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Monetary policy veering off in emerging economies

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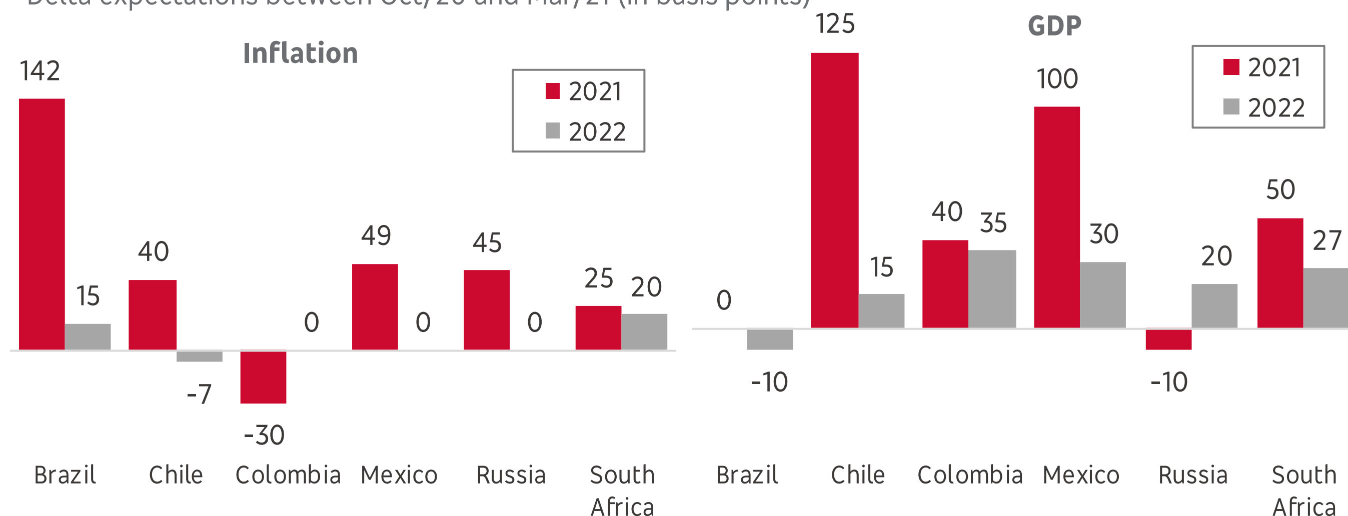
Over the last few weeks, central banks of emerging nations started veering into different paths in terms of monetary policy steering. 2020 was marked by the synchronized rollout of monetary stimuli across all economies, including among emerging countries. Now, there seems to be a divide between this group of nations, with three main subsets. The first features countries like Brazil and Russia, whose central banks kicked off a monetary policy adjustment process. The second subset, which includes countries such as Colombia, Mexico and South Africa, didn't raise interest rates, but adjusted the tone of announcements, reducing the chances of new cuts and signaling the conditions needed to maintain the accommodative policy moving forward, or even hinting to an intention to withdraw stimuli. The third subset – with a behavior closer to that of developed nations – keeps a loose monetary policy stance.

Particularly in the first two subsets, further investigation is warranted to identify the drivers behind such shift in behavior. Interest rate high cycles are typically sparked by one of the following reasons: i) high current inflation beyond a temporary shock, contaminating future inflation expectations; ii) perception or prospect of economic acceleration beyond the potential; or iii) a limit imposed by stricter global financial conditions, which is particularly important to steer monetary policies in emerging nations.

An assessment of growth and inflation expectations reduces the relative importance of the first two explanations. In some cases, there was a relevant adjustment of inflation expectations for 2021, but little or no adjustment for 2022. Regarding the economic activity, the perception of a stronger pace this year does exist, but still seems insufficient to lead towards an expected overheating of emerging economies. In fact, perhaps one of the few countries to which this vision applies is the U.S., which confirmed the expectation of substantial stimulus packages and now undergoes an economic reopening process as vaccination rollout advances.

