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Emerging Markets Spotlight

Following the initial shock of the Russian invasion of Ukraine, it is becoming possible to focus on the secondary effects around the world. These substantially result from the disruptions to the supply of many commodities.

Although highly volatile, prices of many basic commodities have moved very sharply since the start of the year. Compared to December 31, 2021, the Brent crude oil price is (at the time of writing) up 41%, wheat futures are up 37% and urea prices are up 21% (but had already doubled in the fourth quarter of 2021). Although other commodities which Russia is a major exporter of have also risen, for the world's poorest countries, the trinity of fuel, food and fertilizer is absolutely key.

Many of these countries are significant importers of these products, subsidize them to their populations and/or have large weights of these in their inflation baskets. This means that sharp price rises stress both the fiscal and current account balances, while increasing inflation, and also reducing the ability of consumers to purchase other goods and services.

Some of these effects are being seen in major frontier countries, whose equity markets are too small to be in the mainstream emerging market equity asset class.

For example, in Pakistan, recently demoted from the MSCI EM Index, a developing political crisis (where the opposition are seeking to bring down the government through a vote of no confidence) coincides with the need to renew Pakistan's $6bn Extended Fund Facility with the IMF. Without IMF funding, Pakistan will almost certainly face a balance of payments crisis, as foreign exchange reserves have fallen in recent months to just two months of import cover. The ramping price of imports has pushed inflation to 12.7% in the year to March, accompanied by a sharp fall in the Pakistani rupee.

Meanwhile, Sri Lanka's poor agricultural policies, combined with the collapse of tourism because of Covid, have created a weak starting point from which to deal with soaring prices. Widespread street protests over severe shortages of food and power, and rampant price inflation led to the resignation of all the ministers in the government cabinet, and of the central bank governor. In a sign of the depth of the crisis, the new finance minister then resigned after less than 24 hours in post. Sri Lanka faces soaring inflation (18.7% in the year to March) and a probable sovereign debt default in July.

For the mainstream emerging markets, there are three countries potentially exposed to these kinds of risks: Egypt, India and Indonesia.

Egypt is the most exposed of the three. Russia and Ukraine are major wheat exporters, wheat is a particularly high component of typical diets in the Middle East and North Africa, and Egypt imports over 60% of its wheat. Inflation has been pushing higher in recent months, to 8.8% in the year to February, and policymakers have begun to react, devaluing the Egyptian pound by 15%, hiking interest rates and imposing price controls on bread. While these steps are likely to help, and Egypt is a net oil exporter, the non-oil component of

the economy is already showing stress, with PMIs declining sharply. The risk is a repeat of the political unrest that led to the overthrow of the Mubarak government during the Arab Spring in 2011. There are, so far, no signs of unrest, but Egypt must be carefully monitored in the months ahead.

India has historically had vulnerabilities, both as a major importer, but also a major subsidizer of these commodities. Although India's current account deficit will weaken with oil prices above $100/barrel, and inflationary pressures are showing, India is in a much better position than in previous periods of commodity price inflation. Firstly, the reforms to the subsidy regime have essentially removed the risk to the fiscal balance. Diesel subsidies were removed in 2014, while direct LPG subsidies were replaced with cash transfers to poorer citizens, and fertilizer subsidies have been substantially reduced in recent years. Secondly, India has in recent years become a major producer of wheat, even becoming a small exporter, while a series of rich harvests have allowed the government's wheat reserves to reach 21 million tons against a targeted level of 7.5 million tons. The economic reforms the government has driven have absolutely moved India onto a safer and more sustainable footing, and the country should feel the benefit of this in coming months.

The other major emerging market to have had historical problems with fuel subsidies is Indonesia. Indonesia also had problems in the mid-2000s from the fiscal effects of fuel price subsidies. In 2004-5, newly elected president Yudhoyono faced a budget crisis, as spending on fossil fuel subsidies for gasoline, diesel and kerosene had reached $8bn. The government was forced to trim fuel subsidies to alleviate the budget deficit, but this both lifted inflation and hit growth. Subsequently, though, fuel subsidies have been first reformed and then, under current president Widodo, removed. Additionally, inflation in Indonesia is very benign, reaching just 2.6% to March, so commodity price pressures are far more manageable.

Emerging markets are generally countries with macro-economic vulnerabilities, but the examples of India and Indonesia show that good planning and effective economic reform can limit these vulnerabilities. Whilst frontier equity markets and some of the major emerging market sovereign debt issuers may face a difficult 2022, emerging equity markets look to have lower secondary risks from the conflict in Ukraine.

Source for all data JOHCM/Bloomberg (unless otherwise stated)

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