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International Commentary — July 7, 2023

Emerging Market Central Banks Are About to Get Active

Summary

We believe emerging market central banks are on the cusp of initiating, or in select cases continuing, monetary easing cycles. Our *Mid-Year 2023 Outlook* publication highlighted this view; however, our updated monetary policy space framework reinforces this outlook and confirms that many emerging economy central banks have space to cut interest rates before the end of this year. With that said, we believe financial markets are priced for too much easing. So, while we forecast emerging market currency depreciation through the end of 2023, markets adjusting to more cautious easing cycles should contain the extent of depreciation and result in only modest EM FX weakness through the end of this year.

Economist(s)

Brendan McKenna
International Economist | Wells Fargo Economics
Brendan.McKenna@wellsfargo.com | 212-214-5637

Emerging Market Central Banks Have Policy Space for Rate Cuts...

The International Economics Mid-Year 2023 Outlook focused on our view that the global economy is at an inflection point. In our opinion, conditions are evolving in such a way where global growth has peaked and the direction of monetary policy is set to change. We spoke at length about the Fed and G10 central banks approaching the end of their respective tightening cycles; however, we also highlighted how institutions across the emerging markets will be making a more explicit shift toward easier monetary policy in the second half of 2023. This idea comes from the fact that many emerging economy central banks tightened monetary policy earlier and more aggressively than institutions in the advanced economies. Early and aggressive inflation fighting action have yielded positive effects as inflation, both headline and core, are now on sustainable downward trajectories for most countries in Latin America, EMEA and emerging Asia. Improving inflation dynamics have already led to select institutions initiating easing cycles, and the evolution of broader economic and financial market conditions over the first half of this year lead us to believe more EM central banks will actively pivot to interest rate cuts before the end of this year.

While we already forecast many EM central banks to begin lowering policy rates in the near future, we have updated our monetary policy space framework for more visibility into the dynamics policymakers are likely to consider when setting interest rates. Our framework contains four variables: real interest rates, inflation relative to central bank target ranges, economic growth and local currency performance. We define “real interest rates” as the current policy rate minus actual inflation. Typically, the more positive a real interest rate is, the more space a central bank has to lower interest rates. “Inflation from central bank target” utilizes a forward-looking assessment of year-over-year CPI and how far inflation is expected to be from target ranges by the end of this year. Using a forecast allows us to consider the likely path ahead for inflation—one of key inputs policymakers consider when setting monetary policy—and with inflation currently elevated but heading lower, a forward-looking assessment is more appropriate to gauge possible interest rate adjustments. Our framework also includes a measure of how well the local economy is performing. The growth momentum indicator is designed to gauge whether economic activity is improving, stable, or fading in response to aggressive tightening cycles. Central banks associated with slowing activity are more likely to consider easing, while stable or improving activity may not offer a strong reason for lower interest rates. And finally, our framework incorporates financial market developments. In that sense, we consider local currency performance against the U.S. dollar over the last six months. Currency appreciation—which most of the EM FX complex has experienced over the first half of this year—can be rationale for shifting toward more accommodative monetary policy, while currency depreciation will typically trigger a need for higher interest rates.

We score each of these four variables individually. Without going into too much detail on the scoring system, a green box suggests an indicator adds policy space for a central bank to lower interest rates. An orange box is relatively neutral—offering only limited direction for lower policy rate adjustments—while a red suggests that variable offers policymakers no space to cut interest rates. For example, Chinese real interest rates are positive indicated by a green box in Figure 1, suggesting real interest rate dynamics allow for the People's Bank of China to cut interest rates. Inflation is also below the PBoC's informal 2% target, suggesting space for easier monetary policy given subdued local price pressures. Economic growth momentum has slowed, and as of now, our methodology suggests momentum behind activity offers modest capacity for the PBoC to ease monetary policy. And while the renminbi has trended weaker over the course of the first half of this year, the overall depreciation has not been significant enough for PBoC policymakers to tighten monetary policy settings to defend the value of the currency via higher interest rates. In that sense, FX performance also offers the PBoC modest space to lower interest rates. Ultimately, we aggregate these indicators to get an overall gauge of which institutions currently have space for interest rate cuts in H2-2023. The Q3-2023 Monetary Policy Space column represents those aggregated results. Central banks highlighted in green have adequate monetary policy space—which we define as capacity for more than 50 bps of rate cuts, countries highlighted in orange have limited monetary policy space—defined as scope for 25 bps-50 bps of cuts before the end of this year, while countries represented in red have no space for any easing of monetary policy. We also offer our framework's results from the prior quarter for comparison purposes. As for China, our framework suggests the PBoC can lower interest rates, more specifically bank Reserve Requirement Ratios, by more than 50 bps before the end of this year, capacity that has been in place since Q2-2023.

