Emerging Markets Vulnerabilities Amid Policy Normalization

Key Takeaways

- The different stance of monetary policy recently was driven by the degree of economic recovery and inflation.
- Some of DM CB including the Fed sees risk of inflation is higher and soon to start the tightening cycle.
- The Fed monetary policy normalization leave EM countries vulnerable particularly for EM G20 countries which saw rising inflation and higher external debt.
- Room for accommodative policy in EM G20 countries is very limited and policy makers are expected to follow monetary tightening and fiscal consolidation agenda.
- However, the degree of EM G20 countries vulnerability differ with Indonesia is expected to have more resilience on the back of sound macro policy, strong fundamentals and manageable inflation.

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Could this Diverged World to Sustain Any Longer?

It is clear that Covid-19 pandemic shock has triggered global fiscal-monetary coordination. Global central banks eased their monetary policy through namely QE and cutting interest rates. On the fiscal side, government took an extra miles measures by letting their budget deficit to widen. However such accommodative macro-policy measures have different impact across the globe. In advanced economies, gradual reopening supported by aggressive vaccination program have shown not only supporting recovery but also rising inflationary pressure. In contrast, emerging market recovery tend to be slow so far, yet some part of the world also facing challenge in price stability (Exhibit 1).

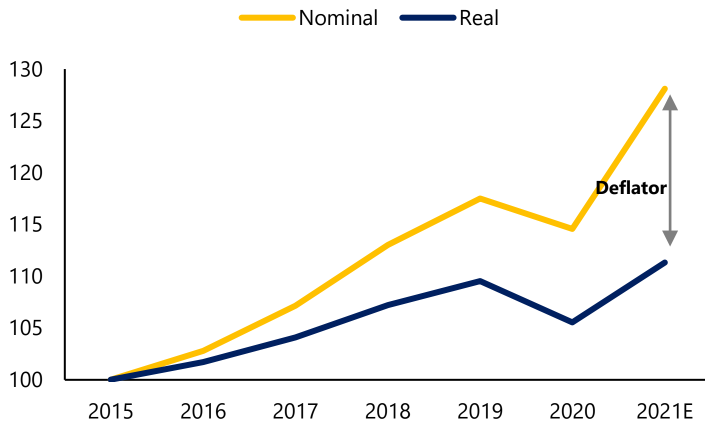
Given the outcome, it seems that the world turned into a divergence. Some of developed country's Central Banks such as BoE and Bank of Korea, took ahead the curve policy by raising their benchmark interest rate since 2H21. Despite keeping interest rate low, Fed & ECB started to calibrate their monetary policy conduct by rolling back their economic policy support namely by tapering off.

The Fed & ECB tapering off is set to conclude in 1Q22. Furthermore, in time of persistently rising inflation, US' central bank will likely to begin monetary tightening as soon as Mar-22. Market participants started to anticipate 4x FFR hike throughout FY22F. In addition, the Fed is also considering to reduce the size of its balance sheet after rising rates, according to officials including Fed's chair Powell.

In some part of the world including Japan, the central bank kept its dovish stance on the back of prioritizing growth over stability as BoJ still see rising inflation to remain below its long term target of 2%. Contradictory, China's monetary authority (PBoC), took a different direction. The threat coming from slowing economy on the back of property and construction sector deceleration has triggered PBoC even to loosen their monetary policy. In Dec-21 meeting, PBoC decided to cut its Loan Prime Rate (LPR) for 1-year and 5-year by 10 bps and 5 bps respectively. This was the first cut since Apr-20 (Exhibit 2).

