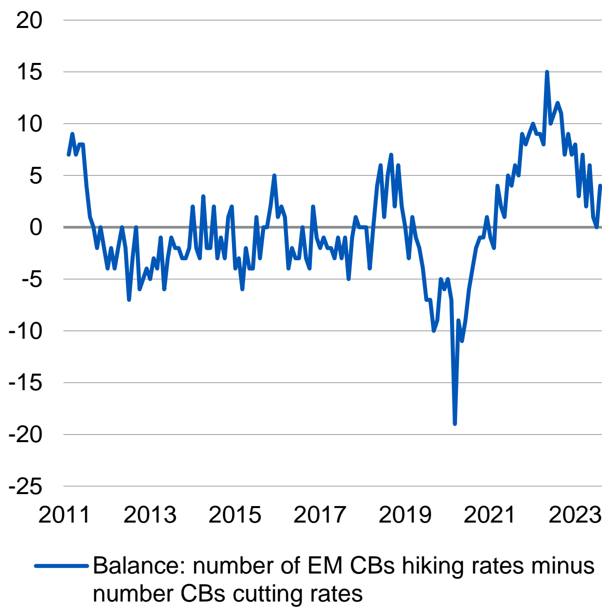
Source: Haver, abrdn, September 2023

As such, policymakers are gaining confidence that inflation risks are receding and are increasingly considering whether to begin monetary easing, if they haven't done so already.

Central banks in Chile, Brazil and Poland all delivered larger-than-expected initial rate cuts. Peru, Paraguay and Uruguay also cut rates, in line with our expectation for LatAm to lead the way on policy easing.

In Europe, Hungary has been easing monetary conditions since May and looks set to continue its path.

Figure 4: EMs increasingly considering rate cuts



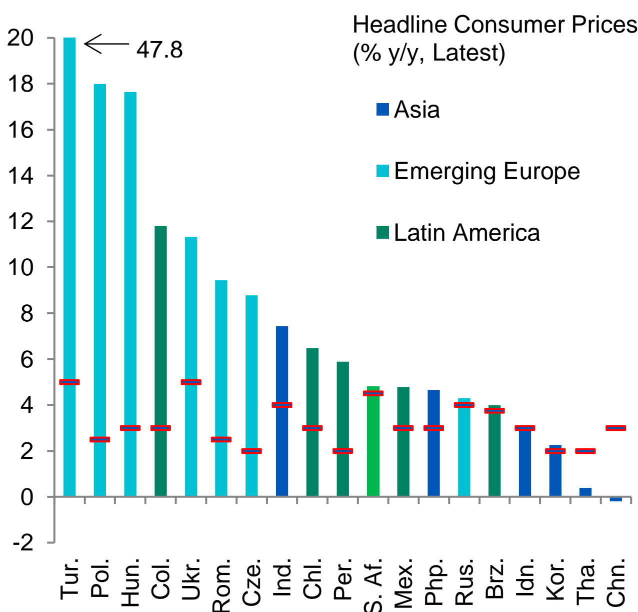
Source: Haver, abrdn, September 2023

A pan-EM easing cycle is unlikely in 2023

There are several factors deterring other central banks from following suit, and this leads us to retain our view that a pan-EM easing cycle is unlikely in 2023.

While receding, in many EMs inflation is still above central banks' targets (see Figure 5). As such, confidence that inflation risks have abated is not shared by all policymakers. Inflation expectations have yet to return to pre-pandemic levels in many EMs, meaning the more cautious central banks are likely to wait for inflation to settle within target range before considering easing policy.

Figure 5: Inflation not yet within target



Source: Haver, abrdn, September 2023

This approach is particularly likely among central banks concerned over a resurgence in commodity prices.

Global energy prices have risen since June on tighter supply conditions, threatening to slow the pace of disinflation. This is compounded by the threat of food price shocks, particularly given the uncertainty over El Niño weather patterns.

India, the Philippines and South Korea have already faced upside inflation surprises in recent months, in part due to food prices. With inflation still above target and expectations elevated, commodity price shocks risk reversing progress made on reducing inflation expectations.

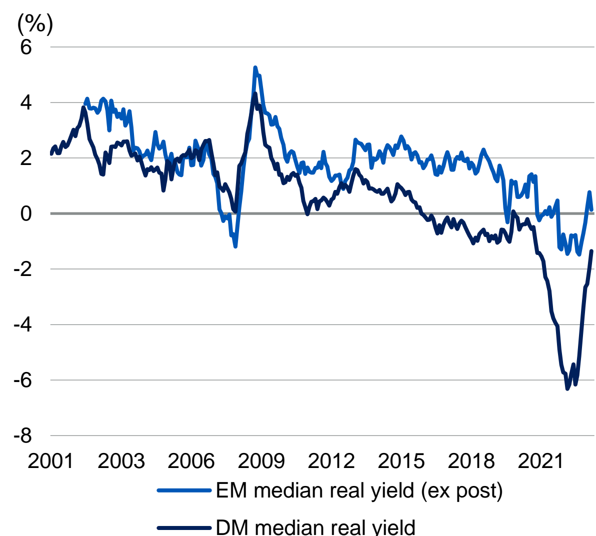
Upside inflation surprises risk weighing on bond prices and complicating plans for rate cuts. Monetary easing, while local currency bonds are already under pressure, could lead to currency weakness, a risk some EM policymakers are concerned about.

