THIS MONTH'S TOPIC

Emerging markets Outlook: getting out from twin shocks?

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The essential

In 2019, we do expect some further economic deceleration until the middle of the year followed by a mild re-acceleration in the second half, barring any recessionary scenario in the US and in China.

A still constructive but very clouded outlook led us to assess the kind of policy mix that the different EM countries can afford to implement in the event that the economic conditions slip more significantly from our central scenario.

We believe that the countries where the monetary policy could turn more supportive are those that are the least externally vulnerable, with better anchored inflation expectations. On the other hand, the built-up fiscal buffers will allow EM to better navigate any challenging times in the future.

Since the half of 2018, macroeconomic conditions in the emerging markets have been deteriorating to the extent that we have been downgrading our main scenario outlook in terms of growth expectations. Since the beginning of the year, we have constantly raised the probability of downside risk to our projections, almost eliminating any upside risk. As of now, we have a 25% probability for downside risk, compared to 5% for the upside. The growth differential between EM and DM has turned decisively in favour of DM, thanks to a solid extended cycle in the US.

Moving to 2019, we do expect some further economic deceleration until the middle of the year followed by a mild re-acceleration in the second half, barring any recessionary scenario in the US and in China. Emerging markets' economic and financial performances in 2018 have been hit by twin shocks, namely a senseless trade policy marking a change in the globalisation process, as we know it, together with the continuation of the Federal Reserve's monetary policy normalisation process. We can argue that the latter didn't come as a surprise; however, the sudden US dollar appreciation that started last April immediately changed the perspective for many EM central banks, in light of the resulting turmoil on their domestic financial markets (equity and local currencies primarily). The rhetoric adopted by Fed Chairman Powell has only recently been giving some signs of relief, in terms of a more dovish monetary policy stance with a hiking cycle that is probably closer to its end than previously expected. However, the trade tensions and the confrontational approach on trade by the US administration towards Chinese business practices (not always considered fair) is still fuelling high geopolitical risks around the world and supporting a strong US dollar as a core asset, somehow preventing a clean and more positive outcome for EM in the short term.

Structurally, the world appears to be moving towards less multilateralism and the future global trade environment is now more uncertain. However, still there are good practices to pursue with the aim of maintaining some sort of cooperation, such as the modernisation of the WTO and/or more customised regional agreements.

A still constructive but very clouded outlook led us to assess the kind of policy mix that the different EM countries can afford to implement in that event that the outlook slips more significantly from our central scenario. On one hand, it's worth assessing which central banks have more room to revert their stance and to ease in order to support their economic cycle, keeping a balance between poorly-anchored inflation expectations (with important currency pass-through) and still high external vulnerability. On the other, it's worth assessing which countries can now benefit from a more prudent fiscal policy adopted in the recent past.

During 2018, a straightforward change of perspective for EM central banks has taken place: the focus has clearly shifted from prevailing domestic considerations at the very beginning of the year, to more global/external factors driving monetary policy stance since April 2018 when the USD started a more convincing strengthening path.

For 2019, we do expect this trend to continue up to a point when the end of Federal Reserve's hiking cycle will become clearer. However, currently deteriorating macroeconomic conditions (mostly externally driven) will soon start to gain more relevance in EM monetary policy decisions, conditioning the future MP path as much as possible. We believe that the countries where the monetary policy could turn more supportive of the economic cycle are those that are the least externally vulnerable (safer in a strong US dollar environment), with better anchored inflation expectations (more stable inflation outlook within or closer to the CB target range). Having said that, monetary authorities should preserve the flexibility in their currencies with the caveat that the impact of FX volatility must be strictly monitored. For a healthy economic development, the exchange rate should remain the ultimate shock absorber and interventions in the FX market should be allowed only in very disorderly and highly volatile FX environments.

With regard to the second tool to the rescue, the different governments that have not already done so should make progress on building up fiscal buffers via more sustainable debt trajectories together with prudent and credible fiscal targets, a higher tax base, more efficiently targeted subsidies policies (if any) and more transparent fiscal rules. When fiscal targets are fixed together with external institutions like the IMF, they should be credible and realistic. In one of the most recent cases, we do not believe that Argentina's fiscal target as set out in the revisited IMF plan is credible or affordable. At some point, it will probably be renegotiated. The built-up fiscal buffers will allow EM to better navigate any challenging times in the future.

**Chart 1: EM policy room
(Monetary and Fiscal Policy apacity)**

Monetary policy capacity \ Fiscal capacity	LOW	MEDIUM	HIGH
LOW	Poland Turkey	Philippines South Africa	Mexico Colombia Indonesia
MEDIUM	Brazil Hungary India		Chile Czech Republic Malaysia Peru Russia
HIGH		China South Korea	Thailand

Source: Amundi Research, as end November 2018.

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