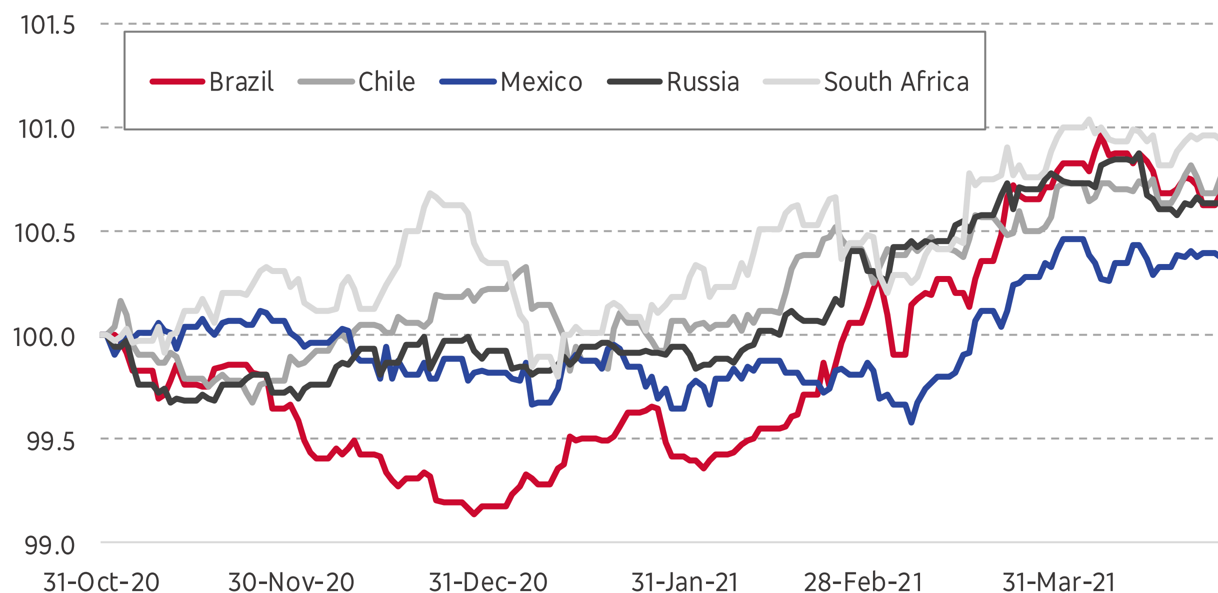
Chart 1: Growth and consumer inflation expectations, 2021 and 2022
Delta expectations between Oct/20 and Mar/21 (in basis points)



Source: Bloomberg, Bradesco

However, emerging economies struggle with tighter financial conditions. Reversing the trend initiated in mid 2020 – when ultra-expansionist policies of central economies were consolidated –, amplified as of November – when the advent of vaccines showed a glimpse of the end of the pandemic –, financial conditions became more restricted in mid February, at the same time longer interest rates in the U.S. started to accelerate more rapidly.