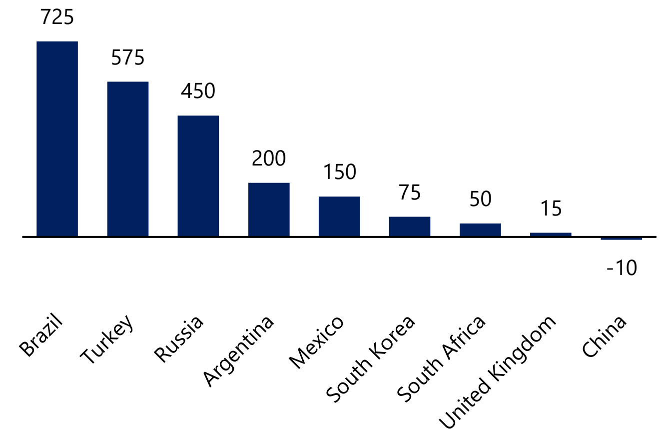
A different outcome and circumstances have proven to be the key driving factors why central banks followed different path across the globe reflecting their priority over pro-growth and stability consideration. Despite the difference on monetary stances, we still see that emerging market economies are posed to threat from capital flows reversal amid policy normalization by the Fed. Downside risks for emerging market economies are not only coming from potential of capital outflows that may depreciate their currencies, threats also come from the degree of indebtedness and limited fiscal space that we tried to assess in this report. All in all we think that emerging market economies are now facing difficult tradeoffs. However we believe that keeping interest rate low and massive fiscal support are no longer option for them in order to foster stability.

Exhibit 1. US V-shaped recovery with rising inflationary pressure (2015=100)



Sources : World Bank, Federal Reserves, MNCS

Exhibit 2. G20 countries policy rate adjustment since the pandemic low

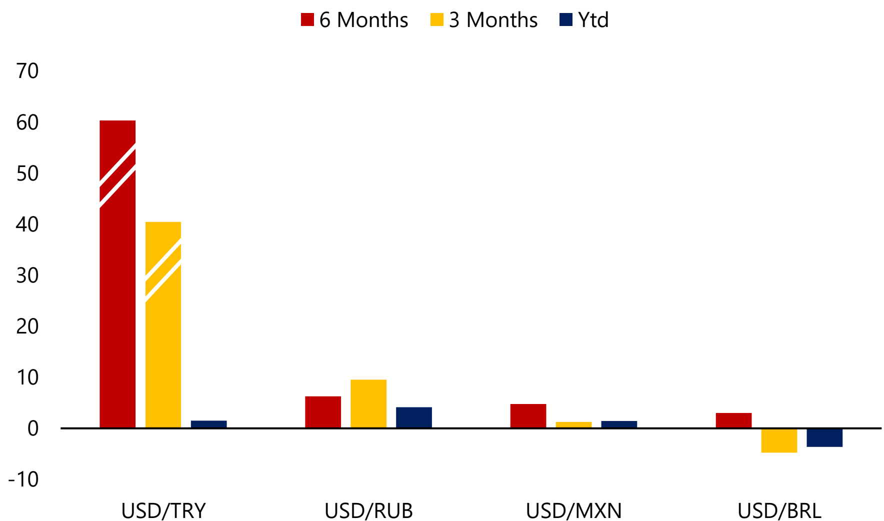


Sources : Trading Economics, MNCS

EM Currency Risk and Vulnerability

In anticipation of Fed policy rate hikes and in some way to control domestic inflation, some of G20 emerging economies have started their tightening cycle. Brazil central bank came with the most aggressive measure by raising interest rates 725bps, followed by Turkey and Russia by increasing policy rate of 575bps and 450bps respectively (Exhibit 2) since the pandemic low. Even with the rate hikes, the country's currencies still saw a depreciation against USD as of year to date and only Brazilian Real that successfully managed to strengthen during the same period. However, compared to the last 6 months period, those currencies have weakened against USD with Turkey's Lira dropped more than 50% (Exhibit 3). Despite the net rate hikes taken by Turkey's central bank, Lira started to depreciated since Oct-21 after the interest rate was cut in Sep-21. In total Turkey's central bank has cut 500 bps from 3Q21. Lack of Turkey central bank credibility has put their currency in pressure.