The most pressing reason for this concern is that currency weakness threatens the disinflation process, particularly for import dependent economies. Bank Indonesia has already signalled its concerns over currency weakness and Poland offers an example of the potential for FX markets to punish hasty loosening. The zloty sold-off sharply in response to the National Bank's decision to cut more than expected in September.

The Fed tightening cycle has added to this squeeze via a tightening of external financing conditions. The dollar has strengthened on a trade-weighted basis close to its early-2000s peak, and higher US Treasury yields have pushed up on EM dollar-denominated bond yields.

While for many of the major EMs, dollar financing is less of an issue compared to frontier markets, the Fed's stance does mean a more challenging backdrop for an EM easing cycle. On a relative basis, DM real yields are now higher, making low yielding EMs less attractive.

Figure 6: EM real yield advantage shrinking



Source: Haver, abrdn, September 2023

The lower yielding EMs such as Thailand, or economies more reliant on external funding, such as the Philippines, may be more hesitant to ease against such a backdrop. Moreover, while recent inflation prints have buoyed market confidence in a soft-landing, there remains a risk that the Fed deems more hikes to be necessary.

Pan-EM easing cycle to proceed Fed cuts

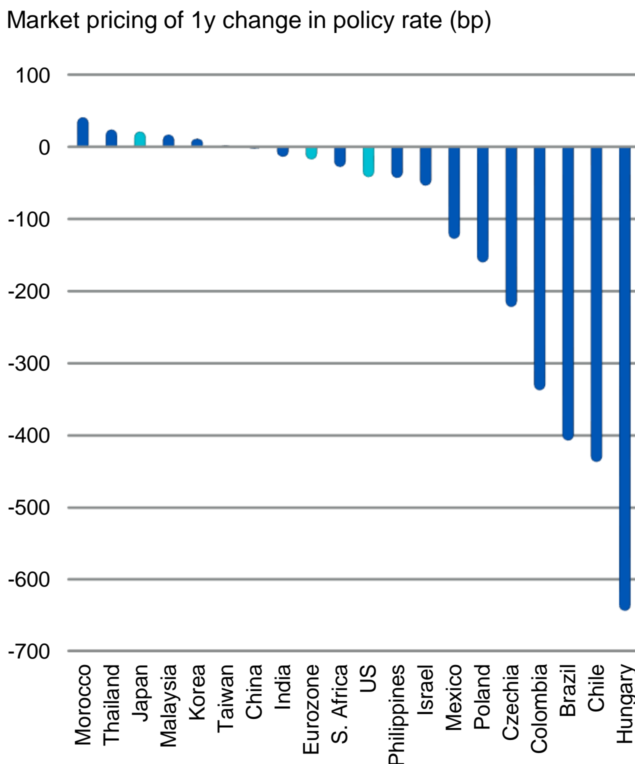
Although this paints a challenging outlook for emerging markets, we expect caution, but not a change in the overall direction of the monetary policy cycle. We maintain our call for a pan-EM easing cycle to begin in early 2024.

While the pace of disinflation may be slowed by these upside risk factors, the downtrend in headline inflation should broadly persist, and, certainly, inflation in 2024 will run lower than in 2022. There remain challenges to EM growth which should cool underlying inflationary pressures too.

The combination of the lagged effects of tight monetary conditions and subdued external demand will dampen business investment and consumption. Fiscal conditions are also likely to be tighter given higher borrowing costs and debt loads post-pandemic.

Markets are pricing policy rate cuts in most EMs within the next year providing even the more cautious central banks to guide towards easing. This is against the backdrop of relatively small cuts priced in for the US and Eurozone.

Figure 7: Monetary easing priced in for most EMs



Source: Haver, abrdn, September 2023

All this widens the scope for monetary easing and raises the prospect of most EMs cutting before a Fed easing cycle. We expect a US recession in mid-2024 and a Fed easing cycle in response but recognise the potential for the Fed to keep rates higher for longer.

On balance, this reaffirms our regional view: LatAm central banks will be best placed to continue cutting policy rates. As noted, most have already cut, and the laggards, namely Colombia and Mexico, have ample scope to ease given declining core inflation and, in Mexico's case, persistent currency strength through 2023.

In CEE, Poland and Hungary are already easing, and even the more credible Czech National Bank is likely to follow in the coming months. However, we still see policy mistake risks as most prominent in CEE given still tight labour markets in Poland and Hungary, with demand to get a boost as real wage growth turns positive.

In Asia, cuts will broadly begin in 2024. We expect Thailand will be the last to enter the cycle given its tourism recovery has further to run, the relatively slow pace of monetary tightening, and likely fiscal stimulus.

Our expectation for a US recession in mid-2024 and a Fed easing cycle will allow EMs to cut even further through the latter part of 2024 and take rates lower than is currently priced by markets, albeit not reaching their pandemic lows.

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