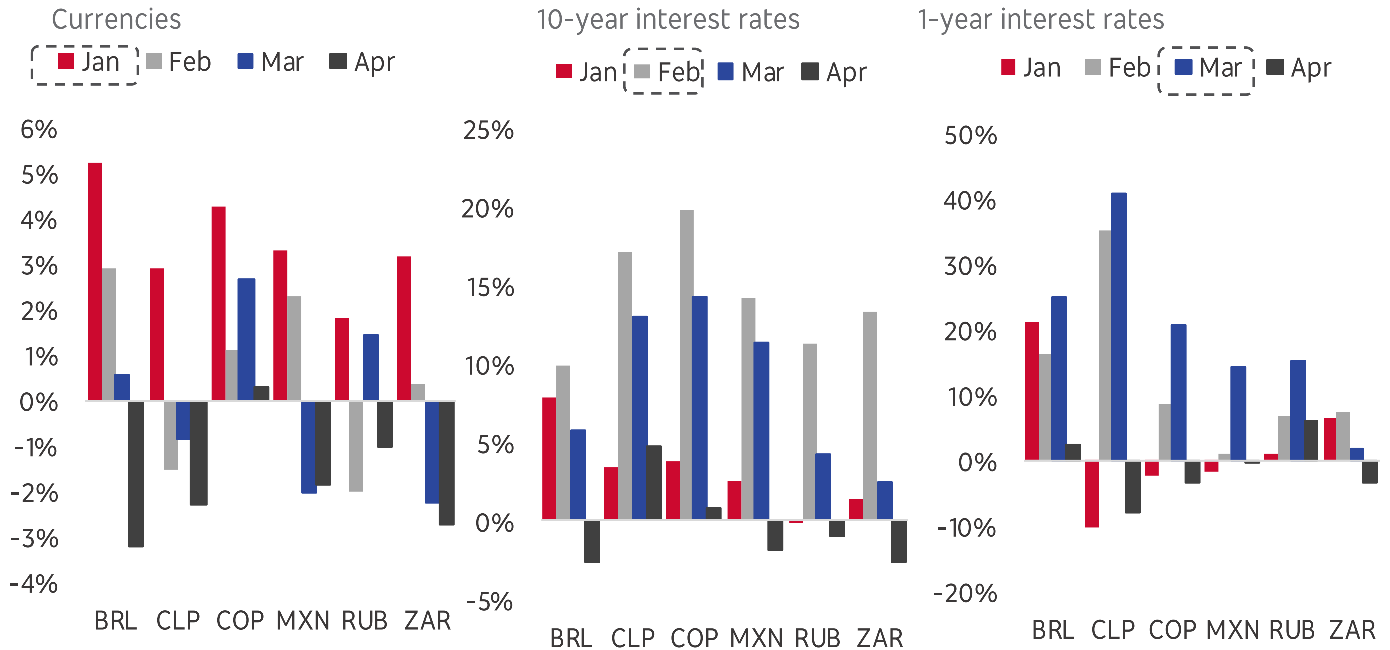
Chart 2: Financial conditions



Source: Bloomberg, Bradesco

This reveals a phased and synchronized trend in asset prices from emerging countries, reflecting the global reflation trend, driven by the U.S. In January, when the perception of a second Covid-19 wave actually came true, caused by variants that affected the global economy before vaccines could be made available to everyone, some risk aversion trend – certainly more limited than the one seen in 2020 – strengthened the U.S. dollar, especially compared to emerging currencies. Later on, the U.S. economy's fast acceleration led to higher interest rates, which in turn caused a more than proportional increase in equivalent rates for emerging nations. Finally, in March, the short end of the yield curve in these countries started to price some kind of adjustment, especially in countries of the first and second subsets, when some of these central banks effectively started raising interest rates.

Chart 3: Monthly variation of asset prices (exchange rate, 10-year interest and 1-year interest)



