29 October 2021

Research EM

Surging commodity prices adds to emerging market vulnerabilities

- **Rising fuel and metal prices leave importers exposed at a time when slow progress in COVID-19 vaccinations threatens to derail economic recovery and looming US rate hikes highlight external vulnerabilities.**
- **Most EM countries in Europe, Asia and Latin America are hurt by higher fuel prices. Turkey, India and Egypt are particularly vulnerable as their external positions are weak to begin with.**
- **In longer term, the global transition to clean energy technologies will benefit net metal exporters, also further boosting China's prominence in the global economy.**

High fuel and metal prices pose another risk to EM outlook

Rising energy and metal prices are a double-edged sword for emerging markets. While net exporters welcome the booming prices, net importers face a rising imports bill. For many economies, rising import costs will further undermine their already weak external position. Acute energy shortages could also lead to electricity rationing and power cuts locally, derailing fragile economic recovery. The energy crisis hits the EM at a time when slow progress in COVID-19 vaccinations is leaving many countries exposed to further negative impacts from the pandemic (See Chart 1). In the context of rate hikes approaching in the US next year and anticipated USD strength, there is a risk of abrupt reversals in net capital flows, adding pressure on EM currencies and debt.

Prices expected to level off, but risks are tilted to the upside

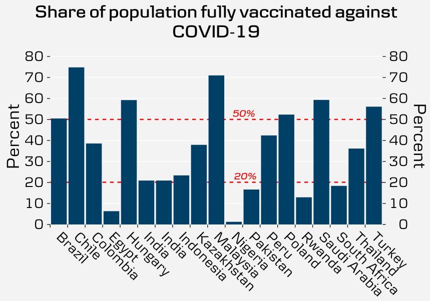
In our baseline, we see oil prices in the range of USD 75-80 for the next two years. OPEC has shown little signs of easing the current tight supply, but if prices continue materially higher from here, a combination of both a response from OPEC and our view of stronger USD should limit the rise over medium term. On the other hand, downside is limited due to low investments into production over the past years. For natural gas, the combination of low supply from Russia, limited availability of LNG globally and low renewables production in Europe is likely to keep the prices elevated through winter's heating season, as we wrote in *Research Euro Area - Looming energy crisis creates a perfect storm*, 4 October.

For metals, the fading growth in China combined with high costs of energy-intensive steel production have already weighed on iron ore producers' terms-of-trade, including Brazil and South Africa. High energy costs continue to contribute to tight refined metals supply for now, but ultimately the Chinese construction sector downturn, increased focus on environmental challenges and deleveraging imply at least moderately lower metal prices over medium term, read more in *Research Global - Power crunch supports metal prices despite fading demand*, 18 October.

Related readings

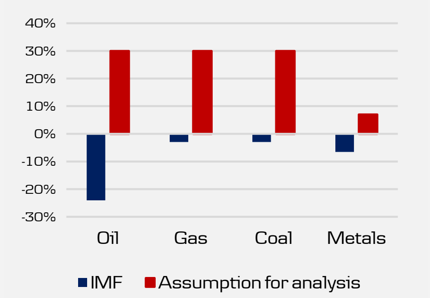
- *Research Euro Area - Looming energy crisis creates a perfect storm,* 4 October
- *Power crunch supports metal prices despite fading demand outlook, 18 October*

Chart 1: Vaccination campaigns are progressing slowly



Sources: Our World in Data, Macrobond

Chart 2: IMF price projections relative to average 2021 level



Sources: IMF WEO, Danske Bank

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The IMF WEO projections factor in a fall for oil, gas and metal prices in 2022 (See Chart 2). While we expect both energy and metal prices to broadly moderate from the current elevated levels, near-term risks are tilted to the upside. We ran calculations assuming fuel prices 30% higher and metal prices 7% higher compared to IMF baseline, and analysed the combined impact on current account balances (See Chart A1 in the Appendix). While this is not in our baseline, the idea is to highlight vulnerabilities in a 'what if' scenario.

Energy crisis to expose external and domestic vulnerabilities across EM

Many emerging and frontier economies run current account deficits, leaving them exposed to sudden reversals in capital flows and currency depreciation (See Charts 3 and A2). From a pure CA balance perspective, amongst CIS and EMEA countries, Turkey is in the most fragile position. Across Middle East and North Africa, Egypt and Pakistan are the most exposed. In Sub-Saharan Africa, several economies run significant deficits, while Asian countries, apart from the exception of Cambodia, are generally in a stronger position. In Latin America, Chile is the most vulnerable while Brazil also runs a deficit.