Figure 1

Country	Q2'23 Monetary Policy Space [1 2]	Q3'23 Monetary Policy Space [1 2]	Real Interest Rate (%)	Inflation From CB Target (%)	Growth Momentum	FX Performance (Last 6 months)
China	Green	Green	Green	Green	Orange	Orange
Chile	Orange	Green	Green	Red	Green	Green
Brazil	Orange	Green	Green	Red	Green	Green
Colombia	Red	Green	Green	Red	Green	Green
India	Orange	Green	Green	Orange	Orange	Green
Philippines	Orange	Orange	Orange	Red	Green	Green
Thailand	Orange	Orange	Red	Orange	Green	Orange
Hungary	Red	Orange	Red	Red	Green	Green
Poland	Orange	Orange	Red	Red	Green	Green
Indonesia	Orange	Orange	Green	Orange	Red	Green
South Africa	Orange	Orange	Green	Red	Green	Red
Mexico	Green	Orange	Green	Red	Red	Green
Peru	Orange	Orange	Orange	Red	Red	Green
Russia	Red	Red	Green	Red	Red	Red
Turkey	Red	Red	Red	Red	Orange	Red
Argentina	Red	Red	Red	Red	Orange	Red

[1] Green indicates "Adequate Monetary Policy Space", Orange indicates "Limited Monetary Policy Space", Red indicates "No Monetary Policy Space"

[2] Adequate Monetary Policy Space represents scope for >50 bps rate cuts, Limited Monetary Policy Space represents scope for 25-50 bps rate cuts, No Monetary Policy Space represents scope for 0 rate cuts

Source: Bloomberg Finance L.P. and Wells Fargo Economics

Running these indicators through our framework confirms most EM central banks have policy space to initiate, or continue, easing cycles in the second half of this year (Figure 1). According to our framework, 13 of the 16 institutions in our sample have space to cut interest rates before the end of this year. In fact, since Q2-2023 select institutions have accumulated more policy space to lower interest rates, in many cases due to still high real interest rates and currency strength/resilience. This is true for central banks in Chile, Brazil, Colombia, India and Hungary. Except for the Hungarian National Bank, policymakers at all of those institutions have space to ease monetary policy by more than 50 bps in the next six months. The one exception where policymakers now have less policy space to lower interest rates is the Central Bank of Mexico. According to our framework, Banxico has space to cut interest rates before the end of this year; however, Banxico has shifted from having “adequate space” (i.e., >50 bps of cuts) to “limited space” (25 bps-50 bps of cuts). Banxico has lost policy space arguably for the best reason. Mexico's economy has performed well over the first half of this year, proving resilient even with aggressive rate hikes and elevated inflation, and has yet to show material signs of deceleration. This solid economic momentum is likely to act as a restraint to significant easing by year-end. Our framework also identifies a few central banks with no policy space for rate cuts. With Russia's economy damaged and influenced by the conflict with Ukraine, inflation has shown tentative signs of trending higher, while the ruble has come under renewed pressure amid escalating tensions and easing capital controls. These dynamics offer Bank of Russia no capacity to cut interest rates, and in fact, official communications suggest the tightening cycle may resume in the near future. Turkish inflation remains well above target, and the lira is one of the worst performing currencies in the world this year. The economy has performed well enough where activity is not the driving force of monetary policy settings, but with real interest rates still in deeply negative territory, the Central Bank of Turkey, according to our framework, is not in a position to ease monetary policy. Indeed, new economic and central bank members recently tightened monetary policy, a direction for interest rates that should continue unless influenced by the Erdogan administration. The Central Bank of Argentina has similar issues in the sense that the peso is set to weaken for the foreseeable future, while Argentina struggles with hyperinflation. Policymakers have boosted interest rates recently, and while they may be on hold before this year's election, economic and financial market trends do not create space for interest rate cuts.

