COMMENTARY
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Emerging Market View: Ahead of the Fed, in the Shadow of Russia

The outlook is poised to darken.

- There is not much to fear from the Fed, but the Russia-Ukraine conflict will take a toll.
- Skyrocketing commodity prices bring more hurt than help.
- Supply constraints limit the upside from higher commodity prices.
- High food prices amplify risks and could stir social unrest.

Emerging markets face an increasingly unsavory table setting. In a rare departure from past global tightening cycles, there is not much to fear from the Federal Reserve, mostly because central banks in the largest emerging economies began to raise rates almost one year ago and remain laser focused on inflation. Rather, high commodity prices and the prospect of a drawn-out military conflict in Ukraine are stirring up the kitchen and reviving old risks, including the prospect of protracted social unrest across the emerging world. With the invasion stretching on, the prospect of only limited disruptions in global commodity markets—the grounding assumption of our March baseline—looks increasingly worn.

With the exception of emerging Europe, where the war has been most deeply felt, the March baseline forecast for most emerging regions carried little change. But the outlook from here on out will grow darker.

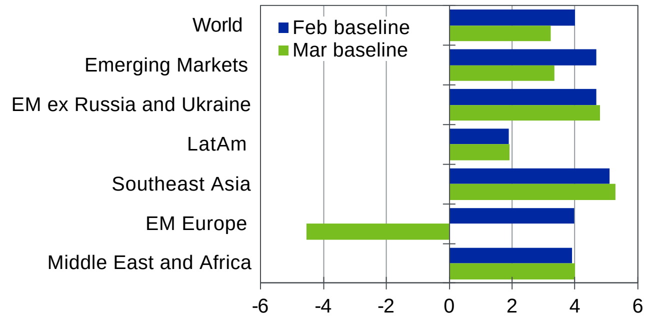
Even if the military conflict reaches a status quo, the disruptions already dealt to commodity markets and global supply chains will trim prospects for already-shaky economies, with more pain for Latin America and a steeper road to recovery for emerging Asia and the Middle East.

Unpacking the March baseline

Our March baseline saw us temper our call for global growth both on account of economic turmoil in Russia and Ukraine—where financial market and trade figures were already flashing red by late February—and from the fallout to core European economies that rely heavily on Russian oil and gas and will hurt most from higher energy prices. The March baseline also featured downgrades to the forecast to the United States and developed Asia, though in smaller servings.

March Baseline a Darker Picture

Real GDP, 2022, % change



Source: Moody's Analytics

The forecast for the rest of the emerging world was little changed, but this was mostly because of a better fourth-quarter showing in Asia and smaller than expected contractions in Mexico and Brazil—Latin America's two largest economies. While we expected Southeast Asia to recover rapidly from Delta-driven setbacks last summer and early fall, trade and industrial production figures for the first two months of the year were blazing hot and will make for a strong first quarter even after accounting for March disruptions.

The economies of Southeast Asia and India also will be scarred by higher inflation and extended disruptions in global supply chains. And China faces its own headwinds from a new COVID-19 outbreak and troubles in the housing market. But combine a strong first quarter that has mostly entered the history books and greater caution for the rest of the year, and the result is a wash. We see a similar pattern in the Middle East and Africa, where a strong first quarter will be tempered by a tenuous rest of the year.

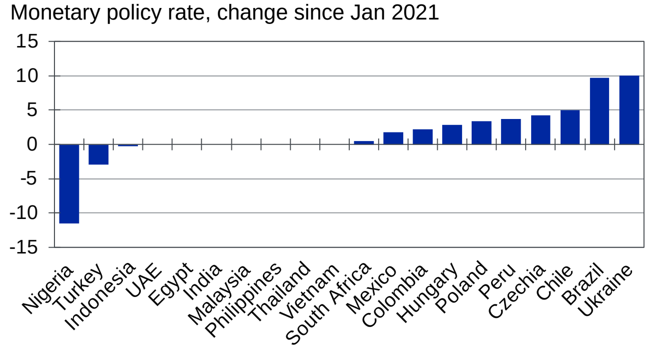
Ahead of the Fed

Rising global interest rates have presaged many an emerging-market crisis, with Fed tightening helping to bring on the Latin American debt crisis in the 1980s and setting the stage for the Asian financial crisis in the 1990s and its global repercussions. But the current tightening cycle is largely on the margin for most emerging economies.