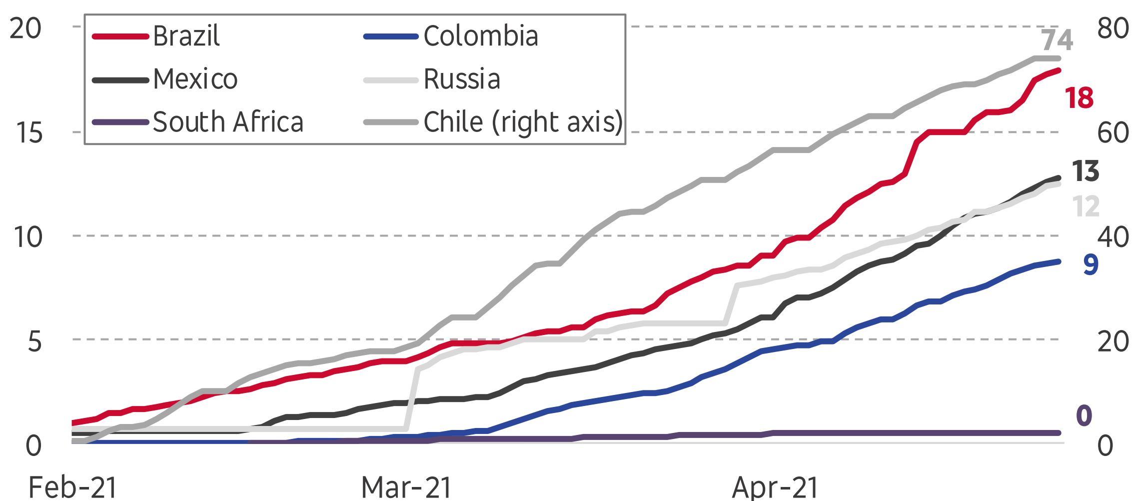
Source: Bloomberg, Bradesco

It is an interesting exercise to try to anticipate the next big moves. Will we continue to see global trends reasonably synchronized with monetary policy steering in emerging nations, or are we entering a period of relative normality, in which each country's characteristics prevail? Paradoxically, both scenarios could play out.

A first set of elements relates to global trends. Both the U.S. dollar's performance and the advance of interest rates in the U.S. fall into this category. In the dollar's case, the jury is still out, but we believe any eventual appreciation trend over emerging currencies tends to be limited. As for Treasuries, there seems to be some consensus that the current level still does not represent "balance" in the medium term. But the timing for this additional hike is still uncertain and will depend on how the U.S. economy reacts in the next few months. If the 10-year Treasuries rate returns to the average level of 2.25%-2.50% seen in the last decade, a movement of approximately 1 p.p. on average would still need to be incorporated to long local rates.

A second set of elements relates to individual characteristics. Initially, the difference in vaccination rollout speed and subsequent return to normality of the economic activity stand out. The faster this process, the faster the monetary policy's normalization. But fiscal conditions have played a key differentiation factor between countries. In addition to restricting the ability to implement direct fiscal stimulus policies, the worse the conditions of public finances, the less room for monetary policy to stimulate the activity. The latest speeches and forecasts of international entities, such as the IMF and the World Bank, have reinforced the warning regarding the limited room emerging countries have to face the challenges of this pandemic and its aftermath. In countries such as Brazil and Colombia, for example, fiscal conditions have been explicitly seen as possible limitations to steering the monetary policy.

Chart 4: Evolution of vaccination in emerging countries
Doses applied for every 100 inhabitants



However, there is an important caveat regarding the conditions of external accounts of emerging nations. In general, they have performed better both in current account balance and in net external liabilities compared to the 2008/09 crisis. Better external fundamentals may limit local currency depreciation trends in case of a new round of appreciation of the U.S. dollar. The still very positive outlook for commodity prices only reinforces this trend.

Despite the differences between countries, 2021 will still be a year of low interest rates compared to the historical pattern of emerging markets. It seems that monetary policy in central economies will still take time to normalize. The Treasuries' own behavior, which has stabilized at 1.6% per annum in recent weeks, suggests that an important part of inflation and economic activity expectations are already priced, and additional surprises are needed for a new round of adjustments. However, gradually and for various reasons, the exceptional environment of low interest rates in emerging markets is gradually beginning to reverse.

Table 1: Interest rate expectations in emerging countries
Consensus extracted from Bloomberg for benchmark interest rates

Country	Current rate	2Q21	3Q21	4Q21	2022
Turkey	19.00%	18.35%	17.15%	15.20%	13.00%
Brazil	2.75%	3.70%	4.55%	4.75%	5.65%
Russia	4.50%	4.75%	4.95%	5.05%	4.95%
Colombia	1.75%	1.75%	1.75%	1.95%	3.00%
Chile	0.50%	0.50%	0.50%	0.65%	1.45%
Peru	0.25%	0.25%	0.25%	0.30%	1.00%
Mexico	4.00%	3.90%	3.85%	3.90%	4.05%
South Africa	3.50%	3.50%	3.50%	3.55%	4.10%
Poland	0.10%	0.10%	0.10%	0.10%	0.20%
Thailand	0.50%	0.50%	0.50%	0.50%	0.65%
Malaysia	1.75%	1.70%	1.70%	1.70%	2.05%
Indonesia	3.50%	3.50%	3.50%	3.50%	3.85%

Source: Bloomberg, Bradesco

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