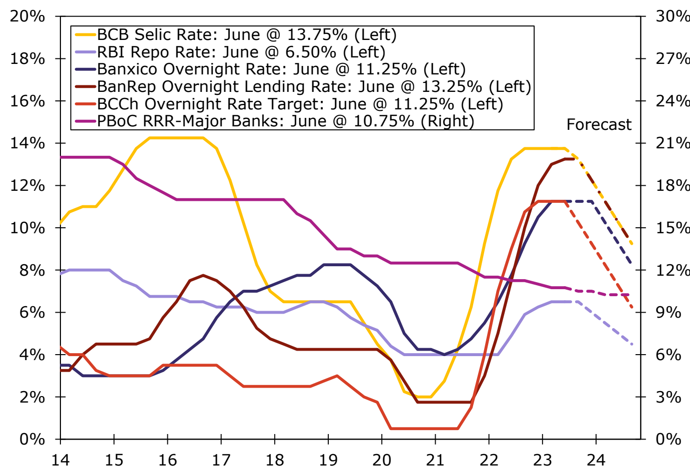
...But, Markets Are Mispricing Easing Cycles

Our framework can be a useful tool, and we use this analysis as a starting point to determine our policy rate forecasts. While our framework does not pick up all relevant factors in determining monetary policy such as policymaker commentary, we can still use this analysis to determine that

many central banks across the emerging markets will cut interest rates in the coming months. As far as our forecasts, we believe the Chilean Central Bank (BCCh) is likely to be the most aggressive in easing monetary policy. A combination of positive real interest rates, softening headline and core inflation, an economy approaching recessionary conditions, and currency stability all provide rationale for policymakers to start unwinding restrictive monetary policy. In our view, **BCCh policymakers are likely to initiate an easing cycle in July with a 50 bps rate cut, and eventually lower the Overnight Target Rate to 9.25% by the end of this year** (Figure 2). Peer Latin American central banks are also likely to ease aggressively in H2-2023. In Brazil, we expect Brazilian Central Bank (BCB) policymakers to begin easing monetary policy in August as the disinflation process has been achieved and the need for one of the highest real interest rates in the world may no longer be appropriate. In our view, the **BCB will begin lowering the Selic rate in August with a 25 bps rate cut and cut policy rates to 12.25% by the end of 2023**. Central bankers in Colombia are also likely to utilize newfound policy space before the end of this year. While the disinflation process took longer to materialize, we believe the Colombian CPI will soften going forward. Combined with a peso that has rallied over the course of this year, **BanRep is likely to lower interest rates by 100 bps to 12.25% in Q4-2023**. In Mexico, we believe Banxico will take a more measured approach to easing. While the disinflation process has started, we believe strong economic momentum, risks of renewed inflation due to uninterrupted activity as well as a Fed easing cycle that is likely to start around mid-2024 should keep Banxico policymakers cautious through the end of this year. In that sense, while our framework suggests Banxico can cut rates up to 50 bps this year, we take a slightly different view, and instead **believe the Banxico easing cycle will begin in early 2024. We forecast a series of 50 bps cuts in Q1-2024 that eventually takes the policy rate to 10.25% by the end of the first quarter of next year**.

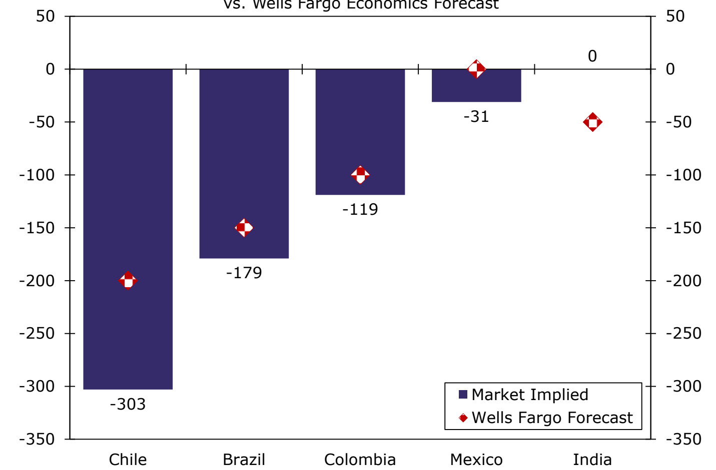
In addition to Latin America, our framework identifies central banks across emerging Asia as also likely to begin easing cycles in the coming quarters. As for central banks that we explicitly forecast, our framework highlights both the PBoC and Reserve Bank of India (RBI) as institutions with adequate monetary policy space. In the case of the PBoC, policymakers have already been easing policy for some time, including earlier this year as post Zero-COVID economic activity fades. With economic momentum under pressure and inflation still subdued, China's central bank has space to continue lowering lending rates and other forms of interest rates. We forecast the major bank Reserve Requirement Ratio (RRR) and see **only a moderate move by the PBoC, with a 0.25 percentage point RRR cut to 10.50% in Q3-2023**. With that said, risks are certainly tilted toward more aggressive PBoC easing, and should economic activity deteriorate further, we would likely add another 0.25 percentage point RRR cut to our forecast profile for the PBoC before the end of this year. With respect to the RBI, as of now we forecast a gradual easing cycle in India. However, with inflation now expected to remain in the central bank's target range and real policy rates well into positive territory, and despite India on track to experience one of the highest growth rates in the emerging markets this year, we believe RBI policymakers will utilize their additional policy space and cut rates at a slightly quicker pace. Recent developments, including financial market stability, lead us to believe **RBI policymakers will now cut the Repurchase Rate to 6.00% by year-end 2023**. Other regional central banks such as the Central Bank of the Philippines (BSP), Bank of Thailand (BOT) and Bank Indonesia (BI) are among those we expect to lower policy rates before the end of this year. With inflation pressures subdued across emerging Asia, **we lean toward BSP, BOT and BI each easing 50 bps before year-end**.

