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Monetary tightening amid heightened uncertainty: implications for emerging markets

The U.S. Federal Reserve (Fed) raised policy rates by 25 basis points, as had been widely expected. The accompanying detail of the statement and press conference leaned hawkish:

- The new dot plot shows a median projection for the benchmark Fed funds rate to end 2022 at about 1.9% and rising further to about 2.8% in 2023
- Fed Chair Powell signaled that a 50 bps increase remains a possibility, adding "every meeting is a live meeting"
- On quantitative tightening, the Fed indicated it would come at a "coming meeting", likely as soon as May
- Finally, St. Louis Fed President James Bullard dissented in favor of a half-point hike, the first vote against a decision since September 2020.

In all, the Fed is signaling a much faster pace of tightening in the face of significantly higher than previously anticipated inflation of 4.3% this year, even as it cut its forecast for GDP growth from 4% to 2.8%.

The latest disruption to global supply chains and surge in commodity prices due to the Ukraine crisis has amplified the dilemma facing major central banks, including the Fed. On one hand, these disruptions will push headline inflation (and inflation expectations) even higher; on the other, it'll amplify the squeeze on real incomes, economic activity, and core inflation further ahead. Tightening into this environment risks exacerbating the downside risks to economic growth. There's very little monetary policy in isolation can do to address cost-push inflation.

Yet many central banks are pushing ahead with monetary policy normalization, from Bank of Canada and European Central Bank last week, to the Fed this week. Quite apart from the questionable efficacy of tightening into a negative global supply shock, this dynamic has important implications for global liquidity. Global liquidity *growth* has slowed markedly—from a record 21.5% in March 2021 to 5.4% last week, the slowest rate since April 2020.¹ A declining global liquidity impulse is most relevant to emerging-markets (EM) growth and earnings, but it also has broader relevance to risk assets.

¹ Bloomberg, Macrobond, Manulife Investment Management, as of 14 March 2022.

Chart 1: Annual growth in global money supply



Source: Bloomberg, Macrobond, Manulife Investment Management, as of 14 March 2022. YoY refers to year over year.

We're still of the view that policymakers' concerns over high inflation will ultimately give way to worries about slower growth. Without structural reform, the real economy is in no shape to absorb any amount of tightening. We're aware this may sound difficult to believe, especially when the popular press has been at pains to tell us how many economies have recovered COVID-19-related damage. But no one ever asks, "is this actually good enough?"

We've argued that the prepandemic level of output was nothing to aspire to and that policymakers were, perhaps, aiming too low. At the end of 2019/early 2020, before anyone knew what the word COVID-19 would come to represent, this was the state of the global economy:

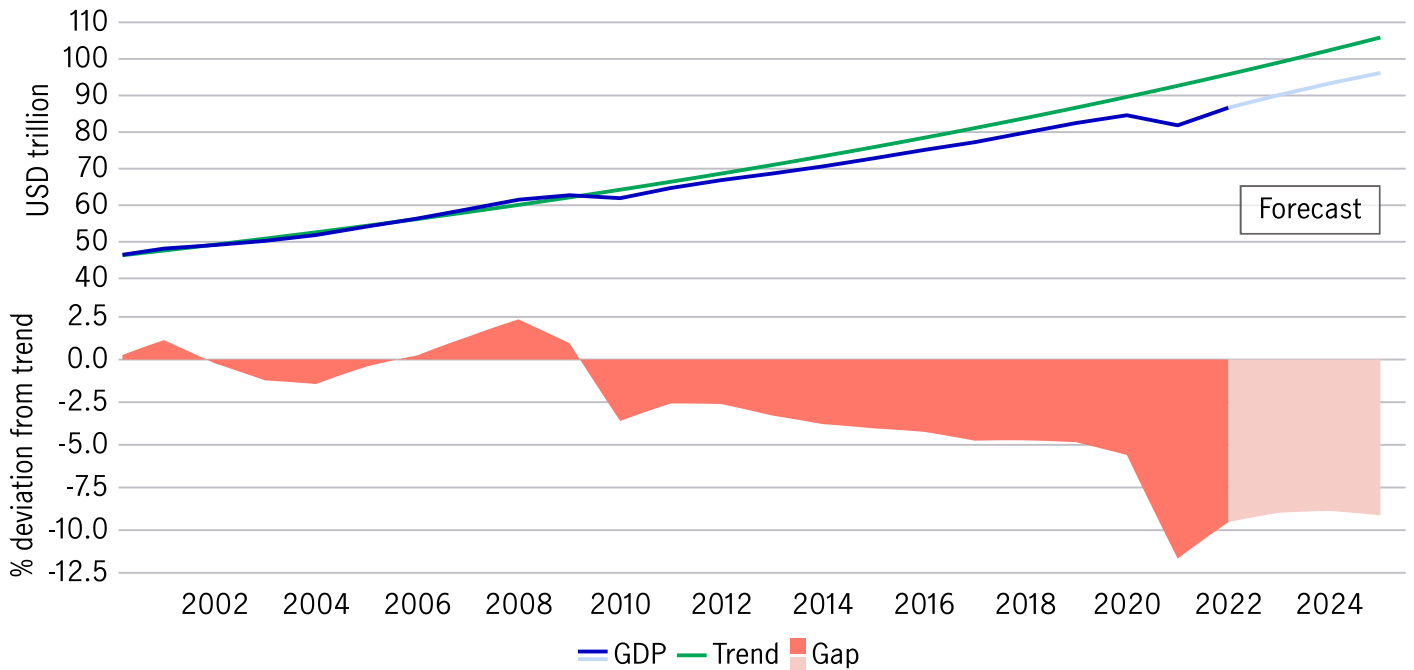
- The World Bank described 2019 as a year during which "[weak trade and investment dragged the world economy to its feeblest performance since the global financial crisis](#)"
- The International Monetary Fund noted that global growth has fallen sharply, and that the slowdown in economic activity has been "more

