



Global Macro Research - Insight

8 April 2024

8:15 minute read

#EM ex. China

/ #Growth

/ #Inflation

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Emerging markets outlook: Facing ‘last mile’ challenges

Emerging market growth has eased off its recent blistering pace, while headline and core inflation have made good progress towards central bank targets, creating scope for monetary easing. However, the ‘last mile’ presents challenges, and policymakers will likely move cautiously until the Fed begins its cutting cycle.

Key Takeaways

- Emerging market (EM) GDP growth eased in recent quarters but remains fairly robust in aggregate. Some major EMs saw growth heading close to zero or contracting towards the end of 2023, but there are notable pockets of resilience, such as India. In some cases, we have seen additional momentum in service sectors and tech exports since the start of the year.
- There has also been a continued decline in headline inflation across regions, as well as a subsiding of core inflation towards central bank targets in most major EMs.
- However, there are elements of upside risks to the inflation outlook, given still elevated services inflation and persistent labour market tightness in some markets.
- These risks, combined with the fact that the Fed is on hold and a strong US dollar, should mean EM policymakers will move cautiously but continue to gradually lower policy rates in the near term.
- Once the Fed and other major central banks begin easing, we expect more EMs – particularly in Asia – to embark on cutting cycles, with still ample scope for rate cuts in a soft-landing scenario.
- That said, market volatility around the US election could prove challenging for some of the lower yielders, particularly in Asia, implying risks of shallower cutting cycles.

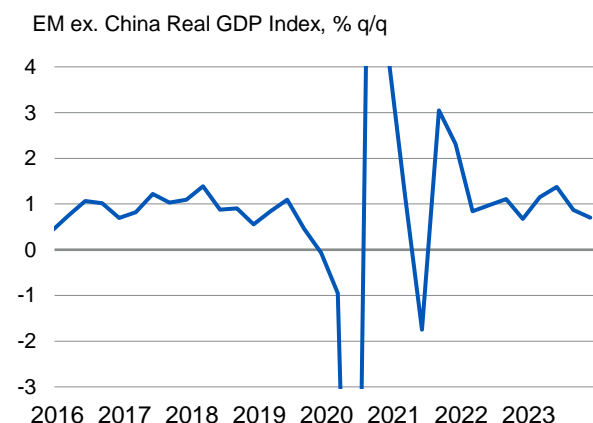
Emerging market growth eases off recent highs

Activity across EMs, excluding China, slowed in the second half of 2023 as a combination of tighter monetary conditions, a softer external demand backdrop and squeezed household incomes weighed on activity.

Growth proved challenging for individual countries – rather than specific regions – with markets such as Czechia, Colombia, Hungary, Malaysia, South Africa and Thailand all suffering from stagnant or contracting growth by the end of the year.

Even in near-shoring favourite Mexico there are signs that the surge in fixed investment is slowing. Nevertheless, as is often the case for EMs, growth is rarely synchronised, and pockets of strength remain, continuing to prop up EM ex. China GDP in aggregate.

Figure 1: EM growth cooled in the second half of 2023, but remains close to pre-pandemic rates



Source: Haver, abrdrn, April 2024. Note: major EMs ex. China included.



Of the major EMs, India stands out for continuing to grow rapidly. Real GDP expanded 7.7% in 2023, boosted by a robust services sector and a ramp-up in public infrastructure investment. And the country is likely to remain an outperformer in 2024.

Despite narrowly avoiding a technical recession, Brazil's GDP figures continue to be heavily influenced by an unwinding of exceptional agricultural strength, which resulted in very strong GDP growth at the start of 2023 and then weaker growth through the rest of the year. Abstracting from this effect, Brazil's economy remains fairly resilient; the service sector and labour market held up in 2023, against a backdrop of tight monetary conditions. And the Economic Activity Index – the leading indicator for output – rose 0.6% month over month in January, beating expectations for a 0.3% rise.

Meanwhile, the key Asian export markets have returned to expansion in recent months, potentially signalling the end to the drag from the global goods cycle. In particular, electronic goods exports have seen a rebound in recent months.

Inflation backdrop increasing scope for rate cuts

Despite the differences in growth dynamics, there has been broad convergence on the inflation front. Through 2023, headline inflation prints continued to fall, with the EM ex. China six-month annualised headline inflation rate down from 8.8% in December 2022 to 3.8% by December 2023.

The combination of softer growth and continued disinflation allowed more EMs to join the monetary easing cycle; central banks in Colombia and Czechia delivered their first cuts of the cycle in January and Mexico also began its easing cycle in March.

