THIS MONTH'S TOPIC

# EM monetary policies normalisation as the low tide is getting higher

**Alessia BERARDI,**
*Head of Emerging Macro and Strategy Research*

*Still dovish monetary policy conditions among the EM with negative or modestly positive real rates*

**The monetary policy conditions in the emerging markets are still definitely dovish. Domestic factors as Inflation and, in certain cases, strong economic rebound are driving the EM Central Banks to normalise their monetary policy course. Tighter global financial conditions should trigger a faster and more generalised normalisation.**

### March 2021: the EM monetary policy course started to "normalise"

While limited to a couple of countries, monetary policy (MP) in emerging markets (EM) started changing course in March 2021. In the same week, Banco Central do Brazil (BCB) raised the Selic Rate more than expected, by 75bps, and the Central Bank of Russia (CBR) raised its policy Rates earlier than expected, by 25bps.

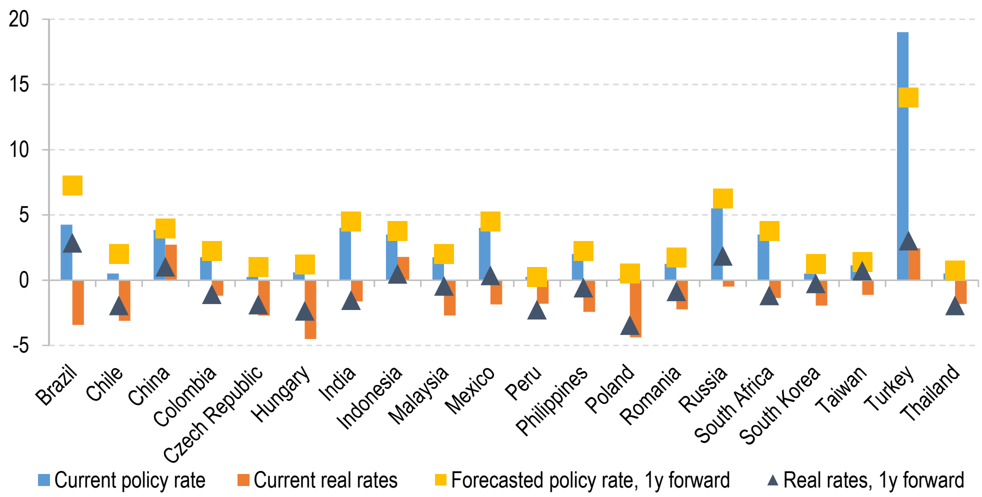
**Early in the year, the markets began to reassess the US macro picture (higher growth and higher inflation) with an increase in US long rates. However, the most important driver behind the change in the MP stance in both countries mentioned above were spikes in their headline inflation,** which were unexpected in their magnitude, as well as forecasts of higher Inflation levels. Therefore, a domestic factor has played a more important role than external factors, for a very orthodox CBR and for a reluctantly (at first) orthodox BCB.

Since then, these two central banks have continued their monetary policy normalisation (+225bps BCB and +125bps CBR) and only few others have followed (Ukraine +150bps and Turkey +200bps), notwithstanding the inflation figures have generally increased and in many emerging market economies are now above the upper end of CB target ranges. **As of today, monetary policy and liquidity conditions in EMs are still definitely dovish. Real rates, measured as the delta between nominal policy rates and inflation, are mostly negative and are expected to remain negative or modestly positive even over a 12-month horizon, barring any abrupt change in global financial conditions.** On top of that, EM CBs have embarked on less orthodox monetary policy conduct (QE of different natures, from liquidity injection to fiscal QE) as well as in a more targeted measures coordinated with various public agencies (e.g., sectoral credit incentives or debt moratoria extensions).

### Dovish and unorthodox monetary policy is getting more neutral/hawkish on higher inflation

During the pandemic it has become **a new normal for some EM CBs to embark in securities purchasing programs** (government and central banks debt, bank bonds) aiming at mitigating the effects arising from the pandemic, directly financing fiscal deficits, easing credit conditions and stabilising domestic financial markets. These operations have mainly happened in the secondary market, with few examples of primary market purchases or private placements. Contrary to expectations that these programs will scale down in emerging markets in 2021, **the first half of the year has seen, on average, an increase of assets purchases as a percentage of GDP, although concentrated in few countries** (India, Indonesia, South Korea, Hungary or

1/ EM Monetary Policy Rates and Real Rates (Current vs Expectations 12M FWD)




Source: Amundi Research - Data as of 22 June 2021

THIS MONTH'S TOPIC

*The direction of MP is clear: policy rates are heading up*

*While domestic factors push for a tighter MP, global financial conditions will play an important role*

Poland to name a few) and a reduction in a few others (Colombia, Chile or, marginally, the Philippines).

Although a lot of uncertainty is still around about possible new waves of pandemic in countries with unsatisfactory vaccinations programs, still struggling to reach levels of pre-pandemic growth, **the next direction of monetary policy rates has become clearer and clearer in recent months: policy rates are "gradually" heading up.** Indeed, more EM central Banks will join soon the BRUT group (Brazil, Russia, Ukraine and Turkey), calibrating their actions according to different aspects, including too high inflation for longer, a classic trade-off between growth and inflation, and their external vulnerability to tighter global financial conditions (namely the Fed).