This is because major EM central banks were quick to respond to inflation pressures stirred by the reopening process and have been raising borrowing costs for almost one year ahead of the Fed's March decision to raise rates. Most of these are in Latin America, but central banks in Eastern Europe, Africa and Turkey were quick to tighten the ropes. Last year's selloff in the Turkish lira was largely caused by the central bank's decision to buck rising inflation and lower rates again rather than by anticipation of Fed tightening.

LatAm, EM Europe Ahead of the Fed

Monetary policy rate, change since Jan 2021

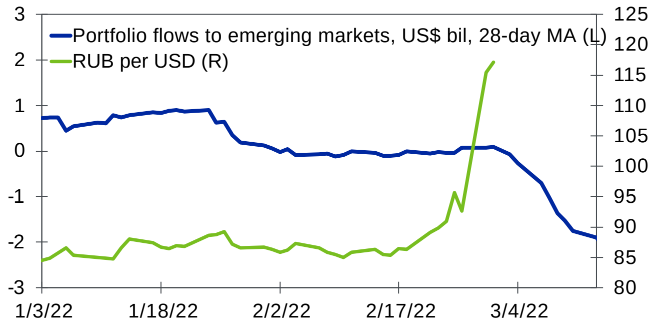


Sources: Central banks, Moody's Analytics

Emerging markets have also been fortified by the rapid recovery in global trade and improvement in external balances, which acted as a form of forced savings. While the reopening process in the U.S. and Europe lifted global trade from pandemic lows, recurrent COVID-19 waves in the emerging world crushed labor markets and snuffed out demand for imports. The result was large trade surpluses, replenished foreign currency reserves, and improvement in current account balances.

Finally, there are few real and financial linkages between Russia and the rest of the emerging world, reducing fears of contagion. Testament to this is that the reversal in emerging market capital flows since the start of the year has been mostly driven by flight from Russia as global investors and Russians themselves sought refuge in safer assets.

Capital Flight Mostly a Russia Story



Sources: Institute of International Finance, Eurostat, Moody's Analytics

While the dollar has strengthened in the current risk-off environment, it has done so mostly against other major currencies. Emerging market currencies, many of them closely tied to commodity prices, have strengthened, and the currencies of Eastern European economies close to Russia and Ukraine have mostly reversed earlier selloffs.

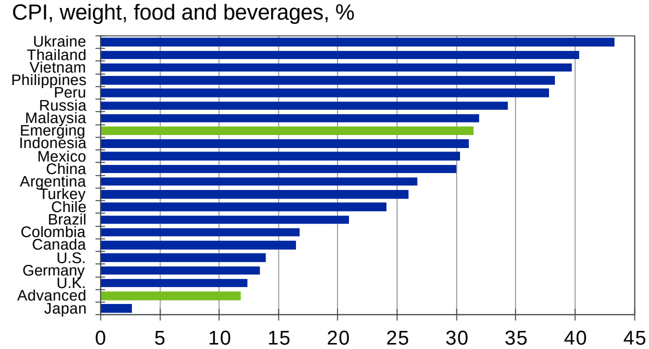
In the shadow of Russia

Gyrations in commodity markets, which saw metals and ag prices strike new highs in recent weeks, have stirred conversation that some emerging economies stand to benefit from extended disruptions. While this could be the case longer term if trade ties with Russia fragment permanently and commodity producers in Latin America, Southeast Asia, and Africa and the Middle East step in to fill the gap, any short-term gains will be more than offset by higher inflation and the consequent erosion of consumers' purchasing power, and by a slowdown in growth stemming from higher domestic interest rates.

Across the emerging world, food and beverage spending makes up an outsize share of the consumer basket. About one-third of the CPI, on average, consists of food and beverage spending for emerging economies, versus around 10% for advanced economy price indexes.

