THIS MONTH'S TOPIC

Addressing the legacy of the crisis in the EM: the right policy mix in an uneven recovery

ALESSIA BERARDI
Head of Emerging Markets Macro and Strategy Research

The duration of the epidemic will ultimately determine the shape of recovery. An uneven recovery and subdued inflation (barring any persistent supply shock) will call for a prolonged accommodative policy mix, in either monetary or fiscal policy. The merger of the two has to be careful monitored in emerging markets.

The current pandemic has hit all emerging economies without distinction, with the apex felt during the first half of 2020. Having said that, the depth of the scars it left has been different from country to country. Across the regions, Eastern Europe and CEE3 (Hungary, Poland and Czech) in particular have proven to be the most resilient, as well as North Asia (China, Taiwan and South Korea). Within Asia, it's worth highlighting the remarkable differences between South and North, with northern countries managing the pandemic and reopening more effectively than the southern countries (India GDP fell by around 24% YoY in Q2 2020), which are still struggling to come out of the first wave.

Although economic conditions when everything began were not the healthiest possible, a return to the pre-crisis economic status is proving slower and more challenging than expected. The pandemic is far from being under control and we are witnessing new outbreaks or second phases across many countries followed by local and targeted lockdowns. Based on daily economic activity data, the robust rebound in place since the easing of the Great Lockdown has stabilised since August and then shifted downward in some countries. Economic activity has slowed down in countries where new targeted lockdowns have been enforced (e.g., in Indonesia, Malaysia and Israel) as well as in countries where the infection rate has temporarily increased above the recent average even in the absence of any new enforced restrictions (e.g. in South Korea in September).

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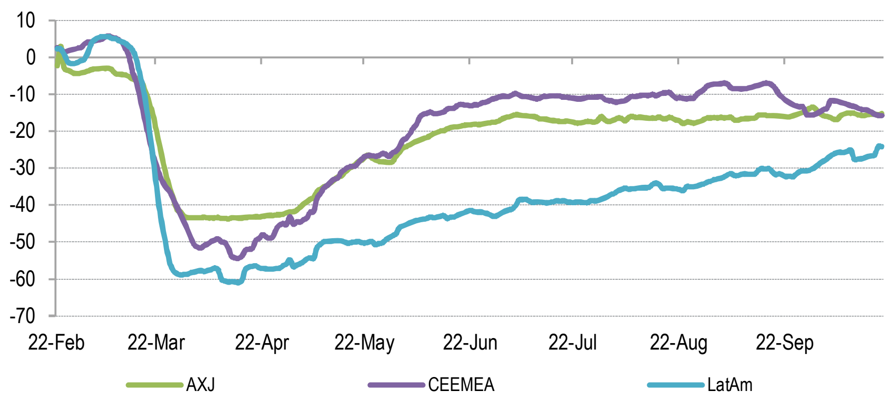
Domestic as well as external demand have driven the current rebound. In the first phase of the crisis, rapidly available cash benefits or transfers have supported consumption in countries where wage subsidies were less effective, due the prominence of the informal sector. Sector-wise, the rebound has mainly concerned manufacturing while services have lagged behind. Tourism is one of the worst-affected sectors in this pandemic. There were zero international tourist arrivals in August for the fifth month in a row in Thailand, where tourism accounts for around 12% of GDP. On a more positive note and still on the external side, EM exports have rebounded robustly since June 2020. Although the recovery in exports has been broadly based, it is worth noting the vibrant tech production and export cycle that favours North Asia countries and generally the tech sector/ companies across the world. Earnings of the MSCI China Index, which has expanded the weighting of new economy companies since 2015-16, are more and more dependent on the EM exports cycle than on general world trade dynamics, highlighting the importance of regional integration.

With regard to inflation, a benign trajectory is underway and we expect only a gradual pick-up in 2021 vs 2020, due to the wider slack in the economy (which existed in part in some countries already before the crisis). The yearly smooth inflation figures could hide some more challenging and volatile dynamics along the year, certainly around Q2 2021, when a spike will be made possible by the very low base in Q2 2020 (driven by the oil price collapse). Provided that the inflation

Benign inflation picture with temporary spikes due to supply disruption and food exports bans in place due to the pandemic

1/ **Mobility data**



Source: Google Mobility data, Data as of 20 October

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The focus is shifting to unconventional space as conventional room has been mostly exhausted