Exhibit 3. Selected EM G20 country's currencies performance against USD (%)

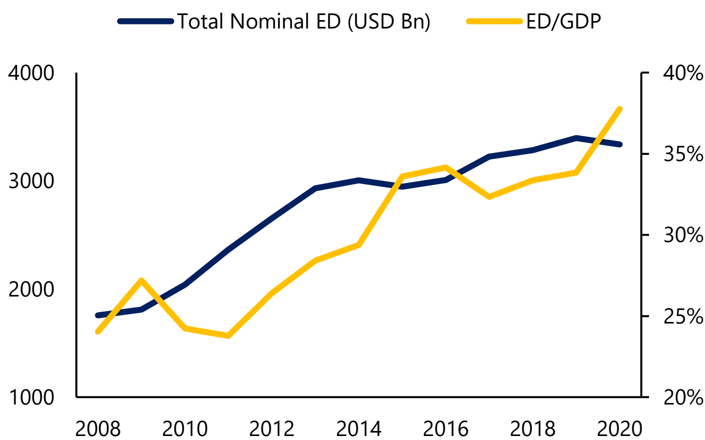


Sources : Bloomberg, MNCS

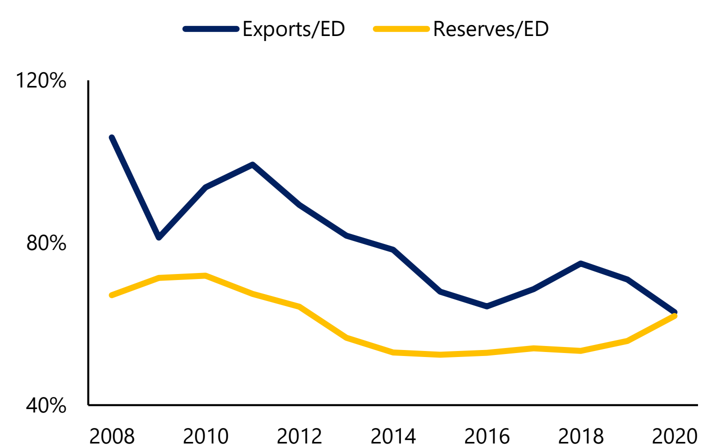
Besides the jump in exports performance during commodity boom and improving current account balance, the currency risk from selected EM G20 economies come from inflation and mounting external debt burden. In the last two decades, EM G20 external debt has risen 5.8% annually (CAGR) with some economies such as Argentina, Brazil, Indonesia and Mexico foreign currency denominated debt rose with the higher pace since 2008 GFC. Even with impressive exports performance and reserves accumulation, external debt remained putting the economies on higher external pressure (Exhibit 4). Indeed we understand that during Covid-19, some of EM G20 economies such as Indonesia tried to benefit global ample liquidity and low interest rate amid QE to issue foreign currency denominated bond to finance budget deficit, therefore increasing the total nominal value of external debt. We expect total external debt to nominal GDP in EM G20 countries to reach 40% in FY22F.

Exhibit 4. Rising external debt leaving EM G20 countries vulnerable

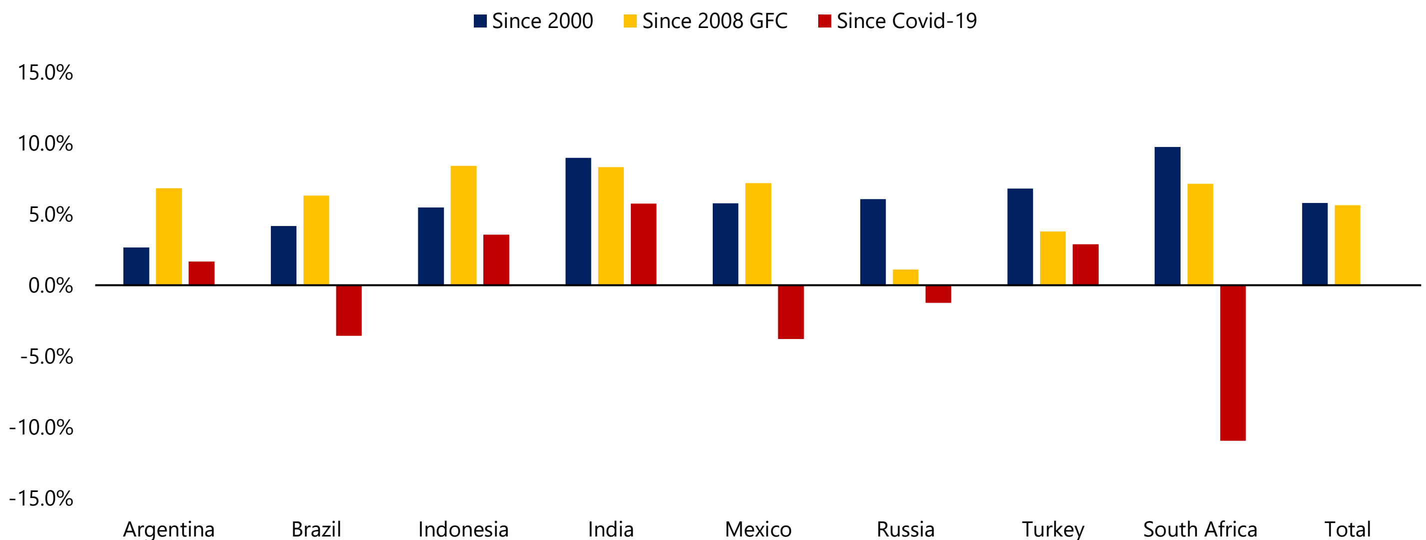
Total nominal external debt in EM G20 economies increased 5.6% CAGR since 2008 GFC...