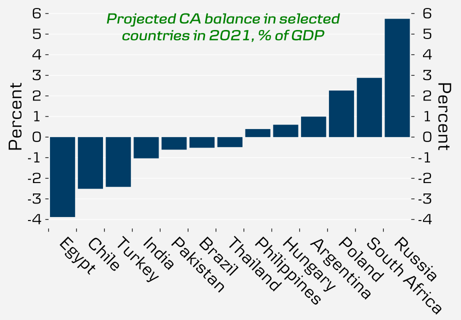
Considering a positive commodity price shock, net exporters will benefit, while net importers will be hit. In Europe, Asia and Latin America most EM economies are net fuel importers, hence only a few benefit from higher prices (See Charts 4 and A3-A6). The dataset for net metals exports talks a similar story, although different countries gain (Chart 5 and A7-A10). Countries like Russia and Kazakhstan, Venezuela and Colombia as well as oil and gas producing countries across Middle East and Africa are the obvious winners from higher fuel prices, while Chile, Peru and Mozambique benefit as metal prices rise.

Chart 6 illustrates the combined net impact on CA balance as %-points of GDP if fuel and metal prices remain high. Chart 7 maps the combined impact on current account against the baseline. Ukraine and Cambodia could see their current account deficits widen by more than 2 %-points of GDP while India, Poland, Egypt and Turkey would also see rising deficits. All these economies face the risk of currency depreciation as their external position is being undermined, but some countries are more vulnerable than others as they on top of the large energy bill also have large external debt exposures. In the context of tightening global financing conditions, countries with high external debt and a large share of foreign ownership could be particularly sensitive to changes in investor sentiment (Chart 8). **Combining the different factors leaves Hungary, Poland, Turkey and to some extent Egypt, particularly exposed.**

Apart from the terms of trade impact, negative implications for growth are likely if acute energy shortages result in load-shedding and blackouts at a local level. In India, for example, *some states have already begun load-shedding* due to coal shortages. Considering country-specific energy mixes, Hungary, Pakistan and Egypt stand out as vulnerable to high gas prices given the relatively high share in electricity production (See Chart A11).

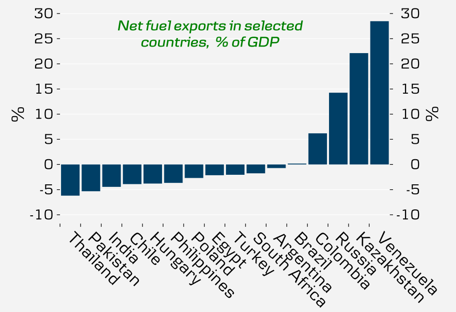
On the other hand, aside from China, countries heavily relying on coal for energy production include India, South Africa and Poland, although the last two are protected by their domestic production (See Chart A12).

Chart 3. Egypt, Chile and Turkey are the most vulnerable from a CA perspective



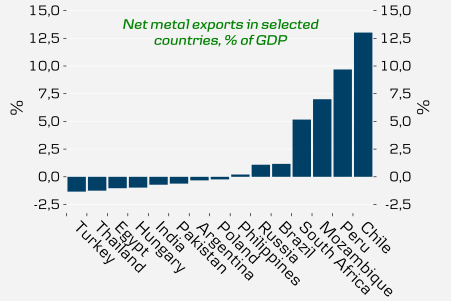
Sources: IMF WEO, Macrobond

Chart 4. Most EM economies are net fuel importers



Sources: WTO, Macrobond, Danske Bank

Chart 5. Chile, Peru and Mozambique benefit from higher metal prices



Sources: WTO, World Bank, Macrobond, Danske Bank

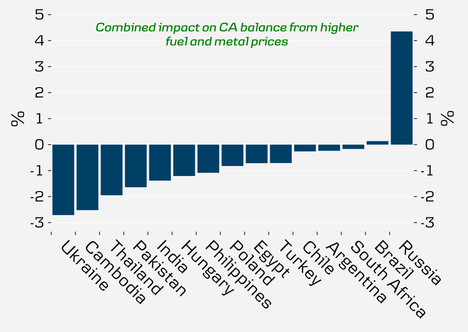
Energy transition could benefit metal exporters in the long term

While the short-term outlook for net fuel importers is challenging, in longer term, the global transition to clean energy technologies could hurt exporters. At the same time, metal exporters could benefit as the transition is expected to substantially boost global demand for industrial and rare earth metals. The IEA has estimated that with current energy policies the world is on track for a doubling of overall mineral requirements for clean energy by 2040, while reaching the goals of the Paris agreement would mean a quadrupling of mineral demand. The increase will be driven primarily by electricity networks, electric vehicles and battery storage. Substantial amount of minerals is also needed for wind and solar PV plants.

