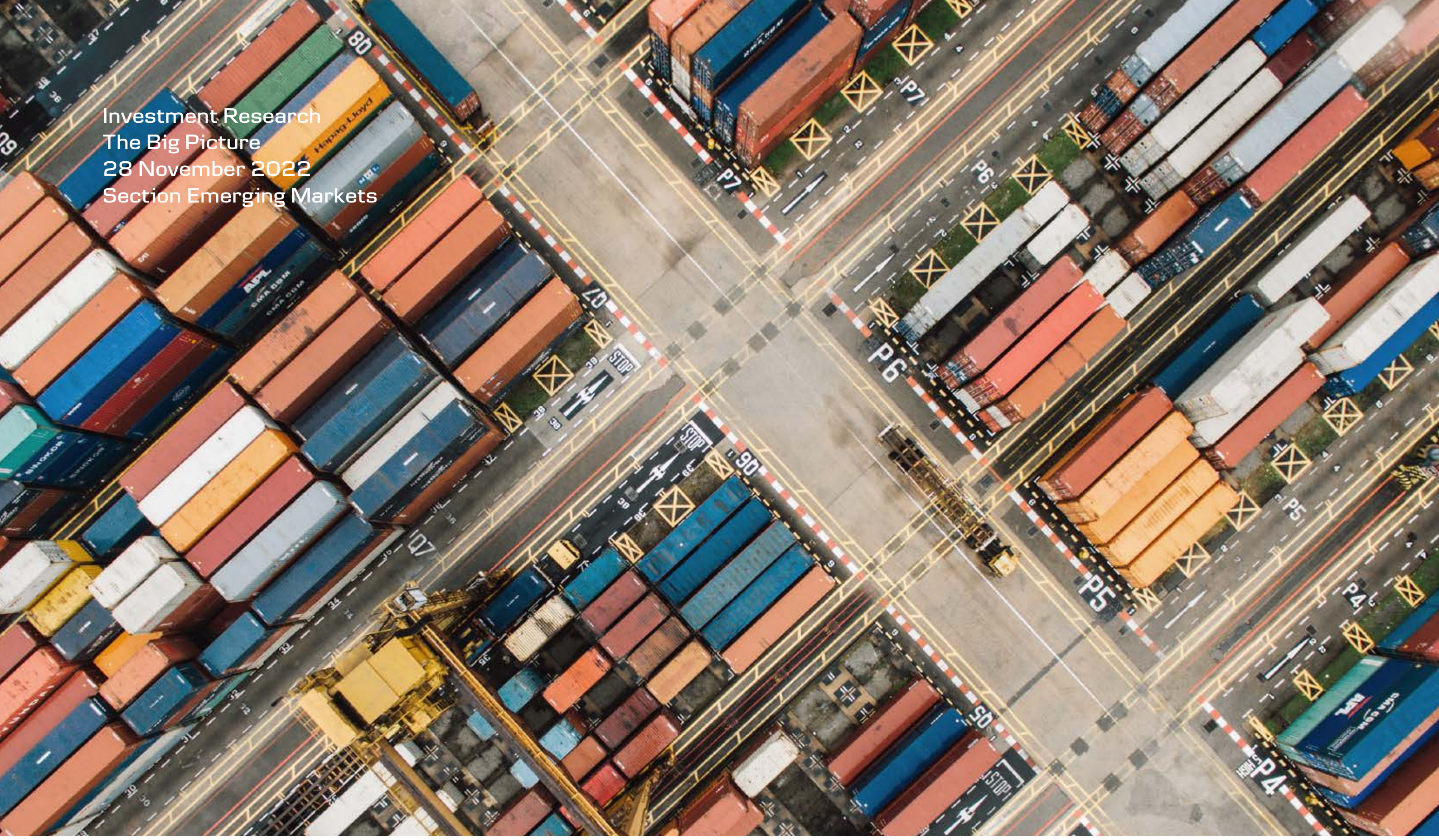



# *Emerging Markets*

## In the eye of the storm

- Large economies are heading into a recession at a time when most emerging economies have yet to fully recover from the pandemic-related economic shock.
- Tighter financial conditions imply higher financing costs for emerging economies, while a stronger US dollar increases the relative burden from USD-denominated debt.
- Several EM economies have already lost access to financial markets and more are likely to follow. More than ten countries have resorted to the IMF this year, seeking support for their balance of payments crises.
- We take a special focus on Latin America, where economic performance this year has been better than expected, many central banks resorted to pre-emptive tightening and a new leftist wave has swept across the continent.

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In the context of tightening global financial conditions, a stagnating world economy and a stronger US dollar, we think emerging economies will struggle to catch up, especially those that were already lagging behind in the global post-pandemic recovery story. While headline inflation has peaked in low-income economies, where food and energy comprise a larger share in the consumption basket, it continues to rise in middle-income economies. Overall, the exceptionally wide differential in headline inflation rates between middle-income and high-income countries underlines how lower-income economies are disproportionately affected by the ongoing cost of living crisis.