Figure 2



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Figure 3



Source: Bloomberg Finance L.P. and Wells Fargo Economics

The outlook for EM monetary policy for the second half of this year is at odds with the potential path of Fed monetary policy. In our view, the Fed is likely to raise interest rates at least another 25 bps in July, with risks tilted toward even more tightening. With EM central banks to pursue more accommodative monetary policy in H2 and the Fed still in tightening mode, this divergence is a key contributor to why we have become less constructive on emerging market currencies for the remainder of 2023. In our *Mid-Year Outlook*, we note that developing market currencies are likely to be stable to modestly weaker against the dollar through the end of this year. Typically, diverging monetary policy paths lead to widespread currency weakness; however, despite our view for interest rate cuts, we believe financial markets are priced for too much easing from most EM central banks. With the Fed still raising interest rates and emerging market policymakers likely to lean more cautious to ensure inflation converges toward target ranges, we believe policymakers will opt to under deliver on interest rate cuts rather than over deliver in an effort to protect against currency weakness and another wave of inflation. So, while nominal policy rate compression may materialize and apply a degree of downward pressure on emerging market currencies, markets adjusting to more gradual paces of easing across the emerging markets complex can act as an offsetting mechanism and a pillar of support in most cases. Market mispricing looks most notable in Latin America. Over the next six months, markets are priced for ~300 bps of easing from the Chilean Central Bank compared to our forecast of just 200 bps of rate cuts (Figure 3). Should markets adjust to the gradual pace of BCCh easing that we forecast, Chilean peso downside can be modest and generally contained through the end of this year. We make the same takeaway for the Brazilian real, Colombian peso and the Mexican peso. Markets are priced for too forceful of easing from each of the respective central banks, and as easing expectations turn more conservative, each of these currencies can find support. The one exception is the Indian rupee, where markets are priced for RBI policymakers to hold rates steady. We believe RBI policymakers keeping rates on hold through the end of this year is unlikely to materialize, so while market adjustments can support Latam FX, the rupee may experience slightly more downside as markets price RBI rate cuts.

In addition, while nominal policy rate compression will occur in the coming months, in many cases real interest rate differentials with the United States may be preserved as inflation is set to remain on a downward trajectory in most developing economies. Even as central banks lower interest rates, softening inflation can keep attractive carry opportunities present for emerging market currencies. Our emerging market currency forecasts take into account all of these dynamics: attractive real interest rates, monetary policy divergences, as well as financial markets potentially mispricing central bank easing cycles. As a result, we are not making significant adjustments to the large majority of our currency forecasts. However, as a result of our revised Reserve Bank of India policy rate forecast, we now believe the Indian rupee can experience more downside than we initially expected through the end of this year. To that point, we now believe the USD/INR exchange rate can reach INR83.25 by the end

of this year before recovering ground over the course of 2024. For simplicity, our entire FX and policy rate forecasts, both for the emerging markets and G10, can be found on the following pages.