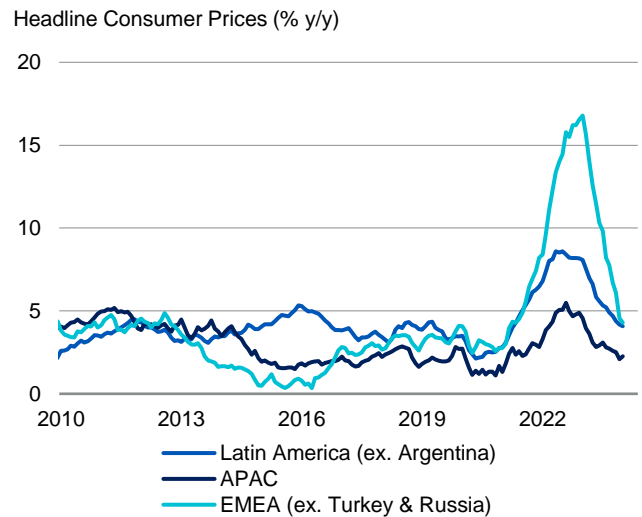
Still, major EMs in Asia have not been cutting, so this cannot be called a 'pan-EM easing cycle'.

Indeed, Taiwan's central bank surprised markets with a hike at its March meeting, citing upside inflation risks and a positive economic backdrop. In India and Indonesia – the region's high yielders – growth has held up, giving the policymakers little reason to cut rates.

And in those where growth has shown weakness, such as Malaysia and Thailand, which are conversely some of the region's lower yielders, currency pressures and politics play into central bank caution.

As noted, headline inflation fell sharply through 2023 and is now a few tenths of a percentage point off pre-pandemic levels in LatAm and EMEA (excluding Turkey and Russia), while it returned to pre-pandemic levels in Asia (see Figure 2). A combination of easing food and energy prices, reduced supply-chain disruptions and easing core goods prices have helped to drive global disinflation.

Figure 2: Headline inflation approaching targets



Source: Haver, abrdrn, April 2024

Across major EMs, only Colombia and Romania are clearly overshooting their respective central-bank-target bands, outside of the perennial inflation messes that Argentina and Turkey are in.

Indeed, the disinflation would look even more impressive, if it weren't for the ongoing food price pressures from El Niño-related weather conditions and disruptions to global supply chains from tensions in the Red Sea.

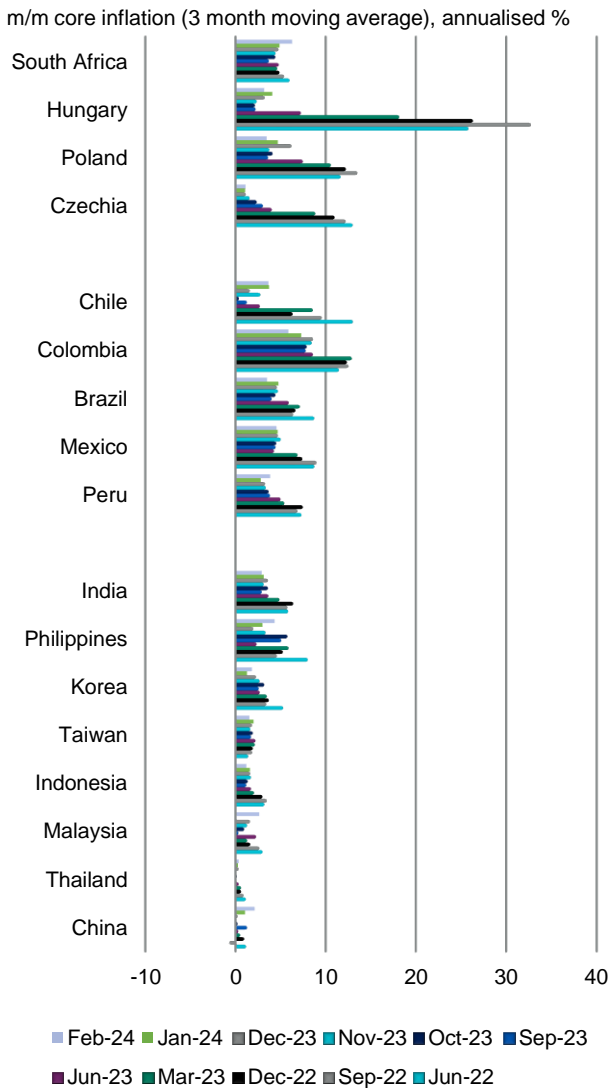
While some lingering food inflation pressures and potential for FX weakness are concerning, the focus is increasingly turning to the path of core inflation and whether underlying pressures have been curtailed to a target consistent level.

Like headline inflation, core inflation has fallen significantly and, for most major EMs, is within the target range.