While demand trajectories related to green transition are subject to significant technology and policy uncertainties, it is safe to assume that the transition will substantially boost the demand of different metals. Clean technologies are already becoming the fastest-growing segment of demand, and in an IEA-modelled Paris-aligned scenario their share rises to 40-90% of total demand depending on the metal. Significant increases are expected in demand volumes of e.g. copper, nickel, aluminium, zinc, cobalt, graphite and rare earth elements.

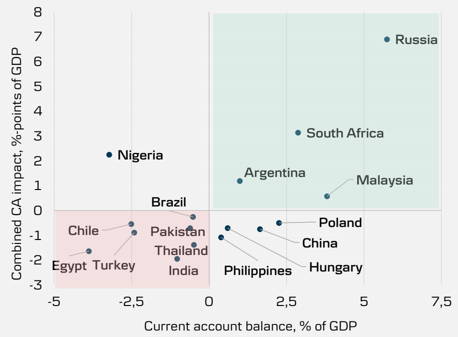
Metal production has a higher geographical concentration than fossil fuel production. This means that rising demand is likely to benefit only a handful of countries. For example, China dominates the extraction and processing of rare earths, graphite and lithium. It also has a key role in nickel and copper production. Chile and Peru are big players in copper as well, while the Democratic Republic of the Congo dominates cobalt extraction. Assuming green transition leads to larger traded volumes in metals (and potentially higher prices), and lower volumes for fossil fuels, the main winners would be Chile, Peru and South Africa, countries that export metals and import fuels (Chart A13). On the opposite, Qatar, Angola, Saudi Arabia and Venezuela, stand to lose the most if the world reduces its dependence on fossil fuels.

Chart 6. Commodity price shock hits particularly EM Europe and Asia



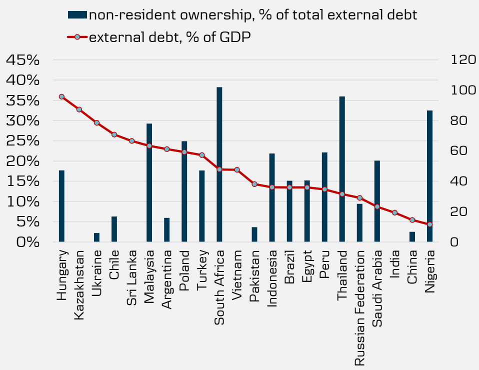
Sources: IMF WEO, WTO, World Bank, Macrobond, Danske Bank

Chart 7. Combined impact on CA balance from higher fuel and metal prices mapped against baseline



Sources: IMF WEO, WTO, World Bank, Macrobond, Danske Bank

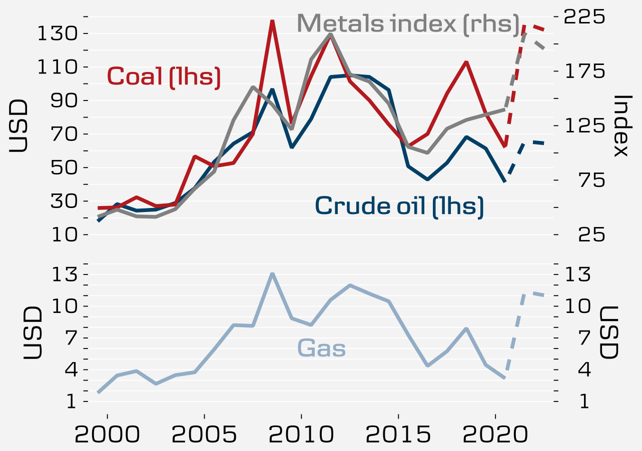
Chart 8. External debt as a % of GDP and non-resident ownership