....while the ratio of exports value and reserves to total nominal external debt value decreased



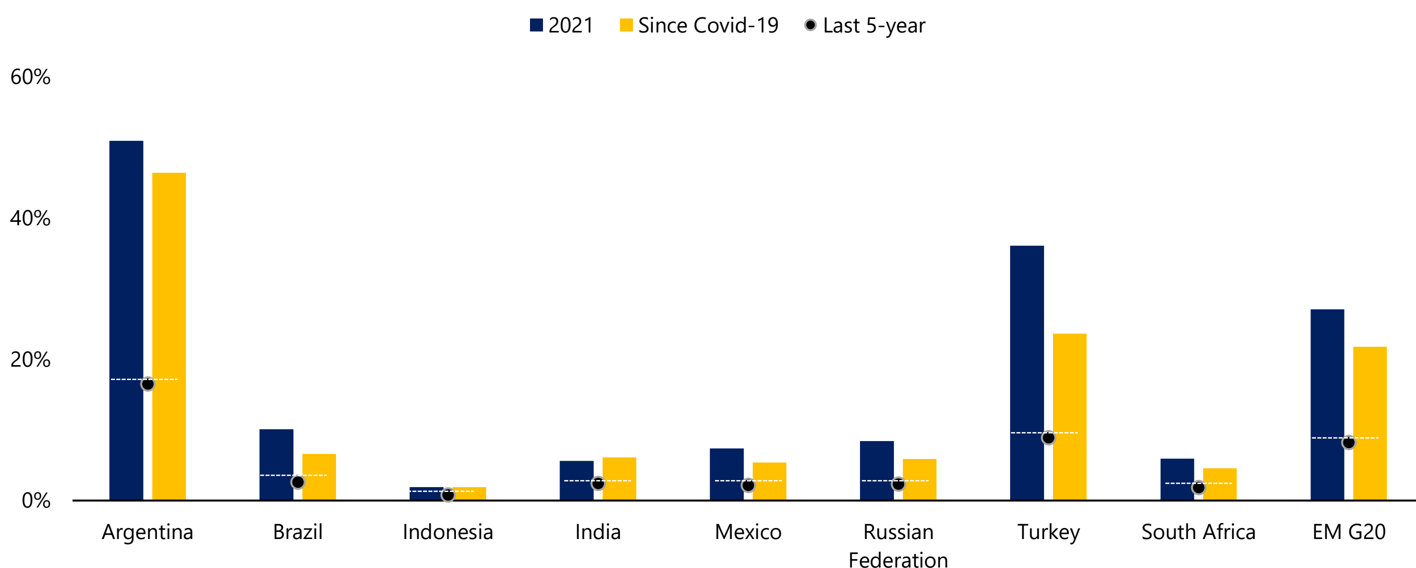
The different growth rate (CAGR) of EM G20 economies external debt in the last two decaddes