pronounced" across EM and developing economies, with a few economies "[suffering macroeconomic and financial stress](#)"

- The Organisation for Economic Co-operation and Development noted that the global outlook was "unstable," and notably, that "[risks of even weaker growth remain high, including from an escalation of trade conflicts, geopolitical tensions, the possibility of a sharper-than-expected slowdown in China, and climate change](#)"
- Real global GDP finished 2021 9.5%² below its long-term trend and was in a worse shape relative to the end of June 2020. At the same time, the global debt mountain has increased to a record high of [US\\$303 trillion](#). On the basis of current consensus forecasts, the GDP gap will still be 9.1% below trend at the end of 2024.²

² Bloomberg, Macrobond, Manulife Investment Management, as of 14 March 2022.

Chart 2: World real GDP versus trend



Source: Food and Agricultural Organisation of the United Nations, Maddison Project Database, World Bank, Macrobond, Manulife Investment Management, as of 14 March 2022.

This is what the U.S. yield curve has been signaling for months. Most prominent among those, the euro-dollar futures and, of course, the 2-year/10-year yield curves, which are flatter today than at any point in the past 18-24 months. The near inversion is happening at extremely low nominal levels, which highlights the precarious state of the global economy. In our view, attempts to rein in rampant cost-push inflation by normalizing interest rates and shrinking balance sheets look a lot like policy errors. We anticipate a dovish Fed pivot in Q3 and the Fed's tightening cycle to ultimately fall short of the market's current pricing¹ in terms of its pace, magnitude, and duration.

Do we need to worry about another Fed tantrum in emerging markets?

A question that we keep coming across is whether we will witness another episode of taper tantrum (like we did in 2013 and, to a lesser extent, in 2018) if and when the Fed embarks on a tapering exercise?

From a macro perspective, there are two ways to answer this question. Let's start with the positive: broadly speaking, emerging-market economies are in a stronger position now relative to before.

In 2013 and 2018, many EMs were heavily exposed to external financing. Current account deficits were commonplace, as were limited foreign exchange (FX) reserve buffers to deal with bouts of currency depreciation. This devolved into a negative feedback loop in many instances; however, this time around, those vulnerabilities aren't as stark.

- **External positions have improved**—The collapse in domestic demand due to pandemic-related restrictions helped to strengthen external balances through most of 2020 and 2021. Within Asia, India and Indonesia have made strong improvements on this front. In other parts of the EM universe, South Africa and Poland stand out.
- **EM central banks have built up stronger FX reserve buffers**—Within Asia, India and Thailand have made strong improvements on this front. Outside of Asia, the Czech Republic and Colombia stand out.
- **EM FX valuations aren't as stretched**—In real effective exchange rate terms, EM currencies are generally weaker relative to 2013 and therefore less prone to sharp depreciation risk. Within Asia, Singapore and Malaysia are better placed to deal with any upcoming periods of volatility relative to

2013. Latin America, however, is notably weaker on this front, with Colombia, Peru, and Chile being the most vulnerable.

That said, it's worth noting that the nature of risk in EM has changed in important ways.

1 **The growth differential between EM economies and developed-market economies has narrowed**

In our view, the economic growth outlook for EM is relatively more depressed versus 2013 and 2018. The traditional growth advantage EM offers relative to developed markets has been eroding for years and is a phenomenon that predates COVID-19.

2 **Real interest rates in EM are generally more negative**

Real interest rates in most EM economies are in negative territory. This implies that regardless of how high nominal interest rates in EM economies may seem, they might not be able to prevent foreign capital outflows should the Fed's tapering trigger capital flight. Some EM economies have begun to tighten policy to head off this risk at the expense of lower economic growth.

3 **Fiscal positions among EM economies are generally weaker**

The pandemic has depressed tax revenues just as governments were ramping up public spending in the face of the pandemic. As a result, fiscal deficits widened sharply across EM. Wider fiscal deficits mean higher public debt-to-GDP ratios. While EM economies tend to have lower debt levels than their developed peers (where debt typically exceeds 100% of GDP), they won't have a free hand to use central-bank-funded fiscal stimulus to support economic activity. In our view, EM economies with high debt and heavy dependence on foreign capital could risk a severe test of policy credibility if the Fed tapers.