Wells Fargo International FX Forecast

Currency Pair*	Q3-2023	Q4-2023	Q1-2024	Q2-2024	Q3-2024
G10					
EUR/USD	1.0800	1.0900	1.1100	1.1300	1.1500
USD/JPY	144.00	141.00	137.00	135.00	133.00
GBP/USD	1.2700	1.2600	1.2500	1.2600	1.2700
USD/CHF	0.9075	0.9050	0.8925	0.8800	0.8700
USD/CAD	1.3300	1.3300	1.3200	1.3100	1.3000
AUD/USD	0.6700	0.6800	0.6900	0.7000	0.7100
NZD/USD	0.6000	0.6100	0.6200	0.6300	0.6500
USD/NOK	10.8325	10.6875	10.4500	10.2200	10.0000
USD/SEK	10.9250	10.8250	10.5850	10.3550	10.1300
Asia					
USD/CNY	7.2000	7.1000	7.0000	6.9000	6.8000
USD/CNH	7.2000	7.1000	7.0000	6.9000	6.8000
USD/IDR	15000	15000	14900	14700	14500
USD/INR	83.00	83.25	82.75	82.25	81.75
USD/KRW	1320	1320	1310	1290	1270
USD/PHP	56.00	56.00	55.50	54.75	54.00
USD/SGD	1.3600	1.3600	1.3500	1.3300	1.3100
USD/TWD	31.25	31.25	31.00	30.50	30.00
USD/THB	35.50	35.50	35.00	34.50	34.00
Latin America					
USD/BRL	4.8000	4.8000	4.6500	4.5500	4.4500
USD/CLP	810.00	810.00	800.00	785.00	770.00
USD/MXN	17.2500	17.2500	17.5000	17.2500	17.0000
USD/COP	4250	4250	4200	4100	4000
USD/ARS	300.00	370.00	465.00	585.00	630.00
USD/PEN	3.6500	3.6500	3.6200	3.5700	3.5200
Eastern Europe/Middle East/Africa					
USD/CZK	22.00	21.50	21.00	20.25	19.75
USD/HUF	347.25	348.50	337.75	327.50	317.50
USD/PLN	4.1675	4.0825	3.9650	3.8500	3.7400
USD/RUB	86.00	88.00	90.00	92.00	94.00
USD/ILS	3.7000	3.7000	3.6500	3.5500	3.4500
USD/ZAR	19.0000	19.2500	19.0000	18.5000	18.0000
USD/TRY	27.0000	28.0000	29.0000	30.0000	31.0000
Euro Crosses					
EUR/JPY	155.50	153.75	152.00	152.50	153.00
EUR/GBP	0.8500	0.8650	0.8875	0.8975	0.9050
EUR/CHF	0.9800	0.9850	0.9900	0.9950	1.0000
EUR/NOK	11.7000	11.6500	11.6000	11.5500	11.5000
EUR/SEK	11.8000	11.8000	11.7500	11.7000	11.6500
EUR/CZK	23.75	23.50	23.25	23.00	22.75
EUR/HUF	375.00	380.00	375.00	370.00	365.00
EUR/PLN	4.5000	4.4500	4.4000	4.3500	4.3000

Forecast as of: July 7, 2023

Source: Bloomberg Finance L.P. and Wells Fargo Economics

Wells Fargo International Interest Rate Forecast

(End of Quarter Rates)

	Central Bank Key Policy Rate					
	2023			2024		
	Current	Q3	Q4	Q1	Q2	Q3
United States	5.25%	5.50%	5.50%	5.50%	4.50%	3.50%
Eurozone[1]	3.50%	3.75%	3.75%	3.75%	3.25%	2.75%
United Kingdom	5.00%	5.75%	5.75%	5.75%	4.75%	3.75%
Japan	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%
Canada	4.75%	5.00%	5.00%	5.00%	4.50%	3.50%
Switzerland	1.75%	2.00%	2.00%	2.00%	1.75%	1.50%
Australia	4.10%	4.35%	4.35%	4.35%	4.10%	3.85%
New Zealand	5.50%	5.50%	5.50%	5.50%	5.50%	5.25%
Sweden	3.75%	4.00%	4.00%	4.00%	3.75%	3.25%
Norway	3.75%	4.25%	4.25%	4.25%	4.00%	3.50%
China[2]	10.75%	10.50%	10.50%	10.25%	10.25%	10.25%
India	6.50%	6.50%	6.00%	5.50%	5.00%	4.50%
Mexico	11.25%	11.25%	11.25%	10.25%	9.25%	8.25%
Brazil	13.75%	13.25%	12.25%	11.25%	10.25%	9.25%
Chile	11.25%	10.25%	9.25%	8.25%	7.25%	6.25%
Colombia	13.25%	13.25%	12.25%	11.25%	10.25%	9.25%

Forecast as of: July 7, 2023

[1] ECB Deposit Rate [2] Reserve Requirement Ratio Major Banks

Source: Bloomberg Finance L.P. and Wells Fargo Economics

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Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Charlie Dougherty	Senior Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Senior Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Jackie Benson	Economist	704-410-4468	Jackie.Benson@wellsfargo.com
Shannon Seery	Economist	332-204-0693	Shannon.Seery@wellsfargo.com
Nicole Cervi	Economist	704-410-3059	Nicole.Cervi@wellsfargo.com
Patrick Barley	Economic Analyst	704-410-1232	Patrick.Barley@wellsfargo.com
Jeremiah Kohl	Economic Analyst	704-410-1437	Jeremiah.J.Kohl@wellsfargo.com
Coren Burton	Administrative Assistant	704-410-6010	Coren.Burton@wellsfargo.com

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