Sources : World Bank, MNCS

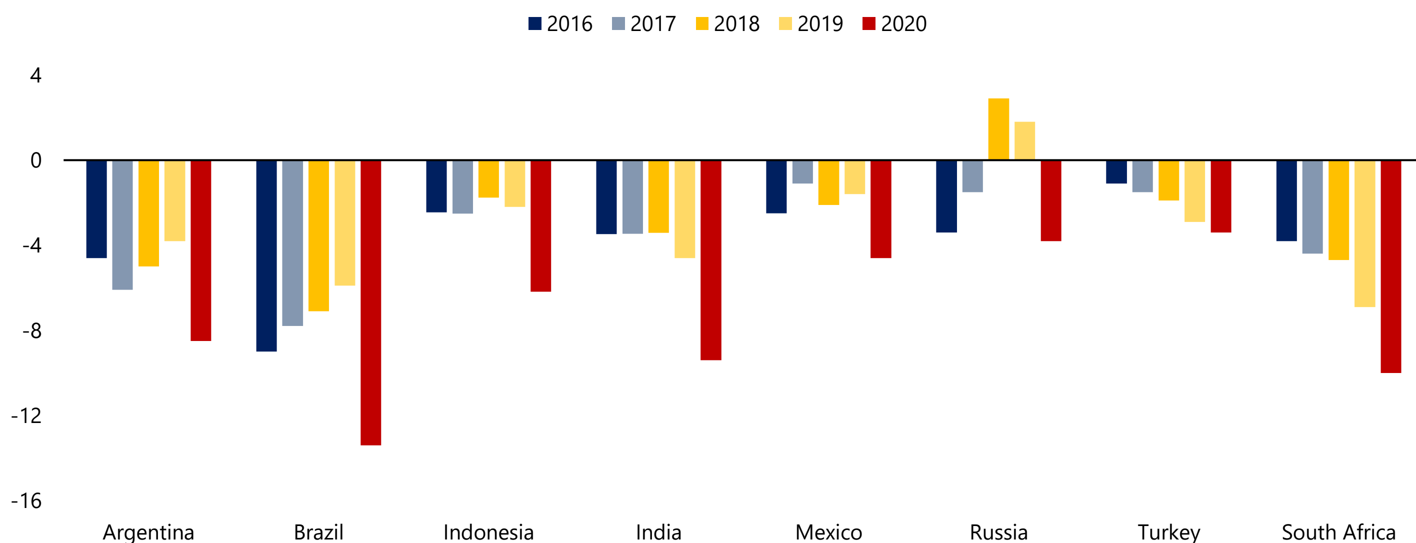
All in all we see room for macro accommodative policy for EM G20 countries to be very limited amid Fed's policy normalization agenda. We think that stability matters more now, and both fiscal and monetary policy should be focused on stabilization, as we all witnessed a mounting pressure in inflation. Since Covid-19 strike, change in CPI in EM G20 countries has risen with average annual inflation growth rate of 22%, significantly above its 5-year annual rate (Exhibit 5). Furthermore, large deficit spending is no longer an option and it may risk healthy fiscal outlook with the recent indebtedness and unprecedented budget deficit (Exhibit 6). Therefore fiscal authority needs to take a serious step on consolidation agenda by tailoring appropriate policy considering their circumstances and vulnerabilities.

Exhibit 5. Change in Annual Inflation in EM G20 Countries



Sources : Bloomberg, MNCS

Exhibit 6. EM G20 Government Budget Balance (%GDP)



Sources : Trading Economics, MNCS

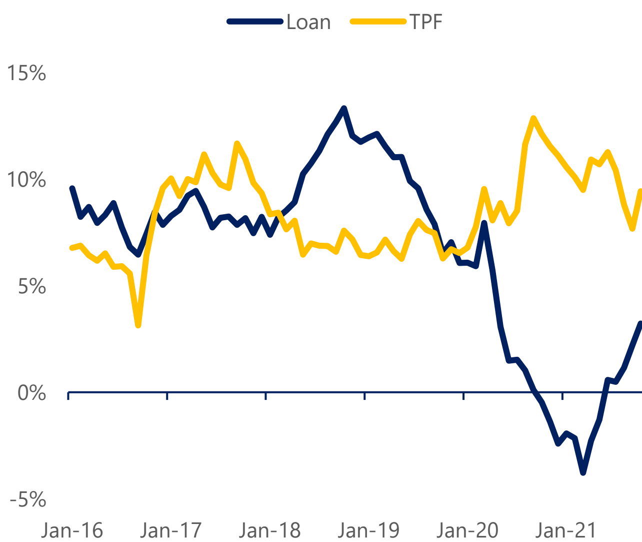
How Vulnerable is Indonesia?