Regardless of the "optically" brilliant GDP growth rates expected in 2021, driven mainly by a positive base effect, the recovery in emerging markets is not yet fully sustainable without a continuing supportive policy mix. Monetary and fiscal policies should only gradually pull back, securing the necessary support for the most vulnerable sectors.

**Notwithstanding that economic growth is still a caveat for faster monetary policy normalisation, there are other important aspects pushing in the opposite direction: the ramp-up in inflation and early talks/signals of monetary policy changes in the US.** Moreover, the risk to the domestic banking system of lower lending rates and debt moratoria for longer are not negligible either.

With few exceptions, headline inflation has been sharply increasing in EMs, driven mainly by its most volatile components (magnified by the local currency weakness), by higher shipping costs and, in some cases, by higher administered prices. Sequential growth in global food prices (FAO Index) has been extraordinarily robust since last year, bringing yearly growth to almost 40% in May 2021, the third highest peak registered in the statistics since 1991. While weighing differently, the food prices component in the EM CPI basket is still very relevant and much more relevant than in advanced economies. Indeed, the previous peak (by a similar magnitude) happened between H2-10 and H1-11, a period characterised by political turmoil in EMs. Persistently increasing since the beginning of the year, the oil price has reinforced its impact on final prices in the latest couple of months, aided by a very low base in the same period last year. Tapering of production cuts by the OPEC+ countries has been slowly catching up with the increase in demand and, overall, oil prices in 2021 should stay higher than in 2020, even if declining towards our FV at around $65/bbl.

Right now, the larger-than-expected magnitude in the inflation spikes and the persistence of the aforementioned factors have lifted headline inflation profiles in most of EMs above the CBs' target ranges and are slowing down their return to more comfortable levels, challenging the MP authorities to persevere in such accommodative monetary policy stance for longer. However, on the back of subsiding input prices and in the absence of more structural demand-side pressures, we do expect inflation to moderate within the CBs' targets, or closer to it, keeping a still relative benign inflation outlook. The prolonged slack still present in the EM economies is well visible in the more subdued dynamics in the core components of consumer prices. Therefore, **we have gradually brought forward the start of the normalisation cycle where the policy stance is excessively dovish in consideration of the more tangible economic rebound and the higher risk of inflation de-anchoring.** Latam and CEEMEA are on the frontline (NBH, CNB and BCCh are next in the pipeline), South Asia will follow later, though the recent and unexpected spike in Indian Inflation has suddenly moved up the RBI shift in stance (from dovish to neutral) and possibly the first rates hike in CY21, from CY22.

### Last but not least global financial conditions will add pressure to the EM central banks

The Federal Reserve's next change of stance is definitely an important variable in EM central banks' monetary policy. It's now commonly understood that EM external vulnerability has decreased since the taper tantrum episode in 2013, looking at the current account or basic balance measures, as well as the reserves adequacy ratios in terms of imports cover. Moreover, the pandemic has further helped rebalance external accounts in many countries that entered the crisis already in better external conditions than some years ago. There is no such a group like the fragile five today (besides Turkey). However, **higher global rates and a stronger USD could still hurt emerging markets, due to their important external debt positions, and push their CBs to normalise earlier, in order to keep a stable currency and to try to preserve a stable rates differential to attract foreign portfolio inflows.**

This was again recently proven in June when the Fed, in a more "hawkish" tone, changed its dots and flagged two rates hikes in 2023 instead of one and EM asset classes, FX primarily, underperformed on the back of a stronger USD, while the US10 years was mostly unchanged. Amid the domestic issues, to prove the importance of the external factors in the EM MP decision

THIS MONTH'S TOPIC

*The faster and sharper tapering will subside in H2*

process, the overall negative performance was less pronounced in FX, whose the monetary policies are perceived as ahead of the curve. The BRL is resilient on the back of a full normalisation process in place.

### China faster and sharper tapering to subside

**PBoC** begun its policy normalisation in the interbank market by rolling back liquidity supports and then shifted to rein in credit growth. So far, **the tapering has been faster and sharper than expected**. Although policy communication reiterated no abrupt turn in macro policies, total social financing (TSF) growth – the broad credit proxy – continued to surprise on the downside in the past months. Its growth rate of 11% YoY in May was already close to pre-Covid level (10.7% YoY in late 2019). The unexpected liquidity tightening ahead of the Chinese New Year was another reminder of embedded tightening bias when the equity and housing markets are boiling.

**After a year's "fast tapering", we expect policymakers to take a breather in H2.** Economic growth momentum has moderated, due in part to the weakening credit and fiscal impulse. Meanwhile, consumption recovery has lagged behind. With a softer economic outlook, the deleveraging pace is likely to slow. TSF growth is expected to hold slightly above 10% throughout the rest of the year. We expect PBoC to maintain its neutral stance in the interbank market, anchoring rates around its desired levels.

**Rate hikes expected only in early 2022.** At Lujiazui Forum (10 Jun), PBoC Governor Yi conveyed a clear message that the central bank will look at average inflation rates instead of recent months of high prints in PPI. Hence, we expect PBoC to stay behind the curve in H2, in particular when commodity inflation risks are easing. However, core CPI will continue to strengthen gradually and rise above 2% in early 2022, while the headline is likely to pick up to over 2.5%. Given strengthening inflation, we expect PBoC to conduct two 5bp hikes in LPR in H1 2022.

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