The sharp reversal of core inflationary pressures in both LatAm and Central and Eastern Europe (CEE) has been a key factor in triggering central banks in both regions to cut rates.



Figure 3: Core inflation rates subsiding



Source: Haver, abrdrn, April 2024

Core inflation looks set to remain closer to target now for most EMs. Indeed, using our preferred measure – a three-month moving average of month-over-month core prices, annualised – we find that underlying inflation is running within or below target bands in most EMs. In fact, only Colombia, Mexico, Peru, the Philippines and South Africa face core inflation pressures that are overshooting target ranges.

However, concerns around the path of underlying inflation are not limited to policymakers in these economies and the threat of the ‘last mile’ of disinflation proving more challenging will prompt caution among many EM central banks over the coming months.

‘Last mile’ challenges not just in DMs

Often characterised in the context of the Fed and the ECB policy decisions, the last mile challenge is also a consideration for EM policymakers. The progress made in bringing inflation down could stall because of a combination

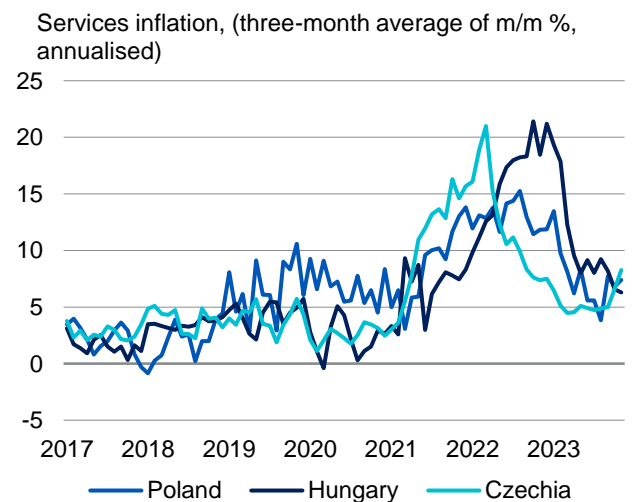
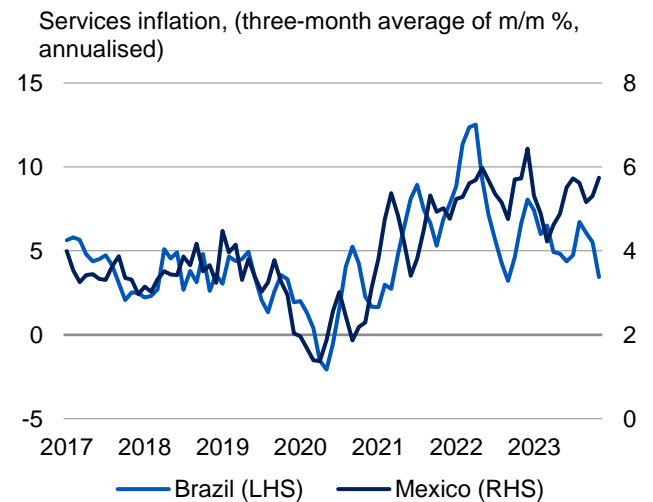
of sticky services inflation; non-linear Phillips curves; higher inflation expectations; and the policy impulse fading.

As such, policymakers and markets will increasingly be watching these factors for evidence that other (i.e. non-core) underlying inflation indicators could run hotter than target-consistent rates, and thus limit the scope for policymakers to credibly cut policy rates.

One area where some stickiness is evident is services inflation. Signs of stickiness have been evident in markets in LatAm and CEE, such as Brazil, Mexico, Czechia, Hungary and Poland. Indeed, the latest annualised rates show services inflation running at over 4% for these markets.

Smoothing for monthly volatility (taking a three-month average) shows a cooling of recent prints in Brazil, but a more concerning upsurge in Czechia and Poland (see Figures 4 and 5).

Figures 4 and 5: Services inflation shows stickiness



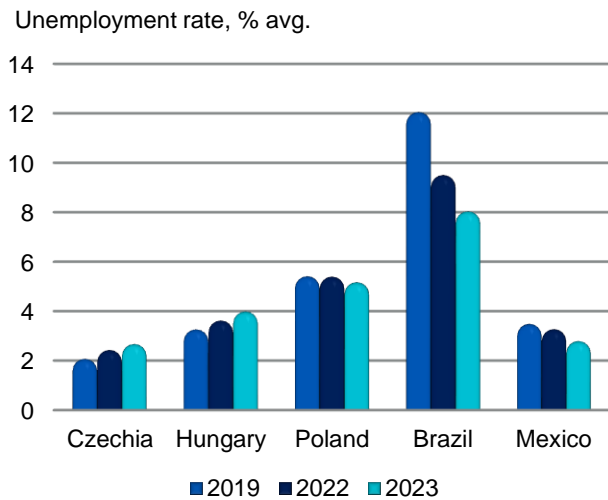
Source: Haver, abrdrn, April 2024



Labour-market dynamics will determine whether central banks believe that services inflation can persist at above-target rates. Jobs markets have proved very resilient in some EMs: unemployment rates in Brazil, Mexico and Poland have been trending downwards, and are below their pre-pandemic rates (see Figure 6). And only Brazil's participation rate is yet to recover from the pandemic shock.