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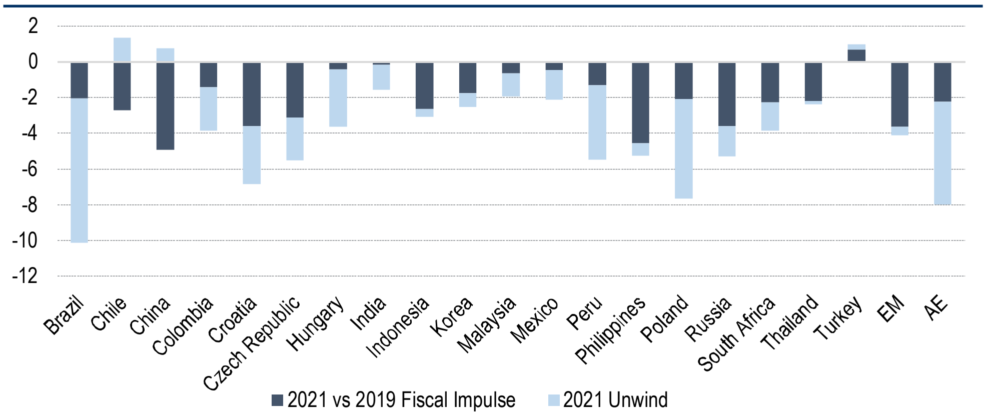
picture remains benign and, generally speaking, within or very close to the CBs targets, the recent mild pick-up reflects the importance of other non-core components in the price basket, as Food. The pandemic has produced a large amount of supply disruption (still difficult to quantify), as well as food export restrictions and this has been immediately reflected in high inflation in the emerging markets. One of the first reactions by many governments around the world was to guarantee adequate supplies of food, facilitating imports (through tariff reductions, streamlining of border procedures, and relaxation of labelling requirements), and/or restricting exports. The World Trade Organization (WTO) on June 18 prohibited members from banning food exports and several of these measures have subsequently been removed. Weak demand and supply disruption are mutually offsetting and though we envisage the first factor as dominant on the background, it's fair to say that the possibility of temporary spikes in inflation above the CB targets (different from the past inflation highs) can't be ruled out. Depending on the structure of the economy and efficiency in the price formation mechanism, these spikes could assume a less temporary shape, as has been happening in India, where inflation has remained above the quite wide RBI band for most of the year.

On the monetary policy front, the focus is shifting to unconventional space as conventional room has been mostly exhausted (with the exception of a few countries such as Mexico). Contrary to DMs, emerging market central banks will mostly use conventional and unconventional tools such as forward guidance (FG) or credit policies and QE in a non-monetary kind of way – mostly on the secondary market to manage and enhance liquidity especially during times of stress. The BCB, for instance, is squarely focused on FG and intends to use QE in the same fashion as its FX reserves. SARB is buying assets in small amounts to 'manage' liquidity only. On the other hand, the NBP and BCCh are buying assets in larger quantities and in a quasi-fiscal fashion, too – the former is purchasing state-backed debt, the latter bank assets. Unconventional MP conduct is made possible by a moderate inflation level, though in some cases it raises concerns about the monetary policy independence from fiscal policy.

In the latest couple of decades, emerging markets central banks have made significant efforts to make their monetary policy frameworks stronger and more credible. That was possible with the incremental use of the FG and with the effective adoption of a credible inflation targeting mandate, leaving the currency as the ultimate shock absorber as much as possible. Only in the recent years have the so-called "high Inflation countries" been able to bring back their Inflation rates back to acceptable levels, today mostly within the CBs' target ranges.

That said, enough is never enough for countries with structural issues and strong dependence on external demand and external financial flows. EM policy makers can't afford to be too complacent with what has already been done; they need to remain vigilant and the pandemic crisis is now raising doubts on the way the new policy tools are being adopted; although many EM central banks can legally buy government securities in the primary market, moving to quasi-fiscal or fiscal quantitative easing remains a last resort. An example of fiscal quantitative easing often reported is the burden-sharing scheme adopted by the Indonesia. The Bank of Indonesia is requested to buy in the primary market to fund the atypically high 2020 fiscal deficit. The process is announced as one-off and the way out officially recognised relies on the purchases targeted amount and on the fiscal consolidation strategy planned for the next few years (FD again below 3% by 2023 from the 6.3% in 2020). We do see the recently announced central bank law revision as background noise not impacting the planned monetary/fiscal strategy.