In response to recent development, Bank Indonesia took an anticipative policy response through liquidity normalization. In Jan-22 RDG meeting, BI decided to gradually increased rupiah statutory reserves for commercial bank from 3.5% to 6.5% throughout this year. The increase in rupiah statutory reserves will be started in Mar-21 by 150 bps to 5%. BI estimated this policy to sap out IDR200tn banking liquidity, without influencing banks capability to lend given the industry still have ample liquidity so far (Exhibit 7).

We agreed and appreciated BI to start policy normalization and staying ahead the curve. Rather than influencing the price of money (mainly by raising interest rate), BI chose to adjust the volume of money and liquidity in the banking system in order to prevent excessive loan disbursement that may trigger overheating. Besides this policy may signaled higher interest rate in the near future, we think pressure on BI to hike BI 7 Day Reverse Repo Rate to stay minimum, given benign inflation and stable rupiah (Exhibit 8).

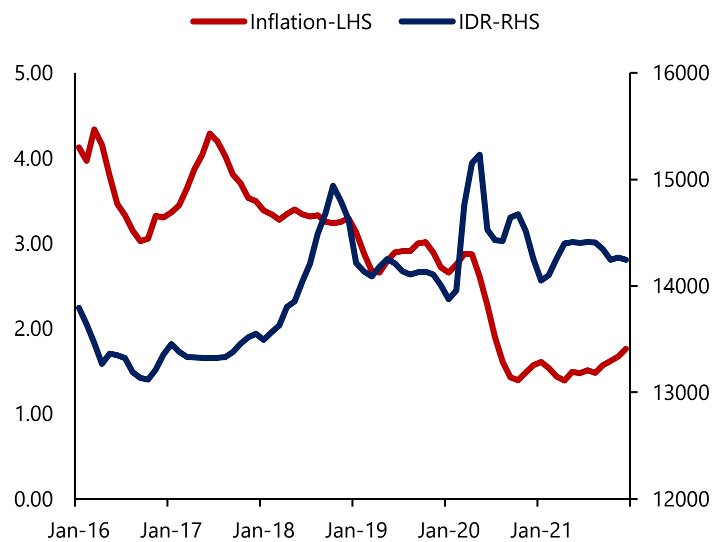
Furthermore, from macro perspective, BI have more flexibility in formulating policy mix. Should the outflows depreciate rupiah, ample FX reserves could be directed for stabilization. In addition, higher commodity prices that could last longer will also benefit Indonesia's external stability. Another good news is that government budget deficit may be lower than target this year on the back of improving economy and fiscal consolidation agenda. All in all with sound macro policy and strong fundamentals, we believe that Indonesia is far more resilient than in 2013 and less vulnerable compared to EM G20 peers.

Exhibit 7. Banking industry ample liquidity



Sources : OJK, MNCS

Exhibit 8. Inflation vs IDR Trend in the last 5 year



Sources : Bloomberg, MNCS

MNC Research Industry Ratings Guidance

OVERWEIGHT: Stock's total return is estimated to be above the average total return of our industry coverage universe over next 6-12 months

NEUTRAL: Stock's total return is estimated to be in line with the average total return of our industry coverage universe over next 6-12 months

UNDERWEIGHT: Stock's total return is estimated to be below the average total return of our industry coverage universe over next 6-12 months

MNC Research Investment Ratings Guidance

BUY : Share price may exceed 10% over the next 12 months

HOLD : Share price may fall within the range of +/- 10% of the next 12 months

SELL : Share price may fall by more than 10% over the next 12 months

Not Rated : Stock is not within regular research coverage

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