There are signs of a slight cooling of labour markets in Hungary and Czechia, with unemployment rates rising in 2023 relative to 2022 and a few percentage points above their 2019 averages. Job vacancy rates have also been falling in both markets.

Figure 6: Labour markets continued to tighten for some EMs in 2023



Source: Haver, abrtn, April 2024

However, wage growth has been strong and there is a concern that, as headline inflation cools, real income growth could pick up, generating the tough 'last mile' via second-round inflationary pressures. Real wage growth is particularly strong in Hungary and Poland (see Figure 7).

Figure 7: Real wage growth is turning positive again



Source: Haver, abrtn, April 2024

Minimum wage hikes have been one factor behind the strength of wage growth. For example, Hungary's 2024 wage hike was brought forward to December 2023, adding to real wage growth at the end of the year. Similarly, plans for double-digit increases in the likes of Poland and Mexico mean real wage growth will likely remain above trend into 2024.

Risks are more elevated in Poland given the expected major economic boost from the unfreezing of EU post-pandemic recovery (€60bn) and cohesion funds (€76bn) under the new government. This could aggravate an already tight labour market.

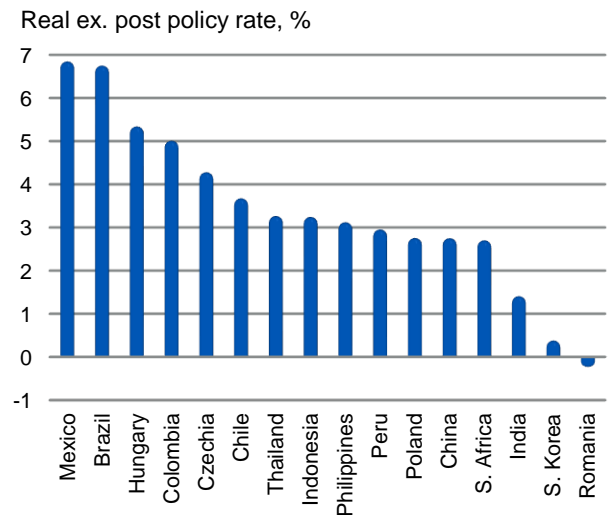
All this is to say that, while easing inflation will provide increasing scope for central banks to cut, it also poses upside risks to real income boosting, which are similar to those seen in developed markets.

Moving with caution ahead of 'super June'

Labour market challenges could slow but should not extend the 'last mile' for most EMs. A moderation in global growth and still tight monetary conditions in many EMs should provide enough room for further rate cuts.

Real policy rates are positive across a broader number of EMs (see Figure 8) and, with the Fed still on hold and a strong dollar, global financial conditions will continue to prove a constraint on activity.

Figure 8: Real policy rates still signal room to cuts



Source: Haver, abrtn, March 2024

Even where labour markets are tight, slowing economic activity should weigh on vacancies and hiring indicators and cap the extent to which wages continue to rise, as well as households' propensity to consume.



As such, we expect EMs will continue to deliver easing but move with caution over the coming months, potentially delivering hawkish surprises with smaller-than-expected cuts or communicating less certainty about the path for future rate moves. This has already played out at Brazil's and Hungary's central bank meetings in March.

Pivotal for EMs will be 'super June', when we expect the Fed and ECB to deliver their first cuts. A soft landing for the global economy with a steady rate-cutting cycle from the major central banks should provide an accommodating backdrop for more EM central banks to join the easing cycle.

We anticipate Asia's central banks to begin delivering cuts in the second half of 2024, with a pan-EM easing cycle

starting around Q3 2024. Timing differences will potentially mean some central banks are nearing the end of easing as others begin but, overall, we expect more central banks to be focused on supporting growth in the second half of the year.

A risk to this view remains the potential market volatility associated with the ebb and flow of US election polling. Some EMs may face greater market pressure in the case of victory by Donald Trump. With the US dollar already strong, and currency pressures on some of the lower yielding EMs, the threat of a renewed trade war could potentially delay monetary easing in Asia and Mexico.

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