2/ **Fiscal impulse**



Source: IMF as of October 2020

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Moving to 2021, following the sharp increase of leverage in 2020, we expect to see slower accumulation of public debt in China

Notwithstanding the tentative fiscal consolidations announced, EM debt levels will take some time to stabilise and to reverse their upward trajectory

QE is not the only viable solution; in some countries, where inflation spikes can't be underestimated or inflation is already not at comfortable levels, central banks should only briefly indulge in unorthodox measures and focus rather on more efficient MP transmission and corporate debt restructuring challenges. The debt moratoria give some time to act until calm is restored but, sooner or later, the corporate debt issue has to be dealt with. In India, for example, it is paramount to reactivate the restructuring process to renegotiate debt through the bankruptcy code, in order for the banks to starting lending faster.

Although the pandemic crisis has had a global impact on both EMs and DMs equally, fiscal affordability considerations, including high borrowing costs, has been moderating the rush towards an aggressive fiscal policy stance in emerging markets, in comparison with developed markets. While we did see some divergences between DMs and EMs in terms of size and timing of execution of fiscal packages, the scope of the most urgent measures has been quite similar: support for the healthcare sector and households (via cash transfers and or job benefits). China has been an exception, and its fiscal deficit has expanded decisively in 2020; most of the funds raised thus far have been directed to infrastructure projects or to ease financing pressures in the corporate sector. The scale of public spending for households is relatively small compared to elsewhere. Moving to 2021, following the sharp increase of leverage in 2020, we expect to see slower accumulation of public debt in China. Although the fiscal deficit will not shrink immediately to pre-Covid levels, a moderate cut down is likely. We don't expect the RMB 1tn Special China Government Bond to be rolled over for another year. A reduction of local government bond issuance quota from RMB 3.75tn is also likely, which had been the main funding support for infrastructure projects.

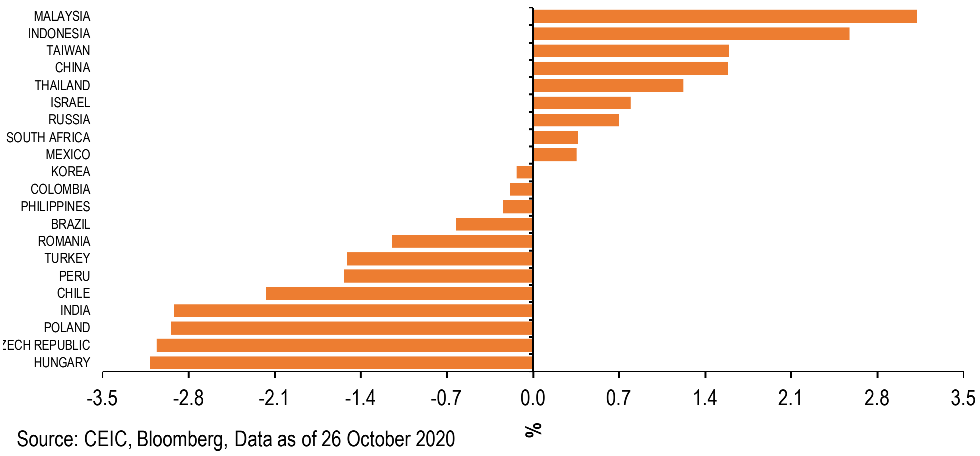
With regard to other EMs, the fiscal picture is quite diverse, despite the fact that a sort of fiscal consolidation is being pencilled in more or less in most of the 2021 budget laws so far announced and approved. On the one hand, there is Brazil, which constitutionally needs to unwind 9% of GDP of fiscal stimulus, and Mexico and Russia, where 2021 budget proposals were not short on prudence. Indonesia will also start renormalising fiscal balances as early as next year. In CEE, KOR, CHL/PER, meanwhile, room exists to cut back fiscal impulse gradually, while in South Africa the double-digit budget deficit will require politically challenging and socially painful cuts to public wages/employment and will therefore likely take some time to unwind.

Notwithstanding the tentative fiscal consolidations announced, EM debt levels (which increased far less than DM levels in 2020) will take some time to stabilise and to reverse their upward trajectory. The risk of an abrupt change in risk premia and, hence, a change in investor confidence (ratified by further rating agencies actions) needs to be carefully monitored. Credibility is as important for fiscal authorities as it is for monetary authorities.

Many low-income countries entered the crisis with already stressed fiscal positions and/or with a resources buffer just barely viable for serving the debt in normal circumstances and had to divert these resources to respond to the pandemic crisis. For these countries, the official sector, represented by the big supranational institutions, has recently agreed to extend the Debt Service Suspension Initiative by six months (till mid-2021) while a new framework is under discussion with the aim to make as more comparable as possible the many creditors involved.

Finalised on 23/10/2020

3/ **EM real policy rates (current)**



Source: CEIC, Bloomberg, Data as of 26 October 2020

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November 2020 #11

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