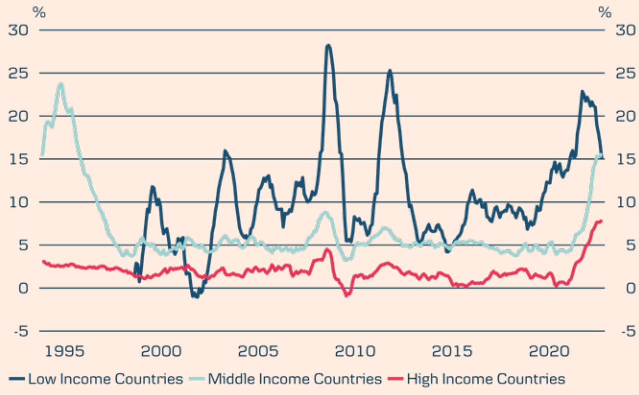
Tighter financial conditions affect EM economies through three channels: 1) financing costs rise following higher credit risk premia, 2) a stronger US dollar increases the relative burden from USD-denominated debt, and 3) access to funding deteriorates as foreign investors prefer low-risk assets that now yield positive nominal returns. In this context, EM economies with substantial external vulnerabilities such as high debt, budget and current account deficits and limited foreign reserves, face the highest risk of acute balance of payments or FX crises. Trade exposures, reliance on specific trading partners such as China or significant reliance on imported fuels add to FX vulnerabilities. Local central banks also play a key role, as too loose monetary policies imply negative real rates that tend to trigger capital outflows.

Since the onset of Russia's war of aggression against Ukraine, at least 13 countries have resorted to the IMF and have received, or are set to receive, support for their balance of payments crises. According to the World Bank, nine emerging market (EM) economies are in acute debt distress and almost 30 countries face high risk of such. With a few exceptions, these are Sub-Saharan economies. Yet, fiscal space is also very limited in G20 emerging economies, such as Brazil, India and South Africa, where budget deficits and debt levels remain elevated after the pandemic. Excluding the very low-income economies, the most exposed EM economies in our view currently include Turkey, Poland, India, Pakistan and Egypt[1]. In contrast, most Latin American countries, as well as Malaysia, Indonesia and Vietnam, despite each having some vulnerabilities, rank among the least exposed.

In the longer term, some EM economies are set to benefit from businesses and investors diversifying away from their exposure to China. The reshuffling of supply chains is likely to benefit economies with sufficient supply of affordable yet skilled labour and economies that foster an enabling business environment with limited political (and sanction) risk. In our view, some economies particularly in Eastern Europe and in Southeast Asia pose significant potential for alternative production locations.

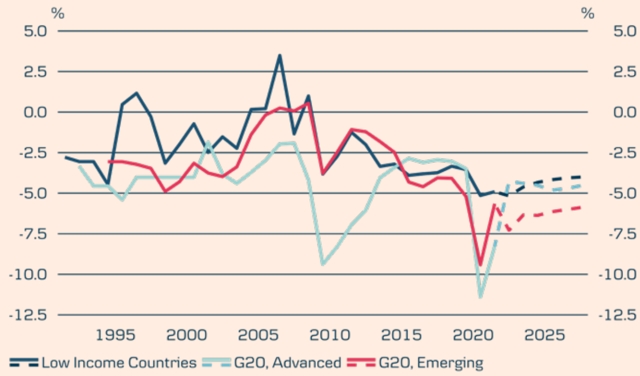
[1] excluding small economies, such as Sri Lanka. Note, the analysis has been conducted to a selected group of Danske Bank's core emerging markets.