For EMs, Food Takes a Bigger Bite

CPI, weight, food and beverages, %

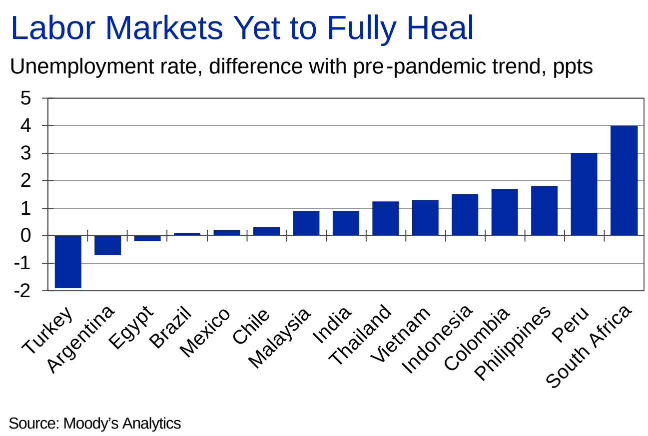


Sources: Statistics agencies, Moody's Analytics

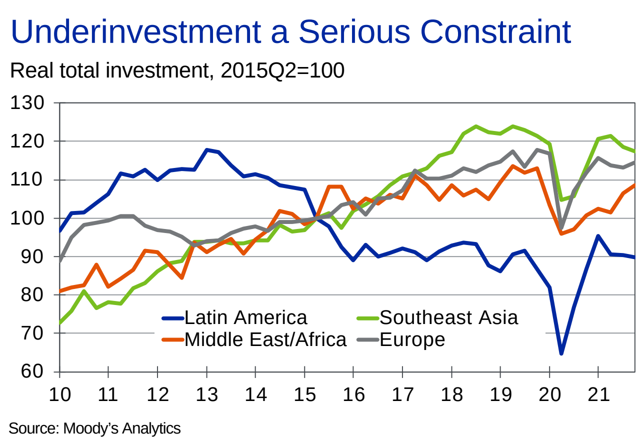
When commodity prices and, in particular, foodstuffs surge, economic damage soon follows. While the

2004-2014 commodities boom is remembered fondly in emerging economies and especially in Latin America, there is a less clear recollection of surging food prices and inflation in 2006 and 2007, which prompted central banks to raise rates and nudged economies into recession. While the emerging market recessions of 2008-2010 were part and parcel of the global financial crisis, rising domestic inflation and aggressive rate-tightening by EM central banks was an important part of the recipe.

If history is a guide, abrupt spikes in commodity prices—like the near doubling of crude oil prices early in 2008—are likely to do more injury than good. This is especially so because in most emerging economies, the labor market has yet to fully heal from the pandemic. In all but three emerging economies—Turkey, Argentina and Egypt—the unemployment rate is still higher than the pre-pandemic average. And lower unemployment rates in these three economies are largely the consequence of how bad things were in the runup to the pandemic with currency crises and inflationary bursts pushing the jobless rate above its trend in the two years prior.



Even if commodity prices remain elevated for longer—our March baseline forecast calls for a peak in the second quarter—there are capacity constraints that will prevent economies from taking full advantage.



Total investment in most emerging regions has not risen meaningfully since 2014, when the commodities boom turned bust, and adding mines, oil wells and crop fields is a process that takes time and requires greater certainty with respect to global economic conditions.

The risks intensify

The intensification of fighting in Ukraine in the past week will mean current disruptions in global commodity markets last longer. There will be markdowns to growth across emerging regions in the coming April forecast, and odds are they will be on the larger side. At this point, the risks are well known. Higher inflation, extended supply-chain disruptions, a more severe global tightening cycle, and the possibility that a potential default in

Russia darken sentiment around fiscally troubled emerging markets. Mentioned less often are the political shock waves in the Middle East and beyond sparked in part by surging food prices in the mid-2000s. Pandemic fatigue has driven greater fault lines in already fragmented politics, and the risk of social unrest and the elevation of unorthodox economic policies should not easily be discarded.