Sources: IIF; Danske Bank

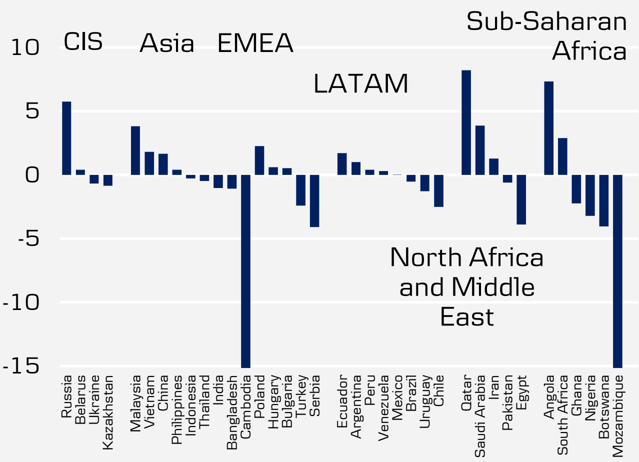
Appendix 1. Chart Pack

Chart A1. IMF WEO commodity price projections



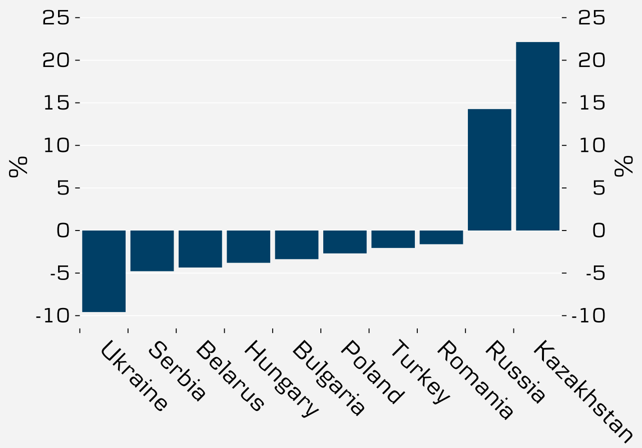
Source: IMF WEO, Macrobond

Chart A2. Current account balance in 2021, % of GDP



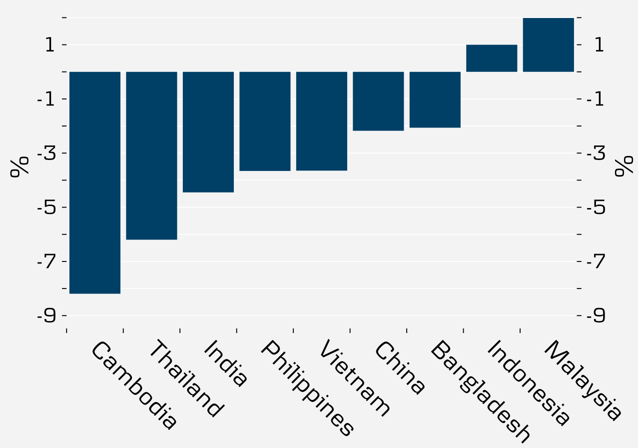
Source: IMF WEO, Macrobond

Chart A3. Net fuel exports amongst a selection of countries in CIS and EMEA, % of GDP