### Headline inflation has peaked in low-income countries but continues to rise elsewhere



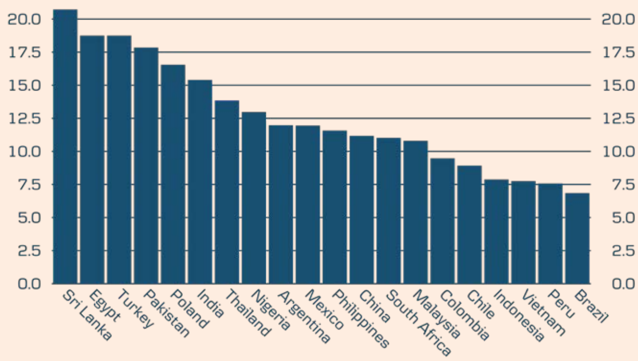

*Source: World Bank Global Economic Monitor, Macrobond Financial, Danske Bank*

### G20 emerging economies have very limited fiscal space to compensate for citizens amidst the cost of living crisis




*Source: IMF Fiscal Monitor, Macrobond Financial, Danske Bank*

### Higher score implies greater vulnerability to external conditions



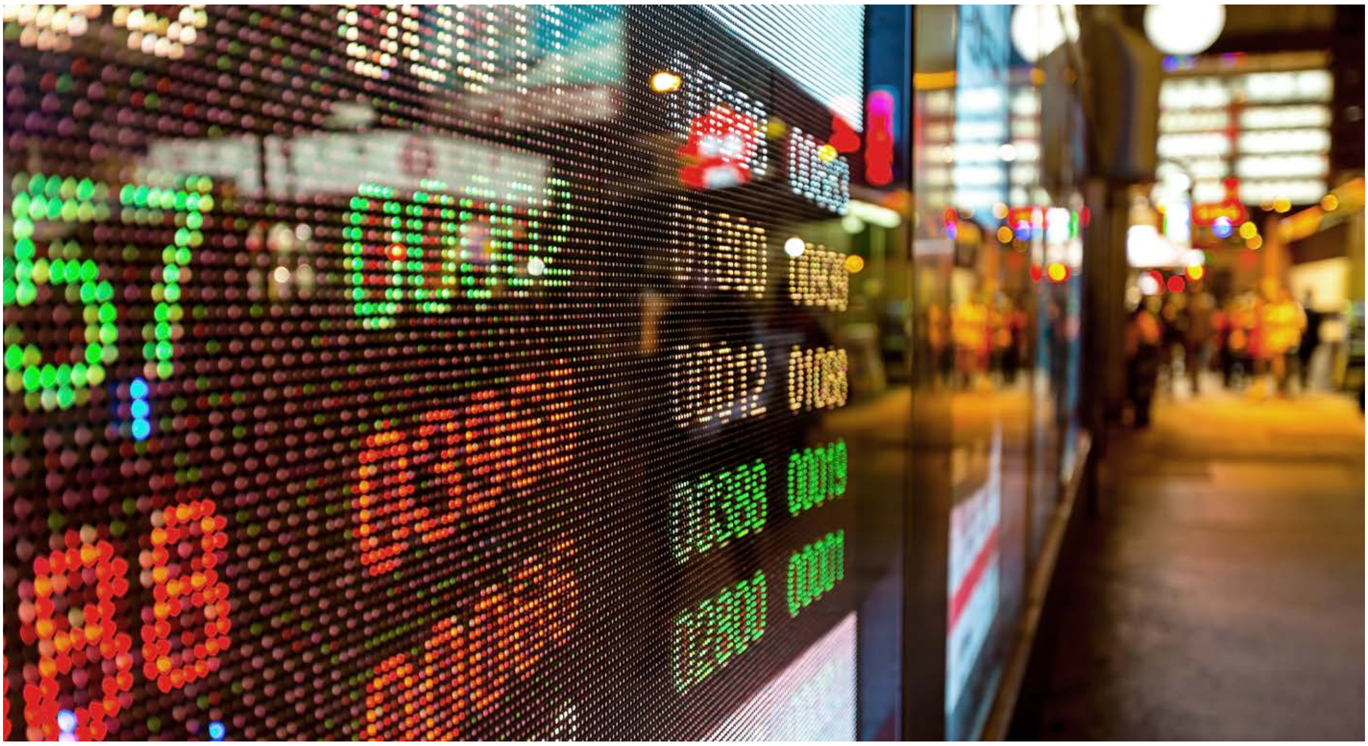

*Source: Macrobond Financial, Danske Bank calculations*

## *Is Latin America getting it right for once?*

The Latin American region is infamous for its chronic sovereign debt problems and striking inequality. With the exception of Mexico, who has managed to climb up in global value chains, most Latin American economies continue to depend on commodity exports, which makes their economic performance volatile. Commodity reliance also implies heavy exposure to China, whose manufacturing industry is the driving force for global raw material demand. Hence, when looking for a model example of a country running sound economic policies, one would tend to look anywhere but Latin America.

Despite the factors mentioned above and thanks to high commodity prices, Latin America has outperformed this year. In the four largest economies (Brazil, Mexico, Argentina and Colombia), GDP growth has exceeded expectations. The Brazilian real, despite the political risk associated with the recent presidential election, is the best year-to-date performer in the EM FX space. Then comes the Mexican peso, which by mid-November had gained 5% against the US dollar. These currencies' remarkable resilience amidst the broad USD strength underlines the importance and the success of the pre-emptive monetary policy tightening conducted by local central banks, which started hiking rates well before the Fed. Brazil hiked already in March 2021; Mexico, Colombia and Chile all followed in the second half of 2021. Unlike Western economies, these economies now run close-to-neutral or positive real rates and in Brazil core inflation seems to have peaked.

Does the 'lesson learning' extend to politics? A fresh 'pink tide' has swept across the region, as left-of-centre candidates have been elected in Mexico, Argentina, Peru and Chile in recent years. This year brought the first-ever leftist leader in Colombia, while Brazil, under the leadership of Lula, is now the latest to turn left. The 'new Left', largely, is striving to distance itself from the 'old Left' and the likes of Cuba and Nicaragua. Climate and social justice are at the core of their agenda. Many Latin American economies supply raw materials that are crucial for the global green transition and electrification of societies, such as metals and critical minerals. In Brazil and Colombia, and broadly across the region, the share of renewables in electricity production is already high (above 60%). Hence, in a region, where decades of efforts to reduce poverty and inequality have been watered down by incompetent policies and corrupted politicians, more inclusive economic policies may now resonate with foreign investors more than ever. That is as long as fiscal discipline remains. Talk is cheap, and implementation is the hard part. The new Left shows promise, but is yet to prove they are any better and more capable than their predecessors.



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