4 **EM reliance on international funding conditions is generally higher**

Whether EM policymakers can support their local economies amid continued COVID-19 outbreaks in the event the Fed tapers will also depend on a number of additional factors. Key among them is the degree to which government finances rely on international funding conditions—even if most debt issuance is denominated in the local

currency, governments may still be exposed to international conditions if foreign investors own a high proportion of their local-currency debt.

5 **Some EM economies have become more reliant on foreign-ownership in the local debt and equity markets**

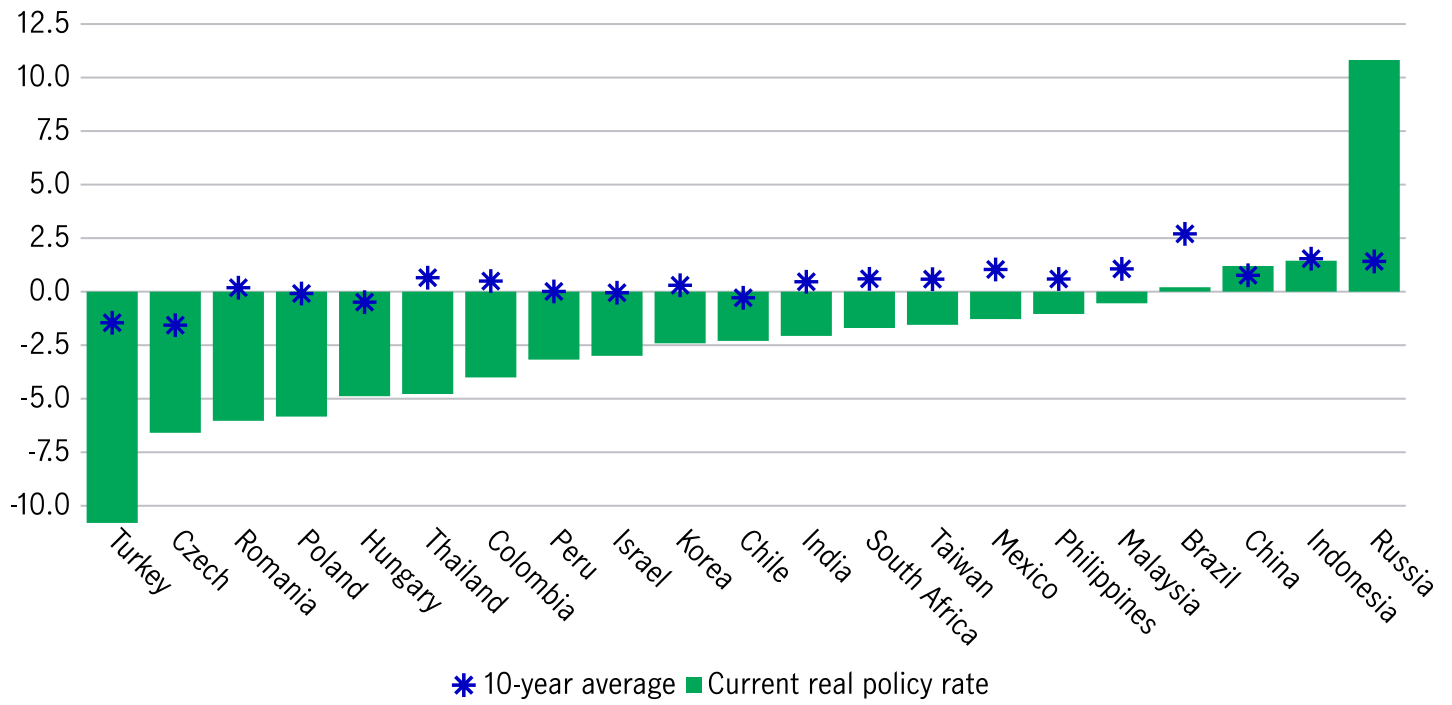
Another constraint on policy action is the risk of disorderly portfolio outflows. EM economies with a high level of foreign ownership in local debt and equity markets relative to official foreign exchange reserves are at the greatest risk. Where foreign ownership is low compared with central bank foreign exchange reserves, such as in India, policymakers have greater scope for action, all else being equal.

The March FOMC meeting told us that the Fed is still prepared to proceed with rate hikes to fight near-term inflation. Meanwhile, geopolitical risks and risk aversion remain elevated and looks set to continue rising. Add in an extended stagflationary environment and we'll be looking at macroeconomic conditions that are typically not conducive for EM; however, should investors throw the baby out with the bathwater? The answer, in our view, is "No." In fact, a comprehensive analytical approach reveals a high degree of differentiation within this asset class. As such, relative value can be captured in a diversified manner, even amid bouts of heightened global market volatility.

That said, it's clear that investors will likely need nerves of steel in the coming weeks and months. The determined effort by global central banks to normalize rates amid heightened uncertainty and low visibility isn't likely to help. Without meaning to sound glib or opportunistic, we believe this is an environment that favors an active investment approach. Investors should proceed with caution.

Chart 3: EM economies are running out of space for conventional monetary easing

Current real policy rate versus 10-year average (%)



Source: National central banks, National Statistic Offices, Macrobond, Manulife Investment Management, as of 14 March 2022.

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