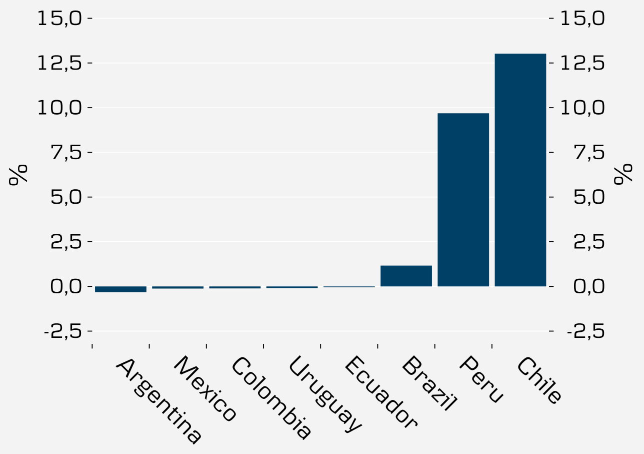
Source: WTO, Macrobond, Danske Bank

Chart A4. Net fuel exports amongst a selection of countries in Asia, % of GDP



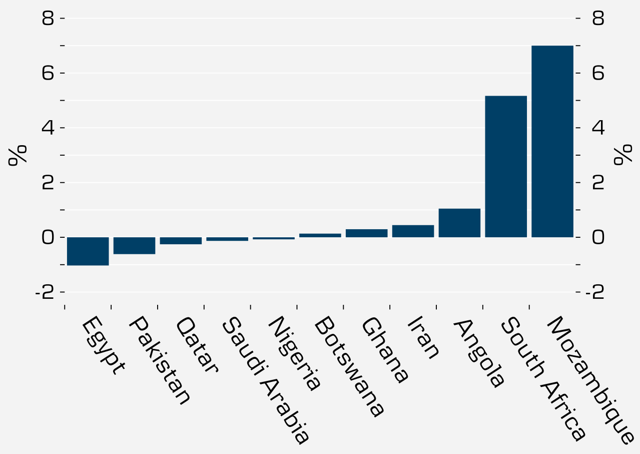
Source: WTO, Macrobond, Danske Bank

Chart A9. Net metal exports amongst a selection of countries in LATAM, % of GDP



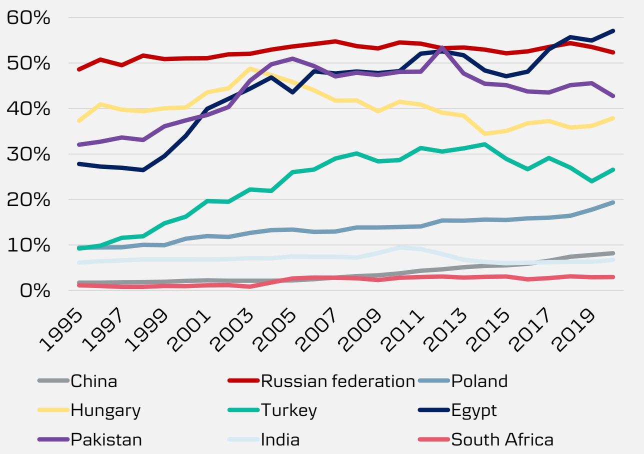
Source: World Bank, Macrobond, Danske Bank

Chart A10. Net metal exports amongst a selection of countries in MENA and Sub-Saharan Africa, % of GDP



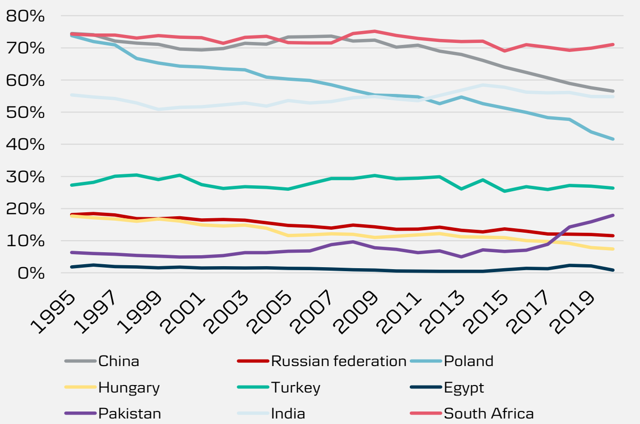
Source: World Bank, Macrobond, Danske Bank

Chart A11. Gas share of total energy consumption



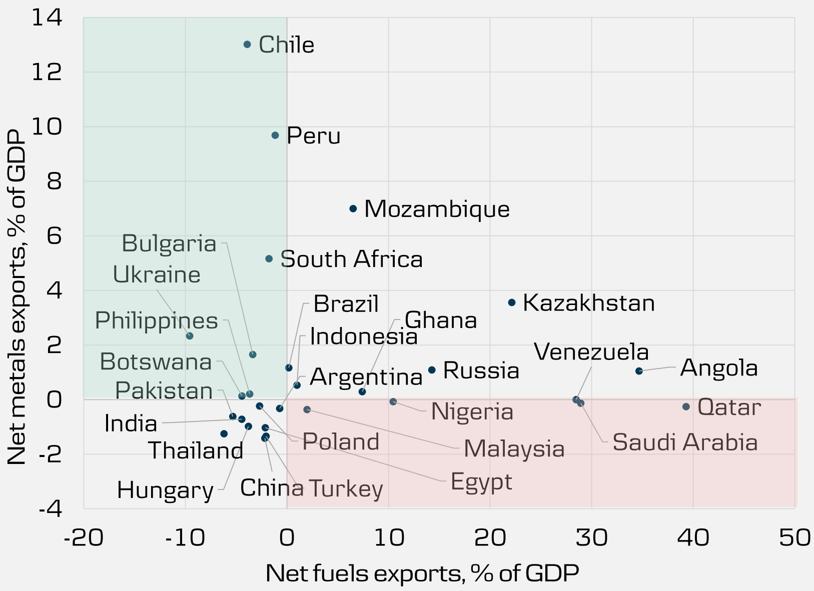
Sources: BP Statistical Review, Danske Bank

Chart A12. Coal share of total energy consumption



Sources: BP Statistical Review, Danske Bank

Chart A13. Net metal exports mapped against net fuel exports



Sources: IMF WEO, WTO, World Bank, Danske Bank

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Minna Kuusisto, Chief Analyst, and Antti Ilvonen, Analyst.

